

# Revenue Based Fiscal Consolidation towards Sustainable Growth



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Mr. Lasantha Wickremasinghe, President, Institute of Chartered Accountants (CA) of Sri Lanka; Honourable Council Members of the CA; Distinguished Invitees, Ladies and Gentlemen; My dear friends.

At the outset, let me thank the Institute of Chartered Accountants of Sri Lanka for inviting me to deliver the 21<sup>st</sup> Annual Tax Oration, organised by the Faculty of Taxation of the Institute. I consider myself deeply privileged to deliver this oration on the topic - “Revenue Based Fiscal Consolidation towards Sustainable Growth”.

## Background

The topic which I am going to talk about today is very important, particularly in the present context of the macroeconomic management challenges in Sri Lanka. After decades of policy forbearance and missed opportunities, Sri Lanka is at an inflection point. There exists the potential for a leap in development. The government is currently engaged in implementing a broader policy package, aimed at harnessing the country’s untapped potential by effectively leveraging its excellent location and international relations with many capital surplus countries in the world. The government is also in the process of implementing a strong fiscal consolidation programme. The Central Bank is also aligning its policies and processes to deliver better outcomes in the future. So, the topic is very relevant to all of us in the today’s context.

## Fiscal and Monetary Policies

As you aware, **fiscal policy** refers to the government’s taxation, expenditure and deficit financing operations. Fiscal policy influences the macroeconomy through a number of ways; it changes the level and composition of **aggregate demand** (through taxation, expenditure and borrowings), changes **aggregate supply** (through taxation and subsidies as well as its impact on savings and investment), and influences **national savings and investments** (through expenditure and taxation). Fiscal policy is implemented through the **government budget** and under section 148 of the

Constitution of Sri Lanka, the control and responsibility of the public finances in the country is vested with the Parliament.<sup>1</sup>

Under the **Monetary Law Act (MLA)**, the Central Bank of Sri Lanka is entrusted with the responsibility of ensuring price and economic stability, and financial system stability of the economy<sup>2</sup>. This encompasses the formulation and implementation of **monetary policy** i.e. the actions to influence cost and availability of money as well as activities related to regulating and supervising key categories of financial institutions, maintaining stability in key financial markets and overseeing the payments and settlements system.

These are complementary but distinctly separate roles. It is, therefore, legitimate to wonder on what basis the Central Bank Governor can speak about revenue, expenditure, budget deficits, deficit financing, debt, fiscal consolidation and such issues, which typically are the responsibility of the government. As I proceed with this speech, I hope the reasons for doing so will become clear. There are important inter-linkages which place a very high premium on good fiscal - monetary coordination.

### Budget Deficits and Inflation

Ladies and gentlemen, it is widely accepted that fiscal deficits resulting from low revenue and/or high expenditure, if monetised would fuel inflation (Buiter, 1985)<sup>3</sup>. The magnitude of this effect could be significantly large, if there exists fiscal dominance such that monetary policy is accommodative to fiscal deficits. The question whether **larger public deficits are always associated with higher inflation** is answered affirmatively by Sargent and Wallace (1981)<sup>4</sup> in their piece on “Some Unpleasant Monetaristic Arithmetic”. Many research studies, including Easterly &

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<sup>1</sup> “Parliament shall have full control over public finance. No tax, rate or any other levy shall be imposed by any local authority or any other public authority, except by or under the authority of a law passed by Parliament or of any existing law”; Section 148, **The Constitution** of the Democratic Socialist Republic of Sri Lanka.

<sup>2</sup> “...the Central Bank is hereby charged with the duty of securing, so far as possible by action authorised by this Act, the following objectives, namely – (a) economic and price stability; and (b) financial system stability, with a view to encouraging and promoting the development of the productive resources of Sri Lanka”, Section 5, **Monetary Law Act (MLA)**.

<sup>3</sup>Buiter, W.H., (1985), “**A guide to public sector debt and deficits**”, Economic Policy (1): 13-80.

<sup>4</sup> Sargent, T. & Wallace, N., (1981), “**Some unpleasant monetaristic arithmetic**”, Monetarism in the United Kingdom: 15-41.

Schmidt-Hebbel (1993)<sup>5</sup>, however, find that various factors, such as unstable demand for money, exchange rate depreciation, and widespread indexation, cloud the link between monetisation of fiscal deficits and inflation over shorter periods. Notwithstanding these views, unsustainable budget deficits are a serious concern for governments and policymakers. Financing them, using domestic funds, crowds out the private sector thereby hindering investment activities. Rising interest rates are the mechanism through which this takes place. In addition, foreign financing tends to magnify foreign exchange exposure risks.

