

# 01 | MACROECONOMIC PERFORMANCE AND PERSPECTIVES



## 1.1 Growth Performance 2010-2015

An average growth rate of 6.43 percent was achieved during the period 2010-2015. This can be attributed to several temporary factors such as growth momentum gained at the termination of the civil conflict in 2009 and the expansion of the construction sector during the period reviewed. This growth had the effect of raising the per-capita GDP to a level of US\$ 3,924 in 2015. However, this average figure conceals the considerable disparities in incomes prevailing among different occupational categories as well as among the provinces. During the period under review, domestic inflation remained at one-digit level thus providing the people, especially the lower income groups to enjoy a modest increase in real income. The improvement in incomes generated consumer demands which remained the main driving force for overall economic growth. The growth in external demand reflected in the performance of the exports was somewhat subdued - a result of the

worldwide economic recession that continued to drag down the economies of the advanced industrial countries.

## 1.1.1 Sectoral Contribution

The main contributions to economic growth during the post-conflict period came from construction, tourism, communications, trade and financial services. The share of agriculture in the GDP declined further from 8.5 percent in 2010 to 7.9 percent in 2015. This decline however reflects the normal shift in the sectoral composition experienced by most countries as they move up the income ladder and hence, does not necessarily reflect a decline in absolute terms.

The satisfactory growth performance resulted in an improved employment situation. The overall unemployment rate now stands at around 4.6 percent. However, the problem is yet to be fully resolved. The available information suggests that the rates of unemployment among youth and educated category are higher than the national rates.

Table 1.1.1: Changes in GDP: 2010-2015 at Constant (2010) Prices \* Rs. Mn

	2010	2011	2012	2013	2014(r)	2015(p)	Contribution to change	Contribution (%)	Annual Average Growth Rate (%)
Agriculture, Forestry & Fishing	544,914	569,954	592,443	611,676	641,493	676,899	131,985	6.0	4.4
Manufacturing, Mining and Quarrying and Other Industries	1,372,486	1,442,149	1,520,844	1,565,642	1,604,056	1,674,224	301,738	13.7	4.1
Construction	336,381	424,798	514,757	553,438	590,111	584,999	248,618	11.3	11.7
Wholesale and Retail Trade, Transportation & Storage	1,459,691	1,643,379	1,792,678	1,840,272	1,914,236	2,002,655	542,964	24.6	6.5
Information & Communication	31,650	33,813	36,674	39,510	44,102	49,613	17,963	0.8	9.4
Financial & Insurance Activities	342,763	382,274	433,714	456,863	500,948	575,073	232,310	10.5	10.9
Real Estate Activities (Including Ownership of Dwelling)	307,112	328,076	369,719	417,024	444,142	486,686	179,574	8.1	9.6
Professional, Scientific, Technical, Administration and Support Service	112,062	127,358	155,741	161,963	166,489	154,698	42,636	1.9	6.7
Public Administration, Defence, Education, Human Health and Social Work	658,950	659,260	726,619	686,499	723,943	746,852	87,902	4.0	2.5
Other Services	592,095	642,995	730,316	803,514	840,946	865,698	273,603	12.4	7.9
Gross Value Added at bp	5,758,104	6,254,056	6,873,505	7,136,401	7,470,466	7,817,397	2,059,293	93.2	6.3
+ Tax on Products	687,833	737,357	748,362	744,923	791,696	846,202	158,369	7.2	4.2
- Subsidies on Products	32,269	38,693	33,351	35,121	28,799	40,770	8,501	0.4	4.8
GDP at Market Prices	6,413,668	6,952,720	7,588,516	7,846,203	8,233,363	8,622,829	2,209,161	100.0	6.1

r-Revised; p -Provisional

\* Estimates based on Department of Census and Statistics (DCS) Data (Base Year - 2010)

Table 1.1.2: Expenditures of Gross Domestic Product ( GDP/ GDE) at Constant 2010 Prices

	Rs. Mn					
	2010	2011(r)	2012(r)	2013(r)	2014(r)	2015(p)
Final consumption expenditure	<b>4,932,545</b>	<b>5,355,454</b>	<b>5,496,156</b>	<b>5,881,197</b>	<b>6,216,685</b>	<b>6,645,913</b>
Household final consumption expenditure (1)	4,390,215	4,824,505	4,933,104	5,317,618	5,618,490	5,985,850
Government final consumption expenditure (2)	542,330	530,948	563,052	563,579	598,195	660,063
Individual consumption expenditure	154,764	155,437	158,577	170,333	178,606	213,157
Collective consumption expenditure	387,566	375,511	404,475	393,246	419,589	446,906
Gross capital formation	<b>1,946,707</b>	<b>2,340,767</b>	<b>2,848,687</b>	<b>2,597,115</b>	<b>2,782,904</b>	<b>2,920,219</b>
Gross fixed capital formation (3)	1,522,847	1,774,951	2,060,075	2,174,090	2,128,343	2,157,168
Changes in inventories	377,651	432,379	721,340	362,375	619,337	734,000
Acquisition less disposals of valuables	46,209	133,437	67,272	60,649	35,224	29,051
External balance of goods and services	<b>-465,584</b>	<b>-743,500</b>	<b>-756,326</b>	<b>-632,110</b>	<b>-770,603</b>	<b>-943,307</b>
Exports of goods and services	1,254,021	1,381,932	1,379,424	1,470,967	1,533,668	1,605,147
Imports of goods and services	1,719,605	2,125,432	2,135,750	2,103,077	2,304,271	2,548,455
Statistical discrepancy, if any						
Gross Domestic Product (GDP/GDE) @ mp	<b>6,413,668</b>	<b>6,952,720</b>	<b>7,588,517</b>	<b>7,846,202</b>	<b>8,228,986</b>	<b>8,622,825</b>
1- Detail table provided by COICOP classification						
2- Detail table provided by COFOG classification						
3- Detail table provided by type of asset						
r-Revised; p -Provisional						

Source: Department of Census and Statistics

### 1.1.2 Investment

The total investment grew by 73 percent in current price terms in 2015 to reach Rs. 3,361.5 billion compared to Rs. 1,946.7 billion in 2010. This represented *Investment/GDP* ratio at 30.1 percent in 2015.

The growth of investment was led by the private sector which accounted for about 77 percent of the total investment. It expanded by 86 percent during 2010-2014. The growth in investment was led by the private sector. Foreign Direct Investment (FDI) in 2015 has increased by 57 percent to US\$ 681.2 million from a level of US\$ 435.1 million in 2010. The largest FDI inflow was to the infrastructure sector, followed by services and manufacturing sectors.

