

# **CHAPTER I**

## **INTRODUCTION**

### **1.1 BACKGROUND OF THE STUDY**

At the beginning of its presidency, the lately elected President Joko Widodo has predetermined the new target of economic growth to be achieved within the next three years is from 5.2% to 7% of the annual growth (Ihsanuddin, 2017). Nearly two years has passed, the economy in Indonesia still has not shown a promising growth. It seems hardly possible for the government to achieve the target amidst the uncertainties of global economic and a lackadaisical domestic performance. In fact, the economy growth remains in an average of 5% per year, which is far behind from the original target. The economy itself is struggling to maintain at 5% growth rate, which is barely sufficient to obliterate the number of poverty in Indonesia. Furthermore, income inequality is also an inevitable problem for Indonesia.

The budget plan set in 2017 primarily focus on fiscal consolidation in terms of revenues and expenditures targets. The central government has predetermined the design of the budget plan to be more realistic, credible, efficient, effective, and sustainable in its implementation. Even though it is important to set high targets, it is also vital to remain realistic on condition where Indonesia recently faces many continuing economic uncertainties. In addition, it is important to preserve a stable budget deficit and continuation of spending for nationwide programs on matters such as infrastructure and social development programs. The country has no longer set a high ambition like in past few years. In fact, the budget targets proposed in 2018 is assumed to be a growth rate of around 5.4%, not much different from the previous year's target which is 5.3%

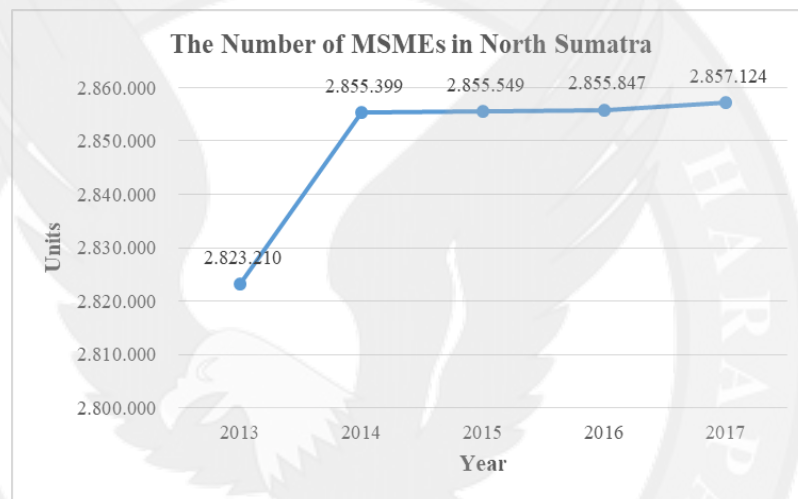
(Dianomi, 2017). To accomplish the objectives, efforts such as fiscal reform have been carried out by the government to meet the expected tax revenue growth since 2015. The central government assures its commitment to preserve the sustainability of structural reform on the 2017 budget plan by optimizing the state revenue through tax sectors. Moreover, the need of compliance and public awareness of tax is also demanded in promoting the economic growth in Indonesia especially in the period of economic stagnation that is happening currently.

The role of tax has been known as one of the most important sectors in a country's revenue. For that reason, the government has always relied on tax sectors as the main source of funds to achieve the nation's ambitions. The state budget year 2017 shows that tax revenue realization has reached Rp 1,498.9 trillion from the total revenue of Rp1,750.3 trillion in 2017 (*Kementrian Keuangan Republik Indonesia*, 2017). In the total revenue, tax sector has contributed 85.6% (52.6% of income tax and 33% of VAT). The source of revenue was mostly derived from income tax receipts amounting to Rp 920.7 million or 52.6% of the total revenue, where one of the source of revenue from income tax is income tax on Micro, Small, Medium Enterprises (MSME) sectors.

The condition of MSMEs in Indonesia has rapidly grown. The number of MSMEs in Indonesia has reached 57.89 million units which equals to 99.99% of the total number of businesses in Indonesia until 2013. Among the number of MSMEs in Indonesia, the micro-sized enterprises consist of 98.78%; small-sized enterprises, 1.12%; and medium-sized enterprises, 0.008% (*Kementrian Koperasi dan Usaha Kecil dan Menengah Republik Indonesia*, 2013). The numbers can grow higher in the future given that there are many MSME business sectors informal nature.

