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TAX REFORM AND INDUSTRIALIZATION
POLICY:A COMMENT ON RECENT
DEVELOPMENT IN KENYA*

by

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* I have benefitted from discussions with J.K. Atchley, Richard Porter and Bernard Wasow.

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ABSTRACT

This paper examines the relationship between current tax reforms - introduction of the Sales Tax, and abolition of G.P.T. and some consumption taxes - and reform of the industrial protection system. The arguments for industrial protection are briefly outlined and the need for reforming the the Kenyan system is discussed. It is concluded that the tax reform is likely to have a beneficial effect on employment and will reduce inequities in the tax system. The effect on the protection system will be neutral with some exceptions. For protection reform the further step of some sort of export subsidy is necessary, with liberalization of the import licensing system.

Current (May 1973) steps in the direction of tax reform appear designed to increase the rate of growth of tax revenues and to provide, within a larger framework of reform measures, more effective incentives for industrial growth. The former is a means of raising public saving for a more rapid rate of economic growth within acceptable limits of dependence on foreign aid and capital import. The latter is a means, at least in part, of accomodating to the inability or unwillingness of Kenya's East African partner states to agree on reform of tariff and trade policies which have important implications for Kenya's industrial growth.

This paper focuses on the latter of these two objectives - the relationship of current tax reform to reform of the industrial protection system. The first section is a brief review of the arguments for industrial protection. The need for reform of Kenya's protection system is argued in the second section. The implications of the current tax reform for industrial protection and some speculation about steps for further reform are set out in the final section.

1. WHY INDUSTRIAL PROTECTION?[1]

A policy of industrial protection arises from the need for industrial growth, together with the existence of obstacles to industrial growth. The need for industrial growth arises from the relationship between population growth and natural resources. For some time to come, of course, the bulk of new employment opportunities must be found in agriculture, but this will become increasingly difficult as population grows. At some not too distant future time in Kenya, land will be more critically scarce than it is today. It is important, long before that point is reached, to create a capacity for employment in sectors other than those based on natural resources. This will take time. Even with moderately rapid expansion, the industrial sector cannot become a major employer within the next decade yet, during that time, the labour force will grow by forty per cent.

The Kenya Government, quite rightly, makes rural development agriculture and rural industrialization a principal concern. What is needed is not a shift of that emphasis nor a shift of resources to industry. Instead,

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1. For a fuller discussion, see the author's "The Role of Protection in Industrialization Policy," Eastern Africa Economic Review, June 1972.

what is required is the removal of unnecessary constraints, some institutional and some result of misguided policies. I will return to this point shortly.

Industrialization should begin early, and it is important to begin it right. It would be disadvantageous to neglect industrialization until land became a critical bottleneck, and then try to launch a massive industrialization drive; it would also be disadvantageous to bias policies toward import substitution and then, when such opportunities are exhaused, suddenly shift to an export bias. It would be equally unwise, within an import substitution strategy, to emphasize only the finishing stages of consumption goods manufacture before attempting backward integration - import substitution in intermediate and capital goods. Such biases force sub-optimal choices, distort structural patterns and create vested interests; subsequent required shifts in policy would be both painful and difficult. Rather, policies must be found that encourage the best choices among all of the available opportunities without bias toward either early or finishing stages in the production process, consumers goods or capital goods, exports or import substitutes, etc. A country that makes the best selective use of its opportunities in each of these areas, will do better than one that follows a particular bias (strategy?) in one direction or another.

While this principle will hardly be disputed, it begs the question: what is a bias?; and to answer that question fully might require a treatise. But most of us can agree, I think, that there are identifiable situations in which relative prices and costs are distorted without apparent rationale. Distortions arise from institutional sources, from misguided government policies, or both, circumstances which can reinforce as well as offset each other's effects. From whatever source, price and cost distortions prevent the economy from achieving its goals efficiently and limit both output and growth. The problem of industrial protection is, then, to correct market failures due to imperfect institutions with a minimum of additional distortion from government policies.

Other possible goals of industrial protection are balance of payments equilibrium or avoidance of a foreign exchange constraint. These require improved incentives for the production of traded goods (import substitutes and exports) vis a vis non-traded goods and are most simply and efficiently accomplished by an exchange rate adjustment. (A uniform change in all tariffs combined with export subsidies would be roughly equivalent). By contrast, increased tariff protection alone (or import bans and licensing)

produces a biased effect, like a multiple exchange rate system, and causes the economy to use more resources than needed to balance the foreign exchange budget.

