The Current Budgetary Policy: Goals, Strategies and Tasks

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Introduction

The 2009 budget has been presented in the parliament. It is the fifth budget of the present government and the fourth budget that has been based on the development framework of *'Mahinda Chintana'*, a vision for a New Sri Lanka - A Ten-Year Horizon Development Framework 2006 – 2016. This new development framework was introduced as an election manifesto of the Presidential election in 2005, and the first came into practise with the 2006 budgetary policies. The 2009 budget is also a successive effort of this development framework. The *Mahinda Chintana* vision is, in fact, a supplementary framework of *'Rata Perata'* development program of the government appointed in 2004. Under this *Rata Perata* program, the United People's Freedom Alliance (UPFA) presented some strategies for national development to make Sri Lanka an economically and socially prosperous country. In this context, the high level of economic growth with improved equity in the country has been the main objective of the government. Specific strategies have also been formulated for different sectors such as agriculture, industry, tourism, etc. and for economic infrastructure development, poverty alleviation, unemployment reduction, human resource development, etc.

The strategies of the *Rata Perata* and also *Mahinda Chintana* development programs were basically formed considering the 'Millennium Development Goals (MDGs) of the United Nations Development Program (UNDP), which were initiated by the United Nations Millennium Declaration, signed in September 2000 (Government of Sri Lanka, 2006). Under this overall policy framework, the present government is moving towards a new goal of national development, paying particular attention on the fiscal policies in accomplishing this goal. The annual budgets play a major role in this process. A variety of new projects, programs and also activities have been initiated under budgetary proposals. Some of the existing programs are also being accelerated to achieve certain objectives. However, for the last one and half decades, the fiscal sector in the country has been critical due to its huge deficit. This widening deficit of the budget, on one hand, has drag the country to an outstanding public debt trap, and on other hand, has compelled the government to curtail essential expenditures significantly. Therefore, the reduction of the fiscal deficit and the public debt to a desired level has been an important task of the government in relation to the fiscal sector. Indeed, this task is not a new one; it has a long history. All governments ruled the country since the late 1980s have attempted to accomplish this task by adopting various measures.

Background of the New Goal

The *Rata Perata* program has been, basically, formulated in the context of neo-liberal policy principles. These policies were initiated by the Washington-based financial institutions in the early 1970s, as a new developmental concept for the world. Particularly, the World Bank (WB) and the International Monetary Fund (IMF) advised the developing countries to implement these policies as an essential requirement for both short-term stabilisation and long-term growth (McGrillvary and White, 1999). The WB and the IMF have further tied these policies to their conditionalities with regard to the development aids and loans for developing countries. As a result, over the last three decades, the neo-liberal policies have spread out rapidly in many countries of the world. The basic foundation of this overall policy is the reduction of state intervention in economic activities, and economic liberalisation and the opening up of the markets (Williamson, 1990 and 2000). In Sri Lanka, all successive governments that ruled after 1977 also adopted more or less the same policy principles in economic management. The *Rata Perata* program of the government elected in 2004 was also based on this spirit of neo-liberalism. However, there were certain strategic changes in this development framework compared to those in the past. Hence, the 2004 government initiated an approach which emphasised a home-grown development strategy for the country within the neo-liberal context (Government of Sri Lanka, 2005).

This strategy is not a new development approach which suddenly evolved; it has a clear link with the early period of the Freedom Alliance government. The Freedom Alliance government elected in 1994 originally initiated a humanitarian outlook to the concept of open economy in order to retrieve the people from the clutches of neo-liberalism. This is simply called the 'human face' in development (Lakshman, 1997). The social justice and democratisation are considered as the general meaning of this new approach. Based on this new ideology, the government came into power in 1994 paid much attention on social welfare and poverty alleviation (Jayasuriya, 1999). A number of social welfare programs such as Samurdhi, food stamps and school mid-day meal were initiated (Gunatilaka, 2000).

In addition, to awaken an indigenous economy, there was an important effort in the country through providing infrastructure facilities, aiming at providing equal opportunities for development in the rural areas of the country (Government of Sri Lanka, 1995). Particularly, the government thoroughly took into account the local development potentials and resources available in its local development planning. All budgetary policies and proposals were formulated based on this focus and hence, the theme of the budget preamble after 1995 was "sustainable economic and social development, based on local values and national priorities". The Finance

Minister tried to adopt this goal intensely in his budgetary strategies from the 1995 budget stating clearly the budget would be a "people-friendly budget" that would be "pro-poor" as well as "pro-growth". This important shift of development policy approach was not just happened in Sri Lanka, but is generally taking place across the developing countries due to some shortcomings in the extremist neo-liberal policies. The IMF and WB also generally recommended some of these reforms and special programs to mitigate the problems arising in the developing world (Prabhu, 2001, Weerakoon, 2004).

