

## ISSUER IN-DEPTH

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## Government of Sri Lanka

### Effective Revenue Reforms Remain Key to Credit Outlook

Sri Lanka's (B1 negative) elevated debt burden, large fiscal deficits and high external borrowing costs continue to expose the sovereign to potential shocks. While the program with the International Monetary Fund (IMF) has helped establish an ambitious roadmap to fiscal consolidation and structural reform, implementation will be challenging. The negative growth impact of tight fiscal and monetary policy and subdued external demand, combined with uncertain effectiveness of tax-broadening measures, could limit the efficacy of the government's reform efforts aimed at consolidation of public finances and shoring up the country's balance of payments.

This report focuses on Sri Lanka's fiscal position and plans for budgetary consolidation, the effectiveness of which will shape the sovereign's credit profile:

**Ability to implement fiscal reforms will drive Sri Lanka's credit profile** Given its weak fiscal position and demands for growth-enhancing public expenditure on infrastructure and development programs, plans to increase government revenues will play an important role in bolstering debt sustainability and the overall sovereign credit profile. Revenue mobilization efforts will likewise be key to creating fiscal space for increased spending and deficit reduction, while tempering external vulnerabilities.

**Revenue-enhancing reforms to channel sustained reduction in fiscal deficit** The government's 2017 budget proposal is broadly consistent with its fiscal consolidation roadmap with the IMF, and illustrates its commitment to fiscal consolidation and to the IMF program. The budget relies on significant increases in tax revenues to drive a material narrowing of the deficit, through a mix of implemented and planned measures.

**Underlying budget revenue and growth assumptions appear ambitious** It could be difficult for the government to pursue fiscal consolidation at the pace it envisages. The significant fiscal tightening currently envisaged, combined with likely relatively tight monetary policy, may dampen GDP growth to a greater extent than currently projected by the government. Moreover, if the government does not manage to implement tax policy and administrative reforms in full, it could cut back on expenditure to meet its fiscal targets. That would also weigh on GDP growth, which in turn would lower revenue collection.

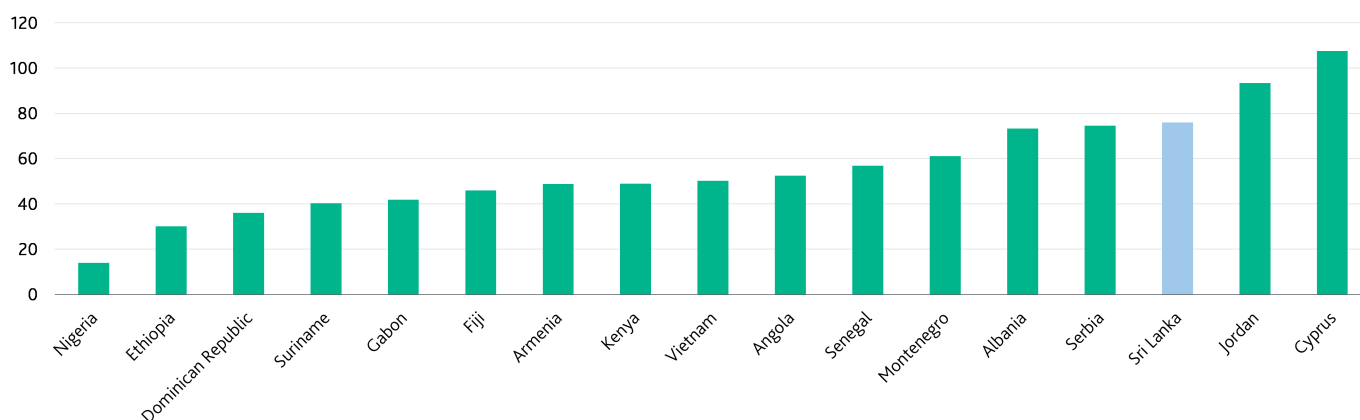
**Inability to implement reforms would damage investor confidence, risk instability** Despite the government's demonstrated commitment to fiscal and structural changes, substantial implementation challenges remain, which could slow or derail reforms. Fractious politics could limit progress on revenue and state-owned enterprise (SOE) reforms. If slower reform progress were to affect availability of external financing, pressure on a still fragile external position would mount.

