Presidents, starting with the redoubtable C. Rajagopalachchari (Rajaji) as independent India's first Governor General. The Indian Civil Service, Judiciary and the Armed Forces have also had a good record of openness to recruitment and promotion of South Indians, often to the highest positions in these branches of the Central government. The most important aspect of Indian federalism, however, has been its provision of space and authority for regional autonomy. In a sense, Annadurai and the DMK were able to focus almost exclusively on their cultural and social reformist agenda until they formed the State government in 1967, because of the competent economic management by successive Congress State governments in Madras.

The DMK and Annadurai were relieved of their separatist burden in 1963, with the passage of the 16th Amendment to the Indian Constitution to ban secessionist political parties. The Amendment was brought in the wake of India's border dispute with China and in a rising mood of bellicose Indian nationalism. The DMK officially dropped its separatist demand from the Party programme, but Annadurai's speech opposing the Amendment during the debate in the Rajya Sabha in Delhi, has been described by an American scholar as one of his "most professional performances". Annadurai based his opposition not on narrow chauvinism, but on the higher principles of liberal constitutionalism, challenging Nehru to leave the constitutional authority with the people – that is, leave it to the people to democratically decide whether his plea for separation was acceptable or not, and not to let a Parliamentary majority deny him his right to advocate separation. After 1963, Annadurai or the DMK did not have any cause to revisit the issue of separatism. When Annadurai became Chief Minister in 1967, he caused the name of the southern Tamilian state to be changed from Madras to Tamil Nadu – a symbolic consummation of *pongu Thamizh* that overlies the reality of Tamil national autonomy within the Indian federation. ■

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SRI LANKA'S BUDGET 2002: TOO LITTLE TOO LATE

Muttukrishna Sarvananthan

Introduction

The new United National Front (UNF) government of Sri Lanka, which came to power in December 2001, inherited an economy that has recorded negative growth (-1.3%) for the first time in the post-independence period. The Sri Lankan economy today faces two fundamental problems; one is the structural and institutional weakness in the macro-economy and the other is the civil war-induced economic woe of the country.

The much-awaited first budget of the new government presented belatedly on March 22nd has failed to adequately address both of these fundamental problems in the economy. Firstly, the Budget 2002 has proposed very little structural and institutional reform of the economy, which are long overdue. Secondly, the government has not taken advantage of the ceasefire agreement with the LTTE by infusing public investment in infrastructure like roads, power, and telecommunications in the war-torn areas that could have boosted the overall economic growth.

This paper is organised as follows; Firstly, we critically look at the proposed public expenditure of the government. Secondly, we discuss the potential 'peace dividend' and impediments to realisation of the same. Thirdly, we look back at the fiscal profligacy during the closing months of the last government and make some suggestions to prevent a reoccurrence of such a predicament. Fourthly, we evaluate the fiscal measures enunciated in the budget. Fifthly, we outline some of the structural and institutional reforms that need to be undertaken in order to attain a sustainable high growth rate.

Public Expenditure

The total public expenditure for 2002 (January 01 to December 31) is proposed to be almost LKR 346 billion, out of which LKR 220 billion is recurrent expenditure and LKR 126 billion is capital expenditure (Table 2). That is, out of the total public expenditure proposed 64% is recurrent expenditure and 36% is capital expenditure. Table 1 catalogues the Ministries (and combination thereof) that receive more than 1% of the total public expenditure in a descending order.

Accordingly, the Defence expenditure (including Defence and Interior Ministries) is once again the single largest public expenditure consuming almost 20% of the total public expenditure. The Finance Ministry consumes the second largest with 18%[1]. The Ministry of Home Affairs, Provincial Councils and Local Government (12%), and the Ministry of Public Administration, Management and Reforms (8%) incur third and fourth largest public expenditures respectively. The Health and Education expenditures, with around 7% of the total public expenditure each, consume fifth and sixth largest public expenditures respectively. The public expenditures on defence, health and education as proportions of total public expenditure in 2002 are greater than in 2001. In sum, 15 Ministries (and combination thereof) as catalogued in Table 1 receive 92% of the total public expenditures earmarked for 2002.

