SHADOW TOURISM: HOW OFFSHORE OPERATIONS THREATEN SRI LANKA'S GROWTH AND FAIR COMPETITION

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"Sri Lanka stands at a turning point in tourism. The country's beauty, culture, and location give it clear strength, and with the right steps, tourism can drive growth. But growth must protect national interests while allowing fair foreign input. As highlighted above, some foreign-run businesses seek to dodge taxes and rules, creating a threat to fair competition. If ignored, this will spread, cutting state revenue, harming local firms, and weakening trust in the law. Over time, the whole economy will pay the price. "

Sri Lanka welcomed 2.1 million international visitors in 2024, and was named the "Most Desirable Island" by Wanderlust Reader Travel Awards in 2024. Beaches, wildlife, and cultural sites continue to draw millions each year. Yet a growing problem of a shadow economy lurks behind this thriving sector, which brought earnings valued at USD 3.169 billion in 2024. This article seeks to analyse this shadow economy invented via foreign-run tourism businesses which prima facie are operating legitimately are channelling vast sums offshore, avoiding taxes and laws. Whether the local authorities are watching from the sidelines or whether such operations are conducted unbeknownst to the government remains an open question, which is out of the scope of this article

This hidden system does more than shrink government revenues. While the local operator struggles to compete which distorts competition within the sector. Workers often face low wages and poor protections undermining the rather rigid labour standards set forth by the laws of Sri Lanka. Furthermore, communities miss out on the wider benefits that tourism should provide. The scale of the problem is growing, putting fiscal stability and sector management at risk, thereby threatening the very roots of Sri Lanka's economic recovery.

Sri Lanka's tourism has unmatched potential. Its beaches, wildlife, and heritage attract visitors worldwide, and there is no denying that foreign

Courtesy: Little Wander Book

entrepreneurs have greatly assisted in expanding its reach. Therefore, while solving this problem requires understanding how these businesses operate and the effects on the economy, coordinated action by the government of Sri Lanka is essential to protect tourism, public revenue, and Sri Lanka's economic independence.

The Mechanics of a Modern Tax Avoidance

As highlighted, at first glance, tourism in Sri Lanka's coastal towns are thriving, with barely any remnants left of the tsunami tidal waves crashing into these coastal towns two decades ago. Every inch of the coast, one may perhaps observe hotels, boutique cafés, fusion restaurants, yoga retreats, surf camps and dive schools.

Sri Lanka's tourism industry is growing quickly, but many businesses operate without proper registration, creating regulatory challenges. In Ella, for example, only 153 of about 600 tourism service providers are registered, leaving nearly 450 unregistered hotels and restaurants. In Arugam Bay, 232 tourism businesses exist, but only around 80 are officially registered. This large unregistered segment makes enforcement difficult, weakens compliance with Sri Lanka Tourism Development Authority (SLTDA) rules, and contributes to overcrowding and poor management at popular destinations. Despite legal requirements and fines under Act No. 38 of 2005, the lack of a strong monitoring system allows unregistered operators to continue functioning largely unchecked, putting pressure on authorities and registered businesses (Mohan, 2025). However, when registered businesses are considered, the picture shifts to a the situation reveals a concerning pattern of tax avoidance and an exploitation of regulatory vacuum.


Courtesy: Stoked For Travel

This article examines how entrepreneurs operate tourist hotels and villas, offering accommodation and package deals that draw a steady stream of foreign visitors. A week-long stay, generally priced between $500 to $1000, can generate significant revenue, with businesses formally registered, licensed, and structured to meet ownership regulations. As such, the local company holds all needed permits and follows ownership rules, at least on paper, but the money moves entirely outside Sri Lanka.

Guests usually discover these establishments through social media platforms or international travel/booking sites and complete their payments via processors such as Stripe or PayPal. To the visitor, it looks like a standard transaction for a Sri Lankan service, but actually, they would be paying a British business, or such foreign parent company, that owes no taxes to Sri Lanka. Seemingly, most of these businesses have mastered the art of appearing fully compliant and appealing to the tourist.

