

## **CHAPTER ONE**

### **INTRODUCTION**

#### **1.1 Background to the Study**

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 (Yitzhaki, 2006). 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 beamed the searchlight on the uniqueness of the SMEs; and this have succeeded in overruling previously held views that SMEs were only “miniature versions” of larger companies (Al-Shaikh 1998; Gaskill et al. 1993).

And although Small and Medium Enterprises have been at the center 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 Small and Medium Enterprises however provides a sense of how important this sector is for sustainable development in emerging economies (Medina, 2001). For instance, recent studies conducted by United Nations Industrial Development Organization (UNIDO) concur that SMEs are: labor-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 labor force as well as over 30 percent of the GDP (Day 2000; Dewhurst and Burns 1993). 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 (Ariyo ,1999; Ihua ,2005).

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 (Yitzhaki, 2006). 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). Thuronyi says that taxes are heavy yokes that frustrates existing investors, and scares away prospective ones.

A study conducted by Shome (2004), in collaboration with the Washington, United States-based Center for International Private Enterprise exposed the actual extent of the burden of multiple taxation on SMEs in South America. According to Shome, 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 (Terkper, 2003).

In Africa, the same attention about the growth and ensuing challenges of SMEs has continued to top discussions among researchers. According to Terkper (2007) and estimates from the Manufacturers Association of Nigeria (MAN) about 1,000 SMEs firms in Nigeria that set out to do business in the country annually end up shutting down due to the unfriendly business environment. Taxes confront the manufacturing sector in different shapes and shades viz: import duties, export & excise duties, sales and VAT, withholdings and income taxes, mobile advertising & billboard levies, education, levies, social responsibility charges (Terkper, 2007).

Taxation practice in Ivory Coast became more pronounced and prevalent in the late 1980's. 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 & Vonortas (1999) in *Survey of High Technology Firms*, they identified several effects of successful taxation as economically:

counter productive, destroys investor confidence, raises cost of doing business and it 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, but especially to those in developing countries like Kenya. And although there are many small and medium enterprises in Kenya, this study involves itself with 656 SMEs which make tax returns to KRA and have a turn over of Ksh 5 million and above. In addition, SMEs have been divided under four major categories. These are: 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 estates), (KRA, 2010). The growth and size distribution of firms within a country --from the very labour intensive to the very capital intensive is of course influenced by taxation behavior. 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 (Osambo, 2009).

Government tax estimates for the years 2007to 2010 is shown in Table 1.1.

**Table 1.1 Government Tax Estimates For the Years 2007to 2010**

<b>Taxes</b>	<b>Periods for Taxation (Values in Kshs Billions)</b>				<b>Totals</b>
	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	
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
<b>Total</b>	<b>305.1</b>	<b>372.1</b>	<b>426.84</b>	<b>487.4</b>	<b>1591.44</b>

**Source: KRA, 2010**

Table 1.1, shows the taxation trends for the years 2007 to 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 small and medium businesses, 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 (Mullei & Bokea ,1999).

Heavy taxation is also a subject of worry not only in developed countries like 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 viz: 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 (Osambo, 2009). By studying taxation behavior 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 mainly 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 study is established. Furthermore, the study will attempt to identify all the taxes subjected to SMEs and their effects on the various levels of operations on the business enterprises. In addition, the study will establish the innovative coping mechanisms utilized by the SMEs to respond to the current effects of taxation. The specific concern will be 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.

## **1.2 Statement of the Research Problem**

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 which include 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 installment tax and excise duties. The stunted growth of the SMEs has often been blamed largely on the challenge of taxation (Gaskill,, Auken & Manning, 1993).

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. And the effects of reduced sales are 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. It is within this backdrop that the current study is established

Entrepreneurship is about change (Richard Cantillon, 1730 as quoted in Baer, 1993) 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 current research will seek to answer this research question.

### **1.3 The Research Objectives**

The study will attempt to achieve the following general objective, which will further be subdivided into subsequent specific objectives.

#### **1.3.1 General Objectives**

The general objective of this study will be to examine the innovative tax coping mechanisms by SMEs in Nairobi County.

#### **1.3.2 Specific Objectives**

The specific objectives of the study will be to:

1. To assess the effect of taxation on the costs of operation of small and medium enterprises.
2. To compare taxation effect on the growth of varying small and medium enterprises (services, wholesalers and retailers, manufacturers and agriculture and financial services).
3. Evaluate business security measures on the growth of small and medium enterprises.

### **1.4 Hypotheses**

The study will test several hypotheses that are as follows.

1.  $H_0$ : There is no significant difference in the effect of taxation on the various costs of operation of SMEs

$H_1$ : Taxation increases the various costs of operation of SMEs



2. H<sub>0</sub>: There is no significant difference in the effect of taxation on the growth of varying small and medium enterprises

H<sub>1</sub>: There is significant difference in the effect of taxation on the growth of varying small and medium enterprises

3. H<sub>0</sub>: There is no significant difference in the effect of tax security measures on the growth of small and medium enterprises

H<sub>1</sub>: There is significant difference in the effect of tax security measures on the growth of small and medium enterprises

### **1.5. Justification of the Study**

The researcher hopes that the findings of the study will go a long way to improve the management of taxation in Kenya. In the first place, the findings will be useful to the Ministry of Finance in formulating a policy action plan to address the negative impact of taxation to the growth of SMEs in Kenyan. Similarly, the recommendations will provide useful suggestions to the players to enable them deal with the challenges facing the growth of SMEs.

Furthermore, the outcomes of the study may become a very resourceful reference material to various stakeholders in the economy and readers in general interested in gaining more knowledge about the effect of taxation on the growth of SMEs.

Specifically, financial institutions and investors in technologies will find the information useful when developing programmes to suit the growth of SMEs. Finally the study results and recommendations may provide useful information to scholars keen on carrying out research in matters pertaining to taxation and their effect on the growth of SMEs.

### **1.6. Scope of the Study**

The study will be carried out in Nairobi County.

The current research will cover SMEs randomly selected from different types of businesses in Nairobi County. It is to the opinion of the author that carrying out a research in Nairobi County only will be adequate since extending it to other areas will amount to a replication. Incidentally, all the other factors influencing SMEs growth other than taxation will be held constant

And, although the County has many Small and Medium Enterprises, only those SMEs that make tax returns to KRA will be included in the current study.

### **1.7. Organization of the Study**

This chapter contains three chapters. In Chapter One, an introduction to the topical issue is made. This introductory chapter gives the background to the study. The chapter also presents the problem the study intends to investigate, the objectives it hopes to achieve and the hypotheses statements it intends to test. A brief statement of the anticipated usefulness of the study also forms part of this introductory chapter. The scope of the study concludes the chapter.

Chapter Two sheds light on the review of related literature, which will basically dwell on taxation, growth of SMEs, taxation and the effect of taxation on the growth of SMEs. Theoretical literature on taxation and the growth of SMEs will also be discussed.

A conceptual framework that relates the relationship among variables in the study will also be presented.

In chapter three, the researcher presents the research design and methodology that will describe the research design, target population, sample and sampling procedures. This chapter also contains a description of the instruments that will be used for data collection, validity and reliability of these instruments, data collection and analysis procedures.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter reviews literature concerning the theoretical and analytical evidence on the underlying effect of taxation and the subsequent innovative tax coping mechanisms employed by the SMEs. First, in section 2.2, a review of the Concept of SMEs, relevance of SMEs to the development of national economy and socio-economic background of Nairobi County are presented. In section 2.3, an overview of tax and taxation are also presented. A discussion of tax multiplicity and types of taxations is made in subsections 2.3.1 and 2.3.2. In section 2.4, the concept of entrepreneurship is presented. Theories of entrepreneurship have been covered in section 2.5. A brief description of the models of innovation and creativity is presented in section 2.6. In section 2.7, the effect of taxation on the growth of SMEs is reviewed. Innovative tax copying mechanisms employed by SMEs has been dealt with in section 2.8. Critical literature reviews of the topics under consideration are further considered in section 2.9. A summary on the literature review, the research opportunity and the conceptual framework for the current study are discussed in section 2.10 and section 2.11.

#### **2.2 The Small and Medium Enterprises**

##### **2.2.1 The Concept of Small and Medium Enterprises**

Small scale enterprises have so 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. However, the followings are some definitions of small and medium scale enterprises: the World Bank Document (Report No 71 14) of 1988, Nigeria defined small and medium enterprises as one whose total fixed assets (excluding land) plus cost of investment do not exceed ten million naira in constant 1985 price. Mead (1998) sees SMEs as firms with less than 50 employees and at least half the output is sold.

According to Bolton committee (1971) defined small and medium scale enterprise 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, and 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 definition have indeed been developed for application in a range of countries. The centre for industrial Research and development (1990) defined small scale industries as one whose total assets in capital equipment, plant and working capital are less than tow hundred and fifty thousand naira and employing fewer than fifty full-time workers.

Onwe (2006) observed that Central Bank of Nigeria (2002) defined SME as a firm with capital outlay of not more than N200 m. National Council of Industry (2003) defined small industry as a project with capital investment of over N1.5 million but not more than N50 million and/or work force of between 1 to 100 workers.

A definition of small and medium scale enterprises which has enjoyed wider acceptance is the one given by the United States Committee for Economic Development (2002). It defined small scale enterprise as any enterprise that is characterized by, at least, two of the following features: management is dependent – usually managers are 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, small scale enterprise 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, small scale enterprise 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 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 (Boune, 2007).

### **2.2.2 Relevance of SMEs to the Development of National Economy**

Small-scale enterprises are dominating other aspects of enterprises in the world economy and Kenya's in particular.

According to Nwankwo (1992), it is estimated that probably up to 90 percent of all registered business organizations in Nigeria are in the category of small and medium scale enterprises. In the case of Ebonyi State, over 96 percent of the business organizations are small-scale businesses. The Kenyan scenario is not different either with hundreds of companies registered daily at the registrar of companies' house. Records available at KRA (2010) show that there are over nine hundred SMEs that make tax returns.

The importance and contributions of small scale enterprises to national economy's growth cannot be over-emphasized. They play a crucial role in providing solid base for a country's social economic development. Small scale enterprises produce goods and services for both end and intermediate users and also utilize low capital cost for creating jobs especially in the fast growing service sector of the economy.

Liedholm and mead (1987) observed that small and medium scale enterprises provide productive employment and earning opportunities. Longnecker et'al (1997) postulated that small scale enterprises in united state of America have created over 3 million new jobs in manufacturing between 1976 and 1986. SSES also play a vital role of introducing innovations. Records show that many scientific breakthroughs have originated with independent inventors and small organizations. Longenecker, Moore and petty (1997) suggest, on the basis of several studies by the U.S Department of commerce, that 50 percent of all innovations since world war if have coke from new and smaller firms.

Ekhaton (2001) found out that most countries in the world that have attained advanced stage in industrial development and did so because they started their industrial development with programmes in the small and medium scale enterprises. SMEs foster linkages within industries and between industries and other sectors of the economy, (Olusoji, 1999). SMEs can also, contribute to long run industrial growth by producing an increasing number of firms that grow up and out of small scale sector. They accelerate rural development and promote the utilization of domestic" resources by adapting to local markets and local sources of material.

