

Effect of Tax Aggressiveness on Value Added Tax Compliance Among Medium Taxpayers in the West of Nairobi Tax District, Kenya

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Abstract

Tax is a vital source of government revenue in almost all countries in the world, as it ensures that the government can offer goods and services to the general public. Therefore, tax compliance is critical in all economies, which recognize the role played by revenue collected from taxes in national development. The broad objective of the study was to establish the effect of tax aggressiveness on value-added tax compliance among medium taxpayers in the West of Nairobi Tax District, Kenya. The study was guided by the following theories Ability to Pay Theory and the Agency Theory. The study adopted an explanatory research design, and the target population was 3872 Medium Taxpayers in the West of Nairobi Tax District, and a sample size of 362 respondents. 261 respondents 72.1% were interested in the questionnaire topic, and in turn accurately completed their questionnaires and submitted them in time, while 101 did not have interest in filling the questionnaires, thus a 27.9% non-response rate. Primary data collection was employed using closed structured questionnaires from the study's objectives. The data was analyzed using descriptive, inferential statistics, and multiple linear regression analysis will be adopted. The regression model found that tax aggressiveness has a negative and significant effect on VAT compliance ($\beta = -0.268$, $p = 0.000$). The study recommends regarding the negative effect of tax aggressiveness on VAT compliance; the government of Kenya should strengthen enforcement mechanisms through increased penalties for avoidance schemes and enhanced audit capabilities.

Keywords: *Tax Aggressiveness on Value Added Tax Compliance and Medium Taxpayers*

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1. Introduction

Tax is a vital source of government revenue in almost all countries in the world as it ensures that the government can offer goods and services to the general public. Therefore, tax compliance is critical in all economies, which recognize the role played by revenue collected from tax in national development. Governments rely heavily on voluntary compliance from taxpayers, who freely and fully perform their tax obligations, to collect taxes. However, because of taxpayer noncompliance, developing countries struggle to generate enough tax income to compensate for the constantly rising public spending (Marti, 2019).

Several tax authorities describe tax compliance as the ability and willingness of taxpayers to pay taxes on time, declare the correct income each year, and comply with tax regulations (Palil, Hamid, & Hanafiah, 2022). One area of concern in tax administration is tax compliance. Tax non-compliance is still a major problem for many governments worldwide, claims Horodnic (2022). According to Alabede (2021), tax disobedience poses a significant obstacle to tax administration and impairs the performance of tax collection in Nigeria and certain other developing nations. One of the internal variables influencing the Kenyan government's capacity to increase direct tax collections and, consequently, fund its ongoing and development expenditures is low tax compliance (Kipkoech & Joel, 2020).

A type of consumption tax is the value-added tax. It is a tax that is paid on goods and services from the time of initial manufacture until the point of sale, during which time value is added to the product. It is a tax on the purchase price from the buyer's point of view. The most noticeable tax change implemented in revenue performance during the last few decades has been the implementation of VAT (Tanzi & Zee, 2020). There is some evidence that nations that have implemented VAT generate more revenue, especially in the third world (Keen & Lockwood, 2020).

When the Value Added Tax Act was passed and put into effect in 2013, both the government and business owners had a number of complaints about the policy. Since the Value Added Tax, the tax collector has added and repealed elements from the Act, KRA (2021). The removal of the Value Added Tax remission, the exclusion of a reduced rate of twelve percent, the combination of the main regulations and the previous subordinate regulations, the reduction of the 8 to 2 scheduling, the increase in the rates of zero-rated tax charges, and the exemption of basic Ernst & Young (2019) are the most notable changes. Registered individuals collect value-added tax at designated locations and send it to the commissioner. Registered individuals only act as Value Added Tax agents in the collection and payment of the tax, while the final consumer of the goods is responsible for paying it.

