8. FISCAL POLICY AND BUDGETARY OPERATIONS

8.1 Overview and Policy Strategy

The successful fiscal deficit reduction achieved in the last two years could not be maintained in 1998. The 1998 Budget expected to reduce the overall deficit to 6.5 per cent of GDP while generating a surplus in the current account. This was an ambitious target considering the high degree of uncertainty that prevailed in late 1997 about the prospects for the world economy, domestic security expenditures and revenue implications of the impending Goods and Services Tax (GST). The reduction of the fiscal deficit was to be achieved through better financial control, enhancing revenue buoyancy, containment of the growth of current expenditures, further progress in public enterprise reforms with private sector participation and the strengthening of debt management. The 1998 Budget also envisaged an increase in public investment to 6.9 per cent of GDP, as inadequate infrastructure facilities were emerging as a constraint for faster economic growth.

In terms of the overall deficit, the fiscal performance in 1998 was a setback. However, on the policy side, progress was made in the structural reforms relating to the tax system, debt management and public enterprise reforms. The budget deficit (before grants and excluding privatisation proceeds) increased to 9.2 per cent of GDP, indicating a substantial fiscal slippage of 2.7 percentage points, when compared with the target of 6.5 per cent of GDP. The current account continued to be in deficit, rising to 2.4 per cent of GDP from 2.2 per cent in 1997. While a slippage could not have been avoided in 1998 owing to revenue and other implications of the slowing down of the economy as a result of the crisis in the global economy, the magnitude of the slippage was worrisome. It thwarted the objective of easing the high interest rates to promote investment and employment. In fact, during the year, interest rates on government debt instruments and the prime lending rate started rising, reflecting the increased domestic resource needs of the government for deficit financing. A further relaxation of monetary policy to dampen the increase in interest rates was not possible, as this would have had adverse implications on price stability and the exchange market. Given these developments and the weaker prospects for economic growth, the target of 6 per cent of GDP for the overall deficit in 1999 as expected in the 1999 Budget appears difficult to achieve. Early measures may have to be taken to contain the budget deficit at a realistic level of around 7.5 per cent of GDP in 1999.

In absolute terms, the budget deficit increased by Rs.23,086 million to Rs.93,147 million. Increased security expenditures and revenue shortfalls were the major reasons for the enlargement of the deficit. Additional security related expenditures accounted for 29 per cent of the increased deficit. Revenue shortfalls, reflected mainly in lower than anticipated turnover taxes/GST, income taxes and import duties, accounted for about 58 per cent. Higher expenditures on non-security related salaries and wages and transfers to loss making public sector entities (Sri Lanka Railways and the Postal Department) also contributed 7 per cent. The inflationary pressures of the enlarged budget deficit were not clearly seen in 1998 as the country benefited from the sharp reduction in import prices, particularly for crude oil, wheat grain, fertiliser and sugar, under depressed world market conditions. These price reductions helped to contain the growth in the import bill, despite a 9.6 per cent depreciation of the rupee against the US dollar, thus leaving more resources with the banking system. It appears that the resources thus freed by these reductions and the relatively slow growth of private sector credit enabled the banking system to finance a large portion of the enlarged budget deficit without exerting excessive pressure on interest rates.

However, several desirable tax policy reforms, aimed at further simplifying the tax structure, reducing tax rates, improving the tax base and increasing transparency of the tax system, were implemented during 1998. The move towards lower rates of taxation was expected to raise savings and private investment. The major structural change made in the tax system was the introduction of the GST with effect from 1 April 1998 to eliminate the cascading effect of the turnover tax and to operate on the destination principle, where all exports are zero rated, while domestic consumption is subject to taxation. Initially, unprocessed agricultural products, public transport, fertiliser, cement, pharmaceuticals and some essential food items were exempted. Imports for the processing of exports, which were exempted under turnover tax by a laborious administrative action, were brought under the GST system with a refunding mechanism. Importers of such goods are entitled to a deferment facility of 45 days to settle their tax liabilities (this period was later increased to 60 days). The banking and financial services sector continued to be under turnover tax, but the tax rate applicable was further reduced from 2 per cent to 1 per cent with a view to reducing the cost of funds. Initially, a single GST rate of 12.5 per cent was applied. Although this rate yield was less than the former turnover tax system, it was considered prudent to start with a lower rate in order to achieve greater public acceptance.

With the introduction of GST, excise tax rates on some items were raised to offset the revenue loss arising from the change. Accordingly, the excise tax on petrol was increased from 25 per cent to 50 per cent, while the excise tax on liquor was raised from 12.75 per cent to 20.2 per cent. In the case of cigarettes, the GST rate was applied to the excise inclusive value.

In order to further rationalise the income tax structure, the 1997 Budget announced a reduction of both the corporate profit tax and the maximum personal income tax rate from 35 per cent to 30 per cent in 1998 and then to 25 per cent in 1999. However, owing to revenue considerations, the proposal was not implemented in 1998. Instead, income tax concessions were granted to selected priority sectors. Accordingly, the corporate tax rate for enterprises in agriculture, fisheries, livestock and tourism was reduced to 15 per cent. The regional industrialisation programme was further strengthened in 1998 with fiscal incentives for relocation, setting up of new garment factories and for the establishment of dedicated economic centres. In addition, generous BOI concessions were granted to selected thrust industries such as electronics, ceramics, glassware, rubber based industries, light and heavy engineering industries, cutting and polishing of gems and diamonds and jewellery manufacturing.

In order to assist the development of the capital market, companies seeking a listing on the Colombo Stock Exchange (CSE) and those already listed were given an income tax bonus of 5 percentage points. Capital gains arising from the sale of equity held in unquoted companies was exempted from income tax, while expenses incurred by companies in seeking a listing were treated as deductible expenses. As the cost of share transactions was considered high, the stamp duty on initial public offers was reduced to 50 cents for every Rs.1,000 and the cess imposed by the Securities and Exchange Commission (SEC) was reduced from 0.15 per cent to 0.10 per cent. Listed companies were allowed to operate their own provident funds. In order to encourage the participation of individuals in stock market activities, a deduction from the assessable income was re-introduced in respect of investments in new shares of listed companies. To bolster investor confidence in the settlement of market transactions, a Settlement Guarantee Fund and a Compensation Fund were established in 1998 to reduce settlement risks.

Unit Trusts, which mobilise funds from small investors, were given a further extension of their tax holiday status in view of their role in mobilising resources for the development of the equity and debt securities market. In order to promote the private sector debt securities market, private sector companies were granted an exemption from income tax on capital gains arising from the sale of debentures and other debt instruments issued by registered companies. Stamp duty on repurchase agreements, pro-notes, bills of exchange, mortgage backed securities and mortgage bonds on lease agreements were substantially reduced with a view to lowering the cost of financial market transactions and improving the secondary market for government securities.

The Presidential Tariff Commission, appointed in 1997 to recommend a more rational tariff structure, submitted its final report in 1998. The main recommendation was to move to a two-rate band tariff structure in two stages. The government decided to adopt a two-rate band tariff structure in the year 2000. Meanwhile, tariff rates other than for agriculture, were reduced further by replacing the existing three-rate structure of 10, 20 and 35 per cent with a 5,10 and 30 per cent rate structure. All imports of industrial raw materials and machinery not manufactured in Sri Lanka were brought under the 5 per cent band, while imports of transport, communication and medical equipment were classified as zero rated. Duty on motor cars and jeeps was brought down from 50-100 per cent to 30 per cent, while a 10 per cent additional excise tax was enforced on all vehicle imports to offset revenue shortfalls resulting from this reduction. With a view to protecting the domestic agricultural sector, the duty on agricultural products was maintained at 35 per cent, while the 20 per cent rate also continued for some imports. Hence, in the interim period until the two-rate structure is established, effectively, Sri Lanka has a five-rate tariff system.

Textile imports were fully liberalised with the objectives of increasing large scale production of textile and other materials locally, eliminating customs delays, reducing corruption and smuggling, reducing the lead time in exports to improve the competitiveness of exporters and preparing textile manufacturers and exporters to face a more competitive international trading environment in the future that would result from the phasing out of restrictions imposed under the Multi Fibre Agreement. Under this liberalisation process, the import of yarn, fabric and all related intermediate and capital goods was made duty free, while the tariff rate on imports of ready-made garments was fixed at 10 per cent to protect the non-export garment industry. A restructuring programme for the textile industry, designed to operate through commercial and development banks, was also drawn up to assist textile industries to modernise and adopt new technology. Under this restructuring programme, a Textile Debt Recovery Fund (TDRF) has been set up by the government to mitigate the adjustment problems faced by the local textile manufacturing industry.

In 1998, the government continued with its welfare programmes by providing vulnerable groups with basic needs such as food, housing and health. The Samurdhi Programme, the key poverty alleviation programme, covered nearly 2 million families. It has diversified its role by launching several credit schemes and leasing facilities for Samurdhi beneficiaries to promote self-employment activities. The setting up of Samurdhi banking societies (which are like savings and loans associations) was also continued with a view to popularising the savings habit among the low income groups. Several housing development programmes were started, targeting specific groups such as fishermen, plantation workers and under-served settlers in urban centres. Private sector participation in free public health services was encouraged by introducing the concept of a two tier private hospital system under the BOI regulations, one tier being dedicated to free health care for the poor with in-door and out-door facilities and the other tier being a fee based health care service.

Expenditure controls were continued with the imposition of a 10 per cent cut on recurrent expenditure other than salaries, pensions and household transfers. The expenditure cut was imposed on all public sector spending agencies other than those in the Ministry of Health and Education. Specific borrowing limits were enforced on public enterprises to improve financial discipline. In spite of this, transfers to some public corporations and institutions such as Sri Lanka Railways and Sri Lanka Transport Board increased further in 1998. With the objective of reducing the interest cost to the government, the option of early retirement of Rupee loans was exercised in 1998. Thus, Rupee loans worth Rs.16,000 million, carrying interest rates of 15 to 16 per cent per annum, were retired early. New Rupee loans at lower interest rates were also issued with a similar option for early retirement.

Progress was made in making the government debt programme more market oriented. Most of the new deficit financing needs of the government were met through Treasury bonds. This was reflected in an increase in the share of Treasury bonds in the total net domestic borrowings from 33 per cent in 1997 to 59 per cent in 1998.

Several measures were taken to improve the market orientation of Treasury bonds. The direct participation of the Employees' Provident Fund (EPF) at the Treasury bond auctions was discontinued in 1998. This stopped the submission of non-competitive bids, i.e., bids without a rate, which was not consistent with market principles. The maturity period of Treasury bond[illegible] [illegible]dually extended from 2 to 4 years, with the expect[illegible] there would be a further extension to at least 6 years in 1999. A system of 'Jumbo' issues of Treasury bonds (one large block of Treasury bonds with a given maturity, but sold in smaller lots at different periods) was introduced with the objective of giving greater flexibility to investors in the management of their portfolios. Commercial banks were permitted to hold Treasury bonds as part of their liquid assets. In addition, commercial banks and Primary Dealers were permitted to use Treasury bonds for transactions at the Central Bank's secondary window for investment of excess funds or to obtain temporary liquidity.

8.2 Budget Out-turn

As mentioned earlier, fiscal performance, in terms of the deficit, recorded a significant setback in 1998. A slow growth of tax revenue, together with large expenditure overruns, particularly in the area of security, derailed the fiscal consolidation process that was seen during the last three years. Total security expenditures increased from Rs.47,718 million in 1997 to Rs.56,390 million in 1998, raising its ratio to GDP from 5.4 per cent in 1997 to 5.6 per cent in 1998. The current account deficit increased to 2.4 per cent from 2.2 per cent of GDP in 1997. Meanwhile, increased capital expenditure and net lending also added 1.1 percentage points to the overall budget deficit. Consequently, the overall budget deficit (before grants and privatisation) rose to 9.2 per cent of GDP from 7.9 per cent in 1997 as against a target of 6.5 per cent envisaged in the 1998 Budget. The primary budget deficit, i.e., deficit excluding interest payments, rose to 3.8 per cent of GDP in 1998 from 1.7 per cent in 1997.

