Chapter 8
FISCAL POLICY AND BUDGETARY OPERATIONS

8.1 Overview and Policy Strategy

The fiscal policy strategy announced in Budget 2002 was formulated with the objective of resolving three problems that have persisted. The first problem was consistently high budget deficits, a consequence of declining revenues and increasing expenditure. The overall fiscal deficit during the last ten years was on average about 9 per cent of GDP. This led to excessive borrowing from domestic sources, causing serious problems for overall macroeconomic management. The second issue was the soaring public debt and debt service payments, the result of running persistently high budget deficits and costly deficit financing. As a result, the outstanding public debt surpassed the gross domestic production of the economy, while debt service payments exceeded the total revenue collection of government. The third was the continuing financial losses incurred by state owned enterprises, caused by inefficient business and financial management practices. Against this background, Budget 2002 proposed measures to consolidate the operations in the fiscal sector. In addition, Budget 2002 emphasised the need for basic reforms to establish a growth oriented economy based on public-private partnership. The budget highlighted major constraints, which required urgently to be eased to raise active participation of the private sector in developing industrial and service oriented activities. The reforms focussed on improving good governance, freeing the economy from excessive bureaucratic controls, revitalising the rural economy, developing infrastructure, encouraging private sector participation and finally creating employment opportunities. It was expected that those measures would accelerate growth momentum, cause a revival in the economy, and lead to a rise in productivity and employment on a sustainable basis. The government was expected to play the role of a facilitator in this process.

The measures introduced in Budget 2002 were expected to restore sustainability in the fiscal sector, by ensuring stability in fiscal operations in 2002 and by strengthening the process of fiscal consolidation in the medium term. Accordingly, an overall deficit of 8.5 per cent of GDP was targeted. Concomitantly, the primary deficit, which is the outcome of the impact of the current fiscal policy stance, and the current account deficit, which reflects the level of government dis-savings, were targeted to be reduced to 1.2 per cent of GDP and 3.4 per cent of GDP, respectively. The improvement in fiscal aggregates were to be achieved by increasing revenue as well as by containing total expenditure. Total revenue collection was estimated to increase to 17.5 per cent of GDP, while total expenditure was targeted to be contained at 26.1 per cent of GDP. A notable feature in Budget 2002 was the drastic reduction in the public investment programme. Public investment was to be streamlined based on the availability of domestic resources, the capacity for undertaking investment projects and priorities in the economy. Accordingly, rupee funded investments were limited to priority sector projects, which generate high returns. Efforts were made to absorb the maximum foreign resources available on concessional terms for other investment programmes. The total public investment programme was to be contained to 5.4 per cent of GDP in 2002. Persistently high borrowing from domestic sources was also a major concern in formulating the budget as it crowds out private sector investment, thereby hampering the long-term growth prospects in the economy. Therefore, Budget 2002 relied heavily on external financing (grants and concessional borrowing) and divestiture proceeds for financing the resource gap. These sources were estimated to provide 35 per cent of the financing requirement, while the balance was expected to be raised from domestic non-bank sources.

The adoption of policies set out in Budget 2002 ensured that overall fiscal operations in 2002 did not deviate significantly from budgetary targets. The overall deficit in 2002 was 8.9 per cent of GDP, 0.4 percentage points higher than the budgeted target of 8.5 per cent of GDP although significantly lower than the deficit in 2001 of 10.8 per cent of GDP. Although notable efforts were made to consolidate fiscal operations, structural weaknesses in the fiscal sector prevented further improvements. The improvement in the overall fiscal aggregates in 2002 compared to 2001 was entirely due to the rationalisation of non-interest recurrent expenditure and capital expenditure, as revenue, remained as in the previous year. Non interest recurrent expenditure declined by 1.4 percentage points to 13.5 per cent of GDP, while capital expenditure and net lending declined by 1.3 percentage points to 4.6 per cent of GDP. Interest payments continued to rise, increasing by 0.7 percentage points to 7.4 per cent of GDP. Large scale borrowing to finance the widening deficits, contracted at high interest rates prevailing in the market in 2000 and 2001, had increased interest expenditure in recent years. In 2002, debt service payments (interest and amortisation payments) exceeded the total revenue of the government. Interest liabilities, together with other fixed liabilities, such as outlays on salaries and pension payments, left very little room for flexibility in budgetary operations. However, improved monitoring of defence expenditure, better targetting mechanisms in welfare programmes, the hiring freeze on recruitment to the public service and strict control over transfers to sub-national governments and public institutions enabled significant savings in recurrent expenditure. Strict controls over the allocation of rupee funds for capital expenditure and under-utilisation of foreign funds earmarked for the public investment programme also contributed to lowering total expenditure in 2002. A cause for serious concern was the continuing decline in tax revenue collection. Despite a series of measures introduced in Budget 2002 to simplify the tax system and improve collection, tax revenue continued to decline. Tax revenue fell to 14 per cent of GDP from 14.6 in 2001. The granting of various tax concessions, delays in implementing additional revenue generating proposals, poor financial performance in some public enterprises and the tax amnesty, reduced tax revenue collection in 2002.

The need to implement vigorously the fiscal consolidation process was clearly evident in the experience in 2002. In order to strengthen this process, a Fiscal Management (Responsibility) Act (FMRA) was enacted towards the end of 2002. The FMRA spells out the fiscal targets to be achieved in the medium-term. The budget deficit is targeted to be reduced to 5 per cent of GDP by 2006 and outstanding government debt is targeted to be reduced to 85 per cent of GDP at the end of 2006. The debt to GDP ratio is expected to be reduced further to 60 per cent by end 2013.

In the fiscal consolidation process, the government has given the highest priority to reforming the tax system by simplifying the tax structure, eliminating ad hoc tax concessions, broadening the tax base and strengthening tax administration to enhance tax collection. Accordingly, four taxes, i.e., the stamp duties collected by the central government, the capital gains tax, the Advance Company Tax (ACT) and the transfer tax on non-residents were abolished. In addition, the 20 per cent surcharge on corporate taxation was abolished, while the 40 per cent surcharge on import duties was reduced to 20 per cent. The consolidation of the Goods and Services Tax (GST) and the National Security Levy (NSL) into a single Value Added Tax (VAT) was a major tax reform in 2002. The replacement of the NSL, a cascading turnover tax, by a value added type tax was a long felt need to improve the tax system. Two new taxes, the Debits Tax on current account transactions in the banking system and the Ports and Airports Development Levy (PAL) on imports, were introduced to recoup revenue losses arising from the abolition of stamp duties. The Withholding Tax on interest and dividend incomes was made a final tax for non-corporate investors in order to broaden the income tax base. The mode of taxing interest earnings of marketable debt securities was changed to be applicable on the basis of the yield to maturity, thereby collecting the entire tax liability at the time of issue of the security in the primary market. Subsequently, a notional tax credit was granted on interest income earned on secondary market transactions in government securities. This effectively reduced the rate of taxation on interest on government paper transacted in the secondary market, thereby affecting the full revenue collecting potential of this tax. The tax advantage afforded to investment in government securities also resulted in raising benchmark interest rates (call market rates), as participants in the call market sought to equate returns in the two markets.

Personal income taxes were further rationalised and simplified. The number of tax slabs was reduced to three (10, 20 and 35 per cent) from the former four (10, 15, 25 and 35 per cent). The tax free threshold was increased from Rs.144,000 per annum to Rs.240,000 per annum. According to Budget 2002, the medium-term policy on income taxes is to reduce the maximum tax rate for both personal and corporate taxes to 20 per cent. To begin this process, the top marginal tax rate for companies with a taxable income of less than Rs.5 million was reduced to 20 per cent. This low-tax policy is expected to ease the burden of direct taxes and encourage higher tax compliance, helping to inculcate a tax paying culture in the society. With regard to the rationalisation of tax incentives, several measures were taken to streamline existing tax incentives by limiting the use of fiscal incentives to a few targeted sectors.

A new tax amnesty was introduced under the Inland Revenue (Special Provisions) Act, to bring tax evaders into the tax net. The new Act provided a tax amnesty to persons who had not declared their income up to the end of the tax year 2001/2002. Persons who make a declaration under this Act get an amnesty from their tax liability not only on account of income taxes but also other taxes, levies, duties and any penalties relating to those taxes. This new amnesty is expected to bring high income earners and operations in the informal economy into the tax system, and thereby expand the tax base.

Budget 2002 indicated the need for establishing a permanent Tariff Commission to minimise the distortionary impact of taxation on the competitiveness of local producers in international markets. The continuously declining trend in the ratio of import duties to total imports (average duty rate) was a matter for concern as it had been one of the major reasons for the falling tax/GDP ratio in the past. The ad hoc duty concessions and waivers on imports, the exemption of raw material imports and the gradual reduction in tariff rates had been identified as the main reasons for the falling average duty rate. To increase revenue, new tariff rates of 2 per cent and 10 per cent were imposed on items previously exempted from customs duties.

The tax administration on liquor was simplified by unifying the excise tax liabilities under the Excise Ordinance and the Excise (Special Provisions) Act. Accordingly, the imposition and collection of excise duties on liquor were brought under the Excise Ordinance, and the Excise Department was made the sole authority responsible for administering this tax. To recoup the revenue lost due to the abolition of excise taxes collected under the Excise (Special

Provisions) Act, the excise tax rates on liquor were revised upward on a revenue neutral basis. The drastic changes introduced to the excise tax on cigarettes by lowering the tax liability on cigarettes with shorter lengths, enabled legal cigarette manufacturers to capture the market previously dominated by illegal products. Aerated waters were brought into the excise tax net in 2002 by the imposition of an excise tax of Rs.4 per litre.

The consolidation of GST and NSL into VAT, has made it the single most important source of tax revenue. The main objectives of this tax reform were to simplify the tax system, eliminate cascading and broaden the tax base, while ensuring revenue neutrality. However, the implementation of VAT with two rate bands to replace the single rate GST regime, new exemptions, and the imposition of a lower tax rate on certain taxable commodities, could undermine the ability to achieve these expected objectives. Further, the proposal to extend VAT to the wholesale and retail sectors needs some changes to the existing tax system as these businesses are liable to turnover taxes under the provincial council tax system. The performance of value added type taxes depends closely on the existence of an efficient tax administration, an area which needs more attention, if the full potential of this tax is to be realised (See box 14).

The weaknesses in the existing tax administration has been continuously highlighted in the past. Therefore, to improve efficiency, the government decided to establish a Revenue Authority, which would combine the administration of the Inland Revenue Department, the Customs Department and the Excise Department under one authority. The Inland Revenue Department took steps necessary to reform its Large Taxpayers Unit (LTU) by bringing the income tax and VAT files of the largest taxpayers under one administrative unit.

On the expenditure side, Budget 2002 took bold measures to rationalise current as well as capital expenditure. A Budget Monitoring Committee and a Defence Expenditure Committee were appointed to monitor closely the implementation of the budget so as to prevent any deviations from budgetary targets. The on-going peace process has enabled the government to streamline expenditure on defence services. However, a comprehensive reform package is required to design a medium-term programme to get the maximum benefit from the peace process. In addition, the suspension of recruitment to the public service, except to technical and professional grades, the introduction of a better targetting mechanism in welfare programmes such as Samurdhi and the school uniforms programmes, and restrictions on resource allocation for unclassified and unforeseen expenses, were some of the main measures implemented to curtail recurrent expenditure. The enactment of the Welfare Benefit Act would help further rationalise welfare expenditure by specifying the entry and exit criteria to and from welfare programmes. The resource allocation policy for the public investment programme and advance account operations were significantly changed to minimise the allocation of rupee funds for non-priority investment generating low returns. The budget also envisaged absorbing the maximum available foreign resources of a concessional nature. However, special attention needs to be paid to the public investment programme to ensure that the infrastructure required to maintain the growth momentum targeted in the medium-term is provided. Insufficient infrastructure, as well as dilapidated infrastructure, impede the long-term growth prospects in the economy. The government's decision to introduce a zero-based budgeting system in the public sector would help rationalise overall expenditure. This would require public sector institutions to justify resource requirements to provide services to the general public and to enable the identification of unproductive public services, which need reform or liquidation.

The reforms to the public service pension scheme were a long felt need. The non-contributory and pay-as-you-go type pension scheme was to be replaced in early 2003 by a contributory pension scheme applicable to all new recruits to the public service. Studies on the existing pension scheme had pointed out that the funding requirement of the total pension liability of the existing pension scheme stood at about Rs.540 billion. Further, annual pension payments to public servants were around 2 per cent of GDP. Sri Lanka's population is ageing at a relatively fast rate. In this context, a non-contributory pension scheme would not have been sustainable in the long term and would have dampened fiscal consolidation efforts in the future. In light of these issues, a contributory pension scheme with appropriate funding on a regular basis, based on actuarial studies, would safeguard the interests of retirees while improving overall fiscal performance. Following on pension reforms, the next step would be to reform the civil service in order to provide an efficient service according to the changing demands in society.

In 2002, special attention was paid to liberalising the operations of commercial public enterprises and devolving more administrative powers. This was done with the objective of improving the viability of these institutions and the quality of services provided to consumers. An automatic pricing formula was introduced for petroleum products and operations in the petroleum sector were liberalised under the Petroleum Products (Special Provisions) Act. In the same vein, the Electricity Reforms Act was enacted with the intention of unbundling activities in the electricity sector. The lack of a transparent and an automatically adjusting fares policy for road transportation had hampered the development of this sector. Therefore, a bus fares policy was introduced by the National Transport Commission to determine the bus fare structure in a more systematic manner. Public enterprises such as SLPA, CPC and CWE, introduced restructuring programmes on their own under which voluntary retirement schemes were introduced as an exit mechanism for excess employees. SLPA alone reported about 3,000 voluntary retirements in 2002. The Department of Civil Aviation was restructured as the Civil

Box 14

Value Added Tax in Sri Lanka

1. Introduction

The Value Added Tax (VAT) also referred to as the Goods and Services Tax (GST) is an indirect tax levied on the consumption of goods and services. VAT, as its name suggests, is a tax on the value added to goods and services at each stage of production and distribution. As VAT is a consumption tax the economic incidence of the tax, i.e., the actual payment of the tax liability is passed on to the consumer, whereas the legal incidence, i.e., the responsibility for paying the tax, falls on the producer/ supplier.

Just over 50 years from its introduction, the VAT has become one of the main sources of revenue in more than 120 countries around the world.[1]. The preference for a value added tax over other consumption taxes has been that it is non-distortionary, because it taxes only final consumption and not intermediate transactions. Secondly, it overcomes the problem of cascading or the tax on tax effect. In a turnover tax, both the inputs into a commodity and the outputs are taxed, resulting in a tax on tax. However, under a value added tax the tax on inputs can be credited when calculating the tax on outputs, hence a tax on tax is avoided.

Sri Lanka had a Turnover Tax (TT) system from 1964, covering manufacturing and non-manufacturing businesses. In 1981, new legislation extended the TT to imports and introduced an input credit scheme for manufacturers. Therefore, since 1981, under the TT System, a partial value added tax system had been in operation. However, because of the various shortcomings in the TT system, in 1990, the Taxation Commission proposed the replacement of the TT with a new value added type tax. The Goods and Services Tax (GST), which is a value added tax, was introduced to replace the TT in April 1998. Although this tax was expected to generate the same level of revenue as the TT that it replaced, its revenue performance was not satisfactory. The large number of exemptions, the less than revenue neutral rate (12.5 per cent) and the refund mechanism that operated contributed to this tax under performing in all years in which it was in operation.

Although a value added type tax has been in operation since 1998, there has been a parallel turnover based tax system that has also been operated in the form of the National Security Levy (NSL). This has resulted in the operation of multiple tax systems and the problem of a tax on tax (cascading taxes) being levied on certain goods and services. The vast exemptions afforded in the GST system has lowered the tax base and significantly eroded the revenue generating capability of the tax. A productivity estimate for value added taxes, which compares the value added tax base as a proportion to GDP (Productivity Ratio = VAT revenue as a % of GDP / VAT rate) indicates a productivity ratio of only 26 per cent. This is lower than the average productivity ratio of 30 per cent experienced in many countries (See Table 1). Such a low rate reflects the narrow base, the result of the large number of exemptions. In view of these weaknesses Budget 2002 proposed to consolidate the GST and the NSL into a single tax, namely, the Value Added Tax (VAT) with effect from August 2002.

TABLE 1

Comparative Productivity Ratios for Selected Countries with a Value Added Tax

Country	VAT/GST revenue as a % of GDP	VAT/GST Rate	Productivity Ratio 1/
Sri Lanka	3.3 2/	12.5	26
Vietnam	4.0	10.0	40
Singapore	1.2	3.0	40
Philippines	3.0	10.0	30
Mauritius	3.0	10.0	30
Thailand	2.8	10.0	28
Indonesia	2.7	10.0	27

1/ Productivity Ratio = VAT revenue as a % of GDP/VAT rate
2/ Average for 1999-2001

Source: The Modern VAT, IMF (2001)

2. Basic Features of VAT in Sri Lanka

Tax Base: VAT is a consumption tax based on the destination principle, i.e. it is a tax on all domestic consumption. Therefore, all imports are taxed while exports are free from tax.

Tax Threshold: Anyone who has supplied taxable goods or services in excess of Rs. 500,000 per quarter or Rs.1.8 million per annum, excluding the value of supplies of wholesale or retail trade carried on as an independent activity is liable to pay VAT. At present, wholesale and retail trade have been excluded from VAT, except if the wholesale or retail trader is a manufacturer or an importer.

Tax Rates: There are two VAT rates. A lower rate of 10 per cent on essential goods and services and a standard rate of 20 per cent on other goods and services. A zero rate continues to apply to exports and specified services for which payment is made in foreign currency.

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[1] Ebrill Liam , Michael Keen, Jean-Paul Bodin and Victoria Summers,2001, The Modern VAT: International Monetary Fund.

Box 14 (contd.)

TABLE 2
Moving from GST and NSL to VAT

Rates under GST and NSL		VAT Rate	Selected commodities and services
Goods with only GST (12.5%)	➡	VAT @ 10%	Electricity > 90kWh, supply of services by hotels, restaurants etc, construction services
Goods with only NSL (6.5%)	➡	VAT @ 10%	Sugar, Maldive fish, milk powder, fertiliser, LP gas, petrol and diesel
Goods with GST (12.5%) and NSL (6.5%)	➡	VAT @ 20%	Telecommunication services, electrical goods, cement
Goods exempt under GST and NSL, or liable only to NSL (6.5%)	➡	VAT-Exempt	Rice, wheat, bread, infant milk, meat, fish, pharmaceuticals, crude oil, kerosene, electricity <30kWh, selected education supplies, health care services
Goods with GST (0%) and no NSL	➡	VAT-zero rate	Export of goods and selected services

TABLE 3
Effective Tax Rate on Imports [1]

Duty Rate (%)	Effective Tax Rate				
	GST 12.5%	NSL 6.5%	GST + NSL 19%	VAT 10%	VAT 20%
10%	13.75	8.94	22.69	11.60	22.00
25%	15.63	10.16	25.79	12.50	25.00
35%	16.88	10.97	27.85	13.50	27.00

[1] Excluding the 20 per cent surcharge on import duties.

3. Problems and Issues in the Implementation of VAT

Price Impact: An analysis of the impact of VAT on the price level using a consumer price index would indicate that although there are changes in the relative prices of certain goods that the introduction of VAT has had a favourable impact on the general price level. One of the main reasons for this was that several essential commodities, such as rice, wheat flour, pharmaceuticals etc., that form a major portion of the consumption basket that were subject to either GST or NSL or both, were exempted under VAT. Another reasons for this favourable impact was that the base of VAT on imports was the elimination of the 25 per cent mark up that was included in charging NSL at the point of imports. As a result, the effective rate of tax under VAT is less than under the GST and NSL system on imports. A comparison of the effective tax rates under the GST and NSL and under a VAT scenario is given in Table 3.

