

## Imposition of Tax Penalties and Interest and Its Influence on Tax Compliance of Small and Medium-Sized Enterprises in Nairobi County, Kenya

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Cite: Muhwa, G., & Omboi, B. (2023). Imposition of Tax Penalties and Interests and Its Influence of Tax Compliance of Small and Medium-Sized Enterprises in Nairobi County, Kenya. *The University Journal*, 5(2), 40-50.

### Abstract

*The purpose of this study was to determine the effect of the imposition of tax penalties and interest on tax compliance of small and medium-sized Enterprises (SMEs) in Nairobi County, Kenya. The economic deterrence theory was used as the theoretical anchor of the study. The population of the study was 195,000 SMEs in Nairobi County, Kenya. The descriptive cross-sectional design was used in the study which focussed on a sample of 399 constituting the managers and owners of SMEs in Nairobi County. Data was gathered using a structured questionnaire that contained closed-ended questions. The collected data was analyzed using descriptive statistics and ordinary least squares regression with the aid of SPSS. The study findings indicated that the imposition of penalties and interest has a positive and significant influence on tax compliance of small and medium enterprises in Nairobi County, Kenya ( $\beta = 0.642$ ,  $t = 10.633$ ,  $p < 0.05$ ). This, therefore, depicts that the imposition of interest and fines makes SMEs to be more tax compliant. The study findings have implications for tax authorities to improve the effectiveness of the tax penalties system that should complement the self-assessment system. The tax authorities should also ensure that the penalty system is equitable, proportionate, clearly defined, and even-handedly administered to encourage voluntary tax compliance and deter tax offenders. The tax authority should also increase the penalty amount to collect more revenue and make it significant for SMEs that do not comply with tax regulations.*

**Keywords:** Interest, Kenya, Nairobi County, Tax compliance, Tax penalties, Small and medium enterprises

### Introduction

In most economies globally, small and medium-sized enterprises (SMEs) account for a significant and increasing portion of the Gross Domestic Product (GDP), employment and innovation. They account for more than half of all firms, more than 90% of all employment, and up to 40% of the GDP in developing nations (World Bank, 2020). The SMEs have been cited as crucial deliverers of inclusive globalization and growth as well as significant factors in promoting both economic and social well-being (Organization of Economic and Co-operative Development, 2017). Additionally, SMEs make up the majority of businesses, they are the primary employer creating 70% of jobs on average, and significantly contribute to value creation, adding 50% to 60% of the value on average (OECD, 2017). However, according to Nguyen (2022), owing to non-compliance with tax regulations and systems, SMEs' contribution to tax income is less than their contributions to employment and growth. Tax compliance-related difficulties largely concern compliance expenses, with the administrative burden of adhering to tax requirements being the largest one. All expenses associated with administrative responsibilities that businesses must complete as a result of the law constitute the tax administrative burden (Bani-Khalid et al., 2022; Werekoh, 2022).

One of the biggest issues facing many tax authorities is the tax compliance of SMEs (Hamis, 2017; Kassa, 2021; Oladipupo & Obaze, 2016; Twum, 2020). Taxpayers are predisposed to lower their tax obligations through tax avoidance or evasion. This might result in their filing their tax returns incorrectly and adversely affecting revenues due to the government. A tax system that imposes high costs on society as a result of an excessively complex regulatory framework and tax regime enforcement makes tax compliance excessively burdensome and frequently has a distorting effect on the growth of SMEs. This is because these businesses are tempted to change into forms that offer a lower tax burden or no tax burden at all. Additionally, a poorly implemented tax system wastes taxpayers' time and is inefficient and expensive to collect. However, due to the inability of tax authorities to enforce tax regulations on a large number of SMEs, many SMEs take advantage and understate their tax burden. As a result, countries have a restricted ability to generate income for development. Many other factors, including penalties, attitudes, education, knowledge, a sizable informal sector, high marginal tax rates, ambiguity in the tax laws, weak regulatory systems, and the effectiveness of tax administration, contribute to the low level of tax compliance mostly in developing countries (Fauziati & Kassim, 2018; Le et al., 2020; Nguyen et al., 2020; Yayuk et al., 2017). Non-compliance of SMEs to tax regulations has been studied globally.

