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Compounding of Tax Offences and VAT Compliance among Micro and Small Taxpayers in Mombasa North Sub-County, Kenya: The Moderating Role of Tax Literacy

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Abstract

The study sought to determine the effect of compounding of tax offenses on Value-added tax compliance among micro and small taxpayers in Mombasa North Sub-County, Kenya. In addition, the study sought to establish the moderating effect of tax literacy on the relationship between compounding of tax offenses and value-added tax compliance among micro and small taxpayers in Mombasa North Sub-County, Kenya. This study used explanatory research to examine the relationship between tax investigation deterrence techniques and value-added tax compliance. KRA records indicate around 3,716 MSTs in Mombasa as of the 2025 financial year. The study focused on business owners/financial managers in these MSTs because they are closely involved in managing tax affairs and reporting business revenue performance. This provided valuable clues about the effect of tax investigations. Compounding had a significant positive effect (B = 0.316, β = 0.205, t = 3.967, p =0.000), leading to rejection of H0. This is more effective for VAT compliance among micro and small taxpayers. The size of its regression effect implies that enforcement has an impact on taxpayers' behaviour when there is a clear consequence of the offence and a formal process for possibly resolving the offence. Similarly, Muhwa and Omboi (2023) show that financial sanctions can affect MST compliance, but they are more effective when transparent and proportionate. The benefit of compounding is not just imposing a fine but also providing an effective pathway for a taxpayer to resolve non-compliance and become regular. KRA should therefore enhance its consistency, communication, and procedural fairness. The study findings suggest that tax literacy is a key independent factor in understanding VAT compliance but does not appear to significantly moderate tax enforcement relationships.

Keywords: *Compounding of tax offences, tax literacy, Value added tax compliance*

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1. Introduction

Taxation is a fundamental source of government revenue that finances economic development, infrastructure and social welfare. Countries with well-established tax systems tend to achieve greater fiscal stability and rely less on external borrowing (OECD, 2024). However, many developing economies still struggle to mobilize domestic revenue because of tax evasion and low compliance. Among the various taxes, Value Added Tax (VAT) is a major source of

government revenue, adopted by more than 170 countries and contributing substantially to total tax collections worldwide (OECD, 2024). Tax evasion, administrative inefficiencies, fraud, unregulated and growing informal economies, and tax underreporting continue to negatively influence tax compliance globally (Adekoya, Olaoye & Lawal, 2021).

Tax compliance challenges are global concerns, considering that developing countries such as the EU reported a VAT compliance gap of approximately 128 billion Euros, equivalent to 9.5% of expected VAT revenue, in 2023 (Bauer & Pandya, 2026), a gap that significantly reduces government revenue and weakens sustainability impairing public service delivery. In Kenya, the struggle to improve tax compliance mirrors the global landscape, despite the development and implementation of key tax reforms. A report by KRA of the Medium-Term Revenue Strategy (FY 2024/25–2026/27) showed that Kenya's tax-to-GDP ratio was approximately 14.1%, significantly below the 20% target, explaining the persistent yearly fiscal deficits and increased reliance on external borrowing to supplement the budget (KRA, 2023). Research evidence attributes low tax compliance to barriers such as complex tax laws, weak enforcement, limited taxpayer knowledge, and low tax morale, which undermine compliance and encourage tax evasion (Taing & Chang, 2021; Njilu, 2023).

OECD (2024) and KRA (2023) note that VAT is one of the most significant sources of government revenue, accounting for approximately 24% of Kenya's total tax revenue. Kenya experiences substantial VAT compliance gaps, estimated at about 4.2% of GDP, reflecting considerable revenue losses relative to potential VAT collections (Kiriga, Nato, Remcho & Eldrup, 2025). These losses largely stem from under-reporting sales, fraudulent input tax claims, and registered taxpayers' failure to remit VAT.

KRA has implemented various compliance and enforcement strategies to address non-compliance, including digital tax systems, taxpayer education, tax audits, and tax investigations (Momanyi, 2024). Tax investigations are KRA's most prominent compliance measures targeting deliberate tax evasion through prosecuting offenders, compounding tax offenses, publicizing enforcement actions, and canceling tax compliance certificates, making them among the strongest enforcement mechanisms. These measures are intended to detect, deter, and disrupt tax offenses while encouraging voluntary compliance. However, evidence regarding their efficacy is limited and it is not well understood if these measures positively impact compliance. While some studies suggest that strict enforcement improves compliance, others argue that excessive punitive measures may create adversarial relationships between tax authorities and taxpayers, particularly where enforcement is perceived as unfair (Aitaa & Adepehin, 2023). MSTs often operate informally, have missing records, and have limited knowledge of their tax clients, which can compound these challenges.

