

PUBLIC REPORT ON THE 2022 BUDGET

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

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December 2021

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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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SECTION I: Introduction to the Report

1.1. Background

The 2022 budget was presented to the parliament on November 12, 2021, outlining the government's proposals to raise public funds through taxation and proposals for expenditure during the year. These proposals form the framework of the executive management of public finance. Therefore, it is in the public's best interest to subject to objective and vigorous analysis, the assumptions and estimates used to arrive at the said proposals.

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

The report was based on four sources: (1) Numbers provided in the budget speech for 2022 presented in parliament on November 12, 2021; (2) Draft budget estimates for 2022 provided to the parliament on November 12, 2021; (3) Fiscal Management Report for 2022 provided to the parliament on November 12, 2021 and (4) Central Bank of Sri Lanka (CBSL) annual report.

The analysis considers the macro-economic framework (relating to inflation, interest rates, fiscal deficits, exchange rates, GDP growth, debt management and fiscal deficits) and economic assumptions of the government, where those assumptions have been identified.

In addition to informing the public and other stakeholders including the executive and the parliament, this assessment also contributes to improving access to crucial information and professionalising the process by which budget estimates are constructed. In the medium term, this is expected to result in better-formulated budgets 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, the assessment had to be completed before the conclusion of the parliamentary budget debates. A further challenge was created by the significant variations between data presented in different documents.

1.3. Overview

The adoption and debate of the annual budget is an important process in the management of public finance. For the government, it is also an important occasion to announce new measures and policies that it plans to implement in steering the country forward. In a well-functioning democracy, a robust involvement of the public in the outcome and process of public finance management is desirable.

The ability of the public to understand and engage with the budget hinges on the quality of information, assumptions, and estimates that underpin the proposals. In the past, many approved budget proposals have later been changed or significantly altered, because the estimates and assumptions that the budget was based on were later found to be defective. Such corrections are costly, and are, in essence, failures of public finance management. Such errors can be minimised if public demand exists for the improvement in public finance management and nuanced parliamentary debates during the budget process. However, perhaps the greatest obstacle to public demand and more reasoned and rigorous debate in parliament is the paucity of information and analysis that is available to the public and members of parliament.

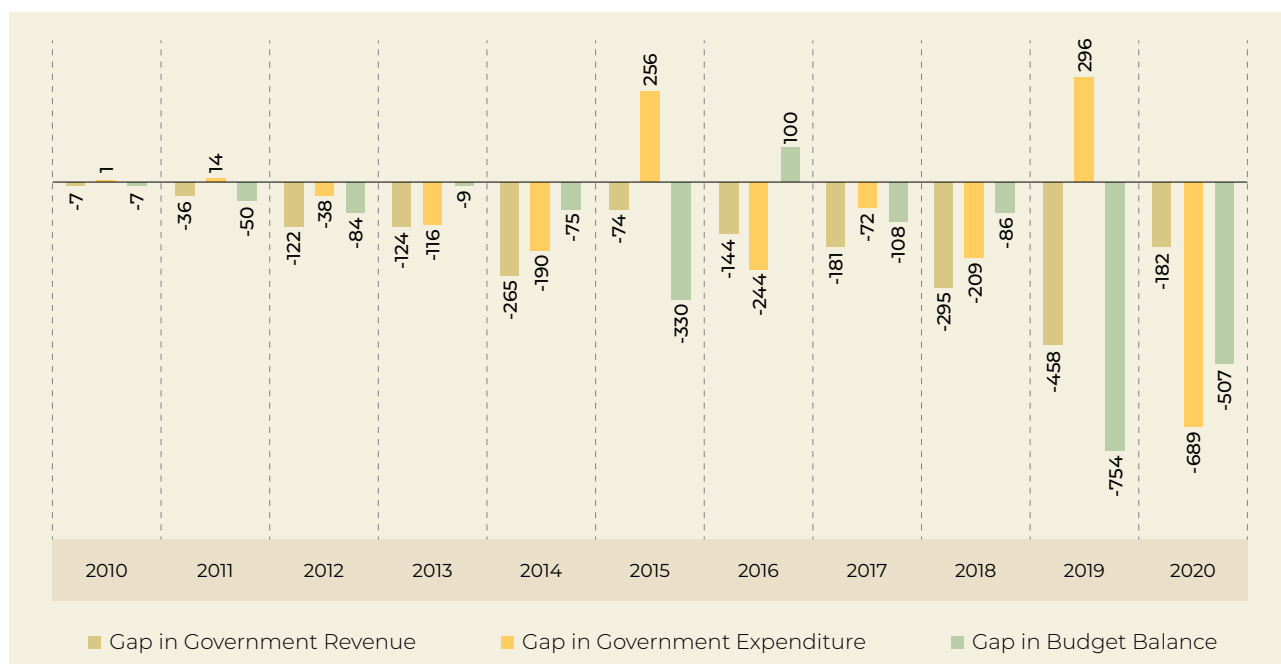
This report was compiled by Verité Research and will be hosted on the online platform, PublicFinance.lk. Through the report, PublicFinance.lk will assist the public and other stakeholders understand the credibility and accuracy of the fiscal and economic assumptions and the revenue and expenditure estimates of Budget 2022. In doing so, this assessment also allows key stakeholders, including parliament, to understand where improvements can be made and engage the executive arm of the government to achieve the necessary changes.

Poor estimations are an established pattern

Government revenue has been significantly and consistently overestimated in the past. The highest difference was recorded in 2019 where the actual was LKR 458 billion less than the estimated. However, revenue would have been affected by the Easter Sunday attacks. In 2019, the government spent LKR 296 billion more than the funds allocated.

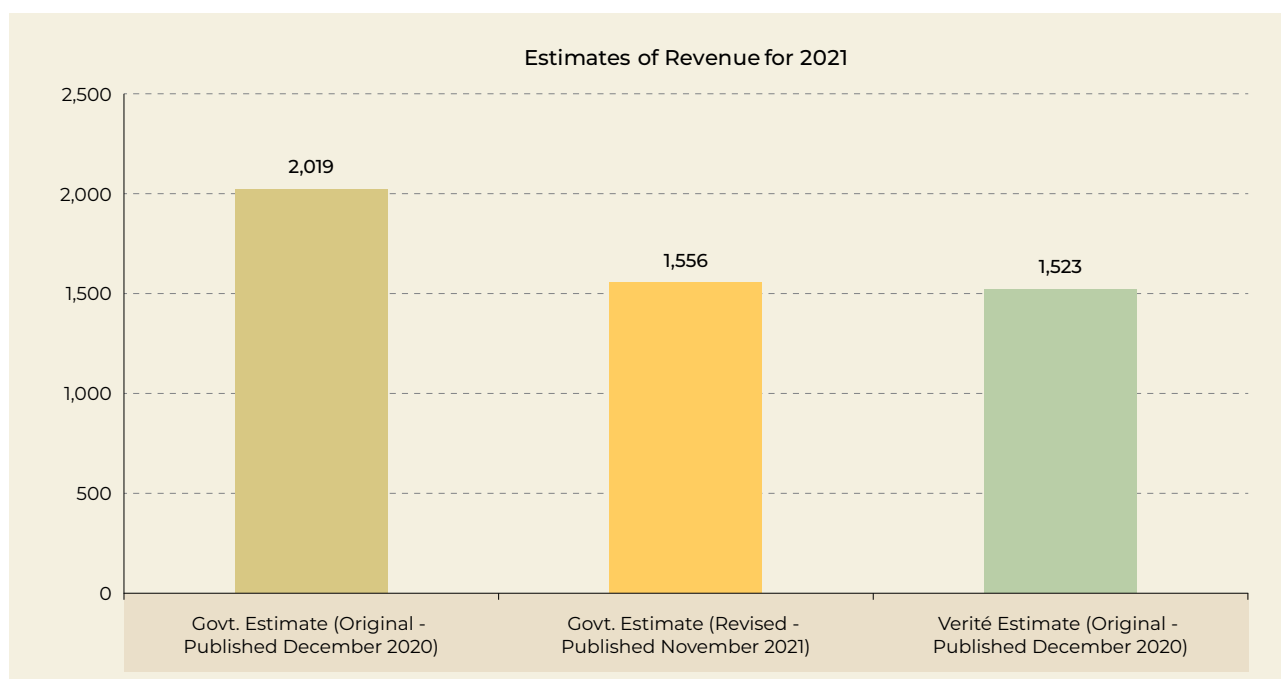
Poor revenue estimation typically results in the government running short of finances for budgeted expenditure. This, in turn, typically results in cutting back on capital expenditure and other discretionary spending of the government, causing delays in project implementation, payments to contractors and so on. In most years, the executive would request a supplementary estimate to obtain approval for additional financing by parliament. The credibility of the entire budget is called into question when revenue estimates are flawed.

Exhibit 1: Estimation gaps in revenue, expenditure and budget balance in LKR billions



Source: CBSL multiple years.

Exhibit 2: Government and Verité estimates of revenue for 2021 in LKR billions



Sources: Verité Research Public Report on the Budget (December 2020), Budget Speech 2021, Budget Speech 2022

In the November 2021 Budget Estimates the government has had to revise down its original estimate for 2021 revenue by 23%. In the previous Public Report on the Budget published in December 2020, Verité Research projected a revenue figure of LKR 1,523 Billion for 2021, which is in line with the government’s revised estimate for 2021.

SECTION 2:

Analysis of the budget estimates

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

- 1. Impractical assumptions:** This section refers to when macro-economic and financial assumptions used to calculate budget estimates are made with an impractical rationale.
- 2. Estimate mismatch:** This section refers to when budget estimates (both revenue and expenditure) fail to match either past data, or the fiscal, financial and economic assumptions provided.
- 3. Unachievable medium-term fiscal framework:** This section refers to when the medium-term targets are not consistent with realistic assumptions/estimates.
- 4. Missing estimates:** This section 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.

2.1. Impractical assumptions

Table 2.1: Macroeconomic and financial assumptions

Macroeconomic Forecasts	2021				2022			
	CBSL	MoF	IMF	WB	CBSL	MoF	IMF	WB
Real GDP growth rate (%)	6.0	N/A*	3.6	3.3	5.2	5.5 ^[1]	3.3	2.1
Inflation rate (%)	4.3	N/A*	6.0 ^[2]	5.1	5.8	5.0	6.5	6.0

Sources: World Bank (WB) South Asia Overview (October 2021), International Monetary Fund (IMF) World Economic Outlook (October 2021), Ministry of Finance (MoF) Fiscal Management Report 2022, MoF Budget Speech 2022, CBSL Annual Report 2020.

