The impact of income on tax compliance: The empirical evidence from small and medium taxpayers of Sri Lanka

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Abstract

Tax compliance has been examined from various perspectives by researchers since its impact on the economy is vital. This study aims to explore the relationship between the income and the taxpayer's compliance behavior using the assumptions in the Slippery-Slope Framework. The research focuses only on the small and medium level business community in Sri Lanka. The study empirically examines how a taxpayer's income influences tax compliance decisions with the perception of trust in the tax regime's authority and power. A self-administered questionnaire has been distributed to obtain the information needed from the target group and received 408 responses. Kendall's tau-b and Spearman's correlation coefficients were used to measuring the association's direction between two variables. The findings suggest that voluntary compliance has a positive connection, while enforced compliance shows a negative association with the taxpayer's income level. Also, the results prove that the level of income is a determinant of tax compliance. Besides, it has been established that the tax authority should take adequate measures to review the strategies developed to implement tax policy. This Research expects to give an insight into the operations of the revenue authority and decisions taken by policymakers and academics to explore the factors that encourage tax compliance.

Keywords: income level, slippery-slope framework and tax compliance

Introduction

This study examines the influence of small and medium scale business owners' income fluctuations concerning total tax compliance. The research anchors on the Slippery-Slope Framework (SSF) assumptions to forecast the variance of business income levels, which influence tax compliance patterns in respect of voluntary and enforced compliances. The contribution made by the tax revenue in support of the economy of a country is essential. The government utilizes tax money on standard development programs, such as supplying public goods, enhancing infrastructure facilities, and creating competitive business opportunities. Therefore, the government attempts to improve tax compliance practices among the taxpayers by using different game plans. Tax fairness inevitably aims to create a system, equal and

straightforward to all taxpayers. A fair tax system motivates the business community to comply more with the tax laws. In a culture where all similar businesses are treated equally and taxed at a uniform rate, the society would not find any contradictions, prejudices, or biases thrust upon them by the authorities. Simultaneously, the reasoning of taxpayers' ability to pay should be thoroughly examined when drafting the tax policy and the law that shapes and regulates a tax system's fairness. According to Kirchler (2007), taxpayers are concerned with the fairness of the tax system. If they realize the tax system is not fair and far from being transparent, the non-compliance rate will increase accordingly, which invariably would give rise to a negative impact on the volume of state revenue collected. In such a situation, the government forces people to pay taxes. When people understand their responsibilities to the state, they tend to make voluntary contributions to the treasury. Therefore, forging a healthy bond between the taxpayer and the tax authority is essential to improve tax revenue collection. In line with this argument, Gangl, Hartl, Hofmann and Kirchler(2019) opine that thassociation's quality between the taxpayer and the tax collector impacts the revenue collection process.

Research problem

There is no empirical evidence in the literature to provide a conclusive answer to how the level of business income impacts the tax compliance behavior of Small and Medium Enterprise (SME) taxpayers in Sri Lanka. Also, the assumptions of SSF have not been tested in respect of the income level of the SME taxpayer in Sri Lanka. Therefore, this descriptive study attempts to ascertain the influence of the level of business income relying upon the SME taxpayers' perception and their compliance behavior. The compliance behaviour measures in terms of voluntary and enforced. This study focuses on finding answers to the questions given below:

- Is there any relationship between the SME taxpayer's level of income and voluntary tax compliance behavior in Sri Lanka?
- Is there any relationship between the income level and enforced tax compliance behavior of the SME taxpayer in Sri Lanka?

This paper aims to study the impact of the level of income of SMEs on tax compliance patterns in Sri Lanka.

Literature Review
Slippery-Slop Framework (SSF) and tax compliance

The factors influencing the taxpayer's compliance behavior could be identified according to economic, behavioral, and psychological determinants (Kirchler, 2007). The SSF has been developed to discuss the compliance

patterns from economic and behavioral points of view, assuming that the power of the authority and trust in the authority would build up into two different relationships between taxpayers and tax collectors, that illustrates the pattern of tax compliance (Kirchler, 2007). Kirchler, Hoelzl and Wahl (2008) highlighted that tax compliance could occur either voluntarily or by forcing the taxpayer. However, both voluntary compliance and enforced compliance increase the total volume of tax collection (Kastlunger, Lozza, Kirchler & Schabmann, 2013). The high level of faith the taxpayer places in the tax regime, and the government tends to increase voluntary tax compliance volume. Most countries work extensively to develop the taxation strategies focusing on voluntary tax compliance systems because it is very much cost-effective and creates a friendly atmosphere between the taxpayer and tax collector (Hauptman, Gürarda, &Korez-Vide, 2015). However, when taxpayers do not comply with the existing tax law, the tax regime uses the powers vested in them by the government to collect money from the taxpayers, though it generates a hostile environment (Kirchler, Hoelzl & Wahl, 2008).

