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Sri Lanka Budget 2013

Increasing Assistance, and Vulnerability

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Increasing Assistance and Vulnerability

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Introduction

Media reporting on the 2013 budget began with the tabling of the Appropriation Bill on 9th October 2012. The plans underlying the spending allocations were presented in a budget speech to parliament on 8th November 2012 by President Mahinda Rajapaksa. The final vote on the 2013 Budget in parliament was passed on 8th December with 158 voting for, and 57 voting against. The UNP, JVP and TNA voted against.

The budget has been subject to much debate in the media since the President's speech in parliament. The coverage in the press has overall been more critical than positive. However, much of the coverage was based on broad brush ready-made criticisms made by opposition parties instead of careful analysis of the specifics.

The gratuitous tax concession for racing cars took on a symbolic meaning beyond its actual impact, and the phrase Lamborghini-Badagini came to over-determine the interpretation of the budget (see figure 1)[1]. This has deprived the thinking public in two ways: (1) under appreciating aspects of the budget that increase direct government assistance to the poor and to small and medium scale enterprises (SMEs), and (2) not spotting specific weaknesses which not only undermine the pro-poor initiatives, but damage the prospects of the non-poor as well, by undermining economic prospects as a whole.

The present analysis focuses on the contradictory nature of the Budget 2013, which on one hand significantly increases the direct government assistance to the poor, and on the other hand increases the vulnerability of the poor and the economy as a whole by reducing support for the institutionalised structures of social welfare, increasing political discretion, projecting unrealistic fiscal revenues, and misallocating resources.

[1] Lamborghini stands for an epitomisation of racing cars, and Badagini is the Sinhala term for "I am hungry"

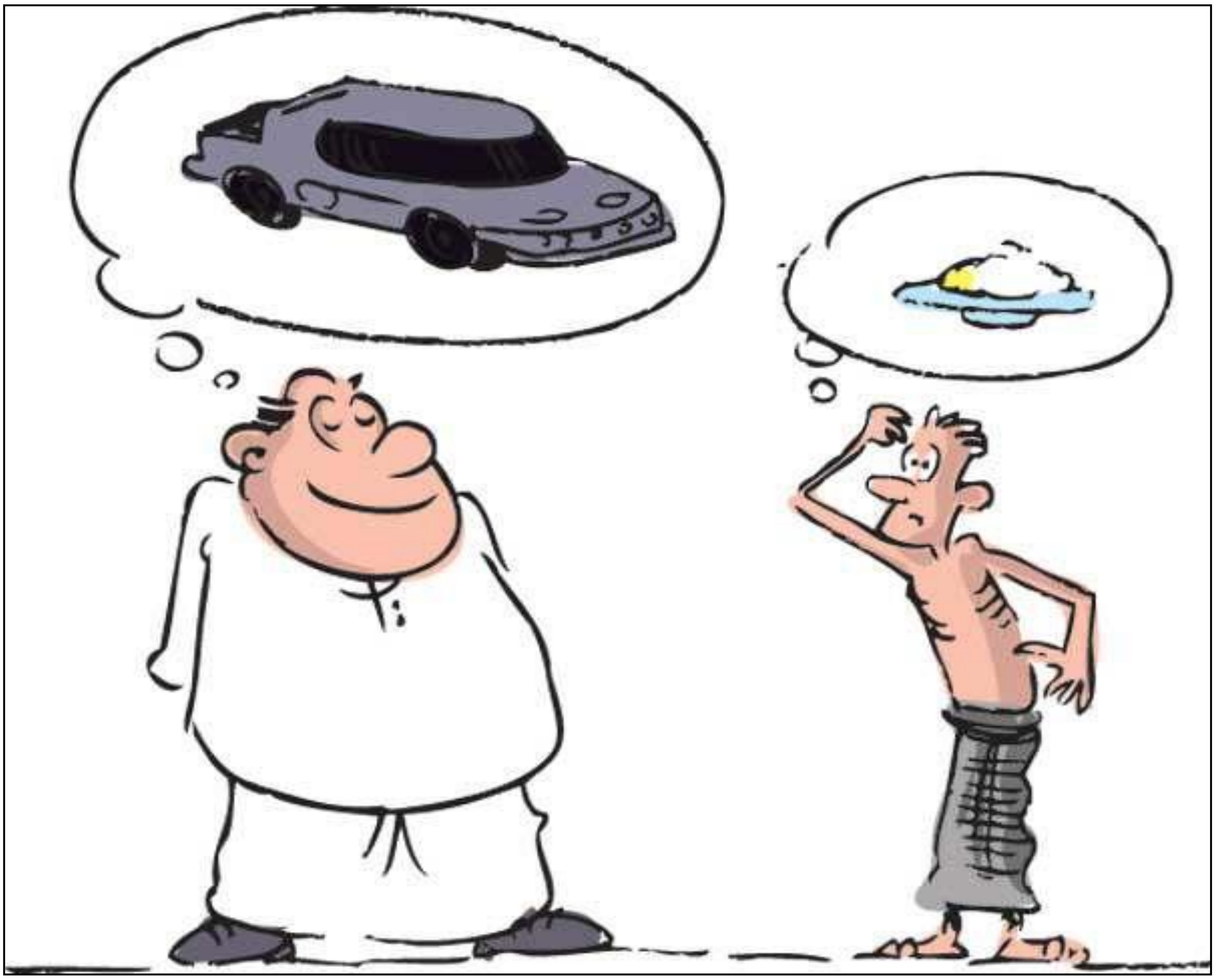

Figure 1: A cartoon contrasting the pre-occupations of a politician vs. a common man.
Courtesy Daily Mirror Editorial 19 November 2012

Highlights of Analysis

Planned to Fail: Revenue, Taxation, Expenditure and Deficit

- Budget 2013 has followed the previous year's pattern of severely over-estimating projected revenue growth. But, expenditure growth is projected to be low. This creates vulnerability as it reduces flexibility for adjustment, and implies that deficit targets will be missed by a wide margin.

- The budgeted trajectory is likely to result in unplanned borrowing in 2013 to finance higher deficits, which in turn could crowd out funding for private sector investment and increase exposure to foreign commercial loans.

- Past trends suggest that pressures on expenditure are likely to make actual disbursements less than what has been budgeted to Provincial Councils and the welfare infrastructure such as Health Care and Education.

- Despite tax revenue being projected to grow at several times the rate of GDP, in the past years, growth in tax collection has not even kept pace with GDP growth. The recommendations of the tax commission, much touted in 2010/2011, seem to have been now forgotten, indicating a significant flip flop in economic policy.

Increased Assistance to and Increased Vulnerability of the Poor

- The budget of the Ministry of Social Services has been greatly increased by 188% and new schemes have been introduced to increase direct assistance to the vulnerable population. Separately, the budget speech also claims Divineguma to have provided some assistance to 2.5 million households, which accounts for half the population of Sri Lanka. The budget has over-all significantly increased the scope of direct assistance to households.

- The nature of the social economy shows signs of multiple transitions that also increase the vulnerability of the poor: (1) from welfare structures to patronage structures, (2) from institutions to politics, as means of delivering assistance (3) weakening of empowerment structures, especially health care and education.

- Costly social welfare related programs, such as Deyata Kirula which is a festival held under the patronage of the President, remain off-budget. In 2012, the program spent 15 times the budget of the Ministry of Social Services. The funding is drawn from various different ministries with the sources and destinations remaining opaque: reflecting poor budgeting practices.

Retreat from the Institutional Welfare State

- The budgets for education and health care continue their trend of declining in proportion to GDP, and even in real terms, in a continuous steady retreat from that historical welfare infrastructure. In that respect, plans have not been sensitive to the social concerns mobilised by FUTA through over 3 months of trade union action.

- What is missing in substance is made up for by rhetoric: the budget speech misrepresents the government's commitments to spending on education. Its claims are not supported by the budgeted numbers in the appropriation bill.

Consistent Concern for Small and Medium Enterprises, But Policies are not Coherent.

