

Fiscal budget proposals for 2022 amidst strong headwinds

The fiscal budget for 2022 proposed by Finance Minister, Mr. Basil Rajapakse, attempts to drive up state revenues to 12.3% of GDP (from the 9.4% of GDP in 2021) and curtail the fiscal deficit at 8.8% of GDP (11.1% of GDP in 2021) whilst stomaching a total expenditure of 21.1% of GDP. Specially battered by pandemic infused economic challenges, global commodity boom, dwindling foreign exchange reserves and given the foreign debt burden, achieving the said fiscal targets for 2022, we believe would be an uphill task. However, the silver-lining seems to be the market friendly nature of the Finance Minister (FM), and his mention of the need to adopt a market price-based pricing formulae for fuel, focus on underutilized state assets, focus on attracting foreign investments and to cut back on recurrent state expenditure.

Consistency

2022 budget proposals are consistent with the previous budgets and the governments' overall plan of maintaining lower taxation, simplify tax systems, move towards renewable energy, digitize the government bureaucracy involved in trade and attract foreign investments. Also mention of enabling entrepreneurs to establish manufacturing capacity and IT service-related job creation is encouraging.

One-off revenue generation tools

The state is short of cash and there is no alternate other than to tax more, despite the government's plan of maintaining a lower taxation regime. Hence the introduction of two new taxes.

1. 25% one-off surcharge tax on entities generating +LKR2 bn Taxable income in FY2020/21, which the FM believes will cough up LKR100 bn in tax monies and would be applicable to only 62 entities.
2. 3% Social Service Tax (a Covid Tax) charged on turnover from entities earning +LKR120mn in revenue, which is estimated to generate LKR140 bn in government revenue

Fiscal budget proposals for 2022 amidst strong headwinds

Conscious on recurrent state expenditure

The FM identified the need to curtail recurrent expenditure and initiated few incremental steps in that path, by prolonging the tenor of elected parliamentarians to qualify for state pensions, cut back on fuel allowances for the state sector and no salary increases for the state sector other than the salary anomalies which were addressed previously. However, no focus has been given to reduce state sector employment, specially in low-to-middle skill category and reduce the burden on recurrent expenditure and which is a need of the hour, instead the state is to provide permanent employment to +50,000 unemployed graduates providing jobs with a total mismatch of their skill set.

Take back from the 2022 budget proposals

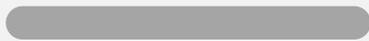
The proposals seem to be fair and progressing, specially considering the challenging environment faced by Sri Lanka. However, implementation of the proposals will be key, since adaptation of last year's budget proposals were very poor. Also, we believe there needs to be more clarity with regards to the new taxes introduced and then the new simplified tax structures proposed. Furthermore, widening the tax base for direct tax collection and digitization of the process needs to be further improved.

Impact on the listed market

At the outset, the 25% one-off surcharge tax is negative to the market, since larger companies will be subject to this cash outflow. However, it is noteworthy that given the fiscal situation, the tax burden on companies could have been much worse. This surcharge tax is one-off, and still some corporates who have paid taxes overseas may not be affected (yet to be clarified) while this additional tax is applicable on FY2020/21 earnings, where economic activity tilted from the SME & medium scale organizations to larger ones due to the pandemic infused lockdowns and operational disruptions. We believe the listed market would have sustainable growth if the fiscal position of the country improves, hence pocketing this one-off taxes is a small sacrifice in the overall gamut of happenings where the state continues to maintain low taxation, by not changing the reduced corporate tax rates and VAT.

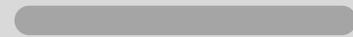
5.5% -6%

Real GDP growth
envisaged at 5.5% -6% for
2022E



12.3%

Revenue & Grants to
touch 12.3% of GDP



8.8%

Fiscal deficit to narrow
down to 8.8% of GDP



Sri Lanka - Budget 2022

Summary Financials

	2018	2019	2020	2021R_	2022E
Total Revenue and Grants	1,932	1,899	1,373	1,561	2,284
Total Revenue	1,920	1,891	1,368	1,556	2,274
Tax Revenue	1,712	1,735	1,217	1,325	1,987
Non-Tax Revenue	208	156	151	170	226
Grants & Provincial Council Tax Sharing and Devolved	12	8	5	66	71
Expenditure and Net Lending	2,693	3,338	3,041	3,387	3,912
Recurrent	2,090	2,425	2,548	2,817	2,996
Capital and Net Lending	604	913	493	582	931
o/w Public Investment	625	631		-12	-15
Interest payment	-852	-1,324	-980	-1,055	-1,115
Current Account Balance	-170	-534	-1,180	-1,261	-722
Primary Balance	91	-115	-687	-771	-513
Overall Fiscal Balance	-761	-1,439	-1,668	-1,826	-1,628