*A value is not provided for either the 2021 real GDP growth rate or the inflation rate. However, based on the numbers in the Budget Speech Annexure 1, using the figures for absolute revenue and revenue as a percentage of GDP for 2021, it is possible to arrive at the imputed nominal GDP growth of 10%.

2.1.1. Real GDP growth

The CBSL in its annual report for 2020 (published May 2021) estimated real GDP growth at 6.0%. An above-trend growth in 2021 can be expected considering the base effect of a 3.6% contraction in 2020. However, international agencies such as the IMF and the WB are less optimistic about the performance of the economy with real GDP forecasts set to be below 4% for both 2021 and 2022. It should be noted, however, that nominal GDP growth for 2021 as projected by MoF is close to the value provided by the IMF.

The MoF's and CBSL's projected real GDP growth rates for 2022 are also considerably more optimistic than the IMF and WB projections. Considering the positive impact of pent-up demand, along with headwinds arising from supply chain bottlenecks and possible disruptions to agricultural productivity, GDP growth in 2022 is likely to fall between the levels estimated by the MoF and the IMF. Based on the numbers in the budget speech for 2022, we worked out (using imputed the imputed nominal GDP growth for 2022 is 12.5%, which is significantly higher than the 10.8% in the Fiscal Management Report (FMR) 2022. The FMR and the Budget Speech are published on the same date, by the same institution (MoF). The significant divergence between nominal GDP growth assumptions in the two documents is a matter of concern.

1 The Fiscal Management Report 2022 states that the economy is expected to expand within a range of 5-6% in 2022. However, overall nominal GDP growth is expected to be 10.8%.

2 Inflation here refers to the change in consumer prices as categorised by the IMF

2.1.2. Inflation

The budget speech does not refer to inflation for 2021 or 2022. Whilst there has been a general uptick in inflation recorded in recent months (the Colombo Consumer Price Index [CCPI] recorded a 9.9% increase for November and it is expected to remain at elevated levels), the level of inflation for 2021 can be considered a reasonable estimate based on recent data as the 12-month moving average inflation (as measured by the CCPI) stood at 5.3% as of November 2021. However, the FMR expects inflation to remain in the 4-6% range for 2022, which may be an underestimate given the recent spike in inflation, along with underlying factors that support an elevated price level in 2022.

2.2. Estimate mismatch

Estimate mismatch occurs when 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 are likely to overstate the revenue that could reasonably be expected to be collected. This is problematic as overstating revenue estimates can lead the parliament to also agree on higher expenditure levels, which when revenue does not meet expectations, leads to higher budget deficits, higher debt, higher interest, and finally a problem of sustainability of public finances. This systemic problem has led parliament to agree to the spending proposals that have resulted in the country's steadily deteriorating debt position amidst numerous downgrades by international rating agencies about the ability to service the growing debt.

2.2.1. Revenue estimates

Table 2.2.1: Revenue estimates as given in the budget speeches (in LKR billions)

Item	2020 Actual*	2021 Estimate	2022 Budget	Y-o-Y Growth	
				2020-2021	2021-2022
Total Revenue and Grants	1,455	1,561	2,284	7%	46%
Total Revenue	1,449	1,556	2,274	7%	46%
Tax Revenue	1,217	1,325	1,987	9%	50%
Income Tax	268	295	496	10%	68%
Taxes on Goods and Services	585	650	1,031	11%	59%
Taxes on External Trade	364	380	460	4%	21%
Non-Tax Revenue	182	170	226	-7%	33%
Provincial Council Tax Sharing and Devolved	51	61	61	20%	0%

* 2020 Actuals are from Draft Budget Estimates 2022

Sources: Draft Budget Estimates 2022, Budget Speech 2022

All revenue estimates are assessed by comparing the actual values for 2021 with the 2022 estimates. It is normally assumed that the tax revenue will increase in line with the nominal GDP growth rate every year with no changes in policy or administrative reforms. The nominal GDP growth rate for 2022 is taken as 10.8% as mentioned in the 2022 FMR. The 2022 budget speech does not explicitly indicate a nominal GDP growth for 2022 and, as such, we refer to the FMR. 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 a concrete administrative reform implemented to make tax collection more efficient.

2.2.1.1: Income tax

Table 2.2.1.1: Revenue estimates on income tax in Ln LKR billions

Tax Type	Revenue Estimates			Increase from 2021			
	2020 Actual	2021 Estimate	2022 Budget Estimate	Total change from 2021	Y-o-Y % increase in Revenue	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
Income Tax	268	295	496	201	68%	32	169
o/w Corporate tax (Incl. Proposed Surcharge Tax)	214	252	446	194	77%	27	167
o/w Non-Corporate tax	28	30	36	6	20%	3	3
o/w Other Tax	25	13	14	1	8%	1	0
						10.8%	-3.11%

Sources: Draft Budget Estimates 2022, Budget Speech 2022

Income tax is expected to account for 22.3% of total tax revenue in 2021 based on the government's estimate. The income tax collection is expected to grow by 68% to LKR 496 billion in 2022 from the estimated income tax collection of LKR 295 billion in 2021. In 2022, the nominal GDP growth is expected to account for 10.8% (LKR 32 billion) of the expected increase and better policy and administrative measures are expected to account for 57.6% (LKR 169 billion) of the increase.

Actions in the 2022 budget

- The 2022 budget introduced a one-off surcharge tax of 25% for individuals and companies with a taxable income exceeding LKR 2 billion payable during the 2020/2021 year of assessment.
- The administrative reforms aimed at increasing tax efficiency introduced in the 2021 budget were further built upon in the 2022 budget. This includes completion of RAMIS, digitalising the tax collection process and strengthening large taxpayers' units and corporate taxpayers' units.
- No changes were made to the corporate and non-corporate tax rates or tax-free thresholds.

Corporate income tax

Analysis

- Corporate taxes are expected to grow by 77% (LKR 194 billion) in 2022. Nominal GDP growth is expected to increase the revenue collected by LKR 27 billion, and policy changes and better administrative measures are expected to increase it by 66.2% (LKR 167 billion).
- The MoF does not provide a quantification of such administrative measures.
- The major policy change on corporate taxes in the 2022 budget is the introduction of the surcharge tax, which is estimated to generate a revenue of LKR 100 billion. As such, the new one-off tax is estimated to account for 51% of the total increase in corporate income tax. Based on information available thus far, the super gains tax introduced in the 2015 interim budget is similar to the surcharge tax and generated a revenue of LKR 50 billion in 2015. The surcharge tax is a retroactive tax that considers the taxable income in the 2020/2021 year of assessment, and as such, it is assumed that the MoF would have access to sufficient data to make an accurate estimate of the expected revenue of LKR 100 billion.
- As there are no tax rate changes in the 2022 budget, excluding growth attributed to nominal GDP growth and surcharge tax, administrative measures alone are expected to increase corporate tax by 34% (LKR 67 billion).

Past experiences (2016–2020)

	Average annual growth rate	Average shortfall from approved budget estimations	Overestimate in 2020 approved budget estimates against 2020 provisional estimates
Corporate tax	10%	2%	21%

Based on: Approved Budget Estimates (multiple years), Draft Budget Estimates 2022

Revenue collection from corporate taxes fluctuates greatly in response to the varying policy changes over the years. The 2022 budget has made no revisions to the corporate tax rates or base. The average annual growth rate of 10% is boosted by the 64% increase in corporate tax collection in 2019 with the full implementation of the inland revenue act. Reduction in corporate tax collection was experienced in 2016, 2017 and 2020. The average annual growth rate that can be attributed to policy changes and better administration reforms is 4%, which is driven by the implementation of the inland revenue act in 2019 as mentioned in the previous section. The administrative measures in 2022 build on the measures introduced in the 2021 budget. Expecting a 34% increase in corporate tax collection in 2022 from administrative measures alone is a significant overestimation, and Verité assumes that a 2.5% increase is a more realistic increase. Further, it is important to identify that the increase in income tax is driven by a one-off surcharge tax, indicating that any increase in corporate income tax experienced in 2022 is unlikely to be sustained.

Non-corporate tax

Analysis

Non-corporate taxes are expected to increase by 20% in 2022. Administrative reforms are expected to increase revenue by 9.2% as there are no policy changes on non-corporate tax in the budget speech. The MoF fails to provide quantification of such administrative measures.

Past experience (2016–2020)

	Average Annual Growth Rate	Average shortfall from approved budget estimations	under-estimate in 2020 approved budget estimates against 2020 provisional estimates
Non-Corporate Tax	-0.30%	14%	24%

Based on: Approved Budget Estimates (multiple years), Draft Budget Estimates 2022

Non-corporate tax revenue includes personal income taxes and other taxes that are not well defined. Non-corporate tax revenues have consistently experienced an increase from 2016 to 2019, driven by the revenue from pay-as-you-earn (PAYE) tax. However, from 2016 to 2020, the average annual growth rate was -0.30%, due to the 53% decline in 2020 as PAYE was abolished. The replacement of PAYE with advanced personal income tax (APIT) along with the upward revision of the tax-free thresholds can be attributed to the decline of the collection by LKR 34 billion. The increase in the threshold has reduced the number of taxpayers eligible for PAYE/APIT, and this is evident in the decline in the number of employees paying Income Tax under PAYE/ APIT Scheme registered with the Inland Revenue Department by 46% from 1,149,883 to 664,828 persons.³ PAYE collection on average accounts for 78% of total non-corporate tax collection (2016–2019). However, in 2020, PAYE/APIT accounted only for 53% of the total non-corporate tax collection.

The average shortfall from approved budget estimates is 14%, and the shortfall was consistent until 2020 where the actual collection of non-corporate taxes exceeded the estimated collection by 24%.

Based on non-corporate revenue collection from 2016 to 2020, administrative and policy changes on average have reduced the tax collection by 7%. Therefore, it is highly unlikely that administrative measures will raise revenue collection by 9.2%.

Other taxes

The income tax classification provided in the draft budget estimates in 2022, includes revenue collected from withholding tax, economic service charge tax (ESC), capital gains tax and taxes on voluntary disclosure. The above taxes are estimated to account for 4.4% and 2.7% of total income tax in 2021 and 2022, respectively.

Revenue from taxes on voluntary disclosure will be generated in 2021 and 2022 in line with the Finance Act No 18 of 2021 and revenue from ESC will cease to exist from 2022 onwards.

