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Effect of Environmental Costs on Income Tax Compliance Among Multinational Corporations in Nairobi City County, Kenya

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Abstract

Tax compliance is important because it directly impacts revenue for most governments worldwide. Despite the tax reforms the Kenya Revenue Authority has been undertaking to increase revenue collection, it has, of late, failed to meet its revenue targets, particularly rental income tax targets. The purpose of the study was to determine the effect of environmental costs on income tax compliance among multinational corporations in Nairobi City County, Kenya**.** The theories that guided this study were the Institutional Theory and the Ability to Pay Theory. The study used an explanatory research design, and the target population comprised 216 multinational corporations in Nairobi City County, Kenya. The study showed that, out of the targeted 218 respondents, only 192 (88.1%) completed and submitted their questionnaires. Primary data were collected using a structured questionnaire. Both descriptive and inferential statistics were computed using software and presented in tables and charts. The study found that environmental costs had a significant negative direct effect on income tax compliance ($\beta = -0.357$, $p = 0.000$). Regarding the negative effect of environmental costs on income tax compliance, the Kenyan government should introduce tax incentives that offset the compliance burden of environmental regulations, such as allowing partial crediting of environmental compliance expenditures against corporate income tax liabilities or establishing accelerated depreciation schedules for environmental protection equipment. Future studies should investigate the effect of tax policy reforms on income tax compliance, examining whether frequent unilateral changes to corporate tax legislation, including the annual Finance Act amendments, create planning uncertainty that incentivizes aggressive avoidance structures.

Keywords: *Environmental Costs, Income Tax Compliance, Multinational Corporations*

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1. Introduction

Taxation is fundamental to state development, in terms of funding infrastructure, redistributing resources, and creating a fiscal social contract between government and citizens. If tax revenue is not adequate to cover requisite expenditure in areas such as infrastructure, health, and education, this becomes a critical concern (Forstater, 2019). Generally, citizens are prepared to pay taxes if they perceive them as fair, especially if they feel the taxes are used for purposes that benefit them. In modern times, there has been widespread recognition of the importance of tax as an instrument of growth and development in states, and of its ability to boost self-sustainability in countries heavily reliant on aid (Brautigam, 2021).

Income tax compliance refers to the extent to which individual and corporate taxpayers accurately report their income, file returns, and pay the legally required taxes within a jurisdiction (OECD, 2024). It is a critical component of public finance because high compliance ensures sufficient revenue collection for government operations and development initiatives. Research shows that individual income taxpayers' compliance is influenced by factors such as tax knowledge, awareness of obligations, perceived fairness of the tax system, and trust in tax authorities (Surugiu et al., 2025).

In Kenya, income tax compliance by multinational corporations (MNCs) is influenced by regulatory complexity and cross-border tax practices, particularly transfer pricing and profit shifting. Pareno (2024) found that many MNCs operating in Nairobi use transfer pricing policies that are only moderately aligned with domestic tax statutes, leading firms to exploit these mechanisms to reduce their tax liabilities and undermining compliance. Hussein (2025) shows that transfer pricing audits positively influence corporate income tax compliance, and that technology integration enhances the effectiveness of these audits for MNCs in Kenya.

Environmental costs refer to the economic value of negative impacts on the environment caused by business activities, including pollution, resource depletion, and ecosystem degradation. These costs are increasingly recognized in fiscal policy through instruments such as environmental, carbon, and pollution taxes, which aim to internalize the externalities associated with environmental damage (OECD, 2022). By assigning a monetary cost to environmental harm, governments create an economic incentive for businesses and individuals to adopt environmentally sustainable practices, reduce emissions, and minimize waste (Fullerton & Wolverton, 2023). Environmental taxation serves as both a regulatory and fiscal tool, encouraging firms to account for the environmental consequences of their operations while generating revenue that can be reinvested in environmental protection and green initiatives (Parry, 2023). The concept highlights the integration of ecological considerations into taxation policy, where the tax burden reflects both financial performance and environmental responsibility.

Multinational companies in Nairobi City County are firms that operate in Nairobi while maintaining headquarters or operations in other countries, engaging in production, services, or commercial activities across borders. These companies leverage international resources, technology, and expertise to compete in local and global markets, while contributing to employment, skills development, and economic growth within Nairobi (Muriuki, 2021; Wanjiku & Omondi, 2020). They often establish subsidiaries, branches, or regional offices in Nairobi to serve East African markets and benefit from the city's strategic position as a commercial and financial hub.

