THE DETERMINANTS OF TAX COMPLIANCE AMONG SMALL AND MEDIUM ENTERPRISES IN UASIN-GISHU COUNTY

BY

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DECLARATION

This Research Project is my Original Work and has not been submitted for a Degree in any other University.

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This Research Project has been submitted for Examination with my Approval as University Supervisor.

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DEDICATION

To

My dear father

William Mutai

(Your inspiration is the Couse of this)

And

My loving mum

Rael Mutai

(Your love and encouragement has brought me this far)

ABSTRACT

This research investigated the determinants of tax compliance in small and medium enterprises (SMEs), focusing on how tax knowledge and compliance costs affected tax compliance behaviour of SMEs in Uasin Gishu County. The main objectives of the study were to investigate how the unique business conditions of SMEs, the perceptions of SME operators towards taxation, levels of tax knowledge and compliance costs affect tax compliance of SME taxpayers. To achieve these objectives, research propositions were stated which mainly stipulated that the current tax system in Kenya does not cater for the special business needs of SMEs and that strong correlations do exist among tax knowledge, compliance costs and tax compliance. The study adopted a chiefly qualitative research design. Methodological triangulation was employed, utilizing the interview method and a questionnaire survey to collect primary data from SMEs in Uasin Gishu County. Interview responses were analyzed through summative content analysis and questionnaire responses were analyzed using SPSS software. The results indicated that SMEs face different business conditions from large companies which cause them to bear high tax compliance burdens. The results also indicated that the perceptions of SME operators about tax fairness, tax service quality and government spending priorities greatly affect their tax compliance decisions. Tax knowledge was discovered to have *no correlation* with tax registration compliance but *weak negative correlations* with filing compliance. Compliance costs were discovered to have *negative correlations* with tax compliance. The study then recommended that the current tax law should be amended to incorporate provisions that grant special tax incentives to SMEs in order to improve voluntary tax compliance by SME taxpayers. The study also recommended that the KRA should disseminate information on tax updates more frequently in order to improve the levels of tax knowledge for voluntary tax compliance

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CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

The exact meaning of tax compliance has been defined in various ways. Kirchler (2007) perceived a simpler definition in which tax compliance is defined as the most neutral term to describe taxpayer's willingness to pay their taxes. Similarly, tax compliance is also defined by several tax authorities as the ability and willingness of taxpayers to comply with tax laws, declare the correct income in each year and pays the right amount of taxes on time (IRS, 2009; ATO, 2009; IRB, 2009). Another definition of tax compliance is a person's act of filing their tax returns, declaring all taxable income accurately, and disbursing all payable taxes within the stipulated period without having to wait for follow-up actions from the authority (Singh, 2003). Furthermore, tax compliance has also been segregated into two perspectives, namely compliance in terms of administration and compliance in terms of completing (accuracy) the tax returns (Chow, 2004).

Taxpayers' behavior towards tax system has evoked great attention among many Revenue Authorities in the World especially in Developed Countries. However, it is debatable on what has been done towards the study of taxpayers behavior towards tax system in developing countries as they concentrate more in studies which would increase their budgets bottom-line in terms of huge revenue collection and enforcement efforts at the expense of studies on taxpayers behavior which would

make increase in this tax revenue to be realized and enforcement efforts work. Perhaps the less developed countries are not to blame as they run on budget deficits hence, scarce resources to see through such studies which are perceived as adding no direct value to revenue collection. Empirical evidence on the ground shows there has been hostility between the taxpayers and tax collectors on issue relating to tax compliance- how about tax evasion cases reported daily in our local newspaper (Daily Nation, July 7, 2006, pg 3) and outward resistance from taxpayers for example the recent protest by taxpayers over implementation of Electronic Tax Registers. Hostility towards tax compliance date back to the History of Taxation, "Taxes are considered a problem by everyone. Not surprising, taxation problems date back to the earliest recorded history" (Director, Taxworld Organization, April 7, 1999).

According to the Director, Taxworld Organization, (1999), during the Roman empire, in 60A.D, Boadecia queen of East Anglia led a revolt that can be attributed to corrupt tax; in Great Britain, the 100 years war (1337-1453) between England and France was renewed in 1369 by among other key factors, the rebellion of the nobles of Aquitaine over the oppressive tax policies of Edward, The Black Prince and in Post-Revolution America, Tax Act of 1864 was challenged several times. Hostile tax payer's behavior implies that given a chance taxpayers would not comply with tax laws. Perhaps, understanding the taxpayers' behavior in terms of factors which influence their attitude towards tax compliance and how to influence the very factors would be a solution to this jigsaw puzzle.

1.1.1 Tax Compliance

Tax compliance is a complex term to define. According to Brown and Mazur (2003), tax compliance is multi-faceted measure and theoretically, it can be defined by considering three distinct types of compliance such as payment compliance, filing compliance, and reporting compliance. Organization for Economic Cooperation and Development (2001) advocates dividing compliance into categories in considering definitions of tax compliance to make it clear. These categories are administrative compliance and technical compliance where the former refers to complying with administrative rules of lodging and paying otherwise referred to as reporting compliance, procedural compliance or regulatory compliance and the latter refer to complying with technical requirements of the tax laws in calculating taxes or provisions of the tax laws in paying the share of the tax. Theoretically, views of the taxpayers and tax collectors are that tax compliance means adhering to the tax laws, which are different from one country to another. The goal of tax administration is to foster voluntary tax compliance (Silvani, 1992) and hence reduce tax gap (difference between taxes paid and owed for all taxes and all taxpayers) and compliance gap. Tax compliance, according to Cobham (2005), is a problem to many countries as measured by tax to GDP ratio although it has been improving for many countries. For example, its one-third of GDP in rich countries; Latin America and the Caribbean - 17% of GDP and low-income countries (in Sub Saharan Africa) showed less than 15% to GDP (the recommended rate). It remains a big challenge to low income countries. This has promoted radical tax reforms in countries like Bolivia, Uruguay, Colombia, Jamaica and Spain with notable success (Bird & De Jantscher, 1992).

The outcome of positive views is tax compliance and negative views are tax non compliance. These views may be explained by Psychology-based theories which reveal that taxpayers' attitude may be influenced by the following factors which eventually influence taxpayers' behavior. Taxpayers perceptions of the tax system and Revenue Authority (Ambrecht, 1998); peer attitude/subject norm (Tanzi,1992); taxpayers' understanding of a tax system / tax laws (Silvani, 1992; Le Baube, 1992); motivation such as rewards (Feld, Frey & Torgler, 2006) and punishment such as penalties; cost of compliance (Slemrod, 1992; Le Baube, 1992); enforcement efforts such as audit; probability of detection (Allingham & Sandmo,1972); difference across - culture; perceived behavioral control and Protestant Work Ethics (PWE) (Furnharn, 1983); ethics / morality of the taxpayer and tax collector; equity of the tax systems (Trivedi & Shehata,2005); image of the government based on whether it is achieving the tax objectives under prescribed principles of taxation; demographic factors such as sex, age, education and size of income and use of informants (Jackson & Milliron, 1986; Murphy, 2004).

1.1.2 Determinants of Tax Compliance

In order to develop methods and instruments for fighting tax evasion and avoidance, it is important to foremost establish a broad understanding of the different determinants underlying tax compliance. Taxpayers' willingness to pay taxes differs widely across the world. It cannot be viewed as simply depending on the tax burden (Alm et al., 2007). These high levels of tax compliance result from the tax morale of society that fosters self-enforcement of tax compliance. Tax morale, attitude and

behavior is, however, not easy to establish. Especially countries without a deep-rooted 'culture' and habit of paying taxes find it difficult to establish tax morale (Brautigam et al., 2008).

Ethnicities have been equated to cultural groups with a set of shared values, beliefs, and norms to solve basic human problems (Basu & Altinay, 2002). An ethnic business is a business having a set of connections and regular patterns of interaction among people sharing common national background or migratory experiences (Aldrich & Waldinger, 1990). Lack of transparency and accountability in the use of public funds contributes to public distrust both with respect to the tax system as well as the government. This, in turn, increases the willingness to evade taxes. If due to high levels of corruption, citizens cannot be certain whether their paid taxes are used to finance public goods and services their willingness to pay suffers and it becomes more likely that they evade their tax liabilities. If the legal system does not operate in accordance with the rule of law, citizens have to fear arbitrariness, discrimination, unequal attendance in court. The lack of rule of law reduces transparency of public action and fosters distrust among citizens. As a result, citizens may not be willing to finance the state through taxes, and decide to evade these liabilities (Kirchler et al., 2007).

Shortfalls in tax collection procedures as well as weak capacities of tax administrations to detect and prosecute tax violators are both factors that contribute to a low enforcement of tax legislation. A well-functioning body of tax investigation is

essential for the detection and prosecution of cases of tax fraud. The lack of sufficient capacities in tax administrations and the use of family and unpaid labor by SMEs reduce the probability of detection that again influences the decision of a taxpayer as to whether evade or not. Additionally, the legal framework is an important prerequisite for any enforcement activity. For example, the size and nature of penalties that are incurred after evasion has been detected is directly connected to the level of tax compliance (Fishlow & Friedman, 1994).

Finally, tax laws and changes in the workforce in many countries, especially in developing countries, changes rapidly, thus producing instability and low transparency of the tax code. As a result, complicated tax legislation and ongoing changes of the tax code confuse tax administrators and taxpayers alike. This produces ample opportunity for tax avoidance and non compliance. Furthermore, it results in tax evasion which is not intentional, but occurs due to lack of knowledge ignorance. In extreme cases, tax evasion and avoidance even become inevitable when the tax system becomes too complex and/or contradictory to follow (Mo, 2003).

