FISCAL SPACE FOR SOCIAL PROTECTION

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UNICEF SRI LANKA WORKING PAPER

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Fiscal space for social protection

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FISCAL SPACE FOR SOCIAL PROTECTION

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EXECUTIVE SUMMARY

Target 1.3 of the UN Sustainable Development Goals commits all countries to implement nationally appropriate social protection systems for all, including floors, for reducing and preventing poverty. The economic and social returns on investments in social protection at the micro and macro level are significant and well-documented. Social protection prevents and reduces poverty and inequality. It supports improved health, nutrition, protection and education outcomes, increases productivity, and promotes gender equality and the inclusion of people with disabilities. As such, it is an important impetus to inclusive economic growth. Furthermore, it stabilizes aggregate demand during times of economic downturn or crisis and increases the ability of societies to respond to shocks as well as structural transformations required to tackle demographic and ecological challenges.

In the current context of the Sri Lankan economic crisis, and the subsequent deterioration in children's outcomes, the case for rapidly scaling up the nation's social protection system is more evident than ever. National social protection floors are a first building block to build a national social protection system that progressively provides higher levels of protection. Such a national social protection floor should include guaranteeing basic income security for children, providing access to nutrition, education, care and any other necessary goods and services. It should also provide income security for older persons, as well as for people of working age who are unable to earn a sufficient income.

Depending on the scale and speed of roll-out of such a national social protection floor, a recent study estimates that initial investments would range between 0.6 and 1.3 per cent of Sri Lanka's Gross Domestic Product (GDP). Upon complete roll out, by 2040, the level of investments would range between 0.7 and 1.8 per cent of GDP depending on the scenario.

Currently, the Government has limited fiscal headroom with which to scale up its investments. In addition, at present, the vast majority of the country's spending on non-contributory social protection programmes is funded by multilateral organizations, and hence cannot be considered sustainable financing sources.

This study, therefore, sets out a series of financing options that the government can adopt to meet the financing requirements for a comprehensive social protection system. It is based on the premise that fiscal space should not be considered a static concept that is restricted by current budgetary limits, but that the creation of fiscal space is a process, with a variety of options to find additional resources for social protection financing. Specifically, this study explores the potential of (1) Increasing tax revenues; (2) Eliminating illicit financial flows; and (iii) Reallocating or reprioritizing public expenditures. Each option is quantified in terms of its potential revenue generation, providing lower and higher estimates, with an analysis on the feasibility of their implementation, and the likely equity impacts they would have.

The combined options set out in this analysis, if implemented together, would raise between 0.85 per cent and 1.36 per cent of GDP. Furthermore, if the government were to be more conservative and adopt only those measures which are easy to implement, and are positive in terms of the equity impact, the potential revenue generation is between 0.52 per cent and 0.85 per cent of GDP.

It is important to note, too, that these estimates do not consider the second-order effects of the potential increases in tax revenues from higher rates of economic growth that these investments would deliver, both in the short-term as it stimulates fiscal multipliers, and in the long-term as they support health and educational outcomes, which are essential for long-term sustainable and inclusive economic growth.

The findings can be used to inform government and social partners on how they can progressively raise and reallocate revenue to create budgetary room to increase the spending on social protection schemes and programmes, especially providing protection to vulnerable groups in Sri Lanka including women, children, individuals with disabilities and older persons.

Introduction

Sri Lanka is currently experiencing its worst economic crisis since independence. It is a result of persistent large fiscal deficits, an unsustainable public debt burden, reduced tax revenue, and low foreign income revenue. For citizens, the crisis has meant skyrocketing inflation - especially for food items - acute shortages in fuel, medicine, and other necessities, and reduced access to government services. It is estimated that 3.9 million or 19 per cent of the population are food-insecure, and over 10,000 households are in need of assistance.[1] Poor and vulnerable communities have been disproportionately affected.

Target 1.3 of the UN Sustainable Development Goals commits all countries to implement nationally appropriate social protection systems for all, including floors, for reducing and preventing poverty.[2] Despite this, even prior to Sri Lanka's existing economic woes and the COVID-19 pandemic, government expenditure on social protection (and other social sectors such as education and health) were low compared to regional peers and middle-income economies.[3],[4] The crisis has placed this allocation in a further precarious situation as historical precedence suggests that governments often deprioritize and deem social protection as unaffordable during times of economic downturn. Over the last year, this has been evident to a certain extent, with recipients of certain social protection programmes (disability allowances and pregnancy vouchers) experiencing delays of two or more months to receive their monthly payments.[5]

Although the economic crisis severely restricts the government's ability to invest in and expand public services, the need has never been greater. In fact, social protection is essential for economic recovery, such that citizens, especially the most vulnerable, are protected; economic growth goes hand in hand with poverty alleviation, reduction in inequality, food security, access to education and health services, and empowerment of women and children. It is an investment in human capabilities and supports a healthier and better educated workforce (Bierbaum and Schmitt 2022). Social protection also increases aggregate demand, which is an automatic stabilizer in times of crises.

In order to achieve this, there is an urgent need to identify gaps in coverage and financing of Sri Lanka's existing social protection system and analyze the 'fiscal space' to better channel resources towards investment in social protection. It is particularly timely now, as Sri Lanka sets out on a path of recovery. Just three months ago, Sri Lanka received board-level approval for a USD 3 billion International Monetary Fund (IMF) programme under the Extended Fund Facility (EFF) arrangement.

1 Food and Agriculture Organization of the United Nations, Special Report – FAO/WFP Crop and Food Security Assessment Mission (CFSAM) to the Democratic Socialist Republic of Sri Lanka, May 2023.

2 United Nations Sustainable Development Solutions Network, (Network n.d.) 1.3.

3 UNICEF, Budget Brief: Education Sector Sri Lanka, 2021.

4 PublicFinance.lk, "Sri Lanka's health expenditure is lagging behind its peers", April 2020.

5 UNICEF, *Impact of the economic crisis on households' social and economic wellbeing: Round 7 findings.*

This report presents findings from an analysis which actively explored and identified sources of additional revenue for social protection. The findings can be used to inform government and social partners on how they can raise and reallocate revenue to create budgetary room to increase the spending on social protection programmes, especially providing protection to vulnerable groups in Sri Lanka including women, children, individuals with disabilities and older persons.

This report consists of four (04) main chapters. **Chapter 1** provides a framework for exploring revenue sources based on the Fiscal Space Handbook (Ortiz et al. 2019). **Chapter 2** outlines the existing resource allocation, and means of financing, for social protection in Sri Lanka. **Chapter 3** assesses the relevance and feasibility of selected financing options (set out in Chapter 1), to expand fiscal space. Finally, **Chapter 4** summarizes the potential revenue that can be channeled towards social protection, from each of the potentially feasible avenues.

CHAPTER 1:
FRAMEWORK FOR FISCAL SPACE ANALYSIS (RESEARCH APPROACH)

The Fiscal Space Handbook published by the ILO and UN Women (see Ortiz et al. 2019, page 9), defines 'fiscal space' as **"the resources available as a result of the active exploration and utilization of all possible revenue sources by a government".** The analysis presented in this report was conducted in line with this definition. This means, it takes the view that fiscal space should not be considered a static concept that is restricted by current budgetary limits, but that the creation of fiscal space is a process, with a variety of options to find additional resources for social protection financing.

The overall 'big picture' approach taken to conduct this fiscal space analysis is detailed in Figure 1. The study drew from two studies to identify the resources available currently and the financing gap for social protection persisting in Sri Lanka. They are: (1) 'Public Expenditure Analysis for Social Protection in Sri Lanka' (Bird et al. 2022) – this review published by UNICEF details Sri Lanka's current public spending on the social protection sector, and (2) 'Building the Case for a Lifecycle Social Protection System in Sri Lanka' (Sibun et al. 2023) - this analysis explores the cost of several potential options for investing in universal lifecycle social protection in Sri Lanka.

This was followed by an assessment of potential sources of finance to fill the financing gap. This report examines several of the eight financing options, based on the Fiscal Space Handbook, to create fiscal space for social protection in Sri Lanka. The following are the options and their brief descriptions (Ortiz et al. 2019, page 11):

(1) Expanding social security coverage and contributory revenue: increasing coverage and therefore the collection of contributions of social security systems is a main reliable way to finance social protection; social protection benefits linked to employment-based contributions are linked to formalization of the informal economy.

(2) Increasing tax revenue: this is another main channel for generating domestic resources and is achieved by expanding the tax base and altering different types of tax rates - e.g., on consumption, corporate profits, financial activities, personal income, property, imports or exports, natural resource extraction, etc. – and/or by strengthening the efficiency of tax collection methods and overall compliance.

(3) Eliminating illicit financial flows: a vast amount of resources, estimated at more than ten times the total aid received, escape developing countries each year illegally. Therefore, policymakers should crack down on money laundering, bribery, tax evasion, trade mis-invoicing and other financial crimes that are illegal and deprive governments of revenues needed for social and economic development.

(4) Reallocating or reprioritizing public expenditures: this is the most orthodox option, which includes assessing on-going budget allocations through a review of public expenditure and other types of thematic budget analyses, replacing high-cost, low-impact investments with those with larger socio-economic impacts, eliminating spending inefficiencies and/or tackling corruption.

(5) Tapping into fiscal and foreign exchange reserves: this includes drawing down fiscal savings and other state revenues stored in special funds, such as sovereign wealth funds, and/ or using excess foreign exchange reserves in the central bank for domestic and regional development.

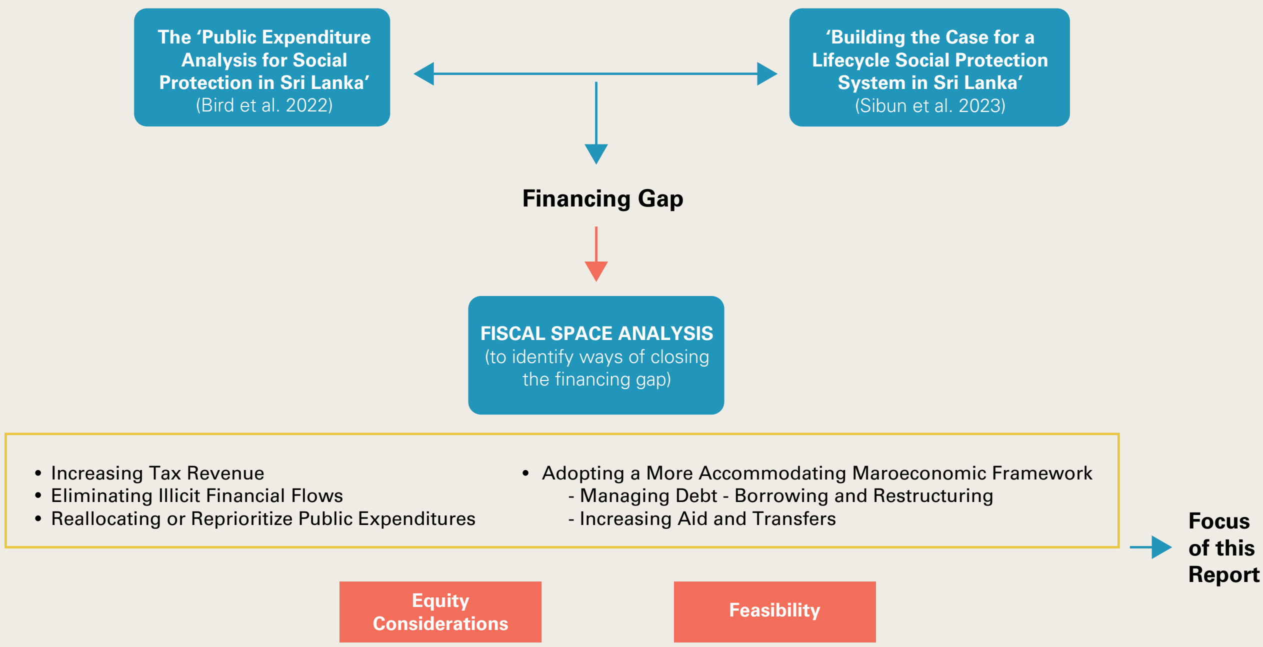
(6) Managing debt – borrowing and restructuring: this involves an active exploration of domestic and foreign borrowing options at low cost, including concessional loans, following a careful assessment of debt sustainability. For countries under high debt distress, restructuring existing debt may be possible and justifiable if the legitimacy of the debt is questionable or the opportunity cost in terms of worsening deprivations of vulnerable groups is high.

(7) Adopting a more accommodating macroeconomic framework: this creates an enabling macroeconomic condition to consider options (5), (6), and (8). It may also entail allowing for higher budget deficit paths and higher levels of inflation without jeopardizing macroeconomic stability.

(8) Increasing aid and transfers: this requires either engaging with different donor governments or international organizations in order to ramp up North-South or South-South transfers.

The selected options for this analysis were **(2), (3), (4) and a combined analysis of (6), (7), and (8)**. The options were selected in order to ensure the most appropriate financing options for Sri Lanka, considering their relevance to achieve macroeconomic sustainability, and considering feasibility and equity.

Figure 1: **Research Approach to Conduct the Fiscal Space Analysis**



Source: Ortiz et al. 2019 and ILO 2021.

Data for the fiscal space analysis was obtained from the Ministry of Finance (Department of National Budget), the Central Bank of Sri Lanka and relevant line ministries and departments. To facilitate global and regional comparisons, and in the absence of national-level data, credible international data sources such as Government Finance Statistics (IMF), World Economic Outlook (IMF), World Social Protection Database (ILO), World Development Indicators (WB) and other databases by the ADB and the United Nations Regional Commissions were used. Data at sub-national level was not included in this study because of the inherent difficulties and time constraints associated with accessing this information.

The fiscal space analysis was preceded by an in-depth literature review to assess existing approaches and literature on the subject. The analysis was followed by a consultation with stakeholders, including government officials, multilateral institutions, and independent economic experts, that provided feedback and validated the report (see Annex 1).

CHAPTER 2:
EXISTING RESOURCES AND ESTIMATED COSTS FOR SOCIAL PROTECTION IN SRI LANKA

This chapter details the existing resources allocated towards social protection in Sri Lanka, the means through which revenue is currently generated, and the cost estimates for the provision of comprehensive and sustainable social protection.

2.1. Existing Resource Allocation for Social Protection

Social protection in Sri Lanka is generally funded through the consolidated fund. The Sri Lankan government allocated LKR 359.5 billion towards social insurance and LKR 126.7 billion towards social assistance programmes for 2023.[6], [7] This represents 1.18 per cent of GDP and 0.42 per cent of GDP respectively.[8] It is notable that Sri Lanka consistently spends more on social insurance (primarily public pensions) than on social assistance, despite having fewer beneficiaries of social insurance schemes (Bird et al. 2022). In 2020, expenditure on social assistance and social insurances was distributed as follows (see Table 1).

Table 1: Public Expenditure on Social Protection in Sri Lanka 2020

Programme	Category	Expenditure (LKR Million)	Expenditure as a % of GDP
Samurdhi	Social Assistance	52,434	0.35%
Thriposha	Social Assistance	1,122	0.01%
Food allowance for pregnant mothers (Poshana Malla)	Social Assistance	4,751	0.03%
School feeding programmes	Social Assistance	2,375	0.02%
Public welfare assistance allowance [2015]	Social Assistance	969.5	0.01%
Elderly assistance programme	Social Assistance	9,868	0.07%
Assistance for persons with disabilities	Social Assistance	4,293	0.03%

6 Ministry of Finance, Approved Budget Estimates 2023.

7 This analysis adopts a definition of social protection focusing on non-contributory (social assistance) and (semi-)contributory schemes (social insurance), consistent with the definitions used in the 'Public Expenditure Analysis for Social Protection in Sri Lanka' (Bird et al. 2022).