Taxation of financial services under a VAT: The removal of the 1 per cent TT on financial services in October 2001, the abolishing of stamp duties in May 2002 and the removal of the 6.5 per cent NSL from August 2002, have effectively removed all taxes on most financial services (except corporate tax on profits). In Sri Lanka however, the financial sector has been one of the fastest growing sectors in the economy and therefore, cannot be completely excluded from the tax base. However, most countries that have implemented VAT have exempted the financial sector because of the difficulty of measuring the value added in financial services. Israel for instance has taxed the value added in the financial sector by the addition method, which is a tax levied on the sum of profits and wages. Sri Lanka too, has adopted this addition method in its application of VAT on financial institutions with effect from 01 January 2003. The problem with this method is that since it is not possible to identify the value added of each transaction it does not allow for any input credits, thus giving rise to cascading, if the tax liability is passed on to the borrower. The budget proposal however, explicitly indicates that financial institutions are not supposed to pass on this tax to customers. Given that the VAT is in principle a consumption tax, it is highly unlikely that financial institutions will refrain from passing this liability to their customers.

Expansion of VAT to the wholesale and retail sectors: The government in Budget 2002 announced the intention to expand the VAT to the wholesale and retail sectors from July 2003. This has since been postponed due to cost of living considerations. The VAT would be in addition to the Turnover Tax (TT) on wholesale and retail trade that is currently being collected by the Provincial Councils. Therefore, the introduction of an additional tax is bound to have an adverse impact on prices. Another issue that would need to be dealt with when extending VAT to the wholesale and retail sectors would be the additional tax files that would be created. It has been estimated that the extension

Box 14 (contd.)

of VAT to the wholesale and retail sectors would result in the opening of about 30,000 new tax files. The administration of VAT is not as straightforward as in the case of the TT. The current resources available at the Inland Revenue Department would be grossly inadequate to administer these additional tax files.

Rationalisation of exemptions and a low, uniform VAT rate: Although, in theory, all consumption items should be taxed, in practice, this has not been the case due to various political, social and administrative reasons. Therefore, the implementation of VAT in most countries has resulted in the exemption or exclusion of certain goods and services from the tax base. This has led to a serious erosion of the tax base and the need for higher tax rates to compensate for the loss of revenue. The VAT introduced in August 2002 has had to take into account the need for a high VAT rate to compensate for the loss of revenue as a result of the large number of exemptions, while taking into account equity considerations and the need for a low rate on essential commodities. This has resulted in the implementation of two VAT rates. The operation of multiple rates creates various problems both for taxpayers and the tax administration. It requires the maintenance of separate records for transactions liable at the different tax rates. Additional refund claims are possible under a multiple rate system. Disputes relating to the rate applicable to commodities may arise in a multiple rate system. The large number of exemptions and the narrow base makes it difficult to implement a single low rate. An analysis of the sector/commodity concentration of consumption taxes reveals that revenue collection is largely dependent on a few commodities, such as motor vehicles, petroleum products, liquor and tobacco. Broad basing the tax base, by expanding the coverage of the tax to a wider range of activities in the economy would require a rationalisation of tax exemptions and improvements in tax administration. This would not only enable the implementation of a single low rate, which will facilitate tax administration and improve tax compliance, but also increase the tax elasticity in the economy.

Aviation Authority of Sri Lanka to provide a more independent working environment. The establishment of the Public Utilities Commission of Sri Lanka (PUC) and the Consumer Affairs Authority (CAA) were two important steps taken to safeguard the interests of consumers. PUC is expected to monitor and regulate operations in the water, electricity, petroleum and civil aviation sectors.

The government's deficit financing was consistent with the government's borrowing policy, which emphasised the need to move towards more market based long-term borrowing from the domestic market. As a result the entire net borrowing requirement from domestic sources was raised through marketable instruments, i.e., Treasury bonds and Treasury bills, with a proper balance being maintained between short-term and long-term debt. This eliminated the financial repression that was the result of high borrowing through non-marketable instruments, which imposed an implicit tax on captive investors. The maturity structure of marketable debt instruments was extended up to six years, thereby helping to generate a longer government securities yield curve. This would be a useful guide for investors in government securities as well as other investors in selecting alternative investments. In addition, the primary dealers system was expanded in 2002 by permitting Licensed Commerical Banks (LCBs) to become primary dealers, thereby increasing the intermediation abilities of the system and infusing more competition and liquidity into the market.

The cessation of hostilities that prevailed throughout the year and the a high degree of fiscal discipline eliminated ad hoc pressure on the domestic borrowing programme in 2002. Further, the cautious borrowing strategy adopted to meet shortfalls in receipts from privatisation and foreign borrowing, helped lower the pressure from higher borrowings on market interest rates. A part of the additional borrowing requirements from the domestic market was raised by issuing the balance Sri Lanka Development Bonds (SLDB). In addition, short-term dollar denominated loans amounting to US dollars 250 million, which were due to be paid back to domestic commercial banks in 2002, were rolled over with longer maturities and lower interest rates. In addition US dollars 50 million of new borrowing was raised from the FCBU of the Bank of Ceylon. These contributed to smoothen domestic loan operations and helped maintain the downward trend in domestic interest rates in 2002.

The problem of low utilisation of foreign resources, available on concessional terms, which has been an issue in the recent past, remained unsolved in 2002. The deficiency lies not only in the archaic government procedures that delay the implementation of projects, but also in the dearth of professionally oriented qualified project managers to run those

Box 15

Sustainability of Government Debt

Debt Sustainability – Fundamentals

The issue of debt sustainability is often discussed in the context of fiscal sustainability, as the government debt is the final outcome of the fiscal policy of a country. The issue of fiscal sustainability generally revolves around the question of whether the present and prospective fiscal stance is heading towards an excessive and persistent accumulation of debt levels. Hence, in order to maintain fiscal sustainability, fiscal policy should plan to stabilise the debt/GDP ratio within a feasible range rather than allowing it to increase to an unsustainable level. However, there is no optimal level of debt appropriate for all economies and the desired level of indebtedness would generally be both country and time specific.

A high and an increasing level of debt has several implications. The government will have to pay a significant amount of its revenue receipts as interest payments on outstanding debt, which will increase the pressure on the government's ability to meet its other commitments, leaving little room for other essential and development-oriented expenditure. It also tends to reduce resource availability to the private sector in addition to increasing the interest rates in the domestic markets. This will increase the cost of borrowing by the private sector and thereby crowd out private investment, adversely affecting the economic growth of the country. High government debt would also increase the need for frequent rollover of existing debt, making fiscal management more difficult. Furthermore, it limits the maneuvering abilities of fiscal policy in responding to economic fluctuations. As such, modern day fiscal policy emphasises the need for bringing down the level of government debt to more desirable levels in the medium to long run, thereby restoring fiscal sustainability.

Considering debt to be total debt, i.e. domestic and foreign government debt taken together (after adjusting the foreign debt for exchange rate variations), the determination of the debt/GDP ratio in a particular year is related to the initial debt level, the primary deficit (revenue minus expenditure, net of interest payments), the nominal interest rate on the government debt and the nominal growth rate of the economy. Accordingly, in the macroeconomic context, there are two major determinants of the sustainability of debt, i.e., the primary deficit and the difference between the nominal interest rate on government debt (i) and the nominal growth rate of the economy (g), as given in the following equation.

$$\frac{\Delta B_t}{GDP_t} = \left(\frac{i_t - g_t}{1 + g_t}\right)\frac{B_{t-1}}{GDP_{t-1}} + \frac{PD_t}{GDP_t}$$

where, GDP = Gross Domestic Product, B = total government debt, PD = primary deficit of the budget, i = nominal interest rate on government debt and g = nominal growth rate of the economy.

This implies that the change in the debt/GDP ratio depends on the primary deficit, the difference between the nominal interest rate on government debt and the nominal growth rate of the economy (interest-output growth differential) and the initial debt/GDP ratio. The first term on the right hand side of this equation implies that when the nominal interest rate on government debt exceeds the nominal growth rate of the economy (i.e. i>g), interest payments add more to the outstanding debt than growth adds to the GDP, requiring a primary surplus in the budget to offset this increase. This also indicates that even if the primary deficit is zero, the debt/GDP ratio can increase because paying interest on outstanding debt increases the numerator of the debt/GDP ratio faster than economic growth increases the denominator.

The primary deficit, the second term in the equation, reflects the outcome of the government's fiscal policy in the period under review. If the primary deficit is high, then the government-borrowing requirement will also be high, leading to an increase in the outstanding debt stock.

An additional factor that determines the level of debt is the effect of the exchange rate variation on outstanding foreign debt. When the local currency depreciates vis-à-vis the foreign currencies in which foreign debt has been contracted, the foreign debt calculated in terms of domestic currency will increase. The magnitude of the impact will depend on the currency composition of the foreign debt and the relative depreciation of such currencies.

Sri Lanka's Fiscal Position

The persistently high fiscal deficits and associated high level of outstanding government debt stock has raised the questions regarding debt sustainability in Sri Lanka. As a percentage of GDP, the overall budget deficit and the outstanding government debt stock have averaged around 10 per cent and 97 per cent, respectively during the period 1990-2002. Interest payments on outstanding debt have also averaged to 6.3 per cent of GDP during the same period. In particular, there has been a significant increase of

Box 15 (contd.)

outstanding debt from 1997, a year in which the lowest debt/GDP ratio (85.8 per cent) was recorded in the recent past, to 2002 where the debt/GDP ratio rose to 105.3 per cent.

The high level of deficits and debt are the combined outcome of various factors. The slowdown in government revenue collection and the relatively high government expenditure are the major factors that affected the increase in the overall deficit. In addition, the slippage in fiscal consolidation efforts in recent years, the reduction of financial repression with increased liberalisation of financial markets and the resulting increase in the average interest rate on government borrowings and the gradual decline in external concessional loans, which had helped keep the average cost of foreign borrowing at a relatively low level, also contributed to the worsening of the fiscal position.

The gradual shift in the deficit financing process towards more domestic borrowings and the consequent structural change in the outstanding debt stock (towards more domestic debt) and increased debt service payments have further aggravated the situation. As about 97 per cent of foreign loans have been obtained at highly concessional interest rates, the interest cost on foreign loans has been only about 9 per cent of total interest payments although foreign loans amount to about 45 per cent of total government debt. However, the continuous depreciation of the Sri Lankan rupee, particularly against currencies in which a large portion of the outstanding foreign debt stock is denominated, such as the Japanese yen and Special Drawing Rights (SDR), has resulted in a significant expansion in the outstanding value of external debt, although net new foreign financing in the budget is very small. The average economic growth rate has also remained below the potential level in the recent past. These developments indicate that debt dynamics are likely to worsen in the future in the absence of a comprehensive and prolonged fiscal consolidation process and economic growth accelerating efforts.

Fiscal Consolidation Efforts

In view of the above, necessary early corrective measures are already being introduced under the fiscal consolidation initiatives adopted by the government to avoid the country from falling into a permanent debt trap. These measures include policies aimed at increasing government revenue, particularly by way of tax reforms, and reducing expenditure, especially recurrent expenditure, over the years to achieve a lower level of overall deficit. The reduced overall deficit will minimise the borrowing requirement, thereby slowing the debt accumulation process. It will also reduce the pressure on the domestic interest rates, reducing the average interest cost of the government debt. Meanwhile, the increased availability of financial resources and low interest rates would encourage private investment, thereby accelerating economic growth.

Rules-Based Fiscal Policy

In line with the fiscal consolidation efforts mentioned above, the achievement of fiscal sustainability in Sri Lanka has also been linked to the recently introduced Fiscal Management (Responsibility) Act (FMRA) (See box 5). FMRA requires the government to bring down the budget deficit and the outstanding government debt to a level of 5 per cent and 85 per cent of GDP, respectively by 2006. It also requires that the outstanding government debt to be reduced to 60 per cent of GDP by 2013.

Medium-Term Framework

All these efforts to achieve fiscal sustainability can be examined based on two scenarios – a 'no adjustment scenario' and a 'strong adjustment scenario'. The former assumes the continuation of the current fiscal policy with no effort to bring the fiscal variables under control. In contrast, the latter is related to the medium-term budgetary programme that the government anticipates to follow over the next few years, which includes strong adjustments in the fiscal sector. Table 1 summarises the major components of these two scenarios, while Chart 1 describes the outcome of the two scenarios in respect of overall deficit/GDP ratio, primary deficit/GDP ratio and total government debt/GDP ratio.

Under the no adjustment scenario, deficit and debt levels deviate significantly from the targets set by FMRA. The overall budget deficit and debt as a percentage of GDP increase significantly to about 15 per cent and 128 per cent, respectively, by 2006. In contrast, the expected outcome of the medium term budgetary framework with strong fiscal adjustments will be consistent with the targets in FMRA. Therefore, depending on the strength of the policy adjustments, the reduction of the debt/GDP ratio will be determined. In the absence of strong policy adjustments, however, there is always a tendency that debt dynamics are likely to worsen while further increasing the required adjustment to ensure achieving fiscal sustainability. As the debt/GDP ratio is also directly related to the growth rate of the economy, strong fiscal adjustment policies should be complemented with economic growth enhancing measures in achieving fiscal sustainability and meeting the targets set out in FMRA.

Box 15 (contd.)

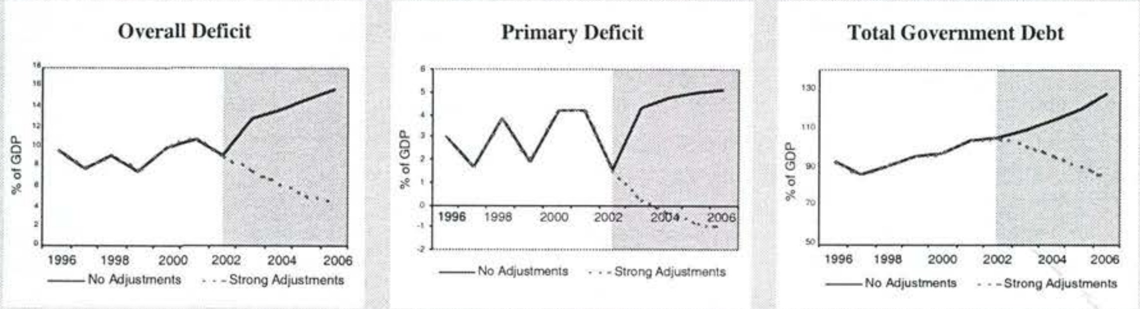
TABLE 1

Major Components of the Two Policy Scenarios

Scenario	Components
1. No adjustment scenario [a]	• Revenue is decreasing in the absence of tax reforms • Current expenditure is increasing significantly as there is no control on it • Interest payments are relatively high • Net domestic financing is very high and net foreign financing is relatively stable • Unstable foreign grants and declining privatisation receipts • Economic growth remains low (considerably below the potential average growth rate)
2. Strong adjustment scenario [b]	• Revenue is increasing consistently with strong tax reforms • Current expenditure is declining considerably as a result of the continuous efforts to reduce lower priority and unproductive current expenditure. • Increasing capital expenditure • Low interest payments (particularly on domestic debt) • Increasing net external financing • Declining net domestic financing • Stable foreign grants and privatisation receipts • Relatively high economic growth (above the past average growth rate)

a/ Continuation of policies without strong adjustments
b/ As given in the government medium-term budget outturn.
Note:
1. All variables used in the analysis are as a percentage of GDP

Chart 1
Outcome of the Two Policy Scenarios



Way Forward

The achievement of fiscal sustainability will be a major thrust in the medium term fiscal policy. Improved discipline in fiscal management will be necessary to achieve this objective. The proposed strong fiscal adjustments are inevitable although they could be temporarily painful to some segments in the economy. In order to implement the adjustments, a careful and well-integrated effort is needed from all stakeholders. The ceilings imposed by the FMRA would help achieve an efficient fiscal consolidation process. However, any significant deviation from the targets would not only adversely affect the macroeconomic stability in the country but also would endanger the credibility of the government. The success of an FMRA type rules-based fiscal policy is therefore yet to be seen in a developing country like Sri Lanka.

A high and accelerated level of economic growth is a must to achieve fiscal sustainability. Hence, efforts should be made to follow the 'golden rule' of public finance, which emphasises that public sector borrowings should be undertaken exclusively for the purpose to financing growth enhancing investment activities. It should also ensure that economic growth and fiscal consolidation efforts should not be in conflict with each other, so that both objectives are achieved. All in all, a prudent fiscal policy is needed without further delay and/or reversals in order to turn around the increasing debt/GDP ratio of the country and to ensure fiscal sustainability in the medium-term.

projects. The foreign aid utilisation ratio improved to 23 per cent, but still remains low, indicating the urgency of adopting measures to accelerate the rate of aid utilisation. The main reason for the low investment in the public sector was the lack of domestic resources and the inability to utilise the available external resources. Considering this issue to be of national priority, the Committee for Monitoring the Progress of Foreign Funded Projects, was appointed. This Committee was assigned the task of monitoring the progress of foreign funded projects and streamlining systems, so as to ensure higher donor funded project utilisation rates and shorter project implementation periods. On the basis of foreign funds presently in the pipeline, the Committee has been given a disbursement target of US dollars 1 billion for 2003.

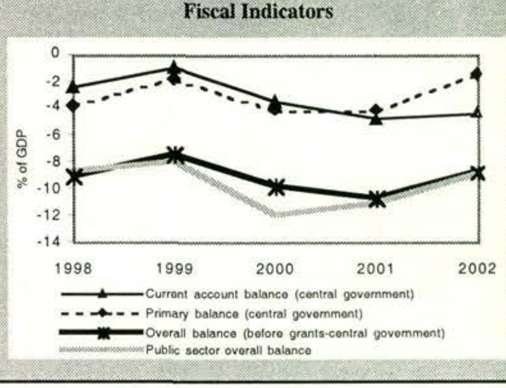
Without a proper market based borrowing strategy and with excessive reliance on the two state banks to finance the resource gap, the quality of overall fiscal management deteriorated and raised issues of transparency and fiscal discipline in government operations. At end 2001, government borrowing from the two state banks through overdraft facilities and unsettled import bills amounted to Rs.38 billion and Rs.12.5 billion, respectively. Recognising the need for improving the transparency in debt management, Budget 2002 proposed, as a first step in this direction, the conversion of the outstanding overdraft to marketable debt instruments such as, Treasury bills and Treasury bonds. This process will continue as it has been proposed to settle the outstanding LCs with the two state banks in 2003. In addition, borrowing through administrative arrangements was suspended and a part of the outstanding administrative debt was settled in 2002. The strict enforcement of this policy would not only improve transparency in fiscal operations, but also minimise undue pressure on institutional investors to finance the government budget.

Budget 2002 recognised the severe constraints imposed on fiscal management by the high and rising debt stock. In 2002, the outstanding government debt stock exceeded the gross domestic product of the economy. Total government revenue collection was insufficient to meet the debt service payments of the government. These developments underscored the urgent need to bring the level of outstanding debt to a sustainable level (See box 15).

8.2 Budget Outturn

Fiscal performance in 2002 was a marked improvement on the performance witnessed in the two previous years. Although the overall deficit exceeded the budgetary target, the realised outcome of 8.9 per cent of GDP was a sharp reduction from 10.8 per cent in 2001 and 9.9 per cent in 2000. The improvement was entirely a result of rationalising expenditure, both non-interest recurrent and capital expenditure, as the level of revenue remained almost unchanged from that in the previous year. Concomitantly, the primary deficit, which reflects the impact of the current year's fiscal operations on the macro economy, declined significantly by 2.5 percentage points to 1.6 per cent of GDP in 2002. The reduction in the primary deficit was higher than the reduction in the overall deficit (1.9 percentage points), highlighting the sharp reduction in non-interest recurrent expenditure by 1.4 percentage points and capital expenditure and net lending by 1.3 percentage points of GDP. Meanwhile, the current account deficit, which measures government dis-savings, declined by 0.5 percentage points to 4.4 per cent of GDP. However, this was significantly higher than the initial budget target of 3.4 per cent of GDP. The expected improvement in the current account deficit was not achieved primarily because of slippage in revenue collection by 1 per cent of GDP from the target in Budget 2002.

Chart 8.1
Fiscal Indicators



The consolidated public sector deficit, which comprises the operations of general government and public non-financial corporations, decreased to 9 per cent of GDP in 2002 from 11 per cent in 2001. This reduction was entirely due to the improvement in central government operations in 2002. The improved financial performance in CPC with the adoption of an automatic pricing formula helped maintain the performance of non-financial corporations as in the previous year. Had the debt recovery adjustment charge not been removed from the pricing formula for petroleum products, there would have been a further improvement of about 0.2 per cent of GDP in the public sector deficit. However, this positive effect was largely off-set by the deterioration in the financial position of CEB, although upward revisions in electricity tariffs helped lower the debt liability by about 0.4 percentage points of GDP. CEB reported large operational deficits, as prices were not raised in line with costs. The increasing liabilities of the CEB are a matter for concern, requiring drastic changes to revive this public enterprise. The introduction of automatic pricing formulae for public enterprises, together with improvements in their operational efficiency, would be the most rational way of improving their commercial viability.

