

Factors That Influence Compliance with Tax Laws among Small and Medium Sized Enterprises in Kenya

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Abstract- This study was meant to analyse the factors influencing tax compliance among the SMEs in Kenya. To achieve this aim, Kiambu County was taken as a case study. In various previous years revenue targets have been set by either the treasury or commissioner general but they are never met. Therefore the actual revenue collected has always been behind the targets. This is as a result of tax noncompliance. Tax non-compliance may be measured in terms of the tax gap. It is very clear that there have been tax gaps every fiscal year. Therefore the researcher opted to carry out this study with the aim of analyzing factors influencing tax compliance among the SMEs and recommend measures to be put in place by the government and KRA to enhance tax compliance in this sector.

The main objectives of the study was to assess tax understanding, tax rates, tax penalties and fines and tax compliance cost on tax compliance level. This have been considered by the researcher to be the most key factors that influences tax compliance level in Kenya.

This study was controlled by the theory of planned behavior. The study used questionnaires and oral interview method to collect data. The population of the study was a number of SMEs in Kenya and the sample size involved a number of SMEs in Kiambu County. A sample size of 400 was drawn from the target population of 2541 SMEs. Once the data was collected, it was coded and analysed with the help of the MS Excel. Mean, frequencies, and percentages were calculated. It was presented in tables, graphs and pie charts using simple percentages. Content analysis was done in order to make a through conclusion on factors influencing compliance with tax laws in Kenya.

As part of conclusion of the study it was very clear from the findings that tax rates and tax compliance cost are the greatest contributing factor in tax compliance. Therefore the results of this study contradict the study that was done by Osebe (Osebe 2012). His study concluded that the greatest contributors of tax compliance level are tax understanding and tax rates. In other words the studies are matching but partly (50%). According to these study findings there is enough proof to conclude that low tax rates and low tax compliance cost are associated with high levels of tax compliance. The study is not striking the other factors out but their impacts are not as for this two. Generally, tax understanding, tax rates, tax compliance cost and tax fines and penalties influences tax compliance level significantly. Finally, the study concludes that tax compliance cost have the most significant effect on tax compliance. In other words Kenyans are not ready to incur extra cost for them to pay tax.

From the study findings it was found that low tax compliance cost have a significant effect on tax compliance. Therefore proper restructuring should be done by KRA in order to address this issue. KRA should set up agents who should be

sited in different locations all over the country. Be it urban centers be it rural areas. Their main objective is to offer tax information advices for free. Some of the key services that they should be offering that are in great need are ; tax computation, filing of tax returns, which tax to be paid where, tax penalties and the due dates.

If this is not possible then they can implement tax information ATM. The purpose of the ATM is to address direct questions. KRA can negotiate with certain banks especially Equity so that they can be located next to their ATM. Am picking Equity because they have the biggest number of branches all over the country.

Also as a way of appreciating new technology which can fit persons KRA can also bring the services to the phones. In this case they can negotiate with service providers such as safaricom, Orange, YU and others who can help to address issues of the tax payers through SMS. Tax payers just need to send standard questions and they get an immediate answer. This will not only help tax payers but also tax practitioners.

KRA should also formally communicate tax information changes. Their system of communication is good but it is not sufficient because not all persons/tax payers get tax information. This brings a lot of confusion and it has reduced the level of tax compliance

However the study recommended that KRA should implement more tax incentives in order to encourage tax payers to continue to pay and also attract more investors hence improving the level of tax compliance. Tax penalties and fines should be harmonized and at least two ranges be created to ensure that those who do not feel the penalties they feel it. Finally there are many persons who are willing to comply with the tax laws but they are not aware. KRA should ensure that there is no tax payer who doesn't pay tax or file tax returns due to failure of tax understanding. This should be in Kenya history books but not a current matter. So to say tax awareness should be improved, tax rates made favorable, penalties increased and tax compliance cost reduced further by enhancing more training on how to use I-TAX SYSTEM. Generally this study shows that with the introduction of I- TAX SYSTEM compliance with tax laws in Kenya has greatly improved.

Index Terms- tax compliance, tax system, evasion, avoidance, penalties, fines

I. INTRODUCTION

Tax compliance refers to fulfilling all tax obligations as required by the tax laws. There has been no charging of

taxes proportionately among small and medium enterprises (SMEs) internationally. High compliance costs, inadequate understanding, high tax rates and tax penalties are some of the variables that can lead to tax evasion and tax fraud. Their size, nature and operation make the issue of tax compliance critical among the SMEs. They are not well established in terms of resources and expertise. (Williams and Round, 2009)

Persons fail to comply with tax laws either willingly or unwillingly. They include [tax resisters](#) and [tax protesters](#). Tax protesters attempt to evade the payment of taxes using alternative interpretations of the tax law, while tax resisters refuse to pay a tax for conscientious reasons. SMEs are characterized by size, uncertainty, innovation and evolution. Proper understanding of SMEs would require a good understanding of its operations (Webley, 2004).

Students are the leaders of tomorrow and therefore it is also a fact that SMEs are the blue chips companies of tomorrow. Most well established companies started as small and medium enterprises. Therefore, the stepping stone of big companies is likely to be small and medium enterprise. Developing countries like Kenya should heavily encourage the SMEs and other private sectors in order to promote the business performance within and without Africa. Their problem was addressed to the letter in order to create a very conducive environment for them to operate. In other words they should be looked from the eye of success but not the eye of failure. A conducive environment for

the business is the best because economy wise the country tend to grow (Hijattulah and Pope, 2008).

