



# THE BUDGET FOCUS

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## Informal sector and Taxation in Kenya

### 1. Introduction

Informal sector is generally viewed as comprising of activities of petty traders operating in the streets of main urban centers. Most are involved in the sale of second-hand items like clothes, some in the business of shoe shining, street vendors, carpentry, vegetable selling, repair and construction work. It can also be described as any activity generating income and profits, though on a small scale, using simple skills, dynamic and not tied to regulation of the activities.

Typically, the informal sector comprises economic activities not regulated by laws such as environmental, labor or taxation, but is subject to the regulations of the local authorities for orderly business operation, and generally not monitored for inclusion in the Gross Domestic Product (GDP) of Nations (Mohamed, 2009).

### 2. What is the size of the informal sector?

Some studies estimate that informal businesses account for 35-50% of GDP in many developing countries. Similarly, in Kenya, the informal sector is quite large, estimated at 34.3% and accounting for 77% of employment statistics. Over 60% of those working in the informal sector are the youth, aged between 18-35 years, 50% being women (Ouma et al 2009). The First 1993 Small & Medium Enterprises (SME) baseline survey revealed that there were approximately 910,000 SMEs employing up to 2 million people. The second SME baseline survey (1995), estimated the size of the SME sector at 708,000 enterprises employing up to 1.2 million people. Compared to the other sectors of the economy, the contribution of the SME sector to the country's Gross Domestic Product (GDP) increased from 13.8% in 1993 to over 18% in 1999, (Sessional Paper No. 2 of 2005). Currently, it is estimated that the contribution to the GDP by this sector stands at over 25% (Economic Survey, 2012).

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More specifically, the trend in both the informal and formal sector employment indicates positive outcomes of some of the employment creation strategies adopted in the country. These may have facilitated the expansion witnessed in the informal sector employment. The formal sector growth over the last decade cannot be said to match that of the informal sector.

### 3. Informal sector and taxation

Available literature indicates that there is a strong relationship between the informal sector and the inability of the Government to collect the requisite taxes. From the informal sector point of view, tax evasion is driven generally by a perception that the tax burden is too high. This poses a number of problems to tax systems, raising difficult questions over how tax policies and tax administration may influence tax compliance incentives and behavior. The compliance tax burden on the Informal Sector may be high relative to that of large companies (higher unit cost in relation to turnover). Further, the cost of complying with a given set of tax rules/regulations is generally higher for the Informal Sector as a percentage of turnover or profit. In theory, a taxpayer's incentive to comply with a tax system depends on an assessment of the relative benefits and costs of complying versus non-compliance.

Indeed, the large numbers of SMEs, their high turnover rates and their sheer diversity present challenges to all administrations. For SMEs, key considerations are to minimise administrative costs while ensuring compliance, including considering the drivers and impacts of operating in the informal economy. The table below shows a comparison of characteristics between informal sector in OECD and Developing Countries.

**Table 1: Comparison between informal sector in OECD and Developing Countries**

High-income OECD country	Low-income country
<ul style="list-style-type: none"> <li>About 10% to 20% of employment and GDP in informal sector</li> <li>Non-compliance is mainly due to unwillingness to comply with formal sector legal requirements (criminal activity, tax and regulation evasion)</li> </ul>	<ul style="list-style-type: none"> <li>Up to 50% of GDP, but higher share of employment (up to 90%)</li> <li>Non-compliance is mainly due to lack of capacity to comply. Illiteracy, innumeracy and weak specific accounting and tax compliance capacities</li> </ul>

