6 FISCAL POLICY AND GOVERNMENT FINANCE

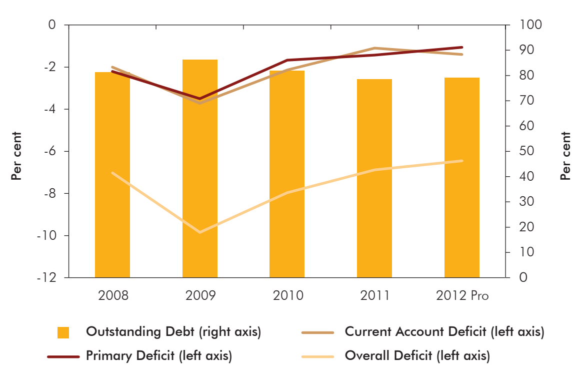
6.1 Overview

The fiscal policy strategy of the government was focused towards strengthening the fiscal consolidation process expecting further improvements in the medium term. In line with that strategy, fiscal policy in the recent past was directed towards reducing the budget deficit while encouraging economic activities to achieve a sustainable high growth momentum in the country and to reduce regional disparity. Accordingly, a multipronged fiscal reforms package has been implemented. On the revenue front, tax reforms were introduced to broad base the tax system and simplify the tax structure while supporting emerging sectors to enhance economic activities. On the expenditure front, government has been committed for rationalisation of recurrent expenditure while maintaining public investment at a desirable level to implement necessary infrastructure development projects with the view of encouraging private sector participation in economic activity. Debt management strategy was focused on meeting the government financing requirement at a lowest possible cost while maintaining risks at a prudent level. Accordingly, the budget deficit as a per cent of GDP has continuously declined recording 9.9 per cent in 2009, 8.0 per cent in 2010, 6.9 per cent in 2011 and 6.4 per cent in 2012.

In 2012, the fiscal policy strategy was formulated in line with the Medium Term Macro Fiscal Framework (MTMFF) for 2012-2015 in order to reduce the budget deficit further while maintaining a higher level of investment to facilitate sustained economic growth. The budget deficit for 2012 was expected to be reduced to 6.2 per cent of GDP from 6.9 per cent of GDP recorded in 2011. To achieve that target, the budget 2012 envisaged an increase in government revenue to 14.7 per cent of GDP from 14.3 per cent in 2011 and a reduction in recurrent expenditure to 14.8 per cent of GDP from 15.4 per cent in 2011, while maintaining public investment at around 6.6 per cent of GDP. However, during the year, the maintenance of fiscal targets became challenging due to a significant shortfall of government revenue, partly reflecting the impact of tight policy measures adopted to strengthen external stability and increased interest expenditure resulting from comparatively high interest rates that prevailed in the domestic market.

In this challenging environment, the government maintained the budget deficit at 6.4 per cent of GDP in 2012 which was below the 6.9 per cent deficit recorded in 2011. Despite the shortfall in revenue, a tight rein on recurrent expenditure together with the curtailment of non-priority capital expenditure, enabled the government to steer fiscal operations close to the 2012 budget target. Expenditure restraint, in both current and capital outlays, reduced total expenditure and net lending of the government from 21.4 per cent of GDP in 2011 to 19.7 per cent of GDP in 2012. Public investment as a percentage of GDP was maintained at 5.5 per cent in comparison to 6.2 per cent recorded in 2011 with the government committed to limit capital expenses to those of a priority nature. The reduction in recurrent expenditure from 15.4 per cent of GDP in 2011 to 14.4 per cent of GDP in 2012 was an over-performance in terms of the 2012 budget target of 14.8 per cent, reflecting the firm commitment of the government towards the fiscal consolidation process. Consequently, the primary deficit of the budget, which excludes interest payments, reduced to 1.1 per cent of GDP in 2012 from 1.4 per cent of GDP in 2011. However, despite the reduction in current expenditure, the deficit in the current account of the budget - which shows the dissavings of the government increased to 1.4 per cent of GDP in 2012 from 1.1 per cent of GDP in 2011 due to lower revenue mobilization. Revenue as a percentage of GDP declined to 13 per cent from 14.3 per cent in the previous year, reflecting the slowdown in domestic economic activity and the impact of policy measures adopted

Chart 6.1 Major Fiscal Indicators (as a percentage of GDP)



to strengthen external sector stability. In financing the budget deficit, more reliance was placed on foreign sources through higher utilization of foreign investments in the government securities market, inflows to the sovereign bond issue and foreign project loans, which contributed 59 per cent of the total financing requirement. The debt to GDP ratio in 2012 increased to 79.1 per cent, reversing the declining trend observed in the recent past, as a result of the significant increase of foreign currency denominated debt due to the sharp depreciation of the Sri Lanka rupee against major currencies.

6.2 Fiscal Policy Direction and Measures

Fiscal policy strategy announced in the budget for 2012 aimed at strengthening the fiscal consolidation process through streamlining the tax policy reforms introduced in recent years to broaden the tax base, simplifying the tax structure to increase government revenue while rationalising recurrent expenditure, and maintaining public investments to stimulate the economy. Accordingly, it was expected that the budget deficit will be reduced to 6.2 per cent of GDP in 2012 from 6.9 per cent of GDP in 2011. In line with that target, the other key fiscal indicators were also expected to improve. Current account deficit was expected to decline to zero per cent of GDP, while primary deficit that reflects current fiscal activities was expected to improve to 1.3 per cent of GDP in 2012 from 1.4 per cent recorded in 2011. Public investment was expected to increase to 6.6 per cent of GDP in 2012 compared to 6.2 per cent in 2011.

Measures introduced in income tax in 2012 were mainly focused on creating an investor friendly environment in the country to encourage investments. Several income tax incentives such as tax holidays were provided under the Inland Revenue Act during the year to

Table 6.1 Summary of Government Fiscal Operations

Item	2011	2012 Approved Estimates	2012 Provisional	2013 Approved Estimates
	Rs. million			
Total Revenue and Grants	949,917	1,126,081	1,003,915	1,277,544
Total Revenue	934,776	1,106,081	987,844	1,257,544
Tax Revenue	812,611	1,000,559	845,297	1,131,041
Non Tax Revenue	122,166	105,522	142,547	126,503
Grants	15,141	20,000	16,071	20,000
Expenditure and Lending Minus Repayments	1,400,097	1,594,946	1,492,882	1,784,944
Current	1,006,633	1,107,902	1,094,249	1,267,390
Capital and Net Lending	393,465	487,044	398,633	517,554
o/w Public Investment	407,488	497,465	417,131	529,250
Current Account Surplus (+)/Deficit (-)	-71,856	-1,821	-106,405	-9,846
Primary Account Surplus (+)/Deficit (-)	-93,481	-98,865	-80,469	-62,600
Overall Fiscal Surplus (+)/Deficit (-)	-450,180	-468,865	-488,967	-507,400
Total Financing	450,180	468,865	488,967	507,400
Foreign Financing (a)	218,956	197,264	286,455	148,000
Domestic Financing	231,224	271,602	202,511	359,400
Market Borrowings	236,022	271,602	202,511	359,400
Non Bank	44,171	207,602	70,984	289,400
Bank	191,850	64,000	131,527	70,000
Monetary Authority	185,848	n.a.	16,101	n.a.
Commercial Banks	6,002	n.a.	115,427	n.a.
Non Market Borrowings	-4,798	-	-	-
	As a percentage of GDP			
Total Revenue and Grants	14.5	15.0	13.2	14.7
Total Revenue	14.3	14.7	13.0	14.5
Tax Revenue	12.4	13.3	11.1	13.0
Non Tax Revenue	1.9	1.4	1.9	1.5
Grants	0.2	0.3	0.2	0.2
Expenditure and Lending Minus Repayments	21.4	21.2	19.7	20.5
Current	15.4	14.8	14.4	14.6
Capital and Net Lending	6.0	6.5	5.3	6.0
o/w Public Investment	6.2	6.6	5.5	6.1
Current Account Surplus (+)/Deficit (-)	-1.1	0.0	-1.4	-0.1
Primary Account Surplus (+)/Deficit (-)	-1.4	-1.3	-1.1	-0.7
Overall Fiscal Surplus (+)/Deficit (-)	-6.9	-6.2	-6.4	-5.8
Total Financing	6.9	6.2	6.4	5.8
Foreign Financing (a)	3.4	2.6	3.8	1.7
Domestic Financing	3.5	3.6	2.7	4.1
Market Borrowings	3.6	3.6	2.7	4.1
Non Bank	0.7	2.8	0.9	3.3
Bank	2.9	0.9	1.7	0.8
Monetary Authority	2.8	n.a.	0.2	n.a.
Commercial Banks	0.1	n.a.	1.5	n.a.
Non Market Borrowings	-0.1	-	-	-

(a) Includes rupee denominated Treasury bonds and Treasury bills issued to foreign investors, the Sri Lankan diaspora and migrant workers.

Source: Ministry of Finance and Planning

encourage investments. The existing tax holiday period was extended to new enterprises engaged in activities such as agriculture, information technology, tourism, healthcare and education. In addition, new small scale enterprises engaged in specified activities were provided with a four year tax holiday, while a four to six year tax holiday was provided for medium scale enterprises. Large scale enterprises were provided with a six to twelve year tax holiday. Also, income tax incentives were given to promote strategic import substitution industries such as cement, pharmaceuticals, fabric and milk powder. Meanwhile, concessionary income tax rates were granted on profits and income of a newly established bank branch of a commercial bank dedicated to development banking, research and development activities, healthcare services, export of value added tea and handloom industry. Additionally, a tax deferment facility was given for the importation of plant, machinery and equipment to established import replacement enterprises. Further, the Economic Service Charge (ESC) was revised to provide more concessions to strategically important enterprises. Accordingly, the ESC threshold was increased and the businesses whose profits were subject to income tax were exempted from ESC.

