FACULTY OF
MANAGEMENT & FINANCE
UNIVERSITY OF COLOMBO

Vol. 04, No. 01, June 2013

Colombo
Business
Journal

International Journal
of Theory & Practice

Importance and Issues of Taxation in Sri Lanka

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Abstract

Fiscal deficit is a chronic problem for many countries including Sri Lanka. Although there are several ways, budget deficit tax revenue will be the best source to finance budget deficit which may consider the adverse repercussions of alternative sources such as money creation and debt. Though increasing share of tax revenue in GDP is an instrumental objective of economic development policy, Sri Lanka has not been successful in raising adequate tax revenue to meet its public expenditure on general public services, social services, economic services, etc. The country faces several issues such as declining of low level tax ratio, slow structural change of tax composition, dismal outcome even after changing of tax system and low level of efficiency and productivity of Value Added Tax (VAT). This paper intends to emphasize the need of enhancing tax revenue while analyzing the adverse repercussion of alternative deficit financing methods such as money creation and debt. This study uses secondary data published by the Central Bank of Sri Lanka, the Department of Inland Revenue and the World Bank and illustrates its finding using graphs and tables. To reduce its dependency on money creation and debt, the country should take several measures including broadening the tax base, simplifying the tax rates, simplifying the tax laws, reducing the number of taxes, facilitating voluntary compliance, avoiding politically motivated tax amnesties and tax concessions, and avoiding political interferences and influences on tax administration to enhance tax revenue.

Keywords: Sri Lanka, Money creation, Debt, Tax ratio, VAT

1. Introduction

Significant fiscal deficit is a chronic problem for many countries. In the past three decades, a number of developing countries have experienced major episodes of financial crises that were brought about by unsustainable fiscal deficits (Mahdavi, 2004). As in the case of a number of other developing countries, the fiscal deficit in Sri Lanka too has been high for a long period. The average fiscal deficit

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was 8.5 per cent of GDP during 1992-2011 (Central Bank of Sri Lanka). However, even 8.5 per cent deficit could be a precarious phenomenon as it could act as a catalyst for financial instability in the country.[1]There are three ways in which fiscal deficit can be financed: money creation, borrowing from abroad, and borrowing from the domestic sector. Each of the different ways of financing the deficit has its own problems. Many developing countries create money (such as borrowing through treasury bills) as an easy way to finance the fiscal deficit. This, however, could instigate harmful repercussions on the economy by creating hyperinflation. Foreign borrowing may lead to external debt problems and borrowings from the domestic commercial banks could reduce domestic investment. That is why debt and money creation are considered as unsustainable sources of revenue. The fiscal crises experienced by several developing countries2 in the past three decades underscored the importance of an adequate level of taxation as the main source of resource to pay for government spending (Mahdavi, 2004). Therefore mobilization of tax revenue is crucial for any country including Sri Lanka. However, Sri Lanka could not raise its tax revenue significantly as a percentage of GDP for a long time in line with the theory and the experience of developed and fast growing countries. Several factors have contributed for the lacklustre performance of the mobilisation of tax revenue in Sri Lanka.

2. Importance of Taxation

The main purpose of taxation is to raise resources to finance government expenditure in a way that is administratively feasible, equitable and efficient (Burgess & Stern, 1993). A country's tax system is one of the determinants of other macroeconomic indices such as economic growth, public debt, fiscal deficit and inflation. Likewise the macroeconomic status of a country has a major bearing on its tax structure. Specifically, there exists a relationship between the level of economic growth and development and the tax structure. Indeed, it has been argued that the level of economic development has a very strong impact on a country's tax base (Musgrave, 1969). Revenue mobilization through taxation is an important element in medium-term development plans that aim to raise domestic investment and government savings while reducing reliance on debt creating capital inflows (Bovenberg, 1986).

Lewis (1984) argues that an increasing share of tax revenue in GDP is an instrumental objective of economic development policy. High-income countries have had rising shares of tax revenue and government expenditures to income as they became more economically advanced. Similarly, comparison among countries at different levels of per capita income generally show higher shares of government expenditure and tax revenue to national income in higher-income countries than in poor countries. There appears to be a relative increase in the demand for government services as per capita income increases.

At very low levels of per capita income, the principle needs are for "private" goods, such as food, clothing, and shelter. The income elasticity of demand for these products falls as per capita income increases and there is an increased demand for "public" goods at higher levels of income. The increased demand is for government services in the areas of transportation, communication and

[1] For example, Brazil's financial crisis in 1999 was closely related to its high budget deficit, which was 8.4% of its GDP (Woo, 2003).

