



Overview of Fiscal Performance

28th September
2020

Definitions

Fiscal Policy - the use of government revenue collection and expenditure to influence a country's economy

Fiscal Dominance – An economic condition that occurs when a country has a large government debt and deficit such that monetary policy targets keeping the government from bankruptcy as opposed to economic targets such as inflation, growth and employment.

Fiscal Multiplier- the ratio of change in national income arising from a change in government spending.

Fiscal Impulse- The change in the government budget balance resulting from changes in government expenditure and tax policies.

Fiscal Profligacy - is a continued unsustainable fiscal position.

Tax policy – it is the choice by the government as to what taxes to levy, in what amounts and on whom.

Progressive Tax System – Taxes are based on individual's ability to pay. Low income earners are taxed at a lower rate while higher income earners are taxed higher e.g.- Income taxes that are based on brackets.

Regressive Tax System – Taxes individuals disproportionately to their income. Low income earners pay a higher proportion of their income as taxes. E.g.- VAT

Tax Expense – Tax expenditures are special provisions of the tax code such as exclusions, deductions, deferrals, credits, and tax rates that benefit specific activities or groups of taxpayers.

Tax subsidy – reduction of the tax burden granted to certain business or industry to promote consumption or production.

Tax Credit – Amount of money that taxpayers can subtract from taxes owed to their government.

Primary and Overall Balance

Primary Balance (PB) is the difference between Government Revenue(R) and non-interest Government expenditure(G)

$$PB = \text{Revenue} - \text{Primary Expenditure}$$

The primary balance is an indication of fiscal performance in each year, interest (I) is on debt that is inherited which is excluded. The PB illustrates how resources raised each year have been used.

Overall balance is the difference between government revenues and total expenditure

$$\text{Overall Balance} = \text{Revenue} - \text{Total Expenditure}$$

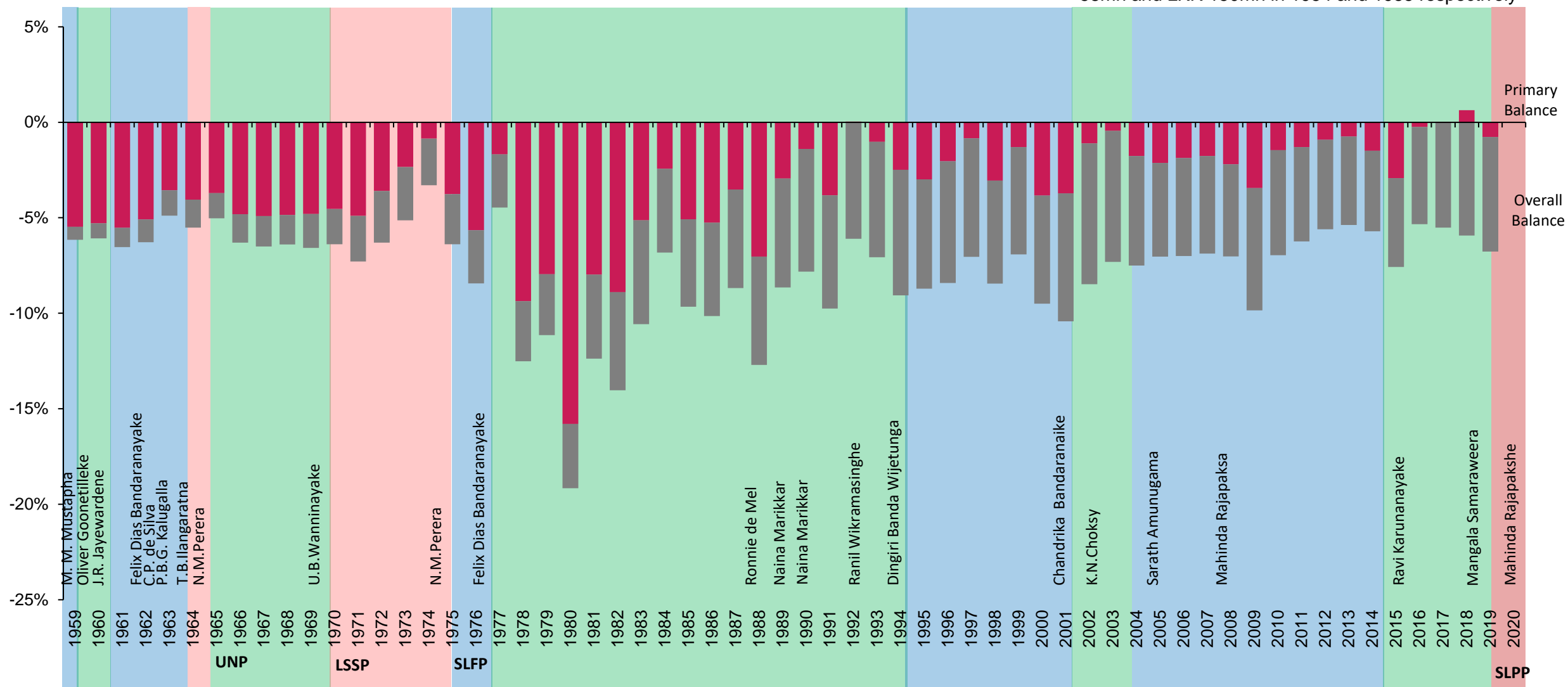


What is the problem?

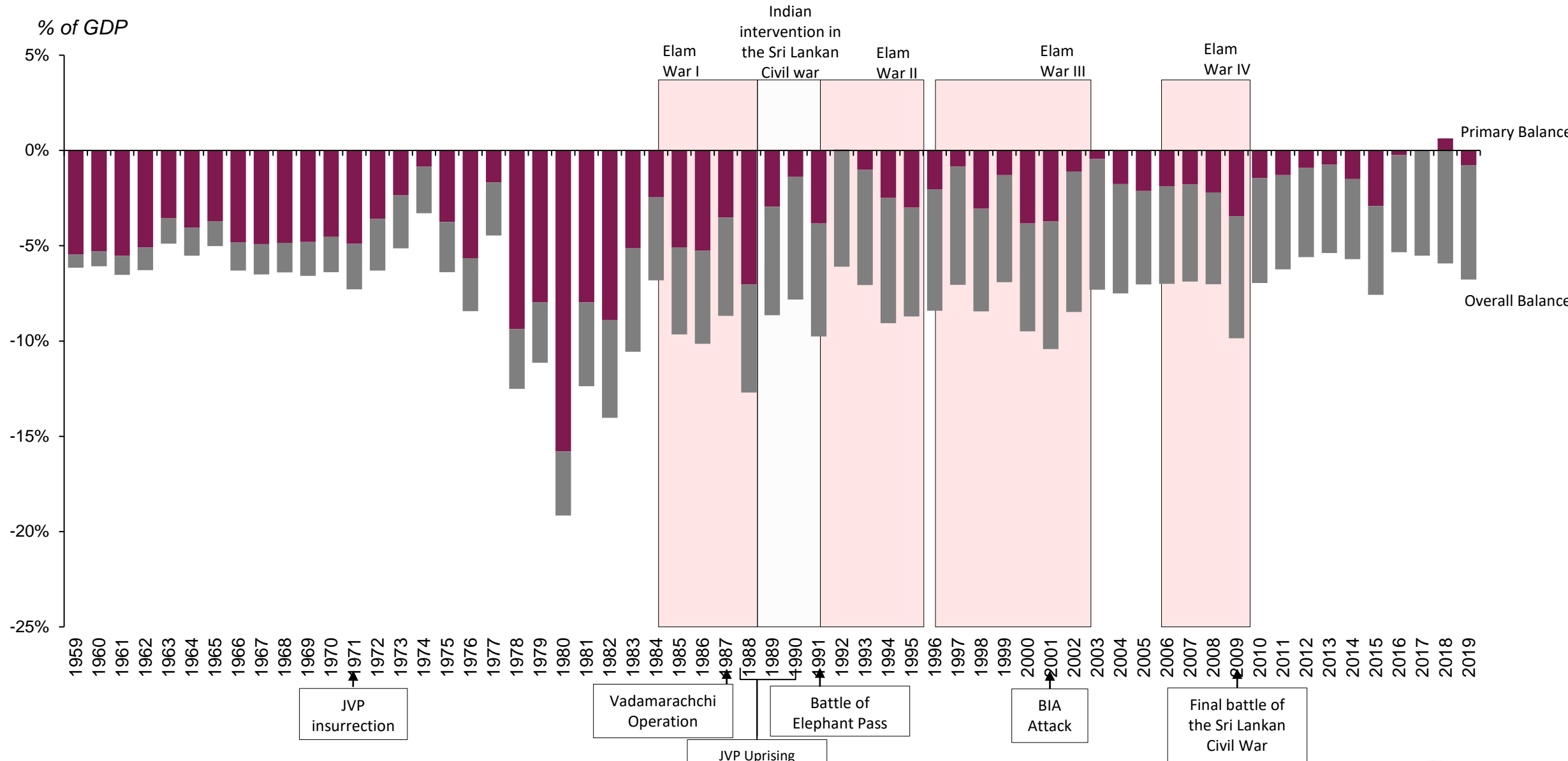
Primary deficits are endemic to Sri Lanka...the concept of fiscal conservatism is nonexistent

% of GDP

Sri Lanka had a positive primary balance of LKR 58mn and LKR 150mn in 1954 and 1955 respectively



How did civil strife and conflict impact on the primary balance



Has the electoral system and cycle contributed to fiscal profligacy ?

An auction of non existing resources

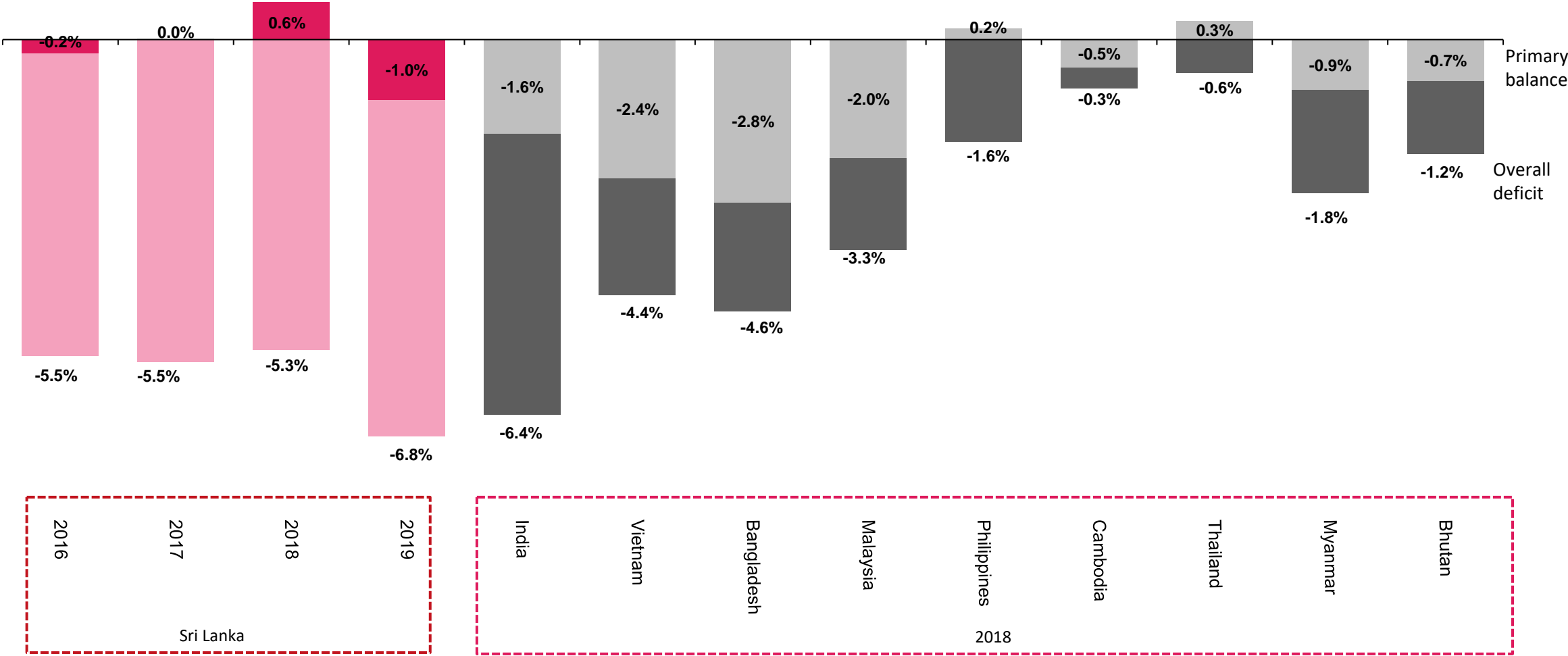
Election	Promise
1952	The UNP promised not to increase the price of rice as it was the staple diet of the public, a quarter of rice will be 25 cents.
1970	PM Sirimawo promised to bring rice from the moon if needed.
1977	President J.R. Jayewardene promised... that all citizens will be provided with 8kg of grain every month.
1994	Former President Chandrika Kumaratunga promised that she will provide bread at Rs. 3.50 when the market price was Rs. 5.00
2015	In order to provide urgent relief to the debt-stricken the salary of public servants will be increased by Rs. 10,000.
2019	Gotabaya Rajapaksha announced that he would increase the daily wage of a plantation worker to Rs. 1,000. This was countered by Sajith Premadasa offering to increase it to Rs. 1,500. Gotabaya Rajapaksha stated that, if elected, we should give free fertilizer to the paddy farmers.

Findings from Academic Research

- Proportionate electoral systems suffer from deficit bias compared to majoritarian systems (Battaglini 2010,14).
- Proportionate systems accumulate more debt than majoritarian systems (Roubini and Sachs 1989).
- Presidential systems have smaller governments than proportional systems.
- Parliamentary systems that increase government spending during recession are unlikely to reverse it during economic expansions.

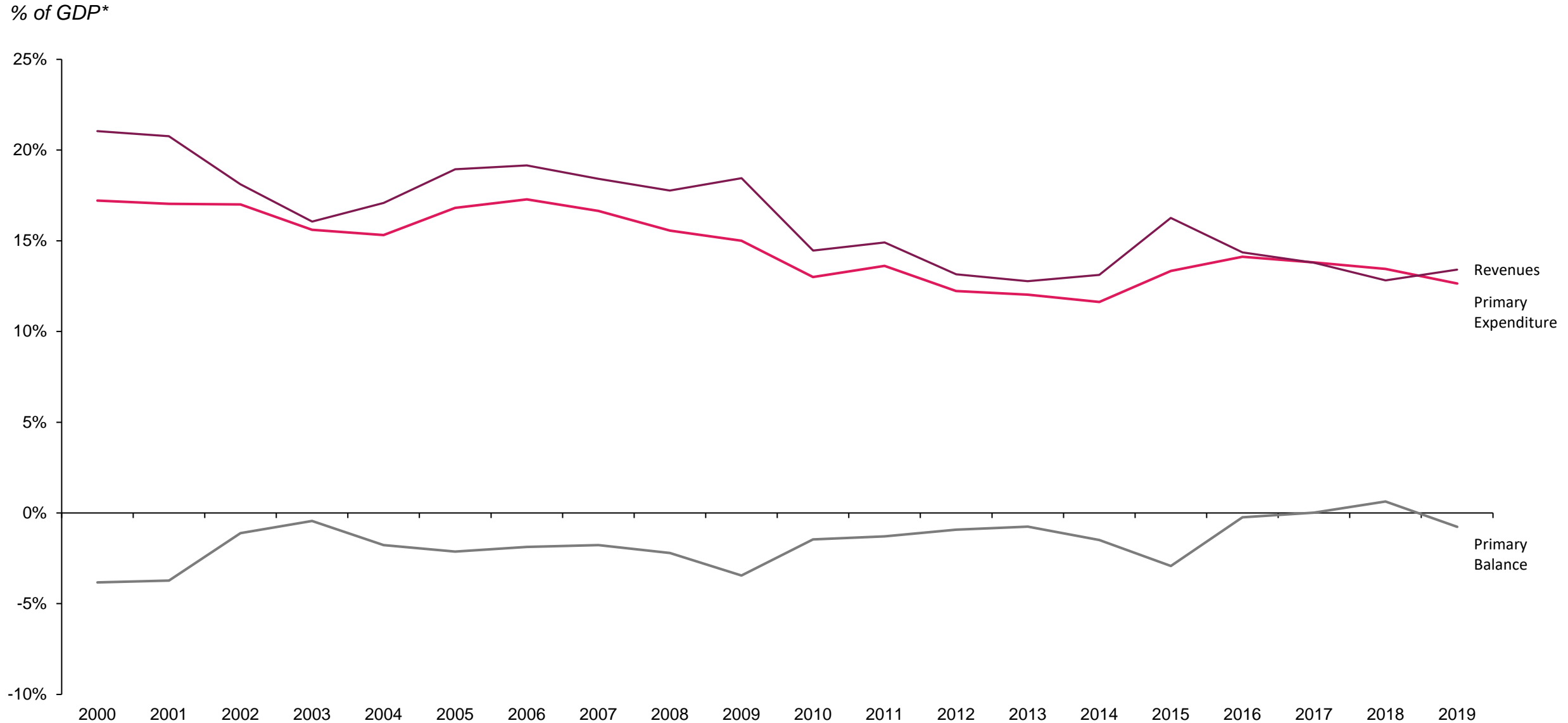
Sri Lanka's fiscal deficits are outliers in comparison to regional peers

Fiscal deficit remains high compared to peers
% of GDP

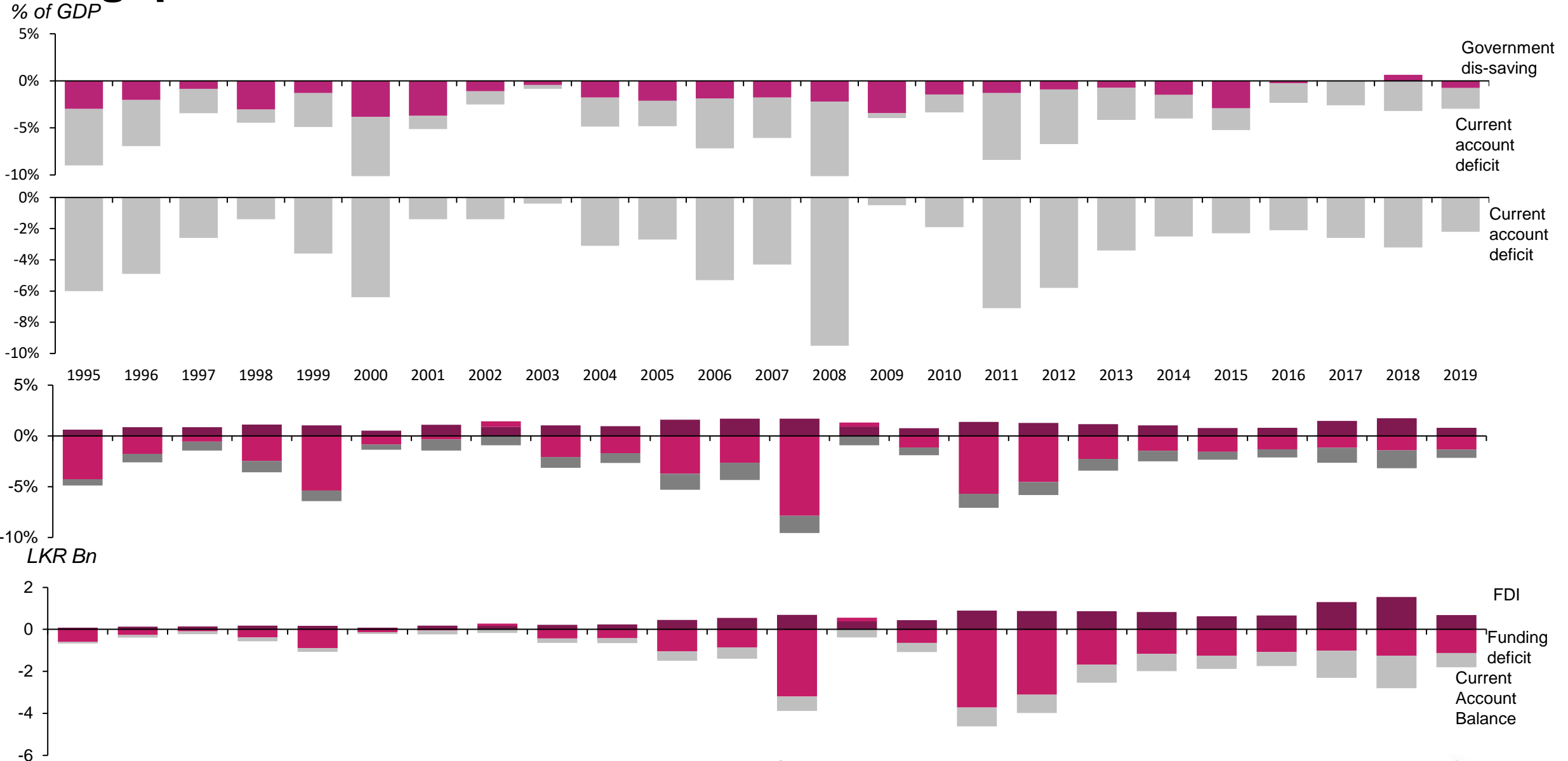


Note: Data points for Vietnam is an IMF estimate for year 2018
Source: CBSL, IMF, Advocata Research