Enudu (1999) noted that small-scale enterprises make use of waste material from big industries for further production. Small business can be an aid to personal and national self-reliance. Ukeje (2003) noted that small-scale business enterprises contribute 70 percent of industrial employment in Kenyan economy though it accounts for only 10-15 percent of manufacturing output. In fact there abound many economic cum social roles SMEs play in the development of the national



economy. To this effect, policies that would facilitate their utilization should be adopted by concerned authorities.

In realization of the advantages of promoting SMEs, Kenyan government is at the forefront in promoting the growth of SMEs in all parts of the country in partnership with development partners, financial institutions and enterprise agencies. In Nigeria, the Federal Government of Nigeria has continued to play pioneering and active roles in stimulating SMEs (Obitayo, 1991). The government has established many institutions to facilitate the growth of SMEs. These institutions include the National Directorate of Employment (NDE), the Family Economic Advancement Programme (FEAP) etc. The government also provided technical assistance to SSEs through its various agencies such as the Industrial Development Centre (IDCs) centre for Industrial Research and Development (CIR), Project Development Centre (PRODA), Small and Medium Scale Enterprise Development Agency of Nigeria (SMEDAN), Small and Medium Scale Enterprise Investment Equity Scheme (SMEIES) etc specifically, the government has played lead role in:

Young Lee and Roger Gordon (2005) gave the following suggestions in their Background Paper for Tax Dialogue Conference, ” that for SMEs to fully develop and use their potential, they need specific policy measures to ensure that technology services and infrastructure are provided’’. Further, research and development institutions that are publicly funded should be encouraged to target the technology needs of SMEs.

Secondly, the problem of access to information may be attributed to the inadequacy of SME support institutions. The need for a supportive policy to encourage the establishment of documentation centers and information networks to provide information to SMEs at an

affordable price (Foluso, 2007).

Thirdly, the government should come up with training for training managerial and technical courses for the small enterprises entrepreneurs. Equally, there should be business information centers (Terkper, 2007).

Fourthly, government should come up with proper regulatory policies that are small enterprises friendly since many of what we have in Kenya; frustrate every effort of a junior entrepreneur. The policies we seem to have, seemed to cater for the well-established businesses.

Since majority of small enterprises lack finance, government should establish friendly small loaning system. This would include low interests rates to ensure the continuity of these businesses (Foluso, 2007).

### **2.2.3 Socio-Economic Background of Nairobi County**

Nairobi is the capital city of Kenya with a thriving SMEs sector that exhibit both formal and informal characteristics. The SMEs in Nairobi's industrial area play a major role in providing products and services to a major population of Nairobi. They also contribute a great deal to the country's economic growth. Major players in the sector come from the middle and lower class levels of the society which comprises of the majority of the population in Nairobi living in Eastland, Eastleigh, Makadara, Mlolongo, South B Estate, sprawling Mathare slums, Kibera and Mukuru Kwa Njenga among others.

### **2.3 An Overview of Tax and Taxation**

Scholars, researchers and economists have always attempted to define and understand the term taxation. However, these groups of experts have not yet defined and standardized the meaning of

tax and taxation (Erosa, Gustavo & Walter, 2009). The origin of the terms tax and taxation has always been a subject of controversy among economists and researchers. Scanty literature on this subject has attempted to trace the first known system of taxation to Ancient Egypt in around 3000 BC - 2800 BC in the first dynasty of the Old Kingdom (McCluskey, William; Franzsen, & Riël, 2005). However, the controversy of taxation has also been compounded by the critical forms that existed then. Such obsolete forms of taxation include *seigniorage* (the tax on the creation of money), *Scutage* tax paid in lieu of military service- a non-tax obligation), *Tallage* (a tax on feudal dependents) and *Tithe* (a tax-like payment (one tenth of one's earnings or agricultural produce), paid to the Church. By bringing these historical issues on tax and taxation to the fore, and how these terms have been understood by generational scholars, key concepts have been identified and used (Arundel & Kabla, 1998).

Anyanwu (1997) noted that taxation has three principal objectives, which are regulation of the economy and economic activities, raising of revenue for the government and controlling of income and employment.

Revenue realizable from taxation depends on some factors but principally on the tax base and rate. Tax base refers to the specification of the minimum amount above which is taxable, while tax rate is the amount which is levied per unit of base. Tax bases simply are those objects upon which tax revenue are derived (Mansfield 1973).

Tax system, therefore, should be consistent with over-all economic policy, which may include such objectives as favoring savings over consumption and raising private investment. Taxes no matter the type and how they are being administered bear effects on payer. Effects of taxation are the changes in the economy consequent upon tax imposition. Anyanwu (1997) contends that

the presence of tax distorts the pattern of production, consumption, investment, employment and other similar patterns for good or for bad and these distortions are collectively viewed as the effects to taxation.

Lewis (2005) observed that an effective and efficient tax administration system is integral to any country's well being. The proper amount of tax must be collected in a timely manner and the enforcement powers of the tax administration must provide an even playing field for business by ensuring that all taxpayers meet their tax filing and paying requirements. The tax administration must balance its educational and assistance role with its enforcement role. The overriding goal is to foster voluntary compliance with the tax laws. This represents a significant challenge in a developing economy.

Taxes may have a great variety of effects. They may cause some goods to become more expensive relative to others and so cause a change in the pattern of consumption. They may fall more heavily on some households than others, thus altering the distribution of net income. "they may effect people's willingness to work and to save, and to take risks, that is, they may effect the total supply to resource s available to the economy", (Seddon 1973).

Raymond & Jakob in their investigation carried out in Ugandan firms on "Are corruption and Taxation Really Harmful to Growth? Firm Level Evidence": *Journal of Development Economics* (2007) studied the relationship between bribery payments, taxes and firm growth. Using industry-location averages to circumvent potential problems of endogeneity and measurement errors, and found that both the rate of taxation and bribery are negatively correlated with firm growth. A one-percentage point increase in the bribery rate is associated with a reduction in firm

growth of three percentage points, an effect that is about three times greater than that of taxation. This provides some validation for firm-level theories of corruption which posits that corruption retards the development process to an even greater extent than taxation.

Bhatt (1973) noted that the tax system is an organic part of the economic system, and hence it is essential that there be some certainty and stability about its basic features. According to him, a large number of ad hoc changes each year create a climate of uncertainty, which hampers productive effort and diverts valuable scarce resources towards speculative and other undesirable channels, as well as encouraging efforts to circumvent the government measures. Thus, the qualitative aspect of taxation in the conventional economic analysis is not much concerned with the revenue-yielding capacity of a tax but with its effects on economic units who are subjected to the payment of tax.

### **2.3.1 Tax Multiplicity**

Tax policy in both developed and developing countries has been largely used to generate maximum revenue for the government and as a result its use for optimal allocation of resources or redistribution of income is being neglected. Anyanwu (1997) noted that tax authority in Nigeria has concentrated on the manipulation of the rates and tax bases in order to generate enough revenue for the government. According to Anyanwu, this has led to imposing of different types of taxes and levies by tax authorities. These different taxes which should have otherwise come under one major type of tax but are split into many forms are in, this work referred to as “multiple tax”.

Ndokwu (1988) observed that so many taxes are imposed at different or supplementary rates and it involves different tax bases and different times of payment. In Nigeria, Tax policy planning is not clearly assigned to specific unit rather than on long term studies, (Anyanwu 1997). Utomi (2000) in line with this view noted that Nigeria has a confused taxation philosophy. This results in proliferation of taxes and tax laws hence tax multiplicity.

Awake (2003) observed that over 300 different taxes are paid by tax payers in some African countries, while in some Asian countries, local officials impose dozen of illegal charges from fees for, growing bananas to taxes on slaughtering pigs-either to top up (increase) the local finances or pad their on pockets.

Taxes generally provide basis for government revenue, which help them in carrying out their functions. This is why Ojo (1996) defined tax as a means by which government appropriate part of private sector's income and expenditure as its revenue for the purpose of meeting recurrent expenditure and creating public capitals formation towards the development and growth of goods and services of the economy.

A good tax possesses the following qualities: fairness, convenience, simplicity and minimum cost of collection and minimum distortions. Ravelo (1980) noted that taxes should be chosen so as to minimize interference with economic decisions in otherwise efficient markets. Imposition of excess burden should be minimized. Again, a good tax system should permit efficient and non-arbitrary administration and it should be understandable to the taxpayer. Taxes therefore are known to play important role in the process of development of an economy. This is the role of providing finance for government expenditure. There are three main objectives of taxation.

These include raising of revenue for the government, regulating the economy and economic activities, and controlling of income and employment.

To tax is to impose a financial charge or other levy upon a taxpayer (an individual or legal entity) by a state or the functional equivalent of a state such that failure to pay is punishable by law.

Taxes are also imposed by many sub-national entities. Taxes consist of direct tax or indirect tax, and may be paid in money or as its labor. A tax may be defined as a pecuniary burden laid upon individuals or property owners to support the government. A tax "is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority" and is "any contribution imposed by government, whether under the name of toll, tribute, impost, duty, custom, excise, subsidy, aid, supply, or other name" (Erosa & Ventura,2009).

The legal definition and the economic definition of taxes differ in that economists do not consider many transfers to governments to be taxes. For example, some transfers to the public sector are comparable to prices. Examples include tuition at public universities and fees for utilities provided by local governments. Governments also obtain resources by creating money (e.g., printing bills and minting coins), through voluntary gifts (e.g., contributions to public universities and museums), by imposing penalties (e.g., traffic fines), by borrowing, and by confiscating wealth. From the view of economists, a tax is a non-penal, yet compulsory transfer of resources from the private to the public sector levied on a basis of predetermined criteria and without reference to specific benefit received.

In modern taxation systems, taxes are levied in money, but in-kind and *corvée* taxation is a characteristic of traditional or pre-capitalist states and their functional equivalents. The method

of taxation and the government expenditure of taxes raised is often highly debated in politics and economics. Tax collection is performed by a government agency such as Canada Revenue Agency, the Internal Revenue Service (IRS) in the United States, or Her Majesty's Revenue and Customs (HMRC) in the UK and KRA in Kenya. When taxes are not fully paid, civil penalties (such as fines or forfeiture) or criminal penalties (such as incarceration) may be imposed on the non-paying entity or individual.

In Kenya, taxation is the single largest source of government budgetary resources. A study carried out by Moyi & Ronge (2006) found out that between 1995 and 2004, tax revenue constituted 80.4% of total government revenue (including grants).

Taxation is used to raise sufficient revenue to fund public spending without recourse to excessive public sector borrowing. Secondly, it is used to mobilize revenue in ways that are equitable and that minimize its disincentive effects on economic activities (ibid).

Unfortunately, over the same period, Kenya has moved from being a low tax burden country to a high tax burden country, yet the country still faces the obvious need for more tax revenues to maintain public services.

