EFFECT OF VALUE ADDED TAX REFORMS ON REVENUE MOBILIZATION FROM SMALL CORPORATE TAXPAYERS IN KISUMU COUNTY, KENYA

BY

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ABSTRACT

Problems of taxation have been receiving special and increasing attention in recent years the world over. In Kenya, because of the limited amount of resources that can be obtained from offshore and from domestic borrowing, the government has focused on increase its tax revenues in order to meet its long term social obligations. VAT as a general tax on consumption applied to commercial activities involving the production and distribution of goods and the provision of services has been debated on leading to the question of its reforms. However, arguments and studies on the subject of tax reforms are deficient. They focus more on the VAT practices and rationale and leave out the joint effect of elements of tax reforms on revenue mobilization. How reform-based broadening of VAT base, corporate compliance with VAT reforms and VAT reforms administration affect revenue mobilization p amongst small corporate taxpayers Kisumu County remains unknown. The objectives of this study were to examine effect of tax-base broadening, corporate compliance to VAT reforms and VAT reforms administration on tax revenue mobilization. Conceptually, the study was designed to investigate a functional relationship between VAT reforms and tax revenue mobilization. The research was correlational survey. The population was 1356 finance and tax officers of small corporate tax payers operating in Kisumu. Sample size was 309 derived through cluster and simple random sampling techniques. Both primary and secondary data collected from respondents and KRA and other publications respectively were used. Semi -structured questionnaire reliable at Cronbach's Alpha=0.73 was used. Validity was ascertained through expert review. The objectives were analyzed using percentages, mean, standard deviation and multiple regression. Results showed broadening of tax base, tax compliance and VAT administration had significant coefficients of β=0.031, 0.052 and 0.113 respectively. This means that the three contribute to unit change in revenue mobilization by 3.1%, 5.2% and 11.3% respectively. The conclusion is that VAT administration has highest effect on revenue mobilization, followed by corporate compliance and lastly VAT bas broadening. It is recommended that the tax collector emphasizes on these areas as they contribute to revenue collection. The study benefits Revenue collector and the tax payer alike through reforms that may emanate from it. Future researchers are advised to study other contexts.

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

VAT is a consumption tax imposed on the sale of goods and services (Keen, 2013). The VAT Directive of the European Union (DEU) defines VAT as a general tax on consumption applied to commercial activities involving the production and distribution of goods and the provision of services. The tax is calculated based on the value added to goods and services at each stage of production and of the distribution chain (European Union, 2006). Misra (2005) describes VAT as a miracle tax measure to broaden the base of tax net in progressive economies. The superiority of VAT lies in the fact that it prevents cascading effect of taxation and reduced tax evasion (Misra, 2005). Bickley (2003) supports this assertion with his reference to VAT as a type of general consumption tax that is fully shifted forward to consumers. Ebrill *et al.* (2001) describe VAT as a self-assessed tax where taxpayers comply with their basic tax obligation without the intervention of tax authorities.

Khadka (2005) traces the origin of VAT idea to 1919 in Germany who was inspired by the problem of tax-on-tax that prevailed in the existing taxes. After about thirty-five years of experimentation with the concept, France adopted the VAT in 1954 for large businesses and extended it in an incremental way to other business sectors (Schenk & Oldman, 2007). Since the France adoption, VAT has been adopted as the main form of indirect taxation by many countries in different parts of the world and at different stages of economic development, and according to Keen (2013),the journey forward for VAT continues unabated and now more than 140 countries use the tax as a major source of revenue".

Many countries, Kenya inclusive have made efforts to design a system that is viable and productive to finance and sustain government expenditure without recourse to deficit financing and foreign credit and aid by initiating tax reform measures. Mahon (1997) observed that tax reform involves the process of changing the way taxes are collected or managed by the government. It also involves the adoption of a Value Added Tax (VAT) or its expansion, elimination of stamps and other minor duties, simplification and broadening of personal or corporate income as well as asset taxes. Other reforms include the revision of tax codes, enactment of comprehensive administration and criminal penalties for evasion (Bird, 2003). Bird further noted that tax reforms also involve institutional aspects of tax reform introducing a Semi-Autonomous Revenue Authority (SARA) model, where traditional line departments are separated from the Ministry of Finance and granted the legal status of semi-autonomous authority. Musgrave (2004) on the other hand, notes that tax reforms involve broad issues of economic policy as well as specific problems of tax structure design and administration. Mahon (1997), observed that at theoretical level, tax reforms are initiated either following an economic crisis or as a response to international pressure.

In Kenya, tax reforms become part of a large structural adjustment programmes that were incorporated in the economic restructuring between the Government of Kenya and the International Financial Institutions in the mid 1980s (Fjeldstand and Rakners, 2003). Consequently, substantial tax reforms followed fiscal crisis that were being experienced at the time and the resulting pressures for reform from IMF and World Bank. In response, the Kenya government adopted tax reforms voluntarily to gain favour with powerful international donors. Further, tax reforms in Kenya were necessitated by increasing complexity of tax codes, narrow tax base and concerns with horizontal equity (Taliercio, 2004). In the policy documents, the government emphasized the need to raise more tax revenue without increasing the burden on those who are already contributing to the exchequer. For instance, the tax measures contained in the Tax Management Administration Guidelines that emphasize broadening the tax base while at the same time continue to strengthen tax administration. Additionally, devising a tax structure that distribute income equitably and promotes rural-urban balance, reduce compliance and administrative costs through low and rationalized tax rates were proposed. Other measures included improved tax administration by sealing leakages loopholes, and designing a buoyant and elastic tax system that keeps revenues expanding at the same pace with income growth without annual changes in rates, among other goals (GoK, 1996). In Karingi *et al.* (2005), it was noted that the government adopted the tax reforms after realizing that the present tax structure could not raise adequate revenues and continuous use of domestic borrowing and seeking external borrowing could not be relied on as a long term strategy of financing budget deficits. Furthermore, potential sources for domestic borrowing are few while external grants reduce the country's autonomy as well as an increase in political and economic dependence (Wawire, 2006). In lieu of this, Wawire (2006) observed that the alternative is to raise money through taxation.

Responsive tax reforms provide the anticipated solution to sustained government financing (Bonnel, 2009). Kusi (1998) asserts that a tax system that is responsive to economic growth is desirable since it enables tax revenue to grow automatically without resorting to the politically difficult task of raising tax rates. Kusi (1998) further noted that if a tax system has tax revenue that is not responsive to changes in national income, it will end up having huge deficit financing which has negative impact on the other macroeconomic variables. As noted by Muriithi and Moyi (2003), the responsiveness of a tax system to change in national income can result from two effects namely in-built flexibility (elasticity) and the buoyancy of the tax structure.

Although the reform suggested by optimal taxation are based upon rigorous economic theory as Thirsk (1995), Deaton (1988) and McClure (1989) emphasized, putting them into operation leads to as intractably large number of rates, which would be difficult to calculate and infeasible to administer effectively. Slemrod (1990) has argued that the optimal tax theory can serve as a guide to designing optimal tax systems only if one considers the technology of tax collection.

According to Kusi (1998), a tax system that is responsive to economic growth is desirable since it enables tax revenue to grow automatically without resorting to the politically difficult task of raising tax rates. Kusi (1998) noted that if the tax system has tax revenue that is not responsive to changes in national income, it will end up having huge deficit financing which has negative impact on the other macroeconomic variables. As noted by Muriithi and Moyi (2003), the responsiveness of a tax system to change in national income can result from two effects namely either in-built flexibility (elasticity) or the buoyancy of the tax structure. Muriithi and Moyi further noted that lthough studies exist with regard to the same, they are deficient in informing the policy process given the various macroeconomic changes that have evolved over time and continued tax reforms that the government has initiated and implemented.

In summary, whereas Kusi (1998) examined tax responsiveness and its effect on revenue growth, Muriithi and Moi (2003) only addressed the underlying causes of tax responsiveness. Whereas Bonnel (2009) and Wawire (2006) argued generally for tax reforms as a solution to government financing, Kariingi (2005) was more specific in advancing that taxation plays a key role in long term government financing. Toliercio (2004) examined the nature of tax reforms quite apart from the works of Thirst (1995), Deaton (1988) and McClure (1989) who looked at tax optimization though was quick to point it leads to high tax rates.

From the works however, it is noted that the areas addressed though varied did not comprehensively cover the subject of tax reforms. They are deficient in informing tax policy and reforms. They also failed to shed light on the role of such reforms on revenue growth. For this reason, these areas are still unclear. Specifically, effect of reform-based broadening of VAT base, corporate compliance with VAT reforms and VAT reforms administration on revenue mobilization particularly amongst small corporate taxpayers in Kisumu County are not clearly addressed. These remain unknown.

Empirically studies have shown that high revenue productivity from a tax system is normally considered as one of the criteria of a good tax system in developing countries (Musgrave, 1989). Studies by Ariyo (1997), Osoro (1993), Karingi *et al.* (2005), Moyi and Ronge (2006) contend that, both tax policy reforms and tax administration reforms, are crucial in making tax revenue responsive to changes in national income which in the process enhances revenue productivity.

Despite these reforms that have led to numerous Newberry and Stern (1987) applied a normative framework to analyze a tax reform process. The optimal taxation approach emphasized the need to analyze the impact of tax reform and evaluate both its administrative costs and its effect on social welfare. This framework has been criticized for its inability to identify the real practical needs of tax reform in developing countries. Its first major shortcoming is that it requires substantial data, which are scarce or non-existent in many developing countries. Secondly, optimal taxation has assumed the existence of perfect administration. However, recent reform experiences have revealed a serious lack of administration capacity in virtually all developing countries, showing the need for simpler administrative structures. The impact of optimal taxation on tax reform in developing countries has been small and indirect because of this deficiency (Gillis, 1989). In addition, under the optimal taxation approach the analysis of revenue productivity of a tax would be of less significance.