## Effectiveness of fiscal reforms will drive Sri Lanka's credit profile

Sri Lanka's robust growth potential, relatively large economy and higher income levels than similarly rated sovereigns support its B1 rating. However, at 76.0% of GDP in 2015, the government debt burden is well above the B-rated median of about 50% (see Exhibit 1) and has climbed rapidly from a recent trough of 68.7% in 2012.

Exhibit 1

### Large Fiscal Deficits Have Resulted in a Higher Debt Burden than Most B1-Rated Peers (General government debt, % of GDP, 2015)

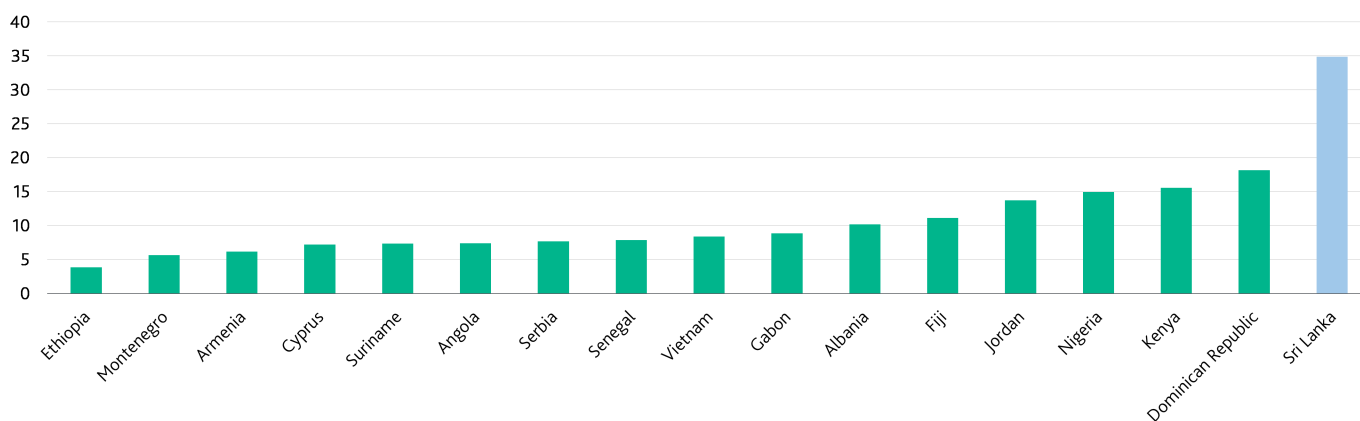


Source: Moody's Investors Service

With nominal GDP growth likely to be slower in coming years than over the past decade, persistent and sizeable deficits will raise debt levels further. Debt affordability is also weak (see Exhibit 2).

Exhibit 2

### Debt Affordability Is Weak Relative to B1-Rated Peers (General government interest payments, % of revenues, 2015)



Source: Moody's Investors Service

Given Sri Lanka's weak fiscal position and need for growth-enhancing public expenditure on infrastructure and development programs, plans to increase government revenues will play an important role in bolstering debt sustainability and the overall sovereign credit profile. Revenue mobilization efforts will likewise be key to creating fiscal space for increased spending and deficit reduction, while tempering external vulnerabilities.

