8. FISCAL POLICY AND BUDGETARY OPERATIONS

8.1 Overview and Policy Strategy

The recent fiscal policy strategy has been formulated with a view to improving macroeconomic stability, increasing investment and saving in the economy, promoting employment and alleviating poverty. Fiscal reforms have aimed at moving towards a simple, low rate, non-distortionary tax system and the rationalisation of expenditure through curtailment of wasteful and non-priority expenses, public enterprise reforms and restructuring of public debt. In line with these policies, the Budget 2000 was designed to further consolidate the fiscal improvements achieved in 1999. However, the achievement of fiscal targets expected in the Budget 2000 was made extremely difficult by two major unfavourable developments; enhanced defence expenditure and increased oil prices in the international market. Consequently, a marked deterioration in fiscal indicators during the year 2000 reflected a veering off from the fiscal consolidation path established in the recent past.

High crude oil prices in the international market, coupled with bearish prospects for the sale of Sri Lanka Telecom (SLT) shares in the international market, were some external factors underpinning the poor fiscal performance. Large outlays on unanticipated defence expenditure were mainly responsible for the instability brought about by the domestic environment. High crude oil prices resulted in increasing the cost structure of some public enterprises. This in turn necessitated the upward revision of most administered prices in the economy. The price revisions, which imposed a burden on consumers, resulted in another wave of fiscal policy measures aimed at providing relief to selected segments of the population. The lacklustre revenue performance also contributed to the budgetary problem. In spite of corrective revenue and expenditure measures taken to arrest the destabilising impact of enhanced military expenditure, the budgetary outlook for 2000 worsened. Consequently, the budget outturn for 2000 reflected a slippage in terms of fiscal performance.

The overall deficit of the budget in 2000 rose to 9.9 per cent of GDP from 7.5 per cent in 1999 as against a target of 7.6 per cent in the original budget. The increase in the fiscal deficit was due to a shortfall in revenue mobilisation and higher outlays incurred largely on account of recurrent expenditure. Revenue as a percentage of GDP decreased to 16.8 per cent of GDP from 17.7 per cent in 1999, while current expenditure increased to 20.3 per cent of GDP in 2000 from 18.7 per cent of GDP in the previous year. On the revenue front, lower collections were experienced in both tax and non-tax sources. The escalation of defence activities in May 2000 largely contributed to the rise in the current expenditure of the government. The combined outcome of a lower revenue mobilisation and a higher current expenditure resulted in the current account deficit of the budget increasing to 3.4 per cent of GDP in 2000 from 1 per cent of GDP in the previous year. This was in contrast to a savings of 0.6 per cent of GDP anticipated in the original budget estimates. Public investment was maintained at 6.4 per cent of GDP in 2000. The higher deficit for 2000 was financed mainly through domestic borrowings, which increased from 6.8 per cent of GDP in 1999 to 9.4 per cent of GDP in 2000 - the highest recorded value for domestic borrowings in the recent past. Borrowings from the banking sector increased from 2.4 per cent of GDP in 1999 to 4.3 per cent of GDP in 2000. The need to resort to bank financing was partly due to an unfavourable external environment, which prevented the sale of SLT shares as originally planned.

The deterioration in the fiscal sector resulted in a worsening of other macroeconomic fundamentals in the economy. The higher deficit of the government was reflected in a worsened current account position of the balance of payments. In the context of limited capital mobility, the fiscal expansion also contributed to the depreciation of the currency. In the monetary sector, higher government borrowings from the Central Bank contributed towards increasing reserve money although the impact of this was offset by a sharp shortfall in external assets. The enhanced demand for domestic funds by the government together with the increased borrowing requirement by public corporations mainly due to high oil import prices, exerted upward pressure on domestic interest rates. The yield rates on market determined government securities rose to unprecedented levels with the yield on two-year Treasury bonds rising to 22 per cent during the year.

The policy implications of this fiscal outturn lie in its deviation from the medium term fiscal policy strategy announced in the Budget 2000. This strategy envisaged a lower budget deficit of 7.6 per cent of GDP in 2000 with gradual budgetary consolidation through a progressive reduction in the deficit in the subsequent years; 6 per cent of GDP in 2001 and 5 per cent of GDP in 2002. The lower deficit was expected to come from fiscal adjustment measures aimed at improving the revenue elasticity of the tax system, containing recurrent expenditure and prudent cash management practices. These measures together were expected to generate a surplus in the current account of the budget amounting to 2.5 per cent of GDP in 2001 and 4 per cent of GDP in 2002. Meanwhile, public investment was expected to increase to 8.8 per cent of GDP by 2002, thereby restoring its status as an important partner in the country's long-term development.

The government in the year 2000 adopted a two pronged approach in its taxation strategy whereby revenue mobilisation and the rationalisation of the tax structure constituted the focal areas for policy action. While revenue mobilisation was intended to address the issue of macroeconomic stabilisation, the government continued with rationalisation of the tax structure with a view to removing the structural constraints in the economy.

Structural constraints imposed by the tax system that hamper the growth of the economy were addressed through the rationalisation of the tariff system. Adjustments were made to the import tariff structure with a view to reducing the bias afforded to international trade through the tax system. As a heavy reliance on external trade taxes can impede an economy's capacity to develop new technologies, thus hampering growth prospects by reducing the exposure of domestic industries to international competition, the tariff reforms constituted a step in the right direction. Thus, the three band tariff structure introduced in 1995 consisting of tariff rates of 10, 20 and 35 per cent, was reduced to a two band rate structure of 10 and 25 per cent. The maximum tariff rate, which was fixed at 30 per cent in 1999, was lowered to 25 per cent in 2000. The 25 per cent rate band applied to finished products while the 10 per cent tariff was imposed on intermediate goods. However, the import duty rate on selected agricultural products was maintained at a higher rate of 35 per cent in order to provide protection to local farmers.

In order to simplify the taxation of petroleum products, the import duty on crude oil was replaced with an excise duty on finished petroleum products. Accordingly, with the removal of the import duty on crude oil in February 2000, an excise tax of 45 per cent was imposed on diesel, kerosene and petrol. This measure simplified the taxation of petroleum products by unifying the hitherto existing excise rates of 15 percent, 50 per cent and zero per cent levied on diesel, petrol and kerosene, respectively. In November 2000, the excise duty rate on these three products was revised downward to 35 percent.

With the downward revision and the simplification of the tariff structure, the government during the year 2000 also resorted to fine tuning the tariff system with a view to enhancing protection afforded to local manufacturers and farmers. The import duty waiver on edible oil was lifted in March 2000 and a surcharge of 25 per cent imposed in addition to an import duty of 25 per cent for protecting the coconut sector. The 5 per cent import duty maintained on maize was raised to 10 per cent in order to rationalise the duty rates. The customs duty on cement, which was unified at a rate of 10 per cent in February 2000, was raised to 25 per cent in June 2000 for selected categories in order to facilitate the restructuring of the domestic cement industry. A surcharge at an ad-valorem rate of 35 per cent was imposed on imported potatoes for a period of three months from end August 2000 ad-walorem to end November 2000 to enhance the protection provided to local farmers. In December 2000 the import duty on potatoes was replaced with a specific duty of Rs.20 per kg and the surcharge removed. The import of rice was brought under licensing requirements in July 2000 with a view to alleviating the problems encountered in marketing the domestic supply of paddy/rice.

In order to improve the elasticity of the tax structure, the government took steps to rationalise the plethora of tax concessions given to both the BOI and the non-BOI sectors. The investment tax allowance, under which the cost of investment was permitted to be set off against the assessable income of a person, ended in March 2000. However, as the balance unutilised portion of investment costs was permitted to be carried forward, the revenue implications of this measure would be felt in the future. Moreover, the grant of new tax holidays under the advanced technology package for new companies and existing undertakings expired on 1 April 2000. The advanced technology package consisted of tax holidays and the facility for duty free imports for industries utilising advanced technology.

With regard to the BOI sector, the government took steps as proposed in the Budget 2000, to rationalise concessions given to BOI enterprises. Prior to 1994, non-export oriented BOI enterprises were granted permission to import project related capital goods free of customs duty for an indefinite period. However, with the 2000 Budget, duty free imports of project related capital goods by non-export oriented BOI enterprises were restricted to the project implementation period. In the case of non-export oriented BOI enterprises who already avail themselves of this facility, the restriction applied from 31 March 2001. Moreover, the facility for the import of duty free vehicles for the replacement of existing vehicles by BOI companies was also withdrawn with effect from January, 2000. In addition, the government also ended in January, 2000 the facility to import luxury vehicles on a duty free basis for BOI enterprises.

In order to streamline the incentive structure and ensure that incentives are available only to priority sectors, while minimising revenue leakages, the Budget 2000 proposed the imposition of minimum investment limits for all incentive categories available under Section 17 of the BOI law. In addition, incentives applicable for regional industrialisation in the form of 5 and 8 year tax holidays were to be granted only to enterprises locating within industrial parks or Export Processing Zones (EPZs) designated as preferred or most preferred. Moreover, the Budget 2000 also proposed the rationalisation of BOI incentives available for large scale projects, which, prior to 1996, constituted a 10 year tax holiday for a minimum investment of Rs.500 million regardless of export orientation. The 2000 Budget proposed to limit this facility to flagship companies, which are enterprises with an investment exceeding Rs.3,500 million. For non-export oriented projects with investments in the range of Rs.500 million to Rs.3,499 million, a concessionary tax rate of 15 per cent was proposed in place of the tax holiday. The minimum investment criteria for investments approved under Section 17 of the BOI Law and the incentives applicable for regional industrialisation and large scale projects are at present being reviewed by the BOI.

Tax incentives in the form of qualifying payments and tax holidays were introduced in 2000 with a view to promoting savings, encouraging specified sectors and improving productivity. In order to encourage contractual savings among self-employed persons and middle income families, qualifying payments, which constitute deductible expenditures from taxable income, were introduced in respect of premia paid for life and medical insurance policies from April 2000 onwards. The qualifying payment is restricted to a sum of Rs.25,000 or one-third of assessable income, whichever is less. With a view to promoting the national film industry, incentives were also granted to the local film industry by way of a qualifying payment allowing the full cost of production of a film to be deductible.

Meanwhile, the qualifying payment introduced in the 1998 Budget for the purchase of new shares of a BOI company engaged in infrastructure development and a BOI sponsored two-tier hospital venture which provides free as well as fee based health services continued up to end March 2000. In the case of an infrastructure company, the tax relief applies to enterprises with an issued share capital of not less than Rs.300 million and an investment exceeding Rs.500 million.

The information technology industry has also been identified for promotion with the grant of a five year tax holiday for the establishment of information technology training institutes located outside the District of Colombo subject to a minimum requirement of 300 students being trained each year. Meanwhile, concessions made available in the 1998 Budget to promote software industries continued in 2000. Incentives provided through the 1996 Budget for the acquisition of advanced technology were also continued for a further period of two years.

In order to enhance professional skills and improve productivity, the government also allowed the expenses incurred on the cost of technical training including travel costs to be treated as a cost incurred in the production of income and therefore to be made deductible in arriving at statutory income.

The year 2000 witnessed the implementation of several measures aimed at enhancing the revenue mobilisation effort. These included the increase in the rate of the National Security Levy (NSL) and the expansion of its coverage to most services, the removal of the exemption granted to timber, cement, all varieties of meat and LP gas (cylinders above 15 kg) under the Goods and Services Tax (GST) and the increase in excise taxes on cigarettes and liquor. The escalation of defence expenditure in the early part of the year required the government to undertake several measures to sustain the revenue momentum, while maintaining budgetary targets. Therefore, in May 2000, the government raised the NSL rate to 6.5 per cent from the 5.5 per cent levied earlier. Simultaneously, excise taxes on cigarettes and liquor were also raised to meet the additional need for war expenditure. While the excise rate on cigarettes was increased by an average of 20 per cent during the year, the excise tax on liquor was increased by Rs.10 per bottle. Meanwhile, the Budget 2000 also expanded the coverage of the NSL to include most services in the tax net. Therefore, most services with a quarterly turnover exceeding Rs.100,000 were made liable to NSL from February, 2000. However, services such as the supply of electricity, water, transport of goods or passengers, leasing of moveable property, educational services, repair services (if GST registered) and medical services were excluded from this chargeability with a view to minimising the potential adverse impact of increasing the NSL rate. Moreover, with a view to strengthening the base for taxation of the GST, the government in February 2000, extended the coverage of GST to include the supply and import of revenue generating items such as timber, cement (including clinker), LP gas and meat. However, in order to reduce the cost of essential services, educational services and passenger transport services with a seating capacity in excess of 30 passengers were granted GST exemption status with effect from July 2000. The exemption granted to passenger transport services coverage of leasing facilities for such motor coaches.

The 2000 Budget also took several steps to improve tax administration and tax payer compliance. The 5 per cent withholding tax deducted at source from payments made to professionals on fees and similar services was extended to all services including payments made to corporate bodies and other businesses. However, the expansion of this mechanism to all businesses has led to some tax administration problems and it is proposed to impose in 2001, a threshold for businesses in this regard. The collection point for stamp duty in the case of imports was also transferred from commercial banks to the Customs Department in April 2000 with a view to facilitating tax administration further.

The government continued its efforts in liberalising the financial sector in 2000. The prevailing restrictions on foreign equity holdings in the banking and insurance sectors were relaxed by allowing foreign ownership up to 60 per cent in banking institutions and 90 per cent in insurance. The increase in foreign equity ownership is expected to improve the capital base and encourage foreign fund flows and help develop Colombo as a regional financial centre. Non-nationals were also permitted to hold 100 per cent stakes in stock broking firms licensed by the Securities and Exchange Commission (SEC) from 2000 onwards. With a view to revitalising unit trusts, the government permitted investments by non-residents in units of equity/growth unit trusts where relevant trust deeds do not permit more than 20 per cent investment in government securities. Such investments are to be routed through the Share Investment External Rupee Accounts (SIERA) to ensure the monitoring of inflows and outflows of funds. In order to expand and diversify investments of venture capital companies, the government amended the law for venture capital companies to opt out of the tax holiday period, which was hitherto linked to investments in specified risk ventures. This move enabled venture capital companies to make investments of their own choice.

With a view to modernising the insurance sector and revamping the insurance industry in Sri Lanka, the Regulation of the Insurance Industry Act No.43 of 2000 was passed by Parliament in August, 2000. The Act provides for the establishment of an Insurance Board for the purpose of developing, supervising and regulating the insurance industry. By repealing the hitherto existing Control of Insurance Act, No. 25 of 1962, the new act establishes a platform for the development of a modern regulatory environment for the insurance industry in Sri Lanka. The Board is empowered and responsible, among other things, to register persons carrying on insurance business as insurers, register insurance brokers, advise the government on the development of the insurance industry and implement policies of the government with regard to insurance.

Action on pension reforms has continued in 2000 with the appointment of a committee on pensions and the adoption of a draft bill to regulate private sector superannuation schemes. The proposed Superannuation Benefit Funds Regulatory Commission aims at protecting the savings of employees, ensure that such savings are invested in a prudent manner, ensure the viability of the superannuation funds and promote such funds by increasing public confidence in such benefit schemes. A Committee on Pensions has been appointed with a view to developing an appropriate pension policy for Sri Lanka, taking into consideration pension policies and superannuation schemes in countries with similar economic and social conditions as Sri Lanka. Moreover, the terms of reference of this committee includes exploring the possibility of amalgamating and simplifying numerous pension schemes with a view to designing a simplified social security scheme for public servants while establishing a sustainable W & OP fund. Recommendations are also expected to be made with regard to the rectification of pension anomalies.

The Budget 2000 further revitalised the economy by liberalising the petroleum sector. Activities of the petroleum sector were opened to private enterprises. With the opening of the lubricant market to the private sector in 1999, the import and distribution of lubricant oil was made more competitive during the year. The LP gas monopoly was also terminated in December, 2000 and the market opened up for competition in gas production, import and distribution. The opening of these activities to the private sector is expected to increase the competitiveness of Colombo as an air and sea travel hub in the region.

