Special Report

30th December, 2011

VERITÉ RESEARCH

Special Report -Budget 2012

<u>Contents:</u>

Macroeconomic Environment

Decrease in government consumption: Overall consumption as a percentage of GDP decreased from 82.1% in 2009 to 81.3% in 2010. But private consumption increased slightly, and in a departure from the recent trends the reduction was driven by the decrease in Government consumption, which reduced from 17.6% to 15.6% of GDP.

Decrease in private investment and FDI: While Foreign Direct Investment (FDI) fell by 14% even in absolute terms from US$ 601 million in 2009 to US$ 516 million in 2010. However, domestic private investment increased from 17.9% of GDP to 21.6% in the period. This is a departure from past trends of declining domestic investment, and the contrast with FDI may also an indication that confidence with regard to investment ventures in Sri Lanka is increasingly dependent on local knowledge and influence-networks, as opposed to the broad institutional and policy infrastructure. If so, future growth in FDI may become increasingly tied to influential local partners or political personalities.

Imports and exports: There was little change in total exports which stood at 16.8% of GDP in 2009, and 16.7% in 2010. In a reversal of recent trends, however, imports increased from 24.3% of GDP to 27.2% in the period. As a result, the trade deficit expanded and increased pressure on the exchange rate, which has been pegged to the US dollar.

Government Debt and Pensions

Recorded government debt has fallen: from 86.2% of the GDP in 2009 to 81.9% in 2010. However, the calculation of government debt fails to account for the unfunded Civil Service pension payments which previous budgets have inaccurately categorised as welfare payments.

Pension payments to civil servants constitute a legally binding debt obligation on the government – and, as all other debt, a claim on future taxes. Omitting the present discounted value of the future pension payments from the assessment of government debt obligations is a serious technical shortcoming in evaluating the true macroeconomic position.

Average annual pension payments per year between 2005 and 20010 are 1.8% of annual GDP. The demographic ageing in Sri Lanka results in the pension burden growing because of (a) regular inflation and growth related upward adjustments to the payments (b) increase in the number of pensioners (c) increase in the longevity of pensioners. Pension payment grew at approximately the rate of nominal GDP growth (inflation + GDP) between 2010 and 2011.[1]

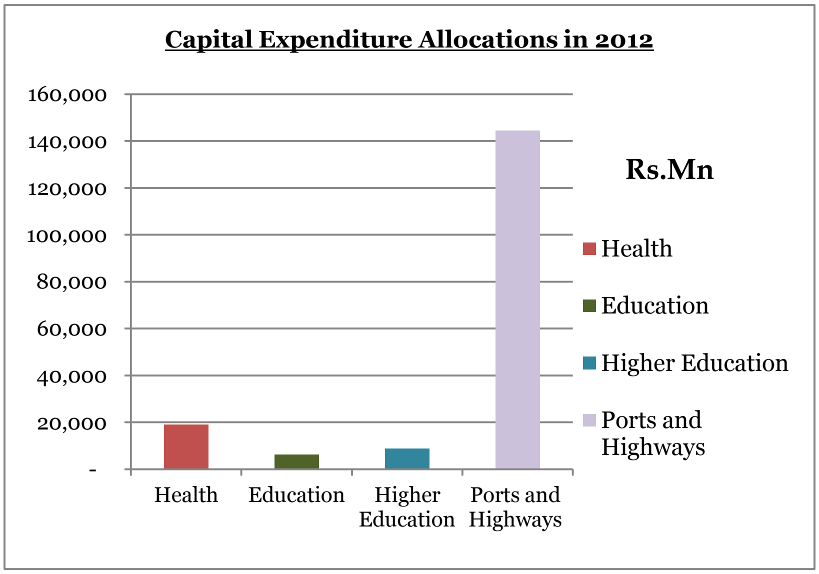
Verité Research has estimated the **existing** present discounted value of the outstanding pension debt obligation – if pensions obligations are limited only to current employees and all new employees are not pensionable – to be **90% of GDP**. This means that the substantively accurate reading of **fiscal debt is 171.9% of GDP** as opposed to the reported figure of 81.9% of GDP.

Exchange rate regime and rupee devaluation: The government devalued the rupee by 3% through the 2012 budget. This is unprecedented, in terms of budget actions. The CB has claimed that the exchange rate is a true reflection of the volatility adjusted market rate. That this claim was being made both before and after the devaluation is illogical. There is also continued reporting that the CB is intervening heavily to defend the LKR against further depreciation.

