Asian Journal of Economics, Business and Accounting

Volume 24, Issue 5, Page 630-643, 2024; Article no.AJEBA.114955
ISSN: 2456-639X

Unlocking Sri Lanka's Tax Landscape: A Comprehensive Analysis of Tax Burden and Policy Dynamics in a Sri Lanka

Shathurshana Rathakrishnan [a++*] and Ramya Yogaraja [b#]

[a] *Department of Business and Management Studies, Trincomalee Campus, Eastern University, Sri Lanka.*
[b] *Trincomalee Campus, Eastern University, Sri Lanka.*

Authors' contributions

This work was carried out in collaboration between both authors. Both authors read and approved the final manuscript.

Article Information

DOI: 10.9734/AJEBA/2024/v24i51337

Open Peer Review History:
This journal follows the Advanced Open Peer Review policy. Identity of the Reviewers, Editor(s) and additional Reviewers, peer review comments, different versions of the manuscript, comments of the editors, etc are available here: https://www.sdiarticle5.com/review-history/114955

Review Article

Received: 09/02/2024
Accepted: 13/04/2024
Published: 19/04/2024

ABSTRACT

This study aims to analyze the tax burden in developing nations with special reference to Sri Lanka, Taxation is a crucial source of revenue for public services, but there are still obstacles in the way of efficient tax collection, especially in developing countries like Sri Lanka. The present study investigates the tax burden in Sri Lanka and suggests strategies to address obstacles related to tax collection. The report makes three major recommendations based on the body of current literature and research: increasing the tax base, lowering tax rates, and enhancing tax administration. While lowering rates can improve revenue collection without worsening inequality, expanding the tax base is necessary to offset revenue loss from both legal and illicit tax evasion. Increasing efficiency and legitimacy need better tax administration, especially via the use of contemporary technologies.

++ *Assistant Lecturer;*
# *Graduate;*
**Corresponding author: E-mail: shathurshikrishna@gmail.com;*

Through the implementation of these measures, policymakers may improve the fiscal sustainability, fairness, and efficacy of taxes, eventually supporting public finances and helping the underprivileged and common people.

Keywords: Tax administration; direct and indirect taxes; developing countries; Sri Lanka.

1. INTRODUCTION

Taxes are essential for funding public services, a fact widely acknowledged. However, a lot of us voice our concerns, show how disappointed we are with our existing system, and even look for methods for avoiding them. Those involved in crafting and executing tax systems, much like those attempting to evade them, perceive themselves as highly sensible individuals, adapting to their environment as they perceive it [1].

"Taxes represent the price we have to pay for society." - Former Justice Oliver Wendell Holmes of the United States Supreme Court Income taxation is a necessary element of progress. Every country's economic and social stability is acknowledged to be contingent upon the presence of a comprehensive and well-functioning tax system. Development is consequently hampered by the lack of such a comprehensive and modern tax system. Over the past thirty years, issues and worries about taxes have often surfaced as major roadblocks to Sri Lanka's economic development. Even after becoming a middle-income country, Sri Lanka has struggled with several ongoing problems with its tax system [2].

The principal aim of taxes is to finance public services and achieve income redistribution by means of payments to households with lower incomes, therefore representing a social contract between the general public and their government. The willingness of residents to pay taxes in exchange for government services is influenced by this mutual agreement. Tax compliance rates are frequently a good indicator of how well public services are delivered; poorer compliance is a result of unhappiness. The government of Sri Lanka offers a range of public services, yet revenue collection is inadequate, maybe because of residents' ignorance or discontent with the standard of care. This deficit highlights the necessity for a strong tax structure to guarantee equal service delivery as it causes citizens to look for private alternatives and be reluctant to pay for underused public services [3]. Nevertheless, the amount of taxes collected falls well short of what is required to pay for these public services. This deficiency may result from poor public service quality and accessibility or residents' ignorance of their part in the social compact. As a result, people prefer private services over public ones and are reluctant to pay for services they believe are underused. Governments cannot serve all residents with exceptional public services without they have a strong tax system [3].

Developed countries usually rely mostly on direct taxes to generate their income; indirect taxes are less important. In contrast, indirect taxes account for a larger portion of government revenue in developing nations like Sri Lanka, with direct taxes making up a smaller portion. However, it is generally acknowledged that emerging nations like Sri Lanka should progressively shift from their reliance on indirect taxes to direct taxes as part of their development process. This is based on both theory and the experiences of developed and fast-rising nations. Sri Lanka remains behind in this transformation. Over 83.6 percent of the entire tax income during this time was generated by indirect taxes, with direct taxes making up only 16.4% of the total [4].

The tax system in Sri Lanka must deal with two major obstacles. First off, throughout the previous thirty years, the proportion of taxes to GDP has consistently decreased, down to 8.4 per cent in 2020 [5]. The preceding information suggests that Sri Lanka's government revenue is significantly low, resulting in continuous budget deficits and adversely affecting its financial stability [6]. Second, income taxes are not generating enough money, leading to an overreliance on indirect taxes. Worries about the makeup of Sri Lanka's tax income are raised by this discrepancy [7]. Statistics show that throughout the last three decades, both problems have gotten worse even though they have advanced to middle-class positions.

The amount of taxes collected in Sri Lanka has consistently declined, from 19.9% of GDP in 1990 to 7.3% in 2022. Tax collection has not kept up with the growth in national wealth, as seen by the GDP per capita rising from $472 in 1990 to $3,474 in 2022 [3].

The nation's revenue collection system is severely imbalanced, with indirect taxes accounting for 69.5% of total tax income. The substantial informal sector, which is difficult to tax, is to blame for this over-reliance on indirect taxes. Over time, the direct-to-indirect tax ratio has continuously remained close to 20:80. Despite a steady increase from around 15% of total tax income in 2000 to 31.5 per cent in 2022, direct taxes have stayed at a low level of roughly 2% of GDP for the previous 20 years, falling short of the rate of economic growth. The tax system has fundamental weaknesses that are responsible for the constant fall in revenue. The frequent and arbitrary changes in taxation are one major problem [3].

