

Probability of Detection and Value Added Tax Compliance among Small and Medium Enterprises in Westlands Sub County, Nairobi, Kenya: Moderating Effect of Tax Service Quality

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Abstract

Purpose: Value-added tax compliance has remained a challenge, especially when it comes to SMEs operating in Kenya. The high level of informality of this sector provides an incentive for most of the SMEs to evade payment of VAT, a situation that has constrained the amount of tax revenues available to finance fiscal budget. This study aimed to determine the moderating role of tax service quality on the relationship between probability of detection and value added tax compliance among small and medium enterprises in Westlands Sub County, Nairobi, Kenya.

Methodology: The study adopted an explanatory design targeting 751 SMEs operating in Westlands Sub- County, Nairobi, Kenya as registered by Nairobi City County. The sample frame was the list of SMEs in Westlands Sub- County that is available in Nairobi City County. The sample size was 261 owners of the said SMEs who were stratified into four categories based on the nature of undertaking of their business and a representative sample from each of these categories was drawn. Gathering of information was by use of a questionnaire. To analyze the collected information, descriptive statistics like means and standard deviations as well as multiple regression analysis was adopted.

Results: Regression of coefficients showed that probability of detection had a positive and significant effect on VAT compliance of SMEs ($\beta=0.358$, $p=0.000$). The findings also revealed that tax service quality moderates the relationship between probability of detection and value added tax compliance among small and medium enterprises ($\beta= 0.086$, $p<0.05$).

Conclusion: The study concluded that probability of detection had a positive and significant effect on VAT compliance of SMEs. In addition, the study concluded that tax service quality moderate the relationship between probability of detection, on value added tax compliance among small and medium enterprises in Westlands Sub County, Nairobi, Kenya. KRA should increase the rate probability of audit detection by coming up with new mechanisms of audit detection thus enhancing VAT compliance of VAT amongst the SMEs. The government should strive to provide SME owners in Westlands Sub County, Nairobi, with services that are of high standards for example at the tax stations as clearly stated in the corporate plan to reduce the need for spending costs to hire skilled persons such as tax consultants.

Keywords: *Probability of Detection, Value Added Tax Compliance, Tax Service Quality*

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1.0 Introduction

Value Added Tax (VAT) has remained acknowledged as one of the most significant tax heads that can be harnessed by developed and developing countries to grow and develop their economies. In developed countries like Japan, Switzerland, and the United States, statistics from Organization for Economic Co-operation and Development (OECD) indicate that VAT accounts for over 20% of the total amount of tax collected in the entire economy on average (OECD, 2022). In most developing countries especially in Africa, OECD reports that an average of 51.9% of the total tax revenue collection is attributed to VAT (OECD, 2022). Against this background, literature on efforts to drive VAT compliance has gathered momentum across the world.

The term VAT compliance has been defined differently by scholars including the ability of the taxpayer to closely abide by the tax laws of a jurisdiction (Cahyonowati, Ratmono & Juliarto, 2023). Defining VAT compliance in administrative terms, involves registration, timely payment, and filing of returns to the tax authority. It also entails efforts taken by the taxpayer to notify the tax authority with respect to the status of a taxpayer (Erul, 2020). In this study, VAT compliance was defined as the ability of eligible taxpayers to get registered, make accurate assessments and payments of their tax obligations, and file tax returns within established timeframes by a tax collection agency on behalf of the government.

Probability of detection is a tax metric that has attracted a significant level of attention among scholars. Allingham and Sandmo (1972) indicated that taxpayers have an incentive to accurately declare their incomes if there is a high probability of detection. Probability of detection shapes and determines the reporting behavior of the taxpayers. This is because taxpayers will always have an incentive to ensure everything has been declared if they believe they will fall victim to a tax audit anytime. Probability of detection can broadly be defined as the likelihood that a tax authority was able to discover noncompliance behavior of the taxpayer and rectify it. Taxpayers will only declare their tax returns in line with the established tax laws if they have information and knowledge that they may be audited at the end of a given year (Biru, 2020).

Service quality is efforts made to attain the desires and needs and desires of customers in a manner that is accurate while balancing the expectations of customers (Amoh & Ali-Nakyea, 2019). According to Parasuraman et al. (1988), quality determines the overall assessment of the level of a service. On this account, tax service quality can be regarded as the provision of all reliable and best services to the satisfaction of the taxpayers. The existing literature indicates various measures of tax service quality including Khudri and Sultana (2015) who established five measures of the same including problem-solving, personal interaction, appearance and reliability as well as policy. Parasuraman et al. (1988) contribute to the literature of tax service quality by highlighting its five key measures which include tangibles, reliability, responsiveness, assurance, and empathy.

