Vavuniya Journal of Business Management
Vol 7 Iss. II, December, 2024.

Faculty of Business Studies
University of Vavuniya
Sri Lanka

A Qualitative Diagnosis of Factors Influencing Presumptive Tax Collection in Sri Lanka

Thampoe[1], E.J., Abeywardena, N.L.E., [2] and Munasinghe, M.A.T.K.[3]

[1,2,3] *Faculty of Commerce & Management Studies, University of Kelaniya,*

[1]*edgarthampoe@yahoo.co.uk*, [2]*erandi@kln.ac.lk*, [3]*amila@kln.ac.lk*

Abstract

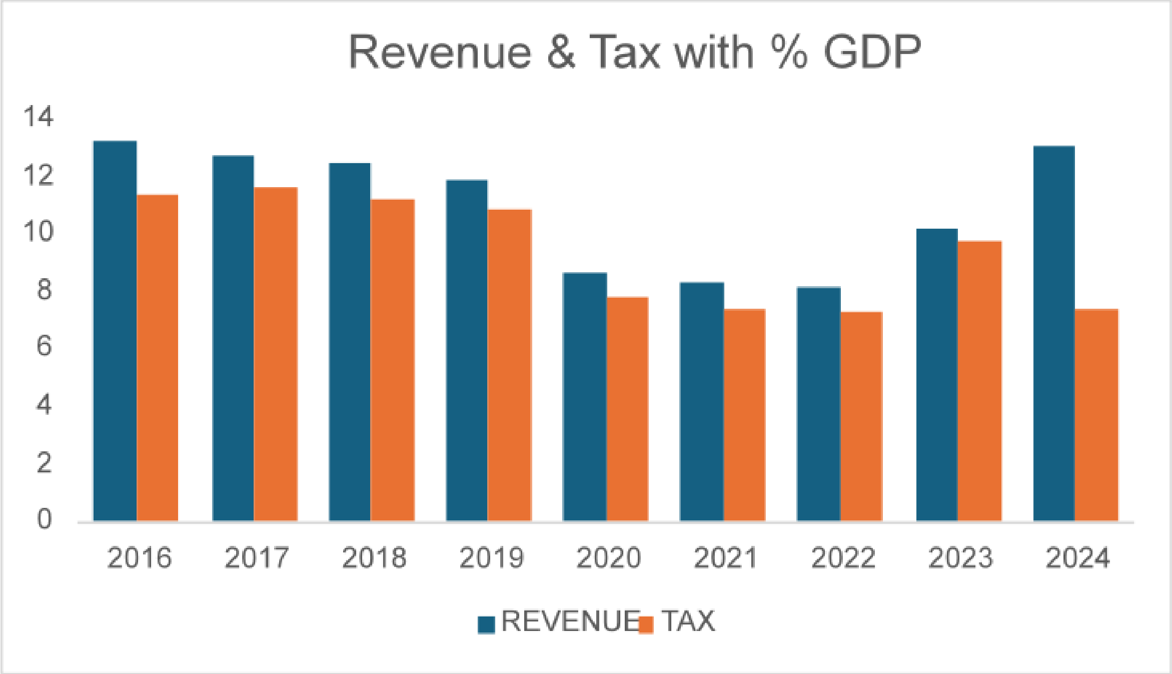
This study aims to explore the factors influencing presumptive tax collection in Sri Lanka. An interpretivist paradigm was employed in this study, utilising a qualitative research approach. Primary data were collected through virtual (Online) in-depth interviews with 15 participants, including tax consultants from the Department of Inland Revenue, tax practitioners, academics, and the General public in Sri Lanka. Qualitative data were analyzed using thematic analysis. The results of the qualitative analysis of the factors influencing presumptive tax collection in Sri Lanka show the institutional, legal and regulatory framework as well as the governance and political factors, which will help the Department of Inland Revenue and policy makers formulate policy strategies to promote presumptive tax collection and voluntary tax compliance in Sri Lanka.

Keywords: Presumptive, Tax collection, Informal economy, Thematic analysis, lump-sum tax systems,

Introduction

A large informal economy is often considered a major obstacle to the implementation of income taxes in developing countries (Memon, 2013:40). A lack of appropriate compliance management and a tradition of voluntary compliance have facilitated the rapid development of the underground economy in many developing countries (Engelschalk, 2015:277). For many decades, Sri Lanka's perilous public finance situation has significantly hindered economic growth, impeding the effective delivery of public services and other development outcomes. The fiscal deficit, averaging 10% of GDP, was not uncommon, with knock-on effects on other critical areas of macroeconomic policy, management, most notably in the conduct of monetary policy. The revenue & tax ratios as a percentage of GDP were 8.2% and 7.8%, respectively, in Sri Lanka.

Figure #1: Sri Lanka revenue & tax with GDP %



Empirical evidence suggests that the taxation of the informal economy is a significant common obstacle in developing countries (Duve, 2021; Schette, 2021), largely due to the unregulated nature of this economic sphere. The literature maintains that worldwide, tax authorities are grappling with managing the informal economy and strengthening tax systems (Vinnychuk & Ziukov, 2013). Tax regulators in developing countries are focused on existing formal operators who make progress socio-economically and those who are neglecting a potential revenue source (informal economy) (Chen, 2012). Mukherjee and Rao (2019) found that tax authorities are concentrating on taxing he formal economy because it is difficult to identify, locate and register participants in the informal economy.

Heggstad et al. (2011) and others argue that, in an economic sense, tax authorities collect more tax revenue from the formal economy than from taxing the multitude of poor people who are struggling to survive. They argue that, from a broader nation-building perspective, expanding the tax base is crucial for establishing concrete psychological fiscal contracts. It is further revealed that governments increase their tax revenue through the taxation of the informal economy (www.sundaytimes.lk, 14th July 2024), although the revenue yield is very insignificant (Fjeldstad, 2013; Mpapale, 2014). This is because the unstructured and unregulated nature of this economic sphere makes establishing and controlling informal economic activities burdensome.

