The Effect of Tax Moral on Sales Tax Compliance among Jordanian SMEs

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Abstract

The current paper examines the relation between tax moral and the sales tax compliance of SMEs. The impact of tax moral on sales tax compliance has been received a very little attention. However, to date, there has been no work on the effect of tax moral on sales tax compliance among Jordanian SMEs. This relationship was then tested based on the survey outcomes from 212 SMEs serving in Jordan. The Partial Least Squares (PLS) results revealed positive influence of tax moral on sales tax compliance. Besides extending the body of knowledge by providing a model to explain how tax moral influence sales tax compliance, the results offer insights on the tax moral of sales tax compliance among SMEs. This study also highlights the implications of this finding towards the owner-managers of SMEs and the potential future research.

1. Introduction

This study extends the literatures on tax compliance by examining the impact of tax moral on sales tax compliance in the context of SMEs. Previous work, such as Pope and Abdul-Jabbar (2008) indicated that the taxation of SMEs has attracted increasing interest in the last decade in developing and developed states alike, SMEs around the globe are characterized by tax non-compliant entities. Arachi and Santoro (2007) suggested that SMEs are considered to be the main contributors of income in the shadow economy in developing countries. Hence, Swistak (2015) indicated that the tax compliance of SMEs requires special interest, so that the issue of an overwhelming number of SMEs being unable to fulfilling their tax compliance can be addressed.

The majority of countries in the world develop their country mainly from tax sources (Palil, 2005). Taxes are essential elements of any attempt to build nations (Young *et al.*, 2016). Therefore, governments should have sufficient revenue to finance infrastructure, social services and ensure adequate provision of services (Ndekwa, 2014). Thus, taxation has become increasingly important for the countries. Tax revenue collection has become a significant issue, particularly after the world economic crisis of 2008, the increasing public fiscal deficit of states has raised the need for tax revenue considerably, and states have turned toward universal collaboration to combat tax non-compliance (Obara and Nangih, 2017; Obadina, 2016; Nar, 2015; Sawyer, 2014). In other words, tax compliance leads to reducing the fiscal deficit and public

debt, thereby it provides funding to satisfy the economic and social development (Alshira'h and Abdul-Jabbar, 2019a).

Consistent with this, prior research agreed that tax non-compliance is a serious and growing problem in all economies and societies in both developing and developed countries (Awang *et al.,* 2018; Alasfour, 2017; Alm *et al.*, 2016; Raza and Naqvi, 2016). Tax non-compliance is a huge problem and a master challenge that is prevalent in developing states (Asrinanda, 2018; Rosid *et al*., 2017; Al-Ttaffi and Abdul-Jabbar, 2015). Yet in spite of being a critical issue for developing countries, tax compliance has obtained little attention in the empirical evidence (Gangl *et al.,* 2015), which demands that the problems be addressed from various perspectives (Finocchiaro and Ilde, 2014), therefore, encouraging many to conduct studies on tax compliance matters (Abdul-Jabbar and Pope, 2008). Yet, there is no consensus on what precisely influences the willingness to pay taxes (Randlane, 2016; Castro and Scartascini, 2015).

On the other hand, the issue of non-compliance activities regarding to the indirect tax had caused to a major wasted to the governments not just in term of the fiscal side, but also non-financial aspects like embargo, quotas and product quality. However, the studies on indirect tax non-compliance have received very little attention between the legislators and researchers (Miskama *et al.,* 2015). The indirect tax non-compliance became as prime concern of the most countries around the globe (Sinnasamy and Zainol, 2017). The sales tax system enhances the impact of an efficient the spending of government on the economic growth of 115 countries (Chan *et al.,* 2017). Therefore, such as any tax, the sales tax is vulnerable to fraud and evasion. Further, sales tax non-compliance is also a topic of independent concern, since, in recent decades, it has replaced other shapes of sales tax in numerous countries and continues to attract new converts (Alshira'h *et al*., 2018, Das-Gupta and Gang, 2003). Sales tax, or as called in many countries, such as Britain, the USA and France, value added tax (VAT), was introduced for the first time in France in 1954, where VAT was considered as a type of consumption tax on goods that was imposed at the production level (Adams and Webley, 2001). Sales tax is seen as crucial in providing the tax revenue base for governments, particularly in developing states, due to their wide coverage (Faridy *et al*., 2016; George and Reddy, 2015).

