

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

This chapter comprehensively reviews the gathered literature consistent with the study's problem statement and objectives. Based on the empirical and theoretical literature, the main topic is justified, contributing to the development of conceptual framework. Notably, empirical literature is first discussed, which narrows down to the theoretical literature. This chapter also outlines and presents a graphical representation of the conceptual framework.

2.2 An Overview of Tax System in the UAE

The tax system in the UAE holds significant appeal for expatriates due to its limited taxation policies. Historically, until January 2018, the absence of income tax and VAT and the introduction of a relatively low VAT rate (at 5%) have been the key appeal. Additionally, the UAE imposed an excise tax on specific products deemed harmful to health or the environment, such as energy drinks and tobacco (Expactica UAE, 2021). Following in June 2023, the UAE introduced a new corporate tax, marking a shift in its tax landscape.

At present, the UAE does not levy income tax on individuals, including freelancers and self-employed residents. However, GCC nationals working in the UAE are subject to a social security regime, with varying rates for UAE nationals and non-nationals (European Commission, Directorate-General for Taxation and Customs Union et al., 2022). As for foreigners working in the UAE, there is no income tax

liability, but they may be subject to taxation in their home countries. Additionally, the UAE adheres to the Common Reporting Standard (CRS) for the exchange of tax data between participating countries. In regards to property and wealth, the UAE generally does not impose capital gain tax or stamp duty. Islamic Shari'a principles govern inheritance in the absence of a will.

The UAE aims to foster global partnerships through Double Taxation Agreements (DTAs) and Bilateral Investments Treaties (BITs). Notably, the country has secured numerous DTAs and BITs to exempt or reduce taxes on investments and profits (Government of UAE, 2022). Corporate taxes are primarily imposed on oil companies and foreign banks. However, companies in 46 free zones enjoy tax exemption. Nevertheless, corporate tax regulations are set to change with the introduction of a federal corporation tax from June 2023, applicable to companies earning net profits of AED 375,000 or more (PricewaterhouseCoopers, 2022). In terms of business taxation, most companies in the UAE are exempted from corporate tax, such as foreign oil companies and branches of foreign banks. The country also implements VAT and excise duty on certain products and services, with specific exemption and rate (Expactica UAE, 2021) specified by the FTA (SHRM, 2022). Furthermore, the UAE imposes various taxes and fees on tourist facilities, property transfers, and rentals, which vary across emirates.

The UAE emphasises compliance with tax laws and regulations to deter tax avoidance and evasion, with penalty for non-compliance. Personal tax advice may be less common due to the absence of income tax; companies often seek professional financial guidance to effectively navigate tax liabilities (Pricewaterhouse Coopers, 2022).

2.3 An Overview of VAT

A tax system is defined as a set of rules, regulations, and procedures with three distinctive aspects. Firstly, it defines what events or states of the world trigger tax liability—for examples, the earning of income, the ownership of a residence that may be subject to property tax, or the sale of a capital asset—and the rate schedule to be applied to these bases (Kenton, 2021). Although this first aspect is the principal object of modern tax analysis, it represents only one part. A tax system also must specify who or what entity must remit the tax liability and when or in other words, remittance rules. For instance, under most income tax systems, it is the employer who remits—actually sends to the government—an approximation of what tax their employees owe on that income. Although standard analysis often dismisses this as irrelevant, recent studies have suggested that, at least in some circumstances, this significantly matters. Thirdly, a tax system details procedures for ensuring compliance, including the provision of third-party information-reporting requirements and the consequences, including penalties, of not remitting legal liability; these are the enforcement rules (Kasim et al., 2020; Munir, 2021; Shakkour, 2021).

The tax base and remittance system can have profound effect on the enforceability of taxation. The enforcement regime can affect the impact of tax rates on taxpayers' decisions that determine the tax base. Tax evasion is an important issue because it affects the resource cost of raising taxes and the distribution of the tax burden—the bread-and-butter concerns of public economics. If tax evasion could somehow be eliminated at no cost, the additional money collected could be used to finance worthy government projects, or cuts in tax rates would benefit most compliant taxpayers. However, expanding government programmes can be financed in several other ways, such as by raising tax rates or by broadening the income tax base; a tax

reduction could be financed by cuts in overall spending (Slemrod, 2019b). Various opinions exist as to the best ways to improve tax compliance. Given the opportunity, many companies only pay taxes if there is a motivation to do so. Some believe that the best way is to increase tax incentives, while others opine that the best way is to increase tax penalties (Barney, 1986; Bachkaniwala et al., 2001).

Sidek and Abdulraqueeb (2022) defined “value added” as the value that a producer (whether a manufacturer, distributor, advertising agent, hairdresser, farmer, racehorse trainer, or circus owner) adds to the raw materials or purchases (other than labour) before selling the new or improved product or service (Cressy, 1996). In other words, the company purchases the inputs (e.g., the raw materials, transport, rent, and advertising), pay their employees wages to work on these inputs, and earn some profits when the final product or service is sold. Increased revenue of VAT system can provide a reliable source of state revenue due to its wide-reaching base and multiple collection sources, unlike traditional sales taxes, which are only applied upon sale. VAT levied at every stage of production captures value added at each step; thus, creating an easy and steady source of state income (Werekoh, 2022). VAT plays an instrumental role in decreasing tax evasion. VAT provides an audit trail of transactions, which allows tax authorities to monitor each step in the distribution and production chain and detect instances of potential fraud. Furthermore, companies required to register as VAT-registered entities and file regular returns increase compliance and decrease the chances for tax evasion (Amirrudin & Nasution, 2021).

The introduction of VAT can be attributed to various considerations, primarily the aim of creating a more effective and equitable tax system. As opposed to traditional sales taxes, which are only levied at the point-of-sale, VAT levies are applied throughout production, which allow the recovery of input tax credits and prevent “tax

pyramiding” (where taxes are added on top of the existing ones, creating higher consumer cost) (Nar, 2023). VAT provides more reliable revenue to the government than other forms of taxation, such as corporate and income taxes, which fluctuate based on economic factors. Through the diversification of revenue sources, the government can better weather economic fluctuations while funding essential public infrastructure (Werekoh, 2022). VAT creates an easy paper trail of transactions, making it an efficient tool for tax authorities to combat tax evasion. This enables them to monitor products and services as they move throughout the economy, monitoring compliance rates, and decreasing tax evasion chances (Keen & Lockwood, 2010).

VAT implementation requires cooperation among all stakeholders—business owners, government agencies, and taxpayers. Compliance and enforcement tax authorities are responsible for upholding VAT laws and regulations by conducting regular audits to monitor compliance with tax obligations (OECD 2010; Government of UAE, 2022). They conduct these audits through audits that involve auditing services that specialise in VAT auditing (OECD 2010). There are several operational guidelines to keep in mind for the VAT implementation in the UAE (European Commission, Directorate-General for Taxation and Customs Union, Poniatowski, Bonch-Osmolovskiy, Śmietanka, 2022; Government of UAE, 2022; IFZA, 2023). Firstly, companies meeting the threshold requirements for VAT registration must register with tax authorities and obtain a VAT Identification Number, which allows them to assess VAT on tax-exempt supplies and claim tax credits on eligible purchases (Government of UAE, 2022). Secondly, VAT applies to products and services provided within a country and imports. Certain essential food items and healthcare services may be exempted from the list of taxable transactions to minimise overburdening households with limited incomes (OECD, 2010). Thirdly, registered companies must issue tax

invoices for every tax-paying transaction they engage in, which include details of the products or services offered, VAT costs incurred, and how long these invoices must be kept (Bala et al., 2019). Adding to that, filing and payment tax returns must be filed periodically (typically monthly or quarterly), depending on where the company operates. Companies typically calculate their VAT obligations by subtracting credits for input tax from output tax before paying any remaining net amounts to tax authorities (Bala et al., 2019).

VAT was first implemented in the UAE on 1 January 2018. Service providers pay a 5% indirect tax imposed on most products and services supplied at every stage of the supply chain through their consumers. The primary goals of VAT are to supply high-quality public services and to reduce the country's reliance on oil and other hydrocarbon resources (UAE, 2021). Every emirate within the UAE utilises the same tax system, including VAT regulations and rates. This uniformity in tax policies and implementation across all emirates is a deliberate strategy by the UAE government to ensure consistency and coherence in taxation throughout the country (Dularif & Rustiarini, 2021).

The primary reasons for the implementation of a unified tax system across the UAE are to promote economic efficiency and to facilitate ease of doing business. Through consistent tax regulations and rates across all emirates, companies operating in different parts of the country face fewer complexities and uncertainties regarding taxation. A unified tax system promotes economic integration and cohesion among the emirates. It eliminates disparities in tax policies that can lead to distortions in economic activities or unfair advantages for businesses in certain regions. The UAE government aims to create a seamless and integrated economic environment conducive to

sustainable growth and development across all emirates by harmonising tax regulations (The Finance Stories, 2021).

Additionally, this uniformity creates a level playing field for businesses and helps foster a more transparent and predictable business environment (Government of UAE, 2022). Moreover, a standardised tax system enhances compliance and enforcement efforts. With uniform tax laws and regulations, tax authorities can effectively monitor and enforce tax compliance across all emirates. It reduces the likelihood of tax evasion and ensures that companies fulfil their tax obligations uniformly, irrespective of their locations within the UAE (IFZA, 2023). Besides that, a consistent tax system enhances the UAE's attractiveness as a business and investment destination on the global stage. Investors and multinational corporations value regulatory stability and predictability when it comes to making investment decisions. The presence of a uniform tax system reinforces the UAE's reputation as a business-friendly jurisdiction and instils confidence among investors regarding the regulatory framework governing taxation (Government of UAE, 2022).

Hence, the decision to implement the same tax system across all emirates of the UAE reflects a strategic approach aimed at promoting economic efficiency, compliance, integration, and investor confidence. The UAE government seeks to create an enabling environment for sustainable economic growth and development across the entire country by ensuring consistency in tax policies and regulations (Expactica UAE, 2021).

Evidently, VAT is a new source of income for the UAE, which ensures the continuity of high-quality government services in the future. Companies and institutions pay the government the taxes collected from consumers, and in some cases, these companies may recover the taxes paid to their suppliers. Consequently, the net tax revenue received by the government is value-added throughout the supply chain stages

(Ministry of Finance UAE, 2017). After all, VAT is a vital source of revenue for countries around the world, and apart from its significant impact on the GDP, it is one of the most widely available means of indirect taxes (Saderuddin & Barghathi, 2018). Therefore, VAT can help the UAE government to diversify its revenues to reduce its dependence on the oil sector (Ministry of Finance UAE, 2017).

In the UAE, instead of taxes, a system of collecting fees is employed, such as residency fees for employees and their families and annual licensing fees. As such, no tax is levied on individual income or companies, which then increases the desire to start their businesses in the UAE (Bachkaniwala et al., 2001; Bird & Gendron, 2007; Ahmad & Brosio, 2010a, 2010b). Furthermore, the establishment of “free zones” in various emirates in the country introduces significant advantages, such as tax-free and duty benefits, which are intended to support the economic growth of the UAE; thus, affecting the country’s fiscal policy (Sidek & Abdulraqueeb, 2022).

Similar to many other countries, the UAE has a large number of SMEs owned by multinational corporations (MNCs) operating within the country (Saderuddin & Barghathi, 2018). For example, Bayt.com, headquartered in Dubai, UAE, is one of the leading job search websites in the Middle East. It provides online recruitment services for employers and job seekers across various industries and sectors in the region. Besides that, Careem is a multinational transportation network company based in Dubai, UAE. It offers ride-hailing services, bike rentals, and food delivery services across several countries in the Middle East, North Africa, and South Asia. Meanwhile, Fetchr is a logistics and delivery company headquartered in Dubai (Genc et al., 2019), UAE. It utilises innovative technology to provide efficient and reliable delivery services to individuals and businesses across the Middle East and beyond. There is also Souq.com, which is now part of Amazon. Based in Dubai, UAE, it is the largest online marketplace

in the Arab world. It offers a wide range of products, including electronics, fashion, household products, and more, catering to consumers across the Middle East (Mohammed, 2019). Property Finder is a real estate portal headquartered in Dubai, UAE. It provides online property listings, real estate news, and market insights for buyers, sellers, and renters across the Middle East and North Africa regions. Anghami is a music streaming platform based in Abu Dhabi, UAE. It offers a vast library of Arabic and international music for streaming and downloading, catering to users across the Middle East and North Africa. Additionally, Mumzworld is an online marketplace for mother-and-baby products based in Dubai, UAE. It offers a wide range of products, including baby gear, toys, clothing, and maternity essentials, catering to parents and families across the Middle East. Dubai-based SellAnyCar.com is an online platform that facilitates the sale of used cars. It provides a convenient and hassle-free way for individuals to sell their vehicles quickly and efficiently (Younis & Adel, 2020).

The UAE follows an open economy system for all nationalities and races. For some owners of these SMEs, English is their first language, which may increase the tax compliance cost burden. This creates an obstacle to the growth of SMEs, affecting the competition between registered and unregistered companies and imposing the burden of compliance on small companies in particular (The Finance Stories, 2021). According to the UAE Cabinet Decision (No. 4) in 2020, VAT is exempted for certain financial services, including residential real estate, with a zero-rating for the export of services. However, this exemption is applied only if these services are present on a short-term basis (e.g., for a month), and their presence is linked with the supply (World Tax Summaries, 2021). Besides that, certain trades between the companies in the designated (free) zones are exempted from VAT compliance. However, according to the UAE's tax legislations, the supplies in designated zones are not exempted from VAT.

