MID – YEAR

FISCAL POSITION REPORT 2003

Issued under section 10 of the
Fiscal Management (Responsibility) Act No. 03 of 2003

K.N. Choksy, PC, MP
Minister of Finance

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1. Background

From the point of taking office, the Government has made clear its commitment to fiscal responsibility, discipline and transparency. With this in view, the 2003 Budget was prepared within a medium term framework rather than for short term gain or political expediency.

The Government's commitment was further manifested in the passing of the Fiscal Management (Responsibility) Act, No.03 of 2003 in January, 2003. Section 3 of the Act sets out its fiscal objectives, and provides five stages at which the Government is required to account to Parliament and the public on its record in the management of the public economy.

Section 10 of the Act, requires that a Mid-Year Fiscal Position Report, in respect of the fiscal performance during the first four months of the year be released to the public by the last day of June of the year and thereafter laid before Parliament. This Mid-Year Report is issued in compliance with this requirement.

The Law indicates that the objective of the Mid-Year Report is to provide updated information on the Government's fiscal performance and thereby enable an evaluation of the Fiscal performance against the fiscal strategy of the Government, as set out in the Fiscal Strategy Statement that is required to be presented with the second reading of the Appropriation Bill. However, as the Law was passed by Parliament subsequent to the second reading of the Appropriation Bill for 2003, no statement was presented by the Government for 2003. Hence, this Report compares developments with the strategies as stated in the Government's Budget for 2003.

2. Budget 2003

The Government presented its Budget 2003 in the context of a need to reduce the fiscal deficit, contain the burgeoning public debt, introduce structural reforms on the fiscal front and achieve medium-term fiscal sustainability.

The highlights of Budget 2003 were:

- a reduction of the fiscal deficit to 7.5 per cent of GDP;

- a reduction of the current account and primary deficits to 2.3 per cent and 0.2 per cent of GDP, respectively;
- an increase in revenue by 0.3 percentage points, to 17.1 per cent of GDP by increasing tax revenue by 0.4 percentage points from 14.5 to 14.9 per cent of GDP;
- a reduction in current expenditure by 1.8 percentage points to 19.3 per cent of GDP;
- an increase in public investments by 0.7 percentage points to 5.3 per cent of GDP; a repayment to the banking sector of 0.8 per cent of GDP (Rs.14 billion).

The increased tax revenue was expected to be through new revenue measures such as the Value Added Tax, broadening the tax base through rationalising tax exemptions and incentives, and strengthening tax administration through the establishment of a Revenue Authority.

Expenditure was to be reduced through strict controls and reduction of recurrent expenditure, to be achieved by containing the size of the public service, better targeting of welfare benefits, curtailing non-priority expenditure, reducing interest expenses by improving public debt management, and containing defence expenditure to appropriate levels.

3. Recent Developments

Fiscal performance is critically affected by economic and other events elsewhere. Hence, a close watch needs to be maintained on such events. Several encouraging developments have taken place, but there also occurred events of concern.

- The unprecedented amount of assistance to support Sri Lanka's ongoing reforms and peace process.
- The acceptance of the Governments policy document, "Regaining Sri Lanka: Vision and Strategy for Accelerated Development".
- The approval by the International Monetary Fund of a Poverty Reduction Growth Facility and Enhanced Financing Facility for our country.
- The continuing ceasefire agreement between the government and the LTTE and its beneficial effects on the economy.

Yet, certain factors beyond the control of the Government have impacted on the economy.

- The Iraqi war required a government subsidy on diesel and kerosene to cushion the adverse consequences to the public. There was also a detrimental impact on export, particularly tea.
- Additional expenditure to provide relief to citizens affected by the recent floods and to restore the damaged infrastructure in five districts.

4. Economic Growth - 2003

The recovery achieved in economic activity in 2002 has continued in 2003, strengthened by the government's commitment to consistent policies and economic reforms.

Certain sub sectors in agriculture performed well in the first few months of 2003. The Maha paddy crop reached a record level. The production of rubber increased. However, tea plantations in the South were damaged by the recent storm and floods.

The government has committed itself to ensuring an uninterrupted supply of power to the country. Adequate rainfall has enabled the increased generation of hydropower, thereby increasing the cost efficiency of the Ceylon Electricity Board. Construction sector has recovered in the first quarter and is expected to grow further in the latter part of 2003. The industrial production has been improving with the recovery in export demand. The private sector industrial production volume index rose by 4.6 per cent during the first four months of 2003 over the corresponding period in 2002.

The continuation of the ceasefire has led to enhanced service sector activities particularly in the telecommunications, transport, hotel and related services. Tourist arrivals and earnings thereon have increased by approximately 28 per cent during the first four months of 2003. Operations in the Port of Colombo indicate a 7 per cent increase in ship traffic.

