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TAX CHANGES BEFORE TAX POLICIES: SRI LANKA 1975-1988

by

Glenn P. Jenkins

Harvard Institute for International Development

Harvard University

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## ABSTRACT

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This study examines the changes in tax policies that occurred in Sri Lanka after the change in Government in 1977. These policies are evaluated in the context of the major reforms that were carried out on most aspects of the economy. These fundamental reforms have experienced significant success in terms of economic growth and employment. The numerous tax incentives and tax holidays initially weakened the income tax system, but significant progress was made with regard to indirect taxation for both domestic and traded goods. After a number of years of consistent economic management, steps have been taken to apply more economically oriented tax policies to strengthen and rationalize the tax system. One result of these changes is that the administration cost of the tax system in terms of revenue collected has been reduced by about 50 percent.

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## TAX CHANGES BEFORE TAX POLICIES:

SRI LANKA 1975-1988

### I. INTRODUCTION

The year 1977 was a major turning point in the modern economic history of Sri Lanka. In that year a new government assumed office and challenged the basic assumption on which economic policy had been made over the previous two decades. The result was a series of major policy changes in ten areas of the economy including:

- a. The adoption of a realistic exchange rate.
- b. The liberalization of foreign exchange markets.
- c. A shift from quantitative restrictions on imports to tariffs as a means of protecting domestic industry.
- d. The lifting of price controls.
- e. Relaxation of interest rate controls to encourage greater savings.
- f. Shift from consumer subsidies to producer incentives.
- g. Creation of favorable business climate for foreign investment.
- h. Removal of excessive administrative controls over investment.
- i. Creation of tax incentives for investments in real assets and for export sectors.
- j. Special tax incentives and technical assistance for small business.<sup>1</sup>

The objectives of these economic policy changes were to promote rapid economic growth, create employment and rationalize the economy. A clear shift was made in economic management from the highly interventionist policies of governments of the previous decade to a much greater reliance on

the private sector and the use of market forces to guide the allocation of resources.<sup>2</sup>

At the time these policy changes were badly needed and, with a few exceptions, have generally been effective. The tax system in 1977 was a prime example of where two decades of misguided tax policies fueled by interventionist tendencies can lead a country. While the economic philosophy of the Government changed dramatically and many tax changes have been made, evidence of the existence of sound tax policies is just beginning to emerge. The basic approach has been one of using the income tax system as a political rather than a fiscal tool, with an incentive for almost every interest group, while relying on poorly designed indirect tax system to raise revenues for the public sector.

## II. THE TAX SYSTEM IN 1977

The Sri Lankan tax system in 1977 contained seven categories of taxes: an income tax system that contained both a corporate as well as a personal income tax; a wealth tax; a business turnover tax; a set of excise taxes; a set of import duties; a set of export taxes; and, sales of Foreign Exchange Entitlement Certificates (FEEC).

This tax system was typical of that found in a highly regulated economy. It was very interventionist with high and differential tax rates, while being largely ineffective as a system for raising revenue.

From Table 1 we find that from 1971 to 1977 the combined personal and corporate income taxes were in the order of 20 percent of total tax revenue, with wealth taxes amounting to about another 2 percent of tax revenues. The

business turnover tax and excise taxes generated about 15 and 24 percent of total tax revenues, respectively.

Because of the heavy reliance on quantitative import controls to ration the use of foreign exchange, the average revenue yield from import duties was relatively small. They amounted to about 9 percent of total revenues, while export duties averaged about 1 percent. These taxes greatly underestimate the total taxes on the export sector because of the highly overvalued exchange rate. From the sale of the rights to use foreign exchange (FEECs) the government obtained additional funds equal to about 19 percent of total revenues.

#### Income taxes

The basic structure of the corporate income tax system in 1977 was a 60 percent rate of tax on taxable income of resident and non-resident companies. In addition, resident companies were required to pay a dividends distribution tax of 33-1/3 percent. Non-resident companies were required to pay an additional 6 percent of taxable income in lieu of Estate duty and also a tax of 33-1/3 percent on dividends remitted abroad.<sup>3</sup>

Offsetting this seemingly harsh corporate tax system, was a set of tax incentives that allowed for immediate expensing of a major portion of new investments. The proportion that could be deducted immediately from taxable income ranged from 50 percent for assets with long lives to 80 percent for assets with short lives. In addition, five year tax holidays were given for a wide range of activities including industrial undertakings employing more than 25 people, activities engaged in the export of goods and services, deep sea fishing enterprises, tourist hotels, and paddy milling. Given the

difficulty of defining what was a "new" activity, there was plenty of room for creative tax avoidance activities.

