Committee on Public Finance

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Introduction

The Committee on Public Finance (COPF) is mandated with the task of providing an assessment of the fiscal, financial and economic assumptions used as bases in arriving at the budget estimates within 4 days of the Budget being presented to Parliament. This report is written in fulfilment of that mandate, after the 2017 Budget was presented to Parliament on November 10, 2016.

At the outset the Committee makes note of some of the constraints and concerns encountered in the process of making this assessment.

- It was expected that the assessment would be based on the numbers provided in the 2017 Budget Speech, the 2017 Draft Budget Estimates provided to Parliament on November 10, 2016, and the assumptions and explanations provided by the Ministry of Finance to the Committee on November 2, 2016.
- However, when COPF was not able to rationalise some of the line breakdowns presented in the Draft Budget Estimates 2017 provided to Parliament with the Budget Speech or the prior assumptions and explanations provided to the Committee, it asked for clarification from the Ministry of Finance. On November 12 the Ministry of Finance then presented COPF with two A4 sheets that had another set of figures where the breakdown of the numbers was more accurately aligned with what was presented to Parliament in the budgetspeach, and significantly different from the Draft Budget Estimates 2017 that were presented to Parliament and the previous assumptions and explanations presented to COPF. These latest numbers will now be referred to as the "Estimates of 12.11.2016 ".
- Table 2 sets out the differences between the Estimates received by Parliament and the Estimates of 12.11.2016. As there are significant variations in the numbers received at different points the Committee has always tried to use the latest set of figures (Estimates of 12.11.2016) and where these don't provide information, it has fallen back first on the Budget Speech, and the Draft Budget Estimates 2017, in that order. The Committee has since November 12th re-worked its assessment to use the best available data in this way.
- This report is prepared under a challenging time-constraint of 4 days after the submission of the budget to Parliament; and has been further challenged by the underlying data being subject to change through the late submission to this Committee, by the Ministry of Finance, of its Estimates of 12.11.2016 that are the basis for numbers presented in the budget. Any errors and omissions that may arise consequently are regretted. This report should be used mainly to inform Parliament and improve access to relevant information and to improve the Draft Budget Estimates. It cannot be expected to serve as a final and definitive analysis.

- The Committee recommends that these Estimates of 12.11.2016 be tabled in Parliament prior to the commencement of the Committee Stage debate.
- It is hoped that in the future the assumptions of the Ministry of Finance will be more realistic and be made transparent to Parliament.

The Committee's work has been assisted by independent experts who volunteered to give of their time expertise without remuneration for same. The Committee wishes to thank Dr. (Mrs.)Anila Dias Bandaranaike, Mrs. Rose Cooray, Messrs ThemiyaHurulle, SarathMayadunne and the team of economists working through Verite Research led by Dr.Nishan De Mel for their invaluable input and assistance.

Assessment

The assessment provided in this report is set out in two sections. Section I is an assessment on the revenue estimates in the budget. Section II is an assessment on the expenditure estimates of the budget.

The Committee wishes to note these overall points with regard to the methodology and approach of its analysis and assessment.

- All numbers in the assessment are discussed in current value terms (there is no inflation adjustment for different years).
- When evaluating the projections from 2016 to 2017 the analysis has accepted, in the first instance, the government's view on inflation (nominal growth in total output) as being 4% and growth in GDP (real growth in total output) as being 6.3% for 2017, as presented in the budget. The Committee has not attempted a sensitivity analysis with respect to possible variances in projected GDP growth.
- When comparing the 2017 annual growth for various revenue estimates, the reference point used is the average growth during the period 2009 - 2014 (both years inclusive). 2015 figures were excluded.

SECTION I : THE REVENUE ESTIMATES IN THE BUDGET

The total revenue of the government is estimated at LKR 2,088 billion in the 2017 budget. This is an increase of 26.7% over the expected revenue for 2016. In contrast, the increase in revenue from 2015 to 2016 was only 9.2%. The assumptions and actions that have been presented in the budget to justify this significant increase in revenue expectation are evaluated here, by examining the total revenue estimation in the component parts.Table A2 in the Annex provides a summary of the proposed revisions to the revenue estimates based on the observations provided with regard to specific revenue measures.

Table 1: Revenue estimates as given in the budget speech 2017(LKR Billions)

	Revenue	**2015**	**2016**	**2017**
	Total	**1509 (100%)**	**1648 (100%)**	**2088 (100%)**
	Tax Revenue	1356 (90%)	1432 (87%)	1821 (87%)
1	Income Tax	263 (17%)	236 (14%)	335 (16%)
2	Tax on Goods and Services	804 (53%)	854 (52%)	1086 (52%)
2.1	o/w VAT	220 (15%)	315 (19%)	380 (18%)
2.2	o/w Excise	498 (33%)	444 (27%)	575 (28%)
3	Taxes on External Trade	289 (19%)	342 (21%)	400 (19%)
3.1	o/w Import Tax/Cess	179 (12%)	190 (12%)	225 (11%)
3.2	o/w PAL/SCL	110 (7%)	152 (9%)	175 (8%)
4	Non Tax Revenue	99 (7%)	144 (9%)	189 (9%)
5	PCs	54 (4%)	72 (4%)	78 (4%)

Source: Budget Speech 2017[1] and Estimates of 12.11.2016; Ministry of Finance

[1]Analysis of revenue at a more disaggregated level was based on estimates of 12.11.2016 provided by the Treasury Department in Annex 1

Table 2: Differences in budget speech and published estimates and prior assumptions for government revenue (LKR Billions)

No		From Draft Budget 2017 Estimates Vol I - III	From 2017 Budget Speech/ Estimates of 12.11.2016	Change from Draft Budget Estimates Vol I - III
	Total	1890	2088	198(10.5%)
	Tax Revenue	1710	1821	111 (6.5%)
1	Income Tax	278	335	58 (20.5%)
2	Tax on Goods and Services	1026	1086	60 (5.8%)
2.1	VAT	380	380	0 (0%)
2.2	Excise Duties	544	575	5.7%
3	Taxes on External Trade	396	400	4 (1.0%)
3.1	Import Duties and Cess	220	225	5 (2.3%)
3.2	PAL/ SCL	175	175	0 (0%)
4	Other taxes	114	131	7 (14.9%)
5	Non-Tax Revenue	180	189	9 (5%)
6	PCs	78	78	0 (0%)

Source: Budget Speech 2017, Budget Estimates (Draft) 2017 and Estimates of 12.11.2016; Ministry of Finance

Note: Other Taxes for Draft Budget Estimates was calculated by including Export Duties, Motor Vehicle Concession Levy, SCL, Tobacco Tax, Telecommunication Levy, NBT, License Taxes and Other Taxes on International Trade not elsewhere specified

1. Income Tax

Income tax revenue assumptions and action are provided in the budget under at least three different categories. 1.1. Corporate Tax, 1.2 PAYE and 1.3. Withholding Tax. The present analysis will address itself to each of these in turn.

