

**FACTORS AFFECTING TURNOVER TAX COMPLIANCE AMONG SMALL AND  
MEDIUM ENTERPRISES IN KENYA, A CASE STUDY OF NAIROBI CENTRAL  
BUSINESS DISTRICT, LUTHULI AVENUE.**

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**POST GRADUATE DIPLOMA  
TAX ADMINISTRATION**

**JOMO KENYATTA UNIVERSITY OF  
AGRICULTURE AND TECHNOLOGY**

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**A RESEARCH PROJECT SUBMITTED TO THE DEPARTMENT OF ECONOMICS, ACCOUNTING AND FINANCE, SHCOOL OF BUSINES IN PARTIAL FULFILMENT OF THE REQUIREMENT FOR THE AWARD POSTGRADUATE DIPLOMA IN TAX ADMINISTRATION AT JOMO KENYATTA UNIVERSITY OF AGRICULTURE AND TECHNOLOGY.**

**DECLARATION**

I declare that this research project is my original work and has not been presented for any degree work in any other University. To the best of my knowledge, the research project contains no material previously published or written except where due reference is made.

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## **DEDICATION**

This Project is dedicated to my family members, my parents Mr. and Mrs. Omondi for their parental love, inspirations, sacrifice and endless support financially To my Brothers Elisha Oguro and Jeff Nyangor for their compassion and encouragement to great achievement. To my colleagues, friends and classmates for their support and friendship that I truly cherish. To my supervisor Dr. Charles Orero for her guidance and mentorship all through.

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## TABLE OF CONTENTS

<b>DECLARATION</b> .....	<b>ii</b>
<b>DEDICATION</b> .....	<b>iii</b>
<b>ACKNOWLEDGEMENT</b> .....	<b>iv</b>
<b>LIST OF TABLES</b> .....	<b>viii</b>
<b>LIST OF FIGURES</b> .....	<b>ix</b>
<b>LIST OF ABBREVIATION AND ACRONYMS</b> .....	<b>x</b>
<b>DEFINITIONS OF TERMS</b> .....	<b>xi</b>
<b>ABSTRACT</b> .....	<b>xii</b>
<b>CHAPTER ONE</b> .....	<b>1</b>
<b>INTRODUCTION</b> .....	<b>1</b>
1.0 Introduction .....	1
1.1 Background of the study .....	1
1.1.1 Determinants of Tax Compliance.....	2
1.1.2 Tax Compliance in Kenya .....	4
1.1.3 The Concept of Small and Medium Enterprise .....	6
1.2 Statement of the problem .....	7
1.3 Purpose of the study .....	8
1.3.1 Objectives of the study .....	8
1.3.2 Research Questions.....	9
1.4 Justification of the study .....	9
1.5 Scope of the study .....	10
1.6 Limitations of the study .....	10
<b>CHAPTER TWO</b> .....	<b>11</b>
<b>LITERATURE REVIEW</b> .....	<b>11</b>
2.1 Introduction .....	11
2.2 Theoretical literature review .....	11
2.2.1 Ricardian Theory of Taxation.....	11
2.2.2 Game Theory Model of Equilibrium in Tax Compliance .....	12
2.2.3 Benefit Theory of Taxation .....	12
2.3 Empirical Review.....	13
2.3.1 Compliance Costs .....	13
2.3.2 Enforcement Instruments.....	15

2.3.3 Turnover Tax Mode of payment.....	17
2.4 Critique of Existing Literature .....	19
2.5 Summary of Literature and Research Gaps .....	20
2.6 Conceptual framework.....	22
<b>CHAPTER THREE .....</b>	<b>24</b>
<b>RESEARCH METHODOLOGY .....</b>	<b>24</b>
3.1 Introduction .....	24
3.2 Research Design.....	24
3.3 Target Population .....	24
3.4 Sample and Sampling techniques .....	25
3.4.1 Sampling Frame .....	25
3.4.2 Sampling Techniques .....	25
3.5 Data Collection procedure.....	26
3.6 Pilot Testing .....	26
3.6.1 Validity of research instruments .....	26
3.6.2 Reliability of research instruments .....	27
3.7 Data Analysis and Presentation.....	27
3.7.1 Data Analysis.....	27
3.7.2 Data Presentation.....	28
<b>CHAPTER FOUR.....</b>	<b>29</b>
<b>RESEARCH FINDINGS AND DISCUSSIONS.....</b>	<b>29</b>
4.1 Introduction .....	29
4.2 Response Rate .....	29
4.3 Demographic Information.....	40
4.3.1 Gender of the Respondents.....	40
4.3.2 Respondent’s age group.....	40
4.3.3 Respondent’s SMEs Sector .....	40
4.3.4 Professional of the Respondents.....	41
4.3.5 Annual Turnover estimate in Kenya shilling.....	41
4.3.6 Level of education .....	42
4.3.7 Ownership of the Enterprises .....	43
4.3 Tax Compliance Cost.....	43
4.4 Enforcement Instruments .....	46
4.5 TOT Modes of Payment.....	48
4.6 Inferential Statistics.....	49

4.6.1 Regression Analysis .....	49
4.6.2 Correlations Statistics .....	52
<b>CHAPTER FIVE.....</b>	<b>54</b>
<b>SUMMARY, CONCLUSIONS AND RECOMMENDATIONS .....</b>	<b>54</b>
5.1 Introduction .....	54
5.2 Summary of the Findings .....	54
5.2.1 Tax Compliance.....	54
5.2.2 Enforcement Instrument .....	55
5.2.3 TOT Modes of Payment .....	55
5.3 Conclusions .....	55
5.4 Recommendations .....	56
5.5 Suggestions for Further Studies .....	57
<b>REFERENCE.....</b>	<b>58</b>
<b>APPENDICES .....</b>	<b>61</b>
Appendix i: Introduction .....	61
Appendix ii: Questionnaire .....	62
Appendix iii: Budget.....	65
Appendix iv: Work Plan .....	66

## LIST OF TABLES

Table 3.1: Target Population.....	25
Table 3.2: Sample size .....	26
Table 4.1: Response rate .....	29
Table 4.2: Gender of the respondents .....	40
Table 4.3: Respondent's age group.....	40
Table 4.4: Respondent's SMEs Sector.....	40
Table 4.5: Annual Turnover estimate in Kenya shilling.....	42
Table 4.6: Tax Compliance .....	44
Table 4.7: Statements on enforcement instruments .....	46
Table 4.8: Statements on TOT Modes of payment .....	48
Table 4.9: ANOVA: Significance Level.....	50
Table 4.10: Regression Coefficients .....	50
Table 4.12: Correlation Matrix .....	52
Table 4.9: Model Summary .....	53

## LIST OF FIGURES

Figure 2. 1: Conceptual framework .....	22
Figure 4.1: Professional of the Respondents.....	41
Figure 4.2: Level of education .....	42
Figure 4.3: Ownership of the Enterprises .....	43

## **LIST OF ABBREVIATION AND ACRONYMS**

<b>CBD</b>	:	Central Business District
<b>ICT</b>	:	Information and Communications Technology
<b>KRA</b>	:	Kenya Revenue Authority
<b>MSE</b>	:	Micro and Small Enterprises
<b>MSME</b>	:	Micro, Small and Medium Enterprises
<b>SME's</b>	:	Small and Medium Enterprises
<b>TOT</b>	:	Turnover Tax
<b>UN</b>	:	United Nations
<b>UTS</b>	:	Unified Tax System
<b>VAT</b>	:	Value Added Tax

## DEFINITIONS OF TERMS

<b>Economic Growth</b>	Economic growth is defined as a sustained increase in a nation's gross national income per capital over a long time period (Hossain, 2000).
<b>Presumptive Tax</b>	This is a tax payable by a resident person whose turnover from business does not exceed Kshs. 5 million during a year of income (Bucci, 2019).
<b>Tax Compliance</b>	A tax compliance, otherwise known as a Tax Clearance Certificate is an official document issued by KRA, as proof of having filed and paid all your taxes (Awitta, 2010).
<b>Turnover tax</b>	A turnover tax is similar to VAT, with the difference that it taxes intermediate and possibly capital goods. It is an indirect tax, typically on an ad valorem basis, applicable to a production process or stage. For example, when manufacturing activity is completed, a tax may be charged on some companies. Sales tax occurs when merchandise has been sold (Simiyu, 2010).
<b>Value Added Tax</b>	is charged on supply of taxable goods or services made or provided in Kenya and on importation of taxable goods or services into Kenya (Njogu, 2015).

## ABSTRACT

Taxation is an important source of income for both the national and county government for it's a vital stream of income for government's improvement ventures. Tax compliance among SMEs is meager. Tax evasion hampers government revenue collection thus inefficiency in Government spending. The number of micro-finance institutions in Kenya continues to grow rapidly. However; their wide presence does not correspond with the growth of small and medium enterprises in Nairobi County. This study aimed to ascertain factors affecting turnover tax compliance among SMEs in Kenya a case study of SME's at Nairobi CBD, Luthuli Avenue in Nairobi County. It was guided by the following objectives: To find out the extent to which rate of tax affect the level of tax compliance of SMEs; To find out what extent does tax regimes affects the level of tax compliance among SMEs; To find out to what extent does mode of TOT payment affects compliance of SMEs. This research adopted a descriptive research design. A descriptive research design is a scientific method which involves observing and describing the behavior of a subject without influencing it in any way. The research target population consisted of 350 registered SME's at Nairobi CBD, Luthuli Avenue in Nairobi County. Sampling methods was used to select 183 small medium scale business enterprises. Primary data was collected using structured questionnaires based on the research questions administered by the researcher. Data was analyzed by use of quantitative methods. Descriptive statistics was used to analyze data including frequencies and percentages and results displayed in tables. Inferential statistics, correlation and regression analysis was used. The study established that apart from income tax administration other factors that affect growth and performance are taxation from county government, business location and tax compliance. Most of the respondents were unsatisfied with the income tax rate based on the sales turn over and some of the respondents did not fully understand income tax and its computation. The study established that the introduction of income tax has affected the profit margins and the respondents agreed that income tax has negatively affected the growth and profitability of the SMEs. The responses were as following 51.3% agreed that they file their returns accurately, 66.4% agreed with the statement that I file my returns on time, 59.7% of the respondents agreed that they file the correct returns, 71.5% of the respondents agreed that all my records like TB; Journals and Ledgers are updated, 67.3% of the respondents agreed that I have registered as a taxpayer in the KRA system. The statements scored a mean of 3.4 with a standard deviation of that implies that the respondents were in agreement with the statements raised in the study. In conclusion the study has established that taxpayer's knowledge, tax rates, filling procedure have positive and significant relationship and affects tax compliance among SMEs in Nairobi County. The research has established that it is important to create awareness on tax laws, create awareness on how the tax system is structured and administered, have less sophisticated rules on taxation for a non-professional to understand, have readily available tax rules information so as encourage tax compliance. The study also concluded that Tax rates are too high, fines and penalties charged for late fillings are stiff, the cost required for filling the tax returns is high, hiring a profession to do the fillings as expensive and that The number of government bodies involved in tax collection are many and this has led to poor tax compliance.

# **CHAPTER ONE**

## **INTRODUCTION**

### **1.0 Introduction**

This chapter section outlines the background information on factors affecting tax compliance among SMEs in Kenya, a case study of Nairobi town CBD, Luthuli Avenue. The chapter further highlights the, study objectives, research questions, statement of problem, scope and study implication.

### **1.1 Background of the study**

Taxation is the main source of revenue to any government, since it's the only stable flow of revenue that is predictable (Akinboade, 2015). According to Pfister (2009), it was echoed at a UN conference Doha in 2008, taxation was acknowledged as the key to domestic resource mobilization. Taxation has helped African countries to achieve millennium development goals. African countries have used taxation, to finance for their social and physical infrastructure needs, provide stable and predictable fiscal environment to promote economic growth and investment, promote good governance and accountability by strengthening the relationship between the government and its citizens; and ensure that the costs and benefits of development are fairly shared (Akinboade, 2015).

Tax Compliance can be defined as the degree to which a taxpayer complies (or fails to comply) with the tax rules of his country, for example by declaring income, filing a return, and paying the tax due in a timely manner. Tax compliance is multi-faceted measure and theoretically, it can be defined by considering three distinct types of compliance such as payment compliance, filing compliance, and reporting compliance. Organization for Economic Cooperation and Development (2001) advocates dividing compliance into categories in considering definitions of tax compliance to make it clear. These categories are administrative compliance and technical compliance where the former refers to complying with administrative rules of lodging and paying otherwise referred to as reporting compliance, procedural compliance or regulatory compliance and the later refer to complying with technical requirements of the tax laws in calculating taxes or provisions of the tax laws in paying the share of the tax.

Theoretically, views of the taxpayers and tax collectors are that tax compliance means adhering to the tax laws, which are different from one country to another. The goal of tax administration is to foster willful and voluntary tax compliance (Silvani, 1997) and hence reduce tax gap (difference between taxes paid and owed for taxes and all taxpayers) and compliance gap. Tax

compliance, according to Cobham (2005), is a problem to many countries as measured by tax to GDP ratio although it has been improving for many countries.

Most large companies have their roots in small and medium enterprises suggesting that the future large corporations are the SMEs of today that must be nurtured to ensure their growth. Thus, SMEs are generally perceived to be the seedbed for indigenous entrepreneurship and generate all the many small investments, which would otherwise not have taken place ( Aryeetey & Ahene, 2004). The problem of tax compliance is as old as taxes themselves. Characterizing and explaining the observed patterns of tax noncompliance and ultimately finding ways to reduce it are of obvious importance to nations around the world. As a public finance topic, tax compliance spans notions of equity, efficiency and incidence. Low tax compliance is one of the internal factors affecting the ability of the Kenyan government to raise direct tax revenues and thus meet its recurrent and development expenditure.