Nevertheless, based on first hand experience, it can be further highlighted that some establishments make no effort in even maintaining such a facade of legitimacy, instead requesting their customers to transfer the payments directly to banks outside of Sri Lanka.

Consequently, much of this income never reaches Sri Lanka's banking system or tax mechanisms. Furthermore, the hotel or villa company will attempt to cover wages and other overheads through the sale of various items, generally lunch, liquor and other necessities, within the hotel itself. Finally, if the operating costs cannot still be covered only would such necessary amounts be transferred to a Sri Lankan bank account via informal transfers. Thus, profits remain offshore, beyond the reach of local authorities.
Additionally, it is worth noting that the business partnership or the company created with 51% local ownership is fictional and only 'on paper'. Typically, the local partner or shareholder is asked to sign an undated document agreeing to transfer their shares or partnership rights. This document can then be used by the foreign partner or shareholder at any time if they decide the local partner is not compliant or controllable.

This practice is not an outright crime. It is a clever and calculated use of legal gaps by the business entity. However, this practice is spreading quickly. Accordingly, across the southern and eastern coasts, foreign-run operations now make up a growing shadow economy within the tourism sector of Sri Lanka. The result is lost foreign exchange and unfair pressure on local businesses that follow the law.

The Scale and Trajectory of the Problem

This shadow economy has grown fast in recent years, especially after Sri Lanka's economic crisis and need for foreign tourists. Estimates suggest foreign-run businesses now control 25-30% of hotels in popular spots like Arugam Bay, Mirissa, and Weligama, rising above 40% in premium surf and wellness tourism. The cumulative financial impact is quite significant (Ranasinghe, 2024).

Growth has sped up since 2022, as tourism bounced back from the Easter Sunday attacks, COVID-19, and the economic crisis. Comparatively low property prices, the negligible competition, and weak enforcement mechanisms have attracted foreign entrepreneurs who are setting up operations rapidly.

A conservative estimate would put the cost to Sri Lanka at $200–400 million a year in lost foreign income and taxes. When considered under the backdrop of the total tourism revenue of about $3.2 billion in 2024, if the laws and regulations had captured the aforementioned estimates into the official revenue mechanism, such funds could support government activities, public programmes, infrastructure development, and social services during a critical rebuilding period.

Tax avoidance at this scale goes far beyond immediate revenue losses, seriously weakening Sri Lanka's development prospects and economic independence. The country's post-crisis recovery relies heavily on rebuilding investor confidence, restoring fiscal stability, and ensuring that economic growth improves living standards on the macrolevel. However, when large parts of the economy operate outside the formally established system, these goals become much harder to reach.

Primarily the competitive distortion created by foreign-run businesses operating outside Sri Lanka's regulatory framework has fundamentally altered the tourism landscape, creating an unlevel playing field that systematically disadvantages legitimate local operators. This competitive disadvantage extends beyond simple price competition to encompass access to capital, marketing reach, and operational flexibility (Wijedasa, 2024). Local entrepreneurs seeking expansion often struggle to access credit from banks that require extensive documentation, collateral, and proof of tax compliance, while foreign operators can leverage overseas financing or reinvest offshore profits without scrutiny. Yet, the foreign-operated establishments using offshore payment processing can maintain the facade of legal compliance through nominee arrangements, allowing them to undercut legitimate operators by substantial margins and capture premium market segments. It is also worth noting that foreign-run businesses typically benefit from superior digital marketing capabilities, international network connections, and access to global booking platforms that local operators cannot match, creating a compound disadvantage that goes far beyond tax avoidance.

The Tourism Development Authority's recent directive requiring tourism businesses to hold valid licenses before accessing credit from finance companies (EconomyNext, 2018) represents an attempt to level the playing field, but this measure primarily affects law-abiding operators who were already seeking formal financing channels.

Additionally, the human development impacts are also troubling. Employment in foreign-run tourism businesses often offers lower wages and fewer benefits than in compliant operations, as the drive to cut local costs reduces labor standards. Workers in these businesses frequently lack formal employment contracts, social security coverage, or legal protections, producing unstable jobs that weaken broader labor market development. Furthermore, the reputational risks from widespread regulatory non-compliance in tourism could also have lasting effects on Sri Lanka's international image. Marketing highlights the country's natural beauty, cultural heritage, and hospitality, but reports of tax evasion, illegal businesses, and regulatory failures create negative narratives that could discourage both tourists and legitimate investors.

