

# Journal of **Accounting** (JACC)

## **ANALYSIS OF FACTORS AFFECTING TAX COMPLIANCE BY SMES IN KIAMBU COUNTY**

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## ANALYSIS OF FACTORS AFFECTING TAX COMPLIANCE BY SMES IN KIAMBU COUNTY

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### Abstract

**Purpose:** The purpose of this study was to determine factors affecting tax compliance by Smes in Kiambu County

**Methodology:** The study adopted descriptive survey design and the research. The study population was 1084 Smes in Kiambu County where a sample size of 325 Smes was selected. Data was collected through structured and unstructured Questionnaires. Data was analyzed using Statistical Package for Social Sciences (SPSS) and results presented in frequency tables to show how the responses for the various questions posed to the respondents.

**Results:** The study findings revealed that Non compliance opportunities, compliance cost, knowledge requirements and decision frames had a positive and significant effect on tax compliance. The study led to conclusion that the authorities had a weak capacity in detecting tax evasion, it was cheaper to bribe a tax official than pay full amount of tax, corrupt, fine and penalties deterred tax evasion and that degree of regulation deterred tax evasion, that tax system and rates affected the rate and amounts of tax evasion, nature and degree of regulations affected tax evasion, size and how the business was structured had a direct or indirect effect on tax evasion, location and focus of business affected tax evasion and that the type of business the tax payers were in affected tax evasion.

**Policy recommendation:** The study recommended that the authorities should adopt high and modern technology to help in detecting tax evasion, proper measures should be emphasized on officials taking bribes, fines and penalties should be issued to those evading paying tax and that proper regulatory framework should be put in place to deter tax evasion and that the government should consider increasing tax incentives such as exemptions and tax holidays as these will not only encourage voluntary compliance but also attract investors who are potential viable tax payers in the future.

**Keywords:** *Factors analysis, Tax compliance, Smes*

## 1.1 Introduction

Most developed countries are characterized by a broad base for direct and indirect taxes with tax liability covering the vast majority of citizens and firms. Developing countries, in contrast, are confronted with social, political and administrative difficulties in establishing a sound public finance system. As a consequence, developing and emerging countries are particularly vulnerable to tax evasion and avoidance activities of individual taxpayers and corporations. This can be considered one of the primary reasons for large differences in the ability to mobilize own resources between developed and developing countries.

While tax revenues in developing countries amount to almost 36 per cent of gross national income in 2007, the share in selected developing regions amounts around 23% in Africa in 2007 and 17,5% Latin America in 2004. Nonetheless, tax revenue has increased over time in many low-income countries. However, this development is mostly due to increased revenues from natural resource taxes, e.g. income from production sharing, royalties and corporate income tax on oil and mining companies and cannot be interpreted as a sign of an improved tax system or administration. (Standard Daily June 2013)

The role of taxes in Kenya has developed dramatically to enable the government to implement its fiscal policy in order to become more independent (Maingot, 2006). The tax system in Kenya was expanded to achieve not only fiscal objectives but also economic and social objectives. Taxes in Kenya are fiscal instruments used by the government to spur the national economy, promote investment in sustainable projects, control consumption of commodities and services, and remedy income disparities among individuals (Ahamed.E&Braithwaithe, (2005). The Kenyan Government has given top priority to reforming the tax system to achieve integration and comprehensiveness in direct and indirect taxes and achieve tax equality.

However, like in many developing countries, Kenya's tax systems is characterized by tax structures being not in line with international standards, by lack of tax policy management, low compliance levels and inappropriate capacities in tax administration. The difference in revenue mobilization also stems from economic conditions (size of the informal sector). In fact, Kenya shows a trend towards the prevalence of indirect taxation. Kenya relies to a great extent on indirect taxes such as value-added taxes (VAT) with indirect taxes amounting for up to two-thirds of total tax revenues