Revenue is on a downward trend



We need to borrow each year to bridge the current account deficit – FDI gap

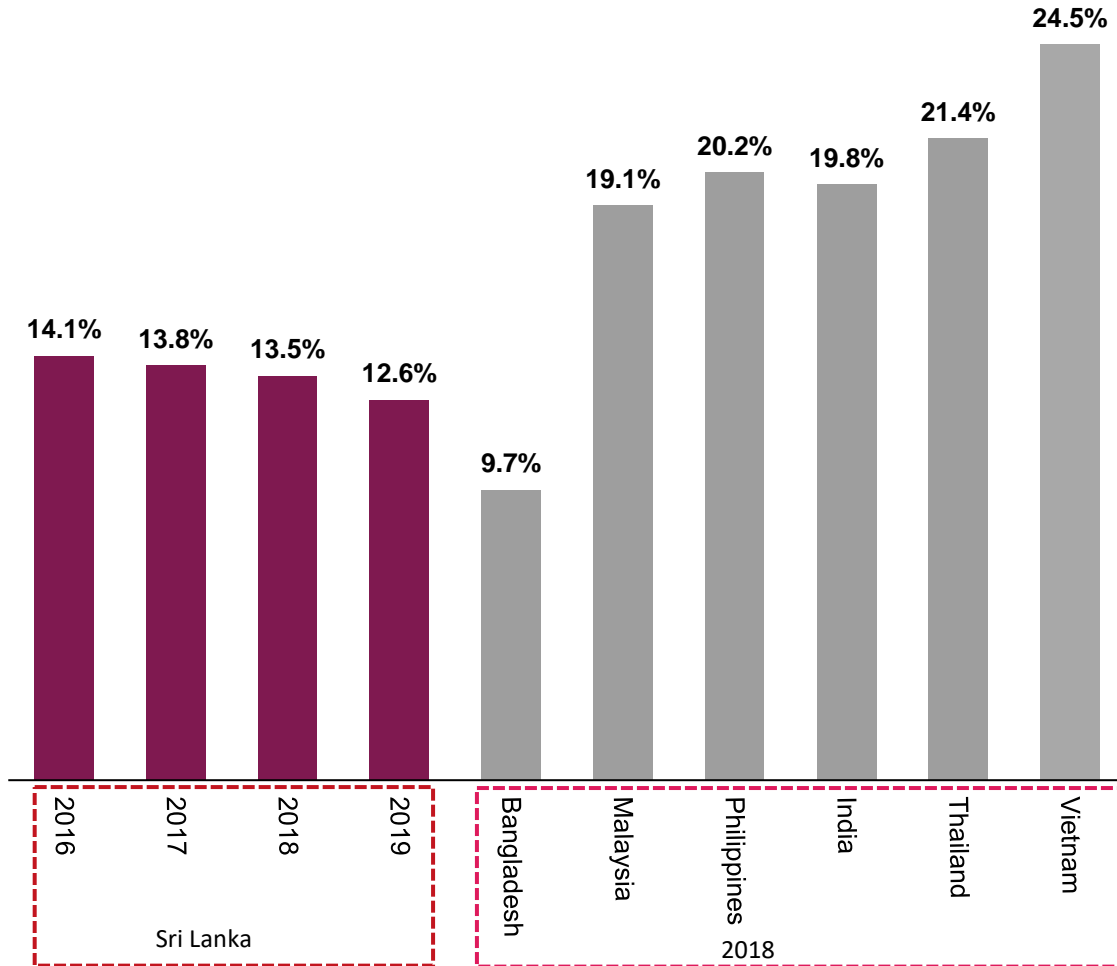




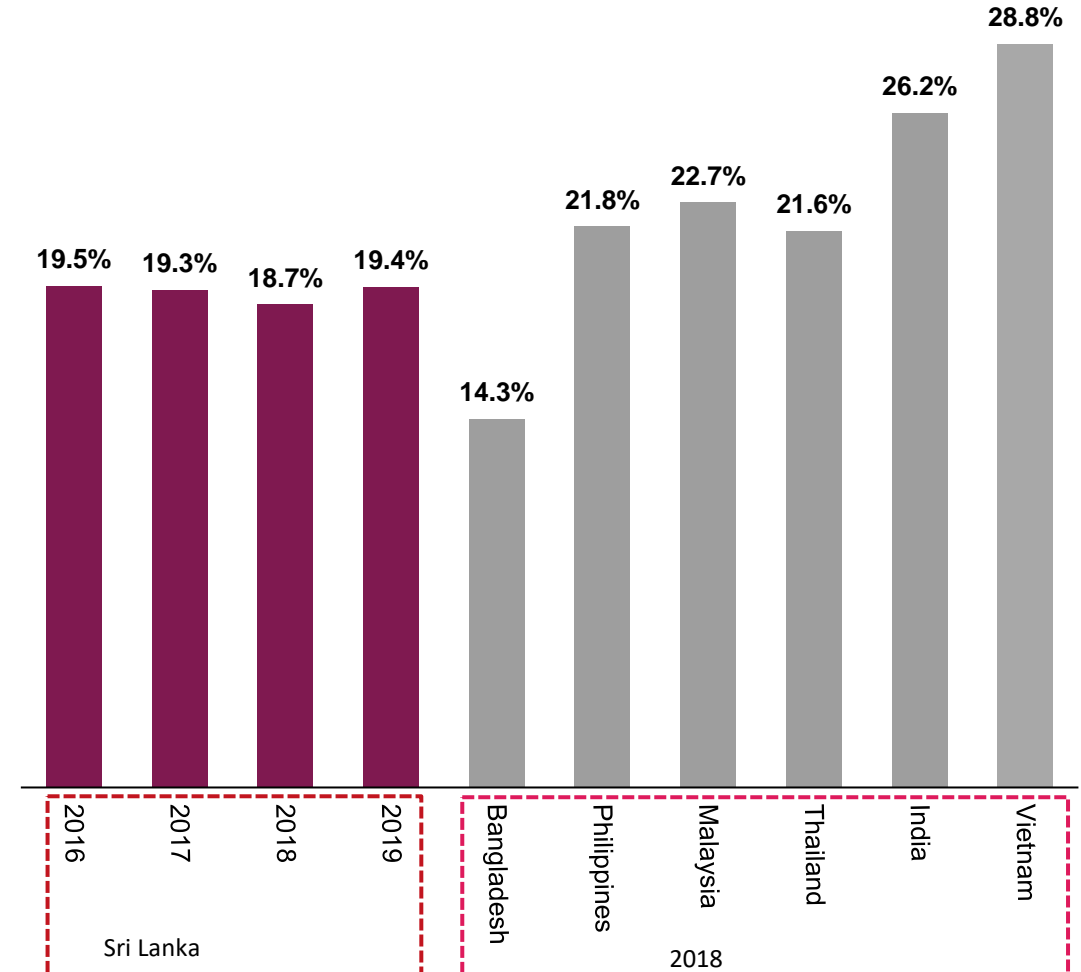
Revenue

Government revenue fell by 1.7% in 2019 due to a slow down in GDP post Easter Bombings...

Government revenue as a % of GDP fell in 2019 due to lower revenues
% of GDP



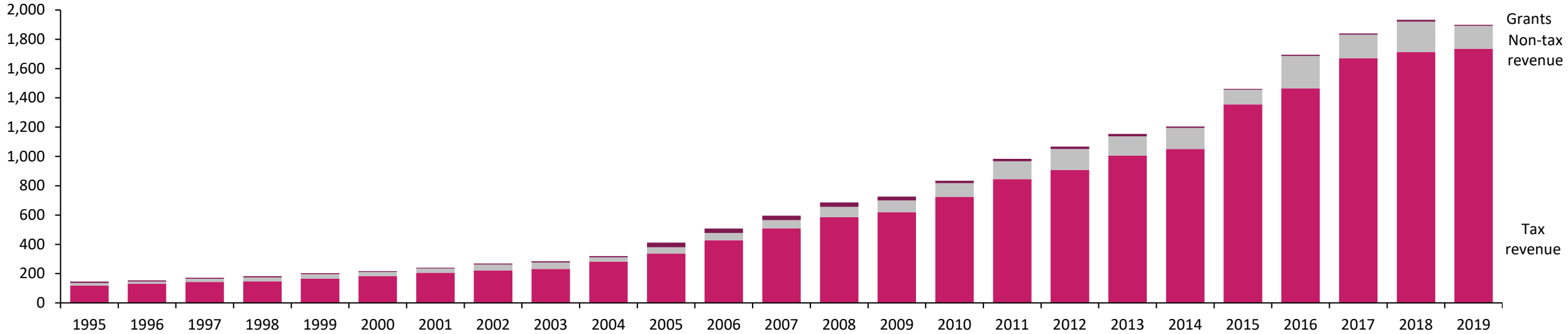
Expenditure as % of GDP increased and expenditure grew at a higher rate than GDP *
% of GDP



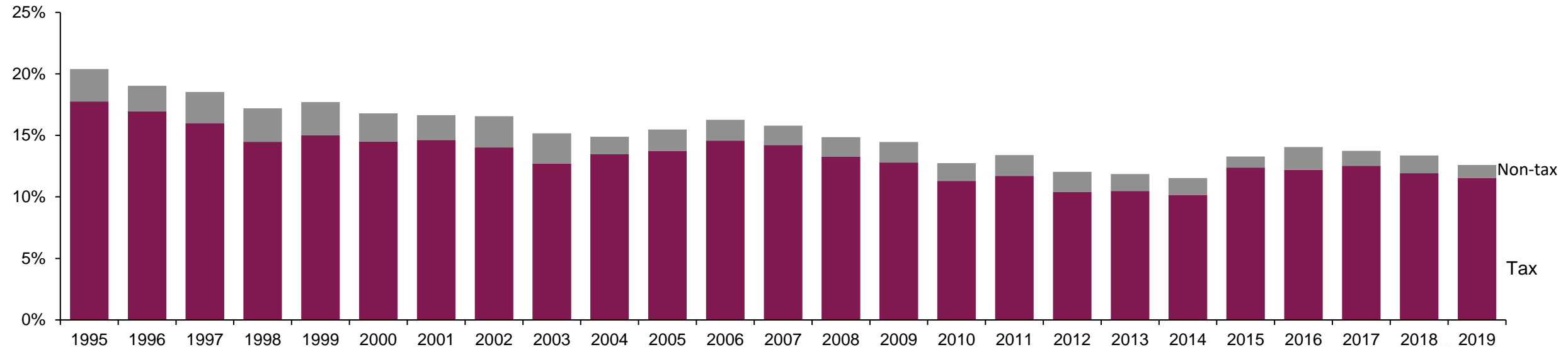
Note: Data point for Vietnam is an IMF estimate for year 2018
Source: CBSL, IMF, Advocata Research

Government revenue has been trending down...

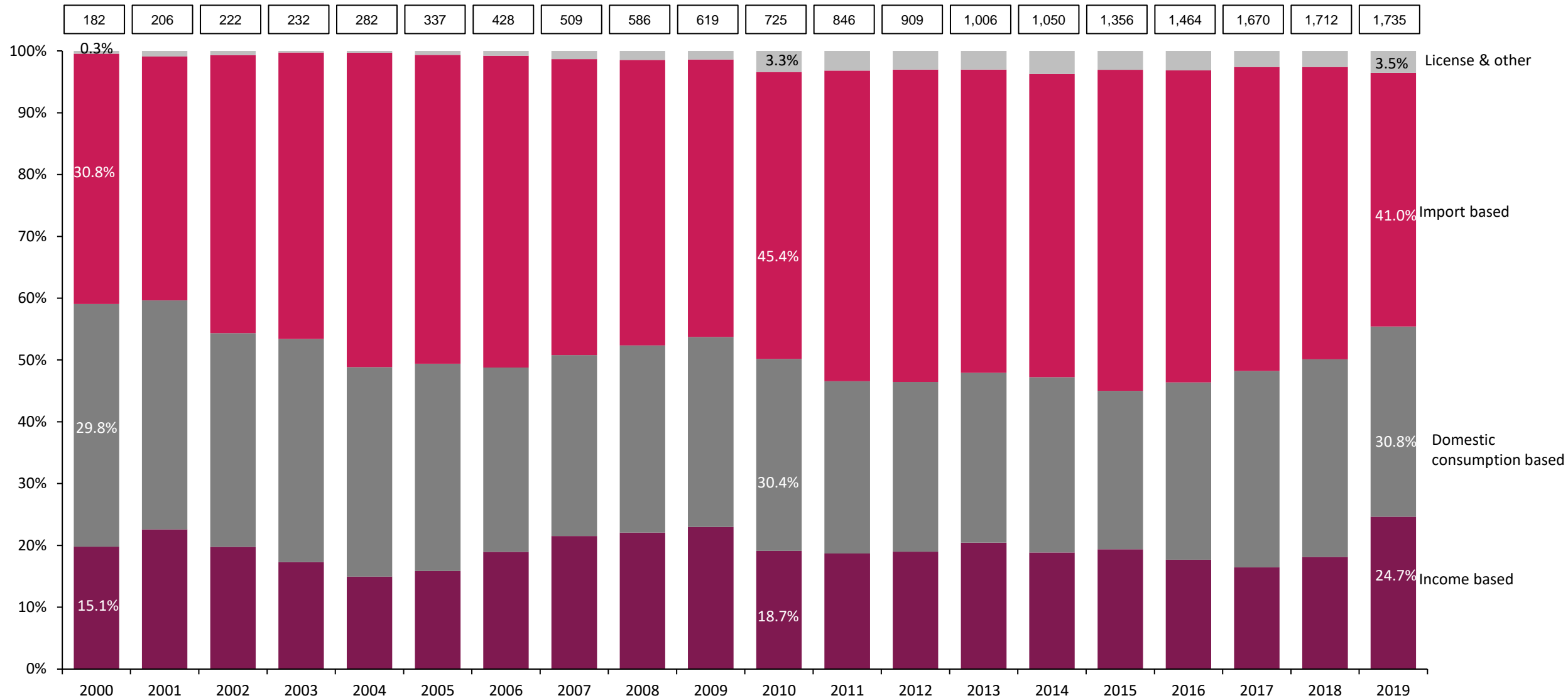
LKR Bn



% of GDP



Indirect taxation accounts for 75% of total tax revenue...highly regressive



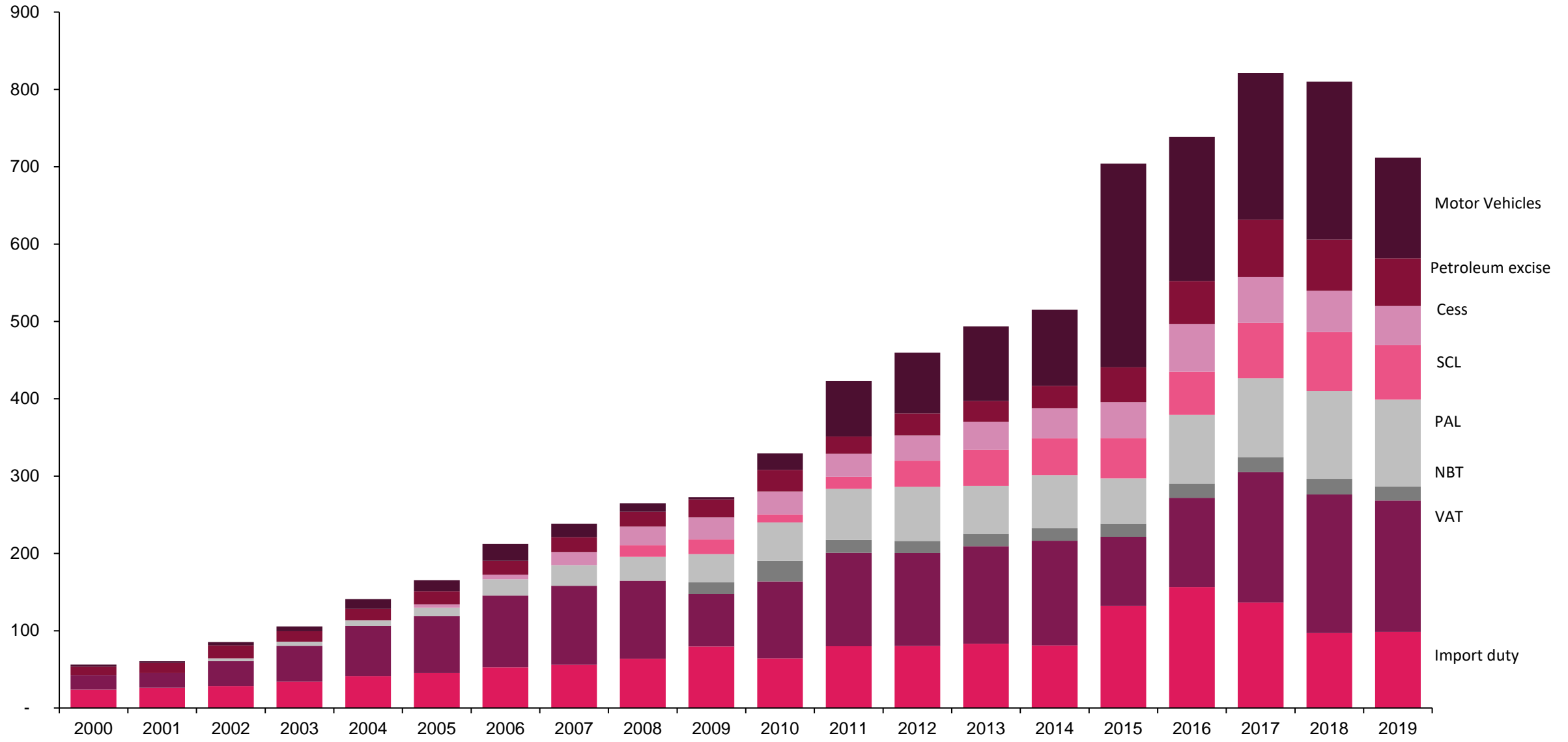
Historical comparison of composition of government revenue

