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Incentivizing Foreign Investment in Sri Lanka and the Role of Tax Incentives

Anushka Wijesinha
Raveen Ekanayake
Gajen Mahendra

INSTITUTE OF POLICY STUDIES OF SRI LANKA
100/20, Independence Avenue, Colombo 7, Sri Lanka

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Please address orders to:
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100/20, Independence Avenue, Colombo 7, Sri Lanka
Tel: +94 11 2143100 Fax: +94 11 2665065
E-mail: ips@ips.lk
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List of Tables

List of Figures

List of Boxes

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Executive Summary

As post-war Sri Lanka gears itself towards sustained fast growth and achieving upper-middle income status, the importance of attracting greater investment from abroad - Foreign Direct Investment (FDI) - has risen to the fore. Although Sri Lanka has seen a steady inflow of foreign investment projects into the country over time, the record has been less than impressive when compared with many emerging economies.

Sri Lanka attracted an annual average FDI of US$ 500 million (about 1.5 per cent of GDP) during the last decade while East Asian countries, for instance, attracted FDI inflows exceeding US$ 5 billion annually - close to 5 per cent of GDP.

With a GDP growth target of 8 per cent or higher, Sri Lanka would need to raise its annual rate of investment from the current level of approximately 26 per cent of GDP to at least 35 per cent. With public investment to be capped at around 6 per cent of GDP, this rise would need to come almost entirely from private investment. Within this, foreign private investment plays a critical role. In addition to helping bridge the domestic savings-investment gap, foreign investment brings other benefits as well -- technology spillovers, management best practices, links to new markets, etc.

Like many developing countries Sri Lanka has offered, and continues to offer, generous tax holidays and other tax-based incentives and exemptions to incentivize FDI inflows to the country. But it is widely acknowledged that they erode the government's tax revenue base significantly.

Fiscal pressures in Sri Lanka are now rising - the government is keen to curb the widening budget deficit and keep it at 6.2 per cent. The tax to GDP ratio has been declining from around 19 per cent pre-1995 to 13-15 per cent in recent years (2010-2011) - far below the benchmark for a middle income country of 25 per cent. Meanwhile, concessionary foreign aid to the country is also rapidly shrinking owing to the country's new lower-middle income status. This means that to finance Sri Lanka's development needs domestic revenue mobilization, i.e., tax revenue, needs to increase. A critical element in this effort is ensuring that revenue leakages in the form of tax exemptions and holidays are minimized and those granted are effective in their intended purpose - attracting more and better foreign investment.

However, in this post-war phase, where Sri Lanka has won itself a new chance at attracting world-class foreign enterprises, the attractiveness of Sri Lanka as an FDI destination has to be maintained. This is important in order to keep the rate of investment high to generate faster growth, to help Sri Lanka further integrate with the global economy, and to provide more and better employment opportunities for the country's people and raise living standards. Sri Lanka is continually competing with other FDI destinations in the South and South East Asian region, especially Malaysia, Thailand, and Indonesia and increasingly also Vietnam, Cambodia, Myanmar and Lao PDR.

So the key medium-term challenge facing the country is to find a balance between providing a competitive tax incentives regime to attract FDI and keeping tax foregone to a minimum in order to preserve domestic revenue.

The effectiveness of tax incentives in attracting FDI is widely debated among tax professionals, treasury officials and investment promotion officers. Some tax experts argue that tax incentives are not necessary for attracting investment, as investors will generally consider other factors that improve a country's investment climate as more important.

Despite insufficient evidence of their effectiveness, tax incentives are still an important part of the policy mix used by countries to increase their appeal to foreign investors.

Tax administrators as well as researchers often highlight the difficulty in measuring the effectiveness of tax incentives due to the absence of high quality firm-level datasets on investment in most countries. Sri Lanka is no different and this paper is also constrained by the same challenge. Estimating the costs vs. benefits of tax incentives is not easy and can be contentious, as widely acknowledged in the literature. Although this was one of the items specified in the mandate of the Presidential Commission on Taxation 2009, it is learned that the Final Report of the Commission has refrained from providing such a cost-benefit outlook. However, rough estimates suggest that, for 2010 the revenue foregone from tax incentives could amount to around Rs. 6.6 billion of GDP[1] or close to 0.9 per cent of tax revenue. This number is likely to be less from 2011 onwards following the substantial cuts in tax rates introduced in the 2011 Budget.

Some may argue that Sri Lanka had to grant generous incentives in the past because of the poor investment climate that existed on account of the armed conflict and now that the war is over we can do away with generous incentives. However, the security situation of a country is not the only factor that would impact an investor's decision to locate.

As this paper argues, other factors like the trade policy regime, openness to international markets, the investment policy regime, and institutional and governance set-up, are important as well.

It appears that Sri Lanka cannot completely do away tax incentives for FDI just yet. Not only because the country does have to try everything available in its arsenal to attract investment at this crucial stage, but also because competitor destinations are still offering a fair amount of tax incentives as well. However, many of these countries have begun moving away from blanket tax holidays towards more targeted incentives of the type that is advocated in this paper; like accelerated depreciation, investment tax relief, minimum investment thresholds, and renewable certificate schemes. For instance, Malaysia and Brazil are using investment tax relief for investment in higher technology sectors; Vietnam is using accelerated depreciation allowances for investment in 'difficult areas'; Brazil is introducing 'minimum investment thresholds' for investments in the IT sector; and Thailand is planning on introducing a 'certification scheme' to ensure better compliance.

Due to severe data limitations, this paper has not undertaken a comprehensive econometric analysis of the effectiveness of tax incentives in enhancing investment and promoting growth in Sri Lanka. Rather, it provides a critical overview of the use of tax incentives in incentivizing investment, reviews some of the available tools, and presents an agenda

[1] At constant (2002) prices.

for the way forward for the country. It draws extensively on international literature on the subject and aims to serve as a reference point for further research and policy analysis on this issue. The paper hopes to advance the knowledge that will help policy makers and administrators to develop, implement and monitor smarter tax incentives.

While this paper does acknowledge that tax incentives are not the only factor in determining the foreign investment attractiveness of the country, that tax incentives violate the equity principle of taxation, that the evidence supporting the effectiveness of tax incentives is contentious, and are a drain on the country's exchequer, it also acknowledges that Sri Lanka would need to maintain some form of tax incentives regime to remain competitive in attracting good quality FDI. The key argument of this paper is that this tax incentives regime must be designed, implemented, and monitored in a smarter and more cost-effective way so that the impact on revenue is minimized and economic policy objectives can be realized.

විධායක සාරාංශය

යුද්ධයෙන් පසුව වේගවත් හා තිරසාර වර්ධනයක් කරා ගමන් කරන ශ්‍රී ලංකාව ඉහළ මධ්‍යම පාන්තික අදායම් තත්ත්වය ලභාකර ගනිමින් සිටින බැවින් රට තුළට වඩා විශාල ආයෝජන නැතහොත් සෘජු විදේශ ආයෝජන ආකර්ෂණය කරගැනීමේ වැදගත්කම කැපී පෙනෙන ලෙස ඉදිරියටම පැමිණ ඇත. කලක් තිස්සේ ශ්‍රී ලංකාව තුළට අනවරතව විදේශ ආයෝජන ව්‍යාපෘති ගලා ඒම සිදුවන බව විද්‍යාමාන වී ඇතත් පවතින වාර්තා අනුව ඒවායේ බලපෑම සිත්ගන්නා සුළු මට්ටමට පහළින් වන බව නැගී එන වෙනත් ලෝක ආර්ථිකයන් හා සංසන්ධනය කිරීමේදි පෙනී යයි.

ශ්‍රී ලංකාව පසුගිය දශකය තුළදී ඇමෙරිකානු ඩොලර් මිලියන 500 ක(දළ දේශීය නිෂ්පාදනයෙන් 1.5% ක් පමණ) වටිනාකමින් යුතු වාර්ෂික සාමාන්‍ය විදේශීය සෘජු ආයෝජන ආකර්ෂණය කර ගන්නා විට නැගෙනහිර ආසියනු රටවල් විසින් ඇමරිකානු ඩොලර් බිලියන 5 ද (ආසන්න වශයෙන් දළ දේශීය නිෂ්පාදනයෙන් 5% ක් පමණ) ඉක්මවනු ලැබූ විදේශීය සෘජු ආයෝජන ආකර්ෂණය කරගෙන ඇත.

ශ්‍රී ලංකාවේ දල දේශීය නිෂ්පාදනයේ වර්ධනය ඉලක්කය 8% ක හෝ ඊට ඉහළින් පවත්වා ගැනීම සඳහා ආසන්න වශයෙන් දල දේශීය නිෂ්පාදනයෙන් 26% ක් පමණ වන එහි වත්මන් වාර්ෂික ආයෝජන ප්‍රමාණය අවම වශයෙන් 35% දක්වා ඉහළ නැංවීමට අවශ්‍යවේ. රාජ්‍ය අංශයේ උපරිම ආයෝජන මට්ටම දල දේශීය නිෂ්පාදනයෙන් 6% ක පමණ අගයකට සීමාවන තත්ත්වයක් යටතේ එම ඉහළ නැංවීම සම්පූර්ණයෙන්ම පාහේ පෞද්ගලික ආයෝජන මඟින් සිදුකළ යුතුව ඇත. එහිදී විදේශීය පෞද්ගලික ආයෝජන ඉතා වැදගත්වේ. විදේශීය සෘජු ආයෝජන රට තුළට ගලා ඒම දිරිමත් කිරීම සඳහා අනෙකුත් බොහෝ සංවර්ධනයවන රටවල් සේම ශ්‍රී ලංකාව ද නිර්ලෝභී බදු සහන කාලසීමාවන්, බදු මත පදනම්වූ දිරිගැන්වීම් සහ නිදහස්කිරීම් පිරිනමා ඇති අතර ඒවා අඛණ්ඩව පවත්වාගෙන යනු ලබයි. නමුදු බහුතර පිළිගැනීම වන්නේ එවැනි ක්‍රියාමාර්ග තුළින් රජයේ බදු ආදායම් පදනම සැලකිවයුතු ප්‍රමාණයකින් සෝදාපාළුවට ලක්වන බවයි.

මේ වන විට ශ්‍රී ලංකාව තුළ මූල්‍යමය පීඩනයන් ඉහළ යමින් ඇති අතර පුළුල් වෙමින් ඇති අයවැය පරතරය 6.2% මට්ටමකට පාලනය කිරීමට රජය උනන්දු වෙයි. වර්ෂ 1995 පෙර 19% ට ආසන්නවපැවති බදු සහ දළ දේශීය නිෂ්පාදනය අතර අනුපාතය මෑත වර්ෂයන් වන විට (2010-2011) 13%-15% දක්වා මට්ටමට අඩුවෙමින් ඇත. එම තත්ත්වය මධ්‍ය අදායම් සහිත රටක එම අනුපාතයේ පාදක මිණුම් ලක්ෂ්‍ය වන 25% මට්ටමට වඩා බොහෝ සෙයින් අඩු අගයකි.මේ අතර රටතුළ පවතින නව පහළ මධ්‍යම අදායම් මට්ටම හේතුවෙන් සහනදායි විදේශ අධාර ලැබීමද ඉතා වේගයෙන් අඩුවෙමින් ඇත. එහි අරුත වනුයේ ශ්‍රී ලංකාවේ සංවර්ධන සඳහා මූල්‍ය සම්පාදනයේදී බදු ආදායම වැනි දේශීය අදායම් යොදා ගැනීම වැඩි කිරීම අවශ්‍ය වන බවයි.ඒ සඳහා වන උත්සාහයේදී ඉතා වැදගත් සාධකයන් වන්නේ බදු නිදහස්කිරීම් සහ බදු

සහන කාලසීමාවන් හේතුවෙන් සිදුවන ආදායම් අහිමිවීම් අවම කරනු ලැබීම සහ ප්‍රධානය කරනු ලබන බදු සහන ඵලදායීව අපේක්ෂිත අරමුණු ලඟාකර ගන්නා බවට වග බලා ගැනීමත් වඩා හොඳ විදේශ ආයෝජන වැඩි වැඩියෙන් ආකර්ශනය කර ගැනීමත්ය.

කෙසේ වුවද මෙම පශ්චාත් යුද සමය තුළ ජාත්‍යන්තර මට්ටමේ විදේශීය ව්‍යාපාර ආකර්ශනය කර ගැනීමේ අවස්ථාව ශ්‍රී ලංකාව දිනා ගෙන ඇති අතර විදේශීය ඍජු ආයෝජන සිදුකිරීමට සුදුසු ස්ථානයක් ලෙස ශ්‍රී ලංකාව ලබා ඇති එම ආකර්ශනීය තත්ත්වය තවදුරටත් පවත්වා ගැනීම සිදුකළ යුතුව ඇත.

වේගවත් වර්ධනයක් ඇති කිරීම සඳහා අවශ්‍ය ඉහළ ආයෝජනය මට්ටමක් පවත්වා ගැනීමටත් ශ්‍රී ලංකාව ගෝලීය ආර්ථිකය සමඟ තවදුරටත් ඒකාබද්ධ වීමටත් සහ රට වැසියන්ගේ ජීවන මට්ටම ඉහල දැමීමට හේතුවන පරිදි තව තවත් හොඳ රැකියා අවස්ථාවන් ලබා දීමටත් එය ඉතාම වැදගත් වෙයි.ශ්‍රී ලංකාව නිරන්තරයෙන්ම දකුණු සහ ගිණිකොණදිග ආසියානු කලාපයන්හි ඇති විශේෂයෙන් මැලේසියාව, තායිලන්තය සහ ඉන්දුනීසියාව මෙන්ම වැඩිවශයෙන්ම වියට්නාමය, කාම්බෝජය සහ ලාඕසය වැනි අනෙකුත් විදේශීය ඍජු ආයෝජන සිදුකරනු ලබන රටවල් සමඟ තරඟ කරමින් සිටියි.

ඒ අනුව,රට මුහුණ දෙමින් සිටින ප්‍රධානතම මධ්‍යකාලීන අභියෝගය වනුයේ විදේශීය ඍජු ආයෝජන ආකර්ශනය කර ගැනීම පිණිස තරඟකාරී බදු දිරිගැන්වීම් ලබාදීම සහ දේශීය ආදායම සුරක්ෂිත කිරීම සඳහා බදු සමාවන් අවම මට්ටමක පවත්වායෙන යෑම යන කරුණු දෙක සමබරතාවයෙන් යුතුව පවත්වා ගැනීමයි.

විදේශීය ඍජු ආයෝජන ආකර්ෂණය කර ගැනීමේදී ලබා දෙන බදු දිරිගැන්වීම් වල සඵලතාවය බදු පිළිබඳ වෘත්තිකයින්, භාණ්ඩාගාර නිලධාරීන් සහ අයෝජන ප්‍රවර්ධන නිලධාරීන් අතර පුළුල්ලෙස විවාදයට ලක්වී ඇත.සමහර බදු විශේෂඥයින් තර්ක කරනුයේ අයෝජකයින් විසින් සමානොයයෙන් වඩා වැදගත්කොට සළකා බලන්නේ රටතුළ ආයෝජනය සඳහා සුදුසු පරිසරයක් වැඩි දියුණුකිරීමට හේතුවන වෙනත් සාධක පිළිබඳව බැවින් ආයෝජන ආකර්ෂණය කර ගැනීමේදී බදු දිරිගැන්වීම ලබාදීම් අවශ්‍ය නොවන බවයි. එම දිරිගැන්වීම්වල සඵලතාව පිළිබඳව ප්‍රමාණවත් සාක්ෂි නොමැති තත්ත්වයක් තිබියදීත් විදේශ ආයෝජකයන් වැඩි වැඩියෙන් ආකර්ෂණය කර ගැනීම සඳහා කටයුතු කරන රටවල් විසින් භාවිතා කරනු ලබන ප්‍රතිපත්ති සංකලනයන් එවැනි දිරි ගැන්වීම් ඉතා වැදගත් අංගයක් ලෙස තවමත් පවතී. බොහෝ රටවල ආයෝජන සම්බන්ධයෙන් උසස් ගුණාත්මයෙන් යුතු තිරසර දත්ත එකතුවක් නොමැතිකම නිසා බදු දිරිගැන්වීම්වල සඵලතාවය මැනබැලීම දුෂ්කරවී ඇති බව බදු පරිපාලකයින් මෙන්ම පර්යේෂකයින් විසින් නිතර හුවා දක්වනු ලබයි.ශ්‍රී ලංකාව තුළද එම තත්ත්වයෙහි වෙනසක් නොමැති අතර එම අභියෝගය හේතුවෙන් මෙම පර්යේෂණ ලිපියද යම් සීමාවන්ට නතුවී ඇත. ශාස්ත්‍රීය ග්‍රන්ථයන්හි පැහැදිලිව සඳහන් වන පරිදි බදු දිරිගැන්වීම්වල පිරිවැයට එරෙහිව ප්‍රතිලාභ ඇස්තමේන්තු කිරීම පහසු කාර්යයක් නොවන අතර එය අඛන්ඩ ක්‍රියාවලියක් විය හැක.

එය 2009 බදුකරණය පිළිබඳ ජනාධිපති කොමිසමේ විශේෂයෙන් දක්වා තිබූ විධි නියමයන් අතරින් එකක් ලෙස එම ඇස්තමේන්තුගත කිරීම් දක්වා තිබුනද එම කොමිසමේ අවසන් වාර්තාව මඟින් එවැනි පිරිවැය සහ ප්‍රතිලාභ සොයා බැලීමක් සම්පාදනය කිරීම පිළිබඳව කිසිවක් සඳහන් කිරීමෙන් වැළකී ඇති බව පෙනී යයි. කෙසේ වෙතත් ඊට අදාළ දල ඇස්තමේන්තු මඟින් යෝජනා කරනුයේ කලින් සඳහන් කළ බදු දිරිගැන්වීම් ලබා දීම නිසා 2010 වර්ෂයේදී ලැබූ අදායම දල ජාතික නිෂ්පාදනයෙන් රුපියල් බිලියන 6.6 පමණ වන බව හෝ ආසන්න වශයෙන් බදු ආදායමෙන් 0.9% පමණ අගයක් ගන්නා බවකි. 2011 අයවැය මඟින් හඳුන්වා දුන් සැළකිවයුතු මට්ටමේ බදු අනුපාතික කපා හැරීම්වලට අනුගාමීව ඉහත අගයන් 2011 වර්ෂයේ සිට ඉදිරියට අඩුවී යෑමේ ප්‍රවනතාවක් පෙන්නුම් කරනු ලබයි. තවත් පාර්ශ්වයකගේ තර්කය වනුයේ සන්නද්ධ ගැටුම හේතුවෙන් ආයෝජනය සඳහා පැවති අයහපත් වාතාවරණය නිසා පසුගිය කාලයේදී ශ්‍රී ලංකාවට නිර්ලෝභී බදු දිරිගැන්වීම් ප්‍රධානය කිරීමට සිදුවූවත් අද වන විට යුද්ධය අවසන්ව ඇති බැවින් එවැනි බදු සහන ලබා නොදීම කළ හැකිය යන්නයි. කෙසේ වෙතත් ආයෝජකයෙකුගේ පැමිණීමේ තීරණයට බලපා හැකි එකම සාධකය රටක පවතින ආරක්ෂක තත්ත්වය නොවන බව සඳහන් කළ යුතුය.