Multinational companies (MNCs) in Nairobi City County are a central feature of the city's business landscape, contributing to strategic innovation and organizational performance. Irimu and Mboya (2025) found that foreign MNCs leverage brand strategy and innovation to enhance their organizational performance in Nairobi, suggesting that global firms adapt strategic positioning to succeed locally. Gacheri (2023) showed that organizational culture strongly influences technology adoption among multinational firms operating in Nairobi, highlighting the importance of internal cultural alignment for competitiveness. Miriti (2021) emphasized that cross-cultural management practices**,** such as recruitment and employee training, significantly affect how MNCs perform in Nairobi's diverse business environment.

1.1 Problem Statement

Despite considerable efforts by many governments to improve infrastructure and spur economic growth, revenue collection has consistently been low. Developing countries still face challenges in tax revenue collection due to low taxpayer compliance. For instance, in the financial year 2024/25, the Kenya Revenue Authority (KRA) set an income tax collection target of KSh 1.677 trillion but collected only KSh 1.611 trillion (KRA, 2025). This trend clearly shows that there is a need for the government and the tax authority to review their efforts in order to seal tax leakages among MNCs.

The government cannot effectively fulfill its purpose, which includes safety, excellent health care and education, better housing and water, and infrastructure development, as a result of the KRA's failure to achieve its goal. This has thus led to anxiety, as the government is striving to achieve its objectives, which is why this study is required. Although studies have examined tax compliance, few have examined income tax compliance among multinational corporations. This study therefore sought to determine the effect of environmental costs on income tax compliance among multinational corporations in Nairobi City County, Kenya.

2. Literature Review

2.1 Theoretical Review

2.1.1 Ability-to-Pay Theory

The Ability-to-Pay Theory was introduced by Adam Smith (1776) and later refined by Musgrave and Musgrave (1989). The theory posits that taxes should be levied according to taxpayers' financial capacity, so that individuals and businesses with higher incomes or wealth contribute a larger share of taxes than those with lower incomes. The principle underlying the theory is that a fair tax system distributes the tax burden equitably based on taxpayers' ability to pay rather than on the benefits they receive from public services (Smith, 1776; Musgrave & Musgrave, 1989).

The theory suggests that taxpayers are more likely to comply with income tax obligations when they perceive the tax system as fair and equitable. When income tax rates, exemptions, deductions, and tax thresholds align with taxpayers' financial capacity, they are more willing to declare their income accurately and remit the correct amount of tax. Conversely, when taxpayers perceive the tax burden as excessive or inequitable relative to their income, they may be less willing to comply, thereby increasing the likelihood of tax evasion or avoidance (Torgler, 2007).

In the context of income tax compliance, the Ability-to-Pay Theory holds that voluntary compliance is strengthened when taxpayers believe the income tax system fairly reflects their economic circumstances. A progressive income tax structure, equitable tax assessments, and transparent tax administration enhance taxpayers' confidence in the tax system and encourage timely filing of income tax returns and payment of taxes. Therefore, tax authorities should design income tax policies that balance revenue generation with fairness to improve taxpayer compliance (OECD, 2023).

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The theory is relevant to studies on income tax compliance because it demonstrates that perceptions of tax fairness significantly influence taxpayers' willingness to comply with income tax laws. When taxpayers consider the tax system equitable and proportionate to their financial ability, they are more likely to comply voluntarily, thereby improving overall income tax compliance.

2.1.2 Institutional Theory

Institutional Theory, as articulated by DiMaggio and Powell (1983), asserts that organizational behavior is shaped significantly by external pressures regulatory, normative, and mimetic rather than by economic rationality alone. In the context of income tax compliance, firms' adherence to tax laws is influenced not only by the desire to avoid sanctions **(**coercive isomorphism**)** but also by the need to maintain legitimacy in the eyes of regulators, investors, and the public; this often leads firms to adopt formalized tax reporting practices and transparent disclosure of tax positions consistent with industry norms (DiMaggio & Powell, 1983; Scott, 2008).

Environmental costs such as expenditures on pollution control, renewable energy adoption, and environmental management systems intersect with tax compliance because many tax jurisdictions provide incentives, credits, or deductions tied to environmentally sustainable investments, obliging firms to accurately document and report such costs to realize the fiscal benefits (Hanlon & Heitzman, 2010; Richardson, 2020). Under normative pressures, professional bodies and sustainability frameworks encourage integrated reporting in which environmental costs and related tax treatments are disclosed as part of ethical corporate governance, thereby reinforcing compliance beyond minimum legal requirements (Gray et al., 1995; Berrone & Gomez-Mejia, 2009).

