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**Effect of Personal and Non-personal Factors on Tax Evasion Among Small and
Medium Enterprises in Nairobi County, Kenya**

RUTH NDICHU

MBA/46618



Submitted in partial fulfillment of the requirements for the award of a Master's in
Business Administration (MBA) Degree

Strathmore Business School

MAY 2019

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Ruth Ndichu

May 2019

Approval

The dissertation of Ruth Ndichu was reviewed and approved by:

Dr. David Mathuva (Supervisor)
Strathmore University

Dr. George Njenga
Dean, Strathmore Business School

Prof. Ruth Kiraka
Dean, School of Graduate Studies
Strathmore University

ABSTRACT

Tax evasion affects various sectors of an economy and has an adverse effect on an economy as a whole. This study assessed the effect of personal and non-personal factors on tax evasion among SMEs in Nairobi County. The specific objectives of the study were to establish the effect of tax rates on tax evasion among SMEs in Nairobi County; the effect of economic factors on tax evasion among SMEs in Nairobi County; and the effect of demographic factors on tax evasion among SMEs in Nairobi County, Kenya. The study adopted a descriptive research design. This study collected primary data from the field using questionnaires. Descriptive analysis was done where measures of central tendencies (frequencies, means and percentages) were used to carry out the analysis. Inferential statistics including correlational analysis and regression analysis were also used. It was established that tax rate has moderate, positive and significant effect on tax evasion. Economic factors have strong, positive and significant effect on tax evasion. Demographic factors have strong, positive and significant effect on tax evasion. The study concluded that tax rate, economic factors and demographic factors are key drivers of tax evasion among SMEs. The study recommends that the Kenya Revenue Authority (KRA) should come up with innovative ways of collecting revenue without necessarily raising the rates. The government should come up with sound economic policies (including macro and micro economic policies) which would increase the taxpayers' incomes hence more taxes. KRA should consider the male and female attributes when designing taxation policies. Penalties for noncompliance may be more stringent to men as compared to women due their differences in willingness to comply with taxes.

TABLE OF CONTENTS

DECLARATION..... ii
ABSTRACT..... iii
TABLE OF CONTENTS iv
LIST OF FIGURES vi
LIST OF TABLES vii
DEFINITION OF TERMS..... viii
LIST OF ACRONYMS ix
ACKNOWLEDGMENTSx
DEDICATION..... xi

CHAPTER ONE: INTRODUCTION1
1.1 Background of the Study 1
 1.1.1 Personal and Non-Personal Factors2
 1.1.2 Tax Evasion3
 1.1.3 Small and Medium Enterprises6
1.2 Statement of the Problem.....7
1.3 Research Objectives9
 1.3.1 General Objective9
 1.3.2 Specific Objectives9
1.4 Research Questions.....9
1.5 Scope of the Study9
1.6 Justification of the Study10
1.7 Significance of the Study.....10
1.8 Organization of the Thesis10

CHAPTER TWO: LITERATURE REVIEW.....12
2.1 Introduction.....12
2.2 Theoretical Framework.....12
 2.2.1 Economics of Crime Model12
 2.2.2 Prospect Theory13
 2.2.3 Social Identity and Self Categorization Theory.....14
2.3 Empirical Review.....15
 2.3.1 Effect of Tax Rate on Tax Evasion.....15
 2.3.2 Effect of Economic Factors on Tax Evasion17
 2.3.3 Effect of Demographic Factors on Tax Evasion.....18
2.4 Summary and Research Gap.....20
2.5 Conceptual Framework.....20
2.6 Operationalization of Variables21
2.7 Chapter Summary22

CHAPTER THREE: RESEARCH METHODOLOGY23
3.1 Introduction.....23
3.2 Research Design.....23
3.3 Target Population.....23

3.4 Sampling Techniques.....	23
3.5 Data Collection Instrument.....	24
3.7 Research Quality.....	24
3.7.1 Validity.....	25
3.7.2 Reliability.....	25
3.7.3 Objectivity.....	26
3.8 Data Analysis and Presentation.....	26
3.9 Ethical Consideration.....	27
CHAPTER FOUR: PRESENTATION OF RESEARCH FINDINGS	28
4.1 Introduction.....	28
4.1.1 Response Rate.....	28
4.2 General Information.....	28
4.2.1 Gender of Respondents.....	28
4.2.2 Age of Respondents.....	29
4.2.3 Level of Education of Respondents.....	29
4.2.4 Length of SME Operation.....	30
4.2.5 Whether Tax Evasion is a Key Concern.....	30
4.3 Descriptive Analysis.....	31
4.3.1 Tax Rate and Tax Evasion.....	31
4.3.2 Economic Factors and Tax Evasion.....	33
4.3.3 Demographic Factors.....	34
4.3.4 Tax Evasion.....	35
4.5 Inferential Statistics.....	36
4.5.1 Correlation Analysis.....	36
4.5.2 Regression Results.....	37
CHAPTER FIVE: DISCUSSIONS, CONCLUSION AND RECOMMENDATIONS	40
5.1 Introduction.....	40
5.2 Discussions.....	40
5.2.1 Tax Rate and Tax Evasion.....	40
5.2.2 Economic Factors and Tax Evasion.....	41
5.2.3 Demographic Factors.....	42
5.3 Conclusion.....	43
5.4 Recommendations of the Study.....	44
5.5 Contribution of the Study to Knowledge.....	45
5.6 Suggestions for Further Studies.....	46
REFERENCES.....	47
APPENDICES.....	53
APPENDIX I: APPROVAL LETTER.....	53
APPENDIX II: QUESTIONNAIRE.....	54

LIST OF FIGURES

Figure 1.1: Conceptual Framework 21

LIST OF TABLES

Table 2.1: Operationalization of Variables	21
Table 3.1: Reliability Results.....	25
Table 4.1: Gender of Respondents.....	28
Table 4.2: Age of Respondents	29
Table 4.3: Level of Education of Respondents	29
Table 4.4: Length of SME Operation	30
Table 4.5: Whether Tax Evasion is a Key Concern.....	30
Table 4.6: Tax Rate and Tax Evasion.....	32
Table 4.7: Economic Factors and Tax Evasion	33
Table 4.8: Demographic Factors.....	34
Table 4.9: Attitudes towards Tax Evasion.....	35
Table 4.10: Correlation Analysis	37
Table 4.11: Model Summary	38
Table 4.12: Analysis of Variance.....	38
Table 4.13: Regression Coefficients	38

DEFINITION OF TERMS

Demographic factors – This include the income level of the SMEs that will enable them to pay the tax

Economic factors – High rate imposed on taxes for the SMEs to pay.

Tax evasion - illegal ways that people employ to avoid paying taxes and these include underreporting income, profit or over reporting the amount of tax deductions.

Tax rates - the ratio (usually expressed as a percentage) at which a business or person is taxed.

LIST OF ACRONYMS

GDP Gross Domestic Product

KRA Kenya Revenue Authority

PAYE Pay as You Earn

SME Small and Medium Enterprise

VAT Value Added Tax

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DEDICATION

I dedicate this research to God, my family, friends, all the respondents, my professors, and to all the people who made this study possible. Most especially, I dedicate this to my family, we have walked this journey together and they represent those who have influenced my life profoundly. God bless you.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

The amount of money spent by the government in provision of health, education, security and infrastructure facilities and therefore economic growth is generally referred as public expenditure (Fagbemi, Uadiale & Noah, 2014). Taxation is a major source of finance for this public expenditure. Taxation of any country form the fiscal policies which are tools used by the government in achieving economic growth and stability. Taxation refers to the levy charged by the state to citizens in order to collect revenue for economic growth and development. According to the World Bank (2013), taxes are a compulsory transfer of resources to the government from the rest of the economy.

The major challenge with tax systems and economies today is an increasing trend in tax evasion. Tax evasion is illegal and negatively affects the growth of an economy (Serem, Robert & Phillip, 2017). Most tax authorities are unable to meet revenue collection targets because of the increased trend in tax evasion among taxpayers across the world (John, Kamau & Nzioki, 2018). In Kenya for instance, the Kenya Revenue Authority (a government tax agent) failed to meet the planed revenue collection targets by Kshs. 50 billion and Kshs. 172.4 billion for the financial years 2016/2017 and 2017/2018 respectively (KRA, 2017). Most economies today are characterized by an increasing trend of tax evasion where businesses are exploring all loopholes within the tax systems that help them either to declare less income as actually reported, fail to file returns in time or 'doctor' the financial statements in their favor. Since tax evasion is a crime, the whole concept can best be illustrated by the economics of crime model theory (Agago, Nittala & Tirfe, 2015). Although this increased trend in tax evasion has received great attention by scholars and academicians, much emphasis of the literature has focused on establishing factors behind this trend in different contexts. Little attention has been paid in relating personal as well as non-personal l factors with tax evasion.

1.1.1 Personal and Non-Personal Factors

Personal factors shape one's personality and determine the undertaken actions and their outcomes by people. Agago et al. (2015) identified personal factors to include the age, occupation, level of income and education qualifications. Rodriguez-Justicia and Theilen (2018) summed up personal factors into demographic components like gender categories, gender, levels of education, the type of one's occupation and marital status. All these factors shape and determine people's personalities. Non-personal factors on the other hand cover a wide range of aspects like the interest rate, inflation, exchange rate, the prevailing tax systems that determine the tax rates and tax bases in the country. More specifically, Litina and Palivos (2016) identified non-personal factors as comprising of the tax rate and the economic factors prevailing in the economy.

Personal and non-personal factors have been used to explain different behavior including tax compliance as well as noncompliance (tax evasion) (Pui-Yee, Moorthy & Choo-Keng Soon, 2017). According to Hofmann, Voracek, Bock and Kirchler (2017), taxpayers with high level of education are deemed to be more knowledgeable on the importance of paying taxes and thus have greater compliance which lowers tax evasion. On the contrary, Kasper, Kogler and Kirchler (2015) indicates that the more educated the taxpayers are, the higher the degree of tax evasion since they have more knowledge on loopholes and flaws within the tax systems which they can capitalize on to evade taxes. According to Abdixhiku, Pugh and Hashi (2018), males tend to evade taxes more as compared to female taxpayers. Brink and Porcano (2016) indicates the people who are employed are economically empowered and thus would have low tax evasion as compared to the unemployed people. Alm (2019) argues that less educated people have little or no knowledge on the need to pay taxes or file returns hence would evade tax as compared to the educated people. According to Basheer, Ahmad and Hassan (2019), the prevailing economic factors like inflation, high interest rates, labor costs and a general decline in the levels of income all motivate taxpayers to evade taxes.

