Effect of Taxpayer Knowledge on Turnover Tax Compliance among Small and Medium Enterprises in Kariokor Market in Nairobi, Kenya

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Abstract

Turnover Tax (TOT) compliance among, small, and medium enterprises (SMEs) in Kenya has faced considerable challenges, with tax collection falling short of targets. This study investigates the effect of taxpayer knowledge on Turnover Tax compliance among small, and medium enterprises in the Kariokor market in Nairobi, Kenya. This study adopted an explanatory research design. The target population for the study was 1382 Turnover Tax registered SMEs in Kariokor Market in Nairobi. Data was analyzed using descriptive and inferential statistics. The findings revealed that taxpayer knowledge exhibited a positive influence on Turn Over Tax Compliance ($\beta = 0.203$, $p = 0.007$), indicating that as tax knowledge among taxpayers increases, their compliance with tax regulations also tends to increase. The research established that there is a positive connection between taxpayer knowledge and turnover tax compliance. When taxpayers possess greater knowledge of tax regulations and procedures, their compliance levels increase. KRA should invest in taxpayer education programs to improve knowledge and awareness among SMEs. This will empower business owners to navigate the tax system more effectively and ensure voluntary compliance.

Keywords: *Taxpayer Knowledge, Turnover Tax Compliance, Small and Medium Enterprises*

1.0 Introduction

The government's main source of revenue is through taxation (Castro & Scartascini, 2015). Taxation is defined as the fees and financial obligations imposed by a government on its residents and non-residents. It applies to all levies including income, corporate, property, capital gains, and sales. Through taxes, the government can provide public utilities such as schools, hospitals, roads, water, and security among others. It is internationally acknowledged that small business plays a vital role in enhancing a country's economic growth and creating jobs. It is therefore in the public interest and in the interest of all governments to provide support to small businesses (Schutte et al., 2019). According to the OECD, Taxation is the only practical means of raising revenue to finance government spending on the goods and services that citizens demand.

Tax compliance refers to the process of following tax laws and regulations by reporting income, claiming deductions and credits, paying taxes owed, and keeping accurate records for tax purposes (Mascagni & Gadenne, 2021). Tax compliance involves several key elements,

including filing tax returns on time, paying taxes owed by the due date, maintaining accurate records, and responding to tax authorities' inquiries or audits. To ensure compliance, taxpayers must understand the tax laws and regulations that apply to them, keep up with changes to tax laws, and seek professional assistance when needed. Governments use a range of tools and strategies to enforce tax compliance, including audits, penalties, and incentives. Tax authorities may conduct audits to verify the accuracy of tax returns, and penalties may be imposed for late or inaccurate tax filings. Incentives, such as tax credits or deductions, may also be offered to encourage compliance with certain tax laws or regulations (Mayega et al., 2021).

Tax compliance among SMEs is a critical issue for both governments and business owners. SMEs often lack the resources and expertise to navigate complex tax regulations, which can result in errors and non-compliance. Non-compliance by SMEs can have significant economic consequences, such as reduced tax revenue, unfair competition with compliant businesses, and increased administrative costs for tax authorities. Studies have shown that SMEs face several challenges in complying with tax regulations, including lack of knowledge, and understanding of tax laws, limited access to accounting and tax expertise, and time constraints due to other business priorities (Keraro, 2017). Additionally, the cost of complying with tax regulations can be relatively high for SMEs, particularly for those operating in multiple jurisdictions (OECD, 2022).

1.1 Problem Statement

There has been a growing challenge in the levels of Tax Compliance among SMEs in Kenya, the majority of the taxpayers who have subscribed under the Turnover Tax have failed in their Compliance levels. The government of Kenya through its taxman strives to meet its revenue targets because of revenue collection shortfalls.

In the financial year 2021/2022, TOT collection amounted to Kshs. 99,739,158 against a target of Kshs 135,050,379 representing a performance of 73.6% (KRA, 2022). In the 2022/2023 financial year, TOT collection was Kshs 112,653,556 compared to a target of Kshs 128,112,921 which resulted in a deficit of Kshs 15,459,365 (KRA, 2023). Furthermore, as of the close of March 2023, total revenue collection averaged 95.1% on the original target and 93.4% on the Supplementary target (KRA reports, 2023).

North of Nairobi tax station registered 956 out of 5507(17%) in 2020, 1058 out of 4448 (24%) in 2021, and 759 out of 2326 (32%) in 2022 TOT late return filings. This trend shows an increase in non-compliance rate from 17% in 2020 to 32% in 2022. Similarly, those who filed Nil returns were 1617,1362 and 785 in 2022,2021 and 2020 respectively whereas those who filled zero returns were 217, 210, and 168 respectively, also showing an increased number of taxpayers with nil and zero returns.

