

Effect of Tax Audit on Value Added Tax Compliance Among Commercial Property Owners in Central Business District, Nairobi, Kenya

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Abstract

Taxation is a major revenue source for governments worldwide; therefore, tax authorities must continuously implement measures to ensure maximum revenue collection. Despite KRA's measures, Value Added Tax compliance has remained low, and therefore, KRA consistently fails to meet annual targets. The main objective of the study was to determine the effect of tax audits on Value-Added Tax (VAT) compliance among commercial property owners in Nairobi's Central Business District, Kenya. The study was guided by the following theories: the Ability-to-Pay Theory of Taxation and Economic Deterrence Theory. The study employed an explanatory research design, targeting a population of 9,785 commercial properties in the Central Business District of Nairobi, Kenya, and a sample of 384. The study used primary data collected via questionnaires administered using the drop-and-pick-later method. The data were analyzed using hierarchical moderated regression, with descriptive and inferential statistics generated. A linear regression model was used to establish the strength of the relationship between independent and dependent study variables. The study found that tax audit had a significant positive effect on Value Added Tax compliance ($\beta = 0.471$, p -value = 0.000). The study recommends that the Kenya Revenue Authority (KRA) should prioritize maintaining and communicating a credible audit presence. Policy should focus on strategically allocating audit resources to high-risk segments while publicly highlighting audit activities to reinforce the perception of detection risk among all commercial property owners. Future research should examine the effect of tax incentives, such as prompt-payment discounts or credits for specific investments, on VAT compliance.

Keywords: *Tax Audit, Value Added Tax Compliance, Commercial Property Owners*

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1. Introduction

The level of tax compliance in an economy is a function of many variables, especially for Value Added Tax (VAT), since it is not easy for the Government to monitor transactions as they occur at the taxpayer's station (Hurst, Li & Pugsley, 2014). Many governments operate on a self-

assessment basis for VAT payments, with companies determining the VAT payable by computing VAT on purchases and on sales. However, one of the challenges noted in previous research is that voluntary compliance, where taxpayers voluntarily determine their tax liabilities and pay, leaves room for some form of manipulation (Gangl et al., 2021).

In Kenya, VAT is enshrined in Article 209 of the Constitution, which grants the national government the authority to impose VAT and other taxes through legislation passed by Parliament (National Tax Policy, 2022). The Value Added Tax Act of 2013 governs the application of VAT on goods and services produced or imported into the country. Micro, small, and medium-sized enterprises (MSEs) are particularly important in Kenya's economy, as they provide goods and services and employment, especially given the country's high unemployment rate (Mbugua, Mwambia, & Baimwera, 2021). Under Kenya's Vision 2030, MSEs have been identified as key drivers of economic growth, job creation, and poverty alleviation. However, many SMEs are either not registered with tax authorities or fail to file tax returns, which hampers their contribution to the country's tax revenue (Mwangi, 2021).

VAT non-compliance has significant repercussions for government revenue, as evidenced by Otusanya (2021), who noted that multinational companies have been implicated in cases of profit underreporting and record manipulation. The primary role of revenue authorities is to ensure high levels of tax compliance to boost revenue collection. To this end, policy guidelines must focus on enhancing compliance measures. For instance, the National Treasury's 2018 budget report emphasized the need to implement strategies to improve domestic revenue collection to fulfill financial obligations (Treasury report, 2021).

According to Alm (2022), a tax audit is a systematic examination or inspection conducted by tax authorities to assess and verify the accuracy, completeness, and compliance of a taxpayer's reported income, deductions, credits, and other tax-related information with the tax laws and regulations of a jurisdiction (OECD, 2021). A tax audit is typically a routine activity, but the result may lead to a reappraisal or a recommendation for a specific examination, particularly where tax evasion is alleged. The primary objective of the tax audit is thus to assess the extent to which the taxpayers may have complied with the applicable legislative requirements of the Tax Act in their audited financial accounts and other tax-related documents.