The intensified defence activities in the North and East of the country necessitated the government to increase defence expenditure. Accordingly, an additional sum of Rs.28 billion was provisioned for defence expenditure in excess of the budgeted military expenditure for the year. In the context of large expenditure overruns in respect of national security and defence, the government re-prioritised its public expenditure programme with a view to containing the budget deficit. Thus, expenditure on nonessential capital transactions such as outlays to be incurred for the purchase of vehicles, construction of new buildings and purchase of furniture and equipment was pruned. The budgetary provisions made available for foreign funded development projects were not subject to these cutbacks. In order to accommodate this expenditure increase and avoid cash flow problems stemming from possible revenue lags and expenditure leads, the government simultaneously made amendments to the Appropriation Act by raising the borrowing limit on two occasions. In May 2000, the government raised the approved borrowing limit of Rs.169 billion by Rs.20 billion to Rs.189 billion. In August 2000, the borrowing limit was again raised by Rs.25 billion to Rs. 214 billion. The Treasury bill limit was also raised by Rs.10 billion to Rs.135 billion.

In order to improve the delivery of basic amenities at the local level, the government provided increased contributions on concessionary terms to the Local Loans and Development Fund (LLDF). Moreover, a higher allocation of Rs.2.7 million was provided for the decentralised budgets of Members of Parliament in order to undertake development activities at the electoral level.

Expenditure rationalisation measures undertaken in 2000 included a compulsory 5 per cent savings from recurrent expenditure by all spending units of the government, public corporations, banks and statutory agencies as envisaged in the Budget 2000. A 5 per cent freeze from the recurrent vote of each spending agency was made by the Treasury, allowing spending agencies to make suitable adjustments to their budgets. Moreover, FR 66 transfers, which permit the transfer of unutilised funds within programmes and projects through the virement procedure, were also stopped with a view to improving financial discipline. Moreover, the Budget 2000 also introduced a system of registered suppliers for the procurement of high value goods by the government with a best price commitment. In order to improve the financial performance of public enterprises and statutory agencies, expenditure evaluation units in the form of audit and management committees were set up with a view to generating savings in the budget. The Budget 2000 also appointed a new Salaries Commission to re-examine the public service salary structure.

The progress made towards expenditure rationalisation was thwarted to some extent in 2000 with the increase in the number of ministries and the appointment of a larger Cabinet. In spite of pressures on budgetary finances, the government increased the number of ministries from 32 in 1999 to 46 in October, 2000. Thus, the number of Cabinet portfolios rose to 44 from 32 in the previous year, while the number of deputy ministers increased to 35 during the year. This will continue to impose an additional burden on the budget in the future, which has to be accommodated through budget cuts elsewhere. Hence, as ongoing public sector rationalisation schemes have targeted an overall reduction in the public sector through measures such as freeze on employment and cadre positions, an increase in the number of ministries can be viewed as a step taken backwards in the area of public sector rationalisation.

Revisions in administrative prices made in 2000 imposed an additional burden on consumers and therefore brought about another wave of fiscal policy measures aimed at providing relief to targeted sectors of the population. Thus, the Samurdhi allowance for beneficiaries in receipt of an income of Rs.250 or less per month was increased by Rs.150 for 1,104,924 families. For families in receipt of an income less than Rs.500 per month, the allowance was raised by Rs.200. The number of families entitled to this benefit was 897,863. Pensioners were also granted an allowance of 10 per cent of the monthly pension subject to a minimum of Rs.500 per month with effect from October 2000. The 10 per cent allowance granted in October 2000 incorporated a sum of Rs.300 earlier granted to pensioners with effect from August 2000. The Budget 2000 increased the allowance for pensioners by Rs.400 per month with effect from January 2000 for pensioners drawing a pension of less than Rs.4,000 per month. Public sector employees whose salaries are not adjusted for changes in the cost of living index were accorded an interim allowance on two occasions. In August 2000, public sector employees drawing salaries of less than Rs.12,000 per month were given an interim allowance of Rs.600 per month. In October 2000 the government granted an additional non-pensionable allowance of 10 per cent of the salary inclusive of allowance granted in August to all public officers subject to a minimum of Rs.1,000 per month. The subsidy on fertiliser was increased in June 2000 by Rs.50 per bag from Rs.398.23 to Rs.448.23 per 50 kg bag in order to maintain the price of urea at the prevailing rate of Rs.350 per 50 kg bag. With the increase in the price of gas, a policy decision was also taken to subsidise low income families in the usage of gas. Accordingly, a cash voucher of Rs.100 was given every two months for a family with a monthly income of less than Rs.5,000 and utilising gas for domestic cooking purposes. Meanwhile, a generalised subsidy in the form of a reduction in the price of wheat flour from Rs.17.95 per kg to Rs.14.95 per kg was also given in July 2000 in order to reduce the burden on consumers. However, budgetary pressures necessitated an increase in the flour price in November 2000 by Rs.2 per kg to Rs.16.95 per kg. The grant of subsidies to various sectors of the population resulted in increasing current expenditures of the budget, contributing to the derailment of the fiscal consolidation process.

The government continued its strategy of making the debt structure more market oriented and medium term. The borrowing requirement for the year was met largely through medium-term market oriented Treasury bonds. Treasury bonds accounted for 85 per cent of total domestic financing for the year. Although this constituted a desirable step in the direction of market orientation, the actual outcome of this policy measure had far reaching ramifications on the interest rate structure of the economy. In the context of unstable expectations and slippages in fiscal policy, the overreliance on market determined Treasury bonds for financing the budget deficit contributed to the sharp rise in interest rates. Treasury bond yield rates on two year maturities increased from 12 per cent in the first half of 2000 to 22 per cent in the second half of 2000. In order to avoid such happenings in the future, careful consideration must be given to the mix of debt instruments that is utilised to fill the borrowing requirement.

Treasury bonds with a call option were issued for the first time in 2000. The addition of this instrument to the present debt portfolio of the government enabled the government to improve the flexibility of its debt management as it provides an option to benefit from a decline in interest rates in the future. The date for exercising the call option was one year after the date of issue.

The Public Debt Department, an agency of the government, continued its efforts to develop the debt market during the year. With a view to strengthening the primary dealer network, 8 public limited liability companies with a dedicated capital of Rs.150 million each were appointed in March 2000 to act as Primary Dealers (PDs). Primary dealers are entrusted with the responsibility of being market makers in government securities. The formation of separate legal entities to act as PDs is expected to develop the debt securities market and thereby facilitate debt management. It is also expected to strengthen monetary and fiscal management, facilitate dealer surveillance, improve the targeting of incentives for primary dealer activities and provide a level playing field for primary dealer activities. The PDs are required to exclusively trade in government securities. Legislation during the year also provided for the Central Bank to engage in the supervision and examination of the activities of PDs in order to ensure that these institutions operate in a sound and efficient manner. The infrastructure necessary for a PD surveillance system also came into being during 2000. A framework and a system for PD surveillance was designed, including the preparation of two operations manuals for on-site examination and off-site surveillance. The manual also provides guidance to PDs as regards international best practices for trading in government securities, overall PD management, organisation and operations. In a bid to further strengthen the surveillance system, the Central Bank proposes to introduce directions relating to various aspects of surveillance including capital adequacy, compliance reporting, audited financial statements, prescribed accounts formats, code of conduct and custodial arrangements in 2001.

With a view to strengthening the economy further by addressing issues arising at the sectoral level, the government in 2000 set up committees consisting of public officials and private sector individuals to solve matters specifically related to various issues or sectors in the economy. Thus, core groups on labour, telecomunication, apparel, taxation and capital market development were established with public/private sector partnership with the objective of initiating and speeding up reforms in these sectors.

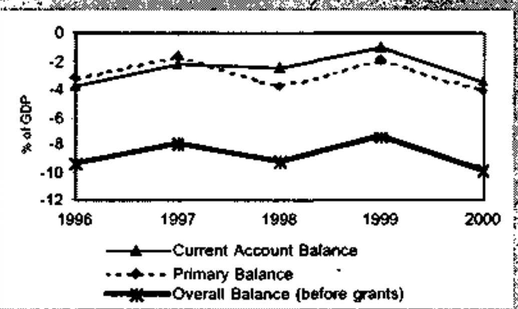
In the context of ongoing tax reforms, the activities of the core group on taxation were directed towards exploring new areas for revenue generation while further rationalising the tax structure with a view to simplifying and enhancing the transparency of the present tax system. The core group engaged in a review of the current tax policy which entailed at the micro level, an examination of specific taxes with a view to improving their effectiveness, and at the macro level, the identification of issues such as elasticity and tax incidence in the present tax system. The terms of reference of the taxation core group also included examining the role of taxation with a view to encouraging foreign investment, capital market and financial sector development.

8.2 Budget Outturn

Fiscal operations for the year 2000 commenced under a vote on account system whereby budgetary operations for the period January-April 2000 were conducted within this framework. The presentation of the budget 2000 took place in February, 2000. The budget envisaged to contain the overall deficit at 7.6 per cent of GDP. With a revenue/GDP ratio of 18.6 per cent and a current expenditure/GDP target of 18.1 percent, the current account of the budget was expected to yield a surplus of 0.6 per cent of GDP in 2000. Public investment was envisaged at 8.1 per cent of GDP. Financing from foreign sources was anticipated at 1.8 percent of GDP while domestic borrowings were expected to reach 3.5 percent of GDP. Proceeds from privatisation were targeted at 2.4 percent of GDP.

The overall deficit of the budget rose by Rs.41,286 million to reach Rs.124,541 million in the year 2000. As a percentage of GDP, the budget deficit increased from 7.5 per cent in 1999 to 9.9 per cent in 2000. The primary deficit of the government, which measures the effects of current budgetary policy by excluding interest payments, amounted to Rs.53,341 million as compared to Rs 21,132 million in the previous year. The primary deficit as a percentage of GDP registered 4.2 per cent in the year 2000 as compared to 1.9 per cent in the previous year. The higher deficit was the combined outcome of a shortfall in revenue mobilisation and increased outlays largely on account of current expenses.

Chart 8.1
Fiscal Indicators



Current expenditure as a ratio of GDP reached 20.3 per cent in 2000. The increase in current expenditure was largely due to the escalation of defence activities in May, 2000. The heightened military activities in the north and east of the country during the early part of 2000 necessitated the passage of a supplementary vote amounting to Rs.28 billion in aid of defence expenditure mainly for the purchase of military hardware and equipments. The unforeseen military expenses increased defence expenditure

TABLE 8.1

Summary of Government Fiscal Operations

Rs. million

Item	1996	1997	1998	1999	2000 Approved Estimates	2000 Provisional	2001 Approved Estimates
Total revenue	146,279	165,036	175,032	195,905	233,974	211,282	264,479
Tax revenue	130,202	142,512	147,368	166,028	201,766	182,392	234,113
Non tax revenue	16,077	22,524	27,664	29,877	32,208	28,890	30,366
Expenditure and lending minus repayments	218,659	235,097	268,179	279,159	329,831	335,823	387,537
Current	175,148	184,749	199,648	207,271	226,751	254,279	281,384
Capital and net lending	43,511	50,348	68,532	71,888	103,080	81,544	106,153
Public investment	45,973	51,260	68,278	71,436	102,261	80,955	106,329
Other net lending	-2463	-912	253	452	819	589	-177
Current account surplus/deficit(-)	-28,869	-19,714	- 24,616	-11,366	7,223	-42,997	-16,905
Primary account surplus/deficit(-)	-23,457	-14,815	- 38,250	-21,132	- 26,809	-53,341	-32,447
Overall deficit (before grants)	-72,380	- 70,061	-93,147	-83,255	-95,857	-124,541	-123,058
Financing	72,380	70,061	93,147	83,255	95,857	124,541	123,058
Foreign financing	17,898	17,287	17,397	8,245	22,166	5,640	28,963
Net borrowings	10,160	9,958	10,197	1,484	14,166	495	21,463
Grants	7,739	7,329	7,200	6,761	8,000	5,145	7,500
Domestic financing	49,754	30,275	71,362	74,876	43,691	118,500	69,095
Market borrowings	39,391	39,644	72,292	75,718	43,691	115,325	69,095
Non bank	26,301	41,816	53,338	49,722	43,691	61,935	68,515
Bank	13,090	-2,172	18,954	25,996	-	53,389	580
Monetary authority	9,873	-13,991	5,609	20,807	-	44,840	-
Commercial banks (a)	3,217	11,820	13,345	5,188	-	8,549	580
Other borrowings	10,363	-9,369	-930	-842	-	3,175	-
Privatisation proceeds	4,728	22,499	4,389	134	30,000	401	25,000
			As a percentage of GDP				
Total revenue	19.0	18.5	17.2	17.7	18.7	16.8	18.3
Tax revenue	17.0	16.0	14.5	15.0	16.1	14.5	16.2
Non tax revenue	2.1	2.5	2.7	2.7	2.6	2.3	2.1
Expenditure and lending minus repayments	28.5	26.4	26.3	25.2	26.3	26.7	26.9
Current	22.8	20.8	19.6	18.7	18.1	20.3	19.5
Capital and net lending	5.7	5.7	6.7	6.5	8.2	6.5	7.4
Public investment	6.0	5.8	6.7	6.5	8.1	6.4	7.4
Other net lending	-0.3	-0.1	-	-	0.1		-
Current account surplus/deficit(-)	-3.8	-2.2	-2.4	-1.0	0.6	-3.4	-1.2
Primary account surplus/deficit(-)	-3.1	-1.7	-3.8	-1.9	-2.1	-4.2	-2.2
Overall deficit (before grants)	-9.4	-7.9	-9.2	-7.5	-7.6	-9.9	-8.5
Financing	9.4	7.9	9.2	7.5	7.6	9.9	8.5
Foreign financing	2.3	1.9	1.7	0.7	1.8	0.4	2.0
Net borrowings	1.3	1.1	1.0	0.1	1.1	0.0	1.5
Grants	1.0	0.8	0.7	0.6	0.6	0.4	0.5
Domestic financing	6.5	3.4	7.0	6.8	3.5	9.4	4.8
Market borrowings	5.1	4.5	7.1	6.8	3.5	9.2	4.8
Non bank	3.4	4.7	5.2	4.5	3.5	4.9	4.7
Bank	1.7	-0.2	1.9	2.4	-	4.3	-
Monetary authority	1.3	-1.6	0.6	1.9	-	3.6	-
Commercial banks (a)	0.4	1.3	1.3	0.5	-	0.7	-
Other borrowings	1.3	-1.1	-0.1	-0.1	-	0.3	-
Privatisation proceeds	0.6	2.5	0.4	-	2.4		1.7

Source: Ministry of Finance and Planning

(a) Provisional

(b) In 2000, borrowings from commercial banks include a syndicated loan of US $ 100 million (Rs.7,754 million) obtained through domestic banks, which is treated as a foreign loan under the Treasury classification.

to Rs.70,773 million in 2000 as against a provision of Rs.48,866 million approved in the Budget 2000. Defence expenditure as a percentage of GDP increased from 3.9 per cent in the Budget 2000 to 5.6 per cent in actual terms. Meanwhile, revisions made to administrative prices as a result of exchange rate changes and high oil prices in the international market necessitated the government to grant wage and pension increases while protecting targeted segments of the population through enhanced welfare payments. Thus, wage increases given to public sector employees, the higher pension allowances granted to pensioners, the increased fertiliser subsidy and enhanced payments given to Samurdhi beneficiaries contributed to the rise in current expenditure of the government. Higher borrowings necessitated by the increase in expenditure have enhanced interest payments in the budget resulting in a further rise in current expenditure.

Although revenue at Rs.211,282 million registered an increase of 8 per cent in absolute terms over the previous year, the revenue/GDP ratio declined to 16.8 per cent in 2000 from 17.7 per cent in 1999. The revenue mobilisation effort fell short of the envisaged target of Rs.233,974 million in the Budget 2000. The shortfall in the revenue collection arose from tax as well as non-tax sources. Tax revenue as a percentage of GDP declined to 14.5 per cent in 2000 from a level of 15 per cent in 1999. Tax revenue shortfalls were registered in corporate income taxes and import duty collections with both these sources of revenue declining in absolute as well as in GDP terms during the year 2000.

Non-tax revenue also witnessed a decline in terms of its GDP ratio registering 2.3 per cent in 2000 from a level of 2.7 per cent in the previous year. Revenue from non-tax sources displayed a poor performance during the year under review largely due to lower profits and dividends obtained from public enterprises.

The combined outcome of lower revenue mobilisation and higher recurrent expenditure exacerbated the current account deficit of the budget to Rs.42,997 million in 2000 reflecting a more than threefold increase over the deficit of Rs. 11,366 million registered in the previous year. As a percentage of GDP, the current account deficit rose to 3.4 per cent in 2000 from 1 per cent in 1999.

