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## Relationship between increased Taxation and Financial Performance of Kenyan Firms

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### Abstract

Taxation plays a critical role in financing government activities, public services, and economic development. This study focuses on examining how taxation impacts the financial performance of firms in Kenya. The complex interplay between tax policies and financial outcomes is multifaceted, and understanding these dynamics is crucial for effective tax strategies and financial optimization. The theoretical frameworks of "Ability to Pay Theory," "Classical Taxation Theory," and "Political Power Theory" are explored to provide insight into the relationships between taxation and business performance. These theories help us understand how tax rates, incentives, and political influences can affect firms' profitability, investment, and overall financial performance. By reviewing existing literature and conducting empirical research, this study aims to shed light on the specific challenges and opportunities that taxation presents to businesses in Kenya. The study observed that the influence of taxation on the financial performance of Kenyan firms is significant and multifaceted. Understanding the effects of customs duty, PAYE, and VAT is crucial for informed decision-making and effective management of financial resources in the business environment. Further research should explore the specifics of these impacts and potential mitigating measures.

**Keywords:** Taxation, Financial Performance, Customs duty, PAYE, VAT

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### 1. Introduction

Taxation refers to the administrative and legal procedure through which a state or government imposes compulsory levies on individuals and commercial entities to finance public amenities and infrastructure. These levies can be imposed on various sources of revenue, including income, property, goods and services, capital gains, and other such financial avenues. The intricate interplay between taxation and financial performance is a multifaceted phenomenon that warrants a thorough examination. While taxation can provide governments with the funds, they need to provide

public services and infrastructure, it can also have negative effects on businesses and individuals. High tax rates can discourage investment and entrepreneurship, leading to slower economic growth. In Kenya, a multitude of tax policy revisions have been implemented, including the recent enactment of the Finance Act 2021, which was officially published on July 1, 2021. This particular legislation has extended the scope of value-added tax (VAT), resulting in the escalation of commodity prices and consequently elevating the overall cost of living.

The primary obligation of the government in any given nation is to ensure the welfare of its citizens by providing

public goods and services. To effectively execute this role, it is crucial that the government is financially equipped. Taxation serves as the primary source of funding for public expenditure in governments, whether regional, local, or central (Pade & Smetters, 2017). Additionally, taxes are utilized for various functions, including regulating and influencing economic activities and behavior, safeguarding domestic infant industries, and promoting social equity among the populace of a nation (Gravelle, 2023). According to Huang and Frenz (2014), taxes play a significant role in the economy and can be categorized into three major roles, namely the allocative role, the distributive role, and the economic stabilization role.

The utilization of taxes as a means of fostering economic development has a long history dating back several years. In Egypt, this practice was initiated as early as 2000 BC, with taxes being collected on commodities such as cooking oil. The primary objective behind the collection of taxes on various products was to facilitate the financing of government activities, specifically those related to economic developments (Deshpande, 2012). It is noteworthy that among European nations, particularly ancient Greece, taxes were imposed on all citizens to aid in covering wartime expenses. In a similar vein, Rome introduced taxes on sales of goods and services, land, polls, and exports and imports.

It is important to take note that the imposition of taxes on England was first introduced by the Roman Empire, as stated in Dowell's (2013) work. Subsequently, during the reign of Charles I from 1625 to 1649, taxation measures were implemented in England after the fall of Roman rule. These measures pertain to the taxation of land and exercise. Furthermore, taxation was introduced by the British in 1800 to provide financial resources for the war against France (Prasad, 2011).

In their inquiry, Shaho & Gerasimos (2018) embarked on an endeavor to meticulously examine the complexities linked to taxation in Iran, with a specific focus on the tax conduct of construction enterprises in the Kurdistan Province. The scholars distributed 165 questionnaires and carried out Scheffe and Friedman tests to assess the ensuing research hypotheses: the effectiveness of tax laws, the importance of tax professionals in ensuring precise tax filings, the detectability of deliberate or inadvertent noncompliance with tax regulations, and the efficiency of penalties with regard to construction companies. The results obtained from the investigation challenge the effectiveness of tax legislation and the system of rewards and punishments. Additionally, they provide evidence of the negative impact of noncompliance with tax regulations on tax revenue. Moreover, the study demonstrates that financial expertise and accounting information do not have a statistically significant role in the completion of tax reports and the reporting of taxable income. Taken together, these findings suggest a highly problematic tax system in Iran, especially in regard to the corporate tax paid by construction

companies in the Iranian Kurdistan region.

In Africa, taxation has a long-standing history that predates colonialism. The chiefs of various tribes demanded their subjects submit their harvest as taxes. During the colonial period, taxation became more formalized with the imposition of direct taxes on cash crops produced by Africans (Forstater, 2005). The taxes had to be paid using colonial currency for the purpose of achieving desired outcomes and monetizing African countries. The justification for the imposition of taxation was to promote civilization in Africa (Nagel & Murphy, 2012). Taxation can be defined as a non-refundable payment that is compulsorily introduced by governments to generate finances for economic development.

Taxation can be classified into two overarching categories, namely indirect and direct taxes, as posited by Olawale and Garwwe (2010). The former category is based on services and goods produced, while the latter encompasses corporations and income taxes, as explained by Keen (2013). Despite the onerous nature of tax obligations, taxpayers are obliged to fulfill their tax payment obligations to buttress government-led development initiatives that ultimately redound to their own welfare, as espoused by Adebisi and Gbegi (2013).

