ISAS Insights

No. 330 – 4 May 2016

Institute of South Asian Studies
National University of Singapore
29 Heng Mui Keng Terrace
#08-06 (Block B)
Singapore 119620
Tel: (65) 6516 4239 Fax: (65) 6776 7505
www.isas.nus.edu.sg
http://southasiandiaspora.org

Sri Lanka's Economic Crisis and Post-Budget 2016 Tax Changes

Iromi Dharmawardhane[1]

Sri Lanka may face a severe balance of payments crisis, primarily brought on by the inability to service foreign loans, a high fiscal deficit and a foreign exchange crisis, if the government fails to finance the deficit in time through foreign borrowings. In an effort to increase revenue and stabilise the economy, the government also plans to make structural changes to its fiscal policy. New taxes and revisions to those proposed in Budget 2016 were announced in March 2016 to widen the country's tax base. While post-war Sri Lanka carries much growth and investment potential, the country's near-term economic outlook remains precarious.

---

[1] Ms. Iromi Dharmawardhane is Research Associate at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore (NUS). She can be contacted at iromi@nus.edu.sg. The facts cited and views expressed in this paper are those of the author, and not of ISAS.

Introduction

As outlined in the Asian Development Outlook (ADO) 2016 Report, Sri Lanka’s balance of payments is in dire straits due to the country’s mounting foreign and domestic public debt, fiscal deficit where government expenditure greatly exceeds revenue, as well as a severe foreign exchange shortfall. Sri Lanka is presently facing a potentially calamitous economic situation primarily due to a serious debt crisis, where the country has not yet secured the means to meet the approximately US $4.5 billion in foreign loan repayments due in the next 12 months (about US $2.5 billion due in 2016[2]) – to be followed by another US $4 billion in the subsequent 12 months.[3] International credit rating agencies Fitch and Standard & Poor’s downgraded Sri Lanka’s international sovereign rating in February and March 2016 respectively, due to the country’s rising fiscal deficit (presently 110 percent of GDP) and foreign debt (highest among emerging markets in Asia), as well as sluggish growth prospects.

While excessive public debt has been accruing over generations and over successive governments, the debt trap that the country is experiencing today is principally due to the non-concessional commercial loans taken from 2009 to 2014 by the previous government of Mahinda Rajapaksa for infrastructure development projects, which about doubled the country’s external debt. The current administration led by Maithripala Sirisena and Ranil Wickremesinghe manifestly worsened the fiscal conditions of the country in 2015,[4] with outstanding debts rising by over 12 percent due to excessive government spending, and foreign debt increasing by 25 percent (albeit primarily to finance loans taken by the previous administration)[5].

Sri Lanka’s foreign currency earnings and reserves are also insufficient to meet its external financing requirements, which have sharply increased due to the need to service foreign loans. The depletion in foreign exchange is a consequence of large foreign capital outflows

---

2 “Govt to stop excess borrowing, eyes cheap funds after IMF deal”, *Reuters*, 12 April 2016, accessed 16 April 2016, http://www.sundaytimes.lk/article/1000678/govt-to-stop-excess-borrowing-eyes-cheap-funds-after-imf-deal.

3 “Economic focus on IMF, political focus on May Day rally”, *The Sunday Times*, 16 April 2016, accessed 16 April 2016, http://www.sundaytimes.lk/160417/columns/economic-focus-on-imf-political-focus-on-may-day-rally-189925.html.

4 As stated in the Annual Report 2015 of the Central Bank of Sri Lanka, the budget deficit increased from 5.7 percent of GDP in 2014 to 7.4 percent of GDP in 2015.

5 “Govt. borrowed 25% more last year than in 2014: Ravi K”, *Daily Financial Times*, 24 March 2016, accessed 15 April, 2016, http://www.ft.lk/article/532881/Govt--borrowed-25--more-last-year-than-in-2014--Ravi-K#sthash.Jr4zMfig.dpuf.

since January 2015 (approximately US $2 billion); reduced exports, largely due to the global economic downturn; and falling remittances from migrant workers employed in the distressed Middle East region. Sri Lanka's gross official foreign reserves amounted to US$ 6.2 billion by the end of March 2016 (declining from US $9 billion in end 2014), which is adequate only for four months of imports. There has also been depreciation in the Sri Lankan rupee since the government floated it in September 2015, due to foreign capital outflows, government spending, and the country's macroeconomic challenges – another risk foreign investors are watching.

Financing the Deficit

As temporary measures to avert a foreign exchange crisis, the government initiated a US $1.5 billion currency swap with the Reserve Bank of India and a $1 billion currency swap with the Central Bank of China in March. The Chinese government, as a gesture of friendship, donated approximately US $73.5 million (500 million yuan), during the Sri Lankan Prime Minister's state visit to China in April. Sri Lanka's Central Bank also plans to raise upto US $3 billion through international sovereign bonds in the international market this year. Also, controversially, on 22nd April, the government froze with immediate effect a 1993 rule permitting exporters to keep their earnings overseas without restriction, and ordered all earnings to be brought to Sri Lanka no later than 1 May 2016, giving exporters less than a week to comply – a move which also contradicts previous policy statements by the government.

