

Indirect Taxation in Sri Lanka: The Development Challenge

Abstract

Sri Lanka is seeking rapid economic growth targeting at doubling per capita income by 2016. Nonetheless, inequality is at its historical highest and thus the development challenge is to ensure that rapid economic growth is achieved while better ensuring equitable income distribution. Since fiscal deficit is significantly high in Sri Lanka, taxation is crucial in generating government revenue because of the harmful macroeconomic repercussions of other means. However, tax ratio is on the decline and the decline is closely related to the decline of the indirect tax revenue. Therefore, enhancement of indirect taxation is vital. Efficiency and productivity of VAT should be improved while taking measures to ensure equity. This will be an important development challenge to the country.

Introduction

Development can be defined as economic progress shared by all, and is particularly so if one focuses on sustainable development. Sri Lanka is seeking a rapid economic growth after ending the thirty-year old civil war. The current target is to double per capita income from the current level of USD 2053 to USD 4106 by 2016. Inequality, as measured by the Gini coefficient however, is at its historical highest, 0.49 in 2006/2007, compared to 0.43, 0.46 and 0.48 in 1978/79, 1986/87, and 1996/97 respectively. Thus, the development challenge is to ensure that rapid economic growth is achieved while better ensuring equitable income

distribution. Taxation, *inter alia*, can be used as a tool to ensure such income distribution across geographical demarcations and income deciles.

In the past three decades, a number of developing countries have experienced major episodes of financial crisis that were brought about by unsustainable fiscal deficits. As in the case of a number of other developing countries, the fiscal deficit in Sri Lanka too has been high for a long period. Though the fiscal deficit was at its peak at 23 per cent of GDP in 1980, it averaged 13 per cent during 1977-1991 and 9 per cent during 1992-2009 (Central Bank of Sri Lanka). However, even a 9 per cent deficit could be a dangerous phenomenon as it could act as a catalyst for financial instability in the country. For example, Brazil's financial crisis in 1999 was closely related to its high budget deficit, which was 8.4 per cent of its GDP (Woo, 2003). When government revenue is insufficient to offset expenditure, the country is forced to depend on foreign and domestic sources to bridge the fiscal deficit. As a result, government's debt as a percentage of GDP (Gross Domestic Product) rises. High levels of debt in turn will increase the pressure on the government's ability to meet its other commitments. This is of particular concern when these commitments involve essential and development-oriented expenditure. Government borrowing also tends to reduce the quantum of resources available to the private sector and results in higher interest rates in the domestic market. This will increase the cost of borrowing for the private sector, thereby crowding out private investment, adversely affecting the economic growth of

Kopalapillai Amirthalingam¹

*Senior Lecturer,
Department of Economics,
University of Colombo.*

the country. This situation necessitates comprehensive policy measures either to reduce expenditure or to increase the revenue base of the country, so that the government need not depend overwhelmingly on debt. However, given the security situation and the need for rapid development of the country, expenditure cuts could be harmful not only economically, but also politically.

Therefore, focusing on taxation is crucial since alternative ways of financing government expenditure, such as, money creation, mandating larger required reserves, domestic borrowing and foreign loans can have harmful macroeconomic repercussions. International empirical evidence on tax ratio (total tax revenue as a percentage of GDP) has 40 per cent, 25 per cent and 18 per cent as the average tax ratios for high-, middle- and low-income countries respectively (Gallagher, 2005). Nonetheless, tax ratio in Sri Lanka has been declining and remains well short of the average rate of developing countries. It is important to note that the tax ratio has declined from 21 per cent in 1979 to 12.8 per cent in 2009. Indirect tax as a percentage of GDP has declined from 15.7 per cent in 1980 to 9.9 per cent in 2009. During the same period, as a percentage of GDP, direct tax has also declined marginally, from 3.1 per cent to 2.9 per cent (Central Bank of Sri Lanka). Here, we can notice that the decline

of tax ratio has been closely related to the decline of indirect taxes as a percentage of GDP.

