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EFFECT OF DOMESTIC TAX REFORMS ON TAX COMPLIANCE AMONG MICRO AND SMALL ENTERPRISES IN NAIROBI COUNTY, KENYA

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Abstract

This paper assessed the effect of domestic tax reforms on Micro and Small Enterprises tax compliance in Kamukunji market in Nairobi, Kenya. The study was premised on the economic theory, neo-classical theory, psycho-sociological theory and benefit theory. The target population was 1,240 Micro and Small Enterprises operating in Kamukunji market. Yamane (1967) formula was employed to come up with a representative sample size of 302 SMEs for the population. Primary data was collected using questionnaires. To ensure questionnaire validity, questionnaire inconsistencies that arose from pilot study were rectified. The coded data was then fed into SPSS version 26 for reliability testing. It was found that there was linearity, multicollinearity test results were satisfactory, that is, between 1and 10 and there was no heteroscedasticity at 5% degree of freedom. Inferential and descriptive statistics were used in data analysis. Model significance was tested using simple regression and variance analysis, correlation and, coefficient of determination. The study found out that domestic tax reforms have a significant influence on Micro and Small Enterprises tax compliance, that is, $F (3, 298) = 18.660$, $p = 0.000 < 0.05$. The study recommended that Kenya Revenue Authority should administer tax education and conduct compliance audit checks. These findings are important to tax administrators in enacting tax reforms, Micro and Small Enterprises in making investment decisions and researchers for reference and further studies.

Keywords: *Domestic tax, Micro, Small and Enterprises (MSEs), Tax compliance, Tax reforms*

Introduction

The history of taxation has evolved from a long time aging back to six thousand years B.C where a common principle that of a levy imposed to citizens which is administered centrally and then utilized for the common good (Gitaru, 2017). In early human history, tax collectors used the most rudimentary methods; some of these methods were so crude that they tarnished the name of the profession (UNCTAD, 2008). Taxation is the major source of government revenue in developed and developing countries.

The tax revenue collection by Sub-Saharan Africa countries is insufficient to support their budget, this results to budget deficits. In exemption to macroeconomic reasons like short-time fiscal stimulus, budget deficits lead to undesirable macroeconomic consequences such as inflation and private investments crowding out effect (Schutte, Labuschagne, et. al, 2019). The main challenge to tax administrations is achieving and maintaining a high level of taxpayers` self-assessment and voluntary compliance.

Micro and Small Entreprises sector have emerged as potential and unexploited for tax (Awasthi, & Engelschalk, 2018). As per the Micro, Small and Medium Enterprises (MSMEs) Bill 2012, Sessional Paper No 2 of 2005, Micro enterprises is a firm, service, trade, business, or industrial activity either formal or informal with at most Ksh. 500,000 annual turn-over and have 1- 9 employees. Small enterprises are trade, firms, service, business or industrial activities whose annual turnover range between Ksh 500,000 and Ksh 5 million and have 10 to 50 employees (GOK, 2012). Tax collected from Micro, Small and Medium Enterprises has been lower than their GDP contribution, this depicts that despite their potential, they are tax non-compliant. Studies on SMEs in developed countries such as the UK suggests that even when offered tax reliefs, they do not take advantage of them due to the strong perception that they are difficult to claim and complex criteria (Keen, 2009). Uncertainty on whether tax refund claims succeed is also another issue.

Improving tax compliance is the main ingredient to build strong, trusted public institutions (Shivanda & Obwogi, 2018). Despite using various initiatives to increase revenue collection, KRA failed to meet the targeted collection by 106 billion for the financial year 2017/18 (KRA, 2018). The government could continue failing to collected significant tax revenue proportion from MSEs sectors if the attention of equal measure like in the large corporation will not be emphasized. Little has been in research on tax in light of the effect of domestic tax reforms on tax compliance among MSEs. Therefore, this paper assesses the effect of domestic tax reforms on Micro and Small Enterprises tax compliance in Kamukunji market, Nairobi, Kenya. MSEs operating in Kamukunji market made a good representation of the MSEs population operating in Nairobi county as it is composed of MSEs dealing with both local and imported products selling on retail and wholesale.

