Salud, Ciencia y Tecnología - Serie de Conferencias. 2025; 4:1364
doi: 10.56294/sctconf20251364

ORIGINAL

Understanding tax compliance in Indonesian SMES: a structural equation modeling approach to tax literacy, knowledge, fairness, power, and trust

Comprensión del cumplimiento de las obligaciones fiscales en las PYMEs Indonesias: un enfoque de modelización de ecuaciones estructurales en relación con la alfabetización fiscal, el conocimiento, la equidad, el poder y la confianza

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Cite as: Pudji Rahayu D, Larasati M, Pamungkas Wibowo B, Al Jaffri Saad R. Understanding tax compliance in indonesian smes: a structural equation modeling approach to tax literacy, knowledge, fairness, power, and trust. Salud, Ciencia y Tecnología - Serie de Conferencias. 2025; 4:1364. https://doi.org/10.56294/sctconf20251364

Submitted: 06-06-2024 **Revised:** 12-09-2024 **Accepted:** 21-12-2024 **Published:** 01-01-2025

Editor: Prof. Dr. William Castillo-González

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ABSTRACT

Introduction: this study aims to examine the determinants of tax compliance among small and medium enterprises (SMEs) in Indonesia, focusing on the roles of tax literacy, tax knowledge, perceptions of fairness, power, trust, and trust in government. Given the importance of tax compliance can guide policymakers in designing effective tax policies.
Method: the research was conducted using a quantitative approach, collecting data from 349 SME owners across various islands in Indonesia through convenience sampling. The data were analyzed using Partial Least Squares Structural Equation Modeling (SEM-PLS), allowing for an in-depth examination of the relationships between independent variables and tax compliance.
Results: these findings suggest that building trust and employing supportive enforcement strategies are essential for encouraging voluntary compliance among SMEs. Surprisingly, tax literacy, tax knowledge, and perceptions of fairness did not significantly impact compliance, indicating that while these factors may play a role, they are not sufficient drivers of compliance without the presence of trust and authority.
Conclusions: based on these findings, it is recommended that policymakers prioritize strategies that foster trust in government and strengthen relationships between SMEs and tax authorities. Enhanced transparency, communication, and fair enforcement can significantly contribute to improved compliance rates.

Keywords: Tax Compliance; SMEs; Trust; Power; SEM-PLS; Indonesia.

RESUMEN

Introducción: este estudio pretende examinar los factores determinantes del cumplimiento de las obligaciones fiscales entre las pequeñas y medianas empresas (PYME) de Indonesia, centrándose en el papel de la alfabetización fiscal, los conocimientos fiscales, la percepción de la equidad, el poder, la confianza y la confianza en el gobierno. Dada la importancia del cumplimiento fiscal, puede orientar a los responsables políticos en el diseño de políticas fiscales eficaces.
Método: la investigación se llevó a cabo utilizando un enfoque cuantitativo, recopilando datos de 349 propietarios de PYME de varias islas de Indonesia a través de un muestreo de conveniencia. Los datos se analizaron mediante el modelo de ecuaciones estructurales por mínimos cuadrados parciales (SEM-PLS), lo que permitió examinar en profundidad las relaciones entre las variables independientes y el cumplimiento de las obligaciones fiscales.

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Resultados: en sugieren que el fomento de la confianza y el empleo de estrategias coercitivas de apoyo son esenciales para alentar el cumplimiento voluntario entre las PYME. Sorprendentemente, la alfabetización fiscal, los conocimientos tributarios y la percepción de equidad no influyeron significativamente en el cumplimiento, lo que indica que, aunque estos factores pueden desempeñar un papel, no son suficientes impulsores del cumplimiento sin la presencia de confianza y autoridad.
Conclusiones: se recomienda que los responsables políticos den prioridad a estrategias que fomenten la confianza en el gobierno y fortalezcan las relaciones entre las PYME y las autoridades fiscales. La mejora de la transparencia, la comunicación y una aplicación justa pueden contribuir significativamente a mejorar los índices de cumplimiento.

Palabras clave: Cumplimiento Fiscal; PYME; Confianza; Poder; SEM-PLS; Indonesia.

