

Midocean University

College of Management

Master of Project Management



دراسة تأثير تطبيق ضريبة القيمة المضافة في المملكة العربية السعودية على المنشآت الصغيرة والمتوسطة

A study of the impact of implementing Vat in KSA on small and medium enterprises

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Introduction:

Many literatures related to taxes do not differentiate between the forms of sizes of business and entrepreneurship. Therefore, this research or study will start with explanation of what is the meaning of small businesses:

It is any profitable trade entity other than those that surpassed a given high asset sill. It includes the owner, corporate forms of business and partnership. Also who have income from self-employment or through free business, even if it's not their main source of income.

Usually, individuals who employed in small business are representing the tax compliance in all administrative decisions such as revenue generation and taxation. Their behavior is important to the success of the project. Small business owners are responsible for collecting as well as for remitting taxes (Christensen et al., 2001). Small business owners are substantial players in tax system of the country. Moreover, small business owner-directors are more probable to cheat than other taxpayers. The theme of paying taxes is a very important topic for small business owners. But small businesses' tax behaviors and the actual experience in paying taxes did not receive good attention.

This research contributes to understanding of small business owners' tax compliance, the extent to which people know the concept of taxation, and how taxes affect small businesses in Saudi Arabia. Efficiency and experiences in tax substances differed significantly between groups of taxpayers and small business owners. Small business owners not only pay their income tax but need to take account of various types of business taxes such as corporate tax, property taxes, and payroll taxes; they need to collect sales taxes such as VAT; and they need to withhold taxes such as personal income taxes in the case of having at least one employee. I assume that the various types of taxes and taxation requirements may significantly shape the perceived tax situation of small business owners.

The practical side of taxation in large companies is separated and the problems of taxation are dealt with by professionals in taxation outcomes. And they do not have directly related to the company's revenues. In addition, to understand compliance must consider the psychological and economic variables (e. Erard and Feinstein, 1994). Tax non-compliance: It is any difference between the amount of taxes due and the amount of taxes paid. This difference happens when there are overstating and understating income, expenses, and deductions.

Non-compliance leads to insufficient understanding of tax laws and also leads to accounting errors Tax: this word for free-business owners make them restricted in their businesses.

Problem Statement:

With the vision of the Kingdom 2030 and the development of social media, people began to expand in trade. People started to open their own SMEs. The tax system was applied recently in Saudi Arabia because of that, there is lack of tax concept and many small entrepreneurs do not have sufficient experience in knowing the effect of tax on them.

Importance:

The main topic, the effect of tax and VAT on small Business in Saudi Arabia and explain the concept of taxation so the importance in this research, a broader perspective will be explored to understand and deal with the impact of tax.

Aims and Objectives of the study:

The aim of this research is to make people more knowledgeable about the concept of taxation and especially for SMEs owners the study aims to show the effects of Tax and how to deal with it.

The objectives of the research are:

1. To know about the effect of tax in small business in Saudi Arabia.
2. Increase people's awareness of the concept of taxation
3. know when should Tax imposed on corporate

Research Questions:

1. What is meaning of Tax and Vat?
2. What is the impact of corporate tax?
3. When is corporate tax imposed?
4. Does the tax have benefits and what are they?

Research Hypothesis:

There is a positive relationship between the concept of the impact of tax and business owners in this research after expanding the scope of their concept of tax

the following hypotheses have been formulated to guide the empirical investigation into the impact of VAT implementation on small and medium enterprises (SMEs) in Saudi Arabia:

Hypothesis 1: Impact on Business Performance

H1: The implementation of VAT has a significant negative impact on the financial performance of SMEs in Saudi Arabia.

Rationale: The introduction of VAT increases the cost of goods and services, which can affect sales revenue, profit margins, and overall financial performance of SMEs.

Hypothesis 2: Compliance Costs

H2: The compliance costs associated with VAT implementation are disproportionately higher for SMEs compared to larger enterprises.

Rationale: SMEs typically have limited resources and may face higher relative costs for VAT compliance, including administrative burdens, accounting services, and time spent on tax-related activities.

Hypothesis 3: Tax Compliance Behavior

H3: The perception of VAT fairness and trust in the tax authorities significantly influences VAT compliance behavior among SME owners.

