Policy Orientations in the Budget 2011: A Critical Appraisal

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Introduction

The Budget Speech delivered in the Parliament by HE the President on November 22, 2010 in his capacity as the Minister of Finance, represents a specific vision and elements of a policy framework designed to reach the principal goals that characterise this vision. The references to policy in the Budget speech have to be understood as further elaborations of the basic philosophy initially given expression as the *'Mahinda Chinthana'*, and developed further in the several official statements including *'Mahinda Chintana Idiri Dekma'* and the *'Mahinda Chintana: Vision for a New Sri Lanka'*. It is clear that the thinking behind the policy framework sketched in the Budget Speech 2011 is influenced to some extent by the realities of the socio-political environment emerging in the aftermath of the dawn of peace and political stability.

The present exercise attempts a critical appraisal of the core economic policies enunciated in the Budget 2011 with a view to examining their relevance and effectiveness in achieving the objectives set forth. There will be an attempt to answer questions, such as, what are the main features of the overall strategy, and whether the proposed measures are consistent with the declared objectives. The first section of the paper is a summary record, according to the author's best judgement and interpretation, of the goals, objectives and strategies explicitly and implicitly presented in the Budget. Section two attempts a critical evaluation of the main policies and strategies and makes some conclusions and recommendations.

The Budget 2011: The Vision and Strategic Policies

A number of statements contained in the Budget Speech 2011 point to a certain vision for the future of Sri Lanka which embodies a substantially higher quality of life covering material, social and spiritual well-being for all. These include—

i. A "Strong middle income economy by 2016"

ii. "They (the people) want a decent living, a clean environment and a better life for their children"

iii. "People in every village will have access to electricity, a road network, drinking water, telecommunication facilities, marketplaces and townships. Above all, they must have food and energy security and a green environment to live in".

iv. "Reduce poverty below 5 percent within the next five years".

v. "Place Sri Lanka as the leading nation in achieving the Millennium Development Goals".

vi. "We must ensure that our society must not be a victim of crimes, drugs, illicit activities, money laundering and financial frauds".

The basic quantitative targets for the economy consistent with this vision have also been set forth. Accordingly, the overall growth rate is about 8 percent in the medium term. It is expected to increase to about 10 percent in the period thereafter. The other relevant targets for the period 2010 – 2016 as a percentage of Gross Domestic Product (GDP) are:

i. Private Investment: 26 to 28
ii. Public Investment: 6 to 7
iii. Total Investment: 32 to 35

The Budget speech, taken along with the several policy statements, provides a good indication of the strategy that the authorities propose to follow to attain these targets. From these, it is clear that, initially, the two main pillars of the proposed strategy are the re-invigoration of the rural economy and resettlement and livelihood restoration of the people affected by the 30-year old civil conflict. This activity is expected to be a springboard for launching the substantive development programme covering the entire country.

The 'Rural Centric' approach to development involving the empowerment of the village is seen as a way of integrating the rural economy more closely with the rest of the domestic economy. Parallel to this is the 'Hub Concept' involving the development of Shipping, Aviation, Commercial, Energy and Knowledge infrastructure to a high level of efficiency which is seen as a way of integrating the service sector more closely with the international economy. This dual approach may be interpreted as a way of maintaining a balance between the allocation of resources between domestic and external sectors.

Another important feature of the overall strategy is that it assigns an active rather than a passive role to the State, where in addition to assuming the ownership of the