The fundamental purpose of taxation is to raise revenue. Inorder to achieve this tax system should be effective and efficient in to ensure that SMEs are not negatively affected. The society should also not complain. Many of the difficulties with the tax authorities are the consequence of poorly set tax systems and policies. Proper research should be done before employing any tax policy in order to have a properly working tax system. The objective of a tax policy should be to abide with tax laws. (James and Alley, 2004).

II. RESEARCH ELABORATIONS

This study conceptualizes that the tax compliance could be affected by tax understanding, tax rates, fines and penalties and tax compliance cost. The main objective of this study was therefore to test the nature and the strength of these four relationships. This study tests the conceptual framework presented in Figure 2.1

INDIPENDENT VARIABLES

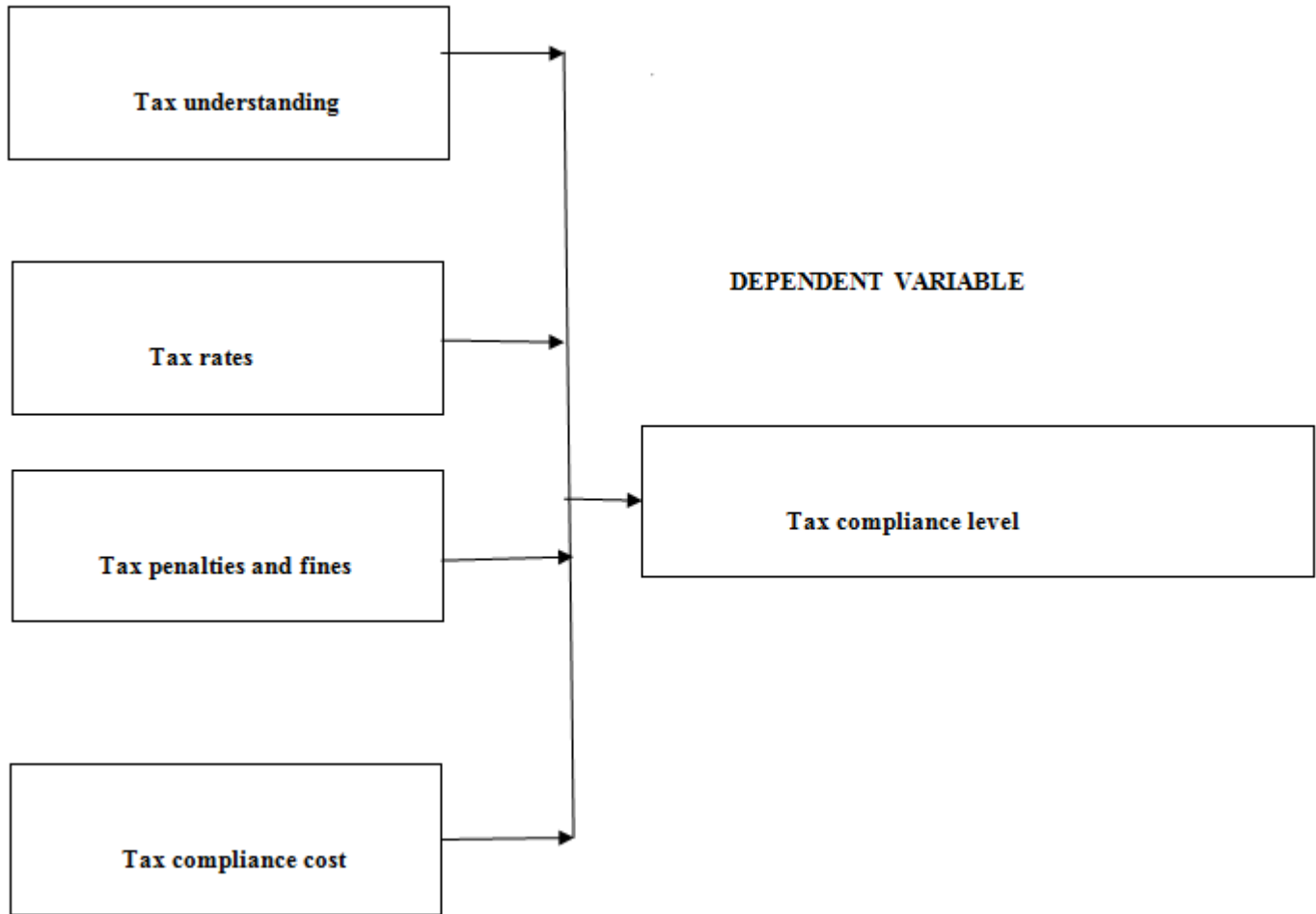


Figure 2.1: Conceptual Framework

2.1 Tax understanding

The influence of tax understanding on compliance behaviors has been done by various researchers. Understanding as one of the factors in compliance is related to the taxpayers' ability to interpret taxation laws, and their willingness and ability to comply. The aspect of tax understanding that relates to compliance is the general understanding about taxation regulations and information pertaining to the opportunity to evade tax (Kasipillai, 2003).