Businesses use aggressive tax planning to boost after-tax profits and increase shareholder value, but these tactics frequently give rise to moral dilemmas and draw criticism from legislators and tax authorities. Multinational businesses (MNCs) have embraced tax-aggressive tactics more frequently as globalization has made cross-border transactions easier, sparking discussions about fair taxes and corporate social responsibility (CSR). The goal of an aggressive tax action, according to Frank et al. (2021), is to engineer a company's taxable profit through tax planning, either legally (tax avoidance) or illegally (tax evasion). A number of metrics, including the Effective Tax Rate (ETR), Book Tax Difference (BTD), Residual Tax Difference (RTC), and Cash Effective Tax Rate (CETR), can be used to quantify tax aggression. ETR is used in this study to quantify tax aggression.

To facilitate tax administration and provide taxpayers with effective services, the Kenya Revenue Authority (KRA) has separated taxpayers into tax districts. There are currently three Domestic Tax Districts: Small Taxpayers, Medium Taxpayers Office (DTD-MTO), and Large Taxpayers Office (DTD-LTO). There are additional tax districts under the final categories. There are four tax districts in Nairobi County alone: East of Nairobi (EON) covers Eastlands, West of Nairobi (WON) covers Westlands, North of Nairobi (NON) covers Northlands, and South of Nairobi Tax District (SON) covers Southlands for Eastlands. Chiromo, Highridge, Kabete, Kangemi, Kitisuru, Kilimani, Lavington, and Westlands are the districts that make up

the West of Nairobi Tax Service Office (iTax, 2019). There are 722,005 taxpayers in the TSO west of Nairobi.

1.1 Problem Statement

All tax authorities are very concerned about withholding tax compliance and tax law compliance, and it is difficult to get all taxpayers to follow the tax rules (James & Alley, 2020). High tax compliance rates ensure that the government will have the money it needs to fund its planned initiatives. According to the OECD (2021), non-compliance deprives the government of necessary money. Many governments around the world are unable to meet financial allocations and provide their inhabitants with necessary services as a result of this denial of money. As a result, governments are now compelled to borrow money from outside sources in order to fund their operations. According to Dwenger (2022), most people are unwilling to register for tax duties, calculate the right tax due, file forms on time, and pay taxes due within the allotted time.

The Kenya Revenue Authority (KRA) has made several reform efforts in recent years to improve revenue compliance, but it has fallen short of the Treasury's goals. For example, the objective of KShs. 314.17 billion KRA (2023) was surpassed by KShs. 272.452 billion (KRA 2023) for the fiscal year 2022/2023. VAT collection in the 2023–2024 fiscal year was KShs. 478.2 billion, falling short of the objective of KShs. 484.2 billion by KShs. 6 billion, KRA, 2024. This indicates a notably low level of VAT collection in comparison to previous years. Therefore, the study sought to establish the effect of tax aggressiveness on value-added tax compliance among medium taxpayers in the West of Nairobi Tax District, Kenya.

2. Literature Review

2.1 Theoretical Review

2.1.1 Ability to Pay Theory

The sixteenth-century scientific idea was put forth by the English economist John Stuart Mill (1806-1873), the French political economist Jean-Baptiste Say (1767-1832), and the Swiss philosopher Jean Jacques Rousseau (1712-1778). The idea makes the claim that an individual's income or capacity to pay taxes dictates the appropriate amount of taxes that should be imposed on them. This serves as the foundation for progressive taxation, meaning that when taxable income rises, so does the tax rate (Jones & Rhoades, 2011). According to the Ability to Pay Theory, taxes ought to be imposed based on a person's or organization's ability to pay; hence, those with higher incomes or wealth ought to make larger contributions to the national coffers. This notion is strongly related to the concepts of equity and fairness in taxation and serves as the foundation for progressive taxation systems.

According to Kagan (2020), this idea emphasizes that everyone should pay taxes equally and that paying more taxes does not result in a heavier burden because those with more money have less use for a given sum. In his article on the ability-to-pay theory, Utz (2017) claims that indirect taxes like the Value Added Tax (VAT), excise, sales, or turnover taxes can be modified to meet the ability-to-pay criterion, but only to a certain degree. For instance, they can exempt essentials like food or adjust tax rates based on the urgency of need. But according to Neumark (2018), such rules are often ineffective, disrupt consumer spending patterns, and are frequently challenging to implement due to their complexity.