1.1. Corporate Tax

Revenue Type	Estimates of 12.11.2016	Percentage of total revenue	Average growth 2009-2014	Increase from 2016 (LKR Billions)	Attributed to policy changes (LKR Billions)	Attributed to normal growth and better administration (LKR Billions)
Corporate Tax	158	8%	8.2%	48	32	16

Source: Estimates of 12.11.2016 andAnnual Report 2015, Central Bank of Sri Lanka

Assumptions and Actions Provided

***Assumptions*:** A nominal increase of after profit taxation (with no policy action) at 16 billion or 14.5% of the 2016 base.

***Actions*:** Increase of the bottom taxation tier from 12% to 14% for SMEs and Exports; from 10% to 14% on Agribusiness and on Education; from 0% to 14% on the export of services. from 12% to 28% for non SME's in tourism, construction, health care; from 10% to 14% for Interest income on dividends, bonds etc. The turnover threshold for defining an SME has also been decreased from LKR 750 million to LKR 500 million. Further, there is an expectation of improving tax collection through improvements in tax administration including the implementation of the RAMIS system.

Analysis

***Past Experience*:** Average corporate tax growth during 2009 to 2014 was 8.2%. In the same period, actual corporate tax revenue on average was 16.9% lower than the budgeted estimate. That is, with regard to corporate taxes the Ministry of Finance has a poor history of providing estimates in the budget that accord with actual outcomes.

Present Evaluation: The LKR 16 billion increase on the status quo assumes 15% each growth of the base – which would be feasible only if revenue administrative measures are successful in creating at least 5% revenue growth, in addition to approximately 10% nominal revenue growth through economic expansion. The estimate provided of LKR 158 billion can be defended by allowing for compounded increases in the tax collection effort involving an increase in the taxable base from the policy actions above, and an increase in tax-collection base through improved administrative capability. Both these would need to increase by over 15% in order to achieve the overall increase of corporate tax by 44% as envisaged.

Observations

- An overall increase of 44% in corporate income tax collection is ambitious based on past experience, where similar policy actions have been attempted.
- There are significant administrative efficiency risks to the successful increases in the tax-collection base by over 15%. There is also the same risk in administratively capturing the full increase in the taxable-base even if that base were to increase by over 15% through the actions set out in the budget.
- It is our view that a downward revision of the estimates by LKR 26 billion to account for the risks and discrepancies, would ensure a more realisable estimate. This still leaves an optimistic estimate of increasing corporate tax collection by over 20% in the next year -- an almost twofold increase from the 2009 - 2014 average of rate 6.8%.
- We note that the Ministry of Finance has a poor track record of making budget predictions on this line item.

1.2 PAYE

Revenue Type	Estimates of 12.11. 2016	Percentage of total revenue	2009-2014 growth (period average)	Increase from 2016 (LKR billion)	Attributed to policy changes (LKR billions)	Attributed to normal growth and better administration (LKR billions)
PAYE	51	3%	8.3%	19	2.5	16.5

Source: Estimates of 12.11.2016 andAnnual Report 2015, Ministry of Finance

Assumptions and Actions Provided

Assumptions: The budget anticipates that PAYE taxes will be increased by only LKR 2.5 billion due to the policy action. That is, almost all the increase (16.5 billion of the 19 billion) is assumed to derive from normal growth in incomes and better tax administration rather than from the policy actions.

Actions: Maximum tax increased from 16% to 24%. Tax threshold increased from LKR 750,000 to LKR 1,200,000 per annum. Earnings in excess of tax free threshold will be taxed at the progressive rate structure which will be 4 % to 24 % having equal slabs of LKR 600,000 per annum at each level.

Analysis

***Past Experience*:** Average PAYE tax growth from 2009 to 2014 was 8.3%, against the present expectation of an increase by 59%. There has been no period in the past where PAYE taxes have increased in the order of magnitude envisaged.

Present Evaluation: The policy actions function to both increase and reduce the potential tax collected. The increase will come from increasing the maximum tax rate to 24% from the current 16%. The reduction will come from moving the initial tax threshold from LKR 750,000 a year to LKR 1,200,000 a year. The income distribution in the country being skewed towards the lower incomes rather than the higher incomes, means that the numbers caught in the new higher tax rates will be relatively small, compared the numbers that face reduced taxes due to the increase in the threshold levels. However the budget assumes that there will be in increase of 2.5 billion based on the policy actions taken.

Past trends and present assumptions on improved collection allow for an assumption of increased collection in the range of 15%. The assessment that the policy actions would generate the envisaged increase, if accepted (there has been no supporting information or assumptions provided to COPF in this regard) that still leaves the total expected increase below 25%, as opposed to the 59% envisaged in the budget.

Observations

- An overall increase of 59% in PAYE tax collection is at a huge variance from the assumptions and expectations that can be constructed based on budget actions and past experience.
- We suggest a downward revision of the estimates by LKR 12 billion to account for adjusted assumptions. This would still leave an optimistic estimate of improving PAYE tax collection by 22.5% which is more than double the 2009-2014 average rate of 8.3%.

1.3 WHT

Revenue Type	Estimates of 12.11.2016 (LKR billion)	Percentage of total revenue	2009-2014 growth (period average)	Increase from 2016 (LKR billions)	Attributed to policy changes (LKR billions)	Attributed to normal growth and better administration (LKR billions)
WHT	84[2]	4%	14.9%	16	26	-

Source: Estimates of 12.11.2016 and Annual Report 2015, Central Bank of Sri Lanka

Note: Data for tax on interest was not disaggregated by type of income

[2] The LKR 84 billion estimate for 2017 refers to the line item 'Tax on Interest Income' in the Estimates of 12.11.2016

Assumptions and Actions Provided

Assumptions: The revenue generated from the increase in withholding tax appears to be reflected in both corporate income tax and tax on interest income. The budget speech estimates that the policy changes relating to WHT will result in an additional LKR 26 billion revenue growth, whilst the increase in tax on interest income as per the estimates of 12.11.2016, is LKR 16 billion. This discrepancy/difference will need to be explained to Parliament.

