

PUBLIC REPORT ON THE 2021 BUDGET

Assessment of the Fiscal, Financial and Economic
Assumptions used in the Budget Estimates

November 2020

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in the Budget Estimates

Verité Research

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Verité Research has contributed to the Committee on Public Finance's Budget Reports in the past with a similar objective. To maintain consistency in the analysis, we have used the same structure as much as possible.

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Contents

Section 1: Introduction to the Report	5
1.1. Background.....	5
1.2. Constraints and Qualifications.....	5
1.3. Overview.....	6
Section 2: Informational Standards and Due Diligence	8
2.1. Irreconcilable differences in numbers across different classifications and formats	8
2.1.1. Differences in numbers across reports.....	8
2.1.2. Differences in numbers within a report	10
2.2. Violation of the Fiscal Management Responsibility Act	10
Section 3: Analysis of The Budget Estimates	14
3.1. Missing Estimates.....	14
3.1.1. Fiscal measures with undisclosed or obfuscated consequences	14
3.1.2. Negative fiscal measures with missing estimations	16
3.1.3. Positive fiscal measures with missing estimations	20
3.2. Impractical Assumptions	21
3.2.1. Real GDP Growth.....	21
3.2.2. Inflation.....	21
3.3. Estimate Mismatch	22
3.3.1. Revenue Estimates	22
3.3.2 Interest Payments.....	39
3.4. Unachievable Medium Fiscal Framework.....	41

Section 1: Introduction to the Report

1.1. Background

The 2021 budget presented to parliament on 17 November 2020 sets out the government's proposals for raising public funds through taxation and proposals for expenditure during the year. These proposals form the key components of the executive's management of public finance. Therefore, it is in the public's interest that the assumptions and estimations used to arrive at such proposals are subject to objective and robust analysis.

This is a public report compiled by Verité Research, which engages a similar mandate to that of the parliamentary Committee on Public Finance (COPF). It provides an assessment and analysis of the fiscal, financial and economic assumptions and estimates applied in the budget. It aims to inform a wider audience of stakeholders, including the parliament, and COPF. Verité Research anticipates that the contents of this report can improve informed engagement, in public and in parliament, with Sri Lanka's annual budget.

The assessment was based on three sources: (1) the numbers provided in the 2021 Budget Speech presented in parliament on 17 November 2020; (2) draft budget estimates for 2021 provided to the parliament on 17 November 2020; (3) updated detailed estimates given by the MoF to COPF.

The analysis considers the macro-economic framework (relating to debt management, inflation, interest rates, exchange rates, fiscal deficits, and GDP growth) and economic assumptions of the government, where those assumptions have been stated. All numbers in the assessment are set out in current value terms.

In addition to informing the public and other stakeholders including parliament and the executive, this assessment also contributes to improving access to relevant information; and professionalise the process by which budget estimates are constructed. This is expected, in the medium term, to result in better formulated budgets, and thereby to improve public finance outcomes in Sri Lanka.

1.2. Constraints and Qualifications

This report is published within a challenging time-frame, beginning after the budget speech was delivered to parliament and yet, with the objective of completing the assessment before the conclusion of the parliamentary budget debates. There was a further challenge created by the significant variations between data presented in different documents, as well as the complication of different accounting formats adopted in different source.

1.3. Overview

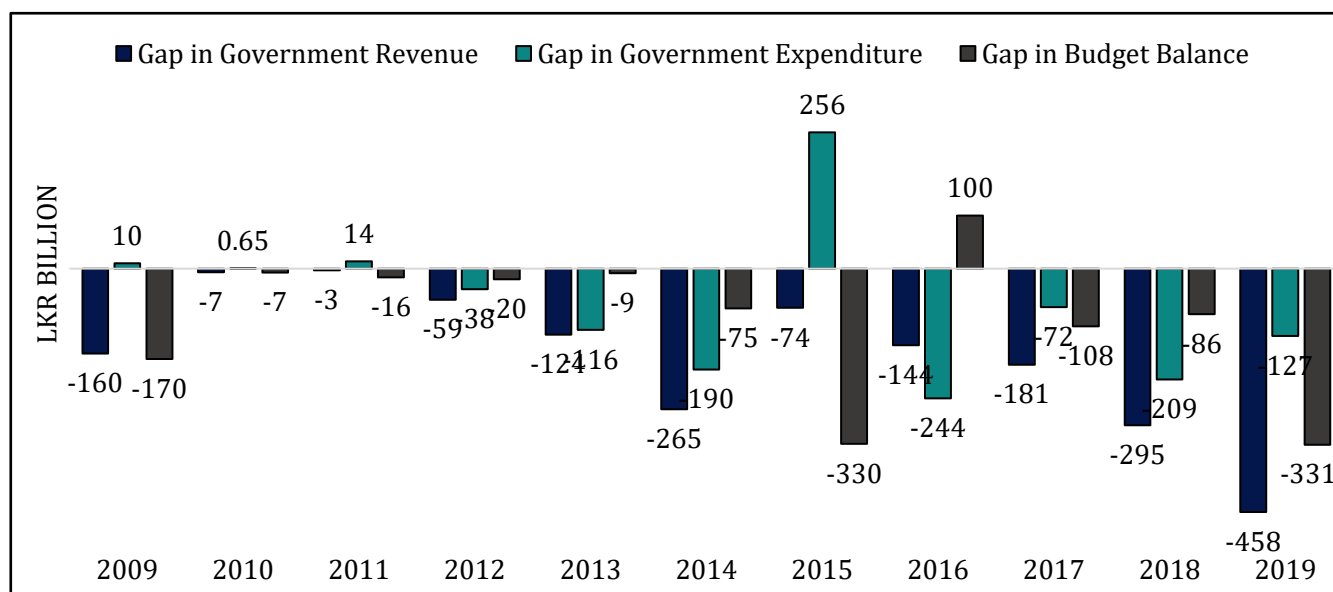
The debate and adoption of the annual budget is a pivotal process in public finance management. For the government, it is perhaps the most important occasion to announce new policies and measures that it plans to take in steering the development of the country. However, almost every such plan will have an implication on public finance. Therefore, what is set out in a budget, which is finally adopted, is of critical importance to the country. In a well-functioning democracy, there must be robust public engagement in the process and outcomes of the management of public finance.

It is hardly necessary to reiterate, therefore, that the ability of the public to understand and engage the budget hinges on the quality of information, estimates, and assumptions that underpin the proposals. In past years, many approved budget proposals have later been shelved or significantly altered, because the estimates and assumptions upon which the proposals were built were later found to have been defective. Such course corrections are costly, and are, in essence, failures of public finance management. Such failures can be minimised if there is public demand for improvements in public finance management and more robust parliamentary debates during the budget process. However, perhaps the greatest impediment to nuanced public demand and more reasoned and rigorous debate in parliament is the paucity of information and analysis that is available to the public and to members of parliament.

This report was compiled by Verité Research and will be hosted on Sri Lanka's online platform, PublicFinance.lk. Through it, PublicFinance.lk will assist the public and other stakeholders in understanding the adequacy, credibility and accuracy of the fiscal, financial and economic assumptions and the revenue and expenditure estimates of budget 2021. In doing so, this assessment also allows these stakeholders, including parliament, to understand where improvements can be made, and engage the executive arm of the government to achieve the necessary change.

Poor estimations are an established pattern

Government revenue has been significantly and constantly overestimated in the past. This trend of higher deviation between the estimated revenue and actual revenue has been increasing over time. The highest deviation was LKR 458 billion in 2019.

Exhibit 1: Estimation Gaps in Revenue, Expenditure and Budget Balance


The miscalculation of government revenue has serious consequences for the economy. Not having adequate revenue to fund the budget means the government will have to cut down on the expenditure commitments given to parliament or increase borrowings in order to fund that expenditure. This is evident through the numbers for the last few years.

Table 1: Variance between the actual and the estimated revenue categories and COPF recommendations (LKR Billions)

Revenue Item	2018	2019
Income Taxes	- 60	43
VAT	- 88	- 85
Excise Taxes	- 51	- 194
Import Duties	- 78	- 42
Other Taxes	- 45	- 65
Non Tax Revenue	24	- 111

Source: Committee on Public Finance reports for 2018 and 2019 Budgets, MoF Annual Reports.

In addition to the overestimation of revenue, the underestimation of interest payment has also been problematic pattern in the budget estimations. In the past five years the deviation or the shortfall in the interest payment estimate compared to the actual was 10%. Interest payments were underestimated consistently in all years, except 2019. The underestimation of interest payments means that when the actual interest payments are higher, the government will have to use funds available from other committed expenditure on the shortfall in allocation.

Section 2: Informational Standards and Due Diligence

Informational Standards and Due Diligence: refers to serious concerns with regard to the internal consistency of data provided and/or with the professionalism and accuracy with regard to generating estimates.

The present section briefly sets out one further concern: the lack of appropriate standards and due diligence in the provision of information. This is highlighted by two types of issues. (1) Irreconcilable differences across classifications and formats; and (2) Violation of the Fiscal Responsibility Act.

2.1. Irreconcilable differences in numbers across different classifications and formats

There are several classifications and formats in which the budget information is presented. However, the public is not provided with a means of reconciling the information that is presented in the different formats.

On the day of the budget speech, the parliament is provided with (1) the budget speech, (2) budget estimates, and (3) the fiscal management report. However, the numbers provided within these reports contain several issues. (1) The numbers across the report contradict each other. (2) the numbers also contradict each other within the same report. Therefore, this leads to circumstances where the public cannot identify the most accurate estimate or reconcile between these reports.

2.1.1. Differences in numbers across reports

The numbers provided in the budget speech and budget estimates report different revenue and expenditure figures. One reason for this could be that there were new budget proposals brought into the budget after the budget estimates were produced. This problem could be minimised by providing a detailed breakdown—similar to that of the budget estimates. Another reason could be that these documents produce estimates in different classifications. This problem maybe generated by the difference in reporting formats. However, it can also be alleviated by a commitment to provide explanatory information on the deviations, which could allow for better interpretation, even within the current formats of reporting.

The following table shows significant deviations in the Budget Speech 2021 from the budget estimates, for which explanatory information has not been provided.