The personal income tax had characteristics similar to that of the company income tax. Until 1979 the taxable unit was the family. The incomes of children under the age of 25 and that of the spouse were aggregated with that of the head of the family. In the early 1970s there were 13 tax brackets, with the top income bracket facing a marginal tax rate of 75 percent.<sup>4</sup> The size of tax brackets and rates were changed almost annually, dropping to 11 tax brackets with a top tax rate of 50 percent in 1976, but then increasing to 14 brackets with a top tax rate of 70 percent in 1978.<sup>5</sup>

There were a number of tax incentives, including the exemption of dividends arising from companies enjoying tax holidays, and for interest (subject to limits) received from the Ceylon Savings Bank, the Ceylon Post Office Savings Bank and the National Savings Bank. In brief, declared taxable income was taxed at very high rates, but the opportunities for tax avoidance were abundant.

### The Wealth Tax

The wealth tax was introduced in 1959 with the objective of increasing the degree of progressivity of the tax system. Like other wealth taxes in developing countries, it has not been effective either as a revenue producer or as an instrument to bring about a better distribution of income. But unlike many such wealth taxes in developed and developing countries, it has not been abolished.

It is applicable to both the movable and immovable property of resident and non-resident companies in Sri Lanka. In addition to a basic deduction,

TABLE 1  
Tax Revenue (1971 - 1977)  
(percentage composition) (Rs Million)

	1971	1972	1973	1974	1975	1976	1977
1 Taxes on Income & Profit	19.9	17.7	21.7	15.3	18.6	20.4	17.3
Corporate	--	--	14.1	10.4	12.4	14.9	12.0
Personal	--	--	7.6	4.9	6.2	5.5	5.3
2 Taxes on Property and Property Transfer	2.2	2.3	2.4	1.8	2.3	1.9	2.0
3 Taxes on Goods and Services	37.6	42.5	38.9	36.9	38.1	37.7	40.0
Business Turnover Tax	14.6	15.4	16.6	15.4	15.6	15.5	12.2
Liquor	7.4	10.4	7.7	5.5	5.0	4.1	4.4
Tobacco	11.1	12.2	10.6	9.5	11.1	9.8	10.9
Tea	1.7	1.7	1.2	4.1	4.0	6.0	10.6
Other	2.7	2.7	2.7	2.3	2.4	2.2	1.9
4 Taxes On Imports	12.6	10.1	6.9	7.1	8.1	10.4	9.6
5 Taxes on Export	11.9	9.1	12.1	16.9	10.4	9.2	11.4
Tea	7.3	6.4	5.3	4.0	4.3	3.6	4.9
Rubber	0.6	0.4	4.5	7.3	3.4	4.4	4.9
Coconut	2.5	1.1	1.0	4.1	1.6	0.1	0.5
Other	1.6	1.2	1.2	1.4	1.1	1.1	1.2
6 FEEC	15.7	18.3	18.2	22.1	22.5	20.4	19.7
7 Total Tax Revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0
8 Tax Revenue as % of Total Current Revenue	86.0	87.2	89.2	91.6	91.1	89.6	88.9

Note: Totals may not add up because of rounding

Source: Central Bank of Sri Lanka

there are further deductions for a house, furniture, jewelry, and an automobile. The asset values that make up the base of the tax have been frozen at their 1977 levels. This provision, along with generous opportunities for tax avoidance and evasion, has resulted in a steady decline in the importance of this tax.

#### The Business Turnover Tax

The business turnover tax (BTT) was originally introduced in 1964. It is a multi-stage sales tax that is applied to gross quarterly receipts from sales at all stages of production and distribution. When it was initially implemented it was highly cascading, but measures to permit tax credits on purchases of current inputs have reduced this characteristic of the tax. It has always had several rates of tax depending on the commodity and stage of distribution. In 1977 there were six rates of tax ranging from 1 to 35 percent.