Notably, businesses and residents in the UAE are liable to comply with the country's VAT regulations. The registration requirements for VAT are determined by a business's status and its level of taxable turnover. For UAE-resident companies, two registration thresholds apply. The compulsory registration threshold is set at AED375,000; companies whose taxable turnover exceeds this amount within a specified period are legally required to register for VAT. Furthermore, a voluntary registration threshold of AED187,500 is available; businesses that surpass this lower amount may opt to voluntarily register for VAT, even if their turnover has not crossed the compulsory threshold (Dularif & Rustiarini, 2021; Government of UAE, 2022).

In contrast, non-resident businesses making taxable supplies in the UAE are required to register for VAT regardless of their turnover, as there is no minimum registration threshold applicable to them. Failure to comply with these requirements may result in penalties, which can be either fixed or tax-geared, reflecting the seriousness of non-compliance with VAT legislation (World Tax Summaries, 2021).

In the UAE, the enactment of laws and legislations ensures the establishment of facilities for the licensing and legislations of labour and commercial laws in order to encourage SMEs. SMEs support and stimulate the country's economy and create an attractive environment for investments (Ahmad & Brosio, 2010a). However, as compared to larger companies, SMEs need tighter restrictions in regards to the resources available to them, such as compliance cost, taxes, and government laws (Amirrudin & Nasution, 2021). Hence, the volume of compliance is high for SMEs (Hansford et al., 2003). Apart from that, specialised skills and knowledge of labour laws, financial management, and tax laws are of particular importance and necessary for SME owners and the administration (Wilson et al., 1996). Various administrative requirements are imposed on SMEs, mainly through the local and central government departments.

Moreover, SMEs' resource constraints increase the difficulties they face in regulatory awareness, understanding, and compliance (Hansford et al., 2003). Among the most visible areas of regulations that SMEs face difficulties in are those that apply to tax laws (Amirrudin & Nasution, 2021).

2.3.1 Corporate Tax

The introduction of corporate tax on 20 June 2023 is the most recent advancement in the UAE's tax system. The standard corporate tax rate will be 9.9%. However, there are exceptions:

- i) Certain companies qualify for a 0% corporate tax rate. This applies to companies operating in designated free zones that meet specific criteria and do not conduct significant trade within the UAE mainland. This exemption is designed to preserve the quality of free zones and attract international direct investments.
- ii) Companies that fall within these guidelines under the agreement on global corporate minimum tax rates must pay an introductory corporate tax rate of 15%. This ensures the compliance of UAE with international tax regulations. The introduction of corporate tax has profound implications on companies operating across the UAE. Companies must be aware of the impact of corporate tax on their profits and possibly alter their structure of operation or pricing strategies.

2.3.2 Excise Tax

The UAE also charges taxes on excise for certain products that are considered harmful to human health or the environment. This includes cigarettes, sugary drinks, electronic cigarettes, and sugary drinks. Excise tax is added to these products in addition to VAT rates, which make the products more expensive to reduce consumption

(Government of UAE, 2022). This policy serves a dual purpose: generating income and promoting health.

2.3.3 Customs Duties

The UAE is liable for customs duties on imports of products. The rate of 5% of the value of freight, products, or insurance (CIF) is standard. However, higher rates apply to certain products, such as cigarettes and alcohol. These taxes protect the domestic industry and help to generate more government revenue.

2.3.4 Real Estate Taxes

Certain emirates charge property taxes for the possession and rental of properties. Tax rates vary based on the emirate's status, property type, and location. Knowing these differences is essential for developers and property investors (Government of UAE, 2022).

2.3.5 Economic Substance Regulations (ESR)

The UAE has adopted Economic Substance Regulations (ESR) that require certain companies to engage in certain activities to demonstrate their capacity to sustain their business within the UAE. This implies having an office space, employing qualified employees, and incurring appropriate operating costs within the UAE (European Commission, Directorate-General for Taxation and Customs Union et al., 2022). These rules aim to tackle tax evasion and ensure that companies operating within the UAE contribute to economic growth.

2.4 General Overview of Tax Compliance

Tax compliance encompasses adherence to laws, regulations, policies, and standards. Failure to comply with VAT regulations can impede a country's overall progress twofold (Thottoli, 2022). Hence, VAT compliance is recognised as a pivotal reform within any country's public financial framework (Shakkour et al., 2021). Tax compliance has been a subject of exploration in diverse literary works, and the concept is as old as the tax itself (Lutfi et al., 2023). Taxes are widely acknowledged as pivotal contributors to a country's overall domestic revenue worldwide. Both direct and indirect taxes serve as fundamental elements in the economic enhancement, bolstering endeavours of most countries.

Although taxation serves as a primary means to reassign wealth and fosters a stable social and economic framework, tax authorities in many countries grapple with dissatisfactory collection, which is typically linked to the extent of adherence among taxpayers. Prior to understanding VAT compliance, it is crucial to comprehend tax compliance first.

In principle, tax compliance entails taxpayers adhering to obligation guidelines, accurately reporting income each year, and timely paying the appropriate amount of tax (Batrancea et al., 2022). Tax compliance is also described as the extent to which citizens abide by tax regulations. Another study suggested that tax non-compliance stems from a mindset among taxpayers, potentially leading to evasion or avoidance, as confirmed by Al-Ttaff and Abdul-Jabbar (2016) within the Middle Eastern context. Consequently, tax compliance remains a significant issue warranting further research. Despite previous assessments, the understanding among stakeholders regarding tax compliance has remained lacking (Randlane, 2016). Sustained tax collection efforts are crucial to counter resistance in the long term (Lutfi et al., 2023).

Despite efforts to encourage tax compliance, the issue still lingers, and no universally agreed-upon definition of tax compliance exists in scholarly literature. Studies have explained this term in diverse manners; for instance, one researcher outlined tax compliance as the tendency of taxpayers to abide by their obligations to support a resilient economy (Adam et al., 2021). Jackson and Milliron (1986a) and Alm (1991) offered a similar elaboration, emphasising the disclosure of all income and payment of taxes as required by the prevailing laws. Roth and Scholz (1989) outlined compliance within the same domain of research as the prompt submission of all necessary tax returns, accurately reflecting taxpayers' responsibility pursuant to pertinent tax laws. Moreover, Brown and Mazur (2003) unveiled various measurement dimensions of tax compliance, categorising taxpayers' adherence into three components: compliance with filing, payment, and reporting requisites. In another study, tax compliance was referred to as a process whereby taxpayers report their taxable income, file tax returns, and settle their taxes within set deadlines (Saad, 2014). Kasim et al. (2020) expanded on this notion by likening tax compliance to a game dependent on taxpayers' confidence in the law, the fairness of the tax system, and the reciprocal interaction between taxpayers' actions and those of the tax authority.

2.5 Internal and External Factors Affecting Compliance Behaviour

2.5.1 Monetary Cost

There are three major components of VAT compliance cost, namely monetary cost, time cost, and psychological cost. Factors influencing compliance cost include the cost of collecting, converting, and calculating product taxes (Agbadi, 2011). Corporate profits and the wages and salaries of employees, including the monetary cost of

acquiring knowledge (e.g., knowledge of legal obligations and penalties), are part of a company's tax compliance cost (Pandey & Kingsley, 2000; Bachkaniwala et al., 2001).

Mukundi et al. (2017) argued that the operational definition for the consideration of cost-related factors for VAT requires the guidance of available data. In this regard, Evans (2008) noted that what must be included or excluded to estimate compliance cost primarily depends on data availability. This includes data on all expenses incurred on tax compliance, which can be classified into external and internal costs. Internal costs are calculated according to the internal amounts arising due to the accounting work done by the employees (Hansford et al., 2003; Mansor & Ferdjani, 2017; Saderuddin et al., 2017), such as the costs of preparing checks, tax lists, equipment expenses, transport, training, printing, communication, storage of records and tax documents, technology equipment, and so on (Highfield, Evans & Walpole, 2016). On the other hand, external costs include all payments made by companies to external entities, such as accountants, consultants, tax experts, and lawyers, for their assistance in tax compliance.

Studies have revealed the involvement of economies of scale and monetary cost in the SME processes. Hence, when compliance cost is expressed as a percentage of the value of trading, its impact becomes more apparent for smaller companies, whereas monetary cost is hardly noticeable for larger companies (Hansford et al., 2003; Woellner et al., 2003; Saderuddin et al., 2017). Financial economies have led to the consideration of compliance cost as "regressive" because smaller companies tend to be more affected than larger companies (International Finance Corporation, 2009; Bannaga, 2017a). In most realistic cases, when cash flow benefits are taken into account, certain large companies face negative compliance cost. This implies that these large companies benefit from collecting and paying VAT before it is transferred to the

tax agency. However, for SMEs, this means an increase in the monetary cost of their compliance (Hansford et al., 2003).

2.5.2 Time Cost

Taxation is characterised by substantial amounts of burden, renewal, and diversity over time, and it is the responsibility of taxpayers to perform various procedures to achieve it efficiently (Zídková, 2014). In other words, every minute spent on working on these tasks is valuable (Lignier & Evans, 2012). The evaluation of the time spent is an important method to determine such cost (Seens, 2013). A timekeeper ensures timely tax compliance (Bikas & Raškauskas, 2011). Therefore, it is crucial to consider the nature of tax liabilities because these liabilities can be classified as monthly, quarterly, or annually; this factor affects the volume of work within the company, which involves time (Godin & Hindriks, 2015). The time taken to prepare declarations and salaries based on the number of hours per year involves measuring three main types of taxes and contributions, namely corporate profits tax, sales tax, and employment tax, as well as the time taken for collection and social security contributions (Wadesango et al., 2018b). Apart from determining the taxes for wages and salaries, it is necessary to calculate the tax and the time taken to keep records and books (Hansford et al., 2003; Mansor & Ferdjani, 2017).

Most SMEs often conduct audits, and SME owners prepare financial statements for the execution of VAT compliance (Hansford et al., 2003). According to Brunton (2005) and Rametse (2006), SMEs have fewer employees than larger companies due to the limited resources owned by these companies, which affect the time required to complete the audit and financial and accounting work in the preparation of financial statements or taxes. Moreover, SMEs' reliance on external consultants or external

auditors increases the time spent on VAT compliance (Saderuddin et al., 2017). Therefore, time is considered an effective factor in the process of complying with VAT (Saderuddin & Barghathi, 2018).

2.5.3 Psychological Cost

Based on most definitions, psychological cost is intangible in nature (Nura et al., 2017). In the tax literature, there is no generally agreed definition of psychological cost, but it has been defined as “the anxiety, tension, and frustration caused by compliance with complex VAT legislation” (Mukhlis et al., 2015). It has yet to be succeeded in accurately measuring psychological factors or complexities.

The exposure of many employees and professionals to psychological stress at work negatively affects their work performance and other aspects of their daily lives and behaviours (Saderuddin et al., 2017). The key reasons for them feeling stressed include their perception of a barrier (e.g., professional, social, and/or psychological barriers) that prevents them from achieving their ambition and the lack of clarity of their roles and responsibilities at the workplace (Batra et al., 2000; Artavanis et al., 2015). Their role at work, such as the lack of efficiency and ability, lack of provision of work requirements, lack of appreciation and encouragement, and lack of suitability with the job in terms of abilities and capabilities also contribute to them feeling stressed (Artavanis et al., 2015).

The difficulty to perform the assigned work can affect one’s concentration (Matthews & Lloyd-Williams, 2000). This difficulty may be due to the failure of taxpayers to know or understand the procedures (Evans, 2008). The tax administration and management of a company play an important role in this area, whereby the absence of clear and simplified instructions and available means for the accountants to take note

of, as well as their lack of clarity can increase the sense of one's difficulty to perform at the workplace (Woellner et al., 2003). In some cases, the difficulty to perform at the workplace can be due to the fact that the amount of work surpasses the time scale of the accounting procedures, resulting in higher psychological cost incurred (Woellner et al., 2003; Ponorica & Al-Saedi, 2015). According to Wadesango et al. (2018b), the complexity of the VAT system and uncertainty in the related laws increase the compliance cost and raise some concerns in the VAT payment process.

Erard and Feinstein (1994) described the role of psychological factors in influencing tax liability using a theoretical model that demonstrated the influence of these factors on tax compliance, including VAT. As the best way to understand psychological factors lies in the light of their theory, the summarised framework identified two central psychological and moral feelings associated with tax compliance and tax evasion, namely shame and guilt (Gerlach-Kristen et al., 2015). The two branches of labour affect tax liability, whereby guilt and shame arise from thinking about imagined perceptions (Yoshino et al., 2016).

Nevertheless, feeling guilty is more effective, but it is independent of disclosure, whereby it is an exclusive penal mechanism that arises when one thinks of violating an internal moral norm (Tambunan, 2016). In both cases, Erard and Feinstein's (1994) model suggested that merely thinking about an incorrect action generates psychological cost, which then produces the desire to reduce the tension by lowering evasion and increasing tax compliance. As such, it can be determined whether the psychological factor is linked to the level of tax liability. Based on Erard and Feinstein's (1994) model, the psychological cost exert positive and negative influence on the tax liability of VAT for both SMEs and large companies.