Following the trend since 1995, total revenue as a ratio of GDP further declined to 17.3 per cent in 1998 from 18.5 per cent in 1997. The revenue target for 1998 was 18.4 per cent. The shortfall in revenue was entirely the outcome of a sharp reduction in tax revenues, from 16 per cent of GDP in 1997 to 14.5 per cent of GDP in 1998. The GST failed to generate sufficient revenue owing to a less than revenue neutral tax rate, transitional problems and a large number of exemptions. Numerous tax exemptions and concessions granted in lieu of income taxes contributed to some erosion of the income tax base. Import tax revenue declined, mainly as a result of exemptions and concessions and a reduction in import values, reflecting the decline in prices of Sri Lanka's major import commodities. Non-tax revenue registered a marked increase of 23 per cent owing to additional profit transfers from public enterprises, increased rent payments from plantation companies and the timely collection of other non-tax revenue such as interest, levies and dividends.

Current expenditure as a ratio of GDP declined by about 1 percentage point owing to lower interest costs and subsidies. Interest payments as a ratio of GDP declined from 6.2 per cent to 5.4 per cent in 1998, reflecting the favourable impact on interest cost of improved fiscal performance during the last two years. The growth of transfers to households was also contained in 1998, and these as a ratio of GDP declined by 0.6 percentage points to 3.7 per cent of GDP in 1998. However, the wage bill increased from 5 per cent of GDP in 1997 to 5.3 per cent of GDP in 1998 both in respect of security personnel and other public employees. This was the result of increased employment in the public sector and wage increases granted during the year.

Public investment in 1998 (6.7 per cent of GDP) almost reached the 1998 Budget target of 6.9 per cent of GDP. This was a significant increase compared with a decline during the last two years to 5.9 per cent of GDP. The maintenance of public investment at a higher level was possible due to increased utilisation of foreign aid during 1998. While gross foreign aid disbursements increased by Rs.6,590 million in 1998, the aid utilisation rate increased from 79 per cent to 82 per cent. In the past, the public investment programme slowed down mainly due to resource constraints. However, as the government was committed to maintaining the investment programme, unlike in the past, the required rupee resources were released and this was reflected in a 41 per cent increase in rupee funds in 1998, compared with 11 per cent in 1997. Capital expenditure was mainly concentrated in key areas such as energy, transport, telecommunication, port and water supply and drainage. Investment in these

TABLE 8.1
Summary of Government Fiscal Operations (a)

Rs. Million

	1994	1995	1996	1997	1998 Approved Estimates	1998 Provi-sional	1999 Approved Estimates
Total Revenue	110,038	136,258	146,279	165,036	188,437	175,032	214,320
Tax Revenue	99,417	118,543	130,202	142,512	164,048	147,368	185,410
Non Tax Revenue	10,621	17,715	16,077	22,524	24,389	27,664	28,910
Expenditure and Lending minus Repayments	170,764	203,483	218,659	235,096	255,085	268,179	283,263
Current	127,084	154,159	175,148	184,749	187,090	199,648	199,205
Capital and Net Lending	43,680	49,324	43,511	50,347	67,995	68,531	84,058
Public Investment	40,455	52,809	45,973	51,260	70,997	68,278	84,556
Other Capital	3,225	-3,486	-2,463	-913	-3,002	253	-498
Current Account Surplus/Deficit (-)	-17,046	-17,901	-28,869	-19,714	1,347	-24,616	15,115
Primary Account Surplus/Deficit (-)	-22,695	-29,000	-23,457	-14,815	-11,282	-38,250	-9,163
Overall Deficit (before grants)	-60,726	-67,225	-72,380	-70,061	-66,648	-93,147	-68,943
Financing	60,726	67,225	72,380	70,061	66,648	93,147	68,943
Foreign Financing	20,035	30,252	17,898	17,287	25,426	17,396	20,283
Net Borrowings	11,778	21,224	10,160	9,958	16,426	10,196	12,283
Grants	8,257	9,028	7,739	7,329	9,000	7,200	8,000
Domestic Financing	37,696	33,972	49,754	30,275	33,221	71,362	40,660
Market Borrowings	38,362	33,424	39,391	39,644	33,221	72,292	40,660
Non Bank	37,205	26,359	26,301	41,816	33,221	53,338	40,660
Bank	1,157	7,065	13,090	-2,171	-	18,954	-
Monetary Authority	1,764	7,662	9,873	-13,991	-	5,609	-
Commercial Banks	-607	-597	3,218	11,820	-	13,345	-
Other Borrowings	-666	548	10,363	-9,369	-	-930	-
Privatisation Proceeds	2,996	3,001	4,728	22,499	8,000	4,389	8,000
			As a percentage of GDP				
Total Revenue	19.0	20.4	19.0	18.5	18.4	17.3	18.5
Tax Revenue	17.2	17.8	17.0	16.0	16.0	14.5	16.0
Non Tax Revenue	1.8	2.7	2.1	2.5	2.4	2.7	2.5
Expenditure and Lending minus Repayments	29.5	30.5	28.5	26.4	24.9	26.4	24.5
Current	21.9	23.1	22.8	20.8	18.3	19.7	17.2
Capital and Net Lending	7.5	7.4	5.7	5.7	6.6	6.8	7.3
Public Investment	7.0	7.9	6.0	5.8	6.9	6.7	7.3
Other Capital	0.6	-0.5	-0.3	-0.1	-0.3	0.0	0.0
Current Account Surplus/Deficit(-)	-2.9	-2.7	-3.8	-2.2	0.1	-2.4	1.3
Primary Account Surplus/Deficit(-)	-3.9	-4.3	-3.1	-1.7	-1.1	-3.8	-0.8
Overall Deficit (before grants)	-10.5	-10.1	-9.4	-7.9	-6.5	-9.2	-6.0
Financing	10.5	10.1	9.4	7.9	6.5	9.2	6.0
Foreign Financing	3.5	4.5	2.3	1.9	2.5	1.7	1.8
Net Borrowings	2.0	3.2	1.3	1.1	1.6	1.0	1.1
Grants	1.4	1.4	1.0	0.8	0.9	0.7	0.7
Domestic Financing	6.5	5.1	6.5	3.4	3.2	7.0	3.5
Market Borrowings	6.6	5.0	5.1	4.5	3.2	7.1	3.5
Non Bank	6.4	3.9	3.4	4.7	3.2	5.3	3.5
Bank	0.2	1.1	1.7	-0.2	-	1.9	-
Monetary Authority	0.3	1.1	1.3	-1.6	-	0.6	-
Commercial Banks	-0.1	-0.1	0.4	1.3	-	1.3	-
Other Borrowings	-0.1	0.1	1.3	-1.1	-	-0.1	-
Privatisation Proceeds	0.5	0.4	0.6	2.5	0.8	0.4	0.7

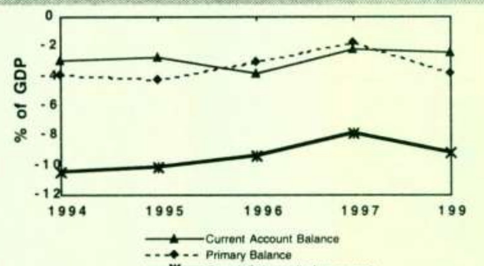
(a) The format of this table has been changed in line with 1996 GFS guidelines. Accordingly, privatisation proceeds have been shifted from the capital expenditure and net lending category to the financing section.

Source: Central Bank of Sri Lanka

areas increased sharply by 41 per cent and accounted for 62 per cent of the total public investment. The increase in public investment was particularly important in a context where private investment has slowed down due to depressed world market conditions.

The total net borrowing requirement of the government, which is equivalent to the overall budget deficit after foreign grants and privatisation proceeds, more than doubled in 1998 to Rs.81,558 million or 8 per cent of GDP. The utilisation of foreign resources for financing the budget deficit remained almost unchanged at 1 per cent of GDP in 1998. Consequently, the borrowing requirement from domestic sources rose considerably to 7 per cent of GDP in 1998 from 3.4 per cent in 1997. The increased demand for domestic

Chart 8.1
Fiscal Indicators



resources by the government led to a marked increase in bank borrowings. Generally, such a large increase in bank borrowings would have added strong pressure on interest rates. However, as private sector credit had slowed down, a sharp increase in interest rates could be avoided with a moderate monetary expansion.

8.3 Revenue and Grants

Total government revenue in 1998 at Rs.175,032 million recorded a slow growth of 6 per cent, in comparison to the 13 per cent rise in 1997. Revenue as a ratio of GDP, which had declined in the recent past from a peak of 20.4 per cent in 1995 to 18.5 per cent in 1997, deteriorated further to 17.3 per cent in 1998. The decline was entirely due to a drop in tax buoyancy. Tax revenue as a percentage of GDP declined further to 14.5 per cent of GDP in 1998, reflecting mainly the deterioration of the revenue base. Correspondingly, the share of non-tax revenue rose from 2.1 per cent of GDP in 1996 to 2.7 per cent of GDP in 1998. The emerging trends in government revenue clearly highlight the compelling need for an improvement of the tax base and strengthening of tax administration. Foreign grants utilised for budgetary purposes were estimated at Rs.7,200 million in 1998 as compared to Rs.7,329 million in 1997.

Tax Revenue

Tax revenue at Rs.147,368 million recorded a marginal increase of 3 per cent in 1998 in comparison to a 9 per cent increase in 1997. As a share of total revenue, tax revenue has declined continuously in recent years from 89 per cent in 1996 and 86 per cent in 1997, to 84 per cent in 1998. Similarly, tax revenue as a ratio of GDP declined to 14.5 per cent in 1998 from 17.8 per cent in 1995 and 16 per cent in 1997. This was the lowest recorded tax/GDP ratio since 1950. Various tax exemptions and concessions granted during the last few years with a view to enhancing investment and developing the capital market and the transformation of the turnover tax system to a GST with a less than revenue neutral tax rate of 12.5 per cent were the major contributory factors to the slowing down of tax revenue in 1998. The slowing down of economic growth also contributed to this decline in revenue.

A major step taken during the year with a view to rationalising the tax structure was the introduction of the GST from 1 April 1998. This new consumption tax, introduced with a standard rate of 12.5 per cent, is levied on the incremental value added at every stage in the production and distribution of goods and services. Although the GST replaced the turnover tax, financial services in the non-manufacturing sector continued to be under the turnover tax system. The implementation of the GST was also accompanied by revisions to excise taxes with a view to maintaining revenue neutrality. However, a marked shortfall in GST collections (by Rs.7,787 million compared with the expected target for the year) resulted in a lacklustre performance of this tax in 1998. Total revenues from the turnover tax and GST at Rs.39,343 million recorded a 9 per cent drop in 1998 as compared to a 16 per cent growth observed in TT collections in 1997.