1.1 Problem Statement

VAT remains one of Kenya's largest sources of government revenue. However, VAT compliance remains challenging, especially among MSTs, due to non-compliant behaviors such as under-reporting sales, non-filing, nil filing, false input tax claims, and non-remittance of collected VAT. Although KRA recorded a 24% increase in VAT income from the MST department and met the May 2025 revenue target by over KSh 110 million, the VAT compliance rate remains low. According to KRA, 22% of VAT-registered taxpayers generate VAT revenue, 52% file returns claiming input tax credits, and 26% file nil returns. These figures show that VAT non-

compliance has persisted despite legislative reforms and the adoption of digitalization systems like the Electronic Tax Invoice Management System (eTIMS).

To mitigate VAT fraud and non-compliance, KRA has improved its tax investigation and enforcement processes, including prosecution, compounding of offenses, and publicizing non-compliant taxpayers through measures such as the VAT special table, cancellation of Tax Compliance Certificates (TCCs), and deregistration of dormant taxpayers. Through these initiatives, KRA flagged over 20,000 dormant taxpayers for deregistration and identified 7,719 taxpayers suspected of VAT fraud, restricting them from input tax claims (KRA, 2023). The VAT Act, 2013, and the Tax Procedure Act provide for the criminal prosecution of taxpayers who commit fraudulent VAT and input tax declarations.

1.2 Objectives of the Study

i. To determine the effect of compounding of tax offences on Value added tax compliance among micro and small taxpayers in Mombasa North Sub-County, Kenya.

ii. To establish the moderating effect of tax literacy on the relationship between compounding of tax offences and value-added tax compliance among micro and small taxpayers in Mombasa North Sub-County, Kenya.

2. Literature Review

2.1 Theoretical Review

Compounding allows taxpayers to resolve offenses through negotiated payment rather than face prosecution. Empirical studies suggest that compounding can enhance compliance while reducing administrative costs. In the Indian context, the Income Tax Department of India (2024) found that taxpayers who used compounding schemes showed higher compliance in subsequent years, suggesting that structured settlements can help boost regulatory trust. Where prosecutions were settled through compounding, re-offending decreased and prosecution and reporting increased, especially among SMEs that may view prosecution as too expensive. Baldwin Cave and Lodge (2012) provide evidence that compounding works well if tax authorities are fair and transparent, and these findings can be directly linked with the principles of regulatory governance.

Refusing to issue TCCs is an administrative arrangement that bars recalcitrant taxpayers from accessing government procurement infrastructure and obtaining a license. In Kenya, the Kenya Revenue Authority (KRA, 2023) links issuance of the country's tax compliance certificate to compliance with tax obligations. Economics and reputation drive incentives for businesses to comply, but noncompliance hinders doing business. Generally, any measure that impedes access to government contracts will raise voluntary compliance, especially among businesses and high-value taxpayers. The International Monetary Fund (IMF, 2022) says. While this trend is broadly observed in Nigeria (FIRS, 2024), its effectiveness in linking compliance to economic privileges is evidenced by the fact that withdrawal of TCCs is a strong deterrent for corporate taxpayers.

Administrative regulations, primarily audits, strongly affect taxpayers' behavior. Auditing affects the propensity to report accurately, and this effect is stronger at higher audit frequencies, consistent with the theory that auditing's deterrent power lies in increasing the certainty of detection rather than the severity of sanctioned punishment. Alm and Torgler (2011) confirm that audit certainty and host productivity significantly increase the compliance effect,

underscoring the value of effective administrative capabilities in tax authorities. Slemrod (2019) reached similar findings, arguing that continued or improved tax compliance is closely linked to official responses to tax violations, such as the strategic use of audits and administrative sanctions.

Empirical research shows that tax deterrence mechanisms take many forms, such as legal enforcement (prosecution), social and reputational enforcement (public exposure), administrative enforcement (compounding), and economic and institutional exclusion (denial of TCCs). (Alm, Burgstaller, Domi, März & Kasper, 2023). The evidence clearly shows that no single method is effective without support from another. But a combination of prosecution, visibility, flexibility, and access-based sanctions, all part of enforcement, gives the best and most lasting results (OECD, 2024; Yang Zhao & Zhou, 2024).

2.2 Empirical Review

Compounding allows taxpayers to resolve offenses through negotiated payment rather than prosecution. Empirical studies suggest that compounding can enhance compliance while reducing administrative costs. In the Indian context, the Income Tax Department of India (2024) found that taxpayers who used compounding schemes showed higher compliance in subsequent years, suggesting that structured settlements can help boost regulatory trust. Where compounding was promoted, re-offending decreased and prosecution and reporting increased, especially among SMEs that may view prosecution as too expensive. Baldwin Cave and Lodge (2012) provide evidence that compounding works well if tax authorities are fair and transparent, and these findings can be directly linked with the principles of regulatory governance.