³ Inland Revenue Department, Annual Performance Reports

Recommendations

- Assumptions used for the revenue estimates for 2022 are based on actual realised income tax collection from January to August 2021 of LKR 175 billion, which is 5% higher than the income tax collection in the same period in 2020 but 26% lower than the collection in the same period in 2019. The actual realised collection is 59% of the revised estimate of LKR 295 billion in 2021. If the estimate of LKR 295 billion is to be met, LKR 120 billion would have to be collected in the 4 months. Based on the actual numbers for January to August and taking into consideration any seasonal revenue collection that can occur from September to December (for instance due to final income tax payments occurring in November), Verité's calculation for income tax collection in 2021 amounts to LKR 292 billion⁴. Therefore, the MoF revised estimate for 2021 is justifiable.
- The average annual growth rate of total income tax from 2010 to 2020 is 8%, with the highest Y-o-Y increase of 38% occurring in 2019. Thereby, a projected increase of 68.4% in income tax collection in 2022 seems to be an extremely ambitious projection given that the economy will still be in recovery mode from pandemic related shocks.
- Based on the income tax collection from January to August of 2021, assuming successful collection of the LKR 100 billion from the surcharge tax and an assumption of administrative measures accounting for an increase of 2.5%, the 2022 estimated income tax collection should be revised downwards by 13% to LKR 430 billion.

Figures in LKR billions

2021 Verité's Revised Estimate	Growth attributed to Nominal GDP growth	Growth attributed to Administrative Measures	Estimated revenue from Surcharge Tax	2022 Verité's Estimate
292	31 10.80%	7 2.50%	100	430

2.2.1.2 Taxes on goods and services

Table 2.2.1.2: Revenue estimates on taxes on goods and services in LKR billions

Tax Type	Revenue Estimates			Increase from 2021			
	2020 Actual	2021 Estimates	2022 Budget Estimates	Total Change from 2021	Y-o-Y % increase in Revenue	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
Taxes on goods and services	573	637	1,065	428	67%	69 10.8%	359 56.4%
o/w VAT	234	310	424	114	37%	33 10.8%	81 26%

⁴ On average, the annual income tax collection is 11% higher than the annualised income tax collection obtained from the January to August figures. This seasonal change has been accounted for when calculating the revised income tax estimate for 2021.

Tax Type	Revenue Estimates			Increase from 2021			
	2020 Actual	2021 Estimates	2022 Budget Estimates	Total Change from 2021	Y-o-Y % increase in Revenue	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
o/w NBT	2	0.30	-	-0.30	-100%	0.03 10.8%	-0.3 -110.8%
o/w excise duties	322	311	463	152	49%	33.6 10.8%	118.4 38.1%
o/w other taxes on goods and services	15	16	21	5	33%	1.7 10.8%	3.5 22.6%
o/w Social Security Contribution			140	140	-	-	-
o/w special goods and services tax (excl. cigarettes and liquor component)			17	17			

Sources: Approved Budget Estimates (multiple years), Draft Budget Estimates 2022

Revenue from taxes on goods and services is primarily from excise duties and VAT, which account for 43% and 40%, respectively, of the total taxes from goods and services in 2022. Further explanation of these two categories of tax revenue will be provided in the next section.

Value Added Tax (VAT)

VAT is expected to account for 23% of total tax revenue in 2022. It is estimated to amount to LKR 310 billion in taxes collected in 2021 and the government expects it to grow by 37% in 2022 to LKR 424 billion.

Actions in the 2022 budget

- The budget for 2022 has indicated no change for the VAT rate except for banks and financial service providers. The VAT rate has increased from 15% to 18% for these institutions. This is expected to increase the revenue by LKR 14 billion according to the 2022 Budget Speech.
- Further the amendments to the application of Value Added Tax Act, No. 14 of 2002 in the 2022 budget is as follows;
- Exemption of VAT on the importation or supply of medical equipment, machinery, apparatus, accessories, hospital furniture, drugs and chemicals donated to a government hospital or the ministry of health to address the pandemic or public health emergency. The revenue impact of these exemptions is not quantified.

5 Other taxes on goods and services include telecom levy, motor vehicle taxes and other taxes on goods and services not elsewhere specified.

VAT estimates in LKR billions

Tax Type	Revenue Estimates			Increase from 2021			
	2020 Actual	2021 Estimate	2022 Budget Estimate	Total change from 2021	Y-o-Y % increase in Revenue (2021 - 2022)	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
VAT	234	310	424	114	37%	33 (10.8%)	81 (26%)

Sources: Approved Budget Estimates (multiple years), Draft Budget Estimates 2022.

Analysis on VAT

- The estimates for 2022 indicate an increase of 37% compared to 2021.
- The actual revenue from VAT for the first eight months of 2021 is LKR 199.5 billion accounting for 64.2% of expected annual revenue. Considering the reduction of movement restrictions, economic activity can be expected to recover to levels similar to that in the first quarter of the year. Accordingly, revenue generated through VAT would amount to LKR 299 billion in 2021.
- After accounting for nominal growth of LKR 33 billion, the budget estimates a further LKR 81 billion increase in revenue from VAT in 2022. However, this ambitious level of revenue growth is not sufficiently supported by policy measures introduced through the budget. The only new proposal submitted is the increment of the VAT rate for financial institutions that is expected to yield LKR 14 billion.

Past experiences (2016-2020)

Average annual growth rate	Average shortfall from approved budget estimations	Overestimate in 2020 approved budget estimates against 2020 provisional estimates
8%	0.10%	3%

Based on: Approved Budget Estimates (multiple years), Draft Budget Estimates 2022

- The five-year average shortfall from approved budget estimates for 2022 is 0.10%. The relatively low five-year average shortfall is influenced by the fact that during 2016 and 2017, VAT collection benefitted from a revision in tax rate from 11% to 15% in 2016. The Y-o-Y nominal growth of VAT collected was 32% in 2016 and 57% in 2017. During the past 3 years, VAT figures have been consistently over estimated with an average shortfall for this period of 12%.

Recommendations

- The expected revenue from VAT in 2022 should be revised to reflect the policies in the budget speech and provide a realistic estimate for 2021. A revised estimate of LKR 351 billion can be made on the following assumptions.
 - Actual VAT revenue in 2021 will be approximately LKR 299 billion, as calculated earlier in this section.
 - Increase in VAT revenue in both 2021 and 2022 due to nominal GDP growth.
 - Increase in revenue due to administrative changes would approximately be 2.5%.
 - Increase in VAT revenue due to the increment of the VAT rate to financial service providers will be approximately LKR 10.3 billion instead of the government's estimate of LKR 14 billion. This number was calculated by taking the actual financial VAT figures for 2020, which was LKR 42.5 billion, and growing it by the expected nominal GDP for 2021 (10%) which would be approximately LKR 46.7 billion for 2021. The rate change was then added along with the nominal GDP growth for 2022 yielding a value of LKR 62 billion. The difference is equal to LKR 15.4 billion from which LKR 5.1 billion is attributable to nominal GDP growth in 2022 and the balance to policy changes which is equivalent to LKR 10.3 billion.
 - The reduction in VAT revenue due to the new exemptions for several health sector items is not quantified in the budget. However, this is not expected to result in a material revenue loss due to the limited product coverage and is therefore ignored in this analysis.

Figures in LKR billions

2021 Verité Revised Estimate	Growth Attributed to Nominal GDP Growth	Growth Attributed to Administrative Measures	Estimated Revenue Increase in VAT for Financial Services	2022 Verité Estimate
299	32 10.80%	8.6 2.50%	10.3	351

Excise duty

Excise duty is expected to account for 22% of tax revenue in 2022. It is estimated to amount to LKR 311 billion in duties collected in 2021 and grow by 38% to LKR 430 billion in 2022.

Actions in the 2022 budget

- Budget 2022 proposed to increase prices on cigarettes by LKR 5 which is a 2% increase in tax on cigarettes. This policy change will take place immediately. This proposal is expected to increase revenue for 2022 by LKR 8 billion.
- It is also proposed to increase excise tax on alcohol immediately, but the exact percentage is not provided in the budget speech. However, the government is expected to receive LKR 25 billion through this proposal.

Excise duty in LKR billons

Tax Type	Revenue Estimates			Increase from 2021			
	2020 Actual	2021 Estimate	2022 Budget Estimate	Total Change from 2021	Y-o-Y % increase in Revenue (2021–2022)	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
Excise Duties	322	311	463 ^[6]	152	49%	33.6 (10.8%)	118.4 (38.1%)

Sources: Approved Budget Estimates (multiple years), Draft Budget Estimate 2022

Analysis on excise duty

- The main contributors to excise duty are taxes on motor vehicles, cigarettes, liquor and petroleum products.
- The estimates for 2021 indicate a reduction of revenue by 3% compared to the actual figures of 2020. This is largely due to import controls and the impact of lockdowns.
- The actual excise revenue for the first eight months of 2021 is LKR 198 billion accounting for 64% of expected revenue. Accordingly, the full-year estimate for 2021 could be revised to LKR 297 billion.
- Excise revenue is expected to grow by 38% in 2022 to LKR 430 billion, from the estimate of LKR 311 billion collected in 2021 according to government projections. A further LKR 33 billion is expected from proposals relating to cigarettes and liquor as mentioned in the Budget Speech. After accounting for nominal growth of LKR 33.6 billion (10.8%), the budget estimates a further 118.4 attributed to policy changes in 2022.

Past experiences (2016–2020)

Average annual growth rate	Average shortfall from approved budget estimations	Overestimate in 2020 approved budget estimates against 2020 provisional estimates
-5%	18%	9%

Based on: Approved Budget Estimates (multiple years), Draft Budget Estimates 2022

- Revenue from excise duty has been overestimated in all the years during the period 2016–2020.
- Average growth rate is -5% primarily due to the past 2 years of import controls and lockdowns. The ban on motor vehicle imports has affected the excise tax revenue significantly.

6 This includes the Cigarettes and Liquor tax component of the proposed Special Goods and Services Tax amounting to LKR 33 billion

Recommendations

- The expected revenue from excise duties in 2022 should be revised to reflect the policies in the budget speech and provide a realistic estimate for the year. A revised estimate of LKR 346 billion for 2022 can be made based on the following assumptions and information:

- **Increase in tax for cigarettes.** The government has overestimated the revenue expected from both cigarettes and alcohol. The starting base for cigarette taxes can be expected to be LKR 83 billion in 2021, which is annualised from the tax collection of the first eight months of 2021. Adding the impact of nominal GDP growth of 10.8%, revenue from cigarettes is expected to be LKR 92 billion. The government has further expected an increase in revenue by LKR 8 billion due to the tax change mentioned in the 2022 Budget Speech. Accordingly, the tax revenue estimate from cigarettes alone for 2022 as per the government's projection should be LKR 100 billion. However, the 2022 draft budget estimates project LKR 120 billion to be collected from cigarettes. This is an overestimate of LKR 20 billion.