In Nairobi's Central Business District (CBD), owners of commercial properties such as office towers, retail outlets, and warehouses are now legally required to charge and remit Value Added Tax (VAT) at the standard rate of 16% on sales and leases. This was decisively clarified by the Kenyan Court of Appeal in *Kenya Revenue Authority v Ndegwa* (Civil Appeal No. 65 of 2019), where the court overturned a previous High Court ruling and confirmed that VAT exemptions apply only to land and residential premises, not commercial buildings, which must therefore be subject to VAT.

1.1 Problem Statement

Value Added Tax (VAT) compliance has remained a challenge for many countries, both developed and developing, despite ongoing tax system reforms (Azmi et al., 2016). In Kenya, VAT is one of the key sources of government revenue, used to fund essential public services such as healthcare, education, infrastructure, and social welfare (OECD, 2023). However, VAT revenue has consistently fallen short of set targets, raising concerns about the level of compliance among taxpayers.

For instance, in the financial year 2022/2023, VAT collection stood at Kshs. 272.45 billion, falling short of the target of Kshs. 314.17 billion (KRA, 2023). In 2023/2024, the collection was Kshs. 478.2 billion against a target of Kshs. 484.2 billion, and in 2024/2025, Kshs. 502.11 billion was collected against a target of Kshs. 526.62 billion (KRA, 2024; 2025). These figures show a consistent shortfall in VAT performance, which limits the government's ability to meet its development goals. Therefore, the study sought to establish the effect of tax audits on Value Added Tax compliance among commercial property owners in the Central Business District, Nairobi, Kenya.

2. Literature Review

2.1 Theoretical review

2.1.1 The Ability-to-Pay Theory of Taxation

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

According to this theory, a citizen pays taxes because they have the ability to do so, and the total tax burden is determined by their relative ability to pay. The theory was bound to be supported by social thinkers because it follows the ideas and concepts of justice and equity. However, the doctrine received equal support from non-social thinkers and became part of the theory of welfare economics. The major principle of this theory is that the tax burden should be paid by the members of society on the canons of justice and equity, and that these canons demand that the tax burden is apportioned according to their relative ability to pay.

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

2.1.2 Economic Deterrence Theory

The Allingham-Sandmo (AS) theory is also known as the economic deterrence theory emanated from the seminal work of Allingham and Sandmo (1972). This model assumes that behavior is influenced by factors such as the tax rate, which determines the benefits of tax evasion and the penalties for fraud, and the probability of detection, which determines the costs (Allingham & Sandmo, 1972). It has developed into the Fiscal Exchange theory over the years. The economic deterrence model, in its basic form, views the individual taxpayer as a rational economic agent who assesses the costs on one side, which are determined by the probability of detection and penalties for fraud, and on the other side, the benefits of evading taxes and thus

chooses not to pay if the benefits of non-compliance outweigh the costs (Walsh, 2012). Economic Deterrence theory is a criminological theory developed by Becker (1968).

The model thus reduces the problem to that of rational decision-making under uncertainty, whereby tax evasion pays off either by reducing taxes or by incurring sanctions (Fjeldstad, Schule-Herenberg, and Sjursen, 2012). The implication of this assumption is that when penalties are low, the tendency toward detection is high, and penalties for evasion are severe, fewer people will be non-compliant. This theory concludes that tax compliance depends more on tax audit and the penalties or fines. This implies that all taxpayers pay their taxes only because they fear being sanctioned. Thus, an increase in sanctions or fines and penalties will increase tax revenue (Awa & Ikpor, 2015). It is on the basis of this assumption that the model advocates stricter audits and harsh penalties for offenders to reduce non-compliance (Fjeldstad et al., 2012). This theory seeks to link the benefits business owners accrue by evading tax, the losses they incur when they are found non-compliant, and the penalties imposed on them.

