K. Amirthalingam (2010) Why is VAT Not a 'Money Machine' in Sri Lanka? Sri Lanka Economic Journal, 11(2),pp.124-140

Why is the VAT Not a 'Money Machine' in Sri Lanka?

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Abstract

Value Added Tax (VAT) has proved itself an effective form of taxation and its growth is unprecedented by any other concept in taxation in the world. As in most other developed and developing countries the push for fundamental tax reform has grown out of frustration over the inefficiency, inequity, and complexity of the existing tax system in Sri Lanka too. Though Sri Lanka introduced VAT with a view to generating greater revenue, the performance of the Sri Lankan VAT contrasts sharply with its reputation as a 'money machine'. The VAT may not be an ideal tax and money machine for Sri Lanka until the four circumstances-(a) small-scale agriculture is important, (b) retail trade is fragmented among very small sellers, (c) basic accounting is not widespread, and (d) efficient and impartial tax administration has not been achieved - disappear as a result of economic change or are resolved by the tax authority.

Introduction

It is argued that the VAT is simply too easy a way for a government to raise money - in other words, that the VAT would be a 'money machine' (Keen, 2007). Judged by the extent and speed of its spread around the world, and the revenue that it raises, the VAT would seem to have been a remarkable success (*Ibid*). The central claim made by advocates of the VAT is that it is a particularly efficient way of raising revenue (Keen and Lockwood, 2009). Some observers see that the VAT would in itself cause an unwelcome growth of government. This argument is most commonly raised in the United States where the fear is that the VAT actually does too good a job of raising tax revenue (Keen, 2007). However, this 'money machine' feature of the VAT should be seen as a potential strength of the tax particularly in developing countries, where enhancing tax revenues is a common element of growth and poverty reduction strategies.

[1] I am grateful for the constructive comments made by Prof. Amala de Silva

The central question that arises in Sri Lanka is that does the VAT function as a 'money machine'? The answer seems to be skeptical because the VAT revenue as a percentage of GDP has been only 3.9 per cent and the share of VAT revenue in the total tax revenue has been only 30.3 in 2010.[2] Therefore it is important to find the reasons for why the VAT is unable to raise sufficient revenue and unable to function as a so called 'money machine' in Sri Lanka. This study tends to find possible reasons for the lackluster performance of VAT and its failure in keeping its reputation of money machine. To do so, it is important to look at the VAT theory, international VAT experience and the Sri Lankan experience on the VAT. The following section discusses the VAT theory, and the next section examines international experience of the VAT. The penultimate section analyses the Sri Lankan VAT experience and the final section provides concluding remarks.

Value Added Tax: A Theoretical perspective

A VAT is a tax on the value that is added to goods and services by enterprises at each stage of the production and distribution process (Lent *et al*. 1973 and Shoup, 1988). After the first adoption in France in 1954[3], VAT has indeed proved itself an effective form of taxation and its growth is unprecedented by any other concept in taxation (Keen and Smith, 2006; Keen, 2007; Ebrill *et al*, 2002; Keen and Lockwood, 2009). "The history of taxation reveals no other tax that has swept the world in some thirty years, from theory to practice, and has carried along with it academics who were once dismissive and countries that once rejected it" (Tait, 1988). Moreover, the VAT has now become a central tool of tax policy in most countries, with the exception of the United States (Salanie, 2003; Keen and Lockwood, 2009). The extent and pace of the spread of the VAT around the world has been one of the most striking international tax developments in recent history (Shoup, 1988; Zee, 2006). In sum, "the VAT has become a fashionable tax in the world. While fashion may not be the best way to develop a tax system, it is, undoubtedly a powerful influence" (Tait, 1988).

