

Medium-term Fiscal Strategy Towards Economic Growth and Stability

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The Budget-2009 was presented in the midst of a global economic turmoil and an unprecedented commodity price hike. The implications of these external shocks for developing countries are yet to be seen. Since the latter part of 2007, the global economy has been heading towards a major recession. The downfall of the United States (US housing and financial markets coupled with international bank failures and credit crunch have adversely affected consumer demand, investment, economic growth and employment in major economies including the US, Japan and the United Kingdom (UK). The domestic economic and financial problems are compounded by the global crisis. The export sector of Sri Lanka has been adversely affected by the slowing down of consumer demand. High domestic inflation and depletion of foreign reserves pose tremendous pressures on domestic economic growth and stability. The domestic economic prospects have been further constrained by the prolonged North-East conflict which necessitated the government to allocate a considerable amount of the country's resources for the humanitarian operation so as to relieve the country from the grips of terrorism that has reached its final phase.

The Budget 2009 was based on the medium-term fiscal framework of the government as laid down in the Fiscal Management Report, 2009, which was placed before the Parliament by the Minister of Finance as required under the Fiscal Management (Responsibility) Act of 2003 (See Box 1). The Fiscal Management Report consisted of the Fiscal Strategy Statement (2008-2011), the Budget, and Economic and Fiscal Position

Report (2009)). This paper attempts to analyse the budgetary trends in the context of the medium-term macro-fiscal framework.

An Overview of the Budget 2009

As shown in Table 1, the expected total revenue for 2009 is around Rs. 855 billion as against the total expenditure at Rs. 1,192 billion, which will result in an overall budget deficit of Rs. 337 billion which would be around 6.5 percent of Gross Domestic Product (GDP). Although the budget deficit in 2009 is larger than the deficits experienced in the last two years, its decline in relation to GDP can be considered as a favourable trend. Nevertheless, the repercussions of the continuous budget deficits cannot be ignored. As can be seen from Table 1, almost the entirety of the tax revenue

has to be allocated to meet the three most important expenditure items of the government, namely, salaries and wages, interest payments and subsidies and transfers. The total revenue is just sufficient to finance recurrent expenditure, reflecting the low savings level of the government. In the past, the government had dis-savings in the sense that recurrent expenditure was higher than the total revenue.

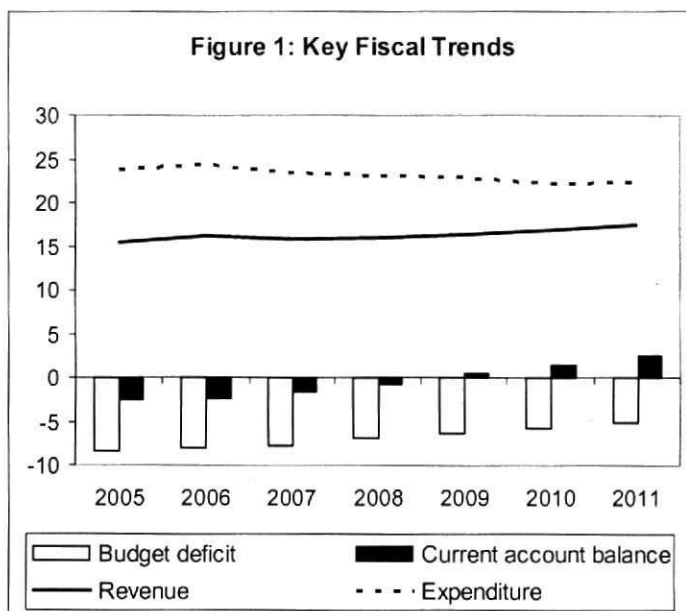
Medium-term Macroeconomic Targets

As shown in Table 2, the Medium-Term Macro-Fiscal Framework (2008-2011) envisages a gradual acceleration of GDP growth rate from 6.5 percent in 2008 to 6.8 percent in 2009, 7.5 percent in 2010 and to 7.9 percent in 2011. This growth path is to be supported by increases in domestic investment/GDP ratio to 33 percent and national savings/GDP ratio to 30 percent by 2011. Inflation is expected to decline to 7.5 percent by 2011. The current account deficit of the balance of payments is targeted to decline to 3.6 percent of GDP in 2011. The Framework also envisages a consolidation of fiscal operations with revenue generation of around 17 percent of GDP while limiting the total expenditure to about 22 percent of GDP. Accordingly, the overall budget deficit/GDP ratio is targeted to decline from 7.0 percent in