Another finding revealed that a constant difficulty for many governments, including Sri Lanka, is the fiscal deficit. Although there are several ways to deal with budget deficits, raising taxes is thought to be the best course of action because of the negative effects of other options like creating money and taking on debt. Even though increasing tax revenue is important for economic growth, Sri Lanka has had trouble raising enough money from taxes to cover its public service spending. The nation has several problems, such as a falling tax ratio, sluggish tax composition changes, disappointing results from changes to the tax system, and low productivity and efficiency of the value-added tax (VAT) [7].

Many emerging economies encounter significant fiscal hurdles: they must increase spending, improve spending efficiency, raise taxes, and enhance tax administration. The international development community expects them to address these challenges while also considering the implications of fiscal policies on various pressing issues, such as informality, poverty alleviation, and gender equality. Additionally, decision-makers must ensure economic sustainability, as large unmanaged deficits are currently unfashionable. Moreover, they must also prioritize their political viability while making these decisions.

Most traditional fiscal policy assumes that it is legitimate to raise taxes. Traditional study in this area focuses on incentives-based restrictions when discussing taxation limitations. These benefits are related to political dynamics, institutions, and knowledge asymmetry. Tax restrictions rarely take the state's administrative capacity into account. Nevertheless, incentive restrictions by themselves are unable to explain the notable worldwide and temporal fluctuations in income levels. High-income nations often collect approximately forty per cent of GDP in taxes, whereas those with low incomes typically collect between 10% and 20% [8].

Practicality who believes in the independence of thought frequently discover themselves influenced by the ideas of earlier economists. International tax tactics are moulded not just by ideas and particular groups, but also by changing economic circumstances, regulatory restrictions, developments in technology, and, most importantly, the political environments in which these components operate (Keynes, 1963).

All nations that are developing, like Sri Lanka, face a variety of general obstacles while putting in place tax structures that are customized to their unique needs and efficiently funding essential public spending. Developing countries want to raise their tax-to-GDP ratios to reduce deficits in their budgets, improve services, and maximize the effectiveness of their tax systems. Like most developing countries, has implemented several tax changes in recent decades [1]. These include the establishment of the developing countries Revenue Authority, a revenue agency; simplification of the tariff code; reorganization of the tax system; reduction of tax exemptions; revision of tax laws, including the Income Tax Act; and establishment of a strong system for tax investigations and litigation.

The need for increased revenue generation has been a major motivator for legislative changes in rising economies. When compared to other methods of resource mobilization such as deficit financing or monetary expansion, the necessity of producing more revenue in the face of significant expenditures has become even more pressing. The goal of restructuring tax regimes is to maximize the amount of money extracted from the reorganization project [9].

Significant budgetary deficits are a recurring problem for many countries. Unbearable budget deficits have led to considerable financial instability in various emerging economies throughout the last three decades [10].

Tax effectiveness seeks to maximize tax revenue collection and reduce tax evasion, while tax fairness assures an equitable allocation of the tax burden based on individuals' willingness to pay. On the other hand, fiscal viability pertains to the ability of the government to keep a balance

between revenue and expenses, hence preventing an unwarranted build-up of public debt. The required tax components—which include tariffs, levies, and contributions—determine the tax burden about GDP. Within this framework, two forms of tax burdens emerge the imposed tax burden, affected by tax rates, contribution levels, and GDP, and the accepted tax burden, driven by actual taxes, levies, contributions collected, and GDP. One important indication of the general fiscal pressure on an economy is the tax burden indicator, which is reported as a percentage of GDP. It is essential to understand the fiscal policies and economic performance of a country. Ene, [11].

In Sri Lanka, the income tax is progressive, and the tax is distributed inequitably among the income groups [12]. A key policy recommendation based on the findings of the study conducted by Liyanage & Amirthalingam [13] is that both direct and indirect taxes have been found to have a long-term impact on the country's GDP, which Sri Lanka should consider when changing its tax structure. While changing the tax policy, the policymakers must be careful and consider the real economic impact over than the political motivation [13]. A study conducted by Asel et al., [14] found a positive impact of tax level on the short and long-term economic growth of Sri Lanka. In terms of tax structure, the expected negative impact on tax structure, is not significant, especially for income taxes. However, an empirical study conducted by Kesavarajah [15] found income taxes have a significant negative impact on output growth. Further, the study reveals, that while total tax burden and excise taxes have no significant impact on Sri Lanka's economic growth, total income taxes, other taxes and foreign trade have a negative impact and consumption taxes (VAT) have a positive impact. Therefore, the purpose of this research is to examine the views of developing countries toward tax burden while offering empirical responses based on a review of the relevant literature.

2. SIGNIFICANCE OF TAXATION

To raise money for government expenditure in a way that is equitable, efficient, and controllable administratively is the main objective of taxes [16]. A country's tax structure affects several macroeconomic variables, including inflation, public debt, economic growth, and fiscal deficit. On the other hand, the tax system of a nation is greatly influenced by its macroeconomic situation. There is a relationship between the tax system and the rate of economic growth and development. There is a claim that a nation's tax base is significantly impacted by its economic progress [17].

In medium-term development plans, tax is a key tool for raising income and reducing dependency on debt-financed capital inflows while increasing government savings and local investment [18].

One of the main goals of economic development policy, according to Lewis [19] is to increase the share of tax income in GDP. As economies have developed, high-income countries have seen an increase in the percentage of tax collection and government spending compared to income. Comparing nations with different per capita income levels also usually shows that wealthier countries have larger national income ratios for government spending and tax revenue than do poorer ones. There appears to be a corresponding surge in demand for government services as per capita income grows.

Development-focused services including education, research on agriculture, including outreach services are usually prioritized by developing countries in addition to normal government spending. To effectively pay for ongoing government costs, government revenue may thus need to increase at a pace faster than the growth of the national income. Infrastructure development also becomes essential and inevitable given the continuous urbanization process that is occurring in almost all emerging nations. Spending on social development tends to increase along with economy. To promote prosperity and combat poverty, developing nations need to devote more funds to healthcare, education, and public infrastructure [4].

