



Tax Compliance among Small and Medium Manufacturing Enterprises in Kenya: Does Tax Morale Matter?

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Abstract: *The study sought to assess the impact of tax morale on tax compliance among SMEs in Nairobi County, Kenya. Most governments especially the developing ones and particularly Kenya rely on taxes as their main source of revenue to run their development agenda. Kenyan SMEs have been in the forefront as the major contributors to Kenya's economic growth and development. However, in the recent past there has been increased tax evasion from the sector.*

This signifies a continued drop in the government revenue and failure by the tax collection authority; KRA to meet the set targets in annual revenue collection. Tax morale has been found to be a key aspect contributing significantly to tax compliance. Locally, it remains unclear on how tax morale influences tax compliance with very few studies focusing on the area locally and of those few focusing on other industries. Descriptive research design was used in the study and the target population was the 1539 registered SMEs in Nairobi CBD. A sampling formula was used to identify a sample size of 318 respondents who were picked through stratified random sampling with the categories of SMEs as the strata. Structured questionnaire was used to collect data for the study which was analysed through descriptive and inferential statistics. The study established that tax morale significantly influenced the tax compliance by the SMEs. It was established that the morale of tax payers was affected by inappropriate use of the collected taxes, lack of the required information, and minimal support from the government, thus affecting the compliance levels. The study concluded that tax evasion has escalated mainly as a result on reduced morale among tax payers due to inappropriate use of the collected taxes and poor accountability among government officials. Enhancing accountability and ensuring responsible use would be essential to enhance tax compliance.

Keywords: *tax morale; tax compliance; small and medium enterprises*

I. Introduction

Tax is an important stream of revenue for government's development projects and therefore all efforts must be made by governments to ensure that it is accurately and efficiently collected so as to facilitate the government's operations. In both developing and developed countries, tax compliance has been a concern among government and other agencies, as low compliance leaves most countries deprived for resources to run their affairs. According to Andreoni, Erard and Feinstein (2012) one of the major areas that have been left out of tax compliance models is social dynamics and morals. While the environments and other externalities differ from one country to another, it goes without saying that morale, culture and social norms have a tied effect of individual behaviour (Bame-Aldred, Cullen, Martin, & Parboteeah, 2013; Hanno & Violettc, 2011). This is to say the lessons from a given environment may not be used in another environment but the context should remain the same such that the social norms, morals and individual behaviours are aligned towards engaging issues on tax compliance. Pope and McKerchar (2011) developed other model on tax morale which explains tax morale as a phenomena that can reveals over compliance of taxpayers that economic deterrence models are failing to explicate. They explained tax morale with six variables, individual attitudes, Family and friends, religious beliefs, society, Tax administration

and Government tax policies, and considered tax morale as a controversial factor with opportunities to evade on compliance decision. The model has not explained that whether mentioned factors can influence tax morale positively or negatively. Additionally model can be described as conceptualizing model and have not applied to the field yet.

The World Bank theory of change for tax compliance (World Bank, 2017), highlights the dynamic relationships between trust, facilitation, and enforcement, and their role in building tax morale. The theory posits that trust is driven by the degree to which the tax system, including the approach to facilitation and enforcement, is characterized as fair, equitable, reciprocal and accountable. As such strengthening tax compliance is not only about improving tax enforcement and “enforced compliance”, but also about pursuing ‘quasi-voluntary compliance’ through building trust and facilitating payments – all underpinned by a credible, fair and equitable system of enforcement. However, to retain the tax compliance morale among the taxpayers, there are influencing factors that ought to retain their competency i.e. the tax expenditure efficiency, taxation policy, social cultural factors and lastly the entrepreneur awareness.

Torgler (2015) in his an annual public opinion survey carried out in 17 Latin American countries (since 1996). His report established the opinions, attitudes, and behaviors of the around 400 million inhabitants of the region. The survey started with 8 countries in 1995 and was extended to 17 countries in 1996. It covers most of Latin America with the exception of Cuba, the Dominican Republic, and Puerto Rico. From his findings, Togler (2015) confirmed that the cohesion created within the society cultural factors facilitated highly on the individual willingness to pay taxes. The analysis done at a global and regional level, was established to mask country-specific variations. The analysis allows the identification of the socioeconomic factors and institutional perceptions that may affect tax morale in Latin America countries, as well as the testing for evidence of the fiscal contract influencing tax morale.