Taxation understanding is necessary to increase public awareness especially in areas concerning taxation laws, the role of tax in national development, and especially to explain how and where the money collected is spent by the government (Mohd, 2010). Attitude towards tax compliance can be improved through the enhancement of taxation understanding. When a taxpayer has a positive attitude towards tax, this will motivate him to pay more and vice versa (Eriksen&Fallan, 1996).

Taxpayers who have attended a tax course would be expected to have better tax understanding and tax compliance attitude in comparison with taxpayers who have never attended a tax course (Mohd, 2010). According to Hite and Hasseldine (2001) tax authority need to emphasize teaching tax courses because of impact of understanding on compliance.

2.2 Tax rates

For the tax system to be efficient and efficient, the tax policy needs to be favoring the tax payers. It should be designed such that the tax rates are fairly rational. Tax policies can be designed in such a way that they do not only directly affect SMEs. They should also accelerate voluntary tax compliance. SMEs constitute untapped revenue potential and an uneven playing field in many countries. As such they need to be captured by the tax net. However, though legislations are necessary regulator for protection of the business environment and security of the economic agents, for establishment of the necessary social security regulations, they may also hamper compliance and the growth of business through additional expenditures and administrative obstacles. (Williams and Round, 2009).

2.3 Fines and Penalties

It is a fact that if many persons are given the chance they may not pay taxes unless there is a motivation to do so. Tax experts have a perception that the best way is to increase tax incentives while others believe the best way is to increase tax penalties. Stopping non compliance requires applying penalties effectively. The most appropriate strategy is to combine various

measures so as to maximize their effects on tax compliance as it were, in order to move the country from a low level of tax compliance to a higher level. (Gruber and Saez, 2002)

Higher tax fines can also lead to tax evasion. Various researchers have also suggested that an increase of penalties can have undesirable effect and result in more tax avoidance. (Kirchler et al., 2007). Tax penalties and Fines are many and they include:

Failure to register – fine not exceeding Kshs.20, 000 or imprisonment for a term not exceeding six months or both

Enforced registration – default penalty of Kshs. 100,000

Failure to submit a return on or before the due date or submitting a payment return without paying the tax due – default penalty of Kshs.10, 000 or five percent of the tax due whichever is the higher and additional interest of 2% per month compounded.

Failure to keep proper records – a default penalty of between Kshs.10, 000 to Kshs.200, 000

Fraudulent Accounting – a fine not exceeding Kshs.400, 000 or double the tax evaded whichever is greater or imprisonment for a term not exceeding three (3) years or both.

Failure to issue a Tax Invoice – an automatic penalty of not less than Kshs.10, 000 but not exceeding Kshs.100, 000/=.

Hindrance or obstruction of authorised officers

Uttering false statements

Charging tax when not registered – tax shown on such invoice is due to the Commissioner within seven (7) days.

Failure to display a certificate of registration – a default penalty of Kshs.20, 000 and a fine not exceeding Kshs.200, 000 or imprisonment for a term not exceeding two (2) years or both.

Failure to comply with VAT regulations

Failure to pay tax and late payment

Note: For offences, which no specific penalty is provided, a general penalty of a fine not is exceeding Kshs.500, 000 or imprisonment for a term not exceeding three (3) years or to both is applicable (KRA tax guide, 2013/2014).

Table4.1 tax understanding on compliance

The following table shows how tax understanding influences tax compliance level

INDIPENDENT VARIABLE	NO. OF RESPONDENTS	NO. OF COMPLIANT	COMPLIANCE LEVEL PERCENTAGE %
TAX UNDERSTANDING	YES 258	202	78.29
	No 142	02	1.41
TOTAL	400	204	79.70

According to the above analysis 258 of respondents understand the tax laws while 142 do not understand. This is out of 400 respondents who contributed to this study. This can be presented as follows:

2.4 Tax Compliance Cost

High tax rates and complex tax legislations can lead to various tax problems. This includes tax evasion, tax fraud. Earlier research (Franzoni, 1998) concluded that companies will create a kind of resentment against authorities who impose too high levies and too complex tax systems. This will accelerate tax avoiding systems (Franzoni, 1998). In addition, because of the complexity of the system, the companies often need to rely on external tax professionals who by means of sophisticated tax avoidance engineering will minimize tax payments (Franzoni, 1998).

Various components of costs of taxation include social costs, audit costs, travelling costs and others. Social costs are incurred by society in the process of transferring purchasing power from the taxpayers to the government. The other elements are administrative costs and deadweight efficiency loss from taxation. Administrative costs are the costs that exist besides the occurrence of compliance costs that are borne by the companies. These costs are cited as costs that the government must also take into account as a public cost to ensure that the tax legislation is obeyed. For example, it obtains the costs to collect taxes and to maintain the system to collect the taxes. These are to some extent substitutable, for example when a country transfers from a system where the tax office calculates the tax owed, to a self-assessment system (Slemrod and Yitzhaki, 1996)

III. FINDINGS

CROSS TABULATION OF INDIPENDENT VARIABLES AND DEPENDENT VARIABLE

The following is the analysis of how independent variables influence dependent variable.

