KENYATTA UNIVERSITY

SCHOOL OF HUMANITIES AND SOCIAL SCIENCES

DEPARTMENT OF PUBLIC POLICY

TAX COMPLIANCE BY SMALL AND MEDIUM ENTERPRISES IN NAIROBI NORTH TAX REGION, KENYA

MARY WAIRIMU GACHIKU

A RESEARCH PROPOSAL SUBMITTED TO THE SCHOOL OF HUMANITIES AND SOCIAL SCIENCES IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF MASTER OF ARTS IN PUBLIC POLICY AND ADMINISTRATION OF KENYATTA UNIVERSITY

2015
DECLARATION

Student’s Declaration

This proposal is my original work and has not been presented for a degree in any other university.

Sign ……………………………………..Date …………………………………….

MARY GACHIKU

Reg. C153/CTY/PT/24822/2012

Supervisor’s Declaration

This proposal has been submitted for the review with our approval as university supervisors.

1. Sign ……………………………      Date …………………………………
   
   Dr. George Kosimbei
   
   Department of Economic Theory

2. Sign ……………………………      Date …………………………………
   
   Dr. Martin Atela
   
   Department of Public Policy and Administration.
ABSTRACT

Taxes are an involuntary charge levied by the government on individual workers income, business profits and on transactions of goods and services. Unfortunately, Kenya does not collect all the taxes that it ought to. This is mostly attributed to high levels of tax non-compliance. In Kenya, the biggest block of taxpayers on the business sector are the Small and Medium Enterprises (SMEs) which are estimated to be at 34.4% of total businesses in Kenya and they account for 77% of employment statistics. This study aimed at assessing the tax compliance by SME’S in the Nairobi North tax region. The study was guided by three objectives: to assess the effect of the current law in Kenya on the tax compliance of SME’s in Nairobi North tax region; the level of tax knowledge and its effect on tax compliance and the tax compliance costs and its effect on the tax compliance of SME’s. The study was guided by the planned behavior theory. This study adopted a descriptive research design. The target population was 1500 SME’s and the sample size was 150 who were divided into two. Data was collected by the use of a structured questionnaire with both closed and open ended questions and analyzed using both descriptive and inferential statistics. Statistical package for social science (SPSS) was used to subject the data to quantitative analysis. The Pearson’s correlation co-efficient was used to check the relationship between variables and a logit model fitted to check the relationship between the dependent and the independent variables. Data was presented in the form of frequency distribution tables, graphs and pie chart. The results of the study was documented economic and social factors that affect small and medium-scale tax compliance. Therefore, the findings of this study not only provided vital information on further research in this area of study, but also contributed to the theoretical development of the field of tax compliance.
DEFINITION OF TERMS

North of Nairobi tax region: This is the geographical area found on the northern part of Nairobi County as demarcated by the Kenya Revenue Authority for better tax co-ordination. It includes; Grogony area in Nairobi’s down town, Thika road, Parklands and Westlands.

Small and Medium enterprises: This is a firm or a business enterprises which is non-subsidiary and independent firm which has less than 50 employees and has a turnover of less than 50 Million euros. (United Nations Development Organization, 2009)

Tax: According to (Bhartia, 2009) is a financial charge or other levy imposed upon a taxpayer by a state or any other functional equivalent of a state such that failure or resistance to pay is punishable by law

Tax Compliance :Certification or confirmation that the doer of an action meets all tax requirements that includes accepted practices, legislation, prescribed rules and regulations, specified standards, or the terms of a contract (BusinessDictionary.com, 2010).
ABBREVIATIONS AND ACRONYMS

CBS       Central Bureau of Statistics
ETR       Electronic Tax Register
GDP       Gross Domestic Product
KIPPRA    Kenya Institute of Policy Research Analysis
KRA       Kenya Revenue Authority
KSHs      Kenya Shillings
MSEs      Micro and Small Enterprises
NON       North of Nairobi
PAYE      Pay As You Earn
PIN       Personal Identification Number
PSC       Parliamentary Service Commission
SPSS      Statistical Package for Social Sciences
SMEs      Small and Medium enterprises
TOT       Turnover Tax
VAT       Value added Tax
Table of Contents
DECLARATION................................................................................................. ii
Student’s Declaration ................................................................................... ii
ABSTRACT....................................................................................................... iii
DEFINITION OF TERMS................................................................................ iv
ABBREVIATIONS AND ACRONYMS............................................................... v
CHAPTER ONE: INTRODUCTION................................................................... 9
1.1 Background of Study ............................................................................... 9
1.1.1 Tax compliance in Kenya .................................................................. 10
1.1.2 Small and Medium Enterprises and Tax Laws .................................. 12
1.2 Statement of the Problem ...................................................................... 15
1.3 Research Objectives .............................................................................. 16
1.4 Research Questions ............................................................................... 16
1.5 Research assumptions .......................................................................... 17
1.6 Justification of the Study ...................................................................... 17
1.7 Significance of the Study ...................................................................... 18
1.8 Scope and Limitation of the Study ......................................................... 18
CHAPTER TWO: LITERATURE REVIEW......................................................... 19
2.1 Introduction ........................................................................................... 19
2.2 Review of Related Literature ................................................................ 19
2.2.1 Theory of Planned Behaviour .......................................................... 19
2.2.2 Theory of Crime .............................................................................. 21
2.3 Theoretical Framework ......................................................................... 22
2.3.1 Previous Empirical Studies on Tax Laws and compliance. ............... 22
2.3.2 The legal framework and the Impact on Tax Compliance of SME’s. ... 25
2.3.3 Tax Knowledge and the Effect on Tax Compliance of SME’s .......... 26
2.3.4 Tax Compliance Costs and the Effect on Tax Compliance by SME’s .... 27
2.4 Conceptual Framework ......................................................................... 29
2.5 Research Gaps ...................................................................................... 30
CHAPTER THREE: RESEARCH METHODOLOGY ....................................... 32
3.1 Introduction ........................................................................................... 32
3.2 Research Design ................................................................................................................. 32
3.3 Target Population .................................................................................................................. 32
3.4 Definition and Measurement of Variables ............................................................................. 33
3.5 Sampling Techniques ............................................................................................................. 33
3.6 Sample Size .......................................................................................................................... 34
3.7 Research Instruments ........................................................................................................... 34
3.8 Validity and Reliability of Research Instruments ................................................................. 35
3.8.1 Validity ............................................................................................................................ 35
3.8.2 Reliability ......................................................................................................................... 35
3.9 Data Analysis ......................................................................................................................... 35
3.10 Data Management and Ethical Considerations .................................................................... 36
CHAPTER FOUR ......................................................................................................................... 38
4.0 DATA ANALYSIS, PRESENTATION AND INTERPRETATION ........................................ 38
4.1 Introduction .......................................................................................................................... 38
Response Rate ............................................................................................................................ 38
Table 4.1: Response Rate ............................................................................................................. 38
Response Rate ............................................................................................................................ 38
Reliability analysis ....................................................................................................................... 39
Table 4.2 Reliability Analysis ..................................................................................................... 39
Validity of Results ....................................................................................................................... 40
4.2 Demographic Information ..................................................................................................... 40
Table 4.3: Background Information ............................................................................................ 40
Table 4.10: Strategies that can improve tax Compliance in Kenya ............................................ 49
Table 4.12: Regression Analysis .................................................................................................. 51
Table 4.13: Model Summary ....................................................................................................... 52
CHAPTER FIVE .............................................................................................................................. 54
5.0 SUMMARY, CONCLUSION AND RECOMMENDATION .............................................. 54
5.1 Introduction ........................................................................................................................... 54
5.2 Summary of Findings ............................................................................................................ 54
5.2.2 The role of the legal framework on tax compliance in Kenya ........................................ 54
5.2.3 The Relationship between Tax Knowledge and Tax Compliance .................................... 55
5.2.4 Effect of the Tax Compliance Costs on Tax Compliance ........................................... 56
5.3 Conclusion ..................................................................................................................... 56
5.4 Recommendations....................................................................................................... 57
5.4.1 Tax Knowledge......................................................................................................... 57
5.4.2 Legal Framework...................................................................................................... 58
5.4.3 Compliance Costs..................................................................................................... 59
5.5 Areas for Further Research ...................................................................................... 59
References ......................................................................................................................... 60
APPENDICES .................................................................................................................. 63
APPENDIX I: INTRODUCTION LETTER ......................................................................... 63
APPENDIX II: QUESTIONNAIRE ....................................................................................... 64
CHAPTER ONE: INTRODUCTION

1.1 Background of Study

Small and medium enterprises (SMEs) are the major business taxpayers in most developing countries and as such their compliance levels directly impact on government tax revenue collections. Small and Medium-sized Enterprises (SMEs) refers to a business company that employs fewer than 250 persons and has an annual turnover not exceeding 50 million euro and an annual balance sheet not exceeding 43 million euro, (E.U Law 2003/361). The SMEs constitute a huge proportion of the national economy in most countries globally. In Europe, there are approximately 23 million of them in the European Union, which account for 99% of all enterprises and provide around 75 million jobs. Compared to the larger companies, the SMEs suffer disproportionately from the regulatory burden because they lack sufficient human and financial resources to manage their obligations efficiently.

Goradichenko et al., (2009) and Vela (2007) argues that tax evasion is a universal and growing phenomenon. Research evidences available have shown that the problems of tax evasion cut across the globe from developing countries to developed countries. For instance, Embaye (2007) reported that tax evasion is considerable in U.S with about 16% overall noncompliance for individual income tax. The concept related to tax evasion is tax avoidance, which is described as creative compliance in McBarnett (2003). However, according to Arogundade (2005) and Sandmo (2005) there is conceptual distinction between tax evasion and tax avoidance. The distinction between these two concepts hinges on the legality of taxpayers actions. Arogundade (2005) argues that the similarity of both concepts is that they lead to leakages in tax revenue.

Sandomo (2005) distinguishes the two concepts from legal perspective. He said that tax evasion is carried out in violation of the law, therefore is illegal while tax avoidance is carried out within
the legal framework of the tax law in order to reduce one's tax liability, therefore tax avoidance is legal. Everest-Phillip and Sandall (2009) argued that public governance quality is necessary to have good tax system and equally good tax system is essential to achieve public governance quality. Citizens support government in its responsibilities through the provision of finance in form of tax payment. What is happening in government therefore, should matter to the taxpayers because they provide the finance for its sustainance. As a result, governance affairs may have either positive or negative influence on the compliance behavior of the taxpayers.