The limited capacity of developing nations to use the tax system for income redistribution is a result of many issues. First off, compared to wealthy countries, emerging countries' tax structures are far more complex and include less income and wealth taxes. Second, wage withholding taxes frequently make up most individual income taxes in emerging nations. Contributions from the work sector often account for more than 90% of total personal income tax receipts. Furthermore, several nations' tax laws have placed limitations on tax administration, therefore shielding forms of income—such as income from overseas assets kept abroad—from taxes. Thirdly, implementing effective income

and wealth taxes can be politically challenging in many countries. While tax legislation may aim to be progressive, in practice, it may not impose significant tax liabilities on the upper classes [20].

Economic development that is inclusive and sustainable requires a well-functioning revenue system. Nonetheless, several emerging nations' revenue systems have serious flaws. The development and growth of businesses are facilitated by governmental investment on physical, social, and administrative infrastructure. Furthermore, the revenue system is essential to maintaining a strong citizen-state bond that underpins responsible, efficient, and long-lasting government. Increasing the tax system's efficiency is a common goal of tax changes. This suggests that the administrative, compliance, and economic expenses related to revenue growth will be decreased under a revised tax structure. Although this could be true in the medium to long run, implementing a new regime comes with upfront administrative and compliance expenditures. Moreover, non-economists may perceive the progressive dynamic benefits that arise from the redistribution of production elements or commodities and services into higher-value applications with skepticism [21].

There isn't a single tax policy that works for all emerging nations to spur economic expansion. While certain nations with low tax loads have low growth rates, others with high tax burdens have strong growth rates. Regarding the effect of taxes on economic growth in emerging nations, there is no simple solution, despite a great deal of theoretical and empirical study as well as policy discussions. Theoretical literature contends that taxes impede economic growth because they can distort economic activity, whereas lower tax rates may encourage profitable investment. Nevertheless, empirical research shows that growth rates and tax burden have both positive and negative correlations. As a result, future tax collections may be greater if the ideal tax rate for maximizing economic activity is lower than the current tax burden [22].

3. PERSPECTIVE OF TAX IN DEVELOPING COUNTRIES

Taxation has several uses, such as funding public goods, correcting market defects, and redistributing money to promote social fairness. While efficiency objectives are connected to the pursuit of economic growth, redistributive policies, and the provision of public goods like health and education improve social justice, especially equality [23].

One essential component of government is taxation. Not only is it a matter of financing public services, but it is also a subject of debate, protest, and avoidance. The way that tax systems are designed and implemented is influenced by how people feel about them. Tax policy experts frequently identify as pragmatic, yet as Keynes (1936) famously pointed out, pragmatic people are frequently shaped by earlier economic ideas. Political institutions play a significant role in shaping tax policy in addition to ideologies and special interests. Developing nations deal with comparable situations. Institutions, ideas, and interests all have a significant impact on how tax laws are shaped. There is no one-size-fits-all tax system since every nation has different conditions. The best tax system must consider several variables, such as the economy, administrative ability, the demand for public services, and the availability of alternative funding sources like assistance or natural resources. Furthermore, intangible elements like tax morale, tax culture, and public-government trust are as crucial to consider (Keynes, 1963).

In 2016, data was analyzed using the dynamic panel generalized method of moments (GMM) estimation. The findings revealed a significant negative correlation between direct taxes and economic growth, while the impact of indirect taxes appeared positive but statistically insignificant. Furthermore, the study identified that direct taxes made a notable and positive contribution to total tax revenue compared to indirect taxes. Ultimately, the study concluded that a tax structure predominantly reliant on direct taxes, such as those imposed on income, profit, and capital gains, may be detrimental to economic growth but proves to be more efficient in terms of tax collection within a country [24].

The empirical literature on the effect of taxes on economic growth in emerging nations will be reviewed in this study. Using GMM panel data analysis, one study examined the impact of Value Added Tax (VAT) on the economic growth of nineteen developing nations between 1995 and 2010. The findings showed that VAT had a detrimental effect on capital accumulation, with sources other than savings and capital accumulation responsible for the favourable impact on economic development [25]. Another

study used secondary data using descriptive, correlation, and regression analysis to ascertain the impact of tax incentives on economic growth in Kenya. The results indicated that the GDP growth rate and tax incentives had the opposite association, while the GDP growth rate and investment levels, the productive population, and literacy levels all showed the same positive link [26].

Eugene and Abigail [27] used OLS regression analysis to look at how tax policy affected economic development in Nigeria during 20 years, from 1994 to 2013. The findings showed that taxes had a considerable impact on Nigeria's economic growth, with indirect taxes having a stronger positive correlation and direct taxes having a lower one.

Lumbantobing and Ichihashi [28] used panel data from 65 nations from the 1970s to 2006 to examine how a country's tax structure affects its economic growth rate and income distribution. According to their study, personal income tax rates had no discernible effect on either economic growth or income inequality, while corporate income tax rates were substantially correlated with both.

The structure of tax systems in countries is influenced by several factors, including the demand for increased public services, the ability to effectively levy taxes, and preferences for achieving specific public policy objectives such as income and wealth distribution and economic growth rates, both nationally and regionally. Kenny and Winer [29] conducted a recent study based on observations from 100 countries over the period of 1975-1992, revealing that countries tend to utilize all tax bases more as tax levels increase: higher spending correlates with higher taxation. Additionally, the reliance on different tax bases over time increases, particularly on bases that become relatively more significant, such as oil revenues in oil-producing countries. Moreover, demonstrate that taxes on bases tend to increase when the administrative costs of imposing those taxes decrease. For instance, higher education levels lower the cost of imposing personal income taxes, leading to increased reliance on such taxes Kenny and Winer [29].

Furthermore, the degree to which reliance on certain revenue sources may produce effective political resistance is suggested by Kenny and Winer [29] to be a crucial factor determining tax structure decisions. They contend that proponents of tax reform should explain any significant changes to a nation's tax structure in terms of the political balance that already exists. Developing nations have several obstacles while creating and executing appropriate tax policies. Large traditional agricultural sectors are difficult for many nations to tax, and it is also challenging to reach other possible tax bases including small companies, the unorganized portion of the economy, and international investments. These nations used to mostly rely on border taxes to regulate international commerce, but pressure to liberalize trade is making it harder and harder to take advantage of this revenue stream.

