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Innovative Tax Coping Mechanisms in Nairobi County: A Literature Review

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Abstract

Taxation has been identified as a major threat to the growth of small and medium enterprises (SMEs) not only in highly industrialized countries such USA but also in less industrialized countries, Kenya included. Taxation in general increases the costs of operation of running small and medium enterprises. To compensate for the increased costs of operation, prices on goods are raised thus causing the amounts of sales to go down. The question that appears to generate surprisingly little debate in Kenya is the scope for legally mitigating taxes by individuals and SMEs. Entrepreneurship is about change and since entrepreneurs are innovators, they should devise ways and means of coping with the adverse and threatening effects of taxation in order to survive, grow and sustain their businesses. How then can Kenyan individuals and business enterprises arrange their affairs within the current legal environment so as to minimize their tax burden? The general objective of this paper is to examine the innovative tax coping mechanisms by SMEs in Nairobi County. This paper is significant as it highlights important ways in which entrepreneurs in Nairobi can cope with taxation within the legal framework to enhance their business performance. Moreover, the paper analyses significant literature that could be used as a point of reference by other scholars conducting research in the same field.

Keywords: SME, tax avoidance, coping mechanism, tax planning, Nairobi.

INTRODUCTION

Since the 1960s to date, small and medium sized enterprises (SMEs) have been given due recognitions especially in the developed nations for playing very important roles towards fostering accelerated economic growth, development and stability within several economies. They make-up the largest proportion of businesses all over the world and play tremendous roles in employment generation, provision of goods and services, creating a better standard of living, as well as immensely contributing to the gross domestic products (GDPs) of many countries (OECD, 2000). Over the last few decades, the contributions of the SMEs sector, the development of the largest economies in the world have shown the spotlight on the uniqueness of the SMEs, succeeding in overruling previously held views that SMEs were only “miniature versions” of larger companies.

Although SMEs have been at the centre of the policy debate for quite some time in both developed and developing countries, little analytical work has been undertaken in this area. The dearth information that exists among researchers on SMEs, however, provides a sense of how important this sector is for sustainable development in emerging economies. For instance, recent studies conducted by United Nations Industrial Development Organization (UNIDO) concur that SMEs are: labour-intensive; providing more opportunities for low-skilled workers; correlated with lower income distribution inequality; necessary for agriculture-dependent nations transitioning to an industrial- and service-oriented economy; excellent sites for innovation and sustainable initiatives due to their inherent flexibility and risk-taking ability (Patricoff & Sunderland, 2005).

In both the UK and Nigeria, the SMEs sector constitutes the largest proportion of the entire businesses. In the UK, for instance, SMEs represent over 95 percent of all businesses and contribute over 65 percent of the labour force as well as over 30 percent of the GDP. Likewise, In, Nigeria, data from the Federal Office of Statistics reveal that about 97 percent of the entire enterprises in the country are SMEs and they employ an average of 50 percent of the working population as well as contributing up to 50 percent to the countries industrial output.

Globally, the growth of any economy is dependent on vibrant SMEs and when the reverse seems the case, the entire economy suffers. The stunted growth of the economy has often been blamed on many factors, top of which is the challenge of uncoordinated tax administration that has crippled production capacity of the SMEs. One of the major impediments to the growth of SMEs is the issue of taxation. The yoke of taxes on SMEs ranked second among the factors stunting the growth of the economy in USA (Thuronyi, 2009). Taxes are heavy yokes that frustrate existing investors and scare away prospective ones (ibid.).

According to Shome (2004), the Jamaican business environment is being suffocated by too many taxes from the national, federal and local governments. Indeed, an indigenous restaurant operator, barber or a hairdresser who has to pay taxes to the various tiers of government in addition to the cost of powering his business via generators, and paying staff salaries will find it an herculean task making profit to keep his business afloat because of high overhead incurred. In Africa, the same attention about the growth and ensuing challenges of SMEs has continued to top discussions among researchers.

