

EFFECT OF TAXATION ON ECONOMIC PERFORMANCE A CASE OF KENYA

BY

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DECLARATION

This research proposal is my original work and has not been presented for the purpose of obtaining a degree or an award in any other university.

DEDICATION

This research study is dedicated to my family members for their prayers, financial support and their encouragement they gave during the study period. I also dedicate this research to the staff both for teaching and non-teaching staff for their tireless efforts without whom this success could not be realized.

ACKNOWLEDGEMENT

I thank God for the good health that He Has given me, my family and friends throughout the study period and those that provided a great contribution to the success of work . I will also want to offer my sincere gratitude to my family members for their financial, moral and social support during this period which has greatly contributed to the success of this research.

May God bless you abundantly.

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List of abbreviation

VAT= value added tax

GDP = growth domestic performance

AFCFTA= African Continental Free Trade Area

EAC= East Africa country

COMESA = common market for East Anf South Africa

GST= goods and services tax

ABSTRACT

The purpose of this study was to investigate the causal relationship between income tax, Excise duty, customs duty and VAT on economic performance. Correlation between taxation and economic performance exist as the most important issue in economic since independence. The level of taxation of taxation affects the level of country's GDP, using regression model ($Y = a + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + e$)

Where y =economic performance

X_1 =Total Income tax/GDP

X_2 =Total VAT/GDP

X_3 =Total Excise duty/GDP

X_4 = Total Custom Duty/GDP

e = GDP

We also use descriptive statistics to find mean and standard deviation for each variable.

In our view we find out that indirect tax increase consumption and reduce savings in Kenya. The implication of this is that policy maker should focus more on enhancing international relation. Income tax revenue has been increasing in recent years at a higher proportion than the other taxes in Kenya, making it an important factor in economic decision making.

CHAPTER ONE

INTRODUCTION

1.1 Background of the study

Taxes are the most important source of government revenue for most countries in the world. Taxation refers to imposition of compulsory levies on individuals or entities by government. From income tax to goods and services tax (GST), taxation applies to all levels. Taxes are levied in almost every country of the world, primarily to raise revenue for government expenditures, although they serve other purposes as well (Ojede & Yamarik, 2012). Tax revenue account for well over 75% of Kenya's total revenue generation, and this clearly indicates that it is in tax that the governments' comparative advantage lies in terms of revenue generation capacity. Taxes differ from other sources of revenue in that they are compulsory levies and are unrequited—that is, they are generally not paid in exchange for some specific thing, such as particular public service, the sale of public property, or the issuance of public debt. Taxes are commonly classified as either direct or indirect, an example of the former type being the income tax and for the latter the sales tax. Economic performance refers to economic growth, labor productivity and welfare of the people (Khramov & Lee , 2013). Economic growth refers to increase in the inflation adjusted market value of the goods and services produced by an economy over time. Statisticians conventionally measure such growth as the percentage rate of increase in real gross domestic product (real GDP). Notably, the performance of an economy is usually assessed in terms of achievement of economic objectives. These objectives can be long term, such as sustainable growth and development, or short term such as the stabilization of economy in response to sudden and unpredictable events called economic shocks. An economy is performing well when there is high economic growth, high productivity of factors of production, and

improved social welfare; Resources were allocated efficiently. GDP per capita can measure how well an economy is performing. Kenyan GDP has been increasing steadily for the last five years at an average growth rate of 6%. The economy is expected to continue growth by 5% in future with many development objectives underway.

Taxation is related to economic growth of a country. The structure and financing of a tax are critical to achieving economic growth. However, there has been an ongoing theoretical debate on whether or not taxation stimulates growth. Since independence in Kenya, correlation between taxation and economic growth has existed as the most important issue in economies. Notably, tax is a compulsory payment that citizens of Kenya should pay to the authorities to allow the government to provide public goods, deliver merit goods and services such as education and healthcare, promote economic growth and broad based development, and to stabilize the economy. As observed by Musgrave (1997), every country imposes taxes to citizens and institutions with the aim of achieving long term objectives such as meeting development activities and promoting economic growth. Tax and country output linkages do exist, and fiscal authorities have relied on this to spur economic growth and development (Ojede & Yamarik, 2012). Both direct and indirect taxes have been used to realize this goal. The former forms the backbone of this study. Although direct taxes have been in existence in Kenya since pre-independence, there have been various reforms to improve productivity of various types of direct taxes. Despite that direct tax revenue has a direct relation to economic growth; mixed thoughts exist to this proposition. Some scholars argue that an objective to raise sufficient tax revenue will bolster the much-needed economic growth and development. Contrary to this, some argue that tax is a burden on their well-earned fortunes while to others; tax is seen as a necessary evil to support the state and its activities. Depending on the side one is, this all depends on the benefit

one derives from the tax system that is the net of tax payments over the respective benefits earned.

Just like other many emerging economies Kenya has revealed its aim of rapid economic growth and broad-based economic development that would bring a growth rate of at least 8% p.a. while pushing economy up to a middle-income class. These are broad objectives of Kenya Vision 2030. Broad based on economic growth and development is indeed important, but not if the country can generate enough internal revenues which would then deliver on these. Currently, Kenyan government relies on the donor support in terms of bilateral and multilateral funding to achieve this rapid progress. For example the ongoing project of Low Emission and Climate Resilient Development in Kenya. According to BMI these mega construction projects helps boost growth of the countrys construction industry by 8.7% and remain steady up until 2026. The level of taxation is assumed to affect the level of countrys GDP. Economic growth cannot take place without proper prioritization of development projects as per the ability of the economy to finance them. This means that the government needs funds to carry out planned programs, strategies and objectives that bring about growth. In most Sub-Saharan African countries such as Kenya the main source of revenue is taxation. This suggests that at least there must be relationship between taxation and economic growth of Kenya.

Taxes affect economic performance through their effect on work effort, savings and investments (Ojede & Yamarik, 2012). The output of an economy will increase because of increased productivity. The productivity of an economy will increase when there is investment in both physical and human capital. Investment comes from both the private and public savings. Thus, any factor affecting investment will influence the economic performance. Income tax is charged on individual income and corporate profits. High taxes on salaries of worker may discourage

work effort and human capital formation. It is also likely to discourage private savings. High taxes on profits discourage investments and entrepreneurial spirit hence reducing economic output. Lower taxes on the other hand may encourage work effort, and increase savings and investment hence improving overall productivity of the economy.

The motives of conducting this research will be to understand and provide insights of effects of income tax to the economic growth in Kenya as well as economic growth for the last 10 years. Today income tax contributes a large percentage of the total revenue in Kenya. On the other hand, the economy of Kenya keeps on growing every day. Therefore, there is need to conduct a broad research on income taxes and its effects on the economic growth. Desire to understand more about income taxes and their effects towards economic performance forms the motive of this study.

1.1.1 Taxation

Taxation refers to imposition of compulsory levies on individuals or entities by government to raise revenue for government expenditure, although they serve other purposes as well. To streamline the process of taxation and ensure transparency in the country, the state and the central government have undertaken various policy reforms over the last two years (Ojede & Yamarik, 2012). The tax structure is commonly composed of direct and indirect taxes. Direct taxes are assumed to be paid by the factors that produce incomes whereas indirect taxes are assumed to be paid by households that consume taxed items. Compared to the direct taxes, indirect taxes contribute to a greater share of overall tax revenue. Direct taxes include; income tax, capital gains while indirect taxes include value added tax, import duty and excise duty. These taxes are the major measures of taxation in Kenya and they affect economic performance as discussed below;

Income tax -was introduced in 1937 when the commercial and manufacturing sectors depicted steady growths. Then in July 1941 two regulations were passed to tax excess profits in addition to the 10% tax on company profits which was supposed to apply to every trade, business profession etc. for whatever period of time it was carried out.

Income tax can be defined as a tax charged on all income of a person, for each of income (income tax act 2010). Income tax forms part of direct tax that is imposed on both individual and corporate bodies. It also covers corporation tax, pay as you earn etc. The general rate of corporation tax is 30% for resident persons or while individual rates from as low as 10% and as high as 30%. The position effects of tax rate cuts on the size of the economy arise because low tax raise the after tax reward to working, saving and investing (Easterly et al 1992). It is worth noting that the tax relief introduced by the government effective April 2020 for persons earning a gross monthly income of up to KES 24,000 per month (currently the lowest tax band for individuals), as a means of cushioning the low income earners from the impact of the COVID-19 crisis, continues to apply. Generally, income tax in Kenya is used for revenue mobilization and income redistribution purposes. Income tax is used to achieve equity objectives through rationalization of tax brackets and rates; in other words, tax brackets could be broadened or the number of brackets increased and the tax rates could be increased or reduced depending on the objective

According to Gordon (2005) Income tax policies can influence economic choices and tax rate cuts will ultimately lead to a larger economy in the long run. While rate cuts would raise after-tax return to working, saving, and investing, they would also raise the after-tax income people receive from their current level of activities, which lessens their need to work, save and invest.