Government revenue collection as a percentage of GDP was 16.5 per cent, 1 per cent below the budget target. The lacklustre performance in revenue was reflected in the continuing deterioration in the tax/GDP ratio. This ratio, which

TABLE 8.1
Summary of Government Fiscal Operations

Rs. million

Item	1998	1999	2000	2001	2002 Approved Estimates	2002 Provi-sional	2003 Approved Estimates
Total revenue	175,032	195,905	211,282	234,296	278,202	261,264	303,933
Tax revenue	147,368	166,029	182,392	205,840	237,150	221,786	264,771
Non tax revenue	27,664	29,877	28,890	28,456	41,053	39,478	39,162
Expenditure and lending minus repayments	268,180	279,159	335,823	386,518	413,627	402,366	438,370
Current	199,648	207,271	254,279	303,362	332,565	330,267	344,611
Capital and net lending	68,532	71,889	81,544	83,157	81,063	72,100	93,759
Public investment	68,279	71,436	80,955	82,491	84,908	72,176	94,977
Other net lending	253	452	589	666	-3,846	-77	-1,218
Current account surplus/deficit(-)	-24,616	-11,366	-42,997	-69,065	-54,363	-69,003	-40,678
Primary account surplus/deficit(-)	-38,250	-21,131	-53,341	-57,915	-18,241	-24,588	-4,259
Overall deficit (before grants)	-93,148	-83,254	-124,541	-152,222	-135,425	-141,102	-134,437
Financing	93,147	83,254	124,541	152,222	135,425	141,102	134,437
Foreign financing	17,397	8,245	5,640	20,038	26,452	9,057	33,678
Net borrowings	10,197	1,484	495	14,538	18,952	1,978	24,678
Grants	7,200	6,761	5,145	5,500	7,500	7,079	9,000
Domestic financing	71,362	74,875	118,500	123,595	87,973	126,352	87,259
Market borrowing	72,292	75,718	115,325	122,848	87,973	127,167	87,259
Non bank	53,338	48,426	58,797	74,294	107,498	132,003	101,259
Bank	18,954	27,292	56,528	48,554	-19,525	-4,836	-14,000
Monetary authority	5,609	20,807	44,840	-6,434	-	-13,266	-
Commercial banks	13,345	6,484	11,689	54,988	-19,525	8,430	-14,000
Other borrowing	-930	-842	3,175	747	-	-816	-
Privatisation proceeds	4,389	134	401	8,589	21,000	5,693	13,500
As a percentage of GDP							
Total revenue	17.2	17.7	16.8	16.7	17.5	16.5	17.1
Tax revenue	14.5	15.0	14.5	14.8	15.0	14.0	14.9
Non tax revenue	2.7	2.7	2.3	2.0	2.6	2.5	2.2
Expenditure and lending minus repayments	26.3	25.2	26.7	27.5	26.1	25.4	24.6
Current	19.6	18.7	20.2	21.6	21.0	20.8	19.3
Capital and net lending	6.7	6.5	6.5	5.9	5.1	4.5	5.3
Public investment	6.7	6.5	6.4	5.9	5.4	4.6	5.3
Other net lending	...	...	...	...	-0.2	...	-0.1
Current account surplus/deficit(-)	-2.4	-1.0	-3.4	-4.9	-3.4	-4.4	-2.3
Primary account surplus/deficit(-)	-3.8	-1.9	-4.2	-4.1	-1.2	-1.6	-0.2
Overall deficit (before grants)	-9.2	-7.5	-9.9	-10.8	-8.5	-8.9	-7.5
Financing	9.2	7.5	9.9	10.8	8.5	8.9	7.5
Foreign financing	1.7	0.7	0.4	1.4	1.7	0.6	1.9
Net borrowings	1.0	0.1	...	1.0	1.2	0.1	1.4
Grants	0.7	0.6	0.4	0.4	0.5	0.4	0.5
Domestic financing	7.0	6.8	9.4	8.8	5.5	8.0	4.9
Market borrowings	7.1	6.8	9.2	8.7	5.5	8.0	4.9
Non bank	5.2	4.4	4.7	5.3	6.8	8.3	5.7
Bank	1.9	2.5	4.5	3.5	-1.2	-0.3	-0.8
Monetary authority	0.6	1.9	3.6	-0.5	-	-0.8	-
Commercial banks (b)	1.3	0.6	0.9	3.9	-1.2	0.5	-0.8
Other borrowings	-0.1	-0.1	0.3	0.1	0.0	-0.1	-
Privatisation proceeds	0.4	...	...	0.6	1.3	0.4	0.8

Source: Ministry of Finance

was 19 per cent in 1990, has steadily declined. The issue has been well recognised and attempts have been made to improve the buoyancy of the tax system. To reverse the trend, government introduced new tax measures such as, expanding the coverage of withholding taxes to government securities, the introduction of PAL and the Debits Tax and broadening the tax base by rationalising existing exemptions, imposing taxes/duties on items previously exempted, conducting vigorous campaigns to increase the number of taxpayers and lowering tax rates to improve compliance. Despite these efforts the tax/GDP ratio declined to 14 per cent in 2002 from 14.6 per cent in 2001. The fall in the tax/GDP ratio in 2002 was largely a result of various new tax concessions, delays in implementing additional revenue generating tax proposals, weak performance in public enterprises and the amnesty granted to tax evaders. The sharp increase in the non-tax revenue/GDP ratio in 2002 helped off-set the decline in the tax/GDP ratio, maintaining the revenue/GDP ratio in 2002 at almost the same level as in the previous year. Non-tax revenue accounted for 2.5 per cent of GDP in 2002 compared to 2.0 per cent of GDP in 2001, owing to higher profit transfers from the Central Bank, payment of interest dues to the government by public enterprises on on-lending activities and the timely collection of revenue from other non-tax sources.

On the expenditure front, significant progress was made in maintaining non-interest expenditure below the 2001 level. Some of the key measures taken to limit current expenses were the streamlining of defence expenses following the cessation of hostilities, better targetting of household welfare programmes, the suspension of recruitment to the public sector, avoidance of ad hoc wage increases, strict controls on transfer payments to sub-national governments and public institutions and the rationalisation of current payments on other goods and services. Accordingly, non-interest current expenditure, as a percentage of GDP, declined to 13.5 per cent from 14.9 per cent in 2001. However, a sharp increase in interest expenditure to 7.4 per cent of GDP from 6.7 per cent of GDP in 2001, offset a part of the gains from the reduction in other recurrent outlays. Consequently, the current expenditure/GDP ratio declined only by 0.8 per cent to 20.8 per cent from 21.6 per cent in 2001. Stricter fiscal discipline and accountability are essential to achieve the targets envisaged in the FMRA, which will come into effect from 2003. Some of the key areas which can provide further reductions in current expenditure are improvements in debt management, improved targetting in welfare programmes with the implementation of the Welfare Benefits Act, reform of the civil service, restructuring of defence services in line with developments in the peace process, rationalisation of ministerial and institutional structures, improved profitability in public enterprises and the introduction of zero-based budgeting, which will avoid allocation of resources to low priority and redundant activities.

The public investment programme for 2002 was designed to absorb the maximum available project related concessional foreign funds, while restricting rupee funds to priority projects with high returns. Consequently, because of resource constraints, allocations for public investment in Budget 2002 were contained to 5.4 per cent of GDP, in comparison to 5.9 per cent in the previous year. However, there was a setback to the planned public investment programme in 2002. Public investment declined to 4.6 per cent of GDP, the lowest level of public investment in the last decade. As in the past, the under-utilisation of foreign funds was the main reason for the non-realisation of the annual investment target. The foreign resource utilisation ratio in 2002 was only 23 per cent, evidence of the slow progress in the utilisation of foreign resources. In addition, the 3-month delay in presenting the budget delayed the implementation of the investment programme. An adequate level of public investment is necessary to complement and stimulate private investment. Significant cutbacks in the public investment programme in terms of resource allocation and the under-utilisation of existing resources would adversely affect the development and maintenance of basic infrastructure and impede the full realisation of the economy's growth potential. Hence, the allocation of more resources for the development of infrastructure is essential. The strategy should be to raise resources through a shift in the composition of expenditure without widening the budget deficit.

The total financing requirement in Budget 2003 (Rs.141.1 billion) was significantly lower than 2001 (Rs.152.2 billion) but exceeded the original target by Rs.5.7 billion. Privatisation proceeds and receipts from foreign sources recorded significant shortfalls amounting to Rs.32.7 billion. The shortfall in expected resources and the additional resources required to bridge the wider resources gap were entirely met from domestic sources. As a result, total net borrowing from domestic sources rose by Rs.38.4 billion to Rs.126.4 billion.

The privatisation programme in 2002 was able to raise only Rs.5.7 billion against the target of Rs.21 billion. The shortfall was due to the inability to finalise some transactions in 2002. The privatisation of Sri Lanka Insurance Corporation (SLIC), and the regional bus companies were postponed to 2003. The government was unable to sell its balance share holding in the Shell Gas Company. The volume of shares of Sri Lanka Telecom sold on the Colombo Stock Exchange was reduced from the original target. The transfer of management in the National Lotteries Board and the liberalisation and restructuring of CPC were both delayed. However, the completion of these privatisations in 2003 will reduce the domestic borrowing requirement in that year.

The under-utilisation of available foreign resources has been an on-going problem. In 2002, in comparison with the annual disbursement target, the shortfall in the external financing programme amounted to Rs.17.5 billion (Rs.17 billion, loans and Rs.0.5 billion, grants). As these funds are almost entirely of a concessionary nature and directly related to the investment programme of the government, the continuation of this high rate of under-utilisation has a direct impact on future growth prospects and incurs a significant economic cost to the country. Considering the importance of resolving this issue, a committee was appointed to expedite the utilisation of foreign resources and reduce project implementation periods.

The mobilisation of domestic resources to finance the deficit declined by 0.8 percentage points to 8 per cent of GDP in 2002 in comparison to 2001, easing government borrowing pressure on the domestic market. However, the accommodation of the shortfall in privatisation receipts and foreign financing, as well as the widening of the budget deficit, resulted in increasing net domestic borrowing by 2.5 per cent of GDP from the original estimate of 5.5 per cent. Despite the increase in the borrowing requirement, the government was able to maintain a market based borrowing policy and raise the entire resource requirement from the domestic market, while reducing its non-marketable debt stock. The high borrowing requirement from domestic sources compelled the government to issue the remaining dollar denominated government bonds, namely, SLDBs. In addition, borrowings from FCBUs of state banks, which were scheduled to be repaid in 2002, were rolled over and new borrowings were raised to finance the resource gap. These events helped ease the high borrowing pressure on the domestic rupee funds market.

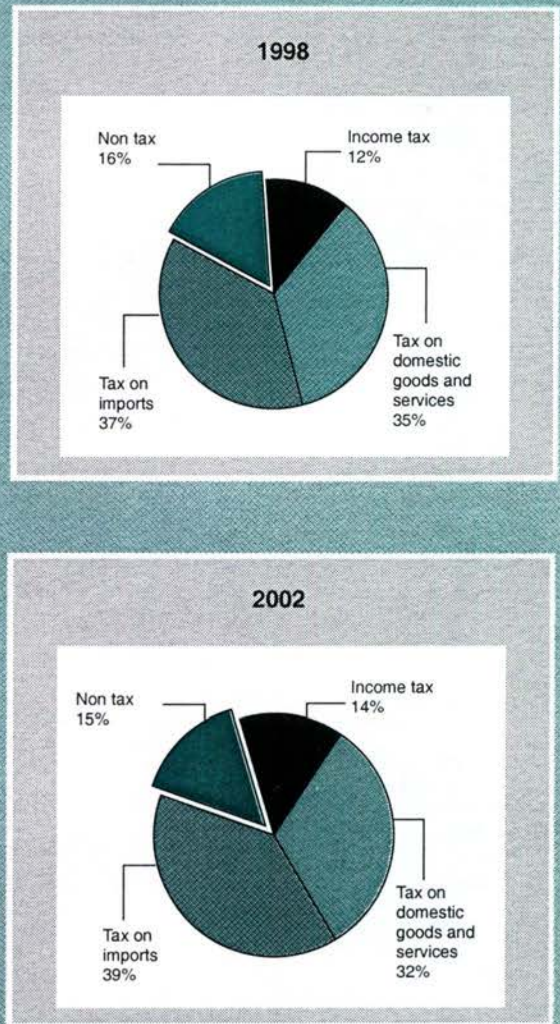
The government was able to reduce its liabilities to the banking system in 2002, after five years. As a result, total government liabilities to the banking system declined by Rs.4.8 billion. This was a net outcome of a reduction in government liabilities to the Central Bank by Rs.13.3 billion and an increase in the government's liabilities to commercial banks by Rs.8.4 billion. In comparison, government borrowing from the banking system in 2001 amounted to Rs.48.6 billion, the net result of an increase in government liabilities to commercial banks by Rs.55 billion and a decline in liabilities to the Central Bank of Rs.6.4 billion. Improved liquidity in the domestic market, transparent government debt management and the revival of investor confidence were some of the main factors that contributed to increased investment in government securities by the non-bank sector in 2002. This development helped reduce the monetisation of fiscal operations, lowering inflationary pressure.

The most favourable development in debt management was the securitisation of unplanned and high cost government borrowing by absorbing such borrowing into the normal public debt programme. Borrowing from the two state banks through overdraft facilities and the non-payment of realised letters of credit (LC), were two ways of financing the widening resources gap, by resorting to means outside the normal borrowing programme. As a result, the outstanding stock of overdrafts and LCs amounted to Rs.50.5 billion at end 2001. With a view to adopting more prudent and transparent fiscal management practices, Budget 2002 proposed the securitisation of this accumulated debt and the imposition of limits on such borrowing for budgetary financing. Accordingly, the outstanding overdrafts with the two state banks were reduced to Rs.3.6 billion by absorbing Rs.34.5 billion into the marketable government securities programme.

8.3 Revenue

In spite of the tax reforms that were undertaken to simplify the tax system, broaden the tax base and improve tax administration, tax revenue as a percentage of GDP has continued to fall, declining to 14 per cent of GDP in 2002 from 14.6 per cent in 2001. The poor performance in tax revenue collection has been due to several factors. The fiscal incentive package granted in October 2001 and the concessions granted in Budget 2002 have contracted the tax base. The sluggish recovery of the economy, the implementation of major tax reforms, combined with a wide tax amnesty reduced the potential tax revenue collection in 2002. The increase in non-tax revenue to 2.5 per cent of GDP in 2002 from 2.0 per cent in 2001, however, helped maintain the total revenue to GDP ratio at 16.5 per cent, almost the same level as in 2001. The improvement in non-tax revenue was mainly due to higher profit transfers from the Central Bank and the payment of interest dues to the government on on-lending activities, by public enterprises.

Chart 8.2
Composition of Revenue



Tax Revenue

In 2002, tax revenue collected amounted to Rs.221.8 billion, growing by 8 per cent over 2001. However, the share of tax revenue to total revenue declined to 85 per cent from 88 per cent in 2001. The composition of taxes remained the same with 83 per cent of tax revenue coming from consumption taxes, and

TABLE 8.2
Economic Classification of Revenue by Component

Rs. million

Item	1998	1999	2000	2001	2002 Approved Estimates	2002 Provi-sional	2003 Approved Estimates
Tax revenue	**147,368**	**166,029**	**182,392**	**205,840**	**237,149**	**221,786**	**264,771**
Income taxes	20,429	28,228	27,457	34,636	38,992	37,619	48,483
Personal	8,099	9,169	10,820	12,203	13,837	12,172	14,646
Corporate	11,788	18,362	15,757	18,673	22,906	13,934	19,937
Save the Nation Contribution	542	697	880	1,027	-	-	-
Tax on interest	-	-	-	2,733	2,250	11,513	13,900
Stamp duties	7,079	7,690	8,163	8,415	3,407	2,511	-
Debits tax	-	-	-	-	2,300	1,312	4,100
Taxes on goods and services	91,706	102,391	122,802	136,633	158,475	148,540	172,676
Turnover tax	16,166	1,799	1,708	1,119	548	733	-
GST/VAT	23,177	35,540	43,893	45,900	87,835	66,458	120,435
Manufacturing	5,533	5,533	11,378	12,521	19,084		
Non-manufacturing	5,437	14,211	13,643	14,453	25,777	35,528	58,812
Imports	12,207	15,796	18,872	18,961	42,974	30,930	61,623
Excise Tax	30,293	35,928	42,655	44,978	52,321	52,099	49,406
Liquor	7,665	8,745	9,531	9,795	10,300	10,228	10,940
Cigarettes	15,051	17,205	19,268	19,475	21,204	20,578	20,713
Petroleum	6,097	7,241	10,700	12,948	17,102	16,706	13,633
Other	1,480	2,737	3,156	2,760	3,715	4,587	4,120
National Security Levy	21,079	28,127	33,539	43,065	17,211	28,695	-
Licence fees/Motor vehicles tax	991	997	1,007	1,570	560	555	2,835
Taxes on international trade	28,154	27,720	23,970	26,156	33,975	31,804	39,512
Imports	28,154	27,720	23,970	26,156	29,775	28,307	33,446
Ports and Airports Development Levy	-	-	-	-	4,200	3,497	6,066
Non tax revenue	**27,664**	**29,877**	**28,890**	**28,456**	**41,053**	**39,478**	**39,162**
Property income	18,462	18,988	18,842	17,406	28,584	25,808	24,259
of which: Central Bank profits	2,650	3,000	3,200	5,000	10,000	10,000	10,000
Interest income	7,786	7,056	7,304	7,626	11,203	11,509	9,548
Fees and charges	2,890	3,375	3,589	3,811	4,764	4,370	4,590
Other non-tax revenue	6,312	7,514	6,459	7,239	7,705	9,301	10,314
Total revenue	**175,032**	**195,905**	**211,282**	**234,296**	**278,202**	**261,264**	**303,933**
			As a percentage of GDP				
Tax revenue	**14.5**	**15.0**	**14.5**	**14.6**	**15.0**	**14.0**	**14.9**
Income taxes	2.0	2.6	2.2	2.5	2.5	2.4	2.7
Personal	0.8	0.8	0.9	0.9	0.9	0.8	0.8
Corporate	1.2	1.7	1.3	1.3	1.4	0.9	1.1
Save the Nation Contribution	0.1	0.1	0.1	0.1	-	-	-
Tax on interest	0.0	0.0	0.0	0.2	0.1	0.7	0.
Stamp duties	0.7	0.7	0.6	0.6	0.2	0.2	0.0
Debits tax	-	-	-	-	0.1	0.1	0.2
Taxes on goods and services	9.0	9.3	9.8	9.7	10.0	9.4	9.7
Turnover tax	1.6	0.2	0.1	0.1	...	...	...
GST/VAT	2.3	3.2	3.5	3.3	5.5	4.2	6.8
Manufacturing	0.5	0.5	0.9	0.9	1.2	0.0	0.0
Non manufacturing	0.5	1.3	1.1	1.0	1.6	2.2	3.3
Imports	1.2	1.4	1.5	1.3	2.7	2.0	3.5
Excise tax	3.0	3.2	3.4	3.2	3.3	3.3	2.8
Liquor	0.8	0.8	0.8	0.7	0.6	0.6	0.6
Cigarettes	1.5	1.6	1.5	1.4	1.3	1.3	1.2
Petroleum	0.6	0.7	0.9	0.9	1.1	1.1	0.8
Other	0.1	0.2	0.3	0.2	0.2	0.3	0.2
National Security Levy	2.1	2.5	2.7	3.1	1.1	1.8	0.0
License fees/Motor vehicles tax	0.1	0.1	0.1	0.1	0.0	0.0	0.2
Taxes on international trade	2.8	2.5	1.9	1.9	2.1	2.0	2.2
Imports	2.8	2.5	1.9	1.9	1.9	1.8	1.9
Ports and Airports Development Levy	-	-	-	-	0.3	0.2	0.3
Non tax revenue	**2.7**	**2.7**	**2.3**	**2.0**	**2.6**	**2.5**	**2.2**
Property income	1.8	1.7	1.5	1.2	1.8	1.6	1.4
of which: Central Bank profits	0.3	0.3	0.3	0.4	0.6	0.6	0.6
Interest income	0.8	0.6	0.6	0.5	0.7	0.7	0.5
Fees and charges	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Total revenue	**17.2**	**17.7**	**16.8**	**16.7**	**17.5**	**16.5**	**17.1**

Source: Ministry of Finance

the rest from income taxes. Taxes on imports increased to 46 per cent of total tax revenue in 2002 from 44 per cent in 2001, while the share of taxes on domestic goods and services declined to 37 per cent from 39 per cent in 2001.

