

# Determinants of tax compliance by small and medium businesses in Embu County, Kenya

Kariuki, Samuel Nduati <sup>a\*</sup> and Zachary, John Mukundi Njeru<sup>b</sup>

*a and b, University of Embu, P.O. Box 6, 60100 Embu*

*Corresponding author's email contact: [kariuki.samuel@embuni.ac.ke](mailto:kariuki.samuel@embuni.ac.ke)*

## ABSTRACT

Small and medium enterprises are a key engine of economic growth in both developing and developed countries. Small and medium businesses being profit making institutions are expected to pay taxes to the government. Therefore, tax compliance is critical in all economies which recognize the role played by revenue collected from tax in national development. Nonetheless, developing countries are dominated by low tax compliance levels, in the face of the frequent appeal from tax collectors for voluntary compliance. As a result, identification of tax evasion approaches and ways to diminish it is one of the central aims of many governments' agenda with the view of achieving higher levels of compliance. As such, many governments have embraced administrative measures such as fines, penalties, rates and tax audits to enforce tax compliance. Interestingly, despite the phenomenal growth of small and medium businesses, the tax collection from the sector is still low. This study therefore, sought to establish the determinants of tax compliance among small and medium businesses in Embu County, Kenya. The study sampled 185 enterprises in Embu County using stratified random technique. The findings show that fines and penalties, tax compliance costs and tax knowledge and education significantly influence tax compliance among small and medium businesses in Embu County. The study recommends that the Kenya Revenue Authority should prepare education and training programs to ensure that small and medium businesses embrace voluntary compliance with all the tax requirements. Further, the study recommends that Kenya Revenue Authority should also evolve policies to decrease tax compliance cost incurred by small and medium businesses to avoid curtailing their growth potential and inspire voluntary tax compliance.

**Keywords:** tax, tax compliance, tax payment, tax collectors, tax audits, tax penalties

## 1.0 Introduction

In spite of branding SMEs as the engine of growth in many developing countries, the small and medium scale sector still remain fluid as there is no concrete regulatory policy in place to monitor its activities thereby making it almost difficult to tax if not difficult to tax (Antwi, Inusah, & Hamza, 2015). SMEs are less tax compliant in comparison to large businesses and are considered the hard to tax group from the informal sector (Akinboade, 2015). Many SMEs either deliberately evade tax payment or are not captured by the net of the revenue authority (Antwi *et al.*, 2015). Moreover, greatest number of SME fail to willingly enlist with tax authorities, whereas the few which list regularly miss to maintain sufficient records, file tax returns, and honour tax obligations punctually

(Terkper, 2003). In diverse studies carried by Nahida *et al.* (2014); Osebe (2013); Chebusit *et al.* (2014); Tusubira and Nkote (2013), several factors have been hypothesized to influence tax compliance by SMEs.

These factors include tax compliance costs, fines and penalties, tax knowledge and the tax system. A tax compliance cost is expenditure incurred by a firm in conforming to government's tax legislation requirements (Nahida *et al.*, 2014). For individuals, these costs would include the financial and time costs of acquiring fiscal knowledge to meet their legal obligations; the costs in the form of time lost in filing up the tax returns, obtaining, filing and storing the data to facilitate the completion of returns (Chattopadhyay & Das-Gupta, 2002).

Fines and penalties act as tax deterrence sanctions, which many governments have adopted as tax compliance administrative measures (Tusubira & Nkote, 2013). The goal of fines and penalties is to foster voluntary tax compliance hence efficient tax administration (Palil, Akir & Ahmad, 2013). The economic deterrence serves as the theoretical foundation, which support the imposition of fines and penalties (Ali, Fjeldstad & Sjursen, 2013.) Similarly, punishment and sanctions influence individuals' tax compliance behavior. For instance, Sapiei, Kasipillai and Eze, (2014) observe that an upsurge in the proportion of penalty charged and a larger likelihood of detection reduces the level of non-compliance.

Tax knowledge could be one of the important factors influencing individual's tax attitudes. Importance of this issue stems from the fact that tax law is generally considered as difficult, complicated and beyond one's depth (Kołodziej, 2012). Consequently, taxpayers appropriately assess their tax obligation and submit tax returns promptly (Palil *et al.*, 2013). By means of taxpayer education and taxpayer service, citizens can be informed and educated about the tax system and be assisted in their attempts to comply with the tax system (International Tax Compact, 2010).