Table 2.1.1: Budget speech numbers vs. budget estimate numbers

Classification of revenue estimates, Budget 2021, *Values in LKR billions*

Budget Speech - Annexure		Budget Estimates		Variance
Revenue Component	Value	Revenue Component	Value	
Total revenue & grants	2,029	Total revenue & grants	1,987	(42)

Tax revenue	1,724	Tax revenue	1,650	(74)
o/w taxes on external trade	530	o/w taxes on international trade	497	(33)
o/w taxes on goods and services	823	o/w taxes on domestic goods & services	778	(32)
		o/w license taxes & others	13	
o/w income tax	371	o/w taxes on income & profits	362	(9)
Non-tax revenue	227	Non-tax revenue	259	32
Provincial council tax sharing and devolved revenue	68	Provincial council revenue	68	Reconcilable
Grants	10	Foreign grants	10	Reconcilable

Source: Budget Speech 2021; Budget Estimates 2021

Classification of expenditure estimates, 2021 Budget Values in LKR billions

Budget Speech - Annexure		Budget Estimates		Comparability
Expenditure Component	Value	Expenditure Component	Value	
Total expenditure	3,594	Total expenditure	3,649	55
Recurrent expenditure	2,534	Recurrent expenditure	2,690	156
o/w Salaries & wages	905	o/w Personal emoluments	635	(270)
o/w Goods & services	188	o/w Goods & services*	244	56
o/w Interest	860	o/w Interest payments	977	117
o/w Transfers	581	o/w Transfers	835	254
Capital expenditure	1,070	Capital expenditure	959	(111)

* Goods & services expenditure is considered to be all other recurrent expenditure other than personal emoluments, subsidies & transfers and interest payments.

Source: Budget Speech 2021; Budget Estimates 2021

Table 2.1.2: Macroeconomic Assumptions used in different report

	2020 Fiscal Management Report	2021 Draft Budget Estimates	2021 Budget Speech
Real GDP Growth Rate	5%	5%	5.50%
Overall Budget Balance (% of GDP)	-8.80%	n/a	-8.90%
Primary Budget Balance (% of GDP)	-3.90%	n/a	-4.00%

Note: All the above-mentioned documents were released on the day of the budget speech (17 Nov 2020).

Source: Budget Speech 2021; Budget Estimates 2021; 2020 Fiscal Management Report

Recommendations

- That the MoF provide a detailed breakdown of the budget speech classification of revenue and expenditure.
- That the MoF provide a full reconciliation/explanation of the differences between the figures in the budget speech and the budget estimates. This should include all discrepancies noted above, as well as any others that exist.

2.1.2. Differences in numbers within a report

While it is problematic to have irreconcilable numbers across different reports, to have irreconcilable numbers within the same report is a deeper concern. It raises questions on professionalism and the budget preparation process.

Table 3.1.1: Different numbers in two different locations of the Budget Speech 2021

Item	Budget Speech – p. 44	Budget Speech Annexure – p. 46
Government Revenue	1,961	2,029
Government Expenditure	3,525	3,594

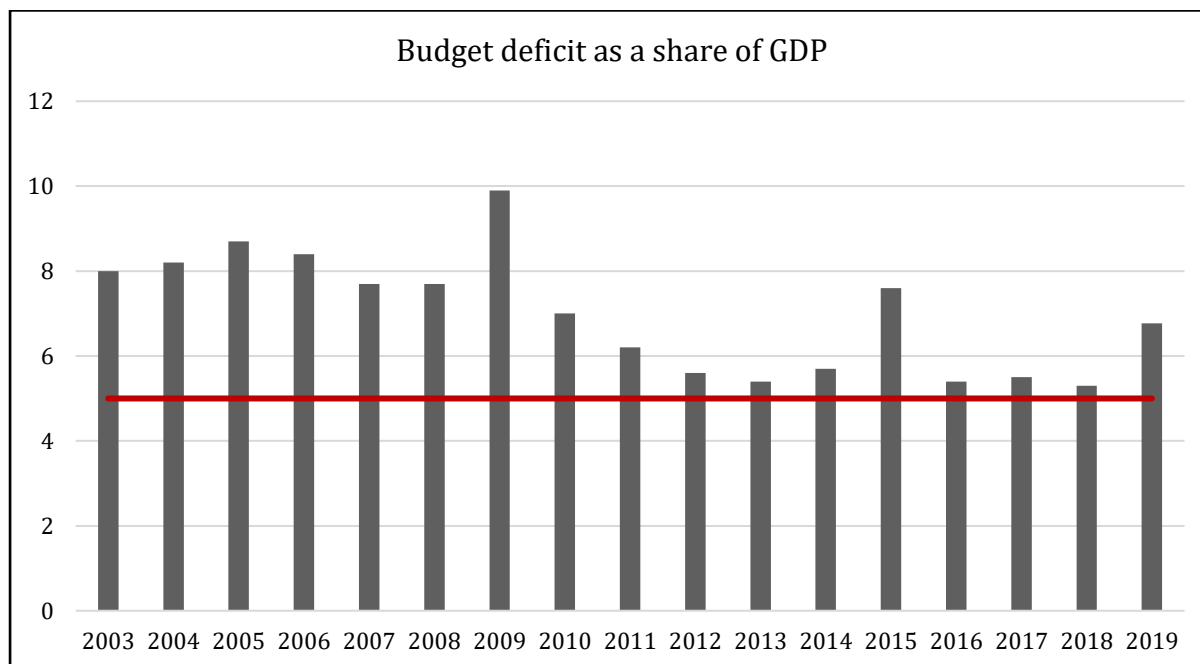
Source: Budget Speech 2021

2.2. Violation of the Fiscal Management Responsibility Act

The Fiscal Management (responsibility) Act (FMRA), No. 3 of 2003 is a piece of legislation enacted to ensure that the principles of responsible fiscal management are entrenched within legislative discipline. The act also provides for measures to enable the public to actively investigate, scrutinise, and oversee the country's fiscal policy and its performance.

The original FMRA, enacted in 2003, limited the budget deficit from exceeding 5% of GDP from 2006 onward. However, the budget deficit as a share of GDP has consistently remained above the set limit, including the proposed budget deficit for 2021.

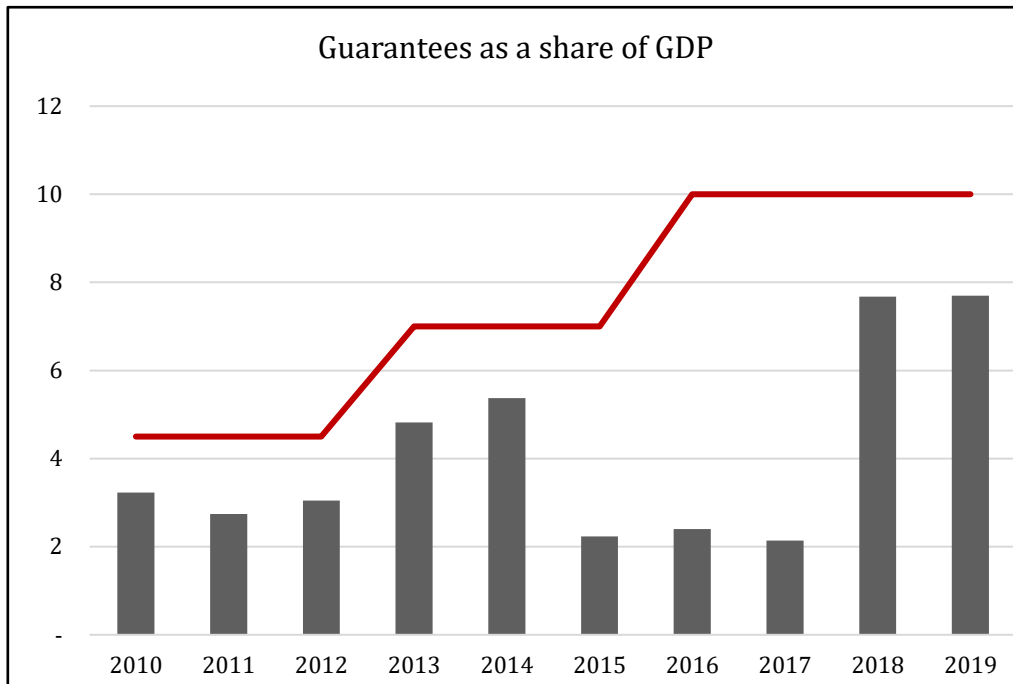
Exhibit 2: Budget deficits across the years



Sources: CBSL Annual Reports, Fiscal Management (Responsibility) Act, No. 03 of 2003, Fiscal Management (Responsibility)(Amendment) Act, No. 15 of 2013 and No. 13 of 2016

The FMRA provides limits on contingent liabilities as well. Sovereign guarantees require the government to repay any amount outstanding on a loan in the event of default. Sovereign guarantees are usually given for State Owned Enterprises. The initial FMRA set out a 4.5% limit for guarantees as a share of GDP in 2003. The limit set out in the act was not violated initially. However, the limits were increased to 7% and 10% in 2013 and 2016 respectively. In November 2020, the finance minister has also proposed to increase the limit further to 15% of GDP.

