



# **BUDGET ECONOMIC AND FISCAL POSITION REPORT - 2004**

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



## 1. Introduction

Section 7 of the Fiscal Management (Responsibility) Act (FMRA) requires the Minister of Finance to present to Parliament each year, on the day fixed for the second reading of the Appropriation Act, the Budget Economic and Fiscal Position Report. This report is issued in compliance with this requirement.

The purpose of this report is to provide information that will form the basis for the evaluation of the Government's fiscal performance against its fiscal strategy as set out in the Fiscal Strategy Statement issued under Section 4 of the FMRA, and presented to Parliament along with this report.

The Fiscal Strategy Statement specifies annual medium term targets for the budget deficit, government revenue and expenditure and the public debt.

The report provides three-year forecasts for selected macroeconomic indicators as listed in paragraph 2 below.

## 2. Medium Term Economic Forecasts

The medium term economic projections of the Government indicate higher economic growth and lower inflation. Interest rates will decline with the easing of inflationary pressures. The anticipated increase in investment will create more employment opportunities and lead to reduction in the unemployment rate. While, the current account deficit in the balance of payments is expected

to widen driven by increased investment related imports funded by foreign capital inflows, this same investment would move the country to a higher growth path in the future.

Fiscal consolidation through revenue enhancement and expenditure containment will, however, bring about a steady reduction in the overall budget deficit, over the medium term, to meet the fiscal targets laid down in the FMRA. Consequently, net Government borrowing is expected to decline over the medium term. Furthermore, the increased availability of concessionary donor funds will reduce government borrowing in the domestic market, thereby releasing resources for private investment.

The medium term projections for the period 2004 to 2006 for selected economic indicators are given in Table 1.

Details of revenue, expenditure and financing, as a percentage of GDP are given in Table 2.

## 3. Bases for the Preparation of Estimates

The bases for arriving at the above estimates are listed below.

### a) Gross Domestic Product

Economic growth is expected to accelerate in the medium term on the basis that public and private investment is expected to increase progressively from 22 percent of GDP in 2003 to 28 percent in 2006 and the expansion of the services and the industry sectors.

Forecasts for 2004 estimate the services sector to grow by 7 percent,

the industry sector by 6 percent and the agriculture sector by 3 percent. This growth is expected to gather momentum in 2005 and 2006.

b) Consumer Prices

Inflation is expected to further decline in the medium term on the basis of continued fiscal consolidation and prudent monetary policy and on account of supply side factors, such as increased domestic agricultural output, rising productivity and lower petroleum prices.

c) Employment and Unemployment

Greater employment opportunities will be created with the growth in the

services and industry sectors and the anticipated increases in investment in infrastructure and construction projects. The implementation of the Government's programmes to enable persons to acquire appropriate skills and training to match market requirements is expected to improve employment opportunities. The programme with regard to labour reforms is also expected to facilitate this process.

d) Current Account of the Balance of Payments

Exports are expected to grow at an annual rate of 8 to 10 percent (in US

**Table 1: Projections for Selected Economic Indicators**

	Unit	2004	2005	2006
Real Gross Domestic Product	% Change	6.0	6.7	7.0
Colombo Consumer Price Index	% Change	6.9	5.9	4.9
Unemployment Rate	%	7.0	6.5	6.0
Current Account Balance	US \$ Mn	-602	-978	-1,122
Current Account Balance	% GDP	-3.0	-4.3	-4.5
Government Revenue	% GDP	16.4	16.8	17.3
Government Expenditure	% GDP	23.2	22.8	22.4
Government Net Borrowing	% GDP	5.7	5.2	4.3

**Table 2: Revenue, Expenditure and Financing as a Percentage of GDP**

	2003 Revised Budget	2004 Budget	2005 Target	2006 Target
Total revenue	16.3	16.4	16.8	17.3
Tax revenue	14.1	14.4	15.0	15.8
Income taxes	2.6	2.9	3.2	3.5
Value Added Tax	6.2	6.0	6.3	6.9
Excise taxes	2.8	2.9	3.0	3.0
Taxes on international trade	2.2	2.3	2.3	2.2

