



FISCAL STRATEGY REVIEW | NOVEMBER 2023

AMBEON
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Executive summary

This report outlines the fiscal strategy in relation to government revenue, expenditure, SOEs and debt.

Medium term fiscal framework

- Government has set an ambitious target to maintain the total budget deficit below -5% of GDP from 2026 onwards with a primary surplus of 2.3% of GDP.
- The revenue, expenditure, and budget deficit targets for 2025-2026 align closely with IMF projections.

Revenue strategy

- The increase of VAT rate from 8% to 15% and the reduction of the threshold contributed largely to increased revenues in 2023.
- Further reforms to VAT are proposed, aimed at eliminating nearly all exemptions and abolition of SVAT.
- Proposed initiatives focus on broadening the tax net and leveraging technological advancements to augment tax collection.

Expenditure management strategy

- A substantial 76% of government expenditure is allocated to recurrent expenditures, with a significant portion (38%) attributed to interest costs.
- Public investment is set to increase to around 4% of GDP in 2024, emphasizing on prioritized sectors.

Strategy on SOEs

- Key government institutions are expected to be restructured while 20% of the shareholding of two large state banks are proposed to be given to public or strategic investors.

Debt management strategy

- Borrowing limit has been enhanced to LKR 7,350 Bn with LKR 3,000 Bn allocated for foreign debt restructuring.
- Fiscal consolidation and external debt restructuring are yet to be completed to achieve debt sustainability.

Medium-term fiscal framework: 2023-2028

(As a % of GDP)	2022 Actual	2023 (R) estimates	2024 estimates	Projections			
				2025	2026	2027	2028
Total Revenue and Grants	8.3	10.1	13.1	15	15	15.1	15.2
<i>IMF Projections*</i>			13.3	14.9	15		
Total Revenue	8.2	10.1	13	14.9	15	15.1	15.2
Tax Revenue	7.3	9.2	12.1	14	14	14.1	14.2
Non Tax Revenue	0.9	0.9	0.9	0.9	0.9	1	1
Grants	0.14	0.04	0.06	0.04	0.04	0.04	0.04
Total Expenditure	18.5	18.9	20.7**	20.3	19.7	19.3	19.4
<i>IMF Projections</i>			19.7	19.9	19.9		
Recurrent Expenditure	14.6	16	16.8	15.9	15.4	14.9	14.9
o/w Interest Payment	6.5	8	8.4	7.6	7	6.5	6.5
Capital Expenditure and Net Lending	3.9	2.9	4	4.4	4.4	4.4	4.5
Current Account Surplus (+)/ Deficit (-)	-6.4	-5.9	-3.7	-0.9	-0.4	0.2	0.3
Primary Balance Surplus (+)/ Deficit (-)	-3.7	-0.7	0.8	2.3	2.3	2.3	2.3
<i>IMF Projections</i>			0.8	2.3	2.3		
Budget Deficit Surplus (+)/ Deficit (-)	-10.2	-8.7	-7.6	-5.3	-4.7	-4.2	-4.2
<i>IMF Projections</i>			-6.4	-5	-4.8		
<i>Gross Financing Needs (GFN) - IMF projections</i>			17.9	15.4	15.9		

(R) – Revised

Targets to be reached by 2025-2026

Revenue to GDP 15%	Expenditure to GDP 20%	Budget deficit to GDP -5%	Primary surplus to GDP 2.3%	Debt to GDP and GFN Reduce
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*Note: IMF projections were made in March 2023, prior to Domestic Debt Optimization (DDO)

**Note: As per the national budget presented to the parliament, total expenditure is 22.2% of GDP

Source: Ministry of Finance

Revenue enhancement measures already taken

VAT rate increase

- The major contributor to government tax revenue increase between Jan-Sep 2023 was VAT increase
- Gradual increase in the **VAT rate from 8% to 15%** over the course of 2022.
- Effective measures to boost revenue collection through consumption taxes.

VAT threshold reduction

- Significant reduction in the VAT registration threshold from **LKR 300 Mn to LKR 80 Mn** in October 2022.
- Aimed at broadening the tax base by including more businesses in the VAT net.

Corporate Income Tax (CIT) Rate Adjustment

- The standard **CIT rate raised from 24% to 30%** in October 2022.
- **Removal of sector-specific exemptions and concessional rates** to ensure fairness across industries.

Advanced Personal Income Tax (APIT)

- Amendment of **APIT rates from 6% to 36%** for every LKR 500,000 per annum.
- Reduction in the tax-free allowance from **LKR 3 Mn per annum to LKR 1.2 Mn** per annum.
- Measures aimed at increasing revenue from high-income individuals.

With Holding Tax (WHT)

- Introduction of mandatory **non-final withholding taxes** on all payments except dividends.
- Implementation of **final withholding tax for dividends** from January 2023.
- Streamlining tax collection through a withholding mechanism for various income streams.

Government revenue, including grants, surged by 46.1% in the first nine months of 2023, reaching LKR 2,118.7 Bn from LKR 1,450.4 Bn in the same period of 2022.

