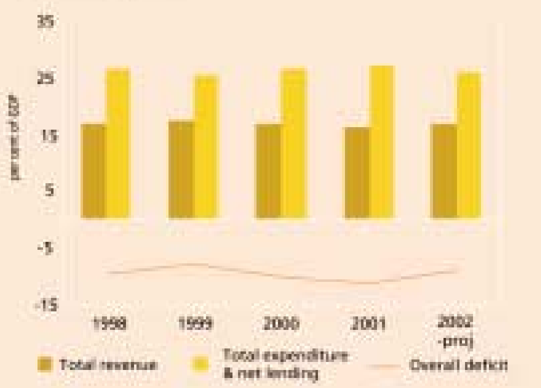
9. GOVERNMENT FINANCE

Budget 2002 envisaged a significant recovery in the overall fiscal performance from the serious fiscal slippage in the previous two years. However, performance during the first half of 2002 and prospects for the second half, indicate that there could be some deviations in fiscal variables from the budgetary targets. Any significant deviation from budgetary targets would not only lead to an unsustainable public debt, but would adversely affect monetary management and economic recovery. In order to keep in line with the medium term fiscal consolidation path and to achieve the fiscal targets set out in the proposed Fiscal Management (Responsibility) Act, the government needs to move forward with its fiscal reform programme. However, as some of them may not be popular policies in the short run, it will be necessary to educate continuously the public on the need for such reforms, their long-term benefits and the consequences of delaying or not undertaking them.

Chart 9.1
Fiscal Developments



Fiscal Policy Strategy

- The fiscal policy strategy in 2002 was formulated with the objective of stimulating economic growth, by encouraging private sector initiative, while the government was to play the role of a facilitator in the development process. Within this framework, the fiscal policy strategy announced in Budget 2002 aimed at implementing well-structured fiscal measures, granting incentives to revive investor confidence, removing bureaucratic constraints to attract private investment and fiscal consolidation to attain macroeconomic stability.

- The consolidation of fiscal sector activities has become a major concern, as weak fiscal performance has been a principal cause for most of the economic ills in the recent past. Persistently high budget deficits, which were largely financed by domestic resources, sluggish revenue performance and the increasing public debt, which has alarmingly increased debt servicing in the future, are some of the main reasons for the deterioration in the fiscal performance during the last few years. Accordingly, Budget 2002 proposed several reforms in all three key areas: taxation, expenditure and public debt management

- The government has given the highest priority to reforming the tax system by minimising the complexity in the existing tax structure, eliminating ad hoc tax concessions, improving tax administration and tax collection. Accordingly several taxes, such as the capital gains tax, the Advance Company Tax (ACT), stamp duties collected by the central government and the transfer tax on non-residents, were abolished. The consolidation of the Goods and Services Tax (GST) and the National Security Levy (NSL) into a single Value Added Tax (VAT) was a major tax reform introduced during the year. The absorption of the NSL, which was a turnover type cascading tax, into a value added type tax was a long felt need. The personal income tax structure was further rationalised and simplified by raising the threshold and reducing the number of tax slabs and rates.

- To move towards a tax system with a broader base and lower tax rates, the government announced its intention to reduce gradually the maximum tax rate for both personal and corporate income taxes in the medium term. Measures were also taken to streamline the existing tax incentives by limiting the use of fiscal incentives to a few targetted sectors. With a view to improving tax administration, the government proposed bringing the Inland Revenue Department, the Customs Department and the Department of Excise under a single Revenue Authority. A permanent Tariff Commission was also set up to minimise the distortionary impact of taxation on the external competitiveness of local producers.

- In the context of expenditure, the government reiterated the need for rationalising both current and capital expenditure in order to ensure a sustainable reduction in the deficit over the medium-term. The hiring freeze in the public sector, streamlining the provision for defence services, better targetting mechanisms for welfare programmes, limited resource allocation for unclassified and unforeseen expenses and strict control on the provision of funds for rupee funded non-priority and less productive capital expenditure programmes were some of the key measures implemented to lower expenditure in the short run.

- Among the major proposals to rationalise government expenditure in the medium-term were the reforms to the present civil service and the non-contributory pension scheme, the introduction of a universal type welfare programme through the Welfare Benefit Law and the rationalisation of government institutions.

- Budget 2002 focussed on strengthening debt management practices by improving the accountability of the public debt. Until 2001, borrowing through various non-instruments such as bank overdrafts and import bills were not accounted for under the overall borrowing limit. As a result, the government's actual borrowings exceeded the parliamentary approved borrowing limit. This issue was addressed in Budget 2002 by including such borrowings through the banking system into the total borrowing limit.