INTRODUCTION

Taxation is a critical revenue source for countries worldwide, including Indonesia, funding infrastructure development, public services, and economic growth initiatives.[1,2] Nevertheless, low tax compliance—especially prevalent in developing countries—remains a significant challenge for governments. Low compliance levels contribute to fiscal deficits, affecting public service quality and overall economic growth.[1,3] This issue is particularly prominent within the small and medium enterprise (SME) sector, which plays a pivotal role in Indonesia's economic development. Tax compliance within SMEs is especially relevant as Indonesia seeks to enhance tax revenues to support national development. SMEs have substantially contributed to the Indonesian economy, employing 96,92 % of the workforce and contributing 60,51 % of the GDP in 2019.[4] Conversely, large corporations, which represent only 0,01 % of enterprises, contribute 34,9 % to the GDP.[5] Although SMEs play a major role in Indonesia's economy, tax revenues from this sector remain substantially lower than the estimated tax potential.[6]

However, the complexity of tax laws and limited understanding of tax obligations often lead to confusion and non-compliance, particularly among SMEs lacking resources to navigate complex tax requirements.[3,7] According to Agusti & Rahman (2023), SMEs' tax contribution is 0,36 % of total tax revenue, with Indonesia's tax system relying on a Self-Assessment System since 1983, placing trust and responsibility on taxpayers to accurately report their obligations.[8] Despite SMEs' considerable economic contribution, a knowledge gap in tax regulations and low tax literacy often result in errors in reporting and payment.[4,8] Additionally, perceptions of inequity in the tax system further reduce motivation for SMEs to comply.[9,10]

Consequently, tax compliance in the SME sector has emerged as a highly relevant and critical issue. This study explores factors influencing SME tax compliance in Indonesia, specifically tax literacy, knowledge, trust in government, and perceptions of tax fairness. The research offers insights for policymakers aiming to identify strategies to enhance tax compliance in this sector (Batrancea et al., 2019; Fauziati et al., 2016). It addresses gaps by focusing on how tax literacy, tax knowledge, and trust in government impact SMEs' tax compliance.[7,12] Integrating these factors, which have received limited attention in the Indonesian SME context, the study also examines trust in tax authorities and perceptions of fairness.[13,14] While previous research primarily addresses corporate tax compliance, this study highlights the often-overlooked SME sector despite its significant economic contributions.[2,6]

Understanding these factors can aid policymakers in designing more targeted and effective tax policies. Insights from this study highlight the critical role of trust-building between SMEs and tax authorities, along with supportive enforcement measures that balance authority and cooperation. Such strategies may better align with the operational realities of SMEs and lead to improved compliance rates. The purpose of this study is thus to identify key determinants of tax compliance among Indonesian SMEs, focusing on the interplay between tax literacy, knowledge, perceptions of fairness, power, and trust in tax authorities, which may collectively support policy formulation aimed at fostering higher compliance within this sector.

Literature review

Tax Compliance

James & Alley (2002) define tax compliance as taxpayers' adherence to their tax obligations, which includes accurate reporting and timely tax payments as per prevailing regulations. Tax compliance is critical in tax systems because it directly contributes to national revenue, which funds development and public services.[16] SMEs are key pillars of the economy in many countries, including Indonesia. By complying with tax regulations, SMEs contribute to national revenue, which funds infrastructure, education, healthcare, and other essential public services.[17] Furthermore, compliance helps SMEs avoid penalties and maintain a positive reputation with government and business partners, increasing trust and business opportunities.[9]

For both taxpayers and business managers, understanding and literacy in tax regulations are essential. Tax literacy enables SMEs to avoid penalties or fines and helps them claim fair tax entitlements, potentially reducing financial burdens.[18] Additionally, Faizal et al. (2017) argue that trust in tax authorities and the government significantly influences compliance levels. When tax authorities act fairly, transparently, and responsibly, taxpayers are more inclined to fulfill their tax obligations. An equitable tax system further ensures that all taxpayers adhere to the same rules, creating a level playing field for businesses (Batrancea et al., 2019).

Tax Literacy and *Tax Compliance*

According to De Clercq (2023), tax literacy encompasses knowledge of tax regulations, rights, and the ability to correctly fulfill tax obligations. For SMEs, tax literacy includes understanding the types of taxes, reporting procedures, tax payments, and available tax incentives.[21] A high level of tax literacy can help business owners avoid errors in tax reporting and payments that could result in penalties. Moreover, tax literacy fosters compliance by enabling taxpayers to meet their obligations accurately.[4] Nalukenge et al. (2015) emphasize that tax literacy not only helps SMEs avoid legal and financial issues but also enhances their reputation with tax authorities and business partners.

