THE EFFECT OF TAX FAIRNESS ON SALES TAX COMPLIANCE AMONG JORDANIAN MANUFACTURING SMEs

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ABSTRACT

Tax compliance leads to reducing the fiscal deficit and public debt, thereby it provides funding to satisfy the economic and social development. Despite the extensive government's efforts, the compliance of sales tax (typically known as value added tax globally) among the small and medium-sized enterprises (SMEs) in Jordan is relatively low, thus, it negatively impacts the government revenues. Previous studies regarding the effect of tax fairness on sales tax compliance among SMEs has been neglected. Therefore, the study aims to examine the effect of tax fairness on sales tax compliance among Jordanian manufacturing SMEs. This study uses a survey method with questionnaires distributed to 660 owners-managers of SMEs in manufacturing sector. In the further data tabulation, only 215 questionnaires were declared eligible to be tested at further stage. The study hypothesis was then tested using PLS software by applying structural equation models (SEMs). The results showed that tax fairness had a significant influence on sales tax compliance. This paper calls for future studies in the area of sales tax compliance of SMEs in order to better understand its determinants. Besides, it also provides valuable information as well as guidance policymakers and SMEs owner-managers to improve sales tax compliance in the future.

Keywords: Sales Tax Compliance, Tax Fairness, SMEs.

INTRODUCTION

Tax compliance has become an important subject for individuals and firm's taxation in both developed and developing countries and it emphasizes a taxpayer's responsibility to report income and determines tax liability (Inasius, 2019). Comprehensive reviews of past major tax compliance studies are provided by Jackson & Milliron (1986) and Richardson & Sawyer (2001), the earlier being well cited in the tax studies. Jackson & Milliron (1986) provide a review of 43 tax compliance studies carried out between the 1970s and 1985. Richardson & Sawyer (2001), in a similar way, provide a review and synthesis of more than 130 tax compliance studies published from 1985 to 1997 (Abdul Jabbar, 2009), and, most 20 importantly, provide discussion on the progress made following suggestions given by Jackson and Milliron. Both reviews considered the key tax compliance variables, methods employed, issues and theory involved.

Taxes are considered to be one of the major elements in managing national income in both developed and developing countries (Alm, 2019; Alshir'ah et al., 2016). Developing ccountries want to use more money on education, public infrastructure, health services and so on, and thus, they need to increase their tax revenue as a proportion of gross domestic product (GDP) if they want to develop and grow (Bird et al., 2008). The majority of countries around the world develop their nation primarily from tax sources, either direct taxes or indirect taxes (Palil, 2005). Hence, taxes and the tax system are essential ingredients of any attempt to build nations, especially in developing and transitional countries (McKerchar & Evans, 2009). Taxation is also the base for the growth in operations, expansion and development as it indicates the process through which a government formally acquires the resources needed to finance efficient governance (John, 2011).

The government should have sufficient revenue to finance infrastructure, social services and ensure adequate provision of services. Furthermore, taxation has become increasingly important for the state and society (Alshira'h et al., 2018). Tax revenue collection has become a significant issue. Particularly after the economic crisis of 2008, the increasing public fiscal deficit of states has raised the need for tax revenue considerably, and states have turned toward universal collaboration to combat tax non-compliance (Sawyer, 2014). The increase in the tax non-compliance behavior of taxpayers is a significant matter for tax authorities and governments (Puspitasari & Meiranto, 2014). The increase in tax revenue lies in the efforts to encourage tax compliance behaviour and thus tax compliance is a prime concern for all countries (Franzoni, 1999). The causes of tax non-compliance raise significant issues for governments and tax authorities because it affects both the justice and effectiveness of the economy (Devos, 2005). Tax non-compliance is a serious and growing problem in all economies and societies in both developing and developed countries (Alshir'ah et al., 2016; Randlane, 2016).