According to Dalu, Maposa, Pabwaungana and Dalu (2012), tax evasion among small business is affected by economic factors, tax rates and demographic factors. Tax rates have been widely recognized as the most primary determinant of tax evasion. Economic factor includes income level which is another important determinant. It usually refers to the adjusted gross income or total positive income of a taxpayer. Gender of the taxpayer has been revealed to be significant in past studies. Vogel (2014) shows that the compliance levels of female taxpayers are higher than for males.

It's against this backdrop that the study seeks to identify the effects of some of the personal and non-personal factors among tax payers while complying or not complying with taxes. Specifically, the study will examine the effect of non-personal factors, specifically tax rates and economic factors on tax evasion. Further, the study will also examine the effect of demographic factors on tax evasion, specifically the gender and age of a tax payer.

1.1.2 Tax Evasion

Tax evasion affects various sectors of an economy and heaps adverse effect on an economy as a whole (Pickhardt & Prinz, 2014). Evasion of taxes tampers on the accuracy of microeconomic statistics thus leading to the misallocation of resources needed to stimulate the growth of an economy. Additionally, the evasion of taxes alters the distribution of income in an arbitrary and erratic way. Increment in the propensity to evade taxes renders most governments unable to deliver it obligations and responsibilities in terms of improvement in standard of living to its citizens. Several countries have experienced loss in tax revenues due to tax evasion (Hashimzade, Myles & Tran-Nam, 2013).

The United Kingdom estimates loss in tax revenues to be \$21 billion per year (Slemrod, 2016), Greece estimates showed loss in tax revenues to be \$30 billion per year (Murphy & Higgins, 2014). In developing countries, overall tax revenues loss due to tax evasion is estimated at \$285 billion per year (Khlif & Achek, 2015). The noncompliant behaviors of

citizens have forced most governments in raising tax revenues thereby heaping most burdens on individuals with favorable compliance behaviors. However, increment in such burdens towards the few citizens complying with taxes may not be economically viable on the basis of moral issues as well as social and cultural characteristics (Oz Yalama & Gumus, 2013).

In Ghana, one of the many problems facing tax administration is tax evasion. Tax evasion is rampant due to lack of appropriate monitoring strategies in tracking tax revenues from tax officials and taxpayers (Adebisi & Gbegi, 2013). Several media platforms in Ghana headlines tax evasion as a massive hit in the Ghanaian economic. In 2012, an additional \$36 million shipped abroad mostly to non-taxable offshore accounted on the blind side of tax authorities. In October 2013, a giant media platform known as peace online reported that the presidential taskforce uncovered over \$367 million was lost in Ghana as a result of the tax evasion. In December 2014, it was reported that about \$140 million in taxes were lost to the state in the mining sector alone between 2005 and 2007. Due to the massive airwave reports on tax evasion, trust issues have been a problem in combating the evasion of taxes in Ghana (Casaburi & Troiano, 2015).

Taxpayers are often of the view that tax officials hold the key to tax evasion by engaging in several corrupt practices such as issuing fake tax payment receipts to taxpayers among others. Aside the trust issues, there are several non-economic and economic factors affecting tax evasion in Kenya. Tax rates, tax audits, penalties, are factors driving the evasion of taxes in Kenya. Therefore, it is important to investigate the drivers of tax evasion in Kenya. Kenya has established jurisdictions concerning administration of tax for example the Kenya Revenue Authority (KRA) in Kenya (KRA, 2017). Tax compliance indicates the ability of citizens in a country to honor their tax obligations in timely and convenient way. Tax compliance is the adherence to the established rules and regulations governing tax in a country.

The tax rate charged by law is unsustainable for some SME businesses and this forces such businesses to adopt tax evasion strategies so as to remain competitive in the

marketplace. In Kenya, the applicable taxes are corporation tax at 30%, Value Added Tax (VAT) at 16%, Capital Gains Tax, Custom Duty at Excise duty ranging between 0% and 25% depending on the goods, gaming taxes at 15% and withholding tax ranging from 5% to 20%. Further the rates of penalties and interest levied under the Tax Procedure Act, 2015 are generally high with penalties being 20% of unpaid tax and 2% monthly interest on outstanding taxes. For an SME paying corporate tax at 30% as well as VAT at 16%, the rates would be too high given all other operating cost of a business (KRA, 2017).

The judicial systems of a country will help in reduction of the tax evasion as it administers legal suits by the perpetrators of tax evasions (Pope, Rupert & Anderson, 2014). Generally, existence of severe penalties and higher audit probabilities significantly leads to tax compliance. Probability of detection indicates the chances or likelihood that non-compliant individuals will be discovered by the tax authorities. People would like to entirely evade their tax liabilities and the only reason they might not do that is presence of non-zero probability of being caught in tax evasion (Wallace, 2015). High tax rates and complex tax legislations significantly add up to tax evasion among businesses (Murphy & Higgins, 2014).

Tax compliance costs are incurred by business entities so as to meet the requirements set out for compliance with certain tax levels and structures. Cost of compliance include accounting costs; economic costs; lobbying costs; training costs and lost revenue from the system. Businesses pay for time spent by internal staff in understanding and applying the rules, payment of external experts, record-keeping costs, developing systems and related incidental costs. Further, some tax returns are to be submitted monthly, and committing human resources to these can lead to cash flow problems, since there would be less activity chasing after business related activities like debt collection. For purposes of this study, focus will not be placed on the compliance-related psychological costs (stress and anxiety of owners and their staff) (Rametse, 2009), but on the administrative workload and its relationship with the performance of the business.

1.1.3 Small and Medium Enterprises

There has been no consensus on the definition of SMEs and researchers have given various definitions. For example, Kinjanjui (2016) defined SME's as firms employing between 1 and 150 persons. Soderbom (2014) defined SMEs in Kenya as businesses employing between 10 and 100 employees. The definition varies from country to country. The broad Kenyan definition of SMEs includes micro enterprises. As per the International Finance Corporation (IFC) definition, SMEs implies any business in the private sector which employs between 50-300 employees. For purposes of this paper we shall go as per the IFC definition of an SME. An SME is an entity that does not have public accountability or publishes general purpose financial statements for external users e.g. owners not involved in day to day management; Kenya Revenue Authority; existing and potential creditors; credit rating agencies and whose debt and equity instruments are not traded in the public market (A domestic or foreign stock exchange or over the counter market) and does not hold funds in a fiduciary capacity for a broad group of outsiders as one of its primary businesses such as banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks (ICPAK.com).

SMEs play an important role in economic development of Kenya. For instance, majority of the firms enrolled in the Kenya Association of Manufacturers (KAM) fall under this category (Schaltegger & Wagner, 2017). Global statistics indicate that SMEs account for more than 70% of business enterprises. For instance, about 80 to 90 percent of business enterprises in the United States are SMEs with similar statistics for Canada. It is a recognized fact that majority of the large global corporations around the world like Ford, Acer Computer, Bata International, and Seagrams were started by founders who later developed business empires (Leonidou, Leonidou, Fotiadis & Zeriti, 2013).

SMEs have traditionally operated in domestic markets, but increasingly find themselves obliged to internationalize, in order to survive in a market that is becoming more and more globally competitive. SMEs have attracted increasing attention in recent years in light of concrete evidence of the importance of new business creation for economic

growth and development (Somsuk & Laosirihongthong, 2014). SMEs in particular are attracting the attention of policy makers and researchers because it has been recognized during the last decade as an important and untapped source of economic growth.

There are several sources of income, for example, corporate profits, individual incomes, employees' salaries and commodities in the market. Corporate bodies pay corporate tax, goods and commodities attract VAT (Kogler, Batrancea, Nichita, Pantya, Belianin & Kirchler, 2013). Properties for instance transfer of title in land attract stamp duty as a source of revenue for the government and capital gains tax. Pay as You Earn (PAYE) is levied on employee income on a graduated scale on a monthly basis.

Tax evasion in Kenya, especially among the small and medium enterprises is generally very high. Kenya is actually ranked among low-income countries or low compliance countries with hard task of ensuring efficient and effective tax administration. The Ethics and Anti-Corruption Commission is recently investigating Darasa Investment that evaded paying Kshs. 2.5 billion taxes (EACC, 2019). In another recent case, Kenya Revenue Authority charged two business people (Mr. Kevalkumar Navin Maisura and Ms. Arti Jagdiesh Bakrania) with tax evasion amounting to Kshs. 7 billion. Hence, there is need to examine the effect of personal and non-personal factors on tax evasion among SMEs in Kenya which informed the study.

1.2 Statement of the Problem

Tax evasion prevalence is vast and greatly impairs taxation's macro-economic objectives thus creating a gulf between actual and potential government tax revenue raising many issues which need urgent attention and solutions. However much the government endeavors to exercise its sovereign right to collect taxes, nobody likes paying taxes although there is great appreciation that taxes need to be paid and this drives some people into tax evasion making the government constantly fail to raise targeted tax revenue (Brink & Porcano, 2016).

Tax evasion remains one of the challenges facing the tax administration for businesses in Kenya despite the fact that KRA performs monthly taxpayer education programmes so as to improve tax compliance (KRA, 2011). Although there has been significant growth in tax collection, by over 300% (2003-2011), the contribution by SMEs has been very low (KRA, 2013). Tax evasion has been a major issue for policies among different scholars although different reactions have been sought.

In Nigeria, Atawodi and Ojeka (2012) studied factors affecting compliance of tax among the small and medium enterprises (SMEs) and established that high tax rates and complex filing procedures are the most crucial factors causing non-compliance of SMEs. This study was carried out in Nigeria and not in Kenya creating a knowledge gap. Macharia (2014) examined the effect of tax evasion on tax revenues in Kenya and established that tax evasion negatively but significantly affects tax revenue. Mukabi (2014) examined factors influencing turnover tax compliance in the Kenya Revenue Authority domestic taxes department and established that perceptions of taxpayers towards the tax system greatly determine the level of compliance for turnover tax. The study did not focus on tax evasion but rather on tax compliance which creates knowledge gap. Karanja (2014) sought to establish factors affecting voluntary tax compliance on rental income and revealed that attitude factors, high tax rate, unfair tax system, social norms, gender and level of education are significant and play a great role towards the compliance or non-compliance of Kenyan taxpayers on rental income. The study also focused on tax compliance and not specifically on tax evasion which create gaps.

