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Influence of Tax Rates on Tax Compliance in The Informal sector in Kenya: Survey of Nyeri Town

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Abstract: Tax non-compliance reduces tax collection and the tax performance within a country. The Kenyan government has implemented various strategies to bring businesses in the informal sector into the tax bracket. However, available data shows that tax collections from the informal sector are above average but on a declining trend. The purpose of this paper is to determine influence of tax rates on tax compliance in the informal sector in Nyeri town. The study adopted a cross-sectional survey design and targeted 715 informal businesses in Nyeri Town. Stratified random sampling technique was used to select 143 informal businesses to participate. Researcher-administered questionnaires were used to collect data from the respondents. Descriptive methods such as frequency distribution, percentages, mean, were used to summarize and organize data. Chi-square tests and correlation analysis were employed to establish relationships between study variables. Findings were presented using tables of frequencies and percentages. Majority (74%) of the respondents indicated that they tried their best to comply with all tax procedures. Results revealed that Majority (75%) of the respondents indicate that the taxes charged were too high. Tax rates ($p=0.000$) had a significant relationship with tax compliance at 95% confidence level. The study cited that tax rates were important predictors of tax compliance in the informal sector. It was recommended that tax rates should be reviewed for those in the informal sector to ensure that they commensurate with economic conditions.

Keywords: Tax rates, tax compliance, informal sector

INTRODUCTION

Taxation is a compulsory levy on private individuals and organizations made by governments to raise revenue to finance expenditure on public goods and services as well as to control the volume of private expenditure in the economy [1]. According to Cullis, Jones, Savoia [2] taxation can also be defined as a compulsory payment by individuals and companies to the state. It is a compulsory levy imposed by authority of the law- making body of a country or by a decree that is enforceable by law.

Tax compliance is the willingness of individuals and other taxable entities to act within the spirit as well as the letter of tax law and administration, without the application of enforcement of activity [3]. Tax authorities need to be professional, responsive, fair, open and accountable in helping the tax payers comply with tax obligations and should also be effective in bringing to account those who do not comply with their tax obligations [3]. Moreover, Improving tax compliance and reducing non-compliance means more tax collection, from the informal sector [11]. However, if the informal sector despite its expansion remains

untaxed due to noncompliance the government is likely to continue losing billions of shillings.

The informal economy under any governing system is diverse and includes small-scaled, occasional members as well as larger, regular enterprises. According to Saad [4] informal economies include garment workers working from their homes, as well as informally employed personnel of formal enterprises. Employees working in the informal sector can be classified as wage workers, non-wage workers, or a combination of both. Informal employment makes up 48% of non-agricultural employment in North Africa, 51% in Latin America, 65% in Asia, and 72% in sub-Saharan Africa. If agricultural employment is included, the percentages rise, in some countries like India and many sub-Saharan African countries beyond 90%. Estimates for developed countries are around 15% Saad [4].

The informal sector in Kenya is quite large, estimated at 34.3% and accounting for 77% of employment statistics .Over 60% of those working in the informal sector are the youth, aged between 18-35

years, 50% being women [12]. According to Chandarasorn [5] higher tax rates increase the gains from cheating from the compliance lottery view. However, it does not make much sense to lower marginal tax rates in order to reduce tax evasion [3]. Tax rate should be designed based on efficiency and equity concerns [2]. However, from a theoretical point of view, Freire-Serén and Panadés [6] opine that the relationship between the tax rate level and the amount of evaded income is one question that has not been satisfactorily resolved as of yet. These studies suggest that that higher tax rates lead to less compliance with underreported income-tax rate elasticity ranging higher tax rates also tend to stimulate tax evasion.

Statement of the Problem

In addressing the issue of taxation of the informal sector, the government introduced Turn over Tax (TOT) in 2009. This was geared towards incorporating the informal sector into the tax brackets reviewing tax procedures, record keeping, and tax computation for Small and Medium Enterprises. These steps, it was hoped, would make it easy for such businesses to file tax returns and reduce non-compliance of tax. Another strategy employed by the government involved reducing the number of taxpayers in the Value Added Tax regime by raising the VAT minimum from KES 3M to KES 5M and subjecting them to a turnover regime at 3% of gross sales.

