SRI LANKA DEVELOPMENT UPDATE

MOBILIZING TAX REVENUE FOR A BRIGHTER FUTURE

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Preface

The Sri Lanka Development Update (SLDU) has two main aims. First, it reports on key developments over the past 12 months in Sri Lanka's economy, places these in longer term and global contexts, and updates the outlook for Sri Lanka's economy. Second, the SLDU provides a more in-depth examination of selected economic and policy issues. It is intended for a wide audience, including policymakers, business leaders, financial market participants, think tanks, non-governmental organizations and the community of analysts and professionals interested in Sri Lanka's evolving economy.

The SLDU was prepared by a team consisting of Richard Walker, Kishan Abeygunawardana (Senior Economists, Macroeconomics, Public Sector, Trade and Investment (MPSTI), and Shruti Lakhtakia (Economist, MPSTI) with inputs from Rajiv Kumar and Sebastian James (Senior Economists, Global Tax Unit), Karina Baba (Senior Financial Sector Specialist, Finance, Competitiveness & Innovation (FCI)), Tatsiana Kliatskova (Financial Sector Economist, FCI), Amila Dahanayake (Economist, FCI), Zoe Leiyu Xie (Senior Economist, South Asia Regional Chief Economist's Office), Nandini Krishnan (Lead Economist, Poverty), Jon Jellema (Senior Economist, Poverty), Marta Schoch (Economist, Poverty), Arvind Nair (Senior Economist, MPSTI), Indira Iyer (Consultant, MPSTI), and Joao Morgado (Economist, MPSTI). The team thanks Mathew Verghis (Regional Director, Equitable Growth, Finance and Institutions (EFI), South Asia Region), Faris Hadad-Zervos (Country Director for Maldives, Nepal and Sri Lanka), Chiyo Kanda (Country Manager, Maldives and Sri Lanka), Shabih Ali Mohib (Practice Manager, MPSTI), Ximena del Carpio (Practice Manager, Poverty) and Peter Mousley (Lead Economist and Program Leader, FCI) for their guidance and comments on the report. Sashikala Jeyaraj provided administration support and was responsible for the layout, design, and typesetting. Dilinika Peiris, Buddhi Feelixge, and Samitha Senadheera led dissemination efforts. For questions, please contact: infosrilanka@worldbank.org

The report was prepared based on published data available on or before September 15, 2023. Data sources include the World Bank, Ministry of Finance, Central Bank of Sri Lanka, Department of Census and Statistics, and press reports.

This report, additional material and previous reports can be found at:

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Abbreviations

BoI	Board of Investment
CAR	Capital Adequacy Ratio
CBSL	Central Bank of Sri Lanka
CCPI	Colombo Consumer Price Index
CEB	Ceylon Electricity Board
CIT	Corporate Income Tax
CPC	Ceylon Petroleum Corporation
CPI	Consumer Price Index
CRM	Compliance Risk Management
DDO	Domestic Debt Optimization
EFF	Extended Fund Facility
EMDEs	Emerging Markets and Developing Economies
FCBU	Foreign Currency Banking Unit
Fx	Foreign exchange
GDP	Gross Domestic Product
GFN	Gross Financing Needs
IMF	International Monetary Fund
IT	Information Technology
IRD	Inland Revenue Department
ISBs	International Sovereign Bonds
LKR	Sri Lanka Rupee
MoF	Ministry of Finance
NCPI	National Consumer Price Index
NIC	National Identity Card
PAL	Ports and Airports Development Levy
PAYE	Pay-As-You-Earn
PIT	Personal Income Tax
PPG	Public and Publicly Guaranteed
RAMIS	Revenue Administration Management Information System
ROA	Return on Assets
SCL	Special Commodity Levy
SDP	Strategic Development Projects
SLA	Sri Lankan Airlines
SLDBs	Sri Lanka Development Bonds
SLDU	Sri Lanka Development Update
SOEs	State-Owned Enterprises
TIN	Taxpayer Identification Number
VAT	Value Added Tax
y-o-y	Year-on-year

Table of Contents

LIST OF FIGURES

LIST OF BOXES

LIST OF TABLES

Executive Summary

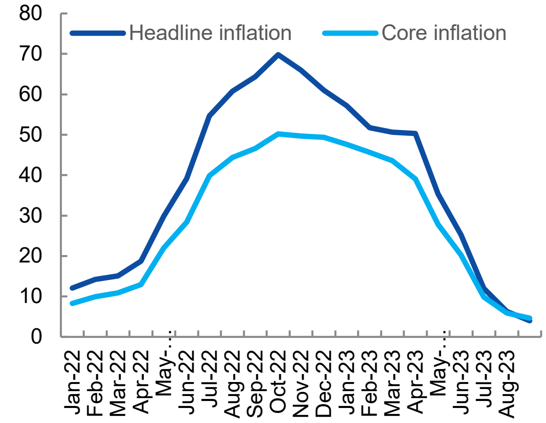
Despite initial signs of stabilization in the first half of 2023, the macroeconomic outlook remains uncertain, contingent on successful debt restructuring and structural reforms.

Sri Lanka's longstanding structural weaknesses plunged the country into a severe economic crisis in 2022. Fiscal indiscipline (linked to low revenue collection) led to high fiscal deficits which, together with risky commercial borrowing, elevated Sri Lanka's debt to unsustainable levels (public and publicly guaranteed debt reached 118.7 percent of GDP in 2022). With official reserves dropping to one week of imports, Sri Lanka announced an external debt service suspension in April 2022, pending debt restructuring. The foreign exchange liquidity constraint caused shortages of fuel, medicine, cooking gas, and other inputs needed for economic activity. The economy contracted by 7.8 percent in 2022 and poverty doubled from 13.1 in 2021 to 25 percent. Inflation peaked at 69.8 percent in September 2022 and the currency depreciated by 81 percent during the year. Faced with falling real incomes, many households turned to negative coping mechanisms, which have likely deteriorated human capital outcomes and already increased food insecurity, malnutrition, and stunting.

The economy has shown initial signs of stabilization, albeit at a low-level equilibrium, in the first half of 2023. Several critical reforms (cost reflective utility pricing, new revenue measures, a floating currency, and monetary tightening and phasing out of monetary financing) helped stabilize the economy. Inflation came back to single digit levels in July 2023 for the first time in 19 months. An improved trade balance, a promising recovery in tourism and remittances, the continuing external debt service suspension, and inflows from development partners helped build usable official reserves to about 5 to 6 weeks of imports (or US$2.4 billion by end-July 2023, compared to US$500 million in December 2022). The primary deficit declined in the first four months of 2023 compared to the same period in 2022; although a sharp rise in interest payments led to a high overall deficit. On the other hand, the macroeconomic adjustment and subdued demand contributed to a contraction of real GDP by 7.9 percent (y-o-y) in the first half of 2023, while external trade remained subdued (Figure 1and Figure 2).

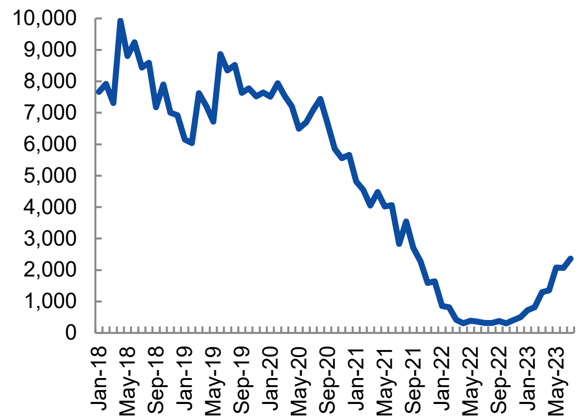
Swift and sufficiently deep debt restructuring is needed to restore Sri Lanka's debt sustainability and regain access to international financial markets. The IMF's Extended Fund Facility (EFF) program, approved in March 2023, sets targets (debt level, gross financing requirement, and external debt service threshold) to restore debt sustainability. The official debt restructuring discussions are continuing, with France, India, and Japan as co-chairs, and China as an observer. The authorities are also expected to reach an agreement with external private creditors on comparable terms. The government is implementing a domestic debt optimization strategy aimed at reducing annual gross financing needs by 1.5 percent of GDP in 2027–2032, on average. The financial sector-held securities issued under domestic law are excluded from domestic debt restructuring to mitigate risks to financial sector stability.

Figure 1: Inflation trends
(Percent)



Sources: Department of Census and Statistics, and staff calculations

Figure 2: Usable official reserves
(US$ million)



Source: Central Bank of Sri Lanka, and staff calculations

The outlook is clouded by significant uncertainty. Growth prospects depend on progress with debt restructuring and the implementation of growth-enhancing structural reforms. Inflation is projected to stay in single digits amid weak demand, as monetization of fiscal deficits wanes. Further monetary loosening and exchange rate pressures could counter this trend. Poverty is projected to increase in 2023 before declining over the medium term, in line with the slow recovery. Despite the removal of import restrictions, the current account deficit will narrow further in 2023 due to continued liquidity constraints and remain benign thereafter with the recovery in tourism and remittances. The primary deficit is expected to decline in 2023, although the overall balance will continue to be high due to the large interest bill. Debt restructuring and revenue-based fiscal consolidation are projected to reduce the overall balance in the medium term.

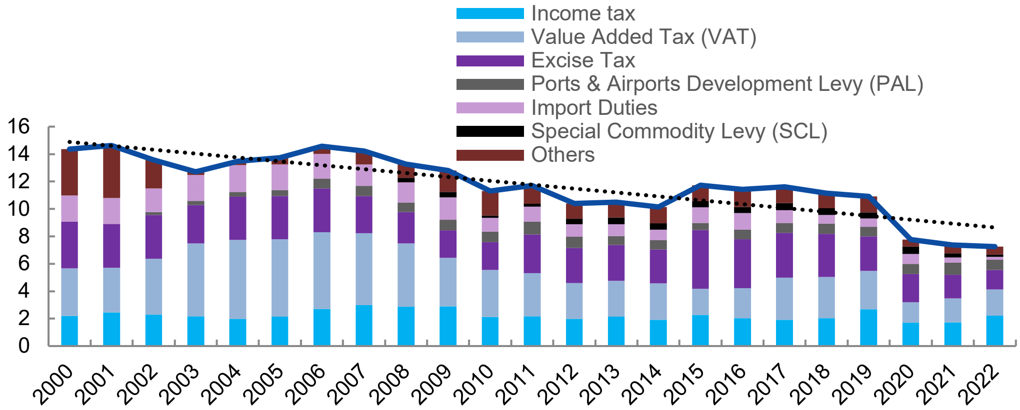
Downside risks remain very high, given a narrow path to recovery and limited buffers. A prolonged or insufficiently deep external debt restructuring, a deterioration in the political situation (including a backlash to the reforms), inadequate domestic revenue mobilization, limited external financing support, a sharper global slowdown, and a prolonged recovery from the scarring effects of the crisis are key risks to restoring stability, regaining a sustainable growth path, and bringing Sri Lanka back to pre-crisis rates of poverty. The financial sector needs continuous monitoring, given high exposures to the public sector, rising non-performing assets, and tight liquidity conditions. While the adjustment process may provoke resistance, and backlash from affected groups, it is essential for the country to stay the course on reforms, carefully navigate political and social pressures, and effectively mitigate the impact of the reforms on the most poor and vulnerable.

Improved revenue mobilization performance is a binding constraint to Sri Lanka's return to macroeconomic stability.

Sri Lanka has one of the lowest tax-to-GDP ratios in the world due to poorly designed tax policy and chronic tax administration challenges (Figure 3). By 2022, the tax system was characterized by low, multiple, and frequently changing tax rates, a narrow and shrinking base, a disproportionate tax burden on labor rather than capital income, overreliance on indirect taxes, and low levels of compliance. These shortcomings have resulted in an excessively complex tax system and have undermined its fairness.

These structural issues, compounded by untimely tax cuts in 2019 and other exogenous shocks, led to the lowest recorded tax-to-GDP ratio in Sri Lanka at 7.3 percent in 2022. This precipitous decline played a significant role in the ongoing economic crisis. In response, the government initiated a series of tax reforms during 2022–23 to enhance domestic revenue mobilization and strengthen the tax system. This tax reform package, under implementation since May 2022, included the introduction of new taxes, a wide range of adjustments to the tax rates and bases, and an intention to improve revenue administration by improving collection efficiency and increasing compliance (Table 1).

Figure 3: Composition of tax revenue as a share of GDP
(Percent)



Sources: Ministry of Finance, and staff calculations

Table 1: Post-crisis major tax reforms

Tax type	Major Reforms
VAT	• Registration threshold lowered from LKR 300 million to 80 million • Standard VAT rate raised from 8 to 15 percent
CIT	• Standard rate raised from 24 to 30 percent for all sectors • Concessionary rates of 14 and 18 percent removed • Exemption to information technology sector removed • Exemption on dividend paid by companies to non-resident persons removed • Several tax exemptions removed
PIT	• Tax free allowance lowered from LKR 3 million to 1.2 million • Maximum marginal rate increased from 18 to 36 percent
Others	• Social security contribution levy, and tax on imports liable to VAT (2.5 percent of import value for importers with annual imports of more than LKR 120 million) • Capital gains tax increased to 30 percent for corporates from October 1, 2022

Sources: Inland Revenue Department, and Ministry of Finance

While the measures already introduced in 2022–23 have led to higher revenues, further reforms are needed to ensure that the tax system is efficient, sustainable, and equitable. Over January–April 2023 (y-o-y), nominal tax revenue collection increased by 36.6 percent driven by both the 2022 reform package and higher inflation. Nevertheless, revenue collection in the first four months of 2023 remains significantly below the approved budget.

On the tax policy front, the government should introduce a minimum corporate tax to guarantee that companies pay a minimum effective tax rate. Additionally, capital taxation should be strengthened through progressive rates on capital income, revamping property taxation based on current market values of properties, and introducing wealth, gift, and inheritance taxes. Tax expenditures should also be rationalized and made more transparent through a comprehensive review of tax incentives and the regular publication of tax expenditure statements.

The effective implementation of the Tax Administration Modernization Strategy will be essential to ensure that these tax policy reforms translate into a sustained increase in revenue collection. Core priorities should include the promotion of e-filing, the utilization of third-party information to strengthen compliance risk management, streamlining dispute resolution, and the recovery of taxes in default. Furthermore, better taxpayer segmentation is crucial for an improved targeting of large and high-net-worth individuals and to bolster the administration's capacity to deal with the complexity of these cases. Maximizing the impact of the reforms on the efficiency of tax administration will require investments to strengthen the information technology (IT) infrastructure which will serve as foundation to each of these interventions.

A. Macroeconomic Developments

1. Context

Sri Lanka faced a severe and unprecedented macroeconomic crisis in 2022, resulting from weak governance and poor fiscal and monetary policy choices. Following the announcement of the external debt suspension in April 2022, the government has entered an IMF program and is undertaking reforms to regain macroeconomic stability.

1. **Sri Lanka's longstanding structural weaknesses plunged the country into a severe economic crisis, leading to a default on its external debt in April 2022.** While the economy grew rapidly after the end of the civil war in 2009, signs of structural weakness had begun to emerge, and were amplified by multiple economic shocks in the last five years. Poor governance, a restrictive trade regime, a weak investment climate, episodes of loose monetary policy, and an administered exchange rate contributed to macroeconomic imbalances. Fiscal indiscipline and low government revenue mobilization led to high fiscal deficits and large gross financing needs (GFN); risky commercial borrowing elevated debt vulnerabilities. Ill-timed tax cuts in 2019 further eroded weak fiscal buffers and led to a rapid growth in debt to unsustainable levels. As Sri Lanka lost access to international financial markets in 2020 and usable official reserves dropped precipitously – declining from US$7.6 billion in 2019 to less than US$400 million[1] in April 2022 – the country announced an external debt service suspension, pending debt restructuring.

