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Taxation in Sri Lanka: Current Trends and Perspectives

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Acronyms

ASYCUDA	Automated System for Customs Data
BDV	Brussels Definition of Value
BIMU	Budget Implementation and Monitoring Unit
BOI	Board of Investment
BOP	Balance of Payments
BTT	Business Turnover Tax
CUSDEC	Customs Declaration
DL	Defence Levy
D – VAT	Digital Value Added Tax
EPS	Economic Policy Statement
ESC	Economic Service Charge
ESCAP	Economic and Social Commission for Asia and the Pacific
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GST	Goods and Services Tax
IMF	International Monetary Fund
IPO	Initial Public Offer
IPS	Institute of Policy Studies of Sri Lanka
IRD	Inland Revenue Department
ISFTA	India Sri Lanka Free Trade Agreement
IT	Information Technology
ITMIS	Integrated Treasury Management Information System
LTU	Large Taxpayer Unit
NAV	Net Annual Value
NBT	Nation Building Tax
NSL	National Security Levy
PAL	Ports and Airports Development Levy
PAYE	Pay As You Earn
PSFTA	Pakistan Sri Lanka Free Trade Agreement

PSDG	Province Specific Development Grant
R & D	Research and Development
RAMIS	Revenue Administration Management Information System
RIDL	Regional Infrastructure Development Levy
RTVAT	Real Time Value Added Tax
SAARC	South Asian Association for Regional Cooperation
SAFTA	South Asian Free Trade Agreement
SCL	Special Commodity Levy
SMEs	Small and Medium Enterprises
SNA	System of National Accounts
SRL	Social Responsibility Levy
SVAT	Simplified Value Added Tax
SWS	Single Window System
TIN	Taxpayer Identification Number
TL	Telecommunications Levy
TOR	Terms of Reference
UN	United Nations
VAT	Value Added Tax
VLN	Value Added Tax Location Number

Acknowledgement

The credit for initiating the project of analyzing the current trends and perspectives of taxation and fiscal policy must first of all go to Dr. Saman Kelegama, Executive Director of the Institute of Policy Studies of Sri Lanka at whose request the author prepared this report. Thanks are also due to Ayoni Rangala of the Institute for the assistance in formatting the publication.

Executive Summary

A country's fiscal policy and taxation system is a major determinant of macro-economic policy and sustainable economic growth particularly in such areas as government revenue, public debt, fiscal deficit, inflation as well as resource allocation, income distribution and economic stability.

Currently, Sri Lanka's fiscal and taxation system is at a critical juncture. With the end of the 30 year old insurgency, Sri Lanka has entered into a new era of growth, reconciliation and reconstruction. Development challenges are many both in the international and national contexts. In this background, this study attempts to analyze the current trends and perspectives of taxation and fiscal policy in Sri Lanka.

Commencing with analyzing the functions of a tax system, it identifies the declining revenue ratio to GDP as perhaps the dominant factor in Sri Lanka's current fiscal problems. The study analyses the reasons for the decline and measures necessary to reverse this trend and make the tax system an effective instrument of economic growth. In this context, the composition of tax revenue reveals the preponderant role indirect taxes play in the tax system in Sri Lanka in relation to direct taxes and the necessity to change the proportion to a more realistic figure.

One of the main reasons for the decline in government revenue is the proliferation of tax incentives and exemptions. While there are pros and cons in granting tax holidays and other concessions to attract much needed Foreign Direct Investment (FDI), these have to be made more realistic and the incentive system must be designed and implemented in a more methodical and cost effective manner.

Other issues discussed in this context is the relatively low elasticity and buoyancy of the tax system in Sri Lanka both being below unity, the role of taxation in savings and capital formation and the low tax base and coverage which affect the growth of tax revenue. Another factor that has led to this situation is the unplanned and ad hoc nature of fiscal policy and tax changes made in respect of allowances, slabs and tax rates from time to time in order to meet revenue requirements. This lack of consistency leads to taxpayer confusion and inconvenience and problems for the tax administration as well. The recent changes in income tax rates, changes to VAT threshold and rates as well as other miscellaneous taxes like NBT etc. can be cited as examples.

All these ad hoc changes also lead to tax evasion which is rampant in Sri Lanka and which issue is discussed in this paper. The problems relating to Value Added Tax (VAT) which has attracted much attention recently, is discussed in detail, its pros and cons, the relatively poor performance and factors such as the threshold, exemptions, zero rating, rate changes, refunds, etc. and measures to remedy these problems.

The paper also discusses other revenue issues such as capital gains taxation, its abolition and the current attempt to re-introduce it as well as customs duties, excise duties and miscellaneous taxes. Decentralization and provincial revenue is discussed in detail including the abolition of the provincial BTT and its implication for both provincial revenue and provincial administration. The resultant complexity of the tax system due to all these factors and the need for simplification is also stressed including the importance of promulgating a new Tax Act incorporating all the required changes.

In the final analysis, it is the level of efficiency of the revenue administration which determines the level of effectiveness of any revenue system. In the current context of the necessity to increase government revenue, the tax administration, its structures, systems and procedures need through examination, its weaknesses identified and measures taken to rectify them. The unsatisfactory number of taxpayers comprising about 3% of the population, low compliance, high default taxes, improvement of audit and investigation and lack of co-ordination between revenue departments are discussed at length as well as recent attempts already taken (including computerization) to improve the administrative system.

කාරක මණ්ඩල සාරාංශය

රටක පොදු දේපොළ සහ බදු අයකිරීමේ පද්ධතිය යනු සාර්ව ආර්ථික ප්‍රතිපත්තියෙහි සහ තිරසාර ආර්ථික වර්ධනයෙහි ඉතා වැදගත් නිර්ණායකයකි. ප්‍රධාන වශයෙන්ම රාජ්‍ය අදායම, මහජන ණය, පොදු දේපොළ හිඟතාවය, උද්ධමනය මෙන්ම සම්පත් බෙදීයාම, ආදායම බෙදාහැරීම සහ ආර්ථික ස්ථායීතාවය වැනි අංශයන්හි පොදු දේපොළ සහ බදු අයකිරීමේ පද්ධතියට හිමිවන්නේ ඉහළ වැදගත් කමකි.

වර්තමානයේදී ශ්‍රී ලංකාවේ පොදු දේපොළ සහ බදු අයකිරීමේ පද්ධතිය පවතිනුයේ ඉතා වැදගත් කාල වකවානුවකය. වර්ෂ 30ක පමණ කාලයක් පැවැති කුරිරු යුද්ධයේ නිමාවත් සමග ශ්‍රී ලංකාව සංවර්ධනයේ, සංහිඳියාවේ සහ ප්‍රතිසංස්කරණයෙහි නව යුගයක් වෙත පිය තබා සිටී. ජාත්‍යන්තර මෙන්ම දේශීය සන්දර්භයන් ද්විත්වය තුළම සංවර්ධන අභියෝගයන් බොහෝය. මෙම පසුබිම තුළ මෙම අධ්‍යයනයෙන් උත්සාහ කරනුයේ ශ්‍රී ලංකාවේ බදු අයකිරීම් සහ පොදු දේපොළ ප්‍රතිපත්තියෙහි වත්මන් නැඹුරුතාවයන් සහ දෘෂ්ඨිකෝණයන් පිළිබඳව විශ්ලේෂණයක් කිරීමයි.

බදු අයකිරිමේ පද්ධතියේ ක්‍රියාකාරීත්වය පිළිබඳව විශ්ලේෂණය කරමින් ආරම්භ කෙරෙන මෙම අධ්‍යයනය ශ්‍රී ලංකාවේ වත්මන් පොදු දේපොළ ගැටළු අතර වැදගත් කරුණක් වශයෙන් දළ දේශීය නිෂ්පාදිතය සඳහා ආදායම් අනුපාතය පහත වැටීම හඳුනා ගනී. අධ්‍යයනය මගින් ආදායම් අනුපාතය පහත වැටීම සඳහා හේතු මෙන්ම මෙම නැඹුරුතාවයන් ආපසු හරවමින් ආර්ථික වර්ධනයෙහි ඵලදායී මෙවලමක් බවට බදු අයකිරීමේ පද්ධතිය පත්කිරීමට අවශ්‍ය ක්‍රියාමාර්ග විශ්ලේෂණය කරයි. මෙම සන්දර්භය තුළ බදු ආදායම අනාවරණය කරනුයේ සෘජු බදුවලට සම්බන්ධව වක්‍ර බදු අතිවිශාල ප්‍රමාණයක් ශ්‍රී ලංකාවේ බදු පද්ධතිය තුළ ක්‍රියාත්මක බවත් මෙම තත්ත්වය වෙනස් කර යථාර්තවත් තත්ත්වයක් නිර්මාණය කිරීම වඩා වැදගත් අවශ්‍යතාවයක් බවත්ය.

රජයේ ආදායම පහළ වැටීමේ එක් ප්‍රධාන හේතුවක් වන්නේ බදු ගෙවීමට දිරිගැන්වීම සහ බදු නිදහස ලබාදීම ප්‍රගුණනයයි. ඉතා අවශ්‍ය සෘජු විදෙස් ආයෝජන (සෘෂ) ආකර්ෂණය කරගැනීම සඳහා බදු නිදහස ලබා දීම සම්බන්ධව වඩාත් යථාර්තවත් සහ දිරිගැන්වීම් පද්ධතියක් නිර්මාණය කළ යුතු අතර වඩාත් විධිමත් සහ පිරිවැය ඵලදායීතා ක්‍රමවේදයක් හරහා ක්‍රියාත්මක කළ යුතුය.

මෙම සන්දර්භය තුළ සාකච්ඡා කළ වෙනත් කරුණු අතර අන්‍යෝන්‍ය වශයෙන් නම්‍යතාවය අඩුවීම සහ ශ්‍රී ලංකාවේ බදු අයකිරීමේ පද්ධතියේ සැහැල්ලුභාවය යන කරුණු ද්විත්වයම එකතුව, ඉතිරි කිරීම්වල බදු අයකිරීමේ කාර්යභාරය සහ ප්‍රාග්ධන සම්පාදනය සහ අඩු බදු පදනම මෙන්ම ආවරණයද බදු ආදායම වර්ධනයට බලපෑම් ඇතිකරවයි. මෙම තත්ත්වයට බලපෑම් කරන ලද තවත් කරුණක් වන්නේ පොදු දේපොළ ප්‍රතිපත්තියෙහි අක්‍රමවත් සහ ආවස්ථික ස්වරූපයයි. එමෙන්ම කලින් කලට ආදායම් අවශ්‍යතා සපුරාලීම වෙනුවෙන් දීමනාල ස්ථර සහ බදු අනුපාතවලට අදාලව බදු වෙනස් කිරීමද ඊට බලපෑම් ඇති කරයි. මෙම අනුරූපීතා නොගැලපීම නිසා බදු ගෙවන්නා වියවුලට සහ අපහසුතාවයට පත්වීම මෙන්ම බදු පරිපාලනයට ගැටළු මතුවීමද සිදු වේ. ඝ්ඔ බද්දට මෙන්ම හර්ඔ වැනි වෙනත් සංකීර්ණ බදු සඳහා සිදු කළ මෑතකාලීන වෙනස්කම් ඊට උදාහරණ ලෙස දැක්විය හැකිය.

මෙම ආවස්ථික වෙනස්කම් සියල්ල ශ්‍රී ලංකාවේ බහුලව දැකිය හැකි බදු පැහැර හැරීමට හේතු වන අතර මෙම ලේඛනයෙහි එම ගැටළුව සාකච්ඡාවට ලක්කර තිබේ. අගය එකතු කළ බද්ද (ඝ්ඔ) සඳහා අදාළ ගැටළු මීට පෙර සවිස්තරව සාකච්ඡා කළ පරිදි විශාල අවධානයක් දිනාගන්නා ලදී. එහි ප්‍රගුණනයන් සහ වාසි සහගත තත්ත්වයන්ල අන්‍යෝන්‍ය වශයෙන් මන්දගාමී කාර්යසාධනය සහ නිදහස් කිරීම්ල ශුන්‍ය පොලී අනුපාතල අනුපාත වෙනස්වීම්ල නැවත ගෙවීම් ආදී කරුණු සහ ක්‍රියාමාර්ග මෙම ගැටළු නිවැරදි කිරීමට හේතු වෙයි.

මෙම ලේඛනය වෙනත් ආදායම් ගැටළුද සාකච්ඡා කරන අතර ප්‍රාග්ධන ලාභ බදු අයකිරීම වැනි ගැටළුද ඒ අතර වේ. එය ඉවත් කිරීම සහ නැවත ප්‍රවර්තන හඳුන්වාදීමට උත්සාහ ගැනීම මෙන්ම රේගු බදුල සුරා බදු සහ ප්‍රකීර්ණ බදු සඳහාද එම ක්‍රියාමාර්ගම ගැනීම සාධනීය වනු ඇත. විමධ්‍යගත කිරීම සහ ප්‍රාදේශීය ආදායම සවිස්තරව සාකච්ඡාවට ලක්කරන ලද අතර ප්‍රාදේශීය ඊඹඹ අවලංගු කිරීම සහ ප්‍රාදේශීය ආදායමට සහ ප්‍රාදේශීය පරිපාලනයට එහි සම්බන්ධය සාකච්ඡා කරන ලදී. මෙම කරුණු සියල්ල නිසා බදු පද්ධතියෙහි ඇතිවන සංකීර්ණතාවය නිසා එහි සරල කිරීමක අවශ්‍යතාවය පැන නැගී තිබෙන අතර අවශ්‍යකරන වෙනස්කම්වලට අනුව නිර්මාණය කළ නව බදු පනත ක්‍රියාත්මක කිරීම හරහා බොහෝ ආතතියන් දුරු වනු ඇත.

අවසාන විශ්ලේෂණයට අනුව ආදායම් පරිපාලනයෙහි ඵලදායීතා මට්ටම ඕනෑම ආර්ථික පද්ධතියක ඵලදායීතා මට්ටම තීරණය කරන බව පැවසිය හැක. වර්තමාන සන්දර්භය තුළ රාජ්‍ය ආදායම ඉහළ නැංවීම, බදු පරිපාලනය, එහි ව්‍යුහයන්, විමර්ෂණ හරහා අවශ්‍ය පද්ධති සහ ක්‍රියා පිළිවෙත්, එහි හඳුනාගත් දුර්වලතා සහ ඒවා නිවැරදි කිරීමට ගත හැකි ක්‍රියාමාර්ග පිළිබඳව බලවත් අවශ්‍යතාවක් මතුව පවතී. ශ්‍රී ලංකාවේ ජනගහණයෙන් බදු ගෙවන්නේ 3% ක් වැනි ඉතා සුළු පිරිසක් වන අතර සංඛ්‍යාත්මකව එය ඉතා අසතුටුදායක තත්ත්වයකි. අනුකූලතාවය දැක්වීම අඩු බව, අධික ලෙස බදු නොගෙවා පැහැර හැරීම, විගණන සහ විමර්ෂණ වර්ධනය සහ ආදායම් දෙපාර්තමේන්තුව අතර සම්බන්ධීකරණය අඩුවීම දීර්ඝව සාකච්ඡා කර ඇති අතර එමෙන්ම මෑතකාලීනව ගනු ලැබ තිබෙන උත්සාහයන් (පරිගණක ගත කිරීම් වැනි) පරිපාලන පද්ධතිය ඉහළ නැංවීමට හේතු වනු ඇත.

நிறைவேற்றுச் சாராம்சம

அரசாங்க வருமானம், பொதுக்கடன், நிதிசார் பற்றாக்குறை, பணவீக்கம் மற்றும் வளங்கள் ஒதுக்கீடு, வருமான பகிர்வு மற்றும் பொருளாதார உறுதிப்பாடு போன்ற பிரிவுகள் அடங்கலாக நிலைபேறான பொருளாதார வளர்ச்சி மற்றும் பரந்த பொருளாதார கொள்கை ஆகியவற்றின் பிரதான தீர்மானமெடுக்கும் காரணியாக நாட்டின் நிதிசார் கொள்கை மற்றும் வரிக்கட்டமைப்பு என்பது அமைந்துள்ளது.