Thus, based on the aforementioned studies, it can be seen that some of them were done in different countries like Nigeria and not in Kenya. Other studies focused more on tax compliance and not tax evasion. This creates research and knowledge gaps that the current study sought to fill by examining the effect of personal and non-personal factors on tax evasion among SMEs in Nairobi County, Kenya.

1.3 Research Objectives

1.3.1 General Objective

The purpose of this study was to the effect of personal and non-personal factors on tax evasion among SMEs in Nairobi County, Kenya.

1.3.2 Specific Objectives

- i. To examine the effect of tax rates on tax evasion among SMES in Nairobi County, Kenya.
- ii. To assess the effect of economic factors on tax evasion among SMES in Nairobi County, Kenya.
- iii. To investigate the effect of demographic factors on tax evasion among SMES in Nairobi County, Kenya.

1.4 Research Questions

- i. What is the effect of tax rates on tax evasion among SMES in Nairobi County, Kenya?
- ii. What is the effect of economic factors on tax evasion among SMES in Nairobi County, Kenya?
- iii. What is the effect of demographic factors on tax evasion among SMES in Nairobi County, Kenya?

1.5 Scope of the Study

The study sought to establish the effect of personal and non-personal factors on tax evasion among SMEs in Nairobi County, Kenya. The study investigated the effect of tax rate, economic factors and demographic factors on tax evasion among SMEs in Nairobi County, Kenya. The study was carried out in Nairobi since there are many SMEs in Nairobi County. The study was conducted using primary data which was collected using questionnaires. The study was carried out in the month of February 2019.

1.6 Justification of the Study

Taxation can have significant effects on the economy, including impacting on SME creation and the growth of SMEs in Nairobi. A 2017 National Economic Survey report by the Central Bank of Kenya (CBK) indicate that SMEs constitute 98 percent of all business in Kenya, create 30 percent of the jobs annually as well as contribute 3% of the GDP.

An exploration of the relationship between tax administration and performance of SMEs is necessary and significant towards the development and growth of SMEs. If businesses are to grow and contribute to economic and social upliftment, the tax obstacles must be identified, and the path eased.

1.7 Significance of the Study

The findings of the study would be important to the management team of the SMEs, the Kenya Revenue Authority and the future scholars and academicians. To the management of the SMEs, the findings would establish the best way of enhancing compliance in taxation for the growth of the economy. The KRA would rely on the findings of the study to come up with best policies and guidelines for regulating tax evasion among businesses in Kenya. Through the findings of the study, the KRA would be able to understand the various factors affecting tax evasion in the country.

The study would add to the existing literature and information on tax evasion in different contexts. This would help future scholars and academicians to carry out similar studies in future. The study would also recommend areas in future that studies should focus on and this would grow the available literature.

1.8 Organization of the Thesis

Chapter one outlines the background of the study, statement of the problem and research objectives. It also has sections on significance and scope of the study. Chapter two

provide an in-depth review of academic research on themes of the study. The theoretical framework is discussed. The section also covers empirical literature. It has a section on conceptual framework, drawing the relationship between the independent and dependent study variables. It also covers the summary of the literature and the research gap. Chapter three provides a brief overview of the research design, population and sampling frame of the study. In addition, it discusses the instruments, data collection and data analysis methods alongside ethical considerations which will be used in the study. Chapter four presents the findings of the analysis while chapter five gives a summary, conclusion and recommendations arising from these findings.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter reviews relevant literature to the study as conducted by other different scholars. The chapter reviews the theories forming the basis of the study, the empirical literature, and critique of the literature, research gaps and the conceptual framework.

2.2 Theoretical Framework

This study was informed by the Economics of Crime Model, Prospect Theory and Social Identity and Self Categorization Theory.

2.2.1 Economics of Crime Model

The Economics of Crime Model was formulated by Becker (1968) when working on the problem on how to stop criminals from committing crimes and whether stopping crime is even desirable. Allingham and Sandmo (1972) were first people to apply the Economics of Crime Model in compliance research. According to Osoro (1995), a rational consumer seeks to maximize the expected utility of tax evasion gamble, by balancing the benefits accruing from successful cheating against risks of likely sufferings from detection in the form of punishment. This school of thought holds that compliance is largely dependent on audit verifications and severity of penalties spelt out to perpetrators.

This model is relevant to this study because it helps give a clear comparative analysis on declared income increases following an increase either in likelihood of been detected and the number of likely audits and verification which may lead to discovery of any form of tax malpractices. It is relevant for this study because it helps put into perspective the likelihood of individuals seeking compliance instead of evading tax compliance (Draca & Machin, 2015). A purely economic analysis of the evasion gamble suggests that most rational individuals should either underreport income not subject to source withholding or over claim deductions not subject to independent verification because it is extremely unlikely that such cheating will be caught and penalized. This theory is relevant in

explaining the best way which tax evasion can be solved. From the theory, it can be inferred that an increase in penalties would make it costly for taxpayers to evade. The resultant effect would be to reduce tax evasion and thus increasing the amount of collected tax revenues.

2.2.2 Prospect Theory

This theory was developed by the psychologists Kahneman and Tversky (1979). According to Prospect Theory, making of decisions under conditions of uncertainty is seen as a choice between gambles or prospects. Decisions that are made in relation to risks signify a choice made between different alternatives that have close association with given gambles or prospects. According to Yitzhaki (1974), when fines are charged on tax evaded and of the preferences of the taxpayer satisfies the assumption of decreasing absolute risks aversion, then a negative relationship between taxes and tax evasion is predicted.

According to the Prospects Theory, the losses and the gains of carrying out a certain action are differently valued. However, people make their decisions based on perceived gains rather than perceived loss. The general idea behind this theory is that when individuals are presented with two choices (both equal) but one with has potential loss and the other one with potential gains, the latter choice will be chosen as opposed to the former choice (He & Zhou, 2011). The theory is relevant to the current study since tax evasion is a risky action. Tax evaders therefore evaluate the perceived gains of evading tax and the potential losses of the same. The decision to evade tax is shaped by the potential gains of evasion as opposed to potential losses of evasion.

Potential gains from tax evasion would be in the form of increased cash at the disposal of the business for investment, purchase of stock or distribution to the investors. On the other hand, potential loss would be penalties, interest or imprisonment is a tax payer is caught evading tax.

2.2.3 Social Identity and Self Categorization Theory

This theory was expressed put forth by scholars by the names Henri Tajfel and John Turner at the beginning of the 1970s and the 1980s. According to the theory, social identities are reflections of the social categories, groups, as well as the networks that an individual may belong. The core function of the assemblage to its members is its utility in increasing self-esteem and ego, internalized stereotypes as well as the norms are advanced in a manner that they advantage the in-group. The theory also posits that the process of singling out the group by stereotype apportionment and the allocation of the cognitive frameworks is christened the “categorization” process

Jackson (2004) defines social category diversity as dissimilarity in social category membership. For instance, it can happen if members of the group vary in relation to gender, age or if they come from different ethnic groups. As a result of these differences, a team would achieve a low level of cohesiveness and satisfaction. A relationship-oriented conflict will have a harmful effect on performance if a team fails to control its differences, (Williams & O'Reilly, 1998; Tjosvold, 2003).

In accordance to social identity theory, personal identity develops among people according to the group to which they fit in (Hogg, Terry & White, 1995). Being a member of a particular group happens when persons stereotype themselves by attributing to them behaviors, attitudes and other characteristics. Self-categorization is defined as the process of seeing oneself as a member of a group (Kulik& Bainbridge 2006). Social identity theory can be termed as a theory of people belonging to a particular membership and portraying similar behavior (Hogg, 1995). It is how individual make sense and understand themselves in social settings and circles. This theory links the differences in demographic factors of tax payers like age, gender and levels of education and their influence on tax compliance or evasion.

2.3 Empirical Review

2.3.1 Effect of Tax Rate on Tax Evasion

The relationship between tax cuts and increment in tax rates in curbing tax evasion has attracted numerous researches around the world. Allingham and Sandmo (2013) argue that tax cuts may broaden tax base and improve compliance behaviors of citizens. However, Goh, Lee, Lim and Shevlin (2016) asserted that increment in tax rates will exert fear into taxpayers' hence encouraging tax compliance. The study adopted descriptive survey design and employed the use purposive sampling method. Tax rates increase will result in an increase propensity to evade taxes. An upsurge in tax rates shifts the burden of tax payments to few individuals complying with taxes. According to Dyreng, Hanlon and Maydew (2018), such upsurge in tax rates will eventually compel taxpayers to adopt noncompliant behaviors hence affecting tax revenues needed to fund public expenditures.

Mazzolini, Pagani and Santoro (2016) state that when tax rates are that high, nobody is going to pay, business will find a way to get out. The study employed a descriptive survey design. High-end clients in New York are holding onto stocks and avoiding selling their business for fear of being bulldozed by a giant capital gains tax bill. The increase in the tax rates will lead to increase in the size of underground economy. Hanlon, Maydew and Thornock (2015) further argues that there should be a reduction in tax rates in the legal sector; increase the punishment for participation in the illegal activities and legalizing currently illegal activities such as gambling and use of marijuana.

Fisman and Wei (2013) were interested in fleshing out a widely held notion that higher tax rates will encourage greater evasion with a study that could assess the magnitude of the effect. Data was collected using structured questionnaires and purposive sampling technique was employed from thirty (30) respondents as a sample size used to collect data from the respondents. So, they decided to examine detailed statistics on a range of

goods exported from Hong Kong to China, paying specific attention to the value and quantity reported by Hong Kong versus what was reported by China. The study indicated that, higher tax rates provoke tax evasion. The author captured this phenomenon in some detail when they look at how importers in China responded to high tariff rates by engaging in a rash of evasive behaviors. They find the reaction in that country to be so intense that tax increases may even produce a reduction rather than an increase in tax revenues. Carrillo, Pomeranz and Singhal (2017) opines that there are widespread practices of underreporting unit value of the imports and mislabeling higher-taxed products as lower taxed products.

