

Tax Compliance among Small and Medium Enterprises (SMEs) in Gampaha District, Sri Lanka: An Analysis of Influencing Factors

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A B S T R A C T

Although tax compliance is essential for tax revenue generation, it continues to be a substantial challenge for small and medium enterprises (SMEs) despite the administrative changes, self-assessment mechanisms, and digital tax systems such as the Revenue Administration Management Information System (RAMIS). This study examines the factors influencing tax compliance among SMEs in Gampaha district, Sri Lanka. Specifically, it investigates the effects of tax knowledge, tax morale, tax rates, tax penalties and audits, and trust in the tax authority on tax compliance behaviour. A quantitative cross-sectional design was employed, using data collected from 125 owner-managers of SMEs through a structured questionnaire. The data were analysed using descriptive statistics and multiple regression techniques in IBM SPSS Statistics. The study contributes to empirical literature by demonstrating that enforcement mechanisms and intrinsic morale are primary drivers of compliance in semi-urban commercial hubs, whereas knowledge and trust operate indirectly through external tax intermediaries. The findings revealed that the overall tax morale and tax compliance of surveyed SMEs is low level. Tax morale, tax penalties, and audits are statistically significant predictors of tax compliance, while tax knowledge, tax rate, and trust in the tax authority are not significant direct predictors. The study findings suggest that moral responsibility and enforcement mechanisms are essential to enhance SME tax compliance in Gampaha District. The study offers important policy implications for tax authorities, such as the reinforcement of audit systems, promoting taxpayers' awareness, the ease of procedures, and fostering ethical responsibility among the SME owners.

Keywords: Small and Medium Enterprises (SMEs), Tax compliance, Tax morale, Tax penalties and Audit.

1. Introduction

Taxation serves as the primary source of revenue for governments globally, funding essential public services and development initiatives. In Sri Lanka, Small and Medium Enterprises

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(SMEs) constitute a substantial portion of the economy, contributing approximately 45% of employment and representing more than half of all registered businesses (World Bank, 2020; OECD, 2019). Despite their economic significance, SME tax compliance remains low, negatively impacting government revenue and reducing the nation's tax-to-GDP ratio.

Prior research has examined factors influencing SME compliance in districts such as Colombo, Kegalle, and Matale, identifying determinants such as tax knowledge, tax morale, enforcement mechanisms, and trust in government authorities (Bandara & Balendran, 2024; Weerawickrama & Tilakasiri, 2020; Perera et al., 2020). However, Gampaha District—a highly industrialised and economically active region—has received limited scholarly attention. This lack of district-specific empirical evidence presents a challenge for policymakers and tax authorities seeking to design effective compliance strategies tailored to local SME conditions (Karunarathna & Senani, 2024).

This study aims to address this gap by investigating the behavioural and administrative factors that affect tax compliance among SMEs in Gampaha District. Behavioural factors include tax knowledge, tax morale, and trust in the tax authorities, while administrative factors encompass tax rates, penalties, and audits. Understanding these determinants is crucial for developing evidence-based policies to enhance voluntary compliance, improve revenue collection, and promote a culture of tax responsibility among SMEs.

1.1 Research Problem

1.1.1 Problem statement

Sri Lanka still faces obstacles in tax compliance by SMEs, notwithstanding the implementation of digital tax administration systems such as the Revenue Administration Management Information System (RAMIS). The Inland Revenue Department (IRD) states that there are significant levels of revenue leakages due to the failure of a significant number of SMEs to register or provide accurate reporting on their taxable income, which negatively affects the effectiveness of the national tax system (IRD, 2022).

Recent empirical studies in other districts of Sri Lanka (e.g. Colombo, Kegalle and Matale) have found that tax compliance is influenced by a range of behavioural and administrative factors (Bandara & Balendran, 2024; Karunarathna & Senani, 2024; Perera & Jayasinghe, 2020). However, the Gampaha District is under-researched and is a priority area. Gampaha is a unique socio-economic setting, being a key industrial and commercial centre, combining urban and semi-rural business activities. There is a scarcity of empirical evidence on how these behavioural and administrative factors are playing out at the district level, which makes it challenging for policymakers and tax authorities to grasp how these factors are interacting at the district level. This local insight is essential if policy measures are to be effectively implemented to boost the voluntary compliance of SMEs in the Gampaha District by designing targeted interventions based on evidence of local needs.