## 1.2 Statement of the problem

SMEs just like anybody else are responsible for collecting as well as for remitting taxes, hence, important players in a country's tax system. Though the evidence is not unequivocal Hanlon (2007) most research suggests that traders who are small business owner are more likely to cheat and not comply than other groups of taxpayers Kirchler (2007). Even the Organisation for Economic Co-operation and Development considers small business owners a high-risk group in terms of tax compliance. In many cases it is impossible to prove noncompliance. For example, the US Internal Revenue Service estimates that only half of corporate non-compliance



is detected Webley, (2004), and that tax audits are generally a costly matter. Increasing voluntary compliance among business owners is thus a worthwhile endeavour. In order to do so, an in-depth understanding of the factors fostering tax evasion is essential. Hanlon M Mills L & Slemrod (2007)

While paying taxes is likely to be an important topic for small business owners, the actual experience of paying taxes and small businesses' tax behaviours have received surprisingly little attention in the small business literature. For example, when searching the International Journal of Entrepreneurial Behaviour and Research for the term "tax," there are 53 hits but only two articles deal directly with tax behavior (Maimbo, S 2010). Many other hits constitute predominantly qualitative research publications that focus on aspects of entrepreneurship other than taxpaying, for example human resource management the entrepreneurial experience or social processes of entrepreneurial innovation. It is therefore against this background that this study seeks to contribute to the quest of furthering our understanding of small business owners' tax compliance by pointing out the factors contributing to tax decisions that tend to be made by and are personally relevant to small business owners, who can be characterized as individual decision makers Schuetze, H.J (2012). It follows from such a conceptualization that tax decisions are susceptible to psychological influences. This reasoning forms the basis for what we consider the main contribution of this study: in a conceptual framework we identify the main and unique characteristics (non-compliance opportunity, knowledge requirements, and decision frames) that may inform small business owners' perception of and reaction to taxation.

### 1.3 Objectives of the Study

- i. To establish if non compliance opportunities affect tax compliance by SMEs in Kiambu county.
- ii. To assess if knowledge requirements affect tax compliance by traders in Kiambu county.
- iii. To establish how decision frames contribute to tax compliance by SMEs in Kiambu County.
- iv. To investigate if compliance costs affect tax compliance by SMEs in Kiambu county.

## 2.0 LITERATURE REVIEW 2.1 Theoretical review

### 2.2.1 Expected Utility Theory

The expected utility Theory (Bernasconi, M & Zanardi, 2004) apply cumulative prospect theory to tax evasion by considering generally two reference point of two states of the world i.e. income is audited and another one income not audited. In their setting, it is possible for the tax evader to be in the domain of gains or in the domain of losses in both states of the world. In these two cases, he showed, the paradoxical comparative static results of the Allingham-Sandmo-Yitzhaki model. Therefore, the only interesting case is that in which the tax payer is in the domain of gains if not caught but in the domain of losses if caught. Theoretical and empirical studies of tax compliance and evasion conclude that increasing penalties and

detection probabilities increase compliance. Expected utility theory advanced by (Yitzhaki, 1974) model of tax evasion predicted a negative relationship between tax rates and evasion.

This theory is relevant to the current study as it builds on the economics-of-crime model, in which an individual maximizes the expected utility of the tax evasion gamble, balancing the benefits of successful cheating against the risky prospect of detection and punishment. This approach concludes that compliance depends largely upon audit and fine rates. Indeed, its central conclusion is that an individual pays taxes only because of the fear of detection and punishment, and will pay more taxes with an increase in the fine or audit rate.