Research Objective

To assess the effects of domestic tax reforms on tax compliance by MSEs in Nairobi County

Literature Review

Domestic Tax Reforms in Kenya

Tax reforms in Kenya were initiated in 1986 while tax administrative changes were commenced in 1995 when KRA was instituted to co-ordinate tax collection and strengthen revenue collection.The KRA Second Corporate Plan (2003/04 – 2005/06) and Third Corporate Plan (2006/07 – 2008/09) were set forth for the Revenue Administration Reform and Modernization Program (RARMP) (KRA, 2012). The Fourth KRA Corporate Plan was enacted between years 2009/10 and 2011/12. It focused on entrenching the reforms at operational levels to improve service delivery and operational efficiencies (KRA, 2012).

The 6th Corporate Plan was built on 5th KRA plan that was anchored to achieve service levels similar to benchmark middle-income states (KRA 2015). KRA 6th Corporate Plan (2015/16 – 2017/18) was built on trust through facilitation to enhance tax compliance. The plan focused on the utilization of innovative technology products and practices to operate efficiently (KRA 2016).The Seventh KRA Corporate Plan 2018/19 – 2020/21 aimed at tax collection through transformation, data-driven, decision- making and expanded Tax Base to facilitate in the achievement of the Jubilee Government`s Big Four Agenda and vision 2030 Third Term Plan (KRA 2018).

Theoretical Review

This study relied on economics and socio-psychology-based theories as detailed in the section below:

Economic Theory

Economic theory is also known as deterrence theory or theory of crime. Becker (1980) on the theory of crime asserted that authorities needed to equalize detection of non-compliers and penalties to the point where non-compliance will be irrational. According to Devos (2012), economic model presents the taxpayers during filing a tax return, reporting and payment, and the amount evaded.

In order to improve compliance, audits and penalties for non-compliance should be increased.

The theory does not only fascinate with the uncertainty and speculation talents in the market but it acknowledges that the government has superior knowledge to that of the market. This theory was useful in examining effect of domestic tax reforms on MSEs` tax compliance in Nairobi county, Kenya.

Neo-Classical Theory

The theory focuses on the microeconomic theory which expounds on the relationship between price changes and government policies (Wolff & Resnick, 2012). They further argue that employees will give up leisure to earn extra units of income after tax (Davidson,2015). However, charging extra units of income marginal tax rates demotivates employees from working extra hours or producing extra units. It applies also to companies whereby taxes charged on an extra unit of capital goods reduces investors` urge to do capital investments to earn more. Therefore, neo- classical theory forms a foundation of establishing an equitable, convenient, certain and effective taxation system. A taxation system that promotes voluntary taxpayers` compliance. This theory was useful in this study in explaining MSE`s tax compliance in light of domestic tax reforms.

Psycho-Sociological Theory

The psycho-sociological theory is based on changes in the factors influencing individual decisions. The proponents of this theory posit that tax authorities should strive to ensure that they put in place tax laws that influence positively the behaviors of the taxpayers towards tax compliance (Ondimu, 2015). Psychology theories postulate psychological factors influence taxpayers towards tax compliance.

Benefit Theory of Taxation

Knut Wicksell in 1896 and Erik Lindhal in 1919 developed the benefit theory. According to Munyoro(2017), Benefit Theory posits that the state should tax individuals based on benefits derived to ensure fairness and equity in taxation.

The benefit theory has been criticized on the bases of tax on individuals to be in proportion to the benefits derived. This theory enabled the researcher to relate MSEs perception on government utilization of public funds and their compliance to variance tax laws.

Empirical Review

Akitoby (2018) in a research study on raising revenue, a case of five developing economies illustrates how best to improve tax collection. The research was anchored on five developing economies. The study established that although the optimal timing and design of reform measures vary among countries, tax policy reform and revenue administration pursue are beneficial to the country`s public finance.

IMF (2019) case study on tax revenue mobilization in low-income countries sought to determine how can developing countries enhance tax collection in order to finance their development projects. The study found that tax reforms require political and stakeholders' goodwill. It was also determined that for tax reforms to be successful, the tax authority should ensure simplification of the tax system, reduce tax exemptions, indirect tax reforms. Kayaga (2007) did a study to review the advantages and disadvantages of tax system changes. Uganda was used as a representative sample of Sub-Saharan Africa countries, in terms of taxes and rates. It was established that despite various tax reforms, growth in domestic tax collection increased relatively below the budget target. The study suggested that appropriately tax policy reforms should be enacted to promote tax collection.

