

VAT Compliance and the Influence of Political and Business Environment: A Proposed Framework for Nigerian SMEs

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Abstract: Oil producing country like Nigeria, for so long has depends largely on petroleum profit tax revenue and seem knowingly had less emphasised on taxes from non-oil sources. However, recent worldwide dropped in the oil prices, which continually lower the tax revenue, alerted the government to consider tax policy decision and administration of non-oil tax revenue. This article focuses on Value Added Tax (VAT) as the available data indicating an alarming trend about VAT noncompliance, especially the small and medium enterprises. Factors that influence compliance behaviour are numerous and derived from various theory and models However, the majority of the studies on factors determining tax compliance concentrated mainly on income tax. By utilising the economics deterrence model, this paper discusses and proposes a VAT compliance framework that incorporates the political environment and business environment as determinants of VAT compliance behaviour in the Nigerian context.

Key words: Value Added Tax • VAT Compliance • Political Environment • Business Environment

INTRODUCTION

Value added tax (VAT) is a consumption tax charged on goods and services in many countries, including in Nigeria since 1994. A business entity is legally required to collect the VAT on behalf of the tax authority. In Nigeria, upon reaching the turnover threshold, the business entity is required to register for VAT with the Federal Inland Revenue Services (FIRS), to collect VAT and to remit the net corresponding amount of VAT to FIRS periodically. Nigeria, being an oil producing country, depends largely on revenue from the Petroleum Profit Tax. The over-dependence on one source of income is considered highly dangerous for any sovereign state. For examples, prior to 2014, over 70% of total revenue in Nigeria was generated from the oil revenue [1]. Conversely, from early 2014 to recent years, oil prices have been highly volatile and dropped significantly [2]. This has resulted to a serious decrease in total revenue of oil producing countries like Nigeria. The annual budget deficits in Nigeria has expanded to over N755billion Naira and N2.2 trillion Naira in 2015 and 2016 respectively [3]. Therefore, for Nigeria to generate more revenue and minimize the budget deficits, the tax authority needs to focus on non-oil revenue sector

as well, especially the VAT. The amount of VAT revenue losses in developing countries as a consequence of noncompliance is more prominent than the amount of loss in the developed countries and it is mainly due to the presence of large informal economy [4]. Also, VAT administration in developing countries is generally weak and characterised by extensive evasion, corruption and coercion [5]. Available statistics indicate an alarming trend of VAT noncompliance issue in Nigeria [2, 6]. VAT compliance in Nigeria is facing serious problems as compared to other non-oil taxes (i.e. income tax and corporate tax) as well [7]. The small and medium enterprises (SMEs) in particular, need an urgent consideration as only less than 10% of SMEs are complying with VAT laws in Nigeria [7]. Thus, focusing on this sector is vital in addressing the overall VAT non-compliance concern in Nigeria.

Besides tax administration concern, the Nigerian government is facing an economic crisis due to the political instability, dispute with labour unions, trade unions and the civil society organizations on the principles and the productivity of VAT [8]. The FIRS, the Nigerian National Assembly (NNASS) and the Joint Tax Board (JTB) disagree on some VAT policies due to

political reasons to the point that a VAT law amendment was stalled for a very long time at NASS [7]. Also, there is various instability in the internal business environment which have an attendant effect on the conduct of business activities [9]. Therefore, VAT, a supposedly friendly tax system has rather generated many political disputes, arguments and controversies and faced many internal problems. Consequently, as it happens often, the situation may instil public fears and public resistance to the VAT policy and these may probably be among the reasons for low VAT compliance in Nigeria.

Nonetheless, most of the prior tax compliance studies in Nigeria seems concentrated on income tax [10, 11]. The scarcity of studies on VAT compliance in developing countries is well observed both in Nigeria and globally. Previous studies also tend to use the deterrence model for investigating VAT compliance behaviour [12, 13]. However, the limited factors in the deterrence model (tax rate, tax audit and tax penalty) are not sufficient in explaining the reasons for lower VAT compliance as there may be other individual and contextual factors that are peculiar to specific tax jurisdictions. Therefore, given the above practical problems, the current paper proposed a framework that expands the deterrence model with political and business environments as additional determinants of VAT compliance behaviour in Nigeria.