Although revenue from income taxes declined marginally to 2.4 per cent of GDP in 2002 from 2.5 per cent in 2001, the performance of the different sources of income tax was mixed. Revenue from corporate taxes declined significantly to 0.9 per cent of GDP from 1.5 per cent in 2001. Revenue from personal income taxes fell marginally to 0.8 per cent of GDP from 1.0 per cent in 2001. However, higher revenue collection from the Withholding Tax in 2002 offset the weak performance in corporate and personal income taxes, preventing a larger reduction in overall revenue from income taxes.

Corporate tax collection in 2002 sharply declined by 25 per cent over 2001, due to several reasons. The removal of the 20 per cent surcharge on corporate taxes had a large impact. Further, the abolition of the Advance Company Tax (ACT) from 01 April 2002 reduced revenue by eliminating the advanced collection of taxes on the distribution of dividends, while allowing companies to set off any previous ACT paid against their current year's tax liability. Similarly, although investment tax allowances were abolished with effect from 01 April 2000, unclaimed balances that can be set off when calculating taxable income are still available to companies that have made large capital investments in the past, considerably reducing corporate tax collection from these institutions. Lower tax payments by certain key government enterprises, such as SLPA, has also significantly reduced corporate tax collection in 2002. The introduction of a lower tax rate of 20 per cent from 01 April 2002, for companies with a taxable income of less than Rs.5 million, encouraged companies to avail themselves of this lower tax rate, reducing the potential corporate tax revenue collection.

The Inland Revenue (Special Provisions) Act No. 7 of 2002 provided a tax amnesty to persons who had not declared their income or assets up to 31 March 2002. This amnesty, which originally covered only income taxes, was extended to cover the collection of taxes, duties, levies and penalties under 26 Acts. Under the new Act those who wished to make use of this tax amnesty were expected to make a declaration and file tax returns for the income tax year 2002/2003 by 30 June 2003. Any person who made such a declaration would enjoy full immunity from liability to any tax, levy or duty and any penalties and from any investigation or prosecution for any offence under any of the laws stated in the Act. In addition, any investigation or prosecution which was in progress would be withdrawn. Since this tax amnesty covers the current tax year (2001/2002) as well, it has had a negative impact on tax collection in 2002. However, the benefits of the tax amnesty on government tax revenue will be observed from 2003.

There was a marginal decline in personal income tax collections in 2002. The increase in the tax free threshold to Rs.240, 000 from Rs.144,000 and the upward revision of tax slabs with effect from 01 April 2002 contributed to this lower tax collection. The removal of the Save the Nation Contribution in October 2001 also contributed to the lower revenue collection from personal income taxes. The Inland Revenue Department has taken active measures in the last few years to broaden the tax base by opening a large number of new tax files. This is expected to have a positive impact on tax collection in the future.

Revenue from withholding taxes increased sharply in 2002, to Rs.11.5 billion in 2002, from Rs.2.7 billion collected in 2001. Over 75 per cent of withholding tax revenue in 2002 was on interest income from government securities. The extension of withholding taxes to government securities from 01 May 2002 and the mode of collecting this tax, contributed to this higher revenue collection. In the case of government marketable instruments, the tax is deducted upfront based on the yield to maturity of the securities at the time of issue. The issue of securities with longer maturities further increased the revenue from this tax.

Revenue from taxes on consumption declined in 2002 to 11.6 per cent of GDP from 12.1 per cent in 2001. While revenue from taxes on domestic goods and services declined to 5.2 per cent of GDP in 2002 from 5.7 per cent in 2001, taxes on imports remained at the same level as in 2001 at 6.4 per cent of GDP. The consolidation of GST and NSL into VAT was intended to improve revenue collection by simplifying the tax system, removing distortions in the tax system caused by cascading taxes and broadening the tax base by reducing the number of exemptions. However, the combined revenue collected from GST, NSL and VAT in 2002 fell to 6 per cent of GDP from 6.3 per cent in 2001. Tax revenue from GST, NSL and VAT on domestic goods and services fell to 3.1 per cent of GDP in 2002 from 3.3 per cent in 2001. Although the intention was to bring all commodities that were liable to both GST and NSL under VAT at 20 per cent, and those that were liable either to GST or NSL under VAT at 10 per cent, and to exempt from VAT all commodities that were exempt from both GST and NSL, there were anomalies in the application of VAT. Some services that had hitherto been liable to NSL, such as certain financial services and hire purchase transactions were exempt from VAT. Some sectors, such as the construction industry, became liable to lower rates under VAT than under GST and NSL. Both those changes reduced revenue. The implementation of a multiple VAT structure has adversely affected revenue collection. Certain final goods and services, such as construction and leasing, are liable to VAT at 10 per cent, while inputs into those sectors are liable at 20 per cent. That has enabled suppliers to claim higher input credits on purchases than VAT payable on sales. Revenue from GST, NSL and VAT on imports remained at the same level as in 2001 at 3 per cent of GDP, although there was a significant growth in imports during the second half of 2002. The exemption of some key commodities from VAT, such as pharmaceuticals, wheat grain and crude oil, which were previously liable to NSL, considerably reduced tax revenue collected on imports in 2002.

Revenue collected from excise taxes grew by 16 per cent to Rs.52 billion in 2002, increasing the revenue to GDP share to 3.3 per cent from 3.2 per cent in 2001. Higher excise tax collection from petroleum products and motor vehicles mainly accounted for this increase. Revenue from excise taxes on petroleum products rose by 29 per cent to Rs.16.7 billion. The main reasons for this significant growth were the payment of excise taxes in arrears amounting to over Rs.2 billion by the CPC and the conversion of excise duties on petroleum products from an ad valorem rate of 35 per cent to a specific excise duty initially at Rs.24 per litre on petrol and Rs.4 per litre on diesel, with kerosene being exempted. Excise rates were subsequently revised in August 2002 with the introduction of the VAT, to Rs.21 per litre on petrol, Rs.3 per litre on diesel, and an excise tax of Rs.1.25 per litre on kerosene was introduced. Revenue collection from excise taxes on motor vehicles grew significantly by 66 per cent in 2002 to Rs.4.6 billion. The increase in revenue from excise taxes on motor vehicles reflected the sharp growth in motor vehicle imports in 2002.

Revenue from excise taxes on cigarette sales rose by 6 per cent to Rs.20.6 billion. Although there was a downward revision in excise tax rates on cigarettes to compensate for the imposition of VAT on cigarette sales, the steady growth in sales of cigarettes liable to higher excise rates and the upward revision of excise taxes on certain brands of cigarettes during the latter part of 2002, contributed to this growth in excise tax collection. A bold policy decision to reduce excise taxes on shorter brands of cigarettes, enabling the legal industry to compete with the illegal white cigarette industry has paid off, with sales in those brands growing rapidly. This too has had a positive impact on revenue collection in 2002.

In order to simplify the tax structure and facilitate administration, Budget 2002 made the Excise Department the sole collector of excise taxes on liquor by abolishing the Excise (Special Provisions) duty on liquor. Excise duty rates under the Excise Ordinance on locally manufactured hard liquor and customs duty on imported hard liquor were adjusted to ensure revenue neutrality. Growth in both soft and hard liquor production in 2002 increased excise revenue collection from liquor to Rs.10.2 billion in 2002, a growth of 4 per cent over the previous year.

Although revenue from import duties grew by 8 per cent in 2002 there was a marginal reduction in its share of revenue to GDP to 1.8 per cent from 1.9 per cent in 2001. The reduction in the share was mainly on account of lower collections from the import surcharge. Total collections from the import duty surcharge fell to Rs.4.6 billion in 2002 from Rs.5.4 billion in 2001, as a consequence of the reduction in the surcharge to 20 per cent from 40 per cent with effect from 15 April 2002. Revenue from import duties (excluding the surcharge) however, grew by 14 per cent in 2002, mainly due to the strong recovery in imports during the second half of 2002. The average duty rate (the ratio of import duty collection excluding the import duty surcharge, to total value of imports) rose marginally to 4.1 per cent in 2002 from 3.9 per cent in the previous year with the inclusion into the tax net, with effect from November 2002, of several items that had hitherto been imported duty free. The full impact of this measure, however, would be realised in 2003. The effective duty rate (the ratio of total duty collected excluding the import duty surcharge, to dutiable imports) however, declined to 14.7 per cent from 15.3 per cent, due to the inclusion of a large number of items that were outside the tax net at duty rates of 2 per cent and 10 per cent.

The complicated structure of stamp duties collected by the central government was abolished with effect from end April 2002. Although PAL was introduced with effect from 01 May 2002 to recoup the revenue lost from the abolition of stamp duties on imports, the introduction of PAL at 1 per cent (0.75 per cent for imports into export processing industries) and various exemptions lowered the revenue yielded from this tax. The introduction of the debits tax of 0.1 per cent on debits from current accounts with effect from 01 June 2002, was intended to recoup some of the revenue lost from the abolition of the stamp duty on financial transactions. However, the revenue collected from this tax, was less than expected because of the large number of exemptions and the narrow base on which the debits tax was imposed. Consequently, the combined revenue collection in 2002 from stamp duties for the first four months and PAL and the debits tax thereafter, was lower than the revenue collected from stamp duties in 2001.

Non Tax Revenue

Non tax revenue in 2002 increased by Rs.11 billion to Rs.39.5 billion from Rs.28.5 in 2001, although there was a shortfall from the target of Rs.41 billion. As a percentage of GDP, non tax revenue collection rose to 2.5 per cent in 2002 from 2 per cent in 2001. The favourable performance in non tax revenue collection was mainly due to higher profit transfers from the Central Bank (Rs.11 billion, of which Rs.1 billion was paid in advance in 2001 to finance budgetary operations in 2001) and the collection of interest dues on on-lending by the government (Rs.11.5 billion). Of the total interest payments to the government CEB, accounted for the largest payment, amounting to nearly Rs.5 billion. This included interest payments rescheduled from 2001, amounting to Rs.1.5 billion. Profits and dividend transfers from public enterprises other than the Central Bank, was Rs.2.3 billion lower than budgeted, mainly due to the non payment of a special levy by SLPA (Rs.2.5 billion). A shortfall in social security contributions (Rs.1.1 billion) and lower rent collection (Rs.0.7 billion) also contributed to reducing the full potential of non tax revenue in 2002.

8.4 Expenditure

In 2002, the government made strenuous efforts to avert expenditure overruns by applying strict expenditure controls and pruning wasteful and non-priority expenditure. Budget 2002 planned to contain current expenditure to 21 per cent of GDP, while maintaining public investment at 5.4 per cent of GDP. The current expenditure to GDP ratio was kept below the target at 20.8 per cent, as a result of improved expenditure rationalisation. However, the public investment programme did not reach the expected level. The streamlining of rupee funded investments due to budgetary constraints and implementation delays in foreign funded projects, limited expenditure on public investment to 4.6 per cent of GDP. Compared to 2001, current expenditure and expenditure on public investment declined by 0.8 per cent of GDP and 1.4 per cent of GDP respectively in 2002. Consequently, total expenditure as a percentage of GDP declined to 25.4 per cent in 2002 from 27.5 percent in 2001.

Current Expenditure

Current expenditure as a percentage of GDP declined from 21.6 per cent in 2001 to 20.8 per cent in 2002, mainly due to the reduction in defence expenditure, as a consequence of the ongoing peace process, better targetting of welfare programmes and the enforcement of strict controls on transfers to public institutions and other levels of government. In nominal terms, current expenditure increased by 9 per cent over the previous year to Rs.330.3 billion in 2002. Salaries and wages, which grew by 13 per cent, amounted to Rs.88.8 billion and accounted for 27 per cent of the current expenditure in 2002. The growth of the salary bill in nominal terms reflects the combined outcome of the full year's impact of the interim allowance of Rs.1,200 per month, which was granted from October 2001 to all public sector employees, and the effect of the normal annual salary increments. The possible increase in expenditure on salaries and wages was partly arrested because of the suspension of new recruitment to all government departments and agencies, except for recruitment to certain technical and professional grades. This enabled the wage bill to be maintained at 5.6 per cent of GDP as in the previous year.

As strict controls were enforced to curtail non-priority current expenditure, the expenditure on other goods and services incurred by the central government (excluding defence) fell significantly by 24 per cent. The cost of defence related goods and services also recorded a significant reduction of 26 per cent between the two years. Although there were expenditure overruns due to the relocation of military bases with the ceasefire agreement and increased cost of food rations for the armed forces, reduced imports of military equipment and hardware with the cessation of hostilities, more than compensated for these increases.

A salutary development in 2002 was the maintenance of defence expenditure (excluding expenditure on public order and safety), close to the budgeted level at Rs.49.2 billion. This was a 9 per cent reduction over the previous year. As a share of GDP, defence related expenditure declined to 3.1 per cent compared to 3.9 per cent in 2001, highlighting the direct benefit from the cessation of hostilities in the North and the East. Meanwhile, the cost of maintaining law and order was Rs.15 billion in 2002 compared to Rs.14 billion in the previous year.

Interest payments, which accounted for 35 per cent of recurrent expenditure in 2002, was the largest single item of current expenditure. In nominal terms, interest payments grew by 24 per cent compared to the previous year, while in GDP terms it rose to 7.4 per cent from 6.7 per cent. This increase was entirely due to the accumulation of high cost domestic debt. The interest on domestic debt amounted to Rs.105.9 billion (6.7 per cent of GDP), an increase of 25 per cent over the previous year. The increased volume of domestic borrowing caused by expanding budget deficits and the shortfalls in other financing sources, coupled with high interest rates in 2000 and 2001, pushed up the domestic interest cost in 2002. Favourable effects of the downward movement in

