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THE EFFECT OF INTEGRATED TAX MANAGEMENT SYSTEM ON TAX COMPLIANCE BY SMALL AND MEDIUM ENTERPRISES IN THE CENTRAL BUSINESS DISTRICT, NAIROBI COUNTY, KENYA

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Abstract

Tax compliance has been an issue of concern, mostly in developing countries. Small businesses are viewed as more likely to evade taxes since the owner and beneficiary of tax evasion, is more likely to also be responsible for keeping the books and filing the tax returns. The introduction of online tax systems has simplified tax compliance on small businesses and form the core group of hard-to-tax taxpayers. The objective of this study was to examine the effect of integrated tax management system on tax compliance by small and medium enterprises in the Central Business District, Nairobi County. For this a descriptive research design was adopted. A sample of 173 SMEs was selected through stratified random sampling. The multiple linear regression was used to establish the relationship between the independent and dependent variables. The study established that the amount of fines and penalties paid and tax consulting/filling expenses associated with integrated tax management system have a positive and significant relationship with tax compliance. The study concluded that the integrated tax management system influences tax compliance by small and medium enterprises in the Central Business District, Nairobi County. The study recommends that KRA should increase the fines and introduce stringent penalties for non-compliance since this would encourage small and medium enterprise owners to comply with taxes.

Keywords: Integrated Tax Management System, Tax Compliance, Tax consulting/filling expenses, Fines and Penalties, Small and Medium Enterprises

INTRODUCTION

Tax is a compulsory levy payable by an economic unit to the government with no quid pro quo to the taxpayer. It dates back to the biblical times of King Pharaoh where Israelites used to pay taxes to Egyptians when they were in captivity. Further, in the New Testament, Jesus was asked if it was right to pay tax and alleged, give to Caesar what is Caesars and to God what belongs to God (Matthew 22:21, Holy Bible). In Kenya, the colonialists imposed hut tax where each household used to pay certain amounts of money to the Governor. The 1901 Hut Tax Regulation imposed a tax of one rupee, payable in kind or through labor, upon every native hut in British East Africa. A subsequent amendment to the law allowed tax to be levied specifically on the owner of the hut (Waris, 2007).

The Kenya's tax system has undergone more or less continual reform over the last twenty years. On the policy side, rate schedules have been rationalized and simplified, a new value-added tax introduced, and external tariffs brought in line with those of neighboring countries in East Africa. At the same time, administrative and institutional reforms have taken place. Most remarkable is the creation of the semi-autonomous Kenya Revenue Authority (KRA) in 1995, which centralized the administration of tax collection (Muriithi, 2003). KRA has been able to collect and grow taxes efficiency, effectiveness and progressively (KRA Annual Report, 2013/2014). Tax collection has been progressive in nature where KRA has collected cumulative revenue in the period July 2013 - June 2014 Kshs. 963.8 billion compared to Kshs. 800.5 billion collected in the period July 2012 - June 2013 which represented a revenue growth of Kshs. 163.3 billion or 20.4 percent. To finance the Kshs. 2.234 trillion budgets for this financial year, the government expects to raise KShs. 1.358 trillion from ordinary revenue during the period (Financial Budget, 2015).

Integrated Tax Management System

Online tax filing was invented in United States, where the Internal Revenue Service's (IRS) began offering tax return e-filing for tax refunds only (Muita, 2011). Over time, the usage of the online filing system has been adopted by at least one out of five individual taxpayers. This however, has been as a result of numerous enhancements and features being added to the software over the years. Today, electronic filing has been extended to other developed countries like Chile, Malaysia, Canada, Italy, United Kingdom, Ireland, Germany, France, Netherlands, Finland, Sweden, Switzerland, Australia, Norway, Singapore, Brazil, Mexico, India, China, Thailand, Malaysia and Turkey (Ramayah, Ramoo&Amlus, 2008). Similarly, developing countries have also been embracing electronic filing of tax returns. Some of the countries, which are embracing the electronic filing, include Kenya, Rwanda and Nigeria (Muita, 2011).

In Kenya, the iTax system was launched in Kenya in the year 2011. The system allows businesses and individuals to file their returns online, view their tax dues and monitor tax status 24 hours a day, upload tax files, request for compliance certificates and actual tax payments. The system is set to integrate more than 30 banks to ensure that most taxpayers are covered. The iTax system has simplified, hastened and secured the tax compliance process, thus bringing down the cost of tax compliance in logistics. Continued implementation and operationalization of the iTax system in Kenya is expected to enhance revenue yield through deepening of the tax base, reducing compliance cost and improving revenue administration (Economic Survey, 2015).