8 The 2023 nominal GDP figure is imputed using figures provided in the Approved Budget Estimates 2023. The figure is LKR 30,320 billion.

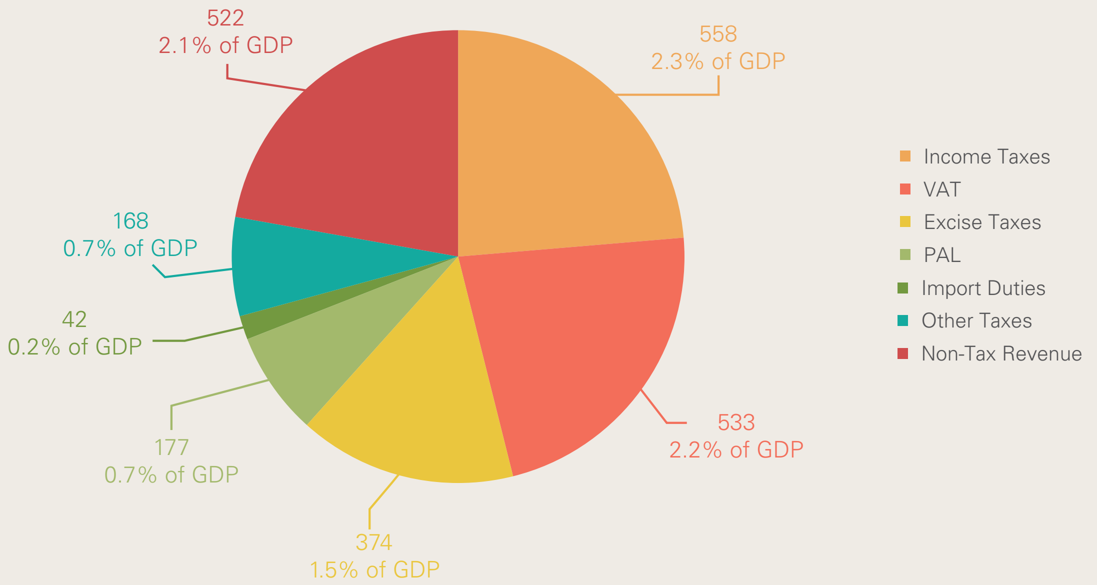
Programme	Category	Expenditure (LKR Million)	Expenditure as a % of GDP
Allowance for patients with CKDU	Social Assistance	1,776	0.01%
Free/subsidized school materials	Social Assistance	7,546	0.05%
Scholarships and bursaries for education	Social Assistance	2,997	0.02%
Season tickets for students	Social Assistance	5,400	0.04%
Flood and drought relief	Social Assistance	237	<0.01%
Public pensions	Social insurance	257,800	1.72%
Soldiers' death and disability com-pensation	Social insurance	37,460	0.25%
TOTAL		389,029	2.60%

Sources: Bird et al. 2022.

2.2. Government Revenue

In 2022, Sri Lanka's total government revenue was LKR 2,373 billion, this was equivalent to 9.97 per cent of GDP.[9] Of this, tax revenue made up 7.78 per cent of GDP and the non-tax revenue made up the remaining 2.19 per cent. Figure 2 details the various revenue sources.

Figure 2: Composition of Government Revenue Sources 2022 (LKR billion)



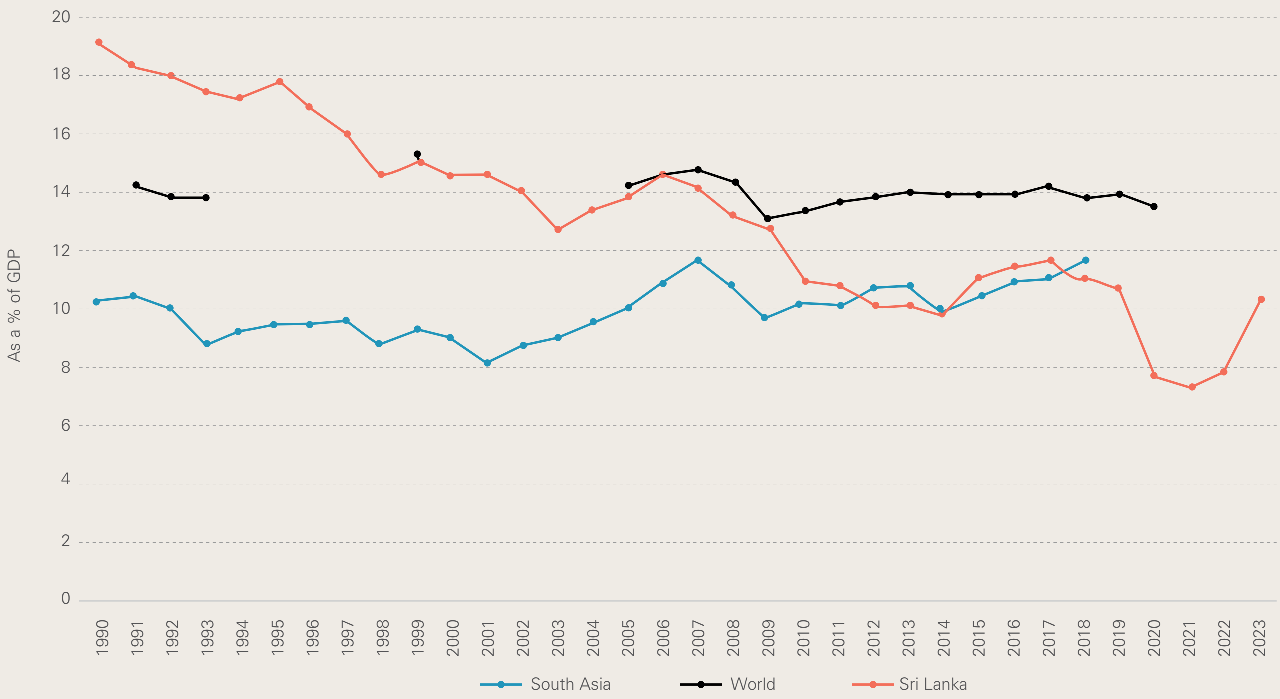
Source: Budget Estimates 2023.

9 Central Bank Annual Report 2022.

It is estimated that in 2023, Sri Lanka's tax revenue will increase to 10 per cent of GDP.[10] This is still a modest share, but it is an improvement from a decreasing trend in tax revenue over the past three decades (see Figure 3).

It is also notable that in most recent years, the country's tax revenue has been below both the regional (South Asian) and global average.

Figure 3: Tax Revenue as a Percentage of GDP 1990-2023



Source: Author's calculations using Budget Estimates 2015-2023, World Bank World Development Indicators June 2023 (Last accessed on 25 June 2023).[11]

Foreign loans and grants are an important source of financing for Sri Lanka's annual budget. Between 2012 and 2019 foreign loan receipts decreased from 2.5 per cent of GDP to just 1.1 per cent of GDP. Since then, the share has oscillated around approximately 2 per cent of GDP.[12] In contrast, the value of foreign grants received by Sri Lanka has remained approximately 0.1 per cent of GDP over the same 11-year period.

Most recently, the World Bank approved USD 700 million in concessionary loans for Sri Lanka. Part of this funding, USD 200 million, will directly support the country's newly introduced "Aswesuma" social safety net programme and seeks to provide better-targeted income and livelihood opportunities to the poor and vulnerable.[13] The remaining USD 500 million will support reforms in Sri Lanka that help improve economic governance and enhance growth and competitiveness.

With regards to Official Development Assistance (ODA), as Sri Lanka transitioned to a lower middle-income country over the last several decades, it has resulted in a trend of reduced donor funding. ODA received by Sri Lanka peaked in 2005, at 3.6 per cent of GDP, following which its share has significantly decreased. Over the past 5 years, ODA has consistently been less than 0.3

10 Ministry of Finance, Approved Budget Estimates 2023.

11 The World Bank database has missing data points, hence the missing figures.

12 World Bank data.

13 "World Bank Group Adopts Country Partnership Framework for Sri Lanka to Help Reset the Economy, Protect the Poor", June 28, 2023, The World Bank. Last accessed via https://www.worldbank.org/en/news/press-release/2023/06/27/world-bank-group-adopts-country-partnership-framework-for-sri-lanka-to-help-reset-the-economy-protect-the-poor on 06.07.2023.

per cent of GDP. This is below the South Asian average for the same period, 0.4 per cent.

2.3. Cost Estimates

Based on an assessment of the current social protection system in Sri Lanka and its coverage, comprehensiveness and adequacy, a recent study explores different options for investing in a universal lifecycle social protection system (Sibun et al. 2023). They are detailed below in Table 2.

The four options were devised based on the assumption that the existing poverty-targeted *Samurdhi* programme would be removed and replaced with one of these more comprehensive universal lifecycle packages. It also assumes that current recipients of the existing poverty-targeted Allowance for Disability, Chronic Illness Allowance and Senior Citizen's Allowance would transition into the universal disability and old age benefits offered under these alternative proposals.

Transition from Sri Lanka's existing social protection system to the proposed universal lifecycle options is estimated to cover a far larger proportion of the population - between 40-90 per cent of all households upon full roll-out depending on the option chosen.

Table 2: Proposed Four Options to Build a Lifecycle Social Security System in Sri Lanka by UNICEF Sri Lanka

Scheme	Age of Eligibility	Monthly Transfer (LKR)	Monthly Transfer (USD)	Monthly Transfer (% GDP per Capita)	Level of Investment in Year 1 (LKR Billion)	Level of Investment in Year 1 (USD Million)	Level of Investment in Year 1 (% of 2023 GDP)
Option 1 – MINIMUM							
Child Benefit	6 months before birth to 4 months, gradually extended to up to 2 years	5,000	13.9	6.55	26	71	0.1
Disability Benefit	0 - 69	7,500 (5,000 for those with moderate disabilities)	20.8 (13.89 for those with moderate disabilities)	9.82	31	85	0.1
Old Age Pension	70+ (pension-tested)	7,500	20.8	9.82	101	280	0.4
Total					**157**	**437**	**0.6**

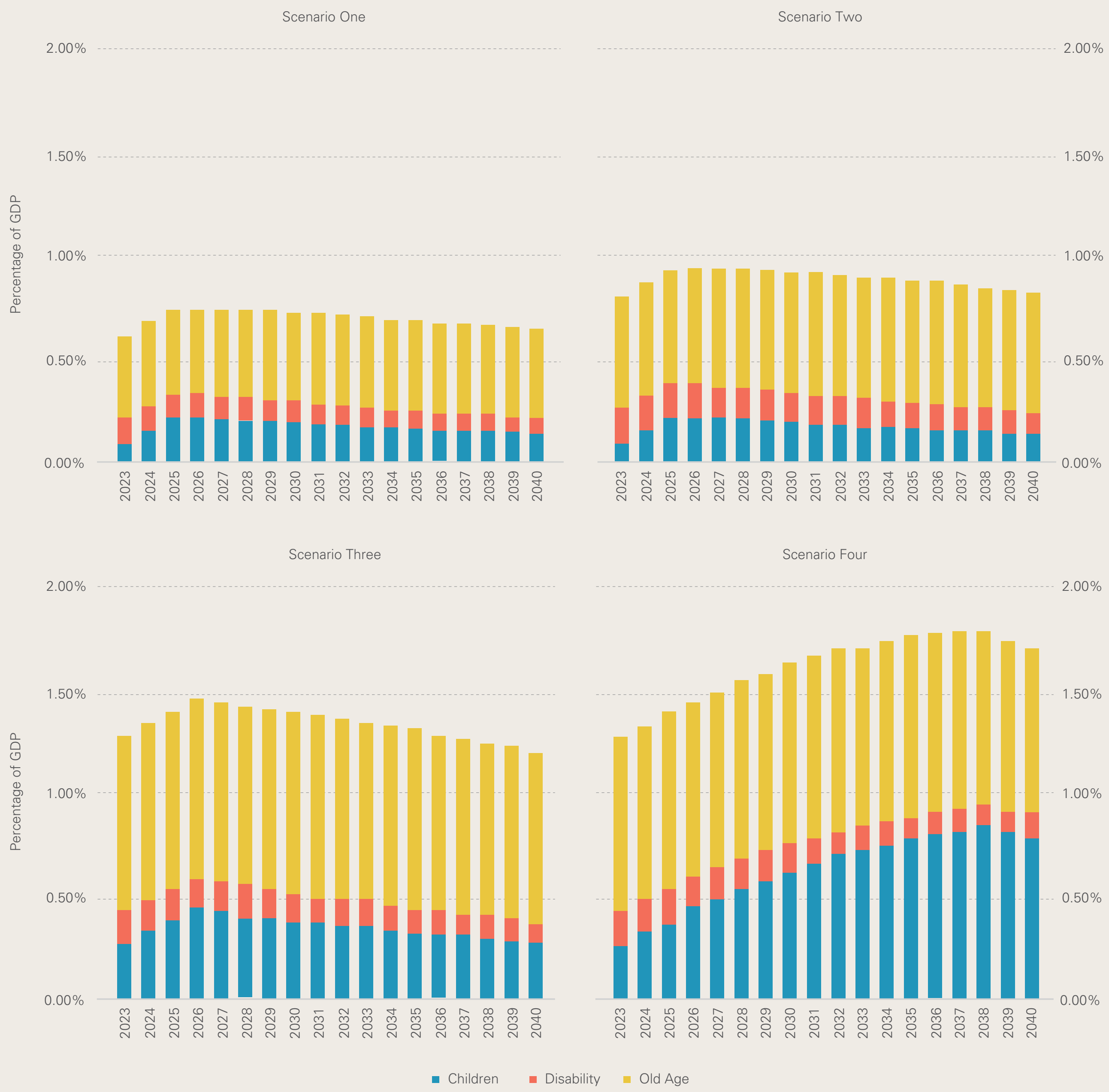
Scheme	Age of Eligibility	Monthly Transfer (LKR)	Monthly Transfer (USD)	Monthly Transfer (% GDP per Capita)	Level of Investment in Year 1 (LKR Billion)	Level of Investment in Year 1 (USD Million)	Level of Investment in Year 1 (% of 2023 GDP)
Option 2- MODEST							
Child Benefit	6 months before birth to 4 months, gradually extended to up to 2 years	5,000	13.9	6.55	26	71	0.1
Disability Benefit	0 - 69	10,000 (7,500 for those with moderate disabilities)	27.8 (20.83 for those with moderate disabilities)	13.09	44	123	0.2
Old Age Pension	70+ (pension-tested)	10,000	27.78	13.09	135	374	0.5
Total					**204**	**568**	**0.8**
Option 3- GENEROUS							
Child Benefit	6 months before birth to 2 years, gradually extended to up to 5 years	5,000	13.9	6.55	66	183	0.3
Disability Benefit	0 - 64	10,000 (7,500 for those with moderate disabilities)	27.8 (20.83 for those with moderate disabilities)	13.09	42	115	0.2
Old Age Pension	65+ (pension-tested)	10,000	27.8	13.09	211	586	0.8
Total					**309**	**884**	**1.3**

Scheme	Age of Eligibility	Monthly Transfer (LKR)	Monthly Transfer (USD)	Monthly Transfer (% GDP per Capita)	Level of Investment in Year 1 (LKR Billion)	Level of Investment in Year 1 (USD Million)	Level of Investment in Year 1 (% of 2023 GDP)
Option 4- VISION							
Child Benefit	6 months before birth to 2 years, gradually ex-tended to up to 17 years	5,000	13.9	6.55	66	183	0.3
Disability Benefit	0 - 64	10,000 (7,500 for those with moderate disabilities)	27.8 (20.83 for those with moderate disabilities)	13.09	42	115	0.2
Old Age Pension	65+ (pension-tested)	10,000	27.8	13.09	211	586	0.8
Total					**309**	**884**	**1.3**

Source: Sibun et al. 2023.

