Effect of Tax Knowledge on Pay As You Earn Tax Compliance Among Small and Medium Enterprises in Thika Town, Kenya

[1]**Chebet Milka Bett,** [2]**Dr. Ogaga Bruce, PhD**, [3]**Dr. Limo Patrick, PhD**
[1,2]**Department of Accounting and Finance, Kenya School of Revenue Administration**
[3]**Department of Accounting and Finance, Moi University**
Corresponding Email: milkabett@gmail.com

Abstract

The government is unable to adequately raise revenue through tax collection to effectively provide for the essential needs of its citizens which include education, healthcare, water, security, roads, and social security among others. This has raised a concern as the Government seeks to achieve its revenue targets hence the need for this study. The study looked at tax knowledge and Pay As You Earn compliance among small and medium enterprises in Thika town Kenya. The study was supported by The Attribution Theory. The study adopted an explanatory research design. The study aimed to focus on Small and Medium Enterprises licensed in Thika town. The target population was 1223 small and medium enterprises with a sample size of 301 small and medium enterprises with a response rate of 83%. Primary data was collected using structured questionnaires. Both descriptive statistics and inferential statistics were carried out. The study found that there is a positive and significant effect of tax knowledge on PAYE tax compliance ($\beta_1 = 0.332$, $p < 0.05$), The study recommends that KRA should therefore work towards simplifying and streamlining the tax compliance processes, reducing unnecessary administrative burdens. Future research should be carried out to determine the effect of tax incentives on TAX compliance.

Keywords: *Tax Knowledge, Pay As You Earn Compliance, Small and Medium Enterprises*

1.0 INTRODUCTION

According to Gcabo and Robinson (2017), tax collection is important to any country even though it's not endorsed or understood by the country's citizens. They argue that, though taxpayers acknowledge the need to pay taxes and enjoy benefits offered by the government in the form of public service, tax compliance is not endorsed by most taxpayers. The importance of tax compliance must be understood because it determines how the government shapes the lives of its citizens (Oberholzer, 2018).

Tax knowledge is an important contributing factor as it helps businesses adhere to tax rules and regulations. Understanding the tax requirements as per their nature of business (manufacturing and servicing) might influence their business strategies. A survey of 147 economies identified low tax awareness and knowledge as the biggest constraint for business operations World Trade Organisation Report (2019). Further, the study by Aruna (2019) stated that businesses faced

problems in their operations as low tax knowledge led to complexities and unorganized administrative costs Barbone (2018).

As noted under the Third Schedule of the Income Tax Act, CAP 470, personal income taxes in Kenya are charged on an individual's income using a graduated scale with the lowest the rate is 10 percent and the highest is 30 percent. The PAYE tax returns must be submitted before the 9th day of the month following the Payroll month. (Income Tax Act, CAP 470). According to Gideon and Alouis (2017), the Income tax return system was associated with high tax compliance costs arising from understated tax obligations. Income tax returns scored low on taxpayer convenience as filing the Return forms was a complicated and cumbersome process.

Pay As You Earn (PAYE) tax is a tax under the provisions of Section 5 of the Income Tax ACT, CAP 470 laws of Kenya. It is a tax that is collected from the employment income of individuals. This applies to weekly wages, monthly salaries, annual salaries, bonuses, commissions, non-cash benefits, and any other form of income (Income Tax Act, CAP 470). As noted under the Third Schedule of the Income Tax Act employee's incomes are taxed using a graduated scale with the lowest being 10 percent and the highest 30 percent. The tax calculated is usually deducted at source and is done by the employer who then remits the amount to the tax authorities.

Small-sized enterprises largely operate in the informal sectors they are commonly referred to as "Jua kali'. The government of Kenya defines this small business as those enterprises employing 10 -49 staff (Kinyua, 2018). These small enterprises operate within SME as the blanket term. The Economy Survey Report (2016) indicated that small enterprises contributed to 70% of the Gross domestic product in Kenya and the sector employs about 80%.

