

Effect of Tax Audits on Tax Compliance of Small and Medium Sized Enterprises in Nairobi County, Kenya

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Abstract

The purpose of this study was to investigate the effect of tax audits in enhancing taxation compliance among small and medium-sized enterprises (SMEs) in Nairobi County, Kenya. The study was grounded on the economic theory of tax compliance and the target population was small and medium-sized enterprises in Nairobi County from which a sample of 399 constituting the managers and owners of SMEs in the County was obtained. The research applied the positivism research philosophy and descriptive cross-sectional design making use of a structured questionnaire for data collection. The data obtained were analyzed through descriptive and regression analysis using SPSS. The findings indicated that there was a moderate positive relationship between tax audits and tax compliance ($R = 0.318$). Moreover, tax audits had a significant positive influence on tax compliance among SMEs in Nairobi County, Kenya ($\beta = 0.423$, $t = 7.656$, $p < 0.05$). This, therefore, depicted that tax audit is key in enhancing tax compliance of SMEs in Nairobi County, Kenya. This study recommends that tax administrators should structure their audits to ensure at least every three years the SMEs are subjected to a tax audit. The audits can be sectoral based or based on embedded risk parameters identified by the tax administration. Besides, tax administration should have a systematic risk-based methodology that quickly identifies taxpayers to be audited and has an elaborate system of monitoring the results that come from these auditing initiatives.

Keywords: Kenya, Nairobi, Small and medium enterprises, Tax audit, Tax compliance.

Introduction

The economies of many countries worldwide are essentially based on tax revenue as the main source of financing. However, this source is largely becoming non effective following constant challenges of non-compliance by taxpayers. McKee et al. (2018) explained that tax non-compliance in developing countries is much more than in developed countries. Generally, tax non-compliance is a problem that dates back to the earliest recorded history of humanity (Hallsworth et al., 2017). Arguably, the phenomenon of tax non-compliance is viewed as a threat to the economy of many countries (Werekoh, 2022). The extent to which a taxpayer complies (or does not comply) with the country's tax laws, such as by disclosing income, submitting a return, and paying the required taxes on time, is known as tax compliance. (Matarirano et al., 2019) indicated that while tax noncompliance is a range of unfavorable activities to a government's tax system, this may include tax avoidance, which is tax reduction by legal means, and tax evasion, which is the criminal non-payment of tax liabilities.

Small and medium-sized enterprises (SMEs) form a large and growing share of the Gross Domestic Product (GDP) of most developing economies. They represent about 90% of businesses and more than 50% of employment worldwide and contribute up to 40% of

national income (GDP) in emerging economies (World Bank, 2020). Small and medium-sized enterprises have been described as essential agents for delivering more inclusive globalization and growth and a key contributor to economic and social well-being (Organisation of Economic and Co-operative Development, 2017). The SMEs form a predominant sect of enterprises providing the main source of employment, accounting for about 70% of jobs on average, and are significant contributors to value creation, generating 50% to 60% of value-added on average (OECD, 2017). However, SMEs' contribution to tax revenue is lower than their contributions to output and employment due to non-compliance with tax regulations and systems (Nguyen, 2022). That fact notwithstanding, SMEs have not become competitive enough to increase their share of output even though they form three-fifths of the number of manufacturing firms where larger manufacturing companies rely on SMEs for their supplies (Le et al., 2020).

According to Kurniawan (2020), SMEs face worse performance reflected in lower profitability, higher staff turnover, and a lower rate of survival; most of them do not celebrate their fifth birth date. Tax compliance-related issues mainly relate to compliance costs, with the major one being the administrative burden associated with complying with tax regulations. Tax administrative burden includes all costs arising from administrative obligations that enterprises must fulfill due to the legislation. The situation is not different as far as SMEs are concerned in the U.S. economy; they account for a high fraction of the GDP and occupy a large proportion of the market. However, SMEs in this part of the world face the problems of financing constraints, expensive financing, and the unreasonable ratio of output value to taxation. There are also difficulties in complying with government taxation policies (Banerjee et al., 2022). However, Cucciniello et al. (2016) indicated that Singaporean small and medium taxpayers had the highest tax compliance rate of 74% compared to Australia at 45%. A study by Alm et al. (2010) showed that SMEs in Yemen adhere to their nation's tax laws with taxpayers willingly filing their tax returns and paying their applicable taxes as required by the government.