- Fiscal slippages in the recent past have compelled the government to rely heavily on the banking system to finance the widening resource gap. Further, a large part of such borrowings were raised through bank overdrafts and import bills. As a result, the outstanding overdrafts and import bills with the two state banks amounted to over Rs.50 billion at end 2001. Considering its impact on the borrowing costs of the government, and on overall economic management, the government decided to reduce the outstanding overdrafts by absorbing a part of it (Rs.30 billion) into the formal government securities programme.

Fiscal Sector Performance in 2002

Overall Developments

- The fiscal performance as indicated by the overall deficit during the first half of 2002 remained at almost the same level as in 2001, i.e., at 4.5 per cent of GDP. However, the primary deficit and the current account deficit moved in opposite directions compared to the previous year. The primary deficit (i.e., the overall deficit net of interest payments), which reflects the outcome of the current year's fiscal operations improved to 1 per cent of GDP from 1.3 per cent of GDP in the first half of 2001. This was mainly due to a sharp reduction in capital expenditure. The current account deficit on the other hand, which indicates the level of government dis-savings, deteriorated to 2.3 per cent of GDP in comparison to the previous year's level of 1.7 per cent of GDP, due to the significant shortfall in revenue and higher than expected expenditure on interest payments.

- Although a significant recovery was expected in the fiscal performance in 2002, slow growth in revenue collection will result in the deviation of fiscal aggregates from the budgetary targets.

- The overall budget deficit in 2002 is estimated to rise to 8.9 per cent of GDP, in comparison to the original target of 8.5 per cent of GDP. This will, however, be significantly lower than the overall deficit in 2001 of 10.9 per cent of GDP. The primary deficit, however, is expected to improve to 1.4 per cent of GDP in 2002 from 4.1 per cent of GDP in 2001, although it would be a deviation from the original target of 1.2 per cent of GDP. According to the original budget estimates there was to be a significant reduction in the current account deficit to 3.4 per cent of GDP. However, the revised current account deficit in 2002 is estimated to rise to 4.3 per cent of GDP. This is, however, lower than the current account deficit in 2001 of 4.9 per cent of GDP.

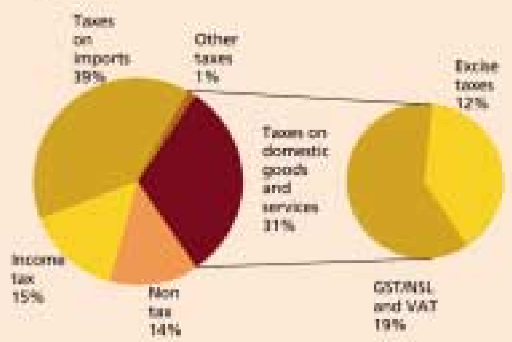
Revenue

- The slow recovery of the economy, the sluggish growth of taxable imports and the contraction of tax bases due to various concessions granted in October 2001 and Budget 2002, as well as delays in the implementation of some budget proposals, will reduce tax revenue collection in 2002.

- Tax revenue collection as a percentage of GDP declined during the first half of 2002 to 6.7 per cent of GDP from 7.4 per cent of GDP in the previous year. This was due to the shortfall in revenue collection from taxes on imports and from income taxes, excluding the withholding tax on interest. In contrast, non-tax revenue increased to 1.3 per cent of GDP from 1.1 per cent of GDP in 2001 due to the sharp increase in Central Bank profit transfers from Rs.5 billion in 2001 to Rs.10 billion in 2002. However, non-tax revenue, net of CBSL profit transfers, showed a marginal decrease in comparison to the previous year as some public enterprises failed to pay their dues to the government.

- According to the revised annual estimates for 2002, government revenue is expected to decline by about Rs.16.1 billion to Rs.262.1 billion (16.8 per cent of GDP) from the original target of Rs.278.2 billion (17.5 per cent of GDP). The shortfall is the combined outcome of a reduction in tax revenue by about Rs.10.8 billion to Rs.226.4 billion (14.5 per cent of GDP) from the budget estimate of Rs.237.1 billion (15 per cent of GDP) and a decline in non tax revenue by Rs.5.3 billion to Rs. 35.7 billion (2.3 per cent of GDP) from the original estimate of Rs.41.1 billion (2.6 per cent of GDP).

Chart 9.2
Composition of Government Revenue 2002



- Tax revenue from GST, NSL and VAT, stamp duties and the Ports and Airports Development Levy is expected to be lower than the original estimates. A shortfall in revenue collection is also expected from the newly introduced Debits Tax.

