

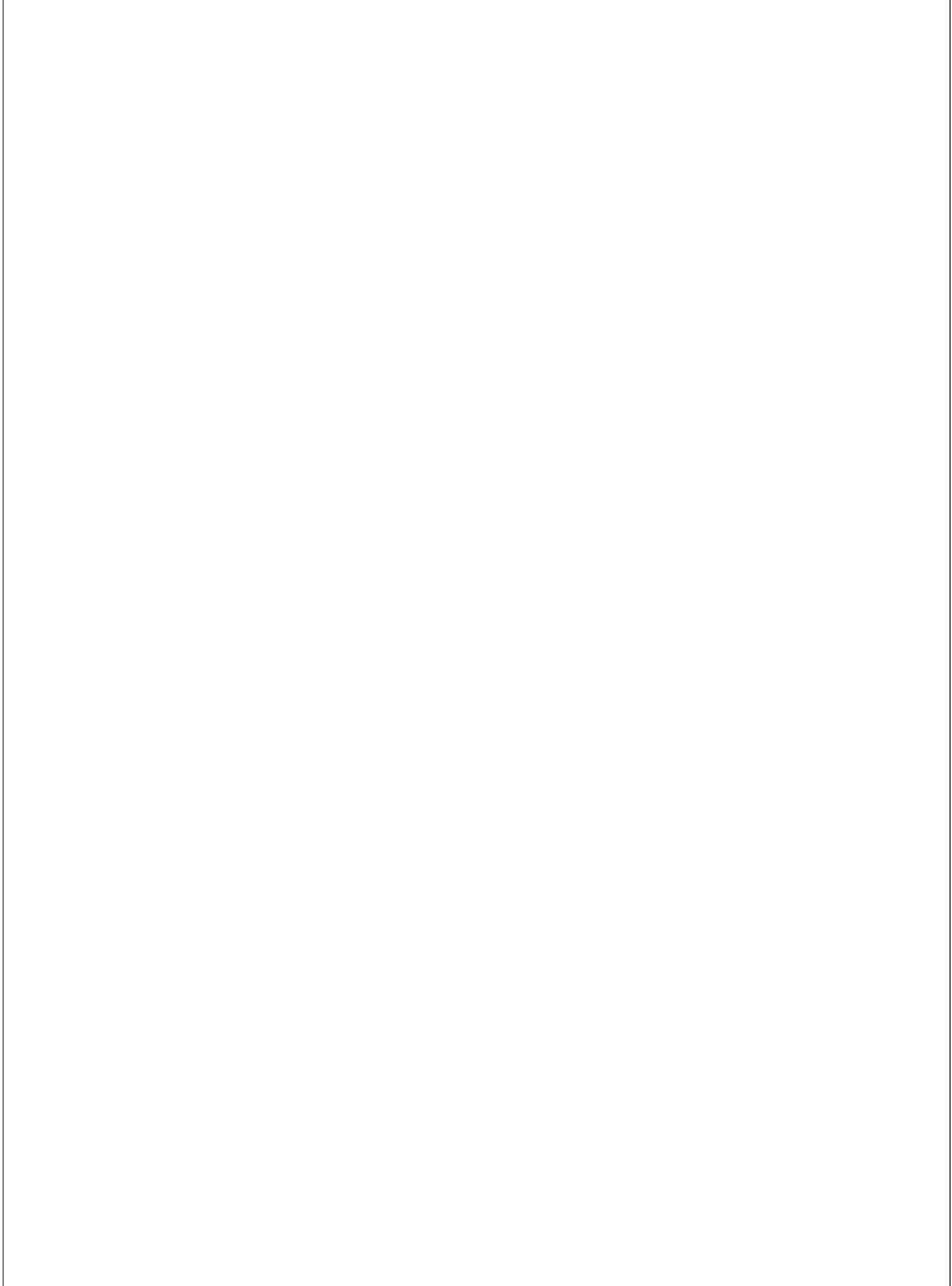


COUNTRY STUDY REPORT
SRI LANKA



Tax Policy and Enterprise
 Development in South Asia





COUNTRY STUDY REPORT

SRI LANKA

TAX POLICY AND ENTERPRISE
DEVELOPMENT IN SOUTH ASIA



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About the Research

This research examines the impacts of property tax, value-added taxes, and tax exemptions and concessions on small enterprise development in South Asia. The goal is to provide decision-makers with data and insights to support more informed policy formulation and implementation for inclusive growth, productive employment, and enterprise development. The research also aims to examine the issues as they affect women entrepreneurs, to promote positive learning experiences among the countries, build fruitful exchanges, and foster effective policy discussions in a regional context.

The targeted outcomes include 5 Country Study Reports as well as a regional report based on Meta analysis. The reports are published and widely disseminated at the policy engagement workshops. Other project outcomes are policy workshops in all five countries and workshop reports, as well as an interactive website to support research and advocacy.

About IPS

The Institute of Policy Studies (IPS) was conceived in the mid-1980s as an autonomous institution designed to promote policy-oriented economic research and to strengthen the capacity for medium-term policy analysis in Sri Lanka. It was established by an Act of Parliament in December 1988 and was formally set up as a legal entity by gazette notification in April 1990 managed by a Board of Governors and the Executive Director. From its inception, the IPS was supported through a collaborative project between the Royal Netherlands Government and the Government of Sri Lanka under four phases of operations to allow the Institute to gradually diversify its income and resource base. In the interim, the IPS has been successful in establishing its own Endowment Fund and setting in motion the transition to full financial independence with the formal ending of the fourth phase of operations in June 2006.

The IPS has now emerged as a national and regional centre of excellence, with a high-caliber staff and a proven track record of independent high-quality research over nearly twenty five years.

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List of Abbreviations & Acronyms

ADB	Asian Development Bank
BOI	Board of Investment
BTT	Business Turnover Tax
CIT	Corporate Income Tax
CMC	Colombo Municipal Council
EPZ	Export Promotion Zone
EU	European Union
FDG	Focused Group Discussions
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Services
GDP	Gross Domestic Product
GOSL	Government of Sri Lanka
GST	Goods and Services Tax
MSE	Medium Size Enterprises
NBT	Nation Building Tax
NCCSL	National Chamber of Commerce of Sri Lanka
NIPFP	National Institute of Public Finance and Policy
IAS	International Accounting Standards
IFC	International Finance Corporation
INGO	International Non-Governmental Organizations
IRD	Inland Revenue Department
IT	Income Tax
JAAF	Joint Apparel Associations Forum
JIAC	Japan Investment Advisory Council
KII	Key Informant Interviews
LVT	Land Value Tax
OECD	Organization for Economic Co-operation and Development

PAL	Port and Airport Development Levy
PWC	PricewaterhouseCoopers
R&D	Research and Development
SD	Standard Deviation
SDP	Strategic Development Project
SLR	Sri Lankan Rupees
SME's	Small and Medium Enterprises
SVAT	Simplified Value Added tax
TIN	Tax Payer Identification Number
TT	Turnover Tax
VAT	Value Added Tax
UNCTAD	United Nation Conference on Trade and Development
WOSME	Women Owned Small and Medium Enterprises

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Executive Summary

The taxation of Small and Medium Enterprises (SMEs) present a critical challenge for policymakers in developing countries like Sri Lanka. On the one hand, taxation provides a vital source of revenue for governments to provide fundamental social and economic services such as the provision of defense, healthcare, education, and infrastructure. On the other hand, both the direct and indirect effects of taxation do influence the SME growth. In developing countries like Sri Lanka, with a relatively small and unsophisticated private sector, in which SMEs dominate, getting the policy mix right with regard to taxation of SMEs is very important. This paper takes a look at Sri Lanka's contemporary tax regime with the aim of addressing research questions under the following three research themes

- 1) Analyze the effects to tax concessions on SMEs
- 2) Analyze the effects of Value Added Tax on SME development
- 3) Assess the Impact of Property Tax on SME

The study employs a mixed methodology approach, including a desk-based literature review of relevant grey material; a firm-level survey followed by statistical analysis of the results; key informant interviews using a semi-structured questionnaire; and focus group discussions.

Findings from the study suggest that the prevailing fiscal incentive structure (tax exemptions and concessions) is largely skewed in favor of large enterprises. Whilst there have been a number tax-related provisions in favor of SMEs, the lack of a sound definition of what constitutes an SME continues to be a major area of concern, and the targeting of fiscal incentive packages have been ineffective as a result. Awareness is another area of concern as the study reveals that the majority of SMEs in Sri Lanka is misinformed with regard to the costs and benefits of tax compliance, and is unaware of the tax concession available to them. Sri Lanka needs to focus more on creating better tax awareness amongst SMEs to increase compliance and formalization. Research findings further suggest that tax compliance is also an area that needs urgent reform. The firm-level survey, which formed the basis of this research study, reveals that SMEs find the prevailing tax structure to be complex and cumbersome, making compliance difficult, costs of compliance regressive, and an overall drag on SMEs growth potential.

The study finds a limited influence of property taxation on SMEs. Given the current methodology of property tax assessment, the direct tax burden in nominal, further the

compliance process simple hence SMEs do not consider it to be a major issue. The real issue with regards to property ownership is the high cost of land and complex procedures associated with purchasing land.

The study points to several policy recommendations. At the outset for the purpose of taxation a common definition of what constitute an SME, taking into account variations within and across economic activities, needs to be urgently established to ensure better targeting of incentives to SMEs. The study also calls for the simplification of the tax structure to ensure that tax compliance is made more SME-friendly. Sri Lanka also has to embark on a major campaign amongst SMEs to create awareness on why and how to become tax compliant and the benefits of formalization. This could be through the effective mobilization of public private partnership arrangements such as tax information clinics.

SECTION-I

Literature Review

1.1 Review of International Literature

1.1.1 Small and Medium-sized Enterprises (SMEs) and Taxation

SMEs form the backbone of the majority of economies across the world. Although smaller in size, when aggregated, SMEs contribute a bigger share to the economy than large enterprises. Most large companies have their roots in SMEs, suggesting that the SMEs of today form the foundations of large companies in the future. SMEs are perceived as the seedbed for indigenous entrepreneurship, and thus, must be nurtured to ensure they blossom into vibrant enterprises. Given the important role that SMEs play in the development process through the mobilization of domestic savings, and the contribution they make towards poverty reduction efforts, it is of paramount importance that developing countries create a conducive environment for SMEs to grow by strengthening factors that lead to business success and address bottlenecks and threats which threaten and/or stifle their very existence/advancement (Atawodi & Ojeka, 2012).

In most high-income countries SMEs contribute close to 50 percent of GDP and employ over 60 percent of the labor force. In developing countries the picture is however starkly different, SMEs only account for 17 percent of GDP and employ 30 percent of the workforce. Whilst there exist a large number of microenterprises and a number of large enterprises SMEs only constitute a handful (Ayyagari et al., 2003). This so-called SME gap in developing countries has been termed the 'missing middle'. Numerous studies have been carried in developing countries to ascertain the causality behind the 'missing middle'; however no study has honed in on a single causality, rather different studies cite different reasons. Tybout (2000) argues that it is because developing country consumers demand different kinds of goods. Other studies such as Rauch (1991) and Klapper et al. (2006) cite that it is as a result of costly business regulatory environments that only large firms can survive and others have to fly under the radar by staying small and informal. In line with the latter taxation has been cited widely as a key regulatory obstacle which contributes to the stifling of investments and enterprise performance

1.1.2 Taxation and its Impact on Enterprise Growth and Investment

In the words of former United State Supreme Court Justice, Oliver Wendell Holmes, 1904, 'Taxes are what we pay for a civilized society'. Governments require a steady source of

funding to finance social programs and to take onboard public investments to foster economic growth and development. Programs such as the provision of healthcare, education, infrastructure and other amenities are fundamental in collectively moving towards a common goal of a prosperous, functional and orderly society. It is a well-established fact that the taxation of businesses and individuals provide a vital stream of finance, which enables governments to undertake such activities (PwC, 2012). In this contemporary era, private enterprises play a central and dynamic role in the process of economic development. Companies employ workers, improve their skills and knowledge base, buy from local suppliers and provide products and services that enhance people's lives and standard of living. Being beneficiaries of government-funded services, whilst being profitable, it is most often the case that private enterprises in both developed and developing economies around the world are expected to oblige by paying their dues to governments in the form of taxes (Atawodi & Ojeka, 2012).

Whilst taxation is essential to ensure the delivery of vital government services, it has a direct bearing on private enterprise growth. In many low-income economies access to and the cost of credit is major constraints to enterprise growth, this is particularly true for smaller enterprises. Such firms therefore have to rely heavily on internally generated funds to finance investments. Under such circumstances, taxation impacts private investment in two ways. Firstly, it reduces the expected after-tax revenue from a given investment project and secondly, it reduces the availability of investment finance. Even if an adequate number of profitable investment projects were available, high business taxation is likely to adversely impact the level of private investment by constraining investment finance. A cross country study by Djankov et al. (2010) in 85 developing countries finds that corporate tax rates are correlated with investments in manufacturing but not with services, as well as the size of the informal economy

1.1.3 Implications of Tax Concessions for Enterprise Growth and Investment

In taxing private enterprises, two broad approaches exist. One such approach is to apply a uniform tax provisions across all forms of businesses whilst applying a low tax rate. The other approach is to tax various business activities differently to achieve economic policy goals, such as increase in private investment, exports or employment. The latter approach is typically implemented through fine-tuned incentives (Chen & Reinikka, 1999). Such incentives often materialize in the form of tax concessions. Tax concessions could be defined broadly as preferential tax treatment for certain types of firms or entities and is a common feature in both developed and developing countries. It is most often the case that concessions are granted to promote investment, in which case they may be termed "tax incentives" or "investment incentives," or to achieve a desired social objective. For instance, tax incentives in the form of corporate income tax (CIT) holidays for five- to ten-

years may be granted to firms that export goods and services or that locate in designated areas or regions. In addition exemptions from import-related duties and taxes on capital imports to promote investment, or on a wide range of other imported goods for statutory or civic bodies or nonprofit organizations may also be extended. In most developing countries tax incentives are extended to foreign investors (Chai & Goyal, 2008). In addition to tax holidays and duty drawbacks and exemptions, developing countries also employ tax incentives such as concessionary tax rates, and accelerated depreciation allowances (UNCTAD 2004). The use of tax concessions can result in a relatively high tax rate in some sectors and hence induce problems for compliance, and adversely affect the general investment climate (Chen & Reinikka, 1999).

1.1.4 Indirect Implications: Taxation and Informality

In addition to the direct impacts of tax rates on investment and enterprise growth a host of indirect implication of taxation on investment and enterprise growth also exists. A number of empirical studies have highlighted that taxation is the core obstacle to the formalization of business. Findings of these analytical studies are further reinforced by the results of business surveys carried out in developing and transition economies. The PwC/World Bank publication of paying taxes reported that 90 percent of the companies surveyed cite tax systems as the major obstacles for business. The main reasons being large numbers of business taxes to pay, complex and lengthy administrative procedures, complex legislation and high tax rates. The report finds direct correlation between burdensome taxation and the incidence of informality. Country specific surveys in South Africa cite that paying taxes and bureaucratic procedures associated with formalization and other levies are the main drivers of the informal economy. Likewise in Kenya, Pakistan, Ukraine and Bulgaria taxation and associated tax burdens tops the list of business obstacles which discourages formalization and investment.

1.1.5 Indirect Implications: Compliance Costs

High tax burdens are not necessarily associated with high tax rates. Rather tax compliance cost can also prove a substantial expense which adds to the cost of formalizing small businesses. A compliance cost survey in New Zealand a country with a more modern and highly efficient tax administration revealed that businesses allocated over 41 percent of total compliance costs to taxation related issues. Compliance costs as defined by Stanford (1989) [cited in IFC, 2007] refers to costs incurred by taxpayers or by third parties such as businesses in meeting the requirements of the tax system over and above the tax liability itself and over and above any harmful distortion of consumption or production to which the tax may give rise. From a business's point of view compliance costs includes costs associated with collecting, remitting and accounting for tax on the products and profits of

the business and wages and salaries of employees. It also covers costs associated with acquiring knowledge/information such as legal obligations and penalties which enable companies to undertake compliance. In light of the above compliance costs thus have both monetary and non-monetary elements which could be broadly categorized into monetary costs (e.g. fees paid to lawyers, accountant, lawyers, salary for staff engaged in tax returns and accounting, tax literature and software and phone calls and postage), time costs, i.e. time spent studying tax legislations, time preparing tax audits and time spent on preparing appeals and lastly psychological costs such as stress and anxiety arising from compliance related activities and frustration as a result of taxpayer harassment by authorities.

Studies have found that tax compliance costs are highly regressive and thus can place a higher burden on formalized small enterprise. Findings of a research study on compliance costs in OECD countries by Stanford (1989) [cited in IFC, 2007] argues that compliance costs are frequently inequitable in their incidence and in particular the compliance costs of business taxes fall heavily on smaller enterprises thus are resented by the smaller entrepreneurs forming a seedbed for tax evasion. More recent studies have shown that overall tax compliance costs remain highly regressive in countries such as New Zealand and the EU. Similar results have been shown in developing and transition economies in Slovenia and Croatia, South Africa and India. In India in particular the study by Das Gupta finds that in all aspects there is a highly regressive incidence.

1.1.6 Pitfalls of Informality in Enterprise Growth

Non-compliance with tax systems enables small informal businesses to gain a competitive edge in terms of pricing over their formal counterparts. In addition they avoid the frustration of adhering to complex tax procedures (compliance costs associated with taxation) and harassment by tax officials. Whilst non-compliance has its own advantages, these advantages are however overshadowed by the disadvantages resulting from non-compliance. Unregistered businesses do not entirely escape taxation; their indirect tax burden may be substantial. Informal enterprises may be able to circumvent the payment of VAT on sales; however they are unable to reclaim VAT credits on inputs. An FIAS sector study in South Africa has shown that the marginal effective tax rate is highest for non-VAT registered small enterprises on capital investments of any sector. Un-registered MSEs may therefore be severely handicapped as a result of their inability to claim refunds of VAT paid on their inputs.