Chart 8.3
Composition of Current Expenditure

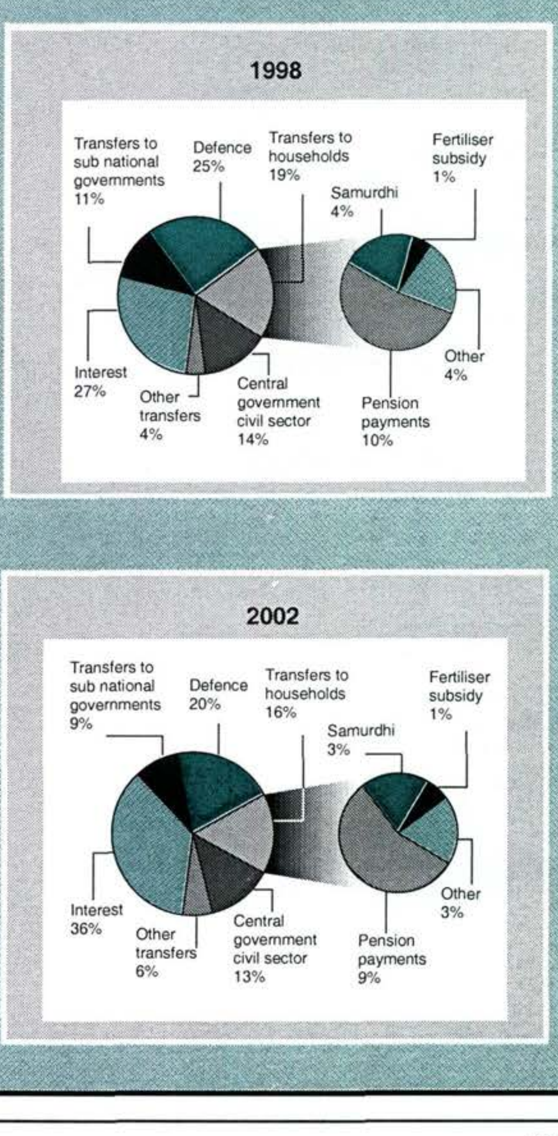


TABLE 8.3
Economic Classification of Expenditure and Lending minus Repayment

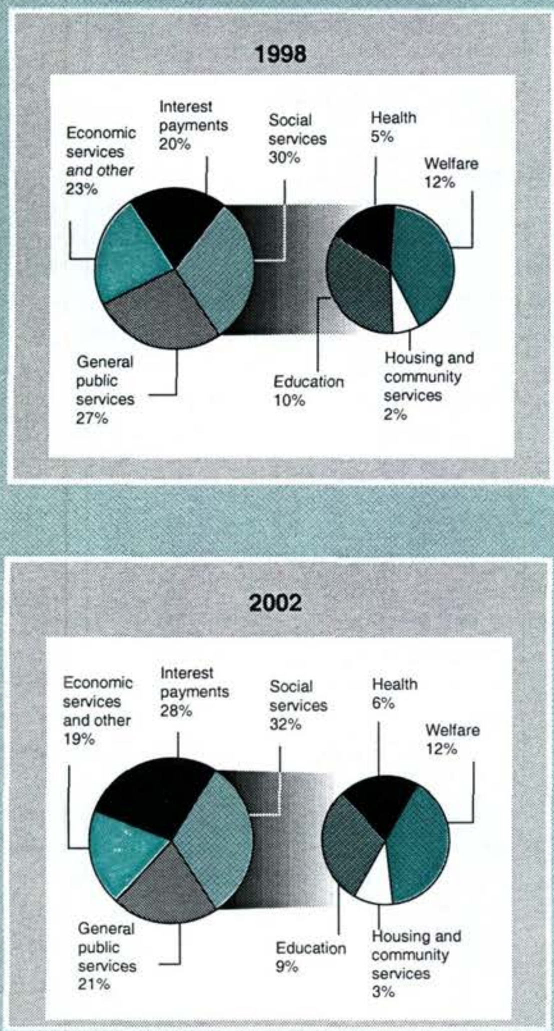
Rs. million

Item	1998	1999	2000	2001	2002 Approved Estimates	2002 Provi-sional	2003 Approved Estimates
Current expenditure	**199,648**	**207,271**	**254,279**	**303,362**	**332,565**	**330,267**	**344,611**
Expenditure on goods and services	97,767	98,223	130,765	143,747	142,127	138,919	137,820
Salaries and wages	53,879	58,532	68,544	78,056	89,931	88,804	90,709
Other goods and services	43,887	39,690	62,221	65,691	52,196	50,115	47,111
Interest payments	54,898	62,123	71,200	94,307	117,184	116,515	130,178
Foreign	7,300	8,752	9,015	9,747	11,389	10,617	14,680
Domestic	47,598	53,371	62,185	84,560	105,795	105,897	115,498
Current transfers and subsidies	46,983	46,925	52,314	65,308	73,254	74,834	76,613
To public corporations	2,967	3,277	3,370	4,376	4,495	8,393	5,412
To public institutions	4,320	4,834	5,705	6,919	12,574	12,091	12,464
To sub national govenments	1,977	1,629	1,424	694	715	392	650
To households and other sectors	37,720	37,185	41,815	53,319	55,471	53,958	58,087
Food stamps, food subsidy etc.	-	334	435	681	740	740	985
Janasaviya / Samurdhi	8,652	8,020	9,661	12,574	9,950	9,910	9,000
Pensions	19,477	19,056	21,602	26,493	31,863	31,123	33,553
Fertiliser subsidy	2,152	1,390	1,733	3,650	2,000	2,448	2,000
Other	7,438	8,385	8,384	9,921	10,918	9,737	12,549
Capital expenditure	**54,160**	**60,340**	**67,769**	**67,902**	**70,632**	**58,594**	**81,612**
Acquisition of real assets	32,246	32,933	32,934	36,115	43,716	26,501	51,403
Capital transfers	21,915	27,407	34,835	31,787	26,916	32,094	30,210
To public corporations	6,801	9,075	12,048	6,973	6,294	11,459	7,179
To public institutions	13,285	15,968	14,522	18,351	14,884	15,118	17,558
To sub national govenments	1,764	2,297	8,218	6,251	5,531	5,421	5,000
Other	65	67	47	212	207	96	472
Lending minus repayments	**14,371**	**11,548**	**13,775**	**15,254**	**10,430**	**13,504**	**12,147**
Advance accounts	2,784	1,585	2,638	2,044	1,500	1,336	1,500
On lending	14,118	11,096	13,187	14,590	14,277	13,582	13,366
Restructuring costs	3,688	4,556	4,159	5,320	5,473	4,689	5,497
Loan repayments	-6,218	-5,689	-6,209	-6,699	-10,820	-6,103	-8,216
Memorandum Item:							
Transfers to Provincial Councils (a)	20,594	22,787	30,731	31,491	37,325	35,789	36,700
Current	19,194	21,122	23,220	26,405	31,684	30,574	31,700
Capital	1,400	1,665	7,511	5,086	5,641	5,215	5,000
Total expenditure and net lending	**268,179**	**279,159**	**335,823**	**386,518**	**413,627**	**402,365**	**438,370**
	As a percentage of GDP						
Current expenditure	**19.6**	**18.7**	**20.2**	**21.6**	**21.0**	**20.8**	**19.3**
Expenditure on goods and services	9.6	8.9	10.4	10.2	9.0	8.8	7.7
Salaries and wages	5.3	5.3	5.5	5.5	5.7	5.6	5.1
Other goods and services	4.3	3.6	4.9	4.7	3.3	3.2	2.6
Interest payments	5.4	5.6	5.7	6.7	7.4	7.4	7.3
Foreign	0.7	0.8	0.7	0.7	0.7	0.7	0.8
Domestic	4.7	4.8	4.9	6.0	6.7	6.7	6.5
Current transfers and subsidies	4.6	4.2	4.2	4.6	4.6	4.7	4.3
To public corporations	0.3	0.3	0.3	0.3	0.3	0.5	0.3
To public institutions	0.4	0.4	0.5	0.5	0.8	0.8	0.7
To sub natioanl governments	0.2	0.1	0.1	...	...		...
To households and other sectors	3.7	3.4	3.3	3.8	3.5	3.4	3.3
Food stamps, food subsidy etc.	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Janasaviya / Samurdhi	0.8	0.7	0.8	0.9	0.6	0.6	0.5
Pensions	1.9	1.7	1.7	1.9	2.0	2.0	1.9
Fertiliser subsidy	0.2	0.1	0.1	0.3	0.1	0.2	0.1
Other	0.7	0.8	0.7	0.7	0.7	0.6	0.7
Capital expenditure	**5.3**	**5.5**	**5.4**	**4.8**	**4.5**	**3.7**	**4.6**
Acquisition of real assets	3.2	3.0	2.6	2.6	2.8	1.7	2.9
Capital transfers	2.2	2.5	2.8	2.3	1.7	2.0	1.7
To public corporations	0.7	0.8	1.0	0.5	0.4	0.7	0.4
To public institutions	1.3	1.4	1.2	1.3	0.9	1.0	1.0
To sub national governments	0.2	0.2	0.7	0.4	0.3	0.3	0.3
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Lending minus repayments	**1.4**	**1.0**	**1.1**	**1.1**	**0.7**	**0.9**	**0.7**
Advance accounts	0.3	0.1	0.2	0.1	0.1	0.1	0.1
On lending	1.4	1.0	1.0	1.0	0.9	0.9	0.7
Restructuring costs	0.4	0.4	0.3	0.4	0.3	0.3	0.3
Loan repayments	-0.6	-0.5	-0.5	-0.5	-0.7	-0.4	-0.5
Memorandum item:							
Transfers to Provincial Councils (a)	2.0	2.1	2.4	2.2	2.4	2.3	2.1
Current	1.9	1.9	1.8	1.9	2.0	1.9	1.8
Capital	0.1	0.2	0.6	0.4	0.4	0.3	0.3
Total expenditure and net lending	**26.3**	**25.2**	**26.7**	**27.5**	**26.1**	**25.4**	**24.6**

(a) Current transfers to provincial councils are classified under expenditure on goods and services and capital transfers to provincial councils are classified under capital transfers to sub national governments.

Source: Ministry of Finance

Chart 8.4
Expenditure by Function



interest rates in the latter part of 2002 would be realised in the interest costs in 2003 and later.

Interest payments on Treasury bonds amounting to Rs.36.4 billion, recorded a sharp increase of 46 per cent over the interest payments in 2001 and accounted for 33 per cent of the domestic interest cost. The full impact of the sharp increase in the Treasury bond stock, borrowed at high interest rates before 2002, and the increase in the outstanding stock by Rs.44 billion during the first half of 2002, could be cited as the main reasons for the high interest payments in 2002. The lower coupon rates on Treasury bonds in 2002 had a favourable impact on the present interest cost. However, as almost all issues of Treasury bonds were sold at a discount, the actual interest was higher than coupon rate. This would be an additional interest cost at the time of maturity of these bonds, causing an unfavourable impact on future budgets. The Treasury bonds maturing in 2002 recorded such interest liabilities amounting to Rs.6.7 billion.

The interest cost on Rupee securities, at Rs.38.2 billion, accounted for 36 per cent of total domestic interest payments. The interest payments on Rupee loans as a share of total domestic interest has declined in recent years, reflecting the combined effect of the policy of less reliance on non-market based debt instruments and the issue of Rupee loans with relatively lower interest rates.

Expenditure on account of interest payments on Treasury bills rose from Rs.18.4 billion to Rs.25.7 billion in 2002, increasing its share in total domestic interest payments to 25 per cent from 22 per cent in the previous year. New issues of Treasury bills amounting to Rs.40 billion, a part of which was issued for the securitisation of government overdrafts, and the change in the composition of Treasury bills to shorter maturities in 2002, were the main reasons for the rise in interest payments. However, the lower interest rates that prevailed during the year helped mitigate this increase.

Interest payments on government overdrafts and outstanding import bills with the two state banks amounted to Rs.4.4 billion compared to Rs.6.1 billion in 2001. The replacement of the high cost government overdraft with marketable debt instruments reduced the outstanding overdraft of the government from Rs.38 billion at end 2001 to Rs.3.6 billion at end 2002. This measure had a bearing on lowering the interest cost and reducing the pressure on the government's cash flow.

Total current transfers and subsidies amounted to Rs.74.8 billion (4.7 per cent of GDP) a growth of 15 per cent over 2001. However, transfers to households, net of pension payments amounting to Rs.21.4 billion declined by 14 per cent in 2002. As a percentage of GDP, they decreased to 1.4 per cent from 1.8 per cent in 2001. The adoption of better targetting mechanisms for welfare programmes, to reach genuinely vulnerable groups, helped this cost reduction. Expenditure on pension payments increased by 17 per cent with the full year impact of the increase in pension payments (Rs.750 per month) granted in October 2001, payment of pension arrears and the increase in the number of retirees by 15,000 in 2002. The introduction of a contributory pension scheme for new recruits to the public sector from 2003 would enable the government to reduce its unfunded pension liability..

The introduction of more effective screening mechanisms, resulting in better targeting, reduced expenditure on the Samurdhi programme from Rs.12.6 billion in 2001 to Rs.9.9 billion in 2002. The number of families obtaining Samurdhi benefits (cash transfers) was reduced by 23 per cent from 1.9 million to 1.4 million. To ensure that benefits are properly targeted and yield results expected from this programme, clearly set out entry and exit criteria should be in place. The enactment of the Welfare Benefits Act in 2002 to make necessary statutory provisions enabling the proper targetting of welfare programmes is of much value. (See box 16).

Box 16

Social Welfare Reforms

1. Introduction

Sri Lanka's achievements in social welfare have been unusually high. Despite remaining a developing country in terms of per capita income, her successes in the areas of literacy, primary school enrolment, gender equality in education, life expectancy, infant and maternal mortality, immunization and other key socio-economic indicators are on par with, or even better than, many developed countries. Sri Lanka has already achieved considerable progress on many indicators identified in the development goals set for the year 2015 in the United Nations Millennium Declaration to which Sri Lanka is a signatory. These achievements have been attributed to the welfare programmes undertaken by successive governments during more than 50 years since independence. Until the late 1970s, the benefits of such programmes were available to all citizens, in terms of free health care facilities, both preventive and curative, free education facilities including at tertiary level, and free food rations to all households. However, economic development in the country was not adequate to sustain these state-funded, universal welfare programmes. Budget deficits ballooned and government debt rose. Consequently, successive governments since 1976 have attempted to rationalise and target these programmes to serve the truly needy, so that their burden on the government budget can be reduced to manageable levels. While state funded health and education facilities have remained, programmes for government transfers to households, both in cash and in kind, have gone through a number of revisions in successive attempts to target them to the truly needy - the poor, the disabled, the disadvantaged children and the elderly.

2. Historical Background

In 1976, in an initial attempt to target welfare transfers, food rations were limited to non income tax payers. Thereafter, in 1979 a food stamp scheme was introduced based on a fixed income criterion for eligibility. By 1986, despite efforts to improve targetting, over 50 per cent (1.84 million) of households were receiving food stamp benefits[1].

The food stamp scheme was replaced in 1989 by the Janasaviya Programme. This Programme introduced a new approach whereby families satisfying a monthly income criterion received monthly benefits for a period of two years in two fixed components, a consumption transfer and an investment transfer. Most of the consumption transfer was expected to be spent on essential food items and the balance on savings. The entire investment transfer was expected to be compulsorily saved, providing collateral at the end of two years for a loan towards an income generating activity. However, during its five years of operation, certain shortcomings were identified. One was that families were provided with fixed benefits, irrespective of their size or their level of income. This was relatively disadvantageous to larger families with lower incomes. In a further attempt to address such shortcomings, this programme was replaced by the Samurdhi Programme in 1995.

The Samurdhi Programme was expected to cover one third of the population at the bottom of the income scale. It also addressed a key shortcoming in the Janasaviya

TABLE 1
Recent Legislative Enactments for Social Welfare Reform

Act	Date	Objective
Janasaviya Act No 4 of 1989	10 May 1989	To make provision for the administration of relief under the Janasaviya programme with a view to maximising the utilisation of human resources, promoting social stability and alleviating poverty, and for connected matters.
Samurdhi Authority of Sri Lanka Act No 30 of 1995	11 December 1995	To establish the Samurdhi Authority of Sri Lanka; and to make provision for the planning and implementation by the Authority of the Samurdhi programme with a view to integrating youth, women and disadvantaged groups into economic and social development activities; and for promoting social stability and alleviating poverty; and for connected matters.
Welfare Benefits Act No 24 of 2002	22 October 2002	To provide the necessary legal framework for the payment of all Welfare Relief Benefits; to set out a transparent selection process by which the recipients of such benefits can be identified; to provide for the termination of such benefits; and to provide for connected matters.

1 IMF Staff Country Report 95 (July 1995)

Box 16 (contd.)

Programme by providing different levels of benefits to families, based on their reported income level and family size, to augment their income to a specified level. Its ultimate objective was to promote self-reliance by nurturing the savings habit and developing income-generating self-employment. It envisaged that beneficiaries would exit this programme once their monthly income exceeded a fixed target for a continuous period of six months or when at least one family member found employment. This would enable new entrants into poverty to join the programme and those who had overcome the poverty threshold to exit.

However, in its seven years of existence, this programme too has been found to have weaknesses in targetting, implementing and monitoring, particularly the ineffective exit process. In fact, recent statistics indicate that a significant share of non-poor families receive Samurdhi benefits, while some of the deserving poor are excluded.

3. Current Welfare Programmes

Currently, Sri Lanka's population comprises approximately 5 million households. Preliminary data from the first three rounds (25 per cent of the sample) of the Household Income and Expenditure Survey (HIES) conducted by the Department of Census and Statistics in 2002 estimated that the percentage of poor households in Sri Lanka was around 24 per cent, where poor households were defined as those that spent more than 50 per cent of their total expenditure on food, while their adult equivalent food expenditure was less than a fixed norm.

Welfare benefit schemes to improve nutrition levels and maternal and child health, as well as to help the disabled and the disadvantaged, administered mainly by the Ministries of Education, Health, Rehabilitation, Resettlement and Refugees and Social Welfare, are expected to cost the government budget around Rs. 10,400 million in 2003. Under the Samurdhi Programme alone, transfer payments to households are expected to cost around another Rs. 9,000 million in 2003.

At end 2002, despite efforts during the year to reduce the cost of the Samurdhi Programme, around 1.9 million households (41 per cent) continued to receive benefits under the Programme, ranging from 75 per cent in Batticaloa District to 15 per cent in Colombo District (Table 3). Data from the first three rounds of the HIES had recorded that of 32.5 per cent of households receiving Samurdhi benefits, less than half (14.4 per cent) were poor households. While monthly payments to households ranged from Rs. 140 to Rs. 1,000, most households received between Rs. 250 and Rs. 700 per month. Yet, the HIES calculated the required per adult equivalent food expenditure to overcome poverty at Rs. 1,338 per month.

Thus, each well intended social welfare reform has had limited success and the level of poverty has not declined materially in the country, although budget deficits and government debt have risen to untenable levels.

Table 2
Central Government Expenditure on Major Welfare Programmes

Rs. mn.

Ministry	Programme	2001	2002 Provisional	2003 Budget
Samurdhi	Samurdhi Benefits	12,574	9,910	9,000
	Infant Milk Food Subsidy	157	120	180
Human Resources Development, Education and Cultural Affairs	School Uniforms	900	799	600
	School Text Books	900	900	1,100
	School Season Tickets	250	250	250
	Other Education Welfare	48	100	79
Health, Nutrition and Welfare	Payments to Disabled Soldiers	2,721	3,235	3,449
	Flood and Drought Relief	290	185	300
	Other Welfare 1/	540	482	1,100
	Assistance to Handicapped Persons & Rehabiltitated Drug Adicts	10	15	18
	Mother and Child Nutrition	36	30	195
	Triposha Nutrition Supplement	488	590	560
Rehabilitation, Reconstruction and Refugees	Refugees	2,568	2,261	2,296
Other	Other Welfare	136	111	245
	Total	**21,618**	**18,989**	**19,372**

1/ Transferred to the Ministry of Rehabilitation, Reconstruction and Refugees from 2003

Box 16 (contd.)

4. The New Welfare Benefits Act

Against this background, the most recent reform was the enactment of the Welfare Benefits Act No 24 of 2002 (WBA) on 22 October 2002. The objective of the WBA is to provide the legal and conceptual framework necessary for the payment of benefits under a Welfare Benefits Scheme that sets out a transparent process by which recipients of these benefits could be selected and exit from the Scheme.

Certain key differences between the WBA and the previous Acts that introduced the Janasaviya and Samurdhi programmes need to be highlighted. The first is that the WBA provides for transparency and accountability not only on the part of the applicant who seeks benefits, but also on the part of officials who sanction those benefits. The second important difference is that the WBA ensures an exit mechanism from all other public assistance schemes in effect for any applicant who has been recognised as being eligible for benefits and has been so informed under the WBA. Also, since the scheme impacts directly on the government budget, unlike in previous state-sponsored welfare programmes, it will come directly under the purview of the Ministry of Finance, so that the implications of the totality of welfare expenditure on the government budget could be regularly reviewed, analysed and addressed. These key differences are expected to minimise leakages that have been endemic under previous programmes for a variety of reasons.

TABLE 3

Households Receiving Benefits under the Samurdhi Programme as at mid 2001

	District [1]	Housing Units [2]	Households receiving Benefits [3]	
		No.	No.	Share
1	Colombo	507,678	77,536	15
2	Gampaha	511,621	159,841	31
3	Kurunegala	411,545	215,770	52
4	Kandy	316,610	130,355	41
5	Galle	253,697	106,306	42
6	Ratnapura	273,447	145,383	53
7	Anuradhapura	206,078	96,730	47
8	Kalutara	270,147	85,460	32
9	Kegalle	211,790	93,711	44
10	Matara	197,552	96,344	49
11	Nuwara Eliya	175,423	53,532	31
12	Badulla	200,076	74,855	37
13	Puttalam	192,295	84,073	44
14	Ampara	145,184	87,023	60
15	Hambantota	148,516	77,282	52
16	Batticaloa	112,778	84,817	75
17	Matale	120,335	63,487	53
18	Moneragala	110,063	57,247	52
19	Trincomalee	81,379	48,430	60
20	Polonnaruwa	98,491	39,416	40
21	Vavuniya	31,849	9,139	29
	Total	4,576,554	1,886,737	41

1/ The Samurdhi Programme did not operate in the four districts of Jaffna, Kilinochchi, Mannar and Mulativu

2/ Census of Population and Housing 2001

3/ Poor Relief Commissioner's Department

The WBA provides for the establishment of a Welfare Benefits Board to be headed by a Commissioner of Welfare Benefits and for the appointment of other technical and administrative officers responsible for its implementation. The WBA also provides for an application process for selection of beneficiaries by Selection Committees and a process of appeal and redress through Appeals Committees, while eligibility of beneficiaries is to be reviewed annually.

Following its enactment, a Steering Committee on Social Welfare Reforms was appointed at end 2002 to develop a plan of action to bring the WBA into operation and implement a new Welfare Benefits Scheme under the WBA. The Steering Committee includes key policy makers and planners from the Ministry of Finance, Samurdhi Authority and the Ministry of Social Welfare, as well as technical and statistical expertise. It is anticipated that the new scheme will introduce the required checks and balances to address shortcomings identified in the existing schemes under one all-encompassing and transparent welfare relief programme, so that government transfers currently going to less needy households could be re-channeled to support the truly deserving at manageable levels for the government budget, with accountability and responsibility built into the conceptual framework to provide a meaningful social safety net.

