Rubber Resilience Under Pressure: The Strategic Fallout of SVAT Abolition and the Uncertain Promise of the Risk-Based Refund System

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Abstract

The recent abolition of the Suspended Value Added Tax (SVAT) scheme in Sri Lanka, replaced by a proposed risk-based refund system, has generated significant concern among rubber products manufacturers and exporters. This paper critically examines the potential operational, financial, and strategic implications of this policy shift for the rubber manufacturing value chain. Key issues include cash flow constraints, administrative inefficiencies, unequal advantages for large BOI enterprises, barriers for SMEs and new entrants, and a potential decline in sectoral competitiveness and investment attractiveness. Drawing on Strategic Choice Theory and Institutional Theory, the article analyses how these reforms influence firms' decision-making under uncertainty and highlights the structural impact on local primary producers, deemed exporters, and overall value chain dynamics. The findings underscore the need for policy coherence, institutional readiness, and digital innovation to sustain the competitiveness of Sri Lanka's rubber export sector. This concept paper proposes two potential pathways: reinstating a revised SVAT mechanism with enhanced digital monitoring or implementing a fully integrated, real-time digital VAT refund system. Both approaches aim to reconcile fiscal integrity with liquidity protection, while reinforcing the economic rationale that VAT, as a consumption-based tax, should be levied on final goods rather than intermediate production materials.

Introduction

The abolition of the Suspended Value Added Tax (SVAT) system, effective from October 1, 2025, has drawn significant opposition from exporters across Sri Lanka, particularly from the rubber products manufacturing sector. As one of the country's key export-oriented industries, rubber manufacturers and exporters actively urged the government to reconsider this decision, highlighting the potential operational and financial disruptions it could cause. Their concerns stem from the sector's vital role in sustaining foreign exchange earnings and industrial employment during a period of economic instability and recovery. Despite these appeals, the government proceeded with the repeal of the SVAT scheme and introduced a so-called "risk-based refund system" in its place. Tax regime of a country plays a vital role in shaping its national economic landscapes (Baiardi et al., 2019; Dabla-Norris et al., 2017)overall tax revenue and tax composition. We find that there is some evidence of a negative and statistically significant relationship between tax revenue and economic growth, while there are no robust relationships between revenue-neutral tax shifts and economic growth. The results hold in different samples of OECD countries for different time periods. We also identify different relationships between the short run and long run. Overall, our results cast doubts on the potential growth enhancing effects of a shift from direct to indirect taxation, with paramount consequences on tax policy.”,”container-title”:”International Tax and Public Finance”,”DOI”:”10.1007/s10797-018-9494-3”,”ISSN”:”0927-5940, 1573-6970”,”issue”:”2”,”journalAbbreviation”:”Int Tax Public Finance”,”language”:”en”,”note”:”number: 2”,”page”:”282-316”,”source”:”DOI.org (Crossref. In economies where growth and sustainability are heavily dependent on exports, tax policy can either infuse or constrain business performance (Chen et al., 2006). This article critically examines the potential adverse effects of this policy shift on the rubber products manufacturing and export supply chain, assesses its broader implications for the national economy, and explores possible strategies that industry stakeholders can adopt to mitigate the emerging challenges.

The VAT and its Sri Lankan Context

The Value Added Tax (VAT) has become the most widely adopted form of indirect taxation globally, with more than 175 countries implementing some variant by 2025 (Brockmeyer et al., 2024). Its widespread acceptance arises from its efficiency in revenue mobilization and its neutrality in economic decision-making (Acosta-Ormaechea & Morozumi, 2021; Ebrill et. al., 2001; Keen & Lockwood, 2010)little is yet known about whether the way tax revenue is raised matters for growth. This paper examines whether, in the context of OECD countries, a revenue-neutral increase in the value-added tax (VAT. Fundamentally, VAT is designed as a consumption-based tax borne by the final consumer, although it is collected in stages along the production and distribution value chain. Each participant in the chain—whether a raw material supplier, manufacturer, or distributor—charges VAT on sales (output tax) and deducts the VAT paid on purchases (input tax). The mechanism ensures that tax is levied only on the incremental "value added" at each stage, thereby avoiding cascading effects and promoting fiscal transparency.