There are a number of reasons which led to the emergence of this new approach all over the world. The curtailment of subsidies and the reduction of state intervention in economic activities under the liberalisation programs, particularly in essential services, have generated harmful results in many economies. The social sector suffered the most under liberalised policies in many countries. Poverty has expanded within developing nations (Rodrik, 2002; Prabhu, 2001). Many international agencies and intellectuals have seriously taken note of these problems, and have come up with ways to minimise the problems. The Report of the UN World Commission on the Social Dimension of Globalisation has stated "Seen through the eyes of the vast majority of men and women around the world, globalisation has not met their simple aspiration for decent jobs, livelihoods and a better future for their children." However, the commission did not devalue the whole potentiality of current process of globalisation in growth and development. It only discusses the shortcomings, particularly with regard to people's social development (World Commission on the Social Dimension of Globalisation, 2004). Hence, by the mid 1980s, an urgent need of a fair and inclusive process of globalisation was clearly visible. As a result of these, many counties embarked on course of redesigning of their policies by themselves, and the IMF and WB were slowly involved thereafter. The WB initiated a special program known as the "Social Dimension of Adjustment" in 1987, and has also been giving greater importance to sectoral loans for education and health (Shan, 1998; Prabhu, 2001). These new reforms and projects are specially aimed at the improvement of the equity and efficiency of the social sectors in developing countries by shifting resources from high cost areas to low cost basic services; compensatory programs to protect the basic living standard of the vulnerable and low-income population during adjustment were introduced (Cornia et al., 1987).

These adverse repercussions of globalisation and structural adjustment policies have been seen in the Sri Lankan economy since the late 1980s. Some of these macro-economic problems, for instance, high inflation and rapidly rising living cost and slow progress of social sector, would have evolved soon after the introduction of liberalised policies (Lakshman, 1999; Shand, 1999). In addition, there was a significant failure of liberalised policies in relation to the distributional effects of development in the country. In fact, the 'trickle down' effect of the liberalised policies was not reflected as much as expected (Government of Sri Lanka, 2005), and therefore, the income inequality has been broadened over the period after 1977. For instance, the income received by the poorest 40% of population during the period 1978-1979 was 16.06%, and it has declined to 14.1 by 2003-2004. Meanwhile, the percentage of income of the 20% riche population has gone up from 49.9% to 52.1% during the same period. In addition, income percentages of rural, urban and estate sectors during 1986-1987 have changed from 63.4%, 31.5% and 5.1% to 75.1%, 22.1%, and 2.7% respectively during 2003/2004 (Central Bank of Sri Lanka, 1986/1987; Central Bank of Sri Lanka, 2005). Consequently, the government elected in 1989 introduced some special programs such as Janasaviya and food stamps, aiming at poor and backward people in the country. The developmental interest of social sector, which has somewhat sidelined before, was also reemphasised by the government.

This new focus was strengthened further from 1994, initiating the approach of 'human face' in development. However, some other internal reasons were also behind this change in globalisation policies. Those factors provided some incentives to change the system existed. The political and economic view of the government elected in 1994 was somewhat different from the already existing policies of the world, and it showed a considerable interest to change the system (Jayasuriya, 1999, Dunham, 2004)). The government which came into power in 1994 was a coalition of left political parties. It was called the United People's Freedom Alliance government. This alliance reemphasised the role of the state and its importance in development to some extent. It has been pointed out that this changing path as a reversal of liberalisation process (Knight-John, 2004). Meanwhile, there was a reorientation with regard to the state-led development, particularly in the welfare and the social services, initiated under the state responsibility (Central Bank of Sri Lanka; 1998, Gunatilaka, 2000). In addition, the government elected in 1994 emphasised the feasibility of the indigenous sector in economic development, particularly the home-grown agricultural sector, and hence, various promotional steps such as expanding credit facilities, subsidies on fertiliser and developing infrastructures have been taken to encourage private sector in agriculture (Central Bank of Sri Lanka, 1998). In this context, the overall development policy was redesigned to some extent, giving special attention to fiscal policies. This new policy direction remained unchanged throughout the period from 1994 to 2004, although there were some temporary setbacks from 2001 to 2002.

