Effect of Simplicity of the Tax System on Income Tax Collection among Small and Medium Enterprises in Kamukuji Sub-County Nairobi, Kenya

Cyrus Gathungu Ndiangui[1], Dr. Robert Odunga[2] & Dr. Paul Kabete[3]
[1]Tax Administration, Moi University
[2,3]School of Business and Economics, Moi University
Corresponding Email: cyrusndiangui@gmail.com

Abstract

Purpose: Taxation is how government finances its expenditure by imposing charges on citizens and corporate entities. A country's tax regime is always a key factor for any business considering moving into new markets. The purpose of this study was to establish the effect of Simplicity of the tax system on income tax collection among small and medium enterprises in Kamukunji Nairobi County, Kenya. The theories that guided this study were Ability-to-Pay Theory of Taxation, and, Unified Theory of Acceptance and Use of Technology.

Methods: The study adopted an explanatory research design. The target population was 3106 small and medium enterprises in Kamukunji Nairobi County. A sample size of 354 respondents was drawn from this population using Yamane's formula. In this study, out of 354 targeted respondents, 283 questionnaires were correctly filled and returned, resulting in a response rate of 79.94%.

Results: The study found that Simplicity had a positive and significant effect on income tax collection ($\beta = 0.236$, $p = 0.000$).

Conclusion: The study recommends that the government should focus on simplifying tax procedures and forms to reduce administrative complexity. This can increase voluntary compliance by making the tax process more accessible, particularly for SMEs that may lack sophisticated accounting knowledge. Future research should Investigate the effect of tax incentives, on companies' financial performance.

Keywords: *Small and Medium Enterprises, Simplicity of The Tax System, Income Tax Collection*

1. 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.

Income tax collection refers to the adherence of taxpayers to the tax laws and regulations of a jurisdiction, ensuring that they accurately report their income, claim deductions and credits correctly, and pay the appropriate amount of tax owed in a timely manner. Compliance involves fulfilling all tax obligations imposed by the tax authorities, including filing tax returns, maintaining proper records, and paying taxes due, OECD, (2021). 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 rate being 10 percent and the highest 30 percent. 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.

The simplicity of the tax system refers to how easy it is for taxpayers to understand, comply with, and navigate the tax laws and regulations. A simple tax system minimizes complexity in tax rates, forms, and filing procedures, reducing the likelihood of errors and the need for professional assistance, James and Alley (2022). It aims to make the process of calculating, reporting, and paying taxes straightforward, thus saving time and resources for both taxpayers and the government. Simplicity in the tax system also enhances transparency and can improve taxpayer compliance and trust in the system (Richardson, 2021).

According to Milliron (2020), simplicity means that taxpayers can avoid a maze of taxes, forms, and filing requirements. A simpler tax system helps taxpayers better understand the system and reduces the costs of compliance. Adequacy means that taxes must provide enough revenue to meet the basic needs of society, Loo et al. (2019). A tax system meets the test of adequacy if it provides enough revenue to meet the demand for public services, if revenue growth each year is enough to fund the growth in cost of services, and if there is enough economic activity of the type being taxed so rates can be kept relatively low (Saad et al., 2019).

In Kenya SME or MSME refers to and means Jua kali or informal sector. According to the Government, any business that employs between one to nine, ten to forty-nine, and fifty to ninety-nine are micro, small, and medium enterprises correspondingly. For purposes of this paper, these common factors shall become the basis of identification to mean and refer to SMEs. The composition of the inventory of SME target groups outlined in the paper for tax base broadening has substantially drawn from these features (Kinyua, 2021). The SMEs in Kenya are rapidly growing at a higher rate and they have the potential to increase the revenue flows however most of the SMEs have been left out of the tax bracket. Taxation of SMEs has been the bane of most tax administrators across the world- largely because it comprises the informal sector. The KIPPRA report highlights the fact that SMEs dominate in the majority of the sectors, including agriculture, business services, community and social services, construction, hotels, insurance, real estate, wholesale and retail trade, restaurants, manufacturing, transport and communication (KIPRA, 2022).