Furthermore, the informal economy is associated with non-static business activities (mobility) (Heggstad et al., 2011), which makes it difficult to tax according to Mpapale (2014). Boakye (2011) viewed informal economy operators as highly mobile, dispersed, and operating at night in many countries. This makes them more difficult for tax authorities to identify. Another challenge noted in the literature is that of capacity. Many tax collection agencies are bedevilled by capacity constraints in terms of competent human resources (Mpapale, 2014).

Furthermore, the informal economy is associated with non-static business activities (mobility) (Heggstad et al., 2011), which makes it difficult to tax according to Mpapale (2014). Boakye (2011) viewed informal economy operators as highly mobile, dispersed, and operating at night in many countries. This makes them more difficult for tax authorities to identify. Another challenge noted in the literature is that of capacity. Many tax collection agencies are bedevilled by capacity constraints in terms of competent human resources (Mpapale, 2014).

There are conflicting viewpoints regarding the profitability of the informal economy (Chen, 2012). Some scholars believe that the informal economy generates very low revenue, and most of those involved earn far less, while others are convinced that the upper layer of the informal economy is more profitable than well-established enterprises (Kristoffersen, 2011; Mpapale, 2014). If the first viewpoint is considered, then it would be a mere waste of time and resources to try to tax this non-profitable economic segment (OECD, 2012; Udoh, 2015).

Furthermore, detecting unreported income and activities does not guarantee future compliance. Economically, it makes no sense to invest a large amount of resources in moderately small tax revenue (OECD, 2024). The existing literature indicates that most income generated in the informal economy falls below the taxable threshold, which is why this sphere has often been overlooked. However, the OECD (2020) suggested that collective tax amounts from the informal economy are substantial and, therefore, constitute a significant source of taxation for the sector. To reduce the growth of this sector, it is necessary to design a tax system that discourages people from entering the informal economy.

Francis (2019) notes that harsh tax enforcement and corruption, combined with inadequate infrastructure and other services, are barriers to effectively collecting taxes from the informal economy. Corruption fosters an environment that facilitates tax evasion and avoidance (Utamire et al., 2013). It is also very challenging to identify and monitor revenue-generating targets across multiple activities within this economic sphere.

Various authors have Identified different factors, such as the use of cash transactions, lack of proper records, the level of illiteracy, and political considerations, that make it difficult for tax authorities to collect taxes from the informal economy. A lack of taxpayer information is considered to be a contributing factor to the taxation of the informal economy. Dube (2014) acknowledges that for any tax system to be effective, there must be information. Without information, identifying potential taxpayers and assessing their tax obligations will be difficult. A close analysis of the existing literature reveals that there is a lack of solid research providing a qualitative analysis of the factors that influence the presumptive tax. Therefore, this article aims to determine the factors influencing presumptive tax collection.

Presumptive Tax

The presumptive tax system, which involves collecting taxes from the informal economy, does not provide a summary of the different taxes collected from different informal economic activities. All the taxes collected from various informal activities are collectively classified as "presumptive taxes". This means that there is a lack of essential information for comparison purposes, and this lack of information will lead to the misappropriation of funds due to the absence of taxpayer information. Tax authorities implemented the presumptive tax system due to a lack of 'costless information for one of the parties.

The presumptive tax systems are commended for their simplicity, which facilitates administration. However, Tax officials worldwide face significant challenges in taxing the informal economy (IMF, 1996). Such challenges include complexity in terms of rules and tax bases, tax uncertainty, scope (too wide or narrow) and lack of data and analysis

A Large economy is often considered to be a significant obstacle in the implementation of income taxes in developing countries (Memon. 2013) and a lack of appropriate compliance and a voluntary compliance tradition facilitated the rapid development of the underground economy in many developing countries (Engelschalk 2015) The idea that small businesses have a greater opportunity for tax evasion than formal business is also well documented (Ogembo 2018)

The rationale behind the use of presumptive tax systems is to reduce taxpayers' compliance costs and administration costs of compliance, enhance enforcement management, and facilitate transition from informal to formal activities (Pashev 2006)

The characteristics of a presumptive tax system vary greatly in terms of their design, coverage, and implementation. (Kundt, 2017:9).

It is prudent that revenue authorities should be familiar with these challenges when designing informal tax policies (OECD, 2020). Fjeldstad (2013) and TRA (2010) note that the challenges associated with taxing the informal economy should be examined from a compliance perspective. There are factors that drive/foster tax compliance, as well as tax law, applicable to both informal and formal economies (Fjeldstad, 2013). In other words, the literature identifies three areas that influence taxpayer behaviour: tax policy, tax administration, and the independence of the tax system.

The presumptive tax system entails various design characteristics, including thresholds, the taxpayer's target, or the time frame of use. Thresholds can be used to minimize the number of taxpayers that the system has to deal with in the first place.

Three main types of presumptive tax systems have been identified from the findings about the presumptive tax system from 20 articles selected analyzed for this study: (1) lump-sum tax systems, (2) turnover/Gross income tax system and (3) Third-party tax reporting Systems. Under the lump-sum tax system, taxpayers pay a fixed amount per period (quarterly, semiannually, or annually) based on their profession or trade. The Gross income or turnover-based tax systems can be structured in different ways. One alternative is to apply the same tax rate to all businesses subject to the tax, irrespective of business activity. A second alternative is to divide the small business community into several business segments with different tax rates for each segment. This takes into account the varying profit margins across different business segments. The third alternative is to introduce a progressive tax on gross income, where different tax rates apply to different levels of gross income. The third type is the third-party reporting system, which is evaluated against the characteristics of the targeted taxpayers, thresholds in place, and the time frame of use. Since small business records are typically not available, the demand for third-party information to reconstruct small business income has gradually increased.

Methodology

Many prior studies on taxation in informal economies have applied quantitative methods, and very little attention has been given to stakeholders' perceptions of the determinants of presumptive taxes, which has been identified as a significant gap in the literature.

