Tax Effort Differentials between Kenya and Nigeria 2002 – 2012

John Njenga Muthui
Kenyatta University
Kenya

Akims K.
Jos University
Nigeria

Jackson I. Mdoe
Kenyatta University
Kenya

Gideon Kiguru Thuku
Moi University Karatina Campus
Kenya

Abstract

Most developing countries are confronted with the need to provide/improve public infrastructure, education, health services and so on toward enhancing economic development. To meet these budgetary demands, these countries are increasingly focusing on domestic resource mobilization toward economic development. In this context,it has become especially crucial for developing countries in sub-Sahara Africa (SSA) to have a modest and efficient taxation system which can essentially supply sufficient internal resources thus, strengthening their domestic revenue bases. This has resulted in many developing countries undertaking various reform programs to improve tax policy and strengthen the taxing capacity of revenue administration. However, apart from the primary objective to meet public spending needs, other reasons for taxation may include; smoothening the cyclical volatility of economic growth; and (re) distributional aspects / improvement of equality. This paper used Tax effort to highlight the differentials in tax system between Kenya and Nigeria for the period 2002 – 2012. Tax effort is tax revenue, as a percentage of gross domestic products (GDP). That is, the tax to GDP ratio. Generally, this ratio is used to identify a country's overall tax efforts. The tax effort gives a general indication of how a country is raising tax revenue relative to its given economic, structural potential and comparator countries. The discussion in this paper shows that tax structure, quality of revenue authority institutions and size of tax base directly influence tax effort whereas size of informal sector and trade openness are inversely related to tax effort. The discussion further shows that the share of mining has offsetting effects on tax effort. However for developing countries the urge to substitute taxes with resource revenue outweighs the dependence on taxation due political reasons and bargaining power of firms involved.

Key words: tax effort, tax revenue, and gross domestic product

1. Introduction

Most developing countries are confronted with the need to provide/improve public infrastructure, education, health services and so on toward enhancing economic development. To meet these budgetary demands, these countries are increasingly focusing on domestic resource mobilization toward economic development. Tanzi and Zee (1997) observed that studies on growth have demonstrated that raising domestic revenues is the most feasible way to achieve fiscal sustainability. In this context, it has become especially crucial for developing countries in sub-Sahara Africa (SSA) to have a modest and efficient taxation system which can essentially supply sufficient internal resources thus, strengthening their domestic revenue bases.

This has resulted in many developing countries undertaking various reform programs to improve tax policy and strengthen the taxing capacity of revenue administration. However, apart from the primary objective to meet public spending needs, other reasons for taxation may include; to smoothen the cyclical volatility of economic growth; and (re) distributional aspects / improvement of equality.

2. Tax Effort

Tax effort is tax revenue, as a percentage of gross domestic product (GDP). That is, the tax to GDP ratio. Generally, this ratio is used to identify a country's overall tax efforts. The tax effort gives a general indication of how a country is raising tax revenue relative to its given economic, structural potential and comparator countries. Pessino and Fenochietto (2010) opined that the tax effort is the ratio between actual revenue and tax capacity. This capacity is obtained using the predicted (potential) tax share. As such tax effort is defined as a ratio of actual tax revenue to predicted tax revenues. Owing to the difficulties in obtaining predicted values of tax revenues GDP is preferred.

3. Tax Structure and Administration

Like many other developing countries, Kenya and Nigeria, seek to apply the tax weapon so as to meet the objectives of raising enough revenue and ensuring that revenue is raised in ways that are equitable and that minimize the disincentive effects of taxation

In Kenya, the taxes are mainly personal. As of December 2014 therefore, a majority of her tax revenues are generated from personal and corporate income taxes. On the other hand Nigeria heavily relies on in rem taxes. The contribution of in rem taxes to total tax revenues for Nigeria stood at 47% as of December 2014. The key in rem taxes for Nigeria include; withholding income tax (on activities/services involving dividends, rent, royalties, commission, and professional/technical fees), Petroleum Profit tax, Tertiary Education Tax (a social obligation placed on all companies), capital gains tax (pertains to all gains accruing to a taxpayer from the sale or lease or other transfer of proprietary rights), and Stamp duties (transaction taxes).