The first effect normally raises economic activity through the substitution effects while the second effect normally reduces it through the income effects

Capital gains tax -It is mainly charged on gains upon disposal of capital properties such as building and other investments. Its a form of direct tax that was initially introduced in 1920 during colonial times through legislation on scale of capital equipment used in business provided that the sale price was more than the written down cost. It was re-introduced in 1975 and then suspended in the year 1985 and then re-introduced in 2014.

Capital gains tax reductions are often proposed as a policy that will increase saving and investment, provide a short term economic stimulus, and boost long-term economic performance. Capital gains tax rate reductions appear to decrease public saving and may have little or no effect on private saving.

Value added tax in Kenya -In Kenya, VAT is administered under the VAT act 2015 following the repeal of the previous VAT act 2010 (cap 476) laws of Kenya. The act guides on how to operate, administer, collect and enforce the tax. VAT forms part of consumption tax charged on acquisition of taxation supplies which could either be in goods or services. The VAT rates in Kenya is 16% being the standard rate in supply of goods and services in Kenya and 0% for the export of goods and services.

An increase in VAT will inevitably impact on consumption and VAT compliance. The combined effect will reduce the expected revenue. Beyond the revenue impact, there will be other unintended consequences including: higher inflation, interest rate hike, more unemployment and people will generally become poorer (Njogu, 2015). One can argue that the objectives of introduction of VAT have been achieved since it eases on doing the business as the

tax is borne by the final consumer. Also, it has enabled the government to increase revenue generation

Import duty -This is a tax imposed on goods imported or exported into or out of Kenya based on pre-determined tariffs contained in the tariffs manual book. It includes any levy, duty etc. This tax is currently being administered under the East African Community customs.

Import duty may affect the economic performance in that it raises the price of imported goods and this increase is likely to reduce imports and increase the demand for domestic goods. Import duty may also enable the domestic industries to have higher production costs and in turn higher profits. The government of a developing economy will levy tariffs on imported goods on industries in which it wants to foster growth and this increases the prices of imported goods and creates a domestic market for domestically produced goods while protecting those industries from being forced out by more competitive pricing.

Excise duty - forms part of an indirect tax charged on sale and production of specific goods or services within a country. It is a consumption tax collected at the production point of goods or on provision of services. Excise duty is a transactional tax in that there must be the occurrence of a specific activity for it to accrue e.g. manufacture or sale of a good; and it is not related to profitability. In Kenya, excise duty is imposed on both goods and services including beer & spirits, soft drinks, cigars & cigarettes, polythene bags (of a particular specification) wine, cars and mobile telephony services among others. It was administered under the Customs & Excise Act 2010, however, effectively, 1 December 2015; the tax is administered under the Excise Duty Act 2015.

Excise duty affects the profits and revenues that firms achieve; when governments levy extra or increased taxes such as excise tax, the manufacturers are forced to raise their prices in order to remain in business or continue making profit.

A gross effective tax rate for an economy is measured by dividing gross revenues from all levels of government by gross domestic product (GDP). If the data is not available tax is estimated by calculating the weighted average of all tax rates.

1.1.2 Kenya Economic performance

Economic performance is usually accessed in terms of the achievement of economic objectives. The objective can be long term such as sustainable growth and development or short term such as stabilization of the economy in response to sudden and unpredictable events called economic stocks (Khramov & Lee , 2013). To know how well an economy is performing against those objectives, economists employ a wide range of economic indicators which measure macro-economic variables that directly or indirectly economist to judge whether economic performance has improved or deteriorated.

These indicators include; levels of real national income, output and spending. These are the key variables that show whether an economy is performing or in recession. These indicators can also be measured per head. Notably growth is determined by real national income, investment levies and the relationship between capital investment and national output, level of savings and savings ratio, price levels and inflation, and competitiveness of exports, levels and types of unemployment. Besides, the productivity of labor influences other economic variables such as economic competitiveness in international markets. Other indicators of economic performance are; the purchasing power of Kenyans currency, debt levels with other countries and trade deficit and surpluses with other countries (Khramov & Lee , 2013). An increasing GDP is often seen as

a measure of welfare and economic success. This indicator estimates the value added in a country which is the total values of goods and services needed to produce them. It is common to divide the indicator by country's population to better gauge how productive and developed an economy is.

Kenya GDP growth rate (2010-2020) Annual percentage growth rate of GDP at market prices is based on constant local currency. Aggregates are based on constant 2010 U.S. dollars. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources.

Kenya GDP growth rate for 2019 was 5.37%, a 0.95% decline from 2018.

Kenya GDP growth rate for 2018 was 6.32%, a 1.51% increase from 2017.

Kenya GDP growth rate for 2017 was 4.81%, a 1.07% decline from 2016.

Kenya GDP growth rate for 2016 was 5.88%, a 0.16% increase from

Year	GDP growth %	Annual change
2019	5.37 %	-0.95
2018	6.32 %	1.51
2017	4.81 %	-1.07
2016	5.88 %	0.16
2015	5.72 %	0.36
2014	5.36 %	-0.52
2013	5.88 %	1.32

2012	4.56	%	-1.55
2011	6.11	%	-2.30
2010	8.41	%	5.10

1.1.3 Taxation and economic performance

The question of whether or not taxation stimulates growth has dominated theoretical and empirical debate for a long period of time. Correlation between taxation and economic performance exist as the most important issue in economics since independence. The level of taxation affects the level of country's GDP, theoretical link between this factors and economic growth was not clearly established in the standard neoclassical models. Government has become increasingly in recent years using taxes on consumption such as sales taxes and value added tax to finance a larger share of their spending taking little attention to form and implement policies that can wide base and expand international tax competition of different tax rate (Engen & Skinner, 1996). This makes it more difficult for government to collect corporate and income taxes from their citizens and a move from taxes on income to taxes on consumption would improve economic efficiency and increase the rate of growth or improve competitiveness and protect employment.

The choice of how much revenue to collect from taxes on consumption rather than taxes on income can be described as a choice of balance between direct and indirect taxation. There are significant differences in the design and economic effect of different taxes within the general classes of "taxes on consumption" or "taxes on income". Taxes on consumption are better for growth than taxes on income. The main argument related to the way different taxes affect savings and labor supply decisions. The different treatment of savings between the two types of

taxes is a key element: with taxes on income subjecting savings to heavier taxation than taxes on consumption. Shift from taxes on income to taxes on consumption does not change total tax revenue and can be expected to encourage savings leading to increased investments and thus economic performance (Engen & Skinner, 1996). This arises because taxes on income include both income that is saved and income from saving. Taxes on consumption exclude savings.

Kenyan Tax Regime Structure

In Kenya the taxes regime is comprised of four main tax heads; Income tax, VAT, Excise duty and custom duty (McNabb & LeMay-Boucher, 2014). The regulations are governed by independent legislators that govern the taxation system; the main legislator, the KRA has different sections that deal with the above taxes while also having the authority to undertake reviews on various companies and corporation with the main goal of limiting corruption as it a problem in the developing nations such as Kenya.