Estimates from the Manufacturers Association of Nigeria (MAN) show that, annually, about 1,000 SMEs in Nigeria that set out to do business in the country end up shutting down due to the unfriendly business environment. Taxes confront the manufacturing sector in different shapes and shades: import duties, export & excise duties, sales and VAT, withholdings and income taxes, mobile advertising & billboard levies, education, levies, social responsibility charges.

Taxation practice in Ivory Coast became more pronounced and prevalent in the late 1980s. This concern was first raised by Foluso (2007) who noted that about 154 taxes had identified in the country and expressed doubt whether these taxes could attract serious investors into the county. According to him, taxation undermines the quest for economic transformation and it is pushing organizations to retrench staff because of the high cost of doing business.

In Gambia, companies pay taxes on more than 100 items imposed by both the state and its various Local Governments. According to Cordes, Hertzfeld and Vonortas (1999), the effects of successful taxation include: being economically counter-productive, destroys investor confidence, raises cost of doing business and is one of the major threats to the growth of manufacturing sector in Gambia.

As pointed out earlier in this study, SMEs are important to almost all economies in the world, especially to those in developing countries like Kenya. In this paper, SMEs were divided under four major categories: services (airline, hotels, education, health, commercial, general services and clearing and forwarding); wholesalers and retailers; manufacturing and agriculture and financial services (construction, financial services Government, NGOs and real estate).

The growth, size and distribution of firms within a country, from the very labour intensive to the very capital intensive, is of course influenced by taxation behaviour. Achievement of this growth is more difficult if SME activity in general is discouraged by harsh policy of taxation (Cohen, Nelson & Walsh, 2000). Using data collected from the personal tax returns of sole proprietors in the US for 2003 and 2006, Carroll (2007) found evidence that marginal tax rates exert statistically and quantitatively significant influence on the growth of SMEs.

In Kenya, while comparison tax costs are difficult to measure, the few studies carried out on taxation have concluded that while total business tax costs tend to be higher for large companies, as a percentage of sales ,they are significantly also higher for SMEs.

Table 1: Government Tax Estimates For the Years 2007to 2010

Taxes	**Periods for Taxation (Values in Ksh Billions)**				**Totals**
	2007	**2008**	**2009**	**2010**	
Income Tax	124.9	165.4	192.8	220.3	703.4
Import Duty	27.5	32.9	36.54	40.6	137.54
Excise Duty	56.4	61.9	68.9	78.1	265.3
VAT	96.3	111.9	128.6	148.4	485.2
Total	**305.1**	**372.1**	**426.84**	**487.4**	**1591.44**

Source: KRA, 2010

It is evident from the table that all the categories of taxes have been increasing during the period under study. These increases in taxation have been a great burden to SMEs.

By reducing tax costs and thereby lowering the overall tax burden on SMEs, simplification provisions help achieve more neutral tax treatment of firms of varying sizes, implying efficiency gains, and encourage compliance with (adherence to) the tax laws of a country. Heavy taxation is also a subject of worry not only in developed countries like the USA but also in Kenya and other less industrialized countries in Africa and Latin America. For instance, taxes in Kenya confront the large manufacturing sector in different shapes and shades: import duties, export & excise duties, sales and VAT, withholdings and income taxes, and PAYE etc. (KRA, 2010).

The high levels of taxation of SMEs in Africa and in Kenya in particular, warrants attention on accelerated research areas aimed at addressing the overall effects of taxation on SMEs. By studying taxation behaviour in five different countries (USA, Gambia, Nigeria, South Africa and Kenya), Derwent (2000) concluded that increased tax burden is a major threat on the overall growth of SMEs. A major area of concern therefore is how to reduce the effects of high tax burden on SMEs. One contribution and response to this phenomenon, has been the role of entrepreneur’s innovative characteristics (Stoner, 2002). In his contribution, Stoner identified several characteristics of an entrepreneur: conceptual fluency, uniqueness, authoritative and flexibility and creative.