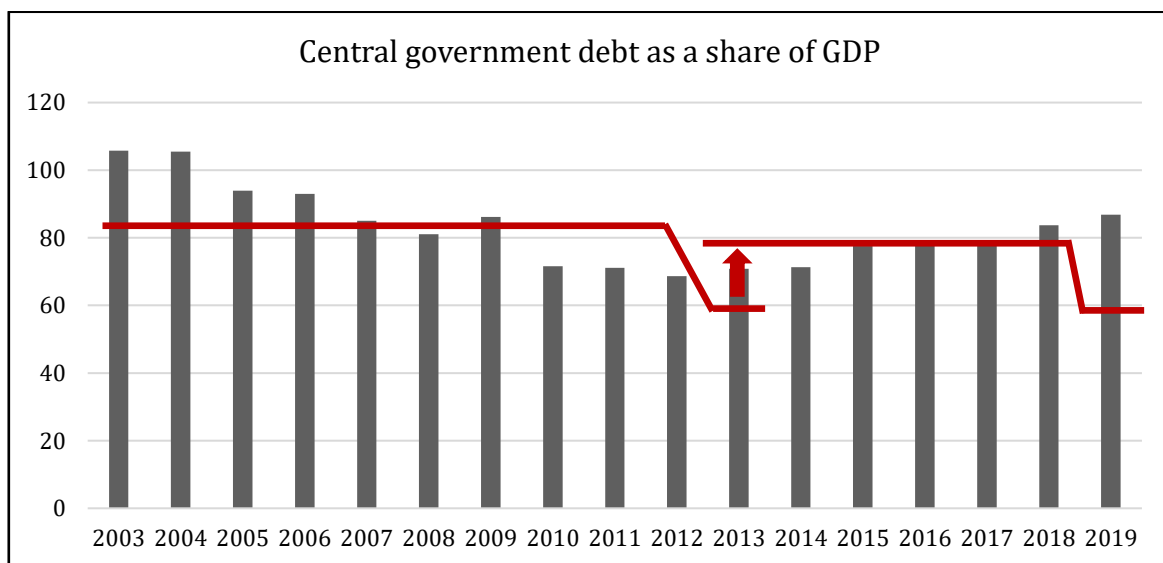
Exhibit 3: Total government guarantees as a share of GDP and the limit set by the FMRA



Sources: CBSL Annual Reports, Fiscal Management (Responsibility) Act, No. 03 of 2003, Fiscal Management (Responsibility)(Amendment) Act, No. 15 of 2013 and No. 13 of 2016

The third limit set in the FMRA is on total liabilities of the government, i.e. the country's total debt. The initial act in 2003 specifies limiting total liabilities, including domestic and external debt at the current exchange rate, to 85 percent of GDP by the end of 2006. It further specifies that total liabilities should not exceed 60 percent of the estimated GDP by the end of 2013. However, this limit was increased through an amendment to the act in 2013. The initial limit set at 60 percent was increased to 80 percent in 2013 and the 60 percent limit was extended till 2020.

Exhibit 4: Central Government Debt over the years, as a share of GDP



Sources: CBSL Annual Reports, Fiscal Management (Responsibility) Act, No.03 of 2003, Fiscal Management (Responsibility)(Amendment) Act, No. 15 OF 2013 and No. 13 of 2016

It is evident that in 2020, the percentage of debt to GDP of the government is well above the 60% limit set in the act. The government has failed to comply with the limits set in the act and will be in violation of it.

The failure of the executive to adhere to the governing fiscal law significantly undermines the overall credibility of the government. In addition, parliament has a responsibility to ensure that the executive is held accountable for such transgressions. The regular violations of the law and changes to the law to accommodate fiscal profligacy are an erosion of credibility of the executive. Furthermore, these violations and changes also undermine the credibility of the very institutions that are intended to provide credibility.

Section 3: Analysis of The Budget Estimates

The main informational issues addressed in this report, with regard to the fiscal, financial and economic assumptions and the budget estimates, are laid out in four parts.

1. **Missing Estimates:** refers to when the estimates of fiscal consequences relating to the budget proposals are absent or obfuscated in the budget and/or the associated documentation.
2. **Impractical Assumptions:** refers to when macro-economic and financial assumptions used to calculate budget estimates are made with impractical rationale.
3. **Estimates Mismatch:** refers to when budget estimates (both revenue and expenditure) fail to match either past data, or the fiscal, financial and economic assumptions provided.
4. **Unachievable Medium Fiscal Framework:** refers to when the medium-term targets are not consistent with realistic assumptions/estimates.

3.1. Missing Estimates

Missing Estimates: refers to when the estimates of fiscal consequences relating to the budget proposals are absent or obfuscated in the budget and/or the associated documentation.

The problem of *missing estimates* is set out in this section in two main parts. The first part sets out examples of fiscal measures with undisclosed or obfuscated consequences. The second part sets out examples of negative and positive fiscal measures with missing information.

3.1.1. Fiscal measures with undisclosed or obfuscated consequences

This section sets out some of the fiscal measures for which the revenue or expenditure consequences are either undisclosed or obfuscated. Table 2.1 provides a table with several examples of this problem.

Table 3.1.1: Undisclosed consequences: indicative examples

No	Policy Proposal in the Budget Speech
1	I propose to simplify the taxes on capital gains, where such taxes will be calculated based on the sale price of a property or the assessed value of a property, whichever is higher
2	Simplify the taxes and fees levied by the local government institutions on tourism with an upper cap
3	Outstanding dues on the taxes, such as the Economic Service Charge and the Nation Building Tax administered by the Inland Revenue Department are proposed to be settled through a mechanism which includes a concessionary payment plan based

	on the payment capacity leading to a full and final settlement resulting in the closure of the those files.
4	In order to develop the local garment industry as a local and international garment manufacturing hub with high quality garment and leather products demanded by foreigners and tourists, relax the import and to implement the new tariff system
5	Personal Income Tax will apply on earnings from employment, rent, interest, dividends or any other source only if it exceeds Rs.250, 000 per month.
6	To classify all imports other than the above (raw materials not available in the country, machineries and equipment with modern technology), under three categories of 0, 10 and 15 percent.
7	TIEP scheme will be implemented to export high quality goods through high value addition to local inputs by providing temporary import facilities for raw materials which are not available in Sri Lanka, spare parts, processing and packing materials, labels, stickers, catalogues and brochures to promote the products of direct and indirect exporters.

3.1.2. Negative fiscal measures with missing estimations

This section sets out examples of fiscal measures that have a negative fiscal impact, but where the estimates on the magnitude of this impact is not provided. It is imperative that every proposal set out is evaluated in terms of the estimated fiscal impact, in order to have a holistic understanding of the implications of the proposal.

In the 2019 Budget Speech there were 11 revenue reducing proposals. However, in the 2021 Budget Speech, revenue reducing proposals with no fiscal measures increased to 36. The number of expenditure proposals with no expenditure allocation increased from 3 proposals to 32 proposals. This indicates a deterioration in budget reporting standards.

Table 3.1.2.1: Revenue reducing proposals

1	I propose to open a Samurdhi Life Savings Account -SLSA for each Samurdhi beneficiary by the Samurdhi Bank and to credit the Samurdhi benefit to that account. In order to secure the savings of the Samurdhi beneficiaries, laws will be introduced to make it mandatory to invest these savings in Government Securities similar to the laws governing the National Savings bank and the Employee Provident Fund which requires them to mandatorily invest in government securities. I also propose to release all interest income of such investments from taxes
2	Release the interest income of the welfare societies and institutions from income taxes which was imposed by the previous government.
3	Treat medical insurance, interest on housing loans, investments in Government Securities and shares of listed companies incurred up to Rs.100,000 per month as deductible expenditures in the calculation of personal income tax.
4	In order to promote investments in the housing market through the Sri Lanka Real Estate Investment Trust (SLREIT) regulated by the Securities and Exchange Commission, I propose to exempt such investments from capital gains tax and dividends free from income tax, and to reduce the stamp duty up to 0.75 percent
5	Provide a 50 percent tax concession for the years 2021/2022 for such companies that are listed before 31 December 2021 and to maintain a corporate tax rate of 14 percent for the subsequent three years.
6	Tax exemption of 5 years for businesses initiated under the vocational education loan scheme
7	Cost of Funds of funds provided for such start-up capital , provided by banks and finance agencies as deductible expenditure in the calculation of taxes. (this is related to the vocational education loan scheme)
8	Provide a tax holiday for private sector institutions which will be standardized under one TVET concept if those institutions double their intake at least upto 50,000.
9	Uphold the policy to limit the importation of all agricultural products which can be produced locally
10	Provide the concession on customs duties for cold room facilities
11	Import of Ginger and Turmeric have been completely stopped
12	Propose to allow the depreciation in 2 years of the capital investments done on latest technology to collect local liquid milk in collaboration with local dairy farmers, enhancements to milk related productions and promotion of liquid milk
13	Provide strategic investment tax concessions for a period of 5 years for capital investments of over USD 25 million with the view of facilitating these companies to process milk powder exports instead of importing milk powder.

14	provide relief on custom duties and financing facilities to obtain land and modern equipment for entrepreneurs investing in value additions to local crops such as pepper, cloves, cardamom and coffee suitable for the export market
15	Allow a tax holiday of 7 years for all renewable energy projects
16	I propose to simplify the taxes and fees levied by the Local Government Institutions on tourism with an upper cap
17	I propose to reduce the import taxes levied on vehicle spare parts required for new production sectors
18	Certain raw materials such as cement, premix, iron rods, bitumen that cannot be produced domestically will be imported in bulk without import duties, to be used to for the construction of mega housing schemes and highways
19	I propose to exempt import tax on the import of machinery with modern technologies
20	I also propose a ten year tax holiday for investments in selected recycling sites to encourage the recycling and re use of material from construction
21	To remove import taxes on the raw materials not available in the country, machineries and equipment with modern technology, to boost exports, and also to encourage domestic industries to produce value added goods
22	If any commodity has been exempted from VAT at its importation point, I propose to exempt from VAT, the domestic production of that particular commodity as well.
23	To ban the importation of batik products under national sub headings in order to develop batik and related fashions as a national industry.
24	It is proposed to reduce the tax imposed on the dividends of multinationals by 25 percent in 2021 and 50 30 percent in 2023 under the condition that they increase their exports by 30 percent and 50 percent in the respective years.
25	In order to maintain a similar amount as the import expenditure in foreign exchange in domestic banks, the interest income of such deposits will be exempted from taxes
26	To develop the latent industries such as mineral sand, phosphate, fertilizer and graphite as high value export industries, I propose to reduce the expenditure on research and development expenses of local entrepreneurs involved with the Institute of Nanotechnology from taxes
27	It is expected to provide concessions on required taxes and specific goods trade, banking and foreign exchange with the objective of converting the Port City Economic Zone as one of the hubs for investment promotions in the country.
28	Related expenditure of the local entrepreneurs who contribute to establish Samurdhi women's shops will be considered as deductible expenditures in the calculation of personal income tax.
29	It is also proposed to grant a tax break of 7 years for local boat and shipbuilding.
30	I propose to exempt the tax on dividends of foreign companies for three years if such dividends are reinvested on expansion of their businesses or in the money or stock market or in Sri Lanka International sovereign bonds.
31	When the commercial banks in Sri Lanka purchase Sri Lanka International sovereign bonds subject to a minimum of USD 100 million, I propose to suspend the risk weighted provisioning under Central Bank Regulations for three years and to free the profits on capital and interest income of this investments from taxes.
32	Investments exceeding USD 10 million with potential to change the landscape of the economy, in the areas of export industries, dairy, fabric, tourism, agricultural products, processing and information technology will be provided with concessions up to a maximum of 10 years under the Strategic Development Law.