Several Value Added Tax (VAT) concessions were granted to targeted areas in the budget for 2012, in order to facilitate domestic economic activities and to support the domestic industries. Accordingly, the importation of machinery and spare parts used in the pharmaceutical industry and bio mass industry were exempted from the VAT. Further, the supply of locally manufactured machinery and equipment used in hydro power generation, supply of locally manufactured products such as canned fish, turbines, pottery products, specific products supplied to state institutions and products manufactured using locally procured raw materials were exempted from VAT. The importation of lorries, trucks and buses were exempted from VAT in order to facilitate the growing demand in the domestic transportation sector. The budget for 2012 proposed to exempt VAT for the supply of research and development services. Further, the Nation Building Tax (NBT) was revised to provide more concessions to strategically important enterprises. In addition, importation of aircraft, ships, yarn and fabric and sales to exporters, were exempted from NBT.

Several changes were made in selected import related taxes during the year. Accordingly, customs duty and other import related taxes applicable on the importation of plant, machinery and equipment by identified strategic import replacement enterprises, were allowed to be deferred during the project implementation period, with the objective of encouraging investment in the country. Customs duty was exempted for imported items for differently abled persons, sports footwear, energy saving lamps and computers. The full customs duty waiver granted on the importation of petroleum products was reduced in early 2012 considering the decline in international petroleum prices. Further, the customs duty applicable on motor vehicle spare parts was also revised upwards. The SCL on some commodities such as potatoes, B' onion and dried fish was revised from time to time, based on the international price movements and performance in domestic supply giving consideration to the movement of domestic price level. SCL was imposed on several new commodities such as edible oil and chilled or fresh fish to protect domestic industries during 2012 and to raise more government revenue. Cess on several imported commodities such as dried vegetables, garlic, onions, mandarin and wheat floor was increased to improve the government revenue.

The excise duty applicable on the importation of motor vehicles was increased in line with the policy package introduced during the first quarter of 2012 to curb the widening trade deficit. Accordingly, excise duty on motor cars, vans, three-wheelers and motor bikes were increased within the range of 6 to 51 per cent. Further, the excise duties on hard liquor and malt liquor were increased in two instances during the year, while excise taxes on cigarettes were also revised upward with a view of enhancing tax revenue of the government.

The government took several measures to enhance non tax revenue during 2012. The Telecommunication Operator Levy on outgoing international calls and incoming international calls was increased with effect from January 2012. Further, revenue licensing annual fee for motor vehicles was revised upward. The online visa fee was reduced to US dollars 10 for citizens of SAARC nations and US dollars 20 for citizens of other countries from the initial US dollars 50 flat rate for all the countries to encourage tourist arrivals to Sri Lanka.

The government placed a greater emphasis on improving tax administration with the view of facilitating the expected outcome of the tax policy reforms. The activities of the Tax Appeals Commission, and the Tax Interpretation Committee continued during the year to a provide more efficient and effective service to tax payers in a fair and unbiased manner and to assist tax payers to clear their doubts with regard to interpretation of tax laws. Further, audits and investigations were undertaken and the frequency of audits was increased in revenue collecting authorities, with a view to achieving the widest possible coverage of the taxpayer population. Programmes were conducted to enhance taxpayer compliance, timely filing of tax returns and paying taxes on a self-assessment basis. The online submission of documents and online payments systems introduced by Sri Lanka Customs would lead to an increase in revenue of the collecting agencies and widen the tax base. Knowledge enhancement and capacity building programmes were conducted to improve the capacity and efficiency of the officers in the Inland Revenue Department and Sri Lanka Customs. The Taxpayer Service Unit conducted seminars and awareness programmes to enhance the knowledge of the public.

On the expenditure front, several measures were taken during 2012 to encourage effective management of public expenditure. Accordingly, all ministries, departments and other government institutions were requested to make a compulsory saving of two per cent of recurrent expenditure and nine per cent of capital expenditure from the budget estimates of 2012 which were presented along with the Appropriation Bill for 2012. Savings in capital expenditure were expected to be achieved by identifying capital programmes which were not required to be implemented on a priority basis and also by the management of capital expenditure prudently and efficiently. In addition, several limitations were imposed on the utilisation of fuel and electricity as an energy conserving measure for controlling and minimizing related expenditure. Accordingly, expenditure on fuel and electricity of all ministries, departments and other government institutions were requested to be managed within the provisions of the budget estimates for 2012, as no additional allocations or fund transfers under financial regulations for those items were approved by the Treasury.

Salaries and wages of the government employees and pension allowances were raised in 2012. Accordingly, the special allowance introduced to all public sector employees in 2011 was increased to 15 per cent of their basic salary. That increase was effective from January 2012 for non-staff grade officers, while for staff grade officers 50 per cent of the increase was paid from January 2012 and the balance from July 2012. In addition, various allowances paid to grama niladaris, members of the judiciary, doctors, engineers and the university staff were revised upwards from January 2012. Meanwhile, the pension payment for persons who retired prior to 31 December 2003 was increased by Rs. 1,000 per month, while it was increased by Rs. 500 per month for pensioners who retired during the period 01 January 2004 to 31 December 2005 with a view to correcting pension anomalies.

The government continued to enhance the support extended to vulnerable groups in the society through various subsidy schemes. The Samurdhi allowance paid to low income families was increased with effect from April 2012. In addition, measures were taken to mitigate the adverse impact of the increase in kerosene and diesel prices in February 2012. Accordingly, a subsidy of Rs. 25 per litre and Rs. 12 per litre were granted to kerosene and diesel fishing boats, respectively, while a kerosene subsidy of Rs. 200 per month was granted to all households without electricity.

The public investment programme was aimed at accelerating the implementation of several strategic infrastructure projects needed to sustain a high growth momentum, while investing in regional infrastructure to ensure more regionally balanced growth. A significant investment was made to develop the road network at national, provincial and rural levels. In addition, investments to increase the capacity of the power sector as well as investments in the areas of port development, rail transportation, water supply and sanitation, and irrigation and water management were expedited during the period under consideration. Meanwhile, investment programmes targeting the rural sector were implemented through rural development initiatives such as "Gama Neguma", "Maga Neguma", "Divi Neguma", and regional development initiatives such as "Uthuru Wasanthaya", "Neganahira Navodhaya" and other provincial development initiatives.

The public debt management strategy was focused to ensure that the government's financial needs and payment obligations were met at the lowest possible cost over the medium term, consistent with a prudent level of risk, by maintaining an optimal mix of domestic and foreign debt, and reducing maturity mismatches in the debt portfolio.

The government successfully completed the issue of the fifth International Sovereign Bond of US dollar 1.0 billion with a 10 year maturity at a yield rate of 5.875 per cent per annum. Sri Lanka succeeded in achieving a continuous reduction in yield for its sovereign bond issuances, despite the volatility seen in global capital markets. In addition, measures were taken to replace part of the maturing Treasury bills with medium to long-term Treasury bonds to address the issue of bunching of maturities while reducing debt rollover risk. Further, continuing the strategy to increase the marketable debt share, non-marketable Rupee loans matured in 2012 were replaced with marketable Treasury bonds.

International rating agencies have affirmed the country rating. Accordingly, Fitch Ratings affirmed Sri Lanka's foreign currency rating of BB- with outlook 'Stable', Moody's Investor Service affirmed Sri Lanka's rating of B1 with outlook 'Positive' and Standard & Poor's affirmed the rating of B+, while changing the outlook from 'Positive' to 'Stable'.

6.3 Government Budgetary Operations

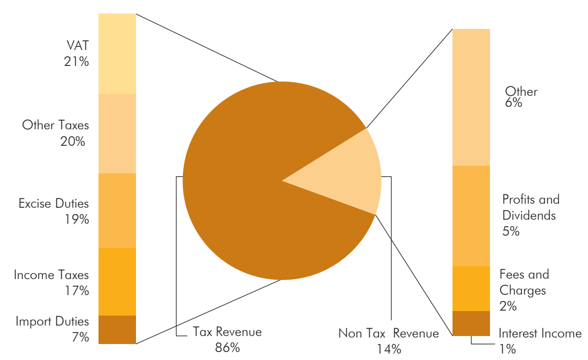
Revenue and Grants

Revenue

Total government revenue as a percentage of GDP declined significantly to 13.0 per cent in 2012 compared to 14.3 per cent recorded in the previous year and 14.7 per cent projected in the budget entirely due to decline in tax revenue as a percentage of GDP. According to the Ministry of Finance and Planning estimates, during the year 2012, the Government had forgone nearly Rs.20.8 billion due to the VAT exemptions given to specified projects[1], and another Rs.38.6 billion due to the exemptions of relevant taxes on vehicles procured

1 The VAT on specified projects under sections c(xxiii) and f(ii) of the exemption schedule of the Value Added Tax Act No. 14 of 2002 and respective amendments thereto

Chart 6.2 Composition of Government Revenue - 2012



by public servants[2] on concessionary duty terms. Forgone revenue due to them in 2011 is estimated to be Rs 8.5 billion and Rs. 18.3 billion respectively. Further, the decline in imports especially consumer goods, subdued domestic economic activities also contributed to lower revenue performance. However, in nominal terms government revenue increased by 5.7 per cent to Rs. 987.8 billion during the year from Rs. 934.8 billion in the previous year. In order to address the issues relating to government revenue, committed efforts would be required to increase government revenue in the near future through the existing tax structure by strengthening the collecting process in revenue agencies and improving tax administration while improving the financial viability of state owned enterprises to reduce their reliance on the government budget and to increase non tax revenue in the form of profits and dividend transfers. Such an endeavor would help generate revenue surpluses which could be used for capital expenditure, thereby reducing debt financing.

Tax revenue as a percentage of GDP continued to decline to 11.1 per cent in 2012 from 12.4 per cent in 2011, although in nominal terms it increased by 4.0 per cent to Rs. 845.3 billion. Total tax revenue was 84.5 per cent of the budgetary target for 2012 and the shortfall was mainly due to the reduction in revenue from VAT

2 Under the Trade and Investment Policy Circular No. 01/2010 dated 10.12.2010.

on imports, import duties, ESC and excise tax on motor vehicles. It was evident that the indirect taxes remained the major source of tax revenue in 2012 accounting for 79.6 per cent of the total tax revenue, compared to 80.6 per cent in 2011. The share of income tax revenue in total revenue increased to 20.4 per cent in 2012 from 19.4 per cent in 2011.

