

**FACTORS AFFECTING SMALL AND MEDIUM ENTERPRISES ON
VAT TAXATION IN KENYA**

(CASE STUDY OF MACHAKOS COUNTY)

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TECHNOLOGY**

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DECLARATION

This research project is my original work and has not been presented to any other examination body. No part of this research should be produced without my consent or that of Kenya School of Revenue Administration.

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Date.....

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HDB336-C016-4079/2016

This research project has been submitted for examination with my approval as the university supervisor

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Date.....

Dr. Marion Nekesa, PhD

DEDICATION

I wish to dedicate this project to my wife for the support that she accorded me which made it easier for me to accomplish the studies.

ACKNOWLEDGEMENT

Special thanks to the following persons for their devoted time to make this research project a success; I acknowledge my supervisor, Dr. Marion Nekesa. You are a great mentor and a guide.

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DEFINITION OF TERMS

Capital requirement is the amount of capital a bank or other financial institution has to have as required by its financial regulator. https://en.wikipedia.org/wiki/Capital_requirement

Taxation is the imposition of compulsory levies on individuals or entities by governments. <https://www.britannica.com/topic/taxation>

Financial literacy is the possession of the set of skills and knowledge that allows an individual to make informed and effective decisions with all of their financial resources. <http://www.nbfira.org.bw/iplanformymoney/what-financial-literacy>

Book keeping is the recording of financial transactions, and is part of the process of accounting in business. <https://en.wikipedia.org/wiki/Bookkeeping>

Small to medium enterprises (SMEs) These are non-subsidary, independent firms which employ fewer than a given number of employees. <https://globalnaps.org › issue › small-medium-enterprises-smes>.

ABBREVIATIONS AND ACRONYMS

GDP	Gross Domestic Product
KRA	Kenya Revenue Authority
SME	Small & Medium Enterprises
TCC	Tax Compliance Certificate
TOT	Turnover Tax
VAT	Value Added Tax
SMEs.	Small to Medium Enterprises

ABSTRACT

The purpose of the study was to investigate the factors affecting taxation of small and medium entrepreneurs in Kenya. The study used descriptive research design with a target population of 79. The study adopted census method to arrive at a sample size. The study used both primary and secondary data collection through questionnaires. Pilot study was carried out which gave a Cronbach's alpha greater than 0.7 for all the variables as a rule of thumb. Data was analyzed by use of descriptive statistics and inferential statistics using Standard statistical techniques including Pearson correlation coefficient and regression analysis employed in the analysis. The data was analyzed by use statistical package for social sciences (SPSS Version 24). Analysis of variance (ANOVA) used to establish if there is a statistical significance between the observed and expected values with the Pearson Chi square giving the degree significance of the relations, hence establishing the hypotheses. In multivariate analysis, multiple regression analysis models were used to determine the type of the relationship that existed between independent and dependent variables.

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. Both descriptive and inferential statistics were used to analyze the data. Statistical significance of relationships among selected variables was determined using multiple regression analysis. The study established that financial literacy, book keeping and financial requirements had a significant effect on tax compliance in Machakos County.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

1.1.1 Global Perspective

The large number of potential taxpayers in the informal sector, and the difficulties of monitoring “hidden” entrepreneurs and small-scale firms, can give rise to serious revenue collection costs for tax authorities in developing countries. At the same time, the revenue potential of taxpayers in the informal sector is fairly modest, as their taxable incomes are usually quite low (Joshi et al., 2014). Informal sector activities are often located in rural areas or come from self-employed sellers living near the subsistence level (La Porta & Shleifer, 2014). Consequently, given the low “value for money” in revenue terms, tax administrations have often given little priority to the taxation of the informal sector firms (Fjeldstad, 2014), which can also be related to equity consideration, namely that taxation falls more strongly on the shoulders of low income informal firms (Joshi et al., 2014). From a conceptual perspective, the direct revenue impacts of informal sector taxation and the associated costs might also be highly difficult to assess as data availability and quality is poor for many developing countries. Taxation of the informal sector allows informal firms to hold the state accountable for the use their payments and can thus contribute to an emerging sense of democratic participation and ownership over governmental actions. The state, in turn, has an incentive to demonstrate accountability and responsiveness to taxpayers in order to foster voluntary tax compliance based on a social norm of paying taxes (Joshi et al., 2014).

The role of the informal sector to local economic development has been discussed by many authors (Tutik, R 2014). Different persons, authors or groups have defined the term “informal sector” their own ways. Torado (2000) defined the” informal sector as one group of economic arrangements which are not subject to government arrangements, which are not subject to government regulations, and which the nature of employment is both self-employment such as home production and petty trading and wage employment such as casual labor, contract labor and piecework, characterized by small competitive firms, petty retail and services, labor intensive methods, free entry, and market-determined factor and product prices”.

The features and characteristics of this very critical sector include among others, their mobile nature, small scale operation, cash transaction and unwillingness to keep business records make it very hard to tax the sectors actors, since the taxation of this commonly referred to as hard-to tax sector“ requires enormous effort and seeming tasking. This sector may also be invisible, irregular, parallel, non-structured, backyard, underground, subterranean, unobserved, or residual (Magbagbeola 1996) cited in (Ekpo and Umoh 2014).

The formalization of informal sector activities has received some particular attention in the international development agenda, and taxation is often regarded as a key ingredient (Joshi et.,al., 2014). In particular, the Addis Ababa Action Agenda outlines that the international community will need to invest continuing efforts to integrate the informal sector into the formal economy in line with country circumstances” (UN, 2015, p. 11). In the same vein, Target 8.3 of the Sustainable Development Goals (SDGs) stresses the need to encourage the formalization and growth of micro-, small- and medium-sized enterprises in order to

promote sustainable and inclusive economic growth.

Widespread informal activities are usually regarded to be a persistent phenomenon in developing countries (Besley & Persson, 2014; La Porta & Shleifer, 2014).

It has been suggested, for example, that some of the largest and fastest growing business sectors in African countries, such as the retail and construction sector, are dominated by informal firms and entrepreneurs (Benjamin et al., 2014). According to the World Bank, the informal sector accounts for the 40% of gross national products (GDP) of low-income countries (Farrell 2004). Despite their significant contributions to the economies of developing countries, they are the least taxed (Patrick Sownali 2011).

The term informal sector originally proposed by Hart (2009), was initially used to refer to employment outside of formal labor markets. The idea was to distinguish businesses on their degree of rationalization, or embodiment of impersonal principles of social organization (Hart 2005). Some studies estimate that informal businesses account for 35-50% of GDP in many developing countries. In general, from a political economy perspective, central and local government can be thought to compete over the same taxable incomes. The central government might thus be reluctant to give up own revenue sources by assigning some collection rights to SNGs (Bird, 2010; UN-HABITAT, 2015). Transfers and subsidies from the central government, which on average represent more than 60% of SNGs revenues in low-income countries, might also crowd out efforts for improved own local taxation.

However, SNGs might be in some instances able to reach out to some parts of the revenue base that would be otherwise left untaxed by the central government, either because the latter is not willing due to high administrative costs (e.g. taxation of small businesses) or

not able due to a lack of monitoring and control (e.g. informal activities). In this sense, SNG revenue authorities might have a comparative advantage in identifying local businesses for the purpose of taxation, as they oversee licensing and regulatory activities, among others. From the perspective of the central government, the successful implementation of local taxes might even lead to a better revenue position in case that own-source taxation reduces the need for central government transfers (Bird, 2010).

Yankon (1992) stated that the operators of this sector mostly lack adequate financial resources to import more advanced technology so the sector heavily relies on labor-intensive mode; for its production. Available literature indicates that there is a strong relationship between the informal sector and the inability of the Government to collect the requisite taxes. From the informal sector's point of view, tax evasion is driven generally by a perception that the tax burden is too high.

1.1.2 Kenyan Perspective

Similarly, in Kenya, the informal sector is quite large, estimated at 34.3% and accounting for 77% of employment statistics. Over 60% of those working in the informal sector are the youth, aged between 18-35 years, and 50% being women (Ouma, 2009). Compared to the other sectors of the economy, the contribution of the SME sector to the country's Gross Domestic Product (GDP) increased from 13.8% in 1993 to over 18% in 1999, (Sessional Paper No. 2 of 2005). Currently, it is estimated that the contribution to the GDP by this sector stands at over 25% (Economic Survey, 2017).

According to Njeru (2012), argued that "taxing the booming informal sector presents the hope of generating extra income to make up for the deficit in tax revenue, yet this is not

without its problems”. Joshi and Ayee (2009) opined that “how to tax the informal sector remains a pressing question”. Njeru (2012) further opined that “there seems to be a consensus that African governments and their tax authorities would have to work around the clock to bring the informal sector into tax bracket, as efforts by governments to widen the tax base will greatly increase revenue leading to a reduction in the reliance on donor funding and in incidences where governments are forced to increase taxes on basic commodities. Despite the low compliance by this sector, the government is still determined to expand the tax net (base) to the informal sector since ignoring the sector’s activities will dampen compliance morale of the few already complying and by extension lead to not just further drop in tax revenue but increased rise on generalized non-compliance among tax payers in the both sectors.

Indeed, the large numbers of SMEs, their high turnover rates and their sheer diversity present challenges to all administrations. For SMEs, key considerations are to minimize administrative costs while ensuring compliance, including considering the drivers and impacts of operating in the informal economy.

Nada and Jack (2009) examined tax reforms in Kenya particularly in regard to policy and administrative issues. The study acknowledges that tax system in Kenya has undergone perpetual reform over the past two decades. For instance, from the policy perspective there has been rationalization and simplification of rate schedules, a new value-added tax introduced, and external tariffs brought on board in order to tally with those of East African countries. It is observed that it is imperative to have continued reform of both policy instruments and both administrative and enforcement capacity of the tax system. The Government introduced Turnover Tax (TOT) regime which came into effect as from 1st

January 2007. This was meant to bring into tax bracket resident person whose income from business is accrued in or derived from Kenya, and does not exceed five million shillings during any year of income.

