



Influence of Mode of Tax Payment and Legal Framework on Tax Compliance Level of SMEs in Kisumu County, Kenya

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Abstract

Small and Medium Enterprises (SMEs) play a key role in driving economic growth, job creation and poverty reduction in Kenya. In Kisumu County, SMEs form a significant part of the local business, contributing to employment opportunities and revenue generation. However, the effective taxation of SMEs remains main challenge for local governments, impacting fiscal sustainability and hindering developmental initiatives. Tax compliance among SMEs, particularly in Kisumu County, is influenced by various factors. The choice of tax payment mode, whether through traditional methods like cash or modern alternatives can significantly impact SMEs' compliance behavior. This study evaluated the influence of mode of tax payment on tax compliance among SMEs in Kisumu County, Kenya. The study was guided by the theory of planned behavior. The research employed a descriptive research design to investigate the influence of the mode of tax payment on tax compliance levels among SMEs. The target population consisted of 105 SMEs that had been operational for at least six months. Utilizing Yamane's (1967) formula, a sample size of 84 was determined. Data was primarily collected through a structured questionnaire. Data was analysed using descriptive and inferential statistics. Results indicated a positive but moderate relationship between the legal framework and compliance cost and tax compliance ($r=0.367$, $p<0.001$). This strong positive correlation suggests that a well-structured legal



framework significantly enhances tax compliance. Further, the correlation between the mode of tax payment and tax compliance, was statistically significant ($r = -0.697$, $p < 0.001$). This strong negative correlation suggests that certain modes of tax payment are inversely related to tax compliance. Specifically, it might imply that more complex or less convenient payment modes reduce compliance. The study recommends that there is need for KRA to conduct an extensive review of existing tax laws with the aim of simplifying language and removing ambiguities. This could involve the consolidation of similar regulations and the elimination of redundant or outdated provisions. Also, develop and implement comprehensive training programs for SMEs focused on the use of online tax filing systems as well as provide technical support.

Keywords: Legal Framework, mode of payment, Tax Compliance, SMEs

Introduction

Taxation is the chief source of revenue for most of the governments around the world (Garaibeh, 2015; Arvin, Pradhan & Nair, 2021). Tax compliance is the key focus of the national revenue, which is achieved by the tax capitulation and compliance by the taxpayers in the economy. However, the non-compliance by the SMEs in the economy absolutely directs most countries into public debt as alternative sources of national finance. Reports by Peters (2022) evidently shows the correlation between the impact of taxes and the public spending, which forms the main public objective. Lower tax capitulation due to non-compliance mainly attract lower or borrowed expenditure in the country to finance the public deficit. In the OECD countries for example, tax non-compliance declined the global yield by about 3.4% (OECD, 2021). Studies show that the tax revenues of the U.S.A was lower by 40% in 2019 due to tax non-compliance (Kim, Parker & Scholar, 2020). The substantial disparity in Australia amounted to a drop of 15% in the national income 2020, due to drastic SMEs non-compliance to tax payment. Spain has continuously recorded poor level of tax compliance by the SMEs, which has led to losses amounting to about 1.8 billion euros (OECD, 2021). In Ireland, research carried out demonstrates that the increasing culture of tax non-compliance by the SMEs translated into shortfall in public finance to 10.3 billion euros (Lambert et al., 2020). In Kenya, reports by the KRA show that the tax knowledge on ETR and iTax System of the KRA has been grasped by less than 78% of the SMEs in the economy, and the SMEs have also not seen the importance of paying and filing iTax. Accordingly, this has caused a drastic loss of about 31.3% in 2013 financial year. In in Kisumu County, the 2020/2021 Budget Committee reported only 32.15% contribution from boda-boda self-



operations, market fees, bus parks, cesses, liquor licenses, single business permits and other SMEs in the county.

This study postulates that the aspects of legal framework and modes of tax payment have significant effects on tax compliance in any economy. This is viewed for some reason that (ITD, 2021) presented an international dialogue on the tax capitulation and sanctions in the developing countries' SMEs, a matter that associate's compliance and non-compliance level to tax with the economic models developed by a country. Conventionally, higher costs of tax compliance creates tax burden and hence non-compliance by the SMEs, as they are economically fragile from lesser cash safeguards than their larger counterparts. In the countries where taxpayers are tax non-compliant, national economic growth and development hits frugal hitch. This is because such governments cannot collect enough revenues needed for the development plans, such as in the developing nations (Fanuel, 2022). Although developing countries lack sophisticated tax sensors and strategies to curb tax evasion, which has unremittingly led to momentous tax non-compliance, the SMEs should be made aware of tax non-compliance. Tax evasion is intentional concealment of tax information by the taxpayers in order to lower tax obligation, which comprehensively form substantive part of non-compliance to tax. This study therefore intended to assess the influence of of mode of tax payment on tax compliance among SMEs in Kisumu County, Kenya.