These nations used to mostly rely on border taxes to regulate international commerce, but pressure to liberalize trade is making it harder and harder to take advantage of this revenue stream. Tax bases usually rise with economic expansion, but globalization may also make budgetary problems worse. It gets harder to impose taxes on capital income as nations grow and integrate into the global economy, which might exacerbate domestic inequality and put political pressure on the tax code. Significant obstacles beset tax authorities in emerging nations, and things are not anticipated to get better.

4. ISSUES OF TAXATION IN SRI LANKA

Primarily, tax revenue hinges on the size of the tax net, encompassing individuals and businesses obligated to pay taxes. A broader tax net typically translates to higher tax revenue. Secondly, tax rates exert a significant influence on tax revenue, although the relationship between them is not always straightforward. Tax rate adjustments may not consistently correlate with changes in tax revenue due to dual effects. While higher tax rates may boost revenue from individual taxpayers, they could also dampen production or income, as individuals may be disinclined to work or produce in light of increased tax burdens [2]. Consequently, the impact of tax rate variations on tax revenue is nuanced. Nonetheless, empirical evidence suggests that this phenomenon is less applicable in most developing nations, where low tax rates typically yield lower tax revenue [30]. Thirdly, tax revenue is substantially influenced by the effectiveness of tax administration authorities in tax collection. This entails factors such as the registration of individuals and businesses with tax authorities like the Inland Revenue

Department (IRD) and the Sri Lanka Customs and Excise Department, as well as their ability to monitor income records. Fourthly, tax revenue is also shaped by tax thresholds, with higher thresholds often resulting in lower revenue by exempting more entities from taxation. Additionally, the complexity of the tax regime, the efficiency of tax administration systems, and the granting of tax concessions and exemptions among other factors, further contribute to the determination of tax revenue levels.

It is no exaggeration to say that tax revenue is the one of the main sources of income for a country. However, there are several challenges to be faced related to the tax revenue. Based on a detailed study past research papers by Amirthalingam [4] and Bird [1] the following can be listed as such challenges that can be addressed in Sri Lanka.

4.1 Tax Ratio

The ratio of tax revenue to GDP is defined as the tax ratio. The tax ratio should be a certain percentage of GDP. According to Kaldor [31] if a country wants to be developed, it should have tax revenue of 25% - 30% of its GDP. Based on this, the following information was obtained while examining the report of the CBSL from 2018 – 2022 regarding the ratio of tax revenue as per GDP in Sri Lanka.

Table 1. Report of the CBSL from 2018 – 2022 regarding the ratio of tax revenue as per GDP in Sri Lanka

Year	Tax Revenue as Per GDP (%)
2018	11.9%
2019	11.6%
2020	8.1%
2021	7.7%
2022	7.3%

Source: Annual Report of Central Bank of Sri Lanka (2018 to 2022), Annual Performance Report of Inland Revenue Department (2019 to 2022)

From the above Sri Lanka's tax ratio is less than 25%. The Sri Lankan tax revenue has not reached the level stated by Kaldor. Thus, low tax revenue may prolong Sri Lanka's growth period. A study conducted by Waidyasekara [32] states, in Sri Lanka, due to complexity of legislations related to taxation, lack of fiscal sustainability, tax administration weaknesses, lack of elasticity and float of fiscal system, tax concession and amnesty, and unplanned and ad hoc fiscal activities such as tax exemptions, the level of tax collection is constantly lower than the optimal. Apart from these, political factors will also cause the tax ratio to decrease.

4.2 Issues Faced by the Tax Administration

Generating revenue from tax rate changes requires effective tax administration. No matter what good tax policy is implemented in the country, it will be of no use if there is no proper tax administration [1]. A country's tax administration may become less efficient due to many issues. When analyzing the annual performance reports of IRD to find such issues of tax administration in Sri Lanka, we were able to identify the followings. (i) enforcement of taxpayer compliance, (ii) tax administration during the COVID-19 pandemic and lockdown periods, and (iii) increasing e-filling, for the period of 2018 to 2022.

4.3 Composition of Direct and Indirect Taxes

Typically, when looking at the tax revenue of developed countries, the contribution of direct tax in total tax revenue is higher than indirect tax. However, in developing countries, it is vice versa. Which means, the indirect tax contributes more than the direct tax. In order to confirm this, the annual performance reports of Sri Lankan IRD contain the following information.

Table 2. Annual performance reports of Sri Lankan IRD

Year	Direct to Indirect Tax Collection Ratio	
	Expected to achieve	Achieved
2019	60:40	20:80
2020	60:40	45:55
2021	60:40	45:55
2022	60:40	30:70

Source: Annual Performance Report of Inland Revenue Department (2019 to 2022)

Based on the above data, Sri Lanka is expecting to achieve a ratio of 60:40 as its direct to indirect tax collection ratio. Although not achieved its target in 2019, 2020 and 2021 can be seen to be a little closer to the target. However, in the year 2022 it has fallen from the previous year.

