6. FISCAL POLICY AND GOVERNMENT FINANCE

The realised fiscal outcome for the first eight months of 2005 and the projections for the balance period of the year indicate that the overall budget deficit in 2005 could be maintained within the revised budgetary estimates which include tsunami related expenditure. Tax revenue as a percentage of GDP may continue its increasing trend, responding positively to the measures taken by the government. Current expenditure may increase, mainly due to the continuation of the fuel subsidy and tsunami related expenditure. Public investment is estimated to be lower than the budgetary target.

Fiscal Policy

- **The fiscal policy strategy announced in the Budget 2005 was based on the government's Medium Term Budgetary Framework (MTBF) formulated within the overall government policy vision articulated in the Economic Policy Framework of the Government of Sri Lanka (EPF-GOSL).** The MTBF expects to increase government revenue to generate a revenue surplus, augmenting the public investment, reducing the domestic financing to enhance available resources for the development of small and medium enterprise (SME) led capital formation and income generation activities. The thrust of this medium term strategy is on stimulating regionally balanced economic growth and reducing poverty.

- **The Budget 2005 reiterated the commitment to and the need for the phased reduction of the budget deficit in the medium term to ensure an orderly correction of structural weaknesses in the fiscal system.** In view of the fiscal performance in the previous several years, as announced in the Budget 2005, a delay of two years is anticipated in meeting targets stipulated in the Fiscal Management (Responsibility) Act (FMRA).

- **Original budgetary targets for 2005 as well as for the medium term were revised by the government incorporating tsunami related relief, rehabilitation and reconstruction (RRR) expenditure.** The expected overall deficit for 2005 was revised to 8.2 per cent of GDP, by incorporating post tsunami developments, from the original target of 7.6 per cent of GDP. The government expects to finance the entire RRR expenditure through foreign concessional loans and grants.

- **A series of measures have been introduced by the government to augment revenue collection.** Major measures are improvements in tax administration, introduction of new tax compliance measures, reformulation of VAT system and improving the refund mechanism, the rationalisation of corporate income taxes, the imposition of a withholding tax on motor vehicles, the revision of the Economic Service Charge (ESC) on selected sectors, the imposition of a presumptive tax on non government organisations (NGOs), increasing the Betting and Gaming Levy, the rationalisation in import duties, the revision of administrative fees and charges, and increasing fines and penalties.

- **Tax administration was strengthened** through the establishment of an appeals unit under a separate commissioner, the introduction of a code of ethics and conduct, setting up of an information centre to collect and analyse information on tax evasion, strengthening surveillance mechanism, the inauguration of 4 dedicated tax courts and the appointment of an independent tax ombudsman. The government also took measures to approve the legislations related to new tax measures before their implementation.

- **The reformulation of the VAT system included the introduction of a 4 - band VAT system by adding a new VAT rate in January 2005, and taking measures to rationalise VAT refunds.** A new VAT rate of 18 per cent (luxury rate) was introduced in addition to the basic commodity rate of 5 per cent, the general rate of 15 per cent and the zero rate. The 18 per cent VAT rate was increased subsequently to 20 per cent with effect from 2 August 2005. In order to rationalise VAT refunds, a three member committee was appointed by the Department of Inland Revenue (IRD).

- **Corporate income taxes were rationalised** mainly through the changes made to the tax on dividends that are not distributed and the removal of deductions allowed on VAT payments on financial services in calculating the taxable income.

- **The rationalisation of import duties involved the reduction of the number of tariff bands from 6 to 5.** In addition, a cess was imposed on a number of additional items, such as maize, chocolate and cereal products, in 2005.

- **Revisions were introduced to the administrative fees and charges relating to a number of services provided by the government.** The increase of the charge for using official vehicles for private use and increasing the rent on government properties are among them.

- **A considerable effort was made to contain recurrent expenditure.** The government expected to contain the increase in the interest cost by retiring high cost Rupee loans with a call option in 2005 and streamlining the allocation of funds for unforeseen current expenditure. To reduce the losses of oil companies and thereby reduce the subsidy on petroleum, the government partly adjusted the domestic petroleum prices in May and June 2005. However, the revisions were inadequate to recover the actual cost.

- **The government implemented a number of programmes to support the people affected by the tsunami.** These included a grant of Rs. 15,000 to the relatives of a person who lost life, weekly grant of Rs. 200 per person in cash and a dry food ration of Rs. 175 per person, a grant of Rs. 2,500 per family to buy kitchen utensils, grants of Rs. 250,000 and Rs. 100,000 for fully and partly damaged houses, respectively, and periodic allowances of Rs. 5,000 for a family and Rs. 2,500 for a single member family.

