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

BY

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A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF SCIENCE IN FINANCE, SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

NOVEMBER 2015
DECLARATION

I declare this research project is my original work and affirm to the best of my knowledge that it has not presented for any academic award in any University.

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D63/75387/2014

This research project has been submitted for examination with my approval as the University Supervisor

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Throughout the long period of preparing this project, many brilliant and exceptional people have accorded me great assistance. It is with the utmost appreciation that I thank all those who contributed their time, resources and opinions to the success of this research project.

First, I thank the Almighty God; The Creator, for being my guide, provider and for giving me strength, good health, wisdom and ability to complete this study.

I am indebted to my esteemed supervisor Mr. Herick Ondigo for the advice, directions and invaluable counsel he constantly gave to me when I needed it.

I owe special thanks to my friends, colleagues, classmates and relatives for the inspiring and supportive deeds they performed.
DEDICATION

This project is earnestly dedicated to my mother; Anne and my siblings; Grace and Wilson for their unquantifiable support and prayers offered. I could not have completed this research without constant encouragement from my relatives and friends.

May the Lord God bless you all
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<tr>
<td>CBD</td>
<td>Central Business District</td>
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<td>DC</td>
<td>Developing countries</td>
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<td>DOI</td>
<td>Diffusion of Innovation</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>IRS</td>
<td>Internal Revenue Service</td>
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<tr>
<td>IT</td>
<td>Information Technology</td>
</tr>
<tr>
<td>iTax</td>
<td>Integrated Tax Management System</td>
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<tr>
<td>KIPPRA</td>
<td>Kenya Institute for Public Policy Research and Analysis</td>
</tr>
<tr>
<td>KRA</td>
<td>Kenya Revenue Authorities</td>
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<tr>
<td>KSHS</td>
<td>Kenya Shillings</td>
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<td>SAS</td>
<td>Self assessment system</td>
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<td>SME</td>
<td>Small and Medium Enterprises</td>
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<tr>
<td>SPPS</td>
<td>Statistical Package for Social studies</td>
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<tr>
<td>TOT</td>
<td>Turn Over Tax</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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ABSTRACT

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. Despite the introduction of online tax systems which simplify tax compliance small businesses 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. To achieve the research objectives a descriptive research design was adopted and the population of interest comprised of the 1737 SMEs in the Nairobi’s Central Business District. A sample of 173 SMEs which was selected through simple random stratified sampling methods was used for the study using the population classification provided in the Nairobi City County website. Multiple linear regressions was used to establish the relationship between fines and penalties and tax compliance costs and tax compliance. The study established that the amount of fines and penalties paid and tax consulting/filling expense have a positive and significant relationship with tax compliance. The study concluded that that the integrated tax management system influences tax compliance by small and medium enterprises in the Central Business District, Nairobi County. The studies recommend 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.
CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

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 where they were in captivity. Further, In the New Testament, Jesus is asked if it is 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 the tax to be levied specifically upon the owner of the hut (Waris, 2007).

The Kenya Revenue Authority (KRA) was formed on 1st July 1995 as government agency with the mandate of collecting taxes on behalf of the Government of Kenya. It collects a number of taxes and duties, which include turnover tax, income tax, value added tax, custom duty, excise duty, stamp duty and ministerial and departmental taxes. Since KRA’s inception, revenue collection has increased noticeably, enabling the government to provide much needed services to its citizenry. These include: - free primary education, maternity services and anti-retroviral medication, defense, preservation of culture, infrastructure, health and social welfare, agricultural development, fund research, tourism recovery, increase employment and payment of
workers, protection of local industries, county government allocation and county development funds (KRA revenue report, 2013).

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 among these is the creation of the semi-autonomous Kenya Revenue Authority (KRA) in 1995, which centralized the administration of tax collection (Muriithi, 2003).

The responsibility of the government to finance public services lies therefore at the heart of taxation. Applying canons of equity, simplicity, certainty, convenience, productivity, elasticity, diversity, flexibility, neutrality, economic and administrative efficiency to tax payers, KRA has been able to collect and grow taxes efficiency, effectiveness and progressively. The tax systems and the spending of government resources creates a virtuous circle of improving fiscal performance, good governance, fair distribution of public goods and services, and ultimately strengthens state legitimacy. It promotes compliance with Kenya's tax, trade, and border legislation and regulation by promoting the standards set out in the Taxpayers Charter and responsible enforcement by highly motivated and professional staff thereby maximizing revenue collection at the least possible cost for the socio-economic well-being of Kenyans (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 Ksh. 163.3 billion or 20.4 percent. To finance the KSh. 2.234 trillion budgets for this financial year, the government expects to raise KSh. 1.358 trillion from ordinary revenue during the period (Financial budget, 2015).

1.1.1 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 program 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).

The Integrated Tax Management System (ITMS) rolled out in 2007 and failed to address certain issues including: - malfunction of online tax system locked out many taxpayers by inefficiencies and bureaucratic systems, paved way to fraud among KRA employees, had serious technical problems and ultimately were not user friendly. The iTax system was launched in Kenya in the year 2011, is implemented by Indian firm Tata to replace the previous online system (ITMS). 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 to simplify and quicken tax compliance and secure exercise, 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). Further, it has help out in reducing interaction between KRA staff and taxpayers thus eliminating cases of bribery claims. It has also allowed for reach ability among taxpayers in terms of time saving, easy access even at the comfort of their homes and offices and where there is internet connectivity. Lastly, it captures a wider geographical coverage and classes of taxpayers.

