



## **FISCAL STRATEGY STATEMENT - 2004**

**Issued by the Hon. Minister of Finance  
in Terms of Section 4 of the  
Fiscal Management (Responsibility) Act No. 3 of  
2003**

**Price: Rs 15.00**

**Web site: <http://www.eureka.lk/fpea>**

## 1. Introduction

The Fiscal Management (Responsibility) Act, No.3 of 2003 (FMRA) requires the Minister of Finance to lay before Parliament and to release to the public, on the day fixed for the second reading of the Appropriation Bill in Parliament, a Fiscal Strategy Statement which lays out the fiscal strategy of the Government. This Statement is issued in compliance with that requirement.

## 2. Background

During the period 1999 to 2001, the fiscal position of the country deteriorated significantly:

- Government revenue, as a percentage of Gross Domestic Product (GDP), declined from 17.7% to 16.7%;
- Government expenditure, as a percentage of GDP, on the other hand, rose from 25.2% to 27.5%;
- as a result of the sharp imbalance between revenue and expenditure, the budget deficit increased from 7.5% of GDP to 10.8% of GDP, a substantial increase in just 3 years; and
- the public debt grew from 95.1% of GDP to 103.2% of GDP.

In December 2001, the present Government took office and determined to control the runaway public debt and impose fiscal discipline. Towards that end, the Government took drastic steps to curtail expenditure during 2002. It also restructured off-budget borrowings of Rs. 40 billion and brought them into the official statistics and issued long term Treasury Bonds for that amount.

The Government's actions improved the country's fiscal position somewhat in 2002 by reducing expenditure to 25.4% of GDP and the budget deficit to 8.9% of GDP.

These improvements required reducing public investment, which dropped to 4.6% of GDP in 2002.

The 2003 budget was prepared within a medium term fiscal strategy framework, rather than for short-term political gain or expediency. The Government's commitment to responsible fiscal management is reflected in the enactment of the FMRA in January 2003. The FMRA sets out the fiscal targets of the Government and the reports through which the Government accounts to Parliament and the public on the discharge of its fiscal responsibilities.

## 3. Medium Term Fiscal Policy

The medium term fiscal policy of the Government is designed to address the following problems:

- Persistently high budget deficits that resulted from a lack of fiscal discipline reflected in increased Government expenditure, notwithstanding declining revenue. [The average overall budget deficit over the past 10 years amounts to approximately 9% of the GDP].
- Soaring debt service payments limited the Government's ability to address important social and economic needs. [Public debt exceeded the annual GDP in 2001.]
- Excessive staffing levels in the public service.
- Continuing financial losses incurred by some State-owned enterprises.

## 4. Broad Strategic Priorities

The broad strategic priorities of the Government for achieving its medium term fiscal policy are to:

- provide an environment that promotes greater economic growth;
- structure Government revenue on a more efficient and equitable basis;
- reduce the public debt burden on the economy;
- make Government expenditure more efficient and effective; and
- improve accountability in Government enterprises.

### 5. Key Fiscal and Other Measures

The key fiscal and other measures that the Government will employ to achieve its broad strategic priorities are identified below:

#### a) Providing an Environment that Promotes Economic Growth

The cornerstone of the Government's policy to achieve fiscal stability is to increase the rate of real growth of the economy through development of the private sector. Private sector led growth is critical if Government revenue is to increase. A set of stable, consistent, and predictable economic policies is essential if the private sector is to have the confidence to make the investments necessary to generate high rates of growth through improved productivity and expanding output. This will be done by:

- **Eliminating the heavy burden of over regulation:** Regulations relating to the use of the seas, airspace, and costal resources will be reformed. The private sector will be encouraged to maximise benefit from the sustainable

development and management of these resources. Special attention will be paid to reducing the regulatory burden on small and medium enterprises.

- **Establishing a multi-sector utility regulator:** Individual laws will be enacted to promote competitive markets and encourage private sector investment in public utilities, such as power, water and ports. Services from these utilities will be priced at levels that will allow for an improved quality of service.
- **Releasing State lands for development purposes:** Government will create five economic zones in the country. An Economic Commission in each of these zones will encourage private sector development of industries, tourism, and agriculture.
- **Reducing bureaucratic delays and excessive administrative controls:** Systems and procedures that hold back economic progress in Government departments, especially in the Customs and Inland Revenue Departments and the Colombo Port Authority, will be streamlined to provide more responsive and efficient services.
- **Fostering public-private partnerships:** The Government will work more closely with the private sector to put in place improved economic infrastructure and quality social services.
- **Government exiting from commercial entities:** In particular, the Government will exit from loss-making commercial enterprises. Businesses that are virtual monopolies, will also be divested as soon as the essential frameworks are in place. Divestiture will be conducted in a

professional and transparent manner, with critical attention being paid to ensuring competition.

b) Structuring Government Revenue More Efficiently and Equitably

On the revenue side, the Government will continue to expand the tax base to improve equity and simplification of the tax system. The medium term objective is to converge to a maximum income tax rate of 20% and provide relief, particularly to households by reducing indirect taxation, as soon as the tax revenue to GDP ratio in the country reaches similar levels in comparable countries. Tax administration and tax compliance will be improved by setting up of a Revenue Authority that will take over the present functions of the Inland Revenue, Customs, and Excise Departments. As a part of the continuing tax reform process, existing tax laws are being reviewed in order to make the changes necessary to realize these objectives.