[2] In 1990, Peru's public deficit was 8.1% of GDP, and Zambia's 8.2%. The fiscal stances of many developing countries were even worse in the 1980s. For example, Mexico's public deficit was 15.4% of GDP in 1982, Zambia's 28.5% in 1986, and Cote d'Ivoire's 14.4% in 1989 (Woo, 2003).

general government administration to deal with increased complexities. Further, the demands for certain welfare services and transfer payments to various poorer sections of the population are felt much more strongly at higher levels of per capita income than at lower ones. All these pressures to increase the level of government expenditure and transfer payments generate a need to increase tax revenue in order to release resources for the provision of these government services.

In addition to general government consumption expenditure, the governments of developing countries usually wish to increase development-oriented services such as education and training, agricultural extension and research. Thus, the government revenue may need to grow at a rate that exceeds the growth of national income in order to provide resources for recurrent government expenditure. Moreover, since urbanization is a continuous process in almost all developing countries, infrastructure development would be crucial and inevitable. Further, when countries' economies grow, expenditure on social development will also increase. Particularly, as developing countries need to spend more on public infrastructure, education, health services and so on, they need to increase their tax ratio if they want to grow and to be less poor. Since private sector plays inconsequential role in the provision of education, health, infrastructure *etc*. in developing countries considering the importance of these sectors for the long term socio-economic development role of states is felt more in the provision of education, health, infrastructure particularly in developing countries. (Bird et al., 2008). Therefore, government's need more financial resources in order to meet the cost of infrastructure and social development. Sri Lanka also needs to spend more on social and economics services particularly after three decades of armed conflict which retarded the socio-economic development of the country and therefore it is vital for the country to raise tax revenue rather than depending overwhelmingly on debt (Amirthalingam, 2011/2012). While tax revenue is a better source than debt and money creation in financing budget deficit, however, Sri Lanka faces numerous challenges which impede the government's attempts to raise revenue to the levels required to support government expenditure on a sustainable basis. The following sections elaborate important issues in regards to Sri Lankan tax system. These issues need to be addressed in a constructive manner by policy makers and policy implementers.

3. Issues in Taxation

Since depending overwhelmingly on money creation and debt creates adverse repercussions on the economy, it is true that the taxation is considered to be the best source for financing the budget deficit. However, there have been several issues related to the Sri Lanka's tax system for a long time. Therefore, it is important to analyse such issues in detail.