More important, tariffs and import controls confine protection to the limited domestic market and thereby constrain growth; in contrast, a rise in the price of foreign exchange protects local industries in both domestic and foreign markets. The latter would promote industrial exports and import substitution industry, opening the way for more rapid industrial growth and avoiding the excessive costs of an industrialization based on the narrow domestic market.

The argument that devaluation as compared to import restriction, implies a terms of trade cost is not valid. The terms of trade effect is one of those market failures that needs to be corrected whatever the exchange rate. As I have argued elsewhere,[2] this calls for special treatment for a few important exports and, at most, a very modest bias against the rest. Once these are taken care of (and it should be done whether the balance of payments is in equilibrium or not), devaluation (or equivalent) is the superior remedy for a balance of payments deficit. Any further tightening of import restrictions would raise the bias against exports above the optimal level. A balance of payments policy should be used to avoid a balance of payments constraint, not for industrial protection.

The need for industrial protection arises, rather, from the existence of market failures; the most important tasks in framing protection policy are to identify them and to evaluate their magnitudes. The latter is a very difficult task, requiring a great amount of specific information beyond the scope of the discussion here. Nevertheless, it is extremely important from the standpoint of rational planning that the government attempt to obtain the necessary facts: what is an appropriate shadow price for unskilled labour? for capital? for the exchange rate? What is the potential for cost reduction from scale expansion or learning-by-doing in different industries? I note that it would be far easier to get reasonable answers to these questions under a regime of policies which minimise additional price distortion.

With respect to the identification of market failures, they can be classified according to their origin: foreign, domestic-institutional, and domestic-policy. The last of these reflects a need for reforming protection rather than a need for protection itself.

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2. Power, op.cit., p. 11.

It is widely recognized that world markets do not operate ideally to facilitate industrialization in less-developed countries. Protection systems in virtually all countries are biased against the import of processed and finished goods, as opposed to raw and semi-processed. In addition, there is a tendency for reactive protectionism against successful efforts of less-developed countries to penetrate the rich countries' markets for manufactured goods. These are serious disadvantages; but so far they have not been decisive for those countries that have avoided their own biases against industrial exports. Recent history suggests that any less-developed country (if small) could expect a high degree of success from "unleashing" its own export potential. This may be true, of course, only because so few have tried it. But this is an element in the situation that is likely to persist. Kenya's small size and good start in this direction (despite strong domestic policy and institutional biases against it) portend success.

But even with the best prospects in the world a country will only succeed in developing a flourishing export trade if its policies favor such a development. One reason is that there must always be considerable risks in opening up export markets - most of them risks facing the individual firm - and if governments pursue policies that make exporting more difficult, then private firms will be correspondingly more reluctant to incur these risks. Since private entrepreneurs tend in general to exaggerate these risks it is the more necessary that governments, which can assess the risks more realistically, should not do anything to discourage exporting but rather pursue policies which minimize their apprehensions and thus encourage them to take the risks. Governments must therefore, if anything, subsidize exports rather than penalize them.

In contrast, a bias toward import substitution tends to increase dependence on a few primary exports, increasing the social risk from exporting manufactures because, while all exports are penalized by protection for import substitutes, primary exports can often remain competitive because of their lower wage and other costs. Moreover, factor prices in primary production are usually flexible (even downward) so that incomes earned there tend to adjust to the combined offer of the world market and negative protection.[3] In contrast, industrial exports are inhibited by relatively higher wage rates (inflexible downward) by negative protection.

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3. For an explanation of negative protection, see Power, op.cit., pp. 12-14.

A single small country like Kenya has, of course, little independent influence on world obstacles to industrialization. Only through joint action with others could appreciable influence be exerted. The one important exception to this generalization is the terms of trade effect of increasing exports. But, as was indicated above, the solution to this problem is not import substitution protection which creates a general bias against all imports. What is needed, rather, are specific policies (possibly including international commodity agreements) for those few exports whose terms of trade effects are important.

With respect to domestic institutional market failures, the most important for Kenya is wage dualism - a market wage in the industrial sector far above earnings of labour in agriculture and other non-industrial activities. This means that primary products can be exported in substantial volume at an exchange rate at which most industrial products cannot compete in world markets. It appears if one accepts market prices, that Kenya has a comparative advantage in primary products and a comparative disadvantage in industrial products. While this is doubtless true in some cases, it is likely to be false in others, owing to the general bias against industrial products created by the distorted wage structure. Kenya ought to have a comparative advantage in a wide variety of labour-intensive manufactures; yet the price system is not allowed fully to reveal this. Instead, industrial exports are made to appear unprofitable and production for the home market is possible only behind protection. It should be added that wage dualism is a case of market failure where Kenya's policies have exaggerated rather than diminished the bias.