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. 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 for instance in financial 2021/2022 the income tax collected was Kshs. 407 billion against a target of Kshs. 415 billion (KRA, 2022). Similarly, for income tax such as PAYE in the financial

year 2021/2022, the tax collections were Ksh. 173.83 billion against a target of Ksh. 215 billion again falling short of the target by Ksh 42 billion (KRA,2023).

This trend in income tax collections is a cause for concern, as it could have significant implications for the government's ability to finance public services and development projects. Therefore, this clearly shows that there is unexplained relative underperformance in income tax in some of the years which means the level of compliance has been fluctuating. some studies have been conducted on tax performance both globally and locally. Another research was conducted to establish the impact of the compliance cost on the general financial performance of registered small-scale industries in Malaysia. Uwaume and Ordu (2019) researched to establish the impact of income tax on economic development in Nigeria and it was concluded that there was enough income tax to enhance industrial growth and the economy. However, little research has been done on the effect of Simplicity of the tax system on income tax collection among small and medium enterprises in Nairobi County, Kenya.

2. Literature Review

2.1 Theoretical Review

2.1.1 The Ability-to-Pay Theory of Taxation

This theory was developed by Adam Smith and supported by Swiss philosopher Jean, the French political economist Say, and the English economist Mill. According to the ability to pay principle, taxes should be distributed according to the capacity of taxpayers to pay them (Hyman, 2014). This theory treats revenue and expenditure of the government separately. The obligation to pay to the government is taken as a social and collective responsibility although the question of who shall pay and in what amount is necessarily an individualized one. Those who have means pay and those who have not need not to pay (Kennedy, 2012).

Ability-to-pay taxation derived by Lade Kendrick in the American Economic Review in 1939 established that Ability-to-pay theory of taxation is a progressive taxation principle that maintains that taxes should be levied according to a taxpayer's ability to pay. The theory is that individuals who earn more money can afford to pay in taxes (Wang, 2021). According to the theory, Wang (2021) states that taxes should be based on the amount of money people earn. For example, those who earn more money are expected to pay a higher rate of taxes--which means a higher portion of their income than people who earn less money. Critics of ability-to-pay taxation state that progressive tax systems reduce the incentive to earn more money and penalize those whose hard work and ingenuity have helped them earn higher incomes. These critics claim that ability-to-pay taxation is not fair for wealthy individuals.

This theory propagates that people should be asked to pay taxes according to their ability to pay and an assessment of their taxable capacity should be made based on income. The most popular and accepted principle of equity or justice in taxation is that citizens of a country should pay taxes to the government in accordance with their ability to pay (Limerick, 2013). It can therefore be argued and appears reasonable and just that taxes should be taxed based on the taxable capacity of a person and in using this principle it can be stated that if the taxable capacity of one individual is greater than that of the other person, that a person who earns more should be asked and expected to pay more taxes in comparison with the one who earns less. The theory supports tax compliance.

2.1.2 Unified Theory of Acceptance and Use of Technology

This theory, developed by Venkatesh et al. (2003), seeks to clarify user motivations when interacting with information systems and their resulting behaviors. It identifies four key

elements that significantly affect the adoption of a new information system: the expectation of performance, the anticipated effort required, social influences, and the conditions that facilitate use. Additionally, these factors are influenced by variables such as gender, age, experience, and the voluntary nature of user participation. For instance, younger users with a background in information technology are often more inclined to perceive a new system as beneficial for their tasks, find it user-friendly due to their technical skills, and are likely to encourage their peers to adopt the same system.

The theory was developed by examining and integrating concepts from eight earlier frameworks, including the widely recognized Technology Acceptance Model. Although this model has been widely applied in research, it has also drawn criticism, especially when compared to the Technology Acceptance Model (Venkatesh & Zhang, 2010). The Unified Theory of Acceptance and Use of Technology underscores the importance of a company's economic environment, industry structure, and internal organization as crucial factors for its growth and development. This theory also highlights the shift from manual processes to automated systems, which enhance efficiency and streamline tasks. Management adopts these information systems to effectively meet specific operational needs. As a result, many organizations have moved away from traditional manual methods in favor of modern information systems, demonstrating the advantages of automation (Venkatesh, 2016).