Bird and Gendron (2007) examined how against the backdrop of increasing globalization and the growing integration of world's economies the way was paved for re-structuring the tax structure that showed unambiguous bias towards the adoption of VATs. While the most important rationale for the original adoption of VAT in Europe was to facilitate trade, in developing countries the core was urgency of maximizing revenue through expanding the tax base and the concern of trade facilitation inspired the adoption of VAT. These persuasions were reinforced by the early adoption of VAT by the EU countries and its demonstrated success; and the role played by the IMF in spreading the success stories to the developing countries (Bird & Gendron, 2007).

In Kenya, VAT on consumer expenditure was introduced in 1990 as a replacement for sales tax, which had been in operation since 1973. It was introduced as a measure to increase government revenue through expansion of tax base, which hitherto was confined to income tax and sales tax. The principle behind VAT is to levy a tax on consumption of taxable goods and services supplied in Kenya or imported into Kenya. Registered persons acting as agents of government of Kenya collect VAT at designated points and then submit to the Kenya Revenue Authority (KRA) (Simiyu 2003). According to Moyi and Ronge (2006), VAT contribution was estimated to an average of 5.4% of GDP between the year of its introduction (1990) and the year 2005. The average of total tax contribution to GDP for the same period was 19.8%. This clearly indicates that in Kenya, VAT contributes substantially to the growth of the economy.

Since inception of VAT, further reforms and rationalization have been continued involving the lowering of top rate from 150% to the standard rates of 16% and reduction of the number of tax rates from 15 in 1990 to three currently. It was expected that these changes would lead to reduction in tax evasion, stimulate saving and investment by simplifying the system and make the system more efficient as large dispersion of tax rate impose heavy costs. Other reforms have specifically focused on surveillance on the tax registers through Electronic Tax Register (ETR), widening of VAT base through VAT rate reduction, and enhancement of compliance awareness among the taxpayers on VAT through education of taxpayers and rewarding (Mutua, 2011).

Nada and William (2009) note that in Kenya, the responsibility for paying VAT on certain sales rests not only with the seller but also with the buyer. This is enabled through a system that was introduced towards the end of 2003 in the name of VAT withholding. It initially applied to government agencies that were purchasing goods and services subject to VAT. It was observed that the government, through these agencies, was paying VAT-inclusive prices to suppliers, who were not necessarily remitting the revenue to the KRA. The agents consisted of purchasers who were required to withhold VAT. Most importantly is that about 40 percent of VAT revenue was collected from these agents the same year (Nada and William, 2009).

In summary, the studies above addressed various issues on tax and tax reforms albeit inconclusively. While Newberry and Stern (1987) failed to show the practical needs of tax reforms in their analysis, Karingi *et al.*(2005) studied tax policy and administration reforms giving their role in revenue productivity. Musgrave (1989) found that a good tax system leads to revenue productivity. On one hand, Bird and Gendron (2007) generally focused on drivers on tax reforms while on the other; Mutua (2011) was more specific. He examined tax surveillance, VAT rate reduction and VAT Compliance awareness. Nada and William (2009) on the contrary addressed the subject of VAT collection agency and its role.

The works above are more inclined towards the content of VAT and VAT reforms than its effect. The studies are inconclusive in the way they address the content of tax reforms and the joint effect of elements of tax reforms on revenue mobilization. They do not clarify effect of reform-based broadening of VAT base, corporate compliance with VAT reforms and VAT reforms administration on revenue mobilization particularly amongst small corporate taxpayers in Kisumu County. Therefore, this situation remains unknown.

1.2 Statement of the Problem

Problems of taxation have been receiving special and increasing attention in recent years. In Kenya, because of the limited amount of resources that can be obtained from offshore and from domestic borrowing, the government needs to increase its tax revenues in order to meet its long term social obligations. Therefore, tax reforms is a crucial subject. However, arguments and studies on the subject of tax reforms are deficient. They focus more on the VAT practices and rationale. Further , the studies are inconclusive in the way they address the content of tax reforms and the joint effect of elements of tax reforms on revenue mobilization. How reform-based broadening of VAT base, corporate compliance with VAT reforms and VAT reforms administration, affect revenue mobilization particularly amongst small corporate taxpayers is not well addressed. This situation particularly amongst small corporate taxpayers in Kisumu County remains unknown.

1.3 Objectives of the Study

The general objective of the study was to investigate the effect of Value Added Tax (VAT) reforms on revenue mobilization from small corporate taxpayers running in Kisumu County.

Specifically, the study sought to;

1. Establish the effect of reform-based broadening of VAT base on revenue mobilization from the small corporate taxpayers in Kisumu county
2. Examine effect of corporate compliance with VAT reforms on revenue mobilization from small corporate taxpayers in Kisumu county
3. Establish the effect of VAT reforms administration on revenue mobilization from small corporate taxpayers in Kisumu county

1.4 Research Questions

Realization of the study intent was guided by the following research questions:

1. What is the effect of reform-focused VAT base broadening on revenue mobilization from small corporate taxpayers in Kisumu County?
2. What is the effect of corporate compliance to VAT reforms on revenue mobilization from small corporate taxpayers in Kisumu County?
3. What is the effect of VAT legislation environment on revenue mobilization from small corporate taxpayers in Kisumu County?

1.5 Significance of the Study

Nationally this study sought to make the much need contribution in addressing the perpetual fiscal budgetary imbalances beleaguering Kenya's budget statement. Findings of this study were anticipated to make contributions to the existing literature on the VAT structure, reforms and respective revenues, while stimulating further research in the area of taxation in Kenya and beyond. Subsequently, the results could be used to design growth-oriented initiatives and carry out tax changes that are growth enhancing. Further, the study provided an empirical groundwork on Kenya's VAT revenue structures upon which prudent tax measures and directions could be based. It would be used to identify the functional relationship between reforms and VAT revenues which when properly understood, documented, and captured in relevant tax revenue models, could make it possible to estimate accurately VAT revenues within a specified period of time, even beyond the small corporate taxpayers. Essentially also, it provided an informed basis for taking action on tax policy in addition to filling the gaps about what is currently known about VAT revenue function in Kenya and specifically in Kisumu County. The rationale of this study was further justified by the national effort to implementing the constitution of Kenya 2010 in compliance with the two-tier governance structure, rationalization of budget, continued reforms as a result of VAT Act 2013, and the structural adjustment process.

1.6 Scope of the Study

The study was conducted in Kisumu County which was one of the 47 established Counties vide Kenya Constitution 2010. In the County, there were 1356 corporate taxpayers with annual sales turnovers ranging from KES 500,000 to KES 500million and consequently classified as small taxpayers. Using these firms, the study focused on their revenue mobilization and subsequent remittance to the Kenya Revenue Authority (KRA) in comparison with VAT reforms since VAT inception in 1990 up to end of Financial Year 2012/13. This period was considered sufficient to derive an objective generalization regarding effect of VAT reforms on tax revenue for the Kenyan government from Kisumu County.

1.7 Conceptual Framework

The study was designed to investigate the functional relationship between VAT reforms and tax revenue mobilization using small corporate taxpayers in Kisumu County as shown below:

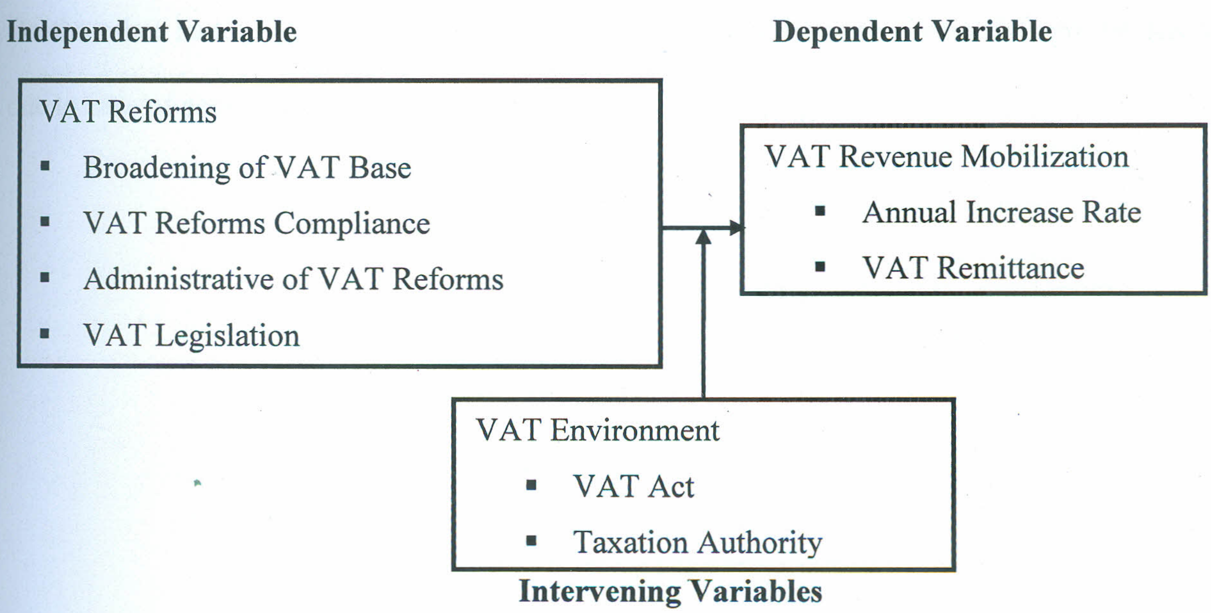

Fig. 1-1: Study's Conceptual Framework showing effects of Tax Reforms on Revenue
Source: Self-Conceptualization (2014)

Tax reform measures are mainly undertaken in order to restore buoyancy to revenues, strengthen modern taxes, and drastically reduce the complexity and lack of transparency of the system. As shown in Fig.1-1, the study focuses on VAT reforms in terms of four main explanatory variables presumed to have effect on revenue performance. These are tax-base broadening, reform compliance, tax administration, and legislation challenges. First, Tax-base broadening was measured using various indicators such as revenue scope, revenue variations, demand of vatable and non vatable items, and remittances to KRA. Second, reforms compliance was studied through complexity of VAT systems, returns systems, under-reporting, penalty, and personal drive. Third, tax reforms administration was assessed using formulation of policies, partnerships, administrative efficiency, disclosure of information, and records protection. And fourth, the effect of legislation challenges on revenue was studied using indicators such as information inaccessibility, sensitization, stakeholder involvement, VAT complexities, penalty application, and administrative frailties. On the other hand, data for indicators on dependant variable were obtained from the KRA due to ease of access in summarized formats.

