# EFFECT OF CORRUPTION IN PUBLIC PROCUREMENT ON TAX REVENUE IN KENYA: A LITERATURE REVIEW

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**Abstract**

Taxation is one of the main ways through which a country finances her budget. This study focused on Value Added Tax (VAT) and it focused on the suppliers who take part in public procurement and, thus, are required to remit VAT for their goods. The objective of the study was to determine the effect of corruption in public corruption on tax revenue in Kenya. The study followed a desktop research design. The paper suggested that as long as there is corruption by procurement officials and other public officials, the government should consider doing away with charging VAT on its procurement goods and services and instead concentrate on buying goods at the recommended retail or wholesale price, arguing that any tax levied on their supplies ends up making the government not only lose the intended tax levy but also some extra money from its own funds.

**Keywords:** Kenya, Public procurement system, bribery, kickback, taxation, VAT

**JEL Classification:** G38; H72

## 1. Introduction

In order to fund the provision of public goods and services and to maintain the social and economic well-being of its residents, a government must compel its citizens to pay a tax (Kwabe, 2020). The

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amount of money obtained by taxing is referred to as tax revenue (Macharia, 2014). Taxation is a key weapon used by governments to promote economic growth and development. It enables a country to implement macroeconomic goals in the domains of monetary and fiscal policy resulting in a forced transfer of funds from people and organizations to the government (Macharia, 2014).

Most countries use taxation as one of the methods of financing their expenditure. It is a major contributor towards a country's revenue. There are many types of taxes which the government can impose on its citizens, and these include income tax, corporate tax, customs tax, sales tax, and Value Added Tax (VAT) among others. In an attempt to boost the productivity of the tax revenue, the Kenyan government has made significant investments in the enhancement of the tax system through the modernization of tax legislation and automation of tax administration. This has born fruits as evident from the fact that the country saw ordinary revenue increased gradually over time, going from Ksh. 682 billion in 2011/12 financial year to Ksh. 1.56 trillion in 2020/21 financial year. Despite the absolute growth, the growth rate has been decreasing over the years (RoK, 2022).

Government spending is greatly influenced by government revenue. Because of this, governments are eager to cut their recurrent expenditure, raise tax revenues, or take on additional debt in order to fund both recurring and non-recurrent expenses (Kithinji, 2019). This study will mainly focus on VAT which was introduced in Kenya in 1990 to replace sales tax because the latter was perceived to be retrogressive and did not provide for the deduction of input tax on businesses (GoK, 2022). Although there are many players in business who by law are bound to pay this type of tax to the government, this study will focus on the suppliers who participate in public procurement and who by extension are supposed to remit VAT for taxable supplies.

In Kenya, the procurement industry is still important since it has a big impact on people's lives and takes up a lot of budgetary resources. In the words of Manyara (2016), procurement in Kenya accounts for 45% of the total budget. The common practice in Kenya is that when a government entity procures goods and/or services from a supplier, the supplier is required by law to pay tax. The supplier acquires goods at their cost price and then adds his/her markup so as to determine the selling price of his goods. Then, in order to determine the price at which s/he should sell the goods to the public procuring entity, s/he adds 16% VAT to cover the tax which the government will tax on the sale of the goods.

The paper objective was to determine the effect of corruption in public corruption on tax revenue in Kenya. The structure of the paper entails examining the status of corruption in Kenya, her effectiveness in achieving tax targets, and the empirical review of literature related to the topic. The paper also presents a discussion and general observations, and conclusions and recommendations.

## 2. Situation on Corruption and Tax Revenue in Kenya

### 2.1. Corruption

In Kenya, corruption is rampant and a major issue in all spheres of the economy (Mutangili, 2019). The country has continued to register a worrying trend as far as her Corruption Performance Index (CPI) ranking over the last ten years is concerned. Table 1 below shows Kenya's CPI over the last ten years.

**Table 1**

**Kenya's CPI Over the Last Ten Years**

| Year | Rank | Score/100 /180 |
|---|---|---|
| 2022 | 123 | 32 |
| 2021 | 128 | 30 |
| 2020 | 124 | 31 |
| 2019 | 137 | 28 |
| 2018 | 144 | 27 |
| 2017 | 143 | 28 |
| 2016 | 145 | 26 |
| 2015 | 139 | 25 |
| 2014 | 145 | 25 |
| 2013 | 136 | 27 |

*Source: Statista (2022)*

Kenya's CPI greatest score in the last ten years is 32, (in 2020) which is the highest score ever. Kenya's score was 28, 27, 28, 31, and 30, correspondingly, according to the 5-year trend study from 2017 to 2021. The country's CPI fluctuated between 25 and 28 from 2012 to 2019, which is a blatant sign that corruption is out of control there. The average grade for Sub-Saharan Africa is 33, and the average rating worldwide is 43 (Transparency International, 2022). All these statistics point to one thing, corruption is high in Kenya, and the vice has spread its roots far and wide, public procurement being no exception.