It was in this context, the United Freedom Alliance government elected in 2004 initiated the *'Rata Perata'* program to be implemented within the next five-year period. The Mahinda Chintana development view was formulated thereafter within the same perspective. Under his election manifesto, the President promised to implement policies towards building a New Sri Lanka, for rapid socio-economic development during his 6-year term of office (Government of Sri Lanka, 2006 budget speech). The vision articulated in 2005 manifesto is a further consolidation of the economic policy framework adopted by the

UPFA Governments since 1994 in which both the private sector and the public sector co-exist in a complementary manner in a market friendly environment to promote a national economy. Thus, the fundamental national view on economy and human face of development which came from 1994 did not change, but it was further strengthened whilst entering new ideas and aspirations. However, by this time, there were some additional problems to be faced, such as food price soaring all over the world which was an indication of a serious food crisis in the future (United Nations, 2008). Relating to this, the UN Food and Agricultural Organisation warned many nations in the world about their future food shortage and hunger. Figures showed that there were about 100 million human beings within the ranks of the poor and hunger. This has basically evolved due to the neglect of agricultural sector for last one and half decades (Subramanian, 2008). Hence, the agricultural development in developing countries currently highlights the slogan of 'back to the land and power to the people'. This upcoming food insecurity issue led Sri Lanka to move toward an agriculturally self-sufficient and indigenous economy. Meanwhile, the rising domestic cost of living owing to world oil crisis and lack of domestically-produced consumer goods also provided a fertile ground to think in an alternative way while providing a guideline to a 'home-grown' economy (Government of Sri Lanka, 2005).

Premise of the Current Budgetary Policy

The budgetary strategies since 2004 have mainly aimed at: (1) making a strong home-grown economy with considerable local ownership and accountability; (2) empowering rural sector for eliminating poverty; and (3) reduction of living cost of the people in the country. The budget proposals have emphasised these three goals since 2005 stating "Creating our Future – Building our Nation" (Government of Sri Lanka, 2005, 2006 and 2007). These targets have, indeed, evolved as a result of the detrimental effects in the Sri Lankan free and liberalised economy stated before. The Freedom Alliance regime has, therefore, opened a new path in development from 2004. The strategies of *Mahinda Chinthana* intensively emphasised these further, while making its proposals. The National Council for Economic Development (NCED), which has become a forum since the UPFA Government was formed in 2004 for a consultative service in economic issues, has contributed immensely towards identifying practical proposals for this assignment. This growing interest can be seen noticeably from the following, in all budgets since 2005:

1. The 2005 budget fundamentally emphasised a home-grown economic development strategy for Sri Lanka. Under this, the government designed policies to empower people through their own initiatives and based on their own strengths. This concept has been currently the fundamental view of national development in Sri Lanka. This strategy was also formulated as a supplementary strategy to the approach of 'human face' in development. The agricultural sector was reconsidered to be an engine of national development, and also one that provides a permanent solution for long-lasting growth and rising living cost in the country in this context (Government of Sri Lanka, 2005 and 2006). In addition, in relation to growth of indigenous sector and domestic food crisis, the government realised the ability of agricultural sector (Government of Sri Lanka, 2007). Hence, creating an attractive environment to agricultural producers, the government is providing the necessary facilities such as seeds, planting material, credit, fertilisers at affordable prices, and also expanding storage and marketing arrangements and elevating the primary agriculture into a processing stage including high quality rice milling through the budgetary proposals (Government of Sri Lanka, 2006, 2007 and 2009).

In addition, different strategies have been also chosen annually to provide incentives to rural agriculture for its self sufficiency. Many special projects/ programs, such as *"Dahasak Maha Vav"*- 1000 major tank rehabilitation program, *"Wari Pubhuduwa"* or irrigation development program and also some tax rebates on exports-based agriculture have been introduced targeting at accelerating agricultural development (Government of Sri Lanka, 2005 and 2006). These programs have been, in fact, initiated under the guidance of budgetary proposals as those conceptualised by both the *Rata Perata* and *Mahinda Chintana* views, in order to carry forward the agricultural economy at a heightened pace. Similarly, this enthusiasm can be seen in all other sectors in the agriculture. In order to develop the livestock and fishing industry, the government is providing required facilities and incentives through the budget proposals (Government of Sri Lanka, 2007 and 2008). In carrying all these sectors forward, the government expects to create a successful *'Krushi Navodaya'*- a new agricultural upliftment, in the Sri Lankan economy allocating Rs. 2 billion each year which might be helpful to alleviate many of the current problems in the country (Government of Sri Lanka, 2006 and 2007).

2. The government devoted a similar effort to the industrial sector in the 'home-grown' development process. In this context, the feasibility of an indigenous industrial sector in income generation and export development was reemphasised. A larger responsibility has been placed on private small- and medium-scale industries (SMEs) by the budgetary proposals. The building of domestic raw material-based small- and medium-scale industries was specially mentioned in development policy, particularly in budgetary proposals in the last couple of years (Government of Sri Lanka, 2005, 2006 and 2009). Meanwhile, the government proposed to set up a Presidential Task Force for National Productivity Improvement. The main objectives of this team are the identification of constraints and to address them on a priority basis, and thereafter, to make necessary arrangements to accelerate the production level in each sector, particularly in the industrial sector. As the government mentioned in the budget speech in 2005, it is also planning to use possible full strength of human and natural resources, marketing prowess and skills in this development.