The above statistics show a continuing trend that KRA does not meet its revenue collection targets and has increased in number of late, nil, and zero fillings over the years, indicating noncompliance. This study sought to determine the effect of Taxpayer knowledge on turnover tax compliance among small, and medium enterprises in the Kariokor market in Nairobi, Kenya.

1.2 Research Hypothesis

H_{01}: Taxpayer's knowledge has no significant effect on turnover tax compliance among SMEs in the Kariokor market in Nairobi, Kenya.

2.0 Literature Review

2.1 Theoretical Review

2.1.1 Expected Utility Theory (EUT)

EUT was developed by Allingham and Sandmo in 1972. The two scholars applied EUT to the problem of tax evasion and stated that assuming taxpayers are rational and will engage in tax evasion only if the expected utility of doing so is higher than the expected utility of paying taxes. They defined expected utility as the sum of the utility of each possible outcome, weighted by the probability of each outcome occurring. In the context of tax evasion, the expected utility of evasion is the sum of the benefits of tax savings and the costs of detection and punishment, weighted by the probability of getting caught. The expected utility of paying taxes is the utility of complying with the law, weighted by the probability of avoiding detection.

Allingham and Sandmo argued that the level of tax evasion will depend on the relatively expected utilities of compliance and evasion. If the expected utility of evasion is higher than the expected utility of compliance, taxpayers will be more likely to evade taxes. Conversely, if the expected utility of compliance is higher than the expected utility of evasion, taxpayers will be more likely to pay taxes.

Jackson and Milliron (1986) conducted a laboratory experiment on tax compliance using undergraduate students as subjects. They found that the level of penalties for noncompliance had a significant effect on compliance behavior and that the perceived probability of detection was also an important factor. Also, Feld and Frey (2002) conducted a study on tax compliance in Switzerland using a survey of 5,000 taxpayers. They found that taxpayers were more likely to comply with tax laws if they believed that the tax system was fair and if they perceived a high level of enforcement. Additionally, Torgler (2003) conducted a study on tax compliance in Switzerland, Australia, and the United States using survey data. He found that tax morale, which refers to the intrinsic motivation to pay taxes, was a strong predictor of tax compliance. These studies provide empirical support for the core propositions of EUT and demonstrate the relevance of this theory to the study of turnover tax compliance.

2.1.2 The Social Learning Theory

The Social Learning Theory was developed by psychologist Albert Bandura in 1977. Social Learning Theory posits that individuals learn through observation, modeling, and reinforcement from their social environment, including family, peers, and other influential figures. Therefore, taxpayers are more likely to comply with tax laws if they observe others doing so, and if they perceive that there are social rewards for compliance and social punishments for non-compliance.

Social Learning Theory also emphasizes the importance of self-efficacy or an individual's belief in their ability to perform a specific behavior. In the context of tax compliance, taxpayers who feel confident in their ability to understand tax laws and complete tax forms accurately are more likely to comply with tax regulations. (De Neve & Nys, 2017), in their study on the Effect of Education on Tax Compliance in Belgium used Social Learning Theory to design a taxpayer education program aimed at increasing compliance with local taxes in Belgium. The study found that taxpayers who received the education program were more likely to comply with local tax laws than those who did not. Furthermore, Kogler et al (2013) suggested that taxpayer education programs should focus on building taxpayers' confidence in their ability to comply with tax regulations. This theory is relevant to the variable of taxpayer knowledge.

2.2 Empirical Review

Taxpayer knowledge can be categorized into two main types: ordinary or official education received, and knowledge of the opportunity to evade tax (Groenland & Veldhoven, 1983). Ordinary or official education received refers to a taxpayer's formal education, including their level of literacy and numeracy, as well as their understanding of tax laws and regulations. Studies have found that individuals with higher levels of education are more likely to comply with tax laws and regulations than those with lower levels of education (Kirchler et al., 2008). Knowledge of the opportunity to evade tax refers to a taxpayer's understanding of the benefits and risks associated with evading tax. Individuals who perceive a higher risk of getting caught for evading taxes are more likely to comply with tax laws (Alm et al., 1995). On the other hand, individuals who perceive a lower risk of getting caught for evading taxes are more likely to engage in tax evasion.