According to Robbins (2006), one of the importance of creativity is that it enables entrepreneurs to appraise and understands problems more fully and to see things differently and also enable them to have a change of approach to problem solving. Can the idea of creativity and innovation be applied by SMEs to help reduce and cope with the heavy tax burden in Nairobi County? It is against this scenario that this paper was formulated. The study attempted to identify all the taxes subjected to SMEs and their effects on the various levels of operations on the business enterprises.

In addition, this paper established the innovative coping mechanisms utilized by the SMEs to respond to the current effects of taxation, the specific concern being to examine the possible effects of taxation on such various levels of operations and the consequent innovative and creative mechanisms that can be employed by SMEs to respond to the tax effects.

The Concept of Small and Medium Enterprises

Small scale enterprises have many definitions due to different criteria employed by different people and institutions in defining it. There is no single, uniformly accepted definition of a small firm (Storey, 1994). Firms differ in their levels of capitalization, sales and employment. Hence, definitions which employ measures of size (number of employees, turnover, profitability, net worth, etc) when applied to one sector could lead to all-firm being classified as small, while the same size definition when applied to a different sector could lead to a different result. Scholars, researchers and international bodies have always attempted to provide a standard definition of SMEs.

No such definitions have been accepted universally. Nigeria defines an SME as one whose total fixed assets (excluding land) plus cost of investment do not exceed ten million naira in a constant (1985's) price (World Bank, 1988). Mead (1998) sees SMEs as firms with less than 50 employees and at least half the output is sold. It can also be defined as a firm that meets the following three criteria: it has a relatively small share of their market place; it is managed by owners in a personalized way, not through the medium of a formalized management structure, and it is independent, in the sense of not forming part of a large enterprise.

There are various criteria of size that might be used to define an SME (turnover, number of employees, capital base, profits, extent of imports and exports) and various definitions have indeed been developed for application in a range of countries. Thus, one can define as one whose total assets in capital equipment, plant and working capital are less than two hundred and fifty thousand naira and employing fewer than fifty full-time workers. The Central Bank of Nigeria (as cited in Onwe, 2006) defined an SME as a firm with capital outlay of not more than N200 million.

A definition of SMEs which has enjoyed wider acceptance is the one given by the United States Committee for Economic Development (2002 as cited in Thuronyi, 2009): "…any enterprise that is characterized by at least two of the following features: management is dependent, managers are usually also the owners; capital is supplied and ownership is held by an individual or small group; area is localized while workers and the owners are of one home or community; market need not be local and the size of the firm is small relative to the industry."

In fact, the concept of small scale enterprises, often called small and medium-size enterprise (SME), is relative and dynamic, hence there is no universal definition for small and medium scale enterprises. Researchers, because of this problem of definition, adopt definitions for small and medium-scale enterprises which are more appropriate to their particular target group. To this end, SMEs, within the context of this work, is any business organization which has working capital between one hundred thousand naira and ten million naira, excluding land, and employs fewer than fifty full-time workers.

Sule (1986) observed that definitions of SMEs vary across countries and business environment as a result of differences in industrial organization at different level of 'economic development in parts of the same country. Characteristics of SMEs identified by Sule (ibid.) include the following distinguishing factors: tax payers tend to be few, owner of the business is also the manager, transactions are based on cash payments and hardly bank payments, the businesses normally have a dynamic lifespan, and the places of business for SMEs are normally fixed but volatile and react to changes/demands. On accounting standards, SMEs tend to have little accounts or records SMEs have a focus on meeting local customers for their market reach and administratively, SMEs engage few or no professional unlike major companies run by professionals (ibid).

Taxation has been identified as a major threat to the growth of small and medium enterprises not only in highly industrialized countries such USA but also less industrialized countries, Kenya in particular (Burke & Jarratt, 2004). For instance, in Kenya, income tax is a direct tax charged on business income, employment income, rent income, pensions and investment income. There are many methods applied in the collection of income tax: PAYE, withholding tax, installment tax, advance tax, presumptive income tax and the direct payments to the Commissioner of Domestic Taxes for balance of tax and arrears.

According to KRA (2009), PAYE is a method for collecting tax at source from individuals in gainful employment. Indirect taxation which is charged includes VAT (Value added tax), corporation tax, and instalment tax and excise duties. The stunted growth of the SMEs has often been blamed largely on the challenge of taxation (ibid).