Kukaj, (2016) analyzed the effect of tax rates on tax evasion by using aggregate US data for the period 1941-1981. The study employed both descriptive and inferential statistics for data analysis. The study focused on the importance of inflation. It seems clear that inflation can affect the decision to evade. Inflation erodes the real value of nominal disposable income and this induces taxpayers to restore their purchasing power through tax evasion. A change in the tax rate exerts two opposing effects on the taxpayer. According to Dyreng, Hanlon, Maydew and Thornock (2017), an increase in the tax rate induces greater evasion since it increases the marginal return to successful evasion. Reducing disposable income, a higher tax rate generates an additional effect (the income effect) which may lead to more or less evasion depending on the individual attitude towards risk. To the extent that an individual is less willing to take risk as his/her after-tax income declines, he/she will be less inclined to evade taxes when the tax rate increases.

Caroll (2013) analyzed the reaction of taxpayers resulted from increasing tax rate. The research investigates a taxpayer panel to evidence the income declared in response of a tax rate change. The study embraced a descriptive research. The study concluded that increasing tax rate causes lowering the declared income for tax purposes. The research shows that income tax rate increasing during 2013 reduced the income gathered from tax administration with 39% at most and 13% at least.

From the reviewed literature, a negative relationship is predicted between tax rates and tax evasion. Most of the reviewed studies suggest that an increase in tax rate would lead to reduction in amount of taxes declared (tax evasion). However, some of these studies were done in advanced economies including United States of America while others collected data from secondary sources which creates knowledge gaps.

2.3.2 Effect of Economic Factors on Tax Evasion

Income level fluctuations have had an impact on taxpayers evading behaviors. It is widely asserted that higher income level attracts higher compliance while lower-income taxpayers connote lower compliance (Kasper, Kogler & Kirchler, 2015). High income earners are expected to exhibit wealth by complying to taxes while low income earners are expected to hide their actual income from tax officials (Donohoe, 2015). An argument made by Birskyte (2013) emphasized that income components is a major driving force in curbing tax evasion. Further, the researcher asserted that income source solely from wages and salaries minimizes tax evasion to an appreciable level (Basheer, Ahmad & Hassan, 2019). Nevertheless, works have also proven that there exists no statistically significant relationship between tax evasion and income.

Mason and Lowry (2013) find that middle income taxpayers are generally compliant with tax laws, while low income level taxpayers and high-income level taxpayers are relatively non-compliant with tax laws. Income source usually refers to the type or nature of the taxpayer's income. Schmolder's (2013) show that when a large part of a country's labor force is engaged in agriculture and small trading, income and profit taxation is unsuccessful. The greatest opportunity to evade income tax exists from those who derive their income from agriculture, independent trades or self-employment, whereas the least opportunity exists for those taxpayers whose source of income is dependent on wages or salaries subject to withholding, such as from the services sector (Lefebvre, Pestieau, Riedl & Villeval, 2015).

According to a study done by Carfora, Pansini and Pisani (2017) the issue is the relationship between tax evasion and economic stability. The study embraced a descriptive research. Increase in the size of the underground activities implies that there is less reported taxable income which means that the government may confront a budget deficiency. Balafoutas, Beck, Kerschbamer and Sutter (2015) point out that higher unofficial activities will decrease the legal GDP which can be interpreted as a sign of recession and increase the uncertainty and the risk of investment. Therefore, tax evasion leads to instability of the economy. Hence, it is expected that the increase in the amount of tax evasion causes the economy to become more instable.

Alabede, Ariffin and Idris (2013) investigated individual taxpayers' attitude and compliance behavior in Nigeria. The study adopted an exploratory research design. The study recognized that several factors may be responsible for low compliance in income tax administration in Nigeria. However, taxpayers' attitude was identified as one factor that play important role in influencing tax compliance behavior. Data for the study were collected through a survey of individual taxpayers' opinion, meanwhile the analysis was carried out using moderated multiple regression. The result of the study indicated that taxpayer's attitude towards tax evasion is positively related to compliance behavior due to the low income. Abdixhiku, Pugh and Hashi (2018) indicate that taxpayer's risk preference has strong negative moderating impact on the relationship between income level towards tax evasion and compliance behavior.

The reviewed literature established that economic factors affecting tax evasion include the level of incomes and presence of underground economies and they have an influence on tax evasion. Some of the studies reviewed however, were carried out in other countries including Nigeria, which points out the need for similar studies in Kenyan context.

2.3.3 Effect of Demographic Factors on Tax Evasion

Gender of the taxpayer has been revealed to be significant in past studies. Calvin (2013) show that the compliance levels of female taxpayers are higher than for males and argue

that this compliance gap is shrinking over time as new generations of liberated women emerge. The study used descriptive research design where secondary panel data was collected. Demographic factors effect on tax evasion cannot be underestimated. On the account of gender, female taxpayers are more compliant than their male counterparts (Vogel, 2014). Evasion of taxes is more unacceptable behavior to female taxpayers than their male counterparts. The emergence of more independent non-traditional generation seems to be lowering the compliance gap between male and female taxpayers. With respect to age, Cyan, Koumpias and Martinez-Vazquez (2016) note that it is believed that the aging taxpayers tend to be more compliant than the younger taxpayers.

According to Eckel and Grossman (2013), younger taxpayers are more risk seeking and less sensitive to penalties. It is also argued that taxpayers who are 65 years and above comply more to taxes. Descriptive research design was adopted, and a questionnaire used to collect data. With regards to ethnicity, minimal research has been undertaken in accounting for the impact of ethnicity on tax compliance. Benk, Budak, Yüzbaşı and Mohdali (2016) note that men and women significantly differ in their willingness to comply with their taxes across countries and conditions. These differences are remarkably large and are consistent across a wide variety of institutional choices. Simply put, women appear to be much more tax compliant than men in every country and under every condition.

The evidence regarding gender differences, however, is somewhat contradictory. Wallace (2015) has shown that men and women behave differently even when facing abstract choices. For example, women tend to be less competitive and less certain of the quality of their performance (Preece & Stoddard, 2015). Eckel and Grossman (2013) have demonstrated in a variety of experiments that women are more altruistic, but others have shown men to be more willing to contribute to the public good. Men and women also appear to have different attitudes and behavior when it comes to taxation specifically. Besley, Jensen and Persson (2019) found out that in contrast to men, women tend to think that the tax code is fairer, the likelihood of getting caught for evasion is greater, and they

overestimate the penalties for evasion. In terms of behavior, several tax compliance experiments have also shown women to be more compliant than men.

The studies reviewed established some of the demographic factors affecting tax evasion as to include the age and education of taxpayers and their gender categories. The studies concur that as compared to men, women are more tax compliant. None of the studies, however, was done in the Kenyan context which brings in the research as well as knowledge gap that the sought to fill.

2.4 Summary and Research Gap

Fisman and Wei (2013) investigated whether tax rates will encourage greater evasion in China; this study had a different contextual setting since it was done outside Kenya. Alabede, Ariffin and Idris (2013) investigated individual taxpayers' attitude and compliance behavior in Nigeria, this study had a different contextual setting since it was done outside Kenya. Kukaj, (2016) analyzed the effect of tax rates on tax evasion by using aggregate US data, these studies were conducted outside Kenya, a different contextual therefore, the finding may not be reflected in the current study. Caroll (2013) analyzed the reaction of taxpayers resulting from increasing tax rate: the study only looked at the reactions and failed to look at the determinant. Carfora, Pansini and Pisani (2017) investigated the relationship between the tax evasion and economic stability; the study did not look at the determinants. Eckel and Grossman (2013) investigated why younger taxpayers are more risk seeking and less sensitive to penalties, the study only concentrated on age.

2.5 Conceptual Framework

A conceptual framework is a model of relationship where researchers present the relationship between variables in a study and show the relationship graphically or diagrammatically. It gives an idea of the variables to be covered by the study. The dependent variable was tax evasion of SME whose indicators were revenue collection

and filled return. The independent variables are to be examined to find out their level of effects on the dependent variable are: economic factors, tax rate and demographic factors.

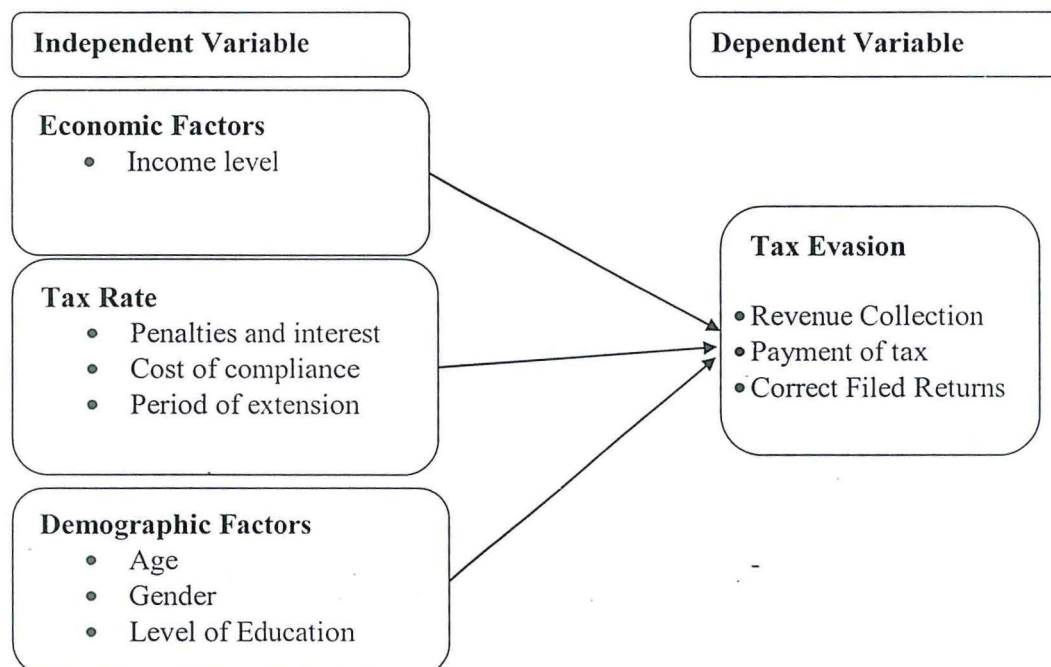


Figure 1.1 Conceptual Framework

2.6 Operationalization of Variables

Table 2.1 gives a summary of how the study variables were operationalized.