TABLE 8.4
Functional Classification of Expenditure

Rs. million

Item	1998	1999	2000	2001	2002 Approved Estimates	2002 Provi-sional	2003 Approved Estimates
Current expenditure							
General public services	**66,158**	**63,220**	**82,644**	**82,149**	**83,894**	**80,970**	**87,534**
Civil administration	15,196	14,513	13,416	14,944	18,844	17,473	23,019
Defence	42,496	40,071	56,915	54,242	50,212	49,163	49,721
Public order and safety	8,466	8,636	12,312	12,963	14,838	14,334	14,794
Social services	**63,595**	**66,319**	**77,160**	**87,968**	**112,373**	**106,095**	**110,247**
Education	20,582	21,642	23,794	23,448	34,650	31,161	32,309
Health	10,089	11,215	15,394	14,785	21,278	20,233	20,132
Welfare	31,472	31,164	35,686	44,635	48,214	47,503	52,575
Community services	1,451	2,298	2,286	5,100	8,230	7,199	5,231
Economic services	**10,547**	**10,075**	**12,103**	**15,839**	**15,634**	**17,583**	**15,681**
Agriculture and irrigation	5,444	5,012	5,706	7,967	7,328	7,635	7,006
Fisheries	175	180	338	308	472	435	623
Manufacturing and mining	325	346	726	419	546	736	414
Energy and water supply	757	884	474	565	386	385	8
Transport and communucation	2,934	2,770	3,558	5,350	5,403	7,144	3,472
Trade and commerce	167	167	137	236	508	349	366
Other	745	716	1,165	995	991	901	3,792
Other	**59,349**	**67,657**	**82,372**	**117,405**	**120,665**	**125,618**	**131,150**
of which; interest	54,897	62,123	71,200	94,307	117,184	116,515	130,178
Total current expenditure	**199,648**	**207,271**	**254,279**	**303,362**	**332,566**	**330,266**	**344,611**
Capital expenditure and lending							
General public services	**6,243**	**6,345**	**7,157**	**6,564**	**4,733**	**4,713**	**4,311**
Civil administration	6,243	6,345	5,610	5,478	4,332	4,075	4,087
Public order and safety	-	0	1,547	1,085	401	638	225
Social services	**15,528**	**17,493**	**16,471**	**14,559**	**20,496**	**15,690**	**24,590**
Education	6,112	7,652	7,135	4,838	8,072	6,048	9,736
Health	4,330	4,456	5,302	3,987	6,443	4,713	7,098
Welfare	967	375	415	452	560	212	996
Housing	1,314	1,647	2,061	3,270	3,081	3,505	3,560
Community services	2,804	3,364	1,558	2,012	2,340	1,212	3,200
Economic services	**44,677**	**44,940**	**54,650**	**54,906**	**53,943**	**51,678**	**60,604**
Agriculture and irrigation	6,018	6,211	6,908	6,034	7,719	6,936	9,584
o/w Mahaweli Project	1,049	1,357	1,716	2,237	2,727	2,663	2,874
Fisheries	562	694	899	705	1,672	743	1,304
Manufacturing and mining	2,191	882	764	324	1,806	863	302
Energy and water supply	8,804	10,702	13,282	14,758	13,713	17,732	12,113
Transport and communucation	18,908	16,892	24,911	21,464	20,323	18,916	19,537
Trade and commerce	230	302	296	370	227	151	256
Other	7,965	9,258	7,590	11,251	8,483	6,337	17,509
Other	**1,829**	**2,659**	**2,680**	**6,463**	**5,738**	**96**	**5,472**
Total capital expenditure and lending	**68,278**	**71,436**	**80,955**	**82,491**	**84,908**	**72,176**	**94,977**
			As a percentage of GDP				
Total expenditure							
General public services	**7.1**	**6.3**	**7.1**	**6.3**	**5.6**	**5.4**	**5.2**
Civil administration	2.1	1.9	1.5	1.5	1.5	1.4	1.5
Defence	4.2	3.6	4.5	3.9	3.2	3.1	2.8
Public order and safety	0.8	0.8	1.0	0.9	0.9	0.9	0.8
Social services	**7.8**	**7.6**	**7.4**	**7.3**	**8.4**	**7.7**	**7.6**
Education	2.6	2.6	2.5	2.0	2.7	2.3	2.4
Health	1.4	1.4	1.6	1.3	1.7	1.6	1.5
Welfare	3.2	3.0	3.0	3.4	3.2	3.2	3.1
Housing	0.1	0.1	0.2	0.2	0.2	0.2	0.2
Community services	0.4	0.5	0.3	0.5	0.7	0.5	0.5
Economic services	**5.4**	**5.0**	**5.3**	**5.0**	**4.4**	**4.4**	**4.3**
Agriculture and irrigation	1.1	1.0	1.0	1.0	0.9	0.9	0.9
Fisheries	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Manufacturing and mining	0.2	0.1	0.1	0.1	0.1	0.1	0.0
Energy and water supply	0.9	1.0	1.1	1.1	0.9	1.1	0.7
Transport and communucation	2.1	1.8	2.3	1.9	1.6	1.6	1.3
Trade and commerce	...	...	...	...	...	...	...
Other	0.9	0.9	0.7	0.9	0.6	0.5	1.2
Other	**6.0**	**6.4**	**6.8**	**8.8**	**8.0**	**7.9**	**7.7**
of which: interest	5.4	5.6	5.7	6.7	7.4	7.4	7.3
Total expenditure and lending	**26.3**	**25.2**	**26.7**	**27.4**	**26.3**	**25.4**	**24.7**

Source: Ministry of Finance

The method of calculating the fertiliser subsidy based on changes in international prices encouraged fertiliser imports even at high international prices. This scheme was withdrawn and a fixed subsidy scheme was introduced from October 2002. Under the new scheme domestic prices were allowed to change according to the cost of imports. With this reform the cost of the fertiliser subsidy was maintained below the previous year's level.

The distribution of school uniforms was targeted to benefit the most needy groups in society. Other welfare transfers to households, which include expenditure on textbooks and season tickets for travel, were maintained at budgeted levels by adopting strict monitoring mechanisms. Further, the cessation of hostilities in the North and the East helped maintain payments to disabled soldiers and dry rations to refugees at the targeted levels.

Transfers to public corporations and public institutions increased significantly in 2002. Large operational losses were incurred by the Regional Transport Companies (Rs.2.2 billion), Sri Lanka Railways (SLR) (Rs.2.8 billion) and the Department of Posts (Rs.1 billion). The non- adjustment of prices according to changes in costs (inclusive of the salary increases), as well as management inefficiencies, resulted in higher transfers to public corporations. Wage increases granted in recent years have increased transfers to public institutions. Continuing operational losses in public corporations are not sustainable, as they will exacerbate the fiscal deficit. The losses being met from the government budget places an undue burden on taxpayers who do not consume those services. Restructuring loss making institutions so that prices take into account the operational costs, while minimising inefficiency, are essential to make them financially viable.

Public Investment

The public investment programme of 5.4 per cent of GDP in Budget 2002 was the lowest planned investment programme in recent years. Given the domestic resource constraints and the past experience of using these scarce resources for non-priority capital expenses, Budget 2002 adopted a strict policy in allocating domestic funds for the public investment programme with more emphasis given to absorbing concessional foreign funds. However, only 85 per cent of the resources allocated were utilised and the realised public investment programme was limited to 4.6 per cent of GDP compared to 5.9 per cent of GDP in 2001. Low foreign resource utilisation mainly contributed to the non-realisation of the envisaged targets, while strict controls on rupee funded projects due to resource constraints, and the delay in presenting Budget 2002, also contributed to reduce the public investment programme in 2002.

The expenditure incurred by central government ministries and departments for the acquisition and maintenance of fixed assets in 2002 decreased in nominal terms by 27 per cent over the previous year. As a percentage of GDP it decreased to 1.7 per cent in 2002 from 2.6 per cent in the previous year. In particular, strict controls adopted to contain non-priority rupee funded projects and the purchase of vehicles and other equipment, helped restrict expenditure on capital assets. Total capital transfers to public corporations were significantly higher than the budgetary provisions due to additional transfer of funds from supplementary capital account votes. Actual capital transfers increased by Rs.6 billion over the budgetary target of Rs.26 billion. Transfers to institutions such as the Road Development Authority (RDA), and the National Water Supply and Drainage Board (NWSDB) mainly contributed to this increase. Major investment programmes undertaken by the RDA were the Colombo-Katunayake expressway, the balance work in the second stage of the Baseline Road Project and the Road Network Improvement Project, while Rural Water Supply and Sanitation Projects were carried out by NWSDB in 2002.

The on-lending programme, which provides foreign funds to commercially oriented public enterprises, was maintained at the budgeted level of 0.9 per cent of GDP. This was a marginal decline from the previous year, where on-lending amounted to 1 per cent of GDP. CEB, which uses more than half of the on-lent funds and institutions such as CPC and SLT who receive sizeable amounts under the on-lending programme, were able to carry out most of their projects for 2002. However, SLPA's utilisation rate was about 50 per cent. The persistent low utilisation of foreign funds is a major concern and is an area that should be urgently addressed. Delays in procurement procedures and processes and various administrative delays are some of the major factors influencing the slow disbursement of funds and steps should be taken to resolve these issues, as the lack of sufficient infrastructure would undermine the government's pledge to rejuvenate the economy.

On a functional basis, investment under economic services accounted for 72 per cent of total public investment. Investment in economic services in nominal terms declined to Rs.51.7 billion in 2002 from Rs.54.9 billion in 2001. As a percentage of the GDP it declined to 3.3 per cent from 3.9 per cent in 2001, due to the limitations of funds from domestic sources. However, in addition to the planned investment programme, new investment was allowed through the supplementary capital vote by the Treasury to accommodate priority projects, as well as to absorb foreign concessional funds. As a result NWSDB, RDA and CEB received funds through this vote. Of the total public investment in economic services, CEB (Rs.8.6 billion), NWSDB (Rs.9.9 billion), Mahaweli Development Authority (MDA) (Rs.2.6 billion) and RDA (Rs.9.9 billion) accounted for the major portion of investments, although, investment in SLPA and SLR were below the original targeted levels.

Public investment in social services was maintained at 1 per cent of GDP in 2002 as in 2001. However, these investments were only about three fourths of the targeted level for 2002. In comparison to the annual investment plan, lower levels of realisation were observed mainly in the health and education sectors, while the housing sector recorded investments above the target. The realised investment programme indicates that the education and health sectors accounted for 68 per cent of total investment in the social sector. The lower utilisation of foreign funds in general education, which declined to around 74 per cent, was the main cause of the lower investment in the education sector, while project implementation delays caused the slowdown in investment in the health sector. Although there has been a continuous decline in public investment in education and health, a notable fact is the continuous increase in private investment in these sectors in recent years. This indicates a favourable development, as lower investment by the government due to resource constraints would otherwise have a detrimental effect on the country as a whole. Therefore future policies should be designed to create a conducive environment to encourage more private sector participation in education and health and to maximise the utilisation of available public funds.

Advance Account Operations

Expenditure overruns in net outlays in the advance account was a factor that contributed to expenditure exceeding the targets in the recent past. However, with better monitoring and control, the expenditure through advance accounts in 2002 was maintained within the budgeted level. The operations in advance accounts resulted in a total net outlay of Rs.1.3 billion against the targeted outlay of Rs.1.5 billion in 2002. Of the total net outlay, about 50 per cent was released as loans to employees in central government through the Public Officers' Advance Account.

8.5 Provincial Councils

Slow progress in revenue mobilisation, a continuing upward trend in recurrent expenditure and a marginal increase in capital outlays were the salient features of fiscal operations in PCs in 2002. The total revenue collected by PCs was sufficient to cover only one fifth of their expenditure. The balance was met from transfers from the central government. The central government continued to transfer funds through capital and current grants, as in previous years.

Although PCs were established to delegate power to the sub-national level units of government, they have, from their inception, been dependent on the central government for funds. The main revenue sources devolved to PCs are inadequate to meet a large portion of their expenditures. As a more satisfactory devolution of power has become an important issue, the financial viability of PCs is a matter of major importance. PCs will be expected to tap new sources of revenue and become more efficient in administration.

Revenue

The revenue of PCs in 2002, at Rs.9.4 billion, increased at a slower rate of 8 per cent compared to 15 per cent in 2001. That lower growth resulted from slower growth in revenue from turnover taxes and the decline in stamp duty collection. These two sources and licence fees accounted for 85 per cent of the total revenue of PCs. Revenue from turnover taxes on wholesale and retail businesses grew by 8 per cent. The spill over effect of the slow expansion of imports and wholesale trading activity, which were liable to turnover taxes in the latter part of 2001 and the first half of 2002, mainly contributed to the slower growth in this revenue source. The slowdown in economic activity, which led to slow growth in property transactions, influenced the decline in stamp duty collection. The increase in vehicle registrations after a significant decline in the previous year yielded a 10 per cent growth in revenue from licence fees in 2002.

The Western Provincial Council was dominant in the collection of devolved revenue in 2002 as in the past. With the heavy concentration of business enterprises, the Western Province accounted for 68 per cent of the total revenue mobilised by the PCs, while the Central, Southern and North Western provinces together accounted for 22 per cent. At the other end of the spectrum were Sabaragamuwa, Uva and North Central provinces, jointly collecting the balance 10 per cent. The collection of revenue in the Northern and the Eastern provinces continued to be vested with the central government.

In 2002 PCs continued to perform their agency function of collecting revenue on behalf of local governments (LGs). Although revenue from stamp duty, interest payments and fines imposed and fees collected by courts has been devolved to LGs, the collection is undertaken by PCs. Accordingly, PCs collected a sum of Rs.2.9 billion on behalf of the LG, an increase of 8 per cent over 2001. The transfer of this revenue is, however, based on requests made by the respective LGs. Reflecting the weaknesses in the present revenue collection identification system by LGs, the PCs continued to utilise some of these funds to cover their expenses.

Expenditure

The total expenditure of PCs, which is a little over one tenth of central government expenditure, increased by 14 per cent in 2002. Recurrent expenditure, which grew by 14 per cent, accounted for 84 per cent of total expenditure. The main reason for this high growth was the full impact of the salary increase

Chart 8.5
Budgetary Performance of Provincial Councils-2002

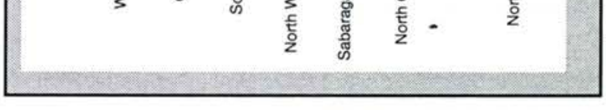


TABLE 8.5
Budget Outturn for Provincial Councils

Rs. million

	1998	1999	2000	2001	2002 Provisional
1 Total revenue	**6,002**	**6,993**	**7,534**	**8,674**	**9,366**
Taxes on production and expenditure	4,114	4,593	5,010	5,533	5,987
Turnover taxes	2,980	3,361	3,705	4,142	4,460
Licence fees	1,127	1,223	1,293	1,372	1,512
Other taxes	8	9	12	20	15
Interest, profits and dividends	129	282	281	355	582
Sales and charges	481	731	759	743	808
Stamp duties	1,267	1,372	1,468	2,006	1,965
Other	11	15	16	37	24
2. Total expenditure	**26,736**	**28,717**	**37,328**	**40,094**	**45,731**
2.1 Current expenditure	25,230	26,284	28,856	33,425	38,268
Functional classification	25,230	26,284	28,856	33,425	38,268
Provincial administration	2,377	2,524	2,129	2,561	2,616
Economic services	1,067	1,154	1,285	1,377	1,717
Social services	21,787	22,605	25,442	29,487	33,935
Economic classification	25,230	26,284	28,856	33,425	38,268
Personal emoluments	19,744	20,431	22,199	26,169	29,993
Other	5,486	5,853	6,657	7,256	8,275
2.2 Capital expenditure	1,506	2,433	8,472	6,669	7,463
Acqusition of capital goods	773	1,140	989	613	713
Capital transfers	75	102	160	85	113
Province Specific Development Projects	0	0	5,523	4,208	3,908
Special projects	0	0	812	1,163	2,127
Other	658	1,191	988	600	602
3 Financing	**20,594**	**22,787**	**31,543**	**30,948**	**37,916**
Block grants	19,194	21,122	23,220	24,699	30,574
Criteria based grants	1,163	1,236	1,323	596	1,000
Matching grants	237	429	665	282	307
Province Specific Development Grants	-	-	5,523	4,208	3,908
Grants for special projects	-	-	812	1,163	2,127

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

awarded in the latter part of 2001 to public servants, resulting in an increase of 15 per cent in the wage bill of PCs. Personal emoluments account for more than three fourths of the total recurrent expenditure of PCs. On a functional basis, current expenditure on social infrastructure claimed 74 per cent of the PC recurrent expenditures, while economic infrastructure claimed around 4 per cent. The Western Provincial Council accounted for 23 per cent of the total current expenditure of the provinces followed by the Central, the Northern and the Eastern provinces, which accounted for 13 per cent each.

Capital expenditure of PCs increased by 12 per cent in 2002. The increase in special foreign funded projects in the irrigated agricultural sector, restoration and rehabilitation of the North and the East and road development in the Southern Province boosted provincial capital expenditure in 2002. However, investment under the Province Specific Development Projects was lower than envisaged, due to the partial release of the Province Specific Development Grant (PSDG). Resource constraints faced by the central government mainly contributed to this decline. Investment in health and education almost reached the targeted levels for the year. Projects associated with provincial roads, roads in backward areas and irrigation were also affected by resources constraints. Special attention needs to be paid to public investment in rural infrastructure projects, as depleted infrastructure would hamper growth in the rural economy

Central Government Transfers

As revenue generated by PCs was sufficient to cover only 20 per cent of their expenditure, the central government continued to supplement their revenue through transfers in 2002. Transfers through block grants, which are used to meet the shortfall in provincial level current expenditure (81 per cent of the total transfers), increased by 23 per cent over the previous year. However, the amount released was Rs.0.8 billion less than budgeted and this was partly offset by increased revenue collected by PCs over the budget targets. The PSDG which was introduced in 2000 for regional development projects identified by PCs, accounted for about 10 per cent of the total transfers and amounted to Rs.3.9 billion. The balance constituted criteria based grants, which finance devolved activities of a capital nature, and matching grants, which is an incentive for efforts made by PCs to enhance revenue collection. Criteria and matching grants were mainly utilised for the acquisition of fixed assets and the rehabilitation and improvement of capital assets.

8.6 Public Enterprise Reform

The government has clearly stated that its goal is to completely move out of all commercial activity that can be more efficiently carried on by the private sector and to address inefficient operations of public enterprises through comprehensive restructuring programmes. In order to achieve these objectives the government reiterated its commitment to the privatisation process, the restructuring of inefficient public enterprises and the liquidation of redundant public enterprises. The public enterprise reform programme in 2002 was therefore, designed to increase private sector activity in several strategic sectors in the economy. This was to be achieved by the divestiture of the government's equity stake in several public enterprises and the liberalisation of sectors that had previously been the monopoly of the state. Several public enterprises were also scheduled to be restructured during 2002. Due to lack of investor interest and various administrative delays, the privatisation of several key institutions was not concluded in 2002. The privatisation programme was confined in 2002 to the divestiture of the government's balance shareholding in several previously privatised public enterprises. Consequently, although the budget envisaged the receipt of privatisation proceeds amounting to Rs.21 billion, actual receipts in 2002 were Rs.5.7 billion.

The government continued the sale of its minority holding (19 per cent) in two plantation companies, namely, Talawakele Plantations Ltd. (Rs.68.5 million) and Malwatte Valley Plantations Ltd (Rs.41.5 million). A 53 per cent stake in Pelwatte Sugar Industries Ltd. (Rs.296 million) and a 90 per cent stake in Sevanagala Sugar Industries (Rs.550 million) were also divested in 2002.

The divestiture of the government's shareholding in Sri Lanka Telecom, (SLT) (39 per cent) had been postponed for several years because of depressed market conditions that prevailed both internationally and locally. However, in 2002, the government was able to divest 12 per cent of its stake in SLT (Rs.3.2 billion) through an offer for sale on the Colombo Stock Exchange. Foreign investors subscribed to 16 per cent of the share issue, while the balance was taken up by domestic retail investors and state and private institutions. The government was looking to divest a larger portion of its shares in the local market (15 per cent) and based on the success of this offer, to go for either an international offer or a private placement of the remaining shares. However, the relatively low level of interest shown by local and foreign investors to the domestic offer prevented them from doing either.

In order to further strengthen the private sector's role in the insurance industry, the government decided to sell its minority holding (39 per cent) in the National Insurance Corporation to its major shareholder Janashakthi Insurance Company Ltd (Rs.288 million). The government was also planning to privatise the Sri Lanka Insurance Corporation in 2002, by divesting 90 per cent of its shareholding. Although several bids were received, the Technical Evaluation Committee required additional information to evaluate the bids and therefore the divestiture was postponed to 2003.

The government announced in Budget 2002 its policy to liberalise the petroleum sector to make it more competitive and efficient. The introduction of an automatic pricing formula for petroleum products at the beginning of 2002 was intended to ensure that the prices of petroleum products reflected market developments, to improve the commercial viability of the industry. The government divested its holdings in Lanka Marine Services (Rs.1.2 billion), a fully owned subsidiary of CPC, engaged in providing bunkering services. The enactment of the Petroleum Products (Special Provisions) Act No. 33 of 2002, was the most significant step taken in 2002 to increase private sector participation in the sector. This legislation provided for the liberalisation of the import and sale of petroleum products and the unbundling of services provided by CPC. This paved the way for the entry of multiple players into the sector.

As part of the reforms in the energy sector, the government enacted the Electricity Reform Act No. 28 of 2002. This legislation sought to reorganise the CEB by unbundling its activities. The monopoly possessed by CEB over power generation and distribution will thus be removed, allowing outside entrants to this sector. The transmission function will, however, continue to be carried out by CEB.

There has been a long felt need for major reforms in the public transport sector. In 2002, the government introduced a bus fares policy, by which bus fares were permitted to be revised annually according to a pricing formula, enabling bus fares to follow changes in costs more closely. The government proposed a private-public partnership in the Regional Bus Companies to improve efficiency and service. The prospective investor was expected to invest in 39 per cent of the equity of the companies and to takeover their management. An offer was made for 6 regional bus companies. However, the transaction was yet to be concluded at the end of the year. Towards the end of 2002, the government called for expressions of interest in the other Regional Bus Companies.

