Chapter 8

FISCAL POLICY AND BUDGETARY OPERATIONS

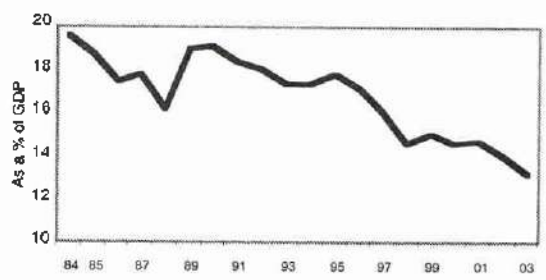
8.1 Overview and Policy Strategy

Government continued in 2003 the policy strategy formulated on the three principles introduced in Budget 2002, viz. reduce public debt to a sustainable level, stimulate economic growth and increase employment opportunities and the earning capacity of people to ensure sustained economic development over the medium-term. The fiscal policy strategy announced in Budget 2003 aimed at strengthening the fiscal consolidation process, which began in 2002. In pursuing its commitment to fiscal prudence, and greater transparency and accountability in fiscal affairs, the government brought in the Fiscal Management (Responsibility) Act (FMRA) at end 2002. This Act requires the overall fiscal deficit to be reduced to 5 per cent of GDP by 2006 and maintained below that level thereafter. It also requires the government to reduce the debt to GDP ratio to 85 per cent by 2006 and further to 60 per cent by 2013. In line with these medium-term fiscal targets, Budget 2003 announced measures to increase revenue, contain expenditure and improve debt management in order to cap the overall deficit at 7.5 per cent of GDP and to reverse the rising trend in the government debt to GDP ratio in 2003. Further, the three year fiscal framework announced in Budget 2003 indicated broad fiscal aggregates and a deficit reduction path consistent with the fiscal targets envisaged under the FMRA and the government's medium-term economic strategy contained in the Poverty Reduction Strategy Paper (PRSP).

The medium-term fiscal consolidation programme aims at improving fiscal operations in several ways, while supporting the development of the economy. The deficit is expected to be reduced gradually with better revenue performance and the rationalisation of recurrent expenditure. The allocation of funds for public investment is expected to be increased to improve physical infrastructure and human capital for accelerated growth momentum. It expects to transform the government from the single largest dis-saver to the largest single saver in the economy and increase funds for public investment with concessional foreign sources and government revenue. The role of the government in the economy is expected to shift from direct participation in economic activity to a regulatory role, allowing the private sector to play a dominant role. Government dependence on the domestic market to finance the resources gap is expected to be reduced, limiting pressure on the domestic market and releasing more funds for private investment.

The declining trend in the tax to GDP ratio is a matter for serious concern. It hampers the medium-term fiscal consolidation process. It has been the main cause for high budget deficits in the past. Since 1990, the ratio had declined by 6 percentage points of GDP to 13.2 per cent in 2003. This reduction is about Rs.106 billion which is more than the public sector wage bill or the public investment in 2003. Several revenue augmenting tax measures introduced over the last decade to reverse the declining trend have been ineffective. Cross country data show that the average tax to GDP ratio is 38 per cent for developed countries and 18 per cent for developing countries. Sri Lanka's tax effort has fallen far below the norm. This problem is a multi-faceted structural issue which has to be addressed through a comprehensive approach correcting tax policy, tax structure and tax administration and incentive systems, simultaneously.

Chart 8.1
Tax Revenue 1984 - 2003



An increase in revenue is expected to be the main contributor to achieve the expected fiscal consolidation path. The VAT, introduced by unifying GST and NSL, has become the main revenue source and is expected to generate revenue close to one half of tax receipts. A series of measures were introduced in 2003 to expand the VAT base and improve the net collection. Among them were extending VAT to financial services, correcting current weaknesses in the VAT refund mechanism and improving VAT administration. However, opposition to VAT, mainly due to poor public awareness, resulted in the postponement of some of the proposed policy measures, including the extension of VAT to wholesale and retail trade. The income tax structure was further rationalised by lowering the highest marginal tax rate from 35 per cent to 30 per cent. In addition, a number of policy measures were introduced to increase indirect tax collection. The main cause for the significant reduction in tariff revenue in the recent past has been the exemption of a number of items from import duty. In view of the need to increase tax collection and to reduce distortions in the tax structure, a new tariff rate of 2 per cent was imposed on most exempted imports in Budget 2003. This rate was increased to 2.5 per cent after the Mid-Year Fiscal Review to further strengthen tax collection in 2003. The excise tax on liquor was streamlined by unifying total excise liabilities under the Excise Ordinance. A Revenue Authority was to be established to improve tax administration. The delay in its establishment was a setback and this process needs to be expedited with the cooperation of the existing revenue collecting agencies.

