

# CHAPTER 1

## INTRODUCTION

### 1.1 Introduction

The importance of value added tax (VAT) can be determined by the fact that, almost a century ago, the concept of VAT was discussed on a limited level and mostly in the handbooks. Today, VAT is a part of over 160 countries, contributing extensively to strengthening and regulating the local economy in the best possible manner (Mureşan et al., 2014). VAT has become a strong part of the tax reform system in both developed and developing countries. Consequently, the rise and implementation of VAT have been some of the most significant developments in tax policies and economic administration during the past two decades (Mureşan et al., 2014).

The development of tax compliance in any society contributes to the timely collection of tax dues to the public treasury, assisting it to achieve its goals and protecting it from slipping into unsafe levels of deficit (Cherian et al., 2021). In light of this, the issue of tax compliance in the United Arab Emirates (UAE) is one of the topics of concern to researchers and staff in the tax administration in general, especially as it has been proven that most financiers in different tax communities do not comply with tax laws, except when they feel that the cost of non-compliance outweighs their revenue (Maher, 2019)—that is when they are sure that the severity of their suffering in the event of tax evasion detection exceeds the value of the tax to be paid (Naicker & Rajaram, 2019). Therefore, the role of tax administration in the UAE must be strengthened in the face of financiers by consolidating its ability to achieve tax compliance and even developing it according to the changes and openness in the UAE market. This depends

on its ability to detect and penalise non-compliant funders (Goher et al., 2021).

In terms of economic growth and sustainable development, small and medium-sized enterprises (SMEs) play an important role. SMEs are of great importance for various economies, especially developing countries, due to their significant contributions to the country's economic growth (Amirrudin & Nasution, 2021). Several studies like Bird and Gendron (2007), Ahmad and Brosio (2010a), Ya'u et al. (2020), and Werekoh (2022) demonstrated the importance of a stable and secure sector for SMEs and the development of several policies aimed to assist the establishment and growth of SMEs (Government of UAE, 2022).

For instance, SMEs add 20% to the annual gross domestic product (GDP) in the Indian economy (Kumar, 2017). In this regard, the contributions can be divided in the forms of industrial output (45%) and exports (40%), the employment of more than 60 million people, providing more than 1.3 billion employment opportunities, and the production of more than 80,000 products for import and export purposes. Meanwhile, in the South African context, small enterprises contribute substantially to the local economy. SMEs in the private sector provide more than 84% of employment opportunities and add more to the total annual GDP (Amanamah, 2016).

It is also worthwhile to note that many large-scale industries have their share in SMEs, indicating the allocation of these large industries into several SMEs. The fact is that many large companies comprise several shareholders who further decide to exclude from the respective companies and establish their own businesses (Amanamah, 2016). For example, in Pakistan, Lever Brothers has been one of the most influential, large-scale businesses. Their company originated in Karachi, Pakistan and worked extensively to provide fast-moving consumer products nationwide. In the 1960s, the company shifted its factory from Karachi to Rahim Yar Khan in Punjab, Pakistan.

However, during the past few years, due to some strategic reformations, Lever Brothers was divided into medium-level enterprises, individually held by the keyholders, with six factories nationwide, providing employment opportunities and contributing substantially to the GDP of Pakistan (Government of UAE, 2022).

Accordingly, there are many differences between small and large companies, and the most fundamental differences are in terms of tax rate, tax compliance, and compliance cost (Penrose, 1959; Lewis & Churchill, 1983). Influencing factors that were applied to large companies and developed according to the data of these companies cannot be significantly and directly used by small companies in light of the VAT (Dularif & Rustiarini, 2021). Hence, VAT is expected to contribute to the complexity of smaller companies' operations, whereby more time and effort are needed to conduct business management at lower cost compared to larger companies that have more resources (Trowers & Hamlins, 2020).

