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Incidence of Income Taxation in Sri Lanka

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Abstract
Taxation is a major instrument of fiscal policy which is used to achieve socio economic objectives. While the primary objective of taxation is to raise revenue to finance government expenditure, it should also be equitable. This study aims to identify the nature of distribution of income tax burden among the income groups in Sri Lanka and provides taxpayers and policymakers with important information on the equity or fairness of the income tax distribution in Sri Lanka. In the case of personal income taxes the burden is unevenly distributed among the registered taxpayers. The study finds that about 87.93 percent of resident individual income taxes shared by only 10.9 percent taxpayers. About 32.95 percent taxpayers pay almost 98.5 percent of income taxes. It depicts the peculiarity of Sri Lanka tax structure where about 43.76 percent of registered individual taxpayers share very insignificant (only 0.97 percent) tax liability. In the case of corporate taxes the major portion of the tax revenue is generated from a small group of companies and corporations. About 66.77 per cent corporate tax payers are paying no taxes for the government showing negative income and revealed as loss cases. About 99 per cent of income tax burden is placed on a small number of (about 13 per cent) corporate tax payers. This study also gives some recommendations which act as remedies for a better tax system in Sri Lanka and would be relevant to other developing countries as well.
Keywords: Equity of taxation, Economic Incidence, Income tax, Statutory Incidence, Tax Progressivity, Tax exemption.

1.Introduction

Taxation forms one aspect of the overall fiscal policy of a government. While taxes in general finance administrative cost of the state, it also diverts and devotes the national economy in the direction the government wishes it to move leading the country eventually to the goal of development (Edirisinge, 1993). Tax policy cannot be viewed in isolation but is part and parcel of general fiscal, economic and social goals pursued by the government (Waidyasekara, 1993). Taxation is considered essential for state formation (Tilly, 1992); economic growth (Gemmel, 1987); for shaping state-citizens relations (Levi, 1988;
and for developing state capacity to deliver services (Semboja and Therkildsen, 1995). We need government, and that means taxes. But when we think about government spending, and the taxes needed to finance its spending, we should also think of the effects of taxation (Williams, 2002).

The year 1977 was a major turning point in the modern economic history of Sri Lanka. After 1977 in keeping with the broad economic policy changes fiscal and tax policies had necessarily to be changed accordingly. Taxation has emerged as a major instrument of fiscal policy and has been used both for resource allocation, increased savings and economic growth. The direct tax system was heavily used for stimulating investment and directing resource allocation through the enlargement of concessions like exemption, tax – holidays and relives to almost every sector of investment and large sectors of the economy (Jayasundera, 1999:116). In Sri Lanka income tax has been the main source of direct taxes. However, it has been argued that the burden of income tax is unevenly distributed among the small group of taxpayers. Thus, in the present study attempt is made to find out “how far the burden of income taxes is equitably distributed among the income groups in Sri Lanka.”

2. Objectives of the Study

The objectives of this study are to

- Identify the nature of the income tax burden distribution among the income groups in Sri Lanka.
- Assess the progressivity of non-corporate income tax and corporate income tax in Sri Lanka.

3. Theoretical Framework for Incidence Analysis

The study of tax incidence is as the study of the effects of tax policies on the distribution of economic welfare (Kotlikoff and Summers, 1987). It is the study of who bears the economic burden of tax. Broadly put, it is the positive analysis of the impact of taxes on the distribution of welfare within a society (Fullerton and Metcalf, 2002). It begins with the very basic insight that the person who has the legal obligation to make a tax payment may not be the person whose welfare is reduced by the presence of the tax (Sakar, 2004)

In general, taxes that are directly imposed on individuals and households are assumed to fall on the individual or household; the household is unable to shift the tax to others. On the other hand, under certain economic conditions, business owners may be able to pass some or all of business taxes to consumers via higher prices then to workers via lower wages and that cannot be shifted to others are absorbed by business owners in the form of lower dividends, profits or return on investment. In the first instance, the tax is considered to be shifted "forward," and in the second and third instances it is considered to be shifted "backward" to the factors of production. A common procedure in carrying out incidence analysis is to employ shifting assumptions of various forms. These may be that a tax is fully shifted forward or backward; or (as is sometimes assumed) that tax is equally (50/50) shifted. In such cases, the incidence conclusion is largely determined by the assumption; and empirical work giving clear indications as to which incidence assumption is most appropriate is limited (John, 1997). In the present study it is assumed that burden of income tax is fallen on the registered income taxpayers.