This article employs a qualitative research design to explore the factors influencing the collection of presumptive taxes in Sri Lanka. The qualitative research approach attempts to gather non-numerical data in the form of observations or interviews. The qualitative data are analysed by grouping into different themes or subthemes (thematic analysis) (Braun & Clarke, 2021). In other words, qualitative research is said to be all-inclusive (holistic), unstructured, real (Natural), and inductive. This approach provides insight and understanding of the phenomenon, offering room for data triangulation. In this study, the researcher has selected a population comprising senior officials of the Department of Inland Revenue of Sri Lanka, including Senior Deputy Commissioners, Commissioners, and Assistant Commissioners. In addition, Tax Consultants have also been interviewed, along with other stakeholders who are actively/directly involved in the process.

The researcher has sought views from the informal economic sector associates, academics and other Government officials to establish the factors leading to poor revenue performance from the informal economy. The participants were chosen based on a purposive study of their field of expertise and experience in tax policy, as well as informal economic issues. A total of 15 participants were interviewed for this research study. The rationale for selecting 15 participants in this study is that it aligns with the guidelines for a qualitative sample of 15 proposed by Guest et al. (2020). The researcher assumed that interviewing 15 participants would enable the researcher to reach a saturation level, a key ingredient in qualitative research (Mason, 2010). This allowed the researcher to manage the complexity of the analytical task (Vasileiou et al., 2018, p. 2). The interviews with 15 participants revealed diverse opinions, identifying all significant issues.

Data Collection and Data Analysis

The data collected in this study were/are mainly from primary and secondary sources. As the focus of the study is on understanding the contemporary tax framework of Sri Lanka, it requires the use of economic, secondary data, whereas its interface with respondents representing varying stakeholders' perceptions, opinions, and emotions regarding informal economy taxation in relation to tax digitalization necessitates the use of primary data (Saunders et al., 2018).

The primary data were collected through direct interviews to elicit detailed information on the factors influencing presumptive tax collection in Sri Lanka. Initially, an interview guideline was developed, along with a questionnaire, based on a documentary analysis of the key variables related to the topic. Policy documents **and official documents were examined to guide the sampling procedure, structure interview questions,** and clarify any discrepancies that may be found (Saleheem, 2013). To understand the underlying issues that restrict the officials of the department of Inland Revenue from effectively collecting presumptive taxes from informal economies, unstructured interviews with relevant stakeholders are integral to the success of this research

The interviews serve as a reliable source of data about 1) the operation of the informal economy. The data collection process lasted approximately three months and was conducted during the latter part of December 2024 and the beginning of January 2025. The interview was conducted in both English and Sinhala. The researcher asked all the questions, and the responses provided were recorded and written.

An in-depth literature review was used as a secondary source of data. A literature review involves the collection of data through the perusal of publicly available documents such as government circulars, press statements, magazines, media reports, journals and government publications. Document analysis enabled the researcher to understand the contemporary tax framework of the informal economy, identify the participants and gain knowledge of the phenomenon in the digital era. Document analysis was used in conjunction with interviews as the means of triangulation to provide a confluence of evidence that affords credibility (Bowen, 2009, p. 28)

To reduce potential bias, the researcher combined the findings from interviews and documentary reviews. This study reviews the Income Tax Act, digitalisation policy documents, the Finance Act, press statements, and other peer-reviewed journal articles. It is essential to note that analysing the said documents is crucial for the topic in question.

Data Analysis

Thematic Analysis is a widely used method for analysing qualitative data obtained from sources such as interviews, focus group discussions, or text data, to identify, analyse, and report patterns (or "themes") within the data. It is beneficial for understanding people's experiences, perceptions, or behaviors. The process of thematic analysis involves several key stages:

The analysis begins with data familiarization by researchers. The answers provided by interviewees are examined in depth to gain an understanding of the content. This is followed by the generation of the initial coding process. The next stage will involve searching for themes by grouping related codes into potential themes. A theme is a pattern noticeable across the data, which captures something significant about the data in relation to the research question.

The researcher systematically identifies interesting patterns in the data. The researcher labels segments of the data with short, descriptive codes that capture key ideas, concepts and themes. The authors moderate (or review) and refine the identified theme to ensure that each theme is coherent, internally consistent and relevant to the research objectives. The researchers then define and name each theme, assigning a descriptive name to each identified theme and describing its essence.

Thematic analysis is flexible, allowing researchers to employ both inductive approaches (where themes are derived directly from the data) and deductive approaches (where pre-existing theories or concepts drive themes). It is often used in social sciences, psychology, and humanities research.

Topic. Policy documents **and official documents** were examined to guide the sampling procedure.

Themes	Subthemes	Definitions
Institutional Factors	Organizational capacity	Human Resource
	Financial capability	Financial Strength
	Commitment and Support	Lack of Committed Staff
Governance Factors	Corporation/Synergies	Lack of commitment of Government officials
	Policy Consistency	Conflict and policy irregularities
	Political Legitimacy & Interference	Political Interference
Legal and Regulatory Framework	Enforcement of rules & regulations	Restrictive tax regulatory framework and enforcement system
	Quality of services	Tax service quality
	Presumptive tax structure	

Three distinct themes emerged from the analysis.

1) Institutional Factors
2) Governance Factors and
3) Legal and regulatory framework

Research Findings

Theme 1. Institutional Factors

Under **Theme 1,** the primary focus is on examining whether institutional factors influence or affect presumptive tax revenue collection in Sri Lanka.

Under **Theme 1,** three sub-themes emerged

1.1 Organizational Capacity
1.2 Financial Capacity
1.3 Commitment and support.

The above sub-themes are analyzed individually below:

Initially, the functions of Inland Revenue in Sri Lanka are carried out by their staff. However, it was clearly evident that it was not a feasible solution, and the interviewees identified that revenue collection in Sri Lanka was mainly affected by factors such as politicisation, lack of transparency (e.g., bribes and corruption), and poor staff control.

A participant (T1) argued

"The information should be shared by various stakeholders in order to tax accurately. The digitalisation of many state sector organisations enables automatic transfers of information. The Land Registry is automated, and the registration of deeds is digitalized because the Lawyers' income has been calculated by the Department of Inland Revenue of Sri Lanka. The requirement for skilled labour, Government support, and a Strong rule of law in the Department of Inland Revenue has decreased significantly.

