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THE DETERMINANTS OF TAX COMPLIANCE IN KENYA

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ABSTRACT

The increased need for social services and infrastructure by the citizenry has put a lot of pressure in Governments to raise additional taxes to finance public expenditure. This expenditure is best financed through tax rather than debt. As at 30th September 2017, Kenya's gross debt level stood at Ksh 4,486.8 billion. This is 51% of the estimated gross domestic product of Ksh. 8,805 billion for 2017. This is already above the World Bank and the International Monetary Fund set Debt Burden Thresholds of 40 – 50%. Sweden's tax-to-GDP ratio of 35% compares unfavorably to the Kenya situation where for the year 2016/2017, the tax-to-GDP ratio stood at 19%. The tax collection has continued to fall behind target. By the end of June 2017, total cumulative revenue collected amounted to Ksh 1,400.6 billion against a revised target of Ksh 1,455.4 billion representing a revenue shortfall of Ksh 54.8 billion. To address the challenges posed by the increasing public expenditure and servicing of public debt, there is need to increase tax revenue collection through tax compliance. This study therefore evaluated the determinants of tax compliance in Kenya. The research aimed at illuminating light onto the influence of determinants of tax compliance in Kenya and if there was a resultant benefit to the taxpayers for voluntary compliance. The Kenya Revenue Authority would also gauge if it was achieving the objectives of increasing tax compliance of its taxpayers. This study was based on the Ricardian Theory of Taxation, the Ability to Pay Theory of Taxation and the Game Theory Model of Equilibrium in Tax Compliance. This was a desk study intended to evaluate the determinants of tax compliance in Kenya. From various studies, it was established that small reductions in the marginal tax rate can have a general positive impact on revenue collection but this is only up to a point where the decrease in rate is sufficiently offset by the increased tax base and thereby a net increase in collections. It also emerged that low compliance cost were associated with high compliance level. Similarly, enforcement instruments, including the audit rates and the punishment function are also determinants of tax compliance. To increase tax compliance, this study recommended an increase in tax base by introducing tax on currently untaxed sources, variation in tax rates, reduction in complexity of returns and compliance procedures, increase in impact of tax audits, application of interest, penalties, fines and jail terms on noncompliant taxpayers and making the same public.

Key Words: *Tax Compliance, Kenya Revenue Authority*

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INTRODUCTION

The increased need for social services and infrastructure by the citizenry has put a lot of pressure in Governments to raise additional taxes to finance public expenditure. A budget deficit occurs when the government expenditures are greater than the revenues it receives. This can arise from either a shortfall of revenue, an increase in expenditures, or both (Perry, 2014). Governments borrow to finance budget deficits giving rise to national debt.

There is an important distinction between a budget deficit and total debt. The national debt is the total amount borrowed and owed by the government. A budget deficit is the yearly accrual of debt, or how much expenditures exceed revenues on a yearly basis. (Albutani & Arahabi, 2010).

According to the National Treasury's Quarterly Economic and Budgetary Review of November, 2017, the gross public debt increased by Ksh 777.5 billion, from Ksh 3,709.3 billion as at end of September 2016 to Ksh 4,486.8 billion by 30th September 2017. The debt comprises of 51.5 per cent of External debt and 48.5 per cent of Domestic debt. The overall increase is attributed to increased external debt due to exchange rate fluctuations and, disbursements from external loans debt during the period. Net public debt increased by Ksh 772.3 billion, from Ksh 3,276.7 billion as at end of September 2016 to Ksh 4,049.0 billion by end of the period under review. (The National Treasury, November, 2017). This is certainly a rapid increase in the public debt. The gross debt level therefore stands at about 51% of the estimated gross domestic product of Ksh. 8,805 billion.

The World Bank and the International Monetary Fund have set Debt Burden Thresholds for Low-income countries at 40% and 50% for Medium Policy and Strong Policy respectively under the Debt Sustainability Framework (DSF) (International Monetary Fund, 2017). Kenya is already above these thresholds. If corrective actions are not taken well in time, the accumulating national debt might lead to a debt crisis. Debt is definitely not the solution to the country's expenditure needs as debt itself requires revenue to pay it back together with interest and adverse foreign exchange fluctuations.