The influence of tax literacy on compliance is evident in studies by Nichita et al. (2019), which suggest that tax literacy shapes social representations of tax mechanisms, thereby encouraging compliance. Simorangkir (2024) echoes these findings, demonstrating that tax literacy positively affects MSME tax compliance. Companies with strong tax literacy are better positioned to adhere to regulations and leverage available tax incentives to improve their financial performance. Based on these findings, the hypothesis is as follows:

H1 : Tax literacy has a significant positive impact on tax compliance.

Tax Knowladge and Tax Compliance

Bornman & Ramutumbu (2019) define tax knowledge as the understanding taxpayers possess regarding tax rules, policies, and procedures. This includes comprehension of obligations, calculations, and procedures within the tax system. Within the tax system, resource constraints often lead to errors in both tax payment and reporting, especially for SMEs [13]. Adequate tax knowledge helps reduce these errors, leading to higher compliance levels among taxpayers. Research by Hardika et al. (2021) supports this, finding that tax knowledge significantly enhances tax compliance. Musimenta (2020) also underscores that greater tax knowledge enables taxpayers to minimize reporting errors and voluntarily comply with tax obligations. Accordingly, the following hypothesis is proposed:

H2: Tax knowledge has a significant positive effect on tax compliance. Tax Fairnes and Tax Compliance.

Menurut Farrar et al. (2020) define tax fairness as taxpayers' perception of equity within the tax system. Sheffrin (2013) identifies dimensions such as horizontal equity (taxpayers with equal abilities pay equally), vertical equity (taxpayers with different abilities pay proportionately), and procedural fairness (fair treatment in tax enforcement). In the SME sector, tax obligations can seem disproportionately burdensome compared to larger enterprises. Perceptions of inequity can reduce SMEs' motivation to comply with tax obligations.[9] However, when SMEs perceive the tax system as fair, they are more likely to voluntarily fulfill their obligations.

Prior studies demonstrate the direct impact of tax fairness on compliance levels.[27] Farrar et al. (2019) found that taxpayers who perceive the tax system as fair are more inclined to comply. Taing & Chang (2021) confirm this, showing that procedural and distributive fairness increase voluntary compliance. Appiah et al. (2024) also corroborate that when taxpayers perceive fairness and transparency, they are more likely to comply. Therefore, we propose:

H3: Tax fairness has a significant positive effect on tax compliance. Trust and Tax Compliance.

Andrew (2002) defines trust as the belief in the integrity and honesty of others to act in accordance with social norms and responsibilities. In the context of taxation, trust stems from the authority's fair practices and provision of necessary legal protections.[31] In some sectors, trust plays a critical role as it often serves as a scarce resource for navigating complex tax regulations, especially within SMEs. Brunetto & Farr-Wharton (2007) highlight that strong trust in tax authorities helps SMEs feel more comfortable in their interactions with officials, alleviating concerns about unintended non-compliance consequences.

Prior studies underscore the importance of trust in tax compliance. Faizal et al. (2017), found that trust significantly influences compliance levels. Batrancea et al. (2022) further affirm that trust in tax authorities strongly correlates with compliance, as taxpayers feel more motivated to fulfill their obligations when they are treated fairly and according to established standards. Gobena & Van Dijke (2017) add that trust-based approaches to compliance are more effective than coercive methods. Based on these insights, the following hypothesis is proposed:

H4: Trust has a significant positive effect on tax compliance. Power and Tax Compliance.

According to Wrong (2017), power is defined as the ability of an individual or group to influence or control others' actions, decisions, and behaviors. The concept of power comprises five bases: legitimate, reward, coercive, expert, and referent power. In the SME sector, power plays an essential role in ensuring tax compliance. Inasius (2019b) notes that business owners with a deep understanding of tax regulations and formal authority in their business operations are more likely to comply with tax obligations. Batrancea et al. (2022) highlight that power has a substantial influence on tax compliance, as the combination of authoritative power and supportive measures from tax authorities fosters higher compliance rates. This aligns with Taing & Chang (2021), who emphasize that the effective exercise of power by tax authorities can enhance compliance levels by establishing trust through fair and supportive interactions. The hypothesis proposed is as follows:

H5: Power has a significant positive impact on tax compliance. Trust in Goverment and Tax Compliance.

