Chapter 6

FISCAL POLICY AND GOVERNMENT FINANCE

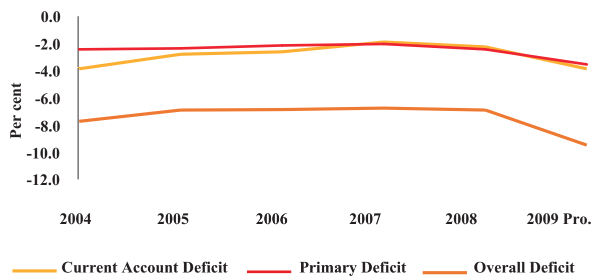
6.1 Overview

As in many other countries, Sri Lanka was confronted with adverse consequences of the slowdown in both domestic and foreign demand and the need to provide fiscal stimuli to mitigate the impact of global economic crisis. As a result, fiscal management was extremely challenging in 2009. During the first half of 2009, fiscal operations came under severe pressure mainly due to the lower growth in government revenue, as a result of the sluggishness in domestic economic activity and shrinking imports. A stimulus package was introduced to assist the industries affected by the economic slowdown and several measures were taken to ease the burden on consumers and to stimulate demand. Meanwhile, the intensified security situation, urgent resettlement, rehabilitation and reconstruction (RRR) activities in the Northern and Eastern provinces and increased interest payments, gave rise to steep increase in government's recurrent expenditure. During the second half of the year, the positive impact of ending of the conflict in May 2009 and the recovery in the domestic economy eased the pressure on fiscal management to some extent. At the same time, there was a strong commitment on the part of the government to maintain the thrust on implementing the infrastructure projects resulting in increased public investment to GDP ratio to 6.8 per cent in 2009. Reflecting the combined impact of these developments, the overall budget deficit in 2009 increased to 9.8 per cent of GDP. This outcome was a notable deviation from the fiscal targets that were set in the Budget 2009 with an overall budget deficit[1] of 5.9 per cent of GDP, and subsequently revised to 7.0 per cent of GDP.

The financing of the deficit indicated a bias towards domestic sources in the first eight months in 2009 and towards foreign sources in the latter part of the year. During the first eight months, the increased borrowing requirement resulting from the sluggish performance in revenue and the increased expenditure, coupled with the difficulty in raising planned foreign borrowings due to the turbulent conditions in the international capital markets, led the government to depend heavily on domestic borrowings in financing the budget deficit. In particular, government borrowing from the banking sector increased significantly during the

1 Foreign grants are classified as a revenue item following the method given in the Government Finance Statistics Manual of 1986.

Chart 6.1 Major Fiscal Indicators (As a per cent of GDP)



first seven months of 2009. However, subsequent developments during the latter part of the year led to a substantial change in the financing mix. The significant increase in foreign financing as a result of the rebound in foreign investments in Treasury bills and Treasury bonds, and the successful completion of the second international sovereign bond issue enabled the government to retire a large amount of Treasury bills held by the Central Bank of Sri Lanka (CBSL) and to repay outstanding amounts to two state banks. This resulted in a significant decline of the borrowings from the banking sector towards the latter part of 2009. Meanwhile, reflecting the higher budget deficit and the lower growth in nominal GDP, the outstanding government debt to GDP ratio in 2009 increased to 86.2 per cent, in an environment where many developed and emerging countries were recording substantial increases in the outstanding debt due to significantly high budget deficits.

Though the end of the conflict, improved macroeconomic conditions and expected economic recovery would provide some space for fiscal operations in 2010, continuation of RRR activities in the Northern and Eastern provinces and strong adjustments needed for strengthening the fiscal sector in the medium term would add pressure on fiscal operations. During the first four months in 2010, fiscal operations are conducted under a Vote on Account (VoA) framework, which was approved by the Parliament in November 2009 (See Box No 10), as the Budget 2010 was not submitted to the Parliament due to Presidential and Parliamentary elections. The Budget for 2010, which will be presented to the Parliament after the general election in April 2010, would reflect strong commitment towards the fiscal consolidation path envisaged in the Medium Term Macro Fiscal Framework (MTMFF).

Table 6.1 Summary of Government Fiscal Operations

Item	2008	2009 Approved Estimates	2009 Revised Estimates (a)	2009 Provisional
	Rs. million			
Total revenue and grants	686,481	885,527	748,708	728,566
Total revenue	655,259	854,999	725,708	702,644
Tax revenue	585,621	779,138	655,779	618,933
Non tax revenue	69,639	75,861	69,929	83,711
Grants	31,222	30,528	23,000	25,922
Expenditure and lending minus repayments	996,126	1,191,671	1,091,566	1,201,927
Recurrent	743,710	823,511	829,641	879,575
Capital and net lending	252,416	368,161	261,925	322,352
o/w Public investment	263,859	370,765	266,580	330,448
Current account surplus (+)/deficit (-)	-88,450	31,487	-103,933	-176,931
Primary account surplus (+)/deficit (-)	-97,169	-55,706	-73,030	-163,686
Overall budget surplus (+)/deficit (-)	-309,644	-306,144	-342,858	-473,361
Total financing	309,644	306,144	342,858	473,361
Foreign financing (b)	-4,643	123,019	34,400	230,807
Domestic financing	314,287	183,125	308,458	242,554
Market borrowings	309,670	183,125	303,458	234,274
Non bank	114,437	165,625	152,458	185,247
Bank	195,233	17,500	151,000	49,027
Monetary Authority	118,403	-	-	-109,241
Commercial banks	76,830	-	-	158,268
Non-market borrowings	4,619	-	5,000	8,280
	As a per cent of GDP			
Total revenue and grants	15.6	17.0	15.2	15.1
Total revenue	14.9	16.4	14.8	14.6
Tax revenue	13.3	14.9	13.3	12.8
Non tax revenue	1.6	1.5	1.4	1.7
Grants	0.7	0.6	0.5	0.5
Expenditure and lending minus repayments	22.6	22.8	22.2	24.9
Recurrent	16.9	15.8	16.9	18.2
Capital and net lending	5.7	7.1	5.3	6.7
o/w Public investment	6.0	7.1	5.4	6.8
Current account surplus (+)/deficit (-)	-2.0	0.6	-2.1	-3.7
Primary account surplus (+)/deficit (-)	-2.2	-1.1	-1.5	-3.4
Overall budget surplus (+)/deficit (-)	-7.0	-5.9	-7.0	-9.8
Total financing	7.0	5.9	7.0	9.8
Foreign financing (b)	-0.1	2.4	0.7	4.8
Domestic financing	7.1	3.5	6.3	5.0
Market borrowings	7.0	3.5	6.2	4.9
Non bank	2.6	3.2	3.1	3.8
Bank	4.4	0.3	3.1	1.0
Monetary Authority	2.7	-	-	-2.3
Commercial banks	1.7	-	-	3.3
Non-market borrowings	0.1	-	0.1	0.2

(a) The numbers used for the IMF Stand-by Arrangement (SBA).
(b) Includes rupee denominated Treasury bonds and Treasury bills issued to foreign investors, Sri Lankan diaspora and migrant workforce.

Source : Ministry of Finance and Planning

Box 10

Vote on Account

What is a Vote on Account?

Vote on Account (VoA) is a "Resolution" submitted to the Parliament by the ruling party to obtain the financial provision for the ongoing commitments of the government for a particular period, usually for a period of three or four months, when circumstances do not warrant the presentation of the annual budget. VoA is therefore, a mechanism to allocate sufficient funds for the government to function until such time a budget is presented in the Parliament. This is usually done when a parliamentary election is held towards the end or beginning of a financial year, so as to allow the newly formed government to present the budget.

Annual Budget Vs Vote on Account

The budget is a policy statement of the government for a definite future period of time (usually for a period of a year), which includes estimates of expenditure and revenue during the period and proposals for financing if there is a deficit. In general, the budget process starts with the presentation to the Parliament of the Appropriation Bill which provides the legal provisions for conducting budgetary operations in a new financial year. Subsequently, the budget for the forthcoming financial year is presented in the Parliament during the last quarter of the year.

A VoA includes mainly expenditure estimates for a part of the financial year covering ongoing recurrent and capital expenditure programmes. It also includes an estimate on the expected revenue, the borrowing limit during the specified period and the maximum limit applicable on Advance Account operations. There are no specific guidelines to decide the amount of expenditure to be spent during the VoA period. When deciding the expenditure amount, it is customary to base it on the annual expenditure estimates in the previous year and decide the amount of expenditure proportionately for the number of months covered by the VoA. Once the VoA is submitted to the Parliament, it is customary that the Parliament will debate it within a very short period of time. If the opposition requests in the Parliament a vote, there will be a debate and the VoA has to be passed by a majority of votes. Since independence, 11 VoAs have been submitted and were passed in the Parliament (Table B 10.1).