Thus there is a need, as well as room to increase the tax ratio in Sri Lanka because increasing tax revenue as a percentage of GDP is vital for the economic development. Lewis (1984) argues that an increasing share of tax revenue in national income or in GDP is an instrumental objective of economic development policy. High-income countries have had rising shares of tax revenue and government expenditures to income as they have become more economically advanced. Similarly, comparison among countries at different levels of per capita income generally show higher shares of government expenditure and tax revenue in national income of higher-income countries than in poor countries. There appears to be a relative increase in the demand for government services as per capita income increases. At very low levels of per capita income, the principal needs are for "private" goods, such as food, clothing and shelter. The income elasticity of demand for those products falls as per capita income increases, and there is an increased demand for "public" goods at higher levels of income. The increased demand is for government services in the areas of transportation, communication and general government administration, to deal with increased complexities. Further, the demands for certain welfare services and transfer payments to various poorer sections of the population are felt much more strongly at higher levels of per capita income than at lower ones. All these pressures to increase the level of government expenditures and transfer payments generate a need to increase tax revenue to release real resources for the provision of these government services. In addition to general government consumption expenditure, the governments of

developing countries usually wish to increase development-oriented services such as education and training, agricultural extension and research. Thus, government revenue may need to grow at a rate that exceeds the growth of national income to provide resources for recurrent government expenditure. As a result, countries are constantly trying to formulate a better tax policy and frequently reforming their tax structure with a view to increasing tax revenue.

Though the main target of a country is to increase total tax revenue, indirect and direct taxes play different roles in developing and developed countries. Developing countries tend to rely on indirect taxation as a revenue source, since such taxes are easier to administer in countries that have poorer income and asset recording systems. High direct taxes are also thought to discourage entrepreneurship and effort, and hence lower direct tax rates are proposed in a bid for greater economic growth. Thus clearly, the growth in tax revenue has to be largely through the expansion of indirect taxation. However, since indirect taxes act as regressive taxes in which the tax burden may fall on everyone equally, regardless of their income (or ability to pay), further enhancement of the indirect taxes might aggravate the equity concerns encompassed in the development objective. This necessitates indirect tax reforms to be sensitive both to equity and growth objectives in the country.

Defining Indirect Taxation

Indirect taxation is defined as taxation that may be imposed upon the persons other than those who are intended to bear the final burden. Unlike direct taxes, indirect taxes are the same for all, irrespective of the income level of the consumer and are therefore regressive. These taxes imposed on producers, can be shifted on to the

consumers by way of increasing the price of goods and services. The most important single fact about indirect taxes in developing economies is the dominant role that they play in the revenue system of almost every country. Historically, indirect taxes have been an important element in stabilisation tax packages that aim at raising revenue in the short run in many countries.

Musgrave (1969) divided the period of economic development into two: the early period when an economy is relatively underdeveloped and the later period when the economy is developed. During the early period, there is limited scope for the use of direct taxes because the majority of the populace resides in rural areas and is engaged in subsistence agriculture, and therefore their incomes are difficult to be estimated. Therefore, indirect taxes play an important role during the early stage of economic development. The difference in direct and indirect tax shares in developed and developing countries confirms Musgrave's theory. He further states that the ratio of indirect taxes to total taxes is related inversely to per capita income, because the economic structure of low-income economies is not suited to the imposition of direct taxes. The following Table clearly shows the difference between Sri Lanka and some developed countries, such as, Canada, New Zealand and Australia and even some other developing countries with regard to the capacity for raising tax revenue through direct taxes (Taxes on income, profits and capital gains).

Table 1, shows that Sri Lanka has raised less revenue from direct taxes (taxes on income, profits and capital gains). This indicates that even in contrast to Thailand, Malaysia, India and Kenya, Sri Lanka has relied excessively on indirect taxation. Other countries have expanded their direct tax

Table 1: Taxes on income, profits and capital gains (% of total taxes) in selected countries

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
Canada	72	71	71	73	74	76	72	74	77	77	..
New Zealand	..	..	..	..	..	..	62	62	67	66	..
Australia	..	..	..	..	..	75	67	70	..	..	..
Thailand	..	..	..	..	..	..	..	39	44	45	48
Malaysia	43	47	44	46	60	55	62	..	..	..	..
Korea, Rep	40	40	39	37	41	38	37	41	44	46	..
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	..	..	..	..	15	16	21	25	27	28	27
Kenya	..	29	33	40	38	33	33	36	39	40	42

Source: World Development Indicators—Not Available

revenue proportion over time significantly unlike Sri Lanka, which began from a lower base and has grown more slowly. Given the regressive nature of indirect taxation, the tax structure is likely to be detrimental to Sri Lanka's progress towards the achievement of social and economic justice. While a major development challenge is to shift the Sri Lankan tax system more towards direct taxation, given the current fiscal deficit problems, it is also important to focus on improving the earnings from indirect taxation in a manner that is least regressive.