4. Data and Methodology

This empirical study was carried out as a combination of (i) desk/archive studies; (ii) key informant interviews (in order to obtain important documents and perceptions). To attain the research objectives, the present study is mainly relies on secondary data. A variety of information of diverse nature and sources required for the study were collected from the following sources: Central Bank Annual Reports, Consumer Finance and Socio Economic Surveys of Central Bank, Administration Report of Commissioner General of Department of Inland Revenue, Budget Speech of government of Sri Lanka, and other historical documents. In addition, discussions were held with several officials in the Inland Revenue Department in order to obtain important documents and perceptions regarding the subject. The study considers: a time series tax data on both direct (personal and corporation income tax) for calculating the revenue trend and marginal and average tax rates over the years and a cross section data for last available fiscal year 2001 to determine the sector wise tax burden, taxpayer's information of different category and revenue yield in each sector.

5. Hypotheses

The following hypotheses were developed for testing.

- Income taxes are inequitably distributed among the income groups in Sri Lanka.
- Income tax is progressive in Sri Lanka.

6. Distribution of Tax Burden for Personal and Corporation Income Taxes in Sri Lanka.

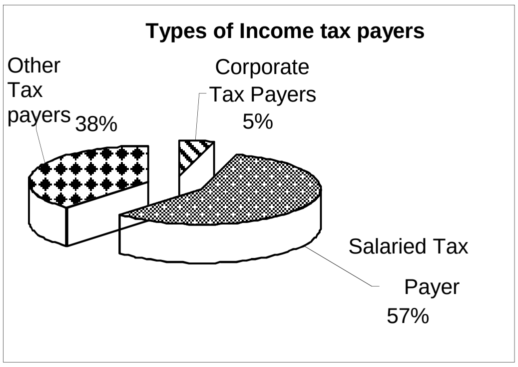
6.1 Types of Income Taxpayers in Sri Lanka

Income taxpayers in Sri Lanka can be categorized in to three main groups. Table1 shows the scenario in detail. The elite group consists of corporate taxpayers those are 4.62 percent of the total taxpayers. The largest and the next group consists of wage earners or salaried taxpayers and shares about 57.24 percent. The last group consists of taxpayers of remaining all others and mainly those who have income from business and profession and shares about 38.14 percent.

Table:1 Types of income taxpayers in Sri Lanka as at 31.12.2001

Types	Number of Taxpayers	%
Corporate Taxpayers	18454	4.62
Salaried Taxpayers	228748	57.24
Other Taxpayers	152431	38.14
Total	399633	100.00

Fig.1 Income tax collection from three major groups of income taxpayers



6.2 Shares of income taxes

Income tax is collected from two main sectors, namely corporate sector and non-corporate sector and labeled as corporate tax and non corporate tax. Analysis of income tax collection from these two main sectors is shown in table2. The large component of income tax is the contribution from the non corporate sector in 2004. Significance of non-corporate tax which includes tax on individuals and other bodies of persons has increased from 42 percent in 2000 to 60 percent in 2004. Corporate taxation constitutes the mainstay of the income tax system in Sri Lanka. The companies contributed in 1985 as much as 75 percent of the total revenue collected from income tax, but has been declining from 2000.