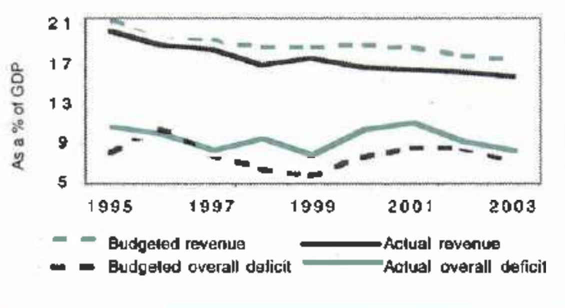
Tax evasion has been recognised as a serious problem and successive governments offered tax amnesties on 9 occasions before 2002 to bring tax evaders into the tax net. These tax amnesties were generally unsuccessful. Because of the severe decline in the tax to GDP ratio and to avoid the weaknesses in previous tax amnesties, the government granted a new tax amnesty in 2002, permitting tax evaders to enter the tax system during the period April 2002 to August 2003. The amnesty covered taxes, duties, levies and penalties under 26 Acts. Declarants were entitled to immunity from liability to pay other penalties and from any other investigation or prosecution for any offence under any of these 26 Acts. However, they would thereafter come within the tax net. Over 50,000 declarations were received by the Inland Revenue Department (IRD) and in terms of numbers registering, this tax amnesty was a success. However, the ultimate success depends on the efficiency of the tax authorities in collecting the proper tax liability from these declarants in the future. As such, it is of utmost importance that the IRD design a new programme without any delay for effective tax collection.

The government recognises that reforms in tax policy should be accompanied by reforms in tax administration as these two are inextricably linked. Although tax policy has undergone a significant transformation in the past, reforms in tax administration have been much slower and have not kept pace with the changes in the tax system and the economy. These tax collecting agencies launched a number of key measures in 2003. The Customs Department implemented several programmes to improve the overall administration of the Department. The Electronic Data Interchange (EDI) was partly implemented in 2003 and the full system will be in operation in 2004. The Gold Card Programme was introduced as a pilot project, selecting large importers who would be given custom clearance within a minimum time. In addition, the existing valuation system was replaced by the WTO valuation system with the objective of estimating the value of imported goods at transactions value, which is the amount actually paid or payable for goods when sold for export to the country for destination. Major reforms introduced by IRD include the amalgamation of the Large Taxpayers Unit (LTU) for income tax with large VAT payers and the establishment of separate audit units to carry out comprehensive audits on VAT and corporate income taxes. The Department set up a special unit to monitor and enforce tax compliance. These administrative reforms are expected to improve efficiency in the collection of tax revenue.

On the expenditure side, considerable efforts have been made to contain recurrent expenditure and rupee funded non-priority capital expenses, while encouraging the externally funded public investment programme. Expenditure rationalising measures introduced in 2002 were continued in 2003. To reduce the overall deficit in line with the medium-term targets set out under the FMRA, expenditure policies were formulated to address short-term expenditure issues as well as to correct structural weaknesses in expenditure. Measures to reduce the overall expenditure in the short-run included suspending recruitment to the public sector (except for professional and technical cadres), avoiding ad hoc general wage and pension increases, streamlining the allocation of funds for defence services, better targetting welfare programmes, limiting allocation of funds for unforeseen and unclassified expenses and controlling funds for rupee funded non-priority public investment programmes. New policies introduced to correct structural weaknesses in government expenditure in the medium to long-term included the establishment of an independent public debt management office, reforming departmental enterprises and imposing limits on government guarantees under the FMRA. In addition, among the key measures continued in 2003 included the continuation of the contributory pension scheme for new recruits to the public service, designing an overall welfare programme under the Welfare Benefit Law and reforming public enterprises.

To strengthen fiscal consolidation, a high level committee, the Poverty Reduction and Growth Facility Monitoring Committee, comprising senior officials from the public sector was appointed to ensure the implementation of structural policies and maintenance of fiscal targets in the Poverty Reduction and Growth Facility (PRGF) programme in 2003. The Committee has taken steps necessary to minimise deviation from the original targets in Budget 2003. In addition,

Chart 8.2
Budgeted vs Actual Revenue and Budgeted vs Actual Overall Deficit



several new measures were introduced during the second half of the year to improve the fiscal operations as the Mid-Year Fiscal Position Report released under the FMRA indicated that there may be deviations from the fiscal target, mainly due to slippages in revenue. However, the full benefit of some of these new measures were not realised because of the political instability during the latter part of the year.