The aspect of tax understanding (i.e., knowledge of the tax system, awareness of tax commitment, and availability of information) concerning VAT compliance is the understanding of tax laws and the opportunity for tax evasion (Atawodi & Ojeka, 2012). As a key determinant of tax compliance, knowledge is closely related to taxpayers' ability to comprehend tax laws and regulations and SMEs' ability to comply with tax rebates (Sandford et al., 1989; Mukundi et al., 2017). Studies have shown a range of factors related to VAT compliance cost, which is defined as administrative factors or external factors (e.g., tax value, compliance by SMEs, tax information, and taxpayers' attitude), which then lead to tax evasion.

Clemens (2008) analysed management factors among Canadian SMEs and highlighted time management and training as crucial for VAT compliance. The study advocated for further exploration of internal and demographic factors impacting compliance cost. Based on a sample of 4,796 companies, Hansford et al. (2003) identified psychological factor, language barrier, and special needs as key contributors to VAT compliance cost and proposed the need to focus on political and economic factors in future research. In another study, Atawodi and Ojeka (2012) investigated 150 SMEs in Kenya and found high tax rates and complex procedures as primary causes of non-compliance. The study then proposed government consideration of increased tax incentive to encourage compliance and attract investors. Meanwhile, Mwangi (2014) sampled 150 representatives and found that tax compliance cost emerged as significant, covering book-keeping, software, and recruitment expenses. SMEs perceived tax payments as providing access to public utilities. However, challenges included data seasonality and methodological complexities. In another study, Naicker and Rajaram (2019) explored VAT complexities among 85 SME owners in South Africa and highlighted VAT as the most burdensome tax. The study emphasised the significant

time investment required for compliance and recommended exploring the influence of demographic factors on VAT compliance. King'oina (2016) studied SMEs in Kisumu County, Kenya and revealed the influence of tax understanding on compliance. The study suggested exploring the influence of VAT on compliance and revenue growth in the construction sector and studying the influence of tax incentive. In a more recent study, Foon et al. (2018) investigated 400 Malaysian SMEs, uncovering significant relationships of service quality, detectability, tax knowledge, and GST non-compliance. The study recommended future longitudinal research to evaluate variables over time and provide comprehensive insights.

2.6 SMEs in the UAE

SMEs are classified into three sectors in the UAE: trade, industrial, and services. Each sector is divided into three categories, namely micro, small, and medium, and these categories vary in the number of employees and annual returns (Gupta & Mirchandani, 2018). The threshold level for SME classification in the UAE is based on certain criteria, including the number of employees and annual returns, which vary across different sectors. For instance, micro-sized companies are defined as those with fewer than five employees and annual returns below a certain threshold (IFZA, 2023). In comparison, small-sized companies can have up to 50 employees and return below a higher threshold. The mandatory threshold level determines the maximum number of employees and annual returns that SMEs must comply with in order to remain within their designated category. This framework provides clarity and consistency for SMEs seeking classification and ensures alignment with regulatory standards, facilitating access to tailored support and resources for their growth and development (IFZA, 2023).

Micro-sized companies in the services sector have less than five employees and returns of below 2 million dirhams (PricewaterhouseCoopers, 2022). Small-sized companies have less than 50 employees, and their returns are below 20 million dirhams. Lastly, medium-sized companies in the services sector have less than 200 employees and returns of no more than 200 million dirhams (Ministry of Finance UAE, 2017). Meanwhile, a medium-sized company has less than 200 employees, and the returns are below 250 million dirhams (Table 2.1). On the other hand, in the industrial sector, micro-sized companies have less than nine people and returns of below 3 million dirhams. A small-sized company in the industrial sector has less than 100 employees and returns of below 50 million dirhams (The Finance Stories, 2021). In contrast, a medium-sized company has less than 250 individuals and returns of approximately 250 million dirhams. In the trade sector, micro-sized companies are those with less than five employees and returns of less than 3 million dirhams (The Finance Stories, 2021), whereas as for small-sized companies, the number of employees is 50, and their returns are below 50 million dirhams.

Table 2.1: Types of SMEs in the UAE

Company Type	Number of Employees	Returns (AED)
Services Sector		
Micro-sized	5	3 million
Small-sized	50	50 million
Medium-sized	200	250 million
Industrial Sector		
Micro-sized	9	3 million
Small-sized	100	50 million
Medium-sized	250	250 million
Trade Sector		
Micro-sized	5	12 million
Small-sized	60	100 million
Medium-sized	More 250	500 million

The implementation of VAT provides the UAE government with a new source of income, which also contributes to the continued provision of quality public services (Narayanan, 2020). Moreover, SMEs are among the best components to help economies develop and succeed (Naicker & Rajaram, 2019). As explained by Naicker and Rajaram (2019), SMEs help in the formation of sustainable employment, improve the GDP, and enhance various types of monetary and social advancements. Hence, creating, supporting, and continuing small businesses is one of the key systems to help reduce neediness, produce important companies together, and form sustainable incomes for the local communities (Finance, 2004).

Although small businesses are exposed to various economic risks, they can emerge from the market as a going concern (Mukundi et al., 2017). Regulatory compliance cost is important and consumes a significant amount of valuable resources to ensure companies remain in compliance with all the applicable laws and regulations of a country and continue to deliver their businesses and services (Hanefah et al., 2002). An alternative use of these valuable resources is to directly focus on the promotion and strengthening of the corporate business locally and internationally. However, SMEs face challenges due to excessive compliance requirements imposed by laws, and timely VAT compliance helps them remain competitive in the UAE. It reduces costs and improves efficiency by eliminating the need for manual processes and ensuring that businesses are aware of their VAT obligations, which help businesses to remain competitive in their respective markets (Gopakumar et al., 2022).

Despite the challenges with the implementation of VAT, SMEs in the UAE comply with the tax regulations, indicating less or no evasion. In order to comply with the new VAT regulations, SMEs make changes to their core operations, financial management, book-keeping, technology, and human resources (Government of UAE, 2022). Additionally, SMEs understand the implications of VAT with the help of professional advisors and make efforts to align their business model to government reporting and compliance requirements (Mogielnicki, 2019). SMEs in the UAE also ensure that their financial records are up-to-date and accurate. Proper training programmes are important to ensure that all employees are aware of the implications of VAT and how it affects business transactions. Proper book-keeping is also essential, as companies that meet the minimum annual turnover requirement need to register for VAT (Almutairi & Naser, 2020). In order to ensure compliance with the VAT

regulations, SMEs in the UAE ensure that their products and services are appropriately marked up with VAT, and that the correct documentation is collected.

According to Bala et al. (2019), VAT compliance helps SMEs build consumers' trust and reputation. Consumers are also assured that companies meet their legal and tax obligations, making them more likely to return for future purchases. Additionally, SMEs in the UAE benefit from reduced audit risk since they have an accurate and up-to-date VAT compliance system in place. Overall, the obtained results in the study showed the significance of VAT compliance for SMEs in the UAE (Government of UAE, 2022). These companies understand and acknowledge the fact that inaccurate or incomplete VAT registration, VAT evasion, and reporting can lead to costly fines and other legal actions. SMEs ensure that they are registered for VAT in the correct jurisdiction, keep up to date with any changes in VAT regulations, and ensure that their VAT compliance system is accurate and updated in order to remain competitive, build consumers' trust, and reduce the risk of costly audits.

However, according to Zafarullah (2018), the International Monetary Fund (IMF) has reported the difficulty encountered by the federal government to maintain control following its implementation of VAT compliance in the UAE. Despite that, the UAE government has continued to provide benefits like medical care, transportation, and public-school facilities to its citizens and residents. VAT compliance is expected to provide a new source of income for the country and improve the quality of public services. Additionally, it supports the government's efforts to become less dependent on revenues from oil and petroleum. The fast-paced growth aspirations of the UAE and the introduction of VAT compliance are part of a larger policy reform aimed at achieving long-term social and economic goals for the Gulf Corporation Council (GCC)

governments. In short, the introduction of VAT compliance facilitates the UAE's plans for faster growth and government reform (Bala et al., 2019).

The enforcement of VAT regulations in the UAE implies that registration is compulsory for each company; examining the average compliance cost and inquiring about the VAT registration status in surveys serve important purposes (Al Salloum, 2021). Firstly, analysing the average compliance cost provides insights on the financial burden imposed on companies to adhere to the VAT regulations. Understanding the average cost incurred helps policymakers, regulatory bodies, and companies themselves to assess the economic impact of VAT compliance (Bala et al., 2019). It allows for the evaluation of whether the costs associated with VAT registration and compliance are reasonable and sustainable for companies of various sizes and sectors. Additionally, inquiring about the VAT registration status in surveys enables the gathering of data on companies' actual compliance behaviour. VAT registration may be compulsory in theory, but practical circumstances may influence companies' decisions regarding VAT registration. Certain companies may need help with their ability to register for VAT. In contrast, other companies may intentionally choose not to register due to various reasons, such as their size, industry, or financial considerations (Al Salloum, 2021). Inquiring about companies' VAT registration status can unravel pertinent insights on the factors influencing these companies' decisions regarding VAT compliance. The gathered information are valuable for policymakers and tax authorities in their efforts to refine VAT policies, address compliance challenges, and design strategic support mechanisms for companies, especially SMEs (Alsharari et al., 2023).

2.7 VAT Compliance and Government in the UAE

Tax compliance cost in the UAE primarily focuses on the burden placed on taxpayers. Tax compliance cost refers to the total expenses and efforts incurred by individuals and companies to fulfil their tax obligations (Government of UAE, 2022). In the UAE, taxpayers bear the responsibility of understanding and adhering to the tax laws, regulations, and filing requirements set forth by the government. This includes maintaining accurate financial records, preparing tax returns, and ensuring timely payment of taxes. The complexity of tax laws and regulations, as well as the need for professional assistance in tax compliance contribute to the overall burden on taxpayers. The government sets the framework for taxation and enforces compliance, while taxpayers incur the direct cost associated with meeting their tax obligations. Therefore, tax compliance cost in the UAE are primarily viewed from the perspective of the burden placed on individual taxpayers and companies, rather than on the government itself (Government of UAE, 2022).

The UAE operates under a federal system, which means that taxation is primarily managed at the federal level. As the main regulatory body for overseeing taxation matters across the UAE, the Federal Tax Authority (FTA) is responsible to administer and implement federal tax laws, including VAT and excise tax (European Commission, Directorate-General for Taxation and Customs Union et al., 2022). The FTA is the principal tax authority at the federal level, but individual emirates within the UAE may also have their regulatory bodies to manage specific tax matters within their jurisdictions. For instance, certain emirates like Dubai and Abu Dhabi have their departments or authorities responsible for certain tax-related issues at the local level (The Finance Stories, 2021).

Apart from the FTA at the federal level and local authorities in individual emirates, tax authorities in the UAE often rely on various agencies for tax collection and enforcement purposes. These agencies may include customs departments, revenue agencies, and other relevant bodies tasked with ensuring compliance with the tax laws and regulations (PricewaterhouseCoopers, 2022). For instance, customs departments play vital roles of collecting customs duties and monitoring cross-border trades, which contribute to the country's overall tax revenue. Similarly, revenue agencies is involved in auditing taxpayers, conducting investigations on potential tax evasion, and implementing measures to enhance tax compliance (Trowers & Hamlins, 2020). Tax authorities collaborate with different agencies and leverage their resources and expertise to effectively collect taxes, enforce tax laws, and address issues related to tax evasion and avoidance. This collaborative approach helps to strengthen the overall tax administration system in the UAE and ensures the integrity of the tax collection process across various sectors and industries (European Commission, Directorate-General for Taxation and Customs Union et al., 2022).

For various reasons, SMEs often need help registering for VAT. One primary reason involves the understanding and awareness of VAT regulations and requirements. Many SME owners may need to fully comprehend the threshold limits for VAT registration or the benefits of being VAT-registered. Moreover, certain SMEs may perceive VAT registration as an administrative burden involving additional paperwork and compliance cost. They are also concerned about increased scrutiny from tax authorities or VAT accounting and reporting complexities.

Non-compliance with VAT regulations occurs when SMEs need to register for VAT despite meeting the registration threshold set by tax authorities. This can lead to legal repercussions, including fines, penalties, and even legal actions by tax authorities

(European Commission, Directorate-General for Taxation and Customs Union et al., 2022). Furthermore, non-compliance with VAT regulations undermines the tax system's integrity, resulting in revenue losses for the government. It also creates an uneven playing field for compliant businesses, as non-compliant SMEs may gain competitive advantage by avoiding VAT obligations. As of mid-2022, the UAE had a total of 557,000 SMEs, which contributed approximately 63.5% to the non-oil GDP. It was projected that, by 2030, the number of SMEs in the UAE would reach 1 million (Government of UAE, 2022).

Several initiatives have been undertaken to support and enhance SMEs in the UAE. The issuance of Federal Law No. 2 of 2014 on SME serves to safeguard, promote, and regulate the operations of SMEs. The introduction of the National SME Programme provides frameworks and guidelines on expertise, training, and technical and administrative support across various sectors to foster the growth of SMEs (European Commission, Directorate-General for Taxation and Customs Union et al., 2022). The establishment of the UAE SME Council focuses on devising strategic plans and policies for SMEs, setting rules and regulations to enhance coordination, and fostering sustainable economic development. Besides that, the launch of the Ministry of Possibilities, which includes the Department of Government Procurement, aims to expedite and simplify government procurement processes, benefitting SMEs. The National Cybersecurity Strategy 2019 aims to establish a comprehensive legal and regulatory framework to combat cybercrimes, secure technologies, and shield SMEs from prevalent cyber threats. These initiatives create a supportive environment for SMEs to thrive, thereby contributing significantly to the economic growth and development of the UAE (IFZA, 2023).