1.1.1 Tax compliance in Kenya
Kenya is ranked among low-income countries or low compliance countries with hard task of ensuring efficient and effective tax administration in order to ensure tax compliance, hence raising more revenue. Administration of tax in Kenya is done by Kenya Revenue Authority (KRA) which was established through an Act of Parliament of July 1st, 1995 (Cap 469). The purpose of Kenya Revenue Authority is assessment, collection, administration and enforcement of tax laws with professionalism governed by integrity and fairness (CIAT, 2006). To achieve this purpose, KRA is divided into operational regions such as North Region, Rift Valley Region, Western Region, Southern Region and Central Region and departments such as Customs Services Department, Domestic Services Department, Road Transport Department and Support Services Department. KRA administers different types of taxes under different Laws (Acts) such as Income Tax, Value Added Tax, Custom duties and Excise Tax among many others.

Kenya introduced the Tax Modernization Programme in 1986 with the hope that this would, among other things, enhance revenue collection, improve tax administration and reduce compliance and collection costs. As in most African countries, the tax reforms became part of the larger Structural Adjustment Programmes (SAPs) that were incorporated in the economic
restructuring agreement between the Government of Kenya and the International Financial Institutions (Wanjiru, 2010).

Even though there have been many tax reforms, Kenya’s tax code is still complex and cumbersome, characterized by uneven and unfair taxes, a narrow tax base with very high tax rates and rates dispersions with respect to trade, and low compliance. Additional challenges include tax systems with rates and structures that (1) taxes are difficult to administer and comply with; (2) are unresponsive to growth and discretionary policy hence low productivity; (3) raise little revenue but introduce serious economic distortions; (4) treat labour and capital in similar circumstances differently; and (5) are selective and skewed in favour of those with the ability to defeat the tax administration and enforcement system (Karingi, et al, 2005).

There are many challenges that hamper the setting up of an efficient and effective tax system in Kenya. The structure of the economy such as the ratio of the formal verses informal economy; and the size of the agriculture sector pose challenges in the tax design and administration. Other impediments include: repeal of tax holidays, high effective protection, high dispersion of tariff rates, detailed and rigid custom rules, poor response of VAT to reforms, weak capacity to process large volumes of returns and refunds for zero-rated transactions. In addition, Kenya’s tax system is burdensome in terms of time taken to prepare and submit tax returns (Karingi, et al, 2005).

Other challenges include poor quality of basic data (to estimate optimal taxation, forecast revenues adequately, and undertake micro-simulations and tax modeling) and politics. Politics have been a major impediment in the recent past, and as an IEA report stated that an unfriendly political economy that is not amenable to rational tax policy may prevent significant tax reforms.
The political elite, who possess high personal income, wealth and property, may use their political influence to oppose the imposition of wealth and property taxes (Karingi et al., 2005). This precisely explains the current situation in which twice the legislatures have collectively ensured that the legislations that were to initiate taxation on benefits/allowances to MPs and other constitutional offices were not enacted initially.

According to data from KRA, North of Nairobi tax region alone has a potential of collecting over 350 billion in Kenya shilling annually, this is largely because this station has the highest number of SMEs amongst all the tax regions in Kenya. However, this has remained a dream since most of these taxpayers either do not pay taxes and those who pay, under declare their tax liability as illustrated below;

**Table 1.1: Revenue collection in North of Nairobi Tax Region**

<table>
<thead>
<tr>
<th>Area</th>
<th>Total Number of Registered Tax Payer</th>
<th>No. of Compliant Tax Payer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Westland</td>
<td>96,000</td>
<td>65%</td>
</tr>
<tr>
<td>Parklands</td>
<td>47,000</td>
<td>64%</td>
</tr>
<tr>
<td>River road Area</td>
<td>184,000</td>
<td>32%</td>
</tr>
<tr>
<td>Thika Road Area</td>
<td>168,000</td>
<td>45%</td>
</tr>
<tr>
<td>Moi Avenue Area</td>
<td>198,000</td>
<td>40%</td>
</tr>
<tr>
<td>Other Areas</td>
<td>136,000</td>
<td>50%</td>
</tr>
</tbody>
</table>

**1.1.2 Small and Medium Enterprises and Tax Laws**

In Kenya, 34.3% of the total economy is contributed by SMEs, This account for 77% of the total employment statistics (Ouma et al, 2007). A huge percentage of the SMEs in Kenya are in the
informal sector and are characterized by poor organization structures, little use of labor intensive technology, and is probably either unregistered or unlicensed. In order to mobilize revenue from this sector, the government of Kenya has made attempts to bring the underground economy into the tax net under the presumptive tax by introducing the Finance bill of 2007 implemented in 2008. It was named the Turnover Tax (TOT). However, it has failed to produce the desired results because the SMEs in Kenya are fond of tax evasion because most of them do not get registered by the government through the proper process. Therefore, they remain undetected and pay no tax. Those that are registered have tendencies of under declaring their taxable income which misrepresents their expenses, thereby translating into lower tax burden for them (Ouma et al, 2007). It is generally perceived that by evading tax, the savings realized will be passed on to the consumers by virtue of lower prices, and hence demand will increase and the organizational competitiveness will be enhanced but this does not happen.

SME’s just like any other taxpayer in Kenya are supposed to adhere to the tax laws and policies. This involves registering for the correct tax obligations and timely payment of taxes due. According Kenya Revenue Authority (KRA) the biggest challenge is ensuring a high level of compliance of these laws. Henry argues that in attempting to measure compliance, it is important to know what is to be measured: evasion, avoidance, compliance or non-compliance (Henry, 1993). The past two decades have had enormous diversity in tax research and it has been focusing more on identifying the material, social or psychological costs that would deter the potential tax evaders, and counter the lure of the benefits of evasion.

The issue of tax compliance is of great importance to those concerned with tax policy matters and its effects on the economy in general, as well as to those concerned with identifying the key roles that the increased tax yields can play in restoring the macroeconomic balance.70% of the
SMEs in Kenya are one person ran businesses, with less than 10 employees. This means that most of the entrepreneurs operating these businesses not only operate at the bottom of the economy, but are also among the 53% of Kenyans living below the poverty line of US$ 1 per day. A survey conducted by the Baseline Companies in 2002 [CBS, ACEG & K-REP] indicated that in 1999, there were 1.3 million MSEs in the country which contributed 18 per cent of Kenya’s Gross Domestic Product [GDP]. It also indicated that 64 per cent of the SMEs were in trade. The activities operate micro trades that allow entrepreneurs to survive with hardly any savings. They are commonly referred to as ‘survivalist’ enterprises. The highest percentage of them operates within the informal economy, previously referred to as the informal sector. In the Kenyan context, this sector is commonly known as the Jua Kali sector. According to the Kenya Labor Force Survey Report of 1998/99, this sector covers a large number of unregulated and semi-organized activities. It is also largely small scale in terms of the provision of employment opportunities. Their premises are usually located on the open markets, both developed and undeveloped premises, market stalls, street pavements, and even in the residential houses (RoK, Labor Force Survey, 2003).

In Kenya, the words SMEs, JuaKali sector, and informal economy are used interchangeably most of the time. It is a major employer to a majority of citizens, with about 77% of them being SME’s. Informal employment was estimated at 4.6 million by the end of the year 2001. With a total wage employment of 72%, employment by the private sector accounted for 81%. The SMEs contribute more than double of the national economic gain provided by the medium and large manufacturing sector that stands at only 7% cent of the country’s GDP (RoK 2003). Furthermore, the SMEs in Kenya sometimes operate without licenses or registration from local authorities or central government, and use simple labor intensive technology. Therefore, Kenyan
authorities define SMEs by turnover for the purpose of tax application and design in the country. The law in Kenya states that any business with an annual turnover not exceeding Shs.5m or USD62,500 is eligible for taxation under the presumptive tax regime for micro and small business in the country known as the Turnover Tax (TOT) regime. The option of opting into the formal sector is always provided but many prefer to remain in the informal sector due to the formalities and tax obligations involved.

1.2 Statement of the Problem
According to Fjeldstad (2007), there is a very high rate of tax evasion in the Kenyan informal sector. Since most of them do not get registered by the authorities as required, they remain hidden and undetected, and thus pay no tax at all. According to the International Finance Corporation, special strategies should be devised to manage the compliance risks of this segment of the taxpayer population so as to enable a cost-efficient administration of small and middle-level taxpayers (International Finance Corporation, 2007). The European Commission (2007) state there is a difference in the compliance behaviors and attitudes between the large taxpayers and the small business segment of the taxpayer population. As opposed to the SMEs, large businesses and wealthy individuals have more access to sophisticated tax advice to develop strategies to reduce their tax liabilities, such as the use of transfer pricing techniques. On the other hand, the SMEs try to reduce their tax burden through tax evasion practices such as hiding a certain part of their business transactions from the tax inspector, or operating completely outside the tax net. As a developing country, Kenya does not have the capacity to effectively monitor such tax evasion practices due to a high level of corruption in the tax administration, or its weak tax administration enforcement capacity. For instance, the Turnover Tax revenue
introduced to maximize tax collection in Kenya has not performed well since it started being operational.

Previous studies have focused on factors that contribute in tax evasion and focuses on various specific sectors. The premise is that if these factors are analyzed carefully and the necessary actions taken, then the problem of tax compliance in the informal sector economy can be solved. If the government will implement the strategies and policies explored in this study, there will be an increase in the amount of revenue it collects from the SMEs by a high margin.

1.3 Research Objectives

The overall objective of this research was to investigate the elements that affect tax compliance by Small and Medium Enterprises. Other specific objectives included:

1. To investigate the legal framework and whether it supports compliance in Nairobi North tax region
2. To assess how the level of tax knowledge of SME operators affect tax compliance by SMES in Nairobi North tax region
3. To investigate how tax compliance costs affect tax compliance by SMES in Nairobi North tax region
4. To investigate the strategies that can improve tax compliance among SME’s in Kenya

1.4 Research Questions

The research questions that guided the research include:

1. How does the legal framework support compliance SME’s in Nairobi North tax region?
2. How does the level of tax knowledge of SME operators affect tax compliance decisions by SMEs in Nairobi North tax region?
3. What is the effect of tax compliance costs affect tax compliance behavior of SMEs in Nairobi North tax region?

4. What are the strategies that can improve the tax compliance behavior of SME’s in Kenya?

1.5 Research assumptions

The research took the following assumptions;

a) That accurate and timely tax knowledge enhances tax compliance by SME’s

b) That the high cost of tax compliance influences the behavior of SME’s towards taxation.

c) That the tax legal framework in Kenya has a positive impact on tax compliance

d) That if proper strategies are implemented by the KRA, the level of tax compliance can improve.