### **1.1.1 Determinants of Tax Compliance**

It is basic to build up wide data in regards to the determinants compliance to tax in order to have the capacity to create measures for battling tax avoidance and evasion. The societal spirit to conform to assessment may upgrade a requirement of self to tax compliance. Nonetheless, tax morale, state of mind and conduct aren't set up, particularly in nations with where the culture is not to pay tax (Braughtigam et.al., 2008). Absence of obligation and receptiveness in funds use from people in general develop doubt amongst taxpayers towards arrangement of tax assessment and organization, subsequently influencing eagerness of levy payment by taxpayers. Because of abnormal amounts of fraud, taxpayers are not ready to learn whether taxes paid are utilized as a part of the financing of public merchandise and provision of services, prompting an adjustment in their ability to pay henceforth the probability they may avoid taxes.

In the event that the lawful framework does not maintain the rule of law it will prompt decreased straightforwardness and cultivate doubt among residents. Nationals will never again have the will fund administration through tax compliance and therefore come about to dodging tax liabilities (Kirchler, 2007). There is an immediate relationship of size and sort of punishments that non-compliers and tax compliance level (Fishlow & Friedman, 1994). Deficiencies in tax accumulation might be consequence of frail limit of framework to identify and arraign tax violators. Utilization of relatives in SMEs through unpaid work likewise diminishes likelihood of recognition in this way affecting the choice of taxpayer with respect to compliance. Chipeta (2010) identifies the causes of tax evasion as the tax rate that are huge in nature that gives SMEs a huge burden that negatively affect their profit margins therefore most

of the SMEs opts to evade tax. Small tax payers face discrimination under the regular tax system since the compliance requirements does not matter regardless to the size of the enterprise as well as tax rate and also the cost of compliance. If the government can reduce compliance cost the tax rate will increase hence the profit margin will go up, this will increase the government tax revenue since the simplified provisions for SMEs will reduce the size of formal economy and the number of noncompliance will increase with regard to registered tax payers (Vasak, 2008).

The operations of SMEs usually have an imperious controlling atmosphere with plethora of regulating organizations, high port charges, numerous charges, burdensome importing procedures and several taxes that constantly put pressure on the operations (Kinyua, 2014). The complex nature of the governing structure and the complex tax regime is a challenge and burdens most of the SMEs that determine their compliance level with affects their growth and performance. The tax system imposes bigger expenses for the SMEs that affect their daily operations (Masato, 2009). Tax system that is weak in nature has low efficiency, waste taxpayers' time as well as authority staff and high collection charges (Farzbod, 2007). Most of the SMEs are affected disproportionately by the compliance costs that are time higher than large organizations (Weichenrieder, 2007).

In Kenya, there is no Act of Parliament that gives the definition of SMEs. Even the Income Tax chapter 470 and the Turnover Tax Rules that govern taxation of the SMEs neither provide for any definition nor mention any of the terms used to refer, mean or represent SMEs. The income tax merely refers under section 12C to persons and the thresholds that determine persons liable to pay turnover tax. Rule 3(1) of Turnover Tax Rules provides: an individual who's earning from the enterprise is above 500,000 and does not exceed 5,000,000 within a calendar year shall be liable to pay turnover tax. Probably, the Act deliberately avoided the use of and to define the term SME after recognizing the difficulty in defining the term. Use of thresholds only to define persons liable to pay turnover tax is a more convenient way of avoiding protracted arguments as to what the term SME mean and to whom it refers (Kinyua, 2014).

The newly enacted Micro-Finance Act No. 19 of 2006, which came into operation on 2nd May, 2008 does not give a definition of SMEs or Micro or low income households whom it is intended to serve. The Act only makes reference to Micro or low-income households without providing a definition of the terms or what they represent. Indeed, in Kenya the definitions are left to and are found in Government policy papers, development plans, budgets and Kenya Revenue Authority (KRA) Unified Tax System [hereafter the UTS] initiative and reports. The terminologies used in Kenya are; the informal sector or the now popularly known as Jua kali

sector or MSME or MSE. MSME is recognized abbreviation for Micro, Small and Medium Enterprises. The UTS initiative defines MSME thus; any business that employs between one to nine, ten to forty-nine and fifty to ninety-nine as micro, small and medium enterprises correspondingly (Wanjiru, 2010). These definitions provided within the context of Kenya are also varying. Even within the same Government Reports, Sessional Papers, Development Plans, Baseline Surveys and United Tax System Reports are provided different definitions. The Acts of Parliament including the Interpretations and General Provisions Act 24 are silent on the definition of SMEs. But of importance is that, all these definitions have common factors which include, though not limited to; the number of employees in, the nature of the business of, sales made, capital, and assets owned or income made by entities or firms or persons which constitute SMEs.

### **1.1.2 Tax Compliance in Kenya**

According to Brown and Mazur (2003) explains tax compliance as a complex term to define because it's a multi-faceted measure. But they went further and define it in three aspects that include reporting, payment and filing compliance. Kircler (2007) defines tax compliance as taxpayer's willingness to pay tax with outermost honesty while Cummings (2007) defines tax evasion as the failure by taxpayer to comply with tax obligation. The complex on tax remittance is seen on the following perspectives; the details required are too much in terms tax rules involved especially when it comes to computerized aspect of tax compliance decision (Richardson, 2006). Andreoni, Erard and Feinstein (1998) define tax compliance as willingness of taxpayer to obey tax laws in order for a country to obtain its economy equilibrium. Kircler (2007) also defines tax compliance as taxpayer's willingness to pay tax with outermost honesty.

Cummings (2007) defines tax evasion as the failure by taxpayer to comply with tax obligation. According to Rile (2011) tax evasion undermines revenue collection; it diminishes government mobilization of resources. According to William and Round (2009) tax penalties, inadequate understanding, high tax rates and high cost of compliances are some of the factors that lead to tax fraud and tax evasion. SMEs will fail to comply with tax laws either unwilling or willingly. Emerging economies should ensure that tax system are efficient and effective for SMEs and don't affect them negatively. The challenges that most authorities face are poor tax system and policies. The main objective of tax policy is to abide with tax laws (James & Alley, 2004).

SMEs in Kenya operate in an informal sector economic survey report 2016 indicates that the sector has semi organized and unregulated activities that are smaller. Understanding and interpreting tax laws determines SMEs ability and willingness to comply. Attitudes towards tax

compliance can be improved through enhancement of taxation understanding, when SMEs have a positive attitude in comparison with one who have never attended any tax related course workshop, or seminar awareness necessary important especially in areas that relate to taxation laws (Mohd, 2010). OCED (2001) categories compliance into two that is technical and administrative compliance while Cobham (2005) explains that tax compliance affects emerging economies and it's a major challenge and this has promoted and encouraged radical tax reforms in these economies.

Studies have established that regulatory burdens fall disproportionately on SMEs ( Pope & Abdul-Jabbar, 2008). Kenya is positioned amongst low-salary nations or low compliance nations with hard undertaking of guaranteeing productive and compelling tax administration. With a specific end goal to guarantee compliance to tax, subsequently raising more income. Kenya Revenue Authority administers tax in Kenya. Built up through Parliament act on July first 1995 (Cap 469). "KRA should advance compliance with Kenyan tax guarantee dependable requirement by exceptionally energetic and proficient staff in this manner amplifying income gathering in any event conceivable cost for Kenyans social-monetary prosperity (CIAT, 2006). Kenya presented Tax Modernization Program in 1986 with the expectation this would, in addition to other things, upgrade income accumulation, enhance tax organization and diminish compliance and gathering expenses (Wanjiru, 2010).

Despite many tax changes, code of tax in Kenya is yet intricate and lumbering, described by uneven and out of line taxes, a thin tax base with high tax rates and rates scatterings as for exchange, and low compliance. Extra difficulties incorporate tax frameworks with structures and rates that: taxes are hard to oversee and consent to; are inert to development and optional approach thus low profitability; raise little income yet present genuine monetary bends; treat work and capital in comparable conditions in an unexpected way and are particular and skewed for those with capacity to defeat tax organization and requirement framework

(Okello, et al, 2005). There are various difficulties hindering proficient setup of a viable tax framework in Kenya. Economy structure, for example, proportion of formal versus informal sectors; extent of agricultural sector post challenges in tax outline and organization. Different obstructions include: nullification of tax occasions, high viable insurance, high scattering of levy rates, point by point and inflexible custom principles, poor reaction of VAT to changes, feeble ability to process substantial volumes of profits and discounts for zero-evaluated exchanges. Also, Kenya's tax framework is difficult as far as time taken to plan and submit government forms (Karingi, et al, 2005). The business environment in Nairobi is majorly dominated by informal enterprises which fall into the three sectors manufacturing, trade and

services industry. The informal sector in Nairobi County plays a greater role in generating employment for a large proportion of the population. There are however challenges between the county government and informal workers since their activities are not licensed and they do not pay taxes. This presents a challenge not only for the county government but also to Kenya revenue authority.

### **1.1.3 The Concept of Small and Medium Enterprise**

SME is a generic term that stands for and is the recognized abbreviation of Small and Medium Sized Enterprises. These enterprises have been associated with informality and they have hence been generally referred to as the informal sector. The notion that informal sector has been in discussion since its inauguration in Africa in early 1970's but defining the sector still is a major problem. However, it may be inferred that the various definitions of SME put forth were greatly influenced by one or more of the three schools of thought that are highly regarded to have laid the foundation on the concept of the informal sector. Although there is no universally acceptable definition of SMEs, there are certain common factors that are discernible from all available definitions on SMEs. These include, but not limited to, the number of employees in, sales made, capital and assets owned by entities or firms or persons that constitute SMEs (Lans, Hulsnik, & Mulder, 2008). In Kenya SME or MSME refers to and means Jua kali or informal sector. According to the Government, any business that employs between one to nine, ten to forty nine and fifty to ninety-nine as micro, small and medium enterprises correspondingly. For purposes of this paper, these common factors shall become the basis of identification of, to mean and refer to SMEs. The composition of the inventory of SMEs target groups outlined in the paper for tax base broadening has substantially drawn from these features (Kinyua, 2014).

Hall and Harvie (2003) explains that SMEs are important in a country economic development and growth in that they create jobs and build a flexible and adaptable base for competitive economy. The Economic Survey Report (2016) indicated that SMEs contribute to 70% of Gross Domestic Product in Kenya and the sector employs about 80%. The following comparative analysis of definitions on SMEs underscores primacy of these common features in defining the subject and scope of study of this paper. Significantly, the paper will use the terms SMEs, MSME, Jua Kali and Informal sector interchangeably to mean, refer to and represent SMEs. The informal sector had grown and become widespread, the Government's concern shifted and now focused on how to tax the sector. It is after it dawned on the Government that, although the sector controls a wide business population, employs a considerable number of people and generates an enormous income it has remained outside the tax net and has not

produced revenue corresponding to their income. In Kenya, the SME segment is very extensive, evaluated at 34.3percent and representing 77 percent of work statistics. More than 60 percent of people working in SMEs are young, aged between 18 to 35 years, half being women (Ouma, et al, 2009). The initial 1993 SMEs benchmark overview uncovered around 910,000 small micro enterprises were utilizing approximate 2million individuals. Second SME standard overview (1995), assessed measure of SME segment at 708,000 endeavors utilizing up to 1.2m individuals. Contrasted with alternate areas of the economy, commitment of small micro enterprises part to nation's GDP expanded from13.8% in 1993 to more than 18% of everyone. These SMEs are part of the main contributors to the economy of the Nairobi County as they create employment and purchase products hence directly supporting livelihoods.

According to Ndemo (2015), most SMEs do not register for tax purposes and most of them operate without licenses from both the county and national governments. Thus, tax compliance issue is a serious problem in most of the SMEs. In addition, millions of shillings are generated from the SMEs business operations on daily basis, which is subject to 999 (Sessional Paper No.2 of 2005). According to Ndemo (2015), most SMEs do not register for tax purposes and most of them operate without licenses from both the county and national governments. Thus, tax compliance issue is a serious matter in most of the SMEs. In addition, millions of shillings are generated from the SMEs business operations on daily basis, which is subject to taxation by the government however; statistics indicate that small businesses in Kenya constitute the base group of hard-to-tax taxpayers (Lumumba,et al,2010). Thus, an investigation on the factors affecting tax compliance by SMEs in Nairobi County in Kenya is vital.

## **1.2 Statement of the problem**

Growing evidence indicates there has been hostility between the tax payers and tax collectors on issues relating to tax compliance. Although complaints by the public on tax payable received responds from KRA through the introduction of online payment, individuals still don't pay taxes promptly.

The KRA introduced Electronic Tax registers (ETRs) in 2005 to minimize compliance cost and ensure full remittance of VAT by firms. This was resisted through street demonstration by the public. It should be noted that customer service activities are very crucial in this field. These activities include such functions as taxpayer's service, returns processing, and the administration of tax reforms and publications. Some of the customer service initiatives aimed at improving voluntary compliance that are required includes expanded telephone assistance for taxpayers, improve taxpayers education (Vazzquez 2005), something KRA had been trying to organized to create awareness, simplified tax, forms among others. This way it should be

recognized that most tax payers want to comply with the law, KRA effects in these areas are designed to make it as easy as possible for them to be fully compliant so that tax collection would not be influenced. There many studies that explain the behavior of tax compliance in a more realistic situation. They focus on the effects of compliance cost, respectively on economic and non-economic factors (Nicoleta, 2011). However, these studies have not revealed to what extent these effects of tax compliance cost have affected tax collection.