Informality may not necessarily be free of charge; MSEs may be subject to substantial demands for bribes by tax officials in exchange for overlooking compliance and not being prosecuted for non-compliance. There also exists the possibility of reduced scope for business expansion as a result of staying informal. Formalized businesses most often have

access to VAT-refunds on input and thus prefer to procure their inputs from VAT-registered clients who can present a VAT invoice to enable them to obtain the refund. Unregistered businesses are unable to comply with such requested and thus may lose out on such businesses. Likewise unregistered MSEs may be disadvantaged as a result of not being able to tap into government tenders as it is most often the standard practice that in order to be awarded a government contract the contract must present a tax clearance certificate. Businesses not registered for taxation cannot obtain such certificates and thus are deprived of tapping into the government contracts. Another serious restraint which undermines the ability of MSEs to grow is the fact that the ability of non-registered enterprises to advertise publicly to attract new clients is thwarted owing to the fact that tax administrators have increasingly started to scan through newspaper advertisements, telephone books and business directories to identify hidden tax payers. The compulsion of having been required operate in a more secluded manner reduces business potential and growth.

An equally serve consequence of non-compliance is the limited access to credit. Mobilizing finances from donor supported micro-finance facilities; government and the formalized credit industry most often require the presentation of taxpayer identification numbers and a business registration certificate. Non-registered enterprises are unable to meet such requirements and thus are unable to access credit formal rates and thus are compelled to depend on informal credit at higher rates. Limited access to credit severely undermines the ability of MSEs to expand their businesses (IFC, 2007).

Taxation could be categorized broadly into direct and indirect taxation. Having explored the consequences of direct taxation (i.e. corporate tax) on enterprise growth and investment, the ensuing section will explore the effects of indirect taxation (namely VAT) on enterprise growth.

1.1.7 Value Added Tax (VAT) and Implications for Enterprise Growth

Indirect taxation is defined as taxation that may be imposed upon the persons other than those who are intended to bear the final burden. Unlike direct taxes, indirect taxes are applied universally and as such the tax burden is the same irrespective of the income level; Indirect taxes by their very nature are therefore regressive. Producers can however pass this tax burden on to consumers by way of increasing the price of goods and services to reflect the amount of the tax. In most developing economies indirect taxes account for the bulk share of tax revenue (Amirthalingam, 2010).

In this contemporary era, VAT is the sales tax of choice in all OECD countries with the exemption of the United States. VAT was first introduced on an extensive scale in France in

1954 and has since been introduced in over 145 countries. It is a broad-based tax levied at multiple stages of production (and distribution) which crucially taxes inputs credited against taxes on output. It is argued that VAT is considered to have advantages over other forms of taxes as it eliminates cascading, allows for zero rating of exports and essential items and is broad-based and difficult to evade (Faridy & Sarker, 2011).

Compared to other forms of indirect taxation, VAT has generally been proven to have more revenue potential, given that it is broad based and entails a trail of invoices that helps improve tax compliance and enforcement. In principle VAT is described as a 'self-enforcing' tax, such description stems from the nature of invoice-based VAT credits – a taxable enterprise is able to claim VAT paid on inputs on submission of purchase invoices. Such a mechanism provides strong impetus for businesses to maintaining invoices on their transaction paving an efficient way for authorities to check and cross-check for enforcement enhancement.

As with all forms of taxation equity is a central issue. VAT like any indirect form of taxation is intrinsically regressive; however the degree of repressiveness determines whether the VAT is equitably distributed. A VAT incidence analysis carried out in Bangladesh highlights that a uniform consumption VAT is more regressive compared to the application of a tiered VAT rate (Hossain, 1995). Informal enterprises do not entirely escape the tax-net, and the indirect tax burden may be substantial. Informal enterprises may be able to circumvent the payment of VAT on sales; however they are unable to reclaim VAT credits on inputs (Barbone et al., 2012). An FIAS sector study in South Africa has shown that the marginal effective tax rate is highest for non-VAT registered small enterprises on capital investments of any sector. Un-registered SMEs may therefore be severely handicapped as a result of their inability to claim refunds of VAT paid on their inputs (IFC, 2007)

1.1.8 VAT Refunds and VAT Compliance – Implications for Enterprise Growth and Investment

In most countries VAT is a consumption-based tax and as such requires investment costs and intermediate inputs be effectively excluded from tax base. To exclude such costs a properly functioning refund mechanism is fundamental for efficiently administering VAT. Delays in VAT refunds would add a layer of "hidden costs" to registered firms and thereby discourage investment. The problem is especially serious for export manufacturers that usually have a huge backlog of refunds but must compete internationally (Le 2003a). Le (2003b) notes that due to six-month delay in a VAT refunds, a typical export apparel-manufacturing enterprise in Vietnam would lose out on 28 cents per each dollar of investment in the present value terms over its lifetime, while the loss to

an export leather shoe-manufacturing project would be 5 cents. Given that access to and the cost of credit for SMEs in particular is a salient issue in developing countries, the loss in such cash flows poses a significant constraint to investment and growth of these enterprises.

Time and administrative procedures in complying with filing VAT claims are also viewed as added compliance cost for businesses. A PwC (2010) study has found that in Kenya supporting information must be submitted along with the monthly return including an analysis of all purchase invoices (invoice dates, invoice numbers, supplier names and registration numbers and the corresponding VAT amounts), plus details of any zero-rated supplies (invoice dates, numbers, and the value of the supplies) and where VAT is withheld (analysis of and including withholding tax certificates). Whilst filing tax returns is carried out online, which can save time, inserting the data into Taxpayer Software is still time-consuming. In the case of China the control of VAT invoices is an important aspect of VAT compliance. VAT invoices on purchases have to be authenticated by the Tax Authority before they can be used to claim input VAT which is an added burden. The study finds that a total of 300 and 218 hours are spent in Kenya and China respectively to comply with VAT. As with the case of complying with corporate tax, compliance costs for VAT registered companies is a significant added burden. Compliance costs are size invariant, thus VAT registered SMEs face the highest tax burden. An IAS study in South Africa highlight that compliance Burden for preparation of tax returns is higher for Vat-registered enterprises operating below the VAT-able threshold compare to informal enterprises operating below the VAT-able threshold (James 2008), a study by Barbone et al. (2012) conclude that, in the EU as well as in a number of other countries that have adopted VAT taxation, compliance costs are regressive, in the sense that small business in particular are more than proportionally burdened.

1.1.9 Property Tax and its Implications for Enterprise Growth

Taxation can act as a tool to manage land use, urban density and expansion, speculation and transaction. Taxation is often used as an urban management tool and a resource mobilization mechanism. Land and property taxation is the practice of creating and using national and/or local revenues from land and improvements over land. It is a vital tool in managing local and central government affairs in many countries. The nature in which the tax is utilized can stimulate the development of land markers and in particular land market transactions. In many countries land and property taxation has taken center stage in view of improving and diversifying revenue sources. In the United States for instance 72 percent of tax receipts to local government in the fiscal year 2006 were via property taxation. Likewise property taxes accounted for 100- and 52- percent respectively of the share of local tax revenue in Australia and New Zealand (Smolka & DeCesare, 2011).

Durand-Lasserve and Clerc (1996) [cited in Smolka & De Cesare, 2011] argue that the distribution of urban poverty tends to overlap with patterns of informal developments. However poverty cannot be the sole causality given that in Latin America the proportion of illegal settlements are typical higher than the number of families living below the poverty line. Another causality put forth by Fernandes (1997) [cited in Smolka & De Cesare, 2011] is the absence of an effective and comprehensive housing policy and the inability of governments in developing countries to deliver sufficient urban infrastructure and service to poor areas. Land use regulation is also another frequently cited concern where stricter regulations results in the majority of the population unable to comply leading to informality. Finally informality begets informality, higher profits from informal land provides incentives for informal developers to expand.

As noted earlier the incidence of informality largely owes to the lack of serviced lands at affordable prices. Whilst a property tax can generate revenue for local governments to provide important infrastructure and services, a land value tax¹ (LVT) has the potential to force more serviced land to the market. A tax such as the LVT which significantly reduces the economic return of vacant land can address both the component of land supply as well as the production of new serviced land and the use of vacant land. An LVT could act as a natural incentive to develop land to its highest and best use and discourage owners from delaying land development in the hope for higher prices.

Communities where property tax is not collected are vulnerable when it comes to access to public services as land owners directly or indirectly influence the decisions on which areas get serviced and thus the issue of which land gets serviced becomes a political hot spot in informal areas. Low income families are willing to pay taxes when doing so prompts the provision of needed public services in the area. It is also argued that the capitalization effect² of a LVT would enable the poor to increase the bidding power of the poor to access lands held by the rich. It is generally the case that, buyers of informal land usually are required to pay much higher rates of interest than formal markets. A LVT through the capitalization effect has potential relevance as a surrogate credit system to acquire serviced land.

Regularizing Titles to informal land - Local government recognition of occupancy usually does not guarantee property titles at the public registry. As Rabello de Castro [cited in Smolka & De Cesare, 2011] argues, however, relying on a cadastral registration number is a

¹LVT aka 'recurrent property tax' is tax levied on the value of land disregarding value of buildings, personal property and other improvements. The tax is levied on the market value of the property.

² As a component of the expected stream of expenses, a land-value tax has a similar effect (albeit with the opposite sign) to that generated by the discounted (present) value of the revenue stream expected to accrue from the land in the future. This effect is analogous to the lower rental value fetched by a property with a higher

feasible way to certify tenure rights Informal occupiers may thus perceive the property tax as a kind of an “entry card” to access the legal world.

1.2 Review of Literature on Sri Lanka

1.2.1 Small and Medium Enterprises (SMEs) in Sri Lanka

Over the years it has been increasingly recognized that SMEs are a major source of employment, income generation, poverty alleviation and regional development in Sri Lanka. SMEs in Sri Lanka are involved in a myriad of economic activities ranging from agriculture, manufacturing and services. Whilst the government of Sri Lanka has recognized and acknowledged the strategic importance of the SME sectors in propelling long-term growth, to date Sri Lanka has not adopted a nationally accepted definition of what constitutes and SME. Rather within the country different institutions defines SMEs based on their assistance programs. For instance the Industrial Development Board defined an SME as an enterprise with a capital investment less than SLR 4Mn, the National Development Bank definition of an SME is an enterprise with a capital investment of less than SLR20Mn excluding land and Buildings. In terms of international norms, definitions of SMEs adopted by different countries could be categorized into three, namely (1) number of fulltime employees, (2) turnover or production and (3) total asset value. In light of international norms the taskforce on the white paper on SME development in Sri Lanka proposed that SMEs should be defined in terms the value of assets. As such a small scale enterprise is defined as enterprise with asset values not exceeding SLR 20Mn excluding land and buildings whilst an enterprise with an asset value of SLR 50Mn excluding land and building is considered a medium scale entity (Government of Sri Lanka 2002).

1.2.2 Taxation in Sri Lanka

At present the government of Sri Lanka employs a total of 19 taxation instruments. From a business point of view the principal taxation instruments are the corporate income tax and the consumption-based Value Added Tax (VAT). VAT accounts 51.97 percent of tax revenue collected for the fiscal year 2010 and is by far the single largest tax revenue source, whilst Income tax revenue comes in a distant second accounting for 27.8 percent of the tax revenue for 2010 (Department of Inland Revenue, 2011).

1.2.3 Tax Exemptions in Sri Lanka

The present income tax regime employs a tiered tax rate in the range of 10 percent, 12 percent, 28 percent and 40 percent applicable for different sectors and base on taxable income. The government however offers a host of fiscal incentives in its bid to achieve underlying socio economic objective. Since undertaking sweeping economic liberalization reform as part of pursuing an export-oriented industrialization, the attraction of FDI to catalyze and sustain an industrial development regime to transform its previously agrarian economy into an industrial hub was formed the concern stone of the Sri Lankan development policy regime. In light of the new policy orientation the introduction of an elaborate tax incentive regime administered by the Board of Investment (BOI) [formerly known as the Greater Colombo Economic Commission] to support the attraction of export oriented foreign ventures was implemented during the late 1970s. At its initial stages concessions were confined to BOI-registered export-oriented foreign ventures operating within specially designated export-processing zone located across the country. Subsequently in 1982 and later on in 1990 tax incentives offered under the BOI Act Section-17 were gradually extended beyond the export-oriented sector to both FDI and local investors operating within and outside the EPZs aimed at general investment promotion. Incentives include tax holidays, concessionary corporate income tax rates, generous depreciation allowances, and import duty and excise exemptions.

In addition to incentives offered under the BOI section -17, the government also introduced tax incentives for non-BOI registered companies through section -16 of the BOI Act which is administered by the Inland Revenue Department. These incentives are focused on attracting investments in areas not covered by the BOI; however in recent years significant overlap prevails. Tax incentives extended under the Inland Revenue Act cover the following areas; the manufacture and export of goods deemed non-traditional exports; agriculture, fisheries, and agro processing; industrial tools and machinery; small- and large-scale infrastructure projects; rehabilitation of underperforming industries; and companies engaged in research and development (World Bank 2012a).

As it stands in 2012 tax concessions offered by the BOI to new investments include full corporate tax holidays ranging from 4 to 12 years based on the sector and scale of the investment. Tax holidays have also been linked to the level of domestic value addition. In addition importation of project related plant, machinery and equipment are exempt from VAT, Customs Duty, and PAL during the project implementation period. Investments identified as strategic import replacement projects enjoy concessionary tax rates after the lapse of the initial tax holiday. Further export oriented ventures in addition to the tax holiday are exempt from duty on raw-material imports on fulfilling export performance requirements. Provision have also been made under Strategic Development Projects Act

No.14 of 2008, to enable the BOI in consultation with the minister in charge of the subject of Investment and the Minister in charge of the subject of Finance the discretion to offer tax exemption for up to 25 years to projects identified under the purview of the Act. As for incentives offered under section -16 of the BOI Act, investors qualify for incentives when investing in the following three sectors; namely activities involving fishing and fish processing, agriculture and agri-business and any manufacturing activity apart from liquor and tobacco. As with BOI incentives, tax concessions are linked to minimum investment requirements, with the tax holidays ranging from 3 to 5 years. It should be noted that minimum investment requirements are much lower under section -16 that in comparison to section 17 projects (BOI 2012).

In addition to tax incentive offered under the BOI Act, the 2012 budget witnessed widespread tax reform encompassing the introduction of a comprehensive tax incentives package targeted at SME promotion. Incentives include pre-establishment cost write-offs, tax holidays for both new investments and expansions ranging from 3 – 6 years depending on the volume of investment, triple deductions on Research and Development expenditure undertaken by SMEs and VAT and duty exemptions for selected manufacturing activities such as handlooms, agriculture processing , fisheries, poultry and rice milling to name a few. Whilst such incentives seem generous and a good first step towards promoting SMEs, as Wijesinha (2011) notes eligibility criteria seems excessive given the size of an SME and thus needs to be revisited and reassessed.

1.2.4 Value Added Tax in Sri Lanka

In line with global developments as well as successful experiences of other countries with different tax systems, Sri Lanka shifted its indirect taxation regime from Business Turnover Tax (BTT,1964-1981) to Turnover Tax (TT,1981-1998) to Goods and Services Tax (GST,1998-2002) and finally to Value-Added Tax (VAT) in 2002. At the time of its introduction, VAT in Sri Lanka constituted a multi-rated structure. In addition to zero rated items and exemption, there existed a 10 per cent concessionary rate and a 20 per cent standard rate (Amirthalingam, 2010). Subsequently, a number of changes to the VAT rate have been witnessed almost on an annual basis. As it stands currently, Sri Lanka adopts a single VAT rate of 12 percent, in addition to zero-rated items and exemptions. VAT is charged on the supply of both locally manufactured and import goods. Both imported and locally manufactured food items deemed essential are zero-rated. Selected raw-material and semi-processed inputs notably pertaining to agriculture such sector such as fertilizer, seed and plants are also zero-rated. In addition, the imports of capital goods for key domestic enterprises are exempted of VAT. As noted earlier project related capital import of BOI-registered enterprises during the project implementation period are also exempt for VAT. In order to open a permanent VAT file a company must record a minimum annual

turnover of Rs.2.5Mn (approximately US\$18,000) (Inland Revenue Department, 2012). A VAT refund mechanism administered by the Inland Revenue Department is also in place, enabling VAT-registered entrepreneurs to claim VAT input credits.

Whilst there exists a handful of literature on the efficiency aspects of VAT in Sri Lanka, the equity implications of VAT on both households as well businesses is yet to be analyzed.

1.2.5 Property Taxation in Sri Lanka

With the 13th amendment to the constitution of Sri Lanka witnessed the power of taxing property in Sri Lanka be devolved down to the Provincial Council level. Property tax and stamp duty on the sale of property is the main source of revenue for municipal Councils, Urban Councils and Pradeshiya Sabhas. The property tax is administered against an assessment made on the value of property and rent. The Tax rate is determined by the individual provincial council.