Thomas (1998) describes trust in government as public confidence in the government's competence, integrity, and goodwill in fulfilling its duties. Trust in government encompasses the belief that governmental actions serve the public interest and are implemented fairly.[37] In business contexts, SMEs often rely on supportive government policies for growth, including access to financing, tax incentives, and legal protection.[38] Trust in government influences SMEs' perspectives on their obligations, including tax compliance. Batrancea et al. (2019) assert that when SMEs trust the government to act responsibly and equitably, they are more inclined to comply with tax regulations.

Research by Taing & Chang (2021) underscores that trust in government significantly affects tax compliance, with taxpayers who have high trust in government more likely to fulfill their tax obligations. Appiah et al. (2024) also found that perceived government fairness enhances taxpayer trust and compliance. Aktaş Güzel et al. (2019) similarly argue that when taxpayers perceive government actions as fair and funds are used for public welfare, compliance intentions increase. Based on these findings, the hypothesis is:

H6: Trust in government has a significant positive impact on tax compliance.

METHOD

Data Collection

Data were collected from various SME owners in Indonesia. This study gathered data from 349 SME owners across various regions in Indonesia, employing a convenience sampling technique to access respondents efficiently (See table 1). Data were collected from January to July 2024 through a structured questionnaire distributed via email and other social media platforms, ensuring broad and accessible reach to participants. Respondents were assured of confidentiality for all responses provided. The sample included diversity in gender, educational background, geographic representation across multiple Indonesian islands, employee count, monthly income levels, and tax identification number (NPWP) registration status. This convenience sampling approach enabled access to participants who were readily available and willing to respond, especially those with relevant tax knowledge and SME management experience. This approach provided practical insights into the Indonesian SME sector while accommodating the study's time and resource limitations.

Scale Development

The questionnaire consisted of seven sections: tax compliance, tax knowledge, tax fairness, trust, power, tax literacy, and trust in government. All questions were adapted from previous studies and modified to suit the SME context in Indonesia. Section 1 assessed tax knowledge within SMEs using three items adapted from.[40] Section 2 measured perceptions of tax fairness in SMEs with four items, modified from Nartey (2023). Section 3 evaluated the level of trust in SMEs using three items modified from Inasius (2019b). Section 4 gauged perceived power with four items, based on Inasius (2019b). Section 5 assessed tax literacy with four items, adapted from Resmi et al. (2019). Section 6 measured trust in government with three items, adapted from Khozen & Setyowati (2023). Finally, Section 7 evaluated tax compliance with four items, modified from Nartey (2023). A five- point Likert scale was employed, ranging from "strongly disagree" to "strongly agree," to measure each variable.

Table 1. Demographic Composition of Respondents

Demographic Characteristic	Category	Frequency (n)	Percentage (%)
Gender	Male	178	51,0 %
	Female	171	49,0 %
Educational Level	High School	85	24,4 %
	Associate Degree	92	26,4 %
	Bachelor's Degree	104	29,8 %
	Master's Degree	68	19,5 %

https://doi.org/10.56294/sctconf20251364

Region (Island)	Java	125	35,8 %
	Sumatra	89	25,5 %
	Kalimantan	45	12,9 %
	Sulawesi	50	14,3 %
	Bali & Nusa Tenggara	40	11,5 %
Employee Count	1-5 Employees	120	34,4 %
	6-10 Employees	110	31,5 %
	11-20 Employees	60	17,2 %
	> 20 Employees	59	16,9 %
Monthly Income	< IDR 10 million	95	27,2 %
	IDR 10-20 million	105	30,1 %
	IDR 20-50 million	80	22,9 %
	> IDR 50 million	69	19,8 %
Tax Identification Number (NPWP) Registration	Yes	250	71,6 %
	No	99	28,4 %
Total		349	100 %

Data Analysis

Structural equation modeling (SEM) was utilized to analyze the data, employing SPSS 26.0 and SmartPLS 4 software. Measurement and structural models were tested following guidelines by Henseler et al. (2016) dan Hair et al. (2022). The initial phase involved reliability and validity testing using Cronbach's alpha for internal consistency, composite reliability, and Average Variance Extracted (AVE) to verify convergent validity. Discriminant validity was assessed using the Heterotrait-Monotrait Ratio (HTMT). In the second phase, the structural model was evaluated using path analysis to test hypotheses on the direct impact of independent variables on tax compliance. Model fit was assessed using indicators like adjusted R^2 and effect size (f^2). Hypothesis testing involved a Bootstrap resampling method with 5000 samples to determine the significance of direct and indirect paths. Path coefficients, p-values, and t-statistics were presented to support the findings.

