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The Alternatives to Universal Tax Registration in Sri Lanka

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The alternatives to universal tax registration in Sri Lanka

by Mick Moore and Nishan de Mel

Abstract:

This note argues that the Sri Lankan government's recent proposal to implement universal tax registration is neither a viable nor effective strategy to increase the country's tax revenue. Instead, the note proposes four alternative measures that are more feasible, while still serving the same purpose of expanding the tax base and generating more revenue.

1 Introduction

In 2021, Sri Lanka's tax-to-GDP ratio reached its lowest level since 1959, dropping to just 8%.[1] Amongst other factors, this is in part due to the country's narrow tax base; by the end of 2021, total taxpayers registered with the Inland Revenue Department (IRD) equalled about 3% of the adult population.[2]

On September 1, 2022, the Sri Lankan government reached a staff-level agreement with the International Monetary Fund (IMF) under the Extended Fund Facility (EFF), which included the imperative to broaden the country's tax base within a relatively short period of time.

Just a day prior, on August 30, 2022, the Sri Lankan President presented an Interim Budget to Parliament, wherein he introduced a policy aimed at widening the Sri Lankan tax net to an extraordinary degree. In his speech, President Wickremesinghe proposed to "introduce compulsory tax registration for all residents who are above 18 years of age without considering their annual income and tax-free thresholds."

This policy note provides three reasons that makes the case against universal tax registration (*Section 2*); and proposes four alternative registration measures that would more effectively contribute to increasing Sri Lanka's tax revenue (*Section 3*). More detailed evidence to support arguments made are provided in *Annexes 1-3*.

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[1] Statistical Appendix, Central Bank of Sri Lanka Annual Report 2021. Available at https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2021/en/16_S_Appendix.pdf

[2] At the end of 2021, there were 507,095 taxpayers registered with the Inland Revenue Department (IRD Annual Performance Report 2021. Available at http://www.ird.gov.lk/en/publications/Annual%20Performance%20Report_Documents/IR_PR_2021_E.pdf). Approximately 90% of them were individuals. According to the Department of Census and Statistics, in 2021 there were 16,044,634 people in Sri Lanka aged over 18 years. This equates to approximately 3% of the adult population over 18 years of age.

2 Issues with universal tax registration

This section details three reasons why compulsory tax registration of Sri Lankan adults is not advisable. These arguments build on concrete precedents from countries that possess an effective tax system without relying on very high rates of tax registration (See *Annex 3*).

2.1 It will be administratively costly and divert scarce resources from more productive uses.

Sri Lanka's Inland Revenue Department (IRD) is already plagued by factors that impede its effectiveness. These include the lack of political support for proper implementation, a deficiency in skilled and motivated staff, inadequate human resources management, an unsuitable core software system (RAMIS), and the absence of a serious investigative capacity.[3]

If universal tax administration were to be implemented at present, it would require the IRD to process at least 30 times as many taxpayer files as it currently handles.[4] This would only exacerbate existing inefficiencies in the IRD and come at a significant administrative cost, diverting resources from the task of efficient revenue collection.

In the medium-term, there is merit in exploring the viability of large-scale taxpayer registration. However, it is not the case at present.

2.2 It is unlikely to yield a significant increase in revenue.

The IRD is only authorized to collect taxes directly from registered individuals, partnerships, and companies who possess a valid Tax Identification Number (TIN). However, as previously stated, the proportion of adult Sri Lankan citizens registered for Personal Income Tax (PIT) is considerably lower than that of other countries.

Simply increasing the number of registered taxpayers, whether they are individuals, partnerships, or companies, is unlikely to result in a significant and worthwhile increase in revenues for Sri Lanka. This is primarily for two reasons.

Firstly, the majority of taxpayers registered with the IRD are unproductive and do not pay any taxes. This could be because they either do not file any tax returns (non-filers) or file returns that show minimal income or profits and have no tax liability (nil-filers). See *Annex 1*.

Secondly, instead of prioritizing a vast increase in unproductive new registrations, it would be advisable for the IRD to focus on increasing more productive registrations and handling already registered unproductive taxpayers in a more efficient manner (i.e. improving tax compliance). Encouraging and nudging registered unproductive taxpayers to submit tax returns is necessary, and these returns need to be examined or audited in an organized way with appropriate engagement. Taxpayers should be made to understand that it is in their best interest to file more accurate tax returns, and they are likely to be called upon for an explanation if they fail to do so.

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[3] The Report of the Presidential Commission on Taxation 2009.

