

## **TAX COMPLIANCE COST AND TAX PAYMENT BY SMALL AND MEDIUM ENTERPRISES IN EMBU COUNTY, KENYA**

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## **ABSTRACT**

Tax collection is a major concern among many governments all over the world. Questions about tax compliance are as old as taxes themselves and history has shown that there has always been a reluctance to pay taxes. As such, the small-scale sector has been noted as difficult to tax and remains a pressing question in the minds of the tax authorities. Though the number of Small and Medium Enterprises is steadfastly growing, the tax inflow from the sector is still insufficient. This study evaluated the determinants of tax compliance by Small and Medium Enterprises in Embu County in Kenya with focus on tax compliance costs. To achieve the research objectives the study employed a descriptive study design. The population of interest comprised all the 615 registered SMEs in Embu County. This study used a sample of 185 Small and Medium Enterprises in Embu County, which were selected using stratified and simple random sampling methods. Data for the

study was collected using questionnaires. Descriptive statistics like mean, standard deviation and percentages of responses were calculated. Inferential statistics like regression, analysis of variance and t tests were used to test the significance. The findings of the study found a significant positive relationship between tax compliance costs and tax compliance by Small and Medium Enterprises in Embu County. The study concluded that there is a significant direct relationship between tax compliance costs and tax payment by Small and Medium Enterprises in Embu County. The study recommended that the Kenyan tax authorities should come up with policies to reduce tax compliance cost in order to enhance tax payment. The policies should also ensure that they do not affect the growth of Small and Medium Enterprises and should encourage Small and Medium Enterprises to comply with taxes.

**Key Words:** *tax, tax compliance, tax payment, SMEs*

## **INTRODUCTION**

Small and Medium Enterprises (SMEs) are considered as a key engine of economic growth in developing and developed countries (Nahida, Copp, Freudenberg & Sarker, 2014). The SMEs sector's importance in the economic development of any country in recent years cannot be underrated especially with regard to creation of employment, innovation, uplifting the people's standard of living and financial contribution to the growth of the country's Gross Domestic Product (Machira & Irura, 2012). SMEs play a crucial role in maintaining high employment and income generation and are therefore critical for a country to achieve sustainable growth (International Tax Dialogue, 2007). Robust economies like the United States of America and the United Kingdom trace their development from growth of their SMEs (Organization for Economic Co-operation and Development, 2009). A study by Amyx (2005) attested that SMEs cover more than 95% of all firms in Sub-Saharan Africa and their importance cannot be overestimated. According to Maseko (2014), SMEs in Zimbabwe represent over 95% of enterprises that generate over 50% of private sector employment. In Cameroon, SMEs employ a substantial proportion of the country's labour force and constitute a very important avenue for

achieving poverty alleviation and reducing unemployment (Akinboade, 2015). In Kenya, the SME sector contributes an estimated 18% of the GDP as well as creating employment for 80% of the workforce population (Wanjohi & Mugure, 2008). SMEs being profit generating establishments are also expected to pay taxes (Atawodi & Ojeka, 2012). Taxation revenues can be used effectively by government for meeting its public expenditures (Shaharuddin, Palil, Ramli, & Maelah, 2012). As such, taxes are fundamental to the existence of governments, for the tax revenues help to finance the bulk of services that governments provide (Tehulu & Dinberu, 2014). Moreover, Awa and Ikpore (2015) posit that tax revenue is the source of funds used for development projects.