Due to the myriad challenges experienced, the authority has continuously failed to meet the target. In FY 2016/2017 only 102M was collected against a target of 425M with a performance of 24%. The target for FY 2017/2018 was reduced to 127M.

KRA introduced several reforms in order to enhance compliance in the informal sector. This includes collaborating with County Governments to impose possession of a valid Tax Compliance Certificate (TCC) when renewing single business permits and when applying for or renewing liquor licenses. This ensures that all taxpayers who require the document must be up to date for them to get the vital document from KRA.

1.2 Statement of the Problem

The large number of potential taxpayers in the informal sector, and the difficulties of monitoring “hidden” entrepreneurs and small-scale firms, give rise to serious revenue collection costs for tax authorities in developing countries. At the same time, the revenue potential of taxpayers in the informal sector is fairly modest, as their taxable incomes are usually quite low. According to a World Bank study in year 2006, Kenya’s informal sector constituted 98 percent of all businesses in the country, absorbed annually up to 50 per cent of new employment seekers had an employment growth rate of 12-14 percent. In the endeavor to realize this goal, KRA faces several problems when dealing with the SMEs.

Some of these problems include financial literacy level of the taxpayers, book keeping and capital requirements. Fischer tax compliance model provides a framework for

understanding the influence of socio-economic and psychological components on taxpayer's compliance decision. Theory holds that the government deters tax evasion through a sanction arrangement and audits. A tax payer will decide to violate the fiscal laws and evade his or her tax obligations when he or she perceives that the cost of evading tax is too low, believing he or she does that he or she is unlikely to be detected or audited. The SMEs are prone to tax evasion as they face difficulties in complying with tax laws. They are expected to comply with strict deadlines, keep proper books of accounts. This kind of environment leads to tax evasion.

Prichard (2009) identified three major reasons why taxation of the informal sector has been almost universally unsuccessful. The first he called "capacity constraints". Talking about capacity, many tax authorities or governments lack the resources (in terms of men, materials, and technology) to initiate, implement, monitor, and enforce tax laws. The second, he identified as "notions of equity". Here he asserted that informal sector operators have very low incomes thereby the argument of them to be exempted from taxation. The third he called "political reasons". Here, he argued state officials and politicians turn blind eye to activities in the informal sector to pressurize government officials to reduce enforcement because informal sector workers form a substantial vote have for politicians (Joshi and Ayee 2009).

Research has been carried out in the past in other countries on the revenue losses implied by the informal sector, also referred to as the Hard to Tax sector (HTT).

According to Cheeseman and Griffiths (2006), although Kenya's tax revenues have increased during the recent process of reform they have fallen in relation to GDP, whilst

the share of government revenue made up through tax revenues has not increased. In Kenya, Memba, Gakure and Karanja (2012) posit that the informal sector is not only a provider of goods and services but also a driver in promoting competition, innovation and enhancing the enterprise culture which is necessary for private sector development and industrialization. They further argue that it is growingly economically important and should effectively respond to challenges of creating productive and sustainable employment opportunities, promoting economic growth and poverty eradication in the country. On the contrary to expectation, Waweru (2007) found collecting turnover tax from these businesses both a challenge and coupled with dwindling revenues. In the endeavor to realize this goal, KRA faces several problems when dealing with the informal sector. Some of these problems include lack of information on taxation matters, lack of equipment like computers, literacy level of the businessmen and accessibility by the taxmen to the businessmen. Its therefore against this that this study aim to determine the challenges facing SMEs on taxation in Machakos County, Kenya.

1.3 Objectives of the Study

The general objective of the study was to determine the challenges facing SMES on taxation in Machakos County, Kenya.

1.3.1 Specific Objectives

The specific objectives of this study were to

- i. To establish the effect of financial literacy on taxation of SMEs in Machakos County.
- ii. To establish the effect of book keeping on taxation of SMEs in Machakos County

- iii. To find out the effect of capital requirement on taxation of SMEs in Machakos County

1.4 Research Questions

- i. What is the effect of financial literacy on the taxation of SMEs in Machakos County?
- ii. What is the effect of the book keeping on taxation of SMEs in Machakos County?
- iii. What is the effect of capital requirement on taxation of SMEs in Machakos County?

1.5 Justification of the Study

1.5.1 KRA Management

The study will help the management of Kenya Revenue Authority to identify the factors which affect the taxation of the informal sector and help strengthen the identified weak areas to achieve their goals and remain to be a leading organization with which other organizations can benchmark against.

1.5.2 Policy Makers

The study will inform the management and help the institutions like the National Treasury to fast track the necessary measures and policies required.

1.5.3 Academicians

The information gathered will help other researchers to advance their understanding on the findings that have been made and improve on them. It will also act as a basis for further references and a source of literature review.

1.6 Scope of the Research Study

This research study set out to determine the challenges facing SMES on taxation in Machakos County, Kenya. This study focused on SMEs operating in Machakos County. Questionnaires were used to collect primary data and secondary data was obtained from KRA yearly reports and treasury revenue reports. Machakos county had a population of 1,098,584 as of 2009. The county borders Nairobi and Kiambu counties to the west, Embu to the north, Kitui to the east, Makueni to the south, Kajiado to the south west, and Muranga and Kirinyaga to the North West.

1.7 Limitations of the Research Study

The following limitations are applicable to this research study. The study was limited to the challenges facing SMES on taxation in Machakos County, Kenya. There is need to replicate the study in other counties in Kenya for external validity and generalization of the results

Survey research is susceptible to participant bias, and it is known that individuals agreed more on socially desirable answers and disagreed more towards socially undesirable answers rather than fully and truly express their feelings and opinions. Secondly, as questionnaires were used to collect the data, the views of the participants will be those at the specific point in time of conducting the survey. To overcome these limitations, the researcher provided an assurance to the respondents regarding the confidentiality of their responses. The questions in the questionnaires was also designed objectively so as to minimize any bias and subjectivity

Time was also a major challenge from the researcher as the researcher was also on full time employment. This was sorted out by a researcher taking two weeks leave to collect and analyze data within stipulated time frame.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter presents a review of literature on taxation in general and turnover tax. It first discusses three theories that provide the theoretical background of this study. The second part discusses the challenges facing taxation of the informal sector in Kenya ending up with a conceptual framework explaining the relationship between the challenges. The final part of the literature review discusses other studies conducted that are relevant to this study.

2.2 Theoretical Framework

This contains a discussion of the relevant theories on this study and how they relate to the variables contained in the study.

2.2.1 Agency Theory

In general, agency theory suggests that policy-makers and tax administrators should be wary about any assumption that uncompelled agents or vendors will represent the state and collect the tax. This does not mean firms will never comply with a request to contribute to society. In fact, there is substantial evidence of corporate social responsibility (Tucker and Henkel, 1992). Finding behavior of people who contribute to the good of an organization or association on a purely voluntary basis is common. Religious organizations, voluntary fire departments, and boys and girl's clubs are among many examples. There are also situations in which groups participate in programs that benefit the community, even though

they are only partially compensated for their activities. In agency models, the government (i.e. the principal) pre-commits to an audit strategy in order to encourage maximum compliance by taxpayers. For instance, Reinganum and Wilde (1985) model the taxpayer as a risk-neutral agent of the government who has private knowledge of his own income. The government, whose goal is to maximize tax revenues net of audit costs, cannot observe actual income without costly investigation. Reinganum and Wilde use this setting to compare a random audit strategy of the type implied in early models with a cut-off audit strategy in which an agent triggers an audit by reporting below a certain level of income. They show that the use of a cut-off strategy weakly dominates a random audit strategy because it will induce truthful reporting at the least cost. In addition to the desirable effect on compliance, they argue that such a strategy would enhance horizontal equity ex- post over random auditing since those with equal incomes will be audited with equal certainty.

2.2.2 Fischer tax compliance theory

Tax compliance determinants based on Fischer model (Fischer 1992) have been an important subject of research in developed countries over the past couple of years. Fischer tax compliance model provides a framework for understanding the influence of socio-economic and psychological components on taxpayer's compliance decision. These factors are categorized by Fischer and associates (Fischer 1992) into 4 groups in his expanded model (Fischer Model): Demographic (e.g.- age, gender and education), Noncompliance opportunity (e.g. income level, income source and occupation), Attitudes and perceptions (e.g. fairness of the tax system and peer influence) and Tax system/structure (e.g. complexity of the tax system, probability of detection and penalties and tax rates). Taxpayers vary in terms of the opportunities available to them to overstating

expenses and understating incomes. Greater tax noncompliance opportunity is generally resulted from self-employment and income sources not subject to withholding taxes. In one of the first tax compliance studies, Groves (1958) argues that income source has a significant impact on tax compliance. Sutherland (1949) argues that tax evasion is considered as a white-collar crime, committed by an individual of respectability and high social status in the course of performing their employment. The Fischer model suggests two major considerations for altering taxpayer's attitudes and perceptions to tax compliance are the fairness of the tax system and peer influence. Fairness of tax system is widely believed by tax administrators and the taxpayers that growing dissatisfaction with the fairness of tax system is the major causes for increasing tax noncompliance.

2.2.3 Allingham and Sandmo Theory

According to (Sandmo, 1972) The AS theory holds that the government deters tax evasion through a sanction arrangement and audits. A tax payer will decide to violate the fiscal laws and evade his or her tax obligations when he or she perceives that the cost of evading tax is too low, believing he or she does that he or she is unlikely to be detected or audited. Tax payers would also evade tax when he or she perceives the cost of compliance is high. Tax systems and procedures that are involving and cumbersome tend to encourage tax evasion. Tax payers who feel that tax rate is high and punitive will evade tax. There is a negative correlation between tax evasion, the probability of detection, the degree of punishment and high transactional costs associated with tax laws. Income tax evasion was pioneered by Allingham and Sandmo (1972), where a rational and a moral taxpayer maximizes expected utility, which solely depends on income. When caught, the agent must pay penalties, imposed on the amount of evaded income. A key comparative static

result is that when the tax rate goes up, competing income and substitution effects might lead to more or less tax compliance. The substitution effect encourages evasion since the marginal benefit of cheating goes up with the tax rate. On the contrary, the income effect tends to suppress evasion since a higher tax rate makes the taxpayer with decreasing absolute risk aversion feel worse-off, and thus decrease risk-taking. Therefore, the net effect is ambiguous.