The contribution from corporate sector has decreased from 58 percent in 2000 to 40 percent in 2004. Figure 2 shows the changing trend of income tax collection from the two main sectors for the period of 2000 to 2004. The main reasons for this drop in revenue were the lower income tax yields from the state corporation sector, particularly from the agriculture and petroleum enterprises, the grant of tax holidays to a wide spectrum of business activity, particularly the non- traditional export sector, introduction of investment tax free allowance in 1998, reduction of top marginal income tax rate and abolish ion of advanced company tax in 2002. The table2 shows that the large component of income tax is the contribution from the non corporate sector in 2004. Significance of non corporate tax which includes tax on individuals and other bodies of persons has increased from 42 percent in 2000 to 60 percent in 2004. Corporate taxation constitutes the mainstay of the income tax system in Sri Lanka. The companies contributed in 1985 as much as 75 percent of the total revenue collected from income tax, but has been declining from 2000. The contribution from corporate sector has decreased from 58 percent in 2000 to 40 percent in 2004.

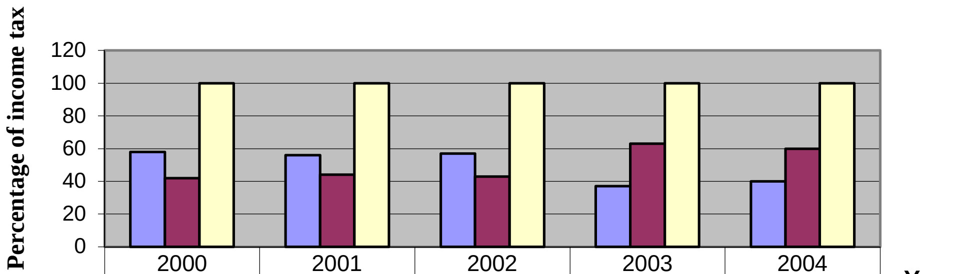
Table 2 Income tax collection 2000-2004

Source	2000		2001		2002		2003		2004	
	Rs. mn	%	Rs. mn	%	Rs. mn	%	Rs. mn	%	Rs. mn	%
Corporate tax	15,256	58	18,680	56	21,435	57	14,264	37	16,663	40
Non Corporate tax	11,122	42	14,934	44	16,247	43	24,337	63	25,293	60
Total	26,378	100	33,614	100	37,682	100	38,602	100	41,956	100

Source: Performance Report of IRD (2000-2004)

Figure 2 shows the changing trend of income tax collection from the two main sectors for the period of 2000 to 2004.The main reasons for this drop in revenue were the lower income tax yields from the state corporation sector, particularly from the agriculture and petroleum enterprises, the grant of tax holidays to a wide spectrum of business activity, particularly the non- traditional export sector, introduction of investment tax free allowance in 1998, reduction of top marginal income tax rate and abolition of advanced company tax in 2002.

Figure 2 Major divisions of collection of income taxes in Sri Lanka 2000-2004



	2000	2001	2002	2003	2004
Corporate tax	58	56	57	37	40
Non Corporate tax	42	44	43	63	60
Total	100	100	100	100	100

Source: Performance Report of IRD (2000-2004)

It is also observed from table 2 and figure 2 that incidence of income tax on corporate sector has decreased whereas that on the non-corporate sector has increased.

6.3 Incidence of non corporate income tax/personal income tax

The nature and extent of tax incidence due to personal and corporation income taxes are different. In the case of personal income taxes the burden is unevenly distributed among the registered taxpayers. In reality, a major portion of income taxes is paid by a small group of people with higher marginal rates. A number of registered tax payers always remain in lower income groups for either due to mainly more available tax incentives or tax exemptions and share a little burden of taxes, often at lower marginal rates (Sarker, 2004). Table 3 shows the result of an analysis of non corporate income tax scenario in Sri Lanka based on income classification.

It shows that about 11.41 non corporate taxpayers pay no tax to the government and reported to as loss cases. About 49.48 percent non corporate tax payers pay only very insignificant income tax (10.22%). Further, more than 2/3 of non corporate tax payers (72.26 percent) contribute only 1.5 percent income tax whereas only 27.74 percent tax payers in the income tax range of more than 200,000 pay 98.5 percent income tax. Interestingly, about 4.22 percent taxpayers contribute 69.28 percent income tax. Thus, it reveals that major portion of income tax is contributed by very small groups of non corporate taxpayers. Resident individuals are the major income tax contributors in the non corporate sector. Out of 62280 non corporate income tax payers, 61,000 are resident individuals (about 97 percent) and share about 93 percent of non corporate income tax revenue.