The infant industry situation is another well-known example of market failure. Economies of scale and a learning process combine to suggest that long-run comparative advantage may be masked by temporary high costs during the early stages of development of an industry. It can be argued, of course, that private investors can see this circumstance as well as the government. The case for government assistance in such cases turns on a denial of this argument, on the government's placing a relatively higher value on long-run advantages, or on recognition of imperfections in capital markets for private investment. In any case, market failure is not confined to industry; it applies equally to some new agricultural industries and to some new technologies in old agricultural industries. Nevertheless, it can be considered an important reason for temporary assistance to selected manufacturing industries. As we shall see below, however, the traditional remedy of tariff protection or import restriction is not appropriate.

Finally there is interdependence of investment decisions which, especially when combined with economies of scale, can often cause social profitability of investments to diverge from their apparent private profitability.[4] Under these circumstances there is an important role for government influence on private investment decisions. Again, however, the remedy of protecting the home market is inappropriate, because it inhibits the exploitation of scale economies and discourages potentially profitable inter-industry linkages.

In sum, there are market failures, of foreign or domestic institutional origin, that would bias investment away from the industrial sector - in the absence of policy measures to counteract them. It is suggested, however, that the traditional form of industrial protection - tariffs and import restriction - are in most cases not the appropriate remedy.

2. THE NEED FOR REFORM.

The need for reform of Kenya's protection system has been the subject of a number of recent papers and seminars at the Institute for Development Studies; the topic is emphasized also in the report of the ILO Employment Mission to Kenya.[5] What follows is a brief recapitulation of the main points at issue.

Industrial protection in Kenya takes the form, principally, of tariffs and restrictions on imports through licensing or outright bans. This means that industries are protected in the home market, but not in the world market. This is not surprising since "protection" has traditionally been viewed as protection of the home market. The modern concept of protection is broader, however, including all of those measures that give home industries an advantage, in any and all markets, over their foreign rivals.[6] Japan, Germany and other

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4. See H. Chenery, "The Interdependence of Investment Decisions," in M. Abramovitz, et. al., The Allocation of Economic Resources, Stanford University Press, 1961.

5. M.G. Phelps and B. Wasow, "Measuring Protection and its Effects," IDS Discussion Paper No. 147 (forthcoming); P.N. Hopcraft, "Toward a Protectionist Economy?," IDS Working Paper No. 29, March 1972; S.R. Lewis, "The Effects of Protection on the Growth Rate of the Economy and on the Need for External Assistance," IDS Discussion Paper No. 140, April 1972; R.C. Porter, "Toward an Export Policy for Kenya," Working Paper No. 105, May 1973; J.H. Power, o Op.Cit.; International Labour Office, Employment, Incomes and Equality: A Strategy for Increasing Productive Employment in Kenya, 1972, especially chapters 11 and 17.

6. Little, Scitovsky and Scott have preferred to call assistance given to export industries "promotion" rather than protection. See their Industry and Trade in Some Developing Countries, Oxford University Press, 1970.

European countries have demonstrated in recent years that it is possible, through appropriate subsidies and exchange rate policies, effectively to give home industries protection in world markets as well as in home markets - something the United States and most newly developing countries have yet to learn.

The failure to provide balanced protection to Kenyan industries in the world market is especially harmful to manufactured exports. As was pointed out above, the less favourable exchange rate which protection defends is more effective in inhibiting exports from the high - rigid-wage industrial sector than from the low - flexible-wage primary sector; the net effect is to heighten Kenya's dependence on primary exports.

In addition to a general bias against exports, there is a further bias due to the wide range of effective rates of protection for import substitutes.[7] Rates vary from close to zero to almost 2,000 per cent, with more than one-third above 100 per cent.[8] In general the bias favours consumers goods and penalizes producers goods. For some potential capital and intermediate goods industries, effective rates of protection would be negative; the system inhibits backward integration. Producers of consumers goods are mostly well protected but, because of the zero or low duties on equipment and supplies from abroad, there is little incentive to establish the more basic stages of manufacturing. The sector remains heavily dependent on imports whose foreign exchange requirement must be earned by the primary sectors.

In addition to the bias against producers goods, widely varying rates of protection among import substitutes suggest (1) that the economy is paying for more to save foreign exchange in some industries than it costs to save or earn foreign exchange in others, or (2) that excessive profits (and perhaps wages) are being earned behind protection. In either case the foreign exchange budget is balanced at an excessive cost to the rest of the economy.