Regulations related to Public Finance

According to Chapter XVII (Articles 148 to 154) of the Constitution of the Democratic Socialist Republic of Sri Lanka, the Parliament has full control over public finances. All revenues and receipts of the government have to be credited to the Consolidated Fund and withdrawal from the Consolidated Fund can be done only after a resolution passed by the Parliament. Therefore, the normal practice is that the annual budget is passed in the Parliament and money can be withdrawn from the Consolidated Fund under the authority of a warrant signed by the Minister in charge of the subject of Finance. Usually a VoA is presented to the Parliament as a resolution under paragraph 2 of Article 150 of the Constitution.

Vote on Account 2010

A VoA for the period January to April 2010 was presented to the Parliament on 03 November 2009 to obtain the approval for government fiscal operations. The VoA, which includes estimates of Rs. 197.5 billion for recurrent expenditure (excluding interest payments), Rs. 159.0 billion for capital expenditure and Rs. 6.2 billion for advance account outflows, was approved by the Parliament on 05 November 2009. The expenditure incurred will have to be incorporated in the Appropriation Bill for 2010, which will be placed before the Parliament after formation of the new government.

Table B 10.1 **Vote on Accounts Presented to the Parliament**

Date Presented	Date Approved	Duration (Months)	Expenditure	Reasons
22.09.1931	22.09.1931	2	Total expenditure: Rs. 13.6 million	Budget should have been presented to the Council in June, but the Council was not inagurated till July.
27.09.1960	28.09.1960	3	Recurrent and capital expenditure: Rs. 456.4 million Advance A/c: Rs. 441.5 million	Two general elections were held in this year.
10.09.1970	12.09.1970	3	Recurrent and capital expenditure: Rs. 792.4 million Advance A/c: Rs. 949.1 million	Insufficient time to prepare a budget.
07.09.1971	09.09.1971	3	Recurrent and capital expenditure: Rs. 972.2 million Advance A/c: Rs. 862.3 million	To adopt the calender year as the finnacial year.
02.11.1982	02.11.1982	3	Recurrent: Rs. 6.9 billion Capital:Rs. 5.4 billion Advance A/c: Rs. 2.1 billion	Presidential election was held on 20.10.1982 and the Referendum had to be held in the same year.
25.10.1988	25.10.1988	4	Recurrent: Rs. 11.6 billion Capital: Rs. 13.1 billion Advance A/c: Rs. 4.0 billion	Presidential election to be held on 19.12.1988.
22.11.1994	25.11.1994	3	Recurrent: Rs. 30.0 billion Capital: Rs. 15.2 billion Advance A/c: Rs. 2.6 billion	Parliamentary election was held on 16.08.1994 and Presidential election was held on 09.11.1994.
11.11.1999	12.11.1999	4	Recurrent: Rs. 51.8 billion Capital: Rs. 45.5 billion Advance A/c: Rs. 5.4 billion	Presidential election to be held on 12.12.1999.
05.12.2000	08.12.2000	4	Recurrent: Rs. 71.4 billion Capital: Rs. 56.6 billion Advance A/c: Rs. 5.3 billion	Insufficient time to prepare a budget.
05.02.2002	07.02.2002	1	Recurrent: Rs. 19.1 billion Capital: Rs. 10.7 billion Advance A/c: Rs. 1.3 billion	Insufficient time to prepare a budget.
03.11.2009	05.11.2009	4	Recurrent: Rs. 197.5 billion Capital: Rs. 159.0 billion Advance A/c: Rs. 6.2 billion	To allow the newly elected government to present a new budget.

Source: Parliament of Sri Lanka

However, there would be several challenges on the fiscal operations in 2010. On the domestic front, the government revenue has not recovered fully yet and the funds need to be channelled to the ongoing mega infrastructure development projects to complete them as planned. Priority also needs to be given to the rehabilitation and reconstruction work in the Northern and Eastern provinces. On the external front, the slow recovery in the global economy could have implications on revenue generation and financing. Hence, to strengthen the fiscal consolidation process, significant changes will have to be introduced to enhance the revenue performance, rationalise recurrent expenditure and reduce the reliance of certain public enterprises on the government budget without compressing public investment to maintain budgetary targets. The impending Budget for 2010 has given an important opportunity for the government to commence this process by introducing necessary fiscal and other appropriate changes, which would strengthen the sustainability of public finances of the country.

6.2 Fiscal Policy Direction and Measures

The thrust of the fiscal policy in 2009 was to prevent a further deterioration of the fiscal performance amidst a challenging domestic and external environment, while also maintaining public investment to achieve a regionally balanced sustainable economic growth, as substantial deviations from the original budget were witnessed from the very beginning of the year. Accordingly, several measures were introduced with the view of enhancing revenue performance and rationalising the recurrent expenditure. The government continued its public investment programme by expediting the implementation of mega infrastructure development projects while implementing other capital investment projects and small-scale infrastructure projects, covering all the regions.

In 2009, the government took further steps to broaden the tax base, change the tax rates and improve tax administration. These included the rationalisation of income taxes, the Value Added Tax (VAT) system and customs duty, introduction of the Nation Building Tax (NBT), revising the excise tax and the Special Commodity Levy (SCL) rates and increasing the Ports and Airports Development Levy (PAL). However, considering the adverse impact of the global recession and the slowing down of the domestic economic activity, selected tax rates were revised downward to ease the pressure on domestic industries as well as the agricultural sector. Further, tax rates applicable for several food items were reduced during the latter part of 2009 to reduce the pressure on domestic prices.

Several changes were made in the income tax system in 2009. Accordingly, personal income tax slabs were revised by introducing three new slabs to ease the tax burden on the middle income earners. The provisions relating to withholding tax on interest income were revised to provide more benefits for pensioners and those who depend on the interest income from their savings. Several income tax exemptions were granted with a view to encouraging foreign currency earnings, promoting exports and developing the cinema industry etc. Further, the upper limit of the Economic Service Charge (ESC) payable was increased while the grace period of 36 months applicable to commence ESC liability was removed.

The VAT system was rationalised aiming to minimise its complexity. Consequent to this, standard VAT rate was reduced from 15 per cent to 12 per cent, the basic VAT rate of 5 per cent was removed, and input tax claim for VAT paid on luxury items was reduced from 15 per cent to 12 per cent. The registration threshold for general VAT was increased to Rs. 650,000 per taxable period (quarter) or Rs. 2.5 million per year, while maximum limit of the registration for optional VAT was increased to Rs. 3.0 million. VAT exemptions were granted for certain items, including the supply of locally manufactured surgical gauze and jewellery and importation of selected categories of solar panel modules and accessories used for the conversion of solar energy into electricity.

Customs duties, SCL and excise taxes on selected items were revised. Customs duty waivers were granted on petrol, diesel, wheat grain and edible oil during the year. SCL on essential food items were increased during the first three quarters, but in the last quarter, it was reduced to ease the price pressure in the domestic market. Furthermore, existing excise tax rates on cigarettes and liquor were increased to enhance government revenue, while an excise tax of 5 per cent or Rs. 8 per kg was imposed on Liquefied Petroleum gas (LP gas). Subsequently, it was revised several times during the year to 5 per cent or Rs. 31.50 per kg by end 2009. However, the excise tax on LP gas was removed fully in March 2010.

Several additional changes were made in the tax system to enhance revenue collection. The PAL rate was increased from 3 per cent to 5 per cent, while a concessionary PAL rate of 2 per cent was imposed on some categories of petroleum oil and oil obtained from bituminous minerals, crude oil, organic chemicals, medicaments and selected categories of machinery such as extruding, drawing and sewing. The cess on certain items such as ceramic products, electric accumulators and garments was increased while, cess was imposed on new items, including safety glasses, parts of footwear and sorghum. The NBT was imposed at a rate of 1 per cent on the liable turnover of importers, manufacturers and service providers with effect from 01 February 2009 and this was subsequently increased to 3 per cent with effect from 01 May 2009.

The Presidential Commission on Taxation was appointed in June 2009 to review and make its recommendations to improve and stregthen the tax system in Sri Lanka. The main tasks assigned included studying the country's tax system, to find out the reasons for declining revenue as a per cent of GDP and making proposals to remedy the situation. In addition, the Commission was dispensed to study the operations of numerous taxes at different levels of the government and propose ways and means to rationalise such taxes at national, provincial and local authority level with a view to maximise revenue objectives at each level. The problems connected with the implementation of the VAT system, the customs tariff regime, excise tax regime and various cess schemes were also among the areas to be examined by the Commission. The Commission submitted its interim report to the Government in November 2009.

A proactive stimulus package of Rs. 16 billion was announced by the government to assist mainly the export oriented industries affected by the global economic recession. The package included the reduction in the prices of petrol, diesel, kerosene, LP gas and passenger bus fares and removal of the Fuel Adjustment Levy charged by the Ceylon Electricity Board (CEB) for tourist hotels and industries, provision of a limited volume of petrol for three wheelers at a subsidized price and implementation of subsidy schemes for manufacturers who are engaged in the rubber industry. Concessions, such as a debt moratorium of 6 months in respect of outstanding credit facilities and waiving off of the penal interest imposed on any defaulted credit facilities were granted for the tourism industry.