2.8 Factors Affecting VAT Compliance in the UAE

Most prior studies concurred that, in general, tax compliance cost encompasses the expenses incurred by taxpayers as part of their tax obligations in accordance with tax procedures and tax laws (Sapiei & Abdullah, 2014; Ramli et al., 2015; Highfield, Evans, & Walpole, 2016; Mansor & Ferdjani, 2017; Nura et al., 2017; Saderuddin et al., 2017). Generally, VAT compliance for companies involves all expenses associated with the relevant tax laws, comprising planning, management, operating, and incorporation costs (Hajdúchová et al., 2015). Mwangi (2014) highlighted high taxes as one of the fundamental reasons for tax fraud, prevention of investment, high compliance, and increased monetary cost incurred by companies that lead to reduced competitiveness. Therefore, the total cost of compliance with the tax regime are tax-deductible and include the costs of tax planning, paperwork, and tax knowledge. Yoshino et al. (2016) asserted that the so-called business “tax compliance cost” also include the time taken for the tax compliance process (Bustos et al., 2019; Keen & Lockwood, 2010).

SMEs are often subject to higher cost in the process of preparing and delivering taxes, including the burden of VAT payments and fines (Pope & Rametse, 2001). Matarirano et al. (2019) reported that the participating SMEs in the study resorted to keeping tax records of tax misuse (e.g., production taxes), which incurred additional costs for the tax compliance process in order to facilitate the completion of revenues generated from VAT. Consequently, companies are required to employ a staff member to manage the records, resulting in higher compliance cost (Mitchell, 2005). Compliance cost, penalties, bribes, and risk of inspections have often prevented the creation and growth of businesses in developing countries and countries in transition (Tran-Nam et al., 2000). Hence, assessment and logging information for VAT

compliance costs can provide valuable data for redesigning reforms for lower costs and risk of compliance among small companies (Pope, 2001). Apart from protecting companies from fines and penalties imposed by the tax authorities, it can increase the VAT tax compliance process (Mukhlis et al., 2015).

The tax administration in the United States reported that SME owners spent 6.6 billion hours of work per year to calculate compliance cost (Ohanian et al., 2008). Besides that, in a study on tax compliance, compliance cost tends to increase with the number of taxes paid by the business owners and vary depending on their attitude (Saderuddin et al., 2017). In a 1996 report for Singapore, a significant reduction in tax compliance cost to SGD 54,615 per SME was noted based on the 1995 data, which was attributed to the simplification of the tax system (Ariff, Ismail & Loh, 1997). Similarly, about 6% of all internal staff were employed, while 94% relied on a group that operated during the fiscal year 1995. Notably, a large proportion of compliance costs (70%) was related to foreign tax (Kasim et al., 2020; Munir, 2021; Shakkour, 2021).

Table 2.2 shows the magnitude of external and internal costs in several developing and developed countries. The table shows the distribution of internal and external compliance costs expressed as percentages in different countries and across different studies. In the United Kingdom, Sandford et al. (1998) found that internal compliance costs accounted for 53% of the total cost, while external costs constituted 47% of the total cost. In Australia, Pope, Fayle, and Chen (1991) observed an equal distribution, with both internal and external costs amounting to 50%. In the United States, Slemrod and Blumenthal (1996) and Slemrod and Venkatesh (2002) reported higher internal costs (84%), as compared to external costs (75%). Conversely, in countries like Singapore (Ariff, Loh, & Talib, 1995; Ariff, Ismail, & Loh, 1997), Malaysia (Loh, Ariff, Ismail, Shamsher, & Ali, 1997; Hanefah, Ariff, & Kasipillai,

2001; Abdul-Jabbar, 2009), and Hong Kong (Chan, Cheung, Ariff, & Loh, 1999), external costs outweighed internal costs, indicating a heavier burden of regulatory compliance imposed by external factors.

Table 2.2: Sources of Internal and External Compliance Costs for SMEs

Reference Studies	Sources (%)		Country
	Internal	External	
Pope, Fayle, & Chen (1991)	50	50	Australia
Ariff, Loh, & Talib (1995)	42	58	Singapore
Slemrod & Blumenthal (1996)	84	16	United States
Ariff, Ismail, & Loh (1997)	42	58	Singapore
Erard (1997)	80	20	Canada
Loh, Ariff, Ismail, Shamsher, & Ali (1997)	28	72	Malaysia
Sandford et al. (1998)	53	47	United Kingdom
Chan, Cheung, Ariff, & Loh (1999)	30	70	Hong Kong
Hanefah, Ariff, & Kasipillai (2001)	75	25	Malaysia
Slemrod & Venkatesh (2002)	75	25	United States
Abdul-Jabbar (2009)	59	41	Malaysia

Source: Sapiei & Abdullah (2014)

Most past studies indicated that tax compliance is determined according to taxpayers' attitude (Lumumba et al., 2010; Mwangi, 2014; Junpath et al., 2016), monetary cost (Sandford, 1995; Franks et al., 1997; Pope & Jabbar, 2008; Mukundi et al., 2017), time cost (Sandford, 1973; Pope & Jabbar, 2008; Mwangi, 2014; Mardhiyah,

2016), tax rate (Ariff, Ismail, & Loh et al., 1997; Woellner et al., 2003; Bird & Gendron, 2007; Grill, 2018), demographic factors (Chan et al., 1999; Lumumba et al., 2010; Sponcil & Gitimu, 2013; Mwangi, 2014; Saderuddin et al., 2017), and tax information (Malmer, 1995; Andreoni et al., 1998; Pope & Fayle, 1991; Mwangi, 2014; Olaoye et al., 2017; Saderuddin et al., 2017), specifically on the procedures and laws issued by the tax authorities. All these are expressed in terms of internal and external costs that affect the behaviour of taxpayers, namely business owners, including SMEs, in complying with VAT and taxes in general (Pope & Jabbar, 2008).

2.8.1 Penalty Imposition

Penalty is an important tool to promote VAT compliance (Sultana, 2022). It not only serves to deter taxpayers from engaging in non-compliant behaviour, but it has also been found to increase the overall level of compliance with the tax regulations. It is often used in conjunction with other compliance measures, such as information campaigns, targeted audits, and taxpayer education. Gillis and Duncan (2016) further argued the use of penalty to discourage non-compliance and to raise revenue. For instance, taking the case of SMEs for e-commerce, the penalty for evading customs duties and import VAT is a percentage of the value of the products plus the duties and VAT evaded. Imposing a penalty can effectively reduce the incentive to evade taxes and encourage taxpayers to report the full amount of their VAT liabilities.

The laxity of certain SMEs has made penalty to be the only option to motivate compliance behaviour (Palil, 2011). Penalty in compliance is the process of increasing the authority's power to ensure enforced compliance (Jones & Mosteanu, 2019). Additionally, Tian et al. (2020) highlighted penalty as the most effective variable in enforcing compliance. Other prior studies on the enforcement of compliance noted the

significant role of penalty in deterring, motivating, and correcting the improper behaviour of SMEs (Maguire et al., 2007; Byukusenge & Munene, 2017).

Azmi et al. (2016) suggested the importance to properly design the penalty system in order to be effective. The system should consider the circumstances of each taxpayer, as well as the level of resources available for monitoring compliance. The penalty system should also be designed to be fair and consistent, so that taxpayers feel that the penalty system is just and that the same rules apply to everyone. Governments must also ensure that penalties are proportional to the level of non-compliance and that they are applied in a timely manner. This ensures that penalties have a deterrent effect on non-compliant behaviour. Meanwhile, Gimba and Ibrahim (2017) elaborated on the enforcement of compliance through the application of tax penalties on taxpayers who are not willing to pay or remit the VAT collection, as the case may be. In addition, penalty has been found to be the most effective tool in the UAE (Ruebling, 1973). Most SMEs evade remitting tax collection by bribing the tax collection officers; they keep two sets of records and relocating to new sites without notifying the tax officials in certain cases (Mukundi et al., 2017). However, Mukundi et al. (2017) posited the potential of penalty to work effectively if it is used as an auxiliary means of delivery with the implementation of a sound compliance strategy.

In short, penalty imposition would influence the compliance behaviour and compliance cost of VAT, as reported in past studies on VAT compliance intention among SMEs in the UAE. This particular finding was found to be in line with prior studies by Mukhlis et al. (2015), Gimba and Ibrahim (2017), Alshirah et al. (2019), and Jones and Mosteanu (2019).

2.8.2 Complexity

The UAE government strives to simplify the VAT system, reduce the compliance burden on companies, and ensure the effectiveness and efficiency of the system (Alotaibi, 2021). Complexity comprises professional tax fees and other incidental costs, corporate profits (Ibrahim, 2013), the wages and salaries of employees, tax compliance cost, and the complexity of acquiring knowledge to enable tax-related work, including knowledge of its legal obligations and penalties (Pandey & Kingsley, 2000; Bachkaniwala et al., 2001). Lockwood and Keen (2007) explained the direct relationship between complexity and tax compliance cost, making it a direct influencing factor in the formation of tax compliance behaviour. When savings in terms of monetary cost of the operation of SMEs are complex (complexity cost expressed as a percentage of turnover), the impact of compliance cost becomes significant for smaller companies (Mukhlis et al., 2015). Monetary cost includes the expenses incurred for technical consultants, miscellaneous cost (consisting of travel expenses), and the purchase of tax-related materials to help payers complete the revenue, litigation costs, and telephone bills (King'oina, 2016). This classification was accepted by Sandford (1973) and other researchers of VAT compliance cost (Hansford et al., 2003; Woellner et al., 2003; International Finance Corporation, 2009; Bikas & Raškauskas, 2011; Atawodi & Ojeka, 2012; Ibrahim, 2013; Bannaga, 2017a; Mukundi et al., 2017; Saderuddin et al., 2017). Mansor and Ferdjani (2017) found that complexity would increase tax evasion and non-integration due to high compliance cost, with the assumption of factors influencing behaviour, such as tax rate, fraud penalties, and POD, according to the deterrence theory (Hansford et al., 2003).

Apart from the time required to comply with the VAT, complexity can be measured by the number of different types of taxes a company must comply with, the

number of compliance rules, and the number of compliance regulations (Eragbhe & Omoye, 2014). Hussain et al. (2022) showed the relationships of overly complex tax systems with high tax evasion and compliance cost. High compliance cost is associated with larger informal sectors, higher level of corruption, and reduced economic growth. Complexity in VAT compliance can be measured by the level of tax knowledge held by taxpayers. Tax knowledge is essential for understanding and being able to comply with the different rules and regulations. Studies have demonstrated that low levels of tax knowledge can contribute to non-compliance and reduced compliance behaviour. Thus, the current study posited the significance of complexity in VAT compliance for companies and policymakers. The system's complexity can lead to difficulties in compliance, higher overall cost, and reduced economic growth.

The current study posited the significant influence of penalty imposition on the complexity that was further predicted to affect VAT compliance behaviour. As noted by Verma (2019), the role of complexity in VAT compliance has been a subject of great interest for policymakers and researchers. The complexity of the VAT system can create compliance difficulties for companies, particularly SMEs. Therefore, it is important to understand how complexity affects VAT compliance. Poddar and Kalita (2010) argued that the complexity of the VAT system is often measured by the number of hours it takes to comply with the tax, as measured by the World Bank's paying taxes study. This indicator reflects the average number of hours it takes for a medium-sized company to prepare, file, and pay VAT per year. Countries with higher compliance hours, such as the UAE, Czech Republic, Hungary, Kingdom of Saudi Arab, and Poland, have more complex systems that require more time to comply.

2.8.3 Probability of Detection

Probability of detection (POD) is a measure of the likelihood that tax evasion by SMEs is discovered. A higher POD acts as a deterrent to tax evasion, as companies may be less likely to engage in illegal activities if they believe there is a high likelihood of being caught. This can help to reduce the overall level of tax evasion among SMEs, which can positively influence government's revenues and the overall fairness of the tax system (Wijaya, 2020).

Studies have demonstrated the correlation between POD and tax compliance among SMEs. Lee (2016) argued a lower likelihood to engage in tax evasion among SMEs with the perception of high detection risk. Agbo (2020) also found the significant influence of higher POD for VAT non-compliance on tax compliance among SMEs. The study found that a 1% increase in the POD increased VAT compliance by 0.4%. Munir (2021) found that a 1% increase in the POD reduced the tax gap (the difference between the amount of taxes owed and the amount of taxes paid) by 0.5% among SMEs. These prior studies provided evidence the positive influence of high POD on tax compliance in terms of lower tax evasion among SMEs.

POD refers to company's direction towards the tax system, tax authority, and tax laws (Mwangi, 2014). Junpath et al. (2016) stated the influence of a variety of influencing factors of tax behaviour and compliance on taxpayers' position. Factors that influence the position of taxpayers vary according to individuals and countries (Andreoni et al., 1998). POD also varies across cultures (Sapiei, 2014) and demographic factors, such as age, gender, and income size (Lumumba et al., 2010). There are no specific factors, but these identified factors exert direct influence on taxpayers' behaviour in general and tax compliance (Pope et al., 1993).

