The Ceylon Chamber of Commerce EIU

Government Revenue in Sri Lanka

11 Insights on 2016 Performance & 2017 Outlook

Taxation is the hot topic of conversation among the business and policy community, as the Government prepares to pass a new Inland Revenue Bill and continues with fiscal reforms driven by an IMF programme. During the course of the last year we witnessed many discussions and proposals for enhancing Government revenue in Sri Lanka, amidst the implementation of the Revenue Administration Management Information System (RAMIS) at the Inland Revenue Department and the drafting of the new Inland Revenue Bill. 'Revenue based fiscal consolidation' is the main focus of the Government's reform efforts, and in that context it is useful to look at the latest revenue numbers. The fiscal reform effort launched in 2016 is already showing results, with Government revenue as a share of GDP recorded 14.2% in 2016, the highest on record since 2010. This report investigates the performance of Government revenue in 2016 - including what contributed to the changes, what impact tax reforms have had on achieving the expected revenue outcome, etc., and a look at the 2017 revenue performance so far and outlook for the rest of the year.

11 Quick Insights

1 Non-Tax Revenue Outperforms Tax Revenue

What really drove government revenue in 2016 was not tax revenue but non-tax revenue. Non-tax revenue doubled it's share in GDP from 0.9% in 2015 to 1.8% in 2016, while the share of tax revenue to GDP remained steady at 12.4%. Revenue collection from non-tax sources increased more than threefold, from LKR 29.8 Bn in 2015 to LKR 108.2 Bn in 2016 as a result of the improved performance of State Owned Business Enterprises (SOBEs) in banking, insurance, petroleum and telecommunications. Total Government revenue increased by LKR 231.2 Bn in 2016 with tax revenue and non-tax revenue contributing by LKR 107.9 Bn and LKR 123.2 Bn respectively.

2 Non-Tax Revenue Thrives On Depressed Oil prices and Profitable SOEs

The growth in non-tax revenue was driven primarily by the revenue generated in two sub components - 'profits and dividend transfers from state owned enterprises (SOEs)' and 'fees and charges'. Revenue collection from profit and dividend transfers of SOEs increased by LKR 78.4 Bn to LKR 108.2 LKR in 2016, supported by the improved performance of SOEs in banking sector, Ceylon Petroleum Corporation (CPC), Sri Lanka Insurance Corporation and Telecommunication Regulatory Commission (TRC).

3 Direct – Indirect Tax Ratio No Closer to 60:40 Target

Although the Government's stated policy objective since 2015 has been to rebalance the indirect tax to direct tax ratio from 80:20 to 60:40 in the medium term, 2016 did not show any signs of getting closer to that target. Indirect tax share in total tax revenue was 82.6% in 2016, the highest share on record since 2010.

4 Which Tax Collector Collected The Most Revenue?

The Department of Customs collected the highest tax revenue in 2016, continuing the trend of previous years. Customs, which accounted for 56.8% of total tax revenue while IRD and Excise Department contributed by 31.8% and 8.2% respectively.

5 Consumers Contributed the Most Tax

The changes to consumption taxes by the Government last year have already begun paying off, with revenues from VAT on domestic goods and services being nearly one-third higher than the year before (28.8%). Meanwhile Nation Building Tax (NBT) jumped 39.2% and Excise Tax on alcohol and cigarettes/tobacco rose 12.8%. Overall, taxes on domestic consumption contributed to 67% of the increase in tax revenue in 2016.

6 VAT Hike Drives Tax Revenue Growth

Revenue from Value Added Tax (VAT) made a strong rebound from the negative growth recorded in 2015 and contributed to 59.1% of the growth in tax revenue in 2016. So far this year, VAT revenue has grown 97.6% YoY (Q1), placing VAT on a strong footing to generate one fifth of Government Revenue in 2017.

7 Excise Tax Collection Falls amidst Weak Vehicle Imports

Excise Tax - the single largest contributor to tax revenue - declined by LKR 42 Bn in 2016 as a result of the sharp fall in revenue generated by its major source, motor vehicles (down by 29.2% YoY). The share of motor vehicles in excise revenue recorded a sharp decline from 52.9% in 2015 to 41% in 2016.

8 Taxes on Foreign Trade Brought Half of Tax Revenue

Government revenue is highly reliant on foreign trade taxes, and it accounted for 50.5% of the tax revenue in 2016. Revenue from import duty grew by 18.4% in 2016, and just 11 products contributed to over three fourths of all imports revenues.

9 No More Super Gains in 2016

The absence of the 'Super Gains Tax', impacted on the revenue from corporate income tax with a dip of LKR 17 Bn in 2016. As a result taxes on net income and profits contracted by 3.5% on YoY basis to LKR 258.9 Bn in 2016.

10 Analysis on 2017 Outlook

The revenue performamance and the devlopments in the tax environment point to four revenue drivers to watch during 2017; (a) Strong growth in VAT makes it a potential source for bringing more than one fifth of tax revenue for 2017; (b) Excise revenue is likely to remain week with the subdued demand for motor vehicle imports and high duty structure on alcohol and tobacco products; (c) Non-tax revenue likely to be influenced by external factors such as oil prices and drought conditions. (d) Proposed IR bill is expected to give a further boost to revenue.

11 Perspectives from the Ceylon Chamber's Taxation Steering Committee

Commenting on the taxation outlook, members of the Taxation Steering Committee of the Chamber indicated that the enactment of the new IR Bill, would broaden the tax base and direct tax collections are likely to improve with the limiting of exemptions and incentives and streamlining of taxes. Overall, revenue collection from VAT and NBT would continue to increase as a result of revisions to rates as well as removal of certain exemptions/lowering of tax liable threshold.