Furthermore, the Rs. 8 billion increase expected through the increase in tax on cigarettes is also overestimated. The primary reason is that the government has decreased excise duty on cigarettes of less than 60mm length from LKR 13.36 to LKR 6.75, which is a decrease of 49.5%. The change in tax rate multiplied by the weighted average consumption of each type of cigarette class gives a weighted average tax increase of just 2%, which results in a LKR 2 billion revenue increase. This was added to LKR 92 billion, resulting in approximately LKR 94 billion collected through cigarettes resulting in the overestimation being even greater.

- **Increase in tax for liquor:** The Expected revenue on liquor also needs to be revised down from the LKR 180 billion expected by the government to LKR 163.3 billion.

Verité estimates the excise tax collection for 2021 to be approximately LKR 134 billion, which was annualized from the first eight months of 2021. An increase of LKR 14.5 billion (attributed to nominal GDP growth of 10.8%) for the year 2022 was added, resulting in LKR 148.5 billion prior to the impact of policy changes. The change in excise tax rates; was calculated using the percentage increase in tax for liquor, which was estimated to be 10% which was then applied to the base of LKR 148.5 billion, leading to an expected liquor excise revenue of LKR 163.3 billion.

- All other components of excise special provisions tax have been increased by nominal GDP growth.

Figures in LKR Billion

	2021 Verite Revised Estimate	Growth attributed to Nominal GDP growth	Growth attributed to Policy Changes	2022 Verite Estimate
Excise	297			346
o/w Liquor	134	14.5 10.8%	14.8	163.3
o/w Cigarette	83	9 10.8%	2	94

	2021 Verite Revised Estimate	Growth attributed to Nominal GDP growth	Growth attributed to Policy Changes	2022 Verite Estimate
o/w Other (Petroleum , Motor Vehicle and Other)	80	8.6 10.8%	-	88.6

Social Security Contribution

The government has introduced a new tax called "Social Security Contribution" (SSC) in the 2022 budget. The contribution will be charged at 2.5% on the annual threshold turnover exceeding LKR 120 million. The government estimates LKR 140 billion revenue through this tax. The SSC appears to be similar to NBT since it is a turnover tax although details of the base have not been provided.

Some issues exist with the assumptions used in deriving a revenue estimate of LKR 140 billion.

1) In 2018 and 2019, revenue collection from NBT was LKR 105 billion. The tax base for 2022 could be estimated as LKR 128 billion by considering nominal GDP growth since 2019. The SSC rate (2.5%) is 25% higher than the NBT rate (2%) which could provide a potential SSC revenue of LKR 160 billion. However, the SSC tax-free threshold (turnover LKR 120 million per annum) is 10 times higher than the NBT threshold (LKR 12 million per annum). A 30% reduction in collection could be assumed due to this higher threshold (reducing the potential SSC collection from LKR 160 billion to LKR 112 billion).

2) Revenue from SSC can only be collected when legislation is passed. This tax is expected to come into effect on 1st April 2022, which means that revenue for the first three months of the year should be discounted. This would further reduce the potential revenue from SSC to LKR 84 billion since only $\frac{3}{4}$ ^{ths} of the year's collection would be feasible at best.

Figures in LKR billions

NBT collection (2019)	Growth attributed to Nominal GDP since 2019	Growth Due to the Rate increment	Threshold Revision	Tax Collection Period	2022 Verite Estimate
105	22%	25%	-30%	-25%	84
	23	32	-48	-28	

2.2.1.3: Taxes on external trade

Table 2.2.1.3: Taxes on external trade in LKR billion

Tax Type	Revenue Estimates			Increase from 2021			
	2020 Actual	2021 Revised Estimates	2022 Budget Estimates	Total Change from 2021	Y-o-Y % increase in revenue	Attributed to nominal growth	Attributed to Policy Changes and Better Administration
Taxes on External Trade	363.8	382.9	478	95.2	24.90%	41.3 10.80%	53.8 14.10%
o/w Customs Import Duties	114.2	100	130	30	30.00%	10.8 10.80%	19.2 19.20%
o/w Cess	49.3	80	90	10	12.50%	8.6 10.80%	1.4 1.70%
o/w PAL & SCL	198.2	200	255	55	27.50%	21.6 10.80%	33.4 16.70%

Sources: Approved Budget Estimates (multiple years), Draft Budget Estimates 2022.

Customs import duty

Actions in the 2022 budget

The government, in its budget speech, proposed to update the HS code system that is currently being used by the Sri Lanka Customs to avoid deficiencies that occur or can occur in charging custom duties.

Customs import duty in LKR billions

Tax Type	Revenue Estimates			Increase from 2021			
	2020 Actual	2021 Revised Estimates	2022 Budget Estimates	Total Change from 2021	Y-o-Y % increase in revenue (2021 - 2022)	Attributed to nominal growth	Attributed to Policy Changes and Better Administration
Customs Import Duty	114.2	100	130	30	30.00%	10.8 10.80%	19.2 19.20%

Sources: Approved Budget Estimates (multiple years), Draft Budget Estimates 2022

Analysis on customs import duty

- The estimate for 2022 is a 30% increase compared to 2021. Of the LKR 30 billion increase, LKR 10.8 billion is attributable to nominal growth in tax revenue and LKR 19.2 billion could be attributable to policy changes and better administration.

- Compared to the 2020 actual figure, the 2021 revised estimate indicates a decrease of 12.4%. The decline was mainly attributable to the downward revision of the duty structure in line with Budget 2021 and general duty waivers granted on the importation of petrol, diesel, wheat grain, and milk powder.
- The actual revenue collected through customs import duties for the first eight months of 2021 is LKR 60.9 billion, which accounts for 60.9% of customs import duty expected during the year. As the monthly import value has been at similar levels so far during the year and since it is expected to maintain a similar trend for the remainder of the year of 2021, the actual collection of customs import duty based on annualization of the collection during the first eight months is likely to be approximately LKR 91.4 billion for 2021.
- Based on the following assumptions: (1) Increase in customs import duty due to nominal growth in GDP of 10.8%; (2) 2021 annualized customs import duty of LKR 91.4 billion, the actual collection from customs import duty in 2022 is likely to be LKR 101.2 billion, which is LKR 28.8 billion lower than the projected estimate of LKR 130 billion for 2022.

Past experiences (2016–2020)

Average annual growth rate	Average shortfall from approved budget estimations	Overestimate in 2020 approved budget estimates against 2020 provisional estimates
4%	17%	18%

Based on: Approved Budget Estimates (multiple years), Draft Budget Estimates 2022

- The five-year average shortfall (2016–2020) in collection of import duties against estimates is 17%. Except for 2016, when the revenue from import duties was 25% higher than expected, the import duties were constantly overestimated for 2017–2020. The annual shortfall between the expected and actual value for 2020 stood at 18%.

Cess

Actions in the 2022 budget

- The budget speech notes that the cost of import and export has increased because of a large number of HS codes being subjected to Cess. Therefore, excluding the HS codes on liquor, cigarettes, motor vehicles and domestically produced agricultural products, the budget speech proposes that the customs duties and Cess rates would be simplified together with the licensing mechanism for imports.

Cess in LKR billions

Tax Type	Revenue Estimates			Increase from 2021			
	2020 Actual	2021 Estimate	2022 Budget Estimate	Total Change from 2021	Y-o-Y % Increase in Revenue (2021 - 2022)	Attributed to Nominal Growth	Attributed to Policy Changes and Better Administration
Cess	49.3	80	90	10	12.50%	8.6 10.80%	1.4 1.70%

Sources: Approved Budget Estimates (multiple years), Draft Budget Estimates 2022

Analysis on Cess

- Compared to 2021, the government expects a 12.5% increase in Cess revenue in 2022. Of this increase, 10.8% is attributable to nominal growth while the rest (1.7%) could be attributable to the policy changes and better administration.
- The estimate for 2021 reflects a 62.4% increase compared to 2020 actual Cess revenue primarily driven by the rate revisions of Cess in Budget 2021. The policies proposed in the 2021 budget led to an increase of 1.6 times in the tax base on which Cess is applied.
- The actual revenue from Cess for the first eight months of 2021 is LKR 51.2 billion. The annualised figure for the year is LKR 76.8 billion. This figure is close to the government's expected figure, hence the estimate for 2021 is reasonable.
- Based on the following assumptions: (1) Increase in Cess revenue due to nominal growth of GDP is 10.8%; (2) Actual revenue from Cess in 2021 will be approximately LKR 76.8 billion and the revenue collection from Cess in 2022 is likely to be LKR 85.1 billion, which is LKR 4.9 billion below the government's estimate of LKR 90 billion.

Past experiences

Average Annual Growth Rate	Average over-execution from approved budget estimations	Overestimate in 2020 approved budget estimates against 2020 provisional estimates
3%	1%	1%

Based on: Approved Budget Estimates (multiple years), Draft Budget Estimates 2022

- The average annual growth rate of Cess revenue in the five years between 2016 to 2020 was 3%. However, except for 2016, which recorded a 37% increase in Cess revenue, the rest of the years between 2017 and 2020 on average experienced an annual decline of 5% in Cess revenue.

Port and Airport Levy (PAL) and Special Commodity Levy (SCL)

Actions in the 2022 budget

The budget speech and technical notes do not indicate any proposals directly relating to the PAL and SCL.