In the manufacturing sector, the combined revenue from the turnover tax and GST declined by 4 per cent in 1998. The overall tax revisions made to excisable products in order to overcome the revenue shortfall arising from the exemption of petroleum products from GST and the reduction in the liquor tax rate from 18 per cent to 12.5 per cent resulted in a revenue shift of about Rs.800 million from GST on manufacturing activities to excise duty in 1998. Moreover, the provision of input credit facilities for service inputs in the manufacturing sector also contributed towards this decline. Meanwhile, in the non-manufacturing sector, TT/GST revenue declined by 5 per cent in 1998 as compared with a substantial growth of 37 per cent in 1997. The exclusion of certain service sectors from the GST, such as shipping, airlines and a major segment of the services rendered by the Ports Authority and Airport and Aviation Services, together with the input tax credit facility newly introduced under the GST can be cited as the major reasons for the decrease in this revenue source. Moreover, the full impact of the reduction of the turnover tax rate from 2 per cent in 1997 to 1 per cent in 1998 on financial activities was felt in 1998, thus contributing to the lower collection from the non-manufacturing sector. Revenue from GST/TT on imports amounted to Rs.25,358 million, while refunds on account of imported inputs totalled Rs.7,826 million. Accordingly, the net revenue collection on account of GST on imports at Rs.17,532 million registered a drop of 15 per cent in comparison to an increase of 9 per cent observed in the import turnover tax revenue collection in 1997. The abolition of the 10 per cent mark up margin (which was 25 per cent before November 1997) for the computation of the import tax base under the GST system, together with the increase in exemptions, have lowered the effective GST base. Possible irregularities in the refund process and the increase in the deferment period from 45 days to 60 days on the request of exporters may have also contributed

TABLE 8.2
Summary of Revenue by Component

Rs. Million

Item	1994	1995	1996	1997	1998 Approved Estimates	1998 Provisional	1999 Approved Estimates
Tax Revenue	**99,417**	**118,543**	**130,202**	**142,512**	**164,048**	**147,368**	**185,410**
Income Taxes	15,277	17,161	20,751	21,548	24,064	20,429	24,192
Personal	5,621	7,358	7,315	8,183	8,639	8,099	9,934
Corporate	9,656	9,803	13,311	13,038	14,850	11,788	13,544
Save the Nation Contribution	-	-	125	327	575	542	714
Taxes on Property	4,386	5,162	5,279	6,392	8,056	7,079	9,293
Tax on Treasury Bills held by Central Bank	471	1,050	1,604	1,080	-	-	-
Taxes on Domestic Goods and Services	56,685	70,797	77,105	86,750	100,968	91,706	120,798
General Sales and Turnover Tax/GST	32,300	36,429	37,631	43,492	47,130	39,343	58,111
Manufacturing	9,171	9,906	8,874	9,475	10,255	9,121	11,993
Non Manufacturing	6,445	7,074	9,711	13,328	10,800	12,690	19,590
Imports	16,684	19,449	19,046	20,689	23,975	17,532	26,528
Excise Tax	14,632	19,436	22,067	24,775	31,464	30,293	34,544
Liquor	4,686	6,298	5,839	6,181	8,369	7,665	9,192
Tobacco	7,888	8,788	12,833	14,139	16,295	15,051	17,002
Other	2,058	4,350	3,395	4,455	6,800	7,577	8,350
National Security Levy	9,693	14,408	16,441	17,338	20,500	21,079	26,700
Licence Fees	60	524	966	1,145	1,874	991	1,443
Taxes on International Trade	22,598	24,373	25,464	26,743	30,960	28,154	31,127
Imports	22,598	24,365	25,459	26,739	30,960	28,154	31,127
Exports	-	8	5	4	-	-	-
Non Tax Revenue	**10,621**	**17,715**	**16,077**	**22,524**	**24,389**	**27,664**	**28,910**
Property Income	7,360	12,011	10,059	15,022	15,178	18,462	18,895
of which: Central Bank Profits	1,200	1,200	1,700	1,500	2,650	2,650	3,000
Interest Income	4,560	6,991	5,222	8,002	7,108	7,786	7,050
Fees and Charges	988	1,751	2,827	2,800	2,858	2,890	3,329
Other Non-tax Revenue	2,273	3,953	3,191	4,702	6,353	6,312	6,686
Total Revenue	**110,038**	**136,258**	**146,279**	**165,036**	**188,437**	**175,032**	**214,320**
			As a percentage of GDP				
Tax Revenue	**17.2**	**17.8**	**17.0**	**16.0**	**18.4**	**14.5**	**16.0**
Income Taxes	2.6	2.6	2.7	2.4	2.7	2.0	2.1
Personal	1.0	1.1	1.0	0.9	1.0	0.8	0.9
Corporate	1.7	1.5	1.7	1.5	1.7	1.2	1.2
Save the Nation Contribution	-	-	-	-	0.1	0.1	0.1
Taxes on Property	0.8	0.8	0.7	0.7	0.9	0.7	0.8
Tax on Treasury Bills held by Central Bank	0.1	0.2	0.2	0.1	-	-	-
Taxes on Domestic Goods and Services	9.8	10.6	10.0	9.7	11.3	9.0	10.4
General Sales and Turnover Tax	5.6	5.5	4.9	4.9	5.3	3.9	5.0
Manufacturing	1.6	1.5	1.2	1.1	1.2	0.9	1.0
Non Manufacturing	1.1	1.1	1.3	1.5	1.2	1.3	1.7
Imports	2.9	2.9	2.5	2.3	2.7	1.7	2.3
Excise Tax	2.5	2.9	2.9	2.8	3.5	3.0	3.0
Liquor	0.8	0.9	0.8	0.7	0.9	0.8	0.8
Tobacco	1.4	1.3	1.7	1.6	1.8	1.5	1.5
Other	0.4	0.7	0.4	0.5	0.8	0.7	0.7
National Security Levy	1.7	2.2	2.1	1.9	2.3	2.1	2.3
Licence Fees	-	0.1	0.1	0.1	0.2	0.1	0.1
Taxes on International Trade	3.9	3.6	3.3	3.0	3.5	2.8	2.7
Imports	3.9	3.6	3.3	3.0	3.5	2.8	2.7
Exports	-	-	-	-	-	-	-
Non Tax Revenue	**1.8**	**2.7**	**2.1**	**2.5**	**2.7**	**2.7**	**2.5**
Property Income	1.3	1.8	1.3	1.7	1.7	1.8	1.6
of which: Central Bank Profits	0.2	0.2	0.2	0.2	0.3	0.3	0.3
Interest Income	0.8	1.0	0.7	0.9	0.8	0.8	0.6
Fees and Charges	0.2	0.3	0.4	0.3	0.3	0.3	0.3
Other Non-tax Revenue	0.4	0.6	0.4	0.5	0.7	0.6	0.6
Total Revenue	**19.0**	**20.4**	**19.0**	**18.5**	**21.2**	**17.3**	**18.5**

Source: Central Bank of Sri Lanka

towards the revenue shortfall from this source in 1998. It is therefore essential to improve GST collections by strengthening tax administration and adopting strict monitoring and auditing procedures.

The revenue collection from excise taxes at Rs.30,293 million registered an increase of 22 per cent in comparison to a 12 per cent growth in 1997. As a share of total tax revenue, excise taxes increased from 17.4 per cent in 1997 to 20.5 per cent in 1998. Revenue from cigarette excise taxes, however, recorded a lower increase of 6 per cent in 1998 in comparison to 10 per cent in 1997. This was mainly due to two reasons. First, it reflects the impact of downward adjustments in excise tax rates on cigarettes to maintain revenue and price neutrality with the implementation of the GST. Accordingly, the shift in tax collection from excise to GST is estimated to be about Rs.1,100 million. Second, price increases on cigarettes in July and November 1998 (the overall price increase was 22-25 per cent) adversely affected the growth in sales. Sales of cigarettes, which grew by 5 per cent during the first half of the year, dropped to less than 1 per cent during the second half of 1998. In contrast, the excise tax revenue mobilised through liquor rose by 24 per cent in 1998, compared to a 6 per cent growth in 1997. This was the combined outcome of the upward revision of the excise tax on hard liquor under the Excise (Special Provisions) Act from 12.75 per cent to 20.20 per cent in April, a further increase of the excise tax by 10 per cent on all varieties of hard liquor and the introduction of an excise tax on malt liquor on a strength basis from November 1998. Moreover, the increase in the production of all hard liquor varieties and malt liquor helped to increase liquor excise revenues. The production of hard liquor increased by 12 per cent, while the production of malt liquor increased substantially by 45 per cent with the commissioning of two beer factories with an annual production capacity of 28 million bulk litres in 1998. Revenue collection under the Excise (Special Provisions) Act, excluding cigarettes and liquor, recorded a significant increase (70 per cent) in 1998. The excise tax on petrol, one of the major revenue sources under this category, was increased from 25 per cent to 50 per cent in April 1998 to offset the revenue losses arising from the exemption of petrol from the GST. This revision, combined with a 4 per cent increase in petrol sales, has resulted in a revenue shift of about Rs.1,500 million from the GST to excise taxes. An additional excise duty of 10 per cent levied on all imported private vehicles from November 1998 also contributed towards the increase in revenue under the Excise (Special Provisions) Act.

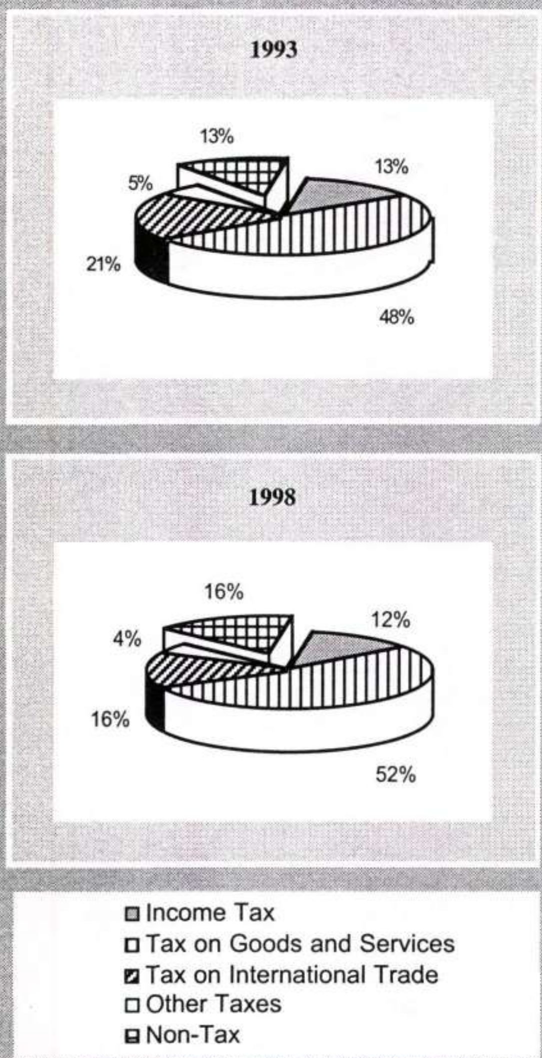
The National Security Levy (NSL) generated Rs.21,079 million, recording a significant growth of 22 per cent in 1998. As a ratio of GDP, NSL collections accounted for 2.1 per cent, while its share in total tax collection was 14 per cent. The expansion of the services sector, together with the upward revision of the price structure of taxable services (telecommunication and electricity) and the increase in the NSL rate from 4.5 per cent to 5.5 per cent during the latter part of 1998, contributed to the increase in revenue from this source. Thus, revenue from NSL on domestic activities increased by 20 per cent in 1998, while that on imports registered a slower growth of 18 per cent. Consequently, the share of NSL on imports declined to 63 per cent of total NSL collections from 65 per cent in 1997.