Kanyi (2014), conduct a study on the Effects of Tax Policy Reforms on Tax Revenue in Kenya. The study also found that the major problem in taxation was non-compliance of the informal sector. It recommended that all stakeholders should be involved when doing tax reforms to promote voluntary compliance. Gathungu (2019) study on determinants of tax compliance among SMEs in Thika town, Kenya was anchored on three explanatory variables, that is, tax penalties, tax system automation and taxpayers` perception on tax laws. The study established that tax penalties, taxpayers` perception and tax system automation have a strong positive correlation to taxpayers' compliance. Munyoro (2017), on the study of effects of iTax system on VAT obligation compliance by SMEs in Kenya in reference to Wote town in Makueni County, based it on tax registration and taxpayers` ICT knowledge. The study concluded that iTax system enhances revenue collection and tax compliance. It recommended KRA to address complexities of annual tax returns, tax policies, punitive penalties, and fines to enhance tax compliance.

Domestic Tax Reforms and MSEs Tax Compliance

The study focused on determining functional relationship between three independent domestic tax reforms against tax compliance of the MSEs in Kamukunji market in Nairobi County.

Predictor Variable **Predicted Variable**

Figure 1: Conceptual Framework

Domestic tax laws and procedures dictates the tax rates, tax administration and tax obligations to be subjected on the MSEs. On the other hand, domestic tax reforms success depends on the MSEs adherence to tax registration, tax filling, self- assessment accuracy and remitting tax. The tax revenue collected from MSEs depends on their compliance to domestic tax requirements. Therefore, the study was seeking to assess the effect of domestic tax reforms on MSEs tax compliance.

Methodology

Research Design

The study adopted a descriptive research method. A descriptive research design gives a valid and accurate representation of variables as per the research questions (Njenga, 2019). Descriptive research design was appropriate for this study as the research study problem was well structured, therefore, precise rules and procedures are required in data collection and analysis.

Target Population

Mugenda and Mugenda (2012) posit that a target population is an entire population, events, or objects having common observable characteristics that the researcher intends to generalize the research results. The target population represented a combination of the entire population that the researcher has in consideration to obtaining the study target population of MSEs in Kamukunji market, Nairobi County. The market was a hub of MSEs running various business activities at different levels of the supply chain. The data on MSEs was obtained from the county government of Nairobi as presented on Table 1:

Table 1: Descriptive Statistics on Study Population

Category	**Population**
Wholesalers	192
Retailers	367
General Merchants and Kiosks	502
Fruit Vendors and Informal Traders	129
Transport business	12
Agri-processors	3
Hotels	35
Total	**1,240**

Source: Nairobi County Government (2020)

Sampling

According to Kumar (2011), sampling is a process of selecting a smaller representative number from the study population. It helps to counter time, logistics, and financial constraints available for the study.

The sampling frame for the study comprised Kamukunji market MSEs. MSEs constituted the majority of the businesses in Kamukunji market. The study grouped the MSEs based on their business activities then a simple random sampling technique was used. To have a clear scope of selection of a representative sample from strata, a stratified sampling technique was used.

The study used Yumane (1967) formula to come up with a representative sample size for the population as described.

$n= \{[N/ (1+N (e)^{2})]\}$

Where n = required sample size, N = given population size, e = Level of confidence determined at 95%, $n =\{[1240/ (1+ 1240 (0.05)^{2}\}$

Hence, the sample size was 302 MSEs.

Sources of data

The study relied on primary and secondary data sources. The study used primary data in determining factors that influence MSEs` tax computation. Primary data consisting of dichotomous and non-dichotomous questions was used to collect data. The background information of the respondents guided the questionnaire in marking appropriate demographic information that fits their classification. The other parts were ranked using a Linkert scale where the following levels represented: (1) strongly disagree, (2) disagree, (3) neutral (4) agree, and (5) strongly agree.

The Secondary data sources on MSEs in relation to tax compliance was reviewed. Secondary data complement the collected primary data using questionnaires.

Pilot Study

The pilot study heralded the actual fieldwork. Seven questionnaires were administered to each category of randomly selected MSEs in Kamukunji market, Nairobi county. The pilot study helped the researcher in analyzing the appropriateness of the question to the research objectives and statistical uses. It also helped in the selection of the model of administering questionnaires.

