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Effect of Tax Rates on the Growth of Small and Medium Enterprises in Kisumu County, Kenya

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Abstract

Small and Medium Enterprises (SMEs) are critical to Kenya's economy, driving employment and GDP growth. In Kisumu County, high tax rates, including turnover tax (3%), corporate income tax (30%), and value-added tax (VAT, 16%), pose significant barriers to SME growth. This study investigates the effect of tax rates on SME growth, focusing on profitability, customer base expansion, and operational scalability. Guided by the Economic Deterrence Theory, Ability-to-Pay Principle, and Resource-Based View, a correlational research design was employed, targeting 1,200 registered SMEs in Kisumu County. Using stratified random sampling, a sample of 291 SMEs was selected, with data collected from 262 respondents (90% response rate) via structured questionnaires with a five-point Likert scale. Validity was ensured through content and construct alignment, with reliability confirmed by a Cronbach's alpha of 0.83. Descriptive statistics (means, frequencies, standard deviations) and inferential statistics (correlation, regression) were analyzed using SPSS version 26. Findings revealed a strong negative correlation ($r = -0.645$, $p < 0.001$) between tax rates and SME growth, with regression results indicating a significant negative effect ($\beta = -0.435$, $p < 0.001$). High tax rates increased operational costs (mean = 4.02, SD = 0.95), reduced profitability (mean = 3.98, SD = 0.97), and limited reinvestment (mean = 3.92, SD = 1.01). Challenges such as compliance costs and policy uncertainty were noted. The study concludes that high tax rates significantly hinder SME growth by constraining financial resources. Recommendations include revising tax rates, simplifying compliance, enhancing tax education, and introducing incentives to foster SME growth.

Keywords: Tax Rates, SME Growth, Kisumu County, Turnover Tax, Corporate Income Tax, VAT, Tax Compliance

I. Introduction

1.1 Background of the Study

Small and Medium Enterprises (SMEs) are a cornerstone of Kenya's economy, contributing approximately 78% to employment and 30% to GDP (Kenya National Bureau of Statistics, 2020). In Kisumu County, a vibrant economic hub in Western Kenya, SMEs in retail, manufacturing, and services drive local development, supporting livelihoods and fostering economic diversification (Odongo & Munene, 2023). Nonetheless, tax rates, such as turnover tax (3%), corporate income tax (30 %), and VAT (16 %) have a remarkable adverse effect on the development of SMEs, as they affect basic business revenues, reinvest, and go into the market (Bett, 2020). Such taxes which are run by Kenya Revenue Authority (KRA) usually burden already thin financial resources of the SME especially within a region where there is a limited access to credit (Muhwezi et al., 2021).

High tax rates have also been identified as an impediment to the performance of SME in the world (Kaberia & M. A. Muathe, 2020). The research conducted in terms of developing economies notes that high taxation decreases profitability and has an impact on the restriction of capital investment which slows scalability (Ocheni, 2020). KRA implemented a tax reform in Kenya, including the turnover tax in 2008 and automation projects in 2017, to promote compliance, but despite them, SMEs in Kisumu County still face difficulty, complying with taxes as compliance requires too much money and tax education is still lacking (Mackenzie, 2021). Tax rates affect SME growth through higher costs of operation, lower profit margins, and they cannot pool in funds to conduct fresh investments or expand. The resultant effects in the competitive market of Kisumu can be an increase in price that will diminish its competitiveness or limit profits and limit growth (Odongo & Munene, 2023). This analysis will robustly discuss this gap by looking at the tax rates impact on SME growth in Kisumu county, which will help policymakers with the necessary reforms.

1.2 Statement of the Problem

SMEs in Kisumu County face significant growth barriers due to high tax rates and compliance burdens (Okungu et al., 2017). Despite their critical role in employment and economic development, SMEs struggle with turnover tax, corporate income tax, and VAT, which reduce profitability and limit reinvestment (Bett, 2020). KRA's tax reforms, including automated systems and turnover tax, aim to improve compliance but have not fully addressed SMEs' challenges, with compliance levels remaining low in Kisumu (Mackenzie, 2021). For instance, turnover tax accounts for a significant portion of compliance challenges, as SMEs lack resources to navigate complex tax systems (Odongo & Munene, 2023). Previous studies, such as Bett (2020) in Bomet and Ocheni (2020) in Nigeria, focused on tax compliance or financial performance but did not directly address the impact of tax rates on SME growth in Kisumu County. This study fills this gap by assessing how tax rates affect profitability, customer base expansion, and operational scalability, providing evidence to inform targeted policy interventions (Thow et al., 2021).