Tax Compliance

Plumley (1996) noted that voluntary tax compliance could be explained by dimensions like timely filing of any required return, accurate reporting of income and tax liability and timely payment of all tax obligations. However, according to Terkper (2003) many small and medium taxpayers do not register voluntarily, while those who do register often fail to keep adequate records, file tax returns and settle their tax liabilities promptly. Hence, in the small business context, opportunities for evasion are high and resources are often scarce for field auditing. Even when high investments are made in auditing, uncovering unreported profits is never going to be an easy task without an adequate audit trail (Ahmed & Braithwaite, 2005).

In developing countries, the income tax compliance has been constrained by the significant number of changes to the tax laws, that are now so complex and only a handful of tax experts can understand them. This creates additional problems for compliance by taxpayers who do not have access to sophisticated tax specialists (Oberholzer, 2008). Moreover, enforcement of these laws cannot reduce non-compliance among taxpayers because some tax measures put small and medium taxpayers under severe liquidity pressure, forcing many to fold in the informal sector (Terkper, 2003).

SMEs in Nairobi

SMEs have awide range of definitions, which vary in different countries. The classification is based on the size of capital investment, the number of employees, the turnover, the management style, the annual turnover, the location and market share (Kasekende & Opondo, 2003). The number of employees or turnover in SMEs tends to be slimmer in developing countries compared to those in developed countries. FSD (2008) defines SMEs as business with 5 to 50 employees or with annual revenues of less than KShs.50 million. Nevertheless, as per the recommendation of the European Commission (2003), a venture is defined as an entity engaged in an economic activity and small and medium enterprises are those, which employ fewer than 250 persons and have an annual turnover of EUR 50 million.

In Kenya SME's were introduced to the tax system in the year 2006 through the Finance Bill of 2006, where the Turnover Tax (TOT) was formalized. That replaced the voluntarily registration by small taxpayers. SME's contribution to the GDP in Kenya has increased from 13.8% in 1993 to over 18% in 1999, (Sessional Paper No. 2 of 2005), over 25% in 2011/2012 (Economic Survey, 2012) and 26.8% in 2014/2015 (Economic Survey, 2015). The government of Kenya through the SME's taxation has been able to meeting its objective by improving tax compliance and thus enhancing tax collection. Further, encouraging filing of tax returns and enticing more taxpayers into the tax bracket through the iTax system and constant training.

Research Problem

The taxation of SMEs has come to attract increasing attention in recent years, in developed and developing countries alike (ITD, 2007). Tax compliance has been an issue of concern, mostly in developing countries as governments are seeking ways to improve efficiency in tax revenue collection to finance their budgets. Small businesses are viewed as more likely to evade taxes since the owner, and beneficiary of tax evasion, is more likely to also be responsible for keeping the books and filing the tax returns (Friedman et al., 2000). According to IFC (2007), despite the introduction of online tax systems which simplify tax compliance, small businesses form the core group of hard-to-tax taxpayers. It has been observed, from previous taxation studies that several SMEs in developing economies are non-tax compliant in spite of major reforms like the online tax filing systems since they cannot easily be located by tax administration and they pay less tax than their fair share of tax (Ahmed & Braithwaite, 2005).

In Kenya, SMEs are one of the vital pillars of vision 2030 due to the contribution to economic growth. The SME sector contributes an estimated 18% of the GDP as well as creating employment for 80% of the workforce population in Kenya. In addition, millions of shillings are generated from the SMEs business operations on daily basis, which is subject to taxation by the government. However, most SMEs do not pay the taxes and tax evasion among SMEs remains far above the ground, with a tax gap of about 35% and 33.1% in 2000/1 and 2001/2 respectively (KIPPRA, 2004).In response to this, the government through KRA has introduced the iTax system to enhance compliance. However, despite the introduction of the Integrated Tax Management System whose main aim was to simplify tax return submissions statistics show most SMEs are yet to embrace the system and tax evasion remains far above the ground. Thus, an investigation of the effects of integrated tax management system on tax compliance by small and medium enterprises in Kenya is vital.

Various studies have been advanced internationally and locally on tax compliance among small and medium enterprises. For instance, Azmi et al (2010) established that improving aspects of the e-filing system that would enhance taxpayer's perceived ease of use, usefulness and reduce the riskiness of the system are essential to increase adoption of the e-filing system. In Kenya, Mandola (2013) found that a majority of the taxpayers consider the development of integrated tax management system a beneficial idea that motivated them to comply with their tax obligations. Ochola, (2012) also revealed that tax knowledge on the introduction of ITMS had a significant impact on tax compliance by large corporations. However, the most studies focus on large corporations who have qualified staff who understand the online tax system compared to most of the SME owners who are not conversant with technology. Thus, there exists little studies on the effect of iTax on tax compliance by SMEs in Kenya hence a gap in literature which requires investigation. Hence, this study intends to determine: What are the effects of integrated tax management system on tax compliance by small and medium enterprises in Kenya?

