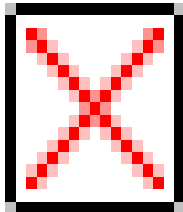


One Nation, Two Regimes, Three Years & Meltdown: Short Analysis of Lanka's Tax Policy

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WHILE

downturn in tax : GDP ratio has been steadily going on in Sri Lanka since 1990's - from a high 19.1% to 8.4% in 2020, and is a subject of many researches ascribing the downturn principally to (a) ad-hoc, gratuitous and profligate nature of tax concessions (b) 14 tax amnesties thus far indicating in good measure the public perception that tax evasion is not a crime and (c) structural inadequacies of tax administration, there are oddities in country's public finance data which mark it as an outlier among the middle income countries (MIC) to which Sri Lanka is generally bracketed. These are (a) regressive revenue generation model administered through a predominantly consumption - based tax system and consequent over reliance on tax on goods and services and tax on external trade at the expense of income tax (b) highly inefficient public sector institutions and hence a negligible non-tax revenue (c) 101% debt to GDP ratio and hence an average of 40% of gross government revenues used for servicing government debts.

Of particular interest for this short analysis is the approach of the two regimes- United National Front (UNP) from 2015 to 2019 and of Sri Lanka PodujanaPeramana (PNP) from 2019-2022 - as evidenced in the budget speeches of respective Finance Ministers from 2019 to 2022 to what was happening to the Sri Lankan public finance and tax system and widely differing pathways for achieving fiscal consolidation, revenue enlargement and tax discipline.

Some operative extracts of Finance Minister's budget speech (UNP) of 2019 under the umbrella motif

"Enterprise Sri Lanka - Empowering the People and Nurturing the Poor" make for interesting reading:

"We achieved a primary surplus for the first time in 5 decades in 2017 and improved it to 0.6% of GDP. This was a major improvement from (-) 2.9% in 2015. Inflation has been brought under control in spite of rising prices of key global commodities. In 2017, we achieved the best ever exports and FDI, and that momentum increased in 2018â€¢. The previous regime was characterized by wasteful expenditure, financed by expensive foreign debt, with no rational plan of repaying this debt. Tax revenues had dwindled to 10% of GDP and exports had crashed to 14% of GDP in 2014. A dismal decline over the two decades- in the year 2000, tax revenue was 15% of GDP and exports 30% of GDP. The economy was over-leveraged."

This was the first projection of a revenue surplus budget (0.2% of GDP) after decades of deficit and a creditable projection of 13.3% of tax to GDP. Truth to tell, there were consistent attempts between 2015 to 2019 for an upward revision of tax rates and major structural tax reforms, which were assiduously resisted by corporates and interest groups.

Budget 2020 under the resplendent slogan **"Vistas of Prosperity and Splendor"**

is not complete without incorporating what happened since November 2019 (when PNP wrested the Presidential elections) until the new Finance Minister rose to deliver his budget speech. This was the interregnum of approximately 2 months when the government without amending the legislations brought forth massive changes to tax policy, tax rates and in a manner changed the course of revenue growth trajectory through administrative fiats and notices. Highest personal income tax was reduced from 24% to 18%. Existing personal income tax slabs of 4,8,12,16,20 and 24% were replaced with a 3 -slab structure of 6,12,and 18%. New income tax exemptions were allowed on income earned through agriculture, plantation crops, livestock, farm activity and from IT and IT enabled services. Corporate tax was reduced from 28 to 24%, and in respect of manufacturing to 18 from 28%. Pay as You Earn (PAYE) tax, a form of TDS on employees' remuneration was replaced with an Advanced Personal Income Tax scheme. Economic Service Charge (ESC) and Nation Building Tax (NBT), both a form of tax on turnover ,were abolished. In budget 2020, over and above ratifying all the previous executive orders on exemption and rate deduction, the

Prime Minister while holding the Finance portfolio proceeded to reduce VAT from 17 to 8%, increased the threshold turnover for VAT to Rs 25 million per month, and exempted most small and medium enterprises from VAT. Contrast the above with the following passage from the Prime Minister's speech:

"Honorable Speaker, the financial position passed down to us is pathetic. If I may begin with the income-expenditure gap, the budget deficit which my government brought down to 5.7% of GDP in 2014, has increased to over 9.6% of GDP by 2019. In fact this is more than the budget deficit recorded of 7% when I assumed office in 2005. When I presented the budget in 2014 for the year 2015, the targeted direction was to bring the budget deficit to 4% by 2020 while making the country free of poverty and become a high middle -income country."

