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Tax Reform in Sri Lanka

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Sri Lanka stands at a crucial stage in a programme of stabilisation and adjustment which started in the late 1980s. Fiscal pressures are severe with government revenue around 21% and expenditures around 31% of GDP in 1990 and 1991 (although expenditure has been reduced to around 28% in 1992, largely through cuts on the capital side). A programme of fiscal adjustment would seem to require both a substantial decrease in expenditure and a substantial increase in revenue. The purpose of the paper is to describe possible sources of revenue expansion, in part by drawing on international comparisons. Sri Lanka's direct taxes contribute very weakly, as a fraction of both GDP and revenue, relative to other countries. Expansion of the personal income tax could provide a major contribution to extra revenue. Advance on corporate tax revenue will depend on the closing of loopholes from exemptions and holidays which have proliferated. The VAT previously announced for April 1994 (now postponed to April 1995) would be a positive development but cannot by itself be expected to raise the extra revenue which appears necessary, and indeed will have to be well administered to replace revenue from existing turnover taxes. The introduction of the VAT, if well-planned, can help in the collection of the personal income tax.

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SUMMARY

Fiscal pressures in Sri Lanka are severe, with government revenue around 21% of GDP and expenditure around 31% in 1990 and 1991 (although expenditure has been reduced to around 28% in 1992, largely through, possibly temporary, reductions on the capital side). The fiscal challenge is to make substantial inroads into this deficit. Whilst this paper has not discussed expenditure in detail it seems that the fiscal change required will be unlikely to arise solely from expenditure reduction. This position, taken together with the deficiencies in the current tax system and desires for greater liberalisation, indicates that the task for tax policy is to raise substantial extra revenue, whilst restructuring the system to provide greater simplicity, efficiency and consistency with a more trade- and market- oriented economy. The paper provides reflections on the possibilities for extra revenue, following visits to Sri Lanka in September 1992 and June 1993.

The Sri Lankan government is fortunate in having before it the valuable report of the Tax Commission of 1990 and much of the way ahead would seem to be charted in that report. The government has made a start in implementing the proposals but some of those recommended policies which might raise substantial extra revenue have not yet been vigorously pursued.

~~Given Sri Lanka's high debt to GDP ratio, real interest~~ rates and growth rate it is argued that a primary surplus is necessary to stop the debt to GDP ratio from rising still further. Interest payments are currently around 6% of national income and the underlying primary deficit (the deficit excluding

interest payments) is of the order of 5% (based on the 1990 and 1991 position). Hence an apparently necessary (if the debt to GDP ratio is to be held at current levels) target would be to reduce the deficit by at least 5 percentage points (relative to 1990 and 1991). Given the size of the debt to GDP ratio (around 100%) and the burden of interest payments Sri Lanka should be looking for a reduction in this ratio over the medium-term and serious inroads would involve cutting the deficit by a few percentage points above 5%. Some of the reduction in the deficit would have to come, no doubt, from pruning expenditure but there are major dangers to the type of growth Sri Lanka envisages. A 'newly-industrialising country' needs physical infrastructure and a healthy, well-educated population. Sri Lanka's achievements in health, education and social welfare are striking amongst developing countries and there is understandably a desire to see them preserved both as ends in themselves and as contributors to growth. Whilst the size and generosity of some of the welfare programmes do, however, suggest some scope for economy, a target of 5% for extra revenue would seem to be a prudent one.

Building on the recommendations of the Tax Commission Report and drawing on comparisons with other fairly poor countries a number of areas for extra revenue which look to be possibilities are described. As potential major sources of extra revenue the discussion identifies the personal income tax (possibly an extra 2 percentage points), the value-added tax (½-1), excises (around 1 percentage point), corporate income tax (½-1 percentage points) and, as a short-run measure, customs (½-1 percentage point). Together such a strategy might yield the extra resources required whilst being consistent with simplicity, growth and efficiency objectives. Not all of these measures could be expected to yield speedy results, hence the need for especially tight expenditure control in the short term. It is possible that some short-run pressures could be partially relieved by privatisation proceeds.

Advance in the personal income tax collections of the order indicated is likely to come from improved enforcement and compliance. These can be helped by the VAT, by computerisation and by the taxation of public-sector emoluments. In this respect the close integration of VAT and income tax administration is important. Improvement in corporate tax revenues should be available from the rolling back of exemptions and holidays. Excise taxation could be increased by expansion of the base to motor fuel, cars and some luxury goods.

§1. Introduction

Sri Lanka stands at a crucial stage in a programme of stabilisation and adjustment. From one perspective this process started in 1977 when the change of government brought a reorientation towards market forces in contrast to the policies of nationalisation and state control pursued by its predecessor. A period of more rapid growth followed but by the mid 1980s this had faltered. The late 1970s and early 1980s saw a rapid fall in public revenues from export duties on the main plantation crops which were cut sharply as profit margins on tea declined under the twin pressures of weak tea prices and productivity problems associated with poor management in earlier periods. This fall in revenue, combined with pressures on expenditure exacerbated by internal security problems since 1983, was associated with large deficits throughout the 1980s. By 1989 the macroeconomic position was severe with government debt more than 100% of GDP and an emerging balance-of-payments crisis. The new government (of 1988) embarked on a programme of stabilisation and adjustment in an attempt to close public deficits, to restructure the public sector through 'peoplisation/privatisation', and to promote private-sector development, particularly with an export orientation and strong inward foreign investment.

For the first two years of the 1990s total government revenue was around 21% of GDP with expenditure around 31% or 32%, although expenditure has declined somewhat in 1992 largely as a result of reductions in capital spending, which are possibly only temporary. We shall argue that, to prevent the debt to GDP ratio from rising, a primary surplus is necessary, compared with a primary deficit over the last few years of around 5%. Thus a fiscal adjustment of the order of 7% of GDP (relative to 1990 and 1991) would seem necessary if a start is to be made in bringing down the debt to GDP ratio. It seems unlikely that such an adjustment could occur only on the expenditure side. Sri Lanka faces a problematic internal security position. The process of restructuring requires investment in physical infrastructure. Sri Lanka has a history in social infrastructure - education, health and social security - which is strikingly superior to many or most other developing countries. That social infrastructure is likely to be a crucial ingredient of future growth. In this paper we do not attempt any detailed analysis of the expenditure side of the budget, although the fiscal position would seem to indicate that expenditure, as a fraction of GDP, will have to be cut substantially. It may be, for example, that the scale of some social security programmes will have to be reduced. It is possible that some short-run pressures could be partially relieved by privatisation proceeds. However the magnitude of the deficit, and the pressures on expenditure indicated, suggest that increases in taxation will also have to play a major part in closing deficits. At the same time the tax system has substantial microeconomic and administrative problems which indicate that the revenue enhancement should be accompanied by comprehensive reform.

The purpose of this paper is to describe how some of the problems of the reform of taxation in Sri Lanka appear to an outside economist with little prior acquaintance with Sri Lanka but with some experience of other developing countries facing similar problems. In the process of providing such a description I shall raise some issues and questions which may contribute to the discussion of how the reform might proceed. The major elements of tax revenue - personal and corporate income taxes on the direct side, and domestic taxes and import duties on the indirect side - are all likely to have a role to play in increasing revenue, as well as requiring important changes in structure to tackle their microeconomic and administrative problems. However, increased emphasis on trade and on the attraction of foreign direct investment imply that two sources, the personal income tax (including social security contributions) and domestic indirect taxation are likely to have to provide the major part of the extra revenue. The government had announced its intention to implement a value-added tax by April 1994, although this has now been put back to April 1995. A well-functioning VAT would be a positive development, given the complex and unsatisfactory network of taxes it would replace, but a VAT is unlikely by itself to provide the additional revenue which will be necessary. Indeed a good performance is required in implementing and administering the VAT if it is to generate revenue equivalent to that from the taxes it will replace. For the purpose of discussion in this paper we shall generally suppose that the adjustment from substantial primary deficit to small primary surplus would occur partly through an increase in taxation and partly a reduction in expenditure. To make this specific we shall at some points pose questions in terms of how an extra 5% of GDP in tax revenue might be generated.