Sales tax[1] non-compliance is also a topic of independent concern, since, in recent decades, it has replaced other shapes of sales tax in numerous countries and continues to attract new converts (Das-Gupta & Gang, 2003). Sales tax, or as called in many countries, such as Britain, the USA, France and Malaysia, value added tax (VAT), was introduced for the first time in France in 1954, where VAT was considered as a type of consumption tax on goods that was imposed at the production level (Adams & Webley, 2001). Sales tax is seen as crucial in providing the tax revenue base for governments, particularly in developing countries (Faridy et al., 2016). Sales tax non-compliance remains unabated, thus there is a need for effective sales tax enforcement to hopefully deter sales tax non-compliance (Lee, 2016). Sales tax compliance activities are considered more of a burden on SMEs compared to other types of tax (Hansford & JohnHasseldine, 2012).

Globally, the issue of sales tax evasion and fraud are not confined to EU countries or to high-income countries. Indeed, sales tax non-compliance is more pervasive in developing countries (Keen & Smith, 2007). However, very few empirical studies have focused on sales tax compliance (Alshira'h et al., 2018). Even through the majority of developing countries depend on tax revenue that comes from indirect taxes rather than direct taxes. In the context of Jordan, the shadow economy increased from 19.4% in 1999 to 20.4% of GDP in 2000, and, consequently, promoted an increase in the sales tax rate from 10% to 13% in 1999. During the period 2010 to 2015 the shadow economy increased from 22.1% to 24.5% of GDP (Jordanian Economic Social Council (JESC), 2014). Arachi & Santoro (2007) suggested that SMEs are considered to be the main contributors of income in the shadow economy in developing countries. Pope and Abdul-Jabbar (2008) indicated that the taxation of SMEs has attracted increasing interest in the last decade in developing and developed states alike. Swistak (2015) indicated that the tax compliance of SMEs requires special interest, so that the issue of an overwhelming number of SMEs being unable to fulfilling their tax compliance can be addressed. Young Entrepreneure Association (YEA, 2011) found that around 87% of small enterprises and 35% of medium enterprises did not pay their sales tax in Jordan, which is all the more worrying as SMEs represent more than 99% of the total enterprises in Jordan. The factors contributing to the tax compliance behaviour of SMEs is yet to be fully ascertained. Therefore, this study aims to investigate the factors that cause the high rate of tax non-compliance in Jordanian SME

Taxes are deemed to be the primary government source of revenue in Jordan (Al-Naimat, 2013). The role of taxes in the country's development has been emphasized after the sharp economic crisis in 1988, and ever since the adoption of the first International Monetary Fund (IMF) economic adjustment program in 1989, the Jordanian government has tried its best to make reforms when it comes to tax system efficiency, increased tax revenue, and reduced dependence on non-tax revenue. Jordan has very limited economic resources, experiencing a chronic budget deficit, and, hence, tax is a very important resource for financing all social and economics projects (Alshira'h et al., 2018).

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Tax compliance

Taxes are critical elements of total domestic revenue in developed and developing states. In the whole world, the countries promote their economy by heavy dependence on both types of taxes whether direct and indirect (Torgler & Schaltegger, 2005; Palil, 2005). Tax compliance is a compulsory duty of all people, whether corporate or individual. All people are expected to voluntarily comply with tax law; but some people do not do so (Kirchler et al., 2014). The companies and individuals who do not comply to pay tax are a critical challenge facing tax agencies (Alm, 2019). Generating and ensuring tax compliance depends on the participation of taxpayers in governmental decisions and expenditures (Alm et al., 1993), and increasing penalties and tax audit (Alm & Torgler; 2011). Despite numerous efforts to address tax compliance, this issue remains a complex and continuous one. Tax compliance is considered one of the contemporary issues, particular in developing countries, which try to determine methods to develop efficiency in collecting of tax revenue to support their budgets financially (Maseko, 2014).

