SANVADA සංවාද சம்வாதம்

'POLICY BRIEF 23'

pathfinder

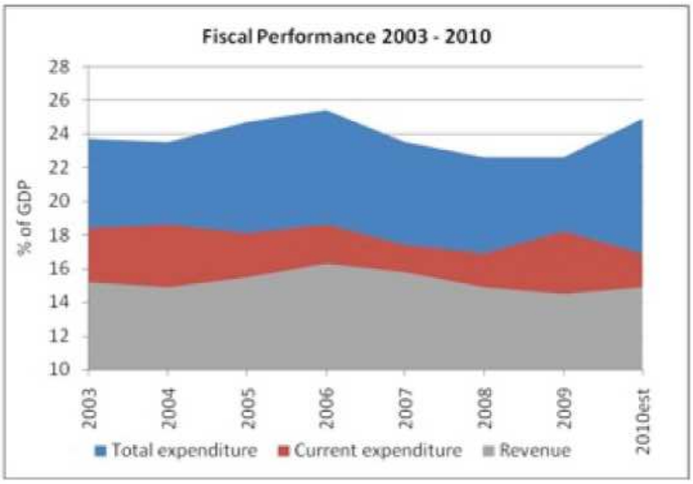
BUDGET 2011 ON THE ROAD TO ECONOMIC MIRACLE: A PRE-BUDGET ANALYSIS AND SUGGESTIONS

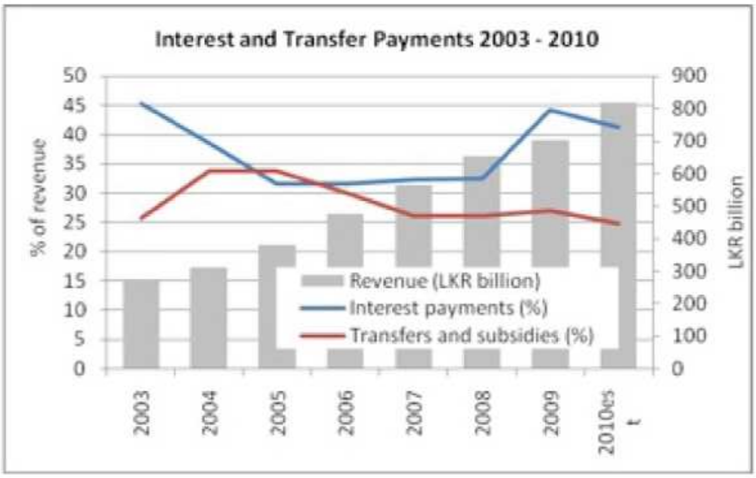
The Budget 2011 of the Sri Lankan Government which will be presented in the parliament in November 22, 2010 is a special one. The economy has just relieved from the major internal and external factors that caused an aggravation of the budgetary performance in the past few years. The government has set its development vision to achieve the goal of medium-term economic prosperity in the post-conflict peaceful environment. Given this background, firstly, the Budget 2011 is important in setting the foundation for addressing the fundamental weaknesses of fiscal operations. Secondly it is also a fundamental policy requirement that the Budget 2011 needs to be consistent with the medium-term development agenda in contributing to an acceleration of growth momentum. Both aspects of the Budget also entail reforms that are politically sensitive by nature and that require long-term restructuring process beyond a single fiscal year. It is, however, a given fact that the decisions have to be made sooner or later and, it is sooner the better. One positive development would be that the accelerated growth naturally contributes to relieve the country's fiscal burden as well.

Fiscal Operations: Fundamental Weaknesses

The fundamental weaknesses of Sri Lanka's fiscal operations which have often been the topics of interest in policy debates in the past are deep-rooted and long-standing. Weaknesses in the heart of the revenue and expenditure patterns and structures are reflected by the actual budgetary outcomes, although every year the annual estimates reflect optimism. The current expenditure exceeds total revenue, compelling the government to borrow for part of the day-to-day expenses (Chart 1). The practice has resulted in an unsustainable current account deficit. Given this fact, public investment appears to be entirely based on borrowings.

The structure of the current account expenditure also reflect a fundamental weakness of the fiscal operations as interest payments alone eat into 40% revenue and, transfers and subsidies to 25% of revenue (Chart 2). The latter includes transfer payments to both households and institutions. There are issues related to distribution of social benefits among different social groups and individuals and the increase in the expenditure on most of the subsidy programmes against the reduction in the share of poor population. *The Annual Report 2008* of the Ministry of Finance and Planning (2008: 140) had already identified the major critical issues related to financial viability and debt accumulation of the public enterprises. These issues, however, appear to have become multiplied and deepened during the past few years exerting further pressure on the government fiscal operations.

