6

FISCAL POLICY AND GOVERNMENT FINANCE

6.1 Overview

Fiscal operations improved significantly in 2010 with revenue performance exceeding expectations and expenditure being contained within the budgetary allocations. The pickup in domestic economic activity and the gradual recovery in international trade contributed to the turnaround in revenue collection during the year. In addition, measures were taken to rationalise recurrent expenditure, while directing capital expenditure to strategic infrastructure development programmes in line with the government's commitment to sustaining a high growth momentum and encouraging more inclusive growth through several regional development programmes.

In view of the Presidential and Parliamentary elections held in early 2010, there was a delay in presenting the budget for 2010. During the period January to April 2010, fiscal operations were conducted under a Vote on Account framework. Fiscal operations for the period May to July 2010 were conducted under the provisions of Section 3 of Article 150 of the Constitution by a Presidential decree. The budget for 2010 was presented to Parliament in June 2010 and was approved in July 2010. Despite the delay in presenting the budget for 2010 and the limited scope for introducing new revenue and expenditure measures, the overall fiscal deficit was maintained within the original budgetary target of 8 per cent of GDP.

Improved investor confidence and favourable conditions in international financial markets enabled the government to raise funds from external sources to finance the fiscal deficit, thus reducing the domestic borrowing requirement. The government was able to raise funds through the issue of a ten year international sovereign bond at a competitive rate and by issuing Sri Lanka Development Bonds (SLDBs) with longer maturities and low yield margins, while continuing to secure foreign investments in government securities. Particularly noteworthy during the year was the reduced reliance on bank financing to bridge the government's resource gap. The reduced financing requirement of the government from domestic sources significantly eased the pressure on domestic interest rates, while making available more funds to the private sector.

6.2. Fiscal Policy Direction and Measures

The focus of fiscal policy in 2010 continued to be on achieving a sustainable fiscal deficit and reducing the public debt burden, while maintaining expenditure on public investment at a level that would support high economic growth. Fiscal operations during the first four months of the year were conducted under a Vote on Account framework and in the following three months under a Presidential decree, until the budget for 2010 was approved in Parliament in July 2010. The delay in presenting the budget for 2010, limited the scope for introducing new fiscal measures during the year.

Despite the delay in presenting the budget for 2010, the government took several measures to simplify the tax system and improve revenue generation from taxes. The tariff structure was simplified by abolishing some taxes, such as the import duty surcharge of 15 per cent and the Regional Infrastructure Development Levy (RIDL) and by reducing the number of customs duty bands from five (0, 2.5, 6, 15 and 28 per cent) to four (0, 5, 15 and 30 per cent). The significant reduction in taxes on certain categories of imports, including motor vehicles and consumer durables, and the sharp rise in those imports, reflecting the pent up demand, increased the revenue generated from taxes on imports substantially.

The government revised several taxes to mitigate the impact of rising international commodity prices on the domestic market. A full customs duty waiver was granted on the import of petrol and diesel at the beginning of the year due to rising crude oil prices in international markets. Customs duties were subsequently reapplied at reduced rates in November 2010 when international crude oil prices declined. In addition, the import or supply of petrol was exempted from Value Added Taxes (VAT) in November 2010 to prevent an increase in domestic fuel prices. Customs duty waivers were granted on the import of milk powder and certain categories of edible oils to reduce the impact of rising international prices. Customs duties on the import of wheat grain were also revised during the year to stabilise the consumer and producer price of staple foods. A customs duty waiver was also granted on the importation of maize in order to support domestic animal feed production. Further, the Special Commodity Levy (SCL) applied on the import of selected food items was also revised periodically during the year to stabilise prices in the domestic market. In addition, the excise duty on LP gas was revised several times during the year to mitigate the impact of fluctuating international prices on domestic prices. All taxes relating to the import of eggs, egg yolk and chicks for breeding and other purposes were removed, while taxes on the importation of meat of fowls were either entirely removed or reduced to address supply shortages in the domestic market.

Several taxes were revised during the year to support selected industries. Imports of certain categories of machinery and equipment for the leather and footwear industry, high-tech medical, laboratory and educational equipment, agricultural machinery and parts, electrical equipment, and high-tech equipment for use in the telecommunication industry were exempted from VAT. The customs duty of 2.5 per cent, which was mostly applied on the importation of raw materials and machinery was abolished to support domestic industries that were adversely affected by the global economic and financial crisis. In addition, all taxes and levies relating to the importation of gold have been removed to promote the jewellery industry. Further, several taxes were removed on imports of electrical items and parts of these electrical items in order to promote Sri Lanka as an international shopping destination.

The Presidential Commission on Taxation submitted its report to the President in October 2010, making several recommendations

regarding the rationalisation of the tax system. The mandate of the Commission was to design a buoyant tax system that would facilitate accelerated economic growth, while addressing the decline in the tax to GDP ratio that has been observed in the last two decades. This decline in revenue collection and the greater involvement of the government in development and social welfare programmes necessitated revenue buoyancy measures. In order to achieve the above targets, the commission examined various taxes collected at different levels of government and proposed measures to broaden the tax base and simplify the tax system, while recommending various administrative improvements in the revenue collecting agencies.

Emphasis continued to be placed on the need to modernise Sri Lanka's revenue administration and expenditure management to create fiscal space to support the government's public investment programme. The Fiscal Management Efficiency Project (FMEP) which aims at a comprehensive Fiscal Management Reform Programme (FMRP) to enhance revenue collection and improve expenditure management continued in 2010. Modernising revenue administration processes by introducing and upgrading the information technology systems in the revenue collection departments was a key component of this project. An integrated treasury management information system is being set up to improve the financial management of line ministries, spending agencies and other public sector institutions. As part of the programme to build and strengthen the financial management capacity of the public sector, an Academy of Financial Studies has been set up to enhance the skills of officers in the Ministry of Finance and Planning, including officers in the revenue collecting agencies.

Concerted efforts to manage the operational expenditure of the government and strict monitoring helped contain recurrent expenditure within the original budgetary allocations. Due to the delay in presenting the budget for 2010, expenditure in the first seven months of 2010 was based on the allocations for 2009. The reformulation of duties and functions of ministries was a major initiative taken by the government to encourage ministries to focus on their core objectives and to restrict expenditure within their budgetary allocations. Co-ordination of policy implementation was strengthened, while expertise from the private sector was introduced into public sector institutions to improve the performance of these institutions. A Cabinet Sub Committee was appointed to make necessary recommendations to simplify administrative and regulatory procedures, practices and related laws with a view to creating a more modern and efficient administrative system. In addition, all line ministries were requested to identify areas which could be opened to the private sector with a view to enhancing the productive use of idle assets.

The public investment programme was directed at accelerating several strategic infrastructure projects to support high growth, while allocating funds to develop rural infrastructure to ensure a more regionally balanced development. To facilitate this growth, several large scale irrigation projects, such as the Moragahakanda and Kaluganga Development Project, river diversions, such as Gin/Nilwala Diversion Project, power projects, such as the Upper Kotmale Hydro Power Project, road sector development projects, such as the Southern Expressway, the Colombo-Katunayake Expressway, the Outer Circular Highway and the Colombo-Kandy Highway as well as port development projects, such as the South Colombo Harbour Development Project, the Hambantota Port Development Project (Phase II), the Oluvil Port Development Project and the Galle Port Development Project are currently underway. In addition, the government initiated several regional development programmes in each of the provinces to address rural urban imbalances.

Two regional programmes, 'Negenahira Navodaya' and 'Uthuru Wasanthaya' in the Northern and the Eastern provinces, respectively were continued in 2010 to expedite

rehabilitation and reconstruction activities. Special projects have been implemented under these programmes to re-establish civil administration, to redevelop infrastructure facilities and to restore the livelihoods of the people in conflict affected areas.

The government's strategy to reform state owned enterprises (SOEs) has been to focus on improving the management and efficiency of these entities so that they would become commercially viable and financially independent. The Ministry of Public Management Reforms was established in 2010 to modernise public management, while the Ministry of State Resources and Enterprise Development was set up to address the issues of underperforming and loss making SOEs. State enterprises are being re-engineered to generate surpluses by utilising their resources to the optimum level, thus reducing dependence on the national budget. SOEs are also being encouraged to explore Public Private Partnerships (PPPs), while small scale SOEs that are not viable are being merged or amalgamated to create commercially viable entities. SOEs will continue to operate in areas of strategic importance and to engage in operations which would not be undertaken by the private sector due to their scale, risk or technological complexity. Although social considerations may necessitate the provision of some services that have economic and social benefits to the country but may not necessarily be financially beneficial to the enterprise, it is important to ensure that these services are properly targeted, so that the burden on the national budget is minimised.