CHAPTER TWO

LITERATURE REVIEW

This chapter discusses literature related to the problem area and specifically of the thematic areas of study. It includes review of both empirical and theoretical literature relating to the concept of tax administration. The specific focus is on reform-based tax broadening, corporate compliance to tax reforms, administration of tax reforms, tax legislation, tax and revenue mobilization, theories of tax reforms, empirical reviews, and literature gaps.

2.1 Theories of the study

The philosophy of tax reform has undergone significant changes over the years in keeping with the changing perception of the role of the state. According to Ahmad and Stern (2001), conventional wisdom on tax reforms provides four different theories of tax reform. First, the Optimal Tax Theory (OTT) model is satisfactory in terms of its theoretical soundness, but has been found to be impractical in its applications. Besides the trade-off between efficiency and equity in tax policy, the information and administrative costs of designing an optimal tax model have been found to be prohibitive and, therefore, as a practical guide to tax policy this has not been useful.

Second, the Harberger Tax Theory (HTT) is well grounded in theory. It, however, draws much more on practical experience. According to this, while efficiency is clearly desirable in the design of tax policy, administrative capability is equally, if not more, important. The principal concern, according to this theory, is not to design a system that will be optimal, but emphasize the system that will minimize tax-induced distortions and at the same time be administratively feasible and politically acceptable. The basic HTT reform package for developing countries, which are price takers in the international market consists of, inter alia, a uniform tariff and a broad-based VAT (Ahmad & Stern, 2001).

The third theory is the Supply-Side Tax (SST) which emphasizes the need to reduce the role of the state. Reduction in the volume of public expenditures has to be achieved by cutting the tax rates, particularly the direct tax rates to minimize disincentives on work, saving and investment. The proponents of this model emphasize the need to broaden the base with minimal exemptions and preferences and to have low marginal tax rates. Again emphasis is on minimizing distortions in relative prices and, therefore, the approach emphasizes less rate differentiation (Ahmad and Stern, 2001).

Finally, Best Practice Theory (BPT) which combines elements of all the other three theories is advocated by modern scholars and practitioners. This incorporates both theory and past reform experiences and takes into account administrative, political and information constraints in designing and implementing reforms. The thrust of this approach is to enhance the revenue productivity of the tax system while minimizing relative price distortions. The BPT has attempted to make the tax systems comprehensive, simple and transparent. The general pattern of these reforms has been to broaden the base of taxes, reduce the tax rates and lower the rate differentiation both in direct and indirect taxes. A broader base requires lower rates to be levied to generate a given amount of revenues. Lower marginal rates not only reduce disincentives to work, save and invest, but also help to improve tax compliance (Dasgupta & Mookherjee, 2008).

Vaish and Agarwal (2006) who advocate for the BPT argue that broadening the tax base helps to ensure horizontal equity, is desirable from the political economy point of view as it reduces the influence of special interest groups on tax policy, and reduces administrative costs. In the case of indirect taxation, the reform agenda includes the levy of a broad-based VAT with minimal exemptions and supplemented by a few luxury excises. Emphasis on horizontal equity also implies emphasis on strengthening administration and enforcement of the tax and the development of proper information systems and automation (Vaish and Agarwal, 2006). This study adopts BPT as the underlying theory.

2.2 Effect of Tax Reforms and Revenue Mobilization

Fjeldstad and Rakner (2003) argue for the case that the major focus of long run tax reforms should be to improve revenue mobilization in form of indirect taxes which should be the basic source of overall tax revenue. They define tax reform is defined as a deliberate change in the tax system geared towards improving tax revenue administration and collection that comply with various tax policies. In this realm, domestic revenue mobilization refers the generation of domestic resources and their allocation to economically and socially productive investments by both public and private sectors through taxation process managed by the state. Tax revenue is potentially the biggest source of long term financing for sustainable development and it is the life blood of all government activities such as the provision of public goods and services (Fjeldstad & Rakner, 2003).

Moyi and Muriithi (2003) similarly contend that tax revenue strengthen fiscal institution because stable and predictable revenue facilitates long term fiscal planning which can help ensure that resources are allocated to priority sectors and translated into outcomes. In addition, Chipeta (2008) says that the tax system should have some level of predictability and reliability to enable the government to determine how much tax revenue is likely to be collected and when. Government needs some assurance that tax revenues will be stable so that required spending can occur. For instance, during economic meltdown wide unemployment causes income tax revenues to decline. If government is collecting other forms of taxes that are less affected by employment level the effect will not occur immediately (Chipeta, 2008).

Assessment and collection of taxes requires personnel and equipment; they are the assets and should be provided efficiently. Further, it is important to examine the effectiveness of a tax system with regard to how much revenue is actually collected per unit cost, since costs rise with every function implemented (Ghura, 1998). Tax reforms must take the administrative dimension of taxation carefully. Tax reforms initiated should take into consideration whether such reforms are applicable elsewhere. The reforms should ensure the predictability and equity of taxes in order that it does not lead to tax avoidance and possibly evasion (Moyi and Muriithi, 2003).

In Kenya, taxation is the key source of revenue that the government uses to provide public services to its citizenry. Over the last decade tax performance in Kenya has significantly improved in nominal terms averaging about 24% of the size of the economy. This has enabled the government to finance 60% of the budget. Due to its importance, tax policy debates and decision making becomes a critical issue to the public, to businesses and the economy at large owing to the varied impact that it will have on each of these entities. Therefore, the design and performance of the tax system has implications for inequality and as such it is the role of the government to ensure that it pursues a fair tax system for equitable distribution of income and welfare of the citizens. Of the total tax revenue collected by the government over the last decade, the largest contributors are income tax, about 40% followed by VAT at 28% (Mutua, 2011). After establishment of Kenya's new constitution, the tax revenue mobilization will reflect a two tier system of government comprising the national and 47 county governments. According to the Constitution (2010), the national government will retain the powers to impose taxes both direct taxes including income taxes and indirect taxes namely; value added tax, excise duty and customs or import duty. On the other hand the county governments' powers to impose tax will be confined to property taxes, entertainment taxes and other taxes that are feasible at this jurisdiction (Constitution of Kenya, 2010).

2.2.1 Effect of Reform-Based Broadening of Tax on Revenue Mobilization

According to Bird and Zolt (2003), tax design in developing countries is strongly influenced by economic structure. For instance, developing countries often have large traditional agricultural sectors that are difficult to tax. Also, many developing countries have a significant informal economy that is largely outside the formal tax structure. This presents its own unique challenges in the design of tax policy and to the tax administration; given that the potential tax base is a relatively small portion of total economic activity. This may pressure governments to increase tax rates, which creates further incentives for tax evasion (Bird & Zolt, 2003).

Governments undertake tax reforms for a number of reasons; namely, a) to simplify the tax system; b) to address the equity question in the distribution of tax burden; c) to strengthen tax administration and d) to ensure revenue adequacy. Karingi *et al.* (2005) show that Kenya tax reforms emphasis has always been towards introduction of new taxes or new rates of existing bases, the need to widen tax bases and reduce exemptions, as well as introducing more stringent administrative changes to seal loopholes and appropriate sanction measures.

As a way of generating more revenue in the wake of 1990, the government introduced the broad based value added tax as a consumption tax. However despite these reforms, according to Mutua (2011), VAT structure has faced a number of challenges including high administrative costs, leakages and distortion of the VAT system owing to exemptions and zero rating as well as low productivity. In addressing these challenges the government introduced and consequently tabled a VAT legislation that seeks to make VAT system simpler and rationalize zero rated and exempted supplies (Mutua, 2011).

According to Karingi et al. (2005), Kenya has moved from a low tax yield country during the 1980s, when total tax revenue as a percentage of Gross Domestic Product (GDP) which is measure of the size of the economy, averaged 19.7% to the current average of about 24% following continuous reforms through the Tax Modernization Programme (TMP) after 1994/95 to date. Although Kenya experienced revenue shortfall at the initial introduction period, VAT performance has subsequently contributed to improved revenue collection at lower administrative and compliance cost. Indeed, the importance of VAT is evidenced by

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The characteristic of the tax system in Kenya is that, tax revenue is spread across various different tax instruments (both direct and indirect). The advantage of this is that it can help the fiscal system to better withstand economic fluctuations and can minimize the tax burden on any particular group of taxpayers or sectors of the economy. Further, tax policy in Kenya has changed over time towards relying more on indirect taxes as a major source of finance for development budget as a deliberate move intended to reduce the burden on income taxation so that savings and investments could be promoted (Karingi *et al.*, 2005).

Chipeta (2008) evaluated effects of tax reforms on tax yields in Malawi for the period 1970 to 1994. The results indicated buoyancy of 0.95 and an elasticity of 0.6. The study concluded that the tax bases had grown less rapidly than GDP.

Kusi (1998) studied tax reform and revenue productivity of Ghana for the period 1970 to 1993. Results showed a pre-reform buoyancy of 0.72 and elasticity of 0.71 for the period 1970 to 1982. The period after reform, 1983 to 1993, showed increased buoyancy of 1.29 and elasticity of 1.22. The study concluded that the reforms had contributed significantly to tax revenue productivity from 1983 to 1993.

Charlet and Owens (2011) studied VAT in the EU countries in relation to how EU countries tried to overturn their persistent budget deficits. The study found that countries usually mitigated deficits by increasing VAT rates. However, the VAT rate increases were found to be combined with a reduction of tax income.

Cashin *et al.* (2008) studied the temporary effect of change in VAT rate in Japan. In general, their results suggest that the rate increase did not have a significant impact on real household expenditures, a finding which stands in contrast to the conventional wisdom that the consumption tax rate increase was largely responsible for Japans recession in the late 1990s, but is consistent with the revenue-neutral nature of the tax reform .