The government focused towards rationalising recurrent expenditure while streamlining capital expenditure. Accordingly, in Budget 2009, all the Ministries and Departments were requested to reduce their recurrent expenditure by 2 per cent from the amount indicated in the Appropriation Act by freezing expenditure allocated on fuel, water and electricity, preferably by 10 per cent. In addition, domestic funds for capital expenditure were only made available on priority basis.

Additional benefits were provided to the public sector employees and pensioners. The Cost of Living Allowance (COLA) of public sector employees and pensioners was increased twice in 2009. Measures were introduced to offer Widows'/ Widowers' & Orphans' Pension entitlement for the members of voluntary armed forces, to enhance the relief granted to persons who suffered from terrorist acts while they were in service, and to revise the pension payments for disabled orphans. In addition, the special allowance given to defence personnel serving in the conflict affected areas were extended to all defence personnel. Housing and property loans, which were provided under subsidised interest rates for the public sector employees, through the state banks, also continued during the year.

The government continued its public investment programme by giving priority to ongoing major infrastructure projects while continuing the infrastructure development activities in the Northern and Eastern provinces. Construction work of mega infrastructure development projects, including power projects such as the Kerawalapitiya Combined Cycle Power Plant (Phase II), Norochcholai Coal Power Plant, Upper Kotmale Hydro Power Plant; road development projects such as the Southern Highway Project, Colombo - Katunayake

Expressway, Colombo Outer Circular Road Project; port development projects such as the Colombo South Habour Project, Hambantota Port and Oluvil Port Development projects; and water supply projects were continued. In addition, rural infrastructure development projects, including *Gama Neguma, Maga Neguma*, small irrigation projects, *Kirigammana* projects and rural electrification projects were also continued. In addition, six flyovers were constructed and a number of large bridges, including Sri Lanka's longest bridge at Kinniya and Irakkandi bridge in the Eastern province were completed.

The welfare facilities provided to the Internally Displaced Persons (IDPs) in the Northern province, immediately after the conflict, also contributed to increase government recurrent expenditure above its targets for 2009. The IDPs were provided with the basic needs such as cooked meals and dry rations, water and sanitation facilities, shelter, clothing, hygiene packs, nursing and emergency health facilities. Health facilities were provided by increasing the cadre, establishing field hospitals, conducting daily medical camps, deploying adequate stocks of essential drugs and providing preventive healthcare facilities. The IDPs were also provided with counselling and legal assistance, while catering to special needs of children, women, pregnant mothers, differently-abled persons and elders. The school aged children among the IDPs were provided with education facilities.

With the complete liberation of the Northern and Eastern provinces, the government took measures to develop basic infrastructure in these provinces to expedite the resettlement of IDPs and establish their livelihoods. For the development of the Eastern province, the *Nagenehira Nawodaya* programme was continued and large-scale development and welfare programmes were implemented under different Ministries. The Ministries focused on implementing RRR activities in the Northern province under the 180-day programme and a two year medium term programme called *Wadakkil Wasantham* to rebuild houses, roads, hospitals, schools etc. in the affected areas (See Box No. 2).

The Public Enterprises Reform Programme (PERP) was continued in 2009 with changes to several public enterprises being introduced to make their operations more vibrant and commercially viable. Accordingly, operations of Hingurana sugar factory was recommenced under the new name of "Galoya Plantations Limited" as a Public Private Partnership (PPP). Measures were taken to liquidate the Lanka Salusala Enterprise and resume its operations with a new business plan as a new entity called "Laksalusala". However, considering the adverse monetary and fiscal implications of feeble financial operations of key State Owned Enterprises (SOEs), introduction of an effective, strong reform programme to make them commercially viable and profitable institutions and enable them to make a greater contribution to the economy is required as an urgent policy priority.

The Strategic Enterprise Management Agency (SEMA) continued its activities of facilitating the SOEs to improve their performance. The SEMA has recommended several initiatives to implement power sector reforms and explored ways and measures of reducing the unaccounted water of the National Water Supply and Drainage Board (NWS&DB). It also explored possibilities for Sri Lanka Railways (SLR) to change its passenger centric revenue model to multiple modes of revenue such as property development, communication, freight and advertising.

Sources of deficit financing were further diversified in 2009 by broadening the investor base of government securities. Accordingly, rupee denominated Treasury bill and Treasury bond markets were opened up for Sri Lankan diaspora and migrant workers. External commercial resources were also mobilised through issuing the second international sovereign bond of US dollars 500 million in October 2009.

Several measures were introduced to further develop the domestic debt market. Foreign investment in rupee denominated Treasury bills and Treasury bonds was further encouraged with the objective of mobilising external commercial resources through non-conventional external markets. Maximum efforts were made to issue

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the bulk of new Treasury bonds with longer-term maturities and certain series of Treasury bills were retired before maturity and they were converted into Treasury bonds to mitigate the high rollover risk of the debt portfolio. Stability in Primary Dealer (PD) system was strengthened to ensure a sound regulatory framework for PDs. Necessary steps have been taken to implement a PD diversification programme to minimise market risk and to ensure financial stability by maintaining PD system stability. In addition, island-wide investor awareness seminar programmes and advertising campaigns through electronic and printed media were also carried out to promote government securities.

6.3 Government Budgetary Operations

Revenue

Total government revenue in 2009 increased by 7 per cent to Rs. 702.6 billion. The tax revenue increased by 6 per cent while the non-tax revenue increased at a higher rate of 20 per cent compared to that of 2008. However, the total revenue was Rs. 23.1 billion lower than the revised estimates of Rs. 725.7 billion owing to slowdown in the collection of tax revenue, which was attributable to the decline in international trade related taxes and reduced domestic economic activity alongside the global economic recession. The non-tax revenue increased mainly due to income from profit transfers of public institutions. As a per cent of GDP, total government revenue in 2009 declined to 14.6 per cent compared to that of 14.9 per cent in 2008.

Despite granting of certain tax exemptions and concessions, revenue from income tax increased by 10 per cent during the year. All the key components of income tax, namely personal and corporate income taxes, ESC and withholding tax on interest income contributed to this increase. Continued efforts to enhance the efficiency of the tax collection system through policy and administrative measures contributed to an increased level of corporate and personal tax revenue. The increase in withholding tax on interest was mainly due to the larger volume of Treasury bills and Treasury bonds issued during 2009.

In 2009, revenue from VAT declined by 16 per cent to Rs. 171.5 billion. This was reflected in import related VAT due to a substantial reduction in imports and the reduction of the standard VAT rate from 15 per cent to 12 per cent with effect from 01 January 2009. The sharp drop in import of motor vehicles and electrical appliances had a direct impact on low revenue collection from import related VAT in 2009 in addition to VAT exemptions granted for certain imported items to encourage domestic economic activities. Meanwhile, revenue collection from VAT on domestic economic activities increased marginally by 1 per cent in 2009 over that of the previous year despite the increase in VAT threshold and VAT exemptions granted on projects such as *Gama Neguma* and *Maga Neguma* which are carried out through the participation of the community.

Government revenue from excise taxes declined by 3 per cent to Rs. 97.6 billion in 2009. This drop was mainly due to the decline in the revenue generated from excise tax on motor vehicles. However, the introduction of excise tax on LP gas and upward revisions of excise tax rates on liquor and cigarettes partly offset the decline in revenue from excise taxes.

Revenue generation from import duty and SCL increased by 25 per cent and 30 per cent, respectively, in 2009 compared to that of 2008. Even though the volume and the value of imports during the year dropped sharply, the introduction of some specific duties on selected items such

Chart 6.2 Composition of Government Revenue - 2009

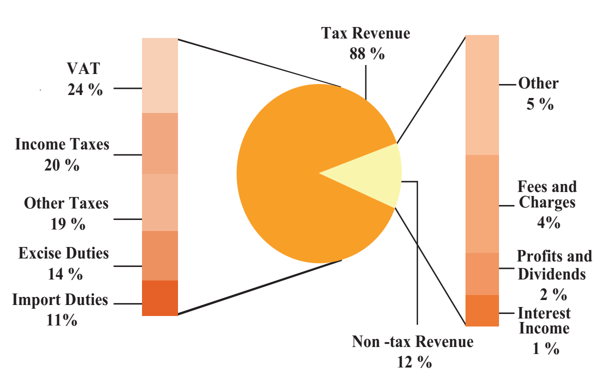


Table 6.2 Economic Classification of Revenue

Item	2008	2009 Approved Estimates	2009 Revised Estimates (a)	2009 Provi-sional
	Rs. million			
Tax revenue	585,621	779,138	655,779	618,933
Income taxes	126,541	166,703	149,717	139,558
VAT	203,646	221,947	185,672	171,529
Excise Tax	100,970	134,965	114,800	97,604
Import duties	63,844	90,592	60,267	79,660
Other taxes	90,620	164,931	145,323	130,582
Non tax revenue	69,639	75,861	69,929	83,711
Total revenue	655,259	854,999	725,708	702,644
	As a per cent of GDP			
Tax revenue	13.3	14.9	13.3	12.8
Income taxes	2.9	3.2	3.0	2.9
VAT	4.6	4.3	3.8	3.6
Excise Tax	2.3	2.6	2.3	2.0
Import duties	1.4	1.7	1.2	1.7
Other taxes	2.1	3.2	3.0	2.7
Non tax revenue	1.6	1.5	1.4	1.7
Total revenue	14.9	16.4	14.8	14.6

(a) The numbers used for the IMF Stand-by Arrangement (SBA).