1.6 Justification of the Study

An appraisal of the budgetary process in Kenya shows that there is an imbalance between the demand and supply of tax revenue. Appropriate revenue projection is necessary in order to manage the countries fiscal deficit. This study helped to increase awareness of the relationship between tax compliance of SME’s and an increase in the tax revenue and economic growth in Kenya. The study also contributed to existing literature on taxes in Kenya besides shedding light on how revenue productivity can increase the pace of Kenya’s economic growth if the country is to achieve vision 2030 targets. Finally, it provided empirical evidence on the performance of taxes in the informal sector in Kenya which is important in the event that a review exercise of the current tax system and/or revenue projection is required.
1.7 Significance of the Study

The study findings documented how the business profile of SMEs in Kenya influences their tax compliance behavior. It also documented economic and social factors that affect small and medium-scale tax compliance. Through this, the government of Kenya, Kenya Revenue Authority and other stakeholders have a source of information for any further studies and utilization, for an effective implementation of their tax collection strategies and initiatives. The study provided the Kenyan government policy makers with insights on the most critical factors to consider when for the purpose of an efficient and effective tax collection policies and an improved service delivery to the public. Therefore, the findings of this study not only provide vital information on further research in this area of study, but also contribute to the theoretical development of the field of tax compliance.

1.8 Scope and Limitation of the Study

This study was limited to the factors influencing tax compliance by SMEs in Nairobi North’s tax region, Kenya. It studies 150 SMEs, due to their accessibility and capacity to represent other SMEs in northern Nairobi.
CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter presents the theoretical background to the study by objectives, the current law in Kenya, the level of tax knowledge of SME’s operators and the compliance costs. Finally this chapter looks at the conceptual framework, research gaps and summary of the whole chapter.

2.2 Review of Related Literature

Economic theories of tax compliance are also referred to as deterrence theory. According to Trivedi and Shehata (2005), economic theories suggest that taxpayers “play the audit lottery,” i.e. they make calculations of the economic consequences of different compliant alternative, such as whether or not to evade tax; the probability of detection and consequences thereof, and choose the alternative which maximizes their expected after tax return/profit (possibly after adjustment for the desired level of risk). The study will be guided by the theory of planned behaviour and the theory of crime:

2.2.1 Theory of Planned Behavior

Theory of planned behavior is an important theory which presents within the scope of the social psychology and tries to explain human behaviors. This theory was developed by Ajzen (1991) and it is just the improved form of the Theory of Reason Action suggested by Ajzen and Fishbein (1980) in order to explain conscious behaviors. According to this theory, behaviors of the individuals within the society are under the influence of definite factors, originate from certain reasons and emerge in a planned way (Erten, 2002). Nevertheless, the ability to perform a particular behavior depends on the fact that the individual has a purpose towards that behavior. As for the factors determining the purpose towards the behavior, they are attitude towards
behavior, subjective norms and perceived behavioral control (Erten, 2002). Factors counted above are also under the influence of behavioral beliefs, normative beliefs and control beliefs (Ajzen, 2002).

Intention is the basis of this theory and performance of a behavior or its transformation into a different behavior depend on the intention that the individual has generated towards the behavior. Ajzen, described intention as the factor indicating the degree of individual efforts in order to perform a certain behavior (Ajzen, 1991). Intention is explained by attitudes towards behavior, individual norms and perceived behavior controls (Klee et al. 2000). Attitude includes the evaluations made by the individual who will perform the behavior regarding the act of that behavior.

Subjective norm refers to the opinions of the other individuals who are important for individuals that will perform the behavior or are taken as reference as regards to this behavior. Finally, perceived behavior control specifies the difficulty level of the performance displayed by an individual. This element can sometimes affect the behavior directly. For example, in case the behavior control does not depend on the desire of the individual, in other words, if there is any legal sanction, perceived behavior control can affect the behavior directly. As a conclusion, the Theory of Planned Behavior posits that individuals' intentions, together with their perceived control over the behavior determine whether or not they will actually engage in the behavior.

It has been observed that empirical studies carried out within the scope of the Theory of Planned Behavior mostly examine behaviors that individuals report and that the studies examining the behaviors that individuals perform is rather scarce in number (Chang, 1998; Allen, 2004). This is because of the fact that observing the individual behaviors is rather costly in terms of time and
money (Erten, 2002). The aim of this study is also to analyze the behaviors reported by the taxpayers included in this study instead of observing the behaviors of the individuals regarding tax compliance.

### 2.2.2 Theory of Crime

The theory of crime asserts that people are rational actors who behave in a manner that will maximize their expected utility. Becker (1968) argued that authorities needed to and appropriately balances between detection of non-compliers and sanctions to the point where non-compliance becomes irrational. In the early 1970s, Alligham and Sandmo (1972) extended Becker’s work on the economics of crime to the taxation context.

They examined taxpayers’ decision to evade taxes when they were filling out their tax returns and examined the relationship between penalty rate for tax evasion at the time, the probability of detection, and degree of tax evasion engaged in. What they found was that there was a relationship between these variables; with a higher penalty rate and probability of detection deterring individuals from evading their taxes. In the 1980s, therefore, many scholars began to question the value of deterrence alone in regulating behavior. They began to focus their attention on researching compliance rather than deterrence and began to realize the importance of persuasion and cooperation as a regulatory tool for gaining compliance. In fact, research has shown that the use of threat and legal coercion, particularly when perceived as illegitimate, can produce negative behavior; these actions are more likely to result in further non-compliance (Murphy and Harris 2007), creative compliance (McBarnet, 2003), criminal behavior or opposition (Fehr and Rokenbach 2003).
2.3 Theoretical Framework

2.3.1 Previous Empirical Studies on Tax Laws and compliance.

According the records in the Bible, taxation dates back from the times of Jesus Christ, defiance of tax laws also dates back to the same time. Most People have always had a hostile attitude towards tax ever since the introduction of tax. “During the Roman Empire, in 60A.D, Boadecia queen of East Anglia led a revolt that can be attributed to corrupt taxation. In Great Britain, the 100 years’ war (1337-1453) between England and France was renewed in 1369 by among other key factors, the rebellion of the nobles of Aquitaine over the oppressive tax policies of Edward, The Black Prince and in Post-Revolution America; Tax Act of 1864 was challenged several times” (Director, Tax world Organization, 1999). Lack of adequate historical data on tax has made the empirical analysis of tax compliance on businesses quite un-intensive. However, a small number of empirical studies have been done in the past. In the 1970’s, small businesses in Kenya were perceived as marginal to main stream activity. They were typically cast as habitual avoiders and evaders. However, in the 1980’s the service sector took off and represented a higher and growing proportion of GDP in many countries. Small businesses accounted for much of this growth, creating employment and efficiently utilizing capital in the process. The taxation of a sector accounting for such a significant percentage of GDP (average 41%) cannot be ignored. However, the task is particularly difficult in developing economies in that the Micro and Small Business are not generally compliant (through ignorance as well as intent) nor are they easily located by the tax administration (Moyi and Njiraini, 2005).

In South Africa, studies conducted by economy watch dog on tax burdens on SMEs revealed that tax requirements procedures acted as stumbling blocks to tax compliance. This is because complying with taxes tended to swallow up the resources that the SMEs could devote to more
economical running of these businesses. A majority of SMEs experience their tax liability as an increasing burden since they lack enough skilled staff to handle tax compliance issues and are therefore forced to incur ‘extra’ tax costs. Most SMEs do not even recognize the tax incentives and services available to them. The study also noted that changes in tax policies sometimes result in an even more complex tax system. A clear finding was that elaborate tax incentive schemes which require sophisticated systems and skilled staff would often result in increasing compliance costs rather than provide real tax relief. As a result, small businesses (and probably other taxpayers as well) would prefer simple cuts in tax rates and penalties.

According to Kiraithe(2009), tax gaps still exists in the Kenyan context because there is a difference between the total amount of revenue the government expects to collect from the taxpayers, and the amount it actually collects. This scenario is usually attributed to the tax compliance costs. Compliance costs are expenditures incurred by taxpayers in meeting the tax requirements imposed by the law and the revenue authorities, over and above the actual payment of tax and any distortion costs inherent in the nature of the tax. They include: labor costs (owner salary, bookkeeping costs, and the unpaid help), external and internal labor costs, postage and telephone, forms and stationery, travelling costs, instructional literature and seminars, and so on. Tax planning is also included as an inherent part of tax compliance costs. In addition, there are technological costs that relate to tax compliance either directly or indirectly, as soon as a taxpayer becomes tax compliant. Electronic Tax Register (ETR) costs are an example, because they bring with them electricity costs, maintenance costs, and so on. Therefore, as opposed to the substantive costs imposed by legislation like the amount of tax to be paid, compliance costs also include the administrative and time costs of complying with legislation. As these costs increase, the chances of tax avoidance increase as well.
In a study carried out in Kenya on activities such as record keeping, the respondents were asked whether they keep up to date transaction records and books of accounts such as journals, ledgers, cash receipts, cash books, trial balances, profit and loss accounts, and balance sheet. The respondents indicated that in terms of keeping up to date records and books of accounts, they had partially complied. This was attributed to the fact that 40% of them kept vital accounting records such as keep Cash receipts, Cashbook, Balance sheet, Invoices, and Profit and Loss accounts (Lumumba et al., 2010). However, other records that are requirements for tax compliance such as the trial balance, Journals and Ledgers were not up to date.

Furnharn, (1983) noted that the taxpayers’ behavior may be influenced by many factors, which are brought about by their attitudes. These factors are many and differ from one individual to the other and from one county to the other. They include: cost of compliance, the general taxpayers perceptions of the tax system, motivation such as reward, perceived behavioral control and Protestant work ethics, taxpayers’ understanding of a tax system/tax laws, ethics/morality of the taxpayer and tax collector, enforcement efforts such as audit, demographic factors such as sex, age, education, use of informants, and equity of the tax systems.

A study on attitude as a factor affecting tax compliance in Kenya revealed that most taxpayers view the Kenyan tax system as unfair. Most respondents said that the tax laws are complex and not easy to understand. They found it difficult to calculate the tax required from them. In order to make business out of their operations, they were forced to underreport profits and operate illegal businesses. The study also established that the taxpayers are given rewards, and that there is use of informants by KRA to report tax evaders.
Generally, taxpayers are indifferent to the paying of tax fines and penalties. KRA tries to enforce tax compliance by carrying out tax enforcement efforts such as carrying out tax audits and ensuring prosecutions of tax evaders. However, there is still a very high degree of undetected tax offenders, fear of tax audits and prosecution notwithstanding. For this reason, more people are beginning to believe in corruption and that tax is not an obligation. Over time, Taxpayers are generally indifferent with the KRA harassments (Lumumba et al, 2010).

