

Tax Composition and Tax Compliance: Sri Lankan Experience

H.R.A.C. Thilanka and J.G. Sri Ranjith

Department of Economics and Statistics, University of Peradeniya, Sri Lanka

Tax compliance has been recognized as an important topic related to governments' tax policies. Tax non-compliance arises mainly due to tax evasion, complexity of the tax policy and weak administration of tax system. In the case of Sri Lanka, tax revenue which consists largely of indirect taxes is the major source of financing the fiscal deficit and the means of meeting needs of other public expenditures. Meanwhile, the data show that tax compliance levels are relatively unsatisfactory. With this background, our study mainly aims at examining the long-run impact of tax composition on tax compliance in Sri Lanka using annual data for the period 1985-2016. The study follows a time series econometric technique employing Vector Error Correction Model (VECM). Empirical findings of our study show that evidence for the presence of long-run impact of tax composition on tax compliance. According to the results, VAT affects positively to the tax compliance implying these two variables move towards the same direction while income tax negatively affects tax compliance. These estimation results imply that current issues and challenges of the fiscal policy in Sri Lanka are mainly stemmed from the narrow tax base and ability to evade the direct taxes imposed on income while inability of tax evasion of indirect taxes imposed on goods and services. However, import duties do not affect the tax compliance because there are proper recording and auditing on import duties. These results pave the way for proper policy directions related to fiscal policy especially improvements of level of tax compliance through adjusting tax composition and proper administration. In order to mitigate the tax evasion and improve the level of tax compliance the government can relies on indirect taxes (VAT) while, taking necessary measures to encourage tax payers to comply with the direct taxes especially through simplifying the tax system, broadening the tax base and imposing tax fines.

Keywords: Fiscal Policy, Tax Compliance, Tax Composition, Vector Error Correction