The increasing trend of disparity between the levels of annual turnover tax compliance on one hand, and the trend of business birth and growth, on the other hand, has been a cause of worry to the government of Kenya. Continued T.O.T collection levels for government are detrimental to economic development of this nation. (Cobham, 2005). A large segment of the informal sector, especially the SMEs in Industrial area in Nairobi exhibit T.O.T compliance levels. This is a great loss of revenues meant for public expenditure. A gap in the reviewed literature exists as far as addressing factors affecting turnover tax compliance among small and medium enterprises in Kenya. It is for this reason the research need to be undertaken to identify factors affecting turnover tax compliance among small and medium enterprises at Nairobi CBD, Luthuli Avenue, Nairobi County. Tax collection has been a major concern among many governments all over the world (Loureiro, 2014; Ayuba, Saad & Ariffin, 2016). According to Agbadi (2011) history has shown that there has always been a reluctance to pay tax. Again, statistical evidence has proven that the contribution of income taxes to the government's total revenue by SMEs remained consistently low (Chebusit et al., 2014). Over the last forty years, tax collection in Kenya, experienced large fluctuations when measured as a ratio of actual tax share of gross domestic product (Waris, Kohonen, Ranguma & Mosioma, 2009). In addition, there has been hostility between the taxpayers and tax collectors on issue relating to tax compliance (Makori, et al., 2013). Most SMEs do not pay the taxes and tax evasion among SMEs remains far above the ground, with a tax gap of about 35% and 33.1% in 2011 and 2012 respectively (KRA, 2015).

### **1.3 Purpose of the study**

The purpose of this study was to evaluate the factors affecting Turnover Tax compliance among Small and Medium Enterprises in Kenya, a case study of Nairobi CBD, Luthuli Avenue.

#### **1.3.1 Objectives of the study**

This study was guided by the following objectives:

- i. To find out the extent to which tax compliance cost affects the level of tax compliance among SMEs in Kenya.
- ii. To determine influence of Kenya's enforcement instruments enhances taxpayer's TOT compliance level among SMEs in Kenya.
- iii. To find out to what extent does mode of turnover tax compliance payment affects compliance of SMEs in Kenya.

### **1.3.2 Research Questions**

This research was guided by the following research questions:

- i. To what extent does tax compliance cost affect the level of tax compliance of SMEs in Kenya?
- ii. Does Kenya's enforcement instruments affect taxpayers' TOT compliance level among SMEs in Kenya?
- iii. To what extent does mode of TOT payment affect compliance of SMEs in Kenya?

### **1.4 Justification of the study**

The government is not able to collect the required taxes from the targeted taxpayers. From the SME point of view, tax evasion is driven generally by a perception that the tax burden is too high. This poses a number of problems to tax systems, raising difficult questions over how tax policies and tax administration may influence tax compliance incentives and behavior. The compliance tax burden on the Informal Sector may be high relative to that of large companies (higher unit cost in relation to turnover). Further, the cost of complying with a given set of tax rules and regulations is generally high.

It is anticipated that the results of this study will provide concepts and grounds on which to develop a framework. The knowledge accruing from this study could benefit the Government of Kenya and its revenue collection body Kenya Revenue authority in its effort to design suitable tax policies for SMEs. This study will provide concepts which to develop a framework to explore tax compliance behavior among SMEs. The research will be useful to the business community and organization's management teams for purposes of knowing the tax compliance environmental factors and how the conditions can be improved or dealt with. Finally, the research will be of interest to scholars and researchers who may require developing and advancing their knowledge in the field of tax compliance and administration. Revenue authorities such as Kenya Revenue Authority will gain superior comprehension of the issues or factors to look out for on revenue collection especially on instituting better reforms regarding

the SMES for better revenue performance. Firms and individuals adopting the ever changing tax systems and laws will gain an insight on the factors and relationship in the context of tax compliance thus helping forge a good relationship between the government and tax payers in the case of Small micro enterprises.

### **1.5 Scope of the study**

The study was conducted at Nairobi central business district, Luthuli Avenue in Nairobi County. The street has 350 SME's in Luthuli Avenue, Nairobi County which comprises of Barber shops, Groceries, Boutiques, Wholesalers, Hardware shops, Electronics shops, Distributors, Restaurants, Milk bars Chemist and Agro vets registered with the County Government in the department of trade as at 2018. The complete PROJECT covered a period of three months.

### **1.6 Limitations of the study**

There was no assurance that the respondents will return all the questionnaires duly completed, neither will there be a guarantee that those who will be interviewed would respond to all the questions put forward to them comprehensively for fear that it will expose their noncompliance to K.R.A. Time constraint will be a limiting factor because the study is to be concluded within a short time. Availability of funds will also be a limiting factor to the study since inadequate resources impede the ability of the researcher to fully engage the various facets of the study.

To counter these limitations, the researcher took leave from work to make time to interview the respondents and also seek funding from relatives. Explaining to them the intent of the study and issuing the transmittal letter as well as the supervisor's contact for verification purposes will overcome the SMEs fear of participation.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter outlines the various schools of thought revolving around tax compliance and evasion. This Chapter identifies the various theories put across by various scholars in relation to tax compliance. Literature reviews are important in establishing knowledge gaps that are related to tax compliance and related studies. The section also covers the study variables that are discussed into details, theories, theoretical framework, research gaps and operationalization of study variables.

#### **2.2 Theoretical literature review**

Hypothetical literature guides examination in distinguishing proof of significance of factors measured and essentialness of their connections in investigation.

##### **2.2.1 Ricardian Theory of Taxation**

Ricardo based his theory of taxation by synthesizing the impact of profit taxation on wages, profits and rents. He especially focused his attention on the effects of profit taxation by examining two different circumstances; when gold is produced locally, and when it is imported. Ricardo's theory of tax on wages is based upon the distinction between natural and money wages. The theory of natural wages led Ricardo to note that taxation on wages is inequitable as workers are only paid that which is enough to ensure that they can survive and meet their daily obligations. He concluded that a tax on wages will lead to a rise in wages as workers would demand for increased earnings, this will lead to a decrease in profit and the end result is the same as if the tax was levied on profits.

On Profits, Ricardo envisaged two scenarios, the first case refers to when gold is produced locally whereby he argued that a tax on profits will increase prices as either manufacturers will quit producing that commodity or increase their prices to offset the tax. The increased partial tax in this instance will lead to disproportionate price in all industries other than gold which is untaxed, this leads to increased supply for gold and thereby there will be an accompanying increase in money. When gold is imported Ricardo argues that any rise in prices is only transitional as it would lead to a deficit as more gold is imported to cater for the rise in price, the outflow of money would reduce the prices of the commodity as it becomes more scarce. He notes that a tax on profit had the same effect on the price of commodities both at home and abroad as before the tax was imposed.

Ricardo's fundamental idea concerning land rent is that the natural price of agricultural products is formed on marginal land that is land last cultivated. He adduced that the rising prices of agricultural products are responsible for the emergence of rent and not the other way around. Consequently, if rent income is taxed, all prices will remain the same and the entire burden of taxation will fall on the recipients of this non-functional income. This led him to the argument that tax on rent forms the best object of taxation as they don't have any distortionary effect on the economy. Finally, Ricardo contends that indirect taxation to a large extent causes final effects similar to those of a profit tax, however since indirect taxation affects both production and consumption its effect on prices and relative prices of commodities are more profound and it should not be used interchangeably with the direct tax on profits.

### **2.2.2 Game Theory Model of Equilibrium in Tax Compliance**

The second group of models that try to explain compliance behaviour among taxpayers are generally based on the standard game-theory concept of equilibrium. Assuming linear tax rate and penalties, risk neutral taxpayer, no additional cost of an audit other than penalties levied on underreporting of income and that the objective of the tax authority is to maximize revenue. A tax authority will pursue the strategy that provides an optimum audit revenue subject to a fixed audit budget by setting up a cut-off, whereby all declarations below the set level are audited with a probability  $p$  but leave out all declarations above the cut-off. The probability  $p$  is determined at a level that ensures that all declarations above the set cut-off are honest. The cut-off is chosen so that the audit budget is just exhausted in equilibrium. The model observes that a higher the budget or reduced cost  $c$  increases the probability of an audit and hereby increases the level of compliance. However, this strategy has only been proved optimal in instances where the taxpayer are risk neutral, in cases where the taxpayers are risk averse there is no audit strategy under the cut-off criterion.

### **2.2.3 Benefit Theory of Taxation**

The theory was put forward by Krauss (1896). This theory maintains that justice in taxation is secured by taxing each citizen in the proportion to the benefits he derives from the activity of state. It is also known as insurance theory or quid pro quo theory of taxation. It implies that taxes should be paid by those people who receive the direct benefit of government programs and projects out of the taxes paid. However, it has some objections; the weak and poorer people receive great benefits from the government in the form of free education e.t.c. Though they receive the greatest benefit, they are however least able to bear the burden of taxation.

This is a theory of taxation that has been advocated as a means to correct the inefficiencies of the Ability to pay theory which has generally been regarded as a ‘get at the rich’ tax theory. The theory advocates that taxes should be designed in a way as to charge entities on services rendered by the government in proportion to how much it costs to provide them. It mimics a user charge levied by the government towards financing for such services rendered by charging a price for the service consumed by the public. Proponents of the theory argue that it gives a notion of equity on the basis of quid pro quo.

The major shortfall of the theory is on the non-excludability of public goods, in such a scenario it is difficult to assign a price to the consumption of such a good or service. Additionally it negates one of the major objectives of taxation which is the redistribution of wealth across the spectrum of the society. Empirical evidence is also consistent in showing that taxes exceed the costs of services rendered by the government and it therefore becomes difficult to reconcile it as a practical theory of taxation.

## **2.3 Empirical Review**

Tax compliance level is determined by a myriad of economic, socio-political and legal factors that influence individual taxpayer’s attitude and behaviour towards complying with the outlined legislations and procedures relating to taxation. This section will highlight several studies that have been conducted in this area by previous researchers and explore their findings. The review has been broken down into four broad thematic areas which are considered to have the biggest impact on the level of tax compliance.

### **2.3.1 Compliance Costs**

Compliance cost involves a myriad of expenses or difficulties encountered by the taxpayer in complying with the tax law both in terms of administrative compliance; that is registration, filing and subsequent payment of the taxes and also technical compliance which involves maintenance of appropriate records, machines and organization of the supply chain so as to observe the requirements of the law. Administrative compliance is mostly direct and therefore it has been the area of concern in most of previous research.

Mogeni (2014) assessed the effects of compliance cost on tax compliance of companies listed at the Nairobi securities exchange. The study used a census survey of all the sixty two listed companies. The study findings showed that compliance cost had the negative effect on level of tax compliance. However, tax knowledge and education had positive effect on level of tax compliance among the tax payers. Similarly, fines/penalties had positive effect on level of tax

compliances, while perceived opportunity for tax evasion had negative effect. The study provides some preliminary evidence that imposing fines/penalties and provision of tax knowledge and education among these companies will improve tax compliance. Conversely, high compliances cost and high opportunity for tax evasion will reduce tax compliance among registered firms.

Thiga and Muturi, (2015) when studying Tax compliance among SME's in Kiambu County observed that low compliance cost are associated with high compliance level, these findings have been vindicated by several researchers including Lumumba *et al*, (2010) and Slemrod (1992). Technical compliance is visible mostly among indirect taxes such as VAT and excise duty that require maintenance of substantive records, machines (ETR, flow meters), and at times might even call for a resident officer to monitor the production process. Although all these help in ensuring compliance it raises cost and increases the premium on non-compliance.

Mahangila (2017) evaluated the impact of tax compliance costs on tax compliance behaviour. The study adopted laboratory experimental methods. The tax context experiment involved 75 small and medium entrepreneurs based in Dar es Salaam, Tanzania's business hub. The participants were first randomly assigned to one of the three experiment treatments. Generally, the results indicated that tax non-compliance significantly increased as tax compliance costs increased. Although the study used small samples of SME taxpayers, therefore the results may not be generalizable, the results imply that tax compliance costs may be responsible for the unsatisfactory tax compliance levels of SME taxpayers.

Also, Zachary, Kariuki and Mwangi (2017) carried out a study on tax compliance cost and tax payment by small and medium enterprises in Embu County, Kenya. The study adopted a descriptive study design. The population of interest comprised all the 615 registered SMEs in Embu County. This study used a sample of 185 Small and Medium Enterprises in Embu County, which were selected using stratified and simple random sampling methods. The findings of the study found a significant positive relationship between tax compliance costs and tax compliance by Small and Medium Enterprises in Embu County. The study concluded that there is a significant direct relationship between tax compliance costs and tax payment by Small and Medium Enterprises in Embu County.

Abdul and Wang'ombe (2018) did a study on tax costs and tax compliance behaviour in Kenya. The study targeted, 1,315 companies were registered as large tax payers and 1,538 companies registered as medium sized tax payers. Due to the nature of the population,

stratified sampling technique is adopted to generate a sample of 200 firms from the two main strata; large and medium-sized private firms. The study used a Structural Equation Modelling (SEM) technique to establish the key cost drivers built using survey data, while controlling for key attributes of the tax system as well as firm characteristics. From the findings, tax compliance in Kenya significantly declines with increase in tax compliance costs, particularly those related to understanding of the existing complex tax laws, changes in tax rules as well as general costs of meeting the compliance and regulatory requirements.