The Governance Framework and its Vulnerabilities

Sri Lanka's governance framework for foreign investment has long aimed to protect national interests while encouraging useful foreign participation. When the legal landscape is considered, the Land (Restrictions on Alienation) Act, No. 38 of 2014, stops foreigners from owning land directly, and the Companies Act, No. 07 of 2007, requires majority local ownership in most service sectors. The Foreign Exchange Act, No. 12 of 2017, demands repatriation of export earnings, and tax laws set clear obligations for businesses in Sri Lanka.

But the digital economy and global finance create enforcement problems these laws and policies perhaps didn't foresee. The main issue is that transactions between foreign parties are hard to monitor, even though the services are provided in Sri Lanka.

Nominee shareholding often meets ownership rules on paper but gives no real local control or benefit. For clarity, nominee shareholding refers to an arrangement where shares are registered in the name of a nominee, who holds them on behalf of the beneficial owner without exercising genuine control or deriving real benefit (Solo, 2025). Local partners usually receive $1,000–3,000 a year for their "majority" shares, without influence on operations, profits, or strategy. These arrangements follow the law's letter while ignoring its intent. It is likely that following the latest amendment to the Companies Act through Act, No. 12 of 2025, will provide some protection against nominee shareholding in theory. A more detailed discussion of this matter will follow in a subsequent section.

It is also worth noting that basic transfer pricing rules, meant to stop profit shifting, trigger only to transactions exceeding LKR 100 million. More detailed documentation requirements, such as Local File preparation, come into effect at the LKR 200 million threshold as per Gazette Notification No. 2217/7 dated March 2, 2021. Most tourism businesses fall below these levels.

Compounding the issue, the outdated regulations of the SLTDA induce foreign tourist businesses to circumvent the laws and exploit existing loopholes in regulation. Based on first-hand accounts from both foreign and local tourism operators, dealing with SLTDA officials and other regulators is often unnecessarily complex, with outdated rules being the main source of difficulty. For instance, the rules of the SLTDA can be readily applied to standardised hotels, which are generally operated by local and foreign conglomerates. However, the SLTDA has not established a regulatory framework governing boutique hotels, inclusive of room sizes, sanitation standards, fire safety compliance, etc. Due to the regulatory vacuum created accordingly, and within the broader context of corruption in Sri Lanka, SLTDA officers frequently grant approvals in exchange for bribes. Refusing to comply with such demands often results in licence applications being denied.

Overview of International Patterns and the Comparative Context

Sri Lanka is not alone in facing problems with foreign-run businesses exploiting legal gaps. Similar issues have propped up in developing countries which are attractive tourist destinations but contain weak enforcement mechanisms. This reflects global trends in tax avoidance and the limits of national tax systems in a digital, connected world.

Thailand has seen the same issues in Phuket, Koh Samui, and Chiang Mai, where foreigners use nominee arrangements and offshore payments. While the country maintains a 49% foreign ownership cap in services (G Claeys, 2025), the government has further sought to tighten disclosure rules, raised penalties, created tourism-focused enforcement units and even streamlined pathways for legitimate FDI (Crosio & Sritas, 2025). Though these reforms have helped, they have not been able to fully solve the problem.

Indonesia faces similar challenges in Bali. Under Indonesian law, nominee arrangements are illegal since it is considered to be a violation of the Investment Law, No. 25 of 2007, and are thus deemed null and void. Serious consequences may entail including loss of property without legal recourse (Dewata Law Firm, 2025). Though nominee agreements still remain a

Courtesy: Ayu In The Wild

practice in Indonesia, special task forces in Bali are actively auditing and enforcing permit compliance and business legality, focusing on illegal foreign-owned villas and permit violations, however loopholes remain (The Jakarta Post, 2025).

