

# BUDGET SPEECH 2003

## Part I

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Mr Speaker, it gives me both pleasure and honour to present to this House and the People of Sri Lanka the Second Budget of the United National Front Government.

## **THE PRESENT STATE OF THE ECONOMY**

I commenced my last Budget Speech by placing before this House the state of Sri Lanka's economy as at the end of last year when the present Government assumed the reigns of office. I then stated that immediate measures were imperative in order to arrest the collapse of the economy. I therefore will commence today's Speech by reviewing the progress made in the economy during the first three quarters of this year.

In 2001, for the first time since independence, a negative growth of 1.4 percent of GDP was recorded. Inflation rode at 14.2 percent. Both industrial and agricultural production had contracted; so also export earnings. The share market was stagnant. The budget deficit rose to 10.9 percent. The public debt stock had spiralled to Rs. 1,450 billion. Every man, woman and child in Sri Lanka carried on his or her shoulder a liability of Rs. 77,500/=, being the pro-rata share of the country's debt burden. The servicing of this debt had crippled growth. Government owned institutions providing mainly utility services, such as electricity, supply of petroleum and public transport, were indebted to the local banking system to the extent of Rs. 41 billion. A severe shortage of power added to the nation's gloom.

The conflict in the North and the East spread over as long a period as twenty years together with the lack of proper management of the economy over the previous seven years had combined to create economic paralysis in the country. So great was the collapse and mismanagement that the International Monetary Fund refused to release to the previous Government the second tranche under the Stand-By Arrangement entered into in July 2001.

Whilst these were the economic problems that confronted us, I nevertheless stated that our Government was committed to facing the problem and proceeding with the task of nation re-building. This, as I stated, would require hard decisions to be taken in the first two years. We took the People into our confidence. We spoke the truth. We told them the process will take time. We told them this would mean a measure of burden on them at the outset, but it was better to work at well-planned measures geared to ultimate benefit rather than short-term temporary gains. They understood. They evidenced this over-whelmingly by voting for our Prime Minister and the United National Front Government's programme for peace and economic development at the Local Authorities elections held a few months ago.

Mr Speaker, our endeavour in nation re-building has been two-fold - firstly, to establish peace, to repair the fabric that bound all Sri Lankans together but had been torn apart by the North-East conflict; and, secondly, to rebuild our battered economy.

I would like to place before you the moderate but sure progress we have made on both these fronts in the past ten months. This we have achieved on the economic front by implementing the cautious strategies and policies contained in the last Budget. We have already succeeded in increasing growth from last year's negative figure to an estimated positive 3 percent of GDP for the year 2002, based on the first two quarter's actuals. Inflation has been reduced to approximately 9 percent. Our foreign reserves have been increased to three and a half month's imports of goods and services. The exchange rate has stabilised. Interest rates have been reduced. The stock market compares well with any in the Region. The power shortage has ended. Our farmers today receive a minimum of Rs. 13/= per Kg., for their paddy. The tourist trade is rapidly regaining its earlier prosperity. Defence payments have reduced, paving the way for diverting more funds to development related activities. The Budget deficit for 2002 is being contained at 8.9 percent of GDP.

We have been able to achieve these improvements despite the recession in the world economy as a whole caused by the threat of war and the resulting contraction of export markets and increased oil prices.

We have thus laid the foundation for "Regaining Sri Lanka" - the development initiative launched by the Government.

On the peace front, two meetings of progressive discussions with the LTTE have taken place. The cease-fire has infused an air of optimism and renewed vigour in all aspects of the life of the nation.

Our steady progress received commendation at the Donors' Forum that was held in Colombo last June. Further recognition comes in the form of the forthcoming Donors' Conference in Oslo, and the Sri Lanka Donors' Forum scheduled to be held in Tokyo early next year.

Mr. Speaker, spectacular and over-night recovery of the economy cannot be expected in the backdrop of the past. But as I have just shown, a definite start has been made, which will give positive results in 2003 - 2004. Employment generation and wages will therefore increase from next year.