The government resorted to low cost external borrowings during the year taking advantage of the favourable conditions prevailing in international financial markets and the improved investor confidence. A third international sovereign bond of US dollars 1 billion with a coupon rate of 6.25 per cent was successfully issued in October 2010. The issue attracted an order book of more than six times the value of the bond, reflecting the improved investor confidence. The proceeds from the bond issue were used to repay some high cost domestic borrowings. Foreign investments in government securities continued up to the maximum limit allowed for non residents of 10 per cent of the total outstanding stock of Treasury bills and Treasury bonds. Consequently, external sources became the dominant source of deficit financing in 2010. In

Table 6.1 Summary of Government Fiscal Operations

Item	2009	2010 Approved Estimates	2010 Provi-sional	2011 Approved Estimates
	Rs. million			
Total revenue and grants	**725,566**	**840,716**	**835,129**	**985,920**
Total revenue	699,644	817,516	818,220	963,320
Tax revenue	618,933	728,744	725,671	861,943
Non tax revenue	80,711	88,772	92,549	101,377
Grants	25,922	23,200	16,909	22,600
Expenditure and lending minus repayments	**1,201,927**	**1,279,553**	**1,280,205**	**1,419,664**
Current	879,575	928,339	937,094	1,017,155
Capital and net lending	322,352	351,214	343,111	402,509
o/w Public investment	330,448	361,214	356,519	413,546
Current account surplus (+)/deficit (-)	**-179,931**	**-110,824**	**-118,874**	**-53,835**
Primary account surplus (+)/deficit (-)	**-166,686**	**-101,630**	**-92,485**	**-79,816**
Overall budget surplus (+)/deficit (-)	**-476,361**	**-438,837**	**-445,076**	**-433,744**
Total financing	**476,361**	**438,837**	**445,076**	**433,744**
Foreign financing (a)	230,807	158,000	243,788	143,750
Domestic financing	245,554	280,837	201,288	289,994
Market borrowings	234,274	280,837	191,999	289,994
Non bank	185,247	235,837	193,891	247,994
Bank	49,027	45,000	-1,892	42,000
Monetary Authority	-109,241	n.a.	-32,112	n.a.
Commercial banks	158,268	n.a.	30,220	n.a.
Non-market borrowings	11,280	-	9,289	-
	As a percentage of GDP			
Total revenue and grants	**15.0**	**15.3**	**14.9**	**15.6**
Total revenue	14.5	14.9	14.6	15.2
Tax revenue	12.8	13.3	13.0	13.6
Non tax revenue	1.7	1.6	1.7	1.6
Grants	0.5	0.4	0.3	0.4
Expenditure and lending minus repayments	**24.9**	**23.3**	**22.9**	**22.4**
Current	18.2	16.9	16.7	16.1
Capital and net lending	6.7	6.4	6.1	6.4
o/w Public investment	6.8	6.6	6.4	6.5
Current account surplus (+)/deficit (-)	**-3.7**	**-2.0**	**-2.1**	**-0.8**
Primary account surplus (+)/deficit (-)	**-3.5**	**-1.8**	**-1.7**	**-1.3**
Overall budget surplus (+)/deficit (-)	**-9.9**	**-8.0**	**-7.9**	**-6.8**
Total financing	**9.9**	**8.0**	**7.9**	**6.8**
Foreign financing (a)	4.8	2.9	4.4	2.3
Domestic financing	5.1	5.1	3.6	4.6
Market borrowings	4.9	5.1	3.4	4.6
Non bank	3.8	4.3	3.5	3.9
Bank	1.0	0.8	...	0.7
Monetary Authority	-2.3	n.a.	-0.6	n.a.
Commercial banks	3.3	n.a.	0.5	n.a.
Non-market borrowings	0.2	-	0.2	-

(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 addition, SLDBs were issued with longer maturities and lower yield margins taking advantage of the positive investor sentiment.

The improved macroeconomic environment and improved investor confidence were also reflected in the sovereign ratings assigned by the three rating agencies. Standard and Poor's upgraded Sri Lanka's long term foreign currency sovereign rating to B+ with stable outlook, while Fitch affirmed Sri Lanka's long term foreign currency rating of B+, while upgrading the outlook to positive. Moody's Investor Service assigned a B1 foreign currency issuer rating with a stable outlook. A Sovereign Rating Committee (SRC) with representatives from the government and the private sector was appointed to operationalise the strategy to upgrade the country's rating to an investment grade of BBB- by 2014. In order to facilitate this process, three Sovereign Rating Advisors (SRAs) were appointed to strengthen the co-ordination between the authorities and the rating agencies.

6.3 Government Budgetary Operations

Revenue and Grants

Revenue

Total government revenue collection in 2010 improved substantially with the picking up of domestic economic activity and the gradual rebounding of external trade. In nominal terms, total revenue increased by 16.9 per cent to Rs. 818.2 billion in 2010 and exceeded the original budgetary estimate of Rs. 817.5 billion, while as a percentage of GDP, total revenue increased to 14.6 per cent in 2010 from 14.5 per cent in 2009. The declining trend observed in the revenue to GDP ratio during the last three years was reversed in 2010 with a higher mobilisation of both tax and non tax revenue. Tax revenue as a percentage of GDP increased to 13 per cent from 12.8 per cent in 2009. The improved performance in tax revenue collection was mainly due to an increase in revenue collection from VAT, Nation Building Tax (NBT) and the Port and Airport Development Levy (PAL), as well as from higher revenue collection from excise taxes. Non tax revenue as a percentage of GDP remained at 1.7 per cent, although in nominal terms it increased by 14.7 per cent to Rs. 92.5 billion in 2010 due to higher transfer of profits and dividends from public institutions.

Tax revenue collection in 2010 amounted to Rs. 725.7 billion, an increase of 17.2 per cent over the previous year. The share of tax collection in total revenue remained at 89 per cent in 2010 as in 2009. The main source of tax revenue collection was consumption based taxes accounting for 81.3 per cent of total tax collection. The proportion of taxes from international trade was 39.4 per cent,

Chart 6.1 Composition of Government Revenue - 2010

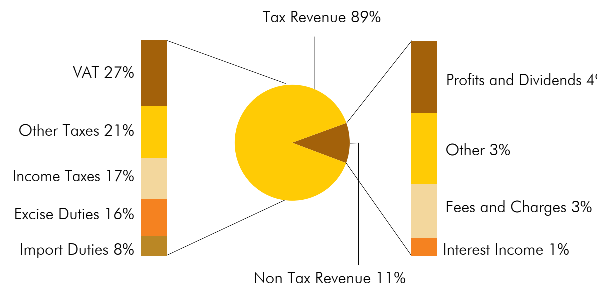


Table 6.2 Economic Classification of Revenue

Item	2009	2010 Approved Estimates	2010 Provisional	2011 Approved Estimates
	Rs. million			
Tax revenue	618,933	728,744	725,671	861,943
Income taxes	139,558	160,344	135,623	154,883
VAT	171,510	206,750	220,168	238,390
Excise taxes	97,604	120,768	129,749	152,250
Import duties	79,560	84,837	64,369	92,803
Other taxes	130,701	156,045	175,763	223,617
Non tax revenue	80,711	88,772	92,549	101,377
Total revenue	699,644	817,516	818,220	963,320
	As a percentage of GDP			
Tax revenue	12.8	13.3	13.0	13.6
Income taxes	2.9	2.9	2.4	2.4
VAT	3.6	3.8	3.9	3.8
Excise taxes	2.0	2.2	2.3	2.4
Import duties	1.6	1.5	1.1	1.5
Other taxes	2.7	2.8	3.1	3.5
Non tax revenue	1.7	1.6	1.7	1.6
Total revenue	14.5	14.9	14.6	15.2

Source: Ministry of Finance and Planning while the share of taxes from domestic goods and services was 41.9 per cent.

Revenue from income taxes as a percentage of GDP declined to 2.4 per cent in 2010 from 2.9 per cent in 2009 as a result of the sharp decline in the withholding taxes on interest income. Revenue from withholding taxes declined as a percentage of GDP to 0.5 per cent in 2010 from 0.9 per cent in 2009 and in nominal terms by 34 per cent to Rs. 29.4 billion in 2010, mainly due to the reduction in interest rates in 2010. Consequently, the share of income taxes in total taxes declined to 18.7 per cent in 2010 from 22.5 per cent in 2009. Revenue collection from corporate income tax increased by 12.7 per cent to Rs. 75.2 billion in 2010, although as a percentage of GDP it declined marginally to 1.3 per cent in 2010. Higher tax payments by the banking sector, which accounted for around 24 per cent of total corporate income taxes, mainly contributed to the increase in corporate tax revenue. Non corporate tax also increased by 9.8 per cent to Rs. 31 billion in 2010, maintaining the ratio of non corporate tax as a percentage of GDP at 0.6 per cent as in 2009. The increase in corporate and non corporate tax revenue was mainly due to the pickup in domestic economic activity as well as the efforts taken to broaden the tax base and to improve tax compliance.

Revenue collection from VAT as a percentage of GDP increased to 3.9 per cent in 2010 from 3.6 per cent in 2009 due to the rebound of domestic economic activity and higher imports. In nominal terms, revenue from VAT increased by 28.4 per cent to Rs. 220.2 billion in 2010 exceeding the budgetary estimate of Rs. 206.8 billion. Consequently, the share of VAT in total tax revenue increased to 30.3 per cent in 2010 from 27.7 per cent in 2009. Revenue collection from VAT on imports increased by 47.5 per cent to Rs. 99.8 billion as a result of a sharp increase in imports, including the import of motor vehicles and petroleum products. VAT on domestic goods and services increased by 15.9 per cent to Rs. 120.4 billion in 2010 as a result of higher domestic economic activity. The main sources of VAT from domestic goods and services were tobacco and alcohol, telecommunication services and insurance.