Theoretical Framework

Theory of Planned Behavior (TPB) proposed by Ajzen in 199, postulated that individuals' intention to comply with tax obligations is determined by their attitudes towards taxation, subjective norms regarding compliance, and perceived behavioral control over tax-related actions (Ajzen, 1991). Studies show that TPB is the proxy measure for human behaviour which represents the consciousness to decision making based on certain attitudes and social norms. In totality, the theory advocates that individual's behaviour is significantly influenced by various definite factors and reasons that emerge in an intended system, in as much as attitude and psychological factors are the basics of this theory. As the utility of this theory emanates in the prediction matrix of taxpayers' behaviour, the attitude construct still remains the subject to social and psychological norms. Individuals' behaviour is more positive to actions when they perceive that they have more resources and confidence (Gablim et al. 2022). This study was guided by the TPB in order to analyse the taxpayers' behaviour subject and attitude to tax compliance (Torgler, 2007).



Empirical Review

Several empirical studies have investigated the impact of legal factors on SMEs' tax compliance behavior. A study by Kirchler et al. (2008) examined the influence of perceived fairness of the tax system on compliance behavior among SMEs in various countries. The findings revealed that SMEs are more likely to comply with tax obligations when they perceive the tax system as fair and equitable. Similarly, a study by Torgler (2003) found that SMEs' perceptions of the clarity and simplicity of tax laws significantly affect their compliance decisions. In Africa, research by Fjeldstad et al. (2008) explored the relationship between tax compliance and the legal framework in several African countries. The study highlighted the importance of clear and consistent tax laws in promoting compliance among SMEs. Furthermore, Maimbo and Saini (2005) emphasized the role of tax administration in enforcing compliance and recommended improvements in legal enforcement mechanisms to enhance SMEs' compliance levels. In Kenya, empirical studies have also examined the legal framework's impact on SMEs' tax compliance. Oguttu and Mwimali (2018) investigated the influence of tax administration on compliance behavior among SMEs in Kenya and identified legal factors such as tax rates, penalties, and enforcement measures as significant determinants of compliance.

On the aspect of tax payment methods, studies by Jinni Birtha (2022) indicate that tax administrators can generate difficulties to the taxpayers when they fail to simplify tax payment methods. For this reason, therefore, the income tax compliance among SMEs will be discouraged and remain low due to proficiencies difficulties in the mode of tax payment. Tina et al. (2021) speculated that flexibilities are to be made as a tax reform for the promotion of compliance. In Kenya for that matter, registered tax agents of the government collect the VAT at designated points, then submit to the KRA (ITA, 2019). In 2005, Kenya implemented the ETC so as to promote the digital spirit of tax collection and minimize tax evasion among the taxpayers (Okore, 2010). Accordingly, VAT contribution has been estimated to 5.4% of GDP between the year of its introduction and the year 2005. In this way, KRA argues that ETC has enhanced the compliance of the SMEs to tax by 42% and has reduced the penalties and interests charged for non-compliance (ITD, 2021). However, most of the SMEs have still evaded tax payment as burdensome and have continually impaired the revenue collection for the government.

Globally, research indicates a variety of factors influencing tax compliance among SMEs. For instance, Pomeranz (2015) conducted a study in several countries and found that perceived fairness of the tax system significantly influences compliance behavior among SMEs. Similarly, Torgler (2007) found that trust in government institutions and perceptions of



corruption impact tax compliance levels among businesses worldwide. In Africa, studies have highlighted the unique challenges faced by SMEs in complying with tax obligations. Maimbo and Yogo (2008) conducted research in several African countries and identified factors such as complex tax regulations, lack of access to information, and informal business practices as barriers to tax compliance among SMEs. Additionally, Kariuki et al. (2018) emphasized the importance of tax education programs in improving compliance levels among SMEs in Africa. In Kenya, research on tax compliance among SMEs has also been conducted. Njagi and Kibera (2017) investigated the factors influencing tax compliance among SMEs in Nairobi and found that perceived fairness of the tax system, tax rates, and trust in government institutions significantly affect compliance behavior. Furthermore, Ogilo et al. (2019) explored the impact of electronic tax systems on compliance levels among SMEs in Kenya and highlighted the importance of technology in enhancing tax compliance.

Methodology

The study was conducted in Kisumu County and the research employed descriptive research design. The target population was 105 SMEs from Seme, Nyando, Muhoroni, Nyakach, Kisumu West, Kisumu East and Kisumu Central sub counties who have been operating for a minimum of six months. This study utilized Yamane's (1967) formula to calculate the sample size of 84 respondents. Structured questionnaire was developed and piloted in the sub-counties to ensure validity and reliability. The reliability of the instrument was estimated using Cronbach-Alpha/Coefficient Alpha formula. The reliability levels for all the variables were tested and were found was 0.935 which was above the recommended level 0.67 reliability. Data was analyzed using descriptive and inferential statistics.

