

BACKGROUND NOTE
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Restoring Efficient Tax Collection Methods:
Withholding Tax and Pay-As-You-Earn

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Members: Prof. Dileni Gunewardena, Prof. Mick Moore, Dr. Nishan de Mel, Prof. Shanta Devarajan.

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Restoring Efficient Tax Collection Methods: Withholding Tax and Pay-As-You-Earn

by Raj Prabu Rajakulendran and Sumini Siyambalapitiya under the guidance of the Verité Research Sri Lanka Economic Policy Group

Abstract:

The note estimates the additional revenue that can be collected from reinstating in Sri Lanka two methods of efficient tax collection that were discontinued in 2020. That is: the withholding tax (WHT) and the pay-as-you-earn (PAYE) methods of tax collection. Without any change in the current, reduced, tax rates, and a WHT of 10% the additional revenue that can be collected is estimated to be 0.70% of GDP (which is LKR 184.2 billion in 2023).

Introduction

Sri Lanka announced major tax policy changes in January 2020, which led to a reduction in the tax revenue from 11.6% of GDP in 2019 to 8.1% of GDP in 2020. This reduction in revenue subsequently led to a fiscal position that made debt servicing unsustainable, and to a credit rating downgrade, which locked Sri Lanka out of global financial markets. Presently, to recover a sustainable path of public finances for Sri Lanka it is necessary to institute measures to increase revenue.

There were two types of tax changes that were announced in January 2020. One that reduced the thresholds and rates for paying taxes, the second that changed the methods of collecting taxes. This policy note focuses on reversing the second type of change and restoring efficient tax collection methods that were dismantled in 2020.

Pay-As-You-Earn (PAYE): The PAYE tax collection method is one that makes it mandatory for most employers to deduct the tax due on the salary of employees and remit that tax directly to the government on a monthly basis. Without this method it is left to the employee to voluntarily initiate deduction on a monthly basis or to self-disclose and file income taxes returns annually, and to individually remit the tax payment.

Withholding Tax (WHT): The WHT tax collection method is one that makes it mandatory for banks and financial institutions paying interest on deposits or firms paying fees, rents etc. to deduct a percentage of the payment as WHT and remit that payment directly to the government. When/if the payee files taxes, they can set off the WHT as a pre-payment on their taxes.

PAYE tax collection method

In January 2020, the government abolished the mandatory Pay-As-You-Earn (PAYE) tax system and replaced it, some months later, with an optional Advanced Personal Income Tax (APIT) system. This meant that instead of the employer being obliged to deduct income taxes from employees and remit it to the government monthly, the onus fell upon each employee to create an individual tax file, disclose their income to the government and pay their respective dues. Due to the ease of the PAYE method, most employees in Sri Lanka did not need to file annual income tax returns, as their tax deductions were done in full through the PAYE method. Therefore, this change required most individual taxpayers that were not previously filing income tax returns to self-initiate the opening of income tax files and the filing of annual returns.

In addition to abolishing the PAYE system, the government also made two other significant changes in tax policy: (1) Increase the income threshold at which an individual was required to pay income taxes; and (2) reduce the rate at which each income category was taxed. The income threshold for tax payment eligibility was increased from employees with an annual income greater than 1,200,000 LKR to employees with an annual income greater than 3,000,000 LKR. The reduction in taxation rate for various income brackets is specified in Exhibit 1.

The combined effect of abolishing the PAYE tax system, increasing the eligible income threshold, and reducing the taxation rate, led to both an increase in the cost of tax administration and a reduction in tax payment compliance. The government's income tax collection in 2019 via PAYE was LKR 49,445 million. In 2021, the income tax collection via APIT was LKR 15,353 MN. This indicates a drop in income tax collection by 69% that has resulted from the combination of these three policy measures.

The Sri Lanka Economic Policy Group attempted to isolate and identify what share of the decrease in income tax revenue was due to the removal of the PAYE collection method and what share was due to the change in tax eligible income threshold and taxation rate. This was done by assuming the scenario where the PAYE method had not been abolished but the revisions to the tax eligible income threshold and income taxation rates had still taken place. Then, using Labour Force Survey (LFS) data from 2019, the "expected" tax revenue for each year was calculated. For the purpose of this exercise, it was assumed that the income distribution pattern of the employed population in Sri Lanka did not change between 2019 and 2021 and is similar between the formal and informal sector. The expected tax revenue calculations are presented in Exhibit 2.