In the United States (US), SMEs make up a significant percentage of the GDP and a sizable component of the market. However, SMEs in the country are more likely than large firms to fail to comply with tax systems and regulations (Banerjee et al., 2022). In Austria, Gangl et al. (2014) noted that SMEs had a 52% tax compliance rate, whereas, in Singapore, SMEs had a 74% compliance rate. Besides, Le et al. (2020) determined that the SME compliance rate with tax laws was just 34%. In African countries such as Ghana, South Africa, and Tanzania, the tax authorities grapple with poor tax compliance among SMEs and the rates of tax compliance among SMEs is low compared to other large businesses. Besides, tax authorities in these developing countries find it expensive to enforce tax laws in SMEs (Hamis, 2017; Matarirano et al., 2019a; Razak, 2013). In Kenya, large taxpayers provided 78.52% of the KES 1.58 trillion tax revenues in 2020 and only 21.48% of taxpayers were SMEs (Kenya Revenue Authority, 2021). This is despite SMEs being over 98% of all businesses in Kenya (Kivuva, 2020). This informed this study to determine how the tax compliance of SMEs in Kenya can be increased.

Given that a taxpayer is seen as a completely amoral, risk-averse or risk-neutral, utility-maximizing person who chooses to avoid tax anytime the projected benefit surpassed the cost, tax authorities have used the threat of punishment as a tool to coerce SMEs to comply with the tax law (Bani-Khalid et al., 2022). Since threats of punishment are anticipated to induce lawful conduct, the economic deterrence theory was established based on the economics-of-crime model, to maximize governmental and private strategies in combating criminal activity (Ahmed & Braithwaite, 2005). Essentially, it is considered that an SME decides whether or not to comply with tax laws when regulations are not clear and solely out of concern that they could be discovered and punished (Alexander & Balavac-Orlic, 2022). Most tax authorities globally employ the prospect of penalty, which includes tax fines, and interest, to discourage SMEs from acting in a non-compliant manner. However, empirical evidence on the impact of penalties and interest is inconsistent. The majority of research generally shows a favorable relationship between penalties and compliance (Matarirano et al., 2019; Nguyen et al., 2020; Yayuk et al., 2017). Other studies, however, provide contradicting findings (Kamleitner et al., 2012; Lavic, 2022; Mohdali et al., 2014). The contradicting results show that the impact of the prospect of penalty on taxpayers who are ready to abide by

tax regulations is minimal (Mohdali et al., 2014). Besides, when tax fines are looming, SMEs tend to not pay their taxes (Lavic, 2022). In Kenya, the extant research includes extensive cross-sectional surveys that focus mostly on behavioral and socioeconomic factors that inform tax compliance (Kivuva, 2020). Nairobi County, which has a diversified mix of SMEs, was the focus of this research. Nairobi County also provides 21.7% of the country's GDP (Kenya National Bureau of Statistics, 2019). Therefore, the purpose of this research was to ascertain how tax penalties and interest affect the tax compliance of SMEs in Nairobi County, Kenya.

### **Statement of the Problem**

There is usually a very low level of tax compliance levels among SMEs and this is brought about by the perceived high tax rates, complex filing procedures, perception that taxes collected do not go towards the public good but is corruptly expended. Other factors contributing to the low levels of non-compliance include multiple taxation and lack of proper enlightenment among the SMEs owners. The non-compliance attitude reduces tax revenue generation capability to the amount planned to be collected by the government and leads to a budgetary deficit (Wanjagi & Ondabu, 2018). The Kenyan government operates a self-assessment tax regime, where a person voluntarily declares the income earned, file the applicable tax returns, and pay the required tax. However, the level of tax non-compliance is high, and this takes a variety of ways: reduction of tax liability, negative tax voluntary compliance attitude, and a general perception not to honor tax commitments. This phenomenon is not different in other parts of the world, tax administrations are faced with tax revenue gaps that impedes government effort in provision of the much needed revenue for both recurrent and development expenditures.

It is imperative that an elaborate tax policy should be formulated that provides the legislative framework that accommodates SMEs coupled with tax education to ensure voluntary compliance, economic growth, and proper utilization of resources. Imposition of tax penalty and interest is one of the administrative process that tax administration can adopt to bridge the gap of tax non-compliance among the SMEs. This study hence sought to determine the influence of imposition of tax penalty and interest on tax compliance of the small and medium enterprises in Nairobi County, Kenya.