These figures indicate that there is no letup in the militarisation of the economy of Sri Lanka despite an indefinite ceasefire being in place. The entire ministerial allocations are provided in Table 2.

The Samurdhi poverty alleviation programme receives 4% of the total public expenditure during 2002 (Table 1), which is higher than last year in absolute amount as well as a proportion to the total public expenditure. A Welfare Benefit Law is proposed in the budget that would define eligibility and exit criteria for claimants of Samurdhi benefits and outline statutory management procedures for the Samurdhi programme. However, it would be very difficult to legally verify a household's income or wealth, especially among marginalised income groups. If so many people can evade income tax payments then what guarantee is there that the proposed Welfare Benefit Law would weed out ineligible claimants of Samurdhi benefits? There is no convincing proposal.in the budget to reform the much-criticised Samurdhi programme.

The Ministry of Women's Affairs receives a negligible 0.04% (LKR 145 million) of the total public expenditure (Table 2), which is the same as last year. However, in absolute terms there is a drop of LKR 5 million on women's affairs this year compared to last year. This meagre budgetary allocation goes against the government's pledge in its election manifesto to improve the livelihood of women. However, the government spending on women could come out of other ministerial allocations as well.

Table 1: Selected Public Expenditure Proposed for 2002

	Recurrent + Capital Expenditure (LKR Million)	As a % of Total Public Expenditure
Defence Expenditure (1)	67,445.4	19.51
Ministry of Finance	62,219.0	18.00
Ministry of Home Affairs, Provincial Councils and Local Government	42,752.7	12.37
Ministry of Public Administration, Management and Reforms	26,390.0	7.63
Ministry of Health, Nutrition and Welfare	24,421.0	7.06
Education Expenditure (2)	22,952.3	6.63
Ministry of Samurdhi	15,383.0	4.45
Ministry of Power and Energy	10,397.0	3.01
Ministry of Highways	9,651.0	2.79
Ministry of Housing and Plantation Infrastructure	7,925.0	2.29
Ministry of Transport, Highways and Aviation	7,872.8	2.28
Ministry of Agriculture and Livestock	6,166.0	1.78
Ministry of Mass Communication	5,750.0	1.66
Ministry of Irrigation and Water Management	5,225.0	1.51
Ministry of Port Development and Shipping	3,672.4	1.06
Selected Public Expenditure	**318,222.60**	**92.06**
Total Public Expenditure	**345,675.30**	**100**

Source: The Appropriation Bill presented to the Parliament on February 19, 2002.
Notes: (1) Defence Expenditure includes the Ministry of Defence and Ministry of Interior. (2) Education Expenditure includes the Ministry of Human Resource Development, Education and Cultural Affairs, Ministry of Tertiary Education and Training, and Ministry of School Education.

Peace Dividend

The Government of Sri Lanka (GOSL) and the Liberation Tigers of Tamil Eelam (LTTE) signed a Memorandum of Understanding (MoU) on February 22&20, 2002 respectively, for a mutually agreed ceasefire with the facilitation of the Royal Norwegian Government. This indefinite ceasefire agreement is expected to provide a peace dividend to the economy of Sri Lanka.

The anticipated peace dividend has two components; one is the anticipated reduction in defence expenditure, and the other is the anticipated increase in domestic and foreign investment, foreign aid, tourist arrivals, etc., due to the ceasefire and restoration of normalcy throughout the country. However, disappointingly, the peace dividend expected from a reduction in defence expenditure has not materialised in the Budget 2002. In fact, the defence expenditure as a proportion of the total public expenditure has risen from 18% in 2001 to 20% in 2002 (both these figures are derived from budgeted expenditures and **not** the actual expenditures). The recurrent expenditure of the defence budget has increased by 10% from LKR 52.54 billion in 2001 to LKR 57.87 billion in 2002, while the capital expenditure of the defence budget has decreased by 12% from LKR 10.85 billion in 2001 to LKR 9.57 billion in 2002 (again these are budgeted expenditures and **not** the actual expenditures). In the past several years the actual defence expenditure has always been considerably higher than the budgeted expenditure[2].