Major sources of government revenue (% of total), 1938/9 and 2011-14*

	1938/9	Average 2011-14
Taxes on imports**	47%	43%
Total income taxes	15%	19% (comprising 13% from personal and corporate income tax and 6% from taxes on interest earned on bank deposits)
Excise taxes on liquor and tobacco	13%	13%
Social security contributions	1.9%	1.3%
VAT and other taxes levied on domestic sales	-	15%
Surplus from public sector income-earning activities	18% (mainly land sales, port, post office, electricity and railway)	(large deficits)
*Sources; Mick Moore 2017		

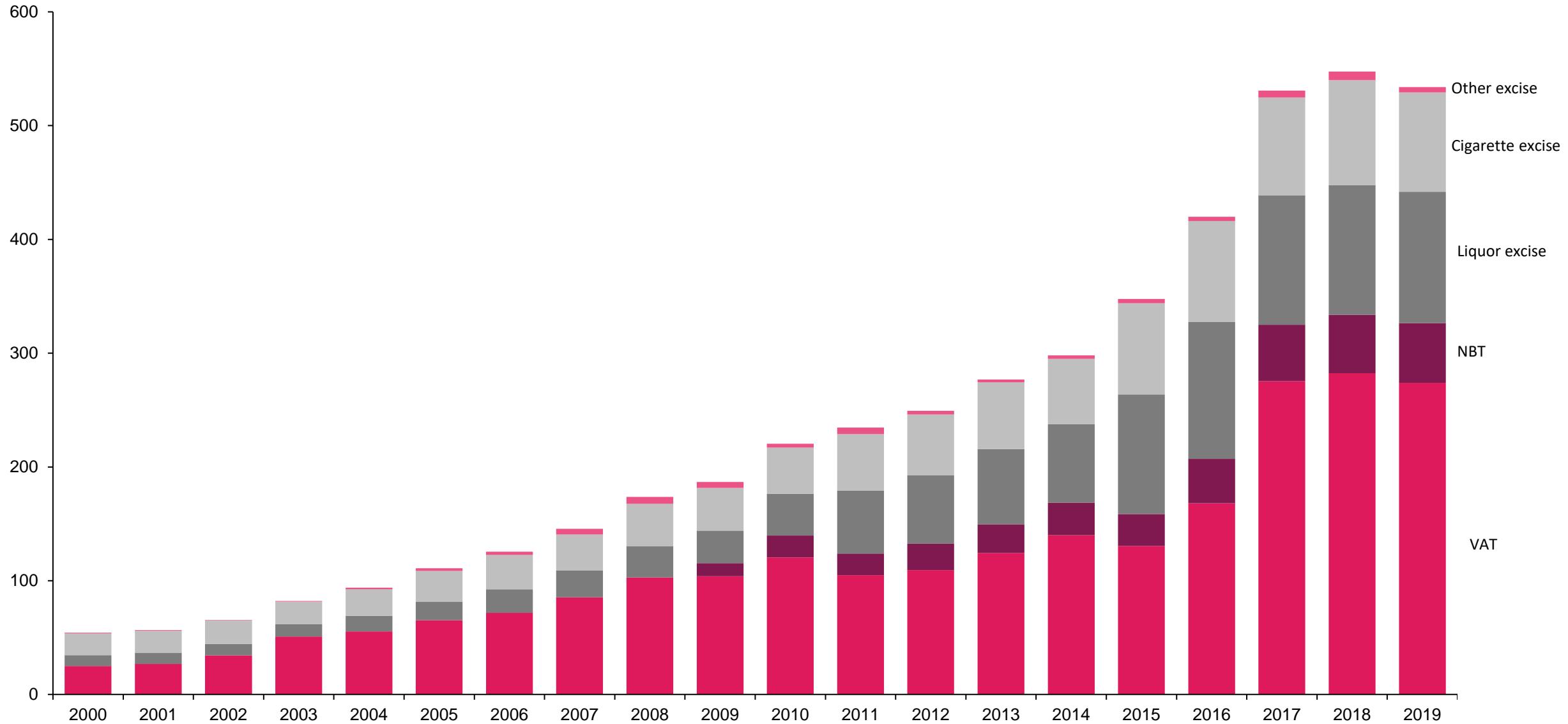
Composition of import taxes

LKR Bn



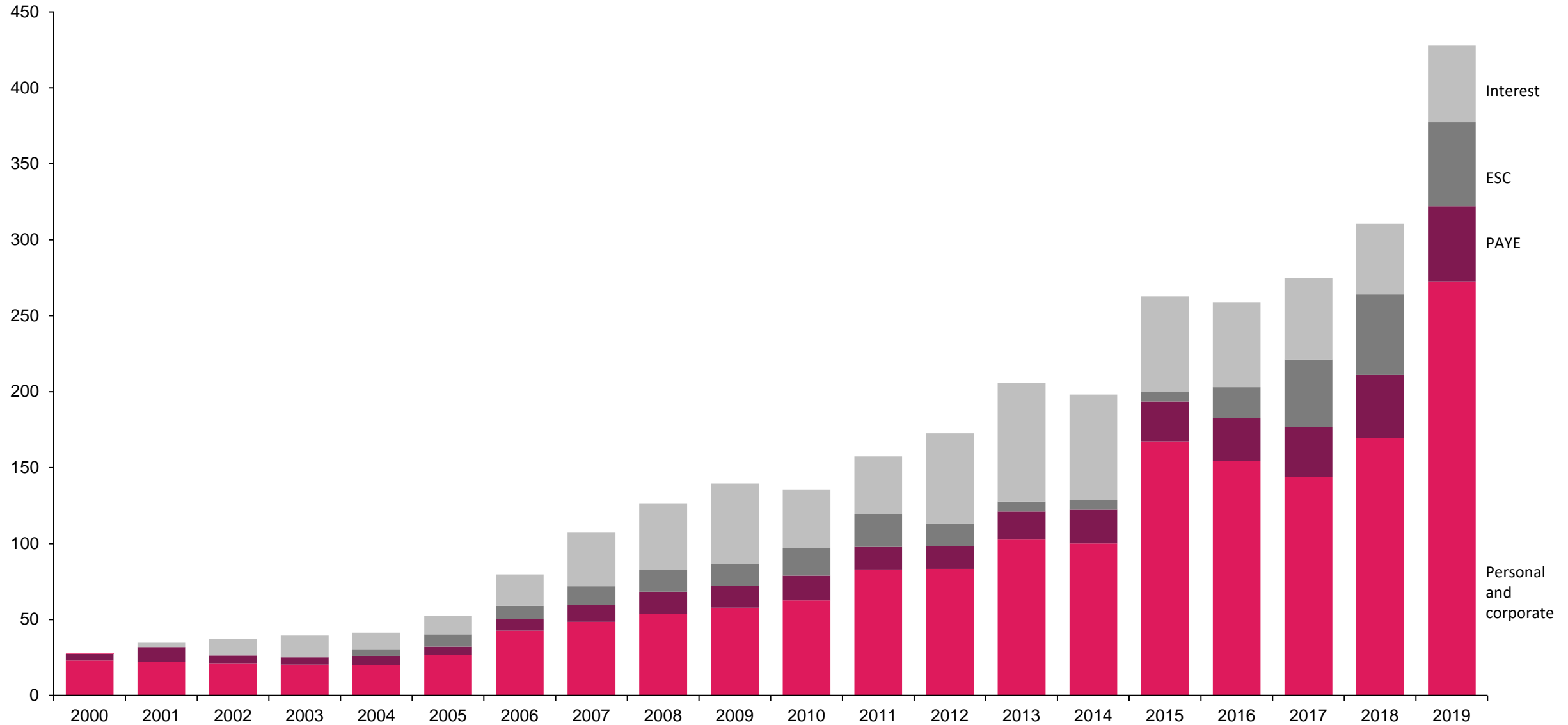
Composition of domestic based taxes

LKR Bn



Composition of Income based taxes

LKR Bn



Tax buoyancy

Tax buoyancy measures how tax revenues vary with changes in output





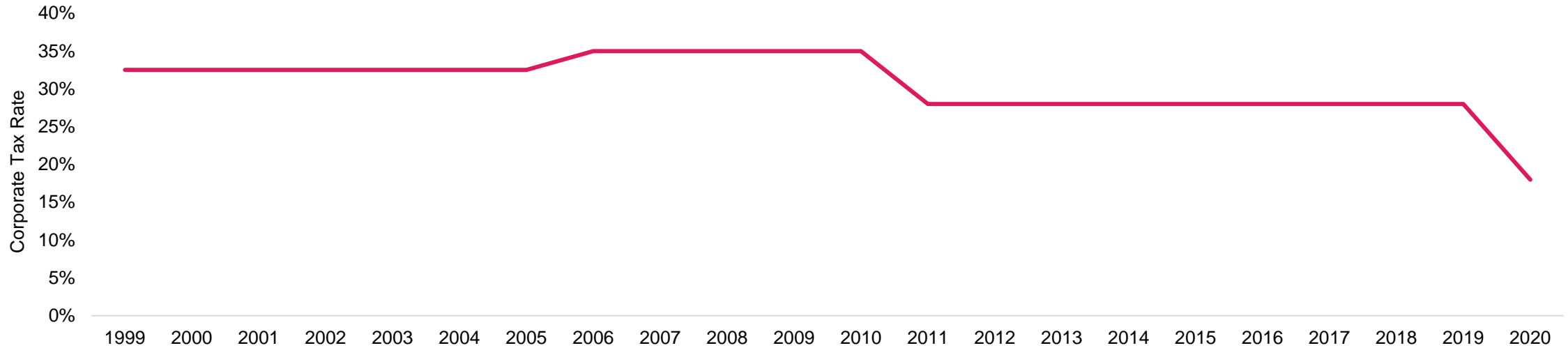
Tax policy and administration

Summary of taxation policy changes implemented in November/December 2019

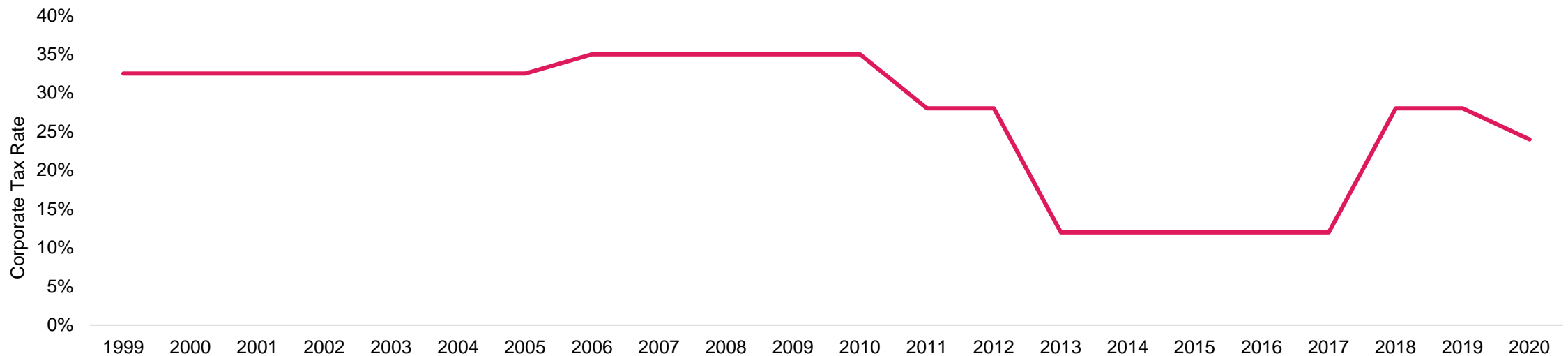
Value Added Tax (VAT)	<ul style="list-style-type: none"> Reduced from 15% to 8% with effect from 1 December 2019. VAT registration threshold has been increased with effect from January 01, 2020, up to LKR 1 million per month or LKR 25 million per annum
Nations Building Tax	<ul style="list-style-type: none"> Abolished with effect from 01 December 2020. Previous rate was 2%.
Debt Repayment Levy (DRL)	<ul style="list-style-type: none"> Abolished with effect from 01 January 2020. Previous rate was 7%.
Income Tax	<ul style="list-style-type: none"> Assessable income tax-free threshold LKR 3 mn. per annum. Taxed at progressive rates of 6%, 12% and 18% for each LKR 3 mn. above the tax-free threshold. Assessable income includes employment income, interest income and dividend income.
Withholding Tax (WHT)	<ul style="list-style-type: none"> WHT on dividend, charge, natural resource payment, rent, royalty, premium or retirement payments made to residents will be removed and such income will form a part of assessable income, with effect from April 1, 2020.
Corporate Tax	<ul style="list-style-type: none"> Standard rate reduced to 24% from 28% Manufacturing reduced to 18% from 28% Liquor, tobacco, betting and gaming unchanged at 40% Construction reduced to 14% from 28% Information Technology (IT) and agribusinesses are exempt

Corporate tax rates have been declining over the years

Business with revenues starting at LKR 100 million



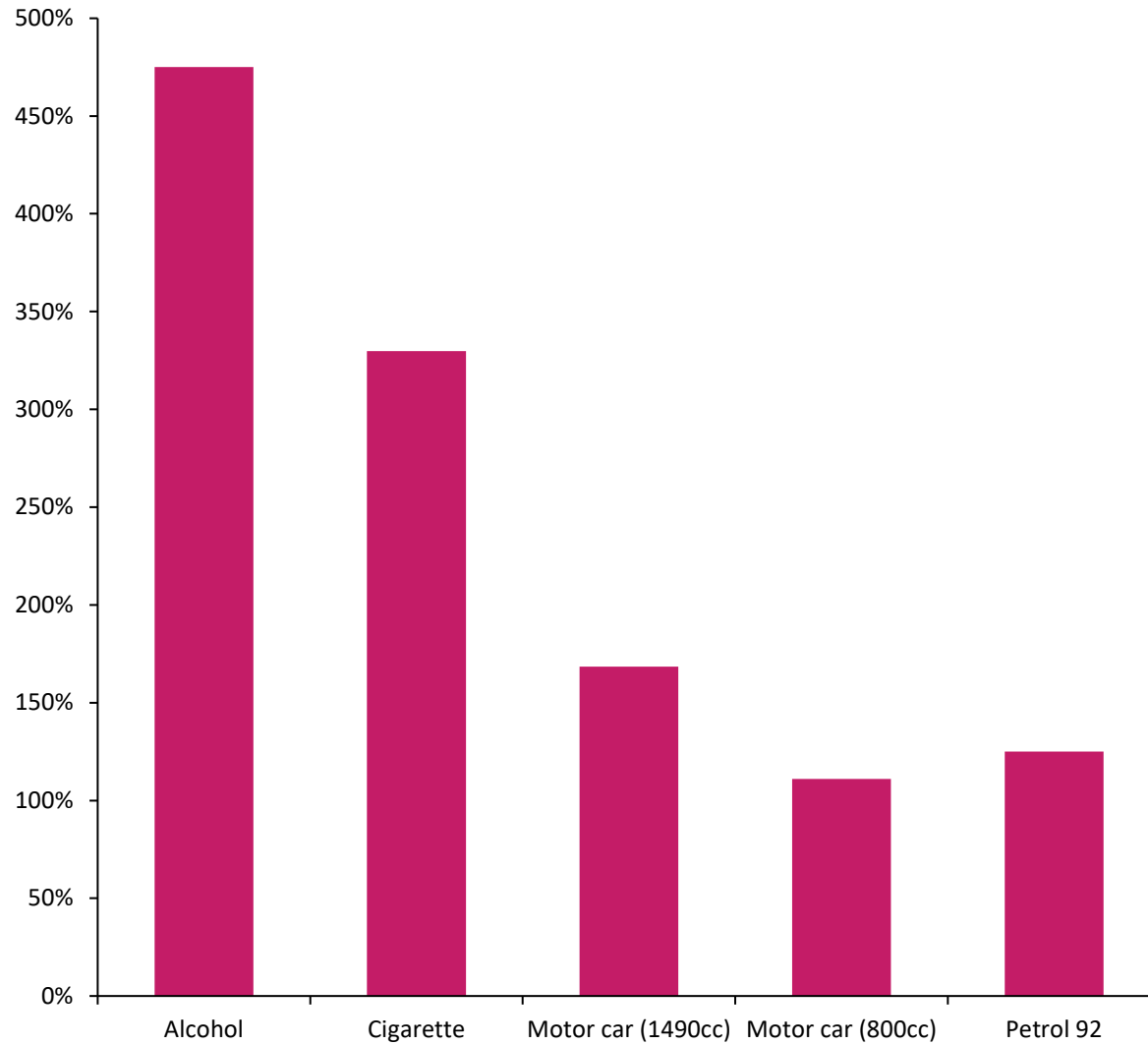
Business with revenues starting at LKR 50 million



Level of indirect taxation on a selection of goods...

