

# TAXPAYERS KNOWLEDGE AND VALUE ADDED TAX COMPLIANCE AMONG MICRO AND SMALL ENTERPRISES IN EMBU COUNTY, KENYA

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**Abstract:** Developing and developed countries of the world have been relying on revenue collected from the formal and informal sectors to develop the economy. Economic growth among developing countries has been associated with Compliance of Micro and Small Enterprises with VAT. However, despite the role of VAT in economic developments among developing countries, majority of Small Enterprises have continued to evade in complying with VAT thus posing a great challenge to the economies of developing countries. This study aimed at establishing the influence of taxpayers' knowledge and value added tax compliance among Micro and Small Enterprises in Embu county, Kenya. The specific objective of the study was to establish the effect of education of taxpayers on VAT compliance among micro and small enterprise in Embu County, Kenya. This study was anchored on rational choice theory. The study adopted cross-sectional research design since it facilitates discovery of new knowledge thus prediction and control of the problem. The target population of the study was 557 micro and small enterprises as per the records of Ministry of Trade in Embu County. Stratified sampling technique was used to select the sample size of the population. To arrive at the ideal sample size of 233, scientific formula proposed by Israel was adopted. Unit of analysis were owners of registered micro and small enterprises in Embu County while unit of observation were registered micro and small enterprises in Embu County. The primary data was collected using a structured questionnaire consisting of close and open-ended questions. In addition, secondary data was collected using content analysis method. The analysis of data was done using Statistical Packages for Social Sciences (SPSS Version 24). Data was analyzed descriptively in form of mean scores, standard deviation, frequency table and percentages. Further, multiple regression analysis was conducted at 95% confidence level and 5% significance level to establish the statistical relationship between variables. Qualitative data obtained from published content was reviewed and deductive arguments were made in relation to the research objective. The analyzed quantitative data was presented in tables and figures. Findings of this study revealed that there exists a positive significant relationship between education of taxpayers and value added tax compliance among micro and small enterprises in Embu County, Kenya. The study concludes that despite that fact that there exists a positive relationship between taxpayers' knowledge and value added tax compliance, numerous challenges were experienced such as lack of awareness, complexity of technology and lack of willingness from taxpayers to submit VAT on time. This study recommends that Kenya Revenue Authority should partner with other agencies like ICT firms, County Governments and law reinforcement agencies to promote the spirit of VAT compliance among small scale traders in Kenya, thus sustainable social economic developments.

**Keywords:** Taxpayers knowledge and Value Added Tax Compliance.

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## 1. INTRODUCTION

Compliance to taxation policies has been a challenge among developing and developed countries around the globe (Charlet & Owens, 2010). Majority of the countries which have economic stability have been associated with efficient and effective taxation policies and systems that enhance individual and organizational compliance to taxation policies. Developed countries of the world ranging from The United States of America, China, Japan and Germany have efficient taxation systems that monitor and track individuals and firms to comply with submission of taxes at the right time without evasion and this can be considered to be the major reasons for the ability to mobilize adequate resources for socio-economic developments (Arum, 2012). Compliance of the business community to VAT regulations is conceptualized to be one of the factors that accelerate economic developments in developed economies of the world (Kariyoto, 2010). Similarly, Yayuk, Margono, Eka and Sudjatno (2017) in Indonesia opine that public perception of tax systems in any economy are largely dependent on participation and awareness of taxpayers. Taxpayers are always seen to be cooperative on tax liabilities in accordance to provisions of tax legislations without necessarily threatening, warning or applying legal and administrative sanctions. Counseling, discussions and delivery of tax information to potential taxpayers are thought to be some of the factors that endorse compliance with taxpayers. According to Klemm and Parys (2009), value-added tax is regarded as one of the approaches adopted by countries in developing countries especially Kenya in raising revenue to fund development projects. Being one of the indirect taxes, it is attributed with 80% contribution of total tax revenue (Saleemi, 2005).