In accordance with Klaver's (2015) findings, the Democratic Republic of the Congo (DRC) imposes taxes on local public and private companies on a territorial basis of taxation. Additionally, non-resident firms and privately owned firms, regardless of whether they are SMEs or any other company conducting business within the DRC, are required to pay taxes on profits earned through fixed establishments located within the country. Gatsi, Gadzo, and Kportorgbi's (2013) study investigated the impact of corporate income tax on the financial performance of listed manufacturing firms in Ghana. To achieve their objective of selecting 10 manufacturing firms listed on the Ghana stock exchange from 2005 to 2012, the researchers employed a descriptive causal research design and purposive sampling technique. The findings of the study revealed a noteworthy negative association between corporate income tax and financial performance. However, the size of the firm, age of the firm, and growth of the firm exhibited a significant positive relationship with financial performance.

In nearly all nations worldwide, taxes are levied with the primary objective of generating income for governmental expenses while also serving additional functions (Ojede & Yamarik, 2012). It is evident that tax earnings constitute a substantial portion of Kenya's total revenue generation, surpassing 75%, thereby indicating that the government's strength lies in taxation with regard to income generation capacity.

In 2017, Kariuki conducted a study with the primary objective of investigating the impact of corporate tax planning on the financial performance of listed firms in Kenya. The study's sample encompassed all 64 companies

listed in Kenya. The results revealed that corporate tax planning and liquidity had a positive and statistically noteworthy impact on this particular research. On the other hand, the correlation between leverage and financial performance among listed companies in Kenya was found to be unfavorable but statistically significant, as revealed by the study conducted by [Kariuki in 2017](#).

A study was conducted by [Kuria, Omboi, and Achoki \(2017\)](#) to assess the impact of tax incentives on the operational effectiveness of EPZ firms in Kenya. Bivariate regression models were employed to investigate the relationship between corporate income tax incentives, capital allowance tax incentives, excise duty incentives, custom duty incentives, and VAT incentives on the performance of EPZ firms in relation to ROA and total job count. Results indicated a significant positive correlation between the aforementioned tax incentives and the performance of EPZ firms.

The study performed by [Njuru, Ombuki, Wawire, and Okeri \(2014\)](#) aimed to examine the influence of taxation on private investment in Kenya through the vector auto-regression technique. The results of this investigation underscored the significance of a well-designed tax system and the implementation of progressive tax reforms, which are essential to furnishing private investors with an adequate basis for setting up operations.

Financial performance, according to the definition put forward by [Ongeri \(2014\)](#), pertains to the proficient execution of any financial activity or the extent to which financial goals and objectives are accomplished. It reflects the efficacy of a company's strategies in attaining desirable results. Thus, as pointed out by [Antwi and Hamza \(2015\)](#), it assists in achieving daily business objectives. Conversely, inadequate performance, as per the definition above, may have negative implications for an organization's overall growth plans due to failure to meet its day-to-day operations. While there are diverse methods accessible for measuring a firm's performance, it is important to consider all measures collectively. Various line items, such as revenue from operations, operating income, cash flow from operations, and total unit sales, can be utilized to assess a firm's performance ([Njeru, 2012](#)). The firm's profitability, on the other hand, can be quantitatively evaluated through measures such as gross margin, net margin (including return on sales), return on equity, economic value added, return on equity less cost of equity, and return on capital employed.

## 2. Statement of the Problem

Taxation is a prominent facet of commercial transactions that has attracted notable consideration in both academic and practical business circles owing to its impact on financial performance. Ascertaining the precise repercussions of taxation on firms in Kenya is imperative for the formulation of efficacious tax strategies and the

optimization of financial outcomes. Nevertheless, the assessment of how taxation policies and practices in Kenya affect the financial performance of this entity presents a formidable challenge.

The domain of taxation is intricate and ever-changing, with potential impacts on business performance that are contingent on multiple factors, including tax rates, regulations, incentives, and the capacity of the company to effectively manage its tax liabilities. Prior investigations have explored the correlation between taxation and financial performance across a variety of contexts. For example, in Kenya, [Oranga and Ondabu \(2018\)](#) conducted a study that revealed that heightened tax rates had an adverse effect on the profitability and financial performance of companies. Likewise, [Matano \(2021\)](#) examined the impact of tax incentives on the financial performance of manufacturing firms in Kenya and discovered a positive association.

Nevertheless, there exists a dearth of scholarly investigations that concentrate on scrutinizing the ramifications of taxation on firms in Kenya. Consequently, it is crucial to comprehend how taxation policies, comprising tax rates, compliance expenses, and feasible incentives, impact the financial performance of the company due to the peculiar characteristics of the firms in Kenya.

This study endeavors to fill the lacuna in the literature by scrutinizing the repercussions of taxation on the financial performance of firms in Kenya. The examination will encompass an analysis of financial metrics, namely, profitability, liquidity, and investment levels vis-à-vis taxation, with a view to furnishing illuminating revelations regarding the distinct hurdles and prospects that taxation engenders for the company.

## 3. Literature Review

The literature review chapter of this study explores the effects of taxation on the financial performance of firms in Kenya. The purpose of this chapter is to provide an overview of the existing literature on taxation and financial performance, with a specific focus on firms in Kenya. This chapter covers a review of the theoretical and conceptual frameworks and concludes by analyzing the empirical review, summarizing the findings of the review, and identifying gaps in the literature.

### 3.1. Theoretical framework

The present construct, as posited by [Grant and Osanloo \(2014\)](#), serves as a guiding framework or a monitoring mechanism for a particular investigation. It represents a schematic representation of a theoretical construct in the research domain of concern, which corresponds to the hypothesis being scrutinized. The following theories will be explored in this inquiry.