1.1 Problem Statement

Despite a number of restructuring exercises, the Kenya Revenue Authority (KRA) has undertaken towards improving its revenue compliance in recent years, it has failed to meet the targets set by the treasury. For instance, in the financial year 2022/2023 the PAYE tax collections were Ksh. 441.60 billion representing a percentage of 96% against a target of Ksh. 459.26 billion thereby falling short of the target by 17.66 billion (KRA, 2023). Similarly, in the financial year 2021/2022 the PAYE tax collections were Ksh. 407.83 billion against a target of Ksh. 415.524 billion representing a percentage of 98% again falling short of the target by Ksh 7.69 billion (KRA, 2022).

As a result, the Government is not able to adequately provide for the needs of its citizens which include education, healthcare, water, security, roads, and social security among others. This has raised a concern as the Government seeks to achieve its targets and hence the need for this study. The study will focus on tax knowledge and PAYE as it has been seen from previous studies that these variables are key factors of PAYE that influence tax compliance.

2.0 LITERATURE REVIEW

2.1 Theoretical Literature

2.1.1 The Attribution Theory

This theory developed by Heider (1957) considers attribution as the process by which people conclude the factors that influence the behavior of others. The theory considers the individual as an amateur psychologist who tries to understand the reasons for events that occurred in the face (Kamil, 2015). Attribution theory tries to find what is causing what, or what motivates

anyone to do anything. The response that we give to an event depends on our interpretation of the event (Kelley, 1967)

According to Robbins (2018), when individuals observe the behavior of a person, they try to determine whether the behavior was caused by internal or external influences. Behavior due to internal behavior is believed to be under the personal control of the individual, while the behavior that caused the external is behavior that is influenced from the outside, which means that individuals will have to behave because of the demands of the situation or the environment (Agus, 2016).

Attribution theory deals with how and why people form an opinion about the reasons for an event or observation (Winkler,2010). This theory is underlined by the idea that perception is the base of human understanding, sense-making, and behavior. The theory suggests that people develop explanations for the behaviours of others based on how they perceive the behavior and the reality surrounding it. The above explanation is based on how the observing person perceives a cause for the actor's behavior. An extensive review of attribution theory in the context of IS, and particularly post-adoptive behaviour, is found (Kelly et al., 2016).

People's first judgment is when they observe a behaviour whether the behaviour was caused by internal and external reasons by the actor or something outside the actor. An observer will be more inclined to make such a judgment if the act affects their welfare. People usually attribute performance outcomes to factors of ability, effort, task difficulty, and luck (Graham,1991).

According to Kamil (2015), the willingness of taxpayers to pay taxes is associated with the perception of the taxpayer in assessing the tax itself. The perception of a person to make a judgment about something is influenced by internal and external from the person. This theory is relevant to this study as it supports the independent variable tax knowledge in that tax knowledge influences one to pay taxes by motivating the taxpayers to be tax compliant.

2.2 Empirical Review

Financial Performance

According to Dostie et al, (2018), PAYE tax is levied on employees based on their aggregate pay. It is deducted directly from the employer's fund and directly tied to employing a worker. This tax deduction is different from other statutory deductions such as social contributions to employment insurance, health and safety at work, disability, and contribution to pension plans. Social contributions' costs are usually shared between the employer and employee varying according to the employee's salary but it can also be paid only by the employer, unlike PAYE tax is deducted directly from the employee's salary. PAYE tax collects approximately 25% of total revenue in OECD countries (Saez, Schoefer & Seim 2017).

Tax Knowledge and PAYE Tax Compliance

Tax knowledge implies a thorough understanding of the tax system's rules and regulations formulated by the government. The three major elements identified regarding tax knowledge are general, procedural, and legal tax knowledge Bornman, 2019). Sulistiani, & Jayanto (2016) defined tax understanding as the understanding or knowledge possessed by the taxpayer related to taxation. Satria (2017) added that tax understanding is the perception of taxpayer toward their knowledge about taxation. Tax understanding is the level of knowledge and ability of taxpayers concerning the enactment and the implementing regulations of the tax law both in content and administration. Previous research from Adiasa (2013), Agustiningsih & Isroah

(2016) concluded there is a relationship between tax understanding and tax compliance. Thus, a higher tax understanding can lead to higher compliance.