தற்போது இலங்கையில் நிதிசார் மற்றும் வரிகட்டமைப்பு என்பது இக்கட்டான நிலையில் காணப்படுகிறது. நாட்டில் 30 ஆண்டுகளாக நிலவிய அமைதியற்ற சூழ்நிலை நிறைவடைந்துள்ள நிலையில், வளர்ச்சி, இணக்கம் மற்றும் மீளக்கட்டியெழுப்பல் எனும் ஒரு யுகத்தினுள் இலங்கை பிரவேசித்துள்ளது. அபிவிருத்திசார்ந்த சவால்கள் என்பது சர்வதேச மட்டத்திலும், தேசிய மட்டத்திலும் காணப்படுகிறது. இதன் பின்னணியில் இந்த ஆய்வினூடாக வரி அறவீடு தொடர்பில் தற்போது காணப்படும் நிலைமைகள் மற்றும் இயலுறுத்தோற்றங்கள் மற்றும் இலங்கையில் காணப்படும் நிதிசார் கொள்கை போன்றன தொடர்பில் ஆராயும் வகையில் அமைந்துள்ளது.

வரி கட்டமைப்பின் செயற்பாடுகள் பற்றி ஆராய்வதுடன் ஆரம்பிக்கும் இந்த ஆய்வில், மொத்த தேசிய உற்பத்தியில் அதன் வருமான பங்களிப்பு விகிதம் என்பது குறைவடைந்து செல்வதை இனங்காண்பதாக அமைந்துள்ளது. இலங்கையின் தற்போதைய நிதிசார் பிரச்சனைகளுக்கு முக்கிய காரணியாக இது அமைந்துள்ளது. இதற்காக காரணிகளை இந்த ஆய்வு ஆராய்வதுடன், இந்த நிலையை மாற்றியமைப்பதற்கும், பொருளாதார வளர்ச்சிக்கு வினைத்திறன் வாய்ந்த ஒரு கட்டமைப்பாக வரிக்கட்டமைப்பை மாற்றியமைப்பது எவ்வாறு என்பது தொடர்பிலும் கவனம் செலுத்தியுள்ளது. இதன் அடிப்படையில், வரி வருமானத்தின் அடக்கக்கூறுகள் என்பது நேரடி வரிகளுடன் ஒப்பிடுகையில் பெருவாரியான மறைமுக வரி அறவீடுகளை இலங்கையின் வரிக்கட்டமைப்பில் கொண்டுள்ளதாக கண்டறிந்துள்ளதுடன், இந்த உள்ளடக்கத்தை பெருமளவு நடைமுறைச்சாத்தியமான பெறுமதியாக மாற்றியமைக்க வேண்டிய தேவை எழுந்துள்ளது.

அரசாங்க வருமானத்தில் வீழ்ச்சி ஏற்படுவதற்கான பிரதான காரணிகளில் ஒன்றாக, மறைமுக வரி அறவீடுகள் மற்றும் விலக்கழிப்புகள் காணப்படுகின்றது. வரி விலக்கழிப்புகளை வழங்குவதில் பல சாதக பாதக கருத்துக்கள் மற்றும் வெளிநாட்டு நேரடி முதலீடுகளை கவர்வதற்கு பெருமளவு சலுகைகள் வழங்கப்படுகின்ற போதிலும், இவை நடைமுறைச்சாத்தியமானவையாக அமைந்திருக்க வேண்டும். அத்துடன், சலுகை முறை என்பது, கட்டுக்கோப்பானதாகவும் செலவீனம் குறைந்த வகையிலும் வடிவமைக்கப்பட்டு நடைமுறைப்படுத்தப்பட வேண்டும்.

இந்த ஆய்வில் கவனம் செலுத்தப்பட்டுள்ள ஏனைய விடயங்களில், குறைந்தமட்ட மீள்திறன் மற்றும் இலங்கையில் வரிக்கட்டமைப்பின் மிதவை தன்மை போன்றன அடங்கியுள்ளன. இவை ஒருமைப்பாடு குன்றிய நிலையில் காணப்படுவதுடன், வரி அறவீட்டு முறை என்பது சேமிப்பு மற்றும் மூலதன சேர்மானத்தில் பங்களிப்பு செலுத்துவது மற்றும் குறைந்தளவு வரி செலுத்தும் இருப்பு மற்றும் வலையமைப்பு ஆகியன வரி வருமான வளர்ச்சியில் பாதிப்பை ஏற்படுத்துகின்றன. இந்த நிலைக்கு காரணமாக மற்றுமொரு விடயமாக, திட்டமிடப்படாத, எழுமாற்றான நிதிக்கொள்கை மற்றும் மேலதிக கொடுப்பனவுகள், வெவ்வேறு கட்டங்கள் போன்றவற்றில் வரி மாற்றங்கள் மற்றும் வருமான தேவைகளை நிவர்த்தி செய்து கொள்வதற்கு வரி வீதங்களை மாற்றுதல் என்பது அமைந்துள்ளது. தொடர்ச்சியற்ற தன்மை காரணமாக, வரி செலுத்துபவர்கள் அதிகளவு குழப்பமடைவதுடன், அசௌகர்யத்தையும் எதிர்கொள்கின்றனர். இது வரி நிர்வாகத்திலும் பிரச்சினைகளை ஏற்படுத்துகிறது. வருமான வரி வீதங்களில் அண்மையில் மேற்கொள்ளப்பட்ட மாற்றங்கள், ஏயுவு (பெறுமதி சேர்க்கப்பட்ட வரி) வரி வீதத்தில் மேற்கொள்ளப்பட்ட மாற்றங்கள் மற்றும் இதர வரிகளான டீேவு (தேசத்தைக் கட்டியெழுப்பும் வரி) போன்றவற்றை உதாரணமாக குறிப்பிடலாம்.

இந்த அனைத்து எழுமாற்றான மாற்றங்களும் வரி எய்ப்புக்கு காரணமாக அமைந்துள்ளன. இலங்கையை பொறுத்தமட்டில் இது கட்டற்ற நிலையாக அமைந்துள்ளது. இது தொடர்பான பிரச்சினைகள் இந்த ஆய்வில் கவனம் செலுத்தப்பட்டுள்ளது. அண்மையில் அதிகளவு கவனத்தை ஈர்த்திருந்த பெறுமதி சேர்க்கப்பட்ட வரி தொடர்பான பிரச்சினைகள் விவரமாக ஆராயப்பட்டுள்ளதுடன், அதில் காணப்படும் சாதக பாதக நிலைகள், ஒப்பீட்டளவில் மோசமான செயற்திறன்கள் மற்றும் தொடக்கநிலை, விலக்கழிப்புகள், பூச்சிய தரப்படுத்தல், கட்டண மாற்றங்கள், மீளளிப்புகள் போன்ற காரணிகள் பற்றியும் கவனம் செலுத்தப்பட்டுள்ளது. இவற்றை சீர் செய்யக்கூடிய முறைகள் பற்றியும் ஆராயப்பட்டுள்ளது.

மூலதன ஆதாய வரி, அது இல்லாமல் செய்யப்பட்டமை மற்றும் தற்போது அதை மீள அறிமுகம் செய்ய முற்படுகின்றமை மற்றும் சுங்கத்தீர்வை, இறை வரி மற்றும் இதர வரிகள் போன்ற இதர வருமானமீட்டக்கூடிய பிரச்சினைகள் பற்றியும் இந்த ஆய்வு கவனம் செலுத்தியுள்ளது. பரவலாக்குதல் மற்றும் மாகாண வருமானமீட்டல் என்பதும் விவரமாக ஆராயப்பட்டுள்ளதுடன், இதில் மாகாண முறைமையை இல்லாமல் செய்தல் டீவுவு மற்றும் அதன் மூலமாக மாகாண வருமானம் மற்றும் மாகாண நிர்வாகம் போன்றவற்றுக்கு ஏற்படக்கூடிய விளைவுகள் போன்றனவும் ஆராயப்பட்டுள்ளன. இந்த சகல விடயங்கள் காரணமாக வரிக்கட்டமைப்பில் காணப்படும் சிக்கல் நிலைகள் மற்றும் எளிமைப்படுத்தப்பட வேண்டிய தேவை என்பதும் கவனம் செலுத்தப்பட்டுள்ளதுடன், இதில், அவசியமான சகல மாற்றங்களையும் மேற்கொண்டு புதிய வரி சட்டமூலமொன்றை நடைமுறைப்படுத்த வேண்டியதன் முக்கியத்துவமும் ஆராயப்பட்டுள்ளது.

இறுதியாக ஆய்வில், வரி நிர்வாக முறையின் வினைத்திறன் மட்டம் என்பது எந்தவொரு வருமான கட்டமைப்பின் செயற்திறன் மட்டத்தை நிர்ணயிப்பதாக அமைந்திருக்கும். அரசாங்க வருமானத்தை அதிகரிக்க வேண்டிய தேவை காணப்படும் தற்போதைய சூழ்நிலையில், வரி நிர்வாகம், அதன் கட்டமைப்புகள், மற்றும் செயன்முறைகள் தொடர்பில் ஆழமான மதிப்பீடுகளை மேற்கொள்ள வேண்டியுள்ளது, அதில் காணப்படும் பலவீனங்கள் இனங்காணப்பட்டு, அவற்றை சீர் செய்வதற்காக மேற்கொள்ளக்கூடிய நடவடிக்கைகள் பற்றியும் கவனம் செலுத்தப்பட்டுள்ளது. மொத்த சனத்தொகையில் 3 சதவீதமானோர் திருப்தியற்ற நிலையில் வரி செலுத்துனர்களாக காணப்படுகின்றனர். குறைந்த மட்ட ஒழுக்கம், உயர் வரி செலுத்தாமை, கணக்குமீளாய்வுகளை மேமம்படுத்தல் மற்றும் விசாரணைகளை மேற்கொள்ளல் மற்றும் வருமான திணைக்களங்கள் மத்தியில் போதியளவு தொடர்புகள் இன்மை போன்றனவும் ஆழமாக ஆராயப்பட்டுள்ளதுடன், அண்மையில் நிர்வாக கட்டமைப்பை மேம்படுத்துவதற்கு மேற்கொள்ளப்பட்டுள்ள நடவடிக்கைகள் (கணினி மயப்படுத்தல் அடங்கலாக)குறித்தும் ஆராயப்பட்டுள்ளது.

Introduction

A country's taxation system and fiscal policy underlying it, is a major determinant of other macro-economic indices such as economic growth, public debt, fiscal deficit and inflation as well as attaining a proper pattern of resource allocation, income distribution and economic stability. Hence periodically, the fiscal policy and the tax structure, including its administrative mechanism has been subject to examination and proposals for modification in order to achieve its basic objectives in relation to the government's policies and objectives prevalent at the time.

In this connection a number of commissions, committees and reports have been released from time to time since 1915 when Sri Lanka's (then Ceylon's) tax system consisted only of Import, Excise and Stamp Duties followed by Export Duties, Income Tax and a whole lot of other taxes such as Profit Tax, Excess Profits Duty, Estate Duty, Capital Gains Tax, Land Tax, Wealth, Expenditure and Gift Taxes, etc. levied and abolished from time to time. Some of these important commissions consisted of the Taxation Commission of 1955 (Chairman K.R.K. Menon and Secretary S. Sittampalam), Taxation Inquiry Commission of 1968 (Chairman A.G. Ranasinha and Secretary A.G. Jegasothy), Presidential Taxation Commission of 1990 (Chairman H.S. Wanasinghe and Secretary D.D.M. Waidyasekera) and the Presidential Commission on Taxation of 2009 (Chairman Prof. W.D. Lakshman and Secretary P.D.K. Fernando). Apart from these, a number of other reports include the Woods Commission (1926), Huxham Report (1929), Downs Report (1955), Kaldor Report (1960) and Cox Report (1986) among others.

All these stressed the importance of developing a rational, consistent, efficient and simple tax system in order to achieve its objectives and functions.

1.The Functions of a Tax System

The functions of a tax system involve several aspects. First, the primary function of a taxation system is to raise revenue for the government for its public expenditure as well as for local authorities and similar public bodies. Its efficiency is therefore primarily judged by whether this function is performed adequately and satisfactorily. The second function is to reduce inequalities through a policy of redistribution of income and wealth. The equity principle in taxation implies that taxes should be imposed in accordance with the ability to pay principle. This has two dimensions: (a) horizontal equity, i.e., similar treatment of persons in similar circumstances, and (b) vertical equity, i.e., different treatment of persons with different taxable capacity. Thirdly, the fiscal system is also employed for social purposes such as discouraging certain activities which are considered undesirable. Excise duties on liquor and tobacco, the Special Excises on luxury and semi-luxury items, the Betting and Gaming Levy are examples of such taxes.

The tax system is also used to increase the level of savings and capital formation apart from protecting local industries from foreign competition through levies such as import duties (including cesses), Value Added Tax (VAT) and excises. Taxation is also used as an instrument of demand management to eliminate or reduce inflationary or deflationary tendencies in the economy. Taxation reduces the effect of the multiplier and so can be used to dampen upswings in a trade cycle.

The size of the multiplier in an open economy is

$$\frac{1}{S+M+1}$$

where

S= marginal propensity to save

M= marginal propensity to import

T= marginal rate of taxation

Finally, the tax system is used to achieve economic growth through its influence on the allocation of resources. This includes

(a) Transferring resources from the private sector to the government sector to finance the public investment programme;

(b) Directing private investment into desired channels through such measures as regulation of tax rates and the grant of tax incentives and concessions. This includes investment incentives to attract foreign direct investment (FDI) into the country;

(c) Influencing relative factor prices for enhanced use of labour and economizing the use of capital and foreign exchange.

These objectives however may to some degree be in conflict. For instance, the objective of attaining a more equitable distribution of income may conflict with growth objectives and in practice there are always bound to be tradeoffs and compromises.

In analyzing the current trends and perspectives of taxation in Sri Lanka, it is necessary therefore to examine how adequately and effectively the fiscal and tax system has performed these functions and how effective the policy and administrative measures have been in solving the problems that have arisen.

2. Economic Background

2.1 International

The current trends and perspectives in fiscal policy and taxation in Sri Lanka have to be viewed in the context of the economic performance and trends both national and international. According to the World Economic Outlook of the International Monetary Fund (IMF), global economic activity remained subdued in 2015 with the decline in growth in emerging market and developing economies amidst the modest recovery in the advanced economies. Global growth which was 3.4% in 2014 slowed down to 3.1% in 2015 due to slow recovery in the developed world and slowdown in the Chinese economy. China's growth rate was 7.4% in 2014, 6.8% in 2015 and expected to fall to 6.3% in 2016. China is embracing what is termed the "new normal" - slower but slightly higher quality growth.

Global growth is estimated at 3.2% in 2016 and 3.5% in 2017 but these projections are subject to revision according to various changes in the global economy. It is centred on changing oil and commodity prices, geo-political uncertainties and stagnating and low inflation in developed countries.

The volatility of the global economic environment posed several challenges to Sri Lanka during 2015 and are expected to persist in 2016 and 2017. The global economic situation is important for a small developing economy such as Sri Lanka where external demand is critical as an enabler of sustained high growth, generating demand absorbing labour surplus and raising productivity. Global changes such as for example Britain's decision to leave the EU (Brexit) tend to have repercussions on Sri Lanka's economy.

2.2 National

From a national point of view, the taxation system has to be viewed as part and parcel of the prevalent economic and development strategy which the country pursues and when these policies change, the fiscal and taxation policies themselves become altered.

Sri Lanka witnessed two contrasting development strategies within the last four decades. The pre-1977 strategy was characterized by an emphasis on the public sector, fixed exchange rates, a controlled economy with the accent on welfare and income redistribution. The concomitant fiscal policies involved high import duties, a redistributive income tax structure with high marginal rates and relatively few concessions to the private sector.