Revenue from income taxes as a percentage of GDP declined marginally by 0.1 per cent to 2.3 per cent in 2012, although in nominal terms, it increased by 9.7 per cent to Rs. 172.6 billion from Rs. 157.3 billion in 2011. The notable increase in the collection of withholding taxes contributed to the improvement in income tax revenue in 2012. Revenue from withholding tax grew significantly by 56.2 per cent to Rs. 59.6 billion in 2012, reflecting an increase in the volume as well as the maturity structure of new Treasury bond issues, higher borrowings through rupee denominated instruments and relatively high interest rates prevailing in the domestic market, compared to the previous year. Corporate and non corporate tax revenue increased only marginally due to lower than expected revenue collected particularly from banking and financial services and

Table 6.2 Economic Classification of Revenue

Item	2011	2012 Approved Estimates	2012 Provisional	2013 Approved Estimates
	Rs. million			
Tax Revenue	812,611	1,000,559	845,297	1,131,041
Income Taxes	157,309	190,270	172,593	221,984
VAT	215,576	264,917	204,806	283,354
Excise Taxes	186,010	223,125	191,947	247,256
Import Duties	75,974	93,830	73,489	97,303
Other Taxes	177,742	228,417	202,462	281,144
Non Tax Revenue	122,166	105,522	142,547	126,503
Total revenue	934,776	1,106,081	987,844	1,257,544
	As a percentage of GDP			
Tax Revenue	12.4	13.3	11.1	13.0
Income Taxes	2.4	2.5	2.3	2.6
VAT	3.3	3.5	2.7	3.3
Excise Taxes	2.8	3.0	2.5	2.8
Import Duties	1.2	1.3	1.0	1.1
Other Taxes	2.7	3.0	2.7	3.2
Non Tax Revenue	1.9	1.4	1.9	1.5
Total revenue	14.3	14.7	13.0	14.5

Source: Ministry of Finance and Planning

the external trade activities. The Pay-As-You-Earn (PAYE) tax collection declined marginally during the year. Revenue from the ESC declined significantly by 30.3 per cent reflecting the simplification of the ESC, exemptions and the increase in the quarterly threshold to Rs. 50 million from Rs. 25 million.

Revenue from VAT as a percentage of GDP declined significantly to 2.7 per cent in 2012 compared to 3.3 per cent in 2011 and 3.5 per cent expected in the budget. The decline in revenue from VAT in 2012 was mainly due to the granting of exemptions, decline in imports as a result of the policy measures introduced in early 2012 and subdued domestic economic activity. In nominal terms also, revenue from VAT in 2012 declined by 5.0 per cent to Rs. 204.8 billion from 215.6 billion in 2011 mainly due to a reduction of import related VAT collection. Consequently, the contribution from VAT revenue to total tax revenue declined to 24.2 per cent in 2012 from 26.5 per cent in 2011 and 30.4 per cent in 2010. VAT on domestic goods and services increased by 2 per cent to Rs. 105.3 billion. VAT on imports declined by 11.4 per cent to Rs. 99.4 billion mainly due to a decline in imports, specially motor vehicles, and the granting of exemptions to imports related to strategic investment projects. Further, the contribution from VAT on domestic goods and services to total tax revenue marginally declined to 12.5 per cent in 2012 from 12.7 per cent in 2011.

Revenue from excise duties as a percentage of GDP declined to 2.5 per cent in 2012 from 2.8 per cent in 2011 due to a decline in excise duty collected from motor vehicle imports. However, in nominal terms revenue from excise duties increased by 3.2 per cent to Rs. 191.9 billion in 2012 from Rs. 186 billion in 2011. Meanwhile, the share of excise duties in total tax revenue declined to 22.7 per cent in 2012 from 22.9 per cent in 2011. Revenue from excise duties on motor vehicles declined by 12 per cent to Rs. 46.5 billion from Rs. 52.8 billion recorded in the previous year. During the year, revenue from excise duties on liquor increased by 8.7 per cent to Rs. 60.1 billion supported by the scaling up of excise duty rates on liquor and the higher production of malt liquor. Revenue from excise duties on cigarettes and tobacco increased by 7.9 per cent to Rs. 53.6 billion in 2012, mainly due to the periodical upward revisions of excise duty rates during the year even though there was a decline in cigarette sales by 4.3 per cent during the year. Excise tax revenue from petroleum imports increased by 26.7 per cent during 2012, due to an increase in the importation of refined petroleum products.

Revenue from NBT as a percentage of GDP remained at 0.5 per cent in 2012, whereas NBT collection in nominal terms increased by 8.6 per cent to Rs. 38.7 billion from Rs. 35.7 billion in 2011. NBT on domestic goods and services increased by 21.2 per cent to Rs. 23.1 billion mainly due to improved performance in the construction and tourism industries. Further, increased registration of wholesale and retail businesses liable for NBT contributed to the growth in NBT collection during that period. However, with the negative growth in imports, NBT collected from imports declined by 5.8 per cent to Rs. 15.7 billion in 2012.

Total revenue from import duties and the SCL as a percentage of GDP remained at 1.4 per cent in 2012, although in nominal terms, it increased by 17.0 per cent to Rs. 107.2 billion. Although revenue from import duties was expected to increase by 23.4 per cent as per the budget estimates for 2012, it declined by 3.3 per cent to Rs. 73.5 billion due to the decline in imports from the second quarter of 2012. The share of import duties in total tax revenue came down significantly to 8.7 per cent in 2012 from 9.3 per cent in 2011. The average customs duty rate, including SCL increased to 4.4 per cent in 2012 from 4.1 per cent in 2011. Further, revenue from import duties from motor vehicle imports declined significantly by 50 per cent to Rs. 14.1 billion in 2012 from Rs. 28.4 billion in 2011 reflecting the lower growth in motor vehicle imports during the year due to the implementation of policy measures to curtail imports and the depreciation of Sri Lanka rupee. Revenue from SCL increased significantly to Rs. 33.7 billion in 2012 from Rs. 15.6 billion recorded in 2011 with the imposition of SCL on several new commodities such as fish, soya bean oil, palm oil, sunflower oil and coconut oil. The share of SCL in total tax revenue increased significantly to 4.0 per cent in 2012 from 1.9 per cent in 2011.

Revenue from other taxes showed a mixed performance during 2012. Revenue from Port and Airport Development Levy (PAL) declined to 0.9 per cent of GDP in 2012 from 1.0 per cent of GDP in 2011. However, in nominal terms, it increased by 5.5 per cent to Rs. 70.1 billion in 2012 from Rs. 66.4 billion in 2011 due to the wider tax base and the granting of fewer exemptions. In nominal terms, revenue from Cess increased by 10.4 per cent to Rs. 32.7 billion in 2012 from Rs. 29.6 billion in 2011. The introduction of Cess on several new items in early 2012 largely contributed to the higher Cess collection in 2012. Revenue from the Telecommunications Levy increased significantly by 19.5 per cent to Rs. 22.3 billion in 2012, from Rs. 18.6 billion in the previous year mainly due to an increase in the telephone density. Revenue from license fees and other taxes in nominal terms declined by 33.9 per cent to Rs. 4.9 billion in 2012 from Rs. 7.4 billion in 2011.

Non tax revenue as a percentage of GDP remained at 1.9 per cent in 2012 as in the previous year and it is significantly above the budgetary target. In nominal terms, non tax revenue increased by 16.7 per cent to Rs. 142.5

billion in 2012 from Rs. 122.2 billion in 2011 mainly due to an increase in Central Bank profit transfers, which increased significantly by 95.5 per cent to Rs. 43 billion in 2012. Profits and dividend transfers from other state owned enterprises increased by 36.1 per cent to Rs. 46.8 billion in 2012 compared to Rs. 34.3 billion recorded in 2011. However, fees and charges which represented more than 18 per cent of non tax revenue, declined significantly to Rs. 26 billion compared to Rs. 37.3 billion recorded in 2011 and Rs. 30.2 billion estimated in the budget. Other non tax revenues such as social security contributions, interest and rent, also declined in 2012 in comparison to the previous year as estimated in the budget. The share of non tax revenue in total revenue increased to 14.4 per cent in 2012 from 13.1 per cent in 2011.

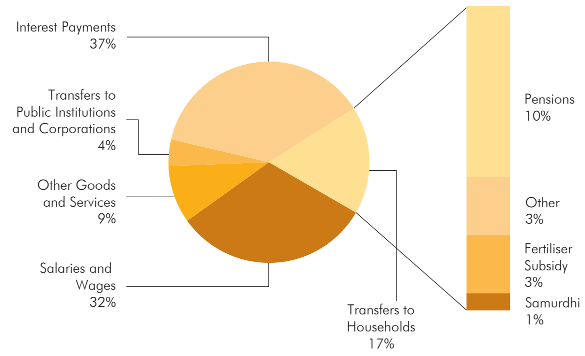
Grants

Foreign grant disbursements increased by 6.1 per cent to Rs. 16.1 billion in 2012 from Rs. 15.1 billion in 2011, although it was below the annual estimate of Rs. 20 billion. Foreign grants from multilateral donors decreased by 42 per cent to Rs. 7.2 billion in 2012 from Rs. 12.1 billion in 2011, lowering the share of grants from multilateral sources to 45 per cent of total grants in 2012 from 80 per cent in 2011. In contrast, grants from bilateral donors increased substantially to Rs. 8.9 billion in 2012 from Rs. 3.0 billion in 2011.

