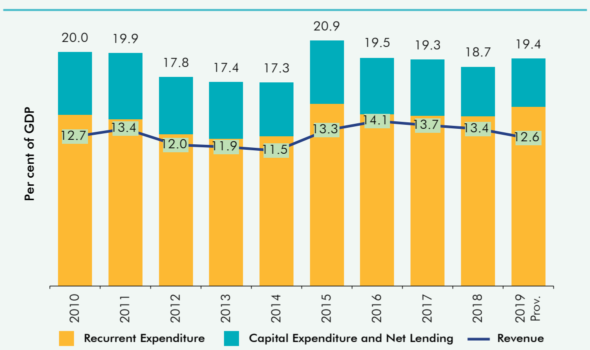
BOX 10
The Importance of Effective Management of Government Expenditure amidst Subdued Revenue Mobilisation

Overview

Sri Lanka's fiscal operations reflect a large structural budget deficit almost throughout the post-independence period amidst subdued revenue collection and growing government expenditure. In fact, government revenue is insufficient to cover even the expenses of a recurrent nature, resulting in a persistent deficit in the government current account (Figure B 10.1). In spite of this, government recurrent expenditure continues to increase, often at a faster pace than the growth of government revenue, worsening the fiscal position further. As recurrent expenditure rises continuously, capital expenditure tends to fall short of the estimates, adversely impacting long term growth prospects of the economy. Nevertheless, the rigidity in primary expenditure of the government (i.e., total expenditure net of interest payments) leaves a constant deficit in the primary balance, except in a few years in the post-independence budgetary operations of Sri Lanka. As the deficits in fiscal operations persisted and were continuously financed through borrowed funds, government debt accumulated over the years, raising concerns about debt sustainability in the period ahead. Unless managed prudently, the management of recurrent expenditure could be challenging in the years ahead, as the government debt stock remains large, and expenditure on interest payments would continue to rise. Other large expenditure categories in recurrent expenditure, such as salaries and wages, and pension payments would make significant pressures on fiscal operations, especially when more cadre is added to the public sector. Moreover, the non-funded pension scheme of the public sector along with an excessive social safety net programmes could exert pressure on fiscal operations, particularly in the backdrop of an increasingly ageing population in the country. Meanwhile, transfer payments to State Owned Business Enterprises (SOBEs) could escalate unless prudent measures are taken to address issues such as management inefficiencies and lack of cost-reflective tariff structures for their products and services. Further, the increased incidence of natural disasters could weigh heavily on expenditure management efforts of the government. While some efforts have been already taken to address these issues, continued focus on the progress of such efforts is essential for fiscal sustainability.

Figure B 10.1
Government Revenue and Expenditure

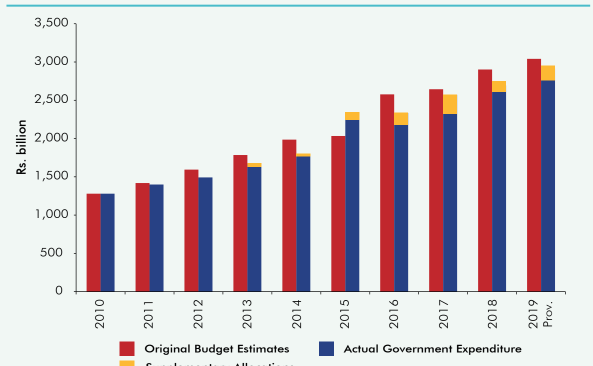


Source: Ministry of Finance, Economic and Policy Development

Government Expenditure: Budgeted vs Actual

Although the actual government expenditure remained below the budget estimates, the effectiveness of the management of government expenditure is called into question by the frequent submission of supplementary allocations[1] in the recent years (Figure B 10.2).[2] The government has raised supplementary allocations continuously for the past seven years and the major portion of them was on account of debt service payments.[3] The submission of supplementary allocations to cover such mandatory expenses of the government does not augur well for prudent management of public expenditure. Such practice often demands a curtailment of expenditure from other areas, mostly capital expenditure, thereby affecting the country's growth prospects. Therefore, it is often argued that issues relating to fiscal operations of Sri Lanka are not only related to revenue shortfall; rather, they also represent the impact of sub optimal management of expenditure.