1.1.2 Research questions

Main Research Question:

- What are the main factors that influence tax compliance among the small and medium-scale enterprises in Gampaha District, Sri Lanka?

Sub-Research Questions:

1. How do tax knowledge and awareness affect tax compliance among SMEs in the Gampaha District?
2. How does tax morale influence tax compliance among SMEs in the Gampaha District?

3. What is the impact of tax rates on tax compliance among SMEs in the Gampaha District?
4. How do tax penalties and audits affect tax compliance among SMEs in the Gampaha District?
5. How does trust in tax authorities influence tax compliance among SMEs in the Gampaha District?

2. Review of the Relevant Literature

Small and Medium Enterprises (SMEs) play a major role in the economic fabric of Sri Lanka, as they employ people, foster entrepreneurship, and contribute to GDP (World Bank, 2020; OECD, 2019). However, tax advantages do not correspond with the tax observance of SMEs, which consequently leads to a loss of tax revenues for the government and a lack of fiscal stability.

2.1 Theoretical Background

Tax compliance of SMEs can be examined from the economic and behavioural perspectives. Tax compliance is a complex decision-making process for SMEs, with economic and behavioural dimensions. It is, therefore, necessary to have a multi-theoretical approach to fully capture these dynamics. The Economic Deterrence Theory considers compliance from an enforcement and financial risk perspective. The Theory of Planned Behaviour, the Slippery Slope Framework, and the Fiscal Exchange Theory are employed as explanations for compliance, all of which are strong motivators for SME owner-managers. These theories are complementary to provide a comprehensive understanding of the effect of different administrative and behavioural factors on the tax compliance of the Gampaha District.

2.1.1 Theoretical underpinnings

2.1.1.1 Economic deterrence theory

The Economic Deterrence Theory proposes that taxpayers will make rational choices about how much to pay based on their perception of the benefits they might reap from their tax cheating and their estimates of the risks of being caught or the severity of their punishment if they are found (Allingham & Sandmo, 1972). Measures taken to enforce compliance, such as audits and penalties, are aimed at improving compliance, but empirical evidence shows that SMEs in the informal sector may comply to a minimum extent even with the threat of enforcement (Weerawickrama & Tilakasiri, 2020; Dharmakeerthi & Weerathunga, 2022).

2.1.1.2 The Theory of Planned Behaviour (TPB)

TPB proposes that attitude to tax requirements, social norms, and perceived behavioural control (Ajzen, 1991) are factors affecting compliance behaviour. If they think it is socially acceptable and possible, they can make the payments if they are SME owners. However, many SMEs in Sri Lanka rely on external accountants for their accounting, which limits the perceived control they have over compliance, and compliance is not very high (Bandara & Balendran, 2024).

2.1.1.3 Slippery slope framework

The Slippery Slope Framework is a combination of faith in the authorities and enforcement power to decide compliance (Kirchler, 2007). Voluntary compliance works with high trust, and compliance with enforcement power works with fear of punishment. In the Gampaha context, transparency in the revenue collection allocation is lacking, and inequity in such distribution can lead to less voluntary compliance. Hence, the need for institutional trust and good enforcement (Jayawardane & Low, 2016; Jayalath & Wijebandara, 2023).

2.1.1.4 Fiscal exchange theory

Under the Fiscal Exchange Theory, if a taxpayer thinks he or she is fairly treated in exchange for a tax levy, he or she will do what is necessary. Citizens are less likely to comply with the tax laws when there is no transparency or tax collection is inefficient, which makes it less likely that SMEs will comply with the tax laws in districts with low institutional trust (CBSL, 2023).

Tax compliance consists of income reporting, timely filing of taxes, and timely payment of taxes. It is voluntary (intrinsic) or enforced (audits and penalties). Knowledge, moral motivation and trust can have negative effects on compliance and may not be desired voluntarily, with regard to SMEs (CBSL, 2024).

2.2 Empirical Literature on SME Tax Compliance

The empirical papers on tax compliance are reviewed in this section. The key determinants identified from the empirical studies are:

2.2.1 Tax knowledge

Tax knowledge is related to tax laws, tax filing, and reporting requirements. There is a positive relationship between low tax literacy and underreporting and non-compliance among SMEs (Weerawickrama & Tilakasiri, 2020). Financial education is identified as a factor that helps to improve voluntary adherence, showing the potential effectiveness of financial education programs on improving adherence (Bandara & Balendran, 2024).