Taxation generally increases the costs of operation SMEs. To compensate for the increased costs of operation, prices on goods are raised thus causing the amounts of sales to go down, leading to reduced profits, reduced capital base and slow creation of employment resulting to slow growth (Thuronyi, 2009). A question that appears to generate surprisingly little debate in Kenya is the scope for legally mitigating taxes by individuals and SMEs.

Entrepreneurship is about change and since entrepreneurs are innovators, they should devise ways and means of coping with the adverse and threatening effects of taxation in order to survive, grow and sustain their businesses (Cantillon, as cited in Baer, 1993). How then can Kenyan individuals and business enterprises arrange their affairs within the current legal environment so as to minimize their tax burden?

The general objective of this paper was to examine the innovative tax coping mechanisms by SMEs in Nairobi County and, in doing so, this paper also assessed the effect of taxation on the costs of operation of small and medium enterprises and compared the effect of taxation on the growth of varying small and medium enterprises (services, wholesalers and retailers, manufacturers and agriculture and financial services).

As derived from the taxation process models, this paper perceived the growth of SMEs as the dependent variable. Consequently, the growth of SMEs was operationalised as a process determined by the effects of taxation. Taxation determines both the cost of operation and its effects on the nature of varying businesses. However, to respond to such adverse effects of taxation, SMEs have devised innovative data security measures to sustain their businesses.

The literature review revealed three independent variables that determine the growth of SMEs and thus the need to include them in the conceptual framework. The conceptual framework further relates the cost of operation as a crucial determinant to the growth of SMEs. Costs of operations are operationalized by analyzing and computing costs before and after taxation. The marginal increase in cost as a result of taxation may determine the rate of growth of SMEs. Arinaitwe (2006) asserts that tax elements heavily influence costs of operation, which is the cost per year of deploying capital in an investment project. Consequently, the effective return on capital is diminished to the extent of tax due on company income.

Tax avoidance measures are useful in exploring the optimal legal procedures in response to the adverse effects of taxation. Within this framework, factors that determine the monetary cost of compliance, like the tax rate and penalty structure, drive tax compliance behaviour (Allingham & Sandmo, 1972). In addition a rational taxpayer will avoid tax as long as the pay-off from avoiding tax is greater than the expected cost of the process avoiding tax. Such processes include, but are not limited to: taxpayer's incentive to purchase tax advisory services; the effect of practitioners on tax avoidance and the effect of the tax administration.

LIMITATION

The major limitation of this paper is that it is entirely based on secondary sources on the tax coping mechanisms of Small and Medium Enterprises in Nairobi, Kenya. No actual study was conducted to ascertain the approaches used by entrepreneurs in the area. Nevertheless, the paper provides rich literature that could inform an actual study on the issue.

METHODOLOGY

This paper is based majorly on document analysis. Documents are records of past events that are written or printed. They include internal papers, communications to various publics and personal files, program descriptions and institutional statistical data. This paper used documents to collect data because they provided background information on the topic under focus and they allowed for criticism to ascertain the authenticity of the information that was collected and therefore gave a clear picture of taxation. The documents assisted the author to study information from KRA and data from other sources. Using a document checklist, it was possible for the researcher to systematically collect relevant data from documents about the trends of tax returns. The document analysis checklist was used to collect secondary data from such bodies as KRA. These documents were collected and the data recorded from them on the Document Analysis Checklist to assist in review of related literature and to enrich and/or verify the primary data during the compiling of this paper. Using a document checklist, it was possible for the author to systematically collect relevant data from documents. In this case, document such as records on entry and exit behavior for SMEs will be collected and then analyzed.

DISCUSSION

The Effect of Taxation on the Costs of Operation of Small and Medium Enterprises

Arinaitwe (2006) has said that the desired capital stock depends not only on output, but also on the costs associated with investments. In other words, an economy on a rapid growth path attracts a high rate of investment, while a stagnant or shrinking economy offers no inducement for net investment aimed at the market.

