

# TAX COMPLIANCE OF SMALL AND MEDIUM ENTERPRISES: EVIDENCE FROM INDONESIA

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## ABSTRACT

*It has been argued that regulatory requirements on business, especially those on SMEs can be a constraint on their growth. Indonesian Small and Medium Enterprises (SMEs) play a significant role in the national economy. This paper measures the tax compliance rate of particular individual retailers known as individual taxpayers on SMEs with annual income ranging from IDR 600 millions up to IDR 4.8 billion (around USD 400,000 with the exchange rate at the time when the research was undertaken) in Indonesia. Four tax compliance variables were examined namely the perception of tax rate, the referral group, the probability of being audited and the tax knowledge. From 319 respondents, who are individual retailers, the result shows the income tax rate is negatively correlated to tax compliance while probability of being audited, referral group, and tax knowledge are positively correlated by tax compliance. Tax knowledge, however, has a more significant impact on individual tax compliance*

**JEL:** H20

**KEYWORDS:** Tax Compliance, SMEs, Individual Taxpayers, Retailers

## INTRODUCTION

**S**MEs in Indonesia, as in many countries, play a significant role for the national economy. They have historically been the main players in domestic activity with the number of SMEs reached 56 million units, accounted for approximately 60 percent of total GDP and holds 97 percent of the total work force in 2012 (Ministry of Indonesian SME, 2012).

Since reform of tax laws in Indonesia in 2008, the number of Taxpayers has increased from year to year. In 2008, of 10,106,159 taxpayers, 3,150,966 registered Taxpayers are individual business taxpayers while in 2012 the number of individual business Taxpayers increased to 4,521,395 from 25,065,810 taxpayers (Inasius, 2014). Understanding of tax knowledge influences taxpayers' compliance. Therefore, a study of Taxpayer compliance is important to understand the behavior of taxpayers. Several studies have been conducted on tax compliance such as Clotfelter (1983), Alm (1991), Eriksen and Fallan (1996), Evans et al. (2005), Kirchler (2007). For the purpose of this paper, the definition of tax compliance based on Kirchler (2007) is defined the willingness of taxpayers to comply with tax laws, to report and pay all taxes on time.

Previous studies have found that compliance costs fall disproportionately on small firms (Sandford et al. 1989). Therefore, in terms of the biggest contribution of Indonesia SMEs to the national Economy, the purpose of this paper is to measure the correlation of four independent variables on the tax compliance level of individual SMEs retailers in Indonesia. The four independent variables consist of the perception of tax rate, the referent group, the probability of being audited and the tax knowledge.

In the international context, this paper contributes to the existing literature on tax compliance by adding observations made from the Asian perspective. On the other hand, in the local context, this study observes the important tax compliance factors to Indonesia. This paper is organized as follows: first, the literature

is reviewed. Second the methodology of the research is presented. The result of the testing is presented in the third part of this paper. Finally the last part concludes this paper

## LITERATURE REVIEW

From one country to another the definition of SMEs varies and so do the definition of SMEs in Indonesia. In Indonesia, the SME Act 2008 defines a SME based on turnover. A micro company is one that has turnover not exceeding 300 million rupiah, a small company has turnover not exceeding 2.5 billion rupiah and finally a medium-sized company has turnover not exceeding 50 billion rupiah. Business turnover is one of the most accepted criteria in determining tax rules for SMEs as there are separate definitions of it for tax purposes.

International experience shows that regulatory burdens appear to fall disproportionately on small medium enterprises. In recognition of their contribution to the national economy SMEs should be supported by the government particularly in the regulatory burden and taxation (Pope, 2008). The complexity of taxation could be best measured by tax compliance cost (Pope, 1993b:70, Simon James et al., 1998:32). The definition of tax compliance is defined by Alm (1991) and Jackson and Milliron (1986) as the reporting of all incomes and payment of all taxes by fulfilling the provisions of laws, regulations and court judgments. Furthermore, according to Kirchler (2007), tax compliance is the most neutral term to describe taxpayers' willingness to pay their taxes.

Previous studies on the probability of being audited, the influence of referent groups and tax knowledge have been done by Palil et al. (2011). Associated with the probability of being audited, they argued that the increase in the number of audit samples may improve tax compliance. Furthermore, with regard to the referent group they argue that personal Cultivating awareness of compliance is important. Finally, tax knowledge becomes the main factor that affects tax compliance behavior in Malaysia. The previous research about tax rates that influences taxpayers' decisions to comply with tax laws has been claimed by Clotfelter (1983: 363) that tax rates is not the only policy with the potential to discourage tax evasion but the tax rate is an important factor in determining tax compliance behavior although the exact impact is still unclear and debatable (Kirchler, 2007: 114). Furthermore, Ali et al (2001) and Torgler (2007) claimed that raising marginal tax rates will likely encourage taxpayers to evade tax more while lowering tax rates does not necessarily increase tax compliance (Kirchler, 2007)

In term of tax audit, previous studies claimed that audits have a positive impact on tax evasion (Jackson and Jaouen, 1989; Shanmugam, 2003; Dubin, 2004). These findings suggest that tax audits can play an important role and their central role is to increase voluntary compliance in self-assessment systems. Furthermore, Witte and Woodbury (1985) also complement in their study of small proprietors that tax audits have a significant role in tax compliance. Butler (1993) also supports these findings that tax audits can change compliance behavior from negative to positive. Furthermore, Evans et al. (2005) in their studies in Australia found that the type of audit on SMEs has a significant indirect impact on tax compliance in terms of record keeping. On the other hand, previous studies by Young (1994) and Slemrod et al (2001) found that probability of being audited was negatively correlated with compliance behavior.

