INFLUENCE OF TAXATION ON FINANCIAL PERFORMANCE OF MICROFINANCE BANKS IN KENYA

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A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT FOR THE AWARD OF THE POST GRADUATE DIPLOMA IN TAX ADMINISTRATION IN JOMO KENYATTA UNIVERSITY OF AGRICULTURE AND TECHNOLOGY

2019

DECLARATION

This research project is my original work and has not been presented for a postgraduate diploma in any other academic institution.

Signature…….. Date……

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HDB336-C016-2399/2016

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

Signature…… Date.....

Dr. Rosaly Wachira Odhiambo

DEDICATION

This project is dedicated to my wife Everlynne and my children Lynne, Milan and Lewin.

ACKNOWLEDGEMENT

First of all, I would like to thank the supreme and almighty God for his blessing and enabling me to complete my studies. Indeed, it has been a wonderful journey.

I would also like to express my gratitude to my supervisor Dr. Rosaly Wachira Odhiambo for her guidance and valuable insights that she afforded me in writing of this project.

Secondly, I would like to acknowledge my lecturers and colleagues whom I interacted with closely and the positive impact this had on my studies. I would also thank my family for understanding and the supportive role they played during my studies. Their prayers and encouragement kept me going, I am forever indebted to them.

ABSTRACT

Microfinance banks have been in existence since 2008 when the Microfinance Act became active. Currently, there is 13 licensed deposit-taking microfinance institutions in Kenya accounting for 23.6% of banks in Kenya. They have provided an employment generation, cheaper access to credit, competition, innovation and empowerment of the urban and rural poor in Kenya. However, they continue to face many challenges stemming from government regulation; primarily taxation and non-performing loans which affect their operation. This study, hence, aimed to establish the effect of taxation on the financial performance of MFBs. Specifically, the study centered on the influence of corporate taxes, tax policy and tax compliance cost on the financial performance of MFBs. The study employed the use of descriptive design. Purposive sampling was to select 13 MFBs based on the period they were licensed to take deposits. The research employed both primary and secondary data sources. Primary data was collected through conducting surveys by administering questionnaires. The response rate was 85 percent. Descriptive and regression analysis were used to analyze the data. The study established that corporate income tax, tax policy and tax compliance cost have negative effect on the financial performance of MFBs in Kenya. The study therefore proposes that the government ought to design policies to reduce tax rates levied to MFBs as well as customize policies that fit microfinance institution which will ensure that they are not burdened by cost of compliance. Additionally, the government should design policies that do not directly affect microfinance banks but promote their growth.

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LIST OF ACRONYMS AND ABBREVIATIONS

CAMEL	Capital, Asset quality, Management quality, Earnings and Liquidity
CGAP	Consultative Group to Assist the Poorest
DTM	Deposit Taking Microfinance
ITD	International Tax Dialogue
MFB	Microfinance Banks
MFIs	Microfinance Institutions
PEARLS	Protection, Earnings, Asset quality, Rates of return and cost, Liquidity and Signs of Growth
TJNA	Tax Justice Network Africa

OPERATIONAL DEFINITION OF TERMS

Corporation Tax – The tax charged on the earnings of a corporation (Lilia & Holzinger, 2016)

Financial Performance – This is the measure of how well the Microfinance Banks are doing, it is measured using Return on Asset (Memmel & Raupach, 2010).

Return on Equity – This is a financial proportion that quantifies how much returns a firm made in relation to the amount of stakeholder equity financed (Memmel & Raupach, 2010).

Return on Asset – This is a financial ratio that measure the returns a firm accrued in comparison to the sum of total asset put in the business (Fama & French, 2015).

Taxation – This is a means by which governments finance their expenditure by imposing changes on citizens and corporate entities (Becker & Holmes, 2010).

Tax policy – Is a policy that the state uses to dictate what taxes to charge, how much to charge and which persons to charge (Lilia & Holzinger, 2016).

Tax compliance Cost – The amount of money incurred on an activity related to a tax obligation, they include, charges for tax payment by commercial banks, tax training costs, storing of accounting records and time spent when complying with a tax obligation (Schmidt, 2010).

Microfinance Banks (MFBs) – Microfinance banks are institutions that provide banking services to groups that include low-income persons, unemployed individuals and startups and small and medium enterprises that cannot easily access funds (Okongo, 2018).

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

In the field of banking and finance, microfinance is fairly a new model. It has been a poverty reduction concept and an economic growth tool designed to assist the low-income population. CGAP (2016) described it as an avenue for the providing financial services to individuals in the lower-income quartile, together with the unemployed and self-employed, entrepreneurs and smallholder farmers. Hermes & Lensink (2011) describe it as a formal scheme intended to improve the wellbeing of underprivileged by improving access to saving and credit services.

Microfinance was started with the aim of providing financial facilities to the poor people who traditionally could not afford the services and products offered by conventional commercial banks. Among the features that distinguish microfinance from commercial banks include simplicity of operations, the little amount of loans advanced, small amounts of deposits taken and the absence of asset-based collateral (Hadi & Kamaluddin, 2015). Bounouala & Rihane (2014) distinguish microfinance banks from conventional banks based on their target clients who are the sidelined set of debtors, and their overall usage of a group- lending method.

Microfinance was elevated to global prominence in the early 90's by small loans to entrepreneurs, initially dubbed microcredit. However, since the mid-2000s, the name microfinance took dominance as it came to the global realization that microfinance encompasses other services such as deposit-taking, money transfer, lending, and insurance. In addition, there was a shift in the justification of the role of microfinance from that of assisting small enterprises

with credit, to poverty alleviation through financial inclusion and participation in the financial sector by the poor. This new approach of financial inclusion not only emphasizes the role of microfinance in offering savings, insurance, and money transfer services but also suggests that low-income client's basic needs such as water, sanitation, housing, or consumption should be served with credit (Mader & Sabrow, 2015).

With the advancement of technology, Microfinance assumed more roles besides acting as a tool for uplifting the rural and urban poor from poverty. The new roles include entrepreneurship promotion, social enterprise, financial linkages and political instrument to fight the world crisis. The new roles attracted various groups of players having different interests, objectives, and expectations, they included: visionaries, charity organizations, funding agencies, developers, bankers, investors, government, and private businesses. It is for this reason that developing economies felt the need to regulate the activities of microfinance institutions (Kowalik, 2013).

Different countries have different methods of microfinance regulation, which in most cases are applied based on the categorization of the microfinance institution. Bakhtiari (2011) suggested that MFIs can be categorized into 3 wide-ranging groups, depending on their source of funds: funding from external sources such as grants and donations; affiliates' money in terms of their contributions and savings in investments by the public masses. It's from this model that Consultative Group to Assist the Poorest uses to supervise a framework template for microfinance management.

Small banking institutions fall under the third category as they are legalized to use the community's deposits and operate as corporate bodies allowed to function as special banks. These institutions face similar regulations to commercial banks as they are deposit-taking banks

(DTB). Siwale & Okoye (2017) assert that, when governments start extensive rules over both the traditional and informal banking segments, there exists a danger of levying regulatory policies unfitting to the tasks of Microfinance Banks.

Among the basis of regulation that is applicable to both normal banks and Microfinance banks is the financial statement. This basis involves regulations which range from accounting specifications to tax and fiscal regulation. Anku-Tsede (2014) advocates for a tiered methodology to external guideline, one that takes into consideration the diverse types of banks and microfinance institutions, the products they offer, and the target markets they serve. Kaboski (2012) assert that even while an accommodative external atmosphere exists, microfinance banks might meet complications from policies that specify what accounting technique to follow, tax and fiscal guidelines that show prejudice against them, thereby constraining their innovations and slowing down their institutional development.

CGAP (2007) advocates for differential tax treatment between traditional banks and Microfinance banks and different countries and states have also tried to implement it. For instance, in the state of Georgia, microfinance institutions are not qualified for identical tax withdrawals as other financial institutions. In Romania, for instance, interest charged on microloans is not tax deductible. In Tajikistan, value added tax isn't calculated using financial services by microfinance institutions; they are also subjected to minimal tax deductions compared to traditional financial institutions.

1.1.2 Microfinance Banking in Kenya

Two types of microfinance institutions in Kenya are distinguished by whether they are regulated or not. One set comprises deposit-taking microfinance (DTM) these are supervised by Central

Bank of Kenya within stipulations of Microfinance policy, they are microfinance Banks. The other set is made up of credit only MFIs, where the only requirement is for one to have a minimum operating license prior to lending cash to enterprises and individuals.