The number of MSMEs sectors in North Sumatra has been increasing for the last few years since 2013 (Figure 1.1). The Minister

of Cooperatives and MSMEs, Puspayoga assessed that the MSMEs culinary field has the potential to be one of the largest contributors of national income. He further stated that the proper development of micro business entrepreneurs will bring good progress to the nation economy (SWAOnline, 2015). With the condition of growing number of MSMEs has surely shown that there is a potential to collect tax from MSME sectors. The number of the taxpayers who have ability to pay tax will certainly increase. Increasing the ability to pay tax will eventually support the tax collection.



**Figure 1.1 The Number of MSMEs in North Sumatra (2013-2017)**  
Source: Utheh (2018)

Higher numbers of MSME has become the backbone of government spending in promoting economic growth especially in developing countries. The contribution in economic growth can be presented in the form of GDP and tax revenue. Besides playing an important role in economic growth, MSMEs also play a vital role in providing employment for labor force as well as income distribution. The existence of MSMEs that provides employment can indirectly become a helping hand in alleviating numbers of unemployment. Furthermore, a platform for new business that involves both producers and consumers will be created through the MSME sectors. New business opportunities that are created will certainly support the

emergence of new taxpayers that may have the ability to pay tax. With these conditions, there may be a positive contribution in the GDP as they encourage the expansion of economic activity.

The sustainable development from MSME sectors has indicated that there are opportunities for the state to impose tax on income earned in the businesses. For that reason, Indonesia's government issued Government Regulation No.46 Year 2013 regarding income tax on certain amount of gross income received or retrieved from the business by the taxpayer. The object of the tax subject to final tax. The final tax rate that will be imposed to MSMEs is 1% with the turnover not more than Rp 4.8 billion per year. The enactment of this regulation is expected to ease and simplify the procedures for the taxpayers to take care of their tax obligation.

Nevertheless, the imposition of tax on MSME sectors can bring a negative impact on the effort itself (Mukhlis, Utomo, & Soesetyo, 2014). It can happen since the feature of tax is coercive as it is an obligation, so people are more likely unwilling to pay it. Considering that tax is a burden, people naturally attempt in looking more ways to reduce, delay or avoid it legally or even illegally. Moreover, the increase in spending cost for their businesses will surely affect the prices of all sorts of produced goods to be increase. The rise in prices of produced goods can be feared as it can influence the competitiveness of the goods, which will also influence the turnover of the businesses.

The contribution of MSMEs in the tax revenue is still relatively small considering that most of the tax revenue is dominated by large enterprises, which is less than 1% of the total number of businesses. Based on the records of Directorate General of Taxation, the realization of final income tax of MSMEs in 2017 is still far from the target. The target of tax realization in 2017 was Rp 156.18 trillion, but only Rp 106.33 trillion or 68.08% was realized (Richard, 2018).

Collecting tax from MSMEs is not an easy task. In both developing or developed countries, MSME sectors are regarded as hard-to-control sectors in terms of tax compliance. The low tax compliance level among MSMEs while they are dominating the economy has affected the sense of fairness. For instance, the unregistered MSME will offer the same goods as registered MSME with lower price. The distortion that occur between unregistered and registered MSME, in the long term, will affect the performance of the registered MSME in the economy. Disincentives to tax compliance can be also created because registered MSME would like to stay competitive in the global market (*Direktorat Jenderal Pajak*, 2015). These conditions have become challenges for the tax authorities to increase the unregistered MSME become registered and at the same time to minimize the possibility of tax evasion by the registered MSMEs.

The proportion of one state's tax revenue will be primarily determined by the scope of the tax compliance from its society (Mukhlis, Utomo, & Soesetyo, 2014). The larger the extent of tax compliance, the larger the nation's ability to collect funds from tax sectors. The theory of tax compliance was previously proposed by Allingham and Sandmo (1972). In their studies, it is stated that the decision of tax compliance of an individual is influenced by several indicators such as tax rate, the amount of income, an audit and penalties. In addition, both internal and external factors most likely affect the compliance of the taxpayers. Internal factor is the factor comes from the characteristics of taxpayers themselves that triggers whether to or not to fulfill the tax obligations. On the other hand, situation or the environment that surrounds the taxpayers is considered the external factors (Fuadi & Mangoting, 2013).

