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Unpacking Finance Bill 2023/24: Addressing Fiscal Sustainability Challenges and Tax Policy Reform in Kenya

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1.1 Executive Summary

Kenya's fiscal landscape has been grappling with multiple challenges, including a mounting debt burden, inefficient expenditure management, and a limited tax base. In response, the Kenya Kwanza government introduced the Finance Bill 2023, aimed at addressing these issues by implementing comprehensive tax reforms, boosting revenue generation, and advancing fiscal consolidation. The Bill contained 84 clauses, proposing significant changes such as harmonizing corporate tax rates, formalizing the informal sector, and introducing measures like electronic tax invoicing to expand the tax base. However, these proposals sparked intense public debate, with concerns raised about the potential effects on small businesses, tax compliance, and the broader economic climate, particularly in light of rising inflation, high interest rates, and a depreciating currency.

The Bill was part of the government's broader strategy to tackle Kenya's fiscal challenges in the face of escalating living costs and an underperforming tax system. The Finance Bill 2023 sought to implement structural reforms aimed at improving revenue collection and reducing the country's reliance on domestic borrowing. Despite the potential benefits of these reforms, public discourse revealed concerns about the Bill's feasibility, especially in relation to the taxation of the informal sector, the rising cost of living, and inefficiencies in government expenditure. These issues underscored the complexity of the reforms and highlighted the need for a structured approach to tax policy.

While the challenges remained, the Finance Bill 2023 presented a critical opportunity to reshape Kenya's fiscal policy and build a more sustainable and inclusive tax framework. Recommendations from experts included enhancing public participation in the policymaking process, expanding the tax base, and addressing barriers to compliance. Furthermore, the need for strategic expenditure control, improved debt

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management, and greater support for small businesses was emphasized as crucial to minimizing any adverse impacts of the proposed reforms. Ultimately, the success of these initiatives depended on collaboration among government bodies, academic institutions, the private sector, and civil society to ensure that Kenya's fiscal policies fostered sustainable economic growth and long-term stability.

1.2 Background

The University of Nairobi, Department of Finance and Accounting, hosted tax experts and professionals to discuss the potential implications of the Finance Bill 2023. The session underscored the need for a more inclusive policymaking process that integrated diverse perspectives, particularly from academia and industry. While the government's emphasis on revenue growth and reducing public debt was commendable, questions were raised about the feasibility of the 17.8% revenue growth target in light of the then economic conditions. Experts pointed to the structural challenges within Kenya's tax system, including the under-taxation of the informal sector, as major barriers to achieving fiscal sustainability.

1.3 Context and Challenges

Kenya’s fiscal policy operates within a challenging economic environment characterized by inflation, currency depreciation, high interest rates, a large untaxed informal sector, and domestic borrowing pressures. These factors undermine revenue generation, create fiscal imbalances, and limit the effectiveness of policy interventions. Addressing these challenges requires a comprehensive and balanced approach to fiscal reform, with a focus on expanding the tax base, improving public financial management, and fostering an environment conducive to private sector growth.

1.3.1 Depreciation of the Local Currency

The Kenyan shilling had faced significant depreciation in recent years, a trend exacerbated by global economic uncertainties, high demand for foreign currency, and reduced foreign exchange inflows. This depreciation had put additional pressure on the country’s import bill, leading to higher costs for imported goods and services, especially fuel, machinery, and other essential imports. As a result, the depreciation had added to inflationary pressures, further weakening the purchasing power of consumers and increasing the cost of doing business. According to Alani (2023), the causes of currency depreciation in African economies include their dependent nature, international monetary policies, civil unrest, sanctions imposed by developed nations, fluctuating commodity prices, increasing domestic borrowing, the non-tradable status of African currencies, and corruption. These factors have resulted in the adoption of liberal exchange markets, the issuance of higher currency denominations, currency redenomination, shifts to alternative currency bases, adoption of multiple currency systems, demonetization of national economies, and a rise in poverty levels.

