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Effect of Legislative Reforms on Turnover Tax Compliance among Small-Scale Traders in Ruaraka Nairobi, Kenya

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Abstract

Turnover tax was introduced in 2008 as a simple tax to bring small and medium enterprises into the tax net. Small and medium enterprises play a critical function in the advancement of the Kenyan Economy. However, much remains to be done to achieve the desired results that were anticipated when TOT was introduced. The study aimed to determine the effects of legislative reforms on turnover tax compliance among small-scale traders in Ruaraka, sub-county, Nairobi, Kenya. The study was anchored on the Ability to pay theory and the Institutional Theory. An explanatory research design was employed in this study and the target population was 3,240 small-scale traders in Ruaraka, sub-county Nairobi with a sample size of 356 respondents. Out of the 356 issued questionnaires, 299 were filled accurately and returned, signifying 84% response rate. The study collected primary data through a questionnaire, and the data was analyzed using descriptive and inferential statistics to determine the association between variables. The correlation matrix found that legislative reforms had a positive correlation of ($r = 0.423$) with turnover tax compliance, implying that improvements in legislative reforms can lead to higher turnover tax compliance. The regression analysis found that legislative reforms had a significant positive effect on Turnover tax compliance. ($\beta = 0.286$, $p = 0.000$). The study recommends that the government should focus on continuous updates and improvements to tax legislation are essential. Ensuring that tax laws are clear, fair, and easily understandable will help in maintaining high levels of compliance. Future research should investigate how inflation and economic growth influence turnover tax compliance.

Keywords: *Small-Scale Traders, Legislative Reforms, Turnover Tax Compliance*

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1. Introduction

Taxation is the best way to promote economic growth and poverty alleviation. It provides a consistent and reliable financial foundation for designing nations to help develop their economies and finance for physical and social strategic priorities such as infrastructures. Integrated with industrial prosperity, it reduces lengthy dependency on assistance and guarantees effective governance by encouraging accountability and transparency to its citizens (Romer & Romer, 2020)

Turnover tax is a lump sum direct tax collected by governments (Parkin, 2020). Turnover tax is worked out by applying to a taxable turnover a single tax rate (McCluskey, 2021) as opposed to an income tax system that incorporates the use of comprehensive rules and procedures that require maintenance of proof on every expenditure. Countries that apply turnover tax use different parameters to determine when the tax needs to be assessed (Parkin, 2020). The structure of a turnover tax varies with governments and types of goods taxed. This is intended to keep it affordable for everyone (Cheeseman & Griffiths, 2021).

Taxpayers are required to observe and comply with the turnover tax obligations of their country. Key compliance items are declaring income, filing a return, and timely payment of tax when due (McCluskey, 2021). Failure to comply with the tax obligations poses a serious challenge to tax authorities as it diminishes the mobilization of resources that governments need to invest in critical areas of socioeconomic development including health, education, and infrastructure development (Cummings, 2021).

Legislative reforms involve the systematic and deliberate alteration of existing laws or the introduction of new laws to address emerging issues, improve legal frameworks, and promote justice, equity, and societal well-being. These reforms aim to update, streamline, or enhance legal provisions to reflect contemporary needs and values (Marmor & Lieberman, 2022).

These are practical changes in tax law aimed at making the tax system responsive to the changing needs of the economy. It is usually legislated in parliament to make it operational. The main factors contributing to improved revenue performance are changes in tax legislation, tax administration, and minimal tax evasion (Mirrlees, 2020). Kenya operated a tax system inherited from the colonial government since independence until the early 1970s when policy and administrative changes were initiated. According to KIPPRA (2006), there were few problems with revenue mobilization until the 1970s energy crisis necessitated tax reforms to mobilize more revenue. Kenya adopted the Income Tax Act in 1973 (African Development Bank Group, 2020).

Micro and Small Enterprises were recognized by the government by forming the Micro and Small Enterprise Authority (MSEA) under the Micro and Small Enterprise Act No. 55 of 2012. to articulate and coordinate guidelines that will enable the assimilation and synchronization of several private and public sector initiatives, for the elevation, progress, and regulation of the MSMEs to become key upcoming industries. MSEs 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, 2013).