- As in the case of direct social assistance programs, several specific measures have been introduced by the Budget 2013 to assist the small and medium scale enterprises (SMEs) in general, as well as in particular industries.

- The extension of the 10% tax ceiling to organisations with turnover of up to 500 million may be moving the reach of these incentives to even larger scale firms beyond SMEs; but the reasoning behind the extension remains unclear.

- For SMEs, favourable fiscal policy measures and incentives, however, countermanded by unfavourable monetary policy, unreliable public utilities, and shortages in skilled labour; none of which were addressed by the budget (NB: Positives changes to loosen regulatory restrictions on credit growth were signalled post budget).

Defence Swallows Urban Development and Substitutes for Jobless Growth

- Sri Lanka's huge defence budget which refused to shrink post war has continued to grow, and at almost 19% in Budget 2013. Capital expenditure has been growing faster than recurrent expenditure in the post-war period, and in Budget 2013.

- The joining in of the Urban Development function has sometimes been conjectured as an explanation for the growth of this budget. To assess, Verité Research has analysed the detailed budget and separated defence and Urban Development related allocations. The Urban Development related allocations accounted for less than 5% of the Ministry's budgetary allocations.

- The wages and upkeep of security forces and staff account for at least half of this budget, with no plans announced to re-skill and encourage the carders towards integrating into the productive economy.

- Re-integration would be a challenge in any case, as the economy is displaying the phenomenon of "Jobless Growth". The number of jobs in seven provinces outside of North and East remained the same in mid-2012 as it was in 2006; despite growth in real GDP being recorded at over 40% in the same period.

Lack of Parliamentary Oversight and Executive Domination of the Budget

- Parliament does not seem to have proper oversight procedures for the big budget ministries, which implies higher levels of discretion for particular Ministers and empowered officials.

- The President has assigned to himself the Ministerial portfolio of three Ministries: (1) Defence and Urban Development, (2) Finance and Planning, (3) Ports and Highways. Together, these three Ministries are allocated two thirds of the finances of the entire budget.

- Debt Amortisation Payments (d.a.p) account for about 45% of the spending from all the funding allocated to these Portfolios of the President. If the budget estimates sans d.a.p. is evaluated then the share controlled by the President's is still about 52%.

The Budget is not Consistent with the Constitution.

- The lack of parliamentary oversight with regard to the budget is mostly a lack of appropriate procedures. This year, however, the Appropriation Bill (which is the means by which the budget is brought to parliament) was also challenged in the courts of law for the powers they vested with particular ministers, without recourse to parliament. The Supreme Court ruled that two clauses of the Appropriation Bill were not consistent with Article 148 of the constitution.

- Minor amendments to the bill could have ensured compliance with the constitution. However, the government placed the bill for vote without making the necessary amendments. It is not clear whether the two thirds majority vote of the government, without a referendum, is adequate to pass it into law despite the inconsistency with the constitution. The opposition has declared the budget to be illegal.

1. Revenue, Taxation, Expenditure and Deficit

Overview: The systematic mis-estimation of revenue, expenditure and deficits has been continued in the present budget. The revenue targets are unrealistic in the extreme. Projections of expenditure increases are moderate, and likely to be underestimated. But even if they are maintained, the revenue shortfall will create significant pressure to finance a higher than expected deficit with commercial loans. If these are drawn on the local market, it will either increase inflation (when borrowed from the Central Bank) or increase the crowding out of financing for private investment (when borrowed from Commercial Banks); and if in the foreign market, it will add to the adverse trend of the government's loan portfolio tilting towards short term foreign denominated commercial loans with exchange rate risks. Either way the economy is tipped to become more **vulnerable due to the lack of fiscal discipline, dishonest budgeting and poor financial planning practices**.

1.1 *Revenue and Taxation*

Verité Research (VR) in its analysis of the 2012 budget indicated that the anticipated revenue growth of about 19% was unrealistic. Indeed, the actual revenue growth in 2012 is now predicted to be only 10.4% (a shortfall of Rs 74.6 billion). Once again the **revenue growth targeted for 2013, at 18%, remains unlikely to be achieved**.

The revenue shortfall for 2012 arose from a significant fall in expected tax revenues[2] (down to 10% from the projected 23% expansion)[3]. Table 1 shows that all categories of tax revenue have performed well below the expected growth projections. Nevertheless, undeterred, those past projections are repeated for 2013 as well. **The projection is for the tax revenue to grow at around 3 to 4 times the rate of GDP growth**. Even though the potential exists for tax revenue to grow faster than GDP, by expanding the tax base in the context of rising per capita income, the projected expectation in a single year remains excessive and cannot be explained in terms of any on-going policy for improving the administration of taxes either. In fact, Budget 2013 declares numerous tax amnesties, which would **further dampen revenue expectations**. The gross over-estimation of tax revenues in preparing Budget 2012, as evidenced by the actual outcomes, does not seem to have functioned as a reality check in preparing Budget 2013.

The 2013 revenue estimates also suggest that the government is pessimistic with regard to grants and that it expects to have to subsidise significant losses in public sector corporations (Non tax revenue) which are currently hidden due to being off-budget.

[2] Tax income on domestic goods and services accounts for about 47.5% of the government revenue
[3] Tax income accounts for about 86% of government revenue.

Table 1 : Revenue and Taxation Estimates – Past and Projected

Category (Year on Year % Change)[4]	2011(a)/2012(b)	2011(a)/2012(c)	2012(c)/2013(b)
Total Revenue and Grants	**18.02**	**10.37**	**18.20**
Total Revenue	**17.90**	**10.12**	**18.54**
Tax revenue	**23.12**	**10.33**	**23.57**
Income Tax	20.95	12.71	24.64
Taxes on Domestic Goods and Services	21.85	6.70	24.56
Taxes on External Trade	28.44	17.99	20.94
License taxes and other	11.55	-12.52	5.83
Non Tax Revenue	**-11.22**	**8.93**	**-9.86**
Grants	**25.30**	**25.30**	**0.00**

Source: VR calculations using Budget Estimates 2011, 2012 and 2013
Note: (a) Actual (b) Budget Estimate (c) Revised Budget Estimate

In 2009, the government appointed a Presidential Commission to recommend improvements to the tax structure. While the budget presented in 2010 appeared to have incorporated its recommendations, especially in terms of simplifying and standardising taxes, ad-hoc changes have been introduced regularly since 2011 to reverse these reforms. The report of the Presidential Tax Commission, though handed over to the President, has not been made public. The main weakness in the tax structure of being dependent on indirect consumption taxes instead of direct income taxes persists with **two negative consequences:** one, the difficulty in making taxation adequately progressive and targeted to favour the poor; and two, the price inflation that results from taxes on consumption.

1.2 Expenditure

Recurrent expenditure usually accounts for about 70% of the budget. This is mainly due to inflexibility in its expenditure components: salaries and wages, interest payment and subsidies and transfers, which account for 17%, 25% and 21% respectively. Under the constraints of meeting deficit targets for 2012 the government has reduced expenditure in line with reductions in revenue. However this reduction is likely to disproportionately affect the category of "other goods and services" of recurrent expenditure (see Table 2), due to inflexibility in the other areas. This **reduces the public services commitments of government expenditure**.

The expenditure targets have been adjusted downwards in the 2013 budget to a growth of just 9.14% reflecting the actual experience in 2012. However, past practice has been to conceal the actual expenditure plans from the budget, and introduce supplementary budget estimates – often for luxury capital purchases for higher echelons of government – about 4-6 months later.