Research Objective

To determine the effect of integrated tax management system on tax compliance by small and medium enterprises in the Central Business District, Nairobi County

LITERATURE REVIEW

Various studies have been carried out by different researchers both locally and internationally in relation to the subject matter. For instance, Brondolo (2009) conducted a study on the challenges facing tax collection, strategies and measures responding to the challenges among EU countries during the global financial and economic crisis of 2008. The study posited that an economic downturn tends to worsen taxpayer compliance in important aspects. Consequently, tax agencies were encouraged to develop tax compliance strategies that are structured around two objectives: containing the growth in noncompliance and helping taxpayers to cope with the crisis.

Palil and Mustapha (2010) studied the tax knowledge and tax compliance determinants in Self-Assessment System in Malaysia. The study used a multiple method of questionnaires (direct and hypothetical questions) and analysis (stepwise multiple regressions and multiple regressions) to analyze the collected data. The study concluded that in the self-assessment system in Malaysia, tax knowledge has a significant impact on tax compliance and the level of tax knowledge varies among respondents. Males, Malaysian, residents of Eastern region, high-income earners and taxpayers who have attended tax courses appear to be the most knowledgeable taxpayer groups. The results also established that tax compliance was influenced by probability of being audited, perception of government spending, penalties, personal financial constraints, and referent group.

In Uganda, Tusubira andNkote (2013) examined the relationship between income tax proficiencies and income tax compliance among SMEs. The study adopted a cross sectional descriptive survey design and gathered data from 326 out of 377 SMEs from Mbale district. The study established that income tax proficiencies are multi-dimensional and significant predictors of income tax compliance. The study recommended that to improve income tax proficiencies in SMEs in Uganda, intensive Uganda Revenue Authority should carry out tax education with practical knowledge to the SMEs' personnel involved in tax matters for efficient compliance.

A study by Mutascu and Danuletiu (2013) investigated the relationship between tax revenues and literacy level, using a panel model approach in Romania. The dataset covered the period 1996 to 2010 and included 123 countries. The estimations suggested that the assumed function is nonlinear, with inverted-U and U-shaped curves. More precisely, a very low literacy level was associated with reduced tax revenues. Furthermore, the study found that government inputs increase as the literacy level increases, reaching a maximum point. Beyond this level, the tax revenues decrease even if the literacy has an ascendant tendency, registering a minimum level. Finally, the tax revenues increase in a parallel manner with the literacy index.

In Kenya, Mararia (2014) also examined the effect Integrated Tax Management System (ITMS) on tax compliance by Medium and Small Taxpayers. The study targeted a sample of 100 SMS and a descriptive survey design. Data was collected using self–administered questionnaires and an interview guide. The study findings established that there was enough proof to conclude that adoption of integrated tax management system is associated with high levels of tax compliance. It also provided evidence that tax compliance cost, tax knowledge and education, and tax fines and penalties are contributory factors in tax compliance.

In their study, Muturi and Kiarie (2015) studied the effects of online tax system on tax compliance among small taxpayers in Meru County, Kenya. The study adopted a descriptive research design and data was collected using structured questionnaire, which covered all the variables of the study from 60 sampled taxpayers from Meru county tax District. The study findings revealed that online tax system does affect tax compliance level among small taxpayers in Meru County. Gwaro, Maina & Kwasira (2016) assessed the level of awareness regarding online filing of tax returns in the context of the Small and Medium Enterprises in Nakuru. The study found that only the computer literacy had significant effect on the influence of tax compliance levels amongst small and medium enterprises in Nakuru County.

Wasao (2014) also investigated the effects of online filing system on tax compliance among small taxpayers in East of Nairobi Tax District. The study adopted quantitative and descriptive methods. Data was collected using a structured questionnaire and a sample of 160 respondents chosen. The study findings established that the online system affects tax compliance levels among small taxpayers in East of Nairobi as far as registration, filing and payments were concerned. The study recommended that a further study should be done to establish how online system not only affect compliance in mines and minerals sector but also other tax districts of small taxpayers, which are considered more/less, advanced than East of Nairobi Tax District.