Public investment at Rs.80,955 million in 2000 registered a 13 per cent increase over the previous year. As a ratio of GDP, public investment was maintained at 6.4 per cent. Main areas for public investment outlays included transport, communication, energy and water supply.

Financing from foreign grants and loans during the year amounted to Rs.5,640 million registering a decrease of 32 per cent over 1999. Foreign loans and grants together accounted for 0.4 per cent of GDP in financing the deficit as compared to 0.7 per cent of GDP in 1999. The share of foreign financing of the deficit declined to 4.5 per cent in 2000 from a level of 9.9 per cent in the previous year.

Privatisation proceeds utilised for financing the deficit in 2000 amounted to Rs.401 million as against a budgeted quantum of Rs.30,000 million envisaged mainly from the international listing of Sri Lanka Telecom in the year 2000. The shortfall in privatisation proceeds arose from the non-sale of Sri Lanka Telecom shares due to low prices prevailing for the telecom sector in the international market.

The shortfall in privatisation and foreign financing proceeds, together with lower revenue mobilisation and overruns in expenditure, necessitated the government to resort to enhanced borrowings from the domestic sector. Domestic financing of the deficit increased from 6.8 per cent of GDP in 1999 to 9.4 per cent of GDP in 2000. The budgeted amount for the year 2000 was 3.5 per cent of GDP. In rupee terms, the quantum of net domestic borrowings increased by Rs.43,624 million to reach Rs.118,500 million in 2000. While borrowings from non-bank sources increased from 4.4 per cent of GDP in 1999 to 5.2 per cent of GDP in 2000, the brunt of deficit financing was met through bank borrowings which increased to 4.3 percent of GDP in 2000 from 2.4 per cent of GDP in the previous year. In absolute terms, borrowings from the banking system rose by Rs.27,393 million to reach Rs.53,389 million in 2000. A large share of bank financing was obtained through the Central Bank. The Central Bank provided a sum of Rs.44,840 million for financing the deficit while commercial banks contributed Rs.8,549 million towards this purpose. In GDP terms, Central Bank financing of the deficit rose from 1.9 per cent in 1999 to 3.6 per cent in 2000 while the share of Central Bank financing in domestic financing rose from 28 per cent to 38 per cent between the years. Active trading in the reverse repo market as a result of the liquidity shortage led to the sharp increase in Central Bank financing facilities to the government in 2000.

8.3 Revenue

The revenue mobilisation effort of the government registered a setback in 2000, with the revenue/GDP ratio declining during the year. Total revenue, as a percentage of GDP, decreased to 16.8 per cent in 2000 from 17.7 per cent in 1999 - the lowest level reached during the last decade. The decline in import duty collection and the lower revenue collection from several key public enterprises largely accounted for the decline in the total revenue collection. However, the revenue collection in nominal terms, amounting to Rs.211,282 million, rose by Rs.15,377 million registering a slower growth of 8 percent in 2000, as compared to a growth rate of 12 percent observed in the previous year.

In spite of the introduction of several revenue mobilisation measures in the Budget 2000 and during the year, tax revenue as a percentage of GDP, declined to 14.5 per cent in 2000, from 15.0 per cent in 1999. An expansion in the base and rate of the National Security Levy (NSL), upward revisions made to excise duty rates on cigarettes and liquor and the extension of the coverage of the Goods and Services Tax (GST) to include the supply and import of revenue generating items were some measures taken to enhance the revenue collection during 2000.

Despite the revenue shortfall, the government continued its agenda of rationalising the tax structure. Accordingly, adjustments were made in 2000, to the tariff structure in order to reduce the highest level of nominal protection from 30 per cent to 25 per cent (except for a few selected agricultural products), while the number of rate bands was also brought down from three to two. The year 2000, also witnessed the rationalisation of the extensive range of incentives given to the BOI sector.

Meanwhile, nontax revenue, which has been stable at around 2.7 per cent of GDP for the last two consecutive years, dropped to 2.3 per cent of GDP in 2000. Reduced payments in the form of profits and dividends from public enterprises can largely account for the lower nontax revenue collection.

The poor revenue performance resulted in a deviation from the revenue targets envisaged in the Budget 2000. Total revenue, targeted at 18.7 per cent of GDP in the Budget 2000, fell short of the target by 1.9 percentage points. Tax revenue, targeted at 16.1 per cent of GDP, was below the target by 1.6 percentage points, while non-tax revenue, envisaged at 2.6 per cent of GDP, fell short of the budgetary target by 0.3 percentage points.

Tax Revenue

Tax revenue, totalling Rs. 182,392 million, registered a slower growth of 10 per cent in 2000, as compared to an increase of 13 per cent observed in the previous year. Reflecting the continuing structural shift towards domestic taxes from international trade oriented taxes, taxes on domestic goods and services amounting to Rs.71,295 million increased their importance in the tax structure. Revenue from domestic goods and services as a percentage of total tax revenue rose from 36 percent in 1999 to 39 percent in 2000. Consequently, the share of international trade oriented taxes as a percentage of total tax revenue declined to 41 percent in 2000, from 43 per cent in 1999. The downward revision of the tariff structure, the high value of duty free imports and the granting of temporary duty waivers for some essential imports, largely contributed to this structural change.

Revenue from income taxes declined by 3 per cent to Rs.27,457 million in 2000. As a percentage of GDP, the income tax collection decreased from 2.6 per cent in 1999 to 2.2 per cent in 2000 while its share in total taxes dropped from 17 per cent to 15 per cent in 2000. The decline in the income tax collection was mainly due to the poor performance of corporate taxes. Revenue from corporate taxes recorded a negative growth of 14 per cent in 2000 in contrast to a very high growth of 56 per cent in 1999, mainly due to lower profits or losses in some major public corporations. Personal income taxes however, showed a significant growth of 18 per cent in 2000 as compared to an increase of 13 per cent in the previous year reflecting the high income growth and widening of the coverage of the withholding tax base.

The revenue collection from corporate taxes declined by Rs.2,605 million to Rs. 15,757 million in 2000. The share of corporate taxes in the total income tax collection dropped to 57 per cent in 2000, from 65 per cent in 1999. Lower tax payments by two key public enterprises namely, the Ceylon Petroleum Corporation (CPC) and the Sri Lanka Ports Authority (SLPA), were the main reasons for the decline in corporate taxes. In 1999, the SLPA and the CPC were the two largest corporate tax payers with payments of Rs.3.4 billion each, together accounting for 37 per cent of the total corporate tax collection. However, due to cash flow problems, the SLPA was only able to meet a partial payment of Rs.1.5 billion as income tax liability for 2000, contributing to the shortfall in the corporate tax collection. The CPC, on the other hand, did not incur any tax liability as the corporation incurred large losses during the year due to the sharp increase in international fuel prices which was not accompanied by timely and adequate compensatory increases in the domestic price of petroleum products. Corporate tax revenue from other institutions however, recorded an increase of 24 per cent in 2000. Sectors that performed particularly well during the year were the banking and finance sector, followed by tobacco and wholesale and retail trade.

The revenue collection from personal income taxes totalled Rs.10,820 million recording an increase of 18 per cent in 2000. Higher salaries of both the public and private sectors together with the widening of the coverage of the withholding tax to all services were the main factors responsible for this growth. The withholding tax, which had hitherto applied only to payments made for professional services, was extended to cover all services, including payments made to corporate bodies and other businesses. The increase in private savings, attracted by high positive real interest rates in 2000, also contributed to the enhanced collection on account of income taxes through higher tax payments on interest income during the year. Meanwhile, revenue from Save the Nation Contribution (SNC) rose by 26 per cent, from Rs. 697 million in 1999 to Rs.880 million in 2000. This was a direct result of increased salaries and improved tax administration by the Inland Revenue Department.

The Goods and Services Tax (GST) generated a sum of Rs.43,893 million in 2000 reflecting a growth of 23 per cent in revenue collection over the previous year. Revenue from GST accounted for nearly a quarter of the total tax revenue in 2000. As a ratio of GDP, GST increased its share from 3.2 per cent in 1999 to 3.5 per cent in 2000. Improved tax administration, widening of the tax base, streamlining of the tax refund system and better economic

TABLE 8.2
Economic Classification of Revenue by Component

Rs. million

Item	1996	1997	1998	1999	2000 Approved Estimates	2000 Provisional	2001 Approved Estimates
Tax revenue	130,202	142,512	147,368	166,028	201,766	182,392	234,113
Income taxes	20,751	21,548	20,429	28,228	29,230	27,457	34,483
Personal	7,315	8,183	8,099	9,169	11,438	10,820	12,643
Corporate	13,311	13,038	11,788	18,362	16,945	15,757	20,720
Save the Nation contributions	125	327	542	697	847	880	1,120
Stamp duties	5,279	6,392	7,079	7,690	9,325	8,183	9,450
Tax on Treasury bills held by Central Bank	1,604	1,080	-	-	-		-
Taxes on goods and services	77,105	86,750	91,706	102,391	136,337	122,802	155,180
Turnover tax	37,631	43,492	16,166	1,799	2,759	1,708	1,965
Manufacturing	8,874	9,475	3,727	161	-		-
Non-manufacturing	9,712	13,329	7,312	1,635	2,759	1,708	1,965
Imports	19,046	20,689	5,127	3	-		-
Goods and Services Tax (GST)	-	-	23,177	35,540	50,536	43,899	54,205
Manufacturing	-	-	5,533	8,927	12,674	11,378	14,258
Non-manufacturing	-	-	5,437	10,704	15,688	13,643	17,203
Imports	-	-	12,207	15,909	22,174	18,872	22,744
Excise Tax	22,067	24,775	30,293	35,928	46,552	42,655	50,100
Liquor	5,839	6,181	7,665	8,745	10,700	9,531	10,900
Tobacco	12,833	14,139	15,051	17,205	18,802	19,268	21,050
Other	3,395	4,455	7,577	9,978	17,050	13,856	18,150
National Security Levy	16,441	17,338	21,079	28,127	35,340	33,539	47,020
Licence fees	966	1,145	991	997	1,150	1,007	1,890
Taxes on international trade	25,464	26,743	28,154	27,720	26,874	23,970	35,000
Imports	25,459	26,739	28,154	27,720	26,874	23,970	35,000
Exports	5	4	-	-	-		-
Non tax revenue	16,077	22,524	27,664	29,877	32,208	28,890	30,366
Property income	10,059	15,022	18,462	18,988	21,360	18,842	19,408
of which: Central Bank profits	1,700	1,500	2,650	3,000	3,200	3,200	5,000
Interest income	5,222	8,002	7,786	7,056	7,100	7,304	7,497
Fees and charges	2,827	2,800	2,890	3,375	4,361	3,589	4,290
Other non-tax revenue	3,191	4,702	6,312	7,514	6,487	6,459	6,668
Total revenue	146,279	165,036	175,032	195,905	233,974	211,262	264,479
			As a percentage of GDP				
Tax revenue	17.0	16.0	14.5	15.0	16.1	14.6	16.2
Income taxes	2.7	2.4	2.0	2.6	2.3	2.2	2.4
Personal	1.0	0.9	0.8	0.8	0.9	0.9	0.9
Corporate	1.7	1.5	1.2	1.7	1.4	1.3	1.4
Save the Nation contributions	-	-	0.1	0.1	0.1	0.1	0.1
Stamp duties	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Tax on Treasury bills held by Central Bank	0.2	0.1	-	-	-		-
Taxes on goods and services	10.0	9.7	9.0	9.3	10.9	9.8	10.8
Turnover tax	4.9	4.9	1.6	0.2	0.2	0.1	0.1
Manufacturing	1.2	1.1	0.4	-	-		-
Non manufacturing	1.3	1.5	0.7	0.1	0.2	0.1	0.1
Imports	2.5	2.3	0.5	-	-		-
Goods and Services Tax (GST)	-	-	2.3	3.2	4.0	3.5	3.8
Manufacturing	-	-	0.5	0.8	1.0	0.9	1.0
Non manufacturing	-	-	0.5	1.0	1.2	1.1	1.2
Imports	-	-	1.2	1.4	1.8	1.5	1.6
Excise tax	2.9	2.8	3.0	3.2	3.7	3.4	3.5
Liquor	0.8	0.7	0.8	0.8	0.9	0.8	0.8
Tobacco	1.7	1.6	1.5	1.6	1.5	1.5	1.5
Other	0.4	0.5	0.7	0.9	1.4	1.1	1.3
National Security Levy	2.1	1.9	2.1	2.5	2.8	2.7	3.3
Licence fees	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Taxes on international trade	3.3	3.0	2.8	2.5	2.1	1.9	2.4
Imports	3.3	3.0	2.8	2.5	2.1	1.9	2.4
Exports	-		-	-	-		
Non tax revenue	2.1	2.5	2.7	2.7	2.6	2.3	2.1
Property income	1.3	1.7	1.8	1.7	1.7	1.5	1.3
of which: Central Bank profits	0.2	0.2	0.3	0.3	0.3	0.3	0.3
Interest income	0.7	0.9	0.8	0.6	0.6	0.6	0.5
Fees and charges	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Other non tax revenue	0.4	0.5	0.6	0.7	0.6	0.5	0.5
Total revenue	19.0	18.5	17.2	17.7	18.7	16.8	18.3

Source: Ministry of Finance and Planning performance were contributory factors for the enhanced GST tax collection.

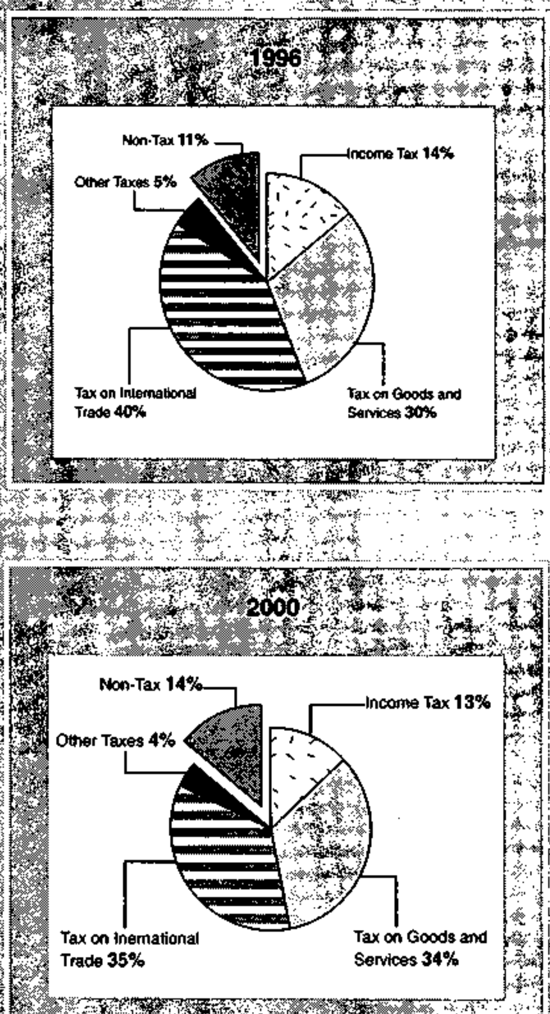
GST revenue from domestically produced goods and services amounted to Rs.25,021 million recording a growth of over 27 per cent. The growth in the liquor and tobacco industries, together with the expansion in the coverage of GST to encompass revenue generating items such as cement, meat, timber and gas, contributed to the higher GST collection from the manufacturing sector. The tobacco industry was the single largest contributor to GST in the manufacturing sector, accounting for 19 per cent of the GST collection from the manufacturing sector and 5 per cent of total GST revenue. The liquor industry was the next largest contributor followed by petroleum. The higher growth in services such as telecommunications, electricity, insurance and construction and the expiry of the GST exemption given to the hotel industry in April 2000, were the main reasons for the growth in GST revenue from the non manufacturing sector. Considerable improvements in GST administration and taxpayer compliance during the year, particularly through the conduct of investigations and audits, also contributed to the higher GST revenue collection in 2000.

