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Tax Compliance among Small and Medium-Sized Enterprises (SMEs) in Nigeria: A Review of Literature

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ABSTRACT

This study provided insights into the concept, theories and empirical studies on the relationship between tax compliance factors and tax compliance among the small and medium sized enterprises. The study adopted conceptual and theoretical approaches by reviewing extant literature. The study discovered conflicting findings between tax compliance factors (such as tax rate, compliance cost, tax law ambiguity and system administration, and multiple taxations) and tax compliance among the small and medium sized enterprises. This study, therefore, recommends that the appropriate tax authorities should pursue more realistic and active means of improving tax compliance among the small and medium enterprises as this will checkmate the extent of tax avoidance and evasion. The essay also identified other research gaps for future studies.

Keywords: Compliance cost, Multiple taxations, Tax compliance, Tax rate, Tax ambiguity, SMEs.

1.0 Introduction

A major concern for government around the world has been the task of improving the rate of tax compliance and the tax base; therefore, the issue of tax compliance has continued to receive researchers' attention over the years. The increasing focus on Small and Medium Size Enterprises (SMEs) tax compliance is grounded in its potential to increase revenue generation and contribution to the economic growth. Therefore, researchers continue to investigate the factors that determine the tax compliance among small and medium size enterprises to assist the policy makers to formulate the effective deterrence tools that will increase taxpayer's compliance levels and to enhance economic development.

Prior studies (Andrew Young School of Policy Studies, 2005; Agwu and Emeti, 2014; Ponorica and Al-Saedi, 2015) show that Small and Medium Size Enterprises (SMEs) contribute greatly to the economic growth and development of most countries. In addition, small and medium size enterprises generate a significant portion of a country's taxable business income, and foster economic growth by contributing to employment, innovation, diversity and competition in the economy. Small and Medium Size Enterprises (SMEs) are recognized for their innovation productivity and contribution to economic growth in both develop and developing nations (Organization for Economic Co-operation and Development (OECD), 2015).

Small and medium sized enterprises have been a source of job creation and empowerment for both develop and developing countries. This has improved per capita income and led to the efficient utilization of the country's natural resources that improves revenue generation and higher productivity (Ariyo, 2005). Despite these contributions to the economic development of the country, the life span of Small and Medium Size Enterprises (SMEs) in developing nations appear to be short. Organization for Economic Co-operation and Development (OECD) (2015) stressed that about 80% of the Small and Medium Size Enterprises (SMEs) in developing nations dies or goes into administration before they are five years. One of the factors attributed to this high mortality rate is the tax related matters which includes high tax rates, unfavourable government policies or excessive regulations, compliance costs, multiple taxation, unfavourable business environment, and penalties (Amanamah, 2016).

The issue of tax compliance is inherent in any self-assessment system, this is due to the tax filling burden that places on the taxpayers rather than the tax authority (Coolidge, 2012). The main objective of the tax administration for every nation is to attain economic growth and development by financing operations and functions of the government, re-distributing income, and influencing the macroeconomic performance of the country's economy (Somorin, 2015). The tax system should not hinder economic growth but encourage investment and the propensity to save. Therefore, tax policies should be applied equitably and proactively, in line with other government policies, without becoming a burden to the taxpayer. In some tax system, the tax compliance cost effect on SMEs appeared to be regressive when measured as a percentage of turnover, the lower the turnover the higher the tax compliance cost percentage (Coolidge, 2012) In addition, complex tax system and regulations such as multiple taxation and other cumbersome requirements exert undue burden on SMEs due to their limited resources (Atawodi and Ojeka, 2012; Eragbhe and Modugu, 2014). Other factors that contribute to this burden, according to Atawodi and Ojeka (2012) include high tax rates, high cost of compliance and inefficient tax administration systems. These challenges have resulted to some SMEs non-compliance behaviour, non-migration to the formal sector and in some extreme cases, closure of their businesses. It is also the fact that the taxation on this group of taxpayers poses several administrative challenges to tax authorities due to their low level of compliance (Swistak, 2015). Consequently, both the authorities and the tax taxpayer are constrained with respect to optimal compliance and revenue generation respectively. Low levels of tax compliance have been observed among SMEs in most developing and some developed countries, leading to a reduction in potential tax revenue, and continued increase in the tax administration cost of the respective countries (Engelschalk, 2005; OECD, 2015).