For manufacturing sectors such as rubber and rubber-based products, this structure directly interacts with the industrial value chain. Raw natural rubber, compounding chemicals, fillers, and additives are purchased with VAT applied, while finished products destined for export are zero-rated. Under normal circumstances, exporters claim refunds for the input VAT they have paid, since exports themselves are not subject to output VAT. Consequently, the smooth operation of the VAT refund system is critical to maintaining liquidity within the production cycle, ensuring uninterrupted cash flow for raw material procurement, energy costs, and logistics operations that underpin export competitiveness (Baiardi et al., 2019; Chen et al., 2006) overall tax revenue and tax composition. We find that there is some evidence of a negative and statistically significant relationship between tax revenue and economic growth, while there are no robust relationships between revenue-neutral tax shifts and economic growth. The results hold in different samples of OECD countries for different time periods. We also identify different relationships between the short run and long run. Overall, our results cast doubts on the potential growth enhancing effects of a shift from direct to indirect taxation, with paramount consequences on tax policy.","container-title":"International Tax and Public Finance","DOI":"10.1007/s10797-018-9494-3","ISSN":"0927-5940, 1573-6970","issue":"2","journal Abbreviation":"Int Tax Public Finance","language":"en", "note":"number: 2","page":"282-316","source":"DOI.org (Crossref.

Sri Lanka introduced VAT through the Value Added Tax Act No. 14 of 2002, making it the central mechanism of indirect taxation. While exports were zero-rated to enhance international competitiveness, exporters were entitled to reclaim input VAT on locally purchased inputs and utilities. For the rubber manufacturing sector—heavily dependent on domestic raw rubber, compounding agents, and high energy inputs—these refunds were essential to sustain production liquidity and price stability. However, over time, systemic inefficiencies in refund administration became entrenched. The 2006 VAT refund fraud, involving more than LKR 3.5 billion, led to the imposition of restrictive verification and control measures that delayed even legitimate claims (Sirimanna, 2010; Sooriyagoda, 2023). As noted by the IMF, 2024, the administrative mindset shifted "from how to pay VAT refunds to how not to pay VAT refunds," reflecting deep institutional dysfunction.

For rubber exporters—particularly those supplying time-sensitive international buyers in Europe, North America and East Asia—refund delays and bureaucratic uncertainty have disrupted production planning, tightened working capital cycles, and eroded competitiveness. This experience mirrors that of other developing economies where weak refund administration hampers export performance and undermines trust in fiscal governance (Iwasaki et al., 2022; Jenkins & Kuo, 2000; Keen, 2008).

From VAT to SVAT: Strategic Policy Response

To address chronic inefficiencies in the VAT refund mechanism, the Government of Sri Lanka introduced the Simplified Value Added Tax (SVAT) scheme in 2011, later formalized through the Value Added Tax (Amendment) Act No. 11 of 2015 (CCC, 2023; IMF, 2024). The SVAT system replaced the refund-based mechanism with a credit-offset arrangement, removing exporters from the conventional VAT cycle. Transactions between registered suppliers (RIS) and purchasers (RIP) were conducted without monetary VAT payments; instead, VAT credit vouchers were issued, maintaining accounting integrity while eliminating the need for refund claims (IRD, 2025).

For the rubber and rubber products export sector the SVAT system became a pivotal policy instrument. It reduced cash-flow friction, stabilized working capital, and restored predictability in financial management. The scheme also lowered compliance costs and diminished opportunities for refund-related corruption, thereby improving trust between exporters and the Inland Revenue Department (IMF, 2024). Consequently, the

SVAT mechanism became widely accepted as a facilitator of competitiveness and business confidence. Industry stakeholders consistently credited it with enhancing liquidity and sustaining production continuity in an industry highly sensitive to global price volatility and raw material cost fluctuations (CCC, 2023; Munasinghe, 2025; NCE, 2025b).

The Abolition of SVAT: Strategic Uncertainty for Export Manufacturers

Sri Lanka's economic collapse in 2021 led to the adoption of an International Monetary Fund (IMF)-supported fiscal stabilization program. Under this program, the government has committed to several structural and tax policy reforms, including the abolition of the SVAT scheme by November 2025 (IMF, 2024, 2024). The Inland Revenue Department (IRD) justifies the move as an effort to minimize preferential tax treatment and align the tax framework with international norms (IMF, 2025).

However, this impending policy shift has generated substantial concern within the export-oriented rubber sector. Industry bodies, including the National Chamber of Exporters (NCE) and SLAMERP, warn that abolishing SVAT could reintroduce the same refund inefficiencies that once crippled exporters' liquidity and competitiveness (CCC, 2023; Ceylon Today, 2025; NCE, 2025a). Rubber exporters fear prolonged refund cycles, increased administrative burden, and a reemergence of informal costs—all of which directly undermine cash flow management and operational predictability. Given the high working-capital intensity of rubber manufacturing, where firms must finance raw material procurement, energy costs, and export logistics well before invoice realization, even short refund delays can have cascading effects across the supply chain. This reversion to a more cumbersome VAT regime risks destabilizing the export performance of one of Sri Lanka's leading foreign exchange–earning sectors.

