

THE NATION BUILDING TAX GAP: WHY NBT REVENUE OF SRI LANKA DOES NOT INCREASE IN LINE WITH ITS TAX BASE

K.K. Sanath Hettiarachchi^{1*}, J.M Ananda Jayawickrama²

¹ PGIHS, University of Peradeniya, Sri Lanka

²Department of Economics and Statistics, University of Peradeniya, Sri Lanka

*kumuduksha@gmail.com

The Nation Building Tax (NBT) is charged on business turnover, which can be approximated by expenditure incurred on final products, i.e. gross domestic expenditure (GDE). It is expected that NBT revenue should maintain a close positive relationship with GDE. However, the NBT revenue of Sri Lanka has not increased in line with its tax base, GDE. It is reported that due to policy decisions taken by the government and issues on tax compliance, there is a gap between NBT revenue collectible and actual net revenue collected, which is known as the NBT gap. The Literature on tax gap in Sri Lanka is mainly focused on income tax and value added tax gaps. This study aims at examining the size of the NBT gap of Sri Lanka and its recent trends and to find reasons as to why the NBT revenue does not increase in comparison to the expansion of its tax base. That the NBT tax revenue does not respond well to its tax base could be due to two reasons: the policy gap and the compliance gap. The policy gap is the difference between the potential NBT revenue and Potential NBT revenue collection. The policy gap depends on government policies on tax rates and tax exemptions and explains the loss of tax revenue due to government policies that was meant for economic growth and development. For example, tax exemptions provided to promote private businesses contribute positively to increase the NBT gap. The compliance gap on the other hand indicates the inefficiency in the tax system as the actual tax collection falls below the potential revenue collectible. A widening compliance gap indicates the inefficiency in tax administration. With better management of the tax system and a growing economy, we expect the compliance gap to be narrower. The Collection Efficiency Ratio shows the percentage of actual NBT tax collection of the potential NBT revenue of government. If the tax system is productive, the collection efficiency ratio should be closer to 100. The paper computes NBT policy gap and compliance gap which together provide NBT gap and Collection Efficiency ratio of NBT revenue. The study uses time series data of NBT of Sri Lanka from 2010-2016 for the calculation of the above gaps and collection efficiency ratio. Household consumption expenditure which is included in GDE was considered as the expenditure incurred on final products. The NBT gap has increased to Rs. 85,632 million in 2015 compared to Rs. 41,781 million in 2010, though it reduced to Rs. 76,009 million in 2016. The main contributing factor of the NBT gap is policy gap: Rs. 35,891 million in 2010 and Rs. 69,844 million in 2015 and Rs. 69,102 million in 2016. The compliance gap has increased from Rs. 5,890 million in 2010 to Rs. 15,787 million in 2015, reporting a three-fold increase. The compliance gap has reduced to Rs. 6,907 million in 2016 compared to the year 2015 due to the inclusion of financial services, real estate and land development, retail trade, LP gas, import of cigarettes to the tax and the increase of number of tax files. Further, a low NBT tax collection efficiency ratio (about 52% in 2016) is found for the period concerned. Large and consistent policy and compliance gaps and low collection efficiency signal the requirement of immediate policy attention to the NBT.

Keywords: Nation Building Tax, Policy Gap, Compliance Gap