Item	Rs. Bn.		
	2007	2008 Revised	2009 Budget
Total Revenue	565.1	709.4	855.0
Tax Revenue	509.0	643.5	779.1
Income Tax	107.2	138.3	166.7
Taxes on Goods and Services	328.6	396.7	464.8
Taxes on External Trade	73.2	108.4	147.7
Non Tax Revenue	56.1	65.9	75.9
Total Expenditure	841.6	1016.7	1191.7
Recurrent	622.8	743.4	823.5
Personnel Emoluments	214.2	243.9	268.4
Interest	182.7	215.9	250.4
Subsidies and Transfers	147.5	170.4	196.0
Other Goods and Services	78.5	113.2	108.7
Public Investment	229.3	278.2	370.8
Other	-10.4	-4.9	-2.6
Revenue Surplus(+)/Deficit(-)	-57.7	-34.0	31.5
Budget Deficit	276.6	307.4	336.7
Total Financing	276.6	307.4	336.7
Total Foreign Financing	131.4	122.8	153.6
Net Foreign Financing	100.9	97.7	123.0
Foreign Borrowings Gross	165.0	189.0	222.5
Debt Repayment	64.1	91.3	99.5
Foreign Grants	30.5	25.1	30.5
Total Domestic Financing	145.1	184.6	183.1
Net Non Bank Financing	111.3	158.9	165.6
Net Foreign Currency Domestic Financing	3.4		
Net Bank Borrowings	12.4		
Other	18.1	25.7	17.5
Revenue/GDP %	15.8	16.0	16.4
Tax Revenue/GDP %	14.2	14.6	14.9
Expenditure/ GDP %	23.5	23.0	22.8
Recurrent Expenditure/ GDP %	17.4	16.8	15.8
Public Investment/ GDP %	6.4	6.3	7.1
Revenue Deficit(-) or Surplus(+)/ GDP %	-1.6	-0.8	0.6
Budget Deficit/ GDP %	7.7	7.0	6.5

Source: Budget 2009

2008 to 5.0 percent in 2011 (Figure 1). The current account balance of the budget is expected to generate a surplus of 2.5 percent of GDP by 2011 thus reversing the dis-saving habit of the government. With less-expansionary effects of the fiscal operations, the reserve money growth target is expected to be around 15 percent in the medium-term, resulting in a broad money growth of around the same rate. The credit growth to the private sector is targeted to be about 15 percent a year. The public debt burden is also expected to decline to 70 percent of GDP by 2011. Thus, the medium term macro-economic framework envisages economic growth as well as stability. It can be observed from Table 2 that the fiscal authorities envisage a gradual reduction of the fiscal deficit relatively to GDP over medium term. This is associated with an improvement in the balance of payments, deceleration of inflation and decline of public debt burden. These objectives reflect the commitment of the authorities to achieve macro-economic stability. On the development front, the envisaged growth momentum is to be buttressed by high savings and investment rates coupled with continuous export growth.



were VAT (37 percent), income tax (21 percent), excise tax (17 percent) and import duty (16 percent). These tax revenues are projected to rise in tandem with GDP growth and improved tax administration.

Medium-Term Fiscal Targets

As shown in Table 3, the total income is projected to be around 16 percent of the GDP in 2009. The bulk of the revenue is to come from taxes which are estimated to be around 15 percent of the GDP in 2009. Around 90 percent of the total government revenue is expected to be generated through taxation. In 2008, the major tax sources

