Key Developments in the Fiscal Sector and the Way Forward

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Highlights of the Current Position

- **Sri Lanka faces an unprecedented economic crisis** caused by the impact of the COVID-19 pandemic, particularly on tourism and remittances, as well as by the terms of trade shock and further shocks from the conflict in Ukraine coupled with past policy mistakes
- Sri Lanka's debt has been assessed as **"unsustainable"** by the IMF
- Government revenue is very low and **the pressure on the budget is severe**
- The **country has virtually no liquid foreign exchange reserves,** and hence cannot repay its debts, and is struggling to secure uninterrupted supply of fuel, food and pharmaceuticals, etc.
- **The need for essential imports and multilateral debt payments would be around USD 4 billion over the next 6 months**
- This dire situation needs urgent attention
- There is international support, led by India, but more forex inflows are needed
- **Significant constraints in the Government budget have adversely affected the efforts in responding to the current situation**

Key area of concern is the fiscal sector…

- Sri Lanka's fiscal policy and performance have been widely reviewed and discussed both in academic and policymaking circles
- The fiscal policy strategies adopted by successive governments since independence have supported considerable socio-economic achievements amidst a three decades long internal conflict
- However, fiscal weaknesses have intensified over the years as reflected in all key fiscal variables.
- **The root cause of prevailing macroeconomic imbalances in Sri Lanka is also of fiscal origin** as the excess aggregate demand created by large fiscal deficits with fiscal dominance has complicated monetary and exchange rate policies as well
- Over the years, the fiscal space has narrowed significantly, and **Sri Lanka can no longer afford to live beyond its means**

Hence, implementation of corrective measures to improve the fiscal performance is critical without any further delay…

In this process, the provision of relief to the people, particularly to the poor and vulnerable segments in the society, is very important given the current circumstances.

Persistent fiscal issues in Sri Lanka…

- Following factors continue to be the key concerns in the fiscal sector.
  - Deterioration of government revenue mobilization over the past decades: The non-reversal of the large tax cuts introduced in 2019 is one of the major contributors to this decline
  - Relatively high and rigid recurrent expenditure
  - Lower than expected efficiency in capital expenditure and implementation of projects without proper feasibility and priority
  - Chronically high fiscal deficits
  - High and unsustainable level of debt and increasing debt service payments
  - Sovereign rating downgrades, & loss of access to international markets
  - Fragile performance of State-Owned Enterprises (SOEs) which contributed to the accumulation of debt, affecting the Banking sector stability
- The COVID-19 pandemic and related developments, and multifaceted external sector challenges also had an adverse impact on the fiscal performance since early 2020

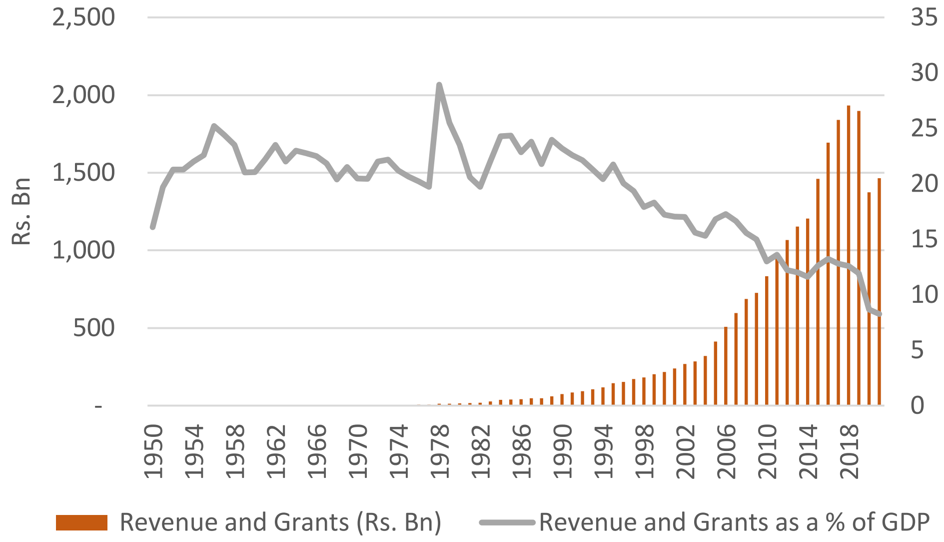
Hence, resolving the above fiscal issues and restoring fiscal discipline are the key to ensure macroeconomic stability and to fast-track economic growth in Sri Lanka….

Revenue Performance 2019, 2020 and 2021

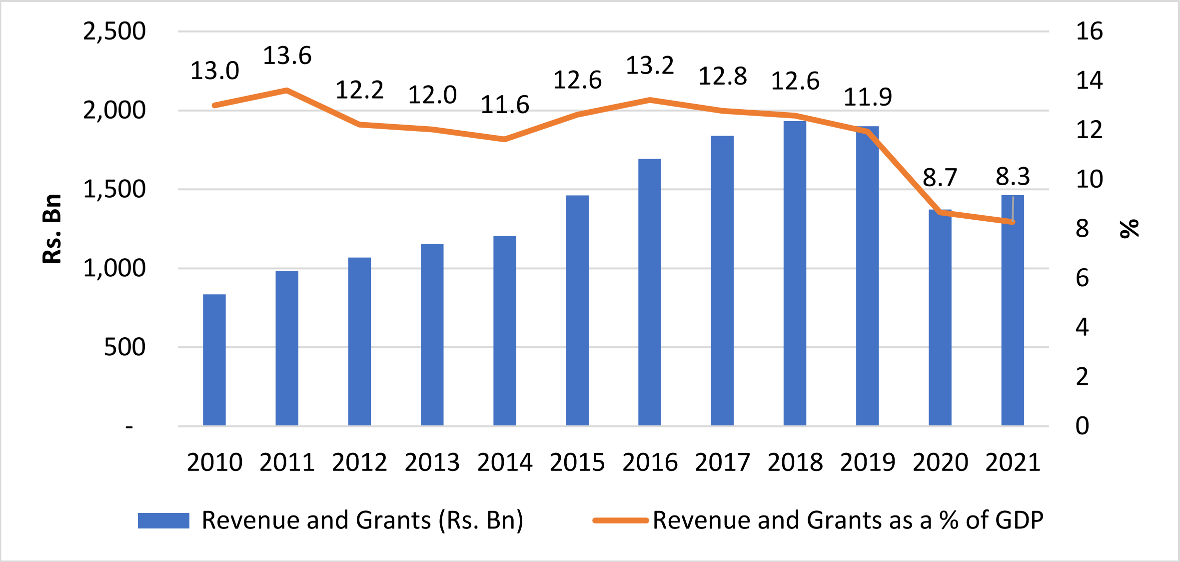
Government Revenue: 2019 - 2021

Item	Amount (Rs. Billion)			Deviation (Rs. Billion)		% Change	
	2019	2020	2021	2019/20	2020/21	2019/20	2020/21
Tax Revenue	1,735	1,217	1,298	-518	81	-29.9	6.7
Income Tax	428	268	302	-159	34	-37.3	12.6
VAT	444	234	308	-210	74	-47.3	31.8
Excise Tax	399	322	307	-78	-15	-19.4	-4.7
Other Taxes	132	31	31	-101	0	-76.6	0.2
o/w Telecommunication Levy	18	13	13	-5	-0.3	-28.1	-2.2
Taxes on External Trade	332	362	350	30	-12	9.0	-3.3
Non Tax Revenue	156	151	159	-5	8	-2.9	5.0
Total Revenue	**1,891**	**1,368**	**1,457**	**-523**	**89**	**-27.7**	**6.5**
Total Revenue and Grants	1,899	1,373	1,464	-526	91	-27.7	6.6