2. **The impact of the economic crisis was severe and unprecedented.** Real Gross Domestic Product (GDP) contracted by 7.8 percent in 2022. The forex liquidity constraint led to severe shortages of essential goods including fuel, medicine, cooking gas, fertilizer, and other inputs needed for economic activity. Fuel shortages subsided thanks to a QR code-based digital rationing system implemented in August 2022. Unprecedentedly high inflation adversely affected real incomes, food security, and living standards. Usable official reserves remained precariously low at less than two weeks of imports of goods and services in December 2022. The crisis is estimated to have doubled the poverty rate, from 13.1 percent in 2021 to 25.0 percent in 2022 (using US$3.65 per capita, 2017 purchasing power parity). Vulnerability to income shocks also increased with the number of households that were marginally above the poverty line expanding between 2020 and 2022.

[1] Excluding a currency swap equivalent to US$1.4 billion with China.

3. **The government is implementing important structural reforms to regain macroeconomic stability and a sustainable growth path**, including cost-reflective utility pricing, State-Owned Enterprises (SOEs) reforms, improved fiscal oversight and debt management, and enhanced competitiveness through better integration into global value chains. Key legislations on monetary policy, debt and public financial management, trade and investment, and fiscal oversight and anti-corruption are being enacted. Domestic debt restructuring is expected to reduce annual GFN by 1.5 percent of GDP in 2027–2032, on average. The government is engaging with official and private creditors on external debt restructuring. With national elections expected in 2024, socio-political challenges remain elevated, due to the hardship caused by the crisis and the necessary macroeconomic adjustment.

4. **In March 2023, the IMF Executive Board approved a 48-month Extended Fund Facility (EFF) of approximately US$3 billion to support the government's reform program.** This followed a Staff-Level Agreement reached between the IMF staff and Sri Lankan authorities in September 2022, and financing assurances from all major official creditors. The disbursement of the first tranche of US$330 million under the IMF EFF was soon followed by budget support from other international development partners, including the World Bank and the Asian Development Bank.

2. Recent Economic Developments

The economy faced a severe contraction in 2022, leading to income and job losses. While there have been initial signs of stabilization – albeit at a low-level equilibrium with moderating inflation, easing foreign exchange liquidity pressures, and some progress in debt restructuring – fiscal and external buffers remain very limited and could threaten macroeconomic stability.

Weak industrial activity continued to drive the contraction.

5. **The sharp economic contraction continued into 2023**. Following the 7.8 percent contraction in real GDP in 2022, real GDP declined by 7.9 percent in the first half of 2023 (1H2023) compared to 1H2022. Industrial activity declined by 18.3 percent in 1H2023, due to contractions in construction, and manufacturing, which were affected by shrinking private credit, shortages of inputs, and supply chain disruptions. The overall contraction in the services sector (3.2 percent, y-o-y) in 1H2023 was driven by large contractions in financial services, insurance, and real estate. This contraction in 1H2023 was partially offset by growth in transportation and accommodation, food and beverage services due to the revival in the tourism sector, declining fuel shortages, and improved foreign exchange liquidity. As the fertilizer shortage eased, and the climate was relatively benign, agriculture grew by 2.2 percent in 1H2023 (Figure 4, Table 2).

6. **Several high-frequency indicators continue to show weak economic activity.** Total cement consumption (both locally produced and imported) declined by 32.5 percent (y-o-y) January–July 2023, reflecting the deep contraction in the construction sector. Electricity sales to industries also declined by 5.9 percent (y-o-y) in January to July 2023 as industrial output, including textiles, continued to shrink. Reflecting these continued challenges in industry, the Index of Industrial Production remained weak in in the first seven months of 2023 (Figure 5). The Manufacturing Purchasing Managers Index also remained lackluster due to a shortage of new orders and overall weak demand. In contrast, the Services Purchases Managers Index improved because of improvements in accommodation and personal services, reflecting a rebound in tourism.

Table 2: Real GDP growth in 1H2023

LKR million	2022	2023	Growth (percent)	Contribution to growth (percentage points)
Agriculture	444,471	454,251	2.2	0.2
Construction	555,101	379,559	(31.6)	(2.8)
Manufacturing	1,057,424	948,195	(10.3)	(1.8)
Other industrial activities	239,068	184,522	(22.8)	(0.9)
Transport	661,176	686,566	3.8	0.4
Financial services	302,360	221,744	(26.7)	(1.3)
Real estate	295,187	260,286	(11.8)	(0.6)
Accomodation and food and beverages	84,125	96,620	14.9	0.2
Other services	2,247,296	2,211,100	(1.6)	(0.6)
Taxes less subsidies	313,266	268,784	(14.2)	(0.7)
Overall growth	**6,199,474**	**5,711,627**	**(7.9)**	**(7.9)**

Source: Department of Census and Statistics, and staff calculations

Figure 4: Contributors to growth (production side)

(Percent/percentage points)

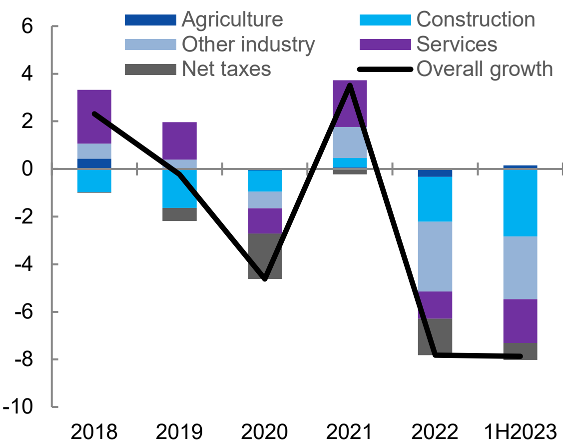
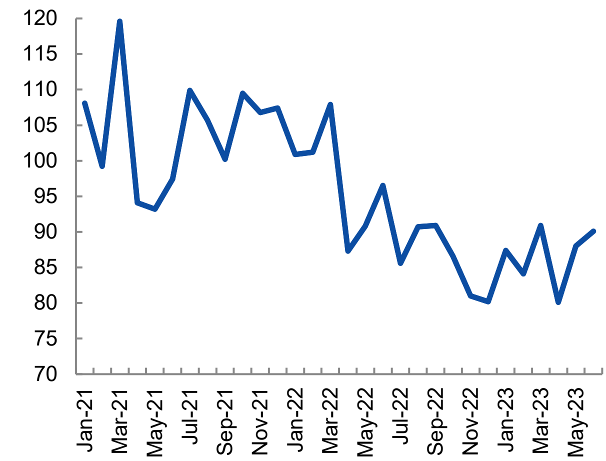


Figure 5: Index of Industrial Production (2015=100)

(Index)



Source: Department of Census and Statistics, and staff calculations

Box 1: Global Economic landscape continues to be challenging

Global economic growth is projected to slow further in 2023 and to stabilize in 2024. In the short term, most countries are grappling with continued high inflation and the effects of monetary policy tightening. Global trade and industrial activity remain subdued.

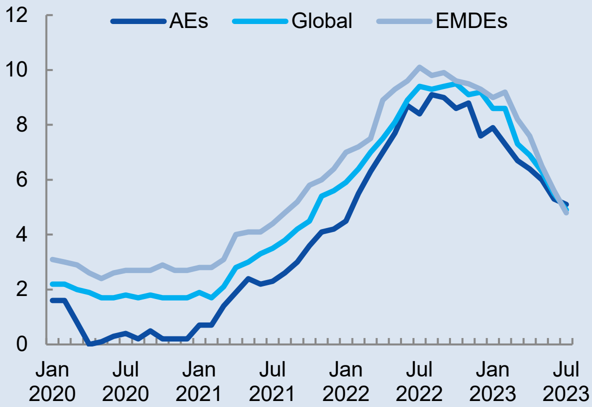
In the United States, there has been an extended period of robust expansion since late 2020, with rapid employment growth and low unemployment, but this is now slowing as excess savings accumulated during the pandemic have largely been spent and demand is decelerating. Credit conditions have tightened along with monetary policy and following the banking sector turmoil earlier this year. The euro area continues to struggle with above-target inflation and is expected to face a steep slowdown in growth. Confidence indicators point to persistent weakness and an increased risk of recession in the next few quarters. In China, the rebound following the post-pandemic economic re-opening appears to have faded. Continued fragilities in the property sector are having widespread spillovers to the rest of the economy, contributing to the emergence of deflation in recent months. Consumer spending has been relatively buoyant this year, but this has been offset by weakness in exports and investment. The government has thus far avoided implementing broad stimulus measures in favor of allowing the overheated real estate sector to cool.

Global inflation is decelerating. The same is true of the pace of policy rate increases by central banks, and the hiking cycle in many major economies appears to be close to peaking. Financial conditions remain tight, as reflected by elevated borrowing costs and tight credit standards. Most EMDEs are weathering this period of financial tightness without severe strain, but several countries in South Asia are exceptions and have struggled with balance of payments difficulties. High interest rates will continue to put pressure on their fiscal positions as debt taken on at low rates is rolled over. Net capital inflows have been low but positive, and bond issuance has rebounded after a severe contraction last year (Figure 6).

Risks to the outlook are predominantly to the downside, with the most pressing concerns related to financial and fiscal stress. Many countries in South Asia have drawn on international assistance to weather the global shock of higher commodity prices and borrowing costs, and to stem substantial capital outflows and currency depreciation. The region's persistent trade deficits – which have averaged 4 percent of GDP since 2015 – require financing by capital inflows that make the region vulnerable to adverse shifts in market sentiment. This vulnerability is particularly high in countries with very limited external buffers, such as Sri Lanka.

Figure 6: Global Inflation

(Percent)



Source: Source: Haver Analytics, World Bank.
Note: AEs = advanced economies; EMDEs = emerging market and developing economies. Median CPI is used. Sample includes 35 AEs and 101 EMDEs. Last observation is June 2023

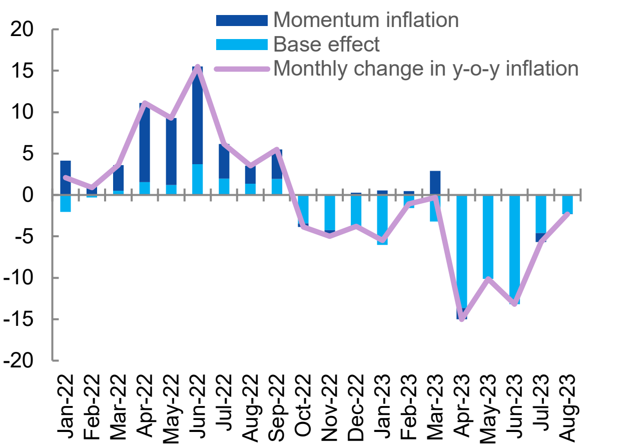
Source: South Asia Development Update, October 2023

Inflation has moderated from a high base.

7. **After peaking at 69.8 percent (y-o-y) in September 2022, headline inflation measured by the Colombo Consumer Price Index (CCPI) began to moderate.** It reached single digit levels in July 2023 (6.3 percent, y-o-y) for the first time in 19 months and further decelerated to 4 percent in August 2023. The reduction in inflation primarily reflects the favorable impact of the base effect and has also benefitted from the phasing out of monetary financing, tighter monetary and fiscal policies, easing of supply-side disruptions, the moderation of global commodity prices, and appreciation of the LKR. Core inflation (computed excluding food and energy prices) fell to 4.6 percent (y-o-y) in August 2023, driven by subdued demand conditions. The National Consumer Price Index (NCPI) shows a similar trend to the CCPI (Figure 7 and Figure 8).

Figure 7: Decomposition of change in inflation

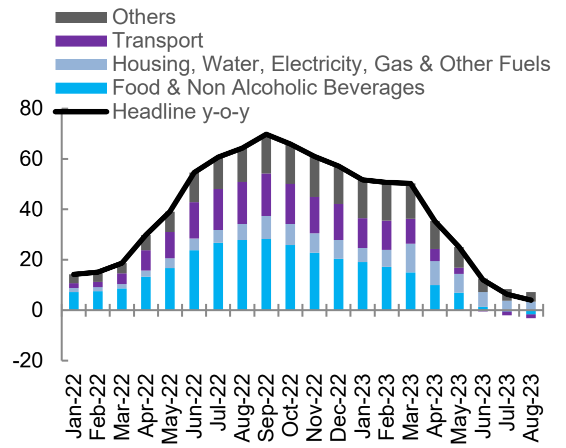
(Percent/percentage points, y-o-y)



Source: Central Bank of Sri Lanka, Department of Census and Statistics, and staff calculations
Note: Monthly change in y-o-y inflation in a given month is approximately equal to m-o-m inflation in that month (momentum inflation) and the base effect.

Figure 8: Contributors to headline inflation

(Percent/percentage points, y-o-y)



Source: Department of Census and Statistics, and staff calculations

8. **Slowing inflation allowed the Central Bank of Sri Lanka (CBSL) to loosen monetary policy.** After raising policy rates by a cumulative 950 basis points in 2022 to curb inflation, CBSL began to loosen monetary policy amid decelerating inflation. Policy rates were cut by 250 basis points (bps) in June 2023, and by a further 200 bps in July, bringing the Standing Deposit Facility rate down to 11 percent and Standing Lending Facility rate to 12 percent. The Statutory Reserve Requirement (SRR) was also reduced by 200 basis points to 2 percent in August 2023, releasing approximately LKR 200 billion liquidity. Supported by monetary easing and the clarity on domestic debt restructuring, the 91-day Treasury bill rates fell below 20 percent in July 2023 (for the first time since April 2022). With decelerating inflation, real interest rates – which had been negative since November 2021 – turned positive again (Figure 9).

Increasing trend in poverty likely eased due to decelerating inflation and initial government support.

9. **Poverty is expected to increase further in 2023, although at a slower rate, following the doubling of poverty from 13.1 to 25 percent between 2021 and 2022.** Households were impacted on different fronts during the crisis. These included high inflation, declining remittances, and contracted wage employment in services and industry (pushing workers to lower-paid agricultural jobs, while incomes from agriculture were falling in response to the ban on chemical fertilizers put in place in 2021.) Faced with falling incomes, many households turned to negative coping mechanisms, which have likely deteriorated human capital outcomes and already increased food insecurity, malnutrition and stunting. Latest data show that 16.2 percent of children under five years of age are underweight as of June 2023, up from 14 percent in June 2022; and the share of pregnant women with anemia increased from 13.3 percent to 16.2 percent during the same period. Inequality is estimated to have increased by 2 points on the Gini index between 2019 and 2022 and large welfare disparities between the estate and other sectors remain. Poverty is estimated to have increased in the first half of 2023, albeit at a slower rate, as decelerating inflation supported an increase in the real value of household incomes, especially for poor households, who spend almost 60 percent of their budget on food.

10. **Government's response has countered (mostly via direct transfers) some of the negative impacts of the crisis.** To some extent, this has also helped protect the poor against the medium-term regressive impacts of some necessary and critical structural reforms, such as the removal of energy subsidies and higher indirect taxation rates. However, poor targeting and low benefit adequacy have limited the impact of these direct transfers (Samurdhi) on poverty reduction. Estimates show that in 2019, the main social protection scheme covered just over 20 percent of the total population, reaching only 38 percent of the poorest consumption quintile, while 16 percent of beneficiaries were from the top two richest quintiles. At the same time, the adequacy of benefits was also low. Samurdhi transfers accounted for 8 percent of post-transfer consumption of beneficiary households on average and 12 percent among beneficiary households in the poorest fifth of the population. More households were reached during the crisis thanks to the program scale-up, and this prevented a further increase in poverty. Reforms are currently underway to bring the social protection system to its full potential, including improved targeting, establishing objective criteria for eligibility, introducing electronic benefit transfers, and increasing transfer adequacy.