Excise duty collection as a percentage of GDP increased to 2.3 per cent in 2010 from 2 per cent mainly due to the higher revenue generated from excise taxes on imports of motor vehicles. In nominal terms, revenue from excise taxes increased by 32.9 per cent to Rs. 129.7 billion exceeding the budgetary target for 2010 of Rs. 120.8 billion. The share of excise taxes in total tax revenue also increased to 17.9 per cent in 2010 from 15.8 per cent in 2009. Revenue from excise duties on motor vehicles increased significantly to Rs. 21.2 billion from Rs. 3.2 billion in 2009 as a result of a sharp rise in motor vehicle imports during the year. Revenue from excise duties on liquor increased by 28.5 per cent to Rs. 36.6 billion due to the periodic scaling up of excise duty rates (around 35 per cent in 2010) and the increase in hard and malt liquor production by 20 per cent and 28.6 per cent, respectively during the year. Revenue collection from excise duties on cigarettes increased by 8.2 per cent to Rs. 40.7 billion during the year over 2009, due to the upward revision of excise tax rates by around 18 per cent and an increase in cigarette sales by 2.1 per cent with the opening of new markets in the Northern and Eastern provinces. Revenue collection from excise duties on petroleum increased by 21.8 per cent to Rs. 28 billion mainly on account of the increase in the volume of petroleum imports during the year.

Revenue collection from import duties and the SCL as a percentage of GDP declined sharply to 1.3 per cent in 2010 from 2 per cent in 2009 due to the reduction in import duties and the granting of duty concessions on several items. Revenue from import duties declined by 19.1 per cent in 2010 to Rs. 64.4 billion (1.1 per cent of GDP), with the share of import duties in total tax revenue falling to 8.9 per cent in 2010 from 12.9 per cent in 2009. The removal of the import duty surcharge of 15 per cent at the beginning of 2010, the full customs duty waiver on petrol and diesel effective throughout the year and the customs duty waiver on wheat grain during the first half of the year, as well as the reduction of taxes on the import of milk powder were the main reasons for the decline in import duty collection during the year. Revenue from the SCL declined sharply by 46.4 per cent to Rs. 10.2 billion in 2010 reducing the share of the SCL in total tax revenue to 1.4 per cent in 2010 from 3.1 per cent in 2009. The removal of the SCL on rice during the first quarter of the year and the reduction of the SCL on big onions and potatoes during the latter part of the year were the main reasons for the decline in revenue collection from SCL. The average customs duty rate, including SCL, declined to 5 per cent in 2010 from 7.8 per cent in 2009, reflecting the reduction in customs duties, the granting of customs duty waivers, the removal of the import duty surcharge, and the zero rate applied on imports under trade agreements with India and Pakistan as well as the revisions to SCL during the year.

Revenue collection from NBT and PAL increased significantly, while revenue collection from Cess levies increased only marginally. NBT collection as a percentage of GDP increased to 0.8 per cent in 2010 from 0.6 per cent in 2009 mainly due to the recovery of imports and the increase in turnover from manufacturing and services in 2010. In nominal terms, revenue from NBT increased significantly by 69.4 per cent to Rs. 46.1 billion in 2010. This was due to the full impact of the upward revision of the NBT rate to 3 per cent in May 2009 and the significant increase in the turnover from imports, manufacturing and services. Revenue from PAL increased as a percentage of GDP to 0.9 per cent in 2010 from 0.8 per cent in 2009 and in nominal terms by 36.8 per cent to Rs. 49.7 billion in 2010 mainly as a result of higher imports. Revenue collection from Cess levies as a percentage of GDP declined marginally to 0.5 per cent in 2010 from 0.6 per cent in 2009, although in nominal terms it increased by 3.5 per cent to Rs. 27.9 billion in 2010. This was mainly due to the removal of the Cess levied on selected imports and the reduction in the Cess levy on imports of raw materials for the construction sector, including cement.

Non tax revenue increased by 14.7 per cent over 2009 to Rs. 92.5 billion in 2010, mainly due to an increase in the transfer of profits and dividends from public institutions. Non tax revenue from profits and dividends increased by 44.7 per cent in 2010 compared to 2009, increasing the share of profits and dividends in total non tax revenue to 50 per cent in 2010 from 39.6 per cent in 2009. Interest income declined by 11.3 per cent to Rs. 8 billion in 2010 due to the low interest rates that prevailed in 2010.

Grants

Continuing the declining trend, foreign grant receipts fell by 34.8 per cent to Rs.16.9 billion in 2010. The gradual move of Sri Lanka towards middle income country status and the lower grant receipts from European countries due to the fiscal problems in many of those countries contributed to the decline in foreign grants in 2010. Foreign grants were mainly from multilateral donors, accounting for 67.1 per cent of total grant receipts in 2010.

Expenditure and Net Lending

Total expenditure and net lending declined to 22.9 per cent of GDP in 2010 from 24.9 per cent of GDP in 2009 due to the efforts by the government to curtail recurrent expenditure, while maintaining capital expenditure at the desired level. The reduction of total expenditure and net lending by 2 percentage points was the combined outcome of a reduction in recurrent expenditure by 1.5 percentage points and capital expenditure and net lending by 0.5 percentage points. However, in nominal terms total expenditure and net lending increased by 6.5 per cent to Rs. 1,280.2 billion in 2010.

Recurrent expenditure, as a percentage of GDP declined significantly to 16.7 per cent in 2010 from 18.2 per cent in 2009, reflecting the government's effort to rationalise recurrent expenditure. In nominal terms, recurrent expenditure increased by 6.5 per cent to Rs. 937.1 billion in 2010 due to an increase in salaries and wages, pension payments and interest payments.

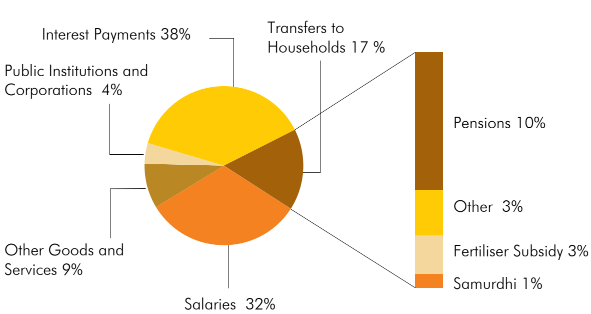
Table 6.3 Economic Classification of Expenditure and Lending Minus Repayments

Item	2009	2010 Approved Estimates	2010 Provisional	2011 Approved Estimates
	Rs. million			
Current expenditure	**879,575**	**928,339**	**937,094**	**1,017,155**
Expenditure on goods and services	379,731	388,246	388,286	455,686
o/w Salaries and wages	271,229	296,710	300,558	344,023
Interest payments	309,675	337,207	352,592	353,928
Foreign	35,698	40,480	55,464	44,528
Domestic	273,978	296,727	297,127	309,400
Current transfers and subsidies	190,168	202,886	196,216	207,541
o/w To households and other sectors	148,993	160,561	156,194	165,182
Samurdhi	9,267	9,300	9,241	9,300
Pensions	85,139	93,000	90,995	98,000
Fertiliser subsidy	26,935	30,000	26,028	20,000
Other	27,652	28,261	29,931	37,882
Capital expenditure	**277,416**	**304,307**	**302,087**	**351,899**
Acquisition of real assets	143,590	170,249	158,488	199,579
Capital transfers	133,826	143,482	143,599	168,975
Provision for under expenditure	-	-9,424	-	-16,654
Lending minus repayments	**44,936**	**46,907**	**41,025**	**50,609**
Total expenditure and net lending	**1,201,927**	**1,279,553**	**1,280,205**	**1,419,663**
	As a percentage of GDP			
Current expenditure	**18.2**	**16.9**	**16.7**	**16.1**
Expenditure on goods and services	7.9	7.1	6.9	7.2
o/w Salaries and wages	5.6	5.4	5.4	5.4
Interest payments	6.4	6.1	6.3	5.6
Foreign	0.7	0.7	1.0	0.7
Domestic	5.7	5.4	5.3	4.9
Current transfers and subsidies	3.9	3.7	3.5	3.3
o/w To households and other sectors	3.1	2.9	2.8	2.6
Samurdhi	0.2	0.2	0.2	0.1
Pensions	1.8	1.7	1.6	1.5
Fertiliser subsidy	0.6	0.5	0.5	0.3
Other	0.6	0.5	0.5	0.6
Capital expenditure	**5.7**	**5.5**	**5.4**	**5.6**
Acquisition of real assets	3.0	3.1	2.8	3.1
Capital transfers	2.8	2.6	2.6	2.7
Provision for under expenditure	-	-0.2	-	-0.3
Lending minus repayments	**0.9**	**0.9**	**0.7**	**0.8**
Total expenditure and net lending	**24.9**	**23.3**	**22.9**	**22.4**

Source: Ministry of Finance and Planning

The reduction in defence related procurement expenditure helped restrict the nominal increase in recurrent expenditure to the minimum.

Chart 6.2 Composition of Government Current Expenditure - 2010



Expenditure on salaries and wages for public servants including those attached to the provincial councils increased by 10.8 per cent to Rs. 300.6 billion in 2010. However, as a percentage of GDP it declined to 5.4 per cent in 2010 from 5.6 per cent in 2009. The share of salaries and wages in total recurrent expenditure was 32 per cent in 2010, marginally higher than 31 per cent in 2009. The increase in the monthly cost of living allowance (COLA) of public sector employees by Rs.750 to Rs. 5,250 with effect from January 2010, the special payment of Rs. 1,000 per month for security personnel and the extension of the operational risk allowance to all security personnel with effect from November 2009, contributed to the nominal increase in salaries and wages in 2010.