[4] BE: Budget Estimate, RBE: Revised Budget Estimate

Table 2 : Expenditure Estimates – Past and Projected

Category	2012 (a)	2012 (b)	2013 (a)	2012 (a)/ 2012 (b) Variance	2012 (a)/ 2012 (b) % change
Total Government Expenditure (Rs '000)	**2,220,000,000**	**2,190,000,001**	**2,515,000,000**	**-29,999,999**	**-1.35**
Recurrent Expenditure	**1,109,000,000**	**1,081,116,864**	**1,258,500,000**	**-27,883,136**	**-2.51**
Salaries and Wages	259,904,087	263,706,092	290,956,499	3,802,005	1.46
Interest	370,030,000	370,030,000	444,835,000	0	0.00
Subsidies and Transfers	317,812,247	328,912,104	365,511,771	11,099,857	3.49
Other Goods and Services	161,253,666	118,468,668	157,196,730	-42,784,998	-26.53
Capital Expenditure	**541,000,000**	**538,883,137**	**509,500,000**	**-2,116,863**	**-0.39**
Public debt Amortisation	570,000,000	570,000,000	747,000,000	0	0.00
Domestic	420,000,000	420,000,000	634,000,000	0	0.00
Foreign	150,000,000	150,000,000	113,000,000	0	0.00

Source: Budget Estimates 2012 and 2013

Note: (a) Budget Estimate (b) Revised Budget Estimate

Further, the over-estimation of revenue can be expected then to also result in unplanned spending cutbacks in the eleventh hour to improve deficit reduction (pressure towards this arises in Sri Lanka from subscribing to IMF facilities), as has happened in 2012. This is likely to affect provincial councils and social welfare dimensions such as health care, where cutback in the provision of medication and testing services is regularly resorted to in order to cope with budget cuts. (In 2012, the already meagre health care budget was reduced by about 4% to accommodate spending cuts).

1.3 Deficit

The 2013 budget proposal set out a fiscal stance which anticipates a real GDP growth of 7.5%; and revenue and expenditure targets of Rs 1,271 billion and Rs 1,768 billion respectively to keep the planned budget deficit at 5.8% of the GDP. The overestimation of revenue and the low expectation on expenditure allows for an optimistic projection on the deficit. As in the case of revenue targets, therefore, **the deficit projection is unrealistic**.

The 2012 budget anticipated a budget deficit of 6.2% of the GDP. However according to internal calculations, projecting on figures reported to date, the budget deficit for 2012 is likely to reach 7.2% of the GDP.[5]

If the profits and losses by Ceylon Petroleum Corporation, Ceylon Electricity Board, and other government corporations, which are off-budget, were to be internalised **the deficit would be as high**

[5]Computed using expenditure stated in revised budget estimate 2012 and central bank's projection on 2012 GDP.

as 9% of GDP. This comprehensive calculation is the substantive measure of the deficit, which will need to be financed through borrowing.

When the deficit is hidden in this way, by the smoke and mirrors of unrealistic projections, problems arise later. For instance, in 2012, the projected deficit of 6.2% of GDP was expected to be financed with 3.6% in domestic borrowing and 2.6% in foreign borrowing. However, as reality failed to match the projections, foreign borrowing went up by Rs 236.8 billion , or 3.2% of GDP, even as early as July 2012. This represented an increase of over 130% in foreign borrowing compared to the corresponding period of 2011. Foreign borrowing was also on commercial terms and creates **further vulnerability by exposure to exchange rate risks**. The deficit was also financed by unplanned inflationary or crowding-out borrowing practices from the domestic market. 19.7 billion was borrowed from the Central Bank (inflationary) and 77.3 billion from Commercial Banks (crowding out private investment borrowing). **The economy in 2013 remains vulnerable to the same pattern of practices.**

2. Ministry of Social Services

Overview: The chief responsibility of this ministry is towards the welfare of the elderly and the disabled. The allocation to this ministry has been on the increase since 2010. The current budget, however, has a record increase of 188%: growing from 1,336.7 million to 3,852.1 million (an increase of 2,515.4 million). Capital expenditure allocation has increased by 80 million from 189.4 million in 2012, to 269.4 million for 2013. Recurrent expenditure has risen by 2,435.2 million and grown from 85.8% of the ministry budget to 93%. The recurrent component is 0.2% of government expenditure in 2013, which is 3 times what it was in 2010.

2.1 Direct assistance to the vulnerable: The major increase in the budget of the ministry of social welfare was driven by a welfare program to provide income assistance to the elderly (defined as those over 70 years of age). Rs. 2,070 million has been allocated for this purpose. Further another Rs. 222 million is allocated for support for low income families.

2.2 From welfare to patronage: The Ministry of Social Services also contributes from its budget to the annual exhibition and development program known as Deyata Kirula. The program is centred around the image and patronage of President Mahinda Rajapakse, and according to its website incurred costs of 20,000 million[6] in 2012 (about 15 times the 2012 allocation to the Ministry of Social Services). Deyata Kirula is not recorded as a separate budget item, and therefore draws its resources from many different Ministries. As a result, the total planned allocation for 2013 is not transparent in the budget.

2.3 From institutions to politics: The increased allocation to this ministry reflects the increased priority given in this budget for direct assistance to the poor and vulnerable. It also reflects the fact that the methods of channelling such assistance is becoming increasingly diverted to flamboyant, new, personality based political-support-building programs that draw from various different government ministries, rather than being embedded in stable government institutions. **This could negatively impact both the durability of the programs and the productivity of the expenditure.**

[6]http://www.deyatakirula.lk/deyata-kirula/

***2.4 From empowerment to dependency*:** But while expenditure was being increased to the Ministry of Social Services, other social infrastructure sectors are facing cuts or significant constraints. The budgetary allocations for ministries such as Child Development and Women's Affairs, Ministry of Resettlement is showing a declining trend, both as a percentage of GDP and total government expenditure. Furthermore, there was a significant cut on the *Commission to Investigate Allegations of Bribery and Corruptions* (reduced by 50.4 million, a decline of 22.7% from 2012). **This gradual retreat from longstanding social protection channels can increase vulnerability of those at the lower socio-economic strata.** The dependency of the poor on the various new, political-support-based, direct assistance schemes is likely to increase, as those schemes also grow in political significance.

3. Education and Health Care: Retreating from the Welfare State

Overview: Free education and health care are strong ideological pillars of Sri Lanka's welfare state. However, over-time both of these have suffered erosions in quality that have required consumers to substitute the state supplied services with private complements – private clinics, laboratories and hospitals in the case of the health sector; private tuition and "international" schools and universities in the case of the education sector. The total percentage of GDP allocated to health and education in the budget, at 2.84 %, is meagre and reflects a trend of de-prioritising this historically important welfare infrastructure.