RESULTS

Measurement Model Evaluation

The measurement model evaluation involved four key assessments: indicator reliability, internal consistency reliability, convergent validity, and discriminant validity (Hair et al., 2022). The first step was evaluating indicator reliability through outer loading values. As shown in table 2, outer loadings exceeded 0,70, indicating that each indicator significantly contributed to explaining the latent constructs.[45] Next, internal consistency reliability was confirmed, with composite reliability and Cronbach's alpha values above 0,70, affirming indicator reliability for each construct (Hair et al., 2022).

Convergent validity was confirmed with AVE values greater than 0,50, indicating robust convergent validity per Hair et al. (2022) recommendations. Discriminant validity was assessed using HTMT, representing the extent to which each construct explained the variance of its indicators compared to other constructs (Hair & Alamer, 2022). Table 3 shows HTMT values below 0,90, confirming that the data were valid and suitable for further analysis.

Table 2. Outer Loadings and Reliability

Variables	Item	OL	α	CR	AVE
Power	P1	0,875	0,928	0,949	0,822
	P2	0,929			
	P3	0,904			
	P4	0,918			
Trust	T1	0,915	0,935	0,959	0,885
	T2	0,95			
	T3	0,957			
Tax Compliance	TC1	0,94	0,937	0,955	0,843
	TC2	0,958			
	TC3	0,942			
	TC4	0,827			
Tax Fairness	TF1	0,864	0,879	0,903	0,701
	TF2	0,863			

	TF3	0,716			
	TF4	0,894			
Trust in Government	TG1	0,931	0,886	0,929	0,814
	TG2	0,883			
	TG3	0,892			
Tax Knowledge	TK1	0,885	0,910	0,944	0,848
	TK2	0,937			
	TK3	0,939			
Tax Literacy	TL1	0,820	0,904	0,925	0,756
	TL2	0,807			
	TL3	0,920			
	TL4	0,925			

Table 3. Discriminant Validity Assessment

Variables	P	TC	TF	TK	TL	T	TG
Power							
Tax Compliance	0,702						
Tax Fairness	0,058	0,065					
Tax Knowledge	0,595	0,634	0,048				
Tax Literacy	0,064	0,072	0,040	0,048			
Trust	0,598	0,711	0,060	0,763	0,124		
Trust in Government	0,724	0,799	0,064	0,707	0,054	0,768	

Structural Model Evaluation

Following the evaluation of the measurement model, the next step involved hypothesis testing within the structural model, covering Collinearity Indicator (VIF), Path Coefficients, Coefficient of Determination (R^2), and Effect Size (f^2). The Collinearity Indicator test ensures no multicollinearity issues exist between the constructs. According to Becker et al. (2015), a VIF value below 5 serves as the threshold. Table 4 shows that VIF values in this study remained below 5, indicating no multicollinearity issues among the constructs.

The structural model analysis revealed varied relationships between each predictor and tax compliance among SMEs. Power was a significant predictor of tax compliance (ß=0,267, t=5,143, p < 0,001), emphasizing that perceived authority or influence from tax authorities directly enhances compliance among SMEs. This finding aligns with Inasius (2019b), highlighting the effectiveness of authoritative measures in tax regulation, which correlates positively with SMEs' compliance behavior. Furthermore, Trust in Government was identified as the strongest predictor of compliance (ß=0,359, t=5,444, p < 0,001), suggesting that SMEs' trust in fair and beneficial government policies significantly influences their willingness to comply with tax obligations (Appiah et al., 2024; Aktaş Güzel et al., 2019). It can be concluded that H3, H4 and H5 are accepted.

Conversely, Tax Knowledge did not significantly predict compliance (ß=0,052, p=0,340), implying that knowledge alone may not suffice to enhance tax adherence among SMEs, a finding corroborated by Musimenta (2020). Similarly, Tax Fairness showed a non-significant effect (ß=- 0,003, p=0,954), diverging from previous studies by Farrar et al. (2020) and Sheffrin (2013), which emphasize fairness as essential for taxpayer compliance. This difference may stem from SMEs prioritizing trust and authority over fairness as motivators for compliance. Therefore, it can be concluded that H1, H2 and H3 are rejected.

Effect size (f^2) was used in SEM analysis to assess each exogenous construct's contribution to the endogenous construct by recalculating R^2 after excluding one exogenous construct at a time. According to Cohen (1988), an effect size of 0,02 is considered small, 0,15 medium, and 0,35 large. In this study, certain constructs had effect sizes ranging from 0,053 to 0,133, indicating small effects. However, other constructs had f^2 values from 0,000 to 0,003, indicating negligible or no effect.