Table 1.1.3: Savings and Investment: 2010 -2015 at Current Market Prices (a)

	Rs. Bn					
	2010	2011	2012	2013	2014	2015 (b)
Total Investment	1,946.7	2,408.6	3,410.5	3,189.3	3,341.2	3,361.5
National Savings	1,825.2	1,897.5	2,908.6	2,865.4	3,081.1	3,113.2
Domestic savings	1,481.1	1,456.3	2,374.9	2,362.8	2,504.7	2,531.0
Private savings	1,600.9	1,513.3	2,454.5	2,430.5	2,632.4	2,777.8
Government savings	-119.8	-57	-79.6	-67.7	-127.7	-246.8
Net Factor Income from Abroad	-69.8	-72	-154.9	-226.1	-236.7	-251.3
Net Current Transfers from Abroad	413.9	513.2	688.6	728.7	813.1	833.5
Investment Ratio (as a % of GDP)	30.4	33.4	39.1	33.2	32.0	30.1
Domestic Savings Ratio (as a % of GDP)	23.1	20.2	27.2	24.6	24.0	22.6
National Savings Ratio (as a % of GDP)	28.5	26.3	33.3	29.9	29.5	27.8

a - the data is based on the base year 2010 GDP estimates of DCS; b - Provisional  
Source: Department of Census and Statistics

## 1.1.3 Savings

Domestic savings were estimated at Rs 2,531.0 billion in 2015, an increase of 71 percent over 2010. Of the total domestic savings, the share of government savings reduced in 2015. The main reason is the lower growth in government revenue against the increased government recurrent expenditure over the period. The domestic savings as a ratio of GDP declined to 22.6 percent in 2015 compared to 23.1 percent in 2010.

National savings, the sum of domestic savings, Net Factor Income from Abroad (NFIA) and net current transfers from abroad were estimated at Rs. 3,113.2 billion in 2015, recording an improvement of 71 percent over 2010. NFIA remained negative, unchanged from previous years. The net current transfers from abroad, which grew by 101 percent to Rs. 833.5 billion in 2015 has continuously supported the improvement of national savings. In 2015, the national savings as a percentage of GDP has declined to 27.8 percent compared to 28.5 percent in 2010. The resource gap (savings-investment gap),

has slightly increased to 2.3 percent in 2015 from 1.9 percent in 2010

## 1.1.4 Export Import Performance

Earnings from exports increased by 4 percent to a value of US\$ 10.5 billion in 2015 compared to US\$ 8.6 billion in 2010. Industrial exports which represents 75 percent of total exports contributed largely to the exports growth during 2010-2015. Earnings from industrial exports increased by 6 percent to a value of US\$ 7.9 billion in 2015 compared to US\$ 6.1 billion in 2010, mainly as a result of the 8 percent export growth of textiles and garments which amounts to 42 percent of the total exports of the country. Rubber products and petroleum products have significantly increased the earnings by 6 percent and 7 percent respectively. However, the earnings from gems, diamonds and jewellery have declined significantly despite the incentives offered.

The share of agricultural exports in total exports increased by only 1 percent to US\$ 2.5 billion in 2015 over 2010. Among agricultural

Table 1.1.4: Value of Exports 2010-2015

	2005	2010	2011	2012	2013	2014	2015	US\$ Mn
								Average Rate of growth (2010 -2015)
1.Agricultural Export	1,153.8	2,306.4	2,527.8	2,331.5	2,581.1	2,793.9	2,482.8	1.5
1.1.Tea	810.2	1,440.6	1,490.9	1,411.9	1,542.2	1,628.3	1,341.0	-1.4
1.2.Rubber	46.9	173.2	206.4	125.1	71.3	45.3	26.0	-31.6
1.3.Coconut Products	113.3	165.8	266	208.9	204.6	356.4	351.8	16.2
1.4.Spices		207.3	235.2	256.1	355.4	264.6	377.9	12.8
1.5.Minor Agricultural Products		71.6	88.7	76.0	101.3	165.2	160.7	17.5
1.6.Other Agricultural Exports	183.4	247.9	240.6	253.5	306.3	334.1	225.4	-1.9
2.Industrial Export	4,948.4	6,096.1	7,991.7	7,371.2	7,749.4	8,262	7,975.7	5.5
2.1.Textiles and Garment	2,894.5	3356	4,191.2	3,991.2	4,508.3	4,929.9	4,825.3	7.5
2.2.Rubber Products	394.4	567.6	884.8	859.4	887.8	889.8	761.0	6.0
2.3.Petroleum Products	130.9	263.4	552.7	463	427.7	338	371.9	7.1
2.4.Gem, Diamond and Jewellery	227.9	409	531.5	558.9	445.5	393.6	331.3	-4.1
2.5.Other Industrial Products	1,300.7	1,500.1	1,831.5	1,498.7	1,480.1	1,710.7	1,686.2	2.4
3.Mineral Exports	143.3	24.2	32.9	61.3	51.6	59.5	28.2	3.1
4.Unclassified Exports	101.2	199.2	6.5	9.6	12.2	14.7	18.3	-38.0
Total exports	6,346.7	8,625.9	10,558.9	9,773.6	10,394.3	11,130.1	10,505.0	4.0

Source: Central Bank of Sri Lanka

exports, tea accounted for 15 percent of total earnings during 2010-2015 followed by spices, other agricultural exports and coconut products with 3 percent each. The total share of tea and rubber exports declined from 70 percent in 2010 to 55 percent in 2015.

Sri Lankan exports faced many challenges including the loss of GSP concessions and restriction on seafood exports to the European Union. The unsatisfactory performance in the area of exports stemmed from a series of policy weaknesses which contributed to a progressive loss of competitiveness in local industries in general as already observed in the introduction section. One such instance is the excessive protection offered to many local industries on a continuing basis which discouraged

movement towards more efficient production on the one hand and increased costs of production for the exporters on the other. A further area of concern is the exchange rate management which resulted in appreciation of the Rupee in real terms despite an apparent depreciation in nominal terms.

A low level of diversification has been an important issue for the Sri Lankan export sector. The following table shows how the Hirschman Index has moved over the years.