Jordanian government undertakes various fiscal measures to maximize domestic throughout the past few decades but according to the annual reports, the country still faces a sharp increase in net public debt and fiscal deficit brought about by the increase in the rate of tax non-compliance (Alshira'h and Abdul-Jabbar, 2019b). Therefore, the tax compliance problems have become a national concern; it is a significant problem that affects Jordanian economy, which is widespread in Jordan (Alshira'h, 2019, Alasfour, 2017; Qtish, 2015). Taxpayers in Jordan generally avoid from paying tax by several ways (Alshir'ah *et al.,* 2016). However, the cases of tax non-compliance related to sales tax more than the income tax (Nsour, 2014). Estimated of shadow economic in Jordan increased considerably during the period from 2005-2010 as shown in the following Table 1.

Table 1. Shadow Economy in Jordan by Types of Tax, 2005-2010. (JD million)

Indicators	Year					
	2005	2006	2007	2008	2009	2010
Indirect Tax	1,840.5	2,214.6	2,878.7	3,804.3	4,054.5	4,634.8
	76.1%	73%	72.9%	73.5%	69.6%	76.2%
Direct tax	578.4	821	1,068.7	1,371.7	1,772.3	1,451.2
	23.9%	27%	27.1%	26.5%	30.4%	23.8%
Shadow Economic	2,418.9	3,035.5	3,947.4	5,175.9	5,826.9	6,086
Shadow Economic of GDP	19.2%	19.4%	22.2%	22.8%	23.2%	22.1%

Source: Alkhdour (2011)

Table 1 above illustrates the major source of shadow economic which was generated from indirect tax. For the same period the contribution of indirect tax in shadow economic increased from JD 1,840.5 in 2005 to JD 4,634.8 in 2010, represented by 76% of the total shadow economic. Earlier, the shadow economy increased after the imposition of sales tax, it increased from 12.5% in 1993 to 22.1% in 2010 of GDP, this is as a result of an increase in the sales tax rate from 10% to 13% in 1999 and to 16% in 2004 (Alkhdour, 2011). Recently, the estimates of shadow economy to 25% in 2015 of GDP (Jordanian Economic

and Social Council [JESC], 2014). Furthermore, taxes are deemed to be the primary government source of revenue in Jordan (Al-Naimat, 2013). The role of taxes in the country's development has been emphasized after the sharp economic crisis in 1988, and ever since the adoption of the first International Monetary Fund (IMF) economic adjustment program in 1989, the Jordanian government has tried its best to make reforms when it comes to tax system efficiency, increased tax revenue, and reduced dependence on non-tax revenue (Alkhdour, 2011). Jordan has very limited economic resources, experiencing a chronic budget deficit, and, hence, tax is a very important resource for financing all social and economics projects (Shahateet *et al.,* 2014).

2. Literature review

2.1. *Tax compliance*

Taxes are critical elements of the total domestic revenue in the developed and developing countries. Countries promote their economy by their heavy dependence on both types of taxes that are either direct or indirect (Tehulu and Dinberu, 2014; Vadde, 2014; Thananga *et al.*, 2013). Tax compliance is a compulsory duty imposed on all people in corporates or as individuals. Therefore, all people are expected to voluntarily comply to tax law, but some people do not follow the tax law (Seidu *et al.*, 2015; Kirchler *et al.*, 2014). Hence, companies and individuals who do not comply to pay taxes are a critical challenge faced by the tax authorities (Jayawardane, 2015).

