Sri Lanka
State of the Economy Report 2013

Chapter 9
The Role of Taxation in Sustaining Public Investments

by
Athula Senaratne

9. The Role of Taxation in Sustaining Public Investments

9.1 Introduction

While it is often assumed that the Sri Lankan state is still the primary financier of social services like education and health, this is rapidly ceasing to be the case. Having once been a generous provider, the Sri Lankan state has, over the years, become less generous compared with its peers. One major reason for this change is that it is collecting less in tax vis-a-vis the country's national income, which is affecting the state's capacity to spend more on human development needs.

For a country of Sri Lanka's per capita income, unparalleled welfare investments were made during the post-independence era, which reaped rich dividends in terms of human development. Sri Lankans enjoy basic human development outcomes better than many comparable countries – an adult literacy rate of 91 per cent, and a near universal primary enrolment rate; low infant mortality (13 per 1,000 live births, better than Indonesia and China at 30 and 17, respectively), maternal mortality (39 per 100,00 live births, better than Thailand and Philippines at 48 and 94, respectively) and high life expectancy (at 71 years, on par with Thailand and Malaysia, at 70 and 73 respectively, and higher than India and Indonesia at 65 and 68, respectively).[1] Yet, new challenges are now emerging in the education and health sectors, and state expenditure has not been able to fully keep up. Addressing these has now become vital in ensuring that the country has a productive population to capitalize on the post-conflict economic dividend. As emphasized in IPS (2012),[2] sustained faster growth as is envisaged in Sri Lanka will not be feasible without a healthy, educated workforce.

> ***‘Emerging expenditure needs, in the face of high fiscal deficits and outstanding government debt, provide a strong rationale to create more fiscal space through revenue mobilization, i.e., taxation’***

[1] World Health Organization (2011), ‘World Health Statistics’.

[2] IPS (2012), *Sri Lanka: State of the Economy 2012*, Institute of Policy Studies of Sri Lanka, Colombo.

Strengthening the financing capacity of the state, and thereby, better provision of these services is vital. This is particularly true in an era of heightened pressure on public finances with the massive, and no doubt vital, post-conflict reconstruction and rehabilitation efforts. Meanwhile, as Sri Lanka moves to the middle-income bracket, it has less access to cheap/concessionary funds from aid donors. Aside from large commercial borrowing, which comes with its own set of issues as highlighted earlier,[3] it is higher tax revenues that will strengthen the capacity of the state to address the critical health and education gaps that are emerging.

Sri Lanka's target is to double per capita income from US$ 2,057 in 2009 to US$ 4,114 by 2016. Lewis (1984) argues that an increasing share of tax revenue in national income or in GDP is an instrumental objective of economic development policy.[4] High-income countries have had rising shares of tax revenue and government expenditures as they have become more economically-advanced. However, in contradiction to the theory, it seems that there are problems in Sri Lanka in raising the tax ratio (total tax revenue as a percentage of GDP), in line with the increase of per capita GDP.

Much of the focus of public investment lately has been on the government's physical infrastructure spending (particularly connectivity infrastructure), and the raising of funds from foreign and domestic sources to support the immediate and large volume of financing needed for this. However, social infrastructure like health and education needs to improve alongside physical infrastructure for the efficiency gains of the latter to be maximized. Social sector spending is more heavily influenced by domestic revenue mobilization and the fiscal space that it avails to the government.[5]

9.2 Human Development Needs: Health and Education

9.2.1 Education

Historically, Sri Lanka has focused strongly on public investment in general education, enabling the country to attain higher levels of education achievement than most developing countries with comparable per capita income levels. Adult literacy is 91 per cent,[6] and Sri Lanka has almost achieved the MDG of universal primary education. However, wide disparities in access to, and quality of, education remain across the country, particularly at higher levels of education.

Investment by the Sri Lankan state in education is low, and has declined steadily over time. Public expenditure in education has averaged at 2.3 per cent of GDP during 2000-2010, falling to a 10-year low of 1.9 per cent of GDP in 2012 (Figure 9.1). Sri Lanka performs poorly globally too. In South Asia, India, Bangladesh, and Nepal, all invested a larger share of their GDP in education than Sri Lanka.[7] Investments in education by the Sri Lankan state were also smaller than the average of middle income countries (Table 9.1). As a percentage of GDP, the average upper middle income country spent 5 per

---

[3] See Chapter 2 on "Macroeconomic Performance" of this report.