Tax concessions result in annual revenue losses of an estimated 2 to 3% or more of GDP. In addition, the economic distortions arising from such unequal tax treatment are even more destructive. Government strategy is to rationalise existing concessions and to harmonise concessions provided by the Board of Investment and under the Inland Revenue Act. This will be the first step towards achieving a globally competitive enterprise tax system.

c) Reducing the Public Debt

The public debt burden is a serious threat to financial stability and to the budget. The strategy of the Government is to retire high interest bearing

debt, issued in the recent past, where possible and to issue in its stead debt carrying much lower interest rates.

A Public Debt Management Office (PDMO) is being established to consolidate various aspects of public debt management that are now carried out by different institutions. The PDMO will recommend ways to reduce financing costs and to improve the management of public debt. Strategic debt analysis, risk management, including the management of foreign currency exposure, and better cash management will contribute towards further reductions in interest costs. Securitisation of Government import bills and other Government debt will also be explored as a mechanism for reducing debt service costs. These efforts will permit Government expenditure to be re-directed towards social and economic needs.

d) Making Government Expenditure More Efficient and Effective

In addition to setting clear medium term targets for Government expenditure, the Government will take the following special measures to ensure that spending is kept within bounds on a year-to-year basis.

- The operations of existing state institutions and departments will be reviewed to identify unnecessary and low priority activities for closure and to eliminate duplication. The termination or merger of activities and/or institutions will be recommended, where appropriate.
- Sri Lanka has over 750,000 public servants, excluding employees in Government owned corporations. This level is one of the most overstaffed public sectors in the developing world. The cost of

these employees accounts for almost one-third of the Government expenditure. The 2000 Salaries Commission appointed by the Government recommended a 30% reduction in the public service cadre, particularly in the middle and lower grades. The Government proposes to achieve such a reduction by offering a voluntary retirement scheme to selected categories of excess public servants.

e) Improving Accountability in Government Enterprises

At present, some Government bodies fail to account for past spending for many years. This makes it difficult to assess whether or not such spending has been undertaken in accordance with Government procedures and/or in line with government priorities. In the future, all public institutions will have to finalise and present audited accounts not later than nine months after the close of each fiscal year as a precondition for continued public funding.

More effective financial management and public procurement practices and procedures will be introduced to ensure that resources are used efficiently and effectively and that waste is reduced. In particular, steps will be taken to streamline and rationalise the defence procurement system.

There are more than 50 statutory and departmental funds, within various Government entities outside budgetary control, without adequate performance reporting or auditing. The activities funded from these sources will be reformed or eliminated, as appropriate. These

funds will be brought under budgetary control and performance reporting and auditing systems will be introduced.

**6. Fiscal Targets and Expected Outcomes**

The Government's fiscal targets over the period 2004 to 2007 are:

- a budget deficit of less than 4.5% of GDP in 2007; and
- total Government liabilities (including external debt at prevailing exchange rates) of 85% of GDP in 2007;

As a result of implementing the fiscal and other measures described above, including steps to enhance economic growth, the Government projects that it will be able to achieve the target levels for the various fiscal indicators shown in Table 1 during the coming fiscal year (2004) and the three following fiscal years.

**7. Risk Factors**

In setting ourselves the above fiscal targets and expected outcomes we have envisaged an environment that is conducive to economic growth. Most critically, these targets and outcomes assume continued progress in the current peace process.

These forecasts are also dependent on economic and political stability in the domestic and international arenas. Additionally, substantive variations in oil prices or in the exports of garments and tea on the international front; or any natural disasters, such as severe droughts and floods, or prolonged industrial disputes on the domestic front could have an adverse effect on these projections.

**Table 1: Fiscal Objectives and Targets**

	Unit	2003 Revised Estimate	2004 Budget	Medium Term Projections		
				2005	2006	2007
Mid year population	Mill.	19.3	19.4	19.6	19.8	20.0
GDP real growth rate	%	5.5	6.0	6.7	7.0	7.0
Average inflation <sup>1</sup>	%	7	6.9	5.9	4.9	4.4
Year end annual interest rate <sup>2</sup>	% p.a	9.3	9.2	7.9	6.5	5.9
Revenue	GDP %	16.3	16.4	16.8	17.3	17.9
Expenditure	GDP %	24.2	23.2	22.8	22.4	22.4
Budget deficit	GDP %	7.8	6.8	5.9	5.0	4.5
Government debt/GDP	%	100.1	94.9	90.0	85.0	79.9

<sup>1</sup> As measured by Colombo Consumers' Price Index.

<sup>2</sup> Average Weighted Prime Lending Rate.