EdinBurg Peer Reviewed Journals and Books Publishers
Journal of Finance and Accounting
Vol. 5||Issue 3||pp 40-49||July||2025
Email: info@edinburgjournals.org||ISSN: 2789-0201

The Effect of Legislative Reforms on Consumption Tax Compliance Among Small and Medium Enterprises in Nakuru Town, Kenya

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Accepted: 01 June 2025 || Published: 05 July 2025

Abstract

Despite undertaking many tax reforms, the Kenya Revenue Authority has been trying to establish ways of ensuring that the set revenue targets are achieved. The Kenya Revenue Authority has consistently missed its consumption tax targets over the years although the revenue collections have been growing. This study sought to determine the effect of legislative reforms on consumption tax compliance among small and medium enterprises in Nakuru Town, Kenya. The study was guided by the following theories: Ability to pay and Neoclassical Theory. The study adopted an explanatory design and the target population was 3748 small and medium enterprises in Nakuru town. Primary data collection was collected using structured questionnaires. The data was analyzed using descriptive which included mean and standard deviation. Inferential statistics included multiple linear regression analysis. Results showed legislative reforms had a statistically significant positive effect on consumption tax compliance ($\beta = 0.391$, $p = 0.000$). The study recommends in regards to legislative reforms that policymakers should prioritize revising the Tax Procedures Act to reduce regulatory complexity in consumption tax reporting while introducing SME-targeted provisions such as graduated penalty systems and compliance incentives. Future research should explore the effect of behavioural factors such as tax morale, and economic variables such as the impact of cash flow patterns on consumption tax.

Keywords: *Legislative Reforms, Consumption Tax Compliance, Small and Medium Enterprises*

How to Cite: Maingi, M. K., Koske, N., & Olweny, T. (2025). The Effect of Legislative Reforms on Consumption Tax Compliance Among Small and Medium Enterprises in Nakuru Town, Kenya. *Journal of Finance and Accounting, 5*(3), 40-49.

1. Introduction

Taxes are the most practical source of public finance in many economies, aside from non-tax revenue sources like user fees and licenses charged for services rendered by government departments and agencies and foreign aid (Tresch, 2021). Taxes collected by governments primarily depend on taxpayers' voluntary compliance, whereby the taxpayers fulfill their tax obligation freely and completely. However, developing economies struggle to raise enough tax revenue to finance the ever-increasing public expenditures due to taxpayer noncompliance (Marti, 2020).

Consumption tax forms an important source of revenue for an increasing number of governments, accounting for almost 31% of all revenue collected by governments across the OECD. Value-added tax (VAT) is the principal form of taxing consumption in most of the OECD member countries and accounts for two-thirds of consumption tax revenues. The remaining third is made up of specific consumption tax such as excise duties (OECD, 2022), a situation which is a replica of the consumption tax in Kenya.

Every step of the production and distribution chain, all the way up to the retail stage, is subject to value-added tax, an indirect tax imposed on the consumption of products and services. It is also applied to taxable products and services that are imported. In order to raise a significant amount of money, VAT was implemented in Kenya in 1990 under Chapter 476 of the country's laws. It is a broad-based tax that is imposed on the consumption of both domestically produced and imported goods as well as services. VAT performance has since helped to enhance revenue collection at lower administrative and compliance costs, despite Kenya's initial revenue shortfall during the launch period. VAT's significance is demonstrated by the fact that it typically contributes 28% of overall tax revenue, ranking second only to income tax (Mutua, 2021).

The tax legislative reforms revolve around the continuous evaluation and modification of tax laws to enhance efficiency, fairness, and revenue mobilization. These reforms are often driven by the need to address economic changes, improve tax compliance, and reduce loopholes that enable tax evasion and avoidance (Barreix & González, 2021). Governments implement tax legislative reforms to create a more transparent and equitable tax system that fosters economic growth while ensuring that taxpayers contribute their fair share (OECD, 2021).

According to KNBS (2016), SMEs are defined as enterprises with less than 50 employees. They are businesses with a turnover of less than Kshs 5 Million. SMEs form part of Kenya’s informal sector which is defined to include all small-scale activities that are semi-organized, unregulated, and use low and simple technologies employing few persons. The main activities that characterize this sector are manufacturing, for instance, jua kali sector, construction, wholesale and retailers, hotels and restaurants, community, social and personal services (KNBS, 2013).

1.1 Problem Statement

The challenge of failure to meet the set targeted budget has been experienced by many countries worldwide. In Kenya Despite undertaking many tax reforms, the Kenya Revenue Authority has been trying to establish ways of ensuring that the set revenue targets are achieved. The Kenya Revenue Authority has consistently missed its consumption tax targets over the years although the revenue collections have been growing KRA, (2022).