World Values Survey Unit (WVSU) effort to identify institutional and socioeconomic factors associated with tax morale an exercise that was repeated with new data from a more recent round of the survey in Asia, confirmed clarity in the identification of long-term trends and possible policy recommendations as the most influential mechanisms in compliance to tax compliance.

In Africa, the tax compliance policy has continuously been dependent on degree of relationship created between the government agency responsible for tax collection and the tax payer. This relationship has determined the level of tax compliance among the nations in Africa depending on the morals installed to the taxpayers and the trust created towards the government by the taxpayers.

Musgrave (2013) study in South Africa, considered three requirements of fiscal policy: the allocation, the distribution and the stabilization aspect. In the context of tax morale, the first two aspects are especially of interest. While the allocation branch influences tax morale by an efficient allocation of resources, the distribution aspect touches equity and incidence considerations, which have an impact on tax morale, too. The allocation branch is important because the spending in the sense of tax revenue allocation affects morale considerations.

While, the distribution branch is important because fairness considerations are strongly related to (tax) morale beliefs. Thus, an optimal tax morale or tax compliance strategy is based on efficiency as well as equity measures.

There is an immediate relationship of size and sort of punishments that non-compliers and tax compliance level (Fishlow & Friedman, 2013). Deficiencies in tax accumulation might be consequence of frail limit of framework to identify and arraign tax violators. Utilization of relatives in SMEs through unpaid work likewise diminishes likelihood of recognition in this way affecting the choice of taxpayer with respect to compliance. Cobham (2014) identifies the causes of tax evasion as the tax rate that are huge in nature that gives SMEs a huge burden

that negatively affect their profit margins therefore most of the SMEs opt to evade tax. Small tax payers face discrimination under the regular tax system since the compliance requirements does not matter regardless to the size of the enterprise as well as tax rate and also the cost of compliance. If the government can reduce compliance cost, the tax compliance morale by the taxpayers would increase hence the profit margin will go up, this will increase the government tax revenue since the simplified provisions for SMEs will reduce the size of formal economy and the number of noncompliance will increase with regard to registered tax payers (Vihanto, 2013). The operations of SMEs usually have an imperious controlling atmosphere with plethora of regulating organizations, high port charges, numerous charges, burdensome importing procedures and several taxes that constantly put pressure on the operations (Kinyua, 2014).

The complex nature of the governing structure and the complex tax regime is a challenge and burdens most of the SMEs that determine their compliance level with affects their growth and performance. The tax system imposes bigger expenses for the SMEs that affect their daily operations (Mbugua at al., 2014). Tax system that is weak in nature has low efficiency, waste taxpayers time as well as authority staff and high collection charges (Fishbein & Ajzen, 2011). Most of the SMEs are affected disproportionately by the compliance costs that are time higher than large organizations .In Kenya, there is no Act of Parliament that gives the definition of SMEs. Even the Income Tax chapter 470 and the Turnover Tax Rules which govern taxation of the SMEs neither provide for any definition nor mention any of the terms used to refer, mean or represent SMEs. The income tax merely refers under section 12C to persons and the thresholds which determine persons liable to pay turnover tax.

According to Wanjohi (2010) high tax rates and high cost of compliances are some of the factors that lead to tax fraud and tax evasion in Kenya. SMEs will fail to comply with tax laws either unwilling or willingly depending on the relationship created between the taxpayers and the government. Emerging economies should ensure that tax system are efficient and effective for SMEs and don't affect them negatively. The challenge that most authorities face are poor tax system and policies. The main objective of tax policy is to abide with tax laws (Ngechu, 2014). SMEs in Kenya operates in operate in an informal sector economic survey report 2016 indicates that the sector has semi organized and unregulated activities that are smaller.