Our effort is to reform the economy in parallel with the peace process. The beneficiaries are the People of Sri Lanka. The process has to be sustained and carried forward. Political continuity and stability are essential pre-requisites for this. We endeavoured to establish such stability by strengthening the Constitutional authority of Parliament, which represents the collective national will.

The significant improvements in the economy which I have outlined above have, it should be noted, been achieved by a Government which has been in office for only ten months.

The economic principles spelt out in the Government's first Budget will be continued through this Budget. In this way, consistent development

could be assured through 2003 and into 2004. Our principal objectives will be,

- ◆ reducing the public debt to a manageable level
- ◆ stimulating economic growth
- ◆ increasing employment opportunities and earning capacity.

At this point I desire to draw attention to a criticism made without merit at our economic programme. It is claimed that we blindly follow the dictates of international Aid Organisations. This is not so. Our critics would do well to bear in mind that the previous Government itself entered into the Stand-By Arrangement with the IMF. Again, these political critics should awake to the fact that one of the world's most potent emerging nations economically - China- has discarded the political and economic creed that our critics still cling onto and is moving into the more enlightened and modern world trends in development. China's economy is perhaps the fastest growing in Asia, with a rate of approximately 8 percent of GDP. High growth, and interaction with the world outside its boundaries, have been the basis of their success. We intend doing the same, but always modifying our onward march to suit and protect national or local requirements.

### **THE DEBT CRISIS AND ECONOMIC RECOVERY**

Mr. Speaker, for too many years, Government has lived beyond its means. This did not spur growth or employment. Instead, our future was mortgaged by the whims of a Government committed to expanding itself without fixed goals or regard to costs or consequences. The national debt, which was contained at Rs. 550 billion in 1994, increased dramatically to Rs. 1450 billion by 2001. Today our debt equals 105 percent of GDP. This year, debt interest servicing alone has cost the Government Rs. 118 billion, and we have had to repay loan instalments of Rs. 38 billion in foreign debt and Rs.130 billion in domestic debt. Debt service payments amounted to Rs.286 billion, compared to Government revenues of Rs.262 billion. Unless we reduce this mountain of public debt, there will be no resources for development activities. This is arguably the most intractable of the economic management problems that we have had to grapple with.

Decisive action is required on two fronts to overcome the debt crisis. First, we need to reduce the budget deficit. Second, we require to sell under-utilised state-owned commercial assets to bring down the debt. Otherwise, the Government will be forced to raise money by increasing taxes on the People.

The choices before us are clear. We either take bold decisions and prosper; or settle for soft options and continue our downward spiral. Such bold decisions have already been taken and implemented, such as, the gearing of petroleum prices to world-market costs, and making more realistic the cost of electricity and water. These steps have become inevitable due to the past mismanagement in these utility services. Success depends on a constructive attitude. What we have done will bring benefits in the medium term.

## **PEACE**

The election victories of the UNF provide a clear mandate to end the conflict in the North-East. The Government has moved swiftly. The cease-fire agreement signed with the LTTE has held. Confidence-building measures have encouraged the free movement of people and goods throughout the country, and revived inter-province economic activity. Reconstruction work in the affected areas is moving ahead rapidly with donor assistance. Those who have suffered loss in the recent unfortunate incidents in Valachchenai and Muttur will be compensated. The Government will make available the requisite funds.

## **ECONOMIC PERFORMANCE 2002**

During the first half of 2002, economic growth turned around, recording positive, albeit low, growth. Inflation decelerated. External reserves increased. Financial markets and exchange rate stability strengthened. Interest rates decreased. Some fiscal consolidation took place with the implementation of the last Budget proposals. There are signs that business confidence has improved with positive movement on the stock exchange. Mr. Speaker, we have an economy that is reviving; but more has to be systematically done to attain our targets.

