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Tax Knowledge and Tax Compliance by Small and Medium Scale Enterprises

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ABSTRACT
This study presents a theoretical discourse on the relationship between tax knowledge and tax compliance among Small and Medium Enterprises (SMEs) operating within the shadow (informal) economy. Adopting a library-based research design, the study relies on extant literature to draw inferences and anchor its discussion within the framework of Behavioural Economics Theory. The issue of improving tax compliance remains a central concern in tax administration and policy formulation across both developed and developing economies. However, evidence suggests that non-tax-paying SMEs, particularly those operating in the shadow economy, account for a significant proportion of the tax-to-GDP gap. Findings from the reviewed literature reveal mixed and inconclusive results. While tax knowledge is generally acknowledged as an important determinant of tax compliance, its influence does not appear to be consistently significant across different contexts. The relationship between tax knowledge and tax compliance is complex, particularly because many SMEs derive economic advantages from remaining within the informal sector. As such, tax knowledge alone may be insufficient to achieve sustained compliance. The study therefore recommends that policymakers adopt a broader approach to tax compliance by addressing other critical tax policy considerations. These include restructuring incentives through cost-benefit analyses that favour compliance, empowering SMEs through capacity-building initiatives, and recognizing that informality may often stem from limitations in power and capacity rather than deliberate choice. Furthermore, the study advocates a reassessment of the relationship between state institutions and actors within the hidden economy as a means of fostering voluntary tax compliance and broadening the tax base.
Keywords: Tax Knowledge, Tax Compliance, Small and Medium Enterprises (SMEs), Shadow Economy, Informal Sector, Behavioural Economics Theory.

1. INTRODUCTION

The concept of the *shadow economy* has been described using various terms, including *informal*, *hidden*, *underground*, *undeclared*, *subterranean*, *unregulated*, and *unobserved* economy. Although these terms differ slightly in emphasis, they collectively refer to economic activities that operate outside formal regulatory and reporting frameworks. According to the enterprise-based definition adopted by the 15th International Conference of Labour Statisticians (ICLS), shadow economy enterprises are private, unincorporated businesses that are either unregistered or operate on a small scale based on the number of persons employed (Hussmans, 2005; ILO, 2012).

Existing literature indicates that shadow economic activities are not limited to entirely informal enterprises; many formally registered businesses also engage in partially concealed transactions to evade regulatory obligations (Small Business Council, 2004; Williams, 2010). The Organisation for Economic Co-operation and Development (OECD) defines the shadow economy as legal production activities that are deliberately concealed from public authorities to avoid income taxes, value-added taxes, social security contributions, and compliance with labour, health, safety, and other statutory regulations (OECD, 2002). In many cases, transactions are either partially reported or not reported at all, thereby reducing tax liabilities and regulatory scrutiny.

The significance of the shadow economy has increased globally due to its substantial contribution to employment and livelihoods. Estimates indicate that approximately 82% of the workforce in South Asia, 66% in Sub-Saharan Africa, 65% in East and South-East Asia (excluding China), 51% in Latin America, and 10% in Eastern Europe and Central Asia derive their primary means of livelihood from the shadow economy (ILO, 2020; Williams & Renooy, 2020). Consequently, tax authorities are increasingly concerned about the loss of potential tax revenues arising from non-compliance within this sector. Such revenue losses constitute a significant component of the tax gap—the difference between actual and potential tax revenues. Nevertheless, given the critical role of the shadow economy in sustaining livelihoods, particularly in developing regions, its complete eradication may be both impractical and economically disruptive.

One strategy frequently proposed for integrating Small and Medium Enterprises (SMEs) operating within the shadow economy into the formal tax system is the enhancement of tax knowledge. Tax knowledge refers to an understanding of the tax laws, policies, and procedures applicable within a country (Fauziati et al., 2016). Previous studies suggest that tax knowledge promotes voluntary compliance by enabling taxpayers to accurately determine and fulfil their tax obligations (Baru, 2016; Adam, 2012; Palil, 2015). Furthermore, tax knowledge has been identified as a significant determinant of taxpayer compliance behaviour under self-assessment systems (Loo, 2016).

