Factors Influencing Tax Payers' Compliance among Small and Medium Enterprises (SMEs) in Sri Lanka

Article · February 2016

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FACTORS INFLUENCING TAX PAYERS' COMPLIANCE AMONG SMALL AND MEDIUM ENTERPRISES (SMEs) IN SRI LANKA

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1. INTRODUCTION

Tax non-compliance is considered a serious challenge, which slackens income tax administration and tax revenue performance. In Sri Lanka, during the last few decades, the total tax revenue as a percentage of GDP has continued to decline and has accounted for 10.7 percent in 2014 in comparison to 11.6 percent in 2013 (Central Bank of Sri Lanka, 2014). Reducing the loss of revenues losses resulting from non-compliance with tax laws is critical to achieve fiscal objectives. Small and medium enterprises (SMEs) are significant for economic growth and generate taxable income for a country. SMEs are less tax compliant in comparison to large businesses and are considered the 'hard to tax group from the informal sector (Akinboade, 2015). This study was conducted to explore the behavior of Small and Medium Enterprises (SME's) towards tax compliance in Sri Lanka.

2. LITERATURE

According to the existing literature, tax compliance of tax payers is influenced by economic, social and psychological factors (Brook, 2001; Devos, 2008; Kirchler, 2007). Kirchler (2007) and Loo (2005) classify tax compliance factors into four categories, namely (i).economic (ii).social (iii).institutional and (iv). individual. Unlike in other research, this classification is based on an interdisciplinary perspective demonstrating a wider perspective of tax compliance determinants. The economic deterrence theory states that taxpayer's behavior is influenced by factors such as the tax rate determining the benefits of evasion, and the probability of detection and penalties for fraud (Allingham and Sandmo 1972; Becker 1968). And also, there is considerable literature suggesting that the compliance with rules is affected by social norms which have been cited as reasons for high compliance (Elster, 1989; Naylor, 1989). In practice, government responsiveness and fairness have a positive effect on tax reporting behavior as it makes the perception that the government is using the tax revenues for socially desirable purposes. In addition to all other factors, personal attitudes which arise with the effect of economic and political behavior also influences towards tax compliance. It has been found that a more encompassing and legitimate state will lead to higher tax compliance by persuading

taxpayers' positive attitudes and commitment to the tax system, with an accompanying positive effect on tax compliance (Smith, 1992). In the social influence model, compliance behavior and attitudes towards taxation is assumed to be affected by the behavior and social norms of an individual's reference group such as relatives, neighbors and friends (Snavely, 1990). Therefore, the number of people who evade tax, his/her commitment to comply will be weaker due to the negative influence coming from reference group. Nevertheless, the importance of demographic factors towards tax compliance has also been discussed in previous studies. Jackson and Milliron (1986) found that income level has a mixed and uncertain impact on compliance and Mohani (2001) raised a positive relationship between income distribution errors and propensity of tax evading.

3. OBJECTIVE OF THE STUDY

The main objective of this study is to explore the prominent factors influencing tax compliance among SMEs in Sri Lanka.

4. METHODOLOGY

This research is basically a quantitative study that uses deductive approach and was conducted according to a designed frame work with primary data. Since the focus group of the study was SMEs in Sri Lanka, the sample was selected from the Nuwaraeliya District. In order to address the objectives of the study, the relevant areas of literature were reviewed and six factors were taken from three main categories based on which the questionnaire was developed. Only the most suitable variables for the Sri Lankan context were used namely tax amount, perception towards government expenditure, tax payers' attitude, referent group, education level and income level. Structured questionnaires were used as the main research instrument to identify the prominent factors influencing tax compliance among SMEs. Sincetax compliance is a complex behavioral issue and the evasion is an illegal activity, data collection was executed by preserving the confidentiality of the respondents. 350 SME owners were included to the sample and purposive sampling method was used to select all the respondents. Statistical treatment of the data included the use of STATA. Descriptive statistics were used to organize, summarize and describe the collected data and the correlation of tax compliance with each factor was tested. Both based on the conceptual framework and empirical evidence, all six factors employed to construct the model. The model was analysed using the Ordered Logistic Regression technique to determine the significance of factors influencing tax compliance. Tax compliance, the

dependent variable, was measured through a composite index. Based on the composite index value, taxpayers (respondents) were grouped based on three compliance levels. The tax compliance has been modeled as a polytomous outcome with three categories: low compliance, moderate and high compliance. In addition, Cronbach's Alpha was used for assessing the reliability of the questionnaire scored with a Likert-type scale.

5. FINDINGS AND THE DISCUSSION

The study found that the socio-economic-demographic characteristics have a very strong association with tax compliance. The results of the study highlights that the tax compliance of SMEs were quite diverse across respondents and the majority of the respondents demonstrate noncompliance behavior. The finding from the study shows that several factors have a significant positive correlation with tax compliance: tax amount, perceptions towards government spending, referent group behavior and income level of the tax payer. Economic and demographic factors were found to be important determinants of tax compliance in high compliance category. However, a further analysis reveals that, there is a considerable level of factor diversification among the compliance levels in SMEs community in Sri Lanka.

6. CONCLUSION

Since Sri Lanka has not fully captured its potential in taxation and it still suffers from the burden of budget deficit, it is vital to explore ways to enhance its taxation. With its emerging trend of SMEs community in Sri Lanka, the study basically focused on the tax compliance of SME owners. The study concerned those factors that influence tax compliance mainly from economic, social and demographic backgrounds. The concise conclusion of the study revealed that tax compliance of SME owners was influenced significantly by three factors: the propensity of being positive at government expenditure pattern, low tax avoidance/ evasion tendency of referent group and earning comparatively low income. They are found as prominent factors that are more likely to deliver the desired increase in tax compliance. In particular, high amount tax payers are more sensitive towards government policy implementation patterns and the way the government uses their tax money. Also, those who earn more income tend to hide their actual income as they are more concerned with investing to expand their business rather than allocating more on taxes. Nevertheless, results are also consistent with prior studies on this taxation in different contexts.

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