

The Effect of Trust on Value Added Tax Compliance Among Small and Medium Enterprises in Mathare Subcounty, Nairobi, Kenya

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Accepted: 18 July 2025 || Published: 03 October 2025

Abstract

Value Added Tax is a very important aspect in any country. Revenue collected from taxes enables a country to provide services for its citizens and also to develop its economy. However, Kenya does not collect as much revenue as it should. This study aimed to establish the effect of trust on value-added tax compliance among small and medium enterprises in Mathare Subcounty, Nairobi, Kenya. The theory that guided this study was the Theory of Planned Behavior. The study population was 4024 small and medium enterprises in Mathare Sub-County. The sample size of this study was calculated using the Yamane 1967 formula, which was 363 respondents. After collection and analysis of the responses, 280 respondents correctly filled and submitted their questionnaires, indicating a 77.1% response rate. The non-response rate of 22.9% can be attributed to matters including but not limited to disinterest in the questionnaire topic and lack of ample time to fill their questionnaire. Data was analyzed using descriptive and inferential statistics. The findings were presented in tables. The study revealed that trust has a significant and positive effect on value-added tax compliance ($\beta = 0.468$, $p = 0.000$). The study recommended that KRA should focus on initiatives that enhance taxpayer trust, such as providing clear communication, addressing taxpayer grievances promptly, and ensuring consistent enforcement of tax laws. Future research is the impact of economic conditions, such as inflation or economic instability, on VAT compliance.

Keywords: *Trust in Value Added Tax Compliance and Small and Medium Enterprises*

How to Cite: Muchiri, G. W., Ogaga, B., & Tuwey, J. (2025). The Effect of Trust on Value Added Tax Compliance Among Small and Medium Enterprises in Mathare Subcounty, Nairobi, Kenya. *Journal of Finance and Accounting*, 5(6), 14-24.

1. Introduction

Tax compliance involves the decision of taxpayers to adhere to tax laws and regulations by paying taxes on time and correctly. It involves the proper payment of taxes based on income, wealth, capital, and consumption, as outlined by tax laws (Ahmed & Kedir, 2020). Tax compliance also encompasses the accurate reporting of income and the appropriate claiming of expenses according to established tax regulations (Sapiei, Kasipillai & Eze, 2022). Additionally, it includes the process of fulfilling the taxpayer's legal obligations, such as timely

tax payments, filing tax returns, and providing necessary explanations to tax authorities (Daniel, Akowe & Awaje, 2022).

Value Added Tax is charged on the supply of taxable goods or services made or provided in Kenya and on the importation of taxable goods or services into Kenya. Taxable goods and services are contained in the various schedules to the VAT Act. There are three tax rates as specified in the 3 schedules to the VAT Act, which are: 16%: This is the general rate of tax and applies to most of the taxable goods and taxable services. 0%: This applies to certain categories of goods and services, which include exports, agricultural inputs, pharmaceutical products, educational materials, and supplies to privileged persons.

Trust, in the context of tax compliance, generally refers to the confidence that taxpayers have in the fairness, transparency, and efficiency of the country's tax system. This trust influences how likely individuals and businesses are to comply with tax laws voluntarily (Schneider et al., 2019). The level of trust amongst taxpayers in a country strongly predicts the country's economic success. Trust in tax compliance is closely tied to trust in government institutions. If taxpayers believe that the government is using tax revenues effectively and for the public good, they are more likely to comply. A transparent tax system, where rules are clear and processes are open, tends to foster greater trust among taxpayers. When taxpayers understand how taxes are calculated and how they benefit from them, they are more likely to comply (Koessler et al., 2020).

In Kenya, SMEs represent a vital part of the economy, being the source of various economic contributions through the generation of income via exporting, providing new job opportunities, stimulating competition, an engine for employment, a contribution to GDP, aiding industrial development, satisfying local demand for services, and introducing innovation and support to large firms with inputs and services. In 2014, 80% of jobs created were dominated by SMEs. The term micro and small enterprises (MSEs) or micro, small and medium enterprises (MSMEs) is used to refer to SMEs in Kenya (OECD, 2022).