Government Finance

Overall Developments

- **The overall budget deficit in the first eight months of 2005 was Rs.118.6 billion.** As a percentage of GDP, it declined marginally to 5.1 per cent from 5.4 per cent in the previous year. The current account deficit (government dissavings) declined to 1.8 per cent of GDP from 2.2 per cent during the same period in 2004. However, the primary deficit (overall deficit net of interest payments) increased to 1.6 per cent of GDP during the first eight months in 2005 from 1.3 per cent for the same period in 2004.

- **The overall budget deficit in 2005 is estimated to be 8.2 per cent of GDP,** which is similar to the deficit envisaged in the post tsunami budgetary estimates and higher than the original estimate of 7.6 per cent in the Budget 2005. This is also similar to the overall deficit recorded in 2004.

Revenue

- Total government revenue during the first eight months of 2005 amounted to Rs. 236.9 billion, which is an increase of about 24 per cent. As a percentage of GDP, the total revenue increased to 10.1 per cent as against the 9.4 per cent recorded during the same period in 2004. Tax revenue increased to 8.9 per cent of GDP from 8.5 per cent in 2004, indicating a continuation of the increasing trend in the tax/GDP ratio that was seen in 2004. Non tax revenue also increased to 1.2 per cent of GDP from 0.9 per cent in the previous year.

- **The increase in tax revenue as a percentage of GDP during the first eight months of 2005 mainly was driven by the increased tax collection by way of income taxes and VAT.** Revenue from excise duties and import duties as a percentage of GDP declined marginally. Income tax collection increased, mainly due to the higher contribution from the ESC. The increase in the VAT collection was mainly driven by the improved VAT refund mechanism. The

Chart 6.1
Government Budget Deficit

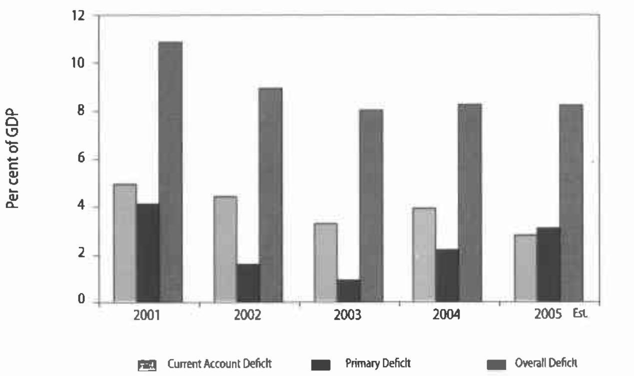
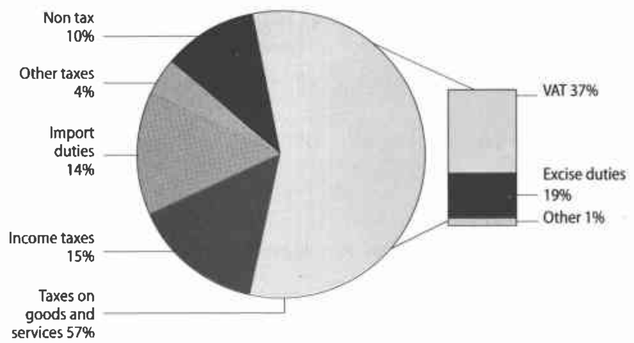


Chart 6.2
Composition of Government Revenue - 2005



marginal decline in the excise duty collection was mainly due to the drop in the excise duty collection from motor vehicles, as the importation of motor vehicles declined during the early period of 2005. The marginal decrease in import duty collection as a per cent of GDP during this period was mainly due to the drop in taxable imports as a result of tax exemption given to imports related to tsunami relief work and decline in motor vehicle imports in the early months of the year.

- **Non tax revenue collection during the first eight months of 2005 increased by 53 per cent to Rs. 27.1 billion.** The increase was mainly due to the increased profit transfers from the Central Bank and Sri Lanka Telecom and increased dividends from some government institutions due to their improved performance.

- **According to the revised annual estimate, government revenue in 2005 is expected to be Rs. 385.7 billion (16.5 per cent of GDP)** against the original target of Rs. 389.5 billion (17.1 per cent of GDP), which is a shortfall of about Rs. 3.8 billion compared with the original estimates. However, the tax revenue/GDP ratio would continue its increasing trend reaching 14.7 per cent in 2005 from 13.9 per cent in 2004. Meanwhile, non tax revenue will also increase to Rs. 40.3 billion (1.7 per cent of GDP), from Rs. 29.9 billion (1.5 per cent of GDP) in 2004. Higher profit transfers from the Central Bank and Sri Lanka Telecom and interest receipts on government on-lending to some institutions would help achieve the non tax revenue target in 2005.