The legislation on microfinance was passed in 2006 with the microfinance act and became active in 2008 with the microfinance Deposit Taking Institutions Regulation that shapes the legal, supervisory and regulatory structure of the microfinance industry in Kenya. It has further undergone subsequent amendments in 2013 and 2016. In the act, Microfinance bank is defined as a company which is qualified to conduct microfinance bank business as approved by Central Bank of Kenya and they include branches, marketing units, outlets and offices.

Central Bank of Kenya licenses small banking institutions as national or community institutions. There are currently 13 microfinance banks according to CBK bank supervision annual report of 2016. According to Gatuhu (2013), microfinance banks have played a critical role of providing low financing to individuals and businesses, as a result, this has promoted entrepreneurship and fostered competition and efficiency among small and micro enterprises. The industry has also played a critical task in deepening financial markets and increasing access to financial products to a great number of Kenyan population.

In comparison, the Banking Act treating a regulation of commercial financial institutions prescribes a primary investment of not less than eight per cent of total risk-adjusted assets. Core capital as a percentage of total deposit liabilities and total risk-adjusted assets is the same in both cases. Minimum core capital requirement is two hundred and fifty million Kenyan Shillings in a case of bank or mortgage financial company and two hundred million Kenyan Shillings in case of financial institution. Banks in Kenya are obliged to pay taxes from interest income, dividends,

non-interest income, and rents and rates. Taxes are collected by Kenya Revenue Authority (KRA). From many taxes set in Kenya, the company income tax at the rate of 30% is applicable to resident banking sector.

Taxation of MFBs is not clearly defined since the Microfinance Act only treats the regulatory issue and it does not consider tax matter affecting MFIs operating under this act. Conversely, the present tax bill does not excuse interest due on savings and loans from the withholding tax requirement for MFB as it does in the case of commercial banks. The current rate is 15 percent of the gross amount payable. Therefore, all licensed deposit-taking MFIs ought to pay income tax on their microfinance profit-generating activity as well as from savings interest paid to their clients and loan interest paid by borrowers. This negatively affects both, institutions and clients.

1.1.3 Performance of Microfinance Banks in Kenya

The concept of financial performance related to MFBs is of critical and vital importance. Firstly, it assures depositors that their deposits are efficiently and effectively utilized, it is useful for monitoring and control by the regulators and it also enables various stakeholders to track the achievement of MFBs social mission of poverty alleviation (David, Nemwel, & George, 2014)

There is no generally accepted instrument relating to financial performance of MFBs, however, different institutions and scholars have designed a number of frameworks to evaluate financial performance and sustainability of microfinance banks. Notable among them being; CAMEL, which was developed by CGAP, it uses indicators such as capital adequacy, the quality of asset, standards of management, earnings of the microfinance, and their liquidity as well. These indicators are viatal in providing an evaluation of the financial risk and well as mitigation and management of the said risk. The other being PEARL, designed by World Bank and contains

indicators such as, rate of return on investment, liquidity of microfinance, growth signs, protection and mitigation measures. The approach is useful in measuring the financial soundness of microfinance institutions.

Every country, however, has different instruments for assessing MFBs Financial performance; many have modified these methods either through merging the two methodologies, adding other indicators to one of the methodologies or adopting one of the methodologies and reducing a few indicators (s) (CGAP, 2016).

In Kenya, every year the CBK releases a bank supervision report that captures the annual performance of banks and microfinance institutions. In assessing microfinance banks, CBK uses parameters such as Pre-Tax Profit, Customer Deposits, Loan Portfolio, capital/Total risk-weighted Assets, Return on Assets, and Return on Shareholder funds, Number of Branches, and total number of employees.

The CBK report released in 2017 indicates that the general performance of Microfinance banks has been on the decline. While comparing the pre-tax profit between 2015 and 2016, it was established that there was a 169 percent decrease from an amount of Five hundred and forty-nine million Kenya shillings for the period ended December 2015 to a loss of three hundred and seventy-seven million Kenya Shillings million for the period ended December 2016. There was also an increase in net non-performing by 94 percent, reduction of customer deposits by 1 percent, reduction in return on assets by 150 percent, return on shareholder funds by 164% and reduction of total number of staff by 2 percent.

The report cited the placement of three banks under receivership in 2016 to be the cause of the dismal performance, stating that it affected the distribution of liquidity in the banking sector.

Nothing, however, was mentioned about taxation and how it might have contributed to the performance, yet empirical review points out that taxation has an impact in the performance of MFBs especially when not designed to be MFB specific.

Schmidt (2010) suggested that there is need to adjust regulation standards to be prudential in order to put up with the fashions in which microfinance varies from customary banking. Policies put above depository MFIs and NBFIs should be different from those that are applied to the commercial banks, especially taxation policies. CGAP (2007) on their framework of microfinance regulation recommends that regulatory and fiscal policies should emphasize on the form of exchange that is undertaken instead of the type of the body that undertakes it.

Due to the role of poverty alleviation that microfinance banks undertake, they should be accorded tax advantages and favourable tax treatments. To give them a sound financial and management performance, it is imperative, therefore, that tax treatment is harmonized across different institution types (CGAP, 2007).

Tax income adds to growth and well-being using three sources; financing public services and effective social transfers, reallocation of income and offering incentives to create more employment opportunities and the effective usage of naturally endowed resources (Besley & Persson, 2013). This apart from the returns accrued by MFBs, goes toward expansion of their companies, in order that their revenue and need for continued existence should to be put under deliberation when constructing a tax policy. In consequence, the tax policy would be one that would embolden MFBs to increase their operations, widen branches and have in their grasp a wider poor population. In an attempt to assess the effects of taxation on MFBs, the paper considered the corporate tax rates, tax policy and tax compliance cost.

1.2 Statement of the problem

As a key source of government income and critical in sustaining the fiscal budget, taxes enable the government to raise funds for development and provision of public service to the citizens. However, the problem arises when there is an indirect link between tax expenses and business's performance and the capacity of businesses to sustain (Armstrong, Blouin, & Larcker, 2012).

Implementation of the Microfinance (Amendment) Act, 2013, permitted the previously Deposit Taking Microfinance institutions (now 'Microfinance banks - MFBs') to manage current accounts, to hand out third party cheques and participate in forex trading. This shows that MFBs are important in enhancing financial inclusion in the country by enabling access to financial services to less fortunate people. Despite these contributions MFBs, performance has continued to deteriorate in the past three years. In 2017 MFBs reported a loss of $7.31 million and a reduction of assets by 4.6 % (CBK, 2018). The regulator has consistently attributed the dismal performance to other factors such as automation of financial services and capping of interest rate.

In this regard, policymakers have focused on addressing regulatory issues on MFBs with disregard to tax issues that they are facing. Khalif (2015), reported that MFBs in Kenya are currently facing a wide range of issues emanating from tax-related issues, which range from; astronomical tax rates; compound taxations; composite tax guideline, massive tax burden and increased cost of compliance.

It is important to observe that the key competitors of MFBs are banks, saving and credit cooperative societies, housing societies etc. Guided by the taxation tenet of equity, it is imperative that the special tax regimen accorded to Banks and other financial institutions is extended to Microfinance Banks. Interests paid to commercial banks are exempt from

withholding tax requirements however those of MFBs are not. Khalif (2015) points out that this can only be achieved by including MFBs in the catalogue of specified financial institutions placed under the policy of income tax to exempt MFBs from withholding tax.

Again, preferential treatment advanced to commercial banks is the 'qualifying interest' whereby withholding tax which is currently 15% of the gross amount payable is deducted from such income is the final tax. This is done to encourage saving, however, income earned from MFBs is not treated as qualifying interest, this imposes a high tax burden on MFBs customers hence reducing deposits and thus impacting negatively on performance.

At the same time, MFBs pay as much corporate taxes of 30% as banks and other financial institutions. This is quite regressive owing to the scope of MFBs; they target low-income earners and charge low-interest rates. The tax policy ignores this crucial factor that could contribute to the survival of MFBs.

Literature review has shown that less effort has been exerted towards examining effects of taxation on the financial activity of MFBs, despite their contribution to poverty alleviation and credit access to a majority of citizens in the country. Most research work in Kenya has put attention on issues that hurt the performance and sustainability of microfinance institutions, which is more general and leads to estimation bias and spurious inference. In addition, as the author observes, there is scarcity of research that has used taxation as a determinant of microfinance institutions performance and specifically on Microfinance banks. Owing to this backdrop, therefore, the research strives to fill this literature deficiency and study importance of taxation on the activity of small banking sectors in Kenya.