2.3.2 The legal framework and the Impact on Tax Compliance of SME’s

The Tax World Organization, (1999), noted that Taxes are considered a problem by everyone. Not surprising, taxation problems date back to the earliest recorded history (ibid). During the Roman Empire in 60A.D, Boadecia, queen of East Anglia, led a revolt that was attributed to corrupt tax. Between 1337 and 1453, there was a more-than-a-century-long war between England and France in relation to tax. The nobles of Aquitaine were rebelling against the oppressive tax policies of Prince Edward, commonly referred to as “The Black Prince”. Even in the Post-Revolution America there were several rebellions challenging the Tax Act of 1864.

In the Kenyan historical context, the small businesses were always perceived as marginal to mainstream activity in the 1970s, and were typically cast as habitual avoiders and evaders. However, the service sector took off in the 1980s and it began to represent a higher and growing proportion of GDP in many countries including Kenya. Moyi and Njiraini (2005), note that this growth was mainly accounted to the small businesses which created many employment opportunities and in the process, utilized capital efficiently. With an average of 41% contribution to GDP, the authorities had to begin taxing the small businesses sector (Ibid). However, this task has always presented the authorities with difficulties because the SMEs are not easily located by the tax administration, and are generally non-compliant to tax).
However, the government of Kenya has made attempts to bring the SMEs into the tax net under the presumptive tax, so as to mobilize revenue from the SMEs and reduce the tax gap. This move was implemented following the introduction of the Finance Bill 2007 that was labeled the “Turnover Tax” (TOT). The bill became operational in 2008. With the introduction of the Turnover Tax, the policy assumed a presumptive tax form whereby the tax base became the business’ turnover. In that case, any business below the Kshs. 5 million was to be taxed at a flat rate of 3% of the annual turnover. The TOT was specifically designed for micro and small non-designated firms that are unable to keep proper records of accounts, among other complexities associated with the regular tax regime. However, it has failed to command better revenue for the government since the SMEs keep evading tax, driven by the perception that the tax burden is too high. For instance, KRA targeted TOT revenue of 442 million for the 2008/2009, but only 136 million was collected. There are broadly two classes of theories that explain the reasons why taxpayers either comply or fail to comply with their tax obligations: the economic based theories which emphasize incentives, and the psychology-based theories which emphasize attitude (Trivedi & Shehata, 2005).

2.3.3 Tax Knowledge and the Effect on Tax Compliance of SME’s
Taxpayers that are better educated generally know more about tax law and fiscal connections and thus are in a better position to assess the degree of compliance. However, according to KRA there are still people with lower education with an acquired high knowledge about taxation. The complexity of tax information is not perceived the same way, and some taxpayers find it more difficult to understand than others (Ibid). According to survey findings, taxpayers that are less educated are consequently less exposed to information about tax compliance and the relevant regulations covering tax. As a result, they require constant assistance. Knowledge about taxation,
the benefits of taxation and the dangers of non-compliance remain a key impediment to tax compliance in many countries. Kenya has been implementing a continuous tax education for taxpayers and children as future taxpayers (Palil, 2010). Kenya has developed interactive websites, disseminate leaflets together with tax returns, opened call centers’ created advertisements or supplied reminders via television and radio (e.g. to remind taxpayers of deadline dates for filings). In addition to tax education, knowledge about tax laws also plays a major role in determining taxpayers’ compliance behavior. Carroll (2011) on taxation among SME’s in the informal sector in Ghana found out that despite the fact that more than half (65 per cent) of the SME’s surveyed were aware that they have to pay taxes, more than half were not well informed as to why they paid tax and more than 50 per cent did not enjoy the benefits of paying it. However, tax education alone cannot guarantee continued tax compliance.

2.3.4 Tax Compliance Costs and the Effect on Tax Compliance by SME’s
Tax compliance procedures include all formal procedures and related activities that taxpayers have to observe to comply with tax obligations. Tax obligations are classified into four categories: Registration in the system, timely filing or lodging of the required taxation information, reporting complete and accurate information (including good recordkeeping), and Payment of taxes on time as per the requirement of the law. Economic theories on taxation hold that, taxpayers are amoral utility maximize. They are influenced by economic motives such as profit maximization, therefore, they analyze alternative compliance paths for instance whether or not to evade tax. Secondly there is a wide perception by the tax payer that tax is a burden especially the small and medium enterprises (Vihanto, 2000) Therefore, the cost of compliance to taxation play a key role in determining taxpayers willingness to pay tax.
Complexity of the various regulatory and administrative obligations that have to be observed by enterprises is one of the most common complaints by business organizations. Compared to larger companies, SMEs suffer disproportionately from the regulatory burden. This is because the smaller enterprises often do not have sufficient financial and human resources to manage their obligations in the most efficient way. Tax obligations such as payment of taxes and other activities such as registration, documentation, reporting and recording constitute some of the most important requirements that enterprises have to comply with. Enterprises require either internal resources and/or external resources, e.g. tax consultants and accountants for their various tax compliance procedures. The cost factor presented by tax compliance is too vital to be underestimated.

With the current hard task of ensuring efficient and effective tax administration, Kenya is ranked among low-income countries or low compliance countries in the world. Tax administration in Kenya is done by the Kenya Revenue Authority, established through an Act of Parliament on July 1st 1995 (Cap 469). The responsibilities of KRA are promoting tax compliance and ensuring a responsible enforcement obligation. It is entrusted with acting professionally to ensure the social-economic well-being of Kenyans. According to the income tax laws relating to businesses in Kenya, the tax compliance requirements include: keeping of up to date books of account by businessmen, acquiring of Personal Identification Numbers (PIN) by all potential taxpayers, determining the taxable income according to the stipulated rules and regulation, accurate determination of tax liability, filing of returns on income by the prescribed date, paying of tax dues by the prescribed date, payment of fines and penalties for overdue taxes, and allowing of audit by tax collectors if deemed necessarily (CIAT, 2006). There has been a big challenge in ensuring effective tax compliance by Kenyan taxpayers because KRA lacks
advanced systems to detect those who evade tax. In Kenya, the SMEs are the most tax non-compliant taxpayers. Majority of SMEs in Kenya operate at the bottom of the economy since most of them are micro enterprises with fewer than 10 employees, while 70 per cent of them are one person, own account workers. The 1999 Baseline Survey [CBS, ACEG & K-REP] indicated that there were 1.3 million SMEs which contributed 18 per cent of Kenya’s Gross Domestic Product [GDP]. The survey stated that about 64 per cent of the SMEs are in trade. Micro trade activities are sometimes referred to as `survivalist’ enterprises - they allow entrepreneurs to survive with hardly any savings. Most of these enterprises operate within the informal economy, a sector previously referred to as informal sector, or in the Kenya context, Jua Kali.

The Kenya Labor Force Survey Report of 1998/99 indicates that the sector covers all semi-organized and unregulated activities that are small scale in terms of employment. The report notes that the activities are largely undertaken by self-employed persons or employees with few workers in the open markets, in market stalls, in both developed and undeveloped premises, in residential houses or on street pavements (RoK, Labor Force Survey, 2003).

2.4 Conceptual Framework

There is a direct influence of the factors under discussion and tax compliance among SMEs in Kenya. Such factors include the tax payers’ attitude towards taxes, the tax compliance cost, the tax system, the tax information/education, and the size of the entities. The conceptual framework figure below illustrates the relationship between the dependent and the independent variables.
A study carried out among SMEs in Kerugoya, Kenya, on the attitudes of taxpayers and their tax compliance established that the attitudes of taxpayers do not encourage tax compliance (Lumumba et al., 2010). Most of them felt that they were paying a fair share of tax, yet they
were not getting the right services. As a result, they concluded that the tax system in Kenya was unfair. Therefore, the factors which influence taxpayers’ compliance behavior among SMEs need to be well evaluated to help correct this economic vice.
CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction
This chapter describes the research design and methodology that was employed in the study. This includes the research design, target population, sampling for the study, data collection instruments and procedures, and data analysis.

3.2 Research Design
This study was conducted using the descriptive survey design. This design was preferred because the subject is being observed in a completely natural and unchanged natural environment. A descriptive study describes phenomenon of how things are in the population (Saunders et al., 2007). Research design involves developing a blue print for fulfilling objectives and answering questions for the study (Saunders et al., 2007). Kothari (2004) indicated that descriptive research is important because it acts as a pre-cursor to quantitative research designs and the general overview gives some valuable pointers as to what variables are worth testing quantitatively. It constitutes the blue print (guide) for the collection, measurement and analysis of data. This design was preferred because it helped to produce data that was holistic, contextual, descriptive, in-depth and rich in details.

3.3 Target Population
The target populations was the SME’S operating within the Nairobi North Tax District and are legally registered by KRA as taxpayers on the category of SMEs. Nairobi North District has a total of 1500 SMEs.(KRA, 2013)


### 3.4 Definition and Measurement of Variables

<table>
<thead>
<tr>
<th>VARIABLE</th>
<th>DEFINITION</th>
<th>MEASUREMENT</th>
<th>VARIABLE TYPE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Tax Compliance</td>
<td>Taxpayers adherence to tax laws voluntarily and to ensure correct tax</td>
<td>Legal framework</td>
<td>Dummy</td>
</tr>
<tr>
<td></td>
<td>obligations are fulfilled</td>
<td>Tax knowledge</td>
<td>1- Complied</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Tax compliance costs</td>
<td>0-Otherwise</td>
</tr>
<tr>
<td>2 Compliance costs</td>
<td>These are costs incurred by taxpayers in meeting the requirements imposed</td>
<td>Number of skilled staff employed.</td>
<td>Continuous</td>
</tr>
<tr>
<td></td>
<td>on them by the law and the revenue authorities over and above the actual</td>
<td>External costs incurred such as book keeping and accounting.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>payment of tax and any distortion costs inherent in the nature of the tax.</td>
<td>The rate of the costs incurred in meeting compliance obligations</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The costs include; labour costs, internal book keeper, forms and stationery,</td>
<td>Frequency of submitting returns</td>
<td></td>
</tr>
<tr>
<td></td>
<td>postage and telephone</td>
<td>The number of levels of government involved in levying and collecting tax.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>The number of taxes that an entrepreneur is subjected to.</td>
<td></td>
</tr>
<tr>
<td>3 Tax Knowledge</td>
<td>Ease of access and understanding of taxation by the business owners</td>
<td>Level of education</td>
<td>Dummy</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Formal training on aspects that cover the tax reporting process</td>
<td>1- Complied</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Simplicity of tax rules</td>
<td>0-Otherwise</td>
</tr>
<tr>
<td>4 Legal Framework</td>
<td></td>
<td>Complexity of the tax law</td>
<td>Dummy</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Tax Rates</td>
<td>1- Complied</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Number of tax law</td>
<td>0-Otherwise</td>
</tr>
</tbody>
</table>

**Table 3.0: Analysis of Variables**

Source: Author

### 3.5 Sampling Techniques

According to Paton (2002), the sample size depends on factors such as what one wants to know, the purpose of the inquiry, what is at stake, what will be useful, what will have credibility and what can be done with the available time and resources. Therefore, since the accuracy of the sample depends on the sampling frame, the researcher ensured a high degree of correspondence
between the sampling frame and the sample population. The sampling techniques that was used in this study was stratified random sampling. The category of the specific enterprise, whether small or medium was used to group the SMEs into strata and 10% of 1500 was selected using the stratified random sampling method.