The next section starts with a review of relevant literature, covering the concepts of VAT compliance, noncompliance and SMEs, in brief and discussing it in relation to proposed independent variables, namely political environment, business environment, detection probability, penalty and complexity. The proposed research framework is presented then, followed by discussion and conclusion.

Literature Review

The Concept of VAT Compliance and Noncompliance:

Many studies on VAT compliance have used the concept of income tax compliance to explain the VAT compliance behaviour [14, 15]. The major difference is that the income tax centred on compliance behaviour of individual or company, the VAT compliance centred on the compliance with the system rules and regulations by the business entities [16]. To understand the compliance behaviour of a business entity on indirect tax, it is necessary to consider the perception of the business owner on the tax rules and regulations.

Tax compliance in general term can be referred to as the degree at which taxpayer comply with the tax laws and regulations [17]. Tax compliance can be viewed as the

taxpayers' willingness, coupled with the ability to pay their taxes as at when due without any hinderers or objections. VAT compliance, on the other hand, can be said to have occurred when the business entity filled and returns the VAT returns form and remits all the VAT dues on time without any complaint. Ocheni, [11] stated that VAT compliance is the ability of a business entity or body to submit the accurate, complete as well as VAT satisfactory returns in conformity with all the VAT laws and regulations of a state authority. Conclusively, VAT compliance refers to the compliance with all the VAT legislation and procedures involves reporting of the true and actual VAT collected and paid; correct compilation of the VAT liability; filing of VAT returns on time and payment of the full amount due promptly. Any contrary activity by the business entity constitutes noncompliance behaviour.

VAT noncompliance, on the other hand, occurs when there is a failure of business to perform accurately and timely VAT reporting, collection and remittance Failure of business to meet up with some of the criteria or requirement also constitutes non-compliance [18]. The next subsection discusses the SMEs and VAT compliance.

SMEs and VAT Compliance. Small and Medium Scale Enterprises (SMEs) plays and important role in designing a tax system of any country. SMEs are part of the critical sector in ensuring socio-economic development agenda of any economy. Therefore, ensuring tax compliance of SMEs shall be given utmost priority in policy considerations. Further, the size and nature of SMEs are important as well in tax compliance decisions [19]. The regulatory agencies (including tax authority) need to consider SMEs in designing regulations in order not to hamper the growth and compliance of SMEs. There are always tendencies of administrative obstacles which may lead to higher expenditure on the business in trying to comply with the regulations. Murphy [20] pointed out that an efficient tax policy is usually designed in such a way that the collection procedures are always favourable to both the taxpayer and the tax collector. The tax system and procedure should be designed to ensure that it does not only improve the growth of SMEs but also ensure voluntary compliance.

Accordingly, for an emerging economy like Nigeria, the tax authority should also focus on SMEs in the process of tax policy considerations that will ensure an efficient tax system. The focus should be expanded to accommodate all type of taxes, more especially the VAT

which is proving to be a viable source of income for many countries [21]. Easing tax regulatory burden and improving the VAT compliance level of SMEs will ensure a substantial rise in the revenue generation.

Political Environment and VAT Compliance. Politics affect almost every aspect of business decisions in any country. First, national politics affect business environments directly, through changes in policies, administration and laws. The political stability and political mood in a country affect the actions a government will take that may have a significant impact on the viability of doing business in the country. The attitude of business owners may also follow the changes in the political system or environment.

