

# DETERMINANTS OF TAX COMPLIANCE AMONG SMALL AND MEDIUM SIZED ENTERPRISES IN SRI LANKA

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**Abstract**— Tax compliance is imperative to any nation since it determine, slackens income tax administration and government tax revenue. This study is about the “Determinants of tax compliance among Small and Medium sized Enterprises (SMEs) in the Colombo district”. The SMEs are considered as the backbone of the any economy and it provides a significant contribution to the government tax revenue. Hence the main purpose of this research is to analyse the impact of demographic factors, tax payers understanding of the tax laws, government accountability and perception on tax system on the SME tax compliance.

The current study has gathered the primary data from 120 SMEs in Colombo district by using a questionnaire. It has used descriptive measures, correlation and regression analysis to analyse the data. It has found that the demographic factors are one of the key determinants of the tax compliance. Moreover, the economic and social dimensions also have an impact on the tax compliance among the small and medium sized enterprises.

**Index Terms**— Government revenue, Small and Medium Enterprises, tax compliance, tax system

## 1 INTRODUCTION

Taxation is a system of imposing financial charge or levy on an individual or a legal entity by a state. A sub-national entity could also impose taxes. Taxation is the most important source of revenues for any governments, typically accounting more than 90% of their income. (Central Bank report in Sri Lanka 2017). The remainder of government revenue comes from borrowing and from charging fees for services. Countries differ considerably in the amount of tax they collected.

Taxes can be further divided into direct tax and indirect tax and may be paid in money or as curve labor. The term “tax” can be more precisely defined as a “pecuniary burden laid upon individuals or property to support the government a payment exacted by legislative authority. It can be also said as “an involuntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority” and is “any contribution imposed by government whether under the name of toll, tribute, tall age, gable, impost, duty, custom, excise, subsidy, aid, supply, or other name”.

In addition to using taxation to raise money, governments may raise or lower taxes to achieve social and economic objectives, or to achieve political popularity with certain groups. Taxation can redistribute a society’s wealth by imposing a heavier tax burden on one group in order to fund services for another. Also, some economists consider taxation an important tool for maintaining the stability of a country’s economy.

Small and Medium sized Enterprises (SMEs) is made up of an enterprise which employ less than 300 employees and which have an annual turnover not exceeding Rs.750 Mn. In this context, micro enterprises are also read with SMEs for any policy related measures. (Ministry of Industry and commerce)

Currently the Department of Inland Revenue mainly admin-

istrated following taxes; these are we can identify under the two category. Under the indirect taxes, we can identify Value added tax, turnover tax ext. Under the direct taxes, we can identify Income Tax (Personal and Corporate), Economic Service charge (ESC), Custom Duties, Remittance Tax, Others-Social Responsibility levy etc.

Tax revenue becomes a problem in Sri Lanka. Sri Lankan government estimated tax revenue they cannot collect in estimated level. The importance of tax systems as a major revenue source in a country is undeniable these statistics have evidenced that tax revenues are one of (if not the) main income source for many governments throughout the world but to maximize tax collection and minimize tax evasion among taxpayers is difficult to achieve in practice.

Department of Inland Revenue in Sri Lanka take several step to collecting the tax revenue. It’s very difficult costly situation for department. In this study identify this situation as a problem according to the above reason. In this research question is how to effect tax compliance in this problematic situation. Because the tax compliance is one of the most powerful variable affect for the current practice of taxation in Sri Lanka. As well as looking at taxation revenues, a second way of looking at the overall impact of the tax system is to look at the views of taxpayers based on their perceptions of broad features of the tax system.

### General Objective

To determine the factors affecting on the tax compliance of the small and medium sized enterprises in Sri Lanka.

### Specific Objectives

1. To identify the impact of demographic factors on the tax compliance.
2. To identify the impact of perception on tax system on the tax compliance.

3. To identify the impact of understanding of the tax law on the tax compliance.

4. To identify the impact of tax payers' perception on accountability of the government on the tax compliance.

#### Research Questions

1. What is the impact of demographic factors on the tax compliance?

2. What is the impact of perception on tax system on the tax compliance?

3. What is the impact of understanding of the tax law on the tax compliance?

4. What is the impact of tax payers' perception on accountability of the government on the tax compliance?

## 2 METHODOLOGY

In the current study, all the Colombo district Small and Medium Enterprises are considered as the population of the study. The data which are relating to the study is collected from Department of Censes and Statistic.

To collect enough data to test hypotheses a survey was conducted to collect data from sample. The unit of analysis of this current study is company. Data were collected from the owners of the SME who represents the SME. In total 120 questionnaires were distributed randomly to owners of SME in Colombo district. 100 numbers of owners were asked to fill the questionnaire for each chosen firm. The research will explore primary data information which are collected using questionnaire. Primary data are collected by or on behalf of the person who is going to use the data directly. There are many ways available to get primary data. The study obtains primary data through questionnaires wherever applicable and possible. Primary data are collected at the SMEs' in Colombo district. A questionnaire consist a set of questions presented to a respondent for his or her answer. Under these study questionnaires were issued to the SMEs' owners. The research questionnaire consists of five major sections. They are, Demographic factors, Tax system, Understanding of the tax law, Government accountability, Tax compliance. Most of the questions are structured one with fixed responses alternatives.