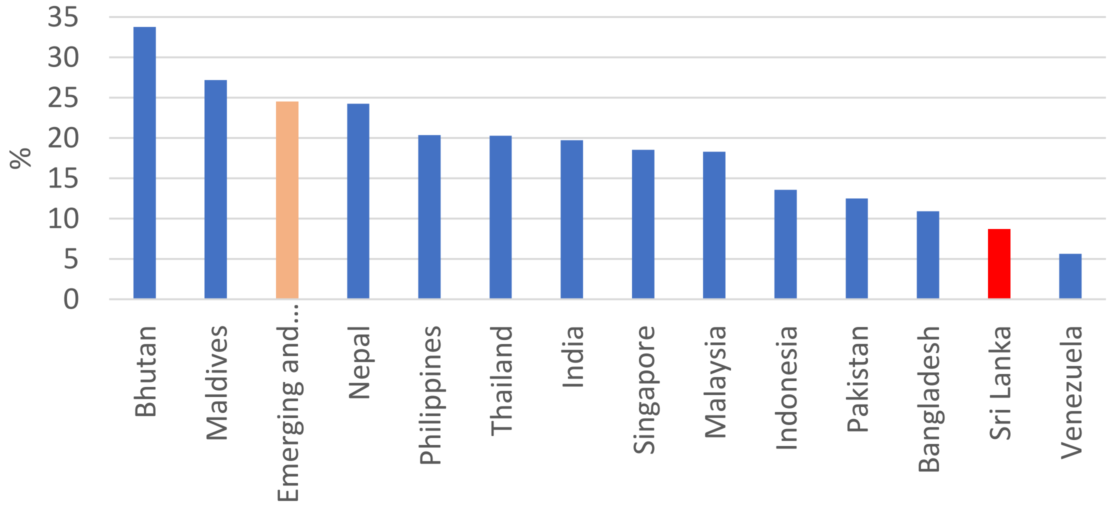
Government revenue (1950-2021)



Government revenue: Recent trends (2010-2021)