2.3 Conceptual Framework

The conceptual framework maps and describes the relationships between the concepts used in the study.

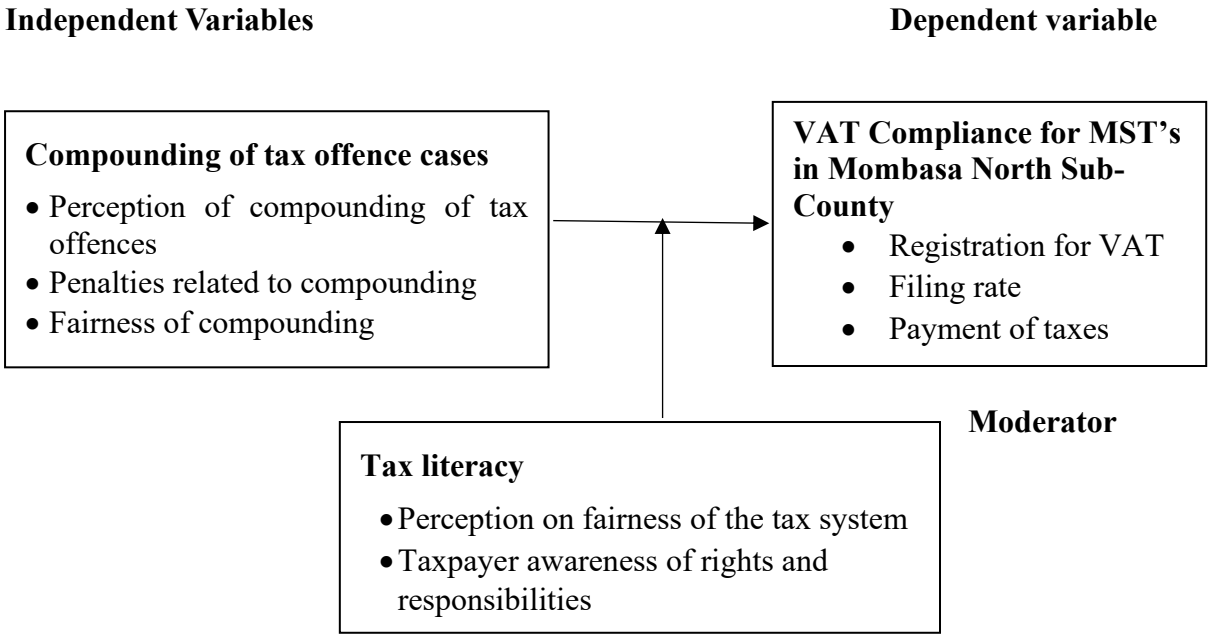


Figure 1: Conceptual Framework

3. Methodology

This study used explanatory research to examine the relationship between tax investigation deterrence techniques and value-added tax compliance. KRA records indicate around 3,716 MSTs in Mombasa as of the 2025 financial year. The study focused on business owners/financial managers in these MSTs because they are closely involved in managing tax affairs and reporting business revenue performance. This provided valuable insights into the effects of tax investigations. The sampling frame used for this study was all 3,716 MSTs in Mombasa North Sub-county. The study used simple random sampling to select the sample. This ensured that every MST in the sampling frame had an equal chance of being selected, avoiding selection bias. The sampling process involved listing all MSTs in Mombasa North Sub-county. We then assigned a number to each MST. The lottery method was used to identify 361 unique numbers. Based on the numbers drawn, MSTs corresponding to the unique numbers were selected and included in the final sample. We collected primary data using structured questionnaires that participants completed. A well-designed questionnaire captured consistent, comparable data by collecting information across factors. Responses were checked to ensure all information was complete. The results were reported using summary statistics, such as tables. Where appropriate, descriptive and inferential tests were used. The collected data were presented using descriptive statistical methods, including the mean, standard deviation, frequency distributions, percentages, graphs, and tables. Inferential statistics performed were Pearson correlation analysis, Spearman correlation analysis, linear regression and hierarchical moderated regression. The results are based on a 95% confidence interval.

4. Results and Discussion

4.1 Descriptive Statistics of the Study Variables

Descriptive statistics summarize the average perceptions and dispersion of responses for tax offense compounding, VAT compliance, and tax literacy. As shown in Table 1, the mean score (M = 4.112, SD = 0.675) indicates that respondents generally report high self-reported compliance in VAT compliance (M = 4.111, SD = 0.675) and tax law literacy (M = 3.617, SD = 0.482). Compounding (M = 3.502, SD = 0.438) had moderate means, suggesting respondents perceived it as a moderate deterrent strategy. Overall, respondents have positive attitudes toward compounding of tax offenses as an enforcement strategy and relatively high levels of VAT compliance.