The irony of prescribing deep tax cuts to revive rapidly diminishing government revenues and that too in the backdrop of Prime Minister's own admitted knowledge of state of government finances he inherited should not be lost on anyone.

Budget 2021 continued with the liberalized tax exemption regime of 2020 and added few additional items to the long list. Personal income tax hence would have a threshold taxability if it exceeded Rs 2,50,000 per month. VAT at 8% for businesses engaged in import and manufacture of goods or provision of services would continue if the business records a turnover in excess of Rs 25 million per month. Exemption to entities engaged in farming including agriculture, fisheries, livestock was extended to another 5 years. Medical insurance, interest on housing loan, interest for making investments in government securities and shares of listed companies were made deductible for computing personal income tax. Tax concession of 50% was allowed to newly listed companies for the relevant budget year with a flat tax rate of 14% for next 3 years, and tax holiday of 7 years for all renewable energy projects exceeding installed capacity of 100MW. What stands out in the budget speech apart from the various tax concessions for business and industry is this paragraph in the concluding part of the speech: "

For the benefit of the country, I request from all entrepreneurs to utilize the funds hidden locally or internationally in order to evade laws relating to taxes and foreign exchange. It is expected to make legal provisions to provide a tax pardon to entrepreneurs thus utilizing the funds for any investments facilitated by this budget under the payment of taxes amounting to 1 percent.

" This incidentally is the 14 th instance of tax amnesty extended by various governments over last many decades and truly reflects yet another admission of failure at enforcement of laws.

Budget 2022 is where it was becoming increasingly apparent to the policy makers, in the context of failing government revenues and burgeoning expenditure (major portion of which accounted for interest on servicing government loans) that the excessively generous tax regime was becoming unsustainable. Extracts from some paragraphs from budget speech read:

"Government revenues shows a downward trend at 9% of GDP. Therefore government revenue which was 21.9% during the period 1950-90 has plummeted to 16.3% during 2000-09. After a gradual decline, government revenue further reduced to 9.2% in 2020 owing to covid-19 pandemic". Despite the decline in the government revenue, government expenditure has increased. The unusual impact of the covid pandemic has also contributed to this. Interest expenditure as a % of government revenue is 71.4% in 2020". Government revenue has come to a level which is insufficient to cover the day to day expenditure. Therefore, deficit in the recurrent account i.e government revenue over recurrent expenditure as a % of GDP has increased by 0.6% from 1.1% during 2010-14 to 1.7% during 2015-19. This has increased to 7.9% in 2020."

After setting the stark factual context, budget 2022 proceeded to impose a one-time surcharge of 25% on persons and companies with taxable income in excess of Rs 2,000 million. VAT on banks and financial service providers was increased to 18%, and a new Social Security Contribution at 2.5% imposed if annual threshold turnover exceeded Rs 120 million.

While larger and complex policy decisions without weighing in the eventual repercussions over past many decades surely would have contributed to the state of economy as Sri Lankans were forced to find out for themselves in 2022 when those decisions started to directly impact their lives and living, the incapacity of the system and unwillingness of the policy makers to make honest attempts at augmenting government revenues and their capitulation to populist pressures are palpable. Over reliance on goods and service tax and tax on external trade as prime sources of revenue generation at the expense of income tax exacerbated burden on the common man. Necessary as they are, Sri Lanka also failed to review and control the ever -increasing commercial borrowing and public stock of debt, which was the only measure employed for deficit funding, exposing it to severe macro -economic vulnerabilities.

Finally, relationship between tax rate and revenue generated being typically non-linear, the optimal level of taxation scientifically established for equitably administering a tax regime was neither discovered nor enforced in Sri Lanka. Hope that a low tax rate and multiple tax exemptions will unleash fresh investments and greater tax revenue in the context of a rapidly shrinking economy has been soundly belied. These tax reliefs in an economy facing huge demand-side depressive conditions invariably end up to enrich the few enterprises holding monopolistic control over certain essential items of goods and services, and in no way benefit the general class nor do they usher in higher government revenues. With a tax system operating much lower than its tax capacity coupled with lack of a political will to enforce laws, low tax rates have always tended to result in low tax revenues in most countries (Thanzi and Zee,2000). Sri Lanka, it is appropriate to say, disregarded the economic costs attached to policy decisions which were deeply embedded in electoral commitments, as the budget announcements of 2020 and 2021 so clearly testify. Reversal of some of the liberal sops and attempts at course correction in 2022 sadly was too little, too late.