Validity and Reliability

Masuwai et al., (2016) assert that content validity shows how items of an instrument are representative of the subject matter that the instrument seeks to measure. The validity of this research study content was determined through a pilot study where the responses of the subject were checked for consistency with research objectives. To ensure questionnaire validity, questionnaire inconsistencies that arose from pilot study were rectified. Research experts` opinion also was used in determining the content validity. Expert judges review the research instruments independent of each other (Nicolas et al., 2016).

The filled questionnaires were verified for consistency and completeness before being coded for data analysis. The degree of which measure is consistent without bias measurement across time and various items in the instrument is reliability (Sritharan, N., Salawati, S., 2019). The coded data was fed into Statistical Package for Social Sciences (SPSS) version 26 for analysis, validation and testing for reliability. The SPSS is user friendly and easy to link with other soft wares utility. Reliability increases as the reliability coefficient gets closer to 1.0, reliability values less than 0.6 are considered to be poor (Mohajan and Mohajan,2017). It was found that there was linearity, multicollinearity test results were satisfactory, that is, between 1 and 10 and there was no heteroscedasticity at 5% degree of freedom.

Data Analysis and Presentation

The processing of the data to make out meaningful deductions is data analysis (Njenga. A. W, 2019). Descriptive and inferential statistics were used in the study. The inferential statistics included the coefficient determination of fitness, correlation, simple regression analysis and analysis of variance for model significance. The following equation was used to represent the analyzed data:

$Y = \beta_0 + \beta_1 X_1 + \beta_2 X2 + \beta_3 X_3 + e$

Where;

β_0 = Y Intercept, Y = Y Intercept, X_1 = Tax obligation, X_2 = Tax administration, X_3 = Tax rates, e = Error term, β_1, β_2, and β_3 = Coefficients of X_1, X_2 and X_3 respectively.

Results and Discussion

Effect of Domestic Tax Reforms on Tax Compliance by MSEs in Nairobi County

The objective of the study was to evaluate and assess the effects of domestic tax reforms on tax compliance by MSEs in Nairobi County. To achieve this objective, a series of data tabulations and analyses were conducted and presented below. The data gathered on the domestic tax reforms consisted of three sections covering on; tax obligations, tax administration, and tax rates. The data in these three sections was gathered by a series of statements on which the respondents selected for participation were requested to give their level of agreement to each. Correlation and diagnostic tests were carried out as well as a regression. This was carried out at 0.05 levels of significance.

Domestic Tax Reforms (Changes) and Tax Compliance

The data of the three reforms taken into account was presented in tables in this section. These three being; tax obligations, tax administration, and tax rates. The tax obligations consisted of seven statements used for its exploration. The tax administration consisted of 11 statements while the tax rates were measured using four statements.

Tax Obligations

The data on the Table 2 is a representation of the levels of agreement to the statements in regard to how tax obligation reforms influence the SMEs tax compliance in Kamukunji market.

Table 2: Descriptive Statistics Findings on Levels of Agreement to the Tax Obligations Reforms.

Statement	Mean	Standard Deviation
Businesses are aware of tax obligations that they should comply with	3.80	1.264
Businesses know when to file and make payments of taxes linked to their business.	3.65	1.194
Few hours are spent in complying with tax obligation(s)	3.77	1.168
Chances of a taxpayer making an error is high while filing tax.	3.77	1.218
Tax compliance is a costly mandatory practice (venture).	3.61	1.161
The tax system is simple to use (user friendly).	3.73	1.233
The Government fails to involve taxpayers in formulation of tax policies and procedures.	3.75	1.125

Source: Survey Data (2020)

Researcher sought to determine taxpayers` knowledge on related changes on tax obligations in relation to their influence on their tax compliance. The researcher found that MSEs are aware of their tax obligations which affirms Akitoby`s (2018) study finding. The study finding on tax system simplicity and tax compliance related costs support Munyoro (2017) study findings but negate from Gathungu (2019) study findings.

Tax Administration

Tax administration reforms require political and stakeholders` goodwill to be successful (IMF, 2019). It was found that taxpayer tax education, and frequent tax audits, and tax penalties enhance tax compliance among SMEs.