The proposed reform thus raises critical strategic questions: Is the policy driven by sound economic reasoning aligned with national export priorities, or primarily by compliance with external fiscal conditions? (ADB, 2024; IMF, 2024, 2025). More importantly, how will the removal of SVAT reshape the strategic decision-making environment of firms operating within Sri Lanka's globally integrated rubber manufacturing sector?

Critical Considerations in Abolishing the SVAT and Introducing the Risk-Based Refund System

The decision to abolish Sri Lanka's Suspended Value Added Tax (SVAT) scheme and replace it with a risk-based refund mechanism has generated serious concern among exporters—particularly within the rubber manufacturing sector, a key contributor to national export earnings. While the reform aims to strengthen tax transparency and compliance, its structural and practical implications raise several critical considerations that question its readiness and appropriateness for an export-dependent economy.

1. Cash Flow Constraints for Exporters

Under the previous SVAT system, exporters were exempt from paying VAT on domestic purchases, allowing uninterrupted liquidity within production cycles. The abolition of SVAT now requires manufacturers to pay the 18% VAT upfront and await refunds after verification. Given that approximately 70–75% of inputs in rubber product manufacturing are locally sourced, this creates a substantial working capital lock-in. Even with the Inland Revenue Department (IRD)'s commitment to a 45-day refund period, administrative realities suggest that refunds may take 60–75 days in practice (Bontempo, 2022; IMF, 2024)the authors analyze how institutional governance and business environment affect countries' competitiveness, their relative importance and what are the implications for Brazil. The authors have collected data from 131 countries related to the institutional governance, business environment and competitiveness of these countries. For the analysis of the mentioned influences, the technique of partial least squares structural equations modeling is used.","container-title":"RAUSP Management Journal","DOI":"10.1108/RAUSP-11-2020-0253","ISSN":"2531-0488","issue":"1","journalAbbreviation":"RAUSP","language":"en","license":"https://www.emerald.com/insight/site-policies","note":"number: 1","page":"49-64","source":"DOI.org (Crossref. Such delays not only constrain liquidity but also affect procurement, wage payments, and export delivery schedules—undermining competitiveness in time-sensitive global markets (Chen et al., 2006; Keen & Lockwood, 2010)the output of final goods for export by the domestic firm increases, while the output of the foreign competitor decreases; (ii.

2. Unproven Nature of the Risk-Based Refund System

The proposed "risk-based" mechanism remains untested within the Sri Lankan tax administration context. Its success depends on the IRD's institutional capacity, digital infrastructure, and transparency—areas that have historically suffered from inefficiency and weak accountability (IMF, 2025). Without a proven track record, exporters fear the system could replicate previous refund bottlenecks under a new label, amplifying uncertainty rather than resolving it.

3. Institutional Inefficiencies within the IRD

Long-standing administrative weaknesses, including inconsistent refund procedures, limited automation, and a shortage of trained officers, have eroded business confidence in the IRD's ability to deliver timely refunds. Past scandals—such as the 2006 VAT refund fraud amounting to over LKR 3.5 billion—led to an overly cautious institutional culture where legitimate refunds were often delayed or questioned (IMF, 2024). As noted by Jenkins and Kuo (2000) and Keen (2008), such administrative fragility is a common challenge in developing countries, where VAT reforms often outpace institutional readiness.

4. Unequal Advantage for BOI Enterprises and Market Distortion

BOI-registered enterprises retain the privilege of importing raw materials VAT-free, creating a competitive imbalance against non-BOI exporters who rely on local inputs subject to VAT. This policy divergence discourages the use of domestically produced raw rubber and latex, potentially depressing prices for local producers and weakening the upstream supply chain. As a result, the reform risks favoring large-scale import-oriented firms at the expense of small and medium-sized manufacturers who form the backbone of Sri Lanka's rubber export base (Vidyaratne, 2022).