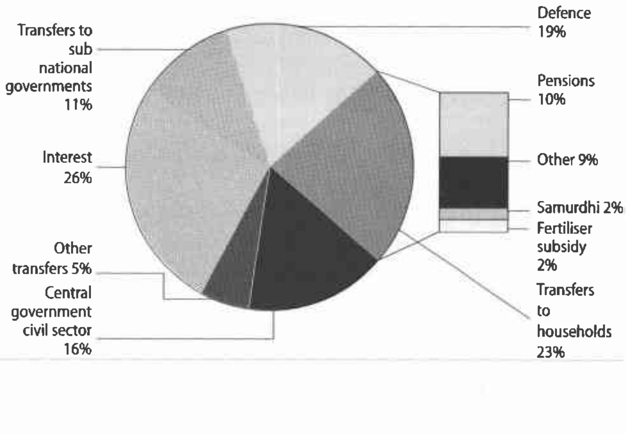
Expenditure

- **Total expenditure and net lending of the government during the first eight months of 2005 are estimated to be about Rs. 355.5 billion.** This accounted for 15.2 per cent of GDP recording a marginal increase from 14.8 per cent during the same period in 2004.

- **Current expenditure is estimated to be Rs. 280.2 billion, a 19 per cent increase over the same period in 2004.** As a percentage of GDP, current expenditure rose marginally to 12.0 per cent from 11.6 per cent in the same period of the previous year. The deferment of due interest payments under the debt moratorium and the retirement of high cost Rupee loans with a call option helped reduce the interest payments during this period. However, recurrent expenditure excluding interest payments increased mainly due to the continuation of the fuel subsidy, tsunami related expenditure, increased wage bill and higher expenditure on the fertiliser subsidy.

- **Capital expenditure and net lending during the first eight months of 2005 increased by 17 per cent to**

Chart 6.3
Composition of Government Current Expenditure



Rs. 75.3 billion. As a percentage of GDP, however, it remained unchanged at 3.2 per cent compared with the same period in the pervious year.

- **The revised estimates for 2005 indicate that total government expenditure and net lending is likely to increase to Rs. 577.6 billion (24.6 per cent of GDP).** This will be a net outcome of the expected increase in current expenditure by Rs. 31 billion to Rs. 450 billion and a decrease in capital expenditure and net lending by Rs. 14 billion to Rs. 127.6 billion. The original targets were Rs. 419 billion and Rs. 141.7 billion, respectively.

- **The expected increase in current expenditure would be mainly due to a number of reasons.** The continuation of the fuel subsidy, tsunami related expenditure, an expenditure overrun in respect of the fertiliser subsidy and increased transfer payments to public institutions are among them. Interest expenditure will be within the revised target for 2005.

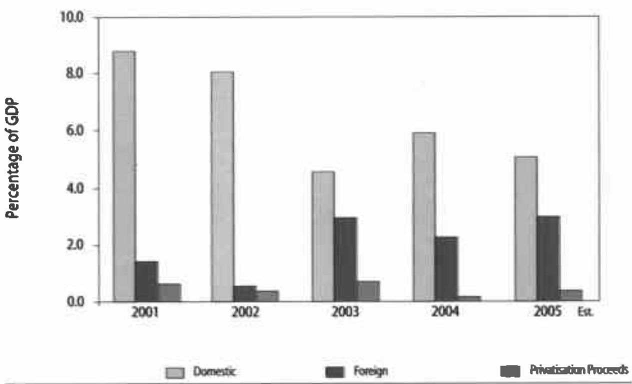
- **Capital expenditure and net lending in 2005 is likely to decrease compared to orginal estimates.** This will be mainly due to the containment of rupee funded capital expenses owing to the shortfall in the revenue collection and the lower utilisation of available foreign resources. Meanwhile, public investment would fall to about 5.5 per cent of GDP compared with the original target of 6.3 per cent of GDP.

Financing the Budget Deficit

- **The budget deficit during the first eight months of 2005 was Rs. 118.6 billion.** Net resources available from the foreign sources for financing the deficit amounted to Rs. 33.6 billion while privatisation proceeds received for budgetary financing amounted to Rs. 0.8 billion during this period. The balance financing of Rs. 84.2 billion (3.6 per cent of GDP) was raised from domestic sources, in comparison to Rs. 88.2 billion (4.3 per cent of GDP) recorded in the same period of 2004.

- **Relatively higher than expected domestic borrowings and inflationary pressures exerted some pressure on domestic interest rates during the first eight months of 2005.** Consequently, the weighted average yield rates on Treasury bills (364 days) and Treasury bonds (2 year) increased by 178 basis points and 218 basis points, respectively from January to August 2005. However, the borrowings from Foreign Currency Banking Units (FCBUs) (on net basis, US dollars 210 million) helped contain the rise in interest rates

Chart 6.4
Deficit Financing



in the domestic market but increased the sensitivity of government debt to exchange rate variations. Consequently, the government's reliance on non instrument domestic borrowings increased during this period. Total non instrument borrowings (such as borrowings from FCBUs, overdrafts and provisional advances) accounted for about 35 per cent of the total net domestic borrowings compared with about 21 per cent during the same period in the previous year.