According to Sessional Paper No 1 of 1986 (GOK, 1996), the Kenyan Government initiated essential policy goals: raise the tax revenue-GDP ratio from 22% in 1986 to 24% by the period 1999/2007, promote saving and investment by placing a greater burden on taxation of consumption, devise a tax structure that distributes income equitably and promotes rural-urban balance, make industry more competitive through reviews of import duties and export compensation, design a buoyant and elastic tax system that keeps revenues expanding at the



same pace with income growth without annual changes in rates, Reduce compliance and administrative costs through low and rationalized tax rates, wider tax bases, self-assessment systems and taxpayer education and services. These reform goals gave birth to the Kenya Revenue Authority (KRA) which was incorporated in 1995.

Thus, KRA amalgamated the five main revenue departments that were initially in the Ministry of Finance namely Customs Duty, Excise Duty, Sales Tax, Income Tax and Corporate Tax).

According to Karingi et al (2005), there have been criticisms leveled against KRA resulting to the problem of ambitious and rapidly changing tax/GDP targets that are externally induced as well as the failure to reform local government taxation. One of the mistakes of the Kenyan tax reform, Karingi continues, is poor sequencing, which results in policy reforms that hurts the growth of SMEs.

Kenya, like many other developing countries, seeks to apply the tax weapon so as to meet the objectives of raising enough revenue. The three main factors of production –labor, capital and land- are used in varying proportions in the productive process of the economy. The returns to these factors- wages, profits and rent –are taxed if the objectives of the tax policy are to be met. In Kenya, the tax system has mainly concentrated on taxing individual income (Personal .Income Tax-PIT), profits (Corporate Income Tax-CIT) and goods and services (VAT, excise duties). However, when this is done progressively, it may hurt some important part of the economic which includes the SMEs.

King & McGrath (2002, observed that compared with a sample of low-income sub-Saharan countries, Kenya's tax/GDP ratio is higher than the sample average. The imbalance between government revenue and expenditure results in large and chronic fiscal deficits. In theory, the financing of a deficit especially through foreign borrowing or additional foreign financing may have considerable effects on interest rates, the balance of payments and the external value of the currency, in this case the shilling. This has prompted Kenya to initiate reforms in the tax structure with diverse objectives. Unfortunately, the reform process began at a time when the macro-economic environment was unstable thus inhibiting the growth of SMEs.

Although Kenya has embarked on massive tax reforms since 1986, little is known about the actual effect of such tax to the growth of SMEs. It is not known how the reforms have affected each tax source. The current study attempts to fill this research gap.

If well designed, taxation has the capacity to raise the incremental savings ratio, which is one of the main determinants of growth (Prest, 1985). The growth in tax revenue must approximate the growth in expenditure for the players of economy to hold (World Bank, 1990).

Osoro (1999) identifies the main elements of the tax reforms programmes beneficial to the growth of SMES which include: Imposing a small number of taxes with the broadest possible base and moderate rates, using VAT to replace commodity taxes in order to minimize disincentives for investments and exports, not only avoiding raising taxes on the poor, but also reducing their tax burden-this is achieved by levying excise duties on luxury items and exempting foodstuffs to protect the low-income groups., avoiding tax incentives and shifting to broader, simpler tax bases on which lower rates are applied, minimizing corporate tax evasion

(some countries levy minimum taxes on a company's net worth), lowering distortions that reduce economic welfare and growth (World Bank, 1990).

Unfortunately, in Kenya more often, tax systems has emphasized the introduction of either new taxes or new rates on existing bases, more stringent administrative changes and the need to widen tax bases and reduce exemptions (Thirsk, 1991).

According to Musgrave (1987), taxation issues include impact of alternative taxes on saving and investment and the resultant challenges for micro balance of the economy. Reforms according to him should address the issue of equity in the distribution of the tax burden as well as composition of the tax structure.

Kenya's tax programme, Wagacha (1999) argues, should seek to (a) improve the efficiency and productivity of taxation, (b) improve tax collection and administration while lowering the rates, and (c) gain tax effectiveness through greater tax elasticity. On the basis of tax/GDP , this author observes that Kenya's tax burden (averaging 26.6%) is high by international standards and therefore the ultimate objective of a tax reform scheme should be to lower the excessive tax burden and efficiency costs of taxation.

### **2.3.2 Types of Taxation**

Taxes consist of direct tax or indirect tax. In the current study, both direct and indirect taxes will be considered since it is easier to measure. According to Osambo (2009), direct taxes include income tax, VAT, customs and excise, national insurance, corporation tax and excise duties.

Income tax is probably the most important tax of all, raising well over a quarter of all tax revenue. It is charged on all income, but the rate increases the more income is earned. The first part is tax-free, but then once you have earned this personal allowance the tax rate is 10% for the next chunk of income. The level at which the rate changes is termed the tax band and these tend to be changed in the budget each year to keep up with inflation. Income tax is collected by the Central governments (Cordes, Hertzfeld & Vonortas, 2004).

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. Which include 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. In this type of taxation, the employer is empowered to deduct tax according to the prevailing rates of tax from their employees' salary or wages on each payday for a month then remit it to the Paymaster.

Withholding tax is a form of income tax deducted at source from the following sources of income: interest, dividends, royalties, management or professional fees, commission, pensions, and rent received by non-resident persons.

Advance tax which was introduced in 1996, is a tax paid in advance before a public service vehicle or commercial vehicle is licensed. The tax is applicable to vans, pickups, trucks, Lorries and saloons.

The main goal of income tax has been to enhance collection by broadening the tax base. However, when this tax is done excessively, it hurts the most contributory agents of the economy (Wanjohi & Mugure, 2008).

VAT (Value added tax) is a tax on spending and is therefore an indirect tax. VAT is charged at every stage of the production and the only people who pay VAT as a tax are the consumers. A firm has to keep a record of all the VAT they have paid on their supplies and all the VAT they have collected on their sales. The current rate of VAT in Kenya is 16 % (KRA, 2011).

VAT was introduced in Kenya in 1990 to replace sales tax. Since 1991, VAT has been broadened to cover the service sector. Stringent measures includes the raising of the minimum turnover level for compulsory registration from Ksh10, 000 to Ksh40, 000 and introducing stiff penalties for defaulters in the following areas: late VAT returns, failure to issue VAT invoices and failure to maintain proper books of account, an aspect of VAT that elicited much interest from the taxpayers especially the SMEs (Nyamunga, 2001).

The national insurance is paid by both employers and employees. According to Cordes, Herzfeld Vonortas (2004), national insurance is a fund maintained by government to pay out for those unemployed and when one reaches retirement age.

Corporation tax is the main business tax. This is a tax charged on company profits and the rate varies according to the size of the business. It is effectively an income tax for business as their income is their profit. Business do also have to pay local business taxes (business rates) to local authorities in the area they are located in, but corporation tax is collected by the national government ( Kortum & Lerner ,1999). In Kenya, corporation tax is income tax levied on

corporate bodies such as Limited Companies, Trust, and Co-operatives. Resident companies are taxable at a rate of 30 % while non-resident companies are taxable at the rate of 37.5 % on the taxable income KRA (2009).

Installment tax is paid by both individual and corporate taxpayers who have tax payable for any year, except in the case of those individuals whose tax liability for a particular year is fully covered under PAYE, or whose final tax liability is below Ksh 40000.

Excise duties are also taxes on spending and are termed indirect taxes, but they are taxes on specific goods. Excise duties are charged on alcohol, tobacco, and petrol and gambling. These taxes tend to be increased each year in the Budget. This is because they are usually set at a fixed rate and so need to be increased to ensure that the revenue from them keeps up with inflation. Excise duties are intended to try to reduce consumption because of the harmful social costs that may be generated as a result (pollution from petrol, etc.). Since 1991, the coverage of excise duties has expanded from domestic production to include imports. Excise duties were rationalized to cover the luxury goods tax element on wine, beer, spirits, mineral water, tobacco products, matches, luxury passenger cars and minibuses. Automotive fuels and cosmetics were also introduced into the excise tax net (Nyamunga, 2001).

Allingham & Sandmo (2004) identifies various taxes that are synonymous with the informal sector. According to them, there are two types of direct presumptive taxes: –withholding and direct tax on all or below threshold businesses. On the other hand, presumptive withholding taxes

requires formal sector tax collector such as customs (imports or exports), marketing agency (agricultural, forestry, etc products), government or private corporation (goods and services purchases), corporation (dividends), financial institution (interest income, pensions, etc).

One of the key objectives of tax reforms in Kenya is to ensure that the tax system can be harnessed to mitigate the perpetual fiscal imbalances. This can be achieved through tax policies intended to make the yield of individual taxes responsive to changes in national income. In addition, it is expected that the predominant taxes in the revenue would be those with highly elastic yields with respect to national income (Kinyanjui & Moyi, 2008). Incidentally this assertion can not hold true when SMEs continue to suffer heavy taxation burdens.

## **2.4 Concept of Entrepreneurship**

Entrepreneurship is an outcome of complex balancing of opportunity initiatives, risks and rewards (Mamun, 2000). Entrepreneurship is as a process by which people pursue opportunities, fulfilling needs and wants through innovations, without regard to the resources they currently control. Entrepreneurial resource is vital ingredient of economic development whereas a key element of economic development is that the 'people of the country' must be major participants in the process that brought about changes in structure of economic and population growths along with consumption pattern. According to North (1990), through the process of entrepreneurship, it is possible to augment the scope of capital formation, employment generation and facilitate industrialization in a country. In addition, entrepreneurship acts as a powerful tool of employment generation, raising productivity through innovation, facilitating transfer of

technology, playing key role in commercializing new products, redistribution of wealth and income, earning foreign exchanges and promoting social welfare (North ,1990).

The concept of entrepreneurship as stated by Rauch & Frese (2000) is multifaceted and used in a wide variety of contexts. At its heart are entrepreneurs, i.e. persons that are believed to have characteristic traits or behave in some characteristic way. On the basis of these characteristic traits entrepreneurship is described as an innovator who undertakes the new combinations of factors of production. Innovation may occur in the form of: i) the introduction of a new goods, ii) the introduction of new method of production, iii) the opening of a new market, iv) the conquest of a new source of supply of factors of production and v) the reorganization of any industry. Entrepreneurs are specially motivated and talented type of individuals who are to see potentially profitable opportunities and tend to exploit them (Saha, 1989). It is recognized that mere existence of resources does not guarantee economic growth (Purhit and Rahman, 1995). Experience shows that progress is basically the human effort and it takes human agents to mobilize capital, to exploit natural resources to create new markets and to carry on trade (Frederick and Myers, 2002). According to J.A. Schumpeter entrepreneurship is the central figure of the development process because the entrepreneur in the modern complex economic world can create opportunities for production technology, by expanding or discovering new market, new product, new source of resources, etc. All these activities will embrace risk and uncertainties and at the same time will increase the demand for higher or increased investment in the economy. This demand for increased investment will necessitate higher capital accumulation and thereby the demand for increased rate of savings in the economy. The cumulative effects of all



these factors will increase level of income and total production of goods and services in the economy. In other words, in totality, the net result of expansion in the volume of economic activities will lead to growth in national economy and if a proper and equitable distribution policy can be formulated by the state to suit the real development in the economy will take place (Saha, 1989).