මෙම පර්යේෂණ ලිපිය මඟින් වෙළඳ ප්‍රතිපත්ති පද්ධතිය, ජාත්‍යාන්තර වෙළඳපොළට ඇති විවෘතභාවය, ආයෝජන ප්‍රතිපත්තීන්, ආයතනික සහ පාලන ව්‍යුහය වැනි අනෙකුත් සාධකයන්ද වැදගත්වන බවට තර්ක කරනු ලබයි.

ඍජු විදේශ ආයෝජන සඳහා බදු දිරිගැන්වීම් ලබාදීම සම්පූර්ණයෙන්ම නවතාලීමට හැකියාවත් මෙතෙක් ශ්‍රී ලංකාවට නොමැති බව පෙනී යයි.ඊට හේතු වන්නේ මෙම තීරණාත්මක අවධියේදී ආයෝජකයින් ආකර්ශණය කර ගැනීම සඳහා භාවිතා කළ හැකි සියළුම ආකාරයේ උපක්‍රමික අවි අත්හදා බැලීමට මෙරටට සිදුවන නිසා පමණක් නොව අනෙකුත් තරඟකාරී ආයෝජන අන්තයන් අයත් රටවල් තවමත් ප්‍රමාණවත් තරම් බදු සහන ආයෝජකයන්ට ලබාදීම හේතුවෙනි. කෙසේ වෙතත් එවැනි රටවල් බොහෝමක් මේ වන විට සියළු පැතිකඩයන් ආවරණය වන පොදු බදු විරාමයන් ලබාදීමෙන් ව්‍යුයුක්තව මෙම පර්යේෂණ පත්‍රිකාව මඟින් ධනාත්මකව සාකච්ඡා කරනු ලබන කඩිනම් ක්ෂයවීම් ගණනය කිරීම, ආයෝජන බදු සහන, අවම ආයෝජන ප්‍රවේෂ සීමාවන් හඳුන්වාදීම සහ පුනර්ජනනීය සහතිකපත් පිරිනැමීම වැනි වඩාත් ඉලක්කගත ආයෝජන දිරිමත් කිරීමේ මෙවලම් දෙසට යොමුවීම අරඹා ඇත.උදාහරණ ලෙස බ්‍රසීලය සහ මලයාසියාව උසස් තාක්ෂණය භාවිතා වන අංශයන්හි ආයෝජන සඳහා ලබා දෙමින් සිටින බදු සහන; දුෂ්කර ප්‍රදේශවල සිදුකරන ආයෝජන සඳහා වියට්නාමය භාවිතා කරමින් සිටින කඩිනම් ක්ෂයවිමේ දීමනා;තොරතුරු තාක්ෂණ අංශයේ ආයෝජන සඳහා බ්‍රසීලය හඳුන්වා දෙමින් ඇති අවම ආයෝජන ප්‍රවේෂ සීමාවන් සහ තායිලන්තය විසින් හඳුන්වාදීමට සැළසුම්කරමින් සිටින වඩා හොඳ අනුකූලතාවක් සුරක්ෂිත කිරීම සඳහා වන සහතිකපත් පිරිනැමීමේ වැඩසටහන දැක්විය හැක.

දත්ත සපයාගැනීම සඳහා ඇති දැඩි සීමාවන් හේතුවෙන් ආයෝජන ඉහළ නැංවීමේදී සහ ශ්‍රී ලංකාවේ වර්ධනය ඉහල නැංවීමේදී බදු දිරිමත්කිරීම්වල සඵලතාවය විස්තරාත්මක ආර්ථිකමිතික විශ්ලේෂණයකට භාජනය කිරීම මෙම පර්යේෂණ පත්‍රිකාව මඟින් සිදු කොට නොමැත. මෙමඟින් වෙසෙසින් සිදුකර ඇත්තේ ආයෝජන දිරිමත් කිරීම සඳහා බදු දිරිදීමනා භාවිතා කිරීම පිළිබඳ විවේච-නාත්මක දළ විශ්ලේණයක් ඉදිරිපත් කිරීම, දැනට භාවිත කරනු ලබන සමහර මෙවලම් විමර්ශනය කිරීම සහ රටේ ඉදිරි ගමන සඳහා න්‍යාය පත්‍රයක් ඉදිරිපත් ඉදිරිපත් කිරීමයි. මෙම පර්යේෂණ පත්‍රිකාව සැකසීමේදී බොහෝ සෙයින් මෙම විෂයට අදාළ ජාත්‍යාන්තර පොත පතහි වන තොරතුරු යොදා ගත් අතර මෙම ලේඛනය මඟින් සාකච්ඡ කරනු ලබන ගැටළුව සම්බන්ධයෙන් සිදු කරනු ලබන වැඩිදුර පර්යේෂණවලදී සහ ප්‍රතිපත්ති විශ්ලේෂණයේදී සමුද්දේශ ලක්ෂ්‍යක් ලෙස යොදා ගැනීමේ ඉලක්කය ඇතිව මෙම පර්යේෂණ පත්‍රිකාව සැකසිනි. මෙම පර්යේෂණ පත්‍රිකාවේ අපේක්ෂාව වන්නේ වඩාත් සිත්ගන්නාසුළු බදු දිරිගැන්වීම් සැකසීම, ක්‍රියාත්මක කිරීම සහ සුපරික්ෂාකාරී නිරීක්ෂණය සඳහා ප්‍රතිපත්ති සම්පාදකයින්ට සහ පරිපාලකයින්ට උපකාරී වන දැනුම ඉහළ නැංවීමයි.

යම් රටක් වෙත විදේශ ආයෝජන ආකර්ෂණය කර ගැනීම තීරණය කරනු ලබන එකම සාධකය බදු දිරිමත් කිරීම් නොවන බව මෙම පර්යේෂණ ලිපිය සඳහන් කරන අතර බදු දිරිමත් කිරීම් බදුකරණයේ සාධාරණතා මූල ධර්මයන් උල්ලංඝනය කරන බවත්, ලබා දෙන බදු දිරිමත්කිරීම්වල සඵලතාවයක් ඇති බව පෙන්වීමට උපකාරි වන සාක්ෂි විවාදාත්මක බවත්, සහ එම දිරිගැන්වීම් භාණ්ඩාගාරය ක්‍රමයෙන් හිස් කරන බවත් පෙන්වා දෙයි. තවද එමඟින් ඉහළ ගුණාත්මයෙන් යුතු විදේශ ඍජු ආයෝජන ආකර්ෂණය කර ගැනීමේ තරඟකාරි තත්ත්වයේ රඳා සිටීමට ශ්‍රී ලංකාව විසින් යම් ආකරයේ බදු දිරිගැන්වීම් ක්‍රමවේදයක් පවත්වා ගත යුතු බවද සඳහන් කරයි. නමුත් මෙම පර්යේෂණ ලිපියේ ප්‍රධානතම තර්කය වනුයේ බදු දිරිගැන්වීමේ ක්‍රමවේදය සැළසුම් කිරීම, ක්‍රියාත්මක කිරීම සහ පාලනය කිරීම රාජ්‍ය අදායම් මත අවම බලපෑමක් ඇතිකරනු ලබන ආකාරයට සහ ආර්ථික ප්‍රතිපත්තිමය අරමුණු අත්පත් කර ගත හැකි වන පරිදි වඩාත් සිත්ගන්නාසුළු සහ පිරිවැය සඵලදායි ආකාරයට සිදු කිරීම අනිවාර්යය බවයි.

நிறைவேற்றுச் சுருக்கம்

யுத்தம் நிறைவடைந்ததைத் தொடர்ந்து இலங்கையானது நிலையான பொருளாதார வளர்ச்சியை முன்னெடுத்து மேல் நிலை வருமான மட்டத்தை அடைந்துள்ளதுடன் இதன் பயனாக வெளிநாட்டு நேரடி முதலீடுகளை (குனுஐ) பாரிய அளவில் கவர்ந்து கொள்வதில் முன்னணியும் வகிக்கின்றமை முக்கிய விடயமாகும். இருந்த போதும், இலங்கையானது நிலையானதும் உறுதியானதுமான வெளிநாட்டு முதலீட்டுச் செயற்திட்டங்களை நாட்டிற்குப் பெற்றுக் கொள்வதற்கான இயலுமையினை அண்மைக் காலமாகப் பெற்றுள்ளதுடன் ஏனைய முன்னேற்றம் அடைந்து வரும் நாடுகளுடன் ஒப்பீடு செய்கின்ற போது இலங்கையின் தரவுகளானது அதன் முன்னேற்றதிலும் பார்க்க குறைவாகவே காணப்படுகின்றன.

இலங்கையானது கடந்த சதாப்த்தின் போது வெளிநாட்டு நேரடி முதலீடாக வருடாந்தச் சராசரியாக 500 மில்லியன் ஐ.அ.டொ தொகையினை வருடாந்தம் கவர்ந்துள்ளது. (மொ.உ.உ சுமார் 1.5 சதவீதம்) அதே வேளை, கிழக்காசிய நாடுகளானது, அண்ணளவாக, வருடாந்தம் ஐ.அ.டொ. 5 பில்லியன்களை நேரடி வெளிநாட்டு முதலீடுகளாக கவர்ந்துள்ளன.- (மொ.உ. உ. 5 சதவீதம்)

மொ.உ.உ வளர்ச்சி இலக்கான 8 சதவீதம் அல்லது அதிலும் அதிகமாக எல்லையை அடைய வேண்டுமாயின், இலங்கையானது தனது தற்பொழுதைய வருடாந்த முதலீட்டு வீதமான மொ.உ.உ 26 மூ சதவீதத்திலிருந்து ஆகக் குறைந்தது 35 மூ சதவீதமாக அதிகரித்தல் வேண்டும். மொ.உ.உ இன் சுமார் 6 சதவீதம் வரை அரச முதலீடுகளை உச்சப்படுத்திக் கொள்ளும் நோக்கில் அதனை முழுமையாக தனியார் முதலீடுகளின் ஊடாக அதிகரித்தல் வேண்டும். இந்த வரையறைக்குள் வெளிநாட்டு தனியார் முதலீடுகள் மிக முக்கியமான பாத்திரத்தை வகிக்கின்றன.

அனேகமான அபிவிருத்தியடைந்து வரும் நாடுகளைப் போன்று நேரடி வெளிநாட்டு முதலீட்டுகளை ஊக்கப்படுத்தும் பொருட்டு இலங்கையானது நியாயமான வரி விடுகைக் காலம் மற்றும் ஏனைய வரியுடன் தொடர்புடைய ஊக்கப்படுத்தல்கள் மற்றும் வரிவிடுதெ-ாகைகளை வழங்கியுள்ளதுடன் தொடர்ந்து வழங்கியும் வருகின்றது. ஆனால், இந்த முறைமைகள் பரந்த அளவில் ஏற்றுக் கொள்ளபட்ட போதும் நாட்டின் வரி வருமானத்தை கனிசமான அளவு விழுங்கியும் விடுகின்றன.

அரசிறை அழுத்தங்களானது தற்பொழுது இலங்கையில் அதிகரித்து வருகின்றன - அரசாங்கமானது வரவு செலவுத்திட்டப் பற்றாக்குறை விரிவடைவதனை கட்டுப்படுத்துவதில் மிக கவனமாகச் செயற்படுவதுடன் அதனை 6.2 மூ சதவீதமாக பேணி வருகின்றது. மொ.உ.உ இன் சதவீதமாக வரி வருமானமானவு 1995 ஆம் ஆண்டுக்கு முன்னர் காணப்பட்ட 19 மூ சதவீதத்திலிருந்து அண்மை ஆண்டுகளில் (2010 - 2011) 13 - 15 மூ சதவீதமாக வீழ்ச்சியடைந்துள்ளது. அதே வேளை, நாட்டின் புதிய கீழ் நடுத்தர வருமான பொருளாதார நிலைமையின் காரணமாக சலுகை அடிப்படையிலான வெளிநாட்டு உதவிகள் தொடர்ச்சியாகவும் நிலையாகவும் குறைந்து கொண்டு வருகின்றன. இதன் மூலம் வெளிப்படுவது, இலங்கையின் அபிவிருத்தித் தேவைகளுக்கான நிதியளிப்புக்களுக்கு உள்நாட்டு வருமானங்களை நாட வேண்டிய தேவை காணப்படுகின்றது. அதாவது வரி வருமானத்தை அதிகரிக்க வேண்டிய தேவை காணப்படுகின்றது. வரி விடுதொகை மற்றும் வரி விடு முறைகளை வழங்குதல் போன்ற விடயங்களினால் அரச வருமானக் குறைவு ஏற்படுகின்றமை உறுதிப்படுத்தப்பட்டுள்ளமை ஒரு முக்கியமான விடயமாக இருப்பதுடன் இவ்வாறு வழங்கப்படும் சலுகைகள் அரசாங்கத்தின் எதிர்பார்த்த இலக்குகளான வெளிநாட்டு முதலீடுகளை மிகச் சிறப்பாகவும் கவர்ச்சிகரமாகவும் அடைந்து கொள்வதற்கு துணை புரிந்துள்ளன.

எவ்வாறாயினும், இந்த யுத்தத்தின் பின்னரான கட்டத்தில், உலக தரத்திலான வெளிநாட்டு தொழில்முயற்சிகளை கவர்ந்து கொள்வதற்கு புதியதொரு வாய்ப்பினை இலங்கை வெற்றி கொண்டுள்ளதுடன் இந்த வெளிநாட்டு நேரடி முதலீட்டு தளமாக இலங்கையின் கவர்ச்சித் தன்மையினை தொடர்ந்து பேணிக் கொள்ள வேண்டிய தேவை காணப்படுகின்றது. இலங்கை மக்களுக்கு அதிகமான மற்றும் சிறந்த தொழில் வாய்ப்புக்களை வழங்குவதற்கும், பூகோள பொருளாதாரத்துடன் ஒருங்கிணைந்து இலங்கைக்கு உதவி புரியும் பொருட்டு உயர் பொருளாதார வளர்ச்சியை உருவாக்குவதற்கு, உயர் முதலீட்டு வீதத்தைப் பேணும் பொருட்டும் இந்த செயற்பாடுகள் மிக முக்கியமாகும். அதன் ஊடாக இலங்கை மக்களின் வாழ்வாதார நிலைமைகளை உயர்வடையச் செய்ய முடியும். இலங்கையானது ஏனைய வெளிநாட்டு நேரடி முதலீட்டு நாடுகளான தென் மற்றும் தென் கிழக்கு ஆசிய பிராந்தியம், விசேடமாக மலேசியா, தாய்லாந்து, இந்தோனேசியா மற்றும் வியட்நாம், கம்போடியா, மியன்மார் மற்றும் லாஓ பிடிஆர் (டுயழ ீனுசு) நாடுகளுடன் தொடர்ச்சியாக போட்டியிடுகின்றது

ஆகவே, வெளிநாட்டு நேரடி முதலீடுகளை கவரும் முகமாக போட்டித் தன்மையான வரிச் சலுகைகளை வழங்கல் மற்றும் உள்நாட்டு வருமானத்தை பாதுகாத்துக் கொள்ளும் பொருட்டு ஆகக் குறைந்த வரி வருமானத்தைப் பேணல் ஆகிய இந்த இரண்டு விடயங்களுக்கிடையில் ஒரு சமநிலையான தன்மையினைப் பேணுவது தொடர்பான முக்கியமான நடுத்தர கால சாவாலினை எமது நாடு முகங்கொடுத்து வருகின்றது.

வரி மதிப்பீட்டாளர்கள், திறைசேரி அலுவலர்கள் மற்றும் முதலீட்டு மேம்பாட்டு அலுவலர்கள் மத்தியில் வெளிநாட்டு நேரடி முதலீட்டை கவர்ந்து கொள்வதில் வரி ஊக்குவிப்புக்களின் வினைத்திறன் பற்றி பரந்த அளவில் விவாதிக்கப்பட்டுள்ளன. முதலீடுகளை கவர்வதற்காக வரிச் சலுகைகளை வழங்குவது தேவையற்றது மாறாக முதலீட்டு நிலைமையை மேம்படுத்துகின்ற சூழ்நிலைகள் மிக முக்கியமானது என முதலீட்டாளர்கள் பொதுவாக கருதுவதாக சில வரி வல்லுனர்கள் விவாதிக்கின்றார்கள்.

அவர்களுடைய வாதத்தில் வினைத்திறனின்மை தொடர்பாக நிறுபிப்பதற்கு போதியளவான சான்றுகள் இல்லாத சந்தர்பத்தில், வெளிநாட்டு முதலீட்டாளர்களுக்கு அவர்களுடைய கோரிக்கைகளை அதிகரித்துக் கொள்ளும் பொருட்டு நாடுகளினால் பரவலாக பயன்படுத்துகின்ற மிக முக்கியமானதொரு கொள்கை ரீதியான கருவியாக தற்பொழுதும் வரிச் சலுகைகள் காணப்படுகின்றன.