Previous studies in ascertaining the importance of referent groups are also claimed by Clotfelter (1983) that referent groups play a significant role in evasion although it was not clearly discussed which was stronger: family members or friends. Furthermore, Hasseldine, Kaplan and Fuller (1994) report that the more respondents know the evaders, the more under-reporting of income may happen. In term of tax knowledge, Eriksen and Fallan (1996) argues that the level of education received by taxpayers is an important factor that contributes to the general understanding about taxation especially regarding the laws and regulations of taxation. On the other hand, previous studies by Lewis (1982) showed that low tax knowledge correlates with negative attitude toward taxation. Furthermore, Eriksen et al. (1996: 398) claimed that tax attitudes

can be improved through better tax knowledge and thus this will in turn increase compliance and reduce the inclination to evade taxes.

## RESEARCH METHODOLOGY

The following hypotheses were tested in order to answer the research objective; the tax compliance in Indonesia.

- H1 Perception of tax rate is positively correlated with tax compliance
- H2 Referral group is positively correlated with tax compliance
- H3 Probability of being audited is positively correlated with tax compliance
- H4 Tax knowledge is positively correlated with tax compliance

The survey was carried out from November 2013 up to January 2014 in Jakarta. Respondents were individual retailers located both in traditional markets as well as in shopping centers. The data is directly distributed to respondents in five regions that consist of Central Jakarta, West Jakarta, North Jakarta, East Jakarta and South Jakarta. The distribution is done by 50 students for the five regions. The answers are obtained in the following weeks after the distribution of questionnaires. In addition, the location of the survey concentrated in Jakarta Province which is the center of the economy with the largest percentage of tax revenues in Indonesia. This is proved from the total domestic tax receipts around 977 trillion rupiah where about a third comes from Jakarta (Inasius, 2013: 152).

The questionnaire in the survey consists of 20 questions. In order to improve the validity and reliability a pilot survey was conducted on a group of 30 retailers in various sectors before a total number of 1000 questioners were distributed to individual retailers throughout Jakarta who were selected at random from the traditional and modern market. The respondents were asked to indicate their degree of agreement with five statements (1= completely disagree to 5= completely agree; also, a “do not know option which was defined as a missing value for the statistical analyses).

The questionnaire was prepared in both Indonesia and English versions to facilitate respondents and was divided into four variables of interest that are the perception of tax rate, influence of referent group, probability of being audit and tax knowledge. As illustrated in Table 1, a total of four tax compliance variables were examined namely the perception of tax rate, the influence of referent group, the probability of being audit and the tax knowledge.

Table 1: The Descriptions of Variables

Variables	Symbol	Description
Tax compliance	TC	Minimum total score for each respondent is 20 (1 mark times 20 questions- non compliant) and maximum score is 100 (5 times 20 questions- very compliant).
Perception of Tax Rate	TR	Taxpayers’ perception on tax rate. Minimum score is 4 (1 times 4 questions- non compliant) and maximum is 20 (5 times 4 questions- very compliant).
Referral group	RG	The referral group (family members and closed friends). Minimum score is 4 (non compliant) and maximum is 20 (very compliant).
Probability of being audited	PA	Probability of taxpayer being audit by the tax authority. Minimum score is 4 (non compliant) and maximum is 20 (very compliant)
Tax knowledge	TK	Minimum score is 4 (non compliant) and maximum is 20 (very compliant)

To test the hypotheses on tax compliance, data was estimated using multiple regressions. The following equation was used to test the hypotheses and establish the tax compliance determinants.

$$TC = \alpha + \beta_1TR + \beta_2RG + \beta_3PA + \beta_4TK + \varepsilon_i \tag{1}$$

Where: 1.) TC = Tax Compliance, 2.) TR = Perception of Tax rate, 3.) RG = Referral Group, 4.) PA = Probability of Being Audited, 5.) TK = Tax Knowledge.

**RESULTS**

Out of 1,000 surveys directly distributed to respondents who are individual retailers and have business turnover less than USD 4 million, 280 were returned with one survey being damaged. The sampling region covers markets and shopping centers across Jakarta with divisions including Central Jakarta, West Jakarta, North Jakarta, East Jakarta and South Jakarta. Each area covers among 2 to 4 shopping centers. Moreover, the surveys were distributed and collected at the time of meeting with respondents who were chosen at random.

The respondents consist of 168 (60%) females and 111 (40%) males. A minimum age of 21 years old was considered reasonable. Overall, respondents aged between 21 and 45 years old made up the largest portion with 210 respondents (75%) and a total of 218 (78%) were married.

