

The best next step for improving tax collection

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In 2021, the country's tax revenue as a share of gross domestic product (GDP) reached its lowest level since 1959 – dropping to just 8%. Increasing tax-to-GDP ratio is one of the most important measures of Sri Lanka's ability to achieve sustainable economic recovery, and meet its commitments on the current International Monetary Fund (IMF) programme.



By Sumini Siyambalapitiya

The Sri Lankan Government has recognized this challenge and taken several steps since 2022 to increase tax revenues, by increasing tax rates and introducing new taxes. Among others, Withholding Tax (WHT) was reinstated at a rate of 5%, Value Added Tax (VAT) was revised upwards from 8% to 15%, and both Personal Income Tax and Corporate Income Tax rates were hiked significantly. Despite this, Sri Lanka is still falling short of its budgeted revenue targets.

Sri Lanka had a target to collect 2.1% of GDP in tax revenue in the first quarter of 2023. It fell short of this target by 11%. The target for June was 4.3% of GDP. The government has publicly acknowledged that the target was not achieved, though the precise shortfall has not been revealed as of yet.

Given that taxes rates have seen huge upward revision, it is clear that Sri Lanka's current problem lies not in how much people are being taxed, but in how well taxes are collected. In essence, it is a problem of tax administration/collection.

A background note published by Verité Research in February 2023, authored by Professor Mick Moore and Dr Nishan De Mel, presented four solutions for improving tax collection.

In June, the government adopted one of the four solutions proposed, which was to mandate all professionals and companies affiliated with a government/professional body to register for a Tax Identification Number (TIN) and file a tax return.

President Ranil Wickremesinghe (also the Minister of Finance, Economic Stabilisation and National Policies) issued a gazette mandating certain classes of persons to register with the Inland Revenue Department (IRD) with effect from 01 June, 2023. Specifically, this included professionals and persons affiliated with a government/professional body – for example, practitioners registered with the Sri Lanka Medical Council, Members of the Institute of Chartered Accountants of Sri Lanka, and Members of the Institution of Engineers of Sri Lanka.

This is an excellent first step in terms of effectively broadening Sri Lanka's taxpayer base. This is because tax registration statistics from the past two decades in Sri Lanka lend support to the claim that income earned by self-employed professionals, including those whose earnings are channelled through partnerships or small companies, is substantially under-reported in terms of income tax filing.

The best next step to improve tax revenue is to implement yet another of the four solutions proposed, which is to mandate all individuals whose total Withholding Tax (WHT) deductions in any year imply earnings in excess of LKR 1.2 million to register with the IRD.

WHT in Sri Lanka primarily applies to high-income individuals – with a large portion of payments subject to WHT being on interest income, rents, winnings from betting/gambling, gems sold at auction, etc. At present, the tax is applied at a rate of 5%, deducted by the bank or financial institution and directly remitted to the IRD. Given that the WHT is levied at 5%, certificates with a cumulative value exceeding LKR 60,000 imply annual taxable earnings greater than the yearly taxable threshold of LKR 1.2 million for personal income tax.

This proposal is critical to improving tax collection, because it can be implemented quickly at little cost, and taps into a guaranteed pool of eligible productive taxpayers that will positively impact Sri Lanka's tax revenue.

The publication by Verité Research also proposes two other strategies to improve Sri Lanka's tax collection: (1) Proactively assigning TINs to all government servants whose basic annual salaries exceed LKR 1.2 million, and requiring them to file a tax return covering all income, including other earnings from government (e.g. allowances, fees and benefits collected beyond the basic salary); and (2) Proactively allocating TINs to all employees who meet both criteria (a) and (b), and requiring them to file tax returns – (a) currently have taxes deducted from salaries under the Pay-As-You-Earn (PAYE) system; and (b) have incomes that are subject to a WHT deduction.

While the government has announced various other measures to improve tax collection, including an attempt at universal tax registration in 2024, it would do well to start with the next best step of registering individuals with WHT certificates exceeding LKR 60,000.

This can be followed by the implementation of the other two strategies proposed – both of which are also likely to be much more productive than attempting universal tax registration for all the reasons that are detailed in the publication.

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