### **Tax Compliance**

According to Ayuba, Saad and Ariffin (2016) tax compliance is the taxpayers' ability and willingness to comply with the relevant tax laws and regulations. Sapiei and Kasipillai (2013) posit that tax compliance is the accurate reporting of income and claiming of expenses in accordance with the stipulated tax laws. Tax compliance is the degree to which a taxpayer complies with the tax rules of their country (Marziana, Norkhazimah, & Mohamad 2010). Tax compliance is an important issue in every economy recognizing the role revenue from tax play in national development (Agbadi, 2011). Developing countries are still characterized by the low tax compliance levels, in the face of the numerous advocacies for voluntary compliance (Alabede, Zaimah & Kamil, 2011). Hence, finding patterns of tax evasion behaviour and ways to reduce it is one of the main goals of many governments' agenda nowadays, in order to achieve higher levels of compliance (Loureiro, 2014). As such, many governments have adopted tax compliance administrative measures like penalties, rates and tax audits to ensure tax enforcement instead of compliance (Chebusit *et al.*, 2014). Wherever authorities decide to levy taxes, individuals and firms try to avoid paying them (International Tax Compact, 2010). The menace of tax noncompliance has long been realized by authorities who have consistently attempted to find ways to improve the situation yet to no avail (Antwi, Inusah & Hamza, 2015). Kenya is ranked among low-income countries or low compliance countries with the hard task of ensuring efficient and effective tax administration, in order to ensure tax compliance, hence raising more revenue (Makori, *et. al*, 2013).

### **Small and Medium Enterprises in Embu County**

SMEs in Embu County range from agricultural producers, supermarkets, restaurants, educational institutions, health institutions, general traders, professional service firms among others (Embu County Government Records, 2015). These SMEs are part of the main contributors to the economy of the Embu County as they create employment and purchase products hence directly supporting livelihoods. According to Ndemo (2015), most SMEs do not register for tax purposes and most of them operate without licenses from both the county and national governments. Thus, the issue of tax compliance is a serious concern in most of the SMEs. In addition, millions of shillings are generated from the SMEs business operations on daily basis, which is subject to

taxation by the government however; statistics indicate that small businesses in Kenya form the core group of hard-to-tax taxpayers (Lumumba *et al.*, 2010). Thus, an investigation on the determinants of tax compliance by SMEs in Embu County in Kenya is vital.

## **PROBLEM STATEMENT**

Tax collection has been a major concern among many governments all over the world (Loureiro, 2014; Ayuba, Saad & Ariffin, 2016). According to Agbadi (2011) history has shown that there has always been a reluctance to pay tax. Again, statistical evidence has proven that the contribution of income taxes to the government's total revenue by SMEs remained consistently low (Chebusit *et al.*, 2014). Over the last forty years, tax collection in Kenya, experienced large fluctuations when measured as a ratio of actual tax share of gross domestic product (Waris, Kohonen, Ranguma & Mosioma, 2009). In addition, there has been hostility between the taxpayers and tax collectors on issue relating to tax compliance (Makori, *et al.*, 2013). Most SMEs do not pay the taxes and tax evasion among SMEs remains far above the ground, with a tax gap of about 35% and 33.1% in 2011 and 2012 respectively (KRA, 2015).

## **OBJECTIVE OF THE STUDY**

The objective of this study was to evaluate effect of tax compliance cost and payment by Small and Medium Enterprises in Embu County, Kenya.

## **SIGNIFICANCE AND SCOPE OF THE STUDY**

The findings of this research is of significance to SMEs as it will help them to determine the relationship between compliance costs, fines, penalties, tax knowledge, the complexity of tax system and tax compliance. Further, the findings of this study are useful to various tax authorities in Kenya. Finally, the findings of this study will advance the existing literature on taxation, which will be of significance to researchers as part of their empirical studies. This study sought to examine the determinants of tax compliance by SMEs including supermarkets, retail stores, financial and money transfer services, small restaurants and hotels and other SMEs in Embu County in Kenya. The study sampled the employees and owners of the SMEs in Embu County.