Isomorphism can further drive firms to emulate competitors that strategically manage environmental costs and leverage tax incentives for sustainable practices, thereby institutionalizing a culture of both environmental stewardship and rigorous tax compliance (Marquis & Qian, 2014). Thus, from an institutional perspective, environmental cost management and income tax compliance are co-constructed practices: firms undertake them not merely for economic gain but to satisfy regulatory expectations, adhere to normative standards**,** and align with industry templates of legitimate behavior**,** demonstrating how institutional environments shape complex organizational practices in tax and sustainability domains (Oliver, 1991; Deegan, 2013).

2.2 Empirical Review

2.2.1 Environmental Costs

Mantzaris and Fosner (2025) investigated the relationship between time spent on tax compliance and tax payments across multiple jurisdictions, focusing on tax administrative costs such as time burden and compliance processes. The study found a positive relationship between the hours taxpayers spend on compliance activities and the amount of tax they ultimately pay, indicating that greater time burdens (a major component of compliance cost alongside bookkeeping and agent hiring) are empirically linked with higher total tax payments. Tax administrative costs identified in the results include the time required to prepare returns, make payments, and meet other tax obligations, thereby reducing efficiency and diverting economic resources. The study concluded that high compliance costs, in the form of time burdens, not only increase the overall cost of compliance for taxpayers but also affect tax payments, suggesting that taxpayers may adjust compliance behavior in response to these environmental costs.

Osebe (2019), in his study of the factors affecting tax compliance by Real Estate developers in Nakuru town, revealed that tax compliance cost is a contributory factor to tax compliance and an indication of its magnitude effect. The study findings provide sufficient evidence that tax compliance costs are associated with high levels of tax compliance. The study also provides some preliminary evidence that fines and penalties play a vital role in improving tax compliance. Specifically, for a tax system with fair tax rates of fines and penalties, tax compliance is likely to improve. The study results also inferred that perceived opportunity for tax evasion has a significant effect on tax compliance. This is because the opportunity to cheat increased non-compliance, regardless of whether the participants actually intended to be non-compliant.

Kamau (2025) investigated tax compliance costs and their effect on income tax compliance among multinational corporations in Kenya, considering compliance costs as a moderating factor. The results showed that tax compliance cost had a significant positive effect on income tax compliance**,** meaning that a higher compliance burden (including costs related to hiring experts or meeting complex requirements) influenced corporations' compliance behavior when moderated by structured agreements such as Advance Pricing Agreements (APAs). The study concluded that rationalizing compliance costs and simplifying requirements would help strengthen corporate compliance. It recommended that Kenya adopt advance pricing agreements, improve dispute resolution systems, and rationalize compliance costs through streamlined processes and affordability to promote openness and a business-friendly tax environment.

2.2.2 Income Tax Compliance

Income tax compliance refers to the extent to which taxpayers accurately report taxable income, file tax returns within statutory deadlines, and pay the correct amount of tax as required by law. Recent studies conceptualize income tax compliance as a multidimensional behavior influenced by both enforced factors such as audits, penalties, and the probability of detection and voluntary factors, including tax morale, perceived fairness of the tax system, trust in tax authorities, and prevailing social norms (Kirchler, Hoelzl, & Wahl, 2021).
Further study shows that simplified tax procedures, effective use of digital tax systems, and taxpayer education programs enhance compliance by reducing compliance costs and information asymmetry (OECD, 2022; Alm & Torgler, 2022). Additionally, institutional credibility and consistent enforcement are critical in shaping taxpayers' long-term compliance attitudes, as weak governance and perceived corruption tend to discourage honest reporting (Mascagni, 2023). Consequently, income tax compliance is increasingly viewed as an outcome of the interaction between legal enforcement, administrative efficiency, and behavioral motivations rather than mere adherence to statutory requirements (Luttmer & Singhal, 2024).

3. Methodology

A research design is a roadmap for conducting a research study (Schallmo, Williams, & Lang, 2018). In this study, the explanatory research survey design was employed. The choice of an explanatory research survey design in this study is justified since the intention is to establish the effect of environmental costs, profit shifting, treaty shopping, and income tax compliance.

The target population consists of individuals or entities sharing similar characteristics (Sekaran & Bougie, 2010). According to Cooper and Schindler (2000), the study population comprises individuals, households, or organizations with similar characteristics about which a researcher wants to make inferences. The study's target population comprised 218 multinational corporations in Nairobi City County, Kenya (KRA, 2025). Table 1 showed that, of the targeted 218 respondents, only 192 (88.1%) completed and submitted their questionnaires. The remaining 26 (11.9%) respondents were deemed non-responsive to the survey due to time constraints. The data were analyzed using descriptive and regression analyses.