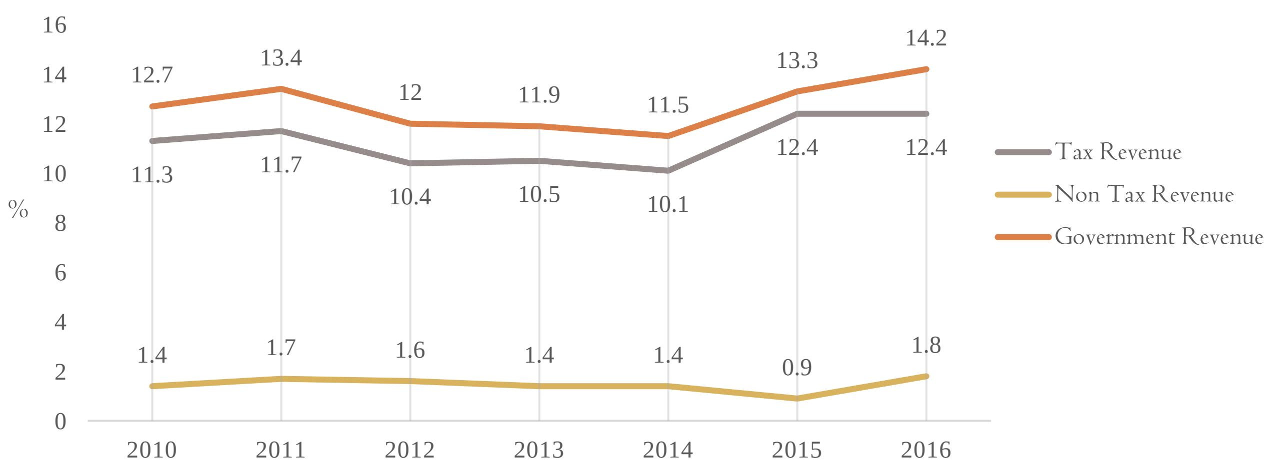
Members of the Committee also had concerns that the tax policy is likely to be influenced by populist demands and political pressures in the year ahead. Further, continued uncertainty with regards changes to tax legislation and the difficulty in understanding the impact of such changes is likely to have an adverse impact on overall business activity and investor confidence, particularly if tax changes are not subject to a robust consultative process with the taxpayer community.

Non-Tax Revenue Outperforms Tax Revenue

Although tax policy is currently the hot topic of debate, in 2016 it was really non-tax revenue that stood out. While tax revenue to GDP (known as the 'tax take' or the 'tax ratio') remained steady at 12.4%, the increase in Government revenue was driven by a significant increase in non-tax revenue, which doubled from 0.9% of GDP in 2015 to 1.8% in 2016 (see Figure 01). In fact, non-tax revenue contributed to over half of the 2016 increase in Government revenue, while tax revenue contributed 46.7%.

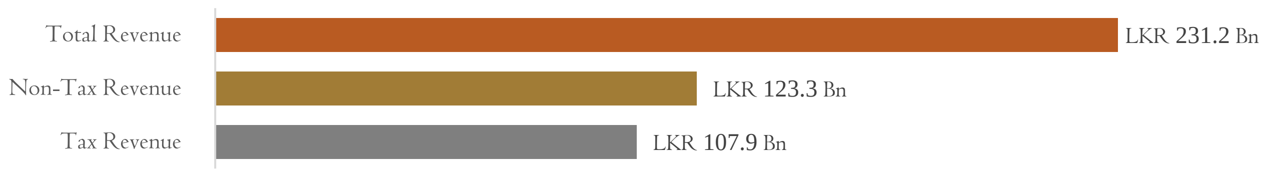
This increase in non-tax revenue is unprecedented, and has never exceeded 25% during the last five years. Non-tax revenue recorded a significant YoY growth of 124% (an increase of LKR 123.3 Bn) to LKR 222.3 Bn in 2016 compared to the negative YoY growth of 31.6% recorded in 2015. . Meanwhile tax Revenue grew marginally by 8% YoY (an increase of LKR 107.9 Bn) to LKR 1,463.7 Bn (see Figure 02). As share in total revenue, non-tax revenue rose from 6.8% in 2015 to 13.2% in 2016, while tax revenue fell from 93.2% in 2015 to 86.8% in 2016.

Figure 1- Government Revenue as a % of GDP



Source: Ministry of Finance

Figure 2-Increase in Government Revenue- 2016

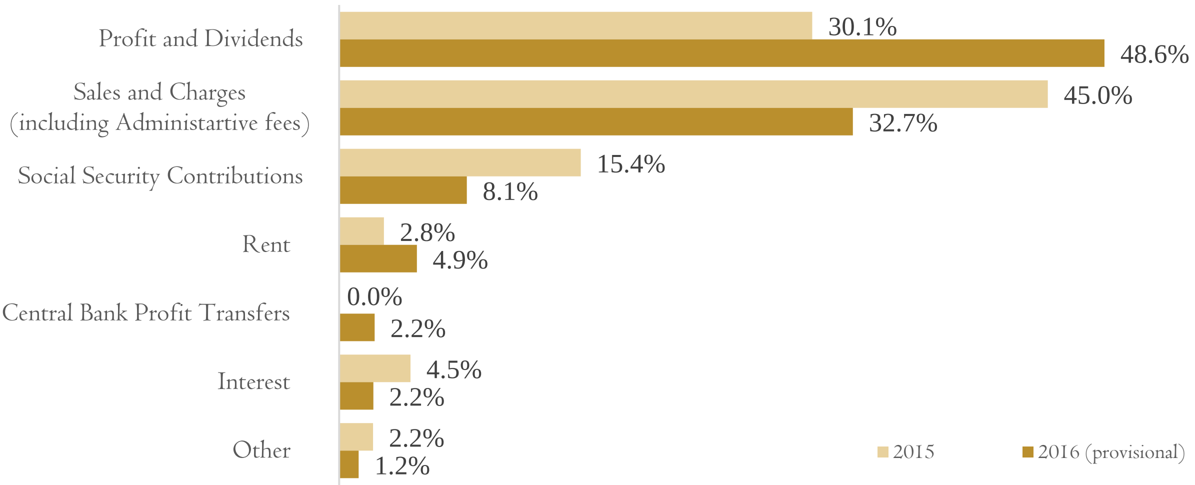


Source: EIU calculations based on Ministry of Finance data

Non-Tax Revenue Thrives On Depressed Oil prices and Profitable SOEs

The growth in non-tax revenues highlighted above were driven primarily by the revenue generated in two sub components - ‘profits and dividend transfers from state owned enterprises (SOEs)’ and ‘fees and charges’. Revenue collection from profit and dividend transfers of SOEs increased by LKR 78.4 Bn to LKR 108.2 LKR in 2016, supported by the improved performance of SOEs in banking sector, Ceylon Petroleum Corporation (CPC), Sri Lanka Insurance Corporation and Telecommunication Regulatory Commission (TRC).