Implementing the first year of a lifecycle social protection system will cost, based on these four options, at minimum 0.6 per cent of GDP and at most 1.3 per cent of GDP. Upon complete roll out, by 2040, the level of investments would range between 0.7 and 1.8 per cent of GDP depending on the scenario (see Figure 4).

Figure 4: Level of Investment as a Percentage of GDP under Different Scenarios, by Scheme



Source: Sibun et al. 2023

Sri Lanka has committed to increase social protection expenditure to a minimum 0.6 per cent of GDP within its current IMF programme,[14] At present, the vast majority of the country's social protection programming is funded by multilateral organizations. Therefore, the question arises, how such programming can be sustained once these funding avenues are no longer available.

Therefore, Sri Lanka has an urgent need to explore alternative financing sources and develop strategies to improve its domestic resource mobilization efforts to achieve universal social protection.

14 IMF, Sri Lanka: Request for an Extended Arrangement under the Extended Fund Facility—Press Release; Staff Report; and Statement by the Executive Director for Sri Lanka, March 2023.

CHAPTER 3:
ASSESSMENT OF RELEVANCE AND FEASIBILITY OF DIFFERENT FINANCING OPTIONS

This chapter provides a detailed analysis of the fiscal space that could be created through selected financing options listed in Chapter 1 through various strategies. Particularly, this chapter prioritizes assessing the relevance of each option in the context of Sri Lanka and the implications in terms of equity, and feasibility for implementation.

3.1. Increasing Tax Revenue

Tax revenue is the main source of government financing for budgeted expenditure, including social protection. The strategy of increasing tax revenue is particularly significant in the context of Sri Lanka because it is persistently amongst the bottom 20 per cent of countries in the world with the lowest level of tax revenue to GDP.[15] Consequently, increasing tax revenue is also one of the main commitments within the IMF programme, which the country formally entered into in March 2023.[16] According to the 2023 budget, the government expects to collect a total of LKR 3,130 billion in tax revenue.

This section discusses opportunities to generate fiscal space through six important sources of tax revenue in Sri Lanka: (i) Value Added Tax (VAT), (ii) Withholding Tax (WHT), (iii) Personal Income Tax (PIT) and Corporate Income Tax (CIT), (iv) the Special Commodity Levy (SCL), (v) the Betting and Gaming Levy (BGL) and (vi) Excise (Special Provisions) Duty on Cigarettes.

Annex 2, Table 12 details Sri Lanka's main tax related sources of income. The top 3 revenue generators are income taxes, VAT and excise taxes, which collectively contributed to 79.1 per cent of total tax revenue in 2022.[17]

Taxes discussed within this section have been selected either for their potential to increase revenue collection or for their potential to improve the equity through changing the incidence of taxation. This will be discussed in detail below.

In preparation for the IMF programme, Sri Lanka has already made significant changes in 2022 and 2023 to some of the above taxes (see Annex 2, Table 12). This section will look the adequacy of some of these changes, and where possible suggest additional changes that could result in the expansion of fiscal space.

15 Publicfinance.lk, Sri Lanka's Already Lagging Tax to GDP Ratio Likely to Decline in 2020, July 2020.

16 IMF, Sri Lanka: Request for an Extended Arrangement under the Extended Fund Facility—Press Release; Staff Report; and Statement by the Executive Director for Sri Lanka, March 2023.

17 Central Bank Annual Report 2022.

(1) Value Added Tax (VAT)

VAT is a tax on the domestic consumption of goods and services. Sri Lanka is significantly reliant on VAT for its tax revenue. In 2022, VAT contributed to 26 per cent of Sri Lanka's total tax revenue and was equivalent to 1.9 per cent of GDP. On average, over the past 7 years (2015-2021), the contribution has hovered close to 23 per cent.

A policy revision which came into effect in December 2019 reduced the country's VAT rate from 15 per cent to 8 per cent. This resulted in the country's VAT revenue declining by 47 per cent, in the course of one year. Economists often point to the package of tax cuts, of which the reduction in VAT was a significant part of, as a critical policy failure that led to the country's economic crisis.

In 2022, in a bid to improve tax revenue, the Sri Lankan government implemented two successive revisions to the VAT rate. In June 2022, the VAT rate was increased from 8 per cent to 12 per cent. Shortly after, in September 2022, the VAT rate was further increased to 15 per cent – a return to the 2019 rate.

Based on government projections, in 2023, Sri Lanka's VAT revenue is estimated to increase by almost 100 per cent from 2022, to LKR 908 billion.[18] It is expected to account for 29 per cent of Sri Lanka's total tax revenue in 2023.

Sri Lanka's VAT rate is relatively high compared to regional peers (see Annex 2, Table 13). For example, compared to Sri Lanka's 15 per cent rate, the VAT rate is just 7 per cent in Thailand, 8 per cent in Singapore and 11 per cent in Indonesia. In some countries, such as India, the VAT rate varies depending on the good or service.

Several equity concerns also exist in relation to VAT. One argument is that VAT is a regressive tax, disproportionately affecting low-income households, who spend a larger proportion of their income on goods and services subject to VAT. This claim, supported by studies from Leahy et al. (2011), Ruiz & Trannoy (2008), and Hossain (1995), which suggest that VAT may contribute to widening income inequality within countries. Nonetheless, these findings are also contested in other studies such as Thomas (2020) and Bird & Smart (2016). For example, a study assessing the VAT burden relative to household expenditure across 27 OECD countries found that the VAT was, in most instances, roughly proportional or even slightly progressive, especially in countries with reduced VAT rates and exemptions (Thomas 2020). However, the same study found a minor degree of regressivity in the results for Chile, Hungary, Latvia, and New Zealand.

Given the recent increase in VAT to a relatively high level of 15 per cent in Sri Lanka, and the potential for VAT to be regressive at higher levels, the present analysis does not recommend a further increase to VAT.

(2) Withholding Tax (WHT)

WHT is a method of collecting taxes at source, from interest earned on deposits, earnings from fees, rents and other forms of non-employment income. During Sri Lanka's package of tax cuts, in 2019, WHT was abolished. Prior to the policy change, banks, financial institutions and those making the payments were mandated to play the role of tax collector and automatically withhold income tax at 5 per cent on the payment. This did not change the tax liability for most categories, but was recorded as pre-payment when filing taxes.[19] It ensured that those evading formal income tax and underreporting were still effectively taxed on these forms of income, at least at a minimal level. Thus, WHT supported better tax collection.

As of 1st January 2023, the Sri Lankan government re-introduced the WHT at a rate of 5 per cent of income from interest income and other non-employment sources.[20] The government expects to raise LKR 90 billion in tax revenue in 2023 through this tax collection method.[21]

18 Ministry of Finance, Approved Budget Estimates 2023.

19 Excluded some categories such as personal interest income, where the 5 per cent was also collected as a final tax.

20 Post-reintroduction no categories were applicable as a final tax for WHT. The final taxable rate was the respective income tax slab.

21 Ministry of Finance, Approved Budget Estimates 2023.

Global data shows that WHT rates tend to vary rather a lot, mostly between 10 per cent and 30 per cent.[22] The WHT rate in Sri Lanka, at 5 per cent, is relatively low. If Sri Lanka were to increase WHT to 10 per cent or 15 per cent, the country could increase revenue by close to two or three-fold, which would be a large expansion in fiscal space (Verité Research 2022).

In terms of feasibility this revision only requires a simple amendment to the Inland Revenue Act, No. 24 of 2017 and can be implemented within a short time frame. Such a revision would not be unusual, as the Act has been amended several times since its introduction. Moreover, an increase in WHT rates is unlikely to face social resistance because (i) it primarily applies to high-income individuals – with large portion of payments subject to WHT being on interest income, rents, winnings from betting/gambling, gems sold at an auction, etc., and (ii) is only a pre-collection, and not a new tax. It is also likely to be popular because (i) there is significant social concern about the failure to expand the tax net, and (ii) a sense of injustice among the middle class that they are taxed more heavily, while higher income individuals escape the tax net.

However, a WHT rate of 15 per cent, or even 10 per cent, could potentially be resisted by a small section of the middle-class, especially retired senior citizens, that live on interest income from relatively small levels of savings. This concern can be managed in two ways. First, by allowing those who would face a lower income tax rate, based on total, to get a tax direction from the Inland Revenue Department (IRD). This would mean the IRD gives prior approval for WHT to not be deducted on a payment made to an individual. The tax direction could then be provided to the respective bank by the individual, such that WHT is not deducted, or deducted at a lower rate. Incidentally, this system of providing tax exemptions is already present and operational within the Sri Lankan tax structure. Second, by improving the administration related to tax refunds. Since the WHT is only a withholding tax, those who are over-taxed can recover it through a refund when taxes are filed. These two measures can address the concerns about retirees living on interest income, without sacrificing the opportunity to expand the tax net and tax collection from a large proportion of non-tax filers with large savings and incomes, that might be evading tax payments.

Overall, the analysis proposes an upward revision to the WHT rate from the present 5 per cent, to either 10 per cent or 15 per cent. The former, would expand fiscal by close to LKR 90 billion per year (low estimate), and the latter, by close to LKR 180 billion per year (high estimate), based on the budget estimates for 2023.[23]

(3) Personal Income Tax (PIT) and Corporate Income Tax (CIT)

Alongside several other major tax revisions in December 2019 (discussed above), the Sri Lankan government also concurrently drastically reduced income taxes (see Table 3). The tax-free annual income threshold for PIT was increased from LKR 1.2 million to LKR 3 million. For incomes above this threshold, increasing marginal tax rates in increments of 4 per cent (up to 24 per cent) for each additional LKR 600,000 earned, was revised down to increasing marginal tax rates in increments of 6 per cent (up to just 18 per cent) for each additional LKR 3 million earned. The standard CIT rate was reduced from 28 per cent to 24 per cent.

These policy changes reduced income tax revenue by approximately 40 per cent in the course of one year. This was consequential, because income taxes are important contributors to Sri Lanka's tax revenue. In 2022, they were the single greatest source of tax revenue, making up 30.5 per cent of the total.

In anticipation of entering into an IMF programme through the EFF and pursuing fiscal consolidation, the Sri Lankan government made substantial revisions to its income tax policy with effect from January 2023 (see Table 3). The tax-free income-threshold was revised

22 OECD Statistics Database, Standard Withholding Tax Rates. Last accessed on June 25, 2023.

23 This analysis notes the possibility that these estimated figures may be slightly lower once the strategies to manage concerns of the middle-class and senior citizens are implemented. But, in effect, targeting would be improved.

down again from an annual income of LKR 3 million to LKR 1.2 million. The size of each tax bracket was reduced from LKR 3 million to 500,000. Three new tax brackets were added, with marginal tax rates of 24 per cent, 30 per cent and 36 per cent. The standard CIT rate was revised up from 24 per cent to 30 per cent. As a result of these policy changes, the government expects income tax revenue to increase by almost 55 per cent in 2023, to LKR 818 billion.[24]

Table 3: Revisions to Sri Lanka's Income Tax Policy

Tax Source	Tax Structure prior to December 2019		Tax Structure post December 2019		Tax Structure with effect from January 2023	
	Income Bracket (LKR per annum)	Tax Rate (%)	Income Bracket (LKR per annum)	Tax Rate (%)	Income Bracket (LKR per annum)	Tax Rate (%)
PIT - Personal Income Tax (a)	0 – 1,200,000	0	0 – 3,000,000	0	0 – 1,200,000	0
	1,200,000 – 1,800,000	4	3,000,000 – 6,000,000	6	1,200,000 – 1,700,000	6
	1,800,000 – 2,400,000	8	6,000,000 – 9,000,000	12	1,700,000 – 2,200,000	12
	2,400,000 – 3,000,000	12	> 9,000,000	18	2,200,000 – 2,700,000	18
	3,000,000 – 3,600,000	16			2,700,000 – 3,200,000	24
	3,600,000 – 4,200,000	20			3,200,000 – 3,700,000	30
	> 4,200,000	24			> 3,700,000	36
CIT Corporate Income Tax (b)	28%		24% (c)		30%	

Note: (a) The figures and rates are applicable for only employment income, (b) This is the standard CIT rate, (c) A concessionary rate of 14% was applicable to many industries.

These most recent revisions to income tax, particularly PIT, have been met with widespread frustration and resistance by Sri Lankan citizens. Since January, many public and private sector workers, including trade unions, bank employees, university lecturers, and employees of the Port Authority, Ceylon Electricity Board (CEB) and Government Medical Officers of Health stepped out in protest. The fundamental complaint, of these largely middle-class income earners, was that the tax hike was "unfair". Many argue that the new tax policy is repressive given the high cost of living (inflation reached a record high of 73.7 per cent in 2022), and that they are not opposing tax increases that would be "fair".

Indeed, this policy sets up a regressive tax outcome on the middle-class, given how quickly the marginal tax rises, with small increases in income.[25] In this context, a more progressive taxation structure for personal income, that also does not compromise the potential for government tax revenue, is desirable. This analysis proposes to revert to, and further expand, the tax structure that existed prior to December 2019 (see Table 4). This would mean that the tax-free annual income threshold of LKR

24 Ministry of Finance, Approved Budget Estimates 2023.

25 "2022 (De Mel 2022): A signal why suspending democracy will not save the economy", October 2022, The Morning. Last accessed via https://www.themorning.lk/articles/224340 on 20.06.2023.

1.2 million remains unchanged. The marginal tax rate increases in increments of 4 per cent for each additional LKR 600,000 in annual income. Whereas previously, the highest marginal tax rate was 24 per cent, it is proposed to maintain it at the current highest marginal tax rate of 36 per cent, but in this more progressive structure of increments, that does not concentrate the increases within a narrow band of middle-class income.

Table 4: Proposed Revisions to Sri Lanka's Personal Income Tax Policy

Income Bracket (LKR per annum)	Tax Rate (%)
0 – 1,200,000	0
1,200,000 – 1,800,000	4
1,800,000 – 2,400,000	8
2,400,000 – 3,000,000	12
3,000,000 – 3,600,000	16
3,600,000 – 4,200,000	20
4,200,000 – 4,800,000	24
4,800,000 – 5,400,000	28
5,400,000 – 6,000,000	28
>6,000,000	36

Implementation-wise, this proposal would only require a simple amendment to the Inland Revenue Act, No. 24 of 2017 (similar to WHT). It is also likely to be socially popular given that it reduces taxes across the board and addresses middle-class grievances of being regressive in relation to the very high-income earners. In turn, it has the potential to increase tax compliance: relatively small tax rate cuts have been shown, in some cases, to decrease incentives to evade taxes and thereby increase revenues. This is known as the Laffer effect.[26] Most importantly, this proposal reduces the tax burden on lower and middle-income earners, but improves progressivity by keeping the highest marginal rate for the higher income earners. For example, under the current income tax structure, an individual with an annual income of LKR 1,800,00 is taxed at a marginal rate of 12 per cent, and an individual with an annual income of LKR 7,000,000 is taxed at a marginal rate of 36 per cent. Under the proposed structure, the first individual is taxed at a marginal rate of just 4 per cent, whereas the second is still taxed at a marginal rate of 36 per cent.