Kamil (2015) did a study on the effect of taxpayer awareness, knowledge, tax penalties, and tax authorities services on tax compliance: (Survey on the individual taxpayer at Jabodetabek & Bandung) in Indonesia. The study found that the awareness of the taxpayer has a positive and significant effect on individual taxpayer compliance. Knowledge has a negative and significant relationship with Taxpayer Compliance. Machogu and Amayi (2013) did a study on the effect of tax knowledge on voluntary compliance, among SMEs in Mwanza City-Tanzania. The study adopted the descriptive research design. Both primary and secondary data were used. The findings revealed that the level of tax knowledge affects tax compliance.

2.3 Conceptual Framework

A conceptual framework is a written or visual presentation that explains either graphically or in narrative form the main things to be studied, the key factors, concepts, or variables, and the presumed relationship among them (Miles et al., 1999). The conceptual model represented in Figure 1 describes the relationship between the variables of the study accordingly.

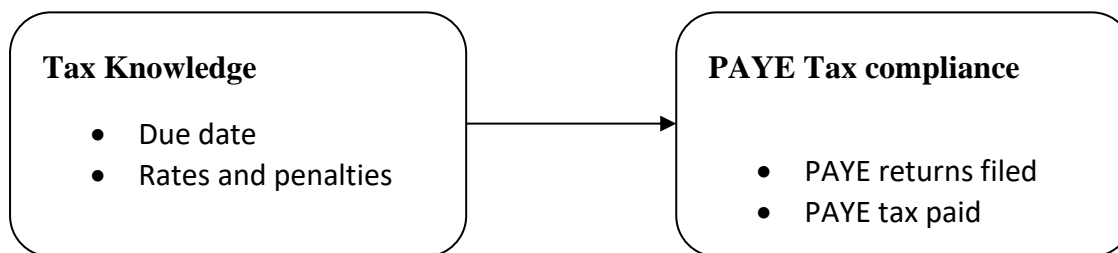**Independent Variables**   **Dependent Variable**

Figure 1: Conceptual Framework

Source: Researcher, (2024)

3.0 METHODOLOGY

In this study the explanatory research design was used, the target population was 1223 licensed SMEs who are business owners in Thika town. and a sample of 301 respondents. Primary data was collected by structured questionnaires using drop and drop-and-pick method. Data was analyzed using descriptive and inferential statistics. The findings were presented in Tables.

4.0 RESULTS AND DISCUSSION

4.1 Descriptive Statistics

4.1.1 Tax Knowledge

Table 1 shows descriptive statistics in regard to tax knowledge. The government provides adequate knowledge and support to help taxpayers comply with the tax laws with a mean score of 4.82. I have received sufficient tax knowledge on due dates and had a mean score of 3.99. I believe that increasing awareness would lead to better PAYE compliance and fewer errors with a mean score of 4.83. I'm aware of penalties for non-compliance with a mean score of 4.75.

Table 1: Descriptive statistics tax knowledge

	Mean	Std. Deviation	Skewness	Kurtosis
The government provides adequate knowledge and support to help taxpayers comply with the tax laws.	4.82	.501	-2.835	6.948
I have received sufficient tax knowledge on due dates	3.99	.353	-.173	5.147
I believe that increasing awareness would lead to better PAYE compliance and fewer errors.	4.83	.487	-2.914	7.485
I'm aware of the penalties for non-compliance	4.75	.565	-2.144	3.447

(Source: Research 2024)

4.1.2 Pay as You Earn compliance

Table 2 indicates descriptive statistics for items of PAYE tax compliance. KRA provides guidelines on the process of filling returns with a mean of 4.84. KRA has offered me an enabling environment for tax filing which can enhance PAYE performance having a mean score of 4.01. Taxpayers have less information on filling PAYE returns with a mean score of 4.81. PAYE returns filled through iTax are complicated and had a mean score of 2.45.