The business creator is the originator of innovative concepts and strategies for growing a company, and they need to consider feedback. The implementation of information systems has an impact on organizations, generally yielding favorable outcomes (Gupta 2011). In Kenya, various elements like the age of users, their educational background, and their willingness to adopt these systems will significantly affect how information systems are utilized. These considerations are essential during the development of such systems to ensure they are user-friendly and face minimal pushback upon their launch. The theory supports independent variable Simplicity of the tax system.

2.2 Empirical Review

2.2.1 Simplicity of the Tax System

Forest and Sheffrin (2022) assert that simplifying the tax system (and therefore generating simpler tax returns) implicitly might not be an effective deterrent to tax evasion because taxpayers may not necessarily consider a complex tax system to be unfair. Forest and Sheffrin were unable to identify any relationship between complexity and perception of unfairness and concluded that while simplifying the tax law would not automatically improve compliance, many taxpayers perceive that tax systems are always complex and burdensome. Although Forest and Sheffrin suggested that the impact of the simplicity of the tax systems was insignificant since the filling of tax returns required a high degree of understanding. It was therefore important to establish whether the simplicity of the tax system influences tax compliance among rental income earners in Eldoret town.

Silvani and Baer (2021) outlined the importance of the fact that a tax authority should have a simple tax return system from a taxpayer's point of view. A tax authority might assume its tax return is simple and easy to complete but it may not be so from the taxpayers' point of view. Therefore, before the final and actual version is delivered to taxpayers, it would be normal to put the forms through a series of 'pilot' tests to validate that the tax return is simple and easy to complete. In the UK, evidence suggests that uncomplicated tax returns play a major role in improving tax compliance (Silvani & Baer, 2019). Although tax knowledge and the simplicity of tax returns have a different impact on compliance (Kirchler et al., 2018), it is noted that a

taxpayer with low tax knowledge may be able to file the tax returns accurately provided the tax returns are simple, clearly explained, and consistent.

Karingi et al. (2022) indicated that Kenya's tax system is very burdensome to the taxpayers. They evaluated the Kenyan tax system in terms of time taken to pay the taxes. On the other hand, Farzbod, (2020) noted that the inefficiency, high administration costs, extended time in tax collection, and the low amounts of received taxes in comparison to optimum allocation of resources is a major drawback for developing countries. Existing empirical evidence indicates that most businesses whether small or large are affected disproportionately by the costs associated with the tax system.

2.2.2 Income Tax Collection

Taxes are part of the business income. The amount of tax payable is decided by the level of the revenue generated during the period considered. Therefore, among many factors, income level is also one of the essential determinants of taxpayers' compliance behavior (Mohammed & Dabor, 2021). The government applies different approaches when imposing taxes to determine how much people should pay according to their earnings. Low-income earners tend to submit incorrect reports and evade tax (Johns & Slemrod, 2020).

Contrary, Alm, Mcclelland and Schulze (2019) found that a high level of business income encourages the business community to pay more taxes to the state. A different view of the income source was pointed out by Kirchler, Muehlbacher, Kastlunger and Wahl (2019) in an experiment conducted to study the impact of hard-earned money and easy earnings on tax compliance contributions. According to their findings, if income was earned by surmounting many roadblocks and obstacles, reluctance inhibits people on such occasions. Naturally, they would be hesitant to declare the actual amount of income.

Ho and Wong (2022) researched to study the relationship between the level of income and tax compliance and found that income has no direct influence on tax compliance. Similarly, Durham, Manly, and Ritsema (2021) concluded the study with the results indicating that there is no significant association between overall compliance and the income source of business. On the other hand, Muzainah & Gurama (2019) found that income level positively and significantly influences tax non-compliance.