Although in nominal terms interest expenditure increased by 13.9 per cent to Rs. 352.6 billion in 2010, this was significantly lower than the increase of 45.7 per cent recorded in 2009. Consequently, interest expenditure as a percentage of GDP declined to 6.3 per cent in 2010 from 6.4 per cent in the previous year. The declining yield rates on government securities coupled with initiatives taken by the government to restructure its debt stock by shifting from high cost domestic debt to low cost foreign debt helped contain interest expenditure during the year. Interest payments on domestic debt increased by 8.4 per cent to Rs. 297.1 billion in 2010 due to the increase in the outstanding domestic debt stock by 12 per cent in 2009, although the average interest rate on domestic debt declined to 12.4 per cent in 2010 from 12.8 per cent in the previous year. Interest payments on domestic debt accounted for 84 per cent of total interest payments. Meanwhile, interest payments on foreign debt increased by 55.4 per cent to Rs. 55.5 billion in 2010. This was due to the increase in the foreign debt stock by 22 per cent in 2009 and the increase in the average interest rate on foreign debt to 3.2 per cent in 2010 from 2.5 per cent in the previous year, on account of the higher share of foreign commercial debt in the total foreign debt stock in 2009.

Table 6.4 Functional Classification of Expenditure

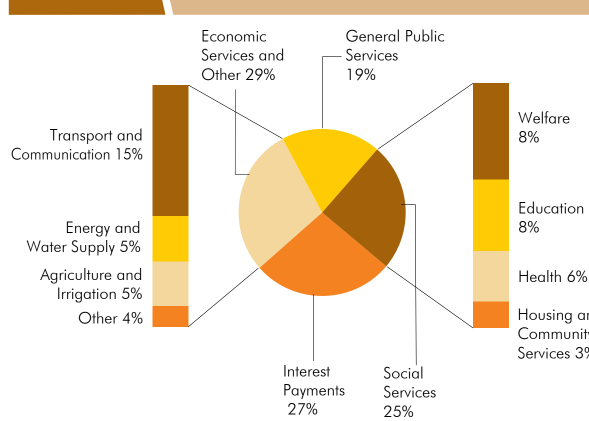
Item	2009	2010 Approved Estimates	2010 Provi-sional	2011 Approved Estimates
	Rs. million			
Current expenditure	**879,575**	**928,339**	**937,094**	**1,017,155**
General public services	224,281	225,766	228,136	256,745
Civil administration	37,123	39,440	37,895	42,236
Defence	144,884	142,348	145,243	163,486
Public order and safety	42,274	43,978	44,998	51,024
Social services	260,071	274,668	267,636	306,506
Education	82,414	84,876	85,195	99,278
Health	58,789	60,802	60,506	70,788
Welfare	105,017	114,091	107,690	121,172
Community services	13,852	14,899	14,245	15,269
Economic services	85,188	87,496	85,440	97,476
Agriculture and irrigation	43,967	45,402	44,081	51,678
Energy and water supply	3,429	3,599	3,492	4,125
Transport and communication	31,068	31,517	31,246	33,856
Other	6,724	6,978	6,621	7,817
Other	310,035	340,409	355,882	356,427
o/w Interest payments	309,675	337,207	352,592	353,928
Capital expenditure and lending	**330,448**	**361,213**	**356,519**	**413,546**
General public services	20,094	22,474	21,510	24,897
Civil administration	18,686	21,133	20,212	23,657
Public order and safety	1,409	1,341	1,298	1,240
Social services	53,938	60,393	56,205	69,122
Education	18,092	19,000	19,053	21,129
Health	12,664	14,146	13,329	16,939
Housing	5,291	6,106	5,489	9,237
Community services	17,891	21,141	18,334	21,817
Economic services	256,411	287,670	278,803	335,721
Agriculture and irrigation	22,105	30,090	24,865	40,521
Energy and water supply	59,983	67,909	66,569	75,537
Transport and communication	139,104	164,360	165,505	182,781
Other	35,219	25,312	21,804	36,881
Other	5	100	1	460
Under expenditure	-	-9,424	-	-16,654
Total expenditure and lending	**1,210,023**	**1,289,553**	**1,293,613**	**1,430,701**
	As a percentage of GDP			
General public services	5.1	4.5	4.5	4.4
Social services	6.5	6.1	5.8	5.9
Economic services	7.1	6.8	6.5	6.8
Other	6.4	6.2	6.4	5.6
o/w Interest payments	6.4	6.1	6.3	5.6
Total expenditure and lending	**25.1**	**23.5**	**23.1**	**22.6**

Source: Ministry of Finance and Planning

Current transfers and subsidies increased by 3.2 per cent to Rs. 196.2 billion in 2010 due to an increase in transfers to households and public institutions, although transfers to public corporations declined. As a percentage of GDP, current transfers and subsidies declined to 3.5 per cent in 2010 from 3.9 per cent in 2009. Current transfers to households, which account for 80 per cent of total current transfers in 2010 increased by 4.8 per cent to Rs. 156.2 billion. Pension payments, which account for 58 per cent of the transfers to households increased by 7 per cent to Rs. 91 billion in 2010 due to the increase in the monthly COLA to pensioners by Rs. 375 to Rs. 2,375 with effect from January 2010 and the addition of about 16,366 new pensioners during the year. The fertiliser subsidy (Rs. 26 billion), the Samurdhi programme (Rs. 9 billion), welfare programmes for disabled soldiers (Rs.10 billion) as well as programmes targeting school children such as providing free school text books and uniforms as well as the school nutritional food programme were the other major transfers to households by the government during the year. Current transfers to public institutions increased by 2.3 per cent to Rs. 27.7 billion in 2010, accounting for 14 per cent of total current transfers in 2010. Transfers to public institutions engaged in economic services and social services, especially in the areas of education, health and community services, increased, while transfers to public institutions engaged in civil administration declined marginally. Current transfers to public corporations declined by 12.5 per cent to Rs. 12.4 billion in 2010 and accounted for 6 per cent of the total current transfers in 2010. The reduction in the operating loss of the Department of Sri Lanka Railways as a result of the rationalisation of maintenance costs, mainly contributed to the decline in transfers to public corporations.

Capital expenditure and net lending increased by 6.4 per cent to Rs. 343.1 billion in 2010, reflecting the government's commitment

Chart 6.3 Total Expenditure by Function - 2010



to expediting infrastructure development projects. Public investment increased by 7.9 per cent to Rs. 356.5 billion in 2010, although as a percentage of GDP it declined to 6.4 per cent during the year compared to 6.8 per cent in 2009. Accordingly, the momentum gained in public investment in recent years continued as there was a strong commitment by the government to maintain expenditure on public investment considering its long term benefits to the national economy. Expenditure on the acquisition of real assets increased by 10.4 per cent to Rs. 158.5 billion in 2010, while capital transfers increased by 7.3 per cent to Rs. 143.6 billion in 2010 mainly due to the increase in transfers to public institutions (9.8 per cent).

The public investment programme in 2010 was directed towards strategically important infrastructure development projects as well as projects to reduce the rural-urban divide. Public investment in economic services continued to be the main component of the government's investment programme amounting to Rs. 278.8 billion in 2010, an 8.7 per cent increase compared to that of the previous year. This included investment in ports, transportation, communication, energy, water supply, agriculture and irrigation. The government's policy is to give the highest priority to improving the road network in the country as it contributes to accelerated economic growth and balanced regional development, while opening up opportunities for national integration. Hence key public investment programmes in transportation, such as the Colombo-Katunayake Expressway, the Outer Circular Highway, the Southern Transport Development Project, the Trincomalee Integrated Infrastructure Project, the National Highway Sector Project, maintenance of roads and bridges programme and the 'Maga Neguma' Rural Road Development Programme were some of the projects carried out in 2010 to develop the road network. In line with the government's policy to improve transport services, investments were made to extend and rehabilitate railway lines and purchase Diesel Multiple Units, locomotives and carriages to upgrade the railway system in the country. As part of the government's vision to position Sri Lanka as a naval/maritime hub, several significant investments were made in 2010 to develop the ports, such as the Hambantota Port Project and the Colombo South Harbour Development Project.

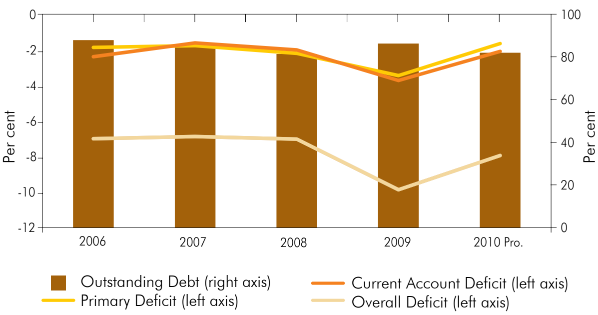
Public investment in social services increased by 4.2 per cent to Rs. 56.2 billion in 2010, of which, Rs. 19.1 billion was on account of education, while Rs. 13.3 billion was in relation to expenditure on health related services. The investment in education was directed towards the improvement and rehabilitation of educational infrastructure, modernisation of secondary education, training and capacity building, developing identified schools, including the Defence Services School, improving relevance and quality of undergraduate education, and enhancing and upgrading advanced technological education. Public investment in the health sector was mainly directed towards hospital rehabilitation and development, health promotion and disease prevention, as well as controlling communicable and non communicable diseases.

The government continued its commitment towards balanced regional development in 2010. Various development programmes were conducted under the Ministry of Economic Development in this regard. Expenditure on key public investment initiatives, such as the 'Gama Neguma' programme and infrastructure development programmes in lagging regions amounted to Rs. 13 billion and Rs. 8 billion, respectively. Further, identifying the uniqueness of each region, their diverse resources and potential, specific regional development initiatives were undertaken in each of the provinces in the country.

