

Determinants of Tax Compliance among Small and Medium Enterprises in Bungoman County, Kenya

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Abstract

Taxation is the main source of revenue to any government, since it the only stable flow of revenue that is predictable. a large segment of the informal sector, especially the smes in Bungoma county exhibit low tax compliance levels. the purpose of the study was to investigate the determinants of tax compliance among smes in Bungoma county. the study was guided by the following objective; to determine the effect of cost on tax compliance among smes in Bungoma county. The study applied a descriptive survey design of all the SMEs in Bungoma county. According to, Nteere et al (2012), and Creswell (2005), descriptive survey design enables the researcher to collect, analyze and link both qualitative and quantitative data in a single study. The population of the study consisted of all the SMEs in Bungoma County. A total of 170 SMEs in Bungoma County were targeted for the study. With a sample of size of 227 respondents. Closed-ended questionnaires covered all the issues relating to the causes of low tax compliance among SMEs in Bungoma County were personally administered the questionnaires to the respondents 227 managers, 1 from each of the sampled organizations in sectors. Pilot test was done to verify the reliability and validity of the research instrument. The data collected was analyzed using descriptive statistics, correlations, and linear regression analysis. Results showed that there was a significant influence of cost on tax compliance in Bungoma County. From study findings and earlier discussion, it was noted that cost influence tax compliance negatively and significantly contributing 9.6% variability to tax compliance by SMEs when other factors are held constant. The Kenya Revenue Authority should consider revising the cost of tax product downwards. Additionally, Kenya Revenue Authority should make the tax filing process convenient, easy and costless. Similarly, Kenya revenue authority, should not impose penalties on late filing of taxes. The tax computation should be as easy as possible to enhance eligible tax payers' compliance.

Keywords: *Tax Compliance, Cost*

1.0 Introduction

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

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

system and Revenue Authority (Ambrecht, 1998); peer attitude/subject norm (Tanzi,2013); taxpayers' understanding of a tax system / tax laws (Le Baube, 1992;Silvani, 1997); 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 behavioural control and Protestant Work Ethics (PWE) (Furnharn, 1983); ethics morality of the taxpayer and tax collector; equity of the tax systems (Trivedi & Shehata,2005).

The 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). 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 labour 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 and 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). 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 favourable 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). According to Alley, Maples, Veal, & Polson Higgs & Co., 2004; Chittenden, Kauser, & Poutziouris, 2003 taxes need to be collected to fulfil three governmental objectives, which are economic, fiscal and social. First they are used to fund public and merit goods and services such as infrastructure, health, education etc. second, they are used to achieve economic goals including

employment, growth and balance of payments. Third, taxes are used to achieve social equality between the rich and the poor, the unemployed, the sick and the elderly.

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 proposals 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 tax 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 Statement of the Problem

A large segment of the informal sector, especially the SMEs in Bungoma county exhibit low tax compliance levels. The tax payers fail to meet their obligations as and when they arise by either evading or avoiding taxes. Tax avoidance is done professionally so as to reduce tax liability. However, tax evasion which is also illegal is on the rise leading to starving the government of its main source of revenue. Taxable persons feel the tax burden is high as per the rates, leading high evasion proportions. The question of why low compliance on tax payment and why deprive the government of its revenue is exhibited by many economists, administrators and scholars.

According to James & Alley, 2000 SMEs were regulated under a self-assessment tax regime which required fair and honest reporting of their tax liability and to pay their taxes on time. The traditional approach to taxing the sector was by use of a presumptive tax system which failed culminating to introduction of Turn Over Tax in 2009. TOT was meant to draw the informal sector into the tax net by simplifying tax procedures, record keeping, and tax computation for SMEs, thus expecting easy filing of tax returns and reduced compliance costs. Since its introduction, TOT has experienced mixed fortunes. In his 2016/2017, budget speech, the Cabinet Secretary for National Treasury, Kenya Hon. Henry Rotich emphasized on the need to widen the tax net so that eligible persons pay tax, including the informal sector. He indicated on the need to explore ways to tax the hard-to-tax segment – informal sector with a view of considering to revert back to presumptive tax. This therefore leaves a knowledge gap in this area- the basis of this study. This research therefore has the main objective of investigating on determinants of low tax compliance among small and medium enterprises (SMEs) in Bungoma county.

2.0 EffECt oF Cost On TAX COMPLiAnCe

To pay taxes, the costs taxpayers actually incur are far greater than the net sums the government collects. Considering only the compliance aspect of the job, Individuals and businesses as taxpayers must pay substantially more in order for government beneficiaries to receive the same value of government services. Before individuals and businesses pay their tax liability; they must spend time collecting records, organizing files and wading through the tax code to determine their tax liability; they also purchase products and services such as tax software or an accountant, to assist them in determining their tax liability- tax compliance outlays. Finally, tax payers must pay the administrative costs to run the tax authorities. To businesses, large and small, hire teams of accountants, lawyers and tax professionals to track, measure, and pay their taxes. This tax infrastructure is also used to optimize the tax liability (Laffer et al, 2011) Tax compliance costs are very high, and these cost have implications for lost economic growth, money spend unnecessarily on professional tax services, and even the collection of revenue. For businesses, these resources would have been better spent on activities that increased capacity and production; and at individual level, on work, saving and investment. (Fichtner & Feldman,2015)