Table 1.1.5: Hirschman Concentrated Index

	1999	2000	2005	2010	2014
Agriculture exports	0.567	0.564	0.494	0.442	0.484
Industrial Exports	0.382	0.363	0.364	0.412	0.393
Total Exports	0.547	0.548	0.476	0.407	0.459

Source: Calculated by Department of National Planning based on Central Bank of Sri Lanka Data

Table 1.1.6: Value of Imports

	2005	2010	2011	2012	2013	2014	2015	Average Rate of Growth (2010-2015)
1. Consumer goods	1,643.9	2,476.4	3,653.6	2,995.2	3,182.5	3,852.5	4,713.0	13.7
1.1. Food and beverages	752.6	1,321.6	1,566.9	1,304.4	1,368.1	1,633.7	1,627.3	4.2
1.2. Non - food consumer goods	891.3	1,154.8	2,086.7	1,690.8	1,814.4	2,218.8	3,085.0	21.8
2. Intermediate goods	5,317.1	8,054.4	12,275.3	11,577.6	10,553.4	11,397.7	9,638.0	3.7
2.1. Fuel	1,655.2	3,040.8	4,794.9	5,044.6	4,308.2	4,597.3	2,700.0	-2.3
2.2. Textiles and textile articles	1,531.0	1,811.9	2,320.7	2,266.4	2,045.8	2,327.6	2,296.0	4.8
2.3. Chemical products	248.6	520.3	702.0	669.7	734.3	808.2	870.0	10.8
2.4. Wheat and maize		265.1	429.4	363.8	323.2	404.7	357.0	6.1
2.5. Fertilizer	135.0	240.3	407.2	311.0	238.7	272.4	290.0	3.8
2.6. Other intermediate goods	1,747.3	2,176.0	3,621.1	2,922.1	2,883.2	2,987.5	3,125.0	7.5
3. Investment goods	1,869.6	2,757.9	4,286.1	4,589.8	4,252.7	4,152.2	4,567.0	10.6
3.1. Building materials	507.0	822.1	1,076.1	1,237.4	1,357.2	1,308.9	1,352.0	10.4
3.2. Machinery and equipment	325.3	1,339.3	2,141.4	2,356.0	2,221.9	2,131.0	2,278.0	11.2
3.3. Other Investment goods	1,037.3	596.5	1,068.6	996.4	673.6	712.3	937.0	9.5
4. Unclassified imports	32.6	162.3	53.9	27.7	13.9	14.4	16.0	-
Total Imports	8,863.2	13,451.0	20,268.9	19,190.3	17,982.5	19,416.8	18,935.0	7.1

Source: Central Bank of Sri Lanka

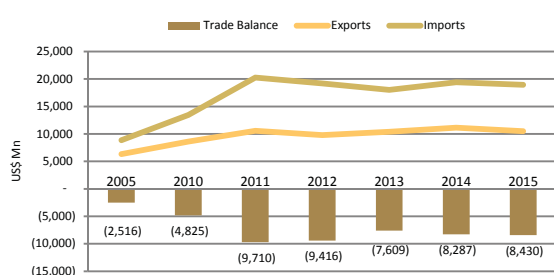
In order to facilitate a longitudinal comparison of diversification, Hirschman Concentrated Index is used. The table tentatively concludes that the Sri Lankan economy displayed very little diversification over time.

Expenditure on imports increased by 41 percent during the period between 2010 and 2015 and the relative share of consumer goods in total imports increased during 2010-2015. There was also a significant increase in the import of non-food consumer goods owing to a reduction in import duties on motor vehicles alongside a depreciation of the Japanese yen. The share of intermediate imports into total imports is 42.9 percent in 2015. Fuel imports is nearly one quarter of intermediate imports in 2015. However, the imports of investment goods slowed down after 2012. In 2015, export earnings were only about 55 percent of import expenditure.

### 1.1.5 Trade Deficit

Overall trade deficit expanded by 75 percent to US\$ 8,430 million in 2015 from US\$ 4,825 million in 2010. As a percentage of GDP, the trade deficit increased to 10.2 percent in 2015 from 9.7 percent in 2010.

Figure 1.1.1: Exports, Imports and Trade Balance (2005-2015)



Source: Central Bank of Sri Lanka

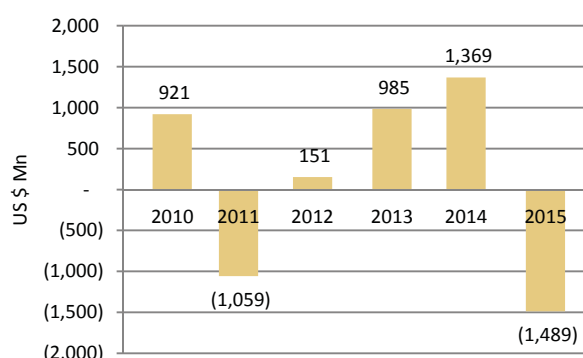
### 1.1.6 Terms of Trade

The export price index increased by an average rate of 5.1 percent during the period 2010-2015 due to increased prices of agricultural, industrial and mineral exports. As against this, the Import Price Index increased at an average 5.7 percent during the same period as a result of an increase in the price levels of Consumer Goods and Intermediate Goods. As an outcome of these changes, the Terms of Trade Index declined marginally from 100 to 99.9.

### 1.1.7 Balance of Payments (BOP)

As a percentage of GDP, the current account deficit declined from 7.8 to 2.4 during the period 2011 to 2015. A noteworthy feature of Sri Lanka's BOP is the relatively large inflow of private transfers consisting mainly of remittances sent by Sri Lankans employed in foreign countries. In 2015, it amounted to US\$ 6,980 million, which is equivalent to about 66 percent of annual export earnings. Thus, over the years, private transfers have made a significant contribution to maintaining stability in the payment position of the country.

Figure 1.1.2: Overall Balance of BOP 2010-2015



Source: Central Bank of Sri Lanka

The deficit in the current account of the BOP is financed by long-term borrowings, short-term borrowings and Direct Foreign Investment. During the period of 2010-2015, the long term borrowings amounted to about 54 percent of the total financing while short-term and FDI inflows amounted to 21 percent and 25 percent respectively. The bulk of the long-term borrowing by the government has gone to finance the public investment projects. Major bilateral aid donors of loan capital were China, India and Japan. Multilateral agencies such as the Asian Development Bank and the IDA (World Bank) have also made important contributions.

During the last 5 years, the overall balance in the BOP has been in surplus except in 2011 and 2015, when it slumped to a negative US\$ 1,059.4 million and US\$ 1488.7 million respectively. However, with the falling prices of Sri Lanka's major imports, there has been a recovery since 2012. Since that year, the net foreign reserve position improved. However in 2015, it has seen a decline in Sri Lanka's external reserves.