Andreoni *et al.* (1998) defined tax compliance as taxpayers' willingness to comply to tax laws in order to support the economy balance of the country. Another definition by Alm (1991) and Jackson and Milliron (1986) defined tax compliance as the reporting of all incomes and payments of all taxes by fulfilling the provisions of laws, regulations and court judgments. Tax compliance, tax avoidance, tax evasion, and tax fraud are used synonymously throughout tax compliance researches, with several researchers making a difference between tax evasion and tax avoidance (O'Shaughnessy, 2014). As for tax non-compliance, it takes either the form of tax evasion or tax avoidance, relying on the legality grade of taxpayers' business (illegal business or legal business) (Bătrâncea and Nichita, 2012; Likhovski, 2007). Regarding tax evasion, it involves illegal and intended business taken by institutions and individuals to lower their legally due tax commitments of under-reporting sales, income or wealth by exaggerating deductions, dispensations or loans or by failing to file suitable tax returns (Ritsatos, 2014).

In a short, tax non-compliance is a worldwide phenomenon; it imposes many economic costs and burdens on all governments. First, tax non-compliance leads unfairness between those who comply and those who do not comply by moving the tax burden to the first group, and thereby generating a motive for further non-comply (Feinstein, 1991). Second, it causes inadequacy in businesses' production, as they resort to stay invisible and small to facilitate non-compliance (Nur-Tegin, 2008). Third, tax non-compliance changes resources to non-productive activities like founding financial subsidiaries to cover up non-compliance (Slemrod, 2007). Finally, non-compliance probably retards the economic growth. Hence, the government's capacity to provide appropriate public goods, infrastructure, development of human capital, and development will fragile and weak (Johnson *et al.,* 2000).

Given the importance of understanding tax compliance, several studies have focused on income tax compliance, whereas very limited studies have been conducted on sales tax compliance, which is also considered the most common and important in many countries in the world. It is important to note that the word 'tax compliance' in the current study refers to tax compliance in general. In the case of indirect taxation, such as sales tax, the specific term 'sales tax compliance' is used. Hence, sales tax non-compliance is a widespread phenomenon that involves the process of manipulating sales tax invoice and altering tax reports to achieve personal benefits, such as paying less sales tax, increasing earning and reducing a cost based on benefits obtained through evading taxes or depending on attitudes, beliefs and norms. Therefore, sales tax compliance is defined as a correct record of details on sales tax invoice, rather than being fraudulent in the details of tax invoice to pay less sales tax.

2.2. *Tax moral*

The morals of taxpayers are a hazy concept to be defined. Morals generally refer to the ethics, values or principles held by a person (Jackson and Milliorn, 1986). Hence, tax moral, tax ethics or tax honesty are

defined as an intrinsic motivation to pay taxes arising from the moral obligation to pay taxes and the belief in contributing to the society by paying taxes (Cummings *et al.*, 2009; Torgler and Schneider, 2009). This concept of moral values can aid in explaining why tax non-compliance deterrence based on the economic factors cannot clarify efficient high levels of tax compliance (Vythelingum *et al.,* 2017; Loureiro, 2014). The moral behaviour is defined as an intrinsic motivation by moral principles and ethical value (Young *et al.*, 2016). That is, morals are systems of principles of behaviour that are developed to supply orientation in social interactions or the relation between people's behaviour and are utilised to adjust and temperate the human affairs (Ho and Wong, 2008). Thus moral works can be explained by five dimensions, namely moral knowledge, socialization, autonomy, empathy, and moral judgment (Hogan, 1973).

In this regard, sales tax moral is considered an intrinsic motivation to pay sales taxes resulting from the ethics compliance to pay sales taxes and the strong belief in contributing to build one's nation. Richardson (2006) revealed that non-economic factors exercise the strongest effect on tax non-compliance in comparison with the economic ones, and moral values were found to be one of the most important factors across the 45 countries. Tax moral was defined as the moral principles or values individuals hold about paying taxes (Alm and Torgler, 2006). Considering the moral feelings, such as guilt and shame, would provide a satisfactory clarification about taxpayer's compliance behaviour (Martinez-Vazquez and Torgler, 2009). Guilt feelings, also referred to as tax moral, may contribute to reduce tax non-compliance (Torgler, 2007). However, moral values are considered a societal phenomenon that is hard to be explained (Torgler, 2002).