Exhibit 1: Changes in Income Tax structure

Prior to abolishing PAYE		After abolishing PAYE	
Income bracket	Tax rate (%)	Income bracket	Tax rate (%)
0 – 1,200,000	0	0 – 3,000,000	0
1,200,000 – 1,800,000	4	3,000,000 – 6,000,000	6
1,800,000 – 2,400,000	8	6,000,000 – 9,000,000	12
2,400,000 – 3,000,000	12	> 9,000,000	18
3,000,000 – 3,600,000	16		
3,600,000 – 4,200,000	20		
> 4,200,000	24		

Exhibit 2: Estimation of the fall in PAYE collection due to rate and threshold changes

2019, Figures in LKR						
Income Bracket	Count	% Of population	Weighted average income	Individual PAYE contribution	Contribution to PAYE	
					Overall	%
0 – 1,200,000	7,993,138	96.97	319,212	-	-	0
1,200,000 – 1,800,000	116,436	1.42	1,323,429	4,937	574,861,187	1
1,800,000 – 2,400,000	43,349	0.53	1,899,541	31,963	1,385,583,896	2
2,400,000 – 3,000,000	29,511	0.36	2,445,851	77,502	2,287,151,113	4
3,000,000 – 3,600,000	12,123	0.15	3,090,995	158,559	1,922,149,758	3
3,600,000 – 4,200,000	13,968	0.17	3,663,647	252,729	3,530,167,223	6
> 4,200,000	32,168	0.39	8,629,896	1,423,175	45,780,324,661	83
Total	8,180,692	100.00			55,480,237,838	100

2021, Figures in LKR						
Income Bracket	Count	% Of population	Weighted average income	Individual PAYE contribution	Contribution to PAYE	
					Overall	%
0 – 3,000,000	8,122,434	99.29	349,768	-	-	0
3,000,000 – 6,000,000	37,119	0.45	3,801	48,067	1,784,204,490	8
6,000,000 – 9,000,000	11,934	0.15	6,609,694	253,163	3,021,296,153	14
> 9,000,000	9,205	0.11	15,890,882	1,780,359	16,387,922,869	77
Total	8,180,692	100.0			21,193,423,512	100

Based on this data, the expected PAYE tax revenue for 2019 and 2021 was calculated as follows. In each respective year, the weighted average income for each income bracket was calculated, which was then used to calculate the average amount of tax paid by income earners in each bracket based on their corresponding taxation rate. Finally, the average tax paid was multiplied by the number of income earners within a tax bracket to identify the contribution from each bracket to PAYE tax revenue. The total PAYE tax revenue for the year was the sum of the contribution from each bracket.

As presented in Exhibit 2, the expected PAYE tax revenue for 2019 and 2021 given the conditions stated above are, LKR 55,480,237,838 and LKR 21,193,423,512 respectively. There was a 62% decrease in tax revenue from 2019. This decrease can be solely attributed to the change in tax eligible income threshold and income taxation rates. Since the government actually incurred a 69% decrease in income tax revenue between 2019 and 2021, the discrepancy between the rates can be attributed to the removal of the PAYE system. That means, abolishing the PAYE collection method directly led to a 7% decrease in the government's income tax revenue.

Exhibit 4 depicts the revenue losses incurred since 2020 and the estimated revenue gains the government stands to make if PAYE is reinstated in the immediate future. Two scenarios are considered; (1) If PAYE is

reinstated at 2019 tax rates and minimum tax eligible income threshold; and (2) If PAYE is reinstated at 2020 tax rates and minimum tax eligible income threshold. Estimated revenue in scenario 1 is calculated by multiplying the previous year's collection with the corresponding nominal GDP growth rate for that year established in exhibit 3. Estimated revenue in scenario 2 is calculated by multiplying the estimated revenue from scenario 1 for that year by the percentage loss in income tax revenue attributed to abolishing PAYE. This percentage (which was calculated to be 7% in 2021), is assumed to be variable over time as a portion of income earners graduate into a higher income bracket from one year to the next, thereby contributing more to income tax and increasing overall income tax revenue had PAYE been in place. It is assumed that the resulting increase in income tax revenue for each year is half that of annual average inflation (i.e., if inflation is 6%, incomes on average, and thereby income tax revenue increases by 3%). Exhibit 3 presents the percentage of increase in income tax revenue due to income earners graduating into higher income brackets for each year and the subsequent impact on the share in the loss of income tax revenue due to PAYE removal.