According to some academics (Due et al., 2018), the way taxes are distributed among people should lessen the income gaps that arise naturally from the market economy throughout the 20th century. However, Mill (2018) and other classical economists believed that equal sacrifice would be extracted if taxes were imposed proportionately to individual earnings. However, contemporary economists contend that the marginal value of income falls as income rises. Only when those with higher incomes pay greater taxes and those with lower incomes pay lower taxes can there be equality of sacrifice.

Since SMEs that can afford to pay their VAT should abide by the rules and procedures about VAT, the ability to pay theory is pertinent to the study and supports the dependent variable. Although SMEs are thought to be the majority of unregistered enterprises, their volume of operations during any given fiscal year qualifies them for mandatory VAT registration, filing, and payment. The other paradox is that since their clients are wealthy, taxes ought to be collected from them as much as possible. In order to increase value-added tax compliance, the theory advises the researcher to concentrate more on the study in order to advance knowledge and attempt to broaden the tax base and guarantee that all elusive and missing but eligible taxpayers are brought into the system.

2.1.2 Agency Theory

To ascertain the ideal level of risk-sharing amongst various individuals, agency theory was developed in the economics literature during the 1960s and 1970s (Spence & Zeckhauser, 1971; Ross, 1973; Jensen & Meckling, 1976; Harris & Raviv, 1976, 1978; Holmstrom, 1979). But over time, the agency theory's scope was expanded to the management field to assess how well different individuals with disparate objectives within the company cooperate and achieve goal congruency (Eisenhardt, 1989).

By elucidating the conflict of interest between company managers (agents) and shareholders (principals), agency theory bolsters the idea of tax aggressiveness. This idea states that managers might use aggressive tax tactics to boost after-tax profits, which would improve the firm's worth, or to reach performance goals linked to their pay. These tactics might not, however, always be in the best interests of shareholders in the long run, particularly if they carry a high risk of legal trouble or damage to one's reputation. Under the pretense of increasing shareholder value, managers may also use tax aggression as a tactic to obtain personal gains.

Desai and Dharmapala (2006) highlight the significance of agency costs in corporate tax behavior by arguing that managers are more inclined to seek aggressive tax tactics for personal benefit in companies with inadequate corporate governance. Because managers' and owners' incentives aren't aligned, some businesses are more likely to be tax aggressive, which Agency Theory helps explain. The agency view of tax avoidance holds that managers, who are typically expected to make tax-effective decisions, may act opportunistically and divert corporate wealth for their benefit, which can lead to conflicts between firm owners and management (Jensen & Meckling, 1976; Desai & Dharmapala, 2006).

Since the total costs of the business, which include expenses directly connected to tax planning operations, additional compliance costs, and non-tax agency costs, may exceed the tax benefits for shareholders, tax aggressiveness may potentially lower the firm's after-tax value (Wang, 2010). An agency view of tax aggressiveness is proposed by Desai et al. (2006), who claim that a complementary link between tax aggressiveness and managerial diversion may lead to agency costs in the form of managerial rent extraction. Tax aggression tactics may be employed

by self-serving management to conceal the opportunistic rent collection (Desai, Dyck & Zingales, 2007). The tax aggressiveness variable is supported by the theory

2.2. Empirical Review

2.2.1 Tax Aggressiveness

Desai and Dharmapala (2020) examine the relationship between tax aggressiveness and corporate governance, specifically focusing on equity-based incentive compensation and the interplay between tax aggressiveness and rent extraction. They contend that under different circumstances, corporations with sound governance have a higher potential to become more aggressive with regard to taxes, while corporations with weak governance have a higher potential to become less active with regard to taxes. Furthermore, they contend that since poorly run businesses are already more tax aggressive than well-run ones, any improvement in the alignment of management and shareholder interests (through equity-based incentive compensation) ought to make poorly run businesses less tax aggressive.

Dwiyanti and Jati (2019) and Disamartha and Noviyari (2020) have demonstrated that inventory intensity has a beneficial impact on tax aggressiveness. Because there are so many supplies, businesses with effective inventory management will see a considerable impact on cost efficiency. The expenses associated with inventory management include personnel, supplies, storage, administration, and other expenses like sales. Because the company's current profits are distributed to those in subsequent periods to lower tax expenditures, businesses with large inventories will become more aggressive on taxes.

