

ISSUER COMMENT

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Government of Sri Lanka

New Inland Revenue Act paves way for revenue reforms and IMF loan disbursement, a credit positive

On 19 June, [Sri Lanka's \(B1 negative\)](#) government made public a new income tax bill that will replace the existing law with a more efficient, modern and broad-based tax framework. The proposed revisions to the Inland Revenue Act, which were gazetted (published) by the Department of Government Printing¹, will contribute to increasing Sri Lanka's very low level of government revenues, a key constraint on the sovereign credit profile.

The gazettement of the proposed tax reforms also paves the way for the International Monetary Fund (IMF) to approve a pending third loan tranche from Sri Lanka's three-year, \$1.5 billion Extended Fund Facility (EFF) program. The continuity of the IMF program will support the authorities' ongoing fiscal and structural reform efforts. While the disbursement of the \$168 million loan will boost Sri Lanka's external liquidity position.

The bill will, among other things, simplify the sources of income, introduce a three-tier tax structure with reduced exemptions and reintroduce the capital gains tax. The act also proposes: modernizing rules related to cross-border transactions to address base erosion and tax avoidance, broadening the tax base by removing excess tax incentives and expanding income tax sources.

Sri Lanka's current Inland Revenue Act is a complicated tax scheme that hinders the transparency of taxes for potential investors in fixed and financial assets, limits the effectiveness of local tax officials' supervision efforts, and contributes to a very low tax-to-GDP ratio. In particular, the current Act does not efficiently deal with modern business structures and commercial transactions, including cross-border transactions.

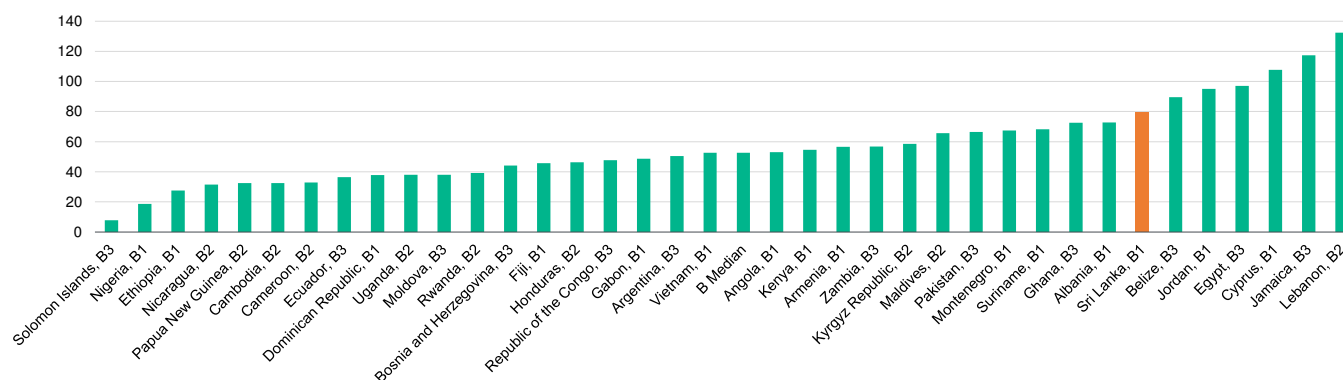
In May, the IMF reached a staff-level agreement with Sri Lankan authorities on the second review under the EFF program. IMF officials indicated that approval of the third loan tranche by the IMF Executive Board would be contingent upon gazetting of the new Inland Revenue Act bill. The bill was approved by Sri Lanka's Cabinet of Ministers in May 2017, and the government expects to table it within Parliament for debate within the next two months, according to media reports. We expect the bill to face limited opposition in Parliament.

The implementation of revenue reforms that foster long-term fiscal consolidation will be critical to shoring up Sri Lanka's credit profile. The country's large debt burden and weak debt affordability weigh significantly on its creditworthiness. The government's debt burden of 79.3% of GDP in 2016 was higher than the median of 53% for B-rated sovereigns (see Exhibit 1). The debt burden has risen from a low of 68.7% of GDP in 2012. With nominal GDP growth forecast to be slower in coming years than over the past decade, persistent and sizeable fiscal deficits would further increase Sri Lanka's debt stock.