#### Selected Sales and Excise Taxes

These taxes have been traditionally on alcoholic beverages, tobacco, tea and coconut oil. Except when the price of tea has been extraordinarily high, the bulk of the revenues have been obtained from tobacco and alcoholic beverages. The application of these taxes and their role in the fiscal system has been fairly consistent for the entire period of the 1970s and 1980s.

### Import Tariffs and FEECs

Until 1977 foreign exchange controls were pervasive. Although tariff rates were high, the principal device for rationing the available foreign exchange were quantitative controls and the sale of Foreign Exchange Entitlement Certificates (FEECs). The FEECs raised quite a large amount of revenue, but a large proportion of this amount had to be turned over to producers in order for them to be willing to produce for the export market. Due to the stagnation of the economy, and in particular the exporting sectors, there was not much foreign exchange available. As a result, the growth in imports and tariff revenues was small.

### Export Taxes

Export taxes on tea, rubber and coconut have been traditional features of the Sri Lankan tax system. Furthermore, the Government's nationalization policies during the early 1970s ensured that these once dynamic sectors would stagnate and experience disinvestment. The combination of an overvalued exchange rate, export taxation and incompetent economic policies during this period have inflicted damage on these agriculture export crops that has not been rectified to date.

## II. TAX CHANGES 1978-1987

### Taxes on Trade

In the years immediately following the change in government in 1977 there have been dozens of tax changes that have shifted the fiscal system further away from direct taxes toward indirect taxation. The first step was taken following the devaluation in 1978, when large export taxes were imposed

on tea and rubber to capture most of the short-run gains that would have accrued to these sectors from the devaluation. Between 1977 and 1978 the proportion of total tax revenues raised by export taxes (Table 2) rose from 11.4 to 40.8 percent. Since that time the reliance on export taxes has gradually decreased to the point where they are now less important than they were in 1977.

Since the removal of exchange controls and the reduction in the use of quantitative controls to restrain imports, the tariff system has become a much more important source of tax revenue. From table 2 we find that since 1979 tariffs have consistently provided more than 20 percent of total tax revenues to the government.

The Presidential Tariff Commission (PTC) that was set up in 1977 has played a very positive role in rationalizing the tariff system over time. In particular, the recommendations that were implemented in 1985 went a long way towards reducing the level and degree of dispersion of the effective rates of protection given to domestic producers of import substitutes.

While the overall levels of effective protection are quite high, their trend (and recommendations of the PTC) have been fairly consistent at moving the tariff system toward a more rational allocation of resources between the production of import substitutes and the other sectors of the economy. The proposals made in the 1988 budget are consistent with this trend. In it the Minister proposed to reduce all import duties that were above 60 percent to 60 percent.

TABLE 2  
Tax Revenue (1978 - 1985)  
(percentage composition) (Rs Million)

	1978	1979	1980	1981	1982	1983	1984	1985	1986
1 Taxes on Income & Profit	10.6	12.2	16.7	14.4	19.0	16.3	18.4	19.4	15.3
Corporate	6.9	8.7	13.7	10.3	13.8	12.0	12.5	15.2	10.5
Personal	3.7	3.5	3.0	4.0	5.2	4.3	5.9	4.2	4.8
2 Taxes on Property and Property Transfer	1.4	1.3	2.1	2.0	2.1	1.9	1.5	1.3	2.0
3 Taxes on Goods and Services	29.9	28.8	28.8	34.9	42.0	46.7	47.3	48.4	47.2
Business Turnover Tax	10.4	10.7	13.1	19.9	26.3	30.1	27.3	33.6	32.2
Liquor	5.3	4.5	5.5	5.6	5.2	4.2	3.4	3.9	14.1
Tobacco	7.3	7.2	8.0	7.9	8.5	6.9	10.8	6.9	14.1
Tea	4.9	2.0	0.8	0.6	1.0	4.5	0.7	3.3	14.1
Other	2.0	4.4	1.4	1.2	1.0	1.0	0.7	0.6	14.1
4 Taxes On Imports	14.1	20.4	23.4	22.7	21.0	23.4	22.1	24.4	30.1
5 Taxes on Export	40.8	37.4	29.1	26.0	16.1	11.9	10.6	6.6	5.2
Tea	26.8	22.4	15.4	13.2	9.4	6.2	5.9	4.1	3.4
Rubber	9.6	11.1	11.1	10.1	4.9	4.1	3.4	1.2	1.0
Coconut	3.3	3.0	1.7	1.7	1.4	1.2	1.0	1.0	0.8
Other	1.0	0.9	1.0	1.0	0.6	0.4	0.3	0.3	0.0
6 FEEC	3.2								
7 Total Tax Revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
8 Tax Revenue as % of Total Current Revenue	93.3	92.7	94.3	93.0	92.8	90.5	87.8	87.3	83.2

