Raising Taxes When the People don't Trust You: The Case for Sri Lanka

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Background

Sri Lanka is experiencing its worst economic crisis since the island nation attained Independence from British rule in February 1948 (Salikuddin, 2022). Decades of political mismanagement have led to rampant inflation, food and fuel shortages, and mass protests (Hindustan Times, 2022). Caused by a crippling budget deficit, as well as a history of loans and debts, there is observed mistrust among the public towards taxpaying due to doubts in utilization of tax revenue. According to the World Bank, trust is key for higher taxes in developing countries (The World Bank, 2023).

Sri Lanka's public are experiencing low trust towards taxpaying due to inefficiency, corruption, and inequality. This paper considers all three factors in depth, as well as Sri Lanka's history of taxation, and the use of tax cuts as election-winning tools. This paper will also present examples of developing countries that have successfully addressed public mistrust, and conclude with recommendations for Sri Lanka to address its own public's mistrust in utilization of tax revenue.

History of Taxation in Sri Lanka

Sri Lanka has been practicing tax collection regimes since 1932, (Inland Revenue Department, 2023). These include income tax, sales tax, excise duties, value added taxes, and various sector or industry-specific initiatives. Political motivations typically lead to initiatives implemented, and removed ad-hoc.

Tax cuts are popular tools used to win elections. The Government which was elected to power in 2019 pledged deep tax direct and indirect tax cuts and implemented these just before the Covid-19 pandemic hit, severely affecting government revenues and worsening the already brewing economic crisis (Bhowmick, 2022).

Hence, the Government resorted to sharply increasing personal income taxes from 1st January 2023. This policy has accelerated brain drain, resulting from droves of professionals migrating from the country to escape the economic crisis, as well as the new taxation policies (Aneez, 2022).

The new taxation policies reduce personal income tax relief from LKR 3,000,000 per year to LKR 1,200,000 per year. Above that, tax is calculated in brackets for every LKR 500,000 earned per year (Inland Revenue Department, 2022). Figure 1 illustrates the 2023 income tax regime.

Personal Income (annual)	***Tax rate***
First LKR 1,200,000	0%
Next LKR 500,000	6%
Next LKR 500,000	12%
Next LKR 500,000	18%
Next LKR 500,000	24%
Next LKR 500,000	30%
Balance	36%

Source: adapted from Inland Revenue Department, 2022

Passing these taxes is no easy feat, as the political actors and government must convince the public to voluntarily pay more tax for collective benefit.

Winning political trust

According to research done by Lim and Moon (Lim, 2022), having political trust in the government can help convince individuals to support policies that are difficult. They add, “Individuals with a greater level of political trust may support the tax increase needed for social welfare expansion.”

Political trust, Moon and Lim note combines people’s evaluations of the government’s performance as well as their expectations from it. This is important as individuals often do not have the resources, time, or energy to understand public policy. Hence political trust is a tool “crucial for citizens in evaluating policies” they know little of.

In Sri Lanka, lecturer in Economics at the University of Colombo, Umesh Moramudali (Moramudali, 2023) says political trust has always been an issue. Currently, it is at a minimum level as the government is headed by a constitutionally appointed President, heading a politically party with no popular mandate.

“Tax increases are a part of unpopular economic reforms taken during crises but such reforms at the end of the day are a political process. Therefore, for people to bear the burden of tax reforms along with other reforms, political trust remains key. When reforms are carried out without a political mandate to do so, such reforms are prone to fail,” explained Moramudali.

Tax auditor and consultant, Kapila Rathnasinghe (Rathnasinghe, 2023) says the new tax regime sees many seeking loopholes to evade tax. “The tax hike is significant this time, and people say they would pay if the money was used for their benefit. But this is not so,” he said.

Another factor which discourages the public from paying taxes is the perception of a high tax burden. Historically, Sri Lankans have been paying low direct taxes (mainly income) and high indirect taxes. While the new regime does not talk about lessening indirect taxes, the progressive increase in taxation, will be at a maximum of 36% for the highest bracket. This is lower than rates in developed countries such as Sweden or France. However, the higher taxes will necessitate a significant reduction in quality of lifestyle for those who pay it.

“Previously if a person earning Rs 350,000 (USD 962) was paying Rs 6,000 (USD 16) in tax, now they will have to pay Rs 50,000 (USD 137) in taxes. So, they think the burden is too much, especially since the cost of living has skyrocketed and our currency has greatly depreciated.”

Moon and Lim note that individuals estimate their tax burdens differently even when they confront the same tax base or rate. Their perceptions of tax burden are shaped by factors such as tax complexity and fairness.

Similarly, Rathnasinghe noted that the current tax filing system was not complex but very bureaucratic, discouraging 99% of people to file their own taxes or open individual tax files.

“It is not that hard, but many hire an accountant to do it for them because they fear they might do it wrong and end up paying more. Also, if they are honest with their declarations, there is a notion that the government will come after them.”

Dealing with the system itself is not easy. The RAMIS online tax system which cost Rs 12-15 billion (USD 33- 41 million) to build is underutilized. Rathnayake notes that not all functions work or the officers themselves are not aware of how to use it. There is very little information given on it and when tax filing season comes, it inevitably fails. These factors which negatively impact perceptions of tax burden, lower citizen's willingness to support tax increases needed to expand social welfare measures.

