

SRI LANKA ECONOMIC QUARTERLY

Highlights

- ☞ **Economic Developments:** Macroeconomic recovery took hold in the third quarter, boosting Sri Lanka's growth prospects for 2002 to 3%. The Government is on track to reach its revised fiscal targets, but more effort is needed to bring inflation under control. Having made progress on regaining macroeconomic stability, the medium-term outlook is promising with 5% growth expected in 2003.
- ☞ **Policy Issues:** The Government is rethinking the way it regulates industries. Regulation by line ministries is being replaced by autonomous regulatory agencies to eliminate conflicts of interest. Moreover, specialized regulators are making way for multisector regulators to minimize costs and further enhance their autonomy. This new generation of regulatory agencies includes the Public Utilities Commission, Consumer Affairs Authority, and the proposed Financial Services Authority.
- ☞ **Development Focus:** With the 2003 budget, the Government is continuing its efforts to bring the fiscal deficit down to a sustainable level. The deficit target of 7.5% of GDP is ambitious but achievable, in line with the medium-term objective of a 5% of GDP deficit by 2006. The Government will need to keep strict control of recurrent expenditures if the overall deficit goal is to materialize.

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I. Economic Developments

Rising from the blows of the 2001 economic collapse, Sri Lanka made a strong showing in the third quarter of 2002. The ceasefire between the Government and the Liberation Tigers of Tamil Eelam (LTTE) provided much needed stability for recovery. The uneasy cohabitation between the Government and the President, who heads the main opposition party, generated some political tension, but the relative peace was an overriding factor. While the recovery has been promising, real output has only recovered from the setbacks of 2001, as investment has responded weakly. Looking forward, the Government needs to consolidate the gains it has made so far and move its focus from short-term stability issues to eliminating the impediments to long-term development.

Output and Growth:

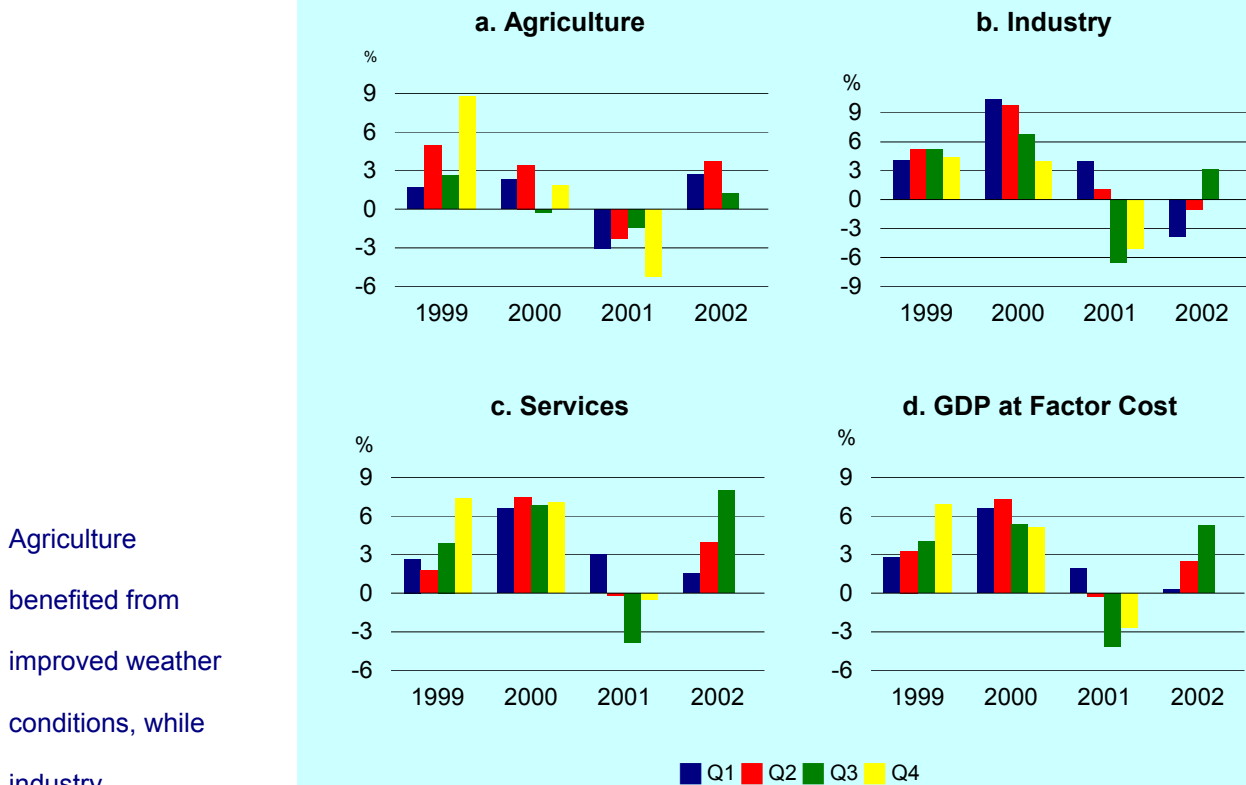
Real gross domestic product (GDP) expanded by 5.3% in third quarter 2002, lifting the 9-month growth rate to 2.7% from the 1.4% growth experienced during the first half of the year. Much of this performance is due to the utilization of available capacity, as the quarterly output is less than 1% over the level achieved in third quarter 2000, the year before the collapse. As Figure 1.1 illustrates, the third quarter results are a continuation and strengthening of the recovery experienced in the first half of the year. While all sectors contributed to the overall expansion, the recovery in the services sector was clearly the leader. That being said, quarterly industrial output experienced its first positive growth following four quarters of declines.