The Public Enterprise Reform Commission (PERC) directed its activities towards identifying new public enterprises for restructuring, while completing the reform activities initiated before 2003. The completion of the privatisation of Sri Lanka Insurance Corporation (SLIC) and the sale of 100 petrol stations and one third of the common user facility of the CPC, together with the leasing of the oil tank farm in Trincomalee were two major programmes completed in 2003. With the privatisation of SLIC, the government moved out almost entirely from the insurance business leaving it in the hands of the private sector to be developed on market principles. The process to select a third player for the petroleum industry continued. With the completion of this programme, the government owned CPC will compete with two private players in the retail petroleum market. Initial measures were taken to unbundle the main activities of the CEB, i.e. generation, transmission and distribution, under the Electricity Reform Act. In addition, PERC has identified several public enterprises to be divested in the future. The two major restructuring programmes launched outside PERC were the reform of the Sri Lanka Railways, converting its functions from a departmental enterprise to an Authority and the restructuring of the CWE to improve its commercial viability. A comprehensive restructuring programme was introduced in 2003 to improve the service delivery of the CWE and to solve its outstanding debt burden, to avoid burdening the government budget with the need to subsidise the CWE. The government took over a part of the CWE's liabilities to the banking system by issuing Treasury bonds amounting to Rs.4.4 billion. In turn, real estate owned by CWE was transferred to the government, which will be divested to settle the liabilities transferred to the government. In addition, a 40 per cent stake of the retail network and the management was sold to the private sector, to infuse private sector skills through private-public sector participation. PERC and the Department of Public Enterprises jointly worked together to reform several selected enterprises in 2003. Under this programme, a separate programme was introduced to merge 4 enterprises, to restructure and reform 51 corporations and enterprises. Finally, 15 public enterprises were earmarked for liquidation after thorough review, which demonstrated that these institutions did not contribute much to the general public.

The government continued its debt management strategy to make the government debt programme more market oriented and to develop a medium to long-term debt market. In addition, several measures were introduced to improve the Primary Dealer (PD) system. In 2003, the borrowing requirement from domestic sources was met almost entirely through medium-term market oriented Treasury bonds. As in 2002, government continued the policy of replacing high cost debt and retiring non-marketable debt. Funds required for this purpose were raised through Treasury bonds. The most notable development in 2003 was the extension of the maturity structure of Treasury bonds. The sharp decline in the resource requirement from the domestic market, improved liquidity and the significant reduction in interest rates created an environment conducive for the government to increase the maturity structure of Treasury bonds gradually from 6 year to 20 years. This helped to establish a benchmark yield curve upto 20 years, a long felt need to develop the long-term secondary market in domestic debt. The completion of the preparatory work for the Scripless Securities Settlement System (SSSS) for government securities was another major development that would improve secondary market activity in government debt. The SSSS commenced operations in early 2004.

The policy of developing the PD system was continued in 2003. Accordingly, the number of PDs operating in the government securities market was increased from 10 to 11. In addition, the government has decided to set up a Special Risk Reserve Fund by transferring a part of the after tax profits of PDs. This Fund would promote the safety, soundness and the stability of the PD system and build up the PD capital base. The minimum capital requirement of PDs was raised to Rs.400 million from Rs.200 million. That minimum is expected to be raise to Rs.450 million before mid-2005, in order to improve the resilience of the PD system. The minimum subscription level of PDs at Treasury bill/bond auctions was reduced to 10 per cent from 15 per cent. The firm two way quote (bid and offer prices) requirement for selected benchmark maturities was expanded to promote the liquidity of the medium and long-term market. Methods of valuation of securities and accounting methods were revised to reflect real purchasing prices and the commercial effect of the transactions (Repo/Reverse Repo), respectively.