Table: 3 Types of taxpayers and incidence of income tax on the basis of non corporate income taxes as at 31.12.2001.

Range	No. of Individual Taxpayers	% of total taxpayers in each category	Income Mn. Rs.	Collection of Tax Revenue Mn. Rs.	Payment of Taxes by each group in %	Effective Tax Rate
Loss Case	7173	11.41	0	0	0	0
1-50000	4388	6.98	120.99	0.90	0.03	0.74
50001-75000	3307	5.26	208.81	0.69	0.02	0.33
75001-100000	6840	10.88	519.68	1.73	0.06	0.33
100001-150000	9403	14.95	1220.76	3.14	0.11	0.26
150001-200000	14325	22.78	2408.62	35.68	1.28	1.48
200001-300000	7474	11.89	1813.20	79.37	2.84	4.38
300001-400000	3839	6.11	1330.96	97.37	3.49	7.32
400001-500000	2426	3.86	1083.26	114.91	4.11	10.61
500001-750000	3030	4.82	1829.43	289.62	10.37	15.83
750001-1M	1330	2.12	1144.54	235.46	8.43	20.57
1M -5M	2349	3.74	4379.92	1140.17	40.82	26.03
Over-5M	303	0.48	3556.22	794.86	28.46	22.35
Total	62880	100.00	19407.58	2793.20	100.00	

Source: Administrative Report of the Commissioner General of IRD (2001)

However, effective income tax rate increases from lower level income groups to higher level of income groups. This indicates that income tax is progressive among the non corporate tax payers except the about 1 % top level income groups.

6.4 Incidence of corporate income taxes in Sri Lanka

Incidence of corporate taxes shows the similar nature as the distribution of personal income taxes in Sri Lanka. Again the burden of corporation taxes is shared among the different sub-sectors namely resident companies, non residence companies and state corporations. Out of 8147 corporate tax payers, 8064 (99%) are resident companies; non resident companies and state corporation are in very small numbers and consist of 42 and 41 respectively. Thus, analysis of figures in the table 4 represents more or less the case of resident companies in Sri Lanka.

Table: 4: Types of corporate taxpayers and incidence of income tax on the basis of corporate income taxes as at 31.12.2001.

Range of Assessable income	No. of Corporation Tax-payers	% of total taxpayers in each category	Assessable Income	%	Collection of Tax Revenue	Payment of Taxes by each group in %
Loss Case	5440	66.77	0.00	0.00	0.00	
1-50000	417	5.12	10.23	0.03	3.49	0.03
50001-100000	248	3.04	17.93	0.05	8.41	0.06
100001-150000	147	1.80	18.24	0.05	5.88	0.05
150001-200000	126	1.55	21.74	0.06	7.20	0.06
200001-300000	189	2.32	46.66	0.12	15.26	0.12
300001-400000	146	1.79	50.68	0.13	16.62	0.13
400001-500000	79	0.97	35.08	0.09	10.95	0.08
500001-750000	180	2.21	109.83	0.29	36.30	0.28
75001-1000000	128	1.57	112.06	0.29	33.39	0.26
1M-3M	391	4.80	698.63	1.82	212.36	1.63
3M-5M	157	1.93	608.78	1.59	211.35	1.62
5M-10M	141	1.73	995.67	2.59	283.34	2.17
10M-15M	91	1.12	1124.05	2.93	329.91	2.53
15M-20M	52	0.64	918.60	2.39	265.59	2.03
20M-25M	33	0.41	729.36	1.90	175.79	1.35
Over-25M	182	2.23	32909.36	85.69	11440.09	87.62
Total	8147	100.00	38406.89	100.00	13055.95	100.00

Source: Administrative Report of the Commissioner General of IRD (2001)

Table4. shows the total tax burden shared by all kind of the corporate tax payers in different income groups. The major portion of the corporate tax revenue is generated from a small group of companies and corporations. This is seen in the analysis of total income tax collection from resident companies, non- resident companies and state corporations as at 31.12.2001. This indicates that 12.86 percent, comprising the larger companies and public corporations contributed 98.95 percent of the corporate tax collection. About 66.77 percent corporate tax payers paying no taxes for the government and showing negative income and revealed as loss cases. Thus about 99 percent of income tax burden is placed on a small number of (about 13 percent) corporate tax payers.