Alm and Torgler (2006) compared the levels of tax moral values between Spain and USA and found that moral values in USA are higher than Spain and other fourteen European countries (Alm and Torgler, 2004). According to Kaplan *et al.* (1997), tax compliance intentions are significantly higher among taxpayers who have a high moral reasoning in their decision. Therefore, tax moral may increase when the taxpayers perceive that the public goods and service provided by the government are equal to their tax payment. Tax moral may also increase through the participation of the taxpayers in the political and the governmental decisions, fair procedures, taxpayers' perceived fairness and friendliness of the tax department (Feld and Schneider, 2010). However, tax moral decreases when the taxpayers have low trust in their government and the tax authorities, and feel lack of respect by the tax authorities (Frey, 2003).

McKerchar *et al.* (2013) reported three main factors as significant for tax moral, namely moral basics and standards that define what suitable behaviour are for persons as portion of a social mass, the perceived inclusive justice of the tax system, and confidence in the state's institutions. Hence, moral values play a vital role in influencing the magnitude of the informal economy, whereby higher moral values cause less shadow economy (Loureiro, 2014; Torgler *et al.*, 2010).

The prior studies found that tax moral has a positive relation with tax compliance behaviour, and increasing the tax moral leads to lower tax non-compliance and greater tax compliance (e.g., Lisi, 2015; Nabaweesi, 2013; Torgler *et al.,* 2007; Witte and Woodbury, 1985). Similarly, Riahi-Belkaoui (2004) found that tax compliance has a positive relationship with tax moral principles. These moral values, as Torgler (2003) argued, are affected positively by trust in the government and the law system. In this regard, Leonardo (2011) and Cummings *et al.* (2009) reported that the quality of the public governance has a significant positive association with tax moral, whereby increasing the willingness to comply is related with a higher quality of the public governance. Therefore, democratic states showed a positive relationship between the democratic values and trust in the government and tax moral.

Therefore, moral of the taxpayers must be taken into account when examining the tax compliance behaviour, since it is one of the factors that could explain compliance behaviour levels that are higher than those expected through the economic theory (Christian and Alm, 2014). On the other hand, Blumenthal, Christian and Slemrod (2001) argued that the taxpayers who have tax moral have a higher tendency towards tax non-compliance. Similarly, Fellner *et al.* (2013) reported that the moral value does not lead to increasing the compliance. Ariel (2012) also revealed that the moral persuasion did not improve the tax compliance. In the context of sales tax, prior studies found that there are positive relationship between tax moral and sales tax compliance (Woodward and Tan, 2015; Webley *et al.,* 2004).

On the basis of the above discussions, the relationship between tax moral and income tax compliance still needs further examinations to be confirmed. However, the majority of the researches on

tax moral and tax compliance have focused on income tax, whereas sales tax compliance has received very limited interest. In addition, tax moral and tax compliance have been examined at the individual level, whereas SMEs' tax compliance with tax moral has been neglected. This is supported by Alm and McClellan (2012) who stated that the potential importance of firm tax moral has been ignored, perhaps because of the absence of firm-level information that would allow a firm's tax moral to be measured. Therefore, more studies are required to determine the relation between tax moral and sales tax compliance since tax moral is one of the main determinants of tax compliance behaviour. Also, to the best knowledge of the researcher, no study has been conducted on the relationship between tax moral and sales tax compliance behaviour of SMEs in the Middle East and Arab countries. Therefore, there is a need for more studies to be conducted on this relationship, especially in Jordan.