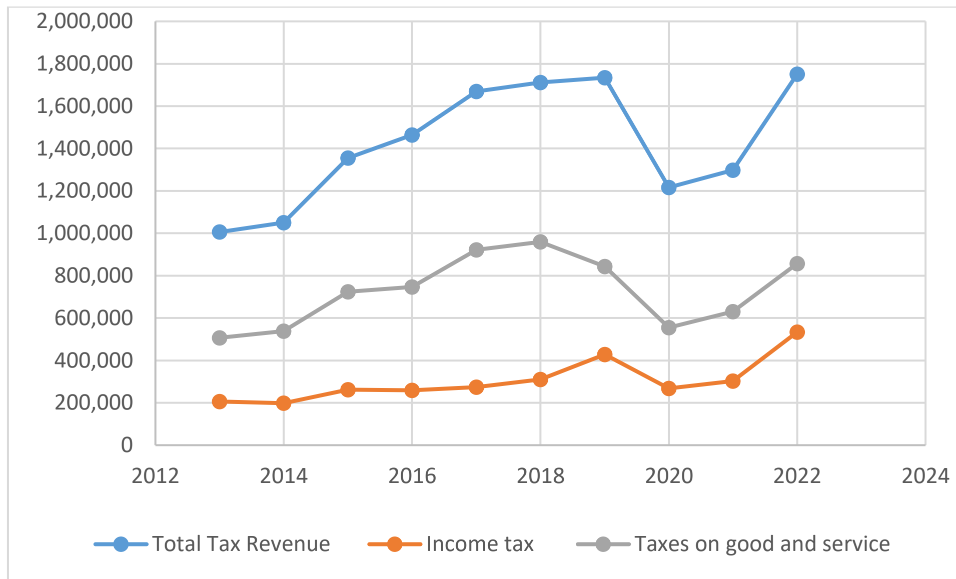

Fig. 1. Source: Annual Report of Central Bank of Sri Lanka (2013 to 2022)

According to the one of the study revealed that there is a major imbalance in the distribution of tax burden in Sri Lanka's tax structure, with a tiny minority of individuals and companies bearing an excessive proportion of the tax cost. It draws attention to the fact that 32.95% of individuals pay about 98.5 per cent of this tax category, although just 10.9 per cent of taxpayers pay approximately 87.93 per cent of resident personal income taxes. In addition, the research highlights the difference in registered individual taxpayers, of whom about 43.76 per cent have a low tax burden of only 0.97 per cent. A comparable trend may be seen in corporate taxation when the majority of tax income is generated by a small number of corporations. Remarkably, 66.77 per cent of business taxpayers record negative income, meaning they have losses, and 13 per cent of corporate taxpayers bear nearly the whole income tax burden (99 per cent). The results highlight the disparity in the population's share of tax liability, indicating that Sri Lanka's existing tax structure is unfair. The report makes suggestions for resolving these differences, which could apply to Sri Lanka as well as other developing countries dealing with comparable issues. In summary, by highlighting the need for a more equal system, this work enhances the body of knowledge and provides future researchers with insightful information [12].

5. SOLUTIONS FOR TAX CHALLENGES

In the previous section, what kind of challenges are being faced in relation to tax collection has been explored. This section explores ways to overcome such challenges. When examining such solutions, it was found that the research of Bird [1] suggested (i) broadening tax base, (ii) reduce rates, and (iii) improve tax administration as solutions. When examining how these solutions could address the challenges faced in Sri Lanka, the following were identified.

5.1 Broadening the Tax Base

Much of the discourse on taxation in developing nations often assumes that the tax base is inherently fixed and only requires effective exploitation, such as reducing exemptions and expanding the tax net. While these measures are crucial in many contexts, this perspective is overly narrow. Tax bases are not predetermined; they can be nurtured or eroded based on how taxes are collected. Tax policies can either encourage or discourage the formalization of the economy, influence the growth of taxable entities like imports, and shape economic development in various ways and for various objectives. Despite their significance, these developmental impacts of tax policies are often overlooked amidst the complexities of politics and fiscal analysis. Yet, over the long term, how taxes are collected from different sources can profoundly impact not only economic growth and income distribution but also the future level and composition of tax revenues themselves. Hence, there is a pressing need to pay more attention to the long-term effects of policy decisions on both tax design and tax administration [1]. Consider four commonly

posed questions regarding tax policy challenges in developing nations:

(1) Should consumption taxes be favored over income taxes?
(2) Are broader tax bases always preferable to narrower ones?
(3) Should tax policy aim to shrink the informal economy?
(4) What should be the approach to tax incentives?

While conventional wisdom typically offers straightforward answers to these questions, such as favouring consumption taxes, broader tax bases, efforts to tax the informal sector, and scepticism towards tax incentives, it is essential to reconsider these answers through the lens of long-term tax base policy development. In many developing countries, personal income taxes often resemble taxes on labour income and serve as de facto consumption taxes [33]. However, these taxes often impose high effective rates on investment, hindering growth without achieving equity. Therefore, the actual operation of taxes matters more than their classification as income or consumption taxes. Moreover, equity and growth can sometimes be reconciled. For instance, while the poor must consume to be productive, societal discontent with growth inequalities often necessitates visible fiscal corrections to sustain growth-facilitating policies. Thus, effective value-added taxes (VATs) in developing nations may sometimes exclude significant portions of poor people's consumption [34]. Additionally, while broader tax bases are generally beneficial, poverty alleviation is primarily achieved through targeted expenditures rather than taxes. Nonetheless, heavy taxes on items vital for the consumption of the poor should be avoided to prevent exacerbating poverty through taxation [35].

The tax base is believed to be severely eroded by legal tax avoidance and illegal tax evasion in most developing countries. This is mostly due to poor tax administration. This leads to loss of tax revenue, weak tax base, and high administrative costs [36]. Thus, the tax base should be robust and appropriate for the economy. A broad tax base is critical to an effective public finance and a good tax system. A study conducted by Thilanka and Ranjith [37] recommends, broadening the income tax base as a remedial measure to enhance the fiscal performance of Sri Lankan government which may indirectly be beneficial for the ordinary and poor sections in the country.

5.2 Reduce Rates

In general, countries tend to raise their tax rates to increase tax revenue. Raising tax rates in the current system is a politically more acceptable approach but an economically less desirable one [1]. His research reveals that raising rates when tax administration is weak is unlikely to increase revenue. Even as income rises, both inequality and inefficiency rise.

Additionally, Over the past three decades, challenges regarding taxation have consistently emerged as significant hurdles in Sri Lanka's economic development journey. Despite attaining middle-income status, the country grapples with persistent issues in its tax system. Particularly concerning are the notably low tax revenue and the inequity within the taxation framework. Data reveals a troubling trend wherein Sri Lanka's tax-to-GDP ratio has dwindled from 19% in 1990 to a mere 11.5% in 2019, positioning it among the countries with the lowest tax-to-GDP ratios globally (World Bank, 2021). Additionally, the nation faces considerable challenges regarding its tax structure. As of 2020, over 80% of the country's tax revenue stems from indirect taxes like the Value Added Tax (VAT) and tariffs on goods. These taxes are typically passed down to consumers, resulting in uniform tax burdens across income brackets. Furthermore, the prevalence of low-income tax rates and tax concessions disproportionately places the tax burden on average citizens, while individuals in higher income brackets enjoy comparatively lower tax liabilities relative to their earnings [2].

