Chapter 8

FISCAL POLICY AND BUDGETARY OPERATIONS

8.1 Overview and Policy Strategy

The measures presented in the Budget 2001 were expected to consolidate fiscal operations after the significant slippage in 2000. They were designed to bring the budgetary outturn back to the medium term fiscal consolidation path as the persistently high budget deficit was not sustainable. These measures, aimed at reducing the budget deficit, while targetting higher public investment, sought to create an environment conducive to higher private sector investment. The higher public investment was to be funded mainly from external sources. The stabilisation measures were expected to reduce consumption expenditure of the government, increase revenue and reduce borrowing from the domestic market. These measures were expected to contain the overall deficit in 2001 to 8.5 per cent of GDP, from a deficit of 11.4 per cent of GDP that would have resulted had there been no changes to the existing fiscal policies. The deficit was targetted to be 1.4 percentage points below the deficit of 9.9 per cent in 2000. In line with this, the current account deficit, which indicates the level of government dis-savings, and the primary deficit, which reflects the impact of the current fiscal policy stance, were to be reduced to 1.2 per cent of GDP and 2.2 per cent, respectively. Meanwhile, public investment was to be increased to 7.4 per cent of GDP with special emphasis on achieving balanced regional development in the economy. The fiscal policy strategy formulated in Budget 2001 aimed at reducing the excessive expansionary pressure exerted by the government on the economy. In line with this stabilisation process, Budget 2001 announced a medium-term fiscal policy strategy, which envisaged a gradual improvement in the fiscal consolidation process. This was to be achieved by increasing the revenue performance and reducing consumption expenditure of the government, while increasing public investment. Accordingly, the overall deficit was expected to be reduced to 5.5 per cent of GDP by 2003 and to 3 per cent of GDP by 2010. Public investment was expected to be increased to 8.5 per cent of GDP by 2003. Consolidation in the fiscal sector was expected to improve macroeconomic stability and reduce interest rates and inflation.

In line with the fiscal consolidation process, the fiscal policy strategy in 2001 attempted to address three critical issues in the economy i.e. unemployment, inflation and poverty. A series of proposals were formulated to increase employment opportunities, reduce demand pressures and raise the income of people on a sustainable basis. Instead of providing general concessions which lead to a waste of resources, Budget 2001 identified key economic activities which were highly sensitive to fiscal incentives and have potential to expand and generate employment. In addition, the need to correct structural weaknesses and impediments, which retard growth in the economy, were also highlighted.

To consolidate fiscal operations, measures were introduced to improve revenue and curtail expenditure. Both consumption and investment expenditure were to be reduced. However, more emphasis was given to reducing wasteful and non-priority consumption expenditure. The capital expenditure programme was also subjected to tight scrutiny with a view to curtailing unproductive and redundant expenditure programmes. Considering the resource constraints faced during the first half of 2001, the Budget proposed the postponement of non-priority construction work by six months.

On the revenue front, stabilisation measures were taken to raise both tax and non tax revenue. In February 2001, a 40 per cent surcharge was imposed on dutiable imports (except for some essential food items) for a 10-month period ending December 2001. In addition, Budget 2001 proposed two major revenue enhancing measures, the imposition of a 20 per cent surcharge on corporate taxes (for a period of one year) and an increase in the National Security Levy (NSL) rate by 1 percentage point to 7.5 per cent. These three measures were expected to generate additional revenue equivalent to 1 per cent of GDP (Rs. 16 billion).

Budget 2001 was aimed at limiting the use of domestic resources in financing the deficit. This was with the objective of reducing the crowding-out impact of budgetary operations and stabilising interest rates in the domestic market. This was anticipated through the reduction in the overall deficit and through the financing of the resource gap mainly by way of non domestic sources. The Budget proposed to raise a commercial loan of US dollars 200 million (Rs.17 billion) from the international market, while the privatisation programme was expected to generate Rs.25 billion. In addition, the public investment programme, which was to be maintained at a significantly high level, was to be directly linked to concessional funding arrangements from external sources.

In spite of these efforts, the fiscal consolidation process suffered a serious setback in 2001. The overall deficit increased to 10.9 per cent of GDP while the current account deficit rose to 4.9 per cent. The deterioration in the fiscal sector was attributable to three main developments in 2001. First, the contraction of economic activity due to the slowing down of the world economy, which was further aggravated by domestic problems such as the prolonged drought and the escalation of the on-going conflict, as well as lower imports, adversely affected the achievement of revenue and privatisation targets, reducing government receipts in 2001 by about Rs.43.8 billion. Second, the poor performance in economic activity, the rising cost of living and the political uncertainty compelled the government to offer a special fiscal stimulus package to extend relief to investors as well as to vulnerable groups in society. Special tax incentives granted to investors under this package included the abolition of import duties on essential raw materials, the reduction of import duty on cement, the withdrawal of turnover taxes on the financial transactions of banks, the increase in the duty rebate on imports, the reduction of the NSL rate from 7.5 per cent to 6.5 per cent, and the reduction of stamp duty on imports from 2 per cent to 1 per cent. As a means of extending relief to employees in the public sector, pensioners and people in middle and lower income categories, special fiscal incentives were granted under the package. These were the payment of an interim allowance to public sector employees, an increase in pensions, the abolition of the Save the Nation Contribution (SNC), abolition of the motor vehicle diesel tax and a guarantee to prevent an increase in the price of wheat flour and LP gas. The total cost of the package was estimated at about Rs.9 billion in 2001 (a reduction of income by Rs.5.4 billion and an increase in expenditure by Rs.3.7 billion), equivalent to 0.6 per cent of GDP. Finally, non-implementation of the fiscal adjustments announced in the Budget, brought about a deviation in the fiscal outcome from the original targets. Some of the major adjustments announced in the Budget such as better targetting of the Samurdhi programme, strict cadre management, strict limits on expenditure relating to parliamentarians and other officials in the public sector, freezing of permits pertaining to the purchase of new vehicles and other non-priority capital purchases by ministries and public institutions, and the adjustment of prices of goods and services provided by public entities to reflect their true cost, were not effectively implemented. In addition to these main reasons, expenses which were not expected at the time of the preparation of the Budget (such as the cost of the general election, the budgetary burden of the prolonged drought etc.) resulted in increasing expenditure and consequently causing a significant deviation of the actual fiscal outcome from the original targets.

The persistently high budget deficit, slow growth in economic activity and the sharp depreciation of the rupee against the major currencies has significantly increased the value of the outstanding government debt stock in the recent past. A continuation of this trend in 2001 resulted in the outstanding government debt stock exceeding national income. (Since Independence, the outstanding debt stock exceeded the national income previously on two occasions, in 1988 and 1989, and this was due to high budget deficits, and slow growth in the national income). The present alarming rate of increase in the government debt stock indicates the non-sustainability of the current fiscal policy stance, urging policy makers to revamp the entire policy structure under an appropriate medium-term fiscal consolidation process.

In view of these developments, the stabilisation of fiscal sector operations is imperative. Meanwhile, the sustainability of the stabilisation process needs to be ensured through the correction of structural weaknesses in the existing system. Stabilisation measures should focus on expenditure control and management, while improving revenue. On the expenditure front, curtailing wasteful current expenditure, rationalising defence expenditure, better targetting of welfare programmes, limiting investment in projects generating low returns and improving cash management are some of the main areas to be considered.

In addition, attention should be paid to civil service reform and pension reform, as well as expediting the on-going public enterprise reform programme, which would help curtail the expenditure of the government in the medium to long run. Two other areas to be considered are the strengthening of the regulatory system and establishing a proper monitoring system at the centre, for effective policy formulation and execution. The appointment of 53 ministers and 7 deputy ministers (in addition there are 40 ministers in the provincial councils (PCs)) goes against the proposed fiscal consolidation process, as a large number of ministries (57) would necessarily place an additional burden on government expenditure. The introduction of a small but well structured ministerial structure, consistent with the structures of other sub-national governments (PCs and Local Government (LGs)) is required to contain expenditure, as well as for the smooth functioning of the fiscal system. The rationalisation of expenditure needs to be complemented with a well defined debt management strategy which aims at minimising borrowing costs.

In line with this process, revenue raising efforts should focus on reducing distortions in the tax structure, while expanding the tax base. This would improve the elasticity in the tax system, which is required for a sustainable growth in revenue in the long run. In addition, streamlining and strengthening tax administration is also necessary in order to improve tax compliance as well as overall tax collection. The burden of paying taxes is borne by a small group of taxpayers as a large number of activities are subject to exemptions, concessions and tax holidays under the current tax system. The two surcharges operating at present have added to the burden of taxpayers, further widening the gap between taxpayers and tax evaders in the system. Continuing with these surcharges would further encourage tax evasion. A future tax policy strategy should, therefore, be designed, to broaden the tax base and lower effective tax rates, while minimising the distortions in the tax system.

The borrowing strategy in 2001 was a deviation from the current borrowing policy of mobilising funds at the lowest cost, while using more market oriented debt instruments. High Central Bank interests prevailing during the second half of 2000 and early 2001 raised the interest rates significantly in the local market compelling the government to rely heavily on less market oriented debt instruments. This was possible because of the government Rupee loan programme and the existence of large institutional investors (such as EPF, NSB, and ETF) whose investment decisions could be influenced by the government. However, as a result, stakeholders in these funds/entities earned lower interest than they may have otherwise earned. Borrowing from non-market sources in this manner is an implicit tax and a form of financial repression and should therefore be avoided.

Nevertheless, in 2001, several steps were taken in the on-going reform of the public debt management system to diversify the scope of investment and expand the investor base. A new dollar denominated debt instrument, namely, Sri Lanka Development Bonds (SLDBs), was introduced under the Foreign Loans Act with a view to attracting external investors into the government securities market. In view of the declining trend in concessional foreign funds, the issue of dollar denominated government securities was a way of exploring the possibility of raising external funds at a reasonable cost. This was also expected lower the pressure of fiscal operations on the domestic market.

The limited number of primary dealers (08) was an impediment to the development of the domestic debt market. Therefore, a decision was taken to permit all licensed commercial banks to enter the primary dealer system (subject to maintaining a dedicated capital of Rs. 150 million) with the objective of strengthening and improving competitiveness and developing a more efficient, deep and stable government securities market. Directives were drafted to strengthen the prudential requirements and the regulatory framework in order to promote an efficient, transparent and sound primary dealer system.

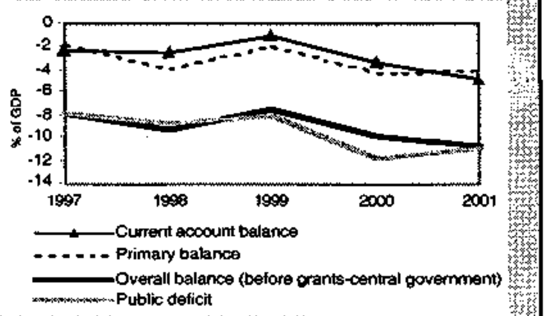
It is evident that the country is entering a different combination of budgetary financing options. Concessional foreign loans and grants are drying up, while receipts from privatisation proceeds are gradually declining as the number of institutions to be privatised decreases. Increased borrowing from domestic sources tends to crowd-out private investment in the country. Borrowing from the banking sector is increasing due to the limited availability of funds in the non bank sector, exerting pressure on interest rates and on inflation. Borrowing from FCBUs has also increased considerably. If borrowing through FCBUs was purely from foreign sources, it would help increase the net foreign assets of the country, while reducing the borrowing requirement from domestic sources. However, if these resources are from domestic savers, it would tend to further reduce resources available to the private sector.

In these circumstances, an effort to maintain a balance in the financing programme has become necessary. A well planned market borrowing programme, which is consistent with other macroeconomic objectives, should be prepared and used as a guide when undertaking domestic budgetary financing operations. Temporary deviations from the planned programme should be soon adjusted. Cash management of the Treasury should be improved to prevent ad hoc borrowing from the market. The significant amount of outstanding overdrafts and import bills is a matter for concern, as these funds are obtained at relatively higher interest rates. There is a need to contain this type of borrowing gradually and incorporate it into the formal borrowing programme. The imposition of a ceiling on bank credit for budgetary operations is urgently required.

An alternative to declining concessional foreign loans and grants will be commercial borrowing from international markets. When borrowing in international markets, steps should be taken to minimise risks from interest rate and exchange rate fluctuations and swings in investor sentiment. One way to reduce the risk is to diversify the currency composition, debt instruments, maturity and markets as well as creditors. However, in order to reduce any possible adverse effects, external debt must be used for real productive projects which increase economic resilience and enhance international competitiveness while reducing the country's vulnerability to contagion and financial shocks. A strong commitment to planning, executing and monitoring foreign funded projects is therefore imperative.

In relation to the general government operations in the country, the present power sharing system of the central government with other sub-national governments (PCs and LGs) is concentrated around the central government making PCs and LGs highly dependent on the centre. From the inception of these sub-national government units, a system of 'gap filling' has operated, where funds required to bridge the deficit of the sub-national government have been transferred from the central government. This has been mainly because, in the current structure, although greater autonomy has been given to these sub-national institutions for resource allocation, their resource mobilisation efforts have been restricted. As the current gap filling approach is highly inefficient, the entire devolution system should be restructured to extend more independence to individual systems while maintaining inter-dependency within the entire general government system. This would be a forward-looking step and a positive action, consistent with the current on-going peace process.

Chart 8.1
Fiscal Indicators



8.2 Budget Outturn

A shortfall in revenue collection and increase in expenditure, entirely on account of current expenditure, resulted in the deterioration of all deficit aggregates in 2001 in comparison to the fiscal performance in 2000 and the fiscal targets in Budget 2001. The overall deficit of the budget increased by 2.4 percentage points of GDP to 10.9 per cent in comparison to the original target of 8.5 per cent of GDP, while it increased by 1 percentage point in comparison to 2000. The primary deficit rose by about 2 percentage points of GDP from the budgetary target to 4.1 per cent of GDP. The effects of fiscal operations in 2001 were the same as in 2000; the sharp increase in interest payments led to the increase in the overall deficit. Meanwhile, the current account deficit increased to 4.9 per cent of GDP from the expected target of 1.2 per cent and last year's deficit of 3.4 per cent. High government dis-savings reduced resources available for investment in the public and the private sectors.

Meanwhile, the public sector deficit, which consolidates the performance of public sector corporations with those of the central government, was 11.1 per cent of GDP in 2001, in comparison to a target of 8 per cent. The public sector deficit in 2000 was 11.9 per cent of GDP. The CEB and CWE reported large operational deficits after failing to adjust their prices in line with the increase in costs. This contributed to increasing the debt stock in public corporations in 2001, emphasising the need for introducing an automatic price adjustment mechanism for goods and services provided by these institutions, which are linked to the cost of production, so that the commercial viability of these enterprises can be improved and the overall burden of the public sector on the economy lowered.