H1: *There is a positive relationship between tax moral and sales tax compliance among Jordanian SMEs.*
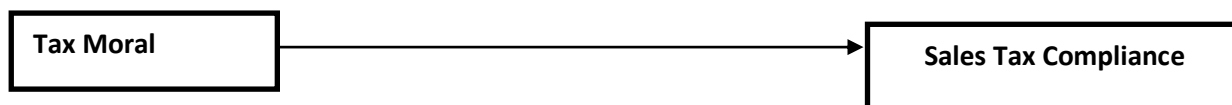
3. Study model

Tax Moral	⟶	Sales Tax Compliance

Figure 1. Research Framework

4. Methodology of research

The current study adopts a quantitative approach to determine the tax moral affecting the sales tax compliance of SMEs in Jordan. The purpose of the quantitative approach is to predict, explain and control social phenomena (Wellington and Szczerbinski, 2007). A popular purpose of quantitative research is to test hypotheses or specific research questions (Zikmund *et al.,* 2013). Additionally, it enables the researcher to concentrate on a particular issue, to pursue a rigorous method, and to generate valid conclusions (Sekaran, 2003). Collecting data through a self-administered questionnaire gives respondents personal space for replying to the questions of the questionnaire (McShane and Glinow, 2012). This method also gives researchers a chance to verbally clarify the significance of the study and can establish rapport and motivate respondent and provide careful explanations, when needed, regarding difficult, significant or sensitive questions. Thus, doubts can be clarified, and the anonymity of respondent is high (Sekaran and Bougie, 2016). Many prior studies used the self-administrated method in the context of taxation (e.g., Kamar, 2015; Mohdali and Pope, 2014).

This research concentrates on the effect of tax moral on sales tax compliance of SMEs. To achieve this purpose, this study focuses on SMEs in the Jordanian manufacturing sector as the population of this study. In this study, the study population comprises of the owner-managers of SMEs in Jordanian manufacturing sector obtained from the list of the Jordan Chamber of Industry (JCI) via an official application procedure, which provides a list of 17,849. The sample list contained the details of every SME in the manufacturing sector, such as name, phone number and email. Furthermore, any business in Jordan is required to register with the JCI to get a license to work. The researcher distributed 660 questionnaires to the SMEs respondents. After around three months, 221 (33.5%) questionnaires were collected from SMEs. Based on Sekaran and Bougie (2016) a response rate of 30% and above is acceptable for a survey.

5. Results

5.1. Measurement model

In the PLS-SEM analysis, the first step is estimate the measurement model. The measurement model comprises the component of the measurement, which determining the loadings for each item, composite reliability (CR), and the average variance extracted (AVE). Table 2 present the factor loadings for the items, composite reliability and (AVE). These items were then used for further analysis in PLS-SEM. Based on Table2, sales tax compliance had four items (STC6, STC7, STC10, STC11), which were loaded less than cut-off value of 0.40 according to Hair *et al.* (2014a), thus this items was deleted. Tax moral had five items that loaded below than cut-off value, such as (TM1, TM6, TM7, TM9, TM10), thus these items were deleted

from this factor. Table 2 also shows the CA values for variables; the CR values of the variables loaded from 0.842 to 0.883, the values of the CR should be equal to or exceed 0.70 (Hair *et al*., 2014b).

Table 2. Average value and outer loading every indicator, CR and AVE

Latent construct	Items	Loading	CR	AVE
Sales tax compliance (STC)	STC1	0.818	0.883	0.519
	STC2	0.819		
	STC3	0.726		
	STC4	0.695		
	STC5	0.665		
	STC8	0.643		
	STC9	0.659		
Tax moral (TM)		0.663	0.842	0.517
		0.782		
		0.747		
		0.673		
		0.693		

As a rule of thumb, the AVE of every latent variable should be higher than 0.50 for establishing adequate convergent validity (Hair *et al.,* 2014b). In the current study, Table 2 shows the values of AVE ranged between 0.517 and 0.520 indicating an adequate convergent validity. Thus, the conclusion can be made that the internal consistency reliability of the measures and convergent validity was verified and confirmed.

5.2. Structural model

After analysing and assessing the measurement model, the following step in the PLS modelling is to test the inner model (structural model). Typically, there are four requirements to assess the structure model comprising: 1) the R^2 values, effect size (f^2), predictive relevance (Q^2) of the model, and path coefficient (β) to test the study hypotheses (Hair *et al.,* 2014b; Henseler *et al.,* 2009). Additionally, the Goodness of Fit (GoF) that Tenenhaus *et al* (2005) suggested was used. Finally, bootstrapping was employed to examine the significance level of the hypothesis in the study model. The results of the analysis are summarized in Table 3.