The financial sector is weathering the challenging times.

11. Financial intermediation remains under pressure amid a challenging macroeconomic and policy environment. Growth in credit to the private sector from banks has consistently slowed down due to economic uncertainty, higher nominal interest rates, as well as the appreciation of the rupee (on loan book valuation) during the first half of 2023. Despite recent downward trends, average interest rates on new lending were still high at 19.3 percent in July 2023, and financial intermediation continued to be subdued. Credit to the private sector contracted by 7.6 percent (y-o-y) in July 2023, a growth rate that is deeply negative in real terms. On the other hand, credit to the government and public corporations grew by 12 percent (y-o-y) in July 2023, reflecting continued pressure to finance the government budget (Figure 10).

To bring down lending rates and promote private credit, CBSL took several administrative measures in August 2023, including imposing interest rate caps on pawning, overdrafts, and credit cards.

Figure 9: Interest rate movements
(Percent)

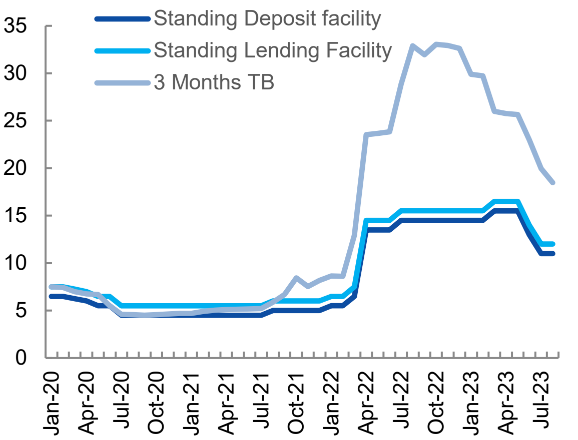
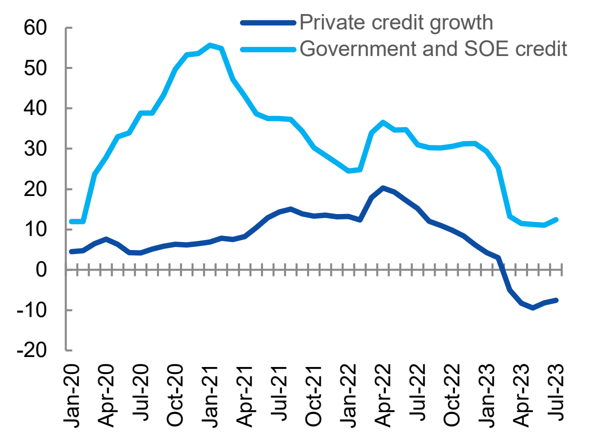


Figure 10: Credit growth
(Percent, y-o-y)



Source: Central Bank of Sri Lanka, and staff calculations

12. **Banks have been exempted from the Domestic Debt Optimization (DDO) strategy, but vulnerabilities in the financial sector are still high.** The government DDO strategy, which excluded banks' holdings of LKR-denominated Treasury securities, aims to avoid prohibitive contagion effects to the banking sector.[2] However, financial sector conditions continued to deteriorate. Banks experienced asset quality pressures, with credit impaired loans increasing to 13.3 percent in 2Q2023 from 12.9 percent in 1Q2023 (and 11.6 percent in 4Q2022). There are likely unrecognized credit risks, while provisioning levels are currently low. The tightening of net interest margins and rising impairment charges have put pressure on profitability, with the Return on Assets (ROA) before taxes to 1.4 percent in 1Q2023 from 2.3 percent in 1Q2022. As credit growth slowed, banks continue to preserve liquidity, reporting liquidity ratios within regulatory limits – although unevenly distributed across banks. The capital adequacy ratio (CAR) benefited from the slowdown in credit intermediation, with the sector reporting a CAR of 16.7 percent in 2Q2023 from 15.1 percent in 1Q2022. Similar trends can be observed for licensed finance and leasing companies, which represent roughly six percent of financial sector assets (excluding CBSL) and are particularly vulnerable (Box 2).

Improvements in the external sector have helped strengthen foreign exchange liquidity.

13. **An improved trade balance and a promising recovery in remittances and tourism contributed to a current account surplus in January-June 2023.** The import bill contracted by US$1.9 billion or 18.6 percent from a high base in 1H2022,[3] mainly driven by subdued imports of intermediate and investment goods, on account of the currency depreciation, lower oil prices, and weak business sentiment. Import restrictions also eased pressure on the import bill. In parallel, total merchandise export earnings declined by about US$700 million or 10 percent (y-o-y) as textile and garment exports suffered due to weak demand from the US and Europe. The faster decline in imports, however, reduced the trade deficit by about US$1.2 billion or 34.7 percent (y-o-y). As arrivals from India, Russia, the United Kingdom, France, and Germany increased, earnings from tourism rose 28.8 percent (y-o-y) from a low base. Remittances also saw a jump of over US$1 billion (or a 75.3 percent increase, y-o-y) in the first six months of the year, due to a significantly high migration of Sri Lankan workers in the latter part of 2022.[4] As external interest

[2] Residual risks related to the success of the DDO still remain.
[3] Import bill in 1H2022 was particularly high due to an overvalued exchange rate and high oil prices, as Indian financial assistance cushioned foreign exchange shortages amid the crisis.
[4] The number of workers leaving for foreign employment, who registered with the Sri Lanka Bureau of Foreign Employment, increased to 311,056 in 2022 from 122,264 in 2021 and 53,711 in 2020.

payments remained low, in line with the debt service suspension, the improved inflows along with the narrower trade deficit are estimated to have led to a current account surplus in the first six months of 2023, compared to a deficit in the corresponding period of 2022 (Figure 11).

Figure 11: Trade balance
(US$ million)

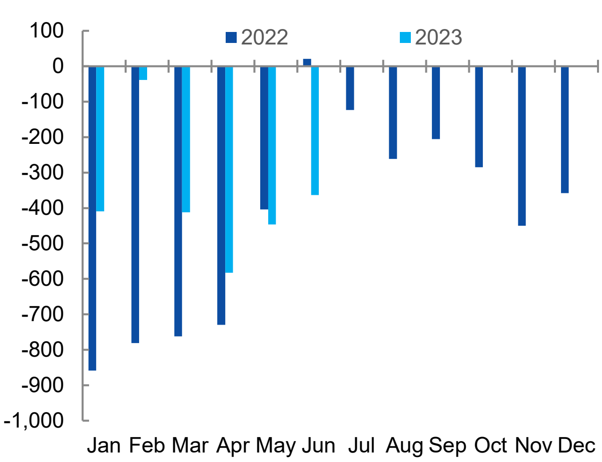
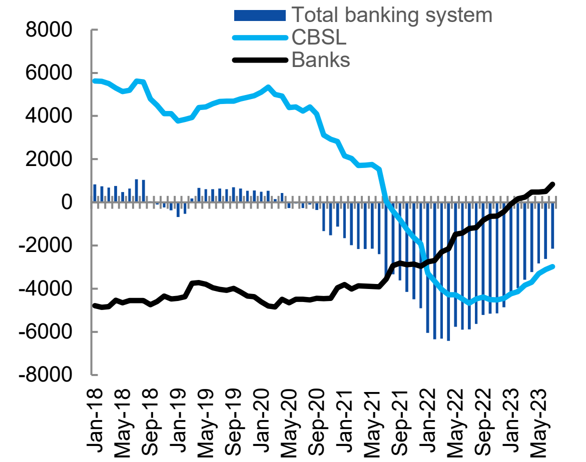


Figure 12: Net foreign assets
(US$ million)



Source: Central Bank of Sri Lanka, and staff calculations

14. **Although they remain low, foreign reserves and liquidity improved due to an improved current account and inflows to the financial account.** In the absence of large debt service payments, inflows from development partners, including: (i) US$330 million from IMF, (ii) US$350 million from ADB, and (ii) US$250 million from World Bank, strengthened the financial account. With the current account already in surplus, these inflows are estimated to have contributed to a balance of payment surplus in the first half of 2023. Along with the central bank's foreign exchange purchases from the market (approximately US$1.7 billion in January-June 2023), usable gross official reserves (excluding a currency swap equivalent to US$1.4 billion with China)[5] increased to US$2.1 billion by end-June 2023, compared to US$500 million in December 2022. This level of reserves is equivalent to five to six weeks of imports of goods and services. Net foreign assets in the overall banking system also increased from US$-6.4 billion in April 2022 to US$-2.1 billion in July 2023. After depreciating by 81 percent against the US Dollar in 2022, the LKR appreciated by 11 percent in the first eight months of 2023 (Figure 12).[6]

Revenues underperformed compared to the budget, and the interest bill remained very high.

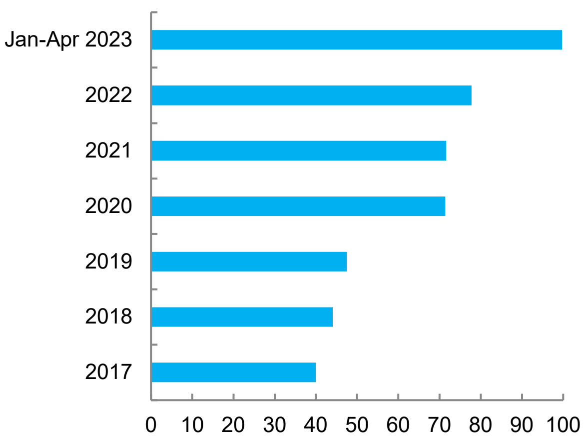
15. **Despite a significant increase in revenues in nominal terms, the fiscal deficit deteriorated in the first four months of 2023, because of a rising interest bill.** Total revenue increased by 30 percent (y-o-y), because of higher collection of Value Added Tax (VAT), and personal and corporate income tax, coming from higher rates, lower thresholds, and fewer exemptions in the case of income taxes. Primary expenditures (expenditures minus interest payments) also increased due to elevated welfare costs, on account of the additional social protection needs to mitigate the impact of the crisis on the poor and vulnerable and a rising public investment bill amid high inflation. Despite this increase in primary expenditures, the increase in revenues led to a significant reduction in the primary deficit. However, a sharp increase in interest payments, due to high domestic interest rates, expanded the overall deficit by 57.3 percent (y-o-y). Broadly, the interest bill (one of the highest in the world) absorbed the total government revenue in the first four months of 2023 (Figure 13 and Figure 14). The overall deficit was financed through domestic banks and non-bank domestic sources such as pension funds and other savings institutions. Net foreign financing continued to remain negative without market access. The government is making progress with debt restructuring, which is essential to restore debt sustainability and regain market access (Tables 3 and 4, Box 2).

[5] To use this currency swap, Sri Lanka needs total reserves equal to three months of import cover.
[6] The LKR depreciated from LKR200.4 in December 2021 to LKR363.1 in December 2022.

16. **The government has committed to implement additional revenue measures and improve tax administration, given the urgent need to ensure fiscal sustainability.** Although revenues increased in nominal terms, the actual tax collected was 24 percent of the budgeted collection in the first four months of 2023. As such, the government announced several additional measures to raise revenues, including: (i) raising alcohol and tobacco taxes from July 1, 2023 and (ii) approving further rationalization of VAT exemptions excluding the health, education, agriculture and transport sectors (yet to be implemented). Reforms to strengthen tax administration are also planned, with a focus on: (i) short term measures to boost revenue and compliance, (ii) measures to address corruption vulnerabilities, (iii) initiatives to deliver sustained modernization of the tax administration, and (iv) effective management and governance. Continued reform is needed in the medium term to rebuild the eroded tax base, strengthen administration, improve equity, and enhance fiscal resilience (see Part B).

Figure 13: Interest to revenue

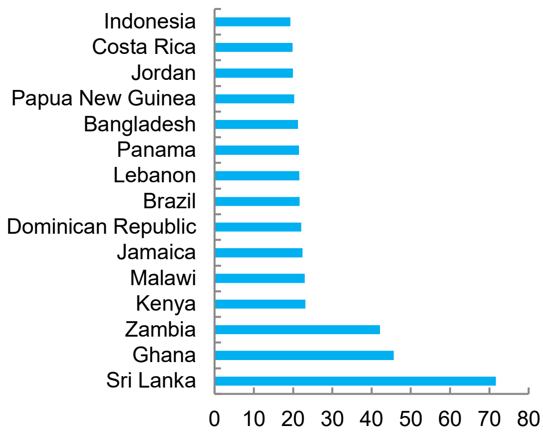
(Percent)



Source: Ministry of Finance

Figure 14: Benchmarking Interest to Revenue (2020)

(Percent)



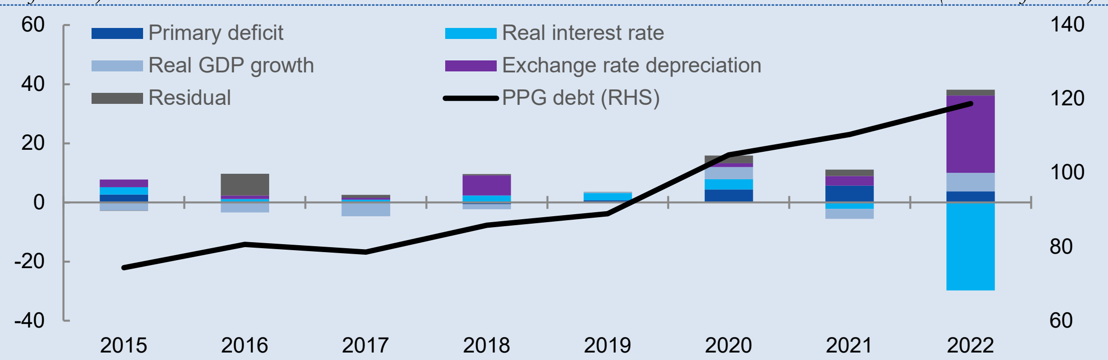
Source: Computed based on World Development Indicators

Box 2: Swift and sufficiently deep restructuring is needed to restore Sri Lanka's debt sustainability

Sri Lanka's public debt is facing both liquidity and solvency challenges. The country continues to be among the most highly indebted developing nations (93rd percentile, 2022).[7] As a share of GDP, the public and publicly guaranteed (PPG) debt rose from 69.3 percent in 2010 to 118.7 percent in 2022 due to a combination of high primary deficits, SOE losses, episodes of currency depreciation, high real interest rates, and decelerating growth. The government's GFN reached 28.4 percent of GDP in 2021, one of the highest among emerging market economies. The foreign currency debt service also increased to 6.3 percent of GDP in 2021 from about 2.6 percent of GDP in 2010 (Figure 15).

Figure 15: Drivers of debt

(Percent of GDP) *(Percent of GDP)*



Sources: Ministry of Finance, and staff calculations,

[7] Computed based on IMF World Economic Outlook, April 2023.

The external debt vulnerabilities are strongly linked to the rise in foreign currency denominated non-concessional debt. The foreign financing mix markedly changed after Sri Lanka started accessing international financial markets. Since 2007, international sovereign bonds (ISBs) issued outside the country and Sri Lanka Development Bonds (SLDBs) issued within the country – both denominated in US dollars – became more prominent foreign currency mobilizing instruments. These instruments have higher interest rates and lower maturities compared to the terms offered by multilateral sources. Moreover, Sri Lanka frequently accessed Chinese banks to raise non-concessional financing, including term facilities and syndicated loans. As a result, the non-concessional and commercial component in the foreign currency-denominated debt increased from 12 percent in 2006 to 59 percent in 2021. This shift elevated debt sustainability risks by shortening maturities,[8] raising borrowing costs,[9] and increasing exposure to exchange rate risk.[10] Since 2017, foreign exchange debt service has absorbed more than 90 percent of gross foreign exchange borrowing, increasing to over 130 percent in 2020 (Figure 16 and Figure 17).