Notes: Totals may not add up because of rounding  
Source: Central Bank of Sri Lanka

## Income and Wealth Taxation

Accompanying the very positive set of economic reforms in 1978 that removed many of the controls on international trade and other areas of the market economy, the government started a process whereby almost every conceivable form of tax incentive has been introduced into the company and personal income tax systems. In the case of company taxation, a 100 percent investment deduction was given for expenditures on assets in housing and hotel development, and for various capital expenditures on new plant, equipment and furnishings. These 100 percent deductions were withdrawn in 1983, but very generous accelerated depreciation allowances are still given for selected capital expenditures.

Tax holidays have been the preferred brand of tax incentive. If approval was granted before March 31, 1983, a five year tax holiday is granted for the development of hotels. If it is a quoted public company, the tax holiday can be extended to ten years. A ten year tax holiday is also given to any new company engaged in property development so long as it becomes a quoted public company two years after starting business. Tax holidays are also available for new industrial activities including agrobusiness, animal husbandry, and off-shore or deep-sea fishing. Companies producing exports are completely tax exempt for the first 5 years and 50 percent of their income is tax exempt for an additional 5 years. Even with substantial tariff protection, new enterprises engaged in import substitution activities are given a five year tax holiday.

As many of these tax holidays are given for approved rather than actual operating businesses, there are many approved, but not yet built, projects that will be eligible for tax holidays in the future. The impact on the

corporate income tax revenues has been quite substantial. Although the amount of activity undertaken by the private sector has increased dramatically since 1977, the share of tax revenues from the company income tax has by the mid-1980s only reached when it was during the mid-1970s.

Since the early 1970s the company income tax law has also given preferential treatment to small business. In this case the tax rates start at 20 percent on the Rs. 50,000 of taxable income, and increasing 10 percentage points on each additional Rs. 100,000 of taxable income until it reaches 50 percent.<sup>6</sup> The same rate of advanced company tax applies to the dividends of small business companies as large business.

In 1979 the government took a positive tax policy step by reducing its rate of company tax from 60 to 50 percent and reducing its dividend withholding tax from 33-1/3 to 20 percent. At the time, this rate reduction brought the Sri Lankan company tax system in line with the tax rates of many other developing and developed countries. Since then, it has not attempted to follow the tax policies of a great many countries engaged in tax reform by reducing its company tax rates further while simultaneously eliminating tax incentives.

In the 1988 Budget it is proposed to increase the degree of integration of the corporate and personal income tax systems. This is to be done by allowing the advance company tax on dividends to be available to offset company income tax due, and to give a tax credit to individual taxpayers who receive dividends equal to 50 percent of the value of the dividends.

The personal income tax system has never been a very effective fiscal tool in Sri Lanka. At the present time less than 4 percent of total tax revenues are raised from this tax. As it is unlikely that the personal

Table 3  
 Financing of Government Capital Expenditure 1978-85  
 (percentage of GDP at current market price)

	1978	1979	1980	1981	1982	1983	1984	1978-84
Capital Expenditure	12.8	14.8	18.6	13.6	16.2	13.6	12.8	14.7
Among which financed by								
Government savings	-1.3	0.4	-3.6	-1.8	-1.4	0.1	3.9	-0.5
Foreign grants	1.5	2.6	4.0	3.2	3.4	2.8	2.2	2.8
Foreign project loans	3.5	1.3	1.5	2.3	3.0	4.0	4.2	2.8
Foreign commodity loans	2.4	2.1	1.6	1.6	1.0	0.8	0.4	1.4
Foreign other loans	1.8	1.1	2.1	1.9	0.8	0.4	0.4	1.2
Domestic non-market borrowing	1.8	1.1	2.1	1.9	0.8	0.4	-0.4	1.1
Domestic market borrowing	0.7	1.7	-0.7	0.4	1.7	1.8	0.5	0.9
Monetary expansion	3.8	4.4	3.1	1.7	4.0	3.3	3.4	3.4