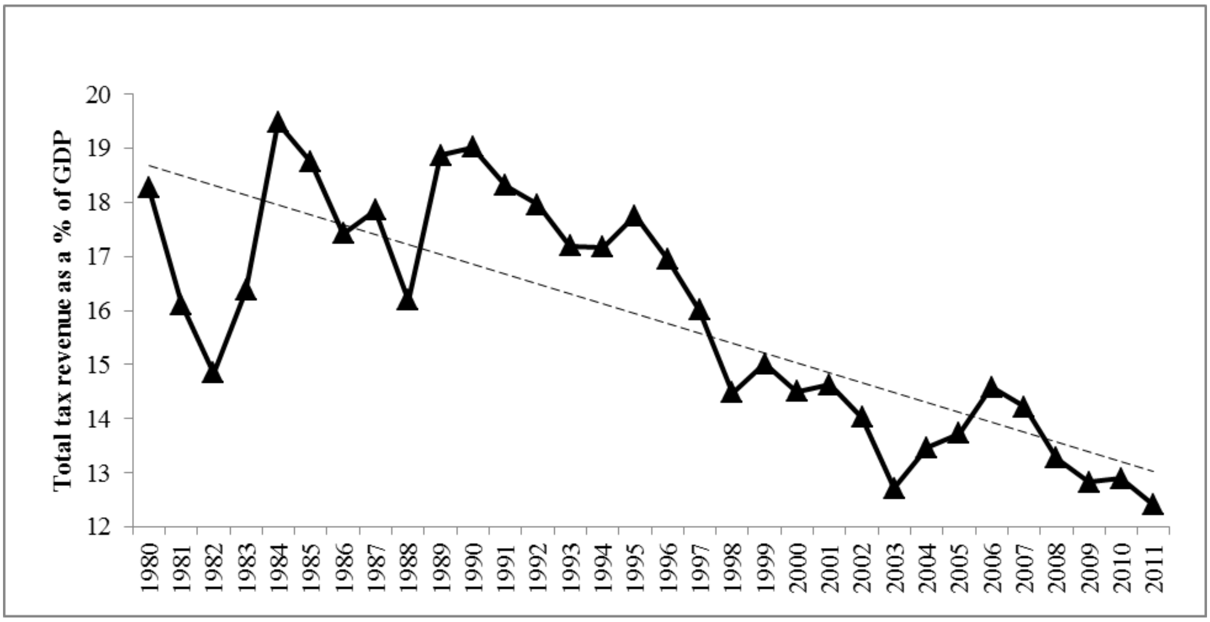
3.1 Low Level of Tax Ratio

Tax ratio is defined as total tax revenue as a percentage of GDP. Almost half a century ago, Kaldor (1963) argued that for a country to become "developed" it needed to collect taxes at 25-30 per cent of GDP. It is obvious that Sri Lanka remains well short of Kaldor's target. International empirical evidence on tax ratio has been 36 per cent, 28.8 per cent and 16.5 per cent and 13.9 per cent as the tax ratios for high- income, upper middle income and lower middle income and low income countries respectively in 2004/2005/2006 (Pessimo & Fenochietto, 2010; IMF, 2011).

Though Sri Lanka's tax ratio fluctuated during the period of 1980-2011, since 1997 it has always been below 16.5 per cent which is the average of lower middle income countries (see Figure 1 and

Table 1). Though Sri Lanka is classified as a lower middle income economy by the World Bank, according to Table 1, Sri Lankan tax ratio has been lower than the average tax ratio of a low income country since 2005. While being a low income country, Ghana's performance is really impressive in its achievement of raising tax ratio even above the average level of lower middle income countries. Similarly, the achievement of lower middle income countries like Thailand and Ukraine is also remarkable. Ukraine, being a lower middle income country, has managed to raise its tax ratio even above the average level of higher income countries. It is important for Sri Lankan tax policy makers and implementers to realize how low income African countries like Kenya and Ghana and lower middle income countries like Thailand and Ukraine managed to raise their tax ratio significantly.

Figure 1: Total Tax Revenue as a % of GDP in Sri Lanka



Source: Central Bank of Sri Lanka (Various Annual Reports)

Table 1: Tax Ratio in Countries with Different Per Capital Income Level

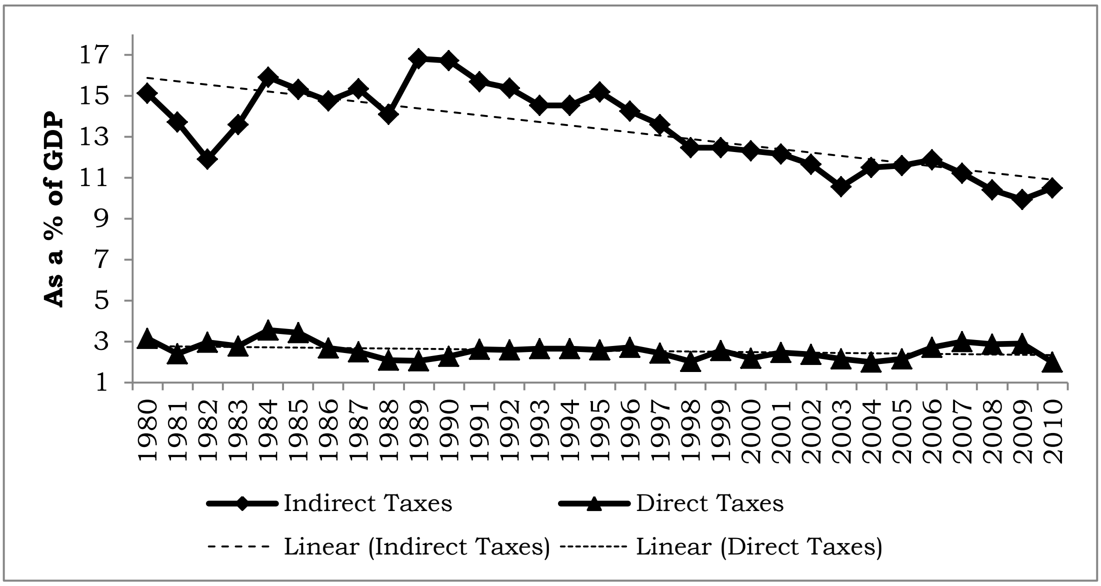
Low- Income			Lower Middle- Income		
Bangladesh	2004	8.1	**Pakistan**	2006	9.5
Mali	2006	15.5	**Sri Lanka**	2005	13.7
Zambia	2006	17	**India**	2005	16.4
Kenya	2005	18.3	**Thailand**	2006	19.5
Ghana	2004	22.4	**Ukraine**	2006	36.6
Average		13.9	**Average**		16.5