A participant (T2) mentioned:

"the digitalization helped the Department of Inland Revenue to revenue mobilization in Sri Lanka. As it was initially constrained by a lack of agreed-upon procedures, corruption, and other illicit activities, digitalisation has eliminated these issues to a greater extent.

The above comments highlight the importance of digitalising information for various stakeholders, which fulfils institutional capacity requirements more effectively than human power for record maintenance. The introduction of the Ramis system at the department of Inland Revenue has enabled the Inland Revenue Department to perform some functions digitally. As a result, when the government introduced compulsory registration for people over eighteen years old, the Ramis system helped register many people within a short period of time.

The Participant (T)observed: .

"The *recruitment and training of its workers on the part of the Inland Revenue Department to ensure revenue collection from the informal economy has also drastically been reduced due to some of these activities being allocated to divisional secretariats. Mainly, Street sellers and mobile businesses are now managed by the Divisional Secretariats.*

However, another Participant (C') pointed out:

In Sri Lanka, opening income tax files for those above the age of 18 was made mandatory. The Department does not provide for any exclusions for those who are not earning any income, disabled people, etc

Subtheme: Financial Capacity

The information gathered from the interviews suggests that Department of Inland Revenue officials attribute the challenges that contribute to the failure of the Department to effectively collect tax revenue from various sectors of the informal economy. Certain Staff Members of the Department of Inland Revenue have revealed that there is a serious shortage of revenue collections, as the number of staff required to collect taxes from regular taxpayers is not adequate.

Another Interviewee (T3) stressed that

"Following up on notice of assessments issued, time to time by the Department of Inland Revenue has not been made due to staff shortage. As a result, the time bar period has ended, and the taxes pertaining to the Notice of Assessment cannot be collected.

Effective monitoring, tracking, and collecting tax revenue from the informal economy requires knowledgeable and skilled manpower (OECD 2020). This central issue was highlighted by most of the interviewees.

Initially, tax collectors lacked knowledge of how taxes are collected from the thriving economic sector, and second, the Department of Inland Revenue is underestimating the revenue potential within the informal economy. The interviewees further elaborate that some operators in the informal economy earn much higher incomes than the tax collected from formal employees. Private practitioners, especially lawyers, are not adequately assessed and reasonably taxed. The problem for the tax authority is its failure to conduct research to determine which business ventures qualify for tax benefits. However, the informal economy is a comparatively major area that is under discussion.

Another Interviewee also stressed the same point (T):

"The department of Inland Revenue does not realize the value of deploying resources effectively for tax collection in the informal economy and the training of personnel needed to be deployed in the tax collection process, as the desired results are always very low and unrealistic".

In conclusion, the tax department lacks adequate and capable staff to effectively handle the tax collection process in an informal economy. The interviewee further stated that the efficient utilization of staff at the department is much lower. The bureaucratic attitude of staff has contributed to the low tax collection from informal businesses.

Subtheme: Commitment and Support

While the majority of participants claimed that implementing a presumptive tax system to fully realise its revenue potential requires a commitment from those who work on the ground. According to the responses from the participants, there is generally a lack of common understanding of the process of its implementation. The lack of commitment among frontline workers was attributed to the absence of incentives and factors that enhance their motivation.

(T) explains that

"It is common knowledge that even though many people are in the informal economy the majority of them are not paying any tax to the government. Considerable effort has been made in recent years, and as a result, the Department of Inland Revenue has decided to concentrate on certain segments of the informal economy that appear to be profitable and operate from a fixed domicile. Pavement sellers need to obtain licenses because their businesses are required to be registered as sole proprietorships or partnerships. These businesses should submit their income and expenditure statement in order to obtain their licenses on a regular basis. Therefore, these businesses can be controlled by the Government in that taxes can be collected at the point of these vendors applying for Business licenses.

Most of the respondents appreciate the existence of a large informal economy in Sri Lanka and the government's efforts to broaden the tax base. However, resource constraints represent barriers to the full rollout of the presumption tax regime in Sri Lanka. This is also true in the literature provided by

Mutsotso (2010) states that it is impossible to bring all informal activities into the tax net due to the administrative challenges.

(C') It is also indicated that the collection of taxes is believed to be fair, which suggests that the government is deemed effective and fair.

"Once the government is perceived to be inefficient and has no capacity to collect taxes from the informal economy, then very few informal economy operators are likely to comply."

The above excerpt aligns with Munjeyi Edmore and FourieHoundini's (2024) view that the high level of informality is an absolute indicator.

Theme B: Governance Factors

This theme aims to determine how governance influences presumptive tax compliance in Sri Lanka. The subthemes that emerged from the analysis of the central theme are outlined below and subsequently analyzed in depth: ·

- Cooperation/synergies with other stakeholders ·
- Policy consistency ·
- Political legitimacy and interference.

Subtheme: Cooperation – relationships with other key stakeholders

Some of the participants highlight how poor governance and political illegitimacy discourage tax compliance.

Although the relationship between the ministry (Treasury) and the Department of Inland Revenue is good, the ministry interferes with the department's work. As a result, there have been delays in obtaining approvals for administrative tasks. The implication here is that the perceived lack of cooperation between the Ministry of Finance and the Department of Inland Revenue deters informal economic participation. A lack of cooperation was observed between the two institutions when the Ministry of Finance prescribed arbitrary presumptive tax rates without consulting the department.

Subtheme: Policy Consistency

The importance of policy consistency in tax administration cannot be overemphasized. The existence of conflict and policy irregularities may influence non-compliant behavior among informal economy operators. One of the participants attempted to confirm instances of a lack of political legitimacy.

Certain corrupt individuals have reversed the gains in functional industries that were inherited, and as a result, the informal economy in Sri Lanka has been increasing. Poor knowledge of tax policies and the adverse commands contributed to resistance by taxpayers.