Despite the moderate growth in the value of imports by 10 per cent in 1998, the duty collected on imports increased only by 5 per cent, as in the previous year, to Rs.28,154 million. The average duty rate, i.e., the ratio of total import duty to total value of imports, dropped marginally to 7.4 per cent in 1998 from 7.7 per cent in 1997. The slow growth in import duty collections can largely be attributed to the removal of import duties on yarn, fabric, intermediate and capital goods for the textile industry and the grant of similar concessions to assist priority sectors such as agriculture, fisheries, industry, telecommunication, computer software manufacturing and tourism. The new duty exemptions limited the growth of dutiable imports to 5 per cent in 1998. Consequently, the share of dutiable imports to total imports declined to 35 per cent in 1998 from 37 per cent in 1997, while the average effective duty rate remained unchanged at 20.9 per cent in 1998. Moreover, the rationalisation of the tariff structure, which brought about a downward revision of the tariff rates from 10, 20 and 35 per cent in 1994 to 5,10 and 30 per cent in November 1998, together with the lower international prices for Sri Lanka's major dutiable imports in 1998, also contributed towards the slow growth in import duty collections.

The revenue from income taxes at Rs.20,429 million showed a 5 per cent decrease in 1998 owing to a marginal reduction in non-corporate income taxes to Rs.8,099 million and a 10 per cent decline in corporate income taxes to Rs.11,788 million. Collections from the Save the Nation Contribution grew from Rs.327 million to Rs.542 million. Income taxes as a percentage of tax revenue declined to 13.8 per cent in 1998 from 15.1 per cent in 1997, while as a percentage of GDP, income tax revenue dropped from 2.4 per cent in 1997 to 2 per cent in 1998. The unification of the tax threshold at Rs.144,000 for all tax payers, the widening of tax slabs to Rs.100,000 and the decrease in the withholding tax rate on interest income from 15 per cent to 10 per cent in 1997, contributed to the decline in the collection from personal income taxes. Corporate income taxes showed a decline of 11 per cent in 1998. Reduction of the corporate tax rate on priority sectors such as agriculture, fisheries, livestock and tourism to 15 per cent, investment tax allowances granted for manufacturing enterprises and tax incentives granted to develop thrust industries under BOI facilities, software industries and for regional industrialisation can be identified as major reasons for the declining trend in the corporate income tax collection.

Stamp duties, totalling Rs.7,069 million in 1998, showed an increase of 11 per cent, compared to a 21 per cent growth

Chart 8.2
Composition of Revenue



in 1997. The reduction of stamp duty on financial instruments such as promissory notes, repurchase agreements relating to Treasury bills and mortgage backed securities and the subsequent removal of the stamp duty on the issue of listed debt instruments such as debentures, promissory notes and repurchase agreements on Treasury bills in November 1998 led to a deceleration in the stamp duty collection. Moreover, the slower growth of imports in 1998 also affected the stamp duty collection from imports.

Despite an increase in the vehicle stock liable for diesel and luxury taxes, revenues from this source declined by 14 per cent to Rs.991 million. The unification of the dual levy on diesel vehicles at the lower rate of Rs.5,000 with effect from 1 April 1997 partly contributed to this decline. Weaknesses in the monitoring of this tax also appear to have been another reason for this decline.

Non-Tax Revenue

Non-tax revenue in 1998 registered a growth of 23 per cent, increasing from Rs.22,524 million in 1997 to Rs.27,664 million in 1998. Its share in total revenue rose to 16 per cent as compared to 14 per cent and 11 per cent in 1997 and 1996, respectively. As a percentage of GDP, non-tax revenue at 2.7 per cent in 1998, was marginally higher than in 1997. This growth in the non-tax revenues offset, to some extent, the shortfall in the tax revenue. Property income, which accounts for 67 per cent of total non-tax revenue, rose by 23 per cent mainly due to higher interest receipts, rent, profits and dividends collected from public enterprises. Interest receipts at Rs.7,786 million were higher than the estimate of Rs.7,108 million in 1998, due to the collection of arrears and the strict enforcement of time limits on payments due from public enterprises such as the Ceylon Electricity Board (Rs.3,069 million) and the Sri Lanka Ports Authority (Rs.727 million). Central Bank profit transfers increased from Rs.1,500 million in 1997 to Rs.2,650 million in 1998. The increase from this source of revenue offset the revenue loss arising from the abolition of the withholding tax on Treasury bills held by the Central Bank. Profits, dividends and levies, excluding Central Bank profit transfers, increased from Rs.4,284 million in 1997 to Rs.6,190 million in 1998, an increase of 44 per cent. Major contributors were the Sri Lanka Ports Authority (Rs.2,350 million), Ceylon Petroleum Corporation (Rs.500 million) and Air Lanka Ltd. (Rs.632 million). Meanwhile, a levy of Rs.1,000 million was collected from Bank of Ceylon under the Finance Act. The government also recovered Rs.658 million from the Bank of Ceylon and Rs.572 million from the People's Bank out of interest payments made on account of restructuring bonds to these two banks. Receipts from rent income increased by 66 per cent to Rs.1,410 million, mainly due to rent collected from privatised plantation companies. Revenue collected from other non-tax sources, such as fees and charges, social security contributions and non-industrial sales, also recorded a considerable increase of 23 per cent totalling Rs.9,202 million in 1998. These sources contributed to the increase in non-tax revenue in 1998.

Foreign Grants

Total foreign grants utilised for budgetary purposes during 1998 at Rs.7,200 million registered a decline of 2 per cent, reflecting a reduction in the flow of non-debt creating foreign aid in 1998. Grants in relation to GDP, at 0.7 per cent, were marginally lower than in 1997. Receipts on account of project grants, which funded the public investment programme, amounted to Rs.4,750 million. Japan continued to be the largest donor of grants, accounting for 46 per cent of the total, followed by India with a 22 per cent share in 1998.

8.4 Expenditure

Total government expenditure and net lending increased by 14 per cent to Rs.268,179 million in 1998. As a per cent of GDP, overall expenditure at 26.4 per cent was at the same level as in 1997. However, this was higher than the 24.9 per cent of GDP expected in the 1998 Budget. The increase in expenditure was mainly due to additional security expenses, a higher wage bill and a considerable increase in public investment. However, current expenditure as a ratio of GDP declined in 1998 to 19.7 per cent from 20.8 per cent in 1997, mainly owing to lower interest payments. Public investment rose to 6.7 per cent of GDP in 1998 from 5.8 per cent of GDP in 1997.

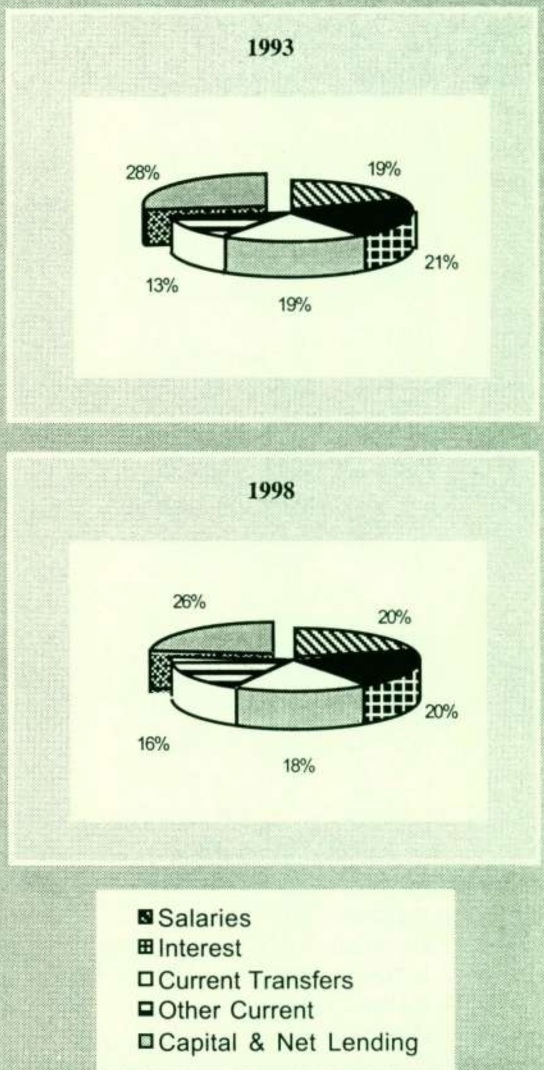
Current Expenditure

Current expenditure increased by 8 per cent to Rs.199,648 million in 1998, as compared to a 5 per cent rise in 1997. As a percentage of total expenditure, current expenditure declined to 74.4 per cent in 1998 from 78.6 per cent in the previous year. The drop in interest payments and current transfers and subsidies helped to avoid large increases in current expenditure. Interest payments declined marginally to Rs.54,897 million in 1998. As a percentage of GDP, interest payments declined from 6.2 per cent of GDP in 1997 to 5.4 per cent in 1998. Current transfers and subsidies, at Rs.46,984 million in 1998, indicated a decline to 4.6 per cent from 5.1 per cent in 1997. Defence and other security related expenditure increased by 13 per cent and accounted for 26 per cent of total current expenditure in 1998. As a percentage of GDP, defence expenditure remained at 5 per cent in 1998, around the same level as in 1997. Meanwhile, expenses on account of salaries of central and provincial government employees and other goods and services incurred by ministries and departments also recorded a considerable increase of 21 per cent in 1998, compared to 5 per cent in 1997.

The total salary bill rose by 21 per cent to Rs.53,880 million in 1998. The increase in 1997 was 17 per cent. As a ratio of GDP, salaries rose to 5.3 per cent in 1998 as compared to 5 per cent in the previous year. The increase in the salary bill was due to enhanced outlays on account of allowances paid to defence personnel for security operations carried out in the Northern and Eastern Provinces and the implementation of the second stage of the salary increase recommended by the Salaries Commission in 1995.

The new salary structure for public sector employees, which came into place in 1998, was implemented in two stages. In the first stage, 40 per cent of the proposed salary increase was granted to all employees from January 1997. The second stage, comprising the balance 60 per cent of the increase, which was scheduled to be implemented from January 1998, was sequenced due to resource constraints. Accordingly, all employees in the defence services and other public sector employees drawing less than Rs.7,500 per month were granted the increase with effect from January 1998. For those drawing salaries in excess of this amount, the balance increase was granted from July 1998 onwards.

Chart 8.3
Composition of Expenditure



The progress made in reducing the fiscal deficit during the previous two years, a relatively lower inflation rate and improved monetary and debt management helped to reduce the interest burden. Interest payments on government debt decreased marginally to Rs.54,897 million, owing to lower interest payments on domestic debt. This was a result of lower interest rates in 1997. Domestic interest payments, as a ratio of end year total domestic debt, declined to 11 per cent from 12.7 per cent in 1997. An improvement in debt management, particularly the popularising of government securities as risk free savings instruments among the people, could help to reduce interest costs further. The importance of reducing the fiscal deficit needs to be re-emphasised in this regard.

In spite of an increase in the outstanding Treasury bill stock by Rs.5,000 million in 1998, interest expenditure on

Treasury bills registered a notable reduction of 31 per cent in 1998. Interest payments for Treasury bills, as a ratio of end year Treasury bill stock, declined from 15.7 per cent to 10.3 per cent in 1998. The retirement of Rs.10,000 million of Treasury bills in 1997 reduced the interest expenditure in 1998 by Rs.350 million.

Interest payments on Rupee loans rose by 10 per cent to Rs.33,100 million in 1998, reflecting a rise in the stock of Rupee loans (Rs.33,500 million in 1997 and Rs.11,000 million in 1998). Interest payments on Rupee loans as ratio of the end year Rupee loan stock increased from 12.6 per cent to 13.2 per cent in 1998. The retirement of Rupee loans, which carried high interest rates of 15.0-16.0 per cent, and their replacement with new Rupee loans at lower interest rates of 11.0-12.25 per cent under the early retirement option reduced the interest cost by Rs.180 million in 1998. Interest payments on account of Treasury bonds increased from Rs.327 million in 1997 to Rs.2,100 million in 1998, mainly due to the increase in the stock of Treasury bonds, which partly replaced fixed interest Rupee loans.