Studies have indicated that there is a lot of corruption that occurs in the event of public procurement. It is one of the government operations that is most susceptible to fraud and corruption, according to EACC (2015*).* Often, this vice is initiated by procurement officers although sometimes Finance officers' shadows also appear on the shared cut. Corruption has been known to take forms. According to a report by Hawkins, Gravier and Powley (2013), comparing public and private sector procurement ethics and strategy in the US State Department, fraudulent practices typically occur during the supplier selection and contract administration stages and involve internal control activities, monitoring, and setting.

From Kimanzi's (2019) point of view, unethical behaviour is highly preferred in public organizations, and it typically occurs during the selection process, as seen by pressure from management to give contracts to particular vendors. The research claims that there is extensive price-inflating collusion between procurement workers and suppliers. There have even been several instances when procurement officials have insisted on only doing business with specific suppliers. Additionally, procurement officers may collude with suppliers to influence tender awards, suppliers may manipulate tender prices in their favour, and they may accept gifts and kickbacks from suppliers to influence bid decisions. This unethical or fraudulent behaviour may also include procurement officers accepting gifts and special treatment from suppliers to contractors, including expensive tours and lunches (Mkaliloto, 2015; Manyara, 2016).

Manyara (2016) argues that it is important to recognize the true costs of corruption in Kenya's public procurement system. According to EACC (2015) estimates, bribery and kickbacks in government contracts increase the overall cost of the deal by 10% to 20%. The majority of companies (53%) use bribes to obtain contracts, and 6–10% of the tender values are used for illicit payments. According to Manyara (2016), estimates of the losses brought about by procurement malpractice fall somewhere between 10 and 25 per cent of contract value and this is often due to poor processes. In this study, corruption will be looked at in two aspects: kickbacks and bribes made in advance so as to secure a contract or tender.

In most cases, procurement fraud involves top leaders or procurement staff who have personal ties to the seller. Bids are tampered with by using unreliable sellers, sometimes the sellers' costs or fees are increased by as much as between 40 to 100% over the stipulated prices market prices. Of concern is the realization that top organization leadership or buying staff are inactive partners of suppliers; and that money from bribes or kickbacks is typically estimated to account for 15 to 25% of each contract that is awarded (Manyara, 2016). This assertion is supported by Narasimhan (2012), who noted that although most kickbacks take the form of a 15 to 20 per cent cash payment of the granted contract, they can also take many other forms, such as the extension of additional personal favours to the buyer in order to be chosen.

According to the Inter-American Center of Tax Administrations (CIAT, 2019), people pay bribes to avoid paying taxes, for example through tax loopholes created in exchange for unlawful kickbacks-commissions, hence the most corrupt governments get less tax revenue. One of corruption's most harmful repercussions, in addition to the direct economic cost of revenue loss, is the erosion of faith in institutions, which undermines the strategy of promoting voluntary compliance with tax duties.

Despite the stringent laws in public procurement, it is believed that there would still be more corruption in public institutions than in private organizations (Mohamood, 2015). This could probably be because the perpetrators feel that those organizations don’t belong to anyone, hence they don’t feel answerable to anybody. In most cases, the supplier or contractor is typically granted a contract over market value, and the procurement staff receives money, materials, or other benefits in exchange for awarding the contract. A supplier may offer a variety of goods or services to a company during the inspection stage, including raw materials, goods manufacturing, transportation, logistics, independent sales and distribution of products, warehousing, consulting, or other substandard services that are still approved because procurement staff conspired with the vendor (Nyanguthii and Oyugi, 2013).

### 2.2. Government Taxation

Kenya’s tax system has several difficulties that negatively affect revenue collection. For instance, despite the significant investment made by the government to modernize the tax system, Kenya’s revenue yield is still below the intended East African Community (EAC) objective of 25% of the Gross Domestic Product (GDP) necessary for the EAC Monetary Union. This pattern brought to light the fundamental problems with the tax system, such as rising tax expenditures, the complexity of taxing expanding economies, international tax disputes, and poor taxpayer compliance (GoK, 2022).