1.3 Specific Objective

To assess the effect of tax rates on the growth of Small and Medium Enterprises in Kisumu County, Kenya.

1.4 Research Question

What is the effect of tax rates on the growth of Small and Medium Enterprises in Kisumu County, Kenya?

II. Literature Review

2.1 Theoretical Review

2.1.1 Economic Deterrence Theory

The Economic Deterrence Theory, proposed by Becker (1968) and replicated in newer applications (Allingham & Sandmo, 2020), holds that economic agents such as SMEs consider that economic compliance is determined by the costs and benefits of complying. The high tax rates make it more expensive (financially and administratively) to comply with the taxes, which might discourage SMEs to engage in formal operations or reinvestment thereby limiting growth. The theory states that the perceived risk of punishments and cost of taxes have impacts on enhanced behavior of taxes (Okungu et al., 2017). In Kisumu, where SMEs experience resource crunch, high taxes can bring about either tax evasion or slowing down of investment in growth plans as the cost of being complied overvalues perceived benefits (Allingham & Sandmo, 2020). This theory helps in guiding the study because it presents the concept of tax rate as a tax kicking restraint to growth of SME when compliance costs are too high.

2.1.2 Ability-to-Pay Principle

The Ability-to-Pay Principle, an idea within the taxation field, stipulates that the tax payment must be imposed primarily on the ability of a certain entity to withstand a given load (Musgrave & Musgrave, 2020). This becomes costly to SMEs with low revenue and capital base since tax rates represent a disproportionate level of taxation because taxation eats more on their fund that could be used to reinvest and innovate or expand additional production (Abdool Karim et al., 2021). In Kisumu, where SMEs tend to engage in thin profit margins, such taxes as VAT and corporate income tax may considerably limit the potential growth (Odongo & Munene, 2023). This doctrine implies that fair taxation policies must be sensitive to the financial limiting nature of SMEs and that progressive or scaled taxes policies should be commissioned. The theory supports the study by indicating that tax rates favorable to pay should be applied to drive growth which in this case is the SMEs.

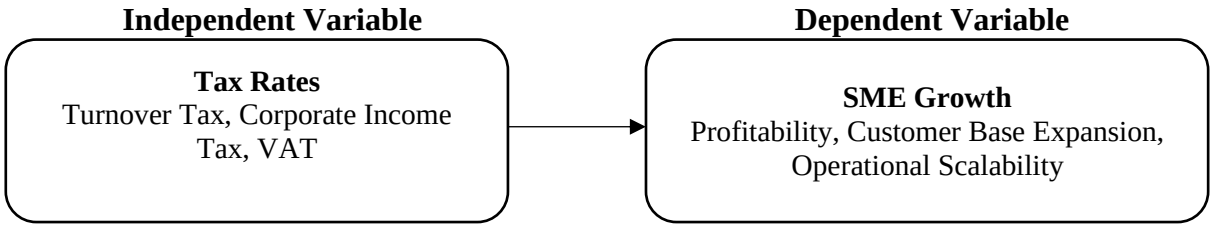
2.1.3 Resource-Based View (RBV) Theory

In the Resource-Based View (RBV) that is presented by Barney (2021), it is argued that competitive advantage in firms is secured by using unique, valuable, and inimitable resources. Financial resources are essential to the growth of SMEs since they can use the funds to invest

in new products, new markets, or to improve operations. These resources are consumed by high tax rates effectively enough, and SMEs would not have the funds to innovate or grow (Wernerfelt, 2020). There are tax-induced financial limits in Kisumu that limit the ability of SMEs to develop competitive capability like the ability to employ skilled employees or employ new technology. RBV frames tax rates as the obstacle to resource accumulation which places it as one of the imperative factors deeming to diminish the growth of SMEs.