Upper Middle Income			High- Income		
Dominican Rep	2005	14.2	**Singapore**	2005	12.7
Argentina	2006	27.4	**United States**	2005	27.3
Jamaica	2005	32.4	**Norway**	2006	43.6
Brazil	2006	34.2	**France**	2006	44.7
Belarus	2006	45.7	**Sweden**	2006	50.1
Average		26.8	**Average**		36

Source: World Development Indicators

Figure 2, indicates that direct taxes (mainly income taxes), as a percentage of GDP, remained at an average of 2.5 per cent during 1980-2011. It shows that the decline in the tax ratio is clearly due to a decline of indirect taxes as a percentage of GDP. There are two issues here. On the one hand, Sri Lanka could not prevent the declining trend of indirect tax revenue as a percentage of GDP, and on the other hand the country could not enhance the direct tax revenue as a percentage of GDP with a view to offsetting the decline of indirect tax revenue as a percentage of GDP. The end result has been a steady declining trend in the tax ratio.

Figure 2: Role of Indirect and Direct Tax Revenue in Total Tax Revenue



Source: Central Bank of Sri Lanka (Various Annual Reports)

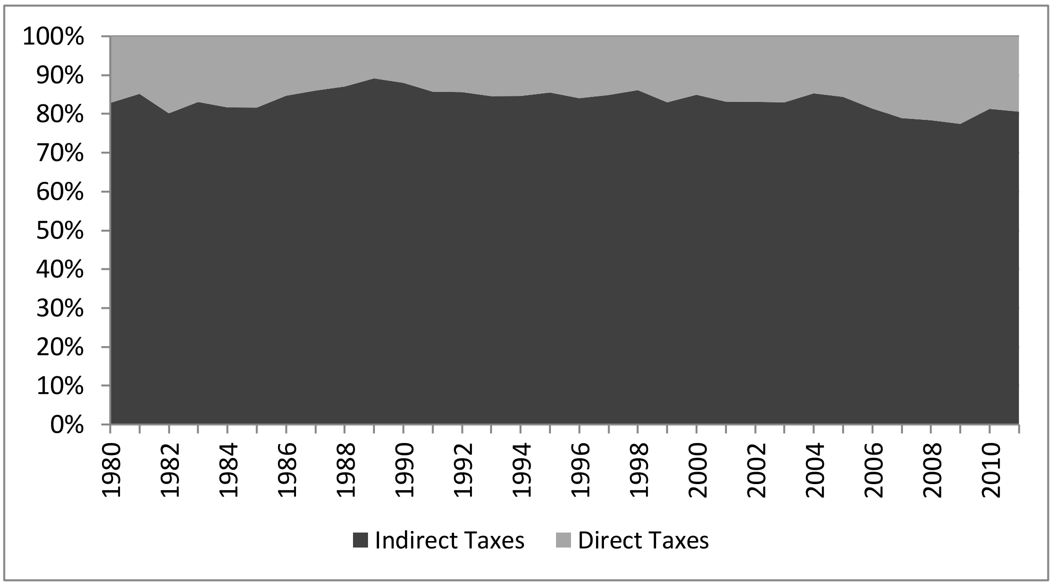
Why is the tax ratio low in Sri Lanka? Like many developing countries, Sri Lanka is characterized by a significant agricultural sector - both in terms of contribution to total output and to employment. Though the total output from agriculture in GDP has been declining (decreased from 31 per cent in 1977 to 11.9 per cent in 2010) employment share of agriculture in the total employment has been almost the same over time (decreased slightly from 36 per cent in 1977 to 32.7 per cent in 2010). The country also has a large informal sector characterized by, many small establishments, and a small share of wages in total national income.[3] These characteristics reduce the possibility of depending on personal income tax and induce the country to be more dependent on indirect taxes. To reduce the burden caused by indirect taxes on the poor, government usually exempt necessities. Moreover, due to some other reasons such as unplanned and ad hoc fiscal measures including tax exemptions, tax amnesties and tax concessions, the increase in the exemption threshold for income tax and the reduction of import duty rates, lack of elasticity and buoyancy of the fiscal system, complexity in tax legislation and lack of fiscal consistency, and the weaknesses in tax revenue administration, the level of tax collection continues to be lower than optimal in Sri Lanka (Waidyasekera, 2004). Political favouritism, political influence, and a lack of a clear cut political rationale on taxation have also adversely affected the tax revenue potential (Amirthalingam, 2010).