Key Fiscal Balances

Reflecting the improvement in the fiscal sector the overall deficit declined to 7.9 per cent of GDP in 2010, within the original estimate of 8 per cent of GDP, and below the deficit of 9.9 per cent recorded in the previous year. Improvements in both revenue

Chart 6.4 Major Fiscal Indicators (as a percentage of GDP)

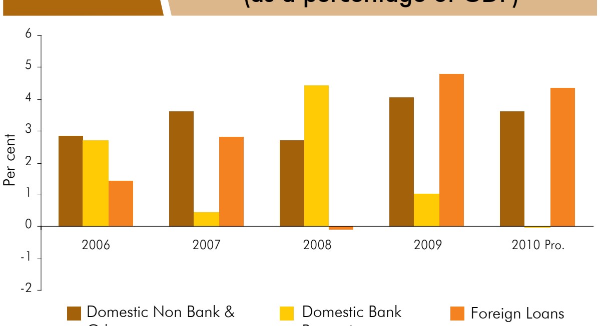


and expenditure contributed to this noteworthy achievement. Government revenue exceeded the target, while expenditure was maintained within the original budgetary allocation, narrowing the government's resource gap and reducing the government's financing requirement. The favourable developments in the fiscal sector were also reflected in other fiscal indicators. The current account deficit, which reflects government dis-savings, narrowed to 2.1 per cent of GDP in 2010 from 3.7 per cent of GDP in 2009, marginally above the targeted level of 2 per cent in the original budget estimate for 2010. Further, the primary deficit, which reflects the current fiscal deficit, as interest payments are determined by the size of previous fiscal deficits, declined to 1.7 per cent of GDP in 2010 from 3.5 per cent in the previous year and below the target of 1.8 per cent.

Financing the Budget Deficit

The greater availability of external resources to finance the fiscal deficit, reduced borrowings from the domestic market in 2010. Accordingly, foreign funds contributed around 55 per cent of the total financing requirement in 2010, while the balance was financed through domestic sources. Consequently, foreign financing amounted to Rs. 243.8 billion compared to the original estimate of Rs. 158 billion, while domestic financing amounted to Rs. 201.3 billion compared to the original estimate of Rs. 280.8 billion.

Chart 6.5 Deficit Financing (as a percentage of GDP)



Considering the composition of net domestic financing (NDF), the government relied almost entirely on non bank financing in 2010. Accordingly, total borrowings from the non bank sector were Rs. 203.2 billion compared to the original estimate of Rs. 235.8 billion and the borrowings of Rs. 196.5 billion from the non bank sector in 2009. There was a net repayment of Rs. 1.9 billion to the banking sector in 2010 compared to the original borrowing estimate of Rs. 45 billion, and the borrowing of Rs. 49 billion from the banking sector in 2009. The net repayment to the banking system in 2010 was the combined outcome of a repayment of Rs. 32.1 billion to the Central Bank and a net borrowing of Rs. 30.2 billion from commercial banks. The government was able to repay some of the high cost borrowings from the banking sector with the proceeds of the international sovereign bond issue. Accordingly, US dollar denominated borrowings from the OBU of the Bank of Ceylon (BOC)

Table 6.5 Sources of Domestic Financing

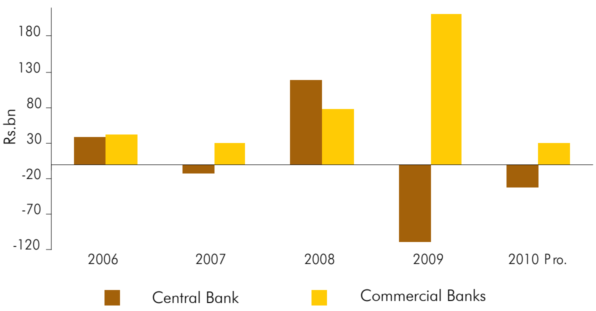
Rs. billion

Item	2007	2008	2009	2010 Provisional
By Instrument	127.7	314.3	245.6	201.3
Treasury bonds (a)	52.8	192.4	201.9	140.4
Treasury bills (b)	37.1	69.8	49.0	82.8
Rupee loans	10.3	-1.5	-17.7	-24.6
Sri Lanka Development Bonds	23.6	65.5	7.6	11.1
Central Bank provisional advances	11.7	15.6	-2.4	4.0
Other	-7.8	-27.5	7.1	-12.4
By Source	127.7	314.3	245.6	201.3
Bank	15.8	195.2	49.0	-1.9
Non bank	112.0	119.0	196.5	203.2

(a) Excludes rupee denominated Treasury bonds issued to foreign investors since 2007 and to the Sri Lankan diaspora and migrant workers since 2009.
(b) Excludes rupee denominated Treasury bills issued to foreign investors since 2008 and to the Sri Lankan diaspora and migrant workers since 2009.

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

Chart 6.6 Sources of Bank Financing



(Rs. 4.7 billion) and outstanding government import bills with the BOC (Rs. 8.6 billion) were repaid, while a part of the government's outstanding overdraft with the two state commercial banks (Rs. 43.1 billion) was settled. In addition, the Central Bank's holdings of Treasury bills amounting to Rs. 55.1 billion were retired with the proceeds from the international sovereign bond. The shift away from bank financing is a positive development as it reduces the inflationary impact of deficit financing.

As part of the government's borrowing strategy of moving towards more market oriented debt instruments for domestic financing, the government relied more on Treasury bills and Treasury bonds as in previous years. Accordingly, net borrowings by way of Treasury bills amounted to Rs. 82.8 billion and net borrowings by way of Treasury bonds amounted to Rs. 140.4 billion, while a net repayment of Rupee loans of Rs. 24.6 billion was recorded during the year. Borrowing from SLDBs amounted to Rs. 11.1 billion. There was a net repayment of Rs. 8.4 billion to other borrowing sources with the repayment of some short term high cost borrowings.

Foreign currency denominated domestic borrowings increased in 2010, due to favourable investor sentiments, in contrast to the net repayment recorded in 2009. Gross borrowings from SLDBs were Rs. 71.2 billion (US dollars 628 million), while repayments amounted to Rs. 60.1 billion (US dollars 530 million). The government repaid Rs.6.8 billion (US dollars 60.5 million) of borrowing to OBUs, while there was no new borrowing from OBUs during 2010. Accordingly, the net value of foreign currency denominated domestic borrowings during the year was Rs. 4.3 billion (US dollars 37.5 million).

The contribution of foreign sources to finance the budget deficit increased to 55 per cent in 2010 from 48 per cent in 2009. Accordingly, total gross borrowings from external sources amounted to Rs. 328 billion (US dollars 2,913 million), while total net foreign financing was Rs. 244 billion in 2010. Of the total gross borrowings 17.8 per cent (Rs. 58.4 billion) was on concessional terms compared to 21.7 per cent (Rs. 77 billion) in the previous year, while the balance was obtained on non concessional terms. The funds raised from the international sovereign bond issue was Rs. 112 billion (US dollars 1,000 million), while gross financing from foreign investments in Treasury bills and Treasury bonds amounted to Rs. 15.8 billion (US dollars 140 million) and Rs. 36.2 billion (US dollars 320 million), respectively. Project loans received from bilateral and multilateral development partners accounted for 50 per cent of total foreign financing. The Asian Development Bank (ADB), Japan and China were the major sources of project financing. The increase in foreign financing helped reduce the pressure on the domestic market arising from budgetary financing and increase the resources available to the private sector.

6.4 Budgetary Operations in Sub National Governments

Policy Direction and Measures of Sub National Governments

The Ministry of Local Government and Provincial Councils continued to work in close coordination with the sub national governments in 2010. The Sub National Government (SNG) system in Sri Lanka consists of Provincial Councils (PCs) and Local Governments (LGs). There are nine PCs established under the 13th Amendment to the Constitution. As at end 2010, the LG system constituted 330 institutions, which were made up of 18 Municipal Councils (MCs), 42 Urban Councils (UCs) and 270 Pradesheeya Sabhas (PSs). As in previous years, grants were provided by the Central Government on the recommendation of the Finance Commission to meet the budgetary requirements of the SNGs.

In line with the objective of providing guidance and support to PCs and LGs, the Ministry of Local Government and Provincial Councils implemented various programmes in PCs and LGs in 2010 covering areas of management, development and reform. Drafting amendments to legislation governing local government, presenting a Local Authorities Election Ordinance to Parliament, initiating programmes to improve provincial and local government administration, enhancing infrastructure in the provinces, providing legal support, promoting services, such as solid waste management, anti-dengue campaigns and fire and rescue services were some of the initiatives taken by the Ministry of Local Government and Provincial Councils during the year. Further special assistance was extended to backward local authorities in the areas of finance, management and institutional support.

Road sector development was the key area facilitated by the Ministry of Local Government and Provincial Councils in 2010. In addition to providing assistance to major road sector development projects, the Ministry initiated a special project to prepare detailed designs and to obtain the required funding for provincial road development. Further, small and medium scale city development projects were carried out in 2010 with the technical and advisory support from the Urban Development Authority (UDA) and Sri Lanka Land Reclamation and Development Corporation. The Sri Lanka Institute of Local Governance continued to engage in programmes to strengthen local authorities in 2010 by developing human resources required for enhancing efficiency and ensuring good governance of local authorities.

The Finance Commission continued its operations in 2010 with a close dialogue with PCs and other stakeholders with the objective of achieving a balanced regional development. The Finance Commission has initiated an institutional capacity development programme in 2010 to implement Results Based Planning and Monitoring within the Provincial Councils with a view to integrating the National Policy Framework into the provincial development plans. The necessary guidelines were issued during the year to implement this system.