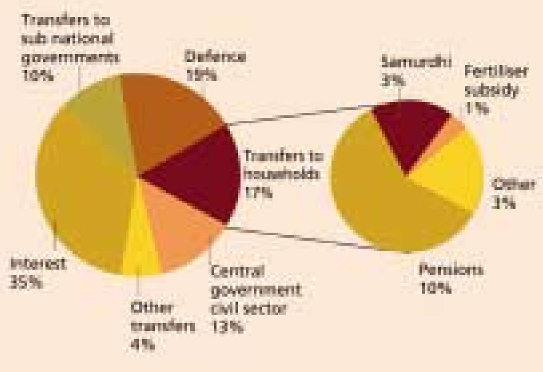
- The sluggish growth in imports during the first half of 2002 has adversely affected tax revenue from imports. However, with the anticipated growth in imports in the second half of 2002, it is expected that tax revenue from imports would improve correspondingly.

- The shortfall in tax revenue collection is also due to the delay in the implementation of tax proposals, such as the one month delay in the implementation of the debit tax, ad hoc changes to certain budget proposals that have narrowed the tax base, such as the increase in exemptions under the VAT (pharmaceuticals and bunker and aviation fuel) and the restriction of the debit tax to bank debits from current account transactions, as well as the exemptions from the debit tax granted to several institutions and transactions, which were not envisaged at the time the budget was prepared. Changes in tax rates, such as the movement of some commodities under the VAT from the 20 per cent rate band to the 10 per cent band would also contribute to lower tax revenue collection in 2002.

- Some of this shortfall in tax revenue collection would, however, be recouped by the unexpected increase in revenue from the withholding tax on interest as a result of the mode of collection of this tax from the interest on government marketable securities. The withholding tax on all future interest payments on marketable government securities is deducted at the point of issue, resulting in a significant increase in up front tax collection. Although this is a favourable development from a revenue point of view in the short term, it would result in increasing the interest payments of the government in the future as investors factor this tax into the yield, resulting in the tax becoming a part of the total interest payment, unlike under the previous system, where the tax was paid separately by the investor.

- The shortfall in non-tax revenue collection is mainly the result of the inability of certain public enterprises to meet their payment obligations to the government, resulting in a rescheduling of such payments. A rescheduling of interest due from the Ceylon Electricity Board (CEB) and non payment of the special levy imposed on the Sri Lanka Ports Authority (SLPA), as well as a shortfall in rent payments by plantation companies, are expected to reduce non-tax revenue collection in 2002.

Chart 9.3
Composition of Current Expenditure 2002



Expenditure

- The maintenance of current expenditure at almost the same level as in the previous year, together with the streamlining of rupee funded capital expenditure, contributed to the overall decline in total government expenditure during the first half of 2002. Government expenditure in terms of GDP, decreased to 12.6 per cent compared to 12.9 per cent during the same period in 2001. This reduction was entirely due to the lower expenditure on the public investment programme, which declined to 2.2 per cent of GDP from 2.6 per cent of GDP in 2001.

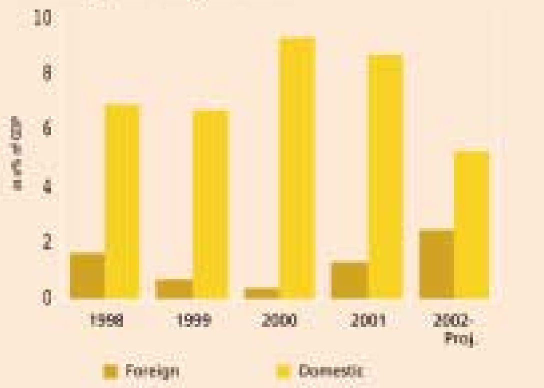
- In spite of the increase in interest payments and a higher outlay on personal emoluments, the reduction of current transfers and expenditure on other current operations helped maintain the overall current expenditure during the first half of 2002 at 10.3 per cent of GDP, almost the same level as in the previous year.

- For the year as a whole, current expenditure is expected to be maintained at almost the budgeted level at 21.1 per cent of GDP (Rs. 330 billion). However, a significant reduction in the capital expenditure programme is expected. As a result expenditure on the public investment programme will fall by Rs. 13.4 billion to Rs.71.5 billion (4.6 per cent of GDP) from the original target of Rs.84.9 billion (5.4 per cent of GDP). Consequently total expenditure in 2002 is expected to decline to 25.7 per cent of GDP (Rs.402 billion) from 26.1 per cent of GDP (Rs.413.6 billion).

- Savings in current expenditure are expected from expenditure on other goods and services of the central government, transfers to households and outlay on salaries and wages while all other current expenditure is expected to be maintained at the budgeted level.