1.1 Problem Statement

There has been a growing challenge in the levels of Tax Compliance among SMEs in Kenya, the majority of the taxpayers who have subscribed under the Turnover Tax have failed in their compliance levels. The government of Kenya through KRA strives to meet its revenue targets because of revenue collection shortfalls. In the FY 2021/2022, TOT collection recorded a performance of 73.6% with a collection of KES 99,739,158 against a target of KES 135,050,379 (KRA, 2022). In the 2022/2023 financial year, TOT collection was at 112,653,556 against a target of KES 128,112,921 which resulted in a deficit of KES 15,459,365 (KRA, 2023). Furthermore, as of the financial year 2023/2024, KRA collected 2.407 Trillion in Income Tax which translates to a performance rate of 95.5% against a target of 2.787 Trillion. The factors affecting Turnover Tax Compliance among SMEs in Kenya have not been exhaustively researched, and no study has been done in Ruaraka area in Nairobi County. This study therefore focused on establishing the effect of legislative reforms on turnover tax compliance among small-scale traders in Ruaraka Nairobi, Kenya.

2. Literature Review

2.1 Theoretical Review

2.1.1 Ability to pay Theory

This theory was developed by Smith and Pigou (1903) "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state." The ability-to-pay principle requires that the total tax burden will be distributed among individuals according to their capacity to bear it, taking into account all of the relevant personal characteristics. This is the most popular and commonly accepted principle of equity or justice in taxation as citizens of a country pay taxes to the government in accordance with their ability to pay. It seems that if the taxes are levied on this principle as stated above, then justice can be achieved. The most suitable taxes from this standpoint are personal levies (income, net worth, consumption, 18 and inheritance taxes) (West, 2016). The economists are not unanimous as to what should be the exact measure of a person's ability or faculty to pay.

The tax should come from him that has, not from him that has not. This theory was espoused by Adams smith in 1776. This therefore means that taxation should be a function of income, as it's known to be. If the prices are not shifted upwards with the same margin as that of excise, does the taxpayer suffer loses, or there is enough for taxpayer to pay the tax and have profits. It can therefore be argued and appears reasonable and just that taxes should be levied on the basis of the taxable capacity of an individual (Chauke, 2016).

While others have argued that it penalizes hard work and success and reduces the incentive to make more money, (opt for flat rate of taxation), others argue that those who have benefitted most from the nation's way of life in the form of higher incomes and greater wealth can afford and should be obligated to give back a little more to keep the system running (Kagan, 2020). This theory expounded on whether the turnover tax has been based on the ability to pay and its general compliance

2.1.2 Institutional theory

Institutional theory is a research tradition that traces its origins back to foundational articles that discussed how organizational founding and change were driven less by functional considerations and more by symbolic actions and external influences than the theory at the time assumed (Meyer & Rowan, 1977). These articles drew on concepts of bounded rationality that are central to behavioral theories and sketched a broad range of potential research questions, but much subsequent research drew away from the firm focus on behavioral theories of organization by emphasizing environmental influences such as the diffusion of new institutionalized practices among firms.

As institutional theory has grown, some branches have moved closer to behavioral theory. Direct dialogue between the perspectives has been started by researchers who have noted that the organizational change processes examined by behavioral theory are influenced by the institutional context (Wezel & Saka-Helmhout, 2006). A growing subfield of institutional theory concerns institutional logic, which is broadly (but not universally) shared assumptions and action patterns (Thornton, 1995). At the organizational level, institutional logic can be seen as a source of managerial decision-making rules, and thus it is related to research on the BTOF and evolutionary theory.

Institutional theory has also moved into examining the founding conditions for new firms (Tolbert et al., 2011). This work questions the conventional assumption that entrepreneurs are rationally able to locate opportunities, and it instead posits that key sources of organization founding activities are institutional features of the social group to which entrepreneurs belong or the symbolic environment they face. Like population ecology, this work moves the concerns for decision-making processes and bounded rationality to the stage of organizational founding.

The institutional theory of taxation posits a fundamental connection between the effectiveness of a taxation system and the quality of the institutional environment within which it functions. This theory emphasizes that the institutional framework has a significant impact on the success of taxation efforts beyond just tax rates and regulations. This encompassing framework includes elements such as the rule of law, the quality of tax administration, and the overall governance structure of a nation (Williams, 2020). The institutional theory emphasizes that the rules, norms, and regulations that govern societies play a pivotal role in shaping individual and collective behavior. In the context of taxation, this theory asserts that the structure and implementation of a taxation system are deeply intertwined with a society's institutions (Horodnic, 2018).

Institutional theory is relevant to the study since Kenya Revenue Authority operations are influenced by different institutions, notably political institutions. As such, the systems put in place to administer tax, and their implementation are partly politically instigated. The same must be in line with relevant tax legislation which should include public participation in the whole process. The theory supports tax reforms.