Despite the tremendous reforms, KRA missed its consumption tax such as Value Added Tax (VAT) and Excise Duty contribute significantly to government revenue KRA, (2023). In the year 2020/2021 financial year, the VAT collected amounted to KShs. 478.2 billion against a target of KShs. 484.2 billion missing targets by KShs. 6 billion. Further, in actual revenue generated from excise duty in the year ended June 2023, the KRA collected KES 264.5 billion on account of excise duty against a target of KES 294 billion, representing a revenue gap of 29.5 (KRA, 2023). It is therefore against these statistics that the study will seek to determine the effect of legislative reforms on consumption tax compliance among small and medium enterprises in Nakuru town, Kenya.

2. Literature Review

2.1 Theoretical Review

2.1.1 Ability to Pay Theory

The ability to pay theory was initially proposed by Adam Smith, in 1776. Notably, Adam Smith is also considered the father of economics, and he had an interest in the way people would respond to tax through the ability to pay theory. The theory suggests that people will only make tax remittances if they can pay, that is the proportion of their income should be fairly distributed to the amount of tax they should pay. No tax system should be higher than the revenues that people derive from the economic activities associated with the tax requirements.

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 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 tax to the government in accordance with their ability to pay. It seems that if the tax is levied on this principle as stated above, then justice can be achieved. The most suitable tax from this standpoint is personal levies (income, net worth, consumption, and inheritance tax) (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 ability-to-pay model, therefore, is key in ensuring that the people would be willing to pay because the tax they remit does not extensively erode their profit margins from the businesses they undertake. The advantage of the theory is that it relates the proportions of the tax that people should pay with the income generated for the relevant economic activities. The disadvantage is that the theory may not apply to everyone uniformly. Even businesses that are in the same industry may have different abilities to pay. This may challenge and hinder their tax compliance and responses.

When the global average corporate tax rate is 23.64%, some countries like the United Arab Emirates sometimes charge a corporate tax rate of 55.0%, which is way above most businesses' ability to pay (Bennedsen & Ezume, 2018). This is a factor that challenges the festiveness of paying tax. In other countries like Botswana, the income tax can be as low as 5%, a factor that encourages the people's ability to remit tax (Kampamba et al., 2021).

2.1.2 Allingham-Sandmo Theory of Tax Compliance

The theory was created in the United States in 1972 by Allingham and Sandmo. The theory posits that a taxpayer will choose to violate fiscal laws and evade tax responsibilities when he or she views the cost of tax evasion to be too low and believes he or she is unlikely to be caught or audited. Taxpayers would also engage in tax evasion if they view the cost of compliance to be excessive. Complex and burdensome tax systems and procedures tend to encourage tax avoidance. Taxpayers who perceive the tax rate to be excessive and punitive will dodge taxation. There is a negative association between tax evasion, the probability of detection, the severity of punishment, and the high transactional costs related to tax legislation.

Allingham and Sandmo (1972) pioneered income tax evasion, wherein a prudent and ethical taxpayer increases predicted utility, which is only dependent on pay. When caught, the operator must pay penalties proportional to the amount of tax evaded. An important relative static result is that when the tax rate rises, competing salary and substitution effects may lead to a substantial increase in tax compliance. The substitution effect encourages tax evasion since the marginal benefit of deception increases with the tax rate. Contrary to expectations, the pay impact will often discourage tax evasion since a higher tax rate makes taxpayers with decreasing overall risk avoidance feel worse off, hence discouraging risk-taking. Thus, the net effect is ambiguous.

Yitzhaki's (2017) result is arguably the most significant finding in the early literature on tax evasion, having inspired a multitude of excellent extensions. SMEs are susceptible to tax evasion because they struggle to comply with tax regulations. They are expected to adhere to stringent deadlines and maintain accurate accounting records. The theory will be used to support the variable on administration tax reforms as it provides a details explanation of how the possibility of not being caught evading tax is likely to encourage taxpayers from not complying with the set tax laws a fact that administration tax reforms aim at preventing. The theory will support the tax reforms variable.

2.2 Empirical Review

2.2.1 Legislative Reforms

Purnamasari and Hindria (2020) analyzed how the modernization of the country 's tax reform system influenced tax compliance among selected SMEs. Four independent factors indicated modernization: organizational structure, organizational strategy, and legislative reforms. “The results suggested that organizational structure had no impact on the degree of tax compliance among taxpayers. However, the compliance rate of taxpayers is affected by two other independent variables: organizational strategy, and legislative reforms. This suggests that the modernization of tax reforms directly affecting taxpayers has an effect on taxpayer compliance.

In Nigeria, Ganyam, Ivungu, and Anongo (2021) investigated how tax legislative reforms affect revenue generation in Benue State. 187 questionnaires were distributed to employees of the Benue State Internal Revenue Service to collect data for the study (BIRS). The acquired data was analyzed using frequency, percentages, the mean, and standard deviation. Using T-test statistics, the hypotheses were evaluated. The findings indicate that Benue state's tax legislative reforms considerably enhance tax responsibility and revenue collection.