1.1.2 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).
The rationale behind the whole system of tax is consistent with three of the four major theories of tax namely; the Ability-to-Pay Principle, proportionate principle and the Equal Distribution Principle. These three principles stress equality and fairness. The Ability-to-Pay talk’s pushes that individuals should be levied taxes based on their ability to pay. The proportionate principle states that if taxes are levied in proportion to the incomes of the individuals, it will extract equal sacrifice. Lastly, the Equal distribution Principle suggests that income, wealth, and transaction should be taxed at a fixed percentage; that is, people who earn more and buy more should pay more taxes, but will not pay a higher rate of taxes (Gabay, Remotin, and Uy, 2012).

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).

1.1.3 Effect of Integrated Tax Management System on Tax Compliance

There is a big correlation between the integrated tax management system and SME’s. It is a statutory requirement for SME’s to pay tax. SME’s qualify to return various types of taxes, which must be filed each month. The iTax system has become an obligatory platform for all taxpayers for tax returns. Tax return and filling has become mandatory for all taxpayers including SME’s who were previous oblivious to the fact that only established corporate’s
comply. Therefore, SME’s are able to return zero despite the fact that they could be liable for turnover tax, thus legally evading tax. For example, In Kenya Turnover tax (TOT) is filed and remitted by the 20th day of the month following the transaction month. Failure to this means non-compliance and attracts penalties of Kshs. 10,000 per month. Manual returns are tedious to file on the part of the taxpayer and in the same magnitude to reconcile on the part of KRA (Muita, 2011), thus the use of electronic filing, which is aimed at ensuring accuracy and timely reconciliation of the data contained, since KRA’s iTax systems does automatic reconciliation and validation of the returns.

A large body of literature studies has investigated on the effect of iTax system on tax compliance by small and medium enterprises in Kenya. A study by Mandola (2013) revealed that majority considers taxpayer’s perceptions towards e-filing technology beneficial and motivated them to comply with their tax obligations. Mukabi (2014) revealed that determinants of tax compliance like perceptions, cost and knowledge have a direct influence on the taxpayer’s efforts in the turnover businesses. Ochola (2012) found out that tax knowledge on the introduction of integrated tax management system (ITMS) had a significant impact on tax compliance even though the level of tax knowledge varies significantly among respondents. Kimeu, (2014) found out that tax reforms have a positive effect on the financial performance of the real estate firms in Kenya, which were weak. Azmi et al. (2010) in Malaysia found out that perceived risk construct had a negative association with the perceived usefulness construct on their e-filing system.
1.1.4 SMEs in Nairobi

SME has a wide 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 sales, the location and market share (Kasekende, 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 formally to the tax system in the year 2006 through the Finance Bill of 2006, which introduced the Turnover Tax (TOT). That replaced the voluntarily registration by small taxpayers. According to the KRA’s Commissioner-General during the Kenya Institute of Management annual dinner in 2010, KRA collected 95% of the total government budget. 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 through the SME’s has been able to meeting its objective by improving tax compliance by enhancing tax collection, encourage filing of tax returns and enticing more taxpayers into the tax bracket through the iTax system and constant training on the same.
The KRA has ever since its formation launched various revenue compliance initiatives with a goal to transform into a modern, effective, efficient, fully integrated client-focused and interactive platform, which small taxpayers can use. With the automation and integration of tax system, SME’s have been allocated unique personal identification numbers (PINs), provided with a weekly training session/ seminar free, encouraged to procure a satellite enabled ETR machine, among others.

1.2 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) investigated the factors that lead to the acceptance of e filing among taxpayers by using technology acceptance model in Malaysia. The study 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 addition, Sharma et al, (2011) in India, analyzed the various factors that affect the acceptance of new information system in light of the some previous tested model like technology acceptance model in tax e filing. The study explained that acceptance of e-return filing can be improved by focusing perceived ease of use, perceived usefulness, perceived credibility and computer awareness. However, these studies were carried out in much advanced nations whom technology adoption is at an advanced level compared to Kenya.
In Kenya, Mandola (2013) examined the factors that influence the adoption and use of integrated tax management system by medium and small taxpayers in Nairobi’s central business district and established 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. However, the study concentrated on adoption integrated tax management system but did not investigate the effect of integrated tax management system on tax compliance. Ochola, (2012) also investigated the impact of Integrated Tax Management system on large corporate taxpayers compliance. The study revealed that tax knowledge on the introduction of ITMS had a significant impact on tax compliance by large corporations. However, the study focused on large corporations who have qualified 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 intents to determine, what are the effects of integrated tax management system on tax compliance by small and medium enterprises in Kenya.

1.3 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.

1.4 Value of the Study
This study will be of significance to policy makers including the government, the line ministries and the Kenya revenue authority in formulating policy framework for planning and organizing its policy framework. Through the examination of the effect of iTax on tax compliance, the study
to some extent will address general problems, advantages, recommendations and solutions eminent in the iTax and applicable to other sectors of the economy.