From this basic condition, one can readily incorporate tax considerations into the analysis. In particular, tax elements heavily influence costs of operation, which is the cost per year of deploying capital in an investment project. From the point of view of the investor, the effective return on capital is diminished to the extent of tax due on company income. However, the cost of paying company tax is offset by any benefit which may accrue to the investor from tax incentives such as tax holidays, preferential tax rates, investment credits or capital allowances in excess of economic depreciation. These benefits arise at different points in time and vary year to year. To handle this complexity, the standard approach is to take the present discounted value of the tax benefits, per unit of the investment outlay.

Investment can be financed by equity or debt. Hence, the overall cost of funds depends on both the tax rate on debt financing and the risk adjusted real rate of return required by entrepreneurs who provide equity financing. In this framework, investment takes place as long as the gross return on additional investment exceeds the *tax-adjusted* cost of capital. In effect, the hurdle value of investment rises with the company tax rate and the tax on dividends, and falls with the value of the tax incentive package. A higher cost of capital reduces the set of viable investment projects. It also provides an incentive for companies to pursue more labour-intensive projects. Conversely, a lower cost expands the set of viable investment projects and favours capital-intensive projects. The net impact of tax hence breaks on job creation.

The Effect of Multiple Taxation on the Costs of Operation of Small and Medium Enterprises

According to Arinaitwe (2006), tax elements heavily influence costs of operation, which is the cost per year of deploying capital in an investment project. From the point of view of the investor, he argues that the effective return on capital is diminished to the extent of tax due on company income. Whereas this statement can be true, and the contents remain valuable, the conclusions on this particular aspect of the problem are at best partial in nature, and at worst not relevant without empirical evidence.

Borgarello, Marignani and Sande (2004) believe that investment takes place as long as the gross return on additional investment exceeds the *tax-adjusted* cost of capital. In effect, the hurdle value of investment rises with the company tax rate and the tax on dividends, and falls with the value of the tax incentive package. The authors treat investment as linear relationship only dependent on tax rate. However, investment is dependent on a number of variables.

The theoretical effect of taxation on investment is mediated by three considerations: the gestation period, deference of projects and liquidity constraints and imperfections in the financial markets. Incidentally, investments can be determined by more than three factors.

Effect of Taxation on the Growth of Small and Medium Enterprises

A comparison of effective average tax burdens for companies located in different jurisdictions (varying small and medium enterprises) is made (Spengel, 1995; Jacobs & Spengel, 1996; Meyer, 1996; Stetter, 2005; Gutekunst, 2005; Hermann, 2006). The effective average tax burden is derived by simulating the development of a corporation over a certain period. According to this arrangement, the effective tax burden is the difference between the pre-tax and the post-tax value of the firm at the end of the simulation period. Referring to the tax rates, the calculations consider statutory linear as well as progressive tax rate structures. In the case of progressive rates - relevant for special provisions for SMEs - the tax rates enter into the model as functions of the relevant income or net assets (non-profit taxes). But the author offers no data to support the argument he is making. In the absence of any supporting evidence there is no way of judging the validity or reliability of his conclusions and this seriously undermines the value of the work.

Innovative Tax Copying Mechanisms Employed by SMEs

Business Security Measures in Line with Tax Avoidance

According to the Entrepreneur Magazine (1995), tax avoidance refers to the legal means by which taxpayers can reduce their tax bill and is a legal utilization of the tax regime to one's own advantage. Tax avoidance is the legal utilization of the tax regime to one's own advantage, to reduce the amount of tax that is payable by means that are within the law. This is the legal right of an individual to decrease the amount of what would otherwise be his taxes or altogether avoid them, by means which the law permits, cannot be doubted (Hoover, 2000).

Milliron and Toy (1988) predict that a rational taxpayer will avoid tax as long as the pay-off from avoiding is greater than the expected cost of taxation. Early economic scholars (Allingham and Sandmo, 1972) treat taxpayers as perfectly moral, risk-neutral or risk-averse decision-makers who maximize utility. Within this framework, factors that determine the monetary cost of compliance, like the tax rate, detection probability, level of income and penalty structure, drive compliance behaviour. Milliron and Toy (1988) point out that more recent extension to these arguments have been achieved by "relaxing assumptions, focusing on specific issues, and utilizing more sophisticated techniques.