33	In order to promote the Colombo and Hambanthota ports as commodity trading hubs in international trading, and to encourage investments in bonded warehouses and warehouses related to offshore business I propose to exempt such investments from all taxes.
34	A five-year tax concession will be made available from 01 January 2021 to domestic industrialists.
35	Further, it is proposed to merge the finance companies functioning under commercial banks with the banks in order to strengthen the banking sector. With the aim of incentivizing the strengthening of banks and finance companies, I propose to consider the investment expenditure in acquisitions as deductible expenditures
36	I also propose to provide incentives for investments on household needs as well as coconut related industries including brooms, ekel brooms, rugs and rubber related products including agricultural and consumer needs, building materials, office furniture, to support them as main industries.

Table 3.1.2.2: Expenditure proposals

1	I also propose to establish a modern investment zone for local and foreign private investors under the Strategic Development Act.
2	It is proposed to upgrade the Nursing schools to that of degree awarding institutions to expand the professional education of nursing and nursing services.
3	I propose to provide loans of Rs.500,000 at an interest rate of 4 percent as start-up capital to support the young men and women, who start their own businesses on the successful completion of vocational education. In order to ascertain that the said loans are invested on the approved business, an annual commitment fee of 0.25 percent will be charged for follow up and extension services
4	I propose the Foreign Employment Bureau to facilitate the youth who possesses specialized skills in sectors like Tourism, Health, Construction, Agriculture and Animal Husbandry to seek foreign employment.
5	I propose to develop 10 sports schools with synthetic race tracks in order to attract the youth to sports and extra curricular activities through sports schools as well as youth community organizations associated with cultural centres.
6	I propose to pay Rs. 2 per dollar above the normal exchange rate for the foreign exchange remittances sent by foreign workers to banks in Sri Lanka.
7	Proposing a support scheme to promote, the cultivation of ginger and turmeric as additional crops in coconut and rubber lands
8	I also propose to increase the government contribution to develop small and medium scale dairy farms through extension services which supports the dairy cattle for breeding.
9	I propose to implement a loan scheme to provide special loan facilities up to Rs. 500,000 at an interest rate of 7.5 percent per annum for the purchase of dairy cattle, setting up of ecofriendly cattle sheds and purchase of equipment for small and medium scale dairy farms.
10	I propose to increase the provisions for developing facilities of fishery harbours and modern fishing vessels and for increasing deep sea fishery production and for increasing deep sea fishery production during 2021-2023 Medium Term Budgetary Framework.
11	I also propose to increase the daily wage of plantation workers to Rs. 1,000 from January 2021.
12	I further propose to expand the railway network in Colombo and suburban areas
13	I propose to expand the Kelani Valley Railway up to Awissawella

14	I propose to add a capacity of 500 MW to the grid, by providing solar panels generating 5 kW to 100,000 houses of low income families, through the loan schemes from the Asian Development Bank and the Indian Line of Credit, to supplement the government's investments in the sector. I propose to provide loans at an interest rate of 4 percent in this regard.
15	I propose to invest on installation of solar panels on roof tops of religious places, public institutions, hospitals, schools and defence establishments.
16	I propose to facilitate private entrepreneurs at rural level, to install solar power plants connected to 10,000 transformers under the theme "Gamata Balagarayak - Gamata Vyavasakayek".
17	I propose to provide capital grants of Rs.150,000 to 10,000 small and medium scale commercial agro entrepreneurs, with agricultural wells to install solar power operated water pumps in order to increase production capacities by harnessing new technology including drip irrigation.
18	I propose to reduce the expenses on electricity by providing solar energy for lift irrigation and drinking water supply projects that use RO plants.
19	I propose to increase renewable energy capacity to 1,000 MW by the expeditious implementation of both off shore wind and floating solar power plants exceeding 100 MW, with incentives provided by the Board of Investment.
20	I propose to provide separate docks, dockyard access facilities and long-term credit facilities to promote boat and shipbuilding activities
21	I propose to implement various development programmes through public enterprises amounting to at least twice as the budget provisions allocated to them.
22	It is proposed to develop railway compartment production as a domestic industry
23	I propose to implement a loan scheme with an annual interest of 6.25 percent with a payback period of 25 years to facilitate the acquisition of these houses.
24	I propose to start the provision of the required building facilities for the Supreme Court and Court of Appeal due to the expansion of Superior Court Complex within this year itself.
25	It is also proposed to integrate the institutes related to import of fertilizer and distribution.
26	I propose to implement a special loan scheme for public servants to obtain solar powered electricity
27	It is proposed to establish a shop in all Grama Niladhari divisions where the network of shops has been adequately expanded targeting 25,000 female entrepreneurs chosen from Samurdhi families
28	I also propose to provide the contribution of Co-operative Development Fund in order to strengthen the network of Co-operative shops
29	I also propose to expand the Lanka Sathosa super market network to urban and semi-urban areas in collaboration with wholesale trade using warehouses of Sathosa and Food Commissioner's Department
30	It is proposed to increase the forest coverage, by using the lands available on both sides of the roads, schools, government and private offices and urban environments coupled with the accelerated program of expanding the forest cover by 15,000 acres.
31	It is proposed to strengthen the surveillance by the Sri Lanka Air Force to prevent illegal deforestation
32	I propose to provide containers to rural agrarian, farmer and community organisations in order to store their harvest safely in villages prone to wildlife attacks.

3.1.3. Positive fiscal measures with missing estimations

This section sets out examples of fiscal measures that have a positive fiscal impact, but where the estimates on the magnitude of this impact are not provided. Two proposals are changes to the structure and rates of taxation. The other three are tax administration improvements.

Table 3.1.3: Revenue Generating Proposals

1	I propose to improve the efficiency of tax collection through the introduction of an online – managed single Special Goods and Service Tax in place of the various goods and service taxes and levies, imposed under multiple laws and institutions on alcohol, cigarettes, Telecommunication, betting and gaming and vehicles, which accounts for 50 percent of the income from taxes and levies
2	To impose CESS to provide the required protection on the imports and exports of domestic production
3	I propose to introduce the required changes to the Department of Inland Revenue to facilitate enhanced self-compliance and strengthen tax audits in ensuring increased tax revenue in the background of the simplified tax regime.
4	Tax law will be amended where it will be mandatory for all Companies to file their taxes only on an “E-Filing” system with effect from 01 April 2021, and the use of the Tax Identification Number (TIN) in all tax and tax related transactions.
5	The Revenue Administration and Management Information System (RAMIS) which I introduced during the period 2013/2014 will be made more effective with the introduction of technical and legal provisions into the tax laws and in further strengthening the tax administration, the various units in place, for this purpose will be brought under one Large Tax Payer Unit (LTPU) targeting those large tax payers, to operate under the direct responsibility of the Commissioner General of Inland Revenue.

3.2. Impractical Assumptions

Table 3.2: Macroeconomic and Financial Assumptions

Macroeconomic Forecasts	2020				2021			
	CBSL	MoF	IMF	WB	CBSL	MoF	IMF	WB
Real GDP Growth Rate (%)	-1.7	1.5	-4.6	-6.7	5.0	5.5 ¹	5.3	3.3
Inflation Rate (%)	4.7	5.0 ²	N/A	4.9	5.0	5.0	N/A	4.9

Sources: World Bank, *South Asia Overview*; IMF, *World Economic Outlook*; MoF, *Fiscal Management Report 2020-21*, Ministry of Finance, *Fiscal Management Report and Budget Speech 2020-2021*; Central Bank of Sri Lanka, *Recent economic indicators 2020*.

3.2.1. Real GDP Growth

The budget assumes a real GDP growth of 1.5% for 2020. This is not realistic given the negative outlook of the economy created by the COVID-19 pandemic. The Central Bank estimates a GDP growth of -1.7% in 2020 in its report “Recent Economic Developments” published on 31st October 2020. International agencies such as the IMF and the World Bank forecasted deeper contractions (-4.7% by the IMF and -6.7% by the World Bank), even prior to the wave of COVID-19 that commenced in October 2020.

The growth rate for 2021 is more aligned with other forecasts as the economy is expected to recover from a low base in 2020.

3.2.2. Inflation

The budget speech does not provide an exact number for the expected inflation rate in 2021 but refers to a target inflation of “around 5%” in the section on Macroeconomic Roadmap. This level of inflation can be considered a reasonable estimate based on recent data as the 12-month moving average inflation stood at 4.6% as of October 2020.

¹ There is also a discrepancy in this figure between the Fiscal Management Report and the Budget Speech. 5.5% is mentioned in the budget speech and 5.0% is mentioned in the Fiscal Management Report.

² The Fiscal Management Report states Consumer Price Inflation is expected to remain at mid-single-digit level in both 2020 and 2021.

3.3. Estimate Mismatch

Estimates Mismatch is where budget estimates fail to match, either with past data, or with the fiscal, financial and economic assumptions provided.

This section sets out examples of several areas of taxation where the revenue estimates provided seem to overstate the revenue that is likely to be collected. Overstating revenue estimates can lead the Parliament to also agree on higher expenditure levels, which then, when revenue does not meet expectations, leads to higher budget deficits, higher debt, higher interest, and finally a problem of sustainability of public finance. Therefore, this problem of overestimation requires special vigilance, as it seems to be a systemic feature of Sri Lankan budgets. Over the years, this problem has led Parliament to agree to spending proposals that have resulted in the country being heavily indebted and facing downgrades in its international risk status with regard to ability to service the growing debt.

