

# Factors Influencing Tax Compliance among Small and Medium Enterprises in Sri Lanka

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**Abstract:** *Small and Medium Enterprises sector is an important sector for tax collection purposes in Sri Lanka so that, researching this particular area is crucial for tax authorities to become more sensitive to the needs of SMEs when introducing or changing tax policies. This study aims to establish factors affecting the level of tax compliance by Small and Medium Enterprises. The main objectives of the study include establishing the influence of tax rates, availability of tax information, attitudes, country's legal framework and cost of tax compliance among Small and Medium Enterprises. The study adopts a descriptive research design involving a quantitative research methodology. The target population was 2,945, out of which a sample size of 196 respondents was drawn, using a simple random sampling technique. Questionnaires were used to collect primary data from the respondents, which were analyzed using SPSS applying both descriptive and inferential statistical tools. There were positive relationships exist between the tax rate ( $r = .013$ ), tax information ( $r = .290$ ) and the attitudes ( $r = .546$ ) with the level of tax compliance however, there were negative relationships exist between the legal framework ( $r = -.162$ ) and the cost of tax compliance ( $r = -.010$ ) with the level of tax compliance. The findings showed that tax information, taxpayers' attitudes and the legal framework had significant relationships with the level of tax compliance. It is recommended that the tax system should provide a clear and simple guideline on how to complete tax returns but also should provide proper training and education to enable taxpayers to understand their rights and obligations as taxpayers. Further, it is also important to maintain a uniform penalty structure to enhance their level of tax compliance.*

**Keywords:** Small and Medium Enterprises, tax, tax compliance, tax evasion

## 1. Introduction

Tax non-compliance has been becoming the key area that almost all the governments and the tax collecting bodies in the world must be addressed. It has been revealed that net tax in default in Sri Lanka as of 31.12.2016 was nearly Rs 18,808 million which represented approximately 3% of the total tax collected in the same year. It has been further noticed that even though necessary steps have been taken to the recovery of tax in defaults, a considerable amount of taxes remains in default (Performance Report (CGIRSL, 2016). The Department of Inland Revenue (DIRSL) in Sri Lanka has engaged in an integrated mechanism involving both facilitation and enforcement measures to enhance the level of tax compliance. The facilitation measures including such things as providing the facility to submit the returns of Value Added Tax, Nation Building and Withholding Tax through their e-Service. On the other hand, the enforcement measures including such things such as regulating tax audits, imposing additional taxes on tax arrears, etc. In addition to that, the government passed a new Inland Revenue Act in the parliament in 2017 (Act No: 24 of 2017), which has been continued since 1st-April-2018. Under the new Act, the government aims to modernize rules to address tax erosion, fight against tax avoidance and reduce complexity through a principles-based drafting style to increase the government revenue while maintaining the higher level of tax compliance among the taxpayers.

### 1.1 Statement of the problem

According to the annual report published by the Central Bank of Sri Lanka in the year 2016, there was a high rate of tax evasion prevailing in the informal sector in Sri Lanka. Although Large enterprises can be able to access too many sources to get necessary instructions to comply with them sometimes, small and medium-sized enterprises do not have such facilities and also due to the financial constraint which

is eventually lead to not comply with the reporting requirements and also payment of taxes on the due dates.

**Table 1.1:** Summary of the default taxes in Sri Lanka as at 31st-December-2016

Type of Tax	Gross taxes in default (Rs.in Millions)	Penalty (Rs.in Millions)	Disputed taxes (Rs.in Millions)	The penalty related to disputed taxes (Rs.in Millions)
Income tax	101,493	58,681	94,413	56,147
VAT	50,903	35,921	43,773	31,016
ESC	4,185	3,488	3,395	2,958
NBT	6,559	5,040	4,086	3,684

According to the above table 1.1, it has been seen that though necessary steps have been taken to recovery of tax in defaults, considerable amount of taxes still remains in default and also it has been further revealed that net tax in default as at 31.12.2016 was Rs 18,808 million which represented nearly 3% of the total tax collected in the year 2016 (Performance Report (CGIRSL, 2016).