The study will also be beneficial to Small and Medium Enterprises since will provide information on non-compliance, problems and benefits of iTax to SMEs. They will be able to take keen notice when filing returns on the challenges and the benefits of paying tax. Moreover, the findings of the study may become a very resourceful reference material to small and medium taxpayers globally in planning and adoption of new technology in filing tax.

Additionally, the study will be of benefit to future scholars and researchers as the study results and recommendations may provide useful information to scholars keen on carrying out research in matters pertaining to iTax and their effect on SMEs. As such, taxation professionals and other interested parties like accountants will find the research useful especially when looking for new market. An analysis of SME’s and their lack of expertise in accounting skills provide an evident market while forecasting on future business.
CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviews the existing literature on the effects of iTax system on tax compliance by small and medium enterprises by different authors and scholars. The chapter presents an overview of the iTax system, the theoretical and empirical literature review and later a summary.

2.2 Theoretical Review

This study will explore on diffusion of innovation theory, to explain how taxpayers adopt to the new technology of tax compliance. The Fischer model elaborates the factors influencing tax compliance in line with socio-economic and psychological components on decision-making. Lastly, the Psychology theories of tax compliance assume that psychosomatic factors which include moral and ethical concerns.

2.2.1 Diffusion of Innovation Theory

The diffusion innovation theory was first developed by Lazarsfeld (1949). Rogers (2003) points out that diffusion is the process in which an innovation is communicated through certain channels over time among the members of social system. Further, innovation is a concept, practice or entity, which is seem new by potential adopters including individuals, organizations, governments and other bodies. Communication channel is the way of transmitting information from one individual or group to another. Lastly, social system is a set of units involved in joint problem solving with a common goal.
According to Rogers (1962), diffusion innovation theory seeks to describe the patterns of adoption to technology, expound on the mechanism of adoption and predicting the success rate beforehand. The theory indicates that technological innovation is communicated via particular channels, over time, among the members of a social system. The theory relates to the country Kenya in that the innovation iTax system is communicated through the various channels by the KRA and accessed via the internet to reach each individual user or group. Additionally, Rogers (2003) argues that the stage through which a technological innovation passes involves five steps, which typically follow each other in a time-ordered manner. The stages are, knowledge: an individual learns of the existence of the innovation, understands its functioning and seeks information on how to use it correctly.

The diffusion of Innovation theory has been categorized into five stages. First is the influence stage where user(s) form of a favorable attitude to the technology or innovation. Second is the knowledge stage where innovation-decision process is evaluated. Third is the resolution stage where user(s) choose to adopt or reject the innovation. According to Rogers, adoption is the full use of innovation as the most favorable course of action available while rejection is not using the innovation. Forth is the execution stage where the innovation is tested or utilized. Last is the confirmation stage, where fortification is pegged on positive outcomes from the innovation and the user(s) look for support for their decision.

2.2.2 Fischer Tax Compliance Model

The tax compliance determinants based on Fischer model (Fischer, 1992) have been an important subject of research in developed countries over the past couple of years. Fischer tax compliance
model provides a framework for understanding the influence of socio-economic and psychological components on taxpayer’s compliance decision. These factors are categorized by Fischer and associates (Fischer, 1992) into 4 groups in his expanded model. These include - Demographic (for instance - age, gender and education), Noncompliance opportunity (for example - income level, income source and occupation), Attitudes and perceptions (for instance - fairness of the tax system and peer influence) and Tax system/structure (for example - complexity of the tax system, probability of detection and penalties and tax rates). Thus, Fischer model of tax compliance incorporates economic, sociological and psychological factors into a comprehensive structure.

The Fischer model suggests that demographic variables indirectly affect taxpayer compliance by their impacts on noncompliance opportunities, attitudes and perceptions. Three major personal characteristics for which there is evidence of a relationship are age, gender and education (Milliron, 1986). In the Fischer model, noncompliance opportunity can affect taxpayer compliance directly through income level, income source and occupation and indirectly through attitudes and perceptions. Almost all the theoretical models indicate that as income rises, tax evasions should increase over most ranges (Andreoni, 1998). The respondents who report an improvement in individual financial/income status during the past 5 years are more likely to commit tax evasion than those who report a deterioration of their financial/income status during the same period (Vogel, 1974).

Partial refinement to this model has been suggested by incorporating another important environmental factor - culture and the interaction effect between noncompliance opportunity and
tax system/structure on tax compliance. Culture is considered a powerful environmental factor that affects the taxpayer’s compliance. In fact, ethical values influenced by social norms may prohibit taxpayers from engaging in tax evasion (Blanthorne and Kaplan, 2008). Hofstede identifies four underlying societal values; individualism, power distance, uncertainty avoidance and masculinity. Chan (2000) suggests that the cultural dimension affecting tax compliance is collectivism and individualism. In Hofstede’s model, individualism and collectivism refer to the degree of interdependence a society maintains among individuals.

The cultural dimension of individualism relates to the degree of integration a society maintains among its members. People focusing on themselves rather than on the group to which they belong signify a high individualism culture. Under this perspective, an individual is seen as separable from and independent of a group affiliation. People in such low individualism culture as Chinese citizens, they tend to be collectivists who are expected to follow and subscribe to the values of their in-groups in order to gain peer acceptance and social status (Hofstede, 1991). In contrast, people focusing on themselves rather than on the group to which they belong signify a high individualism culture such as US citizens. Under this perspective, they view themselves as distinct entities and place great value on individual rights. These cultural differences may have a direct impact on ethical values and moral development and ultimately affecting tax compliance decisions.

