Sri Lanka
State of the Economy Report 2016

Chapter 4
Fiscal Policy for Growth: Sustainable Financing for Development

by
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4. Fiscal Policy for Growth: Sustainable Financing for Development

4.1 Introduction

Sri Lanka's public finances are at a perilous state. Already weakened by years of low revenue growth and high external debt to fund a public investment-led growth process, systemic weaknesses coalesced in 2015 to put the country on the cusp of falling into a public debt triggered economic crisis. A ballooning fiscal deficit and excessive public debt accumulation has resulted in a rising debt service burden; the conduct of monetary policy and exchange rate management has been compromised in attempts to deal with the fallout of funding the fiscal deficit gap. A serious BOP crisis has been averted, at least temporarily for now, with the inevitable decision to seek assistance from the IMF in its role as 'lender of last resort'.

The risks to stability on the macroeconomic front and growth prospects are high. Indeed, Sri Lanka's post-independence history is dotted with a failure to generate surpluses in public finances, leading to structural deficits and ingrained systemic weaknesses. Not surprisingly, fiscal indiscipline and weak institutional quality has led successive governments to accumulate unsustainably high-levels of public debt. From 2010, as the country entered the ranks of a low middle-income economy, this increasingly took the form of high levels of foreign borrowing from external capital markets. The high-risk strategy failed abysmally to give the necessary attention to domestic resource mobilization efforts, with the country's revenue-to-GDP ratio in free fall over the years.

Fiscal policy reforms are fundamentally vital for Sri Lanka to navigate through this impending crisis. At the outset, public expenditure needs to be rationalized by diverting resources away from loss-making public entities and towards investments with high economic returns. Simultaneously, the government's revenue mobilizing framework should be re-evaluated in view of broadening the revenue base and maximizing revenue potential. Only fundamental reforms to public finances will guarantee a measure of macroeconomic stability and improved growth outlook.

Against this backdrop, this chapter examines the trends and patterns of Sri Lanka's fiscal policy agenda and identifies avenues for potential reform. At the outset, the chapter establishes an analytical framework to identify areas of fiscal policy reform within the context of a developing economy. An overview of Sri Lanka's fiscal position is followed by an analysis of public spending and revenue patterns. Finally, the chapter briefly discusses some key areas of potential policy intervention.

4.2 A Framework for Fiscal Policy in a Developing Country Context

Fiscal policy can play a pivotal catalyst role in the process of economic growth and development. In the short-run, counter-cyclical fiscal policy is an important tool for managing business cycle fluctuations to ensure macroeconomic stability, a fundamental prerequisite for growth. In the medium to long-term, fiscal policy, especially in a developing country context – where private sectors are less dynamic and markets either underdeveloped or missing – can play an important role in spurring economic growth. In addition to spending on essential public goods and services such as national defence and the maintenance of law and order, it has now been well recognized that public investments in both physical and social infrastructure, such as roads, ports, power plants and spending on health and education, can enhance productivity of all firms and industries, and ensure that the growth process is more inclusive.[1]

At the same time, however, the manner in which governments go about raising revenue to finance these expenditure outlays also have a bearing on growth. Mobilizing revenue through taxes can harm growth prospects, given that taxes tend to distort economic incentives and behaviour if they are ill-thought through; raising corporate income taxes for instance have a negative impact on investment. Generally, however, different taxes vary in the extent of their distortionary impacts. Likewise, financing spending through excessive accumulation of debt poses risks of macroeconomic instability in the medium to long-term; debt fuelled public investment drives can crowd-out private investments or lead to BOP issues if borrowings are sourced internationally.[2] In light of the preceding, policy makers in developing countries for decades now have grappled with the fundamental fiscal policy challenge of trying to strike the right balance between maintaining a sufficient level of public investment with a view to support growth, whilst at the same time mobilizing enough fiscal resources to finance these expenditure outlays without undermining macroeconomic stability.

4.2.1 Improving Efficiency of Public Spending

Investments made by the public sector are primarily in public or collective goods such as defence and social security, which are under-supplied through market forces due to an inherent inability within the market or increasing returns to scale.[3] Whereas public expenditure on defence and social security is seen to be necessary, its investments in other areas such as health care, education, and infrastructure are more contentious - especially regarding the scale of investment. Public investment is required to be made in light of private investment and consumption patterns in these sectors since both public and private investments compete for the same resources. Public investment decisions also tend to have a complementarity effect on private investment.

1 Gupta, S., B. Clements and G. Incuauste (eds.) (2004), *Helping Countries Develop: The Role of Fiscal Policy*, International Monetary Fund, Washington D.C.

2 *Ibid.*

3 Arrow, K. J., and M. Kruz (2011), *Public Investment, the Rate of Return, and Optimal Fiscal Policy*, Routledge, New York.

The presumed effect of government spending on economic growth can occur through its influence on consumption, investment, and transfer payments. The neo-classical school of thought argues that a shock to government consumption generates negative wealth effects.[4] It is argued that high levels of government spending lead to high levels of taxation, which consequently leads to households feeling poor. The impact on the representative household, in this instance, leads to an increase in labour supply, reducing consumption and lowering real wages. Contrastingly, neo-Keynesian thought posits that government spending causes an outward shift in the demand for goods, due to the presence of nominal rigidities, or countercyclical mark-ups.[5] Moreover, government spending is also seen as a positive influencer on growth due to increasing returns to scale.[6]

Macroeconomic stability is an essential prerequisite for strong and lasting growth, both in developed as well as developing countries. Unviable feasible fiscal policy measures that result in high levels of public debt hamper growth by increasing uncertainty, over-taxation, crowding out private investment, and weakening a country's resilience to shocks. As growth friendly reforms require fiscal space, revenue measures should ideally focus on broadening the tax base and minimizing distortions, while expenditure measures should aim at rationalizing spending and improving efficiency.[7]

Unlike industrialized economies, the budgets of developing economies are typically smaller (as shares of GDP). Moreover, while most of their revenue is gained through indirect taxes, the biggest share of government spending is accounted through the consumption of goods and services. Among spending on public goods and services, payment of public sector wages accounts for a significant proportion. The effectiveness of public spending is heavily dependent on its composition and developing countries are often seen to misallocate resources, whereby seemingly productive expenditure may become unproductive due to an excessive amount of them.[8]

Public spending on infrastructure, education, health, and pensions play an important role in determining the developmental impact of fiscal policy. Infrastructure spending can occur as recurrent expenditure, directly through the government budget or as part of an investment made by an SOE. Public investment in infrastructure considers two components that have diverging relationships with each other. The rationalization of public finances for public goods such as roads is wholly different to that of the utility subsector and travel infrastructure such as railways. For utilities, the basic public finance commitment should be to: (i) compensate for operational expenses that cannot be funded by tariffs - namely, public service obligations and essential service to users genuinely unable to pay, and (ii) create fiscal space for necessary investments where

4 Baxter, M., and R. King (1993), "Fiscal Policy in General Equilibrium", *American Economic Review*, 83(3).

5 Perotti, R. (2007), "Fiscal Policy in Developing Countries: A Framework and Some Questions", World Bank, Washington D.C.

6 Devereux, M. B., *et al*. (1996), "Monopolistic Competition, Increasing Returns, and the Effects of Government Spending", *Journal of Money, Credit and Banking* , 28(2).

7 IMF (2015), *Fiscal Policy and Long-Term Growth,* International Monetary Fund, Washington D.C.

8 Devarajan, S., *et al*. (1996), "The Composition of Public Expenditure and Economic Growth", *Journal of Monetary Economics,* 37(2).

these also cannot be covered by tariffs, ideally through medium or long-term loans to be repaid by the utility revenues, or through loan guarantees.[9] However, the inability of service providers to achieve commercial viability leads to governments assuming even more, and often unsustainable, financial commitments.

For example, some studies note that public investment in transport and communications in developing countries leads to higher economic growth.[10] Similarly, others find that higher infrastructure quantity and quality reduces income inequality.[11] Comparatively, these positive effects of infrastructure investments and economic growth are more pronounced in developing countries than in developed countries. However it is important to note that the positive effect on a country's developmental prospects is dependent on investing in infrastructure that can have high rates of return for the investment. Infrastructure spending on non-viable or 'white elephant' projects may increase the financial burden of governments to unsustainable levels, and reduce the scope for more efficient public investments as well.

Public investment in the education sector is universally considered to be positively associated with economic growth. For example, across countries, more schooling is observed to result in higher individual earnings, with a rate of return of approximately 10 per cent per additional year of schooling.[12] In addition to private returns of investment in education, positive externalities associated with a more educated citizenry leads to positive social returns as well. Improvements in education levels are seen to reduce crime rates, improve health standards, and increase labour force participation.[13]

Moreover, investment in education affects labour productivity, improve an economy's innovative capacity, and increase the ability to replicate technology created abroad.[14] However, returns of public investment in education are not wholly dependent on continued increases in spending, but rather, focus on efficient spending. Middle-income countries, in particular, require investments in education that fulfill the needs of the economy that bridge the skills gap between demand and supply of labour.[15] In addition to efficiency, the inter-sectoral allocation of public spending, private education spending, and governance are also considered to be influential factors in influencing the link between public investment in education and education outcomes.[16]

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9 *Ibid.*

10 Easterly, W., and S. Rebelo (1993), *Fiscal Policy and Economic Growth: An Empirical Investigation,* National Bureau of Economic Research, Cambridge.