### 3.1.1 Ability to Pay Theory

The notion of the ability to pay theory holds substantial significance within the realm of taxation. This theory posits that persons or entities should provide contributions to the tax system commensurate with their capacity to sustain the economic burden of taxation. Moreover, it underscores that individuals with elevated incomes or greater wealth ought to shoulder a more considerable share of taxes relative to those with lower incomes or lesser wealth. The ability to pay theory can be traced back to the works of esteemed economists who contributed to its genesis.

Adam Smith, a prominent figure in the field of economics and widely acknowledged as the progenitor of contemporary economic thought, was an early advocate of the ability to pay theory. In his seminal publication entitled "The Wealth of Nations" (Smith, 1776), Smith postulated a system of taxation that is progressive in nature and predicated on the fundamental principle of ability to pay. He posited that each member of society ought to contribute towards the sustenance of the government in accordance with their respective capabilities.

Joseph A. Schumpeter, a renowned Austrian-American economist, played a pivotal role in advancing the theory. Schumpeter's emphasis on the principle of ability to pay as a mechanism for attaining social justice via taxation represented a noteworthy contribution. He maintained that the distribution of the tax burden should be structured in a manner that mitigates inequality and guarantees equity in society.

The theory of ability to pay holds a robust correlation with the financial performance of corporations. Taxation acts as a notable element that affects the financial standing and profitability of companies. The government's implementation of a progressive tax system based on the ability to pay aims to guarantee that corporations with higher incomes or greater financial resources contribute proportionately more towards tax revenues, thereby facilitating the redistribution of wealth and promoting economic equity.

Several scholarly investigations have been conducted to analyze the effects of taxation on the financial performance of corporations. For instance, Desai and Dharmapala (2006) conducted research that found that corporate tax rates have the potential to influence the investment decisions and profitability of companies. Their study ultimately determined that higher corporate tax rates have a detrimental effect on the performance of firms. Similarly, Ombati (2021) carried out a study to assess the impact of corporate taxation on the financial performance of Kenyan firms. The results of this study demonstrated a significant adverse relationship between corporate tax rates and financial performance metrics, such as return on assets and return on equity.

### 3.1.2 Classical Taxation Theory

Eminent economists such as Adam Smith, David Ricardo, and John Stuart Mill are chiefly attributed to the emergence of the classical taxation theory in the 18th and 19th centuries. This theory primarily revolves around the principles of effectiveness, impartiality, and government non-interference in economic activities concerning taxation. A comprehensive comprehension of the classical taxation theory's genesis forms the basis for scrutinizing its association with the research theme on the influence of taxation on firms' financial performance in Kenya.

In his seminal publication, "The Wealth of Nations" (Smith, 1776), Adam Smith established the foundation for the classical taxation theory. Smith espoused the notion of a tax regime predicated on the capacity to remit, whereby taxes are imposed proportionally according to the earnings of individuals. He posited that taxation ought not to obstruct economic development and should be formulated to foster efficacy and minimal market distortion.

David Ricardo significantly broadened the classical taxation theory in his opus "Principles of Political Economy and Taxation" (Ricardo, 1817). Ricardo posited the notion of comparative advantage and contended for reduced taxation, particularly on productive undertakings, to foster capital investment, ingenuity, and economic progression.

In his literary contribution "Principles of Political Economy" (Mill, 1848), John Stuart Mill expounded on the concepts of Smith and Ricardo. The significance of a well-proportioned tax regime that upholds equity and efficiency was underscored by Mill. He also pointed out the adverse implications of excessive taxation, which include the discouragement of productivity and impeding economic advancement.

The investigation into the impact of taxation on the financial performance of firms in Kenya can be analyzed in relation to the Classical Taxation Theory through the lenses of market distortion and efficiency. The classical taxation theory posits that taxation ought not to impede economic activities and should be designed to minimize distortions in the market.

To substantiate this assertion, a study conducted by Gatsi, Gadzo, and Kportorgbi (2013) in the Kenyan milieu revealed that elevated corporate tax rates exert an adverse influence on the fiscal performance of corporations. The research demonstrated that exorbitant taxation could impede profitability, investment, and expansion for enterprises operating in Kenya.

Moreover, research conducted by Budi (2019) scrutinized the impact of taxation on the fiscal performance of manufacturing enterprises in Kenya. The results revealed a noteworthy inverse correlation between tax burden and the profitability of firms. These findings are consistent with the tenets of the classical taxation theory, which underscore the significance of reducing the tax burden on productive endeavors to encourage economic efficacy.

In synopsis, the classical taxation theory emphasizes the importance of efficacy, impartiality, and limited government intervention in economic undertakings via taxation. In reference to the study subject on the impact of taxation on firms' financial performance in Kenya, the Classical Taxation Theory suggests that exorbitant tax obligations and inconsistencies in the tax structure could potentially have unfavorable ramifications on the organization's profitability and comprehensive financial performance.

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### 3.1.3 Political Power Theory

The study of political power theory explores the relationship between taxation and the allocation of political power within a specific community. It suggests that tax policies are impacted by the dynamics of political influence among diverse interest groups. Familiarity with the origins of this theory affords a valuable understanding of its applicability to the research subject of the influence of taxation on the financial outcomes of firms in Kenya.

The genesis of the Political Power Theory can be traced back to the contributions of eminent economists such as Joseph Schumpeter and Mancur Olson. In his seminal work

"Capitalism, Socialism, and Democracy" (Schumpeter, 1942), Schumpeter emphasized the pivotal role of political elites in shaping tax policies that align with their vested interests, thereby perpetuating their hegemony. He posited that taxation can be wielded as a potent instrument for redistribution or as a facilitator for the elites to amass their riches.