1.1 Problem Statement

Value Added Tax compliance has remained a challenge, especially when it comes to SMEs operating in Kenya (KRA, 2022). The high level of informality of this sector provides an incentive for most of the SMEs to evade payment of VAT, a situation that has constrained the amount of tax revenues available to finance fiscal budget. For instance, in the financial year 2022/2023, the shortfall between actual and targeted VAT collected stood at Kshs. 24 billion (KRA, 2023). It is hoped that strengthening VAT compliance among SMEs in Kenya including

those in Westlands would be critical in countering the aforementioned VAT shortfalls between actual and targeted collections.

The available studies include Tilahun (2018) who analyzed economic and social factors affecting voluntary tax compliance in Ethiopia. The study noted that fairness of the tax system, penalty, tax rate, perceptions of government spending, and compliance cost were found to be the determinant factors that affect taxpayer's voluntary compliance. Muturi and Abdul (2021) analyzed tax structure-related attributes that drive tax compliance among individual taxpayers in Kenya. It was shown that taxpayer knowledge, complexity, and attributes of the individual taxpayer's influence tax compliance. In Bangladesh, Mannan (2020) determined the tax structure factors affecting tax compliance and established them to include fairness, tax penalty, and relationship with regard to taxpayer's perception of government spending. In Indonesia, Sugiyarti et al. (2021) analyzed how tax service quality affected taxpayer compliance and a positive relationship between these variables was established.

From the aforementioned studies, it is evident that while some like Sugiyarti et al. (2021) were conducted in different countries like Indonesia other than Kenya, others like Muturi and Abdul (2021) were conducted focusing on general tax compliance other than VAT. This creates gaps that the proposed study sought to fill by analyzing the moderating role of tax service quality on the relationship between probability of detection and value added tax compliance among small and medium enterprises in Westlands Sub- County, Nairobi, Kenya.

1.2 Research Hypotheses

H₀₁: Probability of detection has no statistically significant effect on value added tax compliance among small and medium enterprises in Westlands Sub County, Nairobi, Kenya

H₀₂: Tax service quality does not moderate the effect on the relationship between probability of detection and value added tax compliance among small and medium enterprises in Westlands Sub County, Nairobi, Kenya

2.0 Literature Review

2.1 Theoretical Review

Economic deterrence theory was developed by Becker (1968) and later on developed further by Allingman and Sandmo (1972) and it stresses that a range of factors such as tax rate, and penalties influences taxpayers' behavior. When there is a high strength of tax audits and penalties, people have less incentive of evading to fulfil their tax obligation. On the other hand, existence of less strength in tax audits and penalties can increase noncompliance behavior of the taxpayers. According to Becker et al (1968), authorities need to appropriately balance between detection of non-compliers and measures to the point where non-compliance becomes irrational (OECD, 2010).

The theory assumes that taxpayers are rational in nature and all their decisions are based majorly on calculations that are determined based on economic calculation. This theory was useful in anchoring the first independent variable being probability of detection and how it influences VAT compliance. It is expected and hypothesized under this theory that existence of periodic tax audits can increase probability of detection of noncompliance behaviour of the taxpayers (Bun, Kelaher, Sarafidis & Weatherburn, 2020). In turn, this is likely to increase the compliance behaviour and attitude of the taxpayers.

2.2 Empirical Review

2.2.1 Value Added Tax Compliance

Alshira'h (2024) did a study on how value added tax compliance can be incentivized. This was an experimental examination of trust in government and tax compliance costs. The study makes use of an online questionnaire survey to collect the required data, and the research model is eventually validated based on 189 responses gathered from the retail industry in Jordan. The obtained data was analyzed using partial least squares-structural equation modeling to examine the effects of trust in government and costs of VAT compliance on VAT compliance. The results showed that VAT compliance costs have no significant influence on VAT compliance; while trust in government was found statistically positively significant with VAT compliance.

Trifan, Szentesi, Cuc, and Pantea (2023) assessed assessing tax compliance behavior among Romanian taxpayers which was an empirical case study. The research hypotheses were tested with a sample of 402 individual taxpayers and quantitative data analysis was carried out using partial least squares-structural equation modeling. The results showed that seven drivers (tax system fairness, trust in government and tax authorities, and knowledge of tax legislation, personal financial constraints, coercive measures, moral standards, and tax legislation simplicity) were significant factors that increased the likelihood of tax compliance among individual taxpayers.