Expenditure and Net Lending

Total expenditure and net lending as a percentage of GDP declined to 19.7 per cent in 2012 from 21.4 per cent in 2011 and 21.2 per cent estimated in the budget, reflecting continuous efforts of the government to curtail recurrent expenditure and lower than expected public investments due to a shortfall in government revenue. The reduction of total expenditure and net lending as a percentage of GDP was the combined outcome of a reduction in recurrent expenditure by 1.0 percentage points and capital expenditure and

Chart 6.3 Composition of Government Current Expenditure - 2012



net lending by 0.7 percentage points. However, in nominal terms total expenditure and net lending increased by 6.6 per cent to Rs. 1,492.9 billion in 2012 from Rs. 1,400.1 billion in 2011.

Recurrent expenditure as a percentage of GDP declined significantly to 14.4 per cent in 2012 from 15.4 per cent in 2011 demonstrating the government's commitment towards rationalising recurrent expenditure. A drop in expenditure as a percentage of GDP on salaries and wages and government purchases of other goods and services mainly contributed towards that decline, as interest payments as a percentage of GDP declined marginally while pension payment as a percentage of GDP remained at the same level as in the previous year. In nominal terms, recurrent expenditure increased by 8.7 per cent to Rs. 1,094.2 billion in 2012 compared to Rs 1,006.6 billion in 2011. However, recurrent expenditure in 2012 was Rs. 13.7 billion lower than the budgetary target of Rs. 1,107.9 billion for the year, despite the increase in interest expenditure by Rs. 38.5 billion in comparison to the budgetary target.

Interest expenditure as a percentage of GDP marginally declined to 5.4 per cent in 2012 from 5.5 per cent in the previous year. However in nominal terms, interest expenditure increased to

Rs. 408.5 billion in 2012 compared to Rs. 356.7 billion in 2011 and Rs. 370.0 billion projected in the budget estimates, owing to the depreciation of the Sri Lanka rupee and relatively high interest rates that prevailed in the domestic market during the first half of 2012. Meanwhile, interest payments continued to be the single largest recurrent expenditure item, accounting for 37.3 per cent of total recurrent expenditure and 41.4 per cent of government revenue in 2012.

Interest payments on domestic debt increased by 10.2 per cent to Rs. 317.7 billion in 2012, while interest payments on foreign debt increased by 32.5 per cent to Rs. 90.8 billion.

Table 6.3 Economic Classification of Expenditure and Lending Minus Repayments

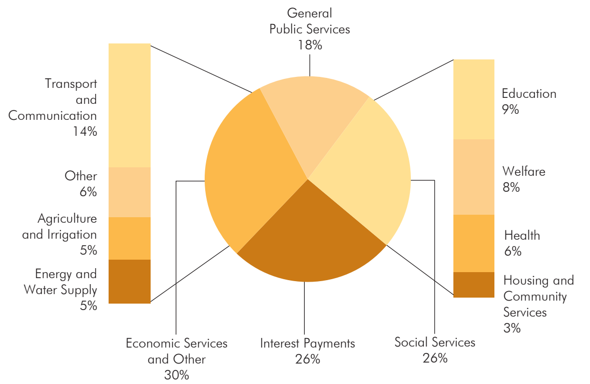
Item	2011	2012 Approved Estimates	2012 Provisional	2013 Approved Estimates
	Rs. million			
Current Expenditure	**1,006,633**	**1,107,902**	**1,094,249**	**1,267,390**
Expenditure on Goods and Services	433,331	501,503	449,206	554,838
o/w Salaries and Wages	319,601	367,980	347,747	414,446
Interest Payments	356,699	370,000	408,498	444,800
Foreign	68,565	48,000	90,839	85,000
Domestic	288,134	322,000	317,659	359,800
Current Transfers and Subsidies	216,602	236,400	236,544	267,752
o/w To Households and Other Sectors	171,438	186,336	189,747	215,966
Samurdhi	9,044	12,900	10,553	14,208
Pensions	99,936	111,353	111,682	129,100
Fertiliser Subsidy	29,802	33,800	36,456	37,800
Other	32,656	28,283	31,056	34,858
Capital Expenditure	**363,001**	**448,732**	**373,240**	**498,179**
Acquisition of Real Assets	202,627	264,289	170,508	296,397
Capital Transfers	160,374	214,678	202,732	210,383
Provision for Under Expenditure	-	-30,235	-	-8,600
Lending Minus Repayments	**30,464**	**38,312**	**25,394**	**19,375**
Total Expenditure and Net Lending	**1,400,097**	**1,594,946**	**1,492,882**	**1,784,944**
	As a percentage of GDP			
Current Expenditure	**15.4**	**14.8**	**14.4**	**14.6**
Expenditure on Goods and Services	6.6	6.7	5.9	6.4
o/w Salaries and Wages	4.9	4.9	4.6	4.8
Interest Payments	5.5	4.9	5.4	5.1
Foreign	1.1	0.6	1.2	1.0
Domestic	4.4	4.3	4.2	4.1
Current Transfers and Subsidies	3.3	3.1	3.1	3.1
o/w To Households and Other Sectors	2.6	2.5	2.5	2.5
Samurdhi	0.1	0.2	0.1	0.2
Pensions	1.5	1.5	1.5	1.5
Fertiliser Subsidy	0.5	0.5	0.5	0.4
Other	0.5	0.4	0.4	0.4
Capital Expenditure	**5.5**	**6.0**	**4.9**	**5.7**
Acquisition of Real Assets	3.1	3.5	2.2	3.4
Capital Transfers	2.5	2.9	2.7	2.4
Provision for Under Expenditure	-	-0.4	-	-0.1
Lending Minus Repayments	**0.5**	**0.5**	**0.3**	**0.2**
Total Expenditure and Net Lending	**21.4**	**21.2**	**19.7**	**20.5**

Source : Ministry of Finance and Planning

The increase in interest payments on domestic debt was mainly due to an increase in the domestic debt stock by 9.3 per cent in 2011, coupled with the marginal increase in the average interest rate on domestic debt to 11.3 per cent in 2012 from 11.2 per cent in the previous year. In the domestic front, interest payments on Treasury bonds increased by 9.8 per cent to Rs. 237.7 billion in 2012 mainly due to the increase in outstanding Treasury bond stock by 8.6 per cent in 2010 and by 10.7 per cent in 2011 as the main borrowing instrument. Interest payments on Treasury bills increased significantly by 40.6 per cent to Rs. 65.0 billion in 2012 reflecting the increase in the outstanding stock of Treasury bills by 14.9 per cent in 2011 and by 6.5 per cent in 2012, and the relatively high interest rates in the domestic market. Interest payments on Rupee loans and Sri Lanka Development Bonds (SLDBs) amounted to Rs. 6.4 billion and Rs. 8.9 billion, respectively. Meanwhile, the share of interest payments on domestic debt declined to 78 per cent of the total in 2012 compared to 81 per cent in the previous year. In the foreign front, the increase in the foreign debt stock by 15.5 per cent in 2011 and the increase in the share of non concessional loans in the total foreign debt stock from 43 per cent to 49 per cent in 2012, contributed towards an increase in the average interest rate on foreign debt from 3.4 per cent in 2011 to 3.9 per cent in 2012.

In 2012, expenditure on salaries and wages as a percentage of GDP declined to 4.6 per cent from 4.9 per cent in 2011, although in nominal terms it increased by 8.8 per cent to Rs. 347.7 billion. An increase in the special allowance given to all public sector employees from 5 per cent to 15 per cent of their basic salary, coupled with an upward revision of various allowances paid to grama niladaries, members of the judiciary, doctors, engineers and the university staff contributed to the nominal increase in salaries and wages in 2012.

Chart 6.4 Total Expenditure by Function - 2012



Even though salaries and wages paid to central government employees, including defence, and public order and safety, increased by 13.4 per cent to Rs. 259.5 billion in 2012, the marginal contraction of the central government's contribution to salaries and wages of provincial council employees by 2.9 per cent to Rs. 88.2 billion moderated the nominal increase in salaries and wages during the year. Meanwhile, salaries and wages continued to be the second largest recurrent expenditure item accounting for 32 per cent of total recurrent expenditure in 2012.

Government purchases of other goods and services declined as a percentage of GDP from 1.7 per cent in 2011 to 1.3 per cent in 2012. In nominal terms, expenditure on other goods and services declined to Rs. 101.5 billion in 2012 from Rs. 113.7 billion recorded in 2011. Expenditure incurred by the central government on other goods and services showed a marginal increase of 1.2 per cent in 2012, while it accounted for 53 per cent of total outlays on other goods and services during the year. Conversely, expenditure incurred on other goods and services for defence services declined by 27 per cent during the period under consideration. Defence expenditure as a percentage of GDP also declined gradually reflecting the decline in expenditure on other goods and services by defence services in 2012.

Current transfers and subsidies as a percentage of GDP declined to 3.1 per cent during 2012 from 3.3 per cent recorded in the previous year. However in nominal terms, current transfers and subsidies increased by 9.2 per cent to Rs. 236.5 billion in 2012 compared to Rs. 216.6 billion in 2011. Households continued to be the largest beneficiaries accounting for 80 per cent of total current transfers in 2012. Public institutions and public corporations accounted for the balance, amounting to 15 per cent and 5 per cent of total current transfers in 2012, respectively.

Current transfers to households increased by 10.7 per cent to Rs. 189.7 billion in 2012 mainly due to an increase in government spending on pensions and the fertiliser subsidy programme. Pension payments continued to be the largest item under transfers to households accounting for 59 per cent of transfers in 2012. In nominal terms, pension payments increased by 11.8 per cent to Rs. 111.7 billion in 2012. An increase in the pension payment with a view to correcting pension anomalies, coupled with the full impact of the addition of 23,447 new pensioners in 2011 and the partial impact of the addition of 17,375 new pensioners in 2012 contributed to this increase. Expenditure on the fertiliser subsidy programme increased by 22.3 per cent to Rs. 36.5 billion in 2012 mainly on account of the extension of the fertiliser subsidy to cover all crops with effect from May 2011. Expenditure on welfare programmes for disabled soldiers increased by 11 per cent to Rs. 14.8 billion in 2012, while expenditure on the Samurdhi programme increased by 16.7 per cent to Rs. 10.6 billion with an increase in the Samurdhi allowance from April 2012. However, transfers under the World Food Programme declined significantly by 70 per cent to Rs. 1.5 billion reflecting the completion of resettlement activities in conflict affected areas. Meanwhile, programmes targeting school children such as the free school text books, uniforms, 6

FISCAL POLICY AND GOVERNMENT FINANCE

season tickets and free Dhamma School books and the school nutritional food programme were among the other major transfers to households by the government during 2012.