Actions: Withholding tax on interest income from individual deposits increased from 2.5% to 5%. WHT for specified fees exceeding LKR 50,000 a month increased to 5%. WHT on interest earned on government securities and corporate debt securities increased from 10% to 14%.

Analysis

Average growth of WHT revenue over the past years from 2009-2014 was 15%. The estimated growth in WHT in 2017 is 24%. There are several factors that lend themselves to making this higher estimate feasible: increase in the WHT rate (100% increase) on deposits; additional measures of removing WHT exemptions; nominal base expansion of about 10%; higher interest rate regime in 2017 compared to 2016.

Observations

The envisaged 24% growth in WHT revenue is plausible on the assumptions and actions outlined.

2. Taxes on Domestic Goods and Services

2.1. VAT

Revenue Type	Estimates of 12.11.2016	Percentage of total revenue	2009-2014 growth (period average)	Increase from 2016 (LKR Billions)	Attributed to policy changes (LKR Billions)	Attributed to normal growth and better administration (LKR Billions)
VAT	380	18%	3.5%	65	45	20

Source: Estimates of 12.11.2016 andAnnual Report 2015, Central Bank of Sri Lanka

Assumptions and Actions Provided

***Assumptions*:** Increase in VAT revenue of LKR 65 billion as per the estimates of 12.11.2016from LKR 315 billion in 2016 to LKR 380 billion in 2017[3].

***Actions*:** Whilst there were no new VAT related changes in the budget, the revisions took place immediately prior to the budget where the VAT rate was increased to 15% from 11% and the threshold was reduced to LKR 3 million per quarter from LKR 3.75 million per quarter. Some VAT exemptions were also removed including liquor, cigarettes, milk powder.

Analysis

The calculation of VAT income against the past few years is complicated by the VAT being exempted for high value sales such as cigarettes in 2015 and most of 2016. The 20% increase in VAT set out for 2017 over 2016 is calculated on a base where VAT is also predicted to have increased by over 40% from 2015 to 2016. That means the budget is assuming a VAT collection in 2017 that is higher by about 75% against collection estimated in 2015. The very high increases reflect the income foregone as VAT in the last two years due to VAT being exempted on high value items such as cigarettes, with some of that value being captured by an increase in the excise taxes instead.

The justification of the final estimates are driven by the policy action of a 37% increase in the VAT rate. The monthly VAT collection in the first nine months of 2016 averaged LKR 21.7 billion at a rate of 11%. If this rate is increased to 15%, when annualised it provides a figure of LKR 355 billion for 2016. 60% of VAT is derived from the domestic economy and this can be assumed to grow at 10% in nominal terms whereas 40% of VAT is import VAT and imports are likely to remain flat. These calculations already provide a VAT projection of over LKR 375 billion. Therefore with the removal of exemptions, the VAT revenue can be expected to over-perform the predicted LKR 380 billion, provided that collection and administration functioned efficiently

Overall Observations

At first glance the expectation of VAT revenue growth (almost a 75% increase over 2015) seems overly high. However, taking into consideration collections reported for the first three quarters of the 2016, as well as the changes being made in rates and applicability of VAT, we have assessed this increase as not only plausible within the assumptions and policy position of the government, but also as being potentially underestimated by about LKR 10 billion.

[3] Draft Budget Estimates Vol I -II estimates 2016 VAT revenue at LKR 270 billion

2.2. Excise Duty

Revenue Type	2017 budget	Percentage of total revenue	2009-2014 growth (period average)	Increase from 2016 (LKR Billions)	Attributed to policy changes (LKR Billions)	Attributed to normal growth and better administration (LKR Billions)
Excise	575	28%	19%	131		
Motor Vehicle	230	11%	9%	50	14	36
Liquor	180	9%	18%	50	8.5	41.5
Cigarettes	105	5%	8%	20		
Petroleum	55	3%	9%	10		

Source: Estimates of 12.11.2016 and Annual Report 2015, Central Bank of Sri Lanka

Assumptions and Actions Provided

***Assumptions*:** The Budget Speech estimates revenue from excise duties to increase by LKR 131 billion to LKR 575 billion (growth of 29%)[4]. The increase estimated in the budget speech is based on a LKR 50 billion increase from both motor vehicles and liquor, LKR 30 billion increase from tobacco and LKR 10 billion increase from petroleum.

***Actions*:** The assumptions on liquor, and tobacco are based on an increase in excise duty rates leading up to the Budget, and new excise duties on imported ethanol (expected to yield LKR 8.5 billion in excise revenue) and related imported inputs. Downward revisions to excise duties of certain motor vehicle imports (hybrids over 3000 cc, electric vehicles) are anticipated to result in an increase in revenue of LKR 14 billion through the increased demand effectively over-compensating for the reduced rates through demand substitution.

Analysis

In the past, when prevailing duty on motor vehicles were high, the reduction in applicable duties have lead to an over-compensating increase in demand and thus increased revenue. The government has anticipated the same for 2017 in a particular class of vehicles.The Budget Speech on increase in vehicle import excise duty revenue also assumes a growth overall in import of motor vehicles leading to the balance increase of LKR 36 billion in excise revenue. There are several analytical considerations in assessing these expectations of revenue increase from motor vehicle imports:

- The year 2015 saw exceptionally high growth in imports of motor vehicles (leading to excise revenue of LKR 223 billion), thus comparing vehicle import growth in 2016 (first 10 months) with 2014 (10 months) indicates growth of 24% in 2016, suggesting robust growth. As demand increases for vehicle imports occur in cycles (responding to policy changes), it is unlikely that this growth over the last two years can be sustained in 2017.

4 However, in the Draft Budget Estimates Vol I -III, excise duty is estimated to grow by LKR 80 billion. The increase in revenue of LKR 80 billion as per the budget estimate is derived from a LKR 40 billion increase in excise duty on motor vehicles, LKR 25 billion increase from liquor, LKR 10 billion from tobacco, and LKR 5 billion from petroleum.