Taxpayer knowledge has been found to have a significant impact on turnover tax compliance. Studies have shown that taxpayers who have a better understanding of tax laws and regulations tend to be more compliant with their tax obligations. This is because when taxpayers have a good knowledge of tax laws and regulations, they are more likely to accurately report their income and claim deductions and credits that they are entitled to, while also avoiding mistakes that could trigger an audit or other enforcement actions. Tax knowledge is positively associated with tax compliance behavior, and this relationship was stronger for taxpayers with more complex tax situations (Lee, Jung & Chung, 2016). A similar study found that taxpayers who received tax education were more likely to be compliant with their tax obligations (Slemrod & Yitzhaki, 2002). Ghani et al. (2020) study of taxpayers' Knowledge and tax performance among self-employed in Malaysia, showed a positive significant effect on taxpayer knowledge and tax compliance. Similarly, an investigation by Pastory (2022) on factors that influence TOT compliance among SMEs in Ilala municipality, Tanzania, found that tax knowledge was a significant determinant of TOT compliance.

Aniefo (2018) found out that taxpayer knowledge about turnover tax was positively related to turnover tax compliance. Similarly, Mamo and Gashaw (2019) found that businesses that received tax education were more likely to comply with turnover tax regulations. The above studies agreed with the findings done in Kenya which showed that SMEs face numerous challenges in complying with tax regulations, including a lack of knowledge and awareness about tax laws and regulations (Mwangi & Githinji, 2018). The study suggested that improving taxpayer knowledge and awareness through tax education programs could be an effective way to enhance compliance among small businesses.

Nelson (2020) investigated the factors affecting turnover tax compliance among small and medium enterprises in Kenya and established that taxpayer knowledge has a positive and significant relationship and affects tax compliance among SMEs in Nairobi County. The research has established that it is important to create awareness of tax laws, create awareness of how the tax system is structured and administered, have less sophisticated rules on taxation for a non-professional to understand, and have readily available tax rules information to encourage tax compliance.

3.0 Methodology

This study adopted an explanatory research design. Apuke (2017) describes explanatory research design as one that employs causal relationships between variables to find out the effect between one variable and another. The target population for the study was 1382 Turnover Tax registered SMEs in Kariokor Market in Nairobi (KRA, 2022). A sample of 311 SMEs was

extracted from a sample population of 1382 using Yamane's formula sampling technique. The data collected in this study were quantitative. The information was primarily based on numerical values and statistical relationships between variables. Descriptive statistics such as frequency, mean, and standard deviation will be used to provide an interpretation of the data. Inferential statistics: correlation and multiple regression analyses were also conducted.

4.0 Results and Discussion

4.1 Descriptive Analysis

4.1.1 Descriptive statistics on Taxpayer knowledge

The items in Table 1 refer to various aspects of tax knowledge, and the Mean and Standard Deviation (Std. Dev) values are provided to indicate the central tendency and variability of responses. The Likert scale used in the survey ranged from 1 (Strongly Disagree) to 5 (Strongly Agree), where higher values indicate stronger agreement with the statements. Participants reported their level of agreement with the following statements:

I know the Turnover tax calculation rate to apply: On average, participants reported a relatively high level of knowledge with a mean of 4.672 (SD = 0.471).

I am aware of the implications of non-compliance: The mean score for this statement was 4.695 (SD = 0.462), suggesting a high level of awareness regarding the consequences of non-compliance with tax regulations.

I am aware of tax return deadlines and penalties: Participants, on average, reported a good understanding of tax return deadlines and penalties, with a mean score of 4.638 (SD = 0.482).

I am aware that I need to file my taxes monthly: The mean score for this item was 4.649 (SD = 0.479), indicating a high level of awareness about the frequency of tax filing.

High levels of tax knowledge encourage tax compliance: Participants, on average, agreed that a strong understanding of taxation encourages tax compliance, with a mean score of 4.649 (SD = 0.479).

These findings suggest that the sample of taxpayers generally possesses a high level of tax knowledge, which could potentially contribute to tax compliance. However, it's important to consider that individual responses may vary, as indicated by the standard deviation values.

Table 1: Descriptive on Taxpayer knowledge

Items	Mean	Std.Dev
I know the Turnover tax calculation rate to apply	4.672	0.471
I am aware of the implications of non-compliance	4.695	0.462
I am aware of tax return deadlines and penalties	4.638	0.482
I am aware that I need to file my taxes monthly	4.649	0.479
High levels of tax knowledge encourage tax compliance	4.649	0.479

4.1.2 Descriptive statistics on turnover tax compliance

Table 2 provides information on several items measuring the level of compliance with turnover tax compliance. Each item is rated on a scale from 1 (strongly disagree) to 5 (strongly agree).