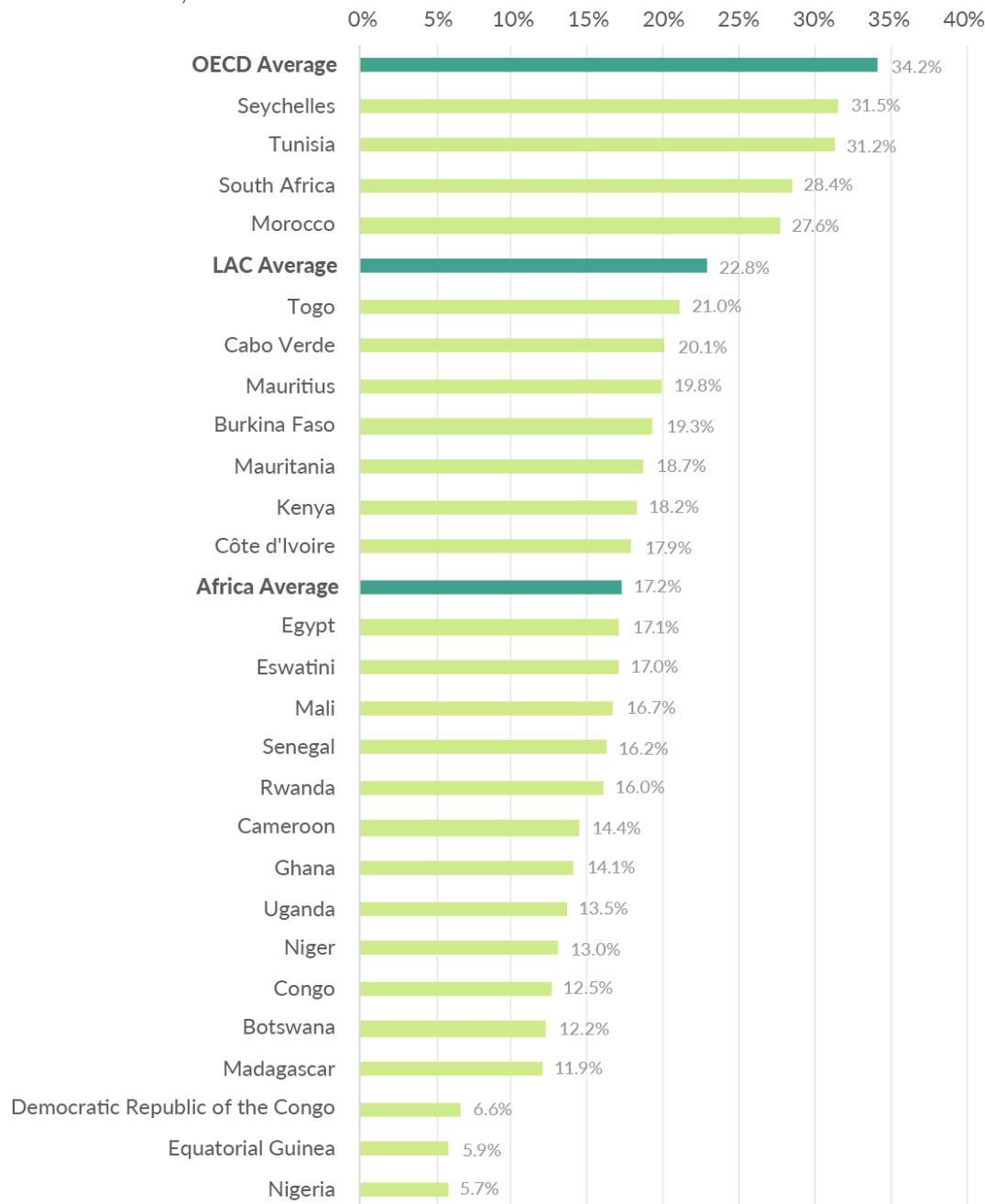
Comparison of tax levels between Kenya and other countries

Based on OECD report on tax revenue statistics in Africa, the average African tax to GDP ratio increased by 1.5 percentage points, from 15. 7 percent to 17.2 percent between 2008 and 2017. This was mainly due to increase from value added taxes (VAT, 0.7 percentage points) and individual income taxes (0.7 percentage points). The average ratio has plateaued at 17.2 percent in 2015, as increase in some countries offset decrease in other countries. Tax -to -GDP Ratios vary significantly among African countries. In 2017, Seychelles (31.5 percent), Tunisia (31.2 percent), and South Africa (28.4 percent) had the highest tax-to-GDP ratios of the 26 countries covered. Nigeria (5.7 percent), Equatorial Guinea (5.9 percent), and the Democratic Republic of the Congo (6.6 percent) had the lowest. Kenya between these periods has a tax to

GDP ratio of 18.2 percent above African average (17.2%) and below LAC average (22.8%). This implies that Kenyan Tax-to-GDP is not bad as compared to other African countries

Tax-to-GDP Ratios Vary Significantly across African Countries

Tax-to-GDP Ratios, 2017



Source: OECD, "Revenue Statistics - African Countries: Comparative tables."

On average, African countries tax structure is relatively similar to that of LAC countries. Notable differences are Africa's relatively higher reliance on individual taxes and lower reliance on social insurance taxes. The average OECD tax structure differs quite substantially from that of the African average, as African countries tend to rely less on individual taxes, social insurance taxes, and property taxes, and more on corporate taxes and consumption taxes.

Between 2008 and 2017, revenue sources have shifted to VAT (increase of 1.7 percentage points of total taxes) and individual taxes (increase of 2.6 percentage points of total taxes). While the share of individual taxes is still lower than the share of corporate taxes, corporate tax revenue has declined by 1.2 percentage points of total tax revenue during the same time frame. Consumption taxes other than VAT have declined by 3.4 percentage points of total revenues.

The decline in consumption taxes other than VAT in many African countries is partly due to lower trade tax revenues. Trade liberalization across the region has led to reduced import tariffs, a narrower base of goods and services subject to excise taxes, and the elimination of taxes on exports, lowering overall trade tax revenues. The 2019 launch of the African Continental Free Trade Area (AFCFTA) will further reduce tariffs and thus decrease trade tax revenues in the short term. In the longer run, however, this decrease is expected to be offset by additional tax revenues resulting from economic growth generated by closer integration. On average, non-tax revenues accounted for 43 percent of the amount of collected tax revenues in 2017. Non-tax revenue varied substantially among the countries covered, ranging from 18.7 percent of GDP in Botswana to 0.5 percent of GDP in South Africa. In almost all countries, non-tax revenues were lower than tax revenues.

Tax Structure in African Countries, 2017

Country	Individual Taxes	Corporate Taxes	Social Insurance Taxes	Property Taxes	Value- Added Taxes (VAT)	Consumption Taxes	Other than VAT	Other VAT
Botswana	0.0%	0.0%	0.0%	0.3%	34.0%	4.4%		61.3%
Burkina Faso	7.4%	15.7%	9.9%	0.7%	36.9%	27.6%		1.9%
Cape Verde	20.2%	12.1%	0.2%	1.5%	36.3%	29.7%		0.0%
Cameroon	6.8%	13.2%	7.3%	1.1%	36.3%	26.5%		8.7%
Congo	23.4%	18.5%	0.0%	0.8%	29.3%	24.5%		3.4%
Côte d'Ivoire	0.3%	11.2%	11.5%	2.6%	20.0%	41.9%		12.6%
Democratic Republic of the Congo								
	17.2%	19.6%	7.5%	0.2%	29.5%	22.4%		3.5%
Egypt	9.6%	27.7%	15.0%	0.6%	21.1%	22.9%		3.0%
Equatorial Guinea								
	11.6%	66.2%	0.0%	0.0%	12.4%	8.6%		1.1%
Eritrea	30.9%	17.9%	13.3%	2.3%	24.8%	10.7%		0.0%
Ghana	14.3%	17.2%	9.0%	0.0%	28.6%	30.1%		0.8%
Kenya	24.9%	12.9%	2.5%	0.7%	24.0%	27.9%		7.1%
Madagascar	11.1%	12.4%	3.5%	0.6%	48.1%	24.0%		0.4%
Mali	7.7%	16.5%	10.5%	2.2%	29.4%	29.3%		4.5%
Mauritania	12.5%	20.9%	2.0%	0.2%	31.8%	32.5%		0.1%

Country	Individual Taxes	Corporate Taxes	Social Insurance Taxes	Property Taxes	Value-added Taxes (VAT)	Consumption Taxes	Other Consumption than VAT	Other
Mauritius	9.8%	14.7%	4.1%	5.5%	34.1%	29.5%		2.2%
Morocco	13.9%	17.6%	19.3%	5.7%	27.8%	14.6%		1.2%
Niger	8.9%	18.1%	6.1%	0.4%	30.9%	29.3%		6.3%
Nigeria	15.9%	44.9%	10.9%	0.0%	14.9%	12.6%		0.8%
Rwanda	22.9%	17.3%	6.2%	0.1%	28.9%	24.5%		0.0%
Senegal	15.5%	9.6%	7.2%	2.5%	34.8%	26.5%		3.9%
Seychelles	14.0%	21.2%	0.0%	1.4%	33.1%	30.4%		0.0%
South Africa	34.4%	16.2%	1.4%	5.6%	22.2%	16.5%		3.7%
Togo	7.0%	10.1%	0.0%	0.7%	43.3%	35.2%		3.7%
Tunisia	20.5%	7.7%	30.7%	1.0%	20.2%	16.4%		3.6%
Uganda	24.7%	6.1%	0.0%	0.0%	31.6%	33.2%		4.3%
Africa								
Average	15.4%	18.6%	8.1%	1.6%	29.4%	24.3%		2.6%
LAC Average	9.5%	15.5%	16.9%	3.4%	27.9%	21.8%		4.9%
OECD								
Average	23.9%	9.2%	26.2%	5.7%	20.2%	12.2%		2.7%

Tax burden- refers to the amount of tax borne by an individual or business. Tax burden vary depending on a number of factors including income level, jurisdiction and current tax rates. It is worth noting that tax burden may not be the same as the tax actually paid because of the possibility of passing a tax on. It helps to explain who has the legal liability of tax, that is “statutory burden” and who actually bears the ultimate burden of the tax- who has the tax burden i.e. bears the economic incidence of the tax.