In his seminal work "The Logic of Collective Action" (Olson, 1965), Mancur Olson elucidated and elaborated upon the aforementioned concepts. He placed particular emphasis on the import of interest groups and their consequential impact on tax policies. Olson posited that organized interest groups, notably those comprised of corporations or affluent individuals, wield a greater degree of influence in directing tax legislation to their benefit as compared to unorganized and fragmented groups.

In consideration of the research topic concerning the impact of taxation on the financial performance of firms in Kenya, it is posited by the Political Power Theory that tax policies and their effects on the company's financial performance may be subject to the influence of political power dynamics within the nation. This infers that the tax burden and the efficacy of tax incentives for Kenyan firms may be susceptible to the interests and power of diverse political factions.

To substantiate this assertion, a study conducted by John (2006) delved into the political economy of taxation in developing nations. The inquiry revealed that the tax policies in these countries have been affected by political factors, such as the power and interests of diverse groups. Furthermore, the investigation identified the presence of tax incentives that are specifically bestowed on particular industries or corporations based on political considerations, which could potentially affect the financial performance of these firms.

Furthermore, an investigation conducted by Kamande (2022) delved into the ramifications of tax incentives on the economic proficiency of local airlines in Kenya. The discoveries indicated that tax incentives, including investment deductions and tax holidays, can generate favorable outcomes for the financial profitability and expansion of companies. Nevertheless, the study also observed that the accessibility and potency of tax incentives might be impacted by political aspects and the negotiating power of various interest groups.

To conclude, the Political Power Theory highlights the importance of political power dynamics concerning tax policies and their consequences. In the context of the research topic pertaining to the impact of taxation on the financial performance of firms in Kenya, the Political Power Theory posits that tax policies and their consequences may be subject to influence by various groups' political interests and power. As a result, the company's financial performance may be impacted.

### 3.2. Taxation and Financial Performance

#### 3.2.1 Financial Performance

The evaluation of a company's financial health and operational efficiency is encompassed by the concept of financial performance, as stated by [Fatihudin, Jusni, & Mocklas \(2018\)](#). This concept provides valuable insights into the effectiveness of a company in generating profits, managing resources, and utilizing assets to achieve financial objectives. For assessing the overall success and sustainability of a business, financial performance is crucial. The ability of a company to manage and control its own resources is a key determinant of financial performance. Research conducted by [Lokuta et al. \(2023\)](#) established that the presence of education has a positive influence on the creditworthiness and performance of Small and Medium Enterprises. The effective handling of taxation matters necessitates the involvement of individuals with a strong educational background or business owners who possess adequate knowledge in this area.

The assessment of a company's financial performance incorporates an array of financial ratios and indicators that offer a comprehensive perspective of the company's financial position. These measures are commonly utilized to evaluate profitability ratios (including net profit margin, return on assets, and return on equity), liquidity ratios (such as current ratio and quick ratio), and efficiency ratios (including inventory turnover and receivables turnover). Such metrics are indispensable in gauging the company's profitability, liquidity, solvency, and efficiency.

In the course of conducting research on the impact of taxation on the financial performance of Kenyan firms, it is noteworthy that customs duty, PAYE, and VAT taxes exert considerable influence. Specifically, customs duty denotes a levy imposed on imported commodities and could conceivably affect the expense of raw materials and supplies for Kenyan firms. Heightened customs duty tariffs have the potential to augment their outlays, thereby exerting an adverse influence on their profitability and overall financial performance.

The tax levied under the Pay As You Earn (PAYE) system, which is subtracted from the salaries of employees, has a notable effect on the labor costs incurred by the company. Elevated rates of PAYE may lead to an upsurge in the company's expenses associated with employee remuneration, ultimately leading to a decrease in its profitability and financial standing.

The value-added tax, or VAT, is a type of consumption tax that is imposed on the purchase of goods and services. For those who operate in Kenyan firms, the VAT may have a significant impact on both their input expenditures (as a result of the VAT paid on purchases) and output pricing (due to the VAT charged on sales). Consequently, this tax can potentially affect the company's overall profitability and pricing approach, thereby exerting an influence on its

financial performance.

Several research studies have investigated the association between taxation and financial performance. As an example, [Karama, Ondiek, and Ngugi's \(2016\)](#) exploration of the influence of taxation on financial performance in Kenya established a negative correlation between taxes and profitability. This indicates that an increase in tax burdens can have an adverse effect on a company's financial performance.

Furthermore, the research conducted by [Gatsi, Gadzo, and Kportorgbi \(2013\)](#) aimed to examine the repercussions of taxation on the financial performance of manufacturing firms in Kenya. The study revealed that the imposition of taxes, such as VAT, resulted in a noteworthy adverse effect on the financial performance of these particular firms.

These investigations underscore the significance of taking into account the implications of trade tariffs, PAYE, and VAT levies on the economic achievements of Kenyan firms. By examining the firm's financial records and evaluating the ramifications of these imposts, it is conceivable to acquire an understanding of how taxation affects its profitability, solvency, and comprehensive financial performance.

#### 3.2.2 Custom Duty

Customs duty, which is a variant of import tax, can exert a notable influence on the financial performance of Kenyan firms. Kenya. The application of customs duty on imported commodities affects the cost framework, profitability, and competitiveness of the company. Several research endeavors have scrutinized the ramifications of customs duty on the financial performance of companies, yielding distinct perspectives on the implications for Kenyan firms.