A resource-based company's view defined the unique packages of materials and intangible resources that include physical capital and human capital, such as skills, knowledge, governance, and staff (Ya'u et al., 2020). Organisational capital includes the procedures, processes, and resources developed throughout a company's history since its inception. Therefore, SMEs inevitably require more resources (Slemrod, 2019a). A small company has a lower level of human capital due to the smaller number of employees. Additionally, small companies rely heavily on the time and skills of key employees. Small business owners are often required to be multifunctional, and in smaller companies, financial management is one of the owner-manager's many responsibilities (Ya'u et al., 2020).

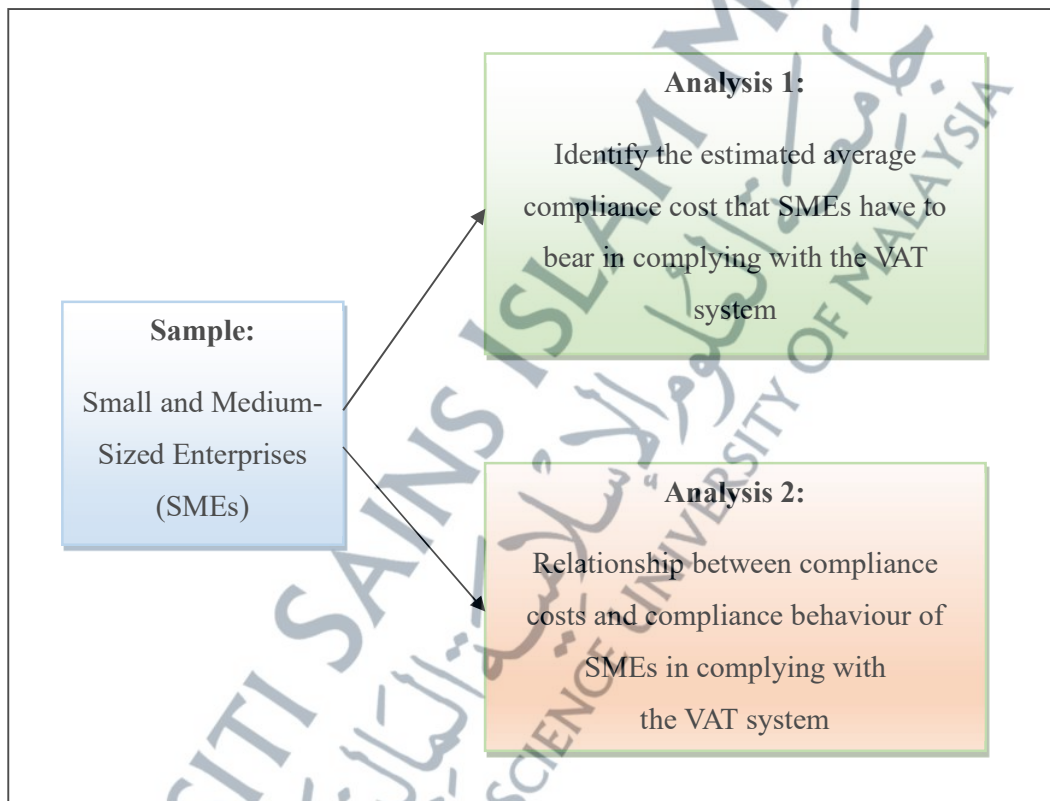
Consequently, companies face time constraints in preparing tax compliance lists, paying taxes, and completing the tax audit process (Pandey & Kingsley, 2000).

Unlike other companies with more efficient regulatory capital, small companies with lower capital may adopt strategies that allow for lack of resources or adopt specific procedures and processes alternative to non-available resources (Yusuf, 1997). A careful assessment of these actions' cost may indicate that they are expensive in terms of efficiency and the owner-manager's time (Pandey & Kingsley, 2000). Nevertheless, owner-managers who complete VAT returns in their spare time may reduce the cost of their inputs and time. In the case of computerised systems and procedures, compliance cost may be reduced by increasing financial and administrative efficiency (Barney, 1986).

