the SUNDAY TIMES

Tax issues - Current system not delivering needed revenue

Too many exemptions, lot of evasion

A few days before President Mahinda Rajapaksa presents the 2011 national budget (takes place tomorrow), Dr. Saman Kelegama, Executive Director, Institute of Policy Studies of Sri Lanka and Member of the Presidential Taxation Commission, spoke to the Business Times on the serious issues that confront tax reform in the country.

Today, approximately 80% of tax revenue comes from indirect taxes and only 20% comes from direct taxation. In other words, the bulk of the taxation has fallen on the less well-off people. Pic shows a small outlet in Galle

Q: What are the key recommendations of the Presidential Taxation Commission?
The final report of the Commission was submitted to the President on October 26. The Commissioners consider the contents as confidential until the report becomes a public document. Thus, I am not in a position to speak about the specific recommendations but I can speak on the overall perspective and raise issues that are of interest in the context of tax policy.

Q: What is the most fundamental problem in regard to the taxation system in Sri Lanka ?
The tax system is not delivering the potential revenue in Sri Lanka. As income increases in a country, the revenue also increases although the rate of increase will decline after some time. This is not happening in Sri Lanka. Sri Lanka's per capita income has increased from US$ 720 in 1995 to US$ 2053 in 2009 but our tax revenue has declined from 20.4 % GDP to 14.6 % GDP during this period. Almost 90% of revenue comes from taxes (10% is accounted by non-tax sources). Tax elasticity measures the extent to which the tax system generates revenue in response to increase in income without change in the tax rates. This is less than unity or one and not a healthy sign.

The key reason for this is that the tax base has not broadened in line with the increase in income or economic activities. The reason for the weak tax base is the multitude of tax exemptions, tax evasion, many discretionary tax measures in operation, and weak tax administration.

Q: Are there any other outstanding specific problems in the Sri Lankan taxation system?

The weak tax revenue over the years has led successive governments to impose ad hoc taxes from time to time, so much so there are about 25 taxes in operation in the Sri Lankan economic system. This is a large number of taxes compared to other developing countries and has made the tax system very complicated. With 8 to 10 taxes in the system, some developing countries have managed to collect a larger per cent of revenue per GDP than Sri Lanka.

Secondly, successive governments have heavily depended on indirect taxes for tax revenue instead of working out a reasonable balance between indirect and direct taxation. Today, approximately 80% of tax revenue comes from indirect taxes and only 20% come from direct taxation. In other words, the bulk of the taxation has fallen on the less well-off people. A better balance would be 60:40. The contribution from direct taxes to total tax revenue is low largely because the tax base has remained narrow.

Q: Any statistics with regard to the direct tax base?

At present, the number of direct tax payers (corporates, non-corporates and PAYE scheme employees) is just under 600,000. Around 25,775 corporate entities contributed Rs 46 billion in 2008, while 219,166 non-corporate tax payers (individuals, partnerships, bodies of persons) contributed Rs 47 billion and 351,726 PAYE tax payers (employees) paid Rs 14.3 billion.

Individual (non-PAYE) income tax has the potential to be a valuable revenue source, but has remained slim for years. The low value placed on getting caught and the disincentives to fully declare income for fear of being harassed by the authorities are just two of many reasons for not being able to attract new tax payers, and the limited revenue collected from existing ones. The Sri Lankan economy generated income taxes (personal, corporate and withholdings) amounting to 2.4% of GDP on average per year in the past five years, whereas in much of the Asia-Pacific region, this figure was close to 5.4% of GDP.

Q: Can you elaborate on tax exemptions and tax evasion?

First on tax exemptions, (a) take the 1.2 million labour force in the public sector – do they pay taxes ? No. In 1979 public servants were exempted from taxation because the government could not afford to grant a salary increase to public servants in line with the private sector. Ever since then, this has become a rigid policy and Sri Lanka may be the only country in the world where public servants do not pay taxes; (b) BOI tax exemptions and tax holidays have led to approximately 1% of GDP revenue losses per annum, and (c) various exemptions on VAT and import duty from time to time have also contributed to eroding the revenue.

Second, tax evasion happens in many ways: (a) some professionals (doctors, lawyers, accountants, etc.) do not disclose their true income and pay less taxes or completely evade paying taxes, (b) successive governments implementing tax amnesties have also led to tax avoidance, (c) under-invoicing of imports is also an evasion of paying correct taxes, (d) over-stating of expenses and transfer pricing, and (e) illegal flows of imports to the country has contributed to losses close to Rs. 300 million a day. These areas have to be seriously examined if we are to strengthen the revenue flows to the government and these areas have been closely examined by the Presidential Taxation Commission (PTC).

Q:There is a lot of discussion on the future of BOI incentives – what is happening?
The rationale of incentives offered by BOI were: (a) offset the investment risks generated by the North/East war related uncertainties, (b) offset the negative impact of problems of "doing business" in Sri Lanka. As is well known, Sri Lanka ranks low in many of the "Doing Business" indicators produced by the World Bank. To offset these problems, the generous tax incentives were offered, and (c) to keep up with Sri Lanka's competitors such as Bangladesh, Vietnam, Indonesia, Mauritius, etc., in attracting FDI.
The BOI incentives came under scrutiny during the IMF Stand By Arrangement (SBA) of 2001 but nothing was done to streamline BOI incentives with the Inland Revenue Department as was suggested in the SBA. The BOI incentives came under scrutiny again under the new IMF package of 2009 but before that, the PTC had identified this area for full examination and it was an item in the PTC terms of reference.