Interest expenditure on account of foreign debt rose only by 9 per cent to Rs.7,300 million, despite a 20 per cent rise in the foreign debt stock in 1998. The annual average interest rate on foreign debt was 1.6 per cent as compared to 1.8 per cent in the previous year, reflecting the concessionary nature of such debt.

Total current transfers and subsidies increased by 3 per cent to Rs.46,984 million in 1998. As a ratio of GDP, however, the expenditure dropped to 4.6 per cent from 5.1 per cent in 1997. The efforts made to consolidate welfare programmes of the government, such as the improved screening process for Samurdhi recipients which led to a reduction of beneficiaries by 44,671 in 1998, helped to contain the growth of transfers to households.

Transfers to households, consisting mainly of pensions, assistance under the Samurdhi Programme, the fertiliser subsidy and other welfare payments, declined marginally by Rs.662 million to Rs.37,719 million in 1998. Accordingly, the household transfers to GDP ratio declined from 4.3 per cent in 1997 to 3.7 per cent in 1998. Outlays on account of pension payments increased by 9 per cent to Rs.19,477 million in 1998 due to the addition of 5,705 new retirees at the end of 1998 and the payment of arrears on account of the cost of living increase granted to pensioners in 1995. Pension payments, as a percentage of GDP, decreased from 2 per cent to 1.9 per cent in 1998. The number of families receiving Samurdhi benefits amounted to 1,973,183 while Samurdhi payments in 1998 marginally declined to Rs.7,963 million. Total transfer payments on account of the Samurdhi Programme also declined from Rs.8,718 million in 1997 to Rs.8,652 million in 1998. The fertiliser subsidy payments increased by 14 per cent to Rs.2,152 million in 1998. In spite of a sharp decline in the international price of urea, from US dollars 182 per metric ton in 1997 to US dollars 133 per metric ton in 1998, the higher outlay incurred was the combined effect of a 4 per cent increase in the usage of urea and the settlement of the 1997 arrears. Other transfers to households, which consist of payments in respect of refugees, school uniforms, school textbooks, school season tickets and other development subsidies, amounted to Rs.7,438 million in 1998. Payments on account of refugees amounted to Rs.2,117 million. The cost of the school uniform programme and the school textbook programme was Rs.1,736 million in 1998. The distribution of dry rations to displaced families in the Northern and Eastern Provinces continued. There were 113,558 recipients and the total expenditure under this programme amounted to Rs.1,054 million in 1998.

Transfers to institutions and corporations rose from Rs.5,350 million in 1997 to Rs.7,287 million in 1998. While transfers to corporations reflected an increase of 10 per cent during the year, transfer payments to public institutions increased by 63 per cent to Rs.4,320 million in 1998. The increase in transfer payments can largely be attributed to the accommodation of the new salary structure in these institutions. However, the reclassification of a major portion of Mahaweli Authority transfers to current from capital was also responsible for the increase in such expenditures to public institutions. Meanwhile, payments made to settle pension, EPF and ETF arrears at the Sri Lanka Central Transport Board (SLCTB) also contributed towards the increase in transfers to corporations (excluding Sri Lanka Railway and Postal Department), which rose from Rs.726 million in 1997 to Rs.1,324 million in 1998. A sharp reduction in wheat grain prices in the international market, to an annual average of US dollars 143 per metric ton (cif) in 1998 from US dollars 175 per metric ton in 1997, helped the government to completely phase out the flour subsidy in 1998, thus moderating the increase in transfers to corporations. Transfer payments to local governments also rose by 2 per cent to Rs.1,977 million owing to higher salaries and wages.

Current operational losses of Sri Lanka Railway (SLR) and the Postal Department increased to Rs.1,643 million as a result of higher wage bills and lower charges. A proposal to increase railway fares in the 1999 Budget by 25 per cent had to be withdrawn eventually. However, the postal rates were raised by 40 per cent from December 1998 and action has also been initiated to improve the commercial viability of the Postal Department by corporatisation. An upward revision of railway fares and a restructuring of the SLR are long overdue.

Expenditure on other goods and services, which represent day to day operational expenditure of government ministries and departments (excluding defence) rose by 38 per cent to Rs.15,930 million.

In terms of the functional classification, current expenditure on social services declined to 6.3 per cent of

TABLE 8.3
Economic Classification of Expenditure and Lending minus Repayment (a)

Rs. Million

Item	1994	1995	1996	1997	1998 Approved Estimates	1998 Provi-sional	1999 Approved Estimates
Current Expenditure	**127,084**	**154,159**	**175,148**	**184,749**	**187,090**	**199,648**	**199,205**
Expenditure on Goods and Services	54,700	75,447	80,003	83,831	85,604	97,768	91,976
Salaries and Wages	29,309	34,909	38,332	44,677	47,855	53,880	54,292
Other Goods and Services	25,391	40,538	41,671	39,154	37,749	43,888	37,684
Interest Payments	38,031	38,225	48,923	55,246	55,367	54,897	59,780
Foreign	5,511	6,162	6,739	6,692	7,418	7,300	8,060
Domestic (b)	32,520	32,063	42,184	48,554	47,949	47,598	51,720
Current Transfers and Subsidies	34,180	40,487	46,223	45,672	45,419	46,984	47,749
To Public Corporations	2,634	7,841	8,232	2,693	2,374	2,967	2,486
To Public Institutions	1,976	2,182	2,284	2,657	5,381	4,320	6,033
To Other Levels of Government	1,307	1,157	1,592	1,941	1,524	1,977	2,103
To Households and Other Sectors	28,263	29,307	34,114	38,381	36,140	37,719	37,127
Food Stamps, Food Subsidy etc.	4,654	1,799	591	-	-	-	-
Janasaviya/Samurdhi	5,369	5,130	8,591	8,718	9,670	8,652	8,374
Pensions	13,271	14,549	15,465	17,916	18,285	19,477	19,321
Fertilizer Subsidy	630	1,345	1,500	1,895	1,500	2,152	1,500
Other	4,339	6,484	7,967	9,852	6,685	7,438	7,932
Provision for Under Expenditure / Contingency	-	-	-	-	700	-	-300
Capital Expenditure	**30,391**	**41,722**	**37,638**	**43,982**	**57,339**	**54,160**	**68,736**
Acquisition of Real Assets	16,747	22,589	20,938	25,468	35,185	32,246	37,734
Capital Transfers	13,644	19,134	16,701	18,514	22,153	21,915	33,597
To Public Corporations	4,246	7,614	6,017	5,880	6,396	6,801	9,828
To Public Institutions	8,433	10,446	9,603	11,041	13,980	13,285	19,261
To Other Levels of Government	914	1,057	1,042	1,511	1,745	1,764	1,975
Other	51	17	39	83	32	65	2,533
Provision for Under Expenditure	-	-	-	-	-	-	-2,595
Lending minus Repayment	**13,289**	**7,602**	**5,873**	**6,366**	**10,656**	**14,370**	**15,322**
Advance Accounts	2,462	-1,560	630	1,226	500	2,784	500
On Lending	10,064	11,087	8,335	7,278	13,658	14,117	15,820
Restructuring Cost	3,739	3,191	90	2,193	1,500	3,688	3,980
Loan Repayments	-2,976	-5,097	-3,182	-4,331	-5,002	-6,218	-4,978
Total Expenditure and Net Lending	**170,764**	**203,483**	**218,659**	**235,096**	**255,085**	**268,179**	**283,263**

As a percentage of GDP

Item	1994	1995	1996	1997	1998 Approved Estimates	1998 Provi-sional	1999 Approved Estimates
Current Expenditure	**21.9**	**23.1**	**22.8**	**20.8**	**18.2**	**19.7**	**19.6**
Expenditure on Goods and Services	9.4	11.3	10.4	9.4	8.3	9.6	9.1
Salaries and Wages	5.1	5.2	5.0	5.0	4.7	5.3	5.4
Other Goods and Services	4.4	6.1	5.4	4.4	3.7	4.3	3.7
Interest Payments	6.6	5.7	6.4	6.2	5.4	5.4	5.9
Foreign	1.0	0.9	0.9	0.8	0.7	0.7	0.8
Domestic (b)	5.6	4.8	5.5	5.5	4.7	4.7	5.1
Current Transfers and Subsidies	5.9	6.1	6.0	5.1	4.4	4.6	4.7
To Public Corporations	0.5	1.2	1.1	0.3	0.2	0.3	0.2
To Public Institutions	0.3	0.3	0.3	0.3	0.5	0.4	0.6
To Other Levels of Government	0.2	0.2	0.2	0.2	0.1	0.2	0.2
To Households and Other Sectors	4.9	4.4	4.4	4.3	3.5	3.7	3.7
Food Stamps, Food Subsidy etc.	0.8	0.3	0.1	-	-	-	-
Janasaviya/Samurdhi	0.9	0.8	1.1	1.0	0.9	0.8	0.8
Pensions	2.3	2.2	2.0	2.0	1.8	1.9	1.9
Fertilizer Subsidy	0.1	0.2	0.2	0.2	0.1	0.2	0.1
Other	0.7	1.0	1.0	1.1	0.6	0.7	0.8
Provision for Under Expenditure /Contingency	-	-	-	-	0.1	-	-
Capital Expenditure	**5.2**	**6.2**	**4.9**	**4.9**	**5.6**	**5.3**	**6.8**
Acquisition of Real Assets	2.9	3.4	2.7	2.9	3.4	3.2	3.7
Capital Transfers	2.4	2.9	2.2	2.1	2.2	2.2	3.3
To Public Corporations	0.7	1.1	0.8	0.7	0.6	0.7	1.0
To Public Institutions	1.5	1.6	1.3	1.2	1.4	1.3	1.9
To Other Levels of Government	0.2	0.2	0.1	0.2	0.2	0.2	0.2
Other	-	-	-	-	-	-	0.2
Provision for Under Expenditure	-	-	-	-	-	-	-0.3
Lending minus Repayment	**2.3**	**1.1**	**0.8**	**0.7**	**1.0**	**1.4**	**1.5**
Advance Accounts	0.4	-0.2	0.1	0.1	-	0.3	-
On Lending	1.7	1.7	1.1	0.8	1.3	1.4	1.6
Restructuring Cost	0.6	0.5	-	0.2	0.1	0.4	0.4
Loan Repayments	-0.5	-0.8	-0.4	-0.5	-0.5	-0.6	-0.5
Total Expenditure and Net Lending	**29.5**	**30.5**	**28.5**	**26.4**	**24.9**	**26.4**	**27.9**

Source: Central Bank of Sri Lanka

(a) In accordance with the 1996 GFS guide lines, privatisation proceeds, which had previously been treated as a net lending item, are now considered as a financing item and hence, this item has been removed fron the above expenditure table.

(b) From 1996 onwards, includes interest payments on long-term bonds issued to the two state banks and the NSB.

GDP in 1998 from 6.7 per cent of GDP in 1997. Expenditure on social services accounted for 32 per cent of total current expenditure. Education and health absorbed almost 50 per cent of the total expenditure on social services.

Current expenditure on economic services showed a marked increase of 42 per cent to Rs.10,547 million during the year. Expenditure on transport and communication, agriculture and irrigation and energy and water supply indicated sharp increases in 1998. Outlays on general public services grew by 12 per cent to Rs.66,158 million in 1998. Expenditure on defence and public order and safety at Rs.50,960 million accounted for 77 per cent of the expenditure on general public services.