## **THEORETICAL REVIEW**

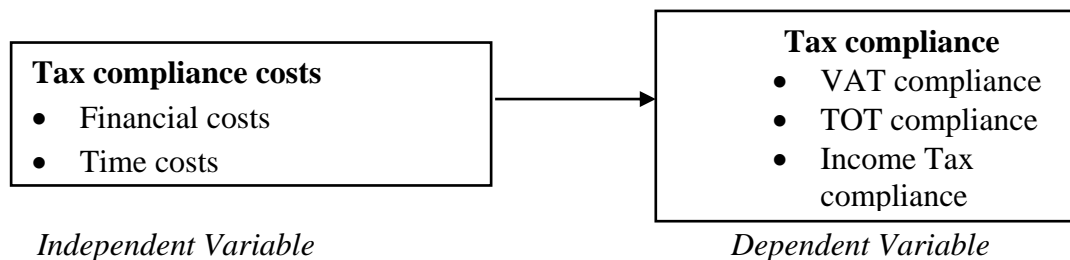
The model posits that tax compliance is a function of three deterrent variables; tax rate, tax audit and probability of detection (Mas'ud, Aliyu & Gambo, 2014). The theory also states that taxpayer behavior is influenced by the factors that determine the benefits and cost of evasion, such as the tax rate, the probability of detection and penalties for fraud (Ali *et al.*, 2013). Further, the theory presupposes that the taxpayer's behaviour is influenced by factors such as the tax rate determining the benefits of evasion, and the probability of detection and penalties for fraud, which determine the costs (Fjeldstad, Herzenberg & Sjursen. 2012). The deterrence theory

emphasizes that an increase in the severity of penalties and the certainty of their imposition will discourage undesirable behaviour (Sapiei, *et al.*, 2014).

The deterrence theory is concerned with the effects of sanctions and sanction threats. Within this framework, the tax rate, detection probability and penalty structure, determine the monetary costs of compliance, which determine taxpayers' compliance behavior (Sapiei & Kasipillai, 2013). The model shows that the extent of tax evasion is negatively correlated with the probability of detection and the degree of punishment. In addition, the economic deterrence model in its basic form views the individual taxpayer as a rational economic agent. The taxpayer assesses the costs that arise when detected as a defaulter, penalties levied for fraud and benefits of evading taxes, and thus chooses not to pay, if the benefit of non-compliance outweighs the costs (Walsh, 2012).

The theoretical principle of economic deterrence have been widely adopted by tax administrations when developing enforcement strategies that rely principally on penalties and the fear of being caught (Cobham, 2005). The theory also suggests that taxpayers are amoral utility maximizers. This means they are influenced by economic motives such as profit maximization and probability of detection (Atawodi & Ojeka, 2012). 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 after tax returns after adjusting for risk (Awa & Ikpor, 2015). The deterrence theory is concerned with the effects of sanction threats on criminal and undesirable behavior; however, this had problems of identifying sanctions, determining how much effect and specifying the mechanism by which the effect occurs (Tusubira & Nkote, 2013).

## CONCEPTUAL FRAMEWORK



**Figure 1: Conceptual Framework**

## EMPIRICAL REVIEW

Tax compliance costs refer to the costs incurred in acquiring and organizing information, hiring internal auditors and purchase of materials and stationeries (Organization for Economic Co-operation & Development, 2009). A study by Eragbhe and Modugu (2015) evaluated the estimated cost of tax compliance for SMEs in Nigeria. The study explored the sum of internal compliance cost, external compliance cost and incidental cost; including bribery psychological

cost related to the different taxes paid by SMEs in Nigeria. The study findings revealed smaller SMEs were taxed more than larger SMEs, and therefore there was existence of tax compliance costs regressivity in Nigeria.

Nahida *et al.*, (2014) also investigated the nature and extent of the relationships between the complexity of Bangladesh's Value Added Tax legislation, the costs of compliance with VAT in Bangladesh, and noncompliance with the VAT legislation by Bangladeshi SMEs. The study findings established that a majority of the compliant SMEs taxpayers listed complexity in VAT law and compliance costs as the two important factors influencing VAT noncompliance in SMEs. A study by Mas'ud *et al.* (2014) examined the correlation as well as the effect of tax rate on tax compliance in Africa using cross-country data. The findings showed that there is significant negative correlation between tax rate and tax compliance. Osebe (2013) analyzed the factors affecting tax compliance in real estate sector in Kenya. The study used explanatory research design and a sample of 271 respondents from Nakuru Town. The study findings established that compliance cost had a negative effect on level of tax compliance of the real estate sector in Kenya.