- The Budget proposes to reduce the loan-to-value (LTV) ratio for motor vehicles to 50% (from 70%) which will lead to less credit availability for vehicle leasing and vehicle loans. This will necessarily lead to lower demand for vehicles which are a highly credit sensitive product. Furthermore, a high interest rate regime will continue in 2017, which will subdue demand for motor vehicles during the year.

These factors suggest that even with increasing incomes and aspirations, it is more probable that demand will be subdued, and excise duty from motor vehicle imports in 2017 would be similar to that of 2016.

Excise duties on alcohol were increased slightly in August 2016, with a 5% increase in duty on beer. The estimate for increase in excise revenue from alcohol is however projected to grow by 32% over and above the additional revenue expected from excise duty increases on ethanol introduced in the 2017 budget. Average annual growth rates in excise duty in the past period have been 18% (which includes a 52% growth in 2015 on the back of several duty revisions in October 2014, and October/November 2015).

Alternatively, providing for a 15% increase in excise duty on alcohol along with the LKR 8.5 billion revenue increase from new excise duties would yield a growth from LKR 130 billion in 2016 to LKR 158 billion in 2017.

Observations

- The assumption that vehicle imports will continue to grow and drive increased revenue in 2017 is inconsistent with the information, assumptions and actions that have been revealed in the budget and otherwise available for analysis with regard to the economic environment and relevant policy changes; even while it is possible that there will be demand substitution due to changes in relative tax rates between types of vehicles.

- Therefore the LKR 230 billion anticipated in the Estimates of 12.11.2016 does not have sufficient support to be deemed plausible. This Committee recommends that these calculations be re-evaluated and revised downward by at least 15% to ensure that projections are not highly over-estimated.

- The 32% growth assumption in increased demand for liquor, thus increasing revenue from excise to LKR 180 billion, is difficult to rationalise with the information and actions provided along with past data. In this case as well the Committee recommends that these calculations be re-evaluated and revised downward by at least 15% to ensure that projections are not over-estimated.

- The revenue estimates for Cigarettes (LKR 105 billion) is plausible if revenue is monitored and excise rates are systematically adjusted in 2017. The estimates for Petroleum (LKR 55 billion) is also within the assumptions and information available.

- These observations would imply a downward revision of total excise duty to around LKR 515 billion - significantly lower than the LKR 575 billion presented in the Budget Speech.

3. Taxes on External Trade

3.1. Import Based Taxes

Revenue Type	Estimates of 12.11.2016	Percentage of total revenue	2009-2014 growth (period average)	Increase from 2016 (LKR billion)	Attributed to policy changes (LKR Billions)	Attributed to normal growth and better administration (LKR Billions)
Import Tax/ Cess	225	11%	5.80%	35	0	35

Source: Estimates of 12.11.2016 and Annual Report 2015, Central Bank of Sri Lanka

Assumptions and Actions Provided

Assumptions: The Budget anticipates growth in revenue from import duty and cess of 18% in 2017, yielding a revenue of LKR 225 billion. The concomitant growth in 2016 was 6%. The revenue growth assumption is predicated on import growth of 7% in 2017, whereas imports in the first 7 months of 2016 contracted by 3%.

Actions: There are no substantive changes in import duty and the government plans to gradually phase out cess charges. The Finance Minister proposed to remove cess on 100 items.

Analysis

The economic environment indicates that imports in 2017 are likely to remain subdued and growth dampened through the high interest rate regime that is expected to continue in 2017. Fiscal conditions will also be tight, and the exchange rate can be expected to depreciate at normal average rates in line with economic fundamentals. Global commodity prices will likely remain moderate given slack global demand conditions.

In terms of rate changes and application, no reasons have been provided to anticipate a material increase in import duty and cess revenue. A revised assumption on import duty and cess growth would be 5% based on improved administrative measures. This would result in a revised revenue estimate of LKR 200 billion.

Observations

The anticipated growth in import duty and cess is reliant on improvements in administrative measures that enhance collection. The revenue from cess could be lower than this estimate if the proposed reduction of cess on 100 items is implemented during the course of the year. Based on the Analysis a reduction in the revenue estimate by at least 25 billion would be prudent.

3.2. Port and Aviation Levy (PAL) and Special Commodity Levy (SCL)

Revenue Type	2017 budget	Percentage of total revenue	2009-2014 growth (period average)	Increase from 2016 (LKR billion)	Attributed to policy changes (LKR billion)	Attributed to normal growth and better administration (LKR billion)
PAL/SCL	175	8%	16%	23	5	18

Source: Annual Report 2015, Central Bank of Sri Lanka, Budget Speech 2017, Budget Estimates (Draft) 2017; Ministry of Finance

Assumptions and Actions Provided

***Assumptions*:** The budget assumes PAL revenue growth of 15% which would yield a revenue of LKR 175 billion, inclusive of a LKR 5 bn increase in revenue from SCL (due to increase of SCL on sugar imports).

***Actions*:** There is no material change in the PAL rate and application, thus revenue growth from this item would need to map import growth and reflect developments in revenue administration.

Analysis

As discussed in Section 3.1, the economic environment would not be conducive for significant import growth and it is likely that imports in 2017 would not grow significantly above the level of 2016.

A revised assumption for PAL growth would be 5%, leading to revenue from PAL and SCL to increase to LKR 160 billion in 2017.

Observations

Considering the analysis on the external sector and specifically modest import growth in 2017, it is probable that a 15% PAL growth is an overestimate. Assuming flat import growth in 2017, revenue from PAL would need to be driven by administrative improvements. Based on the Analysis a reduction in the revenue estimate by at least 10 billion would be prudent.

SECTION II: THE EXPENDITURE ESTIMATES IN THE BUDGET

As in the case of the revenue estimates there were significant variations in the various numbers provided to Parliament, in the budget, and to this Committee. Tables 4 and 5 set out some of the differences that have been observed. Table 3 sets out the increments to expenditure compared to 2016 and Table 6 provides an analysis of these changes based on past years and averages. Table A3 in the Annex provides a summary of the proposed revisions to the expenditure estimates based on the observations provided with regard to specific expenditure proposals.