Through the current PIT structure, the government projects a collection of LKR 100 billion in 2023. This analysis is unable to provide a concrete estimate of the impact of this proposed tax structure revision on fiscal space. It is limited by the lack of reliable disaggregated income data of the population, and contradictory figures provided by multiple sources on the number of citizens PIT is applicable to.

(4) Special Commodity Levy (SCL) on Imported Sugar

SCL is a tax imposed on specific imported goods, with the aim of protecting domestic producers from price competition from imports.

In October 2020, the Sri Lankan government lowered the SCL on imported sugar from LKR 50/kg to LKR 0.25/kg.[27] This reduction has been widely discussed as a tax reduction that allowed vested interests to expand monopoly profits at the expense of government tax revenue. At the time, the government justified the reduction of SCL on imported sugar as a precautionary measure to curb a potential surge in domestic prices with potential increase in global prices. Nevertheless, domestic sugar prices rose, given that they are primarily influenced by the cost of local production. As a result, instead of reducing price to consumers, most of the tax reduction ended up accruing as surplus to importers.

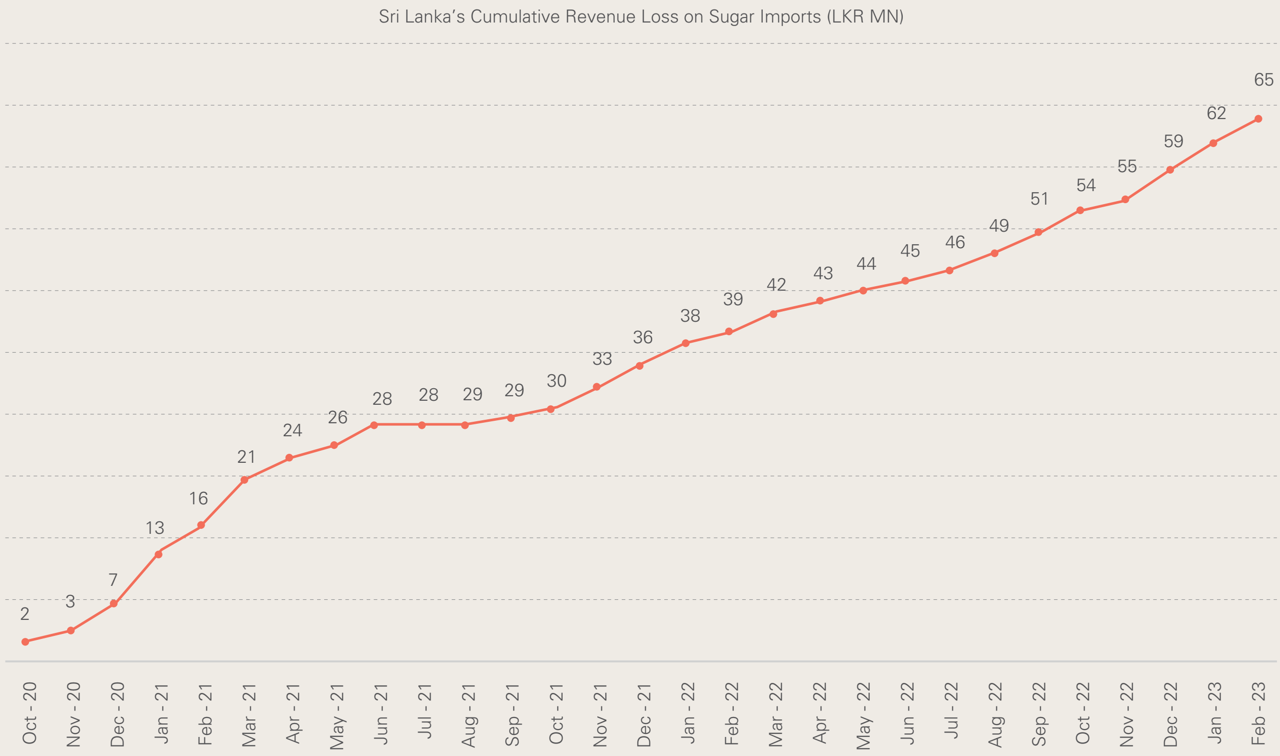
Based on the Auditor General's report's particular calculation methods and extension of the calculation to February 2023, it is determined that the policy revision resulted in an estimated cumulative loss of tax revenue

26 Takáts, Előd, and Tamás K. (Tamás K. Papp 2008) (Matthew Browne 2018). "Tax rate cuts and tax compliance-the Laffer curve revisited." (2008).

27 As of Section 5(1) of Special Commodity Levy Act, No. 48 of 2007, Minister has the power to waive the SCL on certain commodities.

exceeding LKR 65 billion over the 29 months since the policy was introduced (see Figure 5). That is an average loss of LKR 30 billion per year.

Figure 5: Cumulative Revenue Loss due to Reduction in SCL on Sugar Imports



Source: CBSL Monthly Economic Indicators and author's calculations.

Revising the SCL on sugar to LKR 50/kg only requires a gazette notice issued by the Minister, and therefore can be implemented with immediate effect. Based on the analysis, it is not expected that there will be a significant impact on sugar prices in the domestic market since local production will remain unaffected. Such a measure is also in line with popular nationalist sentiment towards import substitution measures that support the market opportunities for local producers.

Increasing the levy is also likely to have a redistributive function. This is because the excess producer surplus was accruing only to a very small number of importers that had gained monopoly like positions (exceeding 25 per cent market share) in the sugar market, and not resulting in a general social welfare gain.

However, consideration is given to the possibility that the increase could also result in a reduction of imports. When the levy was first reduced, in October 2020, 9 of the 10 major sugar importers increased their import quantities by less than 10 per cent, therefore the converse is also likely to occur.

Overall, this analysis proposes an upward revision to the SCL, back to LKR 50/kg. Based on the impact of the removal of the levy which increased imports by 10 per cent, this analysis assumes that the reinstatement of the levy could reduce import volumes by 5 per cent to 15 per cent. Accounting for this potential reduction in import volume, it is expected that the levy would expand fiscal revenues by between LKR 28.5 billion per year (high estimate) to LKR 25.5 billion (low estimate).

(5) Betting and Gaming Levy (BGL)

Sri Lanka's Betting and Gaming Levy (Amendment) Act, No.14 of 2015 imposes taxes on specific forms of gambling and betting, including casinos, horse racing, lotteries, and sports betting. This analysis is focused on three taxes included in the BGL. They are (i) the Annual Levy for Gaming, (ii) the Casino Entrance Levy, and (iii) the Levy on Gross Collection. Table 5 presents the current rates at which they are charged since 2015, as well as different revisions that have been proposed since then, at various times, without being implemented.

Table 5: BGL related Fees/Charges and Revisions Between 2015-2023

Programme	2015 Status quo rate (IRD)	2019 Proposed	2022 Proposed (30 /05/2022)	2022 Proposed (24/10/2022)	2023 Proposed (24/03/2023)
Annual Levy for Gaming	LKR 200 million	LKR 400 million	LKR 500 million	LKR 500 million	LKR 500 million
Casino Entrance Levy	100 USD per person	50 USD per person		200 USD per person	50 USD per person
Levy on Gross Collection	10%	15%	15%	15%	15%

Source: Budget Speech 2019, IRD Website, MOF Press Release 24.10.2022, Parliamentary Bill No. 171 24.03.2023

On paper, BGL related taxes are an important source of tax revenue for the country. The betting, gaming and casino industry primarily serves consumers with higher disposable incomes and lower transparency of profits. The levies therefore compensate for potential under-reporting of incomes. The industry is also regarded as promoting problematic social outcomes with negative externalities in terms of social welfare, with international evidence showing associations with harms to health (both mental and physical), higher alcohol and illicit drug use, and higher rates of unemployment and imprisonment.[28] Therefore, higher levies and taxation on BGL is expected to reduce negative externalities, while also supporting an expansion of fiscal space.

At present, there is double jeopardy with regard to BGL taxes and levies. That is, in addition to various attempts to reduce rather than increase the taxes, there has also been a persistent issue of the applicable taxes and levies not being collected. This has been exposed on public finance reports, parliamentary committees and public discussions.[29] Most recently, at a meeting of the parliamentary Committee on Public Finance (CoPF) held on June 07, 2023, MoF authorities verbally admitted that the Casino Entrance Levy had not been collected for at least 10 years, and collection has restarted only in February 2023. This admission is supported by information that Verité Research received from the IRD in response to a Right To Information (RTI) request that was independently filed with the authority (see Table 6).

28 Browne, Matthew, Nancy Greer, Tess Armstrong, Christopher Doran, Irina Kinchin, Erika Langham, and Matthew Rockloff. "The social cost of gambling to Victoria." (2018).

29 Committee on Public Finance Report on the Budget 2019.

Table 6: Betting and Gaming Tax Revenue from 2013 - February 28th, 2023 (as per Data Provided by the IRD)

Year	Annual Levy (LKR)	Casino Entrance Levy (LKR)	Gross Collection Levy (LKR)	Total Annual Levy (LKR)
2013	441,334,717	-	99,146,072	540,480,789
2014	490,592,395	-	140,042,944	630,635,339
2015	753,950,085	-	219,440,130	973,390,215
2016	796,385,096	-	630,924,858	1,427,309,954
2017	809,438,400	-	1,114,068,742	1,923,507,142
2018	833,411,550	-	1,494,434,549	2,327,846,099
2019	846,700,400	-	1,117,636,484	1,964,336,884
2020	763,850,000	-	798,604,692	1,562,454,692
2021	798,287,500	-	675,395,534	1,473,683,034
2022	1,054,081,876	-	2,621,663,853	3,675,745,728
2023	290,915,000	28,574,346	510,624,599	830,113,945

Sources: RTI response from the IRD, dated 28.03.2023

The Sri Lankan government now expects to collect LKR 10 billion through these tax sources in 2023.[30] If collected, this would be a 400 per cent increase from the estimated revenue collection in 2022. It also represents the benchmark for the potential revenue that could be collected if compliance is prioritized. However, as of yet, the Sri Lankan government has failed to meet its commitment on the IMF programme to increase BGL rates by April 30th 2023.[31]

However, it is noteworthy that the commitment made on the IMF programme does not include revisions pertaining to the Casino Entrance Levy. The most recent proposed revisions to the BGL (see Table 5), if implemented, seeks to reduce the Casino Entrance Levy, but increase both the Annual Levy and the Levy on Gross Collection.

The amendment proposes to reduce the Casino Entrance Levy to just USD 50 per person from the existing rate of USD 100 per person. A previous proposed amendment to the BGL, in October 2022, moved to increase the Casino Entrance Levy to USD 200 per person. Therefore, this analysis proposes that the Casino Entrance Levy be either kept at the current level or increased in line with the October 2022 proposal, alongside the other increases proposed in the same amendment.

This is estimated to result in a total annual revenue of LKR 9.8 billion or LKR 13.3 billion respectively.[32] Given that the highest ever recorded collection from these levies was LKR 3.6 billion, these revisions have the potential to expand fiscal space by between LKR 6.2 billion (low estimate) to LKR 9.7 billion (high estimate) per annum.

Given the demonstrated influence of the BGL industry over the bureaucracy and political establishment in holding off the collection of the casino entrance levy for over 10 years, until it recently became a focal point within the IMF program, the feasibility of keeping the casino entrance levy at the current rates or increasing

30 Ministry of Finance, Approved Budget Estimates 2023.

31 Details can be found at https://manthri.lk/en/imf_tracker, which is an online tool that tracks the progress on government commitments in Sri Lanka's 2023 IMF Programme.

32 Calculations are based on the assumptions that (i) the number of casino entrants per annum remains unchanged from 2019, (ii) the USD value of each relevant business is unchanged from 2019.

it to the proposed rate of USD 200, could depend on the IMF clarifying the expected rates for compliance on the programme.

(6) Excise (Special Provisions) Duty on Cigarettes

Excise duty is a tax charged on the sale of specific goods or services, often imposed at the point of manufacture or distribution rather than at the point of sale.

Excise duty on cigarettes have been a large part of Sri Lanka's Excise (Special Provisions) Duty collection since 2015, with an expected collection of LKR 137 billion in 2023. However, current increases in taxation are likely to achieve less than LKR 100 billion in revenue.

The government sets the absolute rupee value of the excise tax on cigarettes, and the Ceylon Tobacco Company (CTC) – which has a monopoly on the production and sale of cigarettes - passes the tax on to the consumer. The World Health Organization (WHO) recommends raising cigarette taxes to achieve a price increase that exceeds inflation, as well as a total tax incidence on each cigarette at 75 per cent of the retail price (WHO, 2014). Currently, Sri Lanka is failing on both counts. Research shows that price increases have fallen hugely short of the expected increases and that that additionally cigarette sticks are also taxed at only a total of 69 per cent of even this low retail price.

A solution to this enduring problem would be to implement an indexation formula for cigarette taxation. This has been repeatedly championed by several institutions and think tanks as well as the National Authority on Tobacco and Alcohol Taxation (NATA). In 2014, a rational method to set the price/tax formula was devised in a working paper titled "A Technical Case for Affordability Based Pricing of Cigarettes" (Verité Research 2014). This working paper resolves three critical analytical issues: (i) finding the benchmark price for the most consumed type of cigarette; (ii) specifying the criteria on which the benchmark price of cigarettes should be updated; and (iii) applying a coherent method for price differentials between different types of cigarettes.

In the 2019 budget, the Sri Lankan government did announce its intention to implement a formula based on systematic indexation of cigarette prices in line with nominal GDP growth. However, this was not implemented. A commitment on the present IMF programme is that the country will introduce automatic indexation of excise taxes to inflation.[33] This falls short of the WHO guidelines and the indexation formula referred to above. It would yet be an improvement in the current practice of failing to increase prices even in line with inflation. This revision would only require an amendment to the Excise (Special Provisions) Act, No. 13 of 1989 and can be implemented within a three-month period (short term).

Therefore, this analysis proposes the pricing/taxing of cigarettes based on an indexation formula. A publication in 2022 estimated that if cigarette taxes were not increased the government would collect LKR 45 billion less in 2023, than if it was increased in line with the formula.[34] The increase implemented in January 2023 is expected to yield about 10 billion in extra revenue, and therefore, implementing the indexation formula still stands to increase tax collection by about 35 billion more.[35]

33 Details can be found at https://manthri.lk/en/imf_tracker, which is an online tool that tracks the progress on government commitments in Sri Lanka's 2023 IMF Programme.

34 Verité Research, Cigarette Taxation Formula — The Cost of Forgetting, June 2022.

35 Calculations made in line with methodology laid out in "A Technical Case for Affordability Based Pricing of Cigarettes" (De Mel and Fernando 2014). The base year used for calculations is 1981.

3.2. Eliminating Illicit Financial Flows

Illicit financial flows (IFFs), by definition, are "generated by methods, practices and crimes aiming to transfer financial capital out of a country in contravention of national or international laws" (Ortiz et al. 2019). It includes financial crimes, bribery, tax evasion and money laundering. This analysis will expand the established standard definition of IFFs to also consider intra-border IFFs. The main consequence of IFFs, with regard to fiscal space, is the reduction in tax revenue that would have been collected if these finances flowed through legal methods.

This section discusses opportunities to expand fiscal space through two significant sources of IFFs for Sri Lanka, while also considering their feasibility and implications in terms of achieving equity. The sources are: (i) property taxation, and (ii) Illicit trade flows.

(1) Property Taxation

Property taxes serve multiple purposes. One key function is to regulate the accumulation of illicit wealth by discouraging property owners from amassing excessive amounts of property that can be exploited for money laundering or other illicit activities. In addition, they also serve a redistributive function since property ownership is often an indicator of a certain level of wealth. Therefore, revenue from property taxes can be channeled towards social protection. The effectiveness of property taxes, however, depends on a number of factors. This includes the design of the tax system, and the level of enforcement and compliance.