### 1.2 General Objective

To identify the factors that influences the level of tax compliance among Small and Medium Enterprises.

### 1.3 Specific Objectives

- To judge the impact of the tax rates on the level of tax compliance.
- To judge the impact of the availability of tax information on the level of tax compliance.
- To evaluate how taxpayers' attitudes about tax impact on the level of tax compliance.
- To evaluate the impact of the country's legal framework on the level of tax compliance.

- To evaluate the impact of the cost of tax compliance on the level of tax compliance.

**1.4 Significance and Justification of the Study**

This will become useful for tax administrators to take decisions to formulate new policies and development of the programs. This will become vital to the business community and organization's management teams for purposes of knowing the tax compliance environmental factors and how the conditions can be improved. This is also important for scholars and researchers when developing and advancing their knowledge in the field of tax compliance and administration.

**1.5 Scope of the Study**

This research targeted SMEs operating their businesses in the central province in Sri Lanka however, researcher was exclusively planned to focus on SMEs operating in both Matale and Kandy districts since the diversity of the businesses in terms of different type of industries operating in the NuwaraEliya District was relatively low compared with the other two districts hence, NumaraEliya district was excluded from the sampling.

**2. Literature Review**

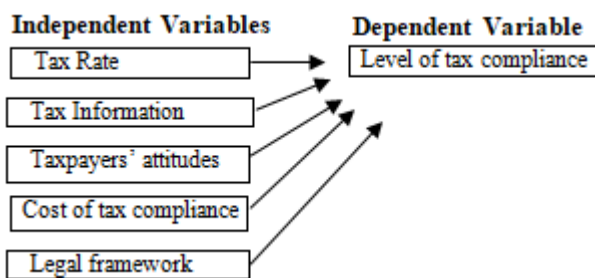
Tax compliance has been defined in various ways by various scholars. According to Roth (1989) defined tax compliance as filing all required tax returns at the proper time and that returns accurately report tax liability by the tax law applicable at the time the return is filed. The detailed summary of the previous empirical evidence can be presented as follows (Table 2.1).

**Table 2.1:** Summary of the Empirical Evidence

Name of the researcher/researchers	Facts Discovered
Sawitri (2017)	Revealed that only 397,000 SMEs who paid taxes from a total of 59 million SMEs in Indonesia.
Baldacchino(2017)	Found that levels of tax collections have remained quite low due to the low level of tax compliance.
Mehari (2017)	Found that tax authority's decision to improving the tax assessment and collection positively affects the voluntary tax compliance of taxpayers.
Angus (2016)	Mentioned the necessity of smooth government's law and regulatory policies
Supriyati (2017)	Highlighted the quality of government services but such efforts have not been able to create voluntary tax compliance behavior.
Institute of Policy Studies in Sri Lanka –IPS (2017)	Discovered that tax compliance appears to be at the minimum level about the Small and Medium Enterprises in Sri Lanka.
International Monetary Fund- IMF (2016)	Emphasized that the existing Inland Revenue Act in Sri Lanka ( No 10 of 2006) reflected a tax system that was highly inefficient to achieve sustainable growth.
Oxford Business Group –OBG (2016)	Highlighted that comprehensive reform is needed if the country is going to effectively deal with its fiscal shortfalls while significantly enhancing the level of tax compliance...

**2.1 Conceptual Framework**

The relationship between the dependent and the independent variables is illustrated in the conceptual framework presented in figure 1 below.



**Figure 1:** Conceptual Framework

relatively low compared with the other two districts hence, Nuwara-Eliya district was excluded from the sampling. The researcher used a simple random sampling technique to select the first sample unit and then the remaining units were automatically selected in a definite sequence of the 15. Therefore, the relevant sample size was 196 organizations, which include small hotels, partnerships, proprietorships, service stations, etc. This study employed a questionnaire as a way of collecting primary data from the respondents. As a part of getting responses from the taxpayers, the researcher was decided to apply both the purposive sampling technique and the snowball sampling technique. The Statistical Package for Social Sciences (SPSS-Version-21) was used to assist in the statistical analysis of the data. In addition to that, both descriptive and inferential statistical tools were used for data analysis purposes.