In Kenya, the government has tried increasing the tax base by introducing various taxation measures. All these measures are aimed at increasing taxation efficiency, but the same has not yielded the much-needed tax revenue. The government collected KES 1.58 trillion in the financial period, 2018 – 2019 (Kenya Revenue Authority - KRA, 2019). The payment filers averaged 41.6% on corporate taxes, 70.1% on personal income taxes, and 23.3% of the registered taxpayers under each tax obligation. However, the filing patterns were dismal, with 38.4% being corporate tax filers, 47% individual filers, and 30% value-added tax (VAT) filers. The large taxpayers contributed 78.52% of the total revenue collected from KES 1.58 trillion. Small and medium taxpayers only accounted for 21.48%. According to a survey done by the Kenya National Bureau of Statistics (KNBS) in September 2016, SMEs in Kenya generated KES 635 million in a month which translated to KES 7.62 billion in a year, and the expected tax revenue was KES 2.29 billion (Kenya Revenue Authority, 2021). This revenue was on corporate tax alone, and the amounts were expected to be much higher when Value Added Tax, which is transactional, and Pay As You Earn (PAYE) were considered. In addition, the figures were expected to be much higher in the subsequent periods, considering the increase in growth rates in the Kenya economy in 2017, 2018, and 2019. However, (Kivuva, 2020) indicates that the tax contributions from SMEs were significantly lower, with a paltry 20% of the total revenue collections.

There is still minimal data in most African countries, including Kenya, on the tax compliance rates among SMEs. Small and medium enterprises' operational challenges and the need to

keep afloat bring in compliance risks. This is not the same case with large corporations with elaborate systems. As a result, SMEs are more likely to engage in tax evasion practices and either operate entirely outside the tax net or hide a certain part of their business transactions from the tax system. The risk of detection of such tax evasion practices can be relatively modest in countries with weak tax administration enforcement capacity or a high level of corruption in the tax administration.

To discourage people from breaking tax rules, governments often deploy enforcement techniques one of which is tax audits. According to the OECD (2017), a tax audit reviews taxpayers' records to see whether they have calculated and submitted their tax burden and complied with the necessary tax duties. Thus, a tax audit is a procedure used by the government to uncover tax violations. How many people are chosen for the audit and the thoroughness of the audit are two factors that might affect the effectiveness of a tax audit (Alexander & Balavac-Orlic, 2022). However, studies on the effectiveness of tax audit are mixed with some studies indicating that tax audit enhances tax compliance (Juan et al., 2016; Koh & Lee, 2015) while other such as (Adibura & Stephen, 2012) indicate that tax audit reduces tax compliance. This study sought to assess the effect of tax audits on tax compliance of the small and medium-sized enterprises in Nairobi County, Kenya.

Taxation compliance and tax compliance problems in Kenya are inseparable. Kenya faces a relatively low tax-to-GDP ratio of 18.2% (OECD, 2019). The rate is 34.2% in OECD countries, 28.4% in South Africa, 16% in Rwanda, and 13.5% in Uganda. This low tax-to-GDP ratio is attributed to the low revenue collection performance, which is attributable to low compliance levels among the small and medium-sized enterprises and the complex taxation system that exists in most developing economies, Kenya included (IMF, 2018). The Kenyan government operates a self-assessment tax regime, where a person voluntarily declares the income earned, files the applicable tax returns, and pays 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. 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).