அனேகமான நாடுகளில் முதலீடு தொடர்பான உயர் தர நிறுவனங்கள் மட்டத்திலான தரவுத் தொகுதியொன்று இல்லாத காரணத்தினால் வரிச் சலுகைகளின் வினைத்திறன்களை அளவீடு செய்வதில் உள்ள சிக்கல்களை அடிக்கடி வரி நிருவகிக்ப்பாளர்கள் மற்றும் ஆய்வாளர்கள் வெளிப்படுத்தியுள்ளார்கள். இலங்கை இவற்றிலிருந்து மாறுபட்டதன்று. அத்தோடு இந்தக் கட்டுறையும் அதே சவால்களினால் தடைப்பட்டுள்ளது. வரிச் சலுகைகளின் கிரயம் மற்றும் அதன் மூலம் கிடைக்கின்ற நன்மைகளை மதிப்பீடு செய்வது இலகுவன்று மாறாக அவை, விவாதத்திற்கு உட்பட்டதுடன் இந்த ஆய்வுக் கட்டுறையில் விரிவாக அங்கிகரிக்கப்பட்டுள்ளது. அதேவேளை, 2009 ஆண்டில் வரிவிதிப்பு தொடர்பான சனாதிபதி ஆணைக்குழுவின் பிரகடணத்தில் குறிப்பிடப்பட்டுள்ள ஒரு விடயமாக இது காணப்படுகின்றது. அத்தோடு இந்த ஆணைக்குழுவின் இறுதி அறிக்கையில் கிரய நன்மை தொடர்பான கண்ணோட்-டமொன்றை வழங்குவதிலிருந்து இவ் ஆணைக்குழு தவிர்ந்து செயற்பட்-டுள்ளமை நன்கு புலப்பட்டுள்ள விடயமாகும். எனினும், 2010 ஆம் ஆண்டுக்கான வரிச் சலுகைகளின் காரணமாக வருமானமானது மொ.உ.உ இன் 6.6 பில்லியன்களாக அல்லது வரி வருமானத்தின் 0.9 மூ சதவீதத்திற்கு அண்மித்ததாக இருக்க கூடும் என மேலெழுந்தவாறான மதிப்பீடுகள் கருதுகின்றன. 2011 ஆம் ஆண்டு வரவு செலவுத் திட்டத்தில் அறிமுகம் செய்த வரி வீதங்களின் கனிசமான

குறைப்பினைத் தொடர்ந்து 2011 ஆம் ஆண்டு தொடக்கம் இந்தத் தொகையானது குறைவாகக் காணப்படுகின்றன.

யுத்தம் நடைபெற்ற காலங்களில் மிக மோசமான முதலீட்டு நிலைமை காணப்பட்டமையின் காரணமாக கடந்த காலத்தில் சலுகை அடிப்படையிலான முதலீட்டு ஊக்குவிப்புக்களை வழங்க வேண்டிய கட்டாயம் இலங்கைக்கு ஏற்பட்டது என சிலர் விவாதிக்கலாம். மாறாக தற்பொழுது யுத்தம் முடிவடைந்துள்ளது, நாங்கள் சலுகை அடிப்படையிலான ஊக்கப்படுத்தல்களிலிருந்து விலகி செயற்பட முடியும். எவ்வாறாயினும், முதலீட்டாளர்கள் முதலீடுகளை மேற்கொள்வதற்கு செல்வாக்குச் செலுத்துகின்ற ஒரே காரணியாக நாட்டின் பாதுகாப்புச் சூழல் மாத்திரம் காணப்படுவதில்லை.

ஏனைய காரணிகள் அதாவது வர்த்தகக் கொள்கை கட்டுப்பாட்டு முறைமை, சர்வதேச சந்தைகளுக்கு நுழைவதற்கான சுதந்திரம், முதலீட்டுச் சூழல் கட்டுப்பாடுகள், மற்றும் நிறுவன மற்றும் நல்லாட்சி அமைப்புக்கள் போன்றனவும் மிக முக்கியமானவை என இந்தக் கட்டுறையானது விவாதிக்கின்றது.

வெளிநாட்டு நேரடி முதலீடுகளை பெற்றுக் கொள்வதற்காக வரிச் சலுகைகளை வழங்குவதிலிருந்து இலங்கையானது முழுமையாக விலகிச் செயற்படவில்லை என்பது இதன் ஊடாக தெளிவாகின்றது. இந்த முக்கியமான கட்டத்தில், வெளிநாட்டு நேரடி முதலீடுகளை கவர்வதற்கு காணப்படுகின்ற சகல உபாயங்களையும் தற்பொழுது இலங்கை முன்னெடுத்து வருகின்றது. ஆனால், போட்டி நாடுகள் தற்பொழுதும் கூட நியாயமான அளவு வரிச் சலுகைகளை வழங்கி வருகின்றமை கண் கூடு. எனினும், அனேகமான நாடுகள் தற்பொழுது கண் மூடித்தனமான வரிச் சலுகைகளை வழங்குவதிலிருந்து விடுபடுவதற்கு ஆரம்பித்துள்ளதுடன் இந்த ஆய்வுக் கட்டுறையில் கூறப்பட்ட மிக முக்கிய கருவிகள் தொடர்பாக இலக்கு வைத்துள்ளன. முதலீட்டு வரி விடுவிப்புக்கள், குறைந்த முதலீட்டு வரையறைகள் மற்றும் புதுப்பிக்கத்தகு சான்றிதழ் திட்டங்கள் போன்ற அதிகரிக்கப்பட்ட பொறுமானத் தேய்வு. போன்ற ஏனைய முறைமைகளை பின்வரும் நாடுகள் முன்னெடுக்கின்றன. அவையாவன: உதாரணமாக, உயர் தொழில்நுட்பத் துறைகளில் முதலீடு செய்வதற்கான முதலீட்டு வரிச் சலுகைகளை மலேசியா மற்றும் பிரேசில் பயன்படுத்துகின்றன. "கடினமான விடயப் பரப்புக்களில்" முதலீடு செய்வதற்காக அதிகரிக்கப்பட்ட பெறுமானத் தேய்வு கொடுப்பனவுகளை வியட்னாம் பயன்படுத்து-கின்றது: தகவல் தொழில்நுட்பத் துறையில் முதலீடு செய்வதற்காக" குறைந்த அளவான முதலீட்டு கட்டுப்பாடுகளை" பிரேசில் அறிமுகம் செய்கின்றது மற்றும் சிறந்த உறுதிப்பாட்டை உறுதிப்படுத்துவதற்கு சான்றுப்படுத்தல் திட்டமொன்றை அறிமுகம் செய்வதற்கு தாய்லாந்து திட்டமிட்டுக் கொண்டிருக்கின்றது.

மிக மோசமான தரவு வரையறைகளின் காரணமாக, இலங்கையில் முதலீட்டினை மேம்படுத்தல் மற்றும் வளர்ச்சியை அதிகரித்தல் தொடர்பில் வரிச் சலுகைகளின் வினைத்திறன் பற்றிய முழுமையானதொரு பொருளாதார ரீதியான ஆய்வொன்றை இந்த ஆய்வுக் கட்டுறை மேற்கொள்ளவில்லை. மாறாக, முதலீட்டு மேம்படுத்தலில் வரிச் சலுகைகளின் பயன்பாடு, நடைமுறையில் காணப்படும் கருவிகளின் மீளாய்வு, மற்றும் நாட்டுக்கான முன்னோக்கிய செயற்பாட்டிற்காக ஒரு நிகழ்ச்சி நிரலைக் கையளித்தல் தொடர்பான முக்கியமானதொரு மீளாய்வினையே இக் கட்டுறை வழங்குகின்றது. இந்தப் பிரச்சினை தொடர்பான மேலதிக ஆய்வு மற்றும் கொள்கை பகுப்பாய்வுக்கான ஒரு ஆய்வு உசாவுகை நோக்காகவும் அதன் குறிக்கோள்கள் தொடர்பில் சர்வதேச ஆய்வுக் கட்டுறையொன்று தொடர்பாக ஆழமான கவனம் செலுத்தப்படுகின்றது.

ஒரு நாட்டின் வெளிநாட்டு முதலீட்டை கவர்ந்திழுக்கின்ற தீர்க்கமாதொரு காரணியாக வரிச் சலுகைகளை இந்த ஆய்வுக் கட்டுறை ஏற்றுக் கொள்ளாததுடன், இந்த வரிச் சலுகைகளானது வரிவிதிப்பு தொடர்பான சமத்துவ கோட்பாடுகளை மீறுகின்றன என்பது ஒரு விடயமாகும், வினைத்திறனான வரிச் சலுகைகளுக்கு ஒத்துழைப்பு வழங்குகின்ற

சான்றுகள் விவாதத்திற்கு உட்படுத்தக் கூடியதும், மற்றும் இவை நாட்டின் வருமானத்தை குறைக்கின்ற கருவியாகவும் மற்றும் வெளிநாட்டு நேரடி முதலீடுகளை சிறந்த தரத்துடன் கவர்ந்து கொள்வதில் போட்டியாளர்களுடன் தொடர்ந்தும் சந்தையில் இருப்பதற்கு சில சிறந்த வரிச் சலுகை முறைகளை பேணுவதற்கான தேவையினை இலங்கை மேற்கொள்ள வேண்டியுள்ளது. இருந்த போதும். இந்த ஆய்வுக் கட்டுறையின் பிரதான விவாதமாக இருப்பது யாதெனில், இந்த வரிச் சலுகைகள் கவர்ச்சிகரமாகவும் கிரயச் சிக்கனமாகவும் அமையும் விதத்தில் வடிவமைக்கப்பட்டு, அமுல்படுத்தப்பட்டு மேற்பார்வை செய்யப்படுதல் வேண்டும். அதன் ஊடாக வருமானம் தொடர்பான பாதக தாக்கங்கள் இழிவுபடுத்தப்படுவதுடன் பொருளாதாரக் குறிக்கோள்களையும் அடைந்து கொள்ள முடியும்.

1. Introduction

Foreign Direct Investment (FDI) has been viewed over the past three decades as a major stimulus to achieving economic growth and development particularly amongst developing countries. In addition to the injection of much need financial resources, FDI has the potential to contribute indirectly to economic growth of a host country through an array of 'spill-over' effects on domestic enterprises. Inward FDI is viewed as a channel through which new technology, marketing and managerial skills and practices, are diffused to domestic firms thus leading to productivity improvements in the overall context of the host economy. FDI is also viewed to play a central role in linking the host economy to the global production networks exports given that affiliates of Multinational Enterprises have marketing channels in place, possess experience and expertise in many complex facets of product development and international marketing, and as such are well placed to take advantage of inter-country differences in the costs of production (Athukorala, 2006).

In light of the increased recognition of the developmental impact of FDI in a host country, the attraction of FDI has formed the cornerstone of national development policy in many developing countries the world over. With countries increasingly vying to attract FDI, the use of fiscal incentives to lure MNEs has become an instrument of choice and has by now become a global phenomenon (Morisse & Pirnia n.d). In developed countries, the most common types of fiscal incentives used are investment tax credits, accelerated depreciation, and favourable tax treatment for expenditure on research and development (R&D). Many transition and developing countries often focus particularly on attracting foreign investment, promoting domestic industries (both export-oriented as well as import-substituting), with tools like tax holidays, regional investment incentives, special economic zones, and reinvestment incentives. Conventional wisdom, however on the effectiveness of fiscal incentives, particularly those offered to attract Foreign Direct Investment (FDI), is that they are unsuitable both in theory and practice - in theory because they distort investment decisions, and in practice as they are often ineffective, inefficient, and prone to abuse and corruption.[1] Yet, almost all countries do deploy tax incentives as a part of their investment attraction package.

Sri Lanka is not unique in offering tax incentives for investment - they are commonly used worldwide and are constantly evolving.

As Klemm (2009) argues, one of the forces shaping tax policy in many countries is the need to maintain a competitive tax system in an increasingly globalized economy. Tax competition, therefore, has become a norm. Tax competition refers to a process in which countries attempt to attract capital or taxable profits by reducing taxes on capital.[2] Countries may also follow more complex strategies and attempt to attract an industry so as to establish a future locational advantage, similar as in the new trade theory.

Sri Lanka's use of fiscal incentives to entice FDI could be traced back to 1960s during the heights of the import substitution industrialization era. From 1963 onwards, some tax holidays were offered in the areas of "pioneering industries", export enterprises and tourism. These were granted under the Inland Revenue Act and administered by the Ministry of Finance and the IRD. Associated with the shift in industrial policy

[1] Easson and Zolt (2002).

[2] See literature surveys by Wilson (1999) and Fuest, Huber and Mintz (2005).

orientation from an inward looking one to a more outward oriented export promotion strategy in 1977, the attraction of FDI has formed the cornerstone of the national development policy since. At the outset, generous fiscal incentive packages encompassing 10-year tax holidays and customs duty exemptions were offered to foreign investors engaged in export-oriented activities operating within specially designated export processing zones operated by the Board of Investment (formerly known as the Greater Colombo Economic Commission). Gradually over time, successive governments increasingly recognizing the importance of FDI extended fiscal incentives to foreign-owned enterprises engaged in all forms of economic activities.

More recently, the government has been confronted with a policy paradox. On the one hand as the World Bank (2012) notes, Sri Lanka's tax revenues since the 1990s have gradually diminished. Along with the fall in revenue, a noteworthy rise in government expenditure as a consequence of the escalation of military expenditure during the latter stages of the civil war as well as subsequent increases of government expenditure on post-war reconstruction and rehabilitation efforts, has in recent years led to the ballooning of fiscal budgetary deficit to undesirable proportions. With revenue considerations in mind, the government since mid-2010 has instructed the BOI the apex government agency entrusted with the attraction of FDI, to curb the use of fiscal incentives as the primary enticement mechanism. Paradoxically however, with Sri Lanka needing increased sources of foreign capital to plug the savings-investment gap to further spur and sustain her growth momentum, the turmoil in the global economy has deemed the sources of foreign capital costly and scarce. Consequently, the need to offer fiscal incentives to sustain the attraction of higher volumes of FDI to fuel the country's economic growth and development has reared its head in the policy debate in recent times.

Faced with this policy paradox, i.e., the need to minimize the use of fiscal incentives on grounds of revenue whilst maintaining the stance of fiscal incentives to entice FDI, this paper attempts to contribute to the policy debate by exploring the literature of the efficiency and effectiveness aspects of the use of fiscal incentives on attracting FDI.

The rest of the paper is organized as follows. At the outset, the paper will explore what are the salient factors which determine the attractiveness of a host economy to FDI in section 2. In section 3, the paper discusses what tax incentives are and the rationale for granting them. Subsequently, section 4 will review the empirical literature on the desirability and usefulness of tax incentives. The different types of fiscal incentives will be discussed in section 5, together with an evaluation of their relative merits and demerits. Section 6 discusses the evolution of the tax incentives regime in Sri Lanka and reviews Sri Lanka's recent FDI performance. Section 7 debates the measurement of costs vs. benefits of tax incentives. Sections 8 and 9 put forward issues for Sri Lanka to consider when designing, administering and monitoring the use of tax incentives to increase investment, employment, and growth while minimizing adverse revenue impacts. Section 10 highlights the importance that non-tax factors play on attracting FDI. Section 11 provides ideas on policy challenges and considerations for the way forward and Section 12 concludes.

2. Host Country Attractiveness to FDI: An Overview

Each country exhibits varying levels of socio-economic development, demographic structures, resources endowments, capabilities and institutions. Thus, the attractiveness of a given country to FDI depends largely on three intertwined factors namely, (1) motivation behind the foreign investor for undertaking the cross-border investment (i.e., tap into the domestic market or to take advantage of factor costs differentials amongst different countries), (2) the nature of activity, and (3) the location specific advantages a 'site' has to offer. In short, it could be argued that the relative attractiveness of a given country for foreign investor involvement depends on both its market potential/comparative advantage in international production and the investment climate. A country's relative attractiveness in terms of market potential/comparative advantage in international production is more often than not, predetermined by the country's level of socio-economic development, demographic structure and factor endowments.

The term 'investment climate' entails both the general business environment and the foreign investment policy regime. The general business climate encompasses factors ranging from macroeconomic and political stability, and the availability and quality of the legislative and regulatory institutions through to the availability of infrastructure, and the clarity of rules governing foreign investors. The foreign investment regime more specifically refers to host country attitudes towards foreign investors (particularly Multinational Enterprises or MNEs) and the policy-induced incentives offered by governments (Athukorala, 1995). All countries to an extent compete for foreign investment; the market interaction is such that, host countries are the suppliers, whilst the MNEs are the buyers. From a buyer's perspective, benefits accrue should they make the right decision in terms of site-selection. From the suppliers' perspective, benefits accrue should they demonstrate themselves as superior suppliers. Guisinger (1985) categorizes FDI markets as per three orientations; investment to cater to a single host country market, investment to cater to a common market and thirdly, an investment undertaken to cater to the worldwide export market. From the supplier's perspective, the foreign investment policy regime which encompasses a multitude of incentive and non-incentive instruments principally directed at foreign investors could be leveraged and adjusted in relation to the market and the underlying objectives of host country governments.

With respect to incentives, host countries have at their disposal two broad types of policy induced incentives; namely, commodity incentives and factor incentives. Commodity incentives refer to tariff protection whilst factor incentives refer to fiscal benefits such as tax holidays, grants and subsidies. Both incentive instruments, directly or indirectly influence the profitability of the foreign investment by shaping the 'site-selection' pay-offs beyond what the economic fundamental of optimal location would have to offer. Host countries typically employ a mix of both commodity and factor protection, which vary across markets and the intensity of competition (Guisinger, 1985). In recent years as noted earlier, the uses of fiscal incentives as a primary mechanism of enticement particularly amongst developing countries in particular, has been a noticeable feature in the prevailing international investment landscape. Later sections will explore empirical evidence on the relative strengthens and weaknesses of the use of fiscal incentives as a primary mechanism to entice FDI.

3. What are Tax Incentives and Why are they Offered?

Although economists have often been sceptical about tax incentives and have instead supported broad tax bases and lower tax rates, there is a continued popularity of incentives. While the theoretical concerns are certainly valid, there are clear forces driving countries, particularly developing countries like Sri Lanka, to adopt tax incentives.

For the purposes of this paper, tax incentives are defined as all measures that provide for a more favourable tax treatment of specific economic activities or sectors vis-a-vis what would otherwise be available to the general private sector. So, an across-the-board cut in the tax rate or a generous accelerated depreciation scheme offered to all firms is not regarded as a tax incentive. Meanwhile, tax incentives may or not may not be part of a special code, and can be written in to the national tax law. Sri Lanka is a case in point where, up to 2011, tax incentives for investment were provided for in the Board of Investment Act, whereas now they are mainstreamed into the Inland Revenue Act.

Tax incentives are special exclusions, exemptions, or deductions that provide special credits, preferential tax rates or deferral of tax liability (Easson and Zolt, 2002). Tax incentives can take the form of tax holidays for a certain limited period, concessionary tax rates for a certain duration, tax deductibility of certain types of expenditures of the firm, or reduced import tariffs and customs duties (either generally, or on particular imports of raw materials, capital goods and machinery, etc.).