GST from imports amounting to Rs.18,871 million recorded a growth of 19 per cent in 2000. This was the combined outcome of a growth of over 20 per cent in imports in 2000, expansion of the GST tax base and improvements made to the tax refund system. GST refunds on imports reduced from Rs.9,137 million in 1999 to Rs.7,121 million in 2000. The reduction in refunds was due to two amendments made to the GST refund system. In the latter half of 1999, the cash payment of input credit refunds to the importer on imported inputs used in the production of exports was replaced with a credit voucher system. In 2000, the cash refund in respect of input credit given to producers supplying to the domestic market was restricted to any excess tax paid on input of local purchases, while the input credit facility for importers, who undertake wholesale and retail trade was completely removed.

Revenue mobilised from excise taxes, which was Rs.42,655 million, accounted for 23 per cent of the total tax revenue collection in the period under review. As in the previous year, revenue from excise taxes grew at 19 per cent in 2000. Excise taxes as a percentage of GDP, increased from 3.2 per cent to 3.4 per cent in 2000. The enhanced revenue collection from petroleum products, as a result of the changes made to the taxation of petroleum products and the upward revisions in the excise duty rates on cigarettes largely contributed to the growth in excise duty collection.

Revenue generated from the excise duty on petroleum products amounted to Rs.10,700 million, recording a sharp increase of 57 per cent in 2000. Accordingly, its share in total excise duty collection also rose to 25 per cent from 20 per cent in the previous year. This improvement reflects both a change in the tax collection system of petroleum products and the sharp increase in diesel sales by 22 per cent in 2000. The removal of import duties on crude oil in the Budget 2000, resulted in the revision of excise duties on petrol and diesel and the imposition of an excise duty on kerosene, in order to maintain revenue neutrality. Excise duties on petrol, diesel and kerosene were set at 45 per cent. However, the sharp increase in international fuel prices in 2000, which led to heavy losses being incurred by the CPC, led to the revision of excise tax rates on petroleum products from 45 per cent to 35 per cent in October, 2000. Revenue from the excise duty on motor vehicles remained

Chart 8.2
Composition of Revenue



almost unchanged in 2000, as the revenue impact of an increase in the excise duty on petrol vehicles from 10 to 15 per cent and diesel vehicles from 60 to 65 per cent in February 2000, was offset by the reduction in the imports of motor vehicles by 11 per cent in 2000.

Revenue from the excise duties on cigarettes amounted to Rs.19,268 million, accounting for 45 per cent of total excise tax collection in 2000. Despite the reduction in total sales of cigarettes by 2 per cent, excise taxes on cigarettes grew by 12 per cent in 2000, due to the increase in taxes on cigarettes by around 20 per cent and the shift in consumption to brands with higher taxes.

Despite an increase in the excise duty rate on hard liquor by Rs.12 per proof litre in May 2000, excise duties on liquor grew at a lower rate of 9 per cent in 2000 compared to 14 per cent in 1999, due to a decline in the production of higher taxed brands of hard liquor in 2000. The revenue collection from malt liquor rose by 3.5 per cent, entirely due to a shift in the production towards higher strength malt liquor which are subject to a higher tax rate.

The National Security Levy was a buoyant source of revenue in 2000, with its GDP share increasing from 2.5 per cent to 2.7 per cent in 2000. Total revenue mobilised from the NSL amounted to Rs.33,539 million in 2000, recording an increase of 19 per cent and accounting for 18 per cent of total tax collection.. The increase in revenue from the NSL was due to the expansion of its coverage to a wider spectrum of services, growth in some key sectors liable for the NSL, such as finance and telecommunications and the upward revision in the tax rate in May 2000, from 5.5 per cent to 6.5 per cent. The NSL on domestic activities continued to show high growth, increasing by 38 per cent in 2000. The major contributor to NSL revenue from domestic activities was the banking sector, which accounted for more than a third of the total NSL revenue collection from domestic sources. However, a slowdown in the growth of revenue from the NSL on imports from 31 per cent to 8 per cent in 2000, reflected the higher share of imports that are not liable to NSL such as defence, intermediate goods and crude oil imports.

Despite a growth in imports by over 20 per cent in 2000, revenue from import duties declined by 14 per cent to Rs. 23,970 million. Consequently, its contribution to total tax revenue also dropped to 13 per cent in 2000 from 17 per cent in 1999. This decline was due to the removal of duty on crude oil imports, the temporary duty waiver afforded to refined petroleum imports, the partial duty waiver on essential food items and the rationalisation of the tariff structure. The Budget 2000 reduced the three-band tariff structure (10, 20 and 35) to two bands (10 and 25) with a special duty rate (protective tariff) of 35 per cent provided for selected agricultural commodities. The duty rate for raw material imports was maintained at 5 per cent. The average duty rate, the ratio of import duties to the total value of imports, declined from 7 per cent in 1999 to 4.5 per cent in 2000. Lower import tariffs and the higher value of duty free imports such as raw materials for export oriented industries, defence purchases ,and crude oil imports in 2000, can account for the lower average import duty incidence. The effective duty rate declined from 21 per cent in 1999 to 15 per cent in 2000. Duty waivers granted during the year, especially the duty waiver given to CPC and the partial duty waiver on certain essential commodities such as sugar, together with the lower tariff structure, contributed to the sharp decline in the effective duty rate.

Revenue collection from stamp duties which was Rs.8,163 million grew at a slower pace of 6 per cent in 2000, compared to the 9 per cent growth recorded in 1999. The reduction in the stamp duty on mortgage backed securities, in order to reduce the cost of borrowing and promote the mortgage market, effected in the Budget 2000, was a major reason for this slow down. To prevent abuses in the system, the Budget 2000 transferred the collection of revenue from stamp duties on trade documents from banks to the customs with effect from April 2000. As a result the base on which stamp duty was imposed was changed from the value of the Letter of Credit (LC) to the invoice value. The change in the collection point from bank to the customs is expected to prevent revenue leakages arising from under invoicing problems. Consequently, the revenue collection from stamp duties on trade documents rose from Rs.3,884 million in 1999 to Rs.5,697 million in 2000, increasing its share in the total stamp duty collection from 51 per cent to 70 per cent in 2000.

Non Tax Revenue

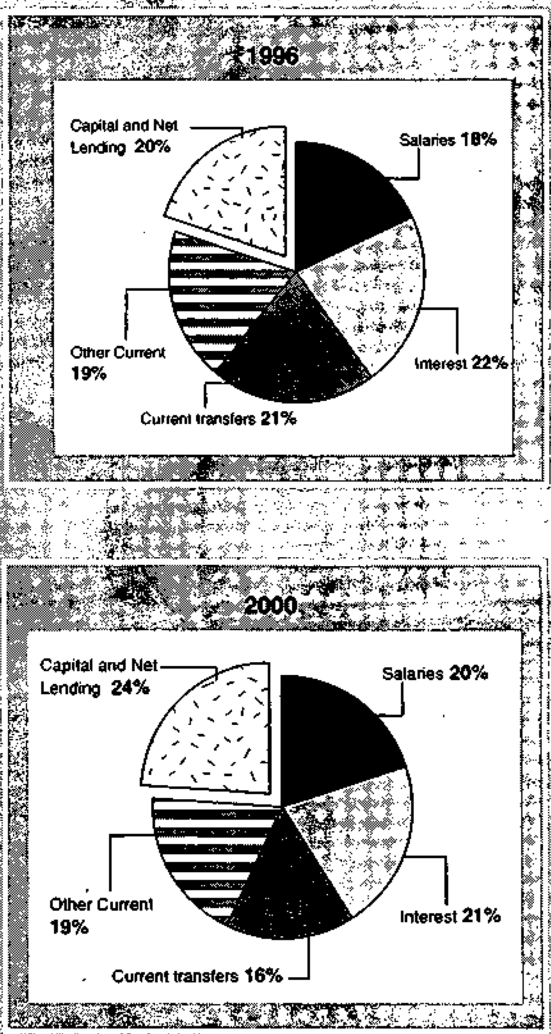
Non tax revenue declined by 3 per cent to Rs.28,890 million in 2000. As a percentage of GDP, non-tax revenue, which had remained stable at around 2.7 per cent in 1998 and 1999, fell to 2.3 per cent in 2000. Lower profit and dividend transfers from public enterprises mainly contributed to this decrease. Although the budget envisaged profit and dividend transfers of Rs.8.8 billion in 2000, only Rs.6.3 billion was realised. As compared to 1999, revenue from profits and dividends (excluding Central Bank profit transfers) declined by 18 per cent in 2000. Losses incurred by the CPC in 2000, and the lower taxable profits of SLT due to large investment allowances and depreciation allowances claimed in 2000, the reduction in international settlements on incoming calls from abroad, as well as the exchange losses suffered on foreign loan repayments due to the sharp depreciation of the rupee during the year, were the major contributory factors for this decline. Central Bank profit transfers increased by Rs.200 million to Rs.3,200 million in 2000. Interest income collected on loans given to public enterprises grew by 4 per cent in 2000 compared to 3 per cent in 1999. The main sources of interest income were the CEB (Rs.2,345 million), SLT (Rs.1,918 million) and SLPA (Rs.988 million). Fees and charges grew by 6 per cent in 2000 reflecting higher passport fees introduced in the Budget 2000.

8.4 Expenditure

In order to maintain the fiscal deficit within the targeted level, the Budget 2000 expected to contain current expenditure at 18.1 per cent of GDP, while maintaining capital expenditure and net lending at 8.2 per cent of GDP. However, there was a substantial deviation from this expected fiscal consolidation path due to unforeseen expenditure on defence activities, higher outlays on salaries and welfare payments and enhanced interest cost in 2000. Total current expenditure exceeded its original target by 2.1 percentage points of GDP, while public investments remained 1.7 percentage points below the anticipated target. In comparison to 1999, current expenditure increased by 1.6 percentage points of GDP to 20.3 per cent of GDP in 2000, while public investment was maintained at 6.4 per cent of GDP. Consequent on these developments, total expenditure as a percentage of GDP rose to 26.7 per cent from 25.2 per cent in 1999.

Total expenditure and net lending amounted to Rs. 335,822 million, a 20 per cent increase in 2000. Current outlays rose by 23 per cent to Rs.254,279 million, while capital expenditure and net lending reported a 13 per cent increase to Rs.81,544 million. The escalation of defence activities in the North and East since May 2000 compelled the government to keep the country on a war-footing and provide required resources to accommodate the needs of the defence services. As a result, there was a substantial increase in expenditure on defence imports, other local purchases related to defence activities and payments of salaries of newly recruited soldiers. In absolute terms, total defence expenditure including public order and safety increased by Rs. 22,066 million to Rs. 70,773 million in 2000. As a proportion of GDP, it rose from 4.4 per cent to 5.6 per cent between the years. This was the highest defence/GDP ratio recorded after 1996; excluding public order and safety it rose by Rs.16,844 million to Rs.56,915 million i.e. as a ratio of GDP from 3.6 per cent to 4.5 per cent. In addition, relief measures (such as increases in salaries and welfare payments for public sector employees, pensioners and Samurdhi beneficiaries) introduced in mid 2000 to compensate for the high cost of living in view of the upward revision of administered prices, and high interest cost on domestic debt due to increased borrowings from the domestic market also contributed to the increase in current expenditure. The resource constraints, resulting from the high current expenditure and shortfall in revenue collection, compelled the government to re-prioritise the public investment programme in 2000. All nonpriority and locally funded public investment programmes were curtailed in mid 2000 specially to accommodate rising defence expenditure, as this was considered a national priority. Meanwhile, slow performance of some of the foreign funded projects and a high level of underutilisation also contributed to the low level of public investment in comparison to the targetted programme in 2000. In view of the national priority needs, the curtailment of capital expenditure to meet current expenses to a certain extent was inevitable. However, in the long run, maintaining capital expenditure at the desired level is essential for sustained economic development and also for the government sector to reinforce the private sector initiatives in capital formation.

Chart 8.3
Composition of Expenditure



Current Expenditure

The Budget 2000 targeted to contain current expenditure at 18.1 per cent of GDP with the objective of further strengthening the fiscal consolidation process implemented in the recent past. In line with this objective, the government was able to maintain outlays within the targeted levels during the early months in 2000. However, the escalation of defence activities after May 2000 compelled the government to provide additional funds to strengthen defence services. Accordingly, five supplementaries, amounting to Rs. 28 billion were approved for defence services, while a further Rs.2 billion was provided for contingency purposes. In addition, a relief package extended to public sector employees, pensioners and Samurdhi recipients to meet the rising cost of living due to the adjustment of various administered prices (such as diesel, electricity and gas) and service charges (telephone, bus fares etc.) contributed to increasing the current expenditure by about Rs. 6,600 million. As a result of these measures, total current expenditure in 2000 increased by 23 per cent to Rs. 254,279 million, compared to a 4 per cent increase in 1999.

Major increases were recorded in expenditure on defence, interest payments and the central government salaries and other goods and services. Defence expenditure increased by 1.2 percentage points to 5.6 per cent of GDP, while expenditure on salaries and other expenditure of the central government rose to 2.9 per cent of GDP from 2.5 per cent of GDP in 1999. Expenditure on interest increased by 0.1 percentage points to 5.7 per cent of GDP. Meanwhile, central government block grants to PCs to meet recurrent expenses of PCs remained at 1.8 per cent of GDP. Expenditure on subsidies and transfers was maintained at 4.2 per cent of GDP in the current year under review as in 1999. With respect to the composition of the current expenditure, 51 per cent was incurred on the purchase of goods and services, while interest payments accounted for 28 per cent. The corresponding shares in 1999 were 47 per cent and 30 per cent, respectively.

The total expenditure on salaries and wages showed an increase of 17 per cent to Rs.68,544 million in 2000, compared with a 9 per cent increase in 1999. Salaries and wages as a percentage of GDP increased from 5.3 per cent in 1999 to 5.5 per cent of GDP in 2000. The wage bill of employees in the central government, at Rs.18,507 million, accounted for 27 per cent of the total salary bill. The growth in the central government employees' salary bill was 26 per cent in 2000 compared to 13 per cent in the previous year. The salary increase (interim allowance) given to public sector employees from August 2000 and the full year impact of the wage bill of 10,000 graduates recruited into the public service in 1999, mainly contributed to this increase. In view of the rising cost of living, the government decided to pay an interim allowance of Rs.600 per month from August 2000 to employees who draw a monthly salary of less than Rs.12,000. However, this allowance was then revised upward to a minimum of Rs.1,000 or 10 per cent of the salary, whichever was higher. Further, the salary increase was extended to the entire public service. Salaries and wages paid for defence and public order and safety services rose by 15 per cent to Rs.28,636 million accounting for 42 per cent of the total salary bill. The payment of the interim allowance and the new recruitment of soldiers primarily contributed to this increase. Meanwhile, salaries and wages of provincial councils (PCs) increased by 13 per cent to Rs.21,401 million. The resource constraints of the central government, limited transfer payments to PCs allowing them to meet part of the rising salary bill through their revenue generation. It has been estimated that the payment of the interim allowance was responsible for 39 per cent of the increase in the wage bill in 2000.

Government purchases of other goods and services, at Rs.62,121 million recorded a significant increase of 57 per cent in 2000. In contrast, these purchases in 1999 decreased by 9 per cent. As a percentage of GDP, expenditure on these items increased to 5.0 per cent in 2000 compared to 3.6 per cent in 1999. The main factor responsible for this sharp increase was the substantial growth in expenditure incurred on defence services, which increased by 77 per cent to Rs.42,137 million, compared to a 15 per cent decline in 1999. The purchase of defence goods and services accounted for 68 per cent of the total outlays on other goods and services. This ratio in 1999 was 60 per cent. The expenditure incurred by the central government on other goods and services also increased by 33 per cent in 2000 compared to 13 per cent in 1999. Meanwhile, the release of grants to PCs on accounts of other goods and services decreased to Rs.1,819 million in 2000 from Rs.2,112 million in 1999.

The total interest expenditure of the central government increased by 15 per cent to Rs.71,200 million in 2000. This increase in 1999 was 13 per cent. Total interest payments accounted for 28 per cent of the current expenditure, while as a percentage of GDP, it increased to 5.7 per cent compared with 5.6 per cent in the previous year. High budget deficits and increased borrowings, especially from domestic sources at market interest rates, were responsible for the high interest cost in the Budget. In order to avert the adverse implications of escalating interest costs on the government budget, corrective measures should be adopted through a rational debt management strategy, while making every effort to contain the fiscal deficit at a sustainable level.