Table 1: Response Rate Analysis

	Number	Percentages
Response Rate	192	88.1%
Non-response bias	26	11.9%
Total Questionnaires issued	218	100%

Reliability analysis

Reliability refers to the consistency, steadiness, or steadfastness of information. At whatever point a researcher measures a variable, the person in question needs to be certain that the estimation gives reliable and steady outcomes (Wikman, 2006). The coefficient of consistency will be assessed using Cronbach's alpha. “Cronbach's alpha coefficients above 0.7 were the cut–off reliability for this study. A test with reliability values of 0.7 or higher was considered an indicator of internal consistency (Mohsen & Reg, 2011). Table 2 shows that all constructs had high reliability, with each Cronbach's alpha>0.7. Specifically, income tax compliance α= 0.984, environmental costs α= 0.822

Table 2: Test of Reliability of Questionnaire

Factor	**Number of Items**	**Cronbach Alpha score**	**Conclusion**
Income Tax Compliance	5	0.984	Reliable
Environmental costs	5	0.822	Reliable

4. Results and Discussion

4.1 Descriptive Statistics

4.1.1 Descriptive statistics of Environmental Costs

Table 3 found that for the statement, "Our company incurs high costs in hiring tax agents or consultants to comply with tax regulations," the mean response of 4.10 and standard deviation of 0.918 indicated that respondents generally agreed with this statement, with a moderate spread of opinions around the mean. Regarding the item, "The cost of bookkeeping software and systems increases our tax compliance expenses", the mean of 4.21 and standard deviation of 0.857 reflected strong agreement with a relatively low dispersion of responses. For the statement, "Our company incurs substantial costs in maintaining proper bookkeeping records for tax purposes", the mean of 3.91 and a notably low standard deviation of 0.529 suggested that respondents tended to agree, with very little deviation from this average opinion. Concerning the item "Expenditure on tax agents has a significant impact on our tax compliance decisions", the mean of 4.05 and a very low standard deviation of 0.379 indicate strong agreement and exceptionally high consensus among participants. Finally, for the statement, "Adequate bookkeeping improves tax compliance despite the associated costs", the mean of 4.20 and standard deviation of 0.667 showed strong agreement with a relatively constrained spread of responses. The overall mean of 4.09 across all items underscores a general consensus on the measures of environmental costs.

Table 3: Environmental Costs

n=192		Mean	Std. Deviation
ENC1	Our company incurs high costs in hiring tax agents or consultants to comply with tax regulations	4.10	.918
ENC2	The cost of bookkeeping software and systems increases our tax compliance expenses	4.21	.857
ENC3	Our company incurs substantial costs in maintaining proper bookkeeping records for tax purposes	3.91	.529
ENC4	Expenditure on tax agents significantly affects our tax compliance decisions.	4.05	.379
ENC5	Adequate bookkeeping improves tax compliance despite the associated costs.	4.20	.667
Overall Mean		4.09	

4.1.2 Descriptive statistics for Income Tax Compliance

Table 4 found that the statement, “Our company files return on income by the prescribed date,” had a mean response of 3.99 and a standard deviation of 0.965; the mean indicated that respondents generally agreed with the statement, while the standard deviation suggested a moderate spread of responses around this average. The statement “Our company pays tax dues by the prescribed date” had a mean of 3.91 and a standard deviation of 0.975, indicating agreement with a moderate level of dispersion. Additionally, for the statement “Our company makes timely and accurate tax declaration,” the mean was 3.98 and the standard deviation was 0.904, supporting a trend of agreement with a similarly moderate level of variability. Regarding “Our company pays fines and penalties for overdue taxes”, the mean was 4.08 with a standard deviation of 0.911, indicating the strongest agreement among the core compliance items and a consistent response pattern. Lastly, the item “Our company cooperates with KRA officers in conducting audits by providing all the necessary records” had the highest mean of 4.15 and a standard deviation of 0.904, denoting the highest level of agreement with relatively low dispersion. The overall mean of 4.02 across all items confirms that, on average, respondents agreed with statements describing proactive tax compliance behaviors.