5.3 Improving Tax Administration

A sound tax administration is essential to an effective tax system. An unfair administration will lead to a discredited tax system and weaken the legitimacy of government action [1]. Further, his research states, that world experience reveals that the most essential factor for an effectual tax administration is a clear recognition at the highest political levels of the significance of the task and a willingness to support good administrative practices. Here it is best to go ahead with these practices even if political friends are hurt. Using modern technology in tax administration is the best way to boost up the administration. According to a study by Bird and Zolt [38] the technology offers encouraging pathways to at least partial solutions in many developing countries.

6. STRATEGIES BASED ON DEVELOPED COUNTRIES

Information on taxpayers plays an important role in improving the efficiency of a country's tax administration. Therefore, the collection of information on all taxpayers in the country is an effective process to improve tax administration and achieve efficiency. According to the research by Moore & Prichard [39] and Moran & Diaz de Sarralde [40] tax administrations have developed multi-channel taxpayer assistance systems to collect tax information of tax payers. The usage of online assistance channels has been increased in high-income countries.

The role of modern technology in improving tax administration is also vital. Alm et al. [41] suggests that the development of blockchain technology is a potential way to improve better control of the activities of all types of taxpayers. And the use of Artificial Intelligence (AI) has paved the path for machine learning models, tools which capable of predicting potential future fraudulent behavior based on past history [42].

Registration and identification of taxpayers is crucial for an optimal and efficient tax system performance. Many tax authorities are focusing more on establishment of unique Taxpayer Identification Number (TIN). Some countries have made it necessary to have a TIN to obtain permits such as driving licenses, passports in order to increase compliance with the TIN (Martinez- Vazquez et al., [43]. Effective January 1st, 2024 in Sri Lanka, persons aged 18 or above must register with the Inland Revenue Department and obtain a Taxpayer Identification Number (TIN), which is required for all tax-related activities [44-46].

7. CONCLUSION & RECOMMENDATIONS

The main objective of this study is to examine the challenges faced in Sri Lanka about taxation and their solutions. The above-mentioned challenges and solutions were identified through the examination of the studies of several researchers and the reports of CBSL and IRD. The country's tax-related reports also confirm that Sri Lanka being a developing country often faces the same problems faced by other developing countries. By properly addressing these challenges, Sri Lanka will be able to make efficient use of its tax system and achieve its future goals. Further, Sri Lanka should take necessary steps to increase the share of tax revenue in GDP, to reduce the over-dependence on public debt and money creation.

A comprehensive examination of Sri Lanka's income tax system highlights several critical concerns that must be resolved to guarantee equity, openness, and efficiency. Sri Lankan income tax is progressive, meaning that as income levels grow, so do the effective rates. The burden of income taxes is distributed unfairly, nevertheless, with a tiny percentage of corporate and non-business taxpayers providing the lion's share of tax revenue. In the past, small enterprises, services, and farm revenues have frequently escaped taxes, whereas direct taxes have historically been biased against salaried workers and the corporate sector [12].

In modern society, taxes are the main source of funding for government functions, allowing the state to meet the changing needs and demands of its people. The contemporary state has grown because of political dynamics, societal needs, and the desire for greater social welfare. These causes have also contributed to more government spending and a greater range of taxes. As such, the increasing tax burden is a result of these changes rather than their underlying cause.

Due to increased globalization and the adoption of neoliberal policies, debates around the idea of shrinking the state gained traction in the 1980s. Attempts were made at this time to encourage a minimalist state and reduce the tax burden. Governmental action was necessary, nonetheless, due to the growth in welfare demands, global or regional crises, and employment-related issues. In summary, a variety of economic conditions and the continuous development of the contemporary state influence the complexity of the tax burden. It has a significant impact on public finances and the whole economy and is a vital indicator for assessing the viability and efficacy of fiscal regimes.

In conclusion, improving tax administration and national efficiency greatly depends on the effective gathering of taxpayer data. Implementing multi-channel taxpayer aid systems—with a focus on internet channels—has become more common, particularly in high-income countries, as a result of initiatives seen in developed countries. Furthermore, by allowing predictive capabilities for spotting possible fraudulent activity and providing improved control

over taxpayer actions, contemporary technologies like blockchain and artificial intelligence (AI) are transforming tax administration. For many tax authorities, the creation of a distinct Taxpayer Identification Number (TIN) has become essential; in fact, several nations now need it to get licenses and permits. The latest effort in Sri Lanka, which requires anyone 18 years of age and older to register and get a TIN, highlights the increasing acknowledgement of the significance of taxpayer identification in promoting compliance and fortifying the tax system. All things considered, these tactics show a deliberate attempt to maximize the effectiveness of the tax system and guarantee fair participation in the taxation procedures.

8. RECOMMENDATIONS

- ✓ Establish policies in place that will encourage tax compliance while easing the tax burden on middle-class and upper-class earnings. This can entail rearranging tax rates and brackets to promote equity.
- ✓ Make sure that the tax net incorporates all qualified people and organizations to increase the tax base.
- ✓ This could necessitate fixing administrative flaws and enhancing tax enforcement systems.
- ✓ To improve compliance and accelerate tax collection, encourage collaboration between local government entities, banks, and financial institutions.
- ✓ To encourage equity and reduce chances for tax evasion, review and remove all income tax limitations.
- ✓ To improve consistency and ease of compliance, keep the tax system stable and straightforward.
- ✓ To ensure equity and justice in the tax system, take steps to deal with the differences in taxes paid to government employees and the private sector.
- ✓ In general, locating these suggestions into practice will help make Sri Lanka’s income tax system more just, open, and effective.
- ✓ The government can strive to raise the tax-to-GDP ratio and achieve long-term fiscal sustainability by improving tax compliance, expanding the tax base, and fostering justice.
- ✓ Extend the tax base to include a greater number of revenue sources and taxpayers.
- ✓ To improve transparency and taxpayer compliance easy, simplify tax rates and laws.
- ✓ To decrease administrative overhead and simplify the tax system, fewer taxes should be imposed.
- ✓ Encourage voluntary compliance with taxpayer aid programs and educational campaigns.
- ✓ Navigate clear of politically driven tax amnesties and concessions to preserve the tax system's equality and fairness.
- ✓ To maintain the accuracy and effectiveness of tax collecting procedures, avoid political meddling in the administration of taxes.