Data from the International Monetary Fund (2018) show that the percentage of tax revenue in Kenya as a proportion of GDP has fallen from 16.866% to 15.063% in 2014 and 2018, respectively. This drop is despite Kenya's economy registering positive upward growth over the same period, from 5.37% in 2014 to 6.318% in 2018. During the 2015/2016 financial period, the KRA collected a record of KES 1.210 trillion marking a 13.2% rise. However, this amount was lower than the exchequer's target of KES 1.2174 trillion. Revenue collection in the financial period 2017/2018 was recorded at Kshs. 1.435 trillion, this was a 5.1% growth. Total tax collections in the financial year ended June 30th, 2019, increased marginally to Sh1.44 trillion but fell short of the Treasury-set target by Sh72.7 billion (KRA, 7th Corporate Plan, 2019). In the 2019 financial period, large taxpayers contributed 78.52% of the total revenue collected, whereas SMEs contributed a paltry 21.48% due to high non-compliance.

Prior studies on tax compliance have concentrated on behavioral attributes, the extrinsic and intrinsic factors affecting tax compliance, and tax evasion (Allingham, & Sandmo, 1972; DeBacker et al., 2015; Hofmann et al., 2017; Nguyen, 2022). This is not different in Kenya, and the studies done are cross-sectional surveys covering a wide field. This study

concentrated on Nairobi County, where a diverse concentration of SMEs is located. Besides, Nairobi County contributes 21.7% of the national GDP (Kenya National Bureau of Statistics, 2019). Through the preliminary analysis of the literature, tax audits are among the main factors affecting tax compliance. This study hence sought to determine the influence of tax audits on tax compliance of the small and medium enterprises in Nairobi County, Kenya.

The study's main objective was to examine the effect of tax audits on tax compliance of small and medium-sized enterprises in Nairobi County, Kenya. The study was anchored on the following null hypothesis:

H₀: Tax audits have no significant effect on tax compliance of small and medium-sized enterprises in Nairobi County, Kenya.

Literature Review

Theoretical Review

This study was based on the economic theory of tax compliance by Allingham and Sandmo (1972). The theory expresses that the government tries to prevent tax evasion by undertaking a series of actions such as putting extra penalties, and tax audits. Taxpayers will decide to evade their tax obligations when they feel that the cost of evading tax is too low. Conversely, taxpayers would also evade tax when they feel that the cost of compliance is high (Ayers et al., 2019). The economic model assumes that taxpayers try to maximize the outcome of the compliance decision by weighing the gain of successful evasion against the risk of detection and punishment (Matarirano et al., 2019). The expected value of non-compliance depends on audit probabilities and fines. The theory, therefore, concludes that an increase in the likelihood of detection through tax audits will always lead to the taxpayers declaring a larger income and complying with tax laws (Wanjagi & Ondabu, 2018).

Empirical Review

A study in the UK by Slemrod (2019) assessed random audits in the country and found a significant and persistent impact of audits on the reported tax liability that reached a remarkable 26 percent increase four years after the audit. The conclusion was that tax audit increases tax compliance because of the deterrent effect of audit on the non-compliance of taxpayers. Another study in the United States (US) by DeBacker et al. (2015) noted that tax audits could be a vital stimulant to increase tax compliance. Firms facing tax audits typically register higher tax payments. However, the research by DeBacker et al. (2015) found that tax payments are lower following an audit based on the personal assumption that another tax audit is unlikely to take effect in the nearest future. A comparable study in the US by Lederman (2018) determined that there is a positive association between voluntary tax compliance and tax audit. The finding indicates that audit productivity may have been understated in several studies in the literature. The conclusion may be motivating for tax experts and tax authorities to enhance audit power and better manage their audit organization to maximize revenue for the state.