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Sri Lanka's low income tax efficiency and tax collection provide significant scope to broaden the tax base and increase the tax revenue-to-GDP ratio, which was only 12.1% in 2015. Continued steps to advance targeted tax policy and administrative reforms, while improving the quality and effectiveness of public expenditure and reducing contingent liabilities from SOEs, would support this goal. Medium-term developments in fiscal strength will be determinant to Sri Lanka's credit profile. <sup>1</sup>

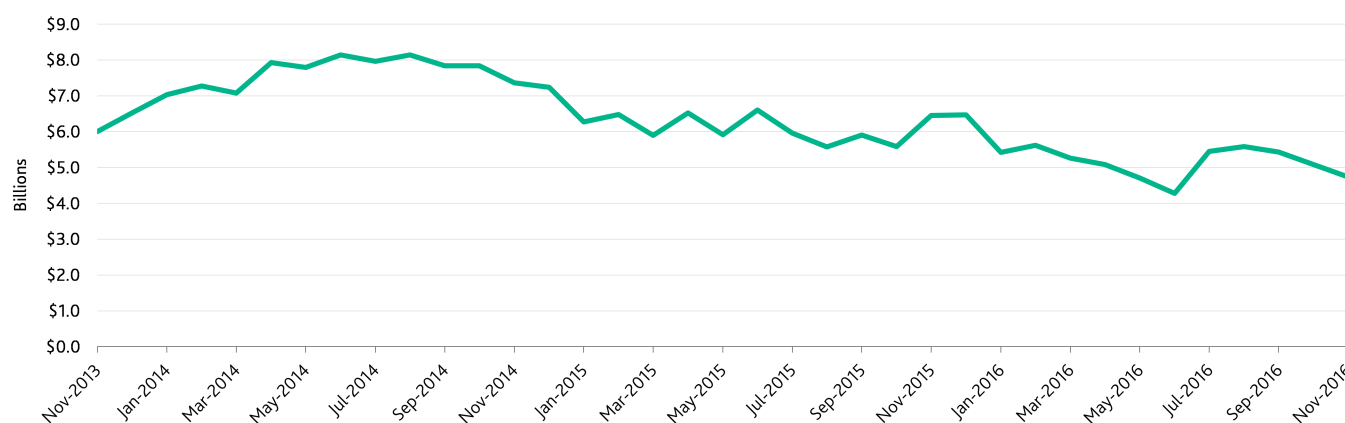
### Revenue-enhancing reforms planned to channel reduction in fiscal deficit

In June 2016, the government entered an Extended Fund Facility (EFF) program with the IMF, providing a basis for the government's objectives to implement reforms towards a stronger fiscal and macroeconomic framework.

Fiscal consolidation forms the cornerstone of the program, which targets a reduction in the general government fiscal deficit to 3.5% of GDP by 2020. The program also aims to reform State-Owned Enterprises (SOEs) and rebuild foreign exchange reserves which have fallen to low levels (see Exhibit 3).

Exhibit 3

#### Sri Lanka's Foreign Exchange Reserves (\$ billions, excluding gold and SDR)



Source: Central Bank of Sri Lanka

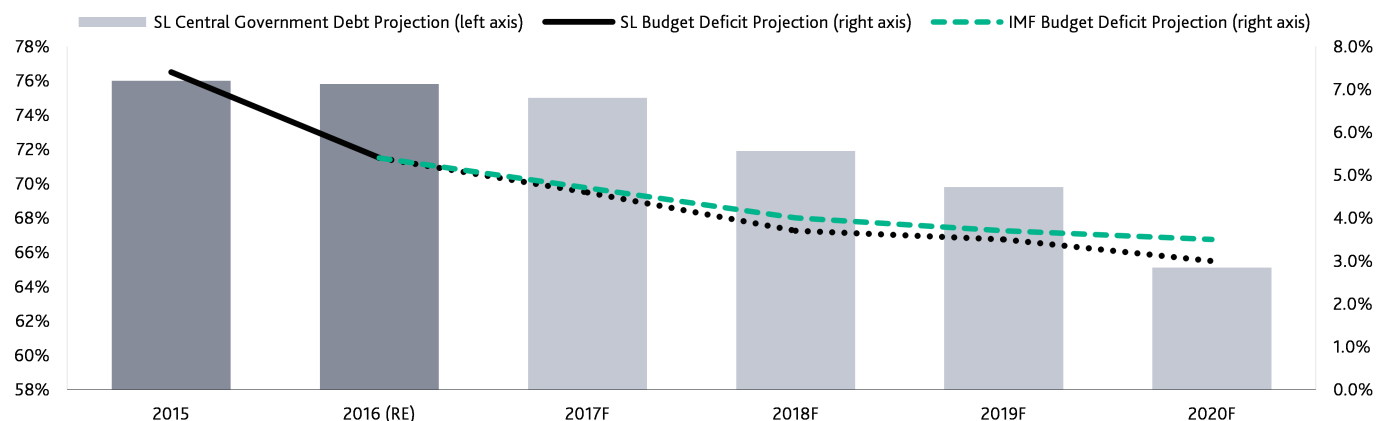
On 10 November 2016, the government presented its 2017 budget proposal, which targets a fiscal deficit of 4.6% of GDP, after 5.4% and 7.4% in 2016 and 2015, respectively. <sup>2</sup> The budget proposal is broadly consistent with the fiscal consolidation roadmap that underpins the IMF program (see Exhibit 4), and demonstrates the government's continued commitment to fiscal reform.