Different scholars have put forth findings on their studies pertaining to why low level compliance to expected tax obligations by the small and medium enterprises in different parts of the world. However, there’s no publication as to what influences low level and or non- tax and rates compliance in Bungoma county and in Bungoma town of Kenya. The review of the relevant research studies in the field indicated that scholars focused on either in compliance costs, level of education, tax information, income level, tax rate, age group and marital status (Mwangi, 2014; Ching, 2013; Tusubira, 2013; Atawodi, 2012). 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. Also 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 they didn't cover factors managerial skills, bureaucracy, tax payers' attitude and costs. The existing studies were also carried out some in cities (Mwangi, 2014; Atawodi, 2012; Ching, 2013; Agbadi, 2011) where the dynamics related to geographical location, population, economic endowment, administration efficiency and interest in entrepreneurship differ with the Bungoma county. Coupled with these the study will bridge the gap by evaluating the determinants of tax compliance among the Small and Medium enterprises in Bungoma County.

3.0 METHODOLOGY

The study applied a descriptive survey design of all the Small and Medium Enterprises in Bungoma county. According to, Nteere et al (2012), and Creswell (2005), descriptive survey design enables the researcher to collect, analyze and link both qualitative and quantitative data in a single study. The population of the study consisted of all the Small and Medium Enterprises in Bungoma County. A total population of 170 Small and Medium Enterprises in Bungoma County were targeted for the study with a sample of size of 227 respondents. Closed-ended questionnaires covered all the issues relating to the causes of low tax compliance among Small and Medium Enterprises in Bungoma County were personally administered the questionnaires to the respondents 227 managers, 1 from each of the sampled organizations in sectors. The data collected was analyzed using descriptive statistics, correlations, and linear regression analysis.

4.0. Discussions

Results on effect of cost on tax compliance were as follows:

Respondents were asked about cost of tax product being high, the results stated that 20 percent strongly agreed, 50 percent agreed that tax product is very high, 20 percent of the respondents were undecided, while 5 percent and 5 percent more disagreed and strongly disagreed respectively. The majority of the respondents agreed. This implied that the cost of tax product was actually high. Likewise on the statement of cost of filing tax being high, 24 percent of the respondents strongly agreed, 60 percent agreed that cost of filing tax is very high, 10 percent of the respondents were undecided, while 3 percent and 3 percent more disagreed and strongly disagreed respectively. The majority of the respondents agreed. This implied that the cost of filing tax was actually high.

Results on whether penalties were being enforced when filing late, the results indicated that 23 percent of the respondents strongly agreed, 62 percent agreed that cost of filing tax is very high, 11 percent of the respondents were undecided, while 1 percent and 3 percent more disagreed and strongly disagreed respectively. The majority of the respondents agreed. This implied that the penalties were being enforced on late filing of tax returns.

On the statement of whether enterprises could hire accountants to file tax for them, the results indicated that 27 percent of the respondents strongly agreed, 57 percent agreed that cost of filing tax is very high, 13 percent of the respondents were undecided, while 2 percent and 1 percent more disagreed and strongly disagreed respectively. The majority of the respondents agreed. This implied that the enterprises were actually hiring the accountants to file tax returns on their behalf.

Table 1 Correlation between Predictors and tax compliance

		Tax compliance
Cost	Pearson Correlation	-0.310**
	Sig. (2-tailed)	0.007
	N	216

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

The analyzed results in the table 1 above established that cost influence tax compliance negatively and significantly at $r = -0.310^{**}$, $P < 0.01$ significant level. Taking the coefficient of determinant, cost contributes 9.6% variability to tax compliance by SMEs when other factors are held constant. Laffer et al, (2011) argues that before individuals and businesses pay their tax liability; they must spend time collecting records, organizing files and wading through the tax code to determine their tax liability; they also purchase products and services such as tax software or an accountant, to assist them in determining their tax liability- tax compliance outlays. Finally, tax payers must pay the administrative costs to run the tax authorities. To businesses, large and small, hire teams of accountants, lawyers and tax professionals to track, measure, and pay their taxes. This tax infrastructure is also used to optimize the tax liability. Fichtner & Feldman, (2015) says Tax compliance costs are very high, and these cost have implications for lost economic growth, money spend unnecessarily on professional tax services, and even the collection of revenue. For businesses, these resources would have been better spent on activities that increased capacity and production; and at individual level, on work, saving and investment. Cost as a factor

with a standardized beta coefficient of $-.086$ indicates that as cost increases by 1 standard deviation, the tax compliance decreases by $-.086$ standard deviations if the effects of other predictors are held constant.

5.0. Conclusion and Recommendation

From study findings and earlier discussion, it was noted that cost influence tax compliance negatively and significantly contributing 9.6% variability to tax compliance by SMEs when other factors are held constant. The Kenya Revenue Authority should consider revising the cost of tax product downwards. Additionally, Kenya Revenue Authority should make the tax filing process convenient, easy and costless. Similarly, Kenya revenue authority, should not impose penalties on late filing of taxes. The tax computation should be as easy as possible to enhance eligible tax payers' compliance.

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