Conceptual framework shows the relationship between independent and dependent variables of the research. The dependent variable is tax compliance. There are many factors that affect in tax compliance in SME sector. Among these factors demographic factors, understanding of the tax law, perception on tax system, perception on accountability of the government are independent variables which selected for this research.

Based on the Conceptual Model, it is necessary to construct hypotheses to test the relationship between dependent variables and independent variables to see the validity of the assumptions. The researcher constructs three hypotheses to test the relationship between dependent variables and independent variables.

H1a: In terms of Age of the Firm the tax compliance differs on a statistically significant basis.

H1b: Males and females are different in terms of the tax compliance on a statistically significant basis.

H1c: In terms of educational qualification the tax compliance differs on a statistically significant basis.

H2: Tax payers understanding of the tax laws is significantly effect to the tax compliance.

H3: Perception on tax system is significantly effect to the Tax Compliance.

H4: perception on accountability of the government is significantly to the Tax compliance

#### Variables and Measurement

All the questions in questionnaire are in the statements. All the questionnaires are divided into five parts. The first part of the questionnaire is for the collection of the personal information about the person who fills the questionnaire. Personal information consists of Gender, Educational Qualification, Experience, Sales level, business activity and the other parts are to get the research information about the influence of variable factors. There were five variables considered for this research such as. Demographic factors, Compliance with tax system, Understanding of the tax law, Government accountability, Tax compliance. Based on five variables the relevant numbers of the variables were stated below,

#### Primary data collection method

Variables	Statement Number
Demographic factors	01,02,03,04,05,06
Compliance with tax system	07,08,09
Understanding of the tax law	10,11,12,13,14
Government Accountability	15,16,17,18,19,20, 21,22
Tax compliance	23

(Source: - Author complied 2018)

The study is about the determinants of tax compliance among small and medium sized enterprises in. In order to achieve the objective of the study, to analyze data used Likert scale method.

#### Likert Scale Method Points

Strongly disagree	5
Disagree	4
Neutral	3
Agree	2
Strongly agree	1

(Source: Author survey.2018)

SPSS version 23.0 (Statistical Package for Social Science) Computer Package was used to analyse the questionnaires. Ratio analysis was used to analyse the secondary data. And also graphical analysis could be applied in this research.

#### Primary data evaluation

For the evaluation purpose the evaluations were carried upon the analysis done with the information collected. Unvaried analysis was carried out with the measure of Mean, Standard Deviation, Pie Chart, Bar Chart etc.

#### Analytical Method

The data collected by the researcher are analysed in such a way to make interpretations. The data collected by the researcher are analysed in such a way to make interpretations. Inferential analysis included linear Regression analysis, Descriptive analysis, Correlated, ANOVA, Model summery it interpreted through the Multiple R, R Square, and P- value also the findings of empirical data are presented using charts and graphs. So the collected data are analysed and interpreted

using the following statistical tools and techniques.

#### Reliability Test

Reliability test is measure of reliability obtained by administering the same twice over a period of time to group of individuals. The various multi items are included under the questionnaire in respect to formal accounting and affecting factors. Cronbach's Alpha is the most popular test on reliability in multipoint-scaled items that indicates the correlation between the variables, it is found that 0.6 is considered moderate, 0.7 is acceptable and 0.8 or more will be good. Cronbach's alpha is a reliability coefficient that indicates how well the items are positively correlated to another. The closer Cronbach's alpha is to 1, the higher internal consistency reliability.

#### Descriptive Analysis

For a data set, the mean is the sum of the observations divided by the number of observations. It identifies the central location of the data some time referred to in English as the average. The standard deviation is the most common measure of variability, measuring the spread of the data set and the relationship of the mean to the rest of the data. If the data points are close to the mean, indicating that the responses are fairly uniform, then the standard deviation will be small. Conversely, if many data points are far from the mean, indicating that there is a wide variance in the responses, then the standard deviation will be large. If all the data values are equal, then the standard deviation will be zero.

#### Correlation Analysis

Correlation analysis is used to quantify the association between two continuous variables. In correlation analysis ranges between -1 and +1 and quantifies the direction and strength of the linear association between the two variables. The correlation between two variables can be positive or negative. Correlation between variables is a measure of how well the variables are related. The most common measure of correlation in statistics is the Pearson Correlation, which shows the linear relationship between two variables. Two letters are used to represent the Pearson correlation: Greek letter ( $\rho$ ) for a population and the letter "r" for a sample.