## **2.5 Theories of Entrepreneurship**

Entrepreneurship theories and research remain important to the development of the entrepreneurship field. Several theories have been put forward by scholars to explain the field of entrepreneurship.

The current study examines three entrepreneurship theories with a bias on the growth of SMEs.

These are: (1) Economic entrepreneurship theory, (2) Psychological entrepreneurship theory and (3) Sociological Entrepreneurship theory.

### **2.5.1 Economic Entrepreneurship Theory**

The economic entrepreneurship theory has deep roots in the classical and neoclassical theories of economics, and the Austrian market process (AMP). However, because of criticisms leveled against the classical and neo-classical conjectures led to the Austrian Market process (AMP) which was a model influenced by Joseph Alois Schumpeter (1934).

Schumpeter (1934) described entrepreneurship as a driver of market-based systems. To him an important function of an enterprise was to create something new which resulted in processes that served as impulses for the motion of market economy. Murphy, Liao & Welsch (2006) contend

that the theory offered a logic dynamic reality. In explaining this, they point to the fact that knowledge is communicated throughout a market system (e.g. via price information), innovation transpires, entrepreneurs satisfy market needs, and system-level change occurs. If an entrepreneur knows how to create new goods or services, or knows a better way to do so, benefits can be reaped through this knowledge. Entrepreneurs effectuate knowledge when they believe it will procure some individually-defined benefits.

Fiet, (2002) held that entrepreneurs are incentivized to use episodic knowledge (that is, possibly never seen before and never to be seen again), to generate value.

Thus, the AMP was based on three main conceptualizations (Kirzner, 1973). The first was the arbitraging market in which opportunities emerge for given market actors as others overlook certain opportunities or undertake suboptimal activity. The second was alertness to profit-making opportunities, which entrepreneurs discover and entrepreneurial advantage. The third conceptualization, following Say (1803) and Schumpeter (1934), was that ownership is distinct from entrepreneurship. In other words, entrepreneurship does not require ownership of resources, an idea that adds context to uncertainty and risk (Gartner, 2004). These conceptualizations show that every opportunity is unique and therefore previous activity cannot be used to predict outcomes reliably.

(Casson, 2005) contends that an entrepreneur is the prime mover in economic development, and his function is to innovate, or to carry out new combinations. Anyone who performs this function is an entrepreneur, whether they are independent or dependent employees of a company.

However, while the causes generating opportunities are unexplained in the entrepreneurship literature, a generation of scholars led by Shane and Ulrich (2004) examined the relationship among the entrepreneur, product development and technological innovation. The studies noted

that the technology opportunity set is endogenously created by investments in new knowledge (Warsh, 2006). However, not only does new knowledge contribute to technological change, it also creates opportunities for use by third party firms (Jaffe, 1989), often-new ventures (Shane, 2001). The creation of new knowledge gives rise to new opportunities through knowledge spillovers; therefore, entrepreneurial activity does not involve simply the arbitrage of opportunities (Kirzner, 1973) but also the exploitation of new opportunities created but not appropriated by incumbent organizations (Acs, Audretsch and Feldman, 1994).

In the current study, just like suggested in the economic entrepreneurship theory by Schumpeter (1934) who described entrepreneurship as a driver of market-based systems, mitigating the adverse effect of taxation requires innovation which is basically dependent on entrepreneurship ,creating of new knowledge ,risk taking and management ,adaptability and leveraging technology.

### **2.5.2 Psychological Entrepreneurship Theory**

The level of analysis in psychological theories is the individual (Landstrom, 1998). These theories emphasize personal characteristics that define entrepreneurship. Personality traits need for achievement and locus of control are associated with entrepreneurial inclination which involves risk taking, innovativeness, and tolerance for ambiguity. The essence of psychological or personal theory is the difference in individuals' attitude. According to this theory the difference in attitude i.e. the internal attitude and ability to judge and forecast the situation lead a man to become a successful entrepreneur.

Coon (2004) defines personality traits as “stable qualities that a person shows in most situations”. Coon argues that there are enduring inborn qualities or potentials of the individual that naturally make him an entrepreneur.

Some of the characteristics or behaviors associated with entrepreneurs are that they tend to be more opportunity driven (they nose around), demonstrate high level of creativity and innovation, and show high-level of management skills and business know-how (Rauch and Frese 2000).

Coon (2004) says that entrepreneurs have been found to be optimistic, (they see the cup as half full than as half empty), emotionally resilient and have mental energy, they are hard workers, show intense commitment and perseverance, thrive on competitive desire to excel and win, tend to be dissatisfied with the status quo and desire improvement, entrepreneurs are also transformational in nature, who are life long learners and use failure as a tool and springboard. They also believe that they can personally make a difference, are individuals of integrity and above all visionary.

David McClelland’s theory (1961) on need for achievement explained that human beings have a need to succeed, accomplish, excel or achieve. Entrepreneurs are driven by this need to achieve and excel. In his theory McClelland emphasized the relationship of achievement motivation or need for achievement (Pervin, 1980). According to McClelland, one would expect a relatively greater amount of entrepreneurship in a society if the average level of need achievement in a society is relatively high. Because having a high achievement encourages an individual to sit challenging goals, work hard to achieve the goals and uses the skills and abilities needed to accomplish them (Pervin, 1980). Moreover, it is the inner drive of individuals that propels them to work more and to achieve something for their own interest by taking personal risk (Islam and

Becker, 2001). Need for achievement then, reflects a strong goal orientation, an obsession with job or task to be done. Consequently, McClelland advocates increasing level of need-achievement in a society in order to stimulate entrepreneurship and economic growth (Frese, 2000). Finally, according to McClelland, entrepreneurs are activated by the high extent of achievement motivation and he also stated a desire to do well, not so much for the sake of social recognition or prestige, but for an inner feeling of personal accomplishment, induce people to be an entrepreneur (Frese, 2000).

An entrepreneur's need for achievement drives him to become innovative by devising tax coping mechanisms in order to survive in the business engagements and excel. This is what motivated the author to adopt the David McClelland's theory (1961).

### **2.5.3 Sociological Entrepreneurship Theory**

These are theories based on sociological aspects. This is because socio-cultural factors have a substantial influence in creating entrepreneur as well as entrepreneurship (Gartner, 2004). Moreover, social and cultural factors places a high value on innovation, risk taking and independence is more likely to produce entrepreneurial events than a system with contrasting values (Mamun,2000). Among these type of theories Max Weber's protestant values is ancient one. In this theory Weber argued that protestant or Calvinistic logic or values were instrumental in promoting capitalist enterprise. These values included, first of all, an emphasis on the inherent goodness of work itself. A person's work was regarded as a calling in the very literal rendering of the concept of vocation. Moreover, the experience of financial rewards from one's work was

regarded as a manifestation that one was blessed by God, a number of elect few predestined to share this grace. However, money created temptations to the flesh, whose yearnings were to be suppressed. Protestant values called for self-restraint and deferral of gratification. By investing one's earnings in the form of capital, one could practice such self-denial. Over a period of many years, repeated investment of earnings created the capital base for the take off of Western societies into the economic break-through of the industrial revolution (Mamun,2000).

A previously stated in this study, social and cultural factors is an important ingredient on innovation, risk taking and independence for a holistic entrepreneurial status. Just in the same vein, the current study envisions that entrepreneurship will thrive well in a climate where tax burden is reduced.

## **2.6 Models of Innovation and Creativity**

### **2.6.1 Schumpeter's Innovation Model**

Schumpeter's model is dynamic system that continually generates change and technological progress. Schumpeter's model is a dynamic one which describes an equilibrium path that the economy follows over time, not the stable equilibrium described by the familiar supply and demand models that were in vogue when Schumpeter first described his concept of creative destruction early in the twentieth century. Schumpeter described the capitalist economy as a "perennial gale of creative destruction" in which each firm sought to gain an advantage in the marketplace through innovation. He complained that "the problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them" (Schumpeter, 1934). Each innovation, such as a more attractive

design, a lowering of production costs, a new product, a new source of supply of inputs or raw materials, or improved management methods was pursued because it held the possibility of generating higher profit for the innovating firm. Such creative activity also destroyed the monopoly power that its competitors had gained by means of their earlier innovations.

Each innovator's gain is, therefore, only temporary because the creative innovation of its competitors will, sooner or later, destroy its hard-earned market power. This continual creation and destruction prevents permanent monopolies from developing, and in the process, society enjoys continuous technological progress. Creative destruction was, according to Schumpeter, the source of economic growth and the enormous increases in living standards that the world was experiencing in the early 1900s (Lewer and Van den Berg, 2004).

### **2.6.2 A Systems Theory of Creativity**

This Theory was advanced by Mihaly Csikszentmihalyi (1988) by relating creative effort by individuals to the state of the domain they are working in and the characteristics of those who assess the worth of the creative endeavor in the field concerned.

According to Mihaly Csikszentmihalyi, the environment has two salient aspects: a cultural, or symbolic, aspect which here is called the domain; and a social aspect called the field. Creativity is a process that can be observed only at the intersection where individuals, domains, and fields interact. This is shown in Figure 2.1.