I Know the Importance of Being Registered as a Taxpayer in the KRA iTax System Mean: 4.626 Standard Deviation: 0.485

Participants, on average, reported a high level of understanding regarding the importance of being registered as a taxpayer in the Kenya Revenue Authority (KRA) iTax system (M = 4.626, SD = 0.485).

I Pay the Tax Liability That Arises from My TOT Obligation Without Failure Mean: 4.655 Standard Deviation: 0.477 Respondents indicated a high degree of compliance with paying their tax liabilities arising from TOT obligations, with a mean score of 4.655 and a standard deviation of 0.477.

I always Make Correct Tax Declarations Mean: 4.649 Standard Deviation: 0.479 Participants tend to consistently make accurate tax declarations, as reflected in the mean score of 4.649 and a standard deviation of 0.479.

I am aware of the due dates for Filing My Tax Returns Mean: 4.638 Standard Deviation: 0.482 On average, respondents reported a high level of awareness regarding the due dates for filing their tax returns, with a mean score of 4.638 and a standard deviation of 0.482.

Table 2: Descriptive on turnover tax compliance

Items	Mean	Std.Dev
I know the importance of being registered as a taxpayer in the KRA Itax system	4.626	0.485
I pay the tax liability that arises from my TOT obligation without failure	4.655	0.477
I always make correct tax declaration	4.649	0.479
I am aware of the due dates for filing my tax returns.	4.638	0.482
N=245		

4.2 Correlation Analysis

Table 3 displays the Pearson correlation coefficients and significance levels (two-tailed) between variables: Dependent variable Turn Over Tax Compliance (TOT), and independent variable (Tax Payer Knowledge). There was a strong positive correlation between Turnover Tax Compliance and Tax Payer Knowledge (r = .620, p = .004, N = 245).

Table 3: Correlation Results

		Turn Over Tax Compliance	Taxpayer Knowledge
Turn Over Tax Compliance		1	
Taxpayer Knowledge	Pearson Correlation	0.62	1
	Sig. (2-tailed)	0.004	
	N	245	

Correlation is significant at the 0.05 level (2-tailed).

4.3 Regression Analysis

The regression analysis was performed to determine the effect of taxpayer knowledge on turn over tax compliance.

Table 4: Regression Results

Model		Standardized Beta	Std. Error	t	Sig.
1	(Constant)	2.812	0.508	5.535	0.000
	Taxpayer Knowledge	0.203	0.082	2.476	0.007

a Dependent Variable: Turn Over Tax Compliance

Taxpayer knowledge exhibited a positive influence on Turn Over Tax Compliance ($\beta = 0.203$, $p = 0.007$), indicating that as tax knowledge among taxpayers increases, their compliance with tax regulations also tends to increase.

For the null hypothesis (H0), which suggested that Taxpayer Knowledge has no significant impact on turnover tax compliance, the p-value is 0.000. This low p-value suggests that Taxpayer Knowledge significantly influences turnover tax compliance, leading to the rejection of the null hypothesis.

4.4 Discussion of Findings

The objective of the study was to establish the effect of taxpayer knowledge on turnover tax compliance among, small, and medium enterprises in the Kariokor market in Nairobi, Kenya. The correlation matrix indicates a positive and statistically significant linear relationship between taxpayer knowledge and turnover tax compliance ($r = 0.620$, $p = 0.004$). The regression model indicates that unit increases in taxpayer knowledge cause a significant increase in turnover tax compliance $\beta = 0.203$, $p = 0.007$. These findings suggest that improving taxpayer knowledge could be an effective strategy for increasing turnover tax compliance among, small, and medium enterprises in the Kariokor market in Nairobi, Kenya (Lee, Jung, & Chung, 2016). A similar study found that taxpayers who received tax education were more likely to be compliant with their tax obligations (Slemrod & Yitzhaki, 2002). Ghani et al. (2020) studied taxpayers' Knowledge and tax performance among self-employed in Malaysia and showed a positive significant effect on taxpayer knowledge and tax compliance. Similarly, an investigation by Pastory (2022) on factors that influence TOT compliance among SMEs in Ilala municipality, Tanzania, found that tax knowledge was a significant determinant of TOT compliance.

5.0 Conclusion

The research established that there is a positive connection between taxpayer knowledge and turnover tax compliance. When taxpayers possess greater knowledge of tax regulations and procedures, their compliance levels increase.

6.0 Recommendations

KRA should invest in taxpayer education programs to improve knowledge and awareness among SMEs. This will empower business owners to navigate the tax system more effectively and ensure voluntary compliance.

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