Summary Financials

% of GDP	2018	2019	2020	2021R_	2022E
Total Revenue and Grants	13.5	12.6	9.2	9.5	12.3
Total Revenue	13.4	12.6	9.1	9.4	12.2
Tax Revenue	11.9	11.6	8.1	8.0	10.7
Non-Tax Revenue	1.4	1.0	1.0	1.0	1.2
Grants & Provincial Council Tax Sharing and Devolved	0.1	0.1	0.0	0.4	0.4
Expenditure and Net Lending	18.7	22.2	20.3	20.6	21.1
Recurrent	14.5	16.2	17.0	17.1	16.2
Capital and Net Lending	4.2	6.1	3.3	3.5	5.0
Interest	5.9	8.8	6.5	6.4	6.0
Current Account Balance	-1.2	-3.6	-7.9	-7.7	-3.9
Primary Balance	0.6	-0.8	-4.6	-4.7	-2.8
Overall Fiscal Balance	-5.3	-9.6	-11.1	-11.1	-8.8

Impact on Listed Counters

General

Proposal	Remark	Counters Impacted	Impact
<p>A one-time tax surcharge of 25% is proposed to be imposed on persons or companies with taxable income over LKR 2,000 million for the year of assessment 2020/2021</p>	<p>Close to 50 companies listed on CSE has earned over LKR 2Bn in PBT (it was proposed to tax on taxable income). We also believe that the proposal could change the charge to PBT like it proposed in 2015 , on Super Gains Tax.</p> <p>However, tax treatment on subsidiaries who have earned over 2Bn and resultant computation of the holding company is still unclear.</p> <p>We also think there is a possibility of companies who earn in foreign currencies and liable to pay taxes overseas may be exempted from this tax.</p> <p>Given that this is taxed on past profits, and for companies who have already distributed profits through dividends may have to even pay the tax obtaining a loan resulting in having pressure on operating cashflow</p>	<p>Close to 50 counters</p>	<p>Negative</p>

General

Proposal	Remark	Counters Impacted	Impact
<p>Social Security Contribution charged at 3% on the annual threshold turnover exceeding LKR 120Mn</p>	<p>All companies which passes this threshold is liable to pay the proposed tax irrespective of whether they make profits.</p>	<p>Majority of counters listed on CSE</p>	<p>Negative</p>
<p>Single Special Goods and Service Tax to replace indirect taxes and levies-imposed on alcohol, cigarettes, Telecommunication, betting, gaming and vehicles wef from Jan'22</p>	<p>This was proposed in 2021 budget aiming at abolishing indirect taxes. All taxes then, is intended to be categorized under Special Goods & Services tax. Further clarification on this front is yet to be disclosed</p>	<p>DIAL, SLT, DIST, LION, MELS, CTC, DIMO, UML, SMOT</p>	<p>Likely Negative</p>

Counters that have earned over LKR 2Bn in PBT for the YE 20/21

Counter	PBT LKR Bn	Counter	PBT LKR Bn
LOLC	57.1	NEST	5.2
COMB	27.5	CIC	4.9
CTC	25.4	LWL	4.6
VONE	19.0	DFCC	4.6
EXPO	16.6	CARG	4.5
SAMP	15.3	LOFC	4.5
DIAL	14.8	HAYC	4.5
HNB	14.6	CTHR	4.5
CARS	14.1	LION	4.3
BUKI	14.1	SINS	3.8
CINS	11.9	LLUB	3.8
DIST	11.7	CDB	3.5
SLT	9.9	GUAR	3.2
LFIN	9.3	COCR	3.2
MELS	9.3	PABC	3.2
NDB	8.4	SEYB	3.1
RCL	8.0	CFVF	2.9
DIPD	7.2	TILE	2.9
CFIN	6.8	CLC	2.7
NTB	6.7	TJL	2.7
RICH	6.6	WIND	2.5
PLC	5.9	CCS	2.4
HHL	5.7	AEL	2.3
JKH	5.4	AAIC	2.3
TKYO	5.2		