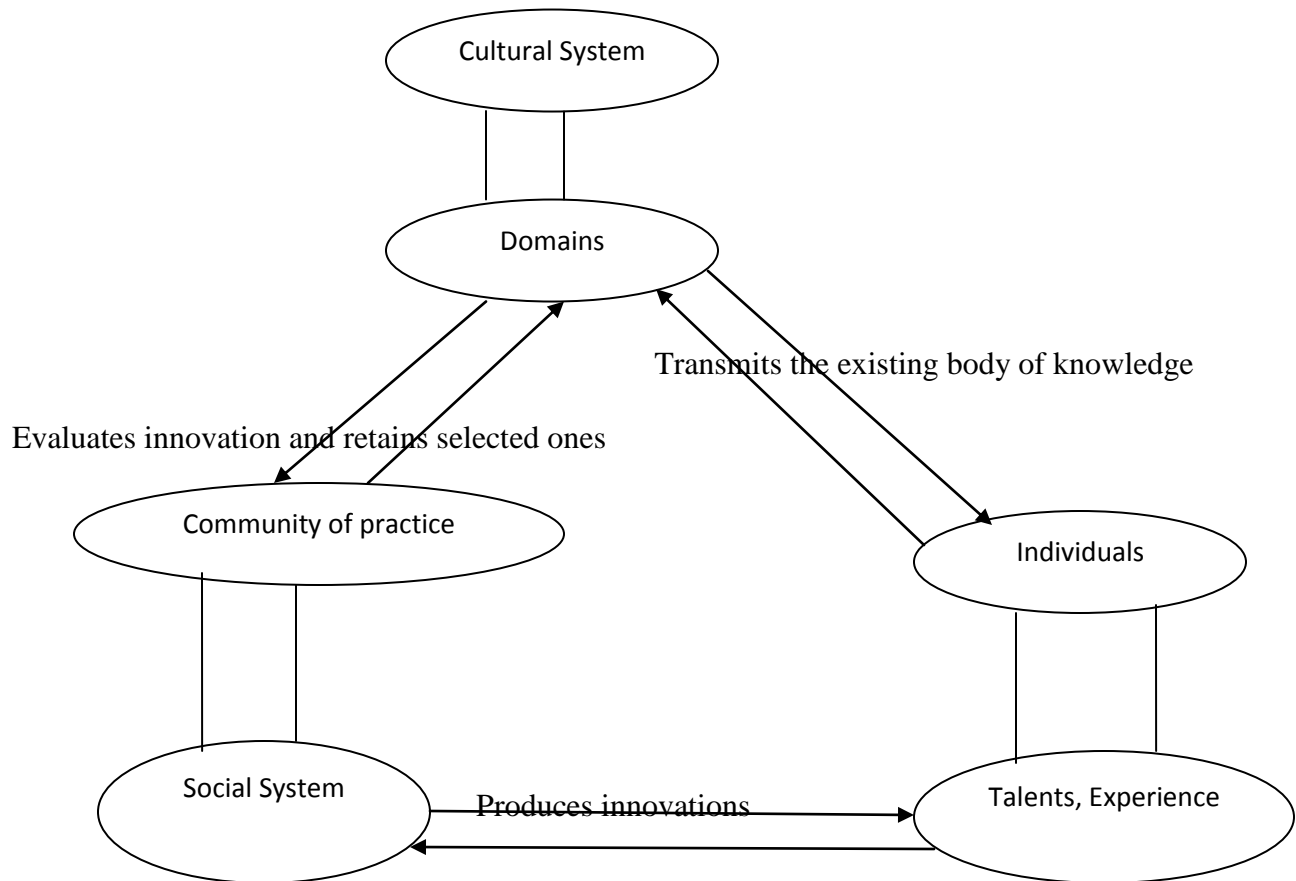


Figure 2.1 A Systems Theory of Creativity

Source: Csikszentmihalyi (1999)

For creativity to occur, a set of rules and practices must be transmitted from the domain to the individual. The individual must then produce a novel variation in the content of the domain. The variation then must be selected by the field for inclusion in the domain.

Creativity occurs when a person makes a change in a domain, a change that will be transmitted through time. Some individuals are more likely to make such changes, either because of personal qualities or because they have the good fortune to be well positioned with respect to the domain – they have better access to it, or their social circumstances allow them free time to experiment (Csikszentmihalyi, 1999).



## **2.7 The Effect of Taxation on the Growth of SMEs**

### **2.7.1 Effect of Taxation on the Costs of Operation of Small and Medium Enterprises.**

Arinaitwe (2006) says 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.

Borgarello, Marignani, & Sande, (2004) argues that 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 labor-intensive projects. Conversely, a lower cost

expands the set of viable investment projects, and favors capital-intensive projects. The net impact of tax hence breaks on job creation.

The theoretical effect of taxation on investment is mediated by three other considerations.

First, 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.)

Second, 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.

Third, 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.

## **2.7.2 To Compare Taxation Effect on the Growth of Varying Small and Medium Enterprises**

A comparison of effective average tax burdens for companies located in different jurisdictions (varying small and medium enterprises) was carried out by (Spengel, 1995; Jacobs and 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. For the computation of the effective average tax burden the entrepreneurs use the economic data of the corporation and tax data as inputs. The entrepreneurs compare effective average tax burdens for companies over a period of ten years. According to this model, 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. The value of the firm is represented by the equity, which includes the capital stock and the cumulative net income of each of the ten periods. At the end of period ten, the tax value of assets and liabilities may differ from their fair value, depending on the tax rules which are to be applied. These hidden reserves and liabilities are added to the taxable income in period ten and are taxed accordingly. As a consequence, only the effects of different tax accounting rules on the liquidity are taken into account. Remaining loss carry forwards at the end of the simulation are dissolved liquidity-related whereas a devaluation of 50 per cent is made if there are no restrictions for the use of loss carry forwards and a devaluation of 75 per cent if there are any restrictions. The computation of the absolute effective average tax burden requires two steps. In the first step, the pre-tax value of the firm at the end of the simulation period is calculated. The pre-tax value of the firm is derived from the estimated cash flows and the value of the net assets at the end of the simulation period. The cash flows are derived from estimates for the cash receipts (sales and other receipts, gains upon the disposal of assets, interest and dividend income)

and expenses (wages and pension payments, expenses for material, energy consumption and other expenses, new investment, interest expenses and distributed profits) covered by the corporate planning model.

The value of the net assets at the end of the simulation period is computed by deducting the liabilities of the corporation from the assets. Both the assets and the liabilities are valued at calibrated parameters that are the same in each country. For assets we use replacement prices and for liabilities nominal values. Pre-tax cash flow at the end of the simulation period + Value of the net assets at the end of the simulation period (= assets in the capital stock at replacement prices – liabilities in the capital stock at nominal values) = Pre-tax value of the firm at the end of the simulation period. In the second step, we calculate the post-tax value of the firm at the end of the simulation period. The determination of the post-tax value of the firm only has cash flow effects and no impact on the value of the net assets. The post-tax cash flow is derived in each period by deducting the tax liabilities from the pre-tax cash flow. In order to calculate the absolute amount of tax liabilities, receipts and expenses enter into the tax balance sheet and/ or into the tax profit and loss account following national taxation rules (e.g. regarding the computation of depreciation allowances).

The reduction of the cash flow due to tax payments (liabilities) also has an impact on the balancing investment or credit and the connected interest receipts or credits. By taking into account these tax-induced effects on the interest income or expense of each period, the deferral of tax payments is integrated into the model. Hidden reserves and liabilities are only relevant for taxation matters at the very end of the simulation.

Finally, 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).

## **2.8 Innovative Tax Copying Mechanisms Employed by SMEs**

### **2.8.1 Business Security Measures in Line with Tax Avoidance**

The Entrepreneur Magazine Small Business (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 behavior. 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. According to Falkinger (1988) the taxpayer and government exchange relationship within an avoidance setting. Falkinger maintains that there is some theoretical support for tax avoidance or a rationalization of past behavior. He believes that inequity as a rational causal factor of avoidance becomes more credible at a low tax level. Other researchers have extended

early economic models to include 1) the taxpayer's incentive to purchase tax advisory services (Beck et al., 1996), 2) the effect of practitioners on tax avoidance (Klepper et al., 1991; Scotchmer, 1989), and 3) the effect of the tax administration (Scotchmer and Slemrod, 1989).

Weigel et al. (1987) argue that 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 behavior 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 behavioral phenomenon. Webley et al. (1991) categorize behavioral theories into two types. The first are integrative or frameworks of the taxpaying process, within which data about tax avoidance can be organized. Examples of this kind include Lewis (1982), Greenland and Van Veldhoven (1983), and Smith and Kinsey (1987). The second category is more straightforward applications of a social-psychological theory to tax avoidance.

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 expected utility theory. In their original article, Kahneman and Tversky 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.

## **2.8.2 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 & Jakabcin (1997), two basic rules apply to tax planning. First, a small business should never incur additional expenses only to gain a tax deduction. Second, 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.

## **2.9 Critical Literature Review**

### **2.9.1 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, Arinaitwe 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, & 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, deferral of projects and liquidity constraints and imperfections in the financial markets.

Incidentally, investments can be determined by more than three factors.

## **2.9.2 To Compare Taxation Effect on the Growth of Varying 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 and 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.

### **2.9.3 Tax Avoidance Measures**

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 behavior. Although not a lot of primary research has been conducted to help support policy recommendations in this subject area, but Allingham and Sandmo (1972) are lacking depth in their explanation of both the data collection process and sample selection criteria. Consequently, the current work, in the absence of adequate detail, it is extremely difficult to assess the validity and reliability of the findings.

Falkinger (1988) maintains there is some theoretical support for tax avoidance or a rationalization of past behavior. He believes that inequity as a rational causal factor of avoidance becomes more credible at a low tax level. In order to determine causality, it is important to hold the variable that is assumed to cause the change in the other variable(s) constant and then measure the changes in the other variable(s). This type of research is very complex and the researcher can never be completely certain that there are not other factors influencing the causal relationship, especially when dealing with people's attitudes and motivations. There are often much deeper psychological considerations, which even the respondent may not be aware of.

## **2.10 Summary, Research Opportunity**

The present study will attempt to address some aspects of taxation not fully covered in the studies discussed hitherto.

Taxation system has evoked great attention among many researchers in the World especially in Developed Countries. However most of the researchers concentrate more in studies which would increase the budgets “bottom-line” in terms of huge revenue collection and enforcement efforts at the expense of studies that would address the effects of such taxes on the growth of SMES.

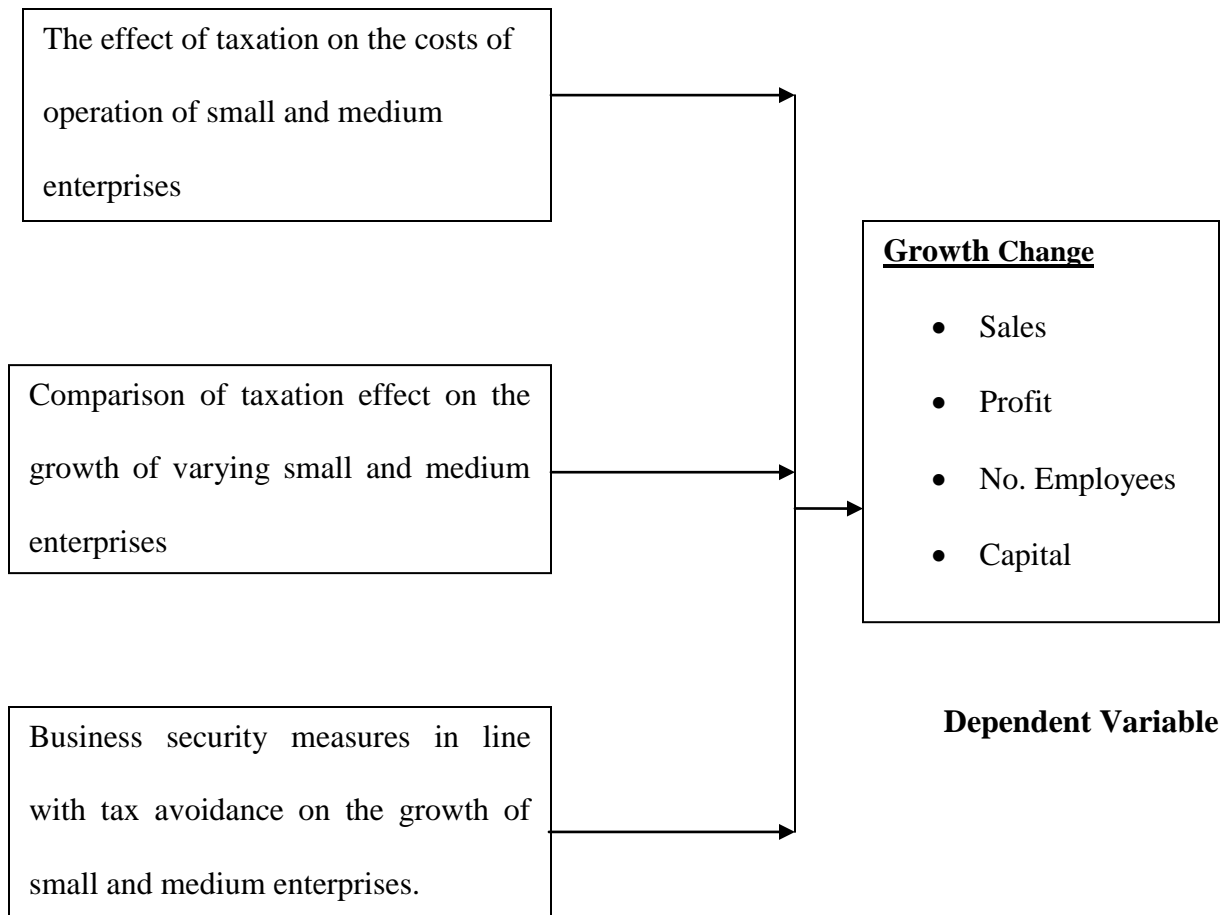
Empirical evidence shows that there has been hostility between the taxpayers and tax collectors on issue relating to tax compliance (Migwi & Wanjohi, 2010).