The tax system comprises of the laws, rules and regulations guiding the collection, administration of taxes in a particular country (Lumumba *et al.*, 2010). Tax laws become complex because of the complexity of the underlying tax base, deductions and concessions, since simple tax systems cannot cater for special cases (Chattopadhyay & Das-Gupta, 2002). The tax laws in many developing countries are amended regularly quickly hence creating uncertainty and little

transparency of the tax code. Consequently, complex tax regulation and continuing alterations of the tax code complicate taxpayers and tax administrators similarly (ITC, 2010).

### **1.3 General Objective**

The study sought to establish the determinants of tax compliance by Small and Medium Enterprises in Embu County, Kenya

#### **1.3.1 Research Questions**

The following were the research questions of the study:

1. What is the influence of tax compliance costs have on tax compliance by SMEs in Embu County, Kenya?
2. How do fines and penalties influence tax compliance by SMEs in Embu County, Kenya?
3. What is the effect of tax knowledge and education on tax compliance by SMEs in Embu County, Kenya?
4. How does tax system affect tax compliance by SMEs in Embu County, Kenya?

### **2.1 Theoretical review**

#### **2.1.1 Fiscal Exchange Theory**

The main proposition of the fiscal exchange approach is that bargaining over taxes is central to building relations of accountability between state and society grounded on shared rights and duties, instead of compulsion and patronage (Cobham, 2005). Accordingly, based on the theory taxpayers compliance behavior is presumed to be influenced by satisfaction or lack of satisfaction with terms of trade with the government (Ali *et al.*, 2013). Torgler (2007) also posited that taxpayers' willingness to cooperate with the tax authority increases, if the authority sees itself as a service institution, provides quality services, and treats the taxpayers as partners. Further, Organization for Economic Co-operation and Development (2007) emphasized that the delivery of quality services to taxpayers will strengthen their willingness to comply with tax rules and regulations voluntarily and, as a result will contribute to the overall level of tax compliance.

#### **2.1.2 Social Psychology Theory**

The social-psychology theory postulates that tax compliance by taxpayers depends on psychological factors. By and large, the theory underscores taxpayers' morals and ethics determine tax compliance level regardless of the likelihood of detection (Atawodi & Ojeka, 2012). Atawodi and Ojeka (2012) further stress that the theory's main focus is the taxpayers' morals and ethics. A common proposition is that individuals form their behavioral intentions on the bases of two basic determinants – personal factors and social influences (McKerchar & Evans, 2009). Personal norms reflect the taxpayers' values, tax ethics, tax mentality, and tax morale, all of which influences attitudes towards tax compliance (Fjeldstad *et al.*, 2012). The proponents of social-psychology theory argue tax compliance behavior is determined by social interactions. Compliance behaviour and attitudes towards the tax system is therefore affected by the behaviour of an individual taxpayer network of friends, neighbors and relatives (Loureiro, 2014).

### **3.0 Methodology**

#### **3.2 Research Design**

The study employed a quantitative cross-sectional study design.

#### **3.3 Target Population and Sampling**

The target population comprised of 615 SMEs in Embu County. The study sampled 185 enterprises in Embu County using stratified random technique.

#### **3.5 Data Collection Instrument**

This study collected primary data using a questionnaire which had both open and close-ended questions. Secondary data was collected using a survey sheet.

#### **3.6 Data Collection Procedure**

Primary data was collected using questionnaires. The questionnaires were dropped to the sampled respondents and then picked after two days. The drop and pick method was considered suitable since it gave the respondents adequate time to discuss, understand and respond to the questions therein. Secondary data on tax compliance amongst SMEs on the other hand, was gathered from research reports, KRA revenue reports, Embu County records and reports.

### 3.7 Pretesting

Pretesting was conducted to ensure that all kinds of errors, which may range from questionnaire construction, ambiguity of words, misinterpretation of questions by respondents, inability to answer a question, presence of sensitive questions in the questionnaire were reduced. This improves the quality of data significantly. Participants for pretesting were selected from a small sample of respondents from the target population, where the feedback by the selected respondents was used to improve the questionnaire.

#### 3.7.1 Validity

To ensure the instruments validity, a draft questionnaire was developed and the views of experts.