"The value-added tax is viewed as the ideal tax – a business tax which does not reduce profit, a consumer tax which unseen by the consumer, a low rate tax with large yield, a tax with built-in self enforcement in collection, a tax which hardly falls on anyone…."(Musgrave, 1972). A VAT is a broad-based tax levied at multiple stages of production with –crucially - taxes on inputs credited against taxes on output (Bird and Gendron, 2006). That is, while sellers are required to charge the tax on all their sales, they can also claim a credit for taxes that they have been charged on their inputs. The advantage is that revenue is secured by being collected throughout the process of production (unlike a retail sales tax) but without distorting production decisions (as a turnover tax does).

2 Unless and otherwise mentioned, data used in this article is from the Annual Reports of the Central Bank of Sri Lanka

3 France imposed only a restricted VAT in 1954 (Shoup, 1955 and 1988). The comprehensive VAT first appeared in Brazil in 1967 (Shoup, 1988). Denmark was the first European country to adopt a VAT extending to the retail level (on July 3, 1967); it was followed by France and Germany (on January 1, 1968). See Lent *et al* (1973) for further details.

Moreover, as Jorgensen and Owens (1995) note that under a VAT system tax is levied at each stage and can be reclaimed in the next link in the trading chain until the final consumer is reached. Since all traders are treated on an equal footing in general, VAT has little or no distortionary effect. They further note that VAT is often considered more difficult to evade than taxes on wholesale or retail sales. The invoice credit system used in nearly all countries leaves a trail of invoices that may be followed by tax auditors. There is in general no common interest between VAT-registered sellers and purchasers to evade tax. Instead, the purchaser has no interest in bringing down the invoice price since he can reclaim a high volume of tax, although the seller has an interest in a low invoice price to reduce his own tax liability.

Unlike the cascade type of turnover taxes, VAT is capable of precisely identifying and rebating the tax on exports, so that they can leave a country free of tax, as well as of taxing imports on exactly the same footing as domestically produced commodities. As a result, the VAT achieves neutrality in the treatment of goods and services entering international trade. In addition, the VAT does not distort domestic production and distribution. Thus, under the VAT, it makes no difference how often a product is traded before it reaches the consumer or whether its value is added earlier rather than later in the production-distribution process. Furthermore, whether a product is manufactured with capital - or labour-intensive technology makes no difference to the tax liability under VAT. The VAT is also neutral with respect to the choice of whether to consume now or to save for future consumption. Although the VAT reduces the absolute return on saving (that is, the amount of future consumption), the tax does not reduce the net rate of return on saving. In contrast, an income tax does affect the net rate of return on saving, because both the amount saved and the interest earned on that amount, are subject to tax. Therefore, if it is assumed that saving increases as the rate of return on saving increases, a VAT is superior to an income tax in promoting saving for investment and hence in stimulating economic growth. In sum, VAT, in principle, is a highly product-neutral, factor-neutral and revenue-productive tax. Purely from a revenue point of view, VAT is probably the best tax ever invented (Cnossen, 1998).

Nonetheless, like in turnover taxes several implementation issues and problems can be observed in the case of VAT as well. Ahmad and Stern (1991) note that a major disadvantage of VAT is, that it involves everyone in the production and distribution chain, thus imposing a substantial administrative cost both on the authorities and the enterprises. Proper documentation and appropriate systems need to be adopted to ensure that VAT frauds are prevented, the scheme works efficiently and the refund process is on track. These measures will all lead to higher administrative cost. Since VAT necessitates registration of all business firms it is essential for all business firms to maintain clear comprehensive accounts which will be a time consuming and costly practice. Moreover, due to the fear of regressivity, countries use zero rating and/or exemption on essentials with a view to assisting the poor. However, through zero rating and exemption not only the poor but also the rich will benefit and importantly though the poor spend a larger proportion of their income on essential goods and services, in absolute terms the rich spend a larger amount of income on the same. As a result zero rating and exemption normally complicate the tax system and reduce tax revenue.