Deficit reduction in 2016 resulted from significant expenditure compression amounting to 2.1% of GDP, driven by a decline in public investment to about 4.1% of GDP from 5.4% in 2015.

The government forecasts total expenditure to increase to 20.2% of GDP in 2017 from 18.9% in 2016. A rebound in public investment in infrastructure by 1.1% of GDP to 4.2% of GDP will be the main driver. It projects recurrent expenditure, such as salaries and wages, and debt service payments, to remain at its current level of 15.0% of GDP.

Exhibit 4

## Government and IMF Fiscal Projections



Sources: Ministry of Finance, IMF

As a result, fiscal deficit reduction in 2017 relies on significant increases in tax revenues (see Exhibit 5).

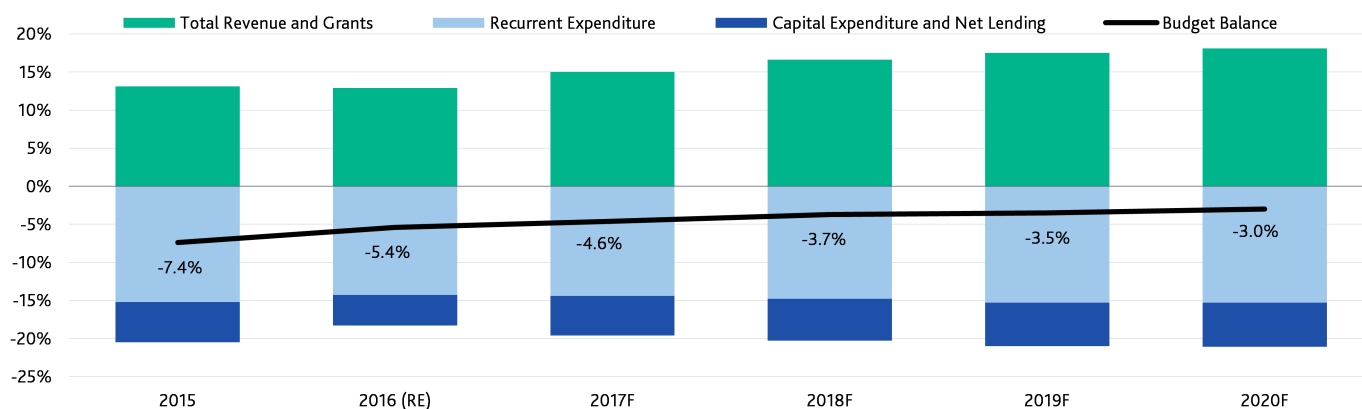
The government projects tax revenues to rise to 13.5% of GDP in 2017 from 11.6% in 2016. That marks a 27.0% year-over-year rise, compared to only a 5.6% gain in 2016. The expected increase is reflected in all major tax components, through a combination of tax rate hikes and exemption exclusions.