1.1.3 Contextual Background (SME's in Uasin-Gishu County)

As with many developing countries, there is limited research and scholarly studies about the SME sector in Kenya. The 1999 National Baseline Survey conducted by Central Bureau of Statistics, ICEG and K-Rep Holdings provides the most recent comprehensive picture of SMEs in Kenya. Mead (1998) observes that the health of the economy as a whole has a strong relationship with the health and nature of micro

and small enterprise sector. When the state of the macro economy is less favourable, by contrast, the opportunities for profitable employment expansion in SMEs are limited. SMEs are generally perceived to be the seedbed for indigenous entrepreneurship and generate all the many small investments, which would otherwise not have taken place (Aryeetey & Ahene, 2004). Therefore, developing economies like Kenya needs to further the development of its private sector by creating an environment favorable to the growth of SMEs, strengthening the factors that lead to business success, and addressing the problems threatening the existence and advancement of small and medium enterprises (Chu, Kara & Benzing, 2008), so they can adequately play the role expected of them in economic transformation. Such role includes mobilization of domestic savings for investment, appreciable contribution to gross domestic product, increased harnessing of local raw materials, employment generation, and significant contribution of poverty reduction efforts through sustainable livelihoods and enhancement in personnel income, technological development and export diversification (Smatrakalev, 2006).

Furthermore, they have the advantage of reaching the farthest corners of the country unlike the larger establishments. For this reason, an ideal tax policy needs to be adopted in order to ensure voluntary compliance, economic growth and proper utilization of resources rather than suffocating the entrepreneur initiative they are out to cater for. It is a well known fact that the revenue generated from the taxation of individuals and businesses is an important stream of income for government. In an economy like ours that is struggling to remain afloat, it is even more important. Tax

revenue is the source of funds used for development projects such as provision of infrastructure like good roads, stable power supply, stable water supply etc. All of which combine to create an enabling environment for businesses –and in turn the economy at large- to grow. Small and Medium Enterprises being profit generating establishments are also expected to pay their dues. The important question however is "how much tax should they be levied". Small and medium enterprises are volatile establishments that need special treatment. Putting their nature into consideration, every little resource at their disposal can make a world of difference. For this reason, a number of Kenyan SMEs choose to remain in the informal sector because they feel the cost of compliance is too high. And a considerable number of those who pay only do so because they are coerced by the authorities.

1.2 Research Problem

The main source of revenue for public expenditure in Kenya is taxation. However, tax revenues have, for quite sometime, remained low relative to the number of both registered and non registered firms and individuals who are legally qualify to pay tax. Continued low revenue collection levels for government is detrimental to economic development of this nation. Fortunately, the large registered firms usually pay their taxes. In contrast, a large segment of the informal sector, especially the SMEs in Uasin-Gishu exhibit low tax compliance levels (www. kra.co.ke).This is a great loss of revenues meant for public expenditure It is for this reason that research need to be undertaken to identify the causes for low tax compliance among small and medium enterprises in Uasin-Gishu. It is also instructive to note that there is little research that

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has been done in this area. In this context SMEs in Uasin-Gishu exhibit low tax compliance levels and this requires and understanding on the determinants of tax compliance to enable the government to improve on its tax collection among the SMEs in Eldoret.

Various studies have been undertaken on tax compliance and SMEs for example Omeri et al (2010) did research on how the Taxpayers' Attitudes Influence Compliance Behavior among SMEs Business Income Earners in Kerugoya Town, Kirinyaga District. Simiyu (2003) looked at the factors influencing taxpayers' voluntary compliance among local authorities, the researcher was not aware of any other study that has been carried out to establish how taxpayers' attitudes influence on tax compliance behavior among local authorities. He pointed out that the non compliance resulted due to lack adequate knowledge on taxation. Also, Schoonjans et al (2011) carried out a survey of tax compliance costs of Flemish SMEs: magnitude and determinants, Environment and Planning. They found out that that the tax compliance costs exceeding over 7% of gross added value are relatively high. Value-added tax, labor taxes, and corporate taxes are the main components of tax compliance costs. In addition, our evidence confirms the regressively hypothesis, according to which smaller companies face relatively higher compliance costs. Furthermore, industry, age, and the proportion of blue-collar workers prove to be determining factors of relative compliance costs. The study concludes by formulating a number of policy recommendations that might contribute to lower compliance costs.

At the same time this was echoed by the writings of Silvani & Baube, 1992 on taxpayers' understanding of a tax system and tax laws. While the above researches made great contributions on some of the factors that affect compliance of tax payment, such compliance for SMEs in Uasin-Gishu has not been adequately dealt with. This therefore leaves a knowledge gap in this area- the basis of this study. This research therefore has the main objective of investigating on causes of low tax compliance among small and medium enterprises (SMEs) in Uasin-Gishu. The question to be addressed should be; what are the causes of low tax compliance among small and medium enterprises (SMEs) in Uasin-Gishu County? The research hypotheses are that there are other factors more important than high tax rates that influence SMEs' failure to pay tax in Kenya. High tax rate is the most crucial factor influencing SMEs' failure to pay tax in Kenya.

1.3 Objectives of the Study

The objectives of the study were:

i) To investigate on the causes of low tax compliance among small and medium enterprises (SMEs) in Uasin-Gishu.

ii) To find out the influence of Tax payers' attitude and behavior on low tax compliance among SMEs in Uasin-Gishu.

iii) To identify the chief motivator for tax compliance among SMEs in Uasin-Gishu.

iv) To examine the impact of low compliance culture on low tax compliance among SMEs in Uasin-Gishu.

v) To find out the impact of bureaucracy and corruption on low tax compliance among SMEs in Uasin-Gishu.

vi) To analyze how compliance costs correlate with tax compliance behaviors of SMEs

vii) To establish the impact of the use of family and unpaid labor on low tax compliance among SMEs in Uasin-Gishu.

viii)   To find out whether a large informal sector has an impact on low tax compliance among SMEs in Uasin-Gishu.

1.4 Importance of the Study

It is hoped that the findings of this study shall be significant to various groups, among them, KRA who will be able to have information that will guide it to improve on tax compliance mechanisms among SMEs; because the goal of tax administration is to foster voluntary tax compliance (Silvani, 1992).It should enable KRA champion its literacy campaigns to improve the taxpayers' ability to understand tax laws for example rates of tax, filing and paying dates etc.

The government will be able to understand the structural requirements and legislation needed to improve the necessary infrastructure to support SMEs. It will help the government demystify that tax is not a punishment to its people but an obligation.

This study will provide useful information to SMEs on the causes of low tax compliance and how they can help eradicate this problem and help the government improve on its collection. The study should also make the taxpayer feel and

understand that they are not paying unfair share of tax. They should work to improve peer attitude i.e. belief that neighbours are reporting and paying tax honestly.

Researchers will find the findings of this study important as it will act a reservoir of knowledge for further research

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter covers various sections. Section 2.2 captures the theoretical literature, while section 2.3 deals with the empirical literature. Section 2.4 highlights the factors determining tax compliance and section 2.5 captures the summary of the chapter.

2.2 Theoretical Literature review

Most large companies have their roots in small and medium enterprises suggesting that the future large corporations are the SMEs of today that that must be nurtured to ensure their growth. Thus, SMEs are generally perceived to be the seedbed for indigenous entrepreneurship and generate all the many small investments, which would otherwise not have taken place (Aryeetey & Ahene, 2004). Therefore, developing economies like Kenya needs to further the development of its private sector by creating an environment favorable to the growth of SMEs, strengthening the factors that lead to business success, and addressing the problems threatening the existence and advancement of small and medium enterprises, so they can adequately play the role expected of them in economic transformation. Such role includes mobilization of domestic savings for investment, appreciable contribution to gross domestic product, increased harnessing of local raw materials, employment generation, and significant contribution of poverty reduction efforts through

sustainable livelihoods and enhancement in personnel income, technological development and export diversification (Smatrakalev, 2006).

Furthermore, they have the advantage of reaching the farthest corners of the country unlike the larger establishments. For this reason, an ideal tax policy needs to be adopted in order to ensure voluntary compliance, economic growth and proper utilization of resources rather than suffocating the entrepreneur initiative they are out to cater for. It is a well known fact that the revenue generated from the taxation of individuals and businesses is an important stream of income for government. In an economy like ours that is struggling to remain afloat, it is even more important. Tax revenue is the source of funds used for development projects such as provision of infrastructure like good roads, stable power supply, stable water supply etc. All of which combine to create an enabling environment for businesses and in turn the economy at large- to grow. Small and Medium Enterprises being profit generating establishments are also expected to pay their dues. The important question however is how much tax should they be levied. Small and medium enterprises are volatile establishments that need special treatment. Putting their nature into consideration, every little resource at their disposal can make a world of difference. For this reason, a number of Kenyan SMEs choose to remain in the informal sector because they feel the cost of compliance is too high. And a considerable number of those who pay only do so because they are coerced by the authorities (Chu, Kara & Benzing, 2008).

Since the individual SME pays a very small amount of tax compared what the larger establishment would pay, tax authorities tend give the larger corporations more attention. This means a good number of SMEs get away with not paying their taxes hence revenue that would otherwise have been invested in development projects that will end up being of benefit even to the SMEs is lost. This therefore is a situation that needs to be corrected. The above brings to light reasons why the issue of taxation of SMEs is really important. First, tax provides revenue for the government to create an environment that will ease the running of all businesses SMEs inclusive.

At the same time if an SME is faced with high compliance costs, it has a tendency to avoid paying taxes hence; the revenue that would have been used to create this environment is diminished thereby reducing the SME's chances of survival.

2.2.1 Theories of Tax Compliance

Various opinions exist about the best ways to improve tax compliance. Given the chance, a lot of businesses will not pay taxes unless there is a motivation to do so. Some believe that the best way is to increase incentives (Feld & Frey, 2007) others believe the best way is to increase penalties. Tax compliance theories can be broadly classified into two. They are economics based theories and psychology based theories.

2.2.1.1 Theory of planned behavior

Theory of planned behavior is an important theory which presents within the scope of the social psychology and tries to explain human behaviors. This theory was

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

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

Subjective norm refers to the opinions of the other individuals who are important for individuals that will perform the behavior or are taken as reference as regards to this behavior. Finally, perceived behavior control specifies the difficulty level of the

performance displayed by an individual. This element can sometimes affect the behavior directly. For example, in case the behavior control does not depend on the desire of the individual, in other words, if there is any legal sanction, perceived behavior control can affect the behavior directly. As a conclusion, the Theory of Planned Behavior posits that individuals' intentions, together with their perceived control over the behavior determine whether or not they will actually engage in the behavior.