LGs continued their operations as important institutions of governance in the country impacting the lives of people at the grass roots level. The revenue sources of LGs include income from assessment rates, licence fees, taxes on businesses, assigned revenue (stamp duty and court fines), and Central Government transfers. PCs worked as the agent for LGs in collecting the two sources of devolved revenue, namely stamp duty and court fines, as assigned under the 13th Amendment to the Constitution. The outlays of LGs comprised personal emoluments, other current expenses and capital expenses.

The revenue structure of the PCs was changed from January 2011. The turnover tax, which was imposed on wholesale and retail trade and collected by the PCs, was abolished and the coverage of the NBT was widened to cover those activities. One third of the revenue collected from the NBT by the Central Government will be transferred to the Provincial Councils' revenue account. In addition, the entire stamp duty collected and 70 per cent of the total revenue generated from motor vehicle registration fees will be transferred to this account.

Budgetary Operations in Provincial Councils

The overall budgetary performance of PCs in 2010 improved compared to the previous year. Total revenue collection of PCs increased by 24 per cent to Rs. 36.5 billion in 2010. Revenue from turnover taxes, licence fees and stamp duties increased due to the recovery in domestic economic activity. As in previous years, the

Table 6.6 Budget Outturn for Provincial Councils

Rs. million

Item	2007	2008	2009	2010 Provisional
Total revenue	**25,868**	**31,368**	**29,433**	**36,474**
Tax revenue	21,473	25,992	24,907	30,825
Non tax revenue	4,395	5,376	4,526	5,650
Total expenditure	**113,067**	**120,011**	**130,260**	**140,531**
Current expenditure	92,721	103,199	111,336	116,843
o/w Personal emoluments	74,711	79,717	86,547	91,433
Capital expenditure	20,346	16,812	18,924	23,688
Central government transfers	**88,317**	**88,942**	**93,999**	**107,032**
Block grants	70,742	76,773	77,386	85,299
Criteria based grants	1,208	2,304	2,276	2,612
Matching grants	205	-	-	-
PSDGs (a)	6,995	7,262	10,945	11,683
Foreign grants for special projects	9,167	2,603	3,393	7,439

(a) Province Specific Development Grants

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

Western Provincial Council continued to be the major contributor to the revenue collection of PCs accounting for 63 per cent of the total revenue collection of PCs in 2010. The Western Province was followed by the Southern, the Central and the North Western provinces each accounting for around 8 per cent of the total revenue collection.

Recurrent expenditure of PCs increased by 5 per cent to Rs. 116.8 billion in 2010. The increase in recurrent expenditure was mainly due to the increase in personal emoluments as a result of the increase in the COLA of public sector employees at the beginning of the year. Personal emoluments accounted for 78 per cent of the total recurrent expenditure of PCs in 2010, with salaries and wages in the education and health sectors accounting for a large proportion of this expenditure. The balance recurrent expenditure was on account of other expenses in relation to the purchase of goods and services.

The total capital expenditure of PCs increased by 25 per cent to Rs. 23.7 billion in 2010. The investment programmes of PCs mainly consisted of Province Specific Development Projects (PSDPs), foreign funded special projects and projects funded by Criteria Based Grants (CBGs). A special programme named Regional Development Initiatives under PSDGs was carried out in 2010 with the objective of enhancing economic growth in the provinces with greater public private partnership. Under this programme the Sabaragamuwa Provincial Council has initiated the Ma-Oya Area Development Project, which aims to develop the area around the Pinnawala Elephant Orphanage and to develop agriculture and livestock activity in the project area. Provinces were also provided with donor funding from international development agencies, such as the Asian Development Bank (ADB), the Japan International Cooperation Agency (JICA) and the World Bank to develop rural roads and improve community livelihood in 2010, in addition to the funds allocated under PSDGs for such activities.

In 2010, Central Government transfers to PCs increased by 14 per cent to Rs. 107 billion. These transfers were in the form of block grants to fund recurrent expenditure, CBGs to fund discretionary expenditure requirements, PSDGs to continue Province Specific Development Projects and grants for special projects. As in previous years, a major portion of government transfers, amounting to 80 per cent of total transfers, were in the form of block grants.

6.5 Government Debt and Debt Service Payments

Government Debt

Government debt as a percentage of GDP declined to 81.9 per cent in 2010 from 86.2 per cent in the previous year due to improvements in fiscal operations. Higher revenue collection which reduced the borrowing requirement, the reduction in the discount factor (which is the net difference in the book value and the face value of issues and maturities of Treasury bills and Treasury bonds) as a result of declining yield rates in government securities and the appreciation of the rupee vis-à-vis major foreign currencies, as well as higher economic growth contributed to the reduction in the debt to GDP ratio. In nominal terms, the total outstanding government debt increased by 10.3 per cent to Rs. 4,590 billion as at end 2010. As a percentage of GDP domestic debt declined significantly to 45.8 per cent of GDP in 2010 from

Chart 6.7 Outstanding Government Debt (as a percentage of GDP)

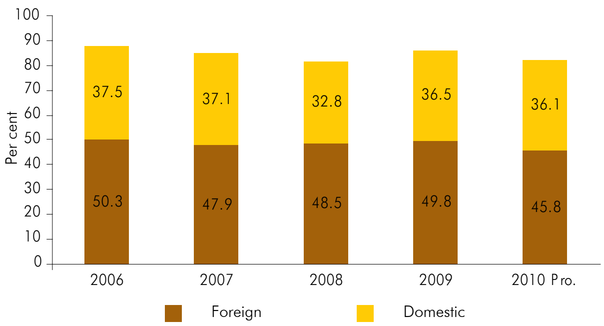
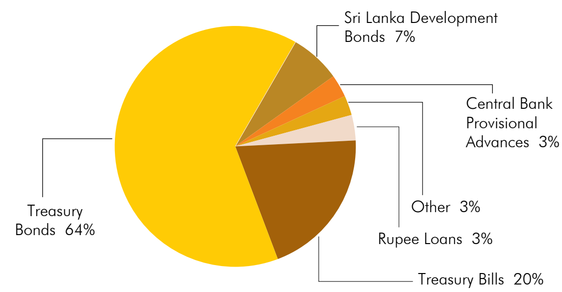


Chart 6.8 Composition of Outstanding Domestic Debt - 2010



49.8 per cent of GDP in 2009, while foreign debt declined to 36.1 per cent of GDP in 2010 from 36.5 per cent of GDP in the previous year.

The share of domestic debt in total government debt declined further in 2010 to 56 per cent from 58 per cent in 2009. Repayment of high cost domestic borrowings with the proceeds of the international sovereign bond and the increase in availability of foreign funds reduced the share of domestic debt in the total debt stock. The share of medium to long term debt to total domestic debt stock declined marginally to 76 per cent in 2010 from 77 per cent in the previous year, while 84 per cent of medium to long term domestic debt comprised Treasury bonds. The share of Treasury bills in short term debt, increased to 83 per cent in 2010 from 79 per cent in the previous year. The outstanding stock of Rupee loans continued to decline to Rs. 88 billion in 2010 from Rs. 112 billion in 2009, due to the repayment and non issuance of Rupee loans during the year, as the debt management strategy has been to move towards more market oriented debt instruments.

Table 6.7 Outstanding Government Debt (As at end year)

Rs. million

Item	2007	2008	2009	2010 Provisional
Total government debt	**3,041,686**	**3,588,962**	**4,161,422**	**4,590,245**
Domestic debt (a)	**1,715,199**	**2,140,228**	**2,400,955**	**2,565,662**
By maturity period				
Short term	363,199	516,365	560,646	619,549
Medium and long term	1,351,999	1,623,863	1,840,309	1,946,113
By institution				
Bank (b)	415,318	657,424	705,765	691,716
Non bank	1,299,779	1,482,704	1,695,089	1,873,845
Foreign debt	**1,326,487**	**1,448,734**	**1,760,467**	**2,024,583**
By type				
Concessional loans	1,099,911	1,227,222	1,271,142	1,266,910
Non concessional loans	45,308	57,491	78,649	147,240
Commercial	181,268	164,020	410,677	610,433
By currency				
SDR	508,241	531,849	567,502	572,354
US dollars	266,645	280,435	330,842	476,490
Japanese yen	338,621	445,596	452,758	508,802
Euro	121,460	132,047	143,566	142,371
Other	91,520	58,807	265,799	324,566
Memo: Exchange rate variation	71,646	117,785	23,114	-4,653

(a) Excludes Treasury bonds amounting to Rs. 4,397 million issued to commercial banks on behalf of CWE in November 2003.
(b) Includes outstanding balance to OBUs.

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

Reflecting the increasing reliance on non bank borrowings, the outstanding debt held by the non bank sector increased by 10.5 per cent to Rs. 1,873.8 billion in 2010. Accordingly, the outstanding stock of Treasury bills and Treasury bonds held by the non bank sector increased by 19.5 per cent and 12 per cent, respectively, in 2010. The EPF and NSB continued to be the major investors in government securities, accounting for 46 per cent and 15 per cent, respectively of the outstanding debt stock held by the non bank sector.