For SMEs, compliance cost is increased by using external consultants for their advice in areas where small business owners need more knowledge or confidence (Hansford et al., 2003). Newly registered smaller companies and companies preparing new procedures may need more time to comply (Yusuf, 1997; Bachkaniwala et al., 2001). Tax payment should not be an issue for companies if proper planning of tax activities is in place that allows optimisation of resources and offers benefits from making contributions. Companies benefit from the collection and payment of VAT before it is transferred to the tax department (Cressy, 1996; Bachkaniwala et al., 2001). Although smaller companies may possess greater administrative advantages in keeping VAT records as compared to larger companies, this is likely to be compensated by the greater cash flow benefits of larger companies and a greater likelihood of deducting income tax from compliance cost (Pandey & Kingsley, 2000).

The influence of VAT implementation on SMEs, specifically in the UAE, has gained growing research interest. With that, the current study's focus would be of interest to SMEs because this would significantly assist them in determining the relationship between compliance cost and compliance behaviour, compliance,

influencing factors of compliance, and the importance of legislations in lowering compliance cost. This study's analysis first focused on compliance cost, specifically on identifying the estimated average compliance cost that SMEs must bear in complying with the VAT system. The results of the analysis were then used in the next analysis to examine the extent to which the relationship between compliance cost and compliance behaviour among SMEs (Figure 1.1).



**Figure 1.1:** Division of Analyses

## 1.2 Problem Statement

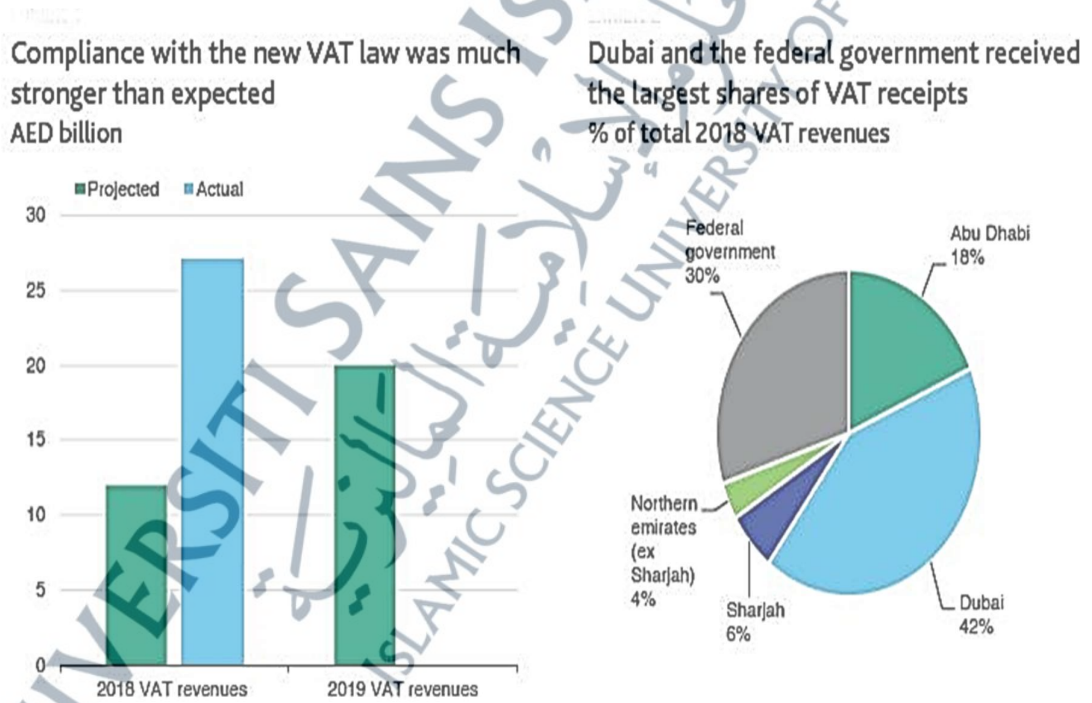
According to Evans (2008), administrative and tax compliance costs stem from three outcomes, namely high compliance cost, low compliance cost, and compliance cost that do not decrease over time. Mardhiyah (2016) posited the presence of a kind of