Tax Rates

The following are the results indicating the level of agreement by the various business operators in Nairobi County with regard to reforms in the tax rates. Four statements were taken into account as measures of the reforms in the tax rates as shown on Table 3:

Table 3: Levels of Agreement to statements in regard to reforms in Tax rates

Statements	Mean	Standard Deviation
I am aware of the current tax rates of various tax obligation I have registered.	3.75	1.109
The tax rates are not appropriate for our business.	3.83	1.114
The rate of turnover tax is prohibitive.	3.75	1.120

Source: Survey Data 2020

It is generally believed that tax rates are the main cause of tax evasion (Mwangi, 2014). The study research finding on tax rates effect on MSEs tax compliance affirmed it.

Diagnostic Test for Domestic Tax Reforms

Linearity Test

Based on the ANOVA, the value significance deviation of 0.810 > 0.05, it was concluded that there is a linear relationship between the domestic tax reforms and the MSEs' Tax Compliance.

Test for Multicollinearity

The determination of the assumption of multicollinearity for the variable of domestic tax reforms. The obtained results indicated VIF values for the three factors in regard to the domestic tax reforms do lie between 1 and 10. This is thus an indication that there is no multicollinearity for the tax obligations, tax administration, and tax rates.

Test for Heteroscedasticity

Based on the output coefficients, the obtained value of significance on Tax Obligations was 0.487 > 0.05, Significance value for Tax Administration is 0.457 > 0.05, and significance value for Tax rates are 0.067 > 0.05, thus it was concluded that there is no heteroskedasticity problem.

Correlation between the Domestic Tax Reforms and MSEs' Tax Compliance

The correlated test results as displayed indicate that there exists a positive and a significant correlation between the MSEs' Tax Compliance and Tax Administration ($r = 0.232$, $p = 0.000$), as well as with tax rates ($r = 0.321$, $p = 0.000$). However, a weak insignificant correlation existed between the MSEs' tax compliance and the tax obligations ($r = 0.089$, $p = 0.121$).

Regression for the MSE Tax Compliance and Domestic Tax Reforms

To effectively evaluate and ascertain whether domestic tax reforms do have any influence on the MSEs’ tax Compliance, a multiple linear regression was carried out. From the regression result, it is clear that 15.8% (R Square = 0.158) variation in the MSEs’ Tax Compliance among the businesses operating in Kamukunji Market and as well as the MSEs in Nairobi County are explained by the three domestic tax reforms.

The results as displayed indicate that the model for the prediction of the MSEs’ tax compliance by the domestic tax reforms is significant; $F (3, 298) = 18.660$, $p = 0.000 <0.05$. The check on the levels of significance for each of the tax reforms indicators in influencing the level of MSEs’ tax compliance, the results indicated that all the three domestic tax reforms had a positive and significant influence on the change in MSEs’ Tax Compliance. These are; Tax Obligations (ß = 0.168, p = 0.000), Tax Administration (ß = 0.227, p = 0.003), and Tax Rates (ß = 0.277, p = 0.000). Thus the overall model for the regression is as follows:

$Y = 1.322 + 0.168X_1 + 0.227X_2 + 0.277X_3$

sThe results as displayed indicate that all the three domestic tax reforms indicators have a positive and significant influence on the change in MSEs’ Tax Compliance.

Conclusion

In regard to the findings of the study, it was concluded that the MSEs operators have an understanding of tax reforms. The reforms in domestic tax affect MSEs tax compliance. Supportive tax policies were found to be effective in enhancing MSEs` tax compliance. This is inclusive of education on tax matters and application of tax penalties. The study found that tax compliance exercise is costly to MSEs in Nairobi County. It was also found that the government failed to involve MSEs` in the formulation of tax policies. Overall, the research makes a conclusion that the reforms in the domestic tax do have a significant positive influence on tax compliance among the MSEs operating in Nairobi County.

Recommendations

The KRA is advised to always conduct regular auditing and also impose tax non-compliance penalties. The KRA should also do public sensitization on the role of the taxes and as well as consistency in training on tax matters. Further, MSEs` opinions should be considered when enacting tax amendments. Based on the foregoing, this study recommends that a research should be conducted to check if sufficient measures are put in place by the Government through the KRA to limit and check on loopholes for the tax evasion among the MSEs operating in Nairobi County.

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