

Measuring the Impact of Special or Concessionary Tax Rate Policies on Corporate Income Tax Revenue of Sri Lanka

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Introduction

The corporate income tax (CIT) is the main direct tax of Sri Lanka. In recent years, it accounted for 9.2 % of total tax revenue and 52 % of income tax revenue of Sri Lanka. One important issue in CIT in the case of Sri Lanka is its gradual decline reported over time as a percentage of GDP. In the early 1980s and early 1990s, the ratio approached 2.5 % and later recorded a gradual decline to about 1% in recent years. At a given marginal corporate income tax rate, it is expected that CIT revenue will increase in line with the expansion of the GDP. But, the declining trend of CIT revenue as a ratio of GDP indicates that CIT revenue does not move in line with the growth of the economy. Jayawickrama (2008) and Madushani and Jayawickrama (2014) show that the income elasticity of the CIT is relatively low in Sri Lanka which indicates the failure of the tax to track GDP closely.

The government of Sri Lanka has granted concessionary /special CIT rates according to the company size and sector to achieve objectives such as the promotion of local and foreign investment, protection of the companies at their early stage to compete the market competition, promotion of agricultural production, promotion of small and medium scale companies and elimination of regional development disparities etc etc. (Wijesinghe, Ekanayake and Mahendra (2013)

Special tax rates or concessionary tax rates granted for different sectors or companies by Sri Lankan governments may be expected to reduce the tax revenue collected in the short run and to expand the sector at a higher growth

rate in the long run. Many resechers argue that the declining tax/GDP ratio is mainly due to tax exemptions, concessionary tax rate policies etc. (Jayawickrama, 2008; Amirthalingam, 2013; Hettiarachchi and Jayawickrma, 2018). However, no studies have computed revenue loss due to exemptions or concessionary tax rate policies granted by the government for different sectors with a view to enhance the growth of the economic activity or the sector.

Objective

The objective of this study is to examine the effect of special and concessionary CIT rate policies granted by the government to different corporate sectors on the loss of tax revenue during the period 2010 to 2017 in Sri Lanka.

Methodology

Theoretically, CIT revenue is computed based on the marginal CIT rate and taxable corporate income. This is known as the potential CIT revenue (Davoodi and Grigorain, 2007). In practice, CIT revenue is computed based on the concessionary tax rates granted for selected sectors and the sector-wise taxable corporate income. This is known as the actual CIT revenue collected. Then, the difference between the potential revenue and the actual revenue collected is explained as the CIT revenue loss due to special and concessionary tax rate policies.

In this study, potential CIT revenue (PCITR) and actual CIT revenue collected (ACITR) are used to compute the loss of CIT revenue (LCITR) due to tax rate policies. In order to measure the decrease in tax revenue collection, the sectors which were granted special tax rates and concessionary tax rates are treated separately. Thus PCITR is defined as follows:

$$PCITR = \tau \sum_{i=1}^n TI_i \quad (1)$$

where, τ is the marginal corporate income tax rate and $\sum_{i=1}^n TI_i$ is the aggregate taxable income (TI) of n number of companies in a given year. The actual CIT

tax revenue collected by the Inland Revenue Department of Sri Lanka is defined as follows:

$$ACITR = \sum_{i=1}^n ACITR_i^s + \sum_{j=1}^m ACITR_j^c \quad (2)$$

Where, $\sum ACITR_i^s$ is the actual CIT revenue collected under special tax rates offered for different sectors/companies and $\sum ACITR_j^c$ is the actual CIT revenue collected under concessionary tax rates offered for different sectors/companies. The loss of CIT revenue (LCITR) due to special and concessionary tax rate policies is defined as the difference between PCITR and ACITR. For the computation, we use information for seven assessment years from 2010/2011 to 2016/2017. In each assessment year, we have a sample 20 % (1015 Companies) out of a population of 5075 companies recording the availability of continuous tax returns for the period. The sample is selected to reflect the different scale of companies - small, medium and large - based on tax computational definitions of the Inland Revenue Department. The sample consists of 656 small companies, 252 medium companies and 107 large companies. The marginal CIT rate used for the computation of potential revenue is 35 % for the assessment year 2010/11 and 28 % for the rest of the period.