The study was premised on the following null hypothesis:

H<sub>0</sub>: Imposition of tax penalties and interest has no significant influence on tax compliance of small and medium-sized enterprises in Nairobi County, Kenya.

### **Literature Review**

#### ***Theoretical Review***

This study was anchored on the economic deterrence theory by Becker (1968). This theory introduced rules and regulatory frameworks that, if violated, require the administration of punishment to offenders, which serves as a deterrent for would-be offenders (Ehrlich, 1982; Kim, 2019). This theory justifies the presence of punishments such as fines, interest and penalties to increase tax compliance. It has been established that the different tax systems contend with the challenge of taxpayers who are not compliant with their tax payment obligations, and the use of the economic deterrent theory is the most favoured in dealing with this tax collection challenge (Mohdali et al., 2014). This theory can be achieved through several approaches, and these could be both punitive and persuasive. Using the punitive nature of the deterrence theory can increase the probability of being detected and subjected to penalties, interest, and fines. The proponents of this theory work on the premise of an optimal

taxation system, a taxation system that takes into account economic efficiency and the need to be fair among its citizenry (Oladipupo & Obazee, 2016). It is concerned with the ultimate usage of those taxes by the governments ensuring delivery of the required public good. Equity dimensions should play a significant role in the implementation of the taxation system, which ultimately reduces the enforcement actions associated with any tax compliance framework (Ehrlich, 2018).

### ***Empirical Review***

Both the help provided to taxpayers in their attempts to be tax registered and compliant and the high efficiency of a tax administration in the execution of tax penalties and interest are essential. However, the coercive power assumed on penalties and interest may inhibit implicit trust toward the tax authority and forces taxpayers to pay their taxes only when pressed to do so. Some scholars have argued that increased enforcement, issuance of penalties, and interest, may “crowd out” the intrinsic motivation to comply with the tax laws (Krustiawan, 2019; McClellan, 2019). Besides, other scholars have argued that penalties and interest are presumed to reduce penalized behaviour. However, the net effect of using punishment to establish a legal behaviour is counterproductive if the relative price effect of the punishment is insignificant (Leandra, 2018, Di Tella et al., 2015; Guyton et al. 2016). There are various studies undertaken to determine whether tax penalties and interest enhance tax compliance. In the US, Christina et al. (2003) examined the behavioural and economic elements that influence taxpayers' compliance with the tax laws under the Arkansas City tax penalty amnesty program. The study determined that respondents did not perceive tax fines and interest to be strong enough deterrents. This supported an earlier study by Alm et al. (1990) that tax penalties do not have a big impact if the auditing does not back them up.

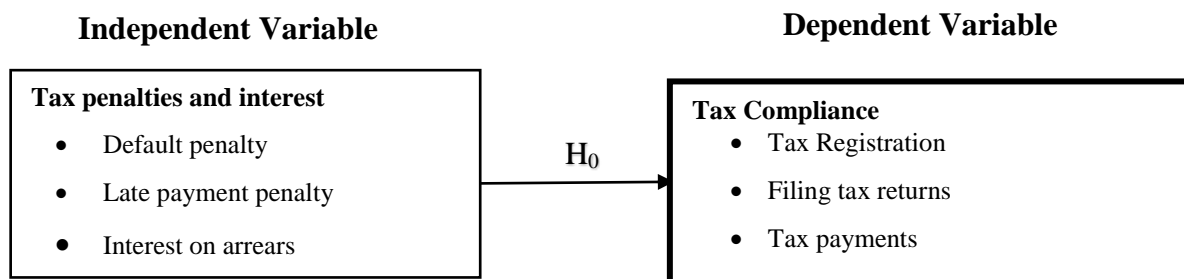
Policymakers in many nations have an interest in corporate tax compliance and they enforce using various motivations and penalties (Fauziati & Kassim, 2018). Blaufus et al. (2017) reviewed the effects of tax penalties on tax compliance in Germany, involving 250 businesses in an experimental investigation. The study applied the tax compliance game to public disclosures. Tax penalties ranging from fines, interest on unpaid taxes, and punitive penalties reduced the probability of tax evasion. In Malaysia, experimental research by Loo (2006) involving two groups of undergraduate students revealed that the tax structure in the country which consisted of the tax rate, audit rate, and penalty rate, was significant on taxpayers' compliance habits. Similar results were also shown by a mixed-methods research by Loo et al. (2009) that tax penalties were a strong deterrent towards tax evasion. In Vietnam, a study by (Nguyen (2022) assessed the variables that influence tax compliance by assessing 310 managers, tax accountants, and accountants at SMEs in the province of Hung Yen. The findings of the experimental study demonstrated that several elements, including tax penalties, the complexity of tax law, social norms, and tax expertise, have varying effects on tax compliance in SMEs in the Vietnamese province of Hung Yen.