11 Serven, L., and C. Calderon (2004), *The Effects of Infrastructure Development on Growth and Income Distribution,* World Bank, Washington D.C.

12 Psacharopoulos, G., and H.A. Patrinos (2004), “Returns to Investment in Education: A Further Update”, *Education Economics*, 12(2).

13 See Lochner, L., and E. Moretti (2004), “The Effect of Education on Crime: Evidence from Prison Inmates, Arrests, and Self-Reports”, *American Economic Review* , 94(1); Currie, J., & Moretti, E. (2003), “Mother’s Education and the Intergenerational Transmission of Human Capital: Evidence from College Openings”, *The Quarterly Journal of Economics*, 118(4); Bowen, W. G., and T.A. Finegan (2015), *The Economics of Labour Force Participation,* Princeton University Press, Princeton.

14 Hanushek, E. A., and L. Wössmann (2007), *Education Quality and Economic Growth,* World Bank, Washington D.C.

15 Eichengreen, B., *et al*. (2013), *Growth Slowdowns Redux: New Evidence on the Middle-Income Trap,* The National Bureau of Economic Research, Cambridge.

16 Abu-Ghaida, D. (2007), “Education”, in C. Gray, *et al*., *Fiscal Policy and Economic Growth: Lessons for Eastern Europe and Central Asia,* World Bank, Washington D.C.

While better health standards positively influence economic growth and reduce inequality, public spending on health and health outcomes are tenuously related. Studies note that an increase in health spending by 1 percentage of GDP results in a rise in the under-5 survival rate by 0.2 percentage points.[17] The World Bank's World Development Report 2004 also notes that efficiency (organization and allocation of spending) and effectiveness (capacity and governance) are influential factors in the relationship between public spending and health outcomes. Furthermore, it is important to note that successfully implemented public health initiatives related to issues such as smoking, alcohol consumption, and education on HIV/AIDS also results in positive effects on the economy.

4.2.2 Challenge of Mobilizing Revenue Resources

Governments have at their disposal a number of sources to mobilize revenue which could be broadly categorized into debt, non-debt capital, foreign aid and other unilateral grants, non-tax revenue including resource rents, seigniorage and taxes, of which a governments' own fiscal revenue pool is typically derived from taxes, non-tax revenue and seigniorage. In most economies, domestic and international taxes of goods and services followed by personal and corporate income taxes form the core sources of government revenue. In addition to these, governments also apply a number of taxes in the form of levies. The most important sources of non-tax revenue typically materialize in the form of requited payments including revenue from assets exploitation (fees, charges, royalty, dividend, interest, auction proceeds, sales of goods and services such as fees and user charges, and sales of licences for regulated activities such as licensing fees, permits, and registration fees). Fines and penalties are also amongst some of the widely utilized non-tax revenue sources.[18] The evidence thus far, however, suggests that many developing countries have tended to underutilize instruments of non-tax revenue. Whilst governments have at their disposal an array of instruments to mobilize fiscal revenue, the choice of instruments has a bearing on growth.

Minimizing distortions in the tax system is vital. Throughout history, taxation has been the instrument of choice for governments in mobilizing their own revenue. Whilst raising revenue is the core objective of any tax system, one of the central challenges confronting developing country governments is to design a tax system that mobilizes sufficient tax revenue to sustainably finance expenditure needed for growth and poverty alleviation, and to do so in a way that does not in itself undercut objectives by unduly worsening pre-existing distortions or inequities.[19] Furthermore, many characteristics of developing economies, such as large informal sectors make the problem of revenue mobilization through taxes particularly challenging. The agricultural sector, in particular is hard to tax in all countries, for both practical and political reasons. Likewise, the capacity of potential taxpayers to comply with tax rules and of the authorities to administer them is another

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[17] Baldacci, E., *et al*. (2003), "More On The Effectiveness of Public Spending on Health Care and Education: A Covariance Structure Model", *Journal of International Development*, 15(6).

[18] Gupta, D. (2015), "Fiscal Resources for Inclusive Growth", in Park, D., *et al*. (eds.), *Inequality, Inclusive Growth and Fiscal Policy in Asia*, Asian Development Bank and Routledge, New York.

[19] IMF (2011), *Revenue Mobilization in Developing Countries,* International Monetary Fund, Washington, D.C.

challenge. Moreover, many of them are themselves likely to be affected by the tax system in force. For instance, heavy taxation of the formal sector will tend to encourage growth of the informal sector, and an inappropriate tax design may provide further opportunities for corruption.[20] All these features constrain effective taxation. Different taxes vary in terms of their long-term efficiency and equity effects. As such employing the right mix of tax instruments to suit individual country characteristics are critical to ensure that the tax system generates sufficient revenue at minimum costs.

Another important aspect to be kept in mind is the growth and distributional effects of taxes. As noted earlier, taxes tend to distort economic incentives and behaviour. Any change in the taxation system would require a change in the base or rate of some taxes. Firms and households would then respond by shifting resources from highly taxed activities to lesser taxed ones. When market prices reflect social costs and benefits reasonably well, this poses a trade-off between revenue and efficiency. Sometimes market prices may not reflect social costs and benefits; taxes can then improve the allocation of resources, but only if market imperfections can be quantified so as to guide the design of the tax structure. As a rule, the economic cost of taxation increases more than proportionately with the rate of taxation. The narrower the base, the higher the tax rate will have to be to generate a given amount of revenue. This is one of the strongest arguments in favour of broad based taxes.[21]

Furthermore, different taxes have varying impacts on growth. For example, in the OECD, corporate income tax (CIT), followed by personal income tax (PIT) are found to be the most distortive taxes for long-term growth, whilst consumption taxes followed by property taxes are least damaging.[22] Likewise, lower CIT rates are found to be associated with faster growth, including in non-OECD countries.[23] These findings support the theory that taxation of capital income has a potentially strong negative impact on investment. In addition to growth effects, taxation also has distributional consequences. Progressive personal tax rates and consumption tax rates are good examples. The issue here is one of the trade-off between growth costs and redistribution benefits. Thus, countries must seek to strike a mix of tax instruments in their bid to minimize adverse effects on growth.

4.2.3 Risks of Debt Financing

As noted earlier, in addition to a government's own source of finances, fiscal expenditures can be financed through debt. Debt financing does have its own merits and demerits. Assuming that returns from a project financed through debt are higher than the interest payment, debt-financed investments have the potential to spur economic growth. However, the strategy is fraught with risk since adequate levels of revenue from a project may not be created. In

[20] Tanzi, V. and H. Zee (2000), "Tax Policy For Emerging Markets: Developing Countries", IMF Working Paper WP/00/35, International Monetary Fund, Washington, D.C.

[21] World Bank (1988), *World Development Report: Opportunities and Risks in Managing the World Economy - Public Finance in Development*, World Bank, Washington D.C.

[22] Arnold, J. (2008), "Do Tax Structures Affect Aggregate Economic Growth? Empirical Evidence from a Panel of OECD Countries," OECD Economics Department Working Paper No. 643, Organization for Economic Cooperation and Development, Paris.

[23] Lee, Y. and R.H. Gordon (2005), "Tax Structure and Economic Growth," *Journal of Public Economics*, Vol. 89(5).

addition, it is particularly important to note that high public debt has a tendency to hamper growth given that it increases uncertainty over future taxation, leading to a crowding out of private investment, and weakening a country's resilience to shocks.

Theoretical literature on the relationship between the stock of external debt and growth has largely focused on the adverse effects of 'debt overhang'. Debt overhang is defined as a situation where the expected repayment on external debt falls short of the contractual value of debt.[24] If a country's debt level is expected to exceed its repayment ability with some probability in the future, expected debt service is likely to be an increasing function of the country's output level. Thus, some of the returns from investing in the domestic economy are effectively 'taxed away' by existing foreign creditors, and investment by domestic and foreign investors - and thus economic growth - is discouraged.[25]

Figure 4.1
Fiscal Deficits and Public Debt

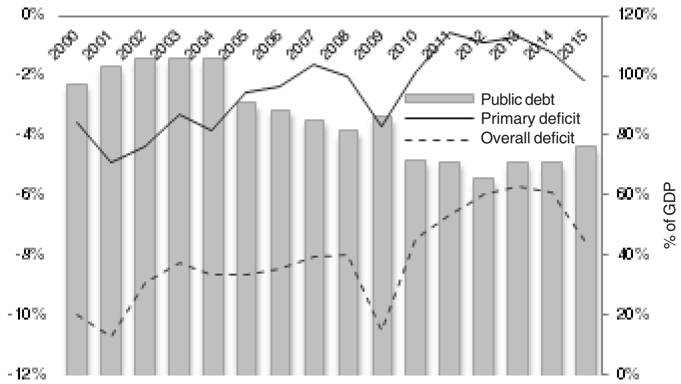
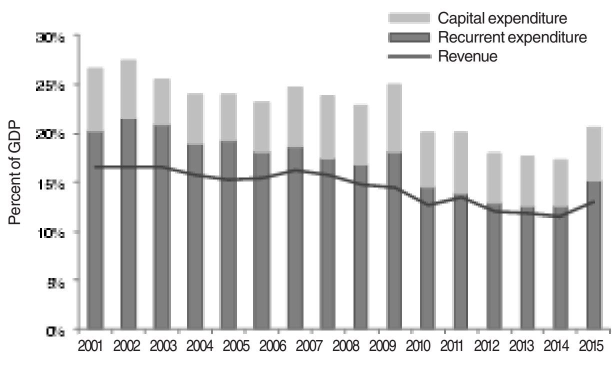


Figure 4.2
Revenue and Expenditure



Source: Estimated using data from Ministry of Finance and Planning, *Annual Report,* Colombo, various years.