Note : Repayment of public debt is excluded

Source: Central Bank of Sri Lanka

income tax can ever be an effective fiscal instrument in a country with as low a per capita income as Sri Lanka, a number of the measures taken since 1977 can be viewed positively. First, adjustments were made in the structure of the basic personal deduction to eliminate low income taxpayers from the tax net. Second, since 1980 steps have been taken to lower the top marginal tax rates, first to 55 percent, and in 1986 and 1988 to 50 and 40 percent, respectively. The basic exemption has also been increased to about 2.5 times the per capita income. The net result is that only about 200,000 people either file tax returns or come under the PAYE system.

While the basic rate structure and personal deductions are realistic, the personal income tax still suffers from the same kind of wide array of deductions and exemptions that is characteristic of Sri Lanka's company tax. For example, the wages of all public servants are exempt from taxation. Although many of the public servants earn incomes of less than the basic deduction, it also means that those with substantial income from other outside sources also enjoy lower tax rates on that income. In a move that facilitated income splitting among members of a family, the law was changed in 1979 to tax personal income on an individual rather than on a family basis.

The ability of a taxpayer to avoid paying significant personal income taxes is enhanced by a wide range of possible deductions. For example, the first Rs. 12,000 of dividends are exempt from personal taxation, as is the first Rs. 2,000 or 1/3 (whichever is larger) of interest income from National Savings Certificates. For administrative reasons, most other interest income avoids taxation. Rental income from houses is largely exempt. Capital gains realized on the sale of quoted public companies is exempt from

tax, as is 75 percent of the capital gains from the sale of houses. One is also able to deduct a wide range of expenditures from taxable income including the purchase of selected ordinary shares, expenditure for the construction and lease of houses, insurance premiums, mortgage interest for houses, pension fund contributions, and the expenditure on the overseas education of a child.'

Positive steps have been taken over the past 10 years to introduce a more realistic rate structure in the company and personal income tax systems. In tax policy terms, however, these tax systems are still extremely weak. Unless steps are taken to reduce the rates of company tax further and to systematically broaden the tax bases of these taxes by the elimination of tax holidays, exemptions, and excessive deductions, they will primarily serve to misallocate resources rather than to obtain financial revenues for the public sector.

While the wealth tax could be classified as a "nuisance tax" with a tax yield of about 1 percent of tax revenues, it has been retained to the present. By fixing asset values at their 1977 levels, this tax will continue to decline in significance and should become a candidate for elimination in the not-too-distant future.

#### Business Turnover Tax

In the evolutionary process of tax policy formation in Sri Lanka over the last ten years, it is the indirect tax system that has experienced the greatest advances. Not only have steps been taken to rationalize the indirect taxes on exports and imports, but the business turnover tax (BTT) has been developed as a central fiscal instrument. In 1978 it generated only

Table 4

Comparison of Administration Costs to Tax Collections  
Income tax, business turnover tax, wealth tax

Financial Year	Percentage
1973	0.90
1974	1.05
1975	1.06
1976	1.02
Average 1973-1976	1.00
1977	n.a.
1978	0.82
1979	0.82
1980	n.a.
1981	0.50
1982	0.47
1983	0.40
1984	0.28
1985	0.33
Average 1978-1985	0.52

Source: Administration Reports of the Commissioner General of Inland Revenue, Colombo, Sri Lanka, 1973 to 1985.

about 10 percent of total tax revenues, but at present, more than 30 percent of total revenues are raised by this tax. Over time, the range of goods and services subject to the BTT has been greatly broadened and the rates of tax increased.