1.2.6 Tax Compliance Costs in Sri Lanka

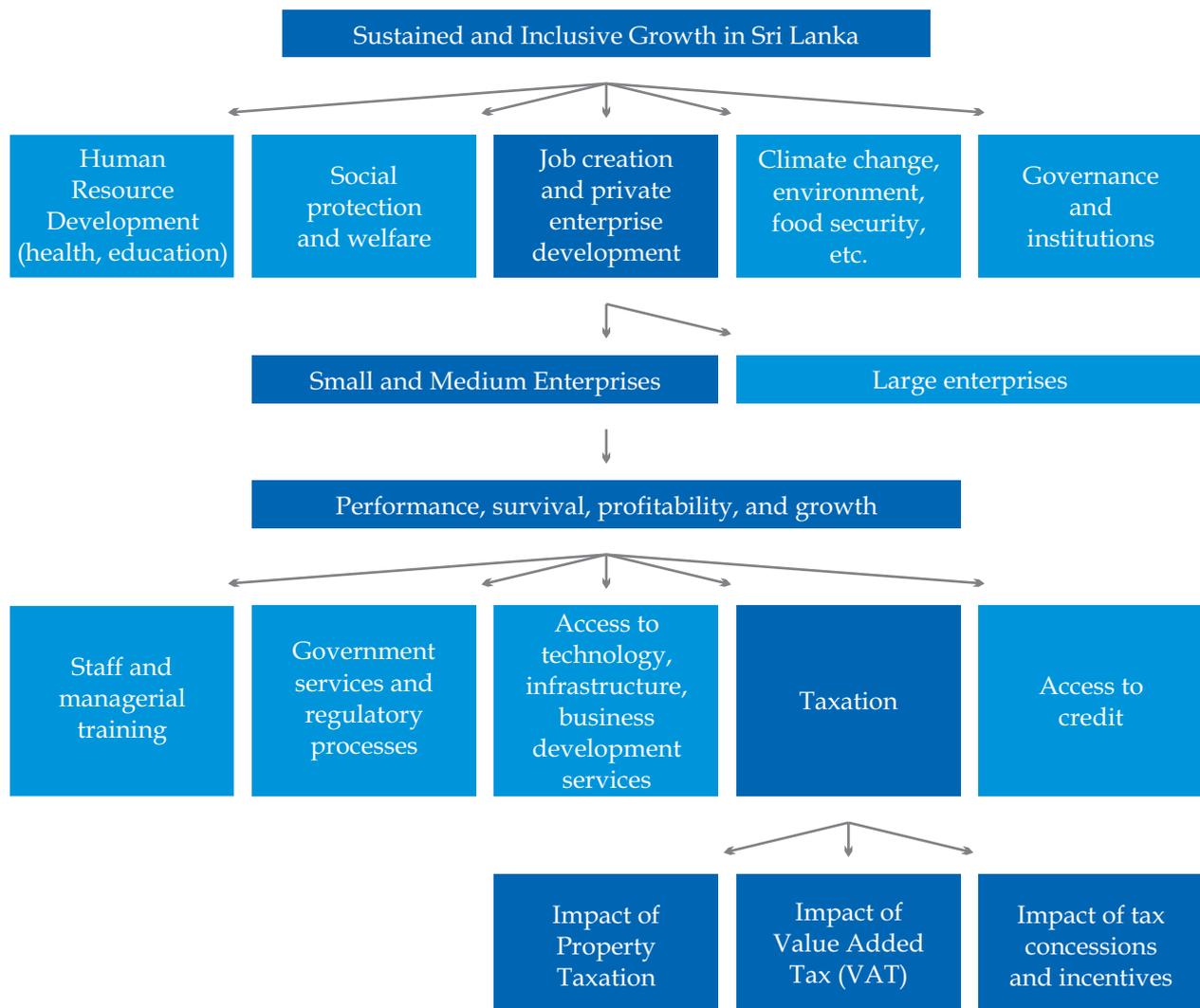
Sri Lanka's global ranking in terms of 'Paying Taxes' as ranked by the World Bank Doing Business 2012 publications is a distant 173 in the ranking of 183 economies on the ease of paying taxes. Likewise it is also the worst performing South Asian economy after Pakistan ranked 153. In complying with tax rules data over time indicate that the frequency of annual tax payments has increased from 58 in 2006 and now stands at a 71 payments in 2012, well above the South Asian average of 28 payments per year. Similarly in terms of the number of hours spent in filing tax returns a staggering 256 hours is required. It is also noteworthy to observe over 50 percent of the time taken in filing tax returns relates to VAT related payments alone, (World Bank, 2012b).

SECTION-II

Conceptual / Theoretical Framework

Sri Lanka has an explicit target of raising per capita incomes to US\$ 4,000 by 2016, and the government's vision is to make the country 'The Miracle of Asia'. This would require a rapid pace of growth, which is seen as viable now with the end of the protracted armed conflict in May 2009. Economic growth would not only need to be a high 8 per cent or more, it would need to be sustained over the medium term. Meanwhile growth would also need to be inclusive, both across geographic regions in the country and across population groups.

Figure 2.1: Diagrammatic Representation of Conceptual Framework



A vital element in this process is job creation by unleashing the potential of Sri Lanka private sector. Thus, enterprise development becomes a key priority. Within this, it is the Small and Medium Enterprise (SME) sector that would be a key driver, given that over 90 per cent of the country's private sector establishments are of this size, rather than large enterprises. Moreover, from an inclusive growth perspective, it is SMEs that are the backbone of Sri Lanka's provincial economies and help bridge the gap between the Western Province and other lagging regions.

SMEs, unlike large enterprises, are often faced with a myriad of difficulties in their quest to survive, remain profitable, grow and expand their business and create more jobs. Of these, research points to factors like access to credit, technology, infrastructure, government regulatory services, business development services, staff training, and taxation. The lattermost is the focus of the present study. Taxation is a key stumbling block for SME growth, and the present study will look at three selected aspects – the three themes - of this challenge: 1) the impact of tax concessions and incentives, 2) the impact of Value Added Taxation (VAT), and 3) impact of property taxation.

In other words, looking at the diagrammatic representation in Figure 1 above (from right to left), the conceptual framework underpinning this study is how key taxation elements like differential tax treatment and provision of tax incentives/concessions; the system and implementation of VAT; and the system and implementation of property taxation impact SMEs, particularly their performance, survival, profitability and growth. In turn, the study aims to delineate the consequent influence this has on the ability of SMEs to strengthen and expand and create more jobs. This overall SME development contributes to overall private enterprise growth in Sri Lanka, a crucial component in achieving sustained and inclusive growth.

2.1 Research Questions

In considering the impact of tax exemptions and concessions on SME development, the study aims to answer the following research questions:

- Do income tax concessions/exemptions offered by the government cause biases between SMEs and larger enterprises in Sri Lanka?
- Do income tax concessions/exemptions offered by the government cause biases between registered SMEs and SMEs operating informally?

- Are SMEs owned/ managed by women particularly impacted by this (a.)?
- What is the extent to which income tax concessions/exemptions impact the performance of SMEs vs. large firms?
- In considering the impact of VAT on SME development, the study aims to answer the following research questions:
 - What are the differences in VAT burdens faced by registered SMEs versus unregistered small enterprises?
 - How much of a determinant is the VAT burden in the degree of informality among small enterprises? (and by extension their ability to grow and increase performance)
 - To what extent do VAT compliance costs determine the ability of small enterprises to grow and improve performance?
- In considering the impact of property taxation on SME development, the study aims to answer the following research questions:
 - What has been the revenue performance of property taxes vis-a-vis other taxes collected at the devolved levels of government?
 - What is the status of revenue generation of local authorities and Provincial Councils vis-à-vis grants and transfers made by the Central Government?
 - What are the key bottlenecks to enhancing local authority revenue, particularly property taxation, and what programs are in place to address these?
 - What weaknesses are present in the property taxation system (structure as well as administration) that limits expansion of property tax revenues?
 - Do weaknesses in property tax administration lead to greater land informality among SMEs?
 - Does land informality among SMEs affect their ability to grow and improve performance (e.g. through constrained access to finance)?

For the purpose of this study, SMEs will be defined as firms employing 49 workers or less, while a larger enterprise will be defined as firm employing 50 workers or more. The reason for choosing number of employees as the key indicator is as it is more easily observable than other indicators like annual turnover and capital investment and often such information is not accurately available.

As for the informal enterprises, SMEs that are not registered with either the Divisional Secretariat or incorporated with Company's Registrar at the national level will be treated

as firms operating in the informal economy (i.e. undocumented). Income tax incentives/concessions will refer to corporate income tax (CIT) holidays and/or reduced/special rates offered under the government's tax laws.

Improvements in performance of an enterprise will be measured by increases in annual profits, expansion in employment, ease of/cheaper access to credit, proportion of retained profits reinvested in the enterprise, and willingness to formalize. Progressivity impacts will refer to the relative ability of SMEs to pass on VAT to final consumers and or obtain VAT refunds for intermediate goods purchases. Cost of VAT compliance will be assessed by the number of documents required for compliance, the level of in-house knowledge to comply with VAT (e.g. preparing accounts and filing returns/refunds etc), the time taken to comply, and (if applicable), the financial burden in hiring specialized help to comply. Performance of local revenue tax performance will be measured through total tax collection, specifically property tax collection, ratio of property tax to total revenue, 'cost of collection' etc.

2.2 Hypothesized Relationships

In terms of tax exemptions, incentives and/or concessions, it is hypothesized that SMEs enjoying tax incentives/concessions have better enterprise performance; that SMEs have benefited less from income tax exemptions/concessions/incentives offered by the government, than larger firms, and within this, women owned/managed SMEs are worse off; and that enjoying tax incentives/concessions cause differences in enterprise performance of registered SMEs vs. informal SMEs. Additionally, it could be hypothesized that continued in-formalization (non-registration) to avoid tax payment results in constrained access to (formal) credit (which may be more concessionary/SME-friendly in nature).

In terms of VAT, it is hypothesized that undocumented enterprises face a heavier VAT burden as they are unable to pass on VAT to final consumer and as they are unable to claim input credit for intermediate good purchases and that smaller firms compared to larger firms lack resources and knowledge to comply with VAT requirements and as such refrain from formalizing to avoid VAT compliance, and this in turn curtails their ability to expand

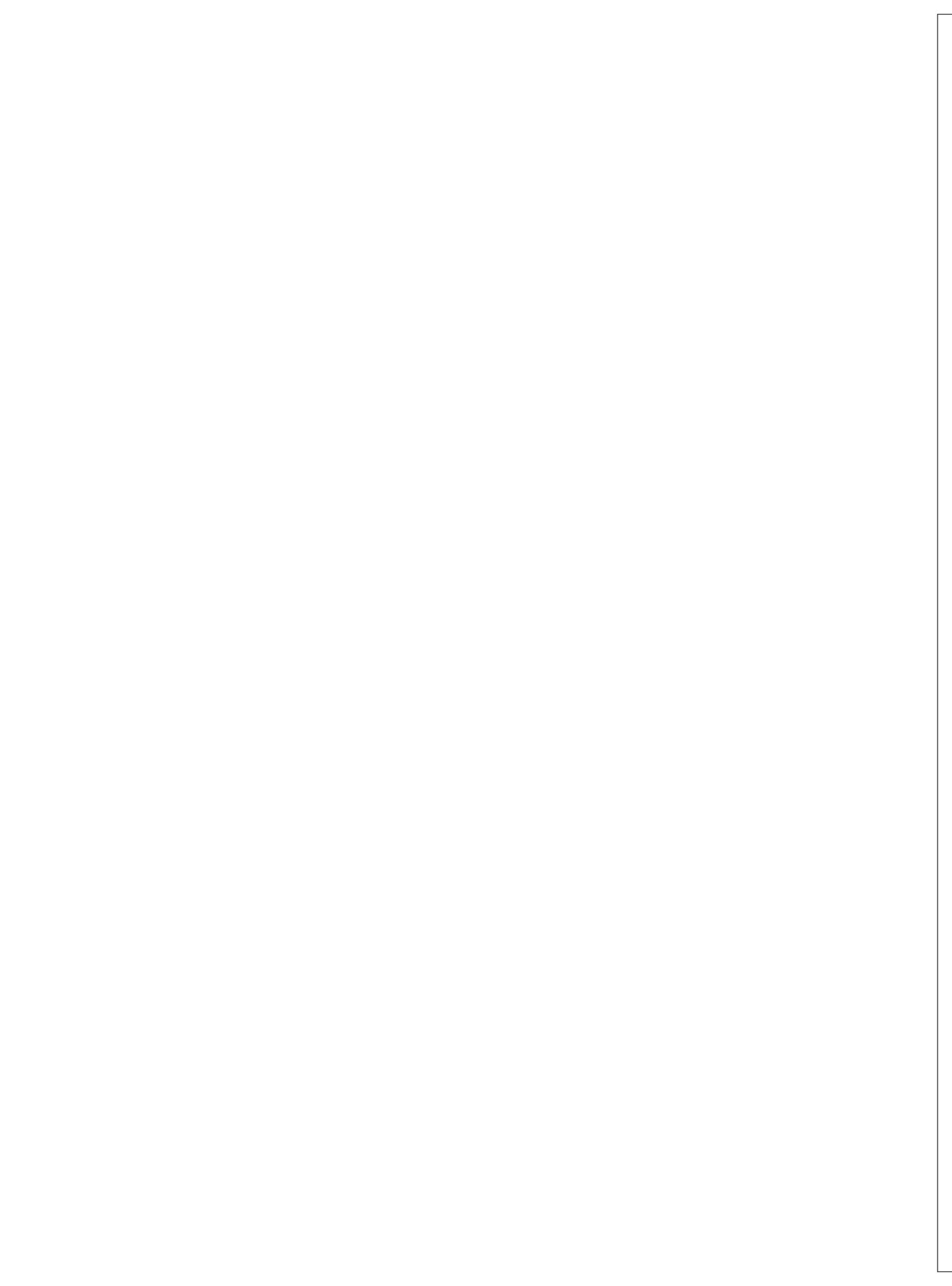
In terms of property taxes, it is hypothesized that generally, the inefficient administration of property taxation is leading to leakages in property tax collection. More specifically, it is hypothesized that land informality is impacting SMEs access to finance/credit and is impacting the ability of local authorities to collect more property tax revenue from SMEs.

SECTION-III

Research Methodology

For the purpose of analyzing the impact of tax policy on enterprise development in Sri Lanka the study team adopted both quantitative and qualitative research methodologies. At the outset key informant interviews (KIIs) were conducted to ascertain background information pertaining to both the contemporary tax regime and to obtain the perception of key informants relating to pressing issues across each of the three research themes under study. Subsequent to the KIIs the study team administered the harmonized firm level survey questionnaire to obtain firm level perception on the tax system.

Due to the limited sample of female respondents in the primary survey to explore the gender dimension of enterprise development, the study team adopted exploratory case study using open-ended interviews to examine the case of a successful female entrepreneur to reveal 'lessons learned' for policy making on taxation and enterprise development. Finally with the aim of soliciting feedback on research results from a policy perspective and to ensure that recommendations are reflective of ground realities focused group discussions were carried out with senior civil servants, tax consultants and industry/business chamber representatives.



SECTION-IV

Survey Findings

4.1 Survey background information

The enumeration of the harmonized questionnaire was contracted out to a specialized survey enumeration company by the name of 'Market Research Services'. This company has been working closely with IPS over the past 8 year on similar projects and has past experience in administering similar enterprise level surveys. The enumeration was carried out over a period of 10 weeks between 16th of September and the 19th of November 2013 and was administered across three districts (i.e. Colombo, Kalutara and Gampha) within the Western Province of Sri Lanka.

The Western Province was selected based on the fact that the province is the largest contributor to the country's GDP and is where much of the country's economic activity is concentrated. It is home to a vast diversity of industries in varying sizes. A total of 150 enterprises have been surveyed. For formalized firms the sampling frame was drawn from the database of registered SMEs with the national chamber of commerce of Sri Lanka (NCCSL). For informal sector firms the sample was drawn based on a database maintained by IPS, which was originally the prepared for a project on assessing the social welfare of Small and Medium Entrepreneurs prior to the main survey, the study team carried out a pre-testing of the survey instrument prior to finalization of same for final use to iron out and streamline the instrument. The study team was present for at least 50% of the interviews for supervision on a randomly selected basis. Selected survey respondents are currently being revisited by the study team to conduct simple verification/reliability checks.

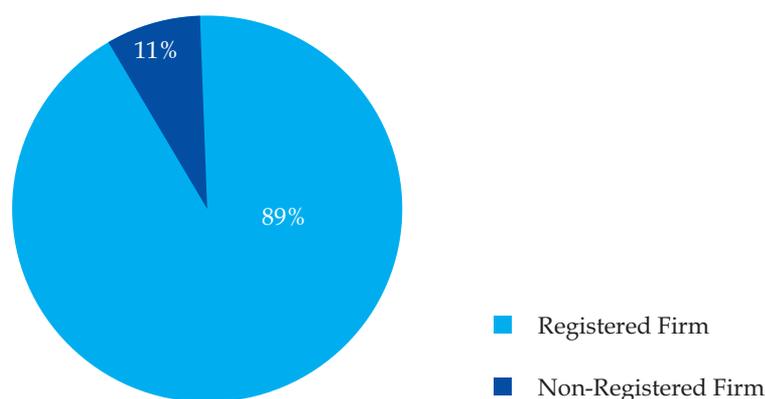
The contracted enumeration company was also responsible for data entry. For the purpose of harmonizing the data in the future, the data has been entered into the template shared by Dr. Kavita Rao of the National Institute of Public Finance and Policy (NIPFP), India via email on the 10th of September 2013. For the purpose of preliminary data analysis STATA and Microsoft Excel has been utilized. The ensuring section of this report will shed light on key descriptive statistics utilizing tabulations, cross tabulations and pictorial representations of data and will where possible attempts to draw and highlight inferences which reiterate the findings of the KIIs.