Government revenue mobilization efforts have failed to even adequately cover public recurrent expenditure needs, let alone capital investment requirements.

[24] Krugman, P. (1988), "Financing vs. Forgiving a Debt Overhang", National Bureau of Economic Research Working Paper No. 2486, Cambridge.

[25] IMF (2011), *Revenue Mobilization in Developing Countries*, International Monetary Fund, Washington D.C.

Debt overhang also depresses investment and growth by increasing uncertainty. As the size of the public debt increases, there will be growing uncertainty about actions and policies that the government will resort to in order to meet its debt servicing obligations, with adverse effects on investment. In particular, as the stock of public sector debt increases, there may be expectations that the government's debt service obligations will be financed by distortionary measures. External debt service (in contrast to the total debt stock) can also potentially affect growth by crowding out private investment or altering the composition of public spending. Other things being equal, higher debt service can raise the government's interest bill and the budget deficit, reducing public savings; this, in turn, may either raise interest rates or crowd out credit available for the private investment, dampening economic growth. Higher debt service payments can also have adverse effects on the composition of public spending by squeezing the amount of resources available for infrastructure and human capital, with negative effects on growth.

Amidst extensive research on debt and growth, there is no consensus on the optimal level of public debt. Yet, numerous studies recognize that a nonlinear relationship between debt and growth exists. Increases in debt at a higher level tend to affect growth more negatively than the same debt increase at a lower level of debt. In their seminal study, Reinhart and Rogoff (2010) find that countries with debt above 90 per cent of GDP experience significant weakening of growth.[26] Other studies also find similar nonlinearity at the same level of debt.[27]

4.3 Overview of Sri Lanka's Fiscal Position

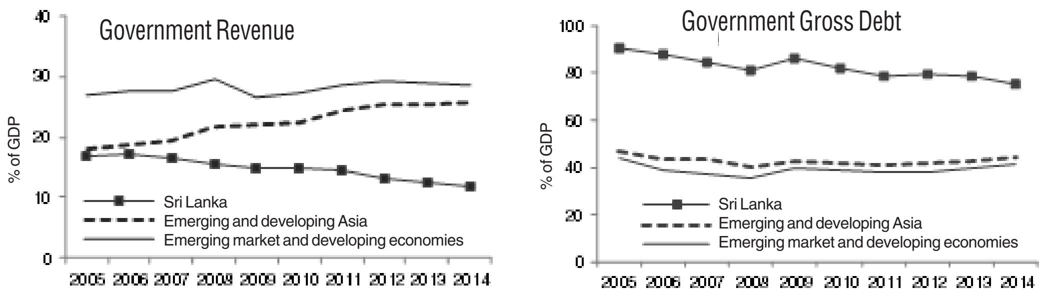
Throughout Sri Lanka's post-independence history, successive Sri Lankan governments have racked up unsustainable fiscal deficits. The implementation of the Accelerated Mahaweli Development Project during the period 1978-1983, in tandem with the first wave of economic reforms, saw the fiscal deficit balloon into unsustainably high double-digit levels, where the deficit peaked to 19.2 per cent in 1980. The second highest deficit of 12.7 per cent was recorded in 1988, which marked the commencement of a fiscal stabilization programme under a second wave of economic reforms. Despite some improvements as shown in Figure 4.1, deficits have continued to average 7-8 per cent of GDP with knock-on effects on other critical areas of macroeconomic policy management, most notably fuelling high and volatile rates of inflation. With rising fiscal imbalances, the country's indebtedness also rose - peaking most recently at 105 per cent of GDP in 2002 - narrowing the options for policy manoeuverability and limiting the ability to respond appropriately to domestic and external shocks.

Figure 4.1 also shows that the government has been a continuous dis-saver, running primary deficits in the range of 2-3 per cent of GDP. This reflects the fact that government revenue mobilization efforts have failed to even adequately cover public recurrent expenditure needs, let alone capital investment requirements (Figure 4.2).

[26] Reinhart, C. M., and K.S. Rogoff (2010), *Growth in a Time of Debt,* National Bureau of Economic Research, Cambridge.

[27] Kumar, M. S., and J. Woo (2010), *Public Debt and Growth,* International Monetary Fund, Washington D.C.

Figure 4.3
Comparative Trends in Government Revenue and Debt



Source: IMF, World Economic Outlook database.

Reforms towards more efficient public finance management have been sporadic and largely ineffective. In 2003, the government enacted the Fiscal Management Responsibility Act, aimed at containing the size of both the fiscal deficit and public debt. However, in the aftermath of the December 2004 tsunami that necessitated a sharp increase in expenditures for reconstruction and rehabilitation, the targets set by the Act were largely ignored. On a more positive note, reporting requirements saw some improvement with the Ministry of Finance tabling mid-year reviews on performance.

Since 2009, Sri Lanka appears at first glance to have made some headway in reversing the country's fiscal fortunes. The fiscal deficit fell progressively to 5.4 per cent of GDP in 2013, while the public debt-to-GDP ratio too climbed down steadily to around 70 per cent of GDP. However, the explanation for this lies in more robust nominal GDP growth over the same period than any underlying efforts at addressing structural weaknesses in fiscal policy management.

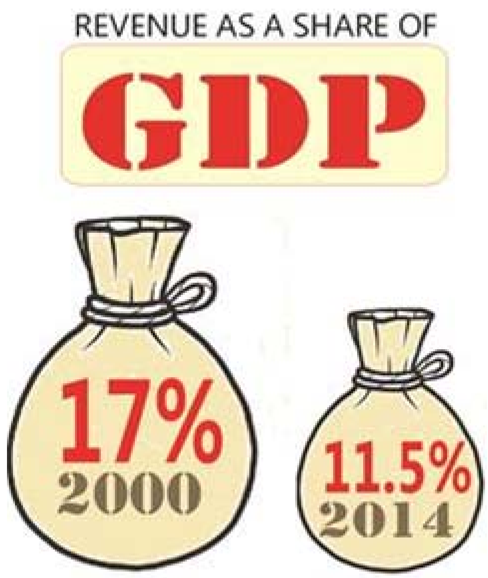
As could be observed from the Figure 4.3, Sri Lanka's fiscal position in comparison with other developing and emerging market economies is poor. Government revenue generation is well below the desired level, while the government debt burden is much higher than countries at similar levels of development.

Sri Lanka's fiscal position in comparison with other developing and emerging market economies is poor.

4.3.1 Trends and Patterns of Tax Revenue Generation

The bulk of Sri Lanka's tax revenue is sourced through indirect taxes, followed by direct taxes and non-tax revenue (Figure 4.4). Whilst the share of direct taxes has remained more or less unchanged over the years, revenue from indirect taxation and non-tax sources have declined significantly over the years which has contributed to the poor revenue collection performance.

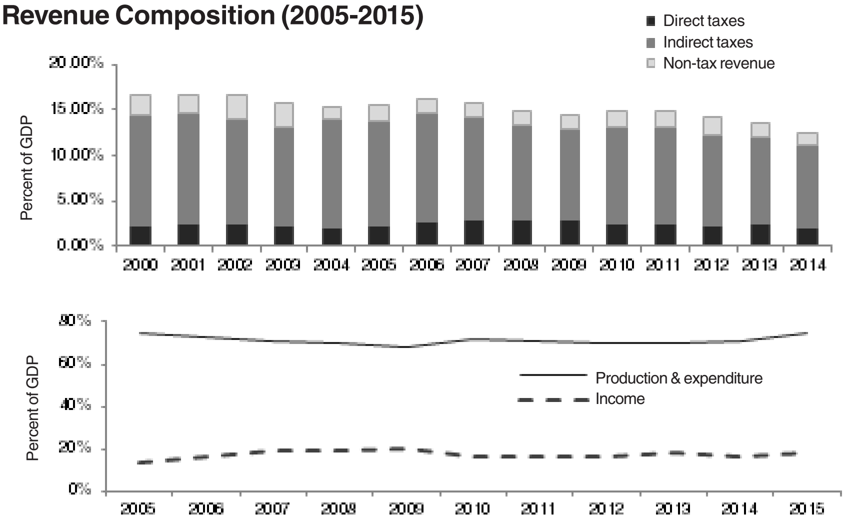
The 'progressivity' of Sri Lanka's taxation system however has improved marginally. The share of taxes on income has begun to trend upwards since around 2010. Nonetheless, this is not truly reflective of the underlying taxation principles adopted, given that the regressivity of taxes such as VAT and import duties have been minimized through exemptions on basic consumption commodities as well as imposing high duties on items considered to be of a 'luxury' nature, etc. Indirect taxes currently make up 80 per cent of total revenue; the government has



announced intentions to reverse this over time to a ratio of 60:40 as indirect and direct sources of tax revenue.