However, Shlomo Yitzhaki (2002) showed that when the penalty is imposed on the amount of evaded taxes, as it is under most current tax laws, the substitution effect vanishes. At the original optimum, the penalty paid on concealed income increases proportionally with the tax rate, and hence, there is no substitution effect. The remaining income effect is responsible for inducing the taxpayer to cheat less. Therefore, the net effect is better compliance. Yitzhaki's (2002) result is perhaps the single most important finding in the early tax evasion literature, having spurred a lot of remarkable extensions. The SMEs are prone to tax evasion as they face difficulties in complying with tax laws. They are expected to comply with strict deadlines, keep proper books of accounts. This kind of environment leads to tax evasion.

2.3 Empirical Literature

As noted in the introduction, increasing attention to the taxation of the informal economy is grounded in its potential importance to revenue, growth and governance. However, it is important to interrogate the basis for this enthusiasm carefully. Most notably, the direct revenue benefits of taxing the informal sector are likely to be relatively modest, and the implications for vertical equity potentially adverse. As such, much of the argument for

taxation of the informal sector is grounded in potentially more indirect revenue benefits, the prospects of accelerated growth and the potential for governance gains. These effects are less well established empirically. On balance, they nonetheless present a convincing argument for increased efforts to expand taxation of the informal economy, though there is a need for sensitivity to potential costs and greater research into predicted benefits.

2.3.1 Financial Literacy

Atkinson and Messy (2005) define financial literacy as the combination of consumers'/investors' understanding of financial products and concepts and their ability and confidence to appreciate financial risks and opportunities, to make informed choices, to know where to go for help and take other effective actions to improve their financial well-being (Siekei, Wagoki & Kalio, 2013). Problems like tax complexity; low tax morale, low tax compliance and shadow economy may all be reduced increasing the level of taxpayers' (individuals') financial literacy. According to the OECD (2013) large informal economy in most developing countries presents a key reason for engaging in taxpayers' education. Engaging and educating individuals could help them overcome tax system complexities and strengthen their feelings of responsibility and identity to the state. Also, increased revenues could impact the improvement of the quality of public goods and services. Moreover, OECD (2013) in their publication states that taxpayer education campaigns can be an efficient and effective way of building trust and increasing public engagement. Developing and transition countries continue to face the challenge of creating a society of well informed and willing taxpayers. This kind of state of mind, in economies where continuous inefficiencies, inequalities, corruption and lack of transparency are everyday problems, presents a challenging venture difficult to achieve. It is well

established that about sixty percent of the informal sector entrepreneurs are unlettered. Associated with this problem (i.e. illiteracy) is the problem of filing out of income returns, preparation of accounts and in general the lack of voluntary compliance. Generally, income return forms are complex to complete and hence calls for one to be fairly educated to enable one peruse the return and complete it appropriately. Again, the income return form does not come in the local languages that the illiterates can easily understand, hence the non-declaration of income form of tax evasion (Otiaku, 1988)

Tax literacy is a rather new and still developing concept which is highly related to financial literacy. Financial literacy presents a very broad concept which is usually defined as basic financial knowledge and financial skills needed to make informed financial choices. Financial literacy reflects individuals' ability to understand financial concepts, financial products and services and enables them to control their personal financial resources (Bahovec et al, 2014). Worthington (2006) argues that although policy makers and researchers have attempted to define financial literacy, it can mean different things to different people. It might be a broad concept involving an understanding of economics, or alternatively a narrower concept focused mainly on basic money management. International Adult Literacy Survey (IALS) defines literacy as "the ability to understand and employ printed information in daily activities, at home, at work and in the community - to achieve one's goals, and to develop one's knowledge and potential." Similarly, UNESCO (2012) considers that "literacy is the ability to identify, understand, interpret, create, communicate and compute, using printed and written materials associated with varying contexts." Financial literacy itself includes several different components. However, very little of research, if any, has focused on what elements should in fact, be

measured as components of financial literacy. It is argued that taxation should be considered as one of the important components since it has a strong potential to influence on individual's or household's financial wellbeing. The ability to meet tax liabilities on time, prepare returns accurately and claim all available entitlements would certainly impact on a person's overall financial position). According to Waris and Murangwa (2012) tax literacy is intended to firstly, help provide information about taxes, secondly, not to support any particular type or amount of taxes, but to simply explain taxes within a domestic system as well as a regional and international system, and how it impacts on those being informed. Furthermore, tax literacy can be defined as the ability to fill in the tax form and calculate tax liabilities independently (Bardai, 1992; Razman and Ariffin, 2000). Tax literacy may be defined as the knowledge which an individual should possess in order to manage the issues concerning personal taxation effectively (Bhushan, Medury, 2013).

According to study made by Madi et al (2010) a person can be considered functionally literate if he/she can read, write and calculate for his/her own self. By analogy tax literacy may be defined as follows: a person is considered functionally tax literate if he/she can independently read and understand tax reports, can engage independently in various tax calculations and is aware of possible tax risks in its financial environment.

2.3.2 Book Keeping

Larry and Cristopher (2009) define book keeping as “the art of recording all money transactions so that financial position of an undertaking and its relationship to proprietors

and outside persons can be readily ascertained". Every enterprise, however simple requires written records which are used by managers as guides to routine action, taking of decisions, formulation of general rules and maintaining relationships with other organizations or with individuals (Frankwood, 2010). Therefore, a business without written records is like a blind man without his aid or a vehicle without a driver for it does not know which way it is going. Frankwood, (2010) identifies the following as the main benefits of keeping business records; They help in calculating business profits or losses, reveal value of debtors in terms of amount due and when payments are due so as to avoid heavy costs of bad debts, they reveal fast moving and slow moving goods and those about to expire, they also help in business planning and are needed by lenders of business finance etc. Hussein (1983) as cited by Ezejiofor, Ezenyirimba, & Olise (2014) notes that, a good accounting system is not only judged by how well records are kept but by how well it is able to meet the information needs of both internal and external decision-makers.

Ezejiofor *et al.*, (2014) in a study to establish the relevance of accounting records in small business performance in Nigeria found that MSEs that kept proper books of account were able to measure accurately the performance of their businesses. They also assert that business decisions with regard to expansion, maintaining a competitive edge, prevention of business failure and filling tax returns need to be supported by quality financial information which needs to be relevant, user friendly and available in a timely manner. They caution that accounting systems that generate the information should be simple in order not to impose unnecessary operative burdens. Most micro-enterprises do not keep books of accounts that will allow them to extract useful accounting information due to lack of accounting knowledge (Fatoki, 2014; Agyei, 2011; Maseko & Manyani, 2011). In

addition, these findings indicate that most micro-enterprises still use manual method instead of computers for operations which results to inefficient use of accounting information to support assessment of financial performance of their businesses. They propose the use of accounting software to improve accounting practices, albeit they lament the unavailability of medium-sized software for MSEs. Ezejiofor *et al.*, (2014) opine that except for statutory demands, MSEs hardly give serious thoughts to the process of sound accounting, yet the inadequacy and ineffectiveness of accounting processes have been responsible for untimely collapse of a host of them. Most MSE owners prefer to recruit unskilled personnel especially clerical and accounting staff the product of which is business stagnation and winding up. This is because unskilled accounting staffs are not able to keep reliable accounting records and cannot correctly determine the profit or loss of the firm. The Kenya Revenue Authority (KRA) commissioner general Waweru in his report on “Addressing the different tax policy and tax administrative challenges of micro, small and medium businesses” observed that, many small businesses in Kenya in the informal sector lack detailed business records as a strategy to avoid taxation (Waweru, 2007). The G20 Seoul Summit (2010) also reports that low levels of financial literacy particularly book keeping skills have contributed to lost opportunities for a large number of MSEs worldwide.

It affirms that information asymmetry arising from MSEs inadequate financial statements or business plans make it difficult for creditors to assess the creditworthiness of potential MSE proposals which makes most lenders reluctant to fund small firms especially those with new products. Mills and McCarthy (2014) confirm this and opine that assessing creditworthiness of small businesses is difficult due to information asymmetry because

their transactions are largely informal. Through business training an entrepreneur can acquire basic skills of Book keeping which increases the transparency of his business and improves his credit standing. In most developing countries many businessmen keep no records of their business transactions. Here in Ghana most self-employed persons are totally indifferent to proper record keeping. However, in tax administration, a very crucial task is the correct determination of the income of the taxpayer so that a proper assessment of the tax liability could be made (Otioku, 1988).

According to Agyei (1984) “three main factors contributing to this low standard of record-keeping could be recognized: illiteracy; general shortage of accountants; and high fees charged by the accountants. The high fees charged by the accountants make it even more difficult for the few self-employed taxpayers who are willing to keep accounts of their business to hire the services of the accountants. Poor book keeping and poor financial management among a majority of MSEs has been attributed to low level of financial literacy especially among the adult population across countries (Lursadi & Mitchel, 2014; FSD, 2009; Fatoki, 2014). Lursadi and Mitchel conducted various studies first with the US adult population of 50 years and above in 2004.

2.3.3 Capital Requirement

The level of technology, employed in the informal sector business units surveyed in Ghana by Yankson (1992), was reported low and in poor conditions. The equipment used by informal sector entrepreneurs are self-crafted or bought locally with subsequent improvements made by the entrepreneurs. The informal sector displays ‘technological ingenuity’ by using locally made equipment. The operators lack adequate financial resources to import more advanced technology. The sector relies heavily on the labour for

its production. The operators in the informal sector cannot afford to purchase quality building materials due to the high cost involved. They tend to put up structures that are of poor standards resulting from the poor quality of the materials used. The end result of these structures is the slums springing up in the urban centres.