3.6 Sample Size
The research employed judgmental and stratified random sampling techniques in any one stratum. Stratified random sampling was preferred because it eliminated bias and gave the elements in the population equal chances of being selected. When targeting businesses that have been in operation for at least 3 years, judgmental random sampling technique was adopted. 10% of the respondents from the sampling frame comprising 1500 SMEs in the KRA register was selected for the study. Therefore, 150 entrepreneurs formed the study.

3.7 Research Instruments
Questionnaires are the main research instrument that was used in this study. The fixed choice and open-ended formats of the item was used in developing the questionnaire items. All questionnaire categories adopted this format. The fixed choice items involved proposing answers to the respondents especially so as to eliminate the tendency to over think. Thus, they ended up choosing the easiest alternative that also provided less self-expression opportunities. For this reason, a few open ended response items had to be combined with this format. The Lickert scale was adopted for most of the items. An example of the Lickert scale that was adopted is: 1-strongly disagree, 2-disagree, 3-undecided, 4-agree, 5-strongly agree).
3.8 Validity and Reliability of Research Instruments

3.8.1 Validity
Validity refers to the degree to which a study accurately reflects or assesses the specific concept that the researcher is attempting to measure. In other words, validity is the degree to which results obtained from the analysis of the data actually represent the phenomenon under study. These helped to ensure that the questionnaires represented the content, they were appropriate for the sample and that the questionnaires were comprehensive enough to collect all the information needed to address the purpose and goals of the study.

3.8.2 Reliability
The extent to which results are consistent over time and an accurate representation of the total population under study is referred to as reliability and if the results of a study can be reproduced under a similar methodology, then the research instrument is considered to be reliable (Mugenda and Mugenda, 1999). A reliable instrument therefore, is the one that constantly produces the expected results when used more than once to collect data from two samples drawn from the same population. Reliability of the instrument were enhanced through a pilot study. Test-re-test method was used. During the study, a randomly selected sample of proprietors of SME’s was given questionnaires to fill. They were requested to fill similar questionnaires after two weeks. The scores from the two tests were correlated using Cronbach Alpha Co-efficient. If the results produced reliability coefficient of 0.7 the instrument were considered reliable.

3.9 Data Analysis
Data was analyzed using both descriptive and inferential statistics. Quantitative data was analyzed through coding in Statistical Package for Social Sciences (SPSS) data editor where
inferences were drawn and descriptive statistics like frequencies of responses were used to give
the results of the analysis. Nominal and ordinal scales were used in measuring variables. Strength
of the relationship between dependent and independent variables were tested using correlation -
co efficient \((r)\). Logistic regression analysis was carried out by the STATA 11 econometric
software. Inferential statistics enabled the research to obtain inferences from the data using the
logit model. The model will therefore be predicted logit of:

\[
\text{Tax Compliance} = \beta_0 + \beta_1 \chi_1 + \beta_2 \chi_2 + \beta_3 \chi_3 + \epsilon
\]

\[
\text{Logit } (p/ p-1) = \beta_0 + \beta_1 \chi_1 + \beta_2 \chi_2 + \beta_3 \chi_3 + \epsilon
\]

\(\chi_1 = \) Legal framework in Kenya

\(\chi_2 = \) Tax Knowledge

\(\chi_3 = \) Tax Administration Costs

\(\beta_0 = \) the constant

\(\beta_{1-n} = \) the regression coefficient or change included in \(Y\) by each \(\chi\)

\(\epsilon = \) error term

Tax compliance is the dependent variable which is a dummy with a value of 1 for tax compliance
and 0 for non-compliance. \(X_1\) is a vector for Legal framework; Complexity of the tax law, Tax
Rates Number of taxes. \(X_2\) is a vector for tax knowledge; Level of Education, Formal training on
aspects of tax reporting process, Simplicity of tax rules. \(X_3\) is a vector for tax administration
costs; External costs, Number of skilled staff, Frequency of submitting returns, Rate of costs.

3.10 Data Management and Ethical Considerations

Data management was carried out accurately ensuring high integrity and at the same time
ensured maintenance of proper work ethics. Authorization was sought from the university and
the taxpayers who provided the data. Taxpayers were informed and assured that the information
they gave was only be for the purposes of the study. If they so wish they can could request for a copy of the project on its completion.
CHAPTER FOUR

4.0 DATA ANALYSIS, PRESENTATION AND INTERPRETATION

4.1 Introduction

This chapter presents findings and discussions on the study as set out in the research methodology. Data collected was both qualitative and quantitative. Data was analysed using descriptive statistics that is mean and standard deviation, and inferential statistics that is correlation and regression. Data is presented using tables, graphs and charts.

Response Rate

A total of 150 questionnaires were given out to owners/managers of SME’s in the Nairobi North area. The table 4.1 shows the response rate. From the study, 136 out of the 150 sampled respondents filled-in and returned the questionnaires making a response rate of 90.67%.

Table 4.1: Response Rate

<table>
<thead>
<tr>
<th>Issued questionnaires</th>
<th>Returned</th>
<th>Response Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>150</td>
<td>136</td>
<td>90.67%</td>
</tr>
</tbody>
</table>

Mugenda and Mugenda (2003) observed that a 50% response rate is adequate, 60% good, while 70% rated very well. This collaborates with Bailey (2000) assertion that a response rate of 50% is adequate, while a response rate greater than 70% is very good. This implies that based on this assertion, the response rate in this case of 78.65% is therefore very good. This reasonable response rate was made a reality after the researcher made personal calls and visits to remind the respondent to fill-in and return the questionnaires and also continued efforts to remind them of the benefits of this research.
Reliability analysis

The value of the Cronbach’s alpha coefficient ranges from zero to one and was used to describe the reliability of factors extracted from questions with two possible answers or multi-point formatted questionnaires or scales. A higher value; close to one, showed a more reliable generated scale. Cronbach’s alpha of well above 0.7 implied that the instruments were sufficiently reliable for the measurement. As most item total correlations were reasonably high, the construct validity of the instruments was considered reasonable (Brown, 2000). Table 4.2 illustrates the results of the reliability analysis. It involved questionnaires from respondents.

Table 4.2 Reliability Analysis

<table>
<thead>
<tr>
<th>Variable</th>
<th>Cronbach’s alpha</th>
<th>No of items</th>
</tr>
</thead>
<tbody>
<tr>
<td>The role of the legal framework and whether it supports compliance in Nairobi North tax region</td>
<td>0.703</td>
<td>19</td>
</tr>
<tr>
<td>The level of tax knowledge of SME operators and tax compliance by SMES in Nairobi North tax region</td>
<td>0.712</td>
<td>5</td>
</tr>
<tr>
<td>The role of tax compliance costs and tax compliance by SMES in Nairobi North tax region</td>
<td>0.814</td>
<td>21</td>
</tr>
</tbody>
</table>

The Alpha coefficients were all greater than 0.7 indicating an acceptable reliability of the instruments. The instruments therefore were appropriate for the study.
Validity of Results

Construct validity is established by relating measuring instruments to a general theoretical framework in order to determine whether the instrument is tied to the concepts and theoretical assumptions they are employing (Nachmias & Nachmias, 2008).

Content validity of this study was determined by first having a discussion of the items in the instrument with my supervisors, and establishing whether it measured what it was meant to measure or not in relation to the research objectives. Content validity index of 0.802 was computed. Neuman (2000) recommends a content validity index of above 0.5, indicating that the validity of the instrument was acceptable.

4.2 Demographic Information

Responses by the owners and managers of the SME’s in Nairobi North area were analyzed on the basis of their background information. This section focuses on location of the company, main business of the company, age of the organization and the number of employees.

Table 4.3: Background Information

<table>
<thead>
<tr>
<th>Information</th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Age of organization</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less than 1 year</td>
<td>3</td>
<td>2.2</td>
</tr>
<tr>
<td>1-3 years</td>
<td>26</td>
<td>19.1</td>
</tr>
<tr>
<td>4-5 years</td>
<td>41</td>
<td>30.14</td>
</tr>
<tr>
<td>More than five years</td>
<td>66</td>
<td>48.53</td>
</tr>
<tr>
<td><strong>Number of permanent employees</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>One</td>
<td>29</td>
<td>21</td>
</tr>
<tr>
<td>Two</td>
<td>18</td>
<td>13</td>
</tr>
<tr>
<td>Five</td>
<td>12</td>
<td>9</td>
</tr>
<tr>
<td>Six</td>
<td>56</td>
<td>41</td>
</tr>
<tr>
<td>Seven</td>
<td>22</td>
<td>16</td>
</tr>
<tr>
<td><strong>Number of casual employees</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>One</td>
<td>28</td>
<td>20.5</td>
</tr>
<tr>
<td>Two</td>
<td>2</td>
<td>1.47</td>
</tr>
<tr>
<td>Three</td>
<td>13</td>
<td>9.55</td>
</tr>
<tr>
<td>Eight</td>
<td>51</td>
<td>37.5</td>
</tr>
<tr>
<td>Nine</td>
<td>42</td>
<td>30.88</td>
</tr>
</tbody>
</table>
The data analysis was as follows; 90% of the respondents were involved in the sale of motor vehicle and machinery spare parts while 3.1% were bookshops and cosmetics shops. When asked how many employees they had, most of the enterprises had six permanent employees, eight casual employees and had no volunteers.

4.4 Determinants of Tax Compliance:

Table 4.4: Determinants of Tax Compliance

<table>
<thead>
<tr>
<th>DETERMINANTS OF TAX COMPLIANCE</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of taxes obligations that an entrepreneur is subject to</td>
<td>4.12</td>
<td>0.324</td>
</tr>
<tr>
<td>The complication of tax legal framework</td>
<td>4.42</td>
<td>0.763</td>
</tr>
<tr>
<td>The number of returns that are required to be submitted</td>
<td>4.14</td>
<td>0.516</td>
</tr>
<tr>
<td>The number of government bodies involved in tax collection</td>
<td>4.07</td>
<td>0.475</td>
</tr>
</tbody>
</table>

1. To a very large extent 2. To a large extent 3. To some extent 4. To a small extent 5. To no extent at all

The data analysis indicates that majority of the respondents were of the opinion that the following factors influences their decision to be compliant or not; to a small extent the number of tax obligations an entrepreneur is subjected to with a mean of 4.12 and a standard deviation 0.324; the complication of the tax legal framework with a mean 4.42 and a standard deviation 0.763; the number of returns that are required to be submitted mean 4.07 and a standard deviation 0.475 as shown in table 4.4.
4.5 Tax Knowledge

Andreoni et al., (1998), in their study on tax compliance reported that the degree of knowledge and information is an important factor in the way taxpayers behave. Better educated taxpayers are supposed to know more about tax law and fiscal connections and thus would be in a better position to assess a higher degree of compliance. However, it should be noticed that there might be people with a lower education who have acquired a high knowledge about taxation. Some taxpayers find the complexity of tax information more difficult to understand than others (Murphy, 2004).