Total interest payments consisted of Rs.62,185 million interest paid on domestic debt and Rs.9,015 million interest paid on foreign debt. Domestic interest payments include interest payments of Rs.6,068 million to the two state banks and the NSB on long-term special Rupee securities issued in 1993 and 1996. The interest cost on domestic debt, net of interest paid to the two state banks, increased by 19 per cent to Rs. 56,117 million. In 2000, the interest cost on domestic debt increased to 5.0 per cent of GDP from 4.8 per cent in 1999. This was entirely due to the heavy borrowings from the domestic market in financing the budget deficit. Meanwhile, interest paid on foreign loans increased by 3 per cent, largely due to exchange rate variations.

Interest payments on account of Rupee securities, at Rs 33,902 million, recorded an increase of Rs 1,100 million mainly due to the increase of Rupee loans stock by Rs 11,486 million in 1999. Although Rupee securities accounted for 55 per cent of the interest cost in 2000, its relative share in total domestic interest payments has declined from 61 in 1999 to 55 per cent in 2000. This was due to the greater use of Treasury bonds for government borrowing and a decline in the average interest rate on Rupee securities. The average interest rate on Rupee securities (total interest payment as a ratio of outstanding Rupee loan stock at the end of 1999) declined to 12.9 per cent in 2000 from 13.1 per cent in 1999 and 13.8 per cent in 1998. The shift in the Rupee loan stock from higher interest bearing Rupee loans to lower interest bearing ones and the exercising of an early retirement option to retire high cost Rupee securities in the recent past were the main factors that contributed to the decline in the average interest rate.

In spite of the increase in the outstanding Treasury bill stock by Rs.10 billion in 2000, interest payments on Treasury bills declined by Rs.319 million to Rs.12,766 million in 2000. Accordingly, interest payments as a ratio of the year end Treasury bill stock dropped to 9.5 per cent in 2000 from 10.5 per cent in 1999. This was the reflection of the relatively low interest rates prevailing during 1999 and the first half of 2000 and the shift of Treasury bill issues from shorter maturity bills (3 months) to longer maturity bills (over 6 months) for which interest is to be paid in 2001.

The interest payment on account of Treasury bonds recorded a sharp increase from Rs.7,487 million to Rs.15,015 million in 2000. Its share in the total interest payments increased from 14 per cent to 24 per cent in 2000. This was entirely due to the substantial amount of funds mobilised through Treasury bonds in 1999 (Rs.55,952 million) and in 2000 (Rs.99,257 million). The outstanding Treasury bond stock increased to Rs.204,124 million at end 2000 from Rs.104,867 million in 1999 and Rs.48,915 million in 1998. However, the reduction of coupon rates on Treasury bonds to a range of 10.75-11.75 per cent for maturities of 2-6 years bonds from 11.00-12.00 per cent in 1999 helped partly to contain the rising interest cost in 2000. The impact of the sharp increase in the interest rates on Treasury bonds since the beginning of the last quarter of 2000, was not directly reflected in the interest cost in 2000 as the coupon rate on Treasury bonds were fixed throughout the year. However, due to the increased gap between the fixed coupon rates and the increased yields on bonds, there was a cash shortfall of Rs.9,339 million in the bond programme in 2000 as bonds were sold at a discount. This will be reflected as interest costs at the time of the maturity of these bonds.

Interest payments on foreign debt recorded a moderate growth of 3 per cent to Rs.9,015 million in 2000. The reduction of borrowings from the external sector on a net basis, a slower rate of depreciation of the Central Bank middle exchange rate, at which debt service payments were made and a lower rate of depreciation of the rupee against the Japanese yen could be cited as some of the main reasons for the slow growth of interest cost on foreign debt in 2000. As a percentage of GDP, interest cost on foreign debt remained at 0.7 per cent, the same ratio observed in 1999.

Current transfers and subsidies increased by 11 per cent to Rs.52,314 million compared to a marginal decline in 1999. As a percentage of GDP, this expenditure was maintained at 4.2 per cent as in 1999. Expenditure on pension payments increased by 13 per cent to Rs.21,602 million in 2000. Pension expenditure accounted for 52 per cent of total transfers to the household sector, while as a percentage of GDP, it remained at 1.7 per cent. In addition to the increase in the number of pensioners by about 8,000, the increase in pension payments from August 2000 contributed to enhancing the pension bill. In view of the impact of the upward revision of the administered prices of certain goods and services on the living standard of pensioners, monthly pension payments were increased by Rs.300 per month for pensioners who receive a pension of less than Rs.6,000 per month from August 2000. This was again revised upward by Rs.200 from October 2000 and the increase granted to all pensioners. The additional cost incurred as a result of this pension revision was estimated at Rs.750 million and accounted for 29 per cent of the increase in the pension bill in 2000.

The increase in the number of families entitled to the income supplementary programme of Samurdhi and upward revision of the value of Samurdhi benefits during the second half of 2000 increased the total cost of the Samurdhi programme by 20 per cent to Rs.9,661 million in 2000. The total number of families entitled to Samurdhi benefits increased by 26,032 to 2,013,685 at the end of 2000. Meanwhile, Samurdhi benefits, which have not been changed since the introduction of the programme, were revised upward in August 2000 to off-set the adverse

TABLE 8.3
Economic Classification of Expenditure and Lending minus Repayment

Rs. million

Item	1996	1997	1998	1999	2000 Approved Estimates	2000 Provisional	2001 Approved Estimates
Current expenditure	**175,148**	**184,749**	**199,648**	**207,271**	**226,751**	**254,279**	**281,384**
Expenditure on goods and services	80,003	83,831	97,768	98,223	107,103	130,765	141,698
Salaries and wages	38,332	44,677	53,880	58,532	62,948	68,544	79,619
Other goods and services	41,671	39,154	43,888	39,690	44,155	62,221	62,079
Interest payments	48,923	55,246	54,898	62,123	69,048	71,200	90,611
Foreign	6,739	6,692	7,300	8,752	9,812	9,015	12,923
Domestic (a)	42,184	48,554	47,598	53,371	59,236	62,185	77,688
Current transfers and subsidies	46,223	45,672	46,982	46,925	49,600	52,314	57,954
To public corporations	8,232	2,693	2,967	3,277	2,721	3,370	3,057
To public institutions	2,284	2,657	4,320	4,834	6,222	5,705	7,038
To other levels of government	1,592	1,941	1,977	1,629	1,625	1,424	777
To households and other sectors	34,114	38,381	37,719	37,185	39,031	41,815	47,082
Food stamps, food subsidy etc.	591	-	-	334	455	435	518
Janasaviya / Samurdhi	8,591	8,718	8,652	8,020	8,000	9,661	10,300
Pensions	15,465	17,916	19,477	19,056	21,228	21,602	24,764
Fertiliser subsidy	1,500	1,895	2,152	1,390	1,500	1,733	2,000
Other	7,967	9,852	7,438	8,385	7,848	8,384	9,500
Provision for under expenditure / contingency	-	-	-	-	1,000		- 8,879
Capital expenditure	**37,637**	**43,982**	**54,161**	**60,340**	**80,542**	**67,769**	**83,942**
Acquisition of real assets	20,938	25,468	32,246	32,933	43,512	32,934	45,507
Capital transfers	16,699	18,514	21,915	27,407	46,054	34,835	50,151
To public corporations	6,017	5,880	6,801	9,075	13,150	12,048	10,582
To public institutions	9,601	11,041	13,285	15,968	22,310	14,522	28,141
To other levels of government	1,042	1,511	1,764	2,297	10,477	8,218	11,323
Other	39	83	65	67	117	47	105
Provision for under expenditure / savings	-	-	-	-	-	9,023	- 11,716
Lending minus repayment	**5,873**	**6,366**	**14,370**	**11,548**	**22,537**	**13,775**	**22,211**
Advance accounts	630	1,226	2,784	1,585	1,500	2,638	1,500
On lending	8,335	7,278	14,117	11,096	21,718	13,187	22,387
Restructuring cost	90	2,193	3,688	4,556	5,219	4,159	6,000
Loan repayments	-3,182	- -4,331	-6,218	- 5,689	- 5,900	-8,209	-7,676
Total expenditure and net lending	**218,658**	**235,097**	**268,179**	**279,159**	**329,831**	**335,823**	**387,537**
	percentage of GDP						
Current expenditure	**22.8**	**20.8**	**19.6**	**18.7**	**18.1**	**20.3**	**19.5**
Expenditure on goods and services	10.4	9.4	9.6	8.9	8.5	10.4	9.8
Salaries and wages	5.0	5.0	5.3	5.3	5.0	5.5	5.5
Other goods and services	5.4	4.4	4.3	3.6	3.5	5.0	4.3
Interest payments	6.4	6.2	5.4	5.6	5.5	5.7	6.3
Foreign	0.9	0.8	0.7	0.8	0.8	0.7	0.9
Domestic (a)	5.5	5.5	4.7	4.8	4.7	5.0	5.4
Current transfers and subsidies	6.0	5.1	4.6	4.2	3.9	4.2	4.0
To public corporations	1.1	0.3	0.3	0.3	0.2	0.3	0.2
To public institutions	0.3	0.3	0.4	0.4	0.5	0.5	0.5
To other levels of government	0.2	0.2	0.2	0.1	0.1	0.1	0.1
To households and other sectors	4.4	4.3	3.7	3.4	3.1	3.3	3.3
Food stamps, food subsidy etc.	0.1	-	-	-	-		-
Janasaviya / Samurdhi	1.1	1.0	0.8	0.7	0.6	0.8	0.7
Pensions	2.0	2.0	1.9	1.7	1.7	1.7	1.7
Fertiliser subsidy	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Other	1.0	1.1	0.7	0.8	0.6	0.7	0.7
Provision for under expenditure/contingency	-	-		-	-0.1		-0.6
Capital Expenditure	**4.9**	**4.9**	**5.3**	**5.5**	**6.4**	**5.4**	**5.8**
Acquisition of real assets	2.7	2.9	3.2	3.0	3.5	2.6	3.2
Capital transfers	2.2	2.1	2.2	2.5	3.7	2.8	3.5
To public corporations	0.8	0.7	0.7	0.8	1.0	1.0	0.7
To public institutions	1.3	1.2	1.3	1.4	1.8	1.2	1.9
To other levels of government	0.1	0.2	0.2	0.2	0.8	0.7	0.8
Other		-	-		-		- -
Provision for under expenditure / savings	-	-	-		- -0.7	0.0	-0.8
Lending minus repayment	**0.8**	**0.7**	**1.4**	**1.0**	**1.8**	**1.1**	**1.5**
Advance accounts	0.1	0.1	0.3	0.1	0.1	0.2	0.1
On lending	1.1	0.8	1.4	1.0	1.7	1.1	1.6
Restructuring cost	-	0.2	0.4	0.4	0.4	0.3	0.4
Loan repayments	-0.4	-0.5	-0.6	-0.5	-0.5	-0.5	-0.5
Total expenditure and net lending	**28.5**	**26.4**	**26.3**	**25.2**	**26.3**	**26.7**	**26.9**

Source: Ministry of Finance and Planning

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

impact of the rising cost of living on the most vulnerable groups. A continuous increase in the number of families entitled to Samurdhi benefits indicates the urgent need for introducing a proper screening process to minimise the leakage of public funds.

Expenditure incurred on the fertiliser subsidy increased to Rs.1,733 million compared to Rs.1,390 million in 1999. This was due to the decision taken by the government to maintain the price of urea at Rs. 350 per 50 kg despite the increase in international prices to US$ 137 per metric ton in 2000 compared to US$ 110 per metric ton in 1999.

The other welfare transfers to households including school uniforms, text books and season tickets, payments made to disabled soldiers and the cost of the dry ration programme for refugees, amounted to Rs.8,517 million in 2000 in comparison to Rs.7,875 million in 1999.

Current transfers to public corporations, institutions and other levels of government increased by 4 per cent to Rs.10,499 million in 2000. As a ratio of GDP, it further dropped to 0.8 per cent from 0.9 per cent in 1999. Transfers to public corporations amounted to Rs.3,370 million, an increase of 3 per cent, while public institutions obtained a sum of Rs.5,705 million, an increase of 18 per cent over 1999. Current transfers to institutions, include mainly transfers to the Mahaweli Authority (Rs.816 million), the Samurdhi Authority (Rs.1,333 million) Sri Jayawardenapura Hospital (Rs.350 million) and Road Development Authority (Rs.251 million).

Transfers to cover the operational losses of Sri Lanka Railways and the Postal Department amounted to Rs.1,529 million and Rs.188 million, respectively for the year 2000. The corresponding transfers in 1999 were Rs.1,848 million and Rs.212 million, respectively. Curtailment of current expenditure while improving the revenue collection were mainly responsible for the decrease in operational losses of these two public enterprises. The substantial level of operational losses at Sri Lanka Railway indicates the necessity of an upward adjustment of railway fares and structural reforms to maintain the viability of the enterprise. Meanwhile, current transfers to other levels of government declined to Rs.1,424 million in 2000 from Rs.1,629 million in 1999 due to resource constraints of the central government.

Public Investment

Total expenditure on public investment increased in absolute terms by 13 per cent to Rs.80,955 million. However, as a percentage of GDP, it was maintained at 6.4 per cent. Although the Budget for 2000 had targeted public investment at 8.1 per cent of GDP (Rs.102,261 million), two main factors, namely, curtailment of non-priority capital expenditure to finance increasing defence expenditure, and a slow progress in foreign funded investment projects constrained the government from achieving the target. Expenditure cuts imposed in May, 2000 were expected to reduce the level of public investment by Rs.7,500 million or 0.6 per cent of GDP. As against a sum of Rs.43,800 million anticipated under the external funding programme for public investment, realised investment was only Rs.28,922 million. The resource shortfall (about Rs.15 billion) resulted in a reduction of the expected level of public investment by 1.2 percentage points of GDP. These events are a matter for concern, as maintenance of public investment at a reasonable level is necessary to create an environment conducive to boosting private investment and to ensuring the growth momentum of the economy along the desired long term path.

Expenditure incurred by ministries and departments of the central government for purchase of capital assets and construction and development of fixed assets declined marginally to Rs.32,934 million. These investments were mainly focused on the improvement of education, health, agriculture and irrigation infrastructure. Total capital transfers to public corporations and institutions (Rs.26,570 million) recorded a slow growth of 6 per cent as compared to 27 per cent growth in the previous year. The slow performances were largely reported in public institutions such as National Water Supply and Drainage Board (Rs.4,695 million), Road Development Authority (Rs.7,119 million), BOI (Rs.1,470 million) and Urban Development Authority (Rs.200 million). Investment activities of Provincial Councils (PCs) reported a significant improvement in 2000. With the implementation of a new regional investment programme, called the 'Provincial Specific Development Programme (PSDP)' under the PC system, total investment expenditure by PCs increased to Rs.8,218 million in 2000 compared to Rs.2,297 million in 1999. This expenditure was mainly incurred on improving education, health and road infrastructure of the provinces.