The post-1977 development strategy was the reverse, the accent being on an open economy with deregulation and decontrols, flexible exchange rates, stimulation of the private sector and a market-oriented economy. Consequently, fiscal and tax policies underwent a change. Import duties were relaxed, the maximum effective level of protection was reduced to 50%, income tax rates progressively reduced and a wide ranging framework of tax incentives and concessions were incorporated in the tax system in the form of tax holidays, exemptions and reliefs.

The changes in governments since 1994 onwards had little impact on the broad lines of fundamental policies except changes in emphasis depending on the socio-economic philosophies of successive governments. These included such programmes as the Rata Perata Programme, Regaining Sri Lanka Programme, Mahinda Chintana and currently the Economic Policy Statement (EPS) of the Prime Minister delivered in Parliament on 5th November 2015.

These policies had both positive and negative effects. The ending of the thirty year old civil conflict in May 2009 and the subsequent reconstruction and development activity, particularly in infrastructure including roads, expressways, irrigation, ports and airports based on the five hub concept and bolstered by development subsidies, skills and educational development, led to economic growth and had a positive effect. As per the figures in the Central Bank Annual Report 2015, GDP at current market prices increased from Rs. 1,258 billion in 2000 to Rs. 6,414 billion in 2010, Rs. 8,732 billion in 2012, Rs. 10,448 billion in 2014 and Rs. 11,183 billion in 2015. The growth rate increased from 6% in 2000 to 8% in 2010, 8.4% in 2011 and 9.1% in 2012. The per capita income grew from Rs. 65,838 (US$ 869) in 2000 to Rs. 427,559 (US$ 3,351) in 2012, Rs. 503,032 (US$ 3,853) in 2014 and Rs. 533,398 (US$ 3,924) in 2015. National savings increased from 21.5% of GDP in 2000 to 33.3% in 2012; investment increased from 28% of GDP in 2000 to 39.1% in 2012; unemployment as a percentage of the labour force in 2012, was 4% and 4.3% in 2014; and inflation of 7.6% in 2012 was reduced to 3.3% in 2014, while the head count poverty was down to less than 7%. The overall budget deficit which was 9.5% of GDP in 2000 was reduced to 7% in 2010, 5.6% in 2012 and 5.7% in 2014.

The above positive features however had also negative aspects. As stated in the Institute of Policy Studies (IPS) 2014 *State of the Economy* report, "Beyond the immediate headline macro-economic numbers, the Sri Lankan economy continues to show skewed growth, high levels of external indebtedness, modest export earnings growth and limited private sector appetite to expand production capacity".

According to provisional estimates released by the Department of Census and Statistics which in July 2015 changed the base year for national accounts statistics from 2002 while adopting the United Nations System of National Accounts (SNA) 2008 standard, the economy grew by 4.8% during 2015 compared to 4.9% in 2014. This growth was largely driven by an increase in consumption demand. In Sri Lanka, levels of consumption are associated with over-extended government fiscal positions, high debt levels and current account deficits. Investment made only a modest contribution and as measured by gross capital formation decelerated during 2015.

According to the statistics of the Central Bank Annual Report 2015, domestic savings declined from 27.2% of GDP in 2012 to 24% in 2014 and 22.6% in 2015 while national savings declined from 33.3% of GDP in 2012 to 27.8% in 2015. The growth in the industry sector which was 9% in 2012 went down steadily to 4.1% in 2013, 3.5% in 2014 and 3% in 2015 reducing the share of industry in GDP to 26.2%. The unemployment rate which was 4% in 2012 increased to 4.3% in 2014 and 4.6% in 2015. Average annual inflation remained in mid-single digit levels, however it picked up in the fourth quarter of 2015 and recorded 2.5% by end 2015, 4.8% in May 2016 and 6% in June 2016.

The Balance of Payments (BOP) which recorded an overall surplus in 2014 of US$ 1,369 million registered a deficit of US$ 1,489 million in 2015 and consequently, Sri Lanka's gross official reserves of US$ 8.2 billion in 2014 declined to US$ 7.3 billion at the end of 2015 equivalent to 3.8 months of imports of goods and services and at March 2016 to US$ 6.3 billion or 3 ½ months of imports. This may be compared to the foreign reserves of countries like Malaysia ($ 137 billion), Indonesia ($ 105 billion), Taiwan ($ 420 billion) and India ($ 360 billion).

The overall fiscal deficit of 5.4% of GDP in 2013 increased to 7.4% in 2015 while total government debt increased from 68.7% in 2012 to 76% in 2015. In terms of the country's external debt, it increased from 53.6% in 2014 to 54.4% in 2015 and increasing debt services from US$ 3,479 million in 2014 to US$ 4,683 million in 2015.

Another result has been rising inequality. According to the Department of Census and Statistics figures, the percentage share of household income from 1995 to 2012 has shown the following indicators:

1. Poorest 20% declined from 5.4% to 4.4%

2. Richest 20% increased from 50.3% to 53.5%

3. Poorest 40% receive 13.3% of total household income

4. Gini Coefficient increased from 0.43 to 0.48 in 2012 for households and 0.53 for income receivers.

Source: Department of Census and Statistics – Household Income and Expenditure Survey 2012/13.

Thus as can be seen from the indicators above, the socio-economic policies pursued by the prevalent respective governments during this period has led to both positive and negative results. Perhaps the most important aspect however, is in the sphere of fiscal sector development in relation to government revenue, expenditure, budgetary deficits, overall management and the results thereof.

3. Declining Trend of Tax Revenue/GDP Ratio

In 1963, Nicholas Kaldor argued that for a country to become "developed", it needed to collect taxes at 25-30% of GDP. The tax ratio is generally regarded as a sort of "national virility symbol." It indicates the proportion or share of national income transferred to the government sector to meet budgetary requirements so as to increase the tempo of economic development without causing inflation. (Zuhair, 1985). In higher income countries the ratio is about 42% of GDP, middle income countries, about 25-29% and developing countries around 20%. Sri Lanka's performance compares poorly with countries like Vietnam (21.1%), Thailand (17.7%), Malaysia (16.6%) but better than its South Asian neighbours India (10.4%), Pakistan and Bangladesh (7.6%). The irony of the situation is that while overall GDP as well as per capita income in Sri Lanka has been steadily increasing over the years, government total revenue and tax revenue has been steadily decreasing! The Table below shows the relationship between the growth of GDP and per capita income and government revenue.

Table 1
GDP, Per Capita and Revenue Ratio - Selected Years

Year	1990	2000	2006	2010	2012	2013	2014	2015
GDP Rs. Billion								
(at market prices)	322	1,258	2,939	6,414	8,732	9,592	10,448	11,183
Per Capita								
Rs.	18,934	65,838	147,776	310,214	427,559	466,110	503,032	533,395
US $	473	869	1,421	2,744	3,351	3,610	3,853	3,924
Total Revenue Ratio	21.1	16.8	16.3	12.7	12.0	11.9	11.4	13.0
Tax Revenue Ratio	19.0	14.5	14.6	11.3	10.4	10.5	10.1	12.1
Non Tax Revenue	2.1	2.3	1.7	1.4	1.6	1.4	1.3	0.9

Source: Central Bank *Annual Report 2015* and various years.

It is seen that total government revenue as a percentage of GDP has steadily declined from 21.1% in 1990 to 16.8% in 2000, 12.7% in 2010 and 11.4% in 2014. Tax revenue ratio has declined from 19.0% in 1990 to 14.5% in 2000, 11.3% in 2010 and 10.1% in 2014. Even non-tax revenue in the form of dividends and transfers of profits from public institutions has declined from 2.3% in 2000 to 1.6% in 2012 and 0.9% in 2015. The increase in the relevant ratio in 2015 as well as in nominal terms was due to the introduction of one-off taxes on private businesses called the Super Gain Tax. The Super Gain Tax was a levy applicable on any company or individual who earned profits over Rs. 2000 million in the assessment year 2013/14 at the one-off rate of 25%. It generated Rs. 50 billion and also the imposition of a "Mansion Tax" on housing as well as increase in excise duties on motor vehicles, liquor and cigarettes made during 2015, apart from a number of other one-off levies.

The critical nature of the situation and the vital necessity to reverse the declining trend has been recognized by the respective governments. In fact it was one of the main terms of reference of the 2009 Presidential Taxation Commission appointed by the government. The first item in the TOR goes as follows:

"2.1Study the country's tax system and make an assessment as to why revenue in relation to GDP has declined over the years and make proposals as to how tax/GDP ratio that is comparable with other emerging economies could be achieved through a buoyant performance in tax revenue and that will also prevent the need to make frequent changes in taxation."

The Taxation Commission report was finalized in October 2010 but is still not available to the public. However the 2011 Budget proposals appear to be largely based on its recommendations and legislated under 15 amending Acts and in 2013 when 21 amending Acts were passed in Parliament. Nevertheless, the declining revenue ratio has not been reversed.

This situation has been recognized by the current administration when the Finance Minister Hon. Ravi Karunanayake in his 2016 Budget Speech stated "It is obvious that the strength of any fiscal system depends on the ability to generate a sufficient amount of revenue to meet the planned and necessary expenditure. Unfortunately it is not the case in Sri Lanka". He continued "Declining government revenue to GDP ratio portrays a major economic concern for the country and this trend has to be reversed on a priority basis. Sri Lanka's tax revenue was 19% of GDP in 1990 falling drastically to 10.2% of GDP by 2014. Ironically the growth of tax revenue in absolute terms was just 4.4% in 2014 much below the nominal growth ratio of 7.3%. Thus tax revenue has been unable to keep pace with economic expansion evidenced in recent years which is a serious phenomenon."

Referring to the measures taken to address these issues, he stated "during the last few months, we took some efforts to address these issues opting for innovative measures of taxation. However, it is time to deviate from temporary solutions but endeavour to create a tax regime based on strong reforms to move forward, implementing such reforms which will have far reaching benefits for the country." (Finance Minister in 2016 Budget Speech on 20th November 2015).

The revenue deficiency is so serious that as the Central Bank Report 2015 states "the country's revenue is not sufficient even to finance the maintenance expenditure of the government. Hence the government is forced to have recourse to borrowings even for its day to day operations". (p. 172). As far as expenditure is concerned several measures have been taken to ensure proper management of public expenditure to avoid overrun in recurrent expenditure while maintaining public expenditure at the expected level. These include National Budget circulars and the establishment of a Budget Implementation and Monitoring Unit (BIMU). Nevertheless, recurrent fiscal deficits continue as indicated in Table 2 below.

Table 2
Fiscal Operations and Deficits 2006-2015 (Rs. Million)

Year	2006	2008	2010	2012	2014	2015(Prov)
Total Revenue and Grants	507,901	686,482	834,188	1,067,532	1,204,621	1,460,892
Expenditure & Lending						
(Minus Repayments)	-713,646	-996,126	-1,280,205	-1,556,499	-1,795,865	-2,290,394
Current Account						
Surplus + /Deficit -	-70,127	-88,450	-119,815	-79,563	-127,692	-246,779
Budget Surplus + /Deficit -	-205,745	-309,644	-446,017	-488,967	-591,244	-829,502
As % of GDP	-7.0	-7.0	-7.0	-5.6	-5.7	-7.4

Source: Central Bank *Annual Report 2015* and various years.

The 2016 deficit, with fiscal measures to enhance revenue and reduce expenditure, is targeted to be brought down to 5.4% of GDP with the medium term 2020 deficit targeted at 3.5%.

These deficits have been financed by domestic borrowings both bank and non-bank as well as foreign borrowings. These fiscal deficits have also a number of economic effects such as:

i) Increase in public debt;
ii) Increase in interest rates;
iii) Decreasing the investments of the private investors;
iv) Decreasing local savings;
v) Increasing inflation;
vi) Decline in international credibility.

4. Reasons for the Decline

There are many reasons for this declining trend in government tax revenue in spite of the overall increase in GDP and per capita income. Some of these include the following:

1. Unplanned ad hoc tax incentives in the form of various tax holidays, reliefs and concessions, duty waivers, etc. which have eroded and narrowed the fiscal base. The exact tax loss from these concessions for each assessment year has not been calculated per year but has been estimated at being close to 1% of annual GDP (Presidential Taxation Commission 2010);

2. Narrow tax base and coverage, the total number of taxpayers being about 3% of the population;

3. Increase in allowable expenses under Section 25 of the Inland Revenue Act;

4. Periodic increases in tax free allowances and ad hoc reductions in rates of tax;

5. Ad hoc changes to the tax system to meet short-term cash flow requirements of the government consequent to lack of consistency in government fiscal policy, leading to uncertainty among existing taxpayers;

6. Lack of elasticity and buoyancy in the tax system both being less than unity;

7. The existence of a large informal economy resulting in large scale tax evasion and avoidance;

8. The grant of periodic tax amnesties which have been largely failures not producing the expected results;

9. A complicated tax system and weaknesses in tax administration and the administrative mechanism.

These issues have to be addressed and remedial measures taken in order to check the tax revenue decline and bring it to a satisfactory level.

5. Composition of Tax Revenue - Direct and Indirect

Direct versus indirect taxation is an age-old controversy. The arguments for or against direct and indirect taxes can be analyzed in the context of revenue generation, efficiency and equity effects and ease and cost of administration.

Direct taxes tend to be progressive and intimately related to the ability to pay and can be used for reducing income and wealth inequalities and thereby socially more desirable. They cause little or no distortions in resource allocation of the economy and leave taxpayers better off in welfare terms. It is also revenue elastic due to the fact that as the income of the community rises, so does the yield from direct taxes.

However, they are more difficult to impose in developing countries where the structure of the economy is markedly different from developed ones due to such conditions as the existence of a large informal economy and severe unemployment. They are also a drag on saving and investment and thus on economic efficiency and improvement of living standards.

Indirect taxation is defined as taxation imposed upon other than the person who is intended to bear the final burden which ultimately falls on the consumers of the taxed commodities. They are an important element in raising quick revenue and mobilizing resources for public investment and social welfare. Indirect taxes are also a powerful tool for guiding resource allocation and discouraging demand on undesirable goods and activities as well as an effective way to correct negative externalities.

Another argument in their favour is that their yield is substantial, individuals are given a choice and they reduce disincentive effects. There is also the added attraction that the public is less conscious of the tax burden as the taxes are generally hidden in the prices and their presence is not readily felt by the consumer. Since they are paid piecemeal when the taxpayer enters into some transaction, it is convenient and less burdensome.

Indirect taxes are also perhaps the only means of reaching the vast majority of the population whom the tax net often fails to capture and the informal and hard to tax activities. They are also often not affected by economic crises and thus remain relatively constant. Administratively, indirect taxes are easier to implement than direct taxes and since they are included in the price of a commodity cannot be easily evaded, and the administrative costs in their collection is relatively low.

However, indirect taxes are heavily criticized for unnecessarily imposing heavy burdens on the lower and middle income groups and those least able to pay and therefore tend to be regressive. Studies have shown that the increase in the tax burden for the low and middle income groups indicates that the rise in indirect taxes has been faster than the rise in income of these groups. Indirect taxes have also a greater adverse effect on the allocation of resources than a direct tax and at a macro level can cause cost-push inflation.

In developed countries, direct taxes such as income tax constitute a significant portion of total tax revenue, while indirect taxes such as taxes on international trade and on domestic goods and services, play a less significant role. In contrast, in the developing countries the opposite is the case with the bulk of government revenue coming from indirect taxes such as customs duties, VAT, sales taxes, excise duties etc. while direct taxes are of lesser importance.