One of the main fiscal issues at present is the low revenue/GDP ratio, which has fallen from around 19 per cent in the early 1990's to 16.5 per cent in 2001. To address this issue, a number of short-term revenue enhancing measures were introduced in 2001. The main measures were the imposition of a 20 per cent and a 40 per cent surcharge on corporate taxes and selected dutiable imports respectively, an increase in the NSL rate and the upward revision of fees and charges for public services. Despite all these efforts, total revenue was 1.8 percentage points below the budgeted target of 18.3 per cent of GDP in 2001. In comparison to 2000, the tax/GDP ratio rose marginally. However, this was offset by a decline in non tax revenue collection. Hence, total revenue as a percentage of GDP declined to 16.5 per cent from 16.8 per cent in 2000. The fall in revenue in 2001 was largely attributable to the contraction of economic activity and lower imports. In addition, the fiscal incentive package granted towards the end of year to stimulate the economy also reduced revenue collection in 2001. The revenue foregone due to the fiscal incentive package was estimated to be about Rs. 5.4 billion in 2001.

Current expenditure, which was expected to be significantly curtailed, overshot by a substantial margin. Government expenditure on current operations (21.5 per cent of GDP) was 2 percentage points above the budgeted target and 1.3 percentage points above the previous year's current expenditure. The payment of an interim allowance to public sector employees, an increase in pensions, high expenditure on defence, the inability to contain transfers under the Samurdhi programme, non-implementation of the required price revisions in departmental enterprises such as railways, an increase in fertiliser subsidy payments, an unexpected parliamentary election and drought relief payments were some of the main reasons for the higher current expenditure in 2001. In addition, interest payments on outstanding government overdraft and unpaid import bills with the two state banks (for which provisions were not adequately provided in the Budget), also contributed to the overruns in current expenditure. Greater accuracy in estimating the Budget and improved discipline and accountability in managing public funds would greatly assist in improving the current operations of the Budget.

The public investment programme suffered a serious setback in 2001, in comparison to the planned investment programme. Though Budget 2001 envisaged an optimistic investment target of 7.4 per cent of GDP, the realised investment programme was only 5.9 per cent of GDP. The investment rate in 2000 was 6.4 per cent of GDP. As in the past, the slow progress of foreign funded investment programmes was the main reason for this decline. At the same time, limitations in resource availability also restricted the release of funds for locally funded investment programmes, reducing the overall public investment programme further. In addition, delays in the presentation of Budget 2001, an unexpected parliamentary election and changes to the structure of the Cabinet and ministers, were also responsible for this slowdown. Public investment in 2001 was mainly expected in roads, railways, power, ports and water supply sectors. A continuous shortfall in the public investment programme is a matter for serious concern as dilapidated and inadequate infrastructure would adversely affect private sector investment activity in the economy.

TABLE 8.1
Summary of Government Fiscal Operations

Rs. million

Item	1997	1998	1999	2000	2001 Approved Estimates	2001 Provi-sional	2002 Approved Estimates
Total revenue	165,036	175,032	195,905	211,282	264,479	231,463	278,202
Tax revenue	142,512	147,368	166,029	182,392	234,113	204,723	237,149
Non tax revenue	22,524	27,664	29,877	28,890	30,366	26,740	41,053
Expenditure and lending minus repayments	235,097	268,179	279,159	335,823	387,537	383,685	413,627
Current	184,749	199,648	207,271	254,279	281,384	300,406	332,565
Capital and net lending	50,348	68,532	71,888	81,544	106,153	83,279	81,062
Public investment	51,260	68,278	71,436	80,955	106,329	82,149	84,908
Other net lending	-912	253	452	589	-176	1,130	-3,846
Current account surplus (+) /deficit (-)	-19,713	-24,616	-11,366	-42,997	-16,905	-68,943	-54,363
Primary account surplus (+) /deficit (-)	-14,815	-38,249	-21,131	-53,341	-32,446	-57,916	-18,241
Overall deficit (before grants)	-70,061	-93,147	-83,254	-124,541	-123,058	-152,222	-135,425
Financing	70,061	93,147	83,254	124,541	123,058	152,222	135,425
Foreign financing	17,287	17,397	8,245	5,640	40,600	20,038	26,452
Net borrowings	9,958	10,197	1,484	495	33,100	14,538	18,952
Grants	7,329	7,200	6,761	5,145	7,500	5,500	7,500
Domestic financing	30,275	71,362	74,875	118,500	57,457	123,595	87,973
Market borrowings	39,644	72,292	75,718	115,325	57,457	122,848	87,973
Non bank	41,815	53,338	48,426	58,797	68,514	74,294	107,498
Bank	-2,171	18,954	27,292	56,528	-11,057	48,554	-19,525
Monetary authority	-13,991	5,609	20,807	44,840	-	-6,434	-
Commercial banks	11,820	13,345	6,484	11,689	-11,057	54,988	-19,525
Other borrowings	-9,369	-930	-842	3,175	-	747	-
Privatisation proceeds	22,499	4,389	134	401	25,000	8,589	21,000
As a percentage of GDP							
Total revenue	18.5	17.2	17.7	16.8	18.3	16.5	17.5
Tax revenue	16.0	14.5	15.0	14.5	16.2	14.6	15.0
Non tax revenue	2.5	2.7	2.7	2.3	2.1	1.9	2.6
Expenditure and lending minus repayments	26.4	26.3	25.2	26.7	26.9	27.4	26.1
Current	20.8	19.6	18.7	20.2	19.5	21.5	21.0
Capital and net lending	5.7	6.7	6.5	6.5	7.4	5.9	5.1
Public investment	5.8	6.7	6.5	6.4	7.4	5.9	5.4
Other net lending	-0.1	...	...	...	...	0.1	-0.2
Current account surplus/deficit(-)	-2.2	-2.4	-1.0	-3.4	-1.2	-4.9	-3.4
Primary account surplus/deficit(-)	-1.7	-3.8	-1.9	-4.2	-2.2	-4.1	-1.2
Overall deficit (before grants)	-7.9	-9.2	-7.5	-9.9	-8.5	-10.9	-8.5
Financing	7.9	9.2	7.5	9.9	8.5	10.9	8.5
Foreign financing	1.9	1.7	0.7	0.4	2.8	1.4	1.7
Net borrowings	1.1	1.0	0.1	...	2.3	1.0	1.2
Grants	0.8	0.7	0.6	0.4	0.5	0.4	0.5
Domestic financing	3.4	7.0	6.8	9.4	4.0	8.8	5.5
Market borrowings	4.5	7.1	6.8	9.2	4.0	8.8	5.5
Non bank	4.7	5.2	4.4	4.7	4.7	5.3	6.8
Bank	-0.2	1.9	2.5	4.5	-0.8	3.5	-1.2
Monetary authority	-1.6	0.6	1.9	3.6	-	-0.5	-
Commercial banks	1.3	1.3	0.6	0.9	-0.8	3.9	-1.2
Other borrowings	-1.1	-0.1	-0.1	0.3	-	0.1	-
Privatisation proceeds	2.5	0.4	...	...	1.7	0.6	1.3

Source: Ministry of Finance

The total resource gap, which reflects the financing requirement of the budget, exceeded the budgetary target by Rs.29 billion in 2001, while financing through the privatisation programme and external financing was Rs.37 billion below expectations. As a result, additional resources required to bridge that gap amounted to Rs.66 billion, this was reflected in the domestic financing programme in 2001. Net borrowing from the domestic sector therefore, increased to Rs.123 billion, more than double the budgetary target of Rs.57 billion.

The privatisation programme in 2001, which initially planned to generate Rs 25 billion, was able to raise only Rs 8.6 billion. However, this was an improvement in comparison to the performance in the privatisation programme during the last three years. The shortfall in the privatisation programme was mainly attributable to the failure to issue part of the government's equity stake in Sri Lanka Telecom (US dollar 250 million). The issue was postponed for the third consecutive year due to the depressed international market for telecom shares.

In 2001, net foreign financing, including grants, amounted to Rs 20 billion. This includes gross trade credits of Rs 13.2 billion provided for the import of security related items to be settled on a deferred payment basis. When security related trade credit and deferred payments are excluded, net foreign resources available for financing the budget were Rs 15.3 billion in 2001 in comparison with the budgetary target of Rs 52.6 billion. The significant shortfall in anticipated foreign financing was the outcome of lower utilisation of concessional foreign resources on account of the slow progress in the public investment programme and the failure to raise US dollars 200 million from the international market due to the uncertain environment that prevailed in local and international markets.

In view of the shortfall in planned foreign financing and privatisation receipts and the widening resource gap over the budgetary estimates, there was a sharp increase in demand for resources from the domestic market. Borrowing from the domestic market, on a net basis, rose by Rs 66 billion to Rs 123 billion (8.8 per cent of GDP). The high borrowing requirement from the domestic sector compelled the government to change the present market based borrowing policy stance to minimise the pressure on the interest rate structure in the domestic market. Accordingly, the Rupee loan programme was extensively used to mobilise resources available with institutional investors, while all new Treasury bills were made as special issues to the Central Bank. The maturity period of new and re-issued Treasury bonds was limited to 2-3 years to avoid locking in funds at high interest rates for a longer period. In addition, the government relied heavily on the two state banks to raise funds directly through bank overdrafts and import bills. As these bank borrowings are entirely outside the normal public debt programme, it reflects a lack of transparency and prudence in debt management in the present system. It is essential to bring such borrowing within the formal debt programme.

In view of the high borrowing requirement from domestic sources and the pressure in the domestic market, the government issued a dollar denominated new debt instrument namely, Sri Lanka Development Bonds (SLDBs) (US dollar 158.5 million), towards the end of 2001. Originally, the intention of issuing these bonds was to raise funds in the external market. However, almost the entire stock was purchased by domestic commercial banks (domestic banking units and foreign currency banking units).

As resources in the non-bank sector were limited (Rs 75 billion), the balance resource requirement of Rs.48.6 billion (3.5 per cent of GDP) was raised from the banking system., although the Budget expected to repay Rs 11 billion (0.8 per cent of GDP) to the banking system. Total borrowing from the banking sector was the net outcome of Rs. 55 billion borrowing from commercial banks and a repayment of Rs.6.4 billion to the Central Bank. In 2001, borrowing from the monetary authority declined entirely due to the reduction in the Central Bank's holding of Treasury bonds in the reverse repo market with the improvement in the liquidity in the market towards the end of the year. Therefore, the expansionary impact of high borrowing from the banking system in 2001 was lower than it was in 2000 due to the repayment to the monetary authority. The effect of large government borrowings from commercial banks was not fully reflected in the interest rates in the domestic market mainly due to two reasons. One reason was that a large share of bank borrowing was from the foreign furrency banking Units (FCBUs). The second reason was the lower private sector demand for credit from the banking system that reduced the overall demand for funds from the banking system.

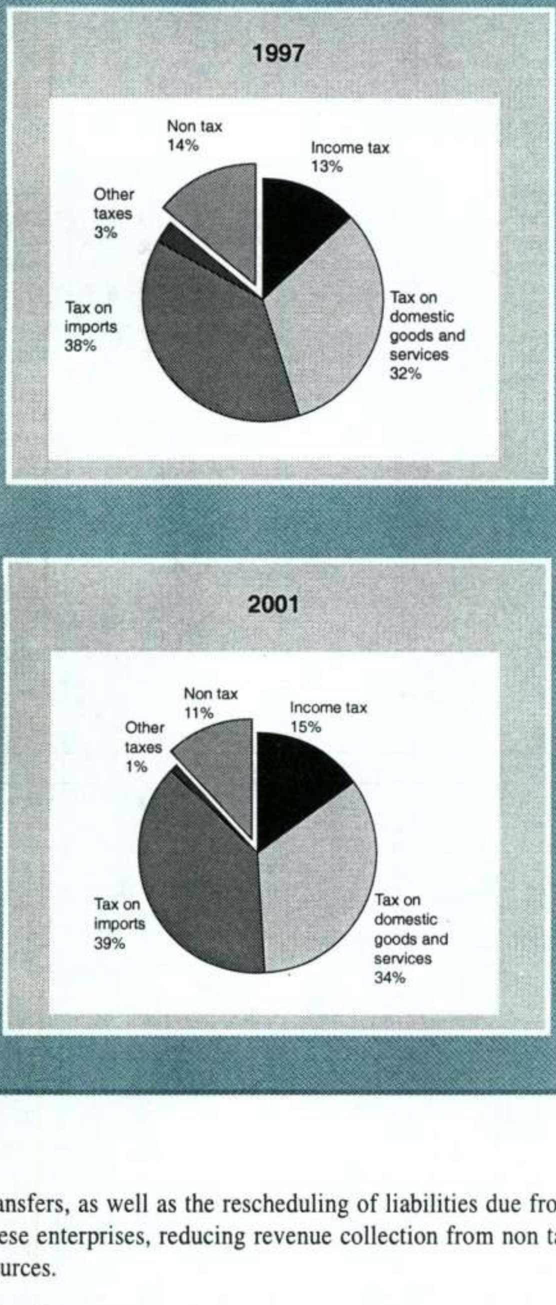
8.3 Revenue

The total revenue collection in nominal terms in 2001 amounted to Rs.231.5 billion, a growth of 10 per cent over 2000. However, as a percentage of GDP, government revenue in 2001, declined to 16.5 per cent from 16.8 per cent in 2000. The setback in revenue collection, despite the introduction of several discretionary revenue enhancing measures, such as the introduction of a corporate tax surcharge of 20 per cent, an import duty surcharge of 40 per cent, and the upward revision in the National Security Levy (NSL) by 1 per cent, was largely attributable to the slowing down of the economy and lower imports in 2001, as well as the generous tax concessions offered as part of a fiscal stimulus package in October 2001 to revive the economy.

The tax/ GDP ratio increased marginally to 14.6 per cent in 2001 from 14.5 per cent in 2000. However, the performance of taxes was mixed. While revenue from income taxes and NSL grew significantly, revenue from GST, excise duties and import duties grew at a much slower pace during the year. The imposition of a 20 per cent surcharge on corporate income taxes and the collection of tax arrears from some public enterprises accounted for the improved performance in corporate taxes, while the upward revision to the NSL rate as well as high growth in certain key sectors liable to NSL despite the slowdown in the economy, were the main reasons for the favourable performance in NSL in 2001. The poor revenue performance in other taxes was mainly the result of reduced economic activity and lower imports during the year.

The ratio of non tax revenue to GDP declined from 2.3 per cent in 2000 to 1.9 per cent in 2001. The adverse economic conditions that prevailed during the year, terrorist attacks both in Sri Lanka and in the United States, as well as the non-adjustment of prices to reflect market conditions affected the financial performance of several public corporations, leading to significantly lower profit and dividend

Chart 8.2
Composition of Revenue



transfers, as well as the rescheduling of liabilities due from these enterprises, reducing revenue collection from non tax sources.

Tax Revenue

Tax revenue collection in 2001 amounted to Rs.204.7 billion, a growth of 12 per cent over the previous year, while the share of tax revenue to total revenue increased to 88 per cent in 2001 from 86 per cent in 2000. Consumption based taxes continued to be the dominant source of tax revenue, accounting for 83 per cent of total tax revenue collection (12 per cent of GDP).

The structure of consumption taxes has undergone a significant change over time. The share of revenue from international trade oriented taxes has declined to 44 per cent of total tax revenue, while the share of tax revenue from domestic goods and services has gradually increased to 38 per cent of total tax revenue in 2001.