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

2.2.1.2 Theory of Crime

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

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

2.2.1.3 Economic Based Theories

They are also known as deterrence theory and they place emphasis on incentives. The theory suggests that taxpayers are moral utility maximizers. They are influenced by economic motives such as profit maximization and probability of detection. As such they analyze alternative compliance paths for instance whether or not to evade tax, the likelihood of being detected and the resulting repercussions and then select the alternative that maximizes their expected gains after tax returns and after adjusting for risk. This process is referred to as "playing the audit lottery" by Trivedi and Shehata (2005).

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Therefore according to the theory, in order to improve compliance, audits and penalties for non-compliance should be increased. Economic Based Theories asserts that the means of strengthening and growing the local economy is to develop and enhance the basic sector. The basic sector is therefore identified as the engine of the local economy. The economic base technique is based on a simple causal model that assumes that the basic sector is the prime cause of local economic growth, that it is the economic base of the local economy.

2.2.1.4 Psychology Theories

Psychology theories on the other hand posit that taxpayers are influenced to comply with their tax obligations by psychological factors. They focus on the taxpayers' morals and ethics. The theories suggest that a taxpayer may comply even when the probability of detection is low. As opposed to the economic theories that emphasize increased audits and penalties as solutions to compliance issues, psychology theories lay emphasis on changing individual attitudes towards tax systems.

2.2.2 Characteristics of Small and Medium Enterprises

The concept of SMEs is relative and dynamic. SMEs are characterized by uncertainty, innovation and evolution. A firm understanding of SMEs would require a good knowledge of its features. SMEs are usually small, owner or family managed business offering basic goods and services, which tend to lack organizational and management structures with the urban ones tending to be more structural than their rural counterparts. This is one of the most generic features of SMEs. They are mostly sole

proprietorships or partnerships although on the surface, they may be registered as Limited Liability Companies as such they are usually not separate legal entities. The ownership style has led small and medium enterprises to have a simple management structure. Factors also contributing to the reasons small and medium enterprises have a simple management structure are few number of employees and the owners' low level of education. Since there is no legal personality between the small and medium enterprise and its owners, it means the lifespan of the enterprise is dependent on the lifespan of its owners for example there is no perpetual continuity (Olorunshola, 2003).

Furthermore, according to Hanefah, Ariff, & Kasipillai (2002), the production processes of SMEs are usually labour intensive and they usually serve as suppliers for the larger manufacturing firms with their operations being highly dependent on raw materials sourced locally. They also require a lower startup capital than the larger companies. The decisions of the managers have a higher tendency to be subjective given that they are managed and controlled by the same individual. The employee-employer relationship found in most SMEs is predominantly informal. Another key feature of the SME sector in any country is that it is heterogeneous varying in size from small retail outlets to highly paid professionals, and substantial manufacturing enterprises. SMEs are also likely to vary in organizational form from sole proprietorships with or without employees, small corporations public or private, professionals and partnerships. This feature usually results in different obligations for record keeping for the enterprise.

In addition, the contributions SMEs usually make to tax revenue are lower than its contributions to output and employment (International Tax Dialogue, 2007). That fact notwithstanding, SMEs have not become competitive enough to increase their share of output even though they form three-fifths of the number of manufacturing firms where larger manufacturing companies rely on SMEs for their supplies (Hanukah et. al, 2002). SMEs are thought to be engine room of innovation this is because entrepreneurial activities such as innovation, risk bearing, employment creation, finding new opportunities and the commercialization of their inventions have been contributed to the prosperity in all regions of the world therefore, any country wishing to remain innovative will support SME growth because they also enhance competition and entrepreneurship and hence have external benefits on economy-wide efficiency, and aggregate productivity growth. Furthermore, SME proponents frequently claim that SMEs are more productive than large firms but financial market and other institutional failures impede SME development. Thus, pending financial and institutional improvements, direct government financial support to SMEs can boost economic growth and development (Demirguc-Kunt & Levine, 2005).

SMEs foster economic growth through innovation by stating that during the economic globalization period and under fierce competition conditions, the research and development activities of small and medium-sized enterprises play an irreplaceable role in promoting technology innovation and national economic development because of their adaptive ability in market, flexible operation mechanism as well as innovation spirit. As a result of this, they can adapt to new situations more easily than large

corporations. Innovation is also critical for getting new ideas into the economy (Hendy, 2003). Small and Medium Enterprises serve as links between the large business enterprise and the consumers as such, large enterprises can hardly survive without them. Therefore, the importance of small business enterprises cannot be over emphasized. Small business enterprises make a larger contribution pro rata in the economy and with efficient control and management techniques of SMEs the benefit it gives can be much greater. Small and medium scale enterprises according to Akinsulire (2010) accelerate rural development while decreasing urban immigration and the problems of congestion in large cities because they have lesser competition by serving dispersed local markets, are closer to their resources and are cheaper to establish in the urban areas entrepreneurs are attracted to invest thus discouraging rural-urban migration and making for an even development. SMEs also contribute to domestic capital formation, play a value-adding role, mobilize private savings and harness them for productive purposes.

Kilby (1969) sees SMEs as a quasi sponge for urban employment and a provider of inexpensive consumer goods with little or no import content, serving an important pressure-releasing and welfare-augmenting function. SMEs also contribute to long-run industrial growth by producing an increasing number of firms that grow up and out of the small-scale sector. The emergence of wholly modern small/medium-scale Kenyan industries is likely to be a prerequisite for any enduring industrialization. Other contributions made by SMEs to the economy according to Hendy (2003) include being able to remain profitable even in turbulent conditions because they are

accustomed to operating in highly fragmented and heterogenous markets. Also, they often serve a special role in creating social capital that is, they are often 'entrenched in local communities another advantage is that because they are fast and flexible, and close to their customers, they can be a competitive spur to large firms. Output growth; they perform important sub-contract functions; they can perform an important import substitution role, while others are exporters.

2.2.3 Taxation of SMEs

Fiscal policy is one of the main components of macroeconomic policy and its tasks have been considered in a double context: first, the core of fiscal policy, and second, the consistency with the monetary policy (Holban, 2007). In general terms, the choice of tax policy to employ depends on the use of one or both two groups of instruments; the first one being the use of special tax preferences and the other incentives to support start-up and growth of small companies. The incentives include the lowering of corporate income tax rates, special tax exemptions and relieves for small businesses. The fundamental purpose of taxation is to raise revenue effectively, through measures that suit each country's circumstances and administrative capacity. In fulfilling the revenue function, a well designed tax system should be efficient in minimizing the distortionary impact on resource allocation, and equitable in its impact on different groups in society (Bolnick, 2004).

It is important that the country's situation is properly analyzed before employing any tax policy in order to have a properly working tax system. Many of the difficulties

with the tax authorities are the consequence of poorly conceived tax policies and a lack of certainty regarding future policy changes. The objective of a tax policy should be to achieve collection cost savings while minimizing the revenue loss, disruption to the economy, and the inequity and capriciousness of the tax burden. For an economy such as Kenya that is still in the throes of a recession, the tax regime must be versatile enough to encourage savings, stimulate investment and reward social responsibility and research funding. To widen the tax net, policy makers must never forget the urgency to provide infrastructure; create jobs and reduce unemployment; expand the productive sectors of the economy; stimulate exports, and substantially raise public revenues from non-oil sources (Punch, 2010).

Hence, tax policies should aim at bringing all taxable adults into the tax net with a graduated rate that should ensure that the well-off pay their own share while the low income earners are given savings-enhancing incentives. An effective and efficient tax administration system is integral to any country's well being. Tax administration must provide an even playing field for business by ensuring that all taxpayers meet their tax filing and paying requirements. The tax administration must balance its educational and assistance role with its enforcement role. The rationale behind the whole system of tax is consistent with two of the three major theories of tax namely; the Ability-to-Pay Principle and the Equal Distribution Principle. These two principles stress equality and fairness. While the Ability-to-Pay talks pushes that individuals should be levied taxes based on their ability to pay, the Equal distribution Principle suggests that income, wealth, and transaction should be taxed at a fixed

percentage; that is, people who earn more and buy more should pay more taxes, but will not pay a higher rate of taxes (Baurer, 2005).

2.2.4 Tax Compliance and SMEs

According to Marti (2010) tax compliance is a complex term to define. Simply put, tax compliance refers to fulfilling all tax obligations as specified by the law freely and completely.

It has been found that regulatory burdens fall disproportionately on small and medium enterprises internationally. Their size and nature makes the issue of tax compliance one of particular importance especially since most SMEs have access to limited resources and inadequate expertise to comply with diverse and complicated regulation. High compliance costs can result in tax avoidance, tax fraud, and inhibit investment by way of diminishing competitiveness of the country in terms of taxation attractiveness (Pope & Abdul-Jabbar, 2008). Tax non-compliance may be in one of many forms; it could either be failure to submit a tax return within the stipulated period or non submission, understatement of income, overstatement of deductions, failure to pay assessed taxes by due date and in some cases non-compliance may mean an outright failure to pay levied taxes (Kasipillai & Abdul Jabbar, 2006).

Studies have shown that the problem of tax evasion is a widespread one (Kasipillai & Abdul Jabbar, 2006). Furthermore, Fagbemi, Uadile & Noah (2010) found that it is prevalent in developing countries and it hinders development thereby leading to economic stagnation and other socio-economic problems. Chipeta (2002) identified

tax rates as one of the causes of tax evasion. He pointed out that a higher tax rate increases taxpayers' burden and reduces their disposable income therefore, the probability of evading tax is higher.

Small taxpayers under the regular system of taxation are discriminated against, since the compliance requirements, cost of compliance and tax rate are the same for both small and large enterprises. Reducing the compliance costs and tax rate increases the small enterprises profit margin. It also increases the Government's tax revenue, since the simplified provisions for small and medium enterprises reduce the size of the informal economy and the number of non-complying registered taxpayers (Vasak, 2008).