5. Barriers for SMEs and New Entrants

The new system introduces significant entry barriers for smaller and emerging exporters. Firms may need to operate for extended periods—up to a year—before qualifying for risk-based refunds. Even after qualification, refund delays of several months remain possible. This reduces sectoral inclusivity and discourages entrepreneurship, particularly among SMEs seeking to transition from domestic to export markets (Ngwaba & Azizi, 2019). Over time, the policy may consolidate export capacity within a few large players, undermining the diversity and resilience of the export sector.

6. Decline in Sectoral Attractiveness and Investment Climate

Policy inconsistency and administrative uncertainty generate a negative signal for investors, both local and foreign. For a sector that relies heavily on continuous reinvestment in technology, quality, and sustainability, such unpredictability can deter capital inflows. The erosion of refund reliability also reduces Sri Lanka's attractiveness relative to competitor countries that maintain stable, export-friendly tax regimes (Baiardi et al., 2019; *Rodrik1991*, n.d.)overall tax revenue and tax composition. We find that there is some evidence of a negative and statistically significant relationship between tax revenue and economic growth, while there are no robust relationships between revenue-neutral tax shifts and economic growth. The results hold in different samples of OECD countries for different time periods. We also identify different relationships between the short run and long run. Overall, our results cast doubts on the potential growth enhancing effects of a shift from direct to indirect taxation, with paramount consequences on tax policy.","container-title":"International Tax and Public Finance","DOI":"10.1007/s10797-018-9494-3","ISSN":"0927-5940, 1573-6970","issue":" 2","journalAbbreviation":"Int Tax Public Finance" ,"language":"en","note":"number: 2","page":"282-316","source":"DOI.org (Crossref.)

7. Policy Contradiction with the Government's Digital Economy Vision

The government's broader economic narrative promotes a cashless, digitally integrated economy. However, the SVAT abolition paradoxically increases cash flow dependency by requiring physical payment and refund cycles. This inconsistency undermines the credibility of the digital transformation agenda, reflecting a lack of policy coherence between fiscal modernization and digitalization objectives (IMF, 2024; Rajagopalan et al., 1993).

Implications for the rubber value chain

The abolition of the Suspended Value Added Tax (SVAT) scheme reverberates across multiple nodes of Sri Lanka's rubber product manufacturing value chain, extending far beyond the immediate cash flow concerns of exporters. The implications are structural, affecting input sourcing behavior, domestic primary production, and the competitive equilibrium between large and small-scale enterprises.

One key consideration is on the natural rubber and latex producers of Sri Lanka, specially the small holders which makes the major part of the local rubber production. Larger exporters, particularly Board of Investment (BOI) enterprises, can continue to import raw materials such as natural rubber and latex without paying local VAT, benefiting from deferred or zero-rated import procedures. While this reduces operational costs for larger firms, it creates a dual challenge:

1. Local primary producers of rubber may face reduced demand for domestically sourced raw materials as large export manufactures are attracted to source rubber internationally, leading to potential price declines and loss of market share.

2. SMEs and smaller exporters that rely on local inputs are placed at a competitive disadvantage, as they remain subject to VAT and the associated cash flow pressures, while also navigating the complexities of the new risk-based refund system.

The reform also disrupts the position of “deemed exporters,” i.e., manufacturing enterprises supplying intermediate goods to export-oriented firms. Under the SVAT framework, these suppliers benefited from suspended VAT on transactions involving export-linked production. The abolition of SVAT removes this liquidity support, exposing deemed exporters to increased operational costs and administrative burdens. Many of these enterprises were established precisely because SVAT allowed them to compete on price parity with imported components; the withdrawal of this mechanism thus raises concerns about firm survival and sectoral consolidation.

From a policy rationale standpoint, the imposition of VAT on primary industrial materials such as raw rubber and latex is economically inefficient. VAT is a consumption-based tax—intended to be borne by the final consumer of finished goods rather than intermediate producers (OECD, 2021). Taxing raw materials within the domestic value chain merely inflates production costs and disrupts competitiveness without generating corresponding fiscal revenue.

Discussion

Where to Next

Despite strong opposition from the export community, the Government of Sri Lanka proceeded with the abolition of the Suspended Value Added Tax (SVAT) scheme, replacing it with a proposed risk-based VAT refund system. While the stated objective of this policy transition is to enhance fiscal transparency and minimize fraud, the decision has triggered significant debate regarding its practicality, institutional readiness, and long-term impact on export-oriented industries such as the rubber products manufacturing sector.