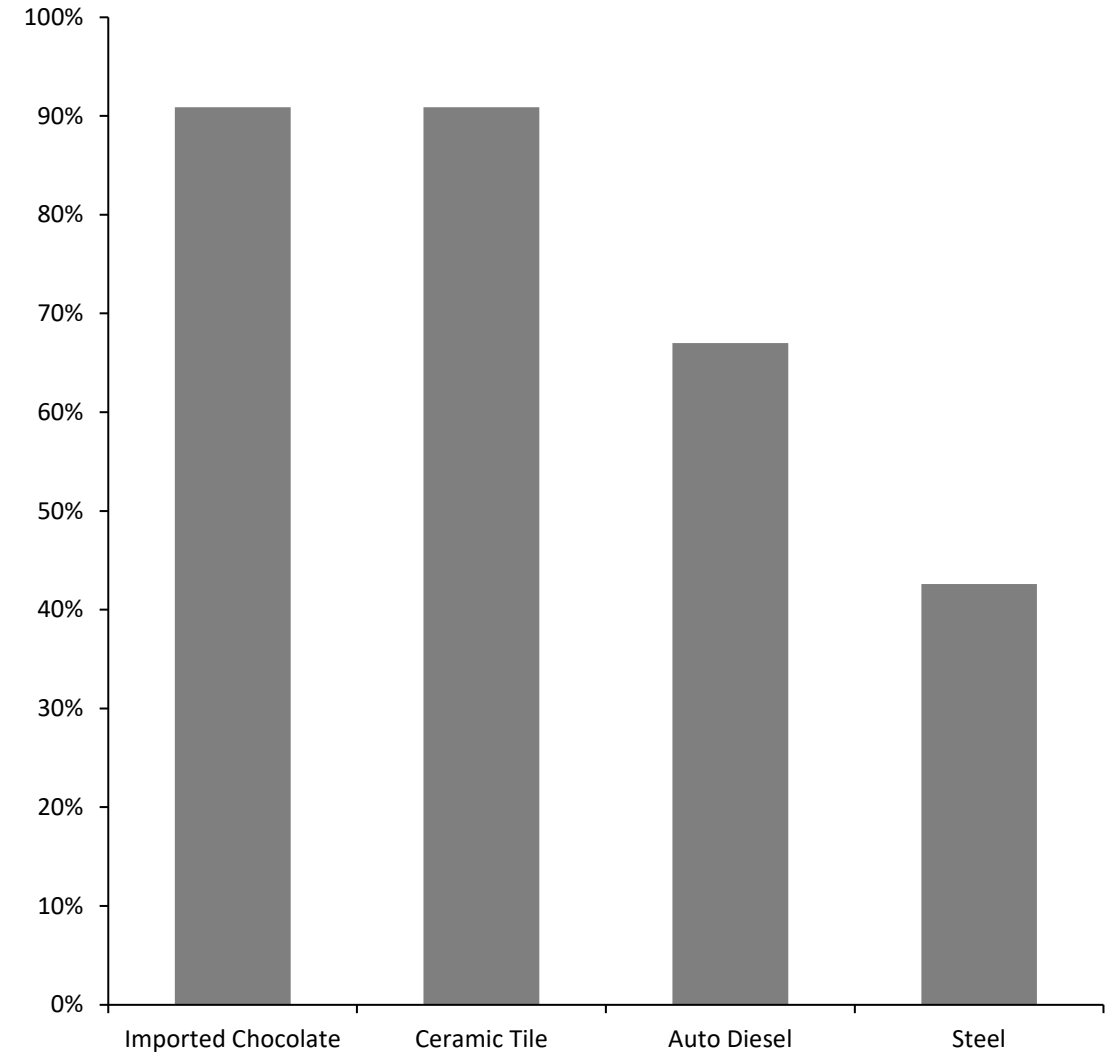
Very High Taxes

Total Tax Value as a % of CIF

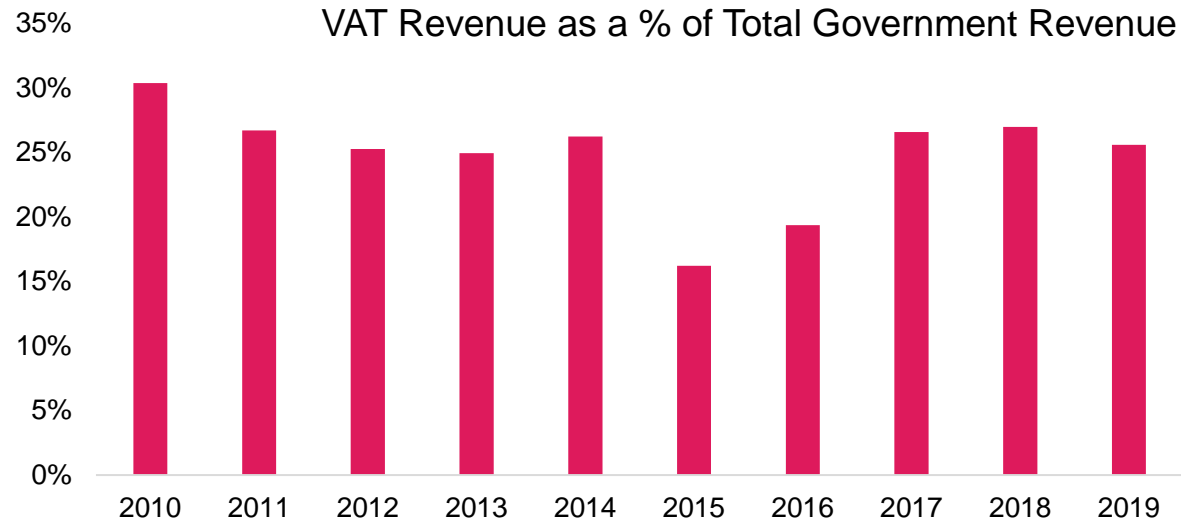
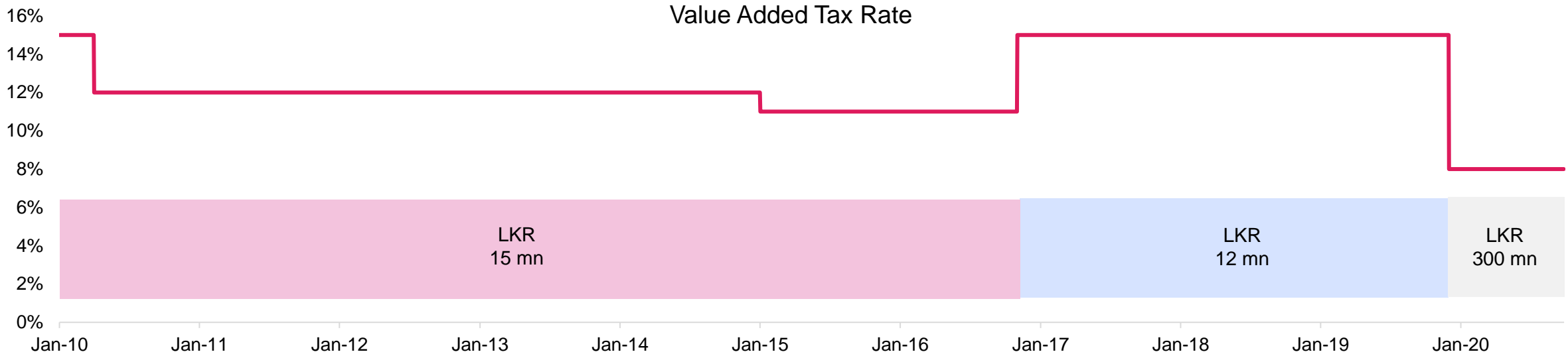


High Taxes

Total Tax Value as a % of CIF



Changes to the VAT system in the last decade



Recent VAT tax amendments in end 2019

- Rate reduced from 15% to 8%
- Base increased from LKR 12 mn to LKR 300 mn
- Exemptions increased including hotels and restaurants

VAT represents 25% to 30% of the revenue base, what is the merit of making such drastic changes that will have relatively modest tax elasticities and growth multipliers.



Tax subsidies

A case for tax subsidies - hotel investment

Assumptions

Investment – LKR 1 bn
 Property, plant & equipment – LKR 800 mn
 Land – LKR 200 mn

Asset Turnover

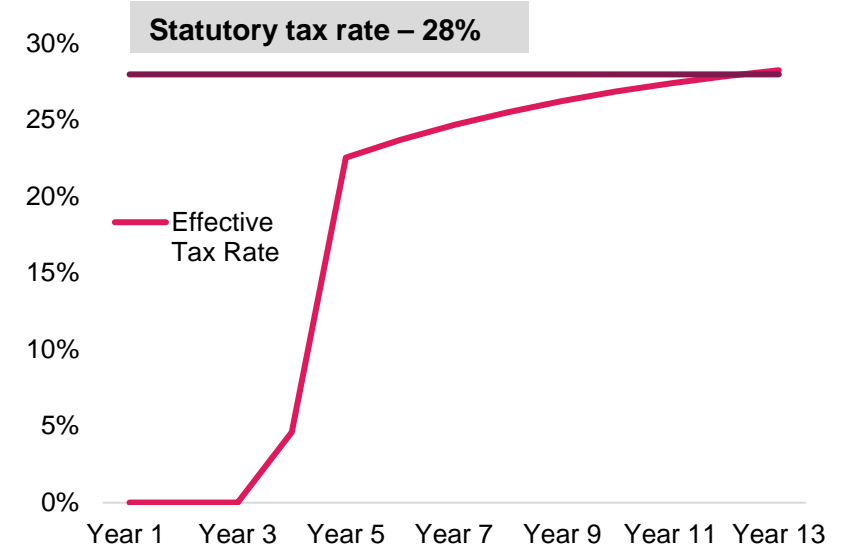
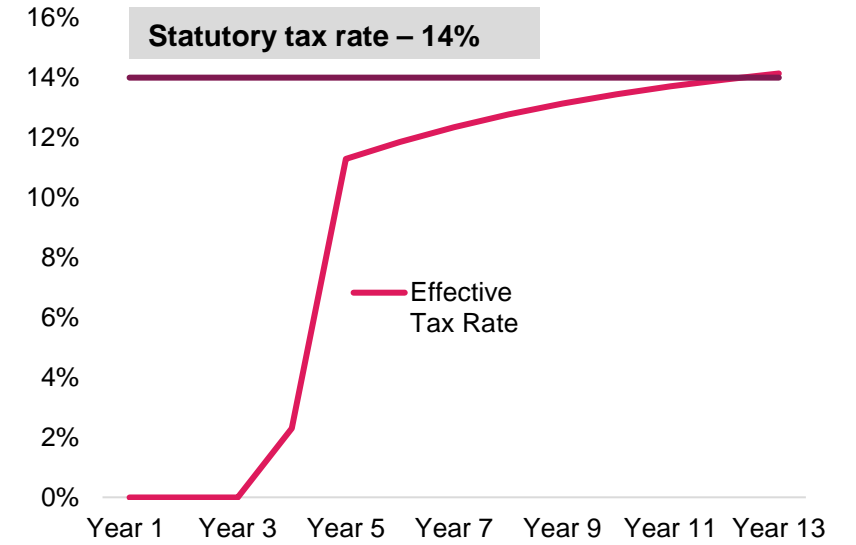
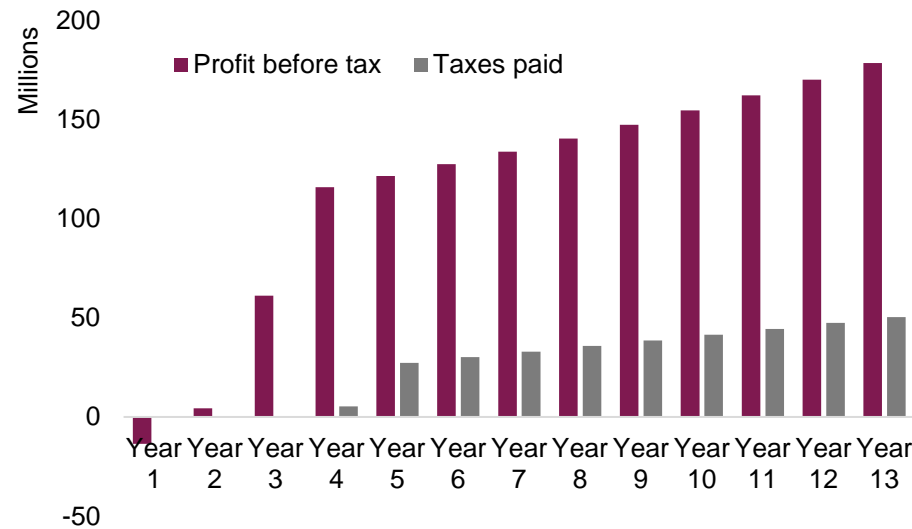
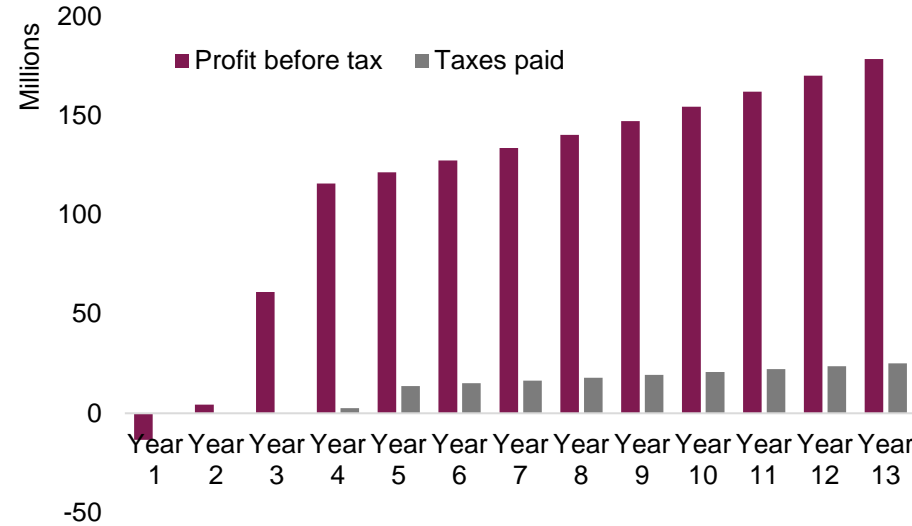
Year 1 – 20%
 Year 2 - 24%
 Year 3 – 32%
 Steady state – 40%

Revenue growth in steady state – 5%
 Gross Operating Margin in steady state – 40%

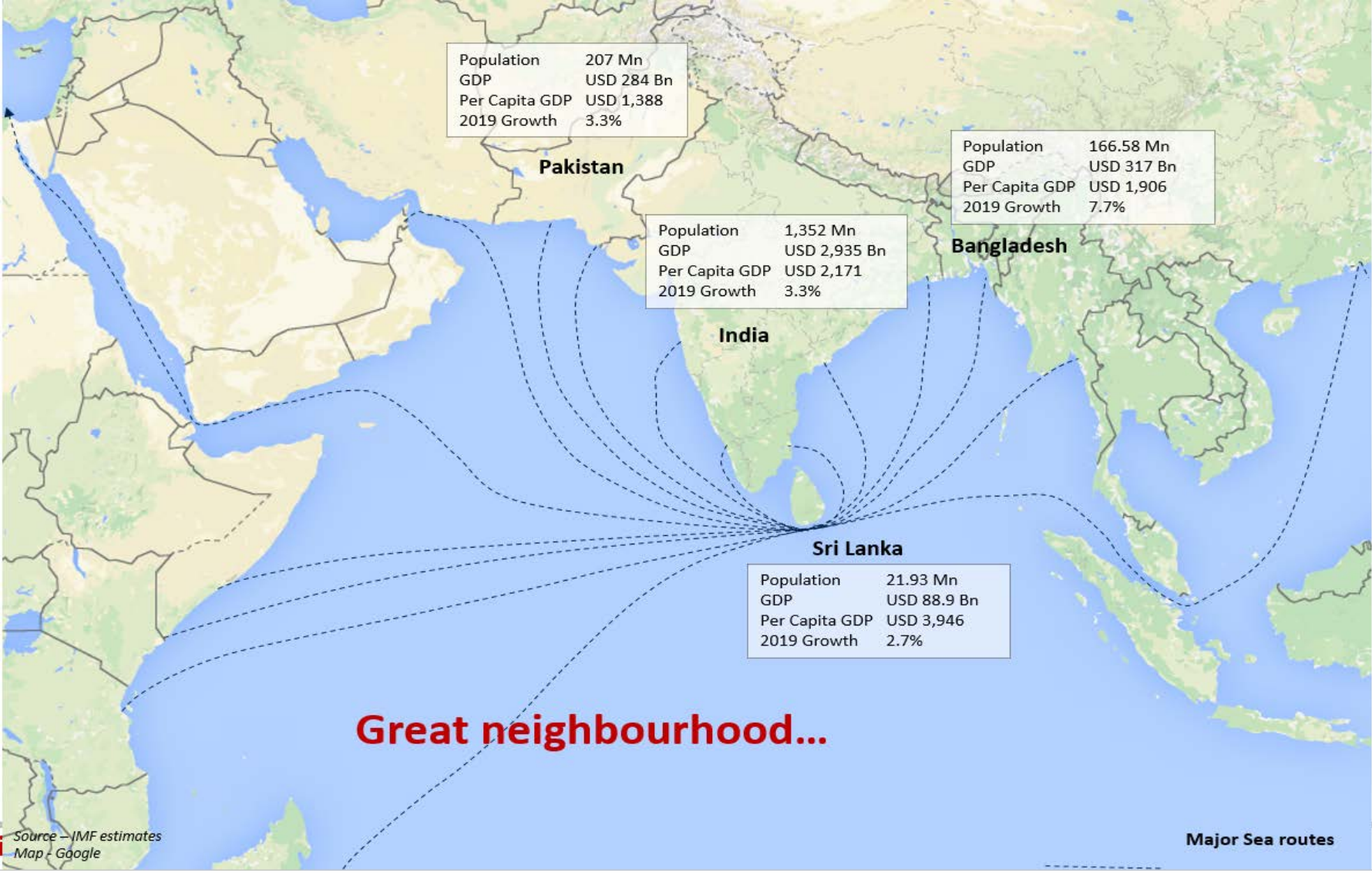
Internal Rate of Return

IRR @ tax rate of 14% - 10.8%
 IRR @ tax rate of 28% - 8.4%

Lowering the tax rate improves IRR closer to the hurdle rate



We are in a great neighborhoodwhy are we giving tax subsidies (0% - 14%) for port related services



Profits in building construction is taxed at 14% whilst its components are taxed at 18%



14%

VS.



18%

What is the rationale for exempting the incomes of the Information Technology (IT) sector