1.3.2 High Inflation

Kenya had been facing high inflation rates before 2023 driven by rising global commodity prices, supply chain disruptions, and local economic pressures. Inflation erodes the purchasing power of money, disproportionately affecting low- and middle-income households by making basic needs more expensive. For businesses, it raises input costs and reduces consumer spending, ultimately slowing economic growth. Nalyanya et al. (2020) highlight the direct relationship between inflation and tax performance, noting Milton Friedman's observation that inflation can act as an effective form of tax. Higher excise duties, for instance, often lead to increased prices, temporarily elevating inflation rates. Consequently, inflation indirectly raises tax burdens, as consumers end up paying more for goods and services.

1.3.3 Rising Interest Rates

The country's rising interest rates prior to 2023, partly a result of the Central Bank's efforts to curb inflation, created a challenging financial environment for both the government and the private sector. The rising interest rates could also be partly explained by the US Federal Reserve response to the global supply chain disruptions between 2020 and 2023. For the government, higher interest rates increase the cost of servicing domestic debt, placing additional pressure on the fiscal budget. For businesses, elevated borrowing costs discourage investment, limiting access to capital for expansion and growth. Furthermore, consumers face higher loan repayment costs, leading to reduced disposable income and a subsequent slowdown in domestic consumption. As Corb (2012) notes, interest rates are a critical economic factor influencing economic growth. They are an essential tool for controlling inflation and fostering economic development. Di Giovanni and Shambaugh (2008) further emphasizes the importance of regulating interest rates on credit and financial instruments to manage economic trends that significantly impact society. Proper control of interest rates helps steer the economy toward stability, ensuring that inflation is kept in check while supporting sustainable growth.

1.3.4 Untaxed Informal Sector

A significant portion of Kenya's economy operates within the informal sector, which remains largely untaxed. This sector, comprising small businesses, street vendors, and other informal enterprises, plays a key role in employment and economic activity. However, due to weak regulatory frameworks, it has not been fully integrated into the formal tax system, limiting the country's revenue base. Expanding the tax base by formalizing and taxing this sector presents a challenge that requires innovative solutions to avoid stifling entrepreneurship while increasing revenue collection. Schneider (2005) refers to the informal sector as the "shadow economy," where economic activities are concealed to evade taxes and social security contributions. As Mpofu (2021) and others highlight, the elusive nature of the informal sector makes it difficult for governments, especially in developing countries, to mobilize domestic revenue effectively. Even with tax policies in place, administrators struggle to engage informal sector participants, often due to the lack of reliable income data and the sector's disorganization. This leads to the use of punitive measures rather than strategies that encourage long-term compliance.

1.3.5 Shift from Foreign to Domestic Borrowing

The Kenyan government's shift from foreign to domestic borrowing aimed to reduce exposure to foreign currency risks but has increased competition for credit within local financial markets. This has constrained private sector access to financing, stifling growth, innovation, and economic diversification. Kenya's ambition to achieve a 10% annual economic growth rate by 2012, as highlighted by Kimolo and Onono (2017), relied heavily on public borrowing to fund flagship projects amid revenue mobilization challenges. However, the dual reliance of the government and private sector on domestic credit has made debt and economic growth critical policy concerns. Despite these efforts, the growth target and the goal to reduce domestic borrowing to below 25% by 2012 were not achieved, reflecting the challenges in balancing public debt with sustainable economic development.

1.4 Key Issues Discussed

The Finance Bill 2023 introduced several key proposals aimed at addressing Kenya's fiscal challenges and improving the overall tax and expenditure framework. These proposed reforms span various sectors, including corporate taxation, rental income, the informal sector, and the expansion of electronic tax systems. The Bill also focused on addressing government expenditure and managing the growing debt burden. While these reforms were seen as a step towards creating a more efficient and equitable tax system, they sparked significant debate and raised concerns among different stakeholders.