The administrative costs of the tax are quite low, at less than 0.4 percent of total revenues. It is far, however, from being a neutral tax. Prior to 1988, there were 10 different rates ranging from 3 to 20 percent on manufacturing enterprises and importers. A tax rate of 1 percent is applied to wholesalers and retailers, and many services are taxed at rates of 1, 3, and 5 percent, depending on the item. In the most recent Budget, there has been a partial rationalization of the turnover tax by reducing the number of rates to 4 categories for commodities and to 3 rate bands for services.

Although the BTT is a tax on the gross quarterly receipts from sales, it has some features of a value added tax. There is a credit mechanism that allows manufacturers to deduct the tax they have paid on inputs from the taxes that are payable on their sales. At all other stages the tax is cascading, and in addition, capital assets are subject to tax. As a result, the effective rates of tax on value added across industries vary greatly. It has been estimated (prior to the 1988 Budget proposals) that the effective rates of taxation on the value added of an industry range all the way from the 30 to 50 percent range on metal products, chemicals, and paper products to the 1 to 2 percent range on such items as textiles, construction and transport.<sup>9</sup>

In the context of indirect taxation in developing countries, the BTT has the important feature of being broad based. It is almost unheard of even in developed countries to have a sales tax that covers the basic food

necessities such as fish, rice, flour, and salt at a 5 percent rate. With this basic policy feature in place it should be a relatively easy task to bring about a greater uniformity in the rate structure and the extension of the credit for taxes paid on capital inputs. If it was thought to be important to have higher tax rates on some items, then a uniform set of excise or luxury taxes could be fairly easily imposed on these objects in addition to the basic rate of BTT tax.

### III. PROCESS AND RESULTS OF ECONOMIC REFORMS

The series of economic reforms undertaken by the Sri Lankan Government from 1977 have made a major change in the direction of economic activity in the economy. Over a period of about three years not only were the foreign exchange markets and prices largely decontrolled, but the widespread consumption subsidies were eliminated.

At the same time, gross capital formation increased dramatically as a percentage of gross domestic product. In 1976 and 1977 this gross capital formation averaged 14.5 percent of GDP, while for the period from 1978 to 1982 it averaged 28.9 percent. Even in the next two years at the beginning of the period of serious communal conflict, this ratio still averaged 27.5 percent.<sup>9</sup>

#### Role of Foreign Assistance

Throughout this period Sri Lanka has received a tremendous amount of support from both the bilateral and multilateral aid agencies. From Table 3 we see that Government capital expenditure amounted to 14.7 percent of GDP over the period from 1978 to 1984. Over this period about 38 percent of

Table 5  
Annual Real Growth Rates of GDP and Selected Sector  
1978-85 (at constant 1970 factor prices)

	1978	1979	1980	1981	1982	1983	1984	1985	1978-85
Agriculture	5.4	2.0	3.1	6.9	2.6	5.0	-0.4	8.7	3.8
Paddy	12.7	1.4	11.9	3.6	-3.4	15.2	-3.5	9.9	5.1
Tea	-4.3	3.5	-7.5	10.0	-10.7	-4.5	16.2	2.9	-0.2
Rubber	5.6	-0.9	-13.0	-6.7	0.6	12.3	3.7	0.7	-1.2
Coconut	15.4	6.4	-11.0	11.5	11.3	-8.3	-7.0	46.4	2.9
Other Agriculture	0.7	0.2	4.7	8.0	6.7	6.2	7.2	n.a	5.9
Mining	20.2	5.3	4.9	4.2	4.1	7.8	1.5	1.5	6.2
Manufacturing	7.8	4.6	0.8	5.2	4.8	0.8	12.3	5.2	4.6
Export Processing	2.1	4.4	-9.8	7.6	-5.3	-4.6	9.0	8.0	0.3
Factory Industry	11.0	4.0	5.0	4.0	8.9	2.0	14.0	9.0	6.2
Small Industry	13.2	9.8	0.0	5.1	10.1	4.0	4.2	3.0	5.6
Construction	28.3	20.9	11.0	-3.0	-2.0	1.0	-0.1	0.5	5.8
Services	7.6	7.8	8.0	6.4	7.0	6.7	7.0	3.9	6.7
GDP	8.2	6.3	5.8	5.8	5.1	5.0	5.0	5.0	5.5

Source: Central Bank of Sri Lanka

these investment expenditures were financed by foreign grants and foreign project loans. In total, foreign assistance and loans financed about 56 percent of all government capital formation, or an amount equal to 8.2 percent of GDP.