Table 1.1: Further Elaborates the Nigerian and Kenyan tax structure

Tax category		Rate		
		Kenya	Nigeria	
In rem	Companies Income Tax	30%	30%	
	Value-Added Tax (VAT)	16%	5%	
	petroleum profit tax	-	85%**	
	Capital gains tax	5%	10%	
Personal Taxes	**Kenya**		**Nigeria**	
	Tax bracket	Rate	Tax Bracket	Rate
	Up to KES10,165	10%	Up to N30, 000	5%
	KES10,165- KES19, 741	15%	N30,000 – N60,000	10%
	KES19, 741- KES29, 317	20%	N60,000 – N110,000	15%
	KES29, 317- KES38, 863	25%	N110,000 – N160,000	20%
	OVER KES38, 863	30%	over – N160,000	25%

Source of Data: Kenya revenue authority and Federal Inland Revenue service of Nigeria

** Only applicable to private companies

Table 1 shows selected personal and in rem taxes for Kenya and Nigeria. It's clear that only the proportions of corporate taxes are equal for both countries. The rest of the taxes, Kenyans are taxed at higher rates than Nigerians except for petroleum tax. The table underscores the fact that Nigeria relies on in rem taxes unlike Kenya that relies on Personal taxes. For her high tax rates and dependence on personal taxes Kenya is expected to have a high tax effort than Nigeria for any given tax base.

Common to KRA and FIRS are administrations bottlenecks. These bottlenecks range from widening of the tax base to low compliance. For instance, despite KRA's considerable progress recruiting 40,537 more VAT tax payers in the fiscal year 2005/06 it has to contend with the problem of low filing compliance (Institute of Economic Affairs, 2006). Similarly, the Federal Inland Revenue Service of Nigeriais challenged by registration of taxpayers in a pluralistic society.

4. *Trend in Kenyan and Nigerian Tax Effort*

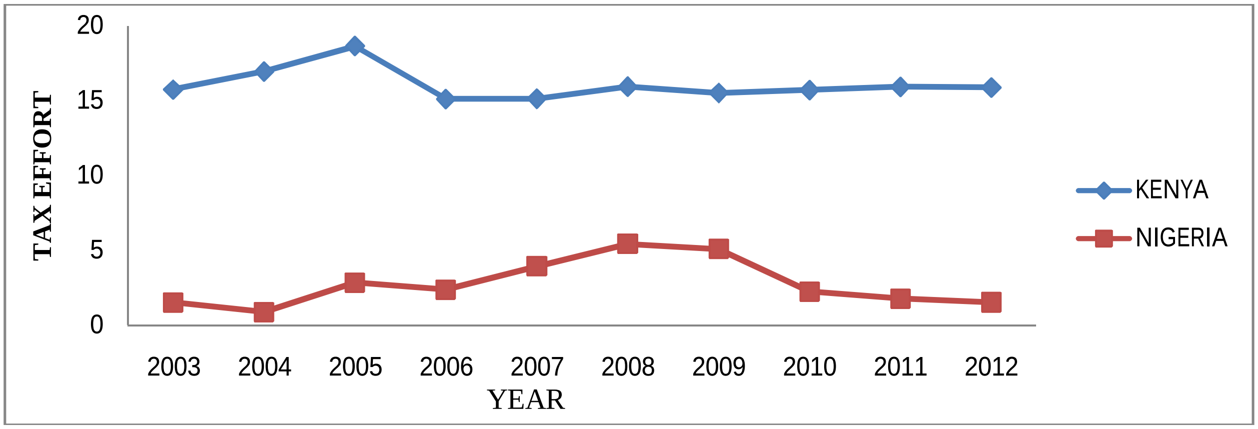

Figure 1.1: Trends in Kenyan and Nigerian Tax effort

Source of Data: World Bank

Figure 1.1 shows that apart from improvements in the tax ratio in 2004 and 2005, the tax ratio for Kenya has been relatively stable at about 15% over the ten year period. On the other hand, Nigeria's tax effort except for 2004 and 2006 has shown improvements up to 2008. Beyond 2008, the effort has declined to levelsbelow 2% of the GDP. Overall, the evidence shows that for the period 2003 – 2012, tax effort for Kenya significantly exceeds that for Nigeria. While tax effort for Kenya has not declined below 15% of GDP, tax effort for Nigeria is stunted at below 5% of GDP. This may be explained by the alternatives to taxation that are available for Nigeria such as oil revenues that contribute over 80% of the cost of government unlike Kenya.

A closer inspection of the two economies reveals that apart from alternatives to taxation the following factors explain the differences in the tax effort. First, the tax effort differentials are mainly explained by differences in tax structure. As shown in table 1, personal taxes for Kenya not only have higher tax rates on personal incomes but also smaller tax brackets that easily graduate to maximum tax rate of 30%. This is a staking contrast to Nigeria that has tax rates as low as 5% and broader tax brackets that sluggishly graduate to the maximum rate of 25%. Therefore for any given tax base the Kenyan tax structure is more productive than Nigerian hence the trends in figure 1.1. Empirical findings such as those of Ebrill et al., 2001 emphasize the relative importance of VAT and Personal income tax in raising the tax effort since they are tied to consumption. In this context, it is not surprising then that the tax ratio for Kenya surpasses that of Nigeria since Nigeria relies lesser on taxes on income and goods and services.