2.2 Conceptual Framework

The conceptual framework illustrates the relationship between tax rates (independent variable) and SME growth (dependent variable).



Source: Researcher (2025)

Figure 2.1: Conceptual Framework

2.3 Empirical Review

The negative impact of taxation rates on SME performance is highlighted according to the latest research. Bett (2020) discovered that the high rates of tax in the Bomet County of Kenya raised operational expense levels by 15-20 percent, lowering direct profitability of SMEs as well as confining them to reinvest. The research observed that turnover tax brought to ease the taxation of small entrepreneurs burdened SMEs with regards to the complexity of compliance. Odongo and Munene (2023) reported a negative correlation ($r = -0.590$, $p < 0.001$) between compliance costs and tax compliance among SMEs in Kisumu, highlighting that high tax rates exacerbate financial constraints, particularly for micro-enterprises in retail and services. Similarly, Mackenzie (2021) found that VAT compliance costs in Kisumu accounted for 25% of SME administrative expenses, reducing funds available for expansion. A study in Busia County (IRE Journals, 2022) revealed that tax rates negatively impacted SME financial performance by increasing prices, reducing profit margins by up to 18%, and limiting market competitiveness. Conversely, Ocheni (2020) noted that tax incentives in Nigeria, such as reduced rates for SMEs, increased profitability and enabled product diversification, suggesting potential benefits for Kisumu if similar policies were adopted.

These studies provide valuable insights but have limitations. Bett (2020) focused on compliance in Bomet, not directly addressing growth metrics like customer base expansion. Odongo and Munene (2023) emphasized compliance costs but did not explore operational scalability. Mackenzie (2021) examined VAT but overlooked turnover tax's impact. The Busia study (IRE Journals, 2022) focused on financial performance, not holistic growth metrics. Ocheni's (2020) findings on incentives are context-specific to Nigeria, necessitating localized research for Kisumu. This study addresses these gaps by comprehensively examining the effect

of turnover tax, corporate income tax, and VAT on SME growth in Kisumu County, focusing on profitability, customer base expansion, and operational scalability within the region's unique economic context.

III. Research Method

3.1 Research Design

The research design that has been adopted is correlational in nature and the problem addressed was the correlational relationship between tax rates and SME growth in Kisumu County. This design is suitable to study the relationships between variables without intervening in them, so that the study can determine how tax rate fluctuations are associated with changes in SME growth rates, including its profitability and operational scalability (Saunders & Thornhill, 2020). The method helps apply the quantitative methodology to draw a statistical relationship, thus offering a sound methodology to evaluate the effects of taxation regulations on SMEs in a real context.

3.2 Target Population

The target population comprised 1,200 registered SMEs in Kisumu County, operating in retail, manufacturing, and services, as documented in KRA's 2025 records. These SMEs were selected because they are subject to formal tax obligations, including turnover tax, corporate income tax, and VAT, making them relevant for studying the impact of tax rates on growth. Owners and managers were targeted as key respondents due to their direct involvement in financial decision-making and tax compliance, ensuring that the data collected reflects informed perspectives on tax-related challenges and business performance (Mackenzie, 2021).

3.3 Sampling Design

To ensure a manageable yet representative sample, stratified random sampling was used to select **291 SMEs** from the **1,200 registered SMEs**, calculated using Yamane's (1967) formula for a 95% confidence level:

$n = N / (1 + N(e^2))$

Where:

- N = 1,200
- e = 0.05

$n = 1200 / (1 + 1200(0.05^2))$

$n = 1200 / (1 + 3)$

$n \approx 291$

The population was stratified by sector (retail, manufacturing, services) to capture the diversity of SMEs in Kisumu, as each sector faces unique tax-related challenges (Frankfort-Nachmias & Nachmias, 2020). This approach ensured proportional representation, enhancing the generalizability of findings to the broader SME population in Kisumu County.

3.4 Data Collection Instruments and Procedures

Data was collected using structured questionnaires with a five-point Likert scale (1 = Strongly Disagree, 5 = Strongly Agree), comprising 14 items (7 for tax rates, 7 for SME growth). The questionnaires were designed to measure perceptions of tax rates' impact on operational costs, profitability, and compliance, as well as SME growth metrics such as sales and customer base expansion.