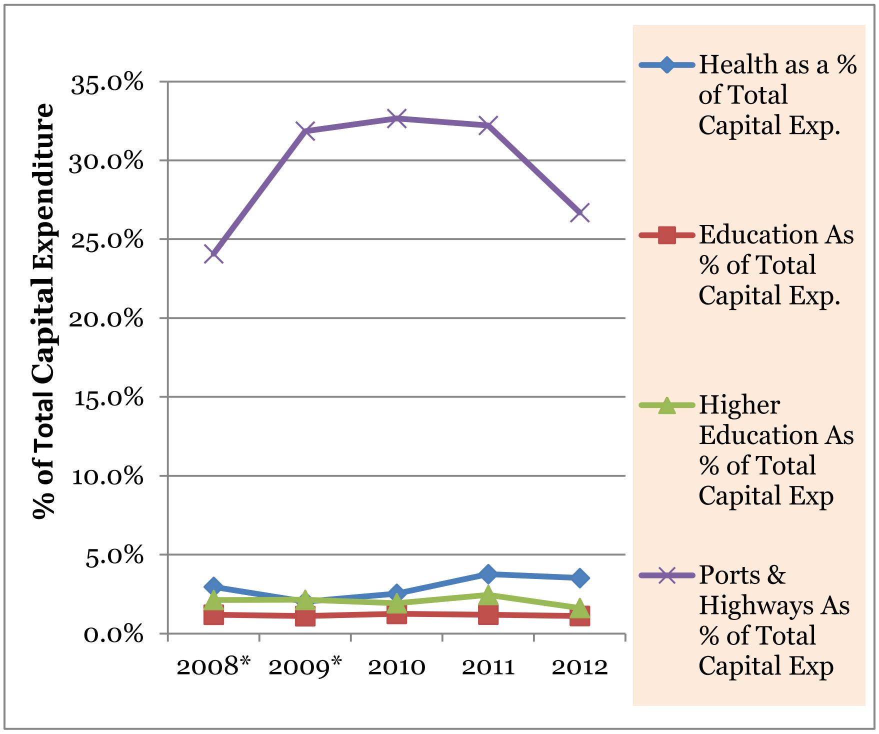
Opacity of exchange rate policy: The logical problem is therefore followed by a legal problem. Section 73(1) of the Monetary Law Act allows the Governor of the CB to determine parities of the exchange rate outside of the market. But when he does so, he is obliged to publish that in the gazette – but presently there is no evident compliance with that law.

Moving away from the welfare state?

Budget 2012 demonstrated a clear intention on the part of the government to focus on rapid infrastructure development in certain key sectors, especially in relation to transportation. The **Ports and Highways** Ministry that comes directly under President Mahinda Rajapakse will see further increases in capital expenditure accounting for more than **25% of total capital expenditure in 2012**. On the other hand **combined capital expenditure on health, education and higher education will be approximately 6% of total capital spending**.



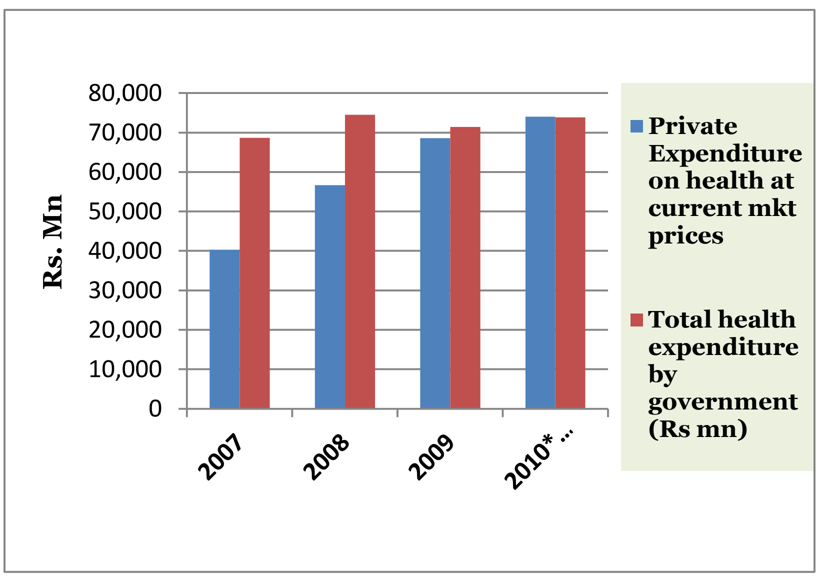
[1] Comparing first 9 months to reflect current data availability for 2011.