To enable Governments meet the expectations of its citizenry, it is incumbent upon it to find ways of increasing tax payment. One way of doing this is through encouraging voluntary compliance. All revenue collection agencies in the world are always concerned about tax compliance of its taxpayers. Tax compliance has always been a concern from the time of conception of the idea of taxation. Taxation is as old as civilization. Bird (2012), postulates that in most developing countries, more than half of the potential tax revenues tend to remain uncollected. This he further accredited to the large volume of the informal sector, dominated by the small business owners. Some countries have a high tax-to-GDP ratio; Sweden, for example, had a tax-to-GDP ratio of 35% as of 2014 (investopedia, 2017) indicating a very high level of compliance.

The Kenya Revenue Authority has recently been seen to be struggling to meet its annual revenue targets. Looking at Sweden's tax-to-GDP ratio of 35%, it compares unfavorably to the Kenya situation where for the year 2016/2017, the tax-to-GDP ratio stood at19% (Kenya Reveneu Authority, 2017). The tax collection has continued to fall behind target. For instance, by the end of June 2017, total cumulative revenue including appropriation in aid actually collected amounted to Ksh 1,400.6 billion against a revised target of Ksh 1,455.4 billion. This represented a revenue shortfall of Ksh 54.8 billion from the annual target (The National Treasury, 2017).

The latest report from the Treasury indicate that National Government cumulative revenue collection including appropriation in aid for the period July 2017 to September 2017 amounted to Ksh 345.6 billion (equivalent to 3.9 per cent of GDP) against a target of Ksh 388.0 billion or 4.4 per cent of GDP. This represented an underperformance of Ksh 42.5 billion mainly due to shortfalls in Income Tax, Excise Duty and appropriation in aid collection (The National Treasury, November, 2017). If this

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revenue collection performance level continues as it is, then the revenue shortfall may be above Ksh 200 billion for the year 2017/18 while the tax-to-GDP ratio may fall to just 16% from that of 2016/17 which as reported at 19%.

Statement of the Problem

Developed countries exhibit high tax-to-GDP ratios. A case in point is Sweden which has tax-to-GDP ratio of 35%. This compares unfavorably to the Kenya situation where for the year 2016/2017, the tax-to-GDP ratio stood at19% (Kenya Reveneu Authority, 2017).

The World Bank and the International Monetary Fund have set Debt Burden Thresholds for Low-income countries at 40% and 50% for Medium Policy and Strong Policy respectively under the Debt Sustainability Framework (DSF) (International Monetary Fund, 2017). Kenya is already above these thresholds. As at 30th September 2017, the gross debt level stood at Ksh 4,486.8 billion. This was 51% of the estimated gross domestic product of Ksh. 8,805 billion for 2017.

Kenya's low tax-to-GDP ratio stood of 19% for the year 2016/2017 need to be improved. The tax collection has continued to fall behind target. By the end of June 2017, total cumulative revenue collected amounted to Ksh 1,400.6 billion against a revised target of Ksh 1,455.4 billion representing a revenue shortfall of Ksh 54.8 billion. (The National Treasury, 2017).

To address the challenges posed by the increasing public expenditure and servicing of public debt, there was need to increase tax revenue collection through tax compliance. This study evaluated the determinants of tax compliance in Kenya.

Objectives of the Study

The general objective of the study was to evaluate the determinants of tax compliance in Kenya. The specific research objectives included:

- To establish the effects of tax rates on tax compliance behavior in Kenya.
- To study the influence of compliance costs on tax compliance behavior in Kenya.
- To evaluate the effects of enforcement instruments on tax compliance behavior in Kenya.

The main research questions to be addressed were:

- What is the effect of tax rates on tax compliance behavior in Kenya?
- How do compliance costs influence the tax compliance behavior in affect in Kenya?
- What is the effect of enforcement instruments on tax compliance behavior in Kenya?