Services were the leading performers in the third quarter, growing by 8% and accounting for nearly 80% of total GDP growth. Here, tourism and shipping made notable advances, albeit from the low base of their 2001 levels. Third quarter 2002 tourism figures are extremely positive. The tourist arrivals in July were at their highest level for that month in more than five years. August and September arrivals as well were back to their usual levels, demonstrating that the sector had fully recovered from the drop following the LTTE attack on the airport a year earlier. Shipping is another sector that has made headway in the third quarter, after a slow start in the first half of the year. Following the removal of the war risk surcharge on ships calling on Colombo Port in the first quarter 2002, ship traffic began to return to its previous levels. With the completion of additional capacity in the by South Asia Gateway Terminal, the private-sector run container port, shipping sector output will expand further. One service sector where declining output is actually a positive outcome is public administration and defense. The 1.1% decline in this sector up to September reflects the Government's freeze on public-sector employment and the peace process' effect in containing defense expenditures.

April to September is the low season for agriculture in Sri Lanka, but favorable weather conditions continued to benefit the sector. Total output expanded by 1.2% in the third quarter, slower than the 3.2% growth experienced in the first half of the year. Tea production, one of the country's key export commodities, of 18.2% was particularly strong and

Sri Lanka's
recovery gained
momentum in the
third quarter of
2002, led by strong
performance in the
services sector.

Figure 1.1: Quarterly GDP Growth by Sector, 1999-2002



Source: Central Bank of Sri Lanka.

Agriculture benefited from improved weather conditions, while industry experienced its first positive growth rate in four quarters.

brought this subsector's quarterly output back to the levels produced in 2000, before the impact of the drought. Rice production, the country's main staple crop, has benefited from the return of the rain, with output in the first nine months of the year rising by 6.9%. Fishing as well posted positive results in the year through September with its increase of 5.6% over the levels in the same period of 2001. The strong showing in paddy and fishing is particularly notable, given the number of poor families that rely on them as their main source of income.

The industry sector grew by 3.1% in the third quarter of 2002, after four consecutive quarters of declines. However, the sector's output during the first nine months of the year is still below the

level during the same period in 2001. With the end of the daily power cuts in May 2002, electricity generation, in gigawatt hours, surged by 26.6% in the third quarter. This increase more than made up for the production declines experienced in the first half of the year. This provided a boost to the utilities subsector, but more importantly, the daily power cuts had been a drag on manufacturing. Manufacturing output expanded by 6% in the third quarter, a positive outcome but insufficient to recover fully from the contraction of the previous year. In contrast, mining and quarrying and construction showed continued declines in production in the third quarter, a reflection of new investment lagging the recovery. Private industries have not yet fully utilized the excess capacity, and public investments have

not been enough to make up for the slack in private sector demand.

Fiscal Policy:

Based on the fiscal performance during the first nine months of the year, the Government revised its deficit target from 8.5% of GDP to 8.9% for 2002. Revenue shortfalls were the main culprit. As of September, total revenue reached SLRs190 billion or 10% of GDP (Table 1.1). While this is a 7% increase over the level achieved during the same period in 2001, collections need to be accelerated in the final quarter if the revised target is to be reached. The transition from the goods and services tax and national security levy to the combined value added tax (VAT) had been delayed until July, but the change does not seem to have affected tax receipts on domestic goods. The delayed recovery in international trade, though, has had an impact on both customs and VAT receipts. Income tax collections actually declined compared with the first nine months of 2001. This is in part due to the lagged effect of last year's economic downturn on income tax receipts, but also because of the removal of the 20% surcharge on corporate taxes and the adjusted rates and increased exemption threshold for personal taxes. To a lesser degree, the lag between the removal of stamp duties and the implementation of

the debit tax also led to a drop in receipts.

The Government has managed to keep current spending under control and should achieve the original budgeted amount. However, spending cuts will need to be made if the revised deficit target is to be maintained, given the revenue shortfalls. Public investment has moved slowly in the first three quarters of the year, providing some breathing room for fiscal operations but at the expense of the longer-term development goals. With a 9-month fiscal deficit of 6.8% of GDP, the Government is on track to reach the revised deficit target. On the financing side, privatization proceeds—less than SLRs2.5 billion as of September compared to a budgeted amount of SLRs21 billion—have been disappointing, although much of the groundwork is now in place for future transactions.

Money and Inflation:

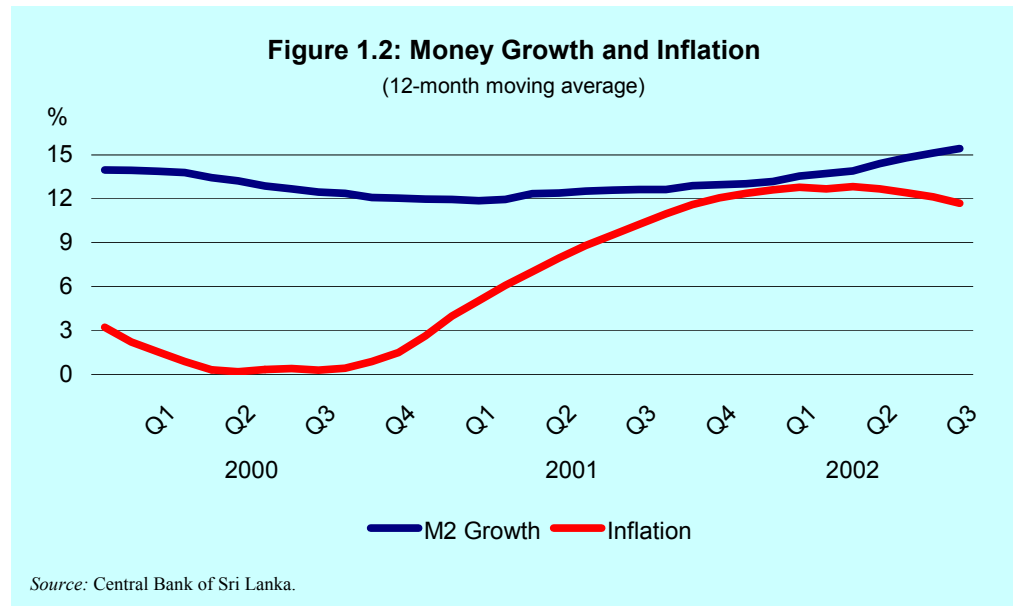
Broad money increased by 9.5% during the first three quarters of the year. Rising net foreign assets, in part from the accumulation of official reserves, and domestic credit to the private sector each accounted for about half of the growth in money supply. Reductions in domestic credit to the government were offset by a slight increase in credit to public corporations, but overall money expansion from credit to the public sector was nominal. As Figure 1.2 indicates, average money growth continues to be relatively high, given the current rates of real growth, and has been rising steadily throughout the year. While the peace process may provide some scope for monetary expansion in the short run—as part of money growth is absorbed by the increased economic activity in the North and East—the monetary authorities must keep close control over the money supply to avoid inflationary pressures.