	2010	2011	2012	2013	2014	2015
1. Trade Balance	-4,825	-9,710	-9,416	-7,609	-8,287	-8,430
1.1 Exports	8,626	10,559	9,774	10,394	11,130	10,505
1.2 Imports	13,451	20,269	19,190	18,003	19,417	18,935
Trade Balance as a % of GDP	-8.5	-14.8	-13.8	-10.2	-10.4	10.2
2. Services (net)	706	1,099	1,262	1,180	1,880	2,325
2.1 Receipts	2,474	3,084	3,800	4,685	5,605	6,397
2.2 Payments	1,768	1,985	2,538	3,505	3,725	4,072
3. Goods & Services Net	-4,119	-8,611	-8,154	-6,429	-6,407	-6,105
4. Primary Income (net)	-617	-647	-1,219	-1,817	-1,808	-2,097
4.1 Compensation of Employees (net)	-11	-11	-20	-50	-50	-63
4.2 Investment Income (net)	-294	-375	-1,199	-1,767	-1,758	-2,034
4.3 Other Investment (net)	-312	-261				
5. Secondary Incomes	3,660	4,643	5,392	5,640	6,227	6,194
5.1 General Government (net)	52	60	53	21	28	27
5.2 Worker's Remittances (net)	3,608	4,583	5,339	5,619	6,199	6,167
6. Current Account Balance	-1,076	-4,615	-3,981	-2,606	-1,988	-2,008
Current Account Balance as a % of GDP	-2.2	-7.8	-6.7	-3.9	-2.5	-2.4
7. Capital Account (net)	164	164	130	71	58	46
7.1 Capital Transfers (net)	164	164	130	71	58	46
8. Financial Account (net)	3,877	4,710	5,004	4,175	3,084	2,621
8.1 Direct Investment	435	896	877	868	827	628
8.2 Portfolio Investment	1,301	1,062	2,106	2,068	2,065	689
8.3 Other Investment	2,141	2,752	2,021	1,239	192	1,304
9. Reserve Assets	-2,086	448	-760	-1,112	-1,548	-350
Overall Balance	921	-1,059.4	151.2	985.4	1,368.9	-1,488.7
GDP at Market Prices	56,726	65,293	68,434	74,294	80,028	82,267
Annual Average Exchange Rate per US\$	113.06	110.57	127.6	129.11	130.56	135.70

Source: Annual Reports, Central Bank of Sri Lanka, Various Issues.

### 1.1.8 Exchange Rate Movement (2010-2015)

During the past six-year period, the main objective of Sri Lanka's exchange rate policy has been to maintain a reasonable degree of stability of the national currency to promote trade and competitiveness of exports. In principle, an Independently Floating Exchange Rate arrangement has been followed with a view to allow market forces to guide its movements. The intervention by the monetary authorities was limited to avoiding extreme fluctuations. The movement of the nominal exchange rate of the Sri Lanka Rupee against the major international currencies is shown in the table below.

Currency	2010 (EOP)	2015 (EOP)	Nominal Depreciation per Year (%)
U.S. Dollar	110.95	144.06	5.4
Japanese Yen	1.3611	1.1960	-2.6
Euro	147.56	157.37	1.3
Indian Rupee	2.48	2.17	-2.65
Chinese Yuan	16.80	22.18	5.71

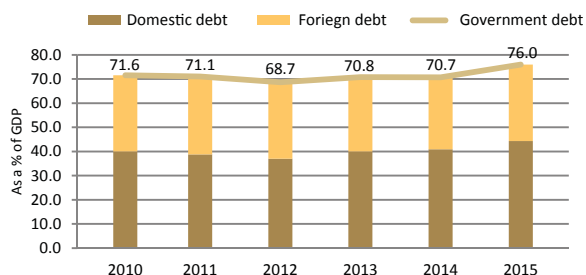
Source: Central Bank of Sri Lanka

During this period the general price level in Sri Lanka as indicated by the GDP deflator has increased at an average rate of 5.3 percent. The international prices appear to have moved at a lower rate of 1.2 percent (MUV index). Therefore, even though the Sri Lanka Rupee underwent a depreciation against the US\$ and the Yuan, it has appreciated in nominal and real terms against the other three currencies shown, which happened to be important for the country's foreign trade.

### 1.1.9 Government Debt

Total Government Debt has increased steeply from Rs 4,590 Billion in 2010 to Rs 8,503 Billion in 2015. The *Debt / GDP* Ratio itself has moved up from 71.6 percent to 76.0 percent during the same period. The share of domestic government debt has been increasing noticeably during the period and stood at 58.3 percent in 2015. The main reason for this increase is the greater reliance placed on domestic sources to finance the budget deficit.

Figure 1.1.3: Government Debt (2010 -2015)



Source: Central Bank of Sri Lanka

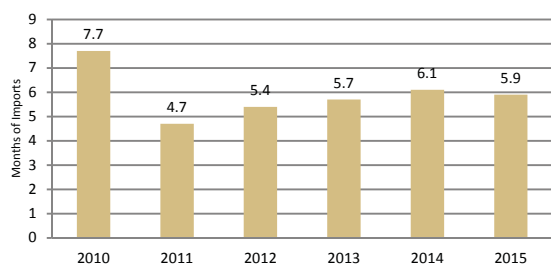
The official debt estimates quoted above do not include the accumulated liabilities incurred by the state owned enterprises under government guarantees. These amounted to about 8 percent of GDP in 2014. Unless these enterprises improve their financial performance, such liabilities will also eventually get translated into government debt.

### 1.1.10 External Reserves

Official reserves of a country which are needed to meet the residual foreign exchange requirement contribute to maintaining stability of the exchange rate. During the period 2010-2014, the size of Gross Official Reserves varied between US\$ 6.7 billion to 8.2 billion. At the end of 2015, the total foreign assets amounted to about 5.9 months of merchandise imports, which can be regarded as an adequate safeguard. The major part of official reserves consisted of foreign securities, currency and deposits held by the Central Bank.