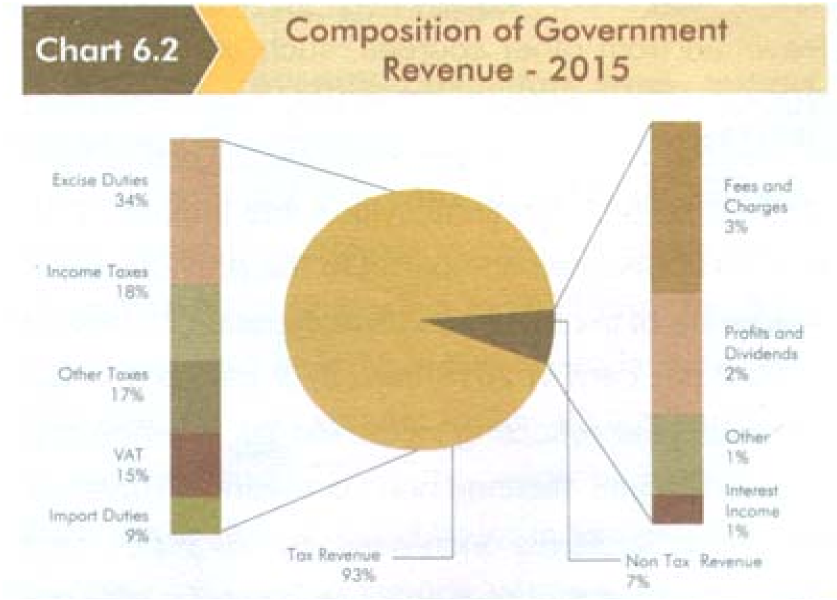
In Sri Lanka, income taxes comprise on average less than 20% of tax revenue or 2% of GDP while the indirect taxes comprise around 80% or 8% of GDP. The composition of revenue is illustrated in the Table and Chart below.

Table 3
Composition of Government Revenue 2014, 2015

Year	2014			2015		
Taxes	Amount Rs. Million	Percentage Share	Percentage of GDP	Amount Rs. Million	Percentage Share	Percentage of GDP
Income Taxes	198,115	17%	1.9	262,583	18%	2.3
VAT	275,350	23%	2.6	219,700	15%	2.0
Excise Duties	256,691	21%	2.5	497,652	34%	4.4
Import Duties	81,108	7%	0.8	132,189	9%	1.2
Other Taxes	239,099	20%	2.3	243,655	17%	2.2
Tax Revenue	1,050,362	88%	10.1	1,355,779	93%	12.1

Source: Central Bank *Annual Reports 2014* and *2015.*

Chart 1: Composition of Government Revenue - 2015



Source: Central Bank *Annual Report 2015*.

It has been realized that this proportion of direct to indirect taxes of 20:80 is too unrealistic if Sri Lanka is to achieve a developed country status from a middle income country status. Apart from developed countries, even countries such as Malaysia (over 60%), India (over 50%), Pakistan (around 40%) Thailand (50%) and Kenya (above 42%) have a higher proportion of direct to indirect taxes than Sri Lanka. It is in this context that the 2009 Presidential Taxation Commission had recommended that the tax ratio of direct to indirect should be progressively changed to 60:40. This policy has been reiterated recently in the Economic Policy Statement (EPS) delivered by the Prime Minister Hon. Ranil Wickremasinghe in Parliament on 5th November 2015. The EPS has even set a quantitative target of securing 40% of the tax revenue from income taxes by 2020 as against the historical average of 20% on that account. This requires policies to reduce the share of indirect taxes from the present 80% to 60% over the years and means increasing the income tax by 100%.

6. Fiscal and Tax Incentives

One of the main reasons for the decline in government tax revenue has been the proliferation of tax incentives in the form of tax holidays, exemptions, expanded allowable expenses in determining taxable income, reliefs, duty waivers and concessions which have eroded and narrowed the tax base. They were originally used from 1951, and after 1977 became a major instrument of development policy. Though attempts have been made to prune them and reduce their scope and coverage from time to time, they are still considerably large covering various sectors such as agriculture, fishing, exports, gems and jewellery, IPO, healthcare, education, tourism, sports and fitness centres, creative work including art work etc. They have been granted both through Law 17 of the Board of Investment (BOI), the Inland Revenue Act as well as other relevant legislation. To minimize the considerable overlapping, the tax provisions were subsequently given largely through the Inland Revenue Act but the BOI appears to be granting them as well.

The rationale for the adoption of fiscal incentives is that they constitute an important, if not a major element in determining investment behaviour. They increase the net rates of returns and thus reduce the need for large capital investment. They also reduce risk and tend to make otherwise unpromising and risky ventures more attractive. Tax incentives benefit concerns which are profitable and to that extent, they do not involve government subsidies or public guarantee to loss makers. Further, even in cases where relief may seem unnecessary, well-conceived incentives may help ventures to build their reserves and embark on expansion. They are also valuable as an indirect stimulant to investment because they publicize and enhance the country's investment climate. They have thus been adopted by most developing countries.

With a GDP growth target of 8% or higher, Sri Lanka would need to raise its annual investment rate from the current 30% of GDP to at least 35% or higher. With public investment to be capped at around 6% of GDP this would need to come about entirely from private investment within which foreign private investment plays a crucial role. Foreign Direct Investment (FDI) to Sri Lanka has seen a significant increase in recent years rising from US$ 234 million in 2004 to $ 889 million in 2008, $ 1066 million in 2011,$ 1338 million in 2012, and $ 1616 million in 2014 which however declined to $ 970 million in 2015. On average, Sri Lanka attracted an annual average FDI of US $ 500 million (about 1.5% of GDP) during the last decade. However, to emulate the East Asian countries, which is Sri Lanka's vision, it is necessary to attract FDI in excess of US $ 5000 million annually, close to 5% of GDP.

However the effectiveness of tax incentives in this respect is debatable. As Heller & Kauffman in concentrating upon the methodology and techniques adopted to evaluate the stimulation generated for investment by tax incentives, state "Economic science has not yet attained a level of sophistication capable of isolating and quantifying the role of the tax factors in investment behaviours." Incentives by themselves apparently do not play a major role vis-à-vis other factors such as infrastructure facilities, cheap and easy credit, production costs, access to markets, a reliable and skilled labour force, labour market flexibility, the regulatory framework, business environment, and political and economic stability. Investment responds to a multiplicity of factors and compared to these, fiscal incentives at best play only a marginal role.

Fiscal and tax incentives have also been called into question on other grounds. One is that they distort investors' decisions and thus produce a less than optimum allocation of resources. Fiscal incentives tend to attract investors who are more keen on making quick profits rather than investments of a substantial nature which are crucially required for developing countries. They also tend to attract "fly-by-night" investors who use the generous incentives only to pull out when the time comes to be regular taxpayers. They also provide a fertile ground for tax avoidance and tax evasion through "tax shelters". Finally, the tax foregone is a matter of vital concern particularly in the current context, as fiscal incentives are costly in revenue terms. It is felt therefore, that the cost of fiscal incentives outweighs their benefits. The revenue loss is estimated to be close to 1% of GDP (Presidential Taxation Commission 2010).

Nevertheless, Sri Lanka considering the competitive international context, e.g., Malaysia, Brazil, Vietnam, Thailand etc., cannot completely do away with tax incentives. However, the tax incentive regime must be designed, implemented and monitored in a more methodical and cost effective way, their cost benefit ratio properly examined and be subjected to continuous review so that the impact on revenue is minimized and the required economic objectives realized. Further, tax holiday businesses and enterprises must be required to send their accounts and balance sheets even during the tax holiday period and should be checked even though exempt. Experience has shown that often they show big profits during the tax holiday period and after the exemption is over, they show losses or pack up and leave. To prevent this, concessionary rates may be applied for a short period after the tax holiday is over before applying the normal rates.

7. Elasticity and Buoyancy of the Tax System

One of the main reasons for the decline in government tax revenue in Sri Lanka is the inherent lack of elasticity and buoyancy in the fiscal system.

Elasticity in a tax system reflects the automatic response or built-in responsiveness of tax revenue to movements in national income or gross domestic product. Buoyancy reflects the total response of tax revenue to changes in national income or GDP including the effects of discretionary adjustments such as expansion in the tax base, increase in tax rates and other changes in fiscal policies. The tax system is said to be elastic or buoyant if the elasticity or buoyancy co-efficients exceed unity. An elastic system will automatically raise revenue at the same time or at a faster rate than the growth of GDP and facilitate a sustained increase in necessary government outlays. An elastic tax system also reduces the economic uncertainties associated with frequent discretionary changes in taxes, duties and levies.

An inelastic fiscal system on the other hand, compels the government to rely on frequent ad hoc increases in order to maintain short-term revenue objectives. Such practices over time tend to produce a complex and economically unproductive fiscal system and lead to adverse economic effects and unintended distributional consequences. Frequent ad hoc changes in tax practices also create uncertainties among taxpayers and affect investment and production adversely.

Factors affecting the low elasticity in the tax system may be summarized as follows:

i) Slow expansion in the tax base;

ii) Absolute as well as relative expansion in certain sectors which are difficult to tax and gradual reduction in size of the sectors which are easy to tax;

iii) Expansion in the tax expenditure coverage;

iv) Lack of progressivity in tax rates;

v) Tax evasion and inefficient tax administration.

In the Sri Lankan fiscal system the overall elasticity has been estimated at 0.7 and the buoyancy at 0.9. (Indraratna, 2003). Both co-efficients however, are below unity and hence overall, the tax and fiscal system is inelastic in Sri Lanka. (Tax Commission Report, 1990).

8. Taxation, Savings and Capital Formation

Taxation and fiscal policy constitute one of the key determinants of savings, capital formation and investment apart from other factors such as government development strategy and the macro economic environment. There is a correlation between development and savings; higher the savings, greater the ability to sustain its growth.

An analysis of savings both domestic and national savings indicate that in Sri Lanka, savings come largely from the private or household sector. Government savings constitute a relatively minor share of both domestic and national savings and in fact, statistically denote a negative index. Table 4 below denotes domestic savings divided into private and government, respectively.

It may be noted that the savings ratio to GDP is only 22.6% as compared to other Asian countries such as India (31%), Thailand (31%), Malaysia (33%) and Singapore (53%).

Domestic private savings have indicated a large increase both in nominal terms as well as percentage of GDP from 2010 onwards and particularly from 2012. Tax rates both corporate and individual from 2011 were drastically reduced from 35% to 28% and 12% for the corporate sector and 24% as maximum personal tax from that year.

While this may invariably have had an effect in increasing private savings, it is however difficult to quantify or draw a direct causal effect to this factor alone as many other factors are determinants of savings and investment.

Table 4
Domestic Savings and Tax Rates 2004 - 2015 (Rs. Million)

Year	2004	2006	2008	2010	2012	2014	2015
Domestic Savings	343,580	498,864	611,598	1,481,123	2,374,918	2,504,682	2,531,040
Private	421,785	568,992	700,048	1,600,938	2,454,481	2,632,374	2,777,819
Government	-78,205	-70,128	-88,450	-119,815	-79,563	-127,692	-246,779
% to GDP	16.4%	17.0%	13.9%	23.1%	27.2%	24.0%	22.6%
Tax Rates							
Company	30%	35%	35%	35%	28%	28%	28%
					12%	12%	12%
Personal Highest Rate	30%	35%	35%	35%	24%	24%	24%

Source: Compiled from Central Bank *Annual Report,* various years.

The same trend is seen in respect of capital formation. It is seen that over 75% of gross domestic capital formation comes from the private sector while the government's share is around 25%. Again, capital formation has shown a large increase from 2010, 2012 onwards. While the decrease in tax rates, particularly the corporate rate from 35% to 28% (and concessionary rate 12%) in 2011 would invariably have had an effect in this trend, it is difficult to establish a direct and precise statistical correlation between tax rates and domestic private capital formation. However, both savings and capital formation appear to be sensitive to effective tax incidence. Hence it is logical to conclude that in order to promote savings and capital formation, the reduction in taxation appears as a necessary, though not by itself, a sufficient condition.

Table 5
Capital Formation and Tax Rates 2004- 2014 (Rs. Million)

Year	2004	2006	2008	2010	2012	2013	2014
Gross Domestic Fixed Capital Formation	473,323	730,910	1,115,310	1,452,002	2,189,805	2,536,648	2,752,263
Private	422,060	624,972	852,708	1,128,151	1,695,184	1,946,925	2,119,243
Government	51,262	105,938	262,602	323,851	494,621	589,723	633,020
% of GDP	22.6%	24.8	25.2	25.4%	25.0%	26.4%	26.3%
Tax Rates							
Company	30%	35%	35%	35%	28%	28%	28%
					12%	12%	12%
Personal Highest Rate	30%	35%	35%	35%	24%	24%	24%

Source: Compiled from Central Bank *Annual Report,* various years.

9. Tax Base and Coverage

One of the important elements in securing a satisfactory level of tax revenue is the base and coverage of the taxes. While certain steps to broaden the tax base and coverage have been taken such as the inclusion to income tax of public servants hitherto exempt, and widening the base of the VAT and NBT by adding the wholesale and retail sectors, the base and coverage still need to be enlarged.

One of the reasons for the declining tax revenue ratio has been the narrowing of the tax base resulting from ad hoc increases in tax free allowances, liberalizing a whole range of allowable deductions under Section 25 of the Inland Revenue Act, adjustments to qualifying payments under Section 34, among others

9.1 Tax Free Allowances and Threshold

Tax free allowances for individuals have been periodically increased from Rs. 144,000 in 2001/02 to Rs. 240,000 in 2002/03, to Rs. 300,000 in 2004/05 and in 2011/12 to Rs. 500,000. For employees or those with employment income, an extra allowance in excess of Rs. 500,000 ranging from Rs. 100,000 to Rs. 250,000 has been granted in the form of a qualifying payment. The tax free allowance has been extended to non-resident Sri Lankan citizens as well. The original tax free threshold for VAT in 2002 of Rs. 500,000 per quarter was increased to Rs. 650,000 per quarter in 2009, Rs. 3 million per quarter in 2013 and Rs. 3.75 million per quarter or Rs. 15 million per annum in 2015 and in May 2016 to Rs. 3 million per quarter. The Nation Building Tax (NBT) was Rs. 500,000 per quarter in 2011, Rs. 3 million in 2013 and in 2015 Rs. 3.75 million per quarter, and in May 2016 Rs. 3 million per quarter. The Economic Service Charge (ESC) was Rs. 50 million per quarter in 2015, an increase from the earlier Rs. 25 million in 2011. All these mean that persons below these thresholds do not pay any tax thus reducing the coverage of taxpayers and reduction of tax revenue.

There is no hard and fast rule regarding the appropriate level of basic tax free allowance for individuals. One factor is the adequacy to relieve the minimum subsistence need of an average family from taxation. Other factors include the per capita income, equity consideration and ease of administration. Some countries use the per capita income multiple (maximum up to five times) as the basis but others do not. In the circumstances, it may be appropriate to consider a suitable measurement basis in the context of Sri Lanka's current circumstances and taxation policy. The current practice recently introduced of tax free allowance to non-resident Sri Lankan citizens should also be reconsidered, limiting it to resident individuals and charitable institutions as in the original Tax Act.

In this context, the 2016 Budget has proposed a threshold limit of Rs. 2.4 million for individuals and a flat rate thereafter which however, due to its drastic implications for revenue as well as equitable considerations has been suspended or put on hold. The basic threshold for 2015/16 of Rs. 500,000 has therefore remained for the year of assessment 2016/17 as well.

9.2 Deductible Expenses for Assessable Income

Another area which has affected the base is the calculation of assessable and taxable income in relation to allowable expenses under Section 25 of the Inland Revenue Act. Section 25(1) allows the deduction of "all outgoings and expenses incurred by such persons in the production" of such profits and income. Though this concept is narrower than the U.K. concept of "wholly and exclusively incurred for the purpose of the trade," the various amendments made to expand deductible expenses to be in line with commercial profits as well as to give various concessions to trades and businesses, have in practice tended to narrow the net income on which the tax rates are applied.

Recent tax legislation has liberalized a whole lot of expenses as well as allowable deductions in computing adjusted taxable profits and income. These include enhanced depreciation allowances, 75% deduction of advertisement expenses originally limited to 50%, foreign travelling expenses, foreign training expenses, pre-commencement expenses, 300% deduction for Research & Development (R&D), maintenance and management expenses among others.