Secondly, the differentials can be explained by the quality of the revenue authorities and supporting institutions. Tanzi and Davoodi (2000), Martinez-Vasquez and Torgler (2004) have observed a positive relationship between tax ratio and the quality of institutions. A country with good institutions would have a better tax system hence a higher tax to GDP ratio. A review of literature shows that tax administrative institution in Nigeria suffers from limitations in manpower, money, tools and machinery to meet the ever increasing challenges and difficulties (Micah, Ebere and Umobong, 2012). Botlhole (2010) corroborates this fact and finds that tax administrative institutions in Kenya are more efficient than those in Nigeria. Therefore, other factor held constant for their efficiency Kenyan institutions would collect more taxes than those in Nigeria thus the trends in figure 1.1.

Thirdly, the differentials may be explained by the size of the tax base. The most traditional explanatory variables in the conventional literature are those controlling for a country‘s economic structure. Economic variables reflect the idea that an availability of tax bases should influence the level of tax effort. As shown by Ebrill et al., 2001, tax effort largely depends on income and VAT taxes (consumption taxes). The tax brackets in table 1 show that Kenya has a wide tax base than Nigeria. The minimum taxable pay is equivalent to KES16, 700 for Nigeria and the least pay that attracts the highest tax rate of 25% is equivalent to KES88, 900. For Kenya the taxable minimum is KES10, 165and the least pay that attracts the highest tax rate of 30% is KES38 893. Therefore, for Nigeria the tax brackets start at relatively high levels of income and graduate sluggishly to the maximum peak of KES88, 900 compared to Kenya whose brackets start at low levels of income and rapidly graduate to the maximum taxable pay of KES38, 893. Therefore Nigeria leaves out a significant portion of the tax base than Kenya hence the trends in figure 1.1.

Fourthly, the trends in figure 1.1 can be explained by the share of extractive (mining) sector in any economy. The hypothesized outcome for resource revenues is two-fold. On one hand, a positive effect on the tax ratio can be expected since a vibrant natural resource sector dominated by a few large firms can generate large taxable surpluses (Gupta (2007). On the other hand however, previous studies by Lim (1988) and Martinez-Vazquez (2001) have shown that countries benefiting from natural resource revenues tend to be less interested to build capacity for collecting taxes. An availability of abundant resource revenues influences the taxing behaviour of governments such that, governments faced with an easy revenue inflow tends to relax efforts to collect more taxes. In addition tax incentives are often granted to foreign mining companies largely for political reason. The Later hypothesis is more applicable to Nigeria that highly depends on oil revenues as an alternative to taxation. This coupled with inadequate fiscal capacity to ensure tax compliance largely diminish the tax revenues collected in Nigeria hence the low tax effort.

Fifth, the openness of an economy determines the tax shares since international trade can easily be taxed. International trade taxes account for a substantial share in tax revenues. Unlike Kenya that pursues protectionist policies in agricultural sector and air travel Nigeria pursues a more liberal approach. Tupy (2005) points out that if trade liberalization occurs primarily through reduction in tariffs then one expects losses in tariff revenue. Since 1986 trade policy in Nigeria has significantly been shifting towards greater liberalization which is characterized by tariff reductions and concessions for foreign companies. This has led to decreased tax revenues and increased GDP hence the low tax effort compared to conservative Kenya.

Finally, the size of the informal sector is an important determinant of tax effort. The unregistered and unregulated economic activities are notoriously hard to tax (Kuuya, 2005). A low labor force participation rate is seen to indicate a high informal sector and therefore a high shadow economy. Alm and Torgler (2004) stated that the latter is shown to be correlated with low tax morale, partly through lower moral cost of tax evasion and otherwise weaker motivation to pay taxes. In Kenya the informal sector is estimated at 34.3% and accounting for 77% of employment statistics (Institute of Economic Affairs, 2012). On the other hand, Nigeria is said to have one of the largest informal sectors in Africa contributing about 58% to the economy (Federal Republic of Nigeria, 2013).Therefore, Nigeria is more inhibited by the larger informal sector than Kenya in raising tax revenues hence the trend in Figure 1.1.

5. Conclusion

The discussion in Section 1.4 shows that tax structure, quality of revenue authority institutions and size of tax base directly influence tax effort whereas size of informal sector and trade openness are inversely related to tax effort. The discussion further shows that the share of mining has offsetting effects on tax effort. However for developing countries the urge to substitute taxes with resource revenue outweighs the dependence on taxation due political reasons and bargaining power of firms involved.

If an economy is interested in meeting her budgetary obligations domestically, it must raise her tax effort. As such the country should appropriately reform her tax structure, increase her tax base and quality of revenue authority institutions. In addition, the country should focus on formalizing the informal sector and integrate appropriately. With regards to the share of extracting sector such a country should bargain effectively to raise more tax revenues from resource extraction.

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