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1.4.1 Corporate Tax Harmonization

The Finance Bill proposed aligning corporate tax rates between subsidiaries and branches to simplify Kenya's tax system, but concerns arose over its potential impact on non-resident entities, particularly regarding repatriation provisions. Corporate taxation has become a contentious issue in both academic and public discussions. Critics argue that corporate taxes can lead to capital flight, shifting the tax burden to more immobile factors like labor, thereby making the tax inefficient. Some advocate for abolishing corporate taxes altogether, while others call for reforms to address inefficiencies. For instance, Palomera Zaidel (2016) suggests replacing the current source- and residence-based tax mix with a pure residence system, which would enhance efficiency by ensuring investors are taxed equally on domestic and foreign income, promoting export neutrality and minimizing opportunities for tax planning.

1.4.2 Rental Income Tax

A reduction in the tax rate on residential rental income was proposed as a strategy to incentivize more landlords to comply with tax regulations and formalize their operations. However, questions about its overall effectiveness persist. Taxes on property owners in the real estate sector are increasingly common globally as governments seek to enhance revenue collection (Ndegwa, Rono & Odunga, 2025). Historically, the rental business has operated largely as an informal sector within the economy, but the rapid growth of the real estate industry has further expanded informal economic activities (Luttmer & Singhal, 2019). To address these challenges, property owners—both residential and commercial—are required to declare rental income for accurate tax computation (Berhane & Yesuf, 2017). Compliance with rental income tax primarily relies on voluntary participation, requiring taxpayers to self-declare income and pay taxes as stipulated by national laws, without coercion by tax authorities (Adeniran, 2011). Encouraging voluntary compliance is vital for improving transparency, accountability, and the effectiveness of revenue collection systems in the real estate sector.

1.4.3 Integration of the Informal Sector

The Bill proposed strategies to formalize Kenya's informal sector, a crucial yet under-taxed component of the economy. The informal sector spans all income classes and economic activities, encompassing self-employed individuals such as secondhand clothing dealers, hawkers, dressmakers, and wage workers like housekeepers, security guards, and carpenters. It also includes registered businesses such as law firms, private hospitals, and private schools that often underreport income and overstate expenses (Greenidge et al., 2009; Ngui et al., 2014). Despite its significance, estimating the size of the informal sector remains a challenge. According to Dellas et al. (2017), informal sector data are typically excluded from national statistics, resulting in inaccurate macroeconomic indicators and complicating effective policy formulation. Formalizing this sector is therefore critical for improving tax compliance, enhancing revenue collection, and ensuring more accurate economic measurements.

1.4.4 Electronic Tax Systems

The extension of the electronic tax invoice system to include income tax faced resistance due to its potential burdens on small businesses, which already struggle with tax compliance. The electronic tax system is a commendable innovation, as it facilitates timely filing and payment of tax returns. However, as Nkundabanyanga et al. (2017) highlight, even with advanced tax collection mechanisms, countries still experience significant cases of non-compliance. These issues are often linked to a lack of voice and accountability, government inefficiency, and opaque tax systems. Taxpayers are more likely to comply voluntarily when they perceive the tax system as transparent and trust that their contributions will be utilized effectively for the intended purposes. Therefore, fostering trust and improving transparency are critical for enhancing the effectiveness of electronic tax systems and promoting voluntary compliance.

1.4.5 Expenditure Control and Debt Management

Kenya is facing a mounting debt burden, with a substantial portion of its budget allocated to servicing interest payments, prompting discussions on the need for efficient government spending and strategic debt management. Public debt management has garnered significant attention in recent years, particularly following the European sovereign debt crisis. Historically, sovereign debt crises were associated primarily with developing countries, but the Greek debt crisis underscored the importance of prudent macroeconomic policies and disciplined spending and borrowing practices, even for developed nations (Ardagna & Caselli, 2012; Taylor, 2011). Sovereign nations often resort to external borrowing to address budget deficits or finance economic development. However, developing countries frequently struggle to meet their foreign debt obligations, leading to recurring financial distress (Das, Papaioannou & Trebesch, 2012). This highlights the critical need for sustainable debt strategies to ensure fiscal stability and economic resilience.