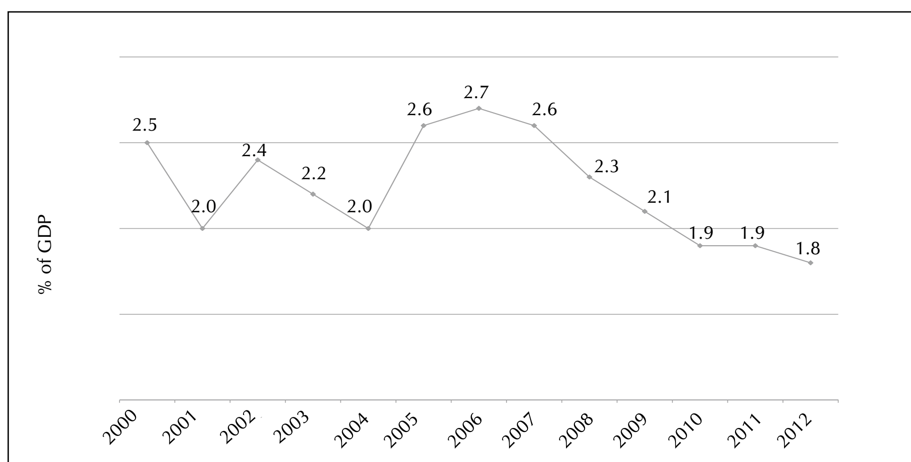
[4] Lewis, S.R. (1984), *Taxation for Development: Principles and Applications*, Oxford University Press, U.K.

[5] The discussion to follow draws on Wijesinha, A., and K. Amirthalingam, "Strengthening State-capacity for Development in Sri Lanka: The Taxation Imperative", ICTD Working Paper (forthcoming).

[6] World Bank, Education Statistics (EdStats) [http://databank.worldbank.org/ddp/home.do], accessed on 13 May 2011.

[7] The available information on public expenditure on education is not strictly comparable across countries, as they may use different definitions to measure public expenditure on education. For example, in Sri Lanka, expenditure by the Ministry of Education is considered as public expenditure on education for the most part. Expenditures incurred on the Kotelawala Defence University and the Vocational Education University, for instance, does not come under the public education budget.

Figure 9.1
State Spending on Education as a Percentage of GDP



Source: CBSL, *Annual Report*, various years.

cent of GDP, and the average lower middle income country spent 4 per cent of GDP on education, against Sri Lanka's 2.3 per cent of GDP.

Of course, one can argue that, unlike some other countries that undertook schooling investments much later, the existence of a well developed school infrastructure in Sri Lanka may mean that the country needs fewer investments in recent times. However, the limited investment in education has constrained access to tertiary education, as well as held back improvements to facilities in schools to gear them towards a knowledge-based economy.

Table 9.1
State Spending on Education in Sri Lanka vs. Selected Countries

	As % of GDP	As % of Total Government Expenditure
Malaysia	4.1	17.2
Singapore	2.6	15.3
Indonesia	2.8	17.9
Philippines	2.8	16.9
India	3.1[a]	n.a
Bangladesh	2.4	14.0
Nepal	3.8	19.0
Sri Lanka	2.3	10.0
Lower middle income countries	4.0[a]	n.a
Upper middle income countries	5.0[b]	13.0[b]

Notes: a. Data for 2006; b. Data for 2007; n.a. = not available.

Source: IPS/UNDP (2012), "Sri Lanka Human Development Report".

The availability of facilities in the country's schools varies widely across districts. For instance, the data reveals that aside from the districts of Colombo, Gampaha, Galle, and Hambantota, less than 40 per cent of schools in all other districts had a permanent library. Meanwhile in 24 out of 25 districts, less than a half of all secondary schools had science labs. Only 10 per cent of secondary schools country-wide have facilities to teach A-level science stream subjects.[8] The poor facilities and resource constraints have weakened the quality of education provided by schools, limited the number of students qualifying for more technical education, and reduced the geographical access to high school education of the type that is required for Sri Lanka to transition to a knowledge-based economy.

The declining state spending on education has also increased out-of-pocket expenditure (OOPE), which in turn has important equity implications. Although education in public schools is free, households need to still spend a considerable sum on education. The average household spends 3.2 per cent of its total expenditure on education – nearly Rs. 800 a month and comprises additional private tuition (45 per cent), stationery (23 per cent), and transport (22 per cent).[9]

The issue is more precarious at higher levels of education. While new higher education institutes have been established, existing universities have been expanded, and new faculties added in recent times, less than one-fifth of the students qualifying for tertiary education in state-run universities (based on performance at A-Levels exam), are able to secure admission. The situation appears to be worsening, because while in 2003, the number of students who qualified to enter university but could not be accommodated stood at 80,556, by 2010 this had risen to 120,868. Clearly, capacity remains a constraint for accessing university education in Sri Lanka.