The OECD's Base Erosion and Profit Shifting (BEPS) initiative has recognized these challenges as global phenomena requiring coordinated international responses. The BEPS initiative targets the tax planning strategies multinational enterprises use to exploit gaps and mismatches in tax rules and shift profits to low- or no-tax jurisdictions (OECD, 2025). The framework stipulates key actions such as requiring transfer pricing documentation, country-by-country reporting, anti-hybrid rules, and enhanced dispute resolution to prevent profit shifting and ensure a fair allocation of taxing rights between countries (Peters, 2015). Indonesia and Thailand are currently in the process of acceding to the OECD, while Sri Lanka has not taken such steps. While seeking membership with the OECD is a policy decision for Sri Lanka to make, provided the resource constraints and technical complexity of modern international tax avoidance schemes, Sri Lanka can partner with OECD member country agencies, the World Bank, IMF, and regional development banks for policy advice, training, and institutional capacity building to modernize its tax administration, deepen financial transparency, and manage risks related to foreign business tax evasion.

Policy Solutions and Enforcement Mechanisms

Addressing the challenges posed by foreign-run businesses requires a broad approach that strengthens regulations, improves enforcement, and creates proper incentives for voluntary compliance. Solutions must balance the genuine need for foreign investment and expertise with making sure all businesses contribute fairly to Sri Lanka's development and operate within legal boundaries.

The most urgent priority is closing the payment processing loophole that allows revenue to be diverted offshore. Sri Lanka could require all tourism-licensed businesses to process payments through local banks or approved processors with real-time reporting to authorities. While this may inconvenience some international customers, similar systems work in other countries without significantly reducing tourism.

Beneficial ownership disclosure rules need major strengthening, including regular updates, public access to ownership information, and strict penalties for false reporting. The nominee shareholder system could be reformed by requiring local shareholders to actively participate in operations, including minimum roles in management, profit-sharing, and oversight. Perhaps, the Companies (Amendment) Act, No. 12 of 2025, is a step in the right direction in this regard, whereby companies are now mandated to disclose their beneficial owners and to further maintain a register of beneficial owners (Sunday Times, 2025). However, researchers have highlighted that this amendment introducing beneficial registers has a fatal flaw due to the unavailability of a verification methodology and limitations to public access (Handy, 2025).

Better coordination between agencies could greatly improve enforcement. The National Tourism Policy of Sri Lanka has identified that the "main impediments to the development of the tourism sector in Sri Lanka are the ineffective coordination between organizations and inefficient governance" (Ministry of Tourism and Lands, Sri Lanka, 2024). Identifying this the current government policy, as reflected in its presidential manifesto of 2024, highlights that "poor coordination among national and provincial tourism authorities and related ministries resulted in policy inconsistency and a lack of a common vision and objectives among all stakeholders" (National Peoples' Power, 2024). To remedy this situation, the current government has projected the establishment of the Tourism Policy Formulation Council (TPFC), with the intention of synergising the functions of various ministries, authorities, private sector, and donors involved in tourism, including aspects of taxation, land-use regulation, licensing, and law enforcement. Functioning as a 'think tank', it envisages to create standardized guidelines, collective decision-making, and systematic progress tracking, which are currently fragmented across agencies. However, the establishment of this entity has not taken place.

Strengthening the role of the Inland Revenue Department is another crucial step in resolving this situation. While local travel agencies and hotels are subjected to Value Added Tax (VAT), Corporate Income Tax (CIT), and Tourism Development Levies, foreign entities as discussed above are not subjected to these taxations. While the Inland Revenue Act must be amended in this regard, expanding tax information exchange agreements (TIEAs), particularly with countries where foreign tourism operators are based or have financial registrations (Casey, 2025), would further enable sharing of financial data and better traceability of offshore income linked to Sri Lankan-source tourism services.

Sri Lanka should also seek to introduce sector-specific reporting requirements mandating tourism businesses to disclose offshore financial arrangements, related-party transactions, and beneficial ownership. This would align with OECD-inspired transparency and anti-BEPS (Base Erosion and Profit Shifting) standards without necessarily requiring OECD membership. Strict penalties for false reporting, failure to disclose, and ongoing regulatory violations, paired with incentives such as reduced penalties or phased regularization opportunities for voluntary compliance, would create a regulatory environment that encourages transparency and tax compliance. These measures would complement existing instruments like the Tourist VAT

Refund Scheme, which aims at encouraging formal retail and tax-compliant tourist spending (Lanka News Web, 2025).