A favourable performance was recorded in income taxes. The income tax to GDP ratio rose from 2.2 per cent in 2000 to 2.5 per cent in 2001. The main reason for this growth was corporate income taxes, which increased by Rs. 5 billion to Rs. 20.8 billion in 2001; in GDP terms, an increase of 0.2 per cent to 1.5 per cent of GDP. The higher revenue collection from corporate taxes was mainly the result of the imposition of a 20 per cent surcharge on corporate income taxes in Budget 2001, which netted in Rs. 1.9 billion, and higher corporate tax payments by the Sri Lanka Ports Authority (SLPA) amounting to Rs.2 billion (this included a payment of arrears of Rs.0.7 billion for 2000). However, if the collection from the surcharge and payment of arrears are excluded, corporate tax collection in 2001 in GDP terms, remained almost the same as in 2000. This indicates that the higher revenue collection was mainly due to the change in the effective tax rate, from 35 per cent to 42 per cent as a result of the imposition of the surcharge, and not because of an expansion in the tax base. The withdrawal of investment tax allowances from April 2000, had a positive impact on revenue collection in 2001, but the full gains from this measure will be realised in the future.

Revenue from personal income taxes grew by 18 per cent in 2001. The tax threshold for personal income taxpayers has remained at Rs.144,000 since 1997. This has led to bracket creep as individuals are pushed into higher tax brackets, thereby increasing the number of PAYE taxpayers and the tax collection from this source. The broadening of the tax base by the opening of 30,000 new income tax files in 2001 also enabled a higher collection from personal income taxes during the year. The removal of SNC during the latter part of 2001 reduced revenue collection from personal income taxes to some extent in 2001. However, the full revenue loss from this source would be reflected in 2002.

The growth in consumption taxes was mainly propelled by the growth in NSL, which continued to be a buoyant source of revenue. Revenue from NSL as a percentage of GDP increased to 3.1 per cent in 2001 from 2.7 per cent in 2000. The upward revision in the tax rate in mid 2000 from 5.5 per cent to 6.5 per cent and then again from 6.5 per cent to 7.5 per cent in Budget 2001 (effective from April to October 2001), widening of the tax base in 2000 to include most services, as well as the high growth of key sectors liable to NSL contributed significantly to increase the revenue collection from this tax. Revenue collection from NSL grew mainly in the non manufacturing sector. Revenue collection from this sector grew by over 50 per cent as a result of the upward

TABLE 8.2
Economic Classification of Revenue by Component

Rs. million

Item	1997	1998	1999	2000	2001 Approved Estimates	2001 Provisional	2002 Approved Estimates
Tax revenue	**142,512**	**147,368**	**166,029**	**182,392**	**234,113**	**204,723**	**237,149**
Income taxes	21,548	20,429	28,228	27,457	34,483	34,618	38,992
Personal	8,163	8,099	9,169	10,820	12,643	12,907	13,837
Corporate	13,038	11,788	18,362	15,757	20,720	20,674	22,905
Save the Nation Contribution	327	542	697	880	1,120	1,037	-
Tax on interest	-	-	-	-	-	-	2,250
Stamp duties	6,392	7,079	7,690	8,163	9,450	8,442	3,407
Debit tax	-	-	-	-	-	-	2,300
Tax on Treasury bills held by Central Bank	1,080	-	-	-	-	-	-
Taxes on goods and services	86,750	91,706	102,391	122,802	155,180	135,567	158,475
Turnover tax	43,492	16,166	1,799	1,708	1,965	1,176	548
GST/VAT	-	23,177	35,540	43,893	54,205	45,603	87,835
Manufacturing	-	5,533	5,533	11,378	14,258	12,521	19,084
Non-manufacturing	-	5,437	14,211	13,643	17,203	14,453	25,777
Imports	-	12,207	15,796	18,872	22,744	18,629	42,974
Excise Tax	24,775	30,293	35,928	42,655	50,100	44,911	52,321
Liquor	6,181	7,665	8,745	9,531	10,900	9,777	10,300
Cigarette	14,139	15,051	17,205	19,268	21,050	19,474	21,204
Petroleum	3,800	6,097	7,241	10,700	14,900	12,948	17,102
Other	655	1,480	2,737	3,156	3,250	2,712	3,715
National Security Levy	17,338	21,079	28,127	33,539	47,020	42,939	17,211
License fees/Motor vehicle tax	1,145	991	997	1,007	1,890	938	560
Taxes on international trade	26,743	28,154	27,720	23,970	35,000	26,096	33,975
Imports	26,739	28,154	27,720	23,970	35,000	26,096	29,775
Exports	4	-	-	-	-	-	-
Port and airport development levy	-	-	-	-	-	-	4,200
Non tax revenue	**22,524**	**27,664**	**29,877**	**28,890**	**30,366**	**26,740**	**41,053**
Property income	15,022	18,462	18,988	18,842	19,408	15,887	28,584
of which: Central Bank profits	1,500	2,650	3,000	3,200	5,000	5,000	10,000
Interest income	8,002	7,786	7,056	7,304	7,497	6,074	11,203
Fees and charges	2,800	2,890	3,375	3,589	4,290	4,215	4,764
Other non-tax revenue	4,702	6,312	7,514	6,459	6,668	6,638	7,705
Total revenue	**165,036**	**175,032**	**195,905**	**211,282**	**264,479**	**231,463**	**278,202**
			As a percentage of GDP				
Tax revenue	**16.0**	**14.5**	**15.0**	**14.5**	**16.2**	**14.6**	**15.0**
Income taxes	2.4	2.0	2.6	2.2	2.4	2.5	2.5
Personal	0.9	0.8	0.8	0.9	0.9	0.9	0.9
Corporate	1.5	1.2	1.7	1.3	1.4	1.5	1.4
Save the Nation contributions	0.0	0.1	0.1	0.1	0.1	0.1	-
Tax on interest	-	-	-	-	-	-	0.1
Stamp duties	0.7	0.7	0.7	0.6	0.7	0.6	0.2
Debit tax	-	-	-	-	-	-	0.1
Tax on Treasury bills held by Central Bank	0.1	-	-	-	-	-	-
Taxes on goods and services	9.7	9.0	9.3	9.8	10.8	9.7	10.0
Turnover tax	4.9	1.6	0.2	0.1	0.1	0.1	-
GST/VAT	-	2.3	3.2	3.5	3.8	3.3	5.5
Manufacturing	-	0.5	0.5	0.9	1.0	0.9	1.2
Non manufacturing	-	0.5	1.3	1.1	1.2	1.0	1.6
Imports	-	1.2	1.4	1.5	1.6	1.3	2.7
Excise tax	2.8	3.0	3.2	3.4	3.5	3.2	3.3
Liquor	0.7	0.8	0.8	0.8	0.8	0.7	0.6
Cigarette	1.6	1.5	1.6	1.5	1.5	1.4	1.3
Petroleum	0.4	0.6	0.7	0.9	1.0	0.9	1.1
Other	0.1	0.1	0.2	0.3	0.2	0.2	0.2
National Security Levy	1.9	2.1	2.5	2.7	3.3	3.1	1.1
License fees/Motor vehicle tax	0.1	0.1	0.1	0.1	0.1	0.1	-
Taxes on international trade	3.0	2.8	2.5	1.9	2.4	1.9	2.1
Imports	3.0	2.8	2.5	1.9	2.4	1.9	1.9
Exports	0.0	-	-	-	-	-	-
Port and airport development levy	-	-	-	-	-	-	0.3
Non tax revenue	**2.5**	**2.7**	**2.7**	**2.3**	**2.1**	**1.9**	**2.6**
Property income	1.7	1.8	1.7	1.5	1.3	1.1	1.8
of which: Central Bank profits	0.2	0.3	0.3	0.3	0.3	0.4	0.6
Interest income	0.9	0.8	0.6	0.6	0.5	0.4	0.7
Fees and charges	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Other non tax revenue	0.5	0.6	0.7	0.5	0.5	0.5	0.5
Total revenue	**18.5**	**17.2**	**17.7**	**16.8**	**18.3**	**16.5**	**17.5**

Source: Ministry of Finance

revision in the NSL rate and the high growth in key sectors liable to NSL such as the banking and telecommunication sectors in 2001. NSL from the banking sector accounted for 38 per cent while the telecommunications sector accounted for 12 per cent of the total NSL revenue collected from domestic activities. Even with lower imports in 2001, revenue collection from NSL on imports grew by 26 per cent in 2001. This growth was the result mainly of the upward revision in the tax rate and the relatively few imports exempted from NSL. However, the downward revision in the NSL rate back to 6.5 per cent in October partly offset revenue gains from this source. The revenue loss to the government in the last quarter of 2001, as a result of this reduction in the NSL rate, was estimated at Rs.3 billion.

Revenue collection from GST suffered a setback during the year. As a percentage of GDP it declined from 3.5 in 2000 to 3.3 in 2001. The negative growth of imports, the slowdown in economic activity and the large number of items exempted from GST, were the major factors behind this setback. The ratio of GST revenue on imports to GDP fell from 1.5 per cent in 2000 to 1.3 per cent in 2001. The growth in revenue collection from GST on the manufacturing and non manufacturing sectors also slowed down considerably in 2001 to 10 and 6 per cent, respectively, from a high growth of 27 per cent in each of these sectors in 2000.

The main source of GST revenue was once again the tobacco industry (6.1 per cent of total GST collection). The other main sources of GST revenue in the manufacturing sector were the liquor (2.9 per cent), petroleum (2.7 per cent) and construction (2.6 per cent) industries. The main contributors to GST revenue collection from the non manufacturing sector were the telecommmunications (4.2 per cent of total GST collection), banking (1.2 per cent), leasing and finance (2 per cent) and power (1.5 per cent) sectors. The expansion of the base to include cement, timber and meat industries into the tax net in Budget 2000 had a positive impact on revenue collection in 2001.

Revenue collection from excise duties, other than excise duties on petroleum products, grew marginally in 2001, causing the excise duty revenue/GDP share to decline to 3.2 per cent in 2001 from 3.4 per cent in 2000. The main factors behind this decline were the shortfall in excise duty collection from cigarette sales and liquor production. Excise duty collection from cigarettes sales fell below the targetted level by Rs.1.6 billion mainly as a result of a decline in sales by 2.5 per cent in 2001 over the previous year. The continuous increase in excise taxes has raised the price of legal brands whilst making illegal brands more attractive to the consumer, resulting in a rapid growth in the illegal cigarette industry. This has posed a serious threat to the legal cigarette industry and has adversely impacted government revenue collection, indicating the need for corrective measures. The liquor industry is facing a similar threat from the illegal liquor industry. Although hard liquor production was maintained at the same level as in the previous year, beer production fell by 3.5 per cent in 2001 and was mainly responsible for the lower excise duty collected.

The share of excise duty revenue on petroleum products increased to 29 per cent of total excise revenue in 2001 from 25 per cent in 2000, recording a growth of 21 per cent. The payment of excise duty arrears by the Ceylon Petroleum Corporation (CPC) amounting to Rs.2 billion was the main contributor to this higher revenue collection. However, a waiver on excise duties granted to CPC in 2001 (Rs.3 billion), as well as unpaid taxes in 2001 carried forward to be settled in the following year (Rs.1.9 billion), reduced the full revenue generating capacity of this tax source.

Excise duty collection from motor vehicles declined in 2001, mainly due to the sharp drop in vehicle imports during the year. The withdrawal of duty free permits and the restriction on duty waivers granted for vehicle imports, as well as the surcharge on imports were mainly responsible for this decline.

Revenue collection from import duties grew by 9 per cent in 2001 maintaining its revenue to GDP share of 1.9 per cent. However, growth in import duty collection was mainly on account of the imposition of a 40 per cent surcharge on imports in February 2001. Excluding the surcharge (Rs. 5.4 billion), revenue from import duties declined by 14 per cent in 2001, reflecting the negative growth in dutiable imports by 13 per cent. In addition, the removal of import duties on around 1000 essential raw materials in October 2001 significantly reduced import duty collection. The estimated loss of revenue as a result of the removal of duty on these items during the last quarter of 2001 amounted to Rs.0.4 billion. The full annual impact of these tariff changes, however, would appear in 2002.

There was a further decline in the average duty rate (the ratio of import duty collection, excluding the import duty surcharge, to the total value of imports) in 2001 to 3.9 per cent from 4.5 per cent in 2000 and 7 per cent in 1999. The removal of tariffs on around 1000 essential raw materials, and the high value of duty free imports, such as raw materials for export oriented industries, defence purchases and crude oil imports, contributed to lowering the average duty rate in 2001. The effective duty rate (the ratio of total duty collection, excluding the import duty surcharge, to dutiable imports) grew marginally from 15.3 per cent in 2000 to 15.4 per cent in 2001 due to the removal of items that are subject to a lower duty rate, such as essential raw materials, which are taxed at a concessionary rate of 5 per cent, from the tax base.

The growth in revenue collection from stamp duties slowed to 3 per cent in 2001. The main source of stamp duty revenue has been the stamp duty on imports, which accounts for around 70 per cent of the total revenue collected from stamp duties. Therefore, the adverse developments in imports in 2001 as well as the lowering of the stamp duty rate on import invoices from 2 per cent to 1 per cent in October 2001, had a negative impact on stamp duty collection.

Revenue collection from license fees and motor vehicle taxes declined significantly in 2001 registering a negative growth of 7 per cent. The lower import of motor vehicles as well as the abolition of the tax on diesel vehicles announced in the fiscal stimulus package contributed to this lower revenue collection.

Non Tax Revenue

Non tax revenue collection in 2001, of Rs. 26.7 billion, was a decline of Rs. 2.2 billion from 2000 and a shortfall of Rs.3.6 billion from the budgeted target of Rs.30.4 billion. The shortfall in non tax revenue was mainly due to lower profit transfers from the Sri Lanka Ports Authority (SLPA) by Rs. 1.8 billion and a rescheduling of interest payments due from the Ceylon Electricity Board (CEB) (Rs. 1.5 billion). The original budget expected to raise Rs. 7.5 billion from interest income on loans given to public enterprises. However only Rs. 6 billion was realised during the year. Due to the adverse conditions faced by the CEB during the year, a rescheduling of interest payments was granted. Profits and dividend transfers, other than profit transfers from the Central Bank, fell short by nearly Rs. 1 billion from the budgeted target of Rs. 4.5 billion. This was mainly on account of the lower profits earned by SLPA as a consequence of the slowdown in port activity following the higher insurance premia charged from ships berthing at the Colombo Port after the terrorist attacks on the Katunayake Airport. A decline in rent income (Rs. 0.4 billion) as a result of lower rent payments from Regional Plantation Companies and a shortfall in revenue from the National Lotteries Board (Rs. 0.7 billion) as a result of the non-implementation of some new revenue generating programmes that were envisaged during the preparation of the Budget, contributed to lowering the revenue from non tax sources during the year. In comparison to 2000, Central Bank profit transfers increased by Rs.1.8 billion to Rs. 5 billion in 2001. However, this included an advance payment for 2002 of Rs.1 billion.