Let us examine the real situation. The country loses 1% GDP of revenue per year as stated earlier to attract about 1.5% GDP worth of FDI every year (BOI contribution to promoting large domestic investment is another matter). This year we will not be able to achieve 1.5% GDP level FDI. Recent international literature has found that the most important factors for attracting FDI are consistency and predictability of policies, stable economic and political environment, and an easy 'doing business' environment. Incentives matter but they do not rank in the top among large multinational investors. Moreover, many countries today are shifting towards non-tax incentives for FDI, like offering investment relief, accelerated depreciation allowances, etc. It is in this context that we have to have a fresh look at BOI incentives.

First, should we use BOI incentives to offset the negative aspects 'doing business' environment? If there are problems in getting land or terminating employment, should we use tax incentives to offset their negative side or address these problems head-on and sort them out once and for all ? The latter should be the correct way forward. Second, the war is over and there is no war related uncertainty in the investment regime for incentives to offset. Third, the fact that competitors are offering tax holidays should not bother us too much. As stated earlier, consistency and predictability of policy, ease of doing business, etc., are more important for business decisions than tax incentives. Thus, the logic for BOI incentives has to be looked at again to see where changes need to take place.

The existing BOI incentive commitment should continue and should not be changed. However, it is high time for the BOI to consider a new incentive system that would be more cost-effective than the existing one for all new investment projects.

Q: What are the issues in regard to VAT?
VAT still does not bring the same revenue as the former BTT (Business Turnover Tax) and GST (Goods and Services Tax) did when they were in operation. VAT brings in 33% of tax revenue which amounts to 5.5% of GDP. The BTT brought an average 6.5 % of GDP revenue and GST brought an average 6% of GDP revenue. VAT is yet to achieve this after eight years of operation. Sri Lanka is still on a learning curve in regard to VAT. This can be seen from the fact that eight amendments were made to the VAT Act over the last eight years and a major VAT fraud costing about Rs. 4 billion took place in 2004. Training personnel, adequate public education, and institutional frameworks were not put in place before VAT came into operation. VAT threshold is a hotly debated topic and VAT refunds are also an issue – there are computational problems and identification issues. The application of VAT to the financial sector is also an issue.

These are by no means arguments for abolition of VAT. VAT is an internationally accepted non-cascading tax system and operates in more than 100 countries in the world. We have to do more groundwork to firmly establish the VAT in the Sri Lankan economy and gradually extend VAT to the wholesale and retail sectors.

Q: What are the issues in regard to import duty?
I highlighted some of them in my address at the AGM of the Import Section of the Ceylon Chamber of Commerce in August this year. Basically, our import duty structure has got complicated by various 'add on' taxes over and above tariffs and VAT (and Excise where applicable). These 'add on' taxes are revenue generators to the Treasury and additional protection for some domestic manufacturers but they are basically nuisance taxes for import traders and importers of manufacturing inputs.

To meet certain development expenditures, the following taxes were imposed and they are applicable at the border: (a) Nation Building Tax, (b) Port and Airport Development Levy, (C) Regional Infrastructure Development Levy, and (d) Social Responsibility Levy. To develop certain commodities the following taxes were imposed: (1) Commodity Export Subsidy Scheme (CESS), and (2) Special Commodity Levy. In 2009, import tariff revenue was close to 2% of GDP but the customs border revenue was 8% of GDP, thus nearly 6% GDP revenue has come from these additional taxes.

All these minor taxes are an irritant to the importer although they fulfill some revenue and protection objectives. These taxes have made the tax structure more complicated and less transparent. And above all, these taxes operate under different tax bases. One reason for illegal imports and undervaluation of imports is due to these taxes. What Sri Lanka should aim at is a less complicated border tariff structure which gives reasonable protection and revenue.

Q: What about further decentralization of taxation to the provinces?
When the Provincial Council (PC) system came into operation after the 13th Amendment to the Constitution in 1987, turnover tax at the wholesale and retail levels was devolved to the PCs. Turnover tax is the highest revenue earner to PCs accounting for 44% of

revenue. This is followed by stamp duty – 28%, licensing fees from motor vehicles and excise -13%, and others -15%.

In Sri Lanka, tax sources devolved to the PCs account for only 4% of the central government revenue (0.6% of GDP). In comparison, province/state revenue is above 50% of central government revenue in India and Australia, and above 15% in Malaysia and Thailand. Apart from limited fiscal decentralization, the provinces lack adequate tax administration capacity and specialized technical skills that the Inland Revenue Department enjoys. There is a lack of motivation among PC revenue collectors in seeking new and innovative sources of revenue. This situation was partly due to the dependence on an annual grant received from the Centre which almost/always ensures PCs that recurrent expenditure needs will be met.

Any increase in PC powers to collect more taxes (i.e., additional fiscal decentralization) should go with a reduction in the allocation of Central government grants (particularly the Block Grant) and improvement of the tax collection capacity of the PCs.

Q: Does the government plan to increase revenue to 20% of GDP during the next 4 to 5 years?

Yes, this should be the final aim. China, India, Korea, Vietnam, and others all have revenue levels at 20% of GDP or more. Such revenue will facilitate Sri Lanka to maintain current expenditure at around 18% of GDP and capital expenditure at 6% of GDP ad keep a budget deficit of about 4% GDP. This is the type of budgetary balance we should aim at in the future.

In the PTC report we have recommended a strategy to broaden the tax base, lower the tax rates and make the tax system less complicated. We have argued the case for a business and people-friendly taxation system.