The necessary arrangements and facilities for this sector are also considered by the government as an urgent requirement. In this context, the state has agreed to develop mortgage-free lending instruments such as credit guarantee schemes, refinance facilities and venture capital funding, to support SMEs (Government of Sri Lanka, 2006 and 2008). The technological development was also recognised in this process as a government responsibility through the proposals while allocating money by the budgets. Furthermore, many levies or duties to protect local SMEs were initiated from the budget, 2009, e.g, paper, furniture, leather and plastics (Government of Sri Lanka, 2009). Meanwhile, the government has proposed, through the budget, to set up at least one industry in each divisional secretariat area, to expand the industrialisation outside Colombo and Gampaha with the objectives of employment generation and creation of income opportunities in rural and peri-urban areas in the country. Depending on the level of investment, the tax reliefs/holidays and other incentives are offered for the private investors who are starting new enterprises outside Colombo and Gampaha districts. These incentives are available for relocation of industries too. The government also currently provides the duty waivers and tax exemptions on the import of plant machinery for SMEs since 2006 (Government of Sri Lanka, 2006). Furthermore, as a strategy of industries and agricultural development, agro-based industries using locally-cultivated grains and other industries involved in processing fruits and vegetable are also given incentives since 2006, For example, 15% income tax exemption on export income earnings, value-added tax (VAT) exemption and economic service charge reduction on fishery and fruit production, custom duty reduction on traditional agricultural processing industries and VAT reduction on handloom textile, etc. (Government of Sri Lanka, 2006, 2007 and 2008).

3. As a developing country, the rural sector in Sri Lanka is large. The concentration of population in this sector is more than 70 percent of the total population in the country. However, we cannot see that an adequate attention has been given by the government to this sector over the last few decades. Consequently, the necessary facilities in the rural sector have not been developed to a required level. The rural people have not been able to meet their basic needs, at least at a minimum level. The poverty, therefore, remained without any sign of decline. In addition, the rural participation in country's development was very weak. The maximum potentials of the rural sector in national development were not used by the governments which ruled since independence For instance, around 48% of GDP is still produced by the Western Province while the individual contribution of other provinces is less than 10% (Central Bank of Sri Lanka, 2007).

This unpleasant situation has been changing since recent past. The current government has paid a considerable attention to awaken the rural economy and to ensure the prosperity of the rural areas using its own capability in national development and also by equitably distributing the benefits to increase their living standards. In this context, the government has specially launched multi-pronged initiatives in different sectors. The largest role in this connection was done by the annual budgets since 2005 (Government of Sri Lanka, 2005). Under the budgetary proposals, the need of public sector capital formation in areas like irrigation and watershed development, rural electrification, extension services infrastructure development, etc. has been thoroughly emphasised as those introduced by new projects. For instance; the *"Sanwardhana Sangramaya"*- a concerted effort for development- that the President inaugurated since 2005, along with the *"Maga Naguma"* or rural road rehabilitation program, "Thousand Industrial Entrepreneur Village" program and the "Navodaya School Development program", are few of the several community-centred, economic capacity building programs.

The *Mahinda Chinthana* proposed a *"Gama Naguma"* program as an initiative to empower the rural community. This is, indeed, planning to adopt programs originated from communities, reflecting their needs. The *'Gama Nagma'* program further aims at providing all rural basic infrastructures such as electricity, telecommunication, water supplies, feeder roads, health centres, pre-schools, marketing facilities, community facilities such as cemeteries, playgrounds and children's parks to all villages in Sri Lanka, to improve their access to development. In addition, to interconnect the rural and urban in order to accelerate rapid growth in the country, many mega-scale projects such as irrigation, electricity, highways and port complexes have been initiated by the government all around the country. Particularly, budgetary allocations were made under the concept of 'E-village' since the 2006 budget attempted to connect rural villages in backward areas with the rest of the world and enable them to blend with the global community and economic trends through information technology. This program has been further strengthened since the 2009 budget allocating huge amount of money to *'Nana Sala* Centres'. Furthermore, various specific provincial development projects such as *'Pubudamu Wellassa' 'Rajarata Navodaya' 'Senkadagala Revival'*, *'Ruhuna* Development' have been initiated in order to develop provinces aiming at regional development of the country (Government of Sri Lanka, 2005, 2006 and 2009).

