8. Public Finance

The fiscal policy strategy has been formulated with a view to improving macroeconomic stability, increasing investment and savings in the economy, promoting employment and alleviating poverty. Fiscal reforms have aimed at moving towards a simple, low rate, non-distortionary tax system and the rationalisation of expenditures through public enterprise reforms, curtailment of wasteful and non-priority expenses and restructuring of the public debt. These reforms have strengthened the resilience of the economy and increased private sector participation.

- The thrust of fiscal policy in the recent past has been aimed at reducing the budget deficit. The overall budget deficit was reduced from 10.1 per cent of GDP in 1995 to 7.5 per cent of GDP in 1999.

- Progress in fiscal consolidation enabled the government to reduce its dis-savings from 2.7 per cent of GDP in 1995 to 1 per cent of GDP in 1999.

- However, due to the destabilising impact of military expenditure, dis-savings of the government rose to 3.4 per cent of GDP and the overall budget deficit increased to 9.8 per cent of GDP in 2000.

- Fiscal consolidation efforts have aimed at lowering expenditure of the government and maintaining the revenue effort in the context of ongoing tax reforms.

- Total expenditure of the government, which declined from 30.5 per cent of GDP in 1995 to 25.1 per cent in 1999, increased to 26.6 per cent of GDP in 2000. The revenue collection of the government was reduced from 20.4 per cent of GDP in 1995 to 16.7 per cent of GDP in 2000.

- The lower revenue mobilisation was partly due to rationalisation of the tax system. The government in the recent past implemented tax reforms with a view to simplifying the tax system, encouraging private investment and reducing the tax burden on the people.

Fiscal Indicators

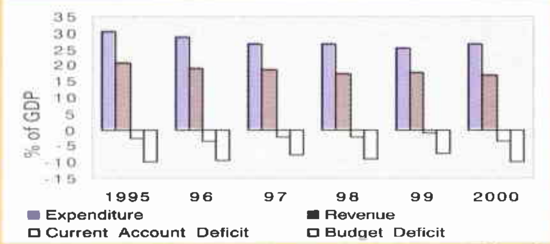

Chart 8.1

Government Revenue 2000

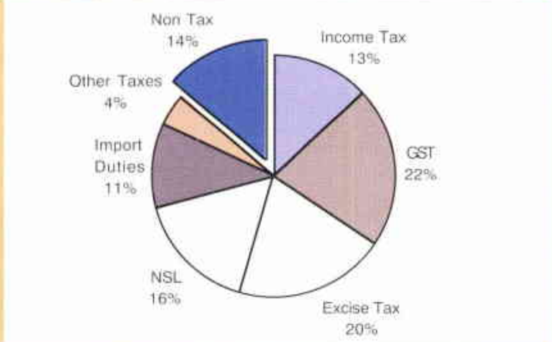

Chart 8.2

- International trade taxes have been reduced with the rationalisation of the tariff structure from three rate bands to two and the lowering of the maximum import duty rate from 40 per cent to 25 per cent.

- In 1998, the Goods and Services Tax (GST) replaced the turnover tax eliminating the cascading (tax on tax) effect of turnover taxes and thereby reducing the tax burden effectively. The GST provides relief to low income groups by exempting essential commodities and a large number of small scale producers from taxation. In addition, the input credit facility available under the GST system encourages private investment.

- Excise taxes have also been rationalised with the removal of a large number of non-revenue generating items from excise taxation and focusing on a few products such as cigarettes, liquor, petroleum products and motor vehicles.

- The burden of income taxes has also been lessened with increases in the tax threshhold and the provision of tax incentives for the corporate sector.

- Meanwhile, the rate of the National Security Levy (NSL) has been increased gradually to 6.5 per cent in 2000 from 4.5 per cent in 1995, while the coverage was also expanded to most services to enhance the tax revenue in line with the increase in defence expenditure.

- On the expenditure front, the government successfully curtailed current expenses by consolidating poverty alleviation programs and reducing wasteful and non-priority current outlays.

- Current expenditure as a percentage of GDP decreased from 23 per cent in 1995 to 20 per cent in 2000. The reduction in current expenditure is entirely on account of lower expenses related to non-defence expenditure.

- Defence expenditure in relation to GDP increased to an average of around 5.4 per cent during the period 1995-2000 as compared to an average of 4.0 per cent in 1990-1994.