1.3 Research objectives

The following general and specific objectives led the study:

1.3.1 General Objective

The general objective is to establish the influence of taxation on financial performance of Microfinance banks in Kenya.

1.3.2 Specific Objectives

i. To establish the impact of corporate income tax on financial performance of Microfinance banks in Kenya.
ii. To evaluate the influence of tax policy on financial performance of Microfinance banks in Kenya.
iii. To analyze the effect of tax compliance cost on financial performance of Microfinance banks in Kenya.

1.4 Research Questions

i. What is the impact of corporate income tax on financial performance of Microfinance banks in Kenya?
ii. What is the influence of tax policy on financial performance of Microfinance banks in Kenya?
iii. What is the effect of tax compliance cost on financial performance of Microfinance banks in Kenya

1.5 Justification of the Study

This study was meant to deliver valuable information to microfinance banks and tax agencies about the association between taxation and the performance of MFBs. The outcome of the survey was designed to profit the CBK in designing an effective regulatory framework for MFB's supervision. Findings of the study are deemed useful to policymakers in understanding the specific tax issues that affect microfinance bank performance and formulate tax policies that can foster the growth of Microfinance banks in Kenya.

The findings are suited to provide a basis for long-term strategic planning for MFBs' management as well as guiding investors in deciding whether investing in MFBs is economically viable. The results may improve the current body of literature available on business finance, this will be important to professionals in academia and research. It may also provide information and impetus for further study on the areas of regulation and additional aspects that drive the bottom-line of Microfinance institutions. To the general public, it may offer guidance in deciding which MFBs to patronize for financial services and investment.

1.6 Scope of the Study

This research was undertaken within Kenya and mainly targeted small financial institutions. The scope was narrowed to the MFBs that were licensed by the CBK to take deposits before 2012 all small financial institutions that existed for more than five years.

1.7 Limitation of the Study

This study mainly used cross-sectional data as it covered microfinance banks over a period of one financial year. One of the key restrictions likely to be encountered is the biasness that results from quantitative methodology. According to Chida and Steptoe (2008), quantitative research is limited by the way in which subjective experience is quantified. It requires a structured research

instrument and one of the weaknesses of structured tools is that it only limited to the text/questions in the tool i.e. the objectives of the study and can therefore not measure the additional elements that might upset the singular financial product activity of MFBs. This hypothesis mitigated the limitation by handing out structured surveys to the respondents and collect additional data using predesigned data collection sheet.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

Literature review below analyzes theoretical contexts relating to taxation and provides summaries of previous research and studies undertaken to scrutinize the link between taxation and the activity of small financial institutions.

2.2 Theoretical Review

This section provides a critical analysis of the theoretical underpinnings of this study. Among the considered theories are Ability to pay theory, the benefit theory of taxation and the economic theory of tax compliance

2.2.1 Ability to Pay Theory of Taxation

According to Kendrick (1939), a taxable ability can be measured, in an objective approach, by means of various indicators such as ownership of property, consumption and the basis of income. The use of income as a measure of faculty is popular among economists as they acknowledge that it is a basic criterion of justice taxation. Faculty theory proposes that taxes should be levied according to the taxable capacity of an individual. It states that everyone should be levied as per his capacity to pay.

According to (Grassi, 2015.), income is considered as the most suitable appraisal of tax-paying capacity. He recognizes that identical individual net income does not essentially imply equal taxable faculty. Additional factors are taken into consideration such as home conditions; grossed against unearned income; excess contrasted with cost elements and capital gains as opposed to

repeatedly recurrent income. The ability to pay is one of the measures for assessing fairness and equity of a tax system.

Ability to pay tenet puts forward that those individuals with equal ability to pay should shoulder equal tax liability while individuals with greater financial ability should shoulder heavier tax liability. This proposition builds towards equity by both horizontal and vertical concepts of taxation. In accordance to equity horizontally, persons ought to be regarded equally, that is, persons with similar capacity to pay ought to pay the equal amount. On the other hand, vertical equity of taxation implies different tax burden for individuals possessing different abilities to pay. Individuals earning higher income should pay a higher level of tax compared to poorer people (Kabinga, 2015).

Corporations in the country are subjected to the same level of corporate taxes of 30% regardless of their earnings. This hinders ease in doing business and results in failure and collapse of small and micro enterprises, including many microfinance institutions. It is therefore imperative that corporations are assessed based on their ability to pay Microfinance Banks should be assessed on their ability to pay taxes based on the pre-tax profits and administer a progressive tax on their earnings (Khalif, 2015)

2.2.2 The Benefit Theory of Taxation

In line with Erik Lindahl in 1919, this concept implies that residents ought to pay in according to the welfares they benefit from public expenditure financed by taxes (Weinzierl, 2014). By this concept, the government exercises taxes on people according to benefits they receive assuming that social goods are linear and homogeneous. This implies that the more an individual enjoys benefits accrued from government expenditure, the higher that individual has to pay taxes.

Taxes are paid in the proportion of benefits derived from the amenities catered for by the government.

The benefit theory places emphasis on the two-way nature of government expenditure-tax decisions. If the public does not pay for the services such as national defense, roads, and hospitals they enjoy, then the government cannot be able to finance the provision of such amenities. However, measuring the benefits each individual has derived from public goods is difficult if not impossible. The benefit theory of taxation suggests a precise technique of spreading the tax encumbrance; that taxes have to be apportioned based on the welfares enjoyed from government spending (Mankiw, Weinzierl, & Yagan (2009).

John Mill points out that those in the society that are most dependent and are the neediest should pay the cost of taxes. To estimate the extent to which different individuals draw benefits from the benefit of the State, we have to consider who among the individuals would suffer the most if the protection of the government, for instance, are withdrawn. Those who are least able to defend themselves, relying heavily on government expenditure, must pay the greatest share of its price (Lilia & Holzinger, 2016)

The benefit theory of taxation practically determines what activities the Government will engage and who will pay for them. The individuals on whom the burden of taxes falls upon determines allocation of economic resources. Tenet posits that the levies paid by an agent must show the value that he derives from public amenities catered for by the State (Neill, 2000).

The application of this theory in Kenya is explored through collection of taxes by various local governments in local jurisdictions and used to develop various social facilities which in the end results into social benefit to members of the public (Mbote & Akech, 2011).

2.2.3 Economic Theory of Tax Compliance

This concept was pioneered by Godwin (1978) and later on advanced by Sandford (1989), Pope (1993) and Andreoni, Erard, & Feinstein (1998). Compliance costs as by Sandford's definition of tax portrays them as expenses incurred by tax-payers submitting to regulations imposed by the constitution and relevant agencies on them. Cost compliance categorizes tax compliance cost by three categories: Psychological, monetary and time costs. The theory examines compliance behavior corresponding to circumstances where taxpayers accurately declare their income, wealth and consumption patterns in time. Several factors influence a person's choice to adhere to fiscal responsibility expected of him/her such as: the undesirable impact of tax load on tax obedience, the sophistication of financial systems to negate tax escape, the ease with which tax evasion can be detected, cultural factors influencing a taxpayer's attitude, tax morale and finally, the complexity of tax and taxation system. Tax compliance, consequently, is an impartial term that best describes the willingness of taxpayers to pay taxes (Muehlbacher & Kirchler, 2010).

The Sandmo (2005) model puts forward a great contribution to the compliance theory by concluding that taxpayers choose a fraction of their revenue to disclose in so as to exploit their anticipated usage of income. The model predicts that a taxpayer will not comply when in the event of getting caught, his/her tax and penalty remains below the tax due when income is declared accurately. This model, however, attracts criticism for lacking an explanation for operative levels of tax evasion. Contrary to the predictions of the model, some individuals declare with totality the accurate sum of their income in spite of little amount of discouragement.

Examining, the (Slemrod, 2001) model of behavioral response to taxation and the effect of compliance costs in the nonexistence of a not-complying state, (Sebastian & Vaillancourt, 2014) found that income tax evasion lessens the tax base and costs. The range of tax evasion activities

was found to depend largely on the presence of vagueness and gaps in the tax laws. The model predicts that low-income earners are not likely to find evasion optimal and evasion grows with rising revenue and occasions for evasion. The Slemrod model puts forward a tax policy proposition of closing loopholes and reducing tax concessions.

