

**MID - YEAR
FISCAL POSITION REPORT 2004**

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

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Dr. Sarath Amunugama, MP
Minister of Finance



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Contents

| | Page No |
|---|---------|
| 1. Introduction | 1 |
| 2. The Economy | 2 |
| 3. Budget 2004 and Revised Estimates | 3 |
| 4. Statements Mandated by Section 12 of the Act | 4 |
| a) Expenditure | 4 |
| b) Revenue | 6 |
| c) Cash Flow Operations of the Government | 10 |
| d) Borrowings | 11 |
| 5. Budgetary and Fiscal Policy | 11 |
| 6. Conclusion | 13 |

Mid-Year Fiscal Position Report

**Issued by the Hon. Minister of Finance
under Section 10 of the Fiscal Management (Responsibility) Act No.03 of 2003**

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| 1. Introduction |
|------------------------|

Section 10 of the Fiscal Management (Responsibility) Act No. 03 of 2003 requires that a Mid-Year Fiscal Position Report, in respect of 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.

Accordingly, this Report gives updated information on the Government's fiscal operations during the first four months of the current year against the estimates published in the Pre-Election Budgetary Report and compares the fiscal performance as against the Fiscal Strategy Statement presented to Parliament in November 2003 .

2. **The Economy**

The economy has been resilient during the first four months of the current year, despite the uncertainty that prevailed on the political front. Several sub sectors of the economy have continued their growth momentum.

Plantation agriculture has indicated a strong growth. In the paddy sector, the Maha output, however, has been adversely affected by the drought. Export and domestic oriented industries have expanded by around 6 per cent in comparison with the corresponding period of 2003. In the service sector, telecommunication and port activities have recorded a significant improvement. The total subscriber base of telephones has increased by 10 per cent, while the total cargo and containers handled in the ports have risen by 8 per cent and 10 per cent, respectively, in the first four months of the current year. Tourist arrivals, having witnessed an impressive increase in the first two months, have recorded a marginal set back during March and April. Due to the drought, generation of hydro power has dropped, increasing thermal power generation. The growth of the economy during the first quarter of the current year recorded an impressive rate of growth of 6.2 per cent of GDP compared to the 5.5 per cent of growth recorded during the corresponding period of the previous year.

Consequent to the recovery in the global economy, the exports during the first four months of 2004 have recorded a growth of 16 per cent, while imports have indicated a growth of 19 per cent, in comparison with the same period of 2003. Exports and imports during the first four months of 2003 grew by 13 per cent. However, due to the higher increase in imports arising mainly due to increased cost of petroleum imports, the trade deficit in the first four months of 2004, increased to US dollar 724 million from US dollar 566 million in the previous year. Although the increased prices of petroleum products and wheat have contributed to the increased value of imports, the 51 per cent growth recorded in imports of investment goods during the period is noteworthy. An increase in industrial exports, dominated by garment exports, mainly contributed to the impressive growth in exports.

Stock market activities have recorded a net inflow amounting to US dollar 4.7 million in the first four months of 2004 in comparison with US dollar 5.1 million in the same period of the previous year.

The country's total reserves have risen to US dollar 3,324 million (5.7 months imports) at end April, 2004 from US dollar 3,218 million, at the end of 2003. During the same period, gross official reserves have declined to US dollar 2,242 million from US dollar 2,329 million. The rupee had depreciated by around 2 per cent against the US dollar at the end of April, 2004.

3. Budget 2004 and Revised Estimates

The Budget 2004 envisaged –

- A budget deficit of 6.8 per cent of GDP;
- Current account and primary deficits of 1.3 percent and 0.8 of GDP, respectively;
- Revenue of 16.4 per cent of GDP;
- Current expenditure to be limited to 17.6 per cent of GDP;
- Public investments to be 5.3 per cent of GDP;
- An amount of Rs.350 billion as total gross borrowings.

