Keynote Speech

By Mr. K.M. Mahinda Siriwardana, Secretary to the Treasury and Ministry of Finance, Economic Stabilisation and National Policies at the Webinar on "*Decoding National Budget 2024: Priorities Revealed*", Organised by Centre for Banking Studies, Central Bank of Sri Lanka and held on 14th November 2023

Budget 2024: A Prelude to the Stable Future

1. Introduction

Budget 2024 marks another crucial milestone in Sri Lanka's path of economic stabilisation and growth. Since the last budget was presented in November 2022, the country has come a long way. Since then, we have seen considerable improvements on the fiscal, monetary, and external economy fronts.

On the fiscal aspects, government tax revenue has grown by 50% in the first half of 2023 compared to the corresponding period in 2022. More importantly, the country has achieved a primary surplus in the first half of 2023 following a primary deficit of 5.7% of GDP in 2021. Arrears have also been controlled and now effectively being eliminated.

State Owned Enterprise reforms are beginning to bear fruit. In 2022, the 52 large SOEs accounted for a collective loss of Rs. 727 billion in the first 8 months of 2022, but this was converted into a profit of Rs. 313 billion in the corresponding period of 2023.

Inflation was reduced from 70% in September 2022 to 1.5% in October 2023 due to the coordinated macroeconomic demand management efforts of the Central Bank and the government, supported by supply-side improvements.

Usable foreign exchange reserves which were around USD 20 million in mid-April 2022 have now recovered substantially. Today, gross official reserves exceed USD 3.5 billion. The improved foreign exchange liquidity in the banking system have enabled the normalisation of supply chains and basic consumption.

Whilst the results of the reform agenda put in place since mid-2022 are indeed encouraging, we are still in relatively early stages of a long and difficult road to a complete recovery. The economy has stabilised significantly compared to where we were last year, but nobody can claim that the stability is fully entrenched. There is no room for complacency and deviate from this reform path.

It is in this context that the 2024 budget is being closely watched not just by the citizens of Sri Lanka, but also by our global development partners, including the International Monetary Fund (IMF), and crucially, Sri Lanka's external creditors.

2. Macroeconomic Path

The budget required a careful navigation of several competing objectives. First, it was necessary to ensure continued adherence to the fiscal consolidation path to ensure macroeconomic stability. Secondly, it was equally important to recognize the pain felt by citizens and to provide some degree of relief, particularly to the most vulnerable groups. Finally, it was also crucial to take the first steps in shifting from stabilisation to economic growth, and putting the economy on a fresh path of better quality growth.

I believe the budget that was presented on Monday has been able to strike the appropriate balance between these competing objectives. The budget ensures a balance of revenue and expenditure to enable a primary surplus of 0.8% of GDP in 2024. Revenue growth is ensured by measures already introduced and significant attention is paid to enhancing tax administration, compliance, and digitisation.

Revenue growth in 2024 is ensured by measures already introduced and reforms to the VAT structure. Amendments to the VAT Act have been submitted to the parliament which will significantly expand the VAT base. The vast majority of VAT exemptions will be eliminated and this will significantly add to revenue in 2024. The already announced increase in the VAT rate will also have a material revenue impact. At the same time, the elimination of import restrictions except for passenger motor vehicles will result in normalisation of imports in 2024. This will also have a significant upside on border taxes and VAT/Social Security Contribution Levy (SSCL) from imports.

With the recent changes, the tax structure is largely in place with a focus on a few core taxes, such as corporate and personal income tax, VAT, and core excises on alcohol, tobacco, and fuel. The government's focus now is on enhancing tax administration, compliance, and digitisation. It is important to understand that Sri Lanka's tax administration structure is saddled with deep, long standing legacy issues. The weaknesses in Revenue Administration Management Information System (RAMIS), a system introduced in 2013, is a reflection of this. There is an urgent need for institutional reform, digitalisation, and change in practices. These constraints cannot be resolved overnight but we have to start somewhere.

At present, a comprehensive effort to improve tax administration and compliance reform is ongoing. Many of these measures are reflected in the budget, such as digitalisation, risk based audits, expanding TIN coverage, and so on. There are several initiatives taking place in parallel – many of which are also covered under the IMF and World Bank reform programmes.

We are confident that the combination of widening the VAT base, increase in VAT rate to 18%, removal of import restrictions, recovery of economic activity, and tax administration efforts, the revenue required to support the 2024 budget will be met. This will enable us to meet the IMF's primary balance target of 0.8% of GDP and ensure the programme remains on track.