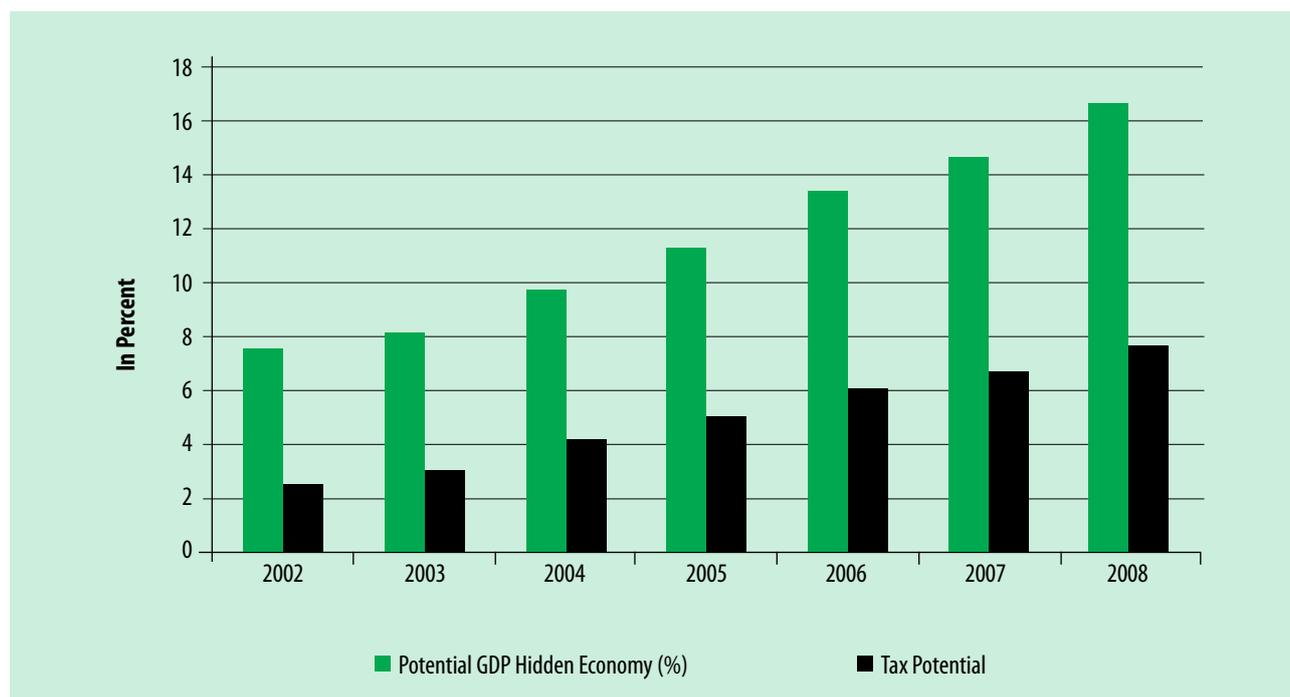
<ul style="list-style-type: none"> <li>Non-compliance with tax concentrated in self-employed service sector and moonlighting, cash or undocumented employment</li> <li>Income levels at or above formal sector</li> <li>Income taxes (IT) and social security payroll taxes provide major incentive for untaxed informal employment</li> </ul>	<ul style="list-style-type: none"> <li>Significant share (5% to 30%) in non-monetary subsistence sector</li> <li>Rural (agriculture and trading) and growing urban sectors (trading, personal services, food and beverage services, petty manufacturing)</li> <li>Below average income levels</li> <li>Social security payroll taxes insignificant; most below income tax threshold (some minimum income)</li> </ul>
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The highest proportion of the underground economy in Kenya was recorded in the 1990s when it averaged 20 per cent of GDP. The potential tax accruable from the underground economy averaged 4 per cent of the GDP, thus the tax authority has the potential to expand the tax base by 4 per cent of GDP. For the year 2005, this would have raised tax collections by about Ksh 55 billion. The figure also reveals that the size of the underground economy has been increasing over the years, probably due to improved technology, more stringent regulations and burdensome taxation measures that force many hidden economic activities to emerge.

This therefore necessitates the need for tax policy debates and research on the potential of this sector towards expanding Kenya's tax base. Contextually speaking, this is timely given that the new constitutional dispensation establishes a devolved system of government with its enormous resource requirements. The issue of unlocking revenue potential is paramount if adequate revenue allocation from national to county governments as a constitutional requirement is to become a reality. The passage of the constitution has without a doubt changed the Public Finance architecture. The Constitution establishes many institutions as well as independent offices. In order for the institutions to serve the intended purpose, there is need to put measures that are geared towards enhancing the revenue base.

To this end, the informal sector offers a great opportunity to expand the tax base. The intention of bringing the informal sector into the tax net is to facilitate the transition of these businesses to the formal sector and reduce barriers for all businesses. This is contrary to popular belief that it is meant to stifle its growth. Exploring opportunities to formality may create new avenues for the poor to realize their potential and raise

**Figure 1: Comparison between Hidden Economy and Tax Potential**



Source: Parliamentary Budget Office

national competitiveness. It is important to note that acquiring formal status, allows entrepreneurs to access formal markets investment with security, obtain new sources of credit, and defend their rights and as such, ensure that the sector contributes immensely to tax revenue. This may as a result, help address economic responses to infrastructure development, security and the other related economic needs in boosting economic growth and development.