Moreover, in recent years VAT has come under a series of attacks. Keen (2007) identifies several important issues with regard to the VAT. One is that VAT does a bad job of taxing the informal sector which tends to be large mainly in developing countries.[4] Second one is that VAT fraud, targeting its refund provisions, has become a serious concern.[5] Another important problem with VAT is the issue of how to tax financial services. It is considered that imposing VAT on financial services (banking, insurance, *etc.)* and real estate is a challenging task. Financial services taxation is the key issue for the VAT. Financial services are generally not included in the tax base of a VAT in view of administrative difficulties and measurement problems resulting from conceptual confusion in identifying the financial intermediation services as well as a concern that taxation may discourage savings (Hockley,1991). No convincing conceptually correct and practical solution for capturing the bulk of financial services under the VAT has yet been developed (Bird and Gendron, 2006) because it is not easy to allocate the value added in the provision of financial services between buyer and seller in such a way as to ensure proper functioning of the crediting mechanism (Keen, 2007).[6] Furthermore, though countries such as Australia, Canada, France, Finland, Hungary, Austria, New Zealand, Netherlands, The United Kingdom, Japan, Korea, Mexico, Italy, Poland, turkey *etc* impose VAT on real estate (supply, leasing, and letting of land and buildings) on different scales, in practice, the appropriate and equitable treatment of real estate remains one of the most difficult areas in the VAT practice the "taxable event"—the recorded exchange of title—is readily visible, the true value of the transaction usually is not.

However, up to date no major tax has been found to be positively good or without fault. A "least bad" tax must be considered as the "best available" tax in the real world. A value-added tax appears to be the least bad and hence the best available tax. (Smith, 1970)

Value Added Tax: International Experience

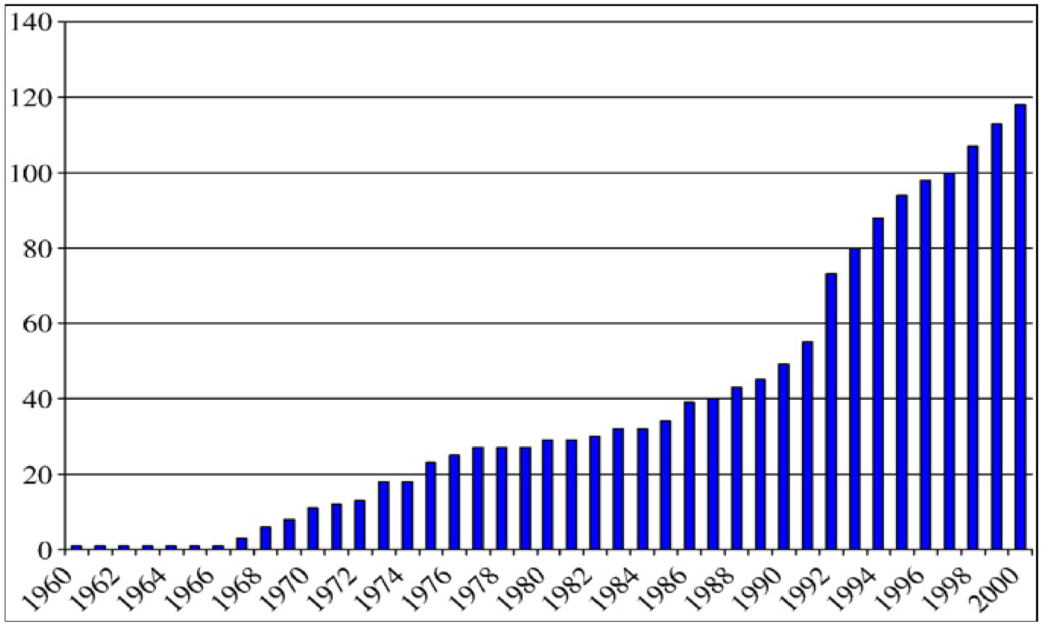
Fifty years ago the value-added tax (VAT) was rarely heard of outside of France but now it is found in over 136 countries, where it commonly raises 20 per cent or more of all tax revenue (Ebrill, *et al*, 2002 and Keen and Lockwood, 2009).