However, the above-mentioned estimates have been revised in February due to several reasons including the relief package granted to households in drought stricken districts, the subsidies granted to minimize the impact on the cost of living arising from the increased international prices of oil, gas and wheat, the delays involved in introducing revenue augmenting amendments to the Value Added Tax and the Income Tax laws, as published in the Pre-Election Budgetary Position Report.

Accordingly, the revised estimates anticipate:

- A budget deficit of 7.3 per cent of GDP;
- Current account and primary deficits of 2.2 and 1.4 of GDP, respectively;
- A total expenditure of 23.1 per cent of GDP (current account expenditure at 18 per cent of GDP and capital expenditure of 5.1 per cent of GDP);
- Revenue of 15.8 per cent of GDP.

The Pre-Election Budgetary Position Report also indicated several significant downside risks which are likely to affect achieving the above-mentioned estimates.

4. Statements Mandated by Section 12 of the Act

(a) Expenditure

Total expenditure and net lending of the government during the first four months, based on the economic classification, amounted to Rs. 156 billion. Out of this, Rs.121 billion was on current expenditure while the balance Rs. 35 billion was on capital expenditure and net lending. Government's total expenditure and net lending during the corresponding period of the previous year amounted to Rs.147 billion. Of this, Rs.120 billion was on current expenditure and Rs.27 billion on capital expenditure. Total expenditure in the first four months of the current year amounted to 33.3 per cent of the revised budget estimates published in the Pre-Election Budgetary Report of 2004, while the current expenditure of Rs. 121 billion during the first four months of 2004 reflects a marginal increase over the same period of the previous year. This was 33.1 per cent of the revised annual estimates. Capital expenditure, which indicates an increase of 30 per cent over the same period of the previous year, amounted to 34 per cent of the revised estimates.

The wage bill, including defence wages, accounted for 32.2 per cent of the revised estimates. The wage bill during the period under review has increased by 15 per cent

over the corresponding period of 2003, reflecting the implementation of the salary revision announced in Budget 2004.

Interest payments at Rs. 44 billion, reflected 36 per cent of the revised estimate. With the lower interest rate regime that continued to prevail during the first four months in 2004, the interest payments declined marginally over the previous year.

Pension payments, which account for 10.2 per cent of revised estimated recurrent expenditure, showed a growth of 6.5 per cent during the first four months over the corresponding period of the previous year. The pension revisions granted in the Budget 2004 was the main contributory factor for this increase. The pension payments, at Rs 11 billion, utilized 29 per cent of annual estimates.

Samurdhi payments at Rs 3 billion had utilized 33.9 per cent of its revised annual allocations during the first four months. The total expenditure on subsidies and transfers, including pensions and Samurdhi, which amounts to 22.6 per cent of the estimated recurrent expenditure was contained at 28 per cent of the annual estimates.

Capital and net lending grew by 30.2 per cent in the first four months in 2004 compared to the same period in the previous year. Foreign financing on projects increased by 12 per cent. Spending on capital projects during the first four months accounted for 34 per cent of the allocation of funds for the year, reflecting improvements both in the utilization of foreign funds and release of rupee funds for capital projects.

With Rs. 91.7 billion of revenue and Rs. 155.9 billion of expenditure, the primary deficit during the first four months of 2004 amounted to Rs. 20.5 billion compared to Rs. 8.2 billion recorded in the same period of the previous year. Among the major contributory factors for the increased primary deficit were the increase in capital expenditure and net lending and reduced revenue.

(b) Revenue

Total revenue collected during the first four months of 2004 amounted to Rs.91.7 billion registering a drop of 3 per cent over the corresponding period of 2003. The revenue collection of the current year realized 29 per cent of the revised estimates. Of the total revenue, tax collection amounted to Rs.82.8 billion indicating a healthy increase of 15 per cent over the collection of Rs.72.2 billion in the previous year. However, the non-tax collection during the period under consideration at Rs.8.9 billion indicated a sharp drop of 60 per cent over the collection of Rs.22 billion last year. The total tax collection and the non-tax collection reflected 30 per cent and 22 per cent of the annual revised estimates.