## **RESEARCH GAPS**

Several studies have examined the determinants of tax compliance cost by various organizations including SMEs around the globe and in Kenya. Most of the reviewed studies have established that tax evasion and avoidance are both common among SMEs and tax compliance has been an issue for policy makers all over the world. In addition, most of the studies have revealed that the level of tax evasion and noncompliance among SMEs is relatively low and there are different determinants of tax compliance in different countries and regions. Notwithstanding, limited studies have been carried out on the determinants of tax compliance among SMEs in Embu County. As such, though numerous studies have been done on tax compliance the problem of non-compliance still exists in Embu County and hence, there is need of evaluating the determinants of tax compliance by SMEs in Embu County, Kenya.

## **RESEARCH METHODOLOGY**

### **Research Design**

In order to achieve the outlined research objectives, this study employed a descriptive cross-sectional study design. This descriptive research sought to provide an accurate description of observations and to determine the status tax compliance. In addition, this research design aimed at providing an accurate and valid representation of the study's variables.

### **Target Population**

The target population comprised of all 615 SMEs in Embu County. Therefore, accessible population of the study comprised of all the registered SMEs in Embu County. According to Embu County 2015, records there are 615 registered SMEs within Embu County.



## **Sampling Techniques and Sample Size**

This study used a sample of 185 SMEs in Embu County. The sample is 30% of the population, which conforms to the recommendation by Mugenda and Mugenda (2006). To select the sample of the study stratified and simple random sampling methods were used. Stratified sampling was used to group the SMEs in various categories or strata based on the type of the SMEs and then simple random sampling method was used to select the respondents from each stratum. Stratified sampling method ensures that sub-groups in the population are represented in the sample while simple random sample gives each respondent a random chance of being included in the study. Table 1 shows the sample size.

**Table 1 Sample Distribution**

Strata	Population	Sample
Supermarkets	18	5
Shops and retail stores	404	122
Financial and money transfer services	83	25
Small restaurants and hotels	37	11
Private education institutions	52	15
Petrol filling stations	21	7
Total	615	185

## **Data Collection and Analysis**

This study used a questionnaire to collect data. The questionnaire consisted of open and close-ended questions. In addition, the questionnaire was designed with questions to cover all the study variables with multi- statements designed on Likert scale of five points. The data collected was analyzed using descriptive and inferential statistics using the Statistical Package for Social Sciences (SPSS) and then presented using tables and charts.

## **RESEARCH RESULTS**

### **Demographic Information**

Research results indicated that 52% of the sampled respondents were the SMEs owners while 48% were employees. This indicates that founders or owners run most of their SMEs. 51.2% of the SMEs had been in operation for less than five years while 26.3%, 14.0% and 8.5% had been in operation for between 6-10 years, 11-5 years and for more than 16 years respectively. 73.6% of the SMEs are sole proprietors whereas 14% are limited companies while 12.4% are in the form of a partnership. This shows sole proprietors own most SMEs in Embu County.

### **Descriptive Statistics**

The results indicated that 31% of the respondents indicated that they incur cost in collecting, remitting and in of filing taxes. The findings also indicate that 17.1% of the respondents incurred

costs associated with accounting staff wages and salaries, 12.4% of the respondents indicated that they incurred cost related to bribes mostly paid to county government agents who collect county government levies while 8.5% incurred cost of acquiring tax knowledge. This indicates that SMEs incur different tax compliance costs, with the highest incurred costs being the cost of collecting, remitting and filing taxes. Results indicated that 52.7% of the respondents indicate that the cost of filing tax returns is high while 24% indicate it very high. The findings also show that 15.5% of the respondents indicated that the cost of filing returns is average while 7.8% indicated that it was low. This finding indicates that the SMEs consider the cost associated with filing tax returns as high. Results also showed that 69.77% of the respondents did not comply with all tax requirements while 30.23% complied with all the tax requirements. This indicates that majority of SMEs operators do not comply with at tax compliance requirements. The results further indicated that 60.5% of the respondents indicated that the compliance to tax requirement was not good while 17.1%, 14.7% and 7.8% indicated that the compliance status was fair, good and excellent respectively. This indicates that the compliance status of most SMEs operators is not good.