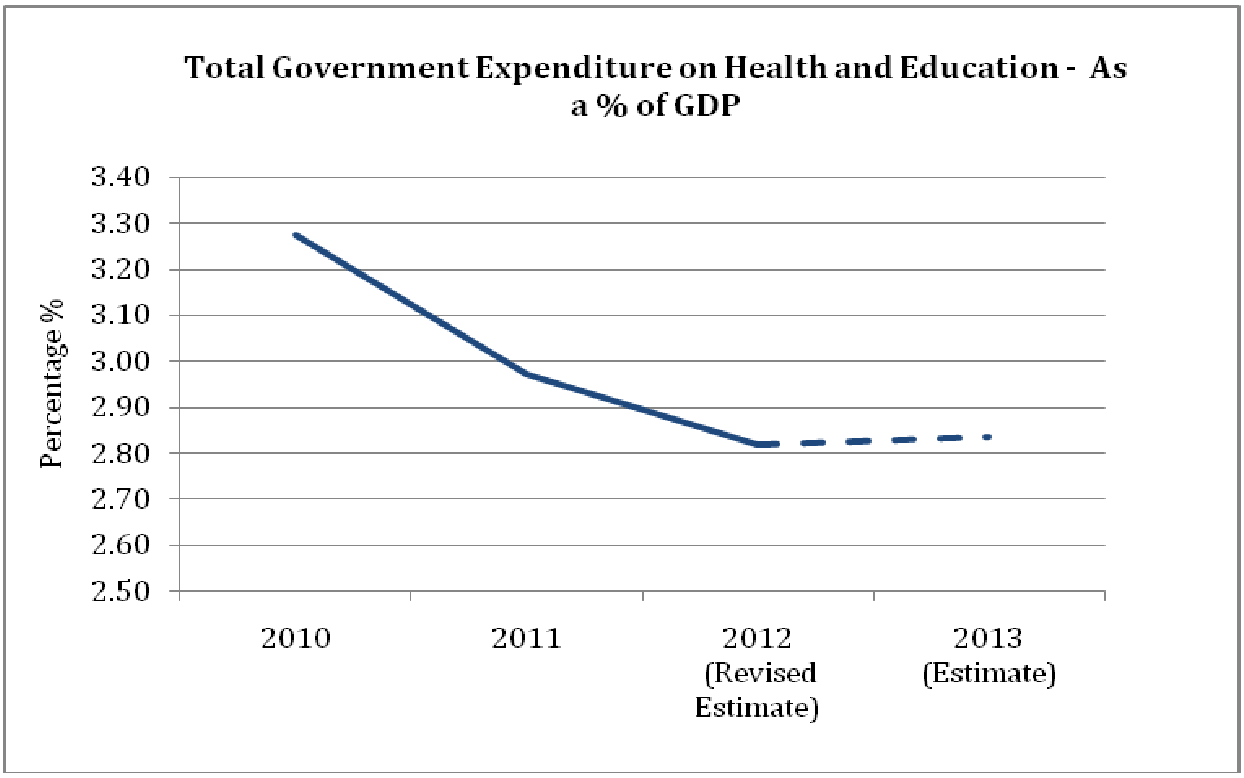

Figure 2 : Government Expenditure on Education and Health
Source: Budget Estimates 2010 - 2013

3.1 Health Care: Undernourished and Centralised

The 2012 budget had allocated 1.31% of GDP for the health sector. The 2013 budget allocates about the same: 1.33%. However, the actual disbursement in 2012 was cut down to 1.26%.

Provincial vs. National: Most of the reduction came from reducing the provincial allocation by 5,153 million. A smaller cut of 560 million was made to the national capital budget. Over the years the share of the health expenditure at the national level has been rising, while the provincial share has been in decline, as seen in Figure 3.

Investing in prevention: The internal allocation of the health care budget reveals some positive developments: the portion of recurrent expenditure allocated for the health promotion and disease prevention activities have doubled over a period of two years.

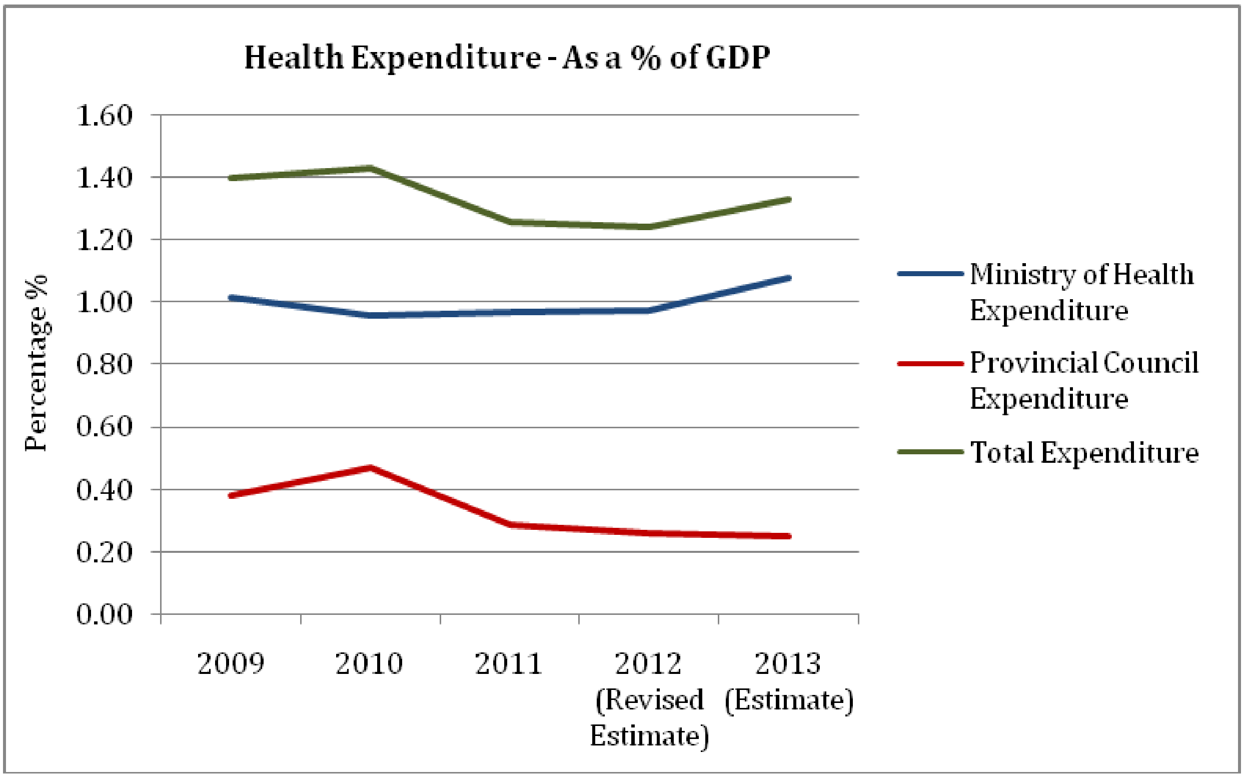

Figure 3 : Health Care Expenditure since 2009
Source: Budget Estimates 2009 - 2013

3.2 Education: Misrepresented and FUTA disregarded

The Federation of University Teachers Associations (FUTA) engaged in a three month trade union action asking for higher pay and a gradual increase of the education budget to 6% of GDP. However, the **total allocation for all education** is 163,400 million[7] in 2013 (1.88 as % of GDP). This is a nominal growth of 5.9% from 2012 and implies **a decline of almost 2% in real terms** as the GDP deflator for 2012 is expected to be about 7.8%.

[7]Inclusive of total government expenditure on education such education expenditure through other ministries, vocational training, scholarships and staff training programmes.

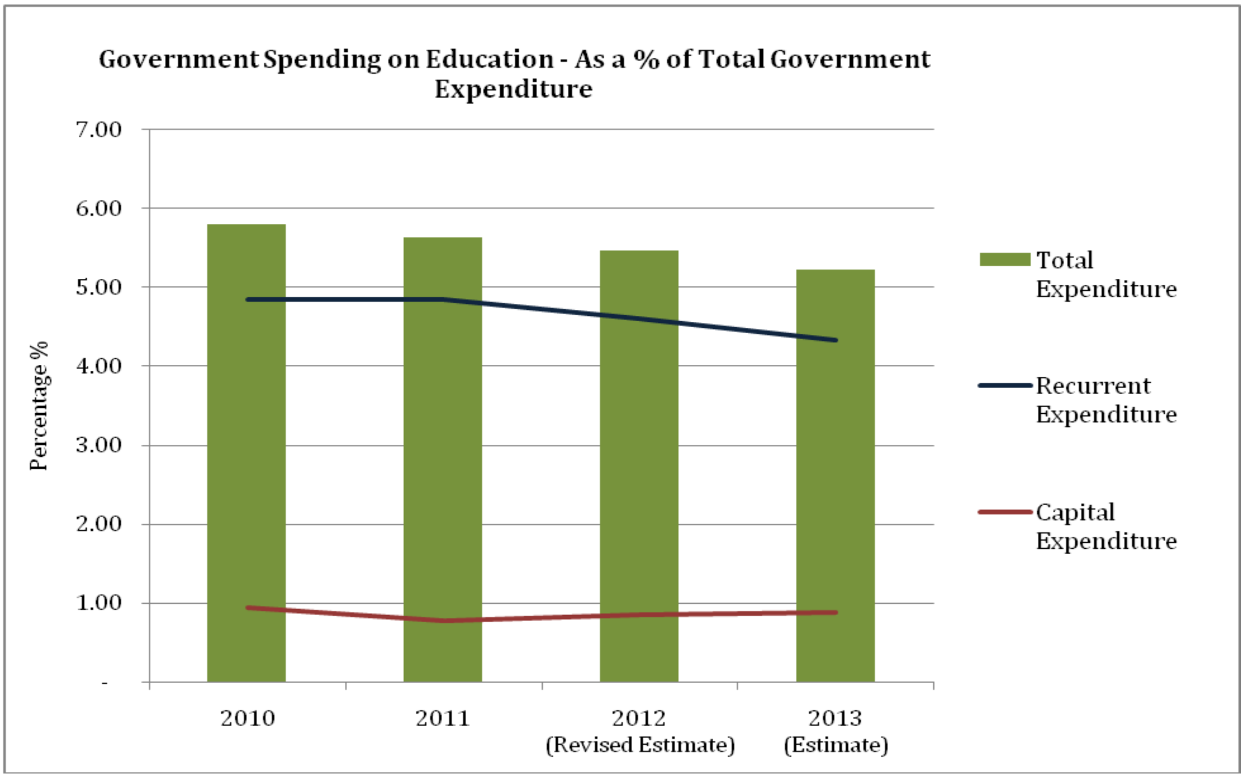

Figure 4 : Trends in Percentage of Government Spending on Education
Source: Budget Estimates 2010 – 2013