4. The economic policy framework of Mahinda Chintana recognises "poverty eradication" as a key objective of policy strategies. So, the budgets from 2005 have been proposed and have executed a number of poverty alleviation programs and activities within the 'home-grown' process and also as new programs. One of the main programs is *'Gama Naguma'*. In fact, this is a program which is expected to develop the rural areas and to reduce poverty through community participation and developing business environment of villages. In addition, the government has initiated certain rural-based programs such as *"Jana Pubuduwa"*, *"Gami Pubuduwa"* and *"Gami Diriya"* to empower the rural grass-root level population at each divisional secretariat level (Government of Sri Lanka, 2005, 2006). Under these

programs, the government expects to promote livelihood development activities in each year. The *"Samurdhi"* beneficiaries are also allowed to increase their monthly income level by participating in such projects (Government of Sri Lanka, 2006).

The government has already set up separate ministries dedicated to the development of children and estate infrastructure and community development in the context of poverty eradication. The Health Ministry has, meanwhile, arranged for the provision of nutritional meals together with maternity clinics and related services to expectant mothers, particularly at rural hospitals, while the Education Ministry implements the free meals program for school children in the less advantaged schools since 2006. The amount allocated since 2007 for this school children programs is more than 300 millions Rupees (Government of Sri Lanka, 2007). In addition, targeting the fulfilment of basic needs, the government has committed to promote a rural housing system through a variety of programs. The *"Jana Sevena"* and *'Bim Saviya'* programs are the main programs in this context which is expected to distribute a large number of land blocks (100,000) with clear titles (Government of Sri Lanka, 2007 and 2008). Furthermore, as a part of the government's commitment in reducing poverty and increasing income of the poor, new livelihood generation activities such as dairy farming, out-grower arrangements for fruit and vegetable cultivation, sub-contracting arrangements for industrial work and micro credit schemes for self-employment are tentatively set to happen. The *'Yovun Diriya'* program is also another program which aims at a poverty reduction through the creation of employment opportunities for youth, particularly in rural areas (Government of Sri Lanka, 2006 and 2007).

5. The rising food price is a serious current economic problem in Sri Lanka (Budget speeches, 2005, 2007, 2008 and 2009). Meanwhile, there is a growing concern also at policy level regarding the future food shortage in the country (Vidanage, 2008). Sri Lanka is not the only country which faces this present crisis. Both problems are clearly visible all over the world. The governments and policy makers in many countries are, therefore, selecting suitable strategies to alleviate the problem. In the Sri Lankan economy, these problems are considered as big challenges, which adversely affect people of every walk of life. The living standards of people in the country are deteriorating day by day. For example, based on Colombo consumer price index (CCPI), the cost of living has gone up by 45% during the period 2002-2006 (Central Bank of Sri Lanka, 2002 and 2006). The annual growth of this living cost is 12% (Government of Sri Lanka, 2007). Hence, as an immediate requirement, the government has come up with the prudent solutions for stabilising prices and ensuring food security. Consequently, for the last couple of years, the government has been involved eagerly in identifying suitable strategies under different policy fronts. The budgetary policies are mainly used in this endeavour by the government by devoting a larger role to it. Particularly, to bring down the high prices of consumer goods, the tax system has been changed (for example; from business turn over tax (BTT), goods and services tax (GST) to value added tax (VAT)), tax rates are reduced (for example; the rate of VAT reduced from 15% to 12% by 2009 while a lager number of commodities are exempted from the VAT), incentives are introduced to enhance the production system and the duties and taxes on domestic production are reduced. Meanwhile, to reduce the burden of rising living cost, the government has increased the cost of living allowance for government's employees and pensioners from 2009 (Government of Sri Lanka, 2008 and 2009).

The government is initiating different programs aimed at future food security. Some of programs in the 'home-grown' framework have been similarly used to control commodity prices while being used to build the home-grown economy. The government has prioritised the agricultural sector. Agriculture development can be a solution to rising living costs and to alleviate the future food shortage (Government of Sri Lanka, 2005). Hence, the government has arranged to provide the necessary facilities and incentives to producers through budgetary allocations. The government is in the process of devoting a large amount of money from the budget to essential facilities such as irrigation, roads, markets, storage facilities, rural electrification and technology development. The government has initiated a new concept, based on a private-public partnership arrangement which is being implemented to provide infrastructure facilities for suppliers to be able to offer essential commodities at wholesale prices.