Figure 3-Composition on Non-Tax Revenue



Source: EIU calculations based on Ministry of Finance data

Aided by depressed global oil prices the financial position of the CPC recovered favourably to record a LKR 69.6 Bn net profit (the net loss in 2015 accounted to LKR 19.4 Bn). Drought conditions in 2016 also increased demand for Diesel and Furnace Oil powered electricity generation, which also favourably impacted CPC’s profitability. The increase in CPC sales in 2016 also had a positive effect on tax revenue as CPC imports and sales are subject to multiple taxes such as VAT, NBT, Excise duty, income tax, import duty and PAL.

Meanwhile in the banking sector, profits and dividends paid by state banks increased by LKR 25 Bn in 2016, a YoY increase of 147%.The lending base and deposit base of state banks[2] grew by 14.8% and 19% respectively in 2016. State banks claimed a share of 49.7% of total deposit base and 44.7% of lending portfolio of the banking sector in 2016. The profitability of Sri Lanka Insurance Corporation (SLIC) also improved from LKR 3 Bn in 2015 to LKR 9.9 Bn by 2016. SLIC also made a dividend payment of LKR 11 Bn in 2016 compared to LKR 1 Bn paid in 2015. SLIC is the only issuer exempt from Insurance Board of Sri Lanka (IBSL) rules on separation of life and general business, and thus enjoys a significant special advantage.

[1]CPC’s petroleum import bill declined by 46.6% in 2016 compared to 2014 (from USD 3.1 Bn in 2014 to USD 1.7 Bn by 2016).

[2] Bank of Ceylon (BOC), People’s Bank (PB) and National Savings Bank (NSB) are the main state owned licensed commercial banks in Sri Lankan banking sector while the State Mortgage and Investment Bank (SMIB), Pradeshiya Sanwardena Bank (PSB), Lankaputra Development Bank (LDB), Sri Lanka Savings Bank (SLSB) and HDFC Bank (HDFC) are the other specialised licensed state banks.

In other non-tax items, revenue from 'administrative fees and charges' increased sharply by 59.6% (or LKR 19.2 Bn) and brought in a total of LKR 51.5 Bn. According to what the data shows, this increase was attained through the increase in revenue collected through sundries, embarkation levy, passport and visa fee in 2016. Interestingly, income generated through sundries[3] increased by nearly 250%. Although we attempted to explore the specific drivers of this increase, the Ministry of Finance was not able to provide this information.

Meanwhile, the fees of passports, visas and dual citizenship together with income from embarkation levy brought in additional LKR 8.2 Bn in revenue.

Direct – Indirect Tax Ratio No Closer to 60:40 Target

Although the Prime Minister's economic policy statement in November 2015 pledged to rebalance the indirect tax to direct tax ratio from 80%:20% to 60%:40% to ensure a more progressive tax system[4], our analysis of the tax revenue structure in the post 2015 period reveals that the actual revenue ratio is moving in the opposite direction. The indirect tax share in total tax revenue reached 82.6% in 2016, the highest share on record since 2010 (see Figure 04 and 05).

We are optimistic that the new Inland Revenue Bill will finally help rebalance this, and improve the direct tax share in Government revenue, with its cutting of exemptions and reducing concessionary taxes. Yet, the success is both hard to predict (as there is no precedent to the new Bill) and is likely to take a year or so to materialise.

Figure 4-Direct Taxes

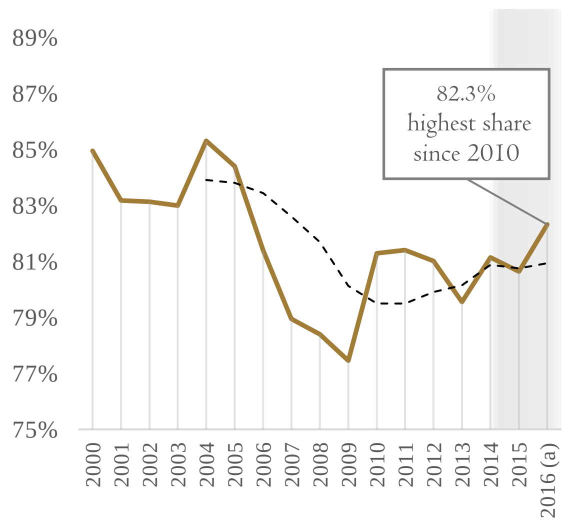
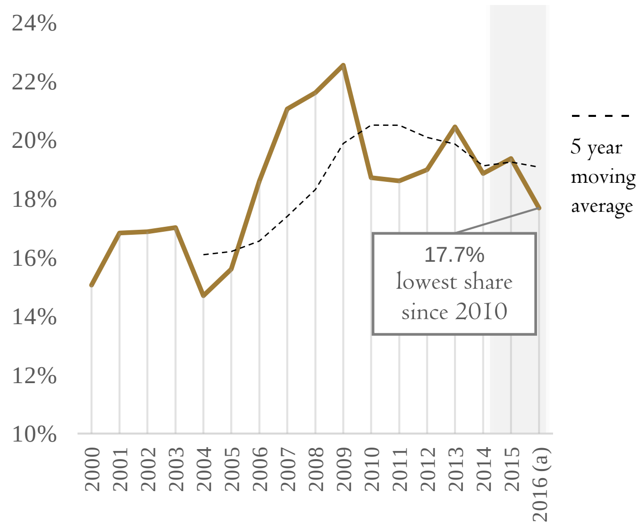