The recovery in Sri Lanka's international trade has continued with both exports and imports having increased by about 13 per cent in US dollar terms in the first four months of 2003.

The growth in both exports and imports resulted in an increase in the trade deficit (due to the broader base of imports), from US $ 503 million in the first four months of 2002 to US $ 566 million in 2003. However, this increase was more than offset by increased inflows through private remittances, capital inflows and portfolio inflows, resulting in a surplus in the overall balance of payments, and the growth in foreign reserves.

Confidence in the Sri Lankan economy has grown both among foreigners and Sri Lankans living abroad. Private remittances have increased by approximately 11 per cent and amounted to US $ 457 million during the first four months of 2003, in comparison to US $ 412 million during the same period of 2002. The stock market, whose activity has increased, has continued to record net inflows, with net foreign investments amounting to around US $ 5.1 million in the first four months of 2003 compared to US $ 3.8 million in 2002.

Sri Lanka's foreign reserves have grown considerably and are now at relatively comfortable levels (sufficient to cover about 5.1 months of imports). The foreign exchange market has been stable with the rupee depreciating only by around 0.5 per cent against the US dollar in the first half of 2003.

5. Inflation and Interest Rates

A matter of concern to the Government has been the relatively high inflation in the past. Consequent to the measures taken, there has been a steady decline in inflation in 2003. The point-to-point change in the Colombo Consumers' Price Index (CCPI) has decreased from 13.6 per cent in January 2003 to 6.0 per cent in May, while the annual average has decreased from 10 per cent to 9.5 per cent over the same period.

This downward trend in inflation is expected to continue during the balance part of the year. The decline in inflation has led to a reduction in market interest rates. The Central Bank has also reduced its interest rates. These reductions have been reflected in the yields on government securities, and the interest rates of financial institutions. Following discussions with the Government, commercial banks have taken steps to pass on the benefits of the reductions in official interest rates to their customers by reducing their lending rates.

6. Monetary Developments

Private sector credit growth was around 13 per cent by end April compared to 5.3 per cent in April 2002 helping to support economic recovery. Borrowing by the public corporations has been curtailed. Plans are being implemented to improve the financial management of major corporations and thereby ensure their economic viability. Proceeds from divestment would be used to reduce public sector liabilities to the banking system.

As noted in the Budget, the Government would continue to exercise fiscal discipline and improve its Treasury cash management. In 2002, the overdraft with the two state banks was reduced by around Rs.35 billion through the issue of market oriented debt instruments. The overall credit to the Government from the banking system had been reduced by around Rs.11 billion in the first four months of 2003. The Government intends to reduce this outstanding level of borrowing still further. This would, inter alia, enable release of more funds to the private sector.

7. Statements Mandated by Section 12 of the Act

(a) Expenditure

Total expenditure and net lending of the government, based on the economic classification, during the first four months amounted to Rs.147 billion. Of this Rs.120 billion was on recurrent expenditure while the balance Rs.27 billion was on capital expenditure and net lending. Total expenditure in the first four months reflects 33.5 per cent of the total budgeted for the year.

Strong expenditure control measures implemented by the Government have contained recurrent expenditure to Rs.120 billion, a growth of only 4 per cent over the previous year. This was 34.7 per cent of the annual estimated expenditure.

The introduction of the contributory pension scheme to persons joining the public service on or after 1st January 2003 as opposed to the payment of pensions out of the Consolidated Fund is an important measure taken towards controlling future expenditure.

The wage bill, including defence wages, which was estimated to absorb 26.3 per cent of the recurrent expenditure, accounted for 24.8 per cent. Strict adherence to the announced policy of freezing of hiring to the state sector, other than for technical grades, helped in achieving the target.

Interest payments, the single largest item in recurrent expenditure, at Rs.44.3 billion accounted for 34 per cent of the annual amount estimated for the purpose. Improved cash and debt management, have helped to reduce interest rates, and hence to keep interest expenditure under control. This will also reduce the interest burden in 2004 and the medium term.

The ongoing peace process has had a direct beneficial impact on the government budget. Total ***defence spending*** , in the first four months of 2003, was 16.1 per cent of the recurrent expenditure, as against an estimate of 18.1 per cent and utilised only 30.7 per cent of the annual allocation.

Pension payments, which account for 9.7 per cent of estimated recurrent expenditure, showed only a 0.5 per cent growth during the first four months over the corresponding period of the previous year. Total pension payments at Rs.10 billion used only 30 per cent of annual allocation for the purpose.

Samurdhi payments at Rs.3 billion had used 33.8 per cent of its annual allocation during the first four months. The total expenditure on subsidies and transfers, including pensions and Samurdhi, which amounts to 22.2 per cent of the estimated recurrent expenditure, was contained at 32 per cent of the annual estimate.