Rationale: Psychological and behavioral economic theories suggest that taxpayers' attitudes towards the tax system and their trust in government institutions affect their compliance behavior.

Hypothesis 4: Informal Economy Transition

H4: VAT implementation encourages the formalization of SMEs operating in the informal economy.

Rationale: VAT is part of Saudi Arabia's broader economic reforms aimed at reducing the informal economy. Formalization can bring benefits such as access to credit and markets but also imposes compliance requirements.

Hypothesis 5: Economic Diversification Benefits

H5: SMEs perceive the benefits of VAT revenues invested in public services and infrastructure as outweighing the immediate tax burden.

Rationale: The government aims to use VAT revenues to support public services and infrastructure, which can create a more conducive environment for business operations and growth.

Hypothesis 6: Sector-Specific Impact

H6: The impact of VAT implementation varies significantly across different sectors of SMEs in Saudi Arabia.

Rationale: Different sectors may experience varying effects due to differences in cost structures, pricing power, and customer bases. For example, retail and service-oriented SMEs may be more affected than those in manufacturing.

Hypothesis 7: Investment and Innovation

H7: VAT implementation negatively impacts the investment and innovation activities of SMEs in Saudi Arabia.

Rationale: Higher tax burdens can reduce the available capital for investment and innovation, potentially slowing down growth and competitiveness.

Hypothesis 8: Awareness and Education

H8: Increased awareness and education about VAT positively influence the compliance rates among SMEs.

Rationale: Providing SMEs with adequate information and education about VAT can improve their understanding and compliance, reducing unintentional non-compliance.

These hypotheses will be tested through empirical research, utilizing quantitative and qualitative data collection methods. The results will provide insights into the validity of these hypotheses and contribute to a deeper understanding of the impact of VAT on SMEs in Saudi Arabia.

Previous studies:

Tax knowledge, tax complexity and tax compliance: Taxpayers' view.

In his paper about (Saad, 2014) examines the relationship among two entities and how they affect the tax compliance of the taxpayers. The first entity is the available knowledge about the tax laws. The second entity is the tax complexity in a country and how it affects tax compliance in taxpayers. In his paper, he examines the possible reasons for non-compliance to the tax system. In reference to (Saad, 2014), some non-compliance behavior is involuntary. Lack of knowledge about the tax laws in a country cause business people to unintentionally engage with the tax non-compliance. Although lack of knowledge is directly related to non-compliance, tax knowledge does not mean that everyone becomes tax compliant. The tax complexity makes it difficult for people to be tax compliant. Tax simplification has led to effective dissemination and understanding of tax regulations to the public.

According to (Saad, 2014), tax compliance is more about the commitment of a citizen to obey the set rules and regulations. Tax compliance brings about the free will of an individual to file tax returns without being forced. Tax compliance is culture independent of knowledge. There are areas where citizens submit their income at the required time while their citizens from other countries record high rates of non-compliance. The tax compliance behavior is caused by several factors which include but are not limited to the level of knowledge, income, tax rates, ethics, and tax complexity.

Following recorded interviews by (Saad, 2014), the tax law is essential for all citizens, the knowledge is not readily available, and many people are non-compliant due to lack of proper information. Complexity is a big drawback causing non-compliance, people try to

understand the tax laws in vain. Two main problems which lead to non-compliance are; non-patriotism and the belief that one can hide from the authorities.

Brawnlee et al. (2016) argued that taxation is a financial charge that is mandatory done to individuals or to their legal entities by the government with an aim of enhancing funding of several public expenditures. However, most of the people in the country always fail to pay the taxes, either through evasion or resistance. In return, this makes the government to impose punishment to those people and make up a follow up of enhancing that tax is paid appropriately. According to Ishikawa et al. (2018), tax is divided into direct or indirect, which is paid in terms of money or as labor.

Several countries have a tax system that aims at paying for the public needs as well as government functions. Different taxes levy different rates on individual's income as well as income from their businesses. Some taxation has flat rates while others have a scale based rates (Jeanne and Korinek, 2018). There has been a difference between legal and economic definitions of taxation whereby economists fail to regard many transfers that is normally done to the government as taxes. For instance, there are several transfers that are compared to prices. In the modern form of taxation, the government levy taxes in terms of money. The method used by a country during taxation is discussed in economics and politics.