PAL and SCL in LKR billions

Tax Type	Revenue Estimates			Increase from 2021			
	2020 Actual	2021 Revised Estimates	2022 Budget Estimates	Total Change from 2021	Y-o-Y % increase in revenue (2021 - 2022)	Attributed to nominal growth	Attributed to Policy Changes and Better Administration
PAL	115.4	140	175	35	25.00%	15.1 10.80%	19.9 14.20%
SCL	82.7	60	80	20	33.30%	6.5 10.80%	13.5 22.50%

Analysis on PAL & SCL

- Estimates for 2021 PAL has increased by 21.7% from 2020. Budget estimates 2022 have forecasted an increase of 25% from 2021 to 2022. The actual revenue through PAL for the eight months of 2021 is LKR 92 billion, accounting for 65.7% of expected revenue in 2021, which results in an annualised figure of LKR 138 billion for 2021. The budget estimates an increase of LKR 35 billion in revenue for PAL in 2022. Given that the 2022 budget does not indicate any policy measures that can justify the increment of PAL revenue, the revised revenue estimate for 2022 should be LKR 153.1 billion based on the annualised collection for 2021 and nominal growth of 10.8% (LKR 15.1 billion)
- The SCL initial estimate for 2021 was LKR 110 billion. However, in the 2022 budget estimate, the 2021 figure for SCL has been revised to LKR 60 billion, which is a decrease of 45.5%. This can be attributed to the decrease of SCL rates for certain products such as onion, sugar, dhal, etc., to ease domestic retail prices of the said commodities.⁷ The actual revenue of SCL for the first eight months of 2021 is LKR 37.8 billion, accounting for 63% of the expected revenue in 2021. The actual collection of SCL is likely to be approximately LKR 56.7 billion based on annualisation for 2021, which is in line with the government's revised estimates for 2021.
- In the case of SCL, the budget estimates an increase in revenue of LKR 20 billion in 2022. However, apart from the LKR 6.5 billion increase in revenue that can be expected from the nominal growth, LKR 13.5 billion cannot be justified as no policy changes or rate revisions have been proposed in the budget. Therefore, the revised estimate for 2022 should be LKR 63 billion based on the annualised collection for 2021 and nominal growth of 10.8%.

⁷ Ministry of Finance, Fiscal Management Report 2022, pg. 19.

Recommendations

- A 30% increase in import duty revenue (LKR 130 billion) in 2022 estimated by the government does not align with the policies proposed in the budget. No material changes have been proposed apart from proposals to strengthen tax administration. Therefore, it is recommended to revise the estimate down to LKR 101.2 billion for 2022.
- The government estimates a Cess revenue of LKR 90 billion in 2022. Considering no material changes have been proposed in the budget for Cess-related policies or rates, it is advisable to revise the estimate down to LKR 85.1 billion for 2022.
- Considering there have been no major rate revisions or policy changes proposed in the budget speech, the PAL and SCL revenue amounts have been overestimated in the 2022 budget. While the government estimates revenue of LKR 175 billion and LKR 80 billion for PAL and SCL, respectively, it is recommended to revise the estimates down to LKR 153 billion and LKR 63 billion, respectively.

Figures in LKR billions

	2021 Verité Revised Estimate	Growth Attributed to Nominal GDP Growth	2022 Verité Estimate
Customs import duty	91	10 10.8%	101
Cess	77	8 10.8%	85
PAL	138	15 10.8%	153
SCL	57	6 10.8%	63

Table 2.2.2: Summary of government revenue estimates and revisions recommended in LKR billions

	MoF Estimates		Verité Estimates	
	2021	2022	2021	2022
Tax revenue	1,325	2,052	1,275	1,657
Income tax	295	496	292	430
o/w Corporate tax	252	346	249	282
o/w Non-corporate tax	30	36	30	34
o/w Other (WHT, CGT, ESC and voluntary disclosure)	13	14	13	14
o/w proposed Surcharge tax		100		100
Taxes on Domestic Goods and Services	637	1065	608	811
o/w VAT (incl. VAT and other charges proposal)	310	424	299	351
o/w Excise duties (Incl. cigarettes and liquor component of proposed special goods and services tax)	311	463	297	346
o/w other taxes on domestic goods and services	16	21	10	13
o/w Social Security Contribution	-	140	-	84
o/w proposed Special Goods and Services tax (excl. cigarettes and liquor component)	-	17	-	17
License taxes and others	10	13	10	11
Taxes on External Trade	383	478	366	405
o/w Import Duties	100	130	91	101
o/w Cess	80	90	77	85
o/w PAL	140	175	138	153
o/w SCL	60	80	57	63
o/w other taxes on external trade	3	3	3	3
Non-Tax revenue	195	259	195	233
o/w non-tax revenue without proposals	195	230	195	216
o/w proposal relating to motor vehicles		4		4
o/w proposal relating to license fees, auctions and other non-tax revenue		25		12.5
Total Revenue	1,520	2,311	1,470	1,890
Foreign grants	5	10	5	10
Total revenue and grants	1,525	2,321	1,475	1,900

Sources: Draft Budget Estimates 2022, Budget Speech 2022 and author's calculations

2.2.2 Expenditure estimates

2.2.2.1 Interest payments

Table 2.2.2.1 Interest payment in LKR billions

Type	Expenditure Estimates		Increase from 2021	
	2021 Estimate	2022 Budget Estimate	Total Change from 2021	Y-o-Y % Increase in Expenditure
Interest Payments	1,055	1,115	60	5.69%

Source: Budget Speech 2022

Actions and assumptions

The government expects to finance the entire budget deficit through domestic financing.

Analysis

Past experiences (2016–2020)⁸

Average annual growth rate	Average over-shoot from approved budget estimations	Underestimate in 2020 approved budget estimates against 2020 provisional estimates
13%	8%	13%

Based on: Approved Budget Estimates (multiple years), Draft Budget Estimates 2022

- The government has been consistently underestimating interest cost expense except for 2019. The 2019 estimated figure was higher by 1%. Discounting 2019, the average shortfall from the approved budget estimate is 11%.
- Domestic interest rates have increased significantly in the latter part of 2021. The primary market interest rate for a one-year treasury bill was 5.05% at the start of the year 2021 and increased to 8.18% by the end of October 2021. The rise in domestic interest rates is expected to continue into 2022. Hence, this would result in an increase in the domestic interest cost in 2022.
- A large primary deficit in 2021 and 2022 can further increase the interest expenditure of the government. In the budget speech, the government expected the primary deficit to be LKR 771 billion in 2021 and LKR 513 billion in 2022.
- The actual cost of interest payments for the first eight months of 2021 is LKR 700.5 billion accounting for 66.4% of estimated expenditure. Assuming a similar debt service structure as the first eight months, expenditure on interest payment would approximately be LKR 1,051 billion in 2021.

⁸ Figure for 2020 actual interest payment was derived through the MoF Annual Report as the budget speech only has estimates.

Recommendations

The increase in domestic interest rates would increase interest payments on the short-term debt component of domestic debt. Furthermore, the high primary deficit in 2022 would further add to the interest cost. Hence, interest expenditure should be revised to LKR 1,046 billion for 2021 and LKR 1,211 billion for 2022.

Figures in LKR billions

2021 Verité Revised Estimate	2022 Verité Estimate
1,046	1,211

2.2.2.2 Salaries and wages

Table 2.2.2.2: Estimates on salaries and wages in LKR billions

	Expenditure Estimates			Increase from 2021			
	2020 Actual	2021 Revised Estimates	2022 Budget Estimates	Total Change from 2021	Y-o-Y % increase in revenue	Attributed to Inflation Rate	Attributed to Policy Changes
Salaries and Wages including Provincial Councils	794	887	1,015	128	14%	51 5.80%	77 8.60%

Sources: Budget Speech 2022, MoF Annual Report 2020

Actions in the 2022 budget

- Proposed to establish a new salary structure for the public service by removing the anomalies in public service salaries with effect from the coming financial year. Further, salary administrative procedures will be simplified by granting the salary increment on the due date without the need for appraisal reports for all government employees, except for those who are subject to disciplinary action.
- Proposed elimination of teachers' and principals' salary anomalies.
- Proposed to offer permanent positions from January 2022 to over 53,000 graduates who have already been recruited to the government service as trainees.

Past experiences⁹

	Average annual growth rate	Average short-fall from approved budget estimations	Overestimate in 2020 revised budget estimates against 2020 provisional estimates
Salaries and Wages	5%	3%	6%

Based on: Budget speeches (multiple years), MOF Annual Report 2020

Analysis on salaries and wages

- The government has consistently overestimated the salaries and wages expenditure in the budget in the period between 2016 and 2020. The average shortfall of the actual expenditure from the revised estimates during this period was 3%. In 2020, the shortfall was twice the five year average, at 6%.
- The revised estimates for 2021 indicate an 11.7% increase compared to the actual figure in 2020. This could be mainly due to the “new recruitment of 53,000 graduate trainees in the latter part of 2020 and early 2021, and provision of permanent positions to 14,500 graduate trainees who were recruited in 2019 together with 30,000 new recruitments to the Multipurpose Development Task Force personnel under the 100,000-job programme in the latter part of 2020.”¹⁰
- The actual salaries and wages expenditure in the first eight months of 2021 is LKR 564 billion, accounting for 63.6% of the estimated expenditure. The government is expecting to spend LKR 323 billion in the latter four months of the year given the planned expenditure on salaries and wages for the year by the government has been revised to LKR 887 billion.
- The estimate for 2022 is a 14% increase compared to 2021. Of this, LKR 51 billion is attributable to inflation of 5.8% expected in 2022 and LKR 77 billion could be attributed to policy changes and making new recruitments permanent as proposed in the budget.

Recommendations

Based on revised salaries and wages expenditure of LKR 887 billion in 2021 and considering inflation of 5.8%, along with additional cost attributed to teacher salaries of LKR 30 billion and revised salary anomalies allocation of LKR 7.6 billion, the expenditure in 2022 on salaries and wages would amount to LKR 976 billion. Therefore, the actual salaries and wages cost is likely to be approximately LKR 39 billion lower than the government’s estimated salaries and wages cost for 2022 (LKR 1,015 billion).

Figures in LKR billions

2021 Verite Revised Estimate	Growth attributed to inflation rate	Removal of salary anomalies of teachers and principals	Confirmation of graduate trainees	2022 Verite Estimate
887	5.80% 51	30	7.6	976

⁹ Figure for 2020 actual salaries and wages was derived through the MoF Annual Report as the budget speech only has estimates.

¹⁰ Ministry of Finance, Fiscal Management Report 2022, pg. 32.

2.2.2.3. Capital Expenditure

Table 2.2.2.3: Estimates on Capital Expenditure in LKR billions

LKR Bn	Expenditure Estimates			Increase from 2021			
	2020	2021 Revised Estimate	2022 Estimate	Change from 2021 Revised Estimate	Y-o-Y % Increase in Revenue	Attributed to Inflation	Attributed to Policy Changes and Better Administration
Capital Expenditure (Public Investment)	812	582	931	349	60.00%	5.80%	54.20%
						34	315

Sources: MoF Annual Report 2020, Budget Speech 2022

Actions in the 2022 budget

- The 2022 budget aims to ensure that public investment amounts to 5% of GDP in 2022.
- It has been proposed to suspend the construction of any new office premises for the next two years, with the hopes of diverting those funds for development activities that would directly benefit the public.
- Further, the budget proposes to replace funds given for recurrent expenditure to state-owned enterprises with funds for capital expenditure to enable them to undertake private and public construction activities that would generate income.
- The MoF fails to provide a quantification of such measures.