3 Though there are 2,627,168 employees in the public sector alone in 2009 (Central Bank of Sri Lanka, 2009) only 475,340 public and private sector employees have registered under PAYE scheme in 2009 (Department of Inland Revenue, 2009).

3.2 Slow Structural Change of Tax Composition

Generally, direct taxes constitute a significant portion of total tax revenue while indirect taxes play relatively an insignificant role in developed countries. In contrast, the experience of developing countries is quite different because bulk of government revenue stems in these countries from indirect taxes while direct taxes contribute much less. However, according to theory as well as the experience of developed and fast growing countries, it is important to note that a developing country like Sri Lanka should gradually reduce its dependency on indirect taxes and to shift on to direct taxes during the development process. However, as far as Sri Lanka is concerned this gradual movement from indirect taxes to direct taxes is relatively very slow. Figure 3 clearly illustrates the slow structural change of tax composition during 1980-2011 period (see Figure 3 and Table 2).The visual inspection of Figure 3 suggests that direct taxes averaged 16.4 per cent of total tax revenue while indirect taxes averaged above 83.6 per cent of total tax revenue during the period of 1980-2011.

Figure 3: Indirect and Direct Taxes (% of Total Tax Revenue)



Source: Central Bank of Sri Lanka (Annual Reports)

Table 2: Taxes on Income, Profits and Capital Gains(% of Total Taxes) in Selected Countries

Country	1990	1992	1994	1996	1998	2000	2002	2004	2006	2008	2010	2011
Sri Lanka	12	14	15	16	14	15	17	15	19	21	19	19
Canada	72	71	71	73	74	76	72	74	77	..	77	77
Thailand	..	..	..	..	..	..	..	39	44	48	42	46
Malaysia	43	47	44	46	60	55	62	..	..	..	67	70
Korea, Rep	40	40	39	37	41	38	37	41	44	..	42	45
India	19	23	29	30	32	36	38	43	47	52	56	56
Pakistan	13	18	21	20	29	28	31	28	28	37	36	37
Uganda	..	..	..	..	15	16	21	25	27	27	31	45
Kenya	..	29	33	40	38	33	33	36	39	42	44	45