### **2.3.2 Enforcement Instruments**

Slemrod and Yitzhaki (2000) observed that enforcement instruments, including the audit rates and the punishment function, are also determinants of tax compliance, although these variables are rarely available for empirical studies. For example, Dubin *et al.* (1990) and Pommerehne and Weck-Hannemann (1996) found that the probability of audit significantly affects tax compliance, whereas they found no evidence of a significant deterrent effect of the penalty. Andreoni *et al.* (1998) based on studies of data generated from the Internal Revenue Service's Taxpayers Compliance Management Programme (TCMP) observed that due to the low probability of detection even high penalties has no observable impact on the level of compliance. Merima *et al.*, (2013) when studying factors affecting tax compliance in a sample of African countries observed that an increase in perception of individuals about the difficulty of evading taxes enhances taxpayer's attitude towards compliance.

In Kenya the audit coverage is less than 1% of the returns filed, this can explain the low levels of compliance especially on tax heads whose audit coverage is low such as Corporation tax and Excise duty. Noncompliance is also enforced as a civic rather than a criminal offence had hereby in most cases the corrective action are penalties rather than jail term. Penalties levied on non-compliance ranges from 20% in areas where there was limited complicity of the taxpayer to 75% in cases where there was willful action on the taxpayer to evade the tax. The new Tax Procedures Act (2015) has harmonized the penalties and interest charged and therefore there can be no observable variance on compliance based on the punishment function across tax heads.

Empirical studies on tax compliance have also spanned to other factors other than economical that influence taxpayer's behavior these include spheres as psychological, moral, political and social factors such as guilt, a civic sense of duty, perception of fairness, and moral preference. Myles and Naylor (1996) reconciled the standard model of tax compliance with the social customs and group conformity, indicating that equilibrium with some complying taxpayers

could exist. Smith (1992) noted that the factors affecting taxpaying behavior are culturally influenced and thus more cross country work must be done. As noted above, factors such as the efficiency of government expenditure and the corruption level of government also affect taxpayer compliance.

Trivedi and Shehata (2005) concluded that some taxpayers' behavior is a mixture of both economic and psychological considerations. This observation was the cornerstone in Lumumba et.al (2010) in their paper on taxpayer's attitude and compliance behavior in Kenya; in their findings they observed that majority of Kenyans view the tax regime to be unfair, complex and punitive in nature. Accountability in government expenditure also had a big role in influencing compliance behavior with most respondents intimating that they didn't comply as they weren't confident their taxpayer's money was used correctly. Impact of tax compliance on revenue has also been a critical area of interest, Besley et al. (1997) contended that the level of taxation and audit policy form the basis of policy decisions of governments. Correspondingly, high rates of noncompliance may necessitate a higher tax rate and higher levels of enforcement than otherwise necessary. Fauvelle- Aymar (1999) investigated differences in the level of tax revenue among developing countries, contending that tax revenue is negatively affected by the degree of taxpayer noncompliance. The data she collected from the developing countries (1980-89) supported the theoretical prediction that tax revenue increases with taxpayer compliance.

In Nigeria, Oladele, Aribaba, Ahmodu, Yusuff and Alade (2019) did a study on tax enforcement tools and tax compliance in Ondo State. Survey research design was adopted using primary data sourced through administration of structured questionnaire on 150 selected respondents from among staff of Federal Inland Revenue Service and State Board of Internal Revenue Service within the state. The Taro Yamane formula and judgment sampling technique were used to arrive at the sampled respondents. Outcome of Ordinary Least Square regression analysis showed regression coefficient and p-value of tax audit (0.278;  $p=0.03$ ).

Majiwa (2014) carried out a study on determinants of tax compliance behaviour in Kenya. This study used a descriptive survey design. Data for the study was obtained using structured questionnaires from 100 respondents arrived at by a stratified random sampling. It was established that tax compliance behaviour varies largely depending on whether the taxpayer is an individual or a corporate entity. The findings indicate compliance levels are higher in corporate than with individual tax payers. Findings showed that for corporate tax payers, enforcement measures had a negative impact on tax compliance level while tax rates,

compliance costs and nature of tax had a positive impact. For individual tax payers; enforcement measures had a positive impact on tax compliance while tax rates, compliance costs, nature of tax had a negative impact on tax compliance.

Mukabi (2014) evaluated the factors influencing turnover tax compliance in the Kenya revenue authority domestic taxes department in Nairobi County. A target population of 560 taxpayers was selected and given the large population of taxpayers in Nairobi County, a total sample size of 56 was picked as representative, to be the focus of this study. A descriptive survey design was used. Stratified sampling technique was used to create a sampling frame ensuring that different and diverse types of entities were included in the survey. The findings reveal that all the identified factors have a direct influence on the tax compliance efforts by taxpayers in the turnover businesses. The perceptions of taxpayers towards the tax system greatly determine the level of compliance for turnover tax.

### **2.3.3 Turnover Tax Mode of payment**

There are several modes of payment of tax in Kenya today. According to Alm et al. (1992), the level of compliance grows with insights of the accessibility of payment methods available. Consequently, the foremost concern of taxpayers is what form of payment methods or services come from the administration in response for taxes paid. From this viewpoint, taxation by the government and the delivery of public services and goods are understood to be an association that is contractual in nature (Moore, 2004). Persons may honor tax payments since they deem the payment methods affixed by the KRA as valuable, identifying that their tax paying is necessary in order to assist the financing of the service and goods delivery and also to motivate others taxpayers to consider contributing (Fjeldstad & Semboja, 2001).

Wasao (2014) assessed the effect of online tax system on tax compliance among small taxpayers in east of Nairobi Tax District. Specifically, the study evaluated whether, online tax filing and online tax remittances influence compliance. The study adopted quantitative and descriptive methods as a research designs. Data was collected using structured questionnaire, which covered all the variables of the study from 160 sampled taxpayers based in East of Nairobi tax District. Data obtained was subjected to quantitative methods of data analysis using SPSS (version 20). Results obtained were presented using tables and graphs for ease of understanding and interpretation. In addition, both correlation and regression analyses were done and summaries presented. The findings of the study were that online system do affect tax compliance level among small taxpayers in East of Nairobi as far as registration, filing and payments were concerned, From the regression analysis, it was revealed that holding online tax

registration, filing and payment to a constant zero, tax compliance would stand at 3.663. A unit increase in online tax registration would lead to increase in tax compliance among small tax payers in east of Nairobi by factor of 0.051 and a unit increase in tax filing would lead to an increase in tax compliance by factors of 0.161 while a unit increase of online tax payment would result to increase in tax compliance by factor of 0.086

Mahoro (2018) did a study on electronic billing and tax compliance in Nyarugenge district, Rwanda. The study adopted both descriptive and analytical designs, and was both qualitative and quantitative in nature. The target population of this study was 4383 comprising 947 employees of Rwanda Revenue Authority and 3436 taxpayers in Nyarugenge District. The sample size of the study was 99 respondents including 22 RRA employees and 77 Nyarugenge District taxpayers. The researcher used stratified and systematic random sampling method. The study found that there is a strong and positive relationship between the usage of EB and Tax compliance. Analysis gave the relationship between Electronic Billing Machine and Tax Collection in Rwanda whereby the respondents N is 99 and the significant level is 0.01, the results indicate that independent variable has positive high correlation to dependent variable equal to .970\*\* and the p-value is .000 which is less than 0.01. When p-value is less than significant level, therefore researchers conclude that variables are correlated. This means that there is a significant relationship between electronic billing and tax compliance in Rwanda

Munyoro (2017) assessed the effects of iTAX system on compliance of VAT Payments by SMEs in Wote Town in Makueni County, Kenya. The study employed both descriptive and diagnostic research design. The target population of this study composed of 581 SMEs taxpayers from Wote Town of Makueni County. The researcher used Radom sampling method to pick a sample of 120 VAT taxpayers the response rate was 87. Both primary and secondary data was used. The data collected was analyzed using ordinary linear regression model. The study found out that majority of the respondents had registered as taxpayers with most of them having registered for VAT and income tax. Registered respondents of Itax and integrated tax system cited less cost, simplicity and time required as benefits of filling VAT returns online and that the respondents had minimal ICT knowledge. The study concluded that registration of VAT taxpayers using Itax enhances revenue collection by KRA. It also enhances the SMEs level of understanding on KRA tax systems. This enhances tax compliance among taxpayers and reduces possible avenues for tax evasion.

Utetiwabo, Mulyungi and Oluoch (2018) evaluated the effect of electronic tax system on tax compliance among small and medium tax payers in Rwanda. The study adopted both

correlational and descriptive research designs. The target population for the study included small and medium tax payers in Nyarugenge sector. A sample of 99 respondents was drawn from a population of 15,507 using Slovin's formula with 10% margin of error. Proportionate stratified and simple random sampling techniques were adopted in selecting the sample size. The findings indicated a strong positive association between E-tax system and tax compliance with high Rsquared value of 68.4%. The study recommended training programs and improved fibre optic network to improve connectivity and server efficiency.

Gwaro, Maina and Kwasira (2016) did a study on the influence of online tax filing on tax compliance among small and medium enterprises in Nakuru Town, Kenya. Specifically, the study sought to examine the influence of computer literacy, online tax system and perceived risks concerns. The study utilized the survey descriptive research design in which quantitative data was collected through use of primary data collection techniques. Primary data was collected using questionnaires. A sample size of 100 respondents from the Small and Medium Enterprises in Nakuru was utilized. The study found amongst the independent variables only the computer literacy had significant effect on the influence tax compliance levels amongst Small and Medium Enterprises in Nakuru.

#### **2.4 Critique of Existing Literature**

There is numerous literature on Turnover Tax compliance among Small and Medium Enterprises SMEs both globally and locally. However most of these studies were conducted as case studies and hence their findings cannot be generalized to all SMEs in Kenya. In addition, these studies had different aims and objectives and focused on different target populations. For instance, Mogeni (2014) aimed at looking how compliance cost on tax compliance in companies listed in Nairobi Stock Exchange. The study did not get the views of SMEs owners but those of NSE staff. On the other hand, Thiga et al., (2015) when studying Tax compliance among SME's in Kiambu County observed that low compliance cost are associated with high compliance level. This study was limited to Kiambu County and hence its findings cannot be generalized to other parts of Kenya including SMEs in Central Business District. The independent variables in this study were tax understanding, tax rates, tax penalties and fines and tax compliance cost. The study therefore did not look at how turn over tax mode payments influence tax compliance.

Further, Zachary et al., (2017) carried out a study on tax compliance cost and tax payment by small and medium enterprises in Embu County, Kenya. Although the independent variable was tax compliance cost, the study looked at different parameters, that is, financial costs and time

costs. The study was also conducted in Embu County while this study was conducted in Nairobi County. The findings of the two studies could not be generalized because two areas have different economic and demographic characteristics.

Oladele et al., (2019) did a study on tax enforcement tools and tax compliance in Ondo State in Nigeria. In their study, they looked at parameters such as tax penalty, tax amnesty and possibility of audit while this study looked at audit rates and punishment function. Further, the study was limited to Ondo State in Nigeria hence the findings cannot be generalized to the SMEs in Kenya due to the different characteristics between the two countries. In his study, Mukabi (2014) evaluated the factors influencing turnover tax compliance in the Kenya revenue authority domestic taxes department in Nairobi County. This study did not look at the influence on SMEs specifically. The perceptions of taxpayers towards the tax system greatly determine the level of compliance for turnover tax.

Lastly, Wasao (2014) assessed the effect of online tax system on tax compliance among small taxpayers in east of Nairobi Tax District. Mahoro (2018) did a study on electronic billing and tax compliance in Nyarugenge district, Rwanda. Munyoro (2017) assessed the effects of iTAX system on compliance of VAT Payments by SMEs in Wote Town in Makueni County, Kenya. Also, Gwaro et al., (2016) did a study on the influence of online tax filing on tax compliance among small and medium enterprises in Nakuru Town, Kenya. The studies were limited to other areas which are different area from the current study area. The proposed study intends to address such gaps by investigating factors affecting Turnover Tax compliance among Small and Medium Enterprises in Kenya, a case study of Nairobi CBD, Luthuli Avenue.

## **2.5 Summary of Literature and Research Gaps**

From the above literature there is a wealth of knowledge in the area of tax compliance and its impact on revenue generation. It can be observed that the general trend is that rates of taxes, nature and complexity of the tax, method of collection, enforcement mechanism, government transparency and the structure of the economy all have a positive impact on the level of compliance. This lends credence to the observation by Brown and Mazur (2003) that tax compliance is a multifaceted aspect which involves economic, psychological and socio-cultural factors. However other than Lumumba *et.al* (2010) and the Simiyu (2003) with the former being mostly localized to SME's in Kirinyaga county and the latter being a book on taxation policy in Kenya, there has been no study on the taxpayer compliance behaviour in Kenya or indeed in the developing world.

The most relevant published paper on this Alm *et.al* (1990), mostly based its research on the area of tax structure in Jamaica concluded that reduced tax rates coupled with bigger payroll benefits leads to higher compliance while there will be low compliance if more severe penalties are imposed or if detection becomes more certain. However the paper only reviewed personal income taxes mostly PAYE rather than the whole range of taxes.

From the literature it can be deduced that taxpayer compliance behaviour is generally correlated with revenue generation, it is therefore imperative that the factors determining taxpayer attitude and behaviour with regards to compliance are adequately studied and reviewed. This paper tries to bridge the gap between the available information about taxpayer compliance behaviour and what is optimal so as to design appropriate policies that can increase Tax performance in Kenya.