### **2.2.1 Prospect Theory**

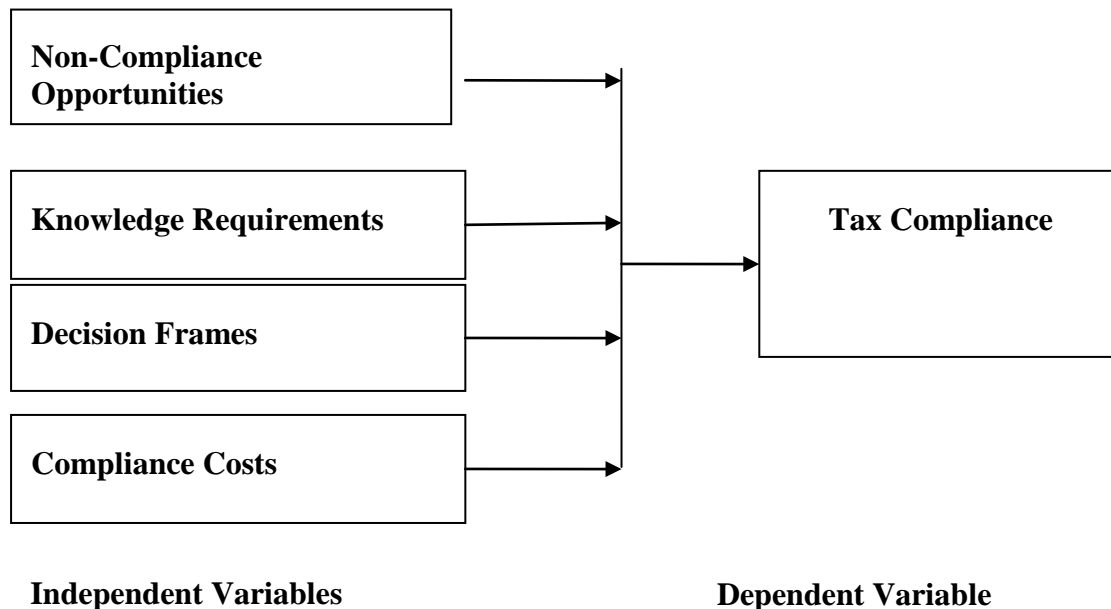
This theory suggest that If fines are imposed on the evaded tax, and if tax payers. Preferences satisfy the (theoretically and empirically plausible) assumption of decreasing absolute risk aversion (DARA), then the Expected Utility Theory (EUT) model of tax evasion predicts a negative relationship between tax rates and evasion ( Yatzaki, 1974). Much empirical and experimental evidence, however, predicts a positive relationship between evasion and the tax rate (M,Bernasconi & a Zarnardi, 2004) Owing to its lack of empirical support, and its counter-intuitive nature, the negative relationship between tax rates and evasion predicted by the EUT model has sometimes been termed the Yitzhaki paradox or Yitzhaki puzzle..

(Dhambi & Al- Nowaihi 2007) claim to show that prospect theory provides a much more satisfactory account of tax evasion including an explanation of the Yitzhaki puzzle.

Prospect theory suggests that advance tax payments may play an effective role in tax enforcement strategy. (ClotFelter 1983) found that voluntary compliance rates in the United States increased consistently with the amount of refund that taxpayers expected to receive upon the filing of a tax return and decreased consistently with the amount of taxes that they still had to pay. (Chan,c.w 200) confirmed experimentally the empirical findings for the United States and several European countries, whereas (Berkery.PM 1992), documenting diaries of taxpayers' tax-related thoughts and behaviors.

This theory suggests further suggest that taxpayers thought primarily in terms of the out-of-pocket gains and losses at the time of filing, concluding that whether taxpayers expect to receive a refund or have to supplement their prepaid taxes is important for the understanding and control of taxpaying behavior. In other contribution, (Carnes 2006) suggest that prospect theory, developed by (Kahneman and Tversky 1979), may help explain taxpayers' observed behavior under obligatory advance tax payments.

## 2.2 Conceptual Framework



## 3.1 Methodology

The study adopted descriptive survey design and the research. The study population was 1084 Smes in Kiambu County where a sample size of 325 Smes was selected. Data was collected through structured and unstructured Questionnaires. Data was analyzed using Statistical Package for Social Sciences (SPSS) and results presented in frequency tables to show how the responses for the various questions posed to the respondents.

## 4.0 RESULTS FINDINGS

### 4.1 Regression Analysis

#### 4.1.1 Pearson's Bivariate Correlation

Bivariate correlation indicates the relationship between two variables. It ranges from 1 to -1 where 1 indicates a strong positive correlation and a -1 indicates a strong negative correlation and a zero indicates lack of relationship between the two variables. The closer the correlation tends to zero the weaker it becomes. The correlation between tax compliance and non compliance opportunities was strong and positive (0.710) and significant (0.000). This shows that a change in non compliance opportunities and tax compliance changed in the same direction though the relationship was strong (0.710). However the relationship is statistically significant at a p value of 0.000. The correlation between tax compliance and knowledge requirements, decision flames and compliance cost was 0.710, 0.758 and 0.783 respectively and all had statistically significant relationships.