With this degree of foreign financing (with very favorable terms) the Government was not required to use the tax system to mobilize resources for the public sector to the same degree as it would have had to if it were not the recipient of this massive amount of foreign assistance. This situation cannot be expected to last for an extended period of time, hence, the recent rationalization of the tax system is necessary if a greater reliance will have to be placed in the future on the mobilization of domestic resources to finance development expenditures.

Technical assistance via the international aid agencies has played an important role assisting in the analysis of policy options in the fiscal area. In the case of taxes and regulations affecting international trade a number of major studies have been sponsored by the World Bank and other agencies. On domestic tax policy, a series of mission reports made by the IMF and the World Bank have addressed the tax structure and administration issues on a regular basis. At no time has there been a formal tax reform study undertaken. Perhaps the economic policy makers in Sri Lanka learned an important lesson from their previous high profile tax reform effort in the 1950s. That partial reform was famous for having been done by Nicholas Kaldor, and for having most of the implemented tax policies abolished within 5 years.<sup>10</sup>

Over the past decade the business community, both small and large businesses alike, have had a very large influence in the formulation of

company and personal income tax policies. After being the focus of government regulation and nationalization for the previous decade, it was felt that the private sector needed maximum encouragement from the tax system in order to build business confidence and the desire to make long term investments. This was reflected in the outpouring of tax incentives and tax holidays. On the other hand, the international assistance agencies have been consistently encouraging the development of a strong domestic tax system that would be capable of mobilizing domestic resources. Recent budgets seem to indicate that the Government is adjusting its position with respect to direct taxation to recognize that many of the tax incentives were counterproductive and that a system with fewer distortions might be better for both the business community and the Treasury.

#### Impact on Revenues and Administration

From 1971 to 1977 Government tax revenues as a percentage of GNP averaged 16.2 percent, with a slight downward trend to 15.0 percent in 1977. Since 1978 this variable has averaged 19.2 percent. If the values for 1978 and 1979 are removed because of the high values for export taxes during those years, the ratio becomes 18.0 percent.<sup>11</sup> From these aggregate statistics it would appear that the changes in the structure of taxation increased the performance of the system by about 20 percent or 3 percentage points of GNP. With the changes that have recently been introduced to simplify the structure of the BTT and remove some of the tax preferences from the income tax, the performance of the tax system may be further enhanced.

By international standards, Sri Lanka has a fairly efficient tax administration, although at the present time it has fallen behind in its

development of computerized information systems. In this context it is surprising to see the significant drop in the administration costs of the tax system that followed the deregulation of the economy in 1978 and the shift of the tax system away from income tax and toward the business turnover tax.

In Table 4 we examine the administrative costs of the Inland Revenue Department from 1973 to 1985. This department administers the income tax, the business turnover tax, the wealth tax and other ad hoc levies. In this table the administrative costs are expressed as a percentage of the tax revenue collected. From 1973 to 1976 the administrative costs averaged about 1.0 percent of tax revenues, but from 1978 to 1985 they averaged only 0.52 percent of tax collection. Furthermore, the trend has been clearly downward with the costs of administration for these taxes from 1982 to 1985 only amounting to 0.37 of tax collections.

This is a clear indication of the relative administrative efficiency of the use of a BTT as compared to an income tax in the context of a developing country. In these calculations of administrative cost, we have not been able to estimate the relative costs of tax compliance. Yet the compliance costs of income taxes are generally much higher than indirect taxes where the determination of the tax base is relatively easy. If this holds for Sri Lanka, administrative and compliance costs probably have fallen by an even greater amount since 1978 than is indicated by the estimates in Table 4.

#### Impact on Economic Growth

Another important objective of the economic reforms was to facilitate economic growth. Although the various tax incentives introduced from 1978 to 1985 were motivated by considerations of accelerating economic growth, it is

difficult to assess the incremental contribution they made as compared to the other fundamental reforms. The tax policies probably had their most important impact on business confidence through the strong message they carried to the business community of the Government's support and belief in the private sector. The tax incentives for many activities do little to alter the relative rate of return of investments. The tax holidays are particularly ineffective for activities such as hotels where the profits are usually low or negative during the first few years of operation.