Furthermore, SMEs usually have to operate in an overbearing regulatory environment with the plethora of regulatory agencies, multiple taxes, cumbersome importation procedure and high port charges that constantly exert serious burden on their operations. An overly complex regulatory system and tax regime or one opaque in its administration and enforcement makes tax compliance unduly burdensome and often have a distortionary effect on the development of SMEs as they are tempted to morph into forms that offer a lower tax burden or no tax burden at all (Masato, 2009), and this results in a tax system that imposes high expenses on the society. A poorly executed tax system also leads to low efficiency, high collection charges, waste of time for taxpayers and the staff, and the low amounts of received taxes and the deviation of optimum allocation of resources (Farzbod, 2000). Existing empirical

evidence clearly indicates that small and medium sized businesses are affected disproportionately by these costs: when scaled by sales or assets, the compliance costs of SMEs are higher than for large businesses (Weichenrieder, 2007).

2.3 Empirical Literature

Spicer and Lundstedt (1976) pointed out that also self-employed taxpayers have more possibilities to avoid taxes than employed taxpayers. However, self-employed taxpayers have also more opportunities for tax evasion and opportunities might further increase with the number of different income sources. Hence, in compliance decisions the level of income might interact with its source. A different aspect of the income source if income was earned by hard work or an effortless job - has been studied in experiments by Kirchler, Muehlbacher, Holzl, and Webley. Participants were less compliant when they reported income earned by low effort than when they reported hard-earned income. It seems that taxpayers are reluctant to lose their hard-earned money by "gambling" with tax authorities.

The importance of how one's economic status is perceived was demonstrated by Vogel (1974). Taxpayers who reported improvement of their economic status were less compliant than others who reported deterioration of their financial well-being. A positive relation of SMEs income and tax compliance also found empirical support. Other studies found no relation of income level and tax compliance. Self-reported compliance behavior was not related to income among Swedish taxpayers (Warneryd & Walerud, 1982) and American (Porcano, 1988). Collins and Plumlee (1991) also

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found decreased compliance among participants with higher income. Fishlow and Friedman (1994) found decreased compliance at low income-level SMEs in archival-empirical data from Argentina, Brazil and Chile, three countries with low economic growth and high inflation rates.

A negative relation of income earned by SMEs and tax compliance is reported by Slemrod (1985), who analyzed archival data from the United States' Treasury tax file for 1977. Consistently, Weck-Hannemann and Pommerehne (1989) found lower compliance among high income earning SMEs in archival data on Swiss taxpayers. Baldry (1987) manipulated participant SMEs income (among other variables) and found lower compliance at higher income-levels.

To summarize, most empirical studies on the impact of tax rates support the assumption that high tax burdens have negative impact on compliance. However, the strong connection of income and tax rate makes final conclusions difficult (Andreoni, Erard, & Feinstein, 1998; Slemrod, 1985). In experimental studies it is hard to separate the effects of tax rates and income, if both variables are varied at the same time.

2.4 Factors Determining Tax Compliance

There are various factors determining tax compliance. In order to develop methods and instruments for fighting tax evasion and avoidance, it is important to foremost establish a broad understanding of the different reasons underlying these problems.

2.4.1 Bureaucracy and Corruption

Lack of transparency and accountability in the use of public funds contributes to public distrust both with respect to the tax system as well as the government. This, in turn, increases the willingness to evade taxes. If due to high levels of corruption, citizens cannot be certain whether their paid taxes are used to finance public goods and services their willingness to pay suffers and it becomes more likely that they evade their tax liabilities. A taxpayer might consider evading taxes if the cost of bribing a tax auditor is lower than the potential benefit from tax evasion. Strong fiscal courts are essential to protect taxpayer's rights and safeguard them from arbitrariness. If the legal system does not operate in accordance with the rule of law, citizens have to fear arbitrariness, discrimination, unequal attendance in court. The lack of rule of law reduces transparency of public action and fosters distrust among citizens.

As a result, citizens may not be willing to finance the state through taxes, and decide to evade these liabilities (Kirchler et al., 2007).

Often, tax administration and collection by ministries of finance are considered inefficient and suffering from corruption and high compliance costs. Therefore the creation of semi autonomous revenue authorities has been pursued in many developing countries mostly as part of comprehensive tax administration reforms. Additionally, unclear responsibilities regarding the collection and administration of specific types of taxes by different institutions can lead to inefficiencies and tax losses and require a reorganization of the tax administration (Moore, 2009).

2.4.2 Perception on Government Spending

Tax compliance is proposed to be studied based on a psychological tax contract representing "a complicated interaction between taxpayers and the government in establishing a fair and reciprocal exchange" Feld & Frey, (2007). The existence and survival of this tax contract is apparent in a number of circumstances in prior studies. For example, if taxes paid and public services provided by government are regarded as equitable, taxpayers may be inclined to comply with tax laws and this has a significant positive effect on tax compliance e.g. Feld & Frey, (2006) Torgler et al.,(2008). The taxpayers indeed are willing to pay taxes even though they were not given the exact value of public goods, as compared to the taxes they have paid, if they perceived the political process as fair and lawful (Feld & Frey, 2007).

As shown in many studies, the involvement of taxpayers in a political process has a positive influence on tax compliance and taxpayers with direct democratic rights are found to be more compliant (e.g. Pommerehne, Hart, & Frey, 1994; Torgler, 2005; Torgler & Schneider, 2007).

The reverse is evident in transition countries such as Russia, Belarus or Latvia after the collapse of communism because of the 'institutional crisis', where the citizens' tax morale is lower, compared to non-transition countries such as Bulgaria and Croatia (Frey & Torgler, 2007). Tax compliance is also influenced substantially by trust in government and legal systems (e.g. Frey,2003; Torgler, 2003b) and this trust can only be gained if the government can assure that taxpayers' expectations are fulfilled (Hardin, 1998). The taxpayers' opinion on the tax system either as a fair or

an unfair system, is also identified as influencing tax compliance behavior, as apparent in a number of research studies (e.g. Alm, Jackson, & McKee, 1993; Murphy, 2003). Overall, voluntary tax compliance may be increased if government achieves a policy exchange approach as promised to its citizens.

2.4.3 Tax payers' Attitude and Behaviour

Taxpayers' willingness to pay taxes differs widely across the world. It cannot be viewed as simply depending on the tax burden. Rather, empirical research indicates that taxpayers throughout the world pay more taxes than can be explained by even the highest feasible levels of auditing, penalties and risk aversion (Alm et al.,2007). These high levels of tax compliance result from the tax morale of society that fosters self-enforcement of tax compliance. Tax morale, attitude and behaviour is, however, not easy to establish. Especially countries without a deep-rooted 'culture' and habit of paying taxes find it difficult to establish tax morale. This willingness to pay" of the taxpayer is influenced by the following factors: In general, citizens expect some kind of service or benefit in return for the taxes paid. If the government fails to provide basic public goods and services o provides them insufficiently, citizens may not be willing to pay taxes and tax evasion and avoidance will be the consequence (Brautigam et al., 2008).

Some studies suggest that high tax rates foster evasion. The intuition is that high tax rates increase the tax burden and, hence, lower the disposable income of the taxpayer (Chipeta, 2002). However, the level of the tax rate may not be the only factor

influencing people's decision about paying taxes. In fact, the structure of the overall

tax system has an impact as well. If, for example, the tax rate on corporate profits is

relatively low, but individuals are facing a high tax rate on their personal income,

they may perceive their personal tax burden as unfair and choose to declare only a

part of their income. Similarly, large companies can often more easily take advantage

of tax loopholes, thereby contributing to the perceived unfairness of the system. Tax

rates and the overall structure of the tax system, therefore, have a significant effect on

the disposition to evade and avoid taxes.

2.4.4 Low Compliance Culture

Ethnicities have been equated to cultural groups with a set of shared values, beliefs,

and norms to solve basic human problems (Basu & Altinay, 2002). An ethnic group

has been defined as a collectivity within a larger society having real or putative

common ancestry, memories of shared historical past (Basu, 2006). An ethnic

business is a business having a set of connections and regular patterns of interaction

among people sharing common national background or migratory experiences

(Aldrich & Waldinger, 1990). SMEs are the dominant form of organizations in most

countries including Kenya (IFC & The World Bank, 2010; OECD, 2004). The

government including those from New Zealand recognizes the important economic

contributions SMEs make towards production and employment (Australian Bureau of

Statistics, 2004; Commerce Committee, 1998; Small Business Advisory Group,

2006). As at February 2008, Kenya SMEs provided 40 percent of all employment in

the country (Ministry of Labour, 2009) and 58 percent of all total value-added output

amounting to Ksh. 48,508 million (Ministry of Industrialization, 2009). The juxtaposition of these statistics highlights the important role SMEs play in terms of the dynamics of the larger economy. Most SMEs in Kenya are concentrated in the larger cities such as Nairobi Eldoret and Mombasa.

Taxation issues are pervasive to SME operators as they affect decisions such as business structures, wages paid, charitable contributions made, and profits declared for the period. Taxation issues are one of their main concerns (Massey & Quin, 2001) and business failures have been associated with poor record keeping for taxation purposes (Prescott & Hooper, 2009). Most tax research on SMEs thus far have not considered the interface of culture (caused by ethnicity) and their tax compliance behaviours and attitudes. However, the study of culture is important as the efficacy with which a culture equips a people to deal with situations it faces is seldom explored, yet it is one of the most important determinants of advantage and disadvantage (Crocombe, 2008).Though the study of ethnicity is considered an emerging issue in tax compliance research (Birch et al., 2003), this research limits the study of ethnicity to SME taxpayers. SME taxpayers are different from other taxpayers as they have regressive tax compliance costs (Hasseldine, 1995); have lower compliance statistics compared to other taxpayers (Giles & Caragata, 1999; Smith & Kinsey, 1987); are tax collectors on behalf of the government for employment and value added taxes (Joulfaian & Rider, 1998); and they have more opportunities to participate in the cash economy (Kirchler, 2007; Noble, 2000). SME

taxpayers are culturally homogeneous in terms of discharging their tax compliance obligations whilst regulated by tax regime.