Figure 1.1.4: Total Foreign Assets (2010 - 2015)

## 1.2 Public Finance



Source: Central Bank of Sri Lanka

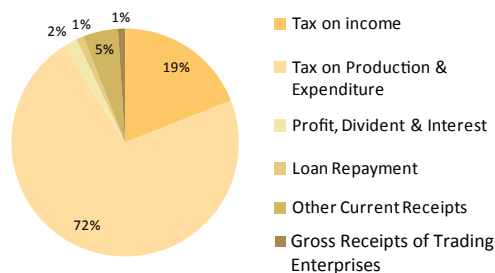
### 1.2.1 Government Revenue

#### 1.2.1.1 Tax Revenue

The decline in the government revenue to GDP ratio remains as the major issue in the fiscal sector which compelled the government to reduce resources for much needed areas including education, health

and other priority sectors. Total tax revenue as a percentage of GDP continued to decline during the period of 2010-2014 and showed an improvement in 2015 at 13.0 percent compared to 11.4 percent in 2014. The decline is mainly due to the multitude of tax exemptions to attract Foreign Direct Investments (FDIs), tax evasion and avoidance. The other contributory factors have been the presence of many discretionary tax measures and weaknesses in tax administration.

Figure 1. 2.1: Government Revenue Structure 2015



Source: Central Bank of Sri Lanka

The weak tax revenue over the years has led successive governments to impose around 25 ad hoc taxes from time to time. Excessive number of taxes compared to other developing countries has made the tax system very complicated. With 8 to 10 taxes in the system, some developing countries have managed to collect a larger per cent of revenue per GDP than Sri Lanka.

In 2015, the main source of tax revenue is excise tax followed by income tax. Revenue from excise tax and special commodity levy increased significantly by 283 percent and 413 percent respectively in 2015 compared to 2010. Tax revenue from NBT and VAT decreased slightly by 2.21 and 0.13 percent respectively in 2015 in comparison to 2010.

Table 1.2.1: Percentage Change in Tax 2010 - 2015

Source of Tax	2010 Rs. Mn	2015 Rs. Mn	% Change
Income tax	135,624	262,583	93.61
VAT	219,990	219,700	-0.13
NBT	46,022	45,004	-2.21
Excise tax	129,864	497,623	283.18
Import Duties	64,165	132,189	106.01
Ports and Airport Development Levy	49,632	58,644	18.15
Special Commodity Levy	10,173	52,276	413.87
Other	69,278	87,760	26.67
Total	724,748	1,355,779	87.06

Source: Department of Fiscal Policy



### 1.2.1.1.1 Direct and Indirect Taxes

Successive governments have depended heavily on indirect taxes for tax revenue instead of working out a reasonable balance between indirect and direct taxation. At present, approximately 80 percent of tax revenue comes from indirect taxes. In other words, the bulk of the taxation has fallen on the middle class people. The contribution from direct taxes to total tax revenue is low largely because the tax base has remained narrow. The government has identified the importance of keeping balance of 40:60 between direct and indirect taxes since 2016.

Table 1.2.2 : Tax Buoyancies 2005-2015

Tax	% Share of Total Tax 2015	Tax Buoyancy (2005 -2015)
Import Tax	9.8	0.537
PAL/RIDL/Other	8.2	2.589
GST/VAT	16.2	0.164
Excise Tax	36.7	1.535
Tax on Net Income and Profit	19.4	1.123
Other Tax	9.8	
<b>Total Tax Revenue</b>	<b>100.0</b>	<b>0.850</b>

Source: Department of National Planning

Before introduction of Value Added Tax, Goods and Services Tax was executed as a production based tax. With the beginning of the new tax schemes, it seems that the tax revenues increase for a short time, thereafter it reduces heavily. The composition of tax revenue in 2015 indicates that the VAT, the PAL/RIDL/SCL and the Excise tax account for 16.2 percent, 8.2 percent and 36.7 percent respectively as a production based tax while Income and Profit tax accounts for 19.4 percent. The rise in government revenue results from the growth in tax base and growth in the tax system.

Tax buoyancy during 2005-2015 in the Sri Lankan economy accounts 0.850. It means that the tax revenue growth is at a lower rate than the growth in GDP. Tax buoyancy for PAL/RIDL/SCL is at the highest at 2.589 and it reflects in part an improvement in tax collection and in part an increase in tax rates. The Buoyancy rates for import tax and VAT are at very low levels at 0.537 and 0.164 respectively.

The total tax revenue as a percentage of GDP indicates a low level and it directly impacts on the current expenditure. The low tax collection imposes a limit on expenditure to meet budget deficit targets.

### 1.2.1.2 Non Tax Revenue

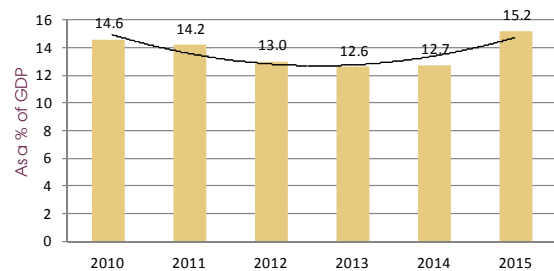
As a percentage of GDP, non tax revenue fell to 0.9 percent in 2015 in comparison to 1.4 percent in 2010.

## 1.2.2 Government Expenditure

### 1.2.2.1 Recurrent Expenditure

Interest payments, salaries and wages continued to be the largest share of the recurrent expenditure of the government and total recurrent expenditure has increased considerably during the period of 2010-2015. In nominal terms, recurrent expenditure was maintained below the budgetary target, although it increased from Rs 937 billion in 2010 to Rs 1,701 billion in 2015. There is a decreasing trend of recurrent expenditure as a percentage of GDP for the period of 2010-2013. This is mainly due to the decline in the Interest Payments/GDP ratio. In general, the government has spent around 1/3 of recurrent expenditure for interest payments. However, recurrent expenditure has increased significantly in 2015 as a percentage of GDP. This is mainly due to increase of salaries of public officers.

Figure 1.2.2: Recurrent Expenditure 2010 - 2015



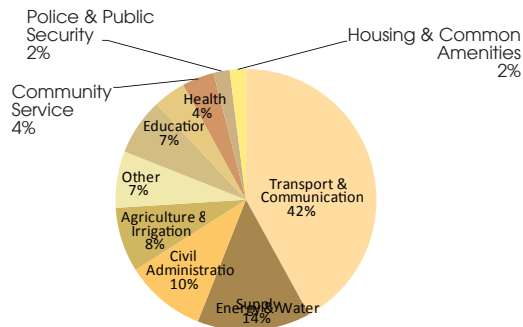
Source: Department of Fiscal Policy

### 1.2.2.2 Capital Expenditure : Public Investment

The total public investment during the 2010-2015 period is around Rs 2,871 billion. About 42 percent of public investment went into transport and communication during the last six year period. This was followed by energy and water supply sectors which

received about 14 percent of the total investment. During this period, the government has given the highest priority to the development of economic infrastructure in the areas of roads and bridges, ports, power generation, water supply and irrigation.