This statement confirms that policy inconsistencies have undoubtedly affected the collection of tax revenue from the informal economy in Sri Lanka. Political leaders have been attempting to push their political agendas to stay in power and gain support, as evidenced by their tax reduction initiatives without a proper income forecast for the country. As a result, the Country has fallen into a severe financial crisis. They argue that people always use populist policies to justify their nonparticipation in the formal sector. Interviewees have also attributed tax noncompliance behavior to the lack of commitment and seriousness on the part of politicians and government officials in enforcing tax rules and regulations.

Sub theme: Political legitimacy and interference

External factors, such as political interference in affairs, have a negative impact on tax revenue collection from the informal economy in Sri Lanka. In order to retain their parliamentary seats in the next election, some politicians advise their supporters not to pay taxes at all. Such an arrangement between corrupt officials and informal economy operators creates challenges for the enforcement of tax rules and regulations. One of the participants (C1') reported that :

"The government and the government must support informal economy, and *in turn must be seen to be transparent in its activities. This is one way you can win this war of trying to tax the informal economy"*

Some businesses in the informal economy may decide to circumvent tax laws because they do not reorganize the legitimacy of the current government. Once taxpayers perceive the government as legitimate, they are more likely to avoid paying taxes. The two excerpts below underline this matter.

"In the political arena, political leaders do not have people's interests at heart. I believe that these politicians are not fulfilling the purpose for which they were elected. They are looting taxpayers' monies and our roads and the health sector are in a state of dilapidation. ".

Participants believed that government officials and other politicians misappropriated public funds, which negatively impacted service delivery. This finding indicates that the severity of government interference in the affairs of the Department of Inland Revenue, Sri Lanka, coupled with deep-seated corruption and tax noncompliance, has increased. Many operators in the informal economy capitalize on perceived weaknesses in the tax system and the politically tense environment. Politicians also mention that senior government officials and politicians should be seen as law defenders; however, they are lawbreakers in Sri Lanka. In light of such perceptions and practices, the informal economy finds it easy to dodge tax rules, as viewed by Participants

"Pay tax for whose benefits? There is no point in paying taxes when the government is failing to provide public goods and services. During the previous regime, various medicines were in short supply, and our healthcare system was struggling. Additionally, our rice supply had been controlled by some market rice owners. If they (politicians) are breaking the law (looting without prosecution), then taxpayers are likely to break it even more, observed some of the Participants.

"The government destroyed vendors' business by long lockdowns during COVID-19. How do you expect vendors to cooperate with tax laws when the very government is not defending and treating them well? Our political landscape is hostile, not friendly, but rather ruthless. (Participant T4)

The statements above show that (service delivery is poor even when taxes have been collected; (ii) Staff in Department of Inland Revenue Sri Lanka networks are not prosecuted when they break tax laws in Sri Lanka; (iii) politicians (especially those in large cities) support the removal of market stalls in a bid to decongest the city (Kulkarni, 2020). This means that the justice system is no longer independent, and generally, there is no adequate law in Sri Lanka, which in turn promotes tax evasion. The responses from the interviews suggest that politicians are not encouraging people in their constituencies to pay taxes but rather empowering their voters to defile tax laws. However, Participant (T) noted:

"If the politicians are committed to raising awareness campaigns about tax compliance, those who voted for them will be motivated to obey because people trust their local leadership. However, in general, there is a lack of political will among local leadership to motivate the general public"

Clearly, from the above statement, political leaders deliberately refuse to support tax enforcement activities in this section of the informal economy, especially those that are likely to disadvantage individuals in the informal economy, in order to widen their support base. This finding is substantiated by Ampaabeng (2018), who notes that the major challenge faced by tax authorities in developing countries in taxing the informal economy is a lack of political will. The following section presents an analysis and interpretation of the results in relation to the legal and regulatory framework.

Theme C: Legal and Regulatory Framework

Participants further cited the legal and regulatory framework as one of the determinants of performance with regard to the presumptive tax system in Sri Lanka. They indicated that it was one of these barriers to effectively taxing those in the informal economy. Overall, the participants think that the restrictive tax regulatory framework and weak enforcement system influence the participation of the informal economy in Sri Lanka.

In establishing these provisions, the following subthemes emerged in this section:

- enforcement of rules and regulations ·
- quality of services ·
- presumptive tax structure.
-

These subthemes are examined below.

Subtheme: Enforcement of Rules and Regulations

Overall, the participants noted that the restrictive tax regulatory framework and weak enforcement system impact the tax collection from the informal economy in Sri Lanka. Responses from the interviewees regarding the enforcement of rules and regulations related to the informal economy revealed that it is perceived as inconsistent and selectively applied. Responses from the interviewees regarding the enforcement of rules and regulations related to the informal economy reveal that it is perceived as weak. One interviewee (T4) described the current enforcement system as follows:

"There should be a special court system formed in order to deal with pending cases to expedite the assessments". This will enable all the pending assessments to be clear within the time bar period

A senior commissioner who is also interviewed (T6) made the following remark:

"The Police and Home Guards should be involved in revenue collection from the street sellers. However, it will be a sign of the tax department's failure. Little is known about why this commando-driven enforcement yields no results, as operators in the formal economy often feel like fugitives…The way vendors are treated, tortured, terrorized and insulted by the state agents, I feel pity; you know that "warlike" atmosphere. Compliance on the part of these vendors is out of fear but won't last…instead, the Department of Inland Revenue and Treasury should demilitarize revenue collection…"

(Participant T7) *…you don't have to use force to make people comply with tax laws; the key to building sustainable tax compliance behaviour is the provision of basic infrastructure such as good health services, roads, water, electricity and other facilities/resources.. These benefits significantly contribute to the increase in tax compliance*. However, Participant (C3') justified the acts of involving law enforcement agents by saying: *Due to economic hardship in the recent past in Sri Lanka, people may not be willing to observe tax laws; therefore, we believe that engaging state agents will help accomplish total tax compliance.*

Another participant, T, pointed out:

Approaching the informal economy without the help of police and soldiers is highly risky because, at times, one can be beaten up or humiliated by angry and unaccommodating operators.