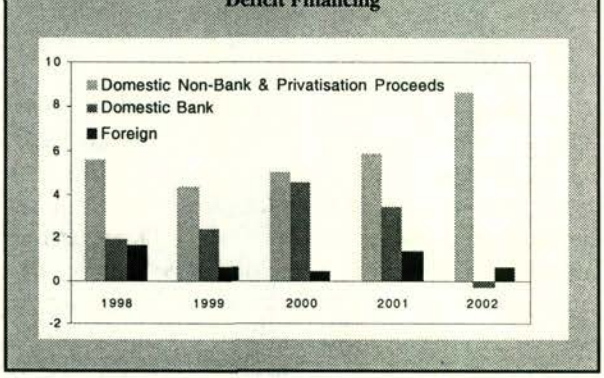
The government has identified several public enterprises that needed to be restructured. The preparatory work in relation to the restructuring of some of these institutions was initiated in 2002, while some public enterprises, such as SLPA, CPC and CWE have already commenced the restructuring process, initiating voluntary retirement schemes in 2002. The government has also instituted a programme to reform the two state banks.

The most recent reforms in public enterprises, particularly those that are engaged in the provision of public utility services, highlights the need for a strong regulatory framework to ensure that the welfare of consumers is protected. PUC and CAA were set up with the objectives of protecting the interests of consumers, promoting competition, preventing unfair trade practices, ensuring the safety and quality of goods and services and ensuring that consumers have adequate access to goods and services. However, adequate attention is crucial in the implementation of these laws, in order to prevent their growth retarding effects, if any.

8.7 Financing the Deficit

The total resources gap of the fiscal outturn in 2002 amounted to Rs.141.1 billion (8.9 per cent of GDP), a 0.4 per cent deviation from the original target (8.5 per cent of GDP). Initially, 65 per cent of the gap was expected to be financed from domestic sources and the balance from foreign sources and privatisation proceeds. In contrast to the original estimates, there was a shortfall of Rs.32.7 billion in net foreign financing (grants and concessional borrowings) and privatisation proceeds. As in previous years, this shortfall was raised entirely from domestic sources. The total amount of resources raised from the domestic sector in 2002 amounted to Rs.126.4 billion (8 per cent of GDP) in comparison to the original target of Rs.88 billion (5.5 per cent of GDP). Despite large borrowings from domestic sources, there was a net repayment of Rs.4.8 billion to the domestic banking sector.

Chart 8.6
Deficit Financing



On the financing front, there were some favourable developments in 2002. First, debt dependency, which is measured as the ratio of total net borrowing relative to the total expenditure of the government, declined significantly. The minimum debt dependency ratio recorded in the recent past was in 1997 (17 per cent). Since then, it increased sharply, to 36 per cent in 2001. Restraint on the resource gap saw a reduction in the debt dependency to 32 per cent in 2002. Second, the liquidity situation in the market and the reduction in the Central Bank's policy rates by 225 basis points in 2002, significantly reduced interest rates on government securities. The raising of resources from SLDBs further reduced the pressure on domestic interest rates. Third, there was increased reliance on market oriented debt instruments in keeping with the debt management strategy. Finally, repayments to the domestic banking system lessened the crowding out of private sector investment, and prevented expansionary pressure on money growth. Despite these positive developments, the continuing high level of under utilisation of concessional foreign resources is a cause for deep concern.

Domestic Borrowing

The improved liquidity situation in the market and reduced market interest rates in 2002 enabled the government to borrow through more market oriented debt instruments at relatively lower cost. Consequently, there was a net repayment of non-marketable debt instruments, in contrast to large borrowing in previous years. The improved market situation also allowed the government to direct its debt management strategy to improve the maturity structure of outstanding government securities by using a more diversified mix of debt instruments and extending the yield curve, thereby reducing the bunching of maturities in future.

Under the market based borrowing strategy of the government, there was a net repayment of Rupee loans amounting to Rs.5 billion in 2002 in comparison to a net borrowing of Rs.29 billion in 2001. The interest rates on Rupee loans issued in 2002 were maintained at 13 per cent with an optional maturity of 2 to 5 years. The issue of Rupee loans with an optional repayment facility allows the government to retire them after two years, if market interest rates decrease. Institutional investors such as EPF (62 per cent) and NSB (32 per cent) were the main investors in Rupee loans in 2002.

The government relied heavily on Treasury bonds to benefit from improved market conditions and net borrowing through this instrument increased substantially to Rs.109 billion from Rs.21 billion in 2001. However, a part of these issues was the result of the securitisation of the government overdraft, following proposals in Budget 2002. Treasury bonds amounting to Rs.69.5 billion were issued as private placements in order to arrest possible undue pressure on interest rates. The maturity period of Treasury bonds varied from 2 to 6 years with coupon rates between 12.50 to 11.50 per cent. The corresponding weighted average yield rates (without withholding tax) ranged from 16.00 to 12.05 per cent. In particular, towards the end of the year, the gap between the coupon rate and the weighted average yield rate (without withholding tax) narrowed markedly (a reduction from a maximum of 448 basis points to a minimum of 5 basis points). Consequently, the cash shortfall of the Treasury bond programme declined significantly to 8 per cent of total net receipts in comparison to the relatively high cash shortfall of 14 per cent of total net receipts in 2001. The domestic non-bank sector, including institutional investors, continued to dominate investments in Treasury bonds in 2002.

On a face value basis, the net amount borrowed through Treasury bills amounted to Rs.40 billion in 2002. This was the outcome of new issues of Rs.44.5 billion and the retirement of Treasury bills of Rs.4.5 billion. As in the case of Treasury bonds, a portion of these new issues of Treasury bills were also used to settle the outstanding government overdraft. About 51 per cent of new issues were purchased by the Central Bank in the primary market. In addition, a considerable amount of re-issues (23 per cent of the total re-issues) were also reserved in advance for the Central Bank, particularly during the second half of 2002. The expansionary impact of the Central Bank's purchases of Treasury bills, however, was negated through the sale of Treasury bills in the secondary market. Overall, the Central Bank's holdings of Treasury bills declined by Rs.17 billion to Rs.40 billion at end 2002. Investments in Treasury bills by commercial banks increased considerably. The yield rates of Treasury bills began to decline in 2002, in line with other market interest rates. The result was that a cash surplus of Rs.2.9 billion, was generated on re-issues of Treasury bills, as the maturing Treasury bills were reissued at relatively lower interest rates. Therefore, on a book value basis, the total cash shortfall was marginal, as the cash surplus from re-issues and the book value of new issues amounted to Rs.39.8 billion in comparison to the face value of net new issues of Rs.40 billion.

Market interest rates on Treasury bills and Treasury bonds declined significantly towards end 2002. The weighted average (without withholding tax) yield rate for 364-day Treasury bills declined to 11.01 per cent at year end from the highest rate of 15.81 per cent that prevailed during the middle of the year. As an indicative rate for all maturities, the weighted average (without withholding tax) yield rate on 4-year Treasury bonds, declined to 12.05 per cent at end 2002 from the highest rate of 15.83 per cent in the second quarter of the year. Improved liquidity in the market, particularly during the second half of the year, and the reduction of Central Bank's policy rates (i.e., Repo and Reverse Repo rates) by a total of 225 basis points in 2002, largely contributed to the decline in market interest rates. This was further supported by the injection of rupee liquidity to the market as the Central Bank purchased the foreign currency proceeds obtained by the government through the issue of SLDBs in the middle of the year. A high level of over subscription (more than twofold the total amount offered), at the Treasury bill and Treasury bond auctions almost throughout the year, provided an additional indicator of liquidity. In addition, frequent review of developments in the government securities market, the close monitoring of progress in the government borrowing programme and considerable improvements in cash management by the General Treasury, prevented ad hoc issues of government securities and helped maintain stability in interest rates in government debt securities. The declining interest rate scenario enhanced flexibility in debt management decision-making, especially expanding the choices in selecting debt instruments for budgetary financing in 2002.

The government issued the balance SLDBs amounting to US dollar 91.5 million (Rs.8.8 billion) in June 2002. Unlike in previous issues in 2001, where the margin over the London Inter Bank Offered Rate (LIBOR) was fixed in advance, investors were given the opportunity to bid in this issue, subject to a maximum of 200 basis points over the 6-month LIBOR and to decide the tenor, subject to a minimum of two years. There was no early retirement facility for this issue. As in the previous issues, subscribers for the entire issue were domestic commercial banks in contrast to the expectation of attracting foreign investors. The weighted average interest rate of the issue was 194 basis points above 6-month LIBOR and all bids were for a tenor of two years.

Government liabilities to the banking system in 2002 declined by Rs.4.8 billion as against a targeted reduction of Rs.19.5 billion envisioned in the budget. This, however, was a significant improvement in the budgetary financing process compared to the continuously high bank borrowing of Rs.27.3 billion in 1999, Rs.56.5 billion in 2000 and Rs.48.6 billion in 2001. Availability of funds from domestic non-bank sources was the main reason for this improvement. The reduction in net credit to the government was the net effect of a repayment of Rs.13.3 billion to the Central Bank and net borrowing of Rs.8.4 billion from commercial banks. Although there was a marginal increase in provisional advances to the government by the Central Bank (Rs.0.9 billion) and an increase in the utilisation of government deposits with the Central Bank (Rs.4.1 billion), the decline in the Central Bank's holdings of Treasury bills (Rs.16.8 billion) and Treasury bonds (Rs.1.5 billion) resulted in a net reduction of government liabilities to the Central Bank.

The increase in net borrowing (Rs.8.4 billion) from commercial banks was the combined outcome of several factors. The government's outstanding overdraft with the two state banks decreased by Rs.34.5 billion. Investments in Treasury bills (Rs.16.2 billion), Treasury bonds (Rs.13.8 billion) and SLDB (Rs.8.8 billion) by commercial banks increased. However, the value of government import bills payable to the domestic units of commercial banks, which rose sharply in 2000 and 2001, remained at almost the same level in 2002. This was achieved due to the cessation of hostilities that prevailed throughout 2002, resulting in lower defence related imports. Further, in Budget 2003 it had been decided to repay the existing import bills without delay in order to reduce the high interest cost associated with them. There was a repayment of administrative borrowings in 2002 amounting to Rs.0.8 billion, in comparison to administrative borrowings of Rs.0.7 billion in 2001 and Rs.3.2 billion in 2000 for budgetary financing purposes.

Improvements in deficit financing in 2002 highlight the need for adopting a strategy to consolidate the present favourable trend to the maximum possible extent. In doing so, the government needs to reduce further the high cost debt in line with the budgetary targets. In addition, it is necessary to minimise significant deviations from budgetary targets by making more reasonable and realistic assumptions on items such as privatisation proceeds and foreign loans to minimise risks associated with the over-estimation of financing sources.

Foreign Borrowing

In 2002, foreign loan disbursements, on a gross basis, amounted to Rs.39 billion, while repayments of foreign borrowings was Rs.37.1 billion, including deferred payments of Rs.13.8 billion for defence related loans. Consequently, net receipts from foreign borrowing amounted to Rs.2 billion, significantly lower than the Rs.18.9 billion envisaged in the original budget. The lower level of foreign loan disbursements was a result of the under utilisation of available foreign resources, caused by various implementation delays related to foreign funded projects. The rate of foreign loan utilisation, as measured by the ratio of total gross disbursements in a year to the total committed undisbursed balance, was only around 23 per cent in 2002.

As the efficient utilisation of available foreign resources is a prerequisite for improving the country's potential for high and sustainable growth, a Committee was appointed in 2002 to monitor the progress on foreign funded projects. The Committee is expected to streamline systems and produce results in terms of higher donor funded project utilisation rates and reduced project implementation periods. According to the target given to the committee by the government, a total of US dollars 1 billion is expected to be utilised in 2003.

Foreign Grants

The amount of foreign grants received for budgetary purposes in 2002 was Rs.7.1 billion, against the original target of Rs.7.5 billion. In absolute terms, this was a considerable increase after the decreasing trend of foreign grants received for budgetary purposes in the recent past. However, as a percentage of GDP, the amount of grants remained unchanged in 2002. The governments of Japan, the Netherlands and Germany were among major donors in 2002. In future, the amount of grants can be expected to increase, when donor support for the rehabilitation and rebuilding of conflict affected areas is received partly in the form of grants.

Privatisation Proceeds

The amount of privatisation proceeds received for budgetary financing in 2002, which amounted to Rs.5.7 billion, was well below the original target of Rs.21 billion anticipated in Budget 2002. The privatisation programme in 2002 did not reach expectations because of procedural delays and sluggish market conditions. The reduced amount of privatisation proceeds imposed considerable pressure on the domestic borrowing programme in 2002. As the number of government institutions to be privatised gradually declines, the expected privatisation proceeds for budgetary financing would be lower in the future.

8.8 Government Debt

Total outstanding government debt stock increased by 15 per cent to Rs.1,669 billion at end 2002, in comparison to Rs.1,453 billion at end 2001. As a percentage of GDP, the outstanding debt stock increased for the fifth consecutive year from 85.8 per cent in 1997 to 105.3 per cent by end 2002. The sharp increase in the outstanding debt stock and its associated high debt service burden raises concerns about the sustainability of government debt. Consequently, the task of restoring fiscal sustainability, through the reduction of the debt/GDP ratio to a more sustainable level, was brought to the forefront of the macroeconomic policy agenda, particularly in designing a medium-term fiscal policy strategy. (See box 17).

The increase in the debt stock in 2002 was due to two major reasons. Firstly, the high fiscal deficit and reliance mainly on borrowing to finance the resources gap, resulted in an increase in the outstanding domestic debt. Second, the depreciation of the rupee against major foreign currencies led to a significant increase (Rs.74 billion) in the outstanding foreign debt stock, accounting for about 34 per cent of the debt increase in 2002. This prevented a gradual reduction in the foreign debt stock, as well as in the total debt stock that could have been achieved as a result of the lower net foreign borrowing for budgetary financing.

During 2002, the main determinants of the debt/GDP ratio i.e. the primary deficit of the budget and nominal interest rates were more favourable in comparison with the previous year. This helped arrest the debt accumulation process and the increase in the debt/GDP ratio to a certain extent. However, the full impact of the favourable developments in some factors, like interest rates and debt structuring were not realised in 2002, as there is a time lag between the issue of new debt and the payment of interest on that debt. On the other hand, exchange rate variation, another important factor that determines the level of external debt, contributed to expand the rupee liability of existing external debt. As a result, the growth rate of the nominal debt stock continued to exceed the nominal growth rate of gross domestic product, increasing debt/GDP ratio in 2002.

Domestic Debt

The government domestic debt stock increased by 16 per cent (Rs.132 billion) to Rs.948 billion as against a 21 per cent increase in the previous year. As a percentage of GDP, domestic debt rose to 59.8 per cent, in comparison with 58.0 per cent at end 2001.

The structure of the domestic debt stock at end 2002 indicated greater concentration towards medium to long-term debt. Of the total outstanding domestic debt, about 73 per cent consisted of medium to long-term debt, in comparison with 66 per cent in 2001. This trend was largely in line with the government debt management policy, aimed at lengthening the average maturity of debt, while shifting to more marketable

Chart 8.7
Composition of Government Debt

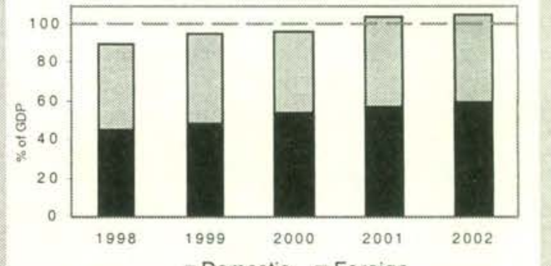


TABLE 8.6
Outstanding Central Government Debt (at end year)

Rs. million

	1998	1999	2000	2001	2002 Provisional
Total Domestic Debt (a)	**463,426**	**543,465**	**676,660**	**815,965**	**948,386**
Short term	163,253	175,886	208,017	278,624	259,205
Medium and long term	300,173	367,579	468,643	537,341	689,181
By debt instrument	463,426	543,465	676,660	815,965	948,386
Rupee securities	250,570	262,056	263,888	292,813	287,701
Treasury bills	119,996	124,996	134,996	170,995	210,995
Treasury bonds	48,915	104,867	204,124	229,174	347,128
Sri Lanka Development Bonds	-	-	-	14,749	24,177
Other	43,945	51,546	73,652	108,234	78,385
By institution	463,426	543,465	676,660	815,965	948,386
Banks	113,054	139,671	199,030	256,808	248,243
Central Bank	27,179	48,867	97,778	92,871	76,342
Commercial banks(b)	85,875	90,804	101,252	163,937	171,901
Sinking fund	100	100	100	100	100
Non bank sector	350,272	403,694	477,530	559,057	700,043
National Savings Bank	67,260	79,555	87,263	95,976	116,632
Employees' Provident Fund	157,711	181,581	211,742	245,028	283,655
Other	125,301	142,558	178,525	218,053	299,756
Total foreign debt	**461,273**	**507,866**	**542,040**	**636,741**	**720,898**
Project loans	400,284	444,423	477,845	542,942	639,949
Non project loans	60,989	63,443	64,195	93,799	80,950
By type	461,273	507,866	542,040	636,740	720,898
Concessional loans	446,331	497,672	535,129	603,571	701,076
Non concessional loans	14,942	10,194	6,911	33,170	19,821
By currency	461,273	507,866	542,040	636,741	720,898
SDR	179,124	195,799	214,471	249,852	297,758
US dollars	89,877	91,282	98,130	137,401	128,568
Japanese yen	132,371	164,800	172,932	185,079	218,916
Deutsche mark(c)	29,747	27,375	28,484	33,101	53,339
Other	30,154	28,610	28,023	31,308	22,317
External supplier's credit	575	530	217	269	n.a.
Total outstanding govt. debt	**924,699**	**1,051,331**	**1,218,700**	**1,452,706**	**1,669,284**
Total outstanding govt. debt net of sinking fund	924,599	1,051,231	1,218,600	1,452,606	1,669,184
Memorandum item:					
Exchange rate variation	65,119	37,989	24,104	48,844	74,044

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, Rs. 29,462 million at end 2001 and Rs. 29,570 million at end 2002.
(c) Since January 2002, outstanding debt in Deutsche mark, French franc and Italian lira has been converted into euro.

debt instruments. This development would help resolve the problem of the bunching of repayment obligations and rollover problems in future debt management processes, while enabling a smooth annual debt repayment schedule.

As a result of more reliance on marketable debt securities in 2002, the composition of the outstanding medium and long-term debt stock (Rs.689.1 billion) shifted towards more market-oriented debt. Treasury bonds, with an outstanding value of Rs.347.1 billion, emerged as the premier instrument in this category, accounting for 50 per cent of the domestic medium and long-term debt stock, in comparison to 43 per cent in the previous year. In addition, its share in total outstanding domestic debt increased to 37 per cent from 28 per cent in 2001. The EPF and the NSB continued their leading positions among the institutional investors and accounted for 43 per cent of the total outstanding amount of Treasury bonds in comparison to 41 per cent in 2001. The outstanding amount of Treasury bonds held by non-bank and non-institutional investors accounted for 46 per cent.

As a consequence of a policy to gradually phase-out borrowings from non-marketable debt instruments, there was a net repayment of Rupee loans (Rs.5.1 billion), resulting in a marginal decline in the outstanding stock of Rupee loans to Rs.288 billion at end 2002. EPF and NSB continued to be the major subscribers to the Rupee loan programme and accounted for 78 per cent of the total outstanding stock of Rupee loans.

Meanwhile, the outstanding stock of SLDBs, denominated in US dollars, amounted to Rs.24.2 billion (US dollars 250 million) at end 2002. This consisted of SLDBs worth Rs.15 billion (US dollars 158.5 million) and Rs.8.8 billion (US dollars 91.5 million) issued in 2001 and 2002, respectively. The entire stock of SLDBs was held by domestic commercial banks.

Treasury bills, amounting to Rs.211 billion, continued to be the major instrument in the short-term domestic debt stock and accounted for 22 per cent of the total domestic debt stock. During the year, there was a significant increase in the outstanding stock of Treasury bills (Rs.40 billion), mainly due to the conversion of the outstanding government overdraft to government debt securities. Meanwhile, the outstanding amount of provisional advances given to the government by the Central Bank amounted to Rs.31 billion. This was an increase of Rs.0.9 billion. The legal provisions under the Monetary Law Act (MLA) stipulate that the increase in advances to the government by the Central Bank for a given year should not exceed 10 per cent of the estimated revenue for the same year. Currently, these advances are provided free of interest.