The on-lending programme, which provides foreign funds to commercially oriented public enterprises, was limited to Rs.13,187 million in 2000 compared to an envisaged sum of Rs.21,718 million in the Budget. The original programme was expected to receive funds from external donors on concessionary terms. Although the three major public enterprises, the CEB (Rs.8,684 million), SLT (Rs.7,293 million) and SLPA (Rs.3,023 million) together were expected to utilise 87 per cent of the original on-lending programme, the actual utilisation rate was only 59 per cent. The SLPA was able to utilise only 22 per cent of the planned on-lent funds in 2000 due to the delay in completion of the North Pier Development Project Stage II and the delay in obtaining funds under the World Bank assisted programme. The foreign fund utilisation rate in 1999 was 23 per cent. The continuous under-utilisation of foreign on-lent funds by the SLPA is a matter for urgent concern as insufficient investments in port infrastructure will

TABLE 8.4
Functional Classification of Expenditure

Rs. million

Item	1996	1997	1998	1999	2000 Approved Estimates	2000 Provisional	2001 Approved Estimates
Current expenditure							
General public services	**53,915**	**58,926**	**66,158**	**63,220**	**70,762**	**62,644**	**79,115**
Civil administration	10,207	13,956	15,196	14,513	20,234	13,418	18,030
Defence	38,117	37,062	42,496	40,071	38,442	56,915	48,161
Public order and safety	5,591	7,908	8,466	8,636	12,086	12,312	12,924
Social services	**59,293**	**59,742**	**63,595**	**66,319**	**73,614**	**77,160**	**94,718**
Education	16,018	17,757	20,582	21,642	22,985	23,794	28,874
Health	9,260	9,581	10,089	11,215	15,133	15,394	19,009
Welfare	32,824	31,251	31,472	31,164	33,195	35,686	41,542
Community services	1,191	1,154	1,451	2,298	2,301	2,286	5,293
Economic services	**8,807**	**7,418**	**10,547**	**10,075**	**11,113**	**12,103**	**12,828**
Agriculture and irrigation	3,894	3,723	5,444	5,012	5,622	5,706	6,730
Fisheries	148	156	175	180	178	338	406
Manufacturing and mining	282	599	325	346	552	726	555
Energy and water supply	590	486	757	884	830	474	651
Transport and communucation	2,423	1,674	2,934	2,770	2,598	3,558	3,339
Trade and commerce	891	159	167	167	418	137	196
Other	580	622	745	716	915	1,165	951
Other	**53,132**	**58,662**	**59,349**	**67,657**	**70,261**	**82,372**	**103,603**
of which; interest	48,923	55,246	54,897	62,123	69,048	71,200	90,611
Provision for under expenditure	-	-	-	-	1,000	-	8,878
Total current expenditure	**175,149**	**184,749**	**199,648**	**207,272**	**226,751**	**254,279**	**281,384**
Capital expenditure and lending							
General public services	**3,161**	**3,442**	**6,243**	**6,345**	**8,234**	**7,157**	**7,057**
Civil administration	1,935	3,442	6,243	6,345	7,614	5,610	5,224
Public order and safety	1,226	-	-	-	620	1,547	1,833
Social services	**10,323**	**11,552**	**15,528**	**17,493**	**20,210**	**16,471**	**21,659**
Education	4,384	4,592	6,112	7,652	8,198	7,135	8,504
Health	2,538	2,554	4,330	4,456	7,109	5,302	7,279
Welfare	868	751	967	375	1,210	415	1,082
Housing	1,174	792	1,314	1,647	2,029	2,061	2,972
Community services	1,359	2,863	2,804	3,364	1,665	1,558	1,822
Economic services	**31,409**	**32,479**	**44,677**	**45,234**	**79,723**	**54,650**	**83,410**
Agriculture and irrigation	4,718	3,780	6,018	6,211	10,875	6,908	11,036
o/w Mahaweli Project	1,940	1,626	1,049	1,357	2,989	1,716	3,930
Fisheries	311	480	562	694	1,478	899	1,751
Manufacturing and mining	356	1,442	2,191	882	777	764	857
Energy and water supply	6,035	6,816	8,804	10,702	15,890	13,282	18,839
Transport and communucation	12,636	12,946	18,908	17,186	35,826	24,911	32,281
Trade and commerce	105	182	230	302	1,254	296	543
Other	7,247	6,835	7,965	9,258	13,623	7,590	18,105
Other	**1,079**	**3,788**	**1,829**	**2,365**	**3,117**	**2,880**	**5,919**
Provision for under expenditure	-	-	-	-	9,023	-	11,716
Total capital expenditure and lending	**45,973**	**51,260**	**68,277**	**71,436**	**102,261**	**80,958**	**106,329**
			As a percentage of GDP				
Total Expenditure							
General public services	**7.4**	**7.0**	**7.1**	**6.3**	**6.3**	**7.2**	**6.0**
Civil administration	1.6	2.0	2.1	1.9	2.2	1.5	1.6
Defence	5.0	4.2	4.2	3.6	3.1	4.5	3.3
Public order and safety	0.9	0.9	0.8	0.8	1.0	1.1	1.0
Social services	**9.1**	**8.0**	**7.8**	**7.6**	**7.5**	**7.5**	**8.1**
Education	2.7	2.5	2.6	2.6	2.5	2.5	2.6
Health	1.5	1.4	1.4	1.4	1.8	1.6	1.8
Welfare	4.4	3.6	3.2	2.9	2.7	2.9	3.0
Housing	0.2	0.1	0.1	0.1	0.2	0.2	0.2
Community services	0.3	0.5	0.4	0.5	0.3	0.3	0.5
Economic services	**5.2**	**4.5**	**5.4**	**5.0**	**7.2**	**5.3**	**6.7**
Agriculture and irrigation	1.1	0.8	1.1	1.0	1.3	1.0	1.2
Fisheries	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Manufacturing and mining	0.1	0.2	0.2	0.1	0.1	0.1	0.1
Energy and water supply	0.1	0.2	0.3	0.2	0.1	0.1	0.1
Transport and communucation	2.0	1.6	2.1	1.8	3.1	2.3	2.5
Trade and commerce	0.1	0.0	0.0	0.0	0.1	0.0	0.1
Other	1.0	0.8	0.9	0.9	1.2	0.7	1.3
Other	**7.1**	**7.0**	**6.0**	**6.3**	**5.8**	**6.8**	**7.6**
of which; interest	6.4	6.2	5.4	5.6	5.5	5.7	6.3
Provision for under expenditure and savings	0.0	0.0	0.0	0.0	-0.6	0.0	-1.4
Total expenditure and lending	**28.8**	**26.5**	**26.3**	**25.2**	**26.2**	**26.7**	**26.9**

Source: Ministry of Finance and Planning directly affect the efficiency and competitiveness of the Colombo Port. The utilisation rate of the on-lending programme of CEB was 69 per cent (Rs.5,963 million) in 2000. Major projects implemented under the on-lending programme of the CEB were the Kukule Ganga hydro power project (Rs.2,333 million), combined cycle power project (Rs.1,569 million) and second power transmission and distribution project (Rs.1,523 million). Total on-lending to SLT amounted to Rs.4,630 million and accounted for 63 per cent of the planned annual programme. As a large share of these foreign resources are directed to the improvement of utility services in the economy, special attention is needed to remove bottlenecks in project implementation and accelerate the utilisation of these concessionary funds.

On a functional basis, public investment in economic services, at Rs.54,650 million, accounted for 68 per cent of the total public investment in 2000. In nominal terms, investment in economic services rose by 21 per cent and was maintained at 4.3 per cent of GDP in 2000. In comparison to the total budgetary provision of Rs.79,723 million, the investment in economic services was limited to 67 per cent due to curtailment of funds allocated for locally funded projects and slow progress in foreign funded projects. Under the economic services, investment in the transport and communications sector showed a sharp increase of 47 per cent to Rs.24,911 million. Sri Lanka Railways (Rs.6,280 million), RDA (Rs.7,119 million), SLT (Rs.4,630 million) and SLTB (Rs.2,132 million) were the major investors accounting for 81 per cent of the investment in this category.

Public investment in the energy and water supply sector reported a 23 per cent increase to Rs.13,282 million and accounted for 24 per cent of total investment in economic services. CEB (Rs.7,442 million) and the National Water Supply and Drainage Board (Rs.3,475 million) accounted for 82 per cent of the investment in this sector in 2000. Public investment in agriculture and irrigation (Rs.6,908 million), and the fisheries (Rs.899 million) sectors recorded an 8 per cent increase in 2000. As in the previous year, the Mahaweli Authority continued to be the main recipient, receiving Rs.1,716 million, followed by the TSHDA (Rs.219 million). In addition, direct investment in agriculture, irrigation and fisheries by the relevant departments amounted to Rs.5,353 million, a 5 per cent increase over the previous year.

Public investment in social services, at Rs.16,471 million, showed a marginal reduction compared with the previous year. This was a combined outcome of the increase in investment on health (Rs.5,302 million), housing (Rs.2,061 million) and welfare services (Rs.415 million) and a reduction of investment in education (Rs.7,135 million) and community services (Rs.1,558 million). Investment in the education and health sectors was mainly for construction and improvement of schools and hospitals and the supply of necessary equipment for these services. Investment in the housing sector was mainly focused on the development of housing facilities in the urban, plantation and fisheries sectors. Of the total investment on community services, one third (Rs.1,558 million) was provided to the Samurdhi Authority to finance various community development programmes.

8.5 Provincial Councils

The total revenue of the Provincial Councils (PCs) grew at a slower pace of 8 per cent to Rs.7,534 million in 2000 in comparison to a 17 per cent growth in 1999. The total expenditure of PCs amounted to Rs.37,328 million in 2000, an increase of 29 per cent compared to a 7 per cent increase in 1999. As a percentage of GDP, revenue remained unchanged at 0.6 per cent, while expenditure increased from 2.6 per cent to 2.9 per cent. In 2000, the total revenue of PCs was sufficient to cover only 20 per cent of their resource needs compared to 24 per cent in 1999. This indicates the increasing dependency of PCs on the central government to undertake functions devolved on them. The resource gap of PCs was entirely met through central government transfers of Rs.31,543 million. This consisted of a block grant of Rs.23,220 million for recurrent expenses and capital grants of Rs. 8,323 million for investment programmes.

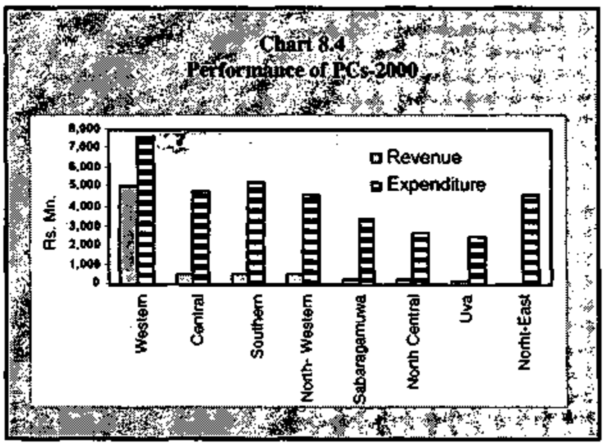


Chart 8.4
Performance of PCs-2000

The current expenditure of PCs increased by 10 per cent to Rs 28,856 million in 2000 due to higher salaries and wages and other current expenses. Capital expenditure at Rs. 8,472 million, recorded about a three fold increase in comparison to the previous year. This increase was mainly due to the transfer of responsibility of implementing and funding the regional development programmes from the central government to PCs in 2000. Prior to 2000, these development programmes were implemented under the Medium Term Investment Programme (MTIP) in which the role of PCs was limited to an implementing agency, while the funding responsibility rested with the respective line

TABLE 8.5
Budget Out-turn for Provincial Councils

Rs. million

	1996	1997	1998	1999	2000 Budget	2000 Provisional
1 Total revenue	**4,884**	**5,395**	**6,002**	**6,993**	**6,729**	**7,534**
1.1 Tax on production and expenditure	3,416	3,744	4,114	4,593	4,679	5,010
Turnover taxes	2,464	2,734	2,980	3,361	3,216	3,705
Licence fees	946	1,000	1,127	1,223	1,452	1,293
Other taxes	6	10	8	9	11	12
1.2 Interest, profits and dividends	67	175	129	282	190	281
1.3 Sales and charges	355	408	481	731	561	759
1.4 Stamp duty	1,036	1,051	1,267	1,372	1,288	1,468
1.5 Other	10	17	11	15	11	16
2. Total expenditure	**22,128**	**23,455**	**26,736**	**28,717**	**41,759**	**37,328**
2.1 Current expenditure	20,941	22,055	25,230	26,284	30,368	28,856
Functional basis	20,941	22,055	25,230	26,284	30,368	28,856
Provincial administration	1,942	1,941	2,377	2,524	3,051	2,129
Economic services	834	939	1,067	1,154	1,416	1,284
Social services	18,166	19,175	21,787	22,605	25,901	25,542
Economic basis	20,941	22,055	25,230	26,284	30,368	28,856
Personal emoluments	16,263	17,067	19,744	20,431	21,842	22,199
Other	4,679	4,988	5,486	5,853	8,526	6,657
2.2 Capital expenditure	1,187	1,400	1,506	2,433	11,391	8,472
Acqusition of capital goods	757	729	773	1,140	1,684	989
Capital transfers	53	55	75	102	243	160
Pro. Specific Deve.Projects	-	-	-	-	6338	5523
Special Projects	-	-	-	-	1,950	812
Other	377	616	658	1,191	1,176	988
3 Financing	**16,873**	**18,348**	**20,594**	**22,787**	**34,451**	**31,543**
3.1 Block grants	15,831	16,855	19,194	21,122	23,163	23,220
3.2 Criteria based grants	800	1,168	1,163	1,236	2,000	1,323
3.3 Matching grants	242	325	237	429	1,000	665
3.4 Pro. Specific Deve. Grants	-	-	-	-	6,338	5,523
3.5 Grants for Special Projects	-	-	-	-	1,950	812

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

ministries of the central government. In 2000, the Provincial Specific Development Programme (PSDP) was introduced in place of the MTIP and the required funds to implement such programmes were transferred through Provincial Specific Development Grants (PSDG) from the central government to PCs. In addition to the PSDP, other capital expenditure programmes, implemented under the criteria based grants and other funding sources, also took place in 2000.

The level of capital expenditure in 2000, though reflecting a substantial increase from last year, was well below the estimated total capital expenditure programme of PCs, which was in the region of Rs.11 billion. The slower implementation of the capital expenditure programme was attributed to the resource constraints of the central government, project implementation delays and a slow growth in revenue collection. The high dependence of PCs on the central government for resources, limited authority devolved to PCs for self-generation of resources and inadequate capacities and skills of PCs to execute development projects were some of the main impediments faced by PCs in reaching their original budgetary targets.

Revenue

Total revenue collection of PCs in 2000 increased at a slower rate of 8 per cent compared to a 17 per cent growth in 1999. This was a result of the reduced rate of growth of revenue in all revenue generating sources. Three major sources of revenue, turnover tax, licence fees and stamp duty, accounted for 86 per cent of the total revenue in 2000. Of the total revenue collection, the devolved revenue of PCs amounted to Rs. 5,505 million compared to Rs.5,054 million in 1999. The balance revenue was collected on behalf of Local Governments (LGs) and the central government. The heavy concentration of revenue collection in the Western Province continued accounting for 67 per cent of the total revenue in 2000. This is mainly due to the heavy concentration of business enterprises in the Western Province.

The turnover tax on wholesale and retail businesses at Rs.3,705 million, recorded an increase of 10 per cent, compared to a 13 per cent growth in 1999. This was a reflection of the increase in the number of tax payers liable for turnover tax and the increase of turnover of business enterprises during the period. The share of turnover taxes in total revenue remained at 50 per cent in 2000. Approximately 74 per cent of total turnover taxes were collected by the Western PC in 2000.

Revenue collection from licence fees, at Rs.1,293 million, recorded a 6 per cent growth in 2000. This was largely due to an increase in licence fees on motor vehicles (Rs.1,125 million) reflecting the new registration of motor vehicles, which totalled 90,000 in 2000. Licence fees on motor vehicles accounted for 87 per cent of the revenue collection from total licence fees, while the balance amount was mainly collected through the issue of liquor licences. Of the total licence fees on motor vehicles, 60 per cent was collected from the Western province.

Despite the reduction of stamp duty rates on mortgages, stamp duty collection increased by 7 per cent to Rs.1,468 million in 2000, maintaining the same rate of growth recorded in the previous year. This indicates the increased volume of property transactions, which were liable for stamp duty in 2000. Of the total stamp duty revenue, 70 per cent was raised from the Western Province.

The balance revenue of Rs.1,101 million comprised mainly court fines (Rs.341 million), fees under the Motor Traffic Act (Rs.227 million) and interest earnings on previous lending to employees of PCs through the advance account (Rs.220 million).

Total revenue collected by the Western PC amounted to Rs.5,062 million in 2000 and accounted for 67 per cent of the total revenue in the PCs. As the revenue collection responsibility of the North - East PC remained with the central government, the balance revenue was raised by the other six PCs. Revenue collection from the Central PC (Rs.573 million), North Western PC (Rs. 576 million) and Southern PC (Rs.559 million) represented 69 per cent of the balance revenue generation.

In 2000, PCs continued to perform their agency function of collecting revenue on behalf of local governments. Although the revenue from stamp duty and court fines has been devolved to the LGs, the collection of this revenue has been undertaken by PCs. Accordingly, PCs collected a sum of Rs.1,809 million from these sources on behalf of LGs in 2000. The transfer of this revenue to LGs is based on the request made by the respective LGs.