Past experience

	Average Annual Growth Rate	Average shortfall from approved budget estimations	Overestimate in 2020 approved budget estimates against 2020 provisional estimates
Capital Expenditure (Public Investment)	7%	17%	12%

Based on: Budget speeches (multiple years), MOF Annual Report 2020

Analysis

The average annual growth rate of 7% is driven by the 29% increase in public investment in 2020. The increase in 2020 was driven by the acquisition of capital assets (including motor vehicles, furniture and office equipment, buildings, and land) financial assets, transfers to public institutions and infrastructure development. The largest increase of 110% was from the acquisition of capital assets through equity contributions. The rehabilitation and improvement of capital assets (buildings, structures, vehicles, etc.) saw a decline of 23% in 2020. According to the measures mentioned in the budget speech, this will likely see a further decline in 2021 and 2022.

Capital expenditure has been consistently overestimated in all the years during the period 2016–2020. The average

shortfall from the approved budget estimates is 17%. The initial estimate for 2021 for public investment was LKR 1,070 billion but it was revised downwards by 46% to LKR 582 billion. Only 46% (LKR 270 billion) of this revised estimate was spent in the first eight months of 2021, of which 34% has been spent on road development and the transport sector.

On average, public investments have accounted for 4.78% of GDP and 24% of total expenditure from 2016 to 2020.

Recommendations

The revised estimate of LKR 521 billion accounts for 4% of GDP in 2021. Based on the average ratio of public investment to GDP of 4.78% from 2016 to 2020 and the estimated nominal GDP figure of LKR 18,332 billion for 2022¹¹, the estimate for public investment should be revised downwards to LKR 877 billion.

Figures in LKR billions

Assumed GDP figure for 2022	Average Public Investment as % of GDP	2022 Verité Estimate
18,332	4.78%	877

Table 2.2.3: Summary of government expenditure estimates and revisions recommended in LKR billions.

	MoF Estimates		Verité Estimate	
	2021	2022	2021	2022
Total Expenditure	3,389	3,917	3,380	3,920
Recurrent Expenditure	2,817	2,996	2,808	3,053
Salaries and Wages	887	1015	887	976
Other Goods and Services	198	203	198	203
Interest	1,055	1,115	1,046	1,211
Subsidies and Transfers	677	663	677	663
Public Investment	582	931	582	877
Other Expenditure	-10	-10	-10	-10

Table 2.2.4: Summary of government budget deficit estimates and revisions recommended in LKR billions.

	MoF Estimates		Verité Estimate	
	2021	2022	2021	2022
Budget Deficit	-1,869	-1,606	-1,905	-2,020

11 The GDP figure for 2022 has been obtained assuming a nominal GDP growth rate of 10.8%.

2.3. Unachievable medium-term fiscal framework

Table 2.3.1: Government medium term fiscal framework for the next five years

As a percentage of GDP	Provisional	Est.	Est.	Projections		
	2020	2021	2022	2023	2024	2025
Total Revenue and Grants	9.2	9.1	12.4	13.6	14.4	15.5
Total Revenue	9.1	9.1	12.3	13.5	14.4	15.5
Tax Revenue	8.1	8.0	11.2	12.2	13.0	13.9
Income Taxes	1.8	1.8	2.9	2.7	2.9	3.3
Taxes on Goods and Services	3.9	3.9	5.7	6.2	6.6	7.1
Taxes on External Trade	2.4	2.3	2.6	3.3	3.5	3.6
Non-Tax Revenue	1.0	1.0	1.1	1.3	1.4	1.6
Grants	0.0	0.0	0.1	0.1	0.0	0.0
Total Expenditure	20.3	20.2	21.2	20.9	20.5	20.4
Recurrent Expenditure	17.0	16.7	16.2	15.4	14.5	13.7
Salaries and Wages	5.3	5.1	5.3	5.1	4.8	4.5
Goods and Services	1.2	1.1	1.0	1.0	0.9	0.8
Interest	6.5	6.4	6.1	6.1	5.8	5.5
Subsidies & Transfers	4.8	4.1	3.7	3.3	3.0	2.8
Capital Expenditure and Net Lending	3.3	3.5	5.0	5.6	6.0	6.7
Public Investments	5.4	3.5	5.1	5.6	6.1	6.7
Current Account Balance	-7.9	-7.7	-3.9	-1.8	-0.1	1.8
Primary Balance	-4.6	-4.7	-2.7	-1.3	-0.3	0.7
Budget Deficit	-11.1	-11.1	-8.8	-7.3	-6.1	-4.8

As a percentage of GDP	Provisional	Est.	Est.	Projections		
	2020	2021	2022	2023	2024	2025
Deficit Financing	-11.1	-11.1	-8.8	-7.3	-6.1	-4.8
Foreign Financing (Net)	-0.6	-0.3	-1.0	-0.4	0.0	-0.3
Domestic Financing (Net)	11.7	11.4	9.8	6.9	6.1	5.2
Central Government Debt (% of GDP)	101.0	102.8	101.7	98.7	94.4	89.2

Source: Fiscal Management Report 2022

Similar to the previous year, the government's medium-term fiscal framework sets out ambitious targets for government revenue, budget 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 89.2 percent by 2025. Instead, the calculations show debt to GDP being 91.0 percent of GDP in 2025 (Table 2.3.2). 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.

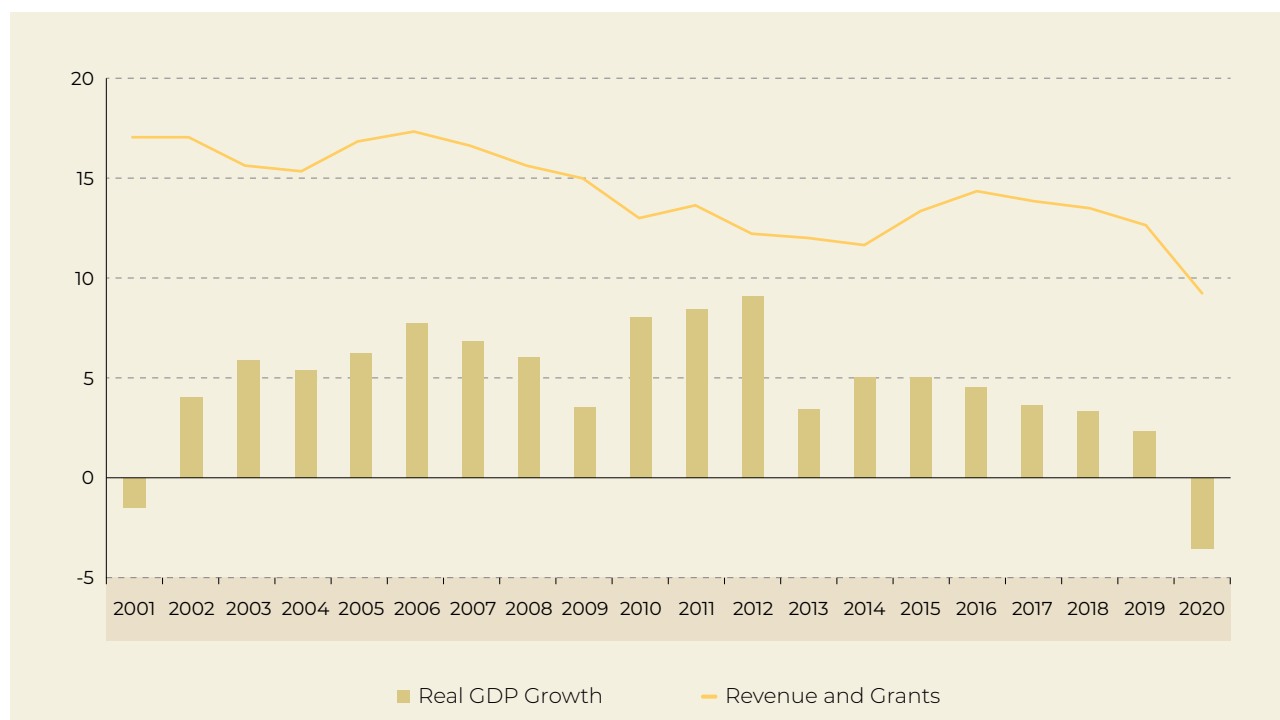
Table 2.3.2: Estimation of Central Government Debt to GDP based on the government's numbers

Year	Fiscal Balance (% of GDP)	GDP (LKR Billions)	Fiscal Balance (LKR Billion)	Debt (LKR Billion)	Debt (% of GDP)
2020	-14.0	14,973	- 2,096	15,117	101.0
2021	-11.1	16,470	-1,828	16,945	102.9
2022	-8.8	18,249	-1,606	18,551	101.7
2023	-7.3	20,220	-1,476	20,027	99.0
2024	-6.1	22,404	-1,367	21,394	95.5
2025	-4.8	24,823	-1,192	22,586	91.0

Sources: Ministry of Finance, Fiscal Management Report 2022 and Central Bank Annual Report 2020

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

1. The Revenue to GDP ratio is expected to grow from 9.1% to 15.5% but the government has stated that the tax structure will remain largely stable for the next 4 years. Many of the key new tax measures introduced in the 2022 Budget are one-off taxes such as the Surcharge Tax and the increase in the Financial VAT. It is impractical to assume that the Revenue to GDP ratio will increase to 15.5% of GDP solely due to nominal GDP growth and administrative measures. Instead, for these targets to be achieved, substantial and sustained revenue generating measures are needed. In fact, the past numbers show the revenue to GDP has reduced in spite of an increase in GDP in years prior to 2020 (see exhibit 3).
2. The model does not factor the currency depreciation effect in considering growth of the foreign debt component.