Exhibit 3: Assumptions on GDP and the rising loss of revenue due to the removal of PAYE

	2019	2020	2021	2022	2023
Annual Average inflation ⁽¹⁾	4.3%	4.6%	6.0%	35.0%	15.0%
% Change in income tax revenue due to rate and threshold change			61.8%	51.0%	47.2%
% Change in income tax revenue due to PAYE removal			7.1%	18.0%	21.8%
GDP (LKR MN)	14,997,157	15,027,374	16,809,309	21,852,102	26,222,522
Nominal GDP growth (%) ⁽²⁾	4.94%	0.20%	11.86%	30.00%	20.00%

Note: (1) Average Annual Inflation is assumed to be 25% in 2022 and 15% in 2023; (2) Nominal GDP growth is assumed to be 30% in 2022 and 20% in 2023

Based on the assumptions and calculations from Exhibit 3, Exhibit 4 presents the revenues to government forgone since 2020 and the estimated increase in government revenue if PAYE is reinstated immediately.

Exhibit 4: Additional Revenue projections if PAYE is reinstated

Figures in LKR MN	2017	2018	2019	2020	2021	2022 (E)	2023 (E)
Actual PAYE collection before and after 2019 policy change	32,920	41,385	49,445	14,973	15,353	19,959	23,950
Estimated additional revenue collection if PAYE is reinstated at 2019 tax rates and threshold (Scenario 1) ⁽¹⁾					40,067	52,087	62,504
Estimated additional revenue collection if PAYE is reinstated at 2020 tax rates and threshold (Scenario 2)					3,962	12,943	18,837

Note: (1) Estimates were calculated based on GDP growth assumptions established in exhibit 3

Exhibit 4 shows that, if PAYE is reinstated at the 2019 tax rates and minimum tax eligible income threshold (scenario 1), government could increase tax revenue by LKR 26.0 billion within the June-December 2022 period. However, if PAYE is reinstated at the 2020 tax rates and minimum tax eligible income threshold (scenario 2), government could increase tax revenue by LKR 6.5 billion within the June-December 2022 period.

WHT tax collection method

The second policy change made with regards to tax collection mechanisms was the abolishing of the Withholding Tax (WHT) method of collecting taxes. This method was used to collect taxes at source, from interest earned on deposits, earnings from fees, rents and other forms of income. Prior to the policy change, banks, financial institutions and those making the payments were mandated to play the role of tax collector and automatically withhold income tax at 5% on the payment. This did not change the tax liability. When filing taxes, it was recorded as pre-payment. But it ensured that those evading formal income tax and under-reporting, were still effectively taxed on these forms of income, at least at a minimal level.

However, from January 2020, this method of collecting taxes was discontinued. A small portion of individuals who did not face WHT deductions, would still continue to file income taxes and pay the dues that were not deducted through WHT. But consequent to the policy change a significant portion would also escape the tax net, resulting in lower tax revenues to the government.

The policy change has gone down a path, not only of an increased cost of tax administration but also a reduction in tax payment compliance and collection. The government's WHT income tax collection in 2019 was LKR 50,351 million. After the policy change that removed WHT, the entirety of tax collected on interest, fees and other income for 2021 was only LKR 12,410 million (this being the full tax amount collected, at rates going up to 18%). This indicates that tax revenue, previously mandated/collected as WHT, reduced by about 75%

The note presents a calculation of the LKR and percentage increase in tax revenue that could be achieved if the pre-2020 WHT collection method is reintroduced. This is done in two parts, first by deriving the WHT related tax collected through the final income tax payments; and second, by estimating the WHT tax revenue that could have been collected if the collection method had not been discontinued.

Exhibit 5 provides the actual amount of income tax collected through WHT prior to 2020, and overall income tax collected on interest, fees and other income through individual disclosure post 2020. Considering that a large portion of payments subject to WHT are most relevant to high-income individuals (e.g. rents, winnings from betting/gambling, gems sold at an auction), it is assumed that the marginal income they receive is taxed at the highest rate within the current taxation structure (18%). To calculate the taxes that are collected despite the withdrawal of WHT, we take the total reported tax payment each year on income streams that would have been subject to WHT, and calculate the proportion of that, which would have been otherwise deductible due to the WHT collection, based on the assumption about the marginal tax rate on that income.