However, with the growing need for tax compliance, research on tax compliance among the small and medium size enterprises has been dominated by studies carried out in developed countries (DeBaker *et al*, 2015; Yucedogru and Hasseldine, 2016; Dlamini, 2017), the same is not true of developing countries, where most studies concentrated only on tax compliance determinants and did not focus on the impact of tax compliance factors among the small and medium size enterprises (Atawodi and Ojeka, 2012; Anyaduba and Modugu, 2014; Sapiei, Kastipillai and Eze, 2014). In addition, there have been various studies in developed and other developing countries to investigate whether tax compliance factors have significant impact on tax compliance among the small and medium size enterprises. However, the findings are inconsistent and mixed (Atawodi and Ojeka, 2012; Dlamini, 2017; Aladejebi, 2018).

Furthermore, most prior studies adopted tax audit, tax education, tax morale, business digitalization, cultural norms and tax amnesty as a determining factor for tax-compliance (Fagbemi and Abogun, 2017; Aladejebi, 2018). Moreover, prior studies in developing nations are yet to focus on some specific tax non-compliance factors (like tax rate, compliance cost, tax law ambiguity and multiple taxations) determining tax compliance among nations (Sapiei, Kastipillai and Eze, 2014; Bruckner, 2015). Hence, a gap exists as a result of tax compliance factors.

In view of this gap, the study basically investigated whether a significant relationship exists between tax compliance factors and tax compliance among SMEs. To achieve this objective, the study restricted its tax compliance factors to tax rate, compliance cost, tax law ambiguity and multiple taxations.

2. Review of Literature

2.1 Small and Medium Sized Enterprises (SMEs)

The term “Small and medium sized enterprises” (SMEs) has no one general definition applicable across countries, or even within countries. This is due to the different policy criteria used by countries to determine what a small business should be. Even within a country there might be several definitions of SMEs depending on the objective of the policy or program (Andrew Young School of Policy Studies, 2015). Some common criteria generally used in defining small and medium sized enterprises include the number of employees, annual turnover or the size of the net assets, but these also vary between and within countries. In the United States of America (USA), and European countries the small business administration includes some manufacturing firms with employees of up to 500. The World Bank (2007), on the other hand defines small firms as having 10-49 employees (with exceptions) and medium size firms as those with 50-249 employees (with exception). Within the United States, there are at least two different definitions of small businesses, the Internal Revenue Service (IRS) Small Business and Self-Employed division defines a small business, for tax purposes as one with less than $10 million of income. On the other hand, the US Small Business Administration generally considers a small business to be an independent business with fewer than 500 employees, although this definition may still vary by industry. Ofoegbu, Akanbi and Joseph (2013) point out some socio-economic factors that may determine the definition of SMEs. They suggested that in a country such as Nigeria, the definition of SME’s should vary by zone, due in large part, to the unbalanced distribution of natural resources, economic activities and poverty level. Currently, the Small and Medium Scale Enterprises Development Agency of Nigeria (SMEDAN) defines SME’s as those enterprises whose total assets (excluding land and building) are above N5 million but less than N500 million with a total workforce of between 10 and 199 employees. The Central Bank of Nigeria (CBN) defines SME as an entity with asset base of N5 million but not more than N500 million (excluding land and buildings) and with employees of between 11 and 200. Besides these general definitions of SME’s there are also “tax-purpose” definition (just like that of the IRS small business division mentioned earlier) based on other factors used to target concessions at SMEs (OECD, 2015). In Japan, for tax purpose, the definition of SMEs is based on business capital while in France and Spain, a gross turnover test is used to determine SME concessionary tax rates. “Tax-purpose” definitions are not only important for administering concession rates, but also, for streamlining other tax preference that benefits SMEs. This enables tax, authorities and other government agencies to perform their tasks efficiently and address policy impacts and needs of SMEs. Furthermore, clear definition enables tax authorities meet their ultimate objectives and goals. Conversely, without clear out definition of SMEs, tax authorities’ compliance efforts may end up futile with considerable wastage of resources in pursuing inefficient studies (Andrew Young School of Policy Studies, 2005).

2.2 Tax Compliance

According to Yocedogru and Hasseldine (2016) and Jackson and Milliron (1986, p.128) define tax compliance ‘as one who files an ‘accurate, timely and fully paid return without tax authority enforcement efforts’ Similarly, the United State Internal Revenue Service (IRS) defines tax compliance as the filling of all required tax return at the proper time and accurately reporting tax liability in accordance with the Internal Revenue Code, regulation and court decision applicable at the time (Roth, Scholtz and Wite, 1989). Sapiei, Kastipillai and Eze (2014) define tax compliance as “the accurate reporting of income and claiming of expenses in accordance with stipulated laws". Therefore, the failure of taxpayers to timely file their return accurately, report or pay the correct amount of tax is considered tax non-compliance.