- » The most significant contribution to the overall increase in tax revenues is projected to come from excise, with related revenues to increase by nearly 30%, representing about 32% of total tax revenues. New excise duties will be introduced and some revised<sup>3</sup> while the government expects the efficiency of excise collection to increase through e-invoicing;
- » The second largest increase stems from higher income tax receipts, accounting for 25% of the total tax revenue rise. Income tax is projected to rise by 42%, representing about 18% of total tax revenues;
- » Receipts from value-added tax (VAT) are projected to rise by nearly 21% to represent about 21% of total tax revenues, consistent with a full year of VAT at the 15% rate following the re-instatement of the rate hike in November 2016.

The government expects non-tax revenues to rise by 31.0% year-on-year. However, non-tax revenue is equivalent to only about 10% of total tax revenues.

Exhibit 5

### Revenue and Expenditure Composition of Budget Projections (% of GDP)



Source: Ministry of Finance

In particular, the government announced an overhaul of the direct income tax regime, which is consistent with its commitment to simplifying and modernizing Sri Lanka's tax system through a new Inland Revenue Act. Based on our GDP forecast, the projected changes would result in an income tax revenue increase of about 0.6% of GDP, to 2.5% of GDP in 2017. This would be achieved through changes to the corporate income tax rate structure, and a revision of the individual income tax structure.

Corporations will be classified into three tax rate tiers: SMEs and exporters of goods and services will pay 14% (up from 12% for goods exports, and exemption for services exports), along with agriculture and education firms (up from 10%); liquor, tobacco, betting and gaming sectors will continue to pay 40%; and all other sectors will pay 28%. This should ultimately contribute to the government's goal of increasing the direct tax component of overall tax collections to 40% from the current level of 15%.

Other changes include: an increase in the withholding tax on interest income to 5%; removal of exemptions on income earned from dividends and investments in listed securities; and a new financial transaction levy on cash transactions.

### Underlying budget revenue and growth assumptions appear ambitious

The 2017 budget focuses on revenue mobilization based on the recent VAT rate hike, simplification of the tax structure, introduction of IT systems to enhance corporate and individual income tax collection, and higher GDP growth. However, if effective, significant fiscal tightening and potentially higher inflation in response to the VAT rate hike will dampen growth. Monetary policy tightening in response to higher inflation, especially if currently high credit growth fuels inflationary pressure, would add to the drag on economic activity. This will limit the revenue dividends of fiscal reforms for the government, at least in the short term. The toll on households and corporates' net incomes will make sustaining tight fiscal and monetary policy for several years increasingly challenging.

In this context, the government's projections for higher revenues rely on ambitious assumptions about real GDP growth and about the effectiveness of the restructuring of income tax and the new electronic tax collection system.

First, the budget assumes near full tax compliance, which would require swift rollout of the planned automation of the Inland Revenue Department (IRD), through implementation of the new Revenue Administration and Management Information System (RAMIS), and linkage with a single window system at Sri Lanka Customs. Full implementation of these pending IT systems will be critical to efficient and effective tax collection and administration, facilitating a shift toward risk-based audit and organizational reform of IRD operations. However, seamless implementation of the new IT systems and full tax compliance appear somewhat challenging.

Second, the government's expectations for a pickup in tax revenues looks somewhat ambitious from an implied tax buoyancy<sup>4</sup> perspective. Applying a nominal GDP growth rate of 10% (consistent with IMF projections and implied estimates from the government budget documents) to the government's tax revenue growth rate projection of 27%, derives an implied tax buoyancy of 2.7. This is high relative to the past, as nominal GDP growth has slowed substantially from an average rate of 16.6% over the decade to 2015,

and revenue growth has been in a steady decline relative to GDP for years, due to a narrowing of the tax base and weak collection. If unusually high tax buoyancy relates to a material increase in effective tax rates, it will dampen disposable incomes and spending.

Third, the budget assumes that real GDP growth will accelerate to between 6% and 7% in 2017, based on expectations of: stable mid-single-digit inflation; a steady exchange rate supported by larger foreign exchange reserves; strong increases in domestic economic activities, complemented by low interest rates; strengthening recovery of the global economy; a balance of payments surplus underpinned by the IMF program; and export growth driven by enhanced external demand from major trading partners, including India (Baa3 positive) and the United States (Aaa stable).