Figure 16: Rise in foreign currency non-concessional debt

(US$ billion) *(Percent of total)*

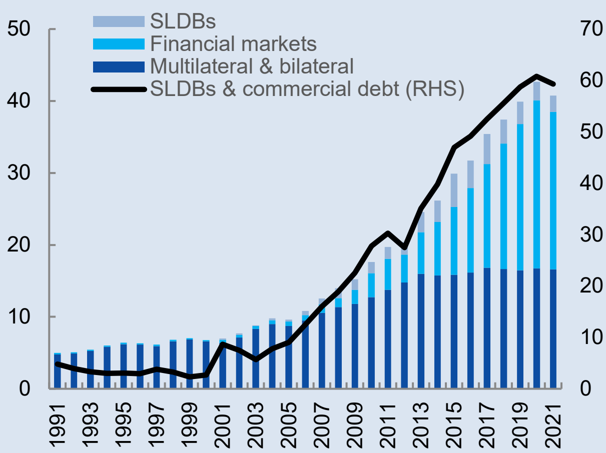
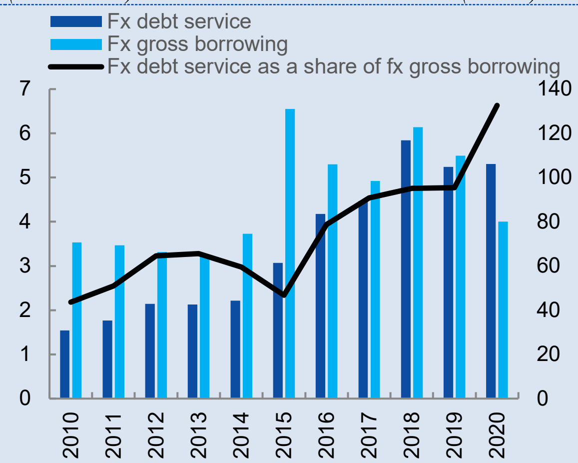


Figure 17: Rise in foreign exchange debt service

(US$ million) *(Percent)*



Source: Central Bank of Sri Lanka, and staff calculations

By end-2022, the debt stock was split equally between debt issued under foreign and domestic law. Approximately US$41.5 billion is issued under foreign law, comprising US$10.5 billion of multilateral debt, US$10.1 billion of bilateral debt, US$17.8 billion of private debt, and US$3.1 billion of central bank debt. China, the single largest bilateral creditor, is estimated to hold approximately 18 percent of the total debt under foreign law. Out of the US$42 billion worth of debt issued under domestic law, approximately 10 percent is denominated in foreign currency while the remainder represents mainly T-bills and T-bonds issued in local currency. The CBSL and private sector pension fund (Employees Provident Fund managed by CBSL) hold around 25 and 29 percent of the total local currency debt, respectively. The remaining local currency debt is held by deposit taking institutions, including banks, insurance companies, other small pension funds, and private individuals and corporates.

Significant and expeditious restructuring is needed to restore debt sustainability. Following the authorities' request for an IMF program, IMF staff carried out a debt sustainability analysis (DSA), using market-access thresholds. This analysis suggested that Sri Lanka's debt was not sustainable without restructuring both external and domestic debt, and set targets for the debt restructuring in the context of the IMF EFF. These debt targets are: (i) level of debt should decline below 95 percent of GDP by 2032; (ii) average GFN should remain below 13 percent of GDP in 2027–2032 and remain on a downward trajectory thereafter; and (iii) foreign exchange debt service should not exceed 4.5 percent of GDP in any year during 2027–32.

The government has actively engaged with external creditors to restructure debt. The government is trying to complete the debt restructuring process by the time of the first review of the IMF EFF. This would include comparable and fair treatment of all external creditors and require a close working relationship and coordination between all official creditors. The official debt restructuring discussions are continuing, with France, India, and Japan

[8] Average time to maturity declined from 9.2 years in 2010 to 6 years in 2021.
[9] Average interest rate is estimated to have increased from 1.3 percent in 2009 to 4.1 percent in 2021.
[10] As reserves also depleted, the share of foreign currency commercial debt to official reserves increased from 52.1 percent in 2010 to 583.4 percent in 2021.

as co-chairs, and China as an observer. The authorities are also expected to reach an agreement with external private creditors on comparable terms.

Significant progress has been made in implementing the domestic debt optimization (DDO) strategy. The Parliament of Sri Lanka approved a DDO strategy in early July 2023. This strategy envisages the restructuring of CBSL-held Treasury bills, superannuation funds-held Treasury bonds, and Sri Lanka Development Bonds (see Table 3). The exchange of new instruments with the existing instruments was finalized in mid-September. The financial sector-held local currency denominated securities were excluded from the DDO to mitigate risks to financial sector stability. The DDO is aiming to reduce annual gross financing needs by 1.5 percent of GDP in 2027–2032, on average.

Table 3: Key terms of the Domestic Debt Optimization

<table>
<tr><td rowspan="1">CBSL's Treasury bills and provisional advances will be converted into Treasury bonds</td><td colspan="3">• Expected annual average GFN reduction is 0.9 percent of GDP in 2027–2032.
• 10 Treasury bonds maturing from 2029 to 2038:
➢ 4 instruments maturing between 2029 and 2032, each equal to 4 percent of the total value
➢ 6 instruments maturing between 2033 and 2038, each equal to 14 percent of the total value
• Step down coupon profile:
➢ 12.4 percent up until 2024 (including)
➢ 7.5 percent up until 2026 (including)
➢ 5.0 percent until maturity</td></tr>
<tr><td>Superannuation fund's Treasury bonds</td><td colspan="3">• Expected annual average GFN reduction is 0.5 percent of GDP in 2027-2032.
• 12 equally amortizing Treasury bonds maturing from 2027 to 2038.
• Step down coupon profile:
➢ 12.0 percent up until 2025 (including)
➢ 9.0 percent up until maturity
• Income tax to increase to 30 percent from the current rate of 14 percent for superannuation funds that do not meet the minimum participation requirement.[11]</td></tr>
<tr><td rowspan="2">SLDBs and FCBU loans</td><td colspan="3">• Expected annual average GFN reduction is 0.1 percent of GDP in 2027–2032.
• Approximately 95 percent of the holders have reportedly selected the LKR option.</td></tr>
<tr><td><u>US$ option 1</u>
• 30 percent nominal haircut
• 6-year final maturity, no grace period
• Linear amortization
• 4 percent interest (fixed)</td><td><u>US$ option 2</u>
• No nominal haircut
• 15-year final maturity, 9-year grace period
• Linear amortization
• 1.5 percent interest (fixed)</td><td><u>LKR option</u>
• No nominal haircut
• 10-year final maturity, no grace period
• Linear amortization
• Policy rate + 1.0 percent interest (floating)</td></tr>
<tr><td colspan="4">Source: Adopted from the presentation delivered to the Cabinet by the Governor, Central Bank of Sri Lanka on June 28, 2023.</td></tr>
</table>

[11] Set at 50 percent for outstanding bonds maturing in 2023 and 100 percent of bonds maturing between 2024 and 2032 (incl.).

Table 4: Fiscal operation, January–April 2023 (actual)

LKR million	2022	2023	Change (percent)
Revenue and grants	631,129	821,347	30.1
Revenue	630,908	820,071	30.0
Tax revenue	543,649	742,578	36.6
Income tax	149,163	191,768	28.6
Domestic consumption based tax	180,090	314,848	74.8
Import based tax	203,582	223,414	9.7
License taxes and others	10,814	12,548	16.0
Non tax revenue	87,259	77,493	-11.2
Grants	221	1,276	477.4
Total expenditure	1,155,228	1,645,602	42.4
Recurrent expenditure	1,016,809	1,484,984	46.0
Salaries and wages	316,051	303,310	-4.0
Pensions	99,659	105,924	6.3
Interest Payments	426,786	818,969	91.9
Others	174,313	256,781	47.3
Public Investment	138,419	160,618	16.0
Primary balance	-97,313	-5,286	-94.6
Overall balance	-524,099	-824,255	57.3
Financing	524,100	824,256	
Foreign Financing	-126,985	-77,498	-39.0
Domestic Financing	651,085	901,753	38.5

Source: Ministry of Finance

3. Outlook, Risks, and Priorities

While recent macroeconomic performance has been better than expected, downside risks over the medium term continue to be very high, given a narrow path to recovery and very low buffers. Recovery and growth prospects depend on progress with debt restructuring, last-mile implementation of growth-enhancing structural reforms, collective support from the international community, and the resolve of political leadership to stay the course on difficult reforms despite backlash and resistance from other stakeholders.

17. **Growth prospects depend on progress with debt restructuring and last-mile implementation of growth-enhancing structural reforms.** The economy is expected to contract by 3.8 percent in 2023 amid subdued private credit, supply disruptions, and lack of inputs. A weak global economy is expected to continue to reduce demand for Sri Lanka's key exports in 2023, while higher taxes and lower real incomes will dampen domestic demand. However, on account of the base effect and expected financial inflows in the second half of the year, the economic contraction in 2023 is projected to be lower compared to the contraction of 7.8 percent in 2022. Going beyond 2023, the scarring effect of the crisis, depletion in human capital, and tight external financing is expected to lead to a fragile recovery. Poverty is projected to increase from 25 percent to 27.9 percent between 2022 and 2023. Poverty reduction could resume from 2024 and continue in 2025, but this depends on continued implementation of structural reforms and a restoration of economic growth and job creation. Inflation is expected to stay in single digits, reflecting weak aggregate demand, improving supply conditions, lower global commodity prices, and discontinued monetization of deficits. Inflationary expectations will be muted in the next few years as demand side pressures remain weak. However, aggressive monetary loosening and exchange rate depreciation could

counter this trend. The current account deficit is expected to narrow further in 2023 thanks to BOP surpluses in the first half of 2023 and, despite weak exports, continued weak import demand in the second half of 2023. Over the medium term, the current account deficit is expected to remain benign along with the recovery in tourism and remittances. Nevertheless, additional resources will be needed in 2023 and beyond, to close the external financing gap. On the fiscal front, the primary deficit is expected to decline in 2023; although the overall balance will continue to be high due to the large interest bill. Debt restructuring and revenue-based fiscal consolidation are projected to reduce the overall balance in the medium term (Table 4).

18. **While recent macroeconomic performance has been better than expected, downside risks over the medium term continue to be very high, given a likely narrow path to recovery and limited buffers.** A prolonged or insufficiently deep external debt restructuring process could exert continued pressure on GFN targets. A deterioration in the political situation (including a backlash to the reforms), inadequate domestic revenue mobilization due to structural base erosion, limited external financing support, a sharper global slowdown, and a prolonged recovery from the scarring effects of the crisis are key risks to restoring stability, regaining a sustainable growth path, and bringing Sri Lanka back to pre-crisis rates of poverty reduction. Higher international food prices and limited supply, especially in other rice-producing countries, resulting from El Niño and other extreme climatic conditions, could negatively impact food security. On the upside, faster-than-expected growth, driven by a stronger rebound in tourism and remittances, could foster recovery and build additional buffers.

Sri Lanka needs to continue implementing several important reforms to address the structural factors and root causes that led to the current economic crisis and achieve a more resilient and sustainable growth path.

19. **To enhance fiscal and debt sustainability, several measures are critical.** First, domestic revenue mobilization needs to be strengthened to reduce fiscal deficits and enhance fiscal resilience (see Part B). Second, in addition to expenditure rationalization, expenditure efficiency and fiscal oversight of the budgetary process need to be improved. The government is currently in the process of enacting the Public Financial Management Act and establishing a Parliamentary Budget Office, to ensure better oversight and fiscal outcomes. Third, improving debt management transparency and practices is essential to ensure that better borrowing decisions are made and debt remains sustainable over the medium-to-long-term.[12] Fourth, addressing fiscal risks associated with SOEs, including through energy sector reforms, is critical. The continued enforcement of cost-reflective utility pricing to limit SOEs' losses and the continued implementation of SOE reforms will address the fiscal, financial, competitive, and governance-related risks posed by SOEs (see Box 3).

Box 3: SOE reforms are urgently needed to address economic inefficiencies and mitigate fiscal and financial risks

As Sri Lanka navigates a path to recovery amidst the economic crisis, restructuring and divesture of State-Owned Enterprises (SOEs) has gained renewed attention. SOEs are a prominent part of Sri Lanka's economic landscape with significant presence across 33 strategic sectors, including energy, water, ports, banking, insurance, transportation, aviation, and construction. They are engaged in a wide range of activities, including infrastructure development, public services, and economic development. Of the approximately 400 SOEs, 52 are recognized as being 'strategically important'. Many SOEs have a dominant or monopoly position in the markets in which they operate, and in an estimated 16 sectors, State-Owned Banks and Enterprises (SOBEs) compete directly with the private sector.[13]

The dominance of SOEs in the economy has been a key cause of overall weak productivity and competitiveness. Poor governance and financial mismanagement, overstaffing, limited accountability, and

[12] Government is working towards consolidating public debt management into a single Public Debt Management (PDM) Office, regulated by an overarching PDM Law, including specific requirements on debt transparency. It also aims to put in place a well-defined legal and operational framework for the provision of guarantees and on-lending operations and the monitoring of associated risks and other contingent liabilities.
[13] 2020 WB Report "Integrated State-Owned Enterprise Framework" – iSOEF Report.

political interference have led to inefficiencies. Operational losses of SOEs, coupled with accumulated high levels of debt, including from State-Owned Banks (SOBs), have created a heavy burden on the financial sector and the national budget (ultimately borne by the taxpayer), and led to adverse macroeconomic and growth implications. Operational losses of the three biggest loss-making SOEs – Ceylon Petroleum Corporation (CPC), Ceylon Electricity Board (CEB), and Sri Lankan Airlines (SLA) – alone was equivalent to 3.9 percent of GDP in 2022. Moreover, outstanding SOE loans on Treasury guarantees amounted to approximately 5 percent of GDP in 2022.

Recognizing these issues, the government embarked on a new SOE reform program in 2022. Sri Lanka has extensive prior experience in SOE reform which started in 1987, with the incorporation of divestiture of SOEs into state policy. This led to extensive SOE reforms between 1989 and 2002 with partial and full divestment of 84 SOEs.[14] However, the record of success has been very uneven. Following a nationalization wave between 2005 and 2014, the ownership structure of SOEs is once again highly dominated by the state, which owns 100 percent of the shares in most public corporations.[15]

Restructuring and divesting SOEs is critical for Sri Lanka's emergence from the ongoing crisis. The current SOE reform program aims to improve efficiency, increase the quality of public services, reduce the fiscal impact and government debt burden, promote market competition, and attract foreign investment. This program is underpinned by four pillars: (i) adoption of a cost reflective pricing strategy for fuel and electricity; (ii) restructuring the balance sheets of selected key SOEs and the cabinet's adoption of a strategy to improve the health and financial sustainability of these SOEs;[16] (iii) introducing competition into key sectors (such as petroleum) and unbundling of CEB, to lead to better pricing and services to consumers; and (iv) divestment of SOEs engaged in commercial activities.[17]

Under the reform program, the government established the SOEs Restructuring Unit (SRU) in the Ministry of Finance (MoF) to oversee reform implementation. The SRU is moving forward on two fronts – institutional building and transactions. Key reforms aimed at institutional building include: (i) the cabinet approval in June 2023 of a SOE Reform Policy, which maps out a comprehensive approach to restructure and divest commercial SOBEs in order to improve competitiveness, investment, service delivery and governance, and address associated social and environmental considerations; (ii) parliamentary approval of a SOE Reform Act (drafting ongoing); (iii) establishment of an SOE Holding Company (HoCo), fully owned by the MoF, to operate as a commercial business and restructure and divest targeted SOEs; and (iv) gazetting SOEs with commercial activities under the HoCo. On the transactions side, cabinet has approved the appointment of transaction advisors, setting the stage for the next phase of the divestiture process, including investor engagement. Recent measures towards cost-reflective pricing have already improved the profitability of the SOE sector. For example, operational losses of CPC and CEB decreased to LKR 14 billion in the first four months of 2023 from LKR 676 billion in the corresponding period of 2022.