4.2 Firm Characteristics

4.2.1 Formality Status

Formalizing a firm in Sri Lanka, implies that the company is registered either with the Registrar of Companies (central government authority) under the companies act of No. 07 of 2007 as a limited liability company or as a partnership or sole proprietorship with the relevant provincial council depending on the area of operation. Furthermore firms can be set up as a cooperative society with the Commissioner of Cooperatives (central government authority). As can be noted from the figure below 89% of the enterprises surveyed are operating in the formal sector as opposed to 11% of enterprises which have not registered themselves with either of the entities noted earlier

Figure 4.1: Formality Status of Surveyed Enterprises



4.2.2 Ownership Pattern: Type of Enterprise

The ownership pattern of the 134 formalized firms is as follows. The greater majority of firms surveyed are sole Proprietorships

Table 4.1: Ownership Structure of Enterprises Surveyed

Type of Firm	No. of Enterprises	Percentage
Limited Liability	6	4.48
Sole Proprietorship	121	90.3
Partnership	5	3.73
Cooperative	1	0.75
Others	1	0.75
Total	134	100

4.2.3 Ownership Pattern: Gender

The ownership pattern based on Gender is as follows

16.67% of firms served are women-owned and managed enterprises

Figure 4.2: Ownership Pattern of Enterprises Surveyed by Gender



4.2.4 Firm Size

The review of literature revealed that Sri Lanka is yet of adopt a nationally accepted definition of what constitutes an SME. Various institutions (both public and private) have adopted various definitions in administering there programs. International experiences suggest there exists no universally accepted definition; rather various countries have adopted various definitions to suit their domestic context. Commonly used definition of classifying enterprise size range from turnover, number of employees and size of capital invested.

4.2.4.1 Firm Size: Turnover

The figure below provides a breakdown of surveyed enterprises categorized by turnover

Table 4.2: Breakdown of Enterprises Surveyed by Monthly Turnover

Turnover (in LKR)	Number of Enterprise
0--20,000	2
20,000--50,000	2
50,000-100,000	19
100,000-200,000	37
200,000--300,000	24
300,000--500,000	22
500,000--1,000,000	10
1,000,000+	8
Total	124

**A total of 26 Enterprises have failed to disclose turnover figures*

Summary Statistics

Mean	Std. Dev.	Min	Max
2,629,734	18,500,000	12,000	200,000,000

4.2.4.2 *Firm Size: Number of Employees*

The table below provides a breakdown of surveyed enterprises categorized by number of employees

Table 4.3 Breakdown of Enterprises Surveyed by No of Persons Employed

Turnover (in LKR)	Number of Enterprises
0—10	102
10 --30	38
30--100	6
100+	4
Total	150

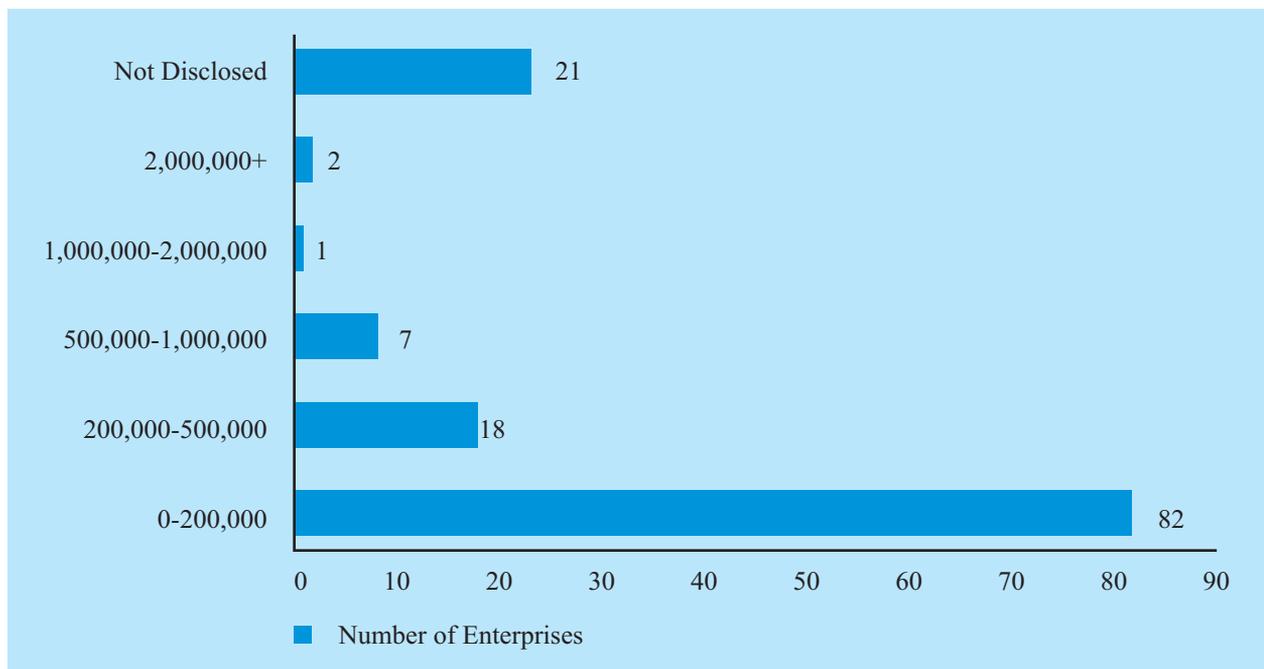
Summary Statistics

Mean	SD	Min	Max
37.35	207.93	1	2100

4.2.4.3 Firm Size: Capital Invested

The figure below provides a breakdown of surveyed enterprises categorized by the capital invested

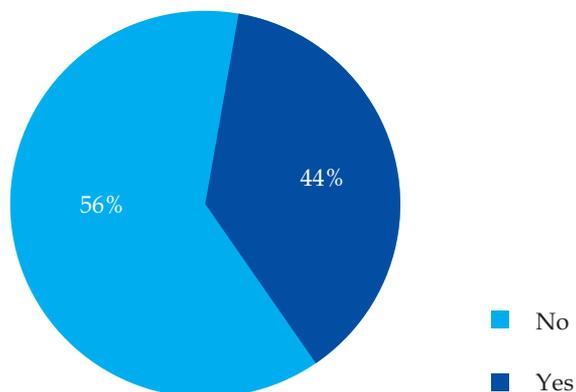
Figure 4.3: Breakdown of Enterprises Surveyed by Capital Invested



4.3 Access to Credit

Of the enterprises surveyed 44% of respondents reported that they have obtained a credit to finance their business over the last five years

Figure 4.4: Number of Firms having Obtained Credit to Finance Business in the Last 5 Years



4.3.1 Breakdown of the source of credit

Table 4.4: Breakdown of Sources of Credit

Commercial Bank	52
Cooperative	1
Money Lender	7
Private Finance	1
Microfinance	0
Not Disclosed	5
	66

4.3.2 Reasons for not Pursuing Formal Credit Channels

Table 4.5: Breakdown of Responses for not Pursuing Formal Channels of Credit

Reasons	No. of Responses
No need for a loan - enterprise had sufficient capital	50
Application procedures were complex	28
Interest rates were not favorable	7
Collateral requirements were too high	2
Size of loan and maturity were insufficient	3
Did not think it would be approved	4
Application required formal registration of company	23
Not Disclosed	33
	150

4.3.3 Outcome of Last Credit Application Made

Table 4.6 Breakdown of Responses Pertaining to the Last Credit Application

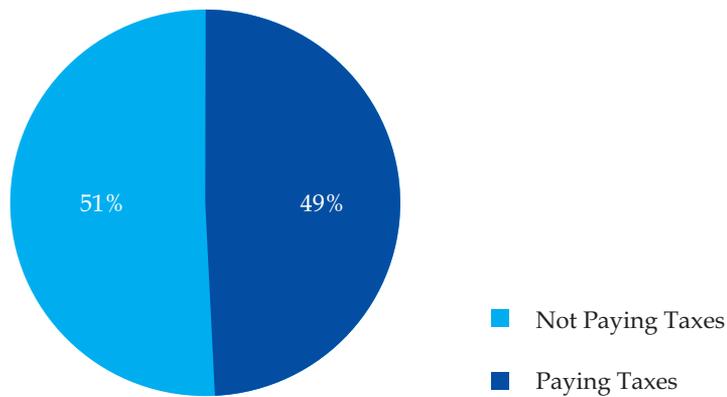
Response	No. of Responses	Percentage
Approved	6	4
Rejected	5	3.33
Still in process	15	10
Don't Know	3	2
Not Applicable	121	80.67
Total	150	100

4.4 General Tax Behavior

4.4.1 Status of Overall Tax Compliance

4.4.1.1 Number of Firms Paying Taxes

Figure 4.5: Breakdown of Firms Paying Taxes



4.4.1.2 Type of Taxes

Breakdown of the most commonly paid taxes are detailed below

Table 4.7 Breakdown of the Type of Taxes Paid by Surveyed Enterprises

Type of Tax	No of Responses
Income Tax	52
Withholding Tax	6
Import Duty	2
General Sales Tax	0
Excise Duty	3
Workers Welfare Fund	2
Others	39

**Largely constitutes VAT*

4.4.1.3 Reasons for Not Paying Taxes

A large proportion of firms stated that they do not pay tax owing to their turnover/income being below the threshold level. This complements KII findings - the current threshold (for income tax is LKR500,000 and for VAT the taxable turnover is LKR650,000) is too high and does not induce compliance. On the contrary however, the high taxable income/turnover threshold could be interpreted as a tax concession aimed at assisting SME

Table 4.8: Breakdown of Key Reasons Given by Survey Respondents for not paying Tax

Response	No of Responses	Percentage
Turnover Below Threshold	71	93.42
No Benefit from Govt. Services	3	3.95
No one came to collect Taxes	1	1.32
Tax rates are too high	1	1.32

4.5 Overall Perception on Tax Policy and Experiences

Currently at the National Level Sri Lanka has deployed a total of 16 direct and indirect tax instruments. In addition at the provincial level property tax in the form of local authority rates are also levied.

4.5.1 Perceptions on the Number of Taxes

As can be noted from the table below, the majority of survey respondents (96%) are of the view that the numbers of instruments deployed are too high. This was iterated by the KII findings

Table 4.9: Breakdown of Surveyed Enterprises Perceptions on Whether the Prevailing Number of Taxes is too High

Response	No of Responses	Percentage
Strongly Agree	57	38
Agree	87	58
Disagree	3	3
Strongly Disagree	1	0.67
Neither Agree nor Disagree	1	0.67
Answer Refused	1	0.67
Total	150	100

4.5.2 Perceptions on Prevailing Tax Laws and Procedures

Once again the greater majority of firms (96%) are of the view that the prevailing tax laws and procedures to fulfill compliance are too complex. This further reinforces the view of the key informants (i.e. the ad-hoc nature in which tax exemptions, concession and special provisions have been granted has made it difficult to interpret tax laws. The current compliance system is complicated and long drawn).

Table 4.10: Enterprises Perceptions on Whether the Prevailing Tax Structure is Complex

Response	No. of Responses	Percentage
Strongly Agree	48	32
Agree	96	64
Disagree	4	2.67
Neither Agree nor Disagree	2	1.33
Total	150	100

4.5.3 Perception on Performance of Revenue Administration

4.5.3.1 Competence of Officials & Convenience of Location

56.67% of survey respondent were of the view that the revenue administration is manned by competent officer and their offices are conveniently located. 38% were however not very sure. This may largely be due to the fact that many of the survey respondents may not be dealing with revenue authorities owing to the fact that they operate below the taxable income/turnover threshold or either files tax returns with the aid of tax consultants.

Table 4.11: Enterprise Perception on Whether Tax Officials are Competent

Response	Number of Firms	Percentage
Strongly Agree	6	4
Agree	85	56.67
Disagree	2	1.33
Neither Agree nor Disagree	57	38

4.5.3.2 Fairness of Staff towards SMEs

As can be noted from the table below, the greater majority of respondents were neutral to the fact that staff of the revenue administration is fair towards SMEs

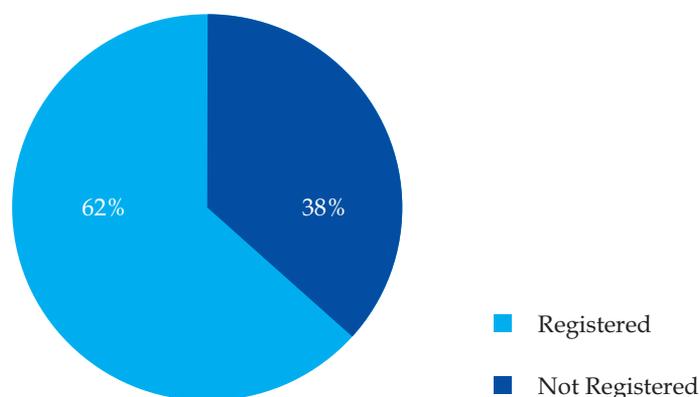
Table 4.12: Enterprise Perception on Whether Tax Officials are Fair Towards SMES

Response	Number of Firms	Percentage
Agree	37	24.67
Disagree	1	0.67
Neither Agree nor Disagree	112	74.67

4.6 Overall Tax Compliance Costs

4.6.1 Status of Registration with the Revenue Administration

For the purpose of paying taxes, enterprises must be registered with the Inland Revenue Department by obtaining a Tax Payer Identification Number (TIN). Of the 150 enterprises surveyed, only 38% had got themselves registered with the IRD. This may be reflective of the fact that many of the enterprises operate below the taxable income/turnover threshold and hence there is no mandatory requirement to get them registered. Of the enterprises registered with the IRD 36.84% of the firms employed the services of specialized persons to handle tax related matters

Figure 4.6: Percentage of Enterprises Surveyed who are Registered with IRD for Tax Purposes

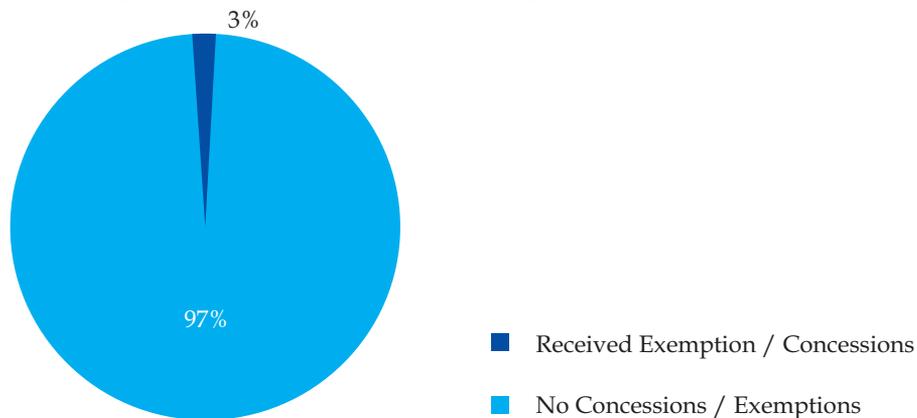
4.7 Impact of Tax Exemptions and Concessions on Enterprise Development

Sri Lanka offers a number of tax exemption and concession package to enterprises to encourage investments in certain key thrust sectors. In addition a number of SME friendly tax concession and provisions have been introduced over the past three years (see KII Section)

4.7.1 Tax Exemptions/Concessions

Of the 150 firms surveyed, 97% of firms responded that they don't receive tax exemptions. The low percentage of firms receiving exemptions may be an indication of the fact that firm may not be aware of the exemptions/concession available to them.

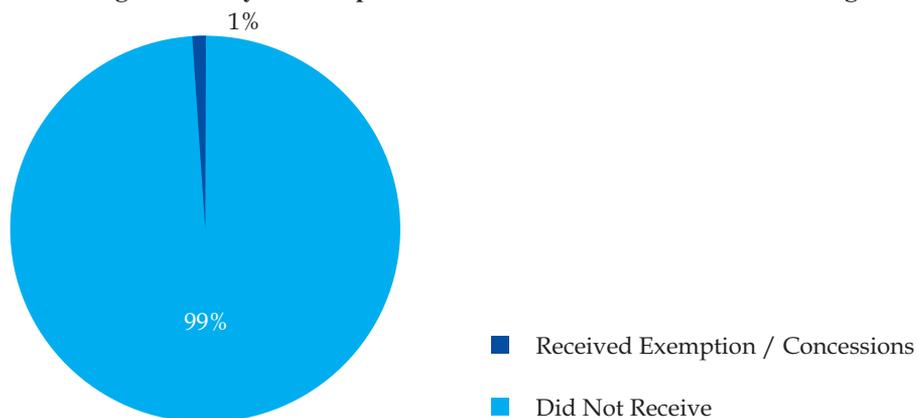
Figure 4.7: Percentage of Surveyed Enterprises Receiving Tax Concessions



4.7.2 Tax Concessions/Exemptions during Establishment

As can be noted from the figure below, a mere 1% (2) of the enterprises surveyed have received tax exemptions/concessions during project implementation.

Figure 4.8: Percentage of Surveyed Enterprises who received Tax Concessions during establishment



4.7.3 Perceptions on the Types of Tax-related Assistance by Government for Business Growth

An interesting observation here is the fact that the majority of SMEs

Table 4.13: Enterprise Perception on the type of Tax related assistance that should be provided by the government

Perception	No of Responses
Reducing tax rates	145
Granting tax holidays	128
Granting tax exemptions	126
Strengthen the services of tax authorities towards SMEs	122

4.8 The Impact of the Value-Added-Tax (VAT) on Enterprise Development

4.8.1 State of Enterprise Level VAT Compliance

The greater majority of firms surveyed (95%) are not VAT compliant

Figure 4.9: Status of VAT Compliance Amongst Surveyed Enterprises



4.8.2 VAT Compliance & Turnover

Table 4.14: Status of VAT Compliance by Enterprise Turnover

Turnover (in LKR)	Compliant	Non-Compliant
0--20,000	0	2
20,000--50,000	0	2
50,000-100,000	0	19
100,000-200,000	0	37
200,000--300,000	0	24
300,000--500,000	0	22
500,000--1,000,000	2	8
1,000,000+	4	4
Total	6	118

4.8.3 Perceptions of VAT Policy

Both VAT and Income Tax Policy in Sri Lanka is developed by the Ministry of Finance and the both taxes are administered by the Inland Revenue Department

4.8.3.1 Perceptions on why VAT Should not be Levied

Majority of respondent are of the view that VAT compliance leads to 'increased raw material costs'.