**Table 1: Pearson's Correlation**

Variable		Tax compliance	Non compliance opportunity	Knowledge requirement	Decision flames	Compliance cost
Tax compliance	Pearson Correlation Sig. (2-tailed)	1				
Noncompliance opportunity	Pearson Correlation Sig. (2-tailed)	0.710 0.000	1			
Knowledge requirement	Pearson Correlation Sig. (2-tailed)	0.710 0.000	0.654 0.000	1		
Decision flames	Pearson Correlation Sig. (2-tailed)	0.758 0.000	0.577 0.000	0.743 0.000	1	
Compliance cost	Pearson Correlation Sig. (2-tailed)	0.783 0.000	0.729 0.000	0.696 0.000	0.763 0.000	1

\*\* Correlation is significant at the 0.01 level (2-tailed).

#### 4.1.2 Multivariate Regression Analysis

After testing for co linearity, the study attempted to establish the statistical significance of the independent variables on the dependent variable (tax compliance) using regression analysis. The regression equation took the following form.

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

Where

Y = Tax compliance

$\beta_0$  = constant term

$\beta_1 = \beta$ coefficient

$X_1$  = Non compliance Opportunities

$X_2$  = Knowledge Requirements

$X_3$  = Decision Frames

$X_4$  = Compliance Costs

In the model,  $\beta_0$  = the constant term while the coefficient  $\beta_i = 1 \dots 4$  was used to measure the sensitivity of the dependent variable (Y) to unit change in the predictor variables. e is the error term which captures the unexplained variations in the model.

Table 2 shows that the coefficient of determination also called the R square are 71.9%. This means that the combined effect of the predictor variables (Non compliance Opportunities, Knowledge Requirements, Decision Frames and Compliance Costs) explains 71.9% of the variations in tax compliance. The correlation coefficient of 84.8% indicates that the combined effect of the predictor variables has a strong and positive correlation with tax compliance.

**Table 2: Multivariate Regression Model Fitness**

Indicator	coefficient
R	0.848
R Square	0.719
Adjusted R Square	0.713
Std. Error of the Estimate	0.25237

Analysis of variance (ANOVA) on Table 3 shows that the combine affect of non compliance opportunities, knowledge requirements, decision frames and compliance costs was statistically significant in explaining changes in tax compliance. This is demonstrated by a p value of 0.000 which is less than the acceptance critical value of 0.05.

**Table 3: ANOVA**

Indicator	Sum of Squares	Df	Mean Square	F	Sig.
Regression	31.968	4	7.992	125.484	0.000
Residual	12.483	196	0.064		
Total	44.451	200			

Table 4 displays the regression coefficients of the independent variables. The results reveal that non compliance opportunities, knowledge requirements, decision frames and compliance costs are positively and statistically significant in explaining tax compliance. The findings imply that all the independent variables were strong determinants of tax compliance.

The results indicate that; an increase in the effectiveness of non compliance opportunities by one unit leads to an increase in tax compliance by 0.282 units; an increase in the effectiveness of knowledge requirements by one unit leads to an increase in tax compliance by 0.157 units;



an increase in the effectiveness of decision flames by one unit leads to an increase in tax compliance by 0.303 units; an increase in the effectiveness of compliance cost by one unit leads to an increase in tax compliance by 0.212 units.