Table 3: Increments to expenditure compared to 2016

Item	Increase due to new proposals (LKR Billion)	Total increase (LKR Billion)
Goods and services	18. 4	31
Transfers	19.6	43
Salaries and wages		25
Capital Expenditure	87.8	207
Total	139.9	389

Source : Draft Budget Estimates Vol I -III and Estimates of 12.11.2016

Based on the new expenditure proposals, outlays are expected to increase by LKR 140 billion while the total expenditure is expected to increase by LKR 389 billion in the budget.

Table 4: Differences in Budget Speech and Estimates of 12.11.2016 for government expenditure (LKR Billions)

Item	Budget Speech (LKR Billion)	Estimates of 12.11.2016 (LKR Billion)	Discrepancy
Total Expenditure	2,723	2,645	78 (2.9%)
o/w Recurrent	2,024	1,946	-78 (4%)
o/w Capital	699	697	-2 (0.2%)

Source : Budget Speech and Estimates of 12.11.2016

Table 5: Differences in published Draft Budget Estimates Vol I -III and Estimates of 12.11.2016 for government expenditure (LKR Billions)

Item	Draft Budget Estimates Vol I – III(LKR Billion)	Estimates of 12.11.2016 (LKR Billion)	Discrepancy
Total Expenditure	2,534	2,645	-111 (4.3%)
o/w Recurrent	1,922	1,946	-24 (1.2%)
o/w Capital	611	697	-86 (14%)

Source : Draft Budget Estimates Vol I –IIIand Estimates of 12.11.2016

Note : It should be noted a further disaggregation of the discrepancies cannot be analysed as the categorization of expenditure between the Estimates of 12.11.2016 and the Draft Budget Estimates Vol I - III is not consistent.

Table 6: Analysis of changes in expenditure compared to past years

	2015	**2016**	**2017**	**2016 Growth**	**2017 Growth**	**2011 - 2015 Growth (Period Average)**	**2011- 2015 Approved v Actual (Period Average)**
Recurrent Expenditure	**1702**	**1770**	**1946**	4.0	9.9	11.9%	1.05%
Goods & Services	184	153	184	(16.8)	20.3	13.1%	-1.90%
Salaries and wages	562	590	615	5.0	4.2	13.4%	-1.75%
Interest Payments							
Foreign	77	113	123	46.8	8.8	23%	49%[5]
Local	450	490	557	8.9	13.7	6.6%	-1.70%
Discounts on Treasury Securities			130				

5 2010 - 2015 discrepancy between approved estimates and actual for foreign interest payments as reported by Annual Report 2015 of the Central Bank of Sri Lanka is 32%

Transfers	**428**	**424**	**467**				
Household welfare	198	184	209	(7.1)	13.6	22%	2.70%
Pension	156	169	182	8.3	7.7	10.7%	-2.50%
Public Corporations & Institutions	87	85	90	(2.3)	5.9	23%	1.90%
Capital Expenditure	**588**	**490**	**697**	**(16.7)**	**42.2**	**13.6%**	-3.50%
Acquisition of real assets	313	275	472	(12.1)	71.6	14.6%	-7.60%
Capital Transfers	274	215	225	(21.5)	4.7	13.4%	-2.40%

Source: Estimates of 12.11.2016 and Annual Report 2015, Central Bank of Sri Lanka

4. Recurrent Expenditure

4.1 Salaries and Wages

Expenditure Type	Estimates of 12.11.2016 (LKR billions)	Percentage of total expenditure	2010-2015 growth (period average)	Increase from 2016 (LKR billions)	Attributed to policy changes (LKR billions)	Attributed to normal growth and better administration (LKR billions)
Salaries and Wages	615	23.25%	13.05%	25	N/A	25

Source: Estimates of 12.11.2016 and Annual Report 2015, Central Bank of Sri Lanka

Assumptions and Actions Provided

Assumptions: The expenditure on salaries and wages is estimated to grow by 4.2%.

Actions: According to the budget speech, there is no reference to an increase of salaries and wages, or to staff cadre. In that context, the estimated increase of 4.2% (LKR 25 billion) can be attributed to nominal growth.

Analysis

The 2010-2015 average annual growth in expenditure on salaries and wages is 13.1%. Historically, the average annual deviation between approved estimates and actuals during the period 2010-2015 has been 1.75%.

However, a number of new institutions have been proposed in the budget. There is no clarity as of yet on how these initiatives will be financed, especially as the staff requirement is likely to involve professional and competitive compensation.

For an evaluation of this budget category it is necessary to clarify the extent to which government staff cadre is expected to change in 2017, and the magnitude of residual salary/allowance increases that remain to be implemented in 2017, if any, from past budgetary promises.

Observations

- Previous budgets have over the last past years (2010-2015) been reasonably accurate with regard to the deviations between approved estimates and actuals.
- If it can be assumed, based on available information, that there are no material increases in staff cadre, only a 4% increment is granted. If this is the case, and there are no other factors that are material, the expenditure increase can be considered realistic, in spite of the low growth estimated for 2017 compared to historical average.
- However, more information is needed, especially with regard to residual obligations from past budgetary promises, and consequences of salary increases implemented in mid 2016. This expenditure estimated should be re-examined on the basis of such enhanced information.

4.2. Goods and Services

Expenditure Type	Estimates of 12.11.2016 (LKR Billions)	Percentage of total expenditure	2010-2015 growth (period average)	Increase from 2016 (LKR Billions)	Attributed to policy changes (LKR Billions)	Attributed to normal growth and better administration (LKR Billions)
Goods and Services	184	6.9%	13.09%	31	18.4	12.6

Source: Estimates of 12.11.2016 and Annual Report 2015, Central Bank of Sri Lanka

Assumptions and Actions Provided

Assumptions: The expenditure on goods and services is estimated to grow by 20.3% whereas annual growth in expenditure on goods and services has averaged 13.1% during the period 2010 - 2015. Historical deviation between approved estimates and actuals is 1.7% average annual deviation between 2010-2015.[6]

Actions: It can be observed that 59% (LKR 18.4 billion of LKR 31 billion) of the increase of expenditure on goods and services comes from new proposals (See Table 3), This leaves LKR 12.6 billion (8.5% growth on 2016 expenditure and a contraction of 9.8% compared to 2015) attributed to nominal growth of expenditure on goods and services. In that context the estimate on goods and services appears to be underestimated. Once the expenditure is disaggregated, further, out of total recurrent expenditure on goods & services increase of LKR 31 billion, LKR 12 billion increase is a result of due to the new proposals relating to recurrent expenditure on goods& services in the Education sector.