We project GDP growth to be lower, rising to 5.2% in 2018 from 5.0% in 2017, similar to the IMF projections - 4.8% and 4.9% in 2017 and 2018, respectively. Our real GDP growth forecast takes into account the likely impact of fiscal consolidation and tighter monetary policy over the next few years. A concerted government effort on regaining competitiveness and resumption of foreign direct investment and development of key projects, including the Colombo Port City and Hambantota port, would enhance Sri Lanka's export potential and eventually contribute to higher exports. However, in a global environment of prolonged slow trade, the returns on such policy may be limited.

If economic activity disappoints or tax-raising measures yield lower outcomes than currently budgeted, the fiscal targets may slip. One option would be to cut back on public investment expenditure, particularly in infrastructure, to meet its targets; but such a scenario would weigh on GDP growth. In turn, fiscal slippage or weakening growth risks undermining foreign investors' confidence in the ability of the authorities to reduce Sri Lanka's long-standing macroeconomic imbalances.

On the monetary policy front, we believe the Central Bank of Sri Lanka's objectives of price stability and moderate credit growth will likely result in relatively high interest rates and generally tighter financing conditions. This will add to the factors weighing on private domestic investment in the near term. In addition, Sri Lanka's relatively low level of foreign exchange reserves further complicates monetary policy, as the central bank may need to hike rates faster than desired in order to limit capital outflows or attract portfolio inflows in an environment where US interest rates are rising and global investors are generally retreating from emerging markets.

### **Inability to implement reforms would damage investor confidence, risk instability**

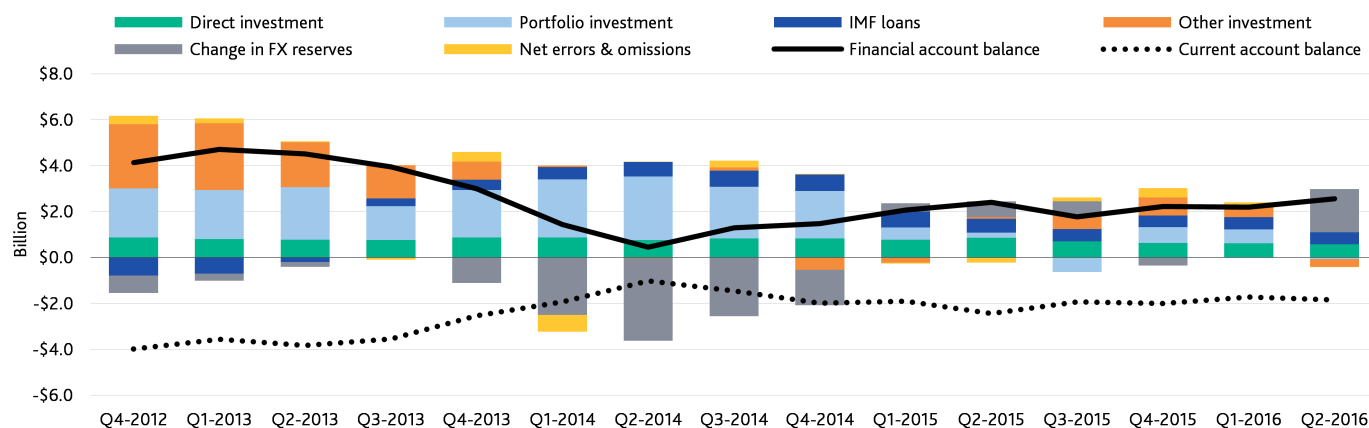
While the government has demonstrated its commitment to fiscal and structural change, substantial implementation challenges remain, which could slow or derail the reform process.

Moving forward, fractious politics and a substantive policy agenda which also includes reform of the constitution and further progress on reconciliation could limit progress on revenue and SOE reforms, resulting in weaker growth, slower fiscal consolidation and losses from SOEs crystallizing on the sovereign's balance sheet. If this happened, foreign investors' confidence may be undermined.