Source : Ministry of Finance and Planning

as petroleum products, edible oil and milk powder contributed to increase the revenue from import duty. However, the reduction of duty rates on major food items and granting of duty waivers on petrol and diesel and several other items during the latter part of the year had a negative effect on revenue. With the increase of SCL in some food items in early part of the year, revenue from SCL increased significantly during the first three quarters of 2009. However, the government policy decision to reduce the SCL rates on several key food items during the fourth quarter of 2009 decelerated the increase in revenue collection from SCL towards the latter part of the year.

Cess levies and NBT made an important contribution to the government revenue in 2009. Revenue from cess increased by 10 per cent to Rs. 26.9 billion during 2009. The upward revision of cess rates on selected items and introduction of cess on new items contributed largely to this increase. The newly introduced NBT helped to generate a revenue of Rs. 27.2 billion in 2009 and accounted for 3.9 per cent of the total tax revenue during the year. Revenue collection from PAL increased by 17 per cent mainly due to the increase in the PAL rate during the year.

Non-tax revenue increased by 20 per cent in 2009. This increase was attributable to increased level of profit transfers and payments of dividends by public institutions including the CBSL and the increase in social security contributions arising from the higher level of salaries and wages of public sector employees as well as enhanced revenue collection from fees and charges. However, the revenue from interest income and rent income, declined by 3 per cent and 30 per cent, respectively.

The foreign grants received in 2009 was Rs. 25.9 billion compared with that of Rs. 31.2 billion received in 2008. Continuing the trend that prevailed in the recent past, foreign grants received were mainly from bilateral donors. An increase in foreign grants cannot be expected in the future since the country has now graduated to a lower middle income country.

Expenditure and Net Lending

In 2009, total expenditure and net lending increased by 21 per cent to Rs. 1,201.9 billion. This was a combined outcome of the increase in recurrent expenditure by 18 per cent and capital expenditure and net lending by 28 per cent. As a per cent of GDP, total expenditure and net lending amounted to 24.9 per cent, compared with that of 22.6 per cent in the previous year.

In nominal terms, recurrent expenditure increased by 18 per cent to Rs. 879.6 billion in 2009. As a per cent of GDP, it increased to 18.2 per cent from 16.9 per cent recorded in 2008. The increase was mainly due to the rise in expenditure on salaries and wages, pension payments, interest payments, counter terrorism activities, provision of humanitarian facilities for IDPs and resettlement activities in conflict affected areas. Expenditure on salaries and wages increased by 13 per cent to Rs. 271.2 billion mainly due to the new recruitments to the defence and other government services, increase of COLA to public sector employees and rectification of salary anomalies. The share of salaries and wages in the total recurrent expenditure was 30.8 per cent. The increase in pension payments by 14 per cent was mainly due to the increase in monthly COLA

Box 11

Investing Decisively on Defence to Achieve Peace

Sri Lanka was able to record a historic milestone by overcoming one of the most ruthless terrorist organisations of the world within a period of less than 4 years. Over such period, the President and the government made a determined effort to defeat the terrorists who had been waging an insurgency against the state for nearly three decades. Many attempts were made since the early 1980's by successive governments to eradicate terrorism and usher lasting peace to the country. It was however, during the past four years that a well planned and a focussed attempt was made with a strong and unwavering commitment on the part of the government, which perhaps was the single most important factor that led to this outcome.

While engaging in the humanitarian effort to liberate the country from terrorism during the last four years, Sri Lanka was also able to successfully overcome many challenges. The achievement of economic growth of 6 per cent on average during the period from 2006 to 2009 is most noteworthy. This impressive growth performance compares very favourably with the average growth of 4.5 per cent that was recorded during the period 1983 to 2005. The GDP per capita income almost doubled to US dollars 2,053 in 2009 from US dollars 1,062 in 2004. Poverty levels reduced to 15.2 per cent in 2006/07 from 28.8 per cent in 1995/96. At the same time, a number of large scale infrastructure projects in the areas of ports, roads, and power and energy were implemented in order to expand the total production capacity of the country.

In the four years, from 2006 to 2009, Sri Lanka's total defence expenditure amounted to Rs. 605 billion or US dollars 5.5 billion; an average of Rs. 151 billion or US dollars 1.4 billion per year, about 3.5 to 4.0 per cent of GDP. This included the cost of aircrafts, ships, battle tanks, arms, ammunition, other equipment, training, wages, food and uniforms for soldiers. This total cost of the humanitarian operations at US dollars 5.5 billion is just a fraction of the cost that has been incurred by the US government up to 2009, in its offensive in Iraq at US dollars 683 billion and in Afghanistan at US dollars 227 billion. In fact, the cost incurred by the US government on clothing and medical equipment alone for their forces in Iraq and Afghanistan for just one year in 2006 amounted to US dollars 2.6 billion while the US government training cost in Afghanistan and Iraq amounted to US dollars 12.9 billion for the year 2007 *(Source: Congressional Research Service Report of 28 September 2009 to the US Congress)*. These comparisons seem to indicate that Sri Lanka's overall financial cost of the war against terrorism had been well managed and highly cost effective.

Table B 11.1 Defence Expenditure in Sri Lanka: 2006-2009

	2006	2007	2008	2009	Total
Rs. billion	106.4	134.3	175.9	188.6	605.2
US $ billion	1.0	1.2	1.6	1.6	5.5
% of GDP	3.6	3.8	4.0	3.9	3.8(a)

(a) Average 2006 - 2009

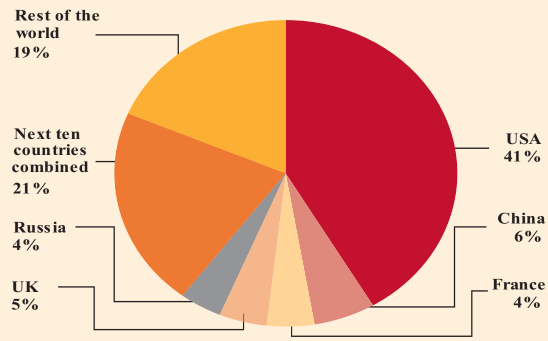
Sources: Ministry of Finance and Planning
Central Bank of Sri Lanka

The successful conclusion of the challenging humanitarian effort to liberate the country at a relatively low financial investment within a short period of time thereby realising the prospect of achieving long term peace dividends is commendable. At the same time, it must also be acknowledged that the loss of human life and the pain and suffering that this conflict imposed on the country can never be quantified in monetary terms. Nevertheless, with the long awaited peace now in place, Sri Lanka will be able to finally create the opportunities to unleash its enormous potential to grow rapidly and usher economic prosperity to all its people who have suffered from terrorism for several decades.

Peace is a vital prerequisite in achieving sustainable economic growth and alleviating poverty. This is because of the adverse repercussions associated with war, which ranges from the destruction of physical wealth to the loss of human lives. In addition, wars divert resources from productive sectors to not so productive sectors. Hence, peace is paramount as the real benefits of economic development and freedom can be enjoyed only in times of peace.

Numerous wars have been fought in the history of mankind and even today, many internal and international conflicts and wars are a frequent occurrence. Unfortunately, wars require incurring a significant quantum of military and other expenditure that will have to be ultimately borne by the public. According to the Stockholm International Peace Research Institute (SIPRI), the military expenditure of the world in 2008 was estimated at US dollars 1,464 billion[1]. In real-terms, this is an increase of 4 per cent over that of 2007 and of a 45 per cent increase since 1999. This is equivalent to 2.4 per cent of the world's gross domestic product (GDP) and US dollars 217 per person.