**3. Research Methodology**

A descriptive survey design technique was selected for this study. This technique was best for this kind of survey because it explains the features attributable to the population. This research aimed SMEs operating their businesses in the central province in Sri Lanka however, researcher was exclusively planned to focus on SMEs operating in both Matale and Kandy districts since the diversity of the businesses in terms of different type of industries operating in the Numara Eliya District was

**4. Research Findings and Discussion**

**4.1 Response Rate**

The study aimed at 196 respondents in collecting data about the factors which influence tax compliance among Small and Medium Enterprises in both Matale and Kandy districts in the central province. Out of the 196 questionnaires issued, 150 were returned, giving a 76% response rate, as shown in Table 4.1 below.

**Table 4.1:** Response Rate

Name of the respondents	Questionnaires administered	Questionnaires Filled and Returned	Percentage
Registered SMEs Taxpayers	196	150	76%

#### 4.2 Analysis of the demographic information

**Table 4.2:** Results of analysis of demographic information

Demographic category	Frequency	Percentage	P-value
<b>Position of the respondent</b>			
Business owner	47	31.3%	
Managing Director	31	20.7%	
Finance Manager	14	9.3%	.000
Accountant	41	27.4%	
Others	17	11.3%	
<b>Age</b>			
Less than one year	13	8.7%	
1-5 years	41	27.3%	.000
6-10 years	49	32.7%	
More than 10 years	47	31.3%	
<b>Type of business activity</b>			
Manufacturing	34	22.7%	
Hotel	27	18%	
Construction	34	22.7%	.002
Trading-( Buying and selling	40	26.7%	
Others	15	10%	
<b>Situation</b>			
Due to the lack of basic tax knowledge	23	15.3%	
Need to comply with tax rules and regulations	70	46.7%	
Need to submit the return on time	18	12%	.001
Need to pay taxes on time without penalties	34	22.7%	
Others	5	3.3%	

As per the above table 4.2, since the p-value under each demographic category is less than the Alpha value of 0.05 therefore, there are differences between the groups regarding the level of tax compliance. Out of the 150 respondents, 31.3% were Business owners, 20.7% were Managing directors, 9.3% Finance managers, 27.3% Accountants while 47 companies are more than 10 years old and 49 business entities are between 6-10 years. 34 business entities are

operating in the manufacturing sector and exactly 27 companies engage in the hotel industry. Around 46.7% of the respondents seek instructions from the external tax experts because they need to comply with tax rules and regulations. Nearly 22.7% of the respondents seek help from external tax experts because of the need to pay their taxes on time to avoid the possible tax penalties.

#### 4.3 Analysis of the reliability tests

**Table 4.3:** Results of the reliability tests

Variable	Cronbach alpha value
Tax rate	0.603
Tax information	0.787
Taxpayers' Attitudes	0.790
Legal Framework	0.617
Level of tax compliance	0.796
Cost of tax compliance	0.675

According to the above table 4.3, Cronbach alpha value for each variable was at the acceptable level hence, existed consistent relationships between the variables.

4.4 Descriptive analysis

Table 4.4: Results of the descriptive statistics analysis

Variable	Mean	Standard deviation	Remarks
Tax rate	Between 2.06 and 3.86	0.250 -. 955	Most of the respondents mentioned that tax rates and tax penalties are very high at the moment. Most of the responses justify the need to implement a uniform tax rate for all companies.
Tax information	Occur between 2.79 and 3.53	0.865-1.012	Most of the responses highlighted the necessity of tax law to become more simplified. The majority of the respondents emphasized greatly that they didn't have enough sources to update their tax knowledge.
Taxpayers' Attitudes	Exist between 2.20 and 3.92	0.712-1.14	A large number of respondents justify significantly the need to disclose all the income sources in the tax return as well as to pay the correct amount of tax. A significant number of responses show the need to change the present tax system in a way that enhances the level of tax compliance.
Legal Framework	Between 2.86 and 3.58	0.634-0.887	Most of the taxpayers mentioned that conducting tax audits are reasonable at a higher level, but their responses to the effectiveness of the appealing process are not at the same as the former one.
Level of tax compliance	Occur between 2.10 and 3.88	0.802-1.13	Most of the responses exhibit that taxpayers prefer to pay their taxes on time if there is a fair tax system in place in a country. Most of the taxpayers do not like to accept tax evasion as an ethical practice.
Cost of tax compliance	Between 2.74 and 3.68	0.451-0.603	Most of the taxpayers believe that most of the time high cost of tax compliance leads to their tax non-compliance decision significantly. The high number of responses also shows that the majority of taxpayers prefer to become more tax-compliant when the cost of tax compliance is low.