### **Inferential Statistics**

The binary logistic regression was adopted in order to establish the relationship between the dependent and the independent variables. The results comprises of the model summary, binary logistics regression analysis and summary of the coefficients.

**Table 1: Model Summary**

-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
<sup>a</sup>	.361	.511

- a. Estimation terminated at iteration number 4 because parameter estimates changed by less than .001.

The model summary results in table 2 consists the Cox & Snell  $R^2$  and Nagelkerke  $R^2$  values, which are used to calculate explained variation. Explained variation in dependent variable based on this model range from 36.1% to 51.1%. Using the Cox & Snell  $R^2$  value, 36.1% of the dependent variable is explained by the independent variables while 63.9% is explained by other factors and the error term.

**Table 2: Variables in the Equation**

	B	S.E.	Wald	df	Sig.	Exp(B)
Constant	-.836	.192	19.028	1	.000	.433

The significance results in table 3 indicate that the model in odds, B value is -0.836 and the p-value of 0.000. P-Value is less than 0.05 ( $0.000 < 0.05$ ) which indicates that the regression model



is significant and a good predictor of the determinants of tax compliance by SMEs in Embu County.

**Table 3: Classification Table**

Observed		Predicted		Percentage Correct
		Tax compliance		
		0	1	
Tax compliance	0	90	0	100.0
	1	39	0	.0
Overall Percentage				69.8

a. Constant is included in the model.

b. The cut value is .500

**Table 4: Coefficients of variables**

	B	S.E.	Wald	df	Sig.	Exp(B)
Compliance costs	.535	.153	2.356	1	.0125	1.265
Constant	-2.350	1.058	4.933	1	.026	.095

a. Variable(s) entered on step 1: Compliance costs, Fines and penalties, Tax knowledge and skills, Tax system.

In table 4 shows the coefficients of independent variable in the equation. From the regression coefficient results it was established that compliance costs ( $p = 0.125$ ) there is a significant positive relationship between all the independent variable in the equation and tax compliance by SMEs in Embu County. The table also indicates compliant costs have an effect on tax compliance [Exp (B) =1.1265]. Based on the results of the study above, the regression model was statistically significant. The model explained 36.1% of the dependent variable and correctly classified 69.8% of the tax compliance cases. Compliance costs can determine compliance up to 1.265 times.

## CONCLUSIONS

The findings of the study established that SMEs incur different tax compliance cost with most incurred costs being the cost of collecting and submitting taxes and the cost of filing taxes. The findings also revealed that the SMEs consider the cost associated with filing tax returns as high and that SMEs are affected adversely and disproportionately by compliance costs and that high tax compliance costs affects the growth and development of SMEs. The binary regression results found a significant positive relationship between tax compliance costs and tax compliance by SMEs. This shows the existence of tax compliance costs.

## **RECOMMENDATIONS**

The study concluded that there is a significant relationship between tax compliance costs and tax payment compliance by SMEs in Embu County. The study thus recommends that the Kenyan tax authorities should come up with policies to reduce tax compliance cost to ensure that they do not affect the growth of SMEs and encourages SMEs to comply with taxes.

This study focused on tax compliance costs, which according to the study findings explain 36.5% of the variation in the dependent variable, that is, tax compliance. This indicates that there are other factors, which influence tax compliance by SMEs in Embu County. This study therefore recommends an additional study on other factors like attitude and perception of taxpayers, effect of technology and online tax filing on tax compliance by SMEs in Embu County. The study also suggests an additional study on the effect of taxation on the growth and profitability of small and medium enterprises by small and medium enterprises in Embu County.

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