Figure 1: The number of countries with a VAT.

[4] Schneider (2002) as quoted by Keen (2007) estimates the informal economy in developing countries to be on average 41 per cent of gross national income. Developing countries are advised by international institutions to broaden the tax base instead of increasing existing taxes. However broadening the tax base of a consumption tax may be welfare reducing in the presence of informality (Piggott and Whalley, 2001).

[5] VAT fraud is common even in developed countries. For example, the European Commission reports that losses from fraud have amounted to 10% of net VAT receipts in some member states, and the German Federal Audit Court has put losses there in the region of 11 per cent of VAT revenue in 2003. Austria is reported as putting total losses from VAT fraud at about 4.4 per cent of total VAT receipts (Keen and Smith, 2006).

[6] Zee (2006) provides a thorough account of the difficulties that arise in bringing the financial sector into the VAT.



Source: Keen, M. and Lockwood, B., (2009).

As noted earlier, France is the first country which implemented the VAT, and this was in 1954. Subsequently well accepted conjectured efficiency and administrative advantages of the VAT have led to it being introduced or replacing other taxes on production and sales, often a general sales or turnover tax, in many countries (Ebrill *et al,* 2002). Therefore, it is noteworthy to examine the experience of France and some other selected countries in regard to the VAT. France introduced only a restricted version of the VAT at the beginning because retailers were not included in the VAT system (Shoup, 1955). However, the VAT avoided the cascading features of a turnover tax by giving firms credit for taxes included in the cost of goods purchased from other firms. Since documentation must be provided in order to obtain the credit, the VAT required extensive record keeping. In France, there was considerable resistance to its implementation, especially from smaller firms. It took another fifteen years before the French VAT became a comprehensive tax that included producers, wholesalers and retailers (Barlow and Snyder, 1994).

Most countries with a Value Added tax followed the "French Model" whose key features are a consumption base, tax credits based on invoices and a destination principle (Agha and Haughton, 1996). A consumption base tax will not discourage growth by reducing the stock of capital and with consumption base tax, the ratio of consumption later to consumption now is left unchanged. Therefore consumption based VAT will not affect saving and investment. (Shoup, 1988). Credit-method VATs are a successful mainstay of fiscal systems in over 130 countries around the world including every OECD country besides the United States (Grinberg, 2006). Under tax credit methods, the VAT does contain an element of self-enforcement. A discrepancy between the two firms' tax records rings a warning bell: one of them must be cheating, or at least have incorrect records. This will help tax officials to capture tax evaders (Shoup, 1988). According to the destination principle, goods are taxed in the jurisdiction where they are to be used. Under this principle, all VAT jurisdictions tax imports and free exports (*Ibid*). This principle helps exporters to maintain their competitiveness in the world market and at the same time help domestic producers to compete with imported goods.

However, it should be noted that when taxation technologies, developed and perfected within the socio-economic context of industrial countries, are transferred to a developing country, they are likely to fail or at least work poorly because the conditions are so different (Barlow and Snyder, 1994). According to Shoup (1988) the VAT is not ideal for all developing countries where (a) foreign trade plays a minor role; (b) small-scale agriculture is important;(c) retail trade is fragmented among very small sellers; (d) vertical integration of producer, manufacturer, wholesaler, and retailer is unlikely to be induced by a turnover tax; (e) discrimination against investment goods is not considered harmful; (f) basic accounting is not widespread, and (g) efficient and impartial tax administration has not been achieved.