2.3 Tax Compliance Theories

Tax compliance studies generally rely on certain theories and models such as those developed by Becker, 1968; Allingham and Sandmo, 1972; Yitzhaki, 1974 and Slemrod, 2003 to name a few. Sapiei, Kasipillai and Ese (2014) suggest two main approaches that can be applied in order to understand tax compliance issues, the economic approach and behavioural approach. The economic approach is built on the concept of nationalism, that is, economic rationality or the rational choice, while the behavioural approach is based on concepts from discipline such as psychology and sociology

Categories of tax compliance theories include Economic deterrence theories (Becker, 1968), Fiscal exchange theory (Slemrod, 2003, Moore, 2004) and Equity theory (Alm, Jackson and McKee, 1993). The economic deterrence theory focuses on the use of economic deterrence techniques such as audits and penalties to coerce taxpayers into compliance. Therefore, in the absence of economic deterrence there will be increased tax noncompliance. This model has been criticized for its unrealistic assumption that taxpayers' responses to change in variable are identical, and they all have the same level of risk preference (Evans and Tran-Nam, 2014). The fiscal exchange theory is based on the premise that the level of tax compliance is determined by government expenditure on public goods and services. In other words, taxpayers are more interested in what they can get from the government in return for filling their taxes. Taxpayers perception of the tax system fairness is the focus of the equity theory, taxpayers comply with tax rates if they believe that the system is impartial and citizens are paying their fair share of taxes (International Centre for Tax and Development (ICTD), 2012). It can therefore be deduced from this theory that if government does not satisfy its own end of the social contract with the citizens, then there will be an incidence of tax noncompliance. The basic theoretical model applied in the economic approach was originally built on the work of Becker (1968) who analysed criminal behaviour using an economic framework known as the economics-of-crime model. The model is based on the premise that taxpayer are utility maximisers deterred by penalties and audits, hence they decide to evade taxes depending on their maximum expected utility or benefit. According to this model, the decision to evade taxes is purely a cost-benefit decision. Becker's theory assumes that taxpayers are perfectly moral, risk neutral and only evade taxes when gains exceed cost. This model was first employed in the tax compliance context by Allingham and Sandmo (1972).

2.4 Review of Prior Studies

This section basically looked at related prior studies that have been advanced on the factors that determine tax compliance among the SMEs.

Tax Rate and Tax Compliance

One of factor of tax compliance found across SMEs related studies is high tax rate. Awa and Ikpor (2015) conducted a study which showed high tax rate, and complex filling procedures as major factors affecting the tax compliance of SMEs. The study concluded that high tax rate is the main reason that SMEs choose to remain in the informal sector. Atawodi and Ojeka (2012) opined that high tax rate was the main cause of tax non-compliance among SMEs. Amanamah (2016) also found that high tax rate affects taxpayers' compliance. In the quest to determine the effect of tax policies on SMEs, Ojeka (2011) conducted an explanatory research which involved a survey of 150 SMEs and observed that most respondents were saddled with the burden of high tax rate which discouraged compliance and ultimately hindered their growth. Clotfelter (1983) carried out studies that exploring the relationship between tax rates and tax evasion. His findings indicated that increase in tax rates has a positive and significance relationship with tax evasion. Contrary to the results of the preceding studies, Sapiei, Kasipillai and Ese (2014) observed in their study that tax compliance was negatively associated with marginal tax rate.

Compliance Cost and Tax Compliance

Tax compliance costs are those costs incurred by taxpayers in meeting the requirements of the tax law, and the revenue authority (Sandford, Godwin and Hardwick, 1989). The gross tax compliance cost of a company less tax compliance benefits such as tax deductibility benefits, cash flow benefits, and managerial benefits is referred to as Net compliance costs. Tax deductibility benefits result from the fact that business taxpayers may be entitled to tax deduction for some of the compliance costs they incur. Cash flow benefits are as a result of the different between the time when the tax is collected by the taxpayer and the time when it is transmitted to the authorities. Managerial benefits may be derived by business taxpayers where the more stringent record keeping requirements imposed by tax compliance result in the administrative efficiency of the business. Lai and Arfin (2011) categorized compliance costs into internal and external costs, Internal costs are those costs generated by staff maintaining and preparing tax information, such as time expended on activities related to tax, completing tax return and making tax payments, while external costs are payments made to acquire professional services in order to gain compliance.

Extant studies revealed a significant positive relationship between compliance cost and tax compliance (Chitenden, Kauser and Poutzouris, 2003; Ligner, Evans and Tran –Nam, 2014; Eragbhe and Modugu, 2014; Sapiei, Abdullah and Sulaiman, 2014). However, an insignificant relationship was found between compliance cost and tax compliance (Chitenden, Kauser and Poutzouris, 2003; Ojeka, 2011; Yucedogru and Hasseldine, 2016) by employing primary data using regression analysis. Therefore, the existence of compliance cost is being considered as a determinant of tax compliance.