2.2 Empirical review

2.2.1 Value Added Tax Compliance

In the United Kingdom, Value Added Tax (VAT) is a key component of the national tax system and applies to most goods and services supplied domestically and from abroad. VAT is a consumption tax charged at each stage of the supply chain, from production to the final sale (McBarnett, 2020). The responsibility for VAT compliance lies with businesses, which must register for VAT if their taxable turnover exceeds the current £90,000 threshold as of 2024. The businesses must accurately maintain VAT records and issue VAT invoices for taxable transactions. Secondly, they must submit periodic VAT returns, usually quarterly, detailing output VAT (collected on sales) and input VAT (paid on purchases). Tilahun & Yidersal (2021). Businesses can reclaim input VAT, ensuring that VAT is ultimately paid only by the final consumer, aligning with the “value added” principle (OECD, 2023).

The VAT compliance in South Africa includes several statutory obligations. Once registered, a vendor must charge VAT on taxable supplies (output VAT), keep accurate records, submit VAT returns usually every two months, and pay any VAT due to SARS. At the same time, businesses can claim input VAT on purchases and expenses used in making taxable supplies, effectively ensuring that VAT is ultimately borne by the final consumer (National Treasury, 2023). Compliance also includes issuing tax invoices, maintaining VAT accounts, and retaining documentation for at least five years. In addition to standard compliance procedures, South African VAT law requires specific attention to timing and documentation.

Value Added Tax (VAT) compliance refers to the extent to which taxpayers comply with VAT regulations, including accurate filing, timely payment, and appropriate documentation of taxable transactions. High levels of VAT compliance are essential for ensuring adequate revenue generation and minimizing tax evasion. According to Bird and Zolt (2020), VAT compliance is influenced by several factors, such as the complexity of the tax system, administrative efficiency, taxpayer education, and the effectiveness of enforcement mechanisms. Poor compliance undermines government revenues and can distort market competition by giving non-compliant businesses an unfair advantage. Therefore, enhancing VAT compliance remains a key priority for tax authorities globally (OECD, 2021).

3. Methodology

According to Kothari (2010), study design is a plan for collecting and using data to obtain the desired information with sufficient precision or to test a hypothesis properly. The study employed an explanatory research design. Saunders *et al.* (2007) state that explanatory studies seek to describe the characteristics of variables and, at the same time, investigate causal relationships between variables. The study population is the full set of cases from which a sample is taken (Mugenda & Mugenda, 2003). The target population was 9,785 commercial properties in the Central Business District, Nairobi, Kenya (KRA, 2025). Target population, sampling framework, sample selection, and sampling technique used are also discussed. Figure 1 shows that, out of the target sample size of 384 respondents, 307 respondents correctly completed questionnaires and submitted them, indicating a strong response rate of 79.9% and a non-response rate of 20.1%, with 77 respondents not responding to the questionnaire items.