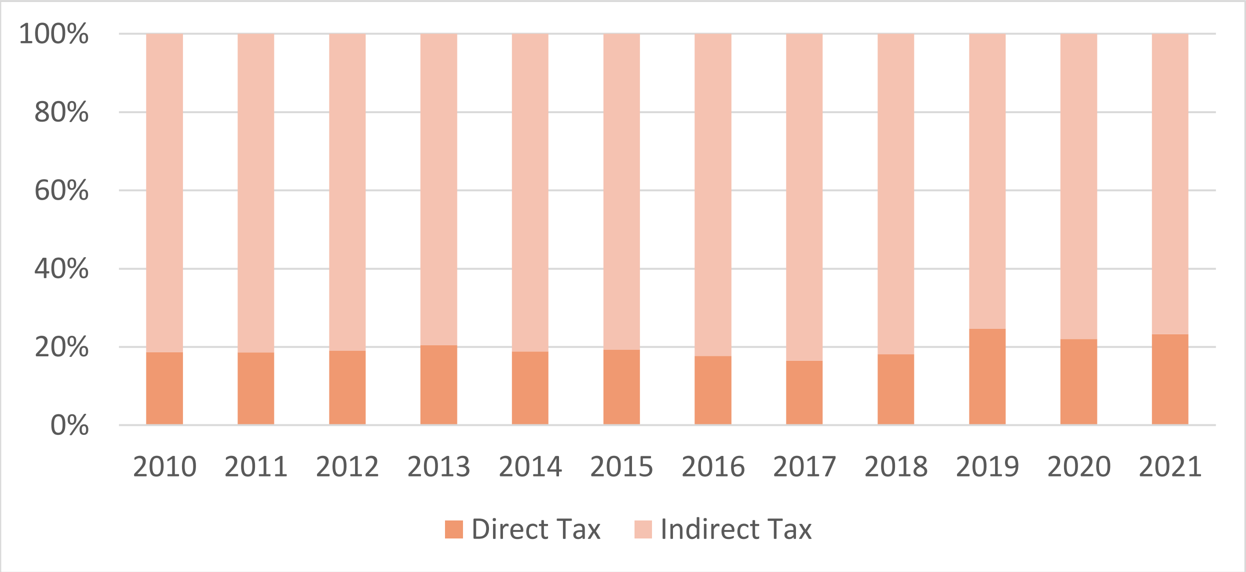


Government revenue as a % of GDP: Sri Lanka at the lowest level

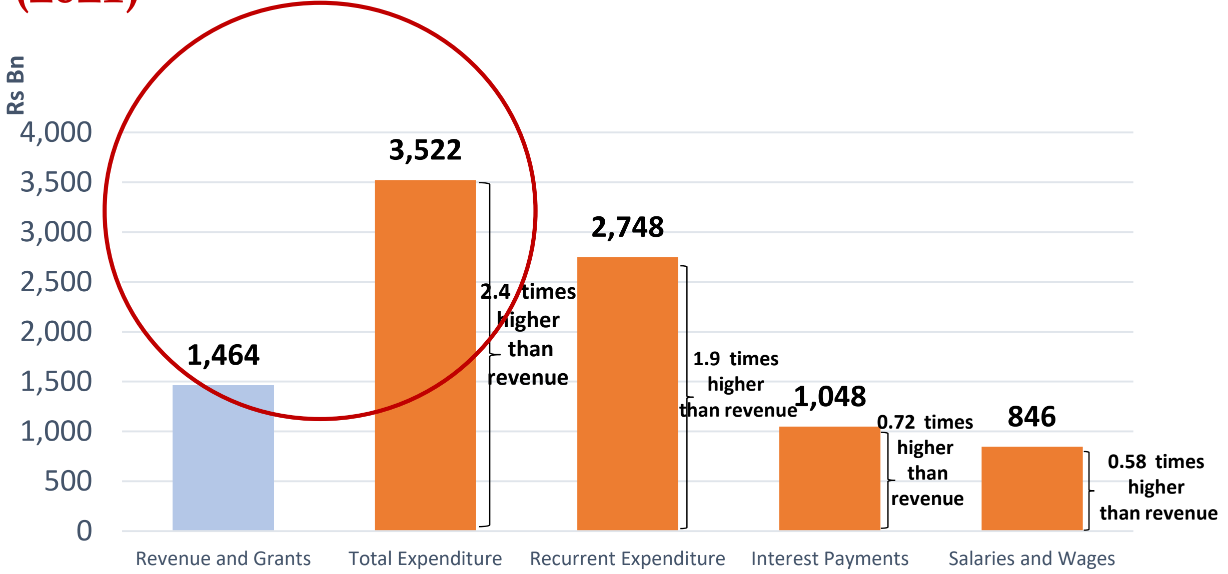


Source: World Economic Outlook, IMF, April 2022

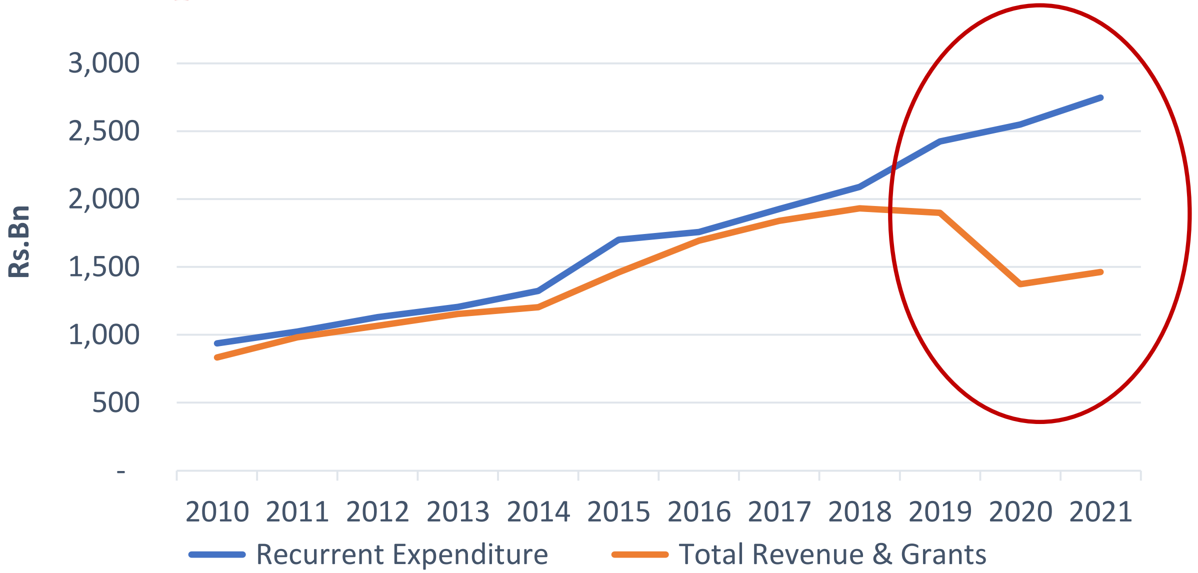
Direct tax to indirect tax remains intact over the years: More tax burden to the poor



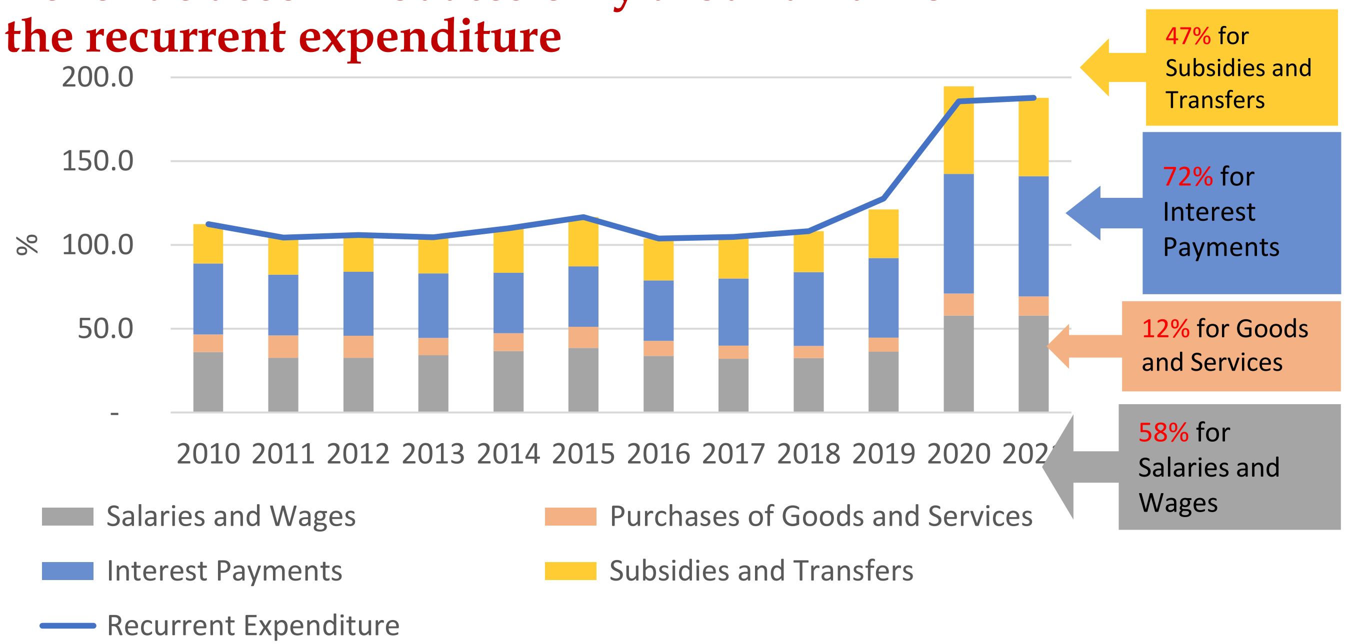
Expenditure significantly higher than revenue (2021)



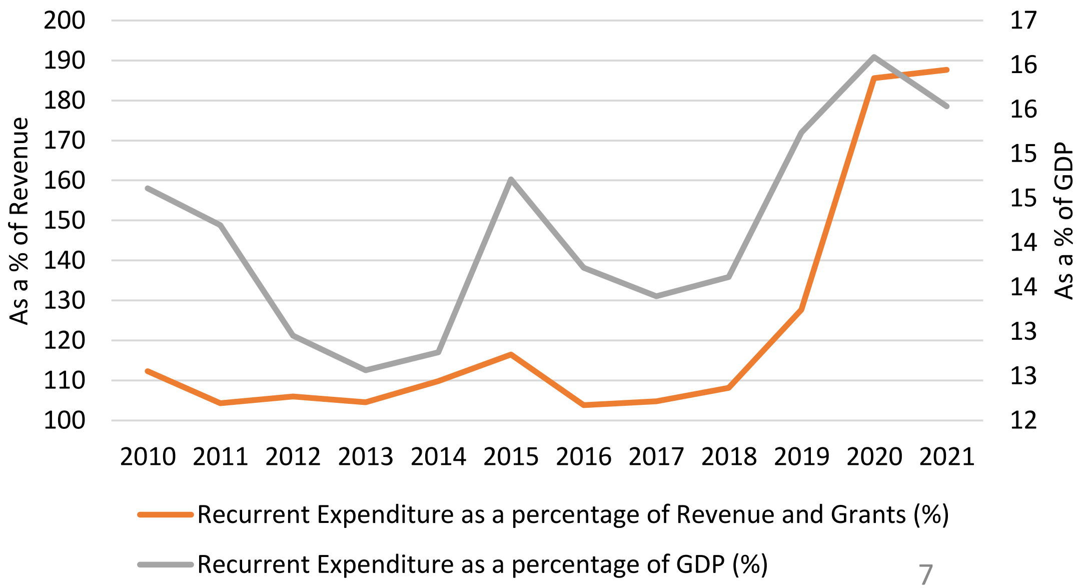
Sharp widening of gap between recurrent expenditure and revenue