9.2.2 Health

In the health sector too, similar issues prevail, as investments by the Sri Lankan state are low. Today, public health care is provided free of charge at government hospitals and dispensaries to all the citizens of the country, although the supply is unable to meet demand. Indeed, the public health sector serves nearly 60 per cent of the country's population, while OOPE on health is very high (as will be shown later).

Although Sri Lanka fares well in most basic health indicators compared to most developing countries, child nutrition is still a major problem in the country. Nearly a half of all women of reproductive age in the estate sector are educated below primary level, and 30 per cent of the women are malnourished. The Badulla district has the highest percentage of underweight children, followed by Trincomalee, Batticaloa, Monaragala, Polonnarura, Nuwara Eliya, Kandy, and Anuradhapura districts. More than a quarter of the children are underweight in each of these districts. Meanwhile, IPS research has shown that 51 per cent of multidimensional poverty in the country is explained by health and nutrition factors.[10]

Sri Lanka is faced with new and different challenges in the health sector, with recent changes in the demographic, epidemiologic and socio-economic character of the country. This is particularly true of NCDs. Deaths

---

[8] As of 2010, there were only 7,212 secondary schools (having classes from year 1-9, 1-11, 1-13 and 7-13).

[9] Arunatilake, N., and P. Jayawardena (2011), "Equity in Education and Health Services in Sri Lanka" in Hyun Hwa Son (ed.), *Equity and Well-being: Measurement and Policy Practice*, Routledge, London and New York.

[10] Nanayakkara, W., (2012), 'Eradicating Poverty in Sri Lanka: Strong Progress But Much Remains To Be Done' in IPS, "Talking Economics Special Report", available at http://www.ips.lk/talkingeconomics/2012/06/understanding-poverty-in-sri-lanka-does-the-multidimensional-poverty-index-hold-the-key/ [accessed on 15th March 2013].

Table 9.2
Health Expenditure as a Share of GDP (2000 vs. 2008)

	Sri Lanka		Global	
	2000	2008	2000	2008
Total expenditure on health as % of GDP[a]	3.7	4.1	8.3	8.5
General government expenditure on health as % of total expenditure on health	48.3	43.7	56.4	60.5
General government expenditure on health as % of total government expenditure	6.9	7.9	13.3	13.9
Private expenditure on health as % of total expenditure on health	51.7	56.3	43.5	38.4
OOPE on health as % of private expenditure on health[b]	83.3	86.7	50.7	50.7
Per capita total expenditure on health at average exchange rate (US$)	101	187	484	854

Notes: a. The sum of expenditures on health by prepaid plans and risk-pooling arrangements, firms' expenditure on health, non-profit institutions serving mainly households, and household OOPE;

b. The direct outlays of households, including gratuities and in-kind payments made to health practitioners and to suppliers of pharmaceuticals, therapeutic appliances and other goods and services. This includes household direct payments to public and private providers of health care services, non-profit institutions, and non-reimbursable cost sharing, such as deductibles, co-payments and fees for services.

Source: IPS/UNDP (2012), "Sri Lanka Human Development Report".

due to NCDs, such as ischemic heart disease, stroke and cancer, are high and rising in Sri Lanka – nearly 90 per cent of the country's disease burden is attributed to NCDs. During the past half-century, the proportion of deaths due to circulatory diseases (such as heart disease and stroke) has increased from 3 per cent to 24 per cent.[11] In all districts, over 10 per cent of the population suffers from chronic illnesses or disability, and over 20 per cent of household heads suffer from chronic illnesses.