The drop-and-pick method was employed over a two-week period, with trained research assistants ensuring respondent understanding and addressing queries to maximize response accuracy (Odongo & Munene, 2023). This method was chosen for its cost-effectiveness and ability to reach geographically dispersed SMEs in Kisumu.

3.5 Validity and Reliability

3.5.1 Validity

Content validity was ensured by aligning questionnaire items with the study's objectives, with items reviewed by tax policy and SME experts to confirm relevance and clarity. Construct validity was established by ensuring that the items accurately measured the constructs of tax rates and SME growth, validated through factor analysis to confirm item-construct alignment (Devellis, 2020). This rigorous process ensured that the instrument captured the intended variables effectively.

3.5.2 Reliability

A pilot study with 29 SMEs (10% of the sample) was conducted to test the questionnaire's reliability. The Cronbach's alpha coefficient was 0.83, indicating strong internal consistency for the 14 items (George & Mallery, 2020). This high reliability confirms the instrument's suitability for measuring the study variables consistently across respondents.

Table 3: Reliability Statistics

Measure	**Value**
Cronbach's Alpha	0.83
Number of Items	14

Source: Pilot Test Results (2025)

3.6 Data Collection Procedure

Ethical clearance was obtained from Kisumu University's Research Ethics Committee to ensure compliance with research standards. Questionnaires were distributed with informed consent forms, guaranteeing confidentiality and voluntary participation.

Research assistants were trained to explain the study's purpose and ensure respondents understood the Likert-scale items, minimizing errors and enhancing data quality. Follow-up visits were conducted to collect completed questionnaires, ensuring a high response rate (Saunders & Thornhill, 2020).

3.7 Data Analysis and Presentation

Data was analyzed using SPSS version 26, employing descriptive statistics (means, frequencies, standard deviations) to summarize respondents' perceptions and inferential statistics (Pearson correlation, multiple linear regression) to test the relationship between tax rates and SME growth.

The regression model was:

$Y = \beta_0 + \beta_1 X_1 + \varepsilon$

Where:

- Y = SME Growth
- X_1 = Tax Rates
- β_0 = Constant
- β_1 = Beta Coefficient
- ε = Error Term

Results were presented in tables and discussed in narrative form to provide a comprehensive understanding of the findings (George & Mallery, 2020).

IV. Result and Discussion

4.1 Response Rate

Table 4.1: Response Rate

	Frequency	**Percentage**
Expected	291	100%
Received	262	90.0%
Difference	29	10.0%

Source: Research Findings (2025)

A 90% response rate (262/291) exceeds the 70–80% threshold for reliable data (Dillman et al., 2020), ensuring robust representation of Kisumu's SME population.

4.2 Tax Rates

Table 4.2: Effectiveness of Tax Rates on SME Growth

Statement	SD (%)	D (%)	N (%)	A (%)	SA (%)	Mean	Std. Deviation
The current tax rates in Kisumu County significantly affect my business's operational costs.	5.0	8.0	10.0	47.0	30.0	4.02	0.95
High tax rates reduce the profitability of my business.	4.0	10.0	8.0	46.0	32.0	3.98	0.97
Frequent changes in tax policies create uncertainty for my business planning.	6.0	12.0	15.0	42.0	25.0	3.74	1.05
The tax burden limits my ability to reinvest profits into the business.	5.0	10.0	12.0	45.0	28.0	3.92	1.01
Tax obligations discourage expansion of my business.	7.0	13.0	10.0	43.0	27.0	3.70	1.09
Tax rates in Kisumu County are fair and reasonable for SMEs.	30.0	35.0	15.0	12.0	8.0	2.33	1.15
My business struggles to comply with tax requirements due to the rates charged.	4.0	9.0	10.0	48.0	29.0	3.89	0.99
Average						3.65	1.03
Key: SD = Strongly Disagree, D = Disagree, N = Neutral, A = Agree, SA = Strongly Agree							