Box 1 Fiscal Management (Responsibility) Act

With a view to strengthening fiscal management, Parliament approved the Fiscal Management (Responsibility) Act (FMRA) on 10 December 2002, effective from the fiscal year 2003. The objective of the Act is to provide a formal framework for fiscal discipline, and to increase transparency and accountability in government fiscal operations. A key element in FMRA is the introduction of medium-term fiscal targets. Specifically, the fiscal deficit was to be reduced to 5 percent of GDP by 2006 and maintained under that level thereafter. The FMRA also had ceilings on total government debt, which was not to exceed 85 percent of GDP by 2006, and 60 percent of GDP by 2013. Explicit government guarantees was limited to 4.5 percent of GDP. The Act mandates the government to present a number of reports including (a) Fiscal Strategy Management Report, with the Budget Speech, (b) Mid-Year Fiscal Reports, (c) Final Budget Position Report, (d) Pre-Election Budgetary Position Reports, within three weeks of the announcement of the general election, and (e) Statements of Responsibility by the Finance Minister and Secretary, together with a Pre-Election Budgetary Position Report.

Table 2: Medium-Term Macroeconomic Fiscal Framework

Indicator	Actuals 2007	Projections			
		2008	2009	2010	2011
GDP at Market prices (Rs. Bn)	3,578	4,420	5,217	6,085	7,058
GDP Growth (%)	6.8	6.5	6.8	7.5	7.9
Inflation-GDP deflator (%)	14	18	11	8.5	7.5
Total Investments/GDP (%)	27.9	30	31.5	32.5	33.2
Private Investments /GDP (%)	20.7	23	23.9	24.9	25.2
Public Investments /GDP (%)	7.2	7	7.6	7.6	8
Domestic Savings /GDP (%)	17.6	16.8	19.8	21.9	23.8
National Savings /GDP (%)	23.4	22.5	25.3	27.5	29.5
Exports (US\$ Million)	7,740	8,507	9,368	10,334	11,418
Imports (US\$ Million)	11,301	14,275	15,340	16,578	17,920
Services (US\$ Million)(net)	238	241	348	501	719
Worker Remittances (US\$ Million)	2,502	3,020	3,374	3,793	4,329
Current Account (US\$ Million)	-1,354	3,077	-2,905	-2,663	-2,220
Current Account Deficit /GDP (%)	-4.2	-7.3	-6.0	-4.9	-3.6
Overall Balance (US\$ Million)	531	300	337	480	527
Gross Official Reserves (US\$ Million)	3,463	3,687	3,922	4,365	4,880
Revenue /GDP (%)	15.8	16.1	16.3	17.0	17.5
Expenditure /GDP (%)	23.5	23.0	22.8	22.7	22.4
Revenue (Deficit/Surplus) /GDP (%)	-1.6	-0.8	0.2	1.5	2.5
Overall Budget Deficit /GDP (%)	7.7	7.0	6.5	5.8	5.0
Government Debt	85.8	78.2	75.6	73.4	70.5
Reserve Money (%)	10.2	12.7	14.8	15.3	15.0
Broad Money Supply (%)	16.6	12.0	15.0	15.5	15.5
Growth in Credit to Private Sector (%)	19.3	13.8	15.7	14.8	15.0

Source: Fiscal Management Report 2009

Indicator	Actuals	Projections			
	2007	2008	2009	2010	2011
Revenue	15.8	16.1	16.3	17.0	17.5
Tax Revenue	14.2	14.7	14.8	15.5	16.0
Income Tax	3.0	3.1	3.2	3.6	3.9
VAT	5.2	5.2	5.2	5.7	6.0
Excise Tax	2.7	2.5	2.4	2.3	2.2
Import Duty	2.0	2.3	2.3	2.3	2.3
Other	1.3	1.6	1.7	1.6	1.6
Non Tax Revenue	1.6	1.5	1.5	1.4	1.4
Expenditure	23.5	23.0	22.8	22.2	22.4
Current Expenditure	17.4	16.8	16.0	15.5	14.9
Revenue (Deficit/Surplus)	-1.6	-0.8	0.2	1.5	2.5
Budget Deficit	-7.7	-7.0	-6.5	-5.8	-5.0
Government Debt	85.8	78.2	75.6	73.4	70.5

Source: Fiscal Management Report 2009

Crowding in or Crowding out?