Through the study, we found that Sri Lanka relies more on indirect tax rather than direct tax. To bring about a change in this situation and to increase the share of direct taxes, a reform in the tax structure is necessary. When the share of direct taxes is higher in developed countries, it is vice versatile in developing countries. Based on theory and the experience of developed countries, Sri Lanka should have a transition from more dependence on indirect taxes to direct taxes (Amirthalingam, [4]). It is well known that a broad tax base not only reduces tax administration costs but also allows higher revenue to be raised at lower rates. Therefore, in developing countries like Sri Lanka, the tax base should be expanded to increase the tax revenue at a low rate and make the tax administration more efficient. Broadening the tax base is considered a very necessary process for the efficiency of tax revenue. The growth in tax collection should be based on widening the tax base and bringing new taxpayers into the tax net more than the expected growth from the organized sector (Overseas Investors Chamber of Commerce and Industry, [46]).

In conclusion, the efficient collection of taxpayer information plays a pivotal role in enhancing tax administration and achieving overall efficiency in a country's tax system. Research by Moore & Prichard [39] and Moran & Diaz de Sarralde [40] highlights the importance of multi-channel taxpayer assistance systems, with online channels witnessing increased usage, particularly in high-income countries. Moreover, the integration of modern technology, such as blockchain and Artificial Intelligence (AI), offers promising avenues for improving tax control and detecting fraudulent behavior, as suggested by Alm et al. [41] and De Mello & Ter-Minassian

[42]. Furthermore, the establishment of unique Taxpayer Identification Numbers (TINs), as emphasized by Martinez-Vazquez et al. [43], is essential for enhancing compliance and ensuring effective tax system performance. The recent mandate in Sri Lanka, effective January 1st, 2024, requiring individuals aged 18 and above to register with the Inland Revenue Department and obtain a TIN underscores the significance of taxpayer registration and identification in fostering tax compliance and administration. These initiatives collectively contribute to strengthening tax systems, promoting transparency, and fostering economic development.

COMPETING INTERESTS

Authors have declared that no competing interests exist.

REFERENCES

1. Bird RM. Tax Challenges Facing Developing Countries. Institute for International Business Working paper. University of Toronto: Toronto; 2008.
2. Moramudali U. Taxation in Sri Lanka: Issues and Challenges. In Economy for All. 2021;93-119.
3. Reforming Sri Lanka's tax system. The morning. 2023. Accessed on 10 March 2024. Available:https://www.themorning.lk/articles/RPPoSJH0W2SWA9VN1yBv
4. Amirthalingam K. Importance and Issues of Taxation in Sri Lanka. Colombo Business Journal. 2013;4(1):13-22. Available:http://220.247.247.85:8081/handle/123456789/7713
5. Central Bank of Sri Lanka. (2021). Annual Report 2020. 2021;147-164. Accessed 10 March 2024. Available:https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2020/en/10_Chapter_06.pdf
6. Weerakoon D, Hewage K. Fiscal Policy, Growth and Macroeconomic Stability. In S. Kelegama, Tax Policy in Sri Lanka Economic Perspective. 2017;7-1.
7. Amirthalingam K. Declining tax ratio: The formidable challenges of future development. In S. Kelegama, Tax Policy in Sri Lanka Economic Perspective. 2017;103-117.
8. Besley T, Persson T. Why do developing countries tax so little? Journal of economic perspective. 2014;25(4):99-120. Available:https://doi.org/10.1257/jep.28.4.99
9. Kelegama S. Tax Policy in Sri Lanka Economic Perspectives. Institute of Policy Studies of Sri Lanka; 2017.
10. Mahdavi S. Shifts in the Composition of Government Spending in Response to External Debt Burden. World Development. 2004;32(7):1139-1157. Available:https://doi.org/10.1016/j.worlddev.2004.01.011
11. Ene MS. Comparative analysis of the tax burden in EEC countries. Revista de Ştiinţe Politice. Revue des Sciences Politiques. 2023;79:25-34.
12. Vijayakumaran R, Vijayakumaran S. Incidence of Income taxation in Sri Lanka. Research Journal of Finance and Accounting. 2014;5(21):185-191. Available:http://repo.lib.jfn.ac.lk/ujrr/handle/123456789/1236
13. Liyanage PTD, Amirthalingam K. Causal Relationship of Taxation and Economic Growth in Sri Lanka; 2019. Available:http://dr.lib.sjp.ac.lk/handle/123456789/8913
14. Asel H, Janaka F, Ananda R. The Dynamic Impact of Taxation on the Economic Growth of Sri Lanka: An ARDL bounds testing approach. Vidyodaya Journal of Management. 2022;8(1). Available:https://doi.org/10.31357/vjm.v8ii.5601
15. Kesavarajah M. Tax composition and output growth: Evidence from Sri Lankan. Staff Studies Central Bank of Sri Lanka. 2016;44(1&2):33-67. Available:https://doi.org/10.4038/ss.v44il-2.4693
16. Burgess R, Stern N. Taxation and Development. Journal of Economic Literature. 1993;31(2):762-830. Available:https://www.jstor.org/stable/2728515
17. Musgrave RA. Fiscal Systems, new haven and London: Yale University Press. The Economic Journal. 1969;80(318):370-372.
18. Bovenberg AL. Fiscal affairs department indirect taxation in developing countries: A general equilibrium approach. International Monetary Fund. 1986;1-44.
19. Lewis SR. Taxation for Development: Principles and Application. University Press, New York, Oxford; 1954.
20. Bird RM, Zolt EM. Introduction to tax policy design and development. Practical Issues

of Tax Policy in Developing Countries. World Bank. 2003;28:1-39.