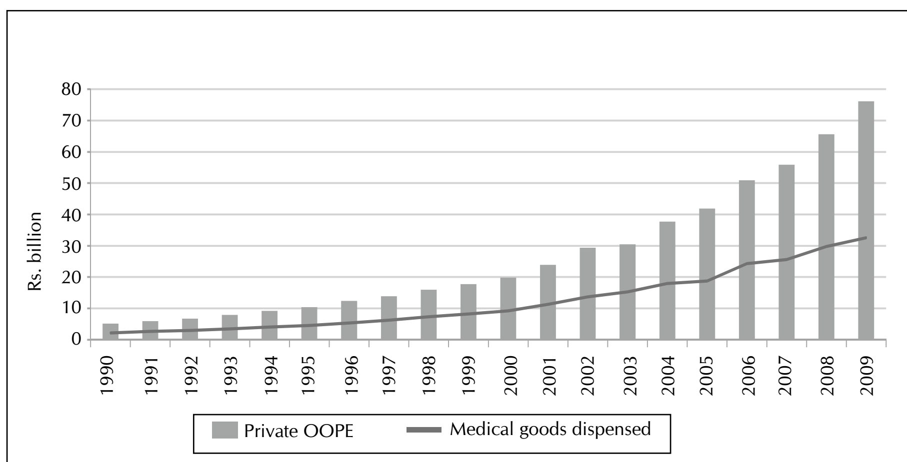
The ability of Sri Lanka to improve health facilities and personnel is compromised by low investment in the heath sector, after years of heavy investment. Total expenditure on health remained below 5 per cent of GDP between 1995 and 2008,[12] and is low compared to the global average of around 8 per cent (Table 9.2). Within this, the contribution from the state was only around 45.8 per cent (2009) – the rest came from private sources (private sector health providers as well as OOPE). A large proportion of the private financing comes from OOPE (i.e., the individual cost borne by the patient) which is around 85 per cent of total private expenditure on health, and 51 per cent of total health expenditure.[13] The proportion of OOPE on private health expenditure has grown over time, rising from about 83 per cent to 87 per cent between 2000 and 2008 (Figure 9.2). Sri Lankans spent Rs. 70 billion more out-of-pocket on healthcare in 2009, than 20 years ago.

[11] Engelgau, M., *et. al.*, (2010), 'Prevention and Control of Selected Chronic NCDs in Sri Lanka: Policy Options and Action', Health, Nutrition and Population Discussion Paper, World Bank, Washington D.C.

[12] Sum of general government expenditure on health and private expenditure on health.

[13] Bandara, S., (2011), "Emerging Health Challenges in Sri Lanka: More Money for Health and More Health for the Money," 'Talking Economics' http://ipslk.blogspot.com/2011/04/emerging-health-challenges-in-sri-lanka.html, April 17th, 2011 [accessed on 15th January 2013].

Figure 9.2
Rising Private Out-of-Pocket-Expenditure on Health by Sri Lankans (1990–2009)



Source: IPS, Sri Lanka National Health Accounts (2011) database.

9.3. Financing the Gaps amidst Contracting Concessionary Aid

The fiscal deficit in Sri Lanka has traditionally been high. Financing the deficit through money creation and domestic and foreign borrowing, as is the case in Sri Lanka today, comes with its own adverse repercussions. Reducing the deficit and expanding the state's 'fiscal space' would come about through two ways: a) expenditure cuts, and b) increasing tax revenue. The former is not easy – considering both the current infrastructure drive, particularly in reconstruction of conflict-affected areas, as well as the political imperatives related to subsidies and transfers. This makes the latter, taxation, ever more crucial. But in the past, it was easy to place less priority on it because of the generous concessionary aid flowing into the country.

Sri Lanka was considered a 'donor darling' as one of the first countries in South Asia to embark on market-oriented reforms following economic liberalization in 1977. Concessional loans from international aid donors soared for a time thereafter, playing a very substantial role in financing Sri Lanka's development needs. Yet, this situation is rapidly changing, driven by two factors. Firstly, the end of the armed conflict has meant that Sri Lanka is no longer a priority country requiring 'emergency' or 'humanitarian' assistance. Aid operations based on North and East recovery efforts are scaling down, with much of the work being mainstreamed into the government's own activities. Secondly, Sri Lanka has moved out of the low-income country status, to the middle-income bracket. The country becomes increasingly less eligible for concessionary loans from sources like the International Development Association (IDA) – which carries low interest rates, long tenors and grace periods, and a high grant element – and others to finance its social sector investments.[14]

[14] 'Sri Lanka to Get Funding from Higher Cost Window: World Bank', *Lanka Business Online* http://www.lankabusinessonline.com/fullstory.php?nid=1230609135, 18th December 2010 [accessed on 20th September 2012]