Musyoka (2022), on the effect of tax reforms on voluntary tax compliance among small and medium enterprises in Kenya: a case of Nairobi County. The specific objectives of the study were to establish the effect of technological tax reforms, to examine the effect of taxpayer education, to determine the effect of legislative tax reforms, and to establish the effect of tax policy reforms on voluntary tax compliance among small and medium enterprises in Nairobi County. The study applied a mixed methods research design and data were collected using semi-structured questionnaires and structured interview guides. The study findings indicated that the combined effect of tax reforms on voluntary tax compliance among these businesses revealed that technological tax reforms, legislative tax reforms, taxpayer education reforms, and tax policy reforms had a joint positive and significant effect on voluntary tax compliance among SMEs in Nairobi County.

2.2.2 Consumption tax compliance

Consumption tax compliance refers to the adherence of businesses and individuals to regulations governing tax levied on goods and services, such as value-added tax (VAT), goods and services tax (GST), and sales tax. Compliance involves proper tax registration, accurate calculation and collection, timely filing and remittance, and adherence to jurisdictional rules to avoid penalties or legal consequences (Doerrenberg, 2022)

Consumption tax such as VAT, sales tax, and excise duties are often categorized as indirect tax. They are generally levied on transactions, products, or events (Rasul et al., 2022) and collected from businesses in the production and distribution chain, before being passed on to final consumers as part of the purchase price of a good or service. They are not directly imposed on income or wealth but rather on the expenditure that income and wealth finance.

Consumption tax forms an important source of revenue for an increasing number of governments, accounting for almost 31% of all revenue collected by governments across the OECD. Value-added tax (VAT) is the principal form of taxing consumption in most of the OECD member countries and accounts for two-thirds of consumption tax revenues. The remaining third is made up of specific consumption tax such as excise duties (OECD, 2022), a situation which is a replica of the consumption tax in Kenya.

3. Methodology

According to Cooper and Schindler (2010), a research design is a strategy or framework that addresses research questions and provides a solution to an issue. Research design, according to Khan (2018), is the blueprint of methods used by the investigator to examine the connection between the independent and dependent variables. This study used an explanatory research design, which looks at the causal relationship between variables and attempts to explain the nature of certain interactions. According to Sekeran and Bougie (2010), a population is a collection of items or people with similar traits; it is the sum of the performance of the elements from which conclusions are drawn about all potential scenarios that are relevant to the investigation. The target population was 3748 and a sample size of 361 small and medium enterprises in Nakuru town (KRA, 2024).

Primary data was used in the investigation. Questionnaires were used to gather this data. According to Cooper and Schindler (2011), a questionnaire is a tool used to gather data that consists of a set of questions that are given to research participants to complete and then returned to the researcher. Data gathered from correctly filled questionnaires were coded, tabulated and analyzed using SPSS software by both descriptive statistics which include mean and standard deviation to capture the characteristics of the variables under study and inferential statistics which included Pearson correlation and Multivariate regression was used to analyze the relationship of the dependent and the independent variables. Data was presented using charts and tables. The number of questionnaires that were issued was 361, from which only 282 questionnaires were correctly filled and submitted back, representing 78.1% response rate

4. Results and Discussion

4.1 Descriptive Statistics

4.1.1 Descriptive statistics Legislative reforms

The descriptive statistics for the legislative reform questionnaire items, measured on a 5-point Likert scale (1 = Strongly Disagree to 5 = Strongly Agree), indicate generally high agreement across all statements as shown in table 1. The item Reforms or changes in tax legislation and tax administration have greatly improved the revenue performance received a mean score of 4.01 (SD= 0.973). Similarly, The ADR process makes it easy for me to settle tax cases fairly, and would thus recommend it to others had a mean of 4.03 (SD = 0.989), reinforcing strong agreement. The statement Our organization supports continuous tax legislative reforms to improve compliance shows a mean of 4.00 (SD = 0.980). Finally, I find it easy to use internal objection review processes has a mean of 3.99 (SD = 0.984), slightly lower but still indicating agreement.