All these have led to a narrowing of the taxable base and reduction of the adjusted taxable profits and income of trades and businesses for tax purposes. In the absence of proper auditing and monitoring of these expenses by tax officials, the enhanced allowable expenditure such as triple expenses for R & D, 75% advertisement expenses etc., need re-examination and limitation. For instance, very often businesses tend to mix business promotion expenses which are allowable with advertisement, hence the necessity to limit the latter. Another section that appears to need re-examination is Section 13(ddd) of the Act which exempts services rendered to persons outside Sri Lanka. While the original intention was the promotion of local professional services, it has now been misused for foreign business, foreign contracts, etc. with enormous profits being made through information technology, all of which are exempt under Section 13(ddd). All these have led to an artificial lowering of taxable income of trades and businesses and a major cause of declining tax revenue.

It is necessary therefore, to re-examine the validity of these enhanced deductions and base it on accepted principles and accounting standards subject to revenue considerations. Whatever system is adopted it should be applicable to individuals, companies and all other entities in the same manner.

10. Tax Rates

10.1 Corporate

Tax rates in Sri Lanka have had a chequered history with at one time in 1978 the corporate rate going up to 60% and in 1964 the personal rate at 80%. With changing economic strategies they have steadily decreased to 45% in 1992/93, 40% in 1993/94, 35% in 1994/95, 30% in 2003/04 and subsequently the standard rate 28% in 2011. There are however a multiplicity of corporate rates with 28% for companies with taxable income over Rs. 5 million, 12% where the taxable income is less than Rs. 5 million (including venture capital companies) while a higher rate of 40% is applied for liquor, tobacco, betting and gaming.

The multiplicity of rates however, has its drawbacks in that it unnecessarily complicates and inhibits the smooth functioning of the company tax system. The lower rate of 12% for taxable income less than Rs. 5 million is a concession for small and medium enterprises (SMEs) to encourage their growth. There is however no definition of a small company in the Inland Revenue Act and taxable income of Rs. 5 million is not the sole criterion of an SME. Further, a company may be small but the owners need not necessarily be persons with low incomes and vice versa. Affluent investors often invest in small venture companies, whereas shareholders of modest means often have their share investments, if any, in large companies of a less risky nature. Moreover, the existence of a lower rate invites the artificial splitting up of corporate enterprises into several tax motivated small companies which would, in reality, continue to operate as parts of the larger enterprises. In order to prevent this, the Act excludes holding companies, subsidiary or associate of any group of companies from the concessionary rate. The main argument against small company relief however, is the administrative difficulty of drawing the boundary line between “large” and “small”; it necessarily involves arbitrary choices and adds to the complexity of the tax structure.

10.2 Personal

The reduction in the rate structure also applies to personal income tax of individuals (including professionals) in relation to both “slabs” and rates. Currently, there is a progressive tax structure with special lower rates and higher rates for specific activities and sources of income. The slabs have been enlarged with the rates ranging from 4% and going up to 8%, 12%, 16%, 20% and 24% (maximum). The maximum rate of tax for employees including professionals however is limited to 16%.

These changes to the personal income tax structure apart from resulting in lowered tax revenue, have also raised a number of contentious issues. Adjustments to “slabs” and rates are generally done periodically to counter what is known as the “bracket creep” in time of rampant inflation. However, inflation which was at one time over 20% has remained consecutively at single digit figures and there is no justification to widen the slabs and reduce the rates, especially when the tax free personal allowances have been increased. Further, the “slabs” in the current rate structure discourage the earning of higher income, since any person may reach the highest rate of tax at a relatively low level of taxable income (above Rs. 3.5 million per annum or Rs. 300,000 per month).

The table below gives the periodic changes to the slabs and rates from year of assessment 2003/04 to 2016/17.

Table 6
Personal Tax Slabs and Rates 2003/04 - 2016/17

Y/A 2003/04 Tax Free Allowance Rs. 240,000	
Slabs Rs.	**Rate%**
First 180,000	10%
Next 180,000	20%
Balance	30%
Income at which highest rate is reached – Rs. 600,000	

Y/A 2004/05 Tax Free Allowance Rs. 300,000	
SlabsRs.	**Rate%**
First 240,000	10%
Next 240,000	20%
Balance	30%
Income at which highest rate is reached – Rs. 780,000	

Y/A 2005/-06Tax Free Allowance Rs. 300,000	
Slabs Rs.	**Rate%**
First 300,000	5%
Next 200,000	10%
Next 200,000	15%
Next 200,000	20%
Next 200,000	25%
Balance	30%
Income at which highest rate is reached Rs. 1,400,000	

Y/A 2006/07 -2008/09 Tax Free Allowance Rs. 300,000	
Slabs Rs.	**Rate%**
First 300,000	5%
Next 200,000	10%
Next 200,000	15%
Next 200,000	20%
Next 200,000	25%
Next 500,000	30%
Balance	35%
Income at which highest rate is reached Rs. 1,900,000	

Y/A 2009/10 & 2010/2011 Tax Free Allowance Rs. 300,000	
Slabs Rs.	**Rate%**
First 400,000	5%
Next 400,000	10%
Next 400,000	15%
Next 500,000	20%
Next 500,000	25%
Next 500,000	30%
Balance	35%
Income at which highest rate is reached Rs. 3,000,000	

Y/A 2011/2012 – 2016/17 Tax Free Allowance Rs. 500,000	
Slabs Rs.	**Rate%**
First 500,000	4%
Next 500,000	8%
Next 500,000	12%
Next 500,000	16%
Next 1,000,000	20%
Balance	24%
Income at which highest rate is reached Rs. 3,500,000	

Source: Compiled from Inland Revenue Acts and Amendments.

10.3 Professionals

Another contentious issue is the concessionary rate granted to a class of professionals under Section 40C of the Inland Revenue Act under Amendment No. 8 of 2014. A "professional" under Section 40C(2) has been defined and if such professional is employed with effect from 1.4.2014, is taxed subject to a maximum rate of 16% (whereas the normal maximum rate is 24%). Further, under Section 59F the professional services of these professionals are taxed at different "slabs" with the maximum rate of tax being 16%.

The tax for professionals can be summarized as follows:

Income from Profession	**Maximum Rate of Tax**
Does not exceed Rs. 25 million	12%
Exceeds Rs. 25 million but does not exceed Rs. 35 million	14%
Exceeds Rs. 35 million	16%

These concessions are available only to those classified as "professionals" under the relevant section and includes registered lawyers, doctors, chartered engineers, chartered accountants, software engineers, licensed pilots, navigation officers, researcher and senior academic recognized as an accredited professional. Other professionals have been excluded from these concessions as well as other individuals earning similar income.

10.4 Flat Rate

A contentious issue is the proposal in the 2016 Budget to increase the tax free threshold from Rs. 600,000 to Rs. 2.4 million per annum and charge only a flat rate of 15% on all income above this amount, irrespective of the amount of income. This is a radical change from a progressive tax system which has existed in Sri Lanka since the introduction of income tax in 1932 to a regressive one. Apart from such tax havens like the Cayman Islands, Isle of Man, Bahamas etc. where there is no income tax, most countries in the world have a progressive income tax system with relatively few exceptions which have a flat rate system. This is a controversial issue and has been suspended with no amending legislation as yet, and the threshold and rate structure for 2016/17 has remained on the 2015/2016 basis, subject to the changes announced from 1.4.2016.

10.5 Current Changes

Due to these factors, the basis of giving concessional rates to small and medium enterprises (SMEs) on the basis of taxable income (less than Rs.5 million) alone, has apparently undergone a change to take into account the nature of their activity rather than the taxable profit they make. From 1 April 2016 the rates are to be based both for corporate and personal income tax taking into consideration their nature and type of activity as well.

Corporate Income Tax

(a) Banking and financial services, insurance industry and trading activities – 28%;

(b) Liquor, tobacco, lottery, betting and gaming – 40%;

(c) All other activities including manufacturing and services – 17.5%;

(d) Other sources such as interest, royalty, dividends etc., to continue on the existing applicable rate depending on the source of income.

Personal Income Tax

i) Current rate structure, tax free allowance, rates etc. 2016/17 to continue – maximum 24%;

ii) Employment income at current slabs and rate for employees with the maximum rate of 16% to continue;

iii) Income from any activity (other than financial, trading, liquor, tobacco, lottery, betting and gaming) – maximum rate 17.5%;

iv) Profits from financial or trading activity – maximum 24%;

v) Profits from liquor, tobacco, lottery, betting and gaming activity limited to 40%;

vi) Income from Net Annual Value (NAV) etc. – maximum rate 24%.

All these above changes would of course, have to be legislated and passed for them to be legally effective.

The above changes would involve a number of complications:

1) The small companies whose income is less than Rs. 5 million would now have to pay at 17.5% from the current concessionary rate of 12%. This would increase the tax burden of small and medium enterprises and a disincentive for SMEs;

2) The overall income tax rate on most big businesses other than those activities (finance, insurance, trading etc.) would now decline from 28% to 17.5%. The corporate rate in India is 34% and in Malaysia 24%. This would lead to a decline in corporate income tax by a considerable amount, which would be known only at the end of the assessment year 2016/17;

3) For personal taxation, having different rates based on nature and activity and income would involve complication in calculation of tax payable by individuals;

4) For businesses it would involve keeping separate accounting records on the nature of activities carried on by a business, while for the tax administration it would involve complicated auditing and monitoring processes.

Considering all these circumstances, there is a view that it would be less complicated and more effective to have a uniform rate of corporate tax rather than taxing them on size and form or the nature of their activity, except in exceptional cases. Relief for SMEs could be given in other forms rather than merely on their taxable income or tax.

Concessions for SMEs for manufacturers and service providers have been given on the basis of turnover under Section 59B of Amendment Act No. 8 of 2014 as follows:

Year	**Turnover**	**Rate**
2011/12 – 13	< Rs. 300 million	10%
2013/14	< Rs. 500 million	10%
2014/15	< Rs. 750 million	12%

Considering these factors in relation to the rate structure, the following issues need examination:

1. Whether the reduction in the tax rate from 35% prevailing earlier is justifiable considering the low tax/GDP ratio and the needto raise tax revenue and increase the direct tax ratio. In this connection, it may be relevant to mention that in the 1990 Presidential Taxation Commission it was decided not to lower the income tax rate below 35% and it was the IMF through its representative and advisor that was vehemently opposed to any further reduction in the rate;

2. Whether to have one standard for the corporate sector (except perhaps liquor, tobacco and gambling) instead of multiple rates which complicate the system, leads to reduction in revenue, encourages tax avoidance and complicates the administrative system. Any concessions for desirable institutions and sectors should be given through other tax provisions and other means;

3. Whether having two separate rates for the corporate sector and individuals who have the benefit of a high tax free threshold, with a lower maximum rate for the latter who include traders, businessmen, professionals often earning very lucrative income, is again justifiable. Differentiation of maximum marginal rates of tax for individuals and companies can lead to unforeseen distortions of economic behaviour. Earlier the tax system had one rate of 35% for all with a reasonable threshold for individuals.

These are some of the issues that need examination and remedial action in the present context.

10.6 The Laffer Curve

The basic theory and principle that underlies the advocacy of a low tax regime and low rates of tax is based on supply side economics. While the Keynsian policy of demand management is based on the proposition that the level of aggregate demand determines the level of national income i.e., that demand creates supply, the supply side economics on the other hand, emphasizes the conditions governing supply such as the availability, cost and quality of resources which are considered the long-term determinants of national income and prices.

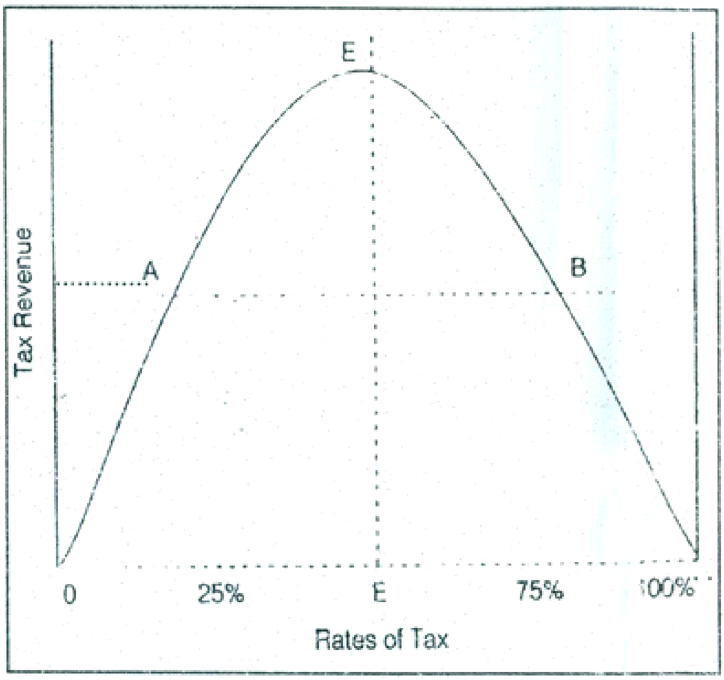
A proposition that characterizes supply side economics is that the rates of direct taxation have a major influence upon aggregate supply through their effects upon the incentive to work. According to supply side economists like Arthur Laffer, Jude Wanniski and others, high taxation acts as a disincentive to work because if marginal tax rates are high, the individual is likely to either forego opportunities to increase income through additional effort or resort to the informal sector (the "black economy") to avoid paying taxes.

The Laffer Curve indicates the effect of tax rates on government revenue. Briefly, the proposition of the Laffer Curve as its starting point is the simple notion that tax revenue is zero if the tax rate is either zero or 100%, with a smooth relationship between the rates and tax revenues connecting these two polar points. The existence of such a relationship suggests that if tax rates are sufficiently high, the "prohibitive range", then a reduction in tax rates could lead to an increase in tax revenues.

The Laffer Curve analysis leads to the followin conclusions:

- High rates of taxation act as a disincentive to work and thus reduce output and employment;
- An increase in tax rates does not always necessarily lead to increased revenue. There is a crucial point (point E in chart) beyond which an increase in tax rates leads to decreasing revenue and national income.
- There are always two rates available (A and B) which can produce the same total tax revenue, one a higher and another, a lower rate. Government, therefore need not necessarily choose a high rate to achieve the required quantum of revenue.

Chart 02 : The Laffer Curve



Studies of selected countries also seemed to indicate that those that imposed a lower effective average tax burden achieved substantially higher rates of growth in GDP than did their more highly taxed counterparts.

The Laffer Curve, however, has had its critics like Paul W. McCraken, Paul Krugman, Robert Lekachman and John Kenneth Galbraith. They have questioned the assumptions and theory behind the Laffer Curve and proved that it is not as scientific as it appears. The supply side cuts of the 1980s do not appear to have raised work efforts or saving and they unquestionably increased the deficit. Empirical studies carried out in two countries (Jamaica and India) where tax changes relevant to the Laffer Curve had been implemented have also concluded that the assertion that tax reduction would lead to revenue increases should at best be treated with caution (Ebrill, 1987).

10.7 Relevant Reforms

Considering all the factors discussed above in respect of measures to reverse the declining tax revenue/GDP ratio including measures relating to tax incentives, broadening the tax base and coverage, revising the allowable expenses in computing adjusted assessable and taxable profit, qualifying payments, tax free allowances and tax rates, it appears necessary to create a new income tax code to generate adequate income tax revenue. In this connection, the latest IMF Mission in 2016 led by Todd Schneider has made an in-depth analysis of the entire situation including the increasingly difficult external environment, the impact of domestic policies including fiscal deficits, public debt, and balance of payment position, real GDP growth, inflation and revenue administration and has made some far reaching recommendations to improve the situation.

Key objectives underlying its reform agenda include:

i) Improving revenue administration and tax policy;

ii) Strengthening public financial management;

iii) State enterprise reforms;

iv) Standard reforms to enable a more outward-looking economy, deeper foreign exchange markets and strengthen financial sector supervision.