political sensitivity in the case of fiscal compliance cost since most governments in the world do not fully commit to efficient and simple tax policy and proceed to reduce research and publicity on the subject (Pandey & Kingsley, 2000). Notably, VAT compliance among SMEs holds paramount importance not only for the economic growth of the UAE but also for the sustainability and competitiveness of the businesses. VAT compliance ensures that SMEs operate within the legal and regulatory frameworks established by the government. Non-compliance can lead to penalties, fines, and even legal action, which can significantly disrupt business operations and tarnishing the company's reputation (Sidek & Abdulraqueeb, 2022).

Tax compliance cost has been extensively explored in numerous studies globally over the past several decades, specifically worldwide in terms of the evolution of tax liability cost (Clemens, 2008). For example, in a study on tax compliance cost for SMEs in Canada, it was argued that there was a need for further research to reduce problems associated with increased government's revenues from tax compliance (Rametse, 2006). Additionally, various studies emphasised the need to comprehensively and accurately review and determine the importance and burden of tax compliance cost for all categories of companies, including SMEs (Abdul-Jabbar, 2009; Highfield, Evans & Walpole, 2016; Saderuddin & Barghathi, 2018).

In general, studies on VAT compliance cost within the context of developed countries have highlighted that the cost of tax compliance is regressive and more onerous than other types of taxes. Typically, VAT compliance cost is high, regardless of whether it is incurred internally or externally, and increases SMEs' burden based on the overall audit of UAE's VAT (Bannaga, 2017a). The UAE only recently applies the system, since the beginning of 2018 to be exact (Ministry of Finance UAE, 2017; Saderuddin & Barghathi, 2018). In the UAE, there have been studies on VAT

compliance behaviour (Figure 1.2) in regards to the report of the General Authority for VAT compliance in 2018 and the implementation of the VAT regulations in the UAE (Federal Tax Authority, 2019). VAT compliance reached AED 27 billion in 2018, as compared to the government’s initial projection of AED 12 billion (Trowers & Hamlins, 2020). As shown in Figure 1.2, VAT revenues in 2018 exceeded the projected value. It is essential to recognise that mere revenue figures do not necessarily reflect full VAT compliance across the board. The discrepancy between projected and actual revenues may suggest a degree of compliance among taxpayers, but it does not provide a comprehensive picture of VAT compliance behaviour across all sectors and businesses (Dularif & Rustiarini, 2021).



Source: Federal Tax Authority (2019)

**Figure 1.2:** UAE VAT Compliance in 2018

Maintaining VAT compliance enhances the overall reputation of SMEs in the marketplace. According to Dularif and Rustiarini (2021), compliant SMEs enjoy higher trust and credibility among consumers, suppliers, and partners. Consumers prefer to engage with businesses that operate ethically and responsibly, including meeting their tax obligations. Compliant SMEs are also more likely to have access to financing and investment opportunities. Financial institutions and investors typically conduct due diligence assessments, including evaluating a company's tax compliance history. VAT compliant SMEs demonstrate financial stability and reliability, increasing their attractiveness to potential investors and creditors.

VAT compliance practices often involve maintaining accurate financial records and adopting robust accounting systems. These practices give SMEs valuable insights on their financial performance, cash flow, and profitability. SMEs can make informed business decisions, identify areas for improvement, and strategically plan for growth and expansion by adhering to VAT regulations (Amirrudin & Nasution, 2021). As a significant source of government's revenues, VAT is essential for funding public services, infrastructure development, and social welfare programmes. SMEs fulfil their civic responsibility and contribute to the broader socio-economic development of the UAE by complying with the VAT regulations (Nar, 2023). VAT compliance ensures fair competition within the business landscape. When all SMEs adhere to the same tax rules and regulations, it creates a level playing field where companies compete based on the quality of their products, services, and innovation, rather than exploiting loopholes or engaging in tax evasion practices (Slemrod, 2019a).