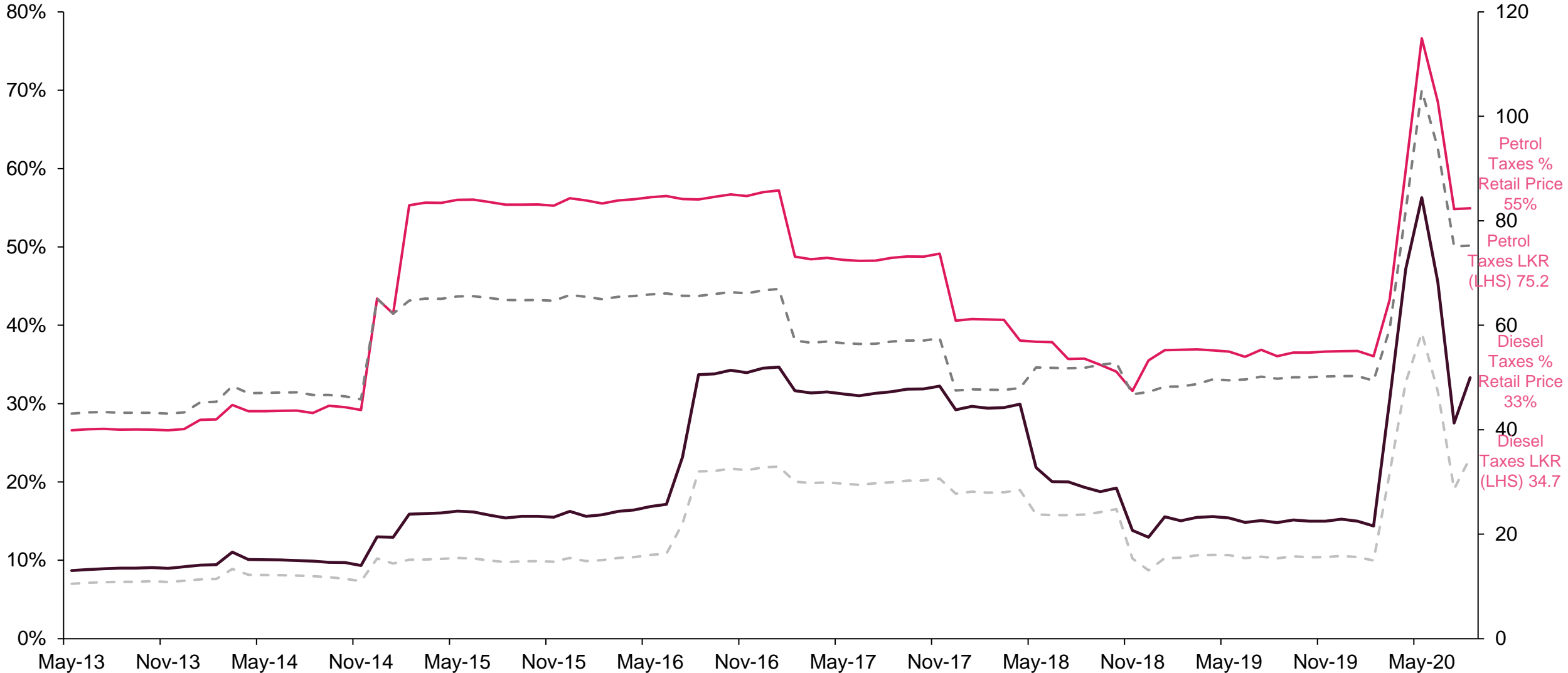
21%

Sri Lankan IT
companies

Exempt

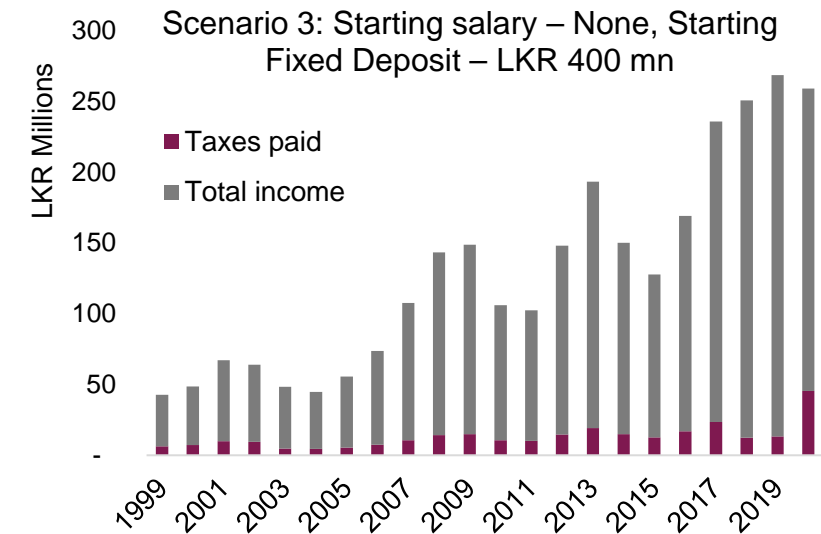
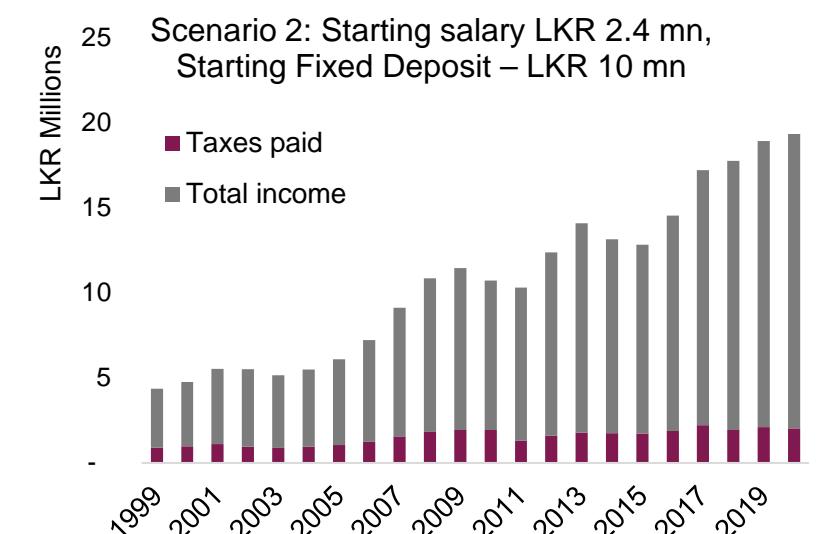
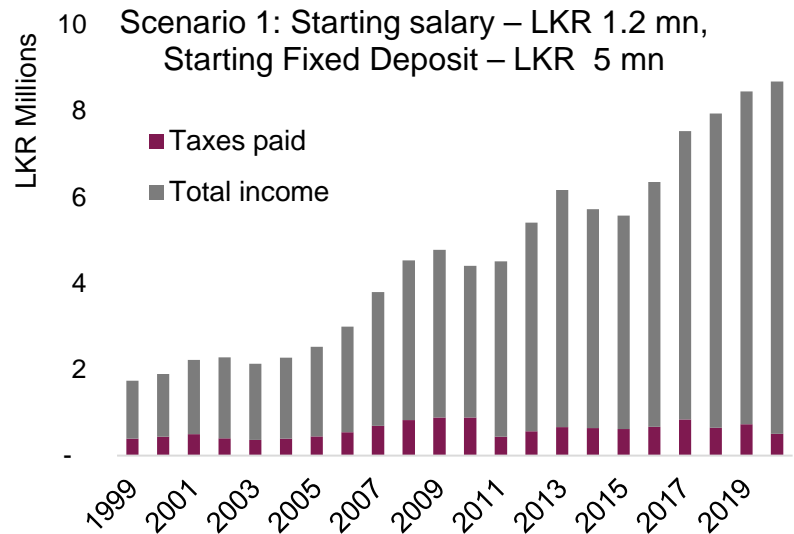
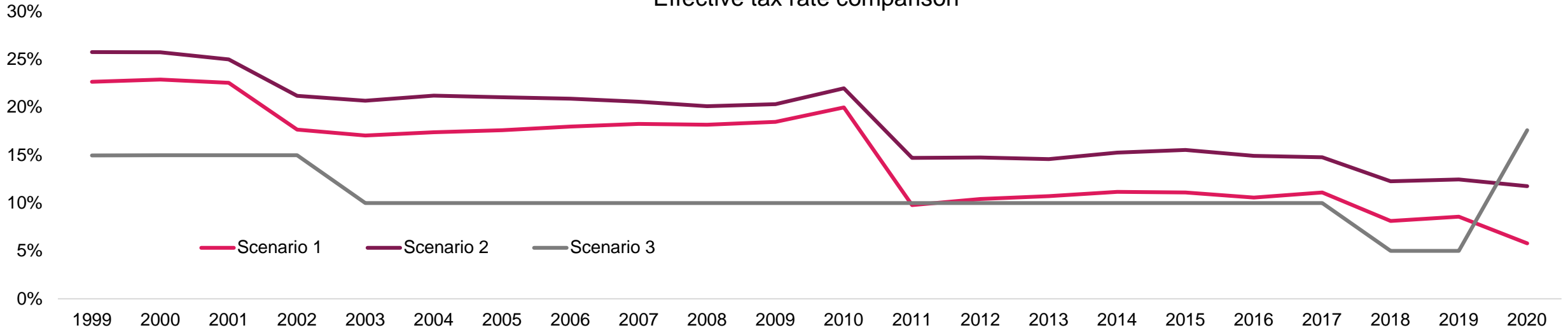
Fuel taxes – what is the rationale for low taxation on diesel

Taxes/ Retail Price, % (LHS) ; Taxes, LKR (RHS)

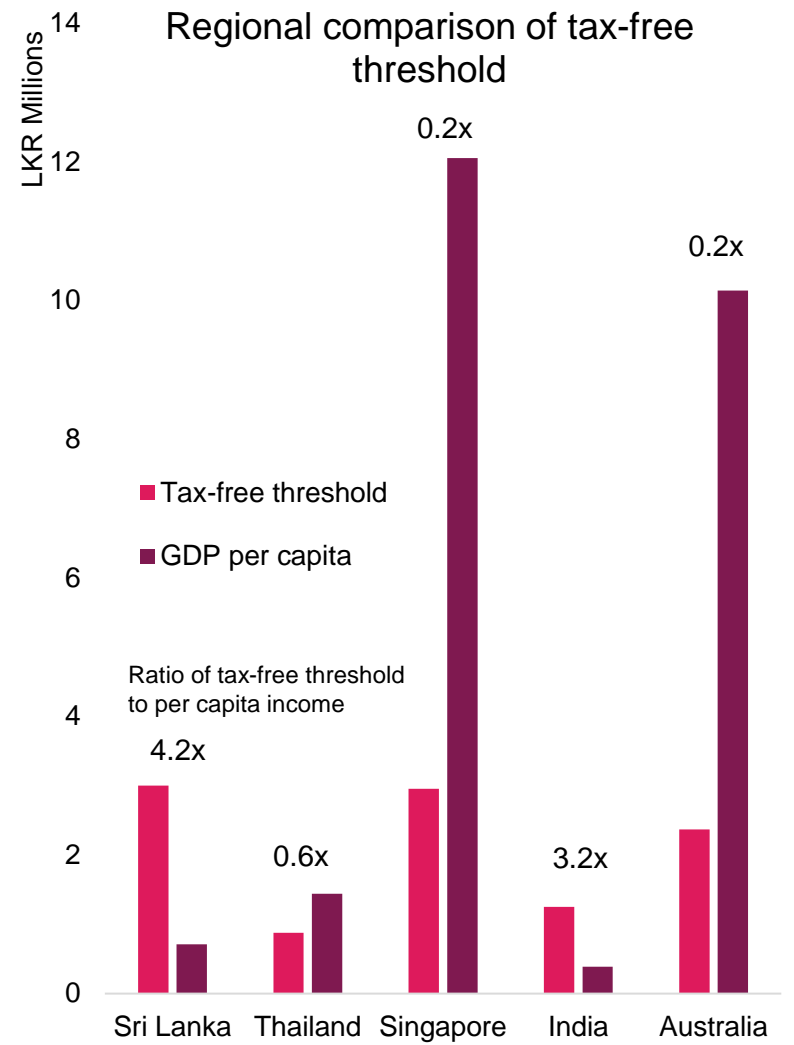
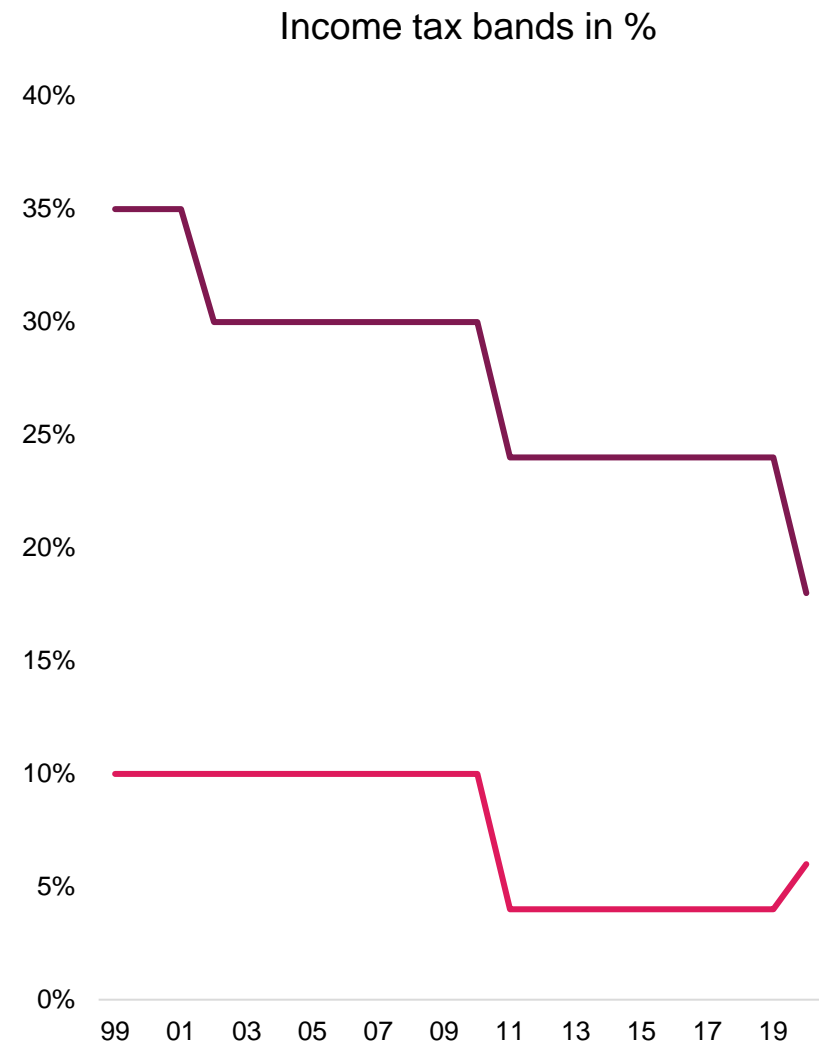
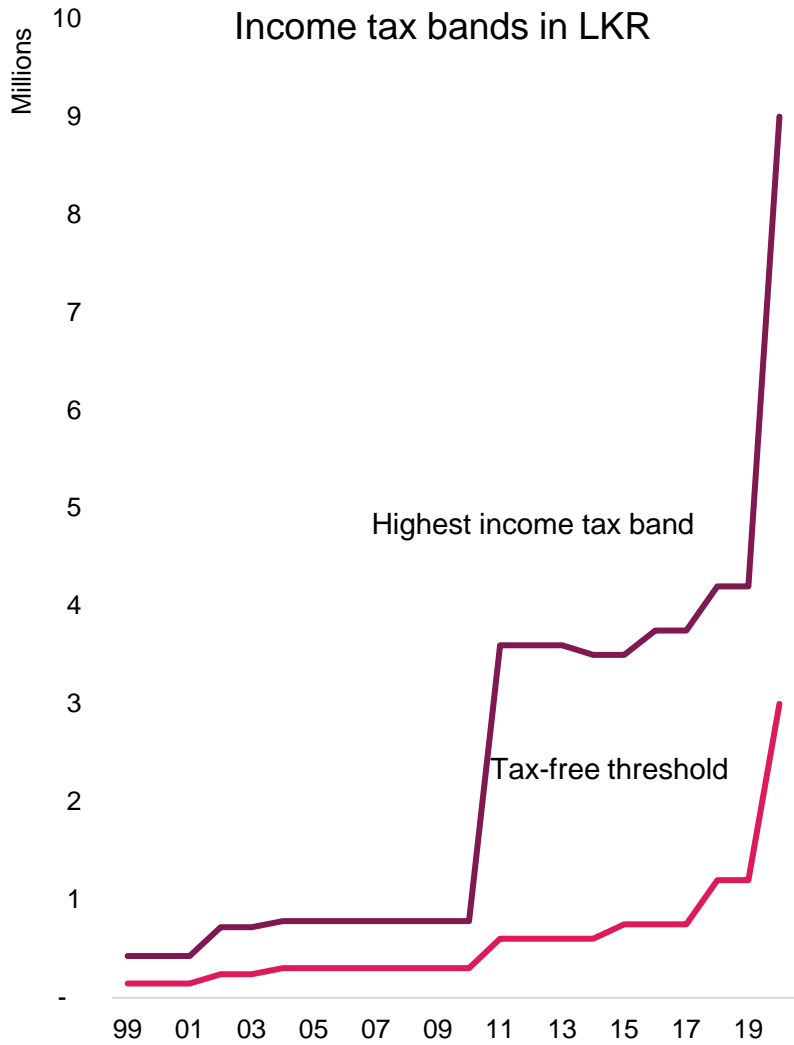


Effective personal tax rates have been on a declining trend




Effective tax rate comparison



Effective personal tax rates have been on a declining trend



Tax administration - Sri Lanka Customs, IRD and Department of Excise

	Sri Lanka Customs	Inland Revenue Department (IRD)	Department of Excise
Established	1806	1932	1913
Number of staff	-	2,597	1,309
Head	Major General G. Vijitha Ravipriya	Nadun Guruge : previously acting Commissioner General of IRD	A. Bodaragama : served 32 years in the department
Amount collected (LKR Mn 2018)	919,045	900,348	113,936 (Alcohol + Tobacco)
Total expenditure as a % of revenue (LKR Mn, 2018)	0.25%	0.46%	0.88%
As a % of total gov. revenue	53.7%	46.9%	6.7%
Office Building			
Key objective	Border control and revenue collection	Revenue collection	Vice prevention and revenue collection
Effecting changes to tax policy	Through gazettes authorized by the Minister of Finance	Through changes in the parliamentary law	Through gazettes authorized by the Minister of Finance

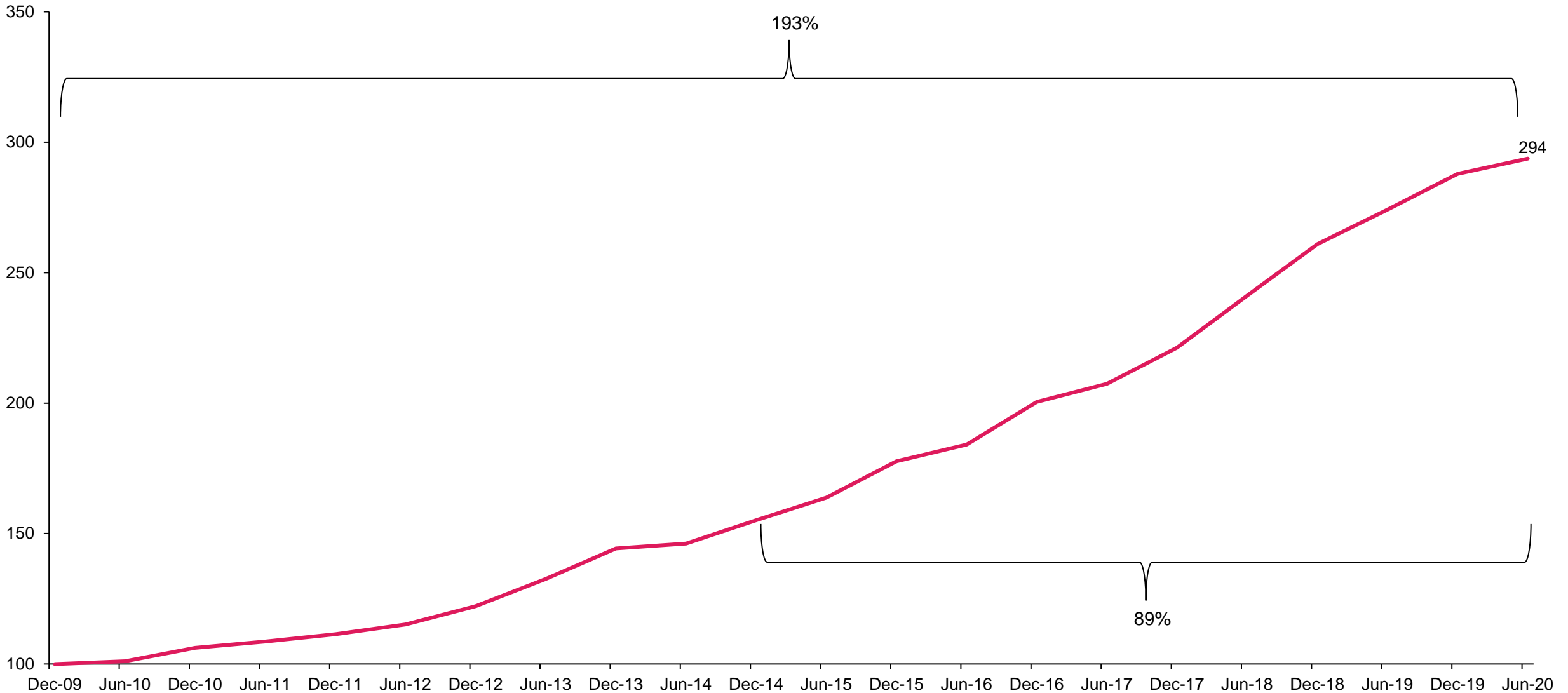
Details of Taxpayer Registration (2018)

Number of Registered Taxpayers as at 31.12.2018		
Income Tax		
<u>Corporate</u>		
Resident Co./ Non – Resident Co.	53,260	
<u>Non - corporate</u>		
Individuals	249,759	
Partnerships	17,033	
Bodies of Persons	804	
Employees paying Income Tax under PAYE	664,828	
Total Income Taxpayers		986,684
Other Taxpayers		
Persons and Partnerships registered for ESC	15,587	
Persons registered for VAT	26,647	
Persons registered for VAT on Financial Services	235	
Persons registered for NBT	95,127	
Persons registered for NBT on Financial Services	235	
Persons registered for Betting Levy Taxpayers	633	
Persons registered for Gaming Levy Taxpayers	4	
Total Other Taxpayers		138,468

Total Other Taxpayers		138,468
Employers Registered under PAYE Scheme	37,230	
Withholding agents registered for Withholding Tax on Interest (Withholding Agents)	492	
Withholding Tax on Specified Fess (Regular monthly schedules Senders)	9,768	
Stamp Duty (Regular Monthly Schedules Senders)	9,914	57,404
Total Number of Tax Files/ Taxpayers as at 31.12.2018		1,182,736

Should property taxes be imposed, say 0.5% of value above Rs 20 mn

Colombo District Land Price Index, Dec 2009 = 100



Why is there an excess reliance on indirect taxation ?

- Indirect taxes are mainly collected through customs and excise, any changes to tax policy are done by way of Gazettes, aka mid night ones, which are within the powers of the Finance Minister.
- Changes to direct taxes require amendments to legislation that require a parliamentary approval process requiring navigating the political economy.
- The tax effort is greater in direct taxation, there are more moving parts in computing the assessable income which requires more effort and skill.
- The bulk of indirect taxes are collected from 4 items – Cigarettes, Liquor, Petroleum and Vehicles. In the case of the first 3 there are only limited producers – Cigarettes (Ceylon Tobacco), Liquor (mainly Distilleries and Lion Breweries) and Petroleum (Lanka IOC and Ceylon Petroleum).