Despite these assertions, empirical evidence regarding the relationship between tax knowledge and tax compliance remains inconclusive. Cuccia (2013) argues that increased tax knowledge does not necessarily translate into higher compliance, as informed taxpayers may still choose to evade taxes despite understanding the legal consequences. Similarly, Bird (2014) contends that a proper understanding of tax regulations does not guarantee adherence to tax laws. Supporting this perspective, Nyamwanza et al. (2014) found that SMEs often fail to comply with tax regulations despite possessing adequate tax information, while Alm et al. (2012) reported that increased tax knowledge produced insignificant changes in taxpayers' attitudes and compliance behaviour.

Given these conflicting findings, the relationship between tax knowledge and tax compliance among SMEs operating in the shadow economy remains a subject of debate. Anchored on behavioural economics theory, this study therefore examines the nexus between tax knowledge and tax compliance among SMEs in the shadow economy. The study further seeks to provide practical recommendations that can assist policymakers in addressing the persistent challenges associated with SME tax compliance and the integration of informal economic activities into the formal tax system.

2. Literature Review

2.1 Tax Compliance

Tax compliance remains a significant challenge for tax authorities worldwide, as persuading taxpayers to adhere to tax regulations is often difficult. In its simplest form, tax compliance refers to the extent to which taxpayers conform to existing tax laws. However, the concept extends beyond mere legal compliance and encompasses economic, social, and behavioural dimensions, reflecting taxpayers' decisions to align with broader societal objectives embedded in tax legislation (Gberegbe & Umoren, 2017).

Several scholars have provided varying perspectives on tax compliance. According to Andreoni, Erard, and Feinstein (2008), tax compliance refers to taxpayers' willingness to obey tax laws in order to contribute to economic equilibrium. Similarly, Enofe, Embele, and Obazee (2019) describe tax compliance as taxpayers' willingness to fulfill their tax obligations. Expanding this view, Song and Yarbrough (2008) define tax compliance as the voluntary ability and willingness of taxpayers to comply with tax laws, influenced by ethical considerations, legal frameworks, and situational factors. In the same vein, the Internal Revenue Service Act (2000) defines tax compliance as the ability and willingness of taxpayers to accurately declare income and pay the correct amount of tax within the stipulated time.

Oladipupo and Obazee (2016) further define tax compliance as the complete reporting of income and payment of taxes in accordance with applicable laws, regulations, and judicial rulings. From an economic perspective, voluntary tax compliance entails the timely filing of tax returns and accurate reporting of tax liabilities in line with prevailing tax regulations. Understanding the extent to which Small and Medium Enterprises (SMEs) comprehend and fulfill their tax obligations has become increasingly important. Despite its significance, this area remains underexplored, particularly in Nigeria, where unresolved factors influencing SME tax non-compliance continue to hinder efforts to improve the country's tax-to-GDP ratio (Amaeshi et al., 2020).

The literature identifies two major models of tax compliance behaviour: the economic model and the behavioral model. The economic model is rooted in Expected Utility (EU) Theory and Deterrence Theory. It views taxpayers as rational utility maximizers who engage in tax evasion when the expected benefits outweigh the associated costs and penalties (Sapiei et al., 2014). Deterrence Theory emphasizes the role of sanctions and the probability of detection, suggesting that higher penalties and stronger enforcement mechanisms reduce tax non-compliance tendencies (Musimenta, 2020; Sapiei et al., 2014).

In contrast, the behavioural model recognizes that tax compliance decisions are influenced by individual attitudes, beliefs, values, ethics, culture, peer influence, demographic characteristics, and social norms (Onu & Oat, 2018). Weber et al. (2014) describe these influences as social effects arising from the taxpayer's socio-cultural environment. Such factors include perceptions of fairness, prestige, group influence, and psychological considerations. Beyond financial penalties, psychological consequences such as shame and social disapproval may also discourage tax evasion and promote compliance (Weber et al., 2014).