2.2.2 Tax morale

Tax Morale is the intrinsic motivation to pay taxes deriving from the ethical responsibility and perception of fairness. A country which is characterised by political and economic instability has a low level of trust in government, which in turn can have a negative impact on tax morale and tax voluntary compliance (Jayawardane & Low, 2016; Jayalath & Wijebandara, 2023). Awareness programmes can help to establish moral awareness and lead to greater compliance.

2.2.3 Tax rate

The more a taxpayer feels that a tax rate is high, the less likely he will stick to the rules, and the lower a tax rate is felt, the more likely it is that people will adhere to the rules. Changes in tax rates and policies can also affect SMEs' compliance in Sri Lanka, as the uncertainty arising from the high frequency of tax rate and policy changes can undermine compliance (Bandara & Balendran, 2024; OECD, 2019).

2.2.4 Penalties and audits

While enforcing measures such as audits and fines will improve compliance in the short term, in the long-term measures must be supported by trust and education (Dissanayake & Premaratna, 2022; IRD, 2023).

2.4.5 Fostering trust in tax authorities.

The perception of fairness, transparency and effectiveness of tax authorities has a positive impact on voluntary compliance. A positive attitude in SMEs towards fair and effective use of tax revenue is more likely to result in compliance with tax laws (Jayawardane & Low, 2016; IMF, 2023).

2.3 Literature Gaps

Most previous studies have focused on both/either behaviour or enforcement problems, and few have addressed the district level. Research related to SMEs in Gampaha District, which is an urban and semi-rural area, is scarce. This study is an attempt to fill this gap, as it focuses on

the interaction of administrative (tax rates, penalties, audits) and behavioural (knowledge, morale, trust) variables in the process of compliance by SMEs.

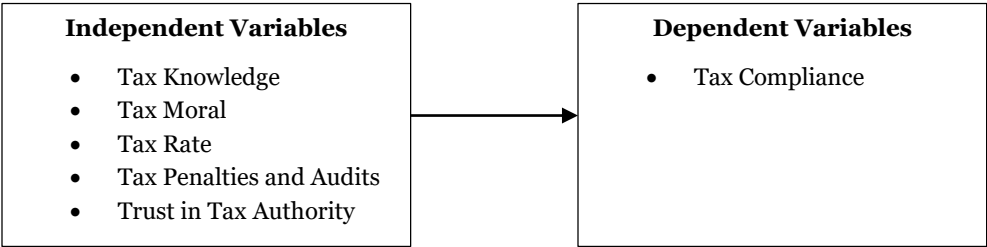


Figure 01: Conceptual Framework

2.4 Hypotheses Development

Based on the literature review and the conceptual framework, the following hypotheses are formulated to analyse the connection between independent variables and tax compliance among SMEs in Gampaha District.

- H1:* Tax Knowledge has a significant positive impact on tax compliance.
- H2:* Tax Morale has a significant positive impact on tax compliance.
- H3:* Tax Rate has a significant negative impact on tax compliance.
- H4:* Tax Penalties and Audits have a significant positive impact on tax compliance.
- H5:* Trust in the Tax Authority has a significant positive impact on tax compliance.

3. Methods

3.1 Research Design, Population and Sampling

The design of the research, population and sampling will be addressed in this section.

The present study adopted a cross-sectional survey design, a widely adopted method in tax compliance studies to analyse the relationship between the variables at a certain point in time (Dissanayake & Premaratna, 2020; Karunarathna & Senani, 2024). This design is appropriate for determining the impact of the selected behavioural and administrative factors on the tax compliance of SMEs.

The target population were Small and Medium Enterprises (SMEs) located in Gampaha District, Sri Lanka, and the unit of analysis was SME owner-managers. The respondents were required to be the decision makers of SMEs within the district so as to be included in the sample. The snowball sampling method was used, due to the absence of an up-to-date and adequate SME database and the practical difficulties of obtaining a complete sampling frame. Initial respondents were identified by local trade networks, and subsequently, other eligible SME owners were referred. Although this non-probability sampling method allowed information to be collected in the informal sector, the results obtained are not necessarily representative of the national SME population. A total of 125 subjects was considered to have adequate power for a multiple regression analysis with five independent variables.