The economic theory of taxpayer compliance behavior analysis by (Dulleck et al., 2016), proposes that as long as production persists being lucrative in the existence of a fiscal policy, acquiescence costs will no longer affect production decisions. The theory explores mandatory costs of tax agreement where this analysis concludes that in absence of compliance costs, the group of taxpayers declaring no revenue or fail to record their revenue will be great. Brockmann, Genschel, & Seelkopf (2016) point out that tax-payers are ethical, profit-driven and their actions are driven by the computation of expenditures and the prospects that accompany. They suggest that responsiveness patterns specially on the basis of the capacity to pay approach and as such, the theory recommends that the tax encumbrance on taxpayers ought to be equivalent to the taxpayers' capacity to pay and consequently improve compliance behaviour.

2.3 Conceptual Framework

This is an analytical instrument which outlines goals of research and presents the parameters that are going to facilitate the achievement of the objectives. The conceptual framework relates dependent and independent variables by use of a diagram. This framework is shown in Figure 2.1; the figures on the left-hand side are the dependent variables. They include; corporate taxes, tax policy, and tax compliance cost. The variable on the right-hand side is the dependent variable, it is business performance which is computed in terms of Return to Asset (ROA).

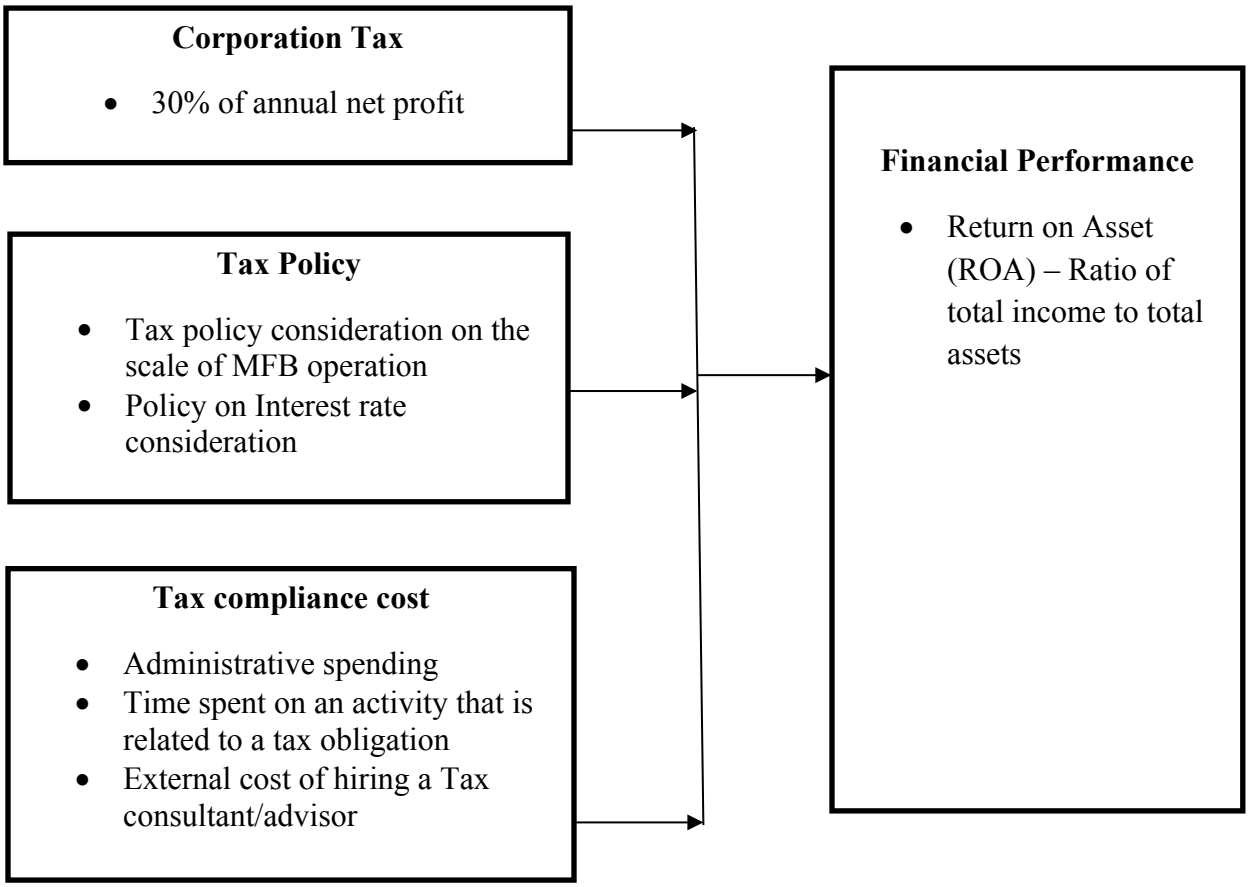

Figure 2.1 Conceptual Framework

2.4 Empirical Literature Review

Section below highlights previous works that have researched the influence of taxation on business performance of microfinance banks

2.4.1 Corporate Income Tax and Financial Performance

Schwellnus and Anorld (2008) used panel data analysis to carry out research concerning effect of taxes mainly corporate, on investment and profitability of financial institutions in OECD economies over periods spanning from 1996 to 2004. The study observed that income tax in corporate fields have adverse impact on firms the influence was more severe in small sized firms. The conclusion was that, corporate taxes eats into the investment and increases the cost of capital. Increase in tax rates was also shown to cause a decrease in the profitability of firms. Rohaya, Nor'Azem and Bardai (2010) evaluated the effect of corporate tax in the bottom-line of Malaysian companies in different sectors such as manufacturing, hotel, general retail and transport sectors. Stratified random sampling and ordinary least square regression approach were employed in the selection process. This study established that corporate income tax had negating effect on companies' gross profit.

Research by De Mooij and Ederveen, (2001) using regression analysis established a negative influence of corporate tax on the bottom-line of institutions in Russia. Becker and Holmes (2010) evaluated effect of corporate tax on profitability of institutions in Germany. Using Panel Autoregressive Distributed Lag approach, the study found out that taxes had adverse effect in revenue and profitability of firms in Germany. Gatsi, Gadzo and Kportorgbi (2013) used random concepts to investigate the effect of taxes in manufacturing firms listed in Ghana's exchange markets. By covering periods spanning from 2005 to 2013, the study established that there existed an inverse relationship in tax and Return on Asset in the listed firms. Okongo (2018)

studied the effect of taxation on business activity of SME institutions in Siaya County, using regression analysis the research established a favorable and substantial effect.

Other studies on the consequences of taxes have produced varied results, Tatu (2006) scrutinized the effect of corporate taxes on the earnings before interest and tax of entities in Bucharest. The study established that tax negatively impacted profitability of the entities, however, there was a variation in the effect based on the size. Noor (2011), using regression analysis on a data collected from 345 staff in Oil sector in Nigeria stablished that the coefficient for tax rate on financial outcome of oil firms was significantly positive. Similarly, Toader and Dragoti (2014), attempted to evaluate performance in profitability within Australian firms. Using descriptive statistics, the research did not find a significant effect.

2.4.2 Tax Policy and Financial Performance

Research on implications by tax policy and financial activity is still limited and the precise influence is unknown. Some studies have produced positive effects while other negative effects. Ironkwe & Nnaji (2017), using random sampling on microfinance banks in Nigeria established presence of favourable liaisons in tax policy together with microfinance business. Policies in tax especially incentive would help ease the problems that plague MFBs such as tax burdens, weak infrastructure, inadequate risk management policies, loan defaults, inadequate internal systems and weak equity base.

Teraoui et al., (2011) analyzed impact of tax policy by firms dealing in exports in Tunisia. Using the Generalized Least Square approach, the study established that regressive tax policies had adverse influence on financial activity within firms. An increase in tax by 1 percent led to a 0.07 percent reduction in profit after interest and tax. Strulik (2003) using a Generalized Method of

Moments found and employing elasticity approach established that 1 percent decrease in tax would result in a 10 percent rise in net profit. Adefeso (2018) used General Method of Moments to study the effect of government fiscal policy on financial activity of processing institutions in Nigeria. The research established a positive influence of tax regulation on the bottom-line of processing institutions. The study pointed out that Nigeria had favorable tax incentive and tax holiday policies that contributed to improved profitability of the firms.