3.3.1. Revenue Estimates

Table 3.3.1: Revenue estimates as given in the Budget Speeches (LKR Billions)

Item	2019 Actual	2020 Estimate	2021 Budget	Y-o-Y Growth	
				2019- 2020	2020- 2021
Total Revenue and Grants	1,991	1,588	2,029	-20%	28%
Total Revenue	1,983	1,580	2,019	-20%	28%
Tax Revenue	1,735	1,358	1,724	-22%	27%
Income Tax	428	324	371	-24%	15%
Taxes on Goods and Services	976	631	823	-35%	30%
Taxes on External Trade	332	403	530	21%	32%
Non Tax Revenue	156	162	227	4%	40%
Provincial Council Tax Sharing and Devolved	92	60	68	-35%	13%

Sources: Budget Speech 2020, Budget Speech 2021

All revenue estimates are assessed by comparing the actual values for 2020 with the 2021 estimates. It is normally assumed that the tax revenue will increase based on the nominal GDP growth rate every year with no changes in policy or administrative reforms. The nominal GDP growth rate for 2021 is taken as 10.5%; inflation is taken as 5% and growth in real GDP as 5.5%. Any increase in the tax revenue above the nominal GDP growth rate should therefore come from a policy change (including tax rate change, changes in the base, etc.) or administrative reform implemented to make the tax collection more efficient.

3.3.1.1: Income tax

Table 3.3.1.1: Revenue estimates on Income tax

Tax Type	Revenue Estimates			Increase from 2020			
	2019 Actual	2020 Estimate	2021 Budget Estimate	Total change from 2020	Y-o-Y % increase in Revenue	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
Income tax	427,700	324,000	371,000	47,000	14.5%	34,020 10.5%	12,980 4.0%
o/w Corporate tax	260,486	271,000	319,000	48,000	17.7%	28,455 10.5%	19,545 7.2%
o/w Non-Corporate Tax	60,959	23,000	35,000	12,000	52.2%	2,415 10.5%	9,585 41.7%
o/w WHT	50,351	13,000	16,000	3,000	23.1%	1,365 10.5%	1,635 12.6%

Sources: Approved Budget Estimates (multiple years), Updated Budget Estimates 2021.

Income tax accounts for 22.5% of tax revenue. It is expected to grow by 14.51% to LKR 371 billion in 2021, from the estimated LKR 324 billion in taxes collected in 2020 under the existing policy.

Actions in the 2021 Budget

- In the 2021 Budget, the government has introduced several administrative reforms aimed at increasing tax efficiency. These include digitalisation of processes, improving transparency, fast-tracking appeals, creating single windows and enhancing self-compliance and controls.
- Several corporate tax exemptions and holidays were also given for various business in sectors such as renewable energy, ship building, bonded warehousing recycling sites, vocational training, investment in Samurdhi Savings, SLREITS and interest income of welfare societies.
- No changes were made to the withholding tax and non-corporate tax for the year 2021. The last changes were made in January 2020.

Analysis on Corporate Tax

- Better administration and policy changes are expected to increase the corporate tax by LKR 19,545 million (7.2%), while the nominal growth in the tax would account for an increase of LKR 28,455 million (10.5%).

- The Ministry of Finance has failed to provide information on the impact expected from measures aimed at improving revenue administration. However, a 7.2% increase in corporate tax is not unachievable if the above-mentioned administrative reforms are implemented effectively at the beginning of the year.

Past experiences (2015-2019)

	Average annual growth rate	Average excess from approved budget estimations	Underestimate in 2019 approved budget estimates against 2019 provisional estimates
Corporate tax	27%	6%	42%

In the past, the tax revenue collected from corporate taxes has fluctuated significantly owing to several policy changes. The annual average growth rate of corporate taxes during 2015 to 2019 amounts to 27%. Yet, this is largely due to policy measures which increased the revenue by 69% and 64% in 2015 and 2019 respectively. The growth in revenue was at -8% for the years 2016 and 2017.

The deviation between the actual and the estimated amount is lower; actual revenue has on average exceeded estimates by 6%. However, this too is largely due to the underprediction of the corporate taxes in 2019 by 42%.

However, the corporate tax estimated for 2020 is likely overstated. Effective from January 2020, the government introduced various tax exemptions and revised the tax rates downwards for several sectors. According to VR's estimates, these changes are estimated to reduce the corporate tax by around 20% for 2020, without considering the impact of COVID-19 or nominal growth. Yet, the revised estimate for corporate tax is LKR 271 billion for 2020, which is LKR 11 billion higher than 2019 value.

Analysis on Non-Corporate Tax

- Non-corporate taxes are expected to increase by 52.2% in 2021 compared to 2020; however, only 10.5% can be attributed to nominal growth. An increase of 41.7% is expected to be through administrative reforms as no policy changes are announced in the budget for this category.
- The Ministry of Finance has failed to provide the impact of these administrative reforms on the tax revenue.

Past experiences (2015-2019)

	Average annual growth rate	Average shortfall from approved budget estimations	Overestimate in 2019 approved budget estimates against 2019 provisional estimates
o/w Non-Corporate Tax	15%	25%	27%

- The annual average growth rate of non-corporate taxes during 2015 to 2019 is 15%. The Ministry of Finance has, similarly to tax categories previously discussed, overestimated growth in non-corporate taxes in the past. The average annual shortfall in this category is 25% and this shortfall has been mostly consistent every year.

Analysis on Withholding Tax

- Withholding taxes are only charged on non-resident individuals from January 2020.
- Withholding taxes are expected to increase by 23.1% in 2021 compared to 2020. According to Ministry of Finance, an increase of 12.6% is attributable to administrative reforms as only 10.5% is attributable to nominal growth.

Past experiences (2015-2019)

	Average annual growth rate	Average shortfall from approved budget estimations	Overestimate in 2019 approved budget estimates against 2019 provisional estimates
WHT	-6%	19%	3%

- In the last 5 years, withholding tax has reduced in all years, except in 2019 when the new Inland Revenue Act became effective. The annual average growth rate of withholding tax was -6% from 2015 to 2019.
- The Ministry of Finance has also overestimated the figure by a large margin in all years except 2018 - the average shortfall for 2015-2019 is 19%.

Recommendations

- Overall, the income tax component has been fairly predicted based on the figures for 2020. A change in the total income tax of 14.5% compared to 2020 seems reasonable; 10.5% due to nominal growth and 4% due to administrative reforms. Although, several exemptions were provided, these exemptions are given to mostly new sectors that do not contribute significantly to tax revenue. Therefore,

these exemptions would not have a significant impact on the overall tax revenue changes.

- However, the figures for 2020, which are used as a base for the increase in 2021 estimates, are overestimated and require revision. The large tax cuts in January 2020 are expected to reduce Income tax revenue by LKR 125 billion (or 31%), without accounting for nominal growth, according to our estimates. The actual values for Income tax realised from January to August 2020 also show that the tax revenue is 30% lower when compared to the same period in 2019. Therefore, based on the actual numbers for January - August 2020, we estimate the income tax for 2020 to be LKR 216 billion. An increase of 14.5% is reasonable to estimate the revenue for 2021 based on this revised revenue estimate for 2020. **Hence, the income tax for 2021 should be revised to LKR 247 billion.**
- Further, individual estimates for non-corporate tax and withholding tax are also unsatisfactory. The increase attributable to administration reforms are as high as 41.7% for non-corporate tax and 12.6% for withholding tax. An increase of 4%-5% is more realistic. Therefore, the 2021 estimate for **non-corporate tax should be revised to LKR 26 billion** and that for **withholding tax should be revised to LKR 15 billion.**

3:3:1:2: Taxes on Goods & Services

Table 3:3:1:2: Revenue estimates on Taxes on Goods & Services

Tax Type	Revenue Estimates			Increase from 2020			
	2019 Actual	2020 Estimate	2021 Budget Estimate	Total change from 2020	Y-o-Y % increase in Revenue	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
Taxes on goods & services	934,399	616,435	807,785	191,350	31.0%	64,726	126,624
						10.5%	20.5%
o/w VAT	443,877	241,000	310,000	69,000	28.6%	25,305	43,695
						10.5%	18.1%
o/w NBT	70,672	3,000	-	-3,000	-100.00%	315	-3,315
						10.5%	-110.5%
o/w Excise duties	399,478	355,000	475,000	120,000	33.8%	37,275	82,725
						10.5%	23.3%
o/w Other taxes on goods & services ^[3]	20,372	17,435	22,785	5,350	30.7%	1,831	3,519
						10.5%	20.2%
License Taxes & Other	39,445	12,855	13,465	610	4.7%	1,350	-740
						10.5%	-5.8%

Sources: Approved Budget Estimates (multiple years), Updated Budget Estimates 2021.

^[3] Other taxes on goods and services includes telecom levy, motor vehicle taxes and other taxes on goods and services not elsewhere specified.

Revenue from taxes on goods & services is primarily from VAT and excise duties, which account for 38.4% and 58.8% of total taxes from goods and services in 2021. Further explanation of these two categories of tax revenue are provided in the next sections.

One of the primary changes to taxes on goods and services is the introduction of a special Goods & Services Tax (GST) on alcohol, cigarettes, telecommunication, betting and gaming and vehicles. The introduction of the GST would replace a host of taxes currently imposed on these sectors, including VAT, excise duty, Cess and other sector-specific levies. The budget speech notes that this measure is expected to recover revenue which is lost through the illicit sale of alcohol and cigarettes, implying an increase in taxes from goods and services. However, no revenue estimates are provided for this proposal and other revenue generating proposals. Hence, the impact of this proposal on public finances is unclear and detailed estimates of its net impact are critical.

Value Added Tax (VAT)

VAT is expected to account for 18% of total tax revenue in 2021. It is estimated to amount to LKR 241 billion in taxes collected in 2020 and grow by 28.6% in 2021 to LKR 310 billion.

Actions in the 2021 Budget

- The budget speech indicates that the VAT rate will remain unchanged at 8% (except for the banking, finance and insurance sectors) for the next five years.
- The budget speech and technical notes provide a number of amendments to the application of the Value Added Tax Act, No. 14 of 2002.³ However, most of these provisions are set to take effect prior to 2021. In addition, three amendments are provided with no effective date specified:
 - a) The piece-based VAT rate applicable on domestic sale of certain garments by export oriented BOI companies will be reduced from LKR 100 to LKR 25;
 - b) Exemption on the supply or donation of health protective equipment and similar products by export oriented BOI companies to the Ministry of Health and Indigenous Medical Services, Department of Health Services, Tri Forces and Sri Lanka Police at their request; and
 - c) VAT exemptions available to goods at the point of importation are extended to the domestic production of such goods.