Compliance to VAT has been the key concern among developing and developed countries of the world for the last decade. It is argued that the rationale behind economic development of any country is based on VAT compliance. Despite high cases of non-compliance to VAT from industry players including micro and small enterprises and large firms, developing countries should strive to develop mechanisms that will enhance VAT compliance from the formal and informal sector for socio-economic developments. Taxpayers' knowledge is thought to be the degree to which individuals or organizations understand and voluntarily comply with VAT. Akintoye and Tashie (2013) argue that taxpayers' knowledge on VAT policies is one of the fundamental aspects that contributes to the economic growth of both developed and developing countries of the world directly or indirectly if appropriate mechanisms are put in place by tax collection institutions. Traders' ability to have education, maximum awareness, structure of the tax system and regulations on taxpayers are thought to influence VAT compliance among small enterprises. Value Added Tax is regarded as a form of indirect tax imposed on goods and services produced in a country (Schenk & Oldman, 2007). In addition, VAT involves the cost and overheads that a trader incurs and obtains respectively after purchasing and selling goods and services. Both developed and developing countries can change VAT policies from time to time based on a number of factors that range from policies, economic, social, technological and ecological and legal. Firms that engage in any commercial activities that involve the production, distribution of goods and the provision of services are likely to comply with taxation policies of each country in which they operate (GoK, 2004).

According to KNBS (2012), compliance of MSE's to VAT policies has contributed to significant economic growth among developing countries of the world. Kenya being one of the developing countries, the increased number of MSE's in the recent past has created a positive impact on the economy through increased indirect taxes. Mechanisms that have been put in place by revenue collection agencies have yielded positive results. The larger the informal economy, the more a government has to rely on indirect taxes. Technology has significantly contributed to improved revenue collection services from MSE's. The initiatives of the Government to create VAT compliance through the media has enhanced public awareness and personal and firm accountability and transparency in submission of VAT.

According to Kimunga (2009), it is evident that MSE's contribute to 72% of the Gross National Product. Through the new constitution of Kenya that was established in 2010, it is evident that MSE's are the major driving forces behind interrelated flow of trade, investment and technology at the County level. According to KNBS (2011), micro and small enterprises are active instruments for rural and urban development as they eliminate high level of unemployment and stimulate economic developments. However, despite the role of MSE's in the Kenyan economy, many are the challenges experienced by the small and micro enterprise sector. Some the challenges range from inability to raise adequate capital to expand the business, inability to meet their financial obligations, poor management, stiff competition, inability to adopt appropriate technology to enhance efficiency and effectiveness and deliberate evasion of paying taxes or complying to tax regulations. Kimunga (2009) asserts that the informal sector in Kenya has significantly contributed to increased revenue collection by the Government. It is evident that the indirect taxes collected from MSE's have greatly contributed to

economic stability compared to direct taxes in the past decade. Despite the contribution of SME's in the growth of the economy, compliance to VAT policies has been an issue of concern from various stakeholders such as Kenya Revenue Authority.

## 2. PROBLEM STATEMENT

According to Kenya National Bureau of Statistics (2017), the Government of Kenya has continued to realize a decline in the total revenue collected from business enterprises and more specifically from micro and small enterprises. Despite existence of legal frameworks on VAT compliance, it is observed that majority (81%) of the micro and small enterprises in Kenya do not submit VAT as required by law. Legal and administrative costs of non-compliance among taxpayers have resulted to slow economic growth. Further, due to violation of VAT regulation, most of the micro and small enterprises are recording declined profits due inconsistencies in service (Lumumba et al., 2010). Despite the efforts of the government to maximize on revenue collected periodically, it is observed that tax collection institutions and more specifically Kenya Revenue Authority has continued to underperform in terms of total amount of tax collected annually thus raising concerns that need to be investigated (Gitaru, 2017). Jeffkins and Thomson (2016) established that there is a correlation between tax compliance by business entities and economic growth in Australia. Further, Kim and Chen (2015) revealed that there was a difference between economic stability and tax compliance among individuals and business entities in China. Morgan (2014) established that tax compliance was significantly correlated with economic developments in Egypt despite challenges of adherence from key stakeholders.