There are also studies in the African continent regarding the relationship between tax penalties and interest with tax compliance. Oladipupo and Obazee (2016) undertook a study on the effect of fines on tax compliance among Nigerian SMEs. The study findings indicated that tax compliance was positively and significantly impacted by tax fines. Another study with similar findings was conducted by Nyamwanza et al. (2014) in Zimbabwe and it determined that sanctions were the most effective means of ensuring compliance. Hassan (2016) analyzed the ways of improving tax compliance by imposing tax penalties in Egypt. The analysis presented an in-depth need to have a well-designed penalty system as a central focus for the tax authority to enhance long-term compliance. The research randomly sampled

60 respondents and found that taxpayers use the information provided by the tax authority on probable penalties, to inform their compliance decisions. In Kenya, Chebusit et al. (2014) assessed the variables impacting tax compliance amongst SMEs and determined that fines and penalties have a favorable impact on compliance costs and tax compliance. Taxation penalties had a negligible impact on compliance, according to findings among SMEs in Nakuru County, Kenya (Aondo & Sile, 2018). The study found that stringent tax penalties had the least impact on SMEs' turnover tax compliance.

**Conceptual Framework**

The conceptual framework that demonstrates the proposed relationships between tax penalties and interest and tax compliance is shown in Figure 1. Tax penalties and interest was the independent variable while tax compliance is the dependent variable. The tax penalty is the late filing fine charged by the tax authority for late filing of the due tax return (Hofmann et al., 2017). Tax interest on the other hand is the fee charged as interest on top of the unpaid taxes (Kaplanoglou & Rapanos, 2015). Penalties may be owed by taxpayers who fail to fulfill their tax responsibilities. The tax authority assesses fines for several violations, such as failing to submit a tax return, failure to pay any taxes one owes promptly and correctly, or failure to create an accurate tax return. If a taxpayer fails to pay a tax or penalty in full, the tax authority may add interest on it. The different forms of tax penalties and interest charged include default penalties, late payment penalties, and interest on arrears (Kim, 2019). Tax compliance, the study's dependent variable, was evaluated in terms of observing tax registration laws, submitting tax returns, and making the appropriate tax payments (Nguyen, 2022).



**Figure 1: Conceptual Framework**

**Methodology**

This research sought to establish the influence of tax penalties and interest on SME tax compliance in Nairobi County, Kenya. To accomplish the study's purpose, a quantitative research approach was used in executing the study. In a quantitative research technique, numerical data is collected and analyzed using statistical processes (Easterby-Smith et al., 2019). Quantitative research is undertaken to measure variables and establish the relationship that exists between variables or to determine the influence of one variable on another (Gitunga & Mugambi, 2021). The study also used a descriptive research design to enable a description of tax compliance and determine the experiences of SMEs regarding tax penalties and interest. The use of the descriptive research design also enabled the study to assess the link between tax penalties and interest on tax compliance amongst SMEs in Nairobi County, Kenya.

The study's target population was the 195,000 active SMEs in Nairobi County, Kenya 1(Kenya Revenue Authority, 2020). The functional activities that the SMEs engaged in served as the strata in the study's stratified sampling approach. These SMEs dealt with

construction, manufacturing, information and communications technology (ICT), general services, and retail and wholesale merchandising. The owners/finance managers of the 399 SMEs that made up the sample were used as the units of observation for the SMEs following the Yamane (1967) formula. Structured questionnaires were used to collect primary data, which was then analyzed using ordinary least squares linear regression analysis and descriptive statistics (means, percentages, and standard deviations). Statistical package for social sciences (SPSS) was utilized in the analysis.