Current transfers to public institutions increased by 8.8 per cent to Rs. 35.0 billion in 2012, while current transfers to public corporations declined by 9.1 per cent to Rs. 11.8 billion. The increase in current transfers to public institutions was mainly on account of an increase in transfers to institutions engaged in higher education and tertiary education. Meanwhile, the decline in current transfers to public corporations was mainly due to a reduction in the operational losses of the Department of Sri Lanka Railways. However, transfers to cover operational losses of the Department of Posts (Rs. 3.3 billion), the Department of Sri Lanka Railways (Rs. 3.8 billion) and the Sri Lanka Transport Board (Rs. 4.0 billion) accounted for around 94 per cent of total current transfers to public corporations in 2012.

Table 6.4 Functional Classification of Expenditure

Item	2011	2012 Approved Estimates	2012 Provisional	2013 Approved Estimates
	Rs. million			
Current Expenditure	1,006,633	1,107,902	1,094,248	1,267,390
General Public Services	245,266	266,174	254,371	303,263
Civil Administration	43,076	49,646	47,135	55,414
Defence	159,553	164,785	163,219	198,997
Public Order and Safety	42,637	51,743	44,017	48,852
Social Services	314,137	357,383	335,991	408,387
Education	99,043	107,988	107,271	121,189
Health	74,443	82,153	81,946	95,016
Welfare	123,122	146,912	128,451	166,724
Community Services	17,529	20,330	18,323	25,458
Economic Services	88,233	99,652	92,034	102,209
Agriculture and Irrigation	46,290	51,471	46,429	55,023
Energy and Water Supply	3,533	3,706	3,612	3,751
Transport and Communication	31,823	32,078	34,995	35,027
Other	6,587	12,398	6,998	8,408
Other	358,996	384,694	411,852	453,531
o/w Interest Payments	356,699	370,000	408,498	444,800
Capital Expenditure and Lending	407,489	497,465	417,130	529,250
General Public Services	32,484	27,851	27,510	37,716
Civil Administration	28,668	26,795	26,565	35,603
Public Order and Safety	3,816	1,057	945	2,113
Social Services	62,953	92,500	70,570	95,228
Education	22,326	33,307	28,930	42,461
Health	14,774	27,878	17,053	23,363
Housing	6,712	10,896	7,319	7,383
Community Services	19,141	20,418	17,267	22,021
Economic Services	311,594	406,764	317,592	403,985
Agriculture and Irrigation	28,568	51,187	30,351	55,997
Energy and Water Supply	74,028	89,962	76,192	75,142
Transport and Communication	186,342	237,539	190,030	225,282
Other	22,656	28,076	21,020	47,564
Other	459	585	1,459	921
Under Expenditure	-	-30,235	-	-8,600
Total Expenditure and Lending	1,414,122	1,605,367	1,570,502	1,796,640
	As a percentage of GDP			
General Public Services	4.2	3.9	3.7	3.9
Social Services	5.8	6.0	5.4	5.8
Economic Services	6.1	6.7	5.4	5.8
Other	5.5	5.1	5.5	5.2
o/w Interest Payments	5.5	4.9	5.4	5.1
Total Expenditure and Lending	21.6	21.4	20.7	20.7

Source : Ministry of Finance and Planning

Capital expenditure and net lending as a percentage of GDP declined to 5.3 per cent in 2012 from 6.0 per cent in the previous year. Considering the lower than expected revenue collection, the government directed resources towards expediting strategically important infrastructure development projects, while curtailing non priority capital expenditure projects. However, in nominal terms, capital expenditure and net lending increased by 1.3 per cent to Rs. 398.6 billion in 2012. Similarly, public investment as a percentage of GDP declined to 5.5 per cent during the year compared to 6.2 per cent in 2011 and 6.6 per cent in the budget estimates, while in nominal terms, public investment increased by 2.4 per cent to Rs. 417.1 billion. Accordingly, public investment in 2012 was Rs. 80.3 billion lower than Rs. 497.5 billion envisaged in the budget for 2012. The utilisation rate of domestic funds for the public investment programme was at a lower level than that of foreign funds, reflecting the impact of the revenue shortfall on the implementation of capital expenditure projects. Within capital expenditure, expenditure incurred by the Ministries and Departments on acquisition of real assets (purchase of capital assets and construction and development of fixed assets) declined by 15.9 per cent to Rs. 170.5 billion in 2012. However, capital transfers increased significantly by 26.4 per cent to Rs. 202.7 billion during the period under review on account of an increase in transfers to public institutions (by 38.2 per cent) and public corporations (by 12.7 per cent) despite a decline in capital transfers to provincial councils by 8.5 per cent. Meanwhile, the on-lending programme which channels foreign funds to commercially oriented public enterprises such as the Ceylon Electricity Board and the Sri Lanka Ports Authority amounted to Rs. 43.9 billion in 2012, compared to Rs. 44.9 billion recorded in the previous year.

Public investment in economic services continued to be the main component of the government's investment programme amounting to Rs. 317.6 billion in 2012, a 1.9 per cent increase compared to that of the previous year. The momentum gained in the implementation of key national infrastructure development projects continued during 2012. Accordingly, a significant investment was made in the areas of roads, ports, power and energy, railways, and water supply and irrigation. Since the government's policy was to give the highest priority to improving the road network, substantial investments were made in 2012 in transportation such as the Southern Expressway Project, the Colombo - Katunayake Expressway Project and the Colombo Outer Circular Highway Project. In line with the government's policy to improve transport services, investments were also made to extend and rehabilitate the railway lines throughout the country. Further, a significant investment was made on the Colombo Port Expansion Project reflecting the government's vision to position Sri Lanka as a maritime hub in the region. Meanwhile, the Upper Kotmale Hydropower Project and the Vauniya Kilinochchi Transmission Line Project were the major investments undertaken in power and energy in 2012. In addition, investments to improve water supply were made through projects such as the Secondary Towns Rural Community Based Water Supply Project and the Integrated Water Supply Scheme for the Unserved Areas Project, while continued investments were made on major irrigation systems such as the Moragahakanda and Kaluganga Reservoir Project and the Uma Oya Diversion Project.

Public investment in social services increased by 12.1 per cent to Rs. 70.6 billion in 2012, of which, Rs. 28.9 billion was spent on education, while Rs. 17.1 billion was in relation to expenditure on health related services. Public investment in education was directed towards the improvement of capital assets in primary and secondary schools, knowledge enhancement & institutional development, uplifting of university infrastructure and improvement of vocational and technical education. Meanwhile, public investment in the health sector was mainly directed towards construction and improvement of hospitals, supply of lab apparatus and bio-medical equipment and control of communicable & non communicable diseases.

The government expedited the implementation of several regional and rural infrastructure development projects with a view to reducing rural-urban disparities. Expenditure under the 'Divineguma' Programme aimed at developing a self-reliant household economy amounted to Rs. 2.9 billion in 2012. In addition, expenditure on the Gamaneguma programme and other community development initiatives including infrastructure improvement projects in the conflict affected areas amounted to Rs. 29 billion during the period under consideration. Further, identifying the uniqueness of each region, their diverse resources, potential and development plans, specific regional development initiatives were under taken in each province.

Financing the Budget Deficit

In 2012, the overall budget deficit of Rs. 489 billion was largely financed through foreign sources. Accordingly, foreign financing contributed to around 59 per cent of the total financing requirement in 2012 compared to 49 per cent in 2011 and 42 per cent targeted in the budgetary estimate for 2012, while the balance was financed through domestic sources. Consequently, net foreign financing (NFF) amounted to Rs. 286.5 billion compared to the budgetary estimate of Rs. 197.3 billion and net domestic financing (NDF) amounted to Rs. 200.4 billion compared to the budgetary estimate of Rs. 202.5 billion.

With respect to the composition of net domestic financing, the government relied heavily on banking sector borrowings in 2012. The borrowings from the banking sector in 2012 were significantly higher amounting to Rs. 131.5 billion compared to the budgetary estimate of Rs. 64 billion. However, the share of banking sector borrowings in total domestic financing declined to 65 per cent in 2012 from 83 per cent in 2011. Borrowings from the Central Bank, which increased to Rs. 88.9 billion by April 2012, declined towards the end of the year to Rs. 16.1 billion, reflecting a significant reduction in Treasury bills held with the Central Bank in December 2012. In addition, provisional advances from the Central Bank amounted to Rs. 16.5 billion. Borrowings from commercial banks increased by Rs. 115.4 billion mainly due to an increase in Treasury bills held by commercial banks and an increase in government overdrafts with the two state banks. Accordingly, net borrowings from the non bank sector amounted to Rs. 71.0 billion compared to Rs. 207.6 billion expected in the budget. However, the share of non bank sector borrowings in total domestic borrowings increased to 35 per cent in 2012, compared to 19 per cent in 2011. As in previous years, the Employees' Provident Fund (EPF) and the National Savings Bank (NSB) continued to be the key institutional investors in the non bank sector.