Gambacorta et al., (2017) reviewed the effect of tax on bank liability structure they focused on microfinance institutions as well as commercial banks. Using comparative study, the study established that, the effect on commercial banks was insignificant while that on microfinance institution was significantly negative. The study concluded that microfinance banks incur higher costs from complying with income tax regulations than other commercial institutions as they do not benefit much from the economies of scale due to their relatively small size. Additionally, recurrent reporting to an administrative authority to make financial disclosures is significantly more difficult for MFBs that focus on relatively smaller transactions related to other banking institutions such as commercial banks.

2.4.3 Tax Compliance Cost and Performance

A couple of studies have been done on tax cost compliance cost, however, most of them have paid attention to the determinants of the cost leaving out its probable effect of performance of firms especially small and micro enterprises and in extension, microfinance banks. Slemrod and Venkatesh (2002), using multiple regression analysis evaluating implications by tax compliance on performance obtained negative and significant coefficients for tax compliance cost. Ali, Sjursen and Michelsen (2015) attempted to study the drivers that led to tax compliance and the subsequent effect on business performance of firms in selected African economies including

Kenya, Uganda, Tanzania and South Africa. The findings revealed that, the effect was negative concluding that, whenever firms comply with the taxes, they incur some cost in the process. Many of them tend to pass it to consumers through increasing prices leading to lower sales or alternatively paying their employees less tampering with productivity.

Locally, Olweny and Omondi (2011) examined the determinants and implications of tax compliance on Firms in Kenya's Nairobi Security exchange. Using Vector Autoregressive time series approach, and monthly data for a period covering 5 years, the study established that tax compliance affected profit margins within firms negatively. The research showed the tax accountability costs prompted many firms to engage in tax evasion behaviors. Similarly, Maina and Sakwa (2012) undertook a study to uncover the implication of tax compliance among NSE listed firms. Using regression analysis, this research found implication to compliance towards tax and financial performance of the firms insignificant. They concluded that, tax compliance is mostly shaped by other variables, e.g., size of firm and the general tax compliance behavior of the management in a firm. They therefore, concluded that tax compliance is not a good measure for determining the health of a firm.

2.5 Summary of Literature Review.

The section above delivers brief appraisal information to hypothetical methodologies and results conveyed in previous interrelated analyses on influence of tax within financial activities of institutions, decision making, also by economic growth. Key theoretical approaches discussed include: faculty theory, benefit theory of taxation and costs of tax compliance. Empirical review provides a general idea of previous works and studies conducted on influence of tax policies, costs in tax compliance and corporate taxes within financial performance of MFBs. A bulk of

the findings tend to agree these three variables have negative influence on microfinance monetary outcome although the degrees are varying.

2.5 Research Gap

From theoretical and empirical review, there is limited research conducted on the implications of taxation on business performance of microfinance institutions in Kenya and globally. Most studies are carried out in other sectors, for instance, the study by Gatsi, Gadzo and Kportorgbi (2013) was based on manufacturing firms in Ghana, Noor (2011) analysed the effect of taxeson performance of oil companies in Nigeria, while Toader and Dragoti (2014) focused on commercial firms in Australia. It is Gambacorta et al., (2017) who conducted a research that linked taxation with microfinance banks, however, the study focused on liability structure of microfinance banks and not their financial performance. Additionally, there is no consensus of the effect of tax and its various elements, that is, tax rate, tax policy and tax compliance on the business performance of companies. This can be shown by the conflicting findings among some of the studies reviewed, for instance, Adefeso (2018) found a positive association between tax policy and performance of institutions in Nigeria, while Gambacorta et al., (2017) established that tax policy had a negative effect on firms' financial performance, on the other hand Toader and Dragoti (2014) did not find a significant effect of tax rate on the performance of firms. Lastly, several of the existing research have been done in other economies which have unique business environments from that in Kenya. This survey aimed to link the research gap through examining influence towards corporate taxes, tax policies together with tax compliance costs within financial performance of MFBs in Kenya.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The section includes: research design, target population, sample and sampling technique, data assemblage instruments, data collection process, pilot testing together with data analysis. Also, it includes methods employed during data collection since a model for analyzing the data is the best way to answer the research question.

3.2 Research Design

The study adopted descriptive research design. Both quantitative and qualitative approaches were used to analyse the influence of taxation on financial performance of MFBs in Kenya. Cooper & Schindler (2014) show research design as structuring of data collection and analysis for the purposes of meeting the research objectives by use of empirical evidence. The use of descriptive design is best fit in this study. The value of this design is on its ability to describe data in a systematic manner and thus giving a clear description of the characteristics of the population or phenomenon under study. In addition, the design is versatile in terms of accommodating data of various forms as well as assimilating human experience: this provides the researcher with the ability to study an array of aspects and an approach to look at the picture as opposed to other types of research design (Kothari, 2004).

3.3 Population of the Study

Cooper and Schindler (2014) describe population as aggregate pool in components that the investigator intends drawing conclusions from. Target population of the research are the 13

MFBs in Kenya, licensed under the Central Bank of Kenya. Currently, thirteen (13) Deposits take Microfinance Banks in Kenya (CBK, 2017).

3.4 Sample and Sampling Technique

Definition of sample is subset of the population containing the elements representative of the characteristics found in the population. A sample could be a segment of people, places or objects containing the same attribute as the population under study. A sampling technique, therefore, is the method used to select the sample (Kothari, 2012). Sampling selection is crucial as it enables generalization of results acquired from sample to entire masses. The research used a census method, where all the 13 MFB were selected for the study. The study aimed to gather the required information from senior level accountants of the thirteen MFBs as they are the people with the right information regarding taxes and financial statements of the organization.

3.5 Data Collection Instruments

Structured questionnaire was employed to gather primary data while data collection forms were used to collect secondary data from the financial statements of the MFBs, internal records, and CBK's Bank supervision annual reports. The choice of the instruments was informed by the quantitative make-up of the data required.

3.6 Data Collection Procedure

Primary data collection procedure entailed administering of structured questionnaires to senior accountants in the 13 MFBs under study. More important data was from financial statements of MFBs by use of data collection forms.

3.7 Pilot Testing

Pilot testing involves examining the honesty and reliability of data picking instruments before to actual information gathering. Validity of information assembling tool is the level up to which the tool computes what it was intended to compute. On the other hand, reliability is an assessment of the consistency of the tool, in other words, it measures whether the tool can be used in future and still produce the same results (Kim-Kang & Weiss, 2008)

According to Kothari (2012), a data collection tool is said to be reliable if it constantly yields similar outcomes when employed on multiple occasions to gather data from a similar sample, randomly drawn from the population. To establish reliability, the researcher administered questionnaires to two samples. Cronbach Alfa was used to investigate the level up to which the subject matter of the questionnaires is constant in provoking the reactions.

3.8 Data Analysis and Presentation

Analysis of data works toward modeling and raw data and compiling it with an aim of obtaining useful information which can be used in formulating constructive conclusions about the population under study (Sekaran, 2006). Data collected was coded, checked for accuracy and completeness and lastly, analyzed using Statistical Package for Social Sciences (SPSS.version 23), the software provides a wide array of statistical analysis and capable of handling quantitative data.

Descriptive and Inferential methods of statistics were used in this data research. Descriptive form of statistics is useful in describing various features of a dataset used in the study, using degrees of central tendency, dispersion degrees, frequencies and summaries (Kothari, 2012). In

carrying out descriptive statistics, the study used degrees of central tendencies and degrees of dispersion.

Kothari (2012) asserts that inferential statistics is useful in enabling the researcher to get the reliability of findings in the study in order to make inferences from the data. The study used regression analysis in carrying out inferential statistics. The results from descriptive statistics presented in form of tables.

3.8.1 Analytical model

To identify the liason between variables, multiple regression model of analysis was best fit. This was guided by a regression model:

Where:

Y= Financial activity measured by ROA

X1 = corporate income tax, measured by a score of four items in a 5-point Likert scale

X2 = Tax policy, measured by a score of five items in a 5-point Likert scale

X3= Tax Compliance cost, measured by a score of seven items in a 5-point Likert scale. It is measured in terms of administrative spending, time spent on an activity that is related to a tax obligation, and External cost of hiring a tax consultant

= Regression constant or the Y-intercept, it represents the value of Y when the dependent variables are zero.

= Partial slope coefficients of corporate tax, Tax policy, and compliance cost respectively. ε = Error term normally distributed about the mean of zero (standard error term).