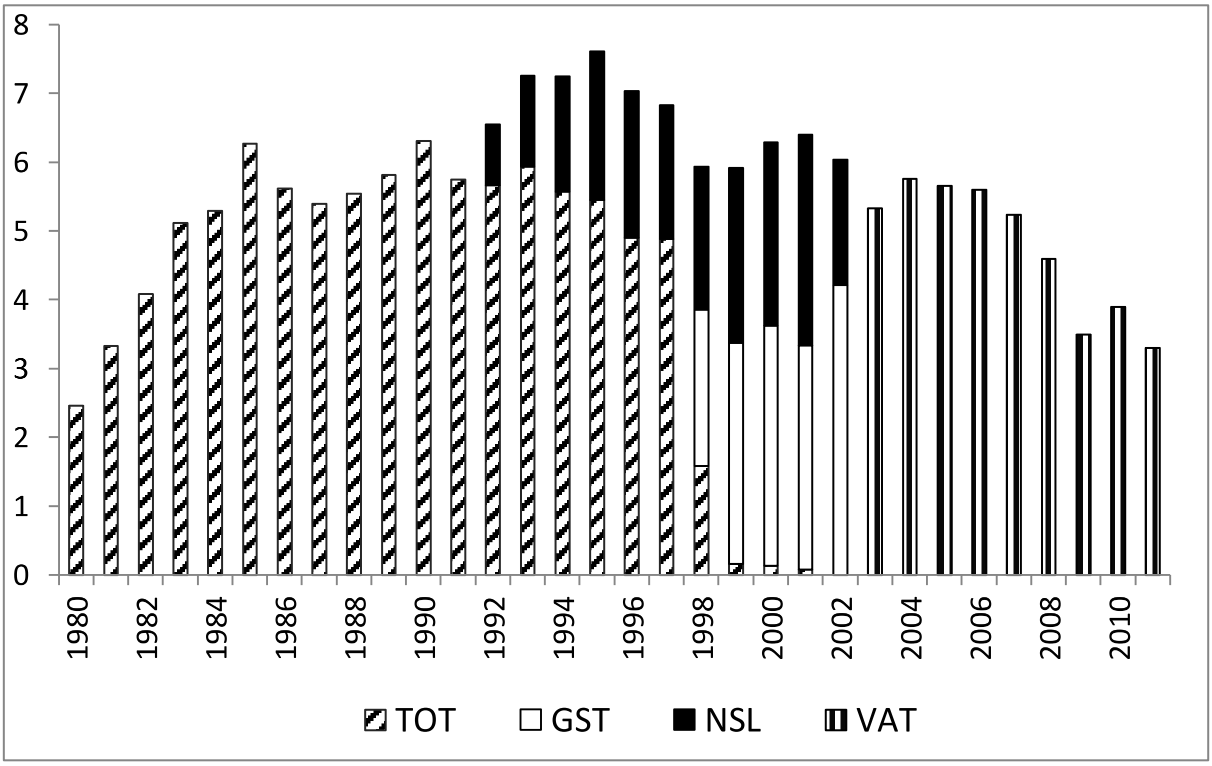
Source: World Development Indicators

..: Not Available

There are two possible options for Sri Lanka. *viz.*, enhancing domestic indirect taxes and/or strengthening the direct tax system, (taxes on income, profits and capital gains). Table 2 illustrates the better performance of Thailand, Malaysia, India and Uganda in raising revenue from income, profits and capital gains. However, according to the same table, Sri Lanka could not emulate the experience of these countries with regard to enhancing revenue from direct taxes (income, profits and capital gains). Alternatively Sri Lanka must maximize revenue through indirect taxes *i.e.* VAT.

Dismal outcome even after the changes of tax system: Countries tend to introduce a new tax due to their dissatisfaction with the existing tax, and tax reforms are common particularly in times of economic crisis. Dissatisfaction arises mainly when the existing taxes are unsatisfactory and the evolution of tax system has not kept pace with the development of the economy (Tait, 1988). Since independence, Sri Lanka has often altered its tax system and has experimented with three different forms of indirect taxation: Business Turnover Tax (BTT), Goods and Services Tax (GST) and Value Added Tax (VAT) on production and expenditure. Although value added type GST had been in operation since 1998, there had been a parallel turnover based tax system that was operated in the form of a National Security Levy (NSL). Sri Lanka shifted from turnover tax to GST due mainly to the cascading effect (tax on tax) of turnover tax in 1998. However after the introduction of the GST, tax revenue as a percentage of GDP declined sharply. In view of the weaknesses of the GST, again Sri Lanka shifted to VAT in 2002. However it has been seen that VAT also has not functioned as a promising tax system.

Figure 4: Revenue from BTT/TT, GST, NSL and VAT(As a Percentage of GDP)



Source: Central Bank of Sri Lanka (Annual Reports)

Figure 4 shows the differences in revenue performance of turnover tax, GST and VAT during the period 1977-2011.It seems that the turnover tax system performed relatively better as far as revenue generation was concerned. This figure clearly demonstrates that there was an upward trend in revenue collection under turnover taxes and that revenue collection even exceeded by 6 per cent of GDP in some years particularly in 1985 and in 1990. However, after the introduction of the GST, tax revenue as a percentage of GDP declined sharply. Initial difficulties and delays in the registration process which is essential for a value added tax (GST is also a value added type tax) contributed much to this decline. Even though all the registered persons and firms were absorbed into VAT there were no significant improvements in revenue generation. Therefore even after the introduction of VAT, Sri Lanka could not experience the much needed revenue boost and the revenue did not reach 6 per cent of GDP, which was achieved under turnover tax in 1985 and 1990, and also during the period of 2003 and 2011. Even though VAT has been considered as a "money machine"[4] its performance in Sri Lanka is not promising.