The paper is organised as follows. In the next section (§2) we provide a brief description of some features and developments in taxation in Sri Lanka over the last 15 years, setting this discussion in an international context. Sri Lanka is fortunate to have had a recent Taxation Commission which produced an impressive report in 1990 and central features of that report and subsequent developments are described in §3. The magnitude of the required fiscal adjustment is discussed in §4. Some future policy issues and questions are raised in §5 in the light of international comparisons, the recommendations of the Commission and the requirements for extra revenue. Some possible sources of extra revenue are indicated. The final section provides concluding comments and some suggestions for further research.

§2. Recent Developments in Sri Lanka in International Context

The following basic indicators for Sri Lanka (from the World Development Report, 1992) may be helpful in drawing international comparisons. The population in mid-1990 was 17 million and GNP per capita as conventionally measured, for 1990 in US dollars, was 470 (although purchasing power parity estimates have generally been very much higher). Life expectancy at birth is 71 years, which is relatively high compared to other developing countries, whilst illiteracy - at 12% on average and 17% for women - is relatively low. The growth rate of GDP since 1965 has averaged around 4% with GNP/capita growing at 2.9% in this period (the same as the average for low income countries). The contribution of agriculture to GDP in 1990 was 26%. Although this proportion is low compared to low income countries as a whole, where agriculture accounted for 31% of GDP, it has been falling much more slowly in Sri Lanka than elsewhere (comparable figures for 1965 are 28% and 41% respectively). The contribution of manufacturing at 15% of GDP is low, and is lower than it was (17%) in 1965. In terms of broad measures of overall structure the economy of Sri Lanka has changed only slowly, although the growth rate in the economy as a whole has not been low. As a small island economy trade plays an important role, with exports ~~forming 30% of GDP in 1990. This, however, is much lower than~~ 1965 when exports constituted 38% of GDP and the fall corresponds to the decline in the size of the plantation sector relative to GDP. Imports were 37% of GDP in 1965 and 38% in 1990. The substantial trade deficit which has emerged has played its part in motivating the current strategy towards trade-oriented growth.

Some broad features of the public finances in Sri Lanka over the last 15 years are set out in Table 1. The figures focus on the revenue side but expenditure data, split into capital and current components, are provided at the foot of the table.[1] The tax system comprises five broad categories: taxes on income, taxes on property, tax on Central Bank holdings of treasury bills,[2] taxes on goods and services, and taxes on international trade. At the start of the period of more market-oriented reforms, under the incoming Jayawardena government in 1978, government revenue stood at 25.9% of GDP (of which 24.2% came from taxation). This figure is unusually high for developing countries (see Table 2) and particularly for poorer developing countries (by the mid 1980s, to which data in Table 2 correspond, Sri Lanka's GNP per capita was around US $420)[3]. Also unusual relative to other developing countries was the very high contribution of taxes on exports which yielded 11.1% of GDP. Of this 11.1%, 7.7% of GDP came from tea and 2.3% from rubber. In this respect Sri Lanka looked not unlike a small country based

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[1] Discussion of the expenditure side is taken a little further in §4 and some figures are provided in Table 4.

[2] The tax on Central Bank holdings of treasury bills was ~~introduced in 1989 by an amendment to the Inland Revenue Act~~. This tax is a somewhat unusual and conceptually problematic entry as a contribution to government revenue. It does seem curious accounting and would merit closer consideration. It seems that it is a device for bringing forward in time the transfer of Central Bank profits to the government.

[3] See World Bank (1990): World Development Report.

on mining which raised the bulk of its revenue from royalties or duties on one or two ores. This situation changed dramatically over the next few years with revenue falling to 16.3% of GDP and export duties falling to 2.7% of GDP in 1982, with only 1.6% of GDP now coming from tea and 0.8% from rubber. By 1986, export duties had dropped below 1% of GDP and they have not risen above this level since then. Total revenues advanced to 22.2% of GDP in 1984 with some recovery in export duties and increases under most other revenue heads (except excises). Total revenues have subsequently been in the range of 19-22%.

The cause of the drop in export revenues appears to have been falling profit margins. Given that the price of tea is determined on world markets export duties have to be set at a level which allows reasonable profit margins, if production is to continue. These margins were sharply squeezed at the end of the 1970s as a result of falling world prices. Further, productivity was stagnant - management appears to have been poor during the period of nationalisation in the 1970s - whereas productivity in competitor countries was rising sharply (Government of Sri Lanka, 1991, p.190). It has also been argued (*ibid*, p.190) that export taxes should, in part, play a stabilisation role when world prices are fluctuating.[4]

Expenditure fell from 39.6% of GDP in 1978 to 32.6% in 1983 and has remained in the range 31-35% since (although there was

[4] Although the history of such funds would not make one very sanguine about their likely effectiveness.

some downward movement to around 28% in 1992 - see §4). Broadly speaking, we have seen, since the mid-1980s, revenue around 21% of GDP and expenditure around 31%. This long period of deficits, itself preceded by a period in the early 1980s of even higher deficits, culminated in severe macroeconomic problems by the late 1980s. There was a balance of payments crisis in mid-1989, inflation had risen to more than 20% and government debt was more than 100% of GDP (of which around 57% is external and 43% internal, see Central Bank of Sri Lanka, Annual Reports). The incoming government under President Premadasa in 1989 embarked on a stabilisation and adjustment programme. However, in 1990 and 1991 revenue was at 21.1% and 20.4% of GDP respectively and expenditure at 31.0% and 32.1%. In 1992 total revenue was much the same as 1991 but, as a result of reductions in capital expenditure/net lending, total expenditure dropped some 4 percentage points (see §4). Whilst total expenditure had not seen a major reduction as a fraction of GDP over the 8 or 9 years (up to 1991), capital expenditure dropped sharply whilst current expenditures have increased. Capital expenditures fell from 12.4% of GDP in 1987 to 9.6% in 1991, a particularly sharp fall occurring between 1989 and 1990, the first years of the new austerity measures (from 13.7% in 1988 to 8.8% in 1990). A further fall to 6.8% took place in 1992, although some of this fall was attributable to a drop in 'net lending' (see §4).

We now examine more closely the composition of government revenue in Sri Lanka, comparing it (using Tables 1 and 2) with that in other developing countries.[5] In 1991[6] total central government revenue as a fraction of GDP in Sri Lanka was 20.4%, with the bulk, 18.3%, coming as tax revenue. We compare the Sri Lankan position in 1991 with that in developing countries with GNP per capita in the range just above the "very poor" in the late 1980s (we take 1987 in Table 2 and the range US $360-749). Sri Lanka's GNP per capita was US $400 in 1987 (World Development Report, 1989). In literacy and purchasing power parity terms, Sri Lanka would score very much higher than many countries in this GNP per capita range. Total tax revenue as a fraction of GDP, averaged across those countries, was a little above that for Sri Lanka, at 19.7%. Thus it would be difficult to argue that in the late 1980s and early 1990s Sri Lanka was a high tax country, although no doubt that would have been the position in the late 1970s.