The escalation of customs duty rates on imported raw materials, equipment, and supplies for Kenyan firms may result in an upsurge in production expenses and a decline in profit margins. According to a study conducted by [Wangui \(2020\)](#) on the influence of trade legislation taxes on manufacturing firms in Kenya, augmented customs duty rates have a negative impact on the financial performance and profitability of corporations.

Customs duty has an impact on the competitiveness of Kenyan firms in the market. This is because higher import taxes can lead to imported goods being more expensive than locally produced alternatives. Consequently, Kenyan firms may encounter difficulties in competing with cheaper imported products. According to [Mwangi and Gitau's \(2022\)](#) research on the influence of custom duty on financial performance in the manufacturing sector in Kenya, it was discovered that custom duty had an adverse effect on firms' profitability and overall financial performance.

Furthermore, variations in customs tariffs have the potential to exert an influence on the financial outcomes of Kenyan firms. Modifications to customs policies and

regulations can result in uncertainties and disturbances within the organization's supply chain, thereby compromising their operational efficacy and profitability. The investigation conducted by Bukachi, Gitonga, and Kosgei (2020) regarding the impact of customs tariffs on the financial performance of textile and apparel firms in Kenya illuminated the fact that inconsistent alterations to customs duties can have a deleterious effect on a company's financial standing.

To mitigate the impact of customs duty on financial performance, Kenyan firms may implement various strategies, including but not limited to sourcing locally or seeking tariff exemptions or concessions for specific goods. Furthermore, optimizing supply chain management, exploring alternative suppliers, and investing in research and development to enhance product differentiation are potential avenues for alleviating the effects of customs duty on the company's financial performance.

Overall, the impact of custom duty on the financial performance of Kenyan firms Kenya is notable. Increased customs duty rates lead to elevated costs of imported inputs, thereby impinging on profitability and competitiveness. The fluctuation of custom duty rates may also introduce uncertainties, underscoring the importance of diligent monitoring and management of the effects of custom duty on the financial performance of Kenyan firms. Such efforts are necessary to ensure sustained growth and profitability.

These investigations underscore the significance of taking into account the implications of trade tariffs, PAYE, and VAT levies on the economic achievements of Kenyan firms. By examining the firm's financial records and evaluating the ramifications of these imposts, it is conceivable to acquire an understanding of how taxation affects its profitability, solvency, and comprehensive financial performance.

### 3.2.3 Pay as You Earn (PAYE)

The PAYE system, utilized to withhold income tax from employees' salaries, presents substantial ramifications for the financial performance of Kenyan firms. The impact of tax rates and PAYE implementation can permeate the cost structure, workforce management, and overall profitability of the organization. Comprehensive research has been undertaken to explore the influence of PAYE and tax rates on the financial performance of firms, furnishing valuable insights for Kenyan firms.

The financial performance of Kenyan firms is subject to direct influence from tax rates, which serve as the determinant for the amount of income tax that is deducted through PAYE. The increase in tax rates can result in a decrease in employees' take-home pay and, hence, negatively impact their motivation, productivity, and retention. A study conducted by Mwangima (2019) on the impact of taxation on employee motivation in Kenya revealed that elevated income tax rates have adverse consequences for

employees' motivation and performance.

Furthermore, the execution of the Pay As You Earn (PAYE) system and strict adherence to tax regulations may impose various administrative duties on Kenyan firms. These obligations may include the precise computation and retention of income tax from employees' salaries, the maintenance of accurate records, and the timely remittance of taxes to the appropriate authorities. Disregard for the PAYE requirements can lead to penalties and legal consequences. Research conducted by Ochola (2017) on the influence of taxation on the performance of small and medium-sized enterprises in Migori County underscored the administrative obstacles encountered by businesses when implementing the PAYE system.

Over time, the financial performance of Kenyan firms can be impacted by alterations made to tax rates and policies. The disposable income of employees and their spending habits can be influenced by adjustments in tax rates, leading to a potential impact on the demand for Kenyan firms' products or services. Furthermore, changes in tax policies can generate broader implications for the business environment, investment decisions, and overall economic conditions, resulting in an indirect impact on the financial performance of companies.

To alleviate the impact of PAYE and tax rates on financial performance, Kenyan firms have the option of implementing several strategies. These strategies include tax planning, employee benefit programs, and talent retention initiatives. Tax planning endeavors can be utilized to optimize tax liabilities, all while ensuring compliance with tax regulations. Employee benefit programs, such as medical insurance or retirement savings plans, can be implemented to improve the overall compensation package and enhance employee satisfaction. Furthermore, investing in talent development and fostering a conducive work environment can assist in attracting and retaining skilled employees, thereby mitigating the potential negative consequences of income tax deductions.

In summary, the repercussions of PAYE and tax rates on Kenyan firms Kenya's financial performance is noteworthy. Increased tax rates can have a negative impact on employees' net income, drive, and efficiency. The adoption of PAYE imposes managerial burdens on enterprises. Adjustments in tax rates and regulations can trigger far-reaching economic consequences. Thus, it is crucial for Kenyan firms to adeptly manage these variables by deploying tax planning tactics and instituting measures to entice, preserve, and invigorate a skilled labor force.

### 3.2.4 Value Added Tax (VAT)

Value Added Tax (VAT) is a crucial component of the Kenyan taxation system, and its influence on the financial performance of Kenyan firms Kenya is of considerable importance. The determination of VAT rates and tax bases plays a critical role in shaping the company's cost structure,

pricing strategies, and overall profitability. A plethora of studies have delved into the impact of VAT and its determinants on the financial performance of firms, thereby furnishing valuable insights into the implications for Kenyan firms.