Zee et al. (2002) define tax incentives in terms of their effect on reducing the relative tax burden on a particular project. This approach compares the relative tax burden on a project that qualifies for a tax incentive to the tax burden that would be borne in the absence of a special tax provision. This approach is quite useful in comparing the relative effectiveness of different types of tax incentives in reducing the tax burden associated with a project. All tax incentives however have one thing in common - they reduce the quantum of tax ultimately payable and consequently increase the post-tax income. The rationale of utilizing the tax system to mobilize and divert investments is based on this characteristic. It is based on the assumption that investment decisions are influenced to a major extent by two considerations namely,
a) the rate of return on the investment
b) the length of the period during which the cost of the investment can be recovered.

The premise behind a government granting a tax incentive is that the capital stock of the country - either of a particular type or in aggregate - is considered to be too low and that the tax system is the obstacle or that other obstacles that exist can be compensated by the tax system (Klemm, 2009). Tax incentives may be used to help correct market failures and to encourage investments that generate positive market externalities. Here, government officials want to distort investment decisions - they seek to encourage those investments that, but for the tax incentives, would not have been made and that may result in such benefits as transfers of technology, increased employment, or investment in less-desirable areas of the country (Easson and Zolt, 2002).

Yet, taxes are just one part of a complex decision as to where to make a new domestic investment or commit foreign investment. There is no simple and direct relationship between tax incentives and investment. While tax incentives can make investing in a particular country more attractive, they cannot compensate for deficiencies in the design of the tax system or inadequate physical, financial, legal or institutional infrastructure. Governments need to consider their role in improving the entire investment climate to encourage new domestic and foreign investment rather than simply dole out tax benefits.

In some countries tax incentives have been justified because the general tax system places investments in those countries at a competitive disadvantage as compared to other countries. It likely makes little sense, however, to use tax incentives to compensate for high corporate tax rates, inadequate depreciation allowances, or the failure to allow companies that incur losses in early years to use those losses to reduce taxes in later years. The better approach is to bring the corporate tax regime close to international practice rather than granting favourable tax treatment to specific investors. Similarly, tax incentives are likely a poor response to the economic or political problems that may exist in a country. For example, if a country has inadequate protection of property rights or a poorly functioning legal system, it is necessary to engage in the difficult and lengthy process of correcting these deficiencies rather than providing investors additional tax benefits.

Yet, in reality, tax incentives may now play a larger role in influencing investment decisions than in the past. Several factors may explain why tax considerations are now more important in investment decisions than before.[3] First, tax incentives may be more generous than in the past. For example, the effective reduction in tax burden for investment projects may be greater than in the past as tax holiday periods increase from two years to ten years, and tax holidays provided in certain enterprise zones have expanded to cover trade taxes, not just income taxes. Second, the last ten years have seen substantial trade liberalization and greater capital mobility. As non-tax barriers decline, the significance of taxes as an important factor on investment decisions increase.

For many developing countries and transition economies, attracting foreign investment is increasingly becoming a priority during policy formulation. Foreign investments help achieve regional and national growth targets, provide employment to locals, introduce new technical knowledge through training, utilize a higher proportion of their investment in research and development and create a "spillover" effect on the socio-economic structure of the host economy (Blomstrom and Kokko, 2003).

Firms that seek to invest abroad base their decisions on various factors. These include political stability, market protection, macroeconomic environment, infrastructure development, the regulatory framework and tax laws of a prospective host economy. Non- tax factors such as stable political and macroeconomic environments play a prominent role in swaying investor decisions pertaining to the location of an investment. Although they play a limited role in influencing investor decisions (Gergely, 2003), tax incentives are used by Governments as a tool to offset negative non- tax factors that might influence location decisions and help dissuade foreign investors from locating their investment in a competitor economy.

4. What does the Empirical Evidence Find?

The general literature on the sensitivity of FDI to taxation shows significant effects but uncertainty on how large this effect is. Hines (1999) and OECD (2001) reviews the literature and conclude that there is little doubt that taxes affect the volume and location of FDI. De Mooji and Ederveen (2003) perform a meta-analysis of published results on this relationship and find a median semi-elasticity of FDI to the tax rate of -3.3 implying that a 1 percentage point increase in the tax rate reduced FDI by 3.3. per cent. They also report enormous variation of the size of this effect (the elasticity) across studies.

Some studies have attempted to specifically examine the effect of tax incentives on investment particularly with regard to FDI, for example the CEC (1992), Hines (1997), De Mooij and Ederveen (2001). Comparing

[3] Easson (2001).

the results of different empirical studies is not easy, owing to differences in data sources, methodologies, and respective limitations. There are also differences in the nature of the FDI, for example, whether the FDI is in real investments in plant and machinery; whether it is via financial flows relating to mergers and acquisitions; whether it is through increased investment in foreign affiliates; and whether it is a joint venture (JV) project.

A UNCTAD (1996) study which reviewed the usefulness of incentives concludes that "as other policy and non-policy conditions converge, the role of incentives becomes more important at the margin, especially for projects that are cost-oriented and mobile" (pp. 44-45). It argues that the cost incurred in providing such investment incentives may have been utilised more effectively for development purposes. Chia and Whally (1992) report mixed results among developing countries. Similar conclusions are reached by Clark (2000), who notes that "empirical work using improved data measuring FDI offers convincing evidence that host country taxation does indeed affect investment flows". But this, according to him, is also a result of relaxing non- tax issues that act as investment disincentives. Moreover, recent work finds host country taxation to be an increasingly important factor in locational decisions.[4] High statutory corporate income tax rates of a host country create an incentive for 'earning stripping' and a high cost of funds acts as a disincentive for investment in that country.

Another study, by Gergely (2003), concludes that tax incentives were viewed as having minimal influence in location decisions of foreign investors with only 10 per cent of the 247 US based foreign investors mentioning fiscal incentives as a condition for investment. She further concludes that there are other non-tax and non- policy factors that play a bigger role in attracting transnational companies and international investors, other than tax incentives. It is also noted that when non- tax and non- policy factors are similar across various locations, tax incentives become more attractive, peripherally, especially to short- term, mobile investments.[5] This observation is further strengthened by Bergsman (1999) who advises that tax incentives become effective in attracting foreign investment only when investors are confronted with similar and comparable locations for investment and that they themselves do not play a decisive role in location decisions.

Yet, the cost of tax incentives may exceed the benefit derived from the new investment, but is often hard to suitably quantify. This is because there are problems in conducting a cost-benefit analysis of tax incentives (see section 7).

Blomstrom and Kokko (2003) examines the justification for using tax incentives to attract FDI, by empirically analysing "spillover" benefits of FDI. Their analysis indicates that the presence of foreign firms or MNEs help "improve allocative efficiency, reduce monopolistic distortions, induce higher technical efficiency and lead to an increase in the rate of technology transfer". Recent studies have shown that the inflow of foreign investment into countries such as Greece, Taiwan, Indonesia and the UK has contributed to the economic growth of those countries. Foreign investment inflow into Mexico during the period 1965- 1982 has been shown to propel productivity of local firms towards US levels. The impact of US

[4] Easson (2001).

[5] Gergely, in a study points out that Governments had accelerated their loosening of FDI regimes, to coincide with a global decline of FDI, by a fifth, in 2002. While reiterating that the decline in FDI was far from uniform, she notes the that FDI "declined the least" in Asia and the Pacific region, contributed largely by China's role as the world's biggest host country. The Asian region was also seen as one of the fastest liberalizing host regions for FDI at that time.

foreign investment in several countries such as France, Germany and Japan was also shown to stimulate local investment in plant and equipment. Further evidence points out that spillovers due to the inflow of FDI, also have inter- industry effects in addition to intra-industry effects. Blomstrom and Kokko (2003) cite the case of foreign investment inflow in to the manufacturing sector of Argentina in the 1950's, which resulted in a significant impact on technical progress in industries not related to that sector. It was also observed that financial incentives such as government subsidies, grants and loans act to have an immediate impact on cash flow and liquidity as opposed to the widely analysed fiscal incentives which are mostly profit based and do not have an immediate impact on cash flow.

A growing literature has explored the specific effect of tax breaks and allowances for research and development (R&D). R&D tax credits are ideal for empirical analysis because they apply to a very specific activity. Griffith et al. (1995) suggests that tax breaks have indeed provided 'substantial advantages' to investors in R&D, when compared to other types of investment. While noting a similar observation in the USA in the 1980's, she cautions on attempting to view tax incentive results of other economies through the USA experience, influenced greatly by the fact that the US is one of the biggest economies in the world. Meanwhile, Clarke (2000) suggests that tax breaks do influence location decision of R&D by multinationals. He adds that a high statutory corporate income tax rate only results in discouraging R&D of the host country. In a panel investigation of nine OECD countries, Bloom et al. (2002) find that a US$ 1 tax expenditure (by way of tax credits) leads to a US$ 1 increase in R&D in the long-run, with a much smaller short-run impact. Moreover, a one-to-one relationship between tax credits and investment suggests that the government could have equally just spent the money directly, on public investment in R&D, themselves. It is assumed, however, that the private sector is better at identifying relevant R&D or in undertaking the research and commercializing it and catalyzing growth. Yet, private firms will naturally engage in R&D driven by private interests and market demands leading to results with very limited spillovers for society and the economy at large, despite receiving tax incentives funded, essentially, by public funds.

There is very little empirical literature specifically exploring the relationship between tax incentives and general investment, especially in developing countries. The little work available typically employs a descriptive or case-study approach, rather than econometric analysis, which is likely explained by the difficulty of obtaining sufficiently reliable and broad data sets. Bond (1981) finds that tax holidays lead to short-lived and small firms in Puerto Rico. Shah (1995) contains papers looking at the effect of tax incentives in a variety of countries and concludes overall that tax incentives are often ineffectual, either because the particular incentives that were offered are not very valuable to firms or because important pre-conditions are not met, such as a favourable macroeconomic environment and public infrastructure. These studies also suggest that investment incentives work better than outright tax holidays. It must be cautioned, however, that, these results may not be fully reliable. A main weakness in most of these studies is that they focus only on one country making it difficult to control for factors other than tax incentives.

5. Types of Tax Incentives

Tax incentives sit within the broader universe of fiscal incentives offered by governments to attract FDI including incentives that are profit-based, capital investment-based, labour-based, sales-based, import-based, export-based, based on value-added, or based on other particular expenses (see Table 5.1).

Table 5.1
Main Types of Fiscal Incentives for FDI

Profit-based	Reduction of the standard corporate income tax rate, tax holidays, concessionary tax rates, allowing carry forward of losses during the holiday period to later periods (to be set off against profits made later), qualifying payments etc.
Capital investment-based	Accelerated depreciation, investment and reinvestment allowances
Labour-based	Reductions in social security contributions, deductions from taxable earnings based on the number of employees or on other labour-related expenditure
Sales-based	Corporate income tax reductions based on total sales
Value-added based	Corporate income-tax reductions or credits based on the net local content of outputs, granting income-tax credits based on the net value added
Based on other particular expenses	Corporate income-tax reduction based on, for example, technology adoption, expenditures relating to marketing and promotion activities
Import-based	Exemption from import duties on capital goods, equipment, machinery or raw materials, intermediate parts and any other inputs related to the production process
Export-based	a. Output-related - e.g. exemptions from export duties, Cesses, preferential tax treatment of income from exports, income tax reduction for special foreign exchange earning activities or for manufactured exports, tax credits on domestic sales in return for export performance b. Input-related - e.g. duty rebates, tax credits for duties paid on imported materials or supplies, income-tax credits on net local content of exports, deduction of overseas expenditure and capital allowance for export duties

Source: Authors' construction.

The designing of tax incentives, specifically, is based primarily on the type of investment that would benefit from such incentives and the form of tax incentive that would be implemented. Tax incentives for investment are implemented through a variety of forms based on their design and structure. Some of the most common tools of tax incentives are,

- tax holidays, partial tax holidays
- reduced corporate tax rates
- carry forward losses
- qualifying payment relief
- accelerated depreciation of capital assets
- investment tax credits and allowances
- reduction of withholding tax rates on remittances to the home country
- reduced taxes on dividends and interest paid abroad (host country)
- credits for reinvested profits
- deduction rules for certain qualifying expenses

5.1 Tax Incentives and Equity Considerations

Tax incentives are often criticized on the grounds that they offend the principles of tax equity. Tax equity embodies two concepts - vertical equity and horizontal equity. Vertical equity is the "treatment of persons in similar circumstances similarly and in dissimilar circumstances dissimilarly". This concept is based on the "ability to pay" principle. On the other hand, the idea of tax equity is also associated with the concept of redistributive justice. The first concept emphasizes the principle of equalising tax burdens while the second stresses the principle of reducing differences in post-tax incomes. Tax incentives run counter to both these concepts.

At the simplest level, tax incentives discriminate in favour of a particular group or activity. They confer advantages by releasing or reducing tax burdens and thus violating the ability to pay concept. There is an inequity at a deep level too. The demands of economic development have come to place greater and greater strains on the tax systems of countries. These systems have been called upon to generate larger and larger amounts of revenue to finance the development projects of their respective countries. The exemption from or reduction of, tax for one group of potential taxpayers means that others who do not enjoy that advantage must bear a larger burden of tax. The inequity of this situation is aggravated when the income levels are higher and the differences in tax burdens increase. Further, the argument that economic objectives must have priority over equity considerations in the short run has little lunch when tax incentives are not effective in achieving such economic objectives.

A further criticism is that even within the parameters of tax incentives themselves, there are inbuilt iniquities. Firstly, a taxpayer has to have a taxable income to benefit by these devices. If a taxpayer does not have taxable income because it is below the taxable limit or because of a loss, he receives no benefit, although he has diverted capital resources to a designated area or economic activity as much as the investor with a profitable result. Secondly, because the income tax is a progressive tax, any exemptions or deduction will be taken off the higher slabs and the higher rates. Consequently, the benefits a taxpayer in the higher income tax brackets derives from these incentives will be far more than in the lower brackets. Where a firm's tax rates have more than one slab this will apply to that area too.

The other limb of tax equity is the notion of re-distributive justice. In relation to this, the charge against tax incentives is that they tend to concentrate wealth in the hands of fewer persons and so undermine the equalization of post-tax incomes. On all counts, therefore, tax incentives fail in the equity test.

5.2 Tax Holidays

Tax holidays are a popular income-based form of tax incentive and by far the most common investment-inducing incentive in developing countries and transition economies. Under a tax holiday, a qualifying firm could be exempt from corporate income taxes, completely exempt from profit taxes, and at times exempt from other forms of taxes and liabilities for a specific period from commencing its business operations. Sometimes a reduced tax rate may also be granted for a subsequent period of time upon completion of the initial holiday period. Tax holidays are aimed at "newly established firms" or expansions, and are not available to existing businesses.

Tax holidays are seen as a relatively simple form of tax incentive. In transitional economies, which have newly established corporate tax systems that are not yet fully developed, tax holidays are a popular tool in inducing foreign firms. They require very little compliance, with qualifying firms not required to calculate income taxes during the holiday period. However, firms will be required to keep track of tax expenditure during the holiday period in order to comply with the tax regime upon completion of the holiday period. Tax holidays may be provided to firms engaged in specific sectors or located in certain regions of the host economy. Targeting firms by sector for tax holidays offers "spillover" benefits like transfer of skills and knowledge to the local labour force. It is widely accepted that foreign multinational companies who routinely take advantage of tax holidays introduce new knowledge by training their local workers and aid in the transfer of techniques for quality control and standardization across their distribution channels (Blomstrom and Kokko, 2003).

For firms that generate a substantial amount of their profits in the early years of their operation, short tax holidays offer an obvious advantage by exempting them from corporate and profit taxes during the initial years in business. Conversely, this attracts short (or "footloose") and medium-term projects which produce quick profits in highly mobile sectors like trade, construction, services and export related businesses like textiles, which aim to utilize the initial holiday period and then move their businesses to another region or location upon expiry of said period.[6] These 'fly-by-night' entities are the biggest drawback of a tax holiday regime. Holland and Vann (1998) also argue that the value of tax holidays depends on the amount of profit earned. By extension, the activities that tend to produce high profits in quick time are the least in need of incentives.

Offering tax holidays for region-specific investment helps regional development and enables the region to access previously unattainable foreign capital, skills and contacts (Clark, 2000). Furthermore, region-specific incentives help achieve policy goals of the Government and regional development objectives. In following region- specific incentives, Governments aim to 'crowd-in' investments into regional development.[7]

Tax holidays are commonly susceptible to tax planning which on most occasions leads to tax avoidance and abuse. Since tax holidays are predominantly offered to foreign owned companies, domestic businesses circumvent taxation by channelling funds into an offshore company which then reinvests the 'dressed up' "foreign" investment in the home country, appearing to the authorities as a foreign- owned company. This is referred to as 'round- tripping' and most commonly occurs in transition economies especially when existing domestic companies acquire previously state- owned enterprises through foreign offshore companies (Johnston, 2011).

Despite their popularity, outright tax holidays are considered to be particularly harmful. First, they are particularly attractive to short-term, footloose type of investments that are rapidly profitable, as the benefits accrue only during the limited period of the tax holiday. These are unlikely to match the authorities' priorities. Second, their costs are often non-transparent, because beneficiaries are either exempt from filing

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[6] An UNCTAD study titled "Income Tax Incentives for Investment" highlights the case of a manufacturer of computer microprocessors who, upon completion of an 8 year tax holiday period provided by an Asian developing country, closed down operations and moved to a neighbouring country which offered a new tax holiday.

[7] Angola, Brazil, Ecuador, Egypt, Ghana, Pakistan and Thailand are some of the countries that offer region specific incentives. Colombia has a special tax incentive regime for the Rio Paez region in its South. Incentives include a 10 year tax holiday from profit tax, income tax, remittance tax and customs duties and tax reduction for shareholders.

tax returns, or, if there is an obligation, may not do so correctly. Given that at most limited tax revenue is at stake, the tax administration has no incentive to closely scrutinize such returns. As a result, policy makers may not have a good idea about revenues foregone. Third, they may cause rent-seeking behaviour, with investors trying to obtain extensions to remain competitive with firms still covered by holidays. In principle, it is possible to think of situations in which a tax holiday could be a useful tool. If, for example, a country is about to begin a major reform towards a more business-friendly environment, then a tax holiday could be used to signal its commitment to the reform, as investors, enticed into the country by the holiday, would leave afterwards, if the planned reforms stall. This appears, however, to be more of a theoretical possibility than a strategy used in practice.[8] Typically, tax holidays are offered continuously or renewed repeatedly for decades. This has largely been the experience in Sri Lanka.