3.2 Data Collection and Instrument

The method of primary data collection was a structured self-administered questionnaire (SAQ). The items used for measurement were based on the existing empirical literature to

ensure the items are built with construct validity: items of tax knowledge were adapted from Bandara & Balendran (2024); tax penalties, audits, and institutional trust were adapted from Karunaratna & Senani (2024). The instrument was split into 2 parts. Section A collected the business profiles of the businesses. Items measuring the independent variables (tax knowledge, tax morale, tax rates, tax penalties and audits, and trust in the tax authority) and the dependent variable (tax compliance, defined as accurate income reporting, timely filing, and full payment) were operationalised in Section B. Each construct was measured on a 5-point Likert-type scale with a range from 1 (“Strongly Disagree”) to 5 (“Strongly Agree”). The questionnaire was pre-tested with a small number of SME owners prior to data collection to enhance content validity and clarity. In addition, information from secondary sources such as government reports and policy documents was gathered to support the analysis and conclusions. The ethical guidelines were strictly followed: participation was voluntary, respondents were informed about the purpose of the study, and anonymity was ensured.

3.3 Data Analysis

The data obtained were analysed using IBM SPSS Statistics version 26. Frequencies and percentages were used to summarise the variables of the study and the characteristics of the respondents. The reliability of the scales was established by examining the internal consistency with Cronbach's alpha. Principal Component Analysis (Varimax rotation) was used to evaluate the construct validity. The secondary data were analysed using multiple regression analysis to evaluate the effect of the independent variables on tax compliance with preliminary diagnostic tests. The basic statistical conditions of regression were satisfied by these tests: no severe multicollinearity, normality of residuals, homoscedasticity, and independence of errors. The p-value was used to assess the statistical significance, and it was determined to be $p < 0.05$.

4. Data Analysis and Findings

4.1 Demographic Profile

The demographic profile shows that most respondents were sole proprietorships and relatively young businesses. Many of the businesses were small, with fewer than ten employees, as the sample size was representative of small businesses. As per the Registration with Inland Revenue Department, more than a quarter of the respondents were not registered, of which there was a noticeable gap in compliance in the district.

4.2 Descriptive Statistics

Table 2: Demographic Profile of Respondents

Characteristic	Category	Frequency	Percentage
Type of business	Sole proprietorship	75	60.0
	Partnership	4	3.2
	Private limited company	46	36.8
Years of operation	Less than 5 years	84	67.2
	5-10 years	21	16.8
	11-15 years	6	4.8
	More than 15 years	14	11.2
Number of employees	Less than 10	69	55.2
	10-20	24	19.2
	21-50	5	4.0
	More than 50	27	21.6
Registered with IRD	Yes	92	73.6
	No	33	26.4

The descriptive results show that all of the major constructs reported mean scores that are below the neutral score of 3.00. The general knowledge about taxes, tax morality, and tax compliance had relatively low mean scores, especially the latter. The findings indicate that the

majority of SME owners in the sample were not motivated and had low compliance behaviour. Trust in the taxman and perceptions of penalties and audits were also below neutral.

Table 3: Descriptive Statistics Summary

Construct	Mean Range	Standard Deviation Range	Interpretation
Tax Knowledge	2.29-2.46	1.076-1.121	Low to moderate understanding of tax laws and procedures
Tax Morale	1.94-2.37	0.972-1.089	Low moral motivation to comply
Tax Rate	2.12-2.64	1.008-1.049	Moderately unfavourable perception of tax burden
Penalties and Audits	2.27-2.35	0.969-0.987	Weak to moderate perceived enforcement pressure
Trust in Tax Authority	2.39-2.51	0.918-1.097	Moderate but below-neutral trust
Tax Compliance	2.10-2.19	1.041-1.108	Low compliance behaviour

4.3 Reliability Analysis

Multi-item scales were determined to be reliable using Cronbach's alpha. Alpha values were acceptable to excellent (all above 0.75) with regard to internal consistency. Tax compliance was the most reliable, with a value of 0.958 and tax rate was moderately reliable, with a value of 0.757.