However, from a theoretical point of view, Freire-Serén and Panadés [6] opine that the relationship between the tax rate level and the amount of evaded income is one question that has not been satisfactorily resolved as of yet. These studies suggest that that higher tax rates lead to less compliance with underreported income-tax rate elasticity ranging higher tax rates also tend to stimulate tax evasion. However, the tax compliance in the Kenyan informal sector is still low [13, 7]. In the year 2012/13, TOT performed at 31% with a total of Kshs. 136 Million against a set target of Kshs. 442 Million [14]. From the beginning of the year 2009/10, the performance of the TOT was above average but on a declining trend. This indicates a very big gap in tax compliance. Tax non-compliance reduces tax collection and the tax performance within a country. It is against this backdrop that the study sought to investigate influence of tax on tax compliance in the informal sector in Nyeri Town.

Objective of the study

To investigate influence of tax rates on tax compliance

Hypothesis

There is no significant relationship between tax rates and tax compliance among businesses in the informal sector in Nyeri Town.

Theoretical background and informing literature

This study is anchored on the theory of planned behavior showing how tax rate influence tax compliance. According to Fishbein and Ajzen [8], the theory is capable of not only clarifying the complexity of tax compliance decision making but, importantly, can also be utilized for the development of broad population compliance strategies.

The theory of planned behavior (TPB), is based on the assumption that human beings are usually quite rational and make systematic use of the information available to them [8]. Carmack & Lewis-Moss [9] explain that the theory contends that people assess the tax rates before deciding to comply or not. Engage in a behavior (intent factor).

According to Chandarasorn [5] higher tax rates increase the gains from cheating from the compliance lottery view. However, it does not make much sense to lower marginal tax rates in order to reduce tax evasion [3]. Tax rate should be designed based on efficiency and equity concerns [2]. However, from a theoretical point of view, Freire-Serén and Panadés [6] opine that the relationship between the tax rate level and the amount of evaded income is one question that has not been satisfactorily resolved as of yet. These studies suggest that that higher tax rates lead to less compliance with underreported income-tax rate elasticity ranging higher tax rates also tend to stimulate tax evasion.

According to Kopczuk [10] complexity permits additional ways to shield income from tax and, consequently, complexity increases the overall cost of taxation. Moreover Kopczuk [15] observes that complexity increases the likelihood that taxpayers make inadvertent mistakes in calculating their tax liabilities. From this standpoint, penalties are a less appealing means of enforcement, and increasing the probability of detection becomes more costly.

Conceptual framework

Higher tax rates lead to less compliance with underreported income-tax rate elasticity ranging higher tax rates also tend to stimulate tax evasion. According to Kopczuk [10] complexity permits additional ways to shield income from tax and, consequently, complexity increases the overall cost of taxation. Moreover complexity increases the likelihood that taxpayers make inadvertent mistakes in calculating their tax liabilities.



METHODOLOGY

The researcher adopted a positivist research philosophy. Positivists believe that reality is stable and can be observed and described from an objective viewpoint [16]. The study adopted a cross-sectional

survey design. The target population consisted of all the informal businesses in Nyeri Town. Data from the Nyeri County office showed that by the end of 2013, there were 715 registered informal businesses in the town.

Category	Population frequency
Second hand items	100
Shoe shinning	85
Street vendor	180
Hawkers	150
Carpentry	50
Vegetable sellers	80
Repair and construction	70
Total	715

Stratified random sampling technique was used to select the informal businesses to participate in

the study since it provided greater precision than a simple random sample of the same size.