The high failure rate has also been attributed to low financial literacy which results to poor planning, limited access to finance and poor financial management (Oluoch, 2014; Agyei, 2014; Njoroge, 2012). Fatoki (2014) concurs with these assertions and also adds that the difficult financial decisions that entrepreneurs make in their personal or business finances could also be a contributing factor. Mounting evidence reveals that apart from access to capital and an enabling environment, the success of MSEs largely depends on the financial management skills of the managers. Individuals with financial literacy skills tend to make better financial decisions with fewer management mistakes than their counterparts who are financially illiterate (Njoroge, 2014; Fatoki, 2014). Penrose (1959) in her theory of enterprise growth posits that entrepreneurial knowledge, motivation and entrepreneurial activity in terms of fund raising skills and entrepreneurial judgment greatly determine a firm's growth. Fund raising ability refers to the ability of the owner to raise needed funds for expansion which requires the entrepreneur to create trust in others and persuade them to invest in his venture based on its merits achieved by keeping appropriate business records to show the profitability of the business. Entrepreneurial judgment dictates the quality of decisions made by the owner manager which largely depends on the ability of the owner to gather information, use consultancy and decide when and how to act. Therefore, MSE growth depends on how well the owner manager is equipped with the right information to make sound financial decisions in the business.

2.4 Conceptual Framework

The study aims to investigate the challenges facing SMEs on taxation in Machakos County, Kenya. The independent variables will include financial literacy, book keeping and capital requirement while dependent variable will be taxation. Financial literacy as a variable was measured in terms of how aware the tax payer is of the relevant taxes they are responsible to pay, and also their financial literacy determines how compliant they are in filing their returns voluntarily. Secondly, book keeping as a variable was gauged as a challenge and measured based on the accountant's fees the small scale traders are charged so as to streamline their books; also the method by which the books are maintained be it manual or computerized impacts the tax yield. Finally, the capital requirement poses a challenge to those in the informal sector as they at times need financial backing from financial institutions who in return require collateral. The lack of collateral may hinder the prosperity of the informal sector hence the tax base and yield are affected.

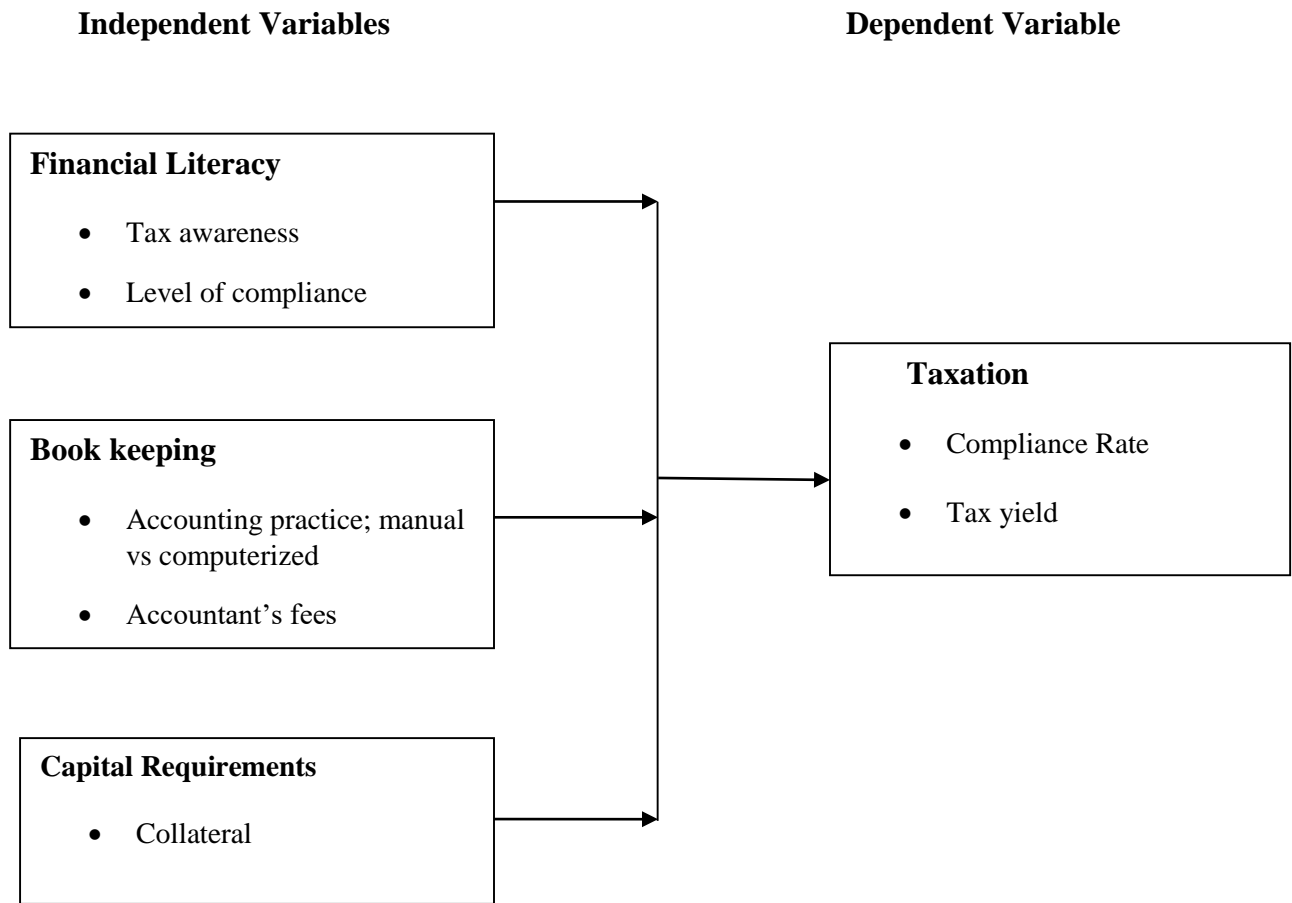


Figure 2.1 Conceptual Framework

Source; Author (2019)

2.5 Critique of the existing literature

Karingi, et.al., (2005) acknowledge that like many other developing countries, Kenya faces challenges in taxing income derived from agriculture and the informal sector. Despite the increasing importance of the SMEs in every sector of the Kenyan economy.

According to Waweru (2007) posits that the current taxation policy towards the SMEs that involves advance tax on Passenger Service and Commercial Vehicles; The Unified Tax System (UTS) which caters for licensing fees and tax liabilities that a business entity is

required to pay periodically, usually one year; and the Turnover Tax (TOT) have not yielded much as the revenues are poor and decreasing with time. Attempts have been made to bring the SMEs sector into the tax bracket by the introduction of TOT in 2008.

But despite these efforts, by mid-2011, only 435 SMEs had adopted the tax system out of a possible 1405 SMEs in Gikomba market; representing a 31% uptake of TOT (KRA, 2011). This has increased the formality of the sector by making the tax system complex due to their inability to maintain books of accounts for their transactions and complexities that are inherent in the regular tax regimes (Okello, 2005).

In Kenya, Memba, Gakure and Karanja (2012) posit that the informal sector is not only a provider of goods and services but also a driver in promoting competition, innovation and enhancing the enterprise culture which is necessary for private sector development and industrialization. They further argue that it is growingly economically important and should effectively respond to challenges of creating productive and sustainable employment opportunities, promoting economic growth and poverty eradication in the country.

2.6 Summary

The large number of potential taxpayers in the informal sector, and the difficulties of monitoring “hidden” entrepreneurs and small-scale firms, can give rise to serious revenue collection costs for tax authorities in developing countries. At the same time, the revenue potential of taxpayers in the informal sector is fairly modest, as their taxable incomes are usually quite low. According to a World Bank study in year 2006, Kenya’s informal sector constituted 98 percent of all businesses in the country, absorbed annually up to 50 per cent

of new employment seekers and had an employment growth rate of 12-14 percent. In the endeavor to realize this goal, KRA faces several problems when dealing with the informal sector. Some of these problems include financial literacy level of the taxpayers, book keeping and capital requirements. Fischer tax compliance model provides a framework for understanding the influence of socio-economic and psychological components on taxpayer's compliance decision. AS theory holds that the government deters tax evasion through a sanction arrangement and audits. A tax payer will decide to violate the fiscal laws and evade his or her tax obligations when he or she perceives that the cost of evading tax is too low, believing he or she does that he or she is unlikely to be detected or audited. The SMEs are prone to tax evasion as they face difficulties in complying with tax laws. They are expected to comply with strict deadlines, keep proper books of accounts. This kind of environment leads to tax evasion.

The SMEs is a crucial sector of most of the developing countries. The liberalization and privatization processes have resulted to the states' failure to be the employer. The private sector is left to take up this role. This indeed is the reason why SMEs should be supported and encouraged. In most cases, the informal sector is viewed as illegal and its activities barred by the government as well as the people working in the formal sector. Urbanization in Kenya on the other end has been occurring in the context of weak economic growth resulting in poor infrastructure, housing and services especially in the slums.

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2.7 Research Gaps

Most of the literature reviewed in regard to taxation of the informal sector is from different countries which apply to various sectors. Much research has been conducted in Kenya regarding their performance and tax compliance as well as the growth. From the empirical review as well as introduction it is evident that this sector in particular forms a great part of the citizens' source of income hence the turnover tax introduction. However, the studies are limited and in reliability since, none has focused on Machakos yet it is a thriving hub

that houses this informal sector to a great extent. Thus, there is a research gap of challenges facing the taxation of the informal sector: key focus being Machakos County.

CHAPTER THREE: RESEARCH DESIGN AND METHODOLOGY

3.1 Introduction

This section highlights the research design and methodology of the study. It is divided into five parts namely; research design, target population, sampling design, and data collection instruments and data analysis methods.

3.2 Research Design

Research design is a formal plan of action for a research project. The purpose of a research design is to structure the research to show all of the major parts of the project (Mugenda & Mugenda, 2009). The study employed a descriptive research design to conduct the study which also involves secondary data. Explanatory approach used since the research design expects to be flexible, allow the consideration to determine the status of the phenomenon under investigation.