#### 4. What is the estimated tax from the Informal Economy?

A study by Parliamentary Budget Office (2010) shows that the potential GDP of the informal economy has been increasing over time. Between 2002 and 2008, the potential GDP of the hidden economy increased steadily every year from 7.58% in 2002 to 16.61% in 2008; with corresponding increase in tax potential as a percentage of GDP up from 2.52% in 2002 to 7.66% in 2008. This implies a continuously expanding underground economy which has the potential to increase the revenue flows but which have been otherwise left out of the tax net.

Generally, if the informal sector remains untaxed, and as more people transition in to the sector, the government is likely to continue losing billions of shillings. Such a scenario will impact on government's

ability to achieve its revenue targets and consequently its development agenda.

Reliable data shows that by extending the tax net to the informal sector, for example in the year 2008, the government could have increased the tax base by approximately 7.66 percentage points, translating to revenue worth Kshs.79.3 billion (figure 1 gives the details).

#### 5. Informal sector Tax Evasion

From the perspective of tax administration, the major obstacle which hinders government in ensuring that the informal sector is incorporated in the taxation bracket is the nature of businesses. The small sizes of the businesses make it easier for them to remain outside the taxation bracket. Mistrust and weak structural dialogue between informal sector and government is another factor that hinders taxing of the informal sector. There is a general mistrust between tax agents and taxpayers, with agents perceiving the informal sector as tax evaders, unwilling and unable to pay their taxes. The operators too are wary of government agencies' high-handedness in collection of taxes. There is lack of structured dialogue between the informal sector and the government as well as other law enforcing authorities. This has led to mistrust and prevents the sector from engaging constructively with the government in reform processes. Other bottlenecks include:

- a) Lack of opportunity to grow and adapt good culture of corporate governance: - The informal sector has limited access to training and professional services that would enable them adapt to a sound culture of corporate governance.
- b) Complicated tax systems and numerous processes (licensing etc.) make it difficult and expensive for start-up firms to act in good faith.
- c) Lack of skills on and access to online tax registration and returns: - Majority of workers in the informal sector have low education background. However, even those with modest education lack computer skills that can enable them use the recently introduced online services for tax registration and returns.
- d) Lack of access to policy updates: - Policies regarding the informal sector are poorly coordinated and disseminated across five different but related government ministries namely finance, trade, industrialization, local government and labour. This confusion often places sector operators at a disadvantaged position more so in terms of accessing policy updates.
- e) Lack of participation in reform processes: - The current policy reforms regarding business regulations and taxation laws and systems have been formulated with little participation of the informal sector. As a result, many workers and business entrepreneurs in the informal sector feel that they have not benefited enough from such democratic reforms and therefore oppose further reform initiatives.
- f) Lack of access to accurate information: - Most prospective entrepreneurs are not aware of business start-up regulations and taxation procedures, mainly due to lack of effective information dissemination strategies on government policies. This prevents the sector operators from entering into formal economy.
- g) Tax evasion and corruption as normal way of doing business: - The informal sector operators who opt not to pay taxes and do business without licenses operate incognito in back alleys and roadsides. They are often mobile and in most cases engage in running battles with law enforcement and council authorities. In the process of evading taxes, they end up paying more money in the form of bribes, to the law enforcers.

## 6. Why is tax compliance so low?

- a) Poor management and internal control practices as many are merely trying to make ends meet.
- b) Informal approach to establishment, operation and dissolution creates an ease of mobility, making it difficult for the tax administration to keep pace.
- c) Cash-based economies have had inadequate accounting records and audit trails in practice.

**Table 2: Turnover Tax Collection in Kshs Million**

KSHS MILLION									
	2007/08			2008/09			2009/10		
	Actual	Target	Per Rate	Actual	Target	Per Rate	Actual	Target	Per Rate
July				25	93	27%	21	36	57%
August				2	6	33%	2.4	3	83%
September				4	6	65%	2	6	42%
October				27	93	29%	23	39	58%
November				2	6	27%	3	3	111%
December				4	6	60%	6	6	99%
January				35	102	34%	22	51	43%
February				2	9	26%	3	3	100%
March				3	6	51%			
April	20	37	54%	23	96	24%			
May	5	37	15%	7	9	77%			
June	3	37	8%	3	9	29%			
<b>Total</b>	<b>28</b>	<b>111</b>	<b>25%</b>	<b>136</b>	<b>442</b>	<b>31%</b>	<b>57</b>	<b>92</b>	

Source: Kenya Revenue Authority

- d) Compliance costs are much higher relative to larger business operations.
- e) Small businesses have limited resources and technical capacity.
- f) Often, the priority of a tax administration is to focus on large taxpayers because of the high delinquency rate and low revenue yields associated with small businesses, with very little enforcement action. This ultimately encourages non-compliance.