Sri Lanka has resorted to extended foreign borrowings to counteract the rising fiscal deficit and strengthen foreign reserves in 2016. An International Monetary Fund (IMF) loan of US $1.5 billion has been granted on a 36-month Extended Fund Facility (EFF) programme as of 29th April, subject to formal approval by the IMF's Executive Board in June. The Sri Lankan Central Bank Governor has stated that the country hopes to obtain an additional US $5 billion in foreign loans from other sources, such as the World Bank, Asian Development Bank, Japanese international lenders, Indian banks and Chinese banks, once the IMF loan – a mark of international confidence – is in effect.

The IMF loan has come only as the Sri Lankan government has agreed to specific conditions required by the IMF (among other criteria) such as: (1) overall 2016 budget deficit not to exceed 5.4% of the Gross Domestic Product (GDP); (2) primary deficit in 2017 not to exceed 0.2% of the GDP; (3) primary surplus in 2018 to be 0.3% of GDP; (4) overall fiscal deficit to be 3.5 percent of GDP by 2020; and (5) the tax-to-GDP ratio to be near 15 percent by 2020. The IMF has also recommended a reform agenda with the objectives of: (i) improving revenue administration and tax policy; (ii) strengthening public financial management; (iii) state enterprise reforms; and, (iv) structural reforms to enable a more outward-looking economy, deepen foreign exchange markets, and strengthen financial sector supervision.

New Taxes

In following IMF recommendations for fiscal consolidation, and due to the country's severe fiscal deficit and limited tax revenue, the government has made proposals to make structural changes in its fiscal policy. On 8 March 2016, the government announced emergency tax measures – new taxes and revisions to those proposed in Budget 2016 (released in January 2015 and amended in October).

An overview of the changes to taxes announced in March 2016 include a widening of the tax base by: (1) increasing corporate income tax (CIT); (2) increasing value added tax (VAT) applicable to businesses, which is passed on to the consumer; (3) reintroducing income tax on capital gains ("Capital Gains Tax"), applicable to individuals and corporations; (4) removing certain previous exemptions on VAT and "Nation Building Tax" (NBT); (5) not implementing changes to personal income tax proposed in Budget 2016[6]; and (6) not implementing the increase of NBT to 4% proposed in the Budget from the current 2%. Additionally, it was announced on 12th April that a Share Transaction Levy (STL) at a rate of 0.3 percent is to be reimposed with effect from 15 April 2016 on all share transactions. The government also shared its plans to introduce a carbon tax (levy) on vehicles (among further tax measures) with the IMF delegation in mid-April.

[6] The revolutionary change in personal income tax of exempting up to Rs. 2.4 million incomes per year, and above that a flat rate of 15%, proposed in Budget 2016 is not to be implemented.

VAT is to be increased to 15% from 11% for all goods and services produced,[7] except on 'essential goods and services'[8] (the two VAT rates 8% and 12.5% proposed in the Budget are not to be implemented). Previous exemptions on VAT for telecommunication services and private healthcare have been removed. It is expected that the telecommunications industry will be subject to 15% VAT in addition to the 25% Telecommunications Levy that is already in place. On 15th April, the Finance Ministry announced that the VAT increase to 15% is to be in effect from 2 May 2016.

Changes to corporate income tax include the increase of taxes to 17.5% from the previously stipulated 10% to 12% on profits earned for the export, small and medium-sized enterprise (SME), tourism, agriculture, and construction sectors.[9] Taxes are to be at 28% for banking and financial services, wholesale and retail (on turnover), and most other sectors (changed from the 15% or 30% in the Budget 2016). NBT is to remain at 2%, while taxable threshold was lowered to a turnover of Rs. 3 million (approximately US $20,550) per quarter (from the Rs. 3.75 million proposed in the Budget).

While the rate and methodology of calculation of the Capital Gains Tax have not yet been announced, in the past, it has included gains made from the sale of shares made on the stock exchange as well as gains made on the sale of property.[10] It is important to note however that it is likely not applicable to investments made by foreign entities through inward remittances. As per Budget 2016 and previous budgets, income taxes have not been applicable to dividend income on investments of non-citizens or foreign companies in listed shares through inward remittances.

The tax changes proposed in March 2016 are however not yet law, and the effective dates for many remain unannounced. Although it was initially proposed that the new taxes were to take effect from 1 April 2016, the government circular dated 31 March 2016 announced that they

---

7 Including for wholesalers and retailers with a quarterly turnover of Rs.100 million or more: "Tax Chart: Year of Assessment 2014/2015", *Sri Lanka Inland Revenue*, last updated 20 November 2015, accessed 12 April, 2016, http://www.ird.gov.lk/en/publications/SitePages/Tax%20Chart.aspx?menuid=1404.

8 Essential goods and services such as electricity; water; pharmaceuticals; public healthcare; and local vegetables, fruits and fresh milk are to be exempt from the proposed VAT increase.