Taxes are only paid when you are successful. It is the price we pay for a civilized society.

Countries in which citizens pay more taxes enjoy better governance.



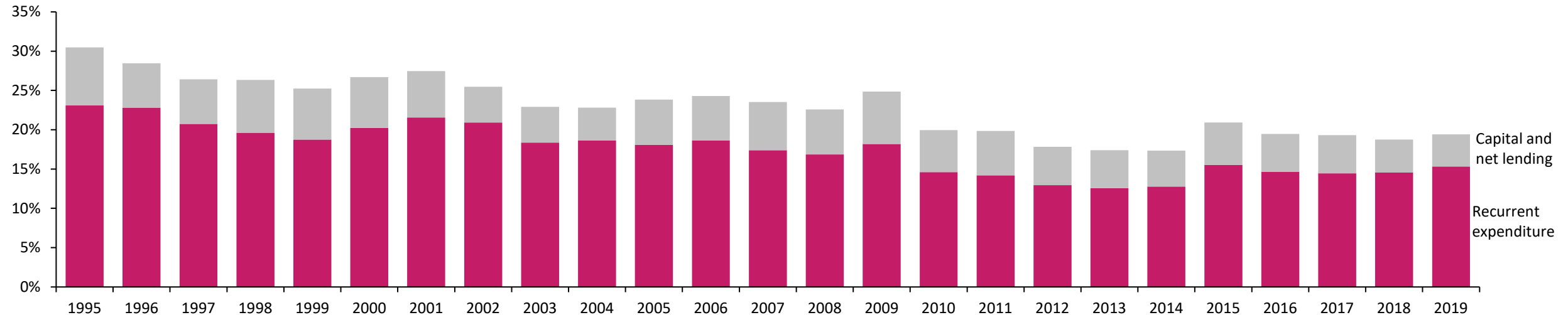
Expenditure

Government expenditure has been trending down

LKR bn

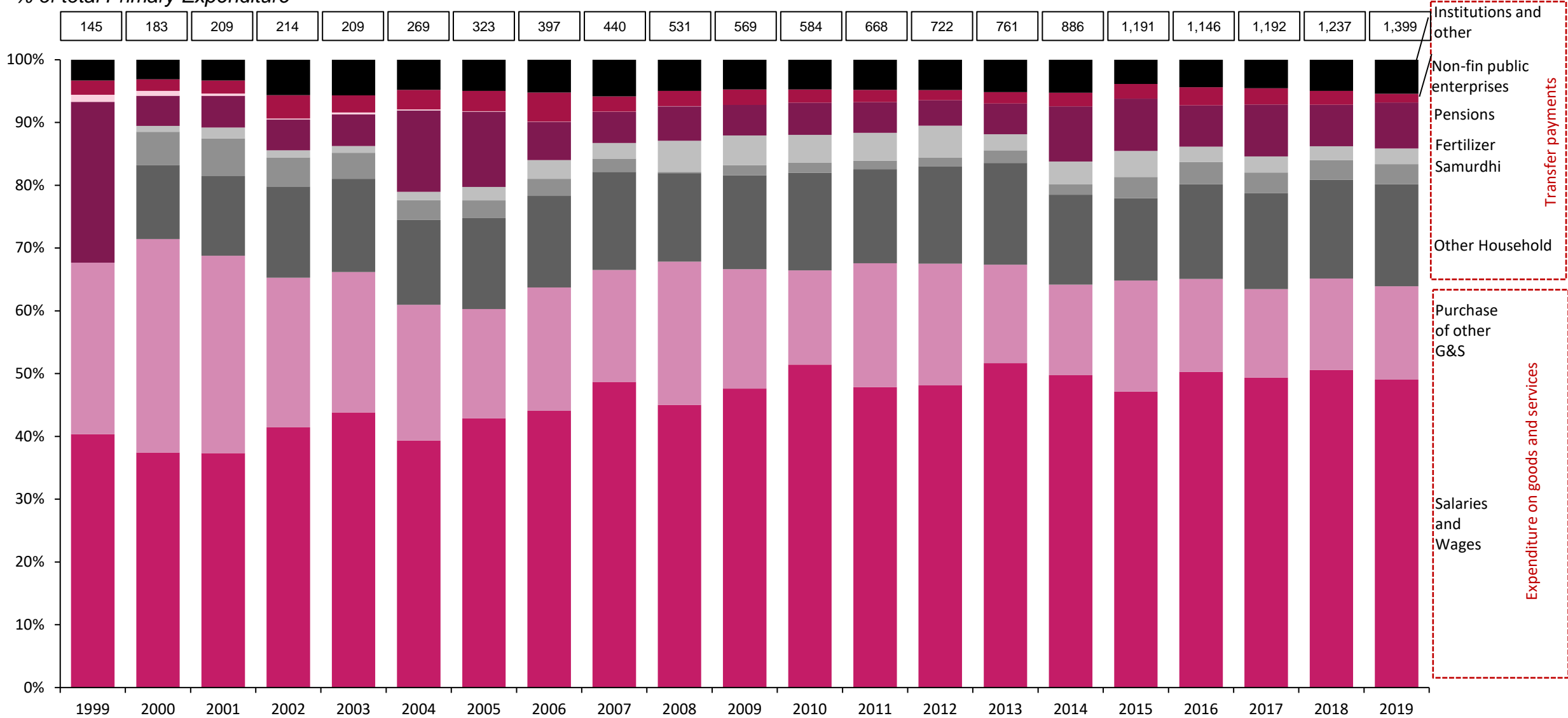


% of GDP



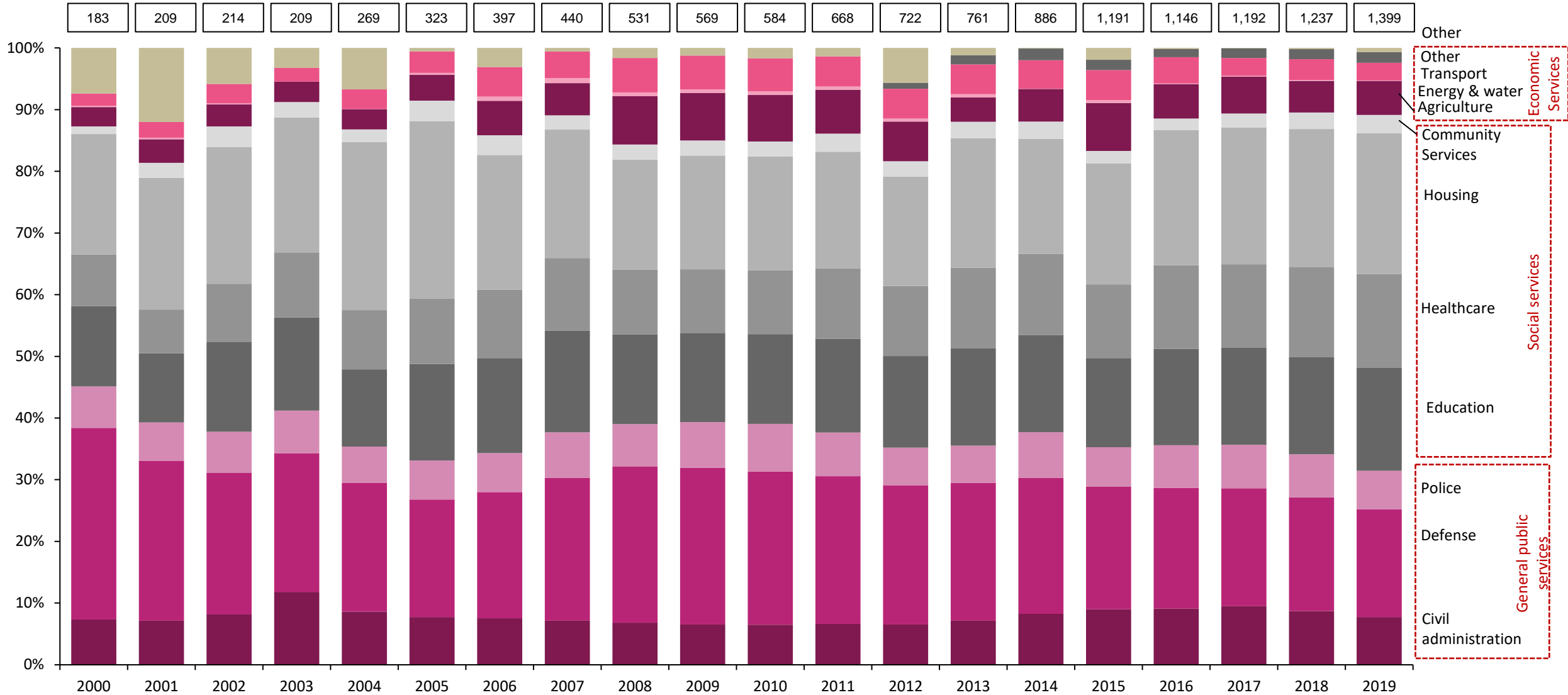
Economic classification of primary expenditure

% of total Primary Expenditure



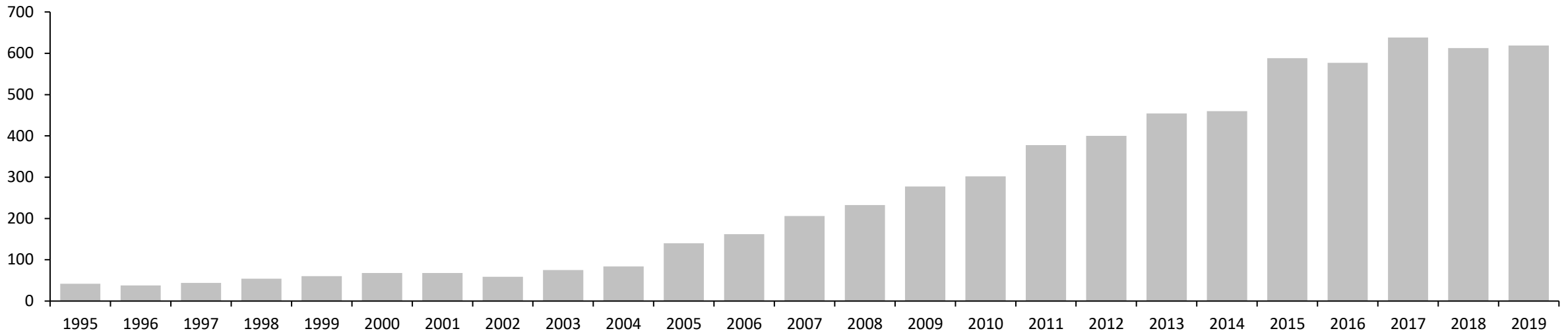
Functional classification of primary expenditure

% of total

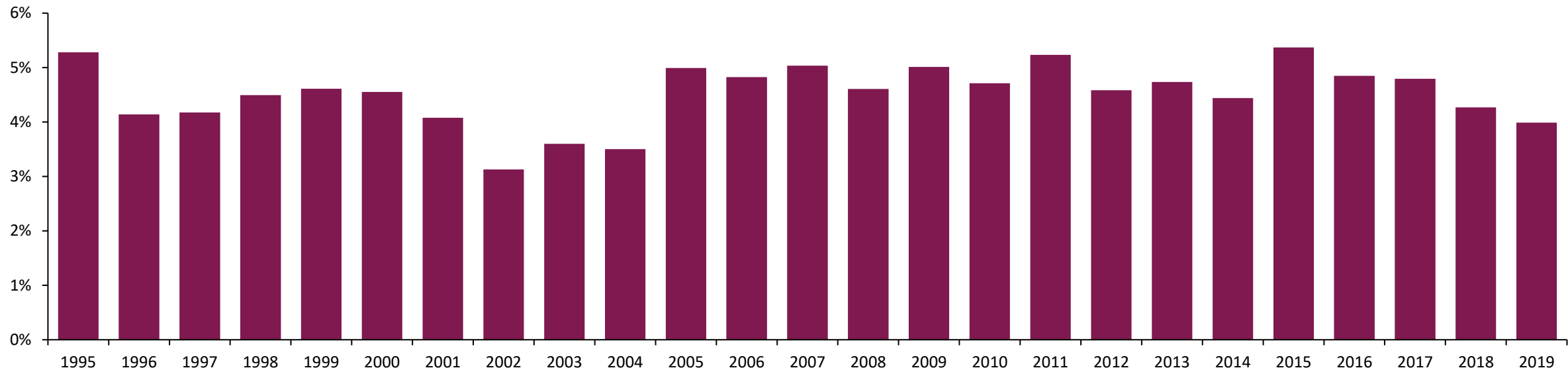


Capital expenditure has been declining...will impact growth...perhaps PPP are an option

