



BUDGET – 2005
STATEMENTS UNDER THE FISCAL MANAGEMENT
[RESPONSIBILITY] ACT NO. 3 OF 2003
AND
MEDIUM TERM MACRO ECONOMIC FRAMEWORK

Dr. Sarath Amunugama, MP
Minister of Finance and Planning

Table of Contents

Contents	Page
Fiscal Strategy Statement 2005	
Medium Term Macro Fiscal Policy Framework 2005 – 2008	1
Macro Fiscal Policy Action Plan	2
Fiscal Targets and Expected Outcome	4
Budget Economic and Fiscal Position Report 2005	
Medium Term Economic Forecasts	5
The Preparation of Estimates	6
Statement on the Sensitivity of the Estimates	8
Statement of Risks	8
Medium Term Macro Economic Framework	9

FISCAL STRATEGY STATEMENT - 2005

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

Fiscal Strategy Statement - 2005

Introduction

This statement is issued in compliance with the Fiscal Management (Responsibility) Act, No. 3 of 2003 (FMRA) which requires the Minister of Finance to lay before the 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 of the Government.

Background

We have witnessed the following unfavorable fiscal developments in the recent past.

- The government tax revenue in relation to GDP has continued to decline to 13.2 percent by 2003.
- Stagnation of the non tax revenue in relation to GDP at 2.0 to 2.5 per cent.
- Public investment has declined steadily with resources channeled to education and health reducing to 3.8 per cent of GDP by 2003.
- The government debt continued to move in upward direction and increased to 105.9 per cent of GDP in 2003 from 103 per cent in 2001.

Medium Term Macro Fiscal Policy Framework 2005 - 2008

The medium term macro fiscal policy framework of the government is designed to achieve the following three key objectives keeping in line with the long-term policy direction provided in the Fiscal Management Responsibility Act;

- Transform the prevailing revenue deficit in the national budget to a surplus and generate government savings of over 2 percent of GDP by 2007.
- Augment public investment over 7 percent of GDP by 2006 in order to accelerate the national infrastructure development programme, rapidly expand provincial and rural infrastructure facilities as well as North East infrastructure rehabilitation and reconstruction and upgrading and modernization of human resource development facilities.
- Reduce domestic borrowings towards 2 percent of GDP in order to enhance available resources for the development of Small and Medium Enterprise (SME) led private sector capital formation and income generating activities.

Table 1: Medium Term Macro Fiscal Framework (Figures in Percentage of GDP)

	2004	2005	2006	2007	2008
Revenue	15.6	17.2	18.0	18.9	19.5
Taxation	14.1	15.5	16.3	17.1	17.7
Income and Profits	2.2	2.4	2.6	2.9	3.1
Goods and Services	9.4	10.1	10.6	11.1	11.5
Non Tax Revenue	1.5	1.7	1.7	1.8	1.9
Profit and Dividend of SOEs	0.3	0.3	0.4	0.5	0.6
Expenditure	24.2	24.8	24.7	24.6	23.9
Current Expenditure	19.3	18.5	17.6	16.7	15.9
HR Development	2.7	2.8	2.9	3.0	3.0
Interest on Public Debt	6.0	5.7	5.4	4.9	4.5
Public Investments	5.0	6.4	7.0	7.8	7.9
Large Scale Infrastructure	2.4	2.5	3.1	3.1	3.3
Provincial/Rural Infrastructure	2.6	3.8	4.0	4.7	4.6
Government Savings	-3.7	-1.3	0.4	2.2	3.6
Budget Deficit	-8.6	-7.6	-6.7	-5.7	-4.4
Overseas Development Assistance	1.7	2.6	3.1	2.9	2.7
Domestic Financing	6.8	4.6	3.5	2.7	1.6
Non Bank Institutional Savings	5.3	4.6	3.5	2.7	1.6
Bank Financing	1.5	0.0	0.0	0.0	0.0
Other	0.1	0.3	0.1	0.1	0.1

Macro Fiscal Policy Action Plan

Taxation Effort

Tax Administration

- Modernizing and strengthening of revenue departments through upgrading technology, human resource development and improved enforcement and surveillance.
- Improving governance and promoting a new tax culture through the implementation of a Tax Charter and a Code of Conduct.