4.1 Tax understanding

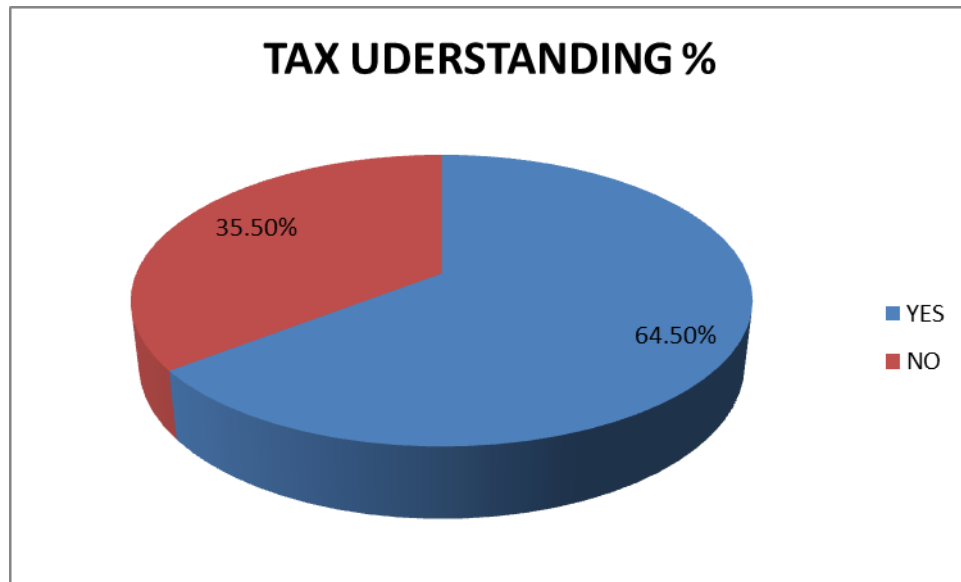


Figure 4.1: Tax understanding

It is clear that 258 of respondents understand the tax laws out of which 202 comply. Therefore 78.29% understand the tax laws and comply. This therefore means tax understanding influences the tax compliance level positively. It is also very clear that those respondents who do not understand the tax laws they do not comply. Out One hundred and forty two (142)

respondents who do not understand tax laws only two (02) comply. In other words only 1.41% of the respondents who do not understand tax laws comply. It is therefore very clear that lack/inadequate tax understanding reduces the level of tax compliance. This means lack of tax understanding or inadequate tax understanding influences tax compliance negatively.

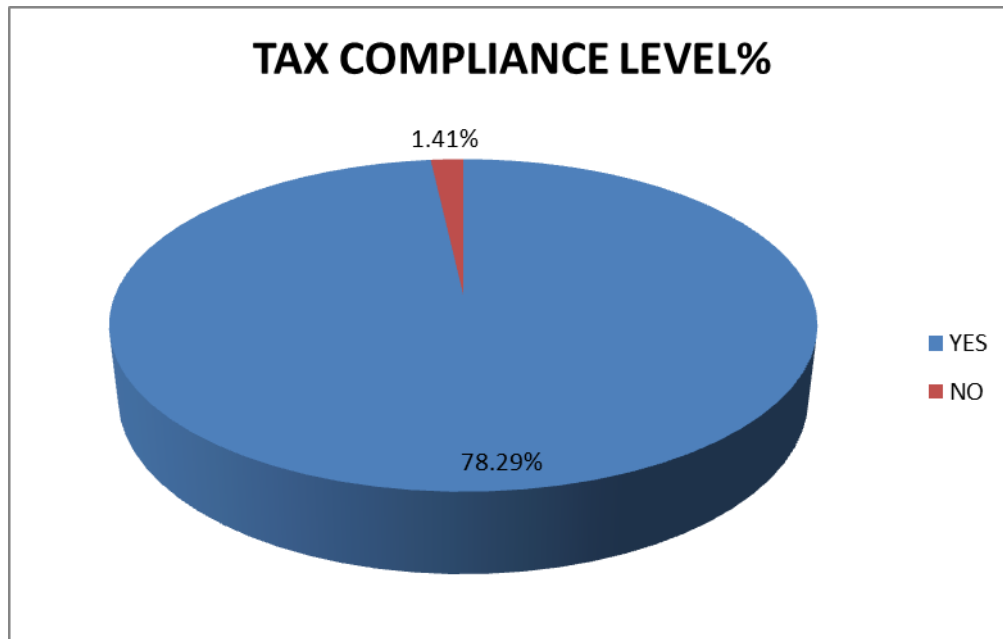


Figure 4.2: Tax understanding on tax compliance

Key

78.29% indicates those respondents who understands and comply

1.41% indicates those respondents who do not understand but they comply

In general many tax payers who understand the tax laws also comply and therefore tax understanding is a key factor that influences compliance with the tax laws. Furthermore the result of this study shows that with the introduction of the new I- tax

system has boosted the level of tax understanding among SMEs. In fact 83% of the respondents stated that their level of tax understanding was enhanced by the new I- tax system. Generally

in Kenya therefore tax understanding influences tax compliance level by seventy nine point seven percent (79.70%)

Previous researchers including (Mohd, 2010) have analysed tax understanding but in a shallow perspective. This study widened the scope by covering many areas of the tax laws. The influence of tax understanding on compliance behaviors has been

done by various researchers. Understanding as one of the factors in compliance is related to the taxpayers' ability to interpret taxation laws, and their willingness to comply. The aspect of tax understanding that relates to compliance is the general understanding about taxation regulations and information pertaining to the opportunity to evade tax.

