EdinBurg Peer Reviewed Journals and Books Publishers
Journal of Finance and Accounting
Vol. 4||Issue 3||pp 42-49||July||2024
Email: info@edinburgjournals.org||ISSN: 2789-0201

The Effect of Tax Administration Restructuring on Income Tax Compliance among Small and Medium Enterprises in Lang'ata Sub County, Nairobi County, Kenya

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How to Cite: Momanyi, A. C., Ogaga, B., & Yego. J. (2024). The Effect of Tax Administration Restructuring on Income Tax Compliance Among Small and Medium Enterprises in Lang'ata Sub County, Nairobi County, Kenya. *Journal of Finance and Accounting*, *4*(3), 42-49.

Abstract

The Kenya Revenue Authority, despite ongoing tax reforms, has been unable to meet the Treasury's income tax targets. This study aimed to determine the effect of tax administration restructuring on income tax compliance among Small and Medium Enterprises in Lang'ata Sub County, Nairobi County, Kenya. The study was guided by optimal theory, and study employed explanatory research design. The study target was 2,182 SMEs in different sectors in Lang'ata Sub County with a sample size of 338 respondents. The study used primary data collected using questionnaires. The descriptive statistics included frequency, percentage, and mean while inferential statistics included correlation and regression. Tax administration restructuring is positively associated with increased compliance ($\beta = 0.103$, $p < 0.05$). The findings reveal the enhancing effect of the relationship between tax restructuring and income tax compliance. The study recommends KRA should continue to invest in streamlining and improving tax administration processes. Future research should be carried out to determine the advancements in tax technology influence SMEs' compliance behavior.

Keywords: *Tax administration restructuring, income tax compliance, Small and Medium Enterprises*

Received: 12th July 2024 Revised: 22nd July 2024 Published: 25th July 2024

1.0 Introduction

Every government relies on tax as a major source of revenue to sustain developmental growth. Indeed, governments across the world have devised and legislated provisions establishing different tax heads such as VAT, income tax, and excise duty, to enhance tax performance. Income tax is one of the tax heads used by governments to raise revenue. It is the tax paid on profits earned by income taxpayers. States have adopted two approaches to how income tax is treated: worldwide and territorial approaches (Siripurapu, 2021). Income taxes comprise income tax, personal income tax, and withholding tax. Tax on capital gains was suspended in 1985 (Moyi & Ronge, 2019).

Income tax is charged on profits at the rate of 30 percent for resident companies and 37.5 percent for non-resident companies (GoK, 2019). Personal income taxes are charged on an individual's income using a graduated scale, with the lowest rate being 10 percent and the highest 30 percent. Income taxes are considered more distortionary and hence less preferred to consumption taxes; replacing income tax with consumption tax is likely to increase savings, investment, and work effort hence increasing economic growth (Engen and Skinner, 2021). For developing countries revenue from income taxes has been increasing but at a lower rate when compared to indirect taxes and international trade taxes (Bahl & Bird, 2018). This has been attributed to inefficiencies in a collection of income taxes. However, in Kenya, the case is different; the share of income taxes in the total tax revenue collection has been increasing compared to that of other taxes.

Tax administration is the management, conduct, direction, and supervision of the execution and application of Government taxation laws and related statutes (Amabali, 2019). Tax administration restructuring usually aims to prevent tax evasion and make it more efficient and effective. The emphasis on improving public officials and restructuring the revenue authorities will help developing and emerging markets achieve their goals of improving tax services by attracting high-quality personnel, fighting corruption, reducing tax collection costs, and modernizing the tax administration (Hammad, 2018). The tax administration is responsible for implementing the requirements of the tax laws in its processes but is also responsible for facilitating and following up the implementation of the tax law in the processes of the businesses. The administration has an important role in influencing the government on the administrative feasibility of the tax rules for the administration as well as for the businesses.

The World Bank (2019) defined small and medium enterprises (SMEs) as micro businesses that consist of 1–9 staff; small-scale businesses consist of 10–49 staff while medium businesses have 50–249 staff. OECD (2014) defines both small and medium-sized enterprises (SMEs) as independent enterprises that hire only a few people. Kenya Revenue Authority (2013) defines a small business as a business that employs 10-49 staff and a medium business as a business that employs 50-99 staff. SMEs in Kenya are described as businesses with full-time employees not exceeding 100 or a minimum annual sales turnover of Ksh 150 million (KRA, 2013). According to KIPPRA (2015), small and medium enterprises in Kenya are defined as enterprises with full-time employees not exceeding 100 or annual sales turnover not exceeding Ksh 150 million.