The financial performance of Kenyan firms is significantly impacted by the VAT rate, which is determined by the government. Alterations in the VAT rates can have a considerable effect on the cost of inputs, production expenses, and consumer demand for goods and services. This can lead to an increase in production costs, resulting in a reduction in profitability and a decline in the company's financial performance. According to a recent study conducted by [Mwangi and Gitau \(2022\)](#), higher VAT rates have a negative influence on the profitability of manufacturing companies in Kenya.

The tax base of the Value Added Tax (VAT), which encompasses the value of goods and services that are subject to taxation, is a significant determinant of the financial performance of Kenyan firms. A wider tax base implies a larger pool of taxable transactions, leading to increased VAT collections. However, the inclusion or exclusion of specific goods or services in the tax base may have implications for the company's pricing strategies and market competitiveness. A study conducted by [Orwa \(2019\)](#) highlights the impact of VAT on business performance in Kenya, indicating that the tax base influenced the pricing decisions of businesses, which ultimately affected their financial performance.

Compliance with value-added tax (VAT) regulations and administrative requirements can significantly impact the financial performance of Kenyan firms. It is imperative for businesses to precisely calculate, collect, and remit VAT to the tax authorities. Non-compliance with VAT obligations may lead to punitive measures, interest charges, and legal consequences. Accurate record-keeping and reporting systems are essential to ensuring compliance with VAT regulations. A scholarly inquiry conducted by [Keraro \(2017\)](#) highlighted the administrative hurdles faced by businesses in conforming to VAT regulations, particularly among SMEs in Nakuru's central business district in Kenya, and underscored the significance of effective tax administration to augment compliance.

To address the consequences of value-added tax (VAT) and its determinants on financial performance, Kenyan firms have the option of considering various strategies, including efficient tax planning, cost management, and market positioning. Engaging in tax planning activities can prove beneficial in terms of optimizing VAT liabilities and identifying opportunities for input tax recovery. By implementing effective cost management practices, the impact of VAT on production costs can be minimized. Moreover, comprehending customer preferences and market dynamics can aid in establishing competitive prices and maintaining market share despite the cost implications

associated with VAT.

In summary, the impact of value-added tax (VAT) and its determining factors on the financial performance of Kenyan firms Kenya is significant. The rates of VAT and the tax base intricately affect the cost structure, pricing approaches, and profitability of the company. Additionally, adherence to VAT regulations and administrative obligations is of paramount importance to circumvent the imposition of penalties and legal ramifications.

[Marshall and Rossman \(2016\)](#) have acknowledged the conceptual framework as a mechanism for substantiating a given study. This notion is consistent with [Ravitch and Riggan's \(2017\)](#) assessment of the framework as a platform that stimulates debate for the research. The two scholars emphasized the importance of grounding the conceptual framework in the literature relevant to the focus of the study. These elucidations collectively underscore the indispensable relationship between the conceptual framework, the study's purpose, and the configuration of research components.

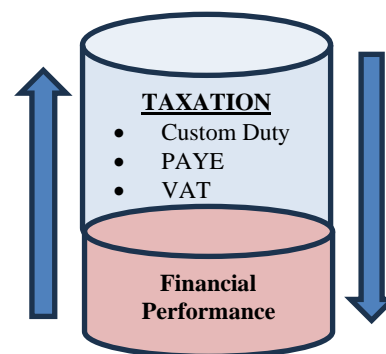


Figure 1: Taxation & financial performance

Figure 1 presents a lucid and all-encompassing portrayal of the correlation between the level of taxation and the financial performance of firms in Kenya. It is evident from the graph that there is a direct correlation between an increase in taxation and a decline in the financial performance of Kenyan firms. This implies that as the rate of taxation imposed on these firms rises, their ability to generate profits and achieve positive financial outcomes diminishes. Therefore, it can be inferred that the financial well-being of Kenyan firms is negatively impacted by higher taxation levels.

#### 4. Empirical Literature Review

Various forms of inquiry have been conducted concerning the correlation between taxation and its impact on financial performance. It is important to note that while certain studies have resulted in definitive findings, others have been impeded by various obstacles.

Recently, [Otwani, Namusonge, and Nambuswa \(2017\)](#) carried out an investigation in Nairobi, Kenya, with the aim of evaluating the impact of corporate income tax on the

financial performance of firms enlisted on the Nairobi Securities Exchange (NSE) market. The primary objective of this study was to furnish empirical evidence on the financial performance of the enlisted companies in the NSE. The findings of this study indicated a positive correlation between corporate income tax and the financial performance of enlisted companies on the NSE in Kenya.

recently conducted a study in Nairobi, Kenya, to assess the effect of corporate income tax on the financial performance of firms listed on the Nairobi Securities Exchange (NSE) market. The purpose of this study was to provide empirical evidence on the financial performance of the listed companies on the NSE. The results of the study showed a positive relationship between corporate income tax and the financial performance of listed companies on the NSE in Kenya. This investigation evinces that the taxation of corporate profits is a pivotal constituent of fiscal policy due to its consequential impact on both the macro- and microeconomic circumstances of businesses and, thereby, the fiscal resources of governments. Corporations frequently remit corporate taxes in advance, in installments, or on the stipulated deadline in an effort to enhance their financial efficacy.

