

ABSTRACT

The role of indirect tax is high in developing countries because of poor tax administration to collect direct taxes, lower per capita incomes and evasion possibilities. The level of revenue from indirect taxes in Kenya has risen steadily from an average of 6.5 percent of GDP in the period 1963-1972 to an average of 12.1 percent in the period 1973-2010. Such a significant increase in tax revenue raises pertinent questions about the effect they have had on economic growth. The motivation for this study was primarily premised on the paucity and inconsistency of empirical literature on the dynamics of indirect tax and growth. The purpose of the study was therefore to analyze the effect of indirect tax on economic growth in Kenya. The objectives of the study were to: establish the effect of custom duty on economic growth, evaluate the effect of excise duty on economic growth and to ascertain the effect of Value Added Tax on economic growth. The study adopted a correlation research design based on its ability determine the strength and direction of relationships between variables while the theoretical framework was anchored on endogenous growth model. In estimation of annual time series data, cointegration test and error correction model was adopted. The empirical results indicate that indirect taxes are positively correlated with economic growth in Kenya supporting the predictions of the endogenous growth models. Though, the effect of Value Added Tax on economic growth was statistically insignificant. Cointegration results indicate that tax revenue and GDP are integrated of order three and there exist a long-run relationship between indirect tax revenue and economic growth. The study concluded that customs and excise duty are growth enhancing while the effect of value added tax on the economy is not large enough to influence the economic growth. It therefore recommended that the government should rely more on custom and excise duty due to their growth prospect and reform VAT system to engineer a system that would have a significant impact on economic growth. The results of the study closes the knowledge gap arising from the paucity and inconsistency of empirics on the growth effects of indirect taxation. The findings of the study are also expected to be instrumental in improving taxation policy in Kenya. Further research is recommended on the model specification to increase its explanatory power.