Exhibit 1

Sri Lanka's debt burden is higher than the median for B-rated sovereigns

2016 general government debt/GDP, %



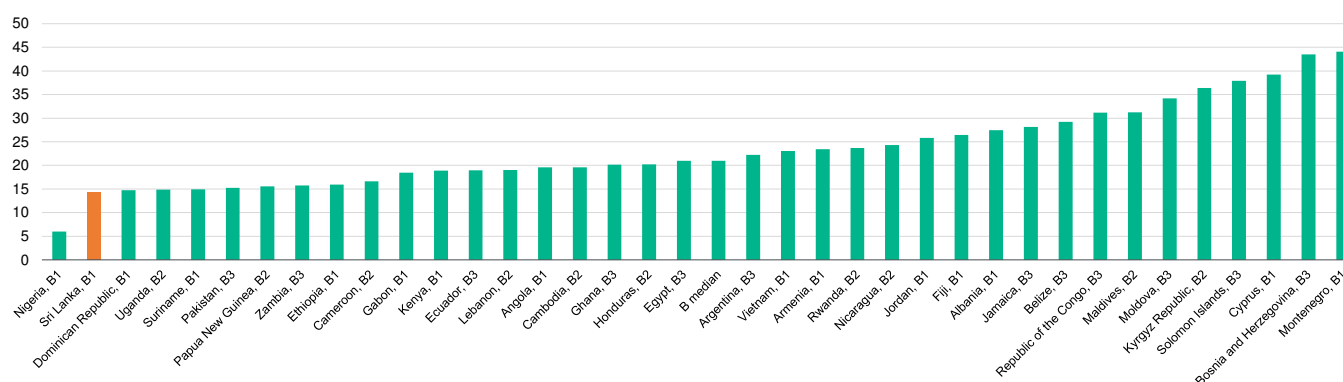
Source: Moody's Investors Service

Sri Lanka's low income tax efficiency and tax collection provide significant scope for revenue reforms that target broadening of the tax base and increasing the tax revenue-to-GDP ratio, which was only 12.4% in 2016. Total government revenues (combined tax and non-tax) are also very low, with a general government revenue-to-GDP ratio of only 14.3% in 2016, one of the lowest among B-rated sovereigns (see Exhibit 2).

Exhibit 2

Sri Lanka's government revenues are low compared with B-rated peers

2016 general government revenue/GDP, %



Source: Moody's Investors Service

Implementation of the value-added tax (VAT) rate hike in late 2016 will contribute to higher revenue generation in 2017. Moving forward, if the government's revenue reforms, including the new Inland Revenue Act, are implemented successfully, we expect general government revenues to increase to about 14.7% of GDP in 2017 and 15.0% by 2018. The IMF projects revenues to rise further to about 16% of GDP by 2021.

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Given Sri Lanka's weak fiscal position and need for growth-enhancing public expenditure on infrastructure and development programs, the government's plans to increase revenues will play an important role in bolstering debt sustainability and fiscal consolidation. Revenue mobilization efforts will help create fiscal space for such increased spending and deficit reduction, while also tempering external vulnerabilities. If successful, these measures will contribute to the strengthening of Sri Lanka's credit profile. However, we expect the benefits of revenue reforms to accrue slowly over time.

Beside the impact of fiscal reform on revenue collection, continuity of the IMF program will provide ongoing support to the authorities' future fiscal and structural reform efforts.

Meanwhile, disbursement of Sri Lanka's third IMF EFF loan tranche will help support the country's external liquidity position. The government's high debt levels and large financing needs - we estimate borrowing requirements at 17.8% of GDP in 2017 - has resulted in significant external vulnerability and government liquidity risk. Continuation of the IMF program will provide direct liquidity and policy support through 2019.

Moody's Related Research

Country Statistics: [Sri Lanka, Government of](#), Jun 2017

Issuer Comment: [Sri Lanka's Drought-Related Costs Add to Challenge of Achieving Fiscal Targets](#), Mar 2017

Regional Outlook: [Sovereigns – Asia Pacific: 2017 Outlook – Stable Outlook Balances External, Political Risks Against Economic, Institutional Reforms](#), Jan 2017

Issuer In-Depth: [Government of Sri Lanka: Effective Revenue Reforms Remain Key to Credit Outlook](#), Dec 2016

Rating Methodology: [Sovereign Bond Ratings](#), Dec 2016

Endnotes

1 [Department of Government Printing](#)

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