### **The Study Results**

Responses were received from 348 out of the 399 owners/finance managers of the selected SMEs to whom questionnaires had been administered. This implies a response rate of 87.22%. Owners and financial managers who were 35 to 44 years old made up 30% of the respondents, while those under 25 made up 5%. In terms of education, 32.5% of respondents had bachelor's degrees, compared to only 2.6 percent who had just completed high school. Additionally, just 6.9% of SMEs were in the wholesale and retail sectors, compared to 42.5% in manufacturing. Additionally, those in construction (17%), other services (20.7%), and ICT (12.9%) were also represented in the research. In terms of annual revenue, 51.7% of the SMEs had less than KES 10 million in 2017, while 60.6% of the SMES had between KES 11 million and KES 30 million in sales in 2018. Furthermore, 48.3% of SMEs had a turnover of between KES 11 million and KES 30 million in 2020 as opposed to 59.2% of SMEs in 2019 who had a turnover of between KES 11 million and KES 30 million. Moreover, 64.4% of SMEs had been in business for more than 20 years, compared to 1.4% who had been in business for fewer than 5 years. The study's findings also revealed that 67% of SMEs relied on clerks and/or accountants to file tax returns and keep business records, while 0.6% relied on business owners.

### ***Descriptive Analysis for Tax Penalties and Interest***

Participants in the study were requested to describe their perceptions of tax penalties and interests that applied to their SMEs. The study had eight items that were used to assess tax penalties and interest which were rated on a five-point Likert scale of 1 to 5 (1 = Not at all; 2 = To a little degree; 3 = To a moderate extent; 4 = To a significant extent; 5 = To a very large extent). The provided responses were analyzed using means (M) and standard deviations (SD) and the findings are provided in Table 1.

**Table 1: Descriptive Analysis of Tax Penalties and Interest**

| <b>Statements of penalties and fines</b>  | <b>M</b> | <b>SD</b> |
|---|----------|-----------|
| We pay our business taxes voluntarily without coercion  | 4.48     | 0.68      |
| We pay less tax for our business if it is known that it would not be penalized and will never be caught by doing so | 1.38     | 1.06      |
| Tax penalties charges are too low to make our business comply with the existing tax obligations                     | 2.01     | 0.99      |
| The existence of penalties enables us to file and pay business taxes diligently                                     | 4.01     | 0.77      |
| Penalties for late payment are effective to enhance tax compliance  | 3.76     | 0.96      |
| We perceive the tax penalties system as unjust and unfair to our business   | 2.73     | 1.06      |
| The interest charged on late payments is high for the survival of our business                                      | 2.61     | 0.82      |
| We are keen on payment timings to minimize penalties and interests payment chances                                  | 4.08     | 0.81      |

|                           |             |             |
|---------------------------|-------------|-------------|
| <b>Average Mean Score</b> | <b>3.13</b> | <b>0.89</b> |
|---------------------------|-------------|-------------|

The results show that the average mean score for penalties and fines dimensions was 3.14 (SD = 0.89). This mean score implies that the listed penalties and fines dimensions applied to a moderate extent to the SMEs in Nairobi County, Kenya. Specifically, study participants were of the view that their SMEs paid their business taxes voluntarily without coercion to a great extent (M = 4.48, SD = 0.68). Besides, study participants were of the view that to a small extent, tax penalty charges are too low to make the SMEs comply with the existing tax obligations (M = 2.01, SD = 0.99). This implies that tax penalties were significant and not too low and this made the SMEs comply with their tax obligations. Study participants also indicated that they do not pay less tax for their SMEs if it is known that they would not be penalized and will never be caught by doing so (M = 1.38, SD = 1.06). This shows that most of the SMEs voluntarily paid their taxes.