1.2 Research problem

Taxation has been identified as a major problem to the economic performance in most developing countries but also developed countries (Burko and Jamal, 2004). For example in third world countries, income taxes are direct analysis of employment income, rent income, pension and investment taxation in general increases the cost of operating small and medium enterprises. To compensate for the increased cost of operation, prices on goods are raised thus lowering the amount of sales. The effects of reduced sales are lower profit, slow creation of employment thus resulting to low economic performance (Thuronvi, 2009). At the same time effective taxation reduces excessive reliance on aid and offers a pathway from unsustainable revenue streams for economic performance, this leads to flourished economic growth.

In Kenya, the situation is not different and such as the government has been changing tax structure where the existing one has not yielded the much targeted amount of tax revenue. This ends up resulting in skewed economic performance. Due to the dynamic tax structure in Kenya, there is lack of an optimum taxation model or structure for the government to rely upon when considering taxation policy changes and also comparing taxation and performance of the economy.

Major of the previous studies have focused on various determinants of tax revenue and how to enhance tax buoyancy and its elasticity in Kenya. However our study aims to add the fiscal policy-economic performance literature by examining how the structures of direct and indirect taxation affect economic performance and the causal link between individual direct taxes with economic growth of Kenya.

Previous studies done on taxation in Kenya have not intensively covered the effect of both direct and indirect taxes on economic performance. They have remained sparse on the issue. Most of the studies have addressed the effects of a single measurement of taxation on economic performance in Kenya. For instance, a research study carried by Otieno (2003) focused on effects of VAT on economic performance. Others have covered areas such as revenue productivity (Njoroge, 1993), tax reforms (Ouma, 2014 and KIPPRA, 2004), and taxation of the underground economy (KIPPRA, 2007). Therefore there is need to examine the effects of major types of taxes on economic performance of Kenya. Research should make available more materials on income taxes, VAT, Excise duty and Custom duty to policy makers and other economic agents for better decision making. This study therefore focuses on the effects of taxation to the economic performance in Kenya, and provides more information on this sensitive subject.

1.3 Research objectives

The general objective of the study is to find out the effect of taxation on economic performance in Kenya.

The specific objectives of the study are:

- i) To find out the effect of income tax on economic performance in Kenya.
- ii) To find out the effect of VAT on economic performance in Kenya
- iii) To find out the effect of excise duty on economic performance in Kenya

iv) To find out the effect of Import duty on economic performance in Kenya

1.4 Research questions

The research will be guided by the following questions;

i) Does income tax affect the economic performance in Kenya?

ii) Does VAT affect the economic performance in Kenya?

iii) Does Import duty affect the economic performance in Kenya?

iv) Does Excise duty affect the economic performance in Kenya?

1.5 Significance of the study

Direct taxes and economic performance information is important to the government, tax collection agencies such as Kenya revenue authority (KRA) and other organizations and so the study provides the required information.

Secondly, citizens i.e. Accountants, will know how tax rules will impact their companies or clients and how to work within those laws for the best benefit.

Thirdly, policy makers will benefit in analyzing the nature of relationship between the direct taxes and economic performance.

Fourthly, other researchers would build on the findings on this study to carry further research in same area to expound, improve, update or enrich the findings of this study.

Finally, the study will also add to the much needed economic literature on taxation and its growth linkages.

1.6 Scope of the study

The paper covers period of 10 years, starting from 2010 to 2020. The variables are measured at a national level. The period carried is extensive and therefore more likely to give accurate results.

1.7 Organization of the paper

The next chapter covers literature review that has been done on the topic; it gives theoretical and empirical literature review followed by an overview of the same. Chapter Three gives the conceptual framework and the methodology used to achieve the research objective. Chapter Four gives the findings after running the regression model. Chapter five has the conclusion, policy recommendations and suggests areas for future research.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

This chapter reviews literature on taxation, income tax and economic performance and attempts to relate this study to available literature .It traces the theoretical development in economic analysis of the relationship income taxes on economic performance in Kenya .It starts with the theoretical then empirical literature and conceptual framework.

2.2 THEORETICAL LITERATURE REVIEW

2.2.1 Supply-side Economic Theory

Supply-side economics is a macroeconomic theory that postulates economic growth can be most effectively fostered by lowering taxes and decreasing regulation (Lucas, 1990). According to supply-side economics, consumers will benefit from greater supplies of goods and services at lower prices, and employment will increase. Demand-side economics opposes this theory.

A basis of supply-side economics is the Laffer curve, a theoretical relationship between rates of taxation and government revenue. The Laffer curve suggests that when the tax level is too high, lower tax rates will boost government revenue through higher economic growth.

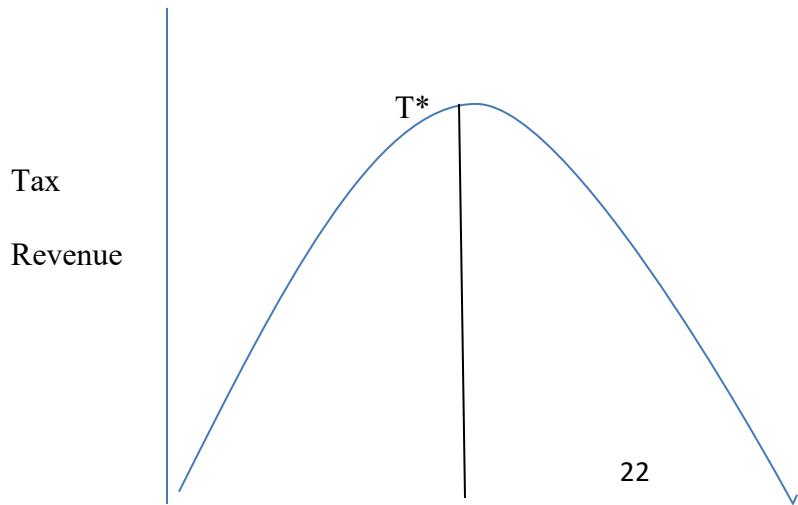
The term "supply-side economics" was thought for some time to have been coined by journalist Jude Wanniski in 1975, but according to Robert D. Atkinson the term "supply side" was first used in 1976 by Herbert Stein (a former economic adviser to President Richard Nixon) and only later that year was this term repeated by Jude Wanniski. The term alludes to ideas of economists Robert Mundell and Arthur Laffer.

Supply-side economics proposed that production or supply is the key to economic prosperity and that consumption or demand is merely a secondary consequence (Lucas, 1990). Early on, this

idea had been summarized in Say's Law of economics, which states: "A product is no sooner created, than it, from that instant, affords a market for other products to the full extent of its own value." Supply-side economics rose in popularity among Republican Party politicians from 1977 onwards. Prior to 1977, Republicans were more split on tax reduction, with some worrying that tax cuts would fuel inflation and exacerbate deficits.

In 1978, Jude Wanniski published *The Way the World Works* in which he laid out the central thesis of supply-side economics and detailed the failure of high tax rate progressive income tax systems and United States monetary policy under Richard Nixon and Jimmy Carter in the 1970s. Wanniski advocated lower tax rates and a return to some kind of gold standard, similar to the 1944–1971 Bretton Woods System that Nixon abandoned.

The Laffer curve



Tax rate %

It is necessarily true, where tax revenue is positive, it must reach a maximum point (T^*). To the left of T^* an increase in tax rate raises more revenue than is lost in offsetting worker and investor behavior. Increase in rates past T^* could cause people not work thereby reducing tax revenue. At any tax rate to the right of T^* , a reduction in tax rate will actually increase total revenue (Laffer, 2004). The location of T^* is dependent on worker and investor preference to work, technology and other economic factors. Government would like to be at point T^* because at this point it collects maximum amount of tax revenue while people continue working hard. In the event the tax rate is on the right side of T^* , then lowering tax rate will stimulate the growth by increasing the incentives to work and investments means at larger tax base. .