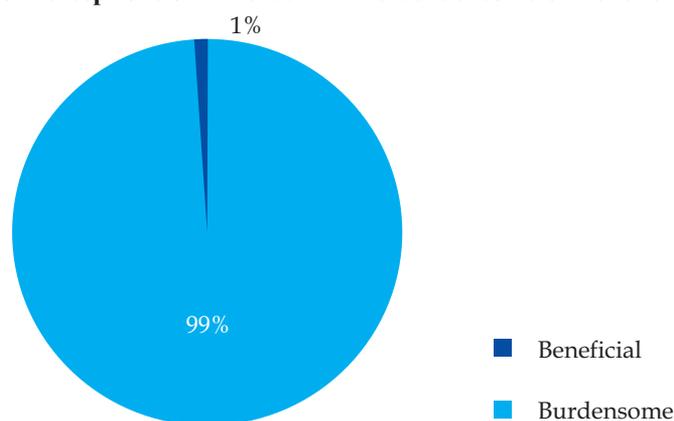
Table 4.15: Perceptions on why VAT Should not Levied

Perception	No of Responses	Percentage
Increased Raw Material Costs	108	72.29
Cannot Say	3	2.03
Complicated Procedures	13	8.78
Will Lower Sales in Domestic Market	2	1.35
More Documentation	1	0.68
Lower Exports	3	2.03
Will Reduce Competitiveness in Market	12	8.11
Others	6	4.05
	148	100.00

4.8.3.2 Perceptions on Whether VAT is Beneficial or Burdensome

The greater majority of respondents are of the view that VAT is burdensome. This is indicative of the fact that enterprises are not well educated relating to the costs and benefits of VAT compliance. Non-VAT compliant enterprises may be able to circumvent the payment of VAT on sales, however they are unable to reclaim VAT credits on inputs, leading to increased costs. Furthermore non-VAT compliant enterprises may lose out on the opportunity to do business with VAT compliant firms as most VAT compliant firms seek to trade with other VAT compliant firms so that they can claim input VAT refunds.

Figure 4.10: Perceptions on Whether VAT is Burdensome or Beneficial?



4.8.3.3 Reasons for not being VAT Compliant

Tables 4.16: Reasons for not being VAT Compliant

Reason	No. of Responses
Lack of Awareness	22
No Benefits	130
Procedural Complexity	21
Problematic Behavior of VAT Administration	12
Possibility of Future Harassment	15
Others	2

4.9 VAT Administration Perceptions and Experience

As noted earlier both VAT and Income tax are administered by the IRD

4.9.1 Difficulties faced by Enterprises when claiming VAT Refunds

The majority of respondents have reported that they have not faced difficulties in obtaining VAT refunds. This may largely be owing to the fact that the majority of firms in the sample are not VAT compliant and thus have not come across the need to obtain refunds

Table 4.17: Types of VAT Refund Related Difficulties Face by Surveyed Enterprises

Response	No. of Responses	Percentage
Have come a Cross Difficulties	2	1.33
Not Come a Cross Difficulties	148	98.67

4.9.2 Perceptions towards Performance of VAT Officials

Table 4.18: Surveyed Enterprise Perception Towards Performance of VAT Officials

Response	No. of Responses	Percentage
Very High	1	0.67
High	4	2.67
Indifferent	125	83.33
Low	1	0.67
Cannot Say	19	12
Total	150	100.00

4.9.3 Friendliness of VAT regulations

Table 4.19: Surveyed Enterprise Perception towards Friendliness of VAT Regulations

Indifferent	128	85.33
High	1	0.67
Cannot Say	17	10.67
Total	150	100

4.9.4 Frequency of visits by VAT Officials

Table 4.20: Frequency of Visits by VAT Officials

Response	No. of Responses
Monthly	1
Quarterly	1
Bi-Annually	2
Annually	3
Never	142
Cannot Say	1
Total	150

4.9.5 Perceptions on whether VAT Officials are less friendly toward Women Owned Enterprises

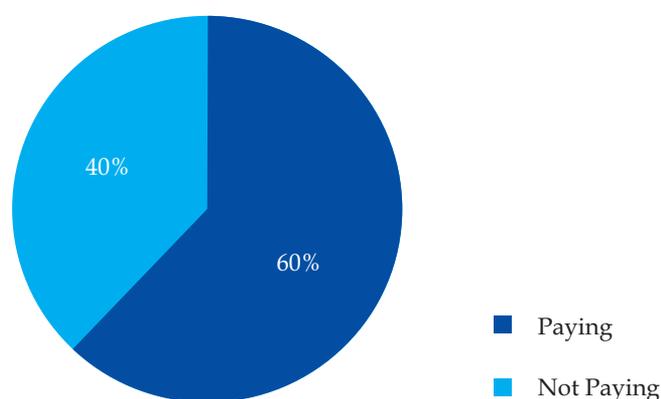
Table 4.21: Surveyed Enterprise Perception on whether VAT officials are friendly towards Women owned SMEs

Response	No. of Responses	Percentage
Yes	2	1.33
No	4	2.67
Don't Know	144	94.67

4.10 Impact of Property Tax on Enterprise Development

4.10.1 Distribution of Firms Paying and Not Paying Property Tax

Figure 4.11: Breakdown of Surveyed Enterprises Paying Property Tax



4.10.2 Breakdown of Annual Property Tax payments

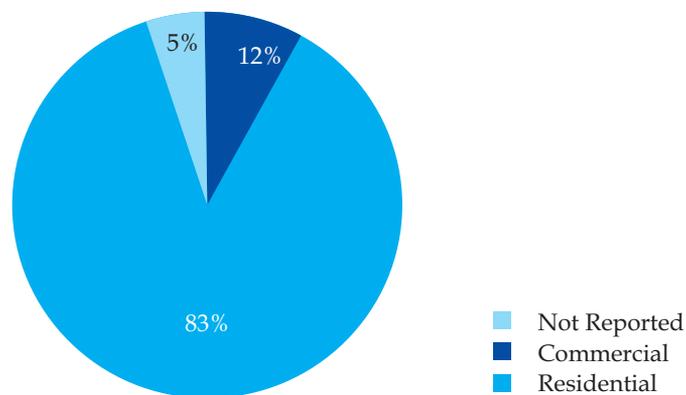
Table 4.22: Breakdown of Annual Property Tax payments

Payments	No. of Responses
0-1000	20
1000-5000	11
5000-10000	0
10000+	4
Don't Know	115

4.10.3 Distribution of the type of Property Tax Rate Paid

Property Tax (i.e. rates) is assessed on the 'Annual Value' of the Property. The Colombo Municipal Council (CMC) applies two different tax rates; commercial properties are charged at a rate of 35% and residential properties are charged at a rate of 25%. Of the enterprises paying property tax, 83% pay at the residential rate.

Figure 4.12: Breakdown on the Type of Property Tax Rate Paid by Surveyed Enterprises



4.10.4 Land Ownership Pattern and Property Tax

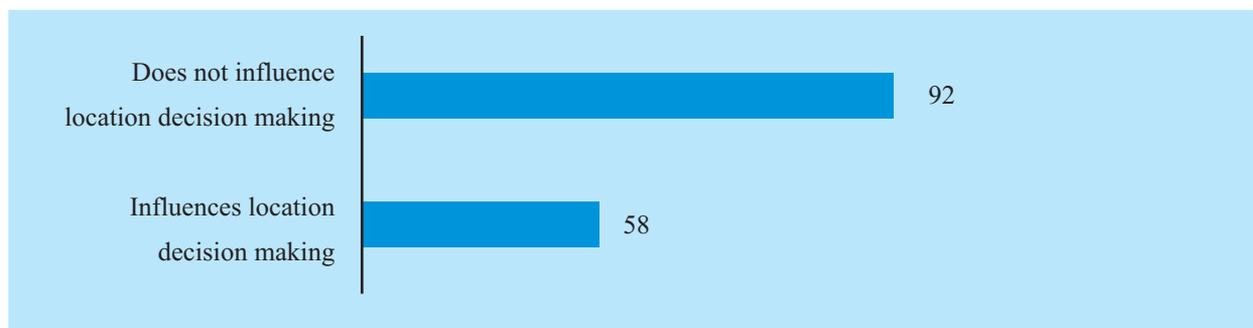
Table 4.23: Breakdown of Land Ownership Pattern

Ownership	Pay Property Tax	Does Not Pay Property Tax
Own Land	80	37
Leased Land	7	22
Total	87	59

4.10.5 Impact of Property Tax on Enterprise Decision Making

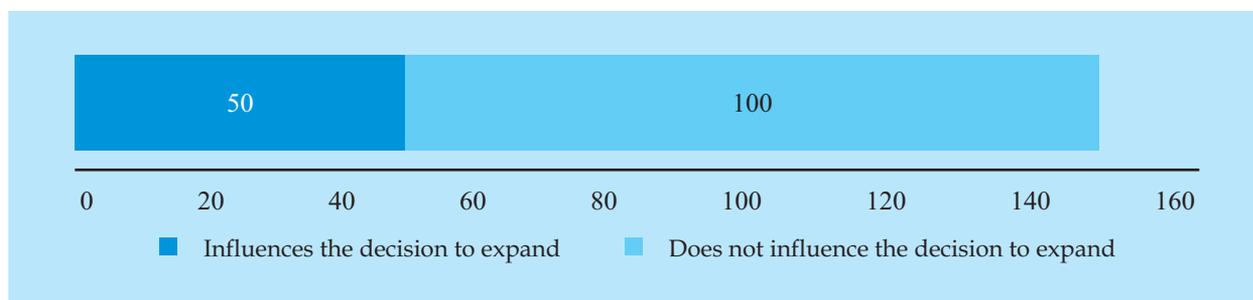
4.10.5.1 Property Tax and Location Decision Making

Figure 4.13: Perception on Whether Property Tax Influences Location Decision Making of Surveyed Enterprises



4.10.5.2 Property Tax and its Influence on the Decision to Expand

Figure 4.14: Perception on Whether Property Tax Influences the Decision to Expand



4.10.5.3 How Property Tax influences the Decision to Expand

Table 4.24: Perceptions on how Property Tax Influences the Decision to Expand

Response	No. of Responses	Percentage
Additional Cost	49	32.66667
Not Applicable	82	54.66667
Not Disclosed	19	12.66667

4.10.6 Perceptions on Land Acquisition and Transaction Costs

4.10.6.1 Reasons for not Operating on Own Land

Table 4.25: Reasons for not Operating on Own Land

Response	No. of Responses
High Costs	16
Answer Refused	32

4.10.6.2 Perception on Land Acquisition Process

Table 4.26: Perceptions on the Complexity of the Land Acquisition Process

Response	No. of Responses	Percentage
Complex	93	62
No Complex	8	5.33
Don't Know	49	32.67

4.10.6.3 Perception on Costs associated with Land Acquisition

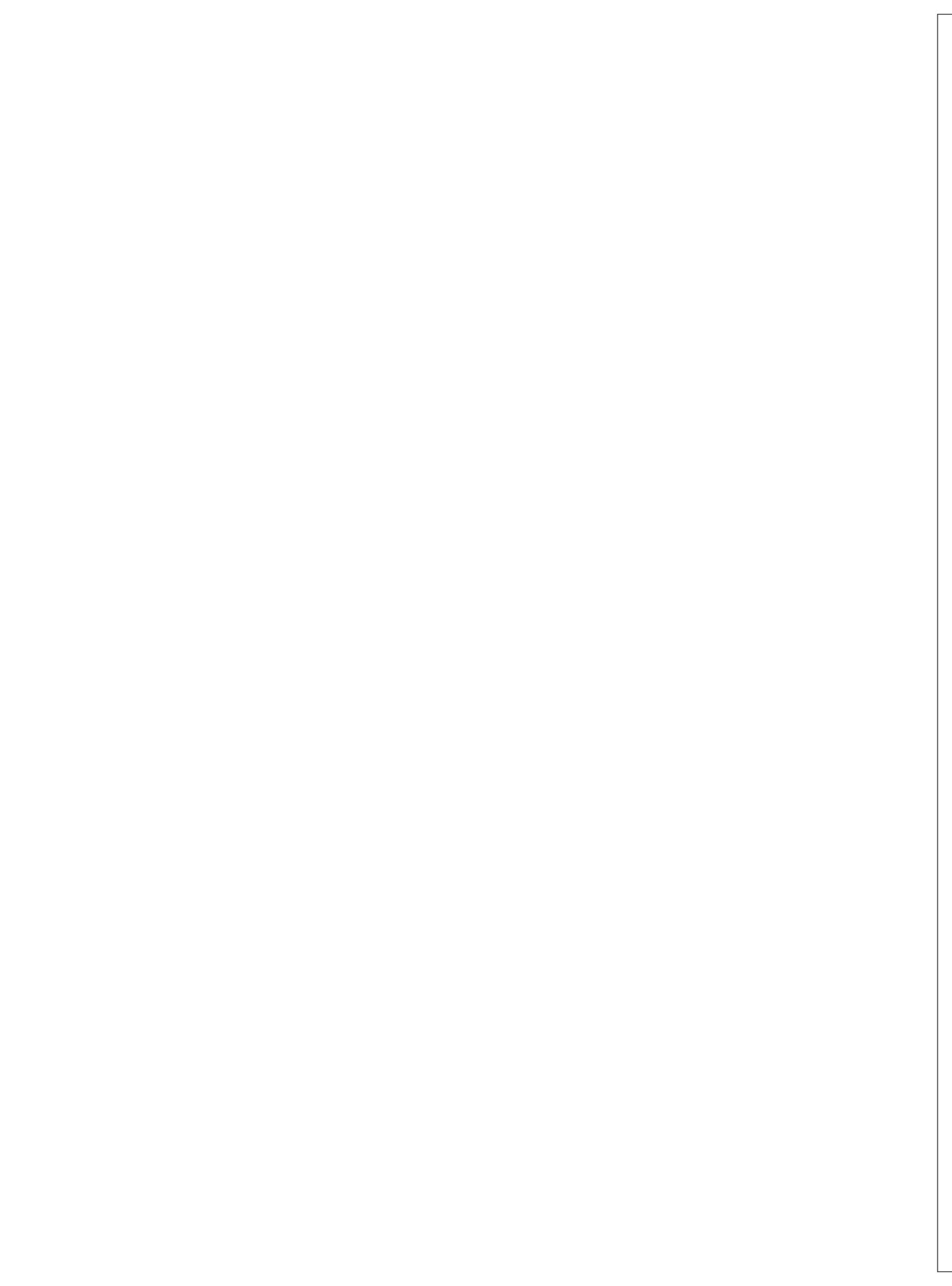
Table 4.27: Perceptions on the Costs Involved in the Land Acquisition Process

Response	No. of Responses	Percentage
Involves High Costs	97	64.6
Does Not Involve High Costs	7	4.67
Don't Know	46	30.6

4.10.6.4 Property Tax Administration Experiences

Table 4.28: Type of Problems Faced by Enterprises in Relation to Property Tax

Response	No. of Responses
No problem for non-payment or payment at a little amount	125
Absence of self-assessment scheme	64
Discretionary valuation of property by taxmenQ75C	25
Frequent asking for increased volume of tax	12
Frequent asking for submission of various documents	8
Frequent visits of taxmen causing business disturbance	2
Absence of dedicated revenue officer for collection of property taxQ75G	1
Other	3



SECTION-V

Key Informant Interview Findings

5.1 Overview of the Contemporary Tax Regime

Historical records indicate that taxation in Sri Lanka dates back to ancient times. The contemporary manifestation of the Sri Lankan tax regime, however could be traced back more recently to 1932, with the introduction of income tax under British rule. Overtime, the tax regime has undergone numerous changes in response to both domestic and global developments. As it currently stands Sri Lanka has deployed a total of 16 indirect and direct tax instruments and levies aimed at mobilizing revenue domestically. Value added tax (VAT) contributes the lion's share (48.54%) followed by income tax (i.e. both personal and corporate income tax) which accounts for 30.64% of the tax revenue collected domestically. The Inland Revenue Department (IRD) is the sole authority tasked with the administering the tax policy, whilst the tax policy is formulated by the Ministry of Finance and Planning.

The prevailing tax regime draws its legal base largely from the Inland Revenue Act No. 10 of 2006, the Value Added Tax Act No.14 of 2002, the NBT Tax Act No. 9 and the Strategic Development Act No.14 of 2008 and their subsequent amendments. In the current context where enterprises are concerned; the three most pertinent taxes are Income Tax (IT), Value Added Tax (VAT) and Nation Building Tax (NBT). VAT, IT and NBT are all administered by the IRD.

5.1.1 Income Tax

Income tax is charged on the basis of the provisions of the Inland Revenue Act No. 10 of 2006 as amended by Inland Revenue Amendment Acts No. 10 of 2007, 9 of 2008 and 19 of 2009. The Inland Revenue Act provides the legal authority to charge, levy and collect income tax on the profits and income of every person, which arose or is arising to such person for every year of assessment commencing on or after 1st of April, 2006.

As it currently stands (assessment year 2012/13) for the purpose of income tax, enterprises are classified as follows; (a) individual/sole proprietorships, (b) partnerships and (c) Companies registered under the Companies Act No. 7 of 2007. Individuals/sole-proprietorships whose statutory income does not exceed SLR 500, 000 per annum are not liable to pay income tax. For those whose income exceeds this threshold they are liable to pay a tax at a progressive rate ranging from 8% through to 24% (see schedule X for detailed

breakdown). In the case of partnerships, the enterprises taxable profit is taxed at a fixed rate of 8%p.a, however individual partners are liable to pay tax should their statutory income exceed the SLR500,000 threshold. For companies registered under the companies act a standard flat rate of 28% is applicable irrespective of the taxable profit threshold.