Table 4: Income Tax Compliance

n=192		Mean	Std. Deviation
ITC1	Our company files an income tax return by the prescribed date	3.99	.965
ITC2	Our company pays tax dues by the prescribed date	3.91	.975
ITC3	Our company makes timely and accurate tax declarations.	3.98	.904
ITC4	Our company pays fines and penalties for overdue taxes	4.08	.911
ITC5	Our company cooperates with KRA officers in conducting audits by providing all the necessary records	4.15	.904
Overall Mean		4.02	

4.2 Correlation Analysis

The correlation analysis assessed the nature of the relationships between each predictor variable and the outcome variable. Table 5 found a negative and significant correlation between environmental costs and income tax compliance ($r = -.690$, $p = .042$). This suggests that the financial burden associated with environmental regulations and compliance for multinational corporations in Nairobi City County is inversely related to their adherence to income tax obligations

Table 5: Correlation Statistics

	Income Tax Compliance	Environmental costs
Income Tax Compliance	1	-0.690**
Environmental costs	-0.690**	1
Sig.	0.042	

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

4.3 Regression Analysis

Table 6 shows that environmental costs were correlated with income tax compliance up to 69% ($R = 0.690$). The results reveal that environmental costs accounted for 47.6% of the variation in income tax compliance ($R2 = 0.476$; adjusted $R2 = 0.471$). The remaining 52.4% of the variation was attributable to other factors not included in the model.

Table 1: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.690[a]	.0.476	.471	.48937

a. Predictors: (Constant), environmental costs _mean

Table 7 shows an F statistic of 237.715 and a p-value of 0.000 < 0.05, indicating that the model was significant in explaining the variance in Income Tax Compliance.

Table 7: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	89.381	1	89.381	237.715	0.000
	Residual	74.247	197	0.376		
	Total	163.628	198			

a. Dependent Variable: Income Tax Compliance
b. Predictor: (Constant), Environmental costs

Table 8 shows that a one-unit change in environmental costs resulted in a 0.357 decrease in income tax compliance. The study found that environmental costs had a significant negative effect on income tax compliance (β = -0.357, p-value = 0.000 < 0.05). Consequently, the null hypothesis was rejected.

Table 8: Regression Coefficients

Variable	Standardized β	Std. Error	t-Statistic	Unstandardized β	Prob.
Constant	4.022	0.034	118.294		0.000
Environmental costs	-0.357	0.066	-5.409	-0.465	0.000

4.4 Discussion

The study sought to establish the effect of environmental costs on income tax compliance among multinational corporations in Nairobi City County, Kenya. The correlation matrix showed that environmental costs were negatively and significantly correlated with income tax compliance (r = -.690, p = 0.042). This suggests that the financial burden associated with environmental regulations and compliance for multinational corporations in Nairobi City County is inversely related to their adherence to income tax obligations. This indicates that as environmental operational costs increase, these corporations' willingness or capacity to fully comply with income tax requirements may diminish. The study found that environmental costs had a significant negative effect on income tax compliance (β = -0.357, p = 0.000 < 0.05). This finding indicated that the financial burden imposed by environmental regulations is a substantial deterrent, suggesting that increased operational costs in this area reduce the resources or willingness of multinational corporations in Nairobi City County to comply fully with their income tax obligations. The finding that environmental costs negatively affect income tax compliance among multinational corporations is consistent with several empirical studies examining compliance costs and taxpayer behavior. Sandford (2019) established that compliance costs, including those related to environmental regulation, constitute financial burdens that influence taxpayer decision-making, and that net compliance costs, after accounting for benefits, still impose measurable constraints on taxpayers' capacity to meet fiscal obligations.

5. Conclusion

The objective was to determine the effect of environmental costs on income tax compliance among multinational corporations in Nairobi City County, Kenya. The study concludes that the financial demands of environmental factors create competing fiscal pressures that diminish multinational corporations' capacity and willingness to meet income tax obligations. This conclusion advances new knowledge by demonstrating that environmental regulation and tax compliance function as substitutes rather than complements within developing-economy contexts, challenging the assumption that corporate social responsibility and fiscal citizenship operate synergistically.

6. Recommendations

Regarding the negative effect of environmental costs on income tax compliance, the Kenyan government should introduce tax incentives that offset the compliance burden of environmental regulations, such as allowing partial crediting of environmental compliance expenditures against corporate income tax liabilities or establishing accelerated depreciation schedules for environmental protection equipment.

Future studies should investigate the effect of tax policy reforms on income tax compliance, examining whether frequent unilateral changes to corporate tax legislation, including the annual Finance Act amendments, create planning uncertainty that incentivizes aggressive avoidance structures.

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