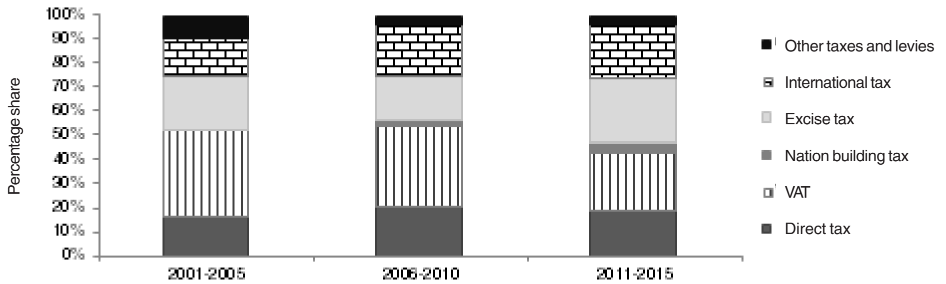
Revenue as a share of GDP has declined persistently from around 17 per cent in 2000 to a historic low of 11.5 per cent in 2014 (see Figure

Figure 4.4
Revenue Composition (2005-2015)



Source: Estimated using data from Ministry of Finance and Planning, *Annual Report,* Colombo, various years.

Figure 4.5
Breakdown of Tax Revenue by Instrument, 2000-2015



Source: Estimated using data from Ministry of Finance and Planning, *Annual Report,* Colombo, various years.

4.2). This is despite a steady rise in per capita income in the country over the same period. As noted earlier, consistent with the characteristics of a developing economy, the bulk of Sri Lanka's tax revenue is sourced through indirect taxation, Value Added Tax (VAT) and a Nation Building Tax (NBT) being the main indirect tax sources (Figure 4.5). There has been a significant drop in revenue generated from VAT, from a high of 5.9 per cent of GDP in 2004 to a historic low of 2.6 per cent of GDP by 2015 which has been a major contributory factor behind the steady decline in the tax-to-GDP ratio over the last decade.

In terms of the direct tax revenue, corporate income tax accounts for the major portion of direct taxes, followed by taxes on interest income and personal income tax. Revenue generated from direct taxes has remained stagnant over the past decade. In an ideal scenario revenue from direct taxes should increase given the progressive nature of such taxes; however, in Sri Lanka's case, despite the high growth rates enjoyed by the country over the past decade, tax revenue mobilization from direct tax sources have been stagnant. Sri Lanka has a long history of offering tax incentives as an instrument to attract investments with limited success, which has also led to the erosion of the tax base and complicated the tax structure further (Box 4.1).

It is important to note that revenue from trade taxes and excise taxes has helped off-set the decline in indirect tax revenue to a large extent. Whilst there was a decline in revenue generated through Customs duties as a consequence of greater trade openness up to 2003, a more restrictive trade policy outlook post-2004 through the application of a less transparent para-tariffs regime - the Port and Airport Levy (PAL), CESS and a Special Commodity Levy - have off-set the fall in Custom duty revenues and contributed significantly to the overall growth of trade tax revenue. In terms of excise taxes, whilst taxes collected from tobacco and liquor account for the lion share of excise revenue, there has been a notable increase in excise collected on motor vehicle sales.

The inability to reverse the country's weakening revenue base comes despite a slew of recommendations to address tax administration and policy under a 2010 Presidential Commission on Taxation. The implementation of reforms at best has been ad hoc and incomplete, weakening overall public finance management in the country.

Box 4.1
History of Tax Incentives in Sri Lanka

Sri Lanka has a long history of offering tax incentives to attract investment dating back to the heights of the import substitution industrialization era. Up until 1977, 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 (IRD).

With the shift towards a market led growth strategy and the emphasis on attracting FDI to catalyze the export sector, tax incentives were offered to foreign investors setting up operations within designated free trade zones owned and operated by the Greater Colombo Economic Commission (GCEC). The amalgamation of the GCEC and the Foreign Investment Advisory Council (FIAC) to form the Board of Investment in 1992, saw the BOI being vested with powers to grant tax incentives to foreign investors. The BOI Act superseded the provisions set out in the Inland Revenue Act with regard to tax incentives offered to BOI projects. Projects receiving 'BOI status' were granted generous income tax concessions and Customs duty exemptions, subject to meeting criteria based on the size of investment, export orientation and employment generation. This however created a dichotomy between local and foreign investors. Thus, recognizing the 'uneven playing field', the government extended BOI tax incentives to local companies from the early 1990s.

In 2006, the government introduced the Nipayum Sri Lanka, 300 enterprise programme which offered a special tax incentive package to investors setting up enterprise outside the Colombo and Gampaha districts. 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 were granted both under the BOI and under the IRD, and new projects had the option of availing themselves of either, not both.

Sri Lanka took an important step in streamlining tax incentives through the Budget 2011. All tax incentives offered related to corporate income tax were written into the Inland Revenue Act. From there onward, tax incentives for new projects are 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.

In the 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.

In addition to tax incentive offered under the BOI Act, successive government budgets over the years have seen the introduction of tax incentives targeted at SMEs. Incentives include pre-establishment cost write-offs, tax holidays for both new investments and expansions ranging from 3-6 years depending on the volume of investment, triple deductions on R&D expenditure undertaken by SMEs and VAT and duty exemptions for selected manufacturing activities such as handlooms, agriculture processing, fisheries, poultry and rice milling to name a few.

4.3.2 Trends and Patterns of Public Expenditure

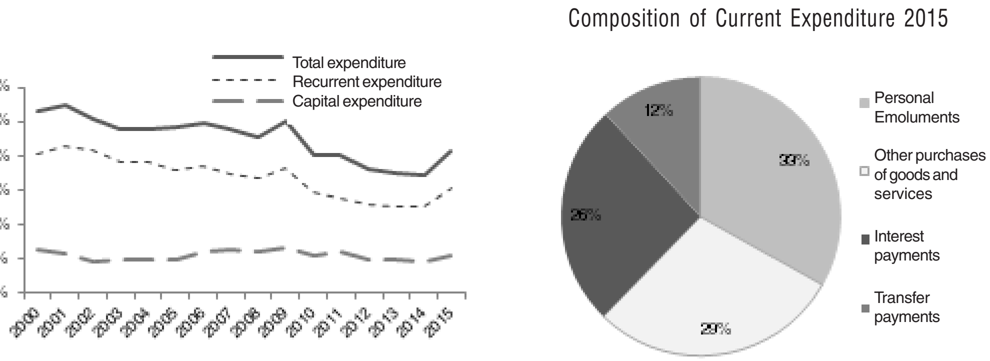
As evident from Figure 4.6, Sri Lanka has seen a steady decline in fiscal expenditure from a high of nearly 27 per cent of GDP in 2000 to 17.2 per cent in 2014. This has come about through a better mix of expenditure, focused on restraining current spending whilst accelerating capital investment.

The bulk of Sri Lanka's fiscal expenditure over the past decade has been expended on financing recurrent government expenditure. Whilst this figure has been falling over the years, it still accounts for a significant portion of expenditure outlays. The composition of current expenditures - primarily made up of salaries and wages, interest payments on public debt, and transfers and subsidies - has hardly changed either, underlying the lack of meaningful reform efforts in public finance management.

Of the three main recurrent expenditure categories, reform initiatives have hardly touched on the country's large public sector or subsidies and welfare measures in place. This is despite the fact that in the case of the latter, a host of subsidies (e.g., fertilizer) and transfers (e.g., Samurdhi) where issues of targeting and the effectiveness of outcomes have been subject to considerable debate.[28] Public finances are heavily burdened by a non-contributory pension scheme, whilst at the same time leaving a large share of Sri Lanka's elderly and vulnerable population without adequate means of social protection.[29]

Sri Lanka has a large and growing cadre of public sector employees, estimated to account for approximately 15 per cent of the total

Figure 4.6
Government Expenditure Trends (2000-2015)



Source: Estimated using data from Ministry of Finance and Planning, *Annual Report,* Colombo, various years.

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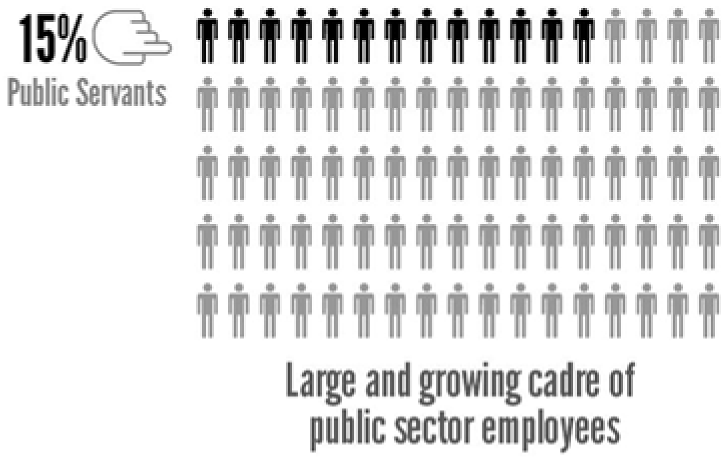
28 Tilakaratna, G., A. Galappattige and R. Jayaweera (2013), "Safety Nets in Sri Lanka: An Overview", report prepared for the World Bank, Colombo.

29 IPS (2015), "Reforming Sri Lanka's Social Protection System" in *Sri Lanka: State of the Economy 2015*, Institute of Policy Studies of Sri Lanka, Colombo.



employed in 2015. Aside from the heavy fiscal recurrent expenditure burden of salaries and a non-funded public sector pension scheme, the Treasury must also grapple with transfers to loss making SOEs.