21. Carnahan M. Taxation Challenges in Developing Countries. Asia & the Pacific Policy Studies. 2015;2(1):169-182. Available: https://doi.org/10.1002/app5.70
22. Nantob NY. Taxes and Economic Growth in Developing Countries: A Dynamic Panel Approach. Munich Personal Repack Archive (MPRA), No. 61346, Available:https://mpra.ub.uni-muenchen.de/61346/ . 2014;1-24.
23. Avi-yonah R, Margalioth Y. Taxation in Developing Countries: Some Recent Support and Challenges to the Conventional View. OCED Conference paper Michigan Law School. 2006;1-32.
24. Hakim TA. Direct Versus Indirect Taxes: Impact on Economic Growth and Total Tax Revenue. International Journal of Financial Research. 2020;11(2):146-153. Available:https://doi.org/10.5430/ijfr.v11n2p146
25. Kolahi GHS, Noor MBZ. The effect of Value Add Tax on Economic Growth and its Sources in Developing. International Journal of Economic and Finance. 2015;8(1):217-228. Available:https://dx.doi.org/10.5539/ijef.v8nlp217
26. Alegana HM. The Effect of Tax Incentives on Economic Growth in Kenya. University of Nairobi. 2014;1-13.
27. Eugene N, Abigail CE. Effect of Tax Policy on Economic Growth in Nigeria (1994-2013). International Journal of Business Administration. 2016;7(1):50-58. Available:https://doi.org/10.5430/ijba.v7n1p50
28. Lumbantobing RIA, Ichihashi M. The Effects of Tax Structure on Economic Growth and Income Inequality. Hiroshima University. 2012;1-26.
29. Kenny LW, Winer SL. Tax System in the World: An Empirical Investigation into the Importance of Tax Bases, Administration Costs, Scale and Political Regime, International Tax and Public Finance. 2006;13(2/3):181-215. Available: https://doi.org/10.1007/s10797-006-3564-7
30. Trabandt M, Uhlig H. The Laffer Curve Revisited. Journal of Monetary Economics. 2011;58(4):305-327. Available:https://doi.org/10.1016/j.jmoneco.2011.07.003
31. Kaldor N. Will underdeveloped countries learn to tax? Foreign Affairs. 1963;41:410-419.
32. Waidyasekara DDM. Current Fiscal Policy. In Kelegama, S. (Ed.), Economic Policy in Sri Lanka: Issues and Debates. New Delhi: Sage Publication; 2004.
33. Bird RM. Evaluating Public Expenditures: Does It Matter How They are Financed? In Anwar Shah, ed., Fiscal Management. Public Sector Governance and Accountability Series (Washington: World Bank); 2005.
34. Bird RM, Zolt EM. Tax Policy in Emerging Countries. Environment and Planning C: Government and Policy. 2008;26(1):73-86. Available: https://doi.org/10.1068/cav3
35. Bräutigam D. Introduction: taxation and state-building in developing countries. In: Bräutigam D, Fjeldstad OH, Moore m (eds) Taxation and state-building in developing countries. Capacity and consent. Cambridge University Press. 2008;1-33.
36. Alm J, Bahl R, Murray MN. Tax base erosion in developing countries. Economic Development and Cultural Change. 1991; 39(4):849-872. Available: https://doi.org/10.1086/451912
37. Thilanka HRAC, Ranjith JGS. The Effect of Tax Composition on Income Inequality: Sri Lankan Experience. Economic Research. 2021:8(2):3-20. Available:https://doi.org/10.4038/sljer.v8i2.134
38. Bird RM, Zolt EM. “Technology and Taxation in Developing Countries: From Hand to Mouse.” National Tax Journal. 2007;61(4):791-821.
39. Moore M, Prichard W. How Can Government of Low-Income Countries Collect More Tax Revenue? In: Hujo, K. (eds) The Politics of Domestic Resource Mobilization for Social Development. 2020; 109-138. Available:https://doi.org/10.1007/978-3-030-37595-9_4
40. Morán D, de Sarralde Míguez SD. Panorama de las administraciones tributarias en los países del CIAT. Ingresos, recursos, funcionamiento y estado de la transformación digital en la antesala previa a la pandemia de COVID-19. Centro Interamericano de Administarciones Tributarias (CIAT); 2021. Available:https://www.ciat.org/Biblioteca/Estudios/2021-panorama-AT-moran-sarralde.pdf

41. Alm J, Beebe J, Kirsch MS, Marian O, Soled JA. New technologies and the evolution of tax compliance. Virginia Tax Review. 2020;39(3):287-356.
42. De Mello L, Ter-Minassian T. Digitalization challenges and opportunities for subnational governments. OCED Working Papers on Fiscal Federalism. 2020;31. Available:https://doi.org/10.1787/9582594a-en.
43. Martínez-Vázquez J, Sanz-Arcega E, Martín JMT. Tax revenue management and reform in the digital era in developing and developed countries. Research Handbook on Public Financial Management. 2013;202-225. Available:https://doi.org/10.4337/9781800379718
44. Central bank of Sri Lanka (2013-2022). Annual Reports. Central Bank of Sri Lanka.
45. Inland Revenue Department (2018-2022). Annual Performance Reports. Inland Revenue Department, Sri Lanka.
46. Overseas Investors Chamber of Commerce and Industry. Taxation Proposals. 2018-2019. In Malik MB. Appraisal of Comprehensive Scheme of Increasing Tax Base proposed by FPCCI. Journal of Public Policy Practitioners. 2022;1(2):1-32. Available:https://doi.org/10.32350/jppp.12.01

© Copyright (2024): Author(s). The licensee is the journal publisher. This is an Open Access article distributed under the terms of the Creative Commons Attribution License (http://creativecommons.org/licenses/by/4.0), which permits unrestricted use, distribution, and reproduction in any medium, provided the original work is properly cited.

Peer-review history:
The peer review history for this paper can be accessed here:
https://www.sdiarticle5.com/review-history/114955