6.5 Types of corporate taxpayers and incidence of income tax on the basis of principal sources of income and status

The analysis of corporate tax payers on the basis of principal sources of income and status(Table 5) shows that only 1.72 percent corporate tax payers in transport sector are heavily faxed. Effective rate of tax is 61.38 percent for the transport sector and this means taxes paid by this sector is very high as compared to their earnings. Next heavily taxed sector is mining and quarrying sector with high effective rate of tax 52.85 percent. Manufacturing and finance and insurance sector is taxed in the same manner. Investment and construction sectors are given much tax exemption and holidays, thus, these sectors are left with very less effective income tax rate of 3.30 percent and 9.14 percent respectively.

Table: 5 Types of corporate taxpayers on the basis of principal sources of income and status as at 31.12.2001.

Principal Source	No. of Individual Taxpayers	% of total taxpayers in each category	Income (mn.Rs.)	%	Collection of Tax Revenue (mn.Rs.)	Payment of Taxes by each group in %	Effective Rate
Primary Product	145	1.78	907.44	1.73	194.05	1.49	21.38
Mining & Quarrying	8	0.10	24.55	0.05	12.97	0.10	52.85
Manufacturing	1509	18.52	13325.15	25.43	3617.51	27.71	27.15
Trading	1750	21.48	5702.70	10.88	1969.58	15.09	34.54
Finance & Insurance	117	1.44	7475.14	14.26	2023.72	15.50	27.07
Construction	244	2.99	1131.25	2.16	103.37	0.79	9.14
Transport	140	1.72	3020.49	5.76	1853.95	14.20	61.38
Services	3039	37.30	6108.79	11.66	1470.48	11.26	24.07
Investment	1073	13.17	11744.70	22.41	387.88	2.97	3.30
Net Capital Gain	37	0.45	235.29	0.45	16.07	0.12	6.83
Other Sources	85	1.04	2730.14	5.21	1406.37	10.77	51.51
Total	8147	100.00	52405.62	100.00	13055.95	100.00	

Source: Administrative Report of the Commissioner General of IRD (2001)

7. Summary and Conclusion

This study unveils the present scenario of tax incidence among different income groups, in the case of personal and corporation income taxes in Sri Lanka.

- Income tax is Progressive in Sri Lanka

Effective income tax rate increases from lower level income groups to higher level of income groups in the corporate taxpayers as well as in non corporate taxpayers

- Income taxes are inequitably distributed among the income groups in Sri Lanka

The major portion of income tax is contributed by very small groups of non corporate taxpayers as well as corporate taxpayers.

- A long-term sustainable solution to enhance transparency, promote growth, improve tax compliance and thus to increase tax to GDP ratio is a much desirable issue in the context of Sri Lanka.
- Historically, Sri Lanka's direct taxes have been heavily skewed against salary-earners and corporate sector.
- Small business, services and farm incomes manage to slip through the tax net effortlessly.

Following suggestion are made by author to improve the present income tax system in Sri Lanka:

- To soften the tax burden among all the taxpayers in such a manner that might reduce the average tax rates of middle and higher income people and encourage them to pay tax.
- To Increase tax base
- To eliminate administrative deficiencies responsible for the low tax base
- Coordinated action plan including different sectors of government, banks and financial institutions and local government.
- Cleaning up of all income tax exemptions
- To maintain stability and simplicity in tax system
- To remove the inequality of taxing the private sector and government employees.

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