Motivation for compliance may result from rewards, penalties, or fairness of the tax systems (Manual & Xin, 2016). Hansford et al. (2003) mentioned that factors like tax compliance and a strong relationship between tax authorities influence taxpayers' attitude. POD encourages tax liability for VAT in all factors affecting taxpayers' attitude (Pope, 2001; Jayawardane & Low, 2016;), which supported the study by Finance (2004), which concluded the equal influence of taxpayers' compliance with tax requirements on their attitude. Numerous studies on taxpayers' attitude reported the need to simplify the process of tax compliance according to the government's approved laws and regulations and to increase the compliance cost (Brunton, 2005; Rametse, 2006; Federal Tax Authority, 2019). Taxpayers' attitude exert strong influence on tax compliance cost, including internal and external compliance costs (Rametse, 2006). Several prior studies have identified both positive and negative attitudes and assessments of POD in relation to tax compliance, which generally affect tax behaviour (Atawodi & Ojeka, 2012; Al-Sarihi, 2018). Hence, a favourable attitude encourages individuals to act in accordance with their job positions. Taxpayers are expected to have a less positive attitude toward tax evasion compared to POD with a negative attitude (Kirchler & Maciejovsky, 2001). However, the POD in the face of tax evasion is typically high (Shehata & Trivedi, 2005).

Besides that, numerous prior studies reported the positive relationship between taxpayers' behaviour and their POD of tax evasion as one of the factors that increase compliance cost for SMEs (Tran-Nam et al., 2000; Lumumba et al., 2010; Ibrahim, 2013; Mwangi, 2014; Junpath et al., 2016). Lumumba et al. (2010) demonstrated varying positions of taxpayers' tax compliance in Kenya, with most of the participating respondents indicated paying a fair share of taxes, and further reported the need to introduce clearer tax laws for better understanding, such as information on payment

dates and tax and deposit accounts. Lumumba et al. (2010) and Xin et al. (2015) further reported that factors affecting the motivation of tax projection for tax compliance include the POD and cost of compliance with enforcement efforts, such as auditing.

2.8.4 Tax Rate

Most prior studies indicated that higher rate of tax compliance behaviour increases the rate of tax paid by companies to the tax authorities (Mwangi, 2014). Poterba (1987) opined that one of the most crucial forms of tax evasion and a reason for negative behaviour of taxpayers is the high tax rates that taxpayers pay for non-compliance. Similarly, Loo et al. (2012) argued that tax evasion motives are based on tax compliance due to the high tax rate considering that those tax gains result from tax evasion. High tax rates are a source of concern not only in developing countries but also in developed countries like the European Union (EU) and other industrialised nations (Poniatowski et al., 2018).

A study conducted in the United States identified high tax rate, apart from complex regulations imposed by the tax authority, as among the most significant costs for companies (Aguirre & Rocha, 2010). According to Derwent (2000), high tax rate, which is reflected in the costs of production, sale, and distribution, would lead to higher prices. This potentially changes consumers' purchasing behaviour, whereby consumers purchase fewer quantities of products due to the high cost, yielding reduced profits. Tax evasion rate increases due to high tax compliance cost, which negatively affects the economic growth rate for SMEs and the country in general (Ibrahim, 2013).

High tax rate increases the burden of tax compliance and monetary costs, especially for SMEs; higher taxes reduce taxpayers' income (Cummings et al., 2006).

Despite that, tax rate is often not considered as the main factor affecting companies'

and taxpayers' tax compliance (Alm et al., 1995). However, Mwangi (2014) considered tax rate as a key factor in VAT compliance, with direct impact on the overall structure and behaviour of tax compliance. Likewise, Bachkaniwala et al. (2001) and Ali et al. (2013) asserted that income is affected when the tax rate rises for taxpayers, resulting in higher cases of total non-disclosure of their income. This applies to SMEs; these companies often easily benefit from not disclosing their financial statements due to high tax rate (Lumumba et al., 2010). According to Pope and Rametse (2001) and Saderuddin and Barghathi (2018), tax rate in accordance with VAT would increase tax compliance behaviour. This particular finding was found to be consistent with prior studies (Ariff, Ismail, & Loh et al. 1997; Derwent, 2000; Woellner et al., 2003; Bird & Gendron, 2007; Loo et al., 2012; Grill, 2018).

Tax rate is widely applied to income or profits. Taking the case of VAT in the UAE, tax rate varies, depending on the jurisdiction and income or profits being taxed (Kaul, 2019). VAT is a consumption tax applied to products and services at each stage of production or distribution. VAT compliance typically involves registering for VAT, charging VAT on products and services, periodically filing VAT returns, and paying any VAT owed to the UAE government. It also includes maintaining accurate records of all VAT-related transactions and keeping the invoices and other supporting documents (Miller, 2019).

According to Mazroui (2019), tax rate affects Emirati SMEs' VAT compliance in several ways. A higher tax rate may increase the cost of products and services, making it more difficult for SMEs to compete with larger companies. This can lead to lower sales and profitability, making it harder for SMEs to afford VAT compliance cost. A higher tax rate may also increase the administrative burden of VAT compliance, as

SMEs have to pay more VAT and file more VAT returns. This can be especially burdensome for SMEs with limited resources and staff.

Bannaga (2017b) noted higher non-compliance risk due to higher tax rate—SMEs may be more likely to engage in tax evasion or avoidance to reduce their tax liability. On the other hand, this study revealed that a lower tax rate makes it easier for SMEs in the UAE to comply with VAT and reduce the administrative burden and compliance cost, which can keep the prices of products and services low and increase their competitiveness. Therefore, the tax rate of 5% is deemed appropriate for specific economic conditions and should be regularly reviewed to ensure that it does not hinder the growth of SMEs in the UAE (Bansal, 2020). Despite the low rate, tax remains a burden for consumers and companies in the UAE, affecting the business sector and raising companies' compliance cost in the first year of application (Federal Tax Authority, 2019; Maher, 2019). Therefore, increasing the tax burden poses substantial threat to tax compliance, which would exacerbate tax evasion (Alm et al., 1995).

2.8.5 Tax Incentive

A tax incentive is an aspect of a government taxation policy designed to encourage a particular economic activity by reducing tax payments (Pope & Fayle, 1991; Mardhiyah, 2016). According to Ibrahim (2013), the tax incentive of complying with VAT would increase compliance behaviour. This was reported to be consistent with the findings of prior studies by Poterba (1987), Pope (1992, 2001), Hansford et al. (2003), Pope and Jabbar (2008), Aguirre and Rocha (2010), Mansor and Ferdjani (2017), and Nura et al. (2017).

Time cost serves as an important factor for VAT compliance cost among SMEs (Hansford et al., 2003; Mansor & Ferdjani, 2017). It was found that Australians spent

an average of 10.7 hours to complete their tax requirements (Lignier & Evans, 2012). Meanwhile, in the United States, individual taxpayers spent only 5.6 hours on average, as compared to SME taxpayers who spent 33.8 hours (Aguirre & Rocha, 2010).

The higher percentage of time costs compared to tax incentives has been observed in various tax authority compliance cost studies (Pope, 2001; Pope & Jabbar, 2008; Nura et al., 2017). This trend is evident in countries such as the United States (Aguirre & Rocha, 2010), Spain (Poniatowski et al., 2018), Malaysia (Foon et al., 2018), and the UAE (Zafarullah, 2018b), where annual tax returns are mandatory for all taxpayers (Brunton, 2005). Besides that, Loo et al. (2012) found a relationship between tax incentive and taxpayers' behaviour towards tax compliance. Another prominent study conducted in the United States showed that the time spent filling tax models influenced SMEs' tax behaviour (Poterba, 1987). In a study conducted in Bangladesh, the results showed that the VAT compliance cost for SMEs included tax incentive, which was estimated to be 6.5 hours per day, affected their tax compliance behaviour due to high compliance cost incurred (Faridy et al., 2017).

Tax incentive can reduce the overall tax burden on SMEs, making it easier for these companies to afford the tax compliance cost. Hadal and John (2022) cited one example of tax incentive in the UAE—tax exemption. The UAE government offers exemption from VAT for certain products and services. This helps SMEs to reduce their VAT liability, making it easier for them to comply with VAT requirements. For example, basic food items, healthcare, and education are some of the VAT-exempted products and services in the UAE. This implies that SMEs providing these products and services do not have to charge VAT.

Munir (2021) cited tax credits as another example of tax incentive in the UAE. The UAE government offers tax credits to SMEs that invest in certain areas or activities.

For instance, SMEs that invest in research and development (R&D) activities or those that hire Emiratis may be eligible for tax credits. This can help SMEs to offset their VAT liability, making it easier for them to comply with VAT requirements. Additionally, UAE has implemented a threshold for VAT registration, which means that only SMEs with annual revenue exceeding a certain limit are required to register for VAT. This helps many SMEs to avoid VAT compliance cost and administrative burden of VAT registration. Overall, study conducted by Munir (2021) indicated the crucial role of tax incentive in the UAE in helping SMEs to comply with VAT. These incentives can reduce the overall tax burden on SMEs and make it easier for these companies to afford tax compliance cost, which can ultimately help to support the growth of SMEs in the UAE (Obeng, 2020).

2.8.6 Challenges of VAT Compliance

The implementation of VAT is now widespread all over the world, driven by the need to create an efficient and fair tax system. Through tax levy at every step of the production process, VAT reduces the tax pyramid and improves the stability of revenue generation. Guidelines for implementing VAT include registration, tax-deductible transactions, tax invoices, the filing and payment process, enforcers, and conformity measures. Successful VAT implementation requires intensive collaboration between companies, government agencies, and taxpayers to comply and maximise the benefits of taxation (European Commission, Directorate-General for Taxation and Customs Union et al., 2022). VAT brings many advantages to the society, including revenue generation and lower tax evasion; however, its implementation also presents many challenges (Trowers & Hamlins, 2020):

- i) **Compliance burden:** VAT systems impose significant compliance burden on various companies, including SMEs. Meeting this standard requires keeping meticulous records of transactions, issuing tax invoices on time, filing regular VAT returns, and incurring additional costs (PwC, 2018). This proves to be challenging for companies with limited resources and administrative capabilities, possibly leading to unexpected costs (Sidek & Abdurqeeb, 2022).
- ii) **Administrative complexity:** VAT regulations can be complex and subject to frequent updates, making VAT compliance challenging for companies. This complexity results from various factors, including different VAT rates for different products and services, as well as exemption cases and regulations governing cross-border transactions, which make interpreting and applying them correctly more complex, resulting in errors and compliance issues (The Finance Stories, 2021) .
- iii) **Tax evasion and fraud:** Despite VAT's potential to reduce tax evasion, its systems remain susceptible to fraud and evasion schemes. Common types of VAT fraud include carousel fraud, where products are traded repeatedly between jurisdictions to exploit VAT loopholes, and missing trader fraud, where fraudulent companies disappear before reporting any VAT collected to tax authorities (Amirrudin & Nasution, 2021).
- iv) **Economic distortions:** VAT can cause economic distortions if it is applied inconsistently or at a high rate, leading to reduced consumption and investment that hamper economic growth and competitiveness. This results in diminished economic growth and reduced competitiveness. Furthermore, exemption or reduced rates for specific products or services can distort market behaviour and the allocation of resources (The Finance Stories, 2021) .

- v) **Burden on low-income households:** VAT is considered a regressive tax, but the effects of taking a more significant percentage from lower-income households than higher-income ones can be offset through exemption and reduced rates for essential products and services. However, such measures may not always reach those most at risk, leading to concerns over its potential burden (SHRM, 2022).
- vi) **Cross-border challenges:** VAT systems face obstacles when it comes to handling cross-border transactions, especially within the digital economy. The borderless nature of e-commerce makes determining taxation jurisdiction and enforcement difficult and causes inaccurate capture of VAT on online transactions, resulting in revenue leakage and unfair competition between domestic and foreign businesses (European Commission, Directorate-General for Taxation and Customs Union et al., 2022).

2.9 Tax Compliance Theories

According to tax workers, in general, internal and external costs are among the most significant challenges in integrating SMEs into tax systems and achieving tax compliance (Mwangi, 2014; Sapici, 2014). Most prior studies suggested that internal and external costs, as compared to other costs like planning and accounting costs, mainly affect the overall corporate VAT compliance (Pope & Fayle, 1991; Hansford et al., 2003; Faridy et al., 2017; Mansor & Ferdjani, 2017; Saderuddin et al., 2017; Saderuddin & Barghathi, 2018). These costs generally affect taxpayers' process of compliance and influence the development and growth of businesses (Ahmad & Al Faris, 2010).

The complexity of tax systems and the high cost of engaging with accountants, consultants, and various operational clients, and licensing of companies increase the external cost of emerging companies. As a result, companies lose the ability to manage their business and tax compliance (Tran-Nam et al., 2000). According to Evans et al. (2013), most entrepreneurs need to learn about tax regulations. They eventually resort to paying the cost of adding companies and lawyers to complete the taxation procedures, reflecting the need for clear policies from tax authorities concerning the dissemination of information on taxes (Ahmad & Al Faris, 2010). Tax authorities should provide taxpayers with sufficient information regarding taxes. After all, taxpayers' right to tax information is consistent with one of the tax regulations and requirements (Xing & Whalley, 2014).