2.2. Tax knowledge

Knowledge as one of the factors in compliance is linked to the taxpayers' ability to understand taxation laws, their willingness to comply and perhaps ways to reduce tax compliance costs. One aspect of knowledge that relates to compliance is the general understanding about taxation regulations and information pertaining to the avenues to evade tax. According to Oladipupo and Obazee (2016) tax knowledge is the magnitude of awareness or sensitivity of the taxpayers to tax legislation. In considering the attitudes of individual taxpayers, the tax law knowledge is essential (Wassermann & Marina, 2020). Tax knowledge forms a significant positive association with tax compliance level (Mukhlis et al., 2015). Oladipupo and Obazee (2016) mentioned that when one has tax knowledge, the compliance level with tax statute could be stimulated.

Lack of tax knowledge might be caused by several factors. For example tax law and tax system complexity causes knowledge gap. Over the years, complexity has been associated with tax statues and

complexity represents but one strand in a web of interrelated factors and propositions influencing compliant tax reporting in a democratic society. Nevertheless, this has been singled out as a factor affecting compliance and its effect thereon can be viewed as one step in an ongoing program of study of noncompliance.

2.3. Tax Knowledge and Compliance

The literature on tax knowledge and compliance is a well research area in tax literature but also one of the most contradictory and this might not be far from the reality that tax knowledge and compliance are increasingly being recognized as falling under the field of behavioral economics research and has gone beyond just tax/accounting research. Research on empirical studies produced mixed results regarding the influence of tax knowledge on tax compliance behaviour. Early studies like that of Erickson and Fallan (1996) found that tax knowledge has positive influence on tax compliance. Several other studies have followed in this direction. Damajanti and Karim (2017) conducted research with individual and corporate taxpayers in Malaysia regarding the effects of knowledge on taxpayer's compliance behavior with tax justice intervening variables. They found that taxpayers' knowledge had remarkable effect on compliance with extant tax laws. But tax knowledge did not exhibit significant effect on tax justice as an intervening variable.

Flowing from the above, Maseko (2014) conducted a study with the SME in Zimbabwe about the impact of tax knowledge on tax compliance. However, most of the SMEs were found to have difficulties in comprehending income taxes and the VAT laws. This scholar also found that the level of education of taxpayers remains an integral factor that booster the knowledge of the tax payer regarding tax requirements, particularly about registration and filing requirements. Confirming the positive effects of tax knowledge, Olaoye, Ayeni-Agbaje, Alaran-Ajewole (2017) examined the impact of tax information, administration and knowledge on tax payers' compliance of Block Moulding Firms in Ekiti State, Nigeria using a survey research design. The data obtained from questionnaire were analysed using the ordinary least square regression method. The results showed that tax information and knowledge had positive significant impacts on tax compliance while tax administration had an insignificant impact on tax compliance. The study, therefore recommended that government should through its agencies educate the potential tax payers on tax laws and regulations by direct free symposia and seminars.

Furthermore, Oladipupo and Obazee (2016) investigated the impacts of tax payers' knowledge and penalties on tax compliance amongst small and medium enterprises in Nigeria using a survey research design. The data obtained from questionnaire were analyzed using the Ordinary Least Square regression method. The results showed that tax knowledge had a positive significant impact on tax compliance while tax penalty had insignificant positive impact on tax compliance. Thus, the study shows that tax knowledge has a higher impact on tax compliance than tax penalty.

Olaoyea and Busari (2021) examined implications of tax audit and investigation on taxpayers 'compliance in Nigeria. The study engaged cross-sectional survey research design, using a self-structured questionnaire administered to purposively select senior members of Federal Inland Revenue Services (FIRS), a body responsible for tax administration in Nigeria. Inferential regressions analysis carried out which revealed that a tax knowledge had a positive statistical significant effect on tax compliance.