LITERATURE REVIEW

Theoretical Framework

Ricardian Theory of Taxation

According to Tsoulfidis (2008), Ricardo based his theory of taxation by synthesizing the impact of profit taxation on wages, profits and rents. He especially focused his attention on the effects of profit taxation by examining two different circumstances; when gold is produced locally, and when it is imported. Ricardo's theory of tax on wages is based upon the distinction between natural and money wages. The theory of natural wages led Ricardo to note that taxation on wages is inequitable as workers are only paid that which is enough to ensure that they can survive and meet their daily obligations. He concluded that a tax on wages will lead to a rise in wages as workers would demand for increased earnings, this will lead to a decrease in profit and the end result is the same as if the tax was levied on profits.

On Profits, Ricardo envisaged two scenarios, the first case refers to when gold is produced locally whereby he argued that a tax on profits will increase prices as either manufacturers will quit producing that commodity or increase their prices to offset the tax. The increased partial tax in this instance will lead to disproportionate price in all industries other than gold which is untaxed, this leads to increased supply for gold and thereby there

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will be an accompanying increase in money. When gold is imported Ricardo argues that any rise in prices is only transitionary as it would lead to a deficit as more gold is imported to cater for the rise in price, the outflow of money would reduce the prices of the commodity as it becomes more scarce. He notes that a tax on profit had the same effect on the price of commodities both at home and abroad as before the tax was imposed.

Ricardo's fundamental idea concerning land rent is that the natural price of agricultural products is formed on marginal land that is land last cultivated. He adduced that the rising prices of agricultural products are responsible for the emergence of rent and not the other way around. Consequently, if rent income is taxed, all prices will remain the same and the entire burden of taxation will fall on the recipients of this non-functional income. This led him to the argument that tax on rent forms the best object of taxation as they do not have any distortionary effect on the economy. Finally, Ricardo contends that indirect taxation to a large extent causes final effects similar to those of a profit tax, however since indirect taxation affects both production and consumption its effect on prices and relative prices of commodities are more profound and it should not be used interchangeably with the direct tax on profits.

Ability to Pay Theory of Taxation

This is one of the major theories of taxation; it is primarily based on the Law of diminishing marginal utility. According to Majiwa (2016), Pigou in 1928 observed that in all instances in order to secure equal sacrifice, the tax formula must be in some measure progressive, in the sense that the rate of taxation per pound of income grows as incomes grow. The ability to pay theory of taxation has been used to justify the progressive tax system of taxation that is widely practiced across the globe. It is based on the following assumptions; the falling rate of marginal utility of money given an increase in supply, sacrifice in payment of taxes and the ability to quantify the sacrifice.

The justification of the ability to pay theory is based on the premise of sacrifice, the taxpayer sacrifices part of their income and it is turned over to the government to be spent on public goods. The sacrifice is measured both in terms of the burden that a taxpayer bears on sacrificing their income to the public but also the ease with which he got that income.

Game Theory Model of Equilibrium in Tax Compliance

This model try to explain compliance behaviour among taxpayers generally based on the standard game-theory concept of equilibrium. Equilibrium behaviour is one of the fundamental concepts of economics: that each player's strategy is a best response to their beliefs about other players' strategies (and that these beliefs are realised) (O'Doherty, 2014). Assuming linear tax rate and penalties, risk neutral taxpayer, no additional cost of an audit other than penalties levied on underreporting of income and that the objective of the tax authority is to maximize revenue. A tax authority will pursue the strategy that provides an optimum audit revenue subject to a fixed audit budget by setting up a cut-off, whereby all declarations below the set level are audited with a probability p but leave out all declarations above the cut-off. The probability p is determined at a level that ensures that all declarations above the set cut-off are honest. The cut-off is chosen so that the audit budget is just exhausted in equilibrium. The model observes that a higher the budget or reduced cost c increases the probability of an audit and hereby increases the level of compliance. However, this strategy has only been proved optimal in instances where the taxpayer are risk neutral, in cases where the taxpayers are risk averse there is no audit strategy under the cut-off criterion.