The **direct expenditure on education**, represented by the allocations made to the Ministry of Education, Higher Education and to the Provincial councils on education amounted to only 131 billion accounting for 1.51% of GDP (5.21% of government expenditure). A clear downward trend is evident in the allocations made to the education sector as a percentage of GDP in four successive budgets from 1.81% in 2010 to 1.51% in 2013. This is driven by sharp decreases in current expenditure on education. The capital expenditure component has recorded marginal increases through the period (see Figure 5).

It was widely publicized that Budget 2013 arose out of a process that consulted widely to incorporate the concerns of people and stakeholders in the allocations. However, the government has roundly ignored the wide public support, on the street and in the newspapers, for significant increases in the education budget (the slogan was 6% of GDP for education).

3.3 Gap between representation and action: Section 36.8 of the budget speech states as follows:

> *"I will assure children and parents of this nation through this august assembly that this Government under no circumstance will compromise its commitment to deepen the scope of free education. In this background, it has been proposed to increase expenditure on education … by a further 15% to about Rs. 177.6 billion in 2013."*

But in fact the budget allocates just 163.4 billion instead of the promised 177.6 billion for education. This represents a nominal increase of only 5.9% and a reduction in of the education budget in real terms. The claim of "*not compromising on commitment to deepen the scope of free education*" is almost directly contradicted. Either there has been an error in apportioning the budget, or the claim is deeply cynical.

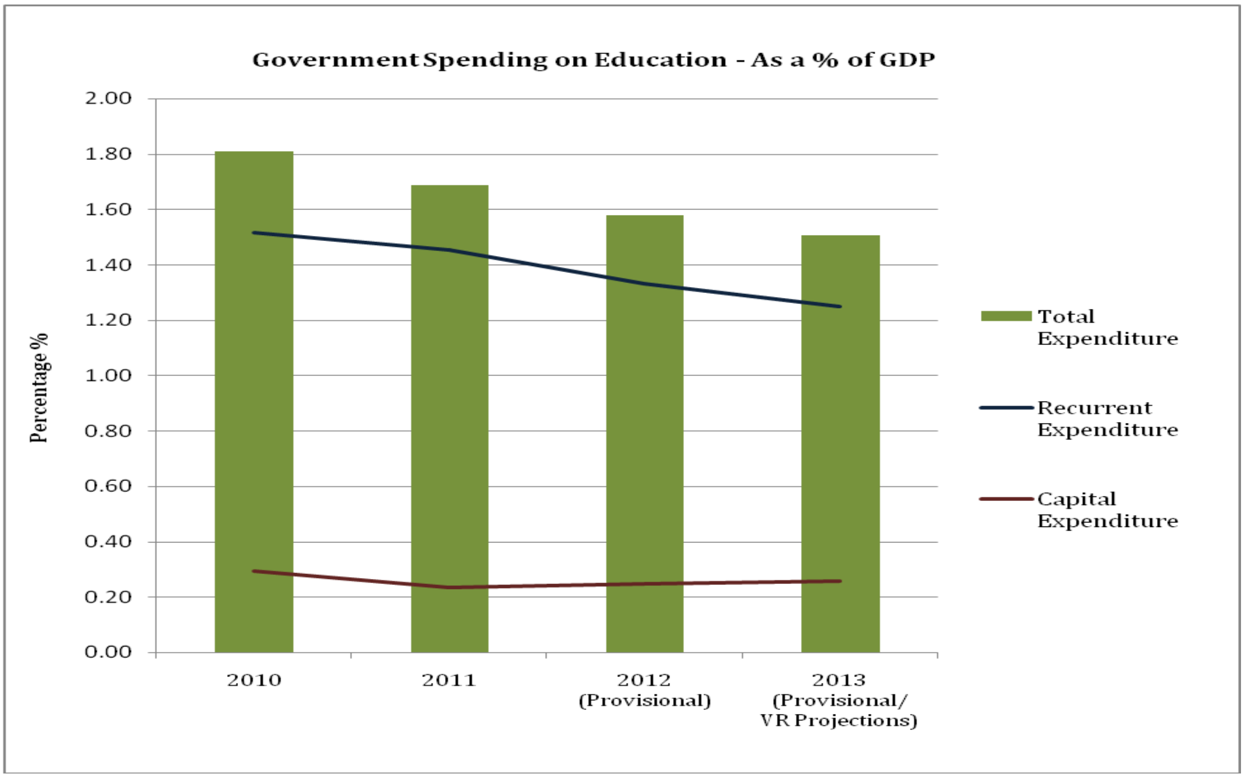

Figure 5 : Education Expenditure - As a percentage of GDP
Source: Budget Estimates 2010 – 2013, Central Bank, VR Projections

3.4 Retreat from the Welfare State

Despite the historical commitment in Sri Lanka to free education, which is echoed in the President's budget speech, education in Sri Lanka has become costly. According to the budget speech itself, estimated private spending on education at present is equal to the public spending on education.
As it has happened in the health care sector, the public sector is gradually reducing its role in this historically important social infrastructure in Sri Lanka. This reprioritisation of education and health care is not a recent phenomenon. It is reflected in the budgetary trends from 2006 onwards.

4. Small and Medium Enterprise (SME) sector

Overview: For the second consecutive year the government confirmed its intent of **assisting and promoting** the SME sector, with a bundle of targeted fiscal incentives. However, monetary policy has not been aligned, and is likely to **also increase the vulnerability** of the sector.

Despite the specific focus on SMEs in successive budgets the government has not provided a definition of what constitutes an SME. In Sri Lanka, the main definitions have sometimes been based on number of employees (where organisations employing up to 149 have been recognized as medium sized enterprises), and sometimes based on the value of assets excluding land and buildings (e.g. The Task Force for the Development of the SME sector in Sri Lanka defined it as LKR 50 million in 2002).

4.1 Financial concessions**:** The revenue level that requires registration for VAT and NBT payments has been increased from 2.5 million per annum to 12 million per annum, providing a significant measure of relief to very small enterprises that would find burdensome the extra administrative costs of the required accounting structures.

The budget also announces various other forms of assistance to SMEs: favourable tax structures at customs to export related products, income tax limits for selected services and local industries, expansion of micro finance schemes and legal aid in dispute resolution. The usefulness of such ad-hoc measures of assistance is, however, uncertain. Announcements of this nature are made in every budget, but without follow up analysis on implementation and effectiveness.

4.2 Changing the definition of SMEs: The most far reaching proposal in the budget, under the section on SME's, is to increase the turnover limit to 500 million from the previous 300 million, to qualify for **a low 10% Tax Ceiling**: In the absence of any other asserted definition, this proposal, in effect, changes the meaning of SMEs, and complicates economic analysis of and incentives to the sector. The limit of 500 million in turnover (almost 10 million a week) could include organisations with a much larger employment base than 150, and asset holding well in excess of limits for defining SMEs**.** It is not clear therefore whether this change in policy is actually targeted to the SME sector or whether it is simply "marketed" as being to the SME sector, while in fact targeting to benefit larger enterprises.