Locally, Okello (2001) noted that developing countries of the world including Kenya have been on the forefront to raise revenue from the formal and informal sectors to fund socio-economic developments. Direct and indirect taxes collected by Kenya Revenue Authority have continued to contribute significantly to economic growth despite challenges of Micro and Small Enterprises complying with VAT policies. A survey by IPSOS (2015) on Knowledge on Tax Issues in Kenya established that majority (63%) of MSE's operating in Kenya are not compliant to VAT. Non-compliance of business with VAT regulations has resulted in slow economic growth and development for a number of decades. A sound tax system can facilitate economic growth though regulation of product and service prices, provision and real income, savings and investment. Masinde and Muyundo (2012) studied on unlocking the revenue potential in Kenya and revealed that he Micro and Small Enterprise in Kenya have continued to play a major role in economic developments through indirect taxes. However, despite the growth of MSE's, many are the challenges experienced by KRA during collection of revenues from MSE's in form of VAT. A number of challenges that have been associated with non-compliance to VAT among Micro and Small Enterprise sector range from; taxation policies, management and systems.

A survey by Institute of Economic Affairs (2011) on taxation in Kenya established that VAT was directly correlated with economic developments despite the challenges of complying with new VAT regulation by industry players. The Government has experienced a significant improvements of economic growth by 24%. It is concluded that efficient tax systems should embrace the principle of simplicity, adequacy and neutrality. However, from the findings of previous studies by Gitaru (2017); Kenya National Bureau of Statistics (2017); Lumumba et al., (2010); Jeffkins and Thomson (2016); Kim and Chen (2015); IPSOS (2015); Morgan (2014); Masinde and Muyundo (2012); Institute of Economic Affairs (2011) and Okello (2001), it is observed that the researchers examined variables of the current study in isolation or partially. Further, some studies were conducted in different geographical and cultural environment such as in China and Australia. Moreover, based on the small sample size used and non-probability sampling techniques and data analysis methods such as factor analysis, the findings were inconclusive to be generalized in this study. Therefore, it is on this background this study sought to investigate taxpayers' knowledge and value added tax compliance among micro and small enterprises in Embu County, Kenya.

### Research Objective

(i) To determine the effect of education of taxpayers and value added tax compliance among micro and small enterprises in Embu County, Kenya.

### Research Questions

(i) How does education of taxpayers influence value added tax compliance among micro and small enterprises in Embu County, Kenya?

### 3. LITERATURE REVIEW

This study was anchored on rational choice theory pioneered by Clarke and Marcus in 1993. The theory argues that consumers are rational in decision making. Rationality of consumers is based on the satisfaction consumers obtain from the social exchange (Purnamasari Hamid & Susilo, 2015). Individuals or firms always seek to maximize utility of goods and services at the lowest price possible. Consumers always change their choices depending on the satisfaction they get after consuming goods and services (Saleemi, 2005). By extension, the theory is linked to the behaviour taxpayers display when submitting VAT. Taxpayers may not comply with VAT based on economic constraints. Even though economic stability may have indirect influence on VAT compliance from context to context, to a larger extent it is viewed that income and expenditure can be key factors that influence rationality of consumers in any system (Alfiah, 2014). Further, Akintoye and Tashie (2013) opine that firms are likely to evade VAT if they do not generate the expected profits to meet financial obligations. Practices of non-compliance to VAT policies by formal and informal sectors are influenced by tax system failures, lack of education and awareness among citizens of a country. Randolph (2015) contends that accountability of public expenditure by the government is likely to enhance citizen participation and accountability in tax submission. Development of policies that discourage people from tax evasion will be enhanced by law enforcement. This theory underpins this study based on the notion that the institutions of revenue collection are likely to minimize cases of non-compliance to VAT among MSE's through establishing tax regulation that are thought to address economic challenges of small and larger business enterprises. Creation of maximum awareness by the government on the value of VAT to individuals and firms will accelerate compliance thus sustainable economic development.