For companies seeking long- term profits, tax holidays offer little incentive. Long- term investments by such companies bring profit only after several years in operation by which time the tax holiday period might have expired, thereby negating any type of advantage they would stand to gain during the tax holiday period. Studies have shown that fiscal incentives, which include tax holidays, are preferred by export-oriented short-term investors (Gergely, 2003). Meanwhile, investors seeking to establish themselves in the market prefer the protection of the market over fiscal incentives such as tax holidays or any other form of incentive.

5.3 Reduced Corporate Tax Rates

The reduction of statutory corporate income tax rates is yet another profit- based form of fiscal incentive, aimed primarily at enticing FDI, used by developing and developed countries alike. Governments, to facilitate increased FDI inflow, set a lower corporate tax rate outside the general tax regime of the country. Reduced corporate income tax rates may be provided based on the type of activity, the type of investment, and the location or region the prospective investment will take place. The reduction of statutory corporate tax rate is also formulated on the sources of the qualifying income. Reductions could apply to all foreign and local income, income from specific activities, income from specific sources, income earned by foreign investors alone, or any combination of the above (Clark, 2000).

Corporate income tax reduction is the most frequently used type of fiscal incentive for foreign direct investment, especially in developed countries. This notion is strengthened by the fact that nearly 80 per cent of all the countries in Central and Eastern Europe offered reduction of corporate income taxes to transnational corporations (Gergely, 2003).

If reduced tax rates apply for a limited time only then similar concerns as for tax holidays apply. Otherwise, it is important that the sectors benefiting from the reduced rate can be easily and objectively identified, to ensure transparency and avoid discretion on the part of the authorities. If the reduced rate is applied to the more capital-mobile sector(s) of the economy, then such a reduced rate could be well justified by economic considerations, even if it led to a permanent split in the tax system. One disadvantage of such a split rate is that there could be repercussions on international tax cooperation, because existing cooperation agreements often proscribe such practices.

8 Bond and Samuelson (1986) argue similarly that in a country which has asymmetric information about its productivity and uses tax holidays to signal to prospective investors about high productivity, if the investors find that this is in fact true they will remain after the end of the tax holiday period.

More generally, start-up firms are known to prefer incentives that reduce their initial investment costs (for example, with lump sum depreciation or initial investment allowances), whereas expansion projects generally prefer tax-related incentives that carry direct positive effects on their profit. Anecdotal evidence in Sri Lanka suggests that manufacturing firms, requiring large investment in fixed assets, are more likely to prefer incentives related to depreciable assets, than non-manufacturing industries (with the exception of housing and property and power projects).

5.4 Accelerated Depreciation of Capital Assets

Accelerated depreciation is a form of capital investment- based investment allowance which provides for the writing off the cost of an asset at a rate faster than the true economic rate of depreciation - in other words, a shorter time period than dictated by the capital's useful economic life. Since any "benchmark" tax regime allows for the depreciation of an asset, it could be argued that accelerated depreciation allows for a concentration of depreciation in the early years of an asset's life. So, while this treatment does not alter the total amount of capital cost to be depreciated, it increases the present value of the claims by shifting them forward, closer to the time of the investment. The present value of claims is obviously the greatest where the full costs of the capital asset can be deducted in the year the expenditure is made. Accelerating the depreciation of an asset does not increase the total nominal depreciation beyond its original cost so that this incentives does not bias the investment decision towards short-lived assets.

Allowing for accelerated depreciation of the value of capital assets is an attractive investment inducer especially in countries that do not already provide for a "declining balance" method of depreciation through their normal tax regime. Further, Douglas et al. (1995) argues that accelerated depreciation is also a means to attract investment for its influence in offsetting the effects of inflation and also for acting as an indirect subsidy to offset the cost of labour.

Since accelerated depreciation is aimed at a company's capital investment, it brings little benefit to a company looking for quick profits, which then seeks to obtain better advantage of tax holidays. Given that accelerated depreciation does not change total deductions, but only brings them forward in time, the maximum benefits to a company is the time value of money. In case of an initially unprofitable investment, there may be no benefit, as deductions will still only be taken in later years.

Accelerated depreciation is, in essence, a 'timing benefit', i.e., it only alters the timing of the tax payable and not the actual amount of tax. Thus, the cost to the exchequer of providing for accelerated depreciation is less than that of tax holidays and investment allowances (Easson and Zolt, 2002). It is the least costly incentive in terms of revenue foregone, as revenue is partially recovered in later years. However, it must also be noted that accelerated capital depreciation is a direct encouragement to capital intensive industrialization as opposed to labour intensive projects. It has the effect of making capital cheaper than labour and new investment going into projects with a low input of manpower and can worsen any unemployment problems that an economy faces.

5.5 Investment Tax Credits and Allowances

Investment tax credits and allowances are forms of capital recovery tax incentives that provide investors relief from capital expenses. Essentially it is an enhanced deduction through which firms are allowed to claim total deductions for the cost of qualifying capital. These incentives are capital investment-based and effectively lower the cost of acquiring capital. While tax credits are used to directly reduce the amount of taxes payable, tax allowances reduce taxable income and are granted as a percentage of new investment and thus indirectly reward the investment.

An investment tax credit is generally to reward expansion, and encourage economic growth. It can be structured to be valid and fixed for the next 5 years, with the provision for review at the end of the 5th year. Both are granted as a fixed percentage of qualifying (or approved) investment expenditure. Investment allowances are deducted against the tax base and its value to the firm depends on the corporate tax applicable to that firm; i.e., higher (or lower) the tax rate, higher (or lower) the amount of tax relief on a given amount of investment allowance claimed. Meanwhile, variations in the applicable corporate income tax rate do not affect the value of investment tax credits to the firm.

Investment allowances and investment tax credits can easily be implemented in a transparent and automotive manner. The main advantage of this type of incentive is that they are contingent on new investment, i.e., the objective of increasing the capital stock is achieved. Yet investment allowances may distort the choice of investment. Investment allowances will distort the choice of capital towards short-lived goods, because any replacement of that capital would gain from the incentive - the allowance or credit. If they are non-refundable (typically they are not) they will create a distortion between the investment of new and established businesses, as only the latter will have profits against which to set off the allowance or credit.

5.6 Credit for Reinvested Profits

Allowances for reinvestment of profits are also a capital investment- based investment allowance which usually takes two forms- either the tax liability of the firm is reduced based on the amount reinvested or, in the case of subsidiaries, the parent company is refunded part of the tax paid depending on the proportion reinvested by its local company.

5.7 Reduction of Withholding Tax Rates on Remittances

Countries which provide reduced rates of withholding taxes as an incentive to induce foreign investment usually do so with the objective of achieving specific objectives, such as technology transfer. It has been shown that a high withholding tax rate acts as a disincentive for foreign investment.

5.8 Deduction Rules for Certain Qualifying Expenses

The objective of deductions for certain expenses could include export promotion, performance enhancement, employment training and technology transfer. Qualifying expenses for certain deductions include investing in research and development, export marketing expenses and training expenses.

5.9 Overall Issues

Up-front tax incentives like some of the types mentioned above can help address cash flow problems that may inhibit investment, particularly in respect of start up projects. Investment tax credits and immediate and full expensing of capital costs are often advocated as an efficient form of investment incentives in that they reward new capital purchases. This reasoning recognizes that tax incentives can yield the greatest efficiencies if they subsidise only investment that would not have occurred in the absence of the incentives. On this basis, it is argued that up-front incentives tied to new capital purchases should be preferred to statutory corporate tax rate reduction that benefit existing ('old') as well as newly installed capital. In this way, incentives will be directly proportional to the amount of actual investment. Tax authorities have to allow firms in a temporary loss position (e.g., start ups) to carry forward balances of earned but unused tax relief including earned but unused investment tax credits and capital costs.

However, one can argue that up-front incentives are inefficiently targeted in that they reward inputs rather than outputs - that is, they subsidize the purchase of capital rather than the productive use of those inputs generating output and thus, profits. But by the same token, granting of tax holidays can also be often inefficiently targeted, as they tend to disproportionately reward the forming of new companies rather than what is more desirable such as an increase in productive assets, improved technology, greater employment generation, labour skills training, and so on. International experience and evidence suggests that tax holidays seem to have a more pronounced effect in attracting 'footloose', short-term investment that may well leave the host country or form a new company once the tax holiday period expires, whereas other incentives types like investment allowances/tax credits and accelerated depreciation may be more effective in incentivizing longer-term investments.

Yet, the possible reason why few countries have replaced tax holidays by accelerated depreciation of capital allowances/tax credits may be the greater benefits of the former to profitable investment. Indeed, if countries attempt to attract particularly the highly profitable investment of multinationals, then such a reform would lead to a less competitive tax system. Still, the risks of that policy remain, in particularly, the possibility that mainly footloose investment is attracted.[9]

Meanwhile, other issues need to be considered in the Sri Lankan context.

Firstly, it must be noted that foreign investors may receive a tax holiday in Sri Lanka but may be paying tax in terms of the residence principle in their home country under a Double Taxation Agreement (DTA), in the absence of appropriate tax sparing provisions. This would mean, the benefit of the tax holiday actually accrues to the exchequer of the investor's home country. The anomaly is aggravated where the home country is a rich, developed, capital-exporting country and the recipient country is a poorer, developing, capital-importing country. The poorer country would then forgo its revenue which the rich country collects. The answer to this is the formulation of Double Tax Treaties with tax sparing provisions. A tax sparing clause allows companies to be treated in their home countries as though the taxes waived through various incentives had actually been paid. Developed countries are increasingly reluctant to grant such a provision and the United States never does.

Sri Lanka currently has DTAs with over 39 countries, including India, UK, USA, UAE, Canada, China, South Korea, Iran, Malaysia, Pakistan, Saudi Arabia, Singapore, Thailand, France, Germany, and Luxembourg among others, with 7 (Austria, Seychelles, Bulgaria, Egypt, Bahrain, New Zealand and South Africa) approved and awaiting ratification and one (Cyprus) under discussion.[10]

[9] Yet, as Klemm (2009) argues, intuitively there may instances in which footloose investment is acceptable, e.g., after a major catastrophe or a war when the main aim of the government would be to create investment and employment quickly. Temporary location of footloose investment may fulfill a useful purpose by creating work and speeding up the recovery process.

[10] As at 31st January 2013.

There are also arguments that tax holidays benefit the formation of new companies rather than investment in new productive assets (as elaborated earlier). Moreover, unlike tax holidays, rewards from these alternative incentives accrue ex-post, i.e., only if and after the action is undertaken, and not for ex-ante promises or projections (of profit, or turnover, for instance). This also minimizes the requirement for frequent monitoring to check if promises made at point of entering into the agreement have been fulfilled.

Therefore, Sri Lanka needs to strongly consider moving away from regular tax holidays towards an appropriate mix of other alternative incentives tools, like investment tax credits/allowances and accelerated depreciation allowances.

6. Tax Incentives and Foreign Direct Investment in Sri Lanka

6.1 Evolution of Tax Incentives Regime

Tax incentives offered to investors have a long history in Sri Lanka. Till 1977, in keeping with the inward-looking economic policy that prevailed, they were offered to certain import-substitution industries, agriculture, housing, non-traditional exports, tourism and gem industry, in addition to the specific incentives offered to the crop sectors of tea, rubber and coconut. All such incentives were offered under the authority of the Inland Revenue Department. This early regime was characterized by little discretion; although one of the conditions that had to be met was approval by the Minister, this approval was almost automatic upon fulfillment of the other criteria.

Following Sri Lanka's economic liberalization in 1977, when the government embarked on a reform process to transform the economy into a more market-oriented one, Foreign Direct Investment (FDI) has been promoted as an important component of the development process. Unlike in the 1960s and 1970s when foreign investment was generally perceived as a harmful source of foreign influence on the local economy, in the 1980s FDI was considered as a desirable means to develop new opportunities, especially for the expansion of the export sector and for the creation of more employment. The institutional structure for promoting FDI was formed by creating the Greater Colombo Economic Commission (GCEC) and the Foreign Investment Advisory Committee (FIAC). However, until late-1989, various policy, regulatory, and institutional barriers (in addition to the uncertainty created by the North/East war) discouraged foreign investment from entering the Sri Lankan economy in any significant volume, and much of the promotion of FDI was mostly limited to the designated Free Trade Zones (FTZs), while some piecemeal FDI came in outside the zones. During this period, the GCEC had little influence outside its area of authority. It would enter into an agreement with a company outside a zone only if there were compelling reasons for doing so. As economic reforms gathered momentum after 1989, FDI promotion gained a renewed impetus, and it was identified that focussing on FDI only within the FTZs could not meet the increasing demands of the economy. Moreover, FDI was recognised as important to fast-track capital accumulation and grow technological capacities in the country at that time.

In order to increase FDI flows and better align those flows with the domestic economy, several measures were taken to manage FDI better. In 1990, the government developed the Industrial Policy Statement (1990), formalised by the Industrial Promotion Act No. 46 of 1990, which sought to identify and fix impediments to private investment in general and FDI, in particular. It was aimed at creating a more conducive investment environment by directly addressing issues that were of major concern to private investors, and making government decisions more responsive to their needs. A more unified and coherent FDI framework was envisaged, including a movement away from case-by-case approvals to automatic approvals. Lifting of restrictions on activities and ownership structures of joint ventures and removing the limitation that FDI is permitted only in designated zones were also envisaged. Nevertheless, implementation of these changes were constrained due to various factors, including the continued North East conflict, macroeconomic imbalances, and also problems in the decision-making processes and power structures that contributed to a stymieing of the efforts to reform the complicated procedural, legal and regulatory frameworks governing new private investment.

Despite the inability to implement all the IPS 1990 proposals, a key one among these aimed at giving a new face to the FDI approving authority was implemented, namely the creation of the Board of Investment (BOI)[11] by merging the Greater Colombo Economic Commission (GCEC) and the Foreign Investment Advisory Council (FIAC).

Since the BOI was established in 1992, it has aimed to become a one-stop-shop for all foreign investment approvals and has continuously undertaken investment promotion drives overseas. Projects receiving 'BOI Status' were granted generous income tax concessions and customs duty exemptions, depending on the size of investment and employment created. Meanwhile, this created a dichotomy between these BOI enterprises and those enterprises that were already in existence sans the tax benefits or who set up later on and who did not qualify for BOI status. It is worth noting, however, that local investors who could not attain BOI status and the incentives offered therewith, continued to perform admirably. In fact, between 1980 and 1990, non-BOI exports had accounted for almost 80 per cent of total exports. However, recognising the uneven playing field that existed, local companies were also entitled to the new incentive package introduced by BOI from 1991; under the 200 Garment Factory Programme, for instance.[12] Some 164 factories were established under this programme and the BOI regarded it as a clear success. After this expansion, however the BOI became increasingly unwieldy.

Box 6.1
BOI Act

The BOI Act provides for two types of investment approvals. Under Section 17 of the Act, the BOI is empowered to grant special concessions to companies satisfying specific eligibility criteria which are designed to meet strategic economic objectives of the government. The mechanism through which such concessions are granted is the Agreement which modifies, exempts and waives identified laws in keeping with the BOI Regulations. These laws include Inland Revenue, Customs, Exchange Control and Import Control. Approval under Section 16 of the BOI Act permits foreign investment entry to operate only under the 'normal laws' of the country; that is, for such enterprises, the provisions of the Inland Revenue, Customs and Exchange Control Laws shall apply. For the purpose of granting approvals and incentives, companies incorporated under the Companies Act are treated equally regardless of whether the shareholding is controlled by nationals or non-nationals.

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11 By way of ammending the GCEC Law No. 4 1978 by Act No. 49 of 1992.

12 Initially, this was introduced for specific development programmes such as the 200 garment factories, where the new company plus the mother company were granted BOI status. Subsequently, this was extended to other local exporters who satisfied certain conditions stipulated by the BOI.

Under the earlier (prior to 2011) legal framework on tax incentives and holidays, some tax holiday provisions for private sector projects were written in to the Inland Revenue Act, while there were many overlapping as well as additional tax incentives that were granted under the BOI Act with no reference made to the Inland Revenue Department. The BOI Act superseded the provisions set out in the Inland Revenue Act with regard to tax incentives offered to BOI projects. This dichotomous structure created difficulties in monitoring of tax incentives granted to enterprises, and left room for discretion by BOI investment promotion officers to grant differential incentives based on the characteristics of each project. It also reduced the clarity and certainty for tax authorities as well as prospective investors.

A good example of problems arising from the dichotomous nature of the system of tax incentives in operation would be the 'Gamata Karmantha' 300 enterprise programme introduced by the government in 2000. The lead agencies in the implementation of this programme were the Ministry of Industries and the BOI. The tax incentives for projects under this programme are granted both under the BOI and under the IRD, and new projects had the option of availing themselves of either, not both. Out of projects that went through the BOI, 121 have begun commercial operation. Meanwhile, for projects that went via the IRD incentive package, although identical in nature, only 51 have begun commercial operation. The dichotomous structure created uncertainty and opacity for investors. Anecdotal evidence suggests that while some investors preferred to go via the IRD provisions, as it was perceived as 'more certain' as they were written in to the IR Act, others preferred to go via the BOI owing to the investor-friendly nature and effective promotion, and lack of cumbersome procedures. Thus it was clear that a 'win-win' scenario could be reached if the actual incentive provisions are written in to the tax code, while the BOI remains as the promotion and facilitation agency.

Sri Lanka took an important step in streamlining tax incentives through the Budget 2011. As of 2011, all tax incentives offered related to corporate income tax were written into the Inland Revenue Act. Tax incentives for new projects are now to be granted in line with the country's general income tax provisions, and the BOI was relieved of the authority to introduce any new incentive packages on its own. This was important from a monitoring point of view too. It is expected that, once all investment incentives are brought under the provisions of the IRD Act, the IRD would assume greater 'ownership' to the incentives offered particularly in terms of monitoring of tax liabilities of BOI projects, especially those completing their tax holiday periods.

Meanwhile, for pioneering investments, special incentives packages are to be negotiated on a case by case basis under the provisions set out in the Strategic Development Projects (SDP) Act of 2008. These are only in respect of investments that require incentives exceeding those stipulated in the tax holiday provisions of the IRD tax code.