1.1 Problem Statement

Income tax is a major contributor to Kenya's Government revenue, for the last 5 financial years contributing an average of 12% to the exchequer. According to KRA 2021/2022 Revenue indicates a reduction in the income tax revenues for the year 2020/2021 by 2.73%. KRA missed its domestic tax target yet again in the 2021/2022 financial year since the income tax collected was Kshs. 173 billion against a target of Kshs. 406 billion (KRA, 2022). From the existing empirical studies by previous researchers, Bananuka (2018) examined the mediating effect of adoption of electronic tax system in the relationship between attitude towards electronic tax system and tax compliance using evidence from small business enterprises (SBEs) of an African developing economy. This study used a quantitative research approach. Questionnaires were used for data collection. Results indicated that adoption of electronic tax system and attitude towards electronic tax system are significantly associated with tax compliance. However little research has been done on the area of tax administration restructuring on income tax compliance among Small and Medium Enterprises in Lang’ata Sub County, Nairobi County, Kenya.

2.0 Literature Review

2.1 Theoretical Review

2.1.1 Optimal Theory of Taxation

The theory of optimal taxation was developed by Ramsey (1927) through the article "A Contribution to the Theory of Taxation". The theory was among the first to focus on revenue collection and growth from an economic standpoint. Optimal taxation theory is concerned with the designing, restructuring, and implementation of a tax system that reduces inefficiency and market distortion. The theory acknowledges that inequality will always exist in markets but any tax system must strive to eliminate inefficiencies as much as possible.

The theory of optimal taxation was first associated with Ramsey (1927) and Mirrlees (1976), Although it has been developed further by Mankiw, Weinzierl, and Yagan (2009) as the study of planning and implementing a tax system that maximizes a social welfare function subject to underlying economic constraints. The social welfare function applied is that of individuals' Utilities. Thus the tax system is chosen to maximize the sum of individual utilities. Tax revenue is required to fund the provision of public goods and other government services, as well as for redistribution from rich to poor individuals (Saez & Stantcheva, 2018).

However, Goldin (2017) observes that most taxes distort individual behavior because the activity that was being taxed becomes relatively less desirable. The optimization problem involves minimizing these distortions away from the efficient state, caused by taxation while achieving desired levels of redistribution and provision of public services (Tuomala, 2018). The theorists assert that a prudent taxation system is proportionate to incomes or abilities to pay. It should also be certain rather than arbitrary and should be payable at times and in ways convenient to the taxpayers. Finally, the taxation system should be cheap to administer and collect (Heathcote & Tsujiyama, 2015). Thus, the theorists suggest that administration restructuring is all necessary to achieve the desired criteria of a prudent taxation compliance

2.2 Empirical Review

2.2.1 Tax Administration Restructuring and Income Tax Compliance

Tax administration generally refers to the aspect of "how to do it" in respect of a tax system. It is the mechanisms available for the achievement of "what to do" in respect of the various taxes. It is therefore the means to actualize the tax laws and systems and as such, it is important for the achievement of the wider taxation goals (Gichuki, 2015). It is therefore distinct from substantive tax law. Tax administration has more to do with the framework that supports day-to-day management of revenue administration and covers systems, structures, management, leadership, and organizational processes that enable a tax agency to meet its core mandate (Kenya Revenue Authority, 2020).

The essential function of the tax administration is to examine consistency and to authorize approvals to guilty parties as given in the principles and guidelines (Ng'eni, 2019). The compelling tax administration should be associated with recognizable proof, appraisal, and accumulation of tax incomes (Gurawa & Mansor, 2015). Successful tax administration is a key hardware of tax income accumulation in both created and creating economy. Tax administration is significant and tax specialists need to configure tax administration reform that can recognize bottlenecks (Baer & Silvan, 2021) that in one way or different influence tax administration activities.

Lisa and Hermanto (2018) studied the effect of administrative and policy tax reforms in Indonesia. The study used the Structural Equation Modeling (SEM) in the analysis. Findings revealed that policy tax reforms (Tax Amnesties) have a positive effect on compliance. Administrative tax reforms (enhanced taxpayer awareness) also showed a positive effect on compliance levels. Musa and Ibrahim (2021) studied effect of administrative and technological tax reforms on small income tax compliance in Nigeria. Results show that both administrative and technological tax reforms have a positive effect on small-income tax compliance.

2.3 Conceptual Framework

A conceptual framework provided a mental sketch of the study by linking the independent variables and the dependent variable (Quinlan & Babin, 2019). The proposed study sought to find out how the independent variables was tax administration restructuring dependent variable Income Tax Compliance The conceptual model represented in Figure 2.1 describes the relationship between the variables of study accordingly.