1.5 Policy Recommendations

In response to the fiscal challenges highlighted in the Finance Bill 2023, a series of policy recommendations have been proposed to improve the country's tax system, public participation, and overall economic stability. These recommendations aim to foster a more inclusive, growth-oriented, and sustainable fiscal environment. Key areas of focus include broadening the tax base, supporting small businesses, improving tax compliance, and enhancing government expenditure efficiency. Additionally, strategies for addressing the cost of living, strengthening academia-industry collaboration, and improving public communication on tax policies have been outlined to ensure that reforms are both effective and equitable.

1.5.1 Enhance Public Participation

The policymaking process in Kenya should be broadened to include diverse stakeholders, particularly professionals and academia, to foster more inclusive and effective tax policies. The Kenyan Constitution of 2010 emphasizes participatory governance, providing a framework for public involvement in decision-making. Public participation involves engaging all stakeholders who have an interest in or may be affected by a project or policy. According to Chambers (2002), it is an empowering process that enables communities to analyze, take control, and build confidence. Mdunyelwa (2008) highlights that public participation aligns with a "people-first" approach, fostering sustainable and meaningful change. It is a cornerstone of democratic governance, promoting decentralized and people-centered decision-making over hierarchical approaches. Odhiambo and Taifa (2009) argue that participation is essential for cultivating a sense of ownership, as people are more likely to accept and support initiatives when they are involved in their formulation rather than having ideas imposed on them. This underscores the need for participatory frameworks to ensure practical, sustainable, and widely accepted policy outcomes.

1.5.2 Promote Growth-Oriented Tax Policies

Tax reforms should balance short-term revenue needs with long-term economic sustainability by incentivizing investment, innovation, and job creation. According to Thugge, Heller, and Kiringai (2011), Kenya's fiscal policy is pivotal in shaping its economic growth trajectory and addressing critical domestic and external challenges. Domestically, these challenges include high population growth, rapid urbanization, weak infrastructure, low investment levels, and pressures from decentralization. Externally, Kenya faces security risks and an unpredictable global economic environment. Effective fiscal policies are essential not only for ensuring macroeconomic stability but also for fostering higher economic growth, reducing poverty, and addressing significant inequalities in income, assets, and regional development.

1.5.3 Expand the Tax Base

Formalizing the informal sector and improving tax compliance are critical strategies to broaden Kenya's tax base and reduce overreliance on a small pool of taxpayers. Mechanisms like a single user identifier to track economic activities could enhance transparency and accountability. Juma, Magero, Makanga, and Aondo (2020) note that the Treasury projects annual revenue targets for the Kenya Revenue Authority (KRA) to fund its budget, yet KRA consistently falls short of these targets. A significant concern lies in the disparity between the number of eligible taxpayers and those who actually pay taxes. By June 2019, only 3.6 million individuals filed tax returns, representing a mere 7.6% of Kenya's population of over 47 million. This limited tax base highlights the need for KRA to address public mistrust in the tax system, improve customer service, and combat tax evasion and fraud. Expanding the tax base requires innovative solutions to engage more citizens and businesses in fulfilling their tax obligations.

1.5.4 Revenue Collection and Expenditure Rationalization

To achieve fiscal targets, the government must enhance efficiency in tax collection and eliminate unnecessary public sector spending. Strengthening procurement processes and controlling recurrent expenditures are critical steps toward optimizing government resources. Nthenge (2020) highlights that revenue collection is a cornerstone of fiscal policy, constituting the largest share of government expenditure in Kenya. Taxation serves as a primary channel for revenue collection worldwide, but its effectiveness varies across nations. Kayaga (2007) observes that while developed countries have advanced taxation policies that bolster revenue collection, developing nations often struggle with inefficient tax systems, limiting their ability to maximize revenue potential. By addressing inefficiencies and modernizing tax systems, Kenya can better align its fiscal policies with its development goals.

1.5.5 Support for Small Businesses

Small businesses play a vital role in driving productivity, employment, and economic growth. Schumpeter (1934, 1942) emphasized their indispensable contributions to market economies, noting that small firms drive renewal by reshaping market structures and fostering innovation. They also serve as a crucial gateway for diverse groups, including women, minorities, and immigrants, to achieve economic inclusion and social mobility. To ensure small businesses continue to thrive, particularly in adapting to electronic tax systems, governments should provide both financial and technical support. Such assistance would not only help these enterprises comply with evolving tax regulations but also sustain their positive impact on macroeconomic growth and societal integration (Robbins et al., 2000).