From a Strategic Choice Theory (SCT) perspective, policy decisions of this magnitude compel firms to recalibrate their strategic and financial choices in an environment of uncertainty (Child, 1997; *Child1972*, n.d.; Rajagopalan et al., 1993). Exporters now face increased cash flow pressures due to the upfront payment of VAT, coupled with refund delays that can extend up to 60–75 days. In an industry where input costs constitute nearly 75% of total production expenses, such liquidity constraints directly undermine competitiveness. Institutional Theory (IT), on the other hand, highlights the state’s intent to restore legitimacy and compliance through formalization of tax administration (DiMaggio & Powell, 2000; Oliver, 1991). However, when institutional capacity—such as digital infrastructure and administrative efficiency—remains weak, reforms risk producing unintended operational burdens rather than governance improvements (Rodrik, 1991; Ngwaba & Azizi, 2019).

Given this context, two potential strategic policy options emerge for restoring stability and trust in the tax system.

A. Reinstating a Revised SVAT Mechanism

One approach is to reinstate the SVAT framework with targeted administrative reforms that address previous weaknesses. Historically, tax administrators raised concerns that Registered Identified Purchasers (RIPs) could issue unlimited credit vouchers to Registered Identified Suppliers (RISs), creating audit and verification challenges (Sooriyagoda, 2023; IMF, 2024). This issue could be rectified through the introduction of transactional limits—for example, assigning a maximum SVAT entitlement to each RIP based on their historical and projected export volumes, local input ratios, and verified production capacities. Moreover, a real-time transaction matching system between RIPs and RISs would enhance transparency and prevent fraudulent credits. Drawing inspiration from digital monitoring systems successfully deployed during Sri Lanka’s fuel distribution crisis (e.g., QR-based rationing), or from global best practices in electronic invoicing and automated reconciliation (OECD, 2022), the SVAT system could evolve into a modern, data-driven credit management platform. This would preserve the liquidity advantage of SVAT for exporters while ensuring accountability and traceability for tax authorities.

B. Developing a Digitally Integrated VAT Refund Framework

The second alternative is to strengthen the new risk-based refund system through full-scale digital integration. A robust online portal that matches input-output VAT claims in real time would address Inland Revenue Department (IRD) concerns about unverifiable transactions. Integration with national payment gateways and banking systems would enable automated validation and refund authorization, reducing human discretion and administrative delay (World Bank, 2023). Requiring that all VAT-related transactions be executed through traceable digital payment systems—similar to the QR-enabled financial tracking used in other sectors—would align with the Government's policy of promoting a cashless, digital economy (CBSL, 2024). Such systems would not only improve refund integrity but also enhance tax visibility across the broader fiscal ecosystem.

Ultimately, both policy paths converge toward the same strategic end: creating a real-time, digitally verified VAT system that balances liquidity protection for exporters with institutional integrity for revenue administrators. Evidence from other developing economies suggests that such e-VAT systems significantly reduce fraud risk and improve refund timeliness when adequately resourced and monitored (Bontempo, 2022; Iwasaki et al., 2022).

Conclusion

The abolition of the Suspended Value Added Tax (SVAT) scheme in Sri Lanka, coupled with the introduction of a risk-based refund system, represents a significant policy shift with profound implications for the rubber products manufacturing and export sector. While the reform aims to enhance tax transparency and compliance, it has generated widespread concern regarding its practical implementation, institutional readiness, and potential impact on export competitiveness. The sector faces immediate challenges, including increased cash flow constraints, extended refund periods, and heightened administrative burdens, which disproportionately affect small and medium-sized enterprises and "deemed exporters."

Moreover, the policy disrupts the domestic rubber value chain, creating potential market distortions that favour large BOI enterprises over smaller, locally integrated firms. From a strategic perspective, the reform introduces uncertainty into firms' decision-making environments, undermining operational predictability and sectoral resilience. Both Strategic Choice Theory and Institutional Theory highlight that, while the state aims to improve legitimacy and compliance, inadequate institutional capacity and insufficient digital infrastructure risk producing unintended negative outcomes.

Looking forward, a digitally integrated, real-time VAT refund system—whether through a revised SVAT framework or enhanced risk-based mechanisms—offers the most viable pathway to balance liquidity protection for exporters with institutional integrity for revenue administrators. Crucially, the underlying rationale for VAT as a consumption-based tax reinforces that levying it on intermediate production inputs, such as raw rubber and latex, contradicts principles of fiscal neutrality and economic efficiency. Policymakers should therefore consider mechanisms that maintain liquidity for exporters while safeguarding public revenue, ensuring that Sri Lanka's rubber sector remains competitive, inclusive, and strategically aligned with the national economic agenda.

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