Value Added Tax: The Sri Lankan Experience

Tax system development in the world is a result of varying experiences and shortcomings faced by different countries in the implementation of alternative tax systems, that have led to reforms and fine tuning of tax systems as countries strive to increase their tax revenue and achieve greater efficiency and equity through taxation. Sri Lanka too has shifted from one tax system to another tax system in the past. According to theory, an optimal tax should be efficient, politically feasible, administratively practicable, and produce sufficient revenue with minimum of economic distortions. It is true that in Sri Lanka as in most other developed and developing countries that the push for fundamental tax reform has grown out of frustration over the inefficiency, inequity, and complexity of the existing tax system. Sri Lanka has shifted from Business Turnover Tax(BTT) to Goods and Services Tax(GST) and then from GST to VAT in the past.

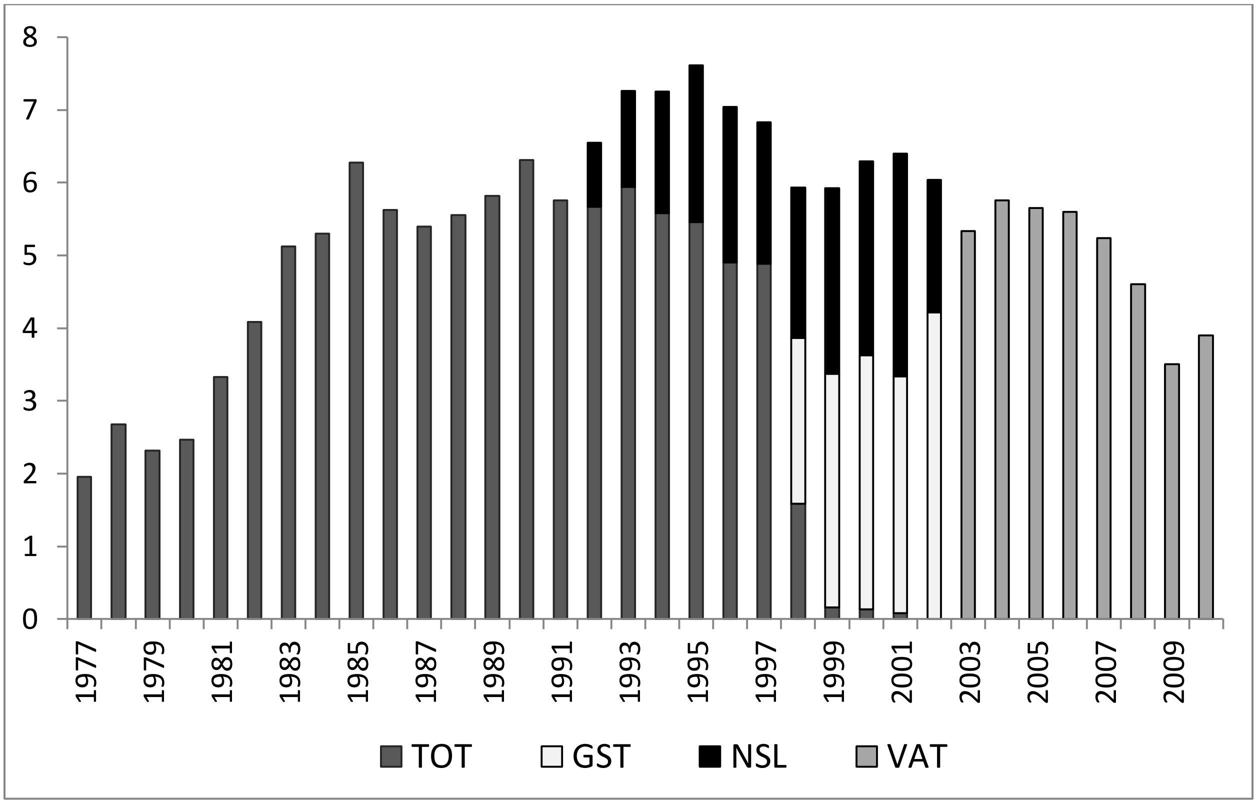
Though the turnover tax is considered to be administratively simple, numerous shortcomings of this tax system existed. Among the criticisms leveled at this tax system were the cascading effect; the difficulty of distinguishing between final sales intermediate input sales; taxation of investment goods; encouraging of vertical integration by firms; vulnerable to evasion and avoidance; difficulty of exempting exports; and the difficulty to evaluate the growth and distributional impacts of such a tax system. As a result of these shortcomings, turnover tax was labeled an inferior tax over time with more demerits than merits. Therefore, like most other countries Sri Lanka also abandoned turnover tax and switched to Goods and Services Tax (GST)