### Role of the Government and Macroeconomic Stability

According to Richard A. Musgrave, widely regarded as the founder of modern public finance, *“the proper roles of government in a market economy fall into three separable branches: **allocation** (efficiency), **distribution** (fairness) and **macroeconomic stability**. The Allocation Branch’s responsibility is to correct for sources of inefficiency in the economic system while the Distribution Branch ensures that the initial distribution is fair. Monetary and fiscal policy and the problems of macroeconomic stability fall to the Stabilization Branch”*.<sup>6</sup>

The success in achieving growth objectives depends largely on the foundation on which the economy operates. A strong foundation with macroeconomic stability is crucial for a robust framework, which facilitates the achievement of sustainable growth. **Macroeconomic stability** exists when key economic relationships are in balance and sustainable—for example, between domestic demand and output, fiscal revenues and expenditure, savings and investment<sup>7</sup> and the balance of payments. These relationships, however, need not necessarily be in surplus or even in exact balance. Imbalances such as fiscal and current account deficits are perfectly compatible with economic stability, provided that they can be financed in a sustainable manner i.e., without creating unsustainable public debt and external reserve dynamics.

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<sup>5</sup> Easterly, W. & Schmidt-Hebbel, K. (1993) **“Fiscal deficits and macroeconomic performance in developing countries”**, The World Bank Research Observer 8(2): 211-37.

<sup>6</sup> **Musgrave’s vision of the public sector: The complex relationship between individual, society and state in public good theory**; Karl E. Case; Journal of Economics and Finance (2008) 32, p348–355.

<sup>7</sup> **Macroeconomic Policy and Poverty Reduction**; Brian Ames et al., IMF (August 2001).

**Macroeconomic stability is essential for high and sustainable growth.** However, macroeconomic stability by itself does not ensure high rates of economic growth. It is a necessary but not sufficient condition. In most cases, sustained high rates of growth also depend upon **key structural policies** as well. The Central Bank has a central role to play in macroeconomic management, in particular the stabilisation role, to achieve sustainable growth. It has responsibility for two of the three key macroeconomic instruments, namely the interest and exchange rates.

### Sound Monetary - Fiscal Coordination

This is not an easy task to achieve. Monetary – fiscal coordination is a **complex but vital component** in overall macroeconomic management. As Mervyn King, the former Governor of the Bank of England, stated, *“Of course, it is very important that they (monetary and fiscal policy) go on working together. From our point of view, that means two things. The first is that we are kept closely informed what is happening to fiscal policy and to revenues and expenditures – and we are briefed where necessary by the Treasury representative at our meetings – and secondly, and more importantly, that the government sticks to its own fiscal rules, namely fiscal policy does in fact meet its medium term objective. From that point of view, we know what the stance of fiscal policy is and in turn, the Chancellor knows that if there were changes in the fiscal policy that we would take those into account when assessing the likely movement of demand in the economy. And that would be one of the factors that would lead us to look at the overall picture and if necessary, respond by a change in interest rates”*<sup>8</sup>.

In Sri Lanka also, we should understand that monetary or fiscal policy cannot be implemented in isolation. These two affect each other due to the associated **macroeconomic dynamics**. Political and social conditions of the country, as well as the global economic developments also impact on the conduct of these two policies. The **overall budget deficit**, and the way it is financed, has important implications, for monetary policy related variables, such as interest rates, money supply, inflation, external reserves and the exchange rate which come under the purview of the Central Bank. Similarly, the **external balance** of the country, as reflected by the

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<sup>8</sup> **Monetary and Fiscal Policy: Present Success and Future Problems**; House of Lords, Select Committee on Economic Affairs, 3<sup>rd</sup> Report of Session 2003-04, Volume 2: Evidence, p.86.

**current account deficit** of the balance of payments (BOP), also has important implications through variations in domestic financial assets of the Central Bank, which determine the level of reserve money while influencing the money supply, interest rates, inflation and the exchange rate, as well as overall aggregate demand in the economy. This, in turn, affects fiscal policy through taxation, expenditures and deficit financing.

The upshot is that monetary and fiscal policies are interrelated within a complex relationship in an **open-economy macroeconomic framework**. Hence, in the operations of the Treasury and the Central Bank, a fine balance has to be maintained through sound monetary – fiscal coordination amidst domestic shocks and volatile global economic conditions. The Monetary Law Act, which governs the Central Bank of Sri Lanka has provided an enabling legal environment to maintain a sound relationship with the Ministry of Finance, which is the **fiscal authority** of the country. Going forward, we need to calibrate our policies carefully to achieve sound management of aggregate demand. This is crucial for attaining robust macroeconomic fundamentals.

### **Need for Fiscal Consolidation**

With this background, let me come to the core of our topic today. As you are aware, large fiscal and current account deficits, or **twin deficits**, are the two key structural problems in Sri Lanka that have been amplified as core weaknesses of the economy for many decades. Throughout this period, the country has been running unsustainable budget deficits, which have boosted excess and untenable demand, leading to inflationary pressures and high nominal interest rates in the economy. This also leads to a higher propensity to import amidst domestic supply limitations, thereby exerting pressure on the BOP and the exchange rate. In an uncertain and volatile global economic environment, especially in today's context, this twin deficit situation of the country increases vulnerability. Hence, clear and consistent policies are required to have a sustainable solution to overcome the twin deficits. On the one hand, trade related policies are necessary remedial actions to address weaknesses related to the deficit in the current account of the balance of payments. These are being implemented by the government. In this presentation, I will concentrate on the other important area, which is related to the budget deficit and

fiscal policy of the country in the context of maintaining macroeconomic stability to achieve sustainable growth.

