POLICY DIALOGUES

# Fiscal Policies in Kenya: Effects on Poverty and Inequalities

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## PITCH

New research[1] analyzes the impact of fiscal policies by Kenya's government on both poverty and inequality, identifying tax and social spending actions that have the greatest potential to alleviate poverty and reduce inequality.

Most previous studies analyze the impact of fiscal policy on either inequality or poverty reduction but not both. Moreover, there is little evidence on the correlations between income inequality and poverty on the one hand and fiscal incidence on the other. Little is also known about whether fiscal measures have differential effects on income distribution and on the poverty level.

The new study analyses the welfare impact of tax and spending actions, and simulates the poverty and inequality effects of substantial increases in cash transfers.

## MOTIVATION

Since Kenya's independence, the government has pursued economic growth as its central strategy for reducing poverty and inequality. It has also committed itself to reducing poverty and inequality through fiscal policy.[2] Yet despite relatively high growth rates and vigorous use of fiscal policy instruments and other measures (including decentralization of fiscal funds), poverty and inequality have remained comparatively high.[3]

The rate at which growth has translated into poverty reduction has been lower than in comparable economies in Africa. For example, Kenya's growth elasticity of poverty reduction was 0.57 in 2015 – lower than in Ghana, Tanzania, or Uganda.[4] While the country's Gini index of inequality fell from 46.5% in the mid-2000s to 40.8% in the mid-2010s, indicating considerable progress, the level remained higher than in the neighboring countries of Ethiopia, Tanzania, and Uganda.

The study analyzes the impact of fiscal actions on both poverty and inequality, asking:

- How much income redistribution and poverty reduction are being accomplished through fiscal policy?
- How progressive are the government's taxes and social spending programs?
- How effective are taxes and social spending in reducing inequality and poverty?
- What could be done to improve redistribution and reduce poverty through changes in taxes and social spending?

## METHODS

The study uses a methodology developed by the Commitment to Equity (CEQ) Institute to analyze the impact of fiscal policy on poverty and inequality.[5] The CEQ assessment enables not only an examination of the redistributive effect of many tax and spending actions together but also the effect of a particular fiscal action.

The study analyzes 2015/16 data from the Kenya Integrated Household Budget Survey, collected by the Kenya National Bureau of Statistics, to carry out a detailed fiscal incidence analysis. In addition to survey information, administrative data on tax and spending from fiscal year 2016 are used to construct variables needed for incidence analysis, such as the per beneficiary amounts spent on public education and health services.

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**Keywords** Fiscal incidence, inequality, poverty, Kenya

**Geography** Kenya, East Africa

**Themes** Fiscal policy, inequality, poverty, economy

*Find out more about this project:** Fiscal Incidence, Inequality and Poverty in Kenya

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## RESULTS

The study finds that the government's fiscal actions (taxes and transfers) lead to a reduction in inequality. But they also lead to increases in both the headcount ratio (the proportion of people below the poverty line) and the poverty gap (the amount by which the income of the poor is below the poverty line).

The role of fiscal policy in reducing inequality in Kenya is among the strongest in the CEQ database. The combined effect of taxes and spending reduced the Gini coefficient by 20.8 percent. The public provision of education and health services leads to a notable reduction in inequality.

Transfers lead to a reduction in poverty, but direct and indirect taxes increase it noticeably. Consumption taxes are associated with large rises in poverty. The headcount ratio and poverty gap both increase from 0.318 and 0.091 at pre-policy disposable income to 0.369 and 0.109, respectively, at post-policy consumable income.

The effect of indirect taxes on increasing poverty is far larger than that of direct taxes. For example, direct taxes worsen the poverty headcount ratio by 0.5 percentage points while indirect taxes worsen it by 5.1 percentage points. The combined effects of taxes and spending lead to an increase in the headcount ratio of 17.9% as the economy moves from market income to the consumable income generated by fiscal actions.

The main outcome is that direct taxes like PAYE, the income tax on profits, and pensions are highly concentrated among the richest households. This is explained by the fact that individual direct taxes are mainly collected from workers in the formal sector, who tend to be better paid than those in the informal sector.

The study has three striking findings on the effectiveness of taxes.

First, direct taxes reduce inequality (by 4.1 percentage points) and increase headcount poverty (by 1.4 percentage points). On the other hand, indirect taxes reduce inequality by 0.8 percentage points and increase poverty by 5.1 percentage points.

Second, VAT effects (direct and indirect) and import duties (indirect effect) are concentrated among the rich. These fiscal actions lead to a reduction in inequality and an increase in poverty.

Third, excise taxes contribute small amounts of revenue, and thus have small effects, in either direction, on poverty and inequality.

The government has introduced several cash transfer schemes to cushion the economic burden on particular social groups, such as older people, vulnerable children, and individuals with severe disabilities.

The study finds that these direct cash transfers are pro-poor or progressive and are well targeted. They reduce poverty and inequality.

Although all the individual cash transfers disproportionately go to the poor, their aggregate effects are surprisingly close to zero for both inequality and poverty reduction. Arguably, this situation is attributable to the small sizes of the transfers.

Both publicly funded healthcare and basic education are progressive and strongly reduce both inequality and poverty. Primary schooling benefits have the greatest impact on inequality reduction and poverty alleviation. Whereas the benefits of tax-funded basic and college education are progressive, the benefits of higher education are regressive.

## RECOMMENDATIONS

- Fiscal policy in Kenya could be redesigned to tackle both inequality and poverty. Actions in three broad fiscal measures could be pursued towards these ends.
- First, since indirect taxes increase poverty, items used predominantly by low-income households (such as kerosene) could be taxed at a lower rate or zero-rated.
- Second, the progressivity of cash and near cash transfers could be enhanced by improving coverage and increasing the amounts disbursed.
- Third, increasing the amounts of cash transfers without increasing the number of beneficiaries is unlikely to reduce poverty and inequality.

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[1]This Policy Dialogue is based on a study titled: *Fiscal Incidence, Inequality and Poverty in Kenya: A CEQ Assessment (2020)*

[2]World Bank. (2018). *Kenya Economic Update: Policy Options to Advance the Big 4.* Washington, DC: World Bank Group.

[3] The decentralized funds include the Constituency Development Fund (CDF), the Local Authority Transfer Fund (LATF), and cash transfers to vulnerable groups.

[4]*Ibid*

[5]For more details visit [www.commitmentoequity.org](www.commitmentoequity.org)

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