4.3 Increased vulnerability due to monetary policy and other factors: Alongside the above measures to assist the SME sector there remain several **aspects of government policy and practice that increase the vulnerability** of the sector. For instance:

- Increased government borrowing from domestic market sources, **crowding out credit for the private sector**, and central bank's policy decision to impose an **18% cap on credit expansion** of the economy remains a key obstacle to SME related fiscal incentives to reap its full benefit. (post budget, the Central Bank has **now announced that this cap will be lifted**, but policies such as this continue to fluctuate and clarity on the future trajectory remains elusive)

- The central bank in its monetary stance for 2012 has adopted a series of policy measures, including **raising the policy rates twice early 2012**, to contract the monetary expansion in an attempt to address the BOP crisis. (Post budget the **policy rates have been reduced**, when a raise was expected, but again, the future trajectory is uncertain).

- The lack of stability (in supply outside of Colombo) and the high cost of government controlled **supply of electricity**; and the **limited skills** and capacity of the available workforce remain core challenge for the SME sector, which are not being resolved by the budget or anticipated policy measures. In fact, the policies in the budget on encouraging greater out-migration of workers for skilled jobs could exacerbate this problem in the short term.

5. Defence and Urban Development

Overview: Sri Lanka's defence budget and urban development budget may be functioning in some respects as a **welfare scheme**, and in other respects as a **discretionary fund** used by the most powerful political personalities. Despite the functions of Urban Development being combined within the defence ministry, the spending on **Urban Development activities accounts for less than 5% of the total budget**, and even within that, excess of half the allocation is for building projects in Colombo and Hambanthota.

This ministry receives one of the highest budget allocations, despite the large expenditures relating to offensive military operations ending in May 2009. The allocation of Rs 289,502,534 million in 2013 is an increase of Rs 46 billion and 18.9% over 2012. This is so far the highest annual increase in this budget in the post war period. The increase consisted of recurrent and capital expenditure increasing by Rs 29 billion and Rs 17 billion respectively.

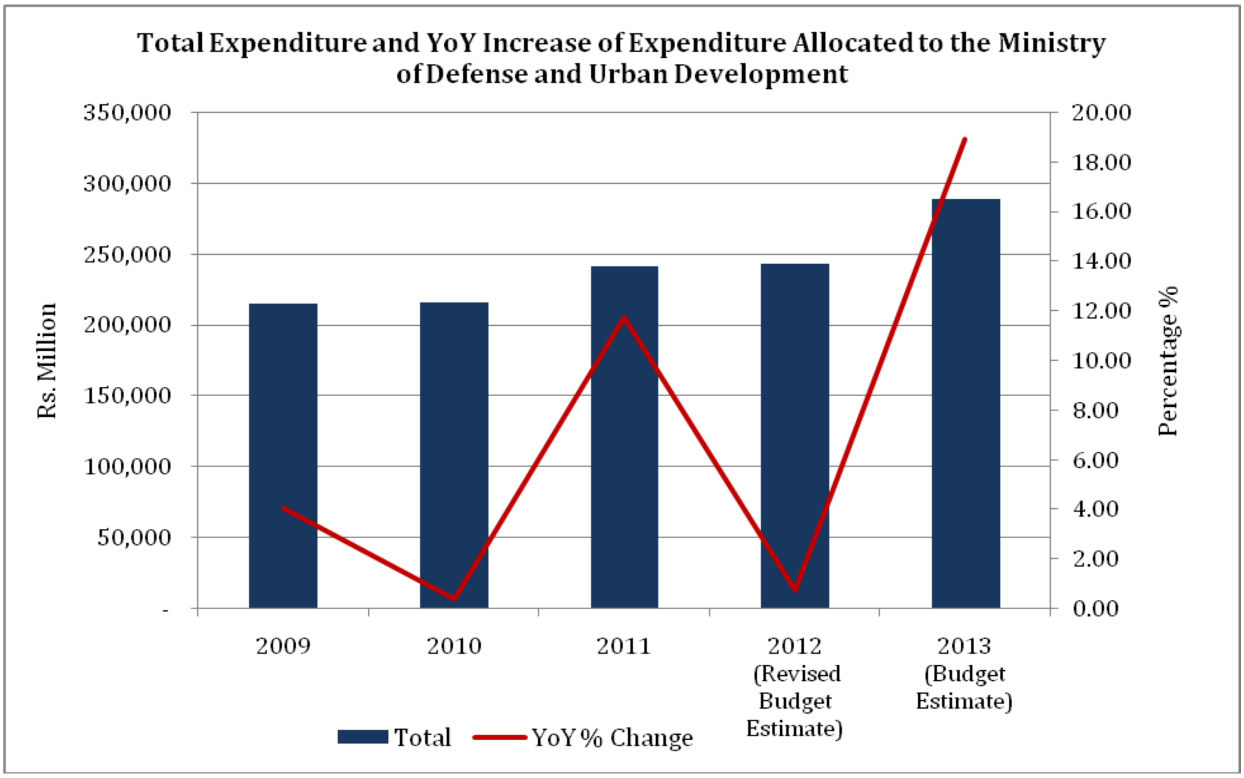

Figure 6 : Expenditure Trends in Ministry of Defence and Urban Development
Source: Budget Estimates 2009 - 2013

5.1 Defence

Air Force Increases in Priority: State security accounts for 73.3% of the Ministry's total allocations, with the biggest share going to the Sri Lankan army (42.2%). That share has fallen overtime from 52.5% in 2009 to 42.2% in 2013. The share allocated to the Sri Lanka Air force shows a significant increase from 9.25% to 14.34% during the reference period. This reflects a 68% growth in the Sri Lanka Air Force budget driven largely by increases to the capital expenditure component.

Employment as indirect welfare: 147 billion or 51% of the Defence and Urban Development Budget is spent on wages and other benefits to those employed. Comparing the claim in the budget speech that the government employed 1.3 million, against the official count of the public sector by the department of census and statistics at around 1 million, it can be deduced that the numbers in the military are around 300,000.[8]

There are indications that military personnel have been increasingly used in non-military activities, including in small scale business enterprises, and assistance to other areas of the public sector. However, this has meant that soldiers are often engaged in activities that are not related to their skill sets, and are also not being formally re-skilled in preparation for productive engagement in the economy. The 2013 budget does not indicate any move to change this status quo.

These employments and benefit payments can therefore be considered as an **indirect welfare scheme**. The main deterrent to re-skilling and de-mobilisation of the forces is that the Sri Lankan economy despite recording high levels of growth has not been creating jobs. This **phenomenon of jobless growth** is analysed in the forthcoming study of Verité Research, on the performance of the economy in 2012. **The problem in a nutshell is as follows:** Excluding the Northern and Eastern Provinces the labour force and employment statistics data for Sri Lanka recorded the existence of 7,105,322 jobs (number employed) in the country, in 2006. Since then, despite the real GDP growing in excess of 40%, job growth was less than 1%. (The number of jobs recorded in the second quarter of 2012 was 7,120,518).

Increased Discretion: However, while this **welfare-through-unproductive employment dimension** explains a significant portion of the budget, it does not account for the ***increases*** in the budget. While the 2013 budget is an increase of 18.9% over 2012, the wages and benefits component increases by only 7%.

The large, non-wage, expenditures increases cannot be traced back to a set of proposals presented to parliament. There is little evidence then of parliament actively exercising its constitutional role of financial oversight with regard to the expenditure priorities of the defence budget. The lack of such oversight provides increased **discretion** on the priorities and quantities of expenditure to the Minister, who in this case is also the President.

[88] Government data sources do not officially report the number serving in the various military-security forces. It was thus extrapolated as explained from the reported information.

5.2 Urban Development

Within the budget, priority towards urban development has also increased with an annual increase of 86.3% in that section of the budget. Nevertheless, as a whole, urban development accounts for only a small part of the budget of this Ministry. **Of the 289 billion budgeted, the amount allocated for urban development is just 13.8 billion, which is 4.7%** (see Figure 7).

