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.