20. **Monetary and financial sector policies need to continue to support macroeconomic stability.** Monetary policy needs to be managed carefully to ensure that aggressive monetary loosening does not lead to inflationary pressures. While the elimination of monetary financing, with the enactment of a new Central Bank Law, will contribute to monetary stability, consistent monetary policy is essential for continued macroeconomic stability. The financial sector needs to be carefully monitored, given high exposures to the public sector, rising non-performing assets, and tight liquidity conditions. Continuation of a market-determined and flexible exchange rate needs to be the first line of defense to facilitate external adjustments and rebuild international reserves.

21. **Enhancing competitiveness is critical to return to a sustainable growth path.** Continued implementation of reforms that support trade and investment – including establishment of the necessary legal and institutional infrastructure and implementation of a unified Investment Law, a SOE Reform Law and a National Tariff Policy – are necessary to enhance competitiveness and enable private sector-led growth. Measures to strengthen the digital economy, including mobilizing private capital and competition

[14] Strategic Insights – Volume 10, Ceylon Chamber of Commerce.
[15] SOEs in Sri Lanka are public corporations, statutory boards or companies incorporated under the Companies Act
[16] A comprehensive strategy to restructure the balance sheets of Ceylon Petroleum Corporation, Ceylon Electricity Board, Road Development Authority and Sri Lankan Airlines is expected.
[17] Including Sri Lanka Airlines, Sri Lanka Telecom PLC, Sri Lanka Insurance Corporation (SLIC), Canwill Holdings Pvt Ltd (Grand Hyatt Colombo), Hotel Developers (Lanka) Ltd (Hilton Colombo), Litro Gas Terminal Pvt Ltd, and Lanka Hospitals Corporation PLC.

in the broadband market, will also help enhance productivity and competitiveness, and improve service delivery.

22. **For Sri Lanka to emerge as a stronger and more resilient economy from the crisis, reform implementation is key**. Initially, the necessary macroeconomic adjustments may adversely affect growth and poverty, but they will correct overall imbalances, help regain access to international financial markets, and build the foundation for sustainable growth. While the adjustment process may provoke resistance, and potential backlash from affected groups, it is essential for the country to stay the course on reforms, carefully navigate political and social pressures, and effectively mitigate the impact of the reforms on the most poor and vulnerable.

Table 5: Summary Macroeconomic Indicators

	2020	2021	2022	2023 e	2024 f	2025 f
Real GDP growth, at constant market prices[a]	-4.6	3.5	-7.8	-3.8	1.7	2.4
Private Consumption	-5.8	2.6	-9.0	-4.1	1.9	2.5
Government Consumption	0.0	-2.8	1.4	-2.6	-1.7	0.9
Gross Fixed Capital Investment	-7.9	6.3	-22.8	-4.4	2.0	3.1
Exports, Goods and Services	-29.6	10.1	10.2	-4.3	2.8	3.1
Imports, Goods and Services	-20.1	4.1	-19.9	-4.6	1.5	2.8
Real GDP growth, at constant factor prices[a]	-2.9	4.0	-6.7	-3.8	1.7	2.4
Agriculture	-0.9	0.9	-4.6	0.8	1.5	1.5
Industry	-5.3	5.7	-16.0	-5.8	1.6	2.4
Services	-1.9	3.5	-2.0	-3.4	1.8	2.5
Inflation (Consumer Price Index)	4.6	6.0	46.4	17.9	5.9	5.9
Current Account Balance (% of GDP)	-1.4	-3.7	-5.3	-1.0	-0.9	-0.7
Net Foreign Direct Investment Inflow (% of GDP)	0.5	0.7	1.2	1.1	1.1	1.2
International poverty rate ($2.15 in 2017 PPP)[b,c]	1.6	1.5	5.8	6.6	6.5	6.3
Lower middle-income poverty rate ($3.65 in 2017 PPP)[b,]	12.7	13.1	25.0	27.9	27.5	26.8
Upper middle-income poverty rate ($6.85 in 2017 PPP)[b,]	49.9	51.1	65.0	67.9	67.6	67.0

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices. Emissions data sourced from CAIT and OECD.
Notes: e = estimate. f = forecast. Poverty data are expressed in 2017 PPP. versus 2011 PPP in previous editions - resulting in major changes. See pip.worldbank.org

(a) GDP by expenditure for 2020 and 2021 are estimates, as the data published on March 15, 2023 by authorities only included GDP by production.

(b) Calculations based on SAR-POV harmonization, using 2019-HIES. Actual data: 2019. Nowcast: 2020-2022. Forecasts are from 2023 to 2025.

(c) Projection using neutral distribution (2019) with pass-through = 0.87 (Med (0.87)) based on GDP per capita in constant LCU.

B. Tax Reforms for a Brighter Future

This part looks at the state of the tax system in Sri Lanka and discusses the key reforms needed to ensure that the system is efficient, sustainable, and equitable. Mobilizing sufficient government revenues is critical to put the Sri Lankan economy on a path of sustainable development and inclusive growth.

Key Messages

- Sri Lanka has one of the lowest tax-to-GDP ratios in the world. By 2022, the tax system was characterized by low, multiple, and frequently changing rates, a narrow and shrinking base, a high tax burden on labor rather than capital incomes, an over-reliance on indirect taxes, and a weak administration with poor compliance outcomes. These features have made the system complex, inefficient and inequitable.
- These structural weaknesses, combined with ill-timed tax cuts in 2019 and other exogenous shocks, led to tax as a share of GDP reaching the lowest recorded rate in 2022 at 7.3 percent, contributing to the current unprecedented economic crisis. In response to the crisis, Sri Lanka introduced several tax reforms during 2022–23 to enhance domestic revenue mobilization and strengthen the tax system.
- While the measures already introduced in 2022–23 have led to higher revenues, further reforms are needed to ensure that the tax system is efficient, sustainable, and equitable. Some of the key short- to medium- term reforms are to:
    - Introduce a minimum corporate tax to ensure that companies pay a minimum effective tax rate
    - Strengthen capital taxation by taxing capital income at progressive rates, revamping property taxation based on current market value of immovable properties, and introducing wealth, gift, and inheritance taxes
    - Rationalize tax expenditures based on a thorough review and evaluation of tax incentives. Enhance transparency by regularly publishing tax expenditure statements showing the revenue foregone due to various tax incentives
    - Focus on potential large and high net worth individuals and strengthen capacity of tax administration to deal with the complexities related to such cases
    - Strengthen tax administration by enhancing e-filing, third-party information use, compliance risk management, effective dispute resolution, and recovery of taxes in default
    - Strengthen the IT infrastructure to enhance the efficiency of tax administration core functions, including e-filing, timely processing of returns, audits, and issuance of refunds.

1. Introduction

23. **Chronic revenue underperformance is at the core of Sri Lanka's fiscal fragility.** Fiscal indiscipline, primarily low revenue mobilization, underpinned by poor revenue policy and administration, was a key cause of Sri Lanka's macroeconomic crisis. Chronic structural weaknesses, including frequent changes in tax policy, a narrow tax base, a reliance on indirect and trade taxes, and a high tax burden on labor rather than on capital income, resulted in an inefficient and inequitable tax system. More recently, ill-timed tax cuts in 2019 – including raising the threshold for paying personal income taxes to LKR 3 million from LKR 500,000, almost halving the VAT rate from 15 to 8 percent in 2019 and abolishing the withholding and Pay-As-You-Earn (PAYE) taxes – further led to a reduction in the number of taxpayers and a collapse in revenues. This squeezing of fiscal space contributed to a rapid growth in debt, making debt unsustainable and, along with other shocks such as the COVID-19 pandemic, plunged the country into a deep economic crisis.

24. **Both tax policy and administration measures are needed to strengthen fiscal sustainability.** As Part A highlighted, Sri Lanka's path to economic recovery remains narrow, with limited fiscal and external buffers. This narrow path is predicated on an ambitious revenue-led fiscal consolidation, with a planned increase in taxes as a share of GDP from a low of 7.3 percent in 2022 to 14.0 percent by 2025. Achieving these targets requires concerted and properly sequenced reforms towards improving tax policy and administration, based on a coherent medium-term strategy.

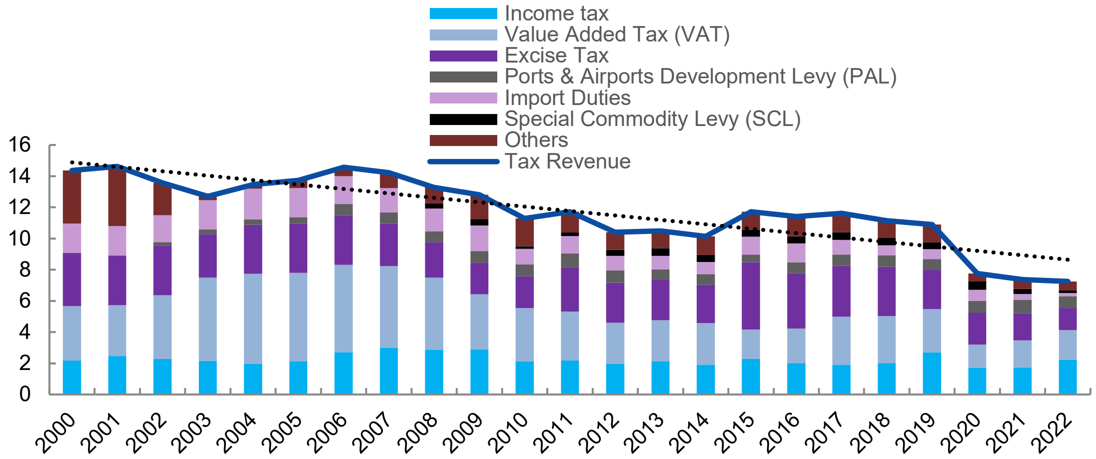
25. **This part explores the role of strengthened tax policy and administration in building fiscal resilience and sustainability** by: (i) improving the quality of revenue generation to reduce distortions, enhance public service delivery, and support economic growth; (ii) ensuring that the tax system is equitable; and (iii) creating fiscal buffers for macroeconomic stability. It presents the key causes of underperformance of tax revenue collection in Sri Lanka and makes recommendations, beyond ongoing reforms, to ensure that the tax system is efficient and equitable.

26. **The rest of this part is structured as follows**: Section 2 summarizes Sri Lanka's revenue performance over time in comparison to other countries; Section 3 discusses potential reasons for underperformance; Section 4 highlights revenue mobilization measures taken in response to the crisis in 2022–23 and their impacts so far; Section 5 provides recommendations on the way forward; and Section 6 concludes.

2. Sri Lanka's Tax Performance

27. **Sri Lanka's tax revenue has been falling continuously over the last two decades, while relying heavily on indirect taxes.** Sri Lanka's tax revenue, which accounted for 87 percent of all revenues in 2022, fell from 17.8 percent of GDP in 1995 to 7.3 percent in 2022. Figure 18 depicts this decline with decadal averages falling to 13.7 percent (in the 2000s) and 11.1 percent (in the 2010s). Untimely tax reductions in 2019, along with the economic shock from the COVID-19 pandemic, resulted in a collapse of revenues as a share of GDP from 10.9 percent in 2019 to 7.8 percent in 2020, bottoming out at 7.3 percent in 2022 (Figure 18). As of 2021, Sri Lanka collected 77 percent of its taxes through indirect taxes such as VAT, turnover, excise, and trade taxes. This share was even higher in the 2000–20 period, with indirect taxes accounting for 81.2 percent of total collection on average. The share of indirect taxes is higher than the regional average (66 percent) and global average (53 percent).

Figure 18: Composition of tax revenue as a share of GDP
(Percent)



Source: Ministry of Finance, and staff calculations

28. **Sri Lanka's tax collection in 2020 was the lowest among peers.** Benchmarking Sri Lanka's tax performance to peer countries puts this decline in perspective. The tax collection as a share of GDP was the lowest among regional countries (including Maldives, India, Bhutan, Malaysia, Pakistan, Indonesia, and Bangladesh) in 2020 (Figure 19). Until 2019, this share was higher than Pakistan, Indonesia, and Bangladesh. Even though the pandemic affected fiscal performance in all countries, the impact on Sri Lanka was worsened by the impact of tax policy changes in 2019, pushing the country's revenue collection to the bottom relative to these peers. However, Sri Lanka performed better than the South Asian average throughout the 2000–2010 decade, and only began to diverge thereafter (Figure 20).

Figure 19: International benchmarking of Sri Lanka's tax performance
(Percent of GDP)

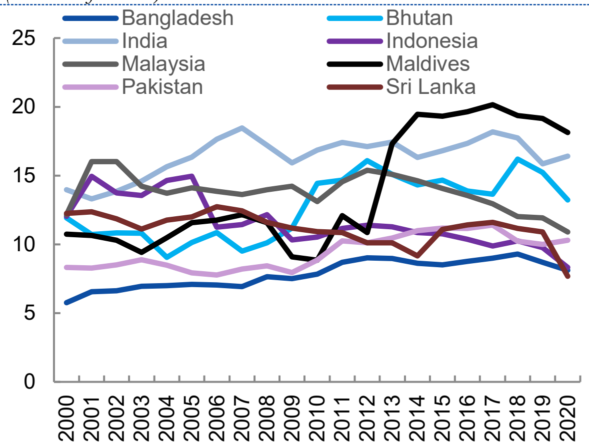
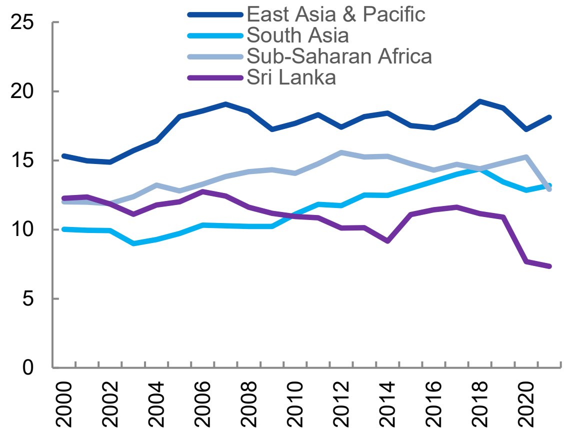


Figure 20: Regional benchmarking of Sri Lanka's tax performance
(Percent of GDP)



Source: UNU-Wider Government Revenue Dataset and staff calculations

29. **Sri Lanka's tax performance is far below its potential when compared with other countries at a similar level of development and trade.** If Sri Lanka had performed at the level of an average performer, among countries at a similar level of income and openness to trade, tax revenue would have been 16.3 percent of GDP in 2019 compared to the actual performance of 10.9 percent of GDP (Table 6).[18] Furthermore, if Sri Lanka had been able to perform at the level of the best performing country,

[18] The Stochastic Frontier Method is used to obtain the "efficiency" of a country's performance, with the best performer scoring 100 percent, and the worst performer scoring 0 percent. Source: IMF Working Paper (2013), Understanding Countries Tax Effort, Ricardo Fenochietto and Carola Pessino. The year 2019 was chosen for the analysis given that this was prior to the impact of the fiscal stimulus, the COVID-19 pandemic, and the economic crisis. Tax rates in 2023 were restored to or went above the 2019 values.

controlling for its tax capacity, it would have been able to collect 23.6 percent of GDP as tax revenue in 2019. This translates to LKR 92,680 of additional funds available for public spending per person in Sri Lanka. This underperformance is reflected in the poor outcomes of Personal Income Tax (PIT), Corporate Income Tax (CIT), and the Value-Added Tax (VAT).