Kumar (2009) used a computable general equilibrium model to examine the Fijian economy wide effects of VAT policy. They found out that while the VAT improves government revenue and brings about a small 0.6% increase in real GDP, it fails to address investment levels. The major criticism on this study is that its primary focus was to develop a model of taxpayer compliance decisions within the Indian setting.

Slobodnitsky and Drucker (2008) conducted a study on the VAT rates and their impact on the Israeli economy. Their findings revealed that VAT revenues are highly correlated with the development of tax base and have high elasticity with regards to VAT rate. They also found that the VAT revenues are "well behaved", especially in comparison with the corporate tax proceeds. For example, they estimated VAT revenues/VAT rate cross elasticity to be high. In periods of VAT rate increase the response is estimated by 91% from the potential, while the response in periods of decreasing VAT rates is 49%. Thus an increase in the VAT rate is likely to generate an increase in the VAT revenue than the rate at which revenue will reduce due to decrease in the VAT rate.

Milambo (2001) used the Divisia Index method to study the revenue productivity of the Zambian tax structure for the period 1981 to 1999. The results showed elasticity of 1.15 and buoyancy of 2.0, which confirmed that tax reforms had improved the revenue productivity of the overall tax system. This study however does not take into account the disparities between the Zambian tax structure which largely is a departmental function in the Government as opposed to a semi autonomous agency.

Njoroge (1993) studied the revenue productivity of tax reforms in Kenya for the period 1972/73 to 1990/91. Tax revenue was regressed on income after adjusting tax revenues for discretionary changes. The period of study was divided into two to make it easier to analyze the effects of tax reforms on revenues from various taxes. Income elasticity of total tax structure was found to be 0.67 for the period 1972 to 1981. This meant that the government received a decreasing share of rising GDP as tax revenues. The elasticity estimates for individual taxes were as follows: sales tax 0.6, import duties 0.45 and income tax 0.93. The buoyancy for the overall tax system for the same period was 1.19, implying that the tax system was quite buoyant. For the period 1982 to 1991, Njoroge (1993) found that the overall elasticity was 0.86 while buoyancy was 1.00. The study concluded that from a revenue point of view, the system did not meet its target, hence it required constant review as the structure of the economy changes.

Muriithi and Moyi (2003) applied the concepts of tax buoyancy and elasticity to determine whether the tax reforms in Kenya achieved the objective of creating tax policies that made yield of individual taxes responsive to changes in national income. The study concluded that despite the positive impact, the reforms failed to make VAT responsive to changes in income (Muriithi & Moyi, 2003).

Osoro (1993) examined the revenue productivity implications of tax reforms in Tanzania for the period 1979 to 1989. In the study, the tax buoyancy was estimated using double log form equation and tax revenue elasticity using the proportional adjustment method. The result gave an overall elasticity of 0.76 with buoyancy of 1.06. The study concluded that the tax reforms in Tanzania had failed to raise tax revenues. These results were attributed to the government granting numerous tax exemptions and poor tax administration within the sample period.

In Ghana, Kusi (1998) studied tax reform and revenue productivity of Ghana for the period 1970 to 1993. Results showed a pre-reform buoyancy of 0.72 and elasticity of 0.71 for the period 1970 to 1982. The period after reform, 1983 to 1993, showed increased buoyancy of 1.29 and elasticity of 1.22. The low buoyancy and elasticity during the pre-reform period was attributed to smuggling, unrecorded trade, tax evasion and laxity in tax collection. The results also showed that income tax had the lowest elasticity and therefore he recommended that authorities should move away from income based taxes in favour of consumption taxation.

The study concluded that the reforms had contributed significantly to tax revenue productivity from 1983 to 1993.

In summary the literature on this subject of tax reforms concentrated on tax elasticity and buoyancy as evidenced by Muriithi and Moyi(2003), Kusi (1998), Osoro (1993). While Chipeta (2008) examined growth of tax base against and found the former slower in relation to the latter, Kusi (1998) investigated tax reforms against revenue productivity similar to Charlet and Owens (2011) who examined effect of increasing VAT rates on tax income. Cashin *et al.* (2008) studied change in VAT rate while Kumar (2009) delved in VAT policy and its effects.

It is clear that the literature above did not clearly address the elements of tax reforms. The works are incomprehensive and focus on revenue productivity because of tax or aspects of tax reforms. The works do not address effect of reform- based broadening of tax. This has therefore remained unknown

2.2.2 Effect of Compliance to Tax Reforms on Revenue Mobilization

Fjeldstad (2003) advocates for a tax system structured to minimize non-compliance, like issues of non-filing, under reporting of income or overstating of deductions and unintentional errors such as miscalculations and lack of understanding rules. A number of tax provisions may encourage non-compliance because the provision is too complex to understand or to comply with procedural rules generally required for all tax systems. Rules to encourage compliance might include mandatory withholding of taxes at source and penalties for non-compliance. Generally compliance measures need a balance between the desired levels of compliance against the costs of enforcement of the tax laws (Fjeldstad, 2003).

Tax authorities need a proper process for determining tax liabilities. This may be done administratively (as with most property taxes) or by some self-assessment procedure (as with most income taxes and VATs). Taxes that are due must be collected in an efficient and proper manner. In many countries, this is best done through the banking system. It is seldom appropriate for tax administration officials to handle money directly. Tax authorities should provide adequate taxpayer service to make taxpayer compliance with the relevant laws and regulations as easy as possible. This can be done in a number of ways, including the provision of sufficient information, pamphlets, forms, advice kiosks, extending payment facilities and options, as well as electronic filing of tax returns. Even tax bills can be used effectively to communicate information (Bird & Zolt, 2003).

Bird and Zolt (2003), advocate for the approach that rests on treating the taxpayer as a client (albeit not a willing one) to be served and not a thief to be caught. Similarly, Silvani and Baer (1997) call for "voluntary compliance" which they define as the timely filing and reporting of required tax information, the correct self-assessment of taxes owed, and the timely payment of those taxes without enforcement action.

Wang (2010) concludes that taxpayers' confidence is largely dependent on the efficiency and efficacy of government services, that is, whether the services provided are cost-efficient and whether the revenue is appropriately spent in a transparent and accountable manner; and the perceived level of fraud and corruption in the government, and whether government is serious in combating fraud and corruption. In an environment where taxpayers generally trust government, voluntary tax compliance is more apparent. With reference to the local government level in Tanzania, Fjeldstad (2006) states that taxpayers' unwillingness to pay is not perceived to be the main problem in revenue collection. He points at misuse of tax revenues by particularly by tax collectors as the major problem.

Kenya's tax system has undergone more or less continual reform over the last years predominantly for the purpose of enhancing compliance. On the policy side, rate schedules have been rationalized and simplified and a new value-added tax introduced. The country has the trappings of a modern tax system, including, for example, a credit-invoice VAT. Notably, however, despite the current number of businesses registered for VAT hitting above 54,000 from 36,000 in 2010, only about 30,000 VAT returns were received each month in 2011/12, suggesting that many firms are either dormant or non-compliant (Eissa & Jack, 2009).

Chipeta (1998) evaluated effects of tax reforms on tax yields in Malawi for the period 1970 to 1994. The results indicated buoyancy of 0.95 and an elasticity of 0.6. The study concluded that the tax bases had grown less rapidly than GDP.

In summary the works above examined diversified areas of tax reforms. While Chipeta (1998), examined tax reforms on tax yields, Essa and Jack (2009) found dormancy or non-compliance high but did not investigate effect. Wang (2010) investigated factors affecting compliance, Fjeldstad (2006) examined unwillingness to comply versus misuse of collected funds. The studies concentrated on establishing status of compliance rather than investigating effect it has on revenue mobilization. This therefore remains unknown.

2.2.3 Effect of Tax Reforms Administration on Revenue Mobilization

Tax administration comprises three interrelated activities, which include identification of taxpayer based on existing tax legislation, assessment of taxes to determine the tax liabilities, and the collection, prosecution and penalties that impose sanctions on tax payers who evade taxes. Such activities require some degree of autonomy if tax administration is to realize the predictable tax revenue (Mutambi, 2004). In order to increase revenue and curb corruption, a number of countries have implemented comprehensive reforms of their tax administration over the past years, one of them being establishing semi autonomous revenue authorities. This was aimed at limiting political interference in the management of the tax bodies. Consequently, the revenue authority recruit motivated and highly trained staff above the civil service standards and can easily dismiss staff on the ground of misconduct, yet in civil service staffs are not easily terminated. Such steps provide incentives for greater job motivation and minimize corruption tendency (Fjeldstad, 2003).

Tanzi (2001) points out, tax administration has a crucial role in determining the real (or effective) tax system, as opposed to the statutory tax system. There is a growing conviction among tax policy specialists in developing countries that "policy change without administrative change is nothing" (Bird, 2003) and that it is critical to ensure that "changes in tax policy are compatible with administrative capacity" (World Bank, 2009). However, only very few developing countries have managed to establish their tax systems in such a way as to achieve an appropriate level of revenue and to keep tax-generated misallocations within tight bounds. In most other countries, neither has it been possible to ensure the financing of public expenditure nor have the tax systems operated in conformity with economic policy objectives (World Bank, 2009)

Bird and Zolt (2003), state that the first task of any tax administration is to facilitate compliance. This requires making sure that those who should be in the system are in the system and that they comply with the rules. In this regard they list four important steps. First is to ensure that taxpayer coverage is as comprehensive as possible. Second, if taxpayers are required to register, the registration process should be as simple as possible under the circumstances. Third, systems must be in place to identify and follow up on those who do not register voluntarily. And forth, tax authorities should adopt an appropriate unique taxpayer identification system to facilitate compliance and enforcement (Bird & Zolt, 2003).