Previous studies have examined the impact of taxation on large and small enterprises in Africa and Kenya in particular on the growth of SMEs in Kenya. However, the reviewed literature does not adequately address ways to mitigate the high tax burden. The current study will therefore endeavor to examine the innovative tax coping mechanisms by SMEs in Nairobi County.

## **2.11The Conceptual Framework**

In this study, the relationship between the dependent and the independent variables will be investigated. These variables are as illustrated by Figure 2.1.

**Figure 2.1: Relationship between Variables in the Study**



### **Independent Variables**

**Source: Researcher's, 2011**

As derived from the taxation process models, the current study perceives the growth of SMEs as the dependent variable. Consequently, the growth of SMEs is operationalised as a process determined by the effects of taxation. Taxation variable determines the (a) cost of operation (b) 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 (see

Figure 2.1). 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 (McQueen and Thorley, 2001). 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 behavior (Allingham and 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 not limited to taxpayer's incentive to purchase tax advisory services (Beck et al., 1996), 2) the effect of practitioners on tax avoidance (Klepper et al., 1991; Scotchmer, 1989), and 3) the effect of the tax administration (Scotchmer and Slemrod, 1989).

Different types of SMEs will respond differently when subjected to the effect of taxation. The effect of taxation on varying nature of businesses can be operationalised by studying the effect of taxation on various types of businesses. The variable cost on each individual type of SMEs as a result of taxation will determine the rate of effect on the growth of such SMEs

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter describes the plan and methodology that will be adopted by the researcher in order to reach the sampled population, collect and analyze data so as to achieve the research objective. In particular this chapter outlines the procedure that will be followed in conducting the study. Section 3.2 opens by discussing the research design and the reasons why it will be used. Sub-section 3.3 describes the boundaries of Nairobi County and why it is preferred for the study. Section 3.4 describes the target population, sample size and sampling procedures. Section 3.5 discusses the tools of data collection. Methods of data analysis which includes both inferential and descriptive statistics will also be discussed. Finally, a brief description of how to test the validity and reliability of research instruments closes this chapter.

#### **3.2 The Research Design**

This research will follow both descriptive and exploration design which will explore the effects of multiple taxation on the growth small and medium enterprises. Scholars have offered varied definitions of research design. Survey design is used to ascertain the nature of a phenomenon from relatively large number of cases (NKPA, 1997).

According to Weirsma (1980), descriptive sample design is research studies conducted in order to establish the status quo. They can, he states, be useful for gathering facts in order to establish important and useful information for the business enterprise. Survey methods collect data through questionnaires or/ and interviews (Orodho 2005). Such factors as type of data, methods

of data collection, level of awareness of respondents and time dimension will dictate the type of research design used (Miller (1991). Silverman (2000) posits that descriptive and exploration research provides deeper understanding of social phenomena than would be obtained from purely qualitative data. A descriptive study, Ogula (1998) asserts is used to gather systematically factual information necessary for decision-making. They are an efficient method of collecting descriptive data regarding the characteristics of a population and the current conditions or needs (Gay, 1992).

In this study, information on costs and multiple taxation constitutes the descriptive analysis. In addition, descriptive statistics utilised with such variables as the effects of multiple taxation on operational costs and varying SMES will be confirmed through inferential statistics.

Descriptive design will also be used in this study because of its appropriateness in establishing relationships between variables and facilitating the collection of information for determining the population parameter. This will be complimented by document analysis, which will be used to collect first hand in-depth data from KRA and other authentic sources that will be used to supplement information, gathered using the descriptive design.

The descriptive studies are the most appropriate for this study because in the study, the researcher will collect information on the state of affairs of small and medium enterprises due to multiple taxation, without manipulating any variables. In summary therefore, the overall design is descriptive in nature but it is however supplemented with an exploratory approach in a purely qualitative paradigm. According to Orodho (2005), qualitative research seeks to describe and analyze the culture and behaviour of humans and their groups from the point of view of those

being studied. It is flexible and encourages researchers to be innovative. It also facilitates follow up questions that gives participants' views, and why they hold such views.

The research designs adopted for the current study will be most preferred since they have previously been utilized by YAhaya (2009) to investigate and described the challenges of multiple taxation SMEs in Kwara State as identified by tax officers in Kwara State in Nigeria. In order to obtain relevant data, a Questionnaire on Challenges of Taxation {QCT} was administered on one hundred and thirty-five purposively selected tax officials in the Kwara State Board of Internal Revenue (KSBIR) as well as Tax agents in the state. A total of one hundred and twenty questionnaires were fully completed and analyzed using relevant statistics.

### **3.3 The Study Area**

This study will be conducted in Nairobi County (see Appendix). Nairobi County comprises the administrative region of the capital city of Kenya. Nairobi County is thus synonymous with the city itself. According to the 2009 Population Census, Nairobi is the Kenya's largest urban centre with 3.1 million people (Kilele, 2010).

The choice of Nairobi County as the study area was influenced by various factors. Nairobi has been selected as the location of the study first because as the administrative and commercial capital of Kenya, the largest share (25 per cent) of modern sector wage employment is found in Nairobi (Economic Survey, 2006, p. 66) and furthermore it is the location where most of SMEs make tax returns to KRA.

Secondly, researcher's own interest formed the choice of locale'. Gay (1992) observed that factors such as familiarity to an area, limitations of time, effort and money may influence the

researchers' choice of locale. Thus Nairobi is familiar to the researcher. That was what influenced the researcher to choose Nairobi County for study.

It will also be prudent for the researcher to identify a location that facilitates data collection.

Moreover, Meredith (1996) notes that carrying out a research in a setting where you are known as a colleague and a friend facilitates data collection.

Nairobi County has over the years grown tremendously both for the population and industries and has prompted the Kenyan Government to create the Ministry of Metropolitan to manage this expansion. It has an estimated six hundred registered small and medium enterprises.

The SMEs have been divided under four major categories. These are: 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 estates), (KRA, 2010). The researcher will be able to follow the behaviour of these enterprises since most of them are accessible and centralised.

These combinations of characteristics make it an appropriate location for a study. Moreover the few studies carried out in Nairobi have only explored the effect of taxation on the growth of large enterprises and thus ignoring the effects of multiple taxation on the growth of small and medium enterprises a research gap that this study will attempt to seal.

### **3.4 The Target Population**

Borg and Gall (1996) defines population as all members of a real set of people, events or objects to which the researcher wishes to generalize the results of the research. According to Chein (1981), a population is the aggregate of all cases that conform to some designated set of specifications (Frankfort-Nachmias & Nachmias, 1996, p.179).



The target population in this study will comprise all the registered SMEs and which make tax returns to KRA. There are currently 574 SMEs which meet this condition in Nairobi

These differ by type and size. These are: 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 estates), (KRA, 2010). These SMEs are distributed across the administrative units.

From these SMEs, all the finance managers will constitute the target population because they are directly in charge of tax management of these SMEs. Table 3.1 shows the target population.

**Table 3.1: Target Population**

Respondents	Other Services	Manufacturing & agriculture	Wholesalers & retailers	Financial services	Total
finance managers	239	133	89	133	574

**Source: Researchers' 2011**

### **3.5 Sampling Techniques and Sample Size**

#### **3.5.1 Sampling Technique**

According to Orodho (2005), sampling is a technique where the investigator seeks knowledge or information about a whole population, objects or events by observing a sample, and extending the findings to the entire population.

One importance of sampling of sampling is that it saves time and money.

This study will employ stratified random sampling within each stratum. Random sampling designs are based on selections where each individual or item has an equal chance of being

represented (Cooper & Schindler). There are many random sampling designs, but the researcher will only employ two designs: stratified and simple random sampling designs.

The SMEs in the population differ by type – services, wholesalers and retailers, manufacturing and agriculture and financial services.

In order to ensure that these different categories are adequately represented in the sample, stratified sampling will be used. According to Frankfort-Nachmias and Nachmias (1996), stratified sampling is used primarily to ensure that different groups in the population are adequately represented in the sample.

These are: 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 estates), (KRA, 2010). These SMEs are distributed across the administrative units

The SMEs in Nairobi County will therefore first be classified according to whether they are services, wholesalers and retailers, manufacturing and agriculture and financial services. The population will thus be sub-divided into four mutually exclusive strata which will be based on the four types of SMEs. The list obtained will serve as the sampling frame from which a representative sample of the population will be obtained.

Simple random sampling will be used to draw the types of SMEs from each stratum. According to Doane (2007), in a simple random sampling, every item in the population has an equal chance of being chosen in a sample of items. For instance, in the stratum other services; airline, hotels, education, health, commercial, general services and clearing and forwarding will be selected by use of simple random.

### 3.5.2 Sample Size

A sample is a representative subset of a population (Nachmias & Nachmias, 1996). According to Singleton and Royce (in Orodho, 2005), the extreme upper limit of the sample size is 2000- 3000 while the extreme lower limit is 30 cases for statistical data analysis.

Gay (1992) asserts that for survey design, a sample of at least 20 per cent is justifiable for the study. On this strength, the researcher will take a sample size of 114 SMEs.

Consequently, the sample size of 114 finance managers will therefore be satisfactory for the study, given cost and time constraints. Table 3.2 shows the sample size.

**Table 3.2: Determination of Sample Size across Strata**

<b>Stratum</b>	<b>Population</b>	<b>Sample</b>	<b>Percentage</b>
Wholesalers & Retailers	89	17	20%
Manufacturing & Agriculture	133	26	20%
Financial Services and Related Services	133	26	20%
Other Services	239	45	20%
<b>Total</b>	<b>574</b>	<b>114</b>	<b>20%</b>

To make the strata on financial services, related services and other services clearer, they were further disaggregated into constituent substrata. These data are presented in Table 3.3.