Results and discussion

Demographic Information of the Respondents

The study of 84 SMEs in Kisumu County revealed diverse demographic and business characteristics: 7.14% of respondents were aged 18-30, 26% were 31-40, 50% were 41-50, and 16.67% were over 50. Regarding education, 60.71% had primary or secondary education, 34.53% held certificates or diplomas, and 4.76% had degrees. Ownership structures included 19.05% sole proprietorships, 63.09% partnerships, and 17.86% private limited companies. Most SMEs were involved in wholesaling, retailing, and hardware (11.9%), and beauty and grooming (10.71%), with fewer in legal advocacy and real estate (4.76%). Additionally, 76.06% of SMEs had been in operation for over 10 years,



and 41.67% had turnovers below KES 500,000, while 30.95% earned between KES 500,000-1,000,000, 20.24% earned KES 1-3 million, and 7.14% earned KES 3-5 million.

Assessment of Legal Framework on Tax Compliance

Table 1 presents responses from SMEs in Kisumu County regarding the influence of the legal framework on tax compliance. The respondents were asked to express their level of agreement with several statements related to tax regulations and policies, using the categories Strongly Disagree (SD), Disagree (D), Neutral (N), Agree (A), and Strongly Agree (SA).

Table 1: Influence of Legal Framework on Tax Compliance

| | SD | D | N | A | SA |
|--|-----------|----------|----------|----------|-----------|
| | % | % | % | % | % |
| The legal framework on tax is simple to interpret | 46 | 34 | 3 | 11 | 6 |
| KRA fully involve taxpayers when formulating tax policies | 84 | 8 | 5 | 2 | 1 |
| Taxpayers do not understand tax systems and mechanisms | 44 | 11 | 25 | 7 | 13 |
| Lack of clarity in investment allowances on capital expenditures | 13 | 20 | 24 | 26 | 17 |

Majority of respondents (46% SD, 34% D) do not find the legal framework on tax simple to interpret. This indicates a widespread perception of complexity within the tax laws, which can hinder compliance. Alm, Jackson, and McKee (1992) have highlighted that complexity in tax systems can lead to higher non-compliance rates due to difficulties in understanding and interpreting tax obligations. Also, 84% of respondents strongly disagree that the Kenya Revenue Authority (KRA) fully involves taxpayers in the formulation of tax policies. This lack of involvement can lead to policies that do not consider the practical challenges faced by taxpayers, thereby affecting compliance. This finding is consistent with the work of Feld and Frey (2002), who argue that taxpayer participation in policy-making can enhance compliance by fostering a sense of fairness and cooperation. Further, a combined 55% of respondents (44% SD, 11% D) believe that taxpayers do not understand tax systems and mechanisms, while 25% are neutral. This suggests a significant gap in tax education and awareness. Bird (2015) emphasizes that improving taxpayer knowledge and understanding is crucial for compliance, as informed taxpayers are more likely to fulfill their tax obligations correctly. Lastly, opinions are more mixed regarding the clarity of investment allowances on capital expenditures. While 43% (26% A, 17% SA) find the



guidelines clear, a notable 33% (13% SD, 20% D) do not. This variability may indicate that while some businesses find the guidelines adequate, others experience confusion, possibly due to varying levels of financial literacy or access to tax advisory services. As noted by Devereux and Griffith (2003), clarity in tax regulations, particularly those related to investments, is essential to ensure that businesses can take advantage of available incentives without misinterpretation.

Influence of Legal Framework on Tax Compliance

Table 2 presents the perceptions of Small and Medium-sized Enterprises (SMEs) in Kisumu County regarding the impact of different tax filing modes on their tax compliance. The responses are categorized into five levels of agreement: Strongly Disagree (SD), Disagree (D), Neutral (N), Agree (A), and Strongly Agree (SA).