[4] The estimates of the number of taxpayers that would result from implementing universal adult registration are based on the IRD's reported figures, including the number of individuals who pay their Personal Income Tax (PIT) through the Pay-As-You-Earn (PAYE) system. However, it's important to note that the IRD does not maintain separate tax files for individual PAYE payers in the same way that it does for other taxpayers. Instead, employers keep records of PAYE payments and submit them annually to the IRD in statutory payroll reports. Therefore, from an organizational perspective, the IRD's records of PAYE-payers do not constitute personal tax files. Taking this into account, universal registration could result in an increase in the number of "real" tax files by 40-60 times the recent levels.

2.3 It will contribute to an increased public burden and potential repression of citizens.

Considering that Sri Lankan citizens are already legally obliged to possess a National Identity Card (NIC), obtaining a TIN would be a duplicative, unnecessary and inconvenient process, particularly for individuals who are not liable to pay PIT, Corporate Income Tax (CIT), or VAT.

This inconvenience is likely to be amplified for citizens residing outside the Western Province of Sri Lanka, as the IRD has a sparse presence beyond Colombo and surrounding urbanized areas.[5] This is because the IRD collects almost all of its revenue from the Western Province. Therefore, imposing mandatory registration for all citizens, particularly those living outside of Colombo, would not only be challenging and inconvenient, but also redundant.

Furthermore, there is a concern that the universal registration requirement could be exploited by the state as a potential means of repression. Marginalized groups and dissenting individuals could risk being targeted and selectively harassed by the police and military if they are unable to produce their tax registration certificate.

[5] In addition to the Head Office, located in Colombo, the IRD has 15 regional offices. 3 of these are located in the Western Province (Gampaha, Kalutara and Negombo). That leaves 12 regional offices to serve the remaining 22 Districts.

3 More effective alternatives to universal tax registration

This section details four specific alternative registration strategies that are more feasible than universal registration and would contribute to both widening the tax base and improving the productivity of the IRD.

3.1 Proactively allocate TINs to all individuals whose total Withholding Tax (WHT) deductions in any year imply earnings in excess of LKR 1.2 million and require them to file a tax return.

In Sri Lanka, Withholding Tax (WHT) is applied to a variety of specific income categories, resulting in a deduction at the source. The most significant category is interest on bank accounts and similar financial deposits, which are presently taxed at a rate of 5%. This tax is deducted by the bank or financial institution from the interest income and directly remitted to the IRD.

When WHT is levied at 5%, those who receive WHT certificates with a cumulative value exceeding LKR 60,000 are earning more than the yearly taxable threshold of LKR 1.2 million for personal income tax.

This measure helps to identify individuals who have income above the taxable threshold and should file a tax return. It also encourages compliance by making the registration process simpler and more efficient for both the taxpayer and the government.

3.2 Proactively assign TINs to all government servants whose basic annual salaries exceed LKR 1.2 million, and require them to file a tax return, covering all income, including other earnings from government (e.g. allowances, fees and benefits collected beyond the basic salary).

At present, most government servants in Sri Lanka are exempt from income tax on their official salaries. However, it can be reasonably assumed that many of them, particularly those in the higher pay brackets, also receive substantial income from other sources. These sources include non-salary payments from government organizations, such as fees for attending meetings or serving on boards, as well as income from other sources like property or businesses.

It would be equitable if government servants, especially the higher paid, were to be liable for personal income tax on all of their clearly identifiable sources of income. In addition to their salary, government servants also accrue pension benefits, which are currently a substantial un-costed and untaxed addition to the value of the remuneration.

The proactive registration of individuals belonging to this group would make a significant contribution towards expanding Sri Lanka's tax base.

3.3 Mandate all individual professionals and companies affiliated with a government/professional body to register for a TIN and file a tax return.

Tax registration statistics from the past two decades in Sri Lanka lend support to the claim that income earned by self-employed professionals, including those whose earnings are channelled through partnerships or small companies, is substantially under-reported in terms of income tax filing (See *Annex 2).*

Many professionals are required to register and obtain a license with professional associations and government bodies as a prerequisite for practicing their profession or conducting specific business activities. Examples include:

- The Sri Lanka Medical Council – for a range of medical professions
- The Supreme Court of Sri Lanka – for lawyers
- The Sri Lanka Institute of Chartered Accountants – for accountants
- The National Gem and Jewellery Authority - for gem miners, gem dealers, and gem cutters

- The Tourist Development Authority – for tourist business owners
- The Sri Lanka Export Development Board – for exporters
- The Excise Department – for liquor business owners
- The Customs Department – for registered importers
- The Tea Board – for tea dealers, manufacturers, packers and exporters
- The Geological Survey and Mines Bureau – for artisanal mining
- The Coconut Development Authority - for exporters, auctioneers, brokers, dealers, and estate owners

Therefore, requiring all professionals affiliated to such a body to register for a TIN and file a tax return would have a positive impact on compliance and widen the tax base effectively.