The above excerpts show that (i) the IRD Sri Lanka, as an entity, has failed to collect tax revenue using statutes in place, as evidenced by the engagement of police and soldiers. (ii) informal economy operators do not comply with tax regulations due to prevailing economic conditions. Insisting on collecting tax revenue from the informal economy without due concern for their plight would mean that taxpayers will not cooperate at all. The scenario described above, in which the informal economy is forced to comply through a 'state apparatus' signifies serious trust and governance issues. It can be surmised that the informal economy will continue to circumvent tax regulations due to frustrations, economic crises, and the absence of a guarantee of legal protection. The use of police and soldiers indicates the weakness of the tax system as a whole and could lead to increased tax noncompliance. The perception that IRD cannot discharge its duties without the help of police and soldiers reduces trust in IRD and tax morale, thereby providing fertile ground for noncompliance behaviour.

Some participants further argue that when taxpayers no longer trust tax authorities, tax revenue will decrease due to tax noncompliance and resistance.

Participant (C') recalled: "In the colonial era, compliance levels were very high compared with those in independent Sri Lanka. All people, even those in the remotest areas in Sri Lanka, paid their tax liabilities on time as they were scared of the British rule. I believe that, currently, legal and regulatory frameworks are strong and effective. My question is: Why is it that postcolonial Sri Lanka, with everything (technology and resources), is failing to influence compliance within the informal economy? What is missing in our tax system? From this perspective, the colonial tax system was effective, and community leaders assisted tax collectors in collecting taxes from villages or wards. Importantly, IRD can draw lessons from Adam Smith's administration to improve tax compliance and increase tax revenue from the informal economy. Taxpayers are more likely to comply with tax laws when they perceive that the tax framework is strong and supportive. Moreover, Participant (C') confirmed:

'Due to the absence of physical addresses and fixed premises, it is difficult to monitor and audit informal economy operators. They often hide from tax officers.'

Participant T substantiated Participant C's claims by confirming that the deterrence measures in place for the informal economy are ineffective *I believe that the process of detection and sanctions available cannot motivate the informal economy to pay tax unless it is implemented equitably (non-discriminatory)… given what is happening in Sri Lanka, namely* misappropriation of public funds and poor service delivery, no one is afraid of being arrested…they may arrest our members every day, but no one is going to comply….

The aforementioned findings indicate that existing deterrence measures have no effect on changing taxpayer compliance behaviour. Participants described the selective application of laws to taxpayers. The perception that there is no accountability in public funds has a significant negative impact on compliance behavior.

Even though there are advertisement boards at various junctions of cities in several districts, accountability for the tax revenue has not been maintained. The government should provide more information on the utilisation of tax revenue.

However, Participant T2 argued: *'When taxpayers fail to give us proof of payment of their tax liabilities, we confiscate their wares.' It is important to note that members of civic societies and the confiscation of wares/goods are used as a way of penalising non-compliance.*

Participant T10 further stated: Penalising non-taxpayers of the informal economy is not an acceptable solution for building a culture of tax compliance. It is essential to engage in dialogue to determine the reasons for non-payment of taxes. Our staff members reported that IRD, Sri Lanka, demands payment without receiving payment on several occasions. I don't think the money collected goes to the treasury.

These assertions suggest that informal operators and their associations are not deterred by the risk of being caught or arrested, and that current deterrence measures are insufficient to create a culture of tax compliance among taxpayers from the informal economy. The fact that informal economy operators are knowledgeable about corrupt practices within the government and the misuse of public funds by top government officials means that they will likely avoid paying taxes.

Subtheme: Quality of Service Delivery

This study investigated participants' views on how the quality of service influences presumptive tax collection in Sri Lanka. All participants conceded that poor service delivery deterred presumptive voluntary tax compliance among informal players. The article revealed that the low performance of presumptive taxes is attributed to the quality of the tax service and the structure of the tax system.

Participants mentioned that tax service quality is often considered to be the availability of public goods and services (service delivery), while the tax structure focuses on the tax base, tax rates and compliance measures. One of the participants, T, mentioned:

"*Tax service quality has a positive impact on voluntary compliance among informal economy operators". In Sri Lanka, people in the informal economy do not see the value of paying taxes due to poor service delivery in towns and cities*. As another participant's response above, '*informal economy taxpayers can comply with presumptive taxes only when they are satisfied with the way in which public funds are used to provide essential social services.*

Various news reports indicate that in Sri Lanka, there are visible signs of abuse and misappropriation of public funds, as evidenced by poor value for money in infrastructure work, a decreasing trend in the health system, and inadequate facilities.

A tax official selected as one of the respondents supported the above opinion: *"Informal economy operators are willing to comply voluntarily, but are demanding tangible benefits (payoff rule) from taxes paid. When taxpayers see state-of-the-art infrastructure services, such as healthcare facilities, good schools, clean water, and other social amenities, they are motivated to fulfil their tax obligations. Therefore, the government should commit itself to providing tangible services".*

Another consultant who was a participant (C4) emphasized,

"IRD Sri Lanka must outline the benefits associated with paying tax. Taxpayers are concerned with the benefits they receive from the tax paid. No benefits, no tax paid —simple equation.

The same point was raised by several participants, who added that many villagers often conclude that the lack of clean water for agriculture is due to the misappropriation of public funds by those in positions of authority.

These responses indicate that the government needs to invest in the provision of goods and services that are of public interest. However, the tax revenue collected by the government is either diverted for their own accounts or pilfered by government officials at the expense of service delivery. Generally, all taxpayers (in both the formal and informal sectors) in Sri Lanka are discouraged from paying taxes due to the deep-rooted levels of corruption and the misuse of taxpayer money that persisted under the previous regime. However, most participants indicate a lack of political will to combat corruption in Sri Lanka. The present government has initiated efforts to combat corruption. For example, a participant (T8) said:

"I believe that the current crop of political leaders has fallen in love with criminality and corruption". It is now a new culture embedded in every facet of life in Sri Lanka. Activists in Sri Lanka were denouncing corrupt practices by top government officials, and guess what? They are either jailed or abducted for exposing corrupt deals. Look at the state of our economy; we ended up in bankruptcy. The state stopped repayments of loans to other countries in April 2022, because of this corruption and poor management.