The government increased its investment expenditure. Capital expenditure and net lending grew by 21.2 per cent over the previous year, while foreign financing on projects increased by 43.6 per cent. The spending on capital projects during the first four months accounted for 29 per cent of the funds allocated for the year and showed an improvement in the utilisation of foreign aid in comparison to past trends.

With Rs.94.3 billion of revenue, and Rs.146.8 billion of expenditure, including interest payments of Rs.44.3 billion, the primary deficit amounted to Rs.8.2 billion. This is an improvement when compared with the primary deficit of Rs.9.6 billion recorded in the same period of the previous year. However, the primary deficit of the current year exceeded the targeted deficit of Rs.1 billion for the first four months in 2003. This is solely due to increased spending incurred in foreign funded capital projects.

(b) Revenue

Total revenue collection based on the economic classification, during the first 4 months of 2003 amounted to Rs.94.3 billion. This was 31 per cent of the estimated revenue for the year. Revenue collection during the comparable period of the previous year was 34 per cent. Of the total revenue, tax revenue amounted to Rs.72.2 billion, and non-tax revenue amounted to Rs.22 billion.

Tax revenue collected was 27 per cent of the estimates whilst the non-tax revenue collected amounted to 56 per cent of the expected annual figure. The under performance of VAT and corporate income tax were the main causes for the drop of revenue collection under taxes.

Income Tax

Income tax collections were Rs.11.8 billion, an increase of 48.5 per cent over 2002. This increase was mainly due to collections from the withholding tax on interest. The collection of corporate and personal income taxes, net of withholding tax, however, shows a decrease of 12 per cent. Total collections of income tax during the first four months of 2003 realized 24 per cent of the estimate, compared to 21 per cent last year. It is however, the normal trend in income tax collection to have disproportionately low collections in the first few months.

Import duty

Import duty collection amounting to Rs.10.7 billion during the first 04 months shows an increase of 21 per cent and was 32 per cent of the estimated revenue, compared to 31 per cent in the previous year. Realisation of revenue under this category was a consequence of the growth in imports.

Excise Taxes

Total collections under excise taxes amounted to Rs.15 billion in the first four months of 2003. This consists of Rs.6 billion collected from cigarettes, Rs.3 billion from liquor, and Rs.5 billion from petroleum, vehicles and beverages. Total collection from excise taxes was 30 per cent of the annual estimates. Excise tax collection on cigarettes decreased by 2.5 per cent compared to the previous year, mainly due to the shifting of about 8 per cent of excise duty on cigarettes to VAT to retain the prices unchanged with the introduction of the VAT. Tax on liquor, recorded a drop of 11 per cent in comparison with 2002 due to unification of tax legislation on liquor which changed the pattern of collection of revenue.

Other Taxes

The Ports and Airports Development Levy and the ***Debits Tax*** have performed satisfactorily, each bringing in 27 per cent of the respective annual estimates. Licence taxes have brought in Rs.280 million, 10 per cent of the estimated revenue.

Value Added Tax (VAT)

VAT collections of Rs.31 billion, during the first four months of the current year, amounted to 26 per cent of the estimated revenue. The VAT replaced the Goods and Services Tax (GST) and the National Security Levy (NSL). During the first four months of the previous year tax collection under GST and NSL achieved 35 per cent of the annual collections. VAT, as the main indirect tax, is expected to generate 46 per cent of the total tax revenue. However, collections of VAT during the period under consideration have been below expectations.

The refunds of input credit under GST/VAT has increased from 12 per cent in 2002 to 14 per cent in 2003. One of the main reasons for this increase is that with the introduction of VAT, certain industries such as construction, leasing etc., that are liable to VAT at 10 per cent have as a substantive part of their input supplies that have been liable at 20 per cent resulting in large claims for refunds. Further, due to heavy capital expenditure in sectors such as electricity and communication, input credit claims have increased above the normal limit resulting in high refunds during this period. However, this position would be arrested to a certain extent with claims allowable on input credit accrued and available to the leasing industry being limited to 10 per cent on all input supplies with effect from July 2003.

In addition, although imports have increased substantially much of this increase is in the categories of imports not liable to VAT or those paying VAT at the rate of 10 per cent.

Non-tax Revenue

Revenue from non-tax sources, except for profits of the Central Bank and rent income, was according to estimates. Profits of the Central Bank remitted to the Government amounted to Rs.7.5 billion against the estimated Rs.10 billion. However, this shortfall was met by the transfer of Rs.2 billion from the Strike Riot and Civil Commotion and Terrorism Fund to the Consolidated Fund. Rent income collected was only 14 per cent of the annual estimate.

(c) Cash Flow operations of the Government

Cash inflows of the Government during the first four months of 2003 amounted to Rs.106 billion as against an estimated Rs.105 billion.

Cash outflows on account of recurrent expenditure amounted to Rs.111 billion as against an estimated Rs.112 billion, generating a net cash deficit of

Rs.4.4 billion as against an estimated deficit of Rs.7.4 billion from operating activities.