1.1 Problem Statement

Despite the efforts made by the government to address the challenges faced by SMEs in Kenya, such as simplifying regulatory procedures, tax reforms, and promoting digitalization, the performance of SMEs continues to be hindered by factors related to value-added tax (VAT). The administrative costs associated with VAT compliance, pricing, and forecasting customer needs pose significant obstacles for SMEs (KRA, 2019).

According to the Kenya National Bureau of Statistics (2017), 67% of the business entities that operate in Kenya are still not VAT compliant even after the implementation of the regulations by the government. It further states that most of the businesses were recording declining profits due to inconsistencies in service because of their failure to comply with VAT laws and regulations (Masaku, 2019).

Despite the reforms that the Kenya Revenue Authority has been undertaking so as to increase revenue collection, it has of late failed to meet its revenue targets, particularly VAT targets. For instance, the financial year 2022/2023 stood at KShs. 272.452 billion (KRA 2023) against a target of KShs. 314.17 billion KRA (2023). The VAT collected in the 2023/2024 fiscal year was KShs. 478.2 billion, falling short of the KShs. 484.2 billion targets by KShs. 6 billion, according to KRA (2024). As a result, this indicates that the Kenyan government is not

performing optimally in VAT revenue, necessitating the need to identify the This study aimed to establish the effect of trust on value-added tax compliance among small and medium enterprises in Mathare Subcounty, Nairobi, Kenya.

2. Literature Review

2.1 Theoretical review

The theory of planned behavior is an important theory that falls within the scope of social psychology and tries to explain human behavior. This theory was developed by Ajzen (1991) and it is just the improved form of the Theory of Reasoned Action suggested by Ajzen and Fishbein (1980) in order to explain conscious behaviors. According to this theory, the behaviors of individuals within society are under the influence of definite factors, originate from certain reasons, and emerge in a planned way (Erten, 2002).

Theory of Planned Behavior (TPB) is an extension of the theory of reasoned action. The concept of intention and behavior, in general, has been studied in the Theory of Reasoned Action (TRA), which was first introduced by Fishbein and Ajzen in 1975. In the TRA framework, behavioral intention can largely determine actual behavior. This behavioral intention is an additive function of two variables, namely subjective attitudes and norms. In the TPB model (Ajzen 1991), intention to behave is an intermediate variable in behavior. That is, individual behavior is generally based on the intention to behave. The intention of using technology services is to raise awareness of the ability to use the services of customers (Nguyen 2020).

Nevertheless, the ability to perform a particular behavior depends on the fact that the individual has a purpose for that behavior. As for the factors determining the purpose towards the behavior, they are attitude towards behavior, subjective norms, and perceived behavioral control (Erten, 2002). Factors counted above are also under the influence of behavioral beliefs, normative beliefs, and control beliefs (Ajzen, 2002). Intention is the basis of this theory, and the performance of a behavior or its transformation into a different behavior depends on the intention that the individual has generated towards the behavior.

Ajzen described intention as the factor indicating the degree of individual effort in order to perform a certain behavior (Ajzen, 1991). Intention is explained by attitudes towards behavior, individual norms, and perceived behavior controls (Klee et al. 2000). Attitude includes the evaluations made by the individual who will perform the behavior regarding the act of that behavior. Theory of Planned Behavior posits that individuals' intentions, together with their perceived control over the behavior, determine whether or not they will engage in the behavior. It has been observed that empirical studies carried out within the scope of the Theory of Planned Behavior mostly examine behaviors that individuals report, and the studies examining the behaviors that individuals perform are rather scarce in number (Chang, 1998; Allen, 2004). This is because of the fact that observing individual behaviors is rather costly in terms of time and money (Erten, 2002).

2.2 Empirical review

2.2.1 Trust

Wahl et al. (2020) found that both high power and high trust lead to increases in tax compliance, compared to low power (trust) conditions. Tax payments were highest when both trust and power were strong, and lowest when both trust and power were weak. When trust

was high, participants perceived compliance as being voluntary. When power was high (and trust low), tax payments were felt as being enforced. Furthermore, the authors found that in low-trust conditions, taxpayers tend to behave strategically by weighing the costs and benefits of tax evasion, thus behaving as rational agents. By surveying students in Austria, Hungary, Romania, and Russia, Kogler et al. (2021) confirmed the findings of Wahl et al. (2020).