The expected boost to the Sri Lankan economy as a result of the MoU may accrue from two sources; one is through the revival of the economy in the North-East province as a consequence of the lifting of the economic embargo, and the other is through the increased productive activities in the rest of the country. The anticipated rise in domestic and foreign investment, foreign aid, tourist arrivals, etc, due to the MoU is expected to take sometime to materialise. For instance, the War Risk Surcharge imposed in the aftermath of the July 24, 2001 attack on the Katunayake airport has still not been withdrawn in practice.

Further, there is a long way to go to realise the potential benefits to the national economy by the revival of the North-East economy due to a variety of factors; primarily due to infrastructural bottlenecks and taxation at both sides of the territorial divide. The roads in the LTTE-held areas are in a deplorable condition, which increases the transport cost of goods. Even after the opening of the A9 highway from Vavuniya to Jaffna the road transport cost is expected to be abnormally high because of heavy wear and tear to vehicles plying that route. Further, the arbitrary tax imposed at both sides of the territorial divide on vehicles carrying goods are another key factor that pushes up the transport cost even higher.

The lack of electricity and telecommunications are another major impediment to the economic revival of the LTTE-held areas in the North and the Jaffna peninsula. The lack of electricity in the LTTE-held areas prohibits manufacturing activities. The limited number of electric generators used is totally inadequate to cater to the needs of the producers and consumers alike. The limited supply of power in the Jaffna peninsula is far short of the requisite. The absence of telecommunication with the rest of the country greatly increases the transaction cost of businesses in the LTTE-held areas. Even the limited telecommunication facilities available in the Jaffna peninsula are totally inadequate to fulfil the demand.

The lack of storage facilities is yet another impediment to economic revival in the LTTE-held areas. For example, though the free flow of petroleum products to the LTTE-held areas is ensured under the MoU there is a lack of demand for diesel and petrol in those areas. This is mainly because almost all the vehicles (two, three, and four-wheelers) in the LTTE-held areas have been converted to run on kerosene (paraffin) during several years of economic embargo. Moreover, there are no underground storage facilities for petroleum products in LTTE-held areas, and over-ground fuel tanks are wasteful due to evaporation.

Furthermore, storage facilities for agricultural and fishery produce are also lacking for want of suitable buildings and ice manufacturing plants. Therefore, the export of perishable agricultural and fishery produce of the LTTE-held areas to the rest of the country is undermined. This calls for the revival of the construction industry in those areas. However, due to the dearth of bank finance (loans and overdraft facilities) to fund construction activities the construction industry is still dormant despite the lifting of the embargo on construction materials such as cement, bricks, asbestos, tiles, etc.

The realisation of the full potential of the lifting of the economic embargo is delayed primarily because of infrastructural bottlenecks such as poor conditions of roads, and lack of electricity and telecommunications. Though there is a surge in the export of consumer goods such as bicycles, bicycle parts and accessories, motorcycles, plastic furniture, office machinery, stationery, radios, televisions, building materials, etc, from the rest of the country to the LTTE-held areas since the lifting of the economic embargo on January 15, 2002, there is a long way to go to exploit the full potential.

Another critical factor inhibiting the realisation of the full potential of the lifting of the economic embargo is the arbitrary taxation of goods *en route* to the LTTE-held areas by the Tamil paramilitary groups in Vavuniya, and taxation by the LTTE on their side. The taxation by the LTTE, though it is justified in order to run a parallel administration in the territory under their jurisdiction, extends to goods meant for personal use as well. This arbitrary taxation at both sides of the territorial divide is debilitating to the entrepreneurial instinct of the masses, especially in the LTTE-held areas. Due to the abnormally high transportation cost and extra-legal taxation the prices of goods in the LTTE-held areas are still quite high though lower than during the embargo time. The recent newspaper reports suggest that generally business turnover in the Jaffna peninsula is quite low nowadays, because people are postponing buying non-essential goods in anticipation of drop in prices once the goods begin to be transported to Jaffna via the A9 highway. Perhaps this is partly a wishful thinking, as we do not think that there would be any significant drop in prices in Jaffna as a result of the opening of the A9 highway because of abnormally high transportation cost and arbitrary taxation.