Within tax revenue, we see that income taxes in Sri Lanka contribute a low percentage of GDP relative to the average of other similarly poor developing countries. For Sri Lanka the personal income tax generated only 0.9% of GDP and the corporate income tax only 1.7%, whereas in other developing countries in our reference group the figures are 2.5% and 2.9%. The difference is striking. A principal reason for this, as emphasised by the 1990 Taxation Commission, is the extensive system of reliefs and exemptions for both the personal and

5 For international comparison see Burgess and Stern (1992a). Table 2 is taken from this source.

6 We use the 1991 figures for discussion here as those for 1992 are still (as of June 1993) provisional.

corporate income tax. Public-sector emoluments are exempt on the personal side and there are extensive tax holidays and exemptions on the corporate side, primarily to encourage foreign investment. Given the extent of public-sector employment in Sri Lanka and the push towards foreign investment-led growth, these two sets of exemptions are major. Further, compliance seems very weak, the Tax Commission reporting only 34,000 resident individuals paying tax with estimates of those who should be eligible 10-20 times this number (Government of Sri Lanka, 1991 pp.111 and 126).

In assessing the contribution of direct taxes one should, however, take account of the role of the Employees Provident Fund (EPF) and the Employers Trust Fund (ETF). Contributions to these funds are compulsory and they are required to invest in government securities. Hence the government has 'captive funds' to finance the deficit and to the extent that interest rates are lower than the 'open market' there is some element of taxation which is akin to direct taxation. The system may also be seen as one of social security contributions - akin to direct taxation if eventual receipts were to turn out not to be tightly related to contributions. The EPF and ETF fall on the private sector and amount to a deduction of around 8% of salary (with a 12% employer contribution). Public servants have a different pension and insurance system which involves a 6% deduction from salary, which is also paid into a 'captive fund'. ~~The number of active~~ accounts with the EPF in the early 1990s was above 1¼ million (Central Bank Annual Report, 1992, p.90) and it has been estimated that the lending to the government by the EPF and ETF might constitute of the order of 1% of GDP.[7] This figure of 1½ million provides an interesting contrast with the number of taxpayers at 34,000.

On domestic indirect taxation the position relative to other countries is reversed, with these taxes in Sri Lanka raising 8.6% of GDP compared with 4.7% in our reference group. The principal difference comes from the sales/turnover taxation which contributes 5.7% in Sri Lanka as compared to 2.3% on average for the reference group. It should be remembered that around half of the sales and turnover tax revenue comes from the taxation of imports but then the sales tax commonly applies to imports in other countries too. Import duties in Sri Lanka are on the low side, particularly bearing in mind that Sri Lanka is a small island economy with imports of the order of 38% of GDP in 1990.[8] Import duties are around 5.0% of GDP compared with an average of 6.7% for our reference group of countries. The emphasis on indirect taxes has been further enhanced by the defence levy (at a rate of 3%) which is imposed (since 1992) on the turnover of manufacturers, importers and banking, insurance and other services. The revenue was 0.9% in 1992 and is projected to be 1.1% for 1993 (Central Bank Annual Report, 1992).

These comparisons should not be taken as directly involving

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[7] Private communication from D.D.M. Waidyasekara, June 1993.

[8] The 38% figure is from the World Development Report 1992 (1991). The Annual Report of the Central Bank of Sri Lanka gives 41.3% for total imports and 33.5% for merchandise imports (1991).

policy conclusions. There is no automatic argument indicating that a country should move to the average. The comparisons are, however, suggestive. They raise the possibility that a move towards base broadening and better enforcement of the income tax may be both desirable and fruitful, since in this case Sri Lanka's background of high literacy and numeracy suggests that income tax collections could be higher than other countries with similar incomes.[9] Second, the comparatively strong performance of indirect tax collections will set a 'hard act' for the VAT to follow. It will be a very successful VAT that raises that amount of revenue currently collected by sales/turnover taxation. Third, although not desirable in the long term, there may be scope for raising import taxation in the short term. As domestic sources improve and/or the import share in GDP grows with successful export expansion, rates of import duty should be lowered to promote efficiency of allocation between domestic and international sources.

Before leaving international comparisons it is interesting to compare Sri Lanka's position with that of India given their common colonial and legal structures prior to independence. The overall position in the two countries now looks similar both in the level and in the general structure of taxation. India also has low income taxation and high domestic indirect taxation relative to the average for countries with a comparable income level (India's GNP per capita in 1987 was $300, World Development

[9] And the argument is reinforced by the wide coverage of the EPF and ETF (see above), suggesting a substantial administrative capability relative to other poor countries.

Report, 1989, and so falls in the poorest group in Table 2). In India in 1988-89, income taxes were around 2% of GDP whilst domestic indirect taxes and customs were around 10% and 4% respectively. In terms of shares in total tax revenue these tax heads accounted for 12%, 62% and 24% respectively.[10]

There are, however, important underlying differences, and some further analogies, which should be emphasised. A large part of India's domestic taxation comes from sales taxes, levied by the states (3.3% of GDP in 1988-89). These were allocated to the states of India in the Constitution and are jealously defended by them as buttresses to their independence. However such separateness in tax policy and administration produces obstacles to reform, particularly in the possible introduction of a VAT (see Burgess and Stern, 1992b, and Burgess, Howes and Stern, 1993). Sri Lanka being a much smaller country would not appear to face this problem so severely. Nevertheless such difficulties are emerging in Sri Lanka. In the late 1980s the decision to establish Provincial Councils in Sri Lanka was taken and the 13th Amendment to the Constitution was passed, paving the way for their establishment. Amongst other things they will act as a conduit for central government funds en route to local authorities. They have, however, been allocated their own tax powers in a spirit similar to the central and state lists in India. An item of major significance which has been included for the Provincial Council list is the taxation of "wholesale and retail sales within such limits as may be enacted by Parliament".

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[10] See Burgess and Stern (1992b).

(Government of Sri Lanka, 1991, p.234). There is a danger here that such powers may be interpreted liberally by the Provincial Councils and discussion with a representative of one of the Councils indicated that this was likely to be their preferred route. There is a potential for confusion over indirect taxes here, particularly with a VAT, which requires careful consideration. However the phrase "within such limits as may be enacted by Parliament" may give the centre sufficient powers to head off the emergence of obstacles to reform of domestic indirect taxation of the kind which have arisen in India from the centre-state demarcation embodied in the "lists".

Provincial governments have been exercising their tax powers since 1991 and their revenue is now of the order of 1% of GDP. Recent elections, in May of 1993, resulted in the government party losing political control of several of the provinces, including the most prosperous around Colombo. The emergence of significant provincial tax revenue together with these political changes imply that the problems for reform associated with Centre-Province relations are unlikely to diminish.

A second feature of the comparison which is misleading is that both India and Sri Lanka raise of the order of 5% of GDP in import duties. Given that India is so much bigger with a correspondingly much lower share of imports in GDP (8-10% compared with Sri Lanka's 35% or more) one might have expected Sri Lanka's contribution from import duties to be substantially higher than that of India. In observing this, however, we must note that India, in the post-July 1991 reforms, is reducing the role of customs duties whereas in Sri Lanka, the revenue contribution remains around 1/3 of tax revenue (with an average effective rate of duty of 14-15% - Central Bank Annual Report, 1992, p.126). And it must also be recognised that India's federal structure limits the sources of revenue going entirely to the Centre. Import duties are central amongst these sources and have therefore been attractive to the Central Government.

Before leaving the India-Sri Lanka comparison we may note that the current position of the two countries looks a good deal closer now than it did in the past (with Sri Lanka's very high contribution from export duties) and than it might look in the future. Sri Lanka is committed to the introduction of a VAT but India needs to resolve a number of centre-state difficulties before such a system could become feasible.