Figure B 10.2
Government Expenditure - Budgted vs Actual



Source: Ministry of Finance, Economic and Policy Development

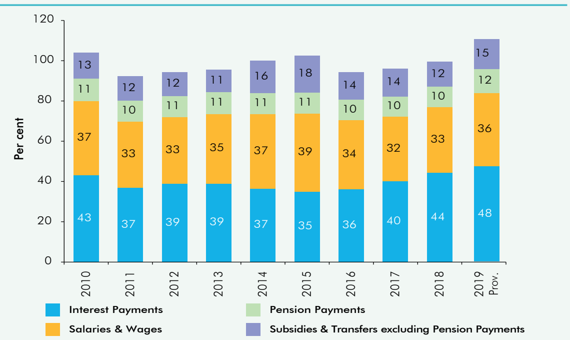
Management of Recurrent Expenditure

The rising share of mandatory fiscal expenses such as interest payments, salaries and wages, and pension payments continues to add pressure on fiscal operations, as these three sub components collectively utilised 96 percent of government revenue in 2019

1 Funds that are raised in addition to the budgeted expenditure for a particular year to fulfill the additional fund requirements of the government.
2 Assuming that the funds raised through supplementary allocations were fully utilised during the year.
3 As per the Performance Reports of the National Budget Department.

(Figure B 10.3). Meanwhile, expenditure on salaries and wages alone utilised about 36 per cent of government revenue in 2019. Moreover, expenditure on subsidies and transfers including pension payments, which has shown a rising trend in recent years, accounted for 26.7 per cent of government revenue in 2019. Such large expenditure on personal emoluments, and subsidies and transfers leave little room for the provision of other recurrent expenditure on social and economic services such as health, education, agriculture and irrigation, let alone resources required for capital expenditure.

Figure B 10.3
Recurrent Expenditure as a percentage of Government Revenue

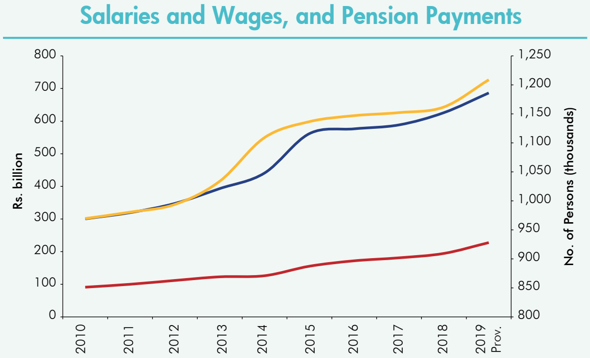


Source: Ministry of Finance, Economic and Policy Development

Expenditure on Personal Emoluments

Expenditure on salaries and wages and pension payments has increased significantly over the years. The increase in public sector recruitments and upward revisions in salary and pension payments contributed to the increase in salaries and wages and pension payments by 11.4 per cent in 2019 over the previous year (Figure B 10.4). During the period 2010-2019, salaries and wages and pension payments, on average, accounted for around 45 per cent of government revenue. As Sri Lanka's population is ageing faster and the size of the government employment tends to be larger in spite of the unfunded pension scheme, fiscal burden on account of expenditure on salaries and wages and pension payments could rise significantly in the period ahead.

Figure B 10.4
Government Employees (a) and Expenditure on Salaries and Wages, and Pension Payments



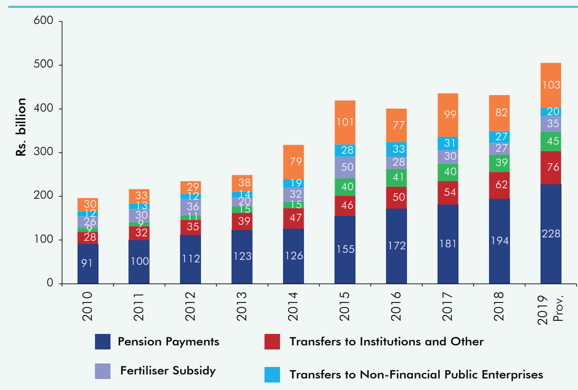
(a) Include employees of the Central Government, Local Government and Provincial Councils

Sources: Ministry of Finance, Economic and Policy Development
Central Bank of Sri Lanka