4.5 Analysis of the results of the correlation test

Table 4.5: Results of the correlation test

Variable	Tax rate	Tax information	Taxpayers' attitudes	Legal framework	Level of tax compliance	Cost of tax compliance
TR	1					
TI	.079 Sig. (2-tailed) .338	1				
Att	.025 Sig. (2-tailed) .759	.489 .000	1			
Legal	-.175 Sig. (2-tailed) .032	-.051 .532	.032 .697	1		
TC	.013 Sig. (2-tailed) .878	.290 .000	.546 .000	-.162 .047	1	
CT	.520 Sig. (2-tailed) .000	-.050 .543	.043 .605	.264 .001	-.010 .899	1

(TR=tax rate, TI=tax information, Att= Attitudes, Legal= legal framework, TC= level of tax compliance, CT= cost of tax compliance). According to the above table-4.5, which reveals that Coefficients for tax rate and the tax information are .013 and 0.290 respectively, which mean r values are less than 0.3 therefore, there is a lower level of positive correlation between the level of tax compliance and the tax rate as well as the level of tax compliance and the tax information. However, the coefficient for taxpayers' attitudes is .546 which means r value is more than 0.5 hence; there is a higher level of a positive correlation between the level of tax compliance and the taxpayers' attitudes. The coefficients for a legal framework and the cost of tax compliance are -.162 and -.010 respectively hence, there is a lower level of negative correlation between the level of tax compliance and the legal framework as well as with the cost of tax compliance because r value is in between -.3 and -.1.

4.6 Analysis of the results of the Regression Model and Multicollinearity Analysis

Table: 4.6 Results of the Regression Model and Multicollinearity Analysis

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig	Tolerance	VIF Value
	B	Std. Error	Beta				
Constant	1.649	0.46		3.588	0		
TR	-0.076	0.096	0.069	-0.797	0.427	0.614	1.629
TI	0.021	0.072	0.023	0.292	0.771	0.741	1.349
Att	0.655	0.095	0.541	6.898	0	0.753	1.328
Legal	-0.209	0.077	-0.206	-2.701	0.008	0.796	1.257
CT	0.083	0.126	0.058	0.656	0.513	0.589	1.698

According to the above-given table-4.6, which shows that P-values for tax rate- (TR), tax information-(TI) and the cost of tax compliance-(CT) are ( 0.427,0.771and 0.513) respectively which are greater than the alpha value of 0.05.

Therefore, there are no significant relationships that exist between the level of tax compliance and each of these independent variables further when the tax rate increase by one unit, this would result in the level of tax compliance is reduced by (.076). However, when increasing the availability of the tax information and the cost of tax compliance, which result in the level of tax compliance is increased by .021 and .083 respectively. P- values for taxpayers' attitudes and legal framework are .000,.008 respectively however, each of these values is less than the alpha value of 0.05. Therefore, there is a significant relationship exist between the level of tax compliance and each of these two independent variables. In addition to that, when tax law becomes more complex to the taxpayers, then this would lead to reducing the level of tax compliance by -.209 however, when the taxpayers' attitudes towards the tax system improve, which is lead to increase the level of tax compliance by .655. Meanwhile, the tolerance values are

higher than 0.10 and the VIF (variance inflation factor) values for each relationship are between 1.257 and 1.698. Thus, there is no evidence for suspecting multicollinearity between the variables further according to the table-4.6, shows that some of the predicted parameters in connection with the independent variables were significant with taxpayers' attitudes contributing 65.5% and the cost of tax compliance 8.3% to the level of tax compliance.