Various studies have examined tax compliance as a voluntary behaviour and attributed it to various factors (Pope, 1992; Kirchler & Maciejovsky, 2001; Loo et al., 2012). Jackson and Milliron (1986b) conducted a comprehensive review of past studies on tax compliance behavior, specifically examining research from the 1970s to 1985. These prior studies identified several behavioural factors and traits of tax compliance behaviour.

Meanwhile, Fischer et al. (1992) broadly categorised tax compliance behaviour into four groups namely i) demographic attributes (such as age, and gender) ii) non-compliance opportunity, iii) attitudes and perception and iv) tax system or structure. There are other potential factors and limitations, such as compliance costs, tax decision-making, tax definitions, and tax incentives, have been explored in studies, though their effects vary (Olaoye et al., 2017). Overall, there have been mixed findings on the factors and determinants of VAT compliance behaviour for taxpayers (both at the individual

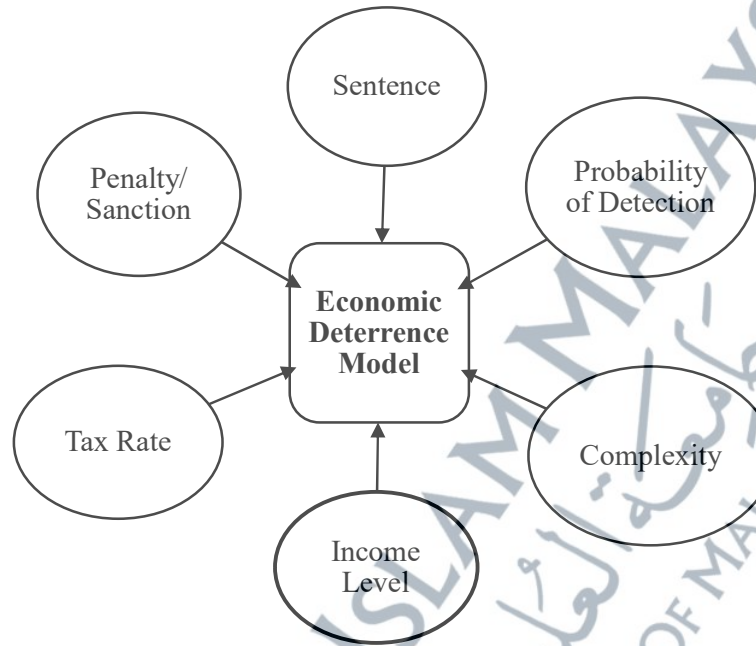
and business levels), with different research methods employed (Jackson & Milliron, 1986b; Lawan & Salisu, 2017).

There have been several observations and reviews of the behaviour of taxation and influential factors, such as taxpayers' attitude, monetary cost, time cost, tax rate, tax information, and demographic characteristics (Sapiei & Abdullah, 2014; Ramli et al., 2015; Highfield, Evans, & Walpole, 2016; Mansor & Ferdjani, 2017; Nura et al., 2017; Saderuddin et al., 2017). In general, these prior studies differed in terms of the variations present in the society in which these studies were conducted in, as well as the factors that were measured with respect to the variables and the types of taxes involved (e.g., incomes, individuals, or companies) that affect tax compliance behaviour.

As for the current study, the effects of internal and external compliance costs were considered to be effective factors in VAT compliance for SMEs in the UAE (Ahmad, Ahmad, & Bakar, 2018). The discussion of the relevant results specifically focused on SMEs. In fact, a large proportion of prior studies on tax compliance explored SMEs' VAT compliance.

Previous studies generally adopted models of economic deterrence and financial psychology to explain taxpayers' tax compliance behaviour (Hasseldine & Li, 1999). The deterrence theory emerged as an embodiment of Becker's economic deterrence model (Figure 2.1). This theory has been used in the methodology of crime and punishment studies, whereby the method was developed based on Becker's (1968) model of crime and punishment (Bello & Danjuma, 2014). The deterrence theory stated that when individuals do not deter themselves from committing crimes, they fear punishment and avoid committing crimes (Foon et al., 2018). In addition, the deterrence theory assumed that individuals decide to participate in a crime when they realise that the benefits gained from committing the crime are greater than the cost of committing

the crime. This theory also assumed tax rate, fraud penalties, and POD as some of the factors that influence behaviour (Hansford et al., 2003).



Source: Becker (1968)

Figure 2.1: Economic Deterrence Model

Furthermore, this deterrence theory emphasised incentive, which was deemed suitable for the current study. The theory suggested that taxpayers' SMEs in the UAE are amoral utility maximisers who are influenced by economic motives, such as profit maximisation and POD. Hence, taxpayers analyse alternative compliance paths, such as whether to evade tax, the likelihood of being detected, and the resulting repercussions, and then select an alternative way that maximises their expected after-tax returns after risk adjustment (Hansford et al., 2003). The possibility of disclosure suggests that tax auditors discover taxpayers who have the intention of non-compliance, while sanction refers to the severe penalty to reduce the intent of non-compliance (Lawan & Salisu, 2017). As such, according to the deterrence theory, penalties for non-

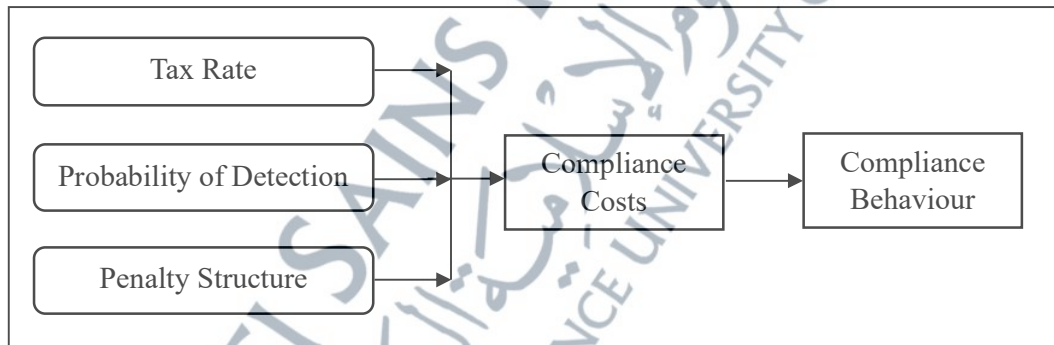
compliance should be increased to improve compliance (Foon et al., 2018). Hence, a theoretical positive relationship between tax penalty and tax compliance exists, whereby an increase in tax penalty would lead to an increase in tax compliance, and vice versa (Al-Ttaffi & Abdul-Jabbar, 2015).

Studies have applied various theoretical frameworks to explore tax compliance within different organisational contexts. Herath and Rao (2009) aimed to identify factors influencing staff compliance with corporate and organisational information security policies by employing the deterrence theory, defensive impulse theory, and organisational behaviour principles. Cheng et al. (2013) applied deterrence theory to identify factors influencing employees' adherence to company policies, emphasising measures to prevent deviation and violation of established procedures. Tambunan (2016) utilised deterrence theory to delve into factors influencing tax compliance among SMEs in Indonesia. Focusing on providing tax information and management insights, including the offered incentives, Olaoye et al. (2017) utilised deterrence theory to investigate tax compliance at block factories. With the aim to uncover factors contributing to reluctance, Foon et al. (2018) employed deterrence theory to assess Malaysian SMEs' tax compliance with GST and highlighted the proportion of GST-registered SMEs. These prior studies highlighted the diverse applications of theoretical frameworks in understanding and addressing tax compliance behaviour across different organisational settings.

Thus, with the application of the deterrence theory across a diverse range of research fields, a relationship was noted between SMEs' tax compliance and influencing factors of their compliance. This theory was deemed appropriate for the current study to discover the influencing factors of SMEs' VAT compliance in relation

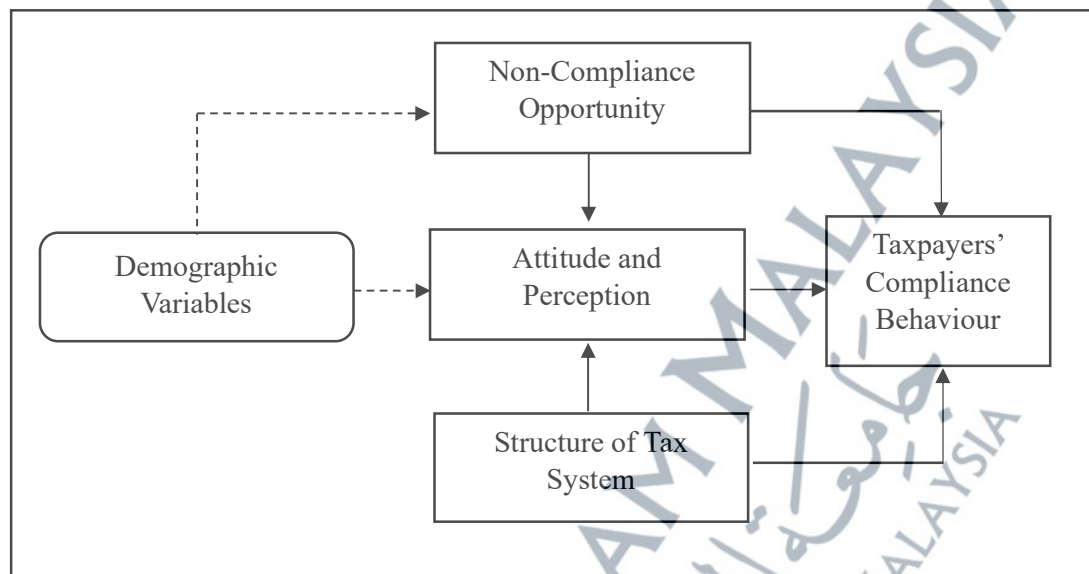
to basic compliance cost or total cost (Cheng et al., 2013; Lawan & Salisu, 2017; Olaoye et al., 2017; Foon et al., 2018).

Additionally, Allingham and Sandm's (1972) application of financial self-interest model within the context of tax compliance was considered. The model was based on the economics curriculum presented by Becker (1968). As illustrated in Figure 2.2, the model indicated tax rate, POD, and penalty structure as the determining factors of compliance cost that affect taxpayers' compliance behaviour. The proposed model did not consider economic variables. Fischer et al. (1992) then expanded the model by including social and psychological variables. As depicted in Figure 2.3, the expanded model predicted the indirect influence of demographic variables on tax compliance behaviour through their influence on non-compliance opportunity and circumstance.



Source: Fischer, Wartick, & Mark (1992)

Figure 2.2: Financial Self-Interest Model



Source: Fischer et al. (1992)

Figure 2.3: Taxpayers' Compliance Model (Expanded)

Although many early studies focused on assessing the impact of VAT compliance cost factors on VAT compliance behaviour, they faced limitations in both theoretical and methodological approaches. These limitations were primarily due to incomplete data, low response rates, or differences in the study population (Lumumba et al., 2010). Nevertheless, most recent studies formed multiple and diverse relationships, suggesting improvement in VAT compliance with reduced compliance cost. Apart from that, prior studies primarily derived the relationship between VAT compliance cost estimates and compliance behaviour from empirical data. Additionally, all variables, including VAT compliance cost, were assumed to be hypothetical (Slemrod, 1985).

According to Chen and Chu (2005), SMEs display low VAT compliance, which is directly influenced by internal and external costs. According to Oladipupo and Obazee (2016), internal costs are among the most challenging aspects regarding tax compliance faced by governments in developing countries. This is caused by the limited ability of developing countries to increase revenues due to the slow economic growth. Based on the findings of previous studies, a positive correlation of internal and external costs with VAT compliance cost among SMEs was concluded, whereby 10 out of 12 studies supported the relationship (Olaoye et al., 2017).

James and Alley (1999) noted the impact of increased tax rates (termed as external costs) on corporate tax compliance in New Zealand and further explained that external costs increase the rates of tax evasion and non-compliance due to the increase of tax rates by the government, the spread of corruption, the lack of accounting systems to regulate the collection of taxes, and the absence of effective management of tax administration (Wilson et al., 1996; Mears, 2016; Olaoye et al., 2017). Meanwhile, Tran-Nam et al. (2000) observed the influence of limited resources and technical capacity on Australian small companies' tax compliance. The study also observed increased tax evasion among SMEs in Bangladesh and attributed this observation to corruption, heightened government scrutiny, and the need to engage consultants. Apart from that, Sarker (2003) discussed the focus of tax authority in Bangladesh on SMEs and the high cost incurred for the engagement with tax consultants to facilitate the survival process outside of tax compliance, resulting in increased tax evasion. Hansford et al. (2003) observed the influence of internal, operating, and external costs, including complex tax laws, on low tax compliance among SMEs in the United Kingdom. In addition, Hansford et al. (2003) attributed SMEs' low tax compliance in the United Kingdom to the influence of external costs incurred, which was described as more

apparent than that for large companies. In Canada, internal mismanagement and internal control factors reduce SMEs' tax compliance (Vaillancourt et al., 2008). Alm and Torgler (2006) found the negative influence of internal costs (e.g., accounting records and auditing) on SMEs' VAT compliance in the United States and Europe, which was more apparent than larger companies. Abdul-Jabbar (2009) discussed the complexities of tax procedures in Malaysia, which increased the tax burden on SMEs and hampered compliance efforts.