2.2.3 Fiscal Psychology Models

The theory of Planned Behavior which was developed by Ajzen (1991) and states that Psychology theories of tax compliance assume that psychological factors – like moral and ethical
Concerns are also significant to taxpayers and thus taxpayers may comply even where the risk of audit is low. This theory of tax compliance assumes that psychological factors including moral and ethical concerns are also important to taxpayers. Psychology theories de-emphasize audits and penalties; instead focus on changing individual attitudes towards tax system (Trivedi and Shehata, 2005).

According to this theory, behaviors of the individuals within the society are under the influence of specific factors, originate from certain reasons and suffice in a planned way. The ability to perform a particular behavior depends on the fact that the individual has a purpose towards that behavior (behavioral intention). Behavioral intention in turn depends on three factors that is Attitude towards the behavior, Subjective norms and Perceived behavioral control (Cobham, 2005). These three factors are also under the influence of behavioral beliefs, normative beliefs and control beliefs. The focus of this theory therefore is on the taxpayer’s morals and ethics. The theory suggests that a taxpayer may comply even when the probability of detection is low. As opposed to the economic theories that emphasize on increased audits and penalties as solutions to compliance issues, psychological theories lay emphasis on changing individual attitudes towards tax systems.

Trivedi and Shehata (2005) indicated that some taxpayers’ behavior might follow economic theories while others may follow the psychological theories and a mixture of the two is possible. Previous studies have identified nine variables as core determinants of tax compliance, namely tax rates; tax audits; perception on government spending; role of tax authority; simplicity of tax
return and administration; probability of detection, awareness on offenses and penalty; and personal financial constraint (Yong & Hooper, 2011).

2.3 Determinants of Tax Compliance

The determinants of tax compliance can divided into three categories. The social psychological determinants comprise attitudes, norms and perceptions. Motivational features relating to tax compliance, political determinants or fiscal policy and economic determinants like the rational decision-making process and the effect of audits, fines, tax rates, income on tax behavior Kirchler (2007).

2.3.1 Fines and Penalties

A fine is a criminal sanction while a penalty is a civil endorsement. Fines and penalty rates may be surrogate of each other due to their linkages as long as neither of them is set to zero (Kirchler et al 2007). Higher fines make evading taxes more rampant among taxpayers and should deter them from evasion. The deterrent effect of fines could not always be supported, as effects are weaker than expected. Further, an increase of penalties can have undesirable effect and result in more tax avoidance (Kirchler et al, (2007). From the tax administration viewpoint, compliance is said to be influenced by educating taxpayers of their social responsibilities to pay and thus their intention would be to comply. As a behavior setback, tax compliance depends on the collaboration with the public. There are better benefits in assisting compliant taxpayers meet their fiscal responsibilities rather than using more resources pursuing the minority of non-compliers. Assisting taxpayers by improving the course and quality of information or education
them in to becoming more responsible citizens has the potential to yield greater revenue than if it were spent on enforcement activities.

Penalties as well as audit probability have an impact on tax compliance. The higher the fines and penalty coupled with the potential audit probability the greater dissuasion from potential tax evasion. The extreme penalties will have no effect, if it is common knowledge that audits virtually do not occur (Allingham and Sandmo, 1972). The increasing tax avoidance and tax resistance due to an increase of fines puts into question how fines should be assessed to be effective. On the one hand, fines should be high enough to decrease the expected value of tax evasion and to assure its deterrent effect on taxpayers. On the other hand, if fines are too high, the tax system would be perceived as unjust and unfair and taxpayers would use any possibility to legally avoid taxes (Kirchler et al., 2007). In Kenya, the maximum penalty for tax evasion is 20% of the evaded amount (Sec 72 D IT Act, Cap 470).

2.3.2 Tax Compliance Costs

Tax compliance costs are incurred by taxpayers, or third parties such as business enterprises, in meeting the requirements laid upon them in complying with a given structure and level of tax (Sandford, 1989). Compliance costs can be categorized into the following depending on the scenarios of incurrence; Accounting Costs, Economic Costs, Lobbying Costs, Training Costs and Lost Revenue. The compliance costs and administrative costs are defined as the operating cost of tax (Evans, 2001). One way of measuring the compliance costs associated with taxation for businesses is to measure the number of hours it takes a business to calculate and pay its taxes. Taking the time to calculate what you owe KRA, then send it in, requires a business to give up a
more productive activity. Research using experiments typically find that high rates of tax are linked to less tax compliance with audited tax returns for individual taxpayers. This is because the high tax rates make the whole issue of tax compliance more expensive to the business people as it reduces their profits. In this regard since businesses must make extra profits to stay afloat they under declare and hind their incomes among other things resulting to noncompliance (Sandford, 1989).

The costs of complying with tax obligations have generated extensive interest among academics, government policy makers and business organizations. Combined, compliance costs and administrative costs are defined as the operating cost of taxation (Evans, 2001). Deadweight efficiency loss from taxation can be defined as opportunity costs. If the compliance costs were no longer necessary, they could be used to recruit more staff, acquire additional assets or introduce higher wages for employees (Sandford, Godwin, Hardwick and Slemrod, 1989).