- A significant reduction in public investment is expected due to the lower utilisation of foreign resources, although rupee funded public investment is expected to be maintained at the budgeted level. Lower repayment on on-lending activities by public enterprises, particularly as a result of the rescheduling of dues from the CEB (Rs.4.2 billion), would, however, increase total net lending. Overall, however, total capital and net lending is expected to fall.

Chart 9.4
Financing the Budget Deficit



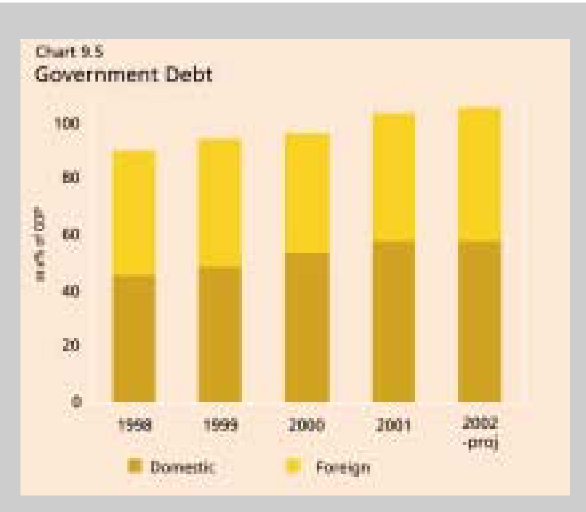
Financing

- During the first half of 2002 net foreign resources, by way of grants and concessional loans, available to finance the resource gap amounted to 0.2 per cent of GDP, while receipts from the privatisation programme were only 0.1 per cent of GDP. Lower receipts from foreign sources and the privatisation programme increased the pressure on domestic borrowing during the first half of 2002.

- During the first half of 2002, total domestic borrowing on a net basis increased to 4.3 per cent of GDP in comparison to 3.8 per cent during the same period in 2001. The pressure arising from higher domestic borrowing on interest rates was a major concern. As a result, a portion of domestic borrowing was issued as private placements, at given interest rates. In addition, Central Bank intervention in the primary market also helped ease the liquidity situation, thereby reducing pressure on interest rates in the domestic market. This debt management strategy and the reduction of the Central Bank's policy rates (Repo and Reverse Repo rates), together with the improvement in liquidity in the domestic market, helped keep interest rates in the government securities market stable.

- During the first half of 2002, borrowing from the banking system remained at almost the same level as in the previous year at 0.4 per cent of GDP (Rs.5.6 billion). This was the combined outcome of a net payment to the Central Bank (Rs.15.4 billion) and net borrowing from commercial banks (Rs.21.0 billion) compared to the repayment of Rs.2 billion to the Central Bank and Rs.9 billion borrowing from commercial banks in 2001. This was a result of the increased investment in government paper by commercial banks due to weak credit demand from the private sector. Therefore, the inflationary pressure of government borrowings from the banking system was relatively lower during the period under review compared to the same period in 2001.

- The total resource gap in 2002 is estimated at Rs. 140 billion. The expected foreign resources to finance the budget deficit consists of foreign grants amounting to Rs. 7.5 billion and net foreign borrowings of Rs. 32.2 billion. Net foreign borrowing will be a combined outcome of gross borrowing of Rs. 70.3 billion and repayments of Rs. 38.1 billion. Foreign borrowing includes the proposed commercial borrowing of US dollars 250 million.



- The privatisation programme in 2002 is expected to raise Rs. 21 billion. During the first nine months of 2002, privatisation proceeds amounting to Rs. 2.4 billion was received for budgetary financing purposes. The balance proceeds, which will mainly be from the divestiture of Sri Lanka Insurance Corporation and the sale of the balance portion of Sri Lanka Telecom, are expected during the last quarter of 2002.

- The balance resource requirement of Rs. 79.2 billion is expected to be raised from domestic sources.

Government Debt

- As in the previous year, the government's outstanding debt stock is expected to grow at a faster rate than the rate of growth in nominal GDP. As a result the debt stock is expected to reach 105.3 per cent of GDP at end 2002 compared to 103.6 per cent of GDP at end 2001. This level of public debt is clearly unsustainable, and hence it is essential that a strategy needs to be devised to reduce outstanding government debt.

- The outstanding domestic debt stock is expected to increase to 57.3 per cent of GDP. This increase reflects the higher overall deficit, which is expected to be financed mainly from domestic sources. The foreign debt stock, which is expected to increase to 48.1 per cent of GDP, would largely be due to the depreciation of the rupee vis-à-vis the Japanese yen and SDR.