3.3 Target Population

The target population is the total number of the individuals in a group that the researcher worked with. The study target population was 79. This included senior managers, middle level managers, operational (technical) staff of the organization and 20 SMEs.

Table 3.1 Target Population

Category	Target Population	Percentage
Senior management	5	6
Middle management	9	12
Operational staff	45	57
Taxpayers (SMEs)	20	25

Total	79	100
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Source: KRA HR DTD (MST)

3.4 Sample and Sampling technique

3.4.1 Sample Size

Sampling is a procedure by which some elements of the population are selected as representatives of the total population through the use of probability to acquire a representative degree of reliability in the selected area, (Mugenda and Mugenda, 2009).

This study adopted stratified sampling techniques to arrive at target population.

3.4.2 Sampling Technique

A census method used in this study to collect information; this made all the population of 79, the sample size of this population. The researcher used census because of the small number of respondents. Considering that all the employees used as a sample size to collect the data the researcher needed.

3.5 Data Collection Methods

3.5.1 Primary Data

This study used primary data collection through questionnaires. The questionnaires were used because of its economy, its ability to ensure anonymity and use of standardized questions. It also provides time for subjects to think about responses. The questionnaires will be made up of closed ended questions in the form of likert scale.

3.5.2 Secondary Data

Secondary data used collected from published materials containing the relevant information on revenue collected from the informal sector over a period of stipulated time. This helped supplement the study with findings that substantiate the challenges encountered in the collection of tax.

3.6 Data Collection Procedures

The relevant data collected from the field with the aid of a research assistant, as the questionnaires was distributed on a drop and pick later method to allow the respondents time to sufficiently go through them and give feedback.

3.7 Pilot Study

The study carried out a pilot test to pretest the validity and reliability of data collected using the questionnaire. A pilot group of 8 individuals from the target population was selected to test the reliability of the research instruments. The major purpose for pilot testing was to test whether the questionnaires could obtain the required results. The pilot study was used to find out the clarity and objectivity of the selected questions.

3.7.1 Reliability of Research Instruments

Reliability is increased by including many similar items on a measure, by testing a diverse sample of individuals and by using uniform testing procedures. In order to test the reliability of the instruments, internal consistency techniques were applied using Cronbach's Alpha.

3.7.2 Validity of Research Instruments

According to Berg and Gall (1989), validity is the degree by which the sample of test items represents the content of test is designed to measure. Content validity that was employed by this study was a measure of the degree to which data collected using a particular instrument represents a specific domain or content of a particular concept. Mugenda and Mugenda (1999) contend that the usual procedure in assessing the content validity of measure is to use a professional or expert in a particular field

3.8 Data Analysis and Presentation

Qualitative and quantitative approaches were applied in this study as advocated for by Neuman (2000); and Babbie and Mouton (2001). These two main research approaches were examined with respect to their suitability to the current research.

3.8.1 The Qualitative Analysis

Qualitative data collected through questionnaires was edited and response rate calculated. The data will then categorize into different themes according to research variable and descriptive statistics such as mean, standard deviation and frequency distribution which according to Kothari (2012) measures the point about which items have a tendency to cluster and describe the characteristics of the data collected was computed.

3.8.2 The Quantitative Analysis

Quantitative data from the questionnaire will be coded and entered into the computer for statistical analysis. The Statistical Package for Social Sciences (SPSS version 20) was used

for analysis. Frequencies, mean and standard deviation was used to summarize the data. Regression model was used to assess variables that are considered in assessing the factors that influence taxation of the informal sector. Regression Analysis is a statistical modeling technique used to identify meaningful, stable relationships among sets of data. The application of analytical procedures is based on the premise that, in the absence of known conditions to the contrary, relationships among information may reasonably be expected to exist. Regression measures the causal relationship between one dependent and one independent variable. Multiple regression analysis measures the effects of multiple independent variables on one dependent variable.

The study also adopted a multi regression model

$$Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \varepsilon$$

Where:

Y = Taxation

β_0 = Constant Term

β_1 = Beta coefficients

X1 = Financial Literacy

X2 = Book keeping

X3 = Capital Requirements

ε = Error term

3.9 Measurement of Variables

Table 3.2 gives a summary of research objectives, variables of study, their indicators, level of measurement, tools of analysis for each objective and type of tool employed for each objective

Table 3.2: Measurement of Variables

Variable	Indicator/Measure	Likert scale
Financial Literacy	<ul style="list-style-type: none"> • Tax awareness • Level of compliance 	5 point
Book keeping	<ul style="list-style-type: none"> • Accounting practice; manual vs computerized • Accountant's fees 	5 point
Capital Requirement	<ul style="list-style-type: none"> • Collateral 	5 point
Taxation	<ul style="list-style-type: none"> • Compliance Rate • Tax yield 	5 point

CHAPTER FOUR: RESEARCH FINDINGS AND DISCUSSIONS

4.1 Introduction

This chapter presents the findings of the study and makes references to relevant research to support the findings of the study. The findings include demographic information about the sample and results obtained from the descriptive statistics on challenges facing taxation of the informal sector in Kenya. In general, analysis was conducted using descriptive statistics and regression model. Lastly, an overview of the results obtained in the study were presented and discussed in this chapter.

4.2 Pilot test

Pilot test refers to the preliminary study conducted to evaluate feasibility and statistical variability in an attempt to predict an appropriate sample size and improve upon the study design prior to performance of a full-scale investigation. The aim of pilot study was to test the reliability of the questionnaires. In this study, 10% of the questionnaires were pilot tested whereby the respondents that are part of the target population but not in the sample were selected in order to get the correct feedback (Mugenda, 2008).

4.2.1 Validity of Research Instruments

The researcher sought to find out the validity of the research instruments by adopting content validity to measure the degree to which the instruments measured what it purported to measure. This study used expert professional judgement from the researcher's project supervisor to measure the validity of the questionnaire.

The research project supervisor's opinion was that the instrument was valid and measured what it purported to measure.

4.2.2 Reliability of Research Instruments

The cronbach's alpha was calculated in a bid to measure the reliability of the questionnaire. The table evidences that all the variables were reliable since their cronbach's alpha was above 0.7. According to Cronbach (2004), an alpha coefficient higher than 0.75 indicates that the gathered data has a relatively high internal consistency and could be generalized to reflect opinions of all respondents in the target population.

Table 4.1 Reliability Test

Variable	α=Alpha	No of items
Taxation	0.897	5
Financial Literacy	0.908	5
Book keeping	0.913	5
Capital Requirements	0.919	5

4.3 Response Rate

The number of questionnaires that were administered to senior managers, middle level managers, operational (technical) staff of the organization and 20 SMEs was 79. A total of 79 questionnaires were properly filled and returned. This represented an overall successful response rate of 100.00% as shown on Table 4.2. According to Babbie (2004) return rates of above 50% are acceptable to analyse and publish, 60% is good and 70% is very good. Based on these assertions from renowned scholars, 100.00% response rate is very good for the study. Thus, the response rate of 100.00% under this study was very good for study.

Table 4.2: Response Rate

Response	Frequency	Percentage
Returned	79	100.00%
Unreturned	0	0.00%
Total	79	100%

4.3 General Information

This section consists of information that describes basic information such as gender, age, working experience and education level.

4.3.1 Gender of the respondents

The respondents were asked to indicate their gender. Majority of the respondents were male who represented 57.60% of the sample while 42.40% were female. This implies that most of the respondents at organizational level were male dominated

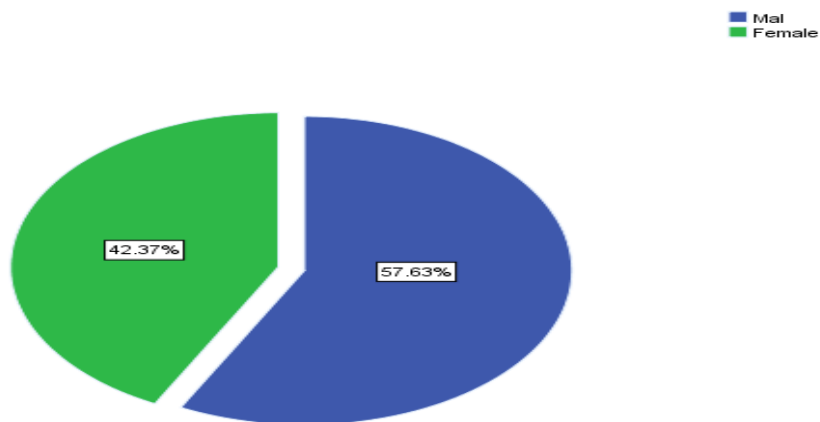


Figure 4.1: Gender of Respondents

4.3.2 Age of the respondents

Respondents were requested to indicate their age brackets. Majority of the respondents who represented 42.40% were on age bracket of 30 – 41 years. 25.40% were on age bracket of 18 – 29 years, 22.00% were on age bracket of 42 – 51 years while 10.20% were above 51 years. This implies that majority of the employees in the organization were older and these were expected to have a good background of the operations within the organization.