The government has reintroduced the duties and taxes on agricultural commodities to protect our indigenous farmers, for example, duty waivers on imported milk items, imposition of special commodity tax on imported milk powder and sugar (Government of Sri Lanka, 2006 and 2009), increase of import duty on wheat grain from 6% to 10% (Government of Sri Lanka, 2009). The government is offering incentives to the private sector through the Budget to invest in modern technology such as food processing industries, for example; tax exemption of agricultural income from 2005 and removal of 15 percent tax on income from exporting agricultural produces (Government of Sri Lanka, 2006). Producer prices have been made remunerative in order to increase local food production. Furthermore, seeds and planting material, credit and fertiliser are made available at affordable prices and storage arrangements (e.g, fertiliser Rs. 350/ 50 kg), processing facilities for value addition of agricultural products are provided under the state with very high priority being given to it. Meanwhile, the government has focused on internationally-accepted tariff controls to provide a proper balance for locally-grown products, as well as to keep the price levels acceptable to consumers (Government of Sri Lanka, 2006).

The Tasks of the Fiscal Sector

As discussed earlier, the present government has assumed a huge challenge in national development. Many of the budgetary strategies are formulated to face this challenge. This challenge, i.e., the building of a 'home-grown' national economy, does not have a long history. It is, indeed, a main goal of the present regime. However, there is a specific task for the current government with a long history, i.e., the reduction of large budgetary deficit. This huge budgetary deficit primarily evolved in the mid 1980s due to a misallocation of budgetary resources, inefficient business and financial management practices, continuous decline of tax revenue and huge government expenses (Central Bank of Sri Lanka, 1998 and 2002; Knight-John, 2004; Waidyasekara, 2004).

All governments which ruled after the late 1980s have more or less intervened in this task expecting to manage it at desired level. The fiscal policy strategy announced in all budgets during the last decade was formulated basically with the objective of resolving these problems that have persisted, e.g., introducing a tight stabilisation measures since the late 1980s (Lakshman, 1999; Jayasuriya, 1999). However, it still persists without a significant change. In fact, the level of budget deficit has remained at the higher level over the period of time than its expectation. As a consequence, a number of adverse trends have been appearing and continuing in the economy. The financing of the deficit through inflationary sources has resulted in becoming the price inflation in the country so serious and uncontrollable. The public debt in the economy has risen to unprecedented levels. It absorbs a huge amount of financial resources from the budget annually repayments and interest payments. A large amount of money flows out from the country for debt servicing (Central Bank of Sri Lanka, 1998; Kappagoda, 2004).

The Budget/Fiscal Deficit

The high budget deficits have continued to be a major cause of Sri Lanka's economic ills for the last two decades, and therefore bridging this budget deficit has been a crucial issue. Basically, there are two reasons for this huge deficit. They are, erosion of government's tax revenues and the growing current expenditures. The tax revenue in the government has declined over the past period on tax evasion, avoidance, collection difficulties and tax concessions and relief under the liberalisation process (Tax commission Report, 1990, Waidyasekara, 2004). On the other hand, the current expenditures of the budget have gone up over the period after 1977, mainly on the rise of governments' salary expenses, interest payments on public debt and defense expenditures (Central Bank of Sri Lanka, 1998; Kappagoda, 2004).

As a primary problem of this high expenditure over the revenue, the revenue deficit of the budget has been declined to a negative rate since 1990 (Figure 1). This negative rate reflects a negative rate of the public savings which is a very unfavourable for any developing country. However, the overall budget deficit before grants averaged at 11 percent of GDP during the period 1977-2008. The recorded highest rate during this period was 23.1 percent in 1980 as shown in the Table 01. At present, this rate is somewhat under control, and therefore, by 2005, it was 8.7% (Table No 1) and 6.5% in 2009 (Government of Sri Lanka, 2009). This budget deficit has tremendously escorted the economy for a huge fiscal deficit. The fiscal deficit in Sri Lanka has increased from 4.6 percent of GDP in 1977 as shows in Table 1 to an unprecedented level of 18.5 percent in 1982 (Central Bank of Sri Lanka, 2002), and after that, it dropped, but remained above 6 percent. For example, the rate was 8.6 percent and 6.2 percent in 2005 and 2008 respectively. This existing rate is still higher and also beyond the governments' desired level (Table 1).