Category	Population frequency	Sample size
Second hand items	100	20
Shoe shinning	85	17
Street vendors	180	36
Hawkers	150	30
Vegetable sellers	80	16
Carpentry	50	10
Repair and construction	70	14
Total	715	143

A researcher-administered questionnaire and a focus group discussion were used to collect data from the respondents. The data collection instrument mainly contained likert scale type questions in the form of 1=Strongly Disagree, 2=Disagree, 3=Uncertain, 4=Agree and 5=Strongly Agree. The questions were scored using the mean of the responses as follows: (1-1.499 = strongly disagreed; 1.500 - 2.499 = disagreed; 2.500 - 3.499 = not sure; 3.500 - 4.499 = agreed and 4.500 - 5.000 = strongly agreed).

Data Analysis

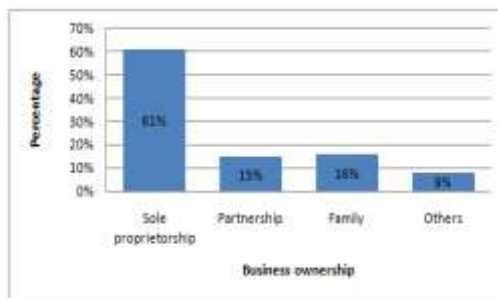
Descriptive methods such as frequency distribution, percentages, mean, were used to summarize and organize data. Pearson correlation coefficient was used to assess the influence of independent variables on the dependent variable. Chi-square tests on the other hand were employed to test the

study hypothesis. Correlation and chi-square tests were computed using Statistical Package for Social Sciences. According to Hair, Black, Babin and Anderson [17] for the test of independence a probability of less than or equal to 0.05 is commonly interpreted by applied workers as justification for rejecting the null hypothesis that the row variable is independent of the column variable. The results from the data analysis were presented using tables of frequencies and percentages.

Findings

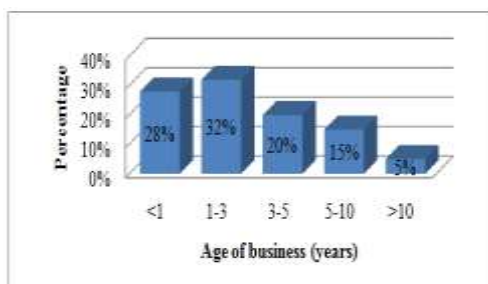
Description of businesses

Majority 61% (n=87) of the informal businesses were sole proprietorships whereas 16% (n=22) were family businesses. Due to lack of adequate capital and skill, majority of businesses are run by individuals without any formal structures.



Thirty two percent (n=46) of the participants indicate that their businesses had been in operation for

between 1 and 3 years. Business which had run for between 3 and 5 years accounted for 20% (n=28).



Majority 66% (n=93) did not have any employees apart from the owner of the business. Twenty three percent (n=32) had between 1 and 3 employees. Since the number of employees is an

indicator of the size of business, it can be said that a significant number of informal business in Nyeri were small.

Number	Frequency	Percentage
None	93	66%
1-3	32	23%
3-5	9	6%
5-10	3	2%
Over 10	5	4%
Total	142	100%

Majority 56% (n=80) had a monthly income of less than KES 10,000/= whereas those businesses that had an income of between KES 10,001/= and KES

50,000/= accounted for 28% (n=39). The findings therefore complement those in Table 4.3 which show that majority of the informal businesses were small.

Income (KES)	Frequency	Percentage
<10,000	80	56%
10,001 – 50,000	39	28%
50,001 – 100,000	21	15%
100,000 – 250,000	2	1%
Total	142	100%

Tax compliance

Forty nine percent of the respondents indicated that they were not aware of the taxes they had to pay. Majority (56%) disagreed that KRA and county officials gave them information on paying taxes. Majority (74%) also indicated that they tried their best

to comply with all tax procedures. Forty nine percent indicated that they were aware of the penalties they could face in failure to pay taxes. Majority (77%) indicated that they were unable to pay taxes due to low income.