According to Napitu and Kurniawan (2016), businesses with the capacity to turn a profit are required to calculate the taxes that must be paid based on their earnings. Therefore, a company's tax aggressiveness will increase by lowering the value of the Effective Tax Rate, and the more profit it makes, the more tax it must pay. Prior research on the relationship between tax aggression and profitability has been carried out by Luke and Zulaikha (2016) and Napitu and Kurniawan (2016).

2.2.2 Value Added Tax Compliance

Value-Added Tax (VAT) compliance is when individuals and companies follow the rules pertaining to the collecting, filing, and sending of VAT to tax authorities. Businesses serve as middlemen in the collection and remittance of VAT, an indirect tax imposed on the consumption of goods and services at every stage of production and distribution (OECD, 2020). Accurate invoicing, timely submission of VAT returns, appropriate transaction documentation, and adherence to exemptions or reduced rates when available are some of the essential components of compliance. Businesses must keep accurate records and strictly adhere to tax laws since non-compliance can lead to penalties, fines, and legal repercussions (European Commission, 2021).

Additionally, automated tax reporting systems and digitization have emerged as crucial instruments for enhancing VAT compliance and lowering errors and fraud (IMF, 2022). Kenya's revenue and financial structure are the largest source of assessment earnings, making it more than just a source of additional money. VAT was viewed as the cost of future developments in line with the country's goal of reducing reliance on direct assessments and trade taxes (KIPPRA, 2022). With the highest rate being reduced from 210% to 16% and the number of duty rates from 15 to 3, VAT has seen substantial justification (KRA, 2020).

2.3 Conceptual Framework

A conceptual framework provided a mental sketch of the study by linking the independent variables and the dependent variable (Quinlan & Babin, 2019). The study sought to find out how the independent, Tax Aggressiveness, was measured by Book-Tax Differences and Tax disclosure. The dependent variable was Value. Added Tax Compliance was measured by Tax payments and Returns filed. As shown in Figure 1.

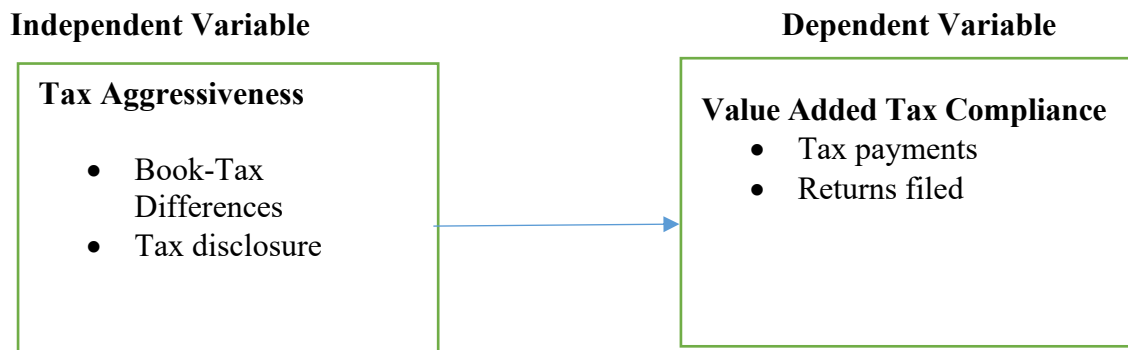


Figure 1: Conceptual Framework

3. Methodology

A research design serves as a guide for achieving the study's goals. An explanatory research design will be used for the investigation. This might be attributed to the well-structured design and well-articulated study topics (Kothari, 2004). Generalizing the findings to the population from which the sample was drawn is frequently the aim (Fowler, 2002). The research space will be Along with the East, North, and South districts, Nairobi County has four domestic tax districts administered by the Kenya Revenue Authority (KRA), including the West of Nairobi Tax District. 3872 and a sample size of 362 medium taxpayers in the Nairobi Tax District's west were the study's target population. Figure 2 shows that 261 respondents (72.1%) were interested in the content of the questionnaire, correctly filled out their forms, and sent them in on time. In contrast, 101 respondents (27.9%) showed no interest in completing the questionnaires.