3.3 Low Level of Efficiency and Productivity of VAT

After the first adoption in France in 1954, VAT has indeed proved itself an effective form of taxation and its growth is unprecedented by any other concept in taxation (Keen, 2007; Ebrillet al.2002; Keen & Lockwood, 2009). The extent and pace of the spread of VAT around the world has been one of the most striking international tax developments in recent past (Shoup, 1988). Since VAT has been accepted by many countries as an effective form of taxation, it will be impossible for Sri Lanka to shift from VAT to another form of tax system in the future. So it is important to Sri Lanka to take measures to enhance revenue through VAT. Since VAT plays a pivotal role in the entire tax system of Sri Lanka, it is important to examine its efficiency and productivity. The efficiency (sometimes called 'C-efficiency') and the productivity of VAT are the two indicators used to measure the performance of VAT in many countries. Efficiency is the ratio of VAT revenue to aggregate private consumption, divided by the standard VAT rate. The productivity index is the ratio of VAT revenue to GDP, divided by the standard VAT rate. The closer these ratios are to zero (one), the lower (higher) the collection efficiency of the VAT (Aizenman & Jinjarak, 2008; and Ebrill et al., 2002). VAT could be the most productive source of revenue for Sri Lanka. To achieve this objective, its efficiency and productivity should be high.

Table 3: Efficiency and Productivity of VAT in Sri Lanka

Year	Efficiency	Productivity
2003	0.40	0.27
2004	0.61	0.38
2005	0.55	0.38
2006	0.55	0.37
2007	0.52	0.35
2008	0.44	0.31
2009	0.46	0.30
2010	0.50	0.33
2011	0.39	0.27

Source: Calculated using data from Central Bank of Sri Lanka (Annual Reports) and Government of Sri Lanka (publications with regard to Value Added Tax Act and subsequent amendments)

According to Table 3, efficiency of VAT in Sri Lanka does not show a clear trend: it increased from 0.40 in 2003 to 0.55 in 2006 but after 2006 there was a significant decline until 2008 and there

[4] See Keen (2007) for the elaboration of this point.

was a slight improvement in 2009 and 2010 but declined significantly in 2011. The VAT collection efficiency can be improved through resources being spent on enforcement, and by increasing the effectiveness of monitoring, collecting and processing information. Theory suggests that the enforceability of taxes has an impact on political economy considerations – greater polarization and political instability which would tend to reduce the efficiency of tax collection, and reducing the resources devoted to tax enforcement. In addition, collection is influenced by structural factors that may affect the ease of tax evasion, like the urbanization level, the share of agriculture in GDP and trade openness (measured as the ratio of imports plus exports to GDP). Several cross country empirical studies (Ansari, 1982; Mahdavi, 2008) show that both urbanization and trade openness are significantly and positively related to tax collection efficiency, but in contrast the share of agriculture in GDP was negatively correlated to tax collection efficiency. So with the prevailing peaceful situation in the country, it is necessary to support industrialization and trade liberalization and channel increased resources to tax administration to improve VAT collection efficiency. It is also important to ensure efficient monitoring, and better usage of modern information technology (MIT) to enhance VAT collection efficiency in the coming years.

The productivity of VAT is not only relatively low, but has declined during 2004 and 2009, although there was a slight improvement in 2010, and it declined in 2011 (Table 3). This figure presents the percentage of GDP that each percentage point of the standard VAT rate collects. Therefore, we can conclude that Sri Lanka has collected only 3.24 per cent of GDP in revenue from VAT in 2010 [VAT productivity (0.27) multiplied by standard VAT rate (12 per cent in 2011]. To improve the level of revenue productivity of VAT, the total revenue from VAT as a percentage of GDP should increase. However, in Sri Lanka VAT has clearly not been achieved its greater revenue-generating objective: this may be due to several reasons such as its complicated structure, administrative weaknesses, political influences, tax avoidance and evasion, complexities in the tax law, lack of application of modern information technology, etc.

4. Conclusion

With a view to reducing its overwhelming dependency on public debt and money creation, Sri Lanka should take measures to increase the share of tax revenue in GDP. To enhance tax revenue, the country should take the following measures; (i) broadening the tax base, (ii) simplifying the tax rates, iii) simplifying the tax laws, (iv) reducing the numbers of taxes, (v) facilitating voluntary compliance, (vi) improving tax administration with the usage of modern information technology, (vii) strengthening investigation, audit and enforcement capacity, (viii) introducing new taxes and/or changing the tax law without complicating the existing tax system, (ix) avoiding politically motivated tax amnesties and tax concessions, (x) reducing corruption by introducing severe penalty systems to tax evaders and corrupt officials, (xi) providing incentives to genuine tax payers and tax officials, and (xii) avoiding political interferences and influences on tax administration.

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