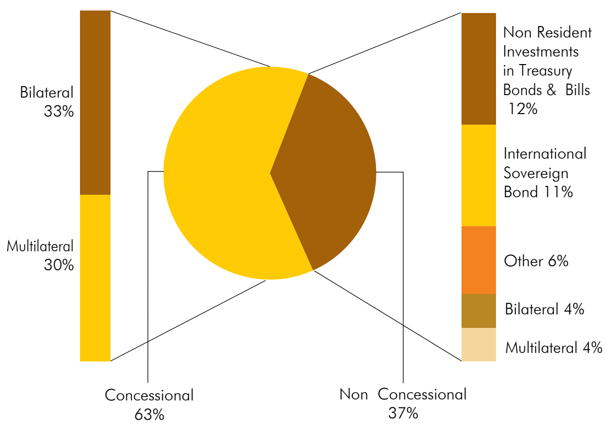
The outstanding debt obligations of the government to the domestic banking system declined by 2 per cent to Rs. 691.7 billion in 2010. The outstanding debt held by the Central Bank declined by Rs. 31.2 billion to Rs. 78.4 billion, while outstanding government debt held by commercial banks increased by Rs. 17.2 billion to Rs. 613.3 billion in 2010. Consequently, the share of banking sector debt in the total domestic debt stock declined to 27 per cent in 2010 from 29 per cent in

2009. Retirement of the Central Bank's holdings of Treasury bills reduced the government debt outstanding to the Central Bank. While, Treasury bill holdings of commercial banks increased by Rs.60 billion to Rs. 220 billion, Treasury bond holdings of the commercial banks declined by Rs. 26 billion to Rs. 162 billion, reflecting the appetite of investors for short term instruments. Further, other outstanding government debt held by commercial banks declined to Rs. 230.8 billion in 2010 from Rs. 247.5 billion in 2009.

Although there was an increase in foreign currency denominated domestic debt in US dollar terms, the rupee value of these debts declined marginally due to the appreciation of the Sri Lanka rupee against the US dollar. The outstanding domestic debt denominated in foreign currency declined to Rs.190.5 billion (US dollars 1,717 million) by end 2010 from Rs.191.8 billion (US dollars 1,676 million) at end 2009. This comprised outstanding OBU borrowings of Rs.16.6 billion (US dollars 150 million) and SLDBs amounting to Rs.173.9 billion (US dollars 1,567 million).

Total outstanding foreign debt increased by 15 per cent to Rs. 2,024.6 billion in 2010, although as a percentage of GDP it declined to 36.1 per cent in 2010 from 36.5 per cent in 2009. The share of concessional debt in the total foreign debt stock declined further to 63 per cent in 2010 from 72 per cent in 2009 as a result of a marginal decline in concessional borrowing together with an increase in non concessional financing in 2010. Non concessional debt increased by 55 per cent to Rs. 758 billion, raising the share of non concessional debt in the total foreign debt stock to 37 per cent at end 2010 from 28 per cent at end 2009. The increase in non concessional debt was mainly due to higher foreign commercial borrowing, which increased by 49 per cent to Rs.610 billion in 2010. The gradual move of Sri Lanka towards middle income country status reduced the availability of concessional foreign financing. However, the favourable environment in international financial markets as well as the improvement in investor

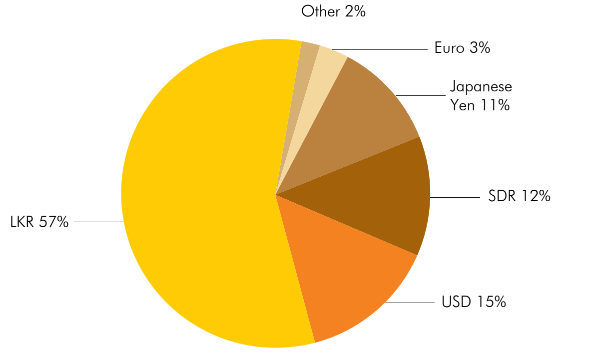
Chart 6.9 Composition of Outstanding Foreign Debt - 2010



confidence enabled the government to raise funds from non concessional external sources to finance the overall deficit.

The rupee value of outstanding debt declined by Rs. 4.7 billion due to the impact of the variation in the exchange rate. The rupee value of US dollar denominated domestic debt (FCBUs and SLDBs) declined as result of the appreciation of the Sri Lanka rupee vis-à-vis the US dollar by 3.1 per cent in 2010. The appreciation of the Sri Lanka rupee against other currencies, such as the Special Drawing Rights (SDR) and the euro by 4.6 per cent and 10.9 per cent, respectively in 2010 also contributed to reduce the outstanding foreign debt stock, since about 59 per cent of the total foreign debt stock is denominated in SDR (28.3 per cent), US dollars (23.5 per cent) and euro (7 per cent). However, since around 25 per cent of the foreign outstanding debt stock is denominated

Chart 6.10 Currency Composition of Total Outstanding Debt - 2010



BOX 13 Government Debt Sustainability

What is Debt Sustainability?

'Debt Sustainability' refers to the ability of a country to meet its current and future debt obligations without resorting to debt rescheduling and without the need for any major fiscal adjustment. Maintaining debt at a sustainable level is important, as a high and rising debt level can reduce the effectiveness of fiscal policy and monetary policy. For instance, countercyclical fiscal policies, such as expansionary fiscal policy during a slowdown in economic growth may not have the desired impact, if a country already has a high outstanding public debt, as economic agents would expect a higher tax burden in the future to service the debt.

For a country to maintain its government debt at a sustainable level, the future primary balances of the government, which is the difference between total government revenue and total government expenditure, excluding interest payments, should be large enough to meet all its debt obligations. Accordingly, if a government runs a primary deficit, it implies that government expenditure, excluding interest payments, is higher than revenue collection and this shortfall would need to be financed through borrowings. This indicates that the total debt stock of the government in the current year would be equal to last year's debt stock, plus interest payments on that debt stock, minus the primary balance of the current year, which can be presented as follows:

$$D_t = D_{t-1} + iD_{t-1} - PB_t$$

where, D_t is the debt stock of the current year, D_{t-1} is the previous year's debt stock, i is the effective interest rate on debt and PB_t is the primary balance. Accordingly, a primary deficit ($PB_t<0$) or higher interest rates will result in increasing the current year's debt stock. If the primary balance is zero ($PB_t=0$), that is if government revenue is sufficient to meet its total expenditure, excluding interest payments, the borrowing in the current year would be necessary only to service the past debt stock. Moreover, if the government is able to achieve a primary surplus ($PB_t>0$), those savings could be utilised to service past debt, thus reducing the need for additional borrowing in the current year.

How to Assess Debt Sustainability?

There are a number of methodologies developed to assess debt sustainability. According to these approaches, debt sustainability depends on the real interest rate, the primary balance, the real exchange rate and the rate of economic growth. A high real interest rate will lead to higher debt servicing costs, while a primary deficit will lead to additional borrowings for budgetary financing. For an open economy, the exchange rate is also a key variable which affects the outstanding public debt, since the depreciation of the domestic currency vis-à-vis a foreign currency would result in an increase in the debt stock denominated in that currency.

The debt to GDP ratio is one of the major indicators of government debt sustainability. A high debt to GDP ratio makes a country more vulnerable to shocks and crises in the future. However, there isn't a particular level of debt to GDP which can be used as a threshold to assess the debt sustainability of a country as this would vary from country to country based on the economic characteristics of each country.

The law of motion of the government's debt-to GDP ratio[1] is a commonly used tool to assess the debt sustainability of a country. Accordingly, the change in the debt stock of a country in the current year can be represented by combining the key variables which affect the debt stock, such that,

$$\frac{D_t}{Y_t} = \left(\frac{r-g}{1+g}\right)\frac{D_{t-1}}{Y_{t-1}} - \frac{PB_t}{Y_t}$$

where, D is debt stock, Y is GDP , r is the real interest rate, g is the rate of economic growth and PB is the primary balance (the exchange rate is ignored in this analysis for simplicity). Accordingly, if the real interest rate is higher than the growth rate it indicates that the interest burden on the existing debt stock would

[1] Developed by IMF and World Bank. See Croce, Enzo, and V. Hugo Juan – Ramón, 2003, "Assessing Fiscal Sustainability: A Cross Country Comparison," IMF Working Paper No. WP/03/145, International Monetary Fund, Washington D.C.

increase, while the debt stock as a percentage of GDP would also increase. Similarly, if the government borrows for financing expenditure other than for servicing the debt stock (that is the government runs a primary deficit) the debt burden as measured by the debt to GDP ratio would increase.

However, if the government can maintain a primary balance which is sufficient to meet the interest cost under a given growth rate (a stabilising primary balance), then the debt to GDP ratio will stabilise at the existing level since there is no need for new borrowing. Further, if the primary balance is higher than the stabilising primary balance, the outstanding government debt would fall over time. Similarly, if the real interest rate is equal to the growth rate, then the primary balance required for debt sustainability will remain constant. However, if the real interest rate is higher than the growth rate, then the actual primary balance required for debt sustainability will increase over time.

Debt Sustainability in Sri Lanka

There has been much debate regarding the sustainability of government debt in Sri Lanka. The debt burden in Sri Lanka during the period 2000 to 2004 was about 102 per cent of GDP on average. The trend was reversed in 2005 and it declined gradually to 81.4 per cent of GDP by 2008. However, the debt to GDP ratio increased in 2009 due to the decline in revenue, slower growth in GDP with the impact of global economic recession and a rise in expenditure with the intensification of the war and post war resettlement and development activities. This situation turned favourable in 2010 with the improvement in the fiscal sector.

According to the medium term macroeconomic projections, the debt to GDP ratio in Sri Lanka is expected to decline to 80 per cent of GDP in 2011 and reach 60 per cent of GDP by 2016. As envisaged in the Fiscal Management Report 2011, the primary deficit is projected to decline to 1.3 per cent of GDP in 2011 and record a zero primary balance by 2012. Further, GDP is projected to grow above 8 per cent in the medium term. Given these projections, the possibility of achieving the targeted debt path can be determined using the law of motion of the government's debt-to-GDP ratio assuming that the exchange rate remains stable over the medium term.