Table 6: Benchmarking Sri Lanka's tax performance as an average / best performer

Country	Tax Revenue - % of GDP (2019)		
	Actual Performance	If the Country was an Average Performer *	If the Country was the Best Performer Globally*
Nepal	18.9	11.5	21.7
Pakistan	11.4	12.0	17.8
Bangladesh	8.9	12.5	18.0
India	15.8	14.1	21.6
Bhutan	13.2	16.1	24.0
Sri Lanka	10.9	16.3	23.6
Maldives	19.0	19.6	30.4

Performance controlling for level of income and openness
Source: UNU Wider Government Revenue Dataset, World Bank Revenue Dashboard

30. **Tax revenue decline was driven by a fall in VAT and excise collections**. The overall decline in revenue has been mainly driven by indirect taxes, including VAT, excise taxes, and import duties, which were among the highest average contributors to tax revenues 2005 onwards (Table 7).[19]

Table 7: Declining share of GDP of major taxes, 2005–19

	Share of GDP (percent)		Change in share of GDP (percent)
	2005	2019	
Income tax	2.7	2.7	(1)
VAT	5.6	2.8	(50)
Import duty	1.8	0.6	(65)
Key para-tariffs (PAL, CESS, SCL)	0.9	1.5	60
Excise tax (excluding vehicles)	2.4	1.7	(31)
Vehicle excise tax	0.7	0.8	11

Source: Ministry of Finance and staff calculations

31. **VAT collections have not kept up with the growth in final consumption in the economy.** VAT collection has not grown in line with GDP. During the 2017–20 period, for example, private and government consumption expenditure, which may be treated as a proxy base for VAT, grew significantly (Table 8). However, this growth in consumption expenditure did not translate into VAT revenues, which declined significantly during this period.

Table 8: Growth of consumption expenditure compared to growth in VAT

	2010–14 (percent)	2017–20 (percent)
Household consumption expenditure	59	16
Government consumption expenditure	60	44
Value-added taxes	25	-47

Source: IMF International Financial Statistics, Ministry of Finance, and staff calculations

[19] Excise collections will be covered in greater detail in forthcoming analysis of the World Bank.

32. **Low tax buoyancy indicates poor performance of both policy and administration in leveraging economic growth to enhance tax collection**. Tax buoyancy is a good indicator of tax performance and refers to the factor by which an increase in GDP is converted into an increase in tax collection. Table 9 presents estimates of the tax buoyancy of different taxes. A tax buoyancy below one means that increases in economic output are not being converted to commensurate additional revenues.

Table 9: Tax buoyancy of major taxes (2000–2018)

	Tax Buoyancy
Tax revenue	0.76
Income tax	*0.92*
VAT	*0.84*

Source: Ministry of Finance, and staff calculations

33. **Sri Lanka's tax system is mildly progressive, but indirect taxes still account for a significant share of income for the poor.** Fiscal incidence analysis for 2019 shows that indirect taxes – measured as a share of pretax incomes – accounted for 7.5 percent of income for households in the poorest decile and 9.7 percent for households in the richest decile. The richest decile accounted for 29.4 percent of total indirect tax collections. Thus, while the impact of higher indirect tax rates is likely to be progressive, the welfare losses at the bottom might still be significant.[20] On the other hand, direct taxes are still more progressive in their incidence on household incomes. Individuals from households in the top 40 percent of the population are liable for direct tax payments, and these payments – when measured as a share of pre-tax income – rise in proportion to taxable income.[21]

3. Causes of Sri Lanka's Tax Underperformance

34. **Sri Lanka's tax system is characterized by multiple taxes and levies with frequent policy changes, creating administrative difficulties and uncertainty for taxpayers.** Sri Lanka's revenue underperformance can be attributed to weaknesses in both its tax policy and administration. For long periods, the tax system has been characterized by low, multiple, and frequently changing rates, a narrow and shrinking base, a high tax burden on labor rather than capital incomes, and a weak administration with poor compliance outcomes. These features have made the system complex, inefficient and inequitable.[22] This section explores some of the causes of this underperformance by examining the key drivers of revenue collection: the tax rates, the tax base, and the performance of tax administration. While the rate and the base set the parameters on how much tax can potentially be collected, the performance of the tax administration determines how much of this potential is collected.

Tax rates are low, with major and frequent changes, and complex structures.

35. **Low tax rates for VAT, CIT, and PIT explain some of the underperformance.** Low tax rates can explain some of the underperformance of the major taxes, especially the PIT. Sri Lanka's maximum marginal rate under the PIT was quite low until 2020, when compared to peers (Table 10). In fact, the maximum rate placed Sri Lanka in the bottom quintile of countries globally. Furthermore, tax thresholds were high, at LKR 4.2 million (US$ 21,000 in 2021), which included a personal relief of LKR 3 million and LKR 1.2 million in expenditure relief.[23] In comparison, India's threshold was an equivalent of US$ 6,500.

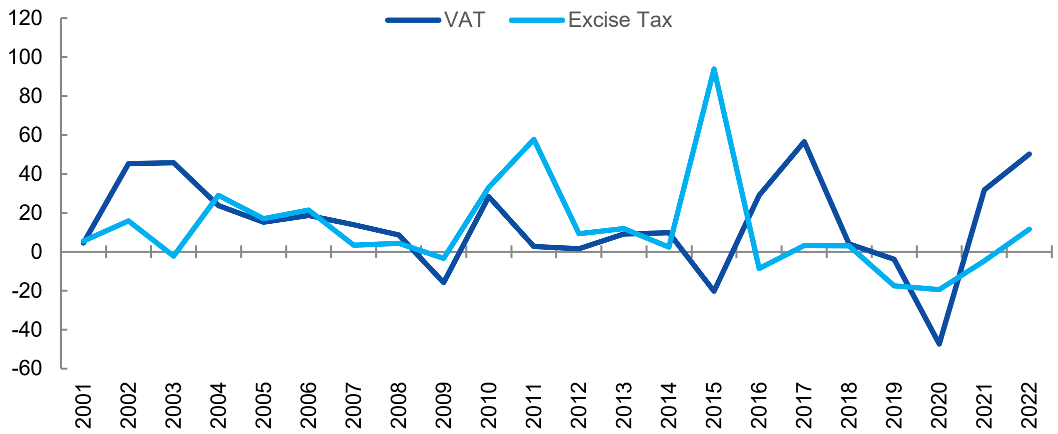
[20] This effect translates into a higher poverty rate in the distribution of consumable income (8.9 percent), relative to the distribution of disposable income (8.6 percent).
[21] Surveys like the Sri Lanka Household Income and Expenditure Survey underrepresent – and sometimes miss altogether – households at the top of the true income distribution, and therefore, also miss substantial numbers of the taxpayer pool. However, tax administration data sources confirm that there was a severely limited direct tax base in fiscal year 2019, making it difficult to expand revenues through direct taxes in general, but especially during times of crisis.
[22] For example, in the form of multiple exemptions provided at the policy level, or in the poor audit selection process at the administration level.
[23] No tax is payable until income reaches this tax threshold. Income above the threshold is then subject to tax.

Table 10: Benchmarking Sri Lanka's tax rates

Country	Maximum Marginal PIT Rate (percent)	Corporate Income Tax Rate (percent)	Standard VAT Rate (percent)
India	42	25	18
Malaysia	30	24	10
Bangladesh	25	32.5	15
Thailand	35	20	10
Sri Lanka (2021)	18	24	8
Sri Lanka (2023)	36	30	15

Source: PricewaterhouseCoopers worldwide tax summaries and Inland Revenue Department

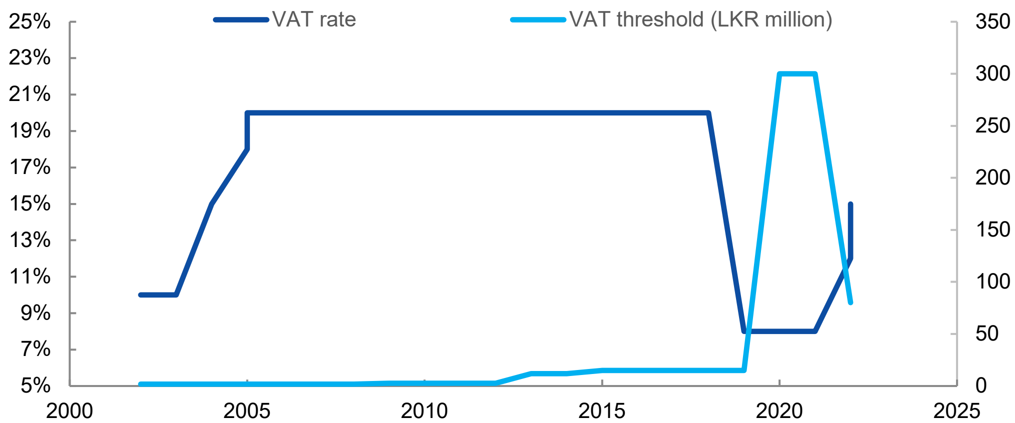
Figure 21: Growth in major taxes
(Percent, y-o-y)



Source: Ministry of Finance, and staff calculations

36. **Frequent policy changes have created uncertainty and introduced volatility in collection, particularly for VAT and excise.** Major and frequent tax policy changes, such as the introduction of new taxes and changes in rates, have increased uncertainty for taxpayers, created administrative difficulties, and made the tax system complex (see Annex 1 for a list of the major changes made over the last decade). These changes have also caused significant revenue volatility, creating challenges for forecasting and budget planning. For example, the growth of VAT and excise revenues has been highly volatile due to frequent policy changes (**Error! Reference source not found.**), including changes in registration threshold and the standard VAT rate during 2002-2023 (Figure 22).

Figure 22: Changes in VAT rate and registration threshold, 2002-22
(VAT standard rate) *(VAT registration threshold, LKR million)*



Source: Inland Revenue Department

37. **Policy design has also been excessively complex, as seen in the design of the excise structure.** Excises on cigarettes vary non-linearly by length, and excises on alcohol vary by type of drink, rather than being determined by alcohol content or strength.[24] At the same time, excises are set in rupees, and while they are updated regularly, they are not automatically linked to inflation, which has eroded their real value in a high-inflation environment.

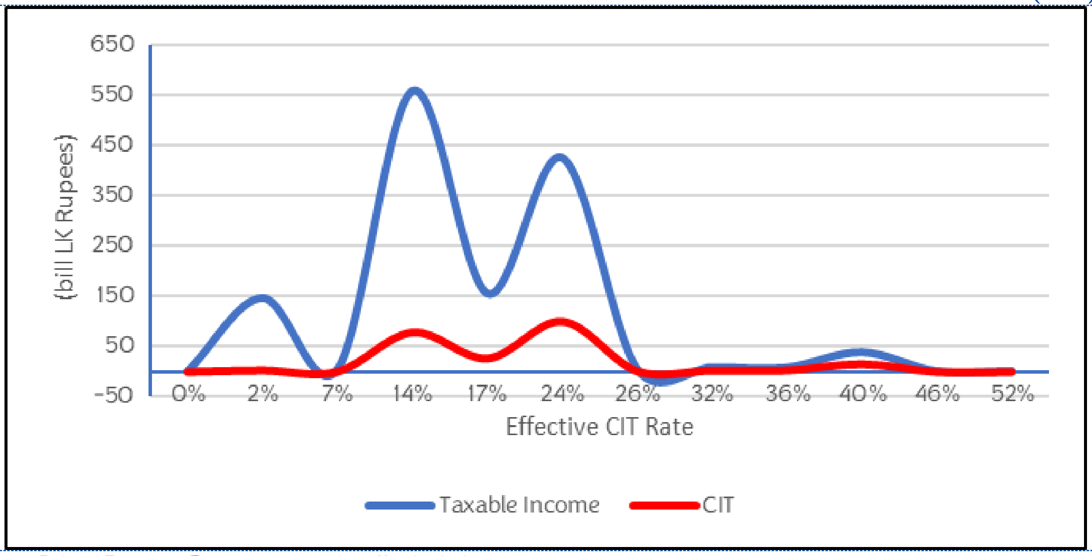
The over-reliance on taxing labor rather than capital income reduces the progressivity of the system.

38. **Capital taxation is currently regressive as capital income, which accrues mostly to high income groups, is taxed at a low and flat rate.** Capital income is subject to lower flat tax rates (instead of progressive rates), thus increasing the tax burden on labor. Further, tax benefits are accorded to income from capital gains, interest, dividends, and rent. These sources of income largely accrue to higher income groups, which makes the design regressive. Capital gains on property other than stocks are taxed at a low rate of 10 percent.

The tax base has been eroded by high thresholds and multiple exemptions.

39. **Corporate tax incentives have eroded the tax base.** CIT collection has, in particular, been eroded due to low rates and several exemptions. Prior to 2022, several sectors were taxed at a concessionary rate of 14 percent.[25] In addition, numerous companies enjoy exemptions on their taxable income under different incentive regimes – such as the Board of Investment (BoI) and Strategic Development Projects (SDP) Acts – thereby paying taxes at very low rates, including at zero percent in some instances. As a result, the concessionary rate of 14 percent had become the dominant rate applied on corporates' taxable income, although overall CIT collection at the standard rate of 24 percent yielded more revenues (Figure 23). Moreover, out of 1,062 BOI companies that were profit making in 2020, 44 percent paid a tax of less than 24 percent of their book profits which was the standard rate; 13 percent paid no corporate income tax at all; while 36 percent paid an effective tax rate of 15 percent or below on their book profits.

Figure 23: Taxable income for CIT and total CIT collected under different CIT Effective Rates (2021)



Source: Inland Revenue Department, and staff calculations.

[24] Excise taxes are imposed mainly on the production of alcohol, tobacco, petroleum products and motor vehicles. Excise collections peaked at 36.7 percent of all tax revenue collected, in 2015, and have registered a sharp drop since. The decline has been driven by a reduction in excise collected on the import of motor vehicles. Excises on liquor, tobacco, and petroleum have largely remained stable as a share of GDP.

[25] These included export income, tourism, agro-processing, healthcare, education, and Small and Medium Enterprises (SMEs).

40. **Discretionary tax incentives undermine policy consistency and erode investor confidence.** In addition to creating significant tax expenditures, these discretionary tax incentives undermine future tax collection by eroding investor confidence due to lack of transparency. For example, projects identified as strategic, under the SDP Act, can negotiate exemptions on many taxes, including CIT, PAYE, VAT, Ports and Airport Development Levy (PAL), and dividends – in some instances running up to 25 years and based on loosely defined criteria.[26] Other companies, however, don't receive exemptions and need to face tax compliance costs in a complex tax administration structure.

Tax administration is rendered ineffective by poor systems and infrastructure, resulting in low filing, and ineffective audit and dispute resolution.