Efficiency and productivity of the VAT

Value-Added Taxes (VAT) can be defined as a tax on the value that is added to goods and services by enterprises at each stage of the production and distribution process (Shoup, 1988). After the first adoption in France in 1954, VAT has indeed proved itself an effective form of taxation and its growth is unprecedented by any other concept in taxation (Keen, 2007; Ebrill *et al.*, 2002; Keen and Lockwood, 2009). Moreover, the VAT has now become a central tool of tax policy in most countries, with the exception of the United States. The extent and pace of the spread of the VAT around the world has been one of the most striking international tax developments in recent history.

Tax development in the world as well as the successful experience of other countries with different tax systems, induced Sri Lanka too to shift from Business Turnover Tax (BTT, 1964-1981) to Turnover Tax (TT, 1981-1998) to Goods and Services Tax (GST, 1998-2002) and finally to Value-Added Tax (VAT, 2002). In Sri Lanka, the VAT involves a multiple rate structure. Apart from zero rate and exemption, there was a 10 per cent concessionary rate and a 20 per cent standard rate when the VAT was introduced in 2002. Subsequently, there were changes almost every year with regard to the rates. At present, VAT rates adopted in Sri Lanka are 20 per cent luxury rate, 12 per cent standard rate, 5 per cent optional rate, zero rates for exports and exemption for specific items (Government of Sri Lanka).

In Sri Lanka, the VAT has contributed 35.7 per cent to total indirect taxes in 2009. Since VAT plays a pivotal role in the entire indirect tax system, it is important to examine the efficiency and productivity of VAT.

efficiency is the ratio of the VAT revenue to aggregate consumption, divided by the standard VAT rate. The productivity is the ratio of VAT revenue to GDP, divided by the standard VAT rate. The closer these ratios are to zero (one), the lower (higher) the collection efficiency of the VAT (Bird and Gendron, 2006; Aizenman and Jinjarak, 2008; Ebrill *et al.*, 2002 and Correia, 1999). The VAT could be the most productive source of revenue for developing countries. To achieve this objective, its efficiency and productivity must be high.

According to Table 2, the efficiency in Sri Lanka does not show a clear trend: it increased from 0.40 in 2003 to 0.61 in 2004 but after 2004

Table 2: Efficiency and productivity of VAT in Sri Lanka

Year	Efficiency	Productivity
2003	0.40	0.27
2004	0.61	0.38
2005	0.55	0.38
2006	0.55	0.37
2007	0.52	0.35
2008	0.44	0.31
2009	0.46	0.30

Central Bank of Sri Lanka (Various Annual Reports) and Government of Sri Lanka (publications with regard to Value Added Tax Act and subsequent amendments)

there has been significant decline till 2008 and then a slight improvement in 2009. The efficiency of the VAT in the world varies country to country. For example, it is very high in some countries (Jamaica: 0.93 and Canada: 0.67) and very low in others (Brazil: 0.16 and Argentina: 0.27) (Bird and Gendron, 2006).

VAT collection efficiency can be improved with the resources spent on enforcement, and with the efficiency of monitoring, collecting and processing information. Theory suggests that the enforceability of taxes is impacted by political economy considerations – greater polarisation and political instability would tend to reduce the efficiency of tax collection, reducing the resources devoted to tax enforcement. In addition, collection is impacted by structural factors that affect the ease of tax evasion, like the urbanisation level, the share of agriculture in GDP and trade openness (measured as the ratio of imports plus exports to GDP). Empirical studies on several countries show that both urbanisation and trade openness will be significantly and positively related to the tax collection efficiency but in contrast the share of agriculture in GDP will be negatively correlated to the tax collection efficiency. So with the prevailing peaceful situation in the country, it is necessary to have meaningful industrialisation and trade liberalisation with increased resources devoted to tax administration, efficient monitoring, and better usage of modern information technology (MIT) to enhance VAT collection efficiency in the coming years.

If we look at the productivity of VAT, not only is it relatively low, but it has been declining during the period 2004 and 2009 (Table 2). This figure presents the percentage of GDP that each percentage point of the standard VAT rate collects. Therefore, we can conclude that Sri

Lanka has collected just 3.6 per cent of GDP in revenue from VAT. The revenue productivity of the VAT in the world is as high as 0.70 (for New Zealand) and as low as less than 0.20 for some countries. Within Latin America the range in productivity varies from around 0.20 (in Haiti, Mexico and Venezuela) about to 0.50 (for Chile and Ecuador) (Bird and Gendron, 2006). To improve the level of revenue productivity of the VAT, total revenue from VAT as a percentage of GDP should be increased. To achieve this goal, government can take many measures including;

- i) more taxation on the growing economic sectors (e.g. - mobile phones),
- ii) heavier taxation on income-elastic items (e.g. - vehicles, petroleum products),
- iii) bringing informal economic activities into tax net, and
- iv) heavier taxation on price-inelastic items (e.g. - alcoholic beverages and tobacco products).