As shown in Table 5, during 1978 to 1985 the growth in real GDP averaged 5.5 percent. This is a substantial improvement over the performance of the economy from 1971 to 1977 when the real growth in GDP averaged only 2.8 percent. From 1978 to 1985 the average growth rates of manufacturing, mining, construction and services were all between 4.6 and 6.7 percent. In contrast, agriculture grew by only 3.8 percent, even though massive investments were being made in irrigation and infrastructure.

While rice production grew quite well at 5.1 percent, the performance of the tree crop sector including tea, rubber, and coconut was very poor. The combination of higher export taxes, a softening of international prices, and the continuation of a high degree of public enterprise activity in these crops, was sufficient to cause tea and rubber to have negative average growth rates during this period.

#### Impact on the Distribution of Income

In the 1950s the tax reform efforts in Sri Lanka were characterized by an emphasis on income redistribution. The Kaldor proposal for expenditure taxes and wealth taxes in Sri Lanka was a typical example. Sri Lanka tried

an expenditure tax and discontinued it as the administration proved to be excessively difficult. A second trial was attempted in 1976, but was repealed in 1977, characterized as "unworkable and impractical in an economy like that of Sri Lanka".<sup>12</sup> Clearly, the redistribution of income was not a stated objective of tax reforms in 1978, except for their overall objective of creating economic activity and employment. On this criteria the government was highly successful in that the rate of unemployment was reduced from rates of about 20 percent to less than 10 percent between 1977 and 1982.<sup>13</sup>

From an examination of the legal structure of the tax system after 1978, it would appear that the tax changes gave more relief through both lower tax rates and tax incentives to the high income individuals. This need not be the case. The administration of the tax system also plays a central role in determining who actually pays more or less tax. In addition, the shifting of the tax system toward the BTT might add to the progressivity of the tax system. Much higher tax rates and broader coverage have tended to be placed on the goods that are more intensely consumed by the higher income groups. Furthermore, the administration of the business turnover tax is much more effective at collection of the tax from the legal tax base than is the personal income tax.

#### IV. LESSONS FROM THE SRI LANKAN EXPERIENCE

The process that Sri Lanka used in the late 1950s and the one policy makers took from 1978 to 1988 to bring about tax policy changes are stark contrasts. In the 1950s a bold attempt was made to bring about a new tax

structure of experimental design. This followed a high profile academically driven tax reform study. The result was a total failure of the tax reform.

The recent experience was quite different. Following a change in Government, many tax measures were taken that, in the first instance, were not clearly positive tax policies. This was followed by a relatively long period of sound economic leadership during which time the tax system evolved slowly in a positive manner. Tax changes such as the lowering of marginal income tax rates for individuals, and the development of a broad based BTT might not have been politically possible if the tax changes that took place over the decade were all put into one "tax reform" package.

Although the BTT is far from being an ideal value added tax, it again supports the view that broad based indirect taxes are preferred to income taxes or taxes on trade as fiscal instruments to raise revenues in developing countries. Economic policy makers in Sri Lanka now should assess how their BTT system can now be improved. Emphasis should be placed on not trading off too much of the broad nature of the tax in order to ease the administration of a more neutral value added tax.

Finally, the tax changes made during the 1980s in Sri Lanka are an example of the benefits of continuous tax policy analysis by both local officials and international agencies over an extended period of time. Through this process the Government was able to take the very poor tax system of the 1970s and to gradually transform it into a workable fiscal instrument.

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3. I. R. A. #4, 1963, S.25(1) (a) and (b) as amended by S.8 of I. R. A. #17 of 1972.
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5. I. R. A. #4, 1963 - 2nd schedule, part viii, as inserted by S.44 of I. R. A. #30 of 1978.
6. I. R. A. #27, 1982; S.35, part iv, 2nd schedule.
7. Until 1988 the amount of deductions of this type was restricted to 1/3 of assessable income up to an annual limit of Rs. 150,000. In the 1988 budget it is proposed to lower the annual limit to Rs. 50,000 per year.
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