Level of income and tax compliance behaviour

Taxes are part of the business income. The amount of tax payable is decided by the level of the revenue generated during the period considered. Therefore, among many factors, the income level is also an essential determinant of taxpayers' compliance behavior (Mohammed & Dabor, 2016). The government applies different approaches when imposing taxes to determine how much people should pay according to their earnings. Low-income earners tend to submit incorrect reports and evade tax (Johns & Slemrod, 2008). Contrary, Alm, Mcclelland, and Schulze (1992) found that a high level of business income encourages the business community to pay more taxes to the state. A different view of the income source was pointed out by Kirchler, Muehlbacher, Kastlunger and Wahl (2007) in an experiment conducted to study the impact of hard-earned money and the easy earnings on tax compliance contributions. According to their findings, if income was earned by surmounting many roadblocks and obstacles, reluctance inhibits people on such occasions. Naturally, they would be hesitant to declare the actual amount of income. Ho and Wong (2008) researched the relationship between the level of income and tax compliance and found that income has no direct influence on tax compliance. Similarly, Durham, Manly and Ritsema (2014) concluded the study with the results indicating no significant association between overall compliance and the income source of business. On the other hand, Muzainah and Gurama (2016) found that income level positively and significantly influences on tax non-compliance.

Research Gap

As none of the studies have tested income level concerning tax compliance in Sri Lanka, this study attempts to fill that gap and understand how the level of income impacts SME taxpayers' tax compliance decision.

Methodology

A quantitative research approach was applied in this study. The sample size of four hundred eight respondents has been selected randomly from the total registered SME taxpayers of Inland Revenue as of December 31, 2019. The survey was conducted in January 2020. There were eighteen (18) questions in the survey form, which were used to measure the variables. This paper discusses voluntary compliance and enforced compliance on total tax compliance at different income levels. The respondents' perceptions for the questions were measured using a 5-point Likert scale, in which the level of agreement spread from 1 = strongly disagree to 5 = strongly agree.

Conceptual framework

The framework illustrated in figure1 was developed using SSF assumptions to examine the relationships between the variables of voluntary compliance, enforced compliance, and tax compliance at four different income levels, as indicated in the questionnaire form, i.e., Rs. <100 Mn., Rs. >100-250Mn., Rs. >250-500Mn., and Rs. >500- 750Mn., which is subsequently enumerated as Income Level 1, Income Level 2, Income Level 3, and Income Level 4.
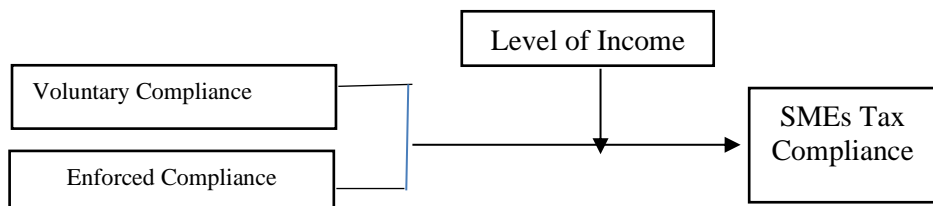