Revenue shortfalls led the Government to revise its deficit target from 8.5% of GDP to 8.9%.

Table 1.1: Fiscal Operations

Item	9 Months		Budget
	2001	2002	2002
Revenue	12.7	12.0	17.5
Tax	11.2	10.3	15.0
Nontax	1.5	1.6	2.6
Expenditure	19.8	18.7	26.1
Current	15.9	15.7	21.0
Capital and net lending	3.8	3.1	5.1
Deficit	-7.1	-6.8	-8.5

Sources: Central Bank of Sri Lanka and Ministry of Finance.



Average inflation continued in the double-digits through third quarter 2002, but indications are that the rate has peaked.

The various consumer price indices published in the country present divergent pictures on the current level of inflation in the country, but the broader indices suggest that Sri Lanka still suffers from double-digit inflation (see Box 1.1 for a comparison of consumer price indices). However, all indices point to a peaking of the 12-month moving average inflation rate in early 2002, and declining thereafter. At the end of the third quarter, the Sri Lanka Consumer Price Index, the price index with the broadest geographical coverage, registered an average inflation rate of 11.7%. While this is roughly the same rate that had prevailed in 2001, it is a decline of roughly 1 percentage point from the peak inflation rate. Movements in the prices of food items, which make up 70% of this index, were the driving force behind this pattern.

The exchange rate has been stable around SLRs96 to the US dollar during the third quarter. In response to declining trends in inflation and international interest rates, the central bank reduced its interest rates twice during the first nine months of 2002, lowering the re-

purchase rate from 12% to 10.5% and the reverse repurchase rate from 14% to 12.75%. The interest rates on the secondary market for Treasury bonds followed these reductions.

Balance of Payments:

In 2001, the dollar value of exports declined by 13% and imports by 18%, with particularly large declines in the months following the LTTE attack on the international airport. Starting from such a low base, the year began with strong expectations of improved performance, but the first half of the year was a disappointment with exports falling by 17% and imports by 10% compared with the first half of 2001. Only in the third quarter did the long-awaited turnaround begin to materialize, but cumulative results up to the end of September were still negative. With exports suffering to a greater degree than imports, the trade gap widened by 11% to \$949 million. The main export goods, textiles and garments, declined by 10% in dollar terms; while tea exports fell by 3.5%.

Box 1.1: Consumer Price Indices in Sri Lanka—A Comparison

Sri Lanka has a number of consumer price indices, which can lead to confusion when discussing inflation. The Department of Census and Statistics publishes three indices: (i) the Colombo Consumer Price Index (CCPI), (ii) the Greater Colombo Consumer Price Index (GCCPI), and (iii) the Sri Lanka Consumer Price Index (SLCPI). The Central Bank of Sri Lanka also publishes a consumer price index, the Colombo District Consumer Price Index (CDCPI). The four indices all differ by geographical coverage, composition of goods and services in the consumption basket, and relative weights placed on the prices of the various goods. The table below illustrates the divergence in measured “inflation” from the four indices.

The CCPI is the oldest of the indices and the most narrow in terms of coverage. The consumption basket is based on the expenditures of a sample of 455 working-class families in Colombo in 1949/50. The geographical coverage is limited to Colombo city, and the index covers only 187 goods and services. Despite the changes in the country during the five decades of the index’s existence, the consumption basket has never been updated. The limited geographic coverage and out-of-date consumption basket make this index a poor measure of inflation. However, the CCPI is the only index that has legal status as a measure of the cost of living, and must be used to determine cost of living allowances for government servants, plantation workers, and workers in other industries covered by the Wages Board Ordinance of 1944. This legal status means the CCPI is the index most widely quoted when discussing price changes, despite its flaws as a measure of inflation.

On the other extreme is the SLCPI, which began publication on a trial basis in March 2002. The SLCPI is the broadest index in terms of geographical coverage and its consumption basket is current, making it an ideal candidate as a measure of inflation, but it has the shortest time series of the four indices. The consumption basket is based on the average expenditure patterns of the households with the lowest 80% of expenditures in the 1995/96 Household Income and Expenditure Survey (roughly 16,000 households), the same survey that is used to derive the poverty line for the country. While the basket is made up of fewer goods and services than the other indices—140 items—prices are collected from 20 districts across the country, only the districts in the North are excluded. The Department of Census and Statistics plans to replace the CCPI with the SLCPI, but given the legal status of the CCPI, this will be a long process including consultations with the unions and clearance by the Government.

The GCCPI covers Colombo city and the surrounding suburbs. The consumption basket includes 304 goods and services, and the weights are based on the average expenditure pattern of the households with the lowest 40% of income in the 1985/86 Labor Force and Socioeconomic Survey. This index provides a longer time series of price changes, but with some loss of generality due to the more narrow coverage than the SLCPI.