Statement of the Problem

Most governments especially in the developing World including Kenya rely on tax collection as their main source of revenue. Notably, through the taxes collected, the government is able to meet its mandate such as infrastructural and provision of social services thus promoting economic growth and development. However, in the recent years, the government of Kenya through Kenya Revenue Authority (KRA) has been unable to meet the projections of tax collection with cases of non-compliance being on the high-rise (GOK, 2017). In the financial year 2014/2015 for instance, the projected amount was KSHs.1.086 trillion while KRA managed to collect KSHs. 1.0 trillion. In the financial year 2018/2019, the projected revenue collection by KRA was KSHs.1.61 trillion but the authority managed KSHs. 1.44 trillion (KNBS, 2019). KRA has majorly blamed tax non-compliance as the main cause of their failure to meet their target and the continued slow-growth of tax collection.

SMEs have been recognized as the major economic drivers through contribution to the tax system as well as provision of employment which also at the end of the day draws to the tax through PAYE. However, as KRA notes, Kenyan SMEs have been the major tax evaders with the collection of taxes from the enterprises not even meeting 50% of the projections. In the year 2014, KRA put tough measures to ensure tax compliance among the SMEs including training, use of electronic systems and redefining the administration structure

into small geographic areas. This however is yet to bear the expected results since noncompliance is still high.

Empirical studies have revealed mixed results on the effect of tax morale on tax compliance. Alshira'h, Abdul-Jabbar and Samsudin (2019) in a study on the influence of tax morale on tax compliance in SMEs in Jordan established that most entrepreneurs were concerned with the government's openness on how the collected taxes were used and if this was not satisfactorily done, most of the entrepreneurs evaded tax. Magiya (2016) on a study on the determinants of tax compliance established that tax morale among the taxpayers determined their willingness to comply with tax laws. Young, Danny and Daniel (2013) on the other hand found that the culture and morale of the taxpayers had an insignificant influence on tax compliance but the laws put across to steer this. This study therefore sought to fill the existing knowledge gap by establishing the tax morale and its influence on tax compliance among SMEs in Kenya.

II. Review of Literature

2.1 Theoretical Framework

This study was anchored on intrinsic motivation theory. Sciences like sociology and psychology have stressed the importance of behavior based on moral and ethical considerations. In economic analysis, internalized values are taken as exogenously given and not influenced by prices or regulations (Becker, 1976 and Hirshleifer, 1985). However, a view economists such as Hirschman (1965) and Sen (1977) took the relationship between external and internal motivation into account. Frey (1997) demonstrates that intrinsic versus extrinsic motivation are also relevant for explaining compliance behavior. He looks at tax morale as a particular kind of intrinsic motivation. It is an attempt to introduce a psychological effect into economics without giving up the rational choice framework. His approach includes a crowding out effect of intrinsic motivation in the analysis of tax compliance.

Increasing monitoring and penalties for noncompliance, individual will notice that extrinsic motivation has increased, which on the other hand crowds out intrinsic motivation to comply with taxes. Thus, the net effect of a stricter tax policy is unclear. If intrinsic motivation is not recognized, taxpayers get the feeling that they can as well be opportunistic.

This puts into account the relevance of policy instruments in supporting or damaging the intrinsic motivation. Intrinsic motivation depends on the application of policy instruments. Frey (1997) claims that tax morale is not expected to be crowded out if the honest taxpayers perceive the stricter policy to be directed against dishonest taxpayers. Regulations which prevent free riding by others and establish fairness and equity help preserve tax morale.