In line with the medium term debt management strategy of improving the government securities market while reducing the risks associated with government debt portfolio, the government relied heavily on marketable debt instruments with longer maturities to finance the budget deficit in 2012. Accordingly, net borrowings by way of instruments

Table 6.5 Sources of Domestic Financing

Rs. billion

Item	2009	2010	2011	2012 Provisional
By Instrument	**245.6**	**202.2**	**231.2**	**200.4**
Treasury Bonds (a)	201.9	140.4	168.4	154.5
Treasury Bills (b)	49.0	82.8	79.6	16.8
Rupee Loans	-17.7	-24.6	-25.7	-3.6
Sri Lanka Development Bonds	7.6	11.1	5.3	18.4
Central Bank Provisional Advances	-2.4	4.0	16.9	16.5
Other	7.1	-11.5	-13.2	-2.2
By Source	**245.6**	**202.2**	**231.2**	**200.4**
Bank	49.0	-1.9	191.9	131.5
Non Bank	196.5	204.1	39.4	68.9

(a) Excludes rupee denominated Treasury bonds issued to foreign investors and to the Sri Lankan diaspora and migrant workers since 2009 and to CPC in 2012

(b) Excludes rupee denominated Treasury bills issued to foreign investors and to the Sri Lankan diaspora and migrant workers since 2009.

Sources: Ministry of Finance and Planning
Central Bank of Sri Lanka

Chart 6.5 Deficit Financing (as a percentage of GDP)

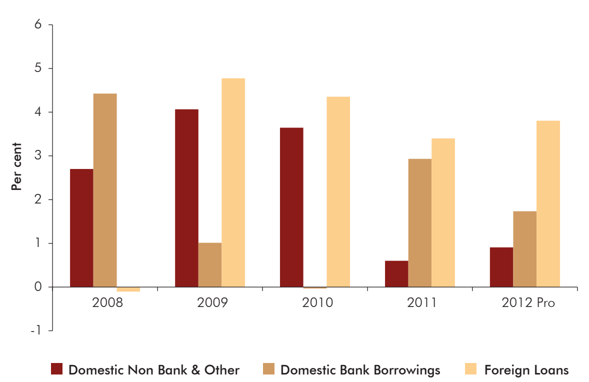
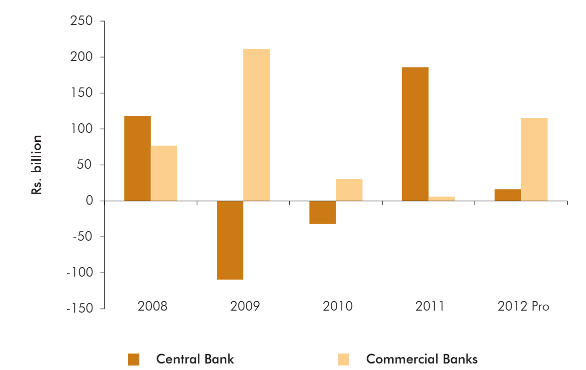


Chart 6.6 Sources of Bank Financing



amounted to Rs. 186.1 billion, comprising Treasury bonds Rs. 154.5 billion, Treasury bills Rs. 16.8 billion and SLDBs Rs. 18.4 billion, while there was a net repayment of Rupee loans amounting to Rs. 3.6 billion. Net borrowing by way of other sources increased to Rs. 14.3 billion during the year from Rs. 3.7 billion in 2011. That was mainly due to the significant increase in borrowings through overdrafts from the two state banks to Rs. 46.7 billion compared to a marginal decline recorded in 2011. Reflecting a larger demand for SLDBs, foreign currency denominated domestic borrowing increased further in 2012 by Rs. 18.4 billion.

In financing the resources gap in 2012, net foreign financing exceeded the budgetary target easing the pressure on the domestic market. Accordingly, total gross borrowings from foreign sources amounted to Rs. 487 billion while net foreign financing amounted to Rs. 286.5 billion during the year. The realisation of proceeds from the International Sovereign Bond issue, a significant increase in foreign investment in rupee denominated government securities and receipt of project loans as expected in the budget contributed to the higher foreign financing in 2012. On net basis, foreign borrowing from the International Sovereign Bond Issue amounted to Rs. 66.2 billion (US dollar 500 million) as US dollar 500 million was repaid in settling the debut sovereign bond issued in 2007. Net borrowings from Treasury bills and Treasury bonds through foreign investors amounted to Rs. 99.7 billion and Rs. 6 billion, respectively. Consequently, foreign investments in government securities increased significantly by more than three fold in 2012 compared to 2011, mainly due to improved investor confidence and an increase in the threshold available for foreign investors to 12.5 per cent from 10.0 per cent in December 2011. Project loans from bilateral and multilateral sources amounted to Rs. 233.9 billion. Accordingly, 60 per cent of net foreign financing was financed through foreign commercial sources while the balance was financed through non commercial sources. The Asian Development Bank (ADB), China and Japan were the major sources of non commercial loans.

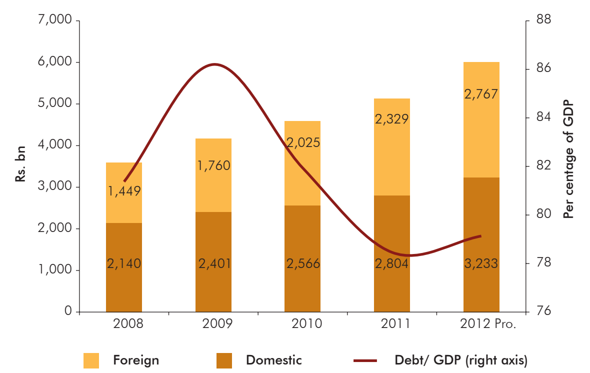
6.4 Government Debt and Debt Service Payments

Government Debt

The declining trend in the debt to GDP ratio experienced in the recent past reversed in 2012 mainly due to an increase in the debt stock arising from the depreciation of the Sri Lanka rupee against major currencies. Government debt, as a percentage of GDP, increased to 79.1 per cent in 2012 compared to 78.5 per cent recorded in the previous year and 77.7 per cent projected in the Medium Term Macro Fiscal Framework. In nominal terms, the outstanding government debt increased notably by 16.9 per cent to Rs. 6,000.1 billion at end 2012 from Rs. 5,133.4 billion at end 2011. The increase in net borrowings, the discount factor and the depreciation of the Sri Lanka rupee against major foreign currencies contributed for that increase. Accordingly, as a percentage of GDP, domestic debt was 42.6 per cent and foreign debt was 36.5 per cent, whereas the corresponding ratios in the previous year were 42.9 per cent and 35.6 per cent, respectively.

The share of domestic debt in total government debt slightly declined to 53.9 per cent at end 2012 from 54.6 per cent at end 2011. That was mainly due to lower borrowing from domestic sources. The share of medium and long term debt in the domestic debt stock decreased marginally to 74.8 per cent in 2012 from 75.1 per cent in the previous year. A major share of medium to long term debt consisted of Treasury bonds (86.6 per cent), while SLDBs and Rupee loans accounted for 9.2 per cent and 2.4 per cent, respectively. The share of Treasury bills in short term domestic debt declined to 77.4 per cent at end 2012 from 84.6 per

Chart 6.7 Outstanding Government Debt



cent at end 2011, while provisional advances from the Central Bank and other liabilities to the banking sector net of bank deposits accounted for 13.7 per cent and 6.6 per cent, respectively from the short term domestic debt.

Government debt held by the non bank sector increased by 13.4 per cent to Rs. 2,174.3 billion at end 2012, while the share of non bank sector debt in domestic debt declined marginally to 67.3 per cent from 68.4 per cent at end 2011. Treasury bills held by the non bank sector increased by 8.5 per cent to Rs. 255.3 billion and the relative share of Treasury bills decreased to 11.7 per cent in 2012 from 12.3 per cent in the previous year. Further, borrowings from the non bank sector by way of Treasury bonds increased by 14.9 per cent to Rs. 1,852.2 billion while the relative share increased to 85.2 per cent in 2012 from 84.1 per cent in the previous year. The EPF (54.0 per cent) and the NSB (15.2 per cent) continued to be the major holders of government debt in the non bank sector.

The outstanding debt obligation of the government to the domestic banking sector increased by 19.4 per cent to Rs. 1,058.4 billion at end 2012. The outstanding debt held by the Central Bank increased marginally by 0.7 per cent to Rs. 265.2 billion at end 2012, while the relative share decreased to 25.1 per cent from 29.7 per cent at the end of the previous year. At end 2012, the major portion of debt held by the Central Bank consisted of Treasury bills (58.1 per cent), while the balance was on account of provisional advances. Outstanding government debt held by commercial banks increased by 27.3 per cent to Rs. 793.2 billion compared to 2011 with the increase in government overdrafts (by 92.9 per cent), SLDBs (by 21.3 per cent), holdings of Treasury bills (by 18.3 per cent) and holdings of Treasury bonds (by 17.6 per cent).

Foreign currency denominated domestic debt increased to Rs. 242.1 billion (US dollars 1,904 million) by end 2012 from Rs. 201 billion (US dollars 1,764 million) as at end 2011. That was a combined outcome of an increase in SLDBs by Rs. 39.2 billion and the depreciation of the Sri Lanka rupee against the US dollar. Foreign currency denominated domestic debt included SLDBs amounting to Rs. 223 billion (US dollars 1,754 million) and outstanding borrowings from offshore banking units (OBUs) of Rs. 19.1 billion (US dollars 150 million).

Table 6.6 Outstanding Government Debt (as at end year)

Rs. million

Item	2009	2010	2011	2012 Provisional
Total Government Debt	**4,161,422**	**4,590,245**	**5,133,365**	**6,000,112**
Domestic Debt (a)	**2,400,955**	**2,565,662**	**2,804,085**	**3,232,813**
By Maturity Period				
Short Term	560,646	619,549	698,190	813,272
Medium and Long Term	1,840,309	1,946,113	2,105,895	2,419,541
By Institution				
Bank (b)	705,765	691,716	886,221	1,058,366
Non Bank	1,695,089	1,873,845	1,917,864	2,174,447
Foreign Debt	**1,760,467**	**2,024,583**	**2,329,280**	**2,767,299**
By Type				
Concessional Loans	1,271,142	1,266,910	1,328,797	1,369,568
Non Concessional Loans	78,649	147,241	235,923	455,069
Commercial	410,677	610,433	764,560	942,662
By Currency				
SDR	567,502	572,354	601,691	682,065
US Dollars	330,842	476,490	678,983	853,832
Japanese Yen	452,758	508,802	560,456	575,196
Euro	143,566	142,371	146,711	174,563
Other	265,799	324,566	341,439	481,643
Memo: Exchange Rate Variation	23,114	-4,653	85,573	207,389

(a) Excludes government bonds of Rs. 4,397 million issued to CWE in November 2003, Rs. 78,447 million issued to CPC in January 2012 and rupee denominated Treasury bonds held by foreign investors from 2007 and the Sri Lankan diaspora and migrant workers from 2009.