Exhibit 5: Loss of Revenue due to the removal of WHT

Figures in LKR MN		2017	2018	2019	2020	2021	2022 (E)	2023 (E)
Pre-2020 WHT collection & Post 2020 total taxes collected on previously WHT liable income streams ⁽¹⁾	On Interest Income	51,351	35,991	30,435	2,712	356	463	555
	On Fees and Other Income	1,983	10,422	19,915	7,277	12,055	15,671	18,805
	Total	53,334	46,414	50,351	9,989	12,410	16,134	19,360
Derivation of what would have been WHT, now collected through above total taxes	On Interest Income					99	128	154
	On Fees and Other Income					3,349	4,353	5,224
	Total					3,447	4,482	5,378

Note: (1) Estimations for WHT related tax collection in 2022 and 2023 were based on GDP growth assumptions set out in exhibit 3.

In order to estimate tax revenue that could have been collected if the WHT collection system had not been abolished, GDP growth assumptions were applied to WHT collection figures prior to the policy change. This is presented in Exhibit 6.

Thus, if WHT collection is reinstated at a 5% or 10% collection rate, Sri Lanka could potentially improve tax revenue pertaining to interest income, fees and other income by LKR 34.4 billion or 68.8 billion from June-December 2022.

Exhibit 6: Additional Revenue projections if WHT is reinstated

Figures in LKR MN		2017	2018	2019	2020	2021	2022 (E)	2023 (E)
Actual Withholding collection before and after policy	WHT on Interest Income	51,351	35,991	30,435	2,712	356	463	555
	WHT on Fees and Other Income	1,983	10,422	19,915	7,277	12,055	15,671	18,805
	Total	53,334	46,414	50,351	9,989	12,410	16,134	19,360
Additional Revenue if WHT was/is maintained at 5% ⁽¹⁾	WHT on Interest Income					34,014	44,218	53,061
	WHT on Fees and Other Income					18,973	24,665	29,598
	Total					52,987	68,883	82,660
Additional Revenue if WHT was/is maintained at 10% ⁽²⁾	WHT on Interest Income					68,028	88,436	106,123
	WHT on Fees and Other Income					37,947	49,331	59,197
	Total					105,974	137,767	165,320

Note: (1) Estimations for WHT related tax collection in 2021, 2022 and 2023 were based on GDP growth assumptions set out in exhibit 3; (2) Estimations for WHT at 10% is calculated as the double to WHT at 5%

Summary

The following policy options exist for increasing tax collecting, without making any changes in the current existing rates of taxation; but by simply re-instating methods that improve the efficiency of tax collection.

1. Reinstating PAYE at current tax rates and thresholds – increase in 2023: LKR 18.8 billion
2. Reinstating WHT at 5% on interest, fees & other income – increase in 2023: LKR 82.7 billion
3. Reinstating WHT at 10% on interest, fees & other income – increase in 2023: LKR 165.3 billion

Exhibit 7 shows that even on a simple minimalist estimation, without counting the impact of higher interest rates leading to higher WHT collection:

- With policy options 1 and 2, Sri Lanka can improve tax collection by LKR 40.9 billion from June to December 2022, and LKR 101.5 billion in 2023. That is a revenue increase of 0.4% of GDP in 2023.
- With policy options 1 and 3 Sri Lanka can improve tax collection by LKR 75.4 billion from June to December 2022, and LKR 184.2 billion in 2023. That is a revenue increase of 0.7% of GDP in 2023.

At a time when the government needs to increase revenue to GDP by 3-4% percent in the next two years, to improve debt sustainability dynamics, these simple policy options offer immediate and significant progress.

Exhibit 7: Summary of Revenue projections if collection mechanisms are reinstated

		2022 (E)	2023 (E)
Estimated additional revenue collection if PAYE is reinstated at 2019 tax rates and threshold ⁽¹⁾	LKR MN	52,087	62,504
	% Of GDP	0.24%	0.24%
Estimated additional revenue collection if PAYE is reinstated at 2020 tax rates and threshold ⁽¹⁾	LKR MN	12,943	18,837
	% Of GDP	0.06%	0.07%
Estimated additional revenue collection if withholding tax is reinstated on interest income and fees and other Income at 5% ⁽²⁾	LKR MN	68,883	82,660
	% Of GDP	0.32%	0.32%
Estimated additional revenue collection if withholding tax is reinstated on interest income and fees and other Income at 10% ⁽²⁾	LKR MN	137,767	165,320
	% Of GDP	0.63%	0.63%

Notes: (1) From Exhibit 4; (2) From Exhibit 7