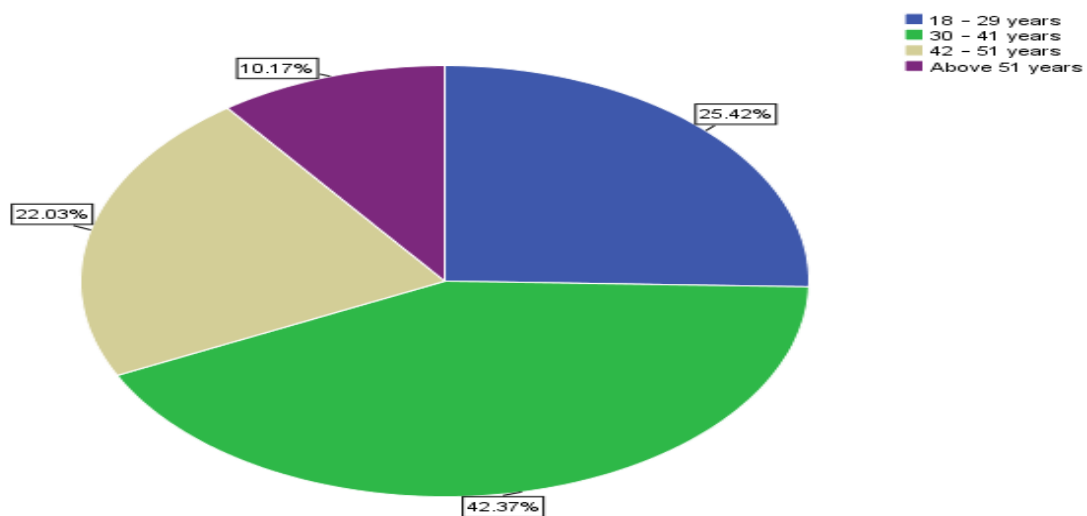


Figure 4.2: Age of Respondents

4.3.3 Working experience

On the question of the working experience, majority of the respondents 40.70% have been in the career for 6-10 years, 23.70% have been in the career less than 5 years, 22.00% have been in the career for 11 - 15 years while 13.60% have been in career for a period of 15 years and above. This implies that majority of the respondents have been in the career for a good period of time thus they were experienced.

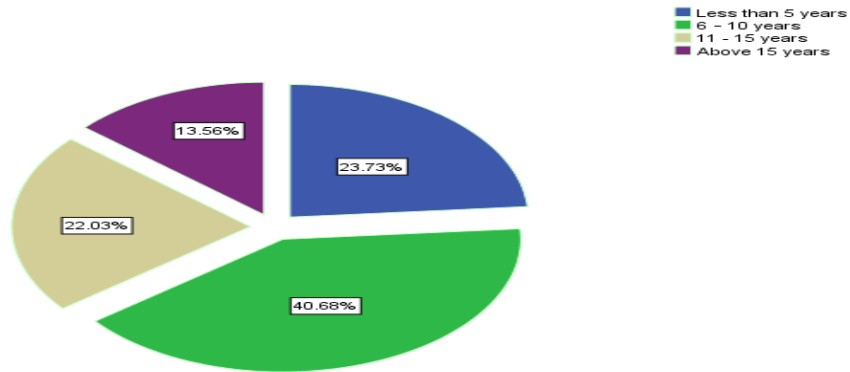


Figure 4.3: Working experience

4.3.4 Highest Level of Education

The respondents were asked to indicate their highest level of education. Results in figure 4.4: show that; 30.50% of the respondents had their highest level of education being university level while 69.50% had college qualification. In as far as the title of study is concerned, the results implied that, the respondents understood the questionnaire and gave valid response since they had better understanding as guided by their level of education which in this case majority having college as the highest level of education.

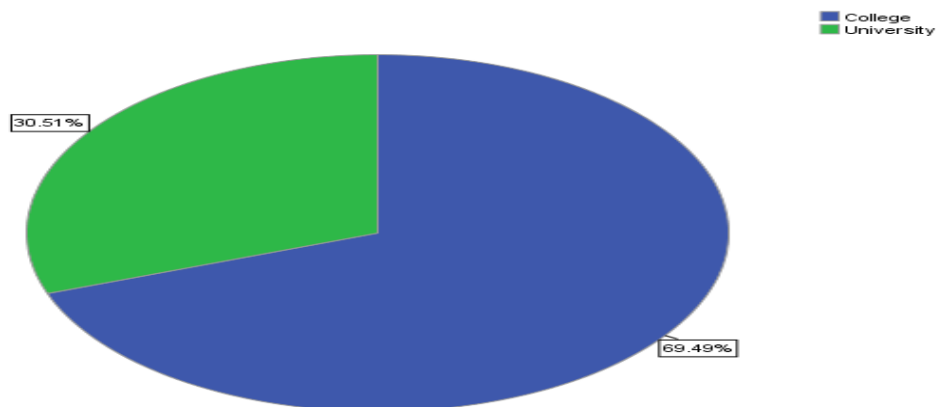


Figure 4.4: Highest level of Education of Respondents

4.4 Descriptive Statistics

This section presents the descriptive results on financial literacy, book keeping, capital requirements and taxation.

4.4.1 Financial Literacy

The first objective of the study was to investigate the effect of financial literacy on taxation of the informal sector in Kenya. Descriptive statistics results for financial literacy were conducted and presented on table 4.3 below.

Table 4.3: Financial Literacy

Statements	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Problems like tax complexity; low tax morale, low tax compliance and shadow economy may all be reduced increasing the level of taxpayers' (individuals') financial literacy.	35.60%	52.50%	11.90%	0.00%	0.00%
Engaging and educating individuals could help them overcome tax system complexities and strengthen their feelings of responsibility and identity to the state.	54.20%	39.00%	6.80%	0.00%	0.00%
Tax literacy is intended to firstly, help provide information about taxes, secondly, not to support any particular type or amount of taxes, but to simply explain taxes within a domestic system as well as a regional and international system, and how it impacts on those being informed.	45.80%	32.2%	22.00%	0.00%	0.00%
A person is considered functionally tax literate if he/she can independently read and understand	20.30%	55.90%	16.90%	6.80%	0.00%

tax reports, can engage independently in various tax calculations and is aware of possible tax risks in its financial environment.

Income return forms are complex to complete and hence calls for one to be fairly educated to enable one peruse the return and complete it appropriately.	61.00%	23.70%	10.20%	5.10%	0.00%
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The respondents were asked to respond on statements on financial literacy. The responses were rated on a five likert scale as presented in Table 4.3.

Majority of 88.10% (35.60%+52.50%) of the respondents agreed with the statement that problems like tax complexity; low tax morale, low tax compliance and shadow economy may all be reduced increasing the level of taxpayers' (individuals') financial literacy, 93.20% agreed with the statement that engaging and educating individuals could help them overcome tax system complexities and strengthen their feelings of responsibility and identity to the state, 78.00% of the respondents agreed that tax literacy is intended to firstly, help provide information about taxes, secondly, not to support any particular type or amount of taxes, but to simply explain taxes within a domestic system as well as a regional and international system, and how it impacts on those being informed, 76.20% agreed that a person is considered functionally tax literate if he/she can independently read and understand tax reports, can engage independently in various tax calculations and is aware of possible tax risks in its financial environment while 84.70% of the respondents agreed that income return forms are complex to complete and hence calls for one to be fairly educated to enable one peruse the return and complete it appropriately.

4.4.2 Book Keeping

The second objective of the study was to investigate the effect of book keeping on taxation of the informal sector in Kenya. Descriptive statistics results for book keeping were conducted and presented on table 4.4 below.

Table 4.4: Book Keeping

Statements	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Accounting records in small business performance in that MSEs that kept proper books of account were able to measure accurately the performance of their businesses.	18.60%	55.90%	25.40%	0.00%	0.00%
Most micro-enterprises do not keep books of accounts that will allow them to extract useful accounting information due to lack of accounting knowledge.	23.70%	22.00%	39.00%	15.30%	0.00%
Poor book keeping and poor financial management among a majority of MSEs has been attributed to low level of financial literacy especially among the adult population across countries.	57.60%	25.40%	16.90%	0.00%	0.00%
The high fees charged by the accountants make it even more difficult for the few self-employed taxpayers who are willing to keep accounts of their business to hire the services of the accountants.	10.20%	62.70%	22.00%	5.10%	0.00%
Use of accounting software to improve accounting practices.	44.10%	47.50%	8.50%	0.00%	0.00%

The respondents were asked to respond on statements on financial literacy. The responses were rated on a five likert scale as presented in Table 4.4. Majority of 74.50% (18.60%+55.90%) of the respondents agreed with the statement that accounting records in

small business performance in that MSEs that kept proper books of account were able to measure accurately the performance of their businesses, 45.70% agreed with the statement that most micro-enterprises do not keep books of accounts that will allow them to extract useful accounting information due to lack of accounting knowledge, 83.00% of the respondents agreed that poor book keeping and poor financial management among a majority of MSEs has been attributed to low level of financial literacy especially among the adult population across countries, 72.90% agreed that the high fees charged by the accountants make it even more difficult for the few self-employed taxpayers who are willing to keep accounts of their business to hire the services of the accountants while 91.60% of the respondents agreed that use of accounting software to improve accounting practices.

4.4.3 Capital Requirements

The third objective of the study was to investigate the effect of capital requirements on taxation of the informal sector in Kenya. Descriptive statistics results for capital requirements were conducted and presented on table 4.5 below.

Table 4.5: Capital Requirements

Statements	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
Evidence reveals that apart from access to capital and an enabling environment, the success of MSEs largely depends on the financial management skills of the managers.	25.40%	57.60%	16.90%	0.00%	0.00%
Enterprise growth posits that entrepreneurial knowledge,	20.30%	66.10%	13.60%	0.00%	0.00%

motivation and entrepreneurial activity in terms of fund raising skills and entrepreneurial judgment greatly determine a firm's growth.

The informal sector displays 'technological ingenuity' by using locally made equipment since the operators lack adequate financial resources to import more advanced technology. 59.30% 30.50% 10.20% 0.00% 0.00%

The operators in the informal sector cannot afford to purchase quality building materials due to the high cost involved. 23.70% 50.80% 13.60% 11.90% 0.00%

The operators lack adequate financial resources to import more advanced technology. The sector relies heavily on the labour for its production. 66.10% 23.70% 10.20% 0.00% 0.00%

The respondents were asked to respond on statements on financial literacy. The responses were rated on a five likert scale as presented in Table 4.5. Majority of 83.00% (25.40%+57.60%) of the respondents agreed with the statement that evidence reveals that apart from access to capital and an enabling environment, the success of MSEs largely depends on the financial management skills of the managers, 86.40% agreed with the statement that enterprise growth posits that entrepreneurial knowledge, motivation and entrepreneurial activity in terms of fund raising skills and entrepreneurial judgment greatly determine a firm's growth, 89.80% of the respondents agreed that the informal sector displays 'technological ingenuity' by using locally made equipment since the operators lack adequate financial resources to import more advanced technology, 74.50% agreed that the operators in the informal sector cannot afford to purchase quality building materials due to the high cost involved while 89.80% of the respondents agreed that the operators

lack adequate financial resources to import more advanced technology. The sector relies heavily on the labour for its production.