If Sri Lanka manages to improve the productivity of VAT, it can ensure greater government expenditures for development objectives. However, the country faces challenges here too, because VAT has clearly not achieved its greater revenue-generating objective; this may be due to several reasons such as its complicated structure, administrative weaknesses, political influence, tax avoidance and evasion, complexities in the tax law, lack of application of modern information technology, etc. VAT, in fact, has performed worse than the previously adopted Business Turnover Tax in terms of revenue generation. However, compared to turnover taxes, VAT is an ideal tax to address the equity concern, because unlike turnover taxes, there is no cascading effect under VAT and zero rate and exemption of essential goods can be used effectively to achieve the distributional objective under VAT. Moreover, VAT is more equitable

than turnover tax because under VAT, the tax rate is clearly specified and as a result there is no hidden element in tax.

Impacts on equity

Equity is, of course, a central issue in taxation almost everywhere. Equity in taxation implies that taxes should be imposed in accordance with the ability to pay. Equity normally has two dimensions: horizontal and vertical. Horizontal equity holds that taxpayers with equal income should pay equal taxes regardless of the source or nature of that income. Vertical equity means that taxpayers with greater ability to pay should pay more (Musgrave, 1976; Musgrave and Musgrave, 1989; Plotnick, 1982). A good tax system must be both equitable and efficient. It is widely recognised that these goals may conflict. Efficient taxes may be inequitable in their effect on the distribution of income. On the other hand, equitable taxes may not be efficient taxes. Efficiency demands that necessities should be taxed more heavily than luxuries. This is of course the opposite of what one would hope for from the equity point of view. Therefore, it is argued that distributive (equity) policies are implemented at a cost in efficiency in almost all countries.

Theory suggests that if a country does not have a well-developed, effective and optimally-adjusted income tax and transfer system to tackle equity concerns with the direct tax system, indirect taxes should be differentiated to incorporate the distributional consideration in addition to the usual efficiency concerns (Stern, 1987). That is why most countries tend to keep many essential goods and services - which are largely consumed by the poor disproportionate to their income - out of the tax net by the ways of zero rate or lower rate or exemption. Furthermore, there is a common

argument that equity could be improved by the greater use of food subsidies accompanied by much higher taxes on luxuries and alcoholic beverages and tobacco products. Indeed, alcoholic beverages and tobacco products are not beneficial for either their users or for society and could actually be harmful, especially for the consumer and the family, and therefore it is argued they could be heavily taxed with no ill effects. Further, since they have less elasticity, they provide a better basis for taxation than most other commodities. Therefore, in practice, different rates are imposed on different goods to ensure equity under VAT. With the view addressing equity concerns, higher tax rates are imposed on alcoholic beverages, tobacco products, petroleum products and other luxuries in Sri Lanka too.

According to the theory, the VAT provides a potentially more equitable and efficient means of taxation. In practice, under the VAT, different mechanisms are adopted to address the equity concern. Hossain (1995) notes that a selective VAT with some zero ratings (or exemptions) and additional excise is clearly preferable to a completely uniform VAT, if distributional issues are of dominant concern. Ahmad and Stern (1987) indicate, in a study in India, that a uniform VAT on all final goods is clearly regressive and undesirable. However, they conclude that a uniform VAT with exemptions or zero rates on certain items to allow for "distributional consideration" is much less regressive than a proportional VAT. Therefore, it is true that greater equity can be achieved under VAT using zero rating and exemption.

Conclusion

Even though the primary focus of Sri Lanka is to achieve a rapid economic growth rate in the coming years and to double per capita income by 2016, the country should take comprehensive measures to

reduce the over dependency on indirect taxes in the long run and should continue to address the equity concern by way of zero rating and exemption under VAT. The major consumption basket (such as food, milk powder, pharmaceuticals, etc.) of low-income group should not be taxed even indirectly. At the same time, comprehensive measures should be taken to improve the efficiency and productivity of the VAT. Only then will the country be able to harness its indirect tax system as an instrument in attaining sustainable development. In fact, this will be an important development challenge to the country.

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Contact Details:

K. Amirthalingam,
198 A, Wasala Road,
Kotahena, Colombo-13.
TP: 0777411547
Email:kamirthalingam@econ.cmb.ac.lk

Footnote:

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