Taxation can be used in distribution of wealth on businesses and various individuals (Aghion et al. 2016). This is done to both individuals as well as businesses. This is simply because they both face different tax burdens. This signifies that some people and organizations benefit more than others, depending on their total revenue. Therefore, taxation is very important in enhancing equality of wealth distribution.

Value-added tax (VAT) is also known as goods and services tax in some countries (Wallace, 2015). It is a type of tax that is assessed incrementally on the bases of the increase in goods and services. The access of VAT is done in form of destination based tax, whereby tax is carried out on the location of consumers as well as the applied sales price. In Saudi Arabia, VAT raises a fifth of the tax revenue in the country. VAT does not only apply in Saudi Arabia, but also in other 193 countries (Alumina and Lopez-Rodriguez, 2018). VAT tax is calculated using two methods; the credit invoice and the account based methods. In credit invoice, the taxation is done on all the transactions with noticing the customers. After taxation, businesses involved may receive a credit on the VAT, on the bases of goods and services sold. Slemrord et al. (2015) discussed that the credit-invoice technique of tax calculation is the most employed method since it allow subtraction of the taxable purchases and the rate of the VAT is applied at the difference, at the end of the reporting period.

Purpose of Taxation On Small Businesses

Taxation levied on small business is very effective in governing or altering prices of goods and services, in order to affect their demand. In the Kingdom of Saudi Arabia, the government has been using VAT taxation on goods and services sold various businesses to obtain capital used in various activities. These activities include expenditures used on economic activities (for instance in building of roads, sanitation in the country, legal systems, public transportation, health care systems as well as education). However, expenditures may exceed tax revenue, leading to the accumulation of debt towards the government. A portion of current tax is used in servicing of the past debt in various situations (Minnis and Sutherland, 2017). For instance; funding of welfare and public services. These include pensions, education system, unemployment benefits, water services, energy as well as waste management. According to Brawnlee (2016), in Chartalist theory that is used in money

creation is not necessary for the creation of government revenue, especially where the government is in a position of offering fiat money.

This enhances taxation which promotes stability of currency in country. In addition, this stability of currency in the country enhances the expression of public policy in terms of distribution of wealth, isolation of the cost of benefits as well as subsidizing of industries. Precisely, taxation is essential to the government in the country, since it allows accumulation of the revenue; which is used in the development of the economy. Below are other discussed purposes of imposing taxation on small businesses;

Limit owners liabilities

The main aim of taxation towards small businesses is to limit owner's liabilities. In sole proprietorship, all owners are liable for the debts and other business liabilities and this can make creditors to go for their personal assets in collection of debts (Wallance, 2015). Taxation enhances formation of corporation and its operation and this protect owners from such liabilities.

Enhance Credibility

Taxation enhances incorporation of businesses and this allows the credibility of business after the business name. The named distinction gives the business an instant credibility as well as instant authority, which enables a small business in developing into an incorporated company.

Protect the brand of the business

VAT form of taxation enhance small businesses to protect their reputation from being dismissed from other organizations producing the same product (Ishikawa et al. 2018), this is achieved through strengthening the business in terms of marketing efforts as well as brand identity. Precisely, taxation enhance in the branding standpoint of a certain product.

Foreign investment

One of the main qualifications of a company in opening of other branches within and outside countries is its consistency in paying of taxes. Therefore, it is very essential for the small organizations to pay all the taxes levied upon them by the government, to secure its better positions for their development.

Enhance Legal Changes

Taxation allows government to change the laws regularly in relation to political policies. This enhances small businesses to be in a position to respond to these changes in legal framework. According to Slemrod et al. (2015), these changes include national minimum wage creation. These wages are currently extended up to the age of 18 years. This is simply because; taxation is sometimes done according to the size and the revenue of the business. This means that; small businesses may not be taxed highly and this encourages the business in creating of more employment as well as expanding their production. In return, the business earns more profit.