What do the people think?

Chayu Damsinghe (Damsinghe, 2023), macroeconomist, and researcher at Frontier Research Group in Sri Lanka has been monitoring social media over what the tax paying Sri Lankans think about the new tax regime. He says the changes really only affect the top 10% of income earners in the country. The majority, he notes is below the tax threshold.

"The issue is that many of these people do not perceive themselves as the top 10%. They believe they are middle class. They complain that the middle class is being targeted instead of the rich."

In 2019, income tax cuts brought in by the populist government at the time benefitted the top 10%. It allowed them to spend the extra income on non-essentials and luxury goods, which did not lead to long term economic growth initiatives. "Now they are stuck with loans to pay and less income to spare. So, there is some frustration," said Damsinghe.

On the economic front however, the new tax regime, he believes may stop expenditure on unproductive spheres, and divert money towards more income generating avenues for the country.

When asked if the people were likely to pay taxes given the crisis the country is in, Damsinghe says it is hard to say. Many have noted that they would pay if the government was less corrupt or more transparent with the money. They also want the government to cut down on expenditure like on the military or the bloated public service. Damsinghe observed that both these factors have been happening. For example, expenditure on the military has dropped from 2% of GDP to 1.3%. The government is also taking steps to downsize the military.

Damsinghe also noted that there was a lack of understanding how taxes subsidized much of the lifestyle Sri Lankans have gotten used to. For example, a household earning around Rs 150,000/month (USD 412/month) would have their fuel and electricity costs subsidized by the government for up to Rs 10,000-20,000 (USD 27-55). Further, the government also offers free healthcare and education up to tertiary levels to all who cannot afford it.

"A lot of these benefits globally are accessible to only around 10% of the human population. But we in Sri Lanka assume that it is a given. We are comparing ourselves to a Western country but are not prepared to pay for the benefits they enjoy."

For the top earners in Sri Lanka, Damsinghe believes the crisis is now. The shortages of 2022 did not affect them as much as the tax increases would do now. But this reset in the economy is a must for the country to recover. "In the last 10-15 years, inequality was encouraged through the taxation policies so that the rich can have a lifestyle beyond what the country could afford."

He does not see much opposition arising from the private sector as they have little bargaining power with the government. Most salaried individuals will bear with the tax cuts and restructure their loans.

The greatest opposition he sees coming is from the professionals working in the government sectors. Port worker unions, electricity board engineers' unions and doctors' unions, have all threatened strikes in the wake of higher taxation. Thus the challenge before the government would be to convince them to get on board. Moramudali emphasized that the higher tax program is a must at present as Sri Lanka seeks IMF assistance and debt restructuring.

"These are determined by both external parties and they want assurances from Sri Lanka that the country will do what it can domestically to get out of the crisis. Thus they expect increase in taxes and without tax increases, the future with IMF and debt restructuring could be quite bleak."

It's not just Sri Lanka

Sri Lanka is not the only country to struggle with taxation policies. The IMF cites examples of five developing countries that have successfully managed to improve their tax collection activities through bolstering of trust among their citizens (Akitoby, 2022). The countries reviewed are Cambodia, Georgia, Guyana, Liberia, and Ukraine.

Georgia's 2003 Rose Revolution gave rise to a new government with a zero-tolerance policy on corruption. This, along with mass simplification of taxation policies served to bolster public trust in the system. Furthermore, electronic systems were installed to ease tax filing and collection, and barriers towards starting businesses were lowered.

Guyana and Liberia adopted simplified tax systems, and rationalised the number and value of tax exemptions granted to various sectors and industries, while ensuring that tax legislation is simpler and clearer.

Cambodia established large taxpayer offices, enabling easier payment of taxes, plus pilot testing new tax and customs regimes before their wider roll-out.

Ukraine bolstered its tax audit schemes, and introduced a targeted audit programme, as well as improving external controls of tax administration. The country also developed an anti-smuggling program at its Customs office.

Recommendations for better compliance

Given these examples, it is not impossible to build a good tax system. The government can start with what is possible - compliance.

Authorities need to address the 'corruption' issue with better enforcement of anti-corruption laws. Tsikas (Tsikas, 2017) shows that greater enforcement can increase trust and power of authorities, improving tax compliance.

Secondly, the government needs to encourage professional bodies to get their members to pay or open a tax file. Damsinghe points out that professionals such as lawyers and doctors often get away by not paying. But you can bring in laws such as connecting their license to practice to tax compliance. "It is a difficult thing to do but advantageous if done."

The government also needs to provide benefits to those who comply. Rathnasinghe pointed out that there was a 'taxpayer privilege scheme' previously but it was not implemented properly. "There needs to be a direct benefit to paying taxes," he said.

The Department of Inland Revenue also needs to be empowered to increase compliance and net in individuals that escape the system. Diverting more resources here, including technical education to officers would be beneficial in the long term.

Finally, the tax system has to be perceived to be equitable and fair across the board. "Finally we need to get that 1% that evades, ideally with a wealth tax. But this is often very hard to get passed," said Damsinghe.

In the meantime, education, and awareness campaigns to change public perception on taxes may slightly improve the situation, as people realize death and taxes are inevitable in life.

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