Fig 1. Conceptual Framework

Results and Discussions

The data were analyzed by using SPSS 26 software. The reliability test shows that all three variables, consisting of 18 items in total, have a Cronbach's Alpha of more than 0.6, which means all 18 items in the questionnaire are acceptable and reliable. The groups of data sets proved statistically significant. The factor analysis also confirmed the appropriateness of these groups of data sets with the Kaiser-Meyer-Olkin Measure of Sampling Adequacy value of 0.924 (p<0.001 Bartlett's Test of Sphericity). The Shapiro Wilk test defined that data are reasonable, and the Scatter Plots show that the

data sets are linear and fit for further analysis. However, according to Scatter Diagrams, there are positive correlations (but weak) between power, voluntary compliance, and total compliance, while there are negative (weak) correlations between power and enforced compliance. Therefore, the study used Kendall's tau-b (τ_b) correlation coefficient and Spearman's correlation to measure the strength and direction of associations between two variables. The correlation coefficients shown in Table 1 prove that there are positive (weak) relationships between total compliance and voluntary compliance with SME taxpayers' income level. When the business community earns more income, they are willing to pay more money in taxes to the government. If taxpayers trust the tax regime and receive some sensible things as returns to their tax money, the compliance rate will increase. According to research findings, higher earnings will increase the levels of compliance. When income levels go up, the business owners invariably explore the possibilities of moving towards advantageous and better positions looking for opportunities, betterment, applying new technologies, and improving marketing strategies. A business transformation shift facilitates the companies and businesses to operate smoothly and remain in the competitive market. The high turnover and the reputation and goodwill of the company also contribute to changing the business owners' attitude to become more responsible citizens in society. Therefore, the business earners do not tend to hide the due taxes to the government when they realize that they are a part of the populace that consumes public goods and services in their day to day life.

Table 1. Correlation coefficients for income levels

Income Level	(τ_b)	Spearman's
IL1 / VC /TC	0.192	0.218
IL2 / VC /TC	0.246	0.289
IL3 / VC /TC	0.402	0.455
IL4 / VC / TC	0.412	0.427
IL1 / EC / TC	-0.096	-0.107
IL2 / EC / TC	-0.060	-0.068
IL3 / EC / TC	-0.208	-0.166
IL4 / EC / TC	-0.412	-0.466

Where, IL1=Income Level 1, IL2=Income Level 2, IL3=Income Level 3, IL4=Income Level 4, VC=Voluntary Compliance, EC=Enforced Compliance, and TC=Total Compliance
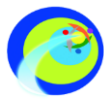
Besides, when business owners want to apply for bank loans, bid for projects, import raw materials required for production, or receive a payment from the government, they must apply for clearance from the tax regime, declaring the actual income concerning the considered period. In a trustworthy tax compliance culture, both taxpayers and tax collectors do not behave in a way that harms the existing tax system. Taxpayers attempt to contribute to the revenue collection process when the government acts reasonably, transparently, and equally treats taxpayers.

Conclusions and Recommendations

This study has examined the influence of business income on tax compliance, and the results show that there is a significant relationship between the level of income and compliance pattern of SME taxpayers in Sri Lanka. Research results imply that the level of income is a determinant of taxpayers' tax compliance pattern. Another finding is that voluntary compliance has a positive effect on tax compliance, revealing that when people earn more, they tend to pay more taxes to the government. On the other hand, enforced compliance shows a negative relationship with tax compliance. Low-income groups would undoubtedly resist being forced to pay taxes and treat them as tax dodgers. When people earn money with much effort, the authorities' enforcement strategies to have their taxes collected would have a severe negative impact. It will undoubtedly make them annoyed, and frustration will go haywire, crippling the system's effects.

Another finding that when the business profit increases, high-income earning taxpayers hire more professional auditors, tax advisors, and qualified accountants to manage their complex transactions and settle the tax-related matters. The high-income groups elicit necessary information and participate in tax awareness programs, in a bid to educate them to steer clear of controversies and go in the right direction. Hence, they do not allow the tax authority to send reminders or take enforcement actions, preferably to pay as per the advice of the professionals involved in the business. These findings will provide essential insights to the policymakers, tax practitioners, academicians, and other responsible authorities engaged in fiscal policy formulations. Notably, the policymakers should focus their attention on reviewing the existing legislation to promote a better tax compliance culture among taxpayers to enhance tax collection efficacy. The academics should measure the impact of voluntary compliance on the revenue generation. The government should fathom the SME taxpayer's psyche and the contribution they make towards revenue collection to better the citizens of the country.

This study is limited to SME taxpayers in Sri Lanka. Therefore, it is difficult to generalize the research to have a holistic view of the entire tax system. Hence, future studies should consider a larger sample size consisting of large taxpayers and self-employed taxpayers.

Acknowledgments

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