Gawehn (2020) undertook a German-based study that aimed to explore the correlation between corporate income taxation and banks. The investigation revealed that taxes play an integral role in various key areas such as debt financing, tax incidence, organizational form choices, profit shifting, financial reporting transparency, and customers' tax avoidance. Furthermore, the research illustrated that corporate taxes lead to incongruities between debt and equity financing, on- and off-balance sheet financing of prices, and investment allocations, which ultimately result in the distortion of banks' decisions. These distortions prompt banks to shift the tax burden onto their customers, which consequently leads to alterations in interest rates, thereby impacting the profitability of businesses. Kengere et al. (2023) have posited that the cost of capital is influenced by several factors. Among these factors are profitability, growth, tax shield, liquidity, and the unpredictability in cashflow. It is noteworthy that all these factors exert a significant and adverse impact on both the cost of capital and business performance.

In 2012, Gachanja conducted an investigation to examine the influence of tax reforms and economic factors on tax revenues in Kenya. The findings revealed that tax reforms had an adverse impact on tax revenues but a positive linear correlation with gross domestic product (GDP). Notably, low government revenues and businesses' low profitability were attributed to corruption and inefficient tax collection systems. Despite the government's efforts to increase revenues through reforms, a drastic restructuring of taxation may lead to tax evasion, resulting in lower than anticipated or budgeted revenues.

Gambocorta, Altunbas, and Marques-Ibanez (2010)

conducted a review aimed at evaluating the impact of taxation on the liability structure of banks, with a particular focus on microfinance institutions and commercial banks. By means of a comparative analysis, the scholars established that the effect on commercial banks was insignificant, whereas the influence on microfinance institutions was considerably adverse. The study found that complying with income tax regulations entailed a greater cost for microfinance banks than for other commercial entities, given their relatively limited size, which prevented them from benefiting from economies of scale. Moreover, MFBs that concentrate on smaller transactions with other banking institutions, such as commercial banks, face greater challenges in terms of routinely communicating with an administrative body and providing financial disclosures.

## 5. Critique of the Existing Literature

The study conducted by De Mooji and Ederveen (2001) utilized regression analysis to show the damaging impact of corporate tax on the financial performance of Russian institutions. Similarly, Becker & Holmes (2010) examined the financial performance of German institutions in relation to corporation taxes. Using the Panel Autoregressive Distributed Lag technique, the study revealed that taxes have a negative influence on the income and profitability of businesses in Germany. In a separate study by Gatsi, Gadzo, and Kportorgbi (2013), the impact of taxes on manufacturing firms listed on Ghana's exchange markets was investigated through the use of random concepts. The investigation ascertained an opposing correlation between taxation and return on assets within the enumerated corporations during the time span ranging from 2005 to 2013. Nonetheless, the scholarly literature solely provides a general outline of the discoveries; it does not delve into the particulars of the inquiries or scrutinize any limitations or consequences of the findings. Further elaboration on the theoretical frameworks applied, the controlled variables considered, and any conceivable biases would have facilitated a more comprehensive comprehension of the research.

A study conducted by Adeniyi and Imade (2018) delved into the examination of the influence of diverse tax systems on sustainable progress among small-scale enterprises in Lagos State. The focus of the study was on the local government of Lagos Island. Using the survey design methodology, 250 respondents were selected randomly from the target population to complete the questionnaire. The paper utilized the multiple regression technique to test the hypotheses. The results indicated a significant correlation between multiple tax burdens and SME performance indicators. The paper recommends the establishment of appropriate institutions to address the issue of numerous taxes in the country. The study provides insightful information on the relationship between various tax loads and SME performance metrics; nonetheless, there are certain constraints that must be taken into

consideration. Firstly, the judgmental selection sampling technique may introduce bias as it relies on the researcher's discretion and may not accurately represent the entire population. In addition, the lack of information on the sample's representativeness raises concerns about the generalizability of the findings.

The present study furnishes valuable insights into the interplay between diverse tax burdens and performance measures of small and medium-sized enterprises. Nevertheless, there are certain limitations that necessitate attention. Chiefly, the employment of the judgmental selection sampling technique may introduce partiality, as it depends on the researcher's discretion and may not comprehensively depict the entire population. Furthermore, the paucity of information concerning the representativeness of the sample raises apprehensions about the applicability of the results. The findings indicate that a decrease in VAT results in a 7% increase in the incidence rate of GDP, as measured by GDP's impact on economic performance. Hence, a significant inverse relationship exists between GDP and VAT rates. However, the study fails to address potential confounding factors or alternative hypotheses for the outcomes. Other factors that may influence economic performance, such as government regulations, the global economic climate, and industry-specific dynamics, should be taken into account. Lastly, the study's conclusion is solely based on the finding that there is a strong inverse connection between VAT rates and GDP. The possible consequences and policy ramifications of this relationship must be understood in the context of economic performance as a whole.

Chesire (2018), on the other hand, undertook a study to determine the effects of excise tax on the profitability of cigarette and alcohol manufacturing enterprises listed on the Nairobi Securities Exchange, which exclusively utilize BAT and EABL. The research relied on secondary data obtained from the financial statements of the companies and the NSE handbook for analysis. The research design employed in this study was descriptive, with excise tax serving as the independent variable in the multiple regression analysis, while net profit and liquidity were utilized as the control variables. The correlation analysis revealed a negative correlation between excise taxes and profitability, implying that excise taxes resulted in reduced profitability for the companies under review. The research design is characterized as being descriptive, with a focus on characterizing the relationship between excise tax and profitability without establishing causality. Although descriptive research can provide valuable insights, it is crucial to investigate other potential factors that may influence profitability, such as market conditions, industry competition, and firm-specific characteristics.

In analyzing the research gaps from the studies

mentioned, several limitations and areas for further investigation can be identified, as discussed below:

Starting with Otwani, Namusonge, and Nambuswa's work, their research on the effect of corporate income tax on financial performance on Nairobi's stock exchange provides useful insights. However, there is no extensive consideration of the specific mechanisms through which corporate income tax affects financial performance in the study. Future research should dive deeper into the routes through which taxes affect financial performance, taking into account issues like tax planning tactics, investment incentives, and the overall tax climate.