It has also recommended the introduction of a new Inland Revenue Act. The introduction of Income Tax was made under the Income Tax Ordinance No. 2 of 1932 which was amended 17 times between 1932 and 1949. Succeeding legislation include:

1) Act No. 1 of 1949 which was amended 6 times;
2) Act No. 3 of 1956;
3) The Inland Revenue Act No. 4 of 1963 which has 12 amendments;
4) Inland Revenue Act No. 28 of 1979 which was amended 19 times;
5) Inland Revenue Act No. 38 of 2000 which had 6 mendments; and
6) Inland Revenue Act No. 10 of 2006 which up to now had 8 amendments and one more pending on the 2016 Budget proposals.

As Todd Schneider recommended, it is time to introduce a new Inland Revenue Act incorporating the necessary revisions and changes needed to improve tax collection and tax revenue in the context of current fiscal and economic policy.

11. Provincial and Local Government Revenue

Recent tax and fiscal changes have had an impact not only on national but also on provincial and local taxation as well. The revenue sources devolved on Provincial Councils under the Thirteenth Amendment are contained in items 36.1 to 36.20 of List I of the Ninth Schedule. They account for only 4% of the country's total revenue and less than 3% of tax revenue or 0.6% of GDP. Expenditure however is around 11% of Central Government expenditure or 2.6% of GDP. The deficit is met by grants from the Central Government consisting basically of three types, Block Grants, Criteria Based Grants and Province Specific Development Grants (PSDG) apart from grants for special projects.

Table 7
Budget Outturn for Provincial Councils 2012 - 2015, Rs. Million

Item	2012	2013	2014	2015
Total Revenue	49,235	49,648	59,133	66,082
Tax Revenue	41,657	42,569	52,569	59,482
Non Tax Revenue	7,578	7,079	6,564	6,600
Total Expenditure	161,341	185,241	216,824	267,696
Recurrent Expenditure	139,121	156,066	172,131	215,836
o/w Personal Emoluments	108,246	117,806	131,162	168,760
Capital Expenditure	22,220	29,175	44,693	52,310
Central Government Transfer	112,106	135,593	157,691	201,614
Block Grants	91,892	108,801	126,144	167,551
Criteria Based Grants	2,861	2,264	3,392	3,753
Province Specific Development Grants	5,901	6,429	8,343	13,345
Foreign Grants for Special Projects	11,452	18,100	19,812	16,965

Source: Central Bank *Annual Report 2015.*

Of the revenue sources, the most important was the provincial turnover tax on wholesale and retail sales which produced around 55% of provincial revenue and was the mainstay of the provincial revenue system. This was abolished from 1 January 2011 by Fiscal Policy Circular No. 01/2010 resulting in a drastic reduction of provincial revenue. It was replaced by a system of transfers from the centre consisting of 100% Stamp Duty collection, 70% of motor vehicle registration fees and 33 $^{1/3}$% of the Nation Building Tax (NBT). The abolition of the turnover tax has narrowed the base and coverage of the provincial system. This is enhanced by the fact that under Section 4.3 of the Ninth Schedule, the stamp duties on immovable property levied under Section 36.5 of the Provincial List as well as court fees, have legally to be transferred to the local government authorities and hence not a revenue resource for the Provincial Council.

This abolition has led to a number of problems. The turnover tax of the Provincial Councils had legally no threshold for its implementation while the coverage of the NBT (1/3 of which is now transferred to the Provincial Councils) is Rs. 3.75 million per quarter. This has also had an adverse administrative effect on the provincial revenue manpower where over 400 are employed in the revenue departments with their work drastically diminished and a loss of morale all round.

Another issue is the legality of its abolition as well as the transfer of other revenue to the provinces. It has been abolished by a Fiscal Policy Circular (No. 01/2010) by the Treasury while any changes to provisions in the Thirteenth Amendment is a constitutional process involving parliamentary approval (by probably a 2/3 majority). This issue has been examined in the Attorney General's Ruling dated 08 August 1989 as appearing in the Appendix in the Salgado Report on "Financial Devolution to the Provinces".

In respect of local government, the recent fiscal and tax changes have however had little impact on local government revenue. The local government system constitutes 335 institutions consisting of 23 Municipal Councils, 41 Urban Councils and 271 Pradesheeya Sabhas. Overall 60% of their revenue is self-generated sources consisting mainly of such items as property tax, acreage tax, rents, trade and business licences, refund of stamp duty and court fees from Provincial Councils and fees for services. Recent fiscal changes have had little impact on local revenue though their revenue system may undergo changes with the implementation of the Grama Rajjaya concept involving the creation of 2500 new units at grass roots level now being planned and considered by the government.

12. Capital Gains Taxation

Taxation of capital gains was introduced in Sri Lanka in 1959 giving effect to a tax reform proposal of Prof. Nicholas Kaldor, but since then has undergone several changes with capital gains on death or on gift being abolished in 1977. Capital gains by definition arise upon the sale, exchange or other disposition of a capital asset for more than its purchase price or value on acquisition, less any costs of buying and selling and of improving such asset. Capital assets include land and buildings, machinery and equipment and stocks and shares. The Inland Revenue Act No. 28 of 1979 in addition included such transactions as the surrender or relinquishment of any right in any property and the redemption of any shares, debentures or other obligations as giving rise to capital gains.

The rationale underlying the imposition of capital gains tax is that realized gains are equivalent to income and provide the recipient with just as much economic power over goods and services as any other form of income. Under this perspective, there is no compelling reason why capital gains should be treated differently from other forms of income. They generally accrue to the property owning class in society and is concentrated largely in higher income brackets. Capital gains taxation also tends to minimize the opportunities for tax avoidance.

Capital gains can be taxed either on an accrual basis or on a realization basis. They are normally taxed on the latter basis. In Sri Lanka capital gains have been taxed upon their realization as from 1 April 1977. In respect of immovable property acquired before that date, the value for purposes of capital gains taxation was deemed to be the value as at 31 March 1977. Section 14 of the Inland Revenue Act No. 28 of 1979 also provided exemptions on capital gains arising from certain transactions of which the most important related to the sale of residential houses. With regard to share transactions, capital gains were exempted from November 1979 for a period of 7 years with the intention of broad-basing companies.

Capital losses were deductible only against capital gains with provisions for allowing any unabsorbed losses to be carried forward for set off against future gains.

The rates of tax on capital gains varied with the period of ownership of property. Where the property was held for not more than 2 years the gains was subject to tax at the normal personal or company rate. Where the property was held for more than 2 years, the rates varied from 25% to 5%, with properties over 25 years being nil. The differential rate structure was intended to distinguish between short-term gains and long-term nominal gains due to inflation.

There are however a number of problems in relation to capital gains taxation. Issues such as "bunching", lock-in effect, part disposal, etc. can arise in capital gains taxation apart from distortions caused by inflation. Capital gains should be formulated in such a way that it would have a minimal impact on investment and business. However, the main issue is administrative arising in respect of valuation such as over-valuation at time of purchase and under-valuation at time of sale, leading to the increase in the number of tax appeals. Since there is no separate unit in the Inland Revenue Department for valuation, valuation problems both in respect of capital gains and stamp duty are referred to the Valuation Department for a realistic valuation. The Valuation Department however was not fully equipped to meet these requirements speedily especially at regional level outside Colombo, leading to both revenue and administrative problems. Improvements have been made in the Valuation Department since but further improvements are needed if capital gains taxation is to be reinstated. In these circumstances, taxation of capital gains was abolished in 2002 under Section 3 of the Amendment Act No. 10 of 2002 and there has been no capital gains taxation since. However, the government has in June 2016 again decided to re-introduce capital gains tax at 10% and legislation in this respect is expected to be introduced shortly.

13. Tax Evasion

There is no doubt that the large incidence of tax evasion in Sri Lanka is a cause of great concern. While the most immediate concern is the loss of revenue, in the long run such evasion tends to reduce the built-in elasticity of the tax system and to the extent that the evaded income is spent on goods and services, generates inflationary pressure and raises the prices of real property. It also distorts the fundamental objectives of a fair and equitable tax system.

Tax evasion can take diverse forms. These include non-declaration or under-declaration of income and assets, over-statement of expenditure or exemptions, fictitious expenses, transfer pricing, concealment of sales, stocks and debtors, fictitious creditors, etc. Other methods resorted to include the formation of private companies, fictitious partnerships, formation of private trusts and family trusts, leading to non-declaration or limited declaration of dividends, over-stated cash in hand, bank overdrafts and bank loans, drawings, etc.

All these involve a number of issues. In the first place, there is no legal definition of "tax evasion" in any tax statute. While Section 163 of the Inland Revenue Act No. 10 of 2006 permits the Assessor to make assessments or additional assessments on grounds of fraud, evasion or wilful neglect, the Interpretation Section 217 does not define any of these concepts. Recourse to judicial dicta do not provide an acceptable definition either.

Tax evasion is not confined to fraud alone, it also includes Wilful Default as well as Wilful Negligence. However, a distinction has to be made between a Fraudulent Return and an Incorrect Return where tax evasion as such is attributable only to the former. Mere omission due to oversight or construing a tax statute in a particular way is not an offence. It must be deliberately made to avoid tax or mislead a tax officer.

13.1 Tax Avoidance

Tax Evasion has also to be distinguished from Tax Avoidance. Tax avoidance has been defined as the "art of dodging without actually breaking the law". The legal definition between the two has been enumerated in the classic tax case of the Duke of Westminster v CIR 19 TC 490, where Lord Tomlins in his judgement made the celebrated dictum "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be". However, with ingenious tax avoidance proliferating, distinctions were subsequently made between (a) Evasion; (b) Abusive or Blatant Tax Avoidance; (c) Tax Avoidance; and (d) Mitigation.

It is difficult to estimate the extent of tax evasion or black money in Sri Lanka. In 1970 the Wanchoo Committee estimated it at 16.3% of GDP while in 1987 the National Institute of Public Finance and Policy estimated the figure of Black Money at Rs. 367,785 crore or 21% of GDP. In 1995 Dr. H.N.S. Karunatilake a former Governor of the Central Bank estimated it at around 10% of GNP. There is a great variance between estimates and there are no verifiable data bases to provide a reliable estimate. However, there is no doubt that tax evasion and black money is rampant in the country.

In this connection, a number of measures have been taken to curb or reduce the incidence of tax evasion. Statutorily a number of provisions have been incorporated in the tax Acts such as provisions relating to transfer pricing and thin capitalization, improving filing and reporting compliance, extension of the Withholding Tax System, more extensive auditing, particularly of large taxpayers, and information reporting among other provisions. However, while combating tax evasion provisions like transfer pricing, thin capitalization, etc., have been incorporated in the taxing statute, actual effective implementation of these provisions seems wanting.

Further, there has to be a more stepped up effort to deter tax evasion such as increasing the audit frequency and audit thoroughness for upper tax bracket taxpayers to ensure that most of the tax evaders incur some risk of being discovered. It also includes implementing an effective programme to detect new taxpayers with the focus on areas where there is reason to believe that significant net revenues could be gained. This involves a more effective system of securing and analyzing information from various sources, sharing of such information with the relevant units and branches within the IRD as well as co-ordination with other revenue departments.

All these processes appear to be inadequate in the current set-up. Further, there should also be a more vigorous application of pecuniary penalties combined with prosecutions in a given number of cases each year in view of their deterrent effect.

13.2 Withholding Taxes

The Withholding Tax system in particular is an effective administrative method of helping to minimize tax evasion and is a path to effective tax administration. It is especially effective in areas where it is difficult or uneconomic to detect evasion if payments were not taxed at source.

Withholding tax on dividends and on certain payments to persons outside Sri Lanka on interest, rent, ground rent, royalty or annuity existed in the tax statute from early times. These were subsequently expanded to deduction under the PAYE scheme, interest on deposits paid by banks and financial institutions, payments to foreign entertainers and artistes, profits on sale of gems, payments as rewards or share of fines to informants, lottery prizes and winnings from gambling and betting.

A further important provision was the application of withholding tax on "specified fees" paid by "specified persons" under Chapter XVII of the Inland Revenue Act No. 10 of 2006. "Specified fees" were defined under Section 153 as amounts over Rs. 50,000 per month or Rs. 500,000 per annum and included any commission, brokerage or other sums of like nature paid in the course of any business, profession or vocation, fees paid on construction work or articles on a contract basis through tender or quotation. It also included rent, lease rent or other payment for the use or occupation of any specified land or building.

Administratively, these provisions constituted a very effective method wide in scope in detecting tax evaders, increasing the coverage of taxpayers and tax revenue, and combating tax evasion. However, from 1 April 2011 these provisions were removed thereby diluting the administrative means and effectiveness of tax administration and should be re-incorporated in the new Tax Act.

13.3 Tax Amnesties

Another policy response that has been used in reducing tax evasion and black money is the grant of tax and foreign exchange amnesties. In Sri Lanka, 11 such tax amnesties have been granted from 1964 to 2002. However, all these amnesties have not produced the expected results. The following Table gives the results of the tax amnesties from 1964 to 2002.

Apart from the above tax amnesties there was the demonetization exercise of 1970. Even this was a relative failure where although an additional tax collection of Rs. 100 million was expected, the actual collection was only Rs. 13 million. (ESCAP, 1983).

Table 8
Results of Tax Amnesties since 1964

Year	No. of Declarants	Amount Recovered (Rs. Million)
1964	78	21
1965	595	38
1978	160	30
1989	9	4
1990	n-a	0.96
1992	n-a	n-a
1993	n-a	n-a
1997	100	285
1998	7	223
2002	592	n-a

Source: Compiled from Minister of Finance K.N. Choksy's statement in Parliament, Hansard 19 February 2003, and keynote address to the International Fiscal Association (Sri Lanka Branch), 29 May 2003.

14. The VAT Debate

In the early days, consumption taxes in Sri Lanka consisted mainly of customs duties and excises. In 1963 the Business Turnover Tax (BTT) was introduced by the Finance Act No. 11 of 1963 and implemented from 1.1.1964. In 1981 the BTT was revised by the Turnover Tax Act No. 69 of 1981 which was virtually a partial VAT. The GST Act No. 34 of 1996 introduced a more fuller value added system but was implemented only from 1.4.1998 along with another tax called the National Security Levy (NSL), under the NSL Act No. 52 of 1991 which was a turnover tax levied on gross sales. These two levies were amalgamated in August 2002 and termed a VAT under the VAT Act No. 14 of 2002.

There is no doubt that in principle, a VAT system is superior to other forms of sales taxation. It achieves neutrality between methods of production and between propensities to save and consume. It permits lower and few rates, minimizes distortion in resource allocation and is transparent, thereby enabling the tax content of a price to be known. Above all, a VAT system eliminates the cascading effects of a turnover tax and through its in-built, self-enforcing and cross-checking mechanism is more suitable for administrative purposes. For these reasons, over 160 countries have a VAT system in some form or other.

In spite of these advantages however, the VAT has also several weaknesses and defects. Some of these are inherent in the

VAT system itself, such as its design, base, coverage and rates. Others are associated with practical and administrative problems, and still others with the context in which VAT was implemented, its timing and effectiveness and its relationship with budgetary goals and medium term strategy of governments.

In terms of revenue, the VAT has not shown much improvement over the Turnover Tax or GST. The turnover tax has been a regular and reliable source of income without much complexity or need for manipulation. The VAT has not shown such regularity and has been characterized by volatility and the need for complex manipulation to prevent revenue erosion in the form of input credit and refunds. An analysis of the VAT performance from its inception in 2002 to 2015 from the Central Bank Annual Reports, shows that every year the actual revenue collected has fallen short of its estimates, the only exception being in 2010 where the collection was Rs. 219 billion in relation to the estimate of Rs. 206 billion. In 2014 the estimate was Rs. 303 billion while the actual collection was Rs. 275 billion, and in 2015 the estimate was Rs. 296 billion and the actual collection only Rs. 219 billion.

In terms of revenue productivity where the standard rate is 1 (perfect productivity) i.e., what every 1% raise of VAT rate in terms of VAT revenue or GDP, Sri Lanka's Productivity Rate is 0.315. This may be compared with countries such as Vietnam (0.562), Nepal (0.398), Indonesia (0.353) and Singapore (0.415).There are a number of reasons for the low performance of the VAT in Sri Lanka.