### 4. EMPIRICAL LITERATURE

#### Education of Tax Payers and VAT Compliance

Asirigwa (2011) revealed that educating tax payers on the consequences of complying with VAT has a significant effect on economic stability of a country. Changing the behavior of tax payers is based on two types of knowledge. IPSOS (2015) further indicated that educating taxpayers on the implications of evading from submitting VAT will be determined by understanding the taxation regulations and information pertaining the opportunity or consequences of evading taxes. However, it was noted that the survey focused on manufacturing sector and addressed different variables like government subsidies but failed to address variables of this study. Chilibasi (2012) also noted that tax knowledge can be divided into; formal education that entails knowledge received by tax payers to have an in-depth understanding of the implications of evading taxes. The education received by taxpayers involves a thorough understanding of the laws and regulations of taxation and the ability to comply. However, the study was confined to different variables like tax policies, business growth but failed to address variables of this study. Otieno (2011) studied the effect of taxpayers' education on VAT Compliance among Small and Medium Sized Enterprises in Kenya and established that, despite the increased number of Micro and Small Enterprises in Kenya, majority (72%) of them are not compliant to VAT. It was noted that most of the industry players were willingly dodging to submit their VAT due to inappropriate mechanisms to monitor and track business transaction. However, it was noted that the study was confined to one variable and concentrated on Small and Medium Sized Enterprises in Mavoko Municipal Council.

Charlet and Owens (2010) established that educating taxpayers through seminars, dialogue, sessions and collaborations with the Ministry of Education will enhance compliance to VAT. On the other hand, Tax authorities should use a combination of channels to educate people of the benefits associated with compliance to VAT. Multiple channels that can be used by tax authorities to educate taxpayers on the benefits associated with accountability and transparency may range from television, radio, newspapers and internet. Changing taxpayers' attitude on compliance to VAT is correlated with the Government's ability to be accountable on the revenue collected to its citizens. Lack of accountability by the Government on revenue collected would automatically affect attitudes of taxpayers on submitting taxes and vice versa. However, the study was confined to firms in United States of America but not in Kenya. Gekonge and Ntabo (2016) noted that non-compliance cases were likely to be reduced if only tax rates were to be reduced and tax systems simplified to meet stakeholder needs. The study revealed that non-compliance can take several forms that range from traders selling goods and services without issuance of receipts, failure of traders to charge VAT on goods and services sold, failure of traders to file returns, under declaration of output to evade VAT and failure of traders to register despite meeting the necessary requirements to the commissioner of VAT. Further, the study postulated that with little awareness of compliance to VAT regulations among MSE's, the Kenyan government has embarked on initiatives that will create an effect on VAT

compliance among taxpayers. These initiatives range from: imposing heavy penalties to VAT defaulters, to provision of reprieves to tax evaders. The major aim of doing this is to encourage taxpayers to voluntarily pay all the taxes due to the tax authority at the right time without escaping. However, it was noted that the study was limited to electronic tax systems and failed to address taxpayers' knowledge on VAT compliance.

## 5. METHODOLOGY

The study adopted cross-sectional research design to collect information at a particular point in time for analysis and presentation in a quantitative manner. The target population of this study consisted of 100 micro and small enterprises in Embu County, Kenya as per the records of the Ministry of the Trade as at July 2018. An approximate of 557 respondents selected from 100 MSE's were the participants of the study. The respondents of this study were selected using random sampling technique. Out of the total population of 557 respondents, an ideal sample size of 233 respondents was arrived at using Israel (2009) formula. Primary data was collected using structured questionnaires with closed-ended questions. The items of the questionnaire were measured using a Likert scale where 5 denotes strongly agree, 4 denotes agree, 3 denotes moderately agree, 2 denotes disagree and 1 denotes strongly disagree. Quantitative data was analyzed using descriptive and inferential statistics such as correlation and regression analysis methods. The specific regression model was of the form:  $Y = \beta_0 + \beta_1 X_1 + \epsilon$ , where; Y represents taxpayers compliance to VAT which is the dependent variable,  $\beta_1$  represents regression coefficient,  $X_1$  represents independent variable which is education of taxpayers while  $\epsilon$  is the error term (0.05) that represents other factors that were not included in the model. A total number of 233 questionnaires were administered to respondents but only 189 questionnaires were received which translated to 81 % response rate which was above 50% as recommended by Fisher (2010). The analyzed data was presented in form of tables and figures.