The current study was deemed necessary to demonstrate how SMEs can be a driving force of the national economy with high expectations to increase the exponential

economic growth in the UAE. SMEs in the UAE are strongly affected by cost-related factors, specifically internal and external VAT compliance costs. Nevertheless, SMEs have continued their efforts because most of these companies represent important nuclei for their managers, and they have social and economic commitment to the market in the UAE. Therefore, it is imperative to present this problem and take measures to promote SMEs based on the compliance cost that would greatly impact the average SME business sector. Besides that, it is important to discover which external and internal expenses make up the tax structure that directly affects SMEs and understand their similarities and differences, as well as the damages they generate, that is, the degree of VAT compliance cost. Specifically, this study examined cost-related factors (internal and external compliance costs) of complying with the VAT for SMEs in the UAE. The results would help improve the management of VAT in the UAE.

Despite the overall increase in revenues generated from VAT, there are still challenges and areas of concern regarding compliance among taxpayers, especially SMEs. Issues related to VAT non-compliance can be seen in various forms—for examples, companies register for VAT but do not charge VAT (partially or fully) on sales; companies charge VAT on sales but do not report (in part or in full); companies state more credit on purchase than the input tax paid; companies do not claim the VAT input credit and do not maintain the books and accounting record documents properly and perfectly.

The issue with VAT compliance lies in the complexity and scope of the VAT system itself, particularly concerning its implementation and enforcement. The extension of the burden faced by SMEs can lead to a form of decision in VAT non-compliance behaviour. Another significant issue is the burden of VAT compliance cost, which disproportionately affects smaller companies. The costs associated with

understanding, implementing, and adhering to VAT regulations can be onerous for SMEs, potentially leading to errors, misunderstandings, or deliberate non-compliance (Ya'u et al., 2020). As a result, taxpayers seek to reduce their compliance cost burden by not complying with either all or part of the requirements of the VAT system.

Moreover, VAT compliance involves various administrative tasks, such as record-keeping, filing returns, and managing input and output taxes. SMEs often lack a dedicated accounting and tax department. Consequently, they may struggle to navigate these requirements efficiently, increasing the likelihood of non-compliance. Furthermore, factors like ambiguity in VAT regulations, inadequate guidance and support from tax authorities, and resource constraints exacerbate compliance challenges for companies of all sizes. Additionally, while the increase in VAT revenues may indicate a degree of compliance, it does not necessarily reflect the prevalence of non-compliance practices, such as underreporting, misclassification, or deliberate evasion, which can undermine the integrity of the VAT system and erode public trust (Sidek & Abdurraqeab, 2022).

In view of the above, this study aimed to determine the total cost of VAT compliance cost and its impact on non-compliance actions and explore significant factors influencing VAT compliance behaviour among SMEs in the UAE. If the compliance cost burden is somehow alleviated to a certain extent, then non-compliance of VAT, either in part or in whole, is likely to reduce. Looking at this problem, this study was deemed pivotal in improving VAT tax compliance among SMEs, which can directly help increase the country's source of income and improve the economic level of SMEs.

### 1.3 Research Objectives

The specific objectives of this study are presented in Table 1.1.

**Table 1.1:** Main and Specific Research Objectives

Main Objectives	Specific Objectives
1. To evaluate the impact of compliance cost on VAT compliance behaviour among SMEs in the UAE.	<ol style="list-style-type: none"><li>1. To identify the compliance cost post-implementation of VAT for SMEs in the UAE and determine the average the compliance cost incurred by SMEs in consideration of both internal and external cost factors.</li><li>2. To measure the total estimated compliance cost of all SMEs in the UAE.</li></ol>
2. To examine the relationship between compliance cost and VAT compliance behaviour at both individual SME and industry levels.	<ol style="list-style-type: none"><li>3. To determine significant internal and external factors that contribute to compliance cost among SMEs.</li><li>4. To examine the relationship between compliance cost and compliance behaviour of VAT in the UAE at the individual SME level.</li><li>5. To determine the relationship between compliance cost and compliance behaviour of VAT among SMEs within different industries.</li></ol>

### 1.4 Research Questions

This study addressed several main and specific research questions, as detailed in Table 1.2.