Studies on how tax audits influence tax compliance have also been undertaken in the African context. Olaoye et al. (2019) studied how tax audits affected Ekiti State's tax compliance and remittance of tax income. This study examined the impact of back duty audits, field audits, desk audits, and registration audit on tax revenue remittance and tax compliance in Ekiti State. A questionnaire with closed-ended questions was utilized to gather the required data, and multiple regression and a correlation matrix analysis were used to perform the research. It was determined that the registration audit, the back duty audit, the desk audit, and the field

audit all had positive and significant effects on tax compliance and remittance in Ekiti State. Surprisingly, the field audit was the most significant predictor criterion out of all the predictor criteria. It was determined that the tax audit might result in tax payment and compliance in the state of Ekiti. These findings are supported by Rahmayanti et al. (2020), and Alm et al. (2013) who established that a tax audit mechanism would lead to higher tax compliance.

Despite some studies showing that tax audits influence tax compliance, some studies have contradictory findings. In Mexico, a study by Hofmann et al. (2017) in their analysis of Mexican country-level data based on audits done for the periods 2003 – 2014, found that tax non-compliance decreases before a certain auditing level is reached and increases beyond that level. This backfiring effect has important implications for the design and implementation of tax audit systems and processes. The core implication is that more auditing may not necessarily be better and that more tax enforcement measures should be considered. However, some studies claimed that tax audits have a positive impact on tax evasion (Ayers et al., 2019). This is based on the validation of secondary data obtained from the Internal Revenue Services to understand the impact of tax compliance based on audit certainty. Other studies on the impact of audit probabilities on tax compliance have shown weak effects. Adibura and Stephen's (2012) review summarizes inconsistent findings on audit probabilities and tax compliance. For example, threatening taxpayers in an experiment with a “close examination” of their upcoming returns increased tax compliance for low and middle-income taxpayers but decreased it for high-income taxpayers.

Conceptual Framework

Figure 1 presents the conceptual framework which illustrates the hypothesized relationships between the study variables. The independent variable is tax audits which are an examination of an individual or business's accounts and financial information to ensure that all taxes have been paid correctly and on time. It is conducted by the tax authorities to verify that taxes have been reported accurately and that all applicable taxes have been paid. Three types of tax audits were considered in this study thus; in-depth audits, an investigative approach, and compliance audits (Amah & Nwaiwu, 2018). An in-depth tax audit is a comprehensive review of a taxpayer's financial records and tax returns by the tax authority. It is a more thorough examination than a regular audit and is usually conducted when the tax authority suspects that a taxpayer has not reported all of their income or has claimed excessive deductions (Banerjee et al., 2022). An investigative tax audit is a type of audit conducted by the tax authorities to determine if a taxpayer has failed to report income, or otherwise violated the tax laws. During an investigative tax audit, the tax authority reviews the taxpayer's financial records and documents to determine if any discrepancies exist (Matarirano et al., 2019). A compliance tax audit is an examination of a taxpayer's financial records and tax returns to ensure that they conform to applicable tax laws (Oyedokun, 2015). The study's dependent variable was tax compliance which was assessed in terms of adhering to tax registration regulations, filing tax returns, and making the right tax payments (Ayers et al., 2019).