1.5.6 Debt Management Strategy

The government should reassess its borrowing strategies to balance domestic and foreign borrowing while mitigating risks from rising interest rates. According to Gibet (2015), the National Treasury develops borrowing targets, including the fiscal balance, domestic financing, and external financing. The Medium-Term Debt Management Strategy prioritizes minimizing borrowing costs by focusing on medium-term domestic debt, which supports the development of the domestic debt market and reduces foreign exchange risk exposure. External non-concessional borrowing is restricted to high-return and infrastructure projects lacking concessional financing, with a preference for concessional loans to lower costs and refinancing risks. This approach aligns with long-term goals of budget sustainability and reduced exposure to volatile external markets.

1.5.7 Cost of Living Mitigation

Policies that alleviate financial burdens on citizens, such as subsidies for essential services and utility sector reforms, are critical for reducing economic pressures on households. As Tinson et al. (2014) highlight, most economic decisions by governments and firms significantly influence the cost of living. Trade policies, for instance, impact the price of imported goods, while planning policies affect land and housing costs. Government interventions can either increase or reduce the cost of essentials. Although indirect taxes, such as VAT and excise duties, may disproportionately affect low-income households, their impact is mitigated in some cases by exemptions or reduced VAT rates on essentials like food and energy. Additionally, the cost of essentials is shaped not only by domestic policies but also by global market dynamics, underscoring the need for balanced, well-targeted measures to shield vulnerable populations.

1.5.8 Improved Communication of Tax Policies

Simplifying tax regulations and enhancing public communication are essential for reducing misunderstandings and improving tax compliance. As Siahaan (2012) notes, effective communication—whether through speech, visuals, or writing—is a powerful tool for tax authorities. When taxpayers clearly understand how tax revenues are used to provide public services and are aware of audit mechanisms, they are more likely to comply voluntarily. Transparent, accurate, and timely information fosters trust by reducing uncertainty and increasing confidence in the tax system. Clear communication about tax policies and their benefits can significantly enhance public trust and encourage compliance.

1.5.9 Strengthen Academia-Industry Collaboration

Strengthening partnerships between academic institutions and industry players can ensure tax policies are grounded in practical economic realities and effectively address current challenges. Such collaborations leverage the complementary strengths of both sectors: academia offers advanced theoretical knowledge, a skilled talent pool, and cutting-edge research facilities, while industry provides resources, practical expertise, and market-driven insights to guide research toward actionable outcomes (Leydesdorff, Etzkowitz & Kushnir, 2016). These partnerships bridge the gap between theory and application, fostering innovation and creating policies that are both effective and relevant (Adenekan, 2023; Akili, 2012).

1.6 Conclusion

The Finance Bill 2023 presented a crucial opportunity for Kenya to address its fiscal challenges and create a more sustainable economic future. While the proposed reforms aim to enhance revenue generation, improve tax compliance, and address key inefficiencies in public spending, it is critical that the government maintains a delicate balance between short-term fiscal needs and long-term economic growth. The narrow tax base, largely driven by the informal sector, remains a significant hurdle in achieving revenue targets. The formalization of this sector and the improvement of tax compliance will be vital in expanding the tax base and ensuring that Kenya’s fiscal policies are more inclusive and equitable.

Furthermore, controlling government expenditure, especially through efficient procurement processes and reducing unnecessary spending, is essential to creating a leaner and more responsive public sector. Strategic debt management, coupled with better control over recurrent expenditures, will help mitigate the rising debt burden and ensure that Kenya's public finances remain sustainable in the face of global economic volatility.

As the country navigates these fiscal challenges, it is paramount that all stakeholders—government, academia, industry, and civil society—collaborate effectively. The involvement of academic experts and industry leaders in the policy-making process will ensure that tax reforms are informed by data-driven insights and grounded in real-world economic conditions. By fostering a culture of collaboration and ensuring that policies are communicated transparently to the public, the government can lay the groundwork for a more robust, resilient, and inclusive fiscal framework. In the end, the successful implementation of the Finance Bill 2023 will depend on the government's ability to balance immediate fiscal needs with long-term sustainability, while creating a tax system that is fair, efficient, and conducive to economic growth.