There is no existing specific standard to defining tax compliance throughout tax compliance researches. Tax compliance is defined as taxpayer's ability and willingness to comply with tax laws, which are determined by ethics, legal environment and other situational factors at a particular time and place (Palil & Mustapha, 2011; Kirchler et al., 2006). Tax compliance is also considered such as a game, which depends on reciprocal interactions between decisions taxpayer and tax agency, and a trust of taxpayer in tax law and fairness of tax system (Kirchler et al., 2006). Tax compliance has multi-faceted measures, where compliance of taxpayers should follow three various types of compliance: reporting compliance, filing compliance, and payment compliance (Brown & Mazur, 2003).

Tax compliance, tax avoidance, tax evasion and tax fraud are used synonymously throughout tax compliance research, with several researchers making a difference between tax evasion and tax avoidance. Tax non-compliance is taking either the form of tax evasion or tax avoidance, relying on the legality grade of taxpayers' business (illegal business or legal business) (Likhovski, 2007). Tax evasion involves of illegal and intended business taken by institutions and individuals to lower their legally due tax commitments, by under-reporting sales, income, or wealth, by exaggerating deductions, dispensations, or loans, or by failing to file suitable tax returns (Ritsatos, 2014). Tax evasion is intended to be premeditated actions of tax non-compliance generating in pay of tax lower than is in fact owed (Kasipillai et al., 2003). Abdul-Jabbar & Pope (2008) said that tax evasion includes some elements of illegal behavior coupled with an intention of the taxpayer to intentionally mislead tax reporting, fool the tax authority to pay low tax than is indeed owed. Tax evasion is always against the tax law. Kasipillai and Abdul-Jabbar (2006) indicated that tax non-compliance may take different measures and they contain: failure to submit a tax return within the stipulated period or non-submission, understatement of income, overstatement of deductions, and failure to pay assessed taxes by the due date.

Tax avoidance occurs when taking advantage of ambiguities or impairment in the tax law to lower duty tax, breaking liabilities, in other words, tax avoidance may be referred as unethical (Slemrod & Yitzhaki, 2002). However, tax avoidance is legal when it indicates the taxpayers' cleverness to regulate his affairs in a suitable manner so as to decrease the payment of tax (Kasipillai et al., 2003). Likhovski (2007) explained that tax avoidance forms act which based on loopholes in the tax law. Slemrod (2004) and Alm et al. (1990) showed that tax avoidance is any legitimate actions that reduce taxes. On the other hand, when taxpayers comply with their tax owed, this indicates that tax gap will be lower. Tax gap refers to the monetary variance between taxes collected and tax due (Mascagni et al., 2014; Strader & Fogliasso, 1989). When numerous people evade their tax commitments, it will be hard for the state to supply the public services, including education, provision of electricity, security, road construction, provision of electricity, and health services at affordable prices. The issue of non-compliance is imperative to policy makers because non-compliance represents lower revenue and results in a serious loss to government. Tax non-compliance may also create an unfair burden on honest taxpayers, leading to disrespect for the tax system. Therefore, many tax administrations put enormous effort into combating non-compliance and identifying all possible measures to improve compliance.

Tax Fairness

Tax fairness is one of main factors of a good tax system (Thomas, 2012). Tax fairness is considered one of main determinants of tax compliance (Jackson & Milliron, 1986). It is widely believed by tax administrators and the taxpayers that growing dissatisfaction with the fairness of tax system is the major causes behind increased tax non-compliance (Chau & Leung, 2009). Tax fairness appears to consist of two dimensions, namely: first dimension appears to include the fairness of the commerce and the interest received for tax given, while the second dimension appears to comprise the justice of the taxpayers' burden in relation to that of other taxpayers (taxpayers understanding of the vertical and horizontal fairness of the tax laws) (Jackson & Milliron, 1986). In addition, the fair tax system is based on three elements, namely: country legitimacy, the motivation of taxpayers compliance to pay their tax and the performance of the tax department (Ajaz & Ahmad, 2010). Ulbig (2002) and Samuel & Dieu (2014) reported that fairness of tax departments and governmental procedure leads to instilling trust in the community and convincing them that the tax laws is fair, and in turn, this leads to tax compliance. This finding is supported by other prior studies (McKerchar et al., 2013; Mcgee, 2012; Kirchler & Wahl, 2010; Feld & Frey, 2007; Mikesell & Birskyte, 2007; Bryan, 2000; Chan et al., 2000; Alm et al., 1992; Alm, 1991).