CHAPTER FOUR

DATA ANALYSIS AND PRESENTATION

4.1 Introduction

This chapter starts by presenting questionnaire response rate and dependability of the tool used in the gathering of data. This section goes ahead to present analysis of data using measure of central tendency and dispersion as well as regression analysis. The chapter also contains interpretations and results with goals of study and empirical literature review.

4.2 Questionnaire Response Rate

Census approach is used in this research sampling the 13 Microfinance banks in Kenya. One questionnaire was sent to each of the 13 MFB banks and 11 questionnaires were returned representing an 85 percent response rate. Mugenda and Mugenda (2003) recommend that response rate of approximately 70 percent that's considered excellent.

4.3 Reliability of the Research Instrument

Dependability of instruments was done to determine whether the research instrument can be used again and produce similar results. In that regard, Cronbach test for reliability was used on the variables with Likert-point items in the questionnaire. Results are as below in Table 4.1.

Table 4.1: Reliability Statistics

Variables	Cronbach's Alpha coefficient	No of items
Tax Rate	0.799	4
Tax Policy	0.813	5
Tax Compliance	0.866	7

Source: Author's Computation, 2019

The variable tax rate had 4 items which had a Cronbach coefficient of 0.799, tax policy had 5 items and had Cronbach's coefficient of 0.813, the next variable tax compliance that had 7 items had a Cronbach coefficient of 0.866. Both of these variables have surpassed the minimum threshold of 0.7, and therefore, the tool is considered reliable and can be used in future studies.

4.4 Demographic Characteristic of the Organization

This section outlines the background information of the organizations under study on the basis of the years they have been in operation, the number of employees, the people responsible in handling tax matters. The section also presents the demographic background of the interviewees in terms of how long, in years, they have worked in the organization.

4.4.1 Years Served in the Organization

It was important to ask the respondents about the number of years they served in the organization as this would give a clear picture of their level of understanding about the operations of the organization.

Table 4.2: Number of Years Served in the Firm

Years served in the company	Frequency	Percentage
Less than 2	1	9.1
2 to 5 years	2	18.2
6 to 10 years	6	54.5
more than 10 years	2	18.2

Source: Author's Computation, 2019

Majority of the respondent's 54.5 percent revealed that they have served in the firm for a period between between 6 to 10 years, 18.2 percent have worked in the company more than 10 years,

similarly, 18.2 percent had also worked in their organization between 2 and 5 years. 9.1 percent had served in the firm for less than 2 years.

4.4.2 Years the Organization Has Been in Operation

Respondents were asked about number of years the organization is in operation. This is important in determining the experience of the organization in the market and matters taxation.

Table 4.3: Years the Organization has been in Operation

Years the organization has been operating	Frequency	Percentage
5-10 years	2	18.2
10-15 years	3	27.3
More than 15 years	6	54.5

Source: Author's Computation, 2019

54.5 percent of the organizations under study have been in operation for more than 15 years, they are followed closely by those that have been in operation between 10 and 15 years at 27.3, while 18.2 percent have operated between 5 and 10 years.

4.4.3 Number of Employees

Interviewees indicated total number of employees that have worked in the organization at previous financial years. This is important in shedding light about size of the organization. The results are shown in Table 4.4

Table 4.4: Number of Employees

Number of employees	Frequency	Percentage
Below 50	0	0
50 to 150	0	0
151 to 500	3	27.3
Above 500	8	72.2

Source: Author's Computation, 2019

Results above reveal that a bulk (72.2 percent) of the MFBs have more than 500 employees, while 27.3 percent have between 151 and 500 employees.

4.5 Corporate Income Tax and Financial Performance of MFBs

This study aims to examine impact of corporate income tax toward business performance of MFBs in Kenya. To achieve this, four set of items were constructed measured using five-point Likert scale to obtain results. Scaling ranged from 1- 5 where 1 indicated that the respondent strongly disagrees and 5 indicated that they strongly agree with the statements/item. Mean and standard deviation were used to present these results.

Table 4.5: Corporate Income Tax Results

Statement	Mean	Std. deviation
Corporate tax payable is not economical to Microfinance Banks	4.10	0.795
The tax rating doesn't take to account the low-interest rate offered by microfinance banks	4.30	0.852
The tax burden of the Microfinance banks should be lighter than that of commercial banks	4.50	0.772
The corporate tax rate is an impediment to Microfinance Bank operations as it consumes a huge chunk of their profit	3.80	0.896

Table 4.5 shows tax rate results, the mean for the statement, corporate tax payable is not economical to Microfinance Banks was 4.10 while its standard deviation was 0.795. The statement tax rate does not take into account the low-interest rate offered by microfinance banks had a mean of 4.30 and a standard deviation of 0.852. The statement tax burden of the Microfinance banks should be lighter than that of commercial banks had a mean of 4.50 and a standard deviation of 0.772 while the statement, corporate tax rate is an impediment to Microfinance Bank operations as it consumes a huge chunk of their profit had a mean of 3.8 and a standard deviation of 0.896 the average mean for the four items was 4.175 meaning that the respondents concur to a larger extent that the existing tax proportion has an adverse impact on the performance of MFBs. The low standard deviation of below 1 could be interpreted to mean that the respondents had no varied view on the subject.

4.6 Tax Policy and Financial Performance of MFBs

This study aims to determine effect of tax policy by bottom-line activity of small financial banks in Kenya. To achieve this, five-point Likert scale was used to rate the responses elicited by the study respondents. Scaling ranged from 1 meaning that the respondents strongly disagree with the line item to 5 an indication that the respondents agree with the statement. Mean and standard deviation is used in analysis, a lower standard deviation of below 1 means that the respondents did not differ much in their attitude and were therefore speaking in one voice. On the other hand, a higher standard deviation means that there was a great dispersion in respondents' attitudes and perception. Results are shown below;

Table 4.6: Tax Policy Results

Statement	Mean	Std. Deviation
The tax policy exerts much disproportionate pressure on micro finance banks	4.30	0.675
Tax policy does not consider the scale of micro finance banks operation hence adversely affecting performance	4.00	0.943
Existing tax policy forms uncertainty among microfinance banks and as a result making compliance involuntary leading to jumps and breaks in their tax	4.20	0.632
Corporate income taxes reduce the income revenue base of microfinance banks	3.90	0.994
The tax policy does not take into account the low interest rate offered by microfinance banks	4.20	0.632
Average Mean and Std. Deviation	**4.12**	**0.7752**

Table 4.6 shows tax policy results. The statement; tax policy exerts much disproportionate pressure on micro finance banks had the highest mean of 4.30, this means that they agree to great extent that the existing tax policy exert disproportionate pressure on their operations. The statement had a standard deviation of 0.675, an indication that the respondents' views on this issue were not varied. The statement, existing tax policy forms uncertainty among microfinance banks and as a result making compliance involuntary leading to jumps and breaks in their tax came closely second with a mean of 4.20 and a standard deviation of 0.632. The statement tied with the item number five which read; the tax policy does not take into account the low interest rate offered by microfinance banks, which also had a mean of 4.20 and a standard deviation of

0.632. That indicates that, the tax policy does not consider the low interest charged by MFBs compared to conventional banks but yet they are subjected to similar tax rates. Additionally, the tax policy creates uncertainty in the market leading to intermittent non-compliance by microfinance banks. The statement; Tax policy does not consider the scale of micro finance banks operation hence adversely affecting performance had a high mean of 4.00 and a small standard deviation of 0.943. This means that the respondents strongly concurred with the statement that the tax policy does not consider the fact that Microfinance banks have small-scale operations and its thus discriminatory. Finally, the statement; corporate income taxes reduce the income revenue base of microfinance banks, had a mean of 3.90 and a standard deviation of 0.994, this means that the respondents agreed in unison that the corporate taxes eats deeply into revenue generated by MFBs and this reduces their financial performance.

4.7 Cost of Tax Compliance and Financial Performance of MFBs

The study aimed to analyze the implication of tax compliance cost on financial performance of microfinance banks in Kenya. To achieve this, a questionnaire with seven items was constructed. The items corresponded to statements related to element of cost of compliance such as administrative cost, time spent on an activity related to a tax obligation, as well as external cost of hiring a tax consultant. A five-point Likert scale was used ranging from strongly disagree to strongly agree. Mean and standard deviation was used in analysis. Results are as shown in Table 4.7.