When presented with the question on whether the respondents had any form of training from KRA, 21.6% of the respondents agreed while 78.4% of the respondents disagreed. Table 4.5 displays the activities that the tax payers could carry out when submitting and filing returns.

Table 4.5: Complexity of Tax Laws

<table>
<thead>
<tr>
<th>Activity</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registration</td>
<td>3.07</td>
<td>0.258</td>
</tr>
<tr>
<td>Filing of returns</td>
<td>3.95</td>
<td>0.213</td>
</tr>
<tr>
<td>submitting the returns to KRA offices</td>
<td>2.93</td>
<td>0.258</td>
</tr>
<tr>
<td>Doing return amendments</td>
<td>2.16</td>
<td>0.949</td>
</tr>
<tr>
<td>Tax Rules are too complicated for a non-professional to understand</td>
<td>4.95</td>
<td>0.486</td>
</tr>
<tr>
<td>Information on tax rules is not readily available</td>
<td>1.98</td>
<td>0.408</td>
</tr>
<tr>
<td>The complexity of tax laws contributes to inaccurate tax returns</td>
<td>2.02</td>
<td>0.408</td>
</tr>
</tbody>
</table>
1. To a very large extent 2. To a large extent 3. To some extent 4. To a small extent 5. To no extent at all

The analysis indicate that most respondents were of the opinion to a large extent they had knowledge in submitting returns to the KRA offices and doing amendments they however agreed to some extent they were not conversant with registration with a mean of 3.07 and a standard deviation of 0.258 and filing returns with a mean of 3.95 and a standard deviation of 0.213. The respondents agreed that the tax rules are too complicated for a non-professional to understand with a mean of 4.95 and a standard deviation of 0.486 the respondents strongly disagreed the information on tax rules is readily available and disagreed the complexity of tax laws contributes to inaccurate tax returns with a mean of 2.02 and a standard deviation of 0.408.

4.6 Tax Compliance costs

In a study carried out on Tax compliance and simplification, OECD (2004), established that Compliance costs tends to increase with the number of taxes that an entrepreneur is subject to, the complexity of the tax rules, the frequency of submitting tax returns, and the number of levels of government involved in levying and collecting tax.

Table 4.6: Compliance Costs

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor</td>
<td>4.43</td>
<td>0.956</td>
</tr>
<tr>
<td>External costs for example consultancy</td>
<td>4.29</td>
<td>0.607</td>
</tr>
<tr>
<td>Stationery and other office costs</td>
<td>4.07</td>
<td>0.475</td>
</tr>
<tr>
<td>communications costs</td>
<td>4.14</td>
<td>0.467</td>
</tr>
<tr>
<td>seminars related costs</td>
<td>4.52</td>
<td>0.887</td>
</tr>
<tr>
<td>legal Costs</td>
<td>4.50</td>
<td>0.778</td>
</tr>
</tbody>
</table>
1. To a very large extent 2. To a large extent 3. To some extent 4. To a small extent 5. To no extent at all

The analysis indicated that the respondents disagreed to a small extent on the following matters: the availability of labor increases compliance with a mean of 4.43 and a standard deviation of 0.956; external costs for example consultancy with a mean of 4.29 and a standard deviation of 0.607; stationery and office costs with a mean of 4.07 and a standard deviation of 0.475; communication costs with a mean of 4.14 and standard deviation of 0.467; seminar related costs with a mean of 4.52 and standard deviation of 0.887 as shown in table 4.6.

Compliance costs are therefore the administrative and time costs of complying with legislation as opposed to the substantive costs imposed by legislation like the amount of tax to be paid. This cost tends to lead to avoidance of tax compliance.

**Table 4.7: Tax Rates**

<table>
<thead>
<tr>
<th>Description</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rates are not too high</td>
<td>4.503</td>
<td>0.87759</td>
</tr>
<tr>
<td>Most businesses do not report taxes fairly</td>
<td>4.521</td>
<td>0.88743</td>
</tr>
<tr>
<td>Tax laws are complicated</td>
<td>4.521</td>
<td>0.94901</td>
</tr>
<tr>
<td>Under declaring taxes increases the profits</td>
<td>4.443</td>
<td>0.81959</td>
</tr>
<tr>
<td>KRA uses informants to report tax non compliant cases</td>
<td>1.910</td>
<td>0.426</td>
</tr>
<tr>
<td>Fines and penalties for non-compliance are ineffective</td>
<td>2.16</td>
<td>0.949</td>
</tr>
</tbody>
</table>

1. To a very large extent 2. To a large extent 3. To some extent 4. To a small extent 5. To no extent at all

The analysis indicated the most of the respondents were of the following opinion to a small extent; Tax rates are not too high with a mean of 4.503 and a standard deviation of 0.877; Most businesses do not report taxes fairly with a mean of 4.521 and a standard deviation of 0.887, tax
laws are complicated, with a mean of 4.521 and a standard deviation of 0.949. Under declaring taxes makes businesses more profitable with a mean of 4.443 and a standard deviation of 0.819, to a large extent they agreed that fines and penalties for non-compliance are ineffective while to a very large extent they agreed that KRA uses informants to report tax non-compliant cases with a mean of 1.910 and a standard deviation of 0.426 as shown in table 4.7.

A study carried out by Kirathe, (2009) revealed that a tax gap still exists. This implies that there is a difference between what the government thinks the tax payers should pay and what it collects. This was attributed to tax compliance costs. Compliance costs are those incurred by taxpayers in meeting the requirements imposed on them by the law and the revenue authorities, over and above the actual payment of tax and any distortion costs inherent in the nature of the tax.
4.7 Factors Affecting Decision To Have Or Not To Have A Premise

When presented with the question whether the SME's had any official premises, 47.22% were of the opinion they had official premises while 52.78% of the respondents did not have any official premises.

Figure 4.7: Official Premises

Table 4.8: Factors Affecting Decision To Have Or Not To Have A Premise

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Standard-Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The nature of business</td>
<td>4.05</td>
<td>0.375</td>
</tr>
<tr>
<td>Legal implications</td>
<td>2.02</td>
<td>0.408</td>
</tr>
<tr>
<td>Cost of premise</td>
<td>4.19</td>
<td>0.450</td>
</tr>
</tbody>
</table>

1. To a very large extent 2. To a large extent 3. To some extent 4. To a small extent 5. To no extent at all
The analysis indicated that majority of the respondents were of the opinion that the following factors influenced their decision to have a premise to a small extent mean the nature of business 4.05 and a standard deviation 0.375; cost of premise mean 4.19 and a standard deviation 0.450; following factor influence to a large extent; legal implication on tax compliance mean 2.02 and a standard deviation 0.408 as shown in table 4.8.

According to the Small Business Service’s MSE survey for 2003, one in five MSEs identified the cost or availability of premises as an obstacle to their business success. This is so for small businesses at the start-up phase as well as for small businesses seeking to expand their operations. Factors such as costly rents, long lease and stringent inflexible tenancy agreements have been identified as contributing to the declining demand for premises by MSEs. On the supply side, investors are discouraged by expectations of poor returns on commercial property developments. The continuous lack of cash flow results in tax compliance avoidance (Moyi and Njiraini, 2005).

**Figure 4.9: Tax compliance As A Result of keeping of records and books of accounts as required By The Law**
As shown in figure 4.9, 26.389% of the respondents were not compliant, 18.056% of the respondents had partial compliance and 55.56% of the respondents were fully compliant. On activities such as record keeping study carried out in Kenya the respondents were asked whether they keep up to date transaction records and books of accounts i.e. cash receipts, invoices, journals, ledgers, cash books, trial balances, profit and loss accounts, and balance sheet. From the research data, the respondents indicated that they had partially complied in terms of keeping up to date records and books of accounts. This was because most of them (more than 40%) keep Cash receipts, Cashbook, Balance sheet, Invoices, and Profit and Loss accounts. But other records like the trial balance, Journals and Ledgers as requirements for tax compliance were not up to date. Generally, there was some sort of non-compliance in keeping up to date records and books of accounts (Lumumba et al., 2010)

**Table 4.8: Decisions to Comply or not**

<table>
<thead>
<tr>
<th>Decision</th>
<th>Mean</th>
<th>STD-Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rates are not too high</td>
<td>4.70</td>
<td>0.513</td>
</tr>
<tr>
<td>Most businesses do not report taxes fairly</td>
<td>4.35</td>
<td>1.044</td>
</tr>
<tr>
<td>Tax laws are complicated</td>
<td>4.72</td>
<td>0.591</td>
</tr>
<tr>
<td>Under declaring taxes increases the profits</td>
<td>4.95</td>
<td>0.213</td>
</tr>
<tr>
<td>KRA uses informants to report tax non compliant cases</td>
<td>3.07</td>
<td>0.258</td>
</tr>
<tr>
<td>Fines and penalties for non-compliance are ineffective</td>
<td>4.74</td>
<td>0.848</td>
</tr>
</tbody>
</table>


The analysis indicated that majority of the respondents were of the opinion that they agreed following factors influences their decision to comply or not to; taxes are not too high 4.70 and a standard deviation 1.044; tax laws are complicated 4.72 and a standard deviation 0.591, under declaring taxes increases the profit 4.74 and a standard deviation of 0.848 the respondents were
neutral about the use of informants by KRA to report tax non-compliant cases with mean of 4.74 and a standard deviation of 0.848 as shown in table 4.8

**Table 4.9: Tax Obligation**

<table>
<thead>
<tr>
<th>Tax Obligation</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registration as a taxpayer in the KRA system</td>
<td>2.95</td>
<td>0.486</td>
</tr>
<tr>
<td>Timely filing</td>
<td>4.02</td>
<td>0.462</td>
</tr>
<tr>
<td>Accurate and timely information from the KRA officers</td>
<td>4.07</td>
<td>0.593</td>
</tr>
<tr>
<td>Timely payment of taxes</td>
<td>4.14</td>
<td>0.467</td>
</tr>
</tbody>
</table>