The absence of motivational concepts suggests the inadequacy of expected utility in this context, as economic deterrence models tend to assume motivation as given and behaviour as primarily responsive to consequent costs and benefits. They point out that the plausibility of this assumption is questioned by the lack of empirical support and the criticism it has provoked.

According to Fiscal psychologists, during the last two decades, policymakers and social scientists have recognized that tax avoidance is a behavioural phenomenon. The Prospect theory was developed by Kahneman and Tversky (1979) using the psychological principles that govern the perception of decision problems and the evaluation of options. A descriptive theory of choice under uncertainty, it is viewed as an alternative to the Expected Utility Theory. They illustrate the concept of "framing" with the example of an unexpected tax withdrawal from a monthly pay check, which is perceived as a loss, and not as a reduced gain.

Tax Planning

Tax planning involves conceiving of and implementing various strategies in order to minimize the amount of taxes paid for a given period. Tax planning evaluates various tax options in order to determine when, whether, and how to conduct business and personal transactions so that taxes are eliminated or reduced (Dailey & Frederick, 1997). One method of tax planning is tax avoidance.

There are many tax planning strategies available to a small business owner. However, regardless of how simple or how complex a tax strategy is, it will be based on structuring the transaction to accomplish one or more of these often overlapping goals: income, reducing, controlling, claiming, controlling and avoiding the most common tax planning mistakes (Albert, 2001).

For a small business, minimizing the tax liability can provide more money for expenses, investment, or growth. In this way, tax planning can be a source of working capital. According to David and Jakabcin (1997), two basic rules apply to tax planning: first, a small business should never incur additional expenses only to gain a tax deduction and, secondly, a small business should always attempt to defer taxes when possible. Deferring taxes enables the business to use that money interest-free, and sometimes even earn interest on it, until the next time taxes are due.

CONCLUSION AND WAY FORWARD

From the review of literature, it is clear that the theoretical effect of taxation on investment is mediated by three considerations:

i) The gestation period for many investments may span several years, particularly for large projects. So there can be substantial lags before tax policies to stimulate investment have an actual impact. Still, policy changes that worsen profitability may provoke an immediate cessation of planned investments.
ii) Recent models that highlight the effect of uncertainty show that investors may defer projects even if they are fundamentally viable. Faced with substantial uncertainty about economic stability or the sustainability of pro-investment policies, along with irreversible start-up costs, investors may choose to wait and see how events unfold before committing funds. Implicitly, they demand a higher hurdle rate consisting of the standard value. The result may be a very sluggish investment response. The antidote is to reduce uncertainty by establishing a track record of dependable policy management.
iii) Liquidity constraints and imperfections in the financial markets can enhance the effectiveness of tax cuts. The neoclassical model assumes that investors have access to debt and equity financing at a market-determined cost of funds (adjusted for risk). This is a reasonable assumption for SMEs. But for many companies the main source of funds for investment is retained earnings. In this case, tax cuts can foster investment by augmenting the company's net cash flow, providing the means to take advantage of viable investment opportunities that otherwise would be missed for lack of finance.

Innovative Tax Copying Mechanisms Employed by SMEs

Tax avoidance refers to the legal means by which taxpayers can reduce their tax bill and is a legal utilization of the tax regime to one's own advantage. The taxpayer, in this case, the SME, and the government have an exchange relationship that exists within an avoidance setting. There is some theoretical support for tax avoidance or a rationalization of past behaviour and inequity, as a rational causal factor of avoidance, becomes more credible at a low tax level.
From the above, it is recommended that the government should reduce taxes on Nairobi County's Small and Medium-sized Enterprises in order to avoid this loss of revenue through avoidance. Small and Medium-sized Enterprises are also encouraged to practice tax planning as well in order to receive the benefits of accrued interest and lessen their tax loads.

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