Following that, Ahmad and Al Faris (2010) discussed the influence of internal and external costs on VAT compliance, hindering the growth of companies in the Gulf Cooperation Council. In another study, Lumumba et al. (2010) observed a strong correlation between taxpayers' position (reflecting internal costs) and tax compliance among 260 SMEs in Kenya. The study further identified the lack of adequate knowledge of tax laws and regulations among companies, the lack of tax information, and the demographic variables of workers (e.g., gender, age, and level of education) as crucial internal costs. Atawodi and Ojeka (2012) identified the informal approach to tax creation, operation, and resolution, which creates ease of movement and renders it difficult for tax administration to keep up with the restrictions, as one of the factors contributing to SMEs' low tax compliance. In another study, Ibrahim (2013) identified anxiety and perceived usefulness as factors contributing to the non-use of electronic payment systems among Malaysian SMEs. worldwide. Oladipupo and Obazee (2016) highlighted the challenges faced by developing countries like Nigeria, where internal costs were reported as major hurdles for SMEs' tax compliance. Zafarullah (2018c) highlighted the challenges faced by SMEs in the UAE, particularly in regards to external costs incurred during the registration process and understanding of tax laws, affecting

their VAT compliance. The findings of these prior studies shed light on the multifaceted challenges and determinants influencing tax compliance behaviour among SMEs.

Additionally, prior studies on VAT compliance cost were mainly conducted in developed countries, such as the European Union (EU), Canada, and the United States (Hansford et al., 2003; Sarker, 2003; Tran-Nam et al., 2000; Alm & Torgler, 2006; Vaillancourt et al., 2008). The cost of tax liability for VAT is one of the most burdensome aspects for SMEs and even large companies. Furthermore, outsourcing VAT compliance services results in higher VAT tax compliance cost. In general, VAT compliance cost is generally high (whether it is incurred internally or externally) and increases the burden for SMEs (Ramli et al., 2015). Based on the comprehensive review of VAT literature from countries around the world, including the Middle East, the influence of VAT compliance cost varies between direct and limited impact (Ahmad & Al Faris, 2010; Joanne Clarke, 2019).

2.10 Theoretical Framework

2.10.1 Deterrence Theory

Cesare Beccaria, who was an Italian philosopher and criminologist known for his published work “On Crimes and Punishments” in 1764, pioneered the deterrence theory. Beccaria argued that punishment should be swift, certain, and proportionate to the crime committed to deter criminal behaviour and maintain social order effectively (Misra, 2019). As a criminological concept, the deterrence theory explored the role of punishment in preventing criminal behaviour. The theory proposed that individuals are deterred from engaging in unlawful activities when they perceive the potential cost or consequences of their actions outweighing the benefits. The theory also suggested that

the certainty, severity, and swiftness of punishment influence the decision-making processes and deterrence effectiveness (Werekoh, 2022).

The basic concepts of the deterrence theory revolved around two main principles: general deterrence and specific deterrence. General deterrence focuses on deterring potential offenders from committing crimes by witnessing the punishment imposed on others for similar offences. On the other hand, specific deterrence deters individuals who have already engaged in criminal behaviour from repeating their actions through the threat of future punishment (Slemrod, 2019a).

Within the context of the current study on compliance cost, the deterrence theory was deemed relevant in understanding how the perceived cost of non-compliance can influence individuals' and companies' compliance behaviours. Thus, the theory was selected to provide the needed conceptual support to the current study. Accordingly, compliance cost encompasses the expenses incurred by entities to adhere to regulatory requirements, including the costs associated with recordkeeping, reporting, and implementing compliance measures (Dularif & Rustiarini, 2021). The theory also suggested that companies may be deterred from violating tax regulations when they anticipate the potential penalties, fines, and reputational damage associated with non-compliance.

Researchers can assess the extent to which the threat of punishment would influence companies' decisions to comply with tax laws by examining the relationship between compliance costs and tax compliance behaviour through the lens of the deterrence theory. The theory highlighted the importance of enforcement mechanisms, such as audits, inspections, and penalties, in deterring non-compliance and promoting voluntary compliance among taxpayers (Ya'u et al., 2020). Furthermore, it underscored the need for policymakers and regulatory authorities to strike a balance between

deterrence strategies and incentives in order to foster a culture of compliance while minimising the burden of compliance costs on businesses.

2.10.2 Institutional Theory

The institutional theory served as another underpinning theory of the current study. The theory indicated the collective factors affecting tax compliance among SMEs in the UAE. Notably, institutional theory has been recognised as a significant concept in sociology, organisational theory, and management research. It emerged during the late 19th and early 20th centuries to understand how institutions shape human behaviour and social structures (Amenta & Ramsey, 2020). The root of the institutional theory can be traced back to the work of sociologists like Max Weber, Emile Durkheim, and Thorstein Veblen. These scholars explored the role of institutions in shaping societal norms, values, and practices. For instance, Weber examined the impact of bureaucracy and rationalisation on organisational behaviour, while Durkheim focused on the role of social institutions in maintaining social order and cohesion (Willmott, 2018).

Following that, in the 1970s and 1980s, institutional theorists like Meyer and Rowan, DiMaggio and Powell, and Scott began to formalise the institutional theory within the field of organisational sociology. These scholars sought to understand how organisations respond to external pressures and expectations from their institutional environment (Putnam & Mumby, 2018). The institutional theory proposed the influence of norms, values, and practices embedded within the environment on the institutions. Institutions, which include regulatory bodies, professional associations, and industry standards, establish specific rules, expectations, and legitimate practices, which shape organisational behaviour and decision-making.

One key proposition of the institutional theory included the concept of institutional isomorphism, suggesting the tendency of organisations within the same institutional environment to become structurally and behaviourally similar over time. This isomorphic pressure arises from three mechanisms: coercive, mimetic, and normative. Coercive isomorphism occurs when organisations comply with external regulations and legal requirements. Mimetic isomorphism occurs when organisations imitate the practices of successful peers or competitors. Normative isomorphism occurs when organisations conform to professional standards and societal expectations (Dacin et al., 2021). The institutional theory has been applied across various domains, including organisational behaviour, corporate governance, and public policy. In the organisational context, the theory elucidated why certain practices become widespread across industries and sectors, even in the absence of direct incentives or mandates.

The institutional theory further highlighted the importance of legitimacy for organisations. Legitimacy refers to the perception that an organisation's actions, structures, and practices are appropriate, desirable, and socially acceptable. Organisations seek to maintain legitimacy by conforming to institutional norms and expectations, thereby enhancing their reputation and credibility in the eyes of stakeholders. Hence, institutional theory provided a valuable framework for understanding how institutions shape organisational behaviour and decision-making. Scholars and practitioners can gain insights on the dynamics of organisational change, adaptation, and legitimacy by examining the influence of institutional pressures and expectations. The theory continues to be a prominent and influential concept in the study of organisations and society (Mukhlis et al., 2015; Gimba & Ibrahim, 2017; Alshirah et al., 2019; Jones & Mosteanu, 2019).

2.10.2.1 Institutional Theory and Tax Compliance by SMEs

In regard to tax compliance by SMEs in the UAE, the institutional theory offered practical insights on the factors affecting compliance and non-compliance behaviours. The tax system in the UAE is entrenched within a wider institutional environment that includes legal frameworks, regulatory bodies, industry norms, and societal expectations. Understanding how these institutional forces shape SMEs' compliance decisions is important for designing effective tax policies and enforcement strategies (Horodnic, 2018). According to the institutional theory, SMEs in the UAE are subject to different institutional pressures that affect their tax compliance behaviour. For instance, coercive isomorphism occurs when SMEs comply with tax regulations due to the peril of penalties and legal sanctions. The UAE government imposes strict penalties for tax non-compliance, including fines, interest charges, and legal proceedings. As a result, SMEs may feel compelled to comply with the tax laws to avoid these coercive sanctions and strengthen their legitimacy in the business community (Williams, 2020).

Furthermore, mimetic isomorphism plays a role in SMEs' compliance decisions as they observe the practices of their peers and competitors. In the UAE, SMEs may mimic the tax compliance behaviour of larger companies or industry leaders, believing that these practices reflect the best practices and industry standards. Mimetic pressures can lead SMEs to adopt tax compliance measures, such as hiring professional tax advisors or executing sophisticated accounting systems, to align with perceived industry norms (Musimenta et al., 2017). Normative isomorphism also influences SMEs' tax compliance behaviour by shaping their perceptions of social and professional norms. In the UAE, SMEs may view tax compliance as a moral and ethical obligation driven by societal expectations and professional standards. SMEs that comply with tax laws may

enhance their reputation and credibility, thereby gaining social approval and acceptance within the business community.

Despite these institutional pressures, certain SMEs in the UAE engage in tax non-compliance due to various factors. Economic constraints, limited resources, and bureaucratic hurdles may hinder SMEs' ability to comply with complex tax regulations. Additionally, perceived inequities in the tax system, such as preferential treatment for larger companies or discrepancies in enforcement practices, can erode SMEs' trust in the tax authorities and undermine their willingness to comply (Bruno, 2019). Cultural and social factors may also affect SMEs' attitude towards tax compliance. In certain cases, informal norms and practices within certain business communities may tolerate or even encourage tax evasion as a means of reducing operational costs and maximising profits (Ottone et al., 2018).

2.11 Development of Conceptual Framework

2.11.1 Development of Conceptual Framework for Compliance Cost

Prior studies demonstrated that the introduction of a new taxation system can indirectly cause significant burden to companies given the substantial costs involved in the management and development processes. Key components of compliance cost in the processing of the model to identify the estimated compliance cost are internal and external costs, as proposed by Sandford (1995) and Pope (2001). These are among the vital costs companies face in complying with taxes, including VAT. These costs are classified based on their sources, either internal or external or other types of costs or planning and accounts (Ibrahim, 2013). The term "internal processing" refers to all expenses incurred by a company, such as operating cost, stationery, finance, time, and effort. On the other hand, external costs mainly refer to the amounts paid by the

company to tax professionals like accountants, lawmakers, and observers (Mitchell & Scott, 2019). Both types of costs are discussed in detail in this subsection.

According to Sandford (1995), internal costs affecting VAT compliance comprise accounting cost, time factor, training, and psychological factors, which exert direct influence on the compliance process. Similarly, Lignier and Evans (2012) opined the direct impact of internal costs on SMEs' tax performance. The study further noted that taxpayers are more restrictive and more influenced by internal factors related to the company's financial situation. Internal costs also include cash cost and operating cost of the company to start work (Malmer, 1995), the salaries, and the costs of filing tax returns and maintenance of the taxpayer. Cash cost refers to the amount spent on tax experts (e.g., accountants and tax agents) and also includes expenses related to tax evidence, communication, costs, books, and other incidental costs (Sandford, 1973; Sandford et al., 1989).

Apart from the establishment of several metrics and conceptual issues in defining a company's internal compliance costs, numerous studies (e.g., Sandford, 1973; Sandford et al., 1989) have made significant contributions in identifying key elements of internal tax compliance costs by. Problems pertaining to internal tax compliance include the allocation of costs incurred for accounting or VAT compliance cost, the cost for compliance with taxpayers, starting recurrent costs, and a distinction between social compliance cost and accounting or tax planning cost (Finance, 2004; Lignier & Evans, 2012; Evans et al., 2013; Sapiei & Abdullah, 2014; Mukundi et al., 2017). Factors that affect productivity are the age of employees, psychological factors, accounting factors, and the internal challenges of the company (Saderuddin & Barghathi, 2018). Sandford (1973) argued that employees' psychological or demographic factors can reduce their productivity within the contexts of the United

States and EU. Moreover, it may increase the internal costs of complying with VAT. Meanwhile, Sapiei and Abdullah (2014) reported that the time spent by a company's staff in the treatment of tax and accounting work depends on the content of internal costs. In addition, companies may incur certain unexpected costs in meeting tax compliance requirements. These costs may include travel cost, stationery and notebooks, mail, telephone and Internet services, utility bills, lectures and seminars, offices and halls, transportation, maintenance of accounting programmes, and any other internal costs related to the companies (Sapiei, 2014; Xing & Whalley, 2014).

On the other hand, Pope and Fayle (1991) listed the external costs of taxes, which included the cash paid by the company due to compliance, the expenses incurred for the company's engagement with tax specialists, and the costs of experts, external examiners, and auditors contracted by the company to collect taxes. Besides that, external costs include the cost of external accountants for operational and consulting services, as well as staff costs for operating accounting, apart from the time taken by commercial companies in the tax department (Pope et al., 1993). According to Finance (2004), psychological costs are due to the company's compliance with the enforced laws and regulations, which is associated with the external costs of compliance (Saderuddin et al., 2017).

The external and psychological costs of GST can be highly complex, and numerous companies realise the need to gain knowledge of correct policies and transaction prices (Pope, 2001). This "fear factor" is often highlighted as an element of obligation, including financial and criminal penalties for non-compliance with tax regulations and costs of concern for compliance with tax obligations (Ramli et al., 2015). The external costs of strike systems, including VAT, can be complicated, and companies are aware that they need more knowledge of the precise policies, size of

compliance, and price of services (Pope et al., 1993; Evans et al., 2013;). Furthermore, external costs are often considered a major concern of companies, particularly SMEs, because there is insufficient liquidity to implement the tax compliance process (Ramli et al., 2015).