Table 2.1: Operationalization of Variables

Objective (s)	Type of Variable	Type of Scale	Indicators	Type of analysis
To examine the effect of tax rates on tax evasion among SMES in Nairobi County, Kenya	Independent tax rates	Ordinal scale	<ul style="list-style-type: none"> • Penalties and interest • Cost of compliance • Period of extension 	<ul style="list-style-type: none"> • Descriptive statistics • Inferential statistics
To assess the effect of economic factors on tax evasion among SMES in Nairobi	Independent economic factors	Ordinal scale	<ul style="list-style-type: none"> • Income level 	<ul style="list-style-type: none"> • Descriptive statistics • Inferential statistics

County, Kenya				
To investigate the effect of demographic factors on tax evasion among SMES in Nairobi County, Kenya	Independent demographic factors	Ordinal scale	<ul style="list-style-type: none"> • Age • Gender • Level of Education 	<ul style="list-style-type: none"> • Descriptive statistics • Inferential statistics
Tax evasion among SMES in Nairobi County, Kenya	Dependent tax evasion	Ordinal scale	<ul style="list-style-type: none"> • Revenue Collection • Payment of tax • Correct Filed Returns 	<ul style="list-style-type: none"> • Descriptive statistics • Inferential statistics

2.7 Chapter Summary

The chapter has reviewed the economics of crime model, prospect theory and social identity and self-categorization theories that provided anchorage to the whole study. In addition to these theories, literature on personal and non-personal factors affecting tax evasion has also been extensively reviewed. The conceptual framework showing the variables of the study and their measurement is also well presented.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the research methodology, the data collection process and data analysis, research design, the location of the study, the target population and sampling method to be used, the data collection instrument, data collection procedure, analysis and ethical considerations.

3.2 Research Design

The study adopted a descriptive research design. This design is appropriate for this study as respondents of the study were expected to provide a description of the different drivers of tax evasion and how they affect the amount of revenue collected (Creswell, 2013). Descriptive research design was appropriate for this study because, this research design concerns itself with collecting information on the respondents understanding, perception and opinion (Yin, 2013). It answers the question on where, what, how and where of a phenomenon or event. The descriptive design is the description of state of affairs as they exist at present.

3.3 Target Population

Population refers to the entire subjects that the researcher wants to study. According to Yin (2013), the population consists of the aggregate of the observable items which the researcher is interested in. The study targeted 2017 top 100 SMEs in Kenya winner list, since they were deemed to be more experienced in matters of taxation (Bizna-Kenya, 2018). The respondents of the study comprised of one director from each of these 100 SMEs hence making up 100 respondents.

3.4 Sampling Techniques

Sampling is the process of selecting a group of subjects within the targeted population, who represent the larger population group. The study adopted purposive sampling

picking only the managing directors. Since the targeted population was relatively small, census was employed and thus 100 respondents were all included in the study. According to Lewis (2015), a census gives valid data as all the population used in the study and there was no generalization of findings. Yin (2017) opines that a census is ideal whenever the population elements are less than 200.

3.5 Data Collection Instrument

This study collected primary data from the field with the help of questionnaires that contained of close ended questions. Questionnaires were used since they were relatively quick and easy to develop code and interpret. The questionnaire covered the demographic information and each of the four study variables (tax rate, economic factors, demographic factor and tax evasion). The questionnaire used the Five Point Likert scale to explain the extent of agreement in each of the study variables. The study applied self-administration method while issuing respondents with the questionnaires. This was meant to raise the response rate of the study. The questionnaires were issued to the respondents at the place of work; respondents were allowed one week to fill the questionnaire before the researcher collected them for analysis. At the point of issuing the questionnaire, contact information of the researcher were given in order to respond to any queries that would arise while filling the questionnaire.

3.7 Research Quality

Before data collection commenced, the researcher took consideration of the elements that made up a good research in terms of validity, reliability and objectivity. This was done to ensure the information that would be collected would be free of bias and would be correct. To ensure research quality, the research instruments were subjected to pilot testing. The study used 5 respondents from 5 SMEs within Nairobi that have are not inclusive of the top-100 SMEs for carrying out pilot testing. The SMEs to take part in the pilot study were purposively selected.

3.7.1 Validity

Validity refers to the extent to which the research instrument measures what it was expected to measure. Validity ensures that the data is reliable, true and accurate (Pickard, 2012). To determine validity, the study engaged the supervisor in reviewing the questionnaires to make sure that the items measure the underlying construct in theories and the conceptual framework. At the end of this review, questions found to be invalid were completely removed from the questionnaires.

3.7.2 Reliability

Reliability refers to consistency in the results obtained and it normally is obtained using the test-retest reliability method (Bernard & Bernard, 2012). To increase reliability, Yin (2013) noted that the similar items for testing need to be increased or testing diverse types of samples of people or events or units using uniform testing procedure. To determine reliability, all the piloted questionnaires were coded into SPSS and the Cronbach Alpha coefficient values were computed. According to Yin (2015), Cronbach alpha coefficient of 0.70 and above implies that the study instruments are reliable. The findings of reliability analysis are shown in Table 3.1.

Table 3.1: Reliability Results

Variable	Number of Items	Cronbach Alpha Coefficient	Remark
Tax rate	8	0.765	Reliable
Economic factors	6	0.874	Reliable
Demographic factors	6	0.739	Reliable
Tax evasion	14	0.760	Reliable

Source; Research Data (2019)

From Table 3.1, all the items have Cronbach Alpha coefficients above 0.7, showing that the instruments were reliable. This finding is in lined with Yin (2015) who recommended a Cronbach Alpha of over 0.7 as adequate for inferring that the instruments are reliable.

3.7.3 Objectivity

The researcher ensured there was no bias during the process of data collection and analysis. This was done by first verifying that the data collection instruments were functional before the actual study commences. The discussions and conclusions were drawn from the study findings and were made free of personal perceptions, assumptions, impressions, feelings and beliefs.

3.8 Data Analysis and Presentation

The data collected was measured to ensure that it conforms to the research objectives. The collected data was sorted to ensure that all the questionnaires are filled. The sorted questionnaires were coded into SPSS Version 23.0 for analysis and presentation. Data was then analyzed by use of descriptive and inferential statistics. Descriptive statistics were presented in form of means and standard deviation. Inferential statistics were presented by use of correlation analysis and multiple regressions.

The multiple regression analysis was specified as follows;

$$Y_{it} = \beta_0 + \beta_{1i}X_{1t} + \beta_{2i}X_{2t} + \beta_{3i}X_{3t} + e_{it}$$

Where,

Y_{it} = Tax evasion

X_{1t} = Tax rate

X_{2t} = Economic factors

X_{3t} = Demographic

e_{it} = is the error term

Whereby:

β_0 = the minimum Y when the rest of the variables are held at a constant zero

The analyzed data was presented in form of figures and tables.

3.9 Ethical Consideration

The researcher aimed at keeping ethics of research while conducting this study. The researcher sought permission from the management of each SME before commencement of data collection (Flick, 2015). The researcher sought permission from the Strathmore University – Institutional Regulatory Board (SU- IRB) to collect data.

Confidentiality was maintained by ensuring the names of the respondents were not indicated anywhere, individual responses were grouped to get an overall opinion that was generalized to the study findings. The researcher endeavored to maintain anonymity of the respondents.

CHAPTER FOUR: PRESENTATION OF RESEARCH FINDINGS

4.1 Introduction

Once data had been collected from the field, it was cleaned and populated in the Statistical Package for Social Sciences (SPSS). The analysis was then conducted on the data as presented in this chapter. For ease of presentation, the chapter is divided into sections starting with the information on respondents and the variables of the study. The inferential statistics covering correlation and regression analysis is also detailed in this chapter. The essence of the inferential statistics was to determine relationship and the effect of the identified factors on tax evasion.

4.1.1 Response Rate

A total number of 100 questionnaires were distributed to managing directors of the 2017 top 100 SMEs companies in Kenya. From these questionnaires, 79 of them were completed by the respondents hence giving a response rate of 79%. The response rate was adequate and conquered with Yin (2017) who opines that for presentation and interpretation, good response rates should be over 70%.

4.2 General Information

The general information on the respondents and the studied SMEs were collected and presented as shown in this section.

4.2.1 Gender of Respondents

The gender distribution of respondents who took part in the study is shown in Table 4.1.

Table 4.1: Gender of Respondents

	Frequency	Percent
Male	58	73.4
Female	21	26.6
Total	79	100.0

Source; Research Data (2019)

The findings in Table 4.1 indicate that while 73.4% of the respondents were male, 26.6% were female. This shows that both male and female respondents were involved in the study hence representative findings were sought on effect of personal and non-personal factors on tax evasion.

4.2.2 Age of Respondents

The age brackets of respondents who took part in the study are as shown in Table 4.2.

Table 4.2: Age of Respondents

	Frequency	Percent
20-30 Years	5	6.3
31-40 Years	11	13.9
41-50 Years	47	59.5
Above 51 Years	16	20.3
Total	79	100.0

Source; Research Data (2019)

From Table 4.2, most of the respondents 59.5% were 41-50 years, 20.3% were over 51 years, and 13.9% were 31-40 years while 6.3% were 20-30 years. This implies that respondents who took part in the study were adults who probably understood tax evasion. Hence, the information they gave on tax evasion was reliable as presented herein.

4.2.3 Level of Education of Respondents

The study sought to understand the highest level of education of the respondents as a way of predicting their knowledge and ability to read, write and interpret the research questions as shown in Table 4.3.

Table 4.3: Level of Education of Respondents

	Frequency	Percent
Certificate	7	8.9
Diploma	18	22.8
Undergraduate Degree	42	53.2
Post Graduate Degree	12	15.2
Total	79	100.0

Source; Research Data (2019)

The study established that 53.2% of the respondents had undergraduate degrees, 22.8% had diplomas, and 15.2% had post graduate degrees while 8.9% had a certificate. This shows that respondents of the study were generally learned and thus could read and interpret the research questions properly. They were also knowledgeable on matters of tax evasion as sought by the study.