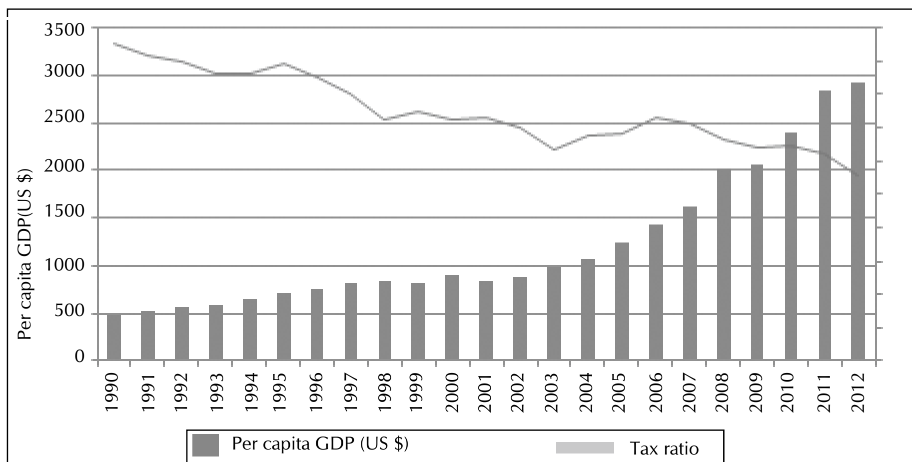
Based on a recent survey of local and international development agencies that rely on foreign funding, it is becoming clearer that Sri Lanka's access to concessionary funding from abroad is rapidly shrinking. Several of the bilateral aid missions surveyed noted that since 2010, Sri Lanka no longer qualifies for bilateral development assistance due to the low-middle income status of the country. Nearly all of those surveyed reported that in the last 2-3 years, there has been a reduction in their funding to Sri Lanka, and that this trend is likely to continue. The head of one UN agency reported that "*the funds we have traditionally accessed have contracted by 70 per cent*;" another remarked that "*in 2012, [institution name removed] we have only been able to mobilize less than one-third of what we mobilized from donor sources in 2009*;" while a leading European bilateral donor indicated a "*more than 60 per cent contraction in funds between 2009 and 2011*."[15] Furthermore, they noted that the changes have been in: 'the volume of the funds received/disbursed'; 'the type of funding'; 'how the funding is being allocated and the nature of projects'; and 'the sources of the donors (countries/agencies) themselves'. The top reasons for these changes/reductions were: 'change in the country's economic situation, change in the types of needs', 'economic growth of the country', and 'status of the global economy'.

This contraction in concessionary donor aid, alongside the current heightened pressure on public finances on account of post-conflict reconstruction and broader development efforts, means that domestic revenue mobilization, i.e., taxation, is essential to strengthen the spending capacity of the state to finance development needs in health and education.

9.4 Performance of Tax Revenue in Sri Lanka

According to Gallagher (2005), the benchmark tax ratio for a low-income country is 18 per cent, and that for a middle-income

Figure 9.3
Tax Ratio and Per Capita GDP in Sri Lanka (1990–2012)



Source: CBSL, *Annual Report*, various years.

[15] In one-on-one interviews with IPS research staff.

country is 25 per cent.[16] Meanwhile, the seminal paper by Kaldor (1963) argued that for a country to become 'developed' it needed to collect taxes at up to 30 per cent of GDP.[17]

In recent decades, Sri Lanka has not managed to raise tax revenues in line with the growth in its economy, or the evolving needs of its people. Tax revenue as a proportion of GDP dropped to around 15 per cent during 2003-2008, compared to about 19 per cent prior to 1995. In 2012, Sri Lanka's tax ratio was just 11.1 per cent (down from 12.4 per cent in 2011), continually declining from a peak of 24 per cent in 1987 (Figure 9.3). Sri Lanka's performance compares poorly with countries like Vietnam, Thailand, Malaysia, Singapore, Ghana, and South Africa; but better than other South Asian neighbours, including India, Pakistan, and Bangladesh; and marginally better than Indonesia, and the Philippines (Figure 9.4).