Effects of taxations on businesses

Government use taxation policy in a country to ensure that businesses are in a position to compete favorably with each other. The government changes the rules and frameworks of taxation from time to time, making businesses to change the means of their operation. Taxation affects small businesses through the following techniques;

Increases the costs of goods

Through taxation, the government imposed an evadable charge to specific goods, to earn government revenue. Businesses on the other hand take part in buying and selling of goods and services to make profit (Jeanne and Korinek, 2018). This means that taxation has an effect on the cost of goods. For instance; a rise in taxation towards goods and services has a direct effect on the cost of goods and services. Businesses are therefore needed to pass this taxation to their customers, for the purpose of reducing the effects of the tax. However, this also has an effect on the bottom line of the business. Tax levied on these goods can either be environmental or VAT. After levying of taxes on these goods and services, their prices go high and this lowers the amount of sales. This affects businesses in such a way that, they cannot be able to meet their target, through making the required profits.

Discourage investments on new and existing goods

As discussed earlier, taxations affect small businesses through increasing the prices of their goods. Making goods and services expensive leads to reduction of the sales. This means that businesses will not make targeted profits (Ishikawa et al. 2018). In return, this will discourage the investment of such goods and services. As well known, investment of a business towards new goods and services enhance its expansion. This means that after taxation, these businesses will not be in a position to expand.

Increase production cost

Through taxation, the cost of production increases, increasing the prices of final goods and services. This in return reduces the number of sales of goods, thus reducing the revenues of the organization.

Increase Business Expenses

Taxation increases the expenses of the business, making it more difficult in achieving its profitability. Businesses are taxed on their goods and services and also forced to pay numerous taxes like; taxes on wages, fees for permits or licenses as well as property taxes. All these have a negative effect on development of the business.

Theoretical Framework

The implementation of Value-Added Tax (VAT) in Saudi Arabia represents a significant shift in the fiscal landscape for small and medium enterprises (SMEs). Understanding the theoretical underpinnings of tax compliance, economic behavior, and the specific impacts on SMEs is essential for analyzing the broader consequences of this policy change. This theoretical framework will explore key concepts and theories related to tax compliance, the economic effects of taxation, and the specific challenges and opportunities VAT presents for SMEs in Saudi Arabia.

Tax Compliance Theory

Tax compliance theory explores the behavior of taxpayers in adhering to tax laws and regulations. The framework includes both economic and psychological dimensions:

1. **Economic Deterrence Model:** This model posits that taxpayers are rational actors who weigh the costs and benefits of compliance versus non-compliance. Factors such as the probability of being audited, the severity of penalties, and the perceived fairness of the tax system influence compliance decisions (Allingham & Sandmo, 1972).
2. **Psychological Models:** These models consider the non-economic factors affecting tax compliance, such as social norms, moral values, and trust in government institutions. The Theory of Planned Behavior (Ajzen, 1991) suggests that attitudes towards taxes, subjective norms, and perceived behavioral control influence compliance intentions.
3. **Behavioral Economics:** This approach integrates insights from psychology and economics to explain irrational behaviors in tax compliance. Concepts like mental accounting, loss aversion, and framing effects are crucial in understanding why SMEs might underreport income or overstate deductions (Thaler & Sunstein, 2008).

Economic Effects of Taxation

The economic impact of taxation, particularly VAT, on SMEs can be understood through several theoretical lenses:

1. **Supply and Demand:** Taxation affects the prices of goods and services, influencing supply and demand. VAT increases the cost of goods, which can lead to reduced consumption and changes in production levels. SMEs, with their limited pricing power, may face greater challenges in passing on these costs to consumers (Jeanne & Korinek, 2018).

2. **Cost of Compliance:** Compliance costs include the administrative burden of tax reporting, the need for specialized accounting services, and the time spent on tax-related activities. These costs are disproportionately higher for SMEs, affecting their profitability and growth potential (Slemrod et al., 2015).
3. **Investment and Innovation:** Tax policies influence investment decisions. High tax rates can deter investment by reducing post-tax returns. Conversely, tax incentives can encourage investment and innovation. Understanding the balance of these effects is crucial for evaluating VAT's impact on SMEs (Minnis & Sutherland, 2017).