**2.4 Empirical Review**

Various studies have been carried out by different researchers both locally and internationally in relation to the subject matter. Empirical review is appropriate when proof sought that certain variables affect other variables in a way. The studies are outlined to identify what was the theme of study and the gaps that have been omitted calling for further research.

**2.4.1 International Studies**

Brondolo (2009) conducted a study on the challenges facing tax collection and strategies and measures for 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. To achieve these objectives, four sets of measures were identified: expanding assistance to taxpayers; refocusing enforcement on the highest revenue risks; introducing legislative reforms that facilitate administration; and improving communication and outreach programs.

Rizalpalil and Mustapha (2010) studied the tax Knowledge and tax Compliance determinants in Self-Assessment System in Malaysia. He 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 indicate that tax compliance was influenced by probability of being audited, perception of government spending, penalties, personal financial constraints, and referent group. These results were validated through a multiple method of questionnaires (direct and hypothetical questions) and analysis (stepwise multiple regressions and multiple regressions).

Tusubira and Nkote (2013) examined the relationship between income tax proficiencies and income tax compliance among SMEs in Uganda. A cross sectional descriptive survey design was used and data was gathered 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.

Mutascu (2013) investigated the relationship between tax revenues and literacy level, using a panel model approach in Romania. The data set 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 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.

Cvrlje (2015) investigated the effects of tax literacy as an instrument of combating and overcoming tax system complexity, low tax morale and tax non-compliance in Croatia. Tax literacy in the financial dimensions possesses specific tax oriented financial knowledge on accounting and numeracy skills, required for managing tax calculations. Tax literacy was intended to help individuals receive information about taxes, to explain those taxes within a domestic system as well as regional and international system. The aim of this paper was to stress out that the complexity of the taxation system as well as some other problems like those that low tax morale and low tax compliance might be combated through promotion and implementation of tax literacy initiatives and programs. By acquiring basic knowledge of taxation and public expenditures, individuals become able to efficiently manage their personal finances and understand the basic logic of possible effects of fiscal policy. On the other side, if individuals are
not taught the basic concepts of taxation, and never acquire needed numeracy skills, they might be more prone to problems like indebtedness or non-compliance of their tax obligations.

2.4.2 Local Studies

Muturi (2005) analyzed the implementation of an online income tax filing system, which allows taxpayers in Kenya to log in from anywhere and file their tax returns online. The system was meant to cover individuals filing their income tax returns. Later it was extended to cover other categories of taxpayers including Value Added Tax (V.A.T) or Customs Duties. The research was specifically for filing tax returns in Kenya only.

Isao (2014) investigated the effects of online filing system on tax compliance among small taxpayers in East of Nairobi Tax District. The objective of the study was answered using three research questions that revolved around online tax registration, online tax filing and online tax remittances, and how each was affected by online system in order to enhance compliance. The study adopted quantitative and descriptive methods and data was collected using a structured questionnaire and a sample of 160 respondents. The study findings established that online system do affect tax compliance level 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.
Mararia (2014) examined the effect Integrated Tax Management System (ITMS) of the year 2007 on tax compliance by Medium and Small Taxpayers. The researcher identified the variables for this research to be Tax compliance, Tax compliance cost, Tax knowledge and education and perceived fines and penalties. The target population of comprised of 200 taxpayers. A total sample size of 100 was selected. A descriptive survey design was used and random sampling technique to create a sampling frame. Data is collected using self–administered questionnaires and an interview guide. The study findings provided direct evidence that Adoption of integrated tax management system is a contributory factor in tax compliance. From the study findings, there was enough proof to conclude that Adoption of integrated tax management system is associated with high levels of tax compliance. The study also provided evidence that tax compliance cost, Tax knowledge and Education, and tax fines and penalties are contributory factors in tax compliance. Lastly, to enhance tax compliance governments should enhance Adoption of E filing systems such as integrated tax management system, reduce tax compliance costs and enhance tax fines and penalties as well as tax knowledge and education.

Wasao (2014) investigated the effects of online filing system on tax compliance among small taxpayers in East of Nairobi Tax District. The objective of the study was answered using three research questions, which revolved around online tax registration, online tax filing and online tax remittances, and how each is affected by online system in order to enhance compliance. The study adopted quantitative and descriptive methods and data was collected using a structured questionnaire and a sample of 160 respondents. The study findings established that online system do affect tax compliance level 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.

Kanyi (2014) examined the reform efforts of the country with respect to revenue generated, and reviewed the strengths and weakness of the tax system as it has evolved over the years from 2003/2004 to 2012/2013. The primary objective was to evaluate the effects of Tax Policy Reforms on Tax Revenue in Kenya while the specific objectives of the research study were to establish the relationship between domestic taxes policy reforms and tax revenue in Kenya and to determine the effects of customs policy reforms on tax revenue in Kenya. The methodology used was a correlation study design. From the results, regression model of Total tax revenue on, Domestic Taxes and Customs showed that all the coefficients of the model were positive and significant at 5% level of significance. Therefore, Total tax revenue can be predicted using Domestic Taxes and Customs Duty.