	<b>2003 Revised Budget</b>	<b>2004 Budget</b>	<b>2005 Target</b>	<b>2006 Target</b>
Other	0.2	0.3	0.2	0.2
Non tax revenue	2.3	1.9	1.8	1.6
Total expenditure and net lending	24.2	23.2	22.8	22.4
Current expenditure	19.2	17.6	16.4	15.6
Civil Service wages and salaries	3.2	3.2	3.0	2.9
Other civilian goods and services	1.2	1.1	1.1	1.1
Security related expenditure	3.5	3.5	3.2	3.1
<i>Of which: defence expenditure</i>	2.7	2.8	2.5	2.4
Subsidies and transfers	4.3	3.9	3.4	3.2
Households	3.0	3.0	2.6	2.4
<i>Of which: Samurdhi</i>	0.5	0.4	0.4	0.3
<i>Of which: Pensions</i>	1.8	1.8	1.6	1.5
Institutions, corp., other govt.	1.3	0.9	0.7	0.7
Interest payments	7.0	6.0	5.7	5.4
Foreign	0.6	0.8	0.8	0.8
Domestic	6.4	5.2	4.9	4.5
Capital expenditure and net lending	5.0	5.5	6.4	6.7
Capital expenditure	4.3	4.6	5.4	5.7
Net lending	0.7	0.9	0.9	1.0
Overall Balance ( Excluding grants and privatisation)	-7.8	-6.8	-5.9	-5.0
Financing	7.8	6.8	5.9	5.0
Net external financing	2.1	2.5	2.7	2.7
Net domestic financing	4.5	3.2	2.5	1.6
Bank	-0.8	-0.5	0.0	0.0
Non-bank	5.3	3.7	2.5	1.6
Assets sales	0.8	0.6	0.3	0.2
Grants	0.5	0.5	0.5	0.5
Memorandum items:				
Current account balance	-2.8	-1.3	0.4	1.7
Primary balance (excl. grants )	-0.8	-0.8	-0.2	0.4

	<b>2003 Revised Budget</b>	<b>2004 Budget</b>	<b>2005 Target</b>	<b>2006 Target</b>
Nominal GDP	1788.0	2027.9	2293.7	2576.9
Real GDP growth	5.5	6.0	6.7	7.0
Total debt	100.1	94.9	90.0	85.0

dollar terms) for the period 2004 to 2006, while imports will grow at a slightly faster rate reflecting an increase in demand for intermediate and capital goods. The trade deficit is therefore expected to widen. However, an increasing surplus is expected in the services account, particularly on account of tourism and port services. This will contain the current account deficit to around 3 to 4 percent of GDP in the medium term.

e) Revenue

A gradual increase in revenue is expected with the continued recovery in the economy and from the implementation of several revenue-enhancing reforms of the Government aimed at simplifying the tax system and broadening the tax base. The establishment of the proposed Revenue Authority would help to improve tax administration and increase compliance. Consequently higher tax collection, particularly from Value Added Taxes and income tax, is expected in the medium term.

f) Expenditure

Recurrent expenditure is expected to be contained primarily through the decline in interest payments resulting from the deceleration and better management of public debt and the better targeting of social welfare

benefits, and through the implementation of several cost saving measures to rationalise the public sector.

It is anticipated that with the savings in recurrent expenditure, capital expenditure will be increased to maintain public investment at a level of 6 percent of GDP in order to provide adequate infrastructure to facilitate private sector, and thereby economic growth.

g) Government Borrowing

The Government borrowing requirement, as a percentage of GDP, is expected to reduce over the medium term. Domestic market borrowings are expected to decline, while foreign borrowing on concessionary terms is expected to increase.

**4. Statement on the Sensitivity of the Estimates**

The medium term economic projections listed in paragraph 2 are based on a scenario, which includes the following:

- progress with the peace process;
- political and social stability;
- continuation of economic reforms and policy adjustments;
- the strengthening of macro-economic management centred around fiscal sustainability;

- the implementation of a time bound programme of structural reforms;
- the development of infrastructure facilities;
- the effective utilisation of external assistance; and
- a favourable international economic environment, i.e. recovery of the global economy and expansion in international trade, lower petroleum prices.

These projections are sensitive to variations on the assumptions mentioned above. Two alternative scenarios have been considered below:

- High Growth Scenario – Envisages peace being achieved earlier than anticipated and an accelerated implementation of policy adjustments and structural reforms. Economic growth could then accelerate to 8 to 10 percent of GDP. The medium term fiscal targets would be more easily achieved; and inflation and unemployment would decline at a faster rate.
- Low Growth Scenario – Any delays or reversal in the peace process would however retard the process. Combined with slow progress in the implementation of economic policy reforms, this could result in economic growth falling below 3 percent. This would impact the budget deficit, inflation and unemployment, all or any of which would rise.

## 5. 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. 20 billion as at the end of June

2003 compared with Rs. 18 billion at the end of last year. The share of Treasury guarantees as a percentage of GDP has, however, declined marginally from 1.13 percent as at the end of 2002 to 1.12 percent at midyear 2003.

- Key proposals of the Government in connection with Government spending not included in the estimates are reflected in the Three Year Development Programme of the Government and in the Physical Infrastructure Development Programme.