Public Investment

Public investment, consisting of capital expenditure and on-lending to public enterprises, recorded a sharp increase of 33 per cent to Rs.68,277 million in 1998. Expenditure directly incurred by ministries and departments under the Public Investment Programme (PIP) for construction and development of fixed assets recorded a 27 per cent increase in 1998 to Rs.32,246 million. Capital transfers to commercially oriented public corporations and boards rose by 16 per cent to Rs.6,801 million. Over 75 per cent of these transfers went to the National Water Supply and Drainage Board (Rs.2,390 million), Ceylon Electricity Board (Rs.432 million), Land Reclamation and Development Corporation (Rs.1,552 million) and the National Housing Development Authority (Rs.867 million). Meanwhile, capital transfers to non-commercial public institutions rose by 20 per cent to Rs.13,285 million in 1998. Principle users of these resources were the Road Development Authority (Rs.7,479 million), Mahaweli Development Authority (Rs.1,049 million), Urban Development Authority (Rs.492 million), the Restructuring

TABLE 8.4

Functional Classification of Expenditure

Rs. Million

Item	1994	1995	1996	1997	1998 Approved Estimates	1998 Provi-sional	1999 Approved Estimates
Current Expenditure							
General Public Services	**30,444**	**47,888**	**53,915**	**58,926**	**56,948**	**66,158**	**58,070**
Civil Administration	4,637	6,562	10,207	13,956	12,577	15,196	14,721
Defence	19,415	35,186	38,117	37,062	36,457	42,496	35,619
Public Order and Safety	6,392	6,140	5,591	7,908	7,914	8,466	7,730
Social Services	**47,656**	**57,648**	**59,294**	**59,742**	**64,356**	**63,595**	**66,763**
Education	14,836	15,784	16,018	17,757	21,920	20,582	22,231
Health	7,666	8,818	9,260	9,581	10,269	10,089	10,651
Welfare	24,560	32,106	32,824	31,251	30,858	31,472	31,168
Housing	-	-	-	-	-	-	-
Community Services	593	941	1,191	1,154	1,309	1,451	2,713
Economic Services	**6,195**	**8,078**	**8,807**	**7,418**	**10,756**	**10,547**	**9,862**
Agriculture & Irrigation	2,506	3,826	3,894	3,723	4,969	5,444	4,963
Fisheries	99	105	148	156	350	175	184
Manufacturing and Mining	351	252	282	599	767	325	436
Energy and Water Supply	518	990	590	486	874	757	876
Transport & Communucation	2,024	2,014	2,423	1,674	2,672	2,934	2,060
Trade & Commerce	72	172	891	159	243	167	306
Other	625	719	580	622	880	745	1,037
Other	**42,789**	**40,546**	**53,132**	**58,662**	**54,332**	**59,348**	**64,811**
of which; Interest	38,031	38,687	48,923	55,246	55,368	54,897	59,780
Provision for Under Expenditure	-	-	-	-	700	-	-300
Total Current Expenditure	**127,084**	**154,159**	**175,149**	**184,749**	**187,091**	**199,648**	**199,206**
Capital Expenditure and Lending							
General Public Services	**2,390**	**5,776**	**3,161**	**3,442**	**7,527**	**6,243**	**8,149**
Civil Administration	1,753	3,962	1,935	3,442	7,527	6,243	8,149
Public Order and Safety	637	1,814	1,226	-	-	-	-
Social Services	**7,677**	**9,854**	**10,322**	**11,552**	**15,059**	**15,528**	**16,969**
Education	2,877	3,124	4,384	4,592	5,957	6,112	7,304
Health	1,519	2,134	2,538	2,554	4,308	4,330	4,774
Welfare	1,681	1,690	868	751	396	967	141
Housing	802	1,610	1,174	792	1,647	1,314	1,514
Community Services	798	1,297	1,359	2,863	2,751	2,804	3,236
Economic Services	**29,304**	**36,106**	**31,409**	**32,479**	**46,633**	**44,677**	**57,526**
Agriculture & Irrigation	5,179	6,060	4,718	3,780	6,730	6,018	9,726
o/w Mahaweli Project	2,598	3,090	1,940	1,626	1,265	1,049	2,127
Fisheries	368	361	311	480	773	562	876
Manufacturing and Mining	22	250	356	1,442	2,167	2,191	836
Energy and Water Supply	5,518	5,003	6,035	6,816	10,203	8,804	12,627
Transport & Communucation	14,522	18,888	12,636	12,946	20,536	18,908	23,013
Trade & Commerce	182	20	105	182	909	230	394
Other	3,513	5,524	7,247	6,835	5,316	7,965	10,055
Other	**1,084**	**1,074**	**1,081**	**3,787**	**1,778**	**1,829**	**4,508**
Provision for Under Expenditure	-	-	-		-	-	-2,595
Total Capital Expenditure and Lending	**40,455**	**52,810**	**45,973**	**51,260**	**70,998**	**68,277**	**84,556**

Source: Central Bank of Sri Lanka

and Rehabilitation Authority of the North (Rs.996 million) and the Board of Investment (Rs.326 million).

The government's on-lending programme, which channels foreign resources to public enterprises, showed a twofold increase in 1998 to Rs.14,117 million. The target in the 1998 Budget was Rs.13,658 million. The Ceylon Electricity Board (CEB) utilised Rs.5,648 million for power generation and transmission projects, while on-lending to the Sri Lanka Ports Authority was Rs.3,356 million. However, Sri Lanka Telecom (Rs.2,426 million) was able to utilise only 71 per cent of its budgetary allocation due to delays in project implementation.

Public investment for economic services rose by 38 per cent to Rs.44,677 million (4.4 per cent of GDP). These investments were largely concentrated in the areas of transport and communication (Rs.18,908 million), energy and water supply (Rs.8,804 million) and agriculture and irrigation (Rs.6,018 million), accounting for 76 per cent of the total investment in economic services. Expenditure incurred on development of the road network through the Road Development Authority was Rs.7,479 million, while funds released to develop railway, port and telecommunication services amounted to Rs.9,239 million. Investments in the energy and water supply sectors through the CEB and the National Water Supply and Drainage Board rose by 29 per cent to Rs.8,804 million in 1998. Expenditure incurred by these two institutions accounted for over 95 per cent of total public investment in the energy and water supply sector in 1998. Capital expenditure on account of social services increased by 34 per cent to Rs.15,528 million in 1998. Investments in the health (Rs.4,330 million), education (Rs.6,112 million), community services (Rs.2,804 million) and housing (Rs.1,314 million) sectors accounted for over 90 per cent of the total expenditure on social services.

Under the public enterprise restructuring programme, a sum of Rs.3,688 million was spent in 1998. A major portion of restructuring expenditure was provided for the retrenchment of personnel at the Mahaweli Development Authority and for restructuring of the textile sector. Reflows of funds on account of loan repayments by public enterprises amounted to Rs.6,218 million. These were from the CEB (Rs.2,137 million), Sri Lanka Telecom (Rs.1,413 million), National Development Bank (Rs.1,162 million), DFCC Bank (Rs.562 million) and the Ports Authority (Rs.476 million), accounting for 92 per cent of total repayments. Meanwhile, operations on advance account activities resulted in a net outflow of Rs.2,784 million, in comparison to a budgetary estimate of Rs.500 million in 1998. The higher borrowing capacity of public sector employees owing to the salary increase and the reduction in interest rates on loans granted to public sector employees led to increased borrowings through the advance account.

8.5 Provincial Councils

The revenues of Provincial Councils (PCs) increased by 11 per cent to Rs.6,002 million, covering 22 per cent of their resource requirement. Their expenditures rose by 14 per cent to Rs.26,736 million in 1998. The PCs had an aggregate overall deficit of Rs.20,734 million in 1998, an increase from Rs.18,060 million in 1997. The deficit was financed through block grants, criteria based grants and matching grants from the Central Government.

Revenue

Major revenue sources of provincial councils were turnover taxes, licence fees and stamp duties. Reflecting an expansion of wholesale and retail businesses, the turnover tax collections increased by 9 per cent to Rs.2,980 million in 1998 and accounted for 50 per cent of the total. Revenues from licence fees increased by 13 per cent mainly due to a substantial increase in the registration of vehicles. Reflecting an increase in the value of property transactions during the year, revenues from stamp duty at Rs.1,267 million showed an increase of 21 per cent. Stamp duties accounted for 21 per cent of the revenue in 1998. Sales and charges, including court fines and fees increased by 18 per cent to Rs.481 million in 1998.

The Western provincial council mobilised Rs.3,981 million, accounting for 66 per cent of the total PC revenues, while the Central, Southern and North Western provincial councils, each accounted for about 8 per cent in 1998.

Expenditure

Current Expenditure

Current expenditure, at Rs. 25,230 million accounted for 94 per cent of the total expenditure as in 1997. There was a 14 per cent increase in current expenditure, in comparison to 6 per cent in 1997. This was entirely due to enhanced expenditure on personal emoluments by 16 per cent to Rs.19,744 million in 1998. The implementation of the second stage of the salary increase proposed in the 1997 Budget was mainly responsible for the higher salary bill. On a functional basis, education (Rs.13,507 million), health (Rs.3,737 million) and divisional administration (Rs.651 million) accounted for 92 per cent of total personal emoluments in 1998. Other recurrent expenses such as travelling, supplies, contractual services, transfers etc. registered a decline as compared to a growth of 6 per cent witnessed in the previous year.

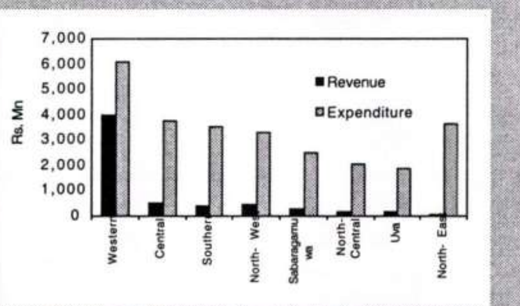
Expenditure on social services consisting of education, health and other social activities at Rs 21,787 million rose by 14 per cent accounting for 86 per cent of total recurrent expenditure. Meanwhile, outlays on account of provincial administration and economic services grew by 22 per cent and 14 per cent to Rs.2,377 million and Rs.1,067 million respectively, during the year.

The current expenditure of the Western Provincial Council at Rs.5,687 million accounted for the largest share of 23 per cent of total current expenditure of all PCs. While the Central provincial council was responsible for the next largest share of 14 per cent, all other provincial councils each accounted for 11 per cent of total current expenditures in 1998.

Capital Expenditure

The capital expenditure programme of the PCs decelerated in 1998. Capital expenditure, which includes equipment outlay, land improvement and structures outlay, capital transfers and subsidies and maintenance of capital assets, at Rs.1,507 million, registered a moderate increase of 8 per cent in comparison to a higher growth of 18 per cent recorded in the previous year. The slow growth in the capital programme was mainly due to resource constraints. PCs have been assigned certain work related to capital expenditure with the necessary funds being provided under the Medium-Term Investment Programme (MTIP) of the respective line ministries.

Chart 8.4
Performance of PCs - 1998



Central Government Transfers

PCs in 1998 had an overall deficit of Rs.20,734 million, as compared to a deficit of Rs.18,060 million in 1997. The Central Government provided a block grant of Rs.19,194 million to meet the current expenditure requirements in 1998. Of the total grants, block grants accounted for 95 per cent. Meanwhile, the balance financial requirement for capital expenditure was provided through criteria based grants and matching grants amounting to Rs.1,163 million and Rs.237 million, respectively, in 1998.