On the other hand, Ajaz & Ahmad (2010) asserted that public governance leads to increase tax fairness, which increases tax compliance. They argued that public governance brings good tax system. According to Tan & Chin-Fatt (2012), a good tax system should be designed on the basis of suitable group of principles, such as fairness and confidence. In the view of Berkeley (2006) and Cummings et al. (2009), tax compliance is increased when the increase the perception of taxpayers about fair fiscal exchange is increased. In other related studies, Maseko (2014) pointed out that the perceptions of SMEs to tax fairness influence tax compliance decisions. In contrast, some prior studies found that tax fairness has an insignificant relationship with tax compliance (Benk et al., 2011). On the other hand, Tumwesigye (2011) revealed a significant negative correlation between tax fairness and tax compliance.

In general, the relationship between tax fairness and tax compliance is still not clear because of the mixed results in the literature. Majority of researches on tax fairness and tax compliance has focused on income tax, while sales tax compliance has received very little attention. Additionally, most of prior studies have examined tax fairness and tax compliance at the level of individuals, while SMEs' tax compliance with tax fairness got very little interest. Therefore, more studies are required to determine the relation between tax fairness and tax compliance. This study considers tax fairness is one of the main determinants of tax compliance. But there is no any study that has been conducted on the impact of tax fairness on sales tax compliance of SMEs in the Middle Eastern and Arab countries, especially Jordan. Therefore, there is a need for more studies on this. Therefore, this study hypothesis is as follows

H1: There is a positive significant relationship between tax fairness and sales tax compliance.

RESEARCH METHOD

The current study is quantitative in nature by investigating the associations among independent and dependent constructs. This research considers registered SMEs in Jordan chamber of industry (JCI) as a sampling frame. 17,849 Jordanian SMEs are registered in (JCI, 2017). The sample size in the current study is 377 according to Krejcie & Morgan (1970). In order to avoid low response rate which is common in most studies involving SMEs. There is need to increase the sample size. This will be founded on prior literature that indicated that a non-response rate is at 75% in the context of business in Jordan (Lutfi et al., 2017; Lutfi et al., 2016). Based on considerations mentioned above, the sample size of the present study increased to be 660 of SMEs. The targeted respondents are owners/managers of SMEs because this type of respondents are sufficiently knowledgeable on taxation and they have an appropriate capacity to reply the requested information. The procedure applied to select a sample was the probability sampling technique because the method has less bias and provides for the most generalizability of findings (Zikmund et al., 2013). Therefore, a systematic random sampling technique was utilized in this study to select 660 of respondents from the list that provided by JCI. The sampling interval for the current study was (population/sample size) 17,749/660=27. At a beginning point the researcher chosen the number 27 and the sampling elements were numbered 27, 54, and 81 and so on up to the last sample to be selected. That is, the sampled element number of 660. After around three months, 221 (33.5%) questionnaires were collected from SMEs. Of them, 6 were incomplete and consequently were removed from the analysis. Therefore, the effective response rate for the present study was (215) 32.5%. Based on Sekaran & Bougie (2016) a response rate of 30% and above is acceptable for a survey. Additionally, Baruch & Holtom (2008) have also suggested that around 30% of the response rate from the organizational level is acceptable.

Hair et al. (2010) suggested that the number of observations to the number of latent constructs (variables) included in research should be at least 5:1. The current research had one latent construct and the number of usable responses was 215. Moreover, Green (1991) and Tabachnick & Fidell (2007), in determining the minimum sample, considered the power level desired, level of significance and number of predictors. Consequently, they suggested the following formula to calculate the size required (N ≥ [50+8 m], where m=number of independent latent variables, and N=the number of cases). Based on this formula, the minimum required number of cases was 58, which is less than the number of cases that this study collected (215 cases). Thus, this study had an acceptable number of observations to proceed with the analysis.