2.3 Conceptual Framework

The conceptual framework illustrates the association between the dependent and the independent variable (Mugenda & Mugenda, 2013). The independent variables were Simplicity of the tax system which was measured by administrative ease. Transparency Adequacy. The dependent variable income tax collection was measured by Tax payments, Registration, and Returns filed as illustrated by the conceptual framework Figure 1.
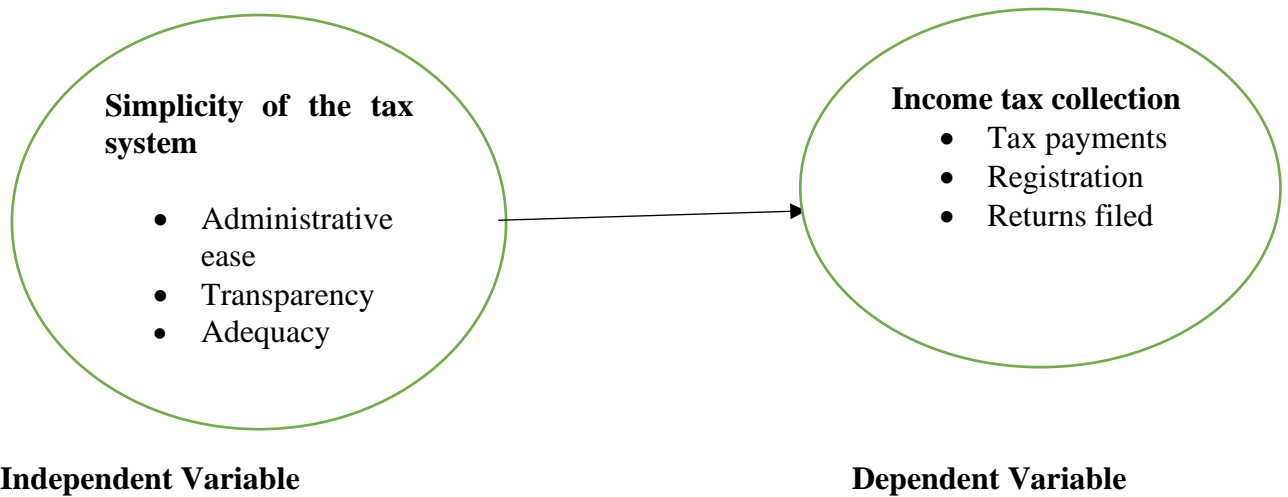
Independent Variable   Dependent Variable

Figure 1: Conceptual Framework

3. Methodology

This study adopted an explanatory research design. An explanatory research design provides the researcher with the tools and capabilities to explain the characteristics of the phenomenon under investigation. (Sekaran & Bougie, 2016). According to Cooper and Schindler (2003), an explanatory design discovers and measures the cause and effect of relationships between variables. The study population was 3106 small and medium enterprises in Kamukunji sub-County Nairobi, Kenya KRA (2023)**.** The target population is crucial because it guides how data is collected, analyzed, and interpreted, ensuring that the findings are relevant to the group being studied or served. Therefore, the sample size of 354 small and medium enterprises in Kamukunji sub-County Nairobi, Kenya. In this study, out of 354 targeted respondents, 283 questionnaires were correctly filled and returned, resulting in a response rate of 79.94%.

Table 1. Response Rate Analysis

Response Rate	Frequency	Percentage (%)
Response	283	79.94%
No Response	71	20.06%
Total	**354**	**100**

Abbott and McKinney (2013) define reliability as the consistency of an examination measure in providing a stable assessment of a concept. In their study, reliability was evaluated using the Cronbach alpha coefficient, a metric used to determine the internal consistency of a set of scale or test items. The study instrument's reliability was tested using Cronbach's alpha, with a threshold set at 0.7. The Cronbach's Alpha for Income Tax Collection is 0.918, suggesting excellent reliability, as values above 0.7 are considered very good. Similarly, the Simplicity of the Tax System has a Cronbach's Alpha of 0.922, indicating that the items measuring this construct are highly consistent.