Figure 1.2.3: Share of Public Investment- 2010-2015



Source: Department of Fiscal Policy & Department of National Planning

An important feature observed is a trend towards the increasing recurrent expenditure at the expense of capital expenditure. One reason for this increase appears to be the excessively large public service and the presence of a multitude of subsidy and transfer payments of doubtful value. Therefore, the Government expenditure activities should focus on rationalizing the recurrent expenditure while maintaining the public investment at a level adequate to achieving the development objectives of the Government.

### 1.2.3 Budget Deficit

Budget deficit recorded a declining trend from 2009 to 2014 period with Medium Term Macro Fiscal Framework (MTMFF) which was based on a prudent fiscal policy strategy. However, it has increased up to 7.4 as a percentage of GDP in 2015. The Government aims to achieve a budget deficit at 3.5 percent as a percentage of GDP by 2020. Hence, effective recurrent expenditure management along with the proposed tax reforms and improvements in tax administration will be implemented in the medium-term.

#### 1.2.3.1 Financing of the Budget Deficit

Increasing domestic financing has been a feature of budget deficit financing during 2009 to 2015 period. Such an increase shows that the government borrowings cause a reduction in credit availability to the private investor. This crowding out effect raises some

concerns over sustainable economic growth in the medium-term ultimately leading to high interest rates and inflation. However, the increasing trend in domestic financing has the advantage of reducing pressure on our foreign debt repayment.

### 1.3 The Government Budget 2017

The 2017 National Budget converges its initiatives towards the theme of "Accelerating Growth with Social Inclusion" emphasizing the participation of the entire population in development. In line with this, 2017 budget mainly focuses on creating high income economy in the Asian region, poverty alleviation with rational investment in rural development, building up a "Green" and an "Innovation Based Economy", encouraging private sector, achieving the United Nations Proclaimed Sustainable Development Goals by 2030, integrating regional countries, developing export and SME sectors and introducing tax reforms to improve government revenue. These features are summarized as follows:

#### (i) Creating Strong High Income Economy in the Asian Region

The medium term strategy of the government is focused on generating one million employment opportunities, enhancing income levels, development of rural economies, ensuring ownership of land to rural and estate sector working class, the middle class and the public sector employees, thus creating a strongly vibrant much wider middle class.

#### (ii) Poverty Alleviation

The medium term strategy of the government has identified the importance of development of rural economies and enhancing income levels of the people which will lead to reduce poverty levels. Therefore, it is necessary to achieve an appreciable level of economic growth to facilitate pro-poor policies. This budget will be a basis to establish a strong economic foundation to achieve goals and targets in eradication of poverty.

#### (iii) "Green" and an "Innovation Based Economy"

It is needed to have economic, social and environment transformation ensuring better tomorrow for Sri Lankans. A national development strategy to build a "Green" and

an “Innovation Based Economy” through progressive reforms will ensure a better future for the children of the country and particularly for the educated younger generation. Productivity enhancement, investment in ICT an infrastructure will be the key requirement of economic growth envisaged.

#### (iv) Private Sector as the “Engine of Growth”

A concerted effort will be adopted to nurture and foster the private sector-the “Engine of Growth”, ensuring and emphasizing a greater role in economic activities in all spheres. Removal of restrictive barriers, provision of necessary legal and institutional support including the creation of an enabling environment for doing business with ease will be further facilitated by the government proactively. Public Private Partnership replacing government dominance in economic development programs will also be pursued positively.

#### (v) Regional Economic Cooperation

The government is prepared to set in motion the program highlighting the strategic importance of Sri Lanka as a hub in the realm of global logistics and commercial operations pursuing among others, economic integration agreements with regional governments such as China, India, Singapore etc.

There is a tremendous potential for integration with markets such as India, China, Japan and Korea and access to such market is being actively pursued while efforts are also being made to exploit further integration opportunities with the ASEAN Economic community and Trans Pacific Partnership (TPP) and China’s One Belt One Road Initiative.

#### (v) Export Developments

A conducive environment will be created for investments catering to export development. It includes, trade and investment based reforms encompassing measures aimed at productivity improvement, trade facilitation, bilateral economic integration agreements, restructuring of the BOI and creation of much needed institutions and elimination of exchange controls will auger well for an improved international trade and investment regime. The government will focus on fair trade and not necessarily free trade thus creating non debt creating foreign fund flows.

#### (vii) SME Development

Small and Medium Enterprises sector is a giant pillar in our economy with more emphasis on industry. The government will concentrate on developing the sector with assistance including financial, marketing and other related facilities to nurture, foster and develop such enterprises. Improving infrastructure for domestic and international connectivity is relevant to SMEs thus facilitating their access to international markets. The policies enhancing financial inclusion will address the issue of inaccessibility to adequate finances prevalent at present.

#### (viii) Tax Reforms

Over the years, tax revenue as a share of GDP has declined. Tax administration is negatively impacted by the complex tax structure and the large number of exemptions and tax holidays, leading to a narrow tax base.

Accordingly, the government has formulated the revenue proposals to increase the direct tax component to 40 percent from around 20 percent at present and gradually reduce the indirect taxes to 60 percent from around 80 percent in the medium term. Further, the government will phase out gradually the para-tariffs in the tax system and also introduce reforms in tax administration.

The public investment and budget deficit have been targeted at 5.2 percent and 4.6 percent of GDP respectively in 2017. The priority sectors for investment have been selected as Human Resource Development, Ports and Aviation, Railways, Water, Irrigation and Transportation.

### 1.4 Sri Lanka in the Global Context

The following table presents some indicators drawn from reputed international publications which compares Sri Lanka’s performance as a nation in the respective subject areas.

Sri Lanka has achieved major success in the indicators related to human development. However, in the case of economic indicators, Sri Lanka may have to work towards achieving higher world standards.

Table 1.4.1: Performance of Sri Lanka in Selected International Indices - 2014

Indicator	No. of Countries	Sri Lanka: Rank
Human Development Index	189	73
Global Competitiveness Index	148	73
Doing Business Index	189	99
Environmental Performance Index	140	69
Global Innovation Index	142	105
Logistics Performance Index	160	89
Basic Requirement Index	145	75
Infrastructure Index	145	75
Prosperity Index	142	62
Economic Freedom Index	185	101
Global Peace Index	162	105

Source: UNDP, WEF, WB and Various International Publications.