#### 3.7.2 Reliability

The study used the Cronbach alpha coefficient to establish the reliability of the study instrument. The study yielded a Cronbach alpha coefficient of 0.845, which was considered appropriate for the study since it was above the recommended alpha value 0.7.

### 3.8 Data Analysis

Binary logistic regression model was used to determine the link between the dependent and the independent variables. The binary logistic regression model took the following form

$$f(z) = \frac{1}{1 + e^{-z}} = \frac{1}{1 + e^{-(\alpha + \sum \beta_1 X_1)}} = \text{for } i \text{ ranging from } 1 \text{ to } n$$

**Equation 3.1**

Where;

$P(z) = f(z)$  is the probability of tax compliance where 1 indicates compliance; 0 otherwise;  $Z$ , random variable that can take on one of two possible values;  $\alpha$  represents a constant;  $e$  represents Euler's number;  $\beta$  represents estimated coefficients and  $X_i$ 's represents independent variables.

### Research Findings and Discussions

The findings indicated that 69.8% of the SMEs in Embu County were tax compliant. The study results further reveal that the logistic regression model was statistically significant explaining

36.1% of the tax compliance. Table 1 presents the coefficients of various determinants of tax compliance in the regression equation. From the regression coefficient results in table 1 it can be seen that compliance costs ( $p = 0.0125$ ), fines and penalties ( $p = 0.0089$ ), tax knowledge and skills ( $p = 0.0460$ ) shows a significant positive relationship with tax compliance among SMEs in Embu County. In contrast, tax systems ( $p = 0.295$ ) had an insignificant positive relationship with the tax compliance among SMEs in Embu County. The table also indicates compliance costs have the highest effect on tax compliance ( $\text{Exp(B)}=1.1265$ ) followed by tax knowledge and skills ( $\text{Exp(B)}=1.155$ ) then tax systems ( $\text{Exp(B)}=1.147$ ) with fines and penalties trailing in the list ( $\text{Exp(B)}=0.996$ ).

**Table 1: Model coefficients of determinants**

	<b>B</b>	<b>S.E.</b>	<b>Wald</b>	<b>Sig.</b>	<b>Exp(B)</b>
Compliance costs	.535	.153	2.356	.0125	1.265
Fines and penalties	-.904	.280	.000	.0089	.996
Tax knowledge and skills	.144	.024	.339	.0460	1.155
Tax system	.137	.131	1.095	.295	1.147
Constant	-2.350	1.058	4.933	.026	.095

### **Conclusions and Recommendations**

The study also found that fines and penalties foster voluntary tax compliance by SMEs and that increase in the penalty rates and the probability of detection result in lower non-compliance. The study found a significant relationship between fines and penalties and tax compliance by SMEs. Thus, the study recommends that the Kenyan tax authority and the government should carry out continuous training on taxation to ensure that SMEs operators can comply with all tax requirements.

The binary logit regression results show a significant positive relationship between tax knowledge and education tax compliance by SMEs. Most SMEs operators do not have formal taxation training

or education hence they do not have good tax knowledge and education. The study found that continuous training can provide good and reasonable tax knowledge and that lack of a combination of tax skills hinders SMEs from complying with various taxes and that taxation knowledge enhances SMEs ability to understand tax laws. This finding concurs with that of Mutascu and Danuletiu (2013) observation that a very low tax literacy level is associated with reduced tax revenues.

It was established that the most paid taxes by SMEs are county government levies and VAT and that the Kenyan tax system was complex to most SMEs operators and one would require training and education to understand the system. The study also found that use of technology, online tax filing makes tax compliance more complicated to SME operators and high tax rates and fixed tax payment dates increase the chances of non-compliance by SMEs. The regression results indicate an insignificant association among the tax system and tax compliance by SMEs.

However, the conclusion was based on the fact that most SMEs in Embu county were not fined or charged for tax non-compliance. Therefore, this study recommends that the Kenyan tax authority should enforce its compliance department and charge all the non-compliance fines and penalties to SMEs in Embu County as this would deter them from non-compliance. Finally, the study concluded that there was no significant relationship between tax system and tax compliance by SMEs in Embu County. The conclusion was based on the fact that most SME operators had a little understanding of the Kenyan tax system. Therefore, the study recommends that the Kenyan tax authority should develop education and training programs to ensure that SME operators comply with all the tax requirements.