Lower capital expenditures on health and education, in comparison to costly infrastructure projects is not unusual, but the increased and sustained widening of the gap between the two indicates a conscious movement away from Sri Lanka's historical emphasis on welfare spending to the development of hard infrastructure. Higher education was the only area in which the capital allocation actually decreased from the previous year (a reduction of 12%).

The shift, as demonstrated by trends in capital expenditure allocations from 2008-2012, can result in stimulating short term growth but could also compromise long-term social development if the trend is not reversed.

*Note: The figures given for 'Ports and Highways' for 2008 and 2009 are the combined figures for the Ministry of Ports and Aviation and Ministry of Highways.



Source: Central Bank Annual Report 2010

As a result of this shift, the government has increasingly shifted the burden of welfare spending, most notably health spending to private individuals. By 2010 total private spending on health had overtaken total government spending on health (combined recurrent and capital expenditure).

However, primary and secondary education spending by the government still remains much higher than private spending. There are no available estimates for private spending on tertiary education, which is likely to be the most costly area of private spending on education.

Health and education as a percentage of GDP: The above cited trend is also affirmed when considering spending (both recurrent and capital spending) as a percentage of GDP.

Health Expenditure

	2005	2010
Total Health Expenditure by Government (Rs.Mn)	44,850	73,835
Govt. Health Expenditure as a % of GDP	1.83	1.32

From 2005 to 2010, the country has recorded a 27.8% decrease in the total expenditure on health as a % of GDP.

Education Expenditure

	2005	2010
Total Education Expenditure by Govt (Rs.Mn)	63,557	104,248
Govt. Education Expenditure as a % of GDP	2.59%	1.86%

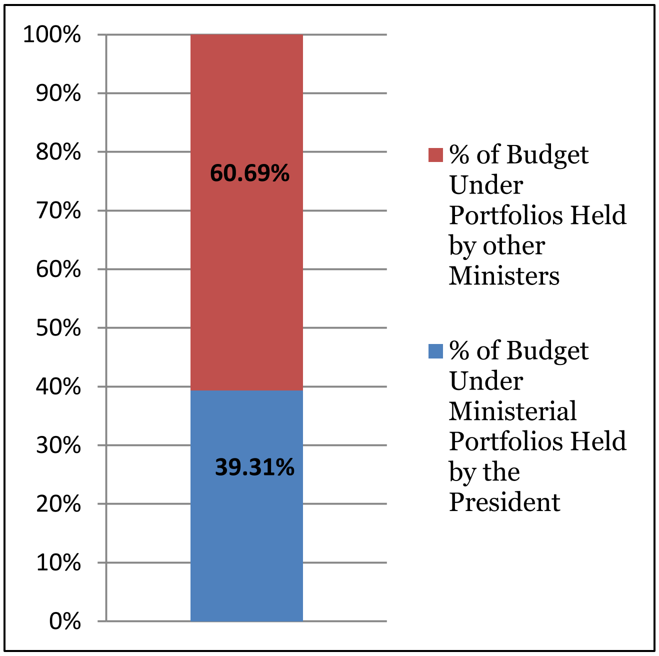
From 2005 to 2010, the country has recorded a 28% decrease in the expenditure on education as a % of GDP.

International comparison: Sri Lanka's falling health and education spending means that its current shortfalls in the provision of these welfare goods in comparison to more developed states will widen in the future.

	USA	UK	India	Sri Lanka
Health Expenditure as a % of GDP	16.2% (2009)	9.3% (2009)	4.2% (2009)	2.6% (2010)
Education Expenditure as a % of GDP	5.5% (2008)	5.4% (2008)	3.1% (2006)	1.86% (2010)

Source: World Bank Data

Government Budget under the Executive – Business as Usual



President Mahinda Rajapakse holds the ministerial portfolios for –

i) Ministry of Defence and Urban Development
ii) Ministry of Finance and Planning
iii) Ministry of Ports and Highways

The chart represents the budgetary allocations for the ministries under the president as a percentage of the total estimated expenditure for 2012. The share of **39.31%** of the total budget is up fractionally from **39.13%** in 2011.

Note: the above includes only allocations to Ministries, and does include other possibly captive funds such as the President's Fund.