41. **Better tax administration is needed to ensure that tax policy measures translate into higher revenue collections.** Even the most efficient or equitable tax policies may fail if the tax administration is unable to effectively implement these policies.[27] Sri Lanka's tax administration performs poorly across many of the standard dimensions of efficiency and effectiveness, which are summarized in Figure 24.[28,29] First, while IRD maintains a taxpayer register, it is subject to errors, given the frequent changes in the tax base due to adjustments of tax thresholds. Taxpayer registration is not an automated process (for example, being linked to the unique National Identification Card (NIC) database) and instead entails a separate Taxpayer Identification Number (TIN) registration process. Second, compliance rates are low, variable, and have generally been declining.[30] The compliance rate for PIT taxpayers dropped from a peak of 62 percent in 2014 to 41 percent in 2018 and to 30 percent in 2019 (see Figure 27). Compliance for the CIT peaked at 70 percent in 2012 but fell to 47 percent in 2019. VAT compliance was as high as 94 percent in 2010 but fell to 47 percent in 2019. The number of registered VAT taxpayers has also been changing due to reductions in the VAT threshold (Figure 25), and the number of PIT taxpayers also declined sharply in 2020 due to the abolishment of PAYE and withholding tax (Figure 26). Such a structural erosion of the base raises the concern that simply increasing tax rates may not lead to higher revenues. Additional efforts may be needed to improve registration and compliance, such that higher rates and broadened bases lead to higher tax collection. Third, Compliance Risk Management (CRM) uses few external data inputs to estimate the risk of non-compliance and, instead, uses discretion in the selection of cases for audit.[31] Fourth, tax dispute resolution is slow, with many pending cases under dispute.[32]

[26] According to the SDP Act, "Strategic Development Project" means a project which is in the national interest and which is likely to bring economic and social benefit to the country and which is also likely to change the landscape of the country, primarily through: (a) the strategic importance attached to the proposed provision of goods and services, which will be of benefit to the public; (b) the substantial inflow of foreign exchange to the country; (c) the substantial employment which will be generated and the enhancement of the income earning opportunities; and (d) the envisaged transformation in terms of technology.
[27] Two primary objectives of tax administration are: (1) to apply the tax laws uniformly to achieve maximum collection at minimum costs; and (2) to promote voluntary compliance by taxpayers (Inter-American Center of Tax Administrators, 1992).
[28] IRD works alongside the Excise Department and the Customs Department, which primarily focus on excises and customs, respectively.
[29] As measured by the Tax Administration Diagnostic Assessment Tool (TADAT) assessment, conducted in January 2023.
[30] Tax compliance rates are defined as the ratio of tax returns filed to the number of registered taxpayers.
[31] Currently, the IRD Risk Management Unit (RMU) carries out risk analysis at the sectoral level, with the choice of sectors based on little actual data. Furthermore, the flow of information to support audits is outside the Revenue Administration Management Information System (RAMIS), making monitoring and control over cases challenging. Moreover, the audit selection is partly decentralized as discretion is available to auditors to manually select cases for audit.
[32] If the taxpayer is not satisfied with the audit outcome, he can refer his case for an administrative review by another officer within the IRD. If the taxpayer and/or IRD are not satisfied with the outcome of the administrative review, they can appeal before the Tax Appeals Commission, which is a specialized tax court. Subsequent appeals then go to the Court of Appeal and the Supreme Court. There are a huge number of cases pending at each appellate level.

Figure 24: Dimensions of Tax Administration Functions

Robust Taxpayer Base	Effective Risk Management	Support to Voluntary Compliance	Timely Filing and Timely Payment	Accurate Reporting in Tax Declarations	Effective Tax Dispute Resolution	Efficient Revenue Management	Accountability and Transparency
Accurate, reliable database of taxpayers and potential taxpayers	Compliance risks, including institutional, operational, and human capital risks	Inspire public confidence by adopting a service orientation and reducing costs of compliance	Efficiency of filing, use of electronic means for filing and payment, timeliness of payments, incidence of tax arrears	Verification of reporting (tax audits, cross-checking with third party information), proactive initiatives, assessment of tax gap	Existence of timely resolution process	Contribution to revenue forecasting by MoF, maintaining a system of revenue accounts, paying tax refunds	Internal audit, external oversight, public perception of integrity, public reporting

Source: Adapted from the Tax Administration Diagnostic Assessment Tool.
Note: Timely Filing and Timely Payment have been combined for representational purposes.

Figure 25: Registered VAT taxpayers
(Number)

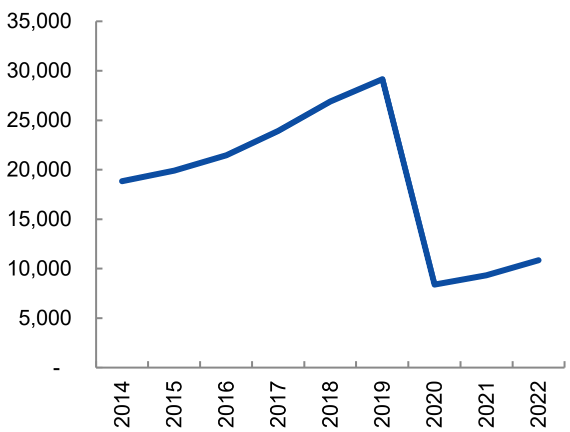
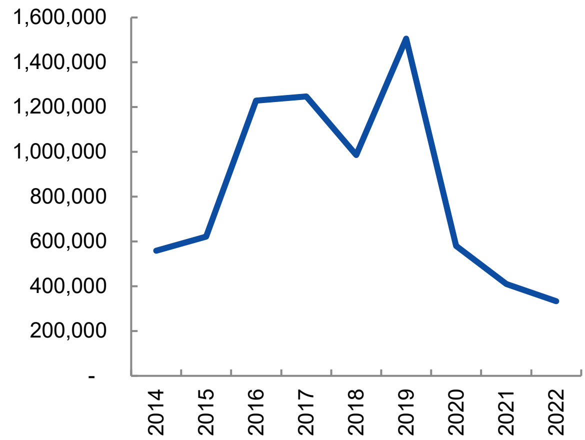


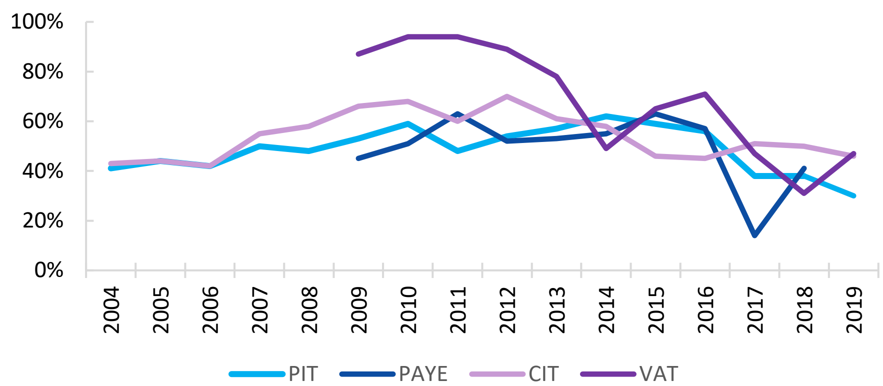
Figure 26: Registered income tax payers
(Number)



Source: Inland Revenue Department

42. **Significant resources are, needed to further strengthen the information and communications technology capacity of IRD, including RAMIS.** Since 2016, IRD has been carrying out all its core functions through an online *Revenue Administration Management Information System* (RAMIS). However, IRD relies on outsourcing to manage RAMIS, including updating the system following changes in the law, maintaining proper functioning, and troubleshooting. This dependence on external sources to manage a critical function makes the IRD vulnerable to operational risks.

Figure 27: Tax return filing compliance ratio
(Percent)



Source: Inland Revenue Department

4. Tax Reforms in a Time of Crisis

43. **To reverse the low tax effort, Sri Lanka has embarked on a series of far-reaching reforms with the support of development partners.** In 2022, the government initiated a revenue-led fiscal consolidation in response to the economic crisis, undertaking reforms aimed at improving revenue as a share of GDP. This tax reform package, under implementation since May 2022, includes the introduction of new taxes, a wide range of adjustments to the tax rates and bases, and an intention to improve revenue administration by improving collection efficiency and increasing compliance (Table 11).

44. **Reforms entail increasing rates of major taxes and adjusting thresholds to expand the tax base.** On PIT, reforms include raising the marginal PIT rate schedule, reducing the PIT tax-free allowance, and introducing mandatory withholding taxes starting from January 2023. On CIT, this includes raising the statutory CIT rate from 24 to 30 percent and removing almost all sector-specific CIT exemptions from October 2022. The increase in the CIT rate from 24 to 30 percent has made Sri Lanka's CIT rate comparable to other countries in the region and globally. The CIT policy changes are expected to raise an additional 0.8–0.9 percent of GDP in taxes depending on the behavioral response to the higher rate. Furthermore, the tax law has been amended, with the intention of discouraging physical cash transactions (transactions outside the banking system) exceeding LKR 500,000, by denying tax deductibility in the computation of taxable income for physical cash transactions above this amount and excluding such physical cash payments from being considered as 'cost of the asset' if the criteria laid down are not complied with.

Table 11: Post-crisis major tax reforms

Tax type	Major Reforms
VAT	• Registration threshold lowered from LKR 300 million to 80 million • Standard VAT rate raised from 8 to 15 percent
CIT	• Standard rate raised from 24 to 30 percent for all sectors • Concessionary rates of 14 and 18 percent removed (export income, tourism, agro-processing, healthcare, education, and Small and Medium Enterprises) • Exemption to information technology sector removed • Exemption on dividend paid by companies to non-resident persons removed • Several tax exemptions removed, including tax holidays to companies in construction material recycling, manufacturing of boats or ships, construction or installation of communication towers, and bonded warehouses
PIT	• Tax free allowance lowered from LKR 3 million to 1.2 million • Maximum marginal rate increased from 18 to 36 percent
Others	• Social security contribution levy, and a tax on imports liable to VAT (introduced at a rate of 2.5 percent of import value for importers with annual imports of more than LKR 120 million) • Capital gains tax increased to 30 percent for corporates from October 1, 2022

Source: Inland Revenue Department, and Ministry of Finance

45. **VAT rates have been increased and thresholds adjusted, with significant further revamping of the system expected in 2024.** The standard VAT rate was raised from 8 to 12 percent in May 2022, and to 15 percent in September 2022, and the VAT registration threshold was reduced in September 2022. These changes to VAT are expected to result in an increase of 2 percentage points of GDP. Fuel excises were also raised in January 2023, to yield an expected additional 0.3 percent of GDP. Potential adverse distributional impacts of VAT rate hikes were mitigated by maintaining certain exemptions, including on basic food items. Although the new VAT rate and threshold are now comparable to some neighboring countries (Table 12), there certainly seems to be room to lower the threshold further. Going forward, the VAT system is expected to be revamped by 2024, with further rationalization of VAT exemptions, speeding up the issuance of valid VAT refunds, and phasing out the Simplified VAT (SVAT) system.[33] In addition, the government plans to reform the property tax, as well as introduce a gift and inheritance tax by 2025.

[33] SVAT is a parallel system for exporters and other firms whose sales are mostly VAT exempt to avoid paying VAT on their inputs, adding complexity to the VAT system.

Table 12: VAT parameters in select countries

Country	VAT Rate (percent)	Threshold (USD)
India	18	51,000
Pakistan	17	48,000
Indonesia	10	320,000
Thailand	10	51,000
Sri Lanka (2021)	8	832,977
Sri Lanka (2023)	15	250,000

Source: Ernst & Young worldwide VAT, Goods & Services Tax (GST), and Sales Tax guide

46. **While recent reforms led to an increase in nominal tax collection, the tax to GDP ratio remained stagnant.** Although full year effects of the tax policy changes implemented in 2022 are only expected in 2023, nominal tax revenue collection increased by 43.4 percent in 2022 compared to 2021, driven by an increase in collections from income tax (76.8 percent) and VAT (50.2 percent).[34] Capital gains tax collections increased in 2022 from a low base due to the higher capital gains tax rate, applicable to corporates from October 1, 2022. Excise revenue collection increased by 11.6 percent (y-o-y) in 2022 in nominal terms.[35] Despite the increase in nominal revenue collection, tax revenue as a share of GDP fell marginally from 7.4 percent in 2021 to 7.3 percent in 2022.

47. **Revenue performance has improved further in nominal terms in 2023 but has fallen short of targets.** Nominal tax revenue collection increased by 36.6 percent in January–April 2023 (y-o-y). This was driven by an increase in the collection of VAT, income tax, excise, and revenue from the Social Security Contribution Levy introduced in October 2022 (Table 4 in Part A). However, as discussed in Part A, some of the nominal increase in revenue is driven by higher inflation. Despite this, revenue collection in the first four months of 2023 has still fallen short of what was budgeted.

48. **Some tax administration reforms are already planned to complement the tax policy changes.** Significant tax administration reforms are needed to ensure that the higher tax rates and broadened bases actually lead to higher revenue. To strengthen PIT collection efficiency, mandatory withholding taxes on employment income, services payments, and capital income were reinstated from October 2022. The government also plans to improve the Large Taxpayer Unit, strengthen IT-based tax administration, and publish the estimated direct costs of corporate tax incentives to help strengthen tax collection efficiency and enhance fiscal transparency.

Fiscal policy has overall been progressive in the aftermath of the crisis, but indirect tax changes have been regressive.

49. **Direct taxes and transfers have been progressive and have helped offset some of the negative impacts of the crisis on household incomes.** The progressivity of direct taxes has increased relative to 2019. As the taxable income threshold was lowered from LKR 3 million to LKR 1.2 million in 2023, the taxation schedule became more progressive, with rates for taxpayers in higher-income brackets increasing to between 6 to 36 percent (relative to between 4 and 24 percent in 2019). Direct taxes now account for 9.5 percent of pre-fiscal income for households in the richest decile, which represents a 4.5 percentage point increase relative to 2019 (Figure 28).

50. **On the other hand, indirect taxation became regressive during the crisis.** While the increase in indirect tax rates was consistent across income groups, consumer price inflation, including for food and energy essentials, significantly eroded purchasing power in the poorest households, resulting in a greater indirect tax burden (measured relative to incomes) than in 2019. In 2019, indirect taxes accounted for 7.5 percent and 8.3 percent of pre-fiscal income for households in the bottom two deciles of the population,

[34] Annual Performance Report, Inland Revenue Department (2022)
[35] Annual Performance Report, Excise Department (2022)

which was marginally less than households in the richest two deciles (at 10.9 percent and 9.7 percent). The increase in indirect taxes (including the VAT rate, fuel and diesel excises, and liquor and tobacco excises), impacted the poor disproportionately. Indirect taxes now account for 11.0 percent and 8.3 percent of pre-fiscal income for households in the bottom two deciles, which is more than the share for households in the top two deciles (at 8.7 percent and 7.9 percent) (Figure 29).

Figure 28: Incidence of taxes and transfers 2019
(Percent of market income)

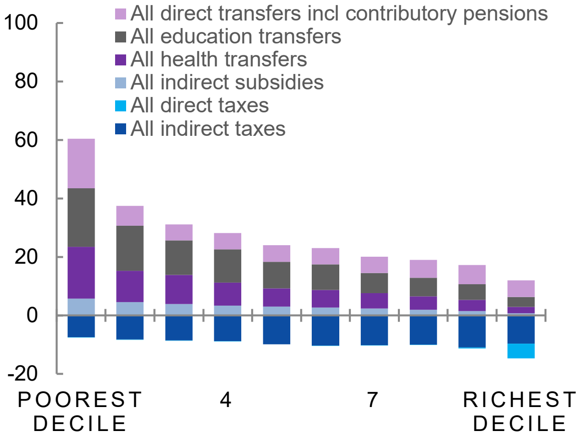
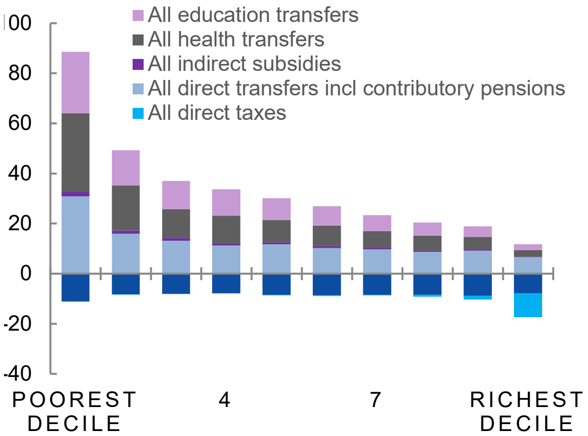


Figure 29: Incidence of taxes and transfers 2023
(Percent of market income)



Source: Staff calculations of fiscal incidence analysis using 2019 HIES.