Pope (2001) and Sandford (1995) proposed a set of factors that depend on the level of compliance with taxes and mitigation of external costs and any changes in tax policy, apart from understanding and simplification of tax laws. For example, the payment of GST imposes a series of necessary duties closely related to the regulations implemented by the Tax and Customs Department. Companies, including SMEs, must also maintain adequate accounting records for all transactions for payment purposes. Not only that, companies must provide supporting documentation of their claims, such as sales invoices, in line with the GST rules (Ramli et al., 2015).

Nonetheless, internal and external costs incurred internally by the company are considered to be within the total tax compliance cost and exert direct influence on the company's position within the market and its ability to grow and cope with economic fluctuations (Sandford, 1973; Ramli et al., 2015). In particular, SMEs tend to be more affected by internal and external costs than large companies that can adapt to these costs better due to the size of their capital and the diversity of their activities, which affect VAT compliance cost (Atawodi & Ojeka, 2012; King'oina, 2016). An illustration of a model to identify the total estimated compliance cost incurred by SMEs to the post-implementation of VAT is presented in Figure 2.4. The relevant models indicated the consistency with the first objective of the current study—to evaluate the impact of compliance cost on VAT compliance behaviour among SMEs in the UAE.

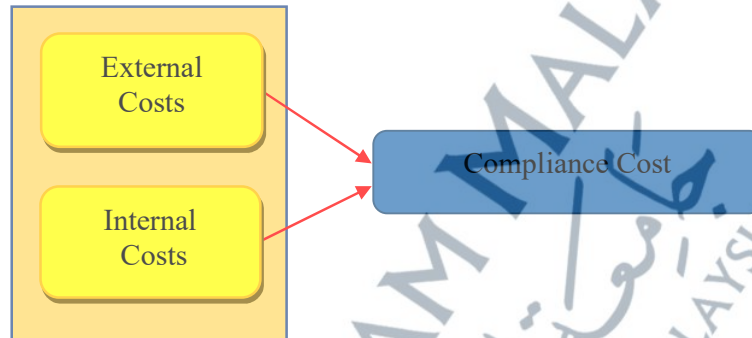


Figure 2.4: Research Model for VAT Compliance Cost

2.11.2 Development of Conceptual Framework for Compliance Behaviour

Measuring tax compliance behaviour in the field of taxation is an extremely difficult and challenging task (Long & Swingen 1991; Webley et al. 1991; Hasseldine & Li 1999). Most of the previous studies highlighted three approaches to measure individual tax compliance behaviour, namely self-reporting, experiment, and tax audit (Long & Swingen 1991; Elffers, Robben & Hessing 1992). As for the self-reporting method, taxpayers are required to report all forms of behaviour in the process of filling out tax forms. This method allows inquiry of any form of questions, either directly (i.e., through their parties) or indirectly (i.e., for third parties). On the other hand, experimental method requires taxpayers to make compliance decisions in a practical setting (typically in a laboratory setting). Meanwhile, the tax audit method depends on facts and data from the tax authorities that can be obtained through audit activities (refer to Swingen (1991) for a comprehensive discussion). The self-reporting method is the

most commonly used method in tax research (European Commission, Directorate-General for Taxation and Customs Union et al., 2022). This method has many advantages, such as easy implementation, cost-effectiveness, and fewer ethical concerns.

However, SMEs in the UAE understate their income in different ways when it comes to dealing with VAT compliance. Underreporting of sales is commonly used. Essentially, this means not recording all sales transactions or conducting cash transactions off the books, which effectively remove these transactions from VAT declarations. Another strategy involves misclassifying expenses. SMEs may label personal expenses as business expenses or exaggerate the value of deductible expenses to lower their taxable income and subsequently decrease their VAT liability (Ya'u et al., 2020). Manipulating invoices to understate income is another way used by certain SMEs. This can involve issuing false invoices or altering invoice details to misrepresent transactions and reduce income. For instance, companies may inflate expenses or understate sales figures to lower the amount of VAT owed (Nar, 2023). Other SMEs may underreport imports or exports in international trade to avoid paying VAT on products and services. This strategy allows them to lower their VAT obligations, but such practice is not legal. Complex business structures can also contribute to income understatement among SMEs. Some businesses use intricate setups or engage in transactions with certain parties to artificially reduce taxable income. They may shift profits between entities or conduct intra-group transactions at artificially low prices to minimise their VAT liability (Nar, 2023).

Although there are methodological limitations, such as distorted statements or biased information (social dissatisfaction), self-reporting has been widely used in measuring tax compliance behaviour, both internationally and in Malaysia (Webley et

al., 1991; Elffers, Robben, & Hessing, 1992; Abdul-Jabbar, 2009; Marziana & Mohd Asri, 2017; Gunn et al., 2020). This method typically consists of two measurement techniques. The first technique requires respondents to answer the avoidance action that has been previously executed, while the second technique requires respondents to answer based on the assumption of specific case scenario. Kirchler and Maciejovsky (2001) hypothesised lower bias towards social dissatisfaction through the use of scenarios describing third-party actions (indirect measures).

According to Joulfaian (2000), companies that commit non-compliance actions are typically managed by executives who fail to comply with Taxpayer Compliance Measurement Program (TCMP) data. Abdul-Jabbar (2009) shared similar views and noted the close relationship between owners and companies, especially small companies, when it comes to tax conditions. The concept of management choice assumed the influence of executives' actions and choices on the corporate behaviour of SMEs. Referring to Joulfaian (2000) and Abdul-Jabbar (2009), the current study employed the concept of management choice as a proxy to measure VAT compliance behaviour. Furthermore, self-reporting was considered the most appropriate method for this study to examine the VAT compliance behaviour among SMEs in the UAE. An illustration of the model for GST compliance behaviour is presented in Figure 2.5.

Notably, the UAE's Ministry of Finance announced a new tax relief initiative aimed at supporting small businesses in the country. According to the ministry, small businesses with revenue of AED 3 million (USD 816,880) or lower can benefit from this initiative, specifically known as Small Business Relief. Based on Article 21 of the corporate tax law, the introduced initiative provides relief to taxable entities with revenue not exceeding a certain threshold in each tax period (Nagraj, 2023).

Apart from the introduction of the federal corporate tax with a standard statutory rate of 9%, Small Business Relief aims to alleviate the tax burden and compliance cost for startups and SMEs (European Commission, Directorate-General for Taxation and Customs Union et al., 2022). Eligible taxable individuals who are residents of the UAE can claim the relief if their revenue in the relevant and previous tax periods is below AED 3 million for each period. However, once the revenue exceeds the threshold in any tax period, they are no longer eligible for the scheme.

The relief initiative specifies the revenue threshold and conditions for eligibility, applicable from tax periods starting on or after 1 June 2023 until 31 December 2026. Taxable individuals not opting for the relief can carry forward tax losses and disallowed net interest expenditure for future tax periods (European Commission, Directorate-General for Taxation and Customs Union et al., 2022). However, multinational enterprise groups and qualifying free zone entities are ineligible for the scheme. Furthermore, entities involved in natural resource extraction activities are exempted from the corporate tax law although they are subject to local emirate-level tax. The corporate tax regime in the UAE operates on a self-assessment principle, mandating companies to ensure the accuracy and compliance of submitted documents to the FTA (Dularif & Rustiarini, 2021). Figure 2.5 shows consistent with the second objective of this study—to examine the relationship between compliance cost and VAT compliance behaviour at both individual SME and industry levels.

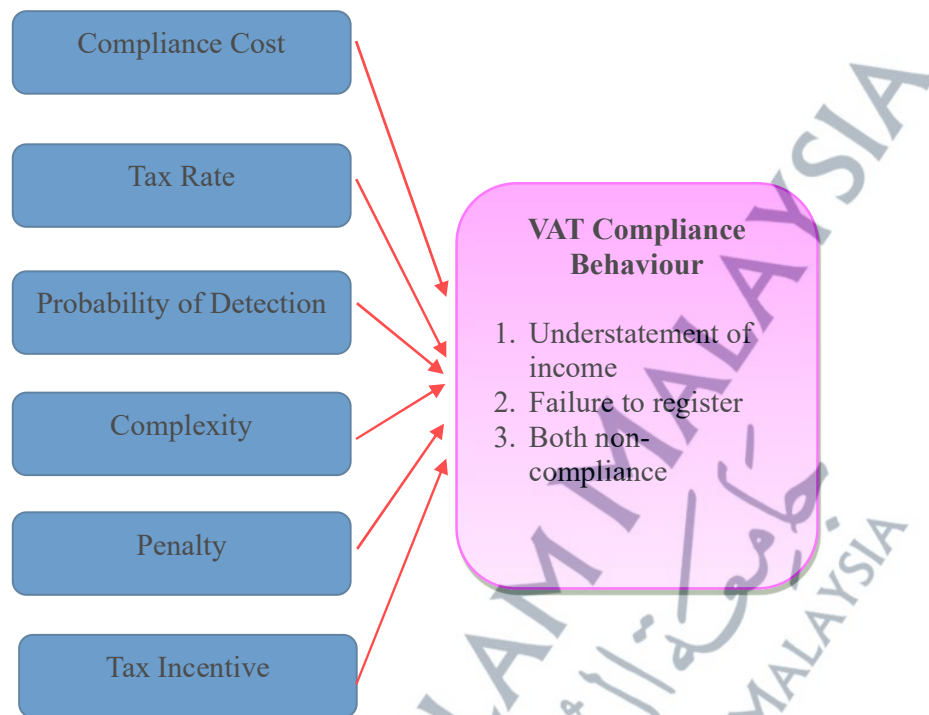


Figure 2.5: Research Model for the Determinants of VAT Compliance Behaviour

2.11.3 Development of Overall Framework

Based on the above discussion, the overall conceptual framework of this study was developed through the scrutiny of previous studies. Compliance cost models and tax compliance behaviours have been identified and developed. Two models were combined into a single conceptual framework model for this study (see Figure 2.6). According to Urbach and Ahlemann (2010), the integrative model provided a more complete description of the underlying causal mechanisms in relationships and unique ideas that cannot be obtained through a single theory-based model. Thus, an integrated theoretical model was developed in this study. As discussed in the previous section, this study was divided into two main analyses. With respect to the first objective of this study, the initial analysis estimated the VAT compliance cost based on internal and external cost factors. Following that, this study proceeded to examining the

relationships of independent variables (compliance cost, penalty imposition, complexity, POD, tax rate, and tax incentive) with the dependent variable, specifically VAT compliance behaviour.

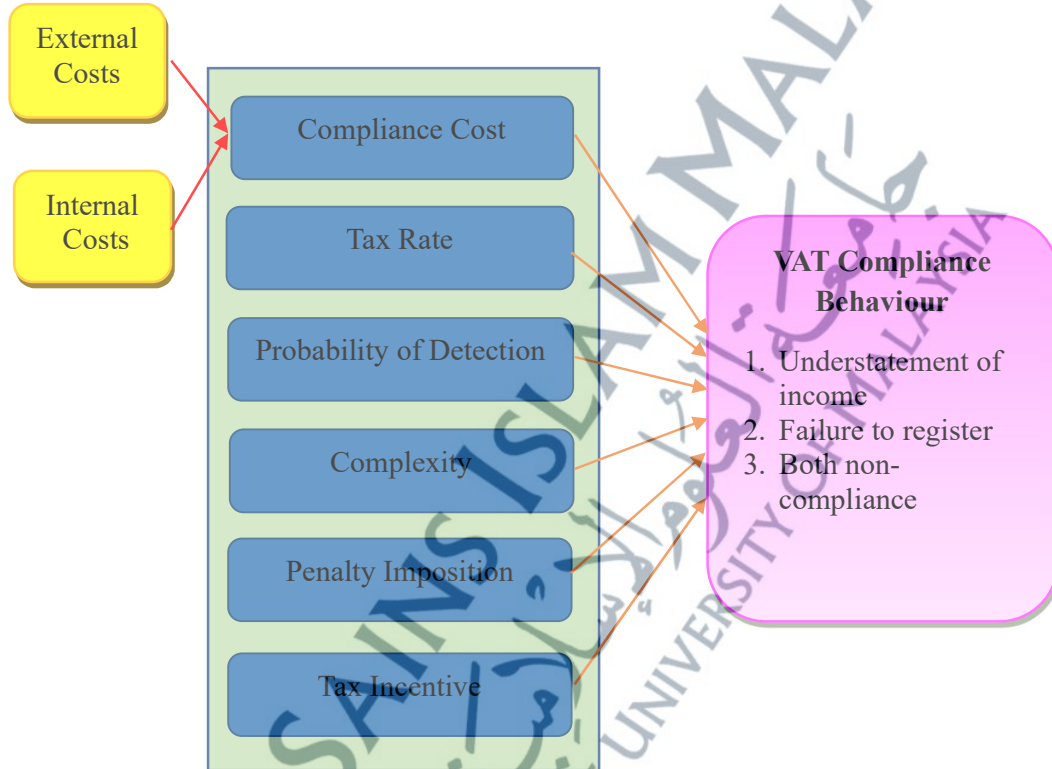


Figure 2.6: Overall Conceptual Framework

2.12 Chapter Summary

This chapter discussed pertinent literature relevant to the current study. The empirical literature first discussed the findings of prior studies on VAT compliance, especially in the UAE. The comprehensive review of relevant literature unravelled the dynamics and influence of internal and external factors on VAT compliance behaviour. Besides that, theoretical literature was discussed, highlighting the underlying theories of this study. Finally, the proposed conceptual framework was discussed.