It is a fact that high fiscal deficits and relatively high debt to GDP ratios jeopardise the prospects for **medium-term debt sustainability**<sup>9</sup> and growth. In Sri Lanka, the overall budget deficit in the period from 2005 – 2015 has averaged 6.8% of GDP. The government debt was 76% of GDP in 2015, which is relatively high compared to our peer rating countries. Although attempts have been made in the past to tackle the high debt to GDP ratio, they have not yielded lasting gains. At present, interest payments on the existing debt stock absorb about 35% of our total revenues. In addition, debt amortization obligations absorb a further 56% of our total revenue. Hence, around 90% of revenue was absorbed by total debt service payments in 2016. The problem has been compounded now that Sri Lanka has become a lower middle income economy as a result of its increased per capita income. This has resulted in a gradual decline in concessional budgetary financing from donors, while increasing exposure to non-concessional and commercial borrowings.

Hence, the reduction of government debt is critical. High government debt imposes significant costs on the economy as it tends to increase interest rates, discourage private investment, and constrain fiscal flexibility. Empirical evidence shows that public debt, beyond certain levels, can have negative effects on economic activity.<sup>10</sup> The legacy of unsustainable fiscal deficits for decades and the associated high level of government debt, has **complicated monetary and exchange rate policy in the country**. Sri Lanka needs to adopt a strong and durable fiscal consolidation programme, supported by comprehensive economic reforms, to overcome what can be called a “**high debt-low growth trap**”.

**Fiscal consolidation** is defined as “*concrete policies aimed at reducing government deficits and debt accumulation*”<sup>11</sup>. While it is reasonably easy to define what fiscal consolidation is, a proper design of fiscal adjustment and effective implementation is

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<sup>9</sup> “Debt ‘sustainability’ is often defined as the ability of a country to meet its debt obligations without requiring debt relief or accumulating arrears”, Development Finance International.

<http://www.development-finance.org/en/topics-of-work/debt-strategy-information/debt-sustainability.html>

<sup>10</sup> “**Threshold effects of sovereign debt: Evidence from the Caribbean,**” Greenidge, Kelvin, Roland Craigwell, Chrystol Thomas, and Lisa Drakes (2012), IMF Working Paper No. 12/157 (Washington: IMF).

<sup>11</sup> “**Fiscal consolidation: Targets, plans and measures**”: OECD (2011), OECD Journal on Budgeting, Vol. 11/2, <http://dx.doi.org/10.1787/budget-11-5kg869h4w5f6>

challenging. There usually are difficult political ramifications which are not easy to handle in the short-term. However, fiscal sustainability is an important prerequisite for a sustained increase in growth, employment and incomes. In the absence of fiscal consolidation, economies become trapped in repeating stop-go cycles with volatile interest and exchange rates. This lack of consistency and predictability in macroeconomic policies undermine the business environment.

There are a number of ways a fiscal consolidation programme can be implemented i.e. (i) by reducing expenditures, (ii) by increasing revenues and (iii) adopting a combination of these two policies. The implications and success of fiscal consolidation largely dependent on the effects of tax (revenue) and expenditure based adjustments in the government budget. In other words, improved tax revenue realisation and expenditure, better aligned with resource availability, are the components of fiscal consolidation. But, these have to be chosen carefully, by focusing on the policy objectives of the government and the macroeconomic situation of the country.

### **Why a Revenue Based Fiscal Consolidation Process for Sri Lanka?**

There can be different views regarding the **most appropriate route** to follow for successful fiscal consolidation. Studies have shown that for countries with large adjustment needs, fiscal consolidation often needs to be a balanced combination of spending cuts and revenue increases<sup>12</sup>. In Sri Lanka, the government has selected to follow a fiscal consolidation path anchored on revenue mobilisation. In order to shed some light on this, I would like to draw your attention to some historical perspectives regarding fiscal performance in Sri Lanka over the past few decades.

At the time of independence, Sri Lanka had a **strong revenue base**, which generated higher revenues from taxing imports and exports. **Taxes on the tree crop sector** (exports) was a major source of revenue and contributed to improved social development. Along with the gradual deepening of the economy following the liberalisation measures introduced in 1977, successive governments phased out the export taxes to support these sectors when profitability declined. Decline in

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<sup>12</sup> Baldacci, Emanuele, Sanjeev Gupta, and Carlos Mulas-Granados (2010), **“Getting debt under control”** Finance and Development, Vol. 47, No. 4, December (Washington: IMF).



international prices; loss of efficiency following nationalisation; and rising wages, were some of the explanatory factors. Similarly, import taxes and non-tariff barriers were also reduced, except for specific areas maintained on grounds of national security, health, environment, quarantine and quality assurance considerations. It is important to point out that these reforms also shifted the economy from a primary commodity export structure to a more **diversified export structure**. However, revenue from export taxes declined from around 5% of GDP in 1978 to around 0.3% of GDP in 2015.