Figure 5-Indirect Taxes



Source: EIU calculations based on Ministry of Finance data

[3]Our attempts to obtain a specific clarification on what drives increase in income from sundries was not possible. According to the technical clarification provided by the Ministry of Finance, this is a sub category which falls under the main revenue code'2003.02.00 – Administrative charges and fees'. Sundries which is given the unique revenue code of 2003.02.99, includes revenue from administrative fees and charges collected from a total of 225 Government departments that cannot be allocated to any of the 21 sub-categories (from 2003.02.01 to 2003.02.21) of the main revenue code 2003.02.00 – Administrative charges and fees.

[4] Economic Policy Statement made by Hon Prime Minister, Ranil Wickremesinghe in Parliament on 5th November 2015 can be accessed at: http://www.pmoffice.gov.lk/download/press/D00000000009_EN.pdf?p=7

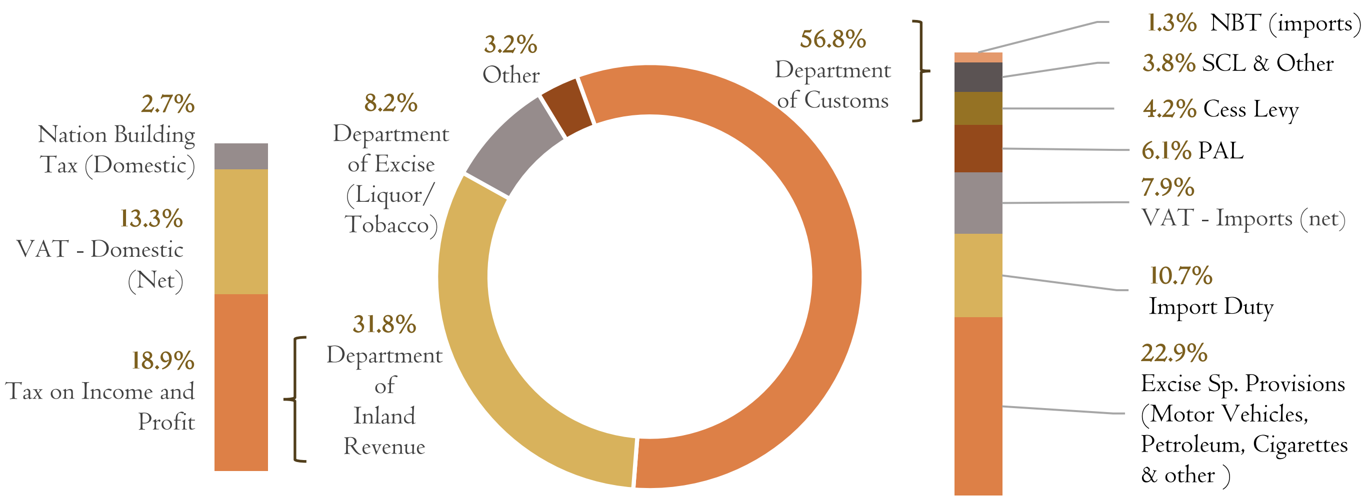
Which Tax Collector Collected The Most Revenue?

The Department of Customs collected the highest tax revenue in 2016, continuing the trend of previous years. Customs, which accounted for 56.8% of total tax revenue (refer Figure 06), saw its collection increase by LKR 43.4 Bn in 2016 - a marginal YoY increase of 5.5% compared to 36.9% the previous year. The sluggish growth was attributed to the fall in revenue from excise duty on motor vehicles.

The Department of Inland Revenue (IRD) was the second highest collector, with a one-third share of total tax revenue, and saw an increase of LKR 44.8 Bn (10.7% YoY growth) in 2016 aided by double digit growth in VAT and NBT on domestic consumption.

Meanwhile, the Excise Department increased its revenue by LKR 14.97 Bn in 2016, and grew its share of total collection from 6.6% in 2014 to 8.2% in 2016 as a result of the hike in duties on cigarettes and tobacco products.

Figure 6-Tax Revenue by Collector



Source: EIU calculations based on Ministry of Finance data

Consumers Contributed the Most Tax

Taxes on domestic consumption contributed 67% (refer Figure 08) of the increase in tax revenue in 2016 while its share in tax revenue increased from 25.6% in 2015 to 28.7% in 2016 (refer Figure 07). Although contribution of foreign trade taxes to increase in revenue saw a decline in 2016, it still accounted for more than 50% of total tax revenue

Figure 7-Composition of Tax Revenue

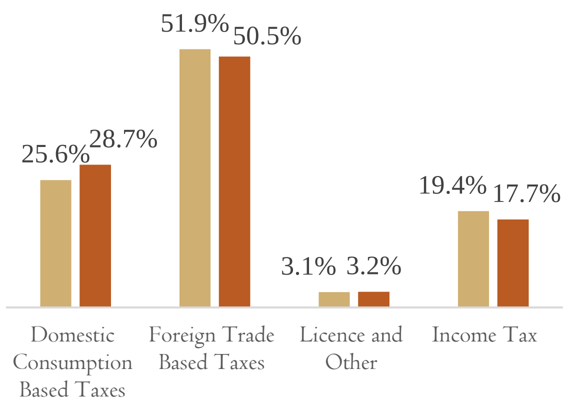
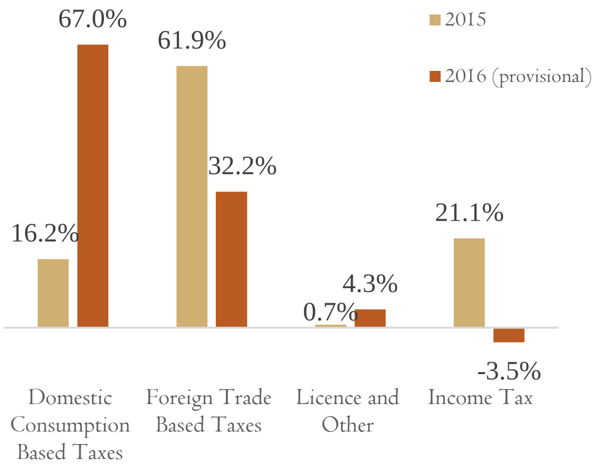