³ See Annexure IV, p. 49 of the Budget Speech 2021

VAT estimates *LKR millions*

Tax Type	Revenue Estimates			Increase from 2020			
	2019 Actual	2020 Estimate	2021 Budget Estimate	Total change from 2020	Y-o-Y % increase in Revenue (2020 – 2021)	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
VAT	443,877	241,000	310,000	69,000	28.6%	25,305 (10.5%)	43,695 (18.1%)

Sources: Approved Budget Estimates (multiple years), Updated Budget Estimates 2021.

Analysis on VAT

- The estimate for 2020 indicates a reduction in revenue of 45.7% compared to 2019. This can primarily be attributed to the reduction in the VAT rate and increase in the threshold for VAT liability on 1 December 2019.
- The actual revenue from VAT for the first eight months of 2020 is LKR 137.8 billion accounting for 57.2% of expected annual revenue. Given the second outbreak of COVID-19 during October 2020 and the resulting reduction in economic activity, the revenue estimate of LKR 241 billion is unlikely to be met. Assuming a similar level of economic activity to prevail as the first 8 months of the year, the revenue earned would be approximately LKR 207 billion.
- After accounting for nominal growth of LKR 25.3 billion, the budget estimates a further LKR 43.7 billion increase in revenue from VAT in 2021. As previously noted, the budget fails to provide revenue estimates for any of the proposed amendments to VAT. However, the policy changes introduced do not include any material revenue generating proposals. Therefore, the expected increase in revenue does not match the information provided with regard to changes in policy.

Past experiences (2015-2019)

Average annual growth rate	Average shortfall from approved budget estimations	Overestimate in 2019 approved budget estimates against 2019 provisional estimates
16%	7%	16%

Based on: Approved Budget Estimates (multiple years), Updated Budget Estimates 2021.

- The five-year average shortfall in collection against the estimate for 2021 is 7%. During 2016-2017, VAT tax collection benefited from a substantial revision in tax rate from 11% to 15% on 2 May 2016. The resulting year-on-year nominal growth

of the VAT collected was 32.3% in 2016 and 56.5% in 2017. However, apart from these years, VAT has been constantly overestimated in budgets during the period 2011-2019. In 2019, VAT revenue reduced by 4% after indicating a low growth rate of 4% in 2018. Further, on 1 December 2019 the VAT rate was reduced to 8%.

Recommendation

- The expected revenue from VAT in 2021 should be revised to reflect the policies in the budget speech and provide a realistic estimate for 2020. **A revised estimate of LKR 228 billion** can be made based on the following assumptions; (1) The positive impact of simplified tax administration would offset the negative impacts of the VAT exemptions and reductions mentioned in the budget speech; (2) Increase in VAT revenue due to nominal growth of GDP is 10.5%; (3) Actual VAT revenue in 2020 will be approximately LKR 207 billion, as calculated earlier in this section.

Excise Duty

Excise duty is expected to account for 27.6% of tax revenue in 2021. It is estimated to amount to LKR 355 billion in duties collected in 2020 and grow by 33.8% to LKR 475 billion in 2021.

Actions in the 2021 budget

- The budget speech and technical notes do not indicate any proposals directly relating to excise duties.⁴
- However, the budget speech introduces a Goods and Services Tax to replace all existing taxes and levies on alcohol, cigarettes, telecommunication, betting and gaming and vehicles. The expected tax revenue or rate of taxation is not specified. Hence there is a lack of clarity on the expected increase in excise revenue in 2021.

Excise duty LKR millions

Tax Type	Revenue Estimates			Increase from 2020			
	2019 actual	2020 Estimate	2021 Budget Estimate	Total change from 2020	Y-o-Y % increase in Revenue (2020 - 2021)	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
Excise Duty	399,478	355,000	475,000	120,000	33.8%	37,275 (10.5%)	82,725 (23.3%)

Sources: Approved Budget Estimates (multiple years), Updated Budget Estimates 2021.

⁴ See Annexure IV, p. 49 of the Budget Speech 2021

Analysis on Excise duty

- Excise duty is primarily earned from motor vehicles, liquor, cigarettes and petroleum products.
- The estimate for 2020 indicates a reduction of revenue by 11% compared to 2019. This can primarily be attributed to the effects of the COVID-19 pandemic. Import controls imposed during March 2020 would be the primary driver of reduced excise revenue. In addition, reduced consumption of liquor, cigarettes and travel would also have a negative impact on revenue.
- The actual excise revenue for the first eight months of 2020 is LKR 214.8 billion accounting for 60.5% of expected annual revenue. Given the second outbreak of COVID-19 in October 2020 and the resulting reduction in economic activity, the revenue estimate of LKR 355 billion is unlikely to be met. Assuming a similar level of economic activity to prevail as the first eight months of the year, the revenue earned would be approximately LKR 322.2 billion.
- Excise revenue is expected to grow by 33.8% in 2021 to LKR 475 billion, from the estimated LKR 355 billion in taxes collected in 2020. After accounting for nominal growth of LKR 37.3 billion, the budget estimates a further LKR 82.7 billion increase in revenue from excise duties in 2021.

Past experiences (2015-2019)

Average annual growth rate	Average shortfall from approved budget estimations	Overestimate in 2019 approved budget estimates against 2019 provisional estimates
17%	5%	33%

Source: Approved Budget Estimates (multiple years), Updated Budget Estimates 2021.

- Revenue from excise duties has been overestimated in all years during the period 2015-2019 except in 2015. Year-on-year nominal growth of excise revenue was 95.1% in 2015, exceeding the estimated provision by 54%.
- The average shortfall from the budget estimates for the period 2015-2019 is 5%. However, when excluding 2015, the average shortfall of the period 2016 to 2019 is much higher at 19.4%.

Recommendation

- The expected revenue from excise duties in 2021 should be revised to reflect the policies in the budget speech and provide a realistic estimate for 2020. **A revised estimate of LKR 372 billion** can be made based on the following assumptions and information; (1) No change in the rate of tax has been indicated in the switch from excise duty to GST. However, the new policy is expected to result in simplified tax administration. The gains from the changes to tax administration can be

estimated at 5%; (2) Increase in excise revenue due to nominal growth of GDP is 10.5%; and (3) Actual excise revenue in 2020 will be approximately LKR 322.2 billion, as calculated earlier in this section.

3.3.1.3: Taxes on External Trade

Table 3.3.1.3: Taxes on External Trade

Tax Type	Revenue Estimates			Increase from 2020			
	2019 Actual	2020 Estimate	2021 Budget Estimate	Total change from 2020	Y-o-Y % increase in Revenue	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
Taxes on external trade	333,382	404,710	531,750	127,040	31.4%	42,495 10.5%	84,545 20.9%
o/w Import duties	98,427	140,000	180,000	40,000	28.6%	14,700 10.5%	25,300 18.1%
o/w Cess	50,703	50,000	70,000	20,000	40.0%	5,250 10.5%	14,750 29.5%
o/w PAL & SCL	182,538	213,000	280,000	67,000	31.5%	22,365 10.5%	44,635 21.0%

Source: Approved Budget Estimates (multiple years), Updated Budget Estimates 2021

Import duties

Actions in the 2021 Budget

Removal of import duties have been proposed for the following areas: raw materials not available in the country; machineries and equipment with modern technology; and cement, premix, iron rods and bitumen that cannot be produced locally and are imported in bulk.

- The following reductions in customs and other import duties are also introduced: vehicle spare parts; cold room facilities; and modern equipment for investing in value addition to local crops such as pepper, cloves, cardamom and coffee suitable for the export market.
- Further, the budget speech also introduces a reduction in rates by revising import tariff bands to 0%, 10% and 15% for all imports other than for specific commodities.
- Bans on import of certain items such as batiks and agricultural commodities except those that cannot be produced domestically (negative list).

- Revenue increasing measures: taxes applicable on the import of fish not available in Sri Lanka for the production of dried, canned and Maldives fish will remain high to encourage domestic production.
- The budget speech also introduces a Temporary Import for Export (TIEP) scheme which will provide temporary import facilities for raw materials not available in Sri Lanka; spare parts; processing and packing materials; labels; stickers; catalogues; and brochures. However, the TIEP scheme is already in existence and hence will not have a material impact on revenue.
- The budget speech introduces a Goods & Services Tax in lieu of the multitude of levies on motor vehicles and other specified goods. Hence, import duties on motor vehicles will be affected by this, however, details on expected revenue of this policy is not provided.

Import duties LKR millions

Tax Type	Revenue Estimates			Increase from 2020			
	2019 Actual	2020 Estimate	2021 Budget Estimate	Total change from 2020	Y-o-Y % increase in Revenue (2020 – 2021)	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
Import duties	98,427	140,000	180,000	40,000	28.6%	14,700 (10.5%)	25,300 (18.1%)

Sources: Approved Budget Estimates (multiple years), Updated Budget Estimates 2021.

Analysis on Import Duties

- The estimate for 2021 is a 28.6% increase compared to 2020. LKR 14.7 billion is attributable to nominal growth in tax revenue and LKR 25.3 billion (or 18.1%) could be attributable to policy changes and better administration.
- The estimate for 2020 indicates an increase in revenue of 42.2% compared to the actual figure in 2019.
- The actual revenue collected through imports for the first eight months of 2020 is LKR 73.2 billion, accounting for 52.3% of import duties expected during the year. As imports continued to be restricted for the remainder of 2020, the actual collection of import duties is likely to be approximately LKR 109.8 million.
- The revenue estimate for 2021 is approximately LKR 60 billion, based on the following assumptions: (1) Increase in import duties due to nominal growth of GDP is 10.5%; (2) Actual revenue from import duties in 2020 will be

approximately LKR 109.8 billion; (3) Revision in tariff bands would result in a 50% drop in revenue from import duties.⁵

⁵ The tariff bands have been reduced from 0%, 15%, 25% and 30% to 0%, 10% and 15%. Thus, the average rate of tariff has decreased from 17.5% to 8.3%, a reduction of approximately 50%.