**5. Summary, Conclusions, and Recommendations**

**5.1 Summary**

Relying on the responses given by the respondents, the researcher came up with the following findings as shown in the below table 5.1, which were used to make the conclusions and the recommendations.

**Table 5.1:** Results of the evaluation of the hypotheses

Variable	Hypotheses Statement	Outcome (As per Correlation Matrix)	Outcome (As per the Regression Model)
Tax Rate	(H <sub>1</sub> ) -There is a relationship between the tax rate and the level of tax compliance among the SMEs in the central province in Sri Lanka.	There is a relationship between the two types of variables but not a significant one.	Not supported ( Non-existence of significant relationship).
Tax information	(H <sub>2</sub> ) -There is a relationship between the tax information and the level of tax compliance among the SMEs in the central province in Sri Lanka	There is a significant relationship exist between the two types of variables.	Not supported (Nonexistence of significant relationship)
Taxpayers' attitudes	(H <sub>3</sub> ) -There is a relationship between the taxpayers' attitudes and the level of tax compliance among the SMEs in the central province in Sri Lanka.	There is a significant relationship exist between the two types of variables.	Supported ( Exist a significant relationship between the two types of the variables).
Legal Framework	(H <sub>4</sub> ) -There is a relationship between the legal framework and the level of tax compliance among the SMEs in the central province in Sri Lanka	There is a significant relationship exist between the two types of variables.	Supported ( Exist a significant relationship between the two types of the variables).
Cost of tax compliance	(H <sub>5</sub> ) -There is a relationship between the cost of tax compliance and the level of tax compliance among the SMEs in the central province in Sri Lanka.	There is a relationship exist between the two types of variables but not a significant one.	Not supported ( Non-existence of significant relationship)

**5.2 Conclusions**

When the tax rate increase by one unit, this would result in the level of tax compliance is increased by .013 but there was no significant relationship exist between them but according to findings of the regression model, when the tax rate increase by one unit, this would result in the level of tax compliance is reduced by (.076) but this was not a significant relationship. However, when the availability of tax information is high, this would lead to an increase in the level of tax compliance by .290 however, in this case, there is a significant relationship exist between them but according to the findings of the regression model, when increasing the availability of the tax information, which results in the level of tax compliance, is increased by .021 but there was no significant relationship exists between them. Meanwhile the taxpayers' attitudes towards the tax system improve, which is lead to increase the level of tax compliance by .546 and also exist a significant relationship between them similarly based on the findings of the regression model, whenever the taxpayers' attitudes towards the tax system improve, which is lead to increase the level of tax compliance by .655 and also exist a significant

relationship between them. On the other hand, when tax law becomes more complex to the taxpayers, then this would lead to reducing the level of tax compliance by -.162 and also there was a significant relationship exists between them. According to the findings of the regression model, when tax law becomes more complex to the taxpayers, then this would lead to reducing the level of tax compliance by -.209 and also there was a significant relationship exists between them. When the cost of tax compliance is increased by one unit, which is lead to reduce the cost of tax compliance by -.010 and also no significant relationship occur at this moment, according to the findings of the regression model, while growing expenditure of tax compliance by one percentage, lead to soaring tax compliance at the percentage of .083% but no significant relationship exists.

**5.3 Recommendations**

They should consider introducing a more uniform penalty structure for all types of taxes however; this should be able to meet the annual revenue targets of the government and the higher level of tax compliance and at the same time, to ensure that there are plenty of magazines and other forms of

documents relating to the taxation are available for the SMEs taxpayers to update their knowledge and these should be more easily understandable further, it is also the responsibility of the Revenue authority to take every possible step to ensure that their online system can be accessible to any taxpayers very promptly and also motivate taxpayers to use the online system instead of relying on the manual system. They should re-organize their tax –refund unit to providing more convenient service to the taxpayers.

#### 5.4 Areas for further research

The researcher has several options to conduct similar research such as factors affecting the SMEs taxpayers' level of tax compliance in the other provinces in Sri Lanka, a study on the relationship between voluntary tax compliance strategy and the enforcement-based strategy, and also consider factors which motivate SMEs to be more tax compliant.

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