However, the tax revenue fell short of the targets set under the IMF-EFF Program mainly due to the underperformance of import-based taxes as a result of continued import restrictions, weak tax administration and unanticipated developments in macroeconomic variables.

Revenue enhancement strategy for 2024 and beyond

Further VAT reforms

- **Removal of almost all product-specific VAT**
- Abolishing the **Simplified VAT** (SVAT) system
- Further, a **property tax** is being designed to be implemented in 2025

Broadening the Tax Base

- Implementation of a policy to initiate tax files for **all individuals above 18 years old**, starting with professionals
- Aimed at bringing **non-taxpayers into the tax net**.

Enforcement Strengthening

- Enhancement of enforcement measures through the bolstering of the **Large Taxpayers' Unit (LTU)**
- Establishment of the **High Net Worth Individuals' (HNWI) Unit**

Technological Upgrades and Focus

- Upgrade to **RAMIS 2.0**, with a shift in focus toward current period return filing and assessing large/wealthy taxpayers.
- Future plans to process all tax collections exclusively through RAMIS for streamlined operations.

Simplification of Online Services

- Plans to **simplify the online portal** for Individual Tax Identification Number (TIN) registration and Personal Income Tax (PIT) filing
- Enhancing accessibility and usability for taxpayers.

Introduction of Key Performance Indicators (KPIs)

- Introducing Key Performance Indicators (KPIs) for the IRD focused on improving **audit effectiveness**, **enhancing tax return filing**, **recovering collectible revenue**, and increasing registration.

Expenditure management strategy

Challenges faced in 2023

- Government expenditure surged by 38.5%, reaching LKR 3,732.3Bn in the first nine months of 2023 from LKR 2,694.8Bn in the same period of 2022.
- **Interest cost absorbed a substantial 89.8% of government tax revenue, posing challenges in managing overall expenditure.**
- Interest Payments surged by 87.3% to Rs. 1,737.3 billion, primarily due to elevated interest rates on domestic borrowing through government securities (Treasury Bills and Bonds).
- **Goods and Services Expenditure increased by 76.8% to Rs. 208.7 billion, driven by escalating prices of fuel, electricity, and other commodities.**

Strategy for 2024 and beyond

- Budget 2024 allocated LKR 6,978 Bn as total expenditures, of which 76% are recurrent expenditures predominantly comprising interest. Total expenditure indicates a growth of 33%YoY for 2024, compared to 2023 estimates.
- Public investment is set to increase to around 4% of GDP in 2024, **emphasizing prioritized sectors** crucial for economic development and social welfare. This shift involves redirecting resources away from non-priority areas toward essential sectors.
- A critical element of the strategy is the introduction of the **Public Financial Management Bill**, slated for submission to Parliament in 2024. This legislation aims to govern fiscal operations, instilling discipline and transparency in financial management practices.
- Emphasis will be placed on **close cooperation among government agencies**. There will be strict monitoring mechanisms in place to prevent duplication of efforts and ensure the efficient utilization of budgetary provisions. This collaborative approach intends to avoid wastage and enhance overall effectiveness.

Strategy with the SOEs

Progress in 2023

- Total loss of the key 52 SOEs amounting to LKR 726.9 Bn in the first eight months of 2022 has **converted into a total profit of LKR 311.5 Bn in the same period of 2023**
- 38 SOEs recorded a profit before tax of LKR 338.5 Bn and the balance, 14 SOEs reported a net loss of LKR 27.0 Bn.
- Notably, **CPC has contributed to 26.2% of the total profit of 38 SOEs** during the period

Strategy for 2024 and beyond

- The Cabinet of Ministers has approved a comprehensive strategy to **restructure** the balance sheets of 4 key SOEs
- **20% of the shareholding** of the two state banks are proposed to be given to public or strategic investors
- Cabinet of Ministers approved a **restructuring** policy for SOEs, a special guideline on **divestiture** of SOEs and the appointment of Transaction Advisors for the divestment of 7 key SOEs



SOE profits and losses

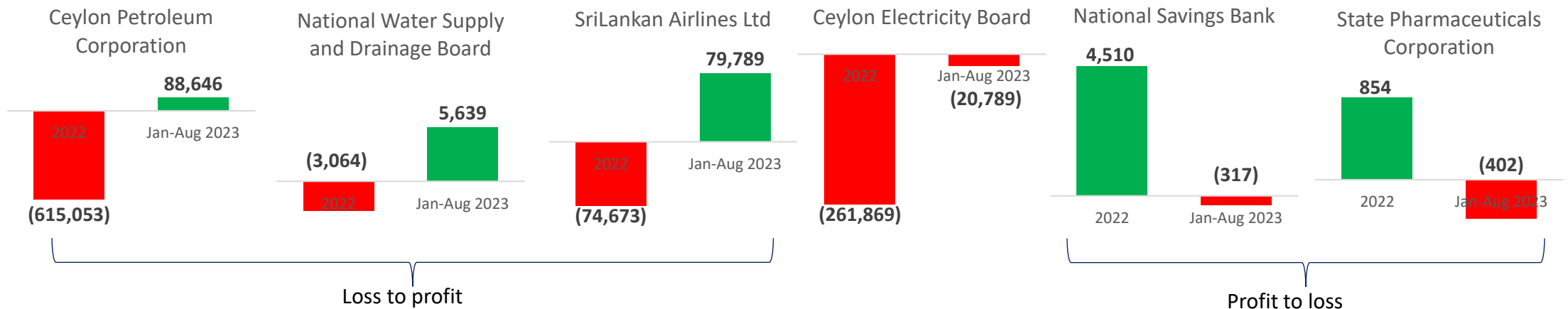
Top 10 profits (Jan – Aug 2023)