Past experiences (2015-2019)

Average annual growth rate	Average shortfall from approved budget estimations	Overestimate in 2019 approved budget estimates against 2019 provisional estimates
9%	11%	30%

Based on: Approved Budget Estimates (multiple years), Updated Budget Estimates 2021.

- The five-year average shortfall in collection of import duties against estimates is 11%. During 2015-2016, the revenue collected from import duties were higher than expected. However, during the period 2017-2019, import duties were constantly overestimated. The average shortfall between the expected and actual values for this period is 30.6%.

Cess

Actions in the 2021 Budget

- The budget speech notes that Cess will be imposed to “provide the required protection on the imports and exports of domestic production”. The relevant HS Codes for this have been specified by Sri Lanka Customs.
- In addition, the Budget Speech introduces a Goods & Services Tax in lieu of the multitude of levies on the telecommunications sector and other sectors. Hence, Cess on telecommunications will be affected by this. However, details on expected revenue of this policy is not provided.

Cess LKR millions

Tax Type	Revenue Estimates			Increase from 2020			
	2019 Actual	2020 Estimate	2021 Budget Estimate	Total change from 2020	Y-o-Y % increase in Revenue (2020 – 2021)	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
Cess	50,703	50,000	70,000	20,000	40.00%	5,250 (10.5%)	14,750 (29.5%)

Sources: Approved Budget Estimates (Multiple Years), Updated Budget Estimates 2021.

Analysis on Cess

- The estimate for 2020 indicates a similar level of revenue in comparison with 2019.

- The actual revenue from Cess for the first eight months of 2020 is LKR 31.3 billion. The annualised figure for the year is LKR 47 billion. Hence, the estimate for 2020 is reasonable.
- After accounting for nominal growth of LKR 5 billion, the Budget Speech estimates a further LKR 14.8 billion increase in revenue from CESS in 2021. The budget speech focuses on imposing Cess as a protectionist measure, and the number of HS Codes on which Cess is imposed has been increased by approximately 1.6 times. Hence, the revenue estimate for 2021 is approximately LKR 82.9 billion, based on the following assumptions and information; (1) Increase in import duties due to nominal growth of GDP is 10.5%; (2) The tax base on which Cess is applied has increased by 1.6 times.

Port & Airport Levy and Special Commodity Levy

Actions in the 2021 Budget

- The budget speech notes that the Special Commodity Levy (SCL) will be imposed to “balance the supply and demand of domestic production for selected agricultural products”. Hence, it is ambiguous whether this is expected to increase revenue from SCL in 2021.
- In addition, the budget speech introduces a Goods & Services Tax in lieu of the multitude of levies on motor vehicles and other specified goods. Hence, the Port & Airport Levy (PAL) on motor vehicles will be affected by this. However, details on expected revenue of this policy is not provided.

PAL & SCL LKR millions

Tax Type	Revenue Estimates			Increase from 2020			
	2019 Actual	2020 Estimate	2021 Budget Estimate	Total change from 2020	Y-o-Y % increase in Revenue (2020 – 2021)	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
PAL	112,714	115,000	170,000	55,000	47.8%	12,075 (10.5%)	42,925 (37.3%)
SCL	70,364	98,000	110,000	12,000	12.2%	10,290 (10.5%)	1,710 (1.7%)

Sources: Approved Budget Estimates (Multiple Years), Updated Budget Estimates 2021.

Analysis on PAL & SCL

- The SCL estimate for 2020 indicates an increase in revenue of 39.3% compared to 2019. Revenue from SCL is then expected to increase further by 12.2% in 2021. Revenue from SCL is subject to the changes in the levy as decided by the government. Given the lack of clarity on proposed SCL changes in the budget speech, there is not enough information to assess the reliability of the estimate in 2021.
- The estimate of PAL for 2020 indicates an increase in expenditure of 2% compared to 2019. The actual revenue from PAL for the first eight months of 2020 is LKR 71.8 billion, accounting for 73.3% of expected revenue in 2020, which is an annualised figure of LKR 108 billion. Hence, the estimate for 2020 is fairly reasonable.
- The budget estimates an LKR 42.9 billion increase in revenue from PAL in 2021, after accounting for nominal growth of LKR 12 billion. However, no policy changes relating to an increase in PAL have been introduced and the expected increase in revenue from PAL is unlikely to materialise. The revised revenue estimate for 2021 could be LKR 127.1 billion, based only on the nominal growth rate of 10.5%.

Recommendations

- The increase in import duties is not matched with the policies proposed in the budget. The estimates should be revised downwards as the government has reduced the import tax brackets downwards. It is advisable to **reduce the estimate down to LKR 60 Billion in 2021.**
- The revenue estimate for Cess has been underestimated and does not reflect the increase in the number of HS Codes subject to Cess. Hence the estimate should be **revised upward to LKR 82.9 billion.**
- The revenue estimates for PAL indicates an increase of 47.8% in PAL although no revenue increasing measures have been introduced. Hence, the estimate should be **revised downward to LKR 127.1 billion.**

Table 3.3.2: Summary of government revenue estimates and revisions recommended

LKR Billion	MoF Estimates		Revised Estimate	
	2020	2021	2020	2021
Tax revenue	1,358	1,724	1,141	1,263
Income tax	324	371	216	247
o/w Corporate tax	271	319	180	206
o/w Non-Corporate Tax	23	35	23	26
o/w WHT	13	16	13	15
Taxes on goods & services	616	808	549	623
o/w VAT	241	310	207	228
o/w NBT	3	0	3	0
o/w Excise duties	355	475	322	372
o/w Other taxes on goods & services	17	23	17	23
License Taxes & Others	13	13	13	13
Taxes on external trade	405	532	363	380
o/w Import duties	140	180	110	60
o/w Cess	50	70	47	83
o/w PAL	115	170	108	127
o/w SCL	98	110	98	110
Non-tax revenue	189	260	189	260
Total Revenue	1,547	1,984	1,330	1,523

Source: Updated Budget Estimates 2021 and author's calculations

*Highlighted in green are numbers that were revised based on the assumptions and action as explained in section 3 under mismatch of revenue estimates.

3.3.2 Interest Payments

Table 3.3.2 Estimates on Interest Payments

Expenditure Type	Expenditure Estimates		Increase from 2020			
	2020 Estimate	2021 Budget Estimate	Total change from 2020	Y-o-Y % increase in Revenue	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
Interest Payments	866	860	-6	-0.69%	91 10.5%	-97 -11.2%

Source: Budget Speech, MoF Annual Report 2019

Actions and Assumptions

- The government expects to finance 95% of the budget deficit through domestic financing mechanisms.

Analysis

Past experiences (2015-2019)

	Average annual growth rate	Average shortfall from approved budget estimations	Overestimate in 2019 approved budget estimates against 2019 provisional estimates
Interest Payments	16%	10%	1%

Source: Approved Budget Estimates (multiple years)

- The government expects a reduction of less than 1% in the total interest paid for 2020 compared to 2019.
- Except 2019, estimates on interest expenditure have fallen short of actual expenditure by 10% on average. Annual average growth in interest expenditure during the period was 16%.
- A large primary deficit in 2020 and 2021 can further increase the interest expenditure of the government. The primary deficit for 2020 is expected to be LKR 1,079 billion as opposed to the government estimate of LKR 400 billion and that for 2021 is expected to be LKR 1,150 billion compared to the government estimate of LKR 705 billion.
- Domestic interest rates have declined significantly in 2020. The primary market interest rates for a one-year treasury bill was 8.5% in the beginning of the year 2020 and reduced to 5% by the end of October 2020.

- In the event interest rates remain close to 5% for the whole of 2021, there will be an interest expense saving on domestic financing of debt. However, the saving will be predominantly on the debt maturing in 2021 for short-term debt instruments such as treasury bills. Short term debt accounted for 30% of the total domestic debt in 2019. The average foreign interest rates for 2019 is 3.7%

Recommendation

- While the decline in domestic interest rates would help reduce interest payments of short term debt, the higher deficits in 2020 and 2021 would increase the interest cost of the government. Therefore, accounting for the reduction in the interest cost on 30% of the domestic debt and the impact of the increased deficit for 2021, **interest expenditure should be revised to LKR 945 billion for 2020 and LKR 968 billion for 2021.**

3.4. Unachievable Medium Fiscal Framework

Table 3.4.1: Medium term fiscal framework for the next five years

As a percentage of GDP	Provisional	Est.	Est.	Projections			
	2019	2020	2021	2022	2023	2024	2025
Total Revenue and Grants	12.6	9.5	10.7	12.1	12.5	13.3	14.2
Total Revenue	12.6	9.5	10.6	12	12.5	13.3	14.2
Tax Revenue	11.6	8.5	9.4	10.5	10.9	11.6	12.5
Income Taxes	2.8	1.9	2.1	2.2	2.4	2.6	3
Taxes on Goods and Services	6.5	4	4.5	5.3	5.5	5.9	6.3
Taxes on External Trade	2.2	2.5	2.8	2.9	3	3.1	3.2
Non-Tax Revenue	1	1	1.3	1.5	1.6	1.7	1.7
Grants	0.1	0	0.1	0.1	0.05	0.04	0.04
Total Expenditure	22.2	17.5	19.5	18.4	18	17.9	18.3
Recurrent Expenditure	16.1	14.9	14.2	13.5	12.9	12.5	12.3
Salaries and Wages	4.6	5	4.9	4.7	4.4	4.3	4.1
Goods and Services	1.2	1	1.1	0.8	0.7	0.7	0.8
Interest	6	5.4	4.9	4.9	4.7	4.7	4.7
Subsidies & Transfers	4.4	3.5	3.3	3.2	3	2.8	2.8
Capital Expenditure and Net Lending	6.1	2.6	5.3	4.9	5.1	5.4	5.9
Public Investments	6.2	2.6	5.4	5	5.2	5.5	6
Current Account Balance	-3.6	-5.4	-3.6	-1.5	-0.4	0.8	1.9
Primary Balance	-3.6	-2.5	-3.9	-1.4	-0.7	0	0.6
Budget Deficit	-9.6	-7.9	-8.8	-6.4	-5.4	-4.6	-4
Deficit Financing	9.6	7.9	8.8	6.4	5.4	4.6	4
Foreign Financing (Net)	3.6	-1.4	0.5	-0.2	0.1	-0.1	-0.1
Domestic Financing (Net)	6	9.3	8.3	6.5	5.4	4.8	4.1
Central Government Debt (% of GDP)	86.8	95.1	96.3	92.4	88.1	82.3	75.5

Source: Fiscal Management Report 2020

The government's medium-term fiscal framework sets out ambitious targets for government revenue, deficits, and debt to GDP. However, even when applying the government's own numbers, the model does not provide the government's expected debt to GDP of 75.5 percent by 2025. Instead, the calculations show debt to GDP being 80.7 percent of GDP in 2025 (given in table 3.4.2). This calculation was performed by adding the current year's negative fiscal balance, in LKR terms, to the previous year's government debt and applying the government's assumptions for nominal GDP growth.