The analysis indicated that majority of the respondents were of the opinion that they agreed following factors increased compliance; timely filing 4.02 and a standard deviation 0.462; accurate and timely information from the KRA officers 4.07 and a standard deviation 0.593, timely payment of taxes 4.74 and a standard deviation of 0.848 the respondents disagreed about the level of compliance increases because of the registration as a taxpayer in the KRA system with mean of 2.95 and a standard deviation of 0.486 as shown in table 4.9

**Table 4.10: Strategies that can improve tax Compliance in Kenya**

<table>
<thead>
<tr>
<th>Strategies</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is need to improve the Kenya’s tax system</td>
<td>4.47</td>
<td>0.750</td>
</tr>
<tr>
<td>The complexity of tax laws contributes to inaccurate tax returns</td>
<td>3.25</td>
<td>1.172</td>
</tr>
<tr>
<td>Understanding of tax rules is important in ensuring compliance</td>
<td>4.00</td>
<td>0.712</td>
</tr>
<tr>
<td>Introduction of appropriate tax system</td>
<td>3.71</td>
<td>0.7</td>
</tr>
</tbody>
</table>
lowered costs of tax compliance & 3.76 & 0.722 \\
Improvement of government services hence change of tax payers attitude towards compliance & 3.31 & 1.016 \\
Availability of information and/or education on tax & 2.82 & 0.861 \\
Tax system in Kenya is to blame for non tax compliance & 2.40 & 1.083 \\

*Key: Strongly Disagree = 1, Disagree = 2, Neutral = 3, Agree = 4, Strongly Disagree = 5*

The analysis indicated that majority of the respondents were of the opinion that the government should do the following to improve the tax compliance in Kenya; improve the Kenya’s tax system mean 4.47 and a standard deviation 0.75; reduce the complexity of tax laws to reduce the inaccurate tax returns with a mean 3.25 and a standard deviation 1.172; of understanding of tax rules is important in ensuring compliance mean 4.00 and a standard deviation 0.712; introduction of appropriate tax system mean 3.71 and a standard deviation 0.7; lowering costs of tax compliance mean 3.76 and a standard deviation 0.722; improvement of government services hence change of tax payers attitude towards compliance mean 3.3 and a standard deviation 1.016; the respondents disagreed the: availability of information and/or education on tax mean 2.82 and a standard deviation 0.861 and tax system in Kenya is to blame for non tax compliance mean 2.40 and a standard deviation 1.083 as shown in table 4.10.

Lopez and Kadar (2001) noted that taxation among Organization for Economic Development Countries (OECD) had uniformly been geared towards efficiency, increased tax revenue, equity and enforceability. Having stated some of the functions of government to the citizens using taxation as a tool, the objective of taxation can therefore be summed up as in Nightingale (2002) and Lyme and Oats (2010): raising revenue to finance government expenditure, redistribution of wealth and income to promote the welfare and equality of the citizens and regulation of the
economy thereby creating enabling environment for business to thrive. Finding out strategies for tax compliance improvement was one of study objectives.

4.6 Hypothesis Testing

Table 4.11: Pearson Correlation

<table>
<thead>
<tr>
<th>Tax Compliance</th>
<th>Legal Framework</th>
<th>Tax Knowledge</th>
<th>Compliance Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pearson Correlation</td>
<td>.508***</td>
<td>.601***</td>
<td>.443***</td>
</tr>
<tr>
<td>Sig. (2-tailed)</td>
<td>.001</td>
<td>.000</td>
<td>.003</td>
</tr>
<tr>
<td>N</td>
<td>136</td>
<td>136</td>
<td>136</td>
</tr>
</tbody>
</table>

There is a positive strong relationship between tax compliance and the independent variables as shown by the Pearson’s co-efficient correlation which is significant as indicated by the P-value at 95% level of confidence.

Table 4.12: Regression Analysis

<table>
<thead>
<tr>
<th>Model</th>
<th>Un-standardized Coefficients</th>
<th>Standardized Coefficients</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std Error</td>
</tr>
<tr>
<td>(Constant)</td>
<td>0.262</td>
<td>0.597</td>
</tr>
<tr>
<td>Legal Framework</td>
<td>1.724</td>
<td>0.279</td>
</tr>
<tr>
<td>Compliance costs</td>
<td>0.133</td>
<td>0.178</td>
</tr>
<tr>
<td>Tax Knowledge</td>
<td>0.541</td>
<td>0.178</td>
</tr>
</tbody>
</table>

The multiple regression analysis was conducted as depicted by the equation.
Legal Framework

In testing the significance of the legal framework in the relationship, it depicts p-value of 0.001, making it much statistically significant. It has a regression coefficient of 1.724, a strong positive relationship. A unit of tax system results to 172.4% changes in tax compliance.

Tax Knowledge

In testing the significance compliance costs practices in the relationship, it depicts p-value of 0.000, making it much statistically significant. It has a regression coefficient of 0.541, a strong positive relationship. A unit of compliance cost results to 54.1% changes in tax compliance.

Compliance Costs

A p-value of 0.003 explains that the regression coefficient corresponding to information is statistically significant in explaining the revenue by SMEs. A regression coefficient of 0.133 implies that unit information on tax to SMEs Increases/reduces the revenue collection by SMEs by 13.3%.

Table 4.13: Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
<th>R Square Change</th>
<th>F Change</th>
<th>df1</th>
<th>df2</th>
<th>Sig. F Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.983a</td>
<td>.965</td>
<td>.964</td>
<td>1.363</td>
<td>.965</td>
<td>356.49</td>
<td>4</td>
<td>132</td>
<td>.000</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), legal framework, tax knowledge, tax compliance costs

b. Dependent Variable: Tax compliance

\[ X_1 = \text{Legal Framework}\]
$X_2 = \text{Tax knowledge}$

$X_3 = \text{Compliance Costs}$

The Adjusted R Squared for all value tells us that the model accounts or 96.5% of variance in the tax compliance by SMEs. 96.5% of the variations in the tax compliance by SME’s can be explained by the identified independent variables: the legal framework, tax knowledge and the compliance costs. This implies that these factors are very significant (since the p-values< 0.05) and therefore need to be considered in any effort to boost revenue collection by KRA. According to Hair et al (2006) if the coefficient of the independent variables are really not all zero then the F-ration should be significantly greater than 1.00 which in this case F-ratio =356.49 with a p-value since the p-values< 0.05.
CHAPTER FIVE

5.0 SUMMERY, CONCLUSION AND RECOMMENDATION

5.1 Introduction

This chapter presented the discussion of findings, the conclusion and the recommendations. The data was analyzed and presented in form of tables and charts. The relationships between the factors that affect tax compliance by small and medium enterprises in Nairobi north tax region, Kenya were tested. The policy implications from the findings and areas for further research are presented as well as areas for further study.

5.2 Summary of Findings

In conclusion the study revealed that most of the MSEs in Nairobi North tax region are owned and run by the owners who are sole proprietors; most of the firms are more than five years old and have less than two permanent employees and less than three casual workers.

5.2.2 The role of the legal framework on tax compliance in Kenya

The findings of this study revealed that there is a strong relationship between legal framework and tax compliance. The tax Acts and laws which are legal documents with legal language are complicated for ordinary taxpayers to comprehend and given the numerous legal amendments every year, taxpayers lack the necessary expertise to complete their tax returns. This is in line with previous findings carried out in the literature review. The study revealed that compliance is less burdensome when tax laws are simple, 51% of taxpayers viewed the corporate tax rates as high while 29.8% viewed them as being fair. In addition, about 85.9% of taxpayers viewed PAYE rates being either very high or high. This implies that the income tax and VAT rates are
punitive and lack in-built mechanisms that would enhance self-assessment. Therefore, There is need to simplify tax laws, tax forms and procedures.

5.2.3 The Relationship between Tax Knowledge and Tax Compliance
The findings of this study revealed that majority of the respondents have a challenge in accessing information about taxes. As earlier discussed in the literature review section of this study, less educated tax payers are less exposed to tax related information and are less informed about relevant tax information and thus are more prone to tax evasion. Some tax payers find the complexity of tax information more difficult to understand than others. This complexity may lead to unintentional noncompliance. The study population generally found the information given by KRA fairly inadequate to enable SMEs complete their tax obligations expected from them. Some taxpayers found the process to be complicated; requiring too much information thus a waste of time and resources, it is thus clear that there is a strong case for improvement of the information available. Majority of the respondents were in agreement that Taxpayer Education/Seminars plays a positive role in enhancing tax compliance. Taxpayer education is one of the powerful tools of enhancing compliance, this is because at such forum, knowledge is passed to taxpayers exhaustively and this enhances future compliance. Communication channels should open up as this enhances friendly relations between the taxpayer and the tax authority. Furthermore, taxpayers would also feel part and parcel of the policy making process. KRA should strive to open ‘Help’ counters and well-structured website for taxpayers to seek help in dispensing information. Well-trained and knowledgeable staff should man the information counters. They should also enhance taxpayer education and remove the ambiguities in the various tax related Acts of parliament.
5.2.4 Effect of the Tax Compliance Costs on Tax Compliance

High compliance costs can result in tax non-compliance, tax fraud, and inhibit investment by way of diminishing competitiveness of the country in terms of taxation attractiveness. (Ojeka, 2012). The study concluded that compliance costs, in form of fees charged by tax consultants and other costs are positively correlated with non-compliance behavior and thus negatively correlated with tax compliance behavior. The respondents in the study felt that consultancy charges and the cost of hiring professional staff is expensive. Concerning the book keeping issues, it was concluded that many SMEs resort to engaging professional tax consultants to be able accomplish the statutory requirement to accompany annual returns with audited accounts, and at the same time a good number of companies have computerized their accounting system to go around those requirements. All these efforts do amount to some cost borne by the taxpayer, The tax authority should endeavor to improve compliance by promoting sound accounting practices as this will greatly reduce the cost of hiring professional services.

5.3 Conclusion

Findings from the study revealed that all the identified factors have a direct influence on the tax compliance among SMEs and they included tax registration in the KRA system, timely filing of returns, complicated tax system, lack of information and education on taxation and costly tax compliance procedure. There was a general feeling from taxpayers that taxes they pay does not translate to services rendered to the public by the government and hence they are demotivated to pay them, the study confirmed that KRA uses both voluntary tax compliance strategy alongside the deterrent measures strategy. Most of the respondents felt the tax rates should be reviewed, thus the government should relook at the tax rates currently charged to SMEs. On availability of tax information, information received by taxpayers is an important factor that contributes to their
understanding of tax responsibilities, especially regarding registration and filing requirements, on the same note KRA should address the complexities of annual tax returns, periodic variations in the tax laws, and levels of penalties and fines. Any amendments in the tax laws should be passed promptly to the SMEs via various channels like tax Seminars, Booklets and Media Channels. This will greatly improve the SMEs level of compliance as the complexities associated with tax matters will be demystified.