Sanders [22] define the political environment in relation to business as Government actions which affects the operations of a company or business. These actions may be on the local, regional, national or international level. Business owners and managers pay close attention to the political environment to gauge how government actions will affect their company. There is no widely agreed accepted definition of what is political. A definition that seems fruitful is to hold that political processes concern with bridging power differences between societies itself and those within the society, bridges that carry inputs both from society to the state and from the state to society [23]. To bridge the different between the society and the states in Nigeria, this paper proposes researcher to assess the level of political stability or the political environment and its impact on VAT compliance behaviour of SMEs.

Defining the degree of political stability or instability have been a challenging task for many scholars. Lipset [24] define political stability as an uninterrupted continuation of political democracy and absence of major political movement that may oppose government policies and laws. Morrison and Stevenson [25] conceptualized political instability as a condition in the political system in which the institutional patterns of authority break down and expected compliance to political authorities is replaced with political violence. Also, Sanders [22] define political instability as challenges to the government or community deviating from the previous patterns of compliance with laws of the state. In Nigeria, the political instability is related to religious and ethnicity crisis.

Most faith-based organizations in Nigeria both Islam and Christianity preaches peace and unity but some politicians brainwashed some religious extremists to believing that violence and destruction are the only way

to heaven [8]. A good example is Boko Haram insurgency which has a link to several politicians in Nigeria [26]. Most of the political instability in the northern part of Nigeria today is related to different activities of Boko Haram [27]. The Boko Haram is a controversial Nigerian Militant Islamist group that seeks the imposition of Sharia law in the northern states of Nigeria. Ideologically, the group opposes not only Western education but Western culture and modern science [28]. The activities of members of this group have raised critical questions among investors about the safety of their investments in Nigeria. It has also threatened the existence and survival of many businesses in Nigeria especially in the northern part of the country. Because of this instability which is political in nature, business activities within the affected areas have been distorted and hence the VAT compliance decision of the business owners may also be affected. This instability has led some companies and small businesses operating in Nigeria to cease their operation and some have moved to other West African countries [29]. This scenario may not only affect the operation of SMEs within the political environment but may also affect their VAT compliance decisions.

Therefore, VAT compliance behaviour in Nigeria may be affected in the event of political instability as currently happenings in Nigeria. Numerous studies established the existence of a relationship between political environment and decisions of the business institutions [20, 30]. Though a number of studies relate political environment in the tax compliance settings [15, 31, 32] but none of these studies conducted in Nigeria or focussed on VAT compliance. Besides political environment, the business environment may also have some influence on the VAT compliance of SMEs, this is discussed below.

Business Environment and VAT Compliance. Business environment can be regarded as the summation of those factors that are both internal; that is within the control of a single business firm and external factors that are beyond the control of a single business enterprise. Agboli and Ukaegbu [8] conceptualized business environment as events, situations, circumstances, settings and positions which surround entrepreneurial activities. Slevin and Covin [33] developed environmental dimensions of the business environment. These include technological sophistication, dynamic, hostility and industry life cycle stage.

Several studies have been conducted on the business environment and its components as either independent or dependent variable and different results

have been obtained. A study by Kohli and Jaworski [34] discovered a positive relationship between community characteristics, internal business environment, competitive strategies and rural retail business performance. Other researchers [8, 35] also established a relationship between business environment and decision ability. This affirmed that business environment could be related to performance and performance was established to be related to compliance. Therefore, this study intends to examine whether there is an existing relationship between internal business environment and SMEs' decision on compliance with VAT in Nigeria.

A Nigerian study [36] on the business environment and competitiveness in considerations for Nigeria's Vision 2020, established that business environment is one of the factors that affects the firm's decision process. Similarly, another study [37] investigated the effect of the internal business environment on management strategies of SMEs, with their finding indicated a significant influence of business environmental factors on firm performance and strategic decisions. The study of Mithas, Tafti and Mitchell [38] examined firms' competitive environment and digital strategies of four hundred US-based enterprises. They reported a relationship between digital business strategy, competitive business environment and management decisions to comply with taxation requirements. The study of Ju, Fung and Mano [39] which was longitudinal in nature, covers a four-year period on both local private firms and foreign wholly owned subsidiaries in China. The institutional environment was found to moderate on the relationship between firm strategic performance and firm ability to comply with taxation. There is only one published study that relates business environment to taxation [40]. However, it does not relate to any tax compliance aspects. Hence, this study together with much more on performance concurs with the objective of this study to link the business environment to specific VAT compliance aspect of Nigerian SMEs.