Although GST was expected to generate more revenue, its revenue performance was not satisfactory. After the introduction of the GST, tax/GDP ratio declined to 14.5 per cent in 1998 from 17.8 per cent in 1995, 17.0 per cent in 1996 and 16 per cent in 1997. This was the lowest recorded tax/GDP ratio since 1950. The vast exemptions afforded in the GST system had narrowed the tax base and significantly eroded the revenue generating capacity of the tax.

In view of the weaknesses of the GST, Sri Lanka introduced value added tax with effect from August 2002. It was expected that the VAT would bring in a larger number of enterprises, businessmen, producers and consumers between production and consumption chains and thereby doing its job as a ‘money machine’ to increase the tax revenue of Sri Lanka. Moreover, since

VAT is based on the value addition rather than total turnover, it was believed by the tax officials and policy makers that VAT would help to raise tax revenue without a cascading effect.[7]

Figure 2: Revenue from BTT/TT, GST, NSL and VAT (As a percentage of GDP).



Source: Central Bank of Sri Lanka (Various Annual Reports)

However, the revenue performance of the VAT has not been satisfactory as compared to turnover tax. The Sri Lankan experience gives us a different outlook which contradicts the theory. Particularly, the performance of the Sri Lankan VAT contrasts sharply with its reputation as a 'money machine'. On the other hand, it seems that the turnover tax system performed relatively well as far as revenue generation is concerned. Figure 2 clearly shows the differences in revenue performance of turnover tax, GST and VAT during the period 1977-2010. This figure clearly demonstrates that there was an upward trend of revenue collection under turnover taxes and that revenue collection even exceeded 6 per cent of GDP in some years particularly in 1985 and in 1990. However, after the introduction of the GST tax revenue as a percentage of GDP declined sharply. Initial difficulties and delays in the registration process which is essential for a value added tax (GST is also a value added type tax) contributed much to this decline. However, even though all registered persons and firms were absorbed automatically into VAT there were not significant improvements in terms of revenue generation. Therefore even after the

7 Waidyasekera, Former Commissioner of Inland Revenue, Secretary of 1990 Tax Commission and a Tax Consultant. Personal communication on 06.08.2009

introduction of VAT, Sri Lanka could not experience the much needed revenue boost and revenue did not reach 6 per cent of GDP, which was achieved under turnover tax in 1985 and in 1990, in any year during the period 2003-2010.

Efficiency and Productivity of VAT in Sri Lanka

Since VAT plays a pivotal role in the entire indirect tax system, it is important to examine the efficiency and productivity of VAT. VAT efficiency (sometimes called 'C-efficiency') and productivity are the two indicators used to measure the collection efficiency of VAT in many countries. The efficiency is the ratio of the VAT revenue to aggregate consumption, divided by the standard VAT rate. The productivity index is the ratio of VAT revenue to GDP, divided by the standard VAT rate. The closer these ratios are to zero (one), the lower (higher) the collection efficiency of the VAT (Bird and Gendron, 2006; Aizenman and Jinjarak, 2008; Ebrill *et al*., 2002 and Correia, 1999). The VAT could be the most productive source of revenue for developing countries. To achieve this objective, its efficiency and productivity must be high.