## 2.6 Conceptual framework

### Independent variables

### Dependent variables

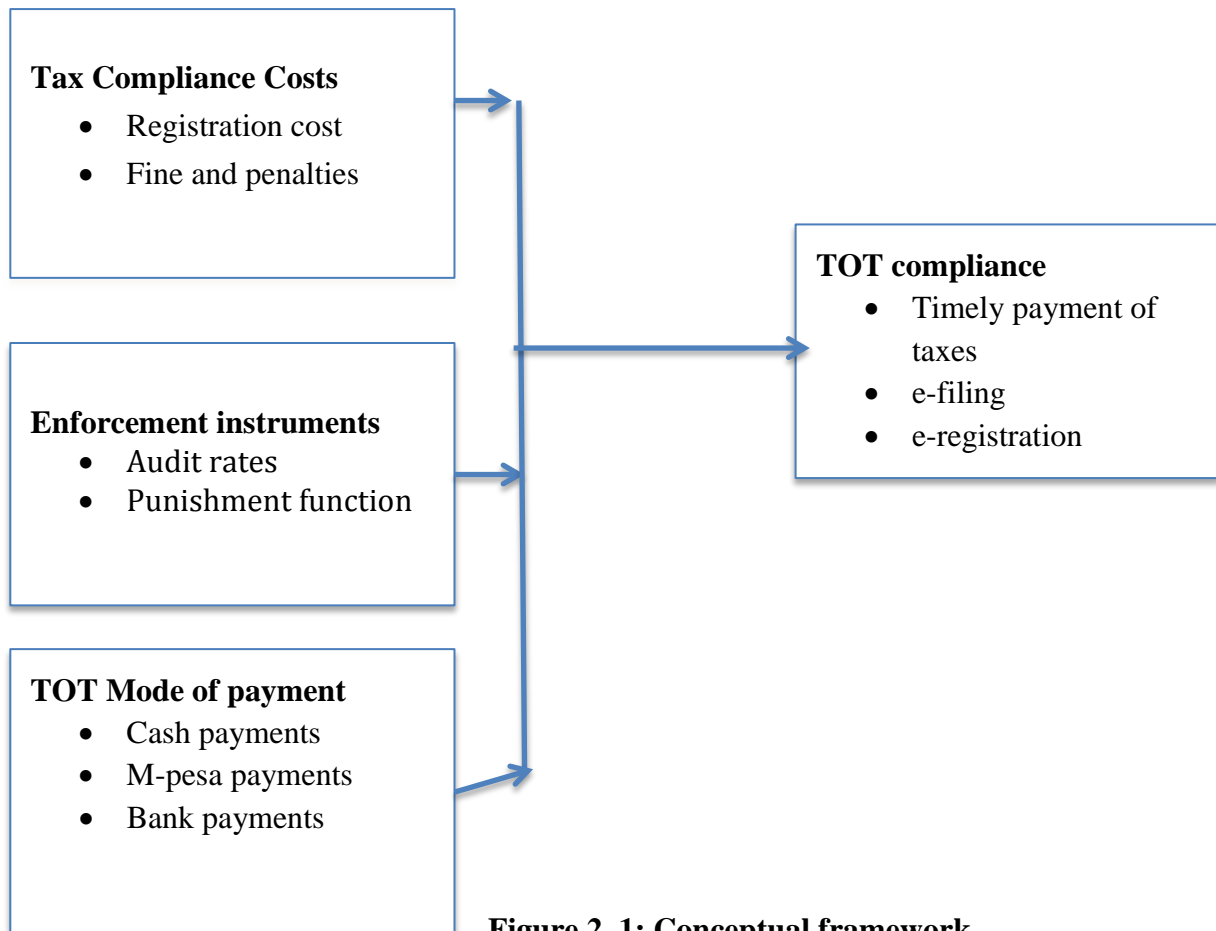


Figure 2. 1: Conceptual framework

### **Fines and penalties:**

It is a fact that if many persons are given the chance they may not pay taxes unless there is a motivation to do so. Tax experts have a perception that the best way is to increase tax incentives while others believe the best way is to increase tax penalties. Stopping non-compliance requires applying penalties effectively. The most appropriate strategy is to combine various measures so as to maximize their effects on tax compliance as it were, in order to move the country from a low level of tax compliance to a higher level. (Gruber & Saez, 2002).

### **TOT mode of payment:**

M-Pesa and Bank payment is among the major technological tax reforms introduced through a Common Cash Receiving System (CCRS) by KRA (Gichuki, 2015). These modes of payment make it easier for the tax payers to be tax compliant. Some tax payers do not like to queue in long lines to fill their taxes, some even fear going to KRA offices to pay their taxes due to fear of being slapped with fines. Mpesa, Bank payment make it easier for the tax payers to easily

file their tax and be tax compliant (Kipkemoi, 2015). Commercial banks are integrated into the system, and a service level agreement entered into to govern the relationship.

**Tax rates:**

It is for most part trusted that a high tax rate is the primary driver of tax evasion. Motivating forces to sidestep tax rely upon the minimal rates of tax collection on the grounds that these oversee the increases from evasion as a total of the total sidestepped. One noteworthy evasion of tax is high individual income rate of taxation which tend to direct taxpayers to dodge tax. Excessively numerous and confounded standards and directions forced by the administration tend to prompt tax evasion. Organizations discover it by and large troublesome frequently not beneficial to work together lawfully (KRA, 2011)

**Tax compliance costs:**

In Kenya, filling tax returns in the past has been done manually where taxpayers were required to fill in manual forms and submit the same forms to KRA .However in 2014, the government launched the online filing system referred to as the iTax that aimed at encouraging the use of internet to file tax returns so as to boost tax compliance and revenue collection. The iTax system allows taxpayers to authenticate more information. Tax compliance methodology incorporates every single formal system and related exercises that taxpayers need to see to conform to tax commitments.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

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

#### **3.2 Research Design**

According to Mcmillan and Schumaker (2001) a research design is a plan for selecting subjects, research sites and data collection procedures to answer the research questions. It is the conceptual framework within which research is conducted and constitutes the blueprint for the collection of data and the analysis thereof of the collected data. Primarily a descriptive study is concerned with determining the frequency with which something occurs or the relationship between variables. The study adopted a descriptive research design.

According to Cooper (2003), a descriptive study finds out, who, what, where, and how of a phenomenon which is the aim of this study. In addition a descriptive study is concerned with finding out the what, where and how of a phenomenon (Ngechu, 2004), thus, this approach was appropriate for this study, since the researcher intended to collect detailed information through descriptions and this was also useful for identifying variables and hypothetical constructs. The goal is to provide a clear understanding of effects of Micro finance institution on the growth of small enterprises in Nairobi County.

#### **3.3 Target Population**

According to Mugenda & Mugenda (2013) and Ngechu (2004), target population entails an entire group of persons or things that have similar features that are preferred by the investigator. Target population consists of a group of entities or elements that might be huge than or distinct from sampled group from which the researcher will draw conclusions about the interested population. The target population of this study will comprise of 350 Small and medium Enterprises in Nairobi CBD, Luthuli Avenue. In Nairobi County, the CBD is a business hub for Small and medium enterprises. The SMEs that will be covered are located along Luthuli Avenue.

**Table 3.1: Target Population**

No	Name of Building	Number of SMEs
1	Nairobi Matt building	90
2	Skymall	140
3	Cianda	120
<b>Total</b>		<b>350</b>

### **3.4 Sample and Sampling techniques**

#### **3.4.1 Sampling Frame**

Lavrakas (2008) defines a sampling frame as a list of the target population from which the sample is selected and that for descriptive designs a sampling frame usually consists of a finite population. Further, a sampling frame is a list of members of the research population from which a random sample may be drawn. The sampling frame of the study was 350 SME's in Luthuli Avenue, Nairobi County which comprises of Barber shops, Groceries, Boutiques, Wholesalers, Hardware shops, Electronics shops, Distributors, Restaurants, Milk bars Chemist and Agro vets registered with the County Government in the department of trade as at 2018.

#### **3.4.2 Sampling Techniques**

Saunders, Lewis and Thornhill, (2015) define sampling as selecting a given number of subjects from a defined population as representative of that population. The study employed a simple random technique to identify the respondents. Simple random refers to a complete enumeration of all items in the population.

According to Saunders, Lewis, & Thornhill, (2015), when the universe is a small one, it is no use resorting to a sample survey. The Number of sme's will comprise of 350 SME registered in the County Government trade department.

Mugenda and Mugenda (2008) suggest that a sample of 10% is sufficient to represent a population and recommends a criteria for selecting a sample size which will be adopted as a model for a sample for this study as follows: Our target population in this study was less than 10,000, thus the sample of 384 was adjusted as follows using the following formula.

$$nf = n / (1 + n/N)$$

In this study therefore

$$nf = n / (1 + n/N)$$

$$384 / (1 + (384/350))$$

384 / (1 + 1.097)

384 / 2.097

= 183 Respondents

**Table 3.2: Sample size**

No.	Name of Building	Number of SMEs	Sample size
1	Nairobi matt building	90	37
2	Skymall	140	80
3	Cianda	120	66
<b>Total</b>		<b>350</b>	<b>183</b>

### 3.5 Data Collection procedure

The researcher applied for a research permit from the Nairobi County Government before going to the field. The researcher also wrote a letter of transmittal of data collection instruments to individual respondents. The researcher then booked appointments with the respondents and agreed on the timings for filling the questionnaires. The questionnaires were dropped and picked later. Follow-ups were also made to monitor the progress of the respondents in filling up the questionnaires. The researcher hired a research assistant to help collect the filled questionnaires.

### 3.6 Pilot Testing

A pilot study also known as a feasibility study was done to assess the feasibility of the study, its validity and reliability. Procedures to be used in pre-testing the questionnaire were identical to those that were used during the actual study or data collection. 10% of the entire sample size was used which is 18 SMEs (Mugenda Mugenda, 2008). Pre-testing helps detect deficiencies like unclear directions, insufficient space to write response, wrong phrasing of questions, vague questions etc..

#### 3.6.1 Validity of research instruments

According to Creswell, (2006) validity is the degree to which results acquired from process of analysis of the data actually embodies the phenomenon under study. There are two types of validity: content validity and face validity. Face validity refers to probability that a question is misinterpreted or misunderstood. According to Cooper and Schindler, (2006) pre-testing is a proper way to increase the possibility of face validity. On the other hand, content validity, also referred to as logical validity, refers to the degree to which a measure depicts all facets of a

given social construct. In this study, the content validity was improved by seeking the opinions of experts in the field of study, particularly the supervisors. Also, the face validity of the research instrument was improved by carrying out a pilot test and changing any unclear and ambiguous question.

### **3.6.2 Reliability of research instruments**

Reliability is the consistency of measurement, or the degree to which an instrument gives the same results each time it is used on the same subjects under the same condition. In the study reliability of the research instrument was measured by measuring the internal consistency of the responses. The Cronbach's Alpha technique was used to measure the internal consistency technique, where alpha values range from 0 to 1, with the reliability increasing as the alpha value increases. The commonly used coefficient of reliability is 0.6 to 0.7, with greater than or equal to 0.8 indicating a good reliability, (Kothari, 2004). In the study, a Cronbach's Alpha of 0.7 and above was accepted but a Cronbach's Alpha of below 0.7 would necessitate adjustment in the research instrument. However, the data obtained from the pilot test was not included in the actual study.

## **3.7 Data Analysis and Presentation**

### **3.7.1 Data Analysis**

The semi structured questionnaire generated both qualitative and quantitative data, which was analyzed differently using different methods. Qualitative data was analyzed by use of thematic content analysis and the results presented in a prose form. Quantitative data was both inferential and descriptive statistics with the help of statistical software known as Statistical Package for Social Sciences (SPSS version 21).

Before analysis, the completed questionnaires was edited for completeness and consistency. Descriptive statistics was used to summarize the background information. Descriptive statistics included percentages, and frequencies, measures of central tendency (mean) measures of dispersion (standard deviation). The data was presented using tables and figures which include bar charts and pie charts. Multiple regression analysis was used to establish the influence of the independent variables on the dependent variable.

The multiple regression analysis took the following model:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Whereby:

Y = TOT compliance of SME's in Nairobi County

$\beta_0$  = Constant

$\beta_1 - \beta_4$  = Beta coefficients

$X_1$  = Tax Compliance Cost

$X_2$  = Enforcement instruments

$X_3$  = TOT Mode of payment

$\varepsilon$  = Error term

### **3.7.2 Data Presentation**

The data was presented by use of descriptive and inferential statistics. The descriptive was in terms of frequencies, means and charts, and other graphical techniques. Statistical techniques was involved in measures of central tendency (mean, median and mode) and measures of dispersion such as standard deviation and variance. Graphical techniques was used in the diagrammatic representation by use of tables and charts. The inferential statistics was used on chi-square test of association to show the relationship between depend and independent variables.

## CHAPTER FOUR

### RESEARCH FINDINGS AND DISCUSSIONS

#### 4.1 Introduction

The section of the study research focuses on the study finding, presentations and discussions, the part is section into respondent's demographic information, presentations according to study variables, limitations of the study as well chapter summary. Data that was gathered from the study survey has been analyzed using SSPS and descriptive statistics and presentations are illustrated in tables and figures.