2.2 Conceptual Framework

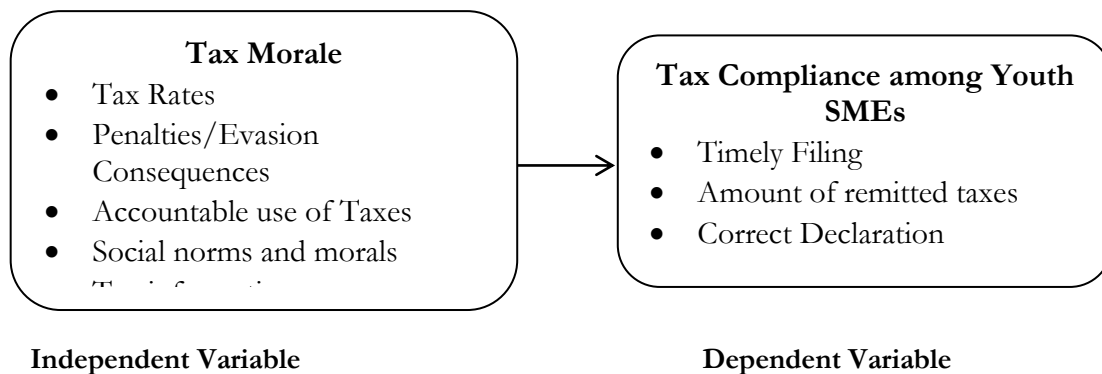


Figure 1. Conceptual Framework

2.3 Review of Empirical Literature

Babatundel, Ibukun and Oveyemi (2017) conducted a study to examine the relationship of taxation and economic growth in Africa from the periods 2004 to 2013. The pre-estimation test carried out was descriptive statistics and unit root tests, which showed that the variables GDP and tax were normal and stationary. However, the findings however for this study indicated that tax revenue is positively related to GDP and promotes economic growth in Africa. The study concluded that tax revenue has a significant positive relationship with GDP. Skinner (1988) used data from African countries to conclude that income, corporate, and import taxation led to greater reductions in output growth than average export and sales taxation. Tosun and Abizahed (2005) studied the relationship between tax policies and economic growth in 21 member nations of the Organisation for Economic Cooperation and Development (OECD) over the period 1980 to 1999 using the random effect model (REM). The result reveals the evidence of the relationship between taxes and economic growth, with positive and significant results on personal income tax and corporate tax.

In Ghana, Luttmer and Singhal (2014), indicate that tax morale is influenced by five main aspects which include; reciprocity, intrinsic motivation, peer effects/social influences, longrun cultural factors and finally the imperfections and deviations of information (awareness). Rewarding tax payers through allowing wavers and recognizing the best in tax compliance plays a critical role in promoting compliance. Moreover, creating the necessary awareness by availing all the information regarding tax compliance helps individuals know exactly what is required of them as far as compliance is concerned. Luttmer and Singhal argue that the cultural factors where one believes in adhering to the rule of law influences the tax compliance behaviour. According to Kornhauser (2013), tax morale is an aspect defined by individual behaviour, personal beliefs and social aspects that motivate one to adhere to the set rules and regulation including tax compliance. Kornhauser indicates that the altruism, external factors as well as the people's trust in government creates a more significant influence in tax compliance.

The degree of resistance on tax compliance in Kenya has been a reflection of the continuing fraud being exercised in various government agencies a condition that has completely led to lose of trust with the government by most of the tax payers. In this view therefore, tax morale captures the non-pecuniary motivations for tax compliance as well as factors that fall outside the standard expected rational economic actor utility framework leading to over dependent on foreign debt (Luttmer and Singhal, 2014). Mutua (2012), Kenya finances a considerable percentage of its annual budget from locally generated sources relative to most East African countries whereby a sizeable chunk of annual expenditure is sourced from foreign aid. This has placed tremendous pressure on taxes to shore up the revenue gaps that have been occasioned by the dwindling resources from foreign aid.

Thiga and Muturi (2015) observed that there is a general positive correlation between Tax understanding, lower tax rates, compliance costs, high fines and penalties to the general level of compliance. According to (CIAT, 2006), due to poor efficiency on tax expenditure as well as poor taxation policies, Kenya is ranked among countries with high levels of tax non-compliance with the revenue authority hard pressed to ensure efficient and effective tax administration.

It is basic to build up wide data in regards to the determinants compliance to tax in order to have the capacity to create measures for battling tax avoidance and evasion. The societal spirit to conform to assessment may upgrade a requirement of self to tax compliance. Nonetheless, tax morale, state of mind and conduct are not set up, particularly in nations with where the culture is not to pay tax (Brautigam et al., 2012). Absence of obligation and receptiveness in funds use from people in general develop doubt amongst taxpayers towards arrangement of tax assessment and organization, subsequently influencing eagerness of levy

payment by taxpayers. Because of abnormal amounts of fraud, taxpayers are not ready to learn whether taxes paid are utilized as a part of the financing of public merchandise and provision of services, prompting an adjustment in their ability to pay henceforth the probability they may avoid taxes.