**Table 4.1: Education of Taxpayers**

Statements	5	4	3	2	1	Mean	SD
My business has an active tax payer identification pin number	56%	24%	11%	07%	02%	3.61	.664
I understand the penalties associated when I do not comply with VAT regulations	61%	20%	09%	09%	01%	3.58	.587
I keep records pertaining to income generated and expenditure	49%	36%	08%	01%	06%	3.33	.596
My business files and submits tax returns on time	21%	10%	60%	00%	09%	2.78	.884
My business declares actual income generated	21%	11%	25%	40%	03%	2.47	.673
Tax institution had done enough in educating people consequences of non-compliance	13%	18%	49%	11%	08%	2.38	.456
I understand the role of taxes in growth of the economy	16%	03%	09%	51%	21%	2.31	.356
<b>Aggregate Mean</b>						<b>3.08</b>	

Respondents of the study were asked to indicate the extent to which education of taxpayers determined compliance to VAT regulations. As shown in Table 4.1, the results indicate that the mean score for 3 of the 7 statements was more than 3.00 indicating that a few respondents agreed with the statement while the rest either disagreed or were neutral. 56% of the respondents agreed that they had active tax identification pin numbers with mean score of 3.61. 61% of them agreed that they understood penalties associated with non-compliance with mean score of 3.58. Some (49%) of them agreed that they kept records of income generated with a mean score of 3.33. Some (60%) of them disagreed that with filing and submitting tax returns with a mean score of 2.78. Some (40%) of them disagreed with declaration of actual income with a mean score of 2.47. Some (49%) of them disagreed on having education VAT non-compliance consequences with a mean score of 2.38 and 51% disagreed on having an understanding on the role of taxes in growth of the economy with a mean score of 2.31. These findings also imply that to a larger extent more than 50% of the small scale traders or entrepreneurs did not comply to VAT. The taxpayers were willing to comply with VAT regulations if their businesses had a conducive operating environment. It was also noted that some taxpayers delayed to submit or avoided to comply due to poor performance of their businesses. Further, it was noted that some taxpayers were not willing to declare actual income generated due to lack of transparency of the government in spending the revenue collected. Despite taxpayers were to

some extent aware of the consequences of non-compliance to VAT, in most cases were unwilling to submit taxes when their businesses were not performing. The findings are consistent with that of Chilibasi, 2012; Otieno (2011); Charlet and Owens (2010) who revealed that education of the taxpayer was one of the factors that contributed to compliance to VAT regulation. Taxpayers were likely to understand legal implications of non-compliance compared to non-educated taxpayers.

**Table 4.2: Correlations Coefficients on the Relationship between Education of Taxpayers and VAT Compliance**

Variable	Pearson Statistics	1	Education of Taxpayers
Education of Taxpayers	Pearson Correlation	.149**	
	Significance (2-tailed)	0.002	
	Sample size	21	
VAT Compliance	Pearson Correlation	0.032	.616**
	Significance (2-tailed)	0.000	0.023
	Sample size	83	83
**Correlation is significant at the 0.01 level (2-tailed).			
*Correlation is significant at the 0.05 level (2-tailed).			