In the context of these developments, many changes introduced to tax rates, tax bases and tax types have not kept pace with the changes in incomes and volumes of trade. Consequently, Sri Lanka's revenue to GDP ratio has persistently declined. It became a major challenge to achieve sustainable fiscal outcomes while meeting much needed social expenditure and public investment. In fact, in 1978, the country's tax revenue-to-GDP ratio was recorded as 24.2%, which has thereafter declined to 14.5% in 2000 and 10.1% in 2014. However, it is noteworthy to mention that, in 2015, tax revenue reflected a turnaround from its declining trend by recording at 12.1% of GDP. It is estimated to be 13% in 2016.

This poor performance in the revenue to GDP ratio was mainly driven by the decline in the **revenue buoyancy**<sup>13</sup>, which is the responsiveness of tax revenue growth to changes in GDP. This can be attributed to various tax exemptions, tax avoidance and weaknesses in tax administration. The revenue buoyancy during 2010-15 period has been estimated to be 0.8 in comparison to 1.14 during 1980-89 period, reflecting a serious erosion of the tax base, which has not responded to the increased national income of the country. The experience in Sri Lanka is different when compared to peer countries. While overall GDP, as well as per capita income, have been increasing, total government revenue and tax revenue as a percentage of GDP has followed a declining path. In assessing this trend, it must be recognised that tax concessions and exemptions were necessary to promote private investment when there was a high risk premium attached to the economy during the prolonged conflict.

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<sup>13</sup> Revenue buoyancy explains this relationship between the changes in government's tax revenue growth and the changes in GDP. When a tax is buoyant, its revenue increases without increasing the tax rate.

The loss in tax revenue stemming from the decline in profitability of traditional exports has not been compensated for by new tax revenue streams from the sectors, which have emerged during the last three decades, such as tourism and apparel. With the end of the conflict, the rationale for widespread tax concessions to promote investment has been eroded. The government's recent rationalisation of tax incentives, therefore, has sound justification.

In order to have a better picture about the current status of revenue collection in Sri Lanka, it would be appropriate to compare it with peer countries as well as with developed nations. Developed nations, like France (47.9%), Denmark (47.6%) and Belgium (47.5%), have a high tax to GDP ratio of around 40 - 50%. The high tax revenues in those countries are used to fund a well-developed welfare state. Countries like Ireland (24.4%), Romania (28.0%) and Bulgaria (29.0%) had a tax to GDP ratio of around 20-30% in 2015.<sup>14</sup> Among Asian peers Thailand (16.0%), Malaysia (14.8%), Philippines (13.6%) and Singapore (13.9%), had a tax to GDP ratio of below 20% in 2014.<sup>15</sup> In general, the ratio of tax to GDP in low-income countries lie between 10- 15% while lower middle income countries are in the range of 15-20% whereas for OECD economies, it is in a higher range of 30-40%.<sup>16</sup> Accordingly, Sri Lanka, as a lower middle income country, had one of the **lowest tax revenue-to-GDP ratios in the world**, which amounted to 10.1% in 2014. As mentioned above, it recovered to 12.1% in 2015 and is estimated to be 13% in 2016.

Another obvious concern regarding tax revenue in Sri Lanka is the **disproportionate share of indirect taxes to direct taxes**. Direct taxes, of which income tax is the main component, comprised only around 19% of tax revenue in 2015 while the indirect taxes, mainly consumption taxes like VAT, comprised around 81% of total tax revenue. Revenue collection from indirect taxes is inherently **regressive** and therefore, it **affects the poor disproportionately**. The share of direct taxes in many other emerging/peer countries is higher than that of Sri Lanka; for instance

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<sup>14</sup> [http://ec.europa.eu/eurostat/statistics-explained/index.php/Tax\\_revenue\\_statistics#Tax\\_revenue-to-GDP\\_ratio:\\_France.2C\\_Denmark\\_and\\_Belgium\\_show\\_the\\_highest\\_ratios](http://ec.europa.eu/eurostat/statistics-explained/index.php/Tax_revenue_statistics#Tax_revenue-to-GDP_ratio:_France.2C_Denmark_and_Belgium_show_the_highest_ratios)

<sup>15</sup> <http://search.worldbank.org/all?qterm=tax%20to%20gdp>

<sup>16</sup> Mascagni G., Moore M., McClusleey R., (2014) "Tax Revenue Mobilisation in Developing Countries: Issues and Challenges.

Malaysia, India, Philippines and Kenya have direct tax shares of over 40% (World Bank).<sup>17</sup>

Meanwhile, **government expenditure** has averaged 18.8% of GDP during the period 2010 – 2015. **Current expenditures** of the government hovered around 13.7% of GDP during this period. Interest payments, the “non-discretionary” spending component of the budget, and the expenditure on salaries and wages, have remained static in terms of current expenditure shares, accounting for over two thirds of recurrent expenditure. Salaries and wages, and interest payments during 2010 – 2015 period have averaged 4.4% and 4.7% of GDP, respectively. Moreover, transfer payments and welfare expenditure of the budget, which include transfers to households, a key component of **poverty alleviation**, have averaged around 3.0% of GDP during this period.