Therefore, in sum, early realisation of the peace dividend is a mirage despite a lot of hype about it.

Fiscal Profligacy

The previous government exhibited fiscal profligacy in the last quarter of 2001, as political survival became the priority. The government breached its own undertaking to enforce a moratorium on public sector hiring on several occasions in the latter half of 2001. The armed forces (army, navy, and airforce) continued to recruit personnel. The recruitment of schoolteachers went on unabated. In October 2001, the government made over 40,000 casual employees in the public sector permanent as a gesture of goodwill to the masses in light of the impending parliamentary elections in December.

Again as a gesture of goodwill to the masses in light of the impending parliamentary elections, the employees of pubic service, semi-governmental institutions, and public corporations and statutory boards were provided a pay hike of LKR.1,200 per month effective from October 2001. As a corollary, pensioners were also offered a hike of LKR 750 per month. Whilst acknowledging the rapid rise in cost of living during 2001 and the consequent hardships faced by the masses, those pay hikes were premature for an ailing economy.

There were other fiscal sweeteners to the electorate as well; diesel vehicle taxes, save the nation contribution, and import duties on raw materials of the construction industry were abolished. The national security levy was reduced to 6.5% from 7.5%. Import duty on cement was reduced. All commercial bank loans of LKR 20,000 and below to farmers were written off. The prices of gas and wheat flour were subsidised by the government in order to prevent price increases. Duty-free imports of motorcycles were accorded to the employees of the Samurdhi authority, Samurdhi Commissioner General's Department, and research officers of the Department of Agrarian Services.

All these pay hikes, tax concessions, and public sector recruitment were a manifestation of fiscal irresponsibility by a defunct government amidst a deepening economic crisis and political morass. These politically motivated relief measures were fiscal opulence an ailing economy could ill afford. The shortsighted fiscal profligacy during election times has become a hallmark of Sri Lankan democratic polity. This was the case in1994 and again in 2001. Therefore, it is high time Sri Lanka introduces a system of statutory controls on public expenditure, during normal times as well as during election times. The history has shown that the politicians of Sri Lanka (whichever political party they belong to) cannot be trusted to manage the public finances prudently and efficiently. It is time to stipulate legally binding targets and ceilings on public expenditure by any government in power. For instance, there should be statutory ceilings on budget deficit and defence expenditure as proportions of the GDP and the total public expenditure respectively. Further, there should be statutory targets for public spending on social sectors such as education and health. That is, a maximum threshold of public spending on defence and a minimum threshold of public spending on selected social sectors as proportions of total public expenditure should be statutorily earmarked. Likewise, a statutory ceiling on the budget deficit as a proportion of the GDP should be stipulated.

The total outstanding public debt (both domestic and external) of Sri Lanka was more than the total GDP of Sri Lanka in 2001. This is not the first time the total public debt has surpassed the GDP in a particular year. During several years in the 1980s this has happened so. Therefore, it is not a new phenomenon and has no political colour. The interest payment on the total public debt during 2001 was LKR 94 billion, which was considerably higher than the total defence expenditure. The statutory public spending controls proposed above may be the only means of arresting fiscal profligacy of the politicians and the total public debt of Sri Lanka.

Fiscal Measures

The government's decision to increase the threshold income for personal income taxation, the proposed reduction of the top rate of personal income tax and the corporate tax in the next couple of years, and a series of tax incentives to the private sector are designed to improve compliance and reward entrepreneurship. The proposed amalgamation of the Goods and Services Tax (GST) and the National Security Levy into a Value Added Tax (VAT) is a positive step. However, the VAT rate on essential goods and services will be 10% and on other goods and services will be 20%. It is important to note here that hitherto essential goods were exempted from the GST. Hence, the VAT covers more goods and services than the GST. Therefore, the cost of living may rise as the government revenue is expected to increase by LKR 3.5 billion in 2002 as a result of the introduction of the VAT.