Analysis

The growth of 20.3% in 2017 is on a lower base in 2016 (which was a 17% contraction compared to 2015). 2017 compared to 2015 sees no real change. It is not clear what has caused the decline in expenditure on goods and services in 2016 in the latest Estimates of 12.11.2016. Extrapolating from the published Draft Budget Estimates presented to Parliament, expenditure on goods and services grew by 8% in 2016 and contracts by 3% in 2017 estimates.[7]

A comparison of 2017 with 2015 suggests no growth in expenditure on goods and services.

Observations

[6] New expenditure proposals categorized under goods and services are given in Table A4 in Annex
[7] Calculated by the summation of recurrent expenditure on supplies, traveling expenses, maintenance expenditure, and services

- Given a lack of clarity on the reason for the decline in expenditure on goods and services in 2016 there needs to be further information provided to build confidence in this estimate, and ensure the expenditure category is not under-estimated.

- Furthermore, considering the increase in expenditure on goods and services through new proposals, it is probable that the expenditure figure is seriously understated. Considering historic averages, a growth of at least 5% may need to be factored into the base case (taken at 2015 levels of LKR 184 billion) in addition to the new expenditure proposals (LKR 18.4 billion) giving a total of LKR 212 billon (15% growth on the 2015 expenditure level).

4.3. Interest Payments

Expenditure Type	Estimates of 12.11.2016 (LKR billions)	Percentage of total expenditure	2010-2015 growth (period average)	Increase from 2016 (LKR billions)	Attributed to policy changes (LKR billions)	Attributed to normal growth and better administration (LKR billions)
Interest Payments	680	25.7%	8.9%	77		

Source: Estimates of 12.11.2016 and Annual Report 2015, Central Bank of Sri Lanka

Assumptions and Actions Provided

Assumptions: The budget speech estimates the approved borrowing limit to decline to LKR 1,579 bn from LKR 1,699 bn in 2016, of which 72% would be domestic borrowing and 28% foreign borrowing. This borrowing mix is not expected to lead to a material change in the foreign and domestic interest repayment obligations in 2017.

Domestic interest payments in the period 2010-2015 showed a 6.6% average annual growth and the deviation between approved estimates and actual was 1.7%. Foreign interest payments in the same period grew 23% and the deviation between approved and actual payments was high at 49%.

Actions: There were no specific proposals in the budget speech related to interest payments or debt servicing.

Analysis

The interest rate in 2017 is expected to be higher than the average interest rate in 2016, and thus domestic interest payments are expected to be higher in 2017 than 2016. The same is likely to apply to US$ interest rates as well, through currency adjustments. The schedule of loans coming due and related interest payments has not been available for this analysis.

Observations

- The domestic interest payments aremore than twice the past average growth rate (2010-2015). This estimate is acceptable given the higher interest rates that will apply.

- The interest payment assumptions and dues on foreign borrowing need to be re-examined. It is probable that the 2017 estimate of 8.8% growth is a serious underestimate, particularly when compared to the historical average growth of 23%. The budgeted expenditure for foreign interest payment has consistently been underestimated in the past by a significant margin of 49% on average -- suggesting a poor track record on the part of the Ministry of Finance in making accurate budget provisions for this line item.

4.4. Transfers

Expenditure Type	Estimates of 12.11.2016 (LKR Billions)	Percentage of total expenditure	2010 - 2015 growth (period average)	Increase from 2016 (LKR Billions)	Attributed to policy changes (LKR Billions)	Attributed to normal growth and better administration (LKR Billions)
Transfers	467	17.65%	18.5%	43	19.6	23.4

Source: Estimates of 12.11.2016 and Annual Report 2015, Central Bank of Sri Lanka

Assumptions and Actions Provided

Assumptions: Expenditure on welfare transfers have several components, that can be examined separately.

Transfer expenditures on households has increased by an average of 22% per annum during the period 2010-2015. The growth estimated for 2017 is 13.5%, though from a low base since households transfers are estimated to have contracted in 2016. [8]
The expenditure on pensions has grown at an annual average of 10.7% over the past years (2010-2015). Estimated growth for 2017 is 7.7%. In these years on average the approved estimate has been 1.5% lower than the actual expenditure on pensions.

[8] The expenditure proposals categorized under transfers are listed in Table A5 in the Annex

Expenditure on transfers to public corporations and institutions has grown by 23% on an average annual basis over the period 2010-2015. The estimated growth for 2017 is 5.9%, off a low base of -2.3% growth in 2016.

On aggregate, as per the estimates of 12.11.2016, transfers to households are estimated to grow by 10% from LKR 424 bn in 2016 to LKR 467 bn in 2017.

Actions: With regard to transfers, 46% (almost LKR 20 billion) increase in expenditure is due to the new proposals. The balance LKR 23 billion increase is attributed to nominal growth of transfers expenditure (5.5% growth).

Analysis

The estimated growth of 13.5% for household transfer growth in 2017 is likely to be an underestimate when compared to past average growth levels. The same applies to pension expenditure, which is estimated to grow 7.7% in 2017, whilst historic averages (10.7%) suggest a higher growth level should be considered. The 5.9% growth (off a low base) in transfers to corporations is also significantly lower than historic averages (23% per annum).

Observations

- Considering past growth levels, and the history of overstating capital budgets, there is a risk that capital expenditures will not materialise at the levels estimated. A more prudential approach would be for Parliament to set out the essential/priority capital expenditure assuming a growth rate of 20%, which is half of what is currently anticipated; and, provide for further capital expenditures (in case where budgetary constraints do not arise as the year progresses) for the balance 20% growth anticipated. This would reduce the firm commitment assumed for capital expenditure outlay by about 100 billion or 0.7% of GDP; and allow for better prioritisation and stability of policy actions envisaged with regard to the increase of capital expenditure.

- However, it must be noted that the 2017 increase is off a lower base in 2016 and that as a share of GDP, the estimate for capital expenditure is 5.2%, which is consistent with historical norms on capital expenditures (average capex as a share of GDP for 2010 - 2015 is 5.5%).