- Implementing a reward system and a scheme to give social recognition to good tax payers.
- Formation of a Taxation Cluster representing professionals to provide a consultative process to resolve technical issues in tax administration.

Tax Policy Development

- Formulation of a tax structure by broadening the tax base, and implementing a simple rate structure to improve transparency.
- Expand the share of income tax revenue to GDP to sustain a proper balance between direct and indirect revenue in tax structure.

Tax Legislation

- Strengthen provisions in tax legislation, close loopholes in tax laws and phase out tax concessions, deductions and clear ambiguities.
- Introduce countervailing measures to deal with informal markets, smuggling and illicit trade activities and expand the legitimate tax base.

Non-Tax Revenue

- Increase the contribution from strategic enterprises by way of profit and dividend.
- Maintain a rational structure for fees, fines and other levies imposed by the public services.

Public Expenditure

- Formulation of budget allocations within a medium term expenditure framework.
- Adopt a public sector wage policy linked to skills development and productivity improvement.
- Introduce procurement management, expenditure control, accounting and auditing standards to reduce wasteful expenditure and improve transparency and accountability.
- Improve public debt management, replace high cost debt by least cost debt instruments and improve treasury operations.
- Restructure public enterprises to operate as self funding entities and to phase out budget support.
- Introduce community based rural development programmes to improve better use of welfare expenditure.
- Revisit public investment programmes to ensure cost efficiency and quality of public investments.
- Prioritize public expenditure towards pro-poor, pro-growth development programmes.

- Implement focused poverty reduction spending programmes at divisional secretaries level, under the overall supervision and coordination of all such spending by the respective divisional secretaries.
- Establish key development targets and disburse funds based on performance.
- Improve public expenditure monitoring system to ensure value for money.

Fiscal Targets and Expected Outcome

The overall thrust of the medium term fiscal policy will be to provide a stable macro economic environment while ensuring that public resources are channeled to achieve a more equitable growth to facilitate a SME led private sector economic progress in the country. The underlying policy strategy based on the fact that Sri Lanka needs a strong private sector as well as a public sector, in order to realise national poverty alleviation and growth objectives. Public investments will be built up within a medium term expenditure framework with a strong focus towards reducing rural and urban poverty as well as regional and income disparities. As such the national budget system will reflect its commitment to equate budgetary allocations with the underlying sectoral policy strategies. A more explicit reflection of policies and priorities will be emphasized to improve the effectiveness of public spending.

The provisions of the Fiscal Management (Responsibility) Act, No.3 of 2003 state under section 3 subsection 3(a) that the reduction of government debt to prudent levels, by ensuring that the budget deficit at the end of the year 2006 shall not exceed five per centum of the estimated gross domestic product and to ensure that such levels will be maintained there after.

However in view of the performance from 2002 to 2004 and the budget deficit of 8.5% in 2003/4 it is unrealistic to assume a budget deficit of less than 5% for 2006. Thus it is envisaged that the budget deficit would be reduced to less than 5% of estimated GDP by 2008.

Further section 3(f) of the FMRA states;

Ensure that at the end of the financial year commencing on 1 January 2006 the total liabilities of the government (including external debt at the current exchange rates) do not exceed eighty five per centum of the estimated gross domestic product for that financial year commencing on January 1 2006. It is expected that this condition would only be fulfilled subsequent to year 2008. However, it is envisaged that the debt levels will gradually decline in the medium term as outlined in the medium term macro economic framework by moving to a high growth in GDP, as well as through the reduction in budget deficit as shown in the Medium Term Macro Fiscal Framework.

