Taxes are the major source of mobilizing internal resources of an economy. A compulsory financial charge or some other type of levy imposed upon the taxpayer by a governmental organization is identified as a tax. Taxation policies have been an important instrument for supplementing revenue in developing countries for which it is the main source of domestic income. The main purpose of imposing taxes can be identified as to raise resources to finance government expenditure which includes general consumption expenditure, expenditure on development-oriented services and expenditure on the provision of welfare services. Tax policies play an important role in attaining a proper allocation of resources, income distribution, and economic stability. The tax system further acts as one of the key determinants of macroeconomic indicators such as economic growth, inflation, public debt, and fiscal deficit. Out of the alternative ways of financing the budget deficit taxation is considered as the best source of financing budget deficits because of the economically harmful repercussions of other financing methods. Although money creation is popular in many developing countries as an easy method to finance deficits, it could result in hyperinflation situations. Similarly, borrowings from domestic and foreign sources to finance budget deficits could also result in debt problems and negative economic impacts. Therefore, increasing the revenue generated through taxation is extremely important to any economy including Sri Lanka.

Since independence, taxation serves as the major revenue generating source for the government while non-tax revenue accounts for a smaller proportion for total government revenue. The tax system of Sri Lanka comprises of two major categories of taxes as direct taxes and indirect taxes. Personal and corporate income taxes and Pay as You Earn (PAYE) tax are the major direct taxes while Value-Added Taxes (VAT), excise duties, Economic Service Charge (ESC), Nation Building Tax (NBT) and import duties are major indirect taxes contributing to tax revenue. Sri Lankan tax system has experienced many changes in the recent past. Introduction of Value Added Tax (VAT) in place of Business Turnover Tax (BTT) and Debits tax in 2002, Economics Service Charge in 2004, Social Responsibility Levy and Share Transaction Levy in 2005 and Nation Building Tax in 2009 are some significant changes that took place in Sri Lankan tax system in recent past. In Sri Lanka, contribution of indirect taxes to total tax revenue has always remained high above the contribution of direct tax revenue over the last few decades. Eighty percent of tax revenue is raised through indirect taxes whereas direct taxes only accounts for twenty percent of tax revenue. By 2018 excise duties and VAT have collectively contributed for 50 percent of total fiscal revenue while the major direct tax, income tax has contributed only by 16 percent.

Sri Lanka which is categorized as an upper-middle-income earning country by 2019 is facing several challenges in mobilizing and increasing tax revenue. One of the key issues on taxation in Sri Lanka is the lower tax ratio (Tax revenue as a percentage of GDP). Significance of agriculture sector in Sri Lankan economy is one of the key reasons for the lower tax ratio. Over the period contribution from agriculture sector to national output has been declining gradually. In 1977 agriculture sector contributed for 31 percent of GDP while in 2018 it declined to 7 percent. Even the contribution of agriculture sector to total output declined the share of employment in agriculture shows only a marginal decline over the period from 36 percent in 1977 to 25.5 percent in 2018. Moreover, the large informal sector of the country which comprises of large number of micro and small level establishments that share a smaller proportion of wages from national income. As a result, the economy is less capable of depending on direct taxes to generate revenue. Hence, the economy has to depend on indirect taxes.
Exemption of necessities from taxes, abolishment of important revenue sources like export duties and lower import duty earnings resulting from various trade agreements decrease the revenue from indirect taxes and thus affect the lower tax ratio. Further, the lower tax ratio is also a result of drawbacks in the tax system of the country. Tax exemptions and concessions, higher exemption threshold for income taxes, complexity in tax legislation and weaknesses in administration also adversely effect on tax revenue resulting a lower tax ratio.

Increasing the share of tax revenue in GDP in Sri Lanka remains as a critical challenge for Sri Lanka. As decline in tax ratio is associated with the decrease in indirect tax percentage in GDP increasing indirect taxes in short run is important to increase the tax ratio but in the long run policies must focused direct taxes to as the main revenue source. Simplifying the tax rates and the tax laws, broadening the tax bases, encouraging voluntary tax compliance, using modern technology to in tax collection and administration can be identified as some possibilities to improve the share of tax revenue in national income.

(References: Dr. K. Amirthahlingam - Importance and Issues of Taxation in Sri Lanka (2013), Dr. K. Amirthalingam - Indirect Taxation in Sri Lanka: The Development Challenge (2010), Annual Reports Central Bank of Sri Lanka (various years))