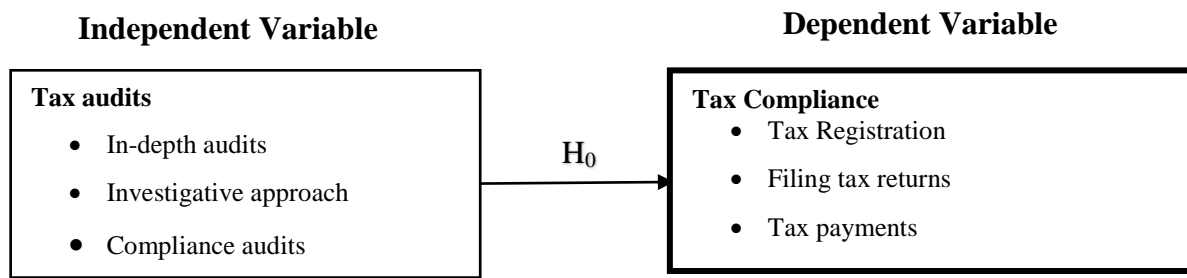


Figure 1: Conceptual Framework

Methodology

The purpose of this study was to describe, determine and explain the effect of tax audits on the tax compliance of SMEs in Nairobi County, Kenya. In order to achieve these objectives, the authors employed use of quantitative research methodology. In a quantitative research methodology, numerical data is gathered systematically, adhering to an established plan, and categorical and numerical (continuous) data are analyzed systematically using statistical procedures (Saunders et al., 2019). Quantitative research deals with quantities and relationships among variables and examines reality in terms of measuring variables and making comparisons. Additionally, the authors utilized a descriptive research design to answer the questions of who, what, where, and how regarding the research problem. This design enabled the study to describe tax audits and tax compliance and also to establish the relationship between the two.

The study targeted 195,000 active SMEs situated within Nairobi County, Kenya (KRA, 2020). Therefore, the specific targeted group was 195,000 SMEs. The study employed a stratified sampling design where the strata were the functional activities that the SMEs were involved in. These included SMEs in the manufacturing sector, construction, information, communication and technology (ICT), wholesale and retail, and those dealing with general services. Using the Yamane (1967) formula, a sample of 399 SMEs was selected and the owners/finance managers were the units of observation for the SMEs. Primary data was gathered using structured questionnaires and the gathered data was then analyzed using descriptive statistics (means, percentages, and standard deviations) and ordinary least squares linear regression analysis.

The Study Results

Questionnaires were administered to the owners/finance managers of the sampled 399 SMEs with 348 of them filling and returning the questionnaires. This depicted a response rate of 87.22%. Those owners/finance managers aged between 35 and 44 years were 30%, while those aged below 25 years were 5%. On education, 32.5% of the study respondents had bachelor's degrees, while just 2.6 percent had secondary school certificates. Besides, 42.5% of the SMEs were in the manufacturing sector whereas only 6.9 percent were in wholesale and retail. Other SMEs included in the study were in other services (20.7%), construction (17%), and ICT (12.9%). Regarding yearly turnover, 51.7% had a turnover of less than 10 million in 2017, while in 2018, those with a turnover of between KES 11 million and 30 million were the majority (60.6%). In 2019, 59.2% of the SMEs had a turnover of between KES 11 million and 30 million whereas, in 2020, 48.3% of the SMEs had a turnover of

between KES 11 million and 30 million. On years of operation, 64.4% of the SMEs had been operational for over 20 years while those that had been operational for less than 5 years were 1.4%. The study results further showed that in 67% of the SMEs, business records and tax returns were prepared by clerks and/or accountants and in 0.6% they were prepared by the business owners.

Descriptive Analysis for Tax Audits

The study participants were required to indicate how they perceived tax audits among their small and medium enterprises in Nairobi County, Kenya. Eight items were used to measure this and the rating was on a five-point Likert scale (1 = Not at all; 2 = To a small extent; 3 = To a moderate extent; 4 = To a large extent; 5 = To a very large extent) and the responses were analyzed using means (M) and standard deviations (SD). The results in Table 1 indicate that the average mean score for tax audit dimensions was 2.97 (SD = 1.35). The mean score implies that the provided statements on tax audit applied to a moderate extent to the small and medium enterprises in Nairobi County, Kenya. The statement giving the highest mean score was 'tax audit has reduced our chances to evade tax for our business' (M = 3.53, SD = 1.22). The statement that 'our business has suffered tax noncompliance deterrent audit effects in the past (M = 1.84, SD = 1.17)' had the lowest mean score indicating that respondents were of the view that this applied to their SMEs to a small extent.