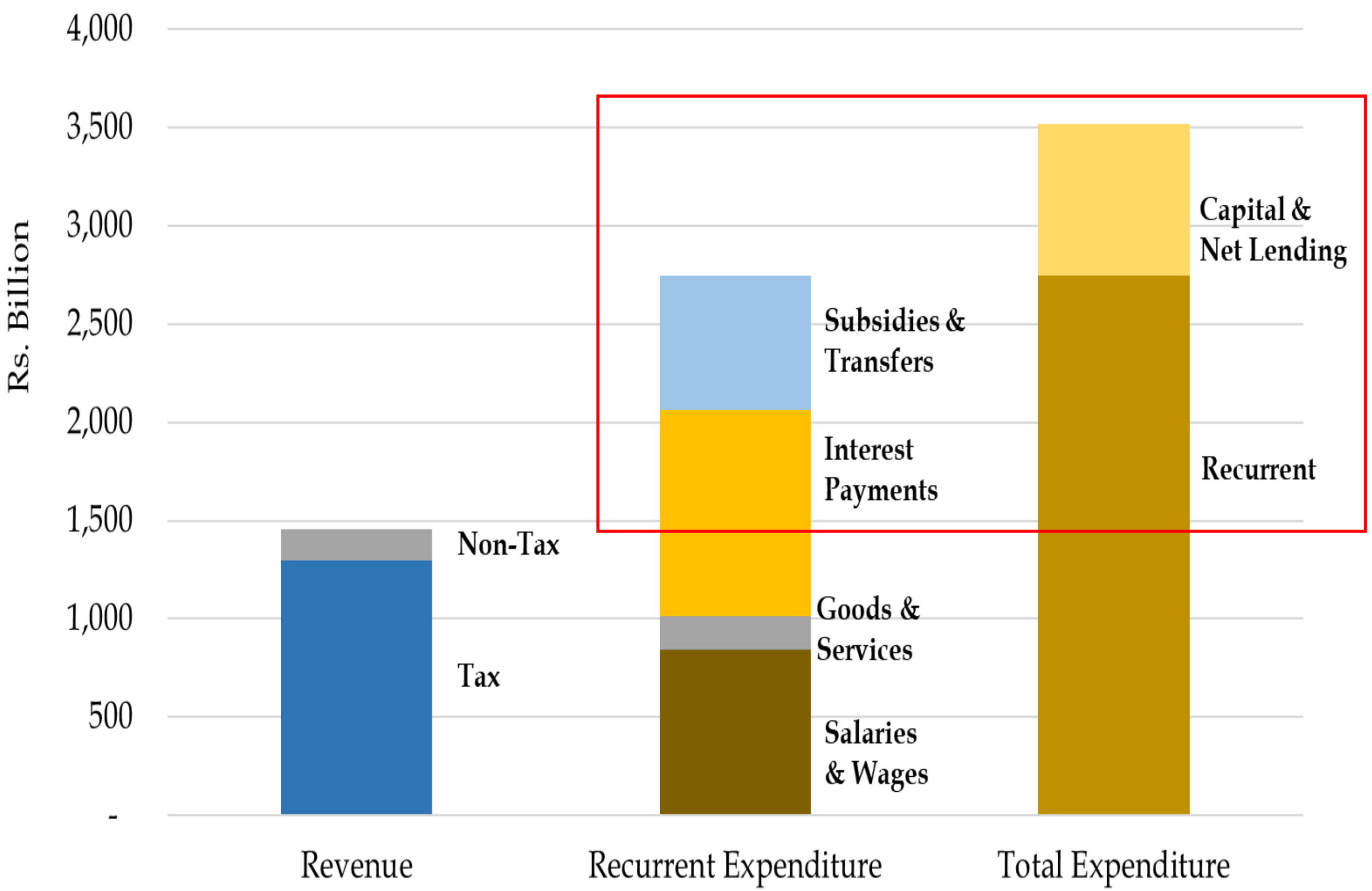
Revenue accommodates only around half of the recurrent expenditure