Gawehn's research on the junction of banks and corporate income taxation in Germany provides insights into the distortions induced by taxes in the banking sector. The study, however, focuses only on the impact of business taxes on financing decisions, ignoring other potential tax-related factors affecting bank profitability. More studies could be conducted to investigate the broader consequences of taxation on banking organizations, such as the impact of tax compliance costs, regulatory frameworks, and tax incentives on bank performance.

Gachanja's study on the influence of tax changes and economic conditions on tax revenues in Kenya reveals a negative contribution of tax reforms to tax collections but a favorable association with GDP. However, the study does not give a deep analysis of the underlying causes of tax reform's negative impact on tax revenues. Future research should delve into the exact factors underlying this link, taking into account concerns such as tax evasion, tax administration efficiency, and tax policy formulation and execution.

Gambacorta et al.'s study on the effect of tax on bank liability structure sheds light on the varied effects of taxes on microfinance organizations and commercial banks. However, the analysis focuses exclusively on compliance costs and reporting requirements, leaving out other potential tax-related problems that these institutions may face, including tax planning tactics, tax incentives for lending activities, and the broader tax climate in which they operate. Future research could look into these additional variables to gain a better understanding of how taxes affect the liability structure and profitability of financial institutions.

The research of De Mooij and Ederveen, Becker and Holmes, and Gatsi, Gadzo, and Kpportorgbi provides valuable insights into the negative impacts of taxes on profitability in the critique of previous literature. The critique, however, does not go into detail on the specific limitations of this research, such as potential omitted factors, endogeneity difficulties, or the generalizability of the findings to diverse contexts. Future studies could fill these gaps by performing more rigorous studies, addressing potential biases, and investigating the specific processes by which taxes affect profitability.

The identified research gaps include a need for a more comprehensive understanding of the mechanisms through which taxes impact financial performance, a consideration of broader tax-related issues affecting banking institutions and tax revenues, a deeper analysis of the factors driving the relationship between tax reforms and tax revenues, a more holistic examination of the effects of taxes on financial institutions, and a critical assessment of the limitations of taxation. These topics offer potential avenues for future research to further our understanding of the effects of taxation on financial performance.

## 6. Summary and Conclusion

Based on the preceding literature, this study investigates the relationship between taxation and financial performance, with a focus on Kenyan firms. The analysis looks at how financial performance, customs duties, PAYE (Pay As You Earn), and VAT taxes affect the company's profitability and overall financial health. Financial performance is measured using numerous financial ratios and indicators, such as profitability, liquidity, and efficiency ratios, which provide information about a company's financial situation. According to studies, there is a negative relationship between taxes and profitability, implying that increasing tax burdens might impair a company's financial success. Customs charges, as an import tax, have an impact on the cost structure and competitiveness of Kenyan firms. Higher customs duty rates can raise production costs and reduce profitability. PAYE taxes, for example, have an impact on labor expenses and employee motivation, whereas VAT taxes have an impact on costs, pricing tactics, and compliance needs. Tax planning and talent retention measures, for example, can help reduce the consequences of taxation on financial success.

Several studies on the relationship between taxation and financial performance are highlighted in the empirical literature review. A study conducted in Nairobi, Kenya, for example, discovered a favorable association between corporate income tax and the financial performance of companies listed on the Nairobi Securities Exchange (NSE). A study in Germany highlighted several dimensions where taxes are relevant, including debt financing, tax incidence, and organizational structure choices. Another study in Kenya found that tax reforms had a negative impact on tax collections but a favorable linear association with GDP. Furthermore, a comparative analysis found that taxes had a considerable negative impact on microfinance organizations

but had no impact on commercial banks. The available literature gives significant insights into the impact of taxation on financial success, but more study and examination of the findings' limitations and consequences is required.

In conclusion, taxation is a complex and multifaceted aspect of economic and financial systems that plays a crucial role in funding government operations and public services. It has a long history, dating back to ancient civilizations, and has evolved over time to serve various economic, social, and political purposes. Taxation can be categorized into direct and indirect taxes, and its impact on the financial performance of individuals and businesses is a subject of significant interest and research. The ability to pay theory, classical taxation theory, and political power theory are among the key theoretical frameworks that help us understand the relationship between taxation and financial performance. These theories emphasize the importance of fairness, efficiency, and the influence of political dynamics in shaping tax policies and their impact on individuals and businesses.

In the context of Kenya, taxation is a critical source of government revenue, and it significantly influences the financial performance of firms. Research in Kenya has shown that high tax rates can have adverse effects on profitability and investment decisions of companies. Tax incentives, on the other hand, can positively impact the financial performance of businesses, but their accessibility and effectiveness may be influenced by political factors and interest groups. This study seeks to contribute to the existing literature by examining the specific impact of taxation on the financial performance of firms in Kenya. By analyzing financial metrics like profitability, liquidity, and investment levels in relation to taxation, it aims to shed light on the challenges and opportunities that taxation presents to businesses in Kenya.

In summary, taxation is a vital component of economic systems, and its impact on financial performance is a complex and dynamic subject. Understanding how taxation policies and practices affect businesses in Kenya is crucial for developing effective tax strategies and optimizing financial outcomes. This study aims to provide valuable insights into this relationship, filling a gap in the existing literature and informing policymakers, businesses, and researchers about the nuances of taxation in Kenya's economic landscape.

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