2.4.5 Large Informal Sector

There exist several circumstances that restrain tax administrations from performing their functions properly thereby increasing the possibility of tax evasion. Shortfalls in tax collection procedures as well as weak capacities of tax administrations to detect and prosecute tax violators are both factors that contribute to a low enforcement of tax legislation. Regarding tax collection, many developing countries face difficulties with respect to important premises for a well functioning tax administration, especially with respect to identifying and administering those citizens and firms that are liable to tax payments due to the fact that the SMEs are a large and an informal sector. Although there has been progress, tax administrations' capacity to introduce and sustain e.g. well-functioning tax registers still pose severe difficulties in many developing countries. Problems of insufficient capacity may also occur due to the organizational set up of the tax administration and its relationship to the ministry of finance. In general, there are two approaches for the organizational set up of tax administration (The World Bank, World Development Indicator, 2008).

2.4.6 Simplicity of Tax Returns

This means the ability of tax payer to understand tax laws. The criteria calls for a tax system which is simple enough to enable the payer to compute his own liability, to avoid administrative difficulties associated with determining the taxable income and

the tax liability. A simple tax per head for all organizations would for example comply with this criterion.

2.4.7 Use of Family and Unpaid Labor

A well-functioning body of tax investigation is essential for the detection and prosecution of cases of tax fraud. The lack of sufficient capacities in tax administrations and the use of family and unpaid labor by SMEs reduce the probability of detection that again influences the decision of a taxpayer as to whether evade or not. Additionally, the legal framework is an important prerequisite for any enforcement activity. For example, the size and nature of penalties that are incurred after evasion has been detected is directly connected to the level of tax compliance (Fishlow & Friedman, 1994).

Finally, tax laws and changes in the workforce in many countries, especially in developing countries, changes rapidly, thus producing instability and low transparency of the tax code. As a result, complicated tax legislation and ongoing changes of the tax code confuse tax administrators and taxpayers alike. This produces ample opportunity for tax avoidance and non compliance. Furthermore, it results in tax evasion which is not intentional, but occurs due to lack of knowledge ignorance. In extreme cases, tax evasion and avoidance even become inevitable when the tax system becomes too complex and/or contradictory to follow (Mo, 2003).

2.5 Summary

A country's tax administration is one of the few public sector organizations which touches the lives of a country's citizens and businesses on a daily basis and, arguably has the greatest impact on their livelihood. Tax administration employees are amongst the most frequently contacted government officials and often represent to the public what is right or wrong about their government. The responsiveness, integrity, and quality of tax administration staff must therefore meet a very high standard. Revenue collected from taxes along with customs collections represents the major funding source for governmental expenditures. An effective and efficient tax administration system is integral to any country's well being. The proper amount of tax must be collected in a timely manner and the enforcement powers of the tax administration must be applied judiciously and in an even handed fashion. The tax administration must provide an even playing field for business by ensuring that all taxpayers meet their tax filing and paying requirements. This requires significant efforts to deal with the underground economy and to, therefore, increase the tax base. Failure to bring business activity from the shadow economy into the tax system puts compliant taxpayers at a competitive disadvantage, and ultimately leads to an erosion of the tax base. The tax administration must balance its educational and assistance role with its enforcement role. The overriding goal is to foster voluntary compliance with the tax laws. This represents a significant challenge in a developing economy.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter contains various sections. Section 3.2 deals with the research design, while section 3.3 highlights population and sample. It also includes section 3.4 that deals with data collection instruments. Section 3.5 covers data analysis and presentation.

3.2 Research Design

The study utilized a descriptive survey design of all the SMEs in Uasin-Gishu. Descriptive survey design was a research design involved in either identifying the characteristics of an observed phenomenon or exploring possible correlations among two or more phenomena. It was a survey of the causes of low tax compliance among small and medium enterprises in Uasin-Gishu. The main aim of a survey is to provide detailed data for the entire population under investigation. A survey gives a description of some pertinent characteristics of the population as well as allow for inferences of cause and effect. A survey focuses on a set of firms thus the SMEs in Uasin-Gishu as per this study.

Survey designs are of particularly of great value for instance when one is seeking help on identifying causes of low tax compliance among SMEs in Eldoret and in which case it is difficult to understand the individual causes that have led to the same

without considering the relationships with each other (Cooper & Schindler, 2000). A descriptive survey design thus, enable the researcher to collect in depth data on the population being studied and allowed the researcher to be more focused in giving specific and relevant recommendations.

3.3 Population and Sample

The population of the study consisted of all the SMEs in Uasin-Gishu County. A total of 250 SMEs in Uasin-Gishu County were targeted for this study. The reason for selecting the Uasin-Gishu County was its proximity to the research and Home County to the researcher. The sample for this study was drawn from all the SMEs in Uasin-Gishu County.

Every fifth firm from each of the stratum key sectors of Agriculture, manufacturing, Transport, Tourism, and Telecommunications was picked to form the sample population. The study used stratified sampling technique where firms were sampled in groups of five in every key sector. Every fifth firm in every cluster was selected and information gathered on the same firms. The study therefore had 138 companies which formed the sample frame. This sampling method was necessary to reduce the average cost of the questionnaire and it gives more accurate results owing to the kind of research being carried out. Purposeful sampling was used to select the respondents to the questionnaire. A total of 53 finance managers, 1 manager each from each of the firms were selected purposely to provide adequate responses to causes of low tax

compliance. These managers were chosen because they are professionally qualified to provide correct responses to the questionnaire.

The formula used to arrive at the sample was:

N/kith:

Where; N= total number of companies in any given sector

kith item = Every fifth firm selected in succession from N to form the sample

e.g. in Agriculture the sample size was 90 firms divided by 5 = 18 firms

Therefore; the sample size that was used for this study was as illustrated in table:

Table 3.1: Sampling Design

Sector	Population (N)	Kith Item (Every 5th item of N
Agriculture	90	18
Manufacturing	50	10
Telecommunications	60	12
Transport	50	10
Tourism	15	3
Total	**265**	**53**

Source: Author (2012)

3.4 Data Collection Instruments

Methods of data collection that were used involve both primary and secondary data. Primary data was derived from questionnaires distributed to those targeted in this study. The questionnaires had closed-ended questions and covered all the issues relating to the causes of low tax compliance among SMEs in Uasin-Gishu County.

The researcher personally administered the questionnaires to the respondents 53 finance managers, 1 from each of the sampled sectors, purposefully selected were asked to fill the questionnaires. Secondary data was gathered from library material, tax compliance and non-compliance journals and reports, media publications and various Internet search engines covering the causes of low tax compliance among SMEs in Uasin-Gishu County.

3.5 Data Analysis and Presentation

The data collected was analyzed using descriptive statistics, correlations, and linear regression analysis. This was achieved through the use of statistical packages for social scientist (SPSS) and MS Excel to generate frequency distributions and percentages to assist in answering the research questions. The analysis sought to answer research questions and explain the nature and strength of associations between the dependent and independent variables.

While descriptive statistics was used to meaningfully describe measurement using statistics. The output was presented in form of tables and figures and Multivariate regression analysis resulted in a prediction equation that describes the relationship between the dependent variables and independent variables (Gujarati, 2000).

3.5.1 Conceptual Model

Y= f(x1, x2, x3, x4, x5)

$$(1)$$

Where y is the tax compliance level;

And xs are the independent variables i.e

X1 –tax payers` attitude and behavior-this is the willingness of the taxpayer to be tax

complaint

X2- Low compliance culture- taxpayers are culturally homogeneous in terms of

discharging their tax compliance obligations

X3-Bureaucracy and corruption by tax administrators has determines levels of tax

compliance

X4-Size of the SMEs informal sector

X5- Use of family and unpaid labour where taxes go for unaccounted.

n- is the total number of variables in the study

3.5.2 Analytical Model

The analytical model for this study is as explained below;

$Y= \beta_0 + \beta_{ij} X_{ij} + \epsilon$

Where

Y   -dependent variable- value of the firm

β_0 -is the constant (y intercept)

X_{ij} -measure of independent variable i for company j

B_{ij} -regression coefficient i for variable j

ϵ -the stochastic error term

In relation to the objectives of the study the researcher used STATA to estimate the following multivariate regression analysis:

$$T0 = \beta 0 + \beta^1 x^1 + \beta^2 x^2 + \beta^3 x^3 + \beta^4 x^4 + \beta^5 x^5 + \varepsilon$$

(2)

Where T0: Tax compliance by SMEs.

$\beta 0$ is the intercept; and reflects the constant of the equation.

β^1 is the sensitive coefficient of each independent variable (i=1,2,3,4,5).

ε is the error term.

To the test the model`s significance the study used the T-test of the pre and tax compliance of SMEs in Uasin-Gishu County. These tests were conducted at 95% level of confidence (α=0.05).

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter covers various sections. These include response rate in relation to gender, age bracket of the respondents, category of representative and highest level of educations of the respondents. The chapter also covers the determinants of tax compliance, regression analysis and summary of statistics.

4.2 Response Rate

The study found out that 46 persons responded for the SMEs to the questionnaires representing 86% while 7% of the respondents did not respond to the questionnaires.

4.2.1 Gender

The researcher sought to find out the gender of the persons filling the questionnaire. The findings indicate that majority of the respondents 31 who filled the questionnaires were male representing 67% as opposed to 15 or 33% of them being female. Figure 4.1 below best illustrates these findings.