Similarly, Kojo, Martin, Ebenezer, Martin, Daniel, Charlse (2020) examined the effect of dimensions of tax knowledge on tax compliance in the Ghanaian context using small and medium enterprises. The survey includes 130 managers of small business enterprises (SMEs) in Ghana, who had participated in tax education campaign organised by the Ghana Revenue Authority in the Nkawkaw Municipality. The data was analysed using a structural equation modelling approach. The results of the study suggest that knowledge of tax rights and responsibilities, knowledge of employment income, and awareness of sanctions were found to have a positive and significant relationship with tax compliance.

On the contrary, Hantono. (2021) examined the effect of tax knowledge, tax awareness and tax morale on tax compliance. Multiple linear regression analysis shows that tax knowledge, tax awareness, and tax morale are significant toward tax compliance. They simultaneously have a significant effect on tax

compliance. It can be concluded that tax knowledge mitigation, tax awareness, and tax morale towards tax compliance. The results of t-test showed that tax knowledge is not approved and indicates it has a significant impact on affecting tax compliance, tax awareness has less impact on affecting tax compliance, tax morale was not significant.

Anyanduba and Oboh (2019) examined the determinants of taxpayers' compliance behaviour under the self-assessment scheme and they used a non-random stratified sampling technique to evaluate taxpayer behaviour. Data was also gathered using questionnaire from three of the six geopolitical zones in Nigeria, namely South-South, South-West and North central zones respectively. The specific locations were Edo state, Lagos state, and Federal Capital Territory, Abuja resulting in 550 respondents which were analysed. The results showed that tax audit and awareness of offences and penalties had a positive and significant impact on tax compliance behaviour under the self-assessment scheme in Nigeria. Simplicity of tax administration and returns, tax knowledge and taxpayers' integrity had a positive but not significant impact on tax compliance behaviour under the self-assessment scheme in Nigeria.

On a comparable note, Adam (2012) found that tax knowledge in Nigeria could not be measured accurately from their findings, which were relied on the systematic theory and contemplated that some people have education others have tax knowledge. Therefrom out of the one hundred questionnaires distributed by the researchers, the result could not distinguish whether the respondents had just been exposed to tax education or knowledge existed amongst the SMEs and therefore failed to conclude if indeed knowledge influenced compliance.

Sahari, Nivakan, Sharon and Ahmad (2021) aims to clarify whether tax knowledge of individual taxpayers motivates tax compliance in Malaysia. The study applied a survey method for data collection. The population targeted was the individual taxpayers across Malaysia, whereby a sample of 419 respondents involved in this study. T-test, One-Way ANOVA, and Pearson correlation analysis had been employed to analyze the data. The outcome of the study reveals that knowledgeable taxpayers are not better tax complaint in Malaysia. Furthermore, they postulated that the relationship between tax knowledge and tax compliance is negative and insignificant.

2.4 Policy Issues in Improving compliance Outcomes for SMEs in Nigeria

SMEs in Nigeria accounts for 96% of business enterprises and 84% of employment opportunities with a total number of about 17.4 million (IMF, 2018; PricewaterhouseCoopers , 2019). They account for over 50% of the industrial employment, 90% of the manufacturing sector, relatively higher in the number of enterprises and dominance in agriculture (IMF, 2018). One of the most important roles attributable to SMEs is the ability to generate employment for a great majority of people (Lawal et al., 2020). In the recent past, various government restructuring programmes have made many Nigerians lose their jobs in both the private and public sectors due to downsizing, mergers and acquisitions and consolidations especially in the banking sector, but SMEs sub-sectors often provide veritable employment alternatives. Although, most jobs provided by SMEs are low paying, they enable families to survive, educate their children and move out of poverty (Lawal et al., 2020).

In contrast to the contributions of SMEs to the national GDP, the same SMEs account for the increasing level of tax evasion in Nigeria (Aladejebi, 2018). There are untapped goldmines in uncollected taxes from activities of small and medium enterprises (SMEs) considering huge contributions of SMEs to Gross Domestic Product (GDP) of the continent and abysmal level of tax collection from same. Nigeria has a huge tax base (due to its growing GDP over the years) but at a disproportionate level to its tax compliance and collection. (Amaeshi et al., 2020; World Bank, 2015).