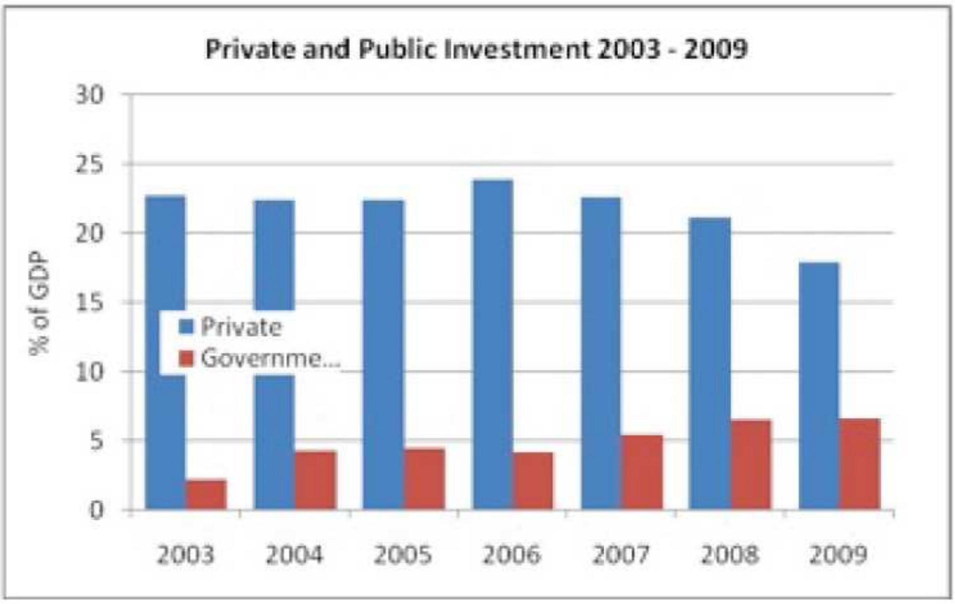




Private Sector-Led Growth Momentum

In the context of the government's policy document – *Mahinda Chintana* Vision (2010), the government has set commendable growth targets to be achieved in the medium-term. As outlined in this policy document, it is expected to sustain over 8 percent rate of economic growth annually and to reach USD 4000 per capita income by 2015. In order to realize these growth targets, it is necessary to raise the investment ratio to about 40% of GDP and to sustain it in the long-run.

There is little dispute about the fact that a significant part of new investment should come from the private sector which should raise their investment ratio nearly by three-fourth (Chart 3), as the increase in public investment above its current level is difficult and subject to the present fiscal and debt constraints. Besides, the government has to deal with cutting down budget deficit within the next few years. In addition, in the past few years the government borrowing from domestic sources has created an increasing pressure on private credit expansion and investment. Even if the domestic policy issues are addressed, it is a given fact that the local private sector is 'too small' and its expansion is 'too long' beyond the medium-term. Therefore, a significant proportion of investment should also come from FDI flows.



Reform Process beyond Fiscal Year

The policy framework, within which the Budget 2011 is formulated, thus, extends well beyond the forthcoming fiscal year to medium-term, as the budgetary outcome can either enhance or undermine the anticipated growth prospects. The relevance of the Budget 2011 in the context of high growth prospects arises especially due to the relationship of the budget to the macroeconomic *fundamentals and the policy and regulatory framework.*

Macroeconomic fundamentals

Macroeconomic fundamentals, as reflected by the average prices in the economy (inflation rate, interest rate and, exchange rate) are directly related to the government's fiscal operations. The policy framework becomes growth-friendly when the prices are stable but flexible and, predictable, which would build investor confidence.

Policy and regulatory framework

Domestic policy and regulatory framework should offer simple, rational and fair 'rules of the game'. Contradictory policies and complicated procedures would not only make fiscal operations complicated and costly, but also hinder potential growth of investment and economic activity. The policy measures and bureaucratic procedures related to government revenue and government expenditure are the areas associated directly with the weaknesses in fiscal management.

Key Areas for Budgetary Reforms

The key areas for budgetary reforms include reforms in revenue generation and government expenditure as well as reforms in other areas which have significant implications in improving fiscal prudence. These other areas include tax collection mechanisms, reforms in public institutions, private investment participation and, reforms in the regulatory mechanisms. It is understandable that some of the reforms related directly and indirectly to an efficient and transparent budgetary management and other areas are limited to a 'short-run' agenda in a particular fiscal year and do not even come under an annual budget. However, the commencement of an overall reform process is vital to improve the budgetary management gradually in the medium-term.

Revenue and Taxation

The composition of direct and indirect taxes should change further with an increase in the share of direct taxes not by raising tax rates, but widening tax base. Although Sri Lanka is one of the few countries with highest marginal direct tax rate of 35% for both individuals and corporate and the total tax rate of 64% of profits, very few are reported to pay taxes. The ad hoc procedures adopted for widening the direct tax base should change to an 'automated data base system' in which income and wealth of all individuals are recorded and reported.