Given the developments indicated above, the **fiscal space**, available in the budget to accommodate other pressing concerns, remains inadequate. This has meant there has been pressure on the outlays for priority sectors, such as **education** and **health**. The fiscal space is the “*budgetary room that allows a government to provide resources for a desired purpose without jeopardising the sustainability of its financial position or the stability of the economy* (Heller 2005)”.<sup>18</sup> Sri Lanka’s lack of fiscal space is in marked contrast to the East and South East Asian success stories. The expenditure outlays in Sri Lanka shows that education and health sectors on average receive only 16% of the total funds channeled through the budget. On average, this accounted for 1.7% and 1.3% of GDP, respectively, during the period from 2010 to 2015. There has been an improvement in 2015 and 2016. Last year, health and education expenditure amounted to around 3.6% of GDP. This situation highlights the need for channeling more funds to most appropriate areas while properly targeting the poor and vulnerable. In addition, attention also needs to be paid to rationalise recurrent expenditure further, while maintaining a sufficient level of public investment to stimulate private sector involvement in economic activity.

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<sup>17</sup> <http://wdi.worldbank.org/table/4.14>

<sup>18</sup> Heller, P. (2005) ‘**Understanding Fiscal Space**’, Policy Discussion Paper PDP/05/4, Fiscal Affairs Department, IMF, Washington DC.

Total expenditure of 19-20% of GDP is acceptable for a country at Sri Lanka's level of development. The problem has been related to revenue mobilisation. The challenges on the expenditure side are related to the composition and quality of public outlays rather than the overall level.

The serious drawback in revenue generation and increased recurrent expenditure over the years has resulted in a **current account deficit (or revenue deficit) in the national budget**. Since 1987, it has averaged to -2.3% of GDP. This means the government has been a dis-saver thereby affecting the country's savings - investment performance as well. Meanwhile, the relatively high overall budget deficit over the past several decades has had **strong spillover effects** to the other sectors of the economy, including the external sector, emanating from the root cause of low revenue collection. Hence, priority has to be given to deficit management through addressing the revenue deficit. This will enable the maintenance of public investment at around 5-6% of GDP in the medium-term without becoming casualty in the deficit reduction efforts. In the past, capital expenditure has borne the brunt of fiscal consolidation with negative implications for future growth and employment generation.

Focusing on **expenditure reduction induced fiscal consolidation** would be generally appropriate in situations where the levels of taxation and spending are already elevated. Given that expenditure is at acceptable levels and there is relatively little room to reduce it, priority should be attached to a revenue based fiscal consolidation path in a country like Sri Lanka. Hence, while making efforts to further **rationalize government expenditure**, the country needs to focus more on enhancing revenue collection through appropriate tax reforms. In one of his recent papers, the Nobel laureate Joseph Stiglitz states that *"tax reform, in particular, offers a path toward both resolving budgetary impasses and making the kinds of public investments that will strengthen the fundamentals of the economy"*.<sup>19</sup> This is very relevant in the Sri Lankan context.

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<sup>19</sup> Stiglitz, Joseph E. (2014), "**Reforming Taxation to Promote Growth and Equity**"; White Paper, (28 May) [http://rooseveltinstitute.org/wp-content/uploads/2014/05/Stiglitz\\_Reforming\\_Taxation\\_White\\_Paper\\_Roosevelt\\_Institute.pdf](http://rooseveltinstitute.org/wp-content/uploads/2014/05/Stiglitz_Reforming_Taxation_White_Paper_Roosevelt_Institute.pdf)

## Benefits of Revenue Based Fiscal Consolidation

Ladies and gentlemen, fiscal reforms towards revenue based fiscal consolidation, will expand the fiscal space to maneuver and allow for more spending on growth drivers in the medium term. It will also preserve the government's capacity for maintaining **infrastructure spending** while pursuing adequate fiscal outlays for key social spending categories, such as education, health and social protection schemes. As I already stated, such a strategy is well aligned with the objective of reducing the budget deficit and the public debt ratio to a sustainable level.

Ben Bernanke, the distinguished former Chairman of the Federal Reserve Bank, USA, once stated that, *a **credible plan** to put the federal budget on a path that will be sustainable in the long run could help keep longer-term interest rates low and boost household and business confidence, thereby supporting economic growth today.*<sup>20</sup> This is equally applicable in the context of Sri Lanka.

Clearly, revenue based fiscal consolidation is also essential to ensure **low and stable inflation** on a long term basis that would create a conducive environment for productive investments to take place in the economy. Historically, the high dependence of the government on **domestic funding sources**, particularly the **borrowings from the banking system**, for deficit financing has been a major concern. In general, high public borrowing from the banking sector consumes a large portion of investable resources in the system and pushes up interest rates in the economy. This crowds out growth and employment supportive private investment in the economy. Therefore, revenue based fiscal consolidation will be supportive of reducing bank borrowings and expanding space for private sector investment to take place for sustained economic growth and employment generation.

Revenue based fiscal consolidation also serves to **minimise external vulnerabilities; disruptive fluctuations in the exchange rate;** and pressure on **official international reserves**, which result from the excess aggregate demand generated by unsustainable budget deficits.