Detection probability and VAT compliance. An audit in taxation refers to the investigation conducted by the tax authority to verify the correctness and accuracy in the tax returns submitted. It can also be referred to as an act to detect non-compliance behaviour. A tax audit is a crucial factor that influences tax compliance as reported by many studies. Pantelidis [41] defined tax audit as the process of examining the degree to which taxpayers properly prepared their financial statements by following the

existing tax legislations. Audit in taxation aimed at ascertaining whether the taxpayers have correctly kept and reported the documents regarding their tax liabilities [42].

Ahmed and Braithwaite [43] stated that the major issue with the VAT audit of SME is that, the documents to be assessed by the auditors are mostly not available. Evans, Carlon and Massey [44] stated that one of the major purposes of records keeping for any business entity is to comply with the relevant tax legislations. Thus, as tax administration increases the level and frequency of audit, the SMEs owners will also make more effort to keep the proper records of their activities. Hence, the primary purpose of auditing is to increase compliance. Therefore, the frequency of the VAT audit and the possibility of the VAT audit to detect noncompliance is what is referred to as VAT detection probability. If the probability of detection is very high, the taxpayers will always declare their income correctly [45]. The probability of detection in audit process would also make the business entity to comply with all tax requirements to avoid the likelihood of being detected for noncompliance [46]. The probability of detecting VAT noncompliance through the audit process will play a significant role in changing SME's compliance behaviours. The primary purpose of a VAT audit is the detection of SMEs' noncompliance within reported VAT returns forms and the actual VAT remitted.

The link between tax audit and tax compliance can also be found in the study by Evans *et al.*, [44] where they stated that low tax compliance would encourage the tax authority to increase their tax audit to investigate the reasons for the decrease in tax compliance. Therefore, this clearly indicates that tax evaders will normally take precautionary measures if they perceived any risk of being detected. Thus, VAT audit of SMEs in Nigeria aims at ascertaining the level of compliance with the relevant VAT laws. The VAT audit process in Nigeria involves dividing the number of VAT returns assessed by the number of VAT returns received.

Penalty and VAT compliance. Paying taxes is compulsory, but fines and penalties are avoidable. Like tax audit, the penalty is also very important in tax compliance. Some studies discussed the probability of detection or audit together with a penalty. However, Kirchler and his colleagues [47, 48] argued that when two variables are discussed together, the extent of the impact of each on tax compliance will not be very clear. It is very important that the two variables be discussed separately to assess the

impact of each variable on compliance behaviour. Penalty refers to the punishment or sanction associated with noncompliance [47]. Schwartz and Orleans [49] stated that the objective of imposing sanction or penalty is to enforce legal obligations. The penalty for the offense will depend on the level or degree of that offense.

Therefore, the fear of penalty will reduce the level of VAT noncompliance among SMEs in Nigeria. Hence, the penalty is one of the important determinants of VAT compliance. Additionally, penalty played a very significant role in regulating VAT compliance. Tax authorities have since discovered that the level of penalty determines the level of tax compliance. From the above arguments on tax compliance and tax penalty, it can be deduced that a tax system that has a higher penalty for VAT noncompliance usually have a higher level of noncompliance. It means that the penalty was increased to increase the compliance level. Furthermore, a tax system with lower VAT penalty means that there will be a high rate of noncompliance as SMEs will use the opportunity to evade VAT. This is a clear indication of how the penalty is very relevant to VAT compliance behaviour.