The above response indicates that the informal economy is reluctant to comply with tax laws due to a lack of basic public amenities, including roads, drinking water, sanitation, and health services. In other words, the availability of these indispensable services influences individuals' short- to long-term tax compliance decisions. Poor service delivery in Sri Lanka constitutes undisputed evidence of the abuse and misappropriation of public funds, which will further perpetuate tax noncompliance behaviour within both the informal and formal economies.

There were similar views among other participants as well, signifying the importance of directing tax revenue to enhance social amenities and encourage tax compliance, thereby improving taxpayers' morale. Improving service delivery, particularly in the health sector, will significantly enhance presumptive tax compliance and, consequently, increase tax revenue. These attributes show that the government is not providing quality goods or services to the public, regardless of whether taxpayers pay taxes.

Forty-three previous government ministers and a member of parliament received a huge amount of compensation ranging from Rs. 542,000 to 91 million, from government funds for their burnt houses. These scandals involve high-profile individuals who are taking advantage of corrupt systems, and the state should utilise the judicial system to punish these looters. It appeared as though Sri Lanka had a lot of corruption, which forced the country into its present crisis.

A tax consultant who was interviewed explained that t*he government is not committed to providing essential services to the people.* Being a country with a collapsed health system, many doctors and consultants are migrating from Sri Lanka due to high tax rates for individuals. Considering the above two points, there is a lack of accountability and commitment on the part of the government. The fact that the government is not prioritising service delivery leads to tax noncompliance among people in the informal economy. They reported that poor service delivery was a catalyst for increasing tax noncompliance among taxpayers. This implies that the lack of tangible benefits motivates a culture of noncompliance among taxpayers.

Various reports have surfaced about scandals involving high-profile individuals, but these perpetrators are not prosecuted at all. Why are these criminals not sent to jail? The Legal system of Sri Lanka enables criminals to obtain bail and be released from jail. The failure of judicial services to challenge perpetrators facilitates tax noncompliance among potential taxpayers from the informal economy in Sri Lanka. The evidence gathered from the data suggests that these unwholesome practices, which are common in all public sector organisations, provide some justification for tax noncompliance in Sri Lanka. Another participant (T5) explained as follows:

…These 'entrepreneurs', upon bribing those who award them tenders, may in turn compromise quality to recover the initial payment made to government officials… Some projects that have long been abandoned, especially those donated by the Indian Advani Group, are also under review. The apparent reason is that officials take money for projects. Do you expect those from the informal economy to pay tax for what? (Participant questioned)

The above attitudes suggest that there is widespread corruption in the tendering and procurement processes in Sri Lanka, which negatively impacts service delivery. Failure to follow procurement and tendering procedures results in the government awarding tenders to undeserving contractors who fail to deliver the services as promised. Overall, service delivery is a crucial factor that taxpayers consider when making their decision to pay. This finding suggests that taxpayers are motivated to pay taxes when there is an improvement in service delivery. They further state that corruption remains a significant challenge, affecting tax revenue mobilisation efforts in developing countries.

Subtheme: Presumptive Tax Structure

The tax system structure emerged as a key determinant of the existing tax compliance status within the informal economy. Therefore, based on the assessment, the paper identifies tax rates, penalties, and the complexity of the tax system as the key elements of the tax system.

One commissioner (T7)is of the view that the Tax structure should be simplified:

"Tax payers find it difficult to compute their tax liability; there are various tax sections, subsections, provisions and schedules which tax payers cannot understand; as a result, they should talk to tax consultants. This will increase the tax liability along with the consultancy payment"

Similarly, all participants interviewed for this study mentioned that the complexity of the tax system influences presumptive tax noncompliance. One of the participants stated the following:

"The presumptive tax is based on an estimation of tax liability. Owing to their failure to understand the criteria for estimation and computation, taxpayers may decide not to comply or end up bribing tax officials to avoid paying more"

Informal economy operators should be charged based on their actual income rather than estimates of their income. The responses collected from the interviews show that the impediment and vagueness of the presumptive tax policy are among the obstacles to tax compliance. Some provisions in the policy are unclear, and taxpayers capitalise on the ambiguities. In reinforcing this point, a participant who is a commissioner (T10) observed:

"Some provisions in the policy document have been criticized for being open to several meanings. There is a need to redefine and rephrase all unclear sections of the presumptive tax policy for simplicity and viability".

The presumptive tax rates prescribed by the Inland Revenue Act are too high compared to formal economy rates. This means that presumptive tax rates are significantly higher than those for the same activities in the formal economy. This response from participant (T5) confirms this:

"I don't think field research was properly done. If proper research had been conducted, the Inland Revenue of Sri Lanka could have prescribed more effective tax rates. How can the government set a high tax rate for the poor? I think our government has lost a sense of humanity; it is charging against poor people who are operating in the informal economy".

One of the Participants also added that "the current tax system is not pro-poor or fair." He indicates that informal economic business operations, controlled by politicians aligned with the ruling party, are not concerned about the high tax rates imposed by the government, especially in the cottage industry. From official documents viewed by the researcher,

The above response from the said participant helps conclude that the tax system is selective and oppressive to poor operators in the informal economy. This appears to contradict the principle of equity and may incentivise further tax evasion (Dube & Casale, 2016). It is common for informal economic operators to resist or avoid paying taxes, and in such a situation, the government is the greatest loser. Political interference in revenue collection weakens the tax system and creates a culture of noncompliance among taxpayers. Based on the above responses from the participants summarised, people may defend against non-compliant tax behaviour, citing legal and regulatory barriers as the primary cause. The participants' comments and observations above provide socio-economic intricacies and constraints that justify tax noncompliance within the sector. Solving this puzzle requires a holistic approach, as concentrating solely on legal and regulatory factors may not be sufficient for building a comprehensive tax culture.