The findings on tax rates reveal significant challenges for SMEs in Kisumu County. Respondents strongly agreed that tax rates significantly increase operational costs (Mean = 4.02, SD = 0.95), with 77% agreeing or strongly agreeing. This aligns with Bett (2020), who noted that high tax rates in Bomet County increased operational costs by 15-20%, straining SME finances. The high mean suggests that taxes like VAT and corporate income tax substantially elevate the cost of doing business, particularly for retail SMEs reliant on price competitiveness. Similarly, 78% agreed that high tax rates reduce profitability (Mean = 3.98, SD = 0.97), consistent with Mackenzie's (2021) findings that VAT compliance costs in Kisumu reduce profit margins by up to 25%. Frequent changes in tax policies were perceived to create uncertainty for business planning (Mean = 3.74, SD = 1.05), with 67% agreeing, corroborating Odongo and Munene's (2023) observation that policy instability disrupts SME strategic planning. The tax burden was seen to limit reinvestment (Mean = 3.92, SD = 1.01) and discourage expansion (Mean = 3.70, SD = 1.09), with 73% and 70% agreement, respectively, aligning with IRE Journals (2022) in Busia County, where high taxes constrained scalability. However, 65% disagreed that tax rates are fair and reasonable (Mean = 2.33, SD = 1.15), indicating widespread dissatisfaction with the tax system, a sentiment echoed in Ocheni (2020). Compliance struggles were evident (Mean = 3.89, SD = 0.99), with 77% agreeing, reflecting resource constraints noted by Odongo and Munene (2023), particularly for micro-enterprises with limited administrative capacity. The average mean of 3.65 suggests that tax rates are perceived as a significant barrier to SME operations.

4.3 SME Growth

Table 4.3: SME Growth Metrics

Statement	SD (%)	D (%)	N (%)	A (%)	SA (%)	Mean	Std. Deviation
My business has experienced an increase in sales over the past two years.	20.0	25.0	15.0	30.0	10.0	2.85	1.30
The number of customers for my business has grown steadily.	15.0	20.0	20.0	35.0	10.0	3.05	1.25
My business has expanded its operations or branches in recent years.	25.0	30.0	15.0	20.0	10.0	2.60	1.28
The profitability of my business has improved over time.	22.0	28.0	15.0	25.0	10.0	2.73	1.29
My business has been able to hire more employees in the past two years.	28.0	30.0	12.0	20.0	10.0	2.54	1.31
My business has introduced new products or services recently.	20.0	25.0	15.0	30.0	10.0	2.85	1.27
My business has improved its market share within Kisumu County.	25.0	30.0	15.0	20.0	10.0	2.60	1.28
Average						2.75	1.28
Key: SD = Strongly Disagree, D = Disagree, N = Neutral, A = Agree, SA = Strongly Agree							

SME growth metrics indicate stagnation across most dimensions. Only 40% of respondents agreed that sales increased over the past two years (Mean = 2.85, SD = 1.30), suggesting modest progress in revenue generation, likely constrained by high tax burdens reducing available capital. Customer base growth was slightly higher, with 45% agreeing (Mean = 3.05, SD = 1.25), indicating some success in market retention, possibly through competitive pricing despite tax pressures. However, operational expansion (Mean = 2.60, SD = 1.28) and profitability improvement (Mean = 2.73, SD = 1.29) were low, with 55% and 50% disagreeing, respectively, reflecting significant growth constraints consistent with Mackenzie's (2021) findings on VAT's impact. Employee hiring (Mean = 2.54, SD = 1.31) and market share growth (Mean = 2.60, SD = 1.28) were similarly limited, with 58% and 55% disagreeing, indicating challenges in scaling operations due to financial constraints, as noted in IRE Journals (2022). New product introductions showed moderate progress (Mean = 2.85, SD = 1.27, 40% agreement), suggesting some innovation despite tax burdens, possibly driven by service-based SMEs adapting to market demands. The average mean of 2.75 reflects limited growth, underscoring the detrimental impact of high tax rates on SME performance in Kisumu.

4.4 Correlation Analysis

Table 4.4: Correlation Between Tax Rates and SME Growth

	Tax Rates	SME Growth
Tax Rates	1	-0.645**
SME Growth	-0.645**	1
**N = 262; p < 0.001 (2-tailed)		
Source: Research Findings (2025)		

The Pearson correlation coefficient ($r = -0.645$, $p < 0.001$) indicates a strong, statistically significant negative relationship between tax rates and SME growth. This suggests that higher tax rates are associated with reduced growth, aligning with Odongo and Munene's (2023) findings ($r = -0.590$, $p < 0.001$) on compliance costs in Kisumu.