2.2.2 CLASSICAL THEORIES ON TAXATION

Adam Smith was the first economist to spell out the qualities of an optimal tax system. He stated that the good tax system should possess the following qualities;

Canon of equity- this principle stipulate that people should pay tax in context with their ability and not the same amount of tax that is those who earn income should pay higher taxes than those of lower income in other word they should have a quality of taxes.

Canon of economy- the cost of collecting taxes should not exceed the amount of tax revenue collected. This will not be economical similarly the tax payer should be left with sufficient fund for investment and consumption after paying taxes. Every taxes would discourage consumption and investment this will affect the economic adversely.

Canon of convenience- the time of paying the tax and the manner in which is paid should be convenient to the tax payers for instance V.A.T is considered to be a convert tax because the tax because the tax payer pays only when they have the means to buy on item.

Canon of certainty- the amount of tax to be paid by a tax payer should be certain about the amount of the expected revenue this is important for planning purposes both for the government business and individual.

Adam Smith theory on production -This theory is based on the principle of 'Laissez —Faire' which requires that the state should not impose any restriction on freedom of an individual. The theory of economic development is based on pillars of saving, division of labor and wide extent of market (Wood, 1993). Laissez principle allows producers to produce as much as they like, earn as much as they can and save as much as they like .Adam smith believed that economy should be propelled by invisible hand; forces of competition motivated by self-interest be allowed to play their role in minimizing the volume of savings for development.

PRODUCTION FUNCTION; Adam Smith recognized three factors of production namely labor, capital, and land. $Y=f(K, L, N)$

K=stock of capital

L=labor force

N=land

He emphasizes that labor is an important factor of production along with other factors.

Division of labor -Rate of economic growth is determined by the size of productive labor and productivity of the labor. The productivity of labor depends upon technological progress of a country and which in turn depends upon division of labor (Wood, 1993). Division of labor brings increases workers efficiency as he can focus on his attention carefully.

Benefits of division of labor include; Increase of dexterity of workers, Saving time required to produce a commodity and Invention of machines and equipment

Division of labor leads to exchange of goods which, in turn, promotes trade and widens the extent of market .Wide extent of market is an essential pre-requisite for economic development.

Capital accumulation -It is the pivot around which the theory of economic development revolves .According to Smith, "any increase in capital stock in a country generally leads to more than proportionate increase in output on account of continually growing division of labor .Adam Smith stated that non capital goods refer to those which are useful directly and immediately to their owner. Fixed capital refers to those goods which are directly used in production processes, without changing hands (Wood, 1993). Classical economist also believed in existence of wage fund. The idea is wages tend to equal to the amount necessary for the subsistence of laborers. If total wages at any time become higher than subsistence level ,the labor force increases ,competition for employment become keener and wages come down to the subsistence level. Adam Smith believed that under stationary conditions, wage rate falls to the subsistence level, whereas in periods of rapid capital accumulation, they rise above this level. The extent to which they rise depends on population growth .This can be concluded that wage fund could be raised by increasing the rate of investment.

Agents of growth -Adam Smith observed that farmers, producers and businessmen are important agents of economic growth. It was the free trade, enterprise and competition that led farmers, producers and businessmen to expand the market and which, in turn, made the economic development interrelated. Development of agriculture leads to increase in construction works and commerce .when agricultural surplus arises as a result of economic development, the demand for commercial services and manufactured articles arises (Wood, 1993).This leads to commercial

progress and establishment of manufacturing industries .On the other hand ,their development leads to increase in agricultural production when farmers use advanced techniques .Thus ,capital accumulation and economic development take place due to the emergence of the farmer, the producer and the businessman.

Process of growth - The process of growth is cumulative. Division of labor made possible by accumulation of capital and expansion of market, increase national income and output, which in turn, facilitates saving and further investment and in this way, economic development rises higher and higher.

Scarcity of natural resources stops the process of growth. A stationary economy is characterized by unchanged population, constant total income, and subsistence wage, elimination of profit in excess of the minimum consistent with the risk and absence of net investment (Wood, 1993). In his opinion, an economy in stationary state finds itself at the highest level of prosperity with its natural resources and environment.

The competition for employment reduces wage to subsistence level and competition among the businessmen brings profits as low as possible. Investments also start declining and in this way, the end result of capitalist is stationary. When this happens, capital accumulation stops, population becomes stationary, profits are minimum, wages are at a subsistence level, there is no change in per capita income and production and the economy reaches the state of stagnation.

2.2.3 Keynesian Theory.

Keynesian Economics is considered a demand side theory that focuses on changes in the economy over a short run. Keynes advocated for increased government expenditures and lower taxes to stimulate demand and pull the global economy out of depression (Crotty, 1980). Keynesian economics was used to refer to the concept that optimal economic performance could

be achieved and economic slumps prevented by influencing aggregate demand through activist stabilization and economic intervention policies by the government. If aggregate demand in the economy fell, the resulting weakness in production and jobs could precipitate a decline in prices and wages. A lower level of inflation and wages would induce employers to make capital investment and employ more people, stimulating employment and restoring economic growth. Poor business conditions may cause companies to reduce capital investment rather than take advantage of lower prices to invest in new plants and equipment.

Keynesian Economics and the great Depression, other economist argued that in the wake of any widespread downturn in the economy, business take advantage of low lower input prices in pursuit of their own self-interest would return output and prices to a state of equilibrium (Crotty, 1980). Keynesian believed Great Depression to counter this theory, he believed that once economic downturn sets in, for whatever reason, the fear and gloom that it engenders among investors and business will tend to become self-fulfilling and can lead to a sustained period of depressed economic activity and unemployment. Due to this reason Keynesian advocated a countercyclical fiscal policy in which during periods of economic woe, the government should undertake deficit spending to make up for decline in investment and boost customer spending in order to stabilize aggregate demand .

2.3EMPIRICAL LITERATURE REVIEW

2.3.1 Income tax and economic performance

Wanyagathi (2012) carried out a research to determine the relationship between income taxes and economic growth. This study focused on trend and analysis, the relationship between income tax and economic performance hence recommending income tax policy that will improve economic performance in Kenya. The study depended heavily on secondary data .its sources include statistical abstracts (Kenya Bureau Of Statistics), World Development Indicators from the World bank database and data from Kenya Revenue Authority. Classical Linear Regression Model is used .The researcher used a time series data .A number of test was conducted on the model to check whether the model was correctly specified and reliable. The researcher ran a regression with economic performance as the dependent variable and the independent variables were income tax, foreign trade ,government consumption ,and population growth rate .Economic performance was measured by the GDP per capita growth rate ,while income tax, consumption tax, foreign trade, government consumption were measured as ratios of GDP. It was established that, income tax has a negative effect on economic performance though this effect is not significant. Government consumption was found to have a significant positive correlation with economic performance. Population growth was found to have a positive effect on economic performance though the effect wasn't significant.

The regression was also fitted in VECM .Johansen cointegration test revealed presence of long run relationship among the variables. In the VECM, it appears there is a long run relationship among the variables used, but no significant relationship between income and GDP per capita growth rate. Income tax influence economic performance negatively, but this relationship is weak and not statistically significant .The VECM and OLS gave as similar result of a negative

correlation that was not significant .This means there is no significant relationship between income tax and economic performance in Kenya.

Gachanja (2012) did a study on economic growth and taxes in Kenya, using time series data for the period 1971-2010. The study reveals a positive relationship between the economic growth and taxes. All the taxes (income tax, import duty, excise duty, sales tax and VAT) show a positive correlation to GDP, with income tax having the highest effect. Gachanja (2012) also tests for the direction of causation of the variables using Granger Causality test, and finds reversal causality between economic growth and excise tax, and a unidirectional relationship between income taxes and economic growth, and economic growth and VAT. Gachanja (2012) points out that different uses of tax revenue affect growth differently. The model however fails to capture variables other than taxes that influence GDP, such as government expenditure and investment.

Carrying out a research study using a simple endogenous model to show the effect of income taxes on growth, Wawire (1990), found that an increase in income tax by 10 percent causes a drop in economic growth by 2 percent. High income taxes will lower the rate of return, which reduce the rate of capital accumulation thus lowering long run growth rates. Furthermore, Engen and Skinner (1992) using data for 107 countries for the period 1970-1985, find that fiscal policy can be both good and bad for growth. The distortionary effects of taxes hurt economic growth, while public goods and infrastructure promote economic development. Their empirical results reveal a significant and negative impact of fiscal policy on output growth rates in the short-term and the long-term. They also point out that taxes on labor income may impact output growth differently from corporate, interest and trade taxes. The effect of labor tax on output growth depends on labor supply elasticity in the short term; in the long run the effect is ambiguous.