On tax compliance cost, the SMEs confirmed to engaging the services of tax agents and professional staff to handle accounting issues. This cost is normally a burden to the SMEs who felt that they should be encouraged to improve their bookkeeping by being offered incentives, such as application of a lower presumptive tax rate for small businesses after meeting certain recordkeeping standards. The government should also engage the small holders in sensitization forums on how to reduce the cost associated with tax compliance.

With regard to the attitude of taxpayers toward payment of taxes to the government, KRA should ensure that taxpayers are always motivated. This is by changing the MSEs’ perception through involvement because already they feel that tax rates are not fair and that business makes high profits by operating illegal business and under reporting profits. They should also make tax laws easy to understand, reward outstanding taxpayers while at the same time penalizing those who default.

5.4 Recommendations

5.4.1 Tax Knowledge
To enhance compliance there is need to intensify taxpayer education in terms of increasing the number of sessions and broadening coverage to include tax consultants. This will enlighten the
taxpayers on existing law and any other tax liability. This will also provide a forum for taxpayers to air their complaints and or compliments.

There is need to continuously train technical staff to keep abreast with the tax law and other emerging tax related issues. This way, the officers will impart proper and correct advice to taxpayers during the time of audits. Customer care lessons should form an integral part of this training. Recruitment of new taxpayers by the authority should be intensified and enhanced. This will broaden the tax base and reduce pressure on the complying taxpayers.

5.4.2 Legal Framework

Consider lowering the tax rates to enhance collections. Lower tax rates make it less attractive to evade taxes as opposed to high rates. High penalty rates will increase compliance but only marginally. This penalty rates should be kept at an optimum level not to discourage taxpayers. Also consider uniform penalty rates for all tax heads.

The current policy reforms regarding business regulations and taxation laws and systems have been formulated with little participation of the informal sector. This has created Mistrust and weak structural dialogue between informal sector and government and this is a factor that hinders taxing of the informal sector. There is a general mistrust between tax agents and taxpayers, with agents perceiving the SME as tax evaders, unwilling and unable to pay their taxes. The operators too are wary of government agencies’ high-handedness in collection of taxes. There is lack of structured dialogue between the SME and the government as well as other law enforcing authorities. This has led to mistrust and prevents the sector from engaging constructively with the government in reform processes. Government should be more involved in making laws that encourage compliance by improving the tax payer’s attitude.
5.4.3 Compliance Costs

Compliance costs normally include all costs associated with obeying the law, including planning and administration, in addition to the direct time and money spent filing paperwork. The complexities for example in the Value Added Tax have the extra burden of having to keep detailed records of all input tax and output tax to facilitate the completion of VAT returns. This may necessitate them having to employ someone skilled in this field, which would be regarded as a compliance cost. The authority should strive to give taxpayers high quality services as stipulated in the corporate plan and in the tax payer charter this improved services will reduce the need to hire skilled persons. Most of the services provided by the authority like refunds, remissions and dispute resolutions were rated poor and thus there is every reason to improve them. Where possible, officers should endeavor to adhere to the taxpayers’ charter in terms of service provision to taxpayers. ‘Help’ counters manned by technical and knowledgeable staff should be introduced and enhanced throughout the authority’s offices to bring services closer to the taxpayers. This will also improve communication between the taxpayers and the authority.

5.5 Areas for Further Research

Future research should attempt to collect data from SME’s from other tax divisions in Kenya and find out whether the effect of tax compliance by small and medium enterprises is the same as in Nairobi north tax region. In addition, further study should concentrate on the relationship between voluntary tax compliance strategy and the deterrence strategy and the factors that motivate SMEs to be tax compliant.
References


Mugenda & mugenda (1999). *Research methods: quantitative and qualitative approaches*


APPENDICES

APPENDIX I: INTRODUCTION LETTER

Mary Gachiku,
P.O Box 10133-00200
Nairobi.

Dear Respondent,

REQUEST TO FILL THE QUESTIONNAIRE FOR RESEARCH PURPOSE

This is to request you to kindly fill in the attached questionnaire for research purpose.

The research focuses on the Assessment of the Determinants of Tax Compliance by Small and Medium-sized Enterprises in Nairobi North Tax Region, Kenya. The information sought from you will be treated with utmost confidentiality, and results of this study will be available for your use/reference.

I am looking forward to your cooperation.

With kind regards,

............... 

Mary Gachiku.
APPENDIX II: QUESTIONNAIRE

Kindly respond to the questions as accurately, completely and as honest as possible.

SECTION A: GENERAL INFORMATION

1. Location of the company
2. Main business activity
3. How old is the company?
   - Less than 1 year
   - 1-3 years
   - 4-5 years
   - More than five years
4. Number of employees in the MSE
   - Permanent
   - Casual
   - Volunteers

SECTION B: DETERMINANTS OF TAX COMPLIANCE BY SMEs

5. By which of the following factors do you consider the tax exemption threshold?

<table>
<thead>
<tr>
<th>FACTOR DETERMINING TAX EXEMPTION THRESHOLD</th>
<th>TO A VERY LARGE EXTENT</th>
<th>TO A LARGE EXTENT</th>
<th>TO SOME EXTENT</th>
<th>TO A SMALL EXTENT</th>
<th>TO NO EXTENT AT ALL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of customers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of Employees</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annual turnover</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Value of Assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business Capital</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raw materials used</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
6. Which of the following are you conversant with?

<table>
<thead>
<tr>
<th>OBLIGATION</th>
<th>TO A VERY LARGE EXTENT</th>
<th>TO A LARGE EXTENT</th>
<th>TO SOME EXTENT</th>
<th>TO A SMALL EXTENT</th>
<th>TO NO EXTENT AT ALL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registration</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Filing of returns</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>submitting the returns to kra offices</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>doing amendments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

7. Rate your by ticking where appropriate

Where Very Poor = 1, Poor = 2, Neutral = 3, Good = 4, Excellent = 5

<table>
<thead>
<tr>
<th>OBLIGATION</th>
<th>VERY POOR</th>
<th>POOR</th>
<th>NEUTRAL</th>
<th>GOOD</th>
<th>EXCELLENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registration as a taxpayer in the Kra system</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Timely filing</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>accurate and timely information from the Kra officers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>timely payment of taxes</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

8. The table below shows determinants of tax compliance, tick where appropriate.

Where strongly disagree =1, Disagree = 2, Neutral = 3, Agree = 4, Strongly Disagree = 5

<table>
<thead>
<tr>
<th>DETERMINANTS</th>
<th>RATING</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>STRONGLY DISAGREE</td>
</tr>
</tbody>
</table>
9. Which of the following Tax compliance costs affect the tax compliance of your business?

<table>
<thead>
<tr>
<th>TAX COMPLIANCE COST</th>
<th>TO A VERY LARGE EXTENT</th>
<th>TO A LARGE EXTENT</th>
<th>TO SOME EXTENT</th>
<th>TO A SMALL EXTENT</th>
<th>TO NO EXTENT AT ALL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>External costs for example consultancy</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stationery and other office costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>communications costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>seminars related costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>legal Costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

10. How can you rate the costs incurred in the process of meeting tax legal requirements?
   (a) Extremely high [ ]  (b) High [ ]  (c) Fair [ ]
   (d) Low [ ]  (e) Very Low [ ]
11. How do the following determinants of tax compliance affect the cost of tax compliance?

<table>
<thead>
<tr>
<th>DETERMINANTS OF TAX COMPLIANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>TO A VERY LARGE EXTENT</td>
</tr>
<tr>
<td>TO A LARGE EXTENT</td>
</tr>
<tr>
<td>TO SOME EXTENT</td>
</tr>
<tr>
<td>TO A SMALL EXTENT</td>
</tr>
<tr>
<td>TO NO EXTENT AT ALL</td>
</tr>
</tbody>
</table>

Number of taxes that an entrepreneur is subject to

the complication of tax legal framework

The number of returns that are required to be submitted

The number of government bodies involved in tax collection

12. Is your business below any tax exemption threshold?

(a) Yes  (b) No

13. Does your business have an official premise?

(a) Yes  (b) No

Which of the following factors have affected your decision to have or not have a premise?

<table>
<thead>
<tr>
<th>FACTOR AFFECTING DECISION TO HAVE OR NOT HAVE A PREMISE</th>
<th>TO A VERY LARGE EXTENT</th>
<th>TO A LARGE EXTENT</th>
<th>TO SOME EXTENT</th>
<th>TO A SMALL EXTENT</th>
<th>TO NO EXTENT AT ALL</th>
</tr>
</thead>
<tbody>
<tr>
<td>The nature of business</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>legal implications</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>cost of premise</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

14. How can you rate your compliance to keeping of records and books of accounts as requirements for tax compliance?

(a) Full compliance  (b) Partial compliance  (c) No compliance
15. State your level of agreement to the following statements

<table>
<thead>
<tr>
<th>Statement</th>
<th>STRONGLY DISAGREE</th>
<th>DISAGREE</th>
<th>NEUTRAL</th>
<th>AGREE</th>
<th>STRONGLY AGREE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax rates are not too high</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Most businesses do not report taxes fairly</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax laws are complicated</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Under declaring taxes increases the profits</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>KRA uses informants to report tax non-compliant cases</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fines and penalties for non-compliance are ineffective</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Information on Tax**

16. Do you have any formal training on tax matters by the Kra?

(a) Yes  
(b) No

17. How to you relate and understand tax laws?

(a) Fully  
(b) Partially  
(c) Not at all

18. What is your level of agreement to the following statements

<table>
<thead>
<tr>
<th>Statement</th>
<th>STRONGLY DISAGREE</th>
<th>DISAGREE</th>
<th>NEUTRAL</th>
<th>AGREE</th>
<th>STRONGLY AGREE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Rules are too complicated for a non-professional to understand</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Information on tax rules is not readily</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
available

The complexity of tax laws contributes to inaccurate tax returns

SECTION C: STRATEGIES THAT CAN IMPROVE TAX COMPLIANCE IN KENYA

19. Do you agree that there are strategies that can be employed to improve the tax compliance rate by SMEs in Kenya?

- Strongly Disagree
- Disagree
- Neutral
- Strongly Agree

20. There is need to improve the Kenya’s tax system

- Strongly Disagree
- Disagree
- Neutral
- Strongly Agree

21. On the table below, tick where appropriate.

<table>
<thead>
<tr>
<th>STRONGLY DISAGREE</th>
<th>DISAGREE</th>
<th>NEUTRAL</th>
<th>AGREE</th>
<th>STRONGLY AGREE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction of a user friendly tax system</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lowered costs of tax compliance on the part of sme’s</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>government to seek the input of sme’s on tax matters</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Easy access of information/education on tax</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

22. Suggest strategies can be used to improve tax compliance by SMEs in Kenya?