8.4 Expenditure

Budget 2001 attempted to bring the fiscal performance back onto the consolidation path set out in the medium term strategy of the government by curtailing non priority expenditure through the implementation of strict expenditure controls, while maintaining public investment at a level necessary for sustained economic development. In terms of this strategy, current expenditure was to be contained at 19.5 per cent of GDP while public investment was to be raised to 7.4 per cent of GDP. However, larger outlays on salaries and pensions, higher interest payments on government debt, particularly on government overdraft balances and unsettled import bills, higher than anticipated defence expenditure, as well as higher transfers on account of the Samurdhi programme and fertiliser subsidy and the increase in the operational expenses of Sri Lanka Railways (SLR) resulted in significant expenditure overruns. As a result, the ratio of current expenditure to GDP exceeded the budgetary target by 2 percentage points to 21.5 per cent of GDP. Meanwhile, public investment fell short of the target by 1.5 percentage points and was 5.9 per cent of GDP, due to the slow implementation of foreign funded projects and strict controls on rupee funded capital investment. In comparison to 2000, current expenditure increased by 1.3 percentage points of GDP, while public investment declined by 0.5 percentage points. The net outcome was an increase in total expenditure by 0.7 percentage points to 27.4 per cent of GDP in 2001 from 26.7 per cent of GDP in 2000.

Current Expenditure

In spite of the measures introduced in Budget 2001 to curtail current expenditure and improve fiscal discipline, current expenditure as a percentage of GDP rose from 20.2 per cent in 2000 to 21.5 in 2001. In nominal terms, current expenditure amounted to Rs.300.4 billion, an increase of 18 per cent over the previous year.

Salaries and wages amounted to Rs.78 billion, a growth of 14 per cent over 2000. This higher wage bill mainly reflects the full year impact of the interim allowance (the higher of Rs.1,000 or 10 per cent of basic salary per month), granted to all public sector employees during the second half of 2000, and the payment of another interim allowance of Rs.1,200 per month from October 2001, as well as the confirmation of temporary, casual and substitute employees in the public sector into the permanent cadre. The cost of the interim allowance granted in 2001 has been estimated at Rs.2.9 billion. In GDP terms, the wage bill increased marginally by 0.1 per cent to 5.6 per cent in 2001, while its share in total current expenditure fell from 27 per cent in 2000 to 26 per cent in 2001. Although the Budget estimated expenditure on salaries and wages at Rs.79.6 billion, actual expenditure amounted to Rs.78.1 billion. A restriction on new recruitment to non-professional grades and lower than anticipated recruitment into the defence services contributed to this saving.

Despite the controls on current expenditure imposed in Budget 2001, expenditure on other goods and services by the central government (excluding defence) increased by 30 per cent in 2001. However, expenditure on other goods and services for defence related activities and the release of grants to the provincial councils (PCs) on account of the purchase of other goods and services declined in 2001.

Although Budget 2001 envisaged a lower outlay on defence, actual defence expenditure including expenditure on public order and safety, amounted to Rs.68 billion, an increase of Rs.6 billion over the budgetary provision. The additional

TABLE 8.3
Economic Classification of Expenditure and Lending minus Repayment

Rs. million

Item	1997	1998	1999	2000	2001 Approved Estimates	2001 Provi-sional	2002 Approved Estimates
Current expenditure	**184,749**	**199,648**	**207,271**	**254,279**	**281,384**	**300,406**	**332,565**
Expenditure on goods and services	83,833	97,767	98,223	130,765	141,698	140,851	142,127
Salaries and wages	44,676	53,879	58,532	68,544	79,619	78,056	89,931
Other goods and services	39,158	43,887	39,690	62,221	62,078	62,795	52,196
Interest payments	55,246	54,898	62,123	71,200	90,611	94,307	117,184
Foreign	6,692	7,300	8,752	9,015	12,923	9,747	11,389
Domestic	48,554	47,598	53,371	62,185	77,688	84,560	105,795
Current transfers and subsidies	45,670	46,983	46,925	52,314	57,953	65,248	73,255
To public corporations	2,693	2,967	3,277	3,370	3,057	4,316	4,495
To public institutions	2,657	4,320	4,834	5,705	7,038	6,919	12,574
To local government	1,941	1,977	1,629	1,424	777	694	715
To households and other sectors	38,380	37,720	37,185	41,815	47,081	53,319	55,471
Food stamps, food subsidy etc.	-	-	334	435	518	681	740
Janasaviya / Samurdhi	8,718	8,652	8,020	9,661	10,300	12,574	9,950
Pensions	17,916	19,477	19,056	21,602	24,764	26,493	31,863
Fertiliser subsidy	1,895	2,152	1,390	1,733	2,000	3,660	2,000
Other	9,851	7,438	8,385	8,384	9,500	9,921	10,918
Provision for under expenditure / contingency	-	-	-	-	-8,879	-	-
Capital expenditure	**43,982**	**54,160**	**60,340**	**67,769**	**83,942**	**67,560**	**70,632**
Acquisition of real assets	25,468	32,246	32,933	32,934	45,507	35,773	43,716
Capital transfers	18,515	21,915	27,407	34,835	50,151	31,787	26,916
To public corporations	5,880	6,801	9,075	12,048	10,582	6,973	6,294
To public institutions	11,041	13,285	15,968	14,522	28,141	18,351	14,884
To sub national governments	1,511	1,764	2,297	8,218	11,323	6,251	5,531
Other	83	65	67	47	105	212	207
Provision for under expenditure	-	-	-	-	-11,716	-	-
Lending minus repayment	**6,366**	**14,371**	**11,548**	**13,775**	**22,211**	**15,719**	**10,430**
Advance accounts	1,226	2,784	1,585	2,638	1,500	2,044	1,500
On lending	7,278	14,118	11,096	13,187	22,387	14,590	14,277
Restructuring cost	2,193	3,688	4,556	4,159	6,000	5,320	5,473
Loan repayments	-4,331	-6,218	-5,689	-6,209	-7,676	-8,235	-10,820
Memorandum item:							
Transfers to provincial councils (a)	18,348	20,594	22,787	30,731	35,844	31,491	36,465
Current	16,855	19,194	21,122	23,220	26,821	26,405	31,684
Capital	1,493	1,400	1,665	7,511	9,023	5,086	4,781
Total expenditure and net lending	**235,097**	**268,179**	**279,159**	**335,823**	**387,537**	**383,685**	**413,627**
	As a percentage of GDP						
Current expenditure	**20.8**	**19.6**	**18.7**	**20.2**	**19.5**	**21.5**	**21.0**
Expenditure on goods and services	9.4	9.6	8.9	10.4	9.8	10.1	9.0
Salaries and wages	5.0	5.3	5.3	5.5	5.5	5.6	5.7
Other goods and services	4.4	4.3	3.6	4.9	4.3	4.5	3.3
Interest payments	6.2	5.4	5.6	5.7	6.3	6.7	7.4
Foreign	0.8	0.7	0.8	0.7	0.9	0.7	0.7
Domestic	5.5	4.7	4.8	4.9	5.4	6.0	6.7
Current transfers and subsidies	5.1	4.6	4.2	4.2	4.0	4.7	4.6
To public corporations	0.3	0.3	0.3	0.3	0.2	0.3	0.3
To public institutions	0.3	0.4	0.4	0.5	0.5	0.5	0.8
To local government	0.2	0.2	0.1	0.1	0.1	...	...
To households and other sectors	4.3	3.7	3.4	3.3	3.3	3.8	3.5
Food stamps, food subsidy etc.	-	-	...	...	...	...	...
Janasaviya / Samurdhi	1.0	0.8	0.7	0.8	0.7	0.9	0.6
Pensions	2.0	1.9	1.7	1.7	1.7	1.9	2.0
Fertiliser subsidy	0.2	0.2	0.1	0.1	0.1	0.3	0.1
Other	1.1	0.7	0.8	0.7	0.7	0.7	0.7
Provision for under expenditure/contingency	-	-	-	-	-0.6	-	-
Capital expenditure	**4.9**	**5.3**	**5.5**	**5.4**	**5.8**	**4.8**	**4.5**
Acquisition of real assets	2.9	3.2	3.0	2.6	3.2	2.6	2.8
Capital transfers	2.1	2.2	2.5	2.8	3.5	2.3	1.7
To public corporations	0.7	0.7	0.8	1.0	0.7	0.5	0.4
To public institutions	1.2	1.3	1.4	1.2	1.9	1.3	0.9
To sub national governments	0.2	0.2	0.2	0.7	0.8	0.4	0.3
Other	...	...	...	...	...	...	...
Provision for under expenditure	-	-	-	-	-0.8	-	-
Lending minus repayment	**0.7**	**1.4**	**1.0**	**1.1**	**1.5**	**1.1**	**0.7**
Advance accounts	0.1	0.3	0.1	0.2	0.1	0.1	0.1
On lending	0.8	1.4	1.0	1.0	1.6	1.0	0.9
Restructuring cost	0.2	0.4	0.4	0.3	0.4	0.4	0.3
Loan repayments	-0.5	-0.6	-0.5	-0.5	-0.5	-0.4	-0.7
Memorandum item:							
Transfers to provincial councils (a)	2.1	2.0	2.1	2.4	2.5	2.3	2.3
Current	1.9	1.9	1.9	1.8	1.9	1.9	2.0
Capital	0.2	0.1	0.2	0.6	0.6	0.4	0.3
Total expenditure and net lending	**26.4**	**26.3**	**25.2**	**26.7**	**26.9**	**27.4**	**26.1**

Source: Ministry of Finance

(a) Current transfes to provincial councils are classified under expenditure on goods and services, and capital transfers to provincial councils (criteria based grants, matching grants and province specific development grants) are classified under capital transfers to sub national governments.

expenditure in 2001 was largely on account of the unutilised budgetary provision for 2000 being transferred to 2001 and utilised to finance import orders placed in 2000. However, defence expenditure as a share of GDP declined to 4.9 per cent in 2001 compared to 5.6 per cent in 2000.

Interest payments have become a significant component of government expenditure, increasing rapidly in the last few years. In 2001, payments on interest amounted to Rs.94.3 billion accounting for 31 per cent of total current expenditure and was the largest single component of expenditure (6.7 per cent of GDP). Interest on domestic debt amounted to Rs.84.6 billion. The rising domestic debt stock and the high interest rates that prevailed in the market during the latter part of 2000 and the first half of 2001, contributed to these higher interest payments in 2001. However, the overrun in actual interest payments over the budgetary allocation was mainly because the budget did not make adequate provision for interest payments on overdraft facilities and outstanding import bills. Interest payments on these instruments amounted to Rs.6.1 billion in 2001, mainly due to the sharp increase in the overdraft facility (the outstanding overdraft of the government increased from Rs.19 billion at end 2000 to Rs.38 billion at end 2001) and the high outstanding balance on import bills (Rs.14.9 billion).

There was a sharp increase in interest payments on Treasury bonds in 2001, to Rs.24 billion, a 60 per cent increase over the interest payments in 2000. The share of interest payments on Treasury bonds to total domestic interest payments increased to 29 per cent from 24 per cent in 2000. The large increase in the stock of outstanding Treasury bonds by 95 per cent, from Rs.104 billion in 1999 to Rs.204 billion in 2000 was the main reason for the higher interest payments in 2001. The lower coupon rates that were offered in 2000 and 2001 however, had a mitigating effect on interest costs in 2001. However, this resulted in a cash shortfall, which will be reflected in the interest payments at the time of maturity of these bonds, increasing the interest cost to the budget in the future.

Interest payments on Rupee loans in 2001 accounted for 44 per cent of total interest payments on domestic debt. However, interest payments on Rupee loans, as a share of total domestic interest payments have steadily declined, from 61 per cent in 1999 and 55 per cent in 2000. The declining importance of Rupee loans as an instrument of debt under the present debt management strategy and the comparatively lower interest rates on Rupee loans in the last few years contributed to this lower interest cost.

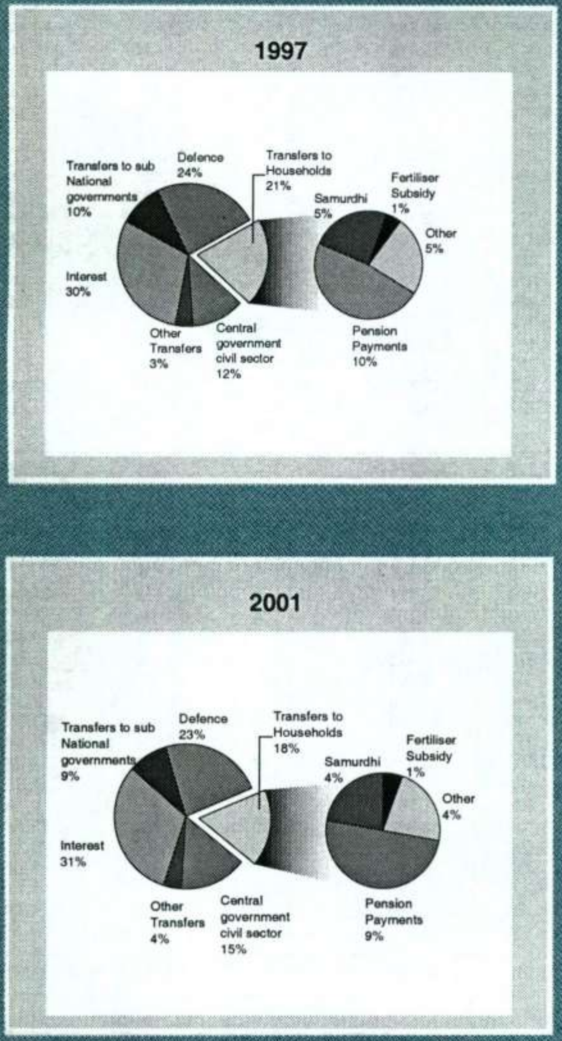
Interest payments on Treasury bills rose in 2001 to Rs.18.4 billion from Rs.12.8 billion in 2000. Interest payments as a ratio of the year end Treasury bill stock increased from 9.5 per cent in 2000 to 10.8 per cent in 2001. The increase in interest payments on Treasury bills was due to three reasons namely, the sharp increase in the stock of Treasury bills, the higher interest rates that prevailed during the second half of 2000 and early 2001 and the change in the composition of Treasury bills towards shorter maturities. The outstanding stock of Treasury bills increased by Rs.10 billion in 2000 and a further Rs.36 billion in 2001. An analysis of the composition of the Treasury bill stock during the year indicates a shift towards shorter maturities (less than 1 year) from 40 per cent of the total stock of Treasury bills at the beginning of 2001 to 60 per cent at end 2001, which also contributed to the high interest cost in 2001.

Unless a concerted effort is made to maintain a sustainable level of debt by containing the fiscal deficit together with an appropriate debt management strategy, ballooning interest payments in the future could severely hamper the fiscal consolidation process.