4.2.4 Length of SME Operation

The findings on the number of years that the studied SMEs had been in operation are summarized in Table 4.4.

Table 4.4: Length of SME Operation

	Frequency	Percent
Less than 3 Years	5	6.3
4-6 Years	29	36.7
7-9 Years	28	35.4
Above 10 Years	17	21.5
Total	79	100.0

Source; Research Data (2019)

As indicated in Table 4.4, majority of the SMEs top 100 SMEs in 2017 had been operation for 4-6 years, 35.4% for 7-9 years, 21.5% for over 10 years an 6.3% for less than 3 years. Thus, most SMEs studied had been in operation for a relatively long period of time hence suitable for case studies.

4.2.5 Whether Tax Evasion is a Key Concern

The study sought to determine whether tax evasion is a key concern issue and the findings are reported in Table 4.5.

Table 4.5: Whether Tax Evasion is a Key Concern

	Frequency	Percent
Yes	58	73.4
No	21	26.6
Total	79	100.0

Source; Research Data (2019)

Table 4.5 shows that most of the respondents 73.4% believed that tax evasion is a key concern. This is probably because it is illegal and attracts heavy penalties and fines once caught up. The finding is consistent with Pickhardt and Prinz (2014) who established that tax evasion affects various sectors of an economy and heaps adverse effect on the economy as a whole. Hashimzade et al. (2013) also points out that several countries have experienced loss in tax revenues due to tax evasion.

4.3 Descriptive Analysis

The study had three specific objectives which were; to examine the effect of tax rates on tax evasion among SMES in Nairobi County, to assess the effect of economic factors on tax evasion among SMES in Nairobi County and to investigate the effect of demographic factors on tax evasion among SMES in Nairobi County, Kenya.

To attain this objective, descriptive statistics including means and standard deviations were used. The questions were formulated using a 5-point Likert scale where 1=strongly disagree and 5=strongly agree. To interpret this Likert scale, values of means was used such that means between 1-1.4 (strongly disagree), 1.5-2.4 (disagree), 2.5-3.4 (neutral), 3.5-4.4 (agree) and 4.5-5.0 (strongly agree). The findings are shown in subsequent sections.

4.3.1 Tax Rate and Tax Evasion

Table 4.9 presents the statements on tax rate and its influence on tax evasion. The statements were structured on a five-point Likert scale, where 1=strongly disagree and 5=strongly agree. To interpret this Likert scale, means and standard deviations were computed. The findings are shown in Table 4.6.

Table 4.6: Tax Rate and Tax Evasion

	Mean	Std. Dev
The tax rates on SMEs are too high	4.26	.308
Increase in tax rate leads to increase in propensity to evade taxes.	4.13	.548
High tax rate will make the owner of the business to be noncompliant.	3.83	.343
When tax rates are high nobody is going to pay.	2.94	.499
Tax avoidance is ethical if tax rates are too high	3.12	.488
Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking	2.43	.498
Taxes are so high, in order to survive, it is understandable why SMEs try and minimize their tax payments	3.97	.488
The increase in the tax rates will lead to increase in the size of underground economy	4.10	.494

Source; Research Data (2019)

Most of the respondents agreed with a mean of 4.26 that the tax rates on their SMEs are too high. The finding is in line with Allingham and Sandmo (2013) who asserted that increment in tax rates will exert fear into taxpayers' hence encouraging tax compliance. Respondents further agreed with a mean of 4.13 that this increase in tax rate leads to increase in propensity to evade taxes. This finding is in line with Allingham and Sandmo (2013) who asserted that tax rates increase will result in an increased propensity to evade taxes. Respondents agreed that the increase in the tax rates will lead to increase in the size of underground economy as shown by a mean of 4.10. This finding is echoed by Mazzolini et al. (2016) who state that the increase in the tax rates will lead to increase in the size of underground economy.

On whether taxes are so high, to survive, it is understandable why SMEs try and minimize their tax payments, respondents agreed with a mean of 3.97. Respondents also agreed that high tax rate will make the owner of the business to be noncompliant with a mean of 3.83. According to Allingham and Sandmo (2013), upsurge in tax rates will eventually compel taxpayers to adopt noncompliant behaviors hence affecting tax revenues needed to fund public expenditures. On the other hand, respondents were neutral on whether tax avoidance is ethical if tax rates are too high with a mean of 3.12, when tax rates are high nobody is going to pay with a mean of 2.94 or tax evasion is

ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking with a mean of 2.43.

4.3.2 Economic Factors and Tax Evasion

The study sought to determine the effect of economic factors on tax evasion. The findings are shown in Table 4.7.

Table 4.7: Economic Factors and Tax Evasion

	Mean	Std. Dev
The level of income of the business has impact on evading behavior	3.64	.674
Higher income level attracts higher compliance	3.35	.620
Lower-income taxpayers connote lower compliance	4.11	.800
Low income earners hide their actual income from tax officials	2.71	.980
Middle income taxpayers are generally compliant with tax laws	3.67	.901
Low income level taxpayers and high-income level taxpayers are relatively non-compliant with tax laws	3.60	.586

Source; Research Data (2019)

Table 4.7 shows that respondents agreed on the fact that lower-income taxpayers connote lower compliance with a mean of 4.11. The finding is consistent with the argument made by Birskyte (2013) that higher income level attracts higher compliance while lower-income taxpayers connote lower compliance. Respondents also agreed that middle income taxpayers are generally compliant with tax laws with a mean of 3.67. The finding agrees with Mason and Lowry (2013) who found that middle income taxpayers are generally compliant with tax laws, while low income level taxpayers and high-income level taxpayers are relatively non-compliant with tax laws.

Respondents agreed that the level of income of the business has impact on evading behavior as shown by a mean of 3.64. According to Birskyte (2013), income level fluctuations have had an impact on taxpayers evading behaviors. Respondents agreed that low income level taxpayers and high-income level taxpayers are relatively non-compliant with tax laws with a mean of 3.60. Mason and Lowry (2013) found that middle income taxpayers are generally compliant with tax laws, while low income level taxpayers and high-income level taxpayers are relatively non-compliant with tax laws.

Respondents were however neutral on whether higher income level attracts higher compliance with a mean of 3.35 or low-income earners hide their actual income from tax officials as shown by a mean of 2.71.

4.3.3 Demographic Factors

The study assessed the effect of demographic factors on tax evasion. The findings are indicated in Table 4.8.

Table 4.8: Demographic Factors

	Mean	Std. Dev
The levels of female taxpayers are higher than for males	3.13	.348
Female taxpayers are more compliant than their male counterparts	3.56	.498
Younger taxpayers are more risk seeking and less sensitive to penalties.	3.59	.494
Men and women significantly differ in their willingness to comply with their taxes across countries and conditions	3.85	.481
Evasion of taxes is more unacceptable behavior to female taxpayers than their male counterparts	3.19	.494
Older taxpayers tend to be more compliant than the younger taxpayers	3.34	.642

Source; Research Data (2019)

As indicated in Table 4.8, most of the respondents agreed that men and women significantly differ in their willingness to comply with their taxes across countries and conditions with a mean of 3.85. This finding is strongly supported by Eckel and Grossman (2013) who established that men and women significantly differ in their willingness to comply with their taxes across countries and conditions and these differences are remarkably large and are consistent across a wide variety of institutional choices.

Respondents further agreed that younger taxpayers are more risk seeking and less sensitive to penalties with a mean of 3.59. Eckel and Grossman (2013) established that younger taxpayers are more risk seeking and less sensitive to penalties. It is also argued that taxpayers who are 65 years and above comply more to taxes. Respondents further

agreed that female taxpayers are more compliant than their male counterparts with a mean of 3.56. This finding is according to Vogel (2014) who established that female taxpayers are more compliant than their male counterparts. On the other hand, respondents were neutral on whether older taxpayers tend to be more compliant than the younger taxpayers with a mean of 3.34, evasion of taxes is more unacceptable behavior to female taxpayers than their male counterparts with a mean of 3.19 or the levels of female taxpayers are higher than for males with a mean of 3.13.

4.3.4 Tax Evasion

The dependent variable of the study was tax evasion and Table 4.9 presents the findings on the same.

Table 4.9: Attitudes towards Tax Evasion

	Mean	Std. Dev
Tax is important for the country's success and economy	4.48	.502
People evade tax because they are not likely to get caught	4.43	.498
The taxes that are collected are not used efficiently	2.94	.494
The consequences of getting caught for tax (penalties, prosecution) is not serious enough	3.26	.498
People do not understand how to submit returns	4.35	.481
There is a general culture of tax evasion in Kenya	2.37	.488
You would pay less tax if you knew you could without being prosecuted	4.43	.498
You would happily pay taxes without any enforcement	2.64	.481
Tax evasion is ethical if a large portion of the money collected is wasted.	2.35	.481
Tax evasion is ethical even if most of the money collected is spent wisely.	2.43	.498
Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.	2.44	.642
Tax evasion is ethical if everyone is doing it.	2.35	.481
Tax evasion is ethical if the government discriminates because of my religion, race or ethnic background	2.34	.481

Source; Research Data (2019)

Most respondents agreed that tax is important for the country's success and economy with a mean of 4.48. Respondents also agreed that people evade tax because they are not likely to get caught with a mean of 4.43. Schmolder's (2013) show that when a large part

of a country's labor force is engaged in agriculture and small trading, income and profit taxation is unsuccessful. The study revealed that one would pay less tax if you he/she could without being prosecuted with a mean of 4.43. The study established that people do not understand how to submit returns with a mean of 4.35. Carfora, Pansini and Pisani (2017) indicate that tax evasion lead to instability of the economy. Hence, it is expected that the increase in the amount of tax evasion causes the economy to become more instable. On the other hand, respondents were neutral on whether the consequences of getting caught for tax (penalties, prosecution) are not serious enough with a mean of 3.26, as to whether taxes that are collected are not used efficiently, the mean was 2.94 and on whether respondents would happily pay taxes without any enforcement, the mean was 2.64.