§3. The Taxation Commission of 1990

The Sri Lankan government established in 1989 a Taxation Commission under the chairmanship of H.S. Wanasinghe and with D.D.M. Waidyasekara as Secretary. The report (Government of Sri Lanka, 1991) was submitted in 1990 and published in 1991. It is an impressive document and provides a valuable blueprint for tax reform in Sri Lanka. We summarise in this section the main elements of its conclusions with a brief commentary and an indication of progress in implementation. This Commission on the tax system was the third major commission, the previous two being in 1955 and 1968. Sri Lanka had also been visited by Nicholas Kaldor in 1958 after Prime Minister Jawarhalal Nehru of India had recommended his services to Prime Minister S.W.R.D. Bandaranaike of Sri Lanka,[11] following Kaldor's work in India which had, apparently, been favourably viewed by Nehru. The 'Kaldor Reforms' were introduced in 1959. Kaldor recommended a system involving all of income tax, expenditure tax, capital gains tax, gift tax and wealth tax. As in India, the last four were introduced. Again, as in India, the new taxes yielded little revenue and administration was problematic, and in both countries the expenditure tax was withdrawn after a few years. Neither would it appear that the 'self-checking' mechanism inherent in the presence of the multiple taxes led to fruitful income tax collections. The gift tax was abandoned in Sri Lanka in 1985 and the government has accepted the proposal of the 1990 Commission to abolish the wealth tax.

The basic themes in the recommendations of the 1990 Commission were (p.303) the widening of the base of both direct and indirect taxes, reducing marginal rates for income taxes, simplifying indirect taxes and reviewing the administrative structure to allow greater efficiency, better compliance and less evasion.

On the personal income tax the Commission recommended the retention of most of the existing basic features including: the residence (as opposed to source) principle; the income (as

[11] Communication from Mr G. Correa, 25 September 1992.

opposed to consumption) base; the self-assessment method; the separate taxation of husband and wife; and a global (as opposed to a schedular) system. It envisaged a threshold of around three times average per capita income (towards or a little above the middle of the range for similar countries) and a four-band schedule with a maximum rate of 35%. It recommended against presumptive taxation on the grounds that "more precise methods of evaluating incomes" (p.96) are available. The elimination, or scaling down, of exemptions was proposed as was the abolition of the exemption of taxation of official emoluments (with adjustment of salary to compensate).

For companies the following were the broad recommendations: a unified rate of 35% for all companies; the scaling down or elimination of tax holidays; the integration of company and personal tax to be carried further using the present imputation method under advance corporation tax; and the retention of the withholding tax on dividends.

The Commission also recommended the abolition of the wealth tax and the scaling down of export duties. The system of excise taxation of alcohol and tobacco was judged to be fairly satisfactory. Its extension to certain goods such as motor fuel, motor cars, some electronics, domestic air conditioners, jewellery and soft drinks was also recommended.

The system of turnover taxes, it argued, should be replaced by a VAT to be introduced by 1 April 1993[12] with the immediate establishment of a VAT Development Office in the Inland Revenue Department. In appraising the relationship with the Provincial Councils and their powers under the 13th Amendment to the Constitution it proposed that the central VAT be "fully-fledged", i.e. up to both wholesale and retail stages, and that it be in addition to any turnover taxation by Provincial Councils.

On administration it recommended the establishment of a Board of Revenue, a permanent National Taxation Commission, a Revenue Ombudsman, a Taxpayers Charter, Revenue Courts, a Revenue Training Institute and entry for professional staff via a combined examination. The proposed VAT and the new excises should be administered by the Department of Inland Revenue. The Inland Revenue Department (IRD) should be organised so that each unit would be responsible for both assessment and collection.

It recommended a rapid expansion of computerisation with a 'master file of all taxpayers, based on the assignment of a unique identification number' (p.270). More frequent auditing was recommended as were vigorous investigation and strong penalties.

The conclusions are broadly in line with modern thinking on taxation and take account of the experience of tax reform in other countries. The case for the recommendations is well argued

[12] The agreed date for VAT introduction was deferred in 1992 to April 1994, and in 1993 to April 1995.

and the evidence carefully martialled. A number of the recommendations of the Commission had already been implemented by the summer of 1992. These include the increase in income tax threshold and the lowering of the marginal rate to the levels suggested. A uniform tax rate of 35% for all companies with effect from 1993/94 has been specified. The task force working on the VAT has been established and the introduction of a VAT announced, to begin on 1 April 1994, subsequently postponed to April 1995. Work on the computerisation of the IRD is well under way.

By the summer of 1993 some further simplifications of some aspects of the tax structure had been introduced. In May 1992 the turnover tax had been simplified to 4 bands (5, 10, 15, 20%) and in November the 15% band was abolished. Turnover tax on telecommunications was shifted from the 10 to 20% band. Revenue from tobacco taxation fell, notwithstanding a tax increase, as a result of a fall in consumption, whereas increases in liquor taxation were accompanied by a substantial increase in revenue (Central Bank Annual Report, 1992).

The government does not, however, appear to have tackled the problem of the erosion of the tax base through exemptions and holidays, indeed it seems that they have been extended rather than reduced. Certainly the arriving visitor *en route* via Air Lanka is regaled on the aeroplane (in a glossy magazine accompanying the aircraft safety instructions) with the many tax dispensations awaiting the foreign investor in Sri Lanka.

Further, no decision on the taxation of public-sector emoluments appears to have been taken. A drive against evaders did not appear to be prominent.

The government has adopted some of the proposals of the Commission but not yet, it seems, those that are likely to generate significant extra revenue. The Commission itself was not charged with the task of suggesting ways of gaining extra revenue, reform with revenue neutrality was the remit, but its proposals are helpful in that direction and, as we have argued earlier (and see §4), the problem of extra revenue is one that must be faced. The VAT, as we shall argue in §5, is a proposal that has strong merits and would be widely welcomed, by this author as well, but it is unlikely to provide substantial extra tax revenue. In any expansion of revenue it seems that personal income taxation should play a major role. Sri Lanka is highly advanced in terms of literacy and numeracy relative to most poor countries, and administrative obstacles would seem less severe than in those countries which raise considerably more under this head.[13] Further contributions can come from the expansion of excise and import duties. Over time the dismantling of tax holidays and incentive schemes should provide a further contribution via the corporation tax. It seems that in many ~~respects the hard decisions on the recommendations~~ of the Commission have not yet been taken.

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13 In this context I found it somewhat curious to read of the call, a few days after I left Sri Lanka in September 1992, by Mr Rajah Kuruppu, the Secretary to the Ministry of State for Finance, for the total abolition of individual income taxation (Island, 29 September 1992).

§4. The Magnitude of the Fiscal Adjustment

In general, economic theory provides only limited guidance on the appropriate size of the deficit or surplus. The definition of the deficit or surplus is itself plagued by conceptual problems (see, for example, Buiter, 1985, and Hills, 1987). Generally guidance has been of the 'consistency' kind, for example, if the debt-GDP ratio is β, the nominal interest rate is r, inflation is π, and the real growth rate is g, then one can derive a relationship (see below) which tells us, under bond finance, how large must be the primary surplus to be consistent with a debt-GDP ratio which is falling. One can develop these formulae to include money finance and the distinction between domestic and foreign debt, to link them to medium-term debt-GDP targets or to look at surpluses which are consistent with long-run steady states. All such calculations, however, have to work with targets for debt-GDP ratios which are deemed to be 'prudent', 'reasonable', or 'sensible'. These are usually seen in terms of 'fiscal capacity', willingness to hold government bonds at reasonable real interest rates and so on. The Maastricht treaty seems to have alighted, for example, on debt-GDP ratios of 60%. There is little, however, in economic theory to tell us what a 'prudent' ratio is or what is an appropriate rate of adjustment to it. Nevertheless, most commentators would see Sri Lanka's debt-GDP ratio as being 'rather high for comfort', in relation for example to the burden on government expenditure imposed by interest payments.