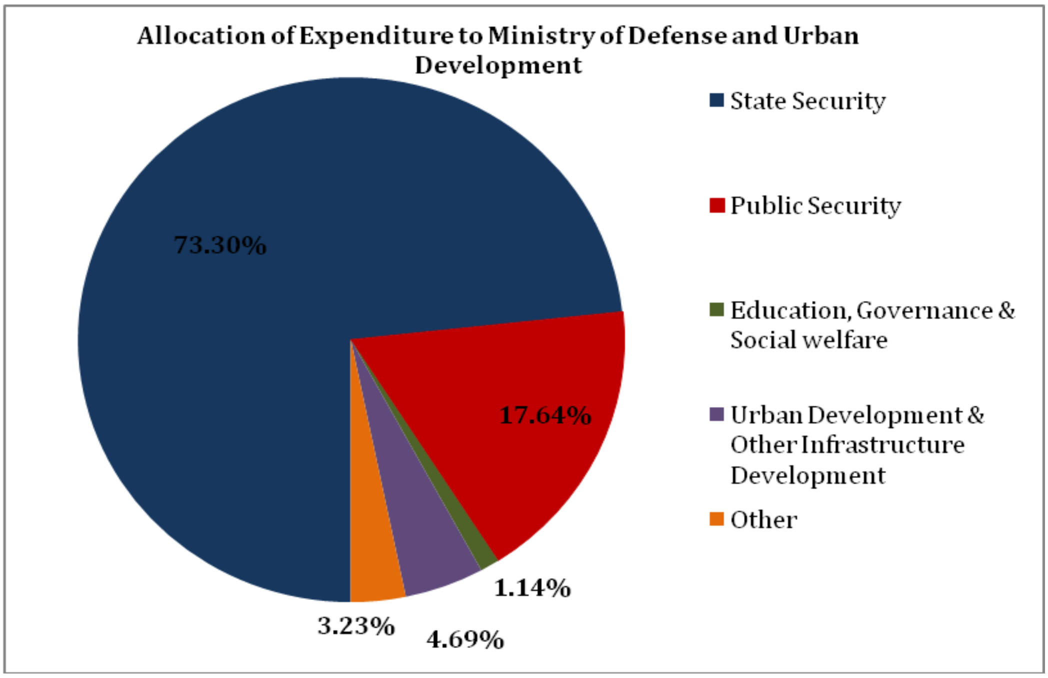

Figure 7 : Allocation of Expenditure to Defense and Urban Development - 2013
Source: Budget Estimates 2013

Figure 8 shows the distribution of expenditures within the allocation to Urban Development. In excess of half the budget is focused around building projects in Colombo and Hambanthota.

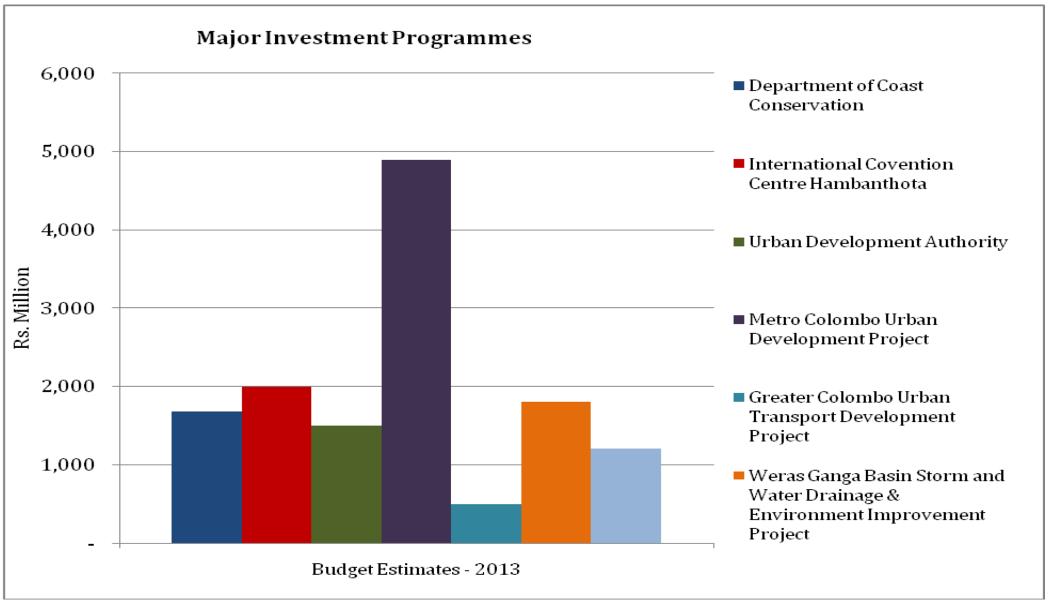

Figure 8 : Distribution of Expenditure within Urban Development
Source: Budget Estimates 2012 and 2013

6. Budget under the Executive

Overview: The question about the proportion of the budget controlled by the Executive has arisen for several years in the past. This did not receive much attention in Budget 2013, but the facts remain important. The Executive controls at least two thirds of the budget. Close upon half of what the Executive controls, however, relates to debt amortisation payments (d.a.p) under the Ministry of Finance.

President Mahinda Rajapakse holds the portfolios for the following ministries:

i) Ministry of Defence and Urban Development
ii) Ministry of Finance and Planning
iii) Ministry of Ports and Highways

The cumulative sum of allocations made to these three ministries was Rs 1,664 billion in Budget 2013, representing an annual increase of 22% from Budget 2012; when stated as a proportion of the total budget.

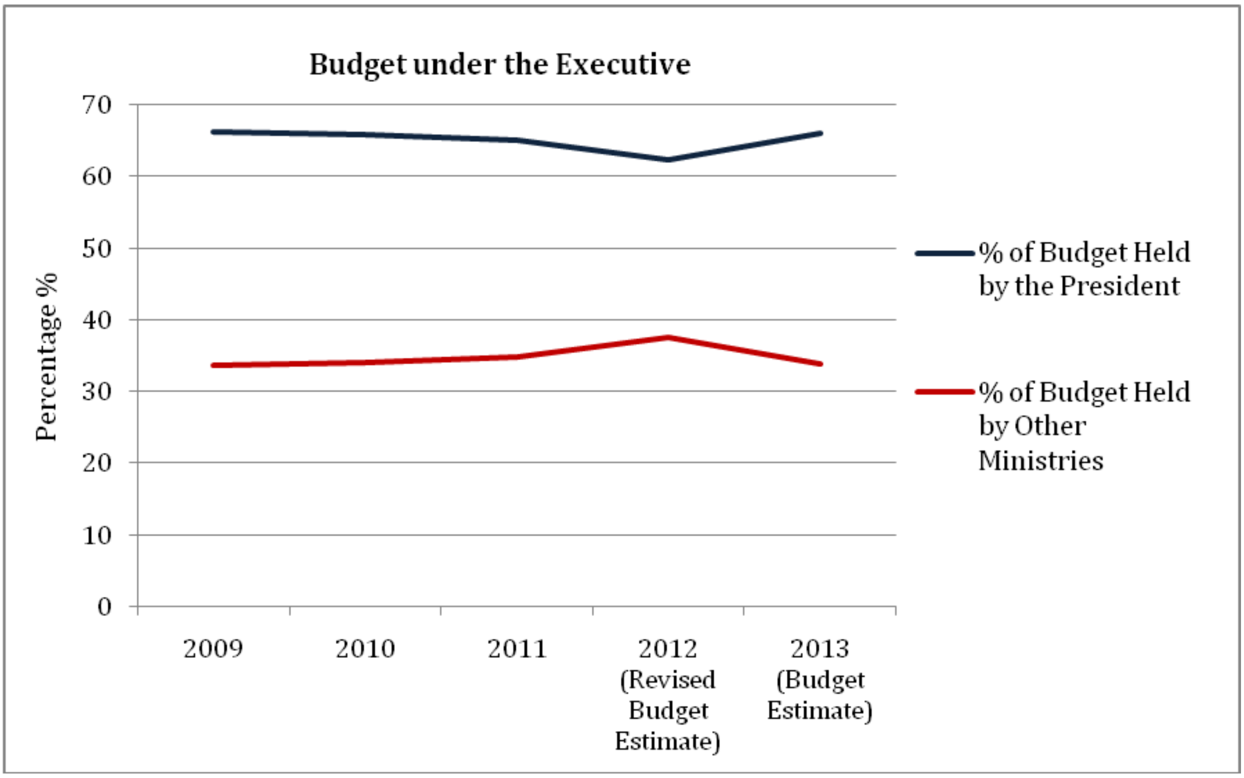

Figure 9 : Trends on Proportion of Annual Budget Controlled by the Executive
Source: Budget Estimates 2009 - 2013

There has been a steady trend to increase this portion of the budget (see Figure 9). When stated as a percentage of the total budget, the allocations made to the above three ministries accounted for 2/3 of the entire budget. It is important to remember however, of the allocations under the President, the bulk which is with the Ministry of Finance has an enhanced share – as it also carries the debt amortisation payments, which in 2013 accounted for 44.6% of budget under the Executive. Therefore, setting aside the d.a.p payments the proportion of the rest budget under the executive would be about 52%.