The rationalisation of fiscal instruments in the budget indicates a continuing reliance on indirect taxation rather than direct taxation. The indirect taxation is regressive while direct taxation is progressive, because the latter is based on one's ability to pay whereas the former is not. Sri Lanka is fast becoming a middle-income country and high time it relies more on direct income taxes rather than indirect taxes. As a way of broad-basing the direct income tax regime the public sector employees should be made to pay income tax. The public sector employees in India, for example, pay income tax and contribute to state pensions. Almost one-fifth of the total labour force in Sri Lanka is in the public sector (including public corporations, statutory boards/authorities, and semi-government institutions). That is, about 1.2 million out of the total labour force of 6 million was in the public sector in 2000. The public sector in Sri Lanka is already overstaffed. There was 1 public sector employee for every 24 citizens in Sri Lanka in 1978, which had shrunk to 1 per every 16 citizens in 2000. The per capita public sector employee in Sri Lanka is the highest in Asia.

The Sri Lankan population has become very dependent on the State for providence of jobs, free health care, free education, free pensions, etc. This dependency has resulted in gross inefficiency and low productivity in the public sector. More alarmingly, in a survey conducted among the youths of the island in the late-1990s Prof. Hettige found that the major aspiration of the rural youth (both in the South and the North) is obtaining public sector employment. It is high time that this dependency culture is discouraged.

The most important incentives for people to seek public sector employment are the exemption from Pay As You Earn (PAYE) tax and non-contributory pension scheme. Therefore, the best way of dissuading the youth from seeking public sector employment is to withdraw these two privileges enjoyed by the public sector employees. In this regard, the proposal to make the new recruits to the public sector contribute 8% of their salary to their pensions in this budget is opportune. However, the government should go further and net the public sector employees into the PAYE scheme. It is high time to inculcate the principle of paying direct income tax according to ability in Sri Lanka.

A debit tax of 0.1% proposed on all debit transactions in all formal financial transactions is a regressive step. Sri Lanka is perhaps the only country in the world that has introduced such a regressive tax. Though it is mentioned in the budget that this tax is temporary there is no time limit mentioned. This tax may encourage informal financial transactions.

Structural and Institutional Reforms

It is disheartening to note that very little structural and institutional reform of the economy is proposed in the Budget 2002. The reform of the bloated bureaucracy, state-dominated financial sector, antiquated labour laws, and the state-ownership of 80% of the land area of Sri Lanka are some of the critical reforms need to be undertaken. These reforms are long overdue. There are no concrete proposals at all to reform the public sector or the financial sector. But, there is some indication in the budget about the proposed labour and land market reforms.

It is always politically convenient to undertake unpopular but necessary economic reforms in the early years of a new government. With the public endorsement of the government policies in the recent local government elections it would have been easier to push through long overdue structural and institutional reforms of the economy. The government's reluctance to bite the bullet, so to speak, is disappointing to say the least.

Conclusion

The government's decision to increase the proportion of public expenditure on defence is self-defeating, because on the one hand the government seems to be quite optimistic about the current peace process but on the other hand has not delivered its own peace dividend to the economy. This dichotomy of government policy in the political and economic spheres provides a confusing signal to the potential investors (both local and foreign) and the foreign donors alike.

Moreover, the government has shrugged off the opportunity to inject public investments in infrastructure such as roads, power, and telecommunications in the war-torn areas that could have been a catalyst to kick-start the ailing economy of Sri Lanka. Only a paltry sum of LKR 300 million is earmarked for public investment in infrastructure in the war-torn areas for 2002. Perhaps the government is expecting donor assistance to undertake these critical investments.

The allocation of LKR 2,800 million or just 0.81% of the total public expenditure to the Ministry of Rehabilitation, Resettlement, and Refugees (Table 2) is yet another indication of the government's failure to deliver its own peace dividend to the beleaguered economy. Out of the total allocation of LKR 2,800 million only LKR 466 million is allocated for capital expenditure. Perhaps the government is expecting the international donor community to foot the major part of the bill on rehabilitation and resettlement.