(b) Includes outstanding balance to OBUs.

Sources: Ministry of Finance and Planning
Central Bank of Sri Lanka

Chart 6.8 Composition of Outstanding Domestic Debt-2012

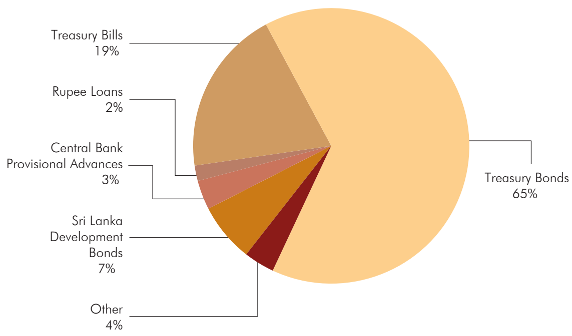
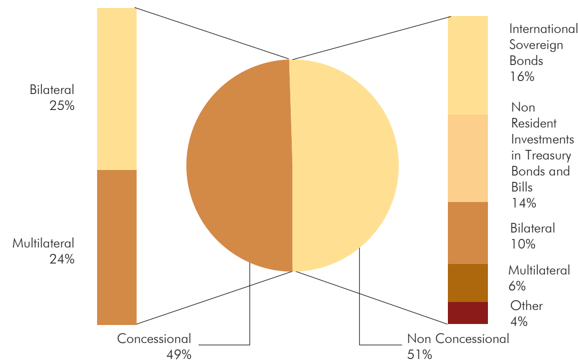


Chart 6.9 Composition of Outstanding Foreign Debt-2012



Total outstanding foreign debt as a percentage of GDP increased to 36.5 per cent at end 2012 from 35.6 per cent at end 2011, while increasing in nominal terms by 18.8 per cent to Rs. 2,767 billion at end 2012. Higher foreign borrowings to finance the budget deficit and the depreciation of the Sri Lanka rupee against major foreign currencies during the year contributed largely to the increase in the foreign debt stock. Non concessional borrowings increased by 39.7 per cent to Rs. 1,397.7 billion raising the share of non concessional debt in the total foreign debt stock to 50.5 per cent at end 2012 from 43 per cent at end 2011. Commercial borrowings increased by 23.3 per cent to Rs. 942.7 billion mainly on account of a substantial increase in foreign investment in government securities and the issuance of the fifth International Sovereign Bond.

The total debt stock increased substantially by Rs. 207.4 billion (2.7 per cent of GDP) during 2012 due to the depreciation of the Sri Lanka rupee against major foreign currencies. The Sri Lanka rupee depreciated against the Euro by 12.6 per cent, Special Drawing Rights (SDR) by 10.5 per cent, US dollar by 10.4 per cent, Indian rupee by 7.6 per cent and Japanese yen by 0.6 per cent. Further, the total outstanding foreign debt stock consisted of US dollars (30.9 per cent), SDR (24.6 per cent), Japanese yen (20.8 per cent), Euro (6.3 per cent), Sri Lanka rupee (14.6 per cent) and other currencies (2.8 per cent). The US dollar denominated domestic debt (SLDBs and OBUs) increased by Rs. 22.8 billion due to the depreciation of the Sri Lanka rupee against the US dollar.

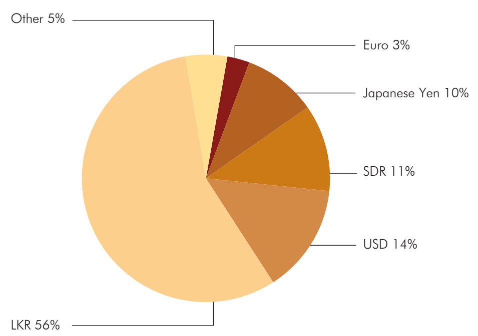
Table 6.7 Assessment of External Debt Vulnerability of Sri Lanka - 2012

Indicator	(UN-ESCAP) Definition Levels			Sri Lanka
	Less Indebted	Moderately Indebted	Highly Indebted	2012 Provisional
Disbursed External Debt Outstanding / Gross National Income	<30%	>30% and <50%	>50%	37.2%
Disbursed External Debt Outstanding / Exports of Goods, Non-Factor Services and Workers' Remittances	<165%	>165% and <275%	>275%	111.0%
Total External Debt Service Payments /Exports of Goods, Non-Factor Services and Workers' Remittances	<18%	>18% and <30%	>30%	11.4%
External Interest Payments / Exports of Goods, Non-Factor Services and Workers' Remittances	<12%	>12% and <20%	>20%	3.6%
Net Present Value of External Debt /Gross National Income (a)	<48%	>48% and <80%	>80%	40.4%
Net Present Value of External Debt /Exports of Goods, Non-Factor Service and Workers' Remittances (a)	<132%	>132% and <220%	>220%	124.9%

(a) Current year and last two years average

Sources: Manual on Effective Debt Management, UN-ESCAP
Central Bank of Sri Lanka

Chart 6.10 Currency Composition of Total Outstanding Debt - 2012



Sri Lanka can be classified as a less indebted country according to parameters defined in the manual on Effective Debt Management of the UN-ESCAP, to assess the external debt vulnerability of a country. The analysis shows that, five out of six external debt indicators in 2012 confirm Sri Lanka as a less indebted country. The only indicator in which Sri Lanka is placed in the "moderately indebted" category is "the Disbursed external debt outstanding to Gross national income" category, where Sri Lanka's indicator value is 37.2 per cent, which is marginally above the threshold level of 35 per cent specified for the "Less indebted" category. In this context, it is noted that these values have been recorded by Sri Lanka at a time when risks of public debt emanating from the global economic slowdown has been rising in many economies.

Debt Service Payments

Debt service payments increased significantly to Rs. 1,017.5 billion in 2012 compared to Rs. 895.4 billion in 2011 and Rs. 940 billion projected in the budget estimates, owing to an increase in domestic interest rates especially in the early part of 2012 and the depreciation of the Sri Lanka rupee against major foreign currencies. Amortisation payments increased by Rs. 70.3 billion to Rs. 609 billion accounting for 59.9 per cent of total debt service payments, while interest payments increased by Rs. 51.8 billion to Rs. 408.5 billion accounting for the balance. Debt service payments to domestic sources increased by Rs. 5.1 billion to Rs. 733.1 billion over 2011. That was a combined outcome of a decline in amortization payments by Rs. 24.5 billion to Rs. 415.4 billion and an increase in interest payments by Rs. 29.5 billion to Rs. 317.7 billion over the previous year. With regard to foreign debt service payments, amortization payments increased by Rs. 94.7 billion to Rs. 193.5 billion and interest payments increased by Rs. 22.3 billion to Rs. 90.8 billion compared to 2011.

Debt service indicators showed mixed performance in 2012. The ratio of debt service payments to GDP improved slightly to 13.4 per cent in 2012 from 13.7 per cent in 2011, while the ratio of total interest payments to GDP also improved slightly to 5.4 per cent in 2012 from 5.5 per cent in 2011. Further, domestic interest payments to GDP decreased from 4.4 per cent in 2011 to 4.2 per cent in 2012. However, the ratio of debt service payments to government revenue increased from 95.8 per cent in 2011 to 103 per cent in 2012 due to the increase in debt service payments by 13.6 per cent compared to the lower increase in revenue collection (5.7 per cent increase over 2011).

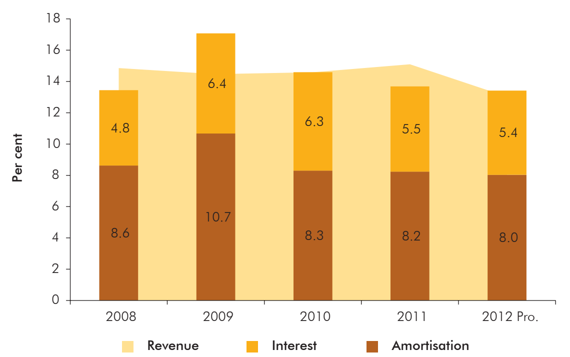
Table 6.8 Government Debt Service Payments

Rs. million

Item	2009	2010	2011	2012 Provisional
Debt Service Payments	**825,687**	**820,448**	**895,382**	**1,017,468**
Domestic	675,274	686,800	728,028	733,100
Foreign	150,414	133,648	167,354	284,368
Amortisation Payments	**516,012**	**467,856**	**538,683**	**608,970**
Domestic	401,296	389,672	439,894	415,441
Foreign	114,716	78,184	98,789	193,529
Interest Payments	**309,675**	**352,592**	**356,699**	**408,498**
Domestic	273,978	297,127	288,134	317,659
Short Term	72,364	58,943	46,257	65,049
Medium and Long Term	201,613	238,185	241,877	252,610
Foreign	35,698	55,464	68,565	90,839

Sources: Ministry of Finance and Planning
Central Bank of Sri Lanka

Chart 6.11 Government Debt Service Payments (as a percentage of GDP)



6.5 Budgetary Operations in Sub National Governments

Policy Direction and Measures of Sub National Governments

Provincial Councils (PCs) and Local Governments constitute the Sub National Government system in Sri Lanka. There are nine PCs established under the thirteenth amendment to the constitution and with the addition of five new local authorities during 2011, the Local Government system in Sri Lanka is made up of 335