Banks, Finance & Insurance

Proposal	Remark	Counters Impacted	Impact
VAT on banks and financial service providers under supply of financial services by specified institutions is proposed to be increased to 18% from 15%	All banks, finance institutions to be affected from a higher VAT, resulting with effective tax increasing from 39% to 42%. However, for larger banks and finance companies which is entitled to pay the one-time tax surcharge of 25% , is now liable to pay an effective tax rate of 67% for FY22.	All banks, finance companies and Insurance companies	Negative

Tax	Prior 2019/20	2020/21	Proposed 22E
Financial VAT	15%	15%	18%
NBT	2%	0%	0%
Income tax	28%	24%	24%
Debt repayment levy (only for banks & finance companies)	7%	0%	0%
Super normal tax (one time tax applicable only for selected banks and other financial institutions)			25%
Effective tax	52%	39%	67%

Alcohol & Tobacco

Proposal	Remark	Counters Impacted	Impact
Tax on Cigarettes to be increased	Price per cigarette is expected to increase by LKR 5/-. Moreover, CTC will also be liable to pay the one-off tax of 25%, increasing the total income tax liability to 65%	CTC	Negative
Alcohol excise duties to be increased.	The increase of excise duties for hard liquor and beer is not clear yet, thus making it difficult to ascertain the direct impact. This tax should result in higher prices for both hard liquor and soft liquor. However, both LION and DIST would be liable for the one off tax of 25% making the income tax liability to 65%	DIST, LION, MELS	Negative
Single Special Goods and Service Tax to replace indirect taxes and levies-imposed on alcohol, cigarettes	This was proposed in 2021 budget aiming at abolishing indirect taxes. All taxes then is intended to be categorized under Special Goods & Services tax. Further clarification on this front is yet to be disclosed	MELS, DIST, LION,CTC	Likely Negative

Construction

Proposal	Remark	Counters Impacted	Impact
LKR 20Bn allocated for the construction of 100,000Km roads	With the prevailing import ban on construction material, the demand for local products would rise. Construction companies to benefit through the proposed road network.	TKYO, AEL	Positive

Telecommunication

Proposal	Remark	Counters Impacted	Impact
Issue licenses issued by Telecommunication Regularity Commission of Sri Lanka through an auction	Could be an added burden to the cost structure of the telecom industry	DIAL, SLT	Likely Negative
Single Special Goods and Service Tax to replace indirect taxes and levies-imposed telecom	This was proposed in 2021 budget aiming at abolishing indirect taxes. All taxes then is intended to be categorized under Special Goods & Services tax. Further clarification on this front is yet to be disclosed	SLT, DIAL	Likely Negative
Install a country wide telecommunication network using Fibre Optic technology covering all state schools	Wider demand for broadband.	SLT	Positive

Dairy & Agri

Proposal	Remark	Counters Impacted	Impact
LKR 1.0Bn allocated to increase liquid milk production	Dairy segment would benefit with such favorable government policies along with the pent up demand	LMF, NEST, LAMB	Positive
Expand the capacity of the organic fertilizer for targeted crops and allocation of additional LKR 5Bn to promote organic fertilizer	The counter is in a position to ramp up the organic fertilizer production due to the large land bank owned and the expertise in organic fertilizer	CIC	Positive

Consumer & Manufacturing

Proposal	Remark	Counters Impacted	Impact
Encourage local pharmaceutical production, promote partnerships with international companies and implement a price mechanism for pharmaceuticals	The decline in imported molecules would ease the pressure on margins, benefitting the counters engaged in pharmaceutical business	HHL, SUN, MELS	Positive
Restrict importing rubber related products and promote investments in producing rubber related finished goods	Counters which manufacture and export rubber related products would benefit	REXP, RICH, HEX, DIPD, TYRE	Positive

Revenue Proposals

Revenue Proposals

Annexure III

Revenue Proposals - 2022

No.	Proposal	Rs. Mn
1	Surcharge Tax	100,000
2	Social Security Contribution	140,000
3	Value Added Tax (VAT) and other charges	14,000
4	Special Goods and Services Tax	50,000
5	Proposals relating to Motor Vehicles	4,000
6	Licence fees, auctions and other non-tax revenue	25,000