The decrease in total revenue collection of the Government during the first four months of 2004 was on account of the significant decline registered in non-tax revenue collection in comparison with last year. Non-tax collection during the comparable period last year was heavily frontloaded with several transfers of funds such as transfers from the Strike, Riot, Civil Commotion and Terrorism Fund, Customs fines and forfeitures and high Central Bank profits which were of a once and for all nature. The absence of such transfers during the first few months of the current year contributed to the sharp drop registered in non-tax revenue and thereby the drop in total revenue.

Income Tax

Income tax collection during the first four months of 2004, at Rs 9.5 billion, registered a decline of 20 per cent over the same period of 2003. Withholding tax collection which dropped to Rs 3.1 billion in this period from Rs 5.6 billion in the same period of 2003, was the main cause for this decline. The lower interest rates that prevailed during the period under review, shorter maturities and lower issues in gross terms of the Treasury bonds in Jan-April 2004 compared to the same period in 2003 contributed to the decline in withholding tax collections. The collection of corporate taxes, at Rs.2.8 billion, recorded a drop of 4 per cent, while the collection under personal Income Tax at Rs. 3.6 billion indicated an increase of 9 per cent over the correspondence period of the previous year. The lower amount of taxes paid by a few banks, two large state entities and the tea

sector during the period under review in comparison to the same period last year was responsible for drop in corporate tax revenue.

The Tax amnesty granted and the delay in introducing several amendments to the Inland Revenue Act aimed at augmenting revenue, were responsible for the drop in Income Tax collection.

Import Duty

Revenue from import duties, at Rs 13.1 billion, recorded an increase of 22 per cent over 2003. This was 32 per cent of the revised estimated revenue for 2004. A 19 per cent growth in imports in US dollar terms as against the estimated growth rate of 10 per cent favorably contributed to the growth in revenue from import duties. Although the partial duty waivers granted on commodities such as B onions, potatoes, chillies and milk powder and full waiver granted on sugar, lentils and wheat during the first four months of 2004 resulted a loss of revenue amounting to Rs 963 million, the impressive increase in the value of imports have helped to offset this effect. The upward revisions in tariff bands announced in the Budget 2004 and increases in specific duties on agricultural commodities such as rice, sugar and B onions in the latter part of 2003 which were effective until the end of January 2004 also contributed to enhanced revenue collection from the import duty during the period under consideration in comparison with 2003.

Excise Duty

Total collection under excise taxes amounted to Rs 20.9 billion during the first four months of 2004 indicating a growth of 39 per cent during the period under review in comparison with the same period of 2003 and accounted for 36 per cent of the revised annual estimates.

The excise duty collected from cigarettes at Rs 7.9 billion recorded a growth of 22 per cent over the corresponding period of 2003 and accounted for 34 per cent of the annual revised estimates. With the reduction of the VAT rate from 20 per cent to 15 per cent the increased excise duty introduced to neutralize revenue with effect from 01/01/04, the

upward revision of price in selected brands of cigarettes in September 2003 and a marginal increase of 2 per cent in the cigarettes sales in the first 4 months of 2004 were responsible for the increased revenue in excise duty collected from cigarettes. In addition, intensified enforcement of detection of smuggled and counterfeits cigarettes since the last quarter of 2003 by the departments of Customs and Excise which led to a drop in the availability of such cigarettes also had a positive impact on the increased sales and thereby the enhanced revenue from excise taxes.