Table 2: Test of Reliability of Questionnaire

Factor	Number of Items	Cronbach Alpha score	Conclusion
Income Tax Collection	5	0.918	Acceptable
Simplicity of the Tax System	5	0.922	Acceptable

4. Results and Discussion

4.1 Descriptive statistics

4.1.1 Descriptive statistics Simplicity of tax systems

Table 3 shows that for the item "I understand the current tax system. The item recorded a mean of 3.95 and a standard deviation of 1.082. This implies that a significant number of respondents believe they understand the current tax system, and the responses don't strongly deviate from the mean score. For the item "I find it easy to file my taxes. The item recorded a mean of 4.04 and a standard deviation of 1.034. This implies that a significant number of respondents find it easy to file their taxes, and the responses don't strongly deviate from the mean score. For the item "The new tax system motivates me to comply with tax laws. The item recorded a mean of 3.78 and a standard deviation of 1.107. This implies that a significant number of respondents are motivated to comply with tax laws under the new system, and the responses don't strongly deviate from the mean score. For the item "I pay actual tax as assessed because I trust in the tax system. The item recorded a mean of 4.03 and a standard deviation of 1.041. This implies that a significant number of respondents trust the tax system and pay the actual tax as assessed, and the responses don't strongly deviate from the mean score. For the item "It is easy to understand all the processes of the current tax system. The item recorded a mean of 4.00 and a standard deviation of 0.986. This implies that a significant number of respondents find it easy to understand all the processes of the current tax system, and the responses don't strongly deviate from the mean score.

Table 3: Simplicity of tax systems

	Mean	Standard Deviation	skewness	kurtosis
I understand the current tax system	3.95	1.082	-.706	-.411
I find it easy to file my taxes	4.04	1.034	-.671	-.812
The new tax system motivates me to comply with tax laws	3.78	1.107	-.433	-.980
I pay actual tax as assessed because I trust in the tax system	4.03	1.041	-.778	-.381
It is easy to understand all the processes of the current tax system	4.00	0.986	-.805	-.047

4.1.2 Descriptive Statistics for Income Tax Compliance

Table 4 displayed the responses for items related to income tax compliance. For the item "Our business always declares the correct income. The mean for this item was 3.93 with a standard deviation of 1.093. This indicates that a substantial portion of respondents affirmed that their business declares the correct income, with moderate deviation from the average response. For the item "I file our tax return on time. The mean score was 4.02, with a standard deviation of 1.041, implying that most respondents file their tax returns on time, with responses moderately clustered around the mean. Regarding the statement "I always report all tax liabilities following applicable tax laws. The mean was 3.76, and the standard deviation was 1.113, suggesting that while a significant number of respondents report all tax liabilities as per the law, there is slightly more variability in these responses. For "Our business pays the right amount of taxes. This item recorded a mean of 4.00 and a standard deviation of 1.052, showing that a majority believe their business pays the correct amount in taxes, with a relatively moderate dispersion around the mean. Lastly, for the statement "Our business pays and declares income tax by the due date because we believe it is morally right. The mean was 4.01, with a standard deviation of 0.987, indicating that the belief in the moral obligation to pay taxes on time is widespread, with responses showing less variability compared to other items.

Table 4: Income Tax Compliance

	Mean	Standard Deviation	skewness	kurtosis
Our business always declares the correct income	3.93	1.093	-.714	-.372
I file our tax return on time	4.02	1.041	-.650	-.857
I always report all tax liabilities following applicable tax laws	3.76	1.113	-.392	-1.030
Our business pays the right amount of taxes	4.00	1.052	-.773	-.333
Our business pays and declares income tax by the due date because believe it is morally right	4.01	0.987	-.778	-.214

4.2 Correlation Analysis

The correlation analysis was conducted to determine the nature of the linear relationships between the study predictor variables and the outcome variable, Creswell (2009). Table 5 shows that the correlation between simplicity in the tax system and income tax collection is positive and significant ($r = 0.353$). This suggests that increased simplicity in the system can positively affect income tax collection. Simplifying processes may encourage taxpayers to comply more readily, enhancing the overall efficiency of tax collection.