5. Recommendations and Way Forward

51. **To achieve macro-fiscal and debt sustainability, and reach its tax potential, Sri Lanka needs to increase its share of tax to GDP substantially.** The country has undertaken significant tax reforms in 2022 and 2023, but additional measures are needed.[36] The recommendations in this section focus on measures that have either not been committed to or are yet to be implemented.[37] The proposals look to increase the effective tax rates for select major taxes, broaden the tax base, and improve tax administration. These recommendations are short to medium-term in nature, and ultimately need to be embedded in a longer-term revenue reform plan.

Impose a minimum CIT on book profits

52. **A minimum CIT, based on an alternate tax base, like book profit, can improve tax collection and is also in line with global trends**. A minimum tax levied on all corporations, including Strategic Development Projects, would mitigate some of the revenue losses due to CIT tax exemptions. A minimum tax of 15 percent on book profits applied on all companies, including BOI companies, would ensure that those below the 15 percent threshold would contribute a minimum amount to tax revenue.[38] Applying the minimum tax on book profits ensures that only profit-making companies contribute towards the minimum tax.[39] Countries that have adopted a minimum tax raise an additional revenue of about 1 percent of GDP as compared to countries that have not adopted such minimum tax.[40]

Strengthen capital taxation

53. **To make the tax system more equitable and collect more revenues, capital gains could be taxed at progressive rates for individual taxpayers.** Currently, capital gains on sale of assets are taxed

[36] IMF EFF assumes an increase to 14 percent of tax to GDP by 2027
[37] As of September 2023
[38] When in subsequent years the tax paid is above 15 percent of book profits, the additional tax could be carried forward to future years. This is akin to the Economic Service Charge that was abolished in 2020 and was applied to turnover instead of book profits.
[39] Book profits are also the basis for the global minimum tax that is being discussed under Pillar-2 by the Inclusive Framework.
[40] A Firm Lower Bound: Characteristics and Impact of Corporate Minimum Taxation, IMF (2021) WP/21/161

at a flat rate of 10 percent for non-corporates (including individual taxpayers), and 30 percent for corporates. Furthermore, for resident individuals, gains up to LKR 50,000 per asset and LKR 600,000 per annum on aggregate are exempt. The bulk of capital gains generally accrue to taxpayers in the upper end of the income distribution. Taxation of capital gains at a progressive rate schedule will ensure that these gains are taxed at the maximum marginal tax of 24–36 percent. While the immediate revenue gain will likely be small, this is an important step to improve equity.

54. **Initial measures could be introduced to improve capital gains taxation.** As a temporary measure, the cost basis of the asset used to calculate the capital gains could be indexed for inflation, with inflation indexes being notified by the IRD each year. The IRD should also notify the minimum market rates that would apply for calculating the capital gains, to address undervaluation of sale prices. Lastly, a non-final 15 percent withholding tax could be considered when the sale price exceeds a minimum threshold to ensure better compliance.

55. **Capital taxation could be strengthened by introducing non-distortive taxes like wealth, gift, and inheritance taxes.** The introduction of a wealth tax could be a useful means of raising revenue in a non-distortive and equitable manner if the full implementation of taxation of capital income is not feasible.[41] Sri Lanka used to have a wealth tax, but this was abolished in 1992. This tax may need to be reinstated, albeit with a better design. The wealth tax should be broad-based, with no exemptions as to the form of the taxpayer (physical person or legal person) and with no exemptions on the type of assets (shares, immovable property, rights). A high enough threshold would ensure that such a tax covers only the very wealthy to minimize compliance costs for others. In the longer term, well-functioning property taxes can help the government raise revenue in a non-distortive, growth-friendly, and equitable manner. While property taxes exist in Sri Lanka, their revenue potential has not been fully reaped. More consistent, and transparent property taxes should be considered by government, and adequate adjustments to inter-governmental fiscal relations (between the central and local governments) may need to be made. Finally, the introduction of gift and inheritance taxes can also contribute towards strengthening capital taxation.

Rationalize tax incentives and publish tax expenditure statements

56. **Tax incentives should be reviewed and rationalized to improve their effectiveness.** Tax expenditures (estimates of revenue foregone due to tax exemptions or tax reductions) granted under VAT, CIT, PIT, and other taxes should be thoroughly reviewed and rationalized to enhance their effectiveness. For instance, exemptions related to the stock market should be curtailed[42] VAT exemptions are still prevalent and require a thorough review, even though some exemptions (such as on the sale of condominium residential houses) have been withdrawn as part of the recent reforms. PIT exemptions are significant. In 2018, more than 90 percent of exempt income claimed by individual taxpayers in the income returns was enjoyed by taxpayers with taxable income exceeding LKR 2.5 million.

57. **Regular publishing of tax expenditure statements will help in improving transparency.** As a first step, the cost of existing tax incentives, in terms of revenue foregone, needs to be quantified and published in a statement of tax expenditures. The statement could cover the major taxes and should be prepared annually and placed before Parliament. This would enhance fiscal transparency by making the public aware of the revenue lost; enhanced public scrutiny could encourage greater fiscal discipline by the government.

Effective implementation of the Tax Administration Modernization Strategy

58. **Expedite tax administration reforms.** The IRD is in the process of developing a *Tax Administration Modernization Strategy* for the short-to-medium term. This includes specific actions for taxpayer

[41] The key difference between the wealth tax and capital income tax is that the former implicitly taxes high-return investments more lightly than the latter.
[42] Currently, a share transaction tax of 3 percent is levied. Such a transaction tax, applied on the transaction value and not the gains, is not equitable, as it is not linked to the level of income. Instead of a share transaction tax, a non-final withholding tax of 15 percent on the capital gains arising on the sale of a share could be considered. Taxpayers would then be obligated to file tax returns, include capital gains in their taxable income, pay taxes at the progressive rates, and take credit for the tax payments that were withheld.

registration, CRM, third party information reporting and matching, e-filing and e-reporting, audit processes, and tax appeals management, underpinned by the upgrading of the RAMIS system (see Figure 30). The remaining recommendations in this section focus on key administration reforms, drawing on select areas under the modernization strategy.

Figure 30: Tax Administration Modernization Focus Areas

Strengthen third-party information use

59. **Effective use of third-party information can strengthen compliance risk management.** Systematic third-party information reporting is needed to strengthen IRD's tax compliance enforcement capability. Third parties are agencies who have access to transactions by taxpayers that may indicate a liability for taxation. For example, high-value purchases, such as an expensive car or house, may indicate a liability for taxation. When such transactions are reported to the tax administration, they serve as useful inputs for CRM.[43] The government has recently amended the tax law to make it mandatory for third parties, including the land registrar, motor vehicle authority, registrar of companies, banks, and financial institutions, to share taxpayer information with IRD.[44] To ensure better monitoring and use of this information received by IRD, such information should be compiled and processed centrally, and disseminated to the field offices through RAMIS in a time-bound manner.

Boost taxation of large and high net worth taxpayers

60. **Strengthen tax administration capacity to deal with complexities related to large and high net worth individuals with high revenue potential.** Large and high net worth taxpayers generally contribute to the bulk of the tax revenues (**Error! Reference source not found.**). As a result, they often require special considerations, particularly regarding CRM. The IRD needs to strengthen its capacity to deal with the complexity arising in many of these cases, including use of third-party information received from foreign authorities under automatic exchange of information, and taxation of international transactions.

Improve compliance

61. **On-time filing compliance and e-filing compliance should be strengthened.** To address low tax return filing compliance rates, the IRD needs to: (i) encourage greater use of e-filing, which reduces costs of compliance; and (ii) improve CRM systems. E-filing enhances the speed and capacity of the tax administration to implement risk-based selection for audits, including using data mining to detect tax evasion. It also greatly increases the capacity of the tax administration to leverage data provided through tax returns and reduces error in tax return processing. Table 13 shows that on-time filing compliance for CIT, PIT, and VAT returns was lower than 50 percent in the 2019-21 period.

[43] Currently, the IRD obtains information on such transactions through Memorandums of Understanding (MoUs) with agencies such as banks and property registration agencies in local government. However, compliance in providing these MOUs is not strong.
[44] Inland Revenue (Amendment) Act, No. 4 of 2023

62. **Although corporate e-filing increased significantly in 2022 after the IRD successfully implemented mandatory e-filing by companies in 2021, e-filing compliance for non-corporates and VAT remains very low.**[45] Only 23 percent of individual taxpayers e-filed in 2021-22, as paper returns continue to be allowed. The tax law has recently been amended to make e-filing mandatory by non-corporate taxpayers. To further encourage e-filing, issuance of refunds for e-filed refunds should be expedited and directly deposited into taxpayers' bank accounts. CRM can also be strengthened by limiting discretion and introducing transparent processes to improve the flow of information.

Table 13: On-time and e-filing performance, 2019-21

Year	Corporate (percent)		Non-Corporate (percent)		VAT (percent)	
	On-time filing	E-filing	On-time filing	E-filing	On-time filing	E-filing
2019–20	46	8	31	6	47	41
2020–21	26	34	21	10	47	69
2021–22	32	100	33	23	46	45

Source: Inland Revenue Department

Strengthen dispute resolution

63. **Strengthen dispute resolution to reduce the pending appeals.** Allocation of cases for administrative review should ideally be random, instead of being jurisdiction-based as is currently done. To manage the appeal workload, suitable thresholds for revenue impact may be used for filtering out small cases. Appeals in pending cases below the threshold can be withdrawn and settled without prejudice to IRD's position in cases that are pending on a similar issue.

Enhance tax administration infrastructure

64. **Upgrading IT infrastructure is critical to enhance tax administration efficiency and effectiveness.** Given the IRD's vulnerability to operational risks, particularly due to its dependence on external providers to manage RAMIS, the IRD could consider in-sourcing the management of RAMIS in the near term by deploying adequate resources, including technical staff, and outsourcing to the domestic IT sector those functions that can be most effectively delivered by the private sector (for example, data centers). This will enable the IRD to fully control timely availability of RAMIS modules needed to effectively manage critical functions and processes, such as e-filing and processing of returns.

6. Conclusion

65. **Resist policy reversals, improve equity, and sequence reforms well.** Sri Lanka's tax system is going through a period of significant reform, which is needed to stem the decline in revenue performance over the last three decades, and especially since 2019. Given the country's history of tax underperformance, the proposed short-to-medium-term policy recommendations will need to be accompanied by additional measures to: (i) ensure that tax policies are not reversed, (ii) rebuild and expand the tax base, and (iii) increase progressivity and ensure fair burden-sharing across various income groups. The overall revenue adjustment needs to be guided by a strategic reform plan that includes an appropriate sequencing of reforms – in line with technical and capacity considerations. Consistent implementation of this plan will drive improvements in revenues as the economy recovers, and it will help build a resilient tax system that can serve as a foundation for fiscal sustainability and better public service delivery.

[45] Inland Revenue (Amendment) Act, No. 4 of 2023

Annex 1: Multiplicity of taxes and levies in Sri Lanka and frequent policy changes

Tax type	Tax base	Status	Major policy changes
Taxes on domestic goods and services			
Value Added Tax	Domestic consumption including financial services and imports	Introduced in 2002	• Registration threshold changed several times during 2002–2023 – 1.8 million (2002), 2.5 million (2009), 12 million (2013), 15 million (2015), 300 million (2020), and 80 million (2022). • Standard VAT rate changed several times during 2002–2023 – 10 percent (2002), 15 percent (2004), 18 percent (2005), 20 percent (2005), 8 percent (2019), 12 percent (2022), and 15 (2022). • Simplified VAT (SVAT) introduced in 2011 for Business-to-Business (B2B) transactions by exporters and suppliers to exporters. • Exemption to sale of condominiums (2019) and information technology and enabling sectors (2020). • VAT introduced for wholesale and retail businesses in 2013 with frequent changes to registration threshold during 2013–15.
Excise Duty	Imports and domestic production of liquor, drugs, fuel, aerated drinks, motor vehicles	Introduced in 1913	• Excise (Special Provisions) Act introduced in 1989 with multiple exemptions in Schedule II. • Rates vary for goods; major rate increase in 2015, and recently in 2023.
Tobacco Tax	Manufactured and imported tobacco products	Introduced in 1973	• Tobacco Tax Act introduced in 1999. • VAT liability on cigarettes temporarily removed in 2014.
Tax on international trade			
Customs Duty	Value of imported goods		• Rates are 0, 10, 15 percent
Ports and Airport Development Levy (PAL)	Value of import of specified goods	Introduced in 2009	• The standard rate is increased from 7.5 percent to 10 percent with effect from 6 December 2019. Apart from the standard rate, three preferred rates were introduced. Such concessionary rate of PAL on articles that were subject to Nation Building Tax (NBT) is increased by 2.5 percent. However, the PAL rate on the articles that were excepted from NBT remained unchanged.
Tax on income, profits, and gains			
Income Tax	Income from employment, business, investment, and other sources	Introduced in 2017	• Tax free allowance increased from 400,000 to 500,000 in 2011; further increased to 3 million in 2020; reduced to 1.2 million in 2023. • Maximum marginal rate reduced from 24 percent to 18 percent in 2020; increased to 36 percent in 2023. • Compulsory PAYE removed in 2020; re-introduced in 2023. • Removal of mandatory Withholding Tax in 2020 • Final withholding tax of 15 percent on dividends introduced in 2023
Surcharge tax	Taxable income	Introduced once in 2020	• Rate is 25 percent of taxable income exceeding 2 bn.
Capital Gains Tax	Gains from transfer of investment assets	Introduced in 2017	• Gains not exceeding 50,000 per asset or 600,000 per annum are exempt. • Rate is 10 percent.
Special Commodity Levy	Import value of specified commodities	Introduced in 2007	• The Special Commodity Levy, imposed in lieu of any tax, duty, levy or Cess, or any other charge imposed in terms of any of the laws
Other Taxes / Levy			
Telecommunications Levy	Value of supply of telecom services by any person	Introduced in 2011	• Telecommunications Levy Act, 2011 • Rate reduced from 15 to 11.25 percent in 2019 and increased to 15 percent in 2022
Tourism Development Levy	Turnover of hotels and tourism institutions	Introduced in 2003	• Rate is 1 percent
Social Security Contribution Levy	Imports value liable to VAT	Introduced in 2022	• Registration threshold is 120 million. • Rate of levy is 2.5 percent. • Exemptions allowed to motor vehicles, unprocessed gems, rice etc.
Economic Service Charge	Turnover of any business, profession, or vocation	Introduced in 2004; Abolished in 2020	• Registration threshold (per quarter) changed – 12.5 million (2006), 25 million (2011), 50 million (2012)
Share Transaction Levy	Sale or purchase value of share transaction	Introduced in 2005	• Rate changed from 0.2 percent to 0.3 percent in 2011
Construction Industry Guarantee Fund Levy	Value of construction contract	Introduced in 2005	• Exemption to contracts for specified projects approved by Ministry of Finance since 2011
Betting and Gaming Levy	Gross turnover of gaming businesses	Introduced in 1988	• Rate changed to 5 percent (2012), 10 percent (2015)
Nation Building Tax	Imports and turnover of manufacturers, wholesalers, retailers, and other businesses	Introduced in 2009; Abolished in 2019	• Rate changed several times during 2009–2019 – 1 percent (2009), 3 percent (2009), 2 percent (2011)
Migrating tax	Foreign exchange taken out of country by citizens permanently leaving Sri Lanka	Introduced in 2015	• Rate of tax is 20 percent
Debt Repayment Levy	Value addition on supply of financial services	Introduced in 2018; Abolished in 2022	• Rate is 7 percent