DATA ANALYSIS

The current study utilizes partial least square structure equation modeling (PLS-SEM) to test the suggested hypothesis. Many scholars suggest that PLS-SEM can work efficiently within particular conditions (Hair et al., 2016; Hair et al. 2012). PLS-SEM is suggested to be a convenient analytical tool when the proposed model contains higher-order latent variables (Becker et al., 2012; Hair et al., 2011). It also works competently when each latent variable has many observed variables. It is worthy to mention that PLS-SEM is an alternate option particularly when the characteristics of the data do not encounter the regression assumptions such as normality and sample size (Hair et al., 2011). Following the rule of thumb suggested by Hair et al. (2011) this study initially examined the validity and reliability of the measurement model. As demonstrated in Table 1, the Composite Reliability (CR) and Cronbach's Alpha (CA) are well above the conventional value of 0.7 which emphasizes the internal consistency reliability of variables. Regarding to indicator reliability, several researchers have suggested a cut-off point of 0.40 (Hair et al., 2017; Hair et al., 2014), which confirms the reliability of the indicators. The current study also asses the validity of the measurement model through Average Variance Extracted (AVE). As illustrated in Table 2, the AVE for each variable were well above the threshold of 0.5.

Table 1
COMPOSITE RELIABILITY, CRONBACH'S ALPHA, AVE AND ITEM LOADING.

Latent construct	Items	Loading	CR	CA	AVE
Sales tax compliance (STC)	STC1	0.818	0.882	0.844	0.519
	STC2	0.819			
	STC3	0.726			
	STC4	0.695			
	STC5	0.665			
	STC8	0.643			
	STC9	0.659			
Tax fairness (TF)	TF1	0.776	0.864	0.817	0.516
	TF2	0.785			
	TF3	0.714			
	TF4	0.669			
	TF5	0.663			
	TF6	0.695			

As shown in Table 1, some items that ranged between 0.40 and 0.70 were omitted as suggested by Hair et al. (2014) to increase the values of the AVE of the related latent variables to the minimum acceptable value, thus necessitating the removal of a number of items from these constructs to establish reasonable reliability, namely, STC6, STC7, STC10, STC11. Accordingly, we can see that all variables in the model explain more than half of their own indicators' variance which implies an adequate convergent validity. Further, to ensure the discriminant validity, we examined the AVE square root. As indicated in Table 2, AVE square root value for each variable was greater than its correlation with the other variables demonstrating a great level of discriminant validity. However, grounding on the figures provided above, there is evidence that the measurement model is valid and reliable. Therefore, we can conclude that our measurement model is suitable for further analyses.

Table 2
THE AVES SQUARE ROOTS

	STC	TF
STC	0.721	
TF	0.010	0.719

Thereafter, the researcher establishes a structure model which is intended to test and examine H1. the researcher assessments the path coefficients and their significance level for each variable in the structure model using PLS algorithm and the PLS bootstrapping procedures using a resample of 5000. The finding of the assessment of the structure model are presented in Table 3. Table 3 shows that the relationship between tax fairness and sales tax compliance was positive and significant β=0.153, t=2.587, $p \leq .0.01$), indicating that as the tax fairness increases, sales tax compliance of SMEs will increase too, thereby the researcher decides to accept H1. The study model explains 24% (R^2) of the dependent variable (sales tax compliance) suggesting large exploratory power.