**Table 1.2:** Main and Specific Research Questions

Main Research Questions	Specific Research Questions
1. How does compliance cost affect the post-implementation of VAT for SMEs in the UAE?	1. How much is the total estimated compliance cost of all SMEs in complying with VAT in the UAE based on internal and external cost factors? 2. Which component is dominant in the compliance cost of VAT?
2. How does compliance cost affect compliance behaviour of VAT among SMEs in the UAE?	3. To what extent is the relationship between compliance cost and compliance behaviour, taken together with other variables (i.e., penalty, probability of detection, complexity, income level, and tax incentive) for each SME?

### 1.5 Significance of Study

Firstly, this study provided valuable insights on factors influencing VAT compliance behaviour among SMEs in the UAE, which would significantly benefit both researchers and practitioners. The obtained results and findings of this study enriched the existing tax literature, which would be of interest to researchers conducting empirical studies. Moreover, this study would contribute to the behavioural research in the adoption of VAT compliance within the Arab region. This study contributed to the body of knowledge for the future development of VAT compliance cost of SMEs. Another significance of this study involved its focus on the Arab world. The VAT compliance cost of SMEs has yet to be addressed substantially, and there have been very limited studies on the factors affecting VAT compliance behaviour in the UAE.

In addition, this study's results and findings would be of interest to SMEs in determining the relationships of compliance cost, penalty imposition, complexity, probability of detection, tax rate, tax incentive, and tax compliance behaviour. Apart from that, this study would significantly benefit tax authorities in the UAE. This study would also substantially assist decision-makers in formulating policies and legislations geared to promoting voluntary compliance with VAT, reducing tax evasion and avoidance. More strategic efforts can be made to assist the government in making major changes to ensure justice, expanding the tax base, and encouraging increased investment, thereby, easing the tax burden on SMEs in the UAE.

Notably, identifying the estimated average compliance cost is crucial for several reasons. Firstly, it offers a comprehensive understanding of the financial burden imposed on companies to meet VAT requirements. This insight is essential for businesses, policymakers, and regulators in assessing the economic impact of VAT compliance on companies, particularly SMEs. Secondly, knowing the estimated average compliance cost allows the evaluation of businesses' overall financial health and viability. It helps determine whether the cost of complying with VAT is proportionate to the company's size, revenue, and industry standards. This assessment is vital for ensuring a fair and equitable tax system that does not unduly burden businesses, especially smaller companies. Thirdly, identifying the estimated average compliance cost facilitates benchmarking and comparison across different sectors and industries. A comparative analysis can highlight disparities and areas where improvements or targeted interventions may be necessary. It also aids in identifying best practices and areas of efficiency that can be shared among businesses, contributing to a more streamlined and effective VAT compliance process. Moreover, understanding the estimated average compliance cost is instrumental in policy formulation and

adjustments. Policymakers can make use of the data to make informed decisions regarding tax policies, incentives, and regulatory frameworks. It enables them to balance revenue generation and ensure businesses thrive in a competitive environment.

## **1.6 Scope of the Study**

This study focused on only one type of community, specifically SMEs in the UAE registered with the country's Ministry of Finance for the year 2019/2020. Seven emirates were included, namely Abu Dhabi, Dubai, Sharjah, Ras Al Khaimah, Ajman, Fujairah, and Umm Al Quwain. Furthermore, considering the employed sampling method, there was a tendency for the selected samples to be from the same group and share similar factors (Fornell & Larcker, 1981). The results on the types of factors affecting the VAT compliance cost of SMEs in the UAE may be limited to this particular circumstance that surrounds the society, spatially and unique experience, and the specificity of the UAE society. Thus, these results can be generalised to other similar types of societies, especially in the Arab region.