Table 1: Descriptive Statistics for the Study Variables

	N	Minimum	Maximum	Mean	Std. Deviation	Skewness
	Statistic	Statistic	Statistic	Statistic	Statistic	Statistic
Compounding	361	1.4000	5.0000	3.502770	.4381693	-.290
VAT Compliance	361	2.0000	5.0000	4.111773	.6751079	-.513
Tax Literacy	361	1.0000	4.4000	3.617590	.4822425	-.987

4.2 Correlation Analysis

As shown in Table 2, VAT compliance was positively and significantly associated with compounding (0.386), and tax literacy was positively and significantly associated with VAT compliance (0.500).

Table 2: Pearson and Spearman Correlations with VAT Compliance

Variable	Pearson r with VAT compliance	Pearson p	Spearman ρ with VAT compliance	Spearman p
Compounding	0.386	< .001	0.376	< .001
Tax literacy	0.5	< .001	0.483	< .001

Note. The complete Pearson and Spearman matrices are reproduced in Appendix E.

4.3 Regression Analysis

Compounding had a significant positive effect (B = 0.316, β = 0.205, t = 3.967, p =0.000), leading to rejection of H0. Similarly, Muhwaa and Omboi (2023) found that penalties and interest strongly affect compliance among Kenyan SMEs, while Trifan, Szentesi, Cuc and Pantea (2023) showed that when penalties are combined with other institutional factors, they can improve compliance among SMEs.

Table 3: Regression Coefficients for Investigation and Enforcement Strategies

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	0.511	.333		1.537	.125
Compounding	.316	.080	.205	3.967	.000

4.4 Moderation Analysis

The interaction term for tax literacy and compounding of tax offences (β=-0.094, p=0.229) did not have a significant effect on VAT compliance.

Table 4: Hierarchical Regression Coefficients for Tax Literacy Moderation

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.175	0.298		3.946	0.000
	Compounding	0.187	0.073	0.182	2.571	0.011
2	(Constant)	0.584	0.278		2.096	0.037
	Compounding	0.113	0.066	0.109	1.694	0.091
	Tax Law Literacy	0.402	0.046	0.411	8.819	0.000
3	(Constant)	0.778	0.282		2.761	0.006
	Compounding	0.111	0.067	0.108	1.654	0.099
	Tax Law Literacy	0.37	0.047	0.378	7.939	0.000
	X*M	-0.094	0.078	-0.074	-1.205	0.229

5. Conclusion

The study concludes that compounding can be a useful tool to make tax administration more effective in promoting VAT compliance among micro and small taxpayers. The size of its regression effect implies that enforcement has an impact on taxpayers' behaviour when there is a clear consequence of the offence and a formal process for possibly resolving the offence. Similarly, Muhwa and Omboi (2023) show that financial sanctions can affect MST's compliance, but they are more effective when transparent and proportionate. The benefit of compounding is not just imposing a fine, but also providing an effective pathway for taxpayers to resolve non-compliance and become compliant. KRA should guarantee its consistency, sensitize taxpayers about it and ensure procedural fairness.

The study findings suggest that tax literacy is a key independent factor in understanding VAT compliance but does not appear to be a significant moderating factor in tax enforcement relationships. This finding suggests that increasing taxpayer understanding can boost compliance even without corresponding increases in the effectiveness of prosecution, compounding, or publicity, or the existence of the TCC cancellation. Recent evidence from Kenya by Kandagor Ogaga and Koske (2024) and Bett, Ogaga and Limo (2024) confirms the importance of tax knowledge and its role in facilitating compliance among SMEs. Taxpayer education should be seen as a compliance strategy, not just an enforcement tool. Overall, the study supports a balance between credible enforcement and accessible tax knowledge, though they are only partially independent.

6. Recommendations

The study found that compounding of tax offences has a positive and significant effect on VAT compliance. Based on this, KRA management should implement transparent, well-understood compounding strategies to improve VAT compliance. The management should ensure that the procedure for compounding are clearly communicated to the MST VAT taxpayers. Tax policymakers should also strengthen policies regarding compounding of tax offences in order to ensure it continues to effectively increase VAT compliance.

The study also found that tax literacy does not moderate the relationship between compounding of tax offenses and VAT compliance, but it does directly affect VAT compliance. The study therefore recommends that management adopt taxpayer education programs to increase tax literacy, not to support enforcement strategies but to increase VAT compliance. The study also suggests that policymakers should develop policies to guide education for MST taxpayers to increase their tax literacy.

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