Tax rates

Table 4.2 tax rate on tax compliance

The following table shows how tax rates influences tax compliance level

INDIPENDENT VARIABLE	NO. OF RESPONDENTS	NO. OF COMPLIANT	COMPLIANCE LEVEL PERCENTAGE
TAX RATES	HIGH 271	15	5.54
	LOW 129	127	98.45
TOTAL	400	194	

According to the above analysis 271 respondents said that tax rates are high 129 respondents said it is low. This is out of 400 respondents who contributed. This can be presented as follows.

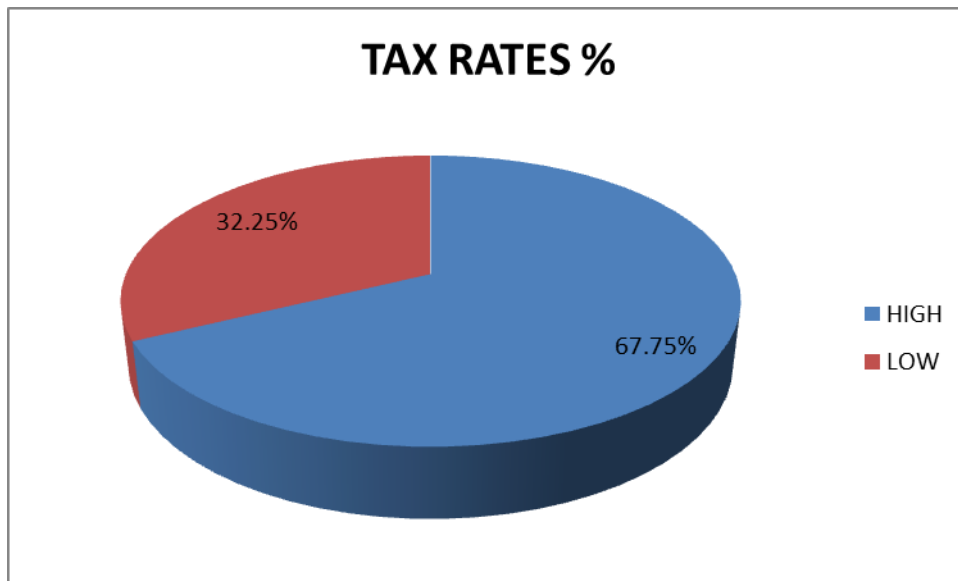


Figure 4.3: Tax rates

Out of 271 respondents who said that tax rates are high only 15 comply. This influences tax compliance by 5.54% Of 129 respondents said that tax rates are low 127 comply with the tax laws. 98.45% of the respondents who said that the tax rates are low also comply with the tax laws. It is also very clear that those

respondents who said that tax rates are high rarely comply with the tax laws. Therefore as the tax rates keeps on increasing tax compliance level keeps on reducing. In other words high tax rates influences tax compliance negatively while low tax rates influences it positively.

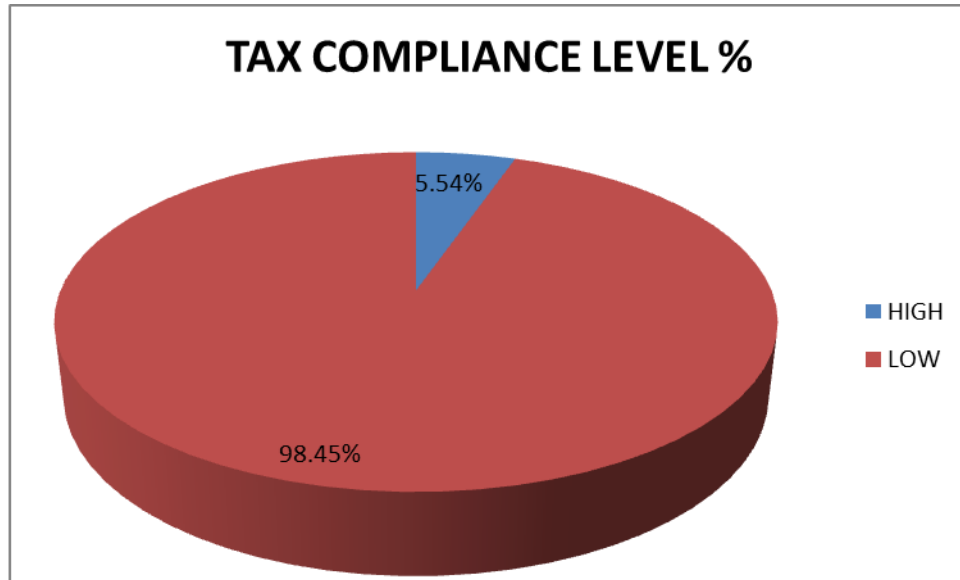


Figure 4.4: Tax rates on tax compliance level

Key

98.45% represents respondents who said tax rates are low and they comply
 5.54% represents respondents who said tax rates are high and they comply

This therefore indicates that the rate of tax influences tax compliance either positively or negatively. KRA should also visit them with an objective of ensuring that they satisfy as many tax payers as possible. Positive influence makes the government to enjoy more tax revenue.

Fines and Penalties

Table 4. 3 tax penalties on tax compliance

The following table shows how tax penalties and fines influences tax compliance level.