Penalties

It is the nature of human beings not to do what is required from them without motivation. This motivation is possible to be one of two options, either incentive to encourage them to do their duties, or a penalty in case they did not do their duties. In some cases, both motivations are needed, where sometimes if the first option is not available or has no pressure, then the second alternative will be needed (Al-Ttaffi & Abdul-Jabbar, 2015)

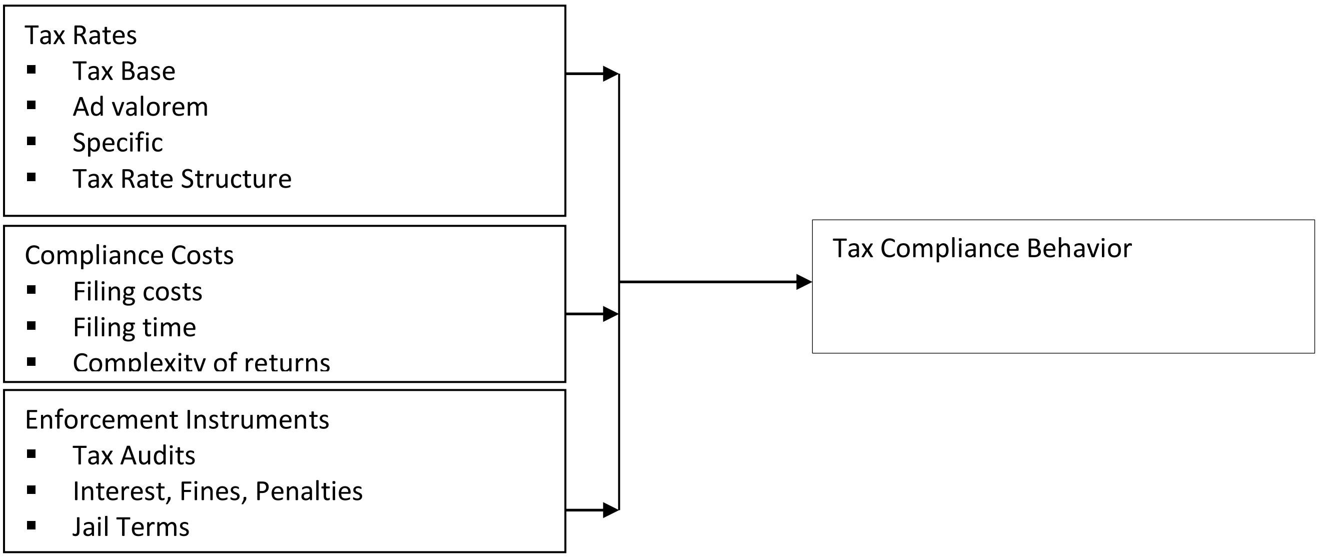

Figure 1: Conceptual Framework

This study postulated that tax rates, compliance costs and enforcement instruments influence tax compliance behavior. These variables were reviewed in detail as follows:

A tax base is a measure upon which the assessment or determination of tax liability is based. For example, taxable income is the tax base for income tax and assessed value is the tax base for property taxes. A tax rate is the percentage, proportion or specific amount payable as a portion or other function of the tax base. When the tax rate is a percentage of a value, then that rate is known as ad valorem. For instance, 16% of sales price before value added tax is an ad valorem rate. On the other hand, a per unit tax, or specific tax rate, is a tax that is defined as a fixed amount for each unit of a good or service sold, such as Ksh.65 per liter as would be for excise duty on beer. It is thus proportional to the particular quantity of a product sold, regardless of its price.

Tax rates range from none to some value. Where there is no tax rate, then the activity is exempt and where the tax rate is zero, then that activity is taxed at zero. Zero rates are usually instituted for special benefits for example to promote exports, value added tax rate is zero.

Tax rates may also be progressive or at a flat rate. A progressive rate is where the rate of tax increases with the increase in amount. For instance, in individual income taxes, income tax rate increases with the increase in income. A flat rate is where the rate remains the same irrespective of the value as it is currently for capital gains tax at 5% of the gain on sale of property.