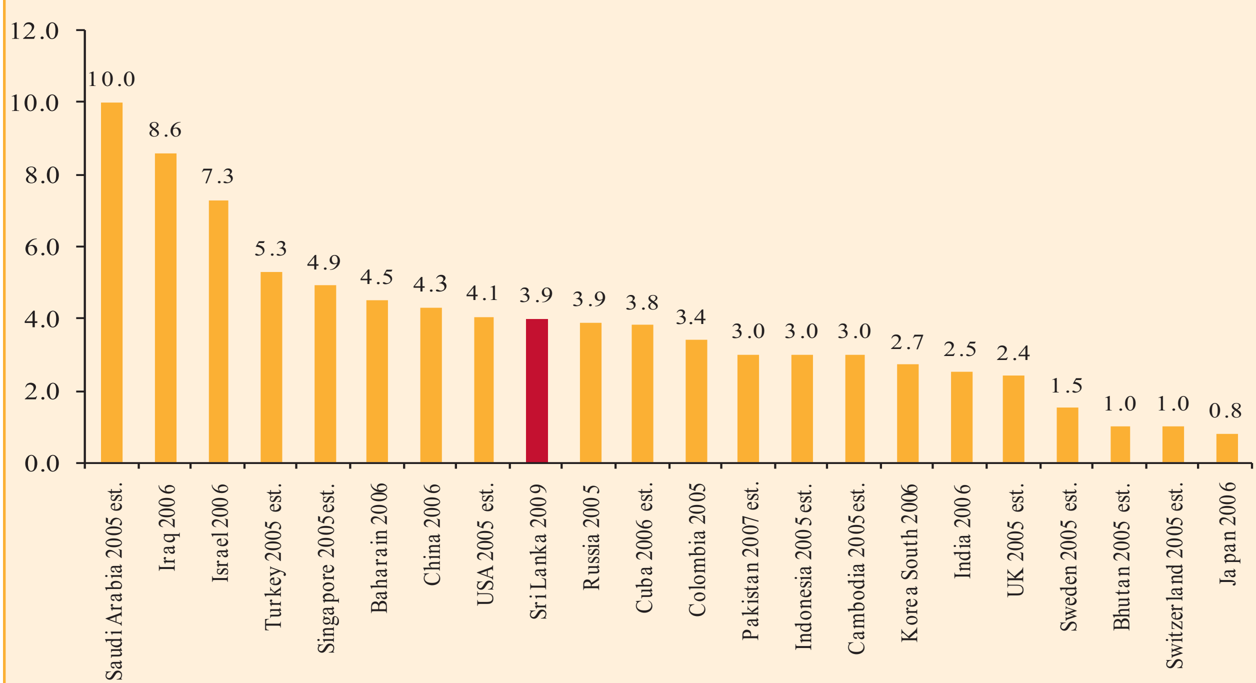
Chart B 11.1 **Global Distribution of Military Expenditure - 2008**



Source: Stockholm International Peace Reasearch Institute, Year Book - 2009

The distribution of the military expenditure has significant variations across the countries in the world. It is particularly interesting to note that some countries maintain high military expenditure, irrespective of the prevalence of conflicts as shown in chart B 11.2.

Chart B 11.2 **Defence Expenditure of Selected Countries (As a per cent of GDP)**



Sources: CIA-The World Fact Book
Ministry of Finance and Planning

1 The SIPRI definition of military expenditure includes, all current and capital expenditure on the armed forces, including peace keeping forces, defence ministries and other government agencies engaged in defence projects, paramilitary forces when judged to be trained, equipped and available for military operations and military space activities(http://www.sipri.org).

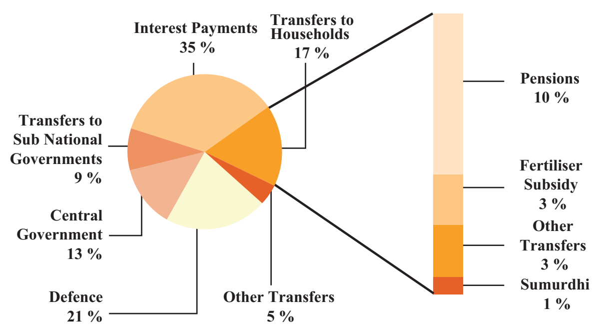
Table 6.3 Economic Classification of Expenditure and Lending Minus Repayment

Item	2008	2009 Approved Estimates	2009 Provi-sional
		Rs. million	
Current expenditure	**743,710**	**823,511**	**879,575**
Expenditure on goods and services	360,327	378,554	379,731
o/w Salaries and wages	239,078	268,356	271,229
Interest payments	212,475	250,438	309,675
Foreign	30,277	32,000	35,698
Domestic	182,198	218,438	273,978
Current transfers and subsidies	170,908	194,519	190,168
o/w To households and other sectors	131,342	149,062	148,993
Samurdhi	9,995	10,850	9,267
Pensions	74,920	86,000	85,139
Fertiliser subsidy	26,450	25,000	26,935
Other	19,977	27,212	27,652
Capital expenditure	**232,607**	**312,383**	**277,416**
Acquisition of real assets	128,605	212,513	143,590
Capital transfers	104,002	170,941	133,826
Provision for under expenditure	-	-71,071	-
Lending minus repayments	**19,809**	**55,778**	**44,936**
Total expenditure and net lending	**996,126**	**1,191,671**	**1,201,927**
		As a per cent of GDP	
Current expenditure	**16.9**	**15.8**	**18.2**
Expenditure on goods and services	8.2	7.3	7.9
o/w Salaries and wages	5.4	5.1	5.6
Interest payments	4.8	4.8	6.4
Foreign	0.7	0.6	0.7
Domestic	4.1	4.2	5.7
Current transfers and subsidies	3.9	3.7	3.9
o/w To households and other sectors	3.0	2.9	3.1
Samurdhi	0.2	0.2	0.2
Pensions	1.7	1.6	1.8
Fertiliser subsidy	0.6	0.5	0.6
Other	0.5	0.5	0.6
Capital expenditure	**5.3**	**6.0**	**5.7**
Acquisition of real assets	2.9	4.1	3.0
Capital transfers	2.4	3.3	2.8
Under expenditure	-	-1.4	-
Lending minus repayment	**0.4**	**1.1**	**0.9**
Total expenditure and net lending	**22.6**	**22.8**	**24.9**

Source: Ministry of Finance and Planning

and the addition of about 11,082 new pensioners to the system. High interest rates that prevailed in the domestic market particularly during the first half of the year, amidst the increased level of domestic borrowings was the main reason for the significant increase in interest payments to Rs. 309.7 billion in 2009. The intensified counter terrorism activities in the Northern province during the first half of the year, providing basic needs for IDPs, and resettlement activities under the *Wadakkil Wasantham* - 180 Day Programme led to an increase in expenditure on other goods and services.

Chart 6.3 Composition of Government Recurrent Expenditure - 2009



The current transfers and subsidies increased by 11 per cent in 2009. Transfers to public corporations increased by 9 per cent, while the current transfers to public institutions increased by 2 per cent. The expenditure on fertiliser subsidy and the Samurdhi programme remained almost at the same level as in 2008, at Rs. 26.9 billion and Rs. 9.3 billion, respectively. The expenditure on other welfare programmes increased significantly by 38 per cent in 2009 given the expenditure related to IDPs.

Public investment, in nominal terms, increased by 25 per cent to Rs. 330.4 billion in 2009. This increase was mainly due to the continuation of mega infrastructure development projects, provincial and rural infrastructure development projects, rehabilitation of minor irrigation projects and implementation of rural electrification projects. Higher attention was also given to the rehabilitation and reconstruction of infrastructure facilities in the conflict affected areas in the Eastern province. In addition, basic infrastructure facilities were provided in conflict affected areas to

Chart 6.4 Total Expenditure by Functions - 2009

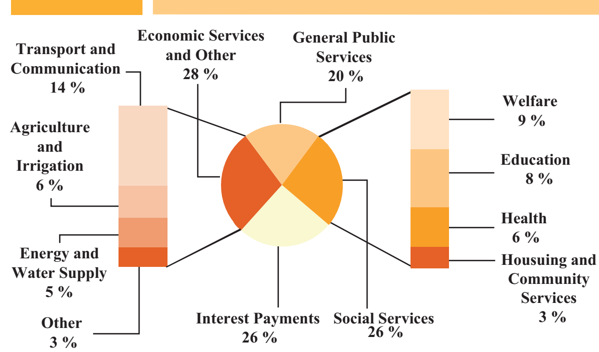


Table 6.4 **Functional Classification of Expenditure**

Item	2008	2009 Approved Estimates	2009 Provi-sional
	Rs. million		
Total current expenditure	**743,710**	**823,511**	**879,575**
General public services	207,348	218,598	224,281
Civil administration	36,150	43,213	37,723
Defence	134,710	134,260	144,284
Public order and safety	36,487	41,125	42,274
Social services	240,768	266,168	260,071
Education	77,141	81,827	82,414
Health	55,874	60,726	58,789
Welfare	94,789	109,878	105,017
Community services	12,963	13,736	13,852
Economic services	80,303	84,148	85,188
Agriculture and irrigation	41,579	41,566	43,967
Energy and water supply	3,323	4,154	3,429
Transport and communcation	29,587	30,065	31,068
Other	5,814	8,363	6,724
Other	215,291	254,597	310,035
o/w Interest payment	212,475	250,438	309,675
Capital expenditure and lending	**263,860**	**370,765**	**330,448**
General public services	34,404	39,693	20,094
Civil administration	29,675	36,685	18,685
Public order and safety	4,728	3,008	1,409
Social services	60,236	97,738	53,938
Education	22,942	36,269	18,093
Health	18,674	25,953	12,663
Housing	4,826	9,659	5,291
Community services	13,794	25,857	17,891
Economic services	168,879	304,054	256,411
Agriculture and irrigation	17,681	34,255	22,105
Energy and water supply	48,783	80,326	59,983
Transport and communcation	82,916	148,934	139,104
Other	19,499	40,539	35,219
Other	341	350	5
Under expenditure	-	-71,071	-
Total expenditure and lending	**1,007,569**	**1,194,276**	**1,210,023**
	As a per cent of GDP		
General public services	5.5	5.0	5.1
Social services	6.8	7.0	6.5
Economic services	5.6	7.4	7.1
Other	4.9	4.9	6.4
o/w interest payments	4.8	4.8	6.4
Total expenditure and lending	**22.8**	**22.9**	**25.1**