There was a substantial increase in current transfers and subsidies in 2001. Transfers to households and other sectors increased from 3.3 per cent of GDP in 2000 to 3.8 per cent in 2001, a 28 per cent growth to Rs.53 billion. Expenditure on pension payments rose considerably in 2001, mainly on account of the increase in pensions granted during the second half of 2000 (Rs.500 per month) and a further increase (Rs.750 per month) granted in October 2001. The additional cost of the pension increase granted in 2001 has been estimated at Rs.0.8 billion. The increasing number of retirees (there were 16,750 new pensioners in 2001) has also added to the pension liability of the government. The rapidly ageing population will have a significant impact on future pension payments by the government. The move towards a contributory pension scheme as announced in Budget 2002 would enable the government to bring its pension liability to a sustainable level in the future.

Budget 2001 envisaged a contraction in expenditure on the Samurdhi programme to Rs.10.3 billion, as a result of the introduction of a more effective screening process and an empowerment programme. Contrary to expectations, actual expenditure on the Samurdhi programme increased to Rs.12.6 billion in 2001 from Rs.9.7 billion in 2000, because of the lack of commitment to achieving these targets. The reduction in the number of Samurdhi beneficiaries by 45,890 in 2001, was not sufficient to counter the impact of the increase in allowances granted to Samurdhi beneficiaries during the second half of 2000. Data from the Consumer Finances and Socio Economic Survey 1996/97 indicate that approximately 1 million families live on less than Rs.860 per capita per month. (The lower poverty line is defined as the cost per capita of a minimum food and non-food consumption bundle and is estimated to be Rs.860). However, about 2 million families currently receive assistance under the Samurdhi Relief Programme, indicating that there is considerable amount of mis-targetting. In order to improve the effectiveness of this programme, as well as to reduce the burden on the budget, it is imperative that a better targetting mechanism is introduced.

Chart 8.3
Composition of Current Expenditure



The cost of the fertiliser subsidy increased significantly in 2001 as a result of the high import price of urea (the fertiliser on which a subsidy was paid), which was further exacerbated by the depreciation of the rupee vis-à-vis the US dollar during 2001. The method used to calculate the fertiliser subsidy, which encouraged the import of fertiliser when the international price was high, further contributed to the higher expenditure on the fertiliser subsidy.

Other welfare transfers to households, which include expenditure on school uniforms, textbooks, season tickets, payments to disabled soldiers, dry rations to refugees etc., also increased in 2001.

Transfers to public corporations and public institutions increased in 2001, primarily due to the non-adjustment of the prices of goods and services provided by them, in line with increasing costs. This has not only exerted pressure on the fiscal deficit, but also imposed a higher burden on taxpayers. Transfers to public corporations rose by 28 per cent to Rs.4.3 billion in 2001. The higher transfers to public corporations were mainly on account of the heavy losses incurred by the SLR (Rs.1.8 billion), the Regional Transport Companies (Rs 0.9 billion) and the Department of Posts (Rs.0.7 billion). SLR accumulated large operational losses in 2001 due to the higher fuel prices and the wage increases granted in the second half of 2000 and 2001, which were not compensated for by an adequate adjustment in railway fares. Initial steps have been taken to align fares in 2001. After 11 years, freight tariffs were revised upwards in September 2001. However, passenger rail fares have not been revised since 1996. There is an urgent need for an upward adjustment in all railway fares, as well as the restructuring of the enterprise, to enable private-public partnerships in rail operations, if this enterprise is to be made viable.

Similar budgetary problems are being faced in public road transportation. Although fuel costs and wages have increased significantly, an adjustment in bus fares adequate to compensate for these increasing costs has not been made, resulting in the Regional Bus Companies incurring high operational losses. Inadequate revision of postal rates, as well as higher operating expenses, mainly due to the wage increases in 2000 and 2001, were the main reasons for the high losses incurred by the Postal Department.

Transfers to public institutions rose by 21 per cent to Rs.7 billion in 2001. The major beneficiary of these transfers was the Samurdhi Authority (Rs. 2.6 billion). The recruitment of a large number of Samurdhi animators, attached to the Samurdhi Authority in 2000 and the wage increases in 2000 and 2001, significantly increased the transfers to this institution. The other main institutions receiving current transfers were the Mahaweli Authority (Rs. 0.8 billion), the Road Development Authority (Rs.0.4) and the Sri Jayawardenapura Hospital (Rs.0.3 billion).

Public Investment

In order to lay the foundation for faster economic growth, Budget 2001 envisaged a higher outlay on public investment. However, due to the slow implementation of foreign funded investment projects, strict controls on rupee funded capital investments, which included curtailing of non priority capital expenditure, and the delay in the presentation of Budget 2001, the total expenditure on public investment was restricted to Rs.82 billion in 2001 in comparison to a budgetary target of Rs.106 billion. In GDP terms, it declined to 5.9 per cent, a shortfall of 1.5 percentage points from the expected target of 7.4 per cent. In comparison, public investment in 2001 at 5.9 per cent was 0.5 percentage points below the realised public investment in the preceding year.

TABLE 8.4
Functional Classification of Expenditure

Rs. million

Item	1997	1998	1999	2000	2001 Approved Estimates	2001 Provisional	2002 Approved Estimates
Current expenditure							
General public services	**58,926**	**66,158**	**63,220**	**82,644**	**79,115**	**82,149**	**82,493**
Civil administration	13,956	15,196	14,513	13,416	18,030	14,944	18,844
Defence	37,062	42,496	40,071	56,915	48,161	54,242	48,802
Public order and safety	7,908	8,466	8,636	12,312	12,924	12,963	14,847
Social services	**59,742**	**63,595**	**66,319**	**77,160**	**94,717**	**87,968**	**111,623**
Education	17,757	20,582	21,642	23,794	28,874	23,448	34,900
Health	9,581	10,089	11,215	15,394	19,009	14,785	21,278
Welfare	31,251	31,472	31,164	35,686	41,541	44,635	48,214
Community services	1,154	1,451	2,298	2,286	5,292	5,100	7,230
Economic services	**7,418**	**10,547**	**10,075**	**12,103**	**12,828**	**15,780**	**15,634**
Agriculture and irrigation	3,723	5,444	5,012	5,706	6,730	7,967	7,328
Fisheries	156	175	180	338	406	308	472
Manufacturing and mining	599	325	346	726	555	419	546
Energy and water supply	486	757	884	474	651	565	386
Transport and communucation	1,674	2,934	2,770	3,558	3,339	5,290	5,403
Trade and commerce	159	167	167	137	196	236	508
Other	622	745	716	1,165	951	995	991
Other	**58,662**	**59,349**	**67,657**	**82,372**	**103,603**	**114,509**	**122,816**
of which: Interest	55,246	54,897	62,123	71,200	90,611	94,307	117,184
Provision for under expenditure	-	-	-	-	-8,878	-	-
Total current expenditure	**184,749**	**199,648**	**207,271**	**254,279**	**281,384**	**300,406**	332,565
Capital expenditure and lending							
General public services	**3,442**	**6,243**	**6,345**	**7,157**	**7,057**	**6,564**	**4,733**
Civil administration	3,442	6,243	6,345	5,610	5,224	5,478	4,332
Public order and safety	-	-	0	1,547	1,833	1,085	401
Social services	**11,552**	**15,528**	**17,493**	**16,471**	**21,659**	**14,559**	**21,246**
Education	4,592	6,112	7,652	7,135	8,504	4,838	8,822
Health	2,554	4,330	4,456	5,302	7,279	3,987	6,443
Welfare	751	967	375	415	1,082	452	560
Housing	792	1,314	1,647	2,061	2,972	3,270	3,081
Community services	2,863	2,804	3,364	1,558	1,822	2,012	2,340
Economic services	**32,479**	**44,677**	**44,940**	**54,650**	**83,410**	**54,563**	**53,943**
Agriculture and irrigation	3,780	6,018	6,211	6,908	11,036	6,034	7,719
o/w Mahaweli Project	1,626	1,049	1,357	1,716	3,930	2,237	2,727
Fisheries	480	562	694	899	1,751	705	1,672
Manufacturing and mining	1,442	2,191	882	764	857	324	1,806
Energy and water supply	6,816	8,804	10,702	13,282	18,839	14,758	13,713
Transport and communucation	12,946	18,908	16,892	24,911	32,281	21,464	20,323
Trade and commerce	182	230	302	296	543	370	227
Other	6,835	7,965	9,258	7,590	18,105	10,909	8,483
Other	**3,788**	**1,829**	**2,365**	**2,680**	**5,919**	**6,463**	**4,988**
Provision for under expenditure	-	-	-	-	-11,716	-	-
Total capital expenditure and lending	**51,260**	**68,277**	**71,142**	**80,958**	**106,329**	**82,150**	**84,909**
			As a percentage of GDP				
Total expenditure and lending							
General public services	**7.0**	**7.1**	6.3	7.1	**6.0**	**6.3**	**5.5**
Civil administration	2.0	2.1	1.9	1.5	1.6	1.5	1.5
Defence	4.2	4.2	3.6	4.5	3.3	3.9	3.1
Public order and safety	0.9	0.8	0.8	1.0	0.9	0.9	0.9
Social services	**8.0**	**7.8**	**7.6**	**7.4**	**8.1**	**7.3**	**8.4**
Education	2.5	2.6	2.6	2.5	2.6	2.0	2.8
Health	1.4	1.4	1.4	1.6	1.8	1.3	1.7
Welfare	3.6	3.2	3.0	3.0	3.1	3.4	3.2
Housing	0.1	0.1	0.1	0.2	0.2	0.2	0.2
Community services	0.5	0.4	0.5	0.3	0.5	0.5	0.6
Economic services	**4.5**	**5.4**	**5.0**	**5.3**	**6.7**	**5.0**	**4.4**
Agriculture and irrigation	0.8	1.1	1.0	1.0	1.2	1.0	0.9
Fisheries	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Manufacturing and mining	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Energy and water supply	0.8	0.9	1.0	1.1	1.4	1.1	0.9
Transport and communucation	1.6	2.1	1.8	2.3	2.5	1.9	1.6
Trade and commerce	...	...	...	...	0.1		...
Other	0.8	0.9	0.9	0.7	1.3	0.9	0.6
Other	**7.0**	**6.0**	**6.3**	**6.8**	**7.6**	**8.6**	**8.1**
of which: Interest	6.2	5.4	5.6	5.7	6.3	6.7	7.4
Provision for under expenditure and savings	-	-	-	-	-1.4	-	-
Total expenditure and lending	**26.5**	**26.3**	**25.2**	**26.7**	**26.9**	**27.3**	**26.3**

Source: Ministry of Finance

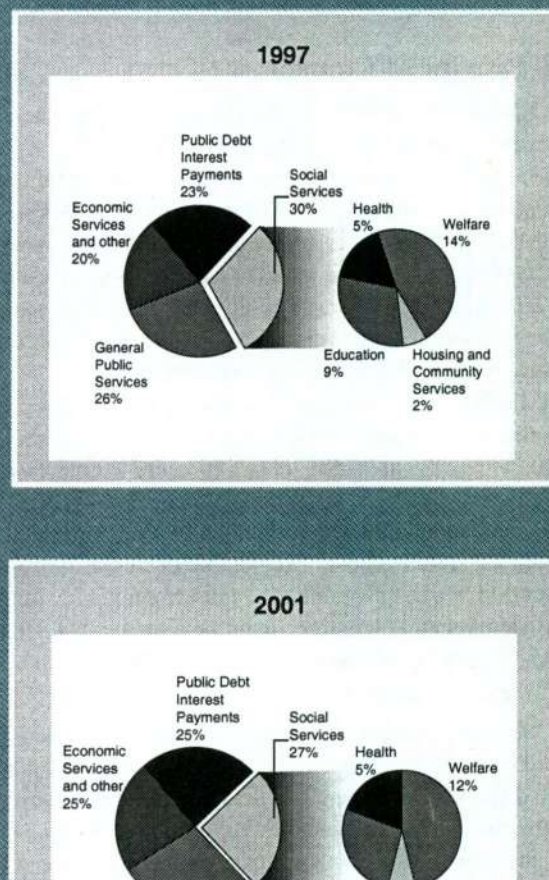
Expenditure on the acquisition and maintenance of capital assets by the central government remained at 2.6 per cent of GDP 2001. These funds were mainly utilised for the improvement of infrastructure facilities directly under the control of the ministries and departments of the central government. Capital transfers declined significantly in 2001 to 2.3 per cent of GDP from 2.8 per cent in 2000. This was due to the lower budgetary transfers to public corporations (from 1 per cent of GDP in 2000 to 0.5 per cent in 2001) and provincial councils (from 0.7 per cent of GDP in 2000 to 0.4 per cent in 2001), mainly as a consequence of the resource constraints faced by the central government, and lower utilisation of foreign funds. The main public corporations that received lower capital transfers in 2001 were the Sri Lanka Land Reclamation and Development Corporation, the National Water Supply and Drainage Board (NWSDB), the Sri Lanka Transport Board (SLTB) and the Ceylon Electricity Board (CEB). Capital transfers to public institutions improved marginally, mainly due to higher transfers to the Road Development Authority (RDA) on account of several large highway projects, such as the second stage of the Baseline Improvement Project, the Ratnapura–Balangoda section of the Ratnapura-Bandarawela Road Rehabilitation Project and the Colombo-Katunayake expressway, that were under construction during the year.

Foreign funds that were provided to commercially oriented public enterprises through on-lending programmes, remained at the same level as in the previous year of 1 per cent of GDP, but fell short of the budgetary target of 1.6 per cent of GDP. CEB, which was to account for almost fifty per cent of the on-lent funds, was able to utilise more than 87 per cent of its allocated funds. The major power projects under construction during the year were the Kukule hydropower project and the Kelanitissa combined cycle power plant. However, lower utilisation of funds by Sri Lanka Telecom, Sri Lanka Ports Authority, CPC and the Regional Plantation companies led to a decline in the overall on-lending programme in 2001. The low utilisation rate of foreign funds is a cause for concern, as these foreign funds are mainly utilised for infrastructure development projects, which are necessary to create an environment that is conducive for enhanced private sector investment. The slow implementation of projects due to various administrative delays and the lack of coordination between the different agencies involved in implementing projects would need to be speedily resolved, if the public investment programme is to be put back on track.

According to a functional classification, capital expenditure on economic services, such as transport, communication, energy, water supply and irrigation, which accounts for around 66 per cent of total public investment, declined to 3.8 per cent of GDP in 2001 from 4.3 per cent in 2000. Although the budget allocated Rs.83 billion for investment in economic services, actual expenditure only amounted to 55 per cent of this budgetary provision. The RDA, the NWSDB, the UDA and the BOI accounted for a significant proportion of the investment in economic services, although the investment in the RDA and the NWSDB was lower than originally envisaged.

Investment in social services declined from 1.3 per cent of GDP in 2000 to 1 per cent of GDP in 2001 as a result of lower investment in education and health. The continuous decline in investment in health infrastructure has led to overcrowding in public sector hospitals and inadequate facilities to deal with the new health challenges faced by Sri Lanka. In the education sector, although there were several donor funded projects to improve infrastructure facilities in schools, the slow implementation of these projects was one of the main reasons for the low public investment in this sector. Although

Chart 8.4
Expenditure by Function



public investment in health and education has declined steadily, there has been a continuous increase in private sector investment in these sectors. This indicates that any future policy in these sectors should be directed towards concentrating public investment on building infrastructure that would crowd-in the private sector, while maintaining adequate investment in areas that may be less attractive to the private sector.