**Table 4: Regression Coefficients**

Variable	Beta	Std. Error	t	Sig.
Constant	0.293	0.205	1.432	0.154
noncompliance opportunity	0.282	0.063	4.474	0.000
knowledge requirement	0.157	0.067	2.36	0.019
decision flames	0.303	0.061	4.955	0.000
compliance cost	0.212	0.058	3.648	0.000

## 5.0 SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

### 5.1 Summary of Findings

#### 5.1.1 Non Compliance Opportunities on Tax Compliance

One objective of the study was to establish the effect of non compliance opportunities on tax compliance. The study findings indicated that on compliance opportunity affected tax compliance. This was demonstrated by descriptive statistics that showed that majority of the respondents agreed that the authorities had a weak capacity in detecting tax evasion, it was cheaper to bribe a tax Official than pay Full amount of tax, Corrupt tax Officials aided in tax evasion, Fine and penalties deterred tax evasion and that degree of regulation deterred tax evasion. Regression results indicated that there was a significantly positive relationship between non compliance opportunities and tax compliance is positive and significant. The findings are congruent with those in Williams and Round (2009) who noted that Business owners are often mentioned as a high-risk group in terms of tax compliance because their opportunities to evade are high. Opportunity has often been documented as a major explanatory factor in non-compliance. In particular, if incomes are not subject to automated third-party reporting, or if taxes are not withheld at source (e.g. in cases of receiving gross incomes or cash payments), opportunities to evade taxes exist.

#### 5.1.2 Knowledge Requirements on Tax Compliance

The second objective of the study was to establish the effect of knowledge requirements on tax compliance. Results indicated that those operating in SMEs had knowledge on how to evade tax. This was supported by the descriptive and inferential statistics that indicated that majority of the respondents agreed that reduction of profit made them reduce tax, through inflating of expenses reduced their tax payable, through reflection of reduced sales reduced reflected income, accounting firms were used in falsification of accounts, Amalgamation of division didn't help in reducing taxable income and that credit sales rather than cash sales reduced chances of tax compliance. Findings further indicated that the use of unreflected bad debt recovery was not reflected as income, Non issue of receipts was for cash sales, exchange or

barter trade was used to avoid cash transfer detection, Marking down prices was used to reflect a lower income and that set off transaction is used as a means to avoid cash transfers. Regression results indicated that there was a significantly positive relationship between knowledge requirements and tax compliance is positive and significant. The findings concur with those in Kirchler&Maciejovsky (2010) who found out that most Businesses are managed on unprofessional lines (poor or no business records) thus there is great uncertainty among traders in Africa region as regard to tax matters and to some extent due to their own making. Kirchler& Schneider F (2009) asserts that, many traders have expressed ignorance about taxes imposed on their businesses. They say that this is highly attributed to the poor work being done by the tax authorities leaving traders ignorant about issues like the way taxes are assessed, advantages of paying taxes and the use to which it is put. Therefore there is a need to sensitize the public especially business owners. The sensitization should be done on different taxes that impact the business owners and the rationale that underlines the imposition of taxes, because tax payers are not aware of the reasons for paying taxes, evasion of tax duties, laws and regulations are very rampant.

### **5.1.3 Decision Frames on Tax Compliance**

The third objective of the study was to establish the contribution of decision frames on tax compliance. Results indicate that decision flames affected tax compliance as this was supported by majority of the respondents who felt that the tax payer Tax Morale influenced the tax compliance, how and where the trader fitted into the society influenced tax evasion, traders paid tax or complied depending on fears of being caught, the extend which the trader was risk seeker, traders viewed on fairness on taxation equity, Tax payers had fears of being detected and that the traders had Trust on tax officials. Regression results indicated that there was a significantly positive relationship between decision flames and tax compliance is positive and significant. The findings are contingent with those in Chang et al. (1987) who pointed out that, there are other possible decision frames. Taxpayers can either view the compliance decision as a choice between a certain loss (tax payment) and a possible larger loss (tax payment plus penalty if audited); or they can view it as a choice between a certain reduced gain (net income after tax payment) and a possible larger gain (gross income without tax payment if not audited).

The findings also agree with those in Kirchler and Maciejovsky (2003) who found out that in their study using scenario techniques that even if the self-employed were given information that allowed them to anticipate additional tax payments or refunds, this information did not influence behaviour. Upon being informed about the outcome of their tax returns, they generally reacted with increased compliance towards tax refunds and with decreased compliance towards additional tax payments. Conversely, small business owners were sensitive towards information on expectations. Expected refunds had a positive effect and expected payments had a negative effect on compliance, whereas neither unexpected refunds nor unexpected payments had an impact on self-reported tax compliance.