Discussion

This research focused on a qualitative diagnosis of the factors influencing presumptive tax collection in Sri Lanka. The analysis of data collected for this study revealed three important factors that promote or influence presumptive tax collection in Sri Lanka. The results show that legal and regulatory factors, institutional factors and governance significantly influence presumptive tax collection.

The first is related to institutional factors that influence voluntary compliance. Regarding the payment of presumptive tax, thiss study establishes that a lack of capacity (both human and financial resources) and commitmen,tas well as inadequated suppor,t has significantly contributed to poor presumptive tax collection in Sri Lanka. The Inland Revenue Department of Sri Lanka is understaffed and lacks a budget to mobilise tax revenue from the burgeoning informal economy in Sri Lanka.

The study further revealed that the major reason for the poor performance of the presumptive tax system was the lack of resources (both human and financial), which represent barriers to the full roll-out of a presumptive tax regime in Sri Lanka.

The second factor that influences the collection of presumptive tax revenue is credit for governance. According to the empirical findings, policy inconsistency, political illegitimacy, and interference are often associated with inefficiencies in tax revenue collection. The participants' responses revealed that political interference and policy inconsistency lead to inefficient presumptive tax revenue collection. The third and final factor is related to legal and regulatory frameworks, specifically the enforcement of rules and regulations, the quality of services, and the presumptive tax structure, which significantly impact presumptive tax collection.

Thus, this study identifies the legal and regulatory agents as critical inhibitors of presumptive tax collection in Sri Lanka. This means that better legal and regulatory measures can augment presumptive tax revenue collection.

Conclusion

This article concludes that the constant low tax revenue from the presumptive tax system in Sri Lanka is influenced by several factors, including institutional factors, a lack of legal and regulatory frameworks, and governance and political factors.

In principle, the informal economy remains a potential revenue base in Sri Lanka. This article has established that taxing this expanse, yet a beneficial sector of the economy, has been a daunting task due to corruption, political interference, the selective use of tax laws and the lack of a proper tax framework.

Based on the factors that emerged from the analysis of data and discussion above, this study recommends that the government of Sri Lanka should develop a proper tax system and phase out cash in the payment system to ensure the traceability of all financial transactions in real-time. Furthermore, the government should invest in public infrastructure, such as hospitals, facilities, roads, and other essential services, to gain the trust of its citizenry.

References

Edmore, M., Samson, M., & Stepen, E. M. (2017). The informal sector tax Revenue potential: A Case of Zimbabwe, Reos, *Research Journal of Finance and Accounting*, 8.

Munyaradzi D. (2021). A Critical Review of the Characteristics of Presumptive tax systems in Developing Countries,' *Research of Business & Management,* 17(2), 27-43.

Munjeyi, E., & Fourie, H.(2017). A Qualitative Diagnosis of Factors influencing Presumptive tax collection in Zimbabwe, *South Asian Journal of Business and Management Cases*.

Bird. R. M & Wallace, S. (2015). The content and role of presumptive taxes in taxing the hard-to-tax: Lessons from theory and practice. *Emerald insight*, 121-158.

Dube, G,,.& Casale, D. (2016). The implementation of informal economy taxation: Evidence from selected African countries. *E-journal of Tax Research*, 149(3), 601-623.

Rajaraman, I. & Bhende, M.J. (1998). A land-based agricultural presumptive tax designed for levy by panchayats, *Economic and Political weekly*, 33(14), 765-778.

Anojan, V. (2014). Tax policy changes and their impact on tax revenue: A case study in Sri Lanka, Vol. 3 (10), *International Research Journal of Social Sciences.*

Emmanuelle, A. & Michael, W. (2005). "Taxation Base in Developing Countries," 89(4).

Michael Carnaham, Taxation challenges in developing countries, Asia & the Pacific policy studies, . 2.

Harsha Konara Mudiyanselage, Anu Rammohan, Shawn Xiaoguang Chen, Tax effort in developing countries: Where is Sri Lanka?

XiaoshuXu, Yujie Su, Yunfeng Zhang, Yunyang Wu, Xinyu Xu, Understanding learners' perception of ChatGPT: A Thematic analysis of peer interviews among undergraduates and postgraduates in China, Heliyon 10(2024)

Auriol, E., & Warlters, M. (2005). *Taxation base in developing countries*. *The American Economic Review, 89*(4), 968–993.

Bird, R. M., & Wallace, S. (2015). The content and role of presumptive taxes in taxing the hard-to-tax: Lessons from theory and practice. *Emerald Insight*, 121–158.

Carnahan, M. (2015). *Taxation challenges in developing countries*. *Asia & the Pacific Policy Studies, 2*(1), 169–182.

Dube, G., & Casale, D. (2016). The implementation of informal economy taxation: Evidence from selected African countries. *E-Journal of Tax Research, 14*(3), 601–623.

Duve, M. (2021). A critical review of the characteristics of presumptive tax systems in developing countries. *Research of Business & Management, 17*(2), 27–43.

Konara Mudiyanselage, H.K., Rammohan, A., & Chen, S. X. (2020). Tax effort in developing countries: Where is Sri Lanka? *Journal of Tax Administration, 6*(1), 162–189.

Munjeyi, E., & Fourie, H. (n.d.). A qualitative diagnosis of factors influencing presumptive tax collection in Zimbabwe. *South Asian Journal of Business and Management Cases*.

Munjeyi, E., Mutasa, S., & Maponga, S. E. (2017). The informal sector tax revenue potential: A case of Zimbabwe. *Research Journal of Finance and Accounting, 8*(1), [pages not specified]. ISSN 2222-1697 (Print), 2222-2847 (Online).

Rajaraman, I., & Bhende, M. J. (1998). A land-based agricultural presumptive tax designed for levy by panchayats. *Economic and Political Weekly, 33*(14), 765–778.

Anojan, V. (2014). Tax policy changes and their impact on tax revenue: A case study in Sri Lanka. *International Research Journal of Social Sciences, 3*(10).

Xu, X., Su, Y., Zhang, Y., Wu, Y., & Xu, X. (2024). Understanding learners' perception of ChatGPT: A thematic analysis of peer interviews among undergraduates and postgraduates in China. *Heliyon, 10*,