At present, evidence suggests that Sri Lanka's current taxation system for property is ineffective. In 2021, municipal and urban councils collected LKR 8.4 billion in total rates (property tax), representing 0.05 per cent of national GDP (when disaggregated by province, revenue collection varied between 0.01 per cent to 0.08 per cent of GDP). In many countries around the world, property tax revenues generally tend to represent between 0.5 per cent to 1 per cent of GDP (McCluskey and Plimmer 2010).

Under-taxation is a critical concern in this regard, and likely stems from the under-valuation of rental and property values. Given that the present scale of under-taxation is in the magnitude of upwards of 10 times, a complete readjustment in the short term is not feasible. Therefore, this analysis proposes an adjustment to provincial property tax collection methodology such that annual revenue can be increased by between 50 per cent (low estimate) to 100 per cent (high estimate). This would result in an increased annual revenue collection of between LKR 12.6 billion to LKR 16.8 billion. Thus, the potential fiscal space created would be between LKR 4.2 billion to LKR 8.4 billion.

Table 7: Potential Revenue through Property Taxes – 2021, figures in LKR billion

	Provincial GDP	Actual Rates Collection	Actual Revenue as a Share of provincial GDP	Potential Rates Collection (Low)	Potential Revenue (Low) as a Share of GDP	Potential Rates Collection (High)	Potential Revenue (High) as a Share of GDP
Western	7,541	6.3	0.08%	9.45	0.13%	12.6	0.17%
Northwestern	1,956	0.4	0.02%	0.6	0.03%	0.8	0.04%
Central	1,787	1.1	0.06%	1.65	0.09%	2.2	0.12%
South	1,604	0.2	0.01%	0.3	0.02%	0.4	0.02%
Sabaragamuwa	1,287	0.1	0.01%	0.15	0.01%	0.2	0.02%
Eastern	975	0.1	0.01%	0.15	0.02%	0.2	0.02%

	Provincial GDP	Actual Rates Collection	Actual Revenue as a Share of provincial GDP	Potential Rates Collection (Low)	Potential Revenue (Low) as a Share of GDP	Potential Rates Collection (High)	Potential Revenue (High) as a Share of GDP
Uva	922	0.0	0.00%	0	0	0	0
North Central	875	0.1	0.01%	0.15	0.02%	0.2	0.02%
Northern	740	0.1	0.01%	0.15	0.02%	0.2	0.03%
National GDP	17,687	8.4	0.05%	12.6	0.07%	16.8	0.09%

Source: Author's calculations using data received from the Department of Census and Statistics (DCS) upon request, and CBSL.

(2) Illicit Trade Flows

There are two sources of trade-related IFFs particularly significant in the context of Sri Lanka: (i) Import under-invoicing, and (ii) Export under-invoicing. Import under-invoicing is when the value of imports is intentionally underreported. Importers under-invoice in order to avoid paying VAT and customs duties, and bypass non-tariff measures (e.g., quotas) or other regulatory requirements applicable to imports exceeding a certain value. Export under-invoicing is when the value of exports is intentionally underreported, thereby reporting lower profits. Exporters under-invoice in order to avoid or pay lower corporate income taxes. Both practices provide unfair benefits to traders and allow high-income individuals to evade the tax net, adversely impacting government revenue.

The magnitude of trade mis-invoicing occurring in Sri Lanka can be estimated to some extent using figures from the Global Financial Integrity (GFI). The GFI analyses discrepancies in international trade data reported between a set of two countries to identify value gaps or mismatches. The primary limitation of the GFI is that it only covers trade with advanced economies and does not encompass trade with developing countries. This is a significant constraint in the context of Sri Lanka because 57 per cent of Sri Lanka's imports in 2015 originated from emerging and developing countries. Additionally, the GFI does not consider mis-invoicing with regards to trade in services because of the absence of bilateral data on services. Despite this, the GFI provides the best available and most widely used indicator to assess trade related IFFs.

Import Under-invoicing

According to the 2015 GFI report, the value of Sri Lanka's under-invoiced imports was equivalent to 12.4 per cent of the country's total trade with advanced economies (see Table 8).[36] Due to the lack of data regarding Sri Lanka's trade with all its trading partners, this value is applied to calculate the rupee value of Sri Lanka's total under-invoiced imports.

In 2015, the gross taxes imposed on imports amounted to 10.1 per cent of the total value of imported goods (see Table 8). This means, the value of potentially lost government tax revenue through under-invoiced imports was USD 356.2 million, or LKR 48 billion in 2015.

Export Under-invoicing

In the case of under-invoiced exports, the 2015 GFI report estimated that it was valued at 2.2 per cent of the country's total trade with advanced economies. Similar to above, due to the unavailability of data on Sri Lanka's trade with all its partners is unavailable, this figure is used to estimate the total rupee value of under-invoiced exports in Sri Lanka.

In 2015, export income was taxed at a rate of 12 per cent. Therefore, the potential loss of government tax revenue due to under-invoiced exports amounted to USD 74.9 million or LKR 10 billion.

36 This is the most recent available GFI data.

Table 8: Import Under-invoicing and Export Under-invoicing in Sri Lanka, 2015

	Import Under-invoicing		Export Under-invoicing	
Total Trade with the World	USD 28,366			
Under-invoicing	*As a Percentage of Total Trade*	*Value*	*As a Percentage of Total Trade*	*Value*
	12.4%	3,517.4	2.2%	624.1
Tax	*Gross Tax Revenue from Imports as a Percentage of Total Value of Imported Goods*	*Gross Tax Revenue from Imports*	*Tax Rate for Export Income*	*Gross Tax Revenue from Exports*
	10.1%	356.2	12%	74.9
Potential for Recovery				
Recovery Goal (Percentage of Illicit Trade Flows)	*Value of Recoverable Trade*	*Value of Potential Tax Revenue*	*Value of Recoverable Trade*	*Value of Potential Tax Revenue*
5% of Under-invoiced imports/exports	175.9	17.8	31.2	3.7
10% of Under-invoiced imports/exports	351.7	35.5	62.4	7.5
15% of Under-invoiced imports/exports	527.6	53.3	93.6	11.2

Note: All USD figures reported are in USD millions.

Assuming that mis-invoicing has persisted at a similar scale since 2015, recovery of lost tax revenue would represent a significant potential source of revenue for Sri Lanka. Recovering mis-invoiced trade is complicated and consists of many loopholes and unknowns. Therefore, this analysis proposes a conservative recovery goal of between 5 to 10 per cent of mis-invoiced trade. With respect to 2015 figures presented in Table 8, this would result in an additional annual tax revenue of between USD 20.5 million, which is now equivalent to LKR 6.6 billion (low estimate) and USD 41 million, which is now equivalent to LKR 13.2 billion (high estimate).

This analysis also proposes the adoption of a transparent National Single Window (NSW) electronic system, since improving the capacity of Sri Lanka Customs is an integral component of reducing trade mis-invoicing in the long term. As opposed to the existing manual system, the NSW aims to provide a single point of electronic entry to facilitate cross-border trade and transit-related regulatory requirements. The NSW will increase efficiency, improve accuracy, providing greater transparency and accountability in customs by allowing for easier tracking and monitoring of the process. This can help reduce the risk of fraud and corruption in cross-border trade by enabling customs officials to identify irregularities or suspicious activity more easily.

3.3. Reallocating or Reprioritizing Public Expenditure

The reallocation and reprioritization of public expenditures involves a reevaluation of the allocation of resources within existing budgets in specific sectors. This is achieved by replacing high-cost, low-impact investments and minimizing expenditure towards less socially desirable and less relevant activities.

This section focuses on five opportunities to secure more fiscal space for social protection in Sri Lanka through the re-allocation of expenditure: (i) the Defense budget, (ii) the cost of operations for a government ministry, (iii) the cost of Sri Lanka's national carrier Sri Lankan Airlines, and (iv) vehicle acquisition expenditure.

(1) The Defense Budget

Since the end of Sri Lanka's civil conflict 14 years ago, successive governments have promised to reduce the size of the country's military and the expenditure on defense. Despite this, a reduction of significance has not taken place.[37] In 2023, the government allocated 7 per cent of the central government budget to the Ministry of Defense; equivalent to 1.4 per cent of Sri Lanka's GDP (see Table 9).[38] In contrast, just 5.5 per cent and 4 per cent of the central government budget were allocated towards the health sector and education sector respectively (these figures exclude allocations from the provincial budget towards health and education).

In the context of the country's present socio-economic challenges, it is prudent to explore methods of rationalizing and optimizing this expenditure allocation.

Table 9: Sri Lanka's Defense Expenditure 2021 – 2023

	2021 Actual	2022 Revised	2023 Estimate
Ministry of Defense (LKR Bn)	326	376	410
As a share of the government budget (%)	9.2%	7.9%	7.0%
As a share of GDP (%)	1.8%	1.6%	1.4%

Source: Author's calculation using Approved Budget Estimates, 2023, World Economic Outlook Database (October 2022), GDP at Current Prices.

This analysis evaluated the defense budget at a granular level and discovered three line items within it that can be adjusted downwards: (i) the outlay for emoluments of tri-force personnel, (ii) the expenses related to the diets and uniforms of tri-force personnel, and (iii) capital expenditure.

63 per cent of Sri Lanka's annual defense budget is spent on tri-force emoluments (i.e., all compensation, including salaries and fees, of all personnel employed by the Sri Lanka Army, Navy and Air Force).[39] In 2023, the government expects to expend LKR226 billion on these emoluments.[40] As a share of Sri Lanka's GDP, expenditure on tri-force emoluments is greater than the country's expenditure on child protection, water, sanitation, and hygiene (WASH) and education (See Figure 6).

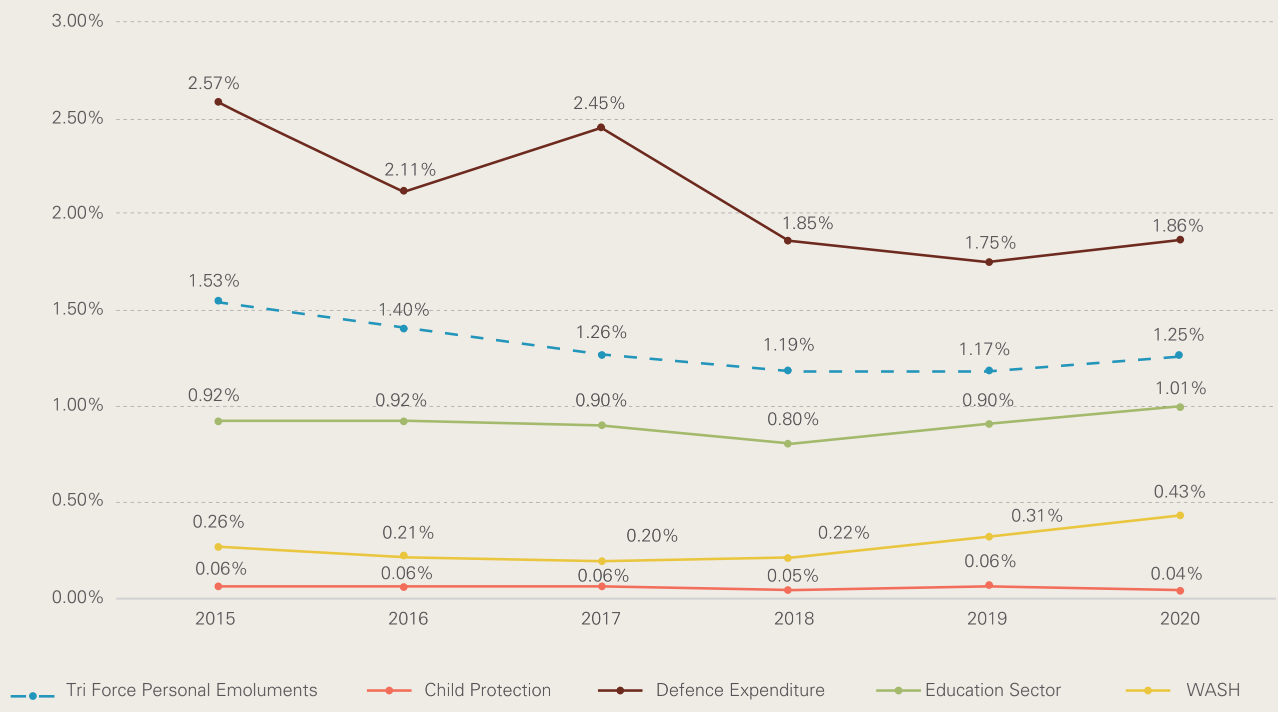
37 For the purpose of this analysis, "defense expenditure" is restricted to the Ministry of Defense and eight relevant departments – the Minister of Defense, Sri Lanka Army, Sri Lanka Navy, Sri Lanka Air Force, Department of Civil Security, Department of Sri Lanka Coast Guard, Department of Multipurpose Development Task Force and Department of Meteorology.

38 Ministry of Finance, Approved Budget Estimates 2023.

39 Ministry of Finance, Approved Budget Estimates 2023.

40 Ministry of Finance, Approved Budget Estimates 2023.

Figure 6: Actual Sectoral Expenditure as a Percentage of GDP, 2015-2020

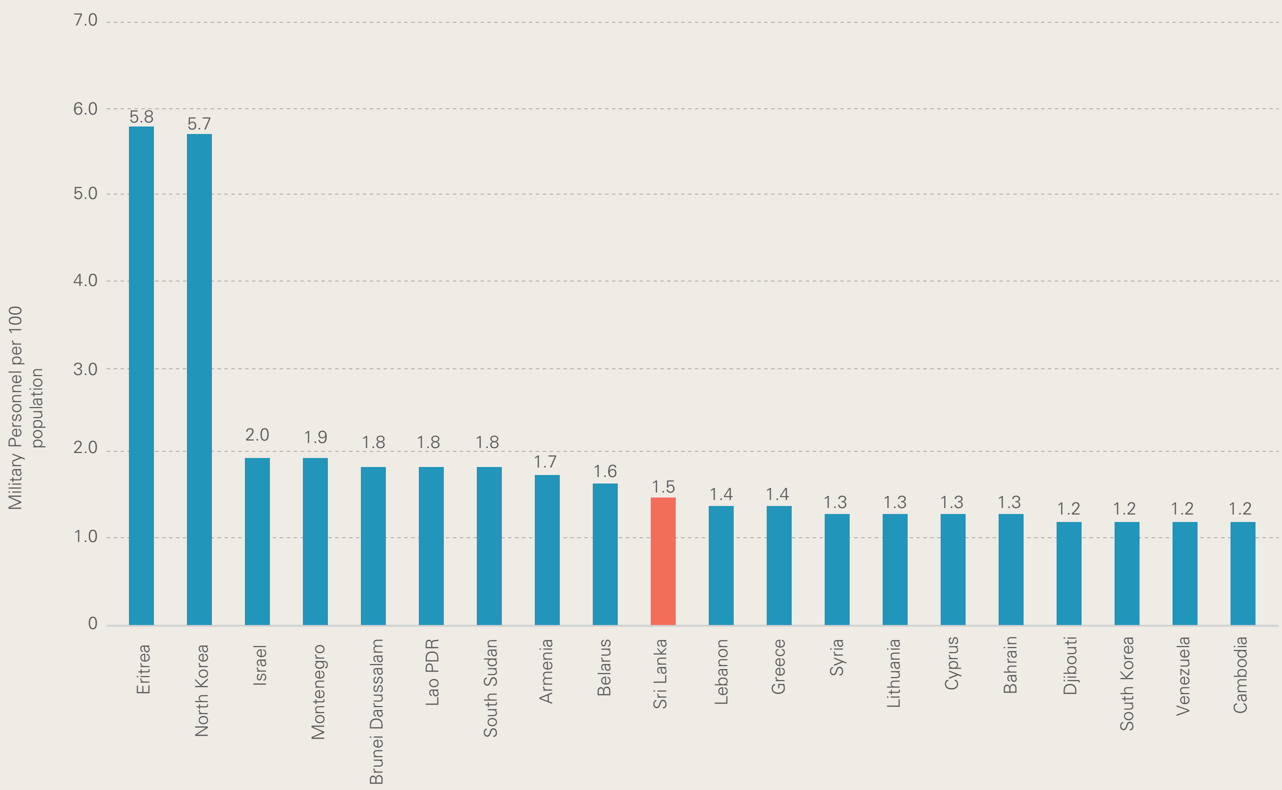


Source: Author's calculations using Budget Estimates 2015-2020, World Economic Outlook Database October 2022 – GDP at Current Prices.