Muehlbacher et al. (2021) surveyed roughly 3,000 taxpayers in Austria, the UK, and the Czech Republic, polling for perceptions of trust in authorities, power of authorities, voluntary and enforced compliance with statements that would proxy for these items. They found that voluntary tax compliance is positively associated with trust, power, and their interaction. Trust, however, had the largest effect. The power of authorities was found to be significantly positively associated with enforced compliance, while the association with vertical trust was negative.

Gangl et al. (2021) showed that Dutch taxpayers value a service-oriented, respectful attitude of the tax authority with increased tax payments. This result seemed to be driven by the authority's trustworthiness. In yet another survey on self-employed taxpayers, Kogler et al. (2020) also confirmed trust as the main driver of voluntary compliance and power as the main driver of enforced compliance. With social norms, the authors identified an additional influencing factor for tax compliance, which was, however, not mediated by trust or power.

Frey and Torgler (2021) discovered that national trust has a positive and significant influence on the tax morale variable. Moreover, the significance of politicians and the attitude of democratic government are critical aspects for clarifying tax morals. Individuals seem to be much more consistent in modern democracies, impacting government spending policies in these nations. According to Bilgin (2020), if individuals are happy with their cultural identity, they might be more faithful to their countries, and thus tax morality might be high. Furthermore, Ostrom (2020) highlighted two aspects of tax compliance and trust in tax authorities. The first is direct contact between government officials and taxpayers in eliciting voluntary tax compliance, and the second is how authorities handle taxpayers. The trust in tax authorities and tax compliance highlights two elements.

2.2.2 Value Added Tax Compliance

VAT is regarded as a form of indirect tax imposed on goods and services produced in a country (Schenk & Oldman, 2021). VAT was introduced in Kenya in 1990 as a means of increasing the government's tax collections by widening the tax base. It is imposed by the Kenya revenue Authority (KRA) as guided by provisions of the Value Added Tax Act 2013. VAT on goods and services supplied in Kenya is collected at each stage of the production process by VAT registered persons who act as the agents of the government. VAT on imported goods and services is paid by the importer. Both developed and developing countries can change VAT policies from time to time based on a number of factors that range from political, economic, social, technological, and legal. VAT contributes about 36% of the total tax revenue collection by the government (KNBS, 2019).

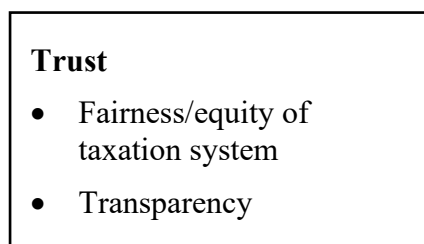
VAT tax compliance ax consistence alludes to the act of citizens registered for VAT documenting their VAT expense forms on time, declaring the correct self-evaluated impose and the provoke instalment of sums due without the mediation of the expert (Palil, 2020). Value Added Tax compliance has turned into the key managerial approach for both individual and corporate duty appraisal in developed nations The world has been encountering an exceptional

progression in the field of data correspondence innovation. These mechanical advancements are accepted to profoundly affect the assessment consistence as they influence the manner by which tax assessment is controlled (Kamel, 2020).

2.3 Conceptual Framework

A conceptual framework is a hypothesized model identifying the model under study and the relationship between the dependent and independent variables (Mugenda, 2008). Garg and Kothari (2014) define an independent variable, also known as the explanatory variable, as the presumed cause of the changes of the dependent variable, while a dependent variable refers to the variable that the researcher wishes to explain. In this study, the independent variable was trust, and the dependent variable was value-added tax compliance. As shown in Figure 1.