Very short-run theories of the appropriate deficit go beyond the simple consistency or accountancy kind and deal with the level of demand as reflected, for example, in the rate of inflation, the level of unemployment or balance of payments deficits. If inflation or the balance of payments deficit is seen as too high then it might be argued that the fiscal deficit should be reduced. That involves macroeconomic theory beyond simple accounting but usually gives only short-run directions of change and not magnitudes, or the pace of adjustment.

We describe a simple version of the consistency theory (following Domar, 1944) which provides a useful framework for discussing the kinds of levels of fiscal deficit or surplus which might be seen as constituting sensible targets for tax reform in Sri Lanka, and go on to discuss recent Sri Lankan data in this context. Using the notation defined above, and writing B for outstanding debt, P for the price level and Y for real GDP, we have, working in continuous time, if deficits are entirely bond-financed,

$$\dot{B} = \alpha PY + rB \qquad (1)$$

where α is the primary deficit (expenditure, excluding interest payments, less taxation) as a fraction of GDP and dots denote differentials with respect to time. Then the proportional rate of change of the debt to GDP, (B/YP), is

$$\frac{\dot{B}}{B} - \frac{\dot{Y}}{Y} - \frac{\dot{P}}{P} = \left(\alpha \frac{PY}{B} + r\right) - g - \pi \qquad (2)$$

$$= \alpha/\beta + \hat{r} - g \qquad (3)$$

where $\hat{r}$ is the real rate of interest. Hence B/YP falls if and only if

$$-\alpha > \beta(\hat{r} - g) \qquad (4)$$

If we take figures illustrative of Sri Lanka we might put $\hat{r}$ at 7%, g at 4% and β at unity. This would give a condition for the debt to GDP ratio to fall involving a primary surplus ($-\alpha$) of 3%. The primary deficit in Sri Lanka in 1990 and 1991 has been of the order of 5%. From this perspective a deficit adjustment of the order of 8 percentage points, relative to 1990 and 1991, of GDP would seem to be required,[14] although this calculation must be adjusted (see below) to take account of seigniorage and the distinction between domestic and foreign borrowing.

Equation (3) tells us that if $\hat{r}>g$ and $\alpha>0$ then the debt to GDP ratio will always be rising. This is the 'instability of debt finance' and tells us that, for debt finance to be stable over the long term there must be a primary surplus (where the real interest rate is greater than the rate of growth). We have seen that for Sri Lanka the debt to GDP ratio has grown so high that, under the above assumptions, a primary surplus of the order of 3% of GDP is necessary to stop it rising still further. If a primary surplus is achieved then from (1) we can readily

[14] In 1992 expenditure did drop (provisional estimates, see Table 1) by around 4 percentage points - an adjustment examined in a little more detail below.

establish that a constant debt to GDP ratio β^* satisfies, for $\hat{r}>g$,

$$\beta^* = \frac{-\alpha}{\hat{r}-g} \qquad (5)$$

The above analysis is readily modified to include money financing or seigniorage and the distinction between domestic and foreign debt (in Sri Lanka in 1992-end year-domestic debt was Rs 170,013 and foreign debt Rs 234,850, 42% and 58% of the total respectively (Central Bank Annual Report for 1992). A constant domestic debt to GDP ratio satisfies

$$\beta^* = \frac{-\alpha + f + s}{\hat{r} - g} \qquad (6)$$

where s is the contribution of money finance to the finance of the deficit (as a fraction of GDP) and f is the contribution of foreign finance. In Sri Lanka high powered money at the end of 1992 was Rs 44,858 million, some 9.4% of 1992 GDP (Central Bank Annual Report for 1992). With inflation of the order of 11%, seigniorage or the inflation tax was around 1% of GDP. This would bring the required surplus down to 2% for a constant aggregate debt to GDP ratio.

One can also look at foreign and domestic debt separately. The (appropriate) extent of f is often judged in relation to foreign debt to export ratios, or ~~debt-service to export ratios~~, which are deemed to be tolerable. A similar kind of analysis yields, for constant d,

$$d = \frac{f/\epsilon}{\gamma - r^*} \qquad (7)$$

where γ is the growth rate of exports, r^* the foreign real interest rate, ε is the export to GDP ratio, and d the foreign debt to export ratio. If would be optimistic to suppose that the denominator on the r.h.s. of (7) could be larger than 3 or 4%. With ε at around 1/3 and a 'safe' (from the perspective of capital markets) value of d usually taken around 2 (it is currently close to this) then f would be of the order of 2%. A value as high as this would depend, however, on exports growing at the rate of around 8% which would seem over-ambitiously high in the medium term, with a GDP growth rate at 4% and exports already around 1/3 of GDP. A growth rate of 6% would be a good performance, bringing f closer to 1%. Calculations based on (6) with β^*around 0.4 and f and s each at 1% would indicate that a primary deficit of 0-1% would be consistent with a constant domestic debt to GDP ratio. This, however, would imply a rising foreign debt to GDP ratio. Thus a primary deficit of 0-1% would seem too lax if we are to introduce some caution on export assumptions and rising foreign debt.

To sum up, bringing in foreign borrowing and seigniorage provides an estimate of the fiscal adjustment required to stop the domestic debt to GDP ratio from rising. Allowing for both, together with prudence on the dimensions described, might bring the required primary surplus down from 3% to 0-1% of GDP and the required fiscal adjustment from around 8 to 5-6 percentage points (compared to 1991 levels). Given a desire to bring down debt to GDP ratios, a target figure for the fiscal adjustment (compared to 1991) of 7-8 percentage points seems appropriate.[15] That is a formidable task.

We comment briefly on this task facing Sri Lanka, looking at the expenditure as well as the revenue side, and at developments during 1992. The position, see Table 1, in 1991 was one of expenditure of 32.1 of GDP and revenue 20.4%, and overall deficit of some 12 percentage points. With interest payments of around 6% of GDP the primary deficit was 6% of GDP. In 1992, however, expenditure dropped (provisional estimates - see Table 1) to 27.8% of GDP. This arose from a drop of 1.5% of the current side (from 22.5 to 21.0%) and a drop of 2.8% on the capital side (from 9.6 to 6.8%). Given that public capital spending was running around 15% of national income in the 1980s this looks like a radical pruning of public investment.

The change does indeed, in part, reflect a trimming of infrastructural investment and, in particular in 1992, delays, probably unplanned, on some major irrigation projects. It reflects also, however, a movement, as a result of a clear and deliberate change in government policy towards more private sector investment. In addition, the capital figure in the statistics includes what is called 'net lending' and privatisation proceeds come under this heading (with a sign which reduces measured capital spending). The position is illustrated in Table 4, from which it can be seen that the major part of the

[15] For analogous analysis along the, fairly standard, lines described here the reader may consult, for example, Anand and van Wijnbergen (1989).

fall in capital expenditure (including net lending) comes from the drop in net lending. The main part of this latter fall comes from privatisation proceeds which approached 1% of national income in 1992. The turn-round in other items also reflects the government policy of channelling less investment through the public sector.

Our discussion of the appropriate fiscal adjustment from the base in 1991 indicated a figure in the region of the order of 7-8 percentage points of national income if debt to GDP ratios are to begin falling. An adjustment of 4 percentage points came in 1992. We have seen, however, that not all of this 1992 adjustment is likely to be sustainable in the medium term. Privatisation can, however, give a little short-run breathing space for other fiscal adjustments to occur. It would seem that around 6 percentage points of fiscal adjustment will be necessary on a medium-term basis relative to the underlying position in 1992. It is not clear how much of this can or will come from the expenditure side. When one goes down a list of expenditure items there are always strong arguments addressed as to why each item cannot be cut.