During 2002, the government's outstanding liabilities to the banking system decreased by 3 per cent to Rs.248 billion. This accounted for 26 per cent of the total domestic debt stock, in comparison to 31 per cent held by the banking system in 2001. This reflected the decreased reliance on bank borrowings for budgetary financing. This was a commendable achievement. The decrease was mainly driven by an 18 per cent decrease in government liabilities to the Central Bank. The Central Bank was extensively involved in secondary market operations, in order to absorb excess liquidity in the market. As a result, a significant amount of its holdings of government paper was unloaded in the market.

In contrast, the government's liability to commercial banks increased moderately by 5 per cent to Rs.171.9 billion in 2002. However, their share as a percentage of total domestic debt stock decreased to 18 per cent, as the growth of borrowing from other sources was relatively higher. The change in liabilities to commercial banks was mainly a combined outcome of increased holding of Treasury bills (Rs.28.9 billion), Treasury bonds (Rs.35.5 billion) and SLDBs (Rs.24.2 billion) and a reduction of overdrafts from the two state banks to Rs.4 billion from Rs.38 billion at end 2001. Total outstanding non-instrument debt of commercial banks decreased to Rs.54 billion in 2002 from Rs.100 billion in 2001. Of this, FCBU borrowings amounted to Rs.30 billion (55 per cent) and import bills amounted to Rs.13 billion (24 per cent), respectively.

Foreign Debt

In 2002, the outstanding stock of foreign debt increased by 13 per cent to Rs.721 billion. This was mainly due to the effect of exchange rate variations amounting to Rs.74 billion, consequent upon the substantial depreciation of the rupee, viz., the Japanese yen and the IMF's Special Drawing Rights (SDR), in a situation where the net inflow of foreign resources for budgetary financing was relatively low. As a percentage of GDP, the outstanding stock of government foreign debt stock remained almost unchanged at 45.5 per cent in 2002.

Of the total foreign debt stock, the share of concessional loans increased to 97 per cent from 95 per cent in the previous year. Japan, as a major bilateral donor, continued to be the main provider of concessional loans, accounting for 31 per cent of the total foreign debt. This was followed by IDA and ADB, the major multilateral donors, accounting for 24 per cent and 23 per cent of the total foreign debt stock, respectively. Meanwhile, the amount of outstanding non-concessional loans decreased to 3 per cent of the total external debt, mainly because of the gradual reduction in defence related loans. Project loans, from bilateral and multilateral sources, dominated the total foreign debt portfolio, accounting for 89 per cent of the total stock of foreign debt.

The cumulative increase in the foreign debt stock due to the exchange rate depreciation during last 6 years which amounted to Rs.251 billion, was about 35 per cent of the total outstanding foreign debt stock at end 2002 and about 15.8 per cent of GDP in 2002. The value of the rupee against the US dollar depreciated at a lower rate (3.7 per cent) in 2002 than in previous years. However, as the amount of government foreign debt denominated in US dollars was only 16 per cent, the net impact on the debt liability was relatively less significant. In contrast, there was a sharp increase in liabilities due to the significant appreciation of cross currency exchange rates of currencies such as the Japanese yen and SDR. As the amount of foreign debt denominated in Japanese yen and the SDR was 72 per cent (31 per cent and 41 per cent, respectively), the higher rate of depreciation of the rupee against these two currencies (by 13.3 per cent and 10.8 per cent, respectively) increased the rupee liability of foreign debt significantly in 2002.

Debt Service Payments

Total debt service payments in 2002 amounted to Rs.284 billion, a significant increase of 59 per cent over the previous year. As a percentage of GDP, this was an increase to 17.9 per cent from 12.7 per cent in 2001. In 2002, total debt service payments exceeded total government revenue for the first time in post independence history. This large increase was a direct result of weak fiscal performance and the corresponding borrowing strategy in the recent past. The high level of debt service payments pre-empted government revenue receipts, requiring additional new borrowing even to finance essential expenditure of the government. This situation ultimately hampered much-needed public investment, adversely affecting the growth prospects of the economy.

The significant increase in debt service payments was mainly caused by the increase in amortisation payments on domestic debt, which almost doubled to Rs.167.8 billion in 2002. This increase was a direct consequence of the debt management strategy adopted during the high interest rate regime in 2000 and early 2001, where government securities were issued mainly in the shorter end of the market. It also underscores the need for strengthening the debt management process to reduce interest costs and smoothen the repayment burden.

Box 17

Public Debt Management in Sri Lanka: Methods, Issues and Strategies

Governments borrow to pay for expenditure, when revenue and grants are not sufficient. Borrowing is usually based on marketable debt securities, which also help develop the debt market. Thus, some governments, even with budget surpluses, continue to borrow to provide an impetus to the debt market, in view of the economic benefits arising from well developed debt markets.

When governments borrow, they need to ensure that they borrow at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk. Prudent risk management to avoid dangerous debt structures and strategies is crucial, given the severe macroeconomic consequences of sovereign debt default, and the magnitude of the ensuing output losses. These costs include business and banking insolvencies, as well as diminished long-term credibility and ability of the government to mobilise domestic and foreign savings.

Different countries use different strategies in raising and managing debt. The two fundamental pillars of sound debt raising and management are the legal framework and the institutional set up. The legal framework should clearly specify several important features relating to the raising and managing of debt, such as the reasons and circumstances under which the debt is raised, person(s) authorised to raise debt, person(s) authorised to manage the debt, definition of 'management', and reports on performance.

The institutional set up differs from country to country. Differences arise from the location of the debt management office, the scope of work, degree of autonomy and accountability, governance principles, management structures and reporting lines. In some countries the debt management office acts as an internal bank of the government that manages both the government's cash and its debt. While the revenue authority collects revenue, the debt office manages the revenue, and disburses funds as per instructions given by the Treasury.

The practice with regard to the location of the debt office also varies from country to country. Frequently, debt offices are found located in the Ministry of Finance, the Central Bank or as a separate entity. Irrespective of the location of the debt office, it should clearly exhibit attributes of efficient debt management.

Legal Framework of Public Debt Management in Sri Lanka

In Sri Lanka, the public debt management is a primary task of the Central Bank of Sri Lanka (CBSL) as stipulated in the Monetary Law Act. However, there exists a degree of decentralisation in raising debt. At least two institutions are involved in raising debt, viz., the CBSL, and the External Resources Department. The debt based on the Government Securities Programme, i.e., Treasury bills, Treasury bonds, and Rupee loans are raised and managed by the Public Debt Department of the Central Bank. Foreign concessional debt is raised by the External Resources Department. In addition, from time to time, other loans such as loans from state banks and commercial borrowings abroad are also raised by the General Treasury.

The decentralisation is a result of the fragmentation in the legal framework permitting debt raising, as illustrated in the following legislation relating to public debt.

i. The Monetary Law Act (MLA) of 1949
Section 106(1) states that 'The Central Bank shall act as the fiscal agent and banker to the government or agencies or institutions acting on behalf of the government, whether established by any written law or otherwise'.
Section 113 states that 'The Central Bank shall, as agent of the government, be responsible for the management of the public debt'.
Section 114 states that 'No new loan shall be raised and no new issue of stock or debentures shall be made by the government or by any agency or any institution referred to in subsection (1) of Section 106, whether in pursuance of authority conferred by any written law or otherwise, unless the advice of the Monetary Board has first been obtained upon the monetary implication of the proposed loan or issue'.

ii. The Local Treasury Bills Ordinance (LTBO) of 1923, 1953, 1992, 1995
Section 2 (1) - empowers the Minister in charge of the subject of Finance whenever authorised by the Parliament to direct the Deputy Secretary to the Treasury to borrow by the issue of Sri Lanka Treasury bills an amount specified in such resolution.
Section 2 (2) - all acts or things necessary for the purpose of and in connection with the issue and repayment of Treasury bills shall be done on behalf of the Deputy Secretary to the Treasury by the Central Bank.

iii. The Registered Stock and Securities Ordinance (RSSO) of 1937 as amended in 1949, 1983, 1985 and 1995
Section 2 (1) - empowers the Minister in charge of the subject of finance to raise any amount of money by any one or more of the following.

Box 17 (contd.)

a. the creation and issue of registered stock.
b. the issue of promissory notes
c. the issue of bearer bonds
d. the issue of treasury bonds

iv. Foreign Loans Act of 1957, 1962, 1963, 1980, 1984
Section 2 - The President or any person specially authorised by him in that behalf may, in the name and on behalf of the Government of Sri Lanka, sign
a. an agreement relating to a foreign loan to the Government of Sri Lanka
b. a guarantee by the Government of Sri Lanka relating to a foreign loan
c. any contract, bond, promissory note or other document required by such agreement or guarantee

Section 4 – The Minister in charge of the subject of Finance may, by Order published in the Gazette, make such provision as may be necessary to give effect to an agreement relating to a foreign loan.

v. Treasury Certificates of Deposit Act (TCDA) of 1989
Section 2 (1) - empowers the Minister, whenever authorised by the Parliament, to direct the Deputy Secretary to the Treasury to borrow by the issue of Sri Lanka Treasury Certificates of Deposits an amount specified in such resolution.
Section 2 (2) - All acts or things necessary for the purpose of and in connection with the issue and repayment of Treasury Bills shall be done on behalf of the Deputy Secretary to the Treasury by an officer of the Central Bank authorised in that behalf by the Monetary Board.

vi. Tax Reserve Certificates Act of 1957, 1961, 1981
Section 2 (1) – The Central Bank is authorised to issue Tax Reserve Certificates up to such amount and of such denomination(s) as the Minister in charge of the subject of Finance may from time to time specify by order published in the Gazette.
Section 2 (2) – The Superintendent of Public Debt in the Central Bank of Ceylon shall be responsible for the issue of certificates, the maintenance of books of issue, the redemption or cancellation of certificates, and all other matters pertaining to the issue of, and repayment in respect of certificates.

vii. Annual Appropriation Act
This Act authorises the raising of loans "in or outside" Sri Lanka, on behalf of the government, to provide for the annual expenditure of the government. It sets an aggregate sum for such borrowing, although this may be adjusted during the year with supplemental legislation.

The existing institutional and legal framework which allows several agencies to raise debt, results in major difficulties in the management of the debt. The decision on terms and conditions of raising a loan should be made by considering features such as the cost and the maturity profile of the existing debt, while taking into consideration risks, such as rollover risk, of debt.

Raising debt on behalf of the government should be a well coordinated activity conducted professionally. There is a need for appointing one institution to be solely responsible for raising and managing debt, especially in view of the large magnitude of the current debt. This institution should bear a series of responsibilities such as reasons and circumstances under which the debt is raised, person(s) authorised to raise debt, person(s) authorised to manage the debt, definition of 'management', discussion on guidelines of debt management by the government, debt office and the Central Bank, and reporting to Parliament evaluating the management of debt.

Institutional Framework in Sri Lanka

In the current arrangement, CBSL raises debt based on instruments such as Treasury bills and bonds, and Rupee loans. The Treasury raises debt through overdraft facilities and other means. Foreign loans are raised by the External Resources Department, mostly on concessionary terms. The State Accounts Department of the General Treasury acts as an internal bank, by collecting revenue, as well as debt proceeds from all sources and channelling it to government institutions. The coordination of raising domestic debt is done by the Domestic Debt Management Committee of CBSL. In view of Sri Lanka's lower dependence on foreign commercial debt, a regular foreign debt raising mechanism has not emerged. However, the institutional setup has to be designed to manage both domestic and foreign debt, giving due consideration to risk elements such as exchange rate risk.

The role of public debt management has evolved to include a significant consideration on the risk of debt management, while minimising the cost of borrowing. The major risk element is the 'roll over' or 'refinance' risk arising from large debt obligations falling due on a particular day. This could happen when various parties negotiate and raise debt independently, without due consideration given to existing repayment patterns arising from domestic debt, foreign debt and government guarantees. Hence, there is a need for coordinating the

Box 17 (contd.)

management of all types of domestic debt, concessionary and non-concessionary foreign debt, and government guarantees. If public debt management is to be separated from CBSL, there are two competing proposals of the new institutional structure – to set up an independent debt office with accountability to Parliament or to establish a department in the General Treasury. However, the latter is not the international best practice. As suggested by various authors the international best practice is to establish an independent debt office accountable to Parliament through the Minister of Finance. Table 1 illustrates relative merits and demerits of alternative institutional structures.

The defining characteristic of a separate debt office is that of a specialised institution established by statute, with clearly defined responsibilities and separate from the Ministry of Finance and the Central Bank. By being separate from the Central Bank, it would ensure that debt policy is not subordinated to monetary policy and by being separate from the Ministry of Finance, it would ensure that debt policy is not connected with short-term political considerations.

The relationship between the various institutions involved in debt policy and the management process would take the following form. The debt office would make proposals to the government on debt policy, strategy and guidelines. The government will decide on the appropriate debt policy, in consultation with the Central Bank. The debt office would execute the debt policy approved by the government. The day to day raising and management of debt would be entirely in the hands of the debt office.

The functional organisation for debt management should be similar to that of an investment institution. Thus, the debt office should be in charge of all income and expenditure flows of the government, with the objective of investing surplus funds and borrowing funds whenever the cash flow is in deficit, taking a long-term view.

Sovereign Debt Market Development

An integral function of the Debt Office is the development of the sovereign debt market, which in turn would help develop the corporate debt market. Well developed debt markets facilitate efficient debt raising both by the government and by corporates. It also provides an efficient means of saving by the public, and develops financial intermediation. The debt office should follow international best practices in raising and managing debt to facilitate debt market development. Among crucial developments are the frequent issue of longer-term bonds to help develop the yield curve and minimise the number of debt instruments. A large number of debt market instruments, such as Treasury bond series now totaling about 90, leads to a fragmentation of the market. The bonds could only be few benchmark bonds, with frequent issues.

TABLE 1

Advantages and Disadvantages of Alternative Institutional Structures

Institutional Structure	Advantages	Disadvantages
A. Remaining as a Department of CBSL	1. Stature of the Monetary Board 2. Ability to hire relatively better qualified staff 3. Operational cost borne by CBSL	1. Possible conflict with monetary policy
B. Transferring to the General Treasury as a separate department	1. Better coordination with relevant Treasury functions	1. Possible politicisation 2. Reduced accountability, transparency and moral hazard problem 3. Limited ability to hire qualified staff 4. Limited scope for future restructuring due to state sector rigidity
C. Separate public sector institution with Public Debt Department of the CBSL and other relevant departments of the General Treasury being amalgamated	1. Autonomy, if granted by statute 2. Clearly defined accountability and transparency by statute 3. Ability to hire qualified staff 4. International best practice	1. Higher cost of operations 2. Possible politicisation

TABLE 8.7
Government Debt Service Payments

Rs. million

	1998	1999	2000	2001	2002 Provisional	2003 Estimates
Debt service payments	114,866	103,885	175,726	179,072	284,358	317,932
Amortisation payments	59,968	41,762	104,526	84,765	167,843	187,754
Domestic	41,617	20,322	81,244	56,844	130,786	152,429
Foreign	18,351	21,440	23,282	27,921	37,057	35,325
Interest payments	54,898	62,123	71,200	94,307	116,515	130,178
Domestic	47,598	53,371	62,185	84,560	105,897	115,498
Short term	12,398	13,085	12,767	26,109	29,422	28,194
Medium and long term	35,200	40,837	49,418	58,451	76,475	87,304
Foreign	7,300	8,752	9,015	9,747	10,617	14,680

(a) Provisional

Source: Central Bank of Sri Lanka

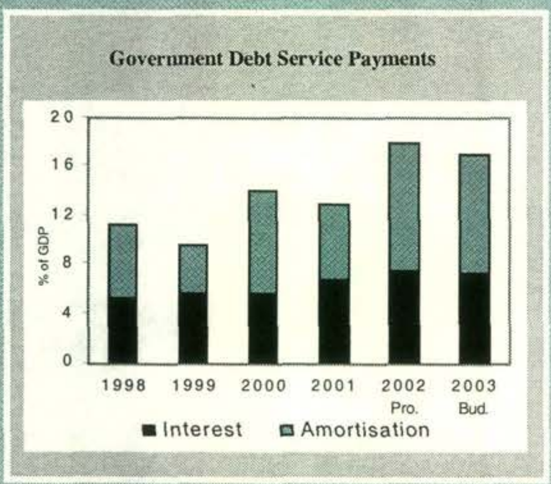
In 2002, total interest payments amounted to Rs.116.5 billion, a 24 per cent increase over the previous year. About 45 per cent of government revenue was absorbed by interest payments. Interest payments on short-term debt increased by 13 per cent, in comparison to a more than twofold increase in 2001. Reduced government borrowing through overdrafts from commercial banks and declining yield rates on Treasury bills mainly contributed to the slower increase in interest payments on short-term debt. Interest payments on medium to long-term debt increased by 31 per cent. The full impact of the shift in the debt composition to medium and long-term maturities issued during a period of high interest rates in 2000 and 2001, was the main reason for this increase.

Foreign debt service payments as a ratio of export of goods and services increased, to 8.3 per cent due to the sharp increase in foreign amortisation payments in 2002. The increase in foreign amortisation payments was mainly due to the rising commitment on deferred payments on defence imports from the mid-1990s to 2002. However, this ratio has remained below 9 per cent in the last few years, reflecting the composition of the outstanding foreign debt, which consists largely of highly concessional foreign debt, contracted at very low interest rates, with long repayment periods. The continuation of peace will lower defence related imports, which would help to improve the foreign debt service ratio in the future.

Public Sector Debt

The outstanding debt stock of the public sector, which includes the central government and non-financial public corporations, amounted to Rs.1,712 billion at end 2002. This was about 108 per cent of GDP in comparison to the 106.1 per cent in 2001. Of this, Rs.43 billion (2.7 percent of GDP), held by public

Chart 8.8
Debt Service Payments



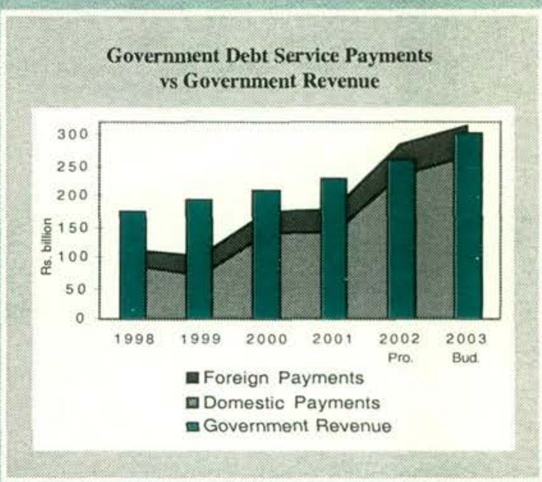


TABLE 8.8
Government Debt Indicators

Percentage

	1998	1999	2000	2001	2002 Provisional	2003 Estimates
Government Debt/GDP	90.8	95.1	96.9	103.2	105.3	103.0
- Domesitc Debt/GDP	45.5	49.1	53.8	58.0	59.8	58.1
- Foreign Debt/GDP	45.3	45.9	43.1	45.3	45.5	44.9
Total Foreign Debt/Exports 1/	124.8	129.1	110.1	115.5	126.2	125.4
Total Debt Service/GDP	11.3	9.4	14.0	12.7	17.9	17.8
Total Debt Service/Government Revenue 2/	65.6	53.0	83.2	76.4	108.8	104.6
o/w Domestic Debt Service/Govrnment Revenue 2/	51.0	37.6	67.9	60.4	90.6	88.2
Total Debt Service/Government Expenditure 3/	35.0	32.4	39.9	38.0	49.9	50.8
o/w Domestic Debt Service/Govrnment Expenditure 3/	27.2	23.0	32.6	30.0	41.5	42.8
Foreign Debt Service/Export 1/	6.9	7.7	6.6	6.8	8.3	7.8
Domestic Interest/GDP	4.7	4.8	4.9	6.0	6.7	6.5
Domestic Interest/Government Current Expenditure	23.8	25.7	24.5	27.9	32.1	33.5
Foreign Interest/Exports1/	2.0	2.2	1.8	1.8	1.9	2.3

1/ Exports of goods and services
2/ Government revenue is in economic format
3/ Government expenditure inclusive of amortisation payments

Source: Central Bank of Sri Lanka

corporations, increased by 5 per cent over the previous year. Three public corporations, CPC, CEB and CWE, continued to be the major debtors, accounting for 91 per cent of the total public corporation debt. During the year, the liability of CEB increased by 45 per cent, while that of CPC and CWE decreased by 13 per cent and 8 per cent, respectively.