This could combine with the expected normalization of interest rates in the US to result in lower capital inflows in, or capital outflows out, of Sri Lanka. Pressure on the fragile balance of payments would increase (see Exhibit 6). In this scenario, the Central Bank of Sri Lanka's policy of less frequent foreign exchange rate intervention could also be tested.

Exhibit 6

### Sri Lanka's Capital and Current Account (\$ Billions)



Note: A negative sign for "Change in FX Reserves" denotes an increase in the country's balance of foreign-exchange reserves, whereas a positive sign indicates a decline.

Sources: Central Bank of Sri Lanka, IMF, Moody's Investors Service

In November, the IMF completed its first review of Sri Lanka's economic performance under the three-year EFF program. The IMF deemed the review satisfactory and agreed to disburse the second tranche of Sri Lanka's \$1.5 billion loan package. The second disbursement of about \$163 million, followed the first disbursement of the same size in June. The next disbursement is scheduled for late April 2017.

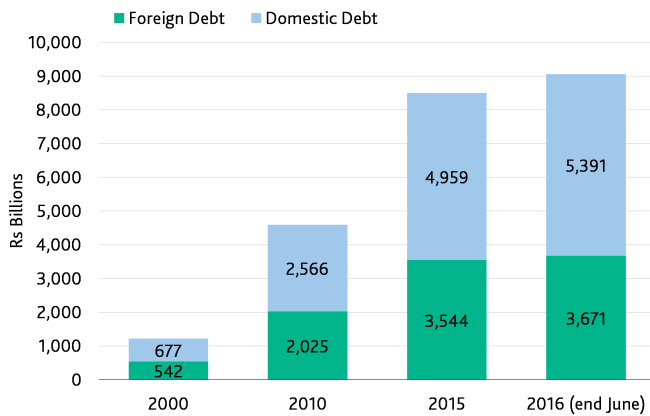
The IMF program and disbursements by other international lenders will continue to play an important part in stabilizing Sri Lanka's foreign exchange reserves and help to offset capital outflows. Program engagement usually leads to a turn in investor confidence, which supports higher portfolio inflows in the short term.<sup>5</sup> Whether Sri Lanka's credit profile gets a temporary or more enduring boost from the IMF program will depend on the government's ability to sustain effective reform implementation, thereby reducing domestic and external imbalances.

However, unless capital inflows increase markedly and stay at a higher level, foreign exchange reserves will remain low in relation to imports and external debt payment needs (see Exhibits 7 and 8).

The value of foreign exchange reserves (excluding gold and SDR) fell by 6.7% in November to \$4.73 billion from \$5.07 billion in October, and a more recent peak of \$5.59 billion in August 2016. We expect Sri Lanka's external vulnerability indicator (EVI)<sup>6</sup>, which measures the ratio of external debt payments due over the next year to foreign exchange reserves, to remain elevated at around 140% at year-end 2016. We expect the EVI to rise to about 155% in 2017, before slowly declining thereafter.

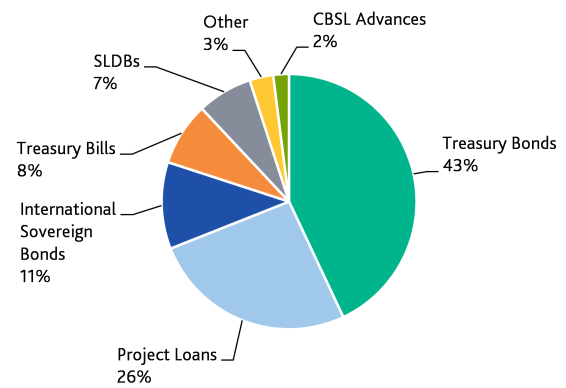
Looking forward, medium-term risks remain as foreign debt repayment obligations are large, especially those due between 2019 and 2022 (see Exhibit 9). Meanwhile, the Central Bank of Sri Lanka currently borrows a large portion of its reserves through temporary FX swap arrangements with domestic commercial banks, which are subject to rollover risk. As of 30 October 2016, the central bank had a total short foreign currency forward position of \$2.81 billion, with combined residual maturity of one month to one year. The IMF has advised Sri Lanka to unwind these swap positions. At this stage, it is not clear how this will be achieved in an environment of fragile capital inflows that may drain rather than inflate foreign exchange reserves.