Figure 8-Contributors to Tax Revenue Growth

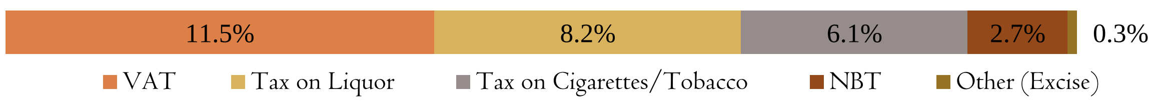


Source: EIU calculations based on Ministry of Finance data

Taxes on domestic consumption contributed to 67% of the overall growth in revenue in 2016. Strong YoY growth was recorded in VAT on domestic goods and services (28.8%), Nation Building Tax (NBT - 39.2%) and Excise Tax on alcohol and cigarettes/tobacco (12.8%) following the upward revision of rates and broadening of tax base though removal/lowering of exceptions on these taxes in 2016.

- Revenue from NBT from domestic consumption increased by LKR 10.9 Bn with the expansion of domestic consumption activities. Although the NBT rate remained unchanged at 2%, policy directives taken towards latter 2016 helped enhance NBT revenue in 2016[5].
- Taxes on liquor and cigarettes/tobacco increased by 14.3% and 12.8% respectively on YoY terms and contributed to an increase of revenue by LKR 23.7 Bn in 2016

Figure 9-Shares of Taxes on Domestic Consumption in Tax Revenue



Source: EIU calculations based on Ministry of Finance data

[5]This was a combined result of the lowering of threshold for registration for NBT (from LKR 3.75 Mn to LKR 3 Mn to LKR 3 million per quarter) and the removal of threshold applicable to restaurants, hotels, guesthouses, the processing of locally procured agricultural produce, educational services etc.

1 2 3 4 5 6 7 8 9 10 11

VAT Hike Drives Tax Revenue Growth

Revenue from VAT grew by 29% to LKR 283.5 Bn in 2016, achieving the highest VAT growth rate recorded in the last decade, subsequent to the amendments to VAT in 2016 (increasing the rate and removal of several exemptions)[6]. VAT became the single largest contributor to tax revenue growth last year and increased both as a % share of GDP (2% in 2015 to 2.4% 2016) and as a share in total tax revenue (16.2% in 2015 to 19.4% 2016). Although the amendments to VAT suffered some hiccups, resulting in substantial delays in implementation, VAT revenue in Q4 2016 saw a sharp increase of LKR 31.1 Bn growing at a rate of 54.2% compared to same period in 2015.

VAT from domestic sources as well as imports grew at double digit rates (28.8% and 29.3% respectively), The share of VAT on domestic sources which was on an increasing trend in the post 2011 period remained stable in 2015 and 2016, while VAT on imports grew at 37.8% to LKR 115.3 Bn and was the biggest contributor to VAT revenue last year in 2016. Three sources of domestic activities - manufacturing, financial services, and other services - collectively contributed to 54.3% of the revenue growth from VAT in 2016. With the 2016 amendments, VAT exemptions granted to sectors such as health services and telecommunication services were removed, reflected the higher collection in the 'other services' segment.

1 2 3 4 5 6 7 8 9 10 11

Excise Tax Collection Falls amidst Weak Vehicle Imports

Excise Tax, which is the single largest contributor to tax revenue, recorded a negative YoY growth of 8.6% for the first time since 2009, and is attributed to the significant fall in revenue generated by its major source, motor vehicle imports.

Revenue from excise taxes on motor vehicles contracted by one-third, equivalent to a dip in revenue of LKR 76.9 Bn. The introduction of a unit rate excise duty structure on motor vehicle imports in November 2015 increased the prices of motor vehicles significantly and this was followed by further tightening of the policy in 2016 with the imposition of a maximum loan to value ratio (LTV) on loans and leases to vehicles[7]. In response

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[6] The amendments to the VAT law resulted in an increase of the VAT rate from 11% to 15%, lowering of VAT threshold from LKR 15 Mn to LKR 12 Mn per annum, reduction of VAT liability for wholesale and retail trade to LKR 12.5 Mn. per quarter and removal of VAT exemptions granted to sectors such as health services, telecommunication services and cigarette and tobacco products contributed to this increase. In addition, the implementation of the Revenue Administration Management Information System (RAMIS) at the Inland Revenue Department (IRD) also helped enhance revenue through improved administration of VAT.

[7] A new leasing scheme for motor vehicles based on Loan to Value (LTV), which was proposed in the National Budget 2017 came into effect in January 2017. LTV ratio applicable under new Central bank Directions are; 25% for three wheelers, 50% for motor cars, sports utility vehicles (SUVs) and vans, 90% for commercial vehicles (lorries and heavy vehicles) and 70% for other vehicles

Banking Act directions provided by the Central Bank with respect to LTV is accessible at:
http://www.cbsl.gov.lk/pics_n_docs/09_lr/_docs/directions/bsd/BSD_2017/BankingActDirectionNo1of2017.pdf

to these policy decisions, motor vehicle imports declined significantly in 2016[8], a Y-o-Y decline of 41.5% in value Terms.