#### One-way ANOVA

In this study the researcher used One-way Analysis of Variance (Anova) as a statistical technique to analyse variation of the tax compliance on the Age of the firm and educational qualification of the manager. Anova is a statistical technique to analyse variation in a response variable which is measured under conditions defined by discrete factor (Larson 2008). Frequently, One-way Anova could be used to test equality among several means by comparing variance among groups relative to variance within groups. One-way fixed-effects Anova model is used to test the null hypothesis that all treatments have the same population mean. The alternative hypothesis is that at least in one population mean differs from the others.

#### Independent Sample t-test

The independent sample t-test is used in situations where two experimental conditions are used. Further, independent samples t-test is used for comparing the means on an interval or ratio variable between two categories on a nominal or ordinal variable. In this study the researcher used independent sample t-test as a statistical technique to analyse vari-

ation of the tax compliance on the gender of the manager.

#### Simple Regression Analysis

Simple regression analysis is an extension of simple linear regression. It is use when want to predict the value of a variable based value of two variables. The purpose of regression analysis is to identify significant value of independent variable on dependent variable. This study is concerned six independents variable and one dependent variable.

$$T_0 = \beta_0 + \beta_1 X_2 + \pi$$

$$T_0 = \beta_0 + \beta_1 X_3 + \pi$$

$$T_0 = \beta_0 + \beta_1 X_4 + \pi$$

$T_0$  -Tax compliance

$\beta_0 - \beta_4$  -regression coefficient of independent variables

$X_2$  - SMEs understanding of the tax laws

$X_3$  -SMEs understanding of the tax systems

$X_4$  - perception on government accountability

$\pi$  -error term, it takes into account all the possible factors that would possibly influence the dependent variable though not captured in the model.

### **3 RESULTS AND FINDINGS**

According to above discussion the study was found out about hypotheses developed in the chapter are accepted or rejected.

H1a: In terms of Age of the Firm the tax compliance differs on a statistically significant basis.

According to this study, the significant value is 0.043. because this result less than 0.05, further accepted hypothesis H1a.

H1b: Males and females are different in terms of the tax compliance on a statistically significant basis.

According to this study the significant value is 0.064. Because significant value more than 0.05, further not accepted hypothesis H1b.

H1c: In terms of educational qualification the tax compliance differs on a statistically significant basis.

According to this study, the significant value is 0.226. Because this result more than 0.05, further not accepted hypothesis H1c.

H2: Tax payers understanding of the tax laws is significantly affect on the tax compliance

The regression coefficient of understanding of the tax law indicates that it has a positive impact on tax compliance, significant value is 0.012. Because this result less than 0.05, further accepted hypothesis H2.

H3: Perception on tax system is significantly affect on the tax compliance

The regression coefficient of perception on tax system indicates that it has a positive impact on tax compliance, significant value is 0.022. Because this result less than 0.05, further accepted hypothesis H3.

H4: perception on accountability of the government is significantly affect on the Tax compliance

The regression coefficient of perception on accountability of the government that it has a positive impact on tax compliance, significant value is 0.003. Because this result less than 0.05, further accepted hypothesis H4.

The Summary of Hypotheses testing

- Hypotheses Result -
- H1a: In terms of Age of the Firm the tax compliance differ on a statistically significant basis. Accepted
- H1b: Males and females are different in terms of the tax compliance on a statistically significant basis. Not Accepted
- H1c: In terms of educational qualification the tax compliance differs on a statistically significant basis. Not Accepted
- H2: tax payers understanding of the tax laws is significantly affect on the tax compliance. Accepted
- H3: Perception on tax system is significantly affect on the tax compliance Accepted
- H4: perception on accountability of the government is significantly affect on the tax compliance Accepted
- (Source: Author complied, 2018)

#### 4 CONCLUSION

The main objective of this study is to determine the factors affecting on the tax compliance of the small and medium sized enterprises in Sri Lanka. The four affecting factors were considered in this study.

In case of the first research objective, based on result of analysis, it can be concluded that some of demographic variables impact on the taxpayer compliance. So 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 demographic factors and other factors. The briefly conclusion of the study revealed that tax compliance of SME owners was influenced significantly by three factors: the propensity of being positive at perception on accountability of the government, perception on tax system, understanding of the tax laws low tax. 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.

#### 5. RECOMMENDATION AND FUTURE RESEARCH

There is need for research focusing on fairness in tax collection and comparative treatments of taxpayers. The authority of the tax governess should provide much more information about tax procedures. Then tax system should be simplified one. Number of customer care centre must be increased above all the recommendations will be increased future tax compliance in Sri Lanka. In this study, tax compliance determinants or indicators were the independent variables. These indicators are affected by various other factors. There is therefore the

need to further investigate the characteristics that affect the independent variables (demographic factors, understanding of the tax law, perception on tax system, perception on accountability of the government) especially the annual macro-economic variables.

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