According to Osei (2006), Ghana's tax reforms constitute the major policy instrument needed to accelerate growth and poverty reduction. Ghana's major changes in tax administration fiscal policies played a key role in improving the country's revenue mobilization and overall fiscal health. The prime factors cited for the increase in revenue are the expansion of tax base, the structure of taxation; and reorganization of the tax administer. If tax administration is to become effective in developing countries, enormous combination of qualitative human and material re-sources needed to perform as the professional roles of revenue institutions. Bougrand, Loko and Mlachila (2002), however, contend that designing a suitable medium-term fiscal framework that fosters a sustainable delivery of better public services and infrastructure while maintaining a credible commitment to fiscal prudence confronts many challenges. The main task of fiscal administration in these ministries tends to be virtually coordinated with expenditure allocation and control by the budget division. However, as revenues, policy is compromised and the actual supervision of revenue performance becomes relaxed, leading to ineffective administration and loss of revenue. Bougrand, Loko and Mlachila (2002), further found that foreign loans are still the most attractive way to finance budget deficits, while a significant devaluation risks and a high levels of domestic interest rates are involved.

In Uganda, a key element of the administrative reform was to move the existing revenue department out of the Ministry of Finance into a semi-autonomous revenue authority overseen by an independent Board of Directors. The philosophy behind this move was mainly to provide incentives for the staff to improve their performance and thereby increase revenues. The reform appeared to be a success in URA's (Uganda Revenue Administration) first years of existence. Reported revenue increased sharply from 7% of GDP in 1991 to around 12% in 1997 (Fjeldstad, 2003).

In Kenya, VAT was introduced in 1990 as a broad-based tax levied on the consumption of not only locally manufactured and imported goods but also on services with a view of generating substantial revenue (Karingi *et al.*, 2005). It is administered by the Commissioner of VAT in the semi-autonomous Kenya Revenue Authority (KRA). Although Kenya experienced revenue shortfall at the initial introduction period, VAT performance has subsequently contributed to improved revenue collection at lower administrative and compliance cost. Indeed, the importance of VAT is evidenced by the fact that it accounts, on average, for 28% of total tax revenue, coming second after income tax. The design of Kenya's VAT adopts consumption–type VAT based on destination principle as is the case with most countries. The method used to compute VAT liability is called invoice/credit-based method. Using this method, any person registered for VAT is required to charge, collect and account for VAT on taxable goods and services and remit the tax to the Commissioner of VAT using the invoice (Mutua, 2011).

Adari (1997) study focused on the introduction of value added tax (VAT) in Kenya that replaced sales tax in 1990. The study analyzed the structure, administration and performance of VAT. The estimated buoyancy and elasticity coefficients were less than unity implying a low response of revenue from VAT to changes in GDP. This suggested the presence of laxity and deficiencies in VAT administration. However, the estimation of buoyancy and elasticity coefficients were done in total disregard of the time series properties and without taking care of unusual observations in the data.

In another study, (Osoro, 1995) used the Prest (1962) method to estimate the individual tax elasticity and that of the overall tax system in 1970-1980. He found that the elasticity of the overall tax system declined from 0.85 in 1970 to 0.782 in 1980. Income tax and Sales tax, which were elastic in 1970's, became inelastic in the 1980's. Import duty, which was inelastic in the 1970s, became elastic in 1980s. He attributed these changes to reduction in import duty rates and a rise in imports, rapid changes in tax base, stemming from steep exchange rate depreciation.

Ariyo (1997) evaluated the productivity of the Nigerian tax system for the period 1970-1990. The aim was to devise a reasonable accurate estimation of Nigeria's sustainable revenue profile. In the study, tax buoyancy and tax revenue elasticity were estimated using the double log form and the proportional adjustment method respectively. The slope dummy equations were used for the oil boom and Structural Adjustment Programmes. The study revealed an overall satisfactory tax productivity level but wide variations in the level of tax revenue by various tax sources. The variations were attributed to the laxity in administration of non-oil tax sources during the oil boom periods.

Milton Ayoki, Marios Owona and Moses Ogwapus (2005) researched on tax reforms and domestic revenue mobilization in Uganda by using the proportional adjustment method. Their findings revealed that the reforms had a positive impact on direct taxes as tax-to-income elasticity index grew from 0.706 to 2.082 after the reforms whiles direct taxes also moved from 1.037 to 1.306. They concluded that the reform was necessary to the economy but there was room for improvement.

In summary while Bougrand, Loko and Mlachila (2002) argued that designing a suitable medium-term fiscal framework fosters tax revenue productivity, Osei (2006 contended that a major policy instrument is needed to accelerate growth and poverty reduction. Bird and Zolt (2003) on the other hand state that the first task of any tax administration is to facilitate compliance agreeing with Tanzi (2001) who points out that , tax administration has a crucial role in determining the real (or effective) tax system. Mutambi (2004) argues for tax autonomy for effective tax realization while Adari (1997) focused on structure, administration and performance of VAT

The works above did not address tax administration issues comprehensively. They concentrated on defining tax administration and determining what it entails. They did not address effect of tax reforms administration on revenue mobilization. This is quite unclear from these studies.

CHAPTER THREE

METHODOLOGY

3.1 Introduction

This section presents the methodological components adopted to identify, collect and analyze data. Specifically, it covers the research design, study area, target population, sample design procedures and sampling techniques to be used, data collection, verification of reliability and validity of instruments, data management and analysis, and ethical considerations.

3.2 Study Area

The study was based in Kisumu County which comprised six sub-counties, covering a total land area of 2085.9Km^2 and with a population density of 465 people per Km^2. The sub-counties are Nyakach, Nyando, Muhoroni, Kisumu East, Kisumu North and Kisumu West. Kisumu County is the third largest city in Kenya after Nairobi and Mombasa. Given its cosmopolitan nature, the responses gave an excellent reflection of the national outlook about various taxation issues. Finally, the researcher was based in Kisumu and the choice of the area achieved significant lowering of the overall cost of the study.Data from the regional KRA office in Kisumu showed that there were 1356 corporate taxpayers with annual sales turnovers ranging from KES 500,000 to KES 500million and consequently classified as small taxpayers (KRA, 2013).

3.3 Research Design

The study adopted a correlational survey research design. Cohen *et al.* (2000) advocate for this design because of its ability to ascertain detailed description of existing situation.

According to Yin (2003), correlational survey research design is structured to examine a number of logical sub-units or units of analysis within organizations.Therefore, it enabled the researcher obtain and study information regarding effect of VAT reforms on revenue mobilization in Kisumu.

3.4 Target Population

The study collected data from all the small corporate taxpayers operating in Kisumu County. Each of the identified corporate entity was represented by either finance officer or one accountant in charge of tax. Aggregately, therefore, the study's target population composed of 1356 finance/tax officers.

3.5 Sampling Design

3.5.1 Sample Size Determination

The sample size was determined by adoption of the Yamane (1967) formula which is defined as:

$n_s = N/\{1 + N(e)^2\}$

Where;

n_s - Sample Size

N - Population Size

e - Precision level (at 0.95 confidence interval, e = 0.05)

Given N = 1356, then;

$n_s = 1356/\{1 + 1356(.05^2)$

= 309 participants

3.5.2 Sampling Techniques

The ultimate study participants were selected through cluster and simple random sampling techniques. This was accomplished by first clustering the corporate tax payers from the same industry then taking responses randomly from each cluster.

3.6 Data Collection

3.6.1 Sources of Data

The study used both secondary and primary data sources. The secondary portions of data were obtained from tax/VAT press articles, KRA other publications and corporate VAT reports. On the other hand, primary data was sieved from respondents representing small taxpayers in Kisumu County.

3.6.2 Data Collection Procedure

The study adopted a variety of data collection instruments in order to get the diverse viewpoints concerning the themes of study. The data collection instruments from the primary sources invoved questionnaires for the selected firms and interview schedule for KRA officers. From the secondary sources, a comprehensive desk review of documents related to VAT reforms and revenue mobilization was accomplished. According to Babbie (2007) questionnaires can obtain information about thoughts, feelings, attitudes, beliefs, values, perceptions, personality, and behavioral intentions of the research participants in a large population. Since this study was a survey, the questionnaire was appropriate because it explored the perceptions, attitudes, feelings and behaviour of the firms to VAT reforms and subsequent impact on revenue mobilization. Moreover, face-to-face interviews using a schedule were used to collect data from the key informants. Cozby (2005) defines an interview as an inter-subjective enterprise of two persons talking about some common themes. The interviewer and respondent often establish a rapport that helps motivate the person to answer all the questions and complete the survey. The KRA officers in charge of compliance, audit and policy were key informants.

Prior to actual instrument administration, the researcher sought permission to carry out research from Maseno University by letter of introduction. After successful application, the researcher conducted a familiarization visit to introduce himself and establish rapport with the taxpayers. During these visits, the researcher booked appointments for administration of questionnaires and fixed dates to meet the identified KRA officers. In each study entity, respondents were given at least one hour or time agreed with management to answer the questionnaires after which they were collected. The interview was done using the interview schedule for the KRA officers at their offices in Kisumu.

3.6.3 Instrument Reliability

Reliability is the consistency of measurement, or the degree to which an instrument measures the same way each time it is used under the same condition with the same subjects (Cohen *et al*, 1990). Kothari and Pal (1993) and Gay (1987) concur with Amin (2005) that reliability is the extent to which the study instruments produce consistent results under similar circumstances. According to Grey (2004), unambiguous and clear questions are likely to be more reliable, and the same goes for items on a rating scale for observers. Another way was by measuring a construct with more than one item. When more than one item is used, individual errors that respondents can make when answering a single item (misreading a question, for example) cancel each other out. That is, more items mean higher reliability. Also, the survey instruments were kept shorter so that respondents did not drop out and to avoid careless hurry in completion.

To achieve this, the questionnaire was pretested on 10 respondents randomly drawn from Kisumu Central Business District. The reliability was estimated using Cronbach's alpha coefficient (Fraekel & Wallen, 2000) and a result of 0.73 was attained. According to Mugenda and Mugenda (2003), the high coefficient implies consistency.

3.6.4 Instrument Validity

Orodho (2005) defines validity as the accuracy and meaningfulness of inference which are based on the research results. According to Streiner and Norman (2006), validity is a judgment regarding the degree to which the components of the research reflect the theory, concept, or variable under study. The researcher sought to attain content validity through expert identification of objectively verifiable indicators which was attained by extensive search of the literature on the concept to be measured. In addition, the same validity was ascertained by minimizing the sources of measurement error like data collector bias through extensive training of research assistants. The study's criterion validity was accomplished through a good knowledge of theory relating to the concept so that the researcher decided what variables were expected to be predicted by and related to it and a measure of the relationship between the measure and those factors.