### ***Descriptive Statistics for Tax Compliance***

To determine tax compliance levels, which served as the study's dependent variable, participants were asked to indicate the extent they agreed to a variety of statements on a five-point Likert scale (1 = Not at all; 2 = To a small extent; 3 = To a moderate extent; 4 = To a great extent; 5 = To a very great extent). Means (M) and standard deviations (SD) were used to analyze the responses and determine the level of tax compliance for the study's participating SMEs. The findings, which are shown in Table 2, indicate that the tax compliance statements yielded an overall mean score of 3.69 and a standard deviation of 0.97. The moderate mean score suggests that respondents believed the assertions about tax compliance applied to small and medium-sized businesses in Nairobi County to a moderate level. Participants in the research specifically indicated that the SMEs willingly pay tax to a very large extent without being forced to do so (M = 4.61, SD = 0.61). Furthermore, SMEs pay taxes to a little extent after being notified of the due dates (M = 1.93, SD = 1.38). These results demonstrated that the SMEs that were surveyed had high rates of tax compliance.

**Table 2: Descriptive Statics for Tax Compliance**

| <b>Statements on Tax Compliance</b>   | <b>M</b>    | <b>SD</b>   |
|---|-------------|-------------|
| We voluntarily pay taxes for our business without coercion  | 4.61        | .61         |
| We disclose all the income for our business before paying the necessary tax                       | 4.58        | .64         |
| We have always cooperated with KRA officials during the tax compliance process                    | 4.31        | .81         |
| We pay taxes for our business after being reminded of payment deadlines                           | 1.93        | 1.38        |
| We have always believed that our taxes are utilized right by the tax authorities                  | 2.93        | 1.86        |
| We trust the government with the tax we pay   | 3.03        | .95         |
| The procedures and structures of tax compliance are friendly and convenience                      | 3.53        | .92         |
| Our level of compliance is influenced by the level of awareness of the importance of paying taxes | 4.57        | .61         |
| <b>Average mean score</b>   | <b>3.69</b> | <b>0.97</b> |

### ***Regression Analysis of Tax Penalties and Interest on Tax Compliance***

The purpose of the study was to examine the effect of the imposition of tax penalties and interest on tax compliance of SMEs in Nairobi County, Kenya. A simple regression analysis

was utilized where the imposition of penalties and fines was regressed against tax compliance. This process aimed at testing the developed study hypothesis which was;

*H<sub>0</sub>: There is no significant relationship between the imposition of penalties and interest and tax compliance of small and medium-sized enterprises in Nairobi County, Kenya.*

The derived statistical results from a simple ordinary least squares regression analysis are presented in Table 3. The results show a positive and statistically significant relationship between the imposition of penalties and interest and tax compliance ( $r = 0.496$ ). Furthermore, the coefficient of variation ( $r^2 = .246$ ) revealed that the imposition of tax penalties and fines explains 24.6 percent of the variation in tax compliance of SMEs in Nairobi County, Kenya. In addition, the overall model was statistically significant ( $F = 113.066$ ,  $p < 0.05$ ). The regression coefficients also indicated that the imposition of tax penalties and fines had a significant positive influence on the tax compliance of SMEs in Nairobi County, Kenya ( $\beta = 0.642$ ,  $t = 10.633$ ,  $p < 0.05$ ). This, therefore, depicts that the imposition of penalties and interest is key in enhancing the tax compliance of SMEs in Nairobi County, Kenya.

**Table 3: Regression of Tax Penalties and Interest on Tax Compliance**

| <b>Model Summary<sup>b</sup></b>                  |                             |            |                           |                            |                   |                   |     |     |               |               |
|---|-----------------------------|------------|---------------------------|----------------------------|-------------------|-------------------|-----|-----|---------------|---------------|
| Model   | R                           | R Square   | Adjusted R Square         | Std. Error of the Estimate | Change Statistics |                   |     |     |               | Durbin-Watson |
|   |                             |            |                           |                            | R Square Change   | F Change          | df1 | df2 | Sig. F Change |               |
| 1   | .496 <sup>a</sup>           | .246       | .244                      | .58514                     | .246              | 113.066           | 1   | 346 | .000          | 1.913         |
| a. Predictors: (Constant), Penalties and Interest |                             |            |                           |                            |                   |                   |     |     |               |               |
| b. Dependent Variable: Tax Compliance             |                             |            |                           |                            |                   |                   |     |     |               |               |
| <b>ANOVA<sup>a</sup></b>                          |                             |            |                           |                            |                   |                   |     |     |               |               |
| Model   | Sum of Squares              |            | df                        | Mean Square                | F                 | Sig.              |     |     |               |               |
| 1   | Regression                  | 38.713     | 1                         | 38.713                     | 113.066           | .000 <sup>b</sup> |     |     |               |               |
|   | Residual                    | 118.467    | 346                       | .342                       |                   |                   |     |     |               |               |
|   | Total                       | 157.180    | 347                       |                            |                   |                   |     |     |               |               |
| a. Dependent Variable: Tax Compliance             |                             |            |                           |                            |                   |                   |     |     |               |               |
| b. Predictors: (Constant), Penalties and Interest |                             |            |                           |                            |                   |                   |     |     |               |               |
| <b>Coefficients<sup>a</sup></b>                   |                             |            |                           |                            |                   |                   |     |     |               |               |
| Model   | Unstandardized Coefficients |            | Standardized Coefficients | t                          | Sig.              |                   |     |     |               |               |
|   | B                           | Std. Error | Beta                      |                            |                   |                   |     |     |               |               |
| 1   | (Constant)                  | 1.266      | .177                      | 7.147                      | .000              |                   |     |     |               |               |
|   | Penalties and Interest      | .642       | .060                      | .496                       | 10.633            | .000              |     |     |               |               |