Fiscal consolidation is also important for reforms being introduced by the Central Bank. As in many other economies, the Central Bank is in the process of moving

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<sup>20</sup> <https://www.federalreserve.gov/newsevents/speech/bernanke20121120a.htm>

towards **flexible inflation targeting** as its monetary policy framework. Revenue based fiscal consolidation aimed at reducing budget deficits and public debt is a precondition for the full implementation of such a monetary policy regime. In this regard, the joint commitment of the government and the Central Bank through more formal arrangements, such as legislation, may be necessary in future for the continuation of a credible flexible inflation targeting regime, facilitating the effective attainment of the Central Bank objective of price stability on a sustained basis.

The limited fiscal space emanating from low government revenue also constrains the government's ability to mitigate the impacts of **adverse shocks** arising from domestic disturbances, such as drought and floods as well as various developments on the international front. This again highlights the importance of following a revenue based fiscal consolidation process on a priority basis to create fiscal buffers to cushion the effects of exogenous and endogenous shocks.

### **Measures Taken in the Recent Past towards Revenue Based Fiscal Consolidation**

Let us now examine the efforts the Sri Lankan government has made in the recent past to improve the revenue collection on a sustainable basis.

In the past, **the decline in the revenue collection has undermined macroeconomic stability**. Hence, a strong effort is needed to rectify it. Unsustainable fiscal outcomes have been the Sri Lankan experience over several decades. This stands in marked contrast to the policies of the successful East and South East Asian countries, which have maintained robust fiscal performance. Hence, we need a national effort to deal with this perennial problem, with strong political commitment and sustained actions. Public awareness also needs to be built up on the need to move away from the toxic combination of populist politics and a deeply entrenched entitlement culture among the people which has undermined the country's development prospects since independence.

In this context, it is very encouraging that the government has already embarked upon a **new fiscal framework** to strengthen fiscal consolidation, reduce the budget deficit and support the macroeconomic stability while creating the much needed fiscal space to achieve anticipated economic progress in the medium term. The government has already begun the much needed reforms and the Honourable

Minister of Finance and his team deserve credit for the good outcomes that were achieved in 2016.

As I have recently announced in the “Road Map: Monetary and Financial Sector Policies for 2017 and beyond”, the Central Bank of Sri Lanka is in the process of establishing two new frameworks i.e. (i) **flexible inflation targeting framework** for monetary policy to maintain low and stable inflation and (ii) **exchange rate management framework**, based on market based policies to maintain the macroeconomic stability. These frameworks seek to complement the fiscal consolidation process.

When we examine carefully the country’s tax system, it is evident that the complexity of the tax regime has increased over the years with all sorts of **exemptions, concessions, and holidays**, which are set-out in many tax and non-tax laws. Consequently, the system became highly distorted. It fails to meet the revenue needs of the government and it is virtually impossible to administer effectively. Hence, priority needs to be attached to addressing complexities, simplifying the tax system, reducing tax exemptions, eliminating distortions, broadening the tax base and increasing buoyancy while substantially strengthening the administrative capacity of the **Inland Revenue Department (IRD)**. These priorities have been highlighted by a number of analyses undertaken by the government, international institutions and **Presidential Commissions** appointed for the purpose of studying the country’s tax system and making recommendations.

The government, after identifying these vital needs and drawbacks, has embarked upon an ambitious revenue based fiscal consolidation programme, aimed at reducing the overall budget deficit to around 3.5% of GDP by 2020 from around 5.4% in 2016. The government is specifically committed to turning the primary balance from a deficit to a surplus by 2018. A revenue surplus is also anticipated whereby the additional revenue over and above the recurrent expenditure can be spent on infrastructure development projects. These developments are expected to help reduce the government debt to around 65% of GDP by 2020 from around 76% in 2016. This entire process entails strong revenue enhancement efforts, aimed at

increasing the revenue to GDP ratio to around 16% of GDP in the medium term from around 13% in 2016.

It has been generally accepted that an **optimal tax system** would be one which has the **lowest possible tax rate** levied on the **broadest possible tax base**. The recent changes to tax policy, including the revisions to the **Value Added Tax (VAT)** and **Nation Building Tax (NBT)** systems, and **income taxation**, have been introduced with the view of establishing such a tax system in the country over the medium term. New measures in the area of income taxation, particularly, are expected to improve the **progressivity of the tax system**. The objective is to eventually increase direct tax collection over the years, in line with other peer countries. The Honourable Prime Minister has spoken of a 60% to 40% balance between indirect and direct taxes. Customs duty structure has also been rationalised by introducing a **three band tariff structure** in place of the four band structure that prevailed earlier.