INDIPENDENT VARIABLE	NO. OF RESPONDENTS	NO. OF COMPLIANT	COMPLIANCE LEVEL %
TAX PENALTIES AND FINES			
	HIGH	192	154
	LOW	208	26
TOTAL	400	346	92.71

According to the above analysis 192 respondents stated that tax penalties and fines are high while 208 respondents said it was low. This has been analysed out of 400 respondents who participated in field work. Presentation can be done as follows

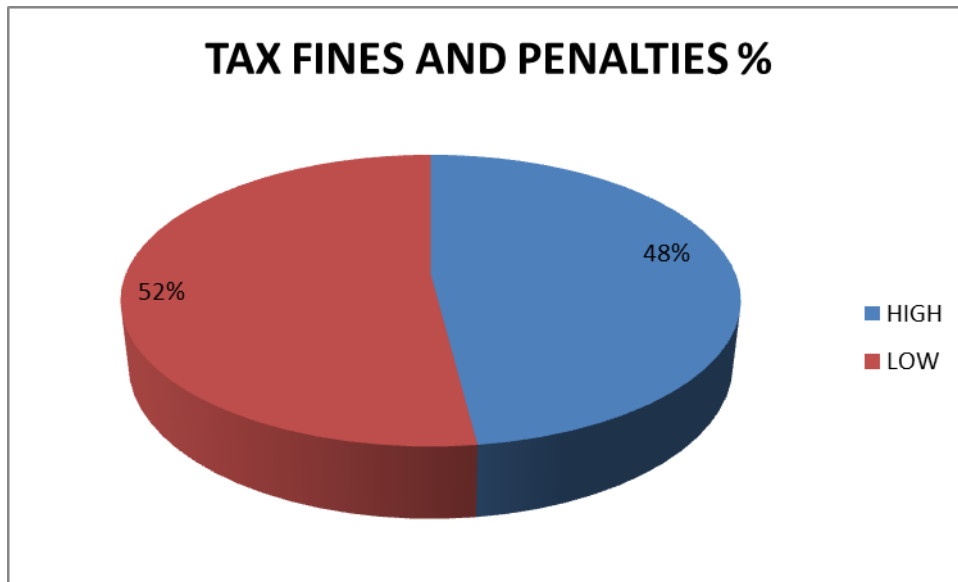


Figure 4.5: Tax penalties and fines

It is very clear that of the 192 respondents who said that tax penalties and fines are high 154 comply with tax laws. This constitutes 80.21% of the respondents who according to them tax penalties and fines are high but this makes them to comply with the tax laws. Also 26 respondents out of 208 suggested that tax penalties are low but despite this they also comply. Therefore even if the tax penalties and fines are high they are ready to comply further. This therefore indicates that fines and penalties

positively influence tax compliance but not to a very great extent. In other words they partly influence tax compliance. However in general high tax penalties and fines boost the level of tax compliance. The government should implement ranges of penalties. This is because those who view them as small or large can be taken in to consideration. The views might not be the same.

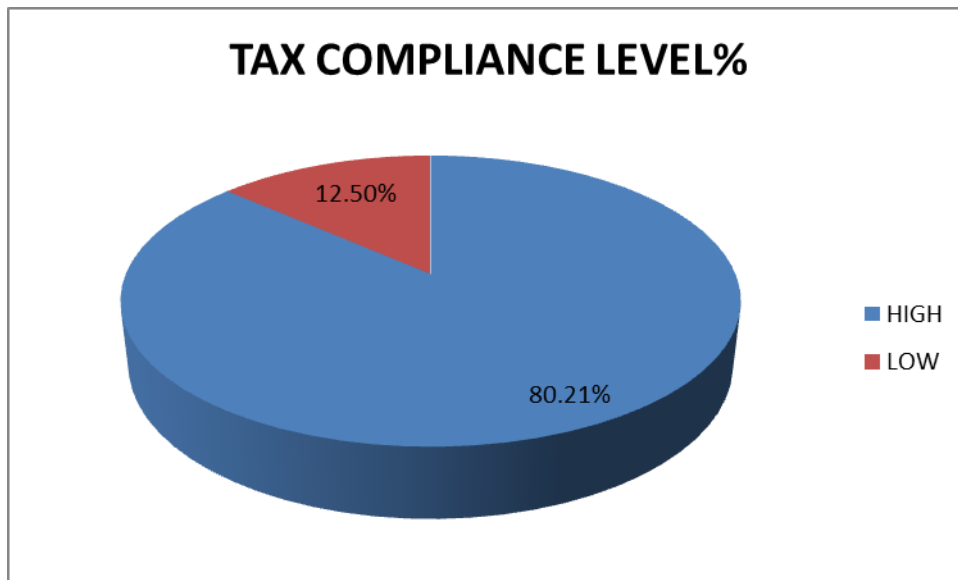


Figure 4.6: Tax penalties and fines on tax compliance level

Key
80.21% represents respondents who said tax penalties are high and this makes them to comply
12.5% represents respondents who said tax fines and penalties are low but they still comply

It is a fact that if many persons are given the chance they may not pay taxes unless there is a motivation to do so. Tax experts believe that the best way is to increase incentives while others believe the best way is to increase penalties. According to this research not all SMEs comply with the tax laws due to high tax penalties and fines. In fact 87.5% of respondents who said tax

penalties are low do not comply. This means they comply due to other factors other than tax penalties and fines. However generally in Kenya tax penalties and fines contribute 92.71% level of tax compliance.