5. Capital Expenditure

Expendit	Estimates of	Percenta	2010-2015	Increase	Attributed to	Attributed to normal

ure Type	12.11.2016 (LKR Billions)	ge of total expendit ure	growth (period average)	from 2016 (LKR Billions)	policy changes (LKR Billions)	growth and better administration (LKR Billions)
Capital Expendit ure	697	26.4%	13.7%	207	87	120

Source :Estimates of 12.11.2016 and Annual Reports of Central Bank of Sri Lanka.

Assumptions and Actions Provided

Assumptions: Capex is assumed to grow by 42.2%, with acquisition of real assets growing by 71.6%, from a low base in 2016 (which had a contraction of 12.1%).

Actions: New capital expenditure proposals amount to LKR 87 billion of the total increase of LKR 207 billion in 2017 compared to 2016 (62.5% of the total increase)

Analysis

The 2010 - 2015 period average growth for acquisition of real assets is 14.6%. It is important to note that historic evidence suggests that figures provided by the Ministry of Finance in the budget regularly overestimated capital expenditure. During the past years (2010-2015) the deviation between approved estimates and actual spending was on average 7.6% per annum. In the past reductions in the capital expenditure outlay at late stage of the financial cycle has led to ad-hoc decisions in terms of reducing expenditures and reduced the ability of Parliament to determine priorities.

Observations

- Considering past growth levels, and the history of overstating capital budgets, there is a risk that capital expenditures will not materialise at the levels estimated. A more prudential approach would be for Parliament to set out the essential/priority capital expenditure assuming a growth rate of 20%, which is half of what is currently anticipated; and also provide for further capital expenditures (in case where budgetary constraints do not arise as the year progresses) for the balance 20% growth anticipated.

This would reduce the firm commitment assumed for capital expenditure outlay by about 100 billion; and allow for proper prioritisation and stability of policy actions envisaged with regard to the increase of capital expenditures. However, it must be noted that the 2017 growth rate is on a lower base in 2016 and that as a share of GDP, the estimate for capital expenditure is over 5% , which is inline with historical norms (average capex as a share of GDP for 2010 - 2015 is 5.5%).

Comment [1]: Average (2010 - 2015) capital expenditure = 5.5. As per unpublished estimates capex is LKR 697 bn or 5.2% of GDP. With a reduction by LKR 100 billion, capex becomes LKR 597 bn or 4.5%

ANNEX

Table A1: Revenue estimates received by COPF as Estimates of 12.11.2016

Rs Billion	2015	2016	2017
Tax Revenue	**1,356** **93%**	**1,432** **91%**	**1,821** **91%**
Income Tax	**263** **18%**	**236** **15%**	**335** **17%**
Corporate	156 11%	110 7%	158 8%
PAYE	26 2%	32 2%	51 3%
Tax on interest	63 4%	68 4%	84 4%
Personal	11 1%	15 1%	22 1%
ESC	6 0%	11 1%	20 1%
Tax on goods and Services	**804** **55%**	**854** **54%**	**1,086** **54%**
VAT	220 15%	315 20%	380 19%
Excise	498 34%	444 28%	575 29%
Liquor	105 7%	130 8%	180 9%
Cigarettes	80 5%	85 5%	105 5%
Motor Vehicles	263 18%	180 11%	230 11%
Petroleum	45 3%	45 3%	55 3%
Other	4 0%	4 0%	5 0%
NBT	45 3%	54 3%	66 3%
Telecommunication levy	33 2%	35 2%	43 2%
Motor vehicle taxes and others	8 1%	6 0%	22 1%
Taxes on External Trade	**289** **20%**	**342** **22%**	**400** **20%**
Imports	132 9%	135 9%	165 8%
Cess	46 3%	55 3%	60 3%
SCL	52 4%	60 4%	65 3%
PAL	59 4%	92 6%	110 5%
Non tax revenue	**99**	**144**	**189**

	7%	9%	9%
Property income	37 3%	57 4%	89 4%
Fines, fees and charges	45 3%	65 4%	73 4%
Other	17 1%	22 1%	27 1%
Total Revenue	**1,455** **100%**	**1,576** **100%**	**2,010** **100%**

Source: Estimates of 12.11.2016

Table A2: Proposed Revisions to Revenue Estimates Based on COPF's Observations

	Based on Estimates of 12.11.2016		Based on Observations			
	2017		Proposed Revisions to 2017		Revised 2017	
	LKR Billion	As a % of GDP	LKR Billion	As a % of GDP	LKR Billion	As a % of GDP
Tax Revenue	**1,821**	**13.5**	**-126**	**-0.9**	**1,695**	**12.6**
Income Tax	**335**	**2.5**	**-38**	**-0.3**	**297**	**2.2**
Corporate	158	1.2	-26	-0.2	132	1.0
PAYE	51	0.4	-12	-0.1	39	0.3
WHT	84	0.6		0.0	84	0.6
Tax on goods and Services	**1,086**	**8.0**	**-48**	**-0.4**	**1038**	**7.6**
VAT	380	2.8	10	0.1	390	2.9
Excise	575	4.3	-58	-0.4	517	3.8
Liquor	180	1.3	-22	-0.2	158	1.2
Cigarettes	105	0.8	0	0.0	105	0.8
Motor Vehicles	230	1.7	-36	-0.3	194	1.4
Petroleum	55	0.4	0	0.0	55	0.4
Other	5	0.0	0	0.0	5	0.0
Taxes on External Trade	**400**	**3.0**	**-40**	**-0.3**	**360**	**2.7**
Imports and Cess	225	1.7	-25	-0.2	200	1.5
PAL and SCL	175	1.3	-15	-0.1	160	1.2

Table A3: Proposed Revisions to Expenditure Estimates Based on COPF's Observations

	Based on Estimates of 12.11.2016		Based on Observations			
	2017		Proposed Revisions to 2017		Revised 2017	
	LKR Billion	As a % of GDP	LKR Billion	As a % of GDP	LKR Billion	As a % of GDP
Total Expenditure	**2,645**	**19.6**	**-64.0**	**-0.5**	**2,579**	**19.1**
Recurrent Expenditure	**1946**	**14.4**	**36.0**	**0.3**	**1982**	**14.7**
Salaries and wages	615	4.6	0	0.0	615	4.6
Goods & Services	184	1.4	28	0.2	212	1.6
Interest Payments	680	5.0	To be quantified	0.0	680	5.0
Transfers	467	3.5	8	0.1	475	3.5
Capital Expenditure	**697**	**5.2**	**-100.0**	**-0.7**	**597**	**4.4**