Engen and Skinner (1996) have suggested that replacing the income tax with a consumption tax, can increase work effort, savings and investment, thus boosting economic growth. They show that increase in taxes rates in the US are accompanied by a decline in economic growth rate. Their empirical estimation reveals a negative relationship between taxes and growth, which is not very strong.

Rosen and others (2001) analyzed the personal income tax returns of a large number of sole proprietors before and after the tax reforms act of 1986 and determined how the substantial reductions in marginal tax rates associated with that law affected the growth of their firms as measured by gross receipts. They found that individual income taxes exerted a statistically and quantitatively significant influence on firm growth rates. The results showed that raising the sole proprietors tax price by 10%, increased receipts by about 8.4%. This finding is consistent with the view that raising income tax rates discourages growth of small businesses.

2.3.1 Excise duty and economic performance

Wachuka (2016) examined the impact of excise tax on the Kenya government revenues and consumption of alcohol and/ or cigarettes and their consumption patterns using an empirical cause and effect study design established no relationship between the consumption of alcohol and cigarettes and excise tax changes; however, there was a linear relationship between excise taxes and contribution to revenue for government. The study established that excise tax increments do not affect consumption of cigarettes and alcohol, and that other methods should be found to lower their consumption. The contributing factors to no changes in consumption are because of the demand in-elasticity of cigarettes and alcohol to price changes (Wachuka, 2016). The research is empirical and designed appropriately for the objectives and helps guide how this research is undertaken and expected outcomes.

Okello, (2001) analyzed the excise taxation system in Kenya to establish the extent to which they meet their intended objectives, which are to discourage and therefore reduce the consumption of some products such as alcohol, promote equity, and raise government revenue. Using several empirical equations and data, it was established that there was additional scope to generate extra revenue for the government from excise duties. The study also established that the excise tax system in Kenya as presently set (at that time) was effective for the purposes of raising revenues; excise taxes on cigarettes in Kenya results in significant additional revenues for government and its income elasticity is close to 1 (one); excise tax in general contributes to 4.5% of Kenya's GDP (Okello, 2001). The research design, equations, analytical methods and findings are done professionally in the context of the study and provide a background to the impact of excise taxes in Kenya for cigarettes and alcohol before the introduction of the excise taxes in 2010.

A research study by Mwiti (2006), showed that excise taxes on cigarettes are highly regressive because the result is usually that instead of the low-income population quitting, they become more burdened by higher cigarette prices. This effectively means that poor people use a larger proportion of their incomes in paying tax than do the rich because excise taxes are usually shifted by manufacturers to the consumer. The poor smoke much more than the rich, so they pay more taxes when they keep smoking at the same rate when cigarette prices rise as a result of excise taxes. In addition to price elasticity of demand, people respond differently to increases in taxes, and therefore cigarette price increases; some cut back on their consumption, others do not change their habits, while others may quit smoking all together due to rises in cigarette prices. Governments use sin taxes to raise revenues, manage consumption, and promote public health. For this research, manufacturers shift the burden of sin taxes to the consumers, sometimes by a factor exceeding the sin tax rate to maintain, or in most cases, actually increase their profits.

2.3.3 Value Added Tax and economic performance

According to Wasyleenko (2007) the rate of economic performance can be affected by policy through the effect that taxation has upon economic decisions. An increase in taxation reduces the returns to investment (in both physical and human capital) and research and development. Lower returns mean less accumulation and innovation and hence a lower growth rate. This is the negative aspect of taxation. Taxation however also has a positive aspect whereby, for instance, some public expenditure can enhance productivity, such as the provision of infrastructure, public education, and health care. Taxation provides the means to finance these expenditures and indirectly can contribute to an increase in the growth rate. Value added tax is charged on the supply of taxable goods or services made or provided in Kenya by a taxable person in the course of or in furtherance of any business carried on by that person and on the importation of goods and services in Kenya (VAT Act, Sec.2).

Wawire (2011) explored the determinants of Value added tax revenue and established that growth elasticities for VAT were significant. The study findings showed that VAT revenues respond with significant lags to variations in its determinants and that VAT revenues are sensitive to unusual circumstances. This study concluded that Kenya's VAT revenue is very responsive to changes in its determinants especially international trade. Wawire used average GDP to capture the fact that taxes are collected in a fiscal year (July to June) as opposed to a calendar year which is the time period of GDP data.

Mbiti (2013) carried out a research on the factors that affect VAT productivity in Kenya.

The productivity was measured through an autoregressive model whereas the factors affecting VAT productivity were sourced from both taxpayers and the tax administration by use of

questionnaires. It was found that VAT is responsive to changes in GDP, a contradiction with previous studies done in Kenya. The research also showed that VAT was rigid to changes in GDP upto the financial year 2004/2005 and the years that brought about the shift in responsiveness were the last seven years running from 2005/06 to 2011/012. The study also found that taxpayers faced challenging compliance costs and that there was a neglect of the medium and small taxpayers because of the computational difficulties and lack of audit. From the above KRA needs to shift focus from revenue collection to coming up with systems that are more taxpayer oriented so as to enhance their compliance with VAT laws.

2.3.4 Custom Duty and Economic performance in Kenya

John (2018) carried out a research study to determine the effects of custom duty on economic performance in Kenya. The research used correlation research design. In his study, he focused on the performance of EPZ firms in Kenya only, thus a sample size of all 86 registered EPZ firms was used. Primary data was obtained using questionnaires. Secondary data from the registered firms was collected on; ROA, number and value of jobs and the length of stay of the firms. The study used both descriptive and inferential statistics to conduct data analysis. The results of study revealed that at 5% significance level, custom duty incentives had a significant relationship with performance of EPZ firms measured using ROA. The results further revealed that at 5% significance level, custom duty incentives were found to have a significant relationship with performance of EPZ firms measured using the total number of workers in Kenya. The results also revealed that at 5% significance level, custom duty incentives were found to have positive

and significant relationship with performance of EPZ firms measured using the number of years in operation. Based on the study findings, the study recommended that the government should offer increased excise duty incentives in order to cut down on imports and in that way promoting the growth of demand for domestic products in the country. The government could pursue this strategy in order to curb smuggling and also to promote the growth of the tourism industry. The study further recommends that policy makers should adopt strategic incentive plans or targeted incentive scheme that targets specific industry or a strategic tax incentive that add value or contribute positively to the economy and are in line with the country's vision 2030.

According to Owino (2019), the fiscal crisis occasioned by the international oil shock in early 1970s, motivated the Kenyan government to shift the tax policy towards greater reliance on indirect taxes. Consequently, the level of revenue from custom and excise taxes has risen steadily in the period 1973-2010; however, this was coupled with a persistent decline in economic growth. Such significant increases in custom and excise tax revenue raise pertinent questions about the effect they have had upon economic growth. Therefore, Owino (2019) carried a study to analyze the effect of custom duty on economic growth in Kenya for the period 1973 to 2010. This study is motivated by two developments. First, by the inconsistency in existing empirics and secondly by the wide knowledge gap occasioned by the paucity of empirical literature on Kenya. Therefore, this study attempts to reconcile the different positions and also close the knowledge gap. The study adopted a correlation research design based on its ability determine the strength and direction of relationships between variables while the theoretical framework was anchored on endogenous growth model. The empirical results indicate that custom duty is positively correlated with economic growth in Kenya.

2.4 CONCEPTUAL FRAME WORK

INDEPENDENT VARIABLE

TAXATION

Income tax(Gross income tax revenue/GDP)

Custom Duty (total custom duty revenue)/GDP

Excise duty (total excise duty revenue/GDP)

VAT (total value added revenue/GDP)

DEPENDENT VARIABLE

ECONOMIC PERFORMANCE

GDP



CHAPTER THREE

RESEARCH METHODOLOGY

3.1 INTRODUCTION

This chapter provides the theoretical and methodological framework used to analyze the relationship between income taxes and economic performance by giving ways in achieving objectives of the study. The study utilizes economic theory and models to define this relationship. This chapter lays out the research design, the type of data, the statistical methods used and limitations of the study.