Independent Variable



Dependent Variable

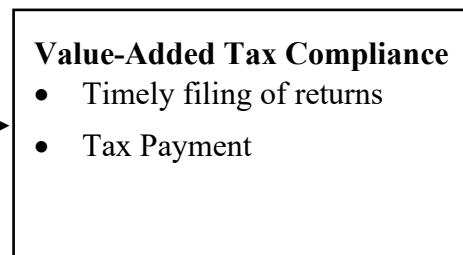


Figure 1: Conceptual Framework

3. Methodology

Research design explains the systematic and scientific procedures appropriate for a given study. It is a detailed plan that outlines the methods, structure, and approach of a study, to identify solutions for the research problems while minimizing variations (Kothari, 2004). This study adopted the explanatory research design, which explains the effect of one variable on another (Gray, 2013). Zikmund, Babin, Carr, and Griffin (2010) argue that a population refers to all items in any field of inquiry. A population is the entire gathering of elements about which extrapolations are made (Cooper & Schindler, 2011) or is a group of the variables that are being studied (Chandan, Singh, & Khanna, 2010). For this study, the target population was 4024 small and medium enterprises in Mathare Sub-County, Nairobi KRA (2023). From the table 1, the study targeted a sample size of 363 respondents, and after collection and analysis of the responses, 280 respondents correctly filled and submitted their questionnaires, indicating a 77.1% response rate, the non-response rate of 22.9%, can be attributed to matter including but not limited to disinterest in the questionnaire topic, and lack of ample time to fill the questionnaire.

Table 1: Response Rate Analysis

	Number	%
Response rate	280	77.1%
Non-Response Rate	83	22.9%
Study Sample size	363	100%

Reliability Analysis

The coefficient of consistency was tested by utilizing Cronbach's alpha. "Cronbach's Alpha coefficients of above 0.7 were the cut-off reliability for this study. A test with a reliability of values greater than or equal to 0.7 was an accepted indicator of internal consistency (Mohsen and Reg, 2011). The results in Table 2 demonstrate strong reliability across all constructs. Responses for Value added tax compliance resulted in a Cronbach's alpha of 0.846 while trust scored 0.876. These results indicate high levels of consistency in the measurement instruments for each construct.

Table 2: Test of Reliability of Questionnaire

Factor	Number of Items	Cronbach Alpha score	Conclusion
Value Added Tax Compliance	4	0.846	Reliable
Trust	5	0.876	Reliable

4. Results and Discussion

4.1 Descriptive statistics

4.1.1 Descriptive statistics for Trust

For the statement We trust that KRA officials usually act honestly and fairly when interacting with taxpayers, had a mean response of 4.01 (SD = 1.091). The standard deviation indicates moderate variability in responses, while the mean suggests that respondents generally agree with this statement. The statement We trust that the tax burden among taxpayers is fairly distributed and equitable, had a mean response of 3.75 (SD = 1.041). The standard deviation reflects moderate variability, and the mean indicates that respondents tend to agree with this statement. The statement We trust that the online portals (iTax) for filing of taxes are efficient and accurate, in calculating the taxes due, had a mean response of 3.76 (SD = 1.083). The standard deviation shows moderate variability, and the mean suggests that respondents generally agree with this statement. The statement We trust that the Government will use the tax revenue collected effectively, had a mean response of 4.04 (SD = 1.113). The standard deviation indicates moderate variability, while the mean suggests strong agreement with this statement. The statement We trust the publicly available information regarding targets vs collections is correct, had a mean response of 4.05 (SD = 1.061). The standard deviation reflects moderate variability, and the mean indicates strong agreement with this statement.

Table 3: Trust

	Mean	SD
We trust that KRA officials usually act honestly and fairly when interacting with taxpayers.	4.01	1.091
We trust that the tax burden among taxpayers is fairly distributed and equitable.	3.75	1.041
We trust that the online portals (Eg, iTax) for filing of taxes are efficient and accurate in calculating the taxes due.	3.76	1.083
We trust that the Government will use the tax revenue collected effectively.	4.04	1.113
We trust the publicly available information regarding targets vs collections is correct.	4.05	1.061
Mean	3.92	
N=280		

4.1.2 Descriptive statistics for Value Added Tax Compliance

Table 4 showed that the VAT compliance was summarized in Table 5. The statement I have registered for VAT obligation had a mean response of 4.09 (SD = 0.555). The low standard deviation indicates minimal variability in responses, and the high mean suggests that respondents strongly agree with this statement. The statement I file my VAT returns on time (by the 20th of each month) had a mean response of 3.97 (SD = 0.818). The moderate standard deviation implies some variability in responses, and the mean indicates that respondents generally agree that they file VAT taxes before the 20th of each month. The statement I compute the VAT due by the tax laws, had a mean response of 4.06 (SD = 0.816). The moderate standard deviation reflects some variability in responses, and the high mean suggests that respondents agree that they compute VAT with the tax laws. The statement I remit the VAT due without fail, had a mean response of 4.07 (SD = 0.807). The moderate standard deviation indicates some variability in responses, and the high mean suggests that respondents are VAT compliant.