	SD	D	U	A	SA	M	StD
I am aware of all the taxes I have to pay	12%	37%	13%	34%	4%	2.81	1.15
KRA and county officials give us information on paying taxes	13%	43%	8%	31%	5%	2.71	1.18
I try my best to comply with all tax procedures	5%	12%	9%	64%	10%	3.62	0.99
I am aware of the penalties of failure to pay taxes	4%	40%	17%	35%	4%	2.94	1.033
Sometimes I'm unable to pay taxes due to low income	4%	5%	14%	47%	30%	3.93	1.01

SD=Strongly Disagree D=Disagree U=Uncertain A=Agree SA=Strongly Agree M=Mean StD = Standard deviation

Tax rates

Majority (58%) of the participants indicated that they were unaware of the tax rates that apply to their business. Majority (75%) of the respondents indicate that the taxes charged were too high. Majority (77%) believed that a business like theirs should pay lower taxes. In addition 64% indicated that tax rates influenced their decision to pay or not to pay taxes.

Seventy six percent of the respondents indicated that if tax was reduced, they would be more committed to paying the taxes. Eighty percent of the respondents in the focus group discussion indicated that the tax rates were too high for their type of business. The findings therefore show that participants found the tax rates to be high.

	SD	D	U	A	SA	M	StD
I am aware of the tax rates that apply to my business	16%	41%	16%	21%	6%	2.61	1.17
The tax rates are too high	6%	12%	8%	41%	34%	3.83	1.19
A business like mine should pay lower taxes	5%	8%	11%	44%	33%	3.92	1.09
Tax rates influence my decision to pay or not to pay taxes	5%	13%	18%	47%	17%	3.58	1.07
If tax was reduced, I'd be more committed to paying the taxes	5%	6%	13%	34%	42%	4.03	1.11

To test the hypothesis, the researcher carried out chi-square tests. The tests were carried out in SPSS at 95% confidence level. In addition, correlation

analysis was conducted to give more information on the strength and direction of relationships between variables.

Variable	Chi-square value	df	P-value	Pearson correlation coefficient value
Tax rates	84.428	16	0.000***	0.745
Complexity of tax returns	38.396	16	0.001***	0.404

Results revealed that tax rates had a significant relationship ($p=0.000$) with tax compliance at 95% confidence level. The researcher therefore rejects the first hypothesis and concludes that there is a significant relationship between tax rates and tax compliance among businesses in the informal sector in Nyeri Town.

Discussion of findings

The study found that tax rates had a significant relationship ($p=0.000$) with tax compliance at 95% confidence level. The findings also indicated that tax rates have strong positive correlation ($r=0.745$) with tax compliance among businesses in the informal sector. The study found that that the tax rates were too high and this informed the respondents' decision not to pay taxes at times. The findings therefore show that tax rates were an important predictor of tax compliance in the informal sector. The findings are in agreement with Freire-Serén and Panadés [6] who found that higher tax rates lead to less compliance with underreported income-tax rate elasticity ranging higher tax rates also tend to stimulate tax evasion. The findings are also in agreement with Saad [4] who found that small cuts in the tax rates can lead to much larger changes in the behavior of taxpayers most importantly; it can make

them much more likely to declare their incomes honestly.

CONCLUSION

The study concludes that tax rates are an important predictor of tax compliance in the informal sector. It's apparent that, tax rates have the highest influence on business owners' willingness to pay taxes. A significant number of business owners in the informal sector were willing to pay taxes but were unable to due to low income.

Recommendations

- Tax rates should be reviewed for those in the informal sector to ensure that they commensurate with economic conditions.
- Kenya Revenue Authority should organize trainings for business owners in the informal sector to train them on tax issues such like, how taxes are calculated and how to use the online tax system.

Suggestions for further study

The current study focused on Nyeri town which is majorly urban. Future studies should be carried out in rural areas for comparative purposes. Future studies could also look into knowledge, attitudes and practices of tax avoidance in the informal sector.

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