**BUDGET ECONOMIC
AND
FISCAL POSITION REPORT - 2005**

Issued by the Hon. Minister of Finance and Planning
in terms of Section 7 of the
Fiscal Management (Responsibility) Act No. 3 of 2003

Budget Economic and Fiscal Position Report - 2005

Introduction

- Section 7 of the Fiscal Management (Responsibility) Act (FMRA) requires the Minister of Finance to present the Budget Economic and Fiscal Position Report, to Parliament each year, on the day fixed for the second reading of the Appropriation Act. Therefore, this report is issued in compliance with this requirement.
- The objective of the report is to provide information that will provide a basis for the evaluation of the Government's fiscal strategy as against its fiscal performance as set out in the Fiscal Strategy Statement.
- This report provides three-year forecasts for selected macroeconomic indicators.

Medium Term Economic Forecasts

- Government's economic policy is designed to position Sri Lanka as a modern economy with equal opportunities for every citizen.
- The Government projects a higher economic growth in the medium term generated primarily from diversified domestic resource based activities scattered throughout the country.
- Economic growth will be backed by infrastructure development to create a balanced regional development. The use of untapped resources coupled with the enhanced regional activities and infrastructure development will create employment opportunities, which in turn would address the issue of unemployment.
- Enhancement of investment activities funded by foreign capital inflows will necessitate higher investment related imports. Although this widens the current account deficit of the Balance of Payments, these imports will positively contribute to higher economic growth in the future.
- The Government is committed to a fiscal consolidation process that would bring about a phase reduction of the budget deficit within a medium term budgetary framework.
- It would refrain from adopting the strategy of compressing capital expenditure to maintain its budget deficit targets.
- The Government will take appropriate measures in striking the right balance between foreign financing and domestic borrowing. This would assist in consolidating a low interest rate regime, which in turn would enable more resources to be channeled to the private sector thus stimulating economic growth.

- Details of revenue, expenditure and financing as a percentage of GDP are presented in Table 1.
- The medium term projections for the period 2005 to 2007 for selected economic indicators are given in Table 2.

The Preparation of Estimates

The bases for arriving at the given estimates are as follows:

- a) Gross Domestic Product
 - Economic growth is expected to accelerate in the medium term through progressively increase in public and private investments.
 - An export sector with more premium value addition will be encouraged.
 - The development of SMEs would be promoted to spearhead the domestic industrial output.
 - Development programmes will be undertaken to revive the agriculture, livestock and fisheries sectors, which have been neglected in the recent past.

Forecasts for 2005 estimate that the industrial sector is expected to grow by 5.3 percent, the service sector by 6.4 percent and the agricultural sector by 2.7 per cent.

- b) Consumer Prices
 - With the revival of agriculture and related sectors, coupled with the measures for fiscal consolidation and prudent monetary policy, and taking the one off impact of the drought and administered price correction in 2004 prices, the rate of inflation is expected to decline in the medium term.
- c) Employment and Unemployment
 - Greater employment opportunities will be created through the Government's strategy of increasing island wide production.
 - A major production drive in identified priority areas in both public and private sectors would create productive employment opportunities over the medium term.
 - Skills development programmes will be undertaken with donor support in creating a productive labour force in the country.

- d) Current Account of the Balance of Payments
 - Exports are expected to grow at an annual rate of 8 to 10 per cent (US \$ terms) for the period 2005 to 2007, while imports will grow at a higher rate reflecting the increase in capital and investment goods.
 - Despite the widening trade deficit, increased surpluses are expected in the service account, particularly through expansion in the tourism and port sectors.
 - The current account deficit will be contained at approximately 3.5 per cent of GDP in the medium term.

- e) Revenue
 - 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 the non-tax revenue income.
 - The gradual increase in revenue is expected through the above strategy combined with measures to eliminate tax loopholes, leakages and abuses. In this background, higher tax collection is expected from income taxes and value added taxes.

- f) Expenditure
 - Sector oriented budgeting within a medium term framework is the basis for the preparation of the national budget.
 - Line ministries are empowered to operate within their sector ceilings.
 - Past practice of curtailing capital expenditure will be abolished and within a planned development programmes in spheres of infrastructure, human resources and rural development, will be undertaken over the medium term.
 - Public investment is expected to grow to 7.9 per cent of GDP over the medium term.
 - The interest payments of public debt accounts for one third of the current expenditure. The Government expects to manage the public debt through maintaining a balance by selecting a proper mix of domestic and foreign borrowings, thus containing the increasing interest cost.