TABLE 8.5
Budget Out-turn for Provincial Councils

Rs Million

	1995	1996	1997	1998(a)
1 Total Revenue	4,440	4,884	5,395	6,002
1.1 Tax on Production and Expenditure	3,181	3,416	3,744	4,114
Turnover Taxes	2,335	2,464	2,734	2,980
Licence Fees	840	946	1,000	1,127
Other Taxes	6	6	10	8
1.2 Profits and Dividends	68	67	175	129
1.3 Sales and Charges	317	355	408	481
1.4 Stamp Duty	867	1,036	1,051	1267
1.5 Other	7	10	17	11
2. Total Expenditure	20,852	22,128	23,455	26,736
2.1 Current Expenditure	19,795	20,941	22,055	25,230
Functional Basis	19,795	20,941	22,055	25,230
Provincial Administration	2,067	1,942	1,941	2,377
Economic Services	755	834	939	1,067
Social Services	16,973	18,166	19,175	21,787
Economic Basis	19,795	20,941	22,055	25,230
Personal Emoluments	16,031	16,263	17,067	19,744
Other	3,765	4,679	4,988	5,486
2.2 Capital Expenditure	1,057	1,187	1,400	1,507
Acqusition of Capital Goods	594	757	729	773
Capital Transfers	66	53	55	75
Other	397	377	616	658
3. Financing	15,288	16,873	18,348	20,594
3.1 Block Grants	14,066	15,831	16,855	19,194
3.2 Criteria Based Grants	897	800	1,168	1,163
3.3 Matching Grants	325	242	325	237

(a) Provisional

Source: Ministry of Provincial Councils & Local Governments

8.6 Public Enterprise Reforms

Public enterprise reforms continued in 1998, with the divestiture of the shares of some major public enterprises, Air Lanka Ltd., plantation companies and Orient Lanka Ltd. However, there was a slowing down of the process due to uncertainty in the global economic environment and the weak stock market. The proceeds from the sale of shares amounted to Rs.4,387 million as compared to a target of Rs.8,000 million in the 1998 Budget.

The divestiture of a 40 per cent equity stake in Air Lanka with a 10 year management contract constituted the single largest privatisation agreement concluded in 1998. While the government received a cash offer of US dollars 70 million for a total of 40 per cent of Air Lanka shares, 26 per cent of the shares were sold in 1998 for a sum of US dollars 45 million (Rs.2,816 million). The remaining 14 per cent stake, amounting to US dollars 25 million, is to be transferred before end December 2000. Under the Air Lanka restructuring and refleeting programme, a sum of US dollars 600 million is expected to be invested on the modernisation of the Air Lanka fleet in 1999 and 2000. The required resources for this investment are expected to be raised from external sources.

The divestiture of 20 per cent of shares in each of the five plantation companies, namely, Madulsima Plantations Limited, Hapugastenne Plantations Limited, Balangoda Plantations Limited, Uda Pussellawa Plantations Limited and Malwatta Plantations Limited through a public share issue generated Rs.232 million in 1998. Further, three plantation companies, viz., Watawala Plantations Limited, Maskeliya Plantations Limited and Balangoda Plantations Limited, transferred 19 per cent of their shares held by the government to the highest bidders on the Colombo Stock Exchange (CSE), collecting Rs.557 million towards government revenue in 1998. However, the annual public enterprise reform programme targetted for plantation companies in 1998 could not be completed during the year due to weak conditions prevailing in the stock market. Among the 21 privatised plantation companies, 13 were listed on the CSE with public offers of 20 per cent of the issued share capital. The market capitalisation of the 13 listed plantations amounted to Rs.5,061 million and accounted for about 4 per cent of the CSE's market capitalisation in 1998. The divestiture of plantation companies, which was begun in late 1995, has so far generated Rs.6.5 billion as government revenue.

The re-divestiture of failed privatised enterprises continued in 1998. Colombo Commercial Company (Engineering) Limited, which was sold to Cargo Boat Dispatch Company Limited (60 per cent of shares) in 1993, but acquired by the government as a failed privatised public enterprise in 1995, was re-divested through the sale of 90 per cent of its shares to Serendib Engineering Agencies Private Limited generating Rs.38 million to government revenue in 1998. Lanka Loha Hardware Limited was also redivested through the transfer of the entire ownership to Ceylon Heavy Industries and Construction Company Limited (CHICO). However, this transaction did not generate revenue for the government as the liabilities of the company exceeded the value of assets.

TABLE 8.6
Realisation of Privatisation Proceeds in 1998(a)

Name of Enterprise	Sale of Majority Share Holding			Public Share Issue		Total Amount Realised Rs. Million
	% Divested	Local Rs. Million	Foreign Rs. Million	% Divested	Amount Realised Rs. Million	
Plantation Companies						
Watawala Plantations				19	231.80	231.80
Maskeliya Plantations				19	171.00	171.00
Madulsima Plantations				20	60.00	60.00
Hapugastenna Plantations				20	40.00	40.00
Balangoda Plantations				39	233.90	233.90
Udupussellawa Plantations				20	19.00	19.00
Kahawatta Plantations				20	33.00	33.00
Other Enterprises						
Colombo Commercial Co (Eng)	90	38.50				38.50
Air Lanka	26		2,816.16			2,816.16
Orient Lanka	37		740.00			740.00
Hingurakgoda Seed Paddy Farm						3.88
TOTAL		**38.50**	**3,556.16**		**788.70**	**4,387.24**

Source: Public Enterprise Reform Commission

(a) The Government accounts show net receipts from divestiture proceeds after payment of commission to Colombo Stock Exchange, other service charges etc. The table shows only the proceeds received through the Public Enterprise Reform Commision. In addition to this, instalment payments are received directly by the Treasury.

The 1998 Budget proposed to improve commercial seed paddy production through the long lease of selected government farms to the private sector. The Hingurakgoda Seed Paddy Farm was leased to CIC Fertiliser (Private) Limited and generated Rs.3.88 million (Rs.3 million for movable assets and Rs.0.88 million for long-term lease of land and fixed assets) as government revenue in 1998.

8.7 Financing of the Deficit

The Budget deficit (before grants and privatisation proceeds) in 1998 rose sharply to Rs.93,147 million from Rs.70,061 million in 1997. Gross foreign borrowings amounting to Rs.28,548 million were utilised for financing the deficit in 1998, an increase of 23 per cent over 1997. However, due to a repayment of Rs.18,351 million, net foreign borrowings during the year amounted to Rs.10,196 million. Net domestic financing of the deficit increased by Rs.41,087 million to Rs.71,362 million in 1998 in contrast to a decline of Rs.19,480 million witnessed in the previous year. Accordingly, net domestic financing as a percentage of GDP witnessed a substantial rise from 3.4 per cent in 1997 to 7 per cent in 1998. While net borrowings through domestic sources consisted of Rs.52,408 million from non-bank sources, bank borrowings amounted to Rs.18,954 million. This was in sharp contrast to a repayment of Rs.2,171 million effected to the banking sector in 1997.

Gross borrowings from domestic sources in 1998 totalled Rs.113,908 million. Gross borrowings from non-bank domestic sources amounted to Rs.94,954 million in 1998 in comparison to Rs.57,048 million in 1997. Rupee loans, Treasury bonds and Treasury bills continued to be the major instruments of resource mobilisation from domestic non-bank sources in 1998. The market orientation of medium-term debt was further enhanced with the mobilisation of Rs.34,509 million through Treasury bonds in 1998 as compared to a sum of Rs.8,224 million in 1997. While the coupon rates on 2, 3 and 4 year maturities of Treasury bonds were fixed at 11.0, 11.5 and 12.0 per cent, respectively, the weighted average yield rates for these securities hovered in a range of 10.81 - 13.94 per cent, 12.44 - 13.93 per cent and 12.93 - 13.94 per cent, respectively, during the year. A considerable deviation between the coupon rate and the weighted average yield resulted in a cash shortfall of Rs.1,156 million during 1998. Major subscribers to the Treasury bond programme continued to be the institutional investors, with the Employees' Provident Fund (EPF) and saving institutions investing Rs.8,812 million and Rs.8,763 million, respectively, in 1998. Reflecting the increased popularity of this instrument, subscriptions to Treasury bonds by other non-bank investors in the private sector amounted to Rs.17,320 million in comparison to Rs.3,503 million in 1997.

Gross borrowings through the floatation of Rupee loans raised a sum of Rs.52,300 million in 1998. However, a repayment of Rs.41,231 million inclusive of a sum of Rs.16,000 million on Rupee securities in respect of which the government exercised the option of early retirement, resulted in a net borrowing of Rs.11,069 million during the year. In 1997, net borrowings through Rupee loans amounted to Rs.33,500 million. The budgetary pressures during the year were reflected in the Rupee loan interest rate structure which increased from 11.00-11.25 per cent during the beginning of the year to 12.00-12.25 per cent in the latter part of 1998. As in the previous year, the principle subscriber to the Rupee loan programme was the EPF with a gross investment of Rs. 38,672 million in 1998. Investment by the National Savings Bank (NSB) amounted to Rs.9,528 million, while the balance Rs.4,100 million was taken up largely by other institutional investors.

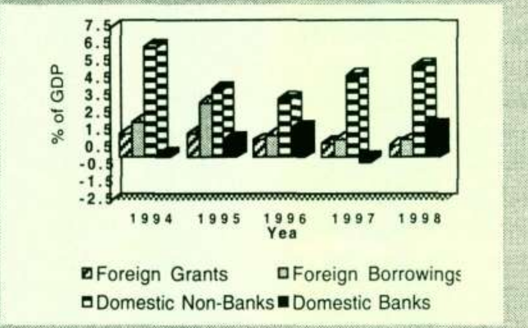
Resource mobilisation through new issues of Treasury bills in 1998 amounted to Rs.7,000 million. However, the retirement of Treasury bills to the value of Rs.2,000 million during the year resulted in a net issue of Rs.5,000 million in 1998. Adjusting for secondary market operations, Treasury bill holdings of the Central Bank increased by Rs.1,016 million to Rs.8,238 million. In contrast, the Treasury bill holdings of commercial banks registered a decline of Rs.6,938 million from Rs.20,490 million in 1997 to Rs.13,552 million in 1998. Consequently, the share of Treasury bills held by the banking sector diminished from 33 per cent in 1997 to 20 per cent in 1998, while that of the non-bank sector increased from 67 per cent to 80 per cent between the two years.

In the wake of a large resource gap in 1998, the government resorted to borrowings from the banking system to finance the deficit. Accordingly, net domestic borrowings from the banking system totalled Rs.18,954 million (including a FCBU loan of US dollars 100 million) in 1998. Despite the contractionary impact exerted by a reduction in cash items in the process of collection by Rs.660 million, the combined effect of the use of provisional advances by Rs.1,885 million, increase in Treasury bill holdings by Rs.1,016 million and a drawdown of government deposit balances by Rs.3,368 million resulted in a net borrowing of Rs.5,609 million from the Central Bank in 1998, contributing to the expansion of reserve money in the economy.

Net credit to the government from commercial banks which increased by Rs.13,345 million in 1998, was reflected in increased utilisation of import bills (Rs.9,892 million), increase in Treasury bond holdings by commercial banks (Rs.3,232 million) and the rundown of government deposits by Rs.2,083 million.

Gross foreign borrowings increased by 23 per cent to Rs.28,548 million in 1998, meeting 91 per cent of what was expected in the 1998 Budget. In net terms, foreign resources available for financing the deficit in 1998, at Rs.10,197 million, amounted to 1 per cent of GDP and were sufficient to finance only 12 per cent of the deficit in 1998. A higher level of on-lending and acceleration of the government's investment as expected in the Budget and the allocation of required domestic funds for capital expenditure can be identified as major reasons for the higher utilisation of foreign aid.