Compiled by Department of Fiscal Policy

Expenditure Proposals

Expenditure Proposals

Expenditure Proposals

No.	Proposal	Allocation (Rs. million)
1.	Providing relief for using organic herbicides	4,000
2.	Modernization of Agriculture	5,000
3.	Modernization of plantation sector and providing relief	10,000
4.	Fisheries and aquaculture development	1,000
5.	Livestock development	1,000
6.	Development of traditional cottage industries	1,000
7.	Development of textile industries including Handloom and Batik	1,000
8.	Infrastructure facilities for new product investment zones	5,000
9.	Small and Medium Scale Industry Zones	5,000
10.	Water for All programme	15,000
11.	<i>Vari Saubhagya</i>	20,000
12.	100,000 km roads (including estate sector roads)	20,000
13.	Development of renewable energy	500
14.	Development of urban houses	2,000
15.	Development of rural houses	5,000
16.	Development of estate houses	500
17.	Rural Development Projects	42,063
18.	Development of local government divisions	19,668
19.	Decentralized budget	3,375
20.	Rural livelihood development	19,894
21.	Relief for Micro, Small and Medium Scale Entrepreneurs	5,000
22.	Relief for school van owners	400
23.	Relief for three-wheeler owners	600
24.	Relief for private bus owners	1,500
25.	Relief for areas of art and entertainment	500
26.	Environment conservation	2,000
27.	Forest conservation	2,000
28.	Wildlife protection	1,000

Expenditure Proposals

No.	Proposal	Allocation (Rs. million)
29.	Development of schools	5,300
30.	Health and indigenous medicine	5,000
31.	Development of sports facilities	3,000
32.	Minor irrigation	2,000
33.	Vocational and Technical Training	2,000
34.	Passenger Transport	2,000
35.	Court infrastructure facilities	5,000
36.	Public security, law and order	500
37.	Sanitary facilities for prisoners	200
38.	Facilities for elders and people with special needs	1,000
39.	Pregnant mothers	1,000
40.	Home economy	15,000
41.	Home shop	15,000
42.	Digitalization of the public sector	500
43.	Motor cycles for government employees	500
44.	Removal of salary anomalies of teachers and principals	30,000
45.	Confirmation of graduate trainees	7,600
46.	Compensating the politically victimized	100
47.	Removal of anomalies of pensioners	500
48.	Maintenance of Buddhist temples	500
49.	Compensation for disappeared people	300
50.	Contribution for professional association	100
51.	Saving of expenditure	(30,000)

Disclaimer

The report has been prepared by Nations Lanka Equities (Pvt) Ltd.. The information and opinions contained herein has been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith. Such information has not been independently verified, no representation or warranty, express or implied is made as to its accuracy, completeness or correctness, reliability or suitability. All such information and opinions are subject to change without notice and are not responsible for the communication of the same. This document is for information purposes only, descriptions of any company or companies or their securities mentioned herein are not intended to be complete and this document is not, and should not be construed as, an offer, or solicitation of an offer, to buy or sell any securities or other financial instruments. In no event will Nations Lanka Equities (Pvt) Ltd. be liable for any loss or damage including without limitation, indirect or consequential loss or damage, or any loss or damage whatsoever arising out of, or in connection with the use of this report and any reliance you place on such information is therefore strictly at your own risk.

Nations Lanka Equities (Pvt) Ltd. may, to the extent permissible by applicable law or regulation, use the above material, conclusions, research or analysis in which they are based before the material is disseminated to their customers. Not all customers will receive the material at the same time. Nations Lanka Equities (Pvt) Ltd., their respective directors, officers, representatives, employees, related persons and/or Nations Lanka Equities (Pvt) Ltd., may have a long or short position in any of the securities or other financial instruments mentioned or issuers described herein at any time and may make a purchase and/or sale, or offer to make a purchase and/or sale of any such securities or other financial instruments from time to time in the open market or otherwise, in each case either as principal or agent.

The information contained in this report is for general information purposes only. This report and its content is copyright of Nations Lanka Equities (Pvt) Ltd. and all rights reserved. This report- in whole or in part- may not, except with the written permission of Nations Lanka Equities (Pvt) Ltd. be reproduced or distributed or commercially exploited in any material form by any means whether graphic, electronic, mechanical or any means.