Table 1: Efficiency and Productivity of VAT in Sri Lanka

Year	Efficiency	Productivity	VAT as a % of GDP
2003	0.36	0.27	5.3
2004	0.52	0.38	5.8
2005	0.52	0.38	5.7
2006	0.55	0.37	5.6
2007	0.52	0.35	5.2
2008	0.44	0.31	4.6
2009	0.46	0.30	3.5
2010	0.50	0.33	3.9

Source: Calculated based on the data and VAT rates provided in the various annual reports of Central Bank of Sri Lanka and publications with regard to Value Added Tax Act and subsequent amendments of VAT

According to Table 1, efficiency in Sri Lanka does not show a clear trend: it increased from 0.40 in 2003 to 0.61 in 2004 but after 2004 there has been significant decline till 2008 and then a slight improvement in 2009 and in 2010. The efficiency of VAT in the world varies from country to county. For example, it is very high in some countries (Jamaica: 0.93 and Canada: 0.67) and very low in others (Brazil: 0.16 and Argentina: 0.27) (Bird and Gendron, 2006).

VAT collection efficiency can be improved through resources being spent on enforcement, and by increasing the effectiveness of monitoring, collecting and processing information. Theory suggests that the enforceability of taxes is impacted by political economy considerations – greater polarization and political instability would tend to reduce the efficiency of tax collection, reducing the resources devoted to tax enforcement. In addition, collection is impacted by structural factors that affect the ease of tax evasion, like the urbanization level, the share of agriculture in GDP and trade openness (measured as the ratio of imports plus exports to GDP). Empirical studies on several countries (Ansari,1982; Gupta,2007; Mahdavi, 2008) show that both urbanization and trade openness are significantly and positively related to tax collection efficiency but in contrast the share of agriculture in GDP will be negatively correlated to tax collection efficiency. So with the prevailing peaceful situation in the country, it is necessary to support industrialization and trade liberalization and channel increased resources to tax administration, to ensure efficient monitoring, and better usage of modern information technology (MIT) to enhance VAT collection efficiency in the coming years (Amirthalingam,2010 and forthcoming) .

The productivity of VAT is not only relatively low, but it has been declining during the period 2004 – 2009 but there is a slight improvement in 2010 (Table 1). This figure presents the percentage of GDP that each percentage point of the standard VAT rate collects. Therefore, for example, we can conclude that Sri Lanka has collected just 3.9 per cent of GDP in revenue from VAT in 2010 [VAT productivity (0.33) multiplied by standard VAT rate (12 per cent in 2010]. The revenue productivity of the VAT in the world is as high as 0.70 (for New Zealand) and as low as less than 0.20 for some countries. Within Latin America the range in productivity varies from around 0.20 in Haiti, Mexico and Venezuela to about 0.50 for Chile and Ecuador (Bird and Gendron, 2006). To improve the level of revenue productivity of the VAT, total revenue from VAT as a percentage of GDP should be increased. To achieve this goal, government can take many measures including; i) more taxation on the growing economic sectors (e.g. - mobile phones), ii) heavier taxation on income-elastic items (e.g. - vehicles, petroleum products, iii) bringing informal economic activities into tax net, and iv) heavier taxation on price-inelastic items (e.g. - alcoholic beverages and tobacco products).

However, presently VAT has clearly not achieved its greater revenue-generating objective: this may be due to several reasons such as its complicated structure, administrative weaknesses, political influence, tax avoidance and evasion, complexities in the tax law, lack of application of modern information technology, etc. VAT, in fact, has performed worse than the previously adopted Business Turnover Tax in terms of revenue generation.