Table 2: Descriptive statistics Pay as You Earn compliance

	Mean	Std. Deviation	Skewness	Kurtosis
KRA provide guidelines on the process of filling returns.	4.84	.473	-2.996	8.068
KRA has offered me an enabling environment for tax filing which can enhance PAYE performance	4.01	.311	.192	7.540
Taxpayers have less information on filling PAYE returns	4.81	.542	-2.716	5.969
PAYE returns filling through iTax is complicated.	2.45	.919	1.655	1.346

(Source: Research 2024)

4.2 Correlation Analysis

A correlation matrix in Table 3 was used to determine the direction of the relationship between the variables showing that there is a positive and significant relationship between tax knowledge and PAYE tax compliance up to 71.3% ($p=0.000<0.05$).

Table 3: Correlation Analysis

		PAYE tax Compliance	Tax Knowledge
PAYE tax Compliance	Pearson Correlation	1	
	N	249	
Tax Knowledge	Pearson Correlation	.713	1
	Sig. (2-tailed)	.000	
	N	249	249

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

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(Source: Research 2024)

4.3 Regression Analysis

The model summary to determine the correlation and coefficient of determination was conducted in Table 4. which indicates that there is a positive correlation of up to 71.3% between Tax knowledge and Pay As You Earn compliance. The coefficient of determination R-square shows that 50.8% of the variation caused by PAYE compliance is caused by tax knowledge leaving 49.2% of the remaining variation caused by factors not analyzed in this model.

Table 4: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.713[a]	.508	.499	0.53801

a. Predictors: (Constant), Tax Knowledge _mean

Source: Research data (2024)

The Analysis of Variance in Table 5 shows that the effects of tax knowledge on PAYE tax compliance were examined using a one-way analysis of variance (ANOVA). The results revealed a significant overall effect of the predictors on PAYE tax compliance. The regression model accounted for a substantial amount of variance in PAYE tax compliance, as indicated by F-statistic 289.037 and the associated p-value of 0.000<0.05. The predictors, including tax Knowledge, contributed to the model's explanatory power.

Table 5: ANOVA Effects of Tax Knowledge on PAYE compliance

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	115.326	1	115.326	289.037	0.000
	Residual	98.641	247	0.399		
	Total	213.967	248			

a. Dependent Variable: PAYE Tax Compliance
b. Predictors: Tax Knowledge

Source: Research data (2024)

The coefficient Table 6 shows that the coefficient table the main regression equation is

$$Y = 1.544 + 0.332TK_1$$

Table 6 shows at a constant of 1.544 a unit change in tax knowledge causes an increase of 0.332 in PAYE compliance. **H_{01}** The null hypothesis was that Tax knowledge has no significant effect on PAYE tax compliance among small and medium enterprises in Thika town, the study found that Tax knowledge has a positive and significant effect on PAYE tax compliance ($p=0.000<0.05$) the null hypothesis is therefore rejected.

Table 6: Regression Coefficients

Model		Standardized Coefficients		Unstandardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.544	0.319		4.840	.000
	Tax Knowledge	0.332	0.067	0.346	4.955	.000

Dependent Variable: PAYE Tax Compliance
Source: Research data (2024)

4.4 Discussion of the Findings

The study was to establish the effect of tax knowledge on Pay As You Earn compliance among small and medium enterprises in Thika town. The study found that there is a positive and significant relationship between tax knowledge and PAYE tax compliance r=0.713 (p=0.000<0.05), The study further shows that there is a positive and significant effect of tax knowledge on PAYE tax compliance β=0.332 (p=0.000<0.05). The study concurs with a study by Agustiningsih & Isroah (2016) which concluded there is a relationship between tax understanding and tax compliance. Thus, a higher tax understanding can lead to higher compliance.

5.0 CONCLUSION

The study was to establish the effect of tax knowledge on Pay As You Earn compliance and revealed a positive and significant relationship between tax knowledge and PAYE tax compliance. The study emphasizes the crucial role of tax education and awareness in enhancing adherence to tax obligations. Efforts to improve tax-related knowledge could contribute to increased compliance with PAYE tax regulations.

6.0 RECOMMENDATIONS

The study indicates that there is a positive impact of improving tax knowledge on PAYE tax compliance. The study recommends that KRA should therefore work towards simplifying and streamlining the tax compliance processes, reducing unnecessary administrative burdens. Future research should be carried out to determine the effect of tax incentives on TAX compliance.

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