Tax Compliance Cost

Table 4.4 Tax compliance cost on tax compliance level

The following table shows how tax compliance cost influences tax compliance level.

INDIPENDENT VARIABLE	NO. OF RESPONDENTS	NO. OF COMPLIANT	COMPLIANCE LEVEL PERCENTAGE %
TAX COMPLIANCE COST HIGH	205	95	46.34
LOW	195	194	99.49
TOTAL	400	375	

According to the above analysis 205 respondents claimed that tax compliance cost is high and 195 respondents said that it

was low. The results are from 400 respondents who contributed in this study. This can be presented as follows

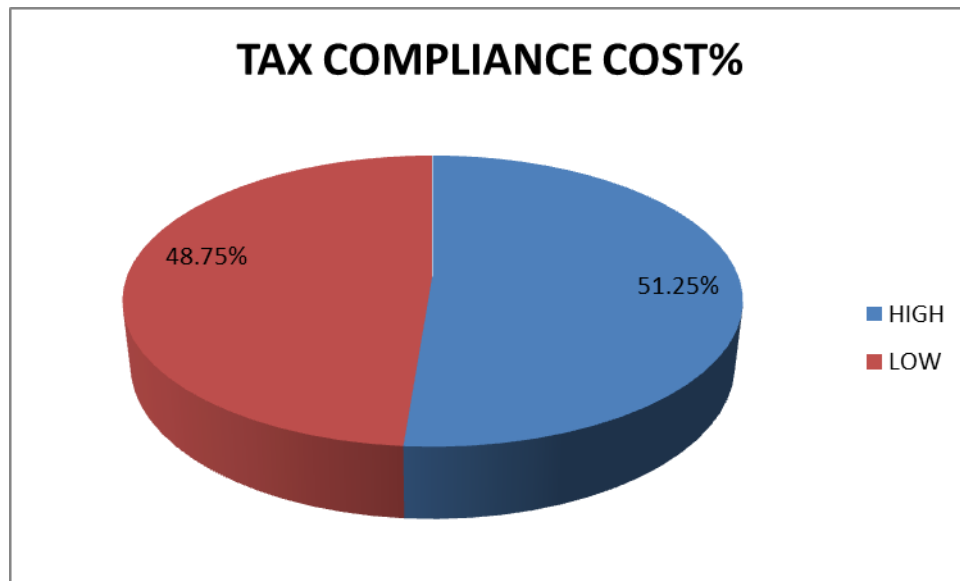


Figure 4.7: Tax compliance cost

Out of 205 respondents who said that tax compliance cost is high only 95 respondents comply with the tax laws. This constitutes 46.34% of the respondents who said that tax compliance cost is high but they also comply. The percentage of these respondents who comply is low. It is also very clear that high compliance cost influences tax compliance level negatively. Furthermore out of 195 respondents who suggested that tax compliance cost is low 194 respondents comply. Therefore

99.49% of the respondents said that compliance cost is low and they also comply. This is an indication that low compliance cost encourages tax payers to comply. It is therefore very clear that if the compliance cost is favorable among tax payers tax compliance level will increase and vice versa. In other words tax compliance cost negatively influence the compliance with the tax laws.

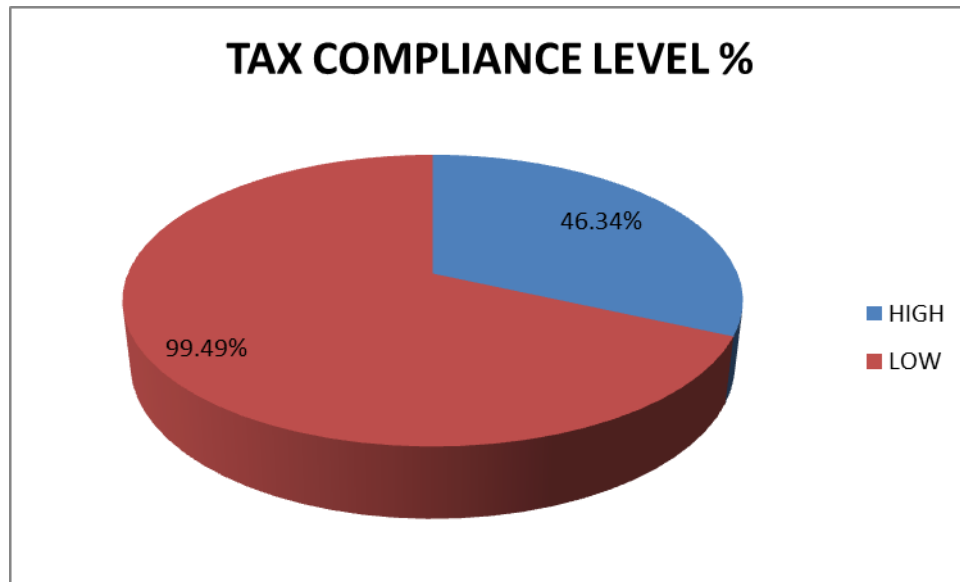


Figure 4.8: Tax compliance cost on tax compliance

Key
 46.36% respondents who said tax compliance cost is high but still comply
 99.49% respondents who said tax compliance cost is low and they still comply

It should also be noted that as a result of the introduction of the new I- tax system the cost of tax compliance has reduced. The data collected and analysed from the respondents shows that 76.75% of the respondents unanimously agree that the tax

compliance cost reduced. The impacts of this can be felt in terms of the total revenue generated which has greatly improved since the implementation of I- tax system. In general tax compliance level in Kenya is fifty two point seven eight percent (52.78%).