Debt Service Payments

- Total debt service payments in 2002 are expected to be Rs.286 billion (18.3 per cent of GDP). Of this, amortisation payments will amount to Rs.168.5 billion, while interest payments are expected to be Rs.117.6 billion. Amortisation payments in 2002 have significantly increased over 2001 mainly due to the bunching of maturities. However, amortisation payments in 2002 would be significantly lower than budgeted, due to the rescheduling of FCBU payments of US dollars 200 million (Rs. 19.3 billion) and the non- exercising of the put option on Sri Lanka Development Bonds (SLDBs) of US dollars 108.5 million (Rs. 10.5 billion) In 2002, interest expenditure, which is equivalent to 7.5 per cent of GDP, is expected to absorb about 45 per cent of government revenue. These developments in debt service payments highlight the need for strong fiscal adjustments and a prudent debt management strategy.

Chart 9.6
Government Debt Service Payments

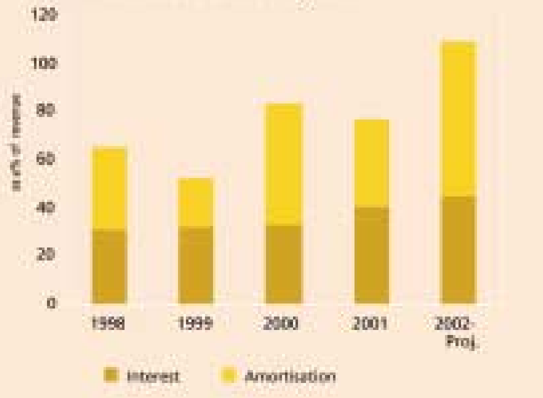
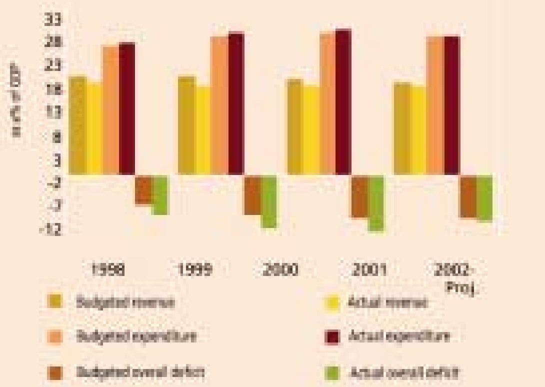


Chart 9.7
Fiscal Developments
Budgeted Vs. Actual



Fiscal Sector – 2003

- In keeping with the medium term fiscal consolidation process, the budget deficit in 2003 is expected to be reduced to about 7.5 per cent of GDP. This would need to be achieved more through expenditure reduction measures than revenue enhancing measures, as discretionary tax policies can adversely affect economic growth.

- However, the expected recovery in the economy and the concomitant increase in imports are expected to have a positive impact on tax revenue collection. The withholding tax on interest is also expected to be a significant source of revenue in 2003 as a result of a policy decision to issue longer-term maturities in government marketable securities, resulting in a higher up front collection of taxes on interest payments. The improvement in tax administration as a result of the establishment of the Revenue Authority is also expected to have a favourable impact on tax revenue collection in 2003.

- Total government expenditure as a ratio of GDP is expected to decline in 2003. Current expenditure is expected to be kept low due to several reasons. Lower outlay on salaries and wages are expected as a result of a continuation of the hiring freeze in the public sector and on the assumption that there will be no salary revisions other than the normal annual increment. Further streamlining of defence expenditure, and a decline in transfers to households, as a result of the implementation of the Welfare Benefit Law, are expected to keep current expenditure down in 2003. Public investment is expected to increase significantly in 2003.

- However, the expected overall improvement in the fiscal sector in 2003 is dependent on the implementation of strong fiscal adjustments and a recovery in the economy. Further, these projections are based on several assumptions, such as the continuation of the peace process, no general election and no ad hoc incentive packages.

- Any deviation in the actual fiscal aggregates from the budgetary estimates would not only lead to an unsustainable public debt, but would adversely affect both monetary management by raising interest rates and inflationary expectations, and the much needed economic recovery, by crowding-out resources from the private sector. Deviations in the actual fiscal performance from the original budget estimates would also raise questions of credibility and jeopardise the government's commitment to maintain the fiscal targets as set out in the proposed Fiscal Management (Responsibility) Act.

- The realisation of the proposed fiscal consolidation would, therefore, depend on the implementation of strong fiscal reforms. However, as most of these adjustments will be painful in the short run, the general public must be continuously made aware of the urgent need for such reforms and their long-term benefits, so as to minimise opposition to their implementation.