3. Debt Restructuring

Following this budget, the next critical milestone would be the next steps in the process of external debt restructuring. Sri Lanka has asked its external creditors to accept significant losses on their holdings of Sri Lankan debt. Creditors will be keeping a close eye on this budget to assess whether Sri Lanka is keeping to its commitments in establishing fiscal consolidation as the country's contribution towards achieving debt sustainability.

Sri Lanka has already provided all groups of creditors with indicative restructuring scenarios that will enable the achievement of the debt reduction targets set by the IMF. That is, the reduction of Debt to GDP from 128% of GDP in 2022 to less than 95% of GDP in 2032, reduction of Gross Financing Needs (GFN) from 34.6% of GDP in 2022 to less than 13% of GDP on average during 2027-2032, and restricting external debt service to GDP from 9.4% in 2022 to less than 4.5% in 2027-2032.

It is now up to external creditors to come to an agreement with Sri Lankan authorities on a debt treatment that helps achieve these targets. China Exim Bank has already come to an understanding with Sri Lanka regarding such a debt treatment. The next step would be for the Official Creditor Committee (co-chaired by Japan, India, and France) to provide a similar understanding. We are very hopeful that this will be materialised soon.

At that point, the IMF will be able to assess whether the debt treatments are sufficient to meet the targets and whether they meet the requirements of comparability of treatment. This would enable the IMF Executive Board to approve the first review and unlock the next tranche of financing. The budget would need to be in line with agreed macroeconomic reform parameters to ensure both the IMF and external creditors are happy to proceed.

The continuity of the IMF programme and debt restructuring process is crucial to ensure global confidence in the Sri Lankan economy, enabling the country to continue to engage in trade finance and regular financial market transactions.

4. Financial Sector Stability

A critical pillar in Sri Lanka's macroeconomic reform programme is ensuring the stability of the financial sector. During times of economic stress, there is typically an increase in pressure on financial sector stability.

The domestic debt optimisation (DDO) process has had material impacts on the balance sheets of the state banks in particular. In order to ensure continued strength of the banking sector, the government has proactively allocated Rs. 450 billion towards recapitalisation of the relevant entities.

There is also an allocation of Rs. 3,000 billion to provide for the issue of new restructured USD bonds in exchange for existing international sovereign bonds (ISBs). Both the above allocations are financed in a manner that will not disrupt the domestic rupee fixed income market.

The bank recapitalisation allocation is more than enough to ensure the banking sector remains stable and well capitalised. However, in parallel, a number of governance and regulatory reforms for the banking sector are being implemented. This includes enhanced disciplines on appointments of key management personnel and boards of state banks, tighter restrictions in terms of single borrower limits and other credit risk parameters, and other measures to ensure the mistakes of the past are not repeated.

5. Relief Measures

Following the economic stabilisation measures, the other key objective of the budget was to provide an affordable and sustainable level of relief to the public. Towards this end, the provisions for social safety nets have been increased targeting the poorest and most vulnerable households. Public sector salaries and pensions have been adjusted to the extent possible given the prevailing fiscal constraints.

Central Bank data indicates that the private sector has seen some wage adjustment in response to inflation over the last 2 years, but public sector wages have remained static. The CBSL private sector wage index has increased by 25% between January 2022 and August 2023 while public sector wage index has not changed with 0% growth according to the same measures. The adjustment of public sector wages addresses this to some extent, whilst ensuring fiscal targets remain in tact.

It has however not been possible to provide relief on tax measures at this stage. Government revenue collection remains below target levels, and it is the aggregate target that is watched closely by the IMF and external creditors. In a context where revenue is below target, and where tax reforms have been in place for less than a year, it has become very difficult to defend a reduction in taxes, particularly those that affect the top 20% of income earners in the country. Any reduction in one type of taxes would have to be matched by an increase in a different tax to maintain the aggregate revenue targets in tact.

Once the results of tax administration and compliance reforms begin to bear fruit, and aggregate tax targets can be met, it will be possible to revisit some relief in terms of tax liability.

6. A New Growth Path

Finally, the budget also needed to provide the stepping stones for a shift from economic stabilisation to growth. A sustainable economic growth level is a crucial component of the overall debt sustainability and fiscal stability framework. Going forward, growth would also need to break from the past trends of debt financed growth driven by the non-tradable sector.