Tax Law Ambiguity and System Administration and Tax Compliance

A good tax system should be simple, proportional neutral and fair in order to aid compliance (Sanmi, 2012). Tax system should be designed in such a manner that will minimize compliance costs and maximize accessibility, efficiently and effectively (Ponorici and Al-Saedi, 2015). Vague and ambiguous tax laws make it challenging for taxpayers to comply with the requirements even for those that have a genuine mindfulness to do so. With regards to the complexity of tax laws, auditors and courts may lack adequate tax knowledge and this may lead to incorrect application of the tax law, and ultimately cause noncompliance by taxpayers (Andreoni, Erard, & Feinstein, 1998). In the US, the federal tax compliance cost of business filters in 2004 was over $100b as a result of the complexity of the federal tax code (Crain, 2005). Crain (2005) argue that the complexity of any tax code undermines the compliance efforts of taxpayers, and as a result forces some taxpayer out of compliance. Faridy *et al*. (2014) assert that there are three main types of tax complexities inherent in any tax system: technical complexity, compliance and structural complexity. They further argued that small businesses tend to feel the impact of tax system complexity more than large businesses due to their inability to spread their cost of compliance over limited resources. The more complex tax legislations are, the wider the knowledge gap between legislature and taxpayers. A skilled professional tax administrator or administration is instrumental in encouraging compliance of SMEs and their decision to become and remain part of the formal economy. Sapiei, Abdullah and Sulaiman (2014) found mixed results between tax rate, complexity, deterrence sanctions and law sanction and tax compliance level.

Multiple Taxation and Tax compliance

Multiple taxations are a situation where a taxpayer is liable for the payment of similar taxes from two or more different levels of government (Sanmi, 2012). The issue of multiple taxations by the different tiers of government remains a major challenge to the SMEs. Atawodi and Ojeka (2012) are of the opinion that SMEs often operate in harsh regulatory environments flooded with multiple taxes from different regulatory agencies from the different tiers of government. These cumbersome requirements tend to exert undue burden on SMEs. Agwu and Emeti (2014) found that multiple taxations of SMEs were also a contributing factor to the tax non- compliance among SMEs. Oboh and Yeye (2013) conducted a survey research to determine the effect of multiple taxations on taxpayer's compliance and found a positive significant relationship between the two. Nwamuo (2017), in a quest to determine the effect of multiple taxes on SMEs, it was discovered that both the state and local government collect similar taxes. Findings from the study indicated that multiple taxes imposed by the state and federal government increased the operational cost of business owners and reduced their profit margins. These studies show that multiple taxations discourage compliance and discouraged the possibly of establishing new businesses within the formal economy.

2.5 Gap in Studies

Having examined several empirical studies from both developed and developing countries, it was observed that most of the studies dwelt more on tax compliance determinants and were based on primary source of data and specific classes of tax compliance factors. From the extent of this study, few of these studies examined tax compliance factors using secondary data. Those that did studies on the tax law ambiguity came out with results affecting SMEs tax compliance with mixed results. Consequently, not much of these studies captured variable like tax law ambiguity and system administration and use of secondary source data. Hence, there lies a gap in Knowledge to fill.

3.0 Methods

The method adopted in carrying out this study is exploratory based on library research. It is a theoretical review of documentary information on the topic as expressed in journal articles, textbooks, government publications, bulletins, unpublished papers and internet-based materials.

4.0 Conclusion

Research has shown that SME tax non-compliance is driven by several economic and behavioural factors. This study focused on some of these economic factors and highlighted a couple of behavioural factors. The literature reviewed comprises of studies conducted in developed and developing countries alike. The results of these studies were mixed and did not suggest the existence of any pattern with regards to the level of economic development. However, the experiments carried out by the researchers in the more developed economies appeared to be more robust, and some that made use of administrative tax return data, appeared to lead to more reliable conclusion. On the other hand, the experiments conducted in the developing countries were on a much smaller scale using survey method. It is unclear if this difference contributed to the variance of the result. Regarding tax rates and multiple taxations, the result was consistent while the results for tax compliance cost and tax law ambiguity varied slightly.

Due to the major role played by SMEs in both developed and developing countries, governments and policy makers need ensure that the tax system and tax laws are simplified, efficient and effective. Tax system should be assessed often to ensure that they are updated in line with the ever-evolving means of doing business to ensure fairness, inclusion and optimal revenue collection. Going forward, this study suggests that tax authorities should dialogue with SMEs to better understand the dynamics of their businesses, and their challenges in meeting tax requirements. Finally, understanding tax compliance behaviour remains a challenge, therefore, this study calls for further research on taxpayer attitudes and perspectives through surveys case studies and tax experiments for more informed tax policy design required to attain optimal tax compliance of Small and Medium-Sized Enterprises (SMEs).

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