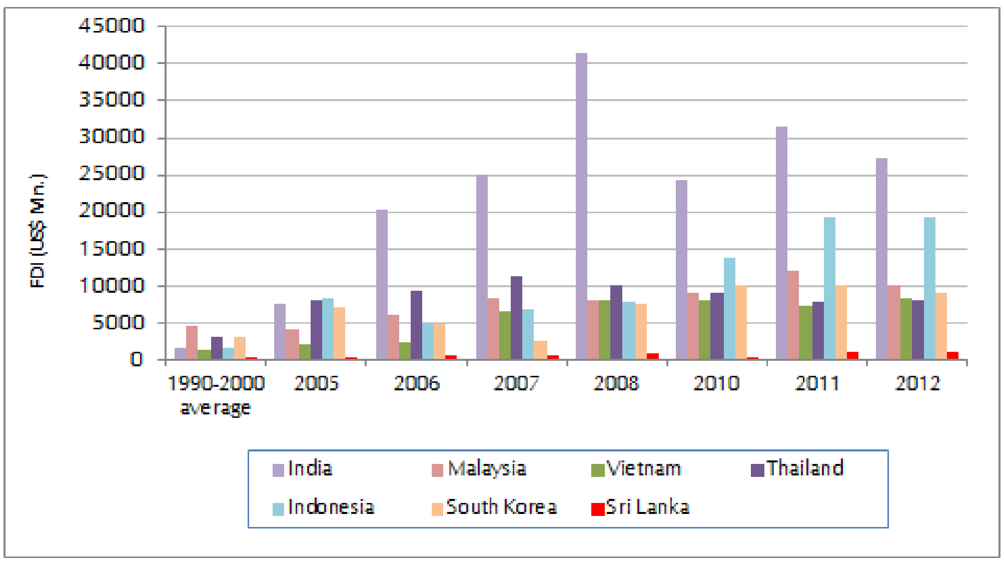
So, while corporate income tax provisions have been streamlined as such, it is unclear as to the status of the border tax concessions (customs duties, etc.) that the BOI Act would/would not grant.

6.2 Recent Performance of FDI

FDI to Sri Lanka has seen a significant increase in recent years, rising from US$ 200 million attracted in 2004 to US$ 889 million in 2008, clearly indicating that FDI inflows to the country steadily increased, even during the time of the conflict, and has increased fairly significantly since the end of the conflict in 2009.[13] FDI dropped to US$ 601 million in 2009 and US$ 516 in 2010, largely due to the global economic downturn which slowed down investment flows worldwide. By 2011, inflows picked up to US$ 1,070 million with several hotel investments. This rose further to US$ 1,340 million in 2012, according to the latest available data. The inflows in 2012 were US$ 400 million less than the target set by the government.

After the end of the war, Sri Lanka is looking to boost foreign direct investment (FDI). Attractiveness of Sri Lanka as an FDI destination has to be maintained in order to keep the rate of investment high. The FDI target for 2013 is US$ 1,500 million (down from the US$ 2,000 million targeted earlier). Sri Lanka attracted an annual average FDI of US$ 500 million (about 1.5 per cent of GDP) during the last decade. Meanwhile, East Asian countries, whose development experience Sri Lanka wishes to emulate, attract in excess of US$ 5,000 million annually - close to 5 per cent of GDP.

Figure 6.1
Cross-country Comparison of FDI Inflows



Notes: Figures for 2012 are preliminary.
Source: Sri Lanka Board of Investment and UNCTAD Database.

At present, Sri Lanka has 1,610 BOI projects in active operation (commenced commercial operation between 1979 and 2009, and still in commercial operation), according to data furnished to the Presidential Commission on Taxation 2009 by the BOI.[14] This refers to projects that have been approved under Section 17 of the BOI Act and under the 200 Garment Factory Programme of the BOI. This figure includes projects that have brought in some component of foreign capital (i.e., FDI), as well as those that are fully domestically financed. The performance of the BOI sector has been relatively strong, with 65 per cent of the country's total exports coming from BOI projects in 2008. Meanwhile, 86 per cent of industrial exports are attributed to BOI projects.[15]

[13] Much of the increase in FDI in 2011 was accounted for by a couple of large foreign hotel investments.

[14] Information available with the BOI as at 15.02.2010.

[15] Calculated using data from BOI Statistics Department and Central Bank *Annual Report* (2008).

Table 6.2
Number of BOI Firms by Category of Activity
(commenced commercial operation between 2000-2009)

Category	Number of Firms
Food Products	59
Beverages & Tobacco	12
Chemical, Petroleum, Coal & Plastic Products	16
Rubber Products	19
Wood Products	11
Textiles & Fabrics	22
Non-Metallic Mineral Products	18
Coir Products	14
Jewellery & Lapidary	9
Electronic & Electrical Goods	13
Fabricated Metal Products	36
Transport Equipments	9
Wearing Apparel	122
Footwear	2
Leather Products (Including Leather Garments)	1
PVC Products	18
Fishing Gear & Accessories	6
Printing	1
Paper & Paper Products	11
Other Manufactured Products	26
Agriculture	41
Hotels, Restaurant Services & Entertainment Complexes	41
Hospital Services & Medical Centres	16
Educational & Training Institutions & Research Organizations	13
Telephone & Communication Networks	6
IT Related Sector	102
Export/Imports Trading Houses	20
Power Generation Plants	52
Housing & Property Developments	76
Other Services	128
200-Garment Factory Programme	41

Source: Sri Lanka Board of Investment (Statistics Department).

Table 6.3
Number of Firms in Commercial Operation by Market Orientation
(commenced commercial operation between 2000-2009)

Sector	Number of Firms	
	Export-Oriented	Local Sales
Manufacturing	583	76
Agriculture	34	18
Housing & Property Developments	n/a	81
Hospitals	n/a	16
Training Institutes	1	18
Trading Houses	23	n/a
Telecommunication	n/a	10
IT Related Projects	88	51
Power Projects	n/a	54
Regional Operating H/Quarters	24	n/a
Hotel & Restaurants	1	56
Other Services	61	52
200 Garment Factory Programme	56	-

Source: Sri Lanka Board of Investment (Statistics Department).

7. Can Costs vs. Benefits of Tax Incentives be Measured?

As is widely acknowledged, the subject of effectiveness or otherwise of tax incentives in promoting investment has generated extensive debate. While of course encouraging investment and acting as a temporary mitigating factor for an otherwise unfavourable investment climate, tax incentives are a drain on the revenue agency and thus, the country's exchequer.

Formally measuring the costs vs. benefits of tax incentives appears a logical first step in evaluating the effectiveness of tax incentives in generating more investment. In fact, the published mandate of the Presidential Commission on Taxation 2009, stated that a 'cost-benefit analysis of tax incentives granted since 1977' needs to be conducted. However, this is not easy.

The cost of tax incentives is broad-based - they go beyond the obvious revenue loss. They include distortions to the economy as a result of preferential treatment of investment qualifying for incentives, administrative costs from running a tax incentives scheme, preventing fraudulent use and abuse of such incentives schemes, and social costs of rent-seeking behaviour, including possibly an increase in corruption (especially in poorly designed schemes that allow for greater discretion).

Even the pure revenue costs cannot easily be quantified. At one extreme, if incentives apply only to investment that would not have taken place otherwise, the cost of direct revenue foregone would be nil. At the other extreme, if incentives are purely redundant and have no effect on investment then the entire tax revenue waived makes up the direct revenue cost. In practice, the true amount of direct revenue losses is likely to be between these two extremes. It is, however, also important to consider the indirect effects. Hence, even if taxes are waived on an investment that would not have taken place without the incentives, there may be indirect revenue losses, if that investment crowds out other, more highly and easily taxable, investment. On the other hand, if there is an increase in aggregate investment and economic activity overall, there may be revenue gains from this, such as from additional employment taxes, consumption taxes or taxes on inputs.

The benefits of tax incentives are even harder to quantify. Tax incentives are often used to achieve medium-term development objectives, which will be affected by many factors other than incentives (more on this in Section 10). Hence, in the typical case of incentives, which are aimed at boosting investment and thus economic growth, it will be difficult to know what the growth performance in the absence incentives would have been. It is even less clear, what would have happened under another tax reform, such as an across-the-board tax rate cut at the same revenue cost as the incentive. Ultimately, however, the benefit of incentives should be assessed in terms of higher investment and growth. This can either be achieved simply by generating more investment or indirectly by initially changing the distribution of investment towards activities with higher spillovers, and then achieving higher growth as a result of these.

Cost-benefit studies of tax incentives are difficult to make and may be misleading if they exclude general equilibrium effects. Typically such studies count the direct financial costs from tax revenue foregone and compare them to the benefits in terms of higher employment and economic activity and the resulting tax revenues. Crowding out of other investment is usually not quantified, as this would be very difficult to do. Equally, such studies typically cannot reveal whether investment was just relocated within a country or from one sector to another, or genuinely additional.

For Sri Lanka, the issues are much the same. While a general description can be provided of the types of benefits that arise from additional investment as a result of tax incentives (adding to the capital stock, job creation, transfer of skills, knowledge and technology, stimulating growth in lagging regions, etc.), it is difficult to fully estimate the benefits resulting from tax incentives with any degree of certainty. Sometimes the benefits are hard to quantify, and at times accrue to parties other than the firm concerned, i.e., spill-over benefits. Estimating the cost of having granted an incentive can be misleading as conducting a counterfactual analysis (by assuming that the investment would have come had the incentive not been offered) is a contentious exercise. For foreign investment, there is a risk that the incentive will amount to little more than a transfer to the home country treasuries, particularly in the case of firms whose home countries collect tax based on the residence principle and without a tax sparing clause in the double taxation treaty. In addition, revenue could be lost through abuse and leakage; this is increasingly likely as the tax incentives regime becomes more complex. Meanwhile, the fact that the government does not track "tax expenditures", i.e., the revenue foregone due to tax incentives and holidays of various kinds, makes any cost-benefit analysis virtually impossible.

A general overview of some of the benefits of BOI projects would indicate that by 2008, 1,610 BOI projects currently in commercial operation provide employment for 259,846 persons both inside and outside BOI special zones. As highlighted earlier, the performance of BOI projects has been strong, contributing 65 per cent of the country's exports, and 86 per cent of the country's industrial exports. A former Director General of the BOI asserted in 2004 that the estimated revenue loss due to corporate income tax and custom duty exemptions for foreign investors since liberalizing the economy in 1977 could be as much as Rs. 257 billion.[16] According to estimates of revenue foregone from tax incentives as calculated by the IMF Mission of 2001, the net revenue loss was roughly computed at close to 1/4th per cent of GDP which amounts to almost Rs. 3 billion or about 1.5 per cent of tax revenue for 2000. On this basis for 2011 with provisional GDP at market prices at Rs. 6,543 billion,[17] the net tax revenue loss for 2011 would roughly amount to around Rs. 16 billion or close to 2 per cent of tax revenue.

Yet, what is nearly impossible to assess is whether these BOI projects, with such number of employment created, and such level of exports, would or would not have been achieved in the absence of the tax incentives granted to them. Without such a counterfactual analysis, it is not possible to provide a credible conclusion on the costs vs. benefits of tax concessions granted over the years.

However, it is argued later in this paper that cost-benefit analyses should be done at the stage of approval of all future projects and that is what is important in the context of enhancing revenue to the government while promoting FDI.

8. Designing Tax Incentives - Issues to Consider

8.1 Overall Considerations

Many of the principles for a good general tax policy and system also apply to tax incentives - especially transparency and predictability. These are important, because investors will need to be able to understand

[16] *Financial Times (2004), 'Massive Rs 257 billion state revenue loss in tax breaks', available at http://www.sundaytimes.lk/041226/ft/10.html [accessed on 15th August 2012].*

[17] Central Bank of Sri Lanka, *Annual Report* 2011.

incentives schemes if they are to base their investment decisions on them. Investors will also need to be able to rely on a certain stability of tax incentives granted, before engaging in a major investment. A project requiring repeat investment over the years would be discouraged by frequent tax changes, even if incentives granted on previous investment were 'grandfathered'.[18] Another argument for transparency is that it reduces the scope for discretion and corruption. Incentives should therefore ideally be part of the country's tax laws. Their inclusion in investment laws is less advisable, because of possible contradictions between different pieces of legislation (Klemm, 2009).

A related issue is that tax incentives should be automatic rather than discretionary. In the hypothetical case of an impartial, incorruptible, predictable and omniscient public service, discretionary incentives would be preferable as these would ensure that limited resources are focused on investment that would not have taken place in the absence of the incentives and which entail the highest possible economic and social return. However, in more realistic settings of most economies, there is a strong case for automatic incentives - one that operate based on clearly defined criteria, reflecting both the risk of corruption and the difficulty governments have in 'picking winners'.

8.2 Administration

Among the initial concern of taxation authorities when providing tax incentives is how to filter and differentiate which investor or business qualifies for incentives. Eligibility for tax incentives is either automatically granted or is provided following an approval process where a high degree of discretion is used by the authorities. The grant of tax incentives is generally in practice the results of lobbying as witnessed by the many amendments to the statutes each year favouring specific activities.

An evident advantage of a discretionary approach to providing investing incentives is that granting of investment approvals could be altered according to policy changes of the Government. Further, the threat of tax avoidance can be averted by carefully reviewing and denying access to incentives that the investor could potentially abuse. Secondly, discretionary approval for tax incentives can be granted to investments that are strategically valuable to the economy and bring long-term benefit. However, the disadvantages and potential risk in discretionary incentive approval outweigh the advantages. Firstly, any approval process is bound to be time consuming, especially if the investor has to struggle to bypass Government bureaucracy. Secondly, since tax incentives promote unproductive rent-seeking activity, a discretionary process is susceptible to corruption and abuse by authorities themselves and would erode the transparency of the tax regime. The need for administrative discretion can be avoided when eligibility requirements for investors are clearly stated in tax and/or industry legislations (Hamdani et al., 2000).

Thus the process of granting tax incentives is mostly a combination of automatic and discretionary measures, whereby an automatic process shortlists the eligible investments or businesses and then a discretionary approval process is followed where a final decision is made as to whether investors should be granted the respective incentives.

Ensuring a smooth and coordinated institutional approach for the overall control of incentives and investments is another cause for concern when designing taxation and tax incentive legislation. A plethora of

[18] See Auerbach and Hines (1988) for a formal treatment of frequently changing tax incentives and how the expectation of changes can increase effective tax rates.

different Government agencies being involved in the various stages of the tax incentive scheme only serves to increase the bureaucratic red tape and inconvenience the investor. Determining which Government agency oversees which aspect of the incentive regime is important. It is advised that even though determining incentives and qualifying investments should be handled by the Ministry allocated to Trade Affairs, fiscal aspects of respective tax incentives be overseen by the Ministry responsible for Finance, since this would ensure the interests of the Treasury are protected (Easson and Zolt, 2002). Further, since such tax incentives and allowances are also a form of public funds, accountability should be ensured through Cabinet and Parliament (Bolnick, 2004).

Another administrative concern when granting tax incentives is to monitor and ensure whether investors fulfill conditions that were initially agreed upon to gain relevant incentives. The rationale for granting incentives should be made explicit. Such conditions might include demonstrating satisfactory factual conditions, the importing of certain machinery, creation of a specific number of jobs or a completion of a project within a time frame. Thus, authorities should make certain that investors fulfill pre- conditions upon granting of the incentive. However, monitoring such aspects of investments is hampered, particularly in developing countries, due to the lack of resources and weak governance structures.

8.3 Achieving Investment Targets

Tax incentives and concessions are provided to acquire specific objectives and benefits for the economy of the host country. The effectiveness of a tax incentive scheme is determined by the extent to which each tax incentive tool improves investment incentives (ibid.). Thus, tax incentives should be designed with a targeted investment in mind. Failing to match a tax incentive to the most suited investment type generally results in leakages, unwanted, distortions and failure to achieve desired objectives.[19] For example, tax holidays which attract short- term investment that make quick profit, are commonly abused. Such short-term businesses do not seek to establish themselves in the economy, hence bringing very little benefit to the host country. Further certain investors regularly inflate workforce numbers purely to qualify for employment related tax incentives. Regular monitoring and conditional clauses such as double deduction for training purposes and tax credits for new employees hired are some of the measures which could be pursued to prevent abuse of this kind.

8.4 Tightening Qualifying Criteria

At the very inception of the BOI (at the stage of GCEC), a key criterion for eligibility for tax incentives was that "the entire cost of the project should be funded from abroad", which has since been relaxed and at present no such stipulation is made. This practice needs to be revisited, as one of the key objectives of offering tax concessions to new investment is to attract new foreign capital via FDI. It has also been contended that certain foreign investment projects receiving BOI approval in fact raised much of their funding requirements from domestic commercial banks, instead of a new inflow of capital from abroad. Often minimal or no collateral is demanded in respect of loans of advances granted and at the end of the tax holiday period, quite a number of firms have closed down and departed without repaying their loans in full or in part.

[19] An UNCTAD study titled "Income Tax Incentives for Investment", notes an example from Lebanon when, immediately after the civil war, tax incentives were granted to encourage construction of new buildings, but not for reconstruction of damaged property. Eventually this resulted in a surplus of new buildings while damaged buildings were neglected.

In this context, an important area to consider is the provision of incentives in line with the proportion of foreign capital brought into the project, considering the present and future need for larger foreign capital inflows to bridge the country's savings-investment gap. The tax incentives regime should be tailored to incentivised foreign inflows of new capital, rather than the raising of finance domestically.

Therefore, Sri Lanka would need to strongly consider introducing a minimum percentage threshold of foreign capital that must enter a project at its inception. This will be important to ensure that the country attracts those projects that will bring in significant foreign capital into the country, and granting of incentives in line with the level of this initial foreign capital component. Yet, the current regime of providing the same incentives regardless of foreign or local investment should continue. Having differential incentives, especially tax holidays, favouring foreign investment may cause various distortions. Also, a constant minimum foreign capital component is hard to enforce, particularly in the event of a sale of the enterprise, as the foreign investor then needs to find a new foreign counterpart to buy the stake in order to maintain this constant ratio, and if not, the investment agreement will be in jeopardy.

8.5 Better Targeting and Categorization

In keeping with government's stated policy direction, there is an immediate need to promote private investment into lagging regions (regions outside the Western, Central and Southern Provinces) and for promoting specific industries like fisheries (processing, canning, cool rooms, ice plants), tourism, palmyrah-based industries, SMIs, etc., in the conflict affected regions. In keeping with these objectives, a useful consideration would be the adoption of more time-bound tax incentives (like those previously provided in the agriculture sector). The aim of this time-bound incentive structure would be to kick-start employment generation more rapidly in chosen geographical areas, and chosen productive sectors. Such mechanisms have proved effective and successful in several other countries.