LKR bn

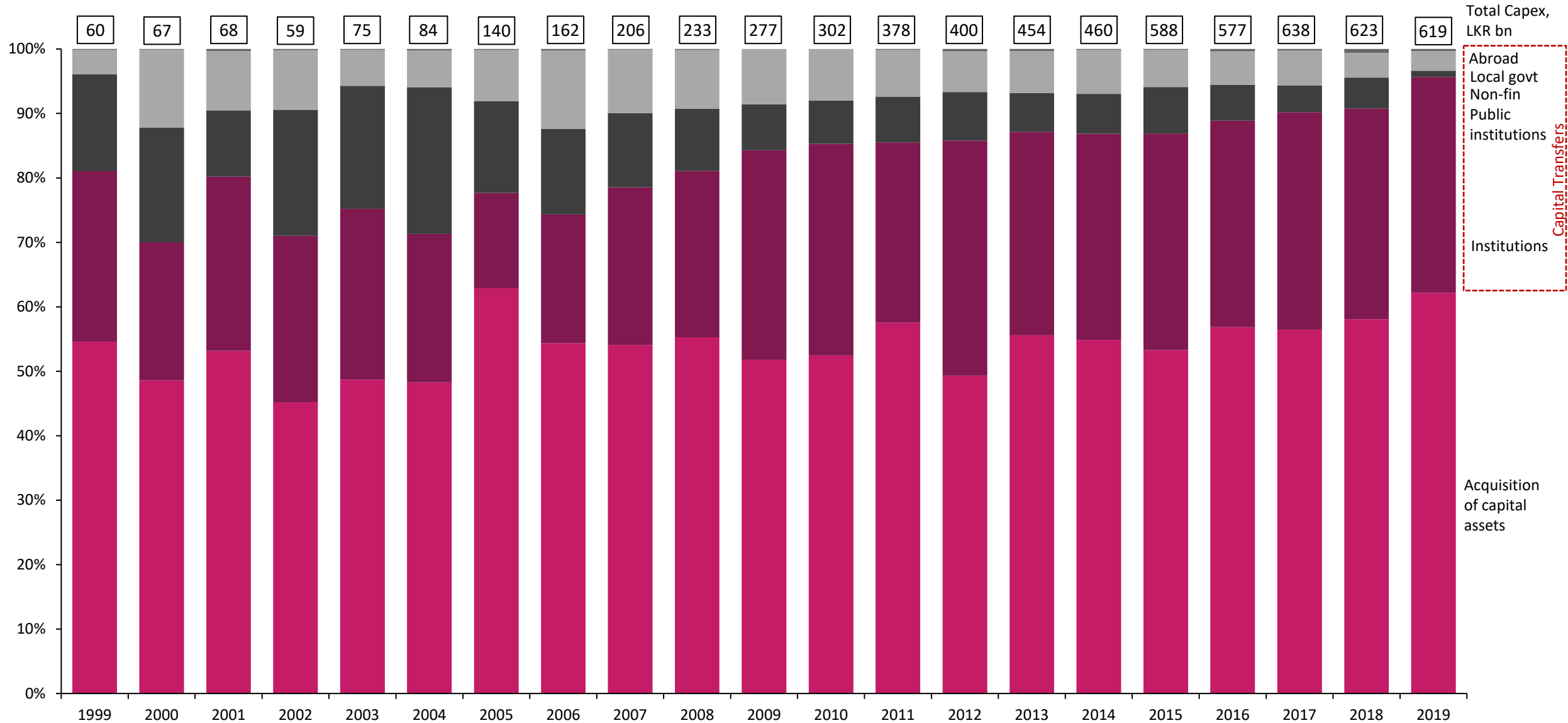


% of GDP

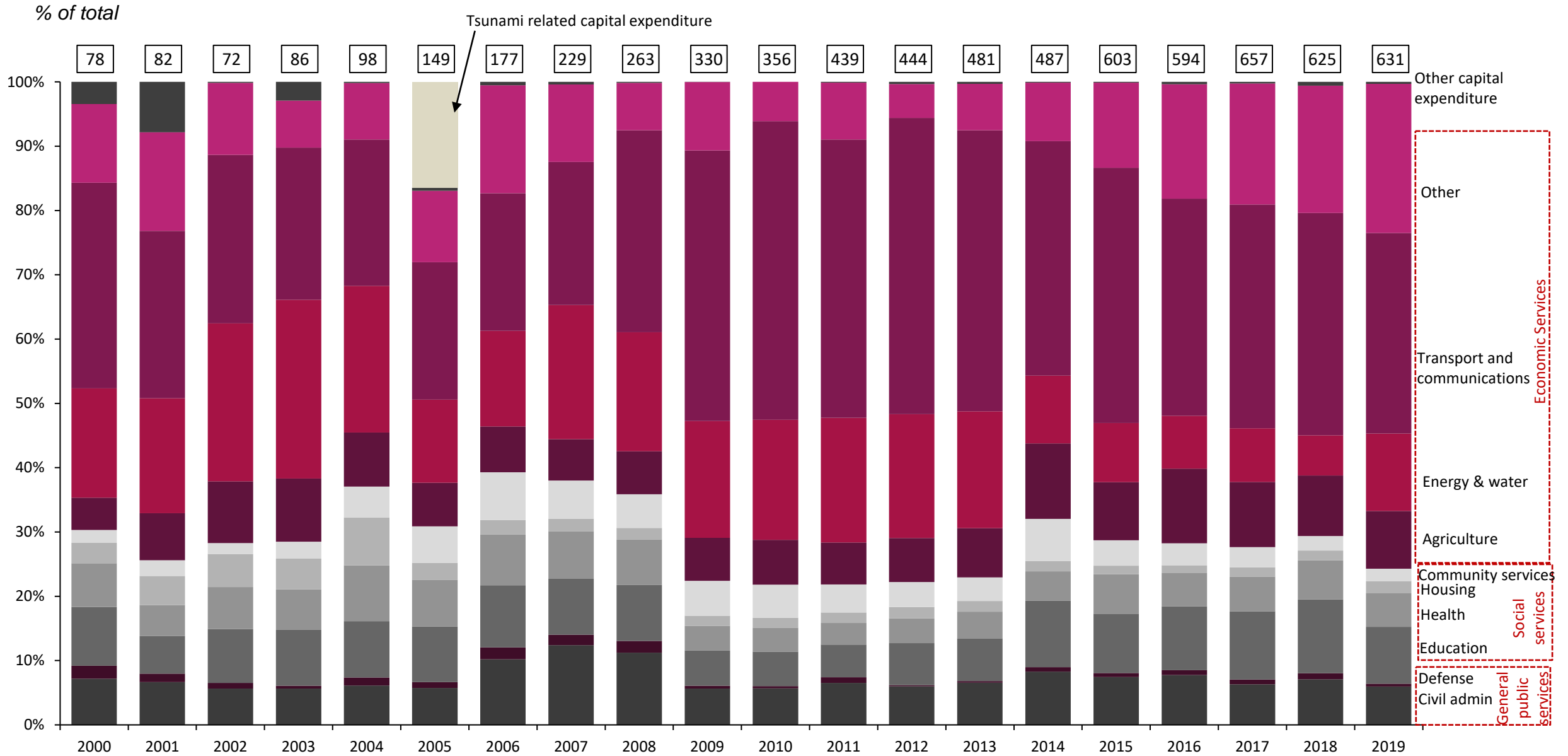


Economic classification of capital expenditure

% of total

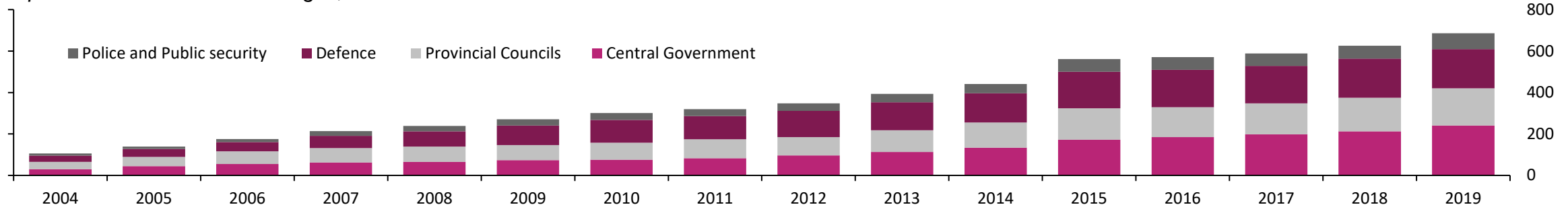


Functional classification of (net) capital expenditure

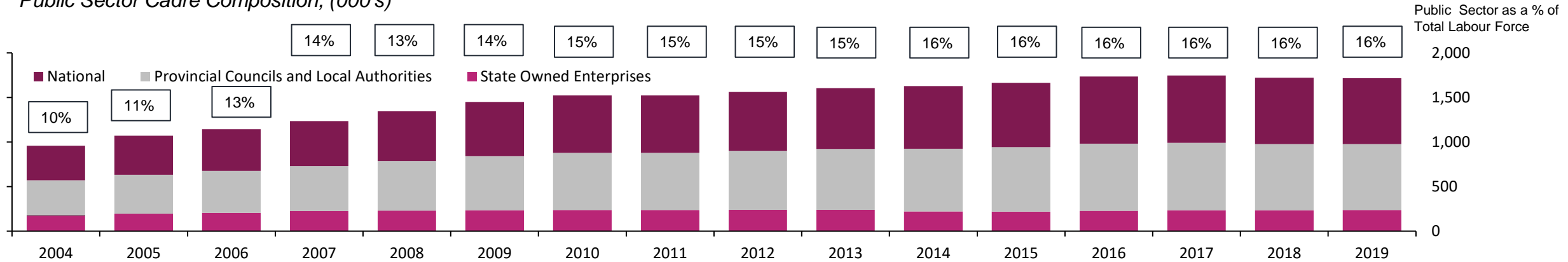


A major component of primary expenditure

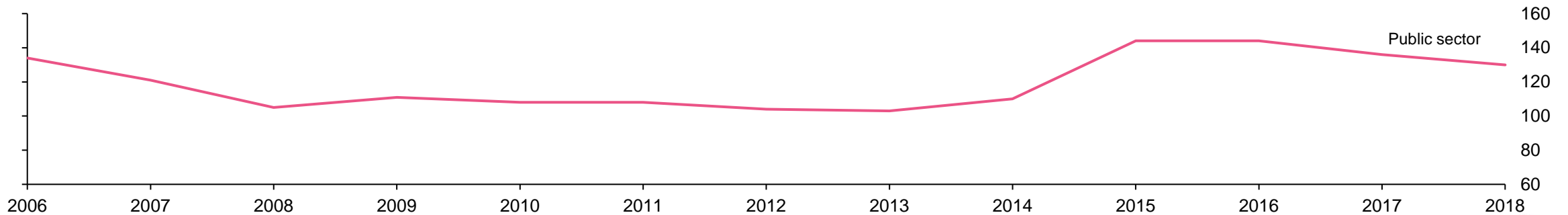
Expenditure on salaries and wages, LKR bn



Public Sector Cadre Composition, (000's)

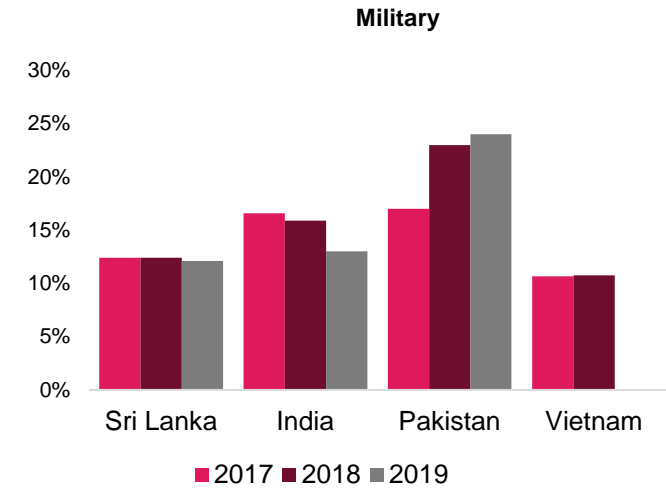
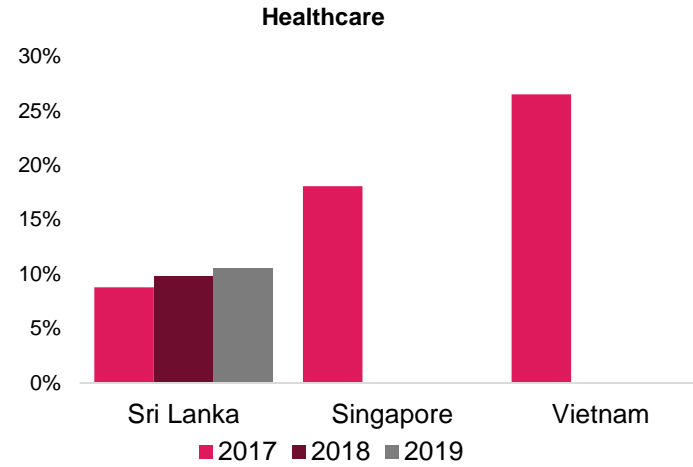
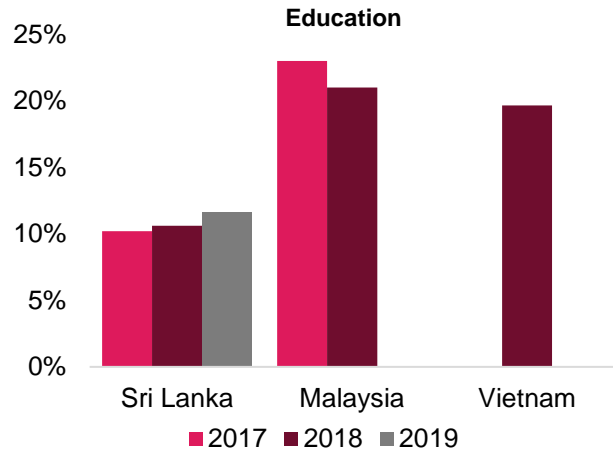


Real Wage Index

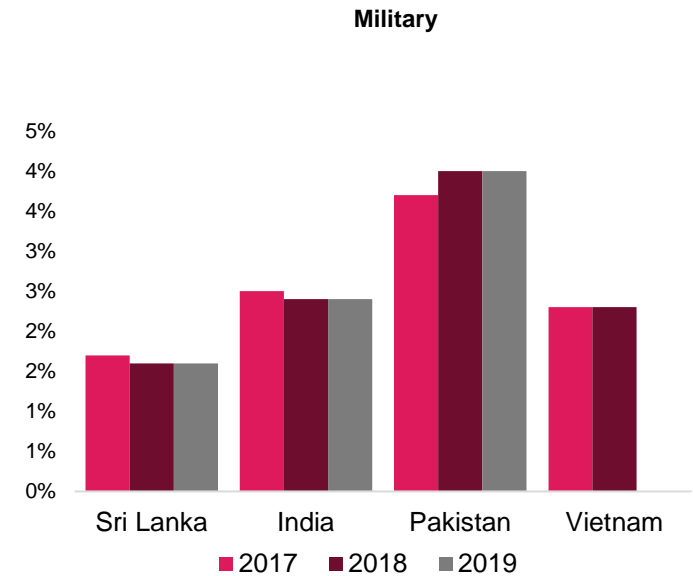
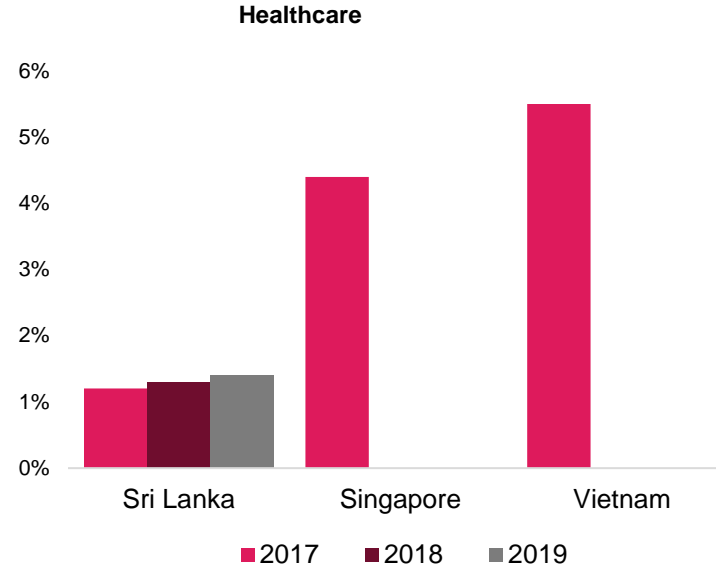
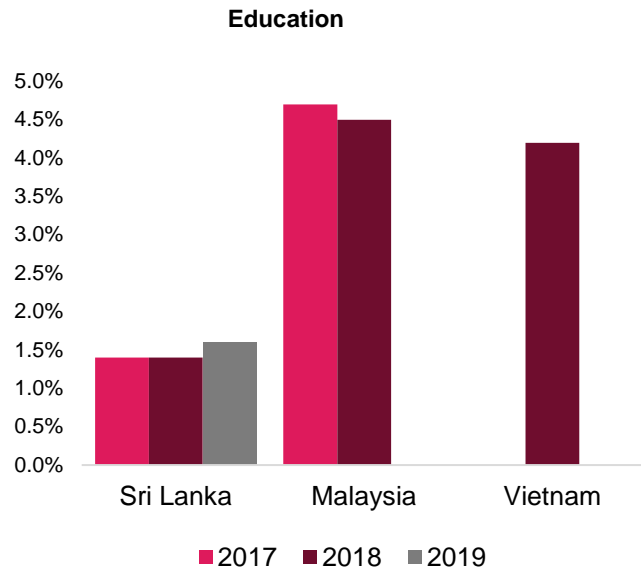


Where have we spent the money

As a Percentage of Primary Expenditure



% of GDP

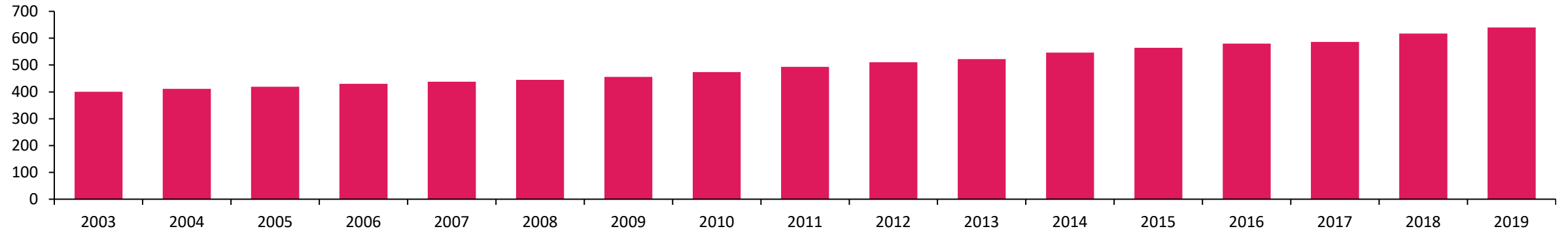


Pension expenditure has been growing

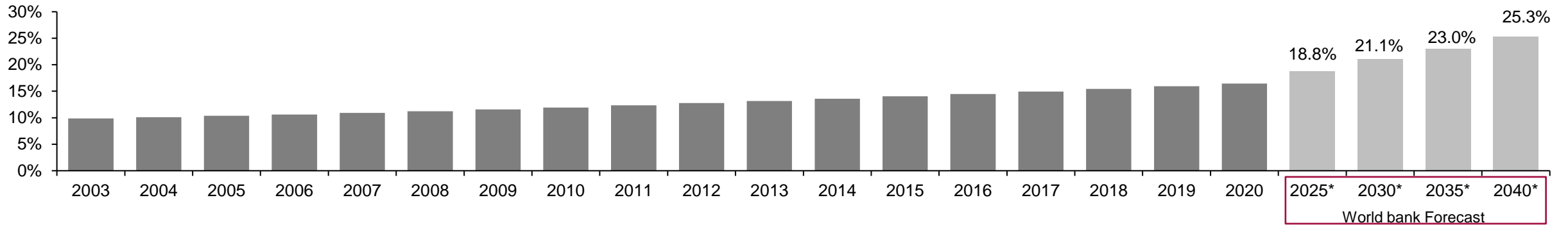
Pension expenditure, (000')



Number of pensioners, (000')



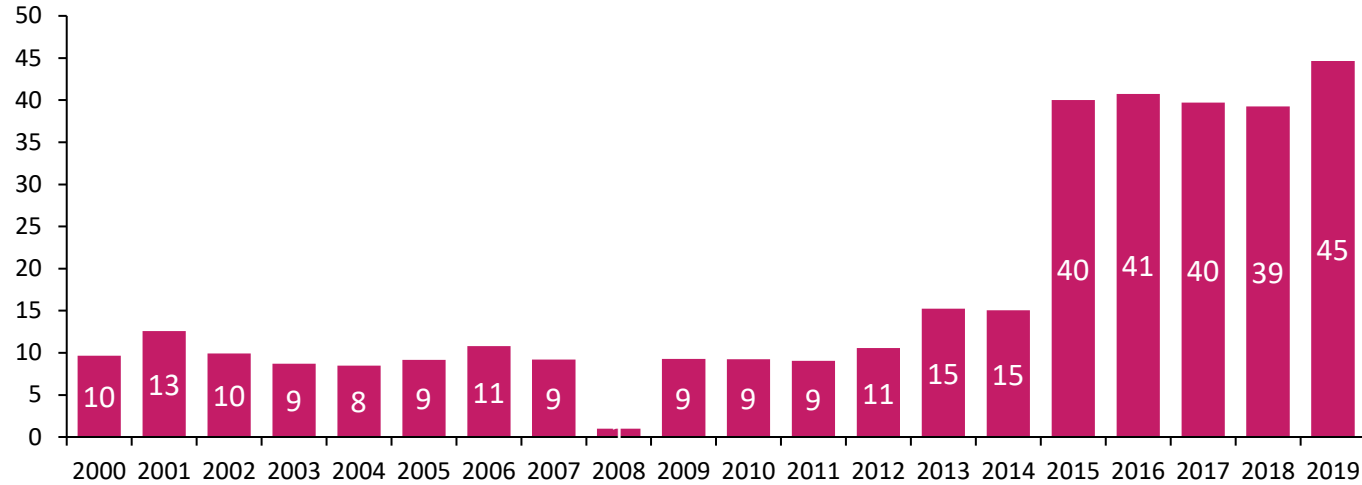
% of total population over 60 years



Subsidy programs

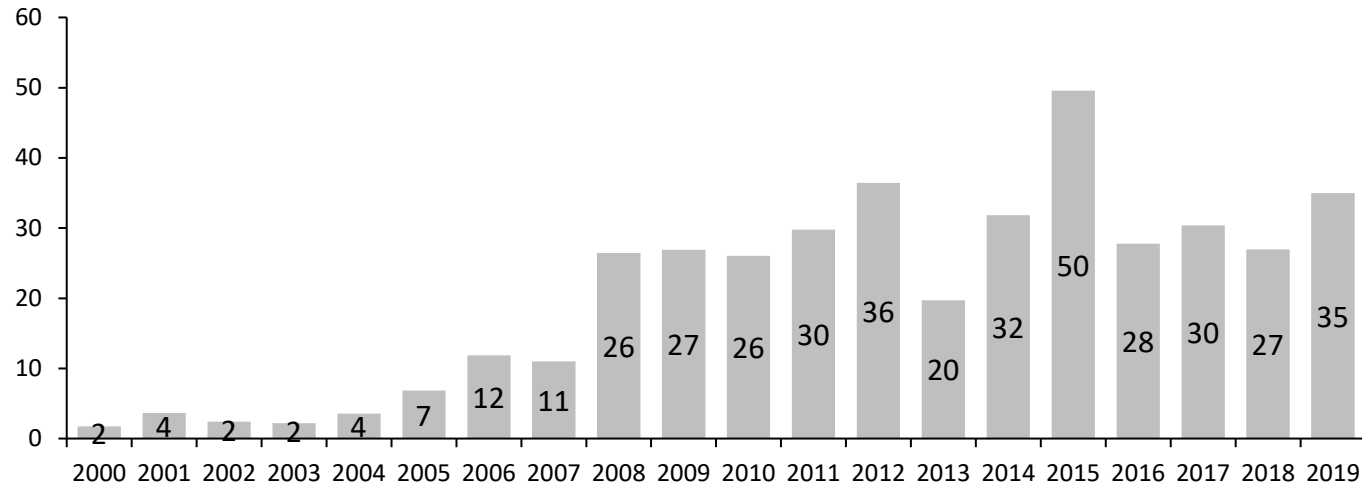
Samurdhi Payments

LKR bn



Fertilizer Subsidy

LKR bn



Subsidies are also transferred through SOE's

Electricity

If consumption is less than 60kWh per month

Monthly Consumption (kWh)	Unit Charge (LKR/kWh)
0-30	2.50
31-60	4.85

If consumption is above 60 kWh per month

Monthly Consumption (kWh)	Unit Charge (LKR/kWh)
0-60	7.85
61-90	10.00
91-120	27.75
121-180	32.00
>180	45.00

In 2019 the average cost per unit was LKR 23.29

Kerosene was sold at a loss of LKR 30 per liter in 2018

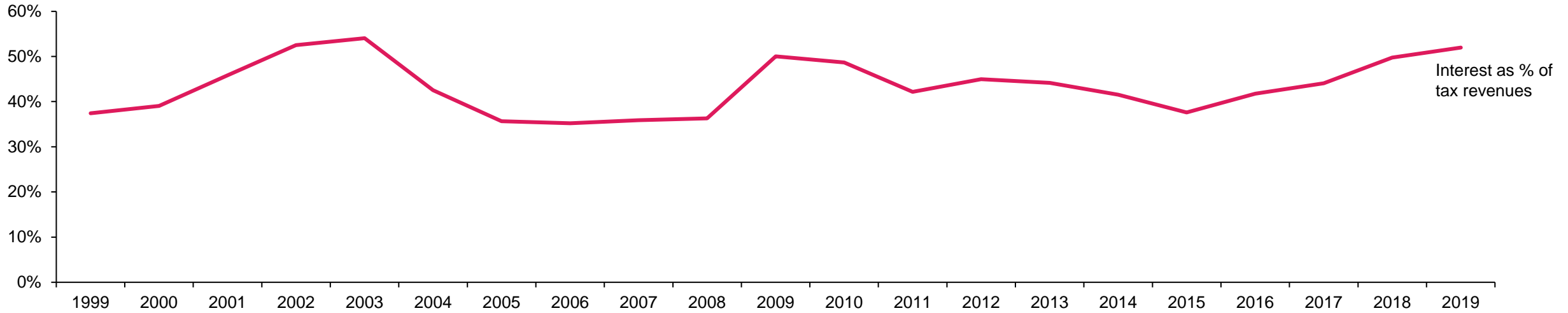
Railways issue season tickets at a significantly cheaper rate