Table 4: Reliability Analysis Results

Construct	Cronbach's Alpha	Number of Items	Reliability Level
Tax Knowledge	0.927	4	Excellent
Tax Morale	0.879	4	Good
Tax Rate	0.757	4	Acceptable
Penalties and Audits	0.894	4	Good
Trust in Tax Authority	0.905	4	Excellent
Tax Compliance	0.958	4	Excellent

4.4 Factor Analysis

Table 5: Factor Analysis Summary

Indicator	Result	Interpretation
KMO measure	0.937	Excellent sampling adequacy
Bartlett's Test	$\chi^2 = 3002.210$; $df = 276$; $p < 0.001$	Correlation matrix suitable for factor analysis
Component 1	Tax Knowledge and Institutional Trust	Tax law clarity, IRD guidance, fairness and trust
Component 2	Tax Compliance Behaviour	Accurate reporting, correct payment and timely filing
Component 3	Tax Morale and Enforcement Pressure	Morality, penalties, audits and tax-rate pressure

The Kaiser–Meyer–Olkin value was 0.937, which is considered a very good KMO value for factor analysis sampling. Bartlett's Test of Sphericity was statistically significant ($\chi^2 = 3002.210$, $df = 276$, $p < 0.001$). The results above showed that the data were appropriate for factor analysis. Three components were extracted that accounted for 71.99% of the total variance using Principal Component Analysis with eigenvalues greater than one.

4.5 Regression Analysis

Table 6: Regression Results

Predictor	B	Std. Error	Beta	t	Sig.	Decision
Constant	-0.158	0.173	-	-0.915	0.362	-
Tax Knowledge	0.063	0.098	0.062	0.643	0.522	Not significant
Tax Morale	0.275	0.110	0.245	2.492	0.014	Significant
Tax Rate	0.032	0.136	0.025	0.234	0.816	Not significant
Penalties and Audits	0.583	0.143	0.492	4.088	<0.001	Significant
Trust in Tax Authority	0.064	0.120	0.056	0.531	0.596	Not significant

A multiple regression analysis was carried out to illustrate tax compliance as affected by tax knowledge, tax morale, tax rate, penalties and audits, and trust in the tax authority. The model had an R value of 0.822 and an R^2 value of 0.676; that is, the five predictors accounted for 67.6% of the variance in tax compliance. The overall regression model, $F(5,119) = 49.721$, $p < 0.001$, was statistically significant.

Model summary: $R = 0.822$; $R^2 = 0.676$; Adjusted $R^2 = 0.663$; Standard Error of Estimate = 0.58612. Regression equation: Tax Compliance = $-0.158 + 0.063(\text{Tax Knowledge}) + 0.275(\text{Tax Morale}) + 0.032(\text{Tax Rate}) + 0.583(\text{Penalties and Audits}) + 0.064(\text{Trust in Tax Authority})$.

4.6 Hypothesis Testing

The results from the hypothesis tests revealed that tax morale and penalties and audits have a significant impact on tax compliance. So, it was found that H2 and H4 were accepted. There were no statistically significant predictors that included tax knowledge, tax rate, or trust in the tax authority, and H1, H3, and H5 were rejected.

Table 7: Hypothesis Testing Results

Hypothesis	Statement	Result	Decision
H1	Tax knowledge has a significant impact on tax compliance.	$p > 0.05$	Rejected
H2	Tax morale has a significant impact on tax compliance.	$p < 0.05$	Accepted
H3	Tax rate has a significant impact on tax compliance.	$p > 0.05$	Rejected
H4	Tax penalties and audits have a significant impact on tax compliance.	$p < 0.05$	Accepted
H5	Trust in the tax authority has a significant impact on tax compliance.	$p > 0.05$	Rejected

5. Discussion and Conclusion

The results from this study reveal that tax morale and tax penalties and audits have the strongest influence on tax compliance among the Gampaha District SMEs. This underscores the importance of tax morale in promoting tax compliance because it indicates that apart from economic motivations, tax compliance is influenced by ethical values, civic responsibility, and intrinsic motivations. Owners of small and medium enterprises that feel an obligation to pay taxes due to the public good and welfare are more likely to maintain accurate records, timely filing, and timely tax payments in order to ensure compliance with tax laws. The discovery confirms the literature that has grown in recent years focusing on the behavioural aspects of tax compliance; and thus, serves to strengthen the argument that taxation is an economic and moral choice (Torgler, 2007; Luttmer & Singhal, 2014).