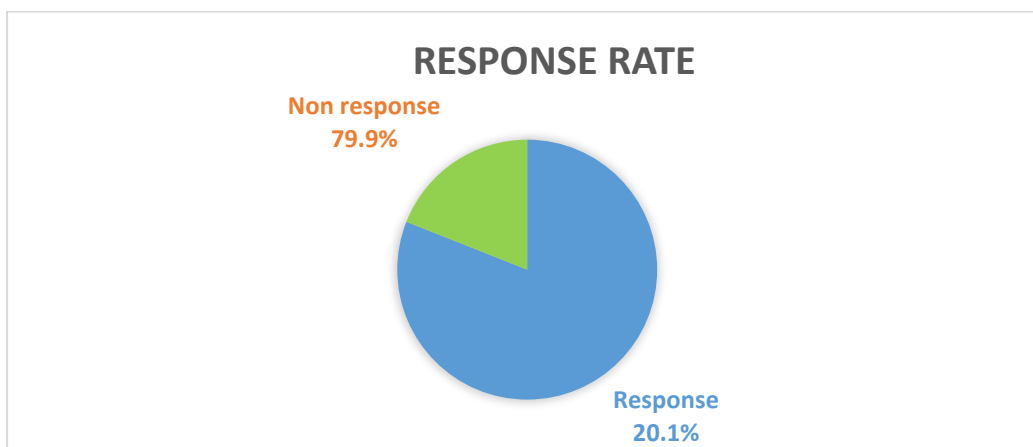


Figure 2: Response Rate

Reliability Analysis

According to Mohajan (2017), alpha values above 0.7 are deemed acceptable and tolerable, above 0.8 are deemed good, and above 0.9 are seen to demonstrate exceptional internal consistency. The benchmark value for dependability is typically set at 0.7. The baseline for this study was the Cronbach's alpha coefficient of 0.7. The reliability statistics presented in Table 1 indicate the internal consistency of the scales used to measure the key constructs in this study. A Cronbach's alpha value of 0.70 or higher is generally considered acceptable for research purposes, while values above 0.90 indicate excellent reliability, although they may sometimes suggest that the questions are too similar. The VAT compliance scale demonstrated exceptional internal consistency, with a Cronbach's alpha of 0.981. This near-perfect reliability coefficient, based on five items, indicates that the items measuring taxpayers' adherence to Value-Added Tax regulations are extremely homogeneous. Similarly, the tax audit scale achieved a Cronbach's alpha of 0.927, indicating that the five items measuring the perception and impact of tax audits consistently capture that concept.

Table 1: Test of Reliability of Questionnaire

Factor	Number of Items	Cronbach's Alpha score	Conclusion
Value-added tax compliance	5	0.981	Reliable
Tax Audit	5	0.927	Reliable

4. Results and Discussion

4.1 Descriptive Statistics

4.1.1 Descriptive Statistics Tax Audit

In Table 2, the statement "Our properties have been audited by KRA field officers" had the highest mean of 4.14 (SD = 0.730), indicating strong agreement. The low standard deviation suggests little variability in responses. The statement, "KRA is able to pick up VAT inconsistency by comparing filed data," also received strong agreement (mean = 4.12, SD = 0.718). The low standard deviation suggests little variability in responses. The statement, "Our property has been audited in the past by KRA," had a mean of 4.05 (SD = 0.708). The low standard deviation suggests little variability in responses. The statement, "Tax audit process is transparent and well-communicated," had a mean of 4.01 (SD = 0.771), indicating agreement. The statement, "Our property has been audited on our claimed expenses in the past," had a mean of 3.99 (SD = 0.796). The low standard deviation suggests little variability in responses, indicating agreement. The aggregate mean of 4.06 indicates a consistent level of agreement across all statements regarding tax audits, suggesting that respondents generally perceive the Kenya Revenue Authority (KRA) as active in conducting audits and capable of detecting inconsistencies.

Table 2: Tax Audit

N= 307	Mean	Std. Deviation
Our property has been audited on our claimed expenses in the past	3.99	.796
Our property has been audited in the past by KRA	4.05	.708
KRA is able to pick up VAT inconsistency by comparing the filled data	4.12	.718
Our properties have been audited by KRA field officers	4.14	.730
The tax audit process is transparent and well-communicated	4.01	.771
Mean statistic	4.06	

4.1.2 Descriptive statistics for Value Added Tax Compliance

Table 3 found that the statement "I file my returns accurately" had the highest mean of 4.09 (SD = 0.793), indicating strong agreement among respondents. The standard deviation suggests a moderate degree of variability in responses. The statement, "The tax system in place motivates me to voluntarily comply with tax obligation," had a mean of 4.03 (SD = 0.844), also indicating strong agreement. The standard deviation suggests a moderate degree of variability in responses. The relatively high standard deviation indicates the most variability in responses for this item. The statement "I have registered for VAT compliance obligation" had a mean of 4.02 (SD = 0.784), indicating strong agreement. The statement "I file my tax returns on time" had a mean of 4.01 (SD = 0.714), indicating strong agreement. The standard deviation was the lowest among the items, indicating the most consensus. The statement, "I pay the tax liability that arises from my VAT obligation without failure," had a mean of 3.98 (SD = 0.756), indicating agreement. The standard deviation suggests a moderate degree of variability in responses. The aggregate mean of 4.03 across all statements indicates a consistent, strong level of agreement on VAT compliance behaviors. This suggests that respondents generally report high levels of adherence to their tax obligations, including timely filing, accurate reporting, and payment of liabilities.