**Table 3.3: Determination of Sample Size across Stratum**

<b>Sub-Strata</b>	<b>Population</b>	<b>Sample</b>
<b>Other Services</b>		
Airline	16	3
Hotels	43	8
Education	10	2
Health	16	3
Commercial	32	6
General Services	16	3
CFC	106	20
<b>Total</b>	<b>239</b>	<b>45</b>
<b>Financial Services and Related Services</b>		
Construction	72	14
Financial Services	15	3
NGOs	15	3
Real Estates	31	6
<b>Total</b>	<b>133</b>	<b>26</b>

**Source: Research (2011)**

The rule of 20% as envisaged by Gay (1992) has been upheld in Table 3.2 and Table 3.3.

### **3.6 Methods of Data Collection**

The research will be conducted using questionnaires and document analysis.

Sub-section 3.6.1 and sub-section 3.6.2 describe what the questionnaires and the Document Analysis contain and how they will be utilized in the current study.

#### **3.6.1 The Questionnaires**

A Questionnaire is a set of questions or statements that assesses attitudes, opinions, beliefs, and Biographical information (McMillan Schumacher, 2001). The current study will utilize Questionnaires because of their economy, permit use of standardized questions, and they have uniform procedures, provide time for subject to think about responses and are easy to score.

Questionnaires also provide greater anonymity. In this study, this is important because information regarding taxation may invoke some reticence on the part of respondents (Weirsma, 1980).

And since a large quantity of data is required, the questionnaire is suitable for this study. The current study will also use them because the population under study can read and write and the researcher did not mail the questionnaires but administered them directly and with the issue of ambiguous items, the researcher will review the reliability and validity of these items with the help supervisors and peers. Further, the researcher will conduct a pilot study to find out if the questionnaires can gather the information they are meant to gather.

The questionnaire will be administered to accountants of the SMEs due to their busy schedules.

The closed and semi-closed questionnaire will be used to collect data relating to the topic of study from the 114 finance managers within Nairobi County.

The Questionnaire will consist of four sections. Section A seeks background information of the SMEs. Section B will seek for information about the effect of multiple taxation on the costs of operation of small and medium enterprises. Data to be collected through questionnaires on costs of operation includes tax/es charged on small and medium enterprises. The impact of such taxes on the costs of operation will also be sought. It will also be important to gather information on the effect of such costs to the growth of SMEs. Statistics of the various types of taxes, estimation of effective tax rates, and threat of multiple taxes on the growth of SMEs will constitute data collection procedures.

Section C will solicit for data that seeks to compare multiple taxation effect on the growth of varying small and medium enterprises (services, wholesalers and retailers, manufacturers and agriculture and financial services). To enhance data collection in this section, data on the effect of taxation on each of the various types of SMEs will be collated and tabulated. The collected information will then be compared to bring out the desired correlation about the magnitude of effects. In addition, data will be provided on the basis of firm size groupings to enable the researcher to compute differential tax effective rates by business category. This will enable the researcher to quantify the impact of various programs in terms of both the impact on the tax rate on individual business, and to measure the differential impact between small and medium business.

Section D will try to establish the entry and exit behavior effect of small and medium enterprises as result of multiple taxation follow-up. The collection of this type of data will involve the researcher to consult various documents to establish the entry and exit behavior of SMEs. In addition, records from KRA will be useful in providing crucial information about tax returns.

Data if available on the number of taxes charged on individual businesses will also be gathered. This will entail collecting data on various goods as they transit from one point of production to another.

Finally, section E will collect information on business security measures in line with tax avoidance on the growth of small and medium enterprises. First, the questionnaires will gather information on what tax security measures are available for the SMEs in Nairobi County. The questionnaires will also contain items that seek information on methods applied by SMEs respond to the effect of multiple taxation.

The sub-sections in the questionnaire will contain Likert Rating (LR) Scale which consists of five statements adopted from Stevens (1951).

### **3.6.2 Secondary Data 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. The current research will use documents to collect data because they will provide background information on the topic under focus and they will allow for criticism to ascertain authenticity of the information that will be collected and therefore give a clear picture of taxation. The documents will assist the researcher to study information from KRA and data from other sources.

Using a document checklist, it will be possible for the researcher to systematically collect relevant data from documents about the trends of tax returns by the SMEs. In this case, document such as budgets, financial records, and entry and exit behavior from SMEs will be collected and then analyzed.

### **3.7 Data Collection Procedure**

The document analysis checklist will be used to collect secondary data from such bodies as KRA, while questionnaire will be used for collecting primary data from the accountants.

Secondary data constitute information from already written sources such as taxation policy documents, budgets and financial records from the SMEs and KRA. The researcher will collect these documents and record the data from them on the Document Analysis Checklist to assist in review of related literature and also enriching and/or verifying the primary data during the compiling of this report.

To ensure that collection of data necessary for study is collected on time, the researcher will involve services of research assistants. These research assistants will be identified and trained to equip them with the necessary skills prior to the actual data collection. The main purpose of training research will be to ensure that ethical research considerations will be strictly observed.

Specifically, research assistants will ensure that enough copies of questionnaires and covering letters are prepared and also contacting the respondents by mail or telephone requesting them to take part in the current study. After preparing enough copies and familiarizing with the locations, the researcher will assign the research assistants specific duties for the respective units in Nairobi County.

Primary data will be gathered from accountants of various SMEs in the field after obtaining the Research Permit, developing the work plan, pre-testing the instruments through a pilot study, and preparing enough copies of the instruments (questionnaires) ready for distribution.

Researcher will personally visit all the sampled 114 SMEs in the County and administered the questionnaires to the finance managers, after establishing a rapport with each general manager of



the SMEs explain the purpose of the study and assure the general. Managers that the information they will be given will be kept confidential. This will ensure high response rates. Enough time will be allowed to fill the questionnaires and after one week, they will be collected. Cooper (1984) asserts that one of the ways to maximize questionnaires response as well as the return rate is by sending a preliminary notification about the questionnaires, and writing passionate requests for cooperation by the respondents. To this end the researcher will make passionate appeals for accountants to cooperate by filling the questionnaires and then alerting the researcher for collection.

### **3.8 Data Analysis**

This sub-section discusses the procedure that will be utilized in data analysis techniques to be used in the current study. After collection of the questionnaires, the first step will task the researcher to read through them in order to ascertain their numbers and to see how/ if all the items will be responded to.

Secondly, the raw data will be sorted out and edited to identify blank spaces or unfilled items, spelling mistakes and those that could have been wrongly responded to. Questionnaires will be organized and classified according to the patterns of the responses given by the respondents, and their homogeneity. Questions will then be coded for purposes of allocations of the magnitude of what is being measured.

Descriptive statistics will be used in the analysis of the data. Descriptive statistics using frequency distributions and percentages will be used to analyze the data. Descriptive statistics contain discrete numerical data (Mugenda and Mugenda, 1999).

Descriptive statistics which include frequencies distribution, percentages, and measure of central tendency such as means, mode and measure of dispersion which includes standard deviations will be derived. These analyzed data will be used to summarize findings and describe the population sample involved.

Qualitative data will be derived from the open-ended questions in the questionnaire. The responses will be organized in relation to the themes or research objectives and from this information, the researcher will write a narrative and interpretive report in order to explain and reflect the situation as it will be occurring in the selected sample.

The coded data will be entered in the computer for analysis using the Statistical Package for Social Sciences (SPSS) version 17.5.

The results of data to be analyzed will be presented in form of tables that will show numerical values in rows and columns. Results from descriptive analysis will be presented both in text and tabular form. Figures that will be drawn from the results in tables will also be used to present the results.

The ensuing sub-sections will discuss the methods of data analysis used in each of the research question/variable in the current study.

### **3.8.1 Methods of Data Analysis Utilized on the Entry and Exit Behavior Effect of Small and Medium Enterprises**

Using a document checklist, it will be possible for the researcher to systematically collect relevant data from documents about the trends of entry and exit of SMEs. In this case, document such as records on entry and exit behavior for SMEs will be collected and then analyzed.

Descriptive statistical tools such as mean, mode and measure of dispersion such as standard deviation will be utilized in the current study. Descriptive statistical tools will be useful in providing a true picture on how SMEs enter the business and then exit after being subjected to a series progressive of taxation.

### **3.8.2 Methods of Data Analysis on the Effect of Multiple Taxation on the Costs of Operation of Small and Medium Enterprises**

After the collection of raw data, coding will be done using numeric codes. This coding of data will be useful in that it is quick for data entry and important in subsequent data re-entry in case a possible error has been spotted. The coded data will be captured through SPSS.

Descriptive statistical tools such as frequency distributions tables, percentages, the measure of central tendency (mean and mode) and the measure of variability will also be utilized. These statistical tools will describe trends and the distribution of data on the effect of taxation on the costs of operation on SMEs.

### **3.8.3 Methods of Data Analysis on Business Security Measures on the Growth of Small and Medium Enterprises.**

After the collection of raw data, listing of responses will be done. Secondly, the listed responses will be condensed and reduced to reduce the number of items to be coded. Coding will be done using numeric codes. The coded data will be captured through SPSS. Descriptive statistical tools such as frequency distributions tables, percentages and median will also be utilized. The statistical tools used will describe trends and the distribution of data on business security measures on SMEs.

### **3.8.4 Methods of Data Analysis Used To Compare Multiple Taxation Effect on the Growth of Varying Small and Medium Enterprises**

In order to compare multiple taxation effect on the growth of varying small and medium enterprises, a one-way ANOVA will be applied. This will involve examining the relationship among the different categories of SMEs when subjected to multiple taxation. One-way analysis of variance will be preferred because it is capable of comparing the means of three or more groups on a given attribute (Seward, 2007). ANOVA produces F statistics.

In interpreting the researcher will focus on the N, Mean, F ratio value and the Sig. level, and ignore the peripheral information such as standard deviation, standard error, sum of squares between and within groups.

The analysis of variance will identify variations in the dependent and independent variables if p value is less than 0.05, meaning that the F statistic is not due to chance or sampling error.

This will mean that there is a statistically significant difference in the effect on the growth of varying small and medium enterprises as a result of multiple taxation.

### **3.8.5 Methods of Data Analysis on the Growth of SMEs**

To measure the growth of SMEs, the study will employ multiple regression models. Multiple regression attempts to determine whether a group of variables together predict a given dependent variable (Orodho, 2005). Multiple regressions incorporate more than one independent variable to explain variations of the dependent variables. The multiple regression models assume the form:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Where;

$Y$  = Growth of SMEs,  $\beta_0$  = the intercept

$\beta_1, \beta_2, \beta_3$  and  $\beta_4$  = partial regression coefficients (shows the change in the expected value of  $Y$  for a unit change in  $X$ )

$X_1$  = behavior effect,  $X_2$  = cost of operation,  $X_3$  = data security,  $X_4$  = nature of business

$\varepsilon$  = random error

For every value of  $\beta$  (slope), a t-value and significance level for each t-value will be determined.

An independent variable will be considered to be a significant predictor of the dependent variable if the absolute t-value of the regression coefficient associated with the dependent variable is greater than the absolute critical t-value.