Various researches have been conducted to analyze the factors influencing the tax compliance. Research by Mukhlis, et al (2015) concludes that the role of tax education has a positive effect on



tax knowledge in East Java. According to the result, strengthening the tax education of taxpayers is crucial in shaping the tax knowledge, therefore tax compliance could be increased. Despite this, another research done by Fauziari et al (2016) concludes that tax knowledge has no impact towards tax compliance of SMEs in Padang. Another research done by Zinavai et al (2015) and Dlamini (2017) conclude that the tax compliance of SMEs in Zimbabwe is still low due to perceived high tax rate, lack of tax audit, and lack of trust in tax authority.

Based on the background of study and prior researches stated above, the writer is interested to conduct a research study with the title of: **“Tax Compliance Challenges: A Survey Study Among MSME Sectors in Medan”**. The chosen title is supported by conditions where tax compliance among MSME sectors is still poor while the number of MSMEs is increasing year-to-year. Moreover, tax compliance issues such as understatement or overstatement of income and expenses, late payment or fail to fulfill the tax obligation can be encountered since the country applies the self-assessment system (SAS).

## 1.2 PROBLEM LIMITATION

The writer will only discuss the three determinants, their relationships and effects between the compliance level of the MSME formal and informal sectors in Medan Petisah district, and variable that has the most dominant influence on tax compliance among these determinants. The MSME sectors that will be chosen in this research is culinary sector as this sector has the potential to be one of the largest sources of revenue for the government (SWAOnline, 2015). In addition, the research study will only focus on income tax. The three determinants that will be adopted in this research are tax knowledge, tax rate and tax sanction.

### **1.3 PROBLEM FORMULATION**

Recognizing there is a problem, the writer formulates the broad problem: “What are the causes of the tax compliance among MSME entrepreneurs of culinary sector?”

### **1.4 OBJECTIVE OF THE RESEARCH**

The purpose of this research is to identify possible causes of tax compliance among MSME entrepreneurs of culinary sector on their tax obligations.

### **1.5 BENEFIT OF THE RESEARCH**

The benefit of the research will be divided into two sections: theoretical and practical benefit.

#### **1.5.1 THEORETICAL BENEFIT**

Based on the research objectives, the research is expected to generate theoretical benefit as follows:

1. For writer, this research is expected to expand the knowledge of the writer regarding the possible determinants of tax compliance and their relationships and effects towards tax compliance of MSME entrepreneurs of culinary sector.
2. For other writers, this research is expected to be used as an overview and input in doing research to the upcoming tax compliance issues in MSME entrepreneurs of culinary sector.

#### **1.5.2 PRACTICAL BENEFIT**

Based on the research objectives, the research is expected to generate practical benefit as follows:

1. For the public, this research will improve knowledge regarding the possible determinants (tax knowledge, tax rate and tax sanction) and their relationships and effects towards tax compliance among MSME entrepreneurs of culinary sector.
2. For MSME sectors, this research will help them to have better understanding of taxation and why it is important to fulfill the tax obligations.
3. For Indonesia government, this research will contribute thoughts regarding tax compliance issues especially for MSME entrepreneurs of culinary sector.

## **1.6 SYSTEMS OF WRITING**

This section contains an overview of the content of thesis from chapter to chapter:

### **CHAPTER I INTRODUCTION**

The first chapter contains information regarding the background of study, problem limitation, problem formulation, research objective, and the benefit of research, which includes theoretical and practical benefit and the systems of writing.

### **CHAPTER II LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT**

The second chapter provides information regarding the theoretical background of MSME sectors and tax compliance, prior research, hypothesis development, research model and framework of thinking.

### **CHAPTER III RESEARCH METHODOLOGY**

The third chapter contains information regarding the research design, population and sample, data collection method, operational variable definition



and variable measurement, and data analysis method that will be applied in chapter four.

#### CHAPTER IV DATA ANALYSIS AND DISCUSSION

The fourth chapter highlights the general description of MSME entrepreneurs of culinary sector, the result of data analysis which contains the descriptive statistics, the result of data quality, the result of classic assumption test and hypothesis testing and its discussion.

#### CHAPTER V CONCLUSION

The final chapter provides the conclusion of the research and suggestions or recommendations for further research.