3.7 Data Analysis

The study's quantitative and qualitative data were analyzed differently. First, the refined and organized quantitative data were analyzed using descriptive statistics involving valid percentages and mean scores to determine varying degrees of response-concentration. Also, standards deviations to measure response-disparity particularly for the pre-coded Likert-scale question items were generated. Other than the use of descriptive analysis, regression analysis was used to analyze interrelationships among the study's key variables and to explain them in terms of their common underlying dimensions.

CHAPTER FOUR

DATA ANALYSIS AND PRESENTATION

4.1 Introduction

The chapter presents the various findings of study based on data input that was realized by way of administering the recommended study tools. These findings are specifically pegged on the study's conceptual areas which included VAT base broadening, corporate compliance on VAT reforms, VAT administration, and VAT reform challenges. At the end, a model is fitted depicting the relationship between these variables and revenue mobilization.

4.2 Demographic Data Analysis

Prior to detailed analysis of the study's thematic indicators, two demographic sets of data were assessed. These included preliminary knowledge on the small taxpayers' mainstream activities and the respective lengths of operational durations. Disseminations from these study indicators were meant to determine the tax orientation and operations of the target entities as a guiding pointer to inclusion.

4.2.1 Small Taxpayers' Mainstream Activities

The majority of small corporate taxpayers belonged to three main operational clusters which included general retailing, service, and manufacturing. Table 4.1 presents the proportions in the highlighted operational clusters.

Fig.4.1: Categories of Small Taxpayers' Business Activities

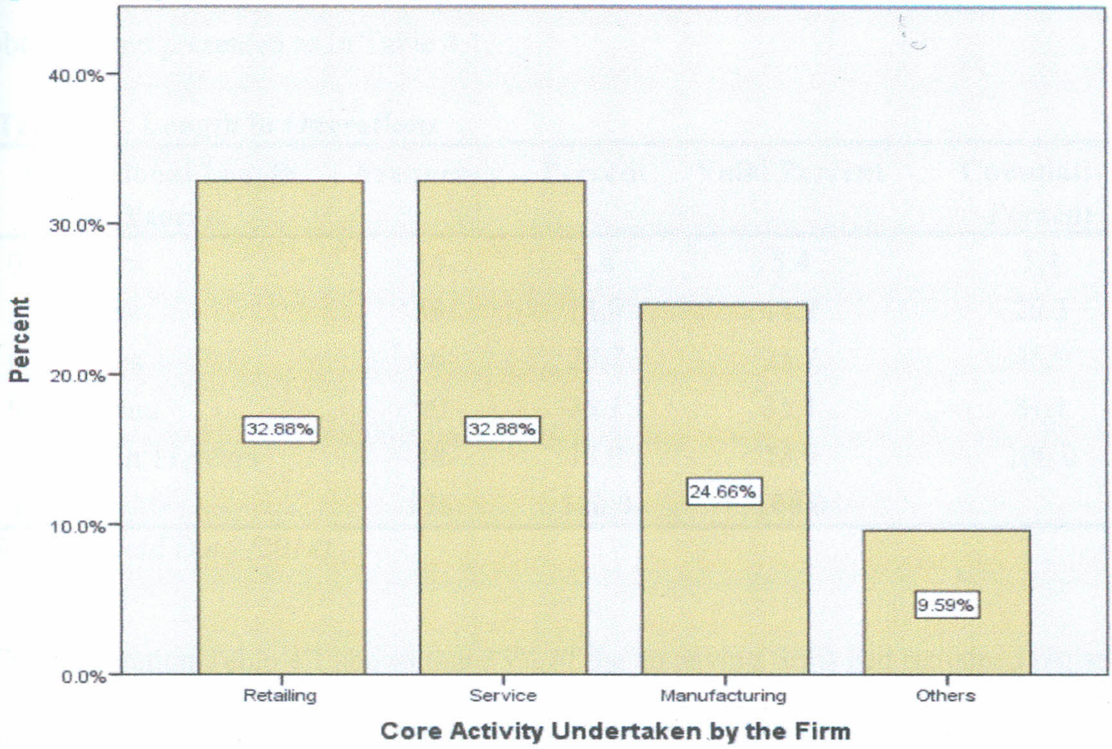


Fig. 4.1 illustrates that majority of the included taxpayers were drawn from general retailing and service industry at 32.9% apiece. In addition to these, 24.7% of the remaining firms had taxable operations in the manufacturing sector, leaving a paltry 9.5% in other non-classified categories. The resulting fact that data inputs were extracted from different small taxpayers in different industries implied a wider participation scope, hence a higher propensity to response validity and reliability.

4.2.2 Length of Business Operation

The successful study institutions had operated their business operations for variant time periods ranging from one to 23 years. The frequencies for the various time intervals were obtained and presented as in Table 4.1.

Table 4.1: Length in Operations

Operational Length (Years)	Frequency	Percent	Valid Percent	Cumulative Percent
0 - 2 years	14	5.4	5.4	5.4
3 - 5 years	38	14.9	14.9	20.3
6 - 8 years	66	25.7	25.7	45.9
9 - 11 years	90	35.1	35.1	81.1
More than 11 years	48	18.9	18.9	100.0
Total	**256**	**100.0**	**100.0**	

Source: Field Data (2014)

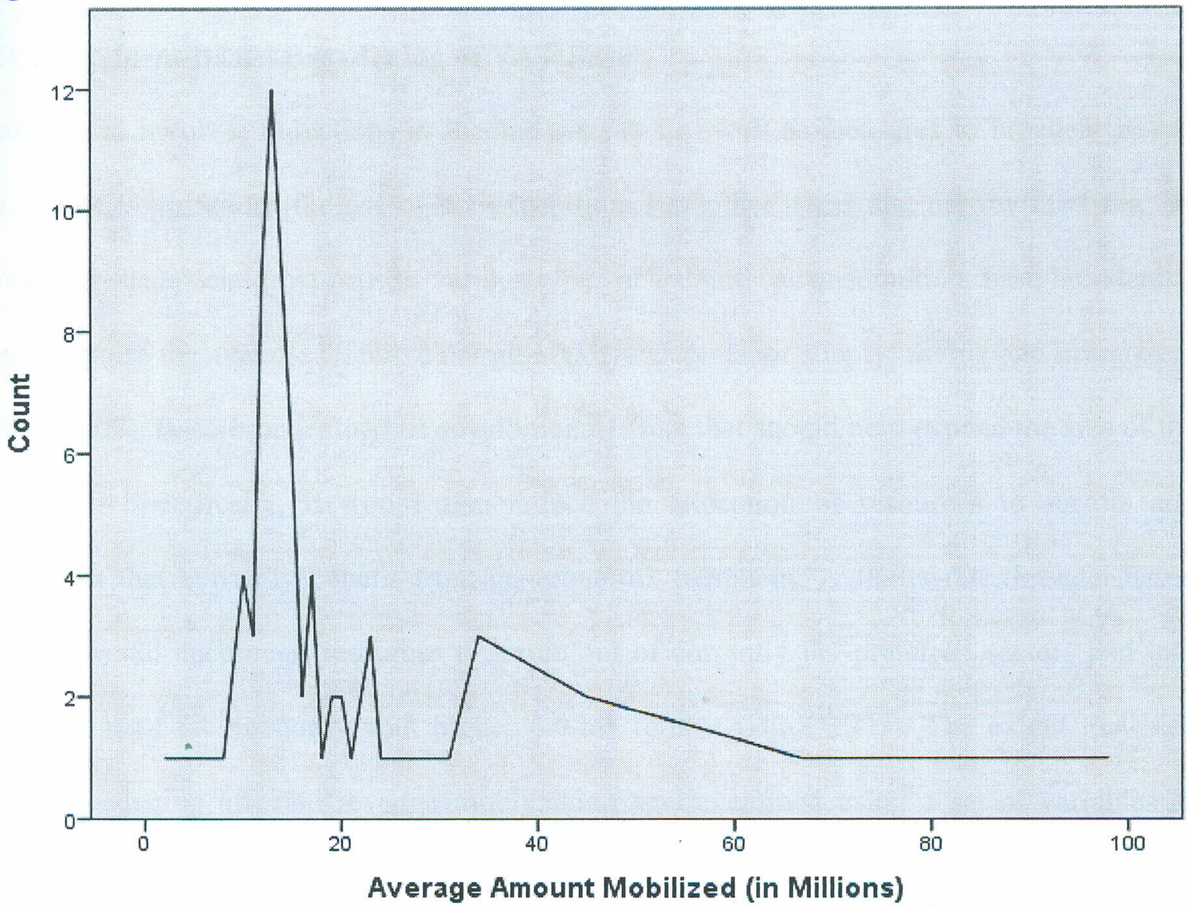
The distribution Table 4.1 shows that 35% of the taxpaying firms had remained registered for a period between 9 – 11 years. Below this sub-category, there were 25.7% of the entities with 6 – 8 years of operation, while the highest category of more than 11 years had 19% of the studied firms. At the lower extreme, there were 20.3% and 5.4% of the firms with 3 – 5 years and less than 3 years respectively. The average operational stay was found to be 9.6 years, which was considerably sufficient for realization of dependable study data inputs.

This important finding reinforces the fact that the operation of the VAT system largely falls in the hands of experienced firms who should provide the key component to the success of the targeted reforms

4.3 Average VAT Revenue Mobilization

In Kenya, a small taxpayer was defined as a firm with annual turnover ranging from Ksh 500,000 to Ksh. 500 million. Based on this criterion, different entities reported dissimilar revenue mobilization potential that ranged from Ksh.1 million to Ksh.98 million. Further details on VAT revenue from the defined sources were as presented in Fig. 4.2.

Fig. 4.2: VAT Revenue Mobilization



Source: Field Data (2014)

Fig. 4.2 illustrates that majority of the small taxpayers in Kisumu County had a VAT revenue mobilization of between Ksh.10 million and Ksh.20 million, while the least contributor surrendered an amount equivalent to Ksh.1 million per annum. These amounts were cumulatively significant to the Kenyan Government and their guaranteed remittances would greatly bolster the economy's Exchequer.