## **1.7 Definitions of Key Terms**

### **i. Value added tax (VAT)**

#### **Functional definition:**

VAT is a consumption tax levied at multiple stages of a product's supply chain, starting from its raw form to the final consumer purchase. It applies during manufacturing, wholesaling, retailing, and consumer transactions, thereby adding value at each stage of the product's journey (Maverick, 2020).

**Operational definition:**

VAT is a taxation mechanism initiated from the inception of product manufacturing until its sale. Governments employ VAT regulations to maintain economic equilibrium and enhance the role of business entities in contributing to the economy.

**ii. Small and medium-sized enterprises (SMEs)**

**Functional definition:**

SMEs are businesses characterised by their assets and employee count falling below specific threshold criteria. While definitions may vary between countries, SMEs universally contribute to financial growth and development (Kenton, 2021).

**Operational definition:**

SMEs encompass professional entities operating with the shared objective of fostering sustainable economic growth and prosperity within their respective countries. These enterprises generate employment opportunities, adhere to tax regulations, and contribute to the country's annual GDP.

**iii. Compliance cost**

**Functional definition:**

Compliance cost encompasses all expenses incurred by businesses to adhere to industry regulations and standards. It includes salaries, time, and financial resources allocated to reporting, implementing new regulatory systems, and other regulatory requirements (Sidek & Abdulraqueeb, 2022).

**Operational definition:**

Compliance cost denotes the financial outlay necessitated for businesses to adhere to industry regulations and legal mandates. This encompasses expenditures incurred by various industries, such as the tobacco industry, to ensure smooth operations within the framework of state laws.

**iv. Compliance behaviour**

**Functional definition:**

Compliance behaviour refers to the psychological inclination of individuals or entities to adhere to the established rules and regulations. In the context of taxation, compliance behaviour represents the expected adherence of the public to tax regulations to foster financial growth and progress (Kenton, 2021).

**Operational definition:**

Compliance behaviour denotes a pattern of behaviour aimed at reinforcing societal norms and ensuring collective welfare and success. It encompasses the psychological aspect of adhering to rules established by external entities or groups of individuals.

**1.8 Thesis Organisation**

Overall, this thesis is organised as follows: Chapter 1 provided an introduction to the study by providing a brief background of the study, problem statement, research objectives, and research questions. Besides that, the scope and significance of the study were discussed.

Chapter 2 explains about the VAT system in UAE and discusses the fields of research that are similar to the subject of this study to help elucidate the research problem. Furthermore, this chapter identifies multiple concepts and areas of study most relevant to this study. In addition, the most suitable theories are discussed and reviewed in this chapter for the development of theoretical framework. The motivation for using the UAE as a case study is also discussed.

In Chapter 3, a detailed discussion of the methods used to accomplish the objectives of this study are presented. The research approaches, research philosophies, and research methods are thoroughly discussed. Moreover, the sampling method, target population, data collection, instrument development, and pre-testing of the questionnaire survey are explained. Lastly, the pilot test results, data coding, data screening, and statistical tests are presented.

Chapter 4 discusses the analysis of the responses provided in Section A of the questionnaire survey. The purpose of this analysis was to assess the validity and reliability of the instrument to ensure no defects or biased elements in the study sample. This chapter also presents the analysis and results of compliance cost and compliance behaviour. Additionally, this chapter also discusses the analysis and findings of Parts B and C of the questionnaire.

Chapter 5 presents a summary of the obtained quantitative results in this study. With respect to the study's objectives, the results on the relationships among the constructs and its significance are discussed. This is then followed by a discussion of the theoretical and practical contributions. The summary of key findings, implications and limitations of the study, and recommendations for future research are discussed accordingly.