The Central Bank began publishing the CDCPI in 1997. The geographical coverage of this index is somewhat larger than the GCCPI—including both rural and urban areas—but the consumption basket of 200 items is much smaller. The consumption basket is, however, more up-to-date than the GCCPI, as it is based on the average expenditure pattern of the households with the lowest 40% of income in the 1996/97 Consumer Finance Survey.

Text Box Table 1.1: Comparison of CPI Inflation Rates

Index (%)	1998	1999	2000	2001	2002 (point-to-point)		
					Q1	Q2	Q3
Colombo CPI	9.4	4.7	6.2	14.2	9.6	9.7	9.4
Greater Colombo CPI	6.9	3.8	3.2	11.0	14.0	11.0	9.5
Sri Lanka CPI	—	4.0	1.5	12.1	13.5	11.0	9.0
Colombo District CPI	7.3	3.6	3.6	10.3	9.5	6.7	6.3

Sources: Central Bank of Sri Lanka and Department of Census and Statistics.

The trade deficit was partly compensated by the inflow of transfers, but the current account balance for the first 9 months of 2002 was a deficit of 1.3% of GDP. The overall balance was positive, and as a result, gross official reserves increased by 9.3% to \$1.5 billion (2.5 months of import coverage) by the end of the third quarter. This was supported in part by the successful completion of the IMF Standby Arrangement in September 2002.

Economic Outlook:

With the strong results in the third quarter, Sri Lanka should achieve real GDP growth of 3.0% for 2002 (Table 1.2). This is led by the services sector—tourism and shipping in particular—which shows indications of continued recovery through the end of the year. International trade will show modest gains, giving support to the manufacturing sector in addition to services. As the power cuts have been eliminated and with the favorable weather conditions, the utilities sector will also continue its expansion through the remainder of the year. However, until the excess capacity is fully utilized, recovery in the construction sector will lag.

Sri Lanka should enjoy stronger GDP growth in 2003. On the external

side, the US economy has begun to rebound, which should give a needed boost to the export sector, particularly in the second half of 2003. Investment should improve in response to the ongoing ceasefire and lower interest rates, and electricity supply should become more reliable with the commissioning of additional thermal generation plants in the first quarter. Agricultural production has shown resurgence in recent months and should perform well during the first half of the year. With continued favorable weather, the economy should grow by 5% in 2003. The possibility of war in Iraq is a key risk to the realization of this scenario as it could have a negative effect on global tourism and shipping, tea exports to the Middle East, and remittances from expatriate Sri Lankans in the Gulf.

Inflation for 2002 of 10% is somewhat lower than the previous year. Looking ahead to 2003, there is reason for optimism in terms of prices. Local prices should have fully adjusted to the tax reforms implemented in 2002 such that inflation will be on a downward trend for the year, but this will be offset somewhat by the possible extension of VAT to cover the wholesale and retail sectors. The inflation rate should fall to 8.5% for 2003; however, money supply

Sri Lanka should achieve 3% GDP growth in 2002, with prospects for further acceleration in 2003.

Table 1.2: Outlook for Key Economic Indicators

Indicator (%)	1999	2000	2001	Projections	
				2002	2003
GDP Growth	4.3	6.0	-1.4	3.0	5.0
Money supply (M2) growth	13.4	12.9	13.6	13.4	13.5
Inflation rate	4.0	1.5	12.1	10.0	8.5
Fiscal balance/GDP ^a	-7.5	-9.9	-10.9	-8.9	-7.4
Merchandise export growth	-3.9	19.8	-12.8	-4.2	6.5
Merchandise import growth	1.5	22.4	-18.4	1.4	9.0
Current account balance/GDP	-3.6	-6.5	-1.7	-3.4	-4.0

^a Excludes foreign grants and privatization proceeds.

Sources: Central Bank of Sri Lanka; Ministry of Finance; staff estimates.

growth needs to be kept in check if the reduction in inflation is to materialize. In this respect, the Government's progress in bringing the fiscal deficit down to a sustainable level is a notable achievement. The Government appears positioned to achieve the revised 2002 deficit target of 8.9% of GDP, but the shortfall in privatization proceeds will mean more reliance on domestic borrowing. The target budget deficit of 7.5% of GDP in 2003 is ambitious, but feasible (Section III has a more complete analysis of the 2003 budget). Again, the effect of a war in the Middle East on oil prices could undermine this otherwise positive outlook for 2003.

While exports will continue to improve during the remainder of 2002, they will still decline for the year by roughly 4% because of the weakness in the global economy. Imports will expand somewhat leading to a widening of the trade deficit, but improved trade in services will help fill the gap keeping the current account deficit around 3.4% of GDP. Following the expected global recovery, particularly in the second half of 2003, Sri Lanka's exports should expand by 6.5%. Imports are projected to grow by 9%, in part from increased demand for intermediate goods, but also

from capital goods to support higher investment rates. As a result, the current account deficit for 2003 should reach 4% of GDP.

Beyond the possible effects of a war in Iraq, the projections for 2003 are also sensitive to the magnitude of the recovery in the US and Europe, Sri Lanka's main export markets. Failure of either of the monsoons would have a negative impact on agricultural output and cause the power sector to rely more on thermal generation (a situation that would be aggravated by high oil prices). The stability arising from the ongoing peace process has been a key part of the recovery in 2002, and further progress is necessary to foster investor confidence in the country. The projections also assume relative political stability during the year, a factor that would be undermined if elections were to be called. Holding elections at this point would pose risks for the peace process and reforms, in addition to the usual pressure on government spending and delays in public investment. In this regard, bringing inflation under control is critical as the rising cost of living has been one of the opposition's main points of criticism of the Government.