Water

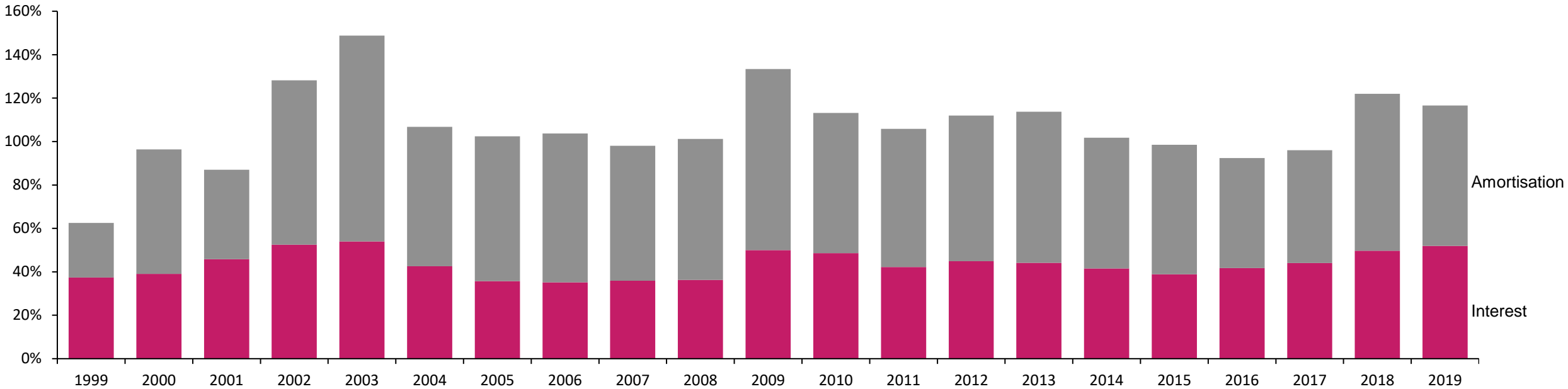
No of Units	Unit Charge (LKR/Unit)	Monthly Service Charge
0-5	12.00	50.00
6-10	16.00	65.00
11-15	20.00	70.00
16-20	40.00	80.00
21-25	58.00	100.00
26-30	88.00	200.00
31-40	105.00	400.00
41-50	120.00	650.00
51-75	130.00	1,000.00
Over 75	140.00	1,600.00

More than 50% of revenue was paid as interest in 2019

Interest as a % of tax revenue, %



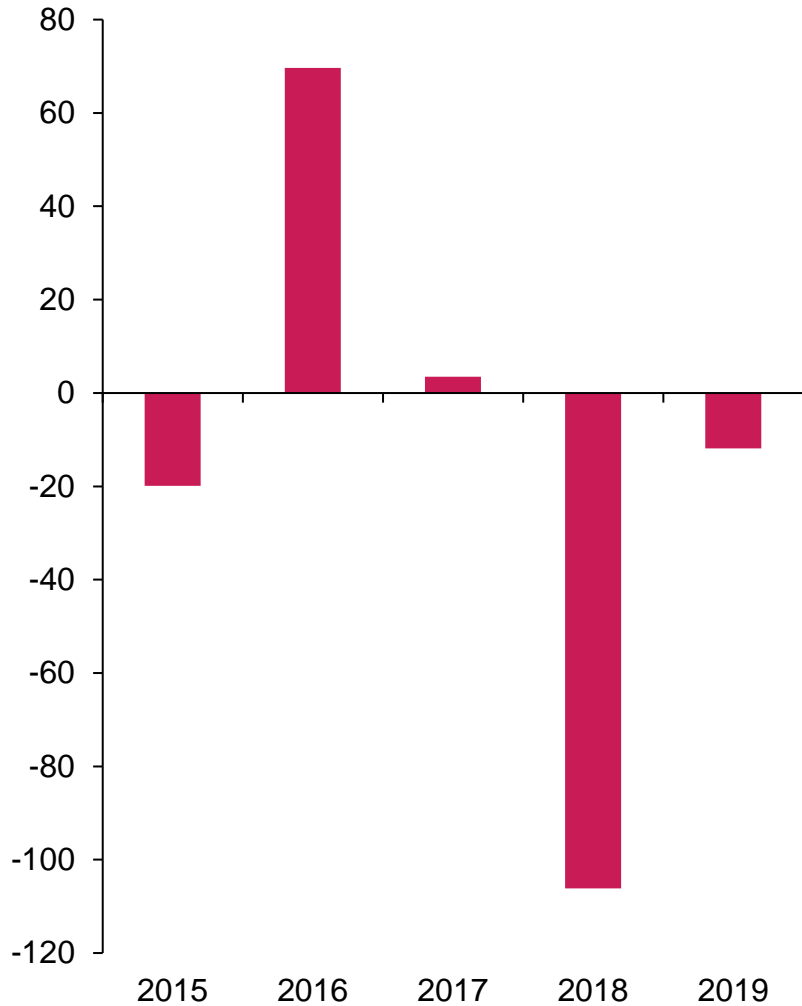
Debt service as % of revenues



State Owned Enterprises incur massive losses

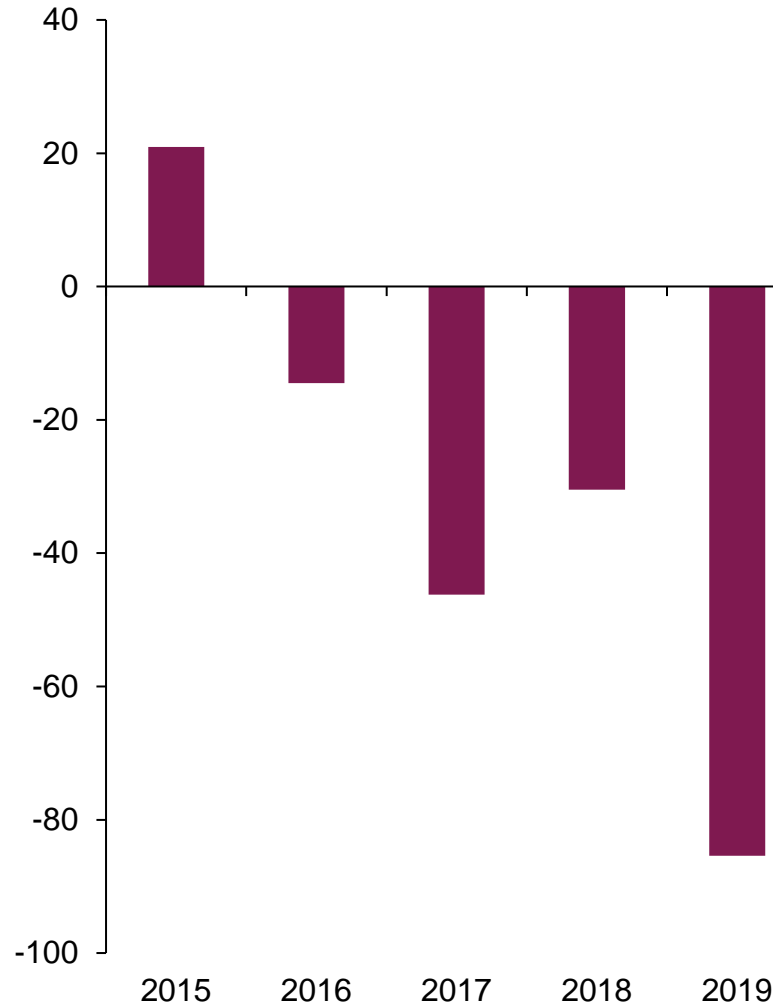
Ceylon Petroleum Corporation

Profit/(Loss), LKR Bn



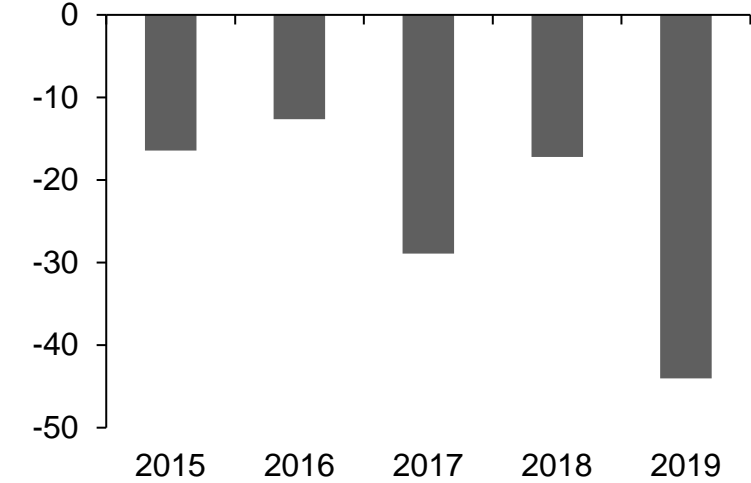
Ceylon Electricity Board

Profit/(Loss), LKR Bn



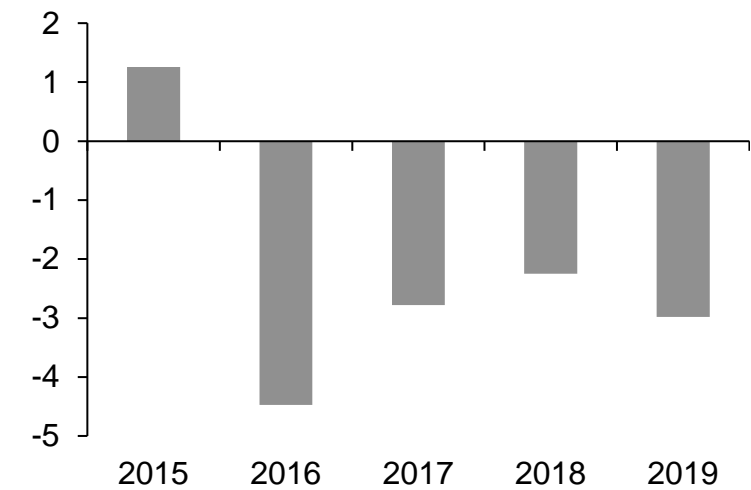
Sri Lankan Airlines

Profit/(Loss), LKR Bn



Lanka Sathosa

Profit/(Loss), LKR Bn



Profitability of 52 SOE's

	Enterprise	Profit/(Loss) LKR Mn	Business Turnover LKR Mn
1	Bank of Ceylon	29,685	239,116
2	People's Bank	19,666	197,040
3	National Savings Bank	10,462	121,929
4	State Mortgage & Investment Bank	465	6,125
5	HDFC Bank	774	8,090
6	Pradeshiya Sanwardana Bank (PSB)	1,344	27,508
7	Employee's Trust Fund Board	20,570	22,885
8	Sri Lanka Insurance Corporation	18,976	48,774
9	National Insurance Trust Fund	3,009	17,717
10	Sri Lanka Export Credit Insurance Corporation	277	457
11	Agriculture and Agrarian Insurance Board	411	4,684
12	Ceylon Electricity Board	-85,411	254,944
13	Ceylon Petroleum Corporation	-11,835	660,646
14	Sri Lanka Ports Authority	15,777	40,770
15	National Water Supply and Drainage Board	-1,177	26,079
16	Airport and Aviation Services (SL)Ltd	15,234	25,652
17	Sri Lankan Airlines Ltd	-44,023	180,340
18	Sri Lanka Transport Board	1,555	41,975
19	State Engineering Corporation	-954	3,872
20	Central Engineering Consultancy Bureau	340	8,032
21	State Development and Construction Corp.	11	5,057
22	Milco (Pvt) Ltd	-619	10,373
23	National Livestock Development Board	-510	2,769
24	Sri Lanka State Plantations Corporation	-239	581
25	Janatha Estates Development Board	-452	589
26	Kurunegala Plantations Ltd	120	499

27	Chilaw Plantations Ltd	89	446
28	Kalubovitiyana Tea Factory Ltd	-53	971
29	Sri Lanka Cashew Corporation	43	107
30	Lanka Mineral Sands Ltd	2,271	3,891
31	Lanka Phosphate Ltd.	28	530
32	Kahatagaha Graphite Lanka Ltd	31	119
33	Development Lotteries Board	2,897	17,361
34	National Lotteries Board	1,323	21,439
35	State Pharmaceuticals and Manufacturing Corp.	592	5,647
36	Sri Lanka Ayurvedic Drugs Corporation	3	706
37	State Pharmaceuticals Corporation	2,176	51,885
38	Sri Jayawardanapura General Hospital	-94	4,587
39	Independent Television Network Ltd	-587	1,142
40	Sri Lanka Rupavahini Corporation	-501	1,742
41	Sri Lanka Broadcasting Corporation	-105	660
42	Sri Lanka Handicraft Board	123	617
43	State Timber Corporation	317	4,282
44	STC General Trading Company	-31	3,474
45	Lanka Sathosa Ltd	-2,982	26,242
46	State Printing Corporation	-169	1,593
47	Ceylon Fisheries Corporation	-28	2,726
48	Ceylon Fishery Harbour Corporation	20	245
49	Ceylon Fertilizer Company Ltd	120	1,870
50	Colombo Commercial Fertilizer Company Ltd	306	1,156
51	Hotel Developers Lanka PLC	-361	2,878
52	Lanka Sugar Company Ltd	-1,308	7,546



Fiscal consolidation and measures to control over borrowing

Fiscal consolidation

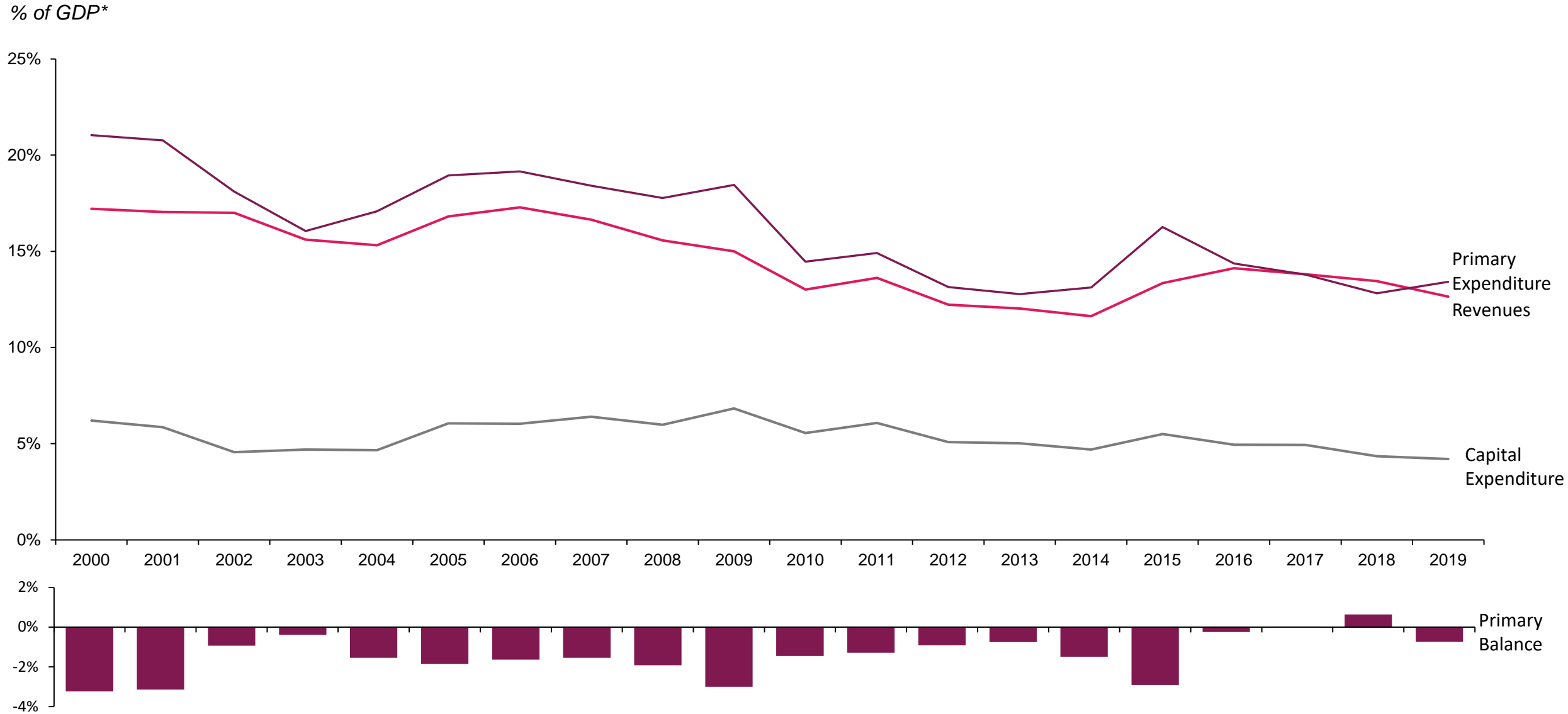
Denotes budgetary measures taken by the government to improve its fiscal position and reduce debt to GDP.

- Measures taken by the budget to enhance revenue and curtail expenditure
- Discretionary, automatic improvements in the fiscal position due to favorable conditions
e.g. a commodity boom is not fiscal consolidation

Important factors

- Size of the adjustment
- Pace and duration of the adjustment
- Composition of the adjustment
- Durability

Fiscal Consolidation



Source: CBSL, IMF World economic outlook database 2020, Advocata Research

Size of the adjustment

Looks at relationship between debt and GDP

Impacts:

- Fiscal adjustment reduces GDP in the near term as it reduces the fiscal multiplier
- This will affect the automatic stabilizer (R-G), lowering tax revenue as growth slows
- This effect is even worse in an already depressed economy
- It is more pronounced if financial markets react to short term data points

Feasibility: it is easier to achieve a primary balance than it is to sustain it

The degree of the adjustment is highly dependent on economic and political circumstances
e.g a proportional electoral systems tend to have a deficit bias compared to a majoritarian one

Pace and duration of the adjustment

Should the primary balance adjustment span over several years?

Fine tuning is often not an option for many countries as they are under watch by markets and rating agencies

Fiscal adjustments should be concentrated in years with low multipliers as much as possible. Multipliers are highest when monetary policy is tight, when the financial sector is impaired and the economy is in a severe economic downturn

Excessive backloading of the adjustment could have credibility issue with markets

Adjustment fatigue – the political cost due to intense fiscal effort and prioritization of easy to implement measures over important ones

Composition of the adjustment

Quick fixes or high-quality reform

It is more successful when the markets and population perceive it to be more durable and growth friendly

Tax increases, lowering expenditure or both

Structural models shed light on the impact of these adjustments

Expenditure multipliers

Multipliers are ranked in order of investment, government wages and government purchases
Improvements in efficiency of spending can also save resources

Revenue multipliers

Multipliers are ranked in order of direct taxes, consumption taxes and property taxes.
Broadening tax base and cutting tax exemptions can enhance revenue

Durability

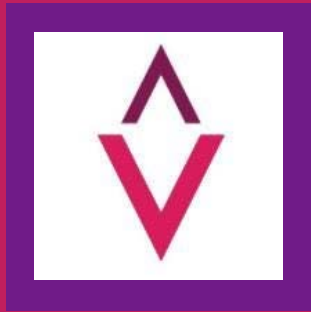
Fiscal adjustment is more lasting when attained through structural reforms that reflect well thought out strategic choices on the role of the public sector. The focus should be on reducing inefficiencies and reorienting the role of the government

Expenditure based consolidation is more durable

Should we have constitutional safeguards to control over borrowing

- Fiscal rules: limit debt accumulation by imposing upper limit
- Budgetary institutions: regulating the preparation and transparency of the budget impact fiscal outcomes





Thank you