## 7. Attempts to tax the informal sector in Kenya

In a bid to mobilize revenue from the underground economy and reduce the tax gap, the Government has made attempts to bring the underground economy into the tax net under a presumptive tax regime, named Turnover Tax (TOT) introduced in the Finance Bill of 2007. TOT is a presumptive tax where the tax base is the turnover; any business below Kshs.5 million is taxed at a flat rate of 3% of annual turnover. It is specially designed for small businesses that are unable to keep proper records of accounts, among other complexities associated with regular tax regime.

The main objective of the system is to draw informal sector into the tax net by simplifying tax procedures, encourage record keeping, and tax computation, thereby making it easy to file tax returns and reduce the cost of tax compliance.

In the year 2008/09, TOT performed at 31% with a total of Kshs. 136 Million against a set target of Kshs. 442 Million. From the beginning of the year 2009/10, the performance of the TOT was above average but on a declining trend. Table 2 shows the performance of TOT over the period 2007/08 to 2009/10.

### Lessons learned

- i. Most micro and small businesses evade taxes owing to the existing loopholes. The huge administrative costs and human resource constraints make it difficult for the tax authority to follow up on each and every eligible taxpayer operating in the underground economy. Thus for the most part, tax evasion in the underground economy goes unchallenged.
- ii. This raises equity and efficiency concerns especially among the compliant taxpayers who have to bear the burden of meeting revenue targets for the

economy and shoulder high tax burdens, thereby creating an uneven ground for competition. This portrays the tax system as systematically unfair. Tax evasion thus erodes voluntary compliance and encourages future evasion even among the compliant tax payers.

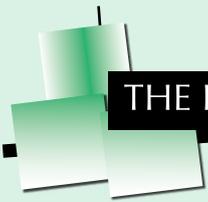
- iii. A presumptive tax system can create major obstacles to small business growth if the transition from the presumptive into the standard taxation regime is costly or complicated.

There is need to:-

- ◆ Offer incentives to improve recordkeeping of businesses in the presumptive system to facilitate compliance with general (simplified) recordkeeping requirements after migration into the standard regime. However, improving recordkeeping practices is also challenging for turnover based systems. The most straightforward and transparent incentive is the application of a lower presumptive tax rate for small businesses meeting certain recordkeeping standards.
- ◆ Provide extensive information campaigns since existing literature demonstrate that mere provision of tax incentives is not sufficient to improve record keeping standards in the Medium-sized Enterprises (MSE).
- ◆ There are a number of other features that could facilitate and encourage a transition from the presumptive to the standard regime. The possibility to claim and carry forward losses is an important element of the standard regime, which benefits MSEs during loss-making periods.

## Policy Recommendations

- i) The existence of a sizeable underground economy implies that indeed, there is room for Kenya Revenue Authority (KRA) to expand the tax base and increase revenue collection. Despite the existence of turnover tax regime that was geared towards netting in the informal sector, there are some implementation and capacity constraints bedevilling the KRA. Among the arguments is the issue of high cost of collection that has forced the Authority to rationalize its staff by putting more effort in areas where it can get maximum revenue. Instead of lumping the Turnover Tax regime amongst the general Domestic Revenue, there is need to segregate the taxpayers more and give the necessary attention to this category of taxpayers.



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- ii) Due to the complexity of the sector, KRA needs to consider “one stop shop” whereby the entities pay the fair share of taxes at the point of licensing. A typical example will be to harmonize the registration system of the Nairobi City Council (NCC) and the KRA database. The current practice whereby the national registration bureau system is linked with the KRA system can be replicated. This will involve linking the KRA system and that of the Nairobi City Council. This will go a long way in formalizing the underground activities and ensuring they take their fair share of fiscal responsibility. In addition, as mentioned by Ouma (2007), there is need to improve data capture and have a reliable database to allow for further analysis of the characteristics of the underground economy.
- iii) There is need for the government to enhance voluntary compliance by establishing a strong enforcement presence which will demonstrate to people that non-compliance can be detected and is punishable.
- iv) Improve bookkeeping among micro and small enterprises by offering incentives, such as application of a lower presumptive tax rate for small businesses meeting certain recordkeeping standards. The government should also engage the small holders in sensitization forums.
- v) Enhance the capacity of the informal sector by offering facilities like; business counselling, training and reducing their cost of registration among other incentives. The aim is to spur growth in the sector thereby driving economic growth and revenues north.

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