To achieve the macroeconomic projections will require continued progress in the peace process and political stability, but the possibility of war in Iraq is a key external risk factor.

II. Policy Issues

The Government is changing its approach to industry regulation by establishing autonomous multisector regulators.

During the past year, the Government has begun major reforms in regulating certain industries, initially focusing on the state-owned utilities. Historically, the regulation activities have been the responsibility of the various ministries. However, the ministries also had direct links to the operations of the agencies they regulated. These dual roles as owner and regulator raised conflicts of interest. For example, the regulation of the power sector was the responsibility of the Ministry of Power and Energy, and the same Ministry also presided over the management and operations of the Ceylon Electricity Board, the state-owned electricity company. To remove the conflict of interest, the Government has begun to establish autonomous regulators, authorities, or commissions that focus solely on regulation, while the ministries will maintain their functions in setting policy directions for the industry and the owning the public enterprises.

Another trend in the reform agenda is a shift away from single-industry regulatory agencies to multisector regulators. The benefit of a multisector regulator includes lower costs—both direct and indirect—fewer overlapping regulatory jurisdictions, and more consistency in regulation across industries. Successful international examples—such as in Singapore, New Zealand, Central and South America—show that a multisector regulator can manage industry-specific issues as well as follow common regulatory practices in areas such as consumer protection and accounting. This new generation of regulatory agencies includes the Public Utilities Commission (PUC), Consumer Affairs Authority (CAA), and the proposed Financial Services Authority (FSA).

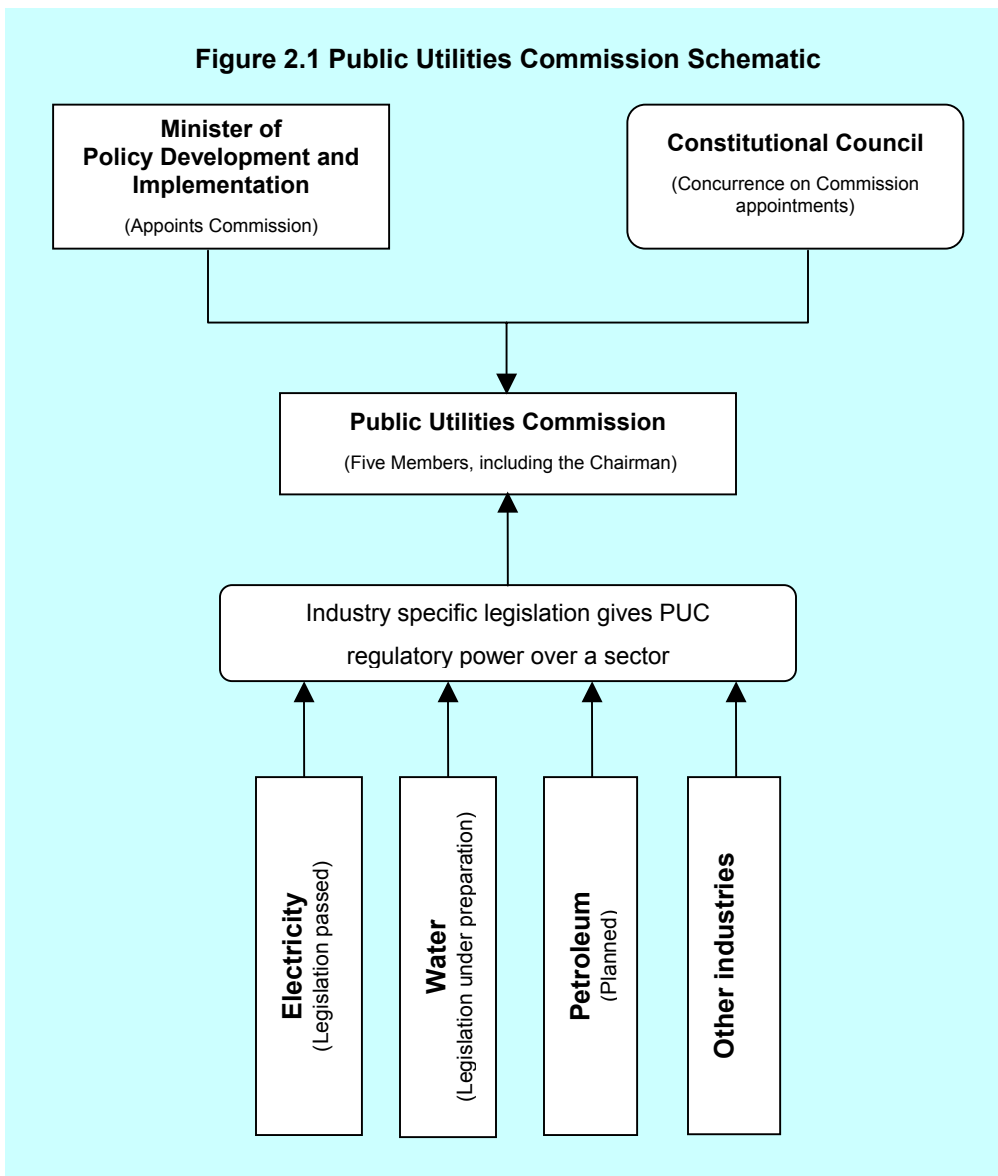
Public Utilities Commission:

The Public Utilities Commission Act, which was enacted in December 2002, established the multisector regulatory body, the PUC. The PUC functions as a regulatory umbrella for the public utilities industries. It will initially regulate the electricity sector, with plans to add water and petroleum industries, as shown in Figure 2.1. The powers and functions regulating each sector within the PUC will be provided in industry-specific legislation.