5.1.2 Value Added Tax

VAT replaced the Goods and Services Tax (GST) which was also a similar tax on the consumption of goods and services. VAT is a tax on domestic consumption of goods and services. The goods imported into Sri Lanka and goods and services supplied within the territorial limits of Sri Lanka are the subject matter of this tax. It is a multi-stage tax levied on the incremental Value at every stage in the production and distribution chain of Goods and Services. The tax is borne by the final or the ultimate consumer of Goods or services. It is an indirect tax and the Government will receive at the end, through all the intermediary suppliers in the chain of production and distribution, an amount equal to the amount paid by the final consumer. Sri Lanka employs two VAT rates, a standard rate of 12% and a zero rate for goods and services which are deemed essential commodities such as essential food items, medicines and medical services as well as intermediary inputs used exports. Enterprises are liable to pay VAT should their turnover exceed SLR3Mn per quarter or SLR 12Mn per Annum. VAT is exempt for enterprises engaged in trading (i.e. buying and selling) other than those enterprises which record a quarterly turnover in excess of SLR500Mn.

5.1.3 Nation Building Tax (NBT)

NBT is a tax similar to VAT. It is payable by every person (individual, company, body of persons) or partnership who (a) imports any article (other than any article in the personal baggage) into Sri Lanka or (b) carries on the business of manufacture of any article or (c) carries on the business of providing a service of any description. An enterprise is liable to pay NBT only if their turnover exceeds SLR650,000.

5.1.4 Tax Compliance

Whilst for the purpose of taxation enterprises are categorized and differentiated tax regimes are applied, in terms of compliance all enterprises must follow a uniform process. Compliance requires that enterprises/individuals liable for paying taxes open a tax file with the IRD and obtain a Tax Payer Identification Number (TIN) upon the submission of the company registration certificate and annual income statements for the past three years. Enterprises liable for paying VAT are further required to obtain a VAT certificate and VAT Registration Number. CIT returns must be filed annually on a self-assessment basis and

paid in five monthly installments. VAT returns must be filed and paid on a quarterly basis.

Sri Lanka has also introduced a simplified value added tax scheme (SVAT). The scheme has been introduced with the aim of eliminating the hassle of enterprises to go through the process of obtaining VAT refund on intermediary inputs. Under this scheme, where trade takes place between two VAT registered companies SVAT voucher is exchanged in place of paying money.

5.1.5 Tax Exemptions and Concessions

The government of Sri Lanka offers a wide array of fiscal incentives to enterprises with the objective of encouraging both domestic and foreign investments in selected priority sectors. Enterprises can qualify for the fiscal incentives under the automatic approval route, where predefined fiscal incentive packages could be accessed upon the fulfillment of predefined eligibility criteria. A second route is via the Strategic Development Projects Act (SDP), where customized fiscal incentive packages could be offered to enterprises on a case-by-case basis by the Minister of Finance and Planning subject to parliamentary approval.

For projects falling under the automatic approval route, the sole authority responsible for granting these fiscal incentives is the IRD. The Board of Investments (BOI) the country's apex investment promotion agency can recommend enterprise they deem fit to receive these benefits, however the sole discretion of whether or not to offer tax exemptions concessions rests with the IRD. For projects falling under the SDP Act, once again the BOI and identify and recommend projects however parliamentary approval is essential and concessions are administered by the IRD.

Fiscal incentive packages largely encompass corporate income tax holidays, concessionary tax rates, VAT and NBT exemptions and Customs Duty Exemptions. Accessing these packages is dependent upon meeting eligibility criteria such as investing in an identified priority sector, meeting minimum investment thresholds, value addition and export performance requirements (please see annexure 1 for detailed breakdown of fiscal incentive packages on offer).

5.2 Fiscal Incentives Targeted at SME Development

5.2.1 Tax Exemptions/Concessions

Successive government budgets of 2011, 2012 and 2013 have seen a number of tax concessions/exemptions being extended specifically directed at SME development. Enterprises registered under the companies act with a profit/income of less than SLR5Mn per annum are exempted from paying IT. An individual/partnership with an annual liable turnover/ supplies not exceeding SLR 12Mn, from all the businesses are exempted from paying both VAT and NBT. Furthermore individuals who returns from foreign employment and invests his/her savings to commence new businesses are exempt from all taxes payable on turnover and on the profits and income from all such new businesses for a period of 5 years.

A number of identified priority economic activities have also been offered special concessionary tax rates, irrespective performance requirements. For instance, the tax rate on profits from poultry farming are taxed at a reduced rate of 10% p.a, profits and income of enterprises engaged in activities such as the manufacture of organic bulk tea, operation of mini hydro power plants or other alternative energy source will be taxed at the concessionary rate of 12%. Locally manufactured products out of coconut waste (coco peat, coir fiber, grow pellets, grow bags, twist fiber, coconut husk) will be exempt from VAT.

5.2.2 SME Friendly Provisions under Tax Deductible Expenses

A number of changes under tax deductible expenses have also been accommodated in view of assisting SMEs. With the aim of helping SME startups; new enterprises which are anticipated to generate a turnover not exceeding SLR 500mn, the pre- commencement expenses incurred on any such enterprises in the year of assessment immediately preceding the year in which the enterprise commences commercial operations will be allowed for deduction from the total statutory income of the year of commercial operation.

Special provisions have also been to tax deductible depreciation allowances. The cost of acquisition of any plant, machinery or equipment acquired on or after April 1, 2013 a) technology upgrading purposes or introducing any new technology will be allowed for deduction at 50% per year; (b) energy efficiency purposes, which provides more than 30% of the total requirement of the power generation out of alternative energy resources will be allowed for deduction in full (c) any export industry will be allowed for deduction at 50% per year. In view of stimulating innovation through research and development (R&D), R&D expenditure carried out through both government and private institutions are

eligible of triple deductions for tax purposes.

5.2.3 SME-friendly Tax Compliance

In terms of tax payer friendliness Sri Lanka ranks poorly (169th out of 188 countries) in the annual Paying Taxes Report published jointly by PwC and the World Bank. As can be noted from the annexure 2, over the years a number of reforms have been accommodated to make the tax payment process and the tax administration more tax payer friendly, however paying taxes entail the collection and submission of a number of documents which consumes a considerable amount of resources and time, and would adversely impact SMEs owing to higher compliance costs.

Being the sole authority responsible for tax administration, the IRD in late 2012, commissioned a 'one stop shop' for tax facilitation at the IRD Head Office. This new initiative provides tax consultancy services for the general public as well as for registered tax payers across the country free of charge. SMEs in particular are encouraged to avail this service to minimize compliance cost.

In the past Sri Lanka's VAT refund mechanism had come under stiff criticism for not processing input VAT refund fast enough leading to enterprises facing cash difficulties. SMEs, SME exporter in particular would face severe working capital shortages bearing adversely upon their day-to-day operations. The SVAT scheme detailed earlier was introduced in 2011, in view of eliminating the need for enterprises to lock in cash for VAT payments.

5.3 Respondents' Perceptions on the Existing Tax Regime and SMEs

As noted earlier the Sri Lankan tax regime has evolved in response to global and domestic developments. As it currently stands the majority of the respondents were of the view that established tax rates are at some of their lowest level in the country's history and is consistent with creating an environment conducive for enterprises to operate and flourish in. The sheer number of taxes and levies, complexity, compliance and weaknesses and corruption entailing the country's tax administration are however are viewed as more serious tax related concerns.

5.3.1 Exemptions and Concessions

As detailed earlier a number of fiscal incentive packages have been extended by the GoSL in view of enticing both domestic and foreign investments. A number of tax relief packages and special provisions have also been accommodated in view of assisting SMEs. Much of the respondent whilst acknowledging that tax concessions are favorable for enterprise growth argued that much of the tax concessions/exemption in place favor large enterprises over SMEs. For instance the size of minimum investment threshold (SLR 50Mn) to qualify for fiscal incentive packages detailed in section X are well beyond the reach of SMEs. This bias towards large enterprises could largely attribute to the lobbying power of the large players as well as the collective bargaining power of particular industry groups. The textile and garment industry is a good case in point. The textile and garments industry being the largest foreign exchange earner and the industry which currently absorbs the largest proportion of labor has been able to collectively mobilize both large and small enterprises through the Sri Lanka Apparel Exporters Association (JAAF).

Whilst there exists special provisions targeted at SMEs, respondents were of the view that their availability has not been adequately communicated to the people concerned. Many entrepreneurs are unaware of the tax concessions/exemptions available to them. Respondents were also of the view that SMEs in particular have not been properly informed of the benefits of formalizing and becoming tax compliant, hence due to the lack of knowledge opt to stay informal, which in effect stifles their growth potential. Respondents were of the view that the GoSL, through the IRD must engage more closely with potential tax payers, educate and create awareness in the bid to pull them out of the informal sector.

The sheer number of tax and levies coupled with the ad-hoc nature in which tax exemptions/concessions and other provisions have been granted have made the tax regime complex and difficult to understand even for qualified tax professionals let alone laymen. As such SMEs most often have to rely on the services of tax consultants to file returns, leading to additional costs. Whilst a One-Stop Shop detailed earlier has been setup in view of educating SMEs about the tax regime and help them file returns, the service is only available at the head office and is only accessible to taxpayers in the locality. This service should be furthered extended to other part of the country.

Respondents were also of the view that the criteria for granting tax exemptions especially for SMEs are not well directed given the lack of a sound definition. Currently the Industrial Development Board defines an SME as an enterprise with a capital investment less than SLR 4Mn, the National Development Bank definition of an SME is an enterprise with a capital investment of less than SLR20Mn excluding land and Buildings. In light of

international norms the taskforce on the white paper on SME development in Sri Lanka proposed that SMEs should be defined in terms the value of assets. As such a small scale enterprise is defined as enterprise with asset values not exceeding SLR 20Mn excluding land and buildings whilst an enterprise with an asset value of SLR 50Mn excluding land and building is considered a medium scale entity (Government of Sri Lanka 2002). A good first step in this regard they argue is to adopt a common definition of what constitute an SME and relate tax benefits with this definition. Characteristics of SMEs vary across the nature of economic activity, hence adopting a blanket definition across all sectors may not be viable, rather they argue that each economic sector (i.e. agriculture, manufacturing and services) have its own definition and taxes and concessions offered accordingly.

5.3.2 Complex Compliance

The whole process of tax compliance, from initial registration with the IRD all the way through to the filing of returns and making payments is complex and long drawn. At the outset enterprises must register with different departments within the IRD tasked with administering a particular type of tax/levy. For instance enterprises must register with the taxpayer services units for income tax, the VAT unit for VAT, the NBT unit for NTB and so on and so forth. Likewise the handing over tax returns must be carried out in similar manner. This system entails filling a number of different forms, the tax returns form itself is extremely complex and difficult to understand and dealing with a number of different departments is a major hassle leading to duplication of work. The complexity associated with the SVAT system which was specifically introduced to assist SMEs is a good case in point. In this light the process of tax compliance is viewed by many as a hassle which is time consuming and incurs considerable compliance costs. Given such complex system, cash strapped SMEs opt to stay informal rather than going through the hassle of compliance.

In view of redressing issues relating to compliance, respondents were of the view that the tax system needs to be completely overhauled. The number of taxes and levies should be reduced in order to make it more comprehensible to laymen especially SMEs and the system of compliance be simplified and automated. In this way enterprises should only need to interact with one department for registration, filing of returns and payments, saving them both time and money.

5.3.3 Corruption

Rampant allegations of corruption in the tax administration are another serious concern. Many respondents voiced concern that SMEs in particular are often harassed by tax officials and bribery is a common practice. Bribery is especially prevalent when companies go to claim VAT refunds. Anecdotal evidence suggest that over the years there have been

many instances where businesses have been forced closed down and owners migrating as a result of constant harassment by tax officials. In such an environment, respondents argue that enterprises prefer to remain informal and operate under the radar just to avoid the inconvenience of being harassed.

5.3.4 Policy Inconsistency

Respondents argue that Sri Lanka's tax policy is highly inconsistent. Over the past five years, in particular, there have been numerous changes to the tax structure, rates and exemptions offered. Policy reversals are a common feature. The lack of policy consistency instills fear in SMEs that once they formalize, they may be subject to unfavorable policy conditions which they may never be able to get out of once caught in the tax net. Hence to avoid such a situation, SMEs prefer to stay informal.

6.3.5 Weaknesses in the Dispute Settlement Mechanism

GoSL in 2012, through the Tax Appeals Commission Act No.23 of 2011, established an Appeals Commission empowered to hear all appeals in respect of matters relating to imposition of any tax, levy or duty by the Commissioner General of Inland Revenue, prior to going into litigation. The present committee comprises of retired judges of the Appellate Courts. Respondents are however of the view that the panel members are not very well conversant with tax laws leading to misinterpretation and may not serve the purpose of the commission effectively. Furthermore, for a dispute to be validated, a 25% of the tax assessment in question needs to be deposited with the IRD. This precondition, especially from the view point of SMEs, is unrealistic. Most often, already cash-strapped SMEs may not be in a position to make the deposit to validate the dispute. This figure requirement needs to be reconsidered.

Tax-related litigation currently goes through the civil courts system. As it currently stands, the courts system is heavily overburdened and litigation drags on for years. Many respondents were of the view that a separate tax court be set up to hear and resolve tax-related disputes to speed up the process.

5.3.6 Other SME and Tax-related Issues and Recommendations

Many respondents were of the belief that most SMEs in Sri Lanka have a fear psychosis towards taxes. This they attribute largely to the lack of knowledge and awareness. In Sri Lanka, there are a number of different government programs implemented by different ministries through various line agencies directed at assisting SMEs (NEDA, IDB). At present, these are largely confined to technical assistance, by way of vocational training, technology and

knowledge transfer and the development of physical infrastructure through industrial zones directed at building and creating to spur SME development. Many of the respondents are however of the view that in addition to such programs, these agencies should also focus of building the management capacity of entrepreneurs. For instance providing the required education and training to maintain books of accounts and creating awareness and educating them of the benefits of formalization would come a long way in bringing them out of the informal sector and making them tax compliant, in the process mutually benefitting both the SMEs and well as the government.

5.4 KII synopsis: Non-tax related SME Issues

A number of government institutions have been mandated with the task of promoting SMEs. Key ministries amongst which are the Ministry of Finance and Planning, the Ministry of Industry and Commerce, the Ministry of Small and Traditional Industries and the Ministry of Economic Development. The ministry of finance and planning is the key ministry tasked with providing the overall policy direction. The other ministries through the various line departments and agencies administer various programs targeted at SME development. Many respondents are of the view that there is a lot of duplication across work done by the various institutions. This system needs to be streamlined and awareness must be created amongst SMEs as to what the various institutions have to offer so that they could appropriately avail the various services on offer.

Many respondents are of the view that taxation is not a major constraint to SME development, rather bureaucratic red tape, access to finance and human resource constraints are more pressing issues. Seeking information let alone assistance and accessing government services is a hassle owing to complex, time consuming procedures and the presence of corruption. Respondents argue that the hassle of dealing with government agencies also constrains their access to finance. The formal banking sector requires various accreditations and documents which need to be sourced from government agencies, for instance various provincial council accreditations such as street line and ownership certificates need to be obtained order for a person to mortgage a property to access credit. The sheer hassle involved in dealing with regulatory authorities often discourage entrepreneurs, SMEs in particular from seeking finance for formal sources.

Respondents are also of the view that in recent years there has been a significant rural to urban migration, resulting in SMEs located in the rural areas not being able to find sufficient labor to operate. Labor shortages are also attributed to people's attitudes and

aspirations; most young people opt for low paying blue collar jobs as opposed better paying industrial sector employment. Lack of skills is another problem pertinent issue. Another common complaint with regard to human resources is lack of skilled workers. Respondents argue that more vocational training programs needs implementation to address this shortage.

5.5 KII Synopsis: Property Taxes

With the 13th amendment to the Sri Lankan constitution the power of taxing property has been devolved down to local governments (also known as local authorities), the third and lowest level of government in Sri Lanka. Local authorities are primarily responsible for providing a variety of local public services including roads, sanitation, drains, housing, libraries, public parks and recreational facilities. Properties taxes and stamp duty on the sale of property often forms the main source of revenue for these authorities. The main instrument used to tax property is 'rates'. Rates are assessed on the 'Annual Value' of the Property. In determining the annual value a 'hypothetical rent' is arrived at taking into account factors such as the age of the building, facilities available and access to public amenities of the building under assessment. Once the annual value is arrived at, a stipulated 'rate' is applied to determine the amount of rates payable. Constitutional provisions provide individual local authorities the leeway to establish their own rates. The Colombo Municipal Council (CMC) applies two different rates; commercial properties are charged at a rate of 35% and residential properties are charged at a rate of 25%. Rates are calculated on an annual basis and payments are to be made quarterly. In order to incentive early payment, the CMC offers a 10% discount on the rates payable should the annual payment be made in full at the start of the year.

Most respondents were of the view that property tax does not have a major bearing on enterprise development and were not well aware of the implications they may have on property markets to comment on.