Given their small size, mobility, and potential political influence, effective taxation of informal sector firms is likely to depend on encouraging greater quasi-voluntary compliance. The likelihood of such quasi-voluntary compliance is linked to the broader questions of the benefits of formalisation described earlier (Perry et al., 2007). Consequently, it is the small but growing literature on formalization that offers the greatest insights into strategies for quasi-voluntary compliance (Kenyon, 2007; Zinnes, 2009).

2.4.1 Shifting incentives: a cost-benefit approach to tax compliance.

The dominant strand of existing research views formalization which is the process bringing the shadow or informal sector into the formal sector as a rational choice: firms will formalize if the benefits of formalization outweigh the costs. Costs of formalization include the cost of registration or getting licenses, the cost of tax compliance, and the cost of following labour laws and other regulations. Encouraging firms to enter the tax net may depend on addressing these broader costs and benefits of formalization.

Among the earliest relevant studies is the work of Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2002), who reported cross-country econometric evidence that higher costs of formalisation were associated with larger informal sectors across a sample of 85 countries. This result has more recently been echoed by Kus (2010) over a larger range of countries, though he argues that this relationship does not hold where law enforcement is weak – as in most low-income countries thus suggesting that other factors are also important in those contexts. While these cross-country studies provide a starting point, they face inevitable limitations in their ability to capture the nuance of these processes. Several empirical surveys have contributed to understanding such cost-benefit calculations, though studies focus disproportionately on costs. Surveys in Sierra Leone, Liberia, and Madagascar show that a significant proportion of informal firms have at some point attempted to become formal, but were deterred by the cost of doing so (Everest-Phillips, 2008). A less conventional cost lies in the complexity of tax legislation. Finally, the costs of formalisation may be higher, and the benefits less accessible, where governance is weak. There is now the need for simplification and cost reducing reform programmes in order to aid formalisation. Garcia-Bolivar (2006) reports the results of reducing the costs of formalisation in Bolivia, which resulted in a 20 per cent increase in the number of firm registrations, and he reports similar increases in Vietnam.

2.4.2. Empowering SME's

In contrast to the dominant cost-benefit approach, some scholars perceive informality primarily as a problem of power and capacity, rather than of choice (Zinnes, 2009). In this view, despite willingness, firms may be unable to register formally due to problems of capacity (illiteracy, limited skills), the transience of their business, the prevalence of cash transactions, or general uncertainty. The broader environment is often not enabling and is characterized by a lack of trust in government and the lack of easy access to a range of services including information, accountancy, security, justice, and insurance. Thus, even if aware of the potential benefits of formalisation, businesses tend to remain in the informal economy. This approach thus stresses the involuntary nature of informality, as opposed to the rational calculations of the cost benefit approach. The implications of this approach for taxation purposes are twofold: a need to adapt tax regimes to the characteristics of informal firms (such as illiteracy, lack of trust, and information); and a need to supplement business environment reform policies (such as reducing the costs of registration) with other supplementary policies such as securing property rights (which are often the cause of transience), improving security (safety from theft or harassment), establishing dispute resolution mechanisms, and affordable accountancy services. The above can help micro-businesses to view taxation as one step toward empowerment and eventual formalisation. Unfortunately, however, we are not aware of any research that has systematically assessed the effectiveness of these types of policies in encouraging formalization and tax compliance.

2.4.3. The Nexus between State Actors and the Informal sector

Complementing the approaches outlined above, a third approach seeks to focus additional attention on politics and the nature of the relationship between the state and informal sector operators (Daly & Spence, 2010). To this end, Kenyon (2007) argues that, beyond simple cost-benefit analysis, formalization policies need to acknowledge and address three key strategic problems: information, credibility, and coordination. The importance of information arises from the fact that many intended beneficiaries in the informal economy simply are not aware of programmes targeted at them, or do not understand the requirements of formalization. While this problem varies from one context to another, it is surprisingly

prevalent, with a significant consequent need for states to adopt strategies that focus on outreach and taxpayer services (Jaramillo, 2009).