Import quantity across major vehicle categories contracted YoY in 2016 (see Table 01); motor cars (58.7%), three wheelers (64.1%), passenger van and buses (40.7%), and goods transport vehicles (27.1%)

Table 1- Motor Vehicle Imports-2015/2016

Category	No of units Imported		Decline in units imported (2015/2016)	
	2015	2016	No	%
Motor Cars	108,866	44,942	-63,924	-58.7%
Three-Wheelers	132,865	47,724	-85,141	-64.1%
Transport Vehicles	44,218	32,221	-11,997	-27.1%
Motor Bicycles	349,441	329,920	-19,521	-5.6%
Passenger Van and Buses	4,687	2,781	-1,906	-40.7%
Tractors	14,233	13,514	-719	-5.1%
Other	510	322	-188	-36.9%
Total	654,820	471,424	-183,396	-28.0%

Source: Ministry of Finance

1 2 3 4 5 6 7 8 9 10 11

Taxes on Foreign Trade Brought Half of Tax Revenue

Sri Lanka continues its heavy reliance on foreign trade taxes, and needs to become a critical focus area of trade policy reforms. Taxes on foreign trade[9] accounted for 50.5% of the tax revenue in 2016, marginally lower compared to the revenue share of 51.9% recorded in 2015 (refer Figure 07).

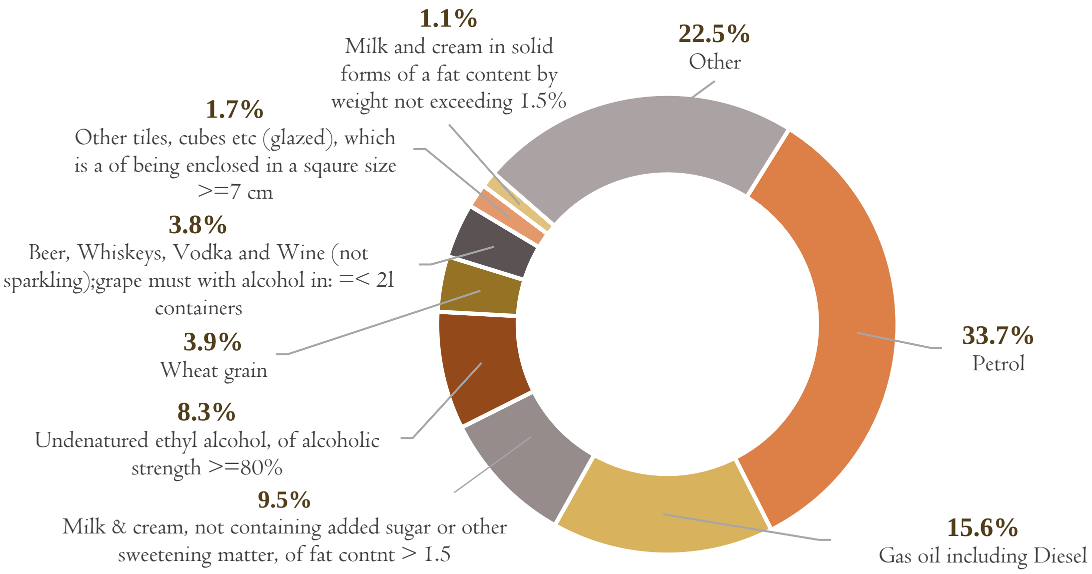
Revenue from import duties grew by 18.4% to LKR 156.5 Bn in 2016 supported by the significant increase in revenue from 02 major revenue categories, petrol and gas oil (including diesel). Petrol imports contributed to 85.8% of the increase in revenue from import duty in 2016; consequently playing a bigger role in total import duty revenues, from one-fourth in 2015 to one-third in 2016. Additionally, import duty from ‘gas oil (including diesel)’ grew by a sharp 155.6%, and doubled its share in import duty revenue from 7.2% in 2015 to 15.6% in 2016.

[8] Motor vehicle registrations also declined by 26.2% on YoY basis from 668,907 in 2015 to 493,328in 2016.

[9] In 2016 a three band tariff structure was also introduced to customs duty consisting of 0% (except duty), 15% and 30% with a view of achieving a simplified duty structure.

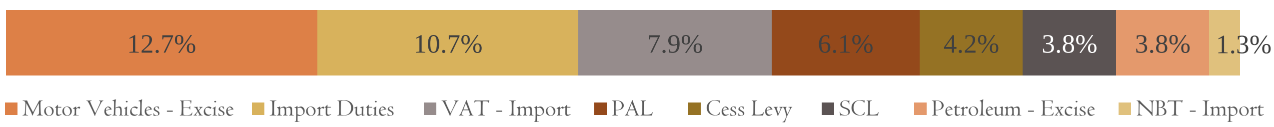
Interestingly, even within Sri Lanka's heavy reliance on foreign trade taxes there is a high concentration in a narrow number of tariff lines. Just eleven HS codes (at 6 digit level) contributed to 77.5%[10] of import duty revenues in 2016 (see Figure 10), and is a sharp rise from 50.3% a year earlier.
Value Added Tax (VAT) on imports rebounded from the negative growth of 34.1% recorded in 2015 and contributed to 24.3% of the growth in tax revenue in 2016. Meanwhile, revenue from Port and Airport Development Levy (PAL) increased by 51.5% to LKR 88.8 Bn, aided by the upward revision of the PAL rate from 5% to 7.5%[11].

Figure 10-Composition of Revenue from Import Duty-2016



Source: EIU calculations based on Ministry of Finance data

Figure 11-Share of Taxes on Foreign Trade in Tax Revenue



Source: EIU calculations based on Ministry of Finance data

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[10] Two products; petrol and gas oil including diesel (HS code 27101220: Petrol and HS code 27101940: Gas oil including Diesel) collectively brought an increased revenue of LKR 35.7 Bn in 2016. The share of these two products in import duty improved from 31.3% in 2015 to 49.2% in 2016.
Four products classified as beverages and spirits[1] accounted for 12.1% in 2016 compared to 6.4% share recorded in 2015. This increase was driven by the significant increase in import duty collected from import of beer which grew by 4351.4% YoY in 2016

[11]The standard PAL rate was revised to lower rate of 2.5% for certain plant and machinery used in construction, agriculture and dairy industry and raw material used in the pharmaceutical industry.