The following Table 2 illustrates the Pearson correlation matrix for dependent and independent variables. Table 3 provides results of tax compliance in which all independent variables except for the perception of tax rate were found to be significantly correlated with TC (p<0.01). The highest correlation occurred between TC and TK followed by RG and PA.

Table 2: Pearson Correlation Matrix for Dependent & Independent Variables

	Tax.Compliance	Group	Audited	Tax.Knowledge	Tax.rate
Tax Compliance	1	0.328**	0.322**	0.365**	0.111
Group	0.328**	1	0.813**	0.826**	0.547**
Audited	0.322**	0.813**	1	0.809**	0.525**
Tax Knowledge	0.365**	0.826**	0.809**	1	0.469**
Tax.rate	0.111	0.547**	0.525**	0.469**	1

Table 2 shows Pearson Correlation Matrix. The first column shows the dependent variable for tax compliance and group audited, tax knowledge and tax rate for independent variable. The second column reports the correlation between the dependent variable and independent variable. The next columns report the correlation between the independent variable and dependent variable as well as the independent variable and independent variable. \*Correlation is significant at the 0.1 level (2-tailed), \*\*Correlation is significant at the 0.05 level (2-tailed), \*\*\*Correlation is significant at the 0.01 level (2-tailed)

To test the hypothesis on tax compliance the data was estimated using a multiple regressions models. Based on this multiple regression, results in Table 3 show that tax compliance was influenced by four variables namely TK (β=0.365), RG (β=0.328), PA (β=0.322) and TR (β=0.111). TK is the only significant predictor.

The findings suggest that high tax knowledge would increase tax compliance and also become a significant factor in determining tax compliance. Therefore, hypothesis H4 (tax knowledge is positively correlated with tax compliance) is accepted. On the other hand, the perception of tax rate, the referral group and probability of being audited would discourage tax compliance.

**CONCLUSION**

The objective of this research is to examine factors influencing taxpayer’s behavior. Four variables of tax compliance were examined in this study, namely the perception of tax rate, the referral group, the probability of being audited and tax knowledge. Using direct questions, results suggest that tax compliance was influenced by tax knowledge, the referent group, the perception of tax rate and the probability of being audited. Interestingly, however, tax knowledge becomes the strongest predictor affecting tax compliance.

In contrast, the perception of tax rate, the referent group and the probability of being audited, although somewhat related are not significant enough to influence tax compliance. Furthermore, it seems that tax knowledge induces tax compliance, thus hypothesis 4 was accepted and supports the results by Eriksen and Fallan (1996).

Table 3: Multiple Regression- Dependent Variable: Tax Compliance

Variables	Coefficients	t	Sig.	VIF
Tax Rate	-0.113	-1.667	0.097	1.469
Ref Group	0.103	0.907	0.365	4.111
Audited	0.084	0.789	0.431	3.666
Tax Knowledge	0.264	2.420	0.016	3.822
Model Fit:				
R	0.380			
R <sup>2</sup>	0.145			
Adjusted R <sup>2</sup>	0.132			
Standard error	2.375			
F statistic	11.592			

*This Table shows the multiple regression of tax compliance as dependent variable. The fourth column reports the significant level of the tax rate, referral group, probability of being audited and tax knowledge with the tax knowledge has the significance level of 0.016. Notes: Significant at p< 5%.*

This study also indicates the perception of tax rate, influence of referent group and probability of being audited are not significant to tax compliance. These results provide new evidence that taxpayers who have the perception of tax rate, high influence from family members and friends and a high probability of being audited would tend to discourage tax compliance. Therefore, hypothesis 1, 2 and 3 were rejected.

With regard to the probability of being audited, the finding is consistent with the result reported by Young (1994), which showed a high probability of audit would potentially decrease the compliance of taxpayers. Therefore, since a high probability of being audited less encourages tax compliance, the tax authority should not only increase the number of audit samples but also the firmness of sanction in tax audits.

In relation to the influence of the referent group, this result is not quite significant to improve the compliance level of taxpayers. This contradicts previous results shown by Clotfelter (1983), Hasseldine et al. (1994) and Palil et.al. The opposite result may due to the character of retailers which rather indifferent to the existing taxation.

With regard to the perception of tax rated, this finding indicates the result is not significantly correlated to tax compliance. In line with Kirchler (2007:114) that tax rate is an important factor in determining tax compliance behavior although the exact impact is still unclear and debatable.

In summary, it could be concluded that tax knowledge has the significant correlation to tax compliance of taxpayers as long as fairness of the tax system occurs. It seems, however, that tax compliance is solely based on tax knowledge, the probability of being audited, the perception of tax rate, and the referent group. Besides the tax knowledge in social level is the determining factor to tax compliance.

Although this study has indicated the tax knowledge is the only significant factor explaining tax compliance, there are several limitations to this study. First, this study excludes a number of independent variables such as financial constraints and the perception of Taxpayers over government spending that may be important in determining tax compliance. Second, the number of samples only covered individual retail and does not include corporate retailers.

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