Table 1: Summary of development strategy

Area chosen for special attention	Proposed policy action (Selected measures)[a]
(1) Savings & Investment	Several tax concessions to Unit Trusts and removal of exchange control restrictions for investment by foreigners. Incentives for listing of companies at CSE (Colombo Stock Exchange). Reducing Income tax burden in general.
(2) Financial Institutions	Removal of Bank Debit Tax, Reduction of VAT (Value-Added Tax), Income and Profits Tax Rates for financial institutions; Exemption of reinsurance commissions and claims from VAT. Appointment of a Presidential Commission on Financial Institutions.
(3) Education	1000 well-equipped secondary schools; Older universities to be upgraded to world class.
(4) Research and Development (R&D)	Setting a 2 percent of GDP target for total R&D expenditure at the end of the next decade. A 200 percent of R & D expenditure allowed as deductions from taxable income of firms, Setting up an Innovation and Technology Development Fund.
(5) Tourism	Reduction of Income Tax Rates on income earnings from tourism industry and related activity. Reduction of import duties and taxes on passenger transport vehicles and machinery and equipment needed for refurbishment and expansion of facilities. Refurbishment of Rest houses and Circuit Bungalows.
(6) Small and Medium Enterprises (SMEs)	SMEs placed on Concessionary rate of Income tax (at 10%). Sub-contracting SMEs to be exempted from the Economic Service Charge. Lower duties for machinery and equipment for clothing, footwear and baggage industries. Assistance to SMEs and underperforming businesses to restructure and optimise.
(7) Information Technology (IT) and Business Process Outsourcing (PBO) Activity	Existing tax incentives for IT and BPO activities further enhanced. Removal of VAT and NBT (Nation Building Tax) on software. Work towards a target of 75% ICT (Information and Communication Technology) literacy in 2016. A 'Knowledge City' linked to a university township to be established in each province.
(8) Public Administration	10,000 graduates to be recruited to the all island services in the Government. A further 1500 to be recruited as management trainees to the State Banks. A 5% increase in Salaries of public servants and a Cost of Living allowance of Rs 600. Establishing a contributory medical insurance scheme and dedicated hospital facilities for the public servants, Provincial Turnover Tax to be abolished and revenue loss to be recouped from several other Central Government taxes.
(9) Ports and Aviation	Port City development in Magampura to be continued. Joint ventures to undertake maintenance, repairs and overhauling of aircraft and cargo operations to be encouraged. A graduate school of Aviation to train pilots and other professionals. Tax exemptions for the Sri Lankan and Mihin Lanka for 10 years.
(10) Export Industries	Income Taxes on all export industries reduced. Import duties and other taxes on machinery and raw materials reduced.Industries with a value-added ratio of 65% or more and those with Sri Lankan brand names with patent rights reserved in Sri Lanka to pay a lower rate of income tax. Laws to curb anti-competitive practices by the shipping trade.
(11) Textile and Garment Industry	Further facilities to promote entrepot trade in apparel and clothing. Measures to attract leading buyers to establish their headquarters in Sri Lanka.
(12) Social Security	Establishing an Employees' Pension Fund to place the employees in the private and corporate sectors on a retirement pension scheme. Establishing an Overseas Employees' Pension Fund to give similar benefit to Sri Lankans employed abroad. Establishing a Citizens' Pension and Insurance Fund for the benefit of all citizens.
(13) The Environment	Introduction of laws to protect the national bio-diversity resources. Actions to be taken to improve the reforestation and water management systems. Identification of land-fill sites for use by the Local Authorities to better manage the waste disposal activity.

[a] Only selected measures are mentioned in Col 2 to illustrate general strategy.

strategic enterprises, the public sector maintains the option of participating directly in selected economic activities where such participation serves the national interest. It is now clear that

Mahinda Chintana not only rules out privatisation of State-owned enterprises in the future, but would also stand ready to reverse any privatisations carried out in the past which have clearly failed to achieve the expected results. However, this does not mean that the private sector is sidelined. On the contrary, the numerous policy measures now proposed in the Budget suggest that the private sector is assigned a very important role in the whole development process. It is clear that government intends to support the development of a healthy and strong private sector and is agreeable to formation of useful partnerships with it where necessary.

It is possible to see that special attention has been paid to a number of key sectors and activities for which substantial tax concessions, along with other fiscal and institutional development measures including investment of public funds have been proposed. Table 1 presents a summary of these chosen thrust areas and the main elements of this strategy as reflected in the Budget 2011.

The list shown above may be considered a sample of sectoral strategy, and is by no means comprehensive. However it is indicative of the thinking of the Mahinda Rajapaksa Government on how economic development of the country should be approached.