3.2 RESEARCH DESIGN

Research design refers to an arrangement of conditions for collection and analysis of data in a way that combines their relationship with the purpose of the research to the economy of state (Leavy, 2017). It concerned about several considerations a researcher should think about and adhere when carrying out a research problem. The choice of a research design is determined by the research purpose categories of data needed, data sources and cost factors among others.

Research design adopted in this study is descriptive correlational research design. In descriptive correlational research design the problem under investigation is structured; the aim being to describe relationship among variables. This research design aims at examining the effect of taxation on economic performance in Kenya and if there is any correlation between taxation and economic performance in Kenya. Statistical analysis included pearson, t-test and multiple regression analysis.

The reason why we've chosen descriptive correlational research design study is to provide explanation and specify the nature of functional correlation between two or more variables. This study identified effect of taxation on economic performance in Kenya.

3.3 POPULATION OF STUDY

The research was a case study of Kenya. The study examined both indirect and direct taxes such as VAT, Income tax, Import duty and Excise duty. The period for the study was from 2010 to 2020. The research involved different methods of collecting income tax, VAT, excise duty and import duty as used by the Kenya Revenue Authority (KRA), to get an exact figure of income tax every year. Furthermore, the study examined economic developments in Kenya within that period. This provided a clear understanding of effects of tax revenue, especially income tax, to economic growth in Kenya.

3.4 DATA COLLECTION, SOURCES AND TYPES

For this research secondary data was used, secondary data is the data that has already been collected through primary sources and made readily available for researchers to use for their research purposes. These data were collected using document analysis approach which involves a systematic procedure of analyzing documentary evidence. this documentary evidence is obtained from various sources which include the Kenya National Bureau of Statistics and Kenya Revenue Authority. The reason why data was collected was to compare GDP of different year and also compare taxation of different type.

3.5 DATA ANALYSIS

Descriptive measures of control tendency using mean and standard deviation were used in data analysis. Mean locate the centre of the relation frequency while standard deviation measures the spread of a set of observations. GDP was taken as dependent variable while income tax, VAT, excise duty and import duty were taken as independent variables. Also, during data analysis, inferential statistic was used. Inferential statistic uses a random sample of data taken from a

population to describe and make inferences about population. Inferential statistics bring about model to be used.

In our study the model that we use is regression model.

$$Y = a + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \epsilon$$

Where y =economic performance

X_1 =Total Income tax/GDP

X_2 =Total VAT/GDP

X_3 =Total Excise duty/GPD

X_4 = Total Custom Duty/

CHAPTER FOUR

4.1 Introduction

This chapter presents an analysis of the data. The chapter presents descriptive statistics of the data, report on regression results as well as hypothesis testing. The analysis dwells on the assessment of the link that exists between Income Tax, VAT, Excise Duty, Custom Duty and economic growth.

4.2 Descriptive statistics

The study statistics namely mean and standard deviation were investigated. Mean is used to locate the center of the relative frequency distribution while the standard deviation measures the spread of a set of observations and is of great importance for evaluation purposes. Other statistics include minima and maxima values as shown on the Table 4.2

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
GDP	11	3104303.0 0	5049686.0 0	4059639.272 7	646234.5613 2
VAT	11	171880.75	413186.11	298176.2645	95946.82178
Income_tax	11	584507.00	706940.00	633542.0000	46430.36272
Customs_duty	11	38873.41	102342.11	72001.8874	22735.81649
Excise_duty	11	26429.10	116857.62	63426.4882	33809.88330
Valid (listwise)	N 11				

Table 4.2 descriptive Statistics Results

The total observations considered in this study were 11 with five variables (one dependent and four independent variables). GDP is the dependent variable and the independent variables are; Value Added Tax (VAT), Income Tax, Custom Duty and Excise Duty.

From table 4.2, it is clear that there is high spread of data among variables. From its nature it was so anticipated since time series data especially those, which aggregates follows a random or stochastic process. The GDP had an average of 4059639.2727, the least value of 3104303, the maximum value of 5049686 and standard deviation of 646234.56132. VAT had an average value of 298176.2645, the least value of 171880.75, the maximum value of 413186.11 and standard deviation of 95946.82178. Income Tax had an average value of 633542, the least value of 584507, the maximum value of 706940 and standard deviation of 46430.36272. Custom Duty had an average of 72001.8874, the least value of 38873.41, the maximum value of 102342.11 and standard deviation of 22735.81649. Excise Duty had the average value of 63426.4882, the least value of 26429.10, the maximum value of 63426.4882 and standard deviation of 33809.88330. All these values are in Kenyan Million Pounds.

From table 4.2, data for GDP was widely spread than other variables 646234.56132 Kenyan Million Pounds. It also has large mean indication of the fact that the economy of Kenya has grown rapidly over the past ten years. Among the independent variables, data for VAT was widely spread than other variables 95946.82178 Kenyan million pounds. This is due to fluctuations in the manufacture of taxable goods and services caused by the unfavourable conditions in the economy such as corruption, politics among others. Besides it is caused by excessive VAT refunds to the registered Traders. Income Tax has a large value of the mean because of the large population of the tax payers. This has been contributed by the growth of population for the last 10 years. The large mean in the Income Tax indicate that the economy revolve around income tax. The range of the data that is the difference between the maximum value and minimum value was huge gap which demonstrates different economic conditions that the Kenyan economy have been going through within the period of this study.

4.3 Estimation

Correlations

		GDP	VAT	Income_tax	Customs_duty	Excise_duty
Pearson Correlation	GDP	1.000	.980	.943	.983	.966
	VAT	.980	1.000	.945	.990	.950
	Income_tax	.943	.945	1.000	.969	.970
	Customs_duty	.983	.990	.969	1.000	.970
	y					
	Excise_duty	.966	.950	.970	.970	1.000
Sig. (1-tailed)	GDP	.	.000	.000	.000	.000
	VAT	.000	.	.000	.000	.000
	Income_tax	.000	.000	.	.000	.000
	Customs_duty	.000	.000	.000	.	.000
	y					
	Excise_duty	.000	.000	.000	.000	.
N	GDP	11	11	11	11	11
	VAT	11	11	11	11	11
	Income_tax	11	11	11	11	11
	Customs_duty	11	11	11	11	11
	y					
	Excise_duty	11	11	11	11	11

Table 4.3.1 Correlation

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.988 ^a	.976	.961	127971.13685	.976	62.252	4	6	.000

Table 4.3.2 Model Summary

a. Predictors: (Constant), Excise_duty, VAT, Income_tax, Customs_duty

ANOVA^a

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	4077931411	4	1019482852	62.252	.000 ^b
		281.750		820.438		
	Residual	9825967119	6	1637661186		
		8.432		6.405		
		4176191082	10			
		480.182				

Table 4.3.3 ANOVA

a. Dependent Variable: GDP

b. Predictors: (Constant), Excise_duty, VAT, Income_tax, Customs_duty

Coefficients^a

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1	(Constant)	4234237.57 3	2205310.59 1		.103
	VAT	2.426	3.237	.360	.482
	Income_tax	-3.783	4.259	-.272	.409
	Customs_dut y	13.787	18.837	.485	.492
	Excise_duty	7.974	5.684	.417	.210

Table 4.3.4 Coefficients

a. Dependent Variable: GDP

The coefficient shows that the impact of income tax is not significant at 5% significance level because the p value is 0.409 which is above 0.05. It has a t value of -0.888 which means there is negative relationship between income tax and economic performance in Kenya. The results show that an increase proxied by GDP by -0.272 Kenyan million. This phenomenon indicates that the increase in income tax on business may be harmful to the economy in the long run. The Kenya Revenue Authority should exercise due care in levying income tax and levy income tax that doesn't act as an incentive to doing business. The results are different from what was predicted in Chapter Three. We expected an adverse significant relationship between the main variables (Poulson and Kaplan, 2008, Lee and Gordon, 2005). From the literature, income tax reduces capital formation and productivity hence adversely affecting the economy (Musgrave and Musgrave, 1989). The results of a non-significant negative relationship between income tax and economic performance can be attributed to how the economic performance was measured. Different studies measure variables differently. This study chose to measure economic performance through GDP per capita growth rate, different from most studies which have used

GDP (Gachanja, 2012),, GDP per capita (Goode, 1984), and GDP growth rate (Engen and Skinner, 1996) among others. The findings of weak negative correlation between income tax and economic performance concur with those of a few other studies (Manas-Anton ,1986; Easterly and Rebelo,1993a). Easterly and Rebelo (1993a) attribute the weak correlation to the fact that it is difficult to isolate the effect of tax policy on growth. The results are similar to those of Harbeger (1964) who concluded that tax policy is not strong enough to influence performance

For VAT, Excise Duty and Custom Duty, the relationship with GDP is positive (.360 ,.480, .417) respectively. For this it is going to favour the economic performance.