5.6 KII synopsis: SMEs and Access to Finance

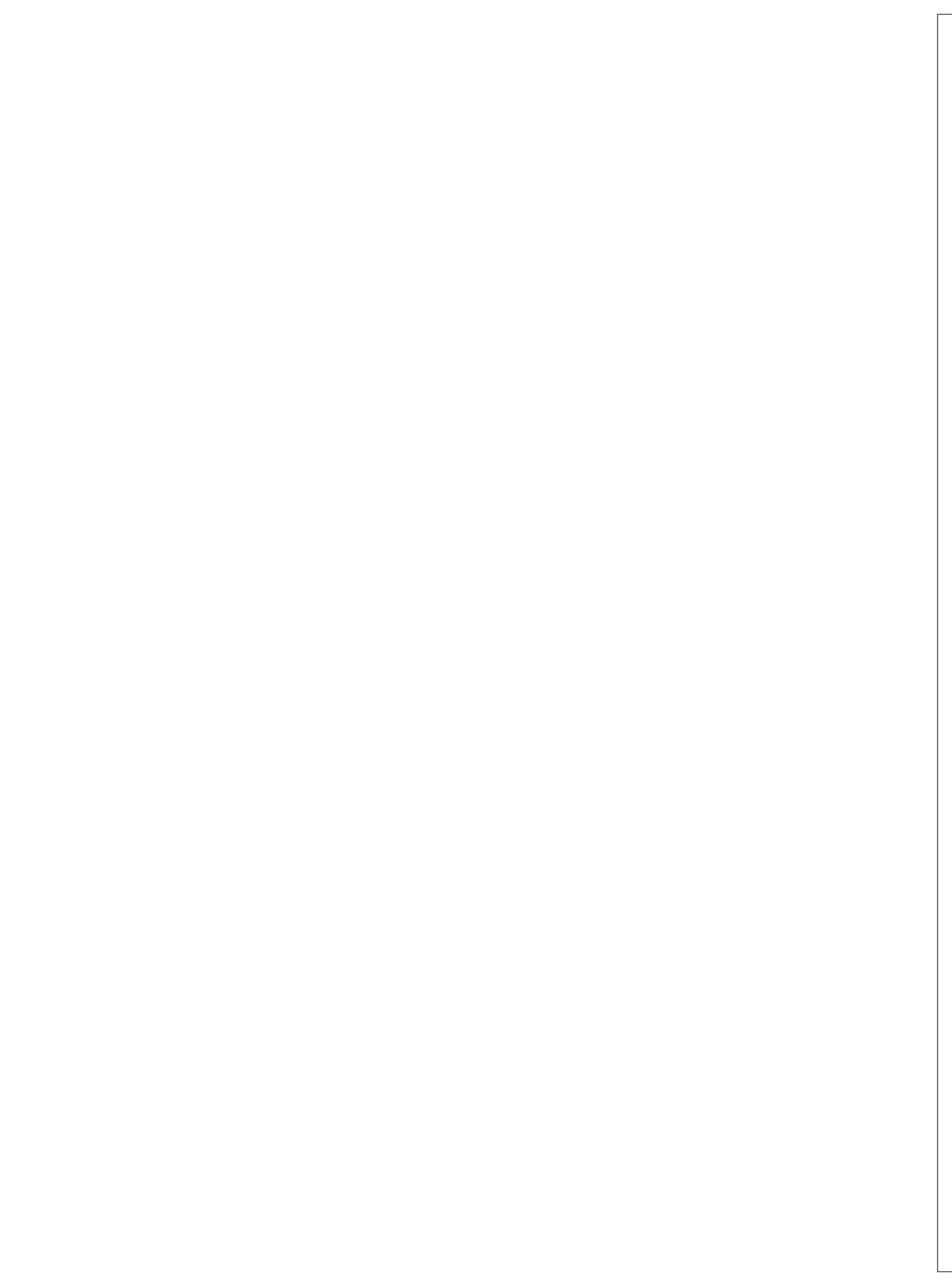
A number of licensed commercial banks and licensed specialized banks operating in Sri Lanka cater to SMEs through special credit lines. These credit lines are either sourced from the GoSL (Treasury) or through various international financial institutions such as KfW,

JIAC, and ADB etc. In addition individual banks also allocate a certain proportion of internally generated funds to cater to the SME sector. The banking sector as a whole does not have a generally accepted definition of an SME rather the definition varies across the different banks and credit lines on offer. Generally the definition is based on either the turnover or the loan amount. In terms of interest rates, generally rates are lower on funds sourced through special credit lines as opposed to internally generated funds in nature; likewise eligibility criteria under special credit lines are much more lenient in comparison.

The priority sectors for lending at present is Tourism, Fisheries, IT and Agriculture and is largely determined by the mandate of the government. All state-owned banks and private banks which access GoSL credit lines must comply with the government mandate when disbursing loans. In the postwar era there has been a higher tendency for SMEs to seeking term loans as opposed to short term loans, respondents were of the view that with the ushering in of peace, SMEs have sought to expand operations hence an increased emphasis on financing capital investments. In terms of the size of loan sanctioned generally agricultural loans tends to be much smaller than non-agriculture loans.

Banks tend to request for immovable property mortgages in instances where the credit exposure is high, or when the borrower is a new entrant, otherwise banks are generally content with the mortgage of movable project assets where the borrower has a good credit history. A recently new development in servicing new SMEs is community/cluster based lending, where banks through various industry/regional associations offer credit to SME members. From a banks perspective cluster based lending minimizes the risk associated with lending to individuals. Form an SME perspective cluster based lending entails less collateral requirements as the guarantee of other members of the clusters provided sufficient securitization in most instances where loan amount requested is small. Collateral is however not the sole or foremost criteria for lending to SMEs, rather banks give more weight to factors such as , the project feasibility (market potential, technical feasibility , profitability etc) , applicants background (management skills, marketing skills, and technical skills).

As for reasons for loan applications being rejected, respondents cited that bad credit history, weak past financial performance and managements and risky/weak market potential to be the main grounds on which loans are turned down. Major reasons for default include poor credit origination (i.e. credit evaluation – not correctly ascertaining the applicants background and project potential) and adverse economic conditions). Tax compliance is not a necessary prerequisite to obtain credit. When a loan goes into default, banks generally as a first step attempt to negotiate with the borrower to restructure the repayment at both the branch and head office level, failing which the legal action is sought after.



SECTION-VI

Case Study: Women Owned Enterprise

The Case of Selyn Exporters (Pvt.) Ltd

Hailing from an aristocratic family in the heart of the North Western Province of Sri Lanka, Mrs. Sandra Wanduragala, a lawyer by profession, back in 1991 embarked on the bold venture of expanding and modernizing her husband's existing handloom business. Striking a delicate balance between her career, business and family life, over the past two and a half decades, she has been able to successfully transform what was once a small backyard handloom textile business employing 15 rural women, into what is now a thriving Fair Trade certified handloom company which manufactures and exports handloom textiles and textile-based toys and handicrafts to 18 countries around the world. Selyn as it is popularly known, currently owns and operates 6 workshops in handloom villages in the rural outskirts of the Northwestern and Eastern provinces of Sri Lanka employing close to 350 rural men and women. Furthermore, in light of vision to give back to society', Mrs. Wanduragala has assisted close to 16 Selyn members, largely former Selyn employees (majority women) to setup and operate 9 handloom workshops and 5 sewing/handwork workshops in villages in the rural outskirts of the Kurunegala and Batticaloa districts which currently as a whole employs a further 750 rural men and women.

In light of her achievements with Selyn, the Women's Chamber of Commerce and Industry has recognized Mrs. Wanduragala as the 'Woman Entrepreneur of the Year' for two consecutive years (2011 and 2012). In addition she has also won the National Chamber of Exporters Award for Best Women Exporter from 2000 to 2006 and the prestigious Indira Gandhi Priyadharshini Award presented by the Federation of Indian Women Entrepreneurs in 2003. Her road to success has however been far from a smooth one. Self-determination, commitment and leadership coupled with supporting role played by her family and various government departments and INGOs has truly played an important part in shaping her success.

6.1 Motivation

A lawyer by profession and having seen her practice grow, her motivation to do business came from two sources; firstly the need for self-empowerment and secondly having seen that most rural household in Sri Lanka face issues of alcoholism of the head of the household (father) and its adverse implications on women and children; she was of the belief that empowerment of women would be key in overcoming such problems. Since her husband was already involved in handlooms - a traditionally women dominated/oriented industry she thought of taking over the leadership of reviving the already ailing family business in her bid to empower herself and at the same time assist rural women empower themselves.

Having taken over the mantle of reviving the family business, Mrs. Wanduragala was identified by the Centre for the Promotion of Imports from developing countries (CPI) - the international development arm of the Netherlands Ministry of Foreign Affairs - to take part in a workshop on the women's role in enterprise development which was jointly conducted in collaboration with the Export Development Board of Sri Lanka. Having already some background knowledge of the technical aspects of the handloom industry, participating in the workshop is where she really got the inspiration and knowledge to innovate and improvise and carry out the business as a profitable venture. The workshop armed her with the knowhow pertaining standard business management practices, information and advice on how to engage in marketing and how to seek and tap into new markets.

6.2 Family Support

Mrs. Wanduragala credits much of her success to her liberal minded husband Dr. Newton Peiris who allowed and has continuously encouraged her to pursue her business aspiration. At the initial stages; having to look after her two small children, whilst engaging in business and at the same having to pursue her legal practice, the joining of Mrs. Wanduragala's brother to Selyn, she credits had given her the added strength to take on the challenge of balancing family life, profession and business. Even today Selyn operates as a truly family owned and operated business enterprise with family members taking on key management responsibilities. Mr. Wanduragala's brother is currently the general manager and her daughter Selyna Peiris oversees the business development aspects of the venture.

6.3 Marketing

At the time of entering into the venture (1991), the handloom industry in Sri Lanka was on the rapid decline owing to international competition as a consequence of open economy liberalization reforms undertaken back in 1977. Mrs. Wanduragala was however adamant on revitalizing the business by way of giving it a new dimension and an exclusiveness to the product. Rather than focusing solely on handloom fabrics she thought of diversifying and differentiating themselves by way of maintaining high standards of quality and producing value added products through innovative designs and novel product ideas to cater to up-market clientele. This gave rise to Selyn embarking on producing and exporting 100% natural cotton fabrics that are transformed into toys, children's accessories, decorative items for children's rooms, home accessories, household textiles and linens and many other products.

Venturing directly into the export market is no small feat for a Small and Medium Enterprise (SME) let alone a woman owned and managed one. Mrs. Wanduragala credits much of her success to the assistance given by Export Development Board (EDB) of Sri Lanka. The EDB at the initial stages she argued played an instrumental role in assisting her tap the export markets by way of linking her with potential international clients. Through the EDB, Mrs. Wanduragala was able to secure an export order to a Japanese buyer, which in her view really set the stage for her export expansion. Over the years she credits the EDB for sponsoring her to take part in number of international trade fairs which opened up markets in the US and EU. Without EDB sponsorship the company would not have been in a position to finance such expenses.

6.4 Taxation

In the face of stiff competition from local power loom textiles and imported textiles of the garment manufacturing companies as a consequence of economic liberalization, the Sri Lankan handloom industry by the late 1980s and early 90s was in a dilapidated state. The government at the time, however recognizing importance of the handloom industry owing to its traditional value sought to revive the industry by way of encouraging handloom entrepreneur to engage in the manufacture of niche handloom products for the export market, which saw handloom exporters being entitled to a duty rebate scheme (This scheme is not in operation now). This duty rebate scheme had greatly help Selyn maintain price competitiveness in the face of international competition and establish themselves in international markets during its infancy.

6.5 Access to Finance

Selyn's ability to secure export orders coupled with Mrs. Wanduragala's profession as a lawyer and being on the lawyer panel of a number of reputed banks operating in the Kurunegala area, she credits to having played a key role in instilling trust in banks to lend to her. The same however could not be said about other women owned SMEs (WOSMEs). In Mrs. Wanduragala's view many women lack the knowledge and confidence in going about securing bank credit. The procedures involved remain too cumbersome and most WOSMEs lack the knowledge and skills to fulfill fundamental formal banking prerequisites such as the maintenance of financial statements which discourages them from applying for bank loans. Likewise dealing with the bureaucratic machinery in Sri Lanka to fulfill other banking requirements; the lack of knowledge and skill to deal with professions including bankers and bureaucrats is also a major barrier for WOSMEs seeking credit from the formal sector.

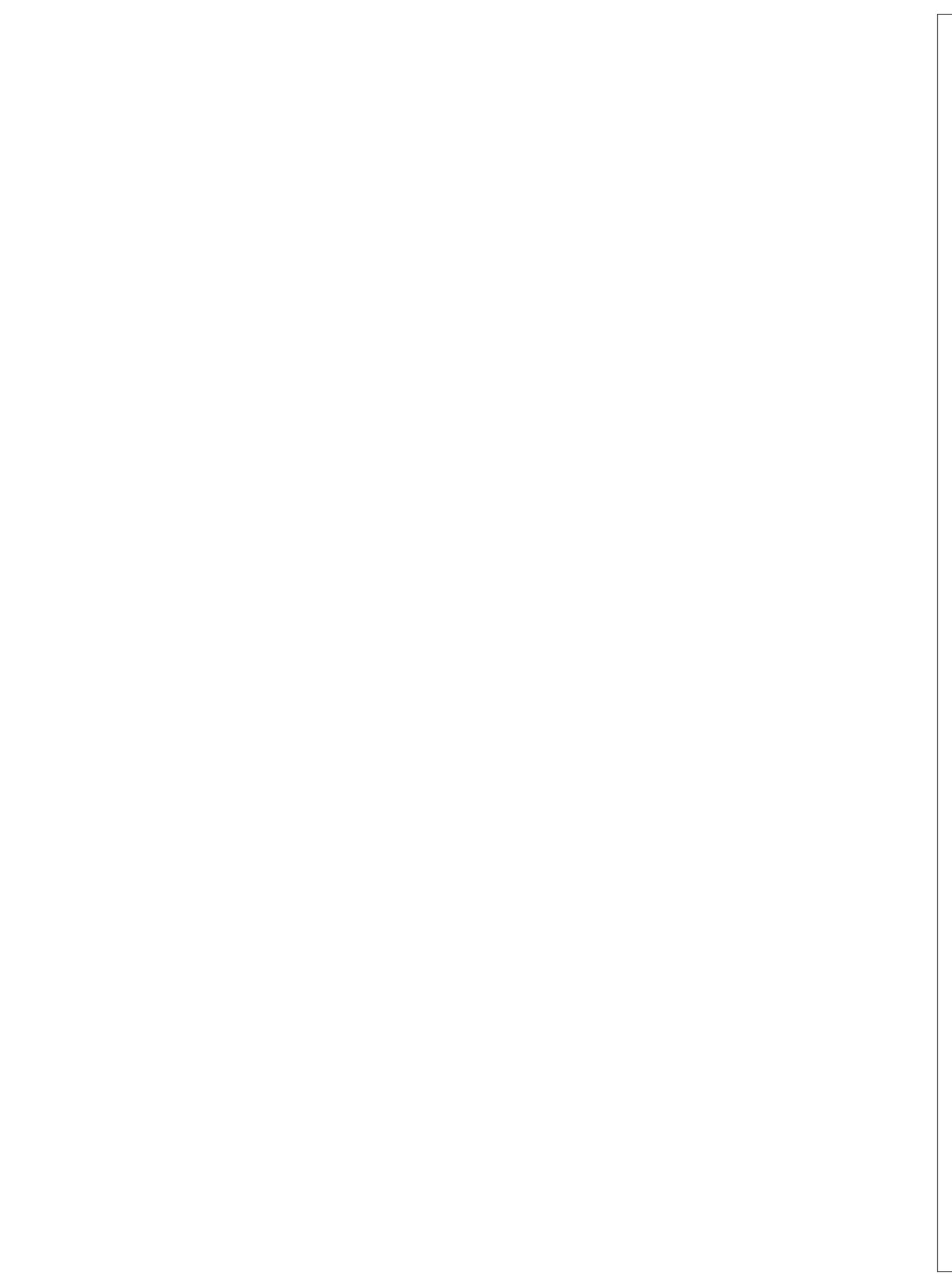
6.6 Towards a Sustainable Entrepreneurship Model

Over the years having garnered valuable insights into the challenges faced by WOSMEs coupled with her desire to empower women whilst also seeing Selyn expand and grow as a successful enterprise, Mrs. Wanduragala has embarked on reorienting Selyn into a social enterprise. In this light the company has been extending both technical and financial assistance to Selyn members (predominantly women) to start up handloom workshops and sewing/handwork workshops in villages in the rural outskirts of the Kurunegala and Batticaloa districts. Currently Selyn has funded 16 such workshops which undertake subcontracts for Selyn products. The aim is to move away from a traditional 'headquarter-based' model into a more 'rural entrepreneurial' model which enables rural artisans, especially women to be self-sufficient and also work within the comfort of their own villages and homes. At the initial stage Selyn has provided financial assistance to setup required infrastructure, machinery and working capital by way of grants and soft loans to former Selyn members who have been unable to continue work in the main workshop due to various reasons, such as leaving young daughters or grandchildren at home alone or helping their husbands in paddy cultivation which are all part and parcel of the life of a rural Sri Lankan woman. Selyn provides the products designs, raw material, and required technical expertise and pay these firms based on the value addition they carry out at a piece rate. All transactions are carried out as per 'fair trade' principals. The company also is actively trying to encourage these women entrepreneurs to adopt standard business management principals such as bookkeeping, adhering to factory

safety standards and manufacturing best practices etc., and in the process, empowers these women entrepreneurs to stand own their own.

6.7 Conclusion

Starting out with 15 workers in her backyard almost 25 years ago to a thriving export oriented venture with over 1000+ employees is one of the very few successful women owned enterprises in Sri Lanka. Self-determination, commitment and leadership coupled with the supporting role played by Mrs. Wanduragala's family and various government departments and INGOs has played an important part in shaping Selyn as a successful woman-owned enterprise.



SECTION-VII

Focus Group Discussion Findings

With the aim of soliciting feedback on research results (i.e. key informant interviews and firm-level survey) and ascertaining policy options/recommendations in light of the practitioner's perspectives, a focus group discussion was organized. The focus group participants comprised of senior civil servants from the Inland Revenue department, senior officials from prominent industry chambers/associations and reputed tax consultants operating in Sri Lanka.

At the outset the following salient issues brought to light from the key informant interviews and firm level survey findings were shared with the participants. All participants were in concurrence with the findings.