The study sought to establish an understanding of the existence of a significant relationship between education of taxpayers and VAT compliance. As illustrated in Table 4.3, the results revealed that education of taxpayers had a significant positive effect on VAT compliance ( $r = +1$ ). The results in Table 4.2 indicate that there exists a positive significant relationship between (education of taxpayers ( $r = .616$ ,  $p < 0.023$ ) on the dependent variable (VAT Compliance). This results imply that there exists a strong positive relationship between education of taxpayers on VAT compliance

**Table 4.3: Model Summary**

Model	R	R Square	Adjusted Square	R	Std. Error of the Estimate
1	0.923	0.832	0.774		0.6173

As shown in Table 4.3, the multiple correlation coefficient (R) of 0.953 (95.3%), means that there is a strong linear relationship between education of taxpayers and VAT compliance. The independent factors that were studied explained only 83.2% of education of taxpayers on VAT compliance. This therefore meant that other factors not studied in this research contributed to 12.1% VAT compliance. Therefore, further research should be conducted to investigate the other factors (12.1%) that influence VAT compliance among small enterprises in Kenya. Adjusted R Square of 0.774 implies that education of taxpayers, contributed 77.4% of the variation in the VAT compliance among small enterprises in Embu County. Table 4.3 depicts results of regression analysis of the four predictor variables (Education of Taxpayers, Awareness of Taxpayers, Structure of Tax System and Regulations to Taxpayers) on the dependent variable (Value Added Tax Compliance).

**Table 4.4: ANOVA Test**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	69322.254	9	7702.473	220.374	.000 <sup>a</sup>
	Residual	34567.406	989	34.952		
	Total	103889.660	998			

Predictors: (Constant)education of taxpayers

b. Dependent Variable: VAT Compliance

As illustrated in Table 4.4, The F-ratio in the ANOVA tests were carried out to determine whether the overall regression model was a good fit for the data. The results of F-test; shows that  $F(9, 989) = 220.374 > 2.61$ , thus the independent

variable significantly influenced the dependent variable. The results therefore indicate that the predictor model could be used in forecasting VAT compliance.

**Table 4.5: Regression Coefficients on the Relationship between Education of Taxpayers and VAT Compliance**

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
1 (Constant)	1.256	1.2935		0.730	0.000
Education of Taxpayers	0.789	0.3232	0.152	2.452	0.011

As illustrated in Table 4.5, coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables. After conducting regression analysis, the regression equation: ( $Y = \beta_0 + \beta_1 X_1 + \epsilon$ ) became:  $Y = 1.256 + 0.789 X_1$ . From the findings of the regression equation indicated that taking all factors into account (education of taxpayers) constant at zero, VAT compliance will be 0.256. The results demonstrate that a unit increase in education of taxpayers will lead to an increase in VAT compliance by unit factors of 0.789 at 5% level of significance and 95% level of confidence. The findings correspond with that of Institute of Economic Affairs (2011), Masinde and Muyundo (2012) who established that there existed a positive significant relationship between knowledge of taxpayers and VAT compliance.

## 6. CONCLUSIONS AND RECOMMENDATIONS

This study established that there exists a positive significant relationship between education of taxpayers and VAT compliance among micro and small enterprises. However, it was pointed out that most of the entrepreneurs did not submit taxes on time despite possession active KRA pin number. Further, despite the knowledge of penalties associated with non-compliance to VAT, it was observed that most of the entrepreneurs were not willing to declare income generated from their business since they did not have confidence and trust on government expenditure on revenue collected. Moreover, it was noted that some of the entrepreneurs did not have adequate information and criteria used to collect taxes from small and larger enterprises. From the findings, this study concluded that despite the fact that education of taxpayers had an influence on VAT compliance, most of the small scale traders were not willing to submit taxes on time and declare actual income of their business. Despite having KRA business pins, it was noted that majority of them were not cooperative due to inability to understand how revenue collected was spent by the government. Despite the knowledge small scale traders had about VAT, most that the small scale traders were not compliance to VAT regulation. The study established that most the small scale traders did not submit taxes on time and were not willing to declare actual income generated by their businesses. Therefore, enlightening traders on the benefits of complying with VAT is a crucial to traders, thus social economic developments in Kenya. KRA management should recruit more staff and equip them with necessary skills to enlighten small scale traders on the values of complying with VAT.

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