The economy is expected to grow at 4.5 percent during the second half of this year, enabling an annual growth of 3 percent for 2002. Inflation has declined from 14.2 percent to 9 percent and is expected to stand at 8 percent at end 2002. Improved business confidence, the removal of war risk charges, the discontinuation of power cuts, progress on the peace front, and the Government's macroeconomic policies contributed to these improvements.

On the external front, the balance of payments projections for the year anticipate an increase in the current account deficit from US \$ 272 million to US \$ 467 million. However, this will be offset by an expected increase in private capital flows and long-term inflows, resulting in an overall balance of payments surplus of US \$ 337 million. This surplus will raise gross official reserves to approximately US \$ 1700 million (3.3 months of imports). The country's total external reserves are expected to be US \$ 2600 million (5.4 months of imports). Meanwhile, the foreign exchange market has become more stable. Forward market activity has increased sharply and the forward margin has decreased. Both these developments reflect increasing market confidence.

## **TAXATION REFORMS**

The focal point of our taxation reforms was the transformation of the GST and NSL into a new Value Added Tax (VAT).

As undertaken in the last Budget, we have abolished complicated taxes such as the Advance Company Tax (ACT). Ad-hoc taxes such as the surcharge on income tax have been eliminated. Relief was granted to low-income earners by increasing the threshold for income tax liability from Rs. 144,000 to Rs.240,000 per annum.

A Revenue Authority, referred to in the last Budget is being established. It will reorganise the functions of the different revenue collecting agencies. These functions will be co-ordinated under the Authority to cater for less bureaucracy, more efficiency, and increased collection of revenue.

Mr. Speaker, as I pointed out last time, it is estimated that there are large sums of money that have not been declared for tax over the past several years. In order to harness this money into development, we enacted the Inland Revenue (Special Provisions) Law to free such monies from penal consequences, if they were declared and invested in approved areas. The tax collection base is still not as wide as it should be, resulting in loss of revenue. We therefore intend giving errant citizens a final opportunity of entering the tax regime without loss of their credibility by expanding the protection given to those persons who make use of the benefit of this Special Provisions Law by immunising them also against penal consequences that may flow from other related tax laws, as set-out in the Notification published on 1st November 2002.

Commencement of a new tax regime from 01<sup>st</sup> April 2003 is contemplated.

## **GOVERNANCE**

Along with reforms aimed at streamlining our tax system, we have endeavoured to maintain fiscal prudence by restraining budgetary expenditures. Strict limits are observed when releasing budgetary allocations. Revenue shortfalls have been met with reductions in non-priority current expenditures of Government departments.

## **Defence Committee**

A Defence Committee which has been entrusted with the task of maintaining defence expenditure has been set up. In the past, substantial defence obligations that were not budgeted for were incurred. In 2002, we have had to pay nearly Rs. 15 billion to clear accumulated defence arrears. For 2003, Rs. 23 billion has to be paid on this account. It has caused Government to borrow resources that could better be utilized by our private sector. The appointment of the Defence Committee has put in place an institutional arrangement to regularise and control defence expenditure.

## **Annual Accounts and Performance Reports**

Secretaries of Ministries have been asked to observe strict time limits in the submission of annual accounts and performance reports to the Ministry of Finance, commencing from the financial year 2002. The reports are required to highlight the performance of the institution in the delivery of services and their cost effectiveness. Starting in the third quarter of 2003, those Government departments which do not submit their accounts and performance reports in due time will have their funding curtailed.

## **Fiscal Management (Responsibility) Law**

My maiden Budget speech stressed the importance of good governance for the effective implementation of fiscal policy. I am proud to say that we will shortly be laying the necessary foundations for this through the passage of the Fiscal Management (Responsibility) Law, which is presently before Parliament. The lack of fiscal prudence in the recent past highlighted the need for such legislation.