Ojo and Shittu (2023) did a review of value added tax compliance, and small and medium enterprises (SMEs) with emphasis on influential factors in Nigeria. Using both primary and secondary data the study population comprised all registered SMEs in Nigeria. The study used a sample of 3,600 SMEs to carry out the analysis. Also, given a total of 18,000 observations, a panel data set of 3,600 SMEs from the years 2018 to 2022 was chosen from the financial records of SMEs. The results indicate that TPA, OC, TCC, and VIE influence VAT compliance. Furthermore, the study discovered that revenue has a positive but not significant effect on VAT compliance. More so, the size and level of profit generated have a positive and significant influence on VAT compliance by SMEs. However, a number of employees and customers had no significant effect on VAT compliance by SMEs.

2.2.2 Probability of Detection and Value Added Tax Compliance

Sinnasamy and Bidin (2017) did a study with emphasis on the moderating effect of probability of detection on the determinants influencing excise duty non-compliance in Malaysia. The questionnaires were distributed using a disproportionate stratified simple random sampling technique. 500 usable questionnaires were collected for analysis. The partial least square analysis was applied to analyze the data. Analysis of data involved throughout Malaysia indicates that tax audit, peer influence, and tax knowledge have a significant positive relationship. In addition, tax audit have a significant negative relationship and tax knowledge has significant positive relationship with moderating effect. The findings from this study provided an indication for the tax administration in maximizing tax collections and encourage taxpayer's compliance.

Ortega and Sanguinetti (2013) determined how deterrence and reciprocity effected tax compliance: experimental evidence from Venezuela. The study entailed tracking of the local business tax compliance of over 6,000 firms in a major municipality in Caracas, which we randomly assigned to a control of no stimulus, or to one of five treatment arms that received letters from the local tax administrator with different types of messages regarding tax compliance. It was found that an enforcement message (that increases the perceived probability of detection) has the largest compliance effect, a message highlighting the public goods and

services provided by the local government (and that affect businesses directly) has the second largest effect, and that other messages have much smaller effects on compliance. In addition, the reciprocity message seems to have more lasting impacts than the enforcement message.

Korongo and Kilonzi (2023) did a review of the deterrent factors influencing value added tax compliance in Kisumu County, Kenya. The specific objectives revolved around tax audits; tax rate and compliance checks and how they influence value added tax compliance in Kisumu County, Kenya. The economic deterrence theory and the Fiscal and Social Psychology Theory provided anchorage to the study. A descriptive approach was adopted targeting 430 businesses in Kisumu town. Stratified random sampling was used to select 129 respondents from these firms. Questionnaire was used to gather primary data that was analyzed through descriptive (means and standard deviations) and inferential statistics (correlation and multiple regression analysis). Tables and figures were used to present the analyzed findings. It was established that compliance checks have the greatest significant contribution towards VAT compliance. The study concludes that deterrent factors have a significant influence on VAT.

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 of the proposed study was 751 SMEs operating in Westlands Sub- County, Nairobi, Kenya as registered by Nairobi City County. The study determined a sample size of 261 using Yamane (1967). The study adopted a stratified random sampling technique. This study gathered primary data with aid of the questionnaire. Data analysis describes the steps that are undertaken to process raw facts into insights for supporting decision-making. Once gathered from the field, the questionnaires was inspected and sorted before being keyed into Excel. From there, it was exported to Statistical Package for Social Sciences (version 26) in readiness for analysis. The analysis took form of percentages and means as descriptive statistics as well as regression analysis as inferential statistic. Two regression models were adopted; one for testing effect of tax structure on VAT compliance (direct regression model) and the other one for determining the moderating effect of tax service quality in the above relationship (moderated regression model).

4.0 Results and Discussion

4.1 Descriptive Statistics

4.1.1 Descriptive Analysis for Probability of Detection

Descriptive analysis results for probability of detection are presented in Table 1.

Table 1: Descriptive Analysis for Probability of Detection

Statement	Strongly disagree	Disagree	Neutral	Agree	strongly agree	Mean	Std.Dev
I believe there is a significant risk of VAT non-compliance being detected	10.00%	3.70%	24.20%	26.00%	36.10%	3.74	1.26
I am confident in the systems for monitoring VAT compliance and detecting non-compliance.	10.50%	13.70%	15.50%	32.40%	27.90%	3.53	1.31
I believe the likelihood of being detected encourages taxpayers to comply with VAT laws	9.10%	4.60%	13.20%	37.90%	35.20%	3.85	1.21
The likelihood of being caught for tax evasion is high	11.00%	0.90%	11.40%	26.90%	49.80%	4.04	1.28