Relative trends of recurrent expenditure

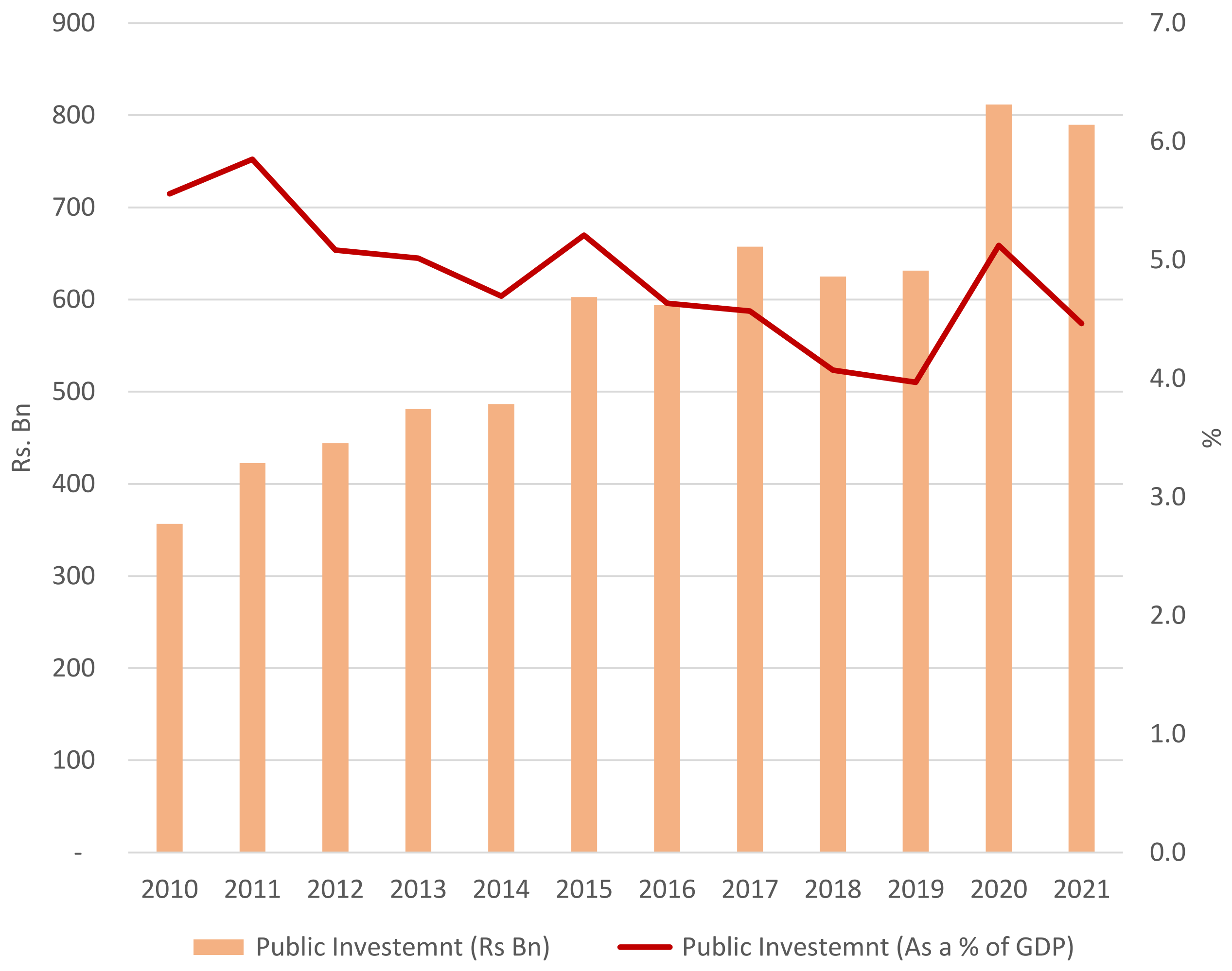


Limited / No fiscal space (2021)



This is one of the key issues in the fiscal sector at present, which needs strong actions aimed at fiscal consolidation.

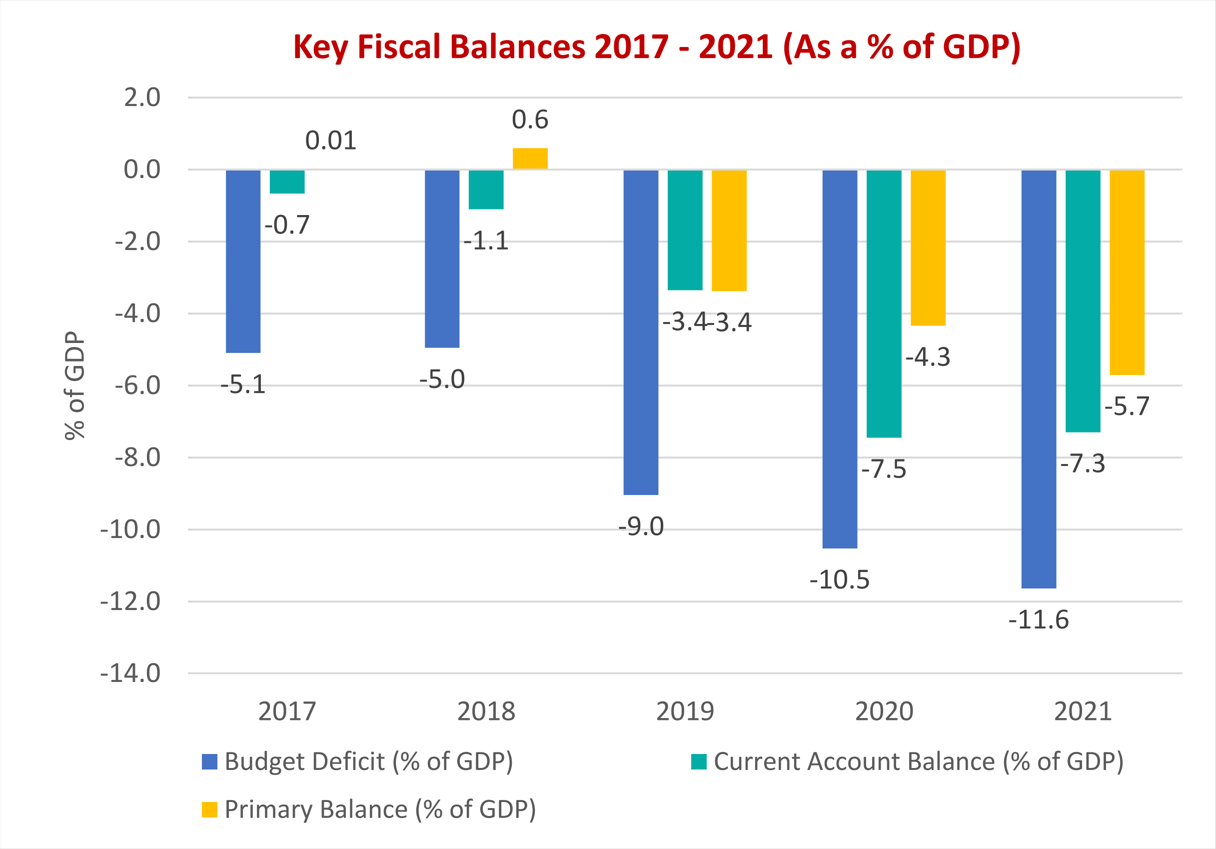
Stagnant public investment



- With the rigid recurrent expenditure, public investment as a % of GDP, which supports the development of the economy in the long run, **has not been growing.**

- In addition, lower efficiency and non-priority in capital expenditure pose another concern that needs to be addressed.