Mr. Speaker, this legislation stipulates that the Government lays before Parliament and the public, a statement detailing the Government's fiscal policy, objectives, targets and performance. This has to be done with the Budget. Thereafter, a mid-term review of performance, and a final performance report at the end of the financial year, have to be placed before Parliament. Responsibility is cast directly on the Minister of Finance to ensure fulfilment. Substantial deviations from announced targets are required to be placed before Parliament. The law further calls for the Government to declare the fiscal implications of any policy measures promised in the run-up to a general election.

Over the medium term, this law envisages a reduction in the Government debt to a level not exceeding 85 percent, and the budget deficit to 5 percent of estimated GDP by the end of 2006. These are targets that have to be achieved.

## **Welfare Benefit Law**

Poverty reduction and subsidy programmes in this country have been beset by weak targeting and management. This has led to high budgetary costs for the Government, while benefits have not reached the poor, as they should. Under the recently enacted Welfare Benefit Law, the Governing Board will be appointed in consultation with the Constitutional Council to ensure its independence. New procedures for identifying beneficiaries on stipulated criteria are being adopted. The various on-going welfare programmes will be reviewed and brought under the requirements of the new law.

Experience has proved that mere handouts for subsistence and state subsidies are not the answer. Future welfare services will therefore be directed towards training beneficiaries for gainful employment, particularly self-employment. However, an effective social safety net will be continued for the sick and disabled.

## **Pension Reforms**

I announced in the first Budget a move to a contributory Pension Scheme for public officers. This will be implemented from January 1, 2003 with new recruits to the public service contributing 8 per cent of their salaries and the Government a further 12 percent. Salaries will be adjusted accordingly. At present, there is an unfunded pension liability of Rs.550 billion. The new pension system will help to cure this. It will also discourage uncurtailed growth in the civil service, since under the new system, only those who contribute to public pensions will receive this benefit.

## **Administrative Reforms**

Mr. Speaker, Sri Lanka has the largest public service in the world on a per capita basis. We cannot have a competitive economy without reducing recurrent expenditure in the public sector. The functions of all Government institutions are therefore being reviewed. Agencies that have outlived their

usefulness or are duplicating functions will be closed or merged. Vacant posts have been eliminated, and any new recruitment must be able to demonstrate a justifiable need.

The Tissa Devendra Salaries Commission Report has recommended an increase in public sector wages. The Commission has further recommended the making of a thirty percent reduction in the cadre of public officers particularly, in the middle and lower levels over a five year period. The resulting unemployment by such a drastic lay-off has not been addressed by the Commission. The practicality of this recommendation is therefore doubtful. The steps the Government is taking to reduce redundant posts, which I just referred to, appear to be the better considered method. This House will have to decide whether or not to implement the Commission's Report as it could precipitate sudden unemployment hardships to public officers.

### **Reducing Government Overdraft Facility**

The unsustainable overdraft facility, which the previous Government had utilised, at high cost to budgetary finances, has been drastically reduced. The interest charges for such a facility exceed the interest paid by the Government to borrow from the public. We have moved decisively to reduce the outstanding balance on our overdraft facility from Rs. 38 billion at the beginning of this year to Rs. 5 billion as at end - October. The lowering of the outstanding overdraft balance has significantly reduced the financing requirements in our daily budgetary operations by lowering interest expenditure.

### **PRIVATISATION**

Government is still involved in a number of loss making commercial activities that can be more efficiently performed by the private sector. Such services are therefore being released from State hands. We hold the mandate of the People to do so in the larger interests. The previous Government had also agreed to privatisation in the Stand-By Arrangement with the IMF.

The Public Enterprises Reform Commission has been continuing the privatisation programme under the control of the Cabinet. Pelwatte Sugar, Sevanagala Sugar, Lanka Marine Services and certain cluster bus companies have already been privatised. Work is in progress to sell some shares of Sri Lanka Telecom, and the Sri Lanka Insurance Corporation. The proceeds of these sales will provide resources for development. We are therefore proceeding with it, adopting transparent procedures.