2.5 Summary of Literature Review

Evident from the theoretical review, there are a few research documents exploring effects of iTax on tax compliance by SME’s in the world. The existing studies reviewed in this research provide a useful starting point for assessing factors that affect adoption and satisfaction with state iTax systems. The studies by Wasao (2014) and Muturi (2005) analyzed the implementation of an online income tax filing system, which allows taxpayers in Kenya to log in from anywhere and file their tax returns online. Isao (2014) investigated the effects of online filing system on tax compliance among small taxpayers in East of Nairobi Tax District. Others including Mararia
(2014) examined the effect integrated tax management system on tax compliance by SME’s. The researcher identified the variables for this research to be Tax compliance, compliance cost, tax knowledge and education and perceived fines and penalties. The research was not based on the integrated tax management system and nothing to do with taxpayers perceived opportunity for tax evasion, fines and penalties and internet connectivity. Cvrlje (2015) in Croatia, Rizalpalil et al., (2010) in Malaysia and Mutascu (2013) in Romania investigated the effects of tax literacy as an instrument of combating and overcoming tax system complexity, low tax morale and tax non-compliance.

Overly, the studies have established that tax noncompliance is disastrous to the KRA, National Treasury and the economy at large. Further, most of the studies have concentrated on different sectors other that the SME sector and thus there results cannot be generalized to the SME context. They also generalized the tax aspect and were not specific to turnover tax and integrated tax management system. Lastly, other studies were undertaken in the international scene and were not related to Kenyan laws, while local studies were done in varied counties other than Nairobi’s Central Business District. This opens up a gap in literature, which is worthy filling by investigating the effect of iTax on tax compliance by small and medium enterprises in Kenya.
CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the research methodology that was used in the study. The chapter includes the research design, study population, sample design, data collection instrument and concludes with data collection procedures and data analysis techniques.

3.2 Research Design

A research design can be considered as the blueprint of those procedures, which are adopted by the researcher for testing the relationship between the dependent variables and the independent variable (Khan, 2008). 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 (Kothari, 2004). According to Mugenda and Mugenda (2003), a descriptive research determines and reports the way things are and attempt to describe possible behavior, attitude, values and characteristics of such things. The study used a descriptive design because it enables the researcher to collect a large quantity of in-depth information about the population being studied. The aim of this study was to establish the effect of tax system on tax compliance among SMEs in Kenya; hence, a descriptive research enabled data collection from the population.
3.3 Population

A population is a well-defined or set of people, services, elements, events, group of things or households that are being investigated (Ngechu, 2004). According to the Nairobi County Website, there are 1737 registered SMEs within the CBD, thus, the population of interest comprised of 1737 SMEs in the Central Business District.

3.4 Sample

A sample design is a definite plan for obtaining a sample from a given population. It refers to the technique or the procedure the researcher would adopt in selecting items for the sample (Kothari, 2004). A sample of 173 SMEs was used for the study. The sample was 10% of the total population according to Mugenda and Mugenda (2003) which states that a sample of 10 – 30% is appropriate if properly selected. The sample size chosen was also a factor of available time and resources to carry out the research. Simple random and stratified sampling methods were used to obtain the sample using population classification provided in the Nairobi City County website. Stratified sampling was used to select the different categories of SMEs while simple random sampling was used to select the respondents once the categories had been identified.

3.5 Data Collection

Both primary and secondary data was used for the study. A data collection form was used to collect primary data. The data collection forms were dropped and picked to the sampled respondents after 2 days. The drop and pick method was deemed suitable since it gave the respondents adequate time to response to the questionnaires. Secondary data on the other hand was sourced, from journals, newspapers, magazines and the internet.
3.5.1 Validity and Reliability

Validity is the extent to which differences found with a measuring instrument reflect true differences among those being tested. The test of reliability is another important test of sound measurement. A measuring instrument is reliable if it provides consistent results (Kothari, 2004). To test the instruments reliability the test-retest method was used. The pre-testing was conducted to assist in determining the accuracy, clarity and suitability of the research instruments. To ensure validity the researcher engaged the project supervisor and other departmental heads who were familiar with the topic.

3.6 Data Analysis

The data collected was analyzed using descriptive and inferential statistics using SPPS. Descriptive statistic involved the use of frequency, percentages and the mean. Inferential statistic was used to draw conclusions. Multiple linear regressions was used to establish the relationship between the independent and dependent variables.

3.6.1 Analytical Model

The regression equation took the following form

\[ Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \varepsilon \]

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
- X_2 – Tax compliance costs measured using the actual amount of tax consulting/ filing expenses
X₃ – Profitability of the SMEs measured using Net profits

X₄ – Size of the SME measured using Net assets

X₅ – Efficiency of the SMEs measured using the SMEs Total turnover

β₀ – intercept

β₁ – β₅ – Coefficients

ε – Error term

3.6.2 Test of Significance

The test significance of independent variables the t-test was used while the F-test was used to test the significance of the model at 5% significance level. In addition, the coefficient of determination was used to establish the variation explained by the model.
CHAPTER FOUR

DATA ANALYSIS, RESULTS AND INTERPRETATION

4.1 Introduction

This chapter provides the descriptive statistics, the inferential statistics and the interpretation of the study findings.

4.2 Descriptive Statistics

This section presents the response rate and the summary descriptive statistics. The results obtained were as follows.