Figure 4.1 Gender of the Respondents
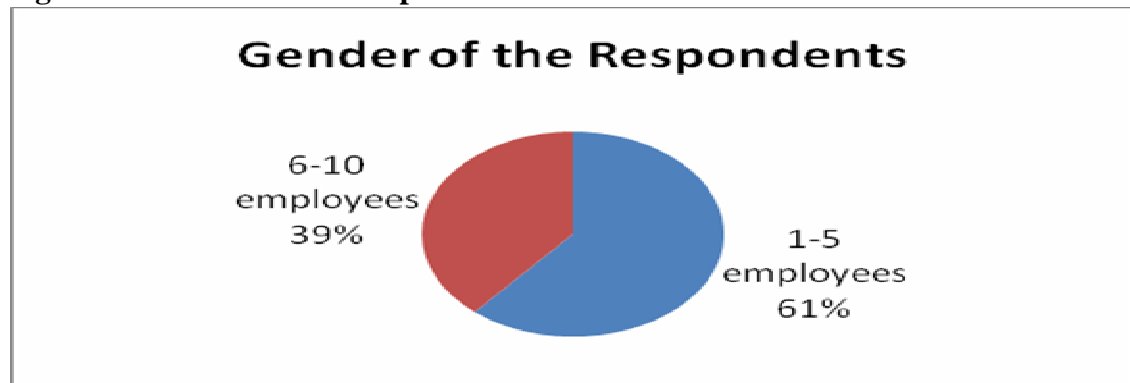
Source: Research Findings

4.2.2 Age Bracket of the Respondents

The researcher was interested in establishing the age bracket of the respondents. The study found out that majority of the respondents was in the age bracket of 40-44 years at 26% followed by those in the age bracket of 35-39 years with 21%. The study findings indicate that 20% of the respondents were in the age bracket of 25-29 years, 15% were in the age bracket of between 30-34 years. Table 4.1 below illustrates these findings.

Table 4.1 Age Bracket of the Respondents

Age Bracket	Frequency	Percentage
19-24 years	3	7
25-29 years	9	20
30-34 years	7	15
35-39 years	10	21
40-44 years	12	26
45 years and above	5	11
TOTAL	**46**	**100**

Source: Research Findings

4.2.3 Category of Representative

The researcher sought to establish the category of representative of the respondents. The findings indicate that majority the respondents 41% were persons directly involved in tax matters, 33% were owners of the enterprise whereas 26% of the respondents were managers of the enterprises.

4.2.4 Highest Level of Educations of the Respondents

The study wanted to find out the highest level of education among the respondents. The findings indicate that 18 of the respondents were college diploma holders, 11 were university degree holders, 10 were college certificate holders in addition 5 were secondary school level holders while 2 of the respondents were primary school level holders. Figure 4.2 below best illustrates the findings.

Figure 4.2 Highest Level of Educations of the Respondents
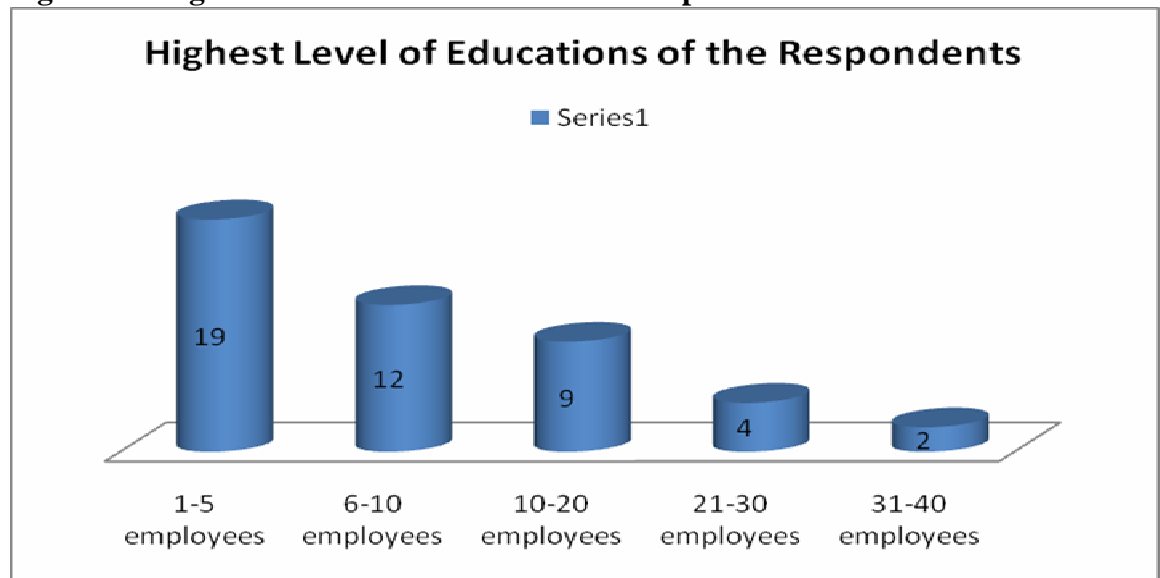
Source: Research Findings

4.2.5 Kind of Business

The study wanted to find out the kind of business that the respondents were carrying out. From the study findings most of the businesses 41% were in the service industry, 35% were in the service industry whereas 24% of the respondents were in the manufacturing industry.

4.2.6 SMEs Duration of Existence

The researcher sought to establish the duration in which the SMEs which responded had been existence. The findings indicate that most 35% of the SMEs had been in operation for a period of 8-15 years, these were followed by those which had been in operation for a period of between 4- 8 years representing 28%. The study findings indicate that 22% of the SMEs had been in operation for a period exceeding 15 years while 15% of the responding SMEs had been in operation for a period between 0-3 years. Figure 4.3 below illustrates these facts further.

Figure 4.3 SMEs Duration of Existence
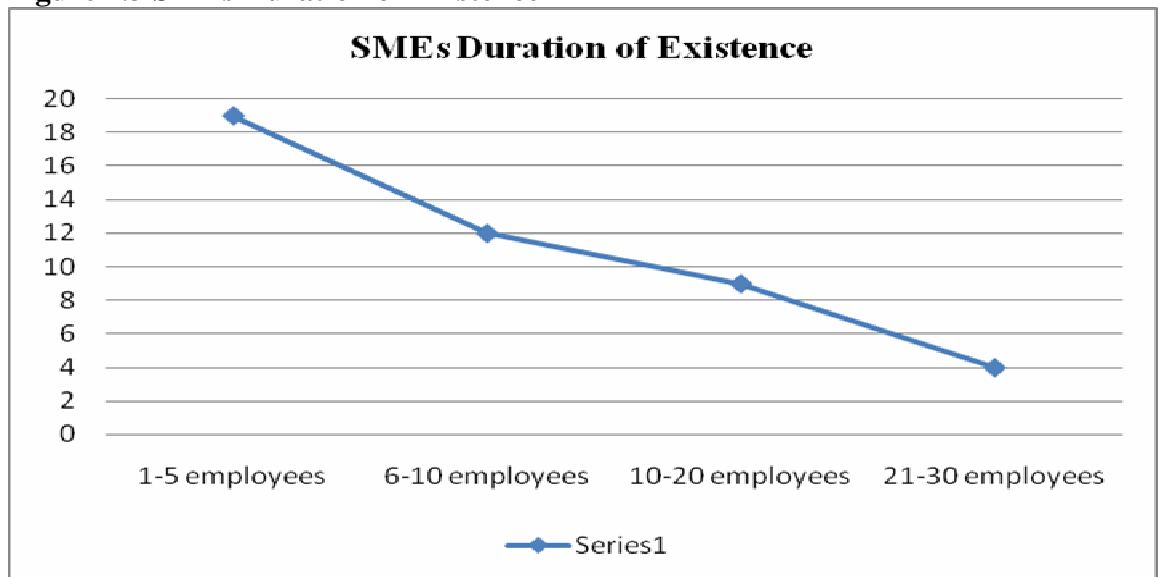
Source: Research Findings

The researcher sought to find out the registration status of the SMEs. The findings indicate that 86% of the respondents indicated that the businesses had formally been registered by the registrar. On the other hand 14% of the respondents indicated that they had not been formally registered by the registrar.

The study wanted to establish the legal form of the business. From the study findings most of the respondents stated that 39% of the SMEs were limited companies, 36% of them were partnership while 25% of them are sole proprietor.

The study sought to find out the number of staff employed in the organizations including the owner of the business. The findings indicate that majority 41% of SMEs which responded had 1-5 staff employed in their organizations followed by organizations with 6-10 employees representing 26%. The findings indicate that 20% of the respondents had 11-20 employees, 9% had 21-30 employees whereas 4% of the SMEs organization had 31-40 employee. Figure 4.4 below illustrates these findings.

Figure 4.4: Staff employed

Source: Research Findings

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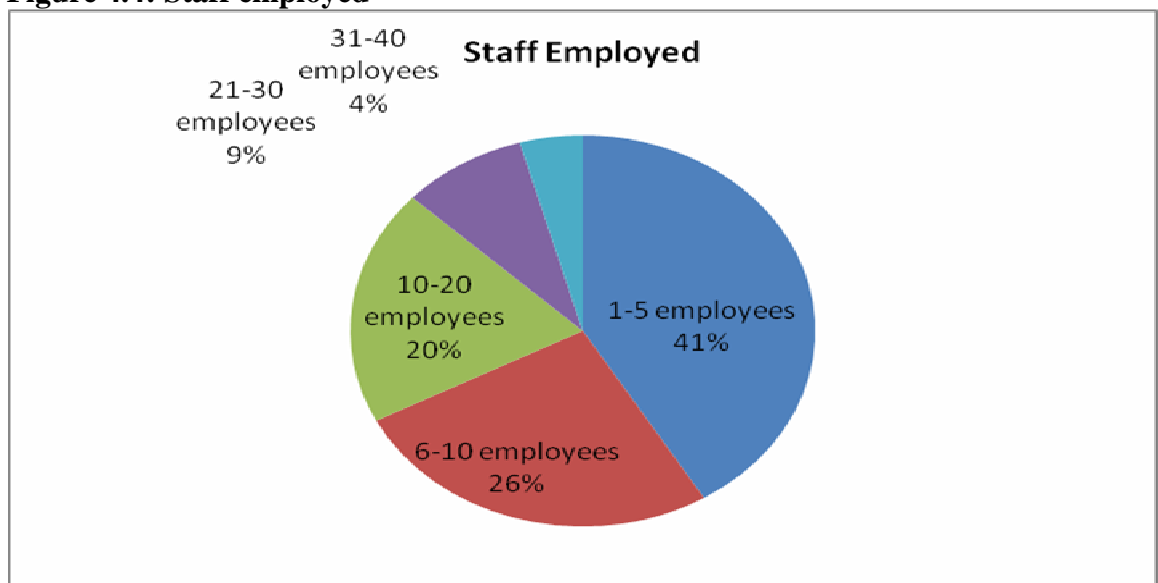
4.3 Determinants of Tax Compliance

The study sought to establish the causes of tax compliance. The respondents were asked whether they thought tax compliance was influenced by any factors and the majority 39 or 85% agreed that there were several factors that can be attributed to tax compliance among SMEs in Uasin-Gishu County. This is as opposed to 7 or 15% of the respondents who thought that tax compliance was not influenced by any factors whatsoever. Those who agreed that tax compliance was influenced by some factors they stated the following as the factors they thought influenced tax compliance. First there was the issue of taxpayers' behavior towards tax system; the tax payers have a negative attitude towards the payment of taxes. Secondly, there was the issue of hostility between the taxpayers and tax collectors. Other factors were outward resistance from taxpayers for example the protest by taxpayers over implementation of Electronic Tax Registers, taxpayers' willingness to pay taxes, the tax morale of society that fosters self-enforcement of tax compliance which did not exist among SMEs.