Sri Lanka currently hosts 245 SOEs under different legal structures such as statutory bodies, limited companies, subsidiary firms, and even government departments. As Table 4.1 illustrates, several loss-making and non-functional SOEs rely heavily on the government budget for recurrent expenditures. Most of the minority share-holding companies fail to pay dividends to the government and accrue heavy debts, which have impacts on bank performance, and an unusual accumulation of inter-SOE debts as well. Among the 245 SOEs, the government has identified 55 SOEs as strategically important. Eleven SOEs among these too have incurred heavy losses - especially in the commercial operations of the energy, aviation, commuter transport, and plantations sectors.

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Table 4.1
Profitability of Selected SOEs (Rs. mn.)

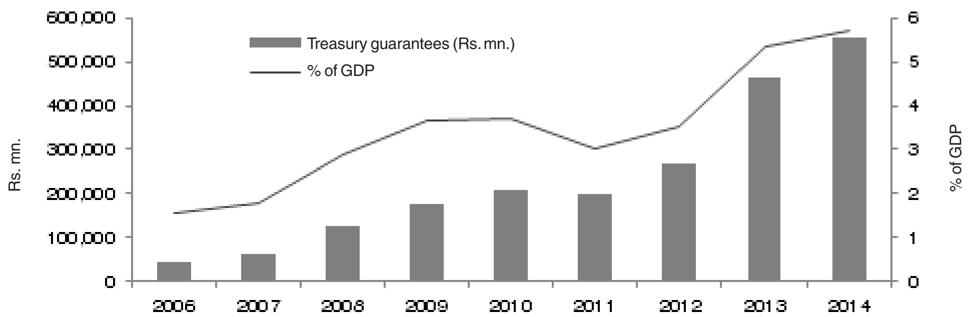
Enterprise	Profit/(Loss)				Budgetary Support (2014)	
	2005	2012	2013	2014	Recurrent	Capital
Sri Lankan Airlines Ltd	480	(21,751)	(32,358)	(16,181)	-	-
Ceylon Electricity Board	(6,852)	(61,447)	22,945	(13,303)	-	16,793
Sri Lanka Transport Board	(1,119)	(2,964)	(10,640)	(9,407)	6,965	1,597
Mihin Lanka (Pvt) Ltd		(2,866)	(2,566)	(1,187)	-	6,528

Source: MOFP, *Annual Report 2014*, Ministry of Finance and Planning, Colombo.

In addition to direct budgetary assistance, in order to sustain the operation of SOEs, the government has also resorted to issuing Treasury guarantees. Sri Lanka's Fiscal Management Responsibility Act of 2003 capped such contingent liabilities at 4.5 per cent of GDP; this was amended and raised to 7 per cent in 2013. Contingent liabilities have increased sharply from 1.6 per cent of GDP in 2006 to 5.7 per cent of GDP in 2014 (Figure 4.7).

These contingent liabilities, therefore, effectively increase the level of government liabilities. As Table 4.2 indicates, many non-revenue generating entities that previously depended on fiscal transfers have resorted to direct borrowing with Treasury guarantees. Among state institutions issued with government-backed guarantees, the Ceylon Petroleum Corporation (CPC) has been issued the most contingent liabilities. Moreover, the Road Development Authority (RDA) has also been granted significant guarantees. This indicates the vicious cycle associated with the subsidization of loss-making SOEs and their impact on ancillary institutions. For instance, the CPC continues to provide fuel to loss-making enterprises such as SriLankan Airlines, Mihin Lanka, and the Ceylon Electricity Board (CEB) that are consequently unable to fulfil financial obligations. In turn, the CPC absorbs a financial loss that is eventually borne by the state.

Figure 4.7
Treasury Contingent Liabilities



Source: MOFP, *Annual Report*, Ministry of Finance and Planning, Colombo, various years.

Table 4.2
Contingent Liabilities Granted to Select Government Agencies, 2014

	Value (Rs. mn.)	Capital on Treasury Guarantee (Rs. mn.)
Airport and Aviation Service Ltd	32,587.23	445.46
CEB	17,985.11	13,876.05
CPC	206,426.00	205,950.00
CPC Storage Terminals Ltd	4,634.50	2,374.50
Lakdhanavi Ltd	5,984.00	5,984.00
Ministry of Defence and Urban Development	7,550.00	7,017.59
National School and Business Management Ltd	8,600.00	2,856.46
Paddy Marketing Board	6,493.00	6,377.01
People Bank Pension Trust Fund	5,000.00	5,000.00
RDA	97,961.81	71,560.45
Sir John Kotalawala Defence University	27,726.39	27,152.53
UDA	21,372.37	21,222.37
West Coast Power	21,993.75	11,184.08
Total	**465,784.03**	**382,261.20**

Source: MOFP, *Annual Report 2014*, Ministry of Finance and Planning, Colombo.

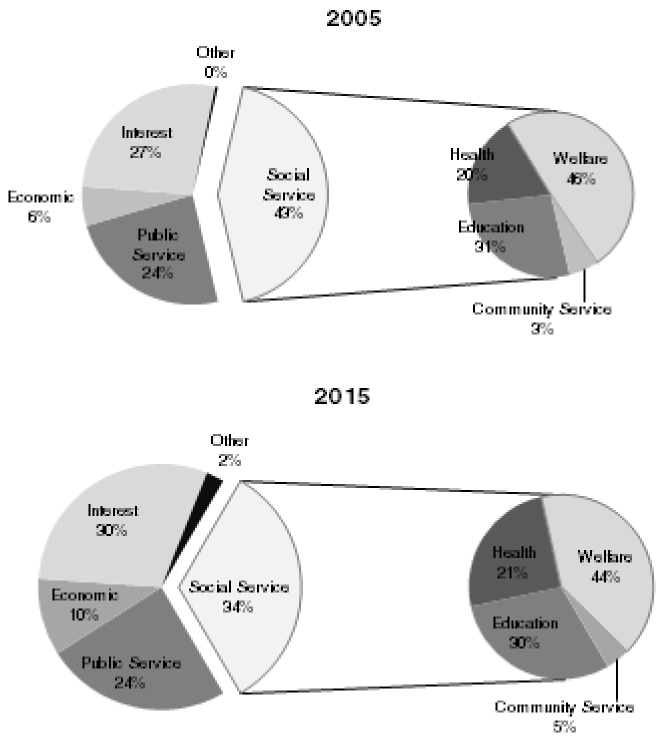
In critical areas for funding such as education and health, the share of public expenditures as a percentage of GDP has been declining. For example, current expenditure on health and education as a share of total government current expenditure has remained the same (Figure 4.8).

Adequate investments in health and education are important not only to ensure a skilled and productive work force, but also to meet broader objectives of socio-economic development and equity. Available evidence suggests that although, education and health services are provided free of user fees, households on average spend 6.2 per cent of their monthly expenditure on health and education.[30] Further, these incidence of out-of-pocket expenditure on health and education is regressive, indicating that this could contribute to widening the existing inequalities in quality and access to these services.

In contrast to recurrent expenditures, there has been a significant change in Sri Lanka's capital investment profile. Sri Lanka's public investment lagged behind for years as other expenditure priorities, particularly spending on defence, took precedence during three decades of armed conflict. This clearly is costly for long-term sustained growth; inadequate attention to

[30] Arunatilake, N., N. Attanayake and P. Jayawardena (2010), "Equitability in Education and Health Services in Sri Lanka", report prepared for the Asian Development Bank, Manila.

Figure 4.8
Breakdown of Current Expenditure, 2005 and 2015



Source: MOFP, *Annual Report*, Ministry of Finance and Planning, Colombo, various years.

Since becoming a lower middle-income country, Sri Lanka has become less qualified for concessional loans, and issues pertaining to debt accumulation and repayments have become more acute.

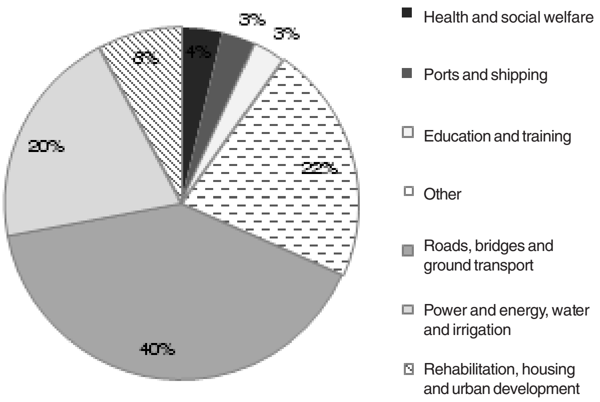
capital spending, especially in investments that have higher returns, reduces the government's capital formation and consequently inhibits the development potential of the country.

Capital expenditure, in non-military productive purposes, is seen to create multiplier effects that stimulate growth and expand economic activities in the private sector in the medium to long-run. As previously noted, capital spending was raised to an average of 6 per cent of GDP post-2006 in support of the government's infrastructure investment led growth strategy. While some projects were clearly justifiable, there were also many that will perhaps not generate returns to repay costs incurred. Given that the bulk of public infrastructure investment was financed through external borrowing, the long-term fiscal implications on debt financing is increasingly of growing concern.