4.2.1 Response Rate

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 represents a response rate of 86% which was considered sufficient for the study.

4.2.2 Summary Statistics

Table 4.1 shows the descriptive summary statistics obtained from the study. The table presents N (the number of observations), maximum and minimum values, mean and the standard deviation.
Table 4.1 Summary Statistics

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of Tax Paid</td>
<td>150</td>
<td>0</td>
<td>987000</td>
<td>169000</td>
<td>223329.438</td>
</tr>
<tr>
<td>Fines and Penalties Paid</td>
<td>150</td>
<td>0</td>
<td>2211300</td>
<td>42800</td>
<td>195301.210</td>
</tr>
<tr>
<td>Tax Consulting filing expenses</td>
<td>150</td>
<td>0</td>
<td>779000</td>
<td>41100</td>
<td>100843.831</td>
</tr>
<tr>
<td>Net Assets</td>
<td>150</td>
<td>1200</td>
<td>3000000</td>
<td>850000</td>
<td>2232979.171</td>
</tr>
<tr>
<td>Net profits</td>
<td>150</td>
<td>18900</td>
<td>5453560</td>
<td>462000</td>
<td>695351.590</td>
</tr>
<tr>
<td>Turnover</td>
<td>150</td>
<td>9320</td>
<td>9531697</td>
<td>1780000</td>
<td>1827117.634</td>
</tr>
</tbody>
</table>

Source: Research Findings

Table 4.1 shows the summary statistics which indicates that the average amount of Tax Paid by SMEs was 169500 with a standard deviation of 223329.438 and minimum and maximum values of 0 and 987000 correspondingly. The results also indicated that fines and penalties had a mean of 42800 and a standard deviation of 195301.210 with the minimum and maximum values of 0 and 2211300 respectively.

Additionally, the results show that the average amount of tax consulting and filing expenses by the SMEs is 41100 with standard deviation of 100843.831 and maximum and minimum values of 779000 and 0 respectively. The results also show that the average values of net assets, turnover and net profit of the SMEs were 850000, 462000 and 1780000 with standard deviations of 2232979.171, 695351.590 and 1827117.634 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.
4.3 Inferential Statistics

This section presents the correlation analysis, regression analysis and the analysis of variance (ANOVA).

4.3.1 Correlation Analysis

The Karl Pearson correlation was used to establish the nature and the degree of the relationship between the study variables. Table 4.2 shows the results obtained.

Table 4.2 Correlation Matrix

<table>
<thead>
<tr>
<th></th>
<th>Amount of Tax Paid</th>
<th>Fines and Penalties Paid</th>
<th>Tax Consulting filing expenses</th>
<th>Net Assets</th>
<th>Net Profits</th>
<th>Turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of Tax Paid</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Fines and Penalties Paid</td>
<td>.237**</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Tax Consulting filing expenses</td>
<td>.352**</td>
<td>-.012</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Net assets</td>
<td>.021</td>
<td>.049</td>
<td>.108</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Net profits</td>
<td>.116</td>
<td>.002</td>
<td>.142</td>
<td>.400**</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Turnover</td>
<td>.213**</td>
<td>.109</td>
<td>.328**</td>
<td>.310**</td>
<td>.282**</td>
<td>1</td>
</tr>
</tbody>
</table>

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

Source: Research Findings
The results on table 4.2 show that tax compliance has a week positive correlation with fines and penalties and tax consulting and filing 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.

4.3.2 Regression Analysis

This section presents the model summary and the regression coefficients. The results are as shown below.

4.3.2.1 Model Summary

Table 4.3 presents the model summary which entails the R value, R square value, the adjusted R and the std. error of the estimate.

Table 4.3 Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.442a</td>
<td>.196</td>
<td>.168</td>
<td>0.91237630</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), Turnover, Fines & Penalties Paid, Net profits, Tax Consulting/filing expenses, Net Assets

Source: Research Findings
According to the study findings on table 4.3, 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.

### 4.3.2.2 Regression Coefficients

The study variables were examined to establish whether they were significant of insignificant. Table 4.4 shows the study results

#### Table 4.4 Regression Coefficients

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1  (Constant)</td>
<td>3.171</td>
<td>.740</td>
<td>4.256</td>
<td>.000</td>
</tr>
<tr>
<td>Fines and Penalties Paid</td>
<td>.270</td>
<td>.086</td>
<td>3.129</td>
<td>.002</td>
</tr>
<tr>
<td>Tax Consulting/filing expenses</td>
<td>.719</td>
<td>.176</td>
<td>4.094</td>
<td>.000</td>
</tr>
<tr>
<td>Net Assets</td>
<td>-.008</td>
<td>.008</td>
<td>-.985</td>
<td>.326</td>
</tr>
<tr>
<td>Net profits</td>
<td>.025</td>
<td>.027</td>
<td>.944</td>
<td>.347</td>
</tr>
<tr>
<td>Turnover</td>
<td>.010</td>
<td>.010</td>
<td>.998</td>
<td>.320</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Amount of Tax Paid

**Source:** Research Findings
From the results on table 4.4 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 4.4 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 -0.008 respectively. 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.

### 4.3.3 Analysis of Variance

Table 4.5 shows the analysis of variance (ANOVA) as per the study findings.