The erratic result in the mobilization is a clear pointer that the collective effort by the registered persons is not targeted to a singular goal. Homogeneity in revenue mobilization will make revenue targets not only easy to forecast, but also achievable during the plan periods.

4.4 Reform-Based Broadening of VAT Base

Tax reform involves reductions in income tax rates as well as measures to broaden the tax base; that is, to reduce the use of tax expenditures or other items that narrow the base. By removing the special treatment or various types of income or consumption, base broadening tends to raise the average effective marginal tax rates on labor supply, saving and investment (Bird, 2007). Base-broadening has an additional effect that should help expand the size of the economy. Specifically, it would also reduce the allocation of resources to sectors and industries that currently benefit from generous tax treatment. A flatter-rate, broader-based system would encourage resources to move out of currently tax-preferred sectors and into other areas of the economy with higher pre-tax returns (Bird, 2007). The extent to which VAT broadening affected revenue mobilization was examined using a set of variables as presented in Table 4.2.

Table 4.2: Reform-Based Broadening of VAT

VAT Broadening Indicators	Mean	Std. Deviation
There is a wider VAT revenue scope as most previously non vatable items are included	3.64	.869
Widening of VAT has resulted unto increase revenue	3.58	.860
Demand for previously non vatable items has drastically gone down	2.81	.715
No significant change in amounts mobilized and remitted to KRA	2.58	.759
Widening base has still not addressed historical anomalies in VAT administration	4.03	.702
Heightened demand for the non vatable items as opposed to vatable substitutes	3.01	.712

Source: Field Data (2014)

The study found that at the higher extent of respondent-agreement, widening of the VAT base had not still fully addressed anomalies in its administration (4.03 mean score and 0.702 standard deviations). Admittedly, however, there was a wider VAT scope as previously non vatable items were included (3.64 mean score). Notably, the study found a marginally above moderate level of agreement that the widening of VAT base resulted into increased revenue for the Exchequer (3.58 mean score). On a positive note, there was a disagreement that introduction of VAT on previously non vatable items reduced their demand (2.81 mean score). This effectively, meant low aggregate score for the statement that "no significant change in amounts mobilized and remitted to KRA" (2.58 mean score). In addition, there was a disagreement that widening of VAT resulted into increase revenue (2.58 mean score). Generally, therefore, other than structural adjustments and reforms of the VAT environment, anticipated benefits were yet to be fully realized; there was an evident taxpayer-authority gap that needed redress for the systems to work as anticipated. These findings are in agreement with the findings of Kusi (1998) who studied tax reform and revenue productivity of Ghana for the period 1970 to 1993. Results showed a pre-reform buoyancy of 0.72 and elasticity of 0.71 for the period 1970 to 1982. The period after reform, 1983 to 1993, showed increased buoyancy of 1.29 and elasticity of 1.22. The study concluded that the reforms had contributed significantly to tax revenue productivity from 1983 to 1993 but the findings of this study on the other hand contradicts the findings of the study by Chipeta (2008) who evaluated effects of tax reforms on tax yields in Malawi for the period 1970 to 1994. The results indicated buoyancy of 0.95 and an elasticity of 0.6. The study concluded that the tax bases had grown less rapidly than GDP.

4.5 Corporate Compliance to VAT Reforms

According to Slemrod (2003), efficiency of a tax system hinges on the compliance behavior of taxpayers, which is the extent to which taxpayers volunteer to comply. Referring to the free-rider problem, Slemrod (2003) concludes that the level of voluntary compliance can be enhanced through the government's improved performance as well as by winning the trust of its people. On the same note, Feld and Frey (2002) acknowledges the relationship between the taxpayers and tax collectors and refers to it as a 'psychological contract' which should be obeyed not for the fear of sanction but for the mutual trust between the actors.

In this study, the extent of psychological contract between the small corporate taxpayers and the tax authority, KRA, was studies using the various indicators as presented in Table 4.3.

Table 4.3: Small Taxpayers' Compliance to VAT Reforms

Compliance Indicators	Mean	Std. Deviation
Various provisions of VAT legislations are too complex to comprehensive and comply	3.57	.893
Regular invites from KRA or other public agencies for sensitization on compliance	2.41	.810
Return filling system adopted by the tax authorities are highly efficient	2.77	.837
There are visible loopholes which make it easy to under-report VAT revenues	3.42	.794
Timely VAT remittances to avoid penalties	4.07	.669
Self initiative to understand VAT legislations to determine self responsibilities	3.31	1.271

Source: Field Data (2014)

Compliance to VAT reforms and conditionalities thereof were greatly influenced by the small corporate taxpayers' intent to avoid inherent penalties arising from failure to remit tax amounts collected. This was pegged on the highest cluster agreement index of 4.07 mean score which was further associated with the minimal disparity measure of 0.669σ. At the opposite extreme, KRA and affiliate tax/public authorities were rated poorly at 2.41 mean score (0.81 σ) in terms of involving the taxpayers in essential tax-related sensitization campaigns. Moreover, the study found that the KRA-endorsed return-filling systems were hardly efficient (2.77 mean score). At the moderate level, compliance was undermined by complexity of understanding and applying provisions in VAT legislations (3.57 mean score), possible loopholes which made it possible to under-report VAT revenues (3.42 mean score), and a rather remote self-initiative to understanding VAT regimes and determination of individual responsibilities (3.31 mean score).

The fact that VAT legislations were not well understood by the taxpayers and that the tax authorities had minimal initiatives to sensitize the population went against the ideals proposed by Adams (2001). The author suggests that tax compliance requires the force of law, and that the duty of every citizen to pay his/her fair share of costs of government that serves and protects them will not be done if laws do not obligate them to do so. Also, Slemrod (2003) argues that taxpayers' compliance is influenced by the government performance; this should motivate the government to invest in its reputation for public goods production.

The key component in this finding is compliance based penalties. The sustainability of this form of compliance is shaky especially when the taxpayers become immune or find a new way of circumventing the penalties. The ideal situation will be where compliance is voluntary and driven by mutual working relationship between the taxpayers and the authorities.

4.6 VAT Reforms Administration

Operating an efficient, professional tax administration is not a simple task in any economy, whether developed or developing. However, as Bird (2003) indicates, it is particularly difficult in developing countries with large informal sectors, low levels of literacy and public morality, poor salary structure for public servants, poor communications, malfunctioning judicial systems, and entrenched interests against radical reform. Despite such handicaps, substantial improvement can be achieved with determined effort and an appropriately designed strategy. What a tax administration can do, however, and how it can best be reformed depends largely upon the environment in which it operates. In the study, administration environment was studied using indicators such as VAT policy formulation, relationship between tax authorities and taxpayers, information flow from KRA, refund processing, unconditional disclosures, and security of VAT systems. On a five-point scale, the feedbacks were analyzed and summarized as presented in Table 4.4.

Table 4.4: VAT Administration Environment

VAT Reform-Administration Indicators	Mean	Std. Deviation
Individual opinion always sought when formulating VAT policies	2.04	.730
KRA considering small taxpayers as core partners in VAT success	2.45	.862
Efficient information flow from VAT authorities enabling administration	2.42	.641
Remittance a reciprocation since KRA processes refunds in time	1.69	.681
Unconditional disclosures due to understanding that remittance is an obligation	3.19	1.056
VAT collection systems and records are tamperproof	2.64	.804

Source: Field Data (2014)

Data summaries from Table 4.4 portrayed a pessimistic VAT administration environment for the small corporate taxpayers in Kisumu County. Other than the unconditional disclosures due to understanding of individual taxpayer obligation (3.19 mean score and 1.056 standard deviations), all the other indicators performed dismally. There were near-uniform disagreements that the tax authorities always sought taxpayer opinion prior to policy formulation (2.04 mean score); considered small taxpayers as core partners in VAT administration success (2.45 mean score); efficiently facilitated flow of information to individual taxpayers (2.42 mean score); processed taxpayer refunds in time (1.69 mean score); and implemented systems that were tamperproof (2.64 mean score).

These findings concurred with those by Alink and Kommer (2011) who identified a number of factors which limited the ability of the developing countries to increase their tax revenue. The factors include weak institutions including tax administration, corruption and a lack of transparency, a tax system characterized by numerous tax exemptions and still heavily reliant on cross border tariff, existence of large informal sectors, outflow of funds to tax havens, and information gray-areas among the authorities and taxpayers. Also, Moore and Schneider (2004) have reinforced the idea of taxpayer participation in policy formulation by regarding taxation as a part of a social contract between state and society as well as a mechanism of financing government.

4.7 VAT Legislation Environment

Well designed tax policies have the potential to raise economic growth, but there are many stumbling blocks along the way and certainly no guarantee that all tax changes will improve economic performance (Bird, 2003). In Kisumu County, the study sought to find out the small taxpayers' opinions on the effects VAT reform challenges had on revenue mobilizations. Based on a variety of indicators, the feedbacks were analyzed as presented in Table 4.5.

Table 4.5: VAT Reforms Environment

VAT Legislation Environment Indicators	Mean	Std. Deviation
Taxpayer always follows keenly changes in tax/VAT laws since they directly affect their businesses	3.57	.861
KRA sensitizes the public on critical tax/VAT legislations	3.18	.817
Prior to enactment of legislations stakeholders are always involved in opinion building	2.26	.663
Complexities contained in VAT laws are mitigated by close work relationship with tax authorities	2.69	.859
Stiffer penalties against non-compliance are a sheer solution to maximization of VAT revenue	2.32	.724
There is weakened compliance to VAT laws due to unaddressed systems and administrative frailties	4.15	.634

Source: Field Data (2014)

The dominant and obvious impediment in revenue mobilization through VAT reforms was found to be weakened compliance as a result of unaddressed systematic and administrative frailties (4.15 mean score and 0.634 standard deviations). Other than this, respondents disagreed that prior to legislative enactment stakeholders were involved in opinion formation (2.26 mean score). Similarly, there were disagreements that complexities contained in VAT laws were mitigated by close work relationships with tax authorities (2.69 mean score) and that stiffer penalties against non-compliance were a solution to maximization of tax revenue (2.32 mean score). At an average extent, taxpayers engaged self-initiative to seek changes in VAT laws for purposes of compliance (3.57 mean score). Moreover, they were moderately sensitized by KRA (3.18 mean score) on basic laws governing VAT existence and administration. A study by Le (2007) confirms these findings by indicating that in developing countries public participatory process does not elevate citizens to the level of partnership, nor does it culminate in citizen control. This is mainly due to the perception that proposals from the stakeholders are rarely considered in making the tax policy decisions (Le, 2007).