No More Super Gains in 2016

Taxes on net income and profits contracted by 3.5% on YoY basis to LKR 258.9 Bn in 2016. Yet, 2015 was an aberration due to the revenue from the 'Super Gains Tax' imposed by the Minister of Finance through the Interim Budget in February 2015. The absence of revenue from the one-off super gains tax[12] had a significant impact on the revenue generated by corporate income tax in 2016. Revenue from corporate income tax recorded a decline of LKR 17 Bn in 2016 (7.5% drop), with it share also falling from 53.1% in 2015 to 47.1% in 2016. However corporate income tax has increased by LKR 40.2 Bn in 2016 compared 2014.

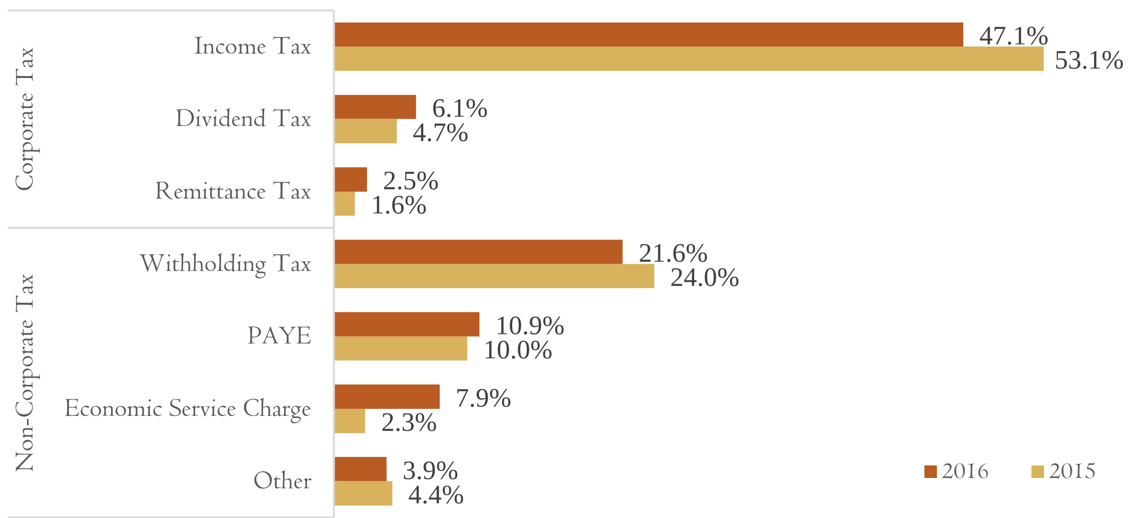
- Dividend tax and remittance taxes, the other two components of corporate tax grew by 28.9% and 54.6% in 2016 (YoY terms) and collectively brought an additional revenue of LKR 5.8 Bn in 2016.

- Revenue from non-corporate income tax grew by 7.5% to LKR 114.7 Bn in 2016 aided by the sharp increase in revenue from Economic Service Charge (ESC) while the revenue from withholding tax on interest income negatively affected the revenue growth in this category.
    - Revenue from PAYE tax increased by LKR 2 Bn (7.5% YoY increase) to LKR 28.2 Bn in 2016.

    - Revenue from ESC recorded a significant YoY increase of 232.8% to LKR 20.5 Bn in 2016 as a result of the upward revision of the ESC rate to 0.5% from 0.25% and the removal of the maximum ESC liability of LKR 20 Mn per year plus removal of exemption of profit-making businesses.

    - Revenue from withholding tax contracted by 23.3% YoY to LKR 55.9 Bn in 2016, largely attributed to the fall in the volume of issuance of Government Securities.

Figure 11-Share of Taxes on Foreign Trade in Tax Revenue



Source: EIU calculations based on Ministry of Finance data

[12] The super gains tax generated a one-off revenue of LKR 49.8 Bn revenue in 2015.

Analysis on 2017 Outlook

The revenue performamance and the devlopments in the tax environment point to four revenue drivers to watch during 2017

01. **The revenue collection from VAT increased by LKR 72.7 Bn during January to April 2017, a significant YoY growth of 90.9% compared to same period in 2016, as a result of the increased VAT rate and removal of some VAT exemptions in late 2016.**
    VAT revenue exceeded the estimated revenue target for first four months by LKR 27.6 Bn and accounted for 40.2% of the 2017 annual VAT revenue estimate. This is a significant improvement compared to the level of 28.2% recorded in 2016 (see Table 02). VAT revenue performance hints that it is a potential source for bringing more than the forecasted level of one fifth of tax revenue for 2017. VAT amendments, the implementation of RAMIS automation, and further measures to improve compliance can further boost revenue from of VAT in 2017.

02. **Excise revenue is likely to remain week with the subdued demand for motor vehicle imports and high duty rates on alcohol and tobacco products.**
    Excise revenue grew by 4.9% YoY, an increase of LKR 7.3 Bn during first four months of 2017. This accounted for 26.9% of the 2017 annual excise revenue estimate, much lower compared to the level of 32.6% recorded in 2016. Excise revenue during first four months was largely impacted by the LKR 47.7 Bn fall in excise tax collections from liquor, cigarettes and tobacco due to the prevailing high duty structure.
    Motor vehicles accounted for 41% of total excise revenue but indicated a weak YoY growth of 7.7% despite the low base effect. Number of Import units of major motor vehicle categories such as motor cars, three wheelers and goods transport vehicles contracted for the second continuous year during first four months of 2017. All though there has been a surge in motor bike imports and a marginal increase in Passenger Vehicle imports, it is unlikely to provide the expected level contribution to revenue with excise revenue from motor vehicles and other category falling behind revenue estimate by LKR 6.2 Bn during the first four months.