Expenditure on Subsidies and Transfers

The government spends about 3-4 per cent of GDP (equivalent to about 15 per cent of government revenue) on subsidy and transfer programmes. Although such subsidies are provided with the aim of uplifting the living standards of economically vulnerable groups, it is often observed that some of the subsidy and transfer programmes are ineffective in reducing poverty and inequality due to inefficiencies stemming from ill-targeting and a high level of leakages. For instance, although the Samurdhi programme is implemented with the objective of uplifting the living standards of vulnerable people in the society, it is often observed that the beneficiaries continue to remain in the programme for years, while ineligible persons could also enter the programme under the current selection process. With regard to the fertiliser subsidy programme, issues such as the overuse of subsidised fertliser hinder the effectiveness and sustainability of the programme while raising concerns over soil and water pollution and food safety of the country. Further, with an ageing population, the country's expenditure needs tend to increase in areas such as health, education and provision of social safety nets. Further, Sri Lanka experiences frequent natural hazards commonly caused by floods, landslides and droughts with increasing losses of life and property while causing additional pressure on the government budget. The recent spread of the COVID-19 pandemic has also highlighted the need for fiscal space to address such catastrophes as well as an improved system to disburse subsidies to affected businesses and individuals when required. Therefore, unplanned expenditure emanating from increased incidence of natural disasters on account

Figure B 10.5
Expenditure on Subsidies and Transfers



Source: Ministry of Finance, Economic and Policy Development of costs incurred on compensation and mitigation measures could exacerbate pressure on managing public expenditure. Moreover, transfers to SOBEs could rise further in the period ahead unless appropriate measures are initiated to revive their weak financial performance on a sustainable basis and improve their financial strength.

Expenditure on Public Investment

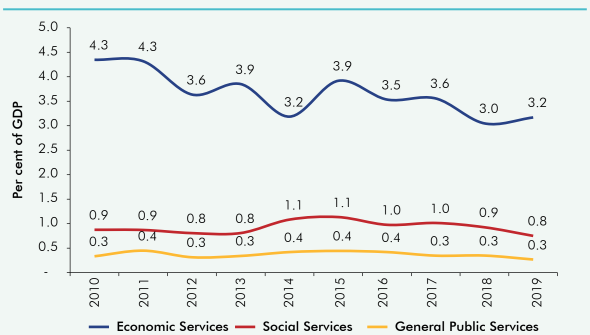
The rising share of recurrent expenditure limits the space available for public investment (Figure B 10.6). However, curtailing public investment is counter-productive and will dampen economic growth over the medium to long term. A moderation in public investment, mainly

Figure B 10.6
Relative Share of Recurrent Expenditure and Public Investment

Source: Ministry of Finance, Economic and Policy Development

in the areas of economic and social infrastructure, was observed in the last decade or so (Figure B 10.7). Expenditure on economic infrastructure, the largest item in public investment, which includes agriculture and irrigation, energy and water supply, and transport and communication reflects significant variations over the years with a general downward trend, while expenditure on social infrastructure that includes education, health, housing, and community services remains low. Maintaining such low levels of public investment in order to offset overruns in recurrent expenditure would hinder long term development prospects of the country.

Figure B 10.7
Composition of Public Investment



Source: Ministry of Finance, Economic and Policy Development

Way Forward

Strengthening fiscal consolidation requires effective management of government expenditure while maintaining an appropriate balance between government revenue and economic growth. Expenditure management requires commitment to fiscal discipline and maintain the budget outturn in line with the annual budget estimate. In this regard, several aspects warrant special emphasis of the government including a well planned policy of recruitment to the public sector, thereby containing the rising expenditure on salaries and wages and pension liabilities. The introduction of a nationwide contributory pension scheme and a possible extension of the retirement age could be considered as alternatives. Meanwhile, the National Pay Commission, which was established in early 2020, could provide guidance and assistance to the government in formulating and executing a National Salaries Policy by revisiting the remuneration structures of the public and private sectors. Further, expenditure on subsidies and transfers could be rationalised by ensuring better targeting of safety net programmes while curtailing the unnecessary administrative expenses. In this regard, identifying the economically vulnerable segments of the society through a carefully designed methodology would help exclude unintended beneficiaries. Moreover, strengthening the monitoring process of SOBEs will enable the government to develop loss making SOBEs as profitable entities while enhancing the profitability of existing profit making entities, thereby reducing the burden on the central government budget. Further, ensuring effective adherence to the Statements of Corporate Intent (SCIs) signed by 13 SOBEs would enhance the effectiveness of SOBEs. Meanwhile, essential investment in physical infrastructure and human capital would need to continue in order to realise the envisaged growth in the medium to long term. In this regard, curtailing or postponing of planned public investment in priority areas need to be avoided while identifying alternative funding arrangements, such as Public Private Partnerships (PPPs) on a sustained basis.

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