Advance Account Operations

Expenditure through the advance account increased in 2001 over 2000 and exceeded the budgetary provision for 2001. The main item in the advance account is the public officers' advance account. The increase in the salaries of government employees makes them eligible for additional loan facilities, and this continuous increase in lending to government employees has resulted in the net outflows from the advance account exceeding the budgetary targets. This highlights the need for better monitoring and control to ensure that the operations of the advance account are kept within the budgetary targets.

8.5 Provincial Councils

The provincial councils (PCs), which were established to decentralise the decision making process by the delegation of powers to sub-national level governments, continued their operations in 2001. The activities devolved to PCs were conducted using resources mainly obtained from two sources, i.e. PCs' own revenue and transfers received from the central government. As the revenue of PCs was much lower than their expenditure, the central government continued to transfer funds to PCs mainly by way of block grants, criteria based grants and matching grants. Province Specific Development Grants (PSDG), which were introduced in 2000, were also provided to PCs in order to implement regional development programmes identified by PCs. In 2001, the total revenue collection of PCs indicated a significant improvement. The notable decrease in capital expenditure due to the central government's resource constraints was also a significant development. Current expenditure, however, increased considerably mainly due to the increase in salaries and wages.

Since its inception, PCs have been highly dependent on central government transfers. This has been due to the limited scope of collecting revenues and inadequate powers granted to PCs for the mobilisation of resources. With the ongoing efforts to resolve the ethnic conflict there would be a need to devolve more fiscal powers to PCs or any other alternative form of sub-national government. The devolution of fiscal powers, therefore, would be a major issue in the years to come, which will, in turn, need significant changes in the existing central government dominated sub-national system..

Revenue

The total revenue of PCs in 2001 increased by 15 per cent. The revenue collection was mainly from turnover taxes (48 per cent), stamp duties (23 per cent), licence fees (16 per cent) and other sources (14 per cent). Of the total revenue, the devolved revenue of PCs accounted for 75 per cent, while the balance was collected on behalf of the local governments (LGs). The substantial increase in revenue in 2001 was due to a significant growth in the collection of stamp duties. The higher collection came from an increase in high value property transactions, in 2001, particularly in the Western Province. The streamlining of stamp duty collection through commercial banks also contributed to this increase. Revenue from turnover taxes increased by 12 per cent. This increase was the combined outcome of higher turnover in business enterprises (8 per cent nominal growth) and an increase in the number of taxpayers. Revenue from licence fees rose marginally, reflecting the slow growth in the registration of new motor vehicles.

The Western Provincial Council continued to be the largest collector of revenue (69 per cent) mainly because of the high concentration of business enterprises and commercial activity within its boundaries. The balance revenue (31 per cent) accrued to the other 6 PCs, in particular the Southern PC (7.2 per cent), Central PC (7.1 per cent) and the North Western PC (7.1 per cent). The collection of revenue in the North-East Province was vested with the central government.

The agency function performed by PCs in the form of collecting stamp duties, court fines and other revenue on behalf of LGs continued in 2001. The amount collected in respect of these items in 2001 was Rs. 2,665 million, an increase of 31 per cent over the previous year. However, the entire collecion was not transferred to LGs by PCs in 2001, due to the weaknesses in the LGs' system of identifying their total revenue collection, enabling PCs to use these funds to meet their own expenses.

Chart 8.5
Performance of Provincial Councils-2001

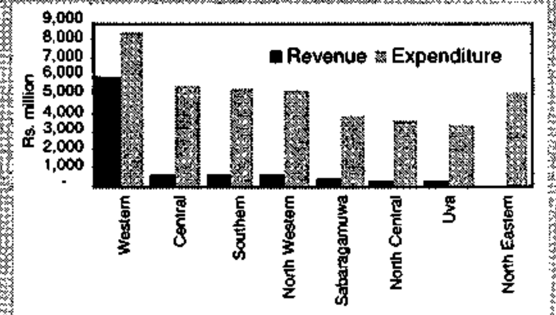


TABLE 8.5
Budget Outturn for Provincial Councils

Rs. million

	1997	1998	1999	2000	2001 Estimates	2001 Provisional
1 Total revenue	**5,395**	**6,002**	**6,993**	**7,534**	**7,528**	**8,674**
Tax on production and expenditure	3,744	4,114	4,593	5,010	5,316	5,533
Turnover taxes	2,734	2,980	3,361	3,705	3,676	4,142
Licence fees	1,000	1,127	1,223	1,293	1,626	1,372
Other taxes	10	8	9	12	14	20
Interest, profits and dividends	175	129	282	281	240	355
Sales and charges	408	481	731	759	427	743
Stamp duty	1,051	1,267	1,372	1,468	1,528	2,006
Other	17	11	15	16	17	37
2. Total expenditure	**23,455**	**26,736**	**28,717**	**37,328**	**45,606**	**40,094**
2.1 Current expenditure	22,055	25,230	26,284	28,856	34,338	33,425
Functional classification	22,055	25,230	26,284	28,856	34,338	33,425
Provincial administration	1,941	2,377	2,524	2,129	3,428	2,561
Economic services	939	1,067	1,154	1,285	1,610	1,377
Social services	19,175	21,787	22,605	25,442	29,300	29,487
Economic classification	22,055	25,230	26,284	28,856	34,338	33,425
Personal emoluments	17,067	19,744	20,431	22,199	25,854	26,169
Other	4,988	5,486	5,853	6,657	8,484	7,256
2.2 Capital expenditure	1,400	1,506	2,433	8,472	11,268	6,669
Acqusition of capital goods	729	773	1,140	989	980	613
Capital transfers	55	75	102	160	125	85
Province Specific Development Projects	-	-	-	5,523	7,023	4,208
Special projects	-	-	-	812	2,234	1,163
Other	616	658	1,191	988	906	600
3 Financing	**18,348**	**20,594**	**22,787**	**31,543**	**38,078**	**32,656**
Block grants	16,855	19,194	21,122	23,220	26,821	26,405
Criteria based grants	1,168	1,163	1,236	1,323	1,000	696
Matching grants	325	237	429	665	1,000	282
Province Specific Development Grants	-	-	-	5,523	7,023	4,208
Grants for special projects	-	-	-	812	2,234	1,165

Sources: Ministry of Home Affairs, Provincial Councils and Local Government
Ministry of Finance

Expenditure

The total expenditure of PCs increased by 7 per cent in 2001. Current expenditure, which increased by 16 per cent over the previous year, accounted for 83 per cent of the total expenditure. According to the economic classification of current expenditure, the salary bill was the single largest expenditure item, accounting for about 78 per cent of current expenditure. The increase in salaries and wages (18 per cent) reflected the salary increases granted to all public sector employees during 2000 and 2001. On a functional basis, current expenditure on social infrastructure, mainly education and health, accounted for 88 per cent of the total current expenditure. Current expenditure on social infrastructure increased by 16 per cent in 2001. Expenditure by the Western Provincial Council continued to be the highest among the PCs, accounting for about 23 per cent of total expenditure by all PCs.

Capital expenditure of PCs decreased by 21 per cent in 2001. The realised investment programme (Rs.6.7 billion) was well below the programme set out in Budget 2001 (Rs.11.3 billion). This was mainly due to the resource constraints of the central government, which resulted in the curtailment of rupee funded programmes. In addition, delays in presenting Budget 2001 and the political uncertainty that prevailed during the second half of the year, also contributed to the slowdown in development activities at the provincial level. Investment activity undertaken in 2001 mainly focused on improving infrastructure in the health and education sectors and in improving the provincial road network.

Central Government Transfers

The devolved revenue of PCs was sufficient to meet about 22 per cent of the total expenditure of PCs. As in the past, more than three fourths of the expenditure of PCs was financed by transfers from the central government. The major transfers from the central government were in the form of block grants (80 per cent of total transfers) which were utilised to meet recurrent expenditure and Province Specific Development Grants (14 per cent) which were used to fund specified provincial development programmes. Grants from the central government for special projects accounted for 4 per cent of the total transfers. The balance was given in the form of criteria based grants and matching grants (a reward for the revenue raising efforts of PCs). This was to be incurred on the rehabilitation of capital assets.

8.6 Public Enterprise Reform

There were several key developments in the public enterprise reform programme in 2001. The sale of a 40 per cent stake in Air Lanka Ltd., was completed. The Build, Own and Transfer (BOT) arrangement with Prima Flour Mill was converted to a Build Own and Operate (BOO) arrangement and fifty one per cent of the shareholdings in National Insurance Corporation Ltd. (NIC) was sold by tender on the Colombo Stock Exchange. In addition the liquidation of 28 public sector entities was finalised and the liquidation process relating to several new entities was initiated. Preparatory work in relation to the next generation of reforms involving greater private-public partnership in some key sectors such as the ports, electricity, petroleum, railways, post and the airport were further strengthened during the year.

Although Budget 2001 expected to raise Rs.25 billion from the privatisation programme, actual proceeds amounted to Rs.8.6 billion. The shortfall was due to delays in the divestiture of a part of the government's equity stake in Sri Lanka Telecom Ltd., through an international placement, which did not take place due to the depressed market conditions that prevailed globally in the telecommunications sector. However, apart from 1997, the highest proceeds generated from the privatisation programme were in 2001.

The transaction in relation to Prima Ceylon Ltd. (PCL) was concluded in June 2001 for a consideration of US dollars 65 million (Rs.5.9 billion). The government also liberalised the importation of wheat grain. The savings to the government from this policy change will be the elimination of the up front costs incurred by the government for the importation of wheat, as well as a lighter burden on the budget from the gradual removal of the wheat flour subsidy.

The divestiture of 51 per cent of the equity stake in NIC through a sale by tender to Janashakthi Insurance Company Ltd. was concluded in June 2001 netting in Rs.450 million. The privatisation of NIC was carried out with the objective of enhancing the skills and technology of the organisation as well as accelerating the development of the insurance industry in Sri Lanka by enhancing private sector participation. The preparatory work being carried out in relation to the divestiture of the Sri Lanka Insurance Corporation, is a further step towards strengthening the private sector's role in this industry. However, with these divestitures the need for proper regulation was recognised. The Regulation of Insurance Industry Act No. 43 was passed in 2000, and the Insurance Board was set up in March 2001. The mandate of the Board is to safeguard the interests of policyholders by supervising and regulating the insurance industry, by ensuring that the insurance business in Sri Lanka is carried out with integrity and in a professional and prudent manner.

The sale of a 40 per cent stake in Air Lanka Ltd. to Emirates Ltd., which was carried out in two stages, was completed in January 2001. Under the first stage a 26 per cent equity stake in the company was sold in 1998. The balance 14 per cent equity stake was transferred in January 2001 for a consideration of US dollars 25 million (Rs.2.2 billion).

A list of 35 public entities was gazetted for liquidation in 2001. Although the liquidation process of some of these entities began over 10 years ago, they were not completed due to pending court cases and other outstanding issues. However, as these entities continued to be a drain on the Treasury, steps were taken to expedite this process and the liquidation of 28 companies was completed by end 2001. The final liquidation of the remaining 7 institutions will take place in the near future. The Public Enterprise Reform Commission (PERC) has identified several more institutions for liquidation and preparatory work in relation to the winding-up of these entities has been initiated.

The reform process in the plantations sector began with the formation of regional plantation companies and the subsequent privatisation of their management together with long-term leasehold rights. This was a stepping stone to divestiture of these companies, which was carried out in four stages: initially, the sale of the majority stake in these companies to a strategic investor, an Initial Public Offering (IPO) of 20 per cent, the distribution of 10 per cent of the shares to the employees and finally, the sale of the government's minority holdings of 19 per cent. As part of this on-going process the government sold its balance equity stake in two plantation companies, Talawakelle Plantations Ltd. and Malwatte Plantations Ltd (Rs.110 million) on the Colombo Stock Exchange in February 2002. A 53 per cent stake in Pelwatte Sugar Industries Ltd. (Rs.294 million) was sold to a strategic investor in April 2002. In 2002, the government also plans to divest itself of its equity stakes in the following companies: Hingurana Sugar Industries Ltd., Sevanagala Sugar Industries Ltd., Shell Gas Lanka Ltd., Lanka Marine Services Ltd. and National Insurance Corporation Ltd.

With a view to encouraging greater public-private participation in all spheres of economic activity, the restructuring of several key sectors such as ports, electricity, petroleum, railways, water supply, telecommunications, posts and urban development have been initiated. Future reforms in the electricity sector would include the unbundling of generation, transmission and distribution operations as well as the setting up of a regulatory authority. In the telecommunications sector, the monopoly on the international gateway ends in August 2002, permitting the entry of other international service providers. Further liberalisation of the telecommunications sector would entail the issuance of licences to other fixed wire line operators.

Box 10

Reforms in Public Sector Enterprises

1. Introduction

Until recently, governments in many countries throughout the world have directly or indirectly controlled a large part of investments through state enterprises. A government may do so in view of its political ideology, or social welfare concerns arising from the perceived ill effects of the market economy. Examples are the establishment of state enterprises when there is a need for producing public goods, and when there are natural monopolies arising from large fixed costs. However, there is evidence that in many cases the expansion of the role of public sector enterprises became a hindrance to economic growth. Therefore, many governments began to reform inefficient public enterprises in the late 1980s and early 1990s. Reforming public sector institutions are necessary as an economy is liberalised due to changes in political ideology and when technological development changes production processes eliminating inefficient enterprises and giving rise to the production of new goods and services. As an economic system becomes complex, a government may not be able to maintain its authority on economic activities. The government has to allow participation of private individuals in complex economic activities, which will reward the economy with enhanced growth and development. Further, the prevalence of moral hazard in institutions adds extra reasons for reforms. The government has to depend on appointed agents to perform designated functions. When there is information asymmetry, agents tend to indulge in activities that are hazardous to the contract between the agent and the government in the carrying out of designated functions.

The failure of centrally planned economies during the 1990s, and increased dissatisfaction in the performance of public enterprises encouraged many countries to adopt market principles for decision making. This resulted in a wave of liberalisation that pushed many countries to embrace free market principles. In those countries, regulations have been dismantled, state activity has been handed back to the private sector and markets have been opened to competition.

2. Historical Overview of Public Enterprises in Sri Lanka

Public sector involvement in economic activity increased during the Second World War (1939-1945) when the government established several government-owned factories to provide essential scarce consumer goods. Public sector activities were increased further in the late 1950s following the government passing laws for the establishment of public sector enterprises in 1955 in two pieces of legislation, viz., Government Sponsored Corporations Act No. 19 of 1955 and the State Industrial Corporation Act No. 48 in 1957. These Acts empowered the government to set up and carry out any industrial undertakings. During the late 1950s and the early 1960s, a large number of public sector enterprises such as Ceylon Petroleum Corporation (1961), Ceylon Steel Corporation (1961), Sri Lanka Tyre Corporation (1962), Ceylon Hardware Corporation (1963), State Fertiliser Corporation (1966) etc. were set up under these Acts. During the 1970-77 period, government intervention and state capital participation in economic activity continued to increase due to the direct investment by the government and the nationalisation of private enterprises under the Business Undertaking (Acquisition) Act of 1970. During late the 1970s, many of these public enterprises became inefficient due to the heavy fiscal protection provided to them and the non-competitive market environment they were operating in.