Table 3.
RESULT OF HYPOTHESES TESTING (DIRECT RELATIONSHIP)

H	Relationship	Path coefficient	T –Value	P – Value	Decision
H1	TF -> STC	0.153	2.587	0.010*	Supported

Note: Significant at $^*p \leq .0.01$ (one-tailed test)

DISCUSSIONS

Tax fairness is one of main determinants of tax compliance. Jackson & Milliron (1986) stated that it is commonly accepted that perceptions of tax fairness and tax compliance are linked. Public perception that the taxation system is fair and equitable is important if the success of that system relies on a significant degree of voluntary tax compliance (Gilligan & Richardson, 2005). Tax fairness is significantly associated with a perception of an improved tax system and tax fairness and tax non-compliance are negatively related (Hite & Roberts, 1992). Thus, the current study hypothesized that tax fairness would have a significant positive association with sales tax compliance (H1). The results of the current study indicated that tax fairness had a significant positive association with sales tax compliance; thus, this supported H1. This finding is in alignment with the socio-psychological approach (Adams, 1965), which posits that the fairness of tax system affects a taxpayer’s behavior positively. This result is also consistent with the extant literature that supports a significant positive relationship between tax fairness and sales tax compliance of SMEs (Woodward & Tan, 2015). However, the relationship between tax fairness and sales tax compliance research is still scarce. Therefore, finding is supported by some past studies that associated tax fairness and income tax compliance as a tax behavior and found a significant positive relationship between tax fairness and income tax compliance (Fochmann & Kroll, 2016; Ross & Mcgee, 2012; Ajaz & Ahmad, 2010; Kirchler & Wahl, 2010). Etzioni (1986) argues that an unjust taxation system will probably lead to tax non-compliance more than an increased tax rate, indicating that taxpayers do not comply with paying taxes when they believe the taxes to be unjust, even when the tax rate is not high. Alasfour et al. (2016) found that improving perceptions on equity and fairness in the Jordanian tax system would increase tax compliance. Therefore, as part of the first objective of this research, this finding provides evidence that tax fairness is a positive determinant of SMEs sales tax compliance in Jordan.

CONCLUSION, POLICY IMPLICATIONS, LIMITATIONS, AND RECOMMENDATIONS

The discussion above reveals that tax fairness has a positive influence on sales tax compliance of Jordanian SMEs. The current study makes several significant theoretical and practical contributions to the literature on accounting and taxation. It contributes to the accounting literature in association with sales tax compliance and tax fairness in developing countries such as Jordan. To the best knowledge of the researcher, very few studies have been carried out in the context of sales tax compliance, and these included studies of New Zealand and Bangladesh (Woodward & Tan, 2015; Faridy et al., 2014). Meanwhile, no study has been conducted on sales tax compliance in the Arab countries and the Middle East, especially in Jordan. Consequently, the present study can be considered a first that was conducted in the context of sales tax compliance and tax fairness in Arab countries and in the Middle East, particularly in Jordan. Therefore, the current study was designed to fill the gap in sales tax compliance literature. The findings of this thesis provide evidence that high tax fairness increases the level of sales tax. In dealing with the tax fairness issue, tax fairness impacts the sales tax compliance when SMEs perceive that compliance with the sales tax is justifiable in light of the fairness of the sales tax system. To increase the sales tax compliance, this research suggests that the tax authority should make the threshold of registration fair and reduce sales tax compliance costs for businesses.

There is no study without limitations; the present study has limitations that should be considered when interpreting the results. Furthermore, these limitations also display opportunities for future research to consider. Therefore, the current study model was capable to explain 24% of the total variance in sales tax compliance, which means that there are other variables that could also significantly explain the variance in sales tax compliance. In other words, the remaining 76% of the variance in sales tax compliance could be explained by other latent variables. Therefore, future study is needed to consider other possible contracts that could impact the sales tax compliance such tax knowledge, religion, external audit, gender of tax auditor, and tax service quality. This study is considered the beginning of research in sales tax compliance in Arab countries and the Middle East, most specifically sales tax compliance in Jordanian context and thus, this study can be utilized as a background theoretical framework for researchers. However, the research is confined to the limited geographical area where it has been carried out. Consequently, future studies could extend the model of this study to other Arab countries and the Middle East.

ENDNOTES

1. It is important to note that sales tax in the Jordanian context is referring to VAT or GST elsewhere. Thus, caution should be made when referring to sales tax context in other countries.

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