Source : Ministry of Finance and Planning

initiate resettlement and to re-establish livelihood activities. As a per cent of GDP, public investment increased to 6.8 per cent, compared to that of 6.0 per cent in the previous year.

As in the previous years, public investment in economic services continued to increase in 2009 due to the implementation of several projects, mainly in the areas of transportation, communication, energy and water supply. The public investment on economic services increased substantially by 52 per cent in 2009. Public investment in social services was amounted to Rs.53.9 billion, of which, Rs.18.1 billon was for education sector and Rs.12.7 billion was for health sector. The investment in education was directed towards upgrading educational infrastructure and developing identified schools in selected Divisional Secretariat areas. Public investment in the health sector was mainly directed towards improving access to healthcare focusing on vulnerable people, while developing health infrastructure and other facilities.

Key Fiscal Balances

The overall budget deficit in 2009 was 9.8 per cent of GDP (Rs. 473.4 billion) compared to 7.0 per cent of GDP expected in the revised estimates. This was a reversal of the decreasing trend that prevailed in the past three consecutive years. The significant shortfall in the government revenue, overrun in the recurrent expenditure and the increase in public investment over and above the expected level during the year were the main reasons for this increase. As a result, the current account deficit, which is defined as the government's dis-savings, increased to 3.7 per cent of GDP compared to 2.0 per cent recorded in 2008 and 2.1 per cent expected in the revised estimates. The primary deficit, which is the overall deficit net of interest payments, increased to 3.4 per cent of GDP from 2.2 per cent recorded in 2008. The higher growth in the non-interest recurrent expenditure, which outpaced the growth in revenue, was the main reason for the higher primary deficit.

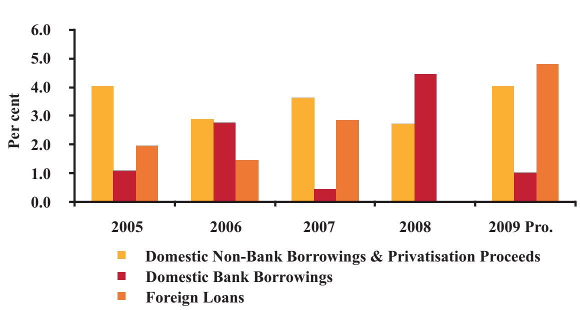
Financing the Budget Deficit

Foreign sources contributed significantly in financing the overall budget deficit in 2009 compared to that of 2008. Net Foreign Financing (NFF) amounted to Rs. 230.8 billion, compared to the revised estimate of Rs. 34.4 billion and the repayment of Rs. 4.6 billion in 2008. Accordingly, net domestic financing (NDF) declined to Rs. 242.6 billion in 2009, compared to the revised estimate of Rs. 308.5 billion and that of Rs. 314.3 billion in 2008. However, in the first half of the year, financing from foreign sources remained low reflecting the spillover effects of the global financial crisis, which resulted in a net outflow of foreign investments in Treasury bills and Treasury bonds and difficulties in mobilising funds from foreign capital markets. Hence, the government had to depend more on domestic financing during the first half of the year. However, this situation changed significantly with the ending of the conflict in May 2009 and the approval of the IMF Stand-by Arrangement (SBA) facility in July 2009. The successful completion of the second international sovereign bond issue and the increase in foreign investments in Treasury bills and Treasury bonds improved the foreign financing position sharply in the second half of the year.

Government borrowings from the banking system declined significantly to Rs. 49.0 billion in 2009. This was a combined outcome of Rs. 109.2 billion of repayments to the CBSL and Rs. 158.3 billion net borrowings from commercial banks. Accordingly, the bank borrowings accounted for 20 per cent of the total NDF against that of 62 per cent in 2008. The relative share of the non-bank sector borrowings increased to 80 per cent in 2009, compared with that of 38 per cent in 2008. As in previous years, the Employees' Provident Fund (EPF) and National Savings Bank (NSB) continued to be the key institutional investors in the non-bank sector.

NDF was raised largely through instrument borrowings in 2009 as in previous years. This consisted of borrowings made through Treasury bills (Rs. 49.0 billion), Treasury bonds (Rs. 201.9 billion), SLDBs (Rs. 7.6 billion) and a repayment of Rupee loans (Rs. 17.7 billion). The maturity structure

Chart 6.5 **Deficit Financing (As a per cent of GDP)**



of the instrument borrowings was more towards the medium term, as observed in 2008. However, with the decline in the domestic interest rates in the latter part of 2009, it was observed that there was a slight tendency towards longer term maturities. A net borrowing of Rs. 1.8 billion was recorded in the total net domestic non-instrument borrowings in 2009.

There was a net repayment of the foreign currency denominated domestic borrowings in 2009. During the year, gross borrowings through SLDBs amounted to Rs. 62.0 billion (US dollars 541.1 million) while there was a repayment of Rs. 54.5 billion (US dollars 475.3 million). Meanwhile, gross borrowing from Off-shore Banking Units (OBUs) amounted to Rs. 11.4 billion (US dollars 100.0 million) and the repayment amounted to Rs. 19.3 billion (US dollars 168.0 million). Accordingly, the net repayment of foreign currency denominated domestic borrowings amounted to Rs. 280.0 million (US dollars 2.2 million).

The government was able to mobilise a significant amount of foreign sources for financing the budget deficit in 2009. Issuance of the international sovereign bond amounting to Rs. 57.4 billion (US dollars 500.0 million) and foreign investment in Treasury bills and Treasury bonds amounting to Rs.146.9 billion (US dollars 1,278.0 million) contributed largely to the total disbursed

Table 6.5 **Sources of Domestic Financing**

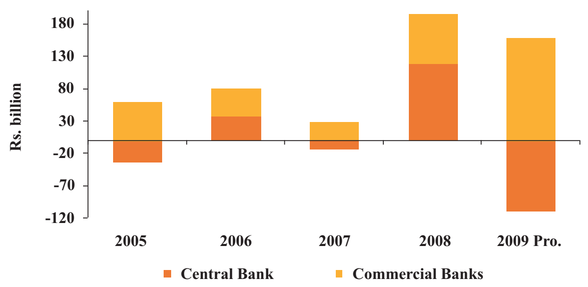
Rs. billion

Item	2006	2007	2008	2009 Provisional
By Instrument	**163.8**	**127.7**	**314.3**	**242.6**
Treasury bonds (a)	97.4	52.8	192.4	201.9
Treasury bills (b)	20.3	37.1	69.8	49.0
Rupee loans	-23.8	10.3	-1.5	-17.7
Sri Lanka Development Bonds	34.3	23.6	65.5	7.6
Central Bank provisional advances	9.3	11.7	15.6	-2.4
Other	26.3	-7.8	-27.5	4.2
By Source	**163.8**	**127.7**	**314.3**	**242.6**
Bank	80.0	15.8	195.2	49.0
Non Bank	83.8	112.0	119.0	193.6

(a) Excludes rupee denominated Treasury bonds issued to foreign investors in 2007, 2008 and 2009 and to Sri Lankan diaspora and migrant workforce in 2009.
(b) Excludes rupee denominated Treasury bills issued to foreign investors in 2008 and 2009 and to Sri Lankan diaspora and migrant workforce in 2009.

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

Chart 6.6 Sources of Bank Financing



gross foreign loans of Rs. 355.8 billion (US dollars 3,103.2 million) recorded in 2009. Out of this, about 21.7 per cent (Rs. 77.3 billion) was on concessional basis while the rest was on non-concessional terms. Project loans received from bilateral and multilateral development partners contributed to about 41.2 per cent of total foreign loans. The major lenders of project loans in 2009 were government of Japan, the government of China and the Asian Development Bank (ADB). The total net foreign financing included foreign investments in Treasury bills and Treasury bonds amounting to Rs. 32.1 billion and Rs. 114.8 billion, respectively for the year 2009.