The tax rates in Kenya range from as low as 5% on income derived from qualifying dividends to a high of 37.5% in corporation tax on non-resident companies. Individual income tax rates are progressive in nature with different tax brackets along the income spectrum.

Compliance Costs: Compliance costs refer to all the resources expended by taxpayers in order to comply with the tax legislation. These include costs incurred to file and pay the taxes, the time taken to file a as well as the skills utilized in filing complex of returns.

Enforcement Instruments: Enforcement instruments are the tools used to discover and remedy noncompliance. These instruments range from tax audits and compliance checks to imposition of interest, fines, penalties or jail terms on those found noncompliant.

Empirical Review

According to Allingham and Sandmo (1972), there is a positive correlation between the tax rate and the level of compliance. These findings have been further supported by Alm & McKee (2004), in their evaluation of the Jamaican income tax structure which showed that small reductions in the marginal tax rate can have a general positive impact on revenue collection but this is only up to a point where the decrease in rate is sufficiently offset by the increased tax base and thereby a net increase in collections. In contrast, Yitzhaki (1974) theoretically proved that tax compliance increases with tax rates. Clotfelter (1983) however found that tax compliance decreases with increasing marginal tax rates, based on data from the Internal Revenue Service's Taxpayers Compliance Measurement Program (TCMP) survey of 1969. There has been no attempt at a specific research in Kenya on the impact of the tax rate on general compliance however insight of this can be garnered from the unpublished report by Mutua (2012) which showed that high rates create undue burden to most businesses and have therefore been a hindrance towards increased compliance.

Atawodi & Ojeka (2012) sought to identify factors that affect tax compliance among SMEs in North Nigeria and found that high tax rates and complex filing procedures are the most crucial factors causing non-compliance of SMEs.

Majiwa (2016) established that tax compliance behaviour is exhibited to a large extent by both individual and corporate tax payers. The findings indicate compliance levels are higher in corporate than in individual tax payers as shown in the composite mean scores (3.78 for individual tax payers and 3.96 for corporate tax payers).

Compliance cost involves a myriad of expenses or difficulties encountered by the taxpayer in complying with the tax law both in terms of administrative compliance; that is registration, filing and subsequent payment of the taxes and also technical compliance which involves maintenance of appropriate records, machines and organisation of the supply chain so as to observe the requirements of the law. Administrative compliance is mostly direct and therefore it has been the area of concern in most of previous research.

Thiga and Muturi, (2015) when studying Tax compliance among SME's in Kiambu County observed that low compliance cost are associated with high compliance level, these findings have been justified by several researchers including Lumumba *et al,* (2011).

Technical compliance is visible mostly among indirect taxes such as VAT and excise duty that require maintenance of substantive records, machines (ETR, flow meters), and at times might even call for a resident officer to monitor the production process.

Although all these help in ensuring compliance it raises cost and increases the premium on non-compliance.

Merima, Odd-Helge & Ingrid (2013) found that tax compliance behaviour among citizens in Kenya, Tanzania, Uganda and South Africa was influenced by perception about difficulty of evading taxes, satisfaction with public service provision, payments to non-state actors, perception of an ethnic group being treated unfairly, and tax knowledge.

Yitzhaki (2000) observed that enforcement instruments, including the audit rates and the punishment function, are also determinants of tax compliance, although these variables are rarely available for empirical studies. For example, Dubin et al. (1990) and Pommerehne and Weck-Hannemann (1996) found that the probability of audit significantly affects tax compliance, whereas they found no evidence of a significant deterrent effect of the penalty. Andreoni et.al (1998) based on studies of data generated from the Internal Revenue Service's Taxpayers Compliance Management Programme (TCMP) observed that due to the low probability of detection even high penalties has no observable impact on the level of compliance. Merima et al, (2013) when studying factors affecting tax compliance in a sample of African countries observed that an increase in perception of individuals about the difficulty of evading taxes enhances taxpayer's attitude towards compliance.