Another area to consider, in targeting incentives better, would be to have more specific categorization of sectors for tax incentives purposes. Take for example, the 'Small Infrastructure Projects' section of the BOI incentives list. It includes a wide spectrum of industries; from power projects and garbage disposal, to tourism and transport. It is clear that this category should be disaggregated more, and the incentives offered to each type of industry or activity should be provided separately. Following this, the specific incentives offered to each of these activities could be revised, and targeted to suit that type of industry/activity. Within each of these categories too, further categorization may be required, in order to target tax incentives to the most promising sectors. This is particularly true of power projects and warehousing - for instance, segregating between renewable power (like mini-hydro) and other forms of power (solar, wind, etc.), as well as between ordinary warehousing and cold storage and other value-added warehousing which requires a lot more technology and/or capital investment.

8.6 Other Issues

Design issues of the individual tax incentive tools are also raised during the implementation and compliance stages of a tax incentives regime.

Tax holidays, which are one of the simpler forms of tax incentives but the most prone to abuse, reinforce such design issues. The decision as to when the holiday period will commence will decide the attractiveness of the incentive to a potential investor. Tax holiday periods could commence either when a firm commences production, from the first year when it makes profit, the first year of it registering cumulative profits or even immediately following the granting of approval for investment. While the earliest possible commencement of the tax holiday period is favourable to a quick- profit making investment, for larger investments that usually make losses during the initial years this provision might not be advantageous since such investments might actually end up paying more taxes during the course of the investment. Tax legislation concerning tax holidays, while usually mentioning year of commencement, fail to specify as to which year of profit, i.e., first year of profit or first year of positive cumulative profit, should be taken into account for the commencement of the holiday period.

Another common design issue pertaining to tax holidays is the length of the holiday. As has been discussed above, tax holidays usually attract short and mid- term investments that are mobile and make quick profits. Since most of the tax holidays granted in developing and transition countries have been of shorter duration, these seldom attract long- term investments which usually produce losses in the initial years of operation.

Additionally, termination of tax holidays can take place due to various reasons including the expiry of the holiday period, non- compliance on the part of the investor, violation of the incentive agreement or repealing of tax legislation. If an investment does not meet the stipulated performance requirement, previously agreed upon, it will be open to termination. However, repealing of tax laws or related legislative changes would be rendered ineffective since companies already enjoying the holiday period would continue to do so, even under new law (Holland and Vann, 1998; Hamdani et al., 2000; Bolnick, 2004). The question of the rate of depreciation of assets and loss carry forward rules during the tax holiday period is another aspect of design issues that confront legislators and tax authorities. Depreciation is a cost when calculating income; hence the ability to defer it to the post-holiday would overestimate the cost and result in increased tax allowance (Holland and Vann, 1998). This phenomenon is critical while awarding tax holidays of shorter duration, since short and mid- term investments that make quick profits, if deference of depreciation is allowed, are more likely to claim higher tax allowances upon completion of the tax holiday period.

Investment allowances and tax credits also raise similar design issues during their formulation and implementation. A major problem encountered while granting tax/ investment allowances is the bias of the incentive towards capital formation and not the usual investment goals of job creation and development.

9. Monitoring and Compliance – Issues to Consider

All forms of tax incentives are prone to abuse and tax planning which most often leads to tax evasion and avoidance. Therefore, host countries like Sri Lanka need to ensure continuous monitoring not only to ensure compliance with pre-approved conditions by investors but also minimise possible abuse.

9.1 Pre-approval Assessment

A system of comprehensive cost-benefit analyses prior to new project approval was in place during the time of the Greater Colombo Economic Commission (GCEC), but has now been sidelined in favour of greater speed of approval, considering the number of projects coming in daily.

It is debatable whether such a system ought to be revisited, and there ought to be more cost-benefit analyses carried out by the BOI before granting of incentives, so as to ensure that projects being granted tax concessions are providing maximum economic benefit to the country. Presently, BOI checks credibility of new applicants using online databases and foreign embassy trade desks. More information asked depends on sector (sensitivity), government land, size of investment, etc. Otherwise, it is assumed that the investor is taking on the risk himself. However, as applications for a host of new investment projects are more frequently submitted to the BOI in the post-war growth phase, it is expected that the investment approvals committee of the BOI need to make more informed judgments on the suitability and sustainability of each project, based on more enhanced information. It is important that rules be introduced to the effect that all new applications must be accompanied with a track record of the enterprise that will indicate previous undertakings of the enterprise and/or parent company and provide projected profitability statements, employment levels, etc. Of course it must be recognized that this information could not be always be treated as completely reliable, as investors could easily prepare the documents to portray a favourable image, but this is a necessary first step to ensure that the country only attracts the 'right' type of foreign investment.

9.2 Tax Registration

Meanwhile, firms enjoying tax concessions must be brought into the tax-paying category in a more regular manner. It is stipulated by the BOI that all enterprises registered with them must file income tax returns with the Inland Revenue Department, regardless of their tax holiday status. However, interviews with IRD officers indicate that currently this is observed largely in the breach. The BOI estimates that in 2007/08, only 62 per cent of enterprises have filed accounts with the BOI. Moreover, the figure indicating the percentage number of BOI tax files opened differs between BOI records and IRD records. This is also largely due to a lack of a formal and clearly instituted information sharing mechanism.

It is important to ensure that, through appropriate legal provisions, BOI enterprises must compulsorily open tax files with the IRD, regardless of tax holiday status and such a provision be fully enforced, but in a client-friendly manner. This should not be just for new investments being registered, but needs to be applied to existing BOI enterprises as well, thereby allowing IRD to closely track BOI enterprises that have completed their tax holiday period and should be within the mainstream tax fold. To smoothen this process, a more formal and coherent BOI-IRD information sharing linkage would be a useful supporting mechanism to provide up to date data on existing, cancelled, suspended and closed BOI enterprises.

Over the years since the establishment of the BOI, a challenge has been to ensure that BOI projects enjoying tax holidays migrate to the mainstream tax fold (under the ambit of the IRD) once their tax holiday period ends. Additionally, it must be recognized that regular revenue officers are naturally less motivated to monitor the tax compliance status of BOI enterprises, as many are on tax holidays and bring in little or no revenue (which in turn impacts the officers' annual incentives). They are naturally more likely to focus their time and attention on files that actually bring in revenue. Therefore, it is imperative to have a set of officers with a specific focus, to achieve this task. This is important in order to ensure that the tax records on all enterprises are continuously monitored, so that when a project's tax holiday expires, or when it moves from a full to a partial tax holiday, the IRD is able to administer the standard tax assessment and collection procedures. The government may need to consider the establishment of a new special 'BOI Income Tax Unit' within the Inland Revenue Department. Much of this is currently handled under the Large Taxpayer Unit of the IRD, but this may not be ideal as all BOI-registered firms may not necessarily be "large taxpayers". This unit would need to consist of officers who are specially trained and thoroughly briefed to be more client-oriented in their approach, with specific guidelines on being more business-friendly.

9.3 Compliance Certification

There also appears to be a need for a more systematic and frequent monitoring of all BOI projects, to ensure that commitments signed onto in the investment agreement - for example, maintaining the agreed employment level throughout the tax holiday period, filing of income tax returns, etc. - are adhered to throughout the lifetime of the project. Currently, monitoring and evaluation is conducted largely on an ad-hoc basis, based on the imperative of the Monitoring and Evaluation Division, and is mainly focussed on investigation of enterprises that are reported to be in breach of an agreement. There is a need for a scheme that ensures this monitoring process is more methodical and frequent. To strengthen continuous monitoring, there could be a formal 'Renewable Certificate' scheme introduced. Such a scheme could be designed such that a 3-year 'Renewable Certificate' is issued at the commencement of a project, where renewing the registration of the project and continuance of the accompanying tax concessions will depend on maintaining the requirements agreed to at the time of registration. Under this scheme, if an enterprise is found in breach, the BOI would be able to take appropriate action, including revoking tax concessions offered after appropriate investigation, warning and a grace period to address issues. The Renewable Certificate scheme will ensure that there is a monitoring process which is ongoing, formalized and institutionalized.

9.4 Information Sharing

Overall, the monitoring of the performance and compliance of BOI enterprises enjoying tax concessions needs strengthening, and information sharing among relevant authorities would be a critically useful step in this regard. For instance, the BOI Monitoring and Evaluation Department could have a dedicated officer in charge of creating and maintaining a formal linkage with the IRD and Customs. This officer will carry out periodic information sharing of key data with the IRD on the tax holiday periods offered to all BOI enterprises in order to recover taxes from those that have completed their tax holiday phase and on their latest status, i.e., in commercial operation, suspended, cancelled, closed, etc. The head of the proposed BOI unit at IRD will be the key counterpart. With the Customs Department he would monitor the duty free approvals process and also any changes to the initial agreements, based on new developments during a BOI projects establishment phase. Some form of 'Cross-Agency Cells' in each of the relevant institutions - BOI, IRD and Customs - could prove useful to enabling such information sharing, where these cells would consist of an officer and/or officers from each of these institutions, to facilitate better sharing of information.

9.5 Proper Administration

The proper administration of existing taxes may well make it unnecessary to adopt other policy measures for resource mobilization. Modernizing the tax administration, improving the prevailing standards, enhancing the effectiveness of tax audits, increasing the level of taxpayer compliance, among other measures would increase confidence in the tax system. Exemption from tax or low rates of tax are of little avail if the fairness of the tax base is in doubt and little value is placed on tax relief if the income tax itself is poorly enforced. It is only in a climate where tax laws are implemented competently and without arbitrariness that policy objectives have any possibility of realization.

10. Incentivizing Foreign Investment - A Holistic Approach

10.1 Role of Non-tax Factors

Several studies and surveys have generally confirmed the theoretical expectation that incentives play only a limited role, relative to other variables, in FDI location decisions among different countries (Gergley, 2003, for example). The key finding in this literature was that while government officials and investment promotion agencies rated tax incentives high on the list of decisive factors that determine FDI decisions, executives at companies, including multinationals, did not. The lack of generous incentives in an otherwise favourable operating environment, coupled with good access to foreign markets, would not severely deter many investors.

But very little empirical evidence exists on this issue. The only recent one is an investor survey conducted in Burundi, Rwanda, and Tanzania which showed that the majority of investors were not highly motivated by tax incentives or exemptions when making investment decisions.[20] Those decisions were largely based on market potential, access to finance, reliable electricity supply and good infrastructure. Only 7.9% of all respondents in all three countries said they would not have invested without the tax and fiscal incentives they received.

Many of the government officials who feel strongly on the effectiveness of incentives are largely basing this view on their frequent interactions with investors, who often bargain hard to maximise on the incentive offering. These officials have learned that investors will bargain as hard as possible to obtain the maximum incentives available and not learnt how many investors would decide against investing in the particular country if it offered a reasonably low and transparent tax regime in general, in an overall favourable investment climate accompanied by progressive and consistent policies.

So, tax considerations are but one factor influencing a foreign investors' decision to invest. Some other factors, which have an equal or often more significant weight on the investment decision of an enterprise include:

1. consistent and stable macroeconomic policy, especially fiscal policy
2. political stability and security
3. adequate physical and financial infrastructure and legal and regulatory frameworks
4. skilled labour force and flexible, yet certain, labour regulations governing employer-employee relations and hiring and firing rules
5. availability of credible dispute resolutions mechanisms
6. foreign exchange rules and the ability to repatriate profits
7. effective, transparent and accountable public administration
8. efficient and accessible government services
9. language, cultural conditions and lifestyle considerations
10. factor and product markets

[20] "Tax incentives and exemptions not necessary to attract investment", IDS website, 20th December 2012, available at http://www.ids.ac.uk/news/tax-incentives-and-exemptions-not-necessary-to-attract-investment.

10.2 Improving the Investment Climate

For over three decades up until May 2009, Sri Lanka had been plagued by a bloody and protracted conflict. This unfortunate escalation of civil strife has had severe socio-economic consequences for the country. Since the initial outbreak of violence, despite intermittent windows of peace, perceptions pertaining to the political climate had remained largely unfavourable. In particular, investor perception deteriorated dramatically in the final stages of the conflict from about 2003. Political instability was, therefore, a major impediment to Sri Lanka's prospects of attracting FDI. Prior to the escalation of the conflict in 1983, two MNC giants in the electronics industry, namely Motorola and Harris Corporation had been particularly eager to set up export-oriented ventures in the country, to the extent that both companies had been in the process of establishing the required infrastructure to commence operations. Brewing political instability as a consequence of the escalation in violence triggered both companies to abandon their investment, leading to their subsequent withdrawal, in search of safer locations. Eventually, Malaysia proved to be the preferred destination (Athukorala, 1995).

With the ending of the civil conflict in May 2009 and the present government coming into power again with a landslide majority, it was envisaged that the renewed confidence in the Sri Lankan political climate is sustained over the longer term to better enhance the country's prospects for attracting good quality FDI. However, political stability is not the only factor that potential investors explore in their location decision. Certain other issues do matter, and this section explores some of them and Sri Lanka's performance.

Sri Lanka is a small open economy dependent on trade. Unlike FDI that would locate in large domestic markets - "market-seeking FDI" - possessing a huge consumer base (like India, for example), FDI coming to Sri Lanka are "efficiency-seeking FDI", looking for good factors enabling their operation as well as easy access to other markets. For the latter, Sri Lanka's investment climate, particularly factors affecting the efficiency of the firms' operating environment, matters.

10.2.1 Investment Climate - Trade Policy Regime

Up until the early 2000s, despite intermittent episodes of backtracking, momentum created by the first two waves of market-oriented reforms witnesses the gradual and systematic liberalization of trade. Beginning 2001, protectionist pressures had however begun to mount; by November of 2004 the relatively liberal trade policies of the preceding decades were systematically and explicitly reversed. The policy reversal has been so drastic that Pursell and Ahsan (2011), maintain that 'Sri Lanka's tariff policies [by 2009] were just as protective as they had been more than twenty years earlier' (p. 1). Being a member of the World Trade Organisation, Sri Lanka is unable to fall-back on her Most Favoured Nation tariff commitments. Rather, this trade policy reversal has been achieved under the guise and unfettered use of para-tariffs. By 2009, in addition to Customs Duties (CDs) the principal tariff levied on imports, nine other border charges and fees (i.e., para-tariffs) had been introduced. By January 2011, two of these para-tariffs have been withdrawn, however the average level of tariff protection remains significantly high (see Table A1). Whilst export-oriented ventures are exempt from CD, they are still liable to incur border charges and fee on importation of both capital goods and raw materials. This in effect is eroding their export competitiveness.

10.2.2 Investment Climate - Labour Market Policy Regime

Sri Lanka has a long history of trade unionisation and worker militancy (Athukorala and Rajapatirana, 2000b). These trade unions wield political influence and are driven by political agendas. Given the degree of politicization, historically, governments were of the view that worker protection was a central priority. Labour market policies reflected this view (UNCTAD, 2001). With the reorientation of the industrial policy, a remarkable degree of labour market flexibility was observed. As Athukorala and Rajapatirana (2000) note, 'this [had] not been an outcome of a well-conceived labour market reform process, rather it [had been] a reflection of specific political circumstances' (p.62). Successive, crushing defeats suffered by the opposition parties at elections, allowed the then incumbent government to subdue major trade union activism. This period saw the number of union registration plunge from an estimated 1,600 in 1977 to a historical low of 900 by 1987 (Athukorala and Rajapatirana, 2000b). More recently trade union activism has been reinvigorated. It is estimated that over 1,900 registered trade unions are active at present (United States Department of State, 2011). Whilst the growth of trade unions threatens to pose obstacles, the more serious and immediate impediment to investors lie in labour redundancy and associated costs. As per the Termination of Employment of Workmen (Special Provisions) Act (TEWA) of 1971, as amended, with the exception of dismissal on serious disciplinary infraction, all other employee dismissals require prior written consent from the Commissioner of Labour. It is also noted that severance pay associated with redundancy dismissal is also highly excessive, considering the levels established by her peers (see Table A2). The above detailed forms of labour market rigidities lead to two forms of difficulties for investors. Firstly, investors lack the flexibility to restructure their labour force in response to future market conditions and technological change since redundancy costs are too high. Secondly, investors are unable to assess the true cost of labour as restricting and exit costs are unknown and may be very high (UNCTAD, 2004). These impediments are particularly detrimental in attracting export-oriented FDI in labour-intensive manufacture, given that these enterprises operate in a highly volatile global environment and thus requires the flexibility to restructure their operations in response to global events to remain competitive.

As the country aims to become a regional hub and globally competitive FDI destination, it is vital for Sri Lanka to review and reformulate the labour laws to adopt global best practices, whilst also preserving workers' interests.

10.2.3 Investment Climate - Investment Policy Regime

Since the second wave of market oriented reforms, the foreign investment policy regime has increasingly been liberalized. Restrictions on foreign equity ownership have either been relaxed further or completely dismantled. With the exception of investments in the media, transportation, electricity and mining sectors, investments in all other sectors permit hundred per cent foreign equity ownership. When compared to her peers, Sri Lanka's average measures of openness to foreign equity ownership are comparatively liberal (see Table A3). Another notable area where Sri Lanka has progressed pertains to the strength of laws enacted to safeguard the interests of foreign investors (see Table A4). In other aspects of FDI regulation however, Sri Lanka is lagging well behind her peers. In terms of the time involved in setting up a fully-fledged foreign venture, the ease of establishing a foreign venture and judicial assistance extended to foreign enterprises in arbitrating commercial disputes, indicators, Sri Lanka's standing is markedly poor (see Table A4).

It is important to note the nature of macro-level averaged indicators found in global policy benchmarking exercises such as the 'Investing Across Border' report are largely based on policy declarations and legal documents and sometimes feedback from existing investors. For Sri Lanka, it however fails to reflect on the prevailing dualistic policy stance. The prevailing foreign investment approval process is marred by political considerations. Preference is extended to projects investing substantial amounts of capital and are agreeable to undertake high-levels of domestic value addition whilst ignoring a project's capability to generate employment and its export potential. The dualistic policy stance is particularly visible considering the Strategic Development Projects (SDP) Act which allows the Minister for Economic Development to extend special fiscal incentives should the Minister deem it appropriate. Priority sectors, identified under the SDP Act are largely confined to investments in relation to information technology and business process outsourcing, tourism and infrastructure. It however may undermine the potential of export-oriented manufacturing in linking Sri Lanka with the global economy.