The government's efforts to invest in major infrastructure projects will certainly exert crowding in effects. The government has commenced the construction of mega irrigation projects, such as Moragahakanda, Uma Oya, Kirindi Oya and Daduru Oya, to economically revive irrigated and backward regions. Steps have also been taken to modernise the road network. Priority has been given for the development of railways and highways system. Construction of large power generation plants at Norochchalai, Upper Kotmale and Kerawalapitya is in progress. Establishment of new townships in the Eastern Province is also given priority in the development agenda. Public investment in the Budget 2009 is estimated to be Rs. 371 billion (7.1 percent of GDP) compared with Rs. 278 billion (6.3 percent of GDP) in 2008.

In the literature, there are different views on government spending as described in Box 2. A major conclusion of the Keynesian theory is that increased government spending has a multiplier effect on the national income and output. Based on the Keynesian income multiplier, a one rupee increase in government spending would raise national income by Rs. 4.17 in Sri Lanka¹. We may consider this as crowding in effect of fiscal deficits. However, we should not ignore the fact that the Keynesian theory mainly

focused on the short-term unemployment problem in the industrial countries during the Great Depression. That problem was caused by a shortfall in aggregate demand which led factories to work below their capacity. The unemployment and slow economic growth what we face in developing countries like Sri

Lanka are quite different from that atmosphere. These countries are handicapped by factors such as low savings and investment, lack of technological progress and foreign exchange shortages, rather than a shortfall in demand. Therefore, one could argue that increased government spending would not be a solution for economic problems in developing countries. However, it is widely recognised now that the government spending on things like infrastructure, health, education, and research and development have a positive impact on economic growth. Generally, the private sector is reluctant to invest in such public goods.

The fiscal deficit exerts a crowding out effect to the extent that the government borrows from the private sector to finance the deficit. As shown in Table 4, the government's total revenue was not adequate to finance the current expenditure up to the period 2007. The excess of current expenditure over revenue was financed by borrowings from the private sector. This is known as the current account deficit or dis-savings of the government (See Box 3.). A favourable trend that can be observed from Table 4 is the gradual reduction of the current account deficit from a peak level of 4.9 percent to 1.6 percent of GDP in 2007. There was a turnaround in 2008 with a marginal current account surplus of 0.1 percent of GDP reflecting positive savings by the government.

Box 2

Different Views of Government Spending

There are different views on the impact of government spending on private investment as follows:

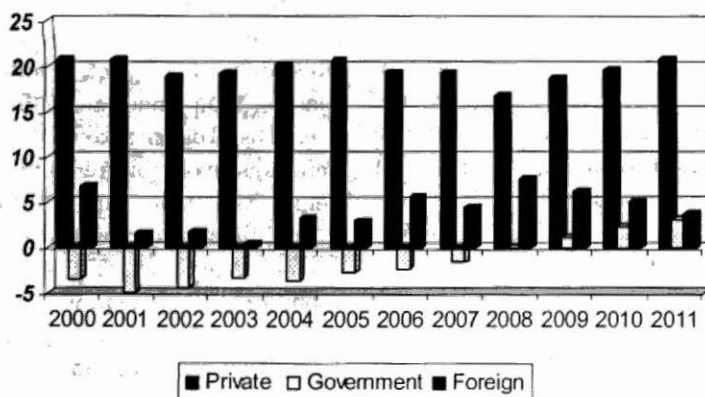
- According to the neoclassical theory, an increase in government spending dampens private investment. This is known as crowding out effect of government spending. The neoclassical view assumes full employment and advocates free competitive market mechanism against government intervention. As explained in the neoclassical loanable funds theory, freely-determined interest rates in competitive financial markets automatically balance saving and investment. In the case of an increase in government spending, interest rates should rise to bring the capital market into equilibrium, dampening private investment.
- In contrast, the Keynesian model suggests that increased government spending stimulates private investment. This is the crowding in effect of government spending. The Keynesian view assumes that there is unemployment in the economy and interest rate sensitivity of investment is very low. This view suggests that government spending has a positive effect on the expectations of the private investors, and therefore, government spending tends to increase private investment. Thus, there is crowding in rather than crowding out.
- A third view on the effect of government spending on private investment is the Ricardian Equivalence theorem, which implies that budget deficits are expected to lead to more taxes in the future, and therefore, individuals do not change their consumption and/or savings. As a result, interest rates and private investment remain unchanged. This means there is no crowding out or crowding in effect of fiscal spending.