A Critical Examination of the Economic Policy Underlying the Budget 2011

It is difficult to disagree with the broad sectoral approach adopted in the Budget. It includes corrections of a number of long-standing mistakes and anomalies, such as, bringing the public servants under the PAYE (Pay As You Earn) Income Tax net and the abolition of the Bank Debit Tax. Even though their impact on the government revenue may not be high, these would certainly help build the confidence of the private sector and will, therefore, be an important factor in obtaining its cooperation to the development initiatives undertaken by the government.

Among the other positive features of the policy framework underlying the Budget proposals are:

i. Movement to a lower average income tax rate for both the corporate and individual taxpayer. The benefits will include higher capacity to save and stronger incentives to work.

ii. Establishment of an Independent Revenue Commission pertaining to Customs, Excise and Inland Revenue. This will provide some relief to the taxpayers and help to improve their relations with the tax authorities. It will also enable better co-ordination of revenue administration presently handled by several departments.

iii. Selection of critical sectors and activities for support through tax and non-tax measures. The examples are the Rural Economy, the Small and Medium Enterprises, Research and Development activity and Human Resource Development. These are critical to achieving both short-term and long-term growth objectives as well as improved income distribution.

There are also certain issues that invite critical comment. These are briefly outlined below:

i. Even though the Minister of Finance promised to simplify the tax system at the outset, there is no evidence that this has happened. In fact, the free use of tax incentives to promote the chosen sectoral objectives has probably resulted in making the system even more complex than before. This is likely to leave greater room for manipulation by those who attempt tax avoidance and fraud.

ii.There is no evidence that the tax base has been broadened except for the extension of the PAYE scheme to public servants. The resulting actual increase in the number of taxpayers may not be significant. Large sectors still remain outside the tax net.

iii. One of the main problems with Sri Lanka's tax regime – low elasticity with respect to GDP, has apparently not been corrected. The outcome is that tax collection may not automatically keep pace with economic growth. This means that ad-hoc corrective measures are required, leading to uncertainties normally detrimental to investment.

iv.A further perennial issue is the regressive nature of the tax regime. This is attributed mainly to the high reliance on indirect taxes. This has important implications on equity - an objective receiving high priority under the present administration. Except for the abolition of the Provincial Turnover Tax, which is hardly adequate, this issue has also not apparently received the attention it deserves.

v. The introduction of a cess on exports of raw materials and semi-processed goods cannot be regarded as sound policy. Since Sri Lanka's development depends critically on the performance of exports, no tax or levy on exports can be regarded as a progressive step. Normally, the raw material and semi-processed goods attract lower duties than finished goods in the importing country. Sri Lanka too adopts this policy for its own imports. Therefore the decision to export goods with higher value-added ratio has to be left to the entrepreneurs who are in a better position to assess the advantages and disadvantages of exporting goods in a particular form. If policy intervention is considered essential, measures other than cesses and levies that make Sri Lankan exports less competitive in the international market have to be considered.

vi.The abolition of the Provincial Turnover Tax requires reconsideration. This move makes the Provincial Councils (PCs) more dependent on the Centre, which goes against the principle of devolution. The option of introducing an alternative tax to be administered by the PCs should have been considered.

vii.The use of import tariffs as an instrument of industrial policy is not in line with modern thinking on development. These may also be in conflict with emerging rules of international trade. Furthermore, Sri Lanka's own experience in the 1960s and early 1970s showed the futility of building up industries behind high protective walls. It slowed down economic growth, discouraged exports and created severe Balance of Payments problems. The present policy regime, further strengthened by the new Budget proposals where imports of investment and intermediate goods are allowed under lower tariffs and final goods are allowed under relatively high tariffs lead to extremely high Effective Protection of domestically-produced goods. It may result in large price distortions detrimental to efficient resource allocation and competitiveness. The resulting growth of industries may be illusory. Therefore, it is difficult to see how such a policy can be reconciled with high growth rates expected in the medium and long terms.