#### 4.2 Response Rate

The researcher distributed 183 questionnaires to the targeted respondents. Only 128 questionnaires were returned duly filled up and were used for the analysis. They recorded a response rate of 80% as tabulated in table 4.1 and figure 4.1 as provided by Mugenda and Mugenda (2003) and echoed by Kothari (2004) any response that is 50% is good and adequate to be administered in research study. According to Creswell, (2012) a response rate above 70% is excellent. Therefore, the study achieved above the recommended thresh hold and the valid sample for the study was based on n=128.

**Table 4.1: Response rate**

<b>Variable</b>	<b>F (n)</b>	<b>Percentage</b>
Returned	128	70
Not returned and incomplete	55	30
<b>Total</b>	<b>183</b>	<b>100</b>

As shown in table 4.1 the number of returned and completed questionnaires were one hundred and twenty that represents 70% of the valid questionnaires that were analyzed and assisted the study in making a conclusive report in relation to study variables.

### 4.3 Demographic Information

#### 4.3.1 Gender of the Respondents

**Table 4.2: Gender of the respondents**

<b>Gender</b>	<b>Frequency (n)</b>	<b>Percentage (%)</b>
Male	120	66
Female	63	34
<b>Total</b>	<b>183</b>	<b>100</b>

As shown in table 4.2 respondents were required to indicate their gender and the finding show that the majority were male at 66% while their female counterpart represented 34%.

#### 4.3.2 Respondent's age group

**Table 4.3: Respondent's age group**

<b>Age group</b>	<b>Frequency (n)</b>	<b>Percentage (%)</b>
Below 30 years	30	16
30-40 years	80	44
41-50 years	53	29
Above 50 years	20	11
<b>Total</b>	<b>183</b>	<b>100</b>

As shown in table 4.3 respondents were asked to indicate which age group that best suits them and the responses were as following majority of the respondents were aged between 30 years and 40 years at 44%, 41 years to fifty years were 29% while above 50 years were at 11% and below 30 years were 16%.

#### 4.3.3 Respondent's SMEs Sector

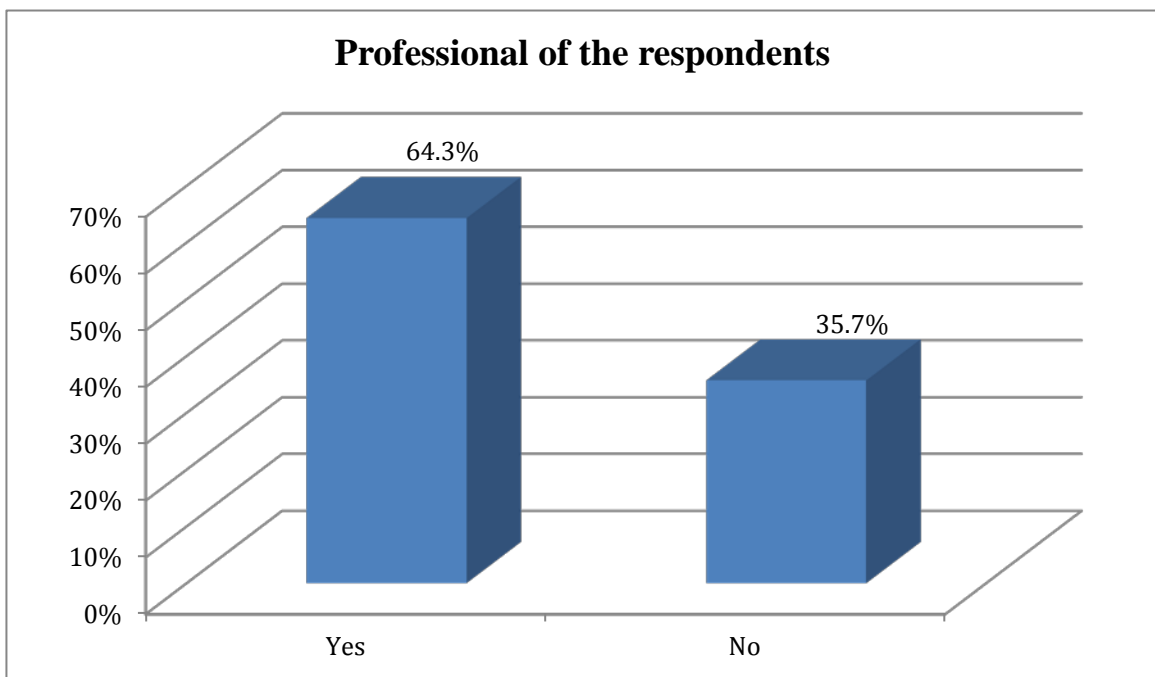
**Table 4.4: Respondent's SMEs Sector**

<b>Years</b>	<b>Frequency</b>	<b>Percentage</b>
Beauty and cosmetic	35	27
Bar/hotel/restaurant	24	19
Electronics stores	23	18
Hardware/construction materials	20	16
Wholesale/ retail trade	13	10
Mechanic/electrical services	10	8
Others	3	2
<b>Total</b>	<b>128</b>	<b>100</b>

The table shows that most of the respondents own beauty and cosmetic business at 27%, they were followed by those with bar/hotel/restaurant at 19%. Then those with electronic stores were found to be 18%. The respondents with hardware and construction materials were found to be 16%, the ones that own wholesale and retail shop were at 10%, while the ones who were between mechanic and electrical services were found to be at 8% which was lastly followed by others business who were at 2%.

#### 4.3.4 Professional of the Respondents

Then the study sought to establish the professional of the respondents. The results were presented in figure 4.1.



**Figure 4.1: Professional of the Respondents**

It was observed that majority of the respondent's possession a professional course at a response rate of 64.3 % while 35.7% of the respondent did hold any professional qualification.

#### 4.3.5 Annual Turnover estimate in Kenya shilling

The researcher sought to establish the annual turnover estimate from the respondents business. The response was presented in Table 4.5.

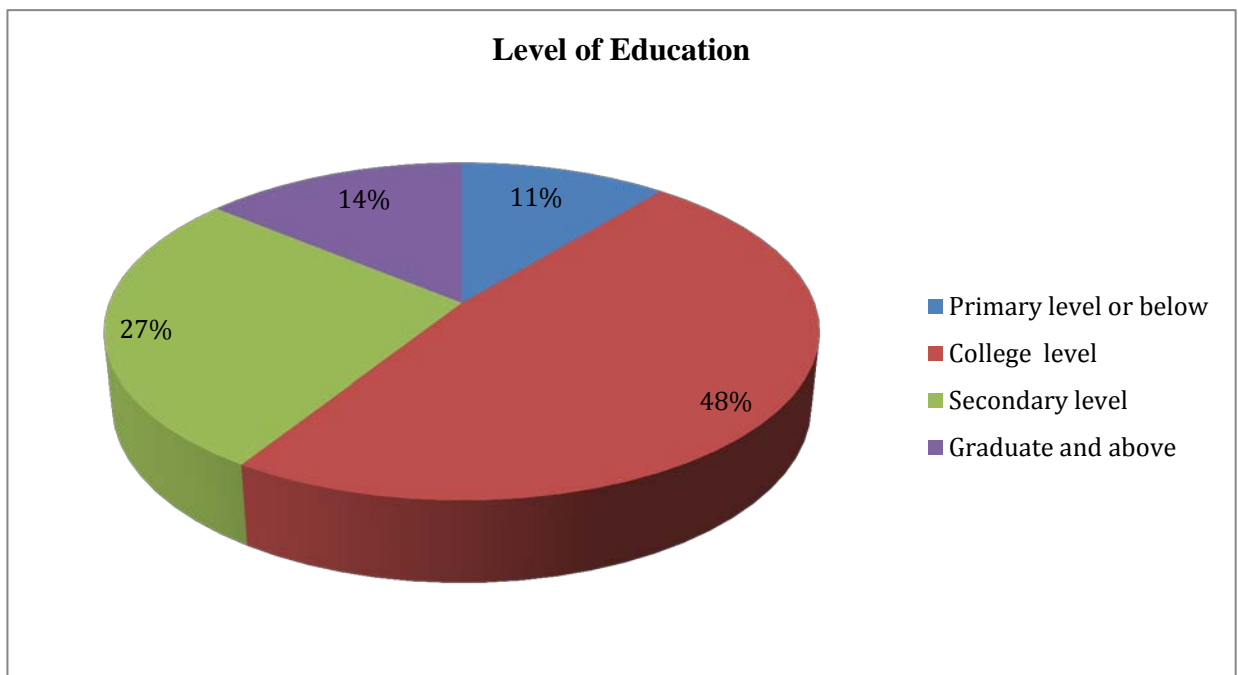
**Table 4.5: Annual Turnover estimate in Kenya shilling**

<b>Estimate of annual turnover in ksh.</b>	<b>Means score</b>	<b>St Dev</b>
Below Kshs 500,000	2.88	1.318
Between Kshs 500,001 and 1,000,000	2.64	1.438
Between Kshs 1,000,001 and 3,000,000	2.64	2.087
Between Kshs 3,000,001 and 4,999,999	2.49	3.673
Above Kshs 5,000,000	1.69	0.766

As shown in Table 4.5 respondents were asked to estimate their annual turnover in Kenya shillings, the business above Kshs. 5,000,000 turnover had a means score of 1.69, business with annual turnover between Kshs.1,000,001 and 3,000,000 at a means score of 2.64. business with annual turnover between Kshs.500,001 and 1,000,000 at a means score of 2.64, business with annual turnover below Kshs.500,000 a means score of 2.88 while business with annual turnover between Kshs.1,000,001 and 3,000,000 at a means score of 2.49.

#### **4.3.6 Level of education**

The study sought to establish the level of education of the respondents. The results were presented in Figure 4.2



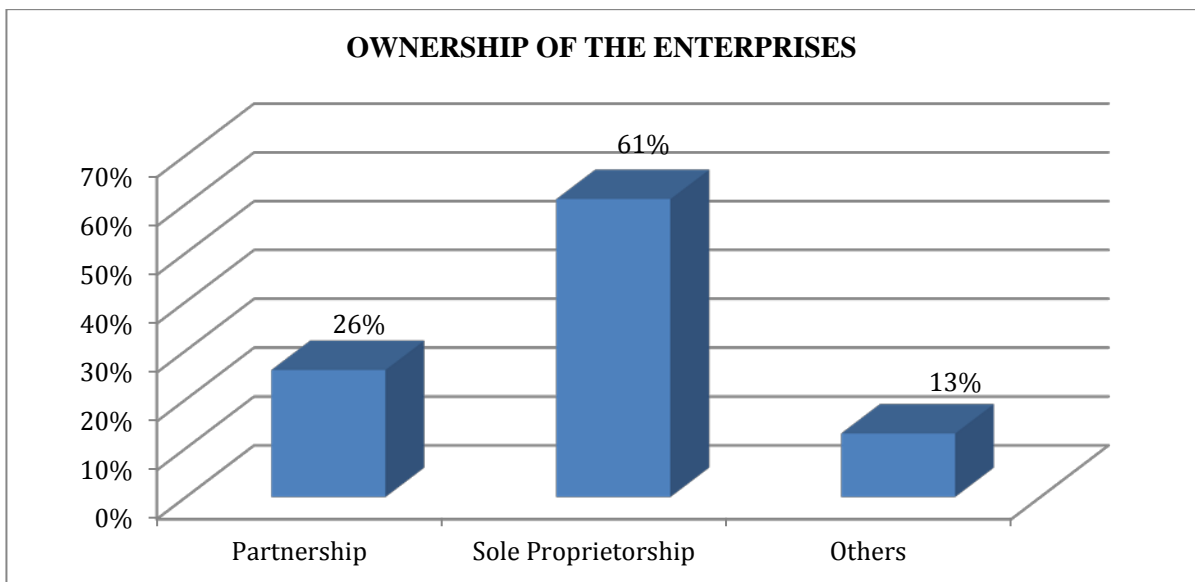
**Figure 4.2: Level of education**

As shown in Figure 4.2 respondents were asked to indicate their highest level of education and

the responses were as following majority of the respondents had attained secondary education level at 48%, those who had attained College level were 27% while graduate level and above were at 14% and primary level were 12%. This can be interpreted that most if not all of the respondents were in a position to respond to research study questions as outlined in the questionnaires. As the study established that majority of the respondents had attained college level of education.

#### 4.3.7 Ownership of the Enterprises

The study further sought information on the respondents' ownership of the enterprises. The response was given in Figure 4.3



**Figure 4.3: Ownership of the Enterprises**

The findings show that most of the respondents own the enterprises with 61%. They were followed by those who are partners at 26% with the least being those who are either employed, family business at 13%.

#### 4.3 Tax Compliance Cost

The researcher asked the respondents to their level of agreement with the statements. The findings were presented in Table 4.6.