Excise duty on liquor amounted to Rs 4.5 billion registering an increase of 32 per cent compared to the first four months of 2003 and achieved 31 per cent of the annual revenue targets under this category. Enhanced excise rates effected to recoup the revenue loss on account of the reduction of the VAT rate by 5 percentage points with effect from 01/01/2004, increased production in hard and soft liquor by 7 per cent and 23 per cent respectively, and the upward revision in excise duty rates on both types of liquor in the latter part of 2003 contributed to the increase in excise duty collection on liquor.

Excise duty from petroleum and other sources, amounting to Rs 8.5 billion, accounted for 40 per cent of the annual estimates. A 27 per cent increase in the CIF value in motor vehicle imports and upward revision on excise duties on rectified spirits announced in the Budget 2004 largely contributed to the growth of the excise duty revenue from these sources. The upward revision in excise duty rates to keep the price neutrality with the imposition of single rate VAT on vehicles also had a positive impact on the excise duty collection from vehicle imports in 2004.

Other Taxes

Port & Airports Development Levy (PAL) and the Debits Tax

The revenue collected under PAL and Debits tax at Rs.2.2 billion and Rs.1.3 billion amounted to 34 and 32 per cent respectively of the revised annual estimates. The collection from PAL indicated an increase of 31 per cent while that under Debit Tax recorded an increase of 18 per cent over the same period last year. The impressive

increase in revenue under PAL was on account of the noticeable increase in the value of imports.

Value Added Tax (VAT)

VAT revenue at Rs 36 billion in the first 4 months, depicted an increase of 14 per cent and accounted for 32 per cent of the annual target. Despite the reduction of the rate by 5 percentage points on several items the increase in VAT collection was mainly on account of increased value of imports and also the increase in rate from 10 to 15 per cent on the import of refined petroleum products. The VAT collected from imports in gross terms, at Rs 22 billion, recorded a growth of 20 per cent over same period in 2003 while the collection from domestic sources, at Rs 19 billion, reflected an increase of 7 per cent. Removal of exemptions granted under VAT on certain items and intensified audits contributed to the increase in revenue from VAT from domestic sources. The slower growth in the VAT collection from domestic sources, however, is on account of unification of VAT at 15 per cent and the delay in introducing several revenue enhancing amendments to the VAT Act.

Non - Tax Revenue

Revenue from non-tax sources in the first four months of 2004 amounted to Rs 8.9 billion, recording a significant decline of 60 per cent compared to the same period of 2003. Total non-tax revenue collection during the first four months of the current year realized 22 per cent of the revised estimates while during the same period last year 56 per cent of the estimates have been collected. In addition to the sharp decline on account of once and for all fund transfers, non realization of estimated profit transfer from CBSL, and a noticeable drop in payment of interest and loan installments by the CEB and the Ports Authority during January to April 2004 in comparison with the same period of the previous year, also contributed to the drop in revenue under non-tax sources.

(c) Cash Flow Operations of the Government

Cash inflows of the Government during the first four months of 2004 amounted to Rs 99.3 billion as against an estimate of Rs107.6 billion.

Cash outflows on account of recurrent expenditure amounted to Rs 112.8 billion as against an estimated Rs116.9 billion, generating a net cash deficit of Rs 13.4 billion as against an estimated deficit of Rs 9.4 billion from operating activities.

Cash outflow on investment activities amounted to Rs 43.8 billion as against an estimated Rs 39.6 billion.

A summary of the cash flow estimates and actual performance for the first four months of 2004 is given in the following table.

Summary of the Government Cash Flow

(Rs. billions)

| Item | Jan – April 2003 Actual | 2004 | | |
|--|-------------------------------|--------------------------|-----------------------|-----------|
| | | Jan – April Estimates | Jan – April Actual | Deviation |
| Total cash inflows | 106.4 | 107.6 | 99.3 | (8.3) |
| Total cash outflow from operating activities | (110.8) | (117) | (112.8) | 4.3 |
| Net cash flow from operating activities | (4.4) | (9.4) | (13.4) | (4.1) |
| Cash flow from investing activities | (19.7) | (39.6) | (43.8) | (4.2) |
| Net cash surplus / (deficit) | (24.1) | (48.9) | (57.2) | (8.3) |
| Opening cash balance | (3.5) | (2.4) | (2.4) | - |
| Net borrowings | 29.5 | 51.7 | 54.7 | 3.0 |
| Temporary employed balance adjustments | (1.4) | | 1.7 | 1.7 |
| Ending balance | 0.4 | 0.3 | (3.2) | (3.5) |