The importance of credibility reflects the fact that firms need assurances that the government will uphold their part of any bargain (provision of benefits) if firms are formalized. Surveys indicate that a fear of predation is a significant deterrent to successful formalization policies (Jaramillo, 2009), driven by a pervasive lack of trust in government. Finally, the importance of coordination lies in the fact that it is only in the interest of firms to formalize if they can be relatively certain that a critical mass of competitors will also do so. Additional research into how to support constructive bargaining between informal associations and governments is much needed.

Although research has been limited, there are powerful reasons to expect that political leaders may have weak incentives to tax the informal economy. The simple version is thus: taxing the informal economy will raise limited revenue, is administratively challenging, and potentially politically unpopular; better to leave them alone (Kloeden, 2011). The more complex version of this argument suggests that it is actually in the interest of politicians to keep the informal economy informal as a captive source of votes (Tendler 2002).

2.4.4. Promoting a change in payment methods

Promoting a change in payment methods and reducing the use of cash promises to be one of the most effective instruments for combatting the underground economy. This is a long process, however, and the willingness of economic actors to use noncash payment methods depends on various circumstances, including the availability of technology; the safety and reliability of the banking system; and costs. These circumstances generally are outside the sphere of influence of ministries of finance or tax administration. While new payment options, such as the development of mobile payment channels, contribute to a steady growth in the percentage of cashless transactions, in practice the level of noncash transactions per capita remains low, particularly in the retail sector, and even more so in developing markets, where they are only a fraction of those in developed countries. Although tax policy can only be one component of a broader strategy to increase the level of cashless transactions, the tax system can either provide a stimulus for moving to noncash payment methods or it can discourage the use of cash. The most direct method for enforcing payments through the banking system. A more effective approach might be to introduce a less favorable tax treatment for cash transactions, possibly combined with targeted tax incentives for noncash payments. Approaches of this kind include disallowing deduction of business expenses from taxable income if the expenses were paid in cash and, on the VAT side, denying a deduction of input VAT for inputs paid in cash

3. CONCLUSION

The study is a theoretical discourse on tax knowledge and tax compliance of SME's in a shadow/informal economy. The research employs a library-based research design in which the study relies on extant literature as the basis for inferences while the discourse is hinged on the behavioural economics theory. Tax knowledge and tax compliance by the SMEs in a shadow economy shows that there is no clear relationship between tax knowledge and tax compliance amongst SMEs in a shadow economy as most enterprises in the shadow economy possess tax knowledge which does culminate into tax compliance. The need to improve tax compliance is almost like a mantra in tax administrators and tax policy circles. However, it is also been well identified that the non-tax paying SMEs especially those in the shadow economy explains a high proportion of the tax-gdp gap. Arguably, there is a rising dominance of the SME's in the shadow economy in most countries and the economic sustenance that the aspect of the economy upholds. Particularly, but in Sub-Saharan Africa, it is estimated to be at 66% of the workforce have their main employment in the shadow economy in sub- Saharan Africa. One of the identified approaches to integrating SME's in the shadow economy into the tax bracket is the role of tax knowledge. In this regards, there has been an avalanche of research efforts targeted at the impact of tax knowledge on tax compliance of SMEs. The findings have been characterized with disparate research outcomes

indicating that though tax knowledge is important, it is not persistently so. Therefore, the study recommends the consideration other tax policy issues namely; Shifting incentives using a cost-benefit approach to tax compliance, empowering SME's as informality may primarily as a problem of power and capacity, rather than of choice and finally, rethinking the Nexus between state actors and the informal sector. Now that the presentation of TIN before a corporates and enterprises account is been open had been made compulsory, this will drag all SMEs in the various relevant tax authorities tax net. Also, the requirement for current year tax clearance certificate as a bases for biding for contracts will help expose SMEs hiding in the shadow economy thereby evade taxes. In other words, this will lead to mandatory capturing of all businesses into the relevant tax authorities tax nets thereby leading to increase in revenue generation. Taxpayers and tax authorities alike should take into cognizance the peril areas identified to devise better strategies in dealing with difficulties in the underground economy.

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