Table 1: Descriptive Statistics for Tax Audits

Statements on tax audit	M	SD
Tax audits have enabled us to enhance tax compliance for our business	2.95	1.64
Our business records have been audited for tax obligations fulfillment	3.00	1.52
Our business has suffered tax noncompliance deterrent audit effects in the past	1.84	1.17
Our business has continued to comply with tax payments even after the audit	2.76	1.46
Issues discovered after an audit process are followed by KRA for compliance	2.97	1.20
We declare all our business income voluntarily immediately before and after the audit process	3.32	1.22
Tax audit has enabled us to be keen on minimizing tax-related errors for our business	3.40	1.33
Tax audit has reduced our chances to evade tax for our business	3.53	1.22
Average mean score	2.97	1.35

Descriptive Statistics for Tax Compliance

Tax compliance was the dependent variable for the study and various statements were provided and study participants were required to score them on a five-point Likert scale (1 = Not at all; 2 = To a small extent; 3 = To a moderate extent; 4 = To a large extent; 5 = To a very large extent). The responses were analyzed using means (M) and standard deviations (SD) to indicate the extent of tax compliance for the SMEs that participated in the study. The results are presented in Table 2 and show that the statements under tax compliance gave an overall mean score of 3.69, and a standard deviation of 0.97. The moderate mean score implies that respondents indicated that the provided statements on tax compliance applied to a moderate extent to the small and medium enterprises in Nairobi County. Specifically, study participants indicated that to a very great extent, the SMEs voluntarily pay tax without

coercion ($M = 4.61$, $SD = 0.61$). Additionally, to a small extent, 'SMEs pay taxes after being reminded of payment deadlines ($M = 1.93$, $SD = 1.38$). These findings showed that levels of tax compliance in the surveyed SMEs were high.

Table 2: Descriptive Statistics for Tax Compliance

Statements on Tax Compliance	M	SD
We voluntarily pay tax 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
Average mean score	3.69	0.97

Regression Analysis of Tax Audits on Tax Compliance

The research objective was to establish the influence of tax audits on tax compliance. A simple regression analysis was utilized where tax audits was regressed against tax compliance. This process aimed at accomplishing the first objective of the study which was to determine the relationship between tax audits as the predictor variable and tax compliance as the outcome variable for small and medium enterprises in Nairobi County. The hypothesis formulated was;

H₀: Tax audits have no significant influence on tax compliance of small and medium-sized enterprises in Nairobi County, Kenya.

The model summary of the derived statistical results from simple regression analysis is presented in Table 3. The study found a significant positive relationship between tax audits and tax compliance ($R = .381$). The coefficient of determination ($R^2 = 0.145$) indicates that tax audits explain 14.5% of the variation in tax compliance amongst SMEs.

Table 3: Model Summary of the Regression of Tax Audits on Tax Compliance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				Durbin-Watson	
					of R Square Change	F	df1	df2		Sig. Change
1	.381 ^a	.145	.142	.62327	.145	58.615	1	346	.000	1.814

a. Predictors: (Constant), Tax Audit
b. Dependent Variable: Tax Compliance

The findings of the analysis of variance (ANOVA) were also obtained by the regression analysis and are shown in Table 4. The study findings showed that the overall model was statistically significant ($F = 58.615$, $p < 0.05$). These results demonstrate that the fitted linear

regression model offered a good fit to the data. Moreover, the implication of the findings is that tax audits had a significant influence on SMEs' tax compliance.

Table 4: ANOVA of the Regression of Tax Audits on Tax Compliance

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	22.770	1	22.770	58.615	.000 ^b
	Residual	134.410	346	.388		
	Total	157.180	347			

a. Dependent Variable: Tax Compliance

b. Predictors: (Constant), Tax Audit

The regression coefficients were obtained from the regression analysis and are shown in Table 5 to help identify the degree and direction of the influence. The t-value and the p value manifest the significant relationship between the two variables ($\beta = 0.423$, $t = 7.656$, $p < 0.05$). This, therefore, depicts that tax audit is key in determining tax compliance of small and medium enterprises in Nairobi County, and thus, the hypothesis that there is no significant relationship between tax audits and tax compliance is rejected.