(LKR Mn)	Actual 2021	Provisional 2022	Provisional 31.08.2023
Ceylon Petroleum Corporation	-81,816	-615,053	88,646
SriLankan Airlines Ltd	166,370	-74,673	79,789
Employees' Trust Fund Board	33,159	43,428	43,246
Airport and Aviation Services (SL) (Pvt) Ltd	-961	6,433	26,626
Sri Lanka Ports Authority	25,601	57,026	24,464
Sri Lanka Insurance Corporation Ltd	11,725	12,476	19,451
Bank of Ceylon	43,190	30,977	16,116
National Insurance Trust Fund	5,936	8,010	9,933
People's Bank	30,387	21,338	7,353
National Water Supply and Drainage Board	-3,054	-3,064	5,639

Top 10 losses (Jan – Aug 2023)

(LKR Mn)	Actual 2021	Provisional 2022	Provisional 31.08.2023
Ceylon Electricity Board	-34,139	-261,869	-20,789
Sri Lanka Transport Board	-3,054	484	-2,198
State Mortgage & Investment Bank	422	-48	-786
Hotel Developers Lanka Ltd	-976	-633	-628
State Engineering Corporation	-1,597	-940	-568
State Pharmaceuticals Corporation	3,199	854	-402
Sri Lanka Broadcasting Corporation	11	-236	-384
National Savings Bank	28,381	4,510	-317
Sri Lanka Rupavahini Corporation	-229	-541	-279
Milco (Pvt) Ltd	114	-391	-265

Selected SOEs' profits and losses (LKR Mn) 2022-2023



Source: Ministry of Finance

Debt management strategy

Progress in 2023

- With the execution of the DDO program, Treasury bill holdings of the CBSL and the provisional advance, a part of SLDB stock, and a part of Treasury bond holdings of superannuation funds were converted to Treasury bonds with longer maturity.
- Government was able to secure a substantial amount of foreign financing, amounting to USD 1,516.3 Mn, between Jan – Sep 2023.



RESET
USD 495.6Mn



IMF Extended Fund Facility
USD 330Mn



Economic Stabilization Program
USD 350Mn

Strategy for 2024 and beyond

- The budget 2024 **extended the borrowing limit to LKR 7,350 Bn** from LKR 3,900 Bn in the previous year.
- The budget also allocated **LKR 3,000 Bn for foreign debt restructuring** and settlement of International Sovereign Bonds (ISBs)
- 2024 budget focuses on non-bank borrowings to refinance the budget deficit. **Non-bank borrowings comprise 75%** of the total financing.
- As per the IMF target the **Debt to GDP need to be brought down to 98% by 2032** while maintaining the Gross Financing Needs at 13% of GDP between 2027 – 2032 and forex debt servicing at a maximum of 4.5% of GDP during the same period.
- Fiscal consolidation and external debt restructuring** are yet to be completed to achieve debt sustainability.
- The **total budget deficit is aimed to be maintained at 5% of GDP** level from 2025 onwards

Observations

Historical budget compliance failure

- Sri Lanka has faced challenges in meeting budget promises historically. This **history of unmet commitments** raises concerns about the ability to deliver on proposed fiscal strategies effectively.

Revenue Targets and Tax Structure

- The revenue targets **heavily rely on indirect taxes** (goods and services), comprising 54% of the total budgeted revenue and grants for 2024. This dependency on indirect taxes poses challenges, potentially impacting the overall revenue stability and fairness of the tax system.

Revenue Administration and Corruption Mitigation

- The IMF has highlighted the significance of improving revenue administration. **Addressing inefficiencies and corruption within revenue collection is crucial.** Implementing IMF recommendations is necessary to enhance efficiency and transparency in revenue administration.

Focus on Governance and Fiscal Discipline

- There's a growing need for emphasis on improving **governance and maintaining fiscal discipline.** Strengthening expenditure planning, and oversight mechanisms, ensuring transparency in financial transactions, and adhering to fiscal targets are crucial for sustainable fiscal management.

External Debt Restructuring and Debt Sustainability

- Completion of **external debt restructuring** is vital to achieve long-term debt sustainability. Managing the country's debt profile and reducing reliance on external borrowing are critical components of ensuring fiscal stability.

Impact on Interest cost

- **Lower interest rates and potential credit rating upgrades** can alleviate pressure on borrowing costs and interest expenses. These factors can positively influence fiscal outcomes by reducing the financial burden on the government.

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