Chart 8.5
Deficit Financing



8.8 Government Debt

Total government debt stood at Rs.907,426 million in 1998. As a percentage of GDP, it increased to 89.4 per cent from 86 per cent in 1997. This was inclusive of a sum of Rs.47,961 million of long-term bonds issued for the re-capitalisation of the two state banks and the National Savings Bank in 1993 and 1996. The outstanding debt, excluding these bonds, amounted to Rs.859,465 million showing an increase of 21 per cent. Domestic debt, excluding restructuring bonds, stood at Rs.398,586 million and accounted for 46 per cent of total debt, compared to 47 per cent in 1997. Total domestic debt consisted of Rs.146,961 million of short-term debt and Rs.251,625 million of medium and long-term debt. Accordingly, the share of short-term debt decreased from 40 per cent in 1997 to 37 per cent in 1998, while medium and long-term debt increased their share from 60 per cent to 63 per cent. The stock of foreign debt increased by 20 per cent to Rs.460,879 million in 1998.

Domestic Debt

Domestic debt, net of restructuring bonds, increased by 19 per cent to reach Rs.398,586 million in 1998. Of this, medium and long-term debt comprised Rs.202,609 million of Rupee securities, Rs.48,915 million of Treasury bonds and a liability of Rs.12 million on account of Treasury Certificates of Deposit. The debt stock on account of Rupee securities, exclusive of those issued for restructuring purposes, stood at Rs.202,609 million in 1998 registering an increase of 6 per cent over 1997 as compared to a rise of 21 per cent witnessed during the previous year. Rupee loans with a longer maturity of 4-10 years were issued during the year at an interest rate of 11-12.25 per cent, as against the issuance of 2-8 year maturities in 1997 with an interest rate ranging from 11.25-14.5 per cent. Major subscribers to the Rupee loan programme continued to be the EPF and the NSB.

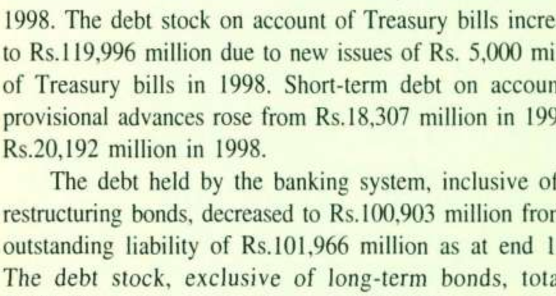
The stock of Treasury bonds rose to Rs.48,915 million in 1998, reflecting the progress made towards market orientation of debt. As a share of medium and long-term debt, Treasury bonds rose from 5 per cent in 1997 to 19 per cent in 1998. Subscriptions to Treasury bonds have shifted from principal subscribers in 1997 such as the EPF, NSB and the banking sector, to other non-bank investors in 1998. The decision to permit commercial banks to treat Treasury bonds as liquid assets and the acceptance of these bonds for transactions relating to the repurchase and reverse repurchase facility of the Central Bank increased the commercial banks' demand for Treasury bonds.

The outstanding liability on account of Treasury Certificates of Deposit continued to decline as in the previous year, with the debt stock in 1998 amounting to Rs.12 million as compared to Rs.83 million in 1997.

Short-term debt, consisting of Treasury bills, provisional advances and borrowings from FCBUs rose from Rs.133,303 million at the end of 1997 to Rs.146,961 million at end 1998. The debt stock on account of Treasury bills increased to Rs.119,996 million due to new issues of Rs. 5,000 million of Treasury bills in 1998. Short-term debt on account of provisional advances rose from Rs.18,307 million in 1997 to Rs.20,192 million in 1998.

The debt held by the banking system, inclusive of the restructuring bonds, decreased to Rs.100,903 million from an outstanding liability of Rs.101,966 million as at end 1997. The debt stock, exclusive of long-term bonds, totalled Rs.52,942 million, registering a marginal decrease of 2 per cent over the debt of Rs.54,005 million at the end of 1997. The debt held by commercial banks registered a decline of 7 per cent to Rs.71,753 million in 1998, mainly due to a reduction in the debt outstanding on account of Treasury bill holdings of commercial banks from Rs.30,857 million in 1997 to Rs.14,850 million in 1998. The decrease in the

Chart 8.6
Composition of Debt



commercial bank debt was in spite of an increase in their outstanding liability on account of Treasury bonds by Rs.4,020 million and the debt of Rs.6,773 million arising from the FCBU loan of US dollars 100 million contracted in 1998. Meanwhile, the debt held by the Central Bank rose from Rs.24,999 million in 1997 to Rs.29,150 million in 1998 mainly due to an enhanced liability on account of Treasury bills by Rs.2,266 million and provisional advances by Rs.1,885 million.

Foreign Debt

The foreign debt at Rs.460,879 million registered an increase of 20 per cent over the debt stock of Rs.383,116 million as at end 1997. The rise in the outstanding liability on account of foreign debt was due to a net borrowing of Rs.12,645 million and a substantial increase of Rs.65,118 million arising from exchange rate variations. In comparison, the increase in the debt stock due to exchange rate variations in 1997 was Rs.2,004 million.

Concessional loans increased by 23 per cent to Rs.445,938 million in 1998, compared to 4 per cent in 1997. As a percentage of total foreign debt, debt on concessional terms rose marginally from 95 per cent in 1997 to 97 per cent in 1998. Debt to multilateral sources accounted for 47 per cent of the total, while the balance was from bilateral sources. Major multilateral sources comprised institutions such as the ADB, IDA and IFAD, while the principal bilateral sources included Japan, the USA and Germany. The debt stock on account of non-concessionary loans reduced to Rs.14,941 million in 1998.

TABLE 8.7

Outstanding Central Government Debt (at end year)

Rs. Million

	1994	1995	1996	1997	1998 Provisional
Total Domestic Debt(a)	**249,119**	**285,759**	**349,007**	**382,962**	**446,547**
Short Term	108,725	127,470	142,689	133,303	146,961
Medium and Long term	140,394	158,289	206,318	249,659	299,586
By Debt Instruments	249,119	285,759	349,007	382,962	446,547
Rupee Securities	137,554	157,928	205,975	239,475	250,570
Treasury Bills	98,896	113,771	124,996	114,996	119,996
Treasury Bonds	-	-	-	10,000	48,915
Other	12,669	14,060	18,036	18,491	27,066
By Institutions	249,119	285,759	349,007	382,962	446,547
Banks	100,043	113,355	103,553	101,966	100,903
Central Bank	21,345	28,684	34,807	24,999	29,150
Commercial Banks(b)	78,698	84,671	68,746	76,967	71,753
Sinking Fund	137	100	100	100	100
Non-Bank Sector	148,939	172,304	245,354	280,896	345,544
National Savings Bank	46,407	48,406	47,794	62,498	67,260
Employees' Provident Fund	79,745	95,000	113,236	134,867	157,711
Other	22,786	28,898	84,324	83,531	120,573
Total Foreign Debt	**301,812**	**346,286**	**359,390**	**383,116**	**460,879**
Project Loans	246,075	286,848	302,666	321,122	399,890
Non-Project Loans	55,737	59,438	56,724	61,994	60,989
By Type	301,812	346,286	359,390	383,116	460,879
Concessional Loans	293,556	336,795	350,024	362,435	445,938
Non- Concessional Loans	8,256	9,491	9,366	20,681	14,941
By Currency	301,812	346,286	359,390	383,116	460,879
SDR	95,340	115,537	130,818	142,733	172,375
US Dollars	67,546	72,488	74,623	89,896	89,757
Yen	89,291	101,537	99,868	98,738	139,548
Deutsche Mark	25,009	29,114	27,313	25,746	29,432
Other	24,626	27,610	26,768	26,003	29,767
External Supplier's Credits	950	1,020	923	499	575
Total Outstanding Govt. Debt	**550,931**	**632,045**	**708,397**	**766,078**	**907,426**
Total Outstanding Govt. Debt Net of Sinking Fund	550,794	631,945	708,297	765,978	907,326
Memorandum Item: Debt/GDP(%)					
Domestic Debt	43.0	42.8	45.4	43.0	44.0
Foreign Debt	52.1	51.9	46.8	43.0	45.4
Total Debt	95.1	94.6	92.2	86.0	89.4

Source: Central Bank of Sri Lanka

(a) Inclusive of Rs. 24,088 million and Rs. 23,873 million of Long Term Bonds issued in 1993 and 1996 respectively

(b) Inclusive of Rs. 6,773 million (US$ 100 million) borrowings from FCBUs.

TABLE 8.8
Effect of Exchange Rate Variation on Foreign Loans (a)

Rs.Million

Item	1994	1995	1996	1997	1998(b)
Gross receipts	19,384	24,359	23,992	24,642	30,996
Repayments	7,606	8,477	8,939	10,004	18,351
Net receipts	11,778	15,882	15,053	14,638	12,645
Change in liability due to exchange rate variations	19,810	28,592	-1,654	2,004	65,118
Liability as at end of period	301,812	346,286	359,685	383,116	460,879

Source: Central Bank of Sri Lanka

(a) Data are based on value date recording system provided by the Public Debt Department of the Central Bank of Sri Lanka
(b) Provisional

Project loans increased by 25 per cent to Rs.399,890 million in 1998 and accounted for 87 per cent of foreign debt. The largest bilateral source for project financing was Japan, with gross disbursements of Rs.11,960 million in 1998, while the ADB and the IDA together accounted for a total disbursement of Rs.14,086 million. Non-project loans in the form of cash, commodity and other loans decreased from Rs.61,994 million in 1997 to Rs.60,989 million in 1998.

Debt Service Payments

The debt service payments of the government increased by 24 per cent to Rs.114,866 million. Of this, Rs.59,968 million was for amortisation payments, accounting for 52 per cent of total debt service payments. Interest payments marginally declined to Rs.54,898 million. Interest payments as a ratio of current expenditure of the government declined to 27.5 per cent in 1998 from 29.9 per cent in the previous year. As a ratio of GDP, debt service payments increased to 11.3 per cent in 1998 from 10.4 per cent in the previous year.

Total amortisation payments at Rs.59,968 million, consisted of Rs.41,617 million on account of domestic debt and Rs.18,351 million on account of foreign debt. The repayment to the domestic sector increased by Rs.17,596 million in 1998 mainly due to the early retirement of Rupee loans with an optional maturity. Amortisation payments to the foreign sector included a sum of Rs.5,434 million on account of deferred payments for purchases of defence services.

Total interest payments on domestic debt and foreign debt in 1998 amounted to Rs.47,598 million and Rs.7,300 million, respectively. In spite of the increase in the volume of outstanding domestic debt by 17 per cent in 1998, interest payments on domestic debt in 1998 showed a marginal reduction to Rs.47,598 million, compared to Rs.48,555 million in 1997. The interest expenditure on Treasury bills declined by Rs.5,776 million to Rs.12,398 million in 1998, reflecting the impact of lower interest rates on the government interest cost. Meanwhile, interest on account of medium and long-term debt rose by Rs.4,819 million to Rs.35,200 million. Interest payments on foreign debt rose by 9 per cent to Rs.7,300 million.

TABLE 8.9
Government Debt Service Payments

Rs.Million

Item	1994	1995	1996	1997	1998(a)
Debt Service Payments	66,213	77,663	81,263	92,519	114,866
Amortization Payments	22,671	36,546	33,240	37,272	59,968
Domestic	15,065	28,069	22,749	24,021	41,617
Foreign	7,606	8,477	10,491	13,251	18,351
Interest Payments	43,542	41,117	48,023	55,247	54,898
Domestic	38,031	34,955	41,284	48,555	47,598
Short Term	18,712	13,947	18,053	18,174	12,398
Medium & Long- Term	16,699	21,008	23,231	30,381	35,200
Foreign	5,511	6,162	6,739	6,692	7,300
Interest /Current Expenditure(%)	34.26	26.67	27.42	29.90	27.50
Debt Service/GDP(%)	11.43	11.63	10.57	10.39	11.32
Foreign Debt Service/Exports(%)	8.27	7.50	7.60	7.27	8.37

(a) Provisional

Source: Central Bank of Sri Lanka