2.2 Empirical review

2.2.1 Legislative Reforms

Chang and Doina (2022) analyzed the impact of legislative tax reforms in six European Union member countries (Austria, Finland, France, Germany, and the UK) on the investment decisions of small and medium-sized enterprises (SMEs), particularly considering the effects of inflation. The study compared the tax incentive effects of these reforms on SME investment decisions, such as tax rates and depreciation rules. The findings indicated that these reforms did not yield positive results for SMEs and entrepreneurship, revealing a tax non-neutrality between financing methods that favored large firms with easier access to bank loans. However, the study focused solely on corporate taxes and did not consider other taxes that also affect SMEs.

For revenue administration reform to succeed, several critical requirements must be met. These include; strong political commitment, clear decision-making, provision of necessary resources, professional and stable leadership, a willingness to abandon outdated and ineffective practices, and the establishment of a formal reform project with a clear, achievable mandate, agreed-upon objectives, and realistic timeframes. Reforming revenue administration is a complex and time-consuming process with many challenges, often reflecting the preconditions for success. In a study by Crandall and Bodin (2020) on revenue administration reforms in Middle Eastern countries it was found that Egypt and Lebanon made significant improvements with the VAT system, although it was not yet used for income tax. Jordan was planning improvements, and some progress had been made in Morocco, Pakistan, Saudi Arabia, and Sudan.

According to Wagacha (2019), Kenya is ranked among low-income countries and low-compliance countries and is further faced with the difficult task of ensuring efficient and effective legislative tax reforms. The problem of tax non-compliance among business firms constrains the realization of revenue collection targets by the Kenya Revenue Authority (KRA). Kenya has had a part of her share with numerous scandals involving the political leaders. Subsequently, the respect of citizens for the government and the institutions that are not able to effectively govern their revenue is low and this makes the level of tax compliance very low. The ability of the government to commendably articulate and implement comprehensive policies on the effective utilization of the revenue encourages taxpayers to voluntarily comply with tax payments (Kinyua, 2014).

2.2.2 Turnover Tax Compliance

The Presumptive Tax was implemented in 2018 as a replacement for the 2007 turnover tax by the Finance Act of 2018. The official implementation date of this law was set for January 1, 2019. To increase small and medium-sized business (SMEs) tax compliance, the turnover tax was reintroduced through the Finance Act 2019 less than a year later. As a result, the government reduced the presumed tax threshold to Kshs. 500,000. Individuals with eligible small companies have the option to register for either the conventional tax system or the turnover tax. A tax rate was simply applied to a "taxable turnover" to calculate turnover tax. There are guidelines for turnover taxes that specify when and how much they should be levied (McCluskey, 2019).

Turnover tax is a lump sum direct tax collected by Governments (Parkin, 2006). Turnover tax is worked out by just applying to a taxable turnover a single tax rate (McCluskey, 2012) as opposed to income tax system that incorporates use of comprehensive rules and procedures that require maintenance of proof on every expenditure. Countries that apply turnover tax use different parameters to determine when the tax needs to be assessed (Parkin, 2006). The structure of a turnover tax varies with governments and types of goods taxed. This is intended to keep it affordable for everyone (Cheeseman & Griffiths, 2005).

To foster economic growth and development, governments need sustainable sources of funding for its development. Globally, taxes have been the primary source of revenue and essential fuel on which most governments run. To boost revenue collection in Kenya, the Kenya Revenue Authority (KRA) through the Finance Act 2006, introduced a ‘simpler’ tax regime for Micro and small enterprises (MSMEs) dubbed Turnover Tax (TOT). Ouma et al (2007) explained that the turnover tax targets small traders which comprise the micro and small businesses. These businesses are largely unregistered and mostly employ labor as the primary means of production, i.e. labor-intensive production functions. In Kenya, Turnover tax is applicable to the groups of businesses whose turnover is expected to be less than 25 million Kenya shillings.

This tax has its roots in the Finance Act 2007 in which the provision of the Income Tax Act, Cap 470, under section 12c, allows the government to operationalize it.

2.3 Conceptual Framework

A conceptual framework is a visual pictorial diagram that gives a clear inter-relationship between the independent and dependent variables of the study (Mugenda & Mugenda, 2003). The conceptual framework shows how the independent variable, which is legislative reforms, was measured by the Tax Law and Tax Procedures Act. The dependent variable, turnover tax compliance, was measured by tax payments and returns filed. as shown in Figure 1.