6.4 Budgetary Operations in Sub National Governments

The Ministry of Local Government and Provincial Councils (MLGPC) continued a close coordination with the Sub National Governments (SNGs) in 2009. The SNG system in Sri Lanka consists of Provincial Councils (PCs) and Local Governments (LGs). There are 9 PCs established under the 13th Amendment to the Constitution. The LG system in the country constitutes of 330 institutions comprising of 18 Municipal Councils (MCs), 42 Urban Councils (UCs) and 270 Pradesheeya Sabhas (PSs) as at end 2009. As in the previous years, budgetary allocations to SNGs as recommended by the Finance Commission (FC) were channelled through the MLGPC. During the year, MLGPC also engaged in improving the administrative capacity and capabilities of SNGs and increasing investment at SNG level, with a view of prioritizing regional development.

During the year, several initiatives were taken by the FC to promote balanced regional development. Based on the new guidelines prepared jointly by the FC and the PCs, 23 sectors have been identified for the capital budget under 5 main categories; economic infrastructure development, social infrastructure development, industries development, agriculture development and community development. Proposals submitted by Sabaragamuwa, North Western and Western provinces under the Regional Development Initiatives Programme were approved by the FC based on the recommendations made by the Steering Committee.

The FC has also initiated a mechanism to review the provincial fiscal position from 2009 onwards with the objective of alleviating discrepancies in fund allocation among the provinces. This would help to ensure fair distrubution and apportionment of actual budgetary allocation by the General Treasury. The FC is also in the process of building rational criteria based on normative assessments of provincial financial needs for the determination of the total allocation by the central government and apportioning the allocated grants among the provinces. Further, FC has revised circulars issued to the provinces under Province Specific Development Grant (PSDG) and Criteria Based Grant (CBG) expenditures considering the current provincial needs. The gap between provincial level fund requirements and actual allocation from the central government is the major issue in the operations of PCs.

Performance of Provincial Councils

Total revenue collection of PCs declined by 6 per cent in 2009 to Rs. 29.4 billion. This was mainly due to the drop in revenue collection of the Western Provincial Council (WPC) by 10 per cent reflecting mainly the slowdown in domestic economic activity during the year. However, as in the previous years, revenue collection in the WPC continued to be the major contributor of the revenue of PCs.

Recurrent expenditure of PCs increased by 8 per cent in 2009. This was mainly due to increased personnel emoluments which contributed

Table 6.6 Budget Outturn for Provincial Councils

Rs. million

Item	2006	2007	2008	2009 Provisional
Total revenue	**19,481**	**25,868**	**31,368**	**29,433**
Tax Revenue	16,586	21,473	25,992	24,907
Non-Tax Revenue	2,895	4,395	5,376	4,526
Total expenditure	**94,470**	**113,067**	**120,011**	**130,260**
Current expenditure	76,428	92,721	103,199	111,336
o/w Personal emoluments	60,497	74,711	79,717	85,855
Capital expenditure	18,042	20,346	16,812	18,924
Central government transfers	**79,029**	**88,317**	**88,942**	**93,999**
Block grants	62,342	70,742	76,773	77,386
Criteria based grants	790	1,208	2,304	2,276
Matching grants	221	205	-	-
PSDGs (a)	7,345	6,995	7,262	10,945
Foreign grants for special projects	8,331	9,167	2,603	3,393

(a) Province Specific Development Grants

Sources: Ministry of Local Government and Provincial Councils
Central Bank of Sri Lanka

to 77 per cent of total recurrent expenditure due to new recruitments to provincial services and the increase of the COLA. The education and health sectors absorbed a major portion of the personal emoluments of PCs and the balance was used for other expenses in relation to purchase of goods and services.

The total capital expenditure of PCs in 2009 increased by 13 per cent to Rs. 18.9 billion. The investment programmes of PCs mainly consisted of PSDP, foreign funded special projects and CBG as well as projects under PPPs. Major projects implemented under PPPs included two Municipal Solid Waste Composed Projects, Tourism and Tourism Resources Improvement Project, Urban Council Plastic Recycling Project in the Western Province, Sectoral Development Project for Poverty Alleviation and Project for Development of Industrial Park in the North Western province. The Ma-oya Area Development Project, which aims to develop tourism around the Pinnawala Elephant Orphanage, was also in progress.

In 2009, the central government transfers to PCs increased by 6 per cent to Rs. 94 billion. As in previous years, major portion of government transfers amounting to 82 per cent of total transfers, was block grants. This was mainly to meet the recurrent expenditure. The balance was for investment expenditure through PSDG, CBG and foreign grants for special projects.

Performance of Local Governments

The major sources of financing in LGs are devolved revenue and transfers from the central government. In collecting some of the devolved revenues, such as property transfer taxes and court fines as assigned under the 13th Amendment to the Constitution, PCs act as the agent for LGs.

6.5 Government Debt and Debt Service Payments

Government Debt

Total outstanding government debt increased by 16 per cent to Rs. 4,161.4 billion as at end 2009 compared to Rs. 3,589.0 billion as at end 2008. Government debt, as a per cent of GDP, increased to 86.2 per cent in 2009 from 81.4 per cent recorded in 2008. This increase in 2009 was due to the combined effect of the lower growth in nominal GDP and increase in the budget deficit. The total government debt consisted of 58 per cent of domestic debt and 42 per cent of foreign debt at the end of 2009. As a per cent of GDP, domestic debt was 49.8 per cent and foreign debt was 36.5 per cent.

The relative share of domestic debt in total government debt declined in 2009. This was due to higher borrowings from foreign sources, especially in the second half of the year through the second international sovereign bond issue and the higher level of foreign investments in the Treasury bills and Treasury bonds. However, of the total domestic debt, the share of the medium to long-term debt increased marginally to 77 per cent in 2009 compared to that of 76 per cent in 2008. Continuing the same trend that prevailed in previous years, Treasury bonds remained as the main instrument in raising domestic debt, contributing to 82 per cent of the medium to long-term domestic debt. Further, the share of Treasury bonds in the total domestic debt increased to 63 per cent in 2009 as against that of 60 per cent in 2008. The issuance of new Treasury bond series and conversion of the short-term debt instruments, especially Treasury bills to Treasury bonds, contributed largely to this increase. The outstanding amount of Treasury bills, which is the main instrument of short-term debt, increased by Rs. 38.4 billion to Rs. 441.0 billion during the year. Accordingly, the relative importance of Treasury bills in short-term debt increased marginally to 79 per cent from 78 per cent in 2008. Continuing the policy of gradually phasing out non-marketable debt instruments, issuing Rupee loans was gradually reduced and as such, there was a net repayment of Rupee loans amounting to Rs. 17.7 billion in 2009.

The total outstanding debt held by the non-bank sector increased by 14 per cent to Rs. 1,695.1 billion in 2009. This increase was reflected in Treasury bills and Treasury bonds held by the non-bank sector, increasing by 61 per cent and 11 per cent, respectively. As in the previous years, the EPF and NSB continued to be the two main investors in this category, contributing to 48 per cent and 15 per cent, respectively, of the non-bank sector outstanding debt.

The outstanding debt to the domestic banking sector increased by 7 per cent to Rs. 705.8 billion in 2009. The outstanding domestic debt owned by the CBSL decreased by Rs. 129.7 billion to Rs. 109.6 billion, while that of commercial banks increased by Rs. 178.0 billion to Rs. 596.2 billion in 2009. As a result, the share of banking sector debt to the total domestic outstanding debt declined to 29 per cent from 31 per cent in 2008. The sharp decline in the CBSL owned debt was attributable mainly to the reduction in the outstanding Treasury bills held by the

Chart 6.7 Outsanding Government Debt (As a per cent of GDP)

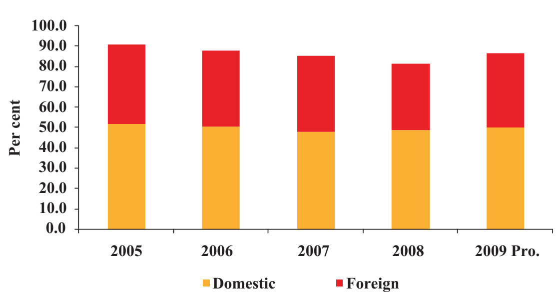


Table 6.7 Outstanding Government Debt (As at end year)

Rs. million

Item	2006	2007	2008	2009 Provisional
Total Government Debt	**2,582,648**	**3,041,686**	**3,588,962**	**4,161,422**
Domestic Debt (a)	**1,479,230**	**1,715,199**	**2,140,228**	**2,400,955**
By maturity period				
Short term	313,218	363,199	516,365	560,646
Medium and long term	1,166,012	1,351,999	1,623,863	1,840,309
By institution				
Banks (b)	395,470	415,318	657,424	705,765
Non bank sector	1,083,660	1,299,779	1,482,704	1,695,089
Foreign debt	**1,103,418**	**1,326,487**	**1,448,734**	**1,760,467**
By type				
Concessional loans	1,023,077	1,099,911	1,227,222	1,271,142
Non concessional loans	31,894	45,308	57,491	78,649
Commercial	48,448	181,268	164,020	410,677
By currency				
SDR	465,679	508,241	531,849	567,502
US dollars	185,647	266,645	280,435	330,842
Japanese yen	317,220	338,621	445,596	452,758
Euro	98,312	121,460	132,047	143,566
Other	36,560	91,520	58,807	265,799
Memo: Exchange rate variation	108,579	71,646	117,785	23,114

(a) Excludes the government Treasury bonds amounting to Rs. 4,397 million issued to comercial banks on behalf of CWE in November 2003.