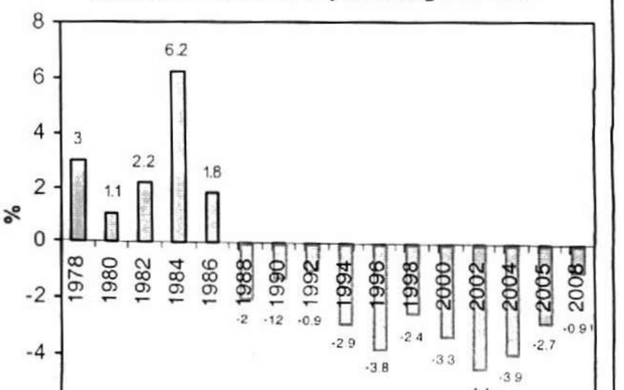
This high fiscal deficit rate has adverse repercussions. It is argued that a fiscal deficit can be inflationary or it may cause external deficits, and is therefore destabilising. It is also argued that even if the fiscal deficit does not cause inflation, it certainly leads to an accumulation of public debt, mounting future interest rate. Furthermore, there are some reasonable arguments against the fiscal deficit that the large deficits "crowd out" the private sector investment by raising interest rates and reducing private credit availability for investment. In addition, the fiscal deficit reflects an excess level of domestic investments over the inadequate domestic savings, and hence, there would be a net inflow of foreign capitals, rising net indebt-ness of an economy. Many of these tendencies have been noticeable in Sri Lanka for last two decades, For example, the level of inflation is 12.2% in 1991, 14.2% in 2001 and 11.6 in 2005, the level of trade balance is 40.9 US $ million in 1977, -702 in 1990 and -2316 in 2005 (Central Bank of Sri Lanka, 2005). Therefore, the IMF and World Bank have strongly emphasised to impose stabilisation measures (Dunham and Kelegama, 1999, Lakshman, 1999, Dunham, 2004).

Table 1
Budget/Fiscal deficit (% of GDP)

Year	Budget deficit before grants	Fiscal deficit
1977	5.8	4.6
1980	23.1	17.0
1985	11.7	11.7
1990	9.9	9.4
1995	10.1	10.6
2000	9.9	9.8
2005	8.7	8.6
2006	8.0	7.8
2007	7.7	7.5
2008	7.0	6.8
2009	6.5	-

Source: Central Bank of Sri Lanka, Annual Reports
Note: Fiscal Deficit = Total expenditure – (Revenue receipts+ Recovery of Loans + Receipts from the Sale of Assets).

Figure 1
Revenue Deficit as a percentage of GDP



Under these circumstances, all governments ruled since the late 1980s intuitionally intervened in controlling fiscal deficit by introducing various strategies and measures. Accordingly, practising the IMF guidelines, the last regime initiated the Fiscal Management (responsibility) Act No 03 which came into effect in 2003. The purpose of this Act is, to apply legislative measures to improve fiscal management, transparency and accountability. The present government is taking necessary steps to reduce the government debt to prudent levels, to maintain the budget deficit in less than five percent and to ensure maintenance of such levels thereafter, to manage the fiscal risks at cautious level, to adopt the policies relating to spending which should not be increased the government debt to excessive levels, and to adopt the policies relating to spending and taxing which should be consistent at a reasonable degree of stability and predictability in the level of tax rates in the future. In this context, the previous government's target of the budget deficit was to reduce to 5 percent of GDP by 2006, and it remains as it is under the present fiscal strategies. Meanwhile, a Fiscal Management Reform Program (FMRP), funded by a loan from the Asian Development Bank (ADB), has also formed in 2004 aiming at modernising and strengthening the fiscal and revenue administration in the country through the adoption of improved processes, enhanced human resource capabilities and complementing information technology improvements. In preparing the budgetary strategies, the present government is also thoroughly taking into account these directions, and hence, the tasks of the fiscal front for the last one and half decades has remained unchanged.

The Pubic Debt

Public debt management is also a rising issue in Sri Lanka for the last decade. The base of this public debt issue has, in fact, attached with open economic policies in the country. As a consequence of opening the economy in 1977, there was a huge inflow of long-term and medium-term capital from foreign sources, pushing the country into a significant indebtness; for example, total external debts was 21% of GDP in 1976, and it went up to 41% in 1978 and 71% in 1987 (Central Bank of Sri Lanka, 2002). Meanwhile, the large fiscal deficit in Sri Lanka over the past two decades was directly escalated the public debt level remarkably. As a result of persistently high budget deficit as shown in the above paragraph and costly deficit financing, the public debts exceeded the GDP level by the early 2000s (Table 2). On the other hand, soaring interest rate on huge volume of debts and rising debt service payments as shown in Figure 02 was further widened the budgetary deficit, putting the country into a considerable debt trap.

Kappagoda (2004) pointed out that the public debt problem in Sri Lanka is not in a crisis as in many developing countries and transitional economies. Although Sri Lanka is not in a same trend as in other developing countries, there is an alarming situation currently regarding public debt. It is, indeed, almost outstanding and also at unmanageable level. As shown in Table 2, it is over 80 percent of GDP. A larger share of this amount is borrowed from domestic marketable and non-marketable sources such as treasury bills, treasury bonds, rupee securities, Central Bank Advances, loan from commercial banks and development bonds. Many of these sources are highly inflationary. Particularly, the treasury bills, treasury bonds, rupee securities, Central Bank Advances, loan from commercial banks generate a huge money supply leading to a general price rise in the economy. Short-term financing, mainly treasury bills and long-term non-marketable rupee securities are a larger share of total domestic debt in recent years (almost 90%) (Central Bank of Sri Lanka, 2002), and therefore, the period of maturity or repayment becomes very small. Consequently, the annual level of repayment has gone up remarkably and it has led to allocate more government's revenues for repayment annually.