4.3.3 Public Debt and Debt Servicing

Successive governments have pursued debt-financed investment as well as debt-financed consumption through both domestic and foreign means of borrowing. For example, the Accelerated Mahaweli Development Programme (AMDP) was mainly a foreign debt-financed investment. Such policy prescriptions led to the accumulation of debt that amounted

Figure 4.9
Composition of Foreign Debt Expenditure, 2005-2014



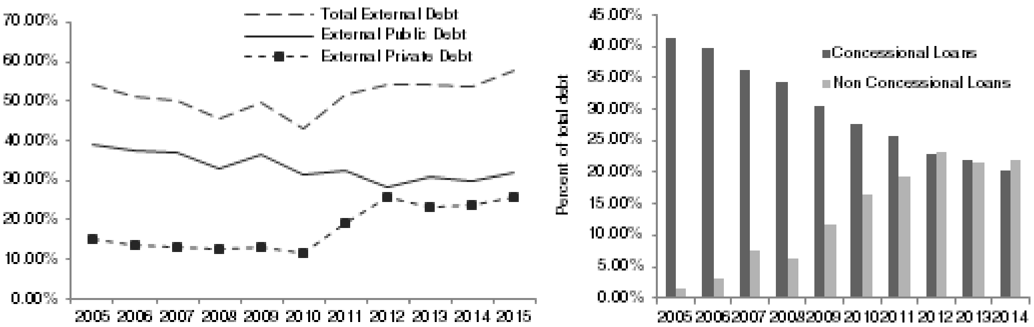
Source: Estimated based on data from MOFP, *Annual Report*, Ministry of Finance and Planning, Colombo, various years.

to 105 per cent of GDP in 2002. Notably, as a low-income country, Sri Lanka was granted access to concessional foreign loans with long repayment periods and low interest rates. However, since becoming a lower middle-income country, Sri Lanka has become less qualified for concessional loans, and issues pertaining to debt accumulation and repayments have become more acute.

The negative impacts of debt-financed investments are somewhat ameliorated with pertinent investments in projects that produce high returns in dollars (or other exchange) through direct or indirect means. Such returns would better facilitate the repayment of debts. Politically motivated investments with low returns result in a necessity for debt rollovers, as the government requires more loans to repay previous loans. As evident from Figure 4.9, a vast proportion of debt expenditure has been spent on investments that have low financial returns such as roads, bridges and ground transport with fewer resources dedicated to

A vast proportion of debt expenditure has been spent on investments that have low financial returns such as roads, bridges and ground transport with fewer resources dedicated to investments with high returns such as education.

Figure 4.10
External Debt Trends



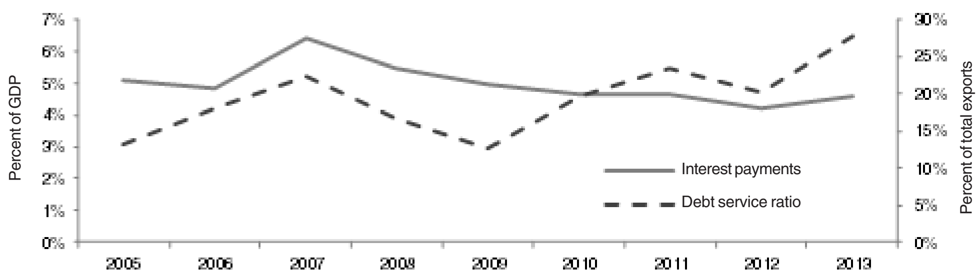
Source: CBSL, *Annual Report*, Central Bank of Sri Lanka, various years.

investments with high returns such as education. The situation is worsened even further if the investments fail to generate employment for domestic citizens.

While Sri Lanka's overall public debt ratios have fallen steadily from unsustainably high levels in excess of 100 per cent of GDP in the early 2000s to 70.7 per cent by 2014 - helped by rapid nominal GDP growth - the country's external debt profile has undergone significant changes. As seen in Figure 4.10, there has been a notable increase in total external debt, driven largely by an increase in private external borrowings; regulations governing foreign borrowing by Sri Lanka's private sector were eased from 2011 in a bid to encourage private firms and commercial banks to tap foreign sources for funding.

Critically, the composition of Sri Lanka's outstanding external debt has swung sharply, away from concessional forms of foreign borrowing to high cost non-concessional borrowing. This is partly a result of Sri Lanka graduating into middle income status in 2010, thus limiting access to the pool of concessional funds from international donor agencies. This increase in non-concessional borrowing has resulted in a significant increase in debt servicing costs, despite the reduction in overall debt levels.

Figure 4.11
Debt Servicing Costs



Source: CBSL, *Annual Report*, Central Bank of Sri Lanka, various years.

Total interest payments on debt as a percentage of GDP has reduced from progressively from 6.4 per cent to 4.2 per cent between 2009 and in 2014 before reversing in 2015 (Figure 4.11). The reduction was primarily due to lower domestic interest rates, as well as foreign currency interest rates in the aftermath of the global financial crisis. However, Sri Lanka's debt service ratio has risen progressively over the same period, with growth in earnings from exports of goods and services lagging behind high external debt accumulation.

4.4 Areas for Reform

As Sri Lanka continues to face a rapid demographic transition associated with an ageing population and dwindling numbers entering the labour force, the pressures on public finances will grow. The necessity is not only to rationalize current spending patterns, but also to focus on better directed public spending in areas such as education and health, to be in line with the changing demographic profile of the country.

4.4.1 Rationalizing Fiscal Expenditure

Reforms to fiscal policy in an economy similar to Sri Lanka's require a careful balance of imposing policy disciplines while maintaining its development objectives. On the expenditure front, it is imperative that an expenditure policy aims to restrain the expansion of non-developmental expenditure while adequately providing for important social and infrastructure needs of a developing economy. Within the government's current fiscal policy reform agenda, some focus has been given to public expenditure, especially in the SOE sector. The IMF intervention of a 36-month Extended Fund Facility (EFF) of US$ 1.5 emphasis has been placed on reforming SOEs and reducing the subsidy bill. However, the extent of expenditure reforms is severely constrained by the political-economy of the country and populist measures - such as the public sector salary increase of Rs. 10,000 through the interim-budget of 2015 - which are counter-intuitive to the reform agenda.

As noted previously, loss-making SOEs have become a severe burden on the taxpayer and immediate reform is required to stem the wastage of resources. Moreover, the state-led development agenda pursued during the past decade or so has crowded-out private investment and has led to the public sector becoming one of the main employment generators in the country, leading to a bloated and inefficient public sector. In recognition of these pitfalls, the government proposed to create a State Holding Corporation Limited in order to manage and establish fiscal and institutional disciplines across SOEs. Even though the exact nature of the State Holding Corporation is yet to be finalized, the process will possibly be developed along the lines of the Temasek Company of Singapore. Simultaneously, the government has proposed to sell shares of ventures deemed to be incongruent to the core competencies of SOEs while creating a 'Special Purpose Vehicle' to concentrate on infrastructural development initiatives.[31]

Cognizant of the political-economy of the country, the pursuit of PPPs is regarded as a more viable option in this regard since complete privatization will require significant political political capital. The adoption of PPPs enables

[31] Economic Policy Statement by Hon. Prime Minister, Ranil Wickremesinghe in Parliament, 5th November 2015.

a developing country to sequence its liberalization process by gradually exposing SOEs and the public sector to increasing levels of private sector participation (especially foreign) and competition.[32] Joint-ventures enable transfers of skills that improves local private sector capabilities while also extracting long-term value-for-money through appropriate transfer of risk to the private sector. In doing so, the government is better capable of stemming a significant outflow of revenue towards subsidizing loss-making SOEs and to direct its expenditure into more efficient investments.

Another area for reform is subsidies and transfers. Given Sri Lanka's fiscal position and its economic growth trends, inclusive growth is becoming a more pertinent policy issue. Towards that end, it is vital that scarce government resources are directed towards policies that will have the most significant impact in alleviating poverty while also mitigating wastage. Conditional cash transfers (CCTs) - both direct and indirect - have been identified as an important tool that balances these needs well in developing economies. Conditional cash transfers, which are also provided in the form of means tested subsidies, can provide a valuable safety net along with investment in human development that benefits the poor.

CCT programmes require recipients to undertake certain behavioural changes in return for the cash transfer, such as enroling children in school and maintaining adequate attendance levels, receiving prenatal and postnatal treatment, and encouraging immunization. It is assumed that major changes in human capital investment can be stimulated through income transfers. Similar programmes have been particularly successful in Latin American and Caribbean nations such as Brazil, Mexico and Jamaica. However, it is important that where necessary, supply-side constraints are also addressed along with stimulating demand in order to fully realize the benefits of a CCT programme.[33] Such targeted programmes are more cost effective than blanket subsidies that have the potential of crowding out low-income individuals from vital services such as health care and education.

It is important to note that as with many developing countries, subsidies are a key component of Sri Lanka's economic policies as well. The fertilizer subsidy and subsidies associated with school uniforms have gained particular focus recently due to policy changes. In order to achieve a 'social market economy', the government initially replaced the granting of fertilizer and uniforms at subsidized rates, with a voucher system. The voucher system was expected to reduce bureaucratic inefficiencies associated with government procurement and also reduce the associated cost burden on the government. In the face of opposition to the new system, the voucher, however, has now been replaced with a cash transfer to target recipients.