Table 4.7: Tax Compliance Cost Results

Statement	Mean	Std. Deviation
The institution incurs substantial expenses when lodging payment to the tax payment cost (e.g. Transaction charges by commercial banks, transportation cost, cost of printing documents etc.)	4.30	0.483
The time taken to prepare the forms required for the purposes of filing tax returns (PAYE return (P11), Company Income (IT2C) Withholding Tax (VAT 32), Informative declarations etc.) is long	4.40	0.356
Revenue collection agency takes quite a long time to process tax refunds	4.50	0.527
The institution finds it expensive to maintain the Information Technology (IT) required for the maintenance of tax system	3.80	1.033
The institution incur quite a considerable amount for the cost of storing and maintaining accounting records	4.20	0.789
the institution finds the penalties associated with non-compliance of tax quite stringent	4.00	0.667
The institutions use a lot of its revenue to meet the cost of hiring external tax consultants	4.10	0.835
Average Mean and Std. Deviation	**4.18**	**0.67**

Table 4.7 shows results of tax compliance cost, among the items, the statement, it takes a long time to get tax refunds from revenue collection agency recorded the highest mean of 4.50, this indicates that respondents concur to some level that it takes a long time to get tax refund form Kenya Revenue Authority and this influences their performance. The item has a lower standard deviation of 0.527 meaning that there was no discrepancy in the respondents' views regarding

that subject. This was followed closely by the statement; The time taken to prepare the forms required for the purposes of filing tax returns (PAYE return (P11), Company Income (IT2C) Withholding Tax (VAT 32), Informative declarations etc.) is long, with a mean of 4.40 and a standard deviation of 0.356. The statement; MFBs incur substantial expenses when lodging payment to the tax payment cost had a mean of 4.380 meaning that respondents agree that costs such as transaction charges by commercial banks, transportation cost, cost of printing documents among others influence financial performance to a large extent. The mean for the statement; it costs MFBs so much to store and maintain accounting records, was 4.20 and its standard deviation was 0.789. Cost associated with hiring an external tax consultant was 4.10 and its standard deviation was 0.835, also indicating that respondents agreed that seeking tax advisory services form external expert adversely influenced their financial performance. The penalties associated with non-compliance of tax are quite stringent, had a mean of 4.00 and a standard deviation of 0.667. Finally, cost of maintaining Information and technology system for purposes of tax recording and reporting had an influence on financial performance with a mean of 3.80 and a standard deviation of 1.033.

4.8 Regression Results

Regression analysis using the Ordinary Least Square was used in determining the magnitude and direction of the effect of independent variables that is, corporate taxes, tax policy and tax compliance cost on return on asset, which was used as a substitute for financial performance of microfinance banks. Results are shown by Tables 4.8, 4.9 and 4.10.

Table 4.8: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.861[a]	0.741	0.631	4.19709

a. Predictors: (Constant), CIT, Tax policy, tax compliance,
Source: Author's Computation, 2019

Table 4.8 shows the model summary in terms of coefficient of determination (R square), which is important in explaining the goodness of fit of the model. Findings show that the R square is 0.741, meaning that 74.1 percent of the disparity in financial performance is explained in the model while the rest (25.9 percent) is explained by other elements that are not in the model. According to Woodridge (2003) a model with a coefficient of determination of above 60 percent is deemed to be a good fit. The model has satisfied this condition and it is therefore good for predicting the performances from the indicators.

Table 4.9: Analysis of Variance

Model		Sum of Squares	df	Mean Square	F	Sig.
1	**Regression**	1389	3	463	19.969	0.000[b]
	Residual	162.3	7	23.185		
	Total	1551.3	10			

a. Dependent Variable: ROA
b. Predictors: (Constant), CIT, Tax policy, tax compliance
Source: Author's Computation, 2019

Table 4.9 illustrates analysis of variance result. The population parameters have a P value of 0.000. The data is therefore well suited for making a sound deduction on the population's parameter.

Table 4.10: Regression Analysis Results

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	9.628	2.018		4.777	0.000
	CIT	-0.2100	0.0848	-0.174	-2.476	0.019
	Tax policy	-0.6957	0.2082	-0.127	-3.341	0.000
	Tax compliance	-0.7590	0.3301	-0.111	-2.299	0.023

a. Dependent Variable: ROA

Table 4.10 shows regression results. The estimated equation derived from the table will be of the form:

The Y intercept is 9.628 meaning that the constant value for ROA is 9.628 irrespective of tax rate, tax policy and tax compliance cost. Partial slope coefficient for corporate income tax is -0.2100 and significant at 5 percent (P-value= 0.019). The results indicate that a percentage rise in corporate income tax would result in a 0.21 percent reduction in the ROA of MFBs in Kenya. This finding agrees with the works Schwellnus and Anorld (2008) which found that corporate tax have a negative influence on the firms and the effect is more severe in small sized firms, in this case microfinance banks. The conclusion was that, corporate taxes eats into the investment and increases the cost of user capital, leading to a reduction in profitability of the firms.

The partial slope coefficient for tax policy is -0.6957 and statistically significant at 1 percent as shown by the P-value of 0.000. The findings indicate that existing tax policies have a detrimental effect to the performance of MFBs in Kenya. The study confirms the finding of Ali, Sjursen and Michelsen (2015), who established an adverse relationship between the two variables. The implication of their research was that, without observing the canon of equity in taxation, the impact of tax rate borne by entrepreneurs in smaller enterprises (for instance MFBs) is higher compared to large enterprises.

In contrast, the coefficient for cost of tax compliance is negative (-0.7590) and significant at 5 percent (P-value of 0.023). The results show a unit rise in adherence cost leads towards 0.75 percent reduction in return on assets of MFBs. The study concurs with the study by Gambacorta et al., (2017) which also asserted that tax compliance cost weighed down on small banks compared to large banks. The study concluded that microfinance banks incur higher costs from complying with income tax regulations than other commercial institutions due to numerous reasons. Additionally, recurrent reporting to an administrative authority to make financial disclosures is significantly more difficult for MFBs that focus on relatively smaller transactions compared to financial institutions like commercial banks.

CHAPTER FIVE

SUMMARY AND RECOMMENDATIONS

5.1 Introduction

This section outlines list of findings that provide conclusion offering commendations according to discoveries of research obtained using descriptive statistics as well as regression analysis. This section presents policy recommendations, limitations related towards fields of further research.

5.2 Summary of Findings

Objectives of this research was establishing effect in taxation by monetary performance of small financial banks in Kenya. This was to be achieved through analyzing the implications of corporate income tax, tax policy and tax compliance cost on the return on asset of small financial banks in Kenya. Cross-sectional information is gathered from eleven microfinance institutions in Kenya, where subjects are senior account persons of these organizations.

5.2.1 Corporate Income Tax and Financial Performance of MFBs in Kenya

First specific goal of this research was establishing effect by corporate income tax on financial evaluation towards small financial banks in Kenya. From regression analysis a negative coefficient of corporate tax was obtained. The findings are consistent with theoretical literature as well as empirical literature. The results agree with studies by De Mooij and Ederveen, (2001) who established a negative influence towards corporate income tax by monetary performance of Russian banking institutions; Becker and Holmes (2010) who found corporate income tax begot negative implications towards profitability within firms in Germany; and Gatsi, Gadzo and Kportorgbi (2013) that established corporate tax had negative effects towards profitability in companies listed at Ghana's stock exchange.

5.2.2 Tax Policy and Financial Performance of MFBs in Kenya

Second goal aimed towards examining effect in tax policy within business activities of small financial banks in Kenya. To achieve this objective, five-point Likert scaling used in rating responses elicited by study subjects. This research obtained a negative coefficient of tax policy in the regression analysis. This research agrees with theory and empirical studies conducted on the subject. Specifically, it agreed with studies by Teraoui, Kaddour, Chichti and Rejeb (2011) who analyzed the impact by tax policy within firms dealing in exports in Tunisia and obtained a negative coefficient by tax policy towards financial evaluation of this firms.

5.2.3 Tax Compliance Cost on Financial Performance of MFBs in Kenya

Third objective aimed towards uncovering implications by tax compliance cost on monetary performance of small financial banks within Kenya. Five-point Likert scale used is a questionnaire with seven items used to gather data. This research obtained negative coefficient of tax compliance cost in regression analysis. Findings of this research concept agree with major empirical findings such as, works by Slemrod and Venkatesh (2002), and Ali, Sjursen and Michelsen (2015) who used multiple regression method of analyzing hence determining effect of tax compliance cost towards monetary performance by firms consequently obtaining negative and significant coefficients for tax compliance cost.