Table 1: Descriptive Statistics Legislative Reform's

	N	Mean	Std.Dev
Reforms or changes in tax legislation and tax administration has greatly improved revenue performance.	282	4.01	.973
The ADR process makes it easy for me to settle tax cases fairly and would thus recommend it to other.		4.03	.989
I'm aware of recent tax legislative reforms in our country.		4.01	.982
Our organization supports continuous tax legislative reforms to improve compliance.		4.00	.980
I find it easy to use internal objection review processes.		3.99	.984
Mean		4.01	

4.1.2 Descriptive Statistics Consumption Tax Compliance

The descriptive statistics for the items assessing consumption tax compliance are presented on Table 2. The statement Our business files tax return on time" had a mean of 4.04 (SD = 1.012), indicating that respondents generally agreed with this assertion. The standard deviation suggests a moderate spread of responses around the mean. For the item Our business declares the correct income, the mean is 4.01 (SD = 1.026), showing agreement among respondents. The standard deviation suggests moderate variability in responses. The statement Our business pays the right amount of tax has a mean of 4.03 (SD = 1.021), reinforcing strong agreement. Respondents also agreed (M = 4.02, SD = 1.014) that Our business reports all tax liabilities following applicable tax laws. Lastly, our business honors all tax obligations in a trustworthy and honest manner and has the highest mean (4.06, SD = 1.011), suggesting the strongest agreement.

Table 2: Descriptive Statistics Consumption Tax Compliance

	N	Mean	Std.Dev
Our business files tax return on time	282	4.04	1.012
Our business declares the correct income.		4.01	1.026
Our Business pays the right amount of tax.		4.03	1.021
Our business reports all tax liabilities following applicable tax laws.		4.02	1.014
Our business honor all my tax obligations in a trustworthy and honest manner		4.06	1.011
Mean		4.03	

4.2 Correlation Analysis

Correlation analysis examines the relationship between two or more variables to determine the strength and direction of their association. Using statistical measures such as Pearson's correlation coefficient, it quantifies how changes in one variable correspond to changes in another. A significant positive relationship exists between legislative reforms and consumption tax compliance ($r = 0.455$, $p = 0.000$). This indicates that clear, fair, and consistently enforced tax laws enhance compliance behavior among SMEs.

Table 3: Represents the correlation statistics

	Consumption Tax Compliance	Legislative Reforms
Consumption Tax Compliance	1	0.455**
Legislative Reforms	0.455**	1

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

4.3 Regression Analysis

The model summary showed that the legislative reforms have a positive correlation to consumption tax compliance at 45.5% or ($R= 0.455$). The results reveal that legislative reforms caused a variation of 20.7% or ($R^2=0.207$ and adjusted R^2 =0.199) in consumption tax compliance

Table 4: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.455	0.207	0.199	0.45890

a. Predictors: (Constant), Legislative Reforms

ANOVA shows an F statistic of 368.878 and p-value =0.000< 0.05 indicating that the variation caused by consumption tax compliance was significantly explained by the model.

Table 5: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
	Regression	12.173	1	12.173	368.878	0.000
1	Residual	9.501	280	0.033		
	Total	21.674	281			

a. Dependent Variable: Consumption Tax Compliance

The hypothesis H_{01} stated legislative reforms have no significant effect on consumption tax compliance among small and medium enterprises in Nakuru town, Kenya. The study found that legislative reforms have a significant effect on consumption tax compliance p=0.009<0.05.

Table 6: Regression Coefficients

	Unstandardized Coefficients		Standardized Coefficients		
Model	B	Std. Error	Beta	t	Sig.
1 (Constant)	0.758	0.236		3.212	0.001
Legislative reforms	0.172	0.065	0.201	2.646	0.009

a. Dependent Variable: Consumption Tax Compliance

4.4 Discussion of Findings

The objective of the study was to determine the effect of legislative reforms on consumption tax compliance among small and medium enterprises in Nakuru town, Kenya. The correlation analysis shows that a significant positive relationship exists between legislative reforms and consumption tax compliance (r = 0.455, p = 0.000). This indicates that clear, fair, and consistently enforced tax laws enhance compliance behavior among SMEs. The study also through the regression model found that legislative reforms have a positive effect on consumption tax compliance β=0.172 p=0.009<0.05. This result is consistent with studies by Kirchler et al. (2023), who found that perceived fairness and simplicity in tax legislation significantly influence taxpayer cooperation, particularly in developing economies where legal uncertainty often discourages compliance.

5. Conclusion

The objective of the study was to establish the effect of legislative reforms on consumption tax compliance among small and medium enterprises in Nakuru town, Kenya. The correlation analysis demonstrated a significant positive relationship suggesting that clear, fair, and consistently enforced tax laws improve compliance behavior. The correlation analysis demonstrated a significant positive relationship; this supports the hypothesis that well-structured tax legislation enhances voluntary adherence. The study concludes that reducing legal ambiguity, ensuring equitable enforcement, and minimizing punitive measures are critical in promoting tax compliance among SMEs.

6. Recommendations

The study recommends in regard to legislative reforms that policymakers should prioritize revising the Tax Procedures Act to reduce regulatory complexity in consumption tax reporting while introducing SME-targeted provisions such as graduated penalty systems and compliance incentives.

Future research should explore the effect of behavioural factors such as tax morale, and economic variables such as the impact of cash flow patterns on consumption tax compliance.

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