The tax authority should understand the situation and impose appropriate penalty or sanctions for VAT noncompliance. Since penalty both higher and lower influences compliance. Detection probability will serve as a measure to control the rate of penalty. If the detection probability is effective, the tendency for noncompliance may be reduced and hence, the penalty does not need to be increased in managing VAT compliance. If the detection probability is weak, the VAT evaders will be caught and the punishment will be enforced. If the punishment is not severe enough to out weight the benefits of evasion, the VAT evaders will still continue to evade VAT until the punishment is increased.

Complexity and VAT Compliance. Complexity in taxation can be defined as difficulties in understanding tax laws and procedures; computing tax [50]; difficulties in analysing [51] and also understanding the system [52]. Tax laws in particular, are mostly associated with series of requirements that made the compliance difficult [53]. VAT complexity can be referred to the difficulties faced by business entities in computing the VAT liability as well as difficulties they encountered in understanding the VAT laws, requirements and the entire VAT system. There is a large number of studies that explored the relationship between tax complexity and tax compliance behaviour.

A pioneer review that concentrated only on tax complexity and tax compliance behaviour was a study by Strader and Fogliaso [54]. The review concludes that complex tax system increases the noncompliance behaviour of taxpayers in Japan, UK, France and the US. A Malaysian study [55] also established that complexity in tax system had affected the compliance level. In Australia, simplicity in tax system improves the compliance level [56]. Furthermore, Saw and Sawyer [57] found that the respondents appeared to be more willing to comply when the act is easy to read and comprehend. Recently in Nigeria, Alabede [10] discovered that too many details and ambiguity in the tax system had affected the willingness of the taxpayers to comply. Certainly, most, if not all of the above study concentrated on income tax compliance behaviour. Though the present study did not come across any relevant study that focused on VAT complexity and VAT compliance, it is appropriate to adapt the income tax complexity into the VAT environment.

Proposed Framework: Given the above, the deterrence model was proposed to be expanded with the political environment and business environment as new factors. The framework has five independent variables (i.e. VAT detection probability, VAT penalty, VAT complexity, political environment and business environment) and VAT compliance behaviour as the dependent variable. Tax rate, being another original variable in the deterrence model, is not considered as the VAT rate in Nigeria remain the same (5%) since its introduction in 1994. The proposed framework is shown in Figure 1.1 below.

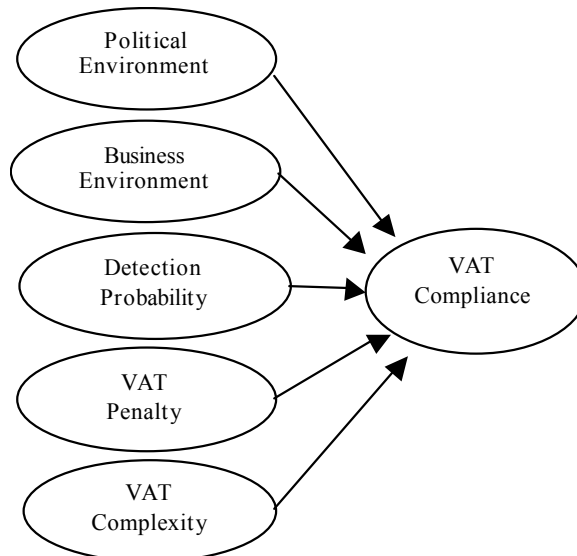


Fig. 1: Proposed VAT Compliance Framework

DISCUSSION AND CONCLUSION

This paper proposes a model for better understanding of the VAT compliance behaviour among the SMEs in Nigeria. This proposed model is an extension of deterrence theory of tax compliance, which incorporates political environment and business environment. These factors have been integrated in the model considering the environmental, social and cultural peculiarity of Nigeria as urged by many researchers [58, 59]. The author is currently conducting research by employing this framework. The outcome of the proposed study may serve as guiding principles in improving further the administration and implementation of VAT in Nigeria and not to mention designing better strategy to improve the VAT compliance among Nigerian SMEs in particular. The proposed framework is also relevant to other VAT jurisdictions and the two new factors can be integrated into other tax compliance theories and models as well.

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