In Kenya the audit coverage is less that 1% of the returns filed, this can explain the low levels of compliance especially on tax heads whose audit coverage is low such as Corporation tax and Excise duty. Noncompliance is also enforced as a civic rather than a criminal offence had hereby in most cases the corrective action are penalties rather than jail term. Penalties levied on non-compliance ranges from 20% in areas where there was limited complicity of the taxpayer to 75% in cases where there was willful action on the taxpayer to evade the tax. The new Tax Procedures Act (2015) has harmonized the penalties and interest charged and therefore there can be no observable variance on compliance based on the punishment function across tax heads.

Empirical studies on tax compliance have also spanned to other factors other than economical that influence taxpayer's behavior these include spheres as psychological, moral, political and social factors such as guilt, a civic sense of duty, perception of fairness, and moral preference. Myles and Naylor (1996) reconciled the standard model of tax compliance with the social customs and group conformity, indicating that equilibrium with some complying taxpayers could exist.

Majiwa (2016) also found that for corporate tax payers, enforcement instruments had a negative impact on tax compliance level while tax rates, compliance costs and nature of tax had a positive impact on tax compliance level. For individual tax payers enforcement instruments had a positive impact on tax compliance level while tax rates, compliance costs, had a negative impact on tax compliance level. Results also indicated that Kenya's tax design enhances taxpayer's compliance level as both individual and corporate tax payers reported tax compliance to a large extent despite asserting presence of many taxes.

According to Hasseldine (1999), most studies have found that compliance increases but only slightly with increases in the fine rate on unpaid taxes; the estimated reported income-fine rate elasticity is typically less than 0.1. Also, penalties need not be limited to financial penalties; that is, the threat of public disclosure of one's own compliance behavior may affect compliance due to concerns that one's information may be viewed by others, and the observation of others compliance (or lack of compliance) may also affect one's own reporting behavior. Experimental evidence shows that public disclosure of non-compliance on balance increases compliance.

METHODOLOGY

This study was a desk study intended to evaluate the determinants of tax compliance in Kenya. The population of interest comprised of the all registered taxpayers in Kenya. This population was ideal in that it indicated the tax registered taxpayers that participated in the taxpaying and it enabled us to study their compliance behavior. Secondary was collected from previous studies. Data was analysed using descriptive statistics and meaning assigned thereon.

FINDINGS AND DISCUSIONS

Majority of studies established that tax compliance is influenced by tax rates, compliance costs and enforcement instruments although the influence of each factor is unique.

From the various studies, it was ascertained that for corporate tax payers, enforcement instruments had a negative impact on tax compliance level while tax rates, compliance costs and nature of tax had a positive impact on tax compliance level. For individual tax payers enforcement instruments had

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a positive impact on tax compliance level while tax rates, compliance costs, had a negative impact on tax compliance level

It was found that compliance increases but only slightly with increases in the fine rate on unpaid taxes; the estimated reported income-fine rate elasticity is typically less than 0.1. Penalties need not be limited to financial penalties; that is, the threat of public disclosure of one's own compliance behavior may affect compliance due to concerns that one's information may be viewed by others, and the observation of others compliance.

From various studies, it was established that small reductions in the marginal tax rate can have a general positive impact on revenue collection but this is only up to a point where the decrease in rate is sufficiently offset by the increased tax base and thereby a net increase in collections. It also emerged that low compliance cost were associated with high compliance level. Similarly, enforcement instruments, including the audit rates and the punishment function are also determinants of tax compliance.

CONCLUSIONS AND RECOMMENDATIONS

Flowing from the above, tax compliance is affected by tax rates, compliance costs and enforcement instruments.

To increase tax compliance, the following is recommended:

- Increase tax base by introducing tax on currently untaxed sources.
- Variation in tax rates may lead to increased compliance.
- Reduction in complexity of returns and compliance procedures may lead to increase in tax compliance.
- Tax audits seem not to have a great impact on compliance due to its low coverage unless the impact if felt across an industry or particular sector.
- Application of interest, penalties, fines and jail terms may lead to increase in compliance especially if the same is publicized.

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