1.7 Call to Action

To address Kenya's fiscal challenges, the following actions are required:

(a) Enhance Public Participation in Tax Policy Formulation: To ensure more inclusive and effective policymaking, it is essential to involve a broader range of stakeholders, including professionals, academia, and civil society, in the process. Public consultations and discussions should be encouraged to gather diverse perspectives, allowing for a comprehensive understanding of the potential impacts of the proposed reforms. Engaging various groups in the policymaking process will foster transparency, build trust, and ensure that the reforms address the needs and concerns of all segments of society.

(b) Formalize the Informal Sector: To expand the tax base and improve tax compliance, it is crucial to develop strategies that integrate the informal sector into the formal economy. This can be achieved by providing incentives and simplifying processes to encourage businesses in the informal sector to formalize. Additionally, implementing digital solutions, such as a single user identifier, would enhance the ability to track economic activities more effectively, streamline tax collection, and ensure that all sectors contribute equitably to the economy. These measures would help address revenue gaps while fostering a more inclusive and efficient tax system.

(c) Promote Growth-Oriented Tax Policies: Tax reforms should be designed to incentivize investment, innovation, and job creation, ensuring that policies strike a balance between meeting immediate revenue needs and supporting long-term economic sustainability. To foster the growth of small businesses and encourage their formalization, targeted tax relief measures should be introduced. These reforms will create a more conducive environment for entrepreneurship, helping small businesses thrive while contributing to broader economic development and revenue generation.

(d) Improve Efficiency in Revenue Collection: Tax administration systems should be strengthened to enhance efficiency and minimize revenue leakages. Expanding the use of electronic tax systems is crucial, ensuring that they are user-friendly and easily accessible, especially for small businesses. This will not only improve compliance but also streamline tax collection processes, reducing administrative burdens while boosting overall revenue generation.

(e) Control Public Sector Expenditure: The government should prioritize rationalizing spending, especially in recurrent expenditures, while improving procurement processes to foster fiscal discipline. This involves directing resources toward projects that yield high social and economic returns, while reducing non-essential expenses. By focusing on strategic investments, the government can optimize its budget, ensuring that public funds are used efficiently to support sustainable development.

(f) Strategic Debt Management: The government should reassess its borrowing strategies to strike a balance between domestic and foreign borrowing, mitigating the risks posed by rising interest rates and currency fluctuations. Strengthening debt monitoring and control mechanisms is essential to manage Kenya's growing debt burden effectively. By implementing these measures, the government can ensure more sustainable debt management while minimizing financial risks and protecting the country's long-term fiscal health.

(g) Mitigate the Cost of Living Pressures: The government should implement targeted subsidies for essential services, such as fuel, food, and utilities, to alleviate the financial burden on households, especially in times of economic stress. Additionally, exploring reforms in the utility sector could help reduce costs and enhance affordability for citizens, ensuring that essential services remain accessible without straining household finances. These measures would provide immediate relief while fostering long-term improvements in the cost of living.

(h) Simplify Communication of Tax Policies: To improve public understanding and compliance, it is essential to use clear and accessible language when communicating tax regulations. Simplifying the language of tax policies will help ensure that they are easily understood by the general public. In addition, the government should develop targeted informational campaigns to raise awareness about new tax policies and their potential benefits, helping citizens understand how these reforms can contribute to the broader economic goals and their personal financial well-being.

(i) Strengthen Academia-Industry Collaboration: It is crucial to foster stronger partnerships between academic institutions and industry players to ensure that tax policies are grounded in empirical evidence and reflect real-world economic conditions. By encouraging joint research initiatives, the government can assess the effectiveness of tax reforms and make data-driven adjustments where necessary. These collaborations will provide valuable insights into the practical impacts of tax policies and help ensure that reforms are both effective and adaptable to changing economic dynamics.

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