Variable	2000	2005	2006	2007	2008	2009	2010	2011
1. Domestic savings	17.4	17.9	17.0	17.6	16.8	19.8	21.9	23.8
2. Government savings (=3-4)	-3.4	-2.6	-2.3	-1.6	0.1	1.1	2.3	3.1
3. Government revenue	16.8	15.5	16.3	15.8	16.1	16.3	17.0	17.5
4. Government current expenditure	20.2	18.1	18.6	17.4	16.0	15.2	14.7	14.4
5. Private savings (=1-2)	20.8	20.5	19.3	19.2	16.7	18.7	19.6	20.7
6. Net factor income	4.0	5.9	5.4	5.8	5.7	5.5	5.6	5.7
7. National savings (=1+6)	21.4	23.8	22.4	23.4	22.5	25.3	27.5	29.5
8. Private investment	24.8	22.4	23.9	22.5	23.0	23.9	24.9	25.2
9. Government investment	3.3	4.4	4.1	5.4	7.0	7.6	7.6	8.0
10. Domestic investment (=8+9)	28.1	26.8	28.0	27.9	30.0	31.5	32.5	33.2
11. Savings-investment gap (=7-10)	-6.7	-3.0	-5.6	-4.5	-7.5	-6.2	-5.0	-3.7
12. Foreign savings	6.7	3.0	5.6	4.5	7.5	6.2	5.0	3.7

Sources: Budget 2009
Central Bank of Sri Lanka, Annual Reports

The Fiscal Management Report-2009 that was presented along with the Budget projects a gradual increase in government savings in the medium term from 1.1 percent in 2009 to 3.1 percent of GDP by 2011. If this is materialised, the government does not have to absorb a part of private savings to meet its dis-savings, and thereby avoiding pre-emption of resources from the private sector as done in the past. Instead, the government will be able to contribute to raise domestic savings from 16.8 percent in 2008 to 23.8 percent of GDP by 2011, as shown in Figure 2.

Figure 2: Sources of Savings by Sector (% of GDP)



Budget Deficit and Interest Rates

Budget deficits can be a source of inflation if they are financed by the banks, particularly the Central Bank. If the Central Bank purchases the government securities to finance the deficits, money supply tends to rise causing inflationary pressure. Currently, the Central Bank has reduced accommodation of fiscal deficits by money creation, and therefore, it has greater implications on interest rates rather than on inflation. The budget deficit has an

Box 3

Fiscal Policy in the Long Run

In the long run, economic growth is determined by three factors, namely, (a) growth in the labour force, (b) the rate of technological advance, and (c) the amount of capital available to the labour force. Of these three factors, the last one can be influenced by fiscal operations. An increase in the capital stock leads to an increase in the productivity of labour force, and thereby accelerating economic growth. Thus, fiscal policy can have a larger effect on economic growth through its influence on the size of the capital stock. This can be illustrated by an introduction to economic accounting as follows:

The total value of national output can be measured in three ways, i.e., (a) by adding up the total value of goods and services produced, or (b) by adding up the expenditure incurred for buying the goods and services, or (c) by adding up the total value of the incomes resulting from that production. Theoretically, the aggregates derived from these three accounts are equal.

In the expenditure method, the Gross Domestic Product (GDP) is equal to the sum of consumptions spending (C), investment (I), government current spending (G) and the difference between exports (X) and imports (M):

$$GDP = C + I + G + (X - M) \quad (1)$$

The alternative measure of total output is the sum of various uses to which income is allocated. Accordingly, GDP is expressed as the sum of consumption (C), private sector savings (S) and tax payments (T):

$$GDP = C + I + T \quad (2)$$

Combining equations (1) and (2), and simplifying, we can derive:

$$I = S + (T - G) + (M - X) \quad (3)$$

The above equation implies that total investment, by definition, is equal to the sum of private savings, government budget balance and the difference between exports and imports. The term (T - G) represents government savings. An excess of tax revenue (T) over current expenditure (G) reflects government savings. If tax revenue is lower than current expenditure, the government has to resort to borrowings to meet its current expenditure. These borrowings are, in fact, government's dis-savings. Other things being equal, a decline in government savings means less investment and slower growth in the capital stock. The term (M - X) in Equation (3) indicates foreign savings.

influence on market interest rates through Treasury Bill rates. The higher the budget deficit, the higher the market interest rates. In a situation where monetary accommodation is ruled out, the government needs to encourage the private sector to increase its subscriptions to Treasury Bills by offering higher returns. This leads to rise in market interest rates. If the private saving does not increase in proportion to the increased deficit, the government can borrow from the domestic market only at the expense of private investment.