3.4 Proactively allocate TINs to all employees who meet both criteria (a) and (b), and require them to file tax returns: a. currently have taxes deducted from salaries under the Pay-As-You-Earn (PAYE) system; and b. have incomes that are subject to a WHT deduction.

As is explained in detail in *Annex 1*, the vast majority of registered taxpayers in Sri Lanka are PAYE payers - individuals in salaried employment who have their PIT liabilities deducted directly from their salaries, with the deductions remitted to the IRD by their employers.

However, despite being classified as registered taxpayers, PAYE payers do not have individual TINs, and the IRD does not maintain a tax file for each individual. This means that the additional income of those with high incomes outside of employment is not automatically captured for tax.

Currently the IRD has no mechanism by which the information they receive through the PAYE system on employees' salaries, can be linked to information that it might obtain on their incomes from other sources.

This proposed measure will improve the productivity of the IRD in tax collection, potentially increasing revenue without adding new taxpayers to the system.

Annex One: How many unproductive taxpayers are in the IRD tax files?

Unproductive taxpayers are defined as taxpayers – whether individuals, partnerships or companies – that are registered with the IRD but in any given tax year either (a) do not file tax returns (*non-filers*) or (b) file tax returns that show no tax liability (no or low net income – *nil-filers*). To determine the exact number of unproductive taxpayers in Sri Lanka, access to IRD files would be required. However, publicly available data relating to CIT in 2008/9 and PAYE in 2015, suggests that a large majority of registered taxpayers fall within the unproductive category.

The majority of the revenue collected by the IRD comes from two sources: VAT and income taxes, specifically CIT and PIT.[6] PIT is collected through two separate channels: (a) from individuals, including small scale businesspeople, who are directly registered with the IRD; and (b) through PAYE, through which employers withhold employees' PIT from their salaries and remit it directly to government.[7]

According to CIT data reported in the Presidential Commission on Taxation 2009 Report (page 76-77), in 2008/2009 the IRD registered 25,769 companies for CIT. Out of these, only 16,992 (66%) actually filed tax returns for that year. The Tax Commission's analysis indicates that, out of the 66% of companies that filed CIT returns, 55% were nil-filers, meaning they declared no taxable income. These figures suggest that roughly 70% of companies registered for CIT were unproductive, and this statistic is likely an underestimate.[8] It is similar to the proportion of unproductive companies in the tax registries of several other African countries.[9]

Furthermore, a significant proportion of the 5,046 registered companies that actually paid CIT in 2008/9 remitted very little revenue to the Sri Lankan treasury. Conversely, almost all the CIT revenue collected (87% of the total) came from just 340 companies, which represented only 1.3% of the total number of companies registered for CIT.

There are no public data available to make comparable estimates of the incidence of *unproductive* 'taxpayers' for either VAT or PIT as a whole. But an estimate for the PAYE component of PIT, is possible. The most recent publicly available statistics on PAYE that are disaggregated in sufficient detail are from 2015.[10]

In 2015, 1,606,255 individuals were recorded as PAYE 'taxpayers'. This means that 1,606,255 names and a few details about remuneration and tax deducted appeared on annual payroll reports submitted by employers to the IRD.

The figures reveal that:

- 73% of registered PAYE 'taxpayers' paid no PAYE in 2015.
- At the top end of the pay distribution, individuals earning over LKR 3.6 million accounted for 1.2% of PAYE taxpayers and 49% of total PAYE collections. Yet, they only remitted 17% of their reported gross remuneration.
- Total PAYE collections only amounted to 3% of the reported gross remuneration of all PAYE taxpayers.

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[6] In 2021, VAT accounted for 49% of IRD collections and income taxes for 48% (IRD, Annual Performance Report 2021, page 11).
[7] PAYE was abolished in early 2020 in favour of a purely voluntary APIT (Advanced Personal Income Tax) but reinstated in the November 2022 Budget.
[8] The Tax Commission Report does not explain why it excluded about a third of all company CIT returns from its analysis (page 76-77). It is possible that the quality of the returns was so poor that they were unusable.
[9] 'Tax Obsessions: Taxpayer Registration and Taxing the Informal Sector in Sub-Saharan Africa', Development Policy Review, Volume 41, No 2, March 2023. Available at https://onlinelibrary.wiley.com/doi/10.1111/dpr.12649. (Some of the African figures are particularly high because governments and tax administrations continually put efforts into registering large numbers of new taxpayers despite clear inability actually to convert new registrations into revenue)
[10] IRD, Annual Performance Report 2015, pages 15, 21 and 27. (The more recent IRD Annual Performance Reports provide less data and analysis than formerly. The pattern of PAYE payments reported here for 2015 was broadly similar in earlier years.)