Table 6.9 Government Debt Indicators

Indicator	2009	2010	2011	2012 Provisional
Government Debt/GDP	86.2	81.9	78.5	79.1
Domestic Debt/GDP	49.7	45.8	42.9	42.6
Foreign Debt/GDP	36.5	36.1	35.6	36.5
Total Foreign Debt/Exports (a)	170.7	161.4	154.4	160.0
Total Debt Service/GDP	17.1	14.6	13.7	13.4
Total Debt Service/Government Revenue (b)	118.0	100.4	95.8	103.0
o/w Domestic Debt Service/ Government Revenue (b)	96.5	84.0	77.9	74.2
Total Debt Service/Government Expenditure (c)	48.1	46.9	46.2	48.4
o/w Domestic Debt Service/ Government Expenditure (c)	39.3	39.3	37.6	34.9
Foreign Debt Service/Exports (a)	14.6	10.7	11.1	16.4
Total Interest/GDP	6.4	6.3	5.5	5.4
Domestic Interest/GDP	5.3	5.3	4.4	4.2
Domestic Interest/Government Current Expenditure	31.1	31.7	28.6	29.0
Foreign Interest/Exports (a)	3.5	4.4	4.5	5.3

(a) Export of goods and services
(b) Government revenue is in economic format
(c) Government expenditure includes amortisation payments

Sources: Ministry of Finance and Planning
Department of Census and Statistics
Central Bank of Sri Lanka

institutions. As at end 2012, the Local Government system comprised 23 municipal councils, 41 urban councils and 271 pradesheeya sabhas.

The activities of the Ministry of Local Government and Provincial Councils during 2012 focused on strengthening good governance in the sub national government level and uplifting the economy with infrastructure facilities to promote equitable and sustainable growth of the country. In line with the current economic structure, necessary legal reforms were executed to ensure efficient and smooth functioning of the subnational governments. Further, infrastructure facilities for local government institutions and their management abilities were enhanced to facilitate an efficient and meaningful service to the public.

'Pura Neguma' Programme was initiated during 2012 with the objective of achieving a balanced regional development in the country while improving the local government infrastructure and service delivery. Under that project, water supply and sanitation facilities, access to roads, maternity and health centers, weekly fairs, market complexes, children's parks, libraries, vehicle parks, restaurants, pradeshiya sabha office building etc. were being constructed. Furthermore, that programme facilitates policy reforms in pradesiya sabhas enabling them to deliver their services efficiently and effectively through the improvement of infrastructure facilities, simplifying procedures relating to levying, assessment rates, other taxes and issuing of license, and making the methodology of approving such levies in a transparent manner. In addition to the 'Pura Neguma' Programme, several small and medium scale town development projects were implemented with the technical and consultancy assistance of the Urban Development Authority and the Sri Lanka Land Reclamation and Development Cooperation as well as the intervention of the

Commissioners of Local Government and the Departments of Engineering Services of the Provinces.

Road development was given priority under provincial level infrastructure development activities during 2012. Accordingly, the Provincial Roads Connectivity Project was implemented with a view to improving connectivity and reliability of provincial roads, while various other road development initiatives were continued in conflict affected provinces. In addition, various infrastructure development projects were implemented to address regional development requirements. Accordingly, several waste management programmes have been initiated and the drainage and sewerage system in the Colombo city was being rehabilitated. Further, projects to upgrade the disaster response network were implemented to provide firefighting facilities and rescue technology to provinces.

The Finance Commission continued to play a strategic role in recommending Central Government transfers to the PCs in 2012 with a view to facilitating balanced regional growth. The Finance Commission has taken action to introduce Agency Results Framework (ARF) approach to improve the existing Results Based Monitoring (RBM) approach followed by the provinces. Under this, a Medium-Term Results Based Framework is developed for each province for the period 2013 to 2017. In addition, the Finance Commission introduced three new sectors, namely estate infrastructure, cultural affairs and local authority roads in recommending government transfers under Province Specific Development Grants (PSDGs) in 2012. Meanwhile, as per the commission, an insufficient fund disbursement to provinces for projects of a capital nature was one of the key issues relating to provincial council operations during 2012.

Budgetary Operations in Provincial Councils

Total revenue collection of PCs increased by 15.7 per cent to Rs. 47.4 billion in 2012 compared to Rs. 40.1 billion in 2011. However as a percentage of GDP, revenue collection remained at the same level of 0.6 per cent as in 2011. Tax revenue increased by 18 per cent to Rs. 41.0 billion in 2012, while non tax revenue marginally increased by 0.5 per cent to Rs. 6.4 billion. The NBT transferred from the central government increased by 19.7 per cent to Rs. 18.6 billion, partly reflecting the base expansion witnessed in NBT with the measures taken to expedite the registration of retail and wholesale trade. In addition, revenue from stamp duties and licence fees also increased during the period under review. As in previous years, in 2012 the Western Provincial Council continued to be the major contributor to the revenue collection of PCs accounting for 53 per cent of the total revenue collection. The Western Province was followed by the North Western, the Central, and the Southern provinces accounting for around 10 per cent, 9 per cent and 9 per cent respectively, of the total revenue collection of PCs.

Recurrent expenditure of PCs increased moderately by 5 per cent to Rs. 136.2 billion in 2012 reflecting the government's efforts to

Table 6.10 Budget Outturn for Provincial Councils

Rs. million

Item	2009	2010	2011	2012 Provisional
Total Revenue	**29,433**	**36,829**	**40,990**	**47,410**
Tax Revenue	24,907	31,049	34,658	41,044
Non Tax Revenue	4,526	5,780	6,332	6,365
Total Expenditure	**130,260**	**145,491**	**157,373**	**159,516**
Current Expenditure	111,336	119,162	129,600	136,153
o/w Personal Emoluments	86,547	91,644	101,886	101,374
Capital Expenditure	18,924	26,329	27,773	23,363
Central Government Transfers	**93,999**	**107,032**	**116,383**	**112,106**
Block Grants	77,386	85,299	94,603	91,892
Criteria Based Grants	2,276	2,612	3,854	2,861
PSDGs (a)	10,945	11,683	9,953	5,901
Foreign Grants for Special Projects	3,393	7,439	7,973	11,452

(a) Province Specific Development Grants

Sources: Ministry of Local Government and Provincial Councils
Ministry of Finance and Planning

rationalise recurrent expenditure. However, as a percentage of GDP it declined to 1.8 per cent in 2012 from 2.0 per cent in the previous year. Personal emoluments continued to be the single largest item under recurrent expenditure accounting for 74 per cent of the total recurrent expenditure of PCs in 2012. Under salaries and wages, personal emoluments of education and health sectors accounted for nearly 90 per cent of the total salary bill. On a functional basis, current expenditure on social infrastructure, mainly education and health, accounted for 88 per cent of total recurrent expenditure amounting to Rs. 119.6 billion in 2012. The balance recurrent expenditure was on account of expenses in relation to provincial administration, economic infrastructure, agriculture and industries. Meanwhile, the Western Province continued to be the largest spending unit accounting for 22 per cent of total recurrent expenditure.

Capital expenditure of PCs declined by 16 per cent to Rs. 23.4 billion in 2012 partly reflecting a decline in capital transfers by the central government. Accordingly, as a percentage of GDP, capital expenditure of PCs declined to 0.3 per cent in 2012 from 0.4 per cent in the previous year, which is in line with the lower than estimated public investments observed in the central government. Foreign funded special projects accounted for a major portion of provincial level investments in 2012, amounting to Rs. 11.5 billion. The Provincial Roads Project, the Northern Road Connectivity Project, the Eastern Province Rural Roads Development Project, the Transforming School Education as the Foundation of a Knowledge Hub Project and the Health Sector Development Project were some of the major foreign funded special projects implemented at the provincial level in 2012, while international development agencies, such as the ADB, the JICA and the World Bank continued to fund those projects. In addition, Rs. 5.9 billion was spent on Province Specific Development Projects (PSDPs) during the year under review, while other provincial level investments incurred amounted to Rs. 6.1 billion in 2012, and were mainly in the areas of acquisition and improvement of capital asset and capital transfers.

Central Government transfers to PCs declined by 4 per cent to Rs. 112.1 billion in 2012 compared to Rs. 115.9 billion in 2011. Those transfers were in the form of block grants, Criteria Based Grants (CBGs), PSDGs and grants for special projects. Block grants to meet the resource gap in the current expenditure programme of PCs continued to be the major form of central government transfer amounting to Rs. 91.9 billion (82 per cent of total transfers). In addition, transfers under PSDGs to continue specific provincial development programmes, CBGs to fund discretionary expenditure requirements and grants for special projects amounted to Rs. 5.9 billion, Rs. 2.9 billion and Rs. 11.5 billion, respectively in 2012. Meanwhile, only 70 per cent of expenditure of PCs was financed by transfers from the central government compared to that of 74 per cent recorded in the previous year. The continuation of that trend with increased provincial revenue was required in order to reduce the PCs' reliance on the central government.

Consolidated General Government Budgetary Operations

A consolidated budget outturn for the Sri Lankan general government as given in the Statistical Appendix Table 112 of this report represents the overall impact of government operations. Consolidation is defined by the Government Finance Statistics (GFS) manual-1986 as a method of presenting statistics for a set of units or entities as if they constitute a single unit. The general government sector is defined as the combination of all government units operating in a country and the sub sectors that may comprise the general government sector are central government; state, provincial or regional governments; local governments including municipalities, school boards, etc.; and any supranational authorities exercising tax and governmental expenditure functions within the national territory. Measuring government operations as a set of consolidated statistics rather than unconsolidated statistics makes the assessment of the overall impact of government operations on the total economy or the sustainability of government operations more effective. Further, consolidation eliminates the distorting effects on aggregates of differing administrative arrangements across countries thereby improving fiscal analysis and international comparability. Considering the above facts, a consolidated budget for the general government of Sri Lanka is prepared by the elimination of payments and receipts between the central government, provincial councils and local governments and the aggregation of their other transactions.