With increased dissatisfaction in PEs, the government adopted a private sector led market based economic development strategy since the late 1970s. In order to facilitate the privatisation process, the government set up various institutions such as the Presidential Commission on Privatisation (PCOP), Public Investment Management Board (PIMB), Commercialisation Division (CD) in the Ministry of Finance and the Task Force on Public Enterprise Reforms (TFPER) during the 1985-1995 period. In 1996, the Public Enterprise Reform Commission (PERC) was set up to assist the government on reforms of public enterprises and other related matters. The PERC replaced TFPER that was set up in 1995. With this institutional set up, the government encouraged private sector involvement in commercial activities and took measures to privatise several public sector enterprises. During the 1989-2001 period, the government privatised 80 public sector enterprises operating in the areas of manufacturing, agriculture, financial and services. *(See Appendix Table 74).*

However, Sri Lanka still has over 70 public enterprises engaged in a broad range of economic activities. Over the years, many of these have become loss making enterprises, with combined losses amounting to 2 per cent of GDP in 2000. They have suffered from over staffing, mismanagement, administered prices

Box 10 (Contd,)

divorced from market realities, inefficient procurement systems, wastage, corruption, excessive government intervention, and inadequate technological and human capital improvement. These factors have made many of the PEs to depend on excessive state subsidies or excessive bank borrowings. Subsidising these institutions has contributed to a widening budget deficit while excessive borrowing from the domestic banking sector has created macro economic imbalances in the economy and crowded out private sector investment. When public enterprises receive subsidies, due to the moral hazard behaviour, the management becomes lax resulting in inefficiencies and creating shortages and bottlenecks throughout the economy.

Changes to the prices of goods and services produced by most public enterprises do not respond to changes in input prices in the market in time exacerbating the poor performance. Administrative prices are often not adjusted fully in response to increases in the cost of production requiring large corrections when the financial situation of public enterprises becomes unsustainable. In addition, this leads to price distortions in the market, misallocation of resources, weak financial position of utility agencies, macroeconomic imbalances of the economy, confusion and uncertainty among the public and policy makers. In most cases, administratively set prices are not sufficient to cover even variable costs of production. As a result, utility enterprises normally report large losses requiring current transfers from the government or excessive reliance on bank loans to finance day to day operations.

For example, in the absence of an automatic price adjustment mechanism, Ceylon Petroleum Corporation (CPC) is reported to have accumulated a large amount of debt amounting to Rs.18.7 billion as at end December 2001. As at same date, the accumulated debt of the Ceylon Electricity Board (CEB) amounted to 16.5 billion. Given this unfavourable situation, CPC has taken initiative to introduce a flexible pricing formula, which will capture all short-term fluctuations in the input market and other changes thereby the market prices of petroleum products would change automatically preventing from making losses from due to unexpected input price movements. The proposed price formula captures changes in the CIF price of crude oil imports, currency exchange rate, jetty pipeline charge, stamp duty, custom duty, GST, NSL, excise duty, finance charges, wholesale costs and margins of CPC, distribution cost and dealer discounts. Under its restructuring programme, CEB is also planning to introduce a flexible pricing formula for electricity by incorporating price changes in generation, transmission and distribution.

3. Possible Ways of Reforming Public Sector Enterprises

The reforms in the public sector enterprises can take place in the form of deregulation, privatisation, de-politicisation, market based prices, changing the management and adopting performance related payments system for employees. Some of specific reforms are as follows.

- Deregulation or abandoning state controls.
- Introduction of price adjustment in line with market changes.
- Removal of subsidies.
- Fragmentation of a PE into several profitable entities.
- Contracting out some activities of public enterprises to private sector to reduce cost.
- Management/employee buy-out and leases management contracts.
- Introduction of performances related incentives.
- Removal of Political interference.
- Privatisation
- Complete liquidation of a PE with the assets ending up in the hands of private purchases while the PEs activity is wound up.

4. The Cost of Restructuring

The restructuring or commercialisation of PEs is associated with some negative consequences as well. It is observed that the existence of non-competitive markets and frequent market failures led to reduce the efficiency of private sector enterprises. If the markets are not competitive, the product prices are likely to be set above the marginal production cost and profits that are retained in the hand of large-scale manufactures deteriorating the income distribution of the country.

The experience in recent privatisation exercises in Sri Lanka also indicated that the government protection mechanism should be in place to protect consumer interests and promote competition in the economy. This will ensure that the consumers will benefit from the market oriented development strategies and safeguard from market failures and imperfections in the market behaviour. This has brought into focus the new

Box 10 (Contd.)

regulatory role that government should play when a competitive market structure does not prevail.

5. Benefits of Restructuring

The improving efficiency through the proper restructuring of PEs will result in improving consumer welfare through improved competition and less burden to the strained government budget. The successful restructuring of commercial activities of public enterprises will also bring benefits by way of promoting innovations through better access to new technology, foreign capital and expertise. It will also reduce opportunities for corruption and political exploitation of public assets. The property rights theory suggests that the changes in ownership from public to private will improve incentives for productive efficiency as rewards are directly related to the performance. The owners pay the price for the bankruptcy, if they do not perform well but in the case of public sector enterprises, inefficiencies call for further subsidies from the government. The restructuring of PEs also promote allocative and productive efficiency of resources in contrast to the public sector monopolies, which are intrinsically inefficient. The restructuring serves as an important signalling devise in attracting foreign investment and modern technology.

Several empirical findings indicated that the restructuring of PEs towards market principles have positive impacts on the economic development and welfare of the people. Bishop and Thompson (1992)[1] found that in 32 cases out of 40 cases, the reforms that opened former state monopolies to competition have been followed by a significant reduction in prices and improve product quality. In Britain, they found the first deregulation of a state monopoly in express coach services in 1980 was followed by price cut up to a third on the main truck routes. In USA, Bailey[2] (1986) found that after the deregulation, freight transport showed that the real rate for truckload shipment has declined nearly by 25 percent between 1975 and 1982. Several studies compared the cost of producing the same goods and services in both the private and public sectors and some concluded that on average, the public sector costs were much higher. According to Pirie (1988)[3], the cost of production in private sector in Britain is about 30 per cent less than pubic sector, in USA the figure is nearly to 40 per cent and in West Germany private business can produce goods and services as lower as 50 per cent of the cost of production in public sector counterparts.

1 Bishop, M and Thompson, D. (1992); " Privatisation in the UK in V.V. Ramanadhan (ed); Privatisation : Global Perspective; Routledge: London.
2 Bailey, E.E (1986); " Price and Productivity Change Following Deregulation : U.S. Experience"; Economic Journal; March
3 Pirie, P. (1988); " Privatisation : A Review of International Experience"; Economic and Political Weekly; No.7; February.

The reform process in the petroleum sector took off with the liberalisation of the lubricants industry in 1999. In 2002, a majority stake in Lanka Marine Services Ltd., a fully owned subsidiary of the Ceylon Petroleum Corporation, engaged in bunkering, is to be divested. A major step in the restructuring process of the petroleum sector was the introduction of an automatic pricing adjustment mechanism for petroleum products at end 2001 and the liberalisation of the import and supply of petroleum products as announced in Budget 2002.

Reforms of institutions, which directly affect consumer welfare, need to be undertaken within a strong regulatory environment. The bill presented in Parliament to establish a Consumer Protection Authority in place of the Fair Trading Commission and the Department of Internal Trade, was an important step taken in this direction. The mandate of this Authority is to streamline and strengthen the regulatory function, so as to promote a competitive environment, whilst safeguarding the interests of the consumer.

The appointment of private sector representatives to the Board of Directors of several government institutions such as Bank of Ceylon, People's Bank, Sri Lanka Insurance Corporation and BOI, as well as the setting up of management committees in public sector enterprises, was initiated with a view to improving the efficiency and competitiveness of these institutions through the acquisition of up to date technology and expertise.

8.7 Financing of the Deficit

The total resource gap of the budget expanded sharply by Rs.29 billion to Rs.152.2 billion (10.9 per cent of GDP) in 2001. Initially more than 50 per cent of the original gap (Rs. 123.1 billion) was expected to be financed from foreign sources and privatisation proceeds while the balance was to be raised from domestic sources. However, there was a significant shortfall of Rs.37 billion from foreign sources and privatisation proceeds. The widening resource gap combined with the shortfall in external resources and privatisation proceeds necessitated raising Rs. 66 billion additional borrowings from the domestic market. As a result, borrowing from the domestic market expanded to 8.8 per cent of GDP in 2001 in contrast to the initial expectation of reducing domestic borrowing to a level of 4 per cent of GDP. Thus, more than 80 per cent of the resource gap was financed from the domestic market. As resources available in the domestic non bank sector were limited to about Rs.75 billion, the balance domestic resource requirement was financed through the banking system. The increased dependence on the banking system to bridge the resource gap is a matter for serious concern in view of its impact on inflation and interest rates and the crowding out of private investment. However, unlike in the previous year, the adverse effects of bank borrowing were largely mitigated by the following developments. First, there was a repayment to the monetary authority in 2001 exerting a contractionery effect on monetary growth. Second, a large part of the bank borrowing came from FCBUs through the issue of Sri Lanka Development Bonds and other dollar borrowings, which did not have a significant impact on rupee interest rates.

Domestic Borrowing

In order to arrest the adverse impact on market interest rates and the cost of borrowing due to the large resource requirement from the domestic market, the government was compelled to rely heavily on less market oriented debt instruments such as Rupee loans. This was a deviation from the borrowing strategy of the government, which was to mobilise funds at the lowest possible cost while moving towards more market oriented debt instruments. Mobilisation of funds through market oriented long and medium term debt instruments during a period of temporary high interest rates is not an appropriate debt management strategy, as it will exert pressure on market interest rates and raise the interest cost to the government. Therefore, the domestic borrowing programme in 2001, largely relied on non market type borrowing instruments. This type of borrowing strategy was possible because resources came mainly from captive institutional investors. The issuance of Sri Lanka Development Bonds in 2001 also helped ease the pressure on the domestic market.

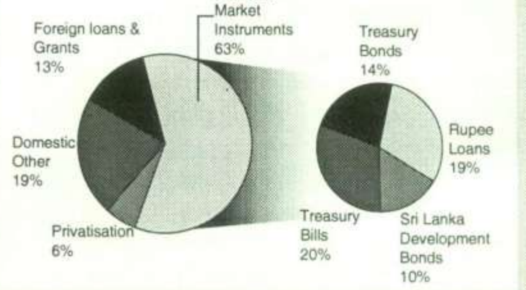
A consequence of the deviation in the borrowing strategy was that Rupee loans became a major source to finance the resource gap in 2001. On a net basis, the Rupee loan programme raised Rs. 28.9 billion for budgetary purposes compared to Rs. 1.8 billion in 2001. In comparison to other government securities with comparable maturity periods, interest rates on Rupee loans were maintained at a low level. During the year Rupee loans were issued with maturity periods of 2-8 years at an interest rate of 13.00–15.00 per cent. The main investors in the Rupee loan programme were the captive investors, led by EPF and NSB, which purchased about 95 per cent of total net issues.

Treasury bonds were sold to raise Rs. 21 billion as compared with Rs. 90 billion in 2000. The maturity period of new and reissues of Treasury bonds was also limited to 2-3 years to avoid locking in funds at higher interest rates for a longer period. EPF (57 per cent) emerged as the biggest subscriber to Treasury bonds on a net basis followed by NSB (24 per cent). The contribution from banks decreased significantly. As the gap between the coupon rate and yield rates narrowed over the course of the year (from 895 basis points to 225 basis points), the cash shortfall in the Treasury bond programme also reduced. The total cash shortfall in the Treasury bond programme in 2001 amounted to Rs.4 billion.

In 2001, the government relied heavily on Treasury bills to finance the resource gap. Budget 2001 increased the authorised limit of Treasury bills from Rs. 135 billion to Rs. 175 billion, with a view to maintaining a well-diversified debt portfolio and providing adequate flexibility in selecting the maturity structure of government debt instruments. On a net basis, total Treasury bill issues amounted to Rs. 36 billion in 2001. Because of the high yield on Treasury bills that prevailed, especially during the first half of the year, the total cash shortfall in the Treasury bill programme amounted to Rs. 6 billion in 2001. As a result, total net borrowings from Treasury bills on a cash basis amounted to Rs. 30 billion in 2001. As in recent years the Central Bank's intervention in the primary market was significantly high in 2001. The Central Bank purchased all new issues and a considerable share of reissues of Treasury bills in order to provide adequate liquidity as the targetted reserve money remained well above the actual level of reserve money. It also helped contain pressure on interest rates, which were already high. As Treasury bills worth Rs. 10.7 billion were subsequently sold by the Central Bank in the secondary market, the expansionary impact of the new issues was mitigated to a large extent. Meanwhile, Treasury bill holdings of commercial banks increased only marginally due to a shift towards Treasury bonds in 2001.

Market interest rates were high at the beginning of the year. During the second half of the year, yield rates started to decline mainly due to improved market liquidity. The Central

Chart 8.6
Deficit Financing



Bank reduced its Repo and Reverse Repo rates after January 2001 by 800-900 basis points. The privatisation proceeds received in the first half of 2001 also helped to dampen the upward movement in yield rates. The injection of liquidity by CBSL through Treasury bill purchases, purchase of foreign currency and the purchase of the dollar proceeds of the Sri Lanka Development Bonds towards the end of the year, further reduced pressure on interest rates. Accordingly, the yield rates on 364-day Treasury bills, which rose to 21.64 per cent during the first quarter of the year declined to 13.74 per cent at the end of the year. The weighted average yield rates of two year Treasury bonds declined to 14.50 per cent from 22.21 per cent in early 2001.

In view of the high resource requirement compared with the limited availability of domestic resources and the postponement of expected foreign commercial borrowings of US dollars 200 million, two issues of US dollar denominated Sri Lanka Development Bonds (SLDBs) were made in 2001. The first issue of US dollars 108.5 million was made in November 2001 with a maturity period of 2 years. This issue had a put option at the end of the first year. The interest rate for the first year was 6 month LIBOR plus 1.75 per cent, while the interest rates for the second year was 6 month LIBOR plus 2.25 per cent. A higher rate in the second year was given as an incentive for not exercising the put option. The second issue of US dollars 50 million was made in December 2001 with a maturity period of 2 years. The interest rate was fixed at the 6 month LIBOR plus a 2.00 per cent margin without a put option. In contrast to the expectations of attracting foreign investors, almost the entire investment for SLDBs (Rs. 14.6 billion) came from commercial banks in Sri Lanka.