There are two most relevant tax policies on which the arguments in this study are based. These are administrative efficiency, and economic growth and efficiency. By administrative efficiency, it means that the cost of compliance by taxpayers and the administration cost to the Revenue Authority should be kept at a minimum level as much as possible. By economic growth and efficiency, it means that the tax system should be coherent with other Government policies and support sustainable economic development (GoK, 2022).

This paper aims to review the scholarly literature on the effect of corruption in public procurement on tax revenues. This review is based on Agency theory by Jensen and Meckling (1976). This theory tries to expose the problem that exists between principals and their agents. The theory argues that there exists a conflict of interest between the principals and the agents. Under this theory, the principals expect agents to act in the best interests of the agents. In the context of this study, the principal is the government while the agents are public procurement officers and other officers involved in the procurement process. It is perceived that if the procurement officers act professionally, corruption would be a thing of the past and in that case, the government will not lose money even if it charged VAT on its procurement.

### 2.3. Empirical Literature

Aghion et al. (2016) voiced the link between taxes and growth and the relationship between taxation and corruption, taxation has a deterrent effect on business owners, but public infrastructure has a favourable impact on them. The key finding of their model was that there is an inverted U connection between taxation and growth, with corruption lowering the optimal taxation level. This finding is crucial to the idea that taxes are bad for growth.

Baum et al. (2017) conducted research on taxes, compliance, and corruption. The IMF-compiled dataset for 147 countries covering the years 1995–2014 served as the study's foundation for analysis. The development of sizable taxpayer offices enhances tax compliance by reducing the perception of corruption, hence improving revenue. It was found that corruption is negatively related to overall tax revenue and most of its components.

According to research done by Piff et al. (2012) on the factors influencing ethical standards in the United States of America (USA), upper-class people behave more illegally than those of lower social classes, and their immoral views encourage unethical activity in public sector procurement.

To examine corruption perception and attitude towards taxation in Africa, using data from the Afrobarometer polls conducted in 36 African nations between 2011 and 2015, Boly (2021) looked at how attitudes about paying taxes were affected by perceived corruption as a proxy for the quality of government. The study produced enough evidence to support the hypothesis that reported attitudes about taxes were negatively impacted significantly by perceived corruption in the president's office. The paper claims that enhancing public opinion of the president's office's governance effectiveness can aid in fostering more favourable views about taxes, leading to an increase in tax collections.

The Impact of tax administration and revenue on economic growth in Nigeria was examined by Ogbonna and Appah (2016). In order to get pertinent information, the investigation led to the collecting of primary and secondary sources. To determine if there was a correlation between the dependent and independent variables, 50 employees were chosen as a sample. According to the findings, there is a significant correlation between per capita income and personal income tax revenue, corporate income tax revenue and Nigeria's GDP, per capita income and VAT revenue, per capita income and petroleum profit tax revenue, and Nigeria's GDP. Therefore, the study draws the conclusion that, throughout the study period, tax administration and revenue did have an impact on Nigeria's economic growth.

Kwabe (2020) became interested in researching how taxes affect Nigeria's economic development. The goal of the research was to determine how Nigeria's actual gross domestic product will be affected by the petroleum profit tax and corporate income tax. The study used an ex-post factor research methodology, and the ARDL (Auto Regressive Distributed Lag Model) was used to analyse the data. For the time span covered by the analysis, the petroleum profits tax was determined to have a long-term, substantial positive connection with gross domestic product.

The effects of corruption on tax compliance and taxation In Pakistan were assessed by Khan, Safdar and Elahi (2021). The study's goal was to examine the impact of corruption on tax compliance, tax revenues, and the impact of corruption in various tax categories in Pakistan from 1984 to 2018. The findings indicated that while corruption lowers all tax receipts, some taxes are more negatively impacted. According to the study, stronger governance, a larger proportion of direct taxes, and more female labour force participation all lower corruption while public investment raises it. The results suggest that in order to lessen the likelihood of rent-seeking, the government must restrict the use of administrative power to obstruct economic activity.

The relationship between tax revenues, the impacts of corruption, and governance in West African Economic and Monetary Union (WAEMU) countries was analysed by Dramane (2022). On a panel of seven nations from 1996 to 2017, the study developed an econometric model utilizing three pertinent methods: the fixed effects technique, fixed effects with sample heteroscedasticity correction, and the instrumental variables approach. The results demonstrate that in WAEMU nations, good governance has a favourable impact on tax collections whereas corruption prevents tax revenues from rising.

In Sub-Saharan Africa, Jahnke and Weisser (2019) investigated how small corruption affects tax morale. The study gathered enough evidence from micro-level data from the Afrobarometer to demonstrate that petty corruption degrades tax morale and that the effect is more pronounced in nations and regions where fewer people are affected by petty corruption and loses significance if extortion of bribes is particularly pervasive. By using a mediation analysis, the study showed that petty corruption not only has a direct impact on tax morale but also undermines trust in tax officials and hence has an indirect impact on tax morale.