There can also be other adverse signals to investors. In October 2011, Sri Lanka enacted legislation titled 'Revival of Underperforming Enterprises and Underutilized Assets' in Parliament. Under the Act, the control of underperforming and underutilized assets of 36 private companies is to be transferred to the government. Whilst Sri Lanka currently provides constitutional provisions against expropriation of foreign-owned assets, such legislation is bound to give an undesirable signal, undermining confidence of both domestic and foreign investors.

10.2.4 Investment Climate - Other Issues

In terms of institutional and regulatory quality indicators Sri Lanka's performance could be improved. As can be noted from Table A5, in terms of controlling corruption Sri Lanka fares better than Bangladesh, India and Vietnam, but lags significantly behind Thailand and Malaysia. Corruption adds to bureaucratic red tape which in turn, as a consequence of added costs, complexities in procedures and delays, reflects poorly in terms of the ease of doing business. The judicial system in particular is marred by excessive delays; most often investors pursue out-of-court settlements. Obtaining essential infrastructure services in Sri Lanka are subject to considerable delay, particularly in relation to its peers (see Table A6). Despite these concerns, Sri Lanka has progressed rapidly up the ranks of the World Bank Doing Business Index of 2013, leapfrogging 15 places to 81st ranking, from 96th the previous year. This positive outlook could largely be attributed to (1) the computerization of the process to obtain a registration number for the Employees' Provident Fund and Employees' Trust Fund; (2) the introduction of an electronic system at the Land Registry in Colombo to register property faster; (3) the strengthening of the country's secure transactions system by establishing an electronic, searchable, collateral registry, and (4) the implementation of the ASYCUDA World electronic data interchange system at Customs which has helped reduce the time for export.

The stated aim of the government is to position the country among the top 30 countries conducive for "doing business".[21] Yet, as highlighted in Table A7 which gives a snapshot of Sri Lanka's standing against some competitor countries, Sri Lanka ranks at the latter end for many indicators such as 'dealing with

[21] Ministry of Finance and Planning, Budget Speech 2013.

construction permits', 'registering property', 'paying taxes' and 'enforcing contracts'. In this light Sri Lanka has further scope for improvement in making doing business much more easier.

Although some of these externally generated rankings may not always accurately reflect the exact status of Sri Lanka with regard to specific indicators, they are globally recognized, widely referred, and aggressively used by investors when negotiating incentives and other exemptions. The perception and signalling role that they play are strong. Therefore, it is important for Sri Lanka to critically evaluate its standings in these rankings, if only to improve the external perception of its investment climate in order to attract more foreign investment.

11. Way Forward

11.1 Key Medium-term Challenge

The key challenge facing the government at this time is reviewing the extensive tax holidays being offered for new BOI investments in the context of the fiscal pressures faced by the government, while simultaneously not discouraging future foreign investment especially in this new growth phase when investor interest in Sri Lanka is high.

Tax holidays and other tax incentives for investment have been granted since 1977 in pursuit of greater export-oriented industrialisation, but have eroded the tax base. However, dramatic reductions in tax incentives could have an adverse impact on FDI attraction. It is claimed by the BOI that a significant scale-back of tax holidays in 1994 (without a reduction in corporate taxation to compensate it) had caused a drop in new FDI, and tax holidays had to be subsequently reintroduced. This drop was not in line with any general global slump in FDI, but it is difficult to fully assess if the FDI decline was purely and wholly due to the scale-back of tax incentives.

Taking such claims into consideration, what is advisable is that Sri Lanka looks at making tax incentives more streamlined and "smarter". Meanwhile, an important step of reducing corporate income tax rates was undertaken in Budget 2011. Tax rates for companies where taxable income was over Rs. 5 million was reduced from 35 per cent to 28 per cent, and for companies with taxable income under Rs. 5 million (Small and Medium Enterprises) rates were reduced from 15 per cent to 12 per cent.

The BOI has previously estimated that the reduction in revenue that is likely to result from a reduction in corporate income tax rates would be offset by increased revenues that may result from increased investor interest due to such lower corporate income tax rates. It estimated that a 1 per cent reduction in these tax rates could produce an approximately 2 per cent increase in FDI.[22]

Meanwhile, fixing the regulatory frameworks, streamlining business procedures and undertaking urgent reforms to improve the overall business climate will be the medium to long-term requirement to make Sri Lanka an attractive FDI destination. It is expected that once a better business climate is in place, particularly following the improvement in socio-economic stability after the end of the conflict, investors' demand for generous incentives will be less.

[22] Based on a presentation made by the BOI to the Presidential Commission on Taxation 2009.

Incentives, however, do act as powerful signals to potential investors. Particularly in a country that seeks to change its image from one that was previously not very attractive to investors due to negative factors like the war, to one that is actively seeking new investors and is actively facilitating private enterprise growth in general, and FDI in particular, the advertising of generous incentives would no doubt be a useful element in the public relations package delivered to new investors, especially those willing to undertake innovative, value-added, large capital, riskier projects.

11.2 Accountability of Tax Incentives

Currently, there is no formal mechanism for the BOI to provide to Parliament, comprehensive information on the tax concessions provided to BOI projects, an estimate of the revenue foregone from these concessions, and the estimated benefit (employment, export earnings, etc. from these projects). For the purposes of enhanced accountability and greater transparency, it must be legislated that the estimated tax revenue forgone as a result of tax concessions granted must be tabled in Parliament annually. This tabled document could be termed a 'Tax Expenditure Statement' or a 'Statement of Revenue Foregone' and must be made on clear assumptions and methodologies. It may be difficult to provide this information for projects already in existence, but this requirement could be introduced for all new projects receiving government approval. Some guidance on introducing such a requirement may be drawn from the Budget Report of the Indian Central Government, which introduced a 'Statement of Revenue Foregone' in the 2006-07 Budget, and has continued to do so since. This document estimates the revenue foregone on account of different tax incentives.

11.3 Fitting FDI into Broader Industrial Strategy

Overall, Sri Lanka must answer a key policy question and structure its incentives accordingly - what kind of investment does the country desire to attract, is the country indifferent between footloose, "fly-by-night" investment and longer-term investors who have the potential to benefit the broader Sri Lankan economy more? There is a need to give clear, futuristic policy direction with regard to FDI in particular, and industrial policy in general. The powerful signalling role that clear, coherent government policy direction provides cannot be underestimated, and this has been noted by the enterprise sector at large. Singapore took the approach not of providing incentives to simply increase overall FDI, but rather to attract investments to specific sectors, within a broader industrial policy framework and vision. Thus, the approach was not to merely increase total FDI, but rather to attract FDI that would positively influence the structure of the economy in keeping with the government's growth vision. Very generous incentives, or more simply very low tax burdens, do not by themselves attract high levels of FDI. For instance, many countries in Sub-Saharan Africa have been unable to attract a level of FDI proportionate to the generous tax holidays and other tax incentives offered to foreign investors. Nepal is another similar example. The reason for the ineffectiveness of these incentives in these countries are largely because, other than some key resource-based activities, these countries do not offer much opportunities to make profits in the kinds of activities that FDI is active in; many of them are also unstable or present other non-economic difficulties; their domestic markets are small and they are isolated from sources of both inputs and foreign markets. On the other hand, Sri Lanka does not suffer from many of these ailments. With the end of the war, firms enjoy significant political and security stability, and can potentially enjoy strong profit-making opportunities with vast new opportunities opening up, particularly in various non resource-based sectors like tourism.

Additionally, production units locating in Sri Lanka will have access to both sides of the international trade shipping routes; to the West - Gulf and the Arabian Sea, and to the East - to the growing industrialized countries of East Asia.

12. Conclusion

This paper has debated the role that tax incentives play in boosting investment in a country - particularly foreign direct investment - with special reference to Sri Lanka. It has highlighted the importance of FDI for Sri Lanka and reviewed the rationale for a government in offering tax incentives to attract more FDI. It has reviewed the international literature on the desirability and design of tax incentives as well as the, albeit limited, empirical evidence on the subject. The paper has provided a comprehensive exposition of the various tax incentives types and tools available for Sri Lanka and a review of their relative strengths and weaknesses. Importantly, this paper has put forward a set of recommendations for tightening Sri Lanka's tax incentives regime in terms of better design, implementation/administration, and monitoring and accountability.

In reviewing the vast literature on the subject, this paper concludes that the scepticism about tax incentives in boosting investment, particularly FDI, while appears warranted, the rationale for their continued use in a country like Sri Lanka with specific policy objectives following the end of a debilitating conflict can be understood.

This paper has acknowledged that given the difficulty in assessing both the costs and benefits of tax incentives, opinions on their desirability may differ. Although it is quite difficult, it is important to recognize that any cost-benefit assessment that does not go beyond the obvious costs in terms of foregone revenue and administrative costs can be very misleading.

Meanwhile, designers and administrators of tax incentives in Sri Lanka need to be very cognizant of the array of arguments and counter-arguments, the advantages and disadvantages, and the design nuances, of the various types of tax incentives options available. Simply continuing the existing type of incentives may not yield optimal policy results of increasing the foreign investment levels in the country. Taking into account new knowledge coming out from global experiences and taking into account changing realities of international investment as well as changing structures of production and industrial organization are vital to ensure that the most efficient and effective tax incentives are being employed.

Overall, while it is important to streamline, and in some instances scale back on the generous incentives offered for new foreign investments as discussed in this paper, the numerous disincentives that have been highlighted - both real and perceived -that impinge on the country's investment climate, need to be addressed simultaneously in order to protect the attractiveness of Sri Lanka as an FDI destination.

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TABLE A1

Sri Lanka: Estimated Unweighted Averages of Protection from Tariffs and Para-tariffs

	November 2002			January 2004			2009			January 2011		
	Customs Duties	Para - Tariffs	Total Protective Rate	Customs Duties	Para - Tariffs	Total Protective Rate	Customs Duties	Para - Tariffs	Total Protective Rate	Customs Duties	Para - Tariffs	Total Protective Rate
Agriculture	21.1	5.2	26.3	24.6	3.5	28.1	24.56	25.0	49.6	25.4	21.4	46.8
Industry	7.6	2.5	10.1	8.8	1.9	10.7	9.95	14.1	24.1	9.1	10.6	19.7
All Tariff Lines	9.6	2.9	12.5	11.3	2.1	13.4	12.12	15.7	27.9	11.5	12.2	23.7

Source: Ashan and Pursell (2011).

TABLE A2
Key Labour Market Indicators: Sri Lanka and Selected Asian Countries (2011)

	Difficulty of Hiring Index		Rigidity of Hours Index			Difficulty of Redundancy Index		Redundancy	
	Fixed term contracts prohibited for permanent tasks?	Maximum length of fixed term contracts (Months)	50-hour workweek allowed	Maximum working days per week	Paid annual leave (working days)	Third party approval if 1 worker is dismissed?	Third party approval if 9 workers are dismissed?	Notice period for redundancy dismissal (weeks of salary)	Severance pay for redundancy dismissal (weeks of salary)
Bangladesh	Yes	No Limit	Yes	6.0	17.0	No	No	4.3	26.3
India	No	No Limit	Yes	6.0	15.0	Yes	Yes	4.3	11.4
Malaysia	No	No Limit	Yes	6.0	13.3	No	No	6.7	17.2
Sri Lanka	**No**	**No Limit**	**Yes**	**5.5**	**14.0**	**Yes**	**Yes**	**4.3**	**54.2**
Vietnam	No	72	Yes	6.0	13.0	No	Yes	0.0	23.1
Philippines	Yes	No Limit	Yes	6.0	5.0	No	No	2.4	23.1
Indonesia	Yes	36	Yes	6.0	12.0	Yes	Yes	0.0	57.8
Thailand	Yes	No Limit	Yes	6.0	6.0	No	No	4.3	31.7
South Korea	No	24	Yes	6.0	17.0	No	No	4.3	23.1

Source: World Bank (2012).

TABLE A3
Openness on Foreign Equity Ownership (%)

Country	Mining, Oil and Gas	Agriculture and Forestry	Light Manufacturing	Telecom	Electricity	Banking	Insurance	Transport	Media	Construction, tourism and retail	Health care and waste management
Sri Lanka	40	100	100	100	71.4	100	100	60	40	100	100
Bangladesh	100	100	100	100	100	100	100	100	100	100	100
Indonesia	97.5	72	68.8	57	95	99	80	49	5	85	82.5
Vietnam	50	100	75	50	71.4	65	100	69.4	0	100	75.5
Philippines	40	40	75	40	65.7	60	100	40	0	100	100
India	100	50	81.5	74	100	87	26	59.6	63	83.7	100
Thailand	49	49	87.3	49	49	49	49	49	27.5	66	49
South Korea	100	100	100	49	85.4	100	100	79.6	39.5	100	100
Malaysia	70	85	100	39.5	30	49	49	100	65	90	65

Source: World Bank (2012).

TABLE A4
Indicators of Starting a Foreign Business and Arbitrating Disputes

Country	Starting a Foreign Business			Arbitrary Commercial Disputes		
	No. of Procedures	No. of Days	Ease of Establishment Index	Strength of Laws Index	Ease of Process Index	Extent of Judical Assistance Index
Sri Lanka	6	65	47.9	95.4	71.3	38
Bangladesh	55	9	55.3	84.9	67.5	55.3
Indonesia	12	86	52.6	95.4	81.8	41.3
Vietnam	94	12	57.9	84.9	81.8	57.5
Philippines	17	80	57.9	95.4	87	33.7
India	46	17	76.3	85.5	57.6	53.4
Thailand	9	34	60.5	84.9	81.8	93.5
Malaysia	11	14	60.5	94.9	81.8	66.7
South Korea	17	11	71.1	94.9	81.9	70.2

Source: World Bank (2012).

TABLE A5
Key Governance Indicators

Country	2007		2008		2009		2010		2011	
	CCI (Percentile Rank)	CPI (Score)	CCI (Percentile Rank)	CPI (Score)	CCI (Percentile Rank)	CPI (Score)	CCI (Percentile Rank)	CPI (Score)	CCI (Percentile Rank)	CPI (Score)
Malaysia	66.5	5.1	59.2	5.1	58.4	4.5	61.2	4.4	57.8	4.3
Thailand	43.2	3.3	42.2	3.5	47.8	3.4	46.4	3.2	44.5	3.3
Sri Lanka	56.3	3.2	51.9	3.23.2	41.6	3.1	39.7	3.2	40.8	3.3
India	40.8	3.4	44.2	3.4	37.8	3.4	35.4	3.3	35.1	3.1
Indonesia	33.5	2.8	34.0	2.6	22.0	2.8	26.3	2.8	27.5	3.0
Vietnam	34.0	2.7	28.2	2.7	39.2	2.7	32.5	2.7	29.9	2.9
Bangladesh	11.2	2.4	14.6	2.1	16.3	2.4	15.3	2.4	16.1	2.7

Source: World Bank (2013a), 2012; Transparency International (2012), Corruption Perception Index.

1. Control of Corruption Indices (CCI) - Percentile Rank (o-Worst Score; 100 - Best Score).
2. Corruption Perception Index (CPI) - (0- Worst Score; 10 - Best Score).

TABLE A6
Access to Infrastructure Services Indicators: Sri Lanka and Selected Asian Countries

Country	Dealing with Construction Permits		Obtaining Electricity		Registering Property	
	No. of Procedures	Time (Days)	No. of Procedures	Time (Days)	No. of Procedures	Time (Days)
Bangladesh	11	201	9	404	8	245
India	34	196	7	67	5	44
Malaysia	37	140	5	46	5	14
Sri Lanka	**17**	**216**	**4**	**132**	**8**	**60**
Vietnam	11	110	6	115	4	57
Philippines	29	84	5	50	8	39
Indonesia	13	158	6	108	6	22
Thailand	8	157	4	35	2	2
South Korea	11	29	4	28	7	11

Source: World Bank (2013b).

TABLE A7
Ease of Doing Business Indicators (2013)

Economy	Ease of Doing Business Rank	Starting a Business	Dealing with Construction Permits	Registering Property	Getting Credit	Paying Taxes	Enforcing Contracts	Closing a Business
South Korea	16	60	22	74	15	49	5	13
Thailand	18	85	16	26	70	96	23	58
Malaysia	12	54	96	33	1	15	33	49
Vietnam	99	108	28	48	40	138	44	149
Sri Lanka	**81**	**33**	**112**	**143**	**70**	**169**	**133**	**51**
Bangladesh	129	95	83	175	83	97	182	119
Indonesia	132	173	182	94	23	152	184	116
India	128	166	75	98	129	131	144	148
Philippines	138	161	100	122	129	143	111	165

Source: World Bank (2013b).

Tax Holidays and Concessions 2011

Activity	Tax Incentive
Tourism - Companies Concessionary Rate and Persons other than Companies	12%
Agriculture, Fishing and Construction Work	5 year tax holiday
Housing – Floor area less than 1500 sq. ft.	EXT up to 31.03.2014
Off-shore companies engaged in international shipping	EXT
Unit Trusts & Mutual Funds	10%
Sale of Gold, Gems & Jewellery	EXT
Export companies carrying on "specified undertaking"	12%
Qualified Exports of Persons other than Companies	12%
Suppliers to Exports or Indirect Exporters	12%
Supply of Services to Garment Exporters	15%
Services Rendered outside Sri Lanka by Resident Company/Partnership	EXT
Income from Manufacture in Foreign Currency	EXT
Company earning profits in Foreign Currency from Services rendered in Sri Lanka	15%
"New undertakings" specified	3-7 year tax holiday
Specified "Pioneering Undertakings"	8-10 year tax holiday
Specified Infrastructure Development Undertakings	6-12 year holiday
Specified Infrastructure Development Small Scale Projects	3-5 year tax holiday
Research & Development	3-5 year tax holiday
New Undertakings Outside Colombo and Gampaha Districts	5-10 year tax holiday
Relocated Undertakings	5 year tax holiday
Venture Capital Companies	3-5 year tax holiday
Manor Houses/Thematic Bungalows for Tourists	3 year tax holiday
Petroleum Exploration & Exploitation	12%
Trans-shipment Agency Fees	15%
Cinema Theatres	7 year tax holiday
Co-operative Societies	EXT
New Undertakings in Eastern Province	5 year tax holiday
New Undertakings in Lagging Regions	5 year tax holiday
Api Wenuwen Api Fund	EXT
Dual Citizens' Income Outside Sri Lanka	EXT
Excellence in Fine Arts, Literature, Sports	EXT up to Rs. 100,000
Foreign income of Sports Associations and International Sports Competitions in Sri Lanka	EXT

Note: EXT - exempt from income tax.