Finally, the fact that tax penalties and audits have a positive and significant effect on enforcement further underscores the need for enforcement mechanisms in encouraging compliance. This result supports the theory of Economic Deterrence Theory, which has proposed that the likelihood of being caught and the penalty for being caught are both increased factors that will make taxpayers more likely to comply (Allingham & Sandmo, 1972; Becker, 1968). In the SME sector, a structured and common understanding of the penalties and regular audits seem to have had an effect on raising awareness of the risk of enforcement, and thus on reducing non-compliant conduct. Therefore, enforcement is an indispensable tool to improve effective compliance of SMEs in Gampaha District.

Interestingly, the factors of tax knowledge, tax rates, and trust in the tax authority were not statistically significant in explaining tax compliance attitudes of this specific sample. From a theoretical standpoint, tax knowledge is insignificant because it goes against the theory of planned behaviour, which presumes that having knowledge (perceived behavioural control) is enough to ensure compliance. Knowing the tax rules does not mean that they are being complied with, unless there is an effective enforcement mechanism that makes it happen in the Sri Lankan context of SMEs. Moreover, the results failed to support the Slippery Slope Framework, which suggests that high trust leads to voluntary compliance, and the absence of a significant link between institutional trust and compliance contrasts with this. With the general economic problems affecting Sri Lanka, entrepreneurs of SMEs might feel more deprioritised, and thus not trust the state as much as they trust the power of enforcement for financial issues. In the end, therefore, tax rates have been insignificant, as SME owners in Gampaha believe the likelihood of being audited (in line with Economic Deterrence Theory) is far more important than the tax rate itself.

In general, the study indicates that the overall tax compliance rate of the SMEs in the Gampaha District is comparatively poor, and it can mainly be attributed to moral and enforcement factors. The results indicate that increasing sustainable compliance needs to be a balanced effort between good enforcement and initiatives to enhance taxpayers' sense of moral responsibility and awareness. Penalties and audit efforts can be expected to improve compliance in the short term, with longer-term gains more likely to result from empowering taxpayers, building a culture of taxpaying and streamlining procedures.

5.1 Recommendations

Several policy recommendations can be made based on the findings. The first policy recommendation is that the Inland Revenue Department undertake systematic audits and routinely apply penalties for tax evasion. The perceived likelihood of deliberate tax evasion decreases with the firm belief in the imposed tax penalty.

Second, the initiatives increasing tax morale need to be broadened. Intensive public campaigns can increase the understanding of taxation as a means of funding the government and tax payment as a legal and moral obligation.

The third recommendation is an active attempt to facilitate tax filing and increase the understanding of taxation. The absence of tax knowledge as a predictor of taxation does not preclude the need for guidance. The preliminary results highlight the need for support regarding tax filing. Workshops, online learning, online support and regional tax advisory services may help reduce the cost of filing.

The fourth recommendation is that the tax authorities increase transparency and further explain the spending of tax revenues. Trust may be improved with the explanation of the spending of tax revenues, and may provide additional compliance.

The fifth recommendation is the increase of SME support services by business associations, regional tax service centres, and digital services. These services may help SMEs manage their tax obligations and may help facilitate compliance.

5.2 Implications and Future Research

This study contributes to the tax compliance literature by providing empirical evidence on the relative importance of behavioural and administrative determinants of SME tax compliance in Sri Lanka. The findings support both Economic Deterrence Theory and Tax Morale Theory, demonstrating that compliance behaviour is influenced by a combination of enforcement mechanisms and intrinsic motivational factors. While audits and penalties reinforce the role of deterrence, the significance of tax morale highlights the importance of ethical and behavioural considerations in compliance decisions.

From a practical perspective, the findings offer valuable insights for policymakers and tax administrators. The integration of primary survey data with contextual evidence provides a comprehensive understanding of SME tax compliance challenges in the Gampaha District. The results suggest that enforcement measures alone are insufficient to achieve sustainable compliance. Instead, a balanced strategy that combines effective enforcement, taxpayer education, procedural simplification, and trust-building initiatives is likely to produce more durable compliance outcomes.

Future research may extend this analysis to other districts in Sri Lanka to examine regional variations in SME tax compliance behaviour. Comparative studies could provide a broader understanding of contextual influences on compliance decisions. In addition, future investigations may incorporate factors such as tax system complexity, digital tax administration, record-keeping practices, perceptions of public expenditure, and political trust. Qualitative approaches, including interviews and focus group discussions with SME owners and tax officials, may also provide deeper insights into the underlying motivations and barriers associated with tax compliance.

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