- **Government borrowings from the banking system amounted to Rs. 16 billion (0.7 per cent of GDP) during the first eight months in 2005.** Borrowings from commercial banks during this period amounted to Rs.31.1 billion as against the repayment of Rs.12.7 billion during the same period in 2004. In contrast, government liabilities to the Central Bank decreased by Rs.15.1 billion in comparison to the net borrowings of Rs. 39.4 billion in the previous year.

- **In financing the overall deficit of Rs. 191.9 billion (8.2 per cent of GDP) in 2005, total foreign resources available by way of foreign loans and grants are estimated at Rs. 50 billion and Rs. 16 billion, respectively.** Total privatisation proceeds envisaged in the revised budget outturn for budgetary financing amounts to Rs. 7.5 billion. The balance resource requirement of Rs. 118.3 billion will have to be raised from domestic sources.

Public Sector Debt and Debt Service Payments

Government Debt

- **The outstanding government debt as at end August 2005 amounted to Rs. 2,165.9 billion,** which is an increase of about Rs. 26 billion compared with the debt as at the end of 2004. The net increase was due to the increase in domestic debt by Rs. 81 billion to Rs. 1,224.5 billion since foreign debt declined by Rs. 54.7 billion to Rs. 941.4 billion.

- **The decrease in foreign debt during the first eight months of 2005 was due to the appreciation of the rupee against major foreign currencies.** The rupee

Chart 6.5
Government Debt

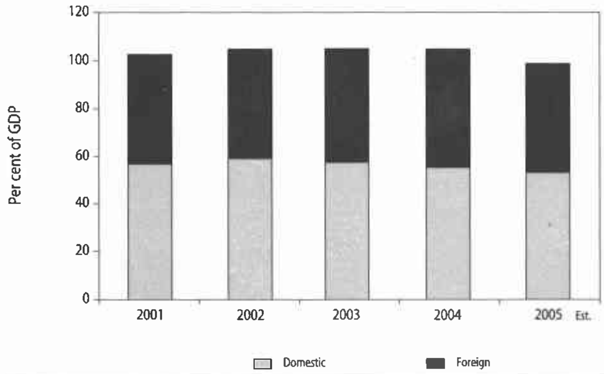
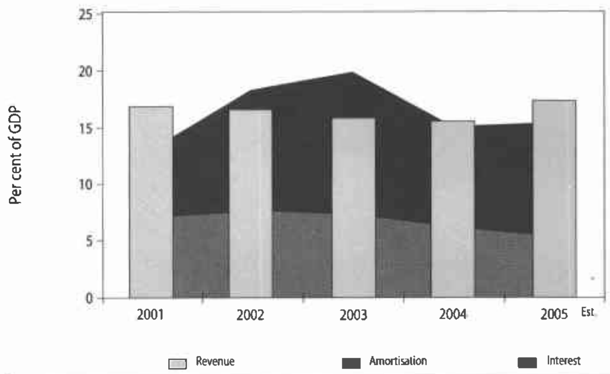


Chart 6.6
Government Debt Service Payments Vs Government Revenue



appreciated by 3.4 per cent, 10.0 per cent and 12.0 per cent against the US dollar, the SDR and the Japanese yen, respectively during this period. The total impact of the exchange rate variation during the first eight months in 2005 was a decline in the foreign debt stock by Rs. 80 billion.

Public Sector Debt

- **Total outstanding debt of the public sector, which includes government debt and liabilities of the non financial public corporations (NFPCs) to the banking system, increased marginally by Rs. 3.2 billion to Rs. 2,183.9 billion at end August 2005.** This resulted from the increase in the government's debt stock and the repayment of Rs. 23 billion to the banking system by NFPCs.

Debt Service Payments

- **The government has received a relief of about US dollars 263 million by way of the debt moratorium granted by the foreign donors in 2005.** Accordingly, interest and amortisation payments in respect of which the deferment facility was received, are being capitalised and rescheduled to be repaid over a four year period, with a grace period of one year. Total amortisation payments and interest payments in 2005 will be Rs.223.3 billion and Rs.119.4 billion, respectively.

Prospects for 2006

- **The government's medium term policy enunciated in the MTMF and the likely outcome in 2005 indicate that the overall budget deficit could be below 8 per cent of GDP.** This level of deficit would be more consistent with the expected medium term fiscal targets. To achieve this, revenue has to be enhanced further through additional measures and current expenditure has to be rationalised. However, public investment has to be increased to enhance the investment needed to generate growth.