- Lack of a sound definition of what constitutes an SME has raised issue relating to effectively targeting tax exemptions/concessions at SME
- Major proportion of existing tax Exemptions and Concessions are biased in favor of large enterprises (e.g. minimum investment threshold to qualify for BOI/IRD tax breaks is Rs. 50Mn)
- At the firm level most SMEs are not aware of the existing exemptions/concessions available to them.
- SME-entrepreneurs are also not well aware of the benefits of tax compliance, hence prefer to stay informal to avoid paying taxes all together
- Ad-hoc nature in which tax exemptions/concessions and other provisions have been granted have made the tax regime complex and difficult to understand – Many SMEs are unaware of the tax/concession and exemptions already available to avail of them
- Sheer number of taxes and levies, coupled with complexities associated with the tax compliance process (initial registration - all the way through to the filing of returns and making payments) is resulting in additional costs (SMEs - have to rely on the services of tax consultants leading to added costs)
- Lack of communication – awareness, advice and training provided by the Inland Revenue Department

Drawing on the silent issued highlighted above and with the aim of ensuring the discussion and the ensuing recommendations is well focused, the guiding questions of the discussion were restricted to and drawn from the following broad areas

- Thoughts and recommendation on the best way to formulate a suitable definition for SMEs
- Thoughts and recommendation on streamlining the tax system, to be more SME friendly
- Thoughts and recommendation on how best to Create Tax Awareness and Provide Advice to Enterprises

7.1 Developing a Suitable Definition

All participants were in consensus for the need to adopt a common definition. It was mentioned that the Ministry of Finance and Planning in collaboration with GIZ, Sri Lanka is currently in the process of obtaining inputs from various stakeholder to formulate a national definition. Participants were, however of the view that whilst there should be a single broad definition at the national level, for the purpose of taxation whilst using the national definition as a base, should developed further definitions to take into stock the varying levels of economic activity across the different types of industries.

For instance it may not be practical to compare an enterprise in the agriculture sector against an enterprise in the service industry. A small enterprise in the agriculture industry would employ a much larger workforce compared to a small enterprise in the services sector due to the labor intensive nature of the latter. Likewise if the definition is to be based on capital invested for example, a manufacturing enterprise may have invested more capital in the form of machinery and technology compared to similar sized firms in the agriculture and services sector. In the preceding light in may not be advisable to use a common definition across the various economic activities/industries. Separate definitions for the various industries should be developed to reflect these variations.

Another concern is the fact that even within industries there may be variations in the level of economic activity across firms. For instance varying rates of technology uptake across firms in the same industry have a tendency send a misleading picture of the size and level of economic activity of a firm. In the paddy sector for instance entrepreneurs have the option of either carrying out cultivation employing labor or mechanizing the process. A

definition based on employment may show two different levels of economic activity for a similar sized cultivation, hence participants were of the view that the definitions should be further refined employing different criteria i.e. based on employment, turnover, capital invested etc) to reflect these realities, rather than employing just one criteria.

7.2 Streamlining the Tax System

Where SMEs are concerned there are three main taxes that need to be paid namely income tax, Value Added Tax and Nation Building Tax, the other levies are incurred during importation. FDG participants from the revenue administration were of the view that this type of tax structure is not too complex as most SMEs only have to deal with paying the three main taxes as they do not most often involved directly in importation. Other participants were however of the view that Nation Building Tax could be done away with altogether or some portion of which could be amalgamated into the VAT as they are both similar indirect taxes.

With regard to compliance where firms do not have competent personnel in house to attend to compliance matters all participants were in consensus that they have to rely on consultants. In some instances the fees paid to these consultants may exceed the amount of tax payable itself. One recommendation coming out of the discussion is the need to simplify the tax filing guidelines issued by the IRD to ensure that even a non-technical person could understand and fill returns on their own. This should be done in consultation with consultants.

Participants from the IRD mentioned that the IRD is working with the Singaporean government to implement a Revenue Administration Management Information System (RAMIS) which is expected to automate all internal processes of the IRD relating to tax administration. It is expected that through the implementation of this system the IRD could reach out to tax payers in a more efficient and effective way. The system is expected to eliminate the duplication of work currently involved in the system and there by ensure speedy service to tax payers. Participants were also of the view that the IRD should also extend e-filing of tax returns as done in many countries of the developed world. Singapore has a very good e-filing system and as they are already providing Sri Lanka with assistance to setup RAMIS, this possibility also should be explored. The implementation of such system would come a long way in reducing compliance costs as enterprises can file and pay tax returns without spending time coming to the IRD. It would also be simpler for SMEs to file returns, as the system will take care of all the technicalities involved in filing returns.

7.3 Creating Tax Awareness

Currently as part of the IRD's tax awareness program the department holds a 'Tax Week' annually in a bid to encourage the public to comply with the country's taxation system. The 'Tax Week' looks to enlighten the public of the contribution they could render towards future prosperity of the country through timely payment of taxes and to also enhance the department's image with the tax-paying public. The tax week is usually designated during the November or December of each year to coincide with the disclosure of National Budget so that the public could be brought up to speed with tax related developments in the budget. During this Week, the IRD in collaboration with industry associations/chambers holds a number of seminars all around the island to educate the tax-paying public of the changes to the tax system. Many participants were of the view that this system is not very effective as it is a one off event. They are of the view that such an awareness creation campaign should be in place through the year so that entrepreneurs can have access to information year round. Whilst a one stop shop has been setup to provide tax advice, the private sector FDG participants were of the view that this is also not very effective with only a handful number of enterprises availing of the service.

In order to create awareness in a more efficient and effective manner FDG participants are of the consensus that a private public partnership model should be embraced. It is envisaged that the IRD works closely with Industry Chambers/Associations, Tax Consultants and the Sri Lanka taxation institute to create awareness through the provision of training and advice. In the view of participants, industry chambers could play an influential role in mobilizing entrepreneurs to attend tax workshops, which are jointly organized by the chambers and the IRD. Both the IRD and tax consultants could provide resource persons to conduct the workshop. The content of the workshops should not just be limited to the provision of information through a series of lectures but also provide hands on practical experience to entrepreneurs with regards to filing of tax returns. This would create awareness and at the same time equip entrepreneurs with the skills to undertake filing of returns on their own thus minimizing compliance costs at the firm level whilst at the same time increasing compliance overall.

Another initiative proposed by participants is to setup tax information centers within the regional offices of business chambers/associations or local councils to provide continues (throughout the year) advice on tax related matters to SME at nominal rates. This would ensure that entrepreneurs have access to tax related advice continuously.

SECTION-VIII

Conclusion and Suggestions

Sri Lanka, having joined the ranks of lower-middle income economies, is now seeking to raise its per capital income to US\$ 4,000 by 2016 and US\$ 7,000 by 2020. This would require a rapid pace of growth of 8 per cent and above, for which the groundwork is now in place following the end of the protracted armed conflict (in May 2009) and the massive public infrastructure drive currently ongoing. Meanwhile, making this growth inclusive, both across geographic regions in the country and across population groups, will become a key medium-term challenge. A vital element in this is job creation by unleashing the potential of Sri Lanka's private sector, which was shackled during the decades of conflict. Within this agenda, the SME sector is recognizing as a key driver, given that over 90 per cent of the country's private sector establishments are of this size, and they are the backbone of Sri Lanka's provincial economies. However, SMEs in Sri Lanka are faced with a myriad of difficulties in their quest to survive, remain profitable, grow and expand their business, and create more jobs. Of these, research points to factors like access to credit, technology, infrastructure, government regulatory services, business development services, staff training, and taxation. The focus of the present study is the lattermost – taxation. The study looked at three themes of taxation - 1) tax concessions and incentives; 2) Value Added Taxation (VAT); and 3) property taxation.

Using a survey instrument administered among 150 enterprises (both SME and large), together with Key Informant Interviews, and in-depth case studies of selected enterprises, this study has explored the various dynamics influencing the SME-tax nexus, across these three themes.

The study suggests that the prevailing tax incentives structure favor large enterprises. So more needs to be done to explore how the tax incentives regime can be reoriented to suit the growth needs of SMEs and also streamline them and enhance awareness about them.

Tax compliance appears to be low, mainly due to the fact that SMEs are not making enough money to be caught into the taxable threshold. This calls for a review of the taxable threshold on one hand, and supporting SME growth so that they become taxpayers on the other hand.

Low awareness on tax matters came across as an overall theme in this study and more needs to be done. While good initiatives have been undertaken by the IRD to improve awareness through workshops, etc., a more regular and continual approach may need to be adopted. An SME friendly tax collection approach would also need to be inculcated

among the IRD regions officials.

A review of huge tax compliance and overall regulatory burden may be warranted, as the study revealed that many SMEs found tax compliance to be cumbersome and burdensome. While it is acknowledged that any enterprise would find tax payment burdensome and would rather not pay, a more user-friendly and streamlined compliance structure may boost compliance.

With regard to land and property taxes, the study does not find any significant influence of this on SMEs, however exploring this area revealed that the critical issue is the availability and access to land for SMEs. Earlier moves to establish a government land bank for commercial undertakings may need to be revisited in huge context of SME growth, and also a review of the existing procedures with regard to land purchase/sale.

An overarching issue that emerged in this research was the lack of a coherent understanding of 'what constitutes an SME?' stemming particularly from the lack of a common definition agreed to by all stakeholders. This has been a perennial issue in Sri Lanka's SME sector. It must be tackled as a priority matter, as it not only has implications on government support to SMEs, SMEs' access to finance, etc., but also has implications for widening the SME tax base and improving tax compliance.

The study will be incomplete if it does not place on record that tax policies, tax rates/structures, tax administration and compliance, and all related tax issues faced by SMEs are but one aspect influencing the growth and success of the SME sector. Other factors like the overall regulatory and business climate, availability of finance, business development services, management and technology upgrading, etc., need to be simultaneously addressed in order to improve the competitiveness of the sector.

In conclusion, the study asserts that while the SME sector is an important sector for tax collection purposes, given the current policy focus on SMEs and the desire to grow the SME sector, tax authorities should be sensitive to the needs of SMEs when introducing or changing taxes. Overall, Sri Lankan authorities must bear in mind that in a context where over 90% of industrial establishments in the country are of small and medium-size, and the vast majority of private sector enterprises outside the Western Province are SMEs, any tax policies that affect the private sector as a whole should necessarily consider the impact on the SME sector in particular. While Sri Lanka pushes forward to improve its tax-to-GDP ratio and gears its tax structure and tax policies to achieve that end, the start up, growth, and job creation potential of SMEs should not suffer. With tax policies that strike a clever balance of tax compliance improvement and growth-promotion, the Sri Lankan SME sector can continue to play a key role in the country's socio-economic development.

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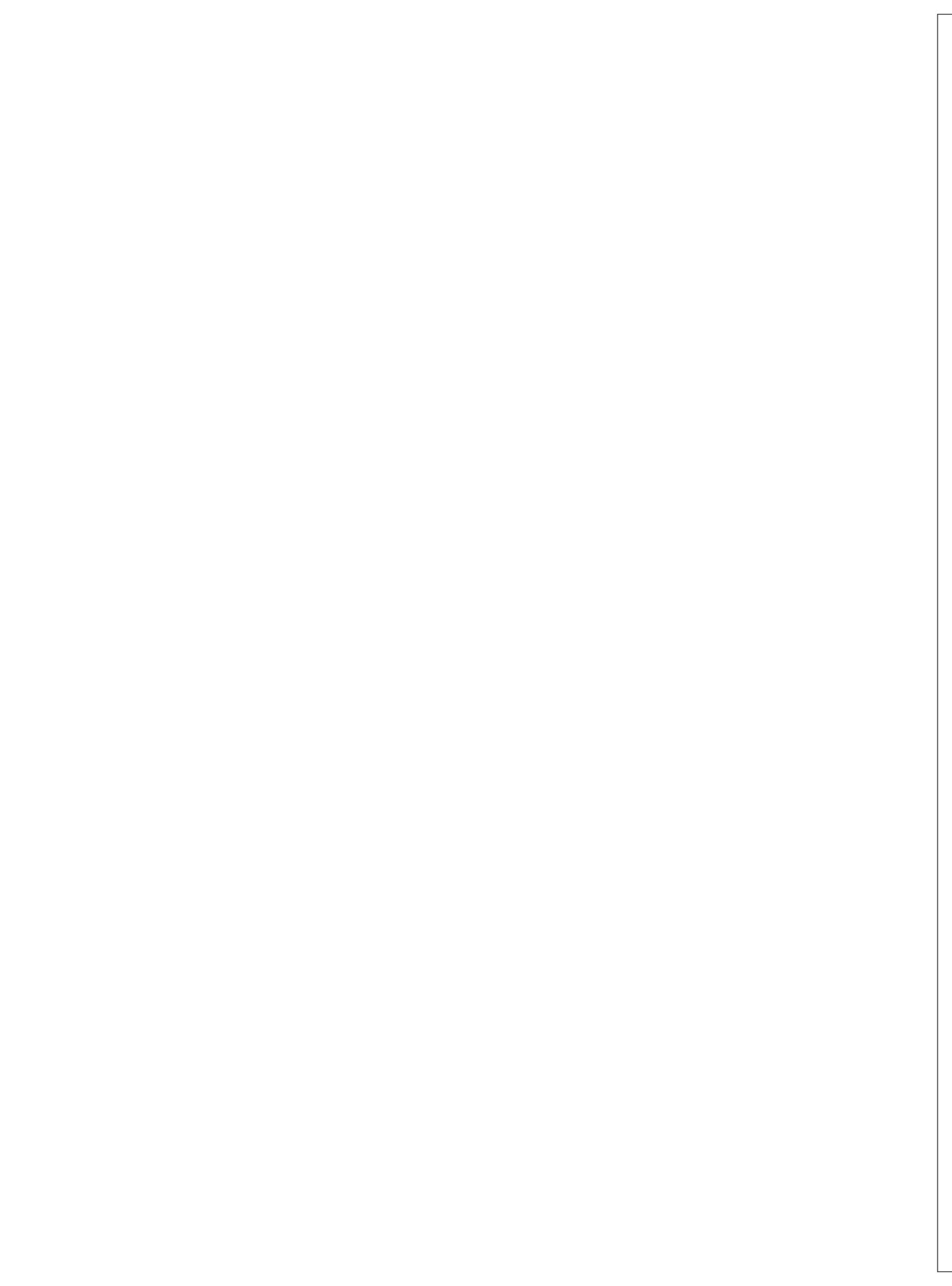
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Annexures

Annexure 1: Investment Incentives Schedule as at 2013

Category	Sector	Amount of Investment (Rs. Mn.)	Tax Incentives		
			Full Tax Holiday (Years)	Concessionary Rate	Other Incentives
i. Tax Incentives for New Enterprises					
Small Scale Enterprises Agriculture	Agriculture	≥25 and <50	4		
	Services (Selected activities only)	≥25 and <50	4		
Medium Scale Enterprises	Manufacturing (excluding liquor and tobacco) for domestic and/or export market	≥50 and <100	4	12% after tax holiday for export oriented manufacturing and 28% for other types of manufacturing	Import duty exemptions on capital goods for manufacturing firms during project implementation period Import duty exemptions on quantity of both capital goods and raw materials for export oriented manufacturing enterprises Exemptions from Exchange Control if export oriented manufacturing firms
	Agriculture	≥100 and <200	5		
	Services (selected activities only)	≥200	6		
Large Scale Enterprises	Manufacturing	≥300 and <500	6	12% after tax holiday for export oriented manufacturing and 28% for other types of manufacturing	Import duty exemptions on capital goods for manufacturing firms during project implementation period Import duty exemptions on quantity of both capital goods and raw materials for export oriented manufacturing enterprises Exemptions from Exchange Control if export oriented manufacturing firms
		≥500 and <700	7		
	Agriculture	≥700 and <1000	8		
		≥1000 and <1500	9		
	Services (selected activities only)	≥1500 and <2500	10		
		>2500	12		

No minimum investment	Undertaking for fishing	N/A	5 years commencing from 1st April 2011		
	Agriculture	N/A	5 years commencing from 1st April 2011		
Strategic Import Replacement Enterprises	Fabric	5 (USD Mn.)	5	12% after expiry of tax holiday	
	Pharmaceutical	10 (USD Mn.)			
	Milk Powder	30 (USD Mn.)			
	Cement	50 (USD Mn.)			

ii. Project Expansions for Existing Enterprises

Small/Medium/Large scale	Agriculture	≥50			Qualifying repayment relief (b) Import duty exemptions on capital goods for medium/large manufacturing firms during project implementation period Import duty exemptions on quantity of both capital goods and raw materials for medium/large export oriented manufacturing enterprises Exemptions from Exchange Control for medium/large export oriented manufacturing firms
	Manufacturing				
	Services				
Strategic Import Replacement Undertakings	Fabric	5 (USD Mn.)		12% for 5 years	Investment treated as \qualifying repayment relief (b) Import duty exemptions on capital goods for manufacturing firms during project implemented period
	Pharmaceutical	10 (USD Mn.)			
	Milk Powder	30 (USD Mn.)			
	Cement	50 (USD Mn.)			

- a) Manufacture, production or processing of non-traditional goods for export (including deemed exports with 90% export requirement and 75% for apparel and textiles), and manufacturing for domestic and/or export market
- b) Investment made in the expansion will be eligible for a qualifying payment for an allowance equal to the amount of investment which shall be deductible from the assessable income subject to: * not exceeding 25% of such investment in that year of assessment and balance 75% to be apportioned in equal amount over 3 years immediately succeeding that year of assessment. * If investment is made in more than one year of assessment, the year of assessment on or after 01.04.2011 in which, the aggregate of the minimum investment requirement is reached, shall be deemed to be the year of assessment to qualify for this deduction.

Year	Ease of Paying Taxes	Tax Payment	Time to Comply	Total Tax Rate
2009	164	170	98	157
2010	166	172	102	159
2011	166	173	102	159
2012	173	180	108	179
2013	169	-	-	-

Annexure 2: Paying Taxes – Sri Lanka

Ease of paying taxes ranking for Sri Lanka

Note: 2013 does not have rankings for the three individual sub categories.

Year	No. of Tax Payments	Total tax time (Hours)	Total Tax Rate
2009	62	256	63.7%
2010	62	256	63.7%
2011	62	256	64.7%
2012	71	256	105.2%
2013	61	254	50.1%



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