The expenditure side has not been closely scrutinised in this study and I, therefore, hesitate to make specific suggestions. The major items are indicated in Table 4. In the short run there may be little discretion over interest payments and defence spending (given the current security position). That does leave government salaries and transfer payments as fairly obvious 'targets'. There is no doubt that social support in Sri Lanka is much more generous than in other developing countries. The social well-being, to which this social support has been a contributory factor has been an achievement of which Sri Lanka can be justly proud. On the other hand an examination of the administration of, for example, the Janasaviya programme in one district in June 1993 did suggest that the targetting of quite substantial transfers may not be very precise. That and related programmes constitute, however, only around 5% of total government expenditure or 1½% of national income. The magnitude of the fiscal adjustment required over the medium term would seem to dictate a substantial increase in revenues. Of the required medium-term adjustment we shall assume that 4 or 5% should come from the revenue side. The remainder of the paper is devoted to a discussion of how this can be achieved.

§5. Future Policy: Issues and Options

We have already raised in §2 and §3, from the perspectives of international comparisons and the Tax Commission of 1990, a number of policy questions concerning sources for the extra revenue in Sri Lanka that is required. In this section we focus more closely on some of the decisions that may be necessary and which sources for extra revenue look more promising and which less promising. In doing this it is useful to have in front of us a 'back-of-the-envelope' calculation which can be used to illustrate some of the potential of different sources.

We present in Table 3 three examples of tax structures, relating collections under different heads to bases and rates. Sri Lanka's 1991 position is included for comparison.[16] It should be emphasised that these examples are for illustrative purposes only but they do serve to highlight in a quantitative manner the possibilities and problems involved in raising extra revenue. We label the three imaginary cases as follows: **extremely ambitious**, raising 26% of GDP in tax revenue and providing for the 8% or so fiscal adjustment, which may be appropriate in the medium term, entirely from the revenue side, allowing expenditure to continue at 1991 levels; **very ambitious**, 23% of GDP, which would, with non-tax revenue, provide the five percentage point adjustment in revenue which is suggested as necessary from the preceding section; **ambitious**, 21% of GDP, which would provide a 3 percentage point increase from current levels of tax revenue and go at least half way towards the revenue adjustment we have suggested as necessary in the medium term. The methods used in constructing the examples are highly transparent in that they simply postulate rates and bases. Further examples following similar methods but with different revenues can easily be constructed by the reader.

We begin by looking at revenue from personal income tax and social security contributions. The ambitious case involves raising 2.0% of GDP from this source, the very ambitious 2.5% and

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[16] The revenue position for 1992 is much the same. We use 1991 figures because those for 1992 are still provisional and the expenditure figures for that year give a misleadingly small impression of the scale of fiscal adjustment necessary.

the extremely ambitious 4%. The current level is around 1%. These figures may be compared with revenues under this head of more than 3% for countries in the comparable range of GDP (taking personal income taxes and social security contributions together in Table 2). Thus whilst it is ambitious by Sri Lanka's standards it would still be less than average for the corresponding group, and even 'very ambitious' at 4% would not be far above the average for this group. A total take of 2.5% of GDP under this head could be achieved by an effective rate of 10% on 25% of national income. The top 10% of income earners are likely to be receiving at least 25% of GDP, even if one assumes that the income distribution is fairly equal by international standards (for example in the UK the top 10% receive 28% of the national income - see the UK Inland Revenue Statistics, 1991). The 1992 World Development Report (Table 30) quotes the share of household income in Sri Lanka going to the top 10% at 43%. To take, for example, 10% of the income of the top 10% would not appear to be draconian. Given the very low number of tax payers, and the current top marginal rate of 35%, it would seem to be the kind of target that should be achievable by an administrative drive.[17] Such a drive would command much greater public acceptability if accompanied by a move to tax public-sector emoluments.

Developed countries raise on average around 17% of national income from personal income tax and social security contributions

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[17] It should be remembered that the rates displayed for income tax and social security contributions in Table 3 are the average rates across the base.

with around half of the 17% coming from each head (see Table 2). Hence the 'extremely ambitious' target of 4% is a long way short of that standard. It is close to the take under this head for the richer developing countries, per capita GDP $1620-6000, although the high level for social security contributions (3.34% of GDP in Table 2) is strongly influenced by the formal programmes in a number of Latin American countries. Whilst Sri Lanka does not have these extensive formal programmes, the level of social welfare provision is high by international standards with, for example, major poverty alleviation programmes (Janasaviya and food stamps) and free mid-day meals for school-children. This type of poverty alleviation programme covers a number of measures which would overlap with social security expenditures in developed countries. Thus in Sri Lanka there would seem to be a case for considering the possibility of a system of social welfare contributions that might raise 1 or 2% of GDP. This would not be a formal programme where individual contributions generate individual entitlements but the linking might help with the preparedness to comply.

The next head is VAT/Sales Taxation. Sri Lanka currently raises 5.8% of GDP from this source (with 1991 turnover/sales taxation). A very successful VAT might cover 40% of GDP but a more realistic estimate (which would itself be a strong achievement) would be one-third of GDP. Rates of around 20% on these bases (which might be viewed as fairly high as average rates) would yield the revenues associated with the extremely ambitious and very ambitious plans respectively. These simple examples emphasise that whilst VAT is a valuable innovation it cannot be expected by itself to make the major contribution to closing revenue gaps. The main advantages of VAT adoption in Sri Lanka would come from improvements in economic efficiency through the removal of distortions inherent in the current turnover tax system and though reinforcement of income taxes. A VAT would not be doing badly if it covered one-third of GDP at an average rate of 15% and that would yield only 5% or so of GDP, below the current level of 5.8% from the turnover taxes.

In thinking of excises rising from 2.8% of GDP to the 3.6% and 4% in the 'very ambitious' and 'extremely ambitious' cases we have in mind the expansion of the base to include motor fuel and luxury goods in addition to liquor and tobacco. The 1990 Commission argued (p. 195-196 of the Taxation Commission Report, 1991) that liquor and tobacco taxation might be close to their revenue limits. The 1992 experience underlines this, at least for the case of tobacco. To the extent that the excise base is expanded successfully, the revenue obtained from a 100% rate (on the assumed 4% base) could well be achieved with a lower rate on a broader base.

We have described in the examples of Table 3 only small increments for customs. As a small country Sri Lanka's trade is large as a fraction of GDP (around 35%) so comparatively low rates of duty can raise substantial revenue. This head already yields 5.3% of GDP so 5.8% (ambitious) or 6% (very and extremely ambitious) would probably not be problematic, at least from the administration perspective. The caution on this front should come from the broad long-term policy objective of increased openness in international trade.

Advance on corporate taxation revenue will depend on the closing of loopholes from exemptions and holidays. Given past commitments this may take some time and even in the 'extremely ambitious' case we have indicated only 2.5% under this head. From the international perspective, for poor countries a target of 3% does not look at all ambitious and is essentially achieved or surpassed on average by each of the groups of developing countries (except the poorest) described in Table 2.

It must again be emphasised that our calculations here are purely illustrative. They do, however, with their international context, serve to raise possibilities. We have identified personal income taxation and social security contributions as being of particular priority. This is based on Sri Lanka's poor performance here, coupled with the high literacy and numeracy, which should assist income taxation, and the high level of social welfare provision. Social security contributions to a formal programme of entitlements is not what we have in mind, rather it is contributions to finance social welfare programmes. Such linking or ear-marking may improve compliance, but if it is judged that it would not have this effect then the extra revenue could be put under the personal income tax head.

In collecting personal income taxation the introduction of

VAT could be of substantial assistance in the provision of information. It will, therefore, be of importance to ensure that the transfer of information between direct and indirect tax administrations works well. The computer system being installed appears well designed to facilitate information flows and it is, indeed, vital that the administration of VAT and the personal income tax be closely related. The UK government missed a substantial opportunity in this respect when it allocated (in the 1970s) VAT collection to the customs and excise department, on the grounds that it replaced the purchase tax which was administered by that department. It was a mistake which should not be repeated by other countries.