The disproportionately larger share of expenditure on tri-force emoluments is because Sri Lanka maintains a disproportionately large armed force. Sri Lanka allocates 1.5 military personnel per 100 persons in the population. Sri Lanka ranks 10th globally among countries with the highest armed force personnel per 100 citizens (see Figure 7). This is a much higher proportion than countries with more serious security concerns; for example, South Korea allocates just 1.2 military personnel per 100 persons in the population. Sri Lanka ranks 90th globally on the Global Peace Index (GPI) in 2022.[41] Typically, countries within the 85th to 95th position allocate an average of 0.3 military personnel per 100 citizens. Based on this benchmark, Sri Lanka could potentially reduce the size of its military by up to 80 per cent. However, the reductions proposed will be based on the expectation that changes to the status quo will be small and gradual.

41 The GPI is a widely accepted measure of a nation's peacefulness. It utilizes 23 indicators from reputable sources to evaluate the level of peace across three domains: societal safety and security, ongoing conflicts, and militarization. This comprehensive assessment is recognized as an authoritative benchmark for evaluating a country's peacefulness.

Figure 7: Top 20 Countries with the Highest Armed Force Personnel per 100 Population

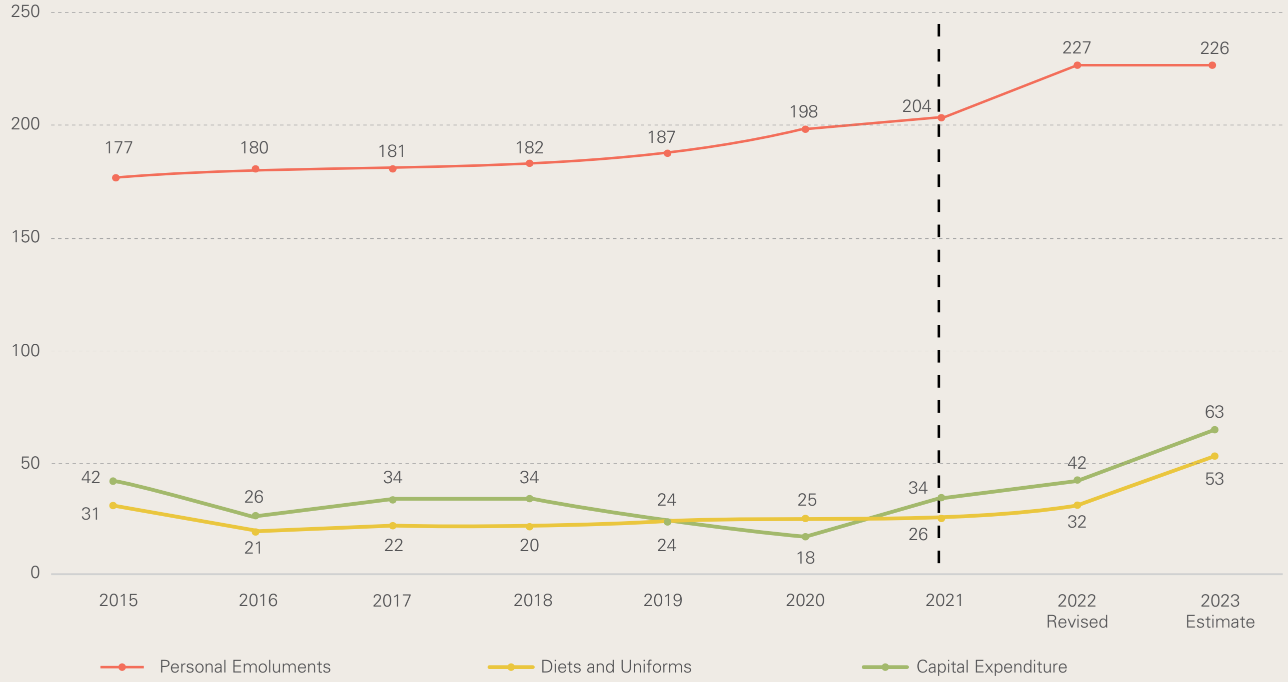


Source: Author's calculation using World Bank data 2019.

Expenditure on diets and uniforms is another major contributory component of Sri Lanka's large defense budget. According to the government's Approved Budget Estimates for 2023, a sharp increase in allocations is recorded since 2021, with projected growth rates of 23 per cent and 66 per cent respectively in 2022 and 2023. However, no justification has been provided for these substantial and disproportionate increases.

Expenditure on capital expenditure, on the other hand, is projected to grow by 50 per cent in 2023. On average, between 2015-2021, the government expended LKR 30 billion annually on defense capital expenditure. The 2023 estimate of LKR 63 billion, is a two-fold increase from that average.

Figure 8: Expenditure on Tri-force Personal Emoluments, Diets & Uniforms and Defense Capital Expenditure (Nominal) 2015-2023



Source: Budget Estimates 2015-2023

Figure 8 graphically represents the significant increases in expenditure towards all three areas since 2021. This analysis proposes a reduction in defense expenditure through reducing the expenditure on emoluments, diets and uniforms, and capital expenditure to 2021 levels.

The reduction in emoluments can be achieved through reducing the replacement rate of personnel retiring. At present, military recruitment might be functioning as a form of social security, particularly for rural youth. Currently, there is a complete revamping of the social welfare distribution system, and a tripling of the allocation for social welfare, which should then be able to encompass households that are in need of income support, without it being necessary to use military recruitment as an inefficient substitute. The proposed universal lifecycle options would even cover a far larger proportion of the population. Depending on the scenario, between 40-90 per cent of all households would receive at least one social protection benefit upon full roll-out.

Reducing defense expenditure as proposed would result in a combined total potential savings of LKR 78.5 billion per annum (high estimate), which would be a significant expansion in fiscal space. However, achieving this goal is likely to be difficult in the short term given that the reductions can only be achieved gradually with regards to expenditure on emoluments, diets and uniforms. Therefore, a more moderate, shorter term goal would be to decrease expenditure to a level where it would yield at least half of the potential savings that could be achieved by reducing expenditures down to 2021 levels. This would result in a fiscal space of LKR 39.2 billion per annum (low estimate).

(2) The Cost of Operations for a Government Ministry

Large cabinets of ministers and corresponding ministries have been a consistent feature of all of the most recent governments in Sri Lanka. The present Cabinet, appointed by President Wickremesinghe as of July 2022 consists of 29 ministries. Previous cabinets over the last decade have included as many as 59 ministries.

Each additional ministry and the appointment of every additional minister directly increases costs that the public must bear in order to maintain that ministry and increases the fiscal burden of government administration. Improving public sector efficiency is a key commitment that Sri Lanka has made on its ongoing IMF programme.

Currently, every ministry receives two main allocations from the budget to function: allocations for the Minister's Office' and the allocation for 'Administration and Establishment Services'. These allocations cover a wide range of necessary expenses such as office rent, utilities, office equipment and supplies, employee salaries and wages, pension contributions, training and development costs, and other expenses essential for carrying out the ministry's functions. In 2023, these allocations for each ministry will cost the Sri Lankan government LKR 4.4 billion on average.[42] This will result in a total expenditure of LKR 126.9 billion.

Since 1986, the Administrative Reforms Committee (ARC) has noted the proliferation of ministries as a result of accommodating political interests. In Sri Lanka's political system, the President and Prime Minister face both incentives and pressure to accommodate the interests of Members of Parliament to become Ministers. It has become an increasingly common practice for the executive to create additional ministries by splitting-up the subjects within a single sector across several ministries. A clear example of such fragmentation is the splitting of the agriculture sector in 2013 into eight individual ministries.

One proposed model for government argues that an effective and efficient cabinet can be maintained by reducing the number of ministries to 15 (Verité Research 2020). This model works with the assumption that the irrationality in the construction of government arises from two critical problems: (1) fragmentation – where related subjects are split across different ministries and (2) misalignment – where unrelated subjects are grouped together under a single ministry. The 15 ministries proposed within this model are detailed in Annex 4 Table 15.

Implementing this model would require an almost halving of the current cabinet – from 29 to 15 cabinet ministries. Given Sri Lanka's political culture, where heads of state rely on large cabinets and coalition politics for their own sustenance, such a significant revision is likely to take several step changes, rather than occurring in a single step. That too, is only likely to occur after a general election, and especially only if it becomes a competitive campaign promise by political parties.

In the context of the above expectations, this analysis is based on a step reduction in the number of ministries to 20. It conservatively assumes that such a reduction will result in savings on the cost of operating a ministry of between 20 per cent to 33 per cent. This is because any reduction in the number of ministries is unlikely to yield a savings of 100 per cent, and especially not in the first year of implementation. Cost reductions are likely to be from the allocation to the Minister's offices and certain administrative expenses. This is estimated to expand fiscal space by between LKR 7.2 billion (low estimate) to LKR 12.5 billion (high estimate).

(3) The Cost of Sri Lanka's National Carrier Sri Lankan Airlines (SLA)

Sri Lankan Airlines (SLA), the country's national airline, has consistently operated on loss over the past eight years, accumulating a significant amount of debt in the process (see Table 10). In 2021, the airline had an annual operational loss of LKR 32 billion.[43]

42 Author's calculations using figures from the Ministry of Finance, Approved Budget Estimates 2023.

43 Sri Lankan Airlines Annual Report 2020/2021

Table 10: Operating Losses of Sri Lankan Airlines

	2014	2015	2016	2017	2018	2019	2020	2021
Operating Loss - In LKR Billion	(26)	(12)	(4)	(7)	(10)	(23)	(5)	(32)
Exchange Rate	131	136	146	152	163	179	186	199
Operating Loss - In USD Billion	(0.20)	(0.09)	(0.03)	(0.05)	(0.06)	(0.13)	(0.03)	(0.16)

Source: Verité Research's calculations using Sri Lankan Airlines Annual Report 2020/21

SLA is a severe fiscal burden on the economy and to citizens. The airline industry is competitively priced, and the government being an inefficient supplier has no social benefit, but has a high cost on the population to subsidize the large losses. It has also been entangled in notable cases of large-scale corruption. [44]

An assessment carried out using the of the IMF 'State Owned Enterprise Health Check Tool' to assess the financial vulnerabilities and risks of Sri Lankan Airlines and the Sri Lankan Airlines Group indicates poor operational and financial performance, and an overall 'high risk' associated with the entities. For more details see Annex 5, Table 16 (Halstead et al. 2021).[45] Sri Lankan Airlines has additionally defaulted on its debt repayments to private parties, which are under government guarantee, causing an additional burden to government finances.

Given the results of this assessment, one feasible strategy is to liquidate the assets of the airlines, settling the liabilities that can be settled and closing down the operation as would be done in a situation of bankruptcy. Doing so would create fiscal space in two ways.

First, by ceasing operations Sri Lanka would save on the operating losses incurred by the airline. Based on data from the past eight years it is projected that in 2023, Sri Lankan Airline's operational loss (prior to financing cost) will be LKR 30 billion (USD 200 million).[46]

Second, by settling liabilities through selling off assets, Sri Lankan Airlines would reduce the stock of liabilities and thereby lower the interest costs on those liabilities, which otherwise continue to accrue and face compounded interest costs. In 2021, the average interest cost of its outstanding liabilities was 8 per cent, which was LKR 36 billion. However, if the airline were to sell off assets, outstanding liabilities would have reduced to LKR 281 billion, in turn resulting in a lower finance cost of LKR 23 billion. This would create a savings of LKR 13 billion.

The alternative is to find a buyer for SLA to take over the assets and liabilities even for one dollar – as offered by a previous state minister of finance in 2018, in relation to a subsidiary of the airline.[47] However, the government has not been successful, despite trying over the years, in finding an investor to take over the airline. Therefore, the alternative of halting and selling assets is likely to be the most feasible in terms of stemming the large losses from continuing to operate the airline, even if that might face the displeasure of the current employees and trade-unions connected to the airline. It is possible that this may lead to a disruption in flight numbers in and out of Sri Lanka, and on flight costs, which could consequentially affect tourism. However, it is expected that such

44 For further details, see https://www.tisrilanka.org/wp-content/uploads/2018/10/Airbus-Letter-to-CoI.pdf

45 The SOE Health Check Tool (HCT) is a practical excel-based tool designed to help countries assess financial vulnerabilities and risks emerging from SOEs. The Tool has been specifically designed to offer country authorities a way of monitoring their portfolio of SOEs with the goal of improving oversight and fiscal risk management. It allows users to identify and monitor those SOEs that are more likely to pose fiscal risks and thereby helps inform early and targeted interventions where necessary.

46 Author's calculations using Sri Lankan Airlines Annual Report 2020/2021.

47 "If required by MR, able to sell Mihin Air for one rupee", December 2015, DailyFT. Accessed via https://www.ft.lk/Opinion-and-Issues/if-required-by-mr-able-to-sell-mihin-air-for-one-rupee-eran/14-509263.

disruption would be temporary in nature, offset by the sale of licensed routes to other airlines.

Overall, this analysis proposes to halt the operations of SLA, and settle all liabilities associated with the airlines through selling off assets and paying off debts. This would result in a total estimated annual expansion in fiscal space of LKR 43 billion.

(4) Vehicle Acquisition Expenditure

Annually, the Sri Lankan government procures a range of vehicles for various purposes, including passenger vehicles, commercial vehicles, and special purpose vehicles (such as ambulances, water canal vehicles, and fire engines). The most scrutinized component of this expenditure is the acquisition of luxury vehicles for government officials and politicians. Presently the government lacks a vehicle inventory/management information system and spends excessively on new luxury vehicles where the benefits accrue narrowly to those in high office. This spending is widely perceived as unnecessary and wasteful.

For 2023, the Sri Lankan government allocated LKR 20.5 billion towards the acquisition of vehicles.[48] This is almost twice the budgeted allocation from the previous year. Including the projected costs for capital payments for leased vehicles and the lease rentals for vehicles procured under operational leasing, the government's total expected vehicle-related expenditure in 2023 is LKR 21.6 billion. This is equivalent to 0.07 per cent of Sri Lanka's GDP.

Over the last decade, government expenditure on vehicles has been equivalent to 0.10 per cent of GDP on average annually. The lowest expenditure to GDP ratio within this period was recorded in 2015, where vehicle-related expenditure was equivalent to just 0.05 per cent of GDP (see Table 11). Consequentially, this was the same year that the *Yahapalanaya* (good governance) regime was elected to power and was proactive about taking measures to cut wasteful expenditure. Therefore, 2015 provides a benchmark for a practical minimum for vehicle-related expenditure.