The increase in net credit to government from the banking system amounted to Rs. 48.6 billion or 3.5 per cent of GDP in contrast with a repayment of Rs. 11 billion to the banking system expected in the original budget. The entire borrowing was from commercial banks (Rs. 55 billion). There was a repayment of Rs. 6.4 billion to the Central Bank. The decrease in borrowings from the Central Bank was the net effect of the significant decrease in Treasury bond holdings by Rs. 27.6 billion, the increase in the holdings of Treasury bills by Rs. 19.3 billion, increased transfer of funds under provisional advances from the Central Bank by Rs. 3 billion and the build up of government deposits with the Central Bank of Rs.1.1 billion. The decline in the Central Bank's holdings of Treasury bonds to Rs. 1.5 billion by end 2001 was due to a significant drop in reverse repo transactions in the secondary market as a result of improved liquidity in the market towards the end of the year.

Increased use of overdraft facilities by the government (by Rs. 18.9 billion) was largely responsible for the expansion in borrowings from commercial banks. In addition, expansion in holdings of Treasury bonds (Rs. 11.9 billion), Treasury bills (Rs. 2.3 billion) and borrowings from FCBUs (excluding SLDBs) (Rs.10.8 billion) also contributed to this increase. However, government import bills payable to the domestic units of commercial banks declined by Rs.2.5 billion as a part of these outstanding bills were settled by borrowing from FCBUs. An extensive utilisation of overdraft facilities raises the issue of transparency in fiscal operations, as such borrowings are outside the normal public debt programme. Imposition of a limit on overdraft facilities would improve transparency in fiscal operations and debt management as well as reduce interest cost. As in previous years, administrative borrowings (Rs.747 million) through institutions such as EPF and NSB were also used for budgetary financing.

Foreign Borrowing

On a gross basis, foreign loan disbursements amounted to Rs.42.5 billion in 2001, including the receipt of defence related medium-term loans of Rs.13.2 billion. The total amount of repayments amounted to Rs.27.9 billion, including Rs.8.5 billion of deferred payments for defence related imports. When adjusted for defence related debt, net receipts of concessional loans amounted to Rs.9.8 billion, in comparison with the original target of Rs.28.1 billion. The lower level of utilisation of foreign resources has been the major issue in the area of foreign financing. The average utilisation rate of loans extended by the three major creditors (Japan, ADB and IDA) from 1998 to 2001 was only 13 per cent. This was mainly due to administrative and other impediments, such as, delays associated with awarding contracts, loan effectiveness (the period between signing of an agreement and the first disbursements date) and the provision of counterpart funds as well as problems relating to the acquisition of land. Corrective measures are necessary to address these issues in order to raise the present low ratio of aid utilisaton. This will not only help reduce pressure on government domestic borrowing but also help achieve targetted public investment.

Grants

Foreign grants received in 2001 were estimated at Rs.5.5 billion. This was a shortfall of Rs.2 billion in comparison to Rs.7.5 billion envisaged in the Budget. Although in absolute terms this was a marginal increase over that in 2000, as a percentage of GDP, this was a continuation of the declining trend observed over the last several years. The increase in Sri Lanka's per capita income and the resultant upgrading of Sri Lanka as a lower middle income country and the general decline in international grants extended to developing countries were the major reasons for this shortfall. The government of Japan, the People's Republic of China and the Netherlands were among the major donors.

8.8 Government Debt

The level of the central government debt stock (Rs.1,450.6 billion) exceeded the national income in 2001. The debt/GDP ratio, which has continuously increased since 1997, reached

103.6 per cent at end 2001. The sharp expansion in domestic borrowing due to the widening fiscal deficits and the increase in the rupee value of foreign debt due to the depreciation of the exchange rate were the main causes for this growth in the debt stock. However, the lower ratio was also partly due to the low GDP level in 2001. Domestic debt increased by 4.5 percentage points to 58.3 per cent of GDP, while foreign debt increased by 2.2 percentage points to 45.3 per cent of GDP during 2001. The sharp increase in the debt stock and the escalating debt servicing burden raises the issue of the sustainability of the public debt.

Domestic Debt

Outstanding domestic debt expanded by Rs. 139 billion to Rs. 816 billion in 2001. The domestic debt stock more than doubled over the last 4 years, increasing by Rs.107 billion per year on average. Fiscal consolidation measures so far implemented have not been successful in making the required downward adjustment in the domestic debt. Therefore, a strong fiscal consolidation strategy is essential to ensure the long-term sustainability of public debt.

The outstanding stock of Rupee securities increased to Rs.292.8 billion. This was an 11 per cent increase compared to a marginal growth observed in the previous year. However, the share of Rupee securities in the total outstanding domestic debt stock decreased to 36 per cent from 39 per cent in 2000 reflecting a higher growth in other debt instruments. Institutional investors such as EPF and NSB continued to be the major subscribers to the programme, accounting for 79 per cent of the total investments.

In 2001, a relatively lower amount was borrowed with medium and long-term market instruments. Consequently, the outstanding stock of Treasury bonds increased by Rs.25 billion (12 per cent) to Rs.229.2 billion, in comparison to the significant growth (95 per cent) observed in 2000. In view of the high interest rates, only Treasury bonds with maturity periods of 2-3 years were issued. EPF and NSB continued to be the leading investors in Treasury bonds.

The outstanding stock of Sri Lanka Development Bonds, the newly issued medium term market debt instrument, amounted to Rs. 14.7 billion (US dollars 158.5 million) and accounted for 1.8 per cent of the total outstanding domestic debt at end 2001.

The larger borrowing requirements and the high interest rates that prevailed in early 2001, compelled the government to rely more on short term debt instruments. Consequently, the short-term debt stock increased at a higher rate (34 per cent) in comparison to medium and long-term borrowings (15 per cent). As a result, the share of short-term domestic debt in the total domestic debt stock increased to 34 per cent in 2001 from 31 per cent in 2000. This shift was mainly reflected in the expansion of Treasury bill issues by Rs. 36 billion to Rs. 171 billion. The revolving credit facility provided by the Central Bank to the government (provisional advances), increased by Rs. 2.9 billion to Rs. 30.1 billion.

The outstanding debt obligations of the government to the banking system was Rs. 256.8 billion at end 2001. Its share in the total domestic debt stock grew from 29 per cent in 2000 to 31 per cent in 2001. Approximately Rs.150 billion of this liability arose during the last 4 years, reflecting the large fiscal deficits which were financed from the banking system. The outstanding amount of debt held by the Central Bank dropped marginally in 2001. In contrast, liabilities to commercial banks increased by 62 per cent, raising its share in the total domestic debt stock to about 20 per cent. Approximately 30 per cent of the expansion in the liabilities to commercial banks was on account of the increased utilisation of overdraft facilities by the government. Outstanding import bills of the government and borrowings from FCBUs (Rs. 29.5 billion) accounted for 26 per cent of bank debt. Non-instrument bank borrowing from commercial banks at end 2001 amounted to Rs. 100 billion.

Foreign Debt

The outstanding total foreign debt stock as a percentage of GDP increased to 45.3 per cent, while its share in the total debt stock decreased to 44 per cent. Although the net inflow of foreign resources to the budget was relatively low, the depreciation of the rupee against major currencies was the main reason for the increase in the foreign debt stock in 2001 (Rs. 48.8 billion). The high share of SDR and US dollar denominated debt and the depreciation of rupee against these two currencies (the rupee depreciated vis-a-vis SDR and US dollar by 8 per cent and 11 per cent, respectively in 2001) had a strong impact on the outstanding foreign debt stock.

The share of concessional loans in the total debt stock decreased to 95 per cent in 2001 from 99 per cent in 2000. The main provider of concessional loans was Japan, accounting for 29 per cent of the foreign debt, followed by IDA (23 per cent) and ADB (21 per cent). The share of non-concessional loans rose mainly due to an increase in

Chart 8.7
Composition of Debt

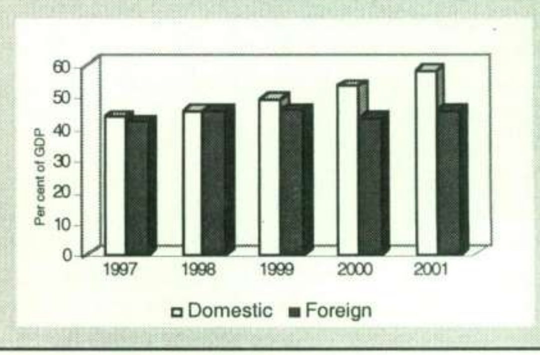


TABLE 8.6
Outstanding Central Government Debt (at end year)

Rs. million

	1997	1998	1999	2000	2001 Provisional
Total domestic debt(a)	**387,740**	**463,426**	**543,465**	**676,660**	**815,965**
Short term	137,494	163,253	175,886	208,017	278,624
Medium and long term	250,246	300,173	367,579	468,643	537,341
By debt instrument	387,740	463,426	543,465	676,660	815,965
Rupee securities	239,475	250,570	262,056	263,888	292,813
Treasury bills	114,996	119,996	124,996	134,996	170,995
Treasury bonds	10,000	48,915	104,867	204,124	229,174
Sri Lanka Development Bonds	-	-	-	-	14,749
Other	23,269	43,945	51,546	73,652	108,234
By institution	387,740	463,426	543,465	676,660	815,965
Banks	100,536	113,054	139,671	199,030	256,808
Central Bank	19,770	27,179	48,867	97,778	92,871
Commercial banks(b)	80,766	85,875	90,804	101,252	163,937
Sinking fund	100	100	100	100	100
Non bank sector	287,104	350,272	403,694	477,530	559,057
National Savings Bank	62,498	67,260	79,555	87,263	95,976
Employees' Provident Fund	134,867	157,711	181,581	211,742	245,028
Other	89,739	125,301	142,558	178,525	218,053
Total foreign debt	**376,331**	**461,273**	**507,866**	**542,040**	**634,622**
Project loans	320,867	400,284	444,423	477,845	542,850
Non project loans	55,464	60,989	63,443	64,195	91,772
By type	376,331	461,273	507,866	542,040	634,622
Concessional loans	362,435	446,331	497,672	535,129	601,701
Non concessional loans	13,896	14,942	10,194	6,911	32,921
By currency	376,331	461,273	507,866	542,040	634,622
SDR	142,733	179,124	195,799	214,471	249,686
US dollars	83,111	89,877	91,282	98,130	135,833
Japanese yen	98,738	132,371	164,800	172,932	185,085
Deutsche mark	25,746	29,747	27,375	28,484	33,101
Other	26,003	30,154	28,610	28,023	31,417
External supplier's credit	499	575	530	575	n.a.
Total outstanding govt. debt	**764,071**	**924,699**	**1,051,331**	**1,218,700**	**1,450,587**
Total outstanding govt. debt net of sinking fund	763,971	924,599	1,051,231	1,218,600	1,450,487
Memorandum item:					
Impact of exchange rate variation	1,960	65,119	37,989	24,104	48,844

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, Rs.12,820 million at end 2000 and Rs.29,461 million at end 2001.

outstanding security related medium-term debt. As in the previous years, project loans dominated the outstanding debt portfolio, accounting for 86 per cent of total outstanding debt.

Debt Service Payments

Total debt service payments dropped marginally from 14 per cent of GDP in 2000 to 12.8 per cent of GDP in 2001. Total amortisation payments in 2001 declined by 19 per cent compared to the previous year. In particular, there was a decrease in domestic amortisation payments by 30 per cent, as the amount of maturing medium and long-term debt was relatively lower than in 2000. The fluctuations in the amount of domestic amortisation payments reflects the issue of bunching maturities, which needs to be addressed by evenly spreading the maturity structure of medium and long-term debt. Meanwhile, amortisation payments on foreign debt increased by 20 per cent.

In contrast, interest payments increased significantly to Rs. 94.3 billion. Borrowing at the shorter end of the market, particularly from commercial banks in the form of overdrafts and import bills and borrowing from FCBUs, resulted in a significant increase in interest payments on short-term debt. Interest payments on medium and long-term debt also expanded due to the sharp increase in the value of debt in the

TABLE 8.7

Government Debt Service Payments

Rs. million

	1997	1998	1999	2000	2001 Provisional	2002 Estimates
Debt service payments	83,729	114,866	103,885	175,726	179,072	326,538
Amortisation payments	28,483	59,968	41,762	104,526	84,765	209,354
Domestic	15,232	41,617	20,322	81,244	56,844	170,406
Foreign	13,251	18,351	21,440	23,282	27,921	38,948
Interest payments	55,246	54,898	62,123	71,200	94,307	117,184
Domestic	48,554	47,598	53,371	62,185	84,560	105,795
Short term	18,174	12,398	13,085	12,767	26,109	30,579
Medium and long term	30,381	35,200	40,837	49,418	58,451	75,216
Foreign	6,692	7,300	8,752	9,015	9,747	11,389

Source: Central Bank of Sri Lanka

TABLE 8.8

Government Debt Indicators

Percentage

	1997	1998	1999	2000	2001 Provisional	2002 Estimates
Government Debt/GDP	85.8	90.8	95.1	96.9	103.6	101.2
Domesitc Debt/GDP	43.6	45.5	49.1	53.8	58.3	57.0
Foreign Debt/GDP	42.3	45.3	45.9	43.1	45.3	44.2
Total Foreign Debt/Exports (a)	192.9	168.2	163.6	166.7	151.1	120.3
Total Debt Service/GDP	9.4	11.3	9.4	14.0	12.8	20.6
Total Debt Service/Government Revenue	50.7	65.6	53.0	83.2	77.4	117.4
o/w Domestic Debt Service/Govmment Revenue	38.6	51.0	37.6	67.9	61.1	99.3
Total Debt Service/Government Expenditure	30.7	33.7	31.3	38.7	37.1	50.2
o/w Domestic Debt Service/Govmment Expenditure	23.4	26.2	22.2	31.6	29.3	42.5
Foreign Debt Service/Exports (a)	10.2	9.4	9.7	9.9	9.0	8.6
Domestic Interest/GDP	5.5	4.7	4.8	4.9	6.0	6.7
Domestic Interest/Government Current Expenditure	27.0	23.8	25.6	25.3	29.6	32.1
Foreign Interest/Exports (a)	3.4	2.7	2.8	2.8	2.3	2.0

(a) Export of goods and services

Source: Central Bank of Sri Lanka

recent past and a larger amount of medium and long-term borrowing with semi-annual interest payments. The increase in interest payments on foreign loans was moderate as the bulk of foreign loans is at highly concessional rates. Interest payments absorbed more than one third of government revenue, while its share in GDP increased from 5.7 per cent to 6.7 per cent. This situation clearly indicates the need for an efficient budgetary and debt management policy to scale down interest costs, and the need for strict controls in using borrowed funds in unproductive areas.

Public Sector Debt

The total outstanding debt to the public sector at end 2001 was Rs.1,491.4 billion. This included Rs. 40.8 billion of debt held by public corporations. In GDP terms public sector debt amounted 106.5 per cent of GDP. In 2000 the public debt/GDP ratio was 100.1 per cent. The outstanding debt obligation of public corporations however, declined marginally to 2.9 per cent of GDP from 3 per cent in 2000. Outstanding debt of CPC, CEB and CWE was equivalent to 2.7 per cent of GDP.