Helhel and Ahmed (2014) conducted a study on elements impacting attitudes on and compliance to tax: A survey study of Yemen. Their aim was to bring about the influence of attitudes and considerations of individual tax payers on tax compliance in Yemen while taking into consideration the internal and external factors. The study was conducted in Sana'a the capital city of Yemen to evaluate and rank the factors that reduce tax payers' compliance rate.

The study established that tax awareness on the processes of remitting taxes and complications in filing returns affected the capability of the taxpayers to comply.

2.4 Research Gaps

The studies reviewed have shown mixed results on the relationship between different aspects of tax morale and tax compliance. Most of the studies focused on the individual tax payers who may be varied based on their age, level of education and understanding level of taxation processes. Also, categorizing individual tax payers is complicated and may not bring a clear perspective of which type taxpayers. The current study focuses on SMEs which have a structure, operation record and can be categorized based on the profit levels. Some of the studies were carried out in different contexts where some were done in Malaysia, Jordan and United Kingdom. This study focuses on SMEs in Kenya thus bringing the concept of a developing country.

III. Research Methods

3.1 Research Design

The study used descriptive research design. The study fitted within the provisions of descriptive research design because the researcher collected data and report the way things were without manipulating any variables.

3.2 Target Population

The target population of interest in this study consisted of owner or managers of SMEs in Nairobi County CBD. According to records from the Nairobi County Council, there were 8259 registered SMEs (Nairobi County Council, 2018) with 1539 SMEs found within the Nairobi's Central Business District as at December 2017. The researcher obtained this data from an official working in the Nairobi County Council business licensing office.

3.3 Sampling Procedures and Sample Size

The study used a sampling formula and a stratified random sampling. Yamane (1973) statistical sampling formula was used to identify the appropriate sample size from a finite population.

$$n = \frac{N}{1 + Ne^2}$$

Where;

n = Sample size

N = Target population

e= maximum acceptable margin of error (5%)

$$n = 1539 / [1 + 1539 (0.05*0.05)] = 1539 / 4.8475 \approx 318$$

The sample size for the study was therefore 318 respondents. Using the categories of the SMEs as the strata, the sample size was proportionately distributed out of which the resulting sample size was randomly picked.

3.4 Data Collection

The study utilized a structured questionnaire to collect primary data. The questionnaire was appropriate since it offered considerable advantages in the administration.

The questionnaire was physically administered to the respondents' places of work, and afterwards collected on an agreed date after the subjects had adequately completed filling in all the items in the instruments.

3.5 Data Analysis and Presentation

Data was analysed using both descriptive and inferential statistics. Descriptive statistics gave the profile of the respondents i.e. frequencies and their percentages. The means and standard deviations were used to quantitatively describe the characteristics of the population and variables. Inferential statistics were used to test and validate the hypothesised relationships between the tax morale and tax compliance among SMEs.

IV. Results and Discussion

4.1 Response Rate

The study had a sample of 318 respondents who were surveyed using a structured questionnaire issued at the respondents' place of work. From the total sample, 261 questionnaires were returned back for analysis which represents a response rate of 82%. This was considered adequate for analysis and making conclusions and recommendations.

4.2 Influence of Tax Morale on Tax Compliance

The study sought to establish the effect of tax morale on tax compliance among the SMEs in Kenya. The respondents were asked to indicate their level of agreement with different statements on tax morale and the findings are as shown in Table 1. As the findings portray, majority of the respondents agreed that the tax rates put across by the government affect tax compliance because they are not friendly. The respondents fairly agreed that they comply with taxes because of the penalties of non-compliance. The findings compare with those by Alm and McClellan (2012) who found that taxation policies that are in line with the expectations of the citizens and flexible to daily changes influence tax compliance. The findings are also in line with the arguments by Leviner (2012) that the way the government uses the taxes collected determines the morale of the taxpayers whereby if the taxes are misused the morale goes down and so is to compliance. As Bame-Aldred, Cullen, Martin and Parboteeah (2013) contend, the culture and social norms of individuals determine their willingness to abide by the set rules and regulations and this replicates tax compliance. According to Loo *et al.* (2010), most entrepreneurs evade tax not because they are willing to do so but because they lack the know-how of when to pay, where to pay and how to pay the taxes hence calling for the stakeholders to enhance awareness to promote morale and compliance.