Independent Variables **Dependent Variable**

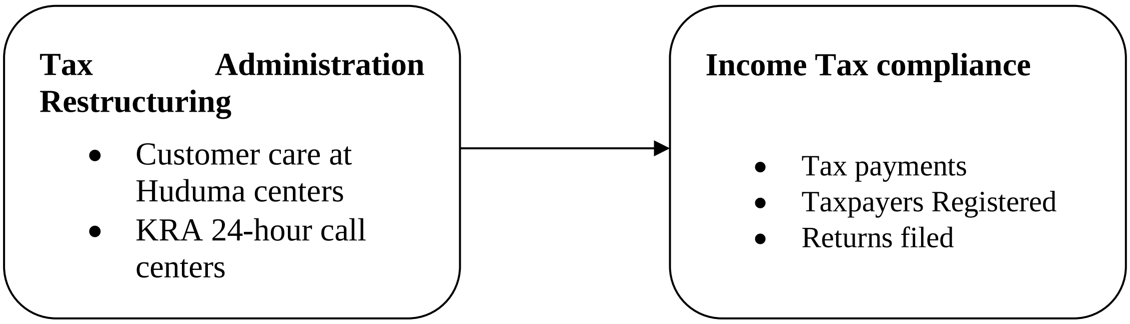

Figure 1: Conceptual Framework

Source: Researcher, (2024)

3.0 Methodology

This research adopted an explanatory research design that tries to explain the nature of certain relationships and investigates the causal relationship between variables., the study target will be 2,182 SMEs in Lang'ata Sub County and a sample of 338 respondents. Primary data was collected by structured questionnaires using drop and drop-and-pick method. In the test to check for validity of questionnaire data Cronbach's alpha was used an alpha >0.7 indicates that the questionnaire responses are reliable. Table 1 shows the results for alpha values tax administration restructuring α=0.950>0.70 and income tax compliance α=0.866>0.70.

Table 1: Reliability tests

Variables	Cronbach's Alpha	N of Items
Tax administration restructuring	0.950	5
Income tax compliance	0.866	5

(Source: Research 2024)

According to Gujarati, (2003) to ensure reliable results, several assumptions must be met. This included linearity, assuming a linear connection between variables, independence of observations, homoscedasticity, normality, and the absence of multicollinearity. The collected data was well examined and checked for completeness and comprehensibility. The data was then summarized, coded, and tabulated.

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4.0 Results and Discussion

4.1 Response Rate

Out of 338 questionnaires that were administered 270 questionnaires were returned and filled. This response rate is considered satisfactory to make conclusions for the study. Figure 4.1 indicates the response rate.

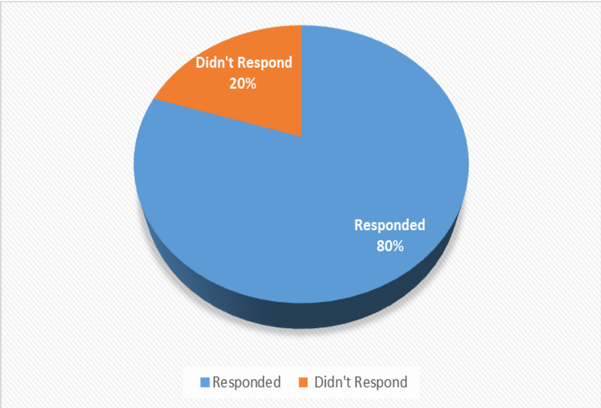

Figure 1: Response rate

4.2 Descriptive Statistics

4.2.1 Tax Administration Restructuring

Table 2. indicates that: The business has been able to easily and quickly access the needed tax services provided by customer care centers placed at Huduma centers and mobile centers. Mean: 4.65. We have had all our queries quickly responded to by the KRA call centers, especially during emergencies at all times. Mean: 4.57. We no longer fear approaching the KRA PIN issuing system by myself. Mean: 3.22. We have been able to conveniently seek assistance in handling issues related to PIN registration from cybercafé operators within my reach whenever. Mean: 4.52. Requiring tax clearance certificates in transacting and accessing services in other government departments has made it hard to evade tax. Mean: 4.54.