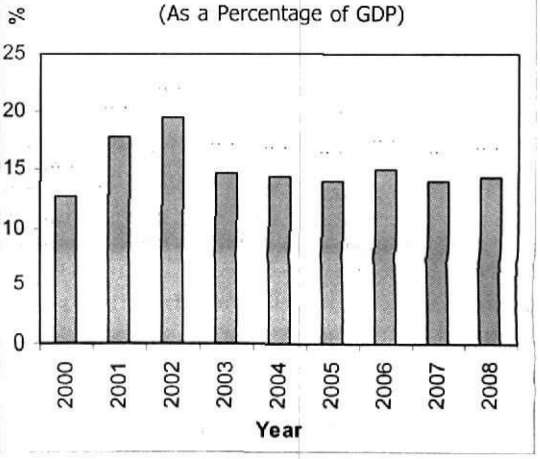
The debt service payment (interest and amortised loan repayments) has also exceeded the total government revenue in some years after 2000. For example, the debt service payment was 17.9 and 19.6 percent of GDP in 2001 and 2007 respectively (Government revenues were 16.7% and 16.5% respectively) (Central Bank of Sri Lanka, 2002 and 2007). In recent years, the government has succeeded, to some extent in maintaining the public debt level at less than hundred percent. As shown in Table 02, the public debt level has reduced to 82% of GDP by 2008. However, the possibility of controlling public debt has been still difficult task owing to annual excessive budgetary expenditures. The current government has, therefore, introduced certain strategies in 2007 to retain the public debt level at a manageable level,

Table 2
Public debt after 1977
(As a percentage of GDP)

Year	Government Debt		Total Govt. Debt
	Domestic	Foreign	
1977	39.5	29.1	68.6
1980	43.7	33.5	77.2
1985	38.6	41.7	80.2
1990	41.6	55.0	96.6
1995	43.3	51.9	95.2
2000	53.8	43.1	96.9
2001	58.0	45.3	103.3
2002	60.0	45.6	105.6
2003	56.0	46.3	102.3
2004	54.7	47.6	102.3
2005	51.6	39.0	90.6
2006	50.3	38.4	88.7
2007	47.9	37.9	85.8
2008	44.6	37.7	82.3

Source: Central Bank of Sri Lanka, Annual Reports.

Figure 2
Total Debt Service
(As a Percentage of GDP)



assuming it a government's important responsibility.

In relation to fiscal policy and its sustainability, the government is considering taking necessary arrangements in public debt management. As a primary step in this process, the government has focused to record all medium- and long-term external debt as soon as possible. Meanwhile, the government is keenly applying the guidance of Fiscal Management (Responsibility) Act also to control public debt as well as the fiscal deficit. Under this Act, the government has planned to reduce public debt also to 85 percent of GDP by end 2006 and to 60 percent by end 2013.The Central Bank of Sri Lanka has also intervened in government's debt management strategy suggested to apply all the fiscal management measures without delay. To turn back the rising borrowings and debt/GDP ratio and to ensure medium-term fiscal and debt sustainability, the Central Bank of Sri Lanka has showed an urgent need of prudent fiscal policies. Thus, the current government has introduced sensible strategies to manage public debt at desired level.

Conclusion

The national development in Sri Lanka is turning into a new path under the *'Rata Perata'* and *'Mahinda Chintana'* approaches. Both frameworks together have been making a *'home grown'* strategy to accelerate economic growth and development. The basis of this new development ideology originally evolved in 1994 with the development framework of the United Freedom Alliance regime. The government elected in 1994 initiated policy reforms in the economy at the initial stage to minimise the adverse effects of neo-liberal policies introduced in 1977. These reforms are, indeed, not a reversal of the existing economic system; it aimed reducing of adverse trends. The basic structure of the development policy which came from 1977 was not changed. The present government elected in 2004 decided to follow same policy framework. It initiated a 'home grown' strategy in a new development route. The goal of this new strategy is to create an agriculture-based national economy. The government has considered the agricultural development as a successful solution for many current economic problems in the country. Annual budgetary allocations and policies have mainly focused to achieve these objectives. Consequently, the deficit in the budget has been uncontrollable. Indeed, the large budget deficit in the country has been a significant problem over the past 20 years. It has created a number of problems in the economy. The government, therefore, has an important task in the fiscal front. Suitable actions should be taken to overcome this imbalance soon. The IMF and WB are also behind the government in finding solutions. All these measures must be properly applied to get out the country of this unfavourable crisis in the fiscal sector.

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