Cash outflow on investment activities amounted to Rs.20 billion as against an estimated Rs.21 billion. This includes advances to District Secretaries /Government Agents totaling Rs.630 million for purchase of paddy, which is recoverable within the current year.

A summary of the cash flow estimates and actual performance for the first four months is given below.

Summary of the Government Cash Flow
January – April 2003 (Rs. billions)

Item	Jan – Apr Estimate	Jan – Apr Actual	Change
Total cash inflows	105.1	106.4	0.9
Total cash outflow from operating activities	(112.5)	(110.8)	1.7
Net cash flow from operating activities	(7.4)	(4.4)	2.6
Cash flow from investing activities	(21.3)	(19.7)	1.6
Net cash surplus / (deficit)	(28.7)	(24.1)	4.2
Opening cash balance	(3.5)	(3.5)	-
Net borrowings	28.1	29.5	1.5
Temporary Employed Balance adjustment	-	(1.4)	(1.4)
Ending Balance	(4.2)	0.4	4.6

(d) Borrowings

In Budget 2003 Parliament approved Rs.316 billion as total gross borrowings (in terms of book value). During January to April 2003, total gross borrowings amounted to Rs.144.8 billion, including private sector development loans. Of this amount, total gross domestic borrowings amounted to Rs.124.8 billion. With domestic repayments totalling Rs.87.3

billion and the Government operations with the banking sector resulting in a net repayment of Rs.1.7 billion, the net domestic borrowings during the first four months amounted to Rs.35.8 billion. Total gross foreign borrowings amounted to Rs.20.0 billion, including foreign borrowings for capital projects and private sector development loans, while repayments on foreign loans were Rs.10.8 billion. Budgetary net foreign borrowings, excluding private sector development loans, amounted to Rs.8.6 billion.

From January to April 2003, total financing amounted to Rs.52.5 billion, of which total net domestic borrowings were Rs.35.8 billion, net foreign borrowings were Rs.8.6 billion, and foreign grants amounted to Rs.2.1 billion. Privatization proceeds contributed Rs.6.1 billion towards financing the deficit.

(e) Other

Events after the presentation of Budget 2003 required the introduction of some changes to the financing of the expected deficit.

Privatisation proceeds, which were originally estimated to bring in Rs.13.5 billion, are now projected to yield Rs.17 billion.

With the reduction in interest rates, the government has taken action to repay high cost debt and replace them with low cost debt. Some of the rupee loans with an optional maturity in 2003, amounting to Rs.33.4 billion will be repaid. Therefore, repayments and gross borrowings will increase by Rs.33.4 billion. This is a shifting of high cost debt to low cost debt and will have no impact on net borrowings and the deficit target of 7.5 per cent of GDP.

8. Expected Fiscal Developments

The main fiscal target, the budget deficit, remains unchanged, from the 7.5 per cent of GDP projected in Budget 2003. The lower than budgeted collections from VAT, the postponement of extending VAT to the wholesale and retail sectors, and the delay in implementing a few other revenue proposals would constrain revenue. However, the Government is taking strong measures to generate additional revenue and is implementing alternative measures to offset this reduction. In this regard, the coverage of VAT has been extended to any person providing financial services as defined in Chapter IIIA of the VAT Act with effect from 1st July, 2003. Strengthened tax administration, especially the activities of the Large Tax Payers' and the VAT units of the Inland Revenue Department with work plans, inter alia, aimed at reducing arrears, are being closely monitored. Measures are being taken to ensure the expeditious receipt of funds from the divestiture of state owned enterprises scheduled for sale, such as the sale of the CPC.

Strict expenditure measures are being implemented to ensure that recurrent expenditure is contained in all Government activities. The projected reduction in interest expenditure would also enable a significant reduction in recurrent expenditure.

9. Conclusion

For the first time in the history of our nation, I have the privilege to present a mid Year Fiscal Position Report of the Government.

The Government enacted the Fiscal Management (Responsibility) Act to ensure that the financial strategy of the Government is based on principles of responsible fiscal management, and to facilitate periodic public and parliamentary scrutiny of fiscal performance.

This report provides an objective analysis of the economic position of our nation as of today.

All indicators show clearly that the Government's fiscal and monetary policies have placed the economy on an upward march–the Colombo Stock Exchange, the international support received at the Tokyo Development Forum, reduced inflation, reduced bank interest rates, a stable exchange rate, increasing foreign direct investment and remittances, greater tourist arrivals, increase in agricultural produce, particularly paddy are all signs of a vibrant economy in which there is public confidence. The opening-up of the markets of the North and East of the country and their productivity also added impetus to the economy.

This Mid-Year Fiscal Position Report reflects these realities of the Government's prudent management of the nation's resources.