Table 5: Regression Coefficients of Tax Audits on Tax Compliance

Model		Unstandardized Coefficients		Standardized	t	Sig.
		B	Std. Error	Coefficients		
1	(Constant)	1.737	.184		9.462	.000
	Tax Audit	.423	.055	.381	7.656	.000

a. Dependent Variable: Tax Compliance

Table 5 further shows that a one-unit change in tax audits leads to a corresponding change of 0.423 in tax compliance amongst SMEs. The regression equation that resulted from the regression model is as;

$$\text{Tax compliance} = 1.737 + 0.423 \text{ Tax audit} + \varepsilon$$

This regression equation implies that an improvement or increase in tax audits would result in an improvement in tax compliance amongst SMEs.

Discussion of Findings

The study determined that tax audits have a significant positive influence on the tax compliance of SMEs in Nairobi County, Kenya. The findings supported the economic theory of tax compliance by Allingham and Sandmo (1972), which indicates that tax audits increase the cost of non-compliance and thus enhance tax compliance. The findings are also in line with (OECD, 2010) that the probability of a tax audit reduces the probability of tax evasion as SMEs are wary of the costs they can incur if a tax audit determines that they had not complied with tax regulations. Moreover, the findings concur with the findings by DeBacker et al. (2015) which indicate that tax audits could be an essential stimulant to increase tax compliance. In addition, the study affirms that firms facing tax audits typically register higher tax payments. Moreover, the findings also agree with the findings by (Slemrod, 2019) who indicated that random audits in the UK enhanced the reported tax liability reached a remarkable 26 percent increase four years after the audit. Moreover, the findings showed that tax audit increases tax compliance because of the deterrent effect of audit on taxpayers' non-compliance.

The findings, of a positive influence of tax audits on tax compliance, however, contradict some studies that have found that tax audits have a positive impact on tax evasion (Ayers et al., 2019). Similarly, Hofmann et al. (2017) in their analysis of country-level data based on audits done for the periods 2003 – 2014 found that tax non-compliance decreases before a certain auditing level is reached and increases beyond that level. This backfiring effect has important implications for the design and implementation of tax enforcement measures. Other studies on the impact of audit probabilities on tax compliance have shown weak effects. A systematic analysis by Adibura and Stephen (2012) summarized inconsistent findings on audit probabilities and tax compliance. For example, the threat of investigative audits increased tax compliance just for low and middle-income taxpayers but decreased it for high-income taxpayers. This indicates that the nature, size, and timing of tax audits may explain why a tax audit will have a negative or positive influence on tax compliance in various contexts.

Conclusions and Recommendations

The study found that tax audits have a significant positive influence on the tax compliance of SMEs. Informed by the study findings, it was concluded that tax audits enable SMEs to improve their tax compliance to a moderate extent. In addition, it was evident that tax audit reduces SMEs' chances to evade tax, which ensure a high tax compliance rate among SMEs. Besides, tax audits enable SMEs to avoid errors in tax compliance as they remain keen on remitting tax returns to ensure compliance. The conclusions from this study have various implications for owners/managers of SMEs and tax authorities. First, this study recommends that SMEs should consider the advantages of tax compliance to ensure the reduction of tax liability either through tax evasion or tax avoidance. On their part, tax administrators should structure their audits to ensure at least every three years the SMEs are subjected to a tax audit. The audits can be sectoral based and or based on embedded risk parameters identified by the tax administration. Moreover, tax administration should have a systematic risk-based methodology that quickly identifies taxpayers to be audited and has an elaborate system of monitoring the results that come from these auditing initiatives. An auditing diagnostic assessment tool can be developed to monitor the whole process.

This study focused on determining how tax audits influence the tax compliance behavior of SMEs. There were however some limitations because the study only focused on tax audits as provided for under the Kenyan tax legislation framework. More so, the sample of the investigation involved only the SMEs in Nairobi County. Thus, it is advisable to explore other tax measures and tax policy frameworks for future research and consider using a larger sample for future studies to include SMEs in other counties in Kenya apart from Nairobi County. Besides, a further study should consider applying qualitative data-gathering tools such as focus group discussions and key informant interviews to provide a deeper explanation of the role played by tax audits on tax compliance.

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