The results showed that majority of the respondents who were 62.1% agreed with the statement that they believe there was a significant risk of VAT non-compliance being detected (mean =3.74, std.dev=1.26). This infers that SME owners felt there was a risk if they failed to comply with VAT. The study results also showed that majority of the respondents who were 60.3% agreed with the statement that they are confident in the systems for monitoring VAT compliance and detecting non-compliance (mean =3.53, std.dev=1.31). This denotes that SME owners were confident with the systems for monitoring VAT compliance and detecting non-compliance. The results also showed that majority of the respondents who were 73.1% agreed with the statement that they believe the likelihood of being detected encourages taxpayers to comply with VAT laws (mean =3.85, std.dev=1.21). This meant that there was a chance of being detected when one failed to pay taxes. The results also showed that majority of the respondents who were 73.1% agreed with the statement that the likelihood of being caught for tax evasion is high (mean =4.04, std.dev=1.28). This infers that SMEs had a likelihood of being caught in case of tax evasion.

4.1.2 Descriptive Analysis for Tax Service Quality

Descriptive analysis results for tax service quality were presented in Table 2.

Table 2: Descriptive Analysis for Tax Service Quality

Statement	Strongly disagree	Disagree	Neutral	Agree	strongly agree	Mean	std. dev
Tax officials approach their job with professionalism and dedication	7.80%	4.10%	9.60%	22.80%	55.70%	4.15	1.23
Tax service is delivered quickly and timely	8.70%	2.70%	29.20%	35.60%	23.70%	3.63	1.14
Tax staff have a polite, friendly, proper communication attitude and respect for businesses	4.60%	10.50%	2.70%	43.80%	38.40%	4.01	1.12
The problems related to the tax support application system of the tax authority are regularly overcome in time	2.70%	6.40%	8.70%	43.80%	38.40%	4.09	0.98

The results showed that majority of the respondents who were 78.5% agreed with the statement that tax officials approach their job with professionalism and dedication (mean=4.15, std.dev=1.23). This denotes that the SMEs were comfortable with the professionalism of the tax officials. The outcomes further showed that majority of the respondents who were 59.3% agreed with the statement that tax service is delivered quickly and timely (mean=3.63, std.dev=1.14). This meant that KRA delivered tax services timely and quickly. The results showed that majority of the respondents who were 82.2% agreed with the statement that tax staff have a polite, friendly, proper communication attitude and respect for businesses (mean=4.01, std.dev=1.12). This infers that the SMEs were comfortable with the tax staff's attitude and respect for their business. In addition, results showed that majority of the respondents who were 82.2 % agreed with the statement that the problems related to the tax support application system of the tax authority are regularly overcome in time (mean=4.09, std.dev=0.98). This denotes that tax support application system of the tax authority is regularly overcome in time.

4.1.3 Descriptive Analysis for Value Added Tax Compliance

Descriptive analysis results for value added tax compliance were presented in Table 3.

Table 3: Descriptive Analysis for Value Added Tax Compliance

Statement	Strongly disagree	Disagree	Neutral	Agree	strongly agree	Mean	std.dev
I am registered for VAT purposes	8.20%	8.20%	12.80%	26.50%	44.30%	3.90	1.28
I submit my VAT returns on time	9.10%	10.00%	16.00%	22.80%	42.00%	3.79	1.33
I pay my VAT taxes on time	6.40%	6.80%	17.80%	22.80%	46.10%	3.95	1.22
I have been charged late payment penalties and interests in the past	15.10%	15.10%	25.10%	16.90%	27.90%	3.27	1.40

The results showed that majority of the respondents who were 70.8% agreed with the statement that they are registered for VAT purposes (mean=3.90, std.dev=1.28). This infers that most SMEs are registered for VATA. The results further showed that majority of the respondents who were 64.8% agreed with the statement that they submit their VAT returns on time (mean=3.79 std.dev=1.33). This denotes that SMEs in Westlands Sub County fill their returns on time. Further results showed that majority of the respondents who were 68.9% agreed with the statement that pay their VAT taxes on time (mean=3.95, std.dev=1.22). This meant that most SMEs pay their taxes on time. The results further showed that majority of the respondents who were 44.8% agreed with the statement that they had been charged late payment penalties and interests in the past (mean=3.27 std.dev=1.40). This meant that some SMEs had paid their taxes late.

4.2 Regression Analysis

Regression analysis was used to show the relationship between variables. Table 4 shows the regression results.