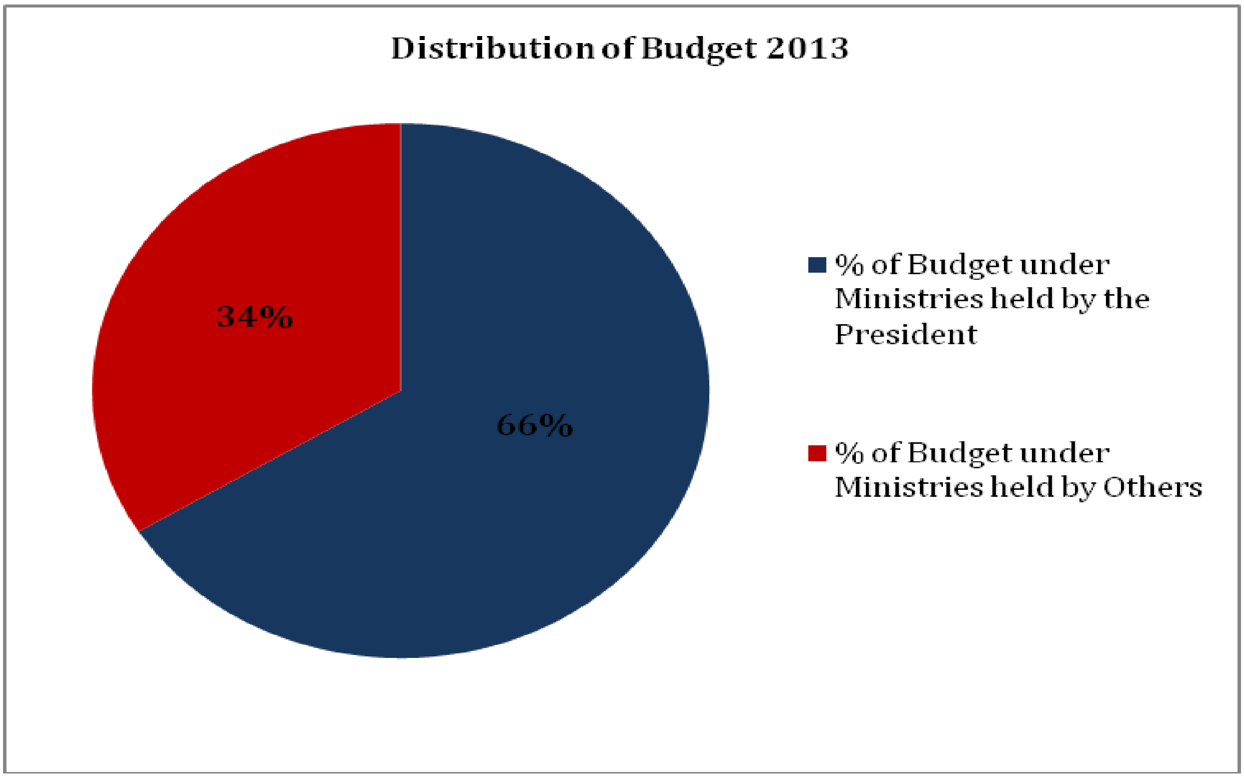

Figure 10 : Distribution of Budget 2013
Source: Budget Estimate 2013

7. Legality of the Budget in Doubt

For the first time in Sri Lanka, the legality of the budget was challenged in the Supreme Court, when the appropriation bill was tabled in parliament in October.

The Supreme Court bench, which did not include the Chief Justice, found that Clause 2(1) (b) and 7 (b) of the Appropriation Bill were not consistent with the constitution.[9] It was ruled to be not consistent with Article 148 of the constitution, which gives parliament full control over the finances.

The two articles referred to two different matters. One, the discretion that existed with the Minister of Finance to allocate funding from the consolidated fund to areas other than those approved by the budget, without seeking ratification from parliament. Two, the discretion that existed with the Minister of Finance to negotiate terms with regard to foreign loans without any recourse to parliamentary approval.

The Supreme Court noted that if these two discretionary clauses were modified to provide parliament its due place in approval and oversight, then the bill would be constitutional.

This matter of legality is yet to be resolved. Instead of making the said amendments, the government seems to have taken the unilateral view that its two-thirds majority in parliament allows it to pass bills

[9] http://www.ft.lk/2012/11/07/sc-rules-appropriation-bill-unconstitutional/

that are not consistent with the constitution. However, in some instances, overcoming violations of constitutional provisions requires confirmation through a referendum. The Supreme Court has not been consulted on and not stated the requirement with regard to overcoming these particular violations to the constitution. There has been no public discussion on the issue either.

The opposition has called the passing of the bill illegal.[10] It will require another intervention in the Courts to determine the legality of the budget. But this may be some time coming, as the government, in the midst of the budget debate, began and rushed through with proceedings to impeach the Chief Justice. At present that imbroglio has overshadowed the Courts and Parliament to such an extent that the concerns about the legality of the budget have been firmly relegated to the back seat.

[10] http://www.infolanka.com/news/IL/dm826.htm

Annexure

Table 3 : Provincial Council Allocations to Social Services

Rs. Million	2005	2011	2012 (a)	2013
Recurrent Expenditure	161	302	336	370
Capital Expenditure	106	240	281	222
Total Expenditure	**267**	**542**	**617**	**592**

Source: Budget Estimates 2005 – 2013
Note: (a) Revised Budget Estimate

Table 4 : Breakdown of Government Expenditure - Year on Year (YoY) Percentage Change

(YoY % Change)	2011 (a)/2012 (b)	2011(a)/2012(c)	2012(c)/2013(b)
Recurrent	8.71	5.97	16.41
Salaries and Wages	3.50	5.01	10.33
Interest	4.82	4.82	20.22
Subsidies and Transfers	4.60	8.25	11.13
Other Goods and Services	43.72	5.59	32.69
Capital	35.74	35.21	-5.45
Total Expenditure (Excluding debt amortisation payment)	**16.30**	**14.19**	**9.14**

Source: VR Calculations using Budget Estimates 2011 – 2013
Note: (a) Actual (b) Budget Estimate (c) Revised Budget Estimate

Table 5 : Debt Financing

As a % of GDP	2011(a)	2011(c)	2012(c)	2012(b)
Total financing	**6.9**	**4.4**	**5.6**	**6.2**
Foreign financing	3.3	1.5	3.2	2.6
Loans	3.0	1.4	1.8	2.3
Treasury bills/bonds	0.4	0.2	1.4	0.3
Domestic financing	3.5	2.8	2.4	3.6
Market borrowings	3.6	2.8	2.4	3.6
Non-bank	0.7	1.3	1.1	2.8
Bank	2.9	1.5	1.3	0.9
Monetary authority	2.8	0.3	0.4	-
Commercial banks	0.1	1.2	0.9	-
Other borrowings	-0.1	-	-	-

Source: Central Bank
Note: (a) Provisional (b) Approved Estimates (c) January - July

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