Expenditure

Total expenditure of PCs rose by 24 per cent to Rs.37,328million in 2000, in comparison to a 7 per cent increase in 1999. This was largely due to a substantial increase in capital expenditure consequent to the transfer of regional development activities to PCs by introducing PSDP. This resulted in increasing the share of capital expenditure in total expenditure of PCs to 22 per cent, from 8 per cent in the previous year. Meanwhile, current expenditure rose by 10 per cent to Rs.28,856 million in 2000. The increase was reflected in the increase in the salaries and wages of employees in the PCs by 9 per cent and the increase of nonwage type expenditure by 14 per cent.

According to the economic classification of expenditure, salaries and wages accounted for 77 per cent of the total current expenditure of PCs (Rs.22,189 million) while the balance Rs.6,657 million covered all other current expenses. The salaries and wages in the education and health sectors accounted for 90 per cent of the total salary bill in 2000. Total current expenditure also included current transfers of Rs.2,304 million (8 per cent of total current expenditure) to LGs to meet their salaries and wages.

On a functional basis, expenditure on social infrastructure increased by 13 per cent to Rs.25,542 million, raising the share in total current expenditure to 88 per cent in 2000 from 86 per cent in 1999. Expenditure on education (Rs.16,207 million) and health (Rs.5,513 million) represented 85 per cent of expenditure on social outlays. Meanwhile, current expenditure on provincial administration (Rs.2,129 million) and economic functions (Rs.1,284 million) accounted for the balance 12 per cent of total current expenditure in 2000.

The Western PC continued to be the largest spending unit, accounting for 23 per cent of total current expenditure. Recurrent expenditure of the Central, Southern, North-East and North Western PCs remained on the 13 - 14 per cent range as in 1999. The Uva PC continued to be the smallest PC, accounting for only 7 per cent of total current expenditure.

Capital Expenditure

Investment expenditure by PCs rose considerably during 2000. Its share in GDP was around 0.7 per cent in 2000 compared with 0.2 per cent in 1999 and 1998. As in the previous year, the North Western PC and the Western PC were the major subscribers to the investment programme, accounting for 15 per cent each of the total capital expenditure programme.

Total capital expenditure consisted of Rs.5,523 million under PSDP, Rs.1,988 million under criteria base grants and matching grants and Rs. 812 million under other financial sources. The PSDP mainly focused on developing health, highways and education in the provinces. The total expenditure incurred on these sectors accounted for over 80 per cent of the PSDP. The balance investments were in other activities such as indigenous medicine, irrigation, agriculture and rural development. The aim of this regional development programme is to achieve a balanced regional growth in the long run. Under the PSDP, the highest provision, which accounted for about 15 per cent of the total expenditure, was made to the North Western PC, while the allocations to the other PCs ranged from 8-14 per cent. Other capital expenditure incurred under criteria based grants and matching grants amounted to Rs.1,988 million. These investments were mainly in the areas of acquisition of fixed assets and rehabilitation and improvements of capital assets. Investments undertaken through PCs' own resources were only a small fraction of total investment and these expenditures were limited to the acquisition of fixed assets. In view of the resource constraint, the capital expenditure programme of PCs needs to be closely monitored and rationalised, particularly to avoid non-priority locally funded capital programmes involving purchase of vehicles, furniture and equipments.

Central Government Transfers

Total grants from the central government to PCs increased significantly by 38 per cent to Rs.31,543 million in 2000, compared to an 11 per cent increase in 1999. Total central government grants to PCs comprised block grants of Rs.23,220 million, Provincial Specific Development Grants (PSDG) of Rs.5,523 million, criteria based grants of Rs.1,323 million and matching grants of Rs.665 million. Transfer of block grants to meet the resource gap in the current expenditure programme increased by 5 per cent. Meanwhile, transfers through criteria based grants and matching grants, which were targetted at other capital expenditure programme of PCs, increased by 20 per cent in 2000. However, with the implementation of the PSDP, total central government transfers for capital expenditure programmes of PCs increased to Rs.8,218 million in 2000 from Rs.2,433 million in 1999.

8.6 Public Enterprise Reforms

International economic developments imposed constraints on the scheduled public enterprise reform program for the year 2000. Proceeds from privatisation amounted to Rs.401 million as against a targeted sum of Rs.30,000 million envisaged in the budget 2000. A substantial portion of privatisation proceeds (Rs. 200 million) was received on account of Lanka Lubricants Ltd. The realisation of a lower quantum of privatisation proceeds was due largely to the non-sale of Sri Lanka Telecom (SLT) shares in the international market. It was expected to seek an international placement for SLT through a further divestiture of its shares. However, depressed international market conditions for telecommunication shares prevented the listing of SLT shares overseas. Nevertheless, progress was made in reforming enterprises in the agricultural and manufacturing sectors during the year. The Public Enterprise Reform Commission (PERC) also continued its preparatory work for the restructuring and privatisation of some key public enterprises in the near future.

The divestiture of shares owned by the government in Malwatte Valley Plantations Ltd continued the process of privatisation in the plantations sector in the year 2000. The transaction comprised the sale of 20 per cent of shares of the company by way of an Initial Public Offer (IPO) through the Colombo Stock Exchange (CSE). Proceeds from this divestiture generated a sum of Rs.40 million. The IPO made in 2000 was consequent to a sale of 51 per cent of shares of the company to a strategic investor, Waymba Plantation (Pvt.) Ltd, in 1997. The sale of government shares in the Malwatte Plantations company is expected to lead to improved performance of the company while generating positive externalities to the plantations sector.

The private sector involvement in the agriculture sector continued in 2000 with activities of the Pelwehera and Hingurakgoda Seed Paddy farms helping to improve seed paddy production. The privatisation of these two enterprises to CIC Fertiliser (PVT) Ltd, through land lease and sale of movable assets on tender, helped bring in much needed technology and know-how to seed production. Improved crop management techniques together with the introduction of new fertiliser mixtures and increased mechanization have resulted in increasing seed production and enhancing the quality of seed. The privatisation of hitherto loss making seed production enterprises has also generated savings to the budget. The sale of movable assets of these two enterprises procured a sum of Rs.3 million as revenue to the government in 2000. The contribution made by the privatisation of these two enterprises has been significant especially in the light of its impact on further encouraging private sector participation in the production of quality seed in sufficient quantity which would directly lead to a productivity improvement in the agricultural sector.

Meanwhile, a part of the sugar plantation in Kantale Sugar Industries was leased out to Agro Trading Lanka (Pvt.) Ltd. for a maize project approved by BOI in 2000. The lease of these lands constitutes an important development in the privatisation of Kantale Sugar Industries as this enterprise, originally privatised in 1993 and brought under government ownership again in 1997 under the Rehabilitation of Public Enterprises Act, could not be re-divested to the private sector for a substantial period of time. Consequently, a part of the sugar plantation was leased out in the year 2000 for a 6 month period raising a sum of Rs.4 million as revenue to the government.

The majority sale (51%) of shares of Bogala Graphite Lanka Ltd. took place in 2000 with the divestiture of these shares to a German strategic investor, Graphit Kroptmuhl AG for a sum of Rs.154 million. The privatisation process of Bogala Graphite Ltd. was started in 1993 with an IPO of 39 per cent of shares to the general public and the transfer of 10 per cent of shares to employees. The involvement of a strategic investor is expected to bring in much needed investment and technological know-how to the manufacturing sector.

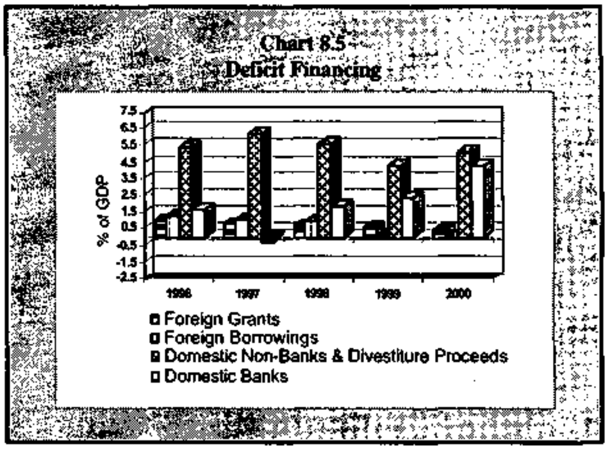
The privatisation process for the sale of 40 per cent shares of Air Lanka Ltd was completed in January, 2001. The privatisation of Air Lanka entailed the divestiture of a 40 per cent equity stake to a strategic partner, Emirates Airlines Ltd, with management control. A financial offer of US$ 70 million was made by Emirates Ltd, for 40 per cent of the shares of the air line. The transaction was executed in two stages with the transfer of 26 per cent of shares in 1998 for a total of US$ 45 million and the balance 14 per cent of shares being transferred in January, 2001 for a sum of US$ 25 million. The business partnership with Emirates has focused on fleet renewal, schedule expansion, product enhancement, human resource development and the upgrade of information technology systems. The airline has been able to modernise its fleet with the purchase of 6 brand new airbuses during 1999 and 2000 and the phasing out of its old fleet of Tristars. With the completion of the re-fleeting program in 2000, SriLankan Airlines (SLA) was an all Airbus carrier at the end of the year. The expanded fleet has enabled the airline to increase its services to existing destinations while the route network has also grown to incorporate new destinations. Synergies have been generated through the strategic partnership with Emirates with increased code-share flights between the two airlines. In the field of information technology, new computerised systems have been introduced covering nearly all major areas of the company's activities.

The PERC continued its preparatory work in the year under review for the reform of some selected public enterprises in the near future. Accordingly, work on some key public enterprises such as the Ceylon Electricity Board (CEB), the Postal Department and the National Insurance Corporation (NIC) progressed in the year 2000.

8.7 Financing of the Deficit

In view of the shortfall in revenue collection and the sharp increase in current expenditure, the total resource gap of the budget expanded considerably by 49 per cent to Rs.124,541 million in 2000. Approximately 95 per cent of this resource gap (Rs. 118,500 million) was financed from domestic sources due to a reduced inflow of foreign financing including substantially lower than expected proceeds from privatisation. Net foreign resources available for budgetary purposes in 2000 was only Rs.5,640 million compared to Rs.8,245 million in 1999. Meanwhile, proceeds from privatisation at Rs.401 million, were well below the expected target of Rs 30,000 million in 2000.

There was a sharp increase in the government demand for resources in the domestic market during the year. The total net borrowing from domestic sources increased to Rs.



118,500 million in 2000 from Rs.74,876 million in 1999. Consequently, the total domestic borrowing in relation to GDP increased from 6.8 per cent to 9.4 per cent between the two years. The domestic non-bank sector was able to finance only 55 per cent (Rs. 65,110 million) of the domestic resource requirement due to limited availability of resources. Consequently, the government was compelled to meet the balance resource requirement from the banking system. As a result, borrowings from the banking system more than doubled to Rs.53,389 million (4.3 per cent of GDP) in 2000 from Rs.25,996 million (2.4 per cent of GDP) in 1999. This was the highest level of bank borrowings by the government recorded during the last decade.

As in the previous year, Treasury bonds, Treasury bills and Rupee loans were the key instruments used in mobilising resources from the domestic market. However, in line with the strategy of market orientation of government debt, Treasury bonds played a major role in raising resources from the domestic market. In 2000, the total issue of Treasury bonds amounted to Rs.125,322 million. The total borrowing under the Treasury bond programme, on a cash basis, however amounted to Rs.90,535 million accounting for 76 per cent of the total financing from domestic sources. The comparable figure in 1999 was Rs.53,379 million. During the first half of 2000, Treasury bonds were issued with a maturity of 2 - 6 years with coupon rates ranging from 10.75 - 11.75 per cent. Interest rates increased sharply in the domestic market during second half of 2000 due to a substantial increase in demand for resources by the government. The weighted average interest rate on 2 year Treasury bonds increased to 22.19 per cent in December 2000 from 12.0 per cent in May 2000. The corresponding rate at the beginning of January 2000 was 13.00 per cent. Hence, the issue of Treasury bonds with longer maturities was restricted to minimise the borrowing cost as the mobilisation of fund during a period of temporary high interest rates is not a prudent debt management strategy. As a result, during the second half of 2000, only Treasury bonds with maturities of 2-3 years were issued.

The interest rate increase in the domestic market was considered a short-term phenomenon and hence the coupon rates on bonds was not revised in line with the rise in domestic market interest rates. Therefore, there was a significant margin between the coupon rate and the weighted average yield rate during the second half of 2000. This led to a total cash shortfall of Rs.9,339 million in the Treasury bond programme, creating difficulties for cash management by the Treasury. The corresponding cash shortfall in 1999 was only Rs.2,572 million. The adverse implications of cash shortfalls on Treasury cash management could be minimised either by maintaining a flexible coupon rate system in line with market interest rates or by the provision of a contingencies facility at the time of budget preparation to meet the likely cash shortfalls under a given borrowing programme. Continuing with last year's trend, the banking sector increased its share in total purchased issues from 5 to 31 per cent in 2000 with subscriptions amounting to Rs. 28,342 million. While institutional investors such as the EPF and the NSB continued to maintain the dominant position, other non-bank investors played a major role in the bond market increasing their share to 62 per cent in 2000 from 59 per cent in 1999. The popularity of this guilt edge security among the general public was enhanced due to increased awareness, attractive interest rates and the marketability of the instrument.

In line with the market oriented medium-term debt strategy of the government, the reliance on the Rupee loan programme in financing the deficit was further reduced in 2000. Although, gross borrowings through the Rupee loan programme in 2000 amounted to Rs.42,210 million in comparison to Rs.22,884 million in 1999, with the repayment of Rs.40,378 million, net resource mobilisation declined to Rs.1,832 million in 2000 from Rs.11,484 million in 1999. The entire Rupee loan programme was subscribed to by captive type investors and interest rates were maintained at a lower level than the interest rates of other government securities of comparable maturity that prevailed in the market. As in the past, EPF continued to be the major subscriber to the Rupee loan programme, with a gross investment of Rs.34,038 million, followed by the NSB with an investment of Rs.7,154 million. These two institutions accounted for 98 per cent of the total Rupee loan subscription in 2000 in comparison to 78 per cent in 1999. The remains sum of Rs.937 million was purchased by the Public Services Provident Fund (PSPF) and other small captive type investors. The total borrowings included a special Rupee loan of Rs.11,000 million issued to the EPF at a rate of 11 per cent with an optional repayment in 5-6 years and another special Rupee loan issue of Rs.8,000 million at an interest rate of 11.90 per cent with a maturity of 1 year. The remain sum of Rs. 23,210 million was issued with an optional maturity of 8-10 years at an interest rate of 12.00 per cent per annum.

The borrowing limit of the Treasury bills programme was revised upward from Rs.125 billion to Rs.135 billion in May, 2000. This additional borrowing facility (Rs.10 billion) was fully utilised during the second half of the year. Initially, new Treasury bills amounting to Rs.3 billion were issued with shorter maturities with the expectation of an improvement in the fiscal situation towards the end of 2000. Nevertheless, these maturing bills were reissued towards end 2000, as the fiscal situation continued to deteriorate. Total net borrowings from Treasury bills on a cash basis amounted to Rs.6,147 million. High interest rates, especially during the second half of 2000, and shifting of a large volume of Treasury bills to one year bills led to a cash shortfall of Rs 3,853 million in 2000. As in the previous year, the Central Bank intervention in the primary market remained high in 2000. Of the total new issues, 70 per cent was absorbed by the Central Bank with the intention of releasing it gradually to the market through its secondary window. The Central Bank intervention in the primary market on re-issues also remained high. The Bank purchased 24 per cent of the total Treasury bill re-issues in 2000 in comparison to 19 per cent in 1999. Meanwhile, Central Bank holdings of Treasury bills and Treasury bonds increased sharply through the reverse repurchase facility reflecting the liquidity shortage in the market resulting from declining external official reserves. As a consequence of these developments, Treasury bills and Treasury bonds holding by the Central Bank (in a book value basis) increased by Rs.41,330 million to Rs.66,593 million by end 2000. Meanwhile, Treasury bill holdings of commercial banks declined during the year due to active trading in the secondary market. Borrowings from the domestic market through administrative arrangements amounted to Rs.3,178 million in 2000. The main sources of administratively borrowed funds were the NSB and the ETF.