Table 4. Path Coefficients, Collinearity Statistics and Effect Size

	ß	T-statistics	P-values	VIF	f^2
Power -> Tax Compliance	0,267	5,143	0,000	1,878	0,100
Tax Fairness -> Tax Compliance	-0,003	0,058	0,954	1,009	0,000
Tax Knowledge -> Tax Compliance	0,052	0,954	0,340	2,212	0,003
Tax Literacy -> Tax Compliance	0,015	0,443	0,658	1,025	0,001
Trust -> Tax Compliance	0,228	3,248	0,001	2,589	0,053
Trust in Government -> Tax Compliance	0,359	5,444	0,000	2,550	0,133

https://doi.org/10.56294/sctconf20251364

DISCUSSIONS

The findings provide insights into the behavioral drivers of tax compliance among SMEs. Trust in Government emerged as the most influential predictor, underscoring the critical role of trust in fostering compliance. This reinforces the notion that when government actions are perceived as fair, transparent, and beneficial, SMEs are more likely to voluntarily comply with their tax obligations (Appiah et al., 2024). Building a strong foundation of trust in government could be a cornerstone for improving compliance rates among SMEs in Indonesia. The significant impact of Power on compliance further suggests that SMEs respond positively to clear authority. This finding supports Inasius (2019b) and suggests that a balanced approach combining enforcement with supportive interactions from tax authorities can effectively improve compliance rates. Trust in tax authorities also plays a pivotal role, as the significant positive relationship indicates that when SMEs perceive tax authorities as reliable and fair, they are more likely to comply with tax obligations voluntarily. This finding aligns with prior studies, which emphasize the role of trust in reducing perceived risks and compliance burdens, ultimately encouraging adherence to tax regulations (Faizal et al., 2017; Batrancea et al., 2019).

Unexpectedly, neither Tax Literacy nor Tax Knowledge significantly influenced compliance. These findings suggest that, although SMEs may possess tax knowledge and literacy, these factors alone are insufficient motivators without accompanying trust or perceptions of fairness. Notably, the negative relationship between tax literacy and compliance may indicate that increased awareness of tax complexities or system inefficiencies could diminish compliance intentions, as SMEs become more critical of the system's fairness or efficiency (Agusti & Rahman, 2023; Batrancea et al., 2019). The lack of significance for Tax Fairness further suggests that SMEs might prioritize other factors, such as trust and authority, over fairness when it comes to compliance. This insight emphasizes the potential effectiveness of focusing on trust-building measures over fairness perceptions to enhance compliance, particularly in developing countries where SMEs face distinct resource limitations.

While this study makes significant contributions, several limitations warrant consideration. First, its cross-sectional design restricts the ability to establish causal relationships between variables. Future research could adopt a longitudinal approach to capture changes in compliance behavior over time. Second, the sample is limited to Indonesian SMEs, which may limit the generalizability of findings to other contexts, particularly in developed countries with different tax systems and regulatory environments.

CONCLUSIONS AND FUTURE RESEARCH

This study offers valuable insights into the factors affecting tax compliance among SMEs in Indonesia, focusing on the roles of tax literacy, knowledge, fairness, power, and trust. Of these factors, Trust in Government emerged as the most significant predictor, followed by Power and Trust in Tax Authorities. These findings emphasize the importance of building trustworthy relationships between the government and SMEs, as well as the strategic use of authority to foster voluntary compliance. Interestingly, tax literacy and tax knowledge were not found to significantly impact compliance, suggesting that while knowledge is vital, it must be complemented with trust and supportive measures to drive compliance behavior among SMEs. Similarly, perceptions of fairness did not significantly influence compliance, indicating that SMEs may prioritize motivators such as trust and authority over fairness considerations.

This study provides both theoretical contributions and practical implications. For policymakers, prioritizing Trust in Government and Trust in Tax Authorities could be key. Enhancing transparency, improving communication, and ensuring fair treatment could all encourage higher compliance rates. Developing educational programs that go beyond basic tax knowledge to emphasize the benefits of compliance and foster trust with tax authorities may also prove beneficial. Additionally, the significance of Power suggests that well-defined and consistent enforcement policies, paired with supportive interactions, could effectively encourage SMEs to meet their tax obligations.

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FINANCING
None.

CONFLICT OF INTEREST
None.

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