Hamoonga (2018) studied how Zambia's economy was affected by corruption in the country's public procurement system. The study's major goal was to determine how corruption in the procurement process affected a country like Zambia's economy. Data for the survey study were gathered by questionnaires given to 165 respondents and 8 interviews, who were senior officers, junior officers, and other departmental support workers. According to the study, corruption in the procurement process raises consumer prices, decreases investment, donor agency commitments, and foreign direct investment, affects governments' capacity to cover budgetary expenses, and slows down economic progress.

Chariye (2016) investigated how much tax morale among corporate organizations in Addis Ababa, Ethiopia, was impacted by corruption. 500 company profit taxpayers who were chosen using a stratified random selection approach for this study were surveyed. The pertinent data were gathered using a structured questionnaire and then analysed using the Probit model. According to the study, corruption and tax morale are inversely associated. According to the report, most public officials take bribes and indulge in corruption, which makes the public believe that their taxes are not being used wisely and that they are not protected by the laws intended to combat corruption.

In Mogadishu, Somalia, Mohamed, Ebar and Ramli (2022) looked at how corruption and governance affected tax income. The findings showed that the regulatory burden and lack of political stability have a major impact on the tax revenue of public sector firms.

Mutangili (2019) conducted comparative research using Kenya and Tanzania as the benchmarks for comparison to highlight integrity in public procurement and combat corruption. The study employed a desk study review technique, reviewing pertinent empirical literature to find key themes. The study came to the further conclusion that while laws and institutions are crucial since they establish requirements for behaviour and set penalties for disobeying them, they are insufficient on their own.

In a study on corruption in the public procurement process in Kenya, Nyambariga (2016) found that suppliers in public institutions fuel procurement fraud by giving bribes to the officers in charge of the selection and tendering committees in order to gain preference in contracts worth millions of shillings.

Zallé (2022) found satisfaction in researching the connections between reliance on natural resources, corruption, and the collection of tax money. The study's goal was to examine the dynamic relationships between reliance on natural resources, corruption, and the collection of tax revenue on a global scale. A technique called cross-section augmented autoregressive distributed lag (CS-ARDL), which takes into consideration temporal dynamics, cross-sectional heterogeneity, and cross-sectional dependency, was employed to accomplish this goal. The study's conclusions demonstrated that, in contrast to overall tax income, lowering corruption encourages the mobilization of non-resource tax revenue. The study did note, however, that tax revenue mobilization might occasionally be a source of corruption and rent evasion from natural resources. To prevent exploitative and rent-seeking conduct, tax administration mechanisms must be reinforced.

According to EACC (2022), corruption skews economic judgment, discourages investment, erodes competitiveness, and ultimately impairs economic growth. Kenya's underdevelopment, poor public service delivery, sloppy project implementation, widening of the gap between the affluent and the poor, and significant loss of public monies are all consequences of corruption.

While acknowledging that corruption has a significant negative impact on the amount of tax revenue that is collected in a nation, Transparency International (2010) quickly notes that the current understanding of the relationship between corruption and tax revenue is incomplete because there is a lack of data on how taxes affect corruption. Few studies, if any, have attempted to investigate the relationship between kickbacks as a type of corruption and its overall impact on tax revenue collection.

In 2019, Kithinji (2019) examined how taxes affected Kenyan government spending. The study's goal was to determine how taxes affected Kenyan government spending. In order to ascertain the impact of tax revenue on government spending and the connection between tax revenue and government spending in Kenya, this study used a causal research approach. The National Bureau of Statistics was contacted for secondary data covering the years 2004/05 to 2010/2011. Descriptive statistics and a regression model were used to evaluate the data. The study found that government revenue greatly affects government spending, and it was advised that for the government to be able to cover both recurring and non-recurrent expenses, it should either lower its recurrent spending, boost tax revenues, or borrow more.

In a study on taxation and revenue stability in Kenya, Muraya (2013) regressed revenue instability against revenue diversification, revenue capacity, and economic base instability and found that, while exogenous variables had an impact on revenue instability in the long run, only economic base instability had a significant impact. Muraya concluded that there was no short-run relationship between revenue instability and the independent variables.