Legislative pieces are often complicated and open to varied interpretations. The coarse relationship between the taxpayers and authorities robs the tax reforms the much needed platform for constant review and consultations.

4.8 Effect of VAT Reforms on Revenue Mobilization

Cumulatively, the extent to which VAT reforms impacted on revenue mobilization was modeled by way of regression analysis with defined significance levels. The results of regression were as presented in Table 4. 6.

Table 4.6: Effect of VAT Reforms on Revenue Mobilization

Model (Average Amount Mobilized set as the Dependent Variable)	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	1.503	.348		4.325	.000
VAT Base Broadening (X_1)	.031	.058	.065	2.041	.046
Corporate Compliance (X_2)	.052	.055	.108	2.043	.043
VAT Administration (X_3)	.113	.052	.252	2.182	.032
VAT Legislation Reforms (X_4)	-.006	.057	.120	1.971	.134

Source: Field Data (2014)

From the table, the following model is deduced:

$$Y = 1.503 + 0.031\mathbf{X_1} + 0.052\mathbf{X_2} + 0.113\mathbf{X_3} - 0.006\mathbf{X_4}$$

The model shows that, tax base broadening (0.031), corporate compliance t tax reforms (0.052), VAT administration (0.113) and VAT legislation challenges (0.006) all significantly affected VAT revenue mobilization in Kisumu County's small taxpayers. While all other effects were positive or in direct relationship, the net effect from VAT reform/legislation challenges was of the inverse relationship. The two relationships implied that tax authorities needed to be apt in bolstering revenue mobilization through rational base broadening, ensuring perfect compliance, eliminating administrative frailties, and mitigating inherent challenges fused with relevant VAT legislations and reforms. These results mean that means that the three contribute to unit change in revenue mobilization by 3.1%,5.2% and 11.3% respectively. The conclusion is that VAT administration has highest effect on revenue mobilization, followed by corporate compliance and lastly VAT bas broadening.These findings are in agreement with the findings of the study done by Milton Ayoki, Marios Owona and Moses Ogwapus (2005) who researched on tax reforms and domestic revenue mobilization in Uganda by using the proportional adjustment method. Their findings revealed that the reforms had a positive impact on direct taxes as tax-to-income elasticity index grew from 0.706 to 2.082 after the reforms while direct taxes also moved from 1.037 to 1.306. They then concluded that the reform was necessary to the economy but there was room for improvement. These findings also concurred with the findings of a study by Slobodnitsky and Drucker (2008) who conducted a study on the VAT rates and their impact on the Israeli economy. Their findings revealed that VAT revenues are highly correlated with the development of tax base and have high elasticity concerning VAT rate. They also found that the VAT revenues are "well behaved", especially in comparison with the corporate tax proceeds. For example, they estimated VAT revenues/VAT rate cross elasticity to be high. In periods of VAT rate increase the response is estimated by 91% from the potential, while the response in periods of decreasing VAT rates is 49%. Thus, an increase in the VAT rate is likely to generate an increase in the VAT revenue than the rate at which revenue will reduce due to decrease in the VAT rate

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the study's summary of findings, conclusions, policy recommendations and suggestions for further studies. These are based on the study's generated findings and interpretations thereof.

5.2 Summary of Findings

The study was set to investigate the effect of VAT reforms on revenue mobilization among small taxpayers in Kisumu County. The objectives of the study were to establish the extent of VAT base broadening, corporate compliance, administration, and legislation affected revenue mobilization. The study found that at the higher extent, widening of the VAT base had not still fully addressed anomalies in its administration (4.03 mean score). However, there was a wider VAT scope as previously non vatable items were included (3.64 mean score). The study found a marginally above moderate level of agreement that the widening of VAT base resulted unto increased revenue for the Exchequer (3.58 mean score). Further, there was a disagreement that introduction of VAT on previously non vatable items reduced their demand (2.81 mean score). This effectively, meant low aggregate score for the statement that "no significant change in amounts mobilized and remitted to KRA" (2.58 mean score). In addition, there was a disagreement that widening of VAT resulted unto increase revenue (2.58 mean score). In conclusion, other than structural adjustments and reforms of the VAT environment, anticipated benefits from VAT reforms were yet to be fully realized due to an evident taxpayer-authority gap that needed redress.

Compliance to VAT reforms was greatly influenced by the small corporate taxpayers' intent to avoid inherent penalties arising from failure to remit tax amounts collected. This was pegged on the highest cluster agreement index of 4.07 mean score. At the opposite extreme, KRA and affiliate tax/public authorities were rated poorly at 2.41 mean score in terms of involving the taxpayers in essential tax-related sensitization campaigns. Moreover, the study found that the KRA-endorsed return-filling systems were hardly efficient (2.77 mean score). At the moderate level, compliance was undermined by complexity of understanding and applying provisions in VAT legislations (3.57 mean score), possible loopholes which made it possible to under-report VAT revenues (3.42 mean score), and a rather remote self-initiative to understanding VAT regimes and determination of individual responsibilities (3.31 mean score).

Other than the unconditional disclosures due to understanding of individual taxpayer obligation (3.19 mean score), all the other indicators performed dismally. There were near-uniform disagreements that the tax authorities always sought taxpayer opinion prior to policy formulation (2.04 mean score); considered small taxpayers as core partners in VAT administration success (2.45 mean score); efficiently facilitated flow of information to individual taxpayers (2.42 mean score); processed taxpayer refunds in time (1.69 mean score); and implemented systems that were tamperproof (2.64 mean score).

The dominant and obvious impediment in revenue mobilization through VAT reforms was found to be weakened compliance as a result of unaddressed systematic and administrative frailties (4.15 mean score and 0.634 standard deviations). Other than this, respondents disagreed that prior to legislative enactment stakeholders were involved in opinion formation (2.26 mean score). Similarly, there were disagreements that complexities contained in VAT laws were mitigated by close work relationships with tax authorities (2.69 mean score) and that stiffer penalties against non-compliance were a solution to maximization of tax revenue (2.32 mean score). At an average extent, taxpayers engaged self-initiative to seek changes in VAT laws for purposes of compliance (3.57 mean score). Moreover, they were moderately sensitized by KRA (3.18 mean score) on basic laws governing VAT existence and administration.

VAT administration and legislation environment ought to be opened to greater healthy interaction between the taxpayers and the tax authorities. The engagement of the taxpayers should stretch back to formative stages of every reform initiative and closer working relationship must be pursued by all concerned parties.

5.3 Study Conclusions

Based on the findings, the study concludes that VAT reforms through base broadening, corporate compliance, VAT administration and acceptance and mitigation of inherent challenges have a cumulative effect on VAT revenue mobilization among small taxpayers in Kisumu County. First, the effect from VAT base broadening originated from gradually widening VAT scope through admission of previously non vatable items, shifts in demand from previously non vatable items, change in amounts mobilized and remitted to KRA, and historical anomalies in VAT administration. Second, corporate compliance comprised of extent of understanding the various provisions of VAT legislations, regular invites from KRA or other public agencies for sensitization on compliance, return filling system adopted by the tax authorities, possibility of loopholes which make it easy to under-report VAT revenues, fear of penalties and self initiative to understand VAT legislations to determine self responsibilities.

Third, VAT compliance was invoked through extent to which KRA sought individual opinion when formulating VAT policies, KRA considering small taxpayers as core partners in VAT success, efficiency in information flow from VAT authorities enabling administration, VAT collection systems and records being tamperproof, unconditional disclosures due to understanding that remittance is an obligation, and remittance understood as a reciprocation to KRA's processing of refunds in time. Fourth and last, VAT reform challenges were found to constitute lack of keenness on changes in tax/VAT laws, KRA hardly sensitizing the public on critical tax/VAT legislations, stiffer penalties against non-compliance not proving a solution to maximization of VAT revenue, weakened compliance to VAT laws due to unaddressed systems and administrative frailties, complexities contained in VAT laws, and non-involvement of taxpayers when enacting legislations that affect their business operations.

5.4 Policy Recommendations

Kenya being a developing country needs efficient in promoting a better tax system to mobilize more revenue. Based on the study conclusions, policy recommendations are made to meet the growing economy's obligations. First, the tax authority, which is itself a reform product, needs to phase out reform components which have failed to yield anticipated results which strategically introducing gradual enactments that not only broadens the VAT base but also induces acceptability among the taxpayers. Second, to induce corporate compliance there is urgency in educating taxpayers to reduce firms' misconceptions and confusion about tax policies and procedures and experience. This would suggest that most firms will comply in paying taxes if they understand their obligations and if they see the tax administration is fair in handling non-compliance. Outreach activities including, TV and radio coverage, advertising and tax themed school programs are also helpful in understanding the civic responsibility of paying taxes. Third, the Government and responsible authorities must seek to improve the efficiency, quality and transparency of delivery of public services through fundamental reforms of the public financial management system. This will be essential in altering VAT administration process for better returns. Finally, the KRA needs to establish a closer partnership with the stakeholders and taxpayers for the sake of quicker identification of impediments and problem solving to avoid incidences of target failures.

5.5 Suggestions for Further Studies

The study results to various essential concerns that needs further scholarly interests. First, it is suggested that further research intent is directed towards establishing reasons for strategic failure in tax-base broadening yet it is recognized as widely applied tool in bolstering public revenue. Secondly, a study is recommended on determinates of corporate tax compliance to guide in the authority's strategic approach. Finally, a study on environmental dynamics and VAT revenue mobilization is recommended to aid in strengthening the authority's surveillance and monitoring roles.

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