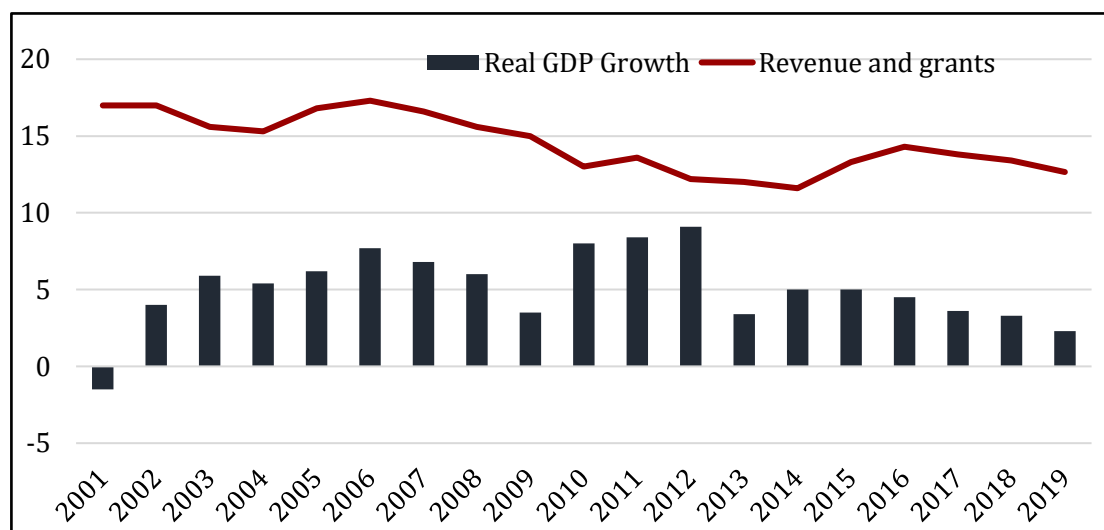
Table 3.4.2: Estimation of the Debt to GDP based on government's numbers

Year	Fiscal Balance (% of GDP)	GDP	Fiscal Balance (LKR Billion)	Debt (LKR Billion)	Debt (% of GDP)
2019	-6.8	15,016.14	- 1,021	13,034	86.80
2020	-10.7 ⁶	15,992.19	- 1,711	14,745	92.20
2021	-8.8	17,591.41	- 1,548	16,293	92.62
2022	-6.4	19,350.55	- 1,238	17,532	90.60
2023	-5.4	21,285.61	- 1,149	18,681	87.76
2024	-4.6	23,414.17	- 1,077	19,758	84.39
2025	-4	25,755.58	- 1,030	20,788	80.71

Source: Ministry of Finance, Fiscal Management Report 2020 and Central Bank Annual Report 2019

Further, the figures in the medium-term framework are underpinned by some assumptions which lack rigour. These assumptions include

1. The GDP is expected to grow at +1.5 percent in real terms in 2020.
2. The Revenue to GDP ratio is expected to grow from 9.5% to 14.2% but the government has stated that the tax structure will remain largely stable for the next 5 years. The Revenue to GDP ratio will not increase to 14.2% of GDP solely due to nominal GDP growth and administrative measures. Substantial revenue generating measures are required to achieve this. In fact, the past numbers show the revenue to GDP has reduced in spite of an increase in GDP (see exhibit 5).
3. The model does not factor the currency depreciation effect in considering growth of the foreign debt component.

Exhibit 5: Comparison of growths of Real GDP and Revenue over time

Source: Central Bank of Sri Lanka

⁶ The government has reported in the budget speech this number as 8.8 percent in the Fiscal Management Report. However, since the 2019 government debt does not include the arrears that were later brought in to the budget numbers, the increase in the 2019 deficit is added as 2020 deficit. Hence, the figure is higher at - 10.7%

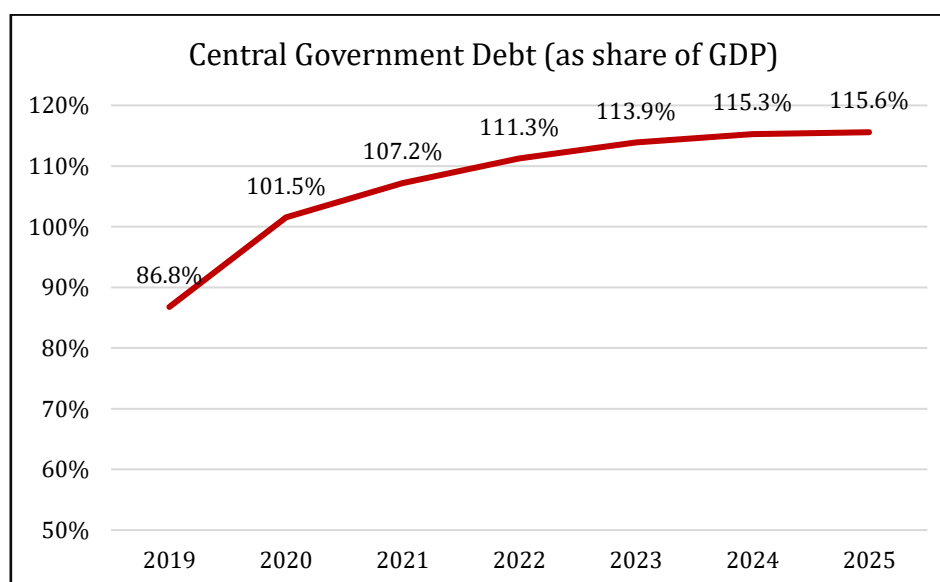
Considering a more realistic set of assumptions— which are still conservative as we assume the GDP growth (from 2021 onwards), interest rates, inflation and domestic financing ratio to be in line with government’s assumptions— the Debt to GDP of the country is expected to rise to 115.6 percent in 2025 – far higher than the government’s forecast of 75.5% of GDP by 2025. The changes to the other fiscal indicators are given in the table 3.4.3. The assumptions used to develop the model are given in table 3.4.4.

Table 3.4.3: Projected Fiscal Indicators based on more realistic assumptions

	2019 Actual	2020 Est	2021 Est	2022 Est	2023 Est	2024 Est	2025 Est
Revenue and grants	12.6%	8.8%	9.2%	9.6%	10.0%	10.5%	10.9%
Total Expenditure w/o interest	13.4%	15.9%	16.5%	15.7%	15.0%	14.3%	13.7%
Interest Payments	6.0%	6.3%	5.8%	5.9%	6.1%	6.3%	6.5%
Overall Budget Balance	-6.8%	-13.4%	-13.1%	-12.1%	-11.1%	-10.1%	-9.2%
Primary Balance	-0.8%	-7.1%	-7.3%	-6.1%	-5.0%	-3.8%	-2.7%
Debt/GDP	86.8%	101.5%	107.2%	111.3%	113.9%	115.3%	115.6%
Interest/Revenue	47.5%	71.0%	63.5%	62.0%	60.9%	60.2%	59.7%

Source: Author’s calculation based on Ministry of Finance and Central Bank of Sri Lanka numbers

Exhibit 6: Estimated Debt to GDP ratio based on realistic assumptions



Source: Author’s calculation based on Ministry of Finance numbers

Assumptions used are as follows

1. The real GDP is expected to grow at -4.4% in 2020 and at 5% 2021 onwards.
2. Revenue is expected to remain lower— in line with the revised numbers recommended in section 3.3— for 2020 and 2021. Thereafter, revenue is expected to increase at the rate of nominal GDP plus 5% increment —considering effective implementation of administrative measures.
3. Expenditure excluding interest rates are assumed to be the same as expected for 2020 and 2021 in LKR terms. From 2021 onwards expenditure is expected to grow at the rate of Inflation.
4. Depreciation of the exchange rate is considered to increase foreign debt by 4.4% every year. This is based on an average of the last 10 years depreciation effect on foreign debt.
5. Domestic Interest rates are expected to remain at a single digit level. Domestic Interest rates will decrease to 5% in 2021, increase gradually to a conservative 7.5% in 2025. Interest rate is expected to increase as domestic borrowing requirements increase.
6. Short term to long term debt ratio are assumed to be 30:70 based on 2019 actuals numbers.
7. The domestic financing ratio will remain at 95% for all years in accordance with Budget Speech financing numbers.
8. Government will achieve its ambitious budgeted capital expenditure targets in 2021. Capital expenditure for 2021 is estimated at LKR 1,070, 72 percent higher than the 2019 actual figure (without considering any arrears). If the government were to reduce the 2021 capital expenditure to 5 percent of GDP, in line with the historical average, the debt to GDP will change to 109 percent in 2025.

Table 3.4.4: Assumptions used for the estimation of the forward fiscal indicators

Assumptions	2020	2021	2022	2023	2024	2025
Domestic one year Average Interest rate	6.5%	5.0%	6.0%	6.5%	7.0%	7.5%
Real GDP Growth	-4.4%	5.0%	5.0%	5.0%	5.0%	5.0%
Inflation	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Nominal GDP Growth	0.60%	10%	10%	10%	10%	10%
Long to Short term domestic debt ratio	70%	70%	70%	70%	70%	70%
Domestic to Foreign Refinance ratio	95%	95%	95%	95%	95%	95%
Depreciation effect on Foreign Debt	4.4%	4.4%	4.4%	4.4%	4.4%	4.4%
Interest Rate on total debt portfolio						
Foreign	3.7%	3.7%	3.7%	3.7%	3.7%	3.7%
Domestic	9.4%	8.1%	7.5%	7.2%	7.1%	7.2%