viii.The Minister of Finance rightly pointed out that one important condition for maintaining a favourable investment climate is the presence of efficient government institutions. However, in the opinion of many observers, the size of the government service, reckoned in terms of the number of employees is too large, the ratio of government employment to total population in Sri Lanka being one of the highest in the world. It is noteworthy that the salary proposals for the government servants presented by the Minister of Finance clearly indicated that it is the sheer size that prevents the government from granting its employees adequate remuneration. The question then arises how an underpaid public service can be effective in facilitating investment. Therefore, any reforms to be undertaken should aim at creating a lean but efficient government service.

ix.One important weakness of the economic development programme represented in the Budget and indeed the economic programme of the *Mahinda Chintana* is the lack of clarity in its macro-economic policy framework. This is in contrast with its strong focus on the sectoral issues and priorities which are generally well-articulated as mentioned above. However, a purely sectoral approach does not guarantee growth.

Several questions relating to the behaviour of the rate of inflation, public sector borrowing, public debt, external debt and the exchange rate during the plan period remain largely unanswered. Given that economic stability has a significant impact on the growth performance of an economy, (via investor sentiments, interest rate movements and savings behaviour among other things), only a well-articulated macroeconomic programme which shows how the economy is expected to move on a non-inflationary path can give the necessary credibility to the economic growth targets.

In the management of its economic policy, Sri Lanka can benefit greatly from the experiences of the East-Asian Countries during the 25 years preceding 1993. During this period, the per-capita incomes in the East-Asian region almost quadrupled. The absolute poverty levels fell by about two thirds on average and health and education underwent a marked improvement. This is sometimes referred to as the 'East-Asian Miracle'. The importance of price stability is highlighted in the following account. *(See Box).*

From the success Story of East- Asian High Performers

"Common to East Asia's success were policies for macroeconomic stability, human resource investments, and outward orientation – quite different from what happened in most other developing regions. Because these economies, to a large extent took international prices as an ultimate guide to domestic resource allocation, macroeconomic stability was seen as central to maintenance of competition. In addition, a number of regimes had a strong aversion to inflation.

And in many areas, including export promotion, it was not just the design and selection of policies; it was also efficient implementation".

Danny M Leipziger and Vinod Thomas (1993):The Lessons of East Asia: An Overview of Country experience (A World Bank Publication)

Conclusion

The major proposals presented in the Budget 2011 appear to be based on a realistic assessment of the development issues facing the country. Accordingly, the fivefold 'Hub Concept' addresses the development of the services sector and the commitment to shared growth through a 'Rural Centric' approach addresses the income distribution issue. The mix of policies presented suggests a strong sectoral approach to development. However, it is also clear that this has not been matched by a suitable approach to correct the macroeconomic fundamentals. Despite this shortcoming, the Budget 2011 has several positive features. It has introduced a number of forward-looking proposals relating to the promotion of investment, research and development, promotion of information technology, education and human resource development. These will undoubtedly have salutary effects on economic growth during the medium and long terms. The high reliance on fiscal incentives for achieving sectoral objectives have the disadvantage that it imposes a limits on what could be done to reduce the average tax rate and to simplify the tax regime. This is perhaps the major dilemma faced by the authorities during the budget exercise. The concerns expressed here about the adequacy of tax reforms have to be viewed in this light.

If the overall growth and development objectives set forth in the Mahinda Chinthana are to be achieved, it may be necessary to learn from our own past experience and those of other countries which succeeded in accelerating economic growth and development. There may be a need to re-examine, in particular, those policies advocating the use of import tariffs to protect inefficient industries over long periods, excessive expansion of the public sector, and direct and indirect measures impinging on the competitiveness of the export industries. What has not been adequately appreciated so far is that most market distortions caused by such wrong policies involve costs to the economy which may be substantial. Apart from slowing down economic growth, such costs also will eventually impact negatively on the fiscal deficit, making fiscal consolidation that much more difficult in the coming years. What may be required at this juncture is greater pragmatism on the part of the policymakers – a willingness to discard failed or discredited policies and strategies and adopt those which have proven track records and aligned closely with the emerging economic realities of an increasingly globalised world. ■