4.4.2 Rethinking Sri Lanka's Tax Policy

An IMF assessment carried out in 2005 set out a revenue-to-GDP target of 15-20 per cent as a reasonable minimum 'threshold' for developing countries.[34] Sri Lanka's revenue to GDP ratio

32 IMF (2015), "Making Public Investment More Efficient", International Monetary Fund, Washington, D.C.

33 Son. Hyun H. (2008), *Conditional Cash Transfer Programmes: An Effective Tool for Poverty Alleviation?,* Asian Development Bank, Manila.

34 IMF (2005), "Monetary and Fiscal Policy Design Issues in Low Income Countries," International Monetary Fund, Washington, D. C.

has been on a steady decline and currently stands at 13 per cent which is well below the minimum threshold, raising concerns with respect to the effectiveness and efficiency of the existing tax system. Furthermore, Sri Lanka's tax structure remains highly regressive with close to 80 per cent of revenue being generated through indirect tax, thus having distributional consequences.

Most economists and policymakers today are of the belief that high tax rates not only discourage and distort economic activity, but are also ineffective in redistributing income and wealth. The common mantra today is to apply lower tax rates on broader bases. As such, the 'holy trinity' of options, proposed by most fiscal experts are broadening bases, lowering rates, and better administration. Consistent with this premise, the budget proposals for 2016 saw the government lowering tax rates on a number of key revenue instruments; however, the narrow tax base continues to remain unaddressed. Whist the government's economic policy statement unveiled in November 2015 expressed the intention to make the tax system more progressive, a number of recently introduced changes to the tax structure run counter to this objective and are regressive in nature, thus having important distributional consequences. Moreover as per the recommendations given by the Presidential Tax Commission, there is a need to downscale the number of taxes to about 8-10 taxes from the current level of about 25 taxes.

Against the preceding backdrop, this section discusses some of the key area Sri Lankan policymakers should contemplate in undertaking reform with a view to strengthening the tax base and address structural flaws and thereby address fiscal sustainability and equity concerns. As shown in Table 4.3, Sri Lanka's tax system has undergone frequent changes that have often made the system more complex and unpredictable.

At the outset, Table 4.3, seats out the chronology of major tax policy developments since 1992, to set the tone for the analysis.

Box 4.2
Successful Tax Reform Experiences in Developing Countries

Successful tax reform efforts in developing countries have been few and far to come by. However, a number of interesting cases exist. Indonesia's tax reform programme during the 1980s has been one to stand out. Prior to 1983, the bulk of Indonesia's fiscal resources were sourced through non-tax oil revenue. The oil crisis of the early 1980s compelled Indonesian authorities to diversify revenue sources paving the way for a comprehensive tax reform agenda. Reforms saw the introduction of a VAT, together with a luxury sales tax. Both personal and corporate income tax bases were broadened by eliminating special tax preferences, and tax rates were lowered to encompass a three-rate structure down from 17 personal income taxes and three business taxes. In addition, Indonesia introduced a property tax and a comprehensive restructuring of the tax administration was carried out. The outcomes of the reforms were impressive; within a period of three years, the share of non-oil revenues as a share of GDP increased by almost 50 per cent.

Vietnam's tax reform experience is another interesting case. Even though Vietnam had attempted to reform its tax system for well over two decades, a new round of comprehensive tax reforms was undertaken in 2006. This new round was necessitated by a relative decline of revenue for SOEs - the major payer of corporate income tax and VAT at the time - the anticipated decline in oil output and hence oil revenues, the rise of the private sector, increased FDI flows into the country, and a decline in trade taxes. The reform package encompassed a reduction in corporate income tax (CIT) rates, the simplification of incentives, and the reduction of exemptions. VAT was modified to reduce the number of exemptions and reduce the number of items that benefitted from a lower tax rate. In addition, the country's tax administrator, the General Department of Taxation (GDT) which had a reputation for red tape and corruption was subject to comprehensive governance reform. To overhaul governance, the government sought to: a) simplify tax administrative procedures, b) enhance and diversify tax services, c) promulgate regulations on audit and examination on the basis of risk management, d) modernise, automate and integrate a single system of tax management, and e) enhance cooperation with foreign tax authorities and international institutions.

The lowering of CIT rates, the introduction of a much revised personal income tax (PIT), and notwithstanding the decline in oil output and the resultant drop in revenues had left the overall tax ratio in 2012 at about the same level as in 2005. This was despite the fact that tax revenues from the oil sector declined from 35 per cent of all tax revenues in 2005 to only 12 per cent in 2012. The revenue levels had been maintained as a result of the improvement in the CIT from non-oil sector companies, as well as from a tripling in revenues from the tax on individuals. In addition, due to legal changes and fierce enforcement, the number of active, registered taxpayers soared from about 4 million in 2006 to about 15 million by 2014. In terms of taxpayer compliance requirements, World Bank reporting indicates that procedures have been streamlined and that the new laws and their regulations are more user-friendly.

Source: Khalidzadeh-Shiraz J and A. Shah (1991), "Tax Reform in Developing Countries, What Constitutes Successful Tax Reform, A Review of Developing Country Experiences", *Finance and Development*, 28(2); ITC-OECD (2015), "Examples of Successful DRM Reforms and the Role of International Co-operation", Discussion Paper, available at https://www.oecd.org/ctp/tax-global/examples-of-successful-DRM-reforms-and-the-role-of-international-co-operation.pdf.

Table 4.3
Major Changes in Tax Structure, 1992-2015

Year	Description
1992	Introduction of Withholding Tax on specified fees and the National Security Levy (NSL)
1998	Introduction of Goods and Services Tax (in place of Turnover Tax) from 01.01.1998 - threshold for registration Rs. 500,000 per quarter or Rs.1,800,000 per annum at 12.5%
2002	Introduction of Value Added Tax – (by abolishing Goods and Services Tax and National Securities Levy) – threshold for registration Rs. 500,000 per quarter or Rs.1,800,000 per annum and charged under 3 types of rates – zero, 10% and 20% for goods specified in the schedules
2003	VAT on financial services was introduced on the book profit of banks and financial institutions
2004	Economic Service Charge was introduced by Finance Act No. 11 of 2004
	Standard VAT rate changed to 15% from 01.01.2004 and basic rate was imposed on several essential goods at 5% with effect from 19.11.2004
2005	Introduced Share Transaction Levy at the rate of 0.2% of tax payable by every buyer and seller
	Introduced Social Responsibility Levy at 0.25% of tax payable
	Luxury VAT rate changed twice; from 01.01.2005 to 01.08.2005 18% and from 02.08.2005 – 20%
2006	Inland Revenue Act No.10 of 2006 introduced
	Economic Service Charge Act No.13 of 2006 – with effect from the quarter commencing on April 1, 2006 ESC imposed under this Act
2008	Introduction of Nation Building Tax (NBT) – rate of 1% from 01.02.2009 and from 01.05.2009 increased to 3%
	Standard VAT rate reduced to 12% and basic rate was removed
	Registration limit for VAT was increased to Rs.650,000 per quarter or Rs. 2.5 million per year
	Optional VAT limit for registration was increased to Rs.3 million
2011	Individual tax free allowance increased to Rs. 500,000
	20% VAT rate was reduced to 12% w.e.f. 23.11.2011 and VAT on financial rate also reduced to 12% from 01.01.2011
	NBT rate was reduced to 2% and extended to wholesale and retail businesses
	Threshold for ESC registration was increased to Rs. 25 million per quarter
2012	Threshold on ESC was increased to Rs. 50 million per quarter and made liable to those who have no taxable income
2013	Registration threshold on VAT and NBT was increased to Rs. 12 million per annum
	Introduction of VAT on wholesale and retail trade, and liable threshold for registration not less than Rs.500 mn. (including exempt supplies) for any consecutive 3 months in a year
	The threshold in relation to partnership tax was increased to Rs.1,000,000
2014	Maximum rate of income tax applicable on employment income of qualified professionals 16%
2015	Threshold on VAT and NBT was increased to Rs. 15 million per annum and rate of VAT reduced to 11%
	Liable threshold for registration of wholesale and retail business reduced to Rs.100 million
	Super Gain Tax was introduced as one off payment, for any individual, companies or group of companies who have earned profits over Rs. 2,000 million in the tax year 2013/2014 and who will be liable to pay 25% of their profit.

Source: IRD, "Policy Changes over the Years", Inland Revenue Department, available at http://www.ird.gov.lk/en/about%20IRD/SitePages/Policy%20Changes.aspx?menuid=110406.

Despite being a major source of revenue, mirroring the global trend, revenue generation through corporate income tax (CIT) has been a challenge for Sri Lanka owing to downward pressure exerted on CIT rates as a consequence of global competition. In view of encouraging investments, the 2016 budget lowered CIT tax rates to a single rate of 15 per cent from a progressive tiered rate structure and subsequently increased to 17.5 per cent in May 2016. This move has two important consequences; firstly, lowering the tax rate whilst the base remains narrow will see revenues from CIT taking a further hit; secondly, a single CIT rate eliminates any sense of progressivity in the CIT structure, working counter to the stated objective of making the tax system more progressive.