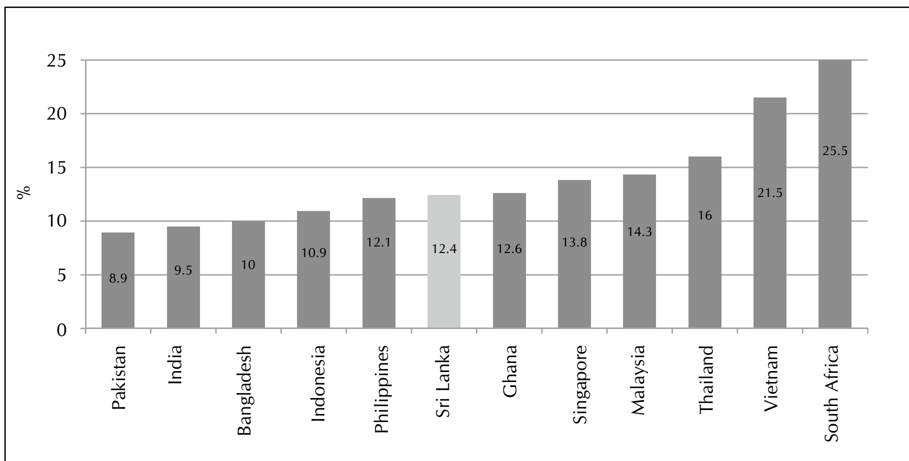
Another important feature of Sri Lanka's tax performance is the mismatch between the tax ratio and per capita GDP. Figure 9.3 clearly illustrates that during 1990-2001, while GDP per capita increased continually, the total tax revenue as a percentage of GDP registered a declining trend (albeit with some fluctuation). An increase in per capita GDP essentially means that the increase in national income is greater than the growth rate of the population in a country. A continual increase in GDP indicates that economic activities are expanding each year. The question then is, why has Sri Lanka been unable to generate a simultaneous increase in tax revenue despite an expansion in economic activity over time?

9.5 Unravelling the Weak Revenue Performance

Sri Lanka's weak revenue performance has been characterized by poor direct tax collec-

Figure 9.4

Tax Revenue to GDP Ratio - Sri Lanka vs. Selected Countries (2009 -2011 average)



Source: IMF (2011), 'Revenue Mobilization in Developing Countries'.

---

[16] Gallagher, M., (2005), "Benchmarking Tax Systems", *Public Administration and Development*, Vol. 25, No. 2, pp. 125-144.

[17] Kaldor, N., (1963), "Taxation for Economic Development," *The Journal of Modern African Studies*, Vol. 1, No. 1, pp 7-23.

tion and the overreliance on indirect taxation. This is driven both by a clear administrative reason, but also by a more probable fundamental reason. The administrative reason is that while the former (corporate and personal income tax) requires more effort and effectiveness on the part of the revenue authorities (auditing tax returns, checking self-reporting, measures to expand base and improve compliance, etc.), the latter (VAT, Customs duty, etc.) is much easier to administer as they are mainly consumption based taxes, or taxes at the border which are collected easily at source. The more fundamental reason is probably the structure of the country's economy.

The economic structure of a country is an important determinant of revenue mobilization. A dependence on the agriculture and service sectors has a significant and negative effect on revenue levels. Like many developing countries, Sri Lanka (especially outside the Western Province) is characterized by a significant agriculture sector. Though the total output from agriculture in GDP has been declining (decreasing from 31 per cent in 1977 to 11.1 per cent in 2012), the employment share of agriculture has remained nearly the same over time (36 per cent in 1977 and 31 per cent in 2012). Tax collection among those in the agricultural sector (from farm or non-farm activities) is challenging owing to the high degree of informality. According to some studies, Sri Lanka exhibits one of the highest levels of informality, not only in comparison to the South Asian region but also in comparison to the neighbouring East Asian region, of around 45 per cent of GDP.[18] Meanwhile, Sri Lanka's services sector is gaining greater prominence in the economy. As noted at a recent forum,[19] tax administration is grappling with the challenges emanating from tax collection in a context where the structure of the economy is changing towards a greater services sector share of GDP, mainly driven by wholesale and retail trade. These sectors have been significant drivers of growth in the post-conflict period.

These characteristics impinge on the lower collection of direct (income) tax collection and compel tax collectors to depend more on indirect taxes.

In Sri Lanka, the source of tax revenues is heavily skewed towards indirect taxes. Between 1980 and 2011, an average of nearly 84 per cent of revenue was generated by indirect taxes,[20] while direct taxes, such as income tax (corporate and personal) and pay-as-you-earn (PAYE) tax, contributed an average of about 16 per cent.

Sri Lanka is conspicuous for its heavy reliance on indirect taxation. Governments of many comparator countries rely on direct taxes (taxes on income, profits, and capital gains), much more than indirect taxes for their revenue (Figure 9.5). Meanwhile, as Table 9.3 shows, Sri Lanka is conspicuous even among developing countries for its low collection of direct taxes. Looking at it over time as well, these countries have been able to steadily increase revenue coming in from these sources, as their economies have developed over time.