a. Dependent Variable: Tax Compliance

The findings in Table 3 further show that a one-unit change in tax penalties and interest leads to a corresponding change of 0.642 in tax compliance amongst SMEs in Nairobi County, Kenya. The resultant regression equation is;

$$\text{Tax compliance} = 1.266 + 0.642 \text{ Tax penalties and interest} + \varepsilon$$

The implication from the regression equation is that an improvement or increase in tax penalties and interest would result in an improvement in tax compliance amongst SMEs.

### ***Discussion of Findings***

The results showed that penalties and fines have a positive and statistically significant influence on tax compliance. The findings support previous studies such as Diana et al. (2018), Krustiawan (2019), McClellan (2019) and Sophie et al. (2018) that a tax administration needs to have a high level of efficiency in the process of enforcing tax interest and penalties as it is to help taxpayers in their attempts to become tax compliant and registered. The findings from the current study also agree with the findings by Oladipupo and Obazee (2016) who evaluated the implications of tax penalties on tax compliance amongst SMEs in Nigeria. Their research revealed that tax penalties had a considerable beneficial influence on tax compliance, but had a lesser effect than tax knowledge. Another study with similar findings was by Fauziata et al. (2016) which was conducted in Indonesia with a sample size of 300 taxpayers to investigate the relationship between tax penalties and tax compliance. According to the findings of the research, tax penalties have a significant little impact on taxpayer compliance.

The findings of the positive influence of tax penalties and interest on tax compliance contradict some previous empirical findings (Leandra, 2018, Di Tella et al. 2015, Guyton et al. 2016). These scholars found that increased issuance of penalties and interest may “crowd out” the intrinsic motivation to comply with the tax laws (Tella et al. 2015). Moreover, Guyton et al. (2016) established that the coercive power assumed by penalties and interest may inhibit implicit trust toward the tax authority and force taxpayers to pay their taxes only when pressed to do so. This was supported by McKee et al. (2018) who examined the behavioral dynamics of tax compliance by assessing taxpayer assistance services available in non-disclosed transactions with fewer records in the US. The study determined that increasing penalties and interest did not lead to an improvement in tax compliance. Another study in Malaysia by Mohdali et al. (2014) had similar findings that the threat of punishment through penalties and interests on unpaid taxes only increased tax evasion behavior.

### **Conclusions and recommendations**

The study concluded that the imposition of penalties and interest has a positive and significant influence on tax compliance. However, most SMEs are willing to comply with tax obligations without any coercion from tax authorities. Still, the existence of penalties imposed on enterprises that fail to pay taxes has contributed to enhanced tax payments and compliance. In addition, the existence of penalties and interests minimizes late payment of tax by SMEs. The findings arising from this study have provided valuable information on the role played by tax penalties and interest in managing tax compliance behavior. The study findings thus have implications for tax authorities in Kenya to improve the effectiveness of the tax penalties system to enable it to complement the self-assessment system. Besides, the tax authorities should ensure that the tax penalty system is equitable, proportionate, clearly defined, and even-handedly administered to encourage voluntary tax compliance and deter tax evasion.

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