Table 4: Value Added Tax Compliance

	Mean	SD
I have registered for VAT obligation	4.09	.555
I file my VAT returns on time (by the 20th of each month)	3.97	.818
I compute the VAT due by the tax laws.	4.06	.816
I remit the VAT due without fail.	4.07	.807
Mean	4.05	
N=280		

4.2 Correlation Analysis

The correlation analysis was conducted to determine the relationship between each of the study variables. The results in Table 5 indicate that trust has a strong, positive, and significant correlation with Value Added Tax compliance ($r = 0.599$, 59.9%). This implies that higher levels of trust are associated with greater compliance with Value Added Tax regulations.

Table 5: Correlation Statistics

	Value Added Tax compliance	Trust
Value Added Tax compliance	1	0.599**
Trust	0.599**	1

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

4.3 Regression Analysis

Table 6 showed that trust had a positive correlation with Value Added Tax compliance up to 59.9% ($R = 0.599$). The results reveal that trust caused a variation of 35.8% or ($R^2 = 0.358$ and adjusted $R^2 = 0.351$) on Value Added Tax compliance. The remaining 64.2% of the 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	.599 ^a	.0358	.351	.41940

a. Predictors: (Constant), Trust _mean

Table 7 shows that there was an F statistic of 356.259 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 7: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	118.278	1	118.278	356.259	0.000
	Residual	92.345	278	0.332		
	Total	210.623	279			

a. Dependent Variable: Value Added Tax compliance

b. Predictor: (Constant), Trust

Table 8 revealed the effects of each independent variable on Value Added Tax compliance. The analysis indicated that a unit change in Trust was associated with a significant 0.463 increase in Value Added Tax compliance, $\beta = 0.463$, $p = 0.000$. This finding suggested that higher levels of Trust positively influenced Value Added Tax compliance.

Table 8: Regression Coefficient analysis

Variable	Standardized β	Std. Error	t-Statistic	Unstandardized β	Prob.
Constant	0.839	0.279	3.007		0.003
Trust	0.463	0.070	6.614	0.251	0.000

4.4 Discussion of the Findings

The study was to establish the effect of trust on value-added tax compliance among small and medium enterprises in Mathare Sub-County, Nairobi, Kenya. The correlation analysis found that trust has a strong, positive, and significant correlation with VAT compliance ($r = 0.599$). This implies that higher levels of trust are associated with greater compliance with VAT regulations. The regression reveals that trust has a significant and positive effect on VAT compliance ($\beta = 0.463$, $p = 0.000$). This indicates that higher levels of trust in tax authorities and the tax system are associated with greater compliance among SMEs. Wahl et al. (2020) found that high trust leads to increased tax compliance, with voluntary compliance being highest when trust is high. Kogler et al. (2021) confirmed these findings, demonstrating that trust positively influences tax compliance.

5. Conclusion

The study objective was to determine the effect of trust on value-added tax compliance among small and medium enterprises in Mathare Sub-County, Nairobi. The study concludes that trust has a significant and positive effect on VAT compliance among SMEs in Mathare Sub-County, Nairobi. Higher levels of trust in tax authorities and the tax system are associated with greater compliance with VAT regulations. This implies that fostering trust between taxpayers and tax authorities is essential for improving compliance rates, as trust enhances taxpayers' willingness to adhere to tax obligations.

6. Recommendations

The study recommended that KRA should focus on initiatives that enhance taxpayer trust, such as providing clear communication, addressing taxpayer grievances promptly, and ensuring consistent enforcement of tax laws. Future research is the impact of economic conditions, such as inflation or economic instability, on VAT compliance

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