Table 2: Descriptive statistics on Tax Administration Restructuring

Statements	Mean	St. Deviation	Skewness	Kurtosis
The business has been able to easily and quickly access the needed tax services provided by customer care centers placed at Huduma centers and mobile centers.	4.65	0.480	0.607	-1.644
We have had all our queries quickly responded to by the KRA call centers, especially during emergencies at all times.	4.57	0.495	0.317	-1.914
we no longer fear approaching the KRA PIN issuing system by myself	3.22	0.493	0.363	-1.882
we have been able to conveniently seek assistance in handling issues related to PIN registration from cybercafé operators within my reach whenever	4.52	0.484	0.540	-1.721
Requiring tax clearance certificates in transacting and accessing services in other government departments has made it hard to evade tax	4.54	0.494	0.348	-1.893
N=270				

(Source: Research 2024)

4.2.2 Income Tax Compliance

Table 3 illustrates that I filed my tax return on time a mean score of 4.83. We declare the correct income with a mean score of 4.61. We pay the right amount of taxes means a value of 2.55. We report all tax liabilities following applicable tax laws a mean score of 4.72. We honor all my tax obligations in a trustworthy and honest manner with a mean score of 4.64.

Table 3: Descriptive statistics on Income Tax Compliance

Statements	Mean	Std. Deviation	Skewness	Kurtosis
We file my tax return on time	4.83	0.06	.286	-1.933
We declare the correct income	4.61	0.26	.523	-1.739
We pay the right amount of taxes	2.55	0.75	.442	-1.818
We report all tax liabilities following applicable tax laws	4.72	0.18	.379	-1.870
We honor all my tax obligations in a trustworthy and honest manner	4.64	0.21	.475	-1.788
N=270				

(Source: Research 2024)

4.3 Correlation Analysis

Correlation analysis is a statistical tool used to observe the relationship between two incessant variables. A correlation matrix in Table 4 was used to determine the direction of the relationship between the variables shows that there is a positive and significant relationship between tax administration restructuring and Income tax compliance up to 65.2% ($p=0.000<0.05$).

Table 4: Correlation Analysis

		Income tax Compliance	**Tax Administration Restructuring**
Income tax Compliance	Pearson Correlation	1	
	N	270	
Tax Administration Restructuring	Pearson Correlation	.652	1
	Sig. (2-tailed)	.000	
	N	270	270

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

Source: Research (2024)

4.4 Model Summary

Table 5 revealed that tax administration restructuring correlates with income tax compliance up to 65.2% (R=0.652) and accounts for a variation of 42.5% (R^2 =0.425). This implies that 57.5% of the change in income tax compliance was caused by other factors which were not included in the study. The findings further reveal that even if the results adjust, the study would still account for 41.8% (AdjustedR^2, 0. 418) variation in income tax compliance.

Table 5: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.652[a]	.425	.418	0.42670

a. Predictors: (Constant), Income tax compliance _mean

Source: Research data (2024)

4.5 Regression Analysis

Regression Coefficients

The coefficient Table 5 shows that the coefficient table the main regression equation is

$Y = 0.012 + 0.103X_1$

Table 6 shows at a constant of 0.012 a unit change in tax administration restructuring causes an increase of 0.103 in Income tax compliance. H_{01} The null hypothesis was that tax administration restructuring has no significant effect on Income tax compliance among Small and Medium Enterprises in Lang'ata Sub County, Nairobi County, Kenya. The study found that tax administration restructuring has a positive and significant effect on Income 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)	0.012	0.009		1.333	.008
	Tax administration restructuring	0.103	0.021	0.267	4.905	.000

Dependent Variable: Income tax compliance

Source: Research data (2024)

4.6 Discussion of the Findings

Tax administration restructuring and income tax compliance

The first objective was to establish the effect of tax administration restructuring on income tax compliance among Small and Medium Enterprises in Lang'ata Sub County, Nairobi County, Kenya. A unit change in tax administration restructuring is associated with an increase in income tax compliance $\beta= 0.103$ $p=0.000$. The finding was in agreement with Lisa and Hermanto (2018) studied the effect of administrative and policy tax reforms in Indonesia. The study used the Structural Equation Modeling (SEM) in the analysis. Findings revealed that policy tax reforms (Tax Amnesties) have a positive effect on compliance. Administrative tax reforms (enhanced taxpayer awareness) also showed a positive effect on compliance levels. Musa and Ibrahim (2021) studied effect of administrative and technological tax reforms on small income tax compliance in Nigeria. Results show that both administrative and technological tax reforms have a positive effect on small-income tax compliance.

5.0 Conclusion

A unit change in tax administration restructuring significantly increases income tax compliance, with a positive correlation emphasizing the facilitative role of enhanced tax administration restructuring. This underscores the vital importance of efficient tax administration in driving compliance among Small and Medium Enterprises (SMEs), aligning with the first specific objective.

6.0 Recommendations

Given the significant positive influence of tax administration restructuring on income tax compliance, it is recommended that KRA continues to invest in streamlining and improving tax administration processes.

Future research should be carried out to determine the advancements in tax technology influence SMEs' compliance behavior.

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