- In 2015, 83% of the total number of tax files open at the IRD were for PAYE taxpayers. However, they only accounted for approximately 10% of total income tax collections, with non-PAYE PIT accounting for 30% and CIT for 60%.

This data was collected prior to the large PIT reductions announced in January 2020, which included the replacement of mandatory PAYE with the voluntary APIT (Advanced Personal Income Tax).[11] These statistics demonstrate how unproductive the PAYE mechanism was in every dimension. There were two main immediate reasons: (1) Even in 2015, PIT obligations were relatively low compared to most other countries - rates were relatively low and the thresholds for eligibility were high[12] (however, these weaknesses have been somewhat addressed in the Budget for 2023); and (2) the IRD did not have a mechanism to automatically link any information on the non-salary incomes of salaried employees to the information they receive through the PAYE mechanism. People paying income tax through deductions made from salaries by employers did not have a Tax Identification Number. If the link could be reliably made, by issuing Tax Identification Numbers to people in the PAYE system, many PAYE taxpayers would be obliged in practice, as they are in law, to also pay additional PIT on the incomes they earn from property rentals, professional fees, or side businesses. This would convert PAYE taxpayers into much more productive taxpayers.

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[11] Between the end of 2019 and the end of 2021, the number of registered employees paying Personal Income Tax fell by 97%; paying in effect became almost voluntary. Over the same time period, the number of companies registered for Value-Added Tax declined by 69% (PublicFinance.lk, Issue 16, September 2022. Verite Research).

[12] For the international comparisons, see Report of the Presidential Commission on Taxation 2009 page 88. Note also that in 2015, PAYE accounted for only about 10% of total income tax collections, non-PAYE PIT for about 30%, and CIT for 60% (IRD Annual Performance Report 2015, page 21).

Annex Two: Unincorporated businesses are increasingly avoiding tax registration

The figures on tax registrations by category for the period 2005 suggest that the tax system has become decreasingly effective at identifying unincorporated businesses earning enough pay PIT. Although a large proportion of incorporated businesses pay little or no CIT, the IRD has ensured that they generally remain registered – not least because of their liability pay a range of other taxes, such as VAT, Economic Service Charge, Nation Building Tax and the Social Security Contribution Levy. From 2005-2021, the numbers of companies registered for CIT has been relatively stable, increasing on average by 7% annually year, which is greater than the rate of economic growth. By contrast, the number of individuals registered for PIT – which excludes PAYE payers and relates mainly to smaller businesses and professionals – has fluctuated but has declined annually by 1% on average over the same period, despite a large expansion of the economy.[13]

Compulsory registration of business and professional licences would help to strengthen the tax net in this vulnerable area.[14]

Annex Three: Governments that tax effectively do not try to register all adults.

The IRD statistics indicate that only approximately 3% of Sri Lankan adults are registered for tax. However, this figure is misleading as the majority of those listed as 'registered' are actually PAYE payers, who do not have individual TINs, individual tax files, or qualify as 'registered taxpayers' in the generally accepted sense of the term (See *Annex 1*). The number of 'real' tax registrations is much lower, and it is lower still when compared to other Asian countries where registration rates of around 10% are more typical.[15]

It is commonly believed that high rates of tax registration are necessary for an effective and productive personal income tax system. However, this is not the case. In OECD member countries, for example, an average of 50% of the adult population were registered for tax purposes in 2020. Only 7 OECD countries had registration rates of 80% or more of the adult population. These countries, including Austria, Finland, Norway, Australia, Denmark, and Iceland, have long histories of high levels of formal sector employment, high female workforce participation, high levels of personal income tax collection relative to average incomes, and high government spending on social welfare.[16] Their national tax registries have expanded gradually over a long period of time and do not include large proportions of unproductive taxpayers, unlike the Sri Lankan tax registry.

[13] All data are from the IRD Annual Performance Reports,
[14] This relative decline in the number of (non-PAYE) PIT-payers is partly the result of weak enforcement and partly the result of policy, notably exemptions and increases in thresholds. Some of these people and businesses would be liable to pay VAT were VAT thresholds not unusually high in Sri Lanka.
[15] Report of the Presidential Commission on Taxation 2009
[16] OECD Tax Administration 2022.

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