## **REFERENCES**

- Akinboade, O. A. (2015). Correlates of Tax Compliance of Small and Medium Size Businesses in Cameroon. *Managing Global Transitions*, 13 (4), 389–413.
- Ali, M., Fjeldstad, O., & Sjurson, O. I. (2013). To Pay or Not To Pay? Citizens' Attitudes towards Taxation in Kenya, Tanzania, Uganda and South Africa. *Working Paper No. 143*. Afrobarometer Working Papers.
- Atawodi, O. W., & Ojeka, S. A. (2012). Factors That Affect Tax Compliance among Small and Medium Enterprises (SMEs) in North Central Nigeria. *International Journal of Business and Management*, 7(12), 87- 96.

- Chattopadhyay, S. & Das-Gupta, A. (2002) The Compliance Cost of the Personal Income Tax and Its Determinants. *Report to the National Institute of Public Finance and Policy*, New Delhi.
- Chebusit, C., Namusonge, G. S., Biraori, O. E., & Kipkoech, E. C. (2014). Factors Affecting Tax Compliance among Small and Medium Enterprises in Kitale Town Trans-Nzoia County, Kenya. *International Journal of Recent Research in Commerce Economics and Management*, 1(3), 60-75
- Cobham, A. (2005). Tax Evasion, Tax Avoidance and Development Finance: QEH Working Paper 129. (Online). Available at <http://www.qeh.ox.ac.uk>.
- Fjeldstad, O., Herzenberg, C. S. & Sjurson, I. H. (2012). Peoples' Views of Taxation in Africa: A Review of Research on Determinants of Tax Compliance. *CMI Working Paper 2012:7*. International Centre for Tax and Development.
- International Tax Compact. (2010). Addressing Tax Evasion and Tax Avoidance in Developing Countries. Eschborn, International Tax Compact.
- International Tax Dialogue. (2007). Taxation of Small and Medium Enterprises, Background paper for the International Tax Dialogue Conference, Buenos Aires.
- Loureiro, J. N. (2014). Behavioural Economics and Tax Compliance: The Role of Identifiability, Geographical Distance and Social Norms on Tax Compliance: An Experimental Study. *Dissertation Proposal*. University of Porto, Portugal.
- Lumumba, O. M., Wanjoli, M. S., Maguta, P. O. & Mokoro, J. M. (2010): Taxpayers' attitudes and tax compliance behavior in Kenya: How the taxpayers' attitudes influence compliance behavior among SMEs Business income earners in Kerugoya Town, Kirinyaga District. *African Journal of Business and Management*, 1.
- McKerchar, M. & Evans C. (2009). Sustaining Growth in Developing Economies through Improved Taxpayer Compliance: Challenges for Policy Makers and Revenue Authorities. *e-Journal of Tax Research*, 7, 171–201.
- Mutascu, M. & Danuletiu, D. (2013). The Literacy Impact on Tax Revenues. Economics Discussion Papers, No 2013-63, Kiel Institute for the World Economy. <http://www.economics-ejournal.org/economics/discussionpapers/2013-63>
- Nahida, F., Copp. R., Freudenberg, B. & Sarker, T. (2014). Complexity, Compliance Costs and Non-Compliance with VAT by Small and Medium Enterprises (SMEs) in Bangladesh: Is there a Relationship? Griffith University.
- Osebe R. P. (2013). An Analysis of Factors Affecting Tax Compliance in the Real Estate Sector in Kenya: A Case Study of Real Estate Owners in Nakuru Town. *Unpublished Project Report*. Kabarak University, Kenya.
- Palil, M. R., Akir, M. R. & Ahmad, W. F. (2013). The Perception of Tax Payers on Tax Knowledge and Tax Education with Level of Tax Compliance: A Study the Influences of Religiosity. *ASEAN Journal of Economics, Management and Accounting*, 1(1), 118-129.



Torgler, B. (2007). Tax Morale, Trust and Corruption: Empirical Evidence from Transition Countries. *Working Paper No. 2004 – 05*. Center for Research in Economics, Management and the Arts.

Tusubira, F. N. & Nkote, I. N. (2013). Income Tax Compliance among SMEs in Uganda: Taxpayers' Proficiencies Perspective. *International Journal of Business and Social Science*, 4(11), 133-143.