Tax Proposals for 2012 – Inconsistencies in Policy

Tax Holidays:

Tax concessions have been given to 'Strategic Import Replacement Enterprises', which refer to specific enterprises (Cement, Steel, Pharmaceuticals, Fabric and Milk Powder) which produce to replace imports.
New enterprises are provided 5 year tax holidays followed by concessionary tax rates of 12% while existing enterprises are provided the concessionary tax rate for a period of 5 years with a 'qualifying payment relief'.

Furthermore, the present tax holiday regime stipulated in Section 16C of the Inland Revenue Act applicable in relation to manufacture of any product was extended to new enterprises engaged in a wide ranging number of new industries. Additionally, section 1.1.7 of the proposals states that the BOI will be authorized through an amendment under the Inland Revenue Act to extend these concessions together with the other relevant concessions to qualified enterprises referred to in above.

These proposals are not consistent with the government's stated aims and the recommendations of the presidential tax commission. The policy is inconsistent when compared with the budget speech of 2011 which stated that "The dichotomy between the BOI and non-BOI regimes will be corrected to create a level playing field." and aimed to reduce differential tax treatments.[2]

[2] http://www.lbr.lk/fullstory.php?nid=201006291538115045- Lanka Business Report -29th June 2010

A previous *Special Report* by Verité Research highlighted the problems of paying taxes faced by Businesses in Sri Lanka that had been identified in report published by the World Bank, 'Doing Business 2012: Doing Business in a More Transparent World'.[3] The *paying taxes* indicator was Sri Lanka's poorest ranked indicator of a total of 10 indicators, 173rd of a universe of 183 countries, despite obtaining an overall rank of 89th (of 183) in the index. Sri Lanka was also the worst performer in the South Asian region in this indicator.

Given the enormity of the existing problems related to taxation, the inconsistent shifts in taxation policy as noted above can be detrimental to not the just the revenue prospects of government but also so for long term investment confidence.

For a full report on the tax proposals for budget 2012 contact reception@veriteresearch.org
A breakdown of all special allowances highlighted in the budget speech is also available in pdf form

[3] http://www.doingbusiness.org/~/media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB12-FullReport.pdf

Summary of Government Revenue, Expenditure and Debt

Expenditure and Revenue

(Rs.Bn)	2010	2011	Growth (%)	2012	Growth (%)
REVENUE					
Income Tax	135.6	159.9	17.9%	190.3	19.0%
Taxes on Goods and Services	435.4	478.2	9.8%	569.4	19.1%
Taxes on External Trade	153.7	189.4	23.2%	240.9	27.2%
Total Tax Revenue	*724.7*	*827.5*	14.2%	*1000.6*	20.9%
Grants	17.0	13.8	-18.8%	20.0	44.9%
Non Tax Revenue	92.5	95.7	3.5%	105.5	10.2%
Total Revenue	**834.2**	**937.0**	**12.3%**	**1126.1**	**20.2%**
EXPENDITURE					
Recurrent					
Salaries and Wages	300.6	321.2	6.85%	367.9	14.5%
Interest	352.6	355.4	0.79%	370	4.1%
Subsidies and Transfers	196.2	212.9	8.51%	236.4	11.0%
Other Goods and Services	87.7	129.3	47.43%	133.5	3.2%
Public Investment					
Education and Health	32.5	39.8	22.46%	45.4	14.1%
Other Infrastructure Devel-opment	324	349.2	7.78%	452.1	29.5%
Other	-13.4	-10.5	-21.64%	-10.4	-1.0%
Total Expenditure	**1280.2**	**1397.3**	**9.15%**	**1594.9**	**14.1%**
Recurrent Expenditure	937.1	1018.8	8.72%	1107.9	8.7%
Capital Expenditure	343.1	378.5	10.32%	487.0	28.7%
Budget Deficit	**-446.0**	**-460.3**	**3.21%**	**-468.8**	**1.8%**

Source: Daily FT- Compiled by Department of Fiscal Policy

Outstanding Government Debt (Rs.bn)

(Rs.Bn)	2008	2009	2010
Domestic Debt	2140	2401	2566
Foreign Debt	1449	1760	2024
Total Government Debt	**3589**	**4161**	**4590**

Source: Central Bank Annual Report 2010

Government Finance (per cent of GDP)

	2008	2009	2010
GDP at Current Market Prices (Rs.Bn)	4410	4835	5602
Debt as a % of GDP	81.4%	86.1%	81.9%
Revenue and Grants as a % of GDP	15.60%	15.00%	14.90%
Revenue as a % of GDP	14.90%	14.50%	14.60%
Expenditure as a % of GDP	22.60%	24.90%	22.90%

Source: Central Bank Annual Report 2010