## 1.5 Developments in the World Economic Situation

As a relatively open economy with extensive trade relations with countries across the world, Sri Lanka's economic performance is sensitive to global economic events. Therefore, it is important to take into consideration the changes of the global economic developments when predictions on our own economy are attempted. Among the most important features of the current world economic scenario is the sharply declining trend in international prices of key traded commodities. These include petroleum and coal prices which have a pervasive impact on most other commodity prices. The declining price trends have affected even agricultural prices albeit at a moderate level. Thus, the World Bank Price forecasts (October 2015) show a 6 percent per annum decline during 2014-2020 for Crude Oil and about 3 percent per annum decline for Coal during the same period. Similar, but more moderate price declines are indicated for several food items and agricultural raw materials including natural rubber.

Prospects for global economic growth in the medium-term are less than satisfactory. Nearly six years after the world emerged from the most serious economic recession in the post-war period, the recovery of the advanced economies has been slower than expected and beset with uncertainties. Thus, the economic growth among the advanced economies during 2016 and 2017 is likely to be about 2.1 percent per annum and that among the emerging and developing economies may reach higher average rates

of 4.3 to 4.7 percent during the same period according to available IMF forecasts. The latter group to which Sri Lanka also belongs, may collectively accelerate their growth slightly during 2017-2020.

As far as Sri Lanka is concerned, these external developments present certain opportunities as well as risks. While lower prices may make our import baskets cheaper and thus help to stabilize domestic prices and consequently improve the real incomes of the people on the one hand and reduce the existing pressures on public financial management, on the other hand, our traditional export industries may have to cope with falling incomes. This trend is already visible in the case of tea and rubber related industries. It is also possible that falling oil incomes in the Middle East will eventually affect the flow of remittances from Sri Lankans employed in the countries concerned.

These unprecedented circumstances call for careful policy initiatives. The respite offered by reduced expenditure pressures will be used profitably to usher in the much needed reforms in public financial management and fiscal consolidation. The private sector establishments affected adversely by world price declines have to themselves make necessary internal structural changes with a view to improving productivity and competitiveness instead of calling for government handouts. The concerned government agencies will device plans and administrative mechanisms to provide the necessary advice, guidance and assistance to the affected industries and establishments. Legal and administrative impediments to making necessary reforms, if any, will be quickly removed and relevant fiscal policies will be reviewed.

## 1.6 Medium-Term Perspectives

During the next four-year period, starting in 2017, determined action will be taken to remove the existing impediments to achieving higher rates of economic growth. Thus, while introducing essential reforms in trade, investment, fiscal and monetary policies there will also be a special effort to weed out corruption in public life which is known to impose significant economic costs on the society apart from being a social evil. Accordingly, the Government has already initiated investigation of cases of serious financial crime including those which caused

large losses and misappropriation of public funds. The legal action that will be taken against those who are found guilty, will serve as deterrents to other who may attempt to commit such crimes in the future.

In managing the nation's development activity, the Government sees its role as one of primarily supporting private investment. The private sector is expected to make the major contribution to economic growth and creation of employment opportunities. Thus the private investor, both local and foreign will be allowed sufficient space to invest in directly productive and profit oriented ventures while the Government will focus on projects such as economic and social infrastructure which, while being critically important to the overall development, may generate benefits to the society only in the long run.

A number of reforms and innovations in institutional arrangements to enhance economic performance and promote equity have also been planned. Among these, the establishment of a number of 'Mega Zones' for concentrating and promoting economic activity and technology development stand out. The principles underlying "Social Market Economy" concept will in general guide the future action in this regard. The main components of the economic strategy will be the following:

(a) Arresting the present decline in export performance by improving productivity and competitiveness of industries as a way of facing the challenges posed by the ongoing world economic recession. There is an urgent need to carry out reforms in the relevant institutions and policies including fiscal, exchange rate and trade policies.

(b) Promoting the inflow of foreign investment by making the country investor-friendly. The measures will be taken to create a level playing field for all investors by moving towards a low tax and low tariff business environment with greatly simplified and transparent administrative procedures. Other known barriers to investment such as delays and complexities in obtaining land leases will be identified and removed.

(i) Making all necessary reforms in the area of government revenue, including those relating to coverage, compliance and tax administration. This will be undertaken for the purpose of increasing revenue

collection. Simultaneously, measures will be introduced to rationalize government expenditure including reduction of waste and elimination of corruption. The objective will be the achievement of a surplus in the current account balance of the budget by the year 2017.

(ii) Where possible, the existing government debt will be restructured to reduce the annual debt service burden. Furthermore, future borrowing will be made only on terms more favourable to Sri Lanka than hitherto, so that the overall public debt will be brought down to a sustainable level within a short period.

(c) Diverting a higher share of government resources for upgrading the quality of human resources - to modernize and improve education, training, health and social welfare so that the indigenous labour force can achieve highest possible productivity standards.

(d) Acting decisively to promote equity in the economic and social spheres. This involves a whole series of measures and policies ranging from strengthening the local and provincial institutions, devolution and decentralization of administration, supporting relevant non-governmental organizations, reforming taxation and subsidy policies, rural development, urban and infrastructure development.

(e) In providing development requirements, steps will be taken to minimize remaining regional disparities and poverty pockets. This will be a main guiding principle in allocating social and economic infrastructure in the next four year period.

(f) In a situation where the economic growth accelerates, special emphasis will be placed on environmental protection, and natural resource conservation. The present policies have already recognized Sri Lanka's commitment to sustainable development. Of these, the particular SDG Goals and Targets pertaining to environmental protection will be kept constantly in view in policy making and implementation.

## 1.7 Planning Targets

The main planning indicators for the four year period 2017-2020 are as follows:

(a) The Gross Domestic Product (GDP) is expected to increase at an annual rate of 6.6 percent per annum.

(b) The Gross Domestic Capital Formation (GDCF) is expected to be maintained at a level of around 31.5 percent of GDP. The total for the period is approximately Rs 19,906 billion. The larger share of this investment outlay around 82 per cent will be undertaken by the private sector. However, its specific magnitude will be revised in step with changes in the ownership of assets and the progress achieved in the flow of direct foreign investment.

(c) Government revenue and grants as a share of GDP will be progressively increased to reach a level of 16.9 percent at the end of four years. Similarly, the budget deficit will be gradually reduced to a level of 3.5 percent of the GDP.

(d) The Current Account Balance of the budget will be 2.2 percent of GDP at the end of the period.

(e) The Domestic Savings Ratio is expected to reach an average of 26.4 percent of GDP during the specific four year period considered.

(f) Public Consumption will amount to an average of about 9.1 percent of GDP. This includes outlays on welfare, resettlement and security related expenditures.