A further reinforcement, or at least removal of impediment, to greater personal income tax collections would be the taxation of public-sector emoluments, which have been exempt from taxation since 1978. Whilst this might produce only a little net revenue in its own right (extra tax revenue would be largely offset in the short-run by salary increases to maintain net public-sector wages and salaries, so raising the expenditure side of the budget) its main role would be via increasing co-operativeness/compliance among the general population. Apparently considerable resentment is generated amongst potential tax payers by the thought that those assessing them and collecting from them pay no income tax. It is also the case that this exemption is extended to many public-sector firms and this causes complications in the implementation of privatisation programmes.

§6. Concluding Comments

This paper has provided reflections on the Sri Lankan tax system from someone with experience in the study of tax systems outside Sri Lanka but who is new to the country. As such the issues raised should be seen in terms of questions and not firm policy recommendations. The requirement for aggregate fiscal policy is clear - to make substantial inroads into a deficit which is running at an underlying rate of around 10% of GDP per annum (notwithstanding some reduction in 1992). Whilst this paper has not discussed expenditure in detail it seems that the change required will be unlikely to arise solely or even largely from expenditure reduction. This position, taken together with the deficiencies in the current tax system, indicates that the task for tax policy is to raise substantial extra revenue, whilst restructuring the system to provide greater simplicity, efficiency and consistency with a more trade and market oriented economy. Although the objectives may be clear, the challenge is daunting.

The Sri Lankan government is fortunate, however, in having before it the valuable report of the Tax Commission of 1990 and much of the way ahead would seem to be charted in that report. The government has made a start in implementing the proposals but some of those recommended policies which might raise substantial extra revenue have not yet been vigorously pursued.

Building on the recommendations of the report and drawing on comparisons with other fairly poor countries a number of areas for extra revenue which look to be possibilities were described and are summarised below. An apparently necessary, target for extra tax revenue would be of the order of 5 percentage points of GDP, if a start is to be made in reducing debt to GDP ratios. A small further contribution would have to come from expenditure reductions. However in pruning expenditure there are major dangers to the type of growth Sri Lanka envisages. A 'newly-industrialising country' needs physical infrastructure and a healthy, well-educated population. Sri Lanka's achievements in health, education and social welfare are striking amongst developing countries and there is understandably a desire to see them preserved both as ends in themselves and as contributors to growth.

As potential major sources of extra revenue the discussion above has identified the personal income tax (possibly an extra 2 percentage points), the value-added tax (½ or 1 percentage points), excises (around 1 percentage point), corporate income tax (½-1 percentage points) and, as a short-run measure, customs (½-1 percentage point). Together such a strategy might yield the extra resources required whilst being consistent with simplicity, growth and efficiency objectives.

Advance in the personal income tax collections of the order indicated could come from improved enforcement and compliance. These can be helped by the VAT, computerisation and the taxation of public-sector emoluments. In this respect the close integration of VAT and income tax administration is important. Improvement in corporate tax revenues should be available from the rolling back of exemptions and holidays. Excise taxation could be increased by expansion of the base to motor fuel, cars and some luxury goods. All of the proposals in this paragraph are contained in the report of the Taxation Commission of 1990.

It must be remembered, however, that reforming the system and raising extra revenue on the scale described will require energetic public relations and marketing. Extra compliance may be assisted by high profile and well publicised enforcements, for example. Those who stand to gain in the medium term have first to be convinced that benefits will indeed be generated by the reforms. Further, popular support for the reforms will have to be mobilised against the opposition of those who will quickly grasp that they will lose.

Further research is needed in a number of directions. These include (i) the more careful quantitative analysis of revenue possibilities, which have been treated fairly crudely in the above, (ii) the potential contribution from the expenditure side in bringing down budget deficits, and (iii) the distributional impact, the identification of who gains and who loses and by how much, as the result of both tax proposals and expenditure cuts.

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TABLE 1

Revenue (by component) and Expenditure

As a Percent of GDP at Current Market Prices

Description	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Tax Revenue (I+II+III+IV+V)	24.2	21.0	18.3	16.1	14.9	16.4	19.5	18.7	17.4	17.9	16.1	19.0	19.0	18.3	18.1
I. Income Tax	2.6	2.6	3.1	2.4	2.9	2.8	3.6	3.4	2.7	2.5	2.1	3.0*	2.3	2.6	2.7
Personal	0.9	0.7	0.6	0.7	0.8	0.7	1.1	0.9	0.8	0.8	0.7	0.9	0.9	0.9	1.1
Corporate	1.7	1.9	2.6	1.7	2.1	2.0	2.4	2.6	1.8	1.7	1.4	2.1*	1.4	1.7	1.7
II. Taxes on Property	0.5	0.3	0.4	0.3	0.3	0.3	0.3	0.3	0.4	0.8	0.8	1.0	1.0	1.8	0.7
III. Tax on Central Bank holdings of Treasury Bills	-	-	-	-	-	-	-	-	-	-	-	-	0.8	0.8	0.5
IV. Taxes on Goods & Services	5.9	5.7	5.3	5.7	6.4	7.2	7.1	8.2	8.2	8.0	7.6	8.4	8.9	8.6	9.2
General Sales & Turnover Tax	2.5	2.3	2.5	3.3	4.1	5.1	5.3	6.3	5.6	5.4	5.5	5.9	6.3	5.8	5.8
Manufacturing	2.0	1.3	1.6	2.0	1.8	2.2	2.0	2.3	1.8	1.9	1.6	1.8	2.1	2.1	1.9
Non-Manufacturing	0.6	1.0	0.9	1.3	1.5	1.6	1.3	1.6	1.3	1.2	1.5	1.2	1.2	0.8	0.8
Imports	0.0	0.0	0.0	0.0	0.7	1.3	2.1	2.4	2.5	2.3	2.4	2.9	3.0	2.8	3.0
Excises	3.2	3.2	2.7	2.3	2.1	1.9	1.7	1.8	2.5	2.4	2.0	2.4	2.5	2.8	2.5
Liquor	1.3	1.0	1.0	0.9	0.8	0.7	0.7	0.7	0.8	0.8	0.8	0.8	0.8	0.8	0.9
Tobacco	1.8	1.5	1.5	1.3	1.3	1.2	1.0	1.2	1.6	1.6	1.2	1.5	1.7	1.8	1.3
Others	0.1	0.7	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.3
Defence Levy	-	-	-	-	-	-	-	-	-	-	-	-	-	-	0.9
Licence Fees	0.2	0.2	0.1	0.1	0.1	0.2	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.0	0.0
V. Taxes on International Trade	15.2	12.5	9.5	7.7	5.2	6.1	8.5	6.8	6.2	6.6	5.6	6.6	6.0	5.3	5.1
Imports	3.3	4.1	3.9	3.2	2.6	3.3	4.3	5.0	5.2	5.6	4.8	6.0	5.2	5.0	4.9
Exports	11.1	8.4	5.6	4.4	2.7	2.8	4.2	1.8	0.9	1.0	0.8	0.6	0.8	0.3	0.2
Nontax Revenue	1.7	1.8	1.3	1.3	1.5	2.8	2.7	3.6	3.3	3.6	2.6	2.6	2.1	2.2	2.2
Total Revenue (Tax + Nontax)	25.9	22.8	19.6	17.4	16.3	19.2	22.2	22.3	20.8	21.4	18.7	21.6	21.1	20.4	20.3
Expenditure	39.6	36.2	42.6	32.9	33.8	32.6	31.1	34.0	32.9	32.5	34.5	32.6	31.0	32.1	27.8
Current	23.1	20.7	18.5	17.2	18.5	18.1	16.0	20.1	18.9	20.1	20.8	22.6	22.3	22.5	21.0
Capital **	16.5	15.5	24.1	15.7	15.3	14.5	15.1	13.9	14.0	12.4	13.7	10.0	8.8	9.6	6.8

Notes:

Source: Compiled from Central Bank of Sri Lanka Annual Reports.
Figures for 1992 are provisional.
* Includes tax on Treasury Bills held by the Central Bank.
** Includes Net Lending.

