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**CAPABILITY OF THE INTRODUCTION OF VALUE
ADDED TAX TO ELIMINATE CASCADING EFFECT
OF PRICE LEVEL ON GOODS AND SERVICES
IN SRI LANKA**



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ABSTRACT

This research study investigates the Goods and services Tax (GST) and Value added Tax (VAT) effects of price levels on Goods and services using the data of Colombo consumer's price index, (CCPI) period from 1996:1 to 2003:4. It focuses to explore the magnitude of the tax effect and duration of such effects to the price levels of goods and services after introduction of new tax system of goods and services tax from 1st April, 1998 and Value Added Tax on 1st August, 2002.

In addition to above, the study investigate general price level changes in other consumer price indexes and whole sale price indexes during the past 8 year periods including the years 1998 and 2002.

This study uses the 32 (thirty two) quarters of Colombo consumer's price index including the quarters of 1998:2 and 2002:3 in order to measure the magnitude and the duration of the effects. Further percentage changes of indirect tax revenue of the past twelve year's analysis to prove the hypothesis that introduction GST/VAT reduces the revenue on the periods' on which the taxes are introduced. The null hypothesis which states that introduction of Value Added Tax mechanism has not been enabled to avoid the cascading effect resulting reduction in general price levels is rejected at -1.3%, -0.4% and -0.5% level of significance only in the food, clothing and miscellaneous group respectively. But all item and fuel and light category indicates 2.2% and 1.2% respectively contradicting to the hypothesis in the quarter in which GST was introduced. However, null hypothesis was rejected at -0.55% level of significance in all items group in CCPI on the quarter in which VAT was introduced.

This study results indicate that the introduction VAT on 1st August 2002, mitigates the cascading effect on price level of goods and services in all items, clothing, food and miscellaneous groups except fuel and light group. Study results are food -1.5% clothing -0.08% and miscellaneous -0.6%. But fuel and light indicate plus value of 0.2% and it is not line with theory that VAT mechanism mitigates cascading effect.

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Main objective of this study is to measure the magnitude of the effect and measure the duration of effect. This study results further indicates that duration of effect limits to the periods/quarters in which taxes are introduced. These results are consistent with other empirical studies results of Valadkhani (2005) and Valadkahni and Layton (2004) on same type of investigation on price level of Australia

The data of 32 quarters of CCPI is analyzed using the ARIMA intervention model and percentage of other indexes compare with previous periods. Finally it can be concluded that VAT mechanism mitigates the cascading effect on price level of goods and services and suggests VAT mechanism capable to eliminate cascading effect after introduction on GST and VAT.