Respondents however, disagreed that tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit them with a mean of 2.44. Respondents further disagreed that tax evasion is ethical even if most of the money collected is spent wisely, there is a general culture of tax evasion in Kenya, tax evasion is ethical if a large portion of the money collected is wasted, tax evasion is ethical if everyone is doing it and on whether tax evasion is ethical if the government discriminates because of my religion, race or ethnic background.

4.5 Inferential Statistics

The study carried out correlation and regression analysis to determine relationship and effect of personal and non-personal factors on tax evasion.

4.5.1 Correlation Analysis

In order to determine the relationship between personal and non-personal factors and tax evasion among SMEs, correlation analysis as conducted. The findings are shown in Table 4.10.

Table 4.10: Correlation Analysis

		Tax Evasion	Tax Rate	Economic Factors	Demographic Factors
Tax Evasion	Pearson Correlation	1			
	Sig. (2-tailed)				
	N	79			
Tax Rate	Pearson Correlation	.485**	1		
	Sig. (2-tailed)	.000			
	N	79	79		
Economic Factors	Pearson Correlation	.564**	.423**	1	
	Sig. (2-tailed)	.000	.000		
	N	79	79	79	
Demographic Factors	Pearson Correlation	.672**	.597**	.677**	1
	Sig. (2-tailed)	.000	.000	.000	
	N	79	79	79	79

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

Source; Research Data (2019)

Correlation results according to Ezekiel (1930) include the coefficient of correlation (r) and the p-values. From Table 4.10, tax rate ($r=0.485$, $p<0.05$) has moderate, positive and significant relationship with tax evasion. Allingham and Sandmo (2013) asserted that such upsurge in tax rates will eventually compel taxpayers to adopt noncompliant behaviors hence affecting tax revenues needed to fund public expenditures.

Economic factors ($r=0.564$, $p<0.05$) has strong, positive and significant relationship with tax evasion. Demographic factors ($r=0.672$, $p<0.05$) has strong, positive and significant relationship with tax evasion. Alabede et al. (2013) investigated individual taxpayers' attitude and compliance behavior in Nigeria and taxpayer's attitude towards tax evasion is positively related to compliance behavior due to the low income.

4.5.2 Regression Results

Regression analysis was carried out to determine the effect personal and non-personal factors on tax evasion. Table 4.11 gives the findings of the model summary.

Table 4.11: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.877 ^a	.768	.759	.45744

a. Predictors: (Constant), Demographic Factors, Tax Rate, Economic Factors

Source; Research Data (2019)

Table 4.11 shows the values of coefficients R of correlation and determination R square respectively. From the findings, R square is 0.768, which show that 76.8% change in tax evasion among SMEs is explained by demographic factors, tax rate, and economic factors. The value of R square is relatively high showing overall fitness of the model to the study. Analysis of Variance (ANOVA) was performed at 5% level of significance as reported in Table 4.12.

Table 4.12: Analysis of Variance

	Sum of Squares	df	Mean Square	F	Sig.
Regression	52.028	3	17.343	82.881	.000 ^b
Residual	15.694	75	.209		
Total	67.722	78			

a. Dependent Variable: Tax Evasion

b. Predictors: (Constant), Demographic Factors, Tax Rate, Economic Factors

Source; Research Data (2019)

From Table 4.12, the value of F calculated is 82.881, while F critical is 2.727. Since the value of F calculated is greater than F critical, it can be summed up that the overall regression model was significant.

Table 4.13 shows the regression coefficients and the p values of respective variables of the study.

Table 4.13: Regression Coefficients

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	25.822	1.338		19.304	.000
Tax Rate	.122	.022	.277	5.594	.000
Economic Factors	.546	.055	.752	9.948	.000
Demographic Factors	.072	.019	.145	3.846	.000

a. Dependent Variable: Tax Evasion

Source; Research Data (2019)

From the findings in Table 4.13, the following regression equation is modeled;

$$Y_{it} = 25.822 + 0.122X_{1t} + 0.546X_{2t} + 0.072X_{3t}$$

Where,

Y_{it} = Tax evasion

X_{1t} = Tax rate

X_{2t} = Economic factors

X_{3t} = Demographic factors

Thus, when all other factors are held constant, tax evasion would be at 25.822. A unit rise in tax rate other factors relaxed would bring about an increase in tax evasion among SMEs by 12.2%. A unit increase in economic factors with other factors held constant would result into 54.6% increase in tax evasion. Holding other factors constant, a unit increase in demographic factors would lead to 7.2% increase in tax evasion among Kenyan SMEs.

At 5% level of significance, the study documents that tax rate has significant effect on tax evasion ($p < 0.05$). Fisman and Wei (2013) were interested in fleshing out a widely-held notion that higher tax rates will encourage greater evasion with a study that could assess the magnitude of the effect. It was indicated that, higher tax rates provoke tax evasion. Economic conditions also have significant effect on tax evasion $p < 0.05$. Carfora, Pansini and Pisani (2017) established that there is an issue is the relationship between the tax evasion and economic stability. Demographic factors have significant effect on tax evasion $p < 0.05$. According to Eckel and Grossman (2013) younger taxpayers are more risk seeking and less sensitive to penalties.

CHAPTER FIVE: DISCUSSIONS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter contains a summary of the analysed findings. The conclusions are provided as informed from the key findings. The chapter also presents the recommendations for further for management, policy and practice. The areas that future studies should focus on are also well discussed.

5.2 Discussions

The purpose of this study was to establish the effect of personal and non-personal factors on tax evasion among SMEs in Nairobi County, Kenya. The study had the following specific objectives; to examine the effect of tax rates on tax evasion among SMES in Nairobi County, Kenya; to assess the effect of economic factors on tax evasion among SMES in Nairobi County, Kenya; to investigate the effect of demographic factors on tax evasion among SMES in Nairobi County, Kenya.

5.2.1 Tax Rate and Tax Evasion

The study established that the tax rate has a positive and significant effect on tax evasion. This shows that any slight increase in tax rates would result to an increase in tax evasion. This observation is in line with Allingham and Sandmo (2013) who asserted that increment in tax rates will exert fear into taxpayers' hence encouraging tax compliance. Similarly, Atawodi and Ojeka (2012) studied factors affecting compliance of tax among the small and medium enterprises (SMEs) and established that high tax rates and complex filing procedures are the most crucial factors causing non-compliance for SMEs. Karanja (2014) sought to establish factors affecting voluntary tax compliance on rental income and revealed that high tax rate is significant and play a great role towards the compliance or non-compliance of Kenyan taxpayers on rental income.

The positive effect of tax rate on tax evasion infers that an increase in tax rates would increase tax evasion. This is particularly true because increasing the tax rate would

increase the burden to be shielded by taxpayers hence being motivated to come up with innovative schemes of evading taxes. One of these creative ways according to the prospect theory is for people to strike balance between the loss and gain of evading taxes. According to Kahneman and Tversky (1979), the motivation to evade tax is more driven by the gains as compared to the losses.

Most of the respondents agreed that the tax rate on SMEs is too high and that this increase in tax rate leads to increase in propensity to evade taxes. The finding is echoed by Allingham and Sandmo (2013) who asserted that increment in tax rates will exert fear into taxpayers' hence encouraging tax compliance and that tax rates increase will result in an increase propensity to evade taxes. Respondents agreed that the increase in the tax rates will lead to increase in the size of underground economy. This finding is consistent with Mazzolini et al. (2016) who stated that the increase in the tax rates will lead to increase in the size of underground economy. Carfora et al. (2017) points out that the increase in the size of the underground activities implies that there is less reported taxable income which means that the government may confront a budget deficiency. On whether taxes are so high, in order to survive, it is understandable why SMEs try and minimize their tax payments, respondents agreed. Respondents also agreed that high tax rate will make the owner of the business to be noncompliant.

5.2.2 Economic Factors and Tax Evasion

The study revealed that economic factors have positive and significant effect on tax evasion. This means that any increase in economic factors would encourage more people to evade taxes. This is supported by Birskyte (2013) who argue that income level fluctuations have had an impact on taxpayers evading behaviors since higher income level attracts higher compliance while lower-income taxpayers connote lower compliance. Respondents agreed on the fact that lower-income taxpayers connote lower compliance. This finding is in line with Birskyte (2013) who indicated that higher income level attracts higher compliance while lower-income taxpayers connote lower compliance

and that high-income earners are expected to exhibit wealth by complying to taxes while low income earners are expected to hide their actual income from tax officials.

The positive effect of economic factors on tax evasion is supported by the Economics of Crime Model, where according to Osoro (1995), a rational consumer seeks to maximize the expected utility of tax evasion gamble, by balancing the benefits accruing from successful cheating against risks of likely sufferings from detection in the form of punishment. Respondents also agreed that middle income taxpayers are generally compliant with tax laws. According to Mason and Lowry (2013), find that middle income taxpayers are generally compliant with tax laws, while low income level taxpayers and high-income level taxpayers are relatively non-compliant with tax laws. Income source usually refers to the type or nature of the taxpayer's income. Respondents agreed that the level of income of the business has an impact on evading behavior. Alabede et al. (2013) investigated individual taxpayers' attitude and compliance behavior in Nigeria and established that taxpayer's attitude towards tax evasion is positively related to compliance behavior due to the low income. Respondents agreed that low income level taxpayers and high-income level taxpayers are relatively non-compliant with tax laws. This finding is in line with Mason and Lowry (2013) who find that low income level taxpayers and high-income level taxpayers are relatively non-compliant with tax laws.

5.2.3 Demographic Factors

The findings of the study showed that demographic factors have positive and significant effect on tax evasion among SMEs. Some of these demographic factors include gender of tax payers (whether male or female tax payers). Indeed, Calvin (2013) shows that the compliance levels of female taxpayers are higher than for males and argue that this compliance gap is shrinking over time as new generations of liberated women emerge. Vogel (2014) opines that demographic factors effect on tax evasion cannot be underestimated such that on the count of gender, female taxpayers are more compliant than their male counterparts.