Table 11: Government Expenditure on Vehicle Acquisition and Other Related Expenses 2012-2023

USD to LKR	127.16	130.75	131.05	144.06	149.80	152.85	182.75	181.63	186.41	200.43	363.11	321.65
In USD millions	2012	2013	2014	2015	2016	2017	2018	2019	2016	2017	2018	2019
Lease Rental for Vehicles Procured Under Operational Leasing	0	5	7	0	0	2	4	4	4	4	2	2
Acquisition of Vehicles	76	39	74	11	9	72	81	87	131	91	29	64
Capital Payments for Leased Vehicles	0	0	2	33	39	31	30	30	12	3	2	2
Total Vehicle Cost	76	44	83	44	47	106	115	121	148	97	33	67
Nominal GDP	68,673	73,361	79,063	80,292	85,534	94,124	84,005	87,599	84,071	87,810	66,503	94,263
% of GDP	0.11%	0.06%	0.11%	0.05%	0.06%	0.11%	0.14%	0.14%	0.18%	0.11%	0.05%	0.07%

Note: Figures provided in USD because vehicles are generally purchased in USD.

Source: Author's calculations using Budget Estimates 2012-2023.

48 Ministry of Finance, Approved Budget Estimates 2023.

In most previous years, vehicle acquisition has been funded under supplementary budgets. Given current budgetary constraints and the oversight of budget target commitments made within the IMF programme, this is now more difficult. This further supports the case for a reduction in expenditure.

The current analysis proposes that annual vehicle-related expenditure be reduced to 0.05 per cent of GDP. Doing so would result in savings (FT 2015)equivalent to 0.05 per cent of GDP, or LKR 5.2 billion (high estimate). Alternatively, a more moderate goal would be to decrease expenditure to a level where it would yield at least 80 per cent of the potential savings that could be achieved otherwise. This would mean a reduction in annual vehicle-related expenditure to 0.06 per cent of GDP. The resulting savings would be LKR 2.2 billion (low estimate)

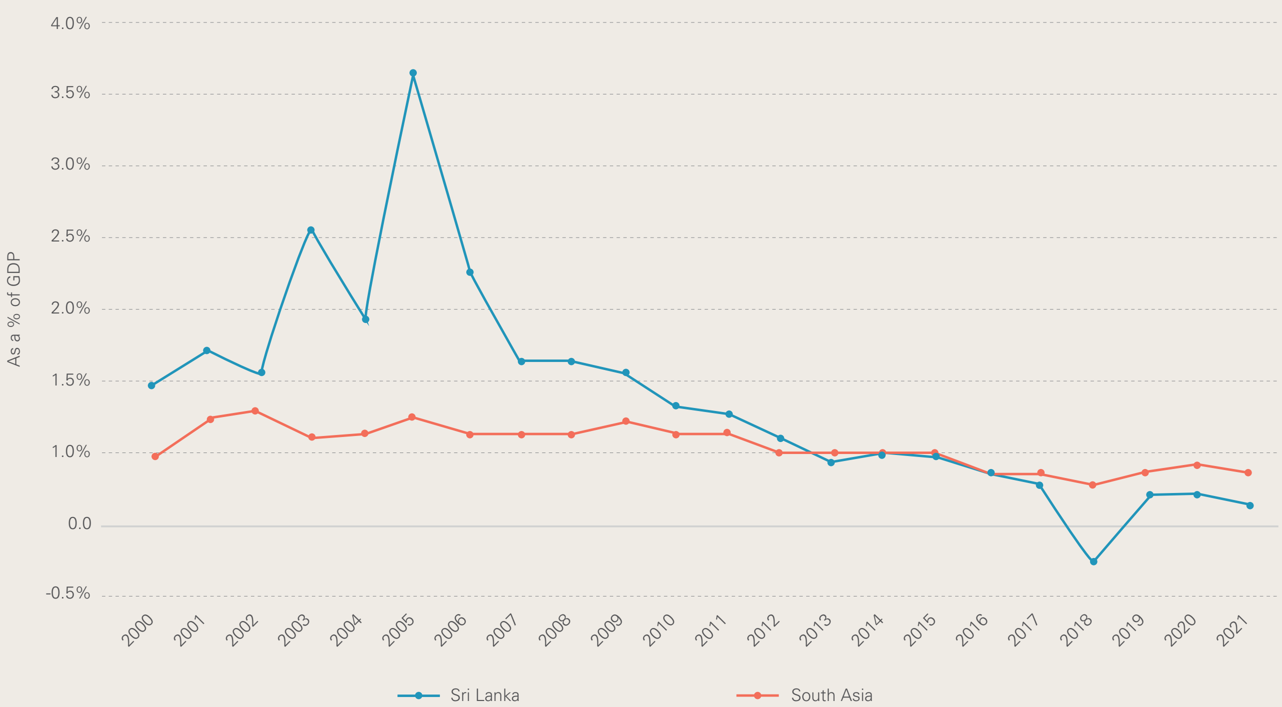
3.4. Adopting a More Accommodating Macroeconomic Framework

A more accommodative macroeconomic framework creates an environment that enables the consideration of options such as higher levels of public borrowing, increasing aid and transfers, or using fiscal and monetary policies.

At present, Sri Lanka's macroeconomic priorities are to achieve short-term stability in its macro-economic indicators and to build confidence towards economic recovery. The commitments made on the ongoing IMF programme set out a specific path with regard to macroeconomic actions and targets that Sri Lanka plans to achieve in this regard.

Given this context, this analysis does not explore any strategies to in terms of adjusting the macroeconomic framework to make it more accommodative.

Figure 9: Sri Lanka's and South Asia Net Official Development Assistance and Official Aid (% Of GDP) 2000-2021



Source: World Bank World Development Indicators

Sri Lanka's post-2015 figures on Official Development Assistance (ODA) have been consistently below 0.5 per cent of its GDP- lower than that of the average for South Asia (see Figure 9). While ODA may have been higher in previous years- 3.5 per cent in 2005 – with the achievement of middle-income status, Sri Lanka has needed to move out of dependence on ODA to borrowing in international financial markets to meets its additional investment requirements.

However, in April 2020, Sri Lanka lost access to international financial markets, and is not expected to regain it prior to mid 2025 (or beyond). This follows from its credit-rating being downgraded 7 times in the last 7 years.[49] Therefore, Sri Lanka has limited options with regards to international borrowing. The limited options it has is with regard to concessionary loan options is through Multilateral Banks, mainly to offset the consequences of the current economic crisis.[50] These facilities are at their highest level at the moment (while the crisis is at its peak) and cannot be expected to increase in the future.

49 PublicFinance.lk, Sri Lanka's (Research, Sri Lanka's Fitch Credit Rating has been downgraded 7 times during the last 7-years (May 2015 – May 2022) 2022) Credit Rating has been downgraded 7 times during the last 7-years (May 2015 – May 2022), 2022.

50 World Bank, (World Bank 2022) Sri Lanka's Eligibility to Access Concessional Financing to Help Stabilize the Economy and Protect Livelihoods, December 2022.

CHAPTER 4:
SUMMARY

This report presented and discussed options to actively explore and identify sources of additional revenue for social protection. The findings can be used by government and social partners to discuss options to find additional budgetary room to progressively invest in a rights-based and universal social protection system that provides adequate protection throughout the lifecycle. In line with international standards and good practices, generating fiscal space for social protection requires exploring the best combination of benefits and schemes in line with the national context, and considering a mix of strategies to mobilize necessary financial resources in a sustainable fashion.

The combined options set out in this analysis, if implemented together, would raise between 0.85 per cent and 1.36 per cent of GDP. Furthermore, if the government were to be more conservative and adopt only those measures which are easy to implement, and are positive in terms of the equity impact, the potential revenue generation is between 0.52 per cent and 0.85 per cent of GDP.

It is important to note, too, that these estimates do not consider the second-order effects of the potential increases in tax revenues from higher rates of economic growth that these investments would deliver, both in the short-term as it stimulates fiscal multipliers, and in the long term as they support health and educational outcomes, which are essential for long-term sustainable and inclusive economic growth.

The table below summarizes the options discussed in Chapter 3.

Option	Brief Description	Proposal	Low Estimate (LKR billion per year)	High Estimate (LKR billion per year)	Time Frame for Imple-mentation (i)	Feasibility and Implementation	Equity Considerations
INCREASING TAX REVENUE							
Value Added Tax (VAT)	VAT is a tax on domestic consumption of goods and services. It is currently applied at a rate of 15%. This follows from two successive revisions to the rate in 2022; first, the rate was revised from 8% to 12%, and subsequently to 15%.	No proposal, given the potential for VAT to be regressive at higher rates.	N/A	N/A	N/A	**[Easy]** Low social resistance in the status quo - the current VAT rate is the same as the level between 2016-2019.	**[Uncertain]** VAT is a consumption tax, which then is expected to be regressive, impacting a larger share of incomes of poorer households. However, research studies on the regressivity of VAT have contrary findings and are not conclusive.
Withholding Tax (WHT)	The WHT taxes income from interest and other non-employment sources, currently at a rate of 5%. The tax was reinstated as of January 2023.	Increase WHT rate to 10% (Low estimate) or 15 % (High estimate).	90	180	Immediate to short term	**[Easy]** Requires only a simple amendment to the income tax law, as has been done frequently. Not likely to face social resistance due to main impact being on high income earners.	**[Positive]** WHT applies to rent, interest and non-salaried incomes — more likely to capture higher income individuals, and especially those outside the tax net. Measures such as prior "tax directions" and refunds allow any lower income individuals to not be adversely impacted by the collection of this tax.

Option	Brief Description	Proposal	Low Estimate (LKR billion per year)	High Estimate (LKR billion per year)	Time Frame for Implementation (i)	Feasibility and Implementation	Equity Considerations
Personal Income Tax (PIT) and Corporate Income Tax (CIT)	PIT is the tax levied on wages, salaries, dividends, interests and other income a person earns throughout the year. Individuals are not subject to PIT below an annual income threshold of LKR 1.2 million. The marginal tax rate increases in increments of 6% (up to 36%) for each additional LKR 500,000 earned beyond the LKR 1.2 million threshold. CIT is the tax levied on the income or capital of corporations and other similar legal entities. The standard CIT rate is 30%.	Revert to the personal income tax structure that was in place prior to December 2019 (A tax-free annual income threshold of LKR 1.2 million. The marginal tax rate increases in increments of 4% - up to 24% - for each additional LKR 600,000 in annual income). Additionally, expand this tax structure upwards, by creating 3 more consistent tax brackets. The marginal tax rate in these brackets will be 28%, 32% and 36% respectively. No proposal with regards to CIT.	Not quantifiable (ii)	Not quantifiable (ii)	Immediate to short term	**[Easy]** Requires only a simple amendment to the income tax law, as has been done frequently. Will be socially popular as it reduces taxes across the board, and will encourage greater compliance among the middle class.	**[Positive]** The proposal reduces the taxation of lower and middle-income earners. But improves progressivity by keeping the highest marginal rate for the higher income earners.

Option	Brief Description	Proposal	Low Estimate (LKR billion per year)	High Estimate (LKR billion per year)	Time Frame for Implementation (i)	Feasibility and Implementation	Equity Considerations
Special Commodity Levy (SCL)	The SCL is a tax imposed on specific imported goods. The levy can protect domestic producers from price competition from imports. The SCL on sugar (which is the commodity the analysis focuses on) was suddenly reduced from LKR 50/kg to LKR 0.25/kg in October 2020, creating windfall gains to producers.	Re-impose the SCL of LKR 50 per kilogram of imported sugar. Assume a reduction in import volume of sugar between 5% (High estimate) and 15% (Low estimate)	25.5	28.5	Immediate to short term	**[Easy]** Can be changed by a gazette notice issued by the Minister. It is not likely to impact price due to local supply that is not affected, and the proposal is in line with nationalist support for import substitution measures.	**[Positive]** Data shows that the reduction in the levy predominantly accrued as producer surplus to importers, and not as consumer surplus. Revising this levy as proposed will convert this excess, producer surplus to a few, into government revenue, benefiting the general public.
Betting and Gaming Levy (BGL)	The BGL Act imposes taxes on specific forms of gambling and betting, including casinos, horse racing, lotteries, and sports betting. Currently, (i) the annual levy for gaming is LKR 200 million, (ii) the casino entrance levy is USD 100 per person, and (iii) the levy on gross collection is at a rate of 10%.	Implement the fees/ charges announced by the State Minister of Finance in October 2022: (i) annual levy for gaming of LKR 500 million, (ii) casino entrance levy of USD 200 per person (High estimate) or retain the existing levy of USD 100 (Low estimate) per person), (iii) levy on gross collection of 15%. Enforce the collection of revenue associated with these taxes.	6.2	9.7	Immediate to short term	**[Easy]** Requires an amendment to the Betting and Gaming law. Actions to increase such taxes have always been popular in the past (such that government announces them even when it doesn't implement). Additionally, the BGL is a focus area with commitments in Sri Lanka's IMF programme, which gives added supportive impetus.	**[Positive]** Betting, gaming and the casino industry serve consumers with higher disposable incomes and have low transparency of profits. The levies compensate for the under-reporting of incomes and impact those with higher levels of income.

Option	Brief Description	Proposal	Low Estimate (LKR billion per year)	High Estimate (LKR billion per year)	Time Frame for Implementation (i)	Feasibility and Implementation	Equity Considerations
Excise Duty on Cigarettes	Excise duty is a tax imposed on the sale of specific goods and services. Currently, taxation on cigarettes, including excise duty is below the recommended WHO guidelines of a total tax incidence of 75 per cent of the retail price for each cigarette.	Implement an indexation formula for cigarette taxation.	35	35	Immediate to short term	**[Easy]** Indexation formulas for cigarette taxation have received public support and are backed by research, and were even announced by the government as part of the 2019 budget. This revision would only require an amendment to the Excise (Special Provisions) Act	**[Positive]** Indexation would challenge the unfair benefits that the CTC currently enjoys due to being the monopoly player.
ELIMINATING ILLICIT FINANCIAL FLOWS (IFF)							
Property Taxation	At present, property tax revenue represents 0.05% of GDP, whereas in most countries it is equivalent to between 0.5%-1% of GDP.	Revise provincial property tax collection in order to increase annual property tax revenue (provincial) by 50% (Low estimate) to 100% (High estimate)	4.2	8.4	Short-medium term	**[Moderate]** Requires a re-assessment of the methodology through which property and rental value is calculated for the purposes of taxation.	**[Positive]** A key function of property taxes is regulating the accumulation of illicit wealth. However, this is not efficiently carried out due to the undervaluation of property value, that benefits wealthy property owners.

Option	Brief Description	Proposal	Low Estimate (LKR billion per year)	High Estimate (LKR billion per year)	Time Frame for Implementation (i)	Feasibility and Implementation	Equity Considerations
Illicit Trade Flows	There are two sources of trade-related IFFs significant to Sri Lanka. Import under-invoicing is when the value of imports is intentionally underreported. Importers under-invoice in order to avoid paying VAT and customs duties, and bypass non-tariff measures (e.g., quotas) or other regulatory requirements applicable to imports exceeding a certain value. Export under-invoicing is when the value of exports is intentionally underreported, thereby reporting lower profits. Exporters under-invoice in order to avoid or pay lower corporate income taxes. In 2015 (latest available data), mis-invoicing was equivalent to 14.6% of total trade.	Recover a portion (5% Lower Estimate - 10% Higher Estimate) of revenue foregone through import under-invoicing and export under-invoicing. Additionally, adopt a transparent National Single Window (NSW) electronic system, to facilitate cross-border trade.	6.6	13.2	Medium to long term	**[Moderate]** Requires better functioning of a currently malfunctioning Customs Agency in Sri Lanka. However, the proposal is targeting only a small reduction in lost tax revenue, and such marginal improvements will be easier than making large improvements.	**[Positive]** Trade under-invoicing provides unfair benefits to traders and allows high-income individuals to avoid the taxnet. Attempting to recover some lost tax revenue and improving the transparency of cross-border trade, will channel additional resources towards government revenue.