Table A4: New Expenditure Proposal Allocations under Goods and Services Expenditure

Proposal	Ministry	Amount in Million
Provide high milk producing cows to farmers	Ministry of Agriculture	400
Provide refrigerators to small scale poultry traders	Ministry of Rural Economic Affairs	75
Support rehabilitation of Minipe Left Bank and Kithul and Rugam, MundeniAru and Tharapuram tank	Ministry of Irrigation and Water Resources Management	600
Implement pilot projects to monitor ground water in Polonnaruwa, Mannar, Vavuniya, Monaragala, Ampara, Hambantota, Anuradhapura and Batticaloa	Ministry of Irrigation and Water Resources Management	200
Basic facilities such as electricity, water and sanitation facilities to all schools	Ministry of Education	2,000
Free tabs to AL teachers and students	Ministry of Education	5,000
Provision to rent a maximum of 50 computers per school	Ministry of Education	5,000
"Subhaga" scholarship scheme to support 1,000 gifted children	Ministry of Education	30
Extend Agrahara Insurance Benefit Scheme, Property	Ministry of Education	25

Loan and Distress Loan facility to semi government schools		
Encourage university students‟ engagement in extracurricular activities	Ministry of Higher Education and Highways	100
Loan scheme for the students who are unable to get into the state universities	Ministry of Higher Education and Highways	300
Loan scheme to 5,000 students to follow Bachelor of Education courses at non state UGC approved institutes	Ministry of Higher Education and Highways	100
Scholarships for students to follow training programmes at government vocational training institutions	Ministry of Skills Development and Vocational Training	300
Stipend for 10,000 youth who will be trained by the private sector in areas such as apparel, healthcare, hospitality and construction	Ministry of Skills Development and Vocational Training	300
Prevention of CKDU	Ministry of Health, Nutrition and Indigenous Medicine	750
Upliftment of Nurses Training School	Ministry of Health,Nutrition and Indigenous Medicine	200
Health authorities visiting every primary school in the country	Ministry of Health,Nutrition and Indigenous Medicine	50
Global Marketing Campaign to boost the exports and Foreign Direct Investment (FDI)	Ministry of National Policies and Economic Affairs	1,000
Colombo Fair Exhibition	Export Development Board/ Sri Lanka Tourism Promotion Bureau/ Sri Lanka Tea Board	50
Provide land, electricity and water facilities to private free trade zones along the expressway corridors	Ministry of Development Strategies and International Trade	1,000

Trade promotional activities	Ministry of Industry and Commerce	50
Celebrate International Vesak Day	Ministry of Buddhasasana	250
Development of Religious places by the Presidential Secretariat	Presidential Secretariat	50
Facilitate rehabilitation of religious places	Ministry of Tourism and Christian Religious Affairs	25
Augment the infrastructure of Pirivena and the capacity development of the Privena teachers	Ministry of Buddhasasana	50
Talent Identification Programme among children and youth	Ministry of Sports	50
Support national level athletes to represent Sri Lanka in major international competitions	Ministry of Sports	100
Capacity development of sports trainers and coaches	Ministry of Sports	50
Promotion of National Co- existence, Dialogues and Official Languages	Ministry of National Co-existence, Dialogues and Official Languages	300
Total		18,405

Table A5: New Expenditure Proposal Allocations under Transfers

Proposal	Ministry	Amount in LKR Million
Provide 50% interest subsidy loan to farmers, farmer organizations and agro processing establishments	Ministry of Agriculture/ Ministry of Finance	400
Interest subsidy loan scheme for improving mechanization of agriculture	Ministry of Agriculture/ Ministry of Finance	50
Provide 50% interest subsidy encouraging private sector	Ministry of Rural	350

investors to invest in the out grower system	Economic Affairs	
Provide refrigerators to small scale poultry traders	Ministry of Rural Economic Affairs	75
New Comprehensive Rural Credit Scheme (NCRC) to establish hatcheries	Ministry of Rural Economic Affairs	100
Provide 50% interest subsidy loan scheme to establish 2,000 floriculture nurseries	Ministry of Agriculture/ Ministry of Finance	50
Provide 50% interest subsidy loan scheme to ornamental fish industry	Ministry of Agriculture/ Ministry of Finance	25
"Subhaga" scholarship scheme to support 1,000 gifted children	Ministry of Education	30
Improvement of special education and increasing the daily allowance to differently abled children	Ministry of Education	175
Extend Agrahara Insurance Benefit Scheme, Property Loan and Distress Loan facility to semi government schools	Ministry of Education	25
LKR 200,000 health insurance for students	Ministry of Education	2,700
Scholarship scheme to best performing undergraduates of the state universities to enter in to top universities around the world	Ministry of Higher Education and Highways	500
Each MP to be provided LKR 1 million per one GramaNiladari division (GN) to be given to selected youth interest free loans	Ministry National Policies and Economic Affairs	7,000
Interest subsidy loan scheme	Ministry of Tourism and Christian Religi-ous Affairs	500
Expand and strengthen the existing Insurance scheme	Ministry of Internal Affairs, WayambaDeve-lopment and Cultural Affairs	50
Provide 50% interest subsidy on loan scheme for promoting electric cars as taxis	Ministry of Transport and Civil Aviation	200
Provide 75% interest subsidy on loan scheme to upgrade school vans	Ministry of Transport and	150

	Civil Aviation	
Provide 50% interest subsidy loan scheme up to LKR 200,000 for 100,000 houses	Ministry of Finance	1,000
Grant pensions to differently abled soldiers	Ministry of Defence	3,500
Contributory Pension Fund	Ministry of Public Administration and Management	1,000
Provide full interest subsidy for loans of LKR 1.5 million to at least 1,000 graduates of state universities to encourage their engagement in business startups	Ministry of Higher Education and Highways	150
Interest subsidy to obtain credit facilities by media personnel to upgrade their equipment	Ministry of Parliamentary Reforms and Mass Media	25
Interest subsidy to households with monthly electricity bill over LKR 2,000 to convert in to solar energy	Ministry of Power and Renewable Energy	1,500
Total		19,555