03. **Earnings from non-tax revenue in QI 2017 accounted for 16.4% of the projected annual revenue for 2017.**
    This is a marginal improvement from the share of 14.2% recorded in 2016. However, it is important to note that non-tax revenue in 2016 was largely dependent on revenue from CPC and therefore remains vulnerable to external shocks that could arise from increased oil prices. Although volatility in the Middle East market remains a major concern, other factors on the supply side such as high inventory levels and production of oil as well as US senate's vote for imposing new sanctions on Russia are likely contribute to depressed oil prices during the second half of 2017. Hydropower generation in QI 2017 was the lowest compared to QI of the past three years, while CEB Coal and CEB Thermal Oil generation were at their highest levels. This is expected to give a boost to CPC sales in 2017 and increase its contribution to revenue, despite the negative consequences the prevailing drought could have on overall economic activity.

04. **Performance of income tax revenue improves and the proposed IR bill is expected to give a further boost to revenue.**

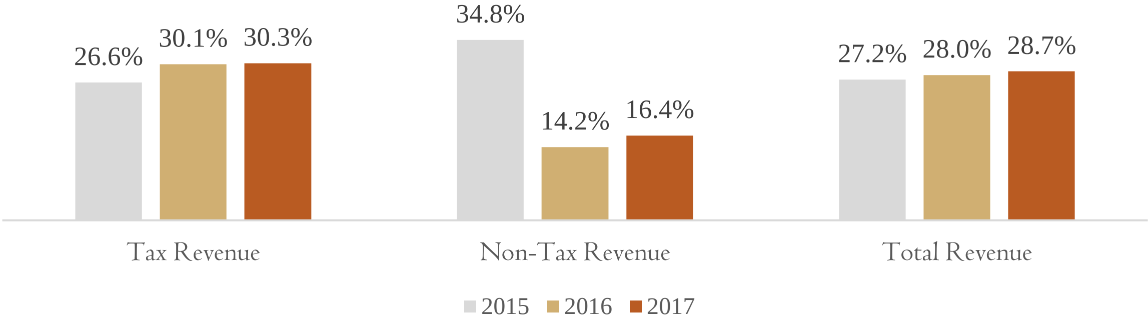
Revenue from income tax increased by LKR 19.6 Bn during first four months of 2017 aided by a substantial increase of LKR 16.3 in ESC revenue, following the upward revision of the ESC rate, removal of exemptions and the maximum ESC liability rate in 2016. The proposed Inland Revenue bill is expected to go through committee stage amendments in Parliament and be passed during August 2017. Income tax related proposal of National budget 2017[13] are expected to be implemented along with the new Inland Revenue bill. The provisions of the IR Bill such as introduction of a three-tier income tax structure for companies, removal of exemption on various direct tax sources, and re-introduction of Capital Gains Tax, etc., has the ability to bring a substantial direct tax revenue to the Government. However the realisation of revenue will be dependent on the date from which the bill is made effective. If, as is indicated now, the Act will come into force from 1 October, the results will be seen by Q4 2017 itself. More broadly, the Government expects these reforms to provide a significant boost to the revenue generated via direct tax sources, an important step towards achieving Government's policy of a more balanced tax regime of 60% from indirect taxes and 40% from direct taxes.

Table 2- First 4 Months Revenue as a share of Annual Revenue

Revenue Source	2015	2016	2017
Tax Revenue	26.60%	30.14%	30.34%
Income tax	21.21%	25.06%	25.25%
VAT	32.79%	28.19%	40.15%
Excise Duty	25.84%	32.63%	26.89%
Import Duty	21.07%	30.96%	28.64%
Non-Tax Revenue	34.81%	14.16%	16.38%
Total Revenue	27.16%	28.04%	28.75%

Source: EIU calculations based on Ministry of Finance data

Figure 13-Government Revenue in First 4 Months as a share of Annual Revenue



Source: EIU calculations based on Ministry of Finance data

[13] On income taxes, National Budget 2017 proposed amendments such as, a single corporate income tax rate of 17.5%, a rate of 28% on banking and financial services and a higher tax rate of 40% for liquor, tobacco, lottery etc. These proposals are to be implemented with the enactment of the IR bill.

Perspectives from the Ceylon Chamber's Taxation Steering Committee*

Positives

Members of the Taxation Steering Committee indicated that with the enactment of the new IR Bill, the tax base would broaden, and direct tax collections are likely to improve with the limiting of exemptions and incentives and streamlining of taxe rates to 3 bands. Overall, revenue collection from VAT and NBT would continue to increase as a result of revisions to rates as well as removal of certain exemptions/lowering of tax liable threshold. Reintroduction of the capital gains tax will have a positive outcome on direct taxes. However capital gain triggers need to be revisited to ensure the expected outcome is achieved. Furthermore, the Government's commitment to not implement legislation on a retrospective basis would enhance the confidence in the taxation system.

Concerns

Members of the Committee observed that although the new IR Bill is coming in, tax administration will continue to be a bottleneck, and the continued undue focus on a handful of taxpayers. Members also noted that while Government's initiative to automate the tax system (RAMIS) is laudable, it might not provide the desired results right away. On tax policy, they acknowledged that it is likely to be influenced by populist demands and political pressures in the year ahead. Meanwhile, continued uncertainty with regards changes to tax legislation and the difficulty in understanding the impact of such changes is likely to have an adverse impact on overall business activity and investor confidence, particularly if tax changes are not subject to a robust consultative process with the taxpayer community.

*Members of the Ceylon Chamber of Commerce Taxation Steering Committee are drawn from tax advisory firms, large conglomerates, banks, and trade associations and collectively have substantial tax expertise. They are the lead group that guides the Chamber's engagement with Government on tax policy and administration issues.

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