The **complexity of the law** is also being addressed through the simplification of the tax law. In fact, according to the IMF (December 2016), *“the existing Inland Revenue Act (IRA: Inland Revenue Act, No. 10 of 2006) reflects a tax system that many view as too inefficient to support sustained growth. Its higher complexity hinders investors’ ability to understand the income tax system and local tax official’s ability to administrate, and is a contributing factor to Sri Lanka’s low tax-to-GDP ratio. In its current form, the IRA does not adequately deal with **modern business structures and commercial transactions** (especially cross-border transactions); creates distortions in investment through ineffective and inefficient tax incentives; targets a narrow tax base; limits collection and assessment powers, and encourages taxpayer challenges; and is inconsistent with international best practices”*.<sup>21</sup> Hence, a **new Inland Revenue Act (IRA)** is being drafted with the view of simplifying and modernising the IRA. This will help broaden the tax base by removing excessive tax incentives and expanding the sources of income; modernising rules related to cross-border transactions to address base erosion and combat tax avoidance; reducing complexity through an improved principles-based drafting style; and strengthening and clarifying existing

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<sup>21</sup> IMF, (December 2016), **“First review under the Extended arrangement under the Extended Fund Facility Criterion – Press Release; Staff Report; and statement by the Executive Director for Sri Lanka”**, p. 8.



powers of the Inland revenue Department (IRD) to improve enforcement (IMF – December 2016). The new IRA will be introduced in 2017. For the first time in the country's history, a Tax Expenditure Statement and a Strategy to Rationalise Tax Expenditures has been introduced.

The government is also committed to improve the **tax administrative efficiency**. This will be complemented by improvements in the **public financial management system**. In addition to the new features that will be introduced to strengthen tax administration, several other measures, particularly the **automation of revenue collecting agencies**, are being undertaken.

The establishment of the **Revenue Administration and Management Information System (RAMIS)** at the IRD, over the last two year period, is a major achievement by the government. This will enable taxpayers to register online for the payment of taxes, such as VAT, NBT, Withholding tax and **Pay-As-You-Earn (PAYE)**, and submission of tax returns, thereby removing many difficulties, which characterise the existing system. RAMIS will also be beneficial for the authorities through enhancing the capacity to monitor performance and make appropriate decisions on a more rapid and informed basis.

The **Single Window System (SWS)** launched by the **Sri Lanka Customs** is an important trade facilitation measure. This will connect all the border regulatory agencies responsible for issuing licenses, approvals, certificates, recommendations as well as tax waivers and exemptions to the core Customs software application namely, **ASYCUDA World**. The main beneficiaries of this new system are the traders involved in the import and export business. Increased efficiency in Custom clearances through digitisation and integration into a single system will reduce the time and cost associated with the clearing process, thereby reducing transaction costs and enhancing competitiveness.

In addition to reforms on the revenue front, expenditure management is also being automated by the government under an **Integrated Treasury Management Information System (ITMIS)** which is being established at the Ministry of Finance (MOF). Through this system, the Ministry is expected to simplify the current business

processes adopted by MOF and spending units for fiscal management through conversion into self-services. Internal business processes and workflows surrounding government financial management are being automated. A comprehensive reporting and analysis framework will also become available to support the MOF in effective planning and monitoring of the government finances.<sup>22</sup>

At this point, I should mention the ongoing **Extended Fund Facility (EFF) arrangement** with the IMF. I am, in fact, happy to say that the policies of the government to introduce fundamental and comprehensive reforms to tax policy and administration, which will ease the burden of public debt and the pressure on the BOP, while providing much needed fiscal space for the government's key social and development spending programmes, have been embedded into the EFF arrangement. Under this programme, the government has embarked on a **strong structural reform programme**, broadly categorised into **five main areas**, namely, fiscal policy management, tax policy reforms, tax administrative reforms, public financial management reforms and the state owned enterprise (SOE) reforms. This reform programme, if implemented effectively, will help introduce a **simpler and more equitable tax system** in the country, reduce the fiscal deficit and rebuild foreign exchange reserves to restore macroeconomic stability to facilitate sustainable and inclusive growth.

### Support Needed from Stakeholders

One can argue that we have changed our strategy. Efforts are underway to move away from **doing business as usual**. Remedial policies have been identified and the treatment is ongoing. We have to stay the course, although the journey is challenging. The **support from all stakeholders and the general public** is needed to implement reforms and achieve successful outcomes. This entails a significant amount of human resource transformation; improvements in the human resource capacity to manage a sophisticated, ICT based, revenue administration system (RAMIS); institutional capacity building; and developing the varying roles played by

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<sup>22</sup> Under the RAMIS, the MOF has launched a new web portal while User Acceptance Testing (UAT), which includes Treasury management, revenue management, budget appropriation, purchasing management, expenditure management, general ledger and system administration, in MOF and the Ministry of Health as a pilot project.

many people, including accountants and tax consultants/practitioners. This needs to be complemented by the support of many others in the private sector, including taxpayers themselves.

I know that the **School of Taxation of CA** is involved in training and providing required knowledge and expertise to professionals and tax practitioners. This is a very important task in this entire process. You play an important role in providing clients or taxpayers with advice on adhering to their tax obligations, as established by legal frameworks in the country. The training and guidance that is acquired from the School of Taxation clearly plays an important role in capacity building in this area. Priority should be attached to going beyond accounting and utilising your skills to offer analyses, assessment support, provide forecasts and measure risks to ensure a proper and better taxation culture in the country. This is particularly important in the context of corporate clients, who contribute to a significant share of the tax revenue collection in the country.

At this point, I wish to make some important remarks on tax consultancy. We know that the tax consultancy, which is also referred to as tax advising, involves the services of the persons who are trained in tax law. Their duty is to advise clients, including professional firms, individuals, families and privately-owned businesses, on complying with the range of government tax legislation and other financial matters. They have been trained to understand the regulations regarding business as well as individual taxes.