9 However, it is to be noted that Budget 2016 provides tax holidays for investments identified as strategic development projects; qualifying SMEs, medium-scale companies and large-scale companies in "thrust industries"; companies engaged in Research and Development in the fields of science and technology; as well as investments in economically lagging regions.

10 "8 March 2016 Breaking Tax News: The Government announces changes to 2016 Budget proposals", *Earnest and Young*, released 8 March 2016.

were not to be implemented from 1 April[11] – likely to avoid public outcry as the implementation of the new taxes would have then coincided with the national New Year festivities in the month of April.

Looking Ahead

Two of the primary aims of the Sri Lankan government are to attract FDI and encourage the private sector to invest more, to spur post-war development and stabilise the balance of payments in the medium and long-term. However, the government's changes to the Budget, i.e. unplanned and ad hoc tax policy changes and other sudden policy changes, have been cited as one of the factors denting investor sentiment at present and causing capital outflows, as well as eroding local business sentiment. These post-Budget policy changes have caused much confusion and a state of uncertainty to prevail in the economy. Predictability and consistency in economic policy are key to a positive business and investment environment.

Downward economic momentum is expected in the near-term with the higher taxes to be implemented negatively affecting low and middle income consumers and SMEs[12], organisations importing raw and intermediate materials, as well as the rate of local investment; diminishing consumer purchasing power due to the rate of inflation rising to 3.1% in April and sharp exchange rate depreciation; low FDI performance; and as a result of the looming balance of payments crisis.

While Sri Lanka's tax revenue is uniquely low and while it is necessary to increase tax revenue to meet growing public debt and to stabilise the economy, higher tax rates serve to discourage business and investment and reduce consumption, leading to less growth. Therefore, with more than half of the registered tax payers in Sri Lanka known to evade paying their taxes, it would benefit Sri Lanka to focus foremost on developing an efficient and comprehensive tax collection mechanism to ensure effective tax administration and compliance.

11 "UPDATE - March 28 IRD notice on new tax guidelines, withdrawn and removed from IRD website", *The Sunday Times Online*, 31 March 2016, accessed 31 March 2016, http://www.sundaytimes.lk/article/99558/update-march-28-ird-notice-on-new-tax-guidelines-withdrawn-and-removed-from-ird-website.

12 SMEs account for 40% of Sri Lanka's GDP.

In this regard, it can also be noted that Budget 2016 which aimed to increase overall tax revenue by 23%, introduced two new and very contentious direct taxes in the retrospective Super Gains Tax and a Mansions Tax under the provisions of the Finance Act, No. 10 of 2015. These could not be implemented due to a lack of parliamentary approval. The Super Gains Tax is applicable to corporations exceeding a profit of Rs. 2 billion (approximately US $13.7 million), including blue chip companies – the private sector that drove economic growth during the war-time years. These taxes were perceived as being repressive and arbitrary, as well as unsustainable as they hurt local business sentiment and infringe on individual rights.

To reduce public debt, the government is looking to privatise loss-making state owned enterprises (SOEs), which account for more than 80 percent of the domestic debt. Sri Lanka has invited Chinese companies and others to invest in these, and in an effort to reduce its foreign debt to China, has proposed a debt-equity swap – although Chinese companies have not yet responded to these proposals. It can be noted here that privatisation of SOEs is not strictly necessary if they are to meet welfare goals, albeit a complete overhaul would be required, constituting structural and institutional reforms as well as sound regulatory systems to improve efficiency and productivity. An example of a successful SOE is the once bankrupt Indian Railways, which records a US $2.3 billion profit today[13].

Despite the deterioration in the balance of payments, Sri Lanka showed a positive growth momentum in 2015. Thus, in the medium-term, following the IMF facility, a turnaround is hoped for in the country's economic outlook. An emerging market, Sri Lanka has many lucrative areas for investment including in the booming tourism sector, the construction sector, and in infrastructure development. Sri Lankan central bank data shows that foreign investors have bought about US $80 million in government bonds in March-April. The IMF projects a real GDP growth of 5% for Sri Lanka in 2016.

That said, some commentators believe that the country appears to lack a clear sense of direction on economic policy and suspect that that the government may not be able to effectively manage the rising balance of payments imbalance. This scepticism stems from the

[13] "Distribution of Railways' Excess of Receipts over Expenditure", *Budget of the Railway Revenue and Expenditure of the Central Government for 2015-16*, http://www.indianrailways.gov.in/railwayboard/uploads/directorate/finance_budget/Budget_2015-16/BudgetStatement1516.pdf, p. 5.

fragmented political landscape caused by the tense alliance between the arch political rivals United National Party (UNP) and (a segment of) the Sri Lanka Freedom Party (SLFP), as well as the unpredictable economic management of the Ministry of Finance. Such a coalition causes paralysis in conjunction with a lack of debate in the policy implementation process. The gloomy near-term economic forecast is bound to test the strength of this coalition further in successfully managing the painful reforms to come.

. . . . .