Tax compliance and smes economics essay

According to Marti (2010) tax compliance is a complex term to define. Simply put, tax compliance refers to fulfilling all tax obligations as specified by the law freely and completely.

It has been found that regulatory burdens fall disproportionately on small and medium enterprises internationally (Pope & Abdul-Jabbar, 2008). Their size and nature makes the issue of tax compliance one of particular importance especially since most SMEs have access to limited resources and inadequate expertise to comply with diverse and complicated regulation. He also believes that high compliance costs can result in tax avoidance, tax fraud, and inhibit investment by way of diminishing competitiveness of the country in terms of taxation attractiveness.

Tax non-compliance may be in one of many forms; it could either be failure to submit a tax return within the stipulated period or non submission, understatement of income, overstatement of deductions, failure to pay assessed taxes by due date. (Kasipillai & Abdul Jabbar, 2006) and in some cases non-compliance may mean an outright failure to pay levied taxes.

Studies have shown that the problem of tax evasion is a widespread one (Kasipillai & Abdul Jabbar, 2006).

Furthermore, Fagbemi, Uadile & Noah (2010) found that it is prevalent in developing countries and it hinders development thereby leading to economic stagnation and other socio-economic problems. Chipeta (2002) identified tax rates as one of the causes of tax evasion. He pointed out that a higher tax rate increases taxpayers' burden and reduces their disposable income therefore, the probability of evading tax is higher.

2. 5 Tax Policy and Level of Voluntary Compliance among SMEs

Small taxpayers under the regular system of taxation are discriminated against, since the compliance requirements, cost of compliance and tax rate are the same for both small and large enterprises. Reducing the compliance costs and tax rate increases the small enterprises profit margin. It also increases the Government's tax revenue, since the simplified provisions for small and medium enterprises reduce the size of the informal economy and the number of non-complying registered taxpayers (Vasak, 2008). Furthermore, SMEs usually have to operate in an overbearing regulatory environment with the plethora of regulatory agencies, multiple taxes, cumbersome importation procedure and high port charges that constantly exert serious burden on their operations. An overly complex regulatory system and tax regime or one opaque in its administration and enforcement makes tax compliance unduly burdensome and often have a distortionary effect on the development of SMEs as they are tempted to morph into forms that offer a lower tax burden or no tax burden at all (Masato, 2009), and this results in a tax system that imposes high expenses on the society. A poorly executed tax system also leads to low efficiency, high collection charges, waste of time for taxpayers and the staff, and the low amounts of received taxes and the deviation of optimum allocation of resources (Farzbod, 2000). Existing empirical evidence clearly indicates that small and medium sized businesses are affected disproportionately by these costs: when scaled by sales or assets, the compliance costs of SMEs are higher than for large businesses

www. ccsenet. org/ijbm International Journal of Business and Management

Vol. 7, No. 12; June 2012 Published by Canadian Center of Science and

Education 91

(Weichenrieder, 2007).

2. 6 Tax Policy that will Encourage Voluntary Compliance by SMEs

SMEs constitute untapped revenue potential and an uneven playing field in

many countries (International Tax Dialogue, 2007) as such they need to be

captured by the tax net. However, though legislations are necessary

regulator for protection of the business environment and security of the

economic agents, for establishment of the necessary social security

regulations, they may also hamper compliance and the growth of business

through additional expenditures and administrative obstacles. Thus

Shahroodi, (2010) stated that for a tax system to be efficient, the tax policy

needs to be designed such that the tax rates are appropriate and rational,

the exemptions are lower in amount, the tax collection organization are

more efficient, the tax burden of the indigent people should be lighter and

the fight against corruption and tax evasion should be much more intense.

Tax policies can be designed in such a way that they do not only directly

affect SMEs but also indirectly push for voluntary compliance and their

growth. Yaobin (2007), emphasized declared that special tax regimes for

SMEs may be appropriate policy instruments for minimizing the cost of

collection. Because awareness of the dangers of inadequate taxation of SMEs

has grown because of the potential of uneven tax enforcement to cause

distortions of competition, voluntary compliance by larger enterprises and by

wage earners, (International Tax Dialogue, 2007), government intervention should help maintain balance while ensuring that countries exploit the social benefits from greater competition and entrepreneurship. Pro-business (and Pro-SME) Tax regimes and enforcement should be simple, consistent and predictable should to lower compliance and administrative costs, and hence reduce uncertainty faced by taxpayers as well as improve the levels of voluntary compliance (Kasipillai, 2005).

2. 7 Theories of Tax Compliance

Various opinions exist about the best ways to improve tax compliance. Given the chance, a lot of businesses will not pay taxes unless there is a motivation to do so. Some believe that the best way is to increase incentives (Feld & Frey, 2007) others believe the best way is to increase penalties. Tax compliance theories can be broadly classified into two. They are; economics based theories and psychology based theories.

2. 7. 1 Economic Based Theories

They are also known as deterrence theory and they place emphasis on incentives. The theory suggests that taxpayers are amoral utility maximizers- they are influenced by economic motives such as profit maximization and probability of detection. As such they analyze alternative compliance paths for instance whether or not to evade tax, the likelihood of being detected and the resulting repercussions and then select the alternative that maximises their expected after tax returns after adjusting for risk. This process is referred to as " playing the audit lottery" by Trivedi and

Shehata (2005). Therefore according to the theory, in order to improve compliance, audits and penalties for non-compliance should be increased.

2. 7. 2 Psychology Theories Psychology theories on the other hand posit that taxpayers are influenced to comply with their tax obligations by psychological factors. They focus on the taxpayers' morals and ethics. The theories suggest that a taxpayer may comply even when the probability of detection is low. As opposed to the economic theories that emphasize increased audits and penalties as solutions