Globally, **tax consultancy** is a service, which has to be provided with **high degree of integrity**. The service providers are expected to conduct their activities in compliance with the **standards on lawful and ethical conduct of business** set out in the industry. In many countries, there are **benchmarks for professional standards and ethics**. In this context, the government expects the providers of tax consultancy services to advise their clients to pay their due taxes, not to evade taxes, not to persuade their clients to dispute taxes unjustifiably; not to guide taxpayers to engage in tactics aimed at unnecessarily delaying the payment of taxes. Similarly, the advice on tax planning is expected to be undertaken towards ensuring tax

efficiency, with appropriate changes to business models. Smart and clever tax consultants can also assist the Government by providing their best advice/alternatives to improve the tax system. They can be valuable partners in strengthening tax enforcement, aimed at enhancing revenue at a time when it is in the enlightened self-interest of everybody to support the government's efforts to achieve revenue based fiscal consolidation. Respected conduct of tax consultancy services will enable the government to collect its fair share of revenue, thereby resulting in a considerable improvement in fiscal outcomes in the future.

### Concluding Remarks

With that, let me conclude my speech today, by emphasising some important points.

The country is in need of improving fiscal outcomes. Fiscal consolidation is an essential but difficult process. Identification of the need for consolidation is relatively easy, but practical and effective implementation is challenging. Nevertheless, I want to highlight that fiscal consolidation is very important to **put the country's public finances back on track**. However, it has considerable political and economic costs as well, particularly in the initial period. Rodrigo de Rato, the former Managing Director of the IMF has said, *"the immediate costs of consolidation can be contained. The implementation of decisive, well-designed fiscal reforms can even turn these costs into short-term benefits. Of course, these benefits are not always available to the same degree; and the situations that yield confidence and credibility gains are the ones that offer the greatest opportunities. However, international experience has shown that if the circumstances are right, fiscal consolidation that is strong in terms of its scope and coordination with other policies can even generate immediate benefits"*.<sup>23</sup>

We can see that the government has taken **steps to enhance revenue**. This needs to be supported further by enhanced contribution from related institutions, stronger policy analyses, improved management and effective decision-making. It will help in further improving the tax policy and tax administration through timely interventions, thus enabling equitable revenue generation.

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<sup>23</sup> Rato, Rodrigo de; (2004), "**Benefits of Fiscal Consolidation**", 25 November, IMF

The commitment of the government to fiscal consolidation has also been shown in the Budget 2017 by reducing the overall deficit target to 4.6% of GDP. The Budget has indicated that there are many uncertainties in the external sector that could have a negative impact on the revenue estimates. Hence, the government will be presenting quarterly expenditure and income outcomes to Parliament, within one month at the end of any quarter, as the government is committed to uphold the **Parliamentary control of Public Finance. If there are revenue shortfalls, expenditure will be realigned with the approval of the Parliament**, thus reflecting the government's commitment to a fiscal consolidation path. In addition, the Budget 2017 had proposed the establishment of a Committee, constituting members from both the private and public sector to oversee budget execution. These are very important measures as they reiterate the fact that **the government has clearly identified the importance and the need for fiscal consolidation and its effective implementation.**

Fiscal consolidation alone may not be enough to reduce significantly the debt levels and hence, other policy options are also be needed to complement these efforts. Hence, fiscal consolidation needs to be complemented by a **comprehensive strategy to reduce public debt**, including the improvement of the efficiency of government spending, containing contingent liabilities, public sector rationalisation, active debt management and debt restructuring, and growth enhancing structural reforms, particularly related to SOEs. The proposed establishment of a separate **Debt Management Unit at the MOF** and the introduction of a **new Public Debt Act** are expected to play a pivotal role in improving debt management in the future. It also removes a conflict of interest, which has hampered the Central Bank's conduct of monetary policy.

This presentation has sought to highlight the important relationships among key concepts, such as fiscal policy, monetary and exchange rate policy, macroeconomic stability and their importance in creating a conducive environment for sustainable economic growth. **This is a very important collective process**, in which all of us are involved in varying degrees. It has to be a **national effort** and each and every institution as well as individual has various responsibilities related to this national endeavour. The ultimate objective of these efforts is to achieve sustainable and

inclusive growth, which is very important for creating employment opportunities, increasing earnings and improving the living standards of the people of Sri Lanka.

In doing so, proper understanding among the key stakeholders, financial markets, and the general public on the government's intentions is very important. I hope fora such as this one will promote **deliberations and continuous discussion of critical issues** like fiscal consolidation. Such engagement will not only assist in building a consensus on the necessary reforms but also improve the quality of policy-making.

Finally, the government deserves credit for the efforts being made to achieve fiscal consolidation and improve the debt management function. **This would enable the Central Bank to have greater room to maneuver not only to conduct effective and independent monetary and exchange rate policy to strengthen macroeconomic stability, but also to deliver lower nominal interest rates and a more stable and competitive exchange rate on a more predictable and consistent basis.** This will clearly create a more conducive business environment.

Thank you!