On the other hand factors such as lack of transparency and accountability in the use of public funds contributes to public distrust both with respect to the tax system as well as the government, shortfalls in tax collection procedures as well as weak capacities of tax administrations to detect and prosecute tax violators are both factors that contribute to a low enforcement of tax legislation which leads to low tax compliance rates.

Also a lack of a well-functioning body of tax investigation which is essential for the detection and prosecution of cases of tax fraud is another determinant of tax compliance. In addition, the lack of sufficient capacities in tax administrations and the use of family and unpaid labor by SMEs reduce the probability of detection that again influences the decision of a taxpayer as to whether evade or not this in most cases leads to low tax compliance.

In addition to the above the findings also indicate that perception on government spending by the tax payers was seen to influence tax compliance, organizational financial constraints was also seen to influence tax compliance. Equally, simplicity of tax return forms and awareness on offences and penalty on those that do not comply with tax payment were to blame for non compliance of tax.

4.3.1 Extent of Influence of Determinants on Tax Compliance

The study sought to establish the extent of influence of the various determinants on tax compliance on a scale of 1-5, 1 being no effect, 2 being the least extent, 3 great extent, 4 greater extent while 5 representing the greatest extent. The findings indicate that the most respondents feel that the extent of tax payers` attitude and behaviour on tax compliance is greater at 25 respondents in number, low compliance culture has a the greatest influence on tax compliance at 30 respondents while bureaucracy and corruption influences tax compliance to most to a greater extent at 28 respondents. On the other hand the size of the SMEs has the least influence on tax compliance at 25 respondents, the use of family and unpaid labour has least influence on tax

compliance while lack of transparency and accountability has the greatest influence on tax compliance. The table 4.2 below best illustrates these facts.

Table 4.2 Extent of Influence of Determinants on Tax Compliance

Factor/Determinant	1-No effect	2- Least extent	3- Great extent	4- Greater extent	5- Greatest extent
Tax payers` attitude and behaviour	5	15	24	25	16
Low compliance culture	10	10	20	25	30
Bureaucracy and corruption	9	17	36	28	14
Size of the SMEs	11	25	10	8	9
Use of family and unpaid labour	12	30	19	9	12
Lack of transparency and accountability	2	8	14	19	32

Source: Author of the study

The study findings indicate that lack of transparency and accountability has the greatest influence on tax compliance followed by low compliance culture and tax payers` attitude and behaviour in the third spot. The determinant with the least influence is the size of the SMEs followed by the use of family and unpaid labour.

Some of the reasons for tax compliance and tax non-compliance as stated by the respondents are as given below. The factors for tax non-compliance among the tax payers were found to be: the inability to understand tax laws i.e. rates of tax, filing and paying dates etc., a feeling that they are not paying a fair share of tax, positive peer attitude for example belief that your neighbours are reporting and paying tax honestly, and rewarding taxpayers such as giving a trophy for being best

tax- payer, and motive for low profits. Some of the factors depending on how they are applied they can facilitate compliance and non- compliance included: avoiding of paying tax fines and penalties; the use of informants by KRA such as report tax evaders, aggressive enforcement efforts by KRA for example ensuring tax audits and prosecutions take place payment of fines and penalties; high degree of being detected for no-payment of tax; high degree of risk aversion for example fear of tax audits; ethics and mobility such as a feeling that tax is an obligation and believing in no corruption; Positive government image for example government is fighting corruption and is achieving tax objectives and harassment from KRA.

4.3.2 Summary of Statistics of the Factors Determining Compliance

The following table 4.3 below is the summary of statistics.

Table 4.3 Summary of Statistics

Variable	Mean	Std	Mode	Median	Skewness	Kurtosis
Tax payers` attitude and behavior	3.10	1.424	2	3.00	1.073	-0.868
Low compliance culture	1.49	0.390	1	1.00	1.312	1.072
Bureaucracy and corruption by tax administrators	2.56	1.367	2	2.00	-0.514	-1.661
Size of the SMEs informal sector	2.71	1.204	3	3.00	-0.564	-0.513
Use of family and unpaid labour	2.26	1.153	2	2.00	0.433	-1.033
Lack of transparency and accountability	2.14	1.052	1	1.00	1.321	1.161

Source: Research Findings

4.4 Regression Analysis Results
Using STATA, the following regression analysis was estimated from the study.

$T0 = \beta 0 + \beta_1 x_1 + \beta_2 x_2 + \beta_3 x_3 + \beta_4 x_4 + \beta_5 x_5 + \varepsilon$

The fitted regression model from the study findings is presented as follows:

T0= 4.146201(0.01511) +3.0026445(0.01413) +0.4270961(0.04113) -

5.016048(0.03124) +6.009067(0.00321) -9.017037(0.00432).

The findings show that the coefficients` *R*-values are given in the parenthesis. In all

the estimated model coefficients, the R-values were less than .05 (i.e. 0.5>R) the

implication of this is that the variables or the determinants tested significantly in this

study influence tax compliance of SMEs in Uasin-Gishu County at 5% significance

level. Also, the findings indicate that the coefficient for tax payers` attitude and

behavior (x_1), low compliance culture (x_2) and the size of the SMEs informal sector

(x_4) are positive, this means that tax payers` attitude and behavior, low compliance

culture and the size of the SMEs informal sector positively relates to tax compliance

for example the higher the (x_1), (x_2) and (x_4), the lower the tax compliance rate

among the SMEs in Uasin-Gishu County and vice versa. The fitted model was

diagnosed and found that the regression was statistically significant at 5%

significance level (regression *R*-value= .05 >. 073414). This shows that the

combination of these factors (explanatory variables) significantly affect the response

variable (tax compliance rates). Further, R-square = 72.624%, implying that the

explanatory variables accounted for 72.624% of the response variable.

The tax payers` attitude and behavior to pay tax influences the extent to which a firm

complies with tax payment requirements. SMEs must be willing to pay tax and their

attitudes and behaviour must be positive if they have to be tax compliant and pay taxes whenever the obligation falls due. In this study period a unit change in tax payers` attitude and behaviour of a firm increased the chances of a tax payment or compliant by 3.0026445 or 30.02 %.

Low compliance culture is another determinant that positively influences tax compliance levels among the SMEs. Taxpayers who are culturally homogeneous in terms of discharging their tax compliance obligations will be more likely to be tax complaint unlike those who lack the compliance culture. The study findings indicate that the chances of SMEs being culturally tax complaint are at 0.4270961 or 42.71%.

All together the influences of explanatory variables captured in the model are significant, and these findings are informative, as they intrigue significant questions regarding determinants of tax compliance in Uasin-Gishu County. With regards to perceptions of bureaucracy and corruption by tax administrators and government spending, those who engage in tax evasion often justify such behavior by suggesting that the government wastes tax revenue and spends unwisely; such arguments can decrease voluntary compliance in the long run (Braithwaite *et. al.* 2009). It is expected that if the government spends taxpayers' money wisely, for example on basic facilities like education, health and safety and public transportation, it is assumed that voluntary compliance will increase. In contrast, if taxpayers perceive that the government spends too much on something else, taxpayers might feel betrayed and attempt to evade. In judging their own behaviour, people tend to believe the cause is due to external attributes and can not be tax compliant. Therefore, the

government should spend taxpayers' money wisely so that tax compliance will increase, thus the tax collection will also increase.

With regard to the influence of the referent group, Allingham and Sandmo (1972) found that influence from family and friends significantly affect tax compliance although the extent of influence was not clearly stated. Spicer and Lundstedt (1976) and Clotfelter (1983) also claimed that referent groups play a significant role in evasion although it was not clearly detailed which was stronger family members or friends. The numbers of evaders known to respondents made the largest contribution to the model of under-reporting income which means that the more respondents know evaders, the more under reporting of income may happen. In line with Spicer and Lundstedt (1976) and Clotfelter (1983), this study also suggests that friends and family members are of significant influence to taxpayers' behaviour. The influence of referent groups tends to be important in tax compliancy, as taxpayers are keen to refer their tax matters to their immediate family members or friends rather than tax experts, in order to minimize their compliance costs. If a taxpayer refers to a compliant taxpayer, then the tendency to commit tax evasion is lower, but if a taxpayer refers to a non-compliant taxpayer, they might become a non-compliant taxpayer as well. Therefore, cultivating personal awareness of compliance is important so that they are less influenced by these factors for example friends and family members' levels of compliance. The regression output showed R-square value of 72.624%. This implies that there could be other factors that contribute to the remaining 27.4% in explaining the variation in tax compliance in Uasin-Gishu County.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter covers various sections including the summary of the study, the conclusion and the limitations of the study. The chapter will also cover recommendations for further research as well as implications for policy and practice.