(g) Earnings of Exports of Goods and Non Factor Services will increase to about Rs. 3,936 billion by 2020.

(h) The total public investment plan for the period 2017-2020 is about Rs. 3,531 billion in current price terms. Of this total, the highest share - nearly 70 percent is likely to be used for economic infrastructure development, which includes roads, railways, bridges, irrigation, ports, airports industry. About 30 percent may be used for human resource development projects which include education, research and development, vocational training, health and social overhead development.

Table 1.7.1: Indicative Macroeconomic Targets for the Year 2020

Indicator	2015 Estimate	Projections					% of GDP
		2016	2017	2018	2019	2020	
GDP Growth Rate	4.8	5.5	6.0	6.5	7.0	7.0	
Investment	30.1	30.1	30.3	31.0	31.5	31.5	
Private Investment	24.7	26.0	25.1	25.6	25.8	25.8	
Public Investment	5.4	4.1	5.2	5.4	5.6	5.7	
Total Expenditure	21.0	18.9	20.2	20.3	20.4	20.4	
Revenue and Grants	13.5	13.5	15.5	16.0	16.4	16.9	
Current Account Balance	-2.2	-1.6	0.5	1.1	1.6	2.2	
Budget Deficit	-7.5	-5.4	-4.6	-4.3	-4.0	-3.5	
Domestic Savings	22.6	23.2	23.8	25.0	25.9	26.4	

Source: Department of National Planning

Table 1.7.2 Key Macroeconomic Indicators 2015-2020

	2015	2016	2017	2018	2019	2020
Private Consumption Rs. Bn	7,666.30	8,338.85	9,171.64	9,938.28	10,848.04	11,929.58
As a % of GDP	68.55	68.10	67.30	66.00	64.90	64.30
Public Consumption Rs. Bn	985.80	1,089.81	1,207.31	1,346.04	1,535.53	1,726.14
As a % of GDP	8.82	8.90	8.86	8.94	9.19	9.30
Gross Domestic Capital Formation Rs. Bn	3,361.50	3,685.75	4,129.28	4,667.98	5,265.23	5,844.20
As a % of GDP	30.06	30.10	30.30	31.00	31.50	31.50
Financing of Investment						
(a) Domestic Savings Rs. Bn	2,531.00	2,840.05	3,249.05	3,773.68	4,331.43	4,897.28
As a % of GDP	22.63	23.19	23.84	25.06	25.91	26.45
(b) External Inflow Rs. Bn	830.50	845.70	880.24	894.30	933.79	946.91
As a % of GDP	7.43	6.91	6.46	5.94	5.59	5.10
Exports of Goods and Non Factor Services Rs. Bn	2,295.40	2,503.30	2,802.60	3,180.94	3,504.51	3,936.36
As a % of GDP	20.53	20.44	20.56	20.71	20.97	21.22
Imports of Goods and Non Factor Services Rs. Bn	3,125.90	3,349.00	3,682.83	4,013.24	4,438.30	4,883.27
As a % of GDP	27.95	27.35	27.02	26.65	26.55	26.32
GDP at Current Market Prices Rs. Bn	11,183.00	12,245.00	13,628.00	15,058.00	16,715.00	18,553.00
As a % of GDP	100.00	100.00	100.00	100.00	100.00	100.00
Mid Year Population Million	20.86	21.05	21.24	21.43	21.62	21.82
GDP per capita Rs	536,072.10	581,765.49	641,680.01	694,596.11	764,119.88	840,592.20
GDP per capita US\$	3,924.00	4,012.18	4,425.38	4,790.32	5,269.79	5,797.19

Source: Department of National Planning and Central Bank of Sri Lanka

Table 1.7.3: Public Investment Programme 2017- 2020

Sector	Projections				Rs. Mn
	2017	2018	2019	2020	2017- 2020 Cumulative
	Total	Total	Total	Total	Total
Education	47,688.00	55,088.38	64,483.46	74,044.80	241,304.64
Higher Education	18,197.00	21,020.87	24,605.89	28,254.34	92,078.10
Skills Education	10,073.00	10,800.00	11,292.00	13,011.00	45,176.00
Labour	3,770.00	3,911.00	4,157.00	4,350.00	16,188.00
Health	43,567.00	50,327.87	58,911.06	67,646.15	220,452.09
Sports	4,525.00	4,700.00	4,800.00	4,900.00	18,925.00
Culture & Heritage	2,551.00	2,947.00	3,449.00	3,961.00	12,907.00
Technology & Research	3,195.00	3,690.00	4,320.00	4,961.00	16,166.00
ICT	19,931.00	20,816.00	24,367.00	27,980.00	93,094.00
Agriculture	11,680.00	12,492.54	15,793.63	18,135.45	58,101.62
Livestock	6,165.00	12,723.00	6,337.00	7,573.00	32,798.00
Plantation	8,252.00	9,474.00	11,089.00	12,734.00	41,549.00
Fisheries	6,026.00	6,955.00	8,172.00	9,363.00	30,516.00
Land	3,487.00	4,030.00	4,706.00	5,408.00	17,631.00
Industries, Trade, Investment & Tourism	20,997.00	20,508.00	22,742.00	25,367.00	89,614.00
Finance	66,372.00	69,235.00	71,235.00	73,235.00	280,077.00
Roads	116,056.00	144,000.00	201,000.00	247,000.00	708,056.00
Transport	34,963.00	40,392.14	47,270.00	54,290.00	176,915.14
Ports & Aviation	1,348.00	2,200.00	2,962.00	3,500.00	10,010.00
Power & Energy	1,061.00	1,227.96	1,437.38	1,650.51	5,376.85
Irrigation	67,502.00	76,969.00	89,725.00	95,215.00	329,411.00
Water Supply & Sewerage	26,679.00	38,657.00	41,976.00	45,425.00	152,737.00
Housing	7,419.00	8,560.00	10,031.93	11,518.00	37,528.93
Urban Development	13,359.00	15,582.00	18,378.00	20,722.00	68,041.00
Governance	72,056.00	81,608.00	90,977.00	94,262.00	338,903.00
Environment	9,154.00	10,574.55	12,322.00	14,206.00	46,256.55
Social Protection	13,940.00	11,717.00	8,332.00	7,468.00	41,457.00
Regional Development	68,778.00	73,079.00	79,030.00	88,060.00	308,447.00
Grand Total	708,790.00	814,002.32	943,900.35	1,064,238.25	3,530,930.92

Source: Department of National Planning