The positive effect of demographic factors on tax evasion are strongly supported by the social identity and self-categorization theory, which infers that men and women significantly differ in their willingness to comply with their taxes across countries and conditions (Wallace, 2015). Most of the respondents agreed that men and women significantly differ in their willingness to comply with taxes across countries and conditions. Wallace (2015) has shown that men and women behave differently even when facing abstract choices. For example, women tend to be less competitive and less certain of the quality of their performance (Preece & Stoddard, 2015). Respondents further agreed that younger taxpayers are more risk seeking and less sensitive to penalties. Eckel and Grossman (2013) younger taxpayers are more risk seeking and less sensitive to penalties. It is also argued that taxpayers who are 65 years and above comply more to taxes. Respondents further agreed that female taxpayers are more compliant than their male counterparts. Eckel and Grossman (2013) have demonstrated in a variety of experiments that women are more altruistic, but others have shown men to be more willing to contribute to the public good.

5.3 Conclusion

Tax rate has a positive and significant effect on tax evasion. The tax rate on most SMEs is too high. The increase in tax rate leads to increase in propensity to evade taxes. The increase in the tax rates will lead to increase in the size of underground economy. Taxes are so high and, in order to survive, it is understandable why SMEs try and minimize their tax payments. High tax rate will make the owner of the businesses to be noncompliant.

Economic factors have a positive and significant effect on tax evasion. Lower-income taxpayers connote lower compliance. Middle income taxpayers are generally compliant with tax laws. The level of income of the business has impact on evading behavior. Low income level taxpayers and high-income level taxpayers are relatively non-compliant with tax regulations.

Demographic factors have positive and significant effect on tax evasion among SMEs. Men and women significantly differ in their willingness to comply with their taxes across countries and conditions. Younger taxpayers are more risk seeking and less sensitive to penalties. Female taxpayers are more compliant than their male counterparts.

5.4 Recommendations of the Study

The study established that tax rate has a positive influence on tax evasion. This finding has an implication that an increase in rate of taxes would encourage more tax evasion. Therefore, the study recommends that the KRA should come up with innovative ways of collecting revenue without necessarily raising the rates. To increase tax revenue without interfering with the tax rate, KRA should think of expanding the tax base to include more people in the tax net. This is especially the self-employed who arguably have more opportunity than the employed to evade tax, since their income is typically not subject to third-party reporting.

In order to reduce the level of underground economy, the study recommends that the KRA should consider reducing the tax rates and provision of incentives that would encourage compliance. Currently SME'S are required to account for corporation tax at 30%, VAT at 16%, county business licenses and account for other agency taxes like withholding tax and Pay As You Earn which makes compliance cost high. Reduced tax rate will result to increased compliance and thus increasing the amount of collected revenues. Further, KRA may consider having simplified taxes and fewer payments. This makes it easier for the SMEs to implement and makes it cheaper for the business since the compliance costs are reduced.

The findings of the study indicated that economic factors positively influence tax evasion. Based on this finding, the study recommends that the government should come up with sound economic policies (including macro and micro economic policies) which would increase the tax payers' incomes hence more taxes. KRA should be considering the middle- and lower-income individual's in formulation of taxation policies.

Demographic factors have positive and significant effect on tax evasion. This study therefore recommends that KRA should consider the male and female attributes when designing taxation policies. KRA may develop a risk matrix based on these demographic factors which may assist in having more targeted tax audits based on the risk rating of the demographic groups. This will reduce the KRA audit and administration costs as more effort will be put-on high-risk taxpayers that would generate more taxes.

5.5 Contribution of the Study to Knowledge

The focus of the study was majorly on the effect of personal and non-personal factors on tax evasion, specifically among the SMEs. From the findings, it has been established that personal as well as non-personal factors all have positive and significant effect on tax evasion. This finding is important as it has expanded the available literature on the factors affecting tax evasion.

The findings of the study have social implications in that, different classes of people in the society have different attitudes on tax compliance. While the more educated group of people in the society are deemed to be more tax compliant, the illiterate and less educated people in the society do not have knowledge and awareness on the need to comply with taxation.

In addition to social dimension, there are also policy implications arising from the findings of the study. In practice, the findings of the study create knowledge to the government in realization that income levels, demographic as well as economic factors have an influence on tax evasion. This is also useful in developing economic policies that propel increased economic growth in the Country. This in turn increases the income level of taxpayers which leads to increased compliance and payment of taxes.

Further, there is need for increased taxpayer involvement by the KRA when developing tax regulations as well as increased taxpayer engagement on tax sensitization and training programmes.

To the senior management teams of the SMEs, the findings of the study create the need to invest in viable opportunities and projects that would increase the revenues which in turn enable business expansion and subsequently payment more taxes to the government.

5.6 Suggestions for Further Studies

The study focused on top 100 SMEs for 2017; however, these firms keep on changing on a yearly basis. The study therefore recommends further studies to focus on SMEs that have consistently remained with top 100 for the last five years. The study focused on three personal and non-personal factors; demographic factors, tax rate, and economic factors. From regression results, personal and non-personal factors explain 76.8% change in tax evasion. This shows that there are other factors (apart from demographic factors, tax rate, and economic factors) that determine tax evasion like the regulatory framework (fiscal and monetary policies). The study therefore recommends the need for more studies to bring out these other drivers influencing tax evasion.

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APPENDICES
APPENDIX I: APPROVAL LETTER



12th March 2019

SU-IERC0328/19

Ruth Ndichu
P.O BOX 13388-00100
Nairobi

Email: ndichuruth@gmail.com

Dear Ruth,

REF **Protocol ID: SU-IERC0328/19 Student Number: 46618**
DRIVERS OF TAX EVASION AMONG SMALL AND MEDIUM ENTERPRISES IN NAIROBI COUNTY, KENYA

We acknowledge receipt of your application documents to the Strathmore University Institutional Ethics Review Committee (SU-IERC) which includes:

1. Cover letter date 21 February 2019
2. Research Proposal version date November 2018
3. Participant Information Sheet and Consent form version date February 2019
4. Research Questionnaire version date November 2018
5. Research Budget
6. CV

The committee has reviewed your application, and your study "*Drivers of Tax Evasion Among Small and Medium Enterprises in Nairobi County, Kenya*" has been granted approval.

This approval is valid for one year beginning **12th March 2019 until 11th March 2020**

In case the study extends beyond one year, you are required to seek an extension of the Ethics approval prior to its expiry. You are required to submit any proposed changes to this proposal to SU-IERC for review and approval prior to implementation of any change.

SU-IERC should be notified when your study is complete.

Thank you

Sincerely,

Amina Salim
Regulatory Affairs Fellow



Ole Sangale Rd, Madaraka Estate. PO Box 59857-00200, Nairobi, Kenya. Tel +254 (0)703 034000
Email info@strathmore.edu www.strathmore.edu

APPENDIX II: QUESTIONNAIRE

SECTION A: GENERAL INFORMATION

1. What is your gender?

Male () Female ()

2. Kindly indicate your age

20-30 Years ()

31-40 Years ()

41-50 Years ()

Above 51 Years ()

3. What is your highest level of education?

Certificate ()

Diploma ()

Undergraduate Degree ()

Post Graduate Degree ()

4. How long has the SME been operating?

Less than 3 Years ()

4-6 Years ()

7-9 Years ()

Above 10 Years ()

5. Do you feel tax avoidance is a key concern?

Yes () No ()

SECTION B: TAX RATE

Below are several statements on how tax rate influence tax evasion among SMEs. Using a Likert scale of 1-5 where; 1=strongly disagree, 2=disagree, 3=neutral, 4 agree and 5 strongly agree; indicate the extent of your agreement with each of these statements.

Statement	1	2	3	4	5
The tax rates on SMEs are too high					
Increase in tax rate leads to increase propensity to evade taxes.					
High tax rate will make the owner of the business to be noncompliant.					
When tax rates are high nobody is going to pay.					
Tax avoidance is ethical if tax rates are too high					
Tax evasion is ethical even if tax rates are not too high because the government is not entitled to take as much as it is taking					
Taxes are so high, in order to survive, it is understandable why SMEs try and minimize their tax payments					
The increase in the tax rates will lead to increase in the size of underground economy					

SECTION C: ECONOMIC FACTORS

Below are several statements on how economic factors influence tax evasion among SMEs. Using a Likert scale of 1-5 where; 1=strongly disagree, 2=disagree, 3=neutral, 4 agree and 5 strongly agree; indicate the extent of your agreement with each of these statements.

Statement	1	2	3	4	5
The level of income of the business has impact on evading behavior					
Higher income level attracts higher compliance					
Lower-income taxpayers connote lower compliance					
Low income earners hide their actual income from tax officials					
Middle income taxpayers are generally compliant with tax laws					
Low income level taxpayers and high-income level taxpayers are relatively non-compliant with tax laws					

SECTION D: DEMOGRAPHIC FACTORS

Below are several statements on how demographic factor influences tax evasion among SMEs. Using a Likert scale of 1-5 where; 1=strongly disagree, 2=disagree, 3=neutral, 4 agree and 5 strongly agree; indicate the extent of your agreement with each of these statements.

Statement	1	2	3	4	5
The levels of female taxpayers are higher than for males					
Female taxpayers are more compliant than their male counterparts					
Younger taxpayers are more risk seeking and less sensitive to penalties.					
Men and women significantly differ in their willingness to comply with their taxes across countries and conditions					
Evasion of taxes is more unacceptable behavior to female taxpayers than their male counterparts					
Older taxpayers tend to be more compliant than the younger taxpayers					

SECTION E: TAX EVASION

Below are several statements on how attitudes influence tax evasion among. Using a Likert scale of 1-5 where; 1=strongly disagree, 2=disagree, 3=neutral, 4 agree and 5 strongly agree; indicate the extent of your agreement with each of these statements.

Statement	1	2	3	4	5
Tax is important for the country's success and economy					
People evade tax because they are not likely to get caught					
The taxes that are collected are not used efficiently					
The consequences of getting caught for tax (penalties, prosecution) is not serious enough					
People do not understand how to submit returns					
There is a general culture of tax evasion in Kenya					
You would pay less tax if you knew you could without being prosecuted					
You would happily pay taxes without any enforcement					
Tax evasion is ethical if a large portion of the money collected is wasted.					
Tax evasion is ethical even if most of the money collected is spent wisely.					
Tax evasion is ethical if a large portion of the money collected is spent on projects that do not benefit me.					
Tax evasion is ethical even if a large portion of the money collected is spent on projects that benefit me.					
Tax evasion is ethical if everyone is doing it.					
Tax evasion is ethical if the government discriminates because of my religion, race or ethnic background					

END

THANK YOU