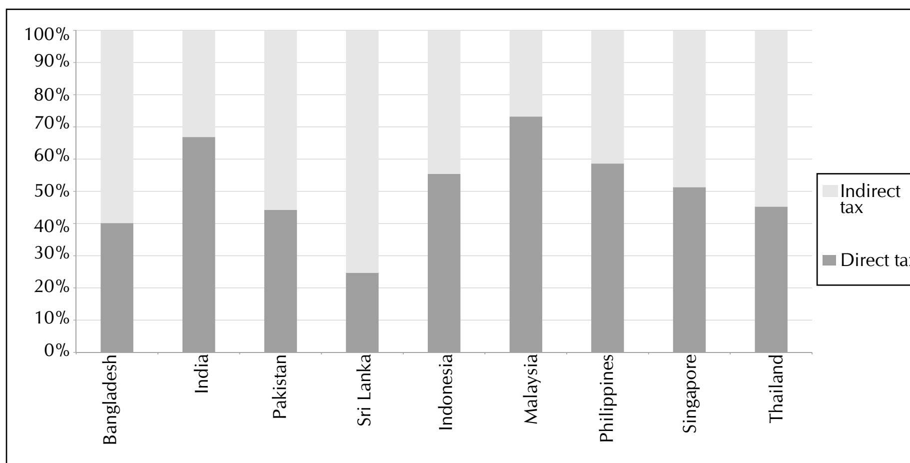
---

[18] Schneider, F., *et. al*., (2010), "Shadow Economies All over the World: New Estimates for 162 Countries from 1999 to 2007," Policy Research Working Paper 5356, World Bank, Washington, D.C.

[19] Keynote Address by the Secretary to the Ministry of Finance and Planning at the "Sri Lanka Economic Summit 2013" organized by the Ceylon Chamber of Commerce, 9-10 July, 2013, Colombo.

[20] Indirect taxes in Sri Lanka include VAT, (previously a Goods and Services Tax - GST), Nation Building Tax (NBT), Customs duty and other border taxes like Port and Airport Levy (PAL), Regional Development Levy (RDL), Social Responsibility Levy (SRL), some of which have been abolished with the Budget 2011.

Figure 9.5
Direct vs. Indirect Taxes (% of Total Revenue) - Sri Lanka vs. Selected Countries (2010)



Source: IPS/UNDP (2012), "Sri Lanka Human Development Report".

Within indirect taxation too, the let-down of the performance of VAT as the main indirect tax, has contributed to the revenue decline. In keeping with developments in tax policy globally and the successful experiences of other countries, Sri Lanka has embraced VAT as its key indirect tax revenue tool, owing to its non-cascading effect. The country did away with a revenue-wise successful Turnover Tax (TT), in favour of a Goods and Services Tax (GST) in 1998, yet it is widely accepted that the revenue administration did not sufficiently modernize to cope with this change. The shift to VAT in 2002 placed further pressure on administration, and VAT performance has been sub-par. The VAT Productivity Ratio, calculated by dividing net VAT collections as percentage of GDP by

Table 9.3
Revenue from Taxes on Income, Profits and Capital Gains as percent of Total Tax Revenue – Sri Lanka vs. Selected Countries (1990 – 2008)

Country	1990	1992	1994	1996	1998	2000	2002	2004	2006	2007	2008
Sri Lanka	**12**	**14**	**15**	**16**	**14**	**15**	**17**	**15**	**19**	**21**	**21**
Thailand	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	39	44	45	48
Malaysia	43	47	44	46	60	55	62	n.a.	n.a.	n.a.	n.a.
India	19	23	29	30	32	36	38	43	47	51	52
Pakistan	13	18	21	20	29	28	31	28	28	38	37
Uganda	n.a.	n.a.	n.a.	n.a.	15	16	21	25	27	28	27
Kenya	n.a.	29	33	40	38	33	33	36	39	40	42

Note: n.a = data not available.

Source: World Bank, "World Development Indicators".

the general VAT rate, is a low 0.27 (2011). Aside from slightly improving in the mid-2000s to around 0.38, it is now back to the productivity level seen soon after its introduction. In other words, the country collected just 3.2 per cent of GDP in VAT revenue in 2011.[21] The closer this ratio is to one, the higher is the collection efficiency of the VAT. Sri Lanka's VAT let-down can be attributed to several reasons, chiefly, a complicated rate structure that existed for years, ad hoc and discretionary exemptions based on special interests/lobbying, and administrative weaknesses.

Overall, Sri Lanka's tax collection has not kept in step with the expansion of economic activity and GDP growth. This can be measured in terms of 'average buoyancy of revenue collection'– essentially, the responsiveness of revenue growth to GDP movements. Average buoyancy in Sri Lanka's tax system is extremely weak. For all South Asian countries except in Sri Lanka, average buoyancy over the past decade is at, or above 1 – which means revenue is growing faster than GDP. Yet in Sri Lanka, it is a very low 0.6.