Low duties on imported materials and equipment combined with high duties on finished goods naturally favour those industries that import their supplies and sell their finished products in the domestic market. This works

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7. Phelps and Wasow, Op. Cit.

8. This is based on the usual measure of effective protection, namely, the proportion by which value added in domestic prices is above value added in world prices. Phelps and Wasow use instead the proportion of value added in domestic prices that is attributable to protection.

to discourage processing of Kenya's own materials, especially when the product might be exported.[9] Yet, according to the ILO Report, it is just these industries that hold the most promise for rapid industrial expansion and growth of manufactured exports.[10]

Related to the bias against the processing of domestic materials and the failure of manufacturing to link backward to agriculture and other primary sectors is the concentration of manufacturing in one or two urban centers. Reform of the protection system should contribute to greater regional balance in the development process.

Finally there is an employment bias in the existing protection system. This has many aspects, only two of which will be singled out here.[11] First the artificial cheapening of capital and other imported inputs encourage their substitution for labour. An overvalued currency (undervaluation of foreign exchange) defended by protectionist policies, combined with zero or minimal duties on (or liberal licensing of) capital and raw material imports, permits prices for these goods levels that would obtain under a free trade equilibrium; their use is heavily subsidised. This together with other subsidies on the use of capital, helps to explain the excessive capital intensity and poor employment performance of Kenyan industry.

Excessive capital intensity is encouraged also by the high wage rates in the industrial sector.[12] Protection of the home market tends to underwrite and intensify wage dualism, if it is not indeed the cause of it. Labour, through the intervention of trade unions and government, is able to capture a share of the protection offered and, thereby, to dilute it to some extent. Protection then may have to be raised further and a wage-protection spiral is under way. This further weakens the export prospects of the manufacturing sector and enhances the labour-saving bias of choices among industries and technologies. There are other disadvantages of the present protection system,[13]

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9. See J.H. Power, "A Note on Protection and the Processing of Primary Commodities," IDS Working Paper No. 60, August 1972.

10. Op. Cit., p. 186.

11. For a fuller discussion, see J.H. Power, "Protection and Employment: a Macroeconomic Approach," IDS Discussion Paper No. 151, November 1972.

12. High relative to earnings in agriculture.

13. See, for example, the section entitled, "Import Substitution and its Main Defects," in Chapter 11 of the ILO Report, Op. Cit., pp. 180-182.

but enough has been said to indicate the main lines of the needed reform. First, the bias against industrial exports (and many non-industrial exports) needs correction. Second, there should be a move toward more uniform rates of tariff protection - the high coming down and the low moving up. Third, import licensing, which in recent months has accentuated most of the bad features of the protection system while introducing some new problems of its own, should be liberalised and its administration streamlined.[14] Fourth, indirect domestic taxes (sales or excise) should be substituted for tariffs and licensing of imports for control of non-essential consumption.[15] Fifth, government tax revenue must be increased to permit substitution of subsidies (including tax remissions and refunds) for tariffs and licensing as instruments of protection.[16] This will permit tariffs to play their legitimate role - that of raising revenue.

An ideal system for correcting the institutional biases against industrialization in Kenya would simultaneously minimize distortions and effectively raise the revenue needed to finance it.[17] But the problem of reform is not to achieve perfection at once; that would be impossible and to attempt it would disrupt the economy unduly. Reform must be gradual. Equally important, it must not be delayed. Each step should be consistent with the new industrialization strategy that Kenya needs at this stage of its economic development.[18] The guidelines for this new strategy were well stated in the ILO Report.[19] There it was proposed that:

> "...future industrialization be turned away to some degree - and strongly so in the case of foreign investment - from protected firms producing import substitutes toward industries that -
>
> (a) use domestic raw materials; given the existing resource base, this means considerable emphasis on industries processing agricultural products;
>
> (b) have potential for developing a comparative advantage in export markets;

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14. See D.S. MacRae, "Import Licensing in Kenya," IDS Working Paper No. 90, March 1973.

15. The disadvantage of tariffs and licensing is that they encourage domestic production of the very goods whose consumption it is desirable to curtail.

16. The principal advantage of subsidies is that they can be unbiased with respect to exports and import substitutes.

17. J.H. Power, *Op. Cit.*, pp. 12-18.

18. The reason that a particular "strategy" is needed now is, in part, to compensate for the biases of a previous strategy.