TABLE 2

Income Breakdown, Tax Revenue by Type (per cent of GDP)

INCOME RANGE (GNP PER CAPITA, $)	AVERAGE GNP PER CAPITA ($)	TOTAL TAX	INCOME TAXES				DOMESTIC TAXES				FOREIGN TAXES				SOCIAL SECURITY	WEALTH AND PROPERTY	OTHER
			TOTAL	INDIVIDUAL	CORPORATE	OTHER	TOTAL	GENERAL SALES, TURNOVER, VAT	EXCISES	OTHER	TOTAL	IMPORT DUTIES	EXPORT DUTIES	OTHER			
<360	239	14.02	3.46	1.36[1]	2.19[1]	0.19[1]	4.55	2.44	1.66	0.46	5.30	4.05	1.09	0.21	0.21	0.24	0.25
360-749	517	19.66	5.74	2.53[2]	2.92[2]	0.21[2]	4.74	2.30	1.95	0.49	7.58	6.70	0.64	0.22	0.79	0.31	0.41
750-1619	1127	18.62	5.98	2.18[3]	4.08[3]	0.30[3]	6.06	2.68	2.64	0.74	4.64	4.10	0.39	0.14	0.78	0.56	0.59
1620-6000	2996	19.79	6.81	2.14	3.80	0.84	5.41	2.40	1.99	1.02	3.12	2.51	0.36	0.24	3.34	0.65	0.75
ALL DEVELOPING	1241	18.05	5.51	2.08[4]	3.29[4]	0.40[4]	5.21	2.46	2.07	0.68	5.13	4.32	0.62	0.20	1.30	0.45	0.45
>6000 (INDUSTRIAL)	13477	31.21	10.96	8.45	2.37	0.14	9.43	5.58	3.02	0.83	0.72	0.70	0.00	0.01	8.90	1.11	0.10

Sources: IMF Government Finance Statistics Yearbook (1989), Table 2.

Notes: For each country the breakdowns are unweighted averages over the three years closest to 1987 for which data were available. GNP per capita is for 1987, in 1987 dollars. Within the total of 82 developing countries there are 20 countries in each of the lower brackets and 21 countries in each of the upper income brackets. There are 21 industrial countries with incomes above $6000.

1 Excluding Maldives, Kenya, Pakistan, Myanmar.
2 Excluding Western Samoa.
3 Excluding Nicaragua, Peru, Jordan
4 Excluding Jordan, Peru, Nicaragua, Western Samoa, Maldives, Kenya, Pakistan, Myanmar.

This Table is taken from R. Burgess and N. Stern, "Taxation and Development", Journal of Economic Literature, forthcoming.

TABLE 3

Possible Tax Structure for Sri Lanka

An Extremely Ambitious Plan (A)
A Very Ambitious Plan (B)
An Ambitious Plan (C)
Current 1991 (D)

Tax Head	Tax Revenue (% of GDP)				Rate (%)			Base (% of GDP)		
	A	B	C	D	A	B	C	A	B	C
Income Tax/Social Security	4	2.5	2.0	0.9	15	10	10	27	25	20
VAT/Sales Tax	8	6.9	6.0	6.0[1]	20	21	18	40	33	33
Excise	4	3.6	3.4	2.8	100	90	85	4	4	4
Customs	6	6	5.8	5.3	17	17	16.5	35	35	35
Corporation Tax	2.5	2.5	2.3	1.7						
Taxes on Property	1.5	1.5	1.5	1.8						
TOTAL	26	23	21	18.3						

Notes:

1 General Sales & Turnover Tax.

(i) We have included central taxes only.
(ii) "Taxes on Property" are mainly on letters of credit and Central Bank holdings of treasury bills which we assume will continue in their present form.
(iv) For a particular tax head the entry, under "Revenue" (under a particular subhead A, B or C), is obtained by multiplying the corresponding entry under "Rate" with the corresponding entry under "Base". For example for case A the 6% of GDP from customs revenue is obtained from a notional 17% rate applied on a 35% base (the current effective rate of import duty is around 14.5%).
(v) Columns may not add to "Total" due to rounding.
(vi) The discussion here has not focussed on corporation and property taxes major sources of extra revenue and we have little background information on them. Accordingly we have not provided base and and rate calculations in the table.
(vii) The source for 'D' is Table 1, 1991, and the remaining entries are own calculations.

Rs Million (current prices)

	1988	1989	1990	1991	1992*
I. Current expenditure	20.8	22.6	22.3	22.3	21.5
1. Purchase of goods and services	9.3	10.1	9.4	9.5	9.4
Salaries and wages	4.5	5.7	4.9	4.8	5.0
o/w civil	3.7	4.0	3.3	3.0	3.1
o/w defence	0.8	1.7	1.6	1.8	1.9
Other goods and services	4.8	4.4	4.5	4.7	4.4
o/w civil	2.5	3.0	2.9	2.3	1.9
o/w defence	2.3	1.4	1.6	2.4	2.5
2. Interest payments	5.7	5.7	6.4	5.9	6.1
Domestic	4.3	4.3	5.3	4.8	5.0
Foreign	1.3	1.3	1.1	1.0	1.1
3. Subsidies and transfers	5.8	6.7	6.5	6.9	5.8
Public corporations	0.6	0.9	0.8	0.5	0.4
o/w railways and postal	0.2	0.2	0.1	0.2	0.2
Public institutions	0.6	0.7	0.5	0.4	0.4
Other levels of government	0.4	0.4	0.4	0.3	0.3
Households	4.1	4.8	4.6	5.4	4.7
Pensions	1.8	1.9	1.4	2.3	1.9
Food and kerosene stamps	0.9	1.4	1.2	0.8	0.7
JSP/midday meal/uniform	0.06	0.2	1.4	1.3	1.3
Other	1.2	1.2	0.6	0.9	0.7
Private inst/abroad/other	0.04	0.04	0.1	0.4	0.1
4. Under expenditure/contingency	0	0			0
II. Capital expenditure	10.3	8.2	5.9	7.2	7.1
1. Acquisition of fixed assets	5.4	5.2	3.6	3.9	4.2
2. Capital transfers	4.9	3.0	2.3	2.9	2.9
Public corporations	1.6	0.6	0.4	0.7	1.0
Public institutions	3.1	2.1	1.6	1.8	1.7
Other levels of government	0.16	0.3	0.3	0.3	0.2
Other	0.03	0.01	0.03	0.08	0.01
3. Under expenditure	0	0			0
III. Lending minus repayments	3.4	1.8	2.7	2.6	(0.16)
On lending	2.3	2.3	2.3	1.7	1.0
Advance account net lending	1.2	-0.4	0.5	0.5	(0.04)
Restructuring costs				0.9	0.18
Repayments	(0.13)	(0.15)	(0.12)	(0.3)	(0.6)
Privatisation proceeds				(0.2)	(0.7)
IV. TOTAL EXPENDITURE	34.5	32.6	29.1	31.9	28.4

Notes: * 1992 figures are provisional. Brackets denote negative numbers. o/w = of which. Source: Communication from Central Bank. There are slight discrepancies with Table 1 for later years, for which final revisions are not yet available.