4.4.4 Taxation

The dependent variable of the study was taxation. The respondents were asked to respond on statements on taxation. Descriptive statistics results for capital requirements were conducted and presented on table 4.6 below.

Table 4.6: Taxation

Statements	Not Serious	Indifferent	Quite serious	Serious	Very serious
KRA website lacks enough information on various tax procedures.	0.00%	0.00%	13.60%	28.80%	57.60%
System slow / not functioning Long queues in gaining access to KRA offices.	0.00%	8.50%	23.70%	40.70%	27.10%
Technical details on brochures and tax Acts that I don't understand Delay in receiving feedback on queries raised.	0.00%	0.00%	20.30%	27.10%	52.50%
Lack of internet to download forms for filling returns.	0.00%	11.90%	59.30%	28.80%	0.00%
High fees charged by tax consultants and other professionals.	39.00%	25.40%	20.30%	15.30%	0.00%

The responses were rated on a five likert scale as presented in Table 4.5. Majority of 86.40% (57.60%+28.80%) of the respondents were serious with the statement that KRA website lacks enough information on various tax procedures, 67.80% were serious with the statement that the system is slow / not functioning and there are long queues in gaining access to KRA offices, 79.60% of the respondents were serious that there were technical

details on brochures and tax Acts that they don't understand delay in receiving feedback on queries raised, 59.30% were quite serious that there is lack of internet to download forms for filling returns while 64.40% of the respondents did not consider it serious that there is high fees charged by tax consultants and other professionals.

4.5 Correlation Analysis

4.5.1 Correlation results on independent variables

Correlation shows the relationship existing between variables in the study.

The results depicted in table 4.7 below

Table 4.7: Correlation between independent variable and dependent variable

		TA	FL	BK	CR
Taxation	Pearson Correlation	1	.486**	.455**	.441**
	Sig. (2-tailed)	-	.000	.000	.000
	N	74	74	74	74
Financial Literacy	Pearson Correlation	.486**	1	.333*	.282
	Sig. (2-tailed)	.000		.016	.075
	N	74	74	74	74
Book keeping	Pearson Correlation	.455**	.313*	1	.135
	Sig. (2-tailed)	.000	.016	-	.307
	N	74	74	74	74
Capital Requirements	Pearson Correlation	.441**	.245	.126	1
	Sig. (2-tailed)	.000	.075	.317	-
	N	74	74	74	74

****.** Correlation is significant at the 0.01 level (2-tailed).

*****. Correlation is significant at the 0.05 level (2-tailed).

The results in table 4.7 indicated that financial literacy had positive and significantly related to taxation ($r = 0.486$, $p\text{-value} = 0.00 < 0.05$) as indicated in table above. This implies that financial literacy was linearly related to taxation. The result also revealed that book keeping had a positive and significantly related to taxation ($r = 0.455$, $p\text{-value} = 0.00 < 0.05$).

The study showed that capital requirements had a positive and significantly related to taxation ($r = 0.441$, $p\text{-value} = 0.00 < 0.05$).

4.6 Regression Analysis

The variables have a curvilinear relationship thus requiring use of analysis of variance (ANOVA) in order to develop a predictive model. From the correlation matrix, regression analysis was carried out in order to develop a model showing the relationship between independent variables and dependent variable. The purpose of the regression analysis was to get the relationship between the variables and come up with predictions model.

4.5.1 Model Summary

The study further analysed regression analysis of the challenges facing taxation of the informal sector in Kenya.

Table 4.8: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.694	.481	.453	.28828	.735

From the model summary, there is a strong positive correlation between the variables of the study as shown by the 69.4% while 48.1% of variations in the dependent variable can be explained by changes in the independent variables hence, the remaining 51.9% is representative of other factors not accounted for in the study.

4.5.2 Analysis of Variance – ANOVA

Analysis of variance determines whether mean scores of the effects of enterprise resource planning components on performance of public entities differ significantly from each other. It also determines whether the various variables interact significantly with each other.

Table 4.9: ANOVA

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	4.241	3	1.414	16.991	.000 ^b
	Residual	4.576	55	.083		
	Total	8.816	58			

The ANOVA was derived from the correlation matrix and was computed by way of dividing the established variations of the group averages by the expected variations. As can be observed in table 4.8 of the Analysis of variance (ANOVA) for regression coefficients, the results demonstrate that the significance of F statistics is less than 0.000 which is less than 0.05 confidence level. Therefore, it implies that there is a significant relationship between enterprise resource planning and the performance of public entities. An F ratio of more than 1 implies that each of the identified factors have an effect on the performance of public entities. From table 4.8, the computed $F = 16.99$ and this implies that all the factors identified have significant effect on taxation of the informal sector in Kenya.

4.5.3 Regression Coefficients

An estimation of the model coefficients emanating from the correlation matrix was done through analysis of the dependent and independent variables. The estimated co-efficient are shown on table 4.10

Table 4.20: Coefficients of Overall Regression Model

Model		Unstandardized Coefficients		Standardized Coefficients		Sig.
		B	Std. Error	Beta	T	
1	(Constant)	.197	.095	-	2.055	.045
	Financial literacy	.318	.094	.234	2.264	.016
	Book Keeping	.266	.096	.355	3.565	.045
	Capital requirement	.296	.095	.314	3.064	.024

a. Dependent Variable: tax compliance

$$Y = \beta_0 + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 + \varepsilon \dots \dots \dots$$

$Y = 0.197 + 0.318X_1 + 0.266X_2 + 0.296X_3$ were significant with p- values of 0.016, 0.0145, 0.024 respectively.

The regression equation above has established that taking all factors into account (financial literacy, book keeping and capital requirement) the findings reveals that assuming other variables are at zero a unit change (increase) in financial literacy will lead to a 0.318 increases taxation; a unit increase in book keeping will lead to a 0.266 increases value taxation; a unit increase in capital requirement will lead to a 0.296 increases taxation. as shown in table 4.20. This infers that financial literacy influences taxation to a great extent followed by capital requirement while book keeping influence to a little extent taxation.

The regression coefficient results indicate a positive significant effect between financial literacy, book keeping, capital requirement and taxation.

CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter summarizes the findings of the study done with specific reference to the objectives and research questions of the study used as units of analysis. Data were interpreted and the results of the findings were correlated with both empirical and theoretical literature available. The conclusion relates directly to the specific objectives and research question. The recommendations were deduced from conclusions and discussion of the findings.

5.2 Summary of Findings

The study sought to establish the Challenges facing taxation of the informal sector, it therefore sought to establish how selected factors: financial literacy, book keeping and capital requirements affect tax revenue collected from the sector in question.

5.2.1 Financial Literacy

The research findings reveal that problems like tax complexity; low tax morale, low tax compliance and shadow economy may all be reduced by increasing the level of taxpayers' (individuals') financial literacy. The study found that person is considered functionally tax literate if he/she can independently read and understand tax reports, can engage independently in various tax calculations and is aware of possible tax risks in its financial environment. Also, tax return forms are complex to complete and hence calls for one to be fairly educated to enable one peruse the return and complete it appropriately.

The findings concur with OECD (2013) which stated that, large informal economy in most developing countries presents a key reason for engaging in taxpayers' education. Engaging and educating individuals could help them overcome tax system complexities and strengthen their feelings of responsibility and identity to the state.

These findings resonate well with a study done by Gitaru (2017) that confirmed taxpayer education is necessary to increase public awareness especially in areas concerning taxation laws, the role of tax in national development, and especially to explain how and where the money collected is spent by the government. This means there is a positive relationship between the level of tax knowledge and tax compliance. Thus, education programs organized by the tax authority or other public education institutions are needed to enhance taxpayers' ability to understand Self-assessment system and to increase their confidence in fulfilling their responsibilities as taxpayers.

5.2.2 Book keeping

The research findings reveal that most micro-enterprises do not keep books of accounts that will allow them to extract useful accounting information due to lack of accounting knowledge, 83.00% of the respondents agreed that poor book keeping and poor financial management among a majority of MSEs has been attributed to low level of financial literacy especially among the adult population across countries. The findings concur with, Ezejiofor et al., (2014) whose study established the relevance of accounting records in small business performance in Nigeria and found that MSEs that kept proper books of account were able to measure accurately the performance of their businesses

The research study also found that the high fees charged by the accountants make it even more difficult for the few self-employed taxpayers who are willing to keep accounts of their business to hire the services of the accountants and that use of accounting software would improve accounting practices and minimize the inefficiencies and loopholes in tax administration.

These findings resonate well with a study done by Arhin (2018), which confirmed record-keeping as a critical aspect for tax compliance. Thus, businesses in the SME sector will generally comply with tax obligations if records are maintained effectively. As general business management is seen as one of the most important reasons of keeping records, good record-keeping practices, in part induced by tax obligations, could lead to improved management control for the businesses. This means that businesses with effective record-keeping systems and practices encounter fewer compliance problems than businesses with poor record-keeping systems. Moreover, a positive and significant relationship between record-keeping and tax compliance indicates that record-keeping contributes positively to how well these businesses comply with tax obligations, though there are some indirect relationships between record-keeping and other tax compliance issues. Thus, an improvement in recordkeeping practice in the SME sector will lead to higher compliance with tax obligations ensuring the long term survival of the businesses

5.2.3 Capital Requirements

The research findings reveal a positive impact on tax revenue as access to capital and an enabling environment, the success of MSEs largely depends on the financial management skills of the managers hence the capital may be available but for the firm to enjoy growth and contribute to the economy through the tax revenue, management must be well trained. Fatoki (2014) concurs with these assertions and also adds that the difficult financial decisions that entrepreneurs make in their personal or business finances could also be a contributing factor.