19. *Op. Cit.*, p. 185.

(c) are more labour-intensive than most of those promoted by import substitution;

(d) would contribut significantly to employment through a backward linkage effect; and

(e) can be economically located in smaller towns and rural areas.

3. TAX REFORM AND THE STEPS AHEAD

The current tax reform involves a substitution of a general ten per cent sales tax for the Graduated Personal Tax and for certain consumption taxes. Exempt from the sales tax are some basic necessities, sales fc. intermediate use and exports. Except for its administration, it is very much like a value-added tax. Capital goods are considered to be final, not intermediate goods. The tax is on the tariff-inclusive price of imported final goods; imports for intermediate use are exempt.

The substitution of a more general and uniform sales tax for particular consumption taxes is a step in the right direction. The elimination of the GPT removes a regressive levy, an administrative headache and, possibly in some cases, a tax on employment - though the precise incidence of the GPT is not certain. This change could have a favourable influence on the use of labor though its quantitative importance is probably modest. There is as yet no indication of how the government will replace the GPT as a source of finance for local government. But these are matters not directly related to the reform of the protection system.

As for its effect on the protection system, where the tariff rather than licensing is the effective protection instrument, and assuming protection is not redundant so that domestic price goes up by the amount of the new tax on imports, the introduction of the sales tax is neutral in its protective effect. The rise in price of imports is exactly offset by the additional tax on the domestic product; there would be no change in domestic value added per unit of output.

This conclusion that the effect of the tax reform on import substitutes is neutral, must be modified where there is excess or redundant protection. With respect to some imports, tariffs are dominated by bans or licensing so that the domestic price is above the tariff-inclusive foreign price. In this case, the domestic price should not rise by the amount of the new sales tax; the effect will be a reduction in excess protection and in the windfall gains of privileged importers. This latter conclusion would have to be further modified to allow for the effects of price controls where these are

decisive. In cases (if there are any) where tariff protection is redundant and it is domestic competition that determines price, excess protection will be reduced. Though the sales tax will have to be paid, there will be no rise in price.

Exports are not favoured by their exemption from the tax; the exemption merely prevents exports from being penalized _vis a vis_ import substitutes. However, if the tax must first be paid by exporters and a refund requested, there will still be some penalty on exports.

The neutral effect on value added per unit of exports is not the whole story. Since imports and import substitutes will be more expensive, domestic consumption will be discouraged, freeing some productive capacity for export. This is only a short-run phenomenon, however, and the effect of the tax reform on exports from the demand side may be less favorable in the long run; exemption of basic foods and other necessities should lead to greater consumption of these items and could harm export prospects for meat, dairy products, maize, etc.

Capital goods are not treated as intermediate goods and are not exempt from the tax. Since most capital goods are imported, the effect in the short run is tantamount to imposition of a ten per cent duty on capital goods. This is a step in the right direction because it helps to correct the artificial under-pricing of capital created by the protection system. It should also help to correct the bias against employment. But since the tax is also on domestically produced capital goods, the long-run effect is to maintain the bias against the development of a domestic capital goods industry. To make the tax more nearly like a duty on imported capital goods domestically produced equipment should be exempted from the tax.

As a fiscal reform, as a device to reduce inequities in the tax system and to create a structure within which government tax revenue will rise as the economy grows, the new tax is all to the good. But for the purposes under consideration here, our main conclusion remains that the tax reform does very little to influence the protection system and, by itself, is not an important reform of the protection system. But it is a pre-requesite to the next steps.

To complement the tax reform and to move in the direction of _protection reform_, the most obvious next step is an export subsidy. Two interesting proposals have been offered by Richard Porter at the Institute for Development

Studies.[20] One is a system of marketable tax vouchers, awarded per unit of foreign exchange earned in exporting. The other is a generalized, uniform drawback system. The latter would substitute a flat rate of drawback applicable to all exports in place of the present variable drawback that must be negotiated within a bureaucratic morass of red-tape and delay. One of Porter's proposals, or something similar, is desperately needed as the next crucial step in reform.

Next there should be a liberalization and simplification of the import licensing system and elimination of import bans. If necessary to curb non-essential consumption in specific cases, luxury consumption taxes should be imposed.

It is clear that the steps already taken are, in a way, a substitute for the failure of the East African Community to act on long overdue questions of tax and tariff reform. While Kenya should continue its effort to persuade the Partner States to revitalize Community trade and protection policies to promote industrialization and growth in all three countries, it should not be deterred from pursuing reforms along the lines outlined above.

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20. Porter, op. cit.