Table 9
VAT Revenue Performance 2002 - 2015

Year	Estimate Rs. Billion	Actual Rs. Billion	Shortfall Rs. Billion
2002	87	66	-21
2003	120	97	-23
2004	124	120	-4
2005	142	138	-4
2006	174	164	-10
2007	202	187	-15
2008	248	203	-45
2009	185	171	-14
2010	206	219	+13
2011	238	215	-23
2012	264	229	-35
2013	283	250	-33
2014	303	275	-28
2015	296	219	-77

Source : Central Bank *Annual Reports 2015* and various years.

14.1 Threshold

The threshold for registration of a person liable to VAT from 1.8.2002 was Rs. 500,000 per quarter or Rs. 1.8 million per annum. This has increased from 1.1.2009 to Rs. 650,000 per quarter or Rs. 2.5 million per annum. From 1.1.2013 it was increased to Rs. 3 million per quarter or Rs. 12 million per annum, and was further increased from 1.1.2016 under the VAT Amendment Act No. 11 of 2015 to Rs. 3.75 million per quarter or Rs. 15 million per year. From 2 May 2016 it was revised to Rs. 3 million per quarter. This regular increase of the threshold has reduced the coverage and number of taxpayers resulting in a decline in revenue.

14.2 Exemptions

Unlike in countries like New Zealand, Singapore, Canada etc. where the base of the tax is very broad with few exemptions, in Sri Lanka under the First Schedule of the VAT Act, a large number of goods and commodities as well as services have been exempted from the tax. These include items of mass consumption as well as services and items considered as incentives for several socio-economic sectors. This has considerably narrowed the base and scope of VAT, retained the cascading effect on such goods and led to the necessity to impose higher rates.

Further, ad hoc changes have been made in respect of exempted items and services from time to time. For instance, under Amendment Act No. 11 of 2015, VAT liability on certain motor vehicles imported and locally manufactured was removed from October 25, 2014, cigarettes and liquor from October 25, 2014 and ethyl alcohol from 1 January 2015. These however again changed in June 2016 when certain exempted sectors have been made liable to VAT such as the telecommunication sector, health care services (with some exemptions), etc. Such ad hoc changes and lack of consistency lead to confusion among taxpayers and the general public apart from variations in tax revenue.

14.3 Zero Rating

Zero rating is a mechanism adopted in a VAT system to relieve certain goods and services from the incidence of VAT. Unlike exemptions however, zero rating enables a supplier of zero rated goods to reclaim all the input taxes he paid on his purchases. Section 7 of the VAT Act includes not only exports which are normally so in a destination principled VAT system, but also includes a host of services consumed outside Sri Lanka. Further, it has incorporated a key clause called "international transportation (including trans-shipment) of goods and passengers" whose interpretation is in fact very wide. All these zero rated items have led to a large refund element which has adversely affected net revenue collection.

Of the gross receipts, a considerable element goes out as refunds especially in sectors such as leasing, construction, exports, garments, manufacturing and the hotel sector. Table 10 gives the amount of refunds in relation to gross collection and manufacturing for a selected number of years.

Table 10
VAT Refunds 2005 - 2014 (Rs. Million)

Year	VAT Collection		Refunds	%
2005	Gross	154,199	12,321	8%
	Manufacturing	31,504	12,279	40%
2006	Gross	175,247	11,176	6%
	Manufacturing	33,389	11,171	33%
2009	Gross	179,518	8,400	5%
2010	Gross	228,432	8,869	4%
	Manufacturing	39,282	7,577	19%
2011	Gross	221,768	6,348	3%
	Manufacturing	37,423	4,598	12%
2012	Gross	207,805	3,149	1.5%
	Manufacturing	39,789	1,302	3%
2013	Gross	218,146	459	0.2%
2014	Gross	239,028	1,112	0.4%
	Manufacturing	46,174	732	1.6%

Source: Compiled from IRD Performance Reports, various years.

It will be seen that in the early years, refunds averaged around 6% of gross VAT collection and in the manufacturing sector about 1/3 of gross manufacturing receipts went out as refunds. Steps have been taken to minimize these refunds through stricter administrative monitoring and controls such as by the implementation of the Deferment Scheme and in 2011 by the Simplified VAT scheme (SVAT). This scheme minimizes VAT refunds for VAT registered persons who are engaged in exports and special projects by the system of issuing credit vouchers. Refunds both overall and in manufacturing have since been reduced from 2011 onwards as the figures above indicate.

However, refunds under a VAT system cannot be entirely eliminated and the tax administration has to manage it in a proper and effective manner. Moreover, refunds have to be paid within one month and interest at 1% every month is due thereafter. Zero rating and refunds have therefore to be controlled carefully to prevent fraudulent requests for refunds.

14.4 Rates

When the VAT system was first introduced in 1998 in the form of a GST, it was characterized by a single uniform rate of 12.5%. A single rate is best both from a compliance and administrative point of view. Multiple rates distort both producer and consumer choices and complicates the system.

In Sri Lanka, VAT rates have been subject to ad hoc changes from time to time. While the VAT Act No. 14 of 2002 had originally two positive rates of 10% and 20%, it was soon unified into a single rate of 15% from January 2004. There was again a modification of rates whereby from 19.11.2004 there was a basic rate of 5%, a luxury rate of 18% and a standard rate of 15% which were in 2005 subsequently changed to 5%, 20% and 15%, respectively. In 2009 the system was again changed to a single rate system of 12% which in 2015 was reduced to 11% and from 2 May 2016 increased to 15%. However, according to IMF estimates, in order to be revenue neutral, the VAT rate in Sri Lanka should be around 17%.

14.5 Financial Services

Due to the difficulty of computing value added in the case of financial services such as banking and insurance, most countries exclude financial services from VAT. Such problems include disentangling the costs of intermediation, the sensitivity of the sector to fine margins, the likelihood of encouraging offshore provision of financial services and the important role finance plays in the economy. In 2014 leasing of movable properties after 25.10.2014 was included as financial services subject to VAT.

In Sri Lanka, financial services were exempted till 31.12.2002 but from 1.1.2003 were included under Chapter 111 A of the VAT Act. However, the method of computing was not the normal Output minus Input used in other sectors but the additive method of Net Profit plus Wages, under which method there is no deduction for input taxes paid. Hence, most banks tend to pass on the VAT to their borrowers leading to cost of credit and affecting investment.

14.6 Wholesale and Retail Trade

Under Section 3 of the VAT Act No. 14 of 2002, VAT was not charged on the wholesale and retail trading sector (unless they were manufacturers or importers of such goods) and they were liable only to Business Turnover Tax (BTT) to the Provincial Councils under Section 36.1 of the Ninth Schedule of the Thirteenth Amendment and subsequently in 2011 to the NBT.

With the abolition of the provincial turnover tax in 2011, wholesale and retail trade was made liable to VAT under VAT Amendment Act No. 17 of 2013. The quarterly turnover applicable to VAT on wholesale and retail trade originally in 2013 was Rs. 500 million and in the process of enlarging the VAT base and coverage, was reduced to Rs. 250 million in 2014 and Rs. 100 million per quarter in 2015. On 2 May 2016 the threshold was administratively reduced to Rs. 3 million per quarter or Rs. 1 million per month which meant that VAT was payable on liable goods and services on turnover over Rs. 33,000 per day. Such frequent ad hoc changes to the threshold as well as rates, lead to problems both to the taxpayers as well as the tax administration. The latest proposal is to revise the threshold from Rs. 12 million to Rs. 50 million per annum i.e., from Rs. 33,000 a day to Rs. 138,000 a day. Enlarging the coverage of taxpayers including VAT payers and the base of the tax including VAT is a necessary ingredient in creating a more effective tax system, particularly in the context of the crucial need to enhance tax revenue and reverse the declining tax/GDP ratio.

However, reducing the threshold of small and medium wholesale and retail traders creates many practical problems for taxpayers in keeping and maintaining records of sales and purchases in terms of VAT liable and exempt goods, zero rated goods etc. It also creates problems of monitoring, inspections, auditing etc. for the tax administration as well. In this context, it may have been more practical to have increased the tax rates while keeping the threshold intact without reducing it to too low levels. In fact, even as early as 1985, the IMF Mission headed by Carlos A. Aguirre when considering the introduction of VAT to Sri Lanka, recommended that “Small retail traders who usually keep inadequate or no records of their activities could be excluded from the tax net” (IMF Report October 25, 1985, p. 15). It is on this basis that Section 3 of the VAT Act No. 14 of 2002 excluded wholesale and retail trade (other than those of manufacturers and importers) from VAT.

14.7 VAT Frauds

VAT is a tax that is susceptible to fraud and is common in many VAT countries. For instance, in 2005 in Germany the “VAT carousel fraud” or “missing trader intra-community fraud” amounted to 17.6 million Euros or 11% of Germany’s annual VAT revenue. In 2006 the VAT fraud across Europe was estimated at a massive Euro 23 billion. Frauds have also been reported from Poland, Canada, Italy, New Zealand, UK etc. From goods it has recently moved into services as well.

There are three leading technology based solutions to this problem. (1) the Real Time VAT (RT VAT); (2) the VAT Location Number (VLN) system; and (3) the Digital VAT (D-VAT). The RT VAT focuses on securing the tax, the VLN focuses on securely tracing the supply and the D-VAT certifies that the correct tax is charged, collected and remitted.

In Sri Lanka, the massive VAT fraud during the years 2002 to 2004 amounted to around Rs. 4 billion making it one of the biggest in South Asia. It was based on fraudulent invoices of companies some of which were non-existent. There are many reasons for VAT being easily susceptible to fraud in Sri Lanka. The refund due to overpaid input tax, zero rating, eligiblility to full refunds, the relatively large sector being put in the zero rated list are some legal provisions in the Act. Others are administrative such as weak administration, lack of a fool proof audit system and verification of invoices, lack of co-ordination of information within as well as between revenue departments, and corrupt officials are other main reasons.

14.8 Administration

One of the most important factors in the inadequate performance of the VAT system in Sri Lanka, are the problems connected with the tax administration. VAT types of taxes are not easy to administer and the much vaunted self-checking and self-policing feature of the VAT has been found to be wanting in the Sri Lankan experience.

Some of the basic requirements for the successful administration of the VAT include:

- A simple VAT return and a taxpayer identification number (TIN);
- An effective taxpayer assistance programme;
- A reliable computerized system providing accurate and timely information;
- An effective system of audit, supervision, monitoring and control;
- A coordinated information system for cross-checking information, invoices, vouchers etc. in the VAT return with information from other sources to detect under-reporting or fraud;
- A sound and effective penalty system.

In most of these issues, the experience of Sri Lanka's VAT administrative system has, in practice, been found to be wanting. Various attempts have since been made to rectify the shortcomings, improve the system and streamline the VAT administration. These include:

- The provision of adequate resources;
- Development of skills and training;
- An extended computerization and EDP system;
- Advance Tax scheme and VAT deferment scheme;
- Optional VAT;
- Simplified VAT system (SVAT);
- Mechanism to cross-check input credit;
- Streamlining regulations relating to refunds such as the establishment of a VAT Refund Fund and the system of releasing funds based on a Bank Guarantee from the exporter;
- Streamlining appeal procedures and arrears collection.

15. Customs Duties, Excises and Miscellaneous Taxes and Levies

15.1 Tarrifs

The Mission statement of the Sri Lanka Customs is "to enforce the customs laws and revenue and social protection laws while facilitating trade and industry with the objective of contributing to the national effort and in due recognition thereof".

In respect of tariffs, export duties have been abolished since 1993 (except on scrap iron and a few other items) and import duties under the current fiscal system are used not so much for revenue as for protective purposes. They are based on the Harmonized System of goods classification and the valuation is based on the "Brussels Definition of Value" (BDV).

A number of steps have been taken to simplify and harmonize customs procedure and practices such as the widespread use of Information Technology (IT), the Harmonized Commodity Description and coding system, Uniform Customs Declaration (CUSDEC) and the ASYCUDA ++ automated data processing system. The Tariff Commission as early as 1985 recommended simplifying and rationalizing the rate structure by reducing the number of duty bands, based on reducing intended levels of effective protection.

The rationalization of the tariff structure is however complicated due to international agreements like the Indo-Sri Lanka Free Trade Agreement (ISFTA) and the Pakistan-Sri Lanka Free Trade Agreement (PSFTA), apart from multilateral trade agreements like SAFTA as well as the WTO. From January 2005 there were 5 bands which were subsequently reduced to 4 bands, zero, 7.5%, 15% and 25% and in 2015 were simplified to a three band structure of zero, 15% and 30%.

From a revenue point of view, the import duties brought in Rs. 81 billion or 0.8% of GDP in 2014 and Rs. 132 billion or 1.2% of GDP in 2015 which was 9% share of revenue.

15.2 Excise Duties

Excise Duty is an old levy having been introduced by the Excise Ordinance No. 8 of 1912 and recently broadened by the Excise (Special Provisions) Act No. 13 of 1989. They are based partly on a specific basis and partly on an ad valorem basis. Excise duties have a large potential for increased revenue due to the increase of demand for items like liquor and cigarettes which is generally inelastic and hence have been subject to frequent rate increases to generate government revenue. There is also considerable scope for enlarging the Special Excises which are levied on the sale of certain luxury and semi-luxury items on an ad valorem basis and to increase the rate of duty as well.

In 2014 Excise duties brought in Rs. 256 billion or 2.5% of GDP while in 2015 it brought in Rs. 497 billion or 4.4% of GDP. As a share of revenue, Excise duty produced 34% of tax revenue in 2015.

Excise duties if properly administered could therefore be utilized to further expand government tax revenues without affecting incentives for savings, investment and production. However, its ultimate effectiveness would depend on several factors like the identification of excisable items, an appropriate rate structure, a rational system of classification and valuation, and last but not least, a properly organized effective administrative network.

15.3 Miscellaneous Taxes and Levies

Apart from the taxes and levies discussed above in the national, provincial and local level, are a number of other miscellaneous taxes and levies that constitute Sri Lanka's taxation system. They include such taxes as the Nation Building Tax (NBT), Economic Service Charge (ESC), Betting and Gaming Levy, Share Transaction Levy, Cellular Mobile Telephone Subscribers Levy, Special Commodity Levy, Port and Airport Levy (PAL), Stamp Duty, Telecommunication Levy and Cess Levy (SCL). They brought in a considerable amount of revenue in 2014 at Rs. 239 billion or 2.3% of GDP and in 2015 Rs. 243 billion or 2.2% of GDP. These other taxes constituted 17% as share of revenue for 2015 as shown in Chart 1.

Table 11
Tariffs, Excise Duties and Miscellaneous Taxes 2010 -2015 (Rs. Million)

Year	2010	2011	2012	2013	2014	2015
Import Duties	64,163	79,811	80,155	83,123	81,108	132,189
Excise Duties	129,864	204,822	223,960	250,700	256,691	497,652
Liquor	36,654	55,286	60,086	66,008	69,100	105,264
Tobacco/Cigarettes	40,675	49,623	53,563	58,567	57,240	80,015
Petroleum	28,038	22,470	28,466	27,131	28,732	45,092
Motor vehicles & others	24,497	77,444	81,845	98,994	101,618	267,282
Miscellaneous Levies						
PAL/RIDL/SCL/other	66,585	82,260	104,479	108,692	117,375	112,042
License Fees	5,512	6,078	4,254	5,449	6,983	6,929
Stamp Duty/Cess Levy						
SRL/NBT DL/TL	92,165	85,326	93,898	101,508	114,742	124,683

Note: PAL - Ports and Airports Development Levy
RIDL- Regional Infrastructure Development Levy
SCL - Special Commodity Levy
SRL - Social Responsibility Levy
NBT - Nation Building Tax
DL - Defence Levy
TL - Telecommunications Levy

Source: Central Bank *Annual Report* 2015.