- g) Government Borrowing
 - The Government borrowing requirement as a percentage of GDP is expected to decline over the medium term.

- Domestic market borrowings are also expected to decline with increased concessionary foreign borrowings.

Statement on the Sensitivity of the Estimates

The medium term economic projections listed above are based on a scenario which includes the following:

- The social and political stability
- A peaceful environment
- A favorable international economic environment, i.e. recovery of the global economy, lower petroleum prices etc
- Favorable weather

Statement of Risks

The risks that may have a material effect on the fiscal position are given below:

- The total value of outstanding Treasury guarantees amounted to Rs 22 billion as at end of June 2004 compared to Rs 22.1 billion at the end of 2003. The share of the Treasury guarantees as a percentage of the GDP declined to 1.11 Per cent at mid year 2004 from 1.26 per cent at the end of 2003.

Table 2: Projections for Selected Economic Indicators

	Unit	2005	2006	2007
Real Gross Domestic Product	% Change	6.0	6.0	6.5
Colombo Consumer Price Index	% Change	10.0	8.0	5.0
Unemployment Rate	%	8.0	7.5	7.0
Current Account Balance	US \$ Mn	-960	-787	-839
Current Account Balance	% GDP	-4.6	- 3.5	-3.5
Government Revenue	% GDP	17.2	18.0	18.9
Government Expenditure	% GDP	24.8	24.7	24.6
Government Net Borrowing	% GDP	6.8	6.2	5.2

MEDIUM TERM MACRO ECONOMIC FRAMEWORK

Medium Term Macro Economic Framework

- A GDP growth in excess of at least 6 percent to generate high per capita income growth, based on regionally diversified production in agriculture, fisheries, livestock, tourism and services together with stable macro economic conditions are needed for a sustained increase in employment and reduction in poverty.
- The overall macro economic strategy is based on the premise that people need to have access to markets for goods and services they produce and consume. Hence, priority is given to investments in infrastructure development both at national and provincial levels, human resources and skills development and strengthen institutions and governance all of which improve opportunities to the people.
- Only 30 percent of rural enterprises have access to electricity from the national grid. This has reduced the chances of rural households setting up new enterprises. Also the lack of a reliable electricity supply reduces productivity of urban manufacturing firms as well. Further transportation constitutes the single most important constraint to rural firms. This is also a barrier to urban firms and tourism. As almost 90% of the paved road network is in poor condition due to lack of maintenance. Therefore, the provision of electricity, better roads and transport facilities at provincial level is a critical element in the public investment strategy.
- Poverty is largely concentrated in rural and estate sectors and hence the revival of agricultural sector growth is a key objective. The centerpiece of this sector investment strategy is to greatly improve irrigation facilities, storage, and access to marketing, availability of seed and protection of environment.
- A higher level of productive investments of around 30 percent of GDP, both in private and public sectors and activities that create demand for the presently unemployed labour force of around 8 percent and the large proportion of underemployed will be necessary to achieve above growth objective. FDI is expected to increase in areas of technology advancement and infrastructure development.

Table 3: Medium Term Macroeconomic Framework (% of GDP)