(d) Borrowings

In Budget 2004 Parliament approved Rs 350 billion as total gross borrowings (in terms of book value) for the current year. During January to April 2004, total gross borrowings including private sector development loans amounted to Rs 87.9 billion. Of this, total domestic gross borrowings amounted to Rs 69.7 billion. With domestic repayments amounting to Rs.17.6 billion the net domestic borrowing amounted to Rs.52.1 billion. This includes borrowings of Rs.10.8 billion from the banking sector. Total gross foreign borrowings amounted to Rs 18 billion, including foreign loans for capital projects and private sector development loans. The repayments on foreign loans amounted to Rs 9.4 billion resulting in net foreign borrowings of Rs 8.3 billion for budgetary purposes. This excludes the private sector development loans.

Total financing during the first four months of 2004 amounted to Rs 64.3 billion. Of this amount total net domestic borrowings were Rs 52.1 billion, net foreign borrowings were Rs 8.3 billion while foreign grants amounted to Rs 1.5 billion. Proceeds from privatisation amounted to Rs 2.4 billion.

5. Budgetary and Fiscal Policy Direction

- The current level of taxation is grossly inadequate given the level of per capita income. Stagnation of non-tax revenue in relation to GDP should also be stopped
- The overall medium term revenue strategy of the Government will include the introduction of an efficient and modern tax administration, mobilization of maximum yield from the present tax structure and improving the financial performance of public enterprises to enhance non-tax revenue flows. Prevailing tax loopholes arising from tax amnesty laws as well as from other concessions, leakages and abuses will be eliminated.
- A new organizational structure for the Department of Inland Revenue that will establish the inter revenue departmental coordination, IT facilities, an effective enforcement mechanism and tax audit will come into force shortly

- The new Strategic Management Enterprise Agency (SEMA) is expected to commercialize important state enterprises to generate the required return on investment as their contribution to the Budget
- The Government aims at moving towards a 20 per cent revenue/GDP target over the next six years to contain the fiscal deficit below 5 percent of GDP over the medium term, keeping in line with the provisions of the Fiscal Management Responsibility Act of 2002
- The 2005 budget will be made within a medium term budget framework in order to incorporate the development strategy of the Government
- Public investment will be protected to ensure that planned development in infrastructure, human resources and rural development is realized
- Wasteful expenditure will be eliminated through strict financial controls, audit and constant reviews. The new procurement laws and regulations are expected to reduce transaction costs considerably. Defence expenditure in relation to GDP will be gradually reduced with the progress in the peace process.
- An equally important aspect in public expenditure policy is the prudent management of public debt since the cost of interest accounts for 7 per cent of GDP and absorbs 45 per cent of Government revenue
- Financial discipline and prudent financial management in the public sector will be given highest priority in order to promote financial stability
- Financial imbalances in the public sector, particularly in the large public enterprises, will be eliminated to reduce potential fiscal risks and such entities from foreign borrowings.
- All endeavors will be made by the Government to contain this year's deficit below 8 per cent of GDP with an appropriate balance between foreign financing and domestic borrowings in order to consolidate the current low interest rate regime, which is essential to provide a growth stimulus

Conclusion

The government is committed to fiscal prudence with continued investments. Therefore, a further consolidation of the fiscal position will be made during a three-year period commencing from 2005, with a view to reducing the deficit to about 5 per cent of GDP that would accommodate a higher public investment level in excess of 7 per cent of GDP