Sri Lanka offers corporate tax holidays and concessions as incentives to encourage investment. International experience, however, suggests that despite their continued popularity, tax incentives are often redundant and ineffective and tend to reduce revenue and complicate the fiscal system without achieving their stated objectives.[35] In addition, excessive use of tax incentives complicates tax administration, facilitating evasion and corruption. With a view to maximize the likelihood of beneficial results from tax incentives and to reduce the damage that may be caused by poorly designed and implemented incentives, countries should at the very least try to offer as minimum number of concessions as possible, and as simple in structure as possible. Moreover, one of the key recommendations of the Presidential Tax Commission of 2010 has been to move towards as system of (i) accelerated depreciation allowances and (ii) interest relief as a replacement for tax holidays.

In light of the above, Sri Lanka should revisit its tax incentive structure and better rationalize its policy with a view to prevent the erosion of its tax base to ensure that revenue considerations are not undermined in the attempt to attract investment. Furthermore, policymakers must rethink the design of the CIT structure with a view to addressing regressive concerns.

Current VAT exemptions are also an area needing reform. As alluded to earlier, VAT accounts for the lion's share of Sri Lanka’s tax revenue; however, its share over the last decade or so has been on a gradual decline raising concerns on its effectiveness in sustaining the required level of revenue. VAT in Sri Lanka is a single rate tax and a number of essential goods and services are zero rated. The VAT rate was increased in May 2016 from 11 per cent to 15 per cent and the base widened to cover some of previously untaxed goods and services. This move whilst contribution to improving revenues is bound to have adverse distributional consequences.

Whilst most developing countries around the world have adopted VAT, international experiences suggest that in many instances flawed design and implementation often undermine the effectiveness of VAT. One of the most common issues that has emerged in developing countries has been the fact that whilst at the time of initial implementation of VAT, most VAT structures usually stand close to the standard broad-based international model, however as time passes by VAT structures tend

[35] Bird, R. (2008) “Tax Challenges Facing Developing Countries”, Working Paper 9, Institute for International Business.

to be littered with privileges and exemptions that gradually erodes the base, thereby minimizing its revenue impact and creating administration difficulties. Ad hoc and extensive exemptions and zero rating also creates classification disputes and increasing compliance costs, opening up scope for VAT evasion, and corruption.[36] As in the case of CIT incentives, Sri Lanka has introduced a number of tax concessions and exemptions with a view to encourage investment in the country. This has been carried out in a rather ad hoc manner which has led to the erosion of the VAT base; it has also complicated the VAT structure, leading to compliance issues.

Unlike in developed countries, receipts from personal income tax (PIT) in developing countries are low and stagnant, and come predominantly from wage withholding on large enterprises and public sector employee.[37] Sri Lanka's experience reflects this; Pay-As-You-Earn (PAYE) is the principal PIT collected from both private and public sector employees. Like the CIT, the PAYE tax was initially applied on a tiered rate structure; however, as of 2016 this was moved to a single rate system, where the standard rate is 16 per cent. As with the CIT, the move to a single rate structure eliminates any sense of progressivity, working contrary to the stated objective of making the tax regime more progressive.

Curbing tax evasion and avoidance by high-income individuals is seen as a potential area for generating additional revenue. Establishing dedicated units within the tax administration to high-income/wealth individuals could provide a focus for enforcement efforts, with high profile prison terms sending a salutary lesson. Strong audit power, including the possibility to use indirect methods to assess tax liabilities, is an effective tool for increasing the effectiveness of audit operations; these enable revenue agencies to use third party information, particularly related to assets and flow of investments, to estimate the taxpayer's income. Taxing property is also seen as a powerful means of taxing the better-off.[38]

4.5 Summary

The legacy of Sri Lanka's welfare-state, history of populist public spending programmes, poorly managed SOEs, and a bloated public sector bureaucracy have made rationalization of expenditures an uphill task. If performance of public finance management on the expenditure front has been mixed, fiscal performance on the revenue front has clearly been very poor since the early 1990s.

The fiscal landscape - marked by high deficits and government borrowing - leaves little leeway to reorient public investment toward high return, high productivity sectors such as education and health care. Some degree of expenditure rationalization is necessary, particularly with regard to the loss making SOEs, poorly targeted subsidies and transfers and populist spending measures adopted from time to time; much will depend on the political will to tackle these and which are perceived as highly sensitive to voter sentiment.

[36] *Ibid*.

[37] Carnahan. M. (2015), 'Taxation Challenges in Developing Countries', *Asia & the Pacific Policy Studies*, 2(1).

[38] IMF (2011), *Revenue Mobilization in Developing Countries*, International Monetary Fund, Washington D.C.

Box 4.3
Property Tax

Property taxes refer to "recurrent taxes on immovable property, measured gross of debt, levied on proprietors or tenants" . While there exists a dearth in research regarding such forms of taxes, analyses and estimates deduce that a nation tends to utilize Immovable Property (IP) taxes as it progresses towards the high income threshold.

The primary advantage of IP taxes is that it provides the state with a stable and predictable revenue source. Property taxes maintain high 'cyclical resiliency' in comparison to other sources of government revenue - i.e., the funds collected through property taxes tend to not fluctuate heavily during swings in the economic cycle. For instance, during 2007-09, when the US found itself in the midst of a pronounced depression, the revenue derived from individual income tax and sales tax plunged between 7.5-17 per cent. However, in comparison, revenue from property taxes increased by 5 per cent during the given time period. As such, the use of such taxes appears to provide much needed relief during times of great financial constraints. Furthermore, by compelling owners to bear a cost for holding property, IP taxes incentivize the efficient allocation of resources to increase productivity. Thus, such taxes can act as a check on unbridled speculative pricing during economic booms. In addition, the immovability and tangibility of the tax base reduces the chance of evasion. Finally, since land taxes are considered to be an endogenous mode of revenue collection, its implementation does not require an impetus on international tax coordination. The possible advantages of IP taxes have encouraged several contemporary developing nations such as Vietnam, Cambodia and Singapore to take the lead in implementing a more refined property tax mechanism. Vietnam, for example, has adopted an area-based tax on non-agricultural land (excluding houses), and is considering further reforms in this particular area. The tax is levied on the value of the land area, with additional improvements exempted from taxation. By enacting such a policy, the Vietnamese policy makers aim to ensure that economic and industrial activities are not discouraged. Furthermore, Singapore has increased the tax levied on home buyers as a means of safeguarding the housing market from rapid appreciation.

However, IP taxes are no golden eggs. The general lack of contemporary enthusiasm in regard to such modes of taxation indicates the presence of drawbacks that need to be considered when analyzing policy decisions. For instance, unlike other forms of taxes, the value of IP cannot be self-assessed. Therefore, the state has to bear the additional costs incurred in assessing rates and collecting revenue from the tax base. This lowers the revenue to expense ratio, thus making the tax a less appealing proposition to law makers. Furthermore, the implementation of a property tax scheme is hindered by the unpopularity of such revenue collection methods amongst general voters. According to Bahl and Bird (2008) for each "per dollar of revenue raised, property taxes generate more negative reaction than any other levy". Thus, politicians tend to be reluctant to campaign for property taxes for fear of losing political mileage. Dissent against property taxes arise, paradoxically, due to its transparency, as the burden is not hidden from taxpayers. Furthermore, such a tax is often considered to be unfair as it assumes that it does delineate between ownership and payability. For instance, citizens who are property rich but income poor, tend to be victimized. Hypothetically, the use of property taxes encourages the efficient reallocation of land. However, when examined from an altruistic manner, it may be a bitter pill to swallow.

The implementation of an IP tax in Sri Lanka can aid the government in combating fiscal vulnerability, and incentivizing the efficient reallocation of (land) resources. In Sri Lanka, the decision making authority in regard to property taxes lies with the Provincial Councils. While such a system reduces the burden of governmental transfers, it prohibits the Centre from maximizing revenue, especially from its urban localities. With Sri Lanka embarking on a massive urbanization endeavour, the base for property taxes is bound to increase. Thus, at this conjuncture - when taking the country's fiscal position and its development trajectory into account - the government has an opportunity to re-evaluate its IP tax policies and verify the feasibility of utilizing such taxes to increase revenues.

Source: Bahl, R., and R. Bird (2008), "The Property Tax in Developing Countries: Current Practices and Prospects", in Toward a 2015 Vision of Land, Lincoln Institute of Land Policy, Taiwan; Trin, H..L. and W. McCluskey (2012). "Property Tax Reform in Vietnam: A Work in Progress" in Papers on Municipal Finance and Governance, Volume VIII, Institute of Municipal Finance and Governance, Toronto.

In the near term, the solution lies squarely in reversing the progressive decline in Sri Lanka's revenue collection efforts. The widespread and ad hoc use of tax incentives as a tool to entice investments has led to a severe erosion of the tax base. This has also contributed to increasing the complexity of the tax structure, leading to issues of monitoring and compliance. Sri Lanka must urgently reevaluate this policy stance in view of broadening the tax base and rationalizing the tax structure with the broad aim of simplifying revenue administration and increasing compliance.

Another critical area of intervention that needs attention is to address distributional weaknesses of the current tax system. Historically, Sri Lanka's tax structure has been a regressive one, with the bulk of revenue generated through production taxes. Whilst the government expressed its intention to arrest this trend and make the structure more progressive, a number of recent tax policy changes introduced in 2016 work counter to this stated objective. With limited fiscal resources constraining investments in social sectors such as health and education and gaps in fiscal support for social protection, especially of the more vulnerable such as the elderly, regressive tax structures will further undermine efforts towards equitable growth and development in the country.