The economic growth is expected to recover in 2024 due to the improved macroeconomic environment. Interest rates have declined to less than half the levels of 2022, inflation has been restored at single digit levels, elimination of import restrictions will address past supply chain bottlenecks, and there will be some pent up demand in the economy as well. The expected conclusion of the external debt restructuring process will address any residual uncertainty in the economic outlook as well. The budget provides further impetus to this through targeted measures to address key sectors such as construction, exports, agriculture, logistics, SMEs and so on.

The budget sets out the framework to support growth, led by non-debt creating inflows. Particular reference is made to integration with global markets for trade and investment. Expansion of free trade agreements, improving trade facilitation measures, addressing supply side bottlenecks are key elements outlined in the budget.

Addressing the constraints to investment promotion are also articulated, particularly in terms of access to land, raw materials, skills development, and so on. A new agency, which is in the final stages of being established, will provide oversight to the development and promotion of trade and investment. Supporting the other areas, including tourism industry, creative economy and gig economic affairs also has given the due attention.

Growth must also be inclusive. That is why a lot of emphasis is placed on the integration of the rural economy and SMEs into broader value chains. This applies to the agricultural modernisation agenda in particular, but also the SME sector. The budget provides significant levels of support to the SME sector through a comprehensive strategy to address financing constraints, capacity development, and market access. Special attention is provided to youth led and women led SMEs in this regard.

The budget also articulates the digital journey that the country is expected to embark on, along with ensuring growth is driven by principles of sustainability and the green economy. Digitalisation of the economy has important fiscal implications as well by helping the economy shift away from cash transactions to more traceable transactions. It also enables better targeting and delivery of welfare measures.

7. Legislation

In the past, whenever Sri Lanka has undergone a reform period and stabilisation is achieved, the tendency has been to slip back into old habits. The country can no longer afford such slippage in the absence of economic buffers to withstand any further shocks. Therefore, it is essential that legislation is put in place that helps lock in the reforms that are being implemented. The Ministry of Finance is in advanced stages of drafting the Public Finance Management Bill. The PFM legislation provides the legal framework to support the ongoing fiscal reforms. This includes robust fiscal rules, enhanced disciplines on budgetary processes, developing the medium term fiscal framework, improved transparency, and clear oversight on budget execution. The legislation is expected to be in place by early 2024.

In addition to the PFM law, there will be other legislation, including the public debt management law, procurement law, SOE law, PPP law, among others, which are expected to lock in the fiscal reforms being implemented. However, we are aware that legislation alone is not sufficient to drive meaningful change. Sri Lanka's experience with the Fiscal Management Responsibility Act FMRA legislation of 2003 is testament to that. Therefore, along with the legislation, it is essential that all stakeholders, that is the Parliament, government officials, civil society, academia, the media, and the general public, all become stakeholders in this process to support the implementation of the PFM bill and other legislation to ensure that fiscal discipline in the country remains on track into the long term.

8. Concluding Remarks

The 2024 budget makes a significant break from the past. Over the years, Sri Lanka has expected successive governments to play a major role in all aspects of the economy, from commercial activity to providing social welfare and being the employer of last resort. However, tax revenues have declined at the same time, leading to a steady build-up of debt which eventually was no longer sustainable, resulting in an unprecedented economic crisis.

To avoid a cycle of repeat crises in the future, it is necessary for Sri Lanka to change this "**Social Contract**". The 2024 budget sets the foundation for such a shift in the economic path of the country. This also requires a major shift in terms of governance. Sri Lanka became the first country in Asia to conduct a comprehensive independent diagnostic of governance structures and corruption vulnerabilities. Many of the findings of this diagnostic are already being addressed through a comprehensive action plan. Corruption must be eliminated and all stakeholders must work together to reset Sri Lanka's governance culture.

Sri Lanka once again finds itself at a crucial cross road. The country can continue along the reform path that has enabled the country to gradually emerge from this deep economic crisis, or we can take short cuts and seek unsustainable relief and deviate from this path. The second option will no doubt lead to a return to a crisis far worse than what we collectively experienced in 2022.

The implementation of the budget proposals is critically important to achieve desired outcomes and stakeholder contribution will be crucial in this regard. Hence, as professionals, it is our responsibility to help navigate the country through this challenging period towards a sustainable economic path that will provide prosperity for all citizens in the medium to long term.

Thank you.