9.6 Tax Policy Reforms

A report by the Presidential Commission on Taxation in 2010 identified many of the issues raised here, and provided comprehensive recommendations to address them in a phased manner – especially with the objective of expanding the tax base. However, full implementation of the recommendations, particularly those on drastically streamlining border taxes and a complete reform of tax administration to make it more effective and efficient, have not taken place due to competing stakeholder interests and political sensitivities. For example, the government may be hesitant to undertake a reform of tax administration (to improve collection and compliance) at this point in time because of a hesitation to tackle the heavily unionized workers in key revenue departments such as Customs and Inland Revenue.

Yet, some reforms aimed at expanding the direct tax base have begun. For instance, in an unprecedented reform measure, the Budget 2011 extended PAYE income tax to public sector employees, stripping away the income tax exemption that they enjoyed since the late 1970s. Additionally, a reduction of corporate and personal income tax (with a view to stimulating economic activity – particularly enterprises – and thus generating more total tax revenues, as well as to encourage greater compliance) were implemented via the 2011 Budget.

But the revenue effect of these reforms is still uncertain. For instance, a recent simulation study by the IPS showed that although adding the previously exempt public servants to the tax base corrects the previous horizontal inequity between public and private sectors employees, the structural changes that came with the new tax scheme may result in a decline in tax revenues.[22] According to the simulated results, the amount of tax revenues is reduced from Rs. 12.2 billion in 2007 to Rs. 6.3 billion in 2011. Two main reasons cited for the decline under the new 2011 tax system are: i) the new tax brackets induced an increase of the 'tax free' threshold from Rs. 300,000 in 2007 to Rs. 600,000 in 2011; and ii) the tax rates were also reduced to 4-24 per cent from 5-35 per cent in 2007.

9.7 Conclusion and Way Forward

As developing countries need to spend more on public infrastructure, education, health services and so on, they need to increase their

[21] Calculated at the standard VAT rate of 12 per cent in 2011.

[22] Arunatilake, N., P. Jayawardena and A. Wijesinha (2012), 'Tax Reforms in Sri Lanka: Will a Tax on Public Servants Improve Progressivity?', PEP Working Paper, December 2012.

tax ratio in order to grow and improve human development outcomes of its people.[23] As this Policy Brief has highlighted, much remains to be done in terms of investments in human development via the health and education sectors. Emerging expenditure needs, in the face of high fiscal deficits and outstanding government debt, provide a strong rationale to create more fiscal space through revenue mobilization, i.e, taxation. Sri Lanka must focus on getting the implementation of VAT right, in a way that lives up to its revenue-raising promise. This would involve gearing the tax administration with modern tools and staff capacity, as well as ending costly exemptions.

Meanwhile, efforts must be strengthened to raise more direct tax, especially in a new post-conflict era of private sector expansion. Undertaking a comprehensive effort to expand the direct tax base by 'stick' approaches like tighter compliance checks, smarter auditing, and higher penalties; as well as 'carrot' approaches like reforming the attitudes and approach of the Inland Revenue Department (IRD) staff to be more tax payer-friendly, and re-orienting IRD practices to encourage greater voluntary compliance, should be a priority. Sri Lanka cannot continue its overreliance on indirect taxes and must increase its direct tax effort. Higher dependence on indirect taxes is not an ideal scenario as it is well established that unlike direct taxes, indirect taxes are inherently regressive. They tax people's consumption of goods and services regardless of their income level, which in turn means they have a higher burden on poorer households than richer ones.

Although beyond the scope of this Policy Brief, it will be incomplete to not mention the complementary role that expenditure rationalization must play alongside the revenue raising effort. This must necessarily include, reducing lower-priority spending, make the subsidies and transfer schemes more cost-effective, and better utilization of existing and new funds. While greater tax revenue will increase the funding space that the state has to spend on education and health, it is only part of the story. An important complementary strategy must be the smarter utilization of funds through, for example, improved allocative efficiency and superior targeting.

Overall, in an economy that is aiming to place itself on a sustainable middle-income growth trajectory, the capacity of the state to deliver services to the broader population and address human development gaps is essential. For this, the state would need a greater availability of domestic financial resources, and stronger tax revenue generation can provide this fillip.

[23] Bird, R., *et. al.*, (2008), "Tax Effort in Developing Countries and High Income Countries: The Impact of Corruption, Voice and Accountability," *Economic Analysis & Policy*, Vol. 38, No. 1.