Indicator	2004	2005	2006	2007	2008
GDP at Market prices (Rs. Bn)	1,988	2,276	2,557	2,859	3,211
GDP at Constant prices (Rs. Bn)	1,079	1,144	1,212	1,291	1,388
GDP Growth (%)	5.2	6.0	6.0	6.5	7.5
Inflation- GDP deflator (%)	7.2	8.0	6.0	5.0	4.5
Total Investments	25.2	28.0	30.0	32.0	34.0
Private Investments	20.2	21.4	22.6	24.2	26.0
Public Investments	5.0	6.6	7.4	7.8	8.0
Domestic Savings	16.2	18.0	21.0	22.9	25.3
Private savings	18.4	18.5	20.3	21.1	19.8
Public Savings	-2.3	-0.5	0.7	1.8	5.5
National Savings	21.4	23.3	26.3	28.4	30.8
Trade Gap (US\$ Mn)	-2185	-2556	-2526	-2763	-2965
Exports (US\$ Mn)	5598	6064	6598	7190	8020
Imports (US\$ Mn)	7783	8620	9124	9953	10985
Services (US\$ Mn)	407	463	519	558	637
Receipts (US\$ Mn)	1561	1697	1839	1988	2200
Payments (US\$ Mn)	1153	1234	1320	1430	1563
Current Account (US\$ Mn)	-715	-960	-787	-839	-831
Current Account Deficit	-3.6	-4.6	-3.5	-3.5	-3.1
Overall Balance (US\$ Mn)	-259	170	178	207	291
External Reserves (US\$ Mn)	1779	1976	2281	2654	2929
Debt Servicing	11.7	12.0	9.9	9.2	7.5
Revenue	15.6	17.2	18.0	18.9	19.5
Expenditure	24.2	24.8	24.7	24.6	23.9
Revenue (Deficit/Surplus)	-3.7	-1.3	0.4	2.2	3.6
Overall Budget Deficit	-8.6	-7.6	-6.7	-5.7	-4.4
Domestic Financing	6.8	4.6	3.5	2.7	1.6
Government Debt	106.2	103.9	102.1	98.1	93.5
Broad Money growth (M2b)*	17.5	14.5	13.4	12.3	11.8
Narrow Money growth (M1)*	17.5	14.0	12.9	11.3	11.3
Growth in Credit to the Government	16.5	-0.7	-2.0	-2.3	-3.5
Growth in Credit to Public Corporations	24.8	-15.7	-11.6	-24.1	-21.2
Growth in Credit to Private Sector	23.3	17.6	16.8	14.2	12.7

*Year on Year

- Inflation is to be reduced towards 5 percent by 2007 by preventing excessive monetary expansion as well as by removing supply bottlenecks particularly in food production and minimizing vulnerabilities to vagaries of weather.
- Fiscal adjustments, which aim at achieving a revenue surplus and eliminating inflationary financing, will aim at protecting public expenditure on human resource development, and quality public investments in infrastructure and rural development.
- Key policy objective in the balance of payments front is to diversify export earnings from trade and services, improve inflows from overseas employment and foreign investments and build external reserves to a level in excess of 3 months imports. In addition to an expansion of exports of tea and garments - the two major export commodities – non-traditional industrial and agricultural exports too will be intensified to generate stronger export growth. Tourism is targeted as a thrust industry to generate over 10 percent annual growth in tourism.
- Positive interest rates will be ensured in conducting monetary policy to sustain a balance between savings , investments and monetary growth will be managed at a level consistent with inflationary targets.

Operational and policy measures underpinning the Medium Term Macro Economic Framework

1. Increase the rate of economic growth
 - a. Promote private investment ,foreign investment and technology.
 - b. Improvement of value added exports and export diversification.
 - c. Improved SME sector performance.
 - d. Improvement of public enterprises.
 - e. Increase the value addition of the financial sector.
 - f. Introduction of new and alternate technology to minimize the adverse impact of droughts and promote alternative energy sources.
 - g. Promote tourism.
 - h. Sustain the quality of public investment in infrastructure development.
 - i. Maintain competitiveness through avoidance of the differential between the world inflation and the domestic inflation.

2. Savings and Investments
 - a. Increased government savings through elimination of the revenue deficit.
 - b. Higher private savings by maintaining positive real interest rates for depositors.
 - c. Higher public and private investment.
 - d. Increase direct foreign investments.

3. Inflation
 - a. Considering high oil prices and supply side shocks, somewhat higher inflation is expected in 2004 and 2005. However, the inflation is expected to decelerate in the medium term through supply side improvements and fiscal consolidation that aims at reducing demand pressure in the economy.

4. Fiscal Aggregates
 - a. Revenue deficit would be phased out.
 - b. Increased public investment will be largely financed by concessionary foreign funds and long term domestic institutional sources.
 - c. Local financing of the deficit will be eliminated.
 - d. Budgetary transfers to state enterprises will be phased out.

5. Monetary Sector
 - a. Avoid demand fueled inflation.
 - b. Facilitate required credit growth for sustained economic activity.