Table 5: Correlations Statistics

	Income Tax Collection	Simplicity in the Tax System
Income Tax Collection	1	0.353[**]
Simplicity in the Tax System	0.353[**]	1

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

4.3 Regression Analysis

The model summary was conducted to determine the effects of the predictor and the level of variance caused by income tax collection among small and medium enterprises in Kamukuji sub -County Nairobi, Kenya. Table 6 The model summary showed that Simplicity of the tax system had a strong correlation with income tax collection up to 35.3% or (R= 0.353). The results reveal that Simplicity of the tax system caused a variation of 12.4% or (R^2=0.124 and adjusted R^2 =0.117) on income tax collection. The remaining 87.6% of variation was caused by other factors not included in the model.

Table 1: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.353a	.0.124	.117	.32568

a. Predictors: (Constant), Simplicity of the tax system _mean

Table 7 shows that there was an F statistic of 216.769 and a p-value of 0.000<0.05, which indicates that the model was significant in explaining the variance caused by Income Tax Collection.

Table 7: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
	Regression	125.076	1	125.076	216.769	0.000
1	Residual	162.148	281	0.577		
	Total	287.224	282			

a. Dependent Variable: Income Tax Collection

b. Predictor: (Constant), Simplicity of the tax system

Table 8 showed that unit change in Simplicity of the tax system caused a 0.236 increase in Income Tax Collection. The study found that Simplicity of the tax system had a positive and significant effect on Income Tax Collection β =0.236 p-value =0.000<0.05. Consequently, the null hypothesis was rejected.

Table 8: Coefficient Regression Analysis

	Standardized Coefficients β	Std. Error	Unstandardized Coefficients β	t	Sig.
(Constant)	0.502	0.229		2.192	0.029
Simplicity of the tax system	0.236	0.050	0.262	4.720	0.000

Dependent Variable: Income Tax Collection

4.4 Discussion of the Findings

The main objective of the study was to determine the effect of Simplicity of the tax system on income tax collection among small and medium enterprises in Kamukuji sub -County Nairobi, Kenya. The study found that the correlation between simplicity and income tax collection was positive and significant r = 0.353). This suggests that increased simplicity in the system can positively affect income tax collection. Simplifying processes may encourage taxpayers to

comply more readily, enhancing the overall efficiency of tax collection. Similarly, the coefficient analysis found that Simplicity had a positive and significant effect on income tax collection ($\beta = 0.236$, $p = 0.000$), indicating that simpler tax procedures encourage better compliance. The study findings agreed with Silvani and Baer (2021) who concluded that a simpler tax return system significantly improves compliance, as evidenced by pilot tests conducted in the UK. This aligns with the findings of this study, which also indicates that simpler tax procedures enhance taxpayer compliance. Similarly (Craig & Slemrod, 2022) highlighted that improving taxpayer education alongside simplifying tax regulations can lead to greater understanding and consequently higher compliance. The current study's emphasis on simplicity resonates with their argument that knowledge paired with straightforward procedures enhances compliance rates.

5. Conclusion

The study objective of the study was to determine the effect of the simplicity of the tax system on income tax collection among small and medium enterprises (SMEs) in Kamukunji sub-county, Nairobi, Kenya. The study concluded that a simpler tax system enhances tax compliance and income tax collection among SMEs. By reducing the complexities and administrative burdens associated with tax processes, the system becomes more accessible to small business owners, encouraging higher rates of voluntary compliance. Therefore, policymakers should prioritize simplification initiatives to improve tax revenue efficiency in this sector.

6. Recommendations

The study recommends that the government should focus on simplifying tax procedures and forms to reduce administrative complexity. This can increase voluntary compliance by making the tax process more accessible, particularly for SMEs that may lack sophisticated accounting knowledge.

Future research should Investigate the effect of tax incentives, on companies' financial performance.

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