The PUC promotes competition, efficiency, safety, and quality of service in public utilities, while protecting the interests of the consumers. The PUC has been vested with the powers of advising the government on all matters such as licensing, regulation, and inspection functions, as well as tariffs and other charges. It also investigates anti-competitive practices and abuses of a dominant position and oversees the activities of monopolies. Initial funding to establish the PUC has been provided by the Government, but the PUC will generate its own funds over time from licensing fees and other charges on the industry operators.

The Electricity Reform Act, which was also enacted in December 2002, provides for the regulation of companies generating, transmitting, and distributing electricity in Sri Lanka. The administration of the Electricity Reform Act will be vested in the PUC, and the PUC will serve as the economic, technical, and safety regulator for the electricity industry. The transmission and distribution areas of the electricity sector will continue to be controlled by the government, while power generation, consisting mostly of thermal power generation,

Figure 2.1 Public Utilities Commission Schematic



The Public Utilities Commission will initially regulate the electricity sector, with plans to cover water and petroleum in the near future.

will be open to private sector participation.

Similarly, the Government is drafting the water services sector regulatory framework and necessary legislation to bring the sector under the PUC umbrella. The water service sector will continue to be a monopoly but will encourage private sector participation through the form of long-term management contracts for investment in the operations of the infrastructure. At a later date, when

other industries such as roads, ports, and air transport become liberalized and regulatory supervision is required, they will successively be brought under the PUC umbrella.

Consumer Affairs Authority:

The recent enactment of the Consumer Affairs Authority Act provides the framework for the promotion of effective competition and the protection of consumers for the regulation of internal trade. The objectives of the CAA are to

enhance the welfare of the consumers as well as ensure that investor and consumer interests are adequately protected. As the Government moves forward in privatizing state monopolies in the infrastructure sector, a coherent policy to deal with consumer protection and competition is required.

The new CAA will protect consumers against unfair trade practices and will be vested with the powers of overseeing price control and any restraint of competition affecting trade or economic development. The CAA aims to promote competitive pricing and ensure healthy competition in trade and manufacturing and tries to prevent unfair and restrictive trade practices. The PUC and the industry specific regulatory bodies will be subject to regulations of the CAA with regard to price fixing and similar anti-competitive practices.

Financial Services Authority:

The Government is considering combining the regulatory bodies of various financial services into a single regulator. The Government has created a Financial Sector Reform Committee, one of several policy development committees, to evaluate all aspects relating to financial reform. One area that the Committee has focused on is the establishment of a single regulator for financial services. The Financial Sector Reform Committee recommends the establishment of a single regulator for the financial sector to be modeled after the United Kingdom's Financial Services Authority, established under the Financial Services and Markets Act, 2000. The recommendation of the Financial Sector Reforms Committee is based on the UK experience, which has shown that "the proliferation of regulatory bodies is indeed counterproductive". The UK is one of only a few countries that

have established a fully operational single financial regulator.

Initially the FSA will have a narrower mandate and will include the regulation of non-banking financial services such as securities firms, insurance companies, and overseeing accounting and auditing standards. The proposed legislation for employer sponsored private pension funds, and anti-money laundering will also be brought under the responsibility of the FSA. Although the FSA will begin its work by regulating non-banking financial services activities, it has been recommended that the supervision of banks and non-bank (deposit taking) financial institutions, which is presently being regulated by the Department of Supervision of the Central Bank, be brought under the FSA in a phased manner within a five to six year period.

Private Sector Participation:

One of the goals of the regulatory reforms is to provide an environment conducive to private sector participation in infrastructure development. In order to improve the economic growth rate of the country, the Government's policy document "Regaining Sri Lanka: Vision and Strategy for Accelerated Development" has highlighted infrastructure development as a priority area. However, given the Government's limited resources, private-sector operators will take a bigger role in sectors that have been dominated by state-owned enterprises in the past such as the telecommunications, power, petroleum, water, and transport industries. Several initiatives have been recommended in these sectors with the view of promoting Sri Lanka as a regional economic and transport hub for the South Asian region.

Private sector participation could also include management and partial

Regulatory reforms
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sector investments
in infrastructure.

ownership over a phased time frame of the enterprises that are presently state owned. The Government's privatization program has been used to encourage private sector investments and ownership with the long-term goal of increasing job opportunities and productivity throughout the economy.

With the legislative framework in place to regulate private sector activity and raise efficiency through increased

competition, it is imperative that the regulatory bodies are fully staffed and given due independence to implement the appropriate functions vested in them. Well-managed and respected regulatory authorities will contribute to more private sector participation in infrastructure sectors and would eventually become a major factor in economic growth for the country.

III. Development Focus

The Government presented its 2003 budget to Parliament on 6 November 2002 and subsequently passed it in December. The main objectives of the budget, as stated in the budget speech, are reducing the public debt to a manageable level, stimulating economic growth, and increasing employment opportunities and earning capacity. However, it is clear from the proposals in the budget that bringing the deficit down to a sustainable level is still on the forefront of the agenda.

Revenue Measures:

The 2002 budget contained a wide array of innovations on the revenue side, and these changes are carried forward and generally refined in the 2003 budget. The main revenue changes in the new budget are the extension of the value added tax (VAT) base. Domestic wholesale and retail trade will be subject to VAT, a positive move in terms of bringing VAT to the end of the supply chain but one that is likely to increase prices. Financial institutions will also be subject to VAT, a controversial move as their “value added” will be calculated as their accounting profit plus wages paid rather than on the input/output method applicable to other establishments.