Furthermore, as noted above, many tourism workers in Sri Lanka work informally, without contracts, social security, or legal protection. Bringing them into the formal system needs a clear, multi-part approach using existing labor, social security, and tourism laws. The SLTDA, Ministry of Labour, and agencies including the Employees' Provident Fund and Employees' Trust Fund must run registration drives, inspections, and outreach targeting informal operators. The SLTDA's Enforcement Unit can inspect both registered and unregistered businesses, with fines for labor law or licensing breaches. Stronger penalties for undocumented workers and proof of social contributions for license renewals will push formalization. Training for small tourism businesses can improve labor standards and include workers in social protections.

One of the most disturbing practices in many foreign-run companies is the local 51% partner, often a nominee, signing a blank transfer document. This document is later used to take shares or control away from them, sidelining minority rights and legal protections.


Courtesy: Reuters

It creates a false image of local ownership while allowing foreign control and profit repatriation.

It is advisable that Sri Lanka enforce corporate governance rules requiring all share transfer documents to be dated, notarized, and recorded with the Registrar of Companies when signed. Measures protecting minority shareholders, mandating disclosures, and requiring independent legal advice for share transfers are necessary. Coercion or fraud using blank documents should be criminalized. Minority partners must have clear ways to challenge illegal transfers. Strengthening registry transparency and ensuring disclosure of beneficial owners would improve accountability and reduce nominee abuses.

Furthermore, the outdated regulatory framework of the SLTDA must be remedied through the introduction of clear and modernised standards that address gaps in oversight, particularly for boutique hotels and other emerging tourism models. Such reforms would not only reduce opportunities for corruption but also create a more equitable business environment and strengthen the long-term sustainability of Sri Lanka's tourism sector.

The Path Forward: Balancing Growth and Governance

Sri Lanka stands at a turning point in tourism. The country's beauty, culture, and location give it clear strength, and with the right steps, tourism can drive growth. But growth must protect national interests while allowing fair foreign input. As highlighted above, some foreign-run businesses seek to dodge taxes and rules, creating a threat to fair competition. If ignored, this will spread, cutting state revenue, harming local firms, and weakening trust in the law. Over time, the whole economy will pay the price.

The goal is not to block foreign investors, since they bring skills, networks, and funds that raise standards. Their work can expand Sri Lanka's reach in world markets, but only if they follow the same rules, pay taxes, and compete fairly.

Small fixes will not work. Skilled operators will always find loopholes, so broad reform is the sole path. Laws must close gaps, enforcement must improve, and incentives must guide good practice. Reform also needs strong will and clear action, with steady support from leaders and enough resources for agencies. Rules must apply to all in the same way.

Tourism is vital for Sri Lanka's economic recovery, therefore action cannot wait, but reforms must also keep the country open and welcoming to visitors. Global moves on tax honesty and open ownership give Sri Lanka tested tools to adapt, making it easier to shape a fair and lasting tourism model.

Conclusion

Sri Lanka's tourism can be a strong driver of growth, but the shadow economy puts this at risk. Foreign-run businesses use gaps in the law to move money offshore, leaving little behind for the country. This cuts tax income, weakens fair competition, and keeps local workers and communities from sharing the full gains of tourism.

The problem is not foreign investors themselves but the manner in which some individuals circumvent the law of the land and respective regulations. Legitimate local operators face unfair disadvantages, while the state loses resources needed for infrastructure, services, and development. Without effective enforcement, these practices continue to expand, weakening confidence in both the sector and the rule of law.

Addressing this problem requires clear rules, consistent enforcement, and stronger financial transparency. Foreign investors should continue to play a role, but only within a system that demands accountability and equal compliance. If managed well, tourism can drive recovery and growth, while safeguarding public revenue and protecting Sri Lanka's long-term economic independence.

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