All three key fiscal balances deteriorated in 2020 and 2021…

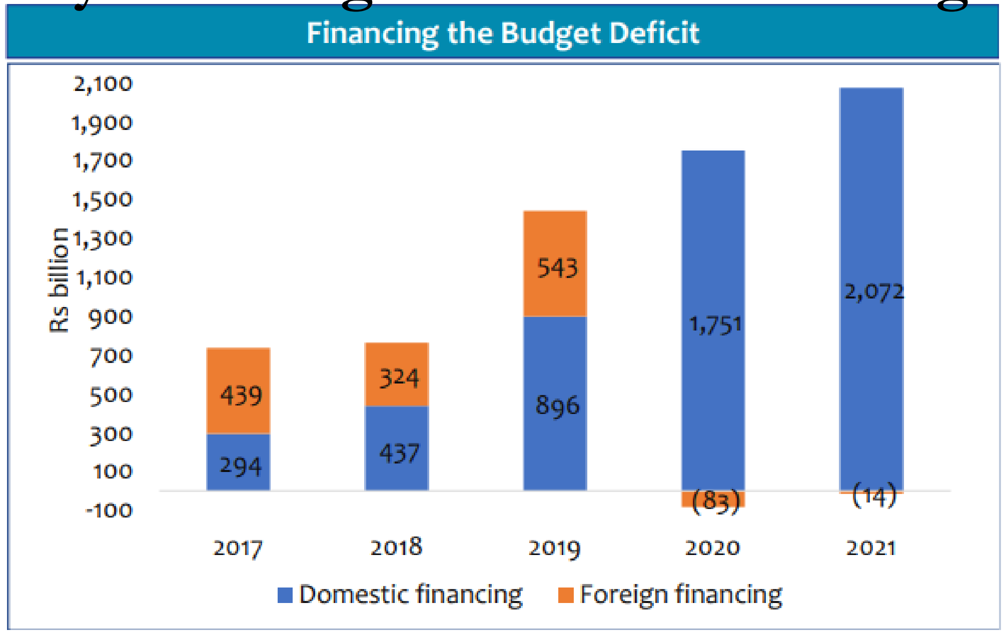


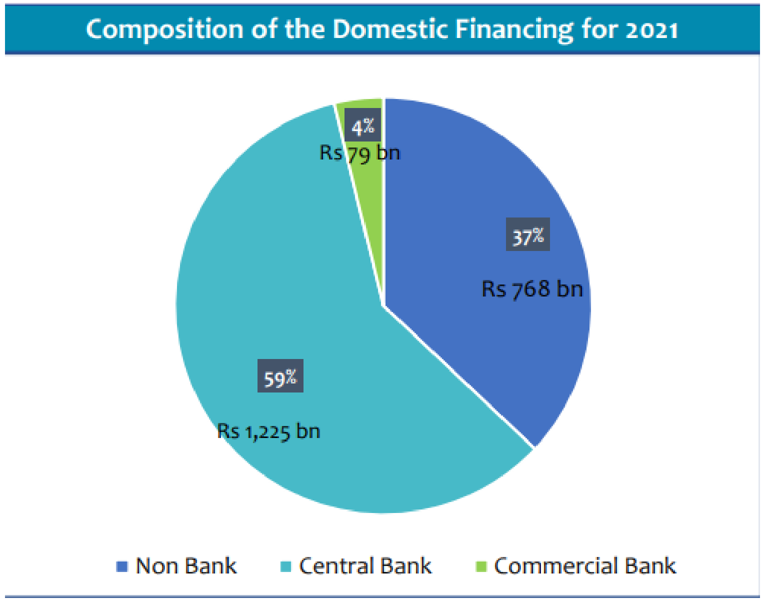
Summary of Government Fiscal Operations

As a % of GDP	2020	2021
Total Revenue & Grants	**8.7**	**8.3**
Total Revenue	8.6	8.2
Tax Revenue	7.7	7.3
Non-Tax Revenue	1.0	0.9
Grants	0.03	0.04
Total Expenditure	**19.2**	**19.9**
Recurrent	16.1	15.5
Capital and net lending	3.1	4.4
Public Investments	5.1	4.5
Current Account Balance	**(7.5)**	**(7.3)**
Primary Balance	**(4.3)**	**(5.7)**
Budget deficit	**(10.5)**	**(11.6)**
Total Financing	**10.5**	**11.6**
Total Foreign Financing (Net)	(0.5)	(0.1)
Total Domestic Financing (Net)	11.1	11.7

Budget deficits in the last two years were financed through domestic sources, which resulted in a depletion of reserves and a sharp increase in monetary financing…

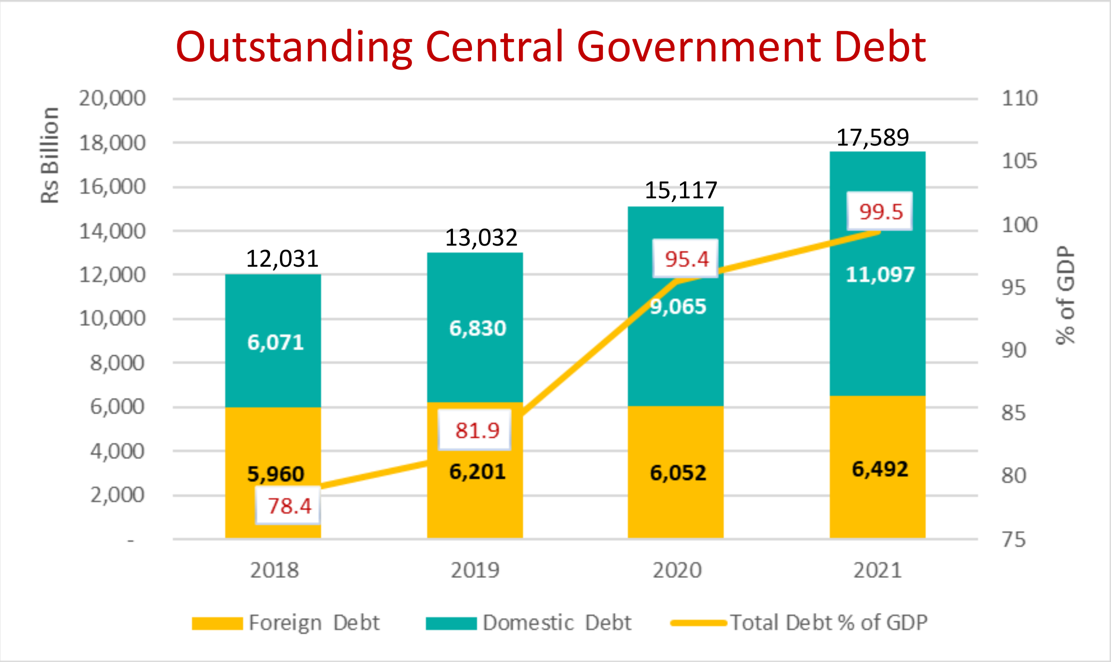
- **A net repayment of foreign debt was recorded in 2020 and 2021.**
- Constrained access to international financial markets with the credit downgrades aggravated the situation.
- The increase of domestic financing is primarily sourced through banks, among which, **monetary financing has increased to a significant level.**