The debit tax, introduced as a temporary measure in 2002, will be expanded to apply to all categories of accounts with financial institutions. The top rate for corporate income tax will be reduced from 35% to 30% as announced in 2002, but half of this difference is to be placed in a Human Resource Endowment Fund, which is effectively an earmarked tax. The 20% surcharge on import duties will continue to the end of 2003, and most items that are currently exempt from customs will be subject to a 2-10% import duty, a move that will

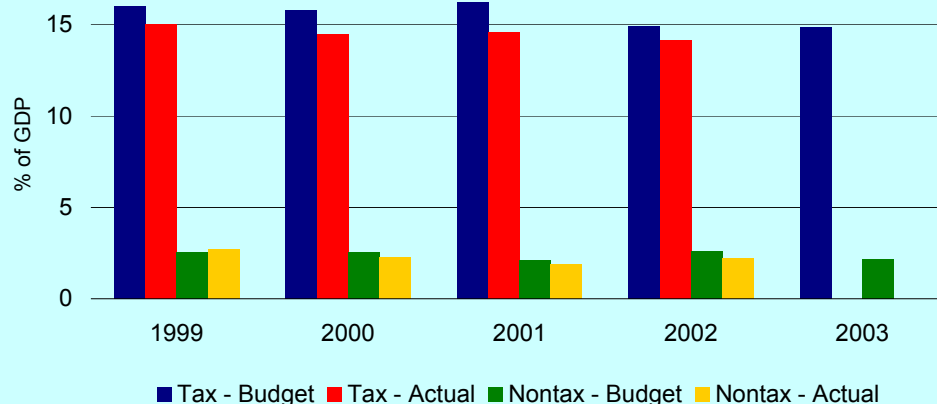
increase the average tariff rate and number of tariff bands. The flat 10% final withholding tax on bank interest introduced in 2002 is to be extended to corporate debt securities and Treasury Bills to simplify administration. Dividends, government rewards, and lottery winnings will be taxed in a similar fashion.

The 2002 budget speech called for the establishment of a modern revenue authority by April 2003. The revenue authority was to combine the functions of existing inland revenue, customs, and excise departments to increase the efficiency of tax administration. While preliminary work on designing the legal framework was carried out in 2002, but the detailed implementation plans are not yet in place. The 2003 budget speech reiterates the Government’s commitment to establishing the revenue authority, but does not give a specific timeframe for the reforms.

For 2003, the revenue projection is SLRs304 billion, a 16% increase over the revised 2002 target, or 17% of GDP. In recent years, Sri Lanka has consistently fallen short of its revenue forecasts (Figure 3.1), with tax shortfalls being the main culprit. In 1999, the budget called for tax revenues of 16% of GDP but actual receipts for the year amounted to only 15%. By 2001, the gap between planned tax revenues and realized receipts had become even more pronounced as the 16.2% of GDP target was undershot by 1.5 percentage points.

While underperformance in revenue mobilization has been the norm in recent years, several factors suggest the moderate increase in the tax ratio announced in the budget is achievable. First, many of the administrative difficulties faced in implementing the 2002 tax changes have been resolved, and the plans to widen

The Government’s
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Figure 3.1: Budget vs. Actual Revenue, 1999-2003

Sources: Central Bank of Sri Lanka, Ministry of Finance, and staff estimates.

the VAT base will further augment collections. Moreover, the recovery in trade will increase customs and VAT collections. One area of uncertainty lies in the establishment of the revenue authority. Such a dramatic institutional change may face “teething troubles” that could lead to temporary shortfalls in collections, the magnitude of which on 2003 revenue depends on the timeframe for implementation.

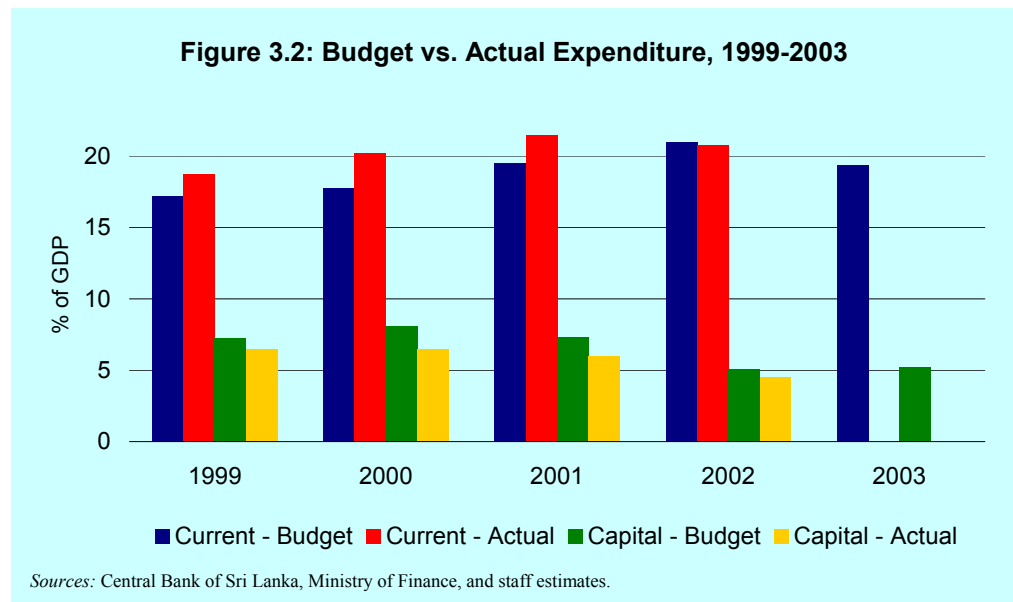
Expenditure Proposals:

As in 2002, the focus on the expenditure side of the budget is containing the growth of outflows rather than reducing the level. While a public service hiring freeze was put in place in the 2002, the 2003 budget takes a step further by abolishing vacant positions in the public service. Redundant or overlapping departments will be merged or closed. Ministries will be encouraged to liquidate idle assets (other than land and buildings) by allowing them to retain half of the proceeds for their own use, with the other half accruing to the central fund. One of the main recurrent expenditure items is the interest on public debt, and with the level of national debt

exceeding annual GDP, there is a need for closer debt management. The Government has proposed establishing an independent public debt management office to oversee all local and foreign borrowing. These functions are currently handled by several agencies including the Central Bank, which plans to eliminate this role under its ongoing restructuring. A comprehensive debt management law will be enacted in early 2003. For more immediate benefit, the Government will issue long-term bonds to replace some of the outstanding high-interest short-term debt.