Independent Variable **Dependent Variable**

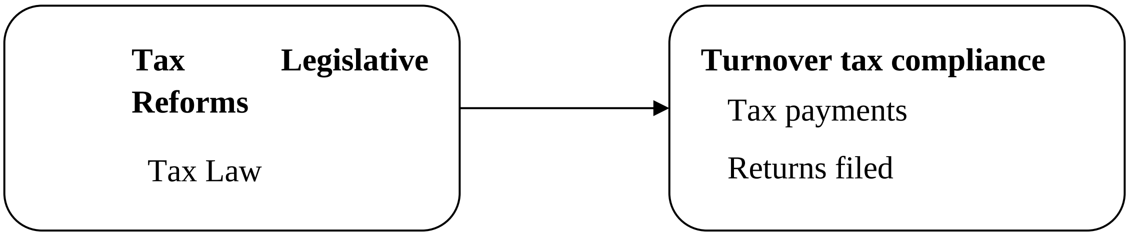

Figure 1: Conceptual Framework

3. Methodology

Harper and Marcus (2003) suggest that research design deals with the detailing of procedures that was adopted to carry out the research study. According to Kothari (2010), study design is a plan for collecting and utilizing data so that desired information can be obtained with sufficient precision or so that a hypothesis can be tested properly. The study employed an explanatory research design. The study population was the full set of cases from which a sample was taken (Mugenda and Mugenda, 2003). The target population was 3240 small-scale traders in Ruaraka, Nairobi (KRA, 2023). The sample size was 356 respondents. Out of 356 targeted respondents, 299 participated and submitted their survey responses, resulting in an 84% response rate. The non-responses could be due to a lack of interest in the survey topic or insufficient time to complete the survey.

Table 1: Response Rate

Response Rate	Frequency	Percentage (%)
Response	299	84%
No Response	57	16%
Target	**356**	

Reliability analysis

According to Dennick (2011), Cronbach's alpha was employed to assess the reliability of the questionnaire responses by measuring internal consistency. This statistic evaluates the extent to which all items in a survey measure the same underlying construct. A high Cronbach's alpha value, typically above 0.7, indicates strong internal consistency, suggesting that the items are reliably capturing the same concept. The turnover tax compliance exhibited a Cronbach's alpha of 0.917, while legislative reforms had Cronbach's alpha values of 0.989 the alpha values were >0.7, this implied strong internal consistency, suggesting that each of the questionnaire items reliably captured the same concept.

Table 2: Test of Reliability

Factor	Number of Items	Cronbach Alpha score	Conclusion
Turnover tax compliance	5	0.917	Acceptable
Legislative reforms	4	0.989	Acceptable

4. Results and Discussion

4.1 Descriptive statistics

4.1.1 Descriptive Statistics Legislative reforms

Table 3 shows that the statement "I believe the modernization of tax laws has improved the economic efficiency of the tax system through the lowering and rationalization of tax rates" received a mean score of 4.037 (SD = 1.047). The standard deviation implies moderate variability in the responses to this statement. The mean indicates that respondents tend to agree with this statement. The statement "Reforms in tax legislation and tax administration have greatly improved my trust in KRA" received a mean score of 4.020 (SD = 1.077). The standard deviation implies moderate variability in the responses to this statement. The mean indicates that respondents tend to agree with this statement. The item "The continuous review of the TOT is important for our business" received a mean score of 3.963 (SD = 1.100). The standard deviation implies moderate variability in the responses to this statement. The mean indicates that respondents tend to agree with this statement. The statement "The introduction of the Tax Procedures Act and changes in government expenditure in the annual national budget have a major impact on our business" received a mean score of 3.993 (SD = 1.071). The standard deviation implies moderate variability in the responses to this statement. The mean indicates that respondents tend to agree with this statement.

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Table 3: Legislative reforms

	N	Mean	SD	Skewness	Kurtosis
I believe the modernization of tax laws has improved the economic efficiency of the tax system through the lowering and rationalization of tax rates	299	4.037	1.047	-.710	-.705
Reforms in tax legislation and tax administration have greatly improved my trust in KRA.		4.020	1.077	-.737	-.664
The continuous review of the TOT is important for our business.		3.963	1.100	-.719	-.607
The introduction of the Tax Procedures Act and changes in government expenditure in the annual national budget have a major impact on our business.		3.993	1.071	-.729	-.569
Mean		4.003			

4.1.2 Descriptive Statistics for Turnover Tax Compliance

Table 4 presents the descriptive statistics for the items related to Turnover Tax (TOT) compliance. The statement "We have registered for Turnover tax compliance obligation" received a mean score of 3.916 (SD = 1.104). This means that respondents tend to agree with this statement. The standard deviation suggests moderate variability in responses. For the item "Our business files tax returns on time," the mean score was 4.043 (SD = 1.040), indicating that respondents generally agree with this statement. The standard deviation shows moderate variability. The item "Our firm pays TOT by or on the due date" had a mean score of 3.799 (SD = 1.111), suggesting that respondents tend to agree with this statement. The standard deviation indicates moderate variability. For the statement "Our business declares and files accurate returns," the mean score was 4.000 (SD = 1.062), indicating agreement among respondents. The standard deviation shows moderate variability. The item "Our firm fully understands my tax obligation" received a mean score of 4.003 (SD = 0.995), indicating agreement among respondents. The standard deviation suggests moderate variability.