Table 1. Tax Morale

Statement	Mean	Std. Dev.
The tax rates put across by the government affect my tax compliance since they are not friendly	3.84	1.04
I comply with taxes because of the penalties of non-compliance	3.68	1.22

I fear the tax evasion consequences thus complying with the taxes as required by the law	3.67	1.21
Due to continued lack of accountability to tax revenues by the government I have little morale to pay taxes	3.77	1.20
I feel my taxes are misused through corruption thus not will to comply	3.43	1.39
I belief tax compliance to me a morally right decision thus comply accordingly	4.10	0.95
I am aware of what is required of me on tax compliance as a tax-payer	4.18	0.90
I have access to tax information thus I'm able to comply accordingly	3.88	1.04

4.3 Tax Compliance

The respondents were asked to state their levels of agreement on the statements regarding to tax compliance using the five Likert's scale. The findings were as indicated on table 2. The findings portray that majority of the respondents agreed with the first statement that I always file the tax returns on time to avoid penalties and this is shown by a mean of 3.81 and a standard deviation of 1.20. The respondents agreed that they ensure that they file the accurate returns and give the correct information to the authority as proven by a mean of 3.86 and a standard deviation of 1.19. Further, the respondents agreed with the statement that the disclosures and declarations of their wealth made during returns wee full and as required.

According to Thiga and Muturi (2015), while SMEs are increasing over the years across the country, tax revenues from the firms have not been increasing with a similar margin an indication that tax compliance among these firms is as low.

Table 2. Tax Compliance

	Statement	Mean	Std. Dev
	I always file the tax returns on time to avoid penalties	3.81	1.20
	I ensure that I file the accurate returns and give the correct information to the authority	3.86	1.19
	The disclosures and declarations of my wealth that I make during returns are full and as required	3.91	1.15
	The taxes that I remit are equivalent to the actual amount that I'm required to pay	3.87	1.16
	My rate of tax compliance has been increasing over time	3.95	1.01

4.4 Regression Model Analysis

The output of the regression model is as shown in Table 3. The R² of 0.690 implied that there is a variation of 69% of tax compliance by the SMEs as a result tax morale. From the results, it was established that a unit increase in Taxa morale would lead to an increase in tax compliance among the SMEs by up to 77.1%. The findings imply that tax morale has a significant and positive influence on tax compliance by the SMEs.

Table 3. Regression Model Results

	Model	R	R ²	F	Beta (β)	t	Sig.
1	(Constant)				5.833	1.839	.000
	Tax Morale	.831 ^a	.690	117.103	0.771	12.639	.000

V. Conclusion

The study concluded that tax morale had a significant influence on the tax compliance among youth entrepreneurs in Kenya. Through the set taxation policies set by the government were key aspects that influenced tax compliance. Tax payers comply because they fear the penalties and tax evasion consequences set by the government. The rate of taxes put across by the government are not favourable to taxpayers hence they affect their tax compliance. The tax payers are discouraged from remitting taxes by how the government spend tax revenues.

Improper accountability, increased corruption cases and lack of appropriate report on government expenditure make taxpayers feel that their money is being misused hence evading taxes. The level of awareness has an influence on tax compliance. Through the sensitization programmes by KRA officials, media reports and advertisements on tax compliance, tax payers are aware of what is required for them to comply with the tax.

Recommendations

The study recommends that the government through the tax agency (KRA) should set affordable tax rates to increase the morale of tax compliance. The government should give clear incentives of taxation to encourage tax payers on tax compliance. The Ethics and Anti-Corruption Commission through Auditor general of the government should ensure accuracy and transparency of government expenditure to give a room for tax payers of accessing the government projects. The government should focus on projects that have a positive impact on tax payers' needs to give the morale of complying with tax. Leaders should set incentives for tax compliance to encourage tax payers on the importance of complying with the tax. Social and cultural groups should set the consequences of tax evasion to encourage members on tax compliance.

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