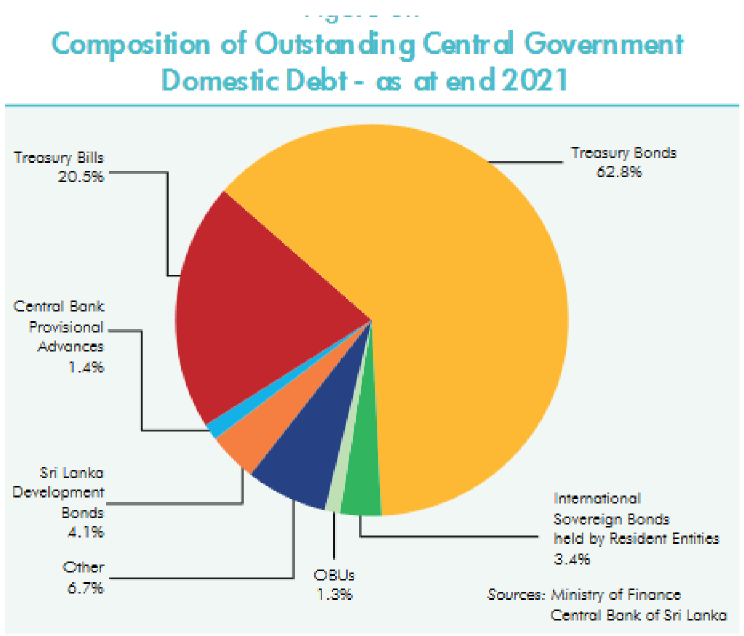




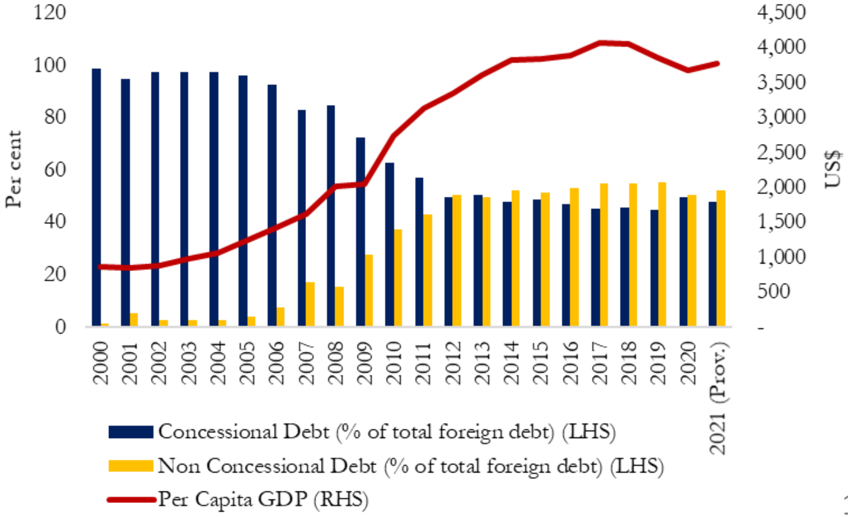
Chronically high fiscal deficits led to high debt accumulation

- Persistently high budget deficits contributed to debt accumulation, and Sri Lanka experienced episodes of high Debt to GDP ratios over 100% (1988-89, 2001-2004) and 99.5 % in 2021
- Increased utilization of foreign sources in deficit financing resulted in a substantially high share of foreign debt accumulation
- Further, the availability of concessional funding in deficit financing declined after Sri Lanka graduated to a middle-income country
- **Sri Lanka officially suspended the payment of selected debt since 12 April 2022 (pre-emptive default) due to the critically low level of reserves and the debt restructuring process**



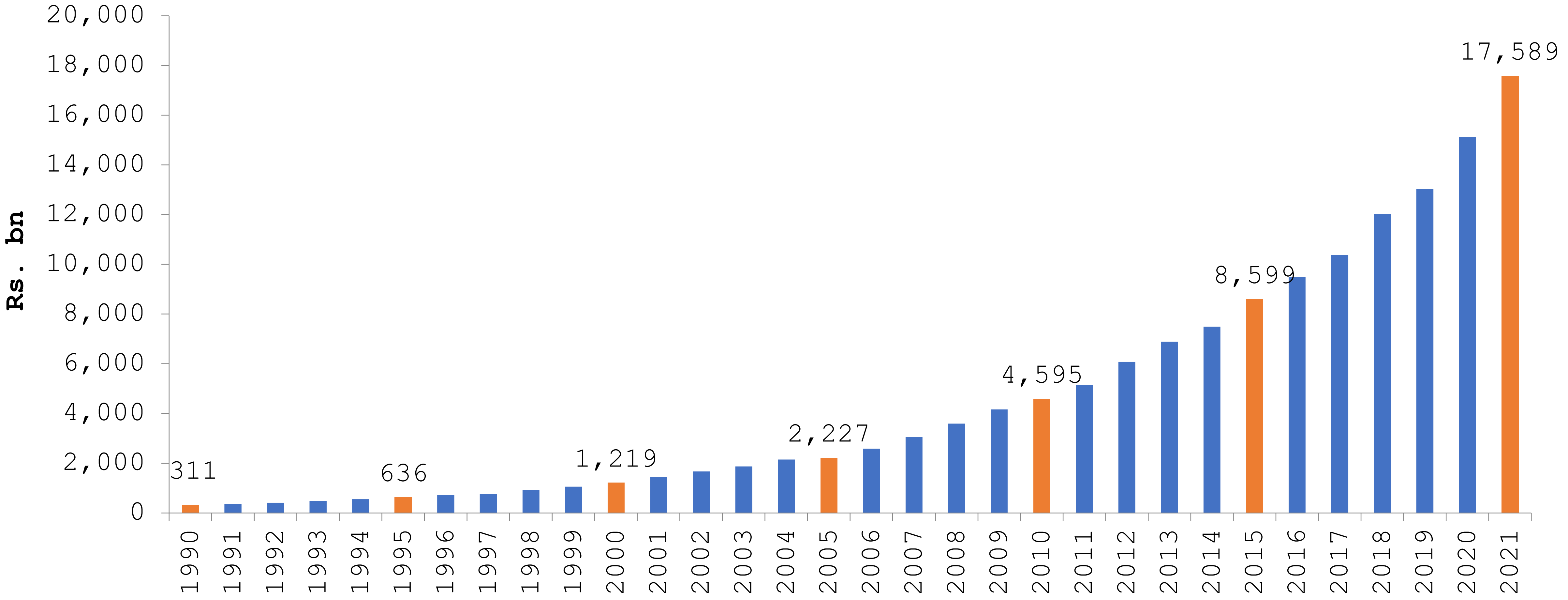


Concessionality of Foreign Debt



Source: Central Bank of Sri Lanka

Government debt has doubled every five years



As a country, this is clearly not sustainable.

High and increasing debt service payments

- Debt service payments increased rapidly in the recent past

Central Government Debt Service Payments

Rs. million

Item	2018	2019	2020	2021 (a)
Debt Service Payments	**2,088,551**	**2,022,507**	**1,941,373**	**2,375,599**
Domestic	1,561,363	1,213,698	1,169,522	1,590,131
Foreign	527,188	808,809	771,851	785,468
Amortisation Payments	**1,236,361**	**1,121,155**	**961,071**	**1,327,216**
Domestic	921,881	546,315	455,899	795,498
Foreign	314,480	574,839	505,172	531,718
Interest Payments	**852,190**	**901,353**	**980,302**	**1,048,383**
Domestic	639,482	667,383	713,623	794,633
Short Term	74,525	81,029	77,965	98,694
Medium and Long Term	564,957	586,354	635,658	695,939
Foreign	212,708	233,970	266,679	253,750

(a) Provisional

Sources: Ministry of Finance
Central Bank of Sri Lanka

- The cash flow management has become a difficult task.
- In addition, there are outstanding bills of about Rs. 159 billion as at end-May, 2022

Constrained Fiscal Flexibility – KEY ISSUES IN THE FISCAL SECTOR - Summary

- Gradual lowering of fiscal space has **reduced the fiscal policy flexibility**
- **Revenue pressures** have limited the accommodation of expenditure needs for public investment, particularly in human capital development
- **Lack of fiscal space has also inhibited the growth prospects of Sri Lanka,** adversely affecting development efforts to reduce poverty
- High budget deficits have led to an instability in the economy
- High and unsustainable debt has created serious issues
- **The excess aggregate demand created by large fiscal deficits has complicated monetary and exchange rate policies**