Table 4: Turnover Tax Compliance

	N	Mean	SD	Skewness	Kurtosis
We have registered for Turnover tax compliance obligation	299	3.916	1.104	-.648	-.594
Our business files tax returns on time		4.043	1.040	-.682	-.823
Our firm pays TOT by or on the due date.		3.799	1.111	-.453	-.985
Our business declares and files accurate returns.		4.000	1.062	-.728	-.542
Our firm fully understands my tax obligation.		4.003	.995	-.789	-.144
Mean		3.952			

4.2 Correlation Analysis

The correlation analysis was conducted, to determine the relationship between legislative reforms and turnover tax compliance among small-scale traders in Ruaraka Nairobi, Kenya. Pearson correlations >0.5 show a strong relationship, and sig<0.05 indicates that the relationship is significant, and has a low likelihood of occurring by random chance (Garson, 2012). Table 5 shows that the Legislative Reforms also exhibit a positive correlation (Pearson correlation = 0.423 with Turnover tax Compliance, implying that improvements in Legislative Reforms can lead to higher Turnover Tax Compliance

Table 5: Correlations Statistics

	Turnover tax Compliance	**Legislative Reforms**
Turnover tax Compliance	1	0.423**
Legislative Reforms	0.423**	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 legislative reforms and turnover tax compliance among small-scale traders in Ruaraka Nairobi, Kenya. Table 6 The model summary showed that Legislative Reforms have a strong correlation with Turnover tax Compliance up to 42.3% or (R= 0.423). The results reveal that legislative reforms caused a variation of 17.8% or (R^2=0.178 and adjusted R^2 =0.171) on Turnover Tax Compliance. The remaining 82.2% of variation was caused by other factors not included in the model.

Table 6: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.423[a]	.0.178	.171	.43892

a. Predictors: (Constant), Legislative reforms _mean

Table 7 shows that there was an F statistic of 179.744 and a p-value of 0.000<0.05, which indicates that the model was significant in explaining the variance caused by TOT compliance.

Table 7: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
	Regression	112.520	1	112.520	179.744	0.000
1	Residual	186.101	297	0.626		
	Total	298.351	298			

a. Dependent Variable: Turnover Tax Compliance
b. Predictors: (Constant), Legislative reforms

Table 8 showed that unit change in Legislative reforms caused a 0.286 increase in Turnover Tax Compliance. The study found that Legislative reforms have a positive and significant effect on Turnover tax Compliance β =0.286 p-values =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)	0.928	0.260		3.569	0.001
Legislative Reforms	0.286	0.058	0.309	4.931	0.000

Dependent Variable: Turnover Tax Compliance

4.4 Discussion

The study sought to establish the effect of legislative reforms on turnover tax compliance among small-scale traders in Ruaraka Nairobi, Kenya. The correlation matrix found that legislative Reforms had a positive correlation of (r = 0.423) with Turnover tax Compliance, implying that improvements in Legislative Reforms can lead to higher Turnover Tax Compliance. The regression analysis found that legislative reforms had a significant positive effect on Turnover tax compliance. (β = 0.286, p = 0.000). The findings concurred with Crandall and Bodin (2020) who found that legislative reforms in Middle Eastern countries led to enhanced tax compliance, especially through the introduction of VAT systems. Such reforms streamlined tax laws and aligned the legislative framework with best practices in tax administration, contributing to improved turnover tax compliance. According to Wagacha (2019), the introduction of comprehensive legislative reforms in Kenya has played a role in addressing low tax compliance, especially when supported by policies designed to promote voluntary compliance.

5. Conclusion

The objective of the study was to establish the effect of legislative reforms on turnover tax compliance among small-scale traders in Ruaraka Nairobi, Kenya. The study concludes that legislative reforms significantly enhance turnover tax compliance among small-scale traders in Ruaraka, Nairobi, Kenya. The positive correlation and significant regression results imply that improvements in legislative reforms lead to higher turnover tax compliance.

6. Recommendations

The study recommends that the government should focus on Continuous updates and improvements to tax legislation are essential. Ensuring that tax laws are clear, fair, and easily understandable will help in maintaining high levels of compliance. Future research should investigate how inflation and economic growth influence taxpayer behavior on turnover tax.

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