It is noteworthy to mention that the VAT has not functioned as a promising tax system in Sri Lankan because there are many differences between Sri Lanka and the rest of the world with regard to the VAT implementation. Like France, Sri Lanka did not introduce a restricted version of VAT at the beginning and did not take many years to introduce a comprehensive tax system. Instead, Sri Lanka introduced a comprehensive VAT within a one year period. A common element among countries that have successfully adopted the VAT has been a meticulously planned campaign of taxpayer education, which has lasted generally two years or longer before initiating the tax. For example, Korea prepared a film about the VAT which was shown in every movie theater (Barlow, Snyder, 1994). It is interesting to note that Australia introduced VAT in the year 2000 after 25 years of consumption tax reform effort. Even China took fifteen years to introduce a comprehensive VAT. In 1979, China started an experiment with VAT in machinery and agricultural machinery and equipment industries, where the problem of multiple-taxation was serious. In 1983, the experiment was extended to five industries (Lin, 2008). However, major tax reforms only occurred in 1994. The Chinese authority has gradually replaced the turnover taxes on goods and services by the VAT. This was introduced product by product in order to even out the possible revenue loss if a one-off migration to the VAT was undertaken (Toh and Lin, 2005).

However, Sri Lanka introduced VAT within a short period of time on a broad base goods and services.[8] Though Sri Lanka introduced VAT on 1st July 2002, even the empowering law was not in place at that time (Gunasingam, 2002). It is important to know that even now the Department of Inland Revenue is not fully equipped to tackle bogus claims for reduction of input VAT (Gunasingam, 2009). This evidence clearly shows that the VAT was hurriedly introduced in Sri Lanka without the development of proper infrastructure. Further, the total number of VAT files for registered VAT payers as at 31.12.2009 was 31,694 as compared to 45,498 for turnover taxpayers as at 31.12.1997 (Department of Inland Revenue, 1997 and 2009). Though the VAT was introduced in 2002, up to date not even 50 per cent of possible tax payers have been included in tax net. As a composite effect, the country is unable to raise tax revenue to the maximum extent possible and therefore the VAT is unable to function as a 'money machine' for Sri Lanka.

In fact, as noted earlier, Shoup (1988) argues that the VAT is not ideal for all developing countries under certain circumstances. Among them four circumstances - (a) small-scale agriculture is important, (b) retail trade is fragmented among very small sellers, (c) basic accounting is not widespread, and (d) efficient and impartial tax administration has not been achieved- are applicable to Sri Lanka. The VAT may not be an ideal tax and money machine for Sri Lanka until these circumstances disappear as a result of economic change or are resolved by the tax authority.

Conclusion

In line with the tax theory and the experience of other countries, Sri Lanka too has shifted from one tax system to another tax system in the past. However, the revenue performance of the VAT has not been satisfactory as compared to turnover taxes. The Sri Lankan experience gives us a different outlook which contradicts the theory. Particularly, the performance of the Sri Lankan VAT contrasts sharply with its reputation as a "money machine" because presently VAT has clearly not achieved its greater revenue-generating objective due to several reasons such as its complicated structure, administrative weaknesses, political influence, tax avoidance and evasion, complexities in the tax law, lack of application of modern information technology, etc. There are other reasons for the VAT to be not functioning as a promising tax system in Sri Lankan because there are many differences between Sri Lanka and the rest of the world with regard to the VAT implementation. Sri Lanka did not introduce a restricted version of VAT at the beginning and did not take many years to introduce a comprehensive tax system. Instead, Sri Lanka introduced a comprehensive VAT within a one year period. A common element among countries that have successfully adopted the VAT has been a meticulously planned campaign of taxpayer education, which has lasted generally two years or longer before initiating the tax. However, VAT was hurriedly introduced in Sri Lanka without the development of proper infrastructure. Further, there are several circumstances- such as small-scale agriculture is important, retail trade is fragmented among very small sellers, basic accounting is not widespread, and efficient and impartial tax administration has not been achieved- impediment for the successful functioning of

8 Gunasingam (2009) criticizes the move of Sri Lanka to introduce the VAT and argues that the country gained little to show for its effort in introducing VAT, except to have pleased the economists of the IMF.

the VAT in Sri Lanka. The VAT may not be an ideal tax and money machine for Sri Lanka until these circumstances disappear as a result of economic change or are resolved by the tax authority.

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