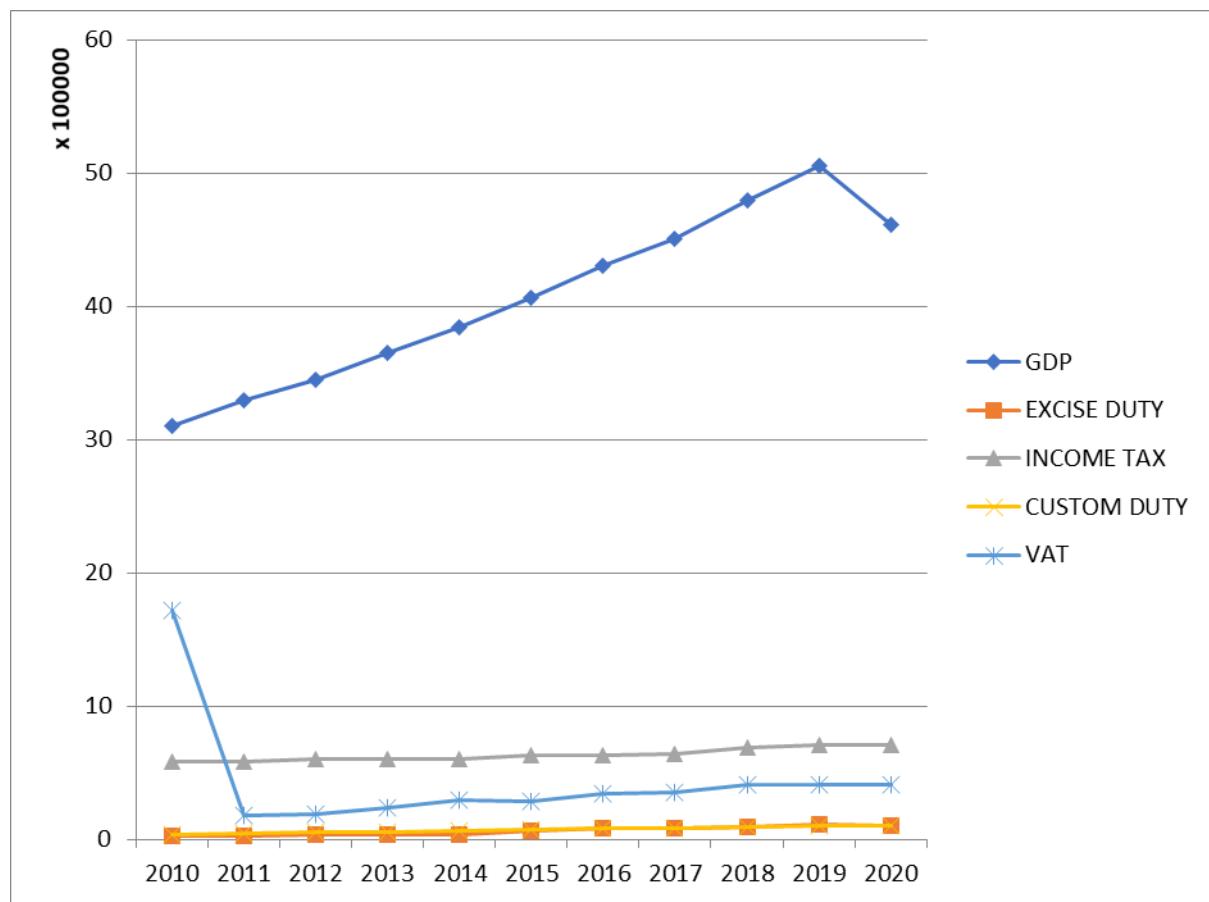


Fig 1: Relationship between GDP, Excise Duty, Income Tax, Custom Duty and VAT

CHAPTER FIVE

5.1 Introduction

This chapter presents a summary of the study and policy recommendation based on the findings of the study. The chapter is comprised of four sections namely, summary and conclusions of the study, policy implications and recommendations, limitations of the study and recommendation of areas for future research.

5.2 Summary and Conclusions

Tax revenue is important for any country since it enables the country's government to cater for the welfare of her people. In addition, a country that mobilizes adequate tax revenue reduces her budget deficit which translates into reduced external borrowing. Reduced external borrowing is good for economic growth since the amount of country's revenue which could be used in paying the external debt can be employed in other productive sectors of the economy. This in turn will assist the country to reduce the level of unemployment as well as attracting foreign direct investment. Higher tax revenue occurs as a result of high tax rates and a large tax base. However, according to Laffer curve, tax revenue increases as tax rates increase up to a certain level beyond which it starts to decline. Kenya has embraced many tax reforms in indirect taxes for instance, moving from sales tax to VAT. However, these reforms are not based on a robust analysis of the effect of each form of tax on Kenya's economic growth. This is because understanding of the weight each tax head on country's economic growth will guide the tax policy makers on where to focus much. Based on this, study sought to investigate the effect of each of the tax head on Kenya's economic growth for the period running from 2010 to 2020. We made a careful selection of the control variables in addition to income tax, VAT, Excise Duty and custom duty as guided by empirical studies in this line of study. For example income tax have negative effect on economic performance. The objective was achieved by running a regression with economic performance as the dependent variable and the independent variables were income tax,,, Economic performance was measured by the GDP per capita growth rate, while income tax were measured as ratios of GDP. From the results, income tax has a ngative effect on economic performance. For VAT, Custom Duty and Excise Duty they have positive effect on economic performance.

The income tax ratio to total revenue has been increasing at a higher rate compared to other taxes . The regression results show a negative effect of income taxes on the Kenyan economy, though not significant. VAT, Excise Duty and custom duty has a positive effect on the economy that is not one significant. Taxes are an important element of the economy, and governments cannot run without them. This study however, shows that the effect of taxes on the economy.

Foreign trade and population growth rate are not significant determinants of the how well the economy is doing. Government consumption was the only variable with a significant positive effect on economic performance. This was attributed to the fact that, expenditure by government on public investment increases productivity and leads to improved economic performance. Government spending also has a multiplier effect on the national income, thereby improving economic performance. The Kenyan government has been investing heavily in infrastructure such as construction of roads and rail transport. This is likely to help improve the economic performance of the country.

5.3 Policy Implications and Recommendations

The findings of this study have important policy implication for economic growth in Kenya. The study has revealed presence of long run relationship between income taxes, excise duty, customs duty and VAT on Kenya's economic growth as measured by GDP. Based on the study findings, the government of Kenya, when considering change of a tax ,

The government should expand the tax bracket of Income Tax in order collect more revenue for funding its expenditure instead of borrowing. This is because Income Tax positively impacts economic growth. Minimal borrowing encourages economic growth because huge debts can signal the possibility of a fiscal crisis and future economic policy reversals hence discouraging foreign direct investment inflows. ly, a combination of both fiscal and monetary policies aimed at raising the aggregate demand such as narrowing of tax base or increasing government expenditure should be pursued. For example a narrow tax base for corporate Income Tax attracts both foreign and local investment which leads to creation of employment. This leads to increased Personal Income taxation because more people would be employed. This will lead to higher absorption of readily available skilled and semi-skilled labour, besides creating a platform for quality labour fermentation via adequate and quality education, and relevant training In addition,

the government should enter into trade agreements which favour free trade as opposed to protectionism. With less controls put in place the degree of openness of the economy to international trade will increase hence more foreign capital inflows. This will attract more corporate taxation that contributes to economic growth as corporate Income Tax positively impact economic growth.

Additionally, indirect taxes such as VAT and excise duty should be streamlined to make them progress such that they are applied discriminatively in that goods and services used by affluent segments of the population attract relatively higher taxes. Also international trade as represented by net exports has a positive correlation with economic growth. To improve cross-border trade, prohibitive restrictions such as high tariffs and general control over mobility of resources would have to be removed. In view of this, the Government must fully and actively participate in the regional economic blocks such as COMESA and EAC.

5.4 Limitations of the Study

A major limitation of the study is the problem of data reliability. Different data sources give different data for the same variable.

5.5 Areas for Further Study

Future researchers ought to investigate the effect of omitted variables on economic growth. For instance, there is need to investigate the effect of tax evasion and avoidance, tax compliance levels and tax literacy on economic growth.

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