5.3 Conclusion

From the descriptive and inferential discoveries of this study, we can draw the conclusion that the study objective has been successfully achieved. The framework of the study had conceptualized that corporate tax, tax adherence cost and policy of tax to have an impact on financial acts in microfinance banks within Kenya.

5.3.1 Corporate Income Tax and Financial Performance MFBs in Kenya

From the foregoing, the effect analysis of corporate income tax relating to financial acts of microfinance firms within Kenya cannot be overstressed. Information provides evidence which corporate income tax has an adverse effect on financial performance of microfinance banks in Kenya. Small financial banks are subjected to the same tax rate as commercial banks and other relatively larger institutions yet they are designed to serve the purpose of financial inclusion that consequently, poverty alleviation. Owing to their small operational activity, the high tax rate reduces the income revenue base of microfinance banks by increasing their running cost contributing to their dismal financial performance.

5.3.2 Tax Policy and Financial Performance of MFBs in Kenya

It is established that link relating to tax policies and monetary performance in microfinance banks is negative. Implications in tax policy by financial activity of microfinance institutions within Kenya include: Its exertion of disproportionate pressure on microfinance banks; its lack of consideration of the of the scale of microfinance banks operation, as well as not taking into account the low interest rate charged by microfinance banks. These factors make taxes burdensome to microfinance banks hindering their growth.

5.3.3 Tax Compliance Cost and Performance of MFBs in Kenya

Finally, from findings of the survey, tax compliance costs have an adverse effect towards business activities of microfinance institutions. The distortionary effect of tax compliance is caused by its various costs such as administrative spending, time spent on an activity that is related to a tax obligation, external cost of hiring a tax consultant, as well as duration taken to file tax returns and complying with the tax regulations.

5.4 Recommendations

5.4.1 Corporate Income Tax

As established by the findings, corporate income tax is distortionary in the effect towards financial activity in microfinance institutions in Kenya. Consequently, a low tax rate is vital for survival of microfinance institutions within Kenya, and therefore, taxes levied to these institutions should be slightly lower than other big institutions.

5.4.2 Tax Policy

The Government through the revenue collection agency should design tax policies that do not directly affect Microfinance banks but instead promote their growth. The government should design policies that are tailor made for such institutions.

5.4.3 Tax compliance Cost

This study found that compliance cost affects the financial outcome of MFBs in Kenya. The revenue collecting agency in conjunction with the government should formulate policies that are geared towards reducing the compliance cost, such as waiving or reducing the transactional charges by banks incurred when remitting taxes.

5.5 Suggested Areas for Further Research

The study established that taxation has a negative influence on the financial performance of microfinance banks in Kenya. Literature has also shown Microfinance banks to be important tools for poverty alleviation in sub-Saharan Africa. It would therefore be imperative to conduct a study to establish whether introduction of tax incentives to these institutions will enhance the financial performance of these institutions. This study therefore proposes a study on the influence of tax incentive on the financial performance of Microfinance banks in Kenya.

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APPENDICES

Appendix I: List of the Registered MFBs in Kenya as at 31st December 2017.

S/no	**Name of DTM**

1	Kenya Women finance trust DTM Ltd
2	SMEP Deposit Taking Microfinance Ltd
3	REMU Deposit Taking Microfinance Ltd
4	Rafiki Deposit Taking Microfinance Ltd
5	Uwezo Deposit Taking Microfinance Ltd
6	Century Deposit Taking Microfinance Ltd
7	SUMAC Deposit Taking Microfinance Ltd
8	U&I Deposit Taking Microfinance Ltd
9	Faulu Deposit Taking Microfinance Ltd
10	Maisha Deposit Taking Microfinance Ltd
11	Caritas Deposit Taking Microfinance Ltd
12	Daraja Deposit Taking Microfinance Ltd
13	Choice Deposit Taking Microfinance Ltd

Source: CBK, 2018

Appendix II: Cover Letter for Data Collection

Date …….

Dear Participant:

My name is Alexander Kagira Mwangi, a post graduate student at Kenya School of Revenue Administration. I am conducting a study on the influence of taxation on the financial performance of Microfinance Banks in Kenya. In order to complete the study, I have prepared a questionnaire that would aid me to collect the data which will be analysed and later on interpreted. I am therefore calling upon you to help fill in the questionnaire as your input is valuable in providing insight adding value to my study.

It is worth noting that your response will be handled with confidentiality and as a result you are not required to include your name on the questionnaire. If you choose to take part in this project, kindly answer all the questions to the best of your knowledge.

I would like to thank you for sparing your time to help me in my academic endeavors. In case you require additional information regarding the study feel free to contact me on the cell phone number listed below.

Sincerely,

Alexander Kagira
0720685396

Appendix III: Questionnaire

SECTION A: Demographic Information

A1. Name of the organization ……

A2. How many years have you worked in this organization?

Less than 2years ☐

2 years to 5 years ☐

5 years to 10 years ☐

More than ten years ☐

A3. For how many years has the organization be in operation?

0-5 years ☐

5-10 years ☐

10-15 years ☐

More than 15 years ☐

A4. Who responds to tax-related issues in your organization?

General Manager ☐

Accountant ☐

External Tax advisor ☐

A5. On average how many employees worked in this organization over the past year?

Below 50employees ☐

51-150 employees ☐

151-500 employees ☐

Above 500 employees ☐

Section B: Corporate Taxes

This section contains related aspects of corporate taxes and how they influence the performance of Microfinance Banks. On a scale of 1 to 5 (where 1= strongly disagree, 2= disagree, 3= Neutral, 4= agree and 5= strongly agree) please indicate the extent to which you agree with the corresponding cells

S/no	Statement	1	2	3	4	5
B1	Corporate tax payable is not economical to Microfinance Banks					
B2	The tax rate does not take into account the low-interest rate offered by microfinance banks					
B3	The tax burden of the Microfinance banks should be lighter than that of commercial banks					
B4	The corporate tax rate is an impediment to Microfinance Bank operations as it consumes a huge chunk of their profit					

Section C: Tax policy

Below are some statements on tax policy and systems and how the influence the performance of Microfinance Banks in Kenya. On a scale of 1- 5 (where 1= strongly disagree, 2= disagree, 3= Neutral, 4= agree and 5= strongly agree) kindly indicate to what extent you agree with the statements.

S/no	Statement	1	2	3	4	5
C1	The tax policy exerts much disproportionate pressure on microfinance banks					
C2	Tax policy does not consider the scale of Microfinance Banks operation hence adversely affecting performance					
C3	Existing tax policy forms uncertainty among Microfinance Banks and as a result making compliance involuntary leading to jumps and breaks in their tax					
C4	Corporate income taxes reduce the income revenue base of Microfinance banks					
C5	The tax policy does not take into account the low-interest rate offered by microfinance banks					

Section D: Compliance Cost

This next section contains related aspects of compliance with tax obligation, below are some statements on how compliance cost in monetary terms and influence the performance of Microfinance Banks in Kenya. On a scale of 1- 5 (where 1= strongly disagree, 2= disagree, 3= Neutral, 4= agree and 5= strongly agree) kindly indicate to what extent you agree with the statements.

S/no	Statement	1	2	3	4	5
D1	The organization incurs substantial expenses when lodging payment to the tax payment cost (e.g. Transaction charges by commercial banks, transportation cost, cost of printing documents etc)					
D2	The time taken to prepare the forms required for the purposes of filing tax returns (PAYE return (P11), Company Income (IT2C) Withholding Tax (VAT 32), Informative declarations etc.) is long					
D3	It takes a long time to get tax refunds from revenue collection agency					
D4	It is expensive to maintain the Information Technology (IT) required for the maintenance of tax system					
D5	It costs the institution a considerable amount to store and maintain accounting records					
D6	The penalties associated with non-compliance of tax are quite stringent					
D7	Cost associated with hiring external tax consultants eats much into our revenue					

Section E: Financial Performance

Kindly indicate on a scale of 1 to 5 to what extent has the organization improved in terms of performance in the past five years. 1 represents no extent, 2=low extent, 3=moderate extent, 4=high extent, 5=to a very high extent.

S/no	Statement	1	2	3	4	5
E1	Net profit					

E2	Total Asset					
E3	Financial liquidity					
E4	Market share gained by Microfinance bank					
E5	Return on Asset					

Appendix IV: Data Collection Sheet for secondary data

1. Name of the organization…….

Variables	**The value in Ksh. reported in the previous five year's Financial Statements.**				
	2018	2017	2016	2015	2014
Net profit					
Total Asset					
Income Tax					