If the government could not demonstrate its faith in the peace process by slashing the huge defence budget how can it expect the private sector, foreign investors, and the foreign donors to have faith in the peace process? Further, if the government does not want to put the money where its mouth is how could it expect the private sector, foreign investors, and the donors to do it? An economy in the red requires a bolder and faster economic reform agenda than what is proposed in the Budget 2002.

Table 2: Public Expenditure Proposed for 2002

	Recurrent Expenditure (LKR Million)	**Capital Expenditure** (LKR Million)	**Total** (LKR Million)	**As a % of Total Public Expenditure**
President's Office	290	38	328	0.09
Prime Minister's Office	55.9	50	105.9	0.03
Ministry of Defence	41,000	9,000	50,000	14.46
Ministry of Interior	16,87	1.8 573.6	17,445.4	5.05
Ministry of Human Resource Development, Education and Cultural Affairs	10,064	5,319	15,383	4.45
Ministry of Tertiary Education and Training	5,444	1,970	7,414	2.14
Ministry of School Education	18.713	6.6	155.3	0.04
Ministry of Samurdhi	15,222	161	15,383	4.45
Ministry of Health, Nutrition and Welfare	19,331	5,090	24,421	7.06
Ministry of Employment and Labour	901	143	1,044	0.30
Ministry of Public Administration, Management and Reforms	26,239	151	26,390	7.63
Ministry of Policy Development and Implementation	528.8	236 7	64.8	0.22
Ministry of Power and Energy	483	9,914	10,397	3.01
Ministry of Transport, Highways and Aviation	4,402	3,470.8	7,872.8	2.28
Ministry of Highways	41	9,610	9,651	2.79
Ministry of State Transport	1,383	4.2	1,387.2	0.40
Ministry of Finance	19,648	42,571	62,219	18.00
Ministry of Agriculture and Livestock	5,227	939	6,166	1.78
Ministry of Enterprise Development, Industrial Policy and Investment Promotion	585.3	1,290	1,875.3	0.54
Ministry of Industries	25.5	100.7	126.2	0.04
Ministry of Port Development and Shipping	95.4	3,577	3,672.4	1.06
Ministry of Foreign Affairs	3,118	134	3,252	0.94
Ministry of Eastern Development, and Muslim Religious Affairs	110	281	391	0.11

Ministry of Housing and Plantation Infrastructure	244	7,681	7,925	2.29
Ministry of Housing Development	25	89	114	0.03
Ministry of Estate Infrastructure	67	119.6	186.6	0.05
Ministry of Urban and Public Utilities	27	95	122	0.04
Ministry of Fisheries and Ocean Resources	343	1,522	1,865	0.54
Ministry of Women's Affairs	69	76	145	0.04
Ministry of Justice, Law Reform and National Integration	1,197	567	1,764	0.51
Ministry of Irrigation and Water Management	1,428	3,797	5,225	1.51
Ministry of Environment and Natural Resources	578.8	1,317	1,895.8	0.55
Ministry of Home Affairs, Provincial Councils and Local Government	35,234.9	7,517.8	42,752.7	12.37
Ministry of Social Welfare	88.9	55.9	144.8	0.04
Ministry of Plantation Industries	368	1,484	1,852	0.54
Ministry of Tourism	125.6	110	235.6	0.07
Ministry of Southern Region Development	60	398	458	0.13
Ministry of Western Region Development	138	1,445	1,583	0.46
Ministry of Central Region Development	30	709	739	0.21
Ministry of Cooperatives	112	54.5	166.5	0.05
Ministry of Mass Communication	3,916	1,834	5,750	1.66
Ministry of Parliamentary Affairs	109	25	134	0.04
Ministry of Youth Affairs and Sports	498	305	803	0.23
Ministry of Rehabilitation, Resettlement and Refugees	2,334	466	2,800	0.81
Ministry of Land	940	473	1,413	0.41
Ministry of Commerce and Consumer Affairs	210	78	288	0.08
Ministry of Economic Reform, Science and Technology	427	1,042	1,469	0.42
Total	**219,654.6**	**126,020.7**	**345,675.3**	**100**

Notes

1. This does not include debt repayments.
2. The actual defence expenditure during 2001 will be known only by end of April 2002.

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