The overall fit of multiple regressions will be based on the F-test. The basis of F-test is based on ANOVA test. The common measure of overall fit used in the current study will be the coefficient of determination or  $R^2$ , which is based on ANOVA table's sum of squares. The coefficient of determination  $R^2$  is used in the context of statistical models whose main purpose is the prediction of future outcomes on the basis of other related information

One-way analysis of variance will be preferred because it is capable of comparing the means of three or more groups on a given attribute (Seward, 2007). The four predictors in the model will be (a) behavior effect, (b) cost of operation, (c) data security and (d) nature of business. ANOVA will be most preferred in the study because it can be used to examine differences among the means of several different groups at once. Since ANOVA is used to test independent variables, the researcher will opt to use it.

The researcher's main test of importance here will be to find out whether or not the dependent variable (response) is determined by any group of independent variables (predictors). F-test will

be used with the assumption in mind that the four samples will be randomly selected from the population and the populations being sampled have equal variances.

One of the assumption of ANOVA is that the response variable will be measured at interval or ratio scales.

### **3.8.6 Hypotheses Testing**

Descriptive statistics used to analyze data will be used to summarize finding and describe the population sample involved in hypotheses testing and making of inferences.

The general guideline that will be used is that the significance value (p or sig.) that represent the percentage or the probability the results are due to chance. The convention to be used is that results must be equal or less than 5 % to chance. That is p must be smaller or equals to 0.05 in order to claim the relationship to be truly significant (Seward, 2007).

Because hypothesis three asks for comparison between two groups: the entry and exit behavior among SMEs and these two are interval data, t-test should be used to analyze the relationship between entry and exit behavior of SMES due to effect of multiple taxation.

Interpretations and decisions on the results of the hypotheses test will be dependent upon the p-values (shown as p in the results). The rule of thumb applied that if the p-value is more than 0.05 the researchers will not reject the null hypothesis. If it could be less than 0.05, then the researcher could reject the Null hypothesis and take up the alternative hypothesis.

Significance will be tested at a level of 0.05, therefore meaning that, the independent samples t-test will be used to compare two independent groups: those SMES entering and those exiting this field when categorized by the effect of multiple taxation because the categories are only two and

this test is normally used to compare the means scores of two sample to a known value, thus comparing the average of the two sample. According to (Seward, 2007), a t-test is any statistical test in which the test statistic follows a student's t distribution if the null hypothesis is supported.

The independent samples t-test will assist the researcher in comparing mean values of those SMEs entering and those forced out of these trades due to multiple taxation and to find out if the difference between the means was statistically significant. This test will be preferred because the two groups will be randomly drawn from normally distributed and independent populations of SMEs therefore meaning that these will be two non-overlapping groups. The test will be preferable since it will help to compare the two independent groups on the same attribute (multiple taxation).

One-way analysis of variance will be used to test the second hypothesis and this test will be preferred because it is capable of comparing the means of three or more groups on a given attribute. This therefore will lock out the use of the t-test to test the second hypothesis because SMEs will be categorized as from : (a) services, (b) wholesalers and retailers, (c) manufacturers and agriculture and (d) financial services. ANOVA will be most preferred in the second hypothesis because it can be used to examine differences among the means of several different groups at once. Since ANOVA is be used to test independent variables, the researcher will opt to use it.

Since F- distribution is the ratio of two variances, the ANOVA test statistic will generate F test statistic. In interpreting the researcher will focus on the N, Mean, F ratio value and the Sig. level, and ignore the peripheral information such as standard deviation, standard error, sum of squares

between and within groups. The null hypothesis will be rejected if the F test statistic (calculated value) exceeds the critical value. The null hypothesis is also rejected if p value is less than 0.05, meaning that the F statistic is not due to chance or sampling error.

The researcher's main test of importance here will be to find out whether or not multiple taxation effect for the four categories of SMEs will be equal or there will be a difference. ANOVA test will be used with the assumption in mind that the four samples will be randomly selected from the population and the populations being sampled have equal variances.

One of the assumption of ANOVA is that the response variable will be measured at interval or ratio scales.

### 3.9 Validity and Reliability

A pilot study is the pre-testing of the research instruments in the field to determine the validity and reliability of the research instruments. Table 3.4 shows the population to be covered.

**Table 3.4 Study Population**

Respondents	Other Services	Manufacturing & agriculture	Wholesalers & retailers	Financial services	<b>Total</b>
finance managers	239	133	89	133	<b>574</b>



### **3.9.1 Internal Validity and External Validity**

A research study has internal validity if the outcome will be dependent upon the variables specifically under study. According to Weirisma (1980), validity is the extent to which the instrument measures what it was designed to measure (Weirisma, 1980, p. 215).

There are many forms of internal validity; namely, content validity, construct validity and criterion validity; however only content validity will be crucial in this study.

Content validity is the extent to which the content of the instrument in terms of the statements, questions or indicators represents the property being measured (Frankfort-Nachmias & Nachmias, 1996). According to Gay (1997), content validity is established by an expert. The researcher will therefore consult the supervisors to approve the content of the instruments.

On the other hand, a study has external validity if the findings generalize to other situations and subjects beyond those that will be studied (Orodho, 2009). In this study, the researcher will be interested with population validity. Population validity is the extent at which the researcher studies a sample of subjects with the objective of generalizing from the sample to the population from which the sample is drawn (ibid). In the present study, the researcher will ensure external validity by selecting a sample from which the generalizations will be made is indeed representative of the population being generalized to. The population to which the study is based will be the small and medium enterprises in Nairobi County.

### **3.9.2 Reliability**

Reliability refers to consistence of measurement or the extent to which the results are similar over different forms of the same instrument or occasions of data collection and the extent to which measures are free from errors (McMillan & Schumacher, 2001). According to Orodho (2005), reliability of an instrument concerns the degree to which a particular instrument can consistently yield a similar result over a number of repeated trials .The researcher will use the test-re-test method to determine the reliability of the instruments. Whereas we have many other reliability methods such as split-halves, equivalent form and the internal consistency techniques, the researcher will to use test- re-test which is appropriate for this study.

The developed questionnaires will be administered to accountants in the pilot SMEs twice at an interval of one week. The scores of each administration will be recorded separately. Pearson's Product Moment Formula will be used to calculate the correlation coefficient between the tests.

Berthoud (2000) states that a reliability index of a minimum of 0.6 is satisfactory for any research instrument.

According to Orodho (2005), a coefficient correlation ( $r$ ) of about 0.75 and above should be considered high enough to judge an instrument as reliable. The researcher's value of coefficient correlation ( $r$ ) will be based upon attaining either of these coefficients to determine whether the instruments will be considered reliable for data collection.

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## APPENDIX I

### QUESTIONNAIRES FOR FINANCE MANAGERS

#### SECTION A

This section contains questions that relate to your business background. Please indicate your responses in the spaces provided in each item.

##### A.1 Form of business (Tick one)

Airline	
---------	--

Hotels	
Education,	
Health	
Commercial	
General Services	
CfC	
Wholesalers & Retailers	
Manufacturing & Agriculture	
Construction	
Financial Services	
NGOs	
Real Estates	

**A.2 Capital Base of Business (Tick one)**

$\leq 5$ million	
5 million	
$\geq 5$ million	

**A.3 How often does the business make tax returns to KRA? (Tick one)**

Regularly	
-----------	--

Rarely	
Never	

## SECTION B

Section B seeks for information about the effect of multiple taxation on the costs of operation of small and medium enterprises.

**B.1 Record how much you pay on each of the following taxes on average per annum for the years 2007-2010 (where applicable).**

Category	2007	2008	2009	2010
Corporate tax				
Income tax				
VAT				
Corporation tax				
Excise duties				
PAYE				
<b>Total</b>				

**B.2 Are there tax/es charged twice or more on a single product? (Tick one)**

Yes	
No	

**B.3 If yes, what are their impacts on the cost of operation? (Tick one)**

Raise costs of operation	
Reduce costs of operation	
No impact on the cost of operation	

**B.4 if the taxes charged raises the costs of operation, what is the effect of such high costs to the growth of SMEs (Tick one)**

Profits reduces	
Laying off workers	
Reduction in production	
Businesses closing down	

**SECTION C**

Section C contains questions that compare multiple taxation effect on the growth of varying small and medium enterprises (services, wholesalers and retailers, manufacturers and agriculture and financial services).

**C.1 How are the growth of following forms of business affected by multiple taxation?  
Please tick your most appropriate response.**

Forms of Business	very	moderately	Neutral	Slightly	Not affected
Airline					
Hotels					
Education					
Health					
Commercial					
General Services					
CFC					
Wholesalers & Retailers					
Manufacturing & Agriculture					
Construction					
Financial Services					
NGOs					
Real Estates					

## SECTION D

Section D contains questions that establish the entry and exit behavior effect of small and medium enterprises as result of multiple taxation follow-up.

**D.1 please provide data on your enterprise performance before and after the introduction of new multiple taxation measures**

Aspect	Before in Ksh	During the taxable period in Ksh
income		

Expenses		
Tax paid		
profit		

**D.2 how do the data in D1 figures compare in relation to the growth of SMEs**

.....  
 .....

**D.3 State the cost incurred as a result of multiple taxation**

.....  
 .....

**D.4 Are the enterprises making profits or losses**

Aspect	Profits	Losses
services		
wholesalers and retailers		
manufacturers and agriculture		
financial services		

**D.5 please read the following statements on the behavior of SMEs and indicate your level of agreement or disagreement**

Statement	Strongly agree	Disagree	Neutral	Agree	Strongly Disagree
Multiple taxation stunt growth of SMEs					

Enterprises are forced out of business due to multiple taxation					
Multiple taxation increases operation costs					
There are no businesses exiting due to taxation					
Most SMEs are winding up due multiple taxation					

**SECTION E**

Section E collects information on business security measures in line with tax avoidance on the growth of small and medium enterprises.

**E.1 please read the following statements on tax security measures that are available for the SME and indicate your level of agreement or disagreement**

<b>Statement</b>	<b>Strongly agree</b>	<b>Disagree</b>	<b>Neutral</b>	<b>Agree</b>	<b>Strongly Disagree</b>
Tax compliance					
Withholding tax					
Savings on mortgages					



Delaying of documentation					
Increased year end purchases					

**E.2 are there cases of tax evasion for SMEs as a result of multiple taxation?**

Yes	
No	

**If yes, in what form are they exhibited?**

A failure to report substantial amounts of income	
A claim for fictitious or improper deductions on a return	
Accounting irregularities	
Improper allocation of income to a related taxpayer who is in a lower tax bracket	

**E.3 how do SMEs respond to the effect of multiple taxation? Please tick your most appropriate response.**

Tax evasion	
Tax avoidance	
Legal Vagueness	

Reducing income	
Take Advantage of tax credit	
Increase your withholding	
Company merger	

### SECTION F

Section F contains questions that establish the impact of multiple taxation on the Growth of SMEs in relation to the following growth indicators: Sales, Profit, and Employees and Capital.

**Indicate in figures the following indicators for the last five years.**

Indicators	Years 2006-2010				
	2006	2007	2008	2009	2010
Sales					
Gross Profit					
Number of Employees					
Capital					