Table 3: Value Added Tax Compliance

N= 307	Mean	Std. Deviation
I file my tax returns on time	4.01	0.714
I have registered for the VAT compliance obligation	4.02	0.784
I pay the tax liability that arises from my VAT obligation without failure	3.98	0.756
The tax system in place motivates me to voluntarily comply with my tax obligation	4.03	0.844
I file my returns accurately	4.09	0.793
Mean statistic	4.03	

4.2 Correlation Analysis

The correlation analysis examined the strength and direction of relationships among the study variables. The Pearson correlations range from -1 to +1, and the significance level was set at 95% confidence. The analysis in Table 4 found a positive and significant correlation between tax audit and VAT compliance ($r = 0.786$, $p\text{-value} = 0.000$). This indicates that heightened perceptions of audit scrutiny are associated with markedly better compliance, a finding that corroborates a recent study by Otieno and Kipchumba (2023), who established that enforcement mechanisms remain a primary driver of tax adherence for businesses in Kenyan urban centers.

Table 4: Correlation Statistics

	Value Added Tax Compliance	Tax Audit
Value Added Tax Compliance	1	0.786**
Tax Audit	0.786**	1
Sig.	0.000	

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

4.3 Regression Analysis

The model summary in Table 5. shows that the R of 0.786 indicates that tax audit correlates with Value Added Tax compliance at 78.6%. The R² of 0.617 indicates that tax audits account for 61.7% of the variance in value-added tax compliance; the remaining 38.3% is attributable to factors not included in the study.

Table 5: Model Summary

Model	R	R Square	Adjusted R-Square	Std. Error of the Estimate
1	.786 ^a	0.617	.613	.38651

a. Predictors: (Constant), Tax audit _mean

Table 6 shows that the F statistic was 433.461 and the p-value was 0.000 < 0.05, indicating that the model was significant in explaining the variance in Value Added Tax compliance.

Table 6: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	91.027	1	91.027	433.461	0.000
	Residual	64.198	305	0.210		
	Total	155.225	306			

a. Dependent Variable: Value Added Tax compliance

b. Predictor: (Constant), Tax audit

Table 7 revealed the effects of each independent variable on Value Added Tax Compliance. The analysis indicated that a unit change in tax audit was associated with a significant 0.471 increase in Value Added Tax compliance, $\beta = 0.471$, $p = 0.000$. This finding suggested that higher levels of tax audit positively influenced compliance with Value Added Tax compliance.

Table 7: Regression Coefficient analysis

Variable	Standardized		Unstandardized		Prob.
	β	Std. Error	t-Statistic	β	
Constant	0.487	0.211	2.308		0.022
Tax Audit	0.471	0.064	7.359	0.518	0.000

4.4 Discussion of the Findings

The study objective was to establish the effect of tax audits on Value Added Tax compliance among commercial property owners in the Central Business District of Nairobi, Kenya. The study found a positive, significant correlation between tax audit and VAT compliance ($r = 0.786$, p -value = 0.000). The study also found that tax audits had a positive and significant effect on VAT compliance ($\beta = 0.471$, $p = 0.000$), underscoring the critical role of enforcement deterrence. This result aligns with Alm and McKee (2022), who found compliance rises with a certain audit probability, and with Cobb and Timmons (2021), who documented a 28% increase in reported liabilities post-audit. The study's conclusion reinforces the established view from Niu (2020) that audits serve as a powerful deterrent and revenue-generation tool.

5. Conclusion

The study objective was to establish the effect of tax audit on VAT compliance. The findings concluded that tax audits exert a strong, direct positive effect on value-added compliance, confirming the central role of enforcement deterrence. This study contributes new knowledge by demonstrating that this deterrent effect is not static but is dynamically amplified by social norms; the perceived risk of an audit is significantly more effective at securing compliance in a community where taxpaying is the prevailing social standard.

6. Recommendations

The study recommends that the Kenya Revenue Authority (KRA) should prioritize maintaining and communicating a credible audit presence. Policy should focus on strategically allocating audit resources to high-risk segments while publicly highlighting audit activities to reinforce the perception of detection risk among all commercial property owners.

Future research should examine the effect of tax incentives, such as prompt-payment discounts or credits for specific investments, on VAT compliance.

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