Total government borrowings from the banking system amounted to Rs.53,389 million in 2000, in comparison to Rs.25,996 million in 1999. The banking sector financed 43 per cent of the overall deficit in 2000 in comparison to 31 per cent in 1999. Net credit to the government by the Central Bank, at Rs.44,840 million, funded 36 per cent of the overall fiscal deficit, in comparison to 25 per cent in 1999. This share was only 6 per cent in 1998. The borrowing from the Central Bank was mainly reflected in an increase in the holdings of Treasury bonds (Rs.28,602 million) and Treasury bills (Rs.12,727 million) and increased transfer of funds under the provisional advances (Rs.4,200 million). It is pertinent to mention that a bulk of this increase was not necessarily due to the government borrowing from the Central Bank but due to the market using its holdings of government securities to obtain liquidity from the Central Bank. Even though the increased dependency on the Central Bank to bridge the resource gap of the budget is a matter for concern in view of its inflationary impact, it enabled the Central Bank to manage the rupee liquidity to support economic activities of the country i.e. preventing a liquidity crunch in the domestic economy.

Net credit to the government from both Domestic Banking Units (DBUs) and Foreign Currency Banking Units (FCBUs) of commercial banks amounted to Rs.8,549 million in 2000. The borrowing from DBUs (Rs.3,762 million) was a combined outcome of an increased utilisation of an overdraft facility (Rs.10,591 million), an increase in other liabilities of the government (Rs.2,076 million), a decline in debt securities holdings (Rs.4,484 million), a decrease in liability on account of import bills (Rs.3,929 million) and a build up of deposits (Rs.490 million) in 2000. The net borrowing from FCBUs (Rs.4,787 million) was mainly the net result of a special external borrowing of US$ 100 million (Rs.7,754 million) arranged through FCBUs and the repayment of an FCBU loan of US$ 41 million (Rs.3,138 million) that had been borrowed in 1998.

Gross foreign borrowings in 2000 amounted to Rs.23,777 million in comparison to Rs.22,974 million in 1999. In comparison to the foreign borrowing programme of Rs.35,800 million in the original budget, the utilisation was only 66 per cent due to the delay in the implementation of some large projects on account of administrative and procedural matters. The under-utilisation of foreign aid in 1998 and 1999 was 10 per cent and 23 per cent, respectively. Foreign borrowings were entirely in the form of project and programme loans received from multilateral and bilateral sources. Japan (Rs.12,437 million), ADB (Rs.5,368 million), and IDA (Rs.3,108 million) accounted for about 90 per cent of total gross borrowings in 2000. With the repayment of Rs.23,282 million, net foreign borrowings available for financing the deficit was only Rs. 496 million (0.04 per cent of GDP). This was sufficient to finance only 0.04 per cent of the budget deficit in 2000. Net foreign borrowings in 1999 and 1998 were Rs.1,484 million and Rs.10,197 million, respectively. Foreign grants received for budgetary purposes also declined to Rs.5,146 million compared to Rs.6,761 million in 1999. The sharp reduction of foreign resources in financing the deficit over these years has exerted additional pressures on domestic resources pushing interest rates upwards. In this regard, it is important to take effective steps to improve foreign aid utilisation by addressing relevant systematic issues as well as project specific issues with the help of implementing agencies.

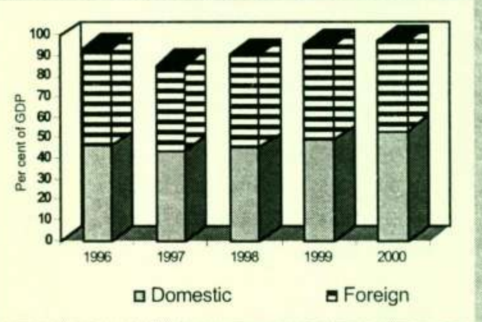
8.8 Government Debt

The total government debt stock increased during 2000 by Rs. 167,369 million (16 per cent) to Rs.1,218,700 million as at the end of 2000. Consequently, the stock of government debt as a percentage of GDP increased from 95 per cent in 1999 to 97 per cent in 2000. A substantial expansion in domestic borrowing accounted for nearly 80 per cent of the increase, while the stock of foreign debt increased in rupee terms by Rs. 34,174 million (7 per cent), largely reflecting the impact of exchange rate variations.

Domestic Debt

Domestic borrowings grew by 25 per cent to Rs. 676,660 million in 2000. Domestic borrowings as a percentage of GDP rose to 54 per cent in 2000 from 49 per cent in 1999. The trend towards greater domestic borrowing was also reflected in the share of domestic debt to total debt, which increased from 52 per cent in 1999, to 56 per cent in 2000. There was a faster growth in outstanding debt in medium and long-term debt instruments than in short term instruments, although both recorded a higher growth in 2000, than in 1999.

Chart 8.6
Composition of Debt



Medium and long-term debt stock increased by 27 per cent in 2000, raising its share in total domestic debt to 69 per cent. The increase was mainly on account of higher government borrowings through Treasury bonds reflecting the shift in public debt towards more market oriented debt instruments with longer maturities. The share of Treasury bonds in total domestic debt increased from 19 per cent in 1999 to 30 per cent in 2000. During the year there were new bond issues of Rs.125,322 million, while Rs.26,065 million worth of bonds were settled. The net result was to increase the outstanding Treasury bond stock by Rs. 99,257 million to Rs.204,124 million by end 2000. As mentioned earlier, Treasury bonds of shorter maturities were issued during the second half of 2000. Consequently, the Treasury bond portfolio was dominated by two and three-year bonds,

TABLE 8.6
Outstanding Central Government Debt (at end year)

Rs. million

	1996	1997	1998	1999	2000 Provisional
Total Domestic Debt(a)	**356,703**	**387,740**	**463,426**	**543,465**	**676,660**
Short term	149,798	137,494	163,253	175,886	208,017
Medium and long term	206,905	250,246	300,173	367,579	468,643
By debt instrument	356,703	387,740	463,426	543,465	676,660
Rupee securities	205,975	239,475	250,570	262,056	263,888
Treasury bills	124,996	114,996	119,996	124,996	134,996
Treasury bonds	-	10,000	48,915	104,867	204,124
Other	25,732	23,269	43,945	51,546	73,652
By institutions	356,703	387,740	463,426	543,465	676,660
Banks	101,764	100,536	113,054	139,671	199,030
Central Bank	34,303	19,770	27,179	48,867	97,778
Commercial banks(b)	67,461	80,766	85,875	90,804	101,252
Sinking fund	100	100	100	100	100
Non bank sector	254,839	287,104	350,272	403,694	477,530
National Savings Bank	47,794	62,498	67,260	79,555	87,263
Employees' Provident Fund	113,236	134,867	157,711	181,581	211,742
Other	93,809	89,739	125,301	142,558	178,525
TotalForeign Debt	**359,685**	**376,331**	**461,273**	**507,866**	**542,040**
Project loans	302,960	320,867	400,284	444,423	477,845
Non project loans	56,725	55,464	60,989	63,443	64,195
By type	359,685	376,331	461,273	507,866	542,040
Concessional loans	350,319	362,435	446,331	497,672	535,129
Non concessional loans	9,366	13,896	14,942	10,194	6,911
By currency	359,685	376,331	461,273	507,866	542,040
SDR	130,818	142,733	179,124	195,799	214,471
US dollars	74,918	83,111	89,877	91,282	98,130
Japanese yen	99,868	98,738	132,371	164,800	172,932
Deutsche mark	27,313	25,746	29,747	27,375	28,434
Other	26,768	26,003	30,154	28,610	28,023
External supplier's credit	923	499	575	530	167
Total Outstanding Govt. Debt	**716,388**	**764,071**	**924,699**	**1,051,331**	**1,218,700**
Total outstanding govt. debt net of sinking fund	716,288	763,971	924,599	1,051,231	1,218,600
Memorandum item: Debt/GDP(%)					
Domestic debt	46.4	43.6	45.5	49.1	53.9
Foreign debt	46.8	42.3	45.3	45.9	43.2
Total debt	**93.3**	**85.8**	**90.8**	**95.1**	**97.1**

Source: Central Bank of Sri Lanka

(a) Includes long term bonds of Rs. 24,088 million and Rs.23,873 million issued in 1993 and 1996, respectively.
(b) Includes outstanding balance to FCBUs: Rs.6,773 million at end 1998, Rs.5,913 million at end 1999 and Rs.12,820 million at end 2000.

accounting for 69 per cent of the total outstanding Treasury bond stock as at the end of 2000. For the first time, the government issued Callable Treasury bonds (two-year bonds with call options). The special feature of these bonds is that the government reserves the option of redeeming these bonds at the end of the first year of issue, or on any date thereafter. However, because of the high interest rates quoted at the primary auctions, the government had to discontinue their issuance after two issues.

Outstanding Rupee securities at end 2000, stood at Rs.263,888 million. There has been a gradual reduction in the use of Rupee loans as a source of government financing, in line with the government's policy of reducing the share of non-marketable securities in the debt market. Its share in total domestic debt declined from 62 per cent in 1997, to 48 per cent in 1999 and to 39 per cent in 2000. Major subscribers to the Rupee loan programme were the EPF and the NSB, together accounting for 98 per cent of total investments in 2000.

The higher borrowing requirement of the government and the rise in interest rates compelled the government to increase its borrowings through short-term debt instruments. The slowdown in the growth of short-term borrowing observed in 1999, was reversed in 2000, with short-term borrowings growing by 18 per cent (Rs.32,131 million) in 2000, compared to 8 per cent in 1999. However, the share of short-term debt in domestic debt declined from 32 per cent to 31 per cent between the two years as medium term borrowings increased at a higher rate. Treasury bill holdings expanded by Rs. 10 billion to Rs. 135 billion by end 2000. Provisional advances stood at Rs.27,169 million, while other short-term debt obligations of the government increased by 64 per cent (Rs.17,931 million) to Rs. 45,852 million at the end of 2000.

Outstanding borrowings from the banking system grew by 42 per cent (Rs.59,359 million) in 2000, to Rs.199,030 million, accounting for 29 per cent of the total outstanding domestic debt. The major portion of this increase (Rs.48,911 million) was on account of borrowings from the Central Bank. Accordingly, the share of outstanding debt to the Central Bank in the total outstanding domestic debt increased from 9 per cent at end 1999, to 14 per cent at end 2000. The increase in the other obligations of the government indicates a sharp increase in government liabilities to the commercial banking system arising out of higher borrowing through overdraft facilities at the two state banks.

In order to develop the market for government debt securities further by improving efficiency and enabling better supervision of companies dealing in government securities, revisions were made to the regulations governing primary dealers. Under the new regulations only companies set up exclusively for trading in government securities, with a minimum dedicated capital of Rs.150 million, were allowed to function as primary dealers. As a result, the number of companies operating in the Primary Dealer System declined from eighteen to eight. A surveillance unit has also been set up in the Public Debt Department to conduct off-site surveillance and on-site supervision of primary dealers. Further strengthening of the PDS will require a revision to the existing legal and regulatory framework governing primary dealers in order to accommodate the introduction of an electronic bidding system and the adoption of the Global Master Repurchase Agreement, as well as to develop a more rigorous process for the licensing of primary dealers. The proposed introduction of a scripless security system will also contribute to the further development of the market for government debt securities.

Foreign Debt

The total external debt outstanding increased by 7 per cent (Rs.34,174 million) to Rs.542,040 million at the end of 2000. As a percentage of GDP however, the outstanding foreign debt stock declined from 46 per cent in 1999 to 43 per cent in 2000. Its share in total public debt also declined from 48 per cent in 1999 to 44 per cent in 2000.

A two-third of the increase (Rs.24,104 million) in the external debt stock was due to exchange rate variations. However, the impact of exchange rate variations in 2000 was lower than that experienced in 1999 (Rs,37,989 million) and 1998 (Rs.65,522 million). Even though the rupee depreciated sharply against the US dollar in 2000, its impact on the foreign debt stock was limited to Rs.10,056 million as only 18 per cent of the total foreign debt stock is denominated in US dollars. The SDR denominated debt stock increased by Rs.10,322 million due to the depreciation of the rupee against the SDR, and the depreciation of the rupee against other currencies accounted for Rs.5,618 million of the increase in the debt stock. The appreciation of the rupee against the Japanese yen, on the other hand, had a favourable impact on the foreign debt stock of Rs. 1,892 million.

Concessional loans which make up almost 99 per cent of the total foreign debt stock witnessed a 7.5 per cent increase in its debt stock in 2000. The stock of non-concessional loans declined by 32 per cent due to the settlement of the outstanding portion of the Floating Rate Note (FRN) issued in 1997. Project loans which account for 88 per cent of the total outstanding debt portfolio increased by 8 per cent, while non-project and commodity loans increased by less than 1 per cent each. The outstanding debt stock from bilateral sources which accounts for 53 per cent of the total foreign debt stock

TABLE 8.7

Effect of Exchange Rate Variations on Foreign Loans (a)

Rs.Million

	1996	1997	1998	1999	2000 (b)
Gross receipts	23,992	24,642	30,996	24,741	27,370
Repayments	8,939	10,004	11,576	16,137	17,300
Net receipts	15,053	14,638	19,420	8,604	10,070
Change in liability due to exchange rate variations	-1,654	2,008	65,522	37,989	24,104
Liability as at end of period	359,685	376,331	461,273	507,866	542,040

Source: Central Bank of Sri Lanka

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

TABLE 8.8
Government Debt Service Payments

Rs. million

	1996	1997	1998	1999	2000 (a)
Debt service payments	82,163	83,729	114,866	103,885	175,726
Amortisation payments	33,240	28,483	59,968	41,762	104,526
Domestic	22,749	15,232	41,617	20,322	81,244
Foreign	10,491	13,251	18,351	21,440	23,282
Interest payments	48,923	55,246	54,898	62,123	71,200
Domestic	42,184	48,554	47,598	53,371	62,185
Short term	18,053	18,174	12,398	13,085	12,767
Medium and long term	23,231	30,381	35,200	40,837	49,418
Foreign	6,739	6,692	7,300	8,752	9,015
Interest/Current expenditure(%)	27.9	29.9	27.5	30.0	28.0
Debt Service/GDP(%)	10.7	9.4	11.3	9.4	14.0
Foreign debt service/Exports(%)	7.6	7.3	8.3	9.3	7.7

Source: Central Bank of Sri Lanka

(a) Provisional

increased by only 6 per cent in 2000 while the debt outstanding on account of multilateral sources increased by 9 per cent during 2000.

Debt Service Payments

Debt service payments increased by 69 per cent to Rs.175,726 million in 2000, mainly due to large amortisation payments on account of Rupee loans and Treasury bonds. Accordingly, the ratio of debt service to GDP rose from 9 per cent to 14 per cent in 2000, the highest ratio recorded in the last decade. Total amortisation payments in 2000, amounted to Rs.104 billion, comprising Rs.81 billion on account of domestic debt and Rs.23 billion on account of foreign debt. Domestic amortisation payments increased sharply by Rs. 60,922 million, while foreign debt repayments increased by Rs.1,842 million during the year.

Interest payments grew by 15 per cent to Rs.71,200 million in 2000. However, the ratio of interest payments to current expenditure declined from 30 per cent to 28 per cent in 2000, reflecting the high rate of increase in current expenditure. Of the total interest payments, 87 per cent was on account of domestic borrowing. Interest payments on domestic debt increased by 17 per cent in 2000, compared to 12 per cent in 1999, due to higher domestic borrowing by the government. Interest payments on medium and long-term debt increased by 21 per cent in 2000, compared to 16 per cent in 1999 as a result of increased borrowing from medium and long-term instruments with semi-annual interest payments. Interest payments on short-term debt declined by 2 per cent in 2000, due to the lower interest rates that prevailed in 1999 and the first half of 2000 and the shift of Treasury bill borrowings from shorter maturities (3 months) to longer maturities (over 6 months), where interest payments would only be made in 2001. Interest payments on foreign debt increased by 3 per cent to Rs.9,015 million, a lower rate of expansion compared to the 20 per cent increase recorded in 1999.

Even though the depreciation of the rupee raises the value of the external debt stock in rupee terms, it is misleading to infer that it would, on a net basis, impose an additional debt repayment burden on the government. This is because foreign debt is repaid by the government out of the current year's revenue and the revenue too rises with the depreciation of the currency. It has been estimated that the net budgetary gain to the government by a depreciation of the currency by 1 per cent amounts to Rs.1,340 million. Hence, there is no additional burden on the budget.