Issue	Required MT Response
Declined Revenue to GDP Ratio	Strong effort to enhance revenue
Continuous Current Account Deficit	Steady reduction in revenue deficit to improve fiscal space
Continuous Primary Deficit	Increasing revenue and reducing non-interest recurrent expenditure through medium term structural reforms towards creating a primary surplus to reduce debt
Constraints in Increasing Public Investment	Bringing in alternative financing mechanisms to enhance public investment
Relatively High Budget Deficits	**Reduction of the budget deficit to a more sustainable level (through all the above mentioned policies and measures)**
High and unsustainable Government Debt to GDP Ratio	Ensuring better debt outcome through reduction of deficits and debt restructuring, complemented by high economic growth
Erratic nature of SOBEs	Introducing identified and required reforms to make SOBEs financially viable entities

Key Message

The fiscal performance has deteriorated as reflected in the above developments.
Hence, remedial fiscal measures need to be implemented urgently to improve fiscal performance, rebuild confidence among stakeholders and instill certainty and stability…

The WAY FORWARD in the fiscal sector needs to be considered in the above context….

The latest developments in the economy and society, as reflected by the shortages of essential items and demonstrations in streets, require a proper balance in fiscal consolidation efforts

Way forward

Medium term fiscal path *(1)*

- Generating a material primary surplus in the government budget in the medium term through strong fiscal consolidation measures.
- Enhancing revenue to GDP ratio to at least 14 percent of GDP in the medium term with appropriate tax policy and tax administration measures.
- Containing the non-interest recurrent expenditure through the rationalization and management of expenditure, while improving quality of expenditure to increase fiscal space for development activities.
- **Increasing allocation of funds and enhancing targeting of such funds <u>for the most vulnerable segments of the society</u> to protect them and uplift their livelihoods under the social safety net programme.**

Medium term fiscal path *(2)*

- Ensuring a robust selection and prioritization of public investment to ensure sustainable and equitable economic growth with a focus on investment in areas such as education, healthcare, public transportation, and sustainable energy.
- Improving the financial viability, competitiveness and governance of the SOEs including energy, water, transport, and aviation sectors.
- Formulating a sustainable debt management strategy to reduce and maintain the debt to GDP ratio at a prudent level.

Way forward for the fiscal sector *(1)*

<u>Strong adjustments are required urgently</u>, given the dire situation of the public finances

Whether IMF is there or not, we need these reforms as a country with numerous accumulated issues

- **Immediate priorities** include macroeconomic stabilization and provision of essential items, engaging with the IMF and debt restructuring, enhanced social protection measures, finding bridging financing

- **Medium term strategy** will include establishing a medium-term fiscal path, state owned enterprises reforms, social safety net infrastructure

Way forward for the fiscal sector *(2)*

- **The immediate priority of the Government is to regain medium term debt sustainability to support economic stabilization**
  - This will have to be done through a **two-pronged approach**
    - Restructuring the debt stock with advice from Legal and Financial advisors
    - Fiscal consolidation
- **Negotiations with Sri Lankan creditors (commercial, bilateral) while working towards an IMF-supported programme**
  - Equal treatment to all creditors is envisaged
  - Legal and Financial Advisors have been appointed to undertake debt restructuring process
  - Discussions for an IMF-EFF are progressing.
    - **Staff level agreement (SLA) is a critical milestone**
    - SLA agreement will help instill confidence on the economy leading to improved forex inflows

Way forward for the fiscal sector *(3)*

- **For fiscal consolidation, <u>revenue enhancement is key</u>, while postponing of non-essential expenditure is also essential**
  - Revenue based fiscal consolidation
    - Key reforms for income Tax and VAT: increase tax rates and widening tax *bases (already announced and will be strengthened further through the revised budget to be presented in several weeks)*
    - Review of exemptions against their economic benefit
    - Strengthening revenue administration
  - Postponing unessential and non-priority Government Expenditure
    - Temporary suspension of non-priority and non-urgent capital expenditure
    - Prudent management of expenditure by line ministries and establish spending discipline
    - Streamline welfare programmes with better targeting

Recent Tax and expenditure policy measures

- Revision of VAT rate and threshold
- Changes to Personal and Corporate Income Tax
- Expenditure control measures
- SOE related (pricing) measures

Further measures will be introduced to strengthen the fiscal consolidation process and the fiscal institutional framework through the revised budget for 2022.

Way forward for the fiscal sector *(4)*

- **A new framework for fiscal consolidation, based primarily on revenue enhancement, and expenditure rationalization, would be an essential prerequisite to successfully negotiate an IMF programme**
  - Principles of this framework, including preliminary realistic fiscal targets (for the overall balance and primary balance) for 2022 and the medium term are being finalised

- **Urgent financing, from both domestic and foreign sources, need to be secured for day-to-day operations until a lasting solution is reached**
  - Reducing the fiscal deficit to the maximum possible extent
  - Minimising Central Bank financing while mobilizing other domestic resources within a rising interest rate environment
  - Efforts to obtain bilateral and multilateral support to secure bridging (foreign) financing

Way forward for the fiscal sector *(5)*

- **Social safety nets must be strengthened to protect the most vulnerable and all social security payments must be made in a transparent manner, particularly using advancements in digital technology**
  - Digital technology will be crucial in revenue enhancement and expenditure rationalization measures as well
- **Cost based pricing for public utilities and the energy sector needs to be implemented**
  - This can be done with a certain level of price smoothing, but persistent losses of related SOBEs add to the burden of the fiscal sector through contingent liabilities and loss of revenue
  - **Social safety nets should be in place parallel to implementing this**
- **Given the dire financial situation of the country, divestiture of underutilized and non-strategic state assets will be required**
  - This could be used to divest unproductive SOBEs as well
- **Medium to long term growth enhancing policies are also in consideration to strengthen the economy going forward.**
  - **In particular, foreign exchange earning sectors need to be strengthened**

Conclusion *(1)*

- The economy of Sri Lanka is passing through the roughest time in its recent history.
- The government has (virtually) exhausted all foreign and domestic resources to finance its day-to-day operations.
  - Usable official reserves have been exhausted
  - The revenue is not sufficient while the ability to print money has also been exceeded its practical limit, given the lack of or no (net) foreign financing.
- Policies are being put in place to stabilize the situation and help the country to rebound while working to secure a Fund-supported programme.
- There is no room for fiscal and monetary policy mistakes, political mistakes and diplomatic mistakes.
- **<u>The current crisis needs tough and decisive measures</u>**

Conclusion *(2)*

- **Careful management of public finances is critical to rebalance the economy.**
  - Irrational and populist policies are no longer possible
  - Right and urgent policies could hurt some segments of the population.
- Therefore, better communication of the measures are critical moving forward, **with focused support for the most vulnerable.**
- **The country has immense potential, which must be harnessed with the support of all segments, including the private sector, general public and international partners.**

Private sector has a specific & critical role to play, by supporting the stabilization efforts, helping the needy segments and implementing policies/measures to support the recovery….

Thank You