Public Expenditure Programme

The fiscal policy is formulated within the overall development strategy and targets laid down in the *Ten-Year Vision* of the government. The government implements fiscal policy so as to meet the targets given in the *Medium-Term Macro-Fiscal Framework (MTMFF)*, which is usually released along with the Budget Speech. In an effort to improve the fiscal position, which is known as "fiscal consolidation", policy measures related to all aspects of budgetary operations – government revenue, expenditure, public investment and public debt management – are included in the MTMFF.

Public expenditure programme is prepared in line with the Medium-Term Fiscal Strategy (MTFS) of the government. Accordingly, fiscal policy in the medium term is directed at continuing fiscal consolidation while supporting development objectives. Fiscal consolidation encompasses increased revenue mobilisation and rationalisation of recurrent expenditure while ensuring public investment in areas critical for supporting economic growth. These efforts are complemented by policies like eliminating inflationary financing and rehabilitating infrastructure in *conflict-affected* areas. An improvement in the utilisation of foreign resources is also expected in the MTFS.

Deficit Financing and Government Debt

As we observed above, government spending has exceeded its revenue, resulting in continuous budget deficits. These deficits have been a major macro-economic problem in Sri Lanka. At present, the budget deficit is around 7 percent of GDP, as shown in Table 1. The government is expected to borrow Rs. 183 billion from domestic sources and another Rs. 154 billion from foreign sources to meet the budget deficit in 2009. As resources available in the non-bank sector were rather limited, the government had to rely heavily on the banking sector in the past. This led to a rapid increase in the money supply causing macro-economic instability. Since 2002, however, the government not only managed to avoid borrowing from the banking sector, but has actually succeeded in repaying a part of past bank borrowings. This reduced the high inflationary deficit financing. Also, it eased pressure on interest rates. Foreign sources include concessional and non-concessional loans. Continuous borrowings from abroad have led to the accumulation of a large foreign debt. Annually, the country has to allocate around 8 percent of her export earnings to meet the capital repayments and interest payments on foreign loans.

The outstanding public debt increased substantially during the last two decades. The accumulated public debt was 105 percent of GDP at end 2002. This resulted from the continuous budget deficits. However, with more prudent fiscal management, the debt stock has declined over the years to reach 78 percent of GDP in 2008, as shown in Table 2. Servicing the government debt, which includes loan repayments and interest payments, has become a severe burden on the government budget. This is reflected by the fact that the total debt service payments are larger than the total revenue of the government. One half of government spending is allocated for debt service. One third of current expenditure is spent for domestic interest payments. About 8 percent of

total export earnings has to be used to service foreign debt.

Conclusion

With the increasing trend in the recurrent expenditure compounded by heavy expenditure on defence exerts considerable pressure on the fiscal operations. The Budget 2009 reflects the government's efforts to address these problems while attempting to sustain economic growth and stability. The fiscal efforts have become increasingly difficult in the background of the adverse effects emanating from the global economic recession. Fiscal discipline has shown an improvement in recent years with the government's attempt to comply with the targets envisaged in the Fiscal Management (Responsibility) Act. One could consider the planned reduction in the overall fiscal deficit and current account deficits as favourable trends that would help to ease inflationary pressures and to mobilise much needed domestic savings. Nevertheless, there is much room for improvement with regard to curtailment of recurrent expenditure. Specifically, action needs to be taken to rationalise and reduce the growing expenditure on items like salaries/wages and subsidies/transfers.

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Footnote

¹ The income multiplier is $1/(1 - mpc + t)$ where mpc = marginal propensity to consume, and t = marginal income tax rate.

Given $mpc = 0.82$ and $t = 0.06$ for Sri Lanka, income multiplier = $1/(1 - 0.82 + 0.06) = 1/0.24 = 4.17$.