Table 2: Influence of mode of tax payment on Tax Compliance

| Statements | SD | D | N | A | SA |
|---|-----------|----------|----------|----------|-----------|
| Online Tax Filing (e.g., iTax) has made it easier for my business to comply with tax regulations | 56% | 24% | 3% | 15% | 2% |
| Using mobile applications for tax filing enhances my business's tax compliance. | 64% | 16% | 15% | 10% | 5% |
| The availability of multiple modes of tax filing (online, manual, mobile) improves my business's ability to comply with tax obligations | 8% | 10% | 4% | 52% | 24% |
| Training and support for online tax filing systems have positively impacted my business's tax compliance. | 74% | 10% | 15% | 6% | 5% |
| Access to reliable internet is a significant factor in my business's ability to comply with tax regulations using online systems. | 8% | 12% | 15% | 43% | 32% |
| The costs associated with different tax filing modes affect my business's tax compliance. | 64% | 26% | 5% | 8% | 7% |
| The convenience of online tax filing motivates my business to comply with tax deadlines. | 5% | 8% | 12% | 57% | 18% |

A significant proportion of SMEs (64% SD, 16% D) disagree that using mobile applications enhances their tax compliance. This high level of disagreement could be attributed to the limitations in mobile technology,



such as smaller screens and less robust features compared to desktop applications, as discussed by Eniola and Entebang (2015). Further, majority of respondents (52% A, 24% SA) believe that having multiple modes of tax filing improves their ability to comply with tax obligations. This flexibility allows businesses to choose the most convenient and efficient method, which aligns with the findings of KRA (2021) that a variety of tax payment options can enhance compliance rates. Also, majority (74% SD) disagree that training and support for online tax filing systems have positively impacted their tax compliance. This suggests a significant gap in training and support services, which is crucial for successful implementation of digital tax systems. The importance of adequate training is highlighted by Ngotho and Kerongo (2014), who emphasize that taxpayer education is key to improving compliance. A substantial number of respondents (43% A, 32% SA) agree that access to reliable internet is a significant factor in their ability to comply with tax regulations using online systems. This is consistent with the findings of Mukabi (2014), who identified reliable internet access as a key factor for effective use of online tax systems. In addition, a large percentage of respondents (64% SD, 26% D) believe that the costs associated with different tax filing modes negatively affect their tax compliance. This highlights the need for cost-effective solutions, as supported by Slemrod (2007), who noted that high compliance costs can be a deterrent to tax compliance. Finally, majority of respondents (57% A, 18% SA) agree that the convenience of online tax filing motivates their business to comply with tax deadlines. This finding is in line with the study by Loo, McKerchar, and Hansford (2009), which showed that convenience is a significant motivator for tax compliance.

Pearson Correlation Coefficient

Table 3 presents the correlation coefficients between three variables: legal framework, mode of tax payment and tax compliance. The significance of these correlations is also provided, interpreting the strength and direction of the relationships.

Table 3: Correlation between legal framework, mode of tax payment and tax compliance

| | | Legal Framework | Mode of tax payment | Tax Compliance |
|---------------------|----------------|-----------------|---------------------|----------------|
| Legal Framework | r | 1 | | |
| | Sig.(2-tailed) | | | |
| Mode of tax payment | r | .367** | 1 | |
| | Sig.(2-tailed) | .002 | | |
| Tax Compliance | r | .594** | -.697** | 1 |
| | Sig.(2-tailed) | .000 | .0025 | |



** For 2-tailed test, correlation is normally significant at the 0.01 level, at N=84

Results indicated a positive but moderate relationship between the legal framework and compliance cost and tax compliance ($r=0.367$, $p<0.001$). This strong positive correlation suggests that a well-structured legal framework significantly enhances tax compliance. The literature supports this, with research by Kirchler, Hoelzl, and Wahl (2008) indicating that taxpayers are more likely to comply when they perceive the legal system as fair and effective.

Further, the correlation between the mode of tax payment and tax compliance, was statistically significant ($r=-0.697$, $p<0.001$). This strong negative correlation suggests that certain modes of tax payment are inversely related to tax compliance. Specifically, it might imply that more complex or less convenient payment modes reduce compliance. This finding is corroborated by the work of Marcuss et al. (2013), who found that simplifying tax payment processes can enhance compliance rates.

Conclusion and recommendation

The findings reveal significant issues related to the legal framework of tax compliance among SMEs in Kisumu County. The complexity of tax laws, lack of taxpayer involvement in policy formulation, insufficient understanding of tax systems, and mixed clarity regarding investment allowances highlight areas needing improvement to enhance compliance. In addition, positive but moderate relationship between the legal framework and compliance cost and tax compliance suggested that a well-structured legal framework significantly enhances tax compliance. Further, the study highlights key areas where the mode of tax payment impacts tax compliance among SMEs in Kisumu County. While multiple modes and the convenience of online filing are seen positively, there are significant challenges related to training, support, internet access, and costs. Also, there was a negative significant correlation between the mode of tax payment and tax compliance implying that more complex or less convenient payment modes reduce compliance. The study recommends that there is need for KRA to conduct an extensive review of existing tax laws with the aim of simplifying language and removing ambiguities. This could involve the consolidation of similar regulations and the elimination of redundant or outdated provisions. Also, develop and implement comprehensive training programs for SMEs focused on the use of online tax filing systems as well as provide technical support.

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