**Table 4.6: Tax Compliance**

<b>Statement</b>	<b>Mean score</b>	<b>St Dev</b>
How do you rate the cost of filing a tax return	2.98	1.318
How do you find the cost of travelling in order to file a return	2.94	1.438
I know how to declare actual income received from all sources to the tax authority	2.64	2.087
The business files its tax returns on time	2.49	3.673
The business pays the right amount of taxes on time	1.69	0.766
I understand that I should pay taxes due within the prescribed period from the date of issue of the Notice of Assessment or within the stipulated period	2.88	1.318
I know I should obtain a tax payer identification pin Number I know which income should be included	2.04	1.438
<b>Average</b>	<b>2.52</b>	<b>1.719</b>

As shown in table 4.5 respondents were required to indicate their views using a five point likert scale to respond to statements that were asked in line with taxpayer knowledge with relation to tax compliance amongst SMEs in Nairobi County. The first statement asked was if respondents are rate the cost of filing a tax return the responses were as follows 47.9% strongly agreed, 11.8 agreed, 31.9 were uncertain while 5.9% disagreed and 2.5% strongly disagreed. The second issues asked their cost of travelling in order to file a return and the responses were as follows 9.2% of the respondent strongly disagreed, 13.4% disagreed while 25.2% were uncertain, 33.6% agreed and 18.5% strongly agreed. The third view was if they declare actual income received from all sources to the tax authority 7.6% strongly disagreed, 7.6% disagreed, 10.1% were uncertain and 47.9% agreed while 26.9% strongly agreed. The fourth issue raised was if files its tax returns on time 4.2% of the respondents strongly disagreed, 4.4% disagreed, 10.3% were uncertain and 20% agreed while 20.7% strongly agreed. The fifth issue raised was if they pays the right amount of taxes on time. The sixth issue raised was if they should pay taxes due within the prescribed period from the date of issue of the Notice of Assessment or within the stipulated period files its tax returns on time 2.2% of the respondents strongly disagreed, 4.2% disagreed, 7.3% were uncertain and 27.1% agreed while 2.7% strongly agreed. The seventh and the final issue raised was if they have a tax payer identification pin number and whether they know which income should be included tax laws complexity add to incorrect tax returns 6.7% of the respondents strongly disagreed, 4.2% disagreed, 8.4% were uncertain while 36.1% agreed and 44.5% strongly agreed. The results show the average mean of 3.8 with a standard deviation of 1.1 this shows that most of the respondents conquered with the

statements raised by the study. The study finding concurs with findings of Fichtner & Feldman, (2015) tax compliance costs are very high, and these cost have implications for lost economic growth, money spend unnecessarily on professional tax services, and even the collection of revenue. For businesses, these resources would have been better spent on activities that increased capacity and production; and at individual level, on work, saving and investment.

#### 4.4 Enforcement Instruments

**Table 4.7: Statements on enforcement instruments**

<b>Statement</b>	<b>Strongly disagree</b>	<b>Disagree</b>	<b>Uncertain</b>	<b>Agree</b>	<b>Strongly agree</b>	<b>Mean</b>	<b>Standard Deviation</b>
The penalty rates are very low and I can afford to pay the penalty compared to compliance cost	5.90%	3.40%	22.70%	36.10%	31.90%	3.85	1.09
The enforcement is very weak	5.90%	9.20%	24.40%	45.40%	15.10%	3.55	1.05
Since the supporting documents do not need to be sent to the KRA, I can manipulate the figure in the tax return	5.00%	14.30%	6.70%	43.70%	30.30%	3.8	1.17
I believe the tax authority has limited capability to investigate all income reported to them so I have an opportunity not to report my exact income	5.90%	10.90%	9.20%	52.10%	21.80%	3.73	1.1
I believe that the probabilities of being detected by the tax authority for not declaring the exact income that I receive are low.	7.60%	18.50%	12.60%	46.20%	15.10%	3.43	1.18
I know how to declare actual income received from all sources the tax authority	8.40%	21.80%	10.10%	21.00%	38.70%	3.6	1.4
<b>Average</b>						<b>3.7</b>	<b>1.2</b>

As tabulated in Table 4.7 respondents were required to indicate their views using a five point likert scale to respond to statements that were asked in line with enforcement instruments with relation to tax compliance amongst SMEs in Nairobi County. The responses were as following for the first view sought was if the penalty rates are very low and they can afford to pay the penalty compared to compliance cost file their returns 5.9% of the respondents strongly disagreed, 3.4% disagreed, 22.7% were not certain while 36.1% agreed and 31.9% strongly agreed. The second view sought was if the enforcement is very weak and 5.9% of the respondents strongly disagreed, 9.2% disagreed, 24.4% were uncertain, and 45.4% agreed while 15.1% strongly agreed. The third question raised was if the supporting documents do not need to be sent to the KRA, I can manipulate the figure in the tax return and the responses were as follows 5% of the respondents strongly disagreed, 14.3% disagreed, while 6.7% were uncertain, 43.7% agreed and 30.3% strongly agreed. The fourth statement asked was if they believe the tax authority has limited capability to investigate all income reported to them so I have an opportunity not to report my exact income and 5.9% of the respondents strongly disagreed, 10.9% disagreed , 9.2% were uncertain while 52.1% agreed while 21.8% strongly agreed. The fifth statement inquired was if I believe that the probabilities of being detected by the tax authority for not declaring the exact income that I receive are low and 7.6% of the respondents strongly disagreed, 18.5% disagreed, 12.6% were uncertain while 46.2% agreed and 15.1% strongly agreed. The fifth statement inquired was if they know how to declare actual income received from all sources to the tax authority and 8.4% of the respondents strongly disagreed, 21.8% disagreed, 10.1% were uncertain and 21 % agreed while 38.7% strongly agreed. The statements scored a mean of 3.7 with a standard deviation of 1.1 that implies that the respondents were in agreement with the statements raised in the study. The findings are consistent with what a studies by Adesina and Obazee (2016) that had established that taxation information, fines and assessment compliance in Nigerian SMEs scale endeavors. Their findings established that tax learning had positively huge effect on tax compliance while taxation penalties had inconsequential positively effect on assesses compliance. Prescription that legislature ought to energize taxpayers information about assessment laws and standards in this way making mindfulness for the common advantages of the administration and the taxpayers.

#### 4.5 TOT Modes of Payment

**Table 4.8: Statements on TOT Modes of payment**

<b>Statement</b>	<b>Strongly disagree</b>	<b>Disagree</b>	<b>Uncertain</b>	<b>Agree</b>	<b>Strongly agree</b>	<b>Mean</b>	<b>Standard Deviation</b>
I file my returns accurately	10.10%	16.00%	22.70%	42.90%	8.40%	3.24	1.13
I file my returns on time	8.40%	18.50%	6.70%	42.90%	23.50%	3.55	1.27
Procedures for tax payment are too complicated.	17.60%	10.10%	12.60%	33.60%	26.10%	3.4	1.43
The complexity of payment methods contributes to late tax returns.	6.70%	10.10%	11.80%	68.10%	3.40%	3.51	0.96
There are delays in electronic payment systems.	9.20%	7.60%	16.00%	59.70%	7.60%	3.49	1.06
<b>Average</b>						<b>3.4</b>	<b>1.2</b>

As tabulated in Table 4.8 respondents were required to indicate their views using a five point likert scale to respond to statements that were asked in line with tax compliance amongst SMEs in Nairobi County. The responses were as following on the first statement that the study inquired was if respondent file their returns accurately and the responses were as follows 10.1% of the respondents strongly disagreed, 16% of them disagreed while 22.7% were uncertain, 42.9% agreed and 8.4% strongly agreed. The second issue the study inquired was if the respondents file their returns on time and 8.4% of the respondents strongly disagreed while 18.5% of them just disagreed, 6.7% were uncertain and 42.9% agreed, 23.5% strongly agreed. The third issues raised was if the procedures for tax payment are too complicated and 17.6% strongly disagreed, 10.1% disagreed, 12.6% were uncertain, while 33.6% agreed and 26.1%

strongly agreed. The fourth statement inquired was if all the complexity of payment methods contributes to late tax returns and 6.7% of the respondents strongly disagreed, 10.1% of them disagreed while 11.8% were certain, 68.1% agreed and 3.40% strongly agreed and finally the last statement that study inquired was whether there are delays in electronic payment systems 16.8% had not registered while 16 % were uncertain and 67.3% indicated they have registered with tax system. The statements scored a mean of 3.4 with a standard deviation of 1.2 that implies that the respondents were in agreement with the statements raised in the study. The study findings are in line with other findings such as study by Isa (2012) that established that tax unpredictability is another detectable significance of taxpayers compliance factor impacting compliance conduct and it might be beginning of avoiding tax Moreover, Isa (2012) focused that tax laws are excessively confounded for taxpayer', making it impossible to keep side by side thinking about the regular change in tax law.

## **4.6 Inferential Statistics**

### **4.6.1 Regression Analysis**

Multiple regression model was used to determine the factors affecting turnover tax compliance among small and medium enterprises in Kenya, a case study of Nairobi central business district, Luthuli Avenue in Nairobi County. Further the model was used to determine the overall fit (variance explained) by the model and the relative contribution of each of the independent variables to the total variance explained. The model was given as follows,

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Whereby:

Y= TOT compliance of SME's in Nairobi County

$\beta_0$  = Constant

$\beta_1 - \beta_3$  = Beta coefficients

$X_1$ = Tax Compliance Cost -Tc

$X_2$ = Enforcement instruments - Ei

$X_3$ = TOT Mode of payment - Tot

$\varepsilon$  = Error term

The output tables were presented and interpreted as follows.

**Table 4.9: ANOVA: Significance Level**

Model		Sum Squares	of Df	Mean Square	F	Sig.
1	Regression	.661	4	.16525	32.393	.000 <sup>b</sup>
	Residual	.417	95	.0834		
	Total	1.078	99			

a. Dependent Variable: the growth of small and medium enterprises in Nairobi County

a. Predictors: (Constant), TC, Ei, Tot.

An ANOVA finding of P- value of 0.000 which is less than a 0.005 significance level in the table above shows that there was a strong significant relationship between the predictor variables and the dependent variable. The *F*-ratio tests whether the overall regression model is a good fit for the data. The table shows that the independent variables statistically significantly predicted the dependent variable,  $F(4, 95) = 32.393, p < 0.0001$ . We therefore conclude that loan disbursement, training, savings and technology strongly affect the growth of small and medium enterprises in Nairobi County.

**Table 4.10: Regression Coefficients**

Model		Unstandardized Coefficients		Standardized Coefficients		Sig.
		B	Std. Error	Beta	t	
1	(Constant)	.475	1.350		.352	.728
	Tax Compliance cost	-.263	.113	.234	-2.323	.028
	Enforcement instruments	.331	.108	.348	3.051	.005
	TOT Mode of payment	.258	.086	.171	2.987	.006

a. Dependent Variable: TOT compliance of SME

The optimal model was therefore;

Multiple regressions generated will be as follows

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3$$

$$Y = .475 + -.263X_1 + .331X_2 + .258X_3$$

Whereby:

Y= TOT compliance of SME's in Nairobi County

$\beta_0$  = Constant

$X_1$  = Tax Compliance Cost

$X_2$  = Enforcement instruments

$X_3$  = TOT Mode of payment

Increasing registration cost, fine and penalties as a tax compliance leads to negative relationship with TOT compliance of SME. From the output, when there is an increase in tax compliance cost, it leads to decrease in TOT compliance of SME by a value of 26.3% on average. These findings concurs with Mwangi et al., (2017) who argues that there is a significant direct relationship between tax compliance costs and tax payment by Small and Medium Enterprises.

The findings above shows when other factors are held constant, an increase in enforcing instruments lead to increase in TOT compliance of SME by 33.1%. This concurs with Majiwa (2014); Mukabi (2014) and Aribaba *et al.*, (2019); who indicates that enforcement measures had a positive impact on tax compliance while tax rates, compliance costs, nature of tax had a negative impact on tax compliance. The mode of payment such as MPESA, bank payment and cash payment have greater impact on TOT compliance of SME. Therefore, when other factors are held constant, an increase use of MPESA, cash payment and bank payment lead to increase in TOT compliance of SME by 25.8% on average.

The p-values of the explanatory variables according to the output above, are all less than the significant value of 0.05, this therefore indicates that variables are statistically significant and that they all have impact on TOT compliance of SME. This concurs with Mahoro (2018) argument that there is a significant relationship between electronic billing and tax compliance.

#### 4.6.2 Correlations Statistics

**Table 4.11: Correlation Matrix**

			TOT compliance of SME	Tax Compliance cost	TOT Mode of payment	Enforcement instruments
TOT compliance of SME	Pearson Correlation		1	-.402	.50	.492
	Sig. (2-tailed)			.028	.005	.006
	N		30	30	30	30
Tax Compliance cost	Pearson Correlation		-.402	1	-.068	-.137
	Sig. (2-tailed)		.028		.721	.471
	N		30	30	30	30
TOT Mode of payment	Pearson Correlation		.50	-.068	1	-.089
	Sig. (2-tailed)		.005	.721		.641
	N		30	30	30	30
Enforcement instruments	Pearson Correlation		.492	-.137	-.089	1
	Sig. (2-tailed)		.006	.471	.641	
	N		30	30	30	30

The correlation coefficient value of Tax compliance cost, TOT mode of payment, and enforcement instruments are -0.402, 0.50 and 0.492 respectively. The findings indicate there is positive linear relationship between dependent variable and independent variable except tax compliance cost which has negative correlation coefficient value. The critical coefficient value is  $C_r = 0.362$ , and from the findings it is evident that all absolute coefficient values are greater than the critical value of 0.362, therefore this indicates that the all variables are statistically significant.

#### 4.6.3 Regression analysis

Multiple regression model was used to determine the factors affecting turnover tax compliance among small and medium enterprises in Kenya, a case study of Nairobi central business

district, Luthuli Avenue in Nairobi County. Further the model was used to determine the overall fit (variance explained) by the model and the relative contribution of each of the independent variables to the total variance explained. The model was given as follows,

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Whereby:

Y = TOT compliance of SME's in Nairobi County

$\beta_0$  = Constant

$\beta_1 - \beta_3$  = Beta coefficients

$X_1$  = Tax Compliance Cost - Tc

$X_2$  = Enforcement instruments - Ei

$X_3$  = TOT Mode of payment - Tot

$\varepsilon$  = Error term

The output tables were presented and interpreted as follows.