Exhibit 7

**Government Debt Breakdown**

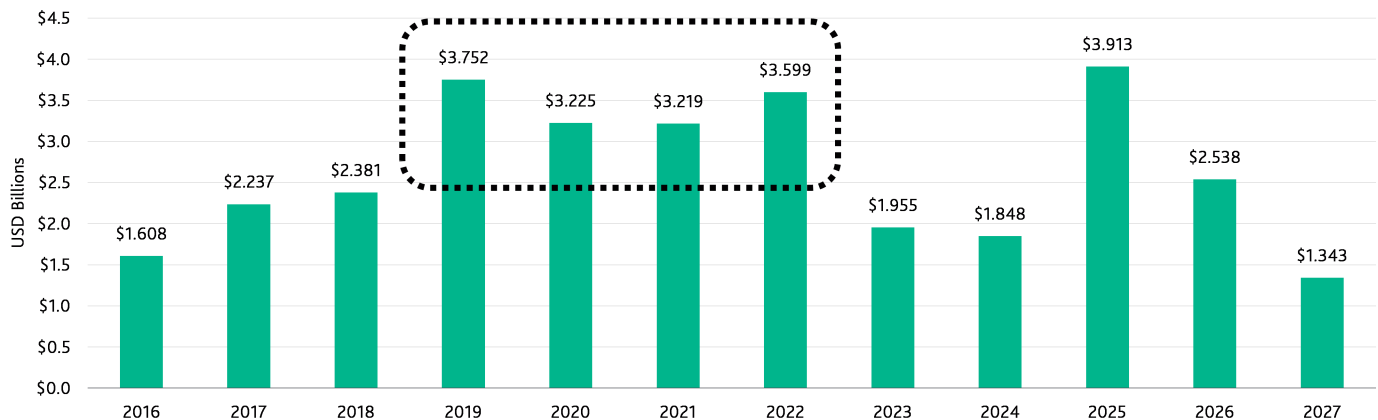
Source: Ministry of Finance

Exhibit 8

**Government Debt Outstanding  
(As of June 2016)**

Source: Ministry of Finance

Exhibit 9

**Foreign Debt Service Payments to Increase in 2019-2022  
(As of September 2016)**

Source: Ministry of Finance



## Moody's Related Research

### Issuer Comment:

- » [Sri Lanka's Reinstated VAT Hike Will Keep IMF Program on Track, a Credit Positive](#), October 2016
- » [IMF Program Will Ease Sri Lanka's Liquidity Pressures, But Not Its Fiscal Challenges](#), May 2016
- » [Sri Lanka Will Benefit from European Union's Termination of Ban on Imported Fish](#), April 2016

### Outlook:

- » [Sovereigns - Global: 2017 Outlook – Negative Outlook As Low Growth, High Debt Limit Policy Options](#), November 2016

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## Endnotes

<sup>1</sup> See [Moody's changes outlook on Sri Lanka's rating to negative from stable; affirms government bond rating at B1](#), June 2016

<sup>2</sup> The 2015 deficit included some one-off measures

<sup>3</sup> New excise duties are introduced on raw materials to produce ethanol, non-potable liquor and imported beer and motor vehicles duty is revised

<sup>4</sup> Tax buoyancy measures the efficiency and responsiveness of revenue mobilization to economic growth.

<sup>5</sup> See [IMF Program Will Ease Sri Lanka's Liquidity Pressures, But Not Its Fiscal Challenges](#), May 2016

<sup>6</sup> External vulnerability indicator = (short-term external debt + currently maturing long-term external debt + total nonresident deposits over one year)/official foreign exchange reserves

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