## **LAND**

The land market is being relieved of stringent and archaic rules. Legislation to vest absolute title in those in occupation of State land under permits will be presented to Parliament shortly. This will benefit 1.2 million persons.

## **LABOUR**

The delays in dispute resolution and inquiries under the Termination of Employment of Workmen's Act caused considerable hardship both to workers and employers. We have addressed this problem by enacting the Industrial Disputes (Special Provisions) Act providing for completion of inquiries within a stipulated time frame. A more equitable termination compensation framework has also been enacted.

The Workers Compensation Ordinance is being amended to enhance the compensation awarded under this law.

## **CAPITAL**

The Government is proceeding with reforms designed to strengthen the financial sector and improve financial intermediation within the economy. A start has already been made in reducing high interest rates, which tend to promote inflation. Strong economies have low interest rates as their base. Improving effectiveness of the State owned banks will play a significant role in reducing lending rates of the commercial banks. The restructuring of the People's Bank was a part of the Stand-By Arrangement

entered into by the previous Government with the IMF because of heavy borrowings by the then Government, which had brought about this Bank's financial woes. The Government is considering various options. Recovery of the non-performing loans will be placed in the hands of an Asset Management Company.

## **POWER AND ENERGY**

Cost escalation, stemming from inefficiencies in this sector, are passed on through the whole system and adversely impact on many aspects of the nation's life. In March, we took steps to arrest the heavy losses incurred by the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC).

Since then, the Government has been able to end the power crisis in the country by establishing the Energy Supply Committee which took prompt action to rectify the power shortage. Action was also taken to rehabilitate the electricity supply system in the Jaffna Peninsula. The Government is pursuing vigorously the target of providing electricity to 80 per cent of the population by end 2003.

The new Electricity Act was presented to Parliament and action is underway to separate the generation, transmission and distribution functions of the CEB. These would be operated as autonomous business entities. The Public Utilities Bill provides the legal basis upon which the Utility Regulatory Authority can regulate pricing, licensing, quality and performance standards for our public and private utilities.

In the petroleum sector, the automatic fuel price adjustment mechanism is in operation. Importation of petroleum products will be opened up to international suppliers on franchises. By doing this, competition will increase and prices will be reduced.

We removed the loss recovery charge from petroleum products, as it is wrong to penalize consumers for the past omissions of the Ceylon Petroleum Corporation. These institutions are now required to work as viable entities.

## **PRIVATE SECTOR DEVELOPMENT**

The beginning was made with the last Budget when we removed many taxes which retarded the private sector. In the past year, substantial deregulation has been effected to further liberalise the enabling environment. Up dating of relevant commercial laws such as the Banking Act and the Monetary Law Act is ready for implementation. The proposed Revenue Authority will further remove administrative obstacles. The new Exchange Management Law will ease exchange restrictions.

We have created the requisite liberal atmosphere and adjusted taxes to enable active participation by the private sector in the economic growth process. It is now up to this sector to move in fast, increase productivity and create jobs and enlarge markets. The country looks to the private sector for early initiative.

## **RURAL DEVELOPMENT AND THE YOUTH CORP**

Mr. Speaker, re-invigorating the rural economy has to be a crucial part of any development strategy for Sri Lanka since some 60 percent of our people still live in the rural sector. Our rural sector is characterised by low productivity and low incomes. The transformation of our rural economy requires an up grading of technology and far greater vocation-oriented education.

Our strategy for revitalising agriculture is based on establishing farmer organisations. In the case of water resources, farmer organisations will be provided entitlements to a certain quantity of water for distribution amongst its members. Funding is being considered to enable these organisations to purchase and hire to members' farm implements which are too expensive to be individually owned and for maintenance of village tanks.

The Youth Corps is designed to produce a workforce that could service the job market. It will provide market-oriented vocational training for unemployed youth in eight regions through 160 centres. The Government will identify at least one centre in each district to start the first

round of implementation. Notices for management staff and the first batch of Youth Ranger Leaders will be published by December. This will be followed up with recruitment of English teachers, computer instructors, and applications for Youth Rangers to undergo an initial round of training. Around 40,000 Youth Rangers will initially benefit from this scheme.