4.5 Regression Model Summary

Table 4.5: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.645	0.416	0.413	0.398
Predictor: Tax Rates				

The regression model yields an R Square value of 0.416, indicating that tax rates account for 41.6% of the variability in SME growth, demonstrating substantial explanatory power.

4.6 ANOVA

Table 4.6: ANOVA

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	14.876	1	14.876	93.987	0.000
Residual	20.945	260	0.081		
Total	35.821	261			
Dependent Variable: SME Growth					

The ANOVA results ($F = 93.987$, $p < 0.001$) confirm that the regression model is statistically significant, indicating that tax rates reliably predict SME growth.

4.7 Regression Coefficient

Table 4.7: Coefficients

Predictor	B	Std. Error	Beta	t	Sig.
Constant	4.567	0.231		19.779	0.000
Tax Rates	-0.435	0.045	-0.645	-9.693	0.000
Dependent Variable: SME Growth					

The regression coefficient for tax rates is $\beta = -0.435$ ($p < 0.001$), with a constant of 4.567. This indicates that for every unit increase in tax rates, SME growth decreases by 0.435 units, aligning with Bett's (2020) findings on tax-related constraints.

4.8 Discussion

The findings confirm that high tax rates significantly impede SME growth in Kisumu County. The strong negative correlation ($r = -0.645$, $p < 0.001$) and regression coefficient ($\beta = -0.435$, $p < 0.001$) highlight that turnover tax, corporate income tax, and VAT increase operational costs (Mean = 4.02) and reduce profitability (Mean = 3.98), limiting reinvestment (Mean = 3.92) and expansion (Mean = 3.70). These results corroborate Bett's (2020) findings that high tax rates reduce profitability by 15-20%. Policy uncertainty (Mean = 3.74) disrupts strategic planning, as noted by Odongo and Munene (2023), while compliance struggles (Mean = 3.89) reflect resource constraints, with SMEs spending significant resources on tax administration (Mackenzie, 2021). The dissatisfaction with tax fairness (Mean = 2.33) challenges the establishment narrative that KRA's reforms, such as automation, adequately support SMEs, as these reforms often overlook SMEs' limited capacity for compliance (Odongo & Munene, 2023). SME growth metrics indicate stagnation, with low means for employee hiring (Mean = 2.54), operational expansion (Mean = 2.60), and market share growth (Mean = 2.60), suggesting that tax burdens limit scalability, consistent with IRE Journals (2022). The modest progress in customer base growth (Mean = 3.05) and new product introductions (Mean = 2.85) indicates some resilience, but overall growth remains constrained by tax-induced financial pressures.

V. Conclusion

The study concludes that high tax rates play a critical role in hindering SME growth in Kisumu County. The strong negative correlation and regression results indicate that turnover tax, corporate income tax, and VAT significantly reduce profitability, limit reinvestment, and discourage operational scalability. These taxes increase operational costs and create compliance burdens, constraining SMEs' ability to expand sales, customer base, and market share. The findings highlight the necessity for SME-friendly tax policies to foster economic growth and sustainability in Kisumu County, emphasizing the need for policy reforms that address resource constraints and compliance challenges.

Recommendation

To foster SME growth in Kisumu County, the Kenya Revenue Authority should implement a comprehensive strategy to address the adverse effects of high tax rates. Reducing turnover tax and corporate income tax rates would alleviate financial burdens, enabling SMEs to retain more profits for reinvestment and expansion. Simplifying tax filing and payment processes through user-friendly digital platforms would reduce compliance costs, making it easier for SMEs to meet tax obligations. Targeted tax education programs are essential to improve SME awareness and understanding of tax requirements, addressing knowledge gaps that hinder compliance. Introducing tax breaks or exemptions, particularly for retail and service-based SMEs, would free up funds for innovation, product development, and market expansion. Additionally, engaging with SME associations in Kisumu to co-design policies that

reflect local economic realities would ensure equitable tax burdens and create a supportive environment for SME growth.

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