As reported in international data reports, Sri Lanka has a complicated and unpredictable tax system, which is costly to the government as well as to the tax payers. For instance, Sri Lanka has 62 number of tax payments per year, which requires 256 hours to complete the procedures. Investors find it risky to do business due to high degree of unpredictability of the taxation system. The problems need to be addressed by:

1. reducing the number of taxes
2. simplifying numerous tax-levying procedures
3. removing irrational or absurd taxes
4. simplifying the tax-paying procedures
5. reducing tax-refunding delays
6. avoiding ad hoc ways of imposing or removing taxes.

Recurrent expenditure

Public enterprises require greater autonomy to operate on the basis of economic and management principles because the issue in question arises due to the strong link between ownership and management and the political objectives that override business principles. It is not advisable to add up more to the number of public enterprises, by taking over the private enterprises. This practice will have a double blow as it would drive away the potential investors on the one hand and, would set the parameters for further increase in fiscal burden. As far as the existing public enterprises are concerned, it is advisable:

1. to delegate not only the powers but also the responsibilities to the public enterprises and,
2. to set the time framework for suspending government transfers for recurrent expenditure.

The government institutions dealing with public administration should also have a greater autonomy and an incentive structure to operate on demand-driven basis. The services delivered by some of the public institutions can be at a cost to the customer, which would contribute to the economy in numerous ways. It would:

1. reduce the scope for bribery as the bribe is now translated into a legitimate price.
2. provide an incentive system for the institution for demand-driven and efficient delivery.
3. reduce the fiscal burden as part of the operational cost or even more is generated internally.
4. set the ground for competition which would result in a continuous improvement.

The provincial council system and the fiscal decentralization have become debatable issues because of the national contribution made by the Provincial Councils which drain annually over 12% of the government revenue. If the Provincial Councils continue to exist, it would be advisable to put them at work and improve competition among them by:

1. increasing financial autonomy to share tax collection and revenue,
2. delegating more administrative, welfare and development functions and,
3. improving competition and accountability. For instance, health, education and, social welfare could be transferred entirely to the Provincial Councils.

For instance, health, education and, social welfare could be transferred entirely to the Provincial Councils.

Household subsidies and welfare

It is necessary to reveal the government's policy stance regarding social security system and its future directions. An important question is how the government intends to change household subsidies in response to the medium-term economic prosperity and the achievement of MDG targets, particularly an increase in per capita income and a reduction in the share of poor people. Apparently, the number of people dependent on the government's poverty alleviation programme should gradually decline by 2015.

Issues poor-targeting, cost-effectiveness and inefficiencies of the country's household subsidy programmes have been widely discussed and debated. An automated data base for taxation (proposed earlier) can be extended to cover the potential beneficiaries of the household subsidies, and numerous other subsidy and welfare measures of the social safety nets. In addition, all forms of benefits can be delivered efficiently by issuing a Social Safety Identification Card to the entitled households or families.

Public investment

It is commendable that the government has expansion of expenditure on public investment due to tax and debt constraints. As the local or foreign private sector can also play a major role in this respect, it is appropriate to attract local and foreign private investment through different private-public partnership mechanisms. This would relieve the government's fiscal burden on the one hand and, would accelerate the investment drive needed for rapid growth on the other hand.

Sector-specific regulations

Taxation and regulation issues should be addressed by taking specific sectors and specific economic activities. This also requires continuous dialogue among the stake holders to undertake reforms. The following are some of the issues in specific sectors. In addition, tax reforms are necessary but not sufficient as there are other issues to be addressed along with tax reforms. Investment promotion requires 'investment registration' rather than 'investment approval' in a non-discriminatory manner between local and foreign investors. Investment registration can also be facilitated through Internet-based application system reducing bureaucratic procedures. There are many problematic areas to be addressed particularly at local government levels.

Sri Lanka's international trade volume as a percentage of GDP has consistently declined in the past few years. This has been contributed by domestic factors as Well, such as the expansion in the non-tradable sector supported by the government development strategy and the distorted incentive structure in the domestic economy. While tax reforms in international trade is important, simplification of the bureaucratic procedures and improvement in Port efficiency are critical issues to be addressed in the medium term.

Concluding Remarks

The reforms are not intended to reduce the tax revenue to the government. On the contrary they will improve tax revenue in the medium-term because the tax base is widened and taxable economic activities are expanded. More importantly, the accelerated growth momentum due to improved investor confidence would definitely raise the tax revenue in the medium-term because ultimately the tax revenue depends on economic growth.

This Policy Brief by Dr. Sirimal Abeyratne, Professor in Economics at the University of Colombo, is based on a public seminar (Sanvada) organized by the Pathfinder Foundation. The rest of the panel at the seminar included Dr. Anura Ekanayake, Mrs. Gayathri Gunaruwan and Mr. Chanuka Wattegama. This Policy Brief can be downloaded from www.sanvada.org

PATHFINDER FOUNDATION | Telephone No: 2 372 895 | E-mail: info@pathfinderfoundation.org
website: www.sanvada.org, www.pathfinderfoundation.org

Editorial Assistance Ms. Ameera Arooz, Project Manager