5.2 Summary of the Study

The objective of the study was to investigate on the causes of low tax compliance among small and medium enterprises (SMEs) in Uasin-Gishu. Majority of the respondents 39 or 85% agreed that there were several factors that can be attributed to tax compliance among SMEs in Uasin-Gishu County. This is as opposed to 7 or 15% of the respondents who thought that tax compliance was not influenced by any factors whatsoever. Those who agreed that tax compliance was influenced by some factors they stated the following as the factors they thought influenced tax compliance. First there was the issue of taxpayers' behavior towards tax system; the tax payers have a negative attitude towards the payment of taxes. Secondly, there was the issue of hostility between the taxpayers and tax collectors. Other factors were outward resistance from taxpayers for example the protest by taxpayers over implementation of Electronic Tax Registers, taxpayers' willingness to pay taxes, the tax morale of society that fosters self-enforcement of tax compliance which did not exist among SMEs.

On the other hand factors such as lack of transparency and accountability in the use of public funds contributes to public distrust both with respect to the tax system as well as the government, shortfalls in tax collection procedures as well as weak capacities of tax administrations to detect and prosecute tax violators are both factors that contribute to a low enforcement of tax legislation which leads to low tax compliance rates.

A lack of a well-functioning body of tax investigation which is essential for the detection and prosecution of cases of tax fraud is another determinant of tax compliance. In addition, the lack of sufficient capacities in tax administrations and the use of family and unpaid labor by SMEs reduce the probability of detection that again influences the decision of a taxpayer as to whether evade or not this in most cases leads to low tax compliance. In addition to the above the findings also indicate that perception on government spending by the tax payers was seen to influence tax compliance, organizational financial constraints was also seen to influence tax compliance. Equally, simplicity of tax return forms and awareness on offences and penalty on those that do not comply with tax payment were to blame for non compliance of tax.

The findings indicate that the most respondents feel that the extent of tax payers` attitude and behaviour on tax compliance is greater at 25 respondents in number, low compliance culture has a the greatest influence on tax compliance at 30 respondents while bureaucracy and corruption influences tax compliance to most to a greater

extent at 28 respondents. On the other hand the size of the SMEs has the least influence on tax compliance at 25 respondents, the use of family and unpaid labour has least influence on tax compliance while lack of transparency and accountability has the greatest influence on tax compliance.

Lack of transparency and accountability has the greatest influence on tax compliance followed by low compliance culture and tax payers` attitude and behaviour in the third spot. The determinant with the least influence is the size of the SMEs followed by the use of family and unpaid labour. Some of the reasons for tax compliance and tax non-compliance as stated by the respondents are as given below. The factors for tax non-compliance among the tax payers were found to be: the inability to understand tax laws i.e. rates of tax, filing and paying dates etc., a feeling that they are not paying a fair share of tax, positive peer attitude for example belief that your neighbours are reporting and paying tax honestly, and rewarding taxpayers such as giving a trophy for being best tax- payer, and motive for low profits.

Some of the factors depending on how they are applied they can facilitate compliance and non- compliance included: avoiding of paying tax fines and penalties; the use of informants by KRA such as report tax evaders, aggressive enforcement efforts by KRA for example ensuring tax audits and prosecutions take place payment of fines and penalties; high degree of being detected for no-payment of tax; high degree of risk aversion for example fear of tax audits; ethics and mobility such as a feeling that tax is an obligation and believing in no corruption;

positive government image for example government is fighting corruption and is achieving tax objectives and harassment from KRA.

The findings indicate that the coefficient for tax payers` attitude and behavior ($x_1$), low compliance culture ($x_2$) and the size of the SMEs informal sector ($x_4$ ) are positive, this means that tax payers` attitude and behavior, low compliance culture and the size of the SMEs informal sector positively relates to tax compliance for example the higher the (x_1), (x_2) and (x_4), the lower the tax compliance rate among the SMEs in Uasin-Gishu County and vice versa. This shows that the combination of these factors (explanatory variables) significantly affect the response variable (tax compliance rates).

All together the influences of explanatory variables captured in the model are significant, and these findings are informative, as they intrigue significant questions regarding determinants of tax compliance in Uasin-Gishu County. With regards to perceptions of bureaucracy and corruption by tax administrators and government spending, those who engage in tax evasion often justify such behavior by suggesting that the government wastes tax revenue and spends unwisely; such arguments can decrease voluntary compliance in the long run (Braithwaite *et. al.* 2009). It is expected that if the government spends taxpayers' money wisely, for example on basic facilities like education, health and safety and public transportation, it is assumed that voluntary compliance will increase. In contrast, if taxpayers perceive that the government spends too much on something else, taxpayers might feel betrayed and attempt to evade. In judging their own behaviour, people tend to believe

the cause is due to external attributes and can not be tax compliant. Therefore, the government should spend taxpayers' money wisely so that tax compliance will increase, thus the tax collection will also increase.

5.3 Conclusion

The absence of a small business tax regime in Kenya causes SME taxpayers to bear disproportionate tax compliance burdens. SME operators' perceptions on tax fairness and tax service quality have the power to influence their tax compliance decisions. The level of education received by taxpayers is an important factor that contributes to their understanding of tax responsibilities, especially regarding registration and filing requirements. Compliance costs, in form of fees charged by tax consultants, are positively correlated with noncompliance behaviour and thus negatively correlated with tax compliance behaviour. Obtaining a tax clearance certificate is the highest motivation to comply with tax laws and regulations for most SME operators in Kenya. Tax penalties can positively influence timely filing of tax returns by SME taxpayers.

5.4 Limitations of the Study

Time was a limiting factor for the researcher since he is in full time employment and therefore did not have adequate time especially in the collection of data, the researcher was faced with the challenge of insufficient data. Data from SMEs was insufficient to be used to answer the research objectives sufficiently and Limited resources on the part of the researcher were another limitation. The researcher lacked

adequate funding for conducting the research owing to the fact that he is self sponsored in the Masters in Business Administration.

5.5 Recommendations for Further Research

As a result of the above mentioned limitations the researcher identified the following areas as areas of further researcher. It will be necessary for a study to be carried out on the thoughts of taxpayers' attitudes towards tax systems, the factors which influence taxpayers' attitudes and the relationship between attitudes and tax compliance behaviour among SMEs business income earners which has encountered a lot of debate in every economy and regional subdivisions. The researcher recommends studies to be conducted, to evaluate the above concepts in all other counties in Kenya to improve on the revenue collection so as to build the Kenyan developing economy and the achievement of vision 2030.

5.6 Implications for Policy and Practice

As a matter of fact Kenya Revenue Authority has the mandate to collect as much as possible tax from those expected to pay tax it is therefore relevant for this study to be carried out to shade more light on what causes compliance on non compliance of tax payment. Given the demand for increased efficiency and effectiveness, it becomes more important to undertake research to understand taxpayer behaviour. As a result of a better understanding of taxpayer behaviour, revenue bodies can make more effective use of their limited resources to develop strategies which will have a true for example outcome-based and sustainable impact on taxpayer compliance. An increase in taxpayer compliance will put governments on a more sound financial footing. In

this context, it is also worth noting that much of the academic research done to date has tended to be directed at understanding and influencing the behaviour of individual taxpayers including the self-employed. Revenue bodies could, accordingly, benefit significantly from research directed at understanding the compliance behaviour of corporations and the role of tax intermediaries and other third parties in this.

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APPENDICES

APPENDIX 1: Research Questionnaire

a.   General Information

1. Name of the Organization..

2. Location of the organization within the County

3. Gender of the person filling the questionnaire Male ( ) female ( ) (please tick the appropriate)

4. Age bracket of the Person

    a) 19 years – 24 years   (   )

    b) 30 years – 34 years   (   )

    c) 40 years – 44 years   (   )

    d) 25 years – 29 years   (   )

    e) 35 years – 39 years   (   )

    f) 45 years and above   (   )

5. Category off representative

    Person directly involved in tax matters   (   )

    Owner of the enterprise   (   )

    Manager   (   )

6. What is your highest level of education?

    a) Primary level   (   )   b) Secondary level   (   )

    c) College Certificate (   )   d) College Diploma   (   )

    e) University Degree (   )

7. Kind of business

    Trade   (   )

    Service   (   )

    Manufacturing   (   )

8. For how long has the SME been in existence? (Please tick the appropriate)

    a) 0 – 3 years ( )   b) 4 years - 8 years ( ) c) 9years – 15 years ( )

    d) Above 15 years ( )

9. Has the business been formally registered by the Registrar? (Please tick the

appropriate)

     a) Yes ( )   b) No ( )

10. What is the legal form of business?

     a) Sole Proprietor ( )   b) Partnership ( )   c) Limited Company ( )

11. What is the number of staff employed in this organization including the owner of

this business?

a) 1- 5 ( )   b) 6 – 10 ( ) c) 11- 20   ( )   d) 21 – 30 ( )   e) 31 - 40 (

)

b. THE DETERMINANT OF TAX COMPLIANCE AMONG SMALL AND

MEDIUM ENTERPRISES (SMES)

1. i) Do you think tax compliance is influenced by any factors?(Tick)

                                                           Yes ( )

                                                           No ( )

ii) If your answer to (5 i) is yes what are the factors that influence tax compliance?

    i)   ………………………………………………………

ii) …………………………………………………………….

iii) …………………………………………………………….

iv) …………………………………………………………

v) …………………………………………………………….

2. Using the scale 1-5 as shown below please tick the extent of influence of the following factors/determinants on tax compliance.

| 1 | 2 | 3 | 4 | 5 |

| No | Least | great | greater | greatest |
| Effect | extent | extent | extent | extent |

Factor	1	2	3	4	5
Tax payers` attitude and behaviour					
Low compliance culture					
Bureaucracy and corruption					
Size of the SMEs					
Use of family and unpaid labour					
Lack of transparency and accountability					

3. What are the reasons for tax compliance and tax non-compliance among the tax payers and the government?

(i) …………………………………………………………..

(ii) …………………………………………………………..

(iii) …………………………………………………………

(iv) …………………….……………………………………..........

4. Any other comment concerning this that you feel should be addressed?

………

………………………………………………………………………