Option	Brief Description	Proposal	Low Estimate (LKR billion per year)	High Estimate (LKR billion per year)	Time Frame for Implementation (i)	Feasibility and Implementation	Equity Considerations
REALLOCATING OR REPRIORITIZING PUBLIC EXPENDITURE							
The Defense Budget	7% of the national budget is allocated to the Ministry of Defense; this is equivalent to 1.4% of Sri Lanka's GDP.	Reduce the expenditure on emoluments for triforce personnel, expenditure for triforce diets & uniforms and defense capital expenditure to 2021 levels (High estimate). A key component of achieving this is by reducing the replacement rate of retiring personnel. A more moderate approach to this proposal would be to decrease expenditure to a level where it would yield at least half of the potential savings that could be achieved by reducing expenditures down to 2021 levels (Low estimate).	39.2	78.5	Medium to long term	**[Moderate]** The high estimate is likely to be difficult in the short term because the higher allocation was already made in the 2023 budget, and reductions are likely to be gradual. But the low estimate is easier due to capital expenditures being not likely to be repeated. Government has also announced their intent to reduce the size of the military.	**[Positive]** Current social security programs are being improved to better provide for low income households, but lack funding from government. Whereas the expenditure on the military has seen disproportionate increases (relative to other sectors) and also unproductive recruitment (removing people from the productive labour force). In this context, military recruitment as a form of social security reduces overall social welfare.

Option	Brief Description	Proposal	Low Estimate (LKR billion per year)	High Estimate (LKR billion per year)	Time Frame for Implementation (i)	Feasibility and Implementation	Equity Considerations
The Cost of Operations for a Government Ministry	Sri Lanka has 29 cabinet ministries. In 2023, the maintenance of each ministry will cost the Sri Lankan government LKR 4.4 billion on average. This will result in a total expenditure of LKR 126.9 billion.	Reduce the number of cabinet ministries to 20, with an expected savings on the cost of operating a ministry of between 20% (Low estimate) to 33% (High estimate).	7.2	12.5	Short to medium term	**[Difficult]** Historically, coalition politics has expanded rather than reduced the number of ministries. Therefore, this is likely to occur only after a general election, and that also, only if it becomes a competitive campaign promise by political parties to garner popular support. Currently a reduction has not been embraced by any political party.	**[Positive]** Serves a redistributive function by taking away money from Ministerial maintenance, and towards spending for the general public.
The Cost of Sri Lanka's National Carrier Sri Lankan Airlines (SLA)	SLA has consistently operated on a loss over the past eight years. In 2021, the airline had an annual operational loss of LKR 32 billion.	Settle all liabilities associated with Sri Lankan Airlines through selling off assets and paying off debts.	43	43	Medium term	**[Moderate]** Due to difficulty of finding a potential buyer to take over the airline in its current stage, alongside the current economic environment in Sri Lanka. The alternative of halting and selling assets will face resistance from current employees and unions. Potential impact on tourism due to frequency of flights, can be managed through the selling of licensed routes.	**[Positive]** Airlines is a competitively priced industry, in which the government being a non-competitive [inefficient] supplier has no social benefit but has a high cost on the population to subsidise the large losses (and large scale corruption as has been exposed).

Option	Brief Description	Proposal	Low Estimate (LKR billion per year)	High Estimate (LKR billion per year)	Time Frame for Implementation (i)	Feasibility and Implementation	Equity Considerations
Vehicle Acquisition Expenditure	For 2023, the Sri Lankan government allocated LKR 20.5 billion towards the acquisition of vehicles. This is almost twice the budgeted allocation for the previous year. The government's total expected vehicle-related expenditure in 2023 is LKR 21.6 billion. This is equivalent to 0.07% of Sri Lanka's GDP.	Reduce annual vehicle-related expenditure to just 0.05% of GDP (High estimate). A more moderate approach to this proposal would be to decrease 0.06% of GPD (Low Estimate).	2.2	5.2	Short term	**[Easy]** This item has often been funded under supplementary budgets, which are now harder under the current budget constraints and oversight of the IMF programme.	**[Positive]** Presently the government lacks a vehicle inventory/management information system and spends excessively on new luxury vehicles where the benefits accrue narrowly to those in high office.
A MORE ACCOMMODATIVE MACROECONOMIC FRAMEWORK							
	A more accommodative macro-economic framework creates an environment that enables the consideration of options such as higher levels of public borrowing, increasing aid and transfers, or using fiscal and monetary policies.	None. At present, Sri Lanka has limited options for international borrowing and its macroeconomic priorities are constrained by the commitments made within the IMF EFF programme.					

Notes: (i) Timeframe for implementation is defined as follows: immediate – within 3 weeks; short term – between 3 weeks and 3 months; medium term – between 3 months to a year; long term – longer than a year. (ii) Due to limited and incomplete data sources.

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ANNEXURES

ANNEX 1 – Combined List of Consulted Stakeholders Consulted in the Formulation and Validation of the Report

Name	Organisation	Designation
Deshal de Mel	Ministry of Finance	Economic Advisor
Dr. Indrajit Coomaraswamy	Central Bank of Sri Lanka	Former Governor
Hon. (Dr.) Harsha de Silva	Parliament of Sri Lanka	Member of Parliament
Sriyani Mudiyanselage	ILO	National Project Coordinator
H.D. Sudarshana A. Jayasundara	ADB	Senior Social Development and Gender Specialist
Dr. Sharmini Coorey	IMF	Former Director of the Institute for Capacity Development (ICD) at IMF
-	Central Bank of Sri Lanka	Economic Research Department
-	World Bank	
-	Asian Development Bank	

The findings and analysis presented in this report are not a reflection of the views of the consulted individuals and organizations.

ANNEX 2 – Tax Rates and Revenue

Table 12: List of Sources of Government Tax Revenue

Tax Sources	Recent Changes in Policy (a)	Tax Revenue 2022 (LKR Million)	Tax Revenue as a % of Total Tax Revenue	Tax Revenue as a % of GDP (b)	Tax Revenue 2023 Estimate (LKR Million)
Income Taxes - Personal Income Tax (PIT) and Corporate Income Tax (CIT)	Income tax is charged on the gains and profits of every individual and business on the basis of the provisions under the Inland Revenue Act, No. 24 of 2017 as amended by the Inland Revenue (Amendment) Act, No. 10 of 2021. Since 2015, income taxes have been subjected to multiple revisions. ▪ In 2015, the maximum income tax rate applicable to employment income was brought to 16% ▪ In 2019, PIT rates were simplified and revised to 6%, 12% and 18% from the previous 4%, 8%, 12%, 16%, 20% and 24%. CIT was also reduced from 28% to 14% for the construction industry and 28% to 24% for banking and finance industries. ▪ In 2022, PIT rates were increased to 6%, 12%, 18%, 24%, 30% and 36%. CIT rates were increased to 30% in addition to the removal of sector specific exemptions.	534,021	30.5%	2.2%	912,000
Value Added Tax (VAT)	VAT is a tax on domestic consumption of goods and services. Since 2015, VAT has been subjected to multiple revisions. ▪ In 2015, the VAT was reduced to 11% and subsequently increased to 15% in 2016. ▪ In 2019, VAT rate was reduced to 8% ▪ In June 2022, the VAT rate was increased from 8% to 12% and it was further increased to 15% in September. Proposed measures with regards to VAT includes a revamp of the VAT system to abolish exemptions.	463,072	26.4%	1.9%	908,000

Tax Sources	Recent Changes in Policy (a)	Tax Revenue 2022 (LKR Million)	Tax Revenue as a % of Total Tax Revenue	Tax Revenue as a % of GDP (b)	Tax Revenue 2023 Estimate (LKR Million)
Excise Taxes	▪ In 2015, excise (Special Provisions) duty rates on cigarettes and excise tax rates on liquor were increased. Excise duty on hybrid motor vehicles was also increased. ▪ In 2019, excise duty on motor vehicles of an engine capacity less than 2,000 cm3 was increased while excise duty on electric vehicles was reduced. In March, excise duties on cigarettes and locally manufactured liquor were increased based on an indexation method. Excise duty on cigarettes was increased in December 2019. ▪ In January 2023, excise duties on cigarettes, alcoholic and petroleum products were increased. Proposed measures with regards to excise duties includes the introduction of an automatic indexation of excise duties to inflation.	342,523	19.6%	1.4%	557,000
Ports and Airport Development Levy (PAL)	▪ In 2016, PAL increased to 7.5% from 5.0%. A rate of 2.5% was introduced for certain electronic and electrical items. PAL on certain items used in construction, dairy and agricultural industries was removed during 2016. ▪ In March 2019, PAL on selected items was reduced from 7.5% to 2.5% but was later revised upward to 10% in December 2019. ▪ In 2023, PAL was revised for several imported items.	180,595	10.3%	0.7%	220,000

Tax Sources	Recent Changes in Policy (a)	Tax Revenue 2022 (LKR Million)	Tax Revenue as a % of Total Tax Revenue	Tax Revenue as a % of GDP (b)	Tax Revenue 2023 Estimate (LKR Million)
Import Duties	▪ From November 2015, customs duty structure was rationalized with the introduction of a three-band tariff structure (30%, 15% and the exempt) along with an increase of customs duty on selected items. ▪ With the aim of reducing applicable duty on fuel imports and discouraging the increasing importation of gold, custom duty changes were made in 2018. ▪ In 2020, customs duty increased in the range of 25-50% for some products, including tobacco prod-ucts. Upward revisions for petrol and diesel were made as well as an imposing of surcharge to maintain domestic retail prices. ▪ In 2020, customs duty rate was brought down to 15% from 30% on selected items. ▪ In March 2022, customs duty on selected food items was increased. From June 2022, surcharge at the rates of 25%, 50%, 75%, 100% and 200% was imposed for 6 months. ▪ Customs duties were exempted on donated goods and imported raw materials for local sanitary napkin manufacturing. ▪ As per the (Extraordinary Gazette Notification No. 2306/14), Fixed rates of Customs Duty were revised on par with the Ad Valorem Rate to arrest leakage of benefits of LKR depreciation	50,009	2.9%	0.2%	80,000
Other Taxes		180,912	10.3%	0.7%	453,000

Tax Sources	Recent Changes in Policy (a)	Tax Revenue 2022 (LKR Million)	Tax Revenue as a % of Total Tax Revenue	Tax Revenue as a % of GDP (b)	Tax Revenue 2023 Estimate (LKR Million)
Betting and Gaming Levy (BGL)	BGL is charged on persons carrying out the business of a bookmaker or business of gaming in Sri Lanka either lawfully or unlawfully. ▪ In 2015, the annual levy payable under the BGL Act was increased to 10% ▪ In April 2023, a bill to amend the Betting and Gaming Levy Act, No. 40 of 1988 was submitted to Parliament.				10,000
Special Commodity Levy (SCL)	▪ In 2015, SCL on several essential goods was revised downwards to reduce market prices. ▪ In 2016, SCL on the importation of several food items was revised to provide protection for farmers and as a measure to curtail price hikes in the domestic market. ▪ Similarly, in 2019, SCL on certain items was increased to support domestic producers while SCL was increased for a range of other goods to reduce price volatility.				70,000

Source: Central Bank of Sri Lanka Annual Report 2022, chapter 06, page 10.

Note: (a) Provisional, (b) GDP estimates (base year 2015) released by the Department of Census and Statistics on 15 March 2023 have been used.

Table 13: VAT rates of countries in South and South-East Asia

Country	VAT rate
Afghanistan	4% BRT - Business Receipt Tax
Myanmar	5%
Thailand	7%
Maldives	8%- Goods and Services Tax (GST) 6% prior to 1 Jan 2023
Singapore	8%
Malaysia	10% on Goods and 6% on Services
Cambodia	10%
Indonesia	11%
Philippines	12%
India	0.25%, 1%, 3%, 5%, 12%, 18% or 28%
Nepal	13%
Sri Lanka	15% (with effect from 2022 September)
Bangladesh	15%
Pakistan	18%
Bhutan	No VAT Currently there is a 20% sales tax and is expecting to introduce a 7% GST

Source: Author's compilation

ANNEX 3 - Defense Expenditure of Selected Countries

Table 14: Defense Expenditure of Selected Countries as a Percentage of GDP

Country	Military expenditure (% of GDP) 2021
Pakistan	3.8
United States	3.5
India	2.7
United Kingdom	2.2
Finland	2.0
Sri Lanka	1.9
China	1.7
Denmark	1.4
Bangladesh	1.3
Nepal	1.3
Sweden	1.3
Germany	1.3

Source: World Bank Data

ANNEX 4 - Rational Model for Cabinet, Consisting of 15 Ministries

Table 15: Rational Model for Cabinet, Consisting of 15 Ministries

1. Finance and Planning
2. Justice
3. Defense
4. Education & Research
5. Health
6. Agriculture
7. Labour
8. Public Utilities
9. Ports, Shipping and Civil Aviation
10. Economic Affairs
11. Home Affairs and Public Administration
12. Foreign Affairs
13. Family and Community Development
14. Society and Culture
15. Environment

Source: Verité Research, A Rational Method for Cabinet Formulation in Sri Lanka – a White Paper, 2020.

ANNEX 5 - Assessment on Sri Lankan Airlines and the Sri Lankan Airlines Group using the IMF SOE Health Check Tool

Table 16: Assessment on Sri Lankan Airlines and the Sri Lankan Airlines Group using the IMF SOE Health Check Tool

	Sri Lankan Airlines		Sri Lankan Airlines Group		Formula
	Financial Indicator	Risk Rating	Financial Indicator	Risk Rating	
Liquidity Indicators					
Current Ratio	0.13	Very Low Risk	0.13	Very Low Risk	Total Current Assets/ Total Current Liabilities
Quick Ratio	0.11	Very Low Risk	0.11	Very Low Risk	(Total Current Assets – Inventory)/Total Current Liabilities
Debtor Turnover Days	77.84	Very High Risk	79.63	Very High Risk	(Trade Receivables x 365)/Revenue from Trading Activities
Solvency Indicators					
Debt to Assets	2.87	Very High Risk	2.78	Very High Risk	Total Liabilities/Total Assets
Debt to Equity	NMF	Very High Risk	NMF	Very High Risk	Total Liabilities/Total Equity
Debt to EBITDA	-9.44	Very High Risk	-9.10	Very High Risk	Total Liabilities/EBITDA
Interest Coverage	-0.86	Very High Risk	-0.88	Very High Risk	EBIT/Finance Costs
Cash Interest Coverage	-1.32	Very High Risk	-1.35	Very High Risk	EBITDA/Finance Costs
Profitability Indicators					
Return on Assets	-0.29	Very High Risk	-0.31	Very High Risk	Net Profit/Total Assets
Return on Equity	NMF	Very High Risk	NMF	Very High Risk	Net Profit/Total Equity
Cost Recovery	0.62	Very Low Risk	0.62	Very Low Risk	Total Revenue Exceeding Government Grants/(COGS + Other Operating Expenses)
OVERALL RISK RATING		High Risk		High Risk	

Source: Author's calculation using the SOE Health Check Tool, and (Airlines 2021) Report 2020/21

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