Results and Discussion

The potential CIT revenue in respect of the sample of 1,015 companies was estimated as Rs. 19,404 million in the 2010/11 assessment year and Rs. 45,866 million in the 2016/17 assessment year. Further, it shows a gradual increase over the years though the marginal tax rate was lowered to 28 % in the 2011/12 assessment year and onwards compared with 35 % which prevailed in the 2010/11 assessment year. The average potential CIT revenue stood as Rs.30,462 million during the period.

The Actual CIT revenue collected by the Department of Inland Revenue was Rs.10,035 million in 2010/11 and it gradually increased thereafter and reached Rs.16,293 million in the 2016/17 assessment year. The average of the actual

CIT revenue collected stood as Rs. 13,040 million during the sample period. The estimated CIT revenue loss due to special and concessionary tax rate policies of Sri Lankan Governments is given in Table 1 below.

Table 1: CIT revenue loss due to special and concessionary tax (Rs. Mn)

Year	Potential CIT Revenue	Actual CIT Revenue	CIT Revenue Loss
2010/11	19,404	10,035	9,369
2011/12	17,618	10,888	6,730
2012/13	19,497	12,639	6,858
2013/14	34,788	13,165	21,623
2014/15	35,874	14,013	21,861
2015/16	40,187	14,245	25,942
2016/17	45,866	16,293	29,573

The CIT revenue loss due to special and concessionary tax rate policies of the government has increased from Rs. 9,369 million in the 2010/11 assessment year to Rs. 29,573 million in the 2016/17 assessment year. There is around a two-fold increase in potential CIT revenue in the 2013/14 assessment year compared to that of the previous year, and a three-fold increase in CIT revenue loss in 2016/17 assessment year compared to that of the previous year.

Following the same method, the computation of CIT revenue loss for the companies at different scale of operation shows that the CIT revenue loss due to special and concessionary tax rates granted for small scale companies stood as Rs. 420 million in 2010/11 and it increased rapidly to Rs. 847 million in 2016/17. Due to tax rate concessions granted for medium companies, the government had a loss of CIT revenue of about Rs. 842 million in 2010/11 and Rs. 803 million in 2016/17 and decreased at a much slower rate. In large companies, tax rate concessions led to a CIT revenue loss of Rs.8,106 million in 2010/11 and Rs.27,923 million in 2016/17. The average loss per company due to special and concessionary tax rate policies stood as follows in 2010/11 and 2016/17 assessment years: small companies – Rs. 0.6 million and Rs. 1.3 million; medium companies- Rs. 3.3 million and Rs. 3.2 million; and large

companies –Rs. 76 million and Rs. 261 million respectively. It seems that special tax rates or concessionary tax rates granted for small and large companies created a substantial CIT revenue loss in recent years. Further, the rapid increase in per company CIT revenue loss indicates that the expected positive impact on tax revenue is not evident over time.

Conclusion

This study computed the loss of CIT revenue due to special and concessionary tax rate policies of the government implemented under various policy objectives. It was found that about Rs. 29,573 million of CIT revenue loss was occurred in the 2016/17 assessment year. And it is about Rs. 16,293 million higher than the actual CIT revenue collected in the year. Further, CIT revenue loss due to special and concessionary tax rate policies has increased rapidly from 2010 to 2017. Moreover, per company CIT revenue loss due to special and concessionary tax rates granted for large, medium and small companies Rs. 261 million, Rs. 3.2 million and Rs. 1.3 million, respectively, in 2016/17. The Average loss of CIT revenue stood as 57% of the potential CIT revenue of the companies. This indicates that an average Rs.17 million tax loss is reported per company. If the projection is made to the population of 5075 companies, the average tax loss would be about Rs. 86,275 million.

Estimated values of CIT revenue loss indicate that the cost of special and concessionary tax rate policies is large and increasing over time. Further, the increasing CIT revenue loss reflects that the negative effect of granting of special tax rates and concessionary tax rates on CIT revenue is continuing at increasing rates. It further indicates that the expected positive effect of the policy through expansionary tax bases is not evident over time. The policy on special and concessionary corporate income tax rates applied for different sectors has eroded the actual corporate income tax revenue of the government. Therefore, it is highly essential that the government make a proper assessment on whether these special or concessionary rates granted for selected companies and sectors met their objectives and whether the continuation of such concessions are still important.

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