#### Table 4.5 ANOVA

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Regression</td>
<td>1.453E12</td>
<td>5</td>
<td>2.906E11</td>
<td>6.999</td>
<td>.000a</td>
</tr>
<tr>
<td>Residual</td>
<td>5.979E12</td>
<td>144</td>
<td>4.152E10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>7.432E12</td>
<td>149</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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

b. Dependent Variable: Amount of Tax Paid

**Source:** Research Findings
The results on table 4.5 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.

4.4 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 while 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.
CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter provides the summary of the findings, the conclusions from the study, recommendations for policy and practice, the study limitations and finally suggestions for further research.

5.2 Summary

The aim 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. The dependent variable was tax compliance while the independent variables included fines and penalties paid, the amount of taxes paid and tax compliance and filling costs whereas the control variables include the turnover, net assets and net profit. The population of interest comprised of the 1737 SMEs in the Nairobi’s Central Business District and a sample of 173 SMEs which was selected through simple random and stratified sampling methods was used for the study.

The study employed the regression model which yielded a R-square is 0.196 which indicated that 19.6% of the variation in the dependent variable (Tax compliance) was explained by the study variables while 80.4% is explained by other factors which have not been considered by the model. In addition, an analysis of variance was undertaken and established that the regression model was significant at 5% level of significance hence the model was fit to examine the effect of integrated tax management system on tax compliance by small and medium enterprises in the Central Business District, Nairobi County.
Additionally, the correlation results established that there was a weak positive correlation between tax compliance and all the study variables which included fines and penalties, tax consulting and filling expenses, net assets, net profits and turnover. In addition, the study established that fines and penalties paid and tax consulting/filing expenses have a positive and significant relationship with tax compliance while the size of the SME measured using the net assets had a negative insignificant relationship with tax compliance. Additionally, the study findings established that turnover and net profits had a positive insignificant relationship with tax compliance by SMEs in the Central Business District, Nairobi County.

### 5.3 Conclusions

The study findings have revealed that fines and penalties paid and tax consulting/filling expense have a positive and significant relationship with tax compliance thus the study concludes that an increase in fines and penalties increases tax compliance by small and medium enterprises while an increase in tax compliance costs 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 an inverse relationship between the size of a SMEs and tax compliance hence the size of an SME would largely determine 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 the profitability and efficiency of SMEs
influences 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.

5.4 Recommendations for Policy and Practice

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 iTax system should also be coupled with an 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.

5.5 Limitation of the Study

This study examined the impact of iTax 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 towns in Kenya since the level of tax understanding and knowledge is different.
The study used a data collection from to obtain data for the study. The questions were structured 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 taxpayer, corruption and tax systems which also influence tax compliance.

5.5 Suggestions for Further Research

Tax compliance has been a trending issue, mostly in developing countries since most governments are seeking ways to improve efficiency in tax revenue collection to finance their budgets. This study examined the impact of iTax on tax compliance by SMEs in Nairobi County; thus, this study recommends further research on the impact of iTax on tax compliance by SMEs in the rural areas in Kenya. The study also suggests an additional research on the factors and challenges influencing tax compliance by small and medium enterprises in Kenya since that would bring into light the factor behind tax noncompliance by SMEs.
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APPENDICES

APPENDIX I: Data Collection Form

My name is Ben Ngigi Maina, a student pursuing a Degree of Masters of Science in Finance, University of Nairobi carrying out a research on the effects of integrated tax management system (I tax system) on tax compliance by small and medium enterprises in Kenya. The research is purely academic in nature and any information obtained will be kept confidential to the later. Your cooperation and support will be highly appreciated.

Section I

Name/ Nature of business (Optional)………………………………………………………………………………………….

Please write the values below as at the End of the year indicated

<table>
<thead>
<tr>
<th>Independent Variables</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of Tax Paid</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fines &amp; Penalties Paid</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax Consulting/ filing expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Control Variable

<table>
<thead>
<tr>
<th>Net Assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net profits</td>
<td></td>
</tr>
<tr>
<td>Total Turnover</td>
<td></td>
</tr>
</tbody>
</table>

Thank you very much for your patience, cooperation, and support in my research.
APPENDIX II: Target Population and Sample Size Table

<table>
<thead>
<tr>
<th>Activity</th>
<th>Population</th>
<th>Sample</th>
<th>Returned Data Collection Forms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traders, shops, retail stores</td>
<td>1036</td>
<td>104</td>
<td>92</td>
</tr>
<tr>
<td>Medium Restaurants</td>
<td>134</td>
<td>13</td>
<td>9</td>
</tr>
<tr>
<td>Medium Professional Service Firms</td>
<td>163</td>
<td>16</td>
<td>15</td>
</tr>
<tr>
<td>Small Financial Services</td>
<td>241</td>
<td>24</td>
<td>22</td>
</tr>
<tr>
<td>Medium Private Education Institutions</td>
<td>72</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>Small and Medium Private Health Facilities</td>
<td>91</td>
<td>9</td>
<td>7</td>
</tr>
<tr>
<td>Total</td>
<td>1737</td>
<td>173</td>
<td>150</td>
</tr>
</tbody>
</table>

Source: Nairobi City County website (www.nairobi.go.ke) 2015