I shall later state the financial inputs that will be made available to the rural sector for its progress on the above-stated lines.

### **COST OF LIVING**

Containing the cost of living has been a priority objective of the Government. To enable the private sector and traders to make agricultural produce and also consumer merchandise available in the market place at affordable prices, the Government took decisive steps. We reduced the customs duty surcharge from 40 percent to 20 percent; stamp duty on commercial documents was abolished; interest rates reduced; the income tax surcharge of 20 percent was removed; corporate taxation was reduced to 20 percent for companies with a taxable income of less than Rs. 5 million; Goods and Services Tax and National Security Levy were abolished; essential food stuffs and pharmaceuticals are exempted from the VAT; the loss recovery charge on fuel was removed. All these measures depleted revenue, but were nevertheless implemented to reduce prices. We are unhappy to see that the resulting benefits have not been passed down by the trading sector to the consumer. Discussions held with the appropriate Trade Chambers have not produced significant outcomes. Whilst the Government does not accept the policy of price control, nevertheless, in the public interest, we are looking to a legal mechanism, possibly the Consumer Protection Law, whereby equitable price levels for the consumer could be ensured on essential items. This is receiving our considered and urgent attention.

### **ECONOMIC PROSPECTS FOR 2003**

The economy is expected to record a growth rate of about 5.5 percent, reflecting recovery in all major sectors. Inflation should decline further to 8 percent. This should result in a further easing of interest rates

and reduced pressure on wages. Improved business and consumer confidence should result in higher investment, particularly, in the private sector. This would create more jobs and increase wages by mid 2003. Providing greater employment outside the public sector and improvement of remuneration in both sectors will be then carefully reviewed.

Sri Lanka's external sector is also expected to improve. Export growth is estimated to be around 13 percent in US Dollar terms. Increased economic activity is also expected to result in import growth of 16 percent in US Dollar terms. The tourism industry, which has shown a significant improvement, will experience further growth in 2003, with the on-going peace process. Foreign direct investment is most likely to continue to increase in 2003 with improved macro-economic fundamentals and progress in the peace process. Reflecting the favourable developments in the external sector, the external assets of the country should improve further in 2003, reducing pressure on the exchange rate. The buoyancy in the share market is likely to continue.

The Government needs to continue with fiscal consolidation. We intend to reduce the fiscal deficit from 8.9 percent of GDP to 7.5 percent in 2003.

There are however, significant risks associated with the world economy. Recovery in the major economies, U.S., Europe and Japan continue to be fragile. Any setback would be damaging to our export markets. The Sri Lankan economy is also vulnerable to any sharp increase in oil prices.

Mr. Speaker, actions speak louder than words. It is quite easy to talk about new policies, but it is far more difficult to achieve tangible changes. To ensure that the economic reform program is fully implemented, an Economic Management Law will be submitted to Parliament for approval. This is in addition to the Fiscal Management (Responsibility) Law. The Economic Management Law will oblige the Government to report to Parliament, on a bi-annual basis, on the progress that has been made in each Ministry in implementing economic reforms. Under that Law, the budgets for the respective line Ministries will be directly linked with progress made in implementing reform.

Over the next twelve months, we have an agenda of reforms to undertake. Amongst others, this includes:

- Enactment and implementation of the Economic Management Law; and the Fiscal Management (Responsibility) Law;
- Promulgation of a new Monetary Law and Exchange Management Law.
- Creation of an Asset Management Company to work out the distressed assets in our banking system.
- Liberalisation of the petroleum sector.
- Development of a new 300 MW power plant in Kerawalapitiya by private enterprise.
- Introduction of new public acquisition procedures for land, to ease the process of developing our nation's highway network;
- Launching of E-Lanka to bring the benefits of modern computer technology to the way in which Government does its business, with donor financial and technical assistance.