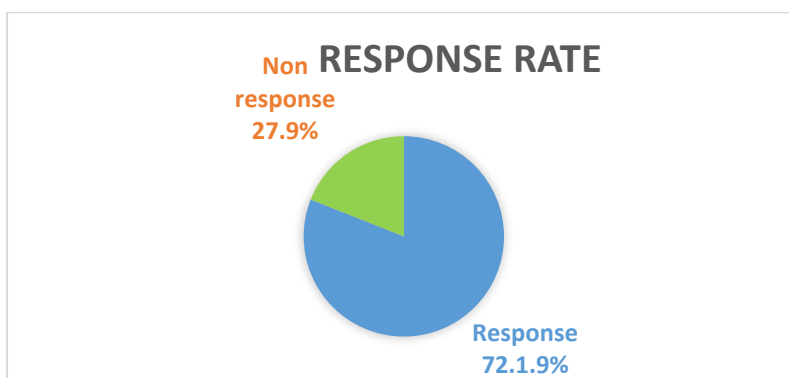


Figure 2: Response Rate

Reliability analysis

A pilot test was conducted in Machakos town, and was conducted on 10% of the sample, hence 36 medium taxpayers in Machakos town. The data collected during the pilot study was

used to test the validity and reliability of the data collection instrument. In general terms Cronbach of 0.7 and 0.8 is an acceptable range, while if it is 0.6 and below is considered poor (Sekaran, 2009). Table 1 showed that the value-added tax compliance scale, comprising 4 items, demonstrated excellent reliability with a Cronbach’s alpha of 0.803. Similarly, the Tax aggressiveness, which consisted of 5 items, exhibited a high level of reliability, with a Cronbach’s alpha of 0.902.

Table 1: Test of Reliability of Questionnaire

Factor	Number of Items	Cronbach Alpha score	Conclusion
Value-added tax compliance	5	0.803	Reliable
Tax aggressiveness	5	0.902	Reliable

4. Results and Discussion

4.1 Descriptive Statistics

4.1.1 Descriptive statistics for Tax aggressiveness

Table 2 showed the descriptive statistics. Our business sometimes looks for loopholes in the tax system to minimize our tax burden." With a considerable degree of response variance, the item's mean of 3.80 and standard deviation of 1.046 demonstrate that most respondents accept using tax loopholes. I believe it is acceptable to engage in aggressive tax planning to reduce my tax liability with a mean of 3.73 and a standard deviation of 0.927. I believe tax avoidance is an acceptable business strategy. This resulted in a mean of 4.06 and a standard deviation of 0.677, indicating substantial agreement with little dispersion. Our business seeks professional advice to minimize my tax payments legally with a mean of 4.07 and a standard deviation of 0.679. Our business avoids underreporting income due to the fear of penalties. The mean of 4.09 and the standard deviation of 0.972 showed strong agreement that penalties deter underreporting, with responses clustered around the mean.

Table 2: Tax Aggressiveness

	Mean	SD
Our business sometimes looks for loopholes in the tax system to minimize our tax burden	3.80	1.046
I believe it is acceptable to engage in aggressive tax planning to reduce my tax liability	3.73	0.927
I believe tax avoidance is an acceptable business strategy	4.06	0.677
Our business seeks professional advice to minimize our tax payments legally	4.07	0.679
Our business avoids underreporting income due to the fear of penalties	4.09	0.972

4.1.2 Descriptive statistics for Value Added Tax Compliance

Table 3 showed that for the item " I file my tax returns on time The item recorded a mean of 4.08 and a standard deviation of 0.642, indicating that a large majority of respondents consistently file their tax returns on time, with minimal deviation from the mean. I have registered for VAT Tax obligation with a mean of 3.65 and a standard deviation of 1.029. I pay the tax liability that arises from my VAT obligation without failure. The mean was 3.79 with a standard deviation of 1.094, reflecting a tendency toward compliance but with notable variability in responses. The tax system in place motivates me to voluntarily comply with my tax obligation. The mean was 4.04 with a standard deviation of 0.956, indicating that while a significant proportion of respondents felt motivated by the tax system, a substantial number remained undecided.