Exhibit 3: Comparison of growths of Real GDP and Revenue over time

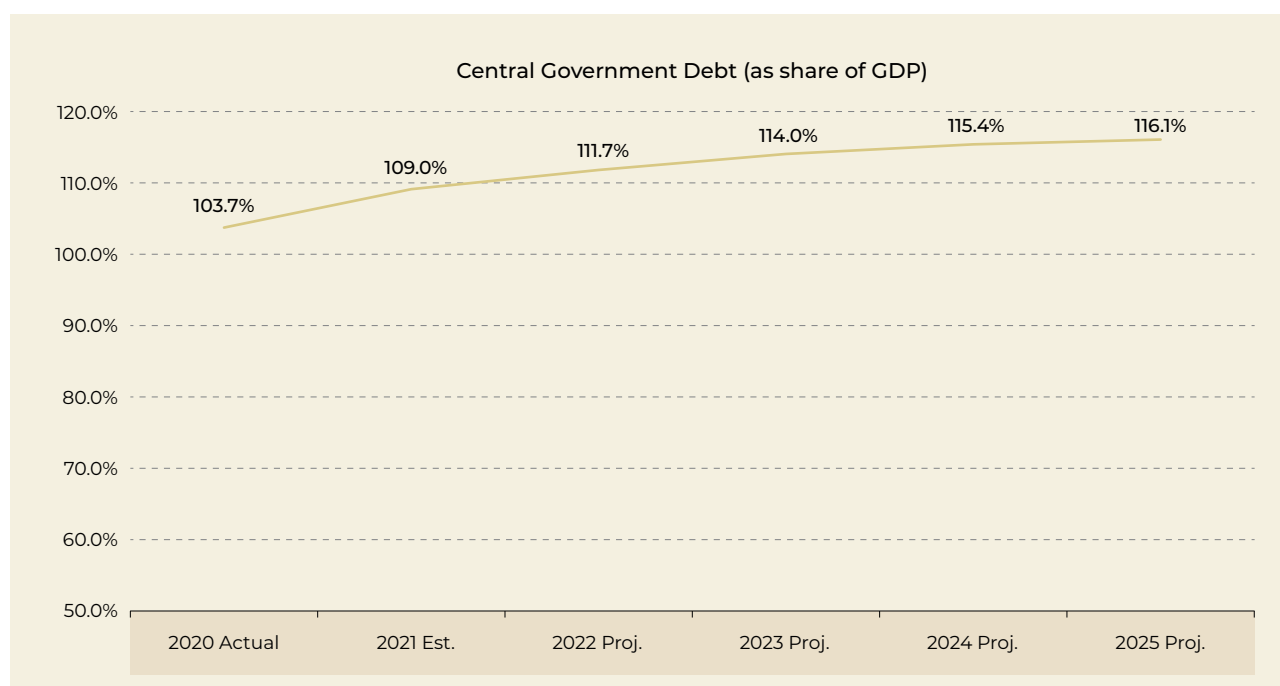
Source: Central Bank of Sri Lanka

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 116.1 percent in 2025 – far higher than the government’s forecast of 89.2% of GDP by 2025. The changes to the other fiscal indicators are given in the table 2.3.3. The assumptions used to develop the model are given in table 2.3.4.

Table 2.3.3: Projected Fiscal Indicators based on more realistic assumptions (As a percentage of GDP)

	2020 Actual	2021 Est	2022 Est	2023 Est	2024 Est	2025 Est
Revenue and grants	9.2%	9.0%	10.4%	10.1%	10.3%	10.5%
Total Expenditure w/o interest	16.6%	14.2%	14.8%	14.2%	13.5%	12.9%
Interest Payments	6.5%	6.3%	6.6%	6.9%	7.3%	7.5%
Overall Budget Balance	-14.0%	-11.6%	-11.1%	-11.0%	-10.5%	-9.9%
Primary Balance	-7.4%	-5.2%	-4.4%	-4.1%	-3.2%	-2.4%
Debt/GDP	103.7%	109.0%	111.7%	114.0%	115.4%	116.1%
Interest/Revenue	71.4%	70.9%	63.7%	68.8%	70.7%	71.3%

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

Exhibit 4: 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 Nominal GDP is expected to grow at 10% in 2021 (based on calculations using data provided in the budget speech) and by 10.8% in 2022 (based on numbers from the FMR). Projections for 2023 to 2025 are assumed to have the same nominal GDP growth as 2022. Inflation is expected to be 5.5% for 2021 and accordingly Real GDP is assumed to grow at 4.5% for the year. For 2022 onwards, Real GDP growth is expected to be 5% and inflation 5.8% making up a nominal GDP growth of 10.8%.
2. Revenue is expected to remain lower— in line with the revised numbers recommended in section 2.2.1— for 2021 and 2022. Thereafter, revenue is expected to increase at the rate of nominal GDP plus 2.5% increment —considering effective implementation of administrative measures. It should be further noted that the proposals regarding the one-off surcharge tax and the increase of VAT rate from 15% to 18% for financial institutions are one-off and accordingly have been deducted from the 2023 expected revenue figure.
3. Expenditure excluding interest rates are based on the revised figures recommended in section 2.2.2. From 2022 onwards expenditure is expected to grow at the rate of Inflation.
4. Depreciation of the exchange rate is considered to increase foreign debt by 5.2% every year. This is based on annual average depreciation over the last 10 years.
5. Domestic Interest rates are expected to increase as the budget deficits from 2021-2023 are expected to be fully financed domestically. The one year interest cost is expected to gradually increase, reaching 9.5% in 2025.

6. Short term to long term debt ratio are assumed to be 30:70 based on 2021 actual figures as of July as per Central Bank data.
7. The domestic financing ratio is expected to be 100% for the years 2021 – 2023 as mentioned previously and will drop to 80% for the years 2024 and 2025 as the government gradually regains access to global capital markets.

Table 2.3.4: Assumptions used for the estimation of the forward fiscal indicators

Assumptions	2021	2022	2023	2024	2025
Domestic one year Average Interest rate	6.0%	8.0%	8.5%	9.0%	9.5%
Real GDP Growth	4.5%	5.0%	5.0%	5.0%	5.0%
Inflation	5.5%	5.8%	5.8%	5.8%	5.8%
Nominal GDP Growth	10.0%	10.8%	10.8%	10.8%	10.8%
Long to Short term domestic debt ratio	70%	70%	75%	80%	80%
Domestic to Foreign Refinance ratio	100%	100%	100%	80%	80%
Depreciation effect on Foreign Debt	7.2%	5.2%	5.2%	5.2%	5.2%
Interest Rate on total debt portfolio					
Foreign	3.7%	3.7%	3.7%	3.7%	3.7%
Domestic	8.9%	8.6%	8.6%	8.7%	8.8%

2.4. Missing estimates

Missing Estimates refer 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.

2.4.1. 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 in the Budget speech 2022. Table 2.4.1 provides a table with several examples of this problem.

Table 2.4.1: Undisclosed consequences: indicative examples

No.	Policy Proposal in the Budget Speech
1	Establish a new salary structure for the public service by removing the anomalies in public service salaries with effect from the next financial year.
2	Extend the retirement age of public service to 65 years.
3	Swiftly commence the implementation of the required restructuring activities to conduct proper investigations into alleged frauds on depositors of cooperative and rural banks, assist such depositors by reimbursing financial damages if such frauds have occurred.
4	Expected to avoid deficiencies that occur or can occur in charging custom duties by updating the HS code system currently being used by Sri Lanka Customs, while also introducing advanced technological tools globally used in customs operations to Sri Lanka Customs.
5	Establish a three-wheeler regulatory authority and to make decisions including the three-wheeler charges and service standardisation through the authority.
6	Establish a contributory pension scheme for senior citizens who do not currently receive pensions.

2.4.2. 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 are not provided. Every proposal set out must be evaluated in terms of the estimated fiscal impact to have a holistic understanding of the implications of the proposal.

The 2021 budget speech consisted of 36 revenue-reducing proposals with no fiscal measures. The 2022 budget speech only consists of three such proposals. The number of expenditure proposals with no expenditure allocation decreased from 32 to 14 proposals. While this may signify an improvement in budget reporting standards, it is still a substantial inadequacy. Additionally, Budget 2022 consists of a notable increase in discretionary spending at the national, provincial and local levels;

Table 2.4.2.1 Revenue-reducing proposals

No.	Proposal
1	Exempt business registration fees in the year 2022 to provide an impetus for new start-ups.
2	Provide the required lands and tax concessions to encourage investors to establish an international school and a hospital in every district.
3	Allow Value Added Tax (VAT) exemptions on supply of medical equipment, machinery, apparatus, accessories and parts thereof and hospital furniture, drugs and chemicals donated to a government hospital or the Ministry of Health to address any public health or pandemic emergency.

Table 2.4.2.2 Expenditure proposals

No.	Proposal
1	Install a countrywide telecommunication network expeditiously covering all 10,155 schools in the country using fibre optic technology, for which the required financial and technological assistance is proposed to be provided to the Telecommunication Regulatory Commission.
2	Introduce an inclusive programme to address the issues related to children and mental health development.
3	Implement a new programme to provide the necessary knowledge, to encourage flower growers and to promote export-oriented production. I entrust the leadership of this task to the Department of National Botanical Gardens, which is under the Ministry of Tourism.
4	Facilitate and encourage the private sector to produce medicines of the highest quality in Sri Lanka targeting the international market.
5	Start the production of the raw materials required both domestically and internationally by the apparel industry, thereby opening a new avenue of entering the international market.
6	Implement a rapid programme to promote the local handloom and batik production industry with the aim of generating an income of USD 1 billion by 2025.
7	Formulate a new programme for establishing new Ayurveda treatment centres and promoting traditional indigenous medicine and natural treatment methods.
8	Expand the capacity of the organic fertiliser production of special categories of fertiliser for targeted cultivations/crops through the provision of the required technical expertise at the Grama Niladhari Division level.

No.	Proposal
9	Promote the diversification of agricultural products and value-added agricultural products to generate foreign income.
10	To promote renewable energy, ensuring the reduction of the use of carbon-emitting fuel and foreign currency outflows, I propose to encourage the local manufacture of equipment and appliances required for the generation of renewable energy.
11	To facilitate the necessary environment for promoting Sri Lanka as a centre for wellness tourism, required action will be taken to link our country to the global wellness tourism industry.
12	Establish hi-tech agro parks to produce new agro-entrepreneurs by providing uncultivated lands to women and youth on a special basis and thereby expanding the extent of cultivated lands in agriculture and plantation sectors.
13	Three new techno-parks are proposed to commence in Habarana, Nuwaraeliya (Mahagasthota), Kandy (Digana).
14	To increase income from foreign remittances, I propose to further improve the existing facilities to provide knowledge, skills and other requirements for going overseas for employment and to enhance opportunities available in this regard by consulting the ambassadors of other countries.

2.4.3 Positive fiscal measures with missing estimations

This section sets out examples of fiscal measures that have a positive fiscal impact but are lacking estimates on the magnitude of this impact. The five revenue-generating proposals are concerned with tax administration.

The expenditure management proposals aim to minimise government expenditure but its expected fiscal impact is unquantified.