Table 3. Structural Model PLS-SEM

Hypothesis No.	Relationship	Path coefficient	T –Value	P - Value	Decision
H1	TM -> STC	0.197	2.865	0.004*	Supported
R^2 sales tax compliance = 0.256; Q^2 sales tax compliance = 0.095					

Note: Significant at * $p < 0.01$ (One-Tailed).

Based on Table 3, The result provided support for H1 ($\beta = 0.197$, t = 2.865, p < 0.01). This signifies that a significant positive relationship exists between (TM) tax moral and sales tax compliance (STC).

5.3. Goodness of Fit of the Model

PLS has only a single measure goodness of fit (GoF), which Tenenhaus *et al* (2005) proposed. A global fit measure (GoF) for PLS path modelling can be defined as the geometric mean of the average communality and average R^2 for the endogenous constructs. The main purpose of the goodness of fit measure is to explain the variance extracted by both the measurement model and structure model (Chin, 2010). The GoF can be calculated by the following formula.

$$GoF = \sqrt{(\overline{R^2} \times \overline{AVE})}$$

(1)

In this study, the GoF value of the model was 0.446, which has been attained as follows:
GOF=√0.256×0.519 = 0.263

In comparing the GoF value of this study with the threshold values of GoF that Wetzels *et al.* (2009) recommends (less than 0.1 represents no fit, between 0.1-0.25 represents small, between 0.25-0.36 represents medium, and greater than 0.36 represents large), the conclusion can be made that the model GoF was medium indicating a sufficient of the global PLS model validity.

6. Conclusions and recommendations

Tax moral is one of the major factors influencing tax compliance (Jackson, Million, 1986). It is a moral commitment to pay tax and contribute to generating revenue for the nation to provide welfare of the society (Torgler, 2003). Evidence points out that, at the aggregate level, states with great levels of tax morals have smaller informal economies (Halla, 2012; Torgler and Schneider, 2009), and taxpayers with a higher level of tax morals are more likely to comply with paying taxes (Blanthorne and Kaplan, 2008; Wenzel, 2005). Hence, hypothesis (H1) shows that association between tax moral and sales tax compliance was positive and significant. The result indicates that tax moral has a significant positive influence on sales tax compliance. In other words, the higher ethics of owner-managers ensures a strong tendency towards sales tax compliance. The finding is consistent with socio-psychological approach predictions (Kohlberg, 1969). Past literature supports these findings, and several researchers have found out a significant positive relationship between tax moral and sales tax compliance of SMEs (Woodward and Tan, 2015; Webley *et al.,* 2004). Nonetheless, previous studies on this specific area remain rare. In general, this result is also in accordance with previous studies related to tax moral and income tax compliance as tax behaviour (e.g., Lisi, 2015; Loureiro, 2014; Nabaweesi, 2013; Torgler *et al.,* 2010; Torgler *et al.,* 2007).

The result in the current study also indicates that the effect of tax morals on sales tax compliance depends mainly on the moral principles or values that individuals hold about paying taxes (Torgler and Murphy, 2004). Even though tax non-compliance is ethically acceptable in Jordan under some circumstances, and indeed, based on cultural differences (Alasfour *et al.,* 2016). However, tax compliance has a positive relationship with tax moral principles in Jordan (AL-Shawawreh and Al-Smirat, 2016). Therefore, adequate tax moral for SMEs owner-managers may significantly and positively influence the sales tax compliance decision. The owner-managers is considered the primary decision maker for a SMEs, and his/her ethics determines the level of sales tax compliance. Therefore, tax moral clearly plays a key role in promoting sales tax compliance. The current study model was capable to explain 25.6% of the total variance in sales tax compliance, which means that there are other variables that could also significantly explain the variance in sales tax compliance. In other words, the remaining 74.4% of the variance in sales tax compliance could be explained by other latent variables. Therefore, future study is needed to consider other possible constructs that could impact the sales tax compliance such tax knowledge, religion, external audit, gender of tax auditor, and tax service quality.

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