Table 3: Value Added Tax Compliance

	Mean	SD
I file my tax returns on time	4.08	0.642
I have registered for VAT Tax obligation	3.65	1.029
I pay the tax liability that arises from my VAT Tax obligation without failure	3.79	1.094
The tax system in place motivates me to voluntarily comply with my tax obligation	4.04	0.956

4.2 Correlation Analysis

According to the investigation, tax aggressiveness and VAT compliance have a substantial negative association ($r = -0.473$, $p = 0.000$), with a correlation of -47.3%. This suggests that companies that use more aggressive tax evasion tactics, like taking advantage of legal loopholes or underreporting transactions, exhibit less adherence to VAT laws.

Table 4: Correlation Statistics

	Value Added Tax Compliance	Tax aggressiveness
Value Added Tax Compliance	1	-0.473**
Tax aggressiveness	-0.473**	1
Sig.	0.000	

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

4.3 Regression Analysis

The model summary in Table 6.6.5 was conducted the R of 0.473 shows that tax aggressiveness correlates to Value Added Tax compliance at 47.3%. The R-squared of 0.223 shows that tax aggressiveness causes a 22.3% variance in value-added tax compliance; the remaining 77.7% was caused by factors not included in the study.

Table 5: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.473 ^a	0.223	.219	.32870

a. Predictors: (Constant), Tax aggressiveness _mean

Table 6 shows that there was an F-statistic of 459.276 and a p-value of 0.000<0.05, which indicates that the model was significant in explaining the variance caused by Value Added Tax compliance.

Table 6: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	73.025	1	73.025	459.276	0.000
	Residual	41.192	259	0.159		
	Total	114.217	260			

a. Dependent Variable: Value Added Tax compliance

b. Predictor: (Constant), Tax aggressiveness

Table 7 revealed the effects of each independent variable on Value Added Tax Compliance. The analysis indicated that a unit change in Tax aggressiveness was associated with a significant -0.268 decrease in Value Added Tax compliance, $\beta = -0.268$, $p = 0.000$. This finding suggested that higher levels of Tax aggressiveness positively influenced compliance with Value Added Tax compliance.

Table 7: Regression Coefficient analysis

Variable	Standardized β	Std. Error	t-Statistic	Unstandardized β	Prob.
Constant	1.824	0.527	3.461		0.001
Tax aggressiveness	-0.268	0.032	-8.375	0.235	0.000

4.4 Discussion of the Findings

The study was to establish the effect of tax aggressiveness on value-added tax compliance among medium taxpayers in the West of Nairobi Tax District, Kenya. The study correlation analysis shows that there is a significant negative correlation between tax aggressiveness and VAT compliance ($r = -0.473$, $p = 0.000$), at -47.3%. This indicates that businesses engaging in more aggressive tax avoidance strategies, such as exploiting loopholes or underreporting transactions, demonstrate lower compliance with VAT regulations. The regression model found that tax aggressiveness has a negative and significant effect on VAT compliance ($\beta = -0.268$, $p = 0.000$). This negative and statistically significant relationship suggests that taxpayers who engage in aggressive tax planning strategies are less likely to comply with VAT regulations. Desai and Dharmapala (2020) found that weak governance structures enable aggressive tax behaviors, aligning with our findings about reduced compliance.

5. Conclusion

The study was to examine the effect of tax aggressiveness on VAT compliance among medium taxpayers in West Nairobi. Findings concluded that there was a significant negative relationship, indicating that aggressive tax strategies undermine compliance. This supports existing literature showing that deliberate evasion tactics reduce tax adherence. The study contributes by demonstrating this phenomenon specifically among medium-sized businesses in Kenya, suggesting policymakers should strengthen anti-evasion measures while promoting ethical tax practices through awareness campaigns.

6. Recommendations

The study recommends regarding the negative effect of tax aggressiveness on VAT compliance; the government of Kenya should strengthen enforcement mechanisms through increased penalties for avoidance schemes and enhanced audit capabilities.

Future studies may examine the role of digitalization through e-filing systems, analyzing peer effects among neighboring businesses, and assessing political trust on voluntary VAT compliance

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