Table 2.4.3.1 : Revenue-generating proposals

No.	Proposal
1	Implement the Revenue Administration Management Information System (RAMIS).
2	Further strengthen the Large Tax Payers Unit (LTU) and Upper Corporate Unit (UCU) to improve revenue collection from large taxpayers.
3	Remove weaknesses in the digital revenue collection systems of the revenue collection bodies; i.e., RAMIS of the Department of Inland Revenue and Single Window System of the Sri Lanka Customs.
4	Expedite the implementation of the digital revenue collection system of the Excise Department and simplify the excise licensing process.
5	Introduce a mechanism to examine the accuracy of the tax documents when filing through the above systems and allow, at every opportunity, to present digital invoices and documents as valid documents.

Table 2.4.3.2 Expenditure management proposals

No.	Proposal
1	Suspend the construction of new office premises for two years.
2	Include amendments to the Appropriation Bill preventing requests for Supplementary Estimates for 2022 by all ministries.
3	Reduce the fuel allowance provided to hon. Ministers and government officers by 5 litres per month.
4	Cut down the telephone expenses of government institutions by 25%.
5	Reduce the provisions for electricity by 10% in government institutions.
6	Extend the period of service from 5 years to 10 years for members of parliament to be eligible for a pension, including the president.

SECTION 3: INFORMATIONAL STANDARDS AND DUE DILIGENCE

3.1. Irreconcilable differences in numbers across different classifications and formats

The budget information, which includes all proposed annual expenditures, revenues, and other government financial activities for the forthcoming period, is presented annually under several classifications and formats via multiple reports.

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. Amongst them, one of the key concerns is that the numbers across the reports contradict each other. In the past years, the numbers within the same report also have contradicted each other. Therefore, this leads to circumstances where the public cannot identify the most accurate estimate or reconcile between these reports. This is a serious concern because in many respects, and for many external users, the budget documents are the most important financial statements issued by the government. The budget also serves as a key tool for financial management and control and is the central component of the process that provides for government and parliamentary oversight of the financial dimensions of operations.

3.2. Differences in numbers across reports

The total, as well as the breakdown of the revenue and expenditure figures reported in the budget speech, differs from that of the budget estimates. This is an ongoing and recurrent issue. There could be several reasons leading to deviations in the numbers across these reports such as:

1. New budget proposals may have been brought into the budget after the budget estimates were produced.
2. Budget speech and budget estimates follow different classification formats. While the budget speech produces estimates according to economic classification, budget estimates estimate according to accounting classifications. Hence, the difference in numbers could be due to the difference in the reporting formats.

One of the ways the government could address the issue of the differences in the numbers across reports is through a commitment to provide explanatory information on the deviations, which could allow for better interpretation, even within the current formats of reporting.

Table 3.2 reveals the deviations that have been noted between Budget Speech 2021 and the budget estimates numbers, for which explanatory information has not been provided.

Table 3.2.1: Budget speech numbers vs. budget estimate numbers, Classification of revenue estimates, Budget 2022 (values in LKR billions)

Budget Speech		Budget Estimates		Revenue Proposals (Budget Speech)	Comparability
Revenue Component	Value	Revenue Component	Value	Value	
Total revenue and grants	2,284	Total revenue and grants	2,048	333	Not reconcilable (+97)
Tax revenue	1,987	Tax revenue	1,748	168	Not reconcilable (-71)
o/w taxes on external trade	460	o/w taxes on international trade	478		Not reconcilable (+18)

Budget Speech		Budget Estimates		Revenue Proposals (Budget Speech)	Comparability
Revenue Component	Value	Revenue Component	Value	Value	
o/w taxes on goods and services	1,031	o/w taxes on domestic goods & services	861	68	Not reconcilable (-89)
		o/w license taxes & others	13		
o/w income tax	496	o/w taxes on income & profits	396	100	Reconcilable
Non-tax revenue	226	Non-tax revenue	230	25	Not reconcilable (+29)
Provincial council tax sharing and devolved revenue	61	Provincial council revenue	61		Reconcilable
Grants	10	Foreign grants	10		Reconcilable

Sources: Budget Speech 2022; Draft Budget Estimates 2022

Table 3.2.2 : Classification of expenditure estimates, 2022budget (values in LKR billions)

Budget Speech		Budget Estimates		Expenditure Proposals (Budget Speech)	Comparability
Expenditure Component	Value	Expenditure Component	Value	Value	
Total expenditure	3,912	Total expenditure	3,597	261.1	Not reconcilable (-53.8)
- Recurrent expenditure	2,996	- Recurrent expenditure	2,879	51.1	Not reconcilable (-65.9)
o/w Salaries & wages	1,015	o/w Personal emoluments	650	37.6	Not reconcilable (-327.4)
o/w Goods & services	203	o/w Goods & services ^[12]	259	0.5	Not reconcilable (+56.5)
o/w Interest	1,115	o/w Interest payments	1,116		Not reconcilable (+1)
o/w Transfers	663	o/w Transfers	853	13	Not reconcilable (+203)
- Capital expenditure	931	- Capital expenditure	718	240	Not reconcilable (+27)

Sources: Budget Speech 2022, Draft Budget Estimates 2022

As shown in Table 3.2.1, the total revenue and grants figure reported in the budget speech is LKR 236 billion higher than what is reported in the budget estimates. As aforementioned, the difference could be due to new budget proposals being brought into the budget after the budget estimates were produced. The revenue proposals reported in Annexure III of the budget speech adds up to LKR 333 billion. Even assuming these revenue proposals were brought in later and therefore not accounted for in the budget estimates when it is added to its total revenue and grants

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

figure, it is not possible to reconcile with the budget speech total revenue and grants figure.

The total expenditure figure reported in the budget speech is LKR 315 billion higher than what is reported in the budget estimates. Similar to the total revenue and grants, the total expenditure figure also cannot be reconciled even after adding the expenditure proposals of LKR 261 billion shown in Annexure IV of the budget speech to the budget estimates' total expenditure figure.

Table 3.2.3 : Macroeconomic assumptions used in different reports

	2021/22 FMR	2022 Draft Budget Estimates	2022 Budget Speech
Real GDP Growth Rate	5.0%	5.0%	6.0%
Nominal GDP growth rate	10.8%	n/a	12.5%
Overall Budget Balance (% of GDP)	-8.8%	n/a	-8.8%
Primary Budget Balance (% of GDP)	-2.7%	n/a	-2.8%

Note: All the above-mentioned documents were released on the day of the budget speech (November 12, 2021).

Sources: Budget Speech 2022; Draft Budget Estimates 2022; FMR 2021-22

Recommendations

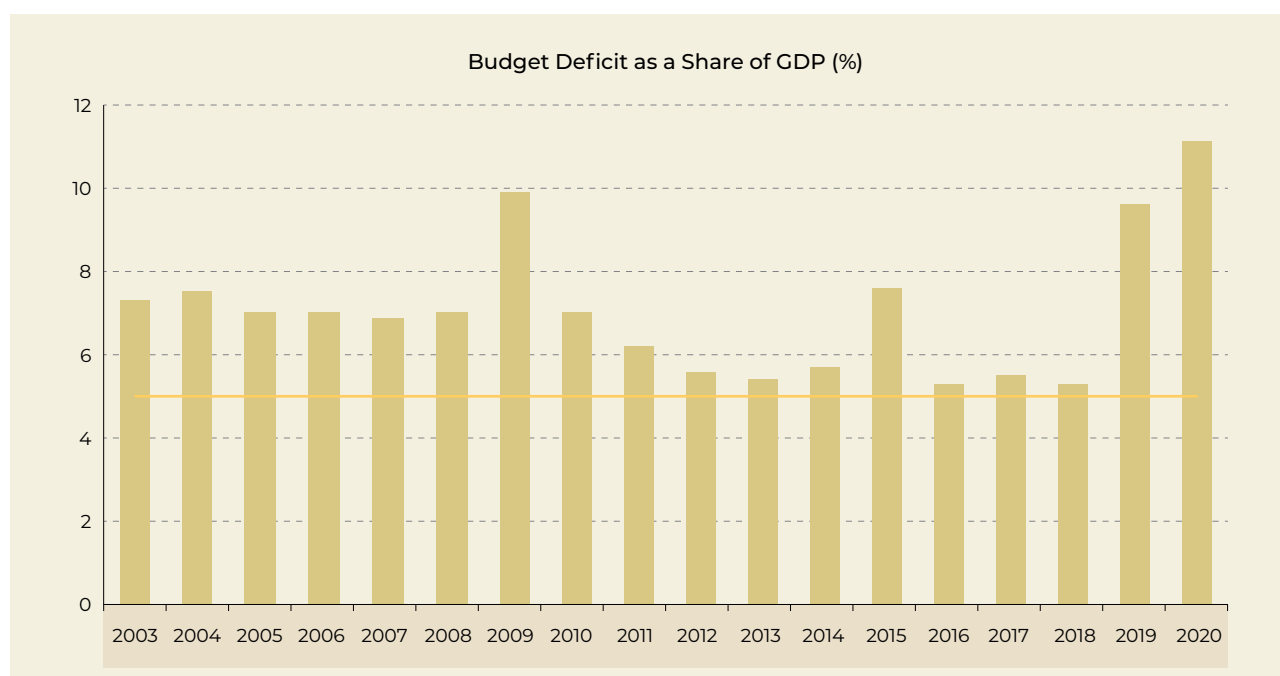
- MoF should provide a detailed breakdown of the revenue and expenditure figures in the budget speech classification similar to that of the budget estimates.
- MoF should provide a full reconciliation/explanation of the differences between the figures in the budget speech and the budget estimates. This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

3.3. 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 the 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 2022, which at 8.8% of GDP is well above the legally allowed limit of 5% of GDP.

Exhibit 5 : Budget deficit 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 also sets a limit on the total liabilities of the government, i.e., the country's total debt. The initial act in 2003 specified limiting total liabilities, including domestic and external debt at the current exchange rate, to 85% of GDP by the end of 2006. It further specifies that total liabilities should not exceed 60% 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% was increased to 80% in 2013 and the 60% limit was extended till 2020. Since the 2020 timeframe was breached, in June 2021, the FMRA was further amended to extend the central government debt limit of 80% of GDP till 2030.

Exhibit 6: 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

The central government debt as a share of GDP in 2021 is estimated at 102.8%. It is well above the 80% limit set in the act. The government has failed to comply with the limits set in the FMRA and will violate them.

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 the credibility of the executive. Furthermore, these violations and changes also undermine the credibility of the very institutions that are meant to provide credibility.