Table 4: Regression of Coefficient

	Unstandardized Coefficients B	Std. Error	Standardized Coefficients Beta	t	Sig.
(Constant)	1.615	0.352		4.594	0.000
Probability of detection	0.366	0.057	0.358	6.409	0.000

The null hypothesis (H_{01}) was that there is no significant effect of probability of detection on value added tax compliance among small and medium enterprises in Westlands Sub County, Nairobi, Kenya. Regression of coefficients showed that probability of detection had a positive and significant effect on VAT compliance of SMEs ($\beta=0.358$, $p=0.000$). Therefore, null hypothesis was rejected and the study concluded that there was a statistically significant relationship between probability of detection of value added tax compliance among small and medium enterprises in Westlands Sub County, Nairobi, Kenya. The study findings agreed with Ortega and Sanguinetti (2013) who found that an enforcement message (that increases the perceived probability of detection) has the largest compliance effect. The findings were

however not in agreement with Sinnasamy and Bidin (2017) who found that probability of detection had a significant influence on excise duty non-compliance in Malaysia.

4.3 Moderating role of tax service quality on the relationship between probability of detection and value added tax compliance

The null hypothesis (H_{05}) *tax service quality does not moderate the effect on the relationship between probability of detection and value added tax compliance among small and medium enterprises in Westlands Sub County, Nairobi, Kenya.* The moderating effect was determined from model 6 where an interactive term was introduced between probability of detection and tax service quality. The beta coefficient for the interactive term was ($\beta = 0.086$, $p < 0.05$). This indicated that the study rejected the null hypothesis and the study concluded that tax service quality moderates the relationship between probability of detection and value added tax compliance among small and medium enterprises in Westlands Sub County, Nairobi, Kenya. This therefore indicated that tax service quality would enhance VAT compliance.

Table 5: Coefficients of Regression for Moderating Effect of Tax Service Quality

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	3.142	1.034		3.04	0.003
Probability of detection	0.093	0.058	0.091	1.592	0.113
TSQ	-0.373	0.294	-0.35	-1.266	0.207
TSQ*Probability	0.086	0.015	0.438	5.839	0.000

4.4 Discussion

The first objective was to determine the effect of probability of detection on value added tax compliance among small and medium enterprises in Westlands Sub County, Nairobi, Kenya. Results showed that there was a statistically significant relationship between probability of detection on value added tax compliance among small and medium enterprises in Westlands Sub County, Nairobi, Kenya. This infers that an enhancement in probability of detection would lead to an improvement in VAT compliance of SMEs. This can be attributed to the fact that taxpayers have an incentive to accurately declare their incomes if there is a high probability of detection. Probability of detection shapes and determines the reporting behavior of the taxpayers. The study findings agreed with Ortega and Sanguinetti (2013) who found that an enforcement message (that increases the perceived probability of detection) has the largest compliance effect. The findings were however not in agreement with Sinnasamy and Bidin (2017) who found that probability of detection has a significant influence on excise duty non-compliance in Malaysia.

The second objective was to assess whether tax service quality moderates the relationship between probability of detection and value added tax compliance among small and medium enterprises in Westlands Sub County, Nairobi, Kenya. The study found that tax service quality moderates the relationship between probability of detection of value added tax compliance among small and medium enterprises in Westlands Sub County, Nairobi, Kenya. The study findings agreed with Susuawu, Ofori-Boateng, and Amoh (2020) who found statistically significant positive effects of reliability, responsiveness, assurance, and empathy on the tax compliance behavior of SMEs.

5.0 Conclusion

The study concluded that probability of detection had a positive and significant effect on VAT compliance of SMEs. The probability of detection plays a significant role in VAT compliance as taxpayers declare taxes accurately if they perceive they will be audited in a particular year. Further, when the taxpayers are confident in the systems for monitoring VAT compliance and detecting non-compliance their compliance increases.

In addition, the study concluded that tax service quality moderates the relationship between probability of detection, on value added tax compliance among small and medium enterprises in Westlands Sub County, Nairobi, Kenya

6.0 Recommendations

KRA should increase the rate probability of audit detection by coming up with new mechanisms of audit detection thus enhancing VAT compliance of VAT amongst the SMEs. The senior tax auditors at KRA should increase the audit rate and the probability of audit detection to drive VAT compliance among taxpayers.

The government should strive to provide SME owners in Westlands Sub County, Nairobi, with services that are of high standards for example at the tax stations as clearly stated in the corporate plan to reduce the need for spending costs to hire skilled persons such as tax consultants. This would improve VAT compliance. In addition, the tax authority should invest more in tax service quality to increase compliance levels of SMEs as well as taxpayers dwelling in other tax regions with similar features as SMEs. The commitment must be held firmly by both parties, namely tax officials and taxpayers. Tax officers must commit to serving taxpayers following the tax officer's code of ethics.

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