VAT and SMEs in Saudi Arabia

The specific context of VAT implementation in Saudi Arabia presents unique challenges and opportunities for SMEs:

1. **Regulatory Environment:** Saudi Arabia's Vision 2030 aims to diversify the economy and reduce dependence on oil revenues. VAT is part of this broader strategy. Understanding the regulatory environment and its evolution is key to analyzing the impact on SMEs.
2. **Informal Economy:** A significant portion of SMEs operates in the informal sector, where tax compliance is lower. The introduction of VAT aims to formalize these businesses, but this transition poses compliance challenges and potential resistance (Aluminia & Lopez-Rodriguez, 2018).
3. **Economic Diversification:** VAT revenues are intended to support public services and infrastructure, potentially benefiting SMEs through improved business environments. However, the immediate impact of increased tax burdens requires careful assessment (Aghion et al., 2016).

Theoretical Integration

Integrating these theoretical perspectives provides a comprehensive framework for analyzing the impact of VAT on SMEs in Saudi Arabia. The research will draw on economic, psychological, and contextual theories to:

1. Assess the behavioral responses of SME owners to VAT.
2. Evaluate the economic impacts on prices, investment, and growth.

3. Understand the regulatory and compliance challenges specific to Saudi Arabia.

The theoretical framework sets the foundation for empirical investigation into the impact of VAT on SMEs in Saudi Arabia. By combining insights from tax compliance theory, economic effects of taxation, and the specific context of Saudi Arabia, this research aims to provide a nuanced understanding of how VAT affects small businesses and contributes to broader economic objectives.

Methodology:

In this research, the quantitative methodology will be used by creating an online survey. The survey will be distributed among people through the social media. It will be conducted in Saudi Arabia in 2024. The target group is small business owners and Saudi citizens. The study aims to approach results in a sample of 100-150 persons whose ages range from 18 and above.

Study tools:

the following tools will be used to collect and analyze data:

1. Online Surveys

A comprehensive online survey will be designed to collect quantitative data. The survey will be distributed through social media to reach small business owners and Saudi citizens in Saudi Arabia. The survey aims to collect data from a sample size ranging from 100 to 150 individuals, aged 18 and above.

2. Social Media

Social media will be used as the primary tool for disseminating and distributing the online surveys. This method will help reach a wide range of target participants efficiently and quickly.

3. Statistical Data Analysis

After data collection, statistical analysis programs such as SPSS and Excel will be used to analyze the quantitative data gathered from the surveys. Various analytical techniques will be employed, including descriptive statistics, ANOVA (Analysis of Variance), and regression analysis, to examine relationships between variables and test research hypotheses.

Scope:

In this section of the proposal , the research will conduct a survey in Saudi Arabia and I hope the number of responses is around 100 -150 respondents.

The scope of this research encompasses the following key areas to explore the impact of implementing Value-Added Tax (VAT) on small and medium enterprises (SMEs) in Saudi Arabia:

Geographic Scope

The research will be conducted within the Kingdom of Saudi Arabia. Data collection will target various regions across the country to ensure a comprehensive understanding of the impact on SMEs in different geographic areas.

Target Population

The primary focus will be on small and medium enterprises (SMEs) operating in Saudi Arabia. Additionally, the study will include Saudi citizens who are business owners or involved in the management of SMEs. The target group will comprise individuals aged 18 and above.

Time Frame

The study will be conducted in 2024, providing a current perspective on the effects of VAT implementation following its introduction.

Areas of Impact

The research will examine several areas of impact on SMEs, including but not limited to:

- **Financial Performance:** Assessing changes in revenue, profit margins, and overall financial health of SMEs post-VAT implementation.
- **Compliance Costs:** Evaluating the administrative and financial burdens associated with VAT compliance for SMEs.
- **Tax Compliance Behavior:** Understanding how SMEs perceive VAT and their compliance behaviors.
- **Formalization of Informal Enterprises:** Analyzing the effect of VAT on the formalization of businesses previously operating in the informal sector.
- **Economic Diversification Benefits:** Investigating the perceived benefits of VAT revenues being reinvested into public services and infrastructure.

- **Sector-Specific Impact:** Identifying how different sectors within the SME category are affected by VAT.

Data Collection Methods

The research will utilize quantitative methodology through online surveys distributed via social media platforms. The survey will aim to collect data from 100 to 150 respondents, providing a sufficient sample size for statistical analysis.

Analytical Techniques

The data collected will be analyzed using statistical methods, including descriptive statistics, ANOVA (Analysis of Variance), and regression analysis, to test the research hypotheses and identify significant trends and patterns.

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