15.4 Simplification

Such a complex system creates difficulties for the revenue administration and leads to confusion both among investors and taxpayers. The simplification of this complex system is an urgent necessity. At one time, there were 22 taxes and levies at national level (apart from the one-off taxes in 2015), 20 at provincial level and 5 at local government level. As part of the simplification process of this complex system, a number of taxes were abolished such as Debits Tax, Social Responsibility Levy, Regional Infrastructure Development Levy, Construction Industry Guarantee Fund Levy and the BTT at provincial level. However the number is still large and the system needs further simplification.

Simplification however does not depend on legislative measures alone but also on administrative procedures and regulations. While various procedural guidelines have been issued to clarify and simplify matters, it has not been as effective as expected.

16. Revenue Administration

In the final analysis, it is the level of efficiency of the revenue administration which determines the effectiveness of any revenue system. In the current context, with the declining tax ratio and the urgent need to increase government revenue, the effectiveness of the tax administration, its structures, systems and processes need thorough examination, its weaknesses identified and measures taken to rectify these weaknesses and make the tax administrative system an efficient and effective instrument of tax collection.

The problems and gaps in revenue administration relate both to the level of policy formulation as well as at the implementation level. At the policy formulation level, the gaps relate to (i) lack of effective institutional structures; (ii) absence of adequate and effective processes for public participation in policy formulation; (iii) inadequacy of monitoring and evaluation of policy implementation; (iv) lack of sufficiently trained personnel for tax policy analysis and research; and (v) unification of collection techniques. At the implementation level, the weaknesses include:

i) The relatively low number of taxpayers and level of compliance;

ii) Improvement of work systems and methods;

iii) Insufficiently trained personnel and modernizing of tax administration;

iv) Attitude of tax administrators towards taxpayers and insufficient public education;

v) Inadequate coordination between different tax administering departments such as between Inland Revenue, Customs, Excise and other revenue authorities including provincial and local authorities;

vi) Shortcomings in the operation of tax administration including audits, inspections, default taxes, combating tax evasion, etc.

16.1 Number of Taxpayers and Files

According to the Inland Revenue Department Performance Report 2014, the total number of taxpayers as at 31.12.2014 was 625,376 comprising 3% of the population. The total number of corporate files was 39,535 though the number of functioning companies under the Companies Act No. 7 of 2007 was at October 2011, 48,658 including listed companies in the Stock Exchange 296.

The total number of income taxpayers was 559,360 comprising of 148,720 individuals and PAYE employees 354,758. VAT registered persons amounted to 15,530, NBT 22,381, Employers registered under the PAYE scheme 12,104 and Economic Service Charge 3515. The total number of Betting and Gaming files was only 1072.

Unregistered taxpayers, stopfiling taxpayers, tax evaders and delinquent taxpayers are however the key factors in judging the effectiveness of a tax administration.

16.2 Compliance

Voluntary compliance is the goal and cornerstone of a tax administration and the most economical way of collecting tax. It is more so under a system of self-assessment. It may be said that the main tasks of tax administration are facilitating compliance, monitoring compliance and dealing with non-compliance. The IRD has taken a number of measures to improve compliance such as providing benefits to individual taxpayers in the form of awarding Privilege Cards (Gold and Silver), grant of tax concessions on importation of motor vehicles, discounts on early tax payments among others. However, the return compliance for income tax on due date appears inadequate as shown in Table 13 below.

Nevertheless, it should also be noted that the return forms are complicated running into several pages. Taxpayers find it difficult to complete them and often have to take recourse to accountants or tax practitioners thereby increasing costs and leading to personal complications. Tax returns should be re-designed and made simpler and preferably limited to a single sheet.

Table 12
Number of Taxpayers and Tax Files as at 31.12. 2014

Income Tax		
Corporate		
Resident Companies	38,502	
Non Resident Companies	969	
State Corporations, Statutory Boards and State Owned Institutions	64	39,535
Non Corporate		
Individuals	148,720	
Partnerships	14,515	
Bodies of persons etc.	1,832	
Employees paying income tax under Pay-As-You-Earn (PAYE) Scheme		
(as at 31.03.2014)*	354,758	519,825
Total Income Taxpayers		**559,360**
Other Taxpayers		
Persons and Partnerships registered for Economic Service Charge (ESC)	3,515	
Persons registered for Value Added Tax (VAT)	15,330	
Persons registered for Value Added Tax on Financial Services	176	
Persons registered for Optional VAT	74	
Persons registered for Nation Building Tax (NBT)	22,381	
Persons registered for Nation Building Tax on Financial Services	175	
Betting Levy Files	1067	
Gaming Levy Files	5	
Total Other Taxpayers		**42,723**
Employers registered under PAYE Scheme	12,104	
Withholding Tax on Interest (withholding Agents)	2,628	
Withholding Tax on Specified fees (Regular Monthly Schedules Senders)	84	
Construction Industry Guarantee Fund Levy	304	
Stamp Duty (Regular Monthly Schedules Senders)	8,173	**23,293**
Total Number of Tax Files/Taxpayers as at 31.12.2014		**625,376**

**Include 45,778 Government employees but does not include employees in the incomplete declarations furnished by employers.*

Source: IRD Performance Report 2014.

Table 13
Tax Return Compliance 2012 to 2014

Tax	Year	Sector	Compliance on Due Date %
Income Tax	2012/2013	Corporate	56%
		Non-Corporate	41%
	2013/2014	Corporate	53%
		Non-Corporate	42%
PAYE	2011/12		52%
	2012/13		53%
	2013/14		55%
VAT	2012		89%
	2013		78%
	2014		49%
ESC	2012		80%
	2013		93%
	2014		71%
NBT	2012		79%
	2013		77%
	2014		84%

Source: Inland Revenue Department, Performance Report 2014.

16.3 Audits and Investigations

Under the existing self-assessment system prevalent, 96% of tax collection is through self-assessment and only 4% by way of official assessment. Nevertheless, auditing and examination of returns and accounts is an integral part of assessment procedure. The audit function should be evaluated in terms of the quantity and quality of audits carried out and the revenue “voluntarily” paid. Audits have been undertaken on taxpayers particularly in the Large Taxpayer Unit (LTU) in terms of business activity, entity type and business size. It has been found that the most productive use of investigation resources has paid dividends in respect of the largest taxpayers.

However, considering the extent of under-reporting of profits and income, particularly by large companies, traders and businesses, professionals and others, whether the extent and scope of auditing, investigation and additional tax collected is sufficient is debatable. For instance, as at October 2011 the total number of functioning companies was 48,658 while the number of resident company files as at 31.12.2014 was 38,502. In 2014 the total additional income tax assessed and agreed in the Corporate Large Taxpayer Unit (LTU) after audit was Rs. 10 billion or about 8% of total additional tax assessed and agreed for the year.

16.4 Default Taxes

Total taxes in default as at 31.12.2014 stood at Rs. 128 billion, which is relatively high. This includes some taxes which have been repealed, abolished or uncollectible like Debit Tax, Turnover Tax, GST, Wealth Tax, Gift Tax etc. Steps should be taken to write off these obsolete taxes from the books and effective steps taken to collect the balance in a planned and speedy manner, as provided in the Default Taxes (Special Provisions) Act No. 16 of 2010 which stipulates that arrears should be maintained at less than 3% of taxes levied in the immediately preceding year.

16.5 Appeals

The speedy and effective settlement of appeals is an important element in improving the administrative system. There are a number of problems in appellate procedure which is lopsided and heavily weighted against the taxpayer, largely due to the absence of a vociferous taxpaying public. The failure to follow proper procedure has often led to protracted delay in the settlement of appeals. In this respect, the earlier Board of Review has been replaced by the independent Tax Appeals Commission through the Tax Appeals Commission Act No. 23 of 2011 which covers Customs appeals as well. However, there are a number of issues which has cropped up including the necessity to make a 25% deposit of the amount of tax and penalty in dispute in order to validate an appeal, a provision which has drawn severe criticism.

Table 14
Analysis of Default Taxes 2014

Type of Tax	Gross Tax in Default (Rs)	Penalty (Rs)	Defaulted Taxes Excluding Penalty (Rs)	Penalty Related to Disputed Taxes (Rs)	Collectible Tax (Rs)	Collectible Penalty (Rs)
Income Tax	56,899,485,469	37,253,768,193	48,386,379,832	33,389,149,188	8,513,105,637	3,864,619,005
Surcharge on Income Tax	406,775,534	269,440,138	404,387,151	268,245,948	2,388,383	1,194,190
Income Tax (WHT on interest)	1,390,837,523	635,829,057	1,356,563,354	592,897,671	34,274,169	42,931,386
Value Added Tax	44,497,939,944	29,802,383,798	39,717,299,223	25,770,072,800	4,780,640,721	4,032,310,998
Value Added Tax						
(Financial Services)	8,593,768,538	4,842,592,562	8,550,240,806	4,830,389,132	43,527,732	12,203,430
Economic Service Charge	7,117,628,614	3,141,589,723	4,335,790,517	2,210,143,380	2,781,838,.097	931,446,343
Nation Building Tax	2,727,620,407	1,920,389,170	1,614,856,989	1,217,591,210	1,112,763,418	702,797,960
Stamp Duty	9,732,724	3,773,302	-	-	9,732,724	3,773,302
Debit Tax	2,215,581,368	-	2,215,581,368	-	-	-
Turnover Tax	2,611,068,311	1,271,691,854	2,611,068,311	1,271,691,854	-	-
Goods & Services Tax	945,024,420	1,038,025,892	945,024,420	1,038,025,892	-	-
National Security Levy	1,538,591,036	627,138,614	1,538,591,036	627,138,614	-	-
Save the Nation Contribution	22,443,029	6,561,055	22,443,029	6,561,055	-	-
Wealth Tax	851,542	473,924	851,542	473,924	-	-
Gift Tax	2,409	1,204	2,409	1,204	-	-
Social Responsibility Levy	2,111,474	154,110	1,864,758	147,171	246,716	6,939
Compounding Penalty	-	283,067,976	-	115,718,169	-	167,349,807
Total	**128,979,462,342**	**81,096,880,572**	**111,700,944,745**	**71,338,247,212**	**17,278,517,597**	**9,758,633,360**

Source: IRD Performance Report 2014.

16.6 Coordination between Revenue Departments

One of the principal defects of the tax administration system in Sri Lanka is the lack of coordination between the revenue departments, and on the policy side the present fractured and isolated character of the activity of policy formulation. As regards these, the previous Tax Commissions have recommended the constitution of a Board of Revenue or Revenue Authority and the creation of a permanent National Taxation Commission as a remedy.

In respect of the former, the lack of coordination between the Inland Revenue, Customs, Excise and provincial and local revenue authorities as well as the Fiscal Policy Division at the Treasury, affects policy formulation, information exchange, and the monitoring of the implementation of taxes. They all tend to operate in isolation. In order to remedy this, the establishment of a Board of Revenue or Revenue Authority vested with the overall authority for revenue administration has been recommended in order to coordinate and improve the overall tax administration system of the country. Such a Revenue Authority is not expected to be a tax collector but to reorganize the administration of the three departments, eliminate overlapping functions and effect coordination where it is possible, so as to cater for less bureaucracy, expedition and increased collection of legitimate revenue.

16.7 Cost of Adnministration

As per the Performance Report of the IRD for 2014, the total expenditure of the Department was Rs. 3,087 million (includes capital expenditure for RAMIS) and the revenue collected was Rs. 514 billion. In 2013 the expenditure was Rs. 1,876 million. The productivity ratio is 166:1 i.e., the cost of collection for Rs. 100 was 60 cents or 0.6% which could be considered as reasonable.

16.8 Measures Taken for Improvement

Considering the weaknesses in revenue administration and the necessity to remedy these weaknesses and improve the efficiency of revenue administration, a number of measures have been taken at all revenue departments including Inland Revenue, Customs and Excise.

In Inland Revenue, the Tax Service Unit established facilitated taxpayers and the public to access the Department's service conveniently. In 2014 the Unit issued 6,054 TIN certificates and 7908 temporary VAT applications for opening of new files as well as 321 clearance certificates for non-taxpayers. Consultancy services were made to the public through the "One Stop Service Centre" while 14 awareness programs were organized during the year.

The Internal Audit Branch examines all payments, daily vehicle running charts, pay sheets, annual board of survey reports and bank reconciliation apart from other actions such as recovering amounts due to dishonoured Cheques,, refunds and checking imprest accounts.

The Economic Research and Planning Unit carries out different types of researches by analyzing data received from various sources such as the Central Bank, Census and Statistics Department etc. The Training Branch vital for training of tax officers to perform their duties effectively, while organizing awareness programs for taxpayers, also provided overseas training for tax officers, participation in overseas seminars and workshops to learn the best practices in other countries in order to maintain a high level of professionalism as tax administrators. Locally, it conducted several programs to provide specialized knowledge on application of tax statutes and other relevant technical areas apart from in-house training, particularly in taxation and accountancy.

In 2011 a Committee for Interpretation of Tax Laws was appointed which is responsible for the issuance of interpretations, clarifications, guidelines etc. on the provisions of the various Acts administered by the Department. The objective of this is to ensure uniformity with regard to interpretations and procedures in tax legislation and administration. A total of 73 interpretations have been given in 2014.

Internationally, in order to eliminate or mitigate the incidence of juridical double taxation and fiscal evasion in international transactions, Sri Lanka has entered into a number of double taxation agreements. The avoidance of double taxation is important for attracting foreign investments, obtaining expertise, modern technology, employment opportunities etc. Sri Lanka currently has 42 such Double Tax Treaties and one multilateral treaty (SAARC).

Finally, the ongoing improvements in tax compliance administration include the automation of revenue agencies, introducing the Single Window System (SWS) at Sri Lanka Customs linking all stakeholders and incorporating into the ASYCUDA World system, automating of the activities of the Ministry of Finance under the Integrated Treasury Management System (ITMIS), introducing the zero based budgeting system by the Finance Ministry and setting up of Budget Implementation and Monitoring Unit (BIMU) to ensure close monitoring of expenditure programmes.

At Inland Revenue, the automation process involves the implementation of the Revenue Administration and Management Information System (RAMIS) aimed at further simplifying the tax administration and tax for taxpayers. RAMIS is also envisioned to support in increasing the revenue collection by enabling IRD to reach out to taxpayers in a more efficient and effective way. It is expected to meet the requirement of infrastructure facilities such as end user hardware, computers, printers and scanners that are necessary to perform the activities of the Department.

RAMIS is expected to widen the tax net and improve compliance, enhancing the efficiency of the revenue collection process, increasing the quality of the work environment to generate higher productivity and provide better service to taxpayers with a view to increasing voluntary compliance. It is expected to be completed by end 2016.

However, it may also be stated that in many instances the expectation of greater effectiveness from computerization has not materialized. Computerization is a necessary but not a sufficient condition to improve the effectiveness of tax administration. Whilst computer technology helps perform routine tasks more rapidly, there is no guarantee that it would automatically increase revenue collections substantially. Computer technology facilitates and improves tax administration but unless accompanied by effective enforcement activities, may help in increasing revenue only marginally. Successful computerization must be accompanied by a fundamental reorganization of both systems and procedures and cannot be used by itself to side-step much needed reform.

17. Concluding Remarks

Sri Lanka's fiscal and taxation system is at a critical juncture. With the end of the 30 year old insurgency, Sri Lanka has entered a new era of growth, reconciliation and reconstruction. Development challenges are many both in the international and national contexts.

The current taxation and fiscal policy issues discussed are of crucial importance especially the recent declining growth in tax revenue ratio, the reasons for the decline and measures necessary to reverse the trend and make the tax system into an effective instrument of economic growth. Relevant issues discussed include the direct and indirect taxes, the pros and cons of the Value Added Tax system and its problems, tax evasion, capital gains taxation, elasticity and buoyancy of the fiscal system, the tariff structure, simplification of the tax system and last but not least, the problems of the tax administration, its weaknesses and measures necessary to strengthen the administration in order to make it an effective mechanism of collecting much needed revenue.

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