**Table 4.9: Model Summary: Determining How Well the Model Fits**

The first table is the model summary table. This table provides the  $R$ ,  $R^2$ , adjusted  $R^2$ , and the standard error of the estimate, which is used to determine how well the regression model fits the data.

**Table 4.11: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.758 <sup>a</sup>	.575	.562	.39768

a. Predictors: (Constant), TC, Ei, Tot.

The "**R**" column represents the value of **R**, the *multiple correlation coefficients*. **R** can be considered to be one measure of the quality of the prediction of the dependent variable. A value of 0.758, indicates a good level of prediction. The "**R Square**" column represents the **R<sup>2</sup>** value (also called the coefficient of determination), which is the proportion of variance in the dependent variable that can be explained by the independent variables (technically, it is the proportion of variation accounted for by the regression model above and beyond the mean model). From the value of 0.575 the independent variables explain 57.5% of the variability of the dependent variable for example, the growth of small and medium enterprises in Nairobi County.

## **CHAPTER FIVE**

### **SUMMARY, CONCLUSIONS AND RECOMMENDATIONS**

#### **5.1 Introduction**

In this section of the chapter the study has outlined the summary of the research findings, study recommendations, conclusion and areas for further study that are established based on the main study objective whose aim was to determine the factors affecting turnover tax compliance among small and medium enterprises in Nairobi Central Business District, Luthuli Avenue, Nairobi County.

#### **5.2 Summary of the Findings**

The research study distributed a total of 183 questionnaires and a total of 128 were fully filled up and were used for analysis in the study. Majority of the respondents were professional. Most of the respondents were sole proprietors, most of the respondents operated under the trade sector that were more than a half of the respondents and for the highest education level most of the respondents had attained above college level of education and finally the most of the indicated the make a daily sales of between Kshs.1, 000,001 and Kshs.3, 000,000.

##### **5.2.1 Tax Compliance**

The study established that apart from income tax administration other factors that affect growth and performance are taxation from county government, business location and tax compliance. Most of the respondents were unsatisfied with the income tax rate based on the sales turn over and some of the respondents did not fully understand income tax and its computation. The study established that the introduction of income tax has affected the profit margins and the respondents agreed that income tax has negatively affected the growth and profitability of the SMEs. The responses were as following 51.3% agreed that they file their returns accurately, 66.4% agreed with the statement that I file my returns on time, 59.7% of the respondents agreed that they file the correct returns, 71.5% of the respondents agreed that all my records like TB; Journals and Ledgers are updated, 67.3% of the respondents agreed that I have registered as a taxpayer in the KRA system. The statements scored a mean of 3.4 with a standard deviation of that implies that the respondents were in agreement with the statements raised in the study.

### **5.2.2 Enforcement Instrument**

The study aimed at determining the effects of enforcement instruments among the SMEs and the study established that there is a positive and significant relationship between Punishment functions and tax compliance among the SMEs in Nairobi County. The study also established that tax knowledge among the tax players leads to tax compliance among the SMEs owners. The responses were as follows 59.7 of the respondents agreed that they are aware of tax laws; while 52.1% of the respondents were in agreement that they are aware how the tax system is administered and structured, 74.8% of the respondents agreed that rules on taxation are too sophisticated for a non-professional to understand, 69.8% of the respondents agreed that tax rules information is not promptly available, 80.6% of the respondents agreed that tax laws complexity add to incorrect tax returns. Understanding and interpreting tax laws determines SMEs ability and willingness to comply. Attitudes towards tax compliance can be improved through enhancement of taxation understanding, when SMEs have a positive attitude in comparison with one who have never attended any tax related course workshop, or seminar awareness necessary important especially in areas that relate to taxation laws.

### **5.2.3 TOT Modes of Payment**

The study third variable was to determine and establish the effect of filling procedure affects tax compliance among the SMEs in Nairobi County. The study established that there is a positive and significant relationship between filling procedure and tax compliance among SMEs.

The study also established that tax fillings procedure determines tax compliance level among SMEs in Nairobi County. The responses were as following 75.6% agreed that the procedure of filling tax procedures for tax filing are too complicated, 70.6% agreed that tax complexity and laws that governor taxation contribute in poor or missing tax compliance, 60.5% of the respondents agreed that forms taxpayer has to present and combining filings number per year are numerous, 54.7% of the respondents agreed that there are delays in electronic filing and payment systems, 75.6% of the respondents agreed that the filling of tax returns online is complex. The statements scored a mean of 3.7 with a standard deviation of 1.2 that implies that the respondents were in agreement with the statements raised in the study.

## **5.3 Conclusions**

From study findings and earlier discussion, it was noted that cost influence tax compliance negatively and significantly contributing 9.6% variability to tax compliance by SMEs when

other factors are held constant. The Kenya Revenue Authority should consider revising the cost of tax product downwards. Additionally, Kenya Revenue Authority should make the tax filing process convenient, easy and costless. Similarly, Kenya revenue authority should not impose penalties on late filing of taxes. The tax computation should be as easy as possible to enhance eligible tax payers' compliance.

Finally, the study concludes that tax compliance cost have the most significant effect on tax compliance. In other words Kenyans are not ready to incur extra cost for them to pay tax. This should be taken seriously by KRA because it seems that Kenyans are greatly feeling the pain of paying tax and this should be the final cost they should incur hence promoting the level of tax compliance.

There are several modes of payment of tax in Kenya today. According to Alm et al. (1992), the level of compliance grows with insights of the accessibility of payment methods available. Consequently, the foremost concern of taxpayers is what form of payment methods or services comes from the administration in response for taxes paid. From this viewpoint, taxation by the government and the delivery of public services and goods are understood to be an association that is contractual in nature (Moore, 2004). Persons may honor tax payments since they deem the payment methods affixed by the KRA as valuable, identifying that their tax paying is necessary in order to assist the financing of the service and goods delivery and also to motivate others taxpayers to consider contributing (Fjeldstad and Semboja, 2001).

The study also found a positive relationship between penalties imposed on noncompliant taxpayers. The study therefore concludes that enforcement measures especially audit and imposition of penalties are an important area in the field of tax collection and administration. It therefore requires KRA to employ the most efficient enforcement measures such as conducting audits and imposing penalties on non-compliant taxpayers in order to increase the VAT revenue collection.

#### **5.4 Recommendations**

On tax rates and tax compliance the study recommends that tax rates should be reduced since expansion in tax rates prompts higher development, appropriation and offering costs which prompt higher costs and accordingly customers change their purchasing conduct. Also by reducing the taxes rates will purchase more. On filling procedures and tax compliance the study recommends that tax laws should not be complex so as to not contribute to wrong tax returns, also lessen measure of time taken for organizations to round out various structures with comparative data, moreover reduce time taken holding up in queues to file returns and

make installments in office that collects tax. This study also recommended that tax authorities should strive to improve retributive justice perception on their tax penalties and procedural justice of systems involved in delivering tax penalties.

On enforcement measures KRA should be sending notices of penalties charged to taxpayers by the data processing unit had a significant effect on tax compliance. If the data processing unit adopted this method concerning penalties, that is, sending out notices of penalties owed, it might greatly improve the effect of penalties on tax compliance. The study recommends that KRA should have an office in every county that will address tax issues at county level and the services to be offered should include tax penalties, filing of tax returns, tax computation and tax differentiation. KRA should also establish different deduction levels and apply the standard rate plan on the revenue turnover less standard deduction. KRA should continuously implement reforms on publicizing prosecution of non-compliant by providing incentives for voluntary compliance and the tax laws should be constantly reviewed to strengthen to seal loopholes that are being exploited by non-compliant SMEs. KRA should create more awareness on the tax compliance among SMEs through policy documentation which classify different SMEs entity.

In regard to TOT modes of payment, KRA should regularly educate and train SMEs on tax related issues and modes of tax payment and collection. KRA should make the process of taxation as simple as possible so as to favour the SMEs owner with little or no education to make the compliance easy for them. KRA should also regularly conduct training on tax education. KRA should provide several modes of payment of tax in Kenya today. This is because the level of compliance grows with insights of the accessibility of payment methods available. The taxpayers concern was what form of payment methods or services comes from the administration in response for taxes paid.

### **5.5 Suggestions for Further Studies**

The main aim of the study was to analyze variables affecting turnover tax compliance among SMEs in Nairobi County, case study of Central Business District (CBD), Luthuli Avenue. Therefore, further study should be carried out in Uganda, Tanzania, Sudan and Rwanda to validate these findings and also have a comparison with what the current research has established. Another study may be done using other variables such as legal framework, government regulation and government policy and their effect on tax compliance among SMEs in Kenya.

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## **APPENDICES**

### **APPENDIX I: INTRODUCTION**

Dear Respondent,

I kindly request you to provide the required information to the best of your knowledge by filling in this questionnaire and offer honest feedback on your experiences in filing tax returns to yield turnover tax revenue. This questionnaire forms part of an academic study to be submitted in partial fulfillment of the requirements for the postgraduate diploma in tax administration examination of Kenya school of revenue Administration. The study focus is on the factors affecting the collection of turnover tax in the Nairobi central business district.

Yours faithfully,

Nelson Mandela Omondi,

(Researcher)

**APPENDIX II: QUESTIONNAIRE**  
**SECTION A: GENERAL INFORMATION**

1. How long has your business been in operation? .....
2. What is the category of your business?

<b>Type of Business</b>	<b>Tick appropriately</b>
Textiles and leather	
Furniture products	
Paper and paper products	
Construction/construction materials	
Wholesale trade	
Retail trade	
Bar/hotel/restaurant	
Beauty and cosmetics	
Real estate	
Vehicle towing	
Mechanic/electrical services	
Electronics stores	
Telcos	
Hard/soft drinks store	

3. Do you have a professionally trained accountant?

Yes [  ]                      No [  ]

4. Which of the following best estimates your annual turnover in Ksh? (Tick one)

Below Kshs 500,000                      [  ]  
 Between Kshs 500,001 and 1,000,000    [  ]  
 Between Kshs 1,000,001 and 3,000,000    [  ]  
 Between Kshs 3,000,001 and 4,999,999    [  ]  
 Above Kshs 5,000,000                      [  ]

5. Which of the following best estimates the highest level of education attained by the owners of the enterprise? (Tick one)

Primary level or below [  ]  
 Secondary level [  ]  
 College level [  ]  
 Graduate and above [  ]

6. Which of the following best describes the ownership of the enterprise? (Tick one)

Partnership [ ]  
 Sole Proprietorship [ ]  
 Other (Specify) .....

## SECTION B: TAX COMPLIANCE COST

This part is concerned with determining effect of tax compliance cost. To what extent do you agree to the following factors affecting turnover tax compliance among SMEs in Kenya? Strongly Disagree=1, Disagree = 2, Uncertain=3, Agree=4 and Strongly Agree=5.

No.	Tax Rates	1	2	3	4	5
1	How do you rate the cost of filing a tax return					
2	How do you find the cost of travelling in order to file a return					
3	I know how to declare actual income received from all sources to the tax authority					
4	The business files its tax returns on time					
5	The business pays the right amount of taxes on time					
6	I understand that I should pay taxes due within the prescribed period from the date of issue of the Notice of Assessment or within the stipulated period					
7	I know I should obtain a tax payer identification pin Number I know which income should be included					
8	I believe that the penalty is lower than my tax saving due to not complying with tax laws.					
9	I know which income should be included or excluded in determining the taxable income					

## SECTION C: ENFORCEMENT INSTRUMENTS

This part is concerned with determining effect of enforcement instruments among the SMEs on tax compliance. To what extent do you agree to the following factors affecting turnover tax compliance among SMEs in Kenya? Strongly Disagree=1, Disagree = 2, Uncertain=3, Agree=4 and Strongly Agree=5.

No.	Accountability	1	2	3	4	5
1	The penalty rates are very low and I can afford to pay the penalty compared to compliance cost					

2	The enforcement is very weak					
3	Since the supporting documents do not need to be sent to the KRA, I can manipulate the figure in the tax return					
4	I believe the tax authority has limited capability to investigate all income reported to them so I have an opportunity not to report my exact income					
5	I believe that the probabilities of being detected by the tax authority for not declaring the exact income that I receive are low.					
6	I know how to declare actual income received from all sources to the tax authority					

#### **SECTION D: TOT MODES OF PAYMENT**

Part is concerned with determining effect of filing procedures among the SMEs on tax compliance. To what extent do you agree to the following factors affecting turnover tax compliance among SMEs in Kenya? Strongly Disagree=1, Disagree = 2, Uncertain=3, Agree=4 and Strongly Agree=5.

<b>No.</b>	<b>Filing Procedures</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
1	Procedures for tax payment are too complicated.					
2	The complexity of payment methods contributes to late tax returns.					
3	There are delays in electronic payment systems.					

***THANK YOU***

### APPENDIX III: BUDGET

The following is a budget PROJECT of the total amount of money to be spent during the entire study:

<b>Item/Activity</b>	<b>Estimated cost (Kshs)</b>
Stationery	3000
Printing/photocopying	10000
Transport	15000
Binding	5000
Data analysis	10000
Miscellaneous	2000
<b>Total cost</b>	<b>45000</b>

**APPENDIX IV: WORK PLAN**

<b>Time</b> <b>Activity</b>	<b>July 2019</b>	<b>August 2019</b>	<b>Sep 2019</b>
Preparation for the study			
Formulation of preliminary and chapter one and two			
Writing of chapter three and the Appendix			
Submission of final research Proposal			