### **5.1.4 Compliance Costs on Tax Compliance**

The fourth objective of the study was to investigate the effect of compliance cost on tax compliance. The findings indicated that compliance cost are very high and therefore intimidating the tax payers. Results are supported by majority of the respondents who agreed

that tax system and rates affected the rate and amounts of tax evasion, nature and degree of regulations affected tax evasion, size and how the business was structured had a direct or indirect effect on tax evasion, Location and Focus of Business affected tax evasion and that the type of Business the tax payers were in affected tax evasion. Regression results indicated that there was a significantly positive relationship between decision flames and tax compliance is positive and significant. The findings agree with those in Eriksen, K & Fallan L (1996) who found out that particularly small and medium sized enterprises (SME) suffer from high compliance costs. A survey among South African firms on the regulatory costs of doing business revealed that taxes, in particular VAT, are perceived as the most problematic set of regulations followed by labor regulation. Above all it is the paperwork that has to be mastered to comply with tax legislation which is deterring firms from paying their taxes appropriately. When asked on their strategy to cope with regulatory costs of running their business about 18 percent responded to simply try to avoid or evade taxation. The findings also concur with those in Habber & Reichel (2007) who found out that regulatory burdens fall disproportionately on small and medium enterprises internationally their size and nature makes the issue of tax compliance one of particular importance especially since most SMEs have access to limited resources and inadequate expertise to comply with diverse and complicated regulation. He also believes that high compliance costs can result in tax avoidance, tax fraud, and inhibit investment by way of diminishing competitiveness of the country in terms of taxation attractiveness

## 5.2 Conclusion

Based on the objectives and the findings of the study the following conclusion can be made.

The study led to conclusion that the authorities had a weak capacity in detecting tax evasion, it was cheaper to bribe a tax Official than pay Full amount of tax, corrupt tax Officials aided in tax evasion, Fine and penalties deterred tax evasion and that degree of regulation deterred tax evasion.

The study also led to conclusion that that reduction of profit made them reduce tax, through inflating of expenses reduced their tax payable, through reflection of reduced sales reduced reflected income, accounting firms were used in falsification of accounts, Amalgamation of division didn't help in reducing taxable income and that credit sales rather than cash sales reduced chances of tax compliance, that the use of unreflected bad debt recovery was not reflected as income, Non issue of receipts was for cash sales, exchange or barter trade was used to avoid cash transfer detection, Marking down prices was used to reflect a lower income and that set off transaction is used as a means to avoid cash transfers.

The study also led to conclusion that the tax payer Tax Morale influenced the tax compliance, how and where the trader fitted into the society influenced tax evasion, traders paid tax or complied depending on fears of being caught, the extend which the trader was risk seeker, traders viewed on fairness on taxation equity, Tax payers had fears of being detected and that the traders had Trust on tax officials.

Finally the study led to conclusion that tax system and rates affected the rate and amounts of tax evasion, nature and degree of regulations affected tax evasion, size and how the business was structured had a direct or indirect effect on tax evasion, Location and Focus of Business affected tax evasion and that the type of Business the tax payers were in affected tax evasion.

### 5.3 Recommendations of the Study

The study recommends that the authorities should adopt high and modern technology to help in detecting tax evasion, proper measures should be emphasized on officials taking bribes, fines and penalties should be issued to those evading paying tax and that proper regulatory framework should be put in place to deter tax evasion.

The study also recommends that traders should be taught on understanding of the rationale of taxes and knowledge of different taxes imposed on them. The study also recommends that compliance costs should be reduced as this will improve the probability of the taxpayer in complying.

The study recommends that the government should consider increasing tax incentives such as exemptions and tax holidays as these will not only encourage voluntary compliance but also attract investors who are potential viable tax payers in the future.

### 5.4 Areas for Further Research

This study was not exhaustive by any means and therefore it is recommended that another study be conducted in other counties and include other variable like multiple taxation. The same study can be conducted in another sector to test whether the findings of this study will hold true in a different context.

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