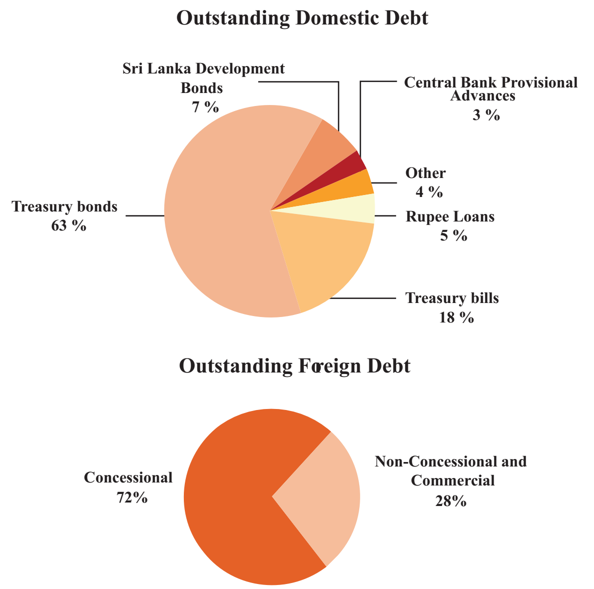
(b) Includes outstanding balance to OBUs.

Source: Central Bank of Sri Lanka

CBSL to Rs. 37.4 billion from Rs. 163.6 billion in the previous year. In contrast, Treasury bill and Treasury bond holdings of commercial banks increased substantially to Rs. 160.1 billion and Rs. 188.6 billion, respectively. The outstanding amount of foreign currency denominated domestic debt obtained from the commercial banks declined slightly during the year. With the net repayment of US dollars 68 million to the OBUs and net borrowing of US dollars 66 million through SLDBs, the outstanding amount of foreign currency denominated domestic debt declined marginally to US dollars 1,684 million by end 2009 from US dollars 1,686 million recorded in 2008.

The total outstanding foreign debt increased by 22 per cent to Rs. 1,760.5 billion in 2009. As a per cent of GDP, it increased to 36.5 per cent by end 2009 as against 32.8 per cent in 2008. The concessional debt, as a per cent of total outstanding foreign debt, declined to 72 per cent. Non-concessional debt increased by 37 per cent to Rs. 78.6 billion in 2009. Foreign commercial outstanding debt increased by 150 per cent to Rs. 410.7 billion due to the large foreign investments in Treasury bills and Treasury bonds and due to

Chart 6.8 Composition of Outstanding Government Debt - 2009



issue of the second international sovereign bond. The share of project loans in the total outstanding foreign debt declined to 77 per cent in 2009 from 87 per cent in 2008.

The outstanding foreign debt consisted of four major foreign currencies; Special Drawing Rights (SDR) (32.2 per cent), Japanese Yen (25.7 per cent), US dollars (18.8 per cent) and Euro (8.2 per cent). The Sri Lanka rupee depreciated against SDR, US dollar and Euro by 2.46 per cent, 1.09 per cent and 2.6 per cent, respectively, while it appreciated against Japanese Yen by 0.89 per cent during the year. Accordingly, the rupee value of the outstanding foreign debt stock increased by Rs. 23.1 billion in 2009, due to the net impact of the exchange rate variation.

Strong commitment and concerted efforts are necessary to achieve the targeted debt to GDP ratio of 60 per cent by 2013 stipulated in the Fiscal Management (Responsibility) Act (FMRA). Given the weak performance in government revenue collection, especially in the first quarter of 2009, the government had to borrow heavily to finance the budget deficit, thereby reversing the trend in the outstanding debt to GDP ratio. Rationalising the recurrent expenditure, while promoting alternative project financing methods, such as PPPs and reducing the fiscal burden arising from some state owned enterprises through reforms, would therefore be imperative in progressing in the fiscal consolidation path that has been already announced in various government policy documents.

Debt Service payments

Total debt service payments increased by 39 per cent to Rs. 825.7 billion in 2009. This consisted of amortisation payments of Rs. 516.0 billion (62.5 per cent of total debt service payments) and interest payments of Rs. 309.7 billion (37.5 per cent of total debt service payments). Amortisation payments to domestic sources stood at Rs. 401.3 billion, while that to foreign sources was Rs. 114.7 billion for the year. Total interest payments in 2009 was significantly higher than the original estimate of Rs. 250.4 billion mainly due to the increase in interest payments on domestic debt over and above the estimates. Total amortisation payments for the year included a part of the debt repayments, which was postponed under the voluntary debt moratorium received in 2005 after the tsumani and the repayment of deferred defence loans.

Debt service indicators deteriorated in 2009. The ratio of total debt service payments to government revenue increased further to 117.5 per cent from 90.5 in 2008, as a result of lower revenue growth and unexpectedly higher debt service payments caused

Table 6.8 Government Debt Service Payments

Rs. million

Item	2006	2007	2008	2009 Provisional
Debt service payments	444,303	500,514	592,804	825,687
Domestic	381,324	415,089	440,918	675,274
Foreign	62,979	85,425	151,886	150,414
Amortisation payments	293,525	317,833	380,330	516,012
Domestic	247,536	253,719	258,720	401,296
Foreign	45,989	64,114	121,609	114,716
Interest payments	150,778	182,681	212,475	309,675
Domestic	133,788	161,370	182,198	273,978
Short term	24,558	53,874	65,364	72,364
Medium and long term	109,230	107,496	116,834	201,613
Foreign	16,990	21,311	30,277	35,698

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

Table 6.9 **Government Debt Indicators**

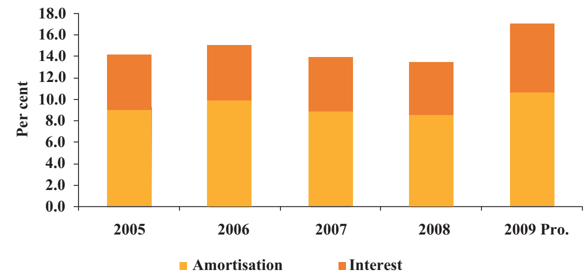
Indicator	2006	2007	2008	2009 Provisional
Government debt/GDP	87.9	85.0	81.4	86.2
Domesitc debt/GDP	50.3	47.9	48.5	49.8
Foreign debt/GDP	37.5	37.1	32.8	36.5
Total foreign debt/exports (a)	124.6	127.4	132.2	170.7
Total debt service/GDP	15.1	14.0	13.4	17.1
Total debt service/ government revenue (b)	93.0	88.6	90.5	117.5
o/w Domestic debt service/ government revenue (b)	79.8	73.5	67.3	96.1
Total debt service/ government expenditure (c)	44.1	43.2	43.1	48.1
o/w Domestic debt service/ government expenditure (c)	37.9	35.8	32.0	39.3
Foreign debt service/exports (a)	7.1	8.2	13.9	14.6
Total interest/GDP	5.1	5.1	4.8	6.4
Domestic interest/GDP	4.6	4.5	4.1	5.3
Domestic interest/ Government recurrent expenditure	24.4	25.9	24.5	31.1
Foreign interest/exports (a)	1.9	2.0	2.8	3.5

(a) Exports of goods and services.
(b) Government revenue is in economic format.
(c) Government expenditure inclusive of amortisation payments.

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

by the higher interest payments. The total debt service payments as a per cent of GDP increased to

Chart 6.9 **Debt Service Payments (As a per cent of GDP)**



17.1 per cent from 13.4 per cent in 2008, reversing the declining trend maintained during the last three years. Total interest payments, as a per cent of GDP, also increased to 6.4 per cent from 4.8 per cent in the previous year. Further, the ratio of total foreign debt to earnings from the export of goods and services increased to 170.7 per cent in 2009 from 132.2 per cent in 2008, due to both the decline in the earnings from the export of goods and services and increase in foreign debt stock.