Macharia (2014) was interested in how tax evasion affected Kenya's tax receipts. Investigating how taxes are avoided, examining the consequences of tax evasion on tax revenues, identifying controls for tax evasion, and determining whether there is a connection between tax evasion and rates of tax in Kenya were the major goals of the study. The Kenya Revenue Authority's investigation of 50 tax evaders was the focus of the research. The analysis clearly showed that overall tax evasions had a negative but considerable impact on Kenya's tax collection.

Manyara (2016) conducted a study on the corruption in Kenya's public procurement system, concentrating on the Ministry of Devolution and Planning. The study's goals were to identify the causes of corruption and determine the degree to which it influences Kenya's public procurement system. Using a proportional stratified sampling technique, a sample of 41 workers was chosen and permitted to take part in the survey. According to the study, corruption was significantly influenced by collaboration, payment, pressure from management and society, social position, and protection.

## 3. Discussion and general observations

From the aforementioned literature, it is evident that there is a lot of corruption which goes on in public procurement. The fact that procurement officials charge as high as 40% kickback is indicative of how the vice has gained root and that many suppliers are competing to get an opportunity to supply to the government. It is also regrettable that some suppliers themselves participate in the corruption by inflating the actual selling price up to twofold.

Going by the fact that the procured goods and/or services are already overpriced by a percentage which is greater than the VAT charged on them (to meet the cost of the cut and maybe the sellers' abnormal profit margin), it follows that the government incurs a net loss. For instance, let us assume a supplier acquires goods at their cost price and then adds his usual markup so as to determine the selling price of his goods. Then, to determine the price at which s/he should sell the goods to the public procuring entity, s/he adds 16% VAT to cover the tax which the government will tax on the sale of the goods. For instance, if the supplier intends to sell goods for KES.100, he needs to include 16% that he will be required to pay the government as VAT, making the selling price KES. 116.

In a case where the accountant, procurement officer or any corrupt other public officer demands a certain percentage as a kickback, this is also often considered when the supplier is calculating the selling price of the commodity, and this is usually a percentage of the value of goods procured (which in itself consists of the selling price inclusive of VAT). Using the illustration above, KES. 116 forms a basis on which kickbacks are calculated since, to the procurement officers, the organization will pay for the good at this price. Assuming a minimum kickback of 15% as documented by Manyara (2016), this means the price will be inflated by KES. 17.40. Hence the government will buy the goods at KES. 133.40. The actual VAT to be deducted at 16% will be calculated at this inflated price, yielding KES. 21.34. Notice that the government has paid an inflated price of KES. 133.40, and it will receive a tax of KES. 20.62. clearly, there is a loss of KES. 12.06 (KES. 33.40 less KES. 21.34). This loss can be mitigated if the government buys the goods at the recommended or prevailing retail price since in most cases the price is readily available and known in the public domain.

Worth noting is the fact that the loss gets bigger when the percentage of kickback increases, or when the supplier decides to charge abnormal profit margin since he knows the procurement officer is also unfairly benefiting from the sale. Moreover, the government loses more in situations where the procuring entity pays for procurement items but either fails to remit tax or pays after a long period of time. For example, it was brought to the limelight in 2023 that some 11 cash-strapped public universities in Kenya owed the government over KES. 9 billion in tax arrears, accumulated over several years, and this led to the freezing of their accounts for some time and the request for tax exemption. This money was in essence 16% VAT for some goods and services procured and which the government paid for, but the tax was and has not been realized.

## 4. Conclusions and recommendations

Judging from the findings of this study, it is recommended that, as long as there is corruption by procurement officials and other public officials, the government should stop charging VAT on its procurement goods and services and instead concentrate on buying goods at the recommended retail or wholesale price. Since such prices are always in the public domain, it will be a bit difficult for procurement officers and suppliers to collude and inflate prices.

Further, there is no reason for the government to pay for a unit of goods at a price inclusive of VAT, and then require the officers to deduct VAT at source since this may also result in delayed remittance of the VAT back to the government. It is worth noting that, delayed remittance back to the government makes money not only to lose value but also delay some projects which could have otherwise been immediately funded with the money. This means that government projects can be started and completed earlier (*ceteris paribus*) since the time lapse between when it pays for procured items and when it collects VAT will be eliminated altogether.

It is also recommended that, by doing away with taxation on public procurement, a country will not only eliminate the complexity of taxing but also eliminate rising tax expenditures resulting from audit. Hence, the government is likely to improve the principle of convenience and the principle of administrative efficiency of tax. It breaks the principle of Convenience (because it adds VAT to the cost of goods and then it gets deducted by the same source hence double work). It also breaks the principle of administrative efficiency in the sense that, in the event of the government paying VAT on the inflated price, it fails to produce the highest possible yield at the lowest possible cost both to the tax authorities and the taxpayer.

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