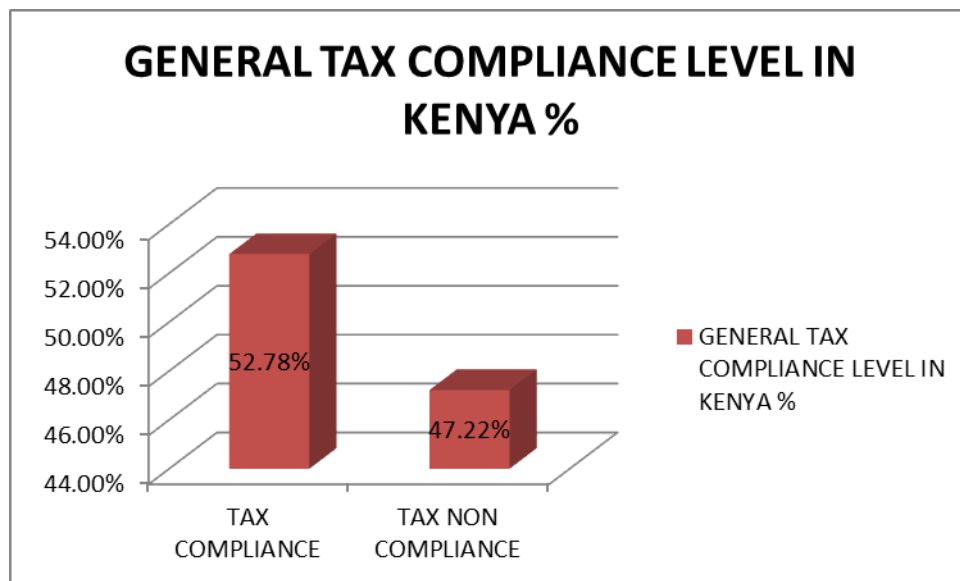


Figure 4.9: General tax compliance level in Kenya

Findings on gender revealed that there are more male than females among the respondents indicating that more men than female are SMEs investors. It should also be noted that some of the respondents were not the owners but managers or accountants. Furthermore majority of the respondents were between the ages brackets of 25-40 years. Significant number of them were also educated and those with undergraduate

contributing the highest percentage followed by those with KCSE certificate reflecting that respondents were generally literate. Findings on information about the SME's affirmed that majority of the SMEs have been in operation for 6-10 years confirming the recent growth in these sector. Majority of the SMEs had a turnover below ksh: 500,000. Findings on tax characteristics acknowledge that most respondents have ever

heard of KRA although majority of them have never been audited.

The study also reveals that most SMEs investors are willing to grow to the level of the company. Therefore there is a need for the tax authority and the government to generate strategies meant to encourage SMEs investors to achieve their dream. This technique includes introducing tax incentives such as high capital allowances, tax holidays and tax exemption of some commodities in order to enhance tax compliance levels. On matters pertaining being penalized by KRA as a result of not filing tax returns, majority of the respondents have not been penalized. The study also found out that most of the respondents do not disclose all their incomes even if they know that the incomes are taxable. The study also examined the effect of tax understanding on tax compliance level. Seventy eight point two nine (78.29%) of those respondents who understands also comply. This means that tax understanding is positively related to tax compliance. Ninety eight point four five (98.45%) of the respondents who said tax rates are low also comply. This means that tax rates are negatively related to tax compliance.

Therefore the higher the tax rates the lower the level of tax compliance. Eighty point two one (80.21%) of the respondents said tax penalties are high and this makes them to comply. This means that tax fines and penalties are positively related to tax compliance. This implies that enforcement of fines and penalties on tax offenders will enhance levels of tax compliance. Ninety nine point four nine (99.49%) of the respondents who said tax compliance cost is low also comply. This means that tax compliance cost is negatively related to tax compliance. This means that high compliance costs reduces tax compliance level. The findings show that the level of tax compliance in Kenya in SMES is fifty two point seven eight (52.78%). This shows that there is a significant improvement since the last research was done. Previous research that was done reflected that tax compliance level was forty six percent (46%). (KRA tax guide 2012/2013).

IV. CONCLUSION

These study findings shows that tax rates and tax compliance cost are the greatest contributing factor in tax compliance. Therefore the results of this study contradict the study that was done by Osebe (Osebe 2012). His study concluded that the greatest contributors of tax compliance level are tax understanding and tax rates. In other words the studies are matching but partly (50%). According to these study findings there is enough proof to conclude that low tax rates and low tax compliance cost are associated with high levels of tax compliance. The study is not striking the other factors out but their impacts are not as for this two. Generally, tax understanding, tax rates, tax compliance cost and tax fines and penalties influences tax compliance level significantly.

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

research that was done by Mohd and Mustapha (2011) which is one of the most recent researches the researchers also analysed the determinants of tax compliance in general. This study concurs with the views of these researchers however the factors have not been analysed specifically. The study also agree with Mohd(2010) that the higher the level of tax understanding the higher the level of tax compliance with tax laws.

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