The budget proposes to establish a number of specialized funds such as the Road Fund, Infrastructure and Corporate Restructuring Fund, Human Resource Endowment Fund, and Agro-Enterprise Development Fund. While specialized funds can be a way to ensure resources are earmarked for key expenditures such as infrastructure maintenance, the design of the funds is critical. If a fund is overfunded, it is not easy to redirect the resources to other uses and noneconomical investments can result; and if underfunded, additional resources may not be available from the central budget.

Underperformance in revenue mobilization has been the norm in recent years, but the budget's moderate increase in the tax ratio is achievable.

Figure 3.2: Budget vs. Actual Expenditure, 1999-2003

The budget's large reduction in recurrent expenditures as a share of GDP will be difficult to achieve but could be balanced by capital spending shortfalls.

Moreover, if a fund becomes politicized, achieving the highest economic benefit from the expenditures may become secondary to achieving political objectives.

The budgeted total expenditures for 2003 are SLRs438 (24.6% of GDP), a 9% increase over the revised 2002 amount. Recurrent expenditures account for 19.3% of GDP, compared with 20.8% in 2002. Although the moves to eliminate redundant departments and lower the interest rate on outstanding debt are positive, this large reduction in expenditures as a share of GDP will be difficult to achieve. The experience during the 1999-2001 period illustrates the difficulty in containing recurrent expenditures (Figure 3.2). Despite the rising spending target as a share of GDP, recurrent expenditures consistently overshoot their budgeted levels by 1.5 to 2.5 percentage points. The Presidential and Parliamentary elections are one factor that undermined fiscal discipline in those years because of additional expenses for holding elections and various government "giveaways" intended to garner support for the ruling party. Preliminary figures for 2002, on the other

hand, display a greater degree of fiscal control, but the possibility of Parliamentary elections in 2003 are a risk to maintaining this control. On the positive side, progress in the ongoing peace process should help contain defense expenditures, and lower interest rates and better debt management will help to reign in interest expenses.

Capital expenditures and net lending are expected to increase from 4.6% of GDP in 2002 to 6.6% of GDP. In 2002, the Government introduced a "pool fund" for capital expenditures, wherein projects that disbursed more quickly than expected could draw on these funds without having to wait for a supplementary budget passed by Parliament. However, many agencies were not fully aware of the operations of the pool and so the arrangement was not widely utilized. In 2003, the pool arrangement will be refined and more broadly disseminated among spending agencies, but the target for capital expenditures will still be difficult to achieve. As such, the overall target for expenditures is ambitious but may be met with capital shortfalls balancing recurrent overruns.

Overall Balance and Financing:

The target for the 2003 fiscal deficit is SLRs134 billion or 7.5% of GDP. This reduction of the gap by nearly 1.5% of GDP continues the trend started with the 2002 budget. The medium-term plans for fiscal consolidation are to achieve a deficit of 5% of GDP by 2006, as a means to bring the debt-to-GDP ratio down from 104% in 2001 to 85% in 2006. However, Government deficit targets have been exceeded by as much as 2.4% of GDP, although the results in 2002 are promising. To add credibility to the fiscal targets, the Government passed the Fiscal Management (Responsibility) Act, which puts the onus on the Minister of Finance to meet the targets. This act requires closer monitoring of the budget outcomes through mid-term and year-end performance reports, both of which will be placed before Parliament. Substantial deviations from approved targets will need to be placed before Parliament, and the Government will also need to report the fiscal impact of any policy measures promised prior to a general election, as a way to curb Government “giveaways” used to attract votes.

The fiscal deficit for 2003 will be financed mainly by domestic borrowing. Targeted privatization proceeds of SLRs14 billion for the year will be difficult to achieve unless the sale of the Sri Lanka Insurance Corporation is successful, as the other planned transactions are relatively small. The target for foreign borrowing is higher than recent trends. Achieving this goal will depend on the Government’s ability to mobilize the work on some of the large public investments already approved, such as the Colombo-Matara highway project and

the Upper Kotmale Hydropower Project, and its success in negotiating an IMF Poverty Reduction and Growth Facility and a World Bank Poverty Reduction Strategy Credit. The amount for foreign grants is somewhat high compared with recent levels, but could be exceeded depending on the progress in the peace process.

The announced budget does not fully reflect the funds necessary for the immediate relief and rehabilitation work planned in the North and East nor the major infrastructure development plans outlined in the budget speech. In November 2002, the Government met with the major bilateral donor agencies to discuss support for the immediate needs for humanitarian relief in the North and East. A larger donor conference including the multilateral finance agencies, planned for Tokyo in June 2003, will discuss medium-term assistance for the core countrywide investments outlined in the budget. Once the external financing has been clarified in the Oslo and Tokyo conferences, a supplementary budget estimate will be presented to Parliament.

As in 2002, the Government has set realistic—albeit ambitious—targets for its fiscal performance in 2003. The Ceylon Chamber of Commerce and the Ceylon National Chamber of Industries, two of the country’s major business chambers, have both released statements supporting the budget. Banks, however, have been very negative on the proposal to extend the VAT to cover financial institutions. The IMF also is generally positive toward the budget, and is processing a Poverty Reduction and Growth Facility for Sri Lanka based on this fiscal framework.

The ambitious target for the fiscal deficit of 7.5% of GDP is part of the medium-term strategy to bring the deficit down to 5% of GDP by 2006.