Government Current Expenditure

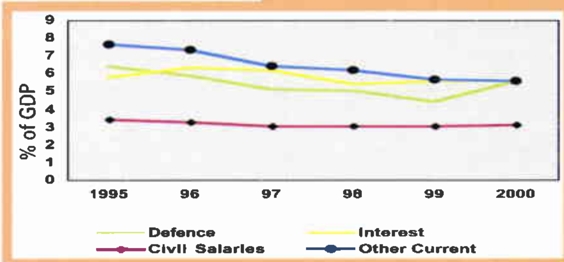

Chart 8.3

Government Current Expenditure 2000

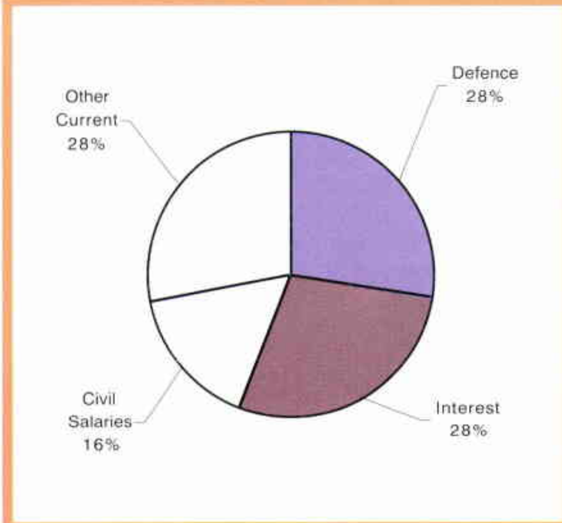

Chart 8.4

▲ The government concentrated its capital expenditure programme mainly on education, health and infrastructure development projects.

▲ Public investment as a percentage of GDP, however, has declined from 7.9 per cent in 1995 to 6.4 per cent in 2000.

▲ The establishment of the Public Enterprise Reform Commission (PERC) strengthened the divestiture programme of the government and streamlined the privatisation process by ensuring public accountability and transparency.

▲ The privatisation of major public enterprises such as Sri Lanka Telecom, plantation corporations, Air Lanka and Colombo Gas Company, together with the encouragement of investments based on a BOO/BOT basis has partly offset the need for public sector participation in investment activities.

▲ The postponement of the divestiture of public enterprises in 2000 due to unfavorable domestic and external environments has exerted additional pressure on the economy.

▲ The financing of the budget deficit in 2000 was mainly through domestic sources due to the reduction in funds from foreign sources. Borrowing from the banking system increased in the recent past due to slippages in fiscal consolidation.

▲ Credit extended by the banking system to the government increased to 3.6 per cent of GDP in 2000 in comparison to 2.3 per cent in 1999.

▲ Government's financial sector reform programme facilitated the evolution of new financial instruments with the financing of the budget deficit moving towards market oriented debt instruments.

▲ The introduction of market oriented Treasury bonds has enabled the government to create a medium term debt market, activate the secondary market and improve the medium term debt portfolio of the government.

Expenditure of Selected Functions

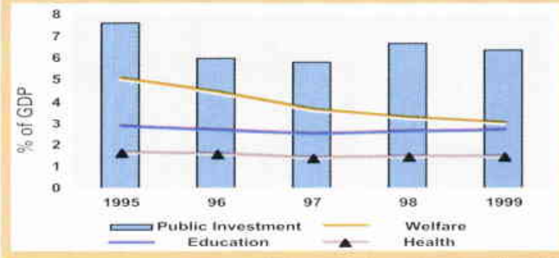

Chart 8.5

Financing of the Deficit

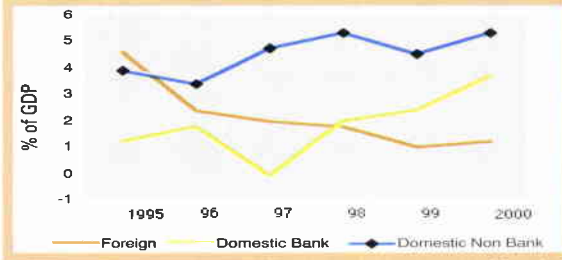

Chart 8.6

▲ Reliance on domestic sources in financing the budget deficit resulted in changing the composition of government debt. Domestic debt as a percentage of total debt increased from 43 per cent in 1995 to 53 per cent in 2000.

▲ Outstanding government debt, which declined to 86 per cent of GDP in 1997 from 95 per cent in 1995, increased to 96 per cent in 2000 due to enhanced borrowings from domestic sources and expansion of external debt due to exchange rate variations.

Outstanding Government Debt

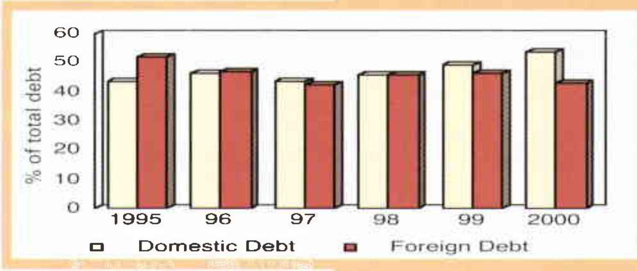

Chart 8.7