In the baseline scenario, if the medium term growth projections are realised and the zero primary balance in 2012 continues until 2016, the targeted debt level of 60 per cent of GDP can be achieved in 2016, provided the real interest rate remains at around 3 to 4 per cent during the medium term. It would be possible to maintain the debt to GDP ratio as expected by 2016, even with an increase in the real interest rate, as the favourable developments in the fiscal sector as reflected by a zero primary balance and the higher growth momentum will mitigate the negative impact of an increasing interest rate on the outstanding debt stock (see Chart B 13.1). Assuming there are no further developments in the monetary, real and fiscal sectors, that is all the variables remain at the 2010 level over the medium term, the debt to GDP ratio will continue to decline, although at a slower rate than envisaged under the baseline scenario, provided the rate of economic growth is above the real interest rate, implying that

Chart B 13.1 Baseline Scenario

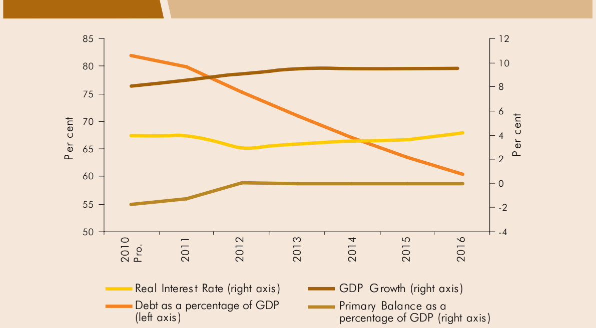


Chart B 13.2 All Variables Prevail at 2010 Level

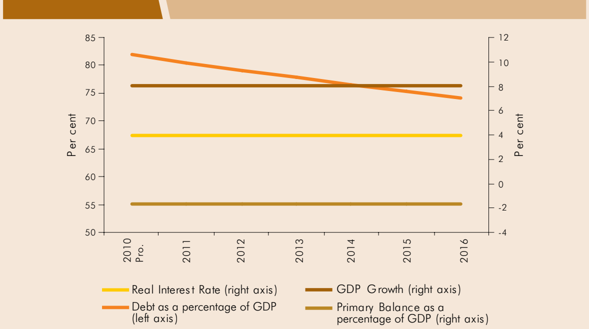


Table B 13.1 Classification of Countries under DSF

Category	Implication
Low risk	All debt indicators are well below the relevant thresholds
Moderate Risk	Under the baseline scenario there is no breach of threshold but alternative scenarios or stress tests result in breaches.
High risk	Breaches the threshold under the baseline scenario but the country does not face any payment difficulty at present
Debt distress	Country is already in arrears

the growth in GDP can mitigate the pressure on debt arising from developments in the monetary and fiscal sectors (see Chart B 13.2).

The IMF and World Bank have also developed a Debt Sustainability Framework (DSF) which can be used as a tool to assess the external debt sustainability of low income countries. Under this framework, countries are classified by comparing the projected public debt indicators with specific thresholds under a baseline scenario, alternative scenarios and stress tests. Accordingly, countries are classified as low risk, moderate risk, high risk and debt distress (see Table B 13.1 for details).

Based on an analysis conducted by the IMF and World Bank in 2009 to assess debt sustainability, Sri Lanka was upgraded to the moderate risk category. However, this study was based on several assumptions made regarding the key macroeconomic variables, such as export growth, GDP growth and the exchange rate. According to the latest projections of the Central Bank, all these macroeconomic variables are expected to be more favourable than assumed by the IMF and World Bank when they undertook this sustainability analysis in July 2009.

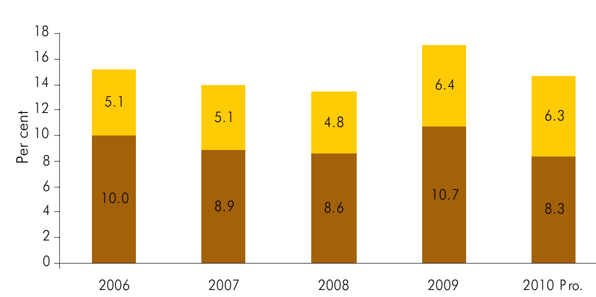
Conclusion

The Government's debt portfolio has been restructured by moving to more market oriented debt instruments with medium to long term maturities at lowest possible cost in order to reduce the rollover risk and interest burden. Bank borrowings have also been declining gradually reducing the inflationary impact of budgetary financing. Similarly, various measures have been taken on the fiscal front to increase government revenue and rationalise expenditure, thus improving the key fiscal balances. Continuing the government's fiscal consolidation process is expected to further improve the primary balance over the medium term. Improved investor confidence and lower inflationary expectations will help to maintain the interest rate at the required level. Further, increasing foreign exchange inflows will support a stable exchange rate. The economy is also expected to grow at a faster rate benefiting from the policies which are currently being implemented. Given these developments, both external and domestic debt can be expected to remain at a sustainable level, enabling the government to meet its future debt obligations.

in Japanese yen, the depreciation of the Sri Lanka rupee against the Japanese yen by 8.8 per cent had a negative impact on the outstanding debt stock.

The improvement in public debt indicators signals a decline in the future debt burden. The improvement in the fiscal sector, lower interest rates and the appreciation of the rupee vis-à-vis major foreign currencies together with the high economic growth reduced the debt to GDP ratio in 2010. The debt to GDP ratio in 2010 fell below the targeted level set in the Medium Term Macro Fiscal Framework of 84 per cent of GDP by 2010. Continuing the fiscal consolidation process and maintaining a high economic growth would be required to reduce the outstanding debt stock to the targeted level of 60 per cent by 2016.

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



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FISCAL POLICY AND GOVERNMENT FINANCE

Table 6.8 Government Debt Service Payments

Rs. million

Item	2007	2008	2009	2010 Provisional
Debt service payments	**500,514**	**592,804**	**825,687**	**820,448**
Domestic	415,089	440,918	675,274	686,800
Foreign	85,425	151,886	150,414	133,648
Amortisation payments	**317,833**	**380,330**	**516,012**	**467,856**
Domestic	253,719	258,720	401,296	389,672
Foreign	64,114	121,609	114,716	78,184
Interest payments	**182,681**	**212,475**	**309,675**	**352,592**
Domestic	161,370	182,198	273,978	297,127
Short term	53,874	65,364	72,364	58,943
Medium and long term	107,496	116,834	201,613	238,185
Foreign	21,311	30,277	35,698	55,464

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

Debt Service Payments

Total debt service payments declined by Rs. 5.2 billion to Rs.820.4 billion in 2010 due to lower amortisation payments, as interest payments increased during the year. Total amortisation payments, which accounts for 57 per cent of total debt service payments, declined by 9.3 per cent to Rs. 467.9 billion. Of the total amortisation payments, Rs. 389.7 billion was made to domestic sources and Rs. 78.2 billion to foreign sources, including deferred repayments on defence loans. A decline in the maturing debt stock in 2010 and the appreciation of the rupee, which reduced the rupee value of foreign debt repayments, mainly contributed to the decline in amortisation payments to external sources. Total interest payments increased by 13.9 per cent to Rs. 352.6 billion in 2010. Although domestic interest payments increased by 8.4 per cent over the last year, this was well below the 50.4 per cent increase in interest payments recorded in the previous year. The main reason for the lower growth in domestic interest payments in 2010 compared to 2009 was the declining yield rates on government securities in 2010. Interest payments on foreign debt increased by 55.4 per cent, mainly due the increase in non concessional foreign borrowings.

Table 6.9 Government Debt Indicators

Indicator	2007	2008	2009	2010 Provisional
Government debt/GDP	85.0	81.4	86.2	81.9
Domestic debt/GDP	47.9	48.5	49.8	45.8
Foreign debt/GDP	37.1	32.8	36.5	36.1
Total foreign debt/exports (a)	127.3	132.2	170.7	166.4
Total debt service/GDP	14.0	13.4	17.1	14.6
Total debt service/government revenue (b)	88.6	90.5	118.0	100.3
o/w Domestic debt service/ government revenue (b)	73.5	67.3	96.5	83.9
Total debt service/government expenditure (c)	43.2	43.1	48.1	46.9
o/w Domestic debt service/ government expenditure (c)	35.8	32.0	39.3	39.3
Foreign debt service/exports (a)	8.2	13.9	14.6	11.0
Total interest/GDP	5.1	4.8	6.4	6.3
Domestic interest/GDP	4.5	4.1	5.3	5.3
Domestic interest/Government current expenditure	25.9	24.5	31.1	31.7
Foreign interest/exports (a)	2.0	2.8	3.5	4.6

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

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

Debt indicators improved in 2010 reversing the unfavourable trend recorded in the previous year. The ratio of debt service payments to revenue declined to 100.3 per cent from 118 per cent in 2009 with the increase in revenue collection and the decline in debt servicing costs. The higher GDP growth in 2010 together with the decline in debt servicing costs contributed to the decline in the total debt service to GDP ratio to 14.6 per cent in 2010 from 17.1 per cent in 2009. Total interest payments to GDP also declined to 6.3 per cent in 2010 from 6.4 per cent in 2009. Further, the ratio of foreign debt to earnings from the export of goods and services declined to 166.4 per cent in 2010 from 170.7 per cent in 2009 due to higher export growth in 2010.