RESEARCH METHODOLOGY

To achieve the research objectives, a descriptive research design was adopted. Descriptive research studies are those studies which are concerned with describing the characteristics of a particular individual, or of a group. The study targeted all the SMEs in the Nairobi Central Business District and a sample of 173 SMEs was selected for the study using simple random and stratified sampling methods. The sample chosen was a factor of available time and resources to carry out the research. Data for the study was collected using a data collection form which were dropped and picked to the sampled respondents after 2 days. The collected data was analyzed using descriptive and inferential statistics using SPPS. Descriptive statistic involved the use of frequency, percentages and mean while inferential statistics entailed the use of multiple linear regressions to establish the relationship between the independent and dependent variables. The regression equation took the following form

$$Y = \beta_\circ + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \varepsilon$$

Where,

Y - Tax compliance measure using the amount of tax paid (Technical compliance)

X_1–Fines and penalties measured by the actual amount of fines and penalties (Independent Variable)

X_2–Tax compliance costs measured using the actual amount of tax consulting/ filing expenses (Independent Variable)

X_3 – Profitability of the SMEs measured using Net profits (Control Variable)

X_4 – Size of the SME measured using Net assets (Control Variable)

X_5 – Efficiency of the SMEs measured using the SMEs Total turnover (Control Variable)

$\beta_\circ$- Intercept

β_1–β_5 – Coefficients

ε – Error term

FINDINGS AND DISCUSSIONS

Summary Statistics

A total of 173 data collection forms were dropped to the sampled SMEs in Nairobi County. However, only 150 data collection forms were returned fully filled while 24 of the form were not returned. This represented a response rate of 86% which was considered sufficient for the study. Table 1 shows the descriptive summary statistics obtained from the study.

Table 1: Summary Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Amount of tax Paid	150	0	987,000	169,000	223,329.438
Fines and penalties paid	150	0	2,211,300	42,800	195,301.210
Tax consulting/filing expenses	150	0	779,000	41,100	1,008,43.831
Net assets	150	1,200	3,000,000	850,000	2,232,979.171
Net profit	150	18,900	5,453,560	462,000	695,351.590
Turnover	150	9,320	9,531,697	1,780,000	1,827,117.634

The results on table 1 indicate that the average amount of tax paid by SMEs was 169,500and the average fines and penalties paid by the SMEs is 28,000. Additionally, the results show that the average amount of tax consulting and filing expenses by the SMEs is 41100 and the average values of net assets, turnover and net profit of the SMEs were 850000, 462000 respectively. The above results indicate that some of the SMEs do not completely pay taxes thus they do not incur tax consulting and filling expenses despite them being profitable and making sales (turnover).

Correlation Analysis

Table 2: Correlation Matrix

	Amount of tax paid	Fines &penalties paid	Tax consulting/ filing expenses	Net Assets	Net profits	Turn over
Amount of tax paid	1					
Fines and penalties paid	.237**	1				
Tax consulting/ filing expenses	.352**	-.012	1			
Net assets	.021	.049	.108	1		
Net profits	.116	.002	.142	.400**	1	
Turnover	.213**	.109	.328**	.310**	.282**	1

**. Correlation is significant at the 0.01 level (2-tailed).

The results on table 2 show that tax compliance had a week positive correlation with fines and penalties and tax consulting and filling expenses as shown by the correlation coefficients of -0.237 and 0.352 respectively. The results also show that net assets, net profits and turnover have a weak positive correlation with tax compliance with correlation coefficients of 0.21, 0.116 and 0.213 respectively. These results indicate that there is weak correlation between the study variable and tax compliance.

Regression Analysis

Model Summary

Table 3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.442[a]	.196	.168	0.91237630

a. Predictors: (Constant), Turnover, Fines &penalties paid, Net profits, Tax Consulting/filing expenses, Net assets

According to the study findings on table 3, the value of R-square is 0.196 which shows that 19.6% of the variation in the dependent variable (tax compliance) is explained by the study variables while 80.4% is explained by other factors which have not been considered by the model. In addition, the r value of 0.442 indicates that there is positive relationship between the integrated tax management system and tax compliance.

Analysis of Variance

Table 4: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
	Regression	1.453E12	5	2.906E11	6.999	.000[a]
1	Residual	5.979E12	144	4.152E10		
	Total	7.432E12	149			

a. Predictors: (Constant), Turnover, Fines and penalties paid, Net profits, Tax consulting/ filing expenses, Net assets

b. Dependent Variable: Amount of tax paid

The results on table 4 indicate that the regression model is significant at 5% level of significance as the p values of 0.000<0.05. This indicates that the regression model is fit and there is a significant relationship between the integrated tax management system on tax compliance by small and medium enterprises in Nairobi County.