Despite the increasing importance of the SMEs in every sector of the Kenyan economy, Kenya faces challenges in taxing income derived from agriculture and the informal sector and majority of the respondents were serious with the statement that KRA website lacks enough information on various tax procedures that would help in facilitating the filing of the tax from this sector.

The study found that enterprise growth posits that entrepreneurial knowledge, motivation and entrepreneurial activity in terms of fund-raising skills and entrepreneurial judgment greatly determine a firm's growth. The informal sector displays 'technological ingenuity' by using locally made equipment since the operators lack adequate financial resources to import more advanced technology. Taxes reduce the amounts available for saving. Hence, the funds available for loaning to firms are limited or are obtained at high costs which tend to discourage investors. It was also seen that the high resultant costs end up as a discouragement to the entrepreneurial culture in the potential investors.

5.2.4 Tax Performance

The study found that the performance of tax is highly reliant on the compliance of the entrepreneurs which puts the projected revenue from this base at a risk, since the investors can easily comply and still avoid the tax owing to the discussed challenges.

5.3 Conclusions

The study therefore concludes that informal sector taxation is not a new concept despite going by the findings and familiarity with respondents. It thus can be concluded that the parties that are involved in transactions that attract this tax are well conversant with its working. The study also concludes that financial literacy is a challenge to the taxation of the informal sector. This is so since some of entrepreneurs involved in the informal sector

lack the proper and sufficient know how on accounting practices as well as filing the tax returns and also the study concludes that book keeping is a challenge to the taxation of informal sector as they do not keep records that can be used to determine what profit they have acquired during the month or the financial year. Finally, the study concludes that despite the challenge that acquiring capital poses the entrepreneurs can source for it in various ways since the business they choose to venture in can either be labour or capital intensive.

5.4 Policy Recommendations

5.4.1 Recommendations on Financial Literacy

There is need by the ministry of education to introduce taxpayers' education and try to include the public finance and taxation course in the curriculum of all departments. This is because, tax is one of the major sources of revenue for a government which is used in general to finance public expenditures and if tax education influences tax compliance attitude of tax payers, the tax course (similar to civics and ethics) must be provided as a common course for all. Greater education potentially increases compliance; as educated taxpayers are more aware of their responsibility as well as the sanctions to be imposed if they were not compliant with tax laws. Education levels become more important in increasing tax compliance across countries. One of the measures to increase voluntary compliance is by assuring that taxpayers have a certain level of qualifications, ability and confidence to exercise their tax responsibility

5.4.2 Recommendation on Book keeping

The Kenya Revenue Authority as part of its taxpayer education program, should undertake record-keeping programs to improve the quality of reporting by the businesses in the SME

sector. The program should primarily be an education initiative that seeks to increase taxpayer compliance by developing policies on Tax audit schemes to target businesses with poor record-keeping. Managers must take advantage of developments in information, communications and technology to assist them in their record keeping.

5.4.3 Recommendations on Capital Requirements

There is need to provide affordable financing facilities to SME businesses in order to enhance their operations and increase profitability. Financial institutions should relax the stringent lending conditions to SMEs in order to grow the sector.

In addition, there is a need to broaden the range of financing instruments available to SMEs and entrepreneurs, in order to address diverse financing needs in varying circumstances, increase SMEs' resilience to changing conditions in credit markets and improve their contribution to economic growth.

Additionally, Equity finance holds particular promise for firms with a high risk-return profile, such as new and innovative SMEs. Seed and early stage equity finance can boost firm creation and growth, while other equity instruments, such as specialized platforms for SME public listing, can provide financial resources to growth-oriented SMEs. Business angel investment may also play a significant role, although it is difficult to estimate their weight in SME financing due to data issues

It's imperative to complement financial support for SMEs with non-financial elements, such as counselling and mentoring, so as to enhance SME financial skills and planning. In this regard, the providers of SME-targeted programmes, including governments, public financial institutions, multilateral development banks (MDBs) and relevant non-for profit institutions, can play a key role to foster SME financial capabilities.

5.6 Suggestions for further studies

Similar studies should be done in other regions in the country and the results of the findings be compared for more accurate generalization. There is a need for a study to be conducted on other factors that affect the tax compliance of SMEs. There is need for further research to be done on the effect of taxpayer education and book keeping on SME taxpayers in Kenya. Finally, a further study is necessary to investigate the factors affecting effective implementation of online tax systems as a strategy for enhancing revenue collection in Kenya.

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APPENDICES

APPENDIX I: INTRODUCTION LETTER

Albert Donny Omondi

P.O Box 50976

Nairobi, Kenya

24th February, 2019.

Dear Respondent,

RE: **DATA COLLECTION**

I am a student at KESRA currently undertaking a research study to fulfill the requirements of the Award of Post Graduate Diploma in Tax Administration on the effect of tax payer education on Revenue Collection strategy in KRA in Kenya. You have been selected to participate in this study and I would highly appreciate if you assisted me by responding to all questions in the attached questionnaire as completely, correctly and honestly as possible. Your response will be treated with utmost confidentiality and will be used only for research purposes of this study only.

Kindly note that the study will be conducted as academic research and the information you provide will be treated as confidential.

Your participation in the exercise is voluntary and so you are free to choose to or not to participate. But it would be helpful if you could participate fully. Kindly spare a few minutes from your busy schedule to complete the attached questionnaire.

Thank you in advance for your co-operation.

Yours Faithfully,

Albert Omondi

APPENDIX II – QUESTIONNAIRE

For each of the question below, please tick in the space provided for the answer that describes your opinion

SECTION A: GENERAL INFORMATION

1. Gender

Male

Female

2. Age Bracket

18 – 29 years

30 – 41 years

42 – 51 years

Above 51 years

3. Working Experience

Less than 5 years

6 – 10 years

11 - 15 years

Above 15 years

4. Highest level of Education

Secondary

College

University

Post Graduate

**SECTION B: CHALLENGES AFFECTING TAXATION OF THE INFORMAL SECTOR
IN KENYA**

a) Financial Literacy

Using the following scale, state your opinion by ticking on the space

1- Strongly Agree 2- Agree 3- Neutral 4- disagree 5- Strongly Disagree

Effects of Financial Literacy on Tax	1	2	3	4	5
Problems like tax complexity; low tax morale, low tax compliance and shadow economy may all be reduced increasing the level of taxpayers' (individuals') financial literacy.					
Engaging and educating individuals could help them overcome tax system complexities and strengthen their feelings of responsibility and identity to the state.					
Tax literacy is intended to firstly, help provide information about taxes, secondly, not to support any particular type or amount of taxes, but to simply explain taxes within a domestic system as well as a regional and international system, and how it impacts on those being informed..					

A person is considered functionally tax literate if he/she can independently read and understand tax reports, can engage independently in various tax calculations and is aware of possible tax risks in its financial environment					
Income return forms are complex to complete and hence calls for one to be fairly educated to enable one peruse the return and complete it appropriately					

b) Book Keeping

Using the following scale, state your opinion by ticking on the space

1- Strongly Agree 2- Agree 3- Neutral 4- disagree 5- Strongly Disagree

Effects of Book keeping on Tax	1	2	3	4	5
Accounting records in small business performance in that MSEs that kept proper books of account were able to measure accurately the performance of their businesses.					
Most micro-enterprises do not keep books of accounts that will allow them to extract useful accounting information due to lack of accounting knowledge					
Poor book keeping and poor financial management among a majority of MSEs has been attributed to low level of					

financial literacy especially among the adult population across countries					
The high fees charged by the accountants make it even more difficult for the few self-employed taxpayers who are willing to keep accounts of their business to hire the services of the accountants.					
Use of accounting software to improve accounting practices					

c. Capital Requirements

Using the following scale, state your opinion by ticking on the space

1- Strongly Agree 2- Agree 3- Neutral 4- disagree 5- Strongly Disagree

Effects of Capital Requirements on Tax	1	2	3	4	5
Evidence reveals that apart from access to capital and an enabling environment, the success of MSEs largely depends on the financial management skills of the managers.					
Enterprise growth posits that entrepreneurial knowledge, motivation and entrepreneurial activity in terms of fund raising					

skills and entrepreneurial judgment greatly determine a firm's growth					
The informal sector displays 'technological ingenuity' by using locally made equipment since the operators lack adequate financial resources to import more advanced technology.					
The operators in the informal sector cannot afford to purchase quality building materials due to the high cost involved					
The operators lack adequate financial resources to import more advanced technology. The sector relies heavily on the labour for its production.					

d. Taxation

Tick your opinion on a scale of 1-5; where 1= „Not Serious“ and 5 for „Very serious

Challenges affecting taxation of the informal sector	1	2	3	4	5
KRA website lack enough information on various tax procedures					
System slow / not functioning Long queues in gaining access to KRA offices					
Technical details on brochures and tax Acts that I don't understand Delay in receiving feedback on queries raised					
Lack of internet to download forms for filling returns					
High fees charged by tax consultants and other professionals					

Thank You for Your Cooperation

APPENDIX III - QUESTIONNAIRE FOR INFORMAL TAXPAYERS

1. For how many years has your firm been operating? _____

2. Tick (x) the appropriate category of your business

Food and beverage Manufacturer	
Textiles and leather	
Wood based Manufacturer	
Bar/Hotel/ Restaurant	
Wholesale trader	
Retail trader	
Passenger car services	

3. Do you have a professionally trained accountant?

Yes No

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

Below Kshs. 1,000,000

Between Kshs 1,000, 001 and 3,000,000

Between Kshs 3,000, 001 and 4,999,999

5. Highest level of education attained by the owners of the enterprise? (Tick one)

Primary level or below Secondary level

Above secondary but not graduate Graduate and above

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

Partnership

Sole Proprietorship

Other (Specify).....

7. How well do you understand iTAX system which was rolled by the authority in 2013?

Explain

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

8. Do experience any challenges when filing your returns?

Yes No

9. Does tax officials provide accurate advice on tax matters?

Yes No

10. How can the government and the Authority improve the iTax system? Explain

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

Thank You for Your Cooperation