Regression Coefficients

Table 5: Regression Coefficients

odel		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.
1	(Constant)	3.171	.740		4.256	.000
	Fines and penalties paid	.270	.086	.236	3.129	.002
	Tax Consulting/filing expenses	.719	.176	.325	4.094	.000
	Net assets	-.008	.008	-.082	-.985	.326
	Net profits	.025	.027	.078	.944	.347
	Turnover	.010	.010	.084	.998	.320

a. Dependent Variable: Amount of Tax Paid

From the results on table 5 the regression equation can be rewritten as follows:

$$Y = 3.171 + 0.270X_1 + 0.719X_2 - 0.008X_3 + 0.025X_4 + 0.010X_5 + \varepsilon$$

Table 5 shows that fines and penalties paid and tax consulting/filing expenses have a positive and significant relationship with tax compliance while size of the SME as measured by net assets has a negative and insignificant relationship with tax compliance as shown by the beta coefficients of 0.270, 0.719 and -0.008respectively. The results also show that profitability as measured using net profits and efficiency as measured using turnover have a positive and insignificant relationship with tax compliance by SMEs in Nairobi County.

Interpretation of the Findings

This study examined the effect of integrated tax management system on tax compliance by small and medium enterprises in Nairobi County. The study findings established that some of the SMEs do not completely pay taxes thus they do not incur tax consulting and filling expenses. The study findings also established that there was a weak correlation between the study variables and tax compliance. In addition, the study established that fines and penalties paid and tax consulting/filing expenses have a positive significant relationship with tax compliance. This indicates that there is a direct relationship between fines and penalties, tax compliance cost associated with integrated tax management system and tax compliance by SMEs. The study also found that turnover and net profits had a positive and insignificant relationship with tax compliance. Additionally, the study findings established that net assets have a negative and insignificant relationship with tax compliance by SMEs in Nairobi County.

These findings concur with those of Mararia (2014) who established that tax compliance cost and tax fines and penalties are contributory factors in tax compliance. A study by OECD (2009) also established that compliance costs in addition to the tax payable, which may discourage SMEs from complying with income taxes. Weichenrieder (2007) also observed that small and medium sized businesses are affected disproportionately by compliance costs: when scaled by sales or assets since the compliance costs of SMEs are higher than for large businesses. Atawodi and Ojeka (2012) also posited that the problem of high tax rate promotes non-compliance and pushes most SMEs to remain in the informal sector.

CONCLUSIONS

The study findings have revealed that fines and penalties paid and tax consulting/filling expense associated with integrated tax management system have a positive and significant relationship with tax compliance thus the study concludes that an increase in fines and penalties associated with integrated tax management system increases tax compliance by small and medium enterprises while an increase in tax compliance costs associated with integrated tax management system positively influences tax compliance by SMEs in the Central Business District, Nairobi County. In addition, the study has also established that net assets have an insignificant positive relationship with tax compliance. Thus, the study concludes that there is no significant relationship between the size of a SMEs and tax compliance hence the size of an SME would not whether the SME complies or not. The study also established that net profits and turnover have a positive insignificant relationship with tax compliance. Thus, the study concludes that there is no significant relationship between profitability and efficiency of SMEs and tax compliance by SMEs. Finally, the study concludes that the integrated tax management system influences tax compliance by small and medium enterprises in the Central Business District, Nairobi County.

RECOMMENDATIONS

As per the study findings, the study recommends that the Kenya Revenue Authority should develop training programs for SMEs so that they can acquire additional knowledge on integrated tax management systems. The integrated tax management system should also be coupled with accounting software where KRA returns can be calculated before filing taxes to reduce taxation illiteracy. The study also recommends that KRA should increase the fines and introduce stringent penalties for non-compliance since this would encourage small and medium enterprise owners to comply with taxes. The study also recommends that SMEs to develop effective ways to ensure that they comply with taxes to ensure that they reduce the fines and penalties charge to them for non-compliance as penalties reduce profits and are not exempted for taxation purposes.

LIMITATIONS OF THE STUDY

This study examined the impact of integrated tax management system on tax compliance by SMEs in the Nairobi Central Business District thus its findings are limited to SMEs with Nairobi town and may not be generalized to SMEs in other counties in Kenya since the level of tax understanding and knowledge is different. The study used a data collection form to obtain data for the study. The questions were structure such that the respondents only provided figures and ignored other qualitative views on tax compliance. The study also did not cover other qualitative aspects like the attitude of the tax payer, corruption and tax systems which also influence tax compliance.

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