The operations of Provincial Councils (PCs), under the existing power sharing system with the central government established under the 13th Amendment to the Constitution in 1987, continued in 2003. As the revenue generating powers devolved to meet their expenditure commitments of the PC system was not sufficient, PCs had to depend on the central government under the ongoing gap filling approach to finance the deficit. The weaknesses in the central government funding arrangements through the grant structure would depend on the revenue performance of the central government's and PCs. Slippage in revenue collection at the centre curtailed the rupee funded investment activities planned by PCs in their annual investment programmes. Further, the lack of a proper institutional set-up with sufficient legal backing at the centre to regulate and monitor the operations of PCs was one of the main causes for the weak relationship with the central government. The Finance Commission, which was established

Box 14

The New Government Finance Statistics (GFS) System

The current system of organising/compiling data on government operations used in Sri Lanka and in most of the other countries is based on the 1986 Government Finance Statistics Manual (GFSM 1986) introduced by the International Monetary Fund. Since then, many changes have taken place in government financial operations, fiscal analysis and macroeconomic statistics. In addition, increasing emphasis has been placed on replacing the present cash based accounting data with accrual data on all transactions and summary data on a cash basis, as cash transactions alone do not capture the timing of fiscal actions and their impact on the economy. Since the current system does not require governments to prepare a balance sheet, a new system has made it a part and parcel of the government accounting systems. Considering these developments, the IMF has introduced to its member countries a new Government Finance Statistics Manual 2001 (GFSM 2001). The highlights of the new system are briefly discussed below.

Objectives of the New System

The provision of a comprehensive conceptual and accounting framework suitable for analysing and evaluating fiscal policy, especially the performance of the general government sector, is the main purpose of the new GFS system. Accordingly, this framework includes a new set of interrelated statements that integrate flows and stocks relating to government operations. The harmonisation of government finance with other macroeconomic analytic systems, namely, Balance of Payments, National Accounts and Money and Banking, to facilitate consistency of statistical analysis is another objective of the GFSM 2001. The new system will address the treatment of items related to transactions under accrual accounting, which are not cash transactions (such as consumption of fixed capital). It will remedy classification shortcomings in the GFSM 1986 methodology (e.g. government sale of non financial public enterprise), other economic flows (e.g. valuation changes of buildings and non financial public enterprise) and other issues not covered in the GFSM 1986 methodology (e.g. incurrence of explicit contingent liabilities). It is expected that the new system will also be useful in macroeconomic analysis, as it has more government finance summary balances than in the previous system. The inclusion of a balance sheet and other economic flows will also provide a more comprehensive and integrated system to assess policy and measure the sustainability of the fiscal position of government activities.

Main Features

GFSM 2001 covers the activities of general government (which includes central government, state/provincial governments and local governments) as defined in the System of National Accounts (SNA 1993) introduced for an adoption of a uniform national accounting system by world's nations. The compilation and reporting system calls for a set of interrelated statements on stocks (assets and liabilities) and flows (transactions and other economic flows) of government operations. The double entry accounting system is used to record the stocks and flows. Flows are recorded on an accrual basis when an economic value is created, exchanged, transformed or extinguished. Transactions and stocks are to be valued at market prices. Stocks are defined as a unit's holding of assets and liabilities at a specific time[1]. A unit's net worth is derived by deducting total liabilities from total assets.

Analytical Framework[2]

The framework has three main financial statements:

(1) Statement of government operations

(2) Statement of other economic flows

(3) The balance sheet.

In addition, a 'Statement of Sources and Uses of Cash' is also included to provide information on liquidity.

1. Statement of Government Operations

Transactions of general government related to revenue, expense[3], non-financial assets, financial assets and liabilities are included in this statement. This statement summarises the transactions of the general government in an accounting period, irrespective of whether the cash flow had taken place or not. The effect of fiscal policy on the net worth of general government sector, as well as its holdings of assets and liabilities, are reflected in this statement. The transactions are classified according to whether they increase net worth (revenue), decrease net worth (expenses), change the stock of non-financial assets (capital assets) and/or change the stock of a financial asset or a liability (financing).

1 In the present system, liabilities are only recorded in terms of the outstanding debt of the government, while changes that occur to the government's financial position other than the transactions are not captured.

2 Details of the framework are given in Chart 1 while balances that can be generated in the framework are summarised in Table 1.

3 Expenditure in the 1986 system has been re named as 'expense' in the 2001 system. The main feature of this definition change is that the latter does not include 'transactions on non financial assets' (i.e. the acquisition of fixed assets and changes in inventories etc.).

Box 14 (contd.)

2. Statement of Other Economic Flows

This statement records items (other than government operations) that influence the government's financial position. It summarises other economic flows that affect the value of assets and liabilities. Price changes, exchange rate changes, debt write-offs and catastrophic losses (wars and earthquakes) are examples of such items. Among changes that affect the value of assets, liabilities and net worth due to price effects are known as 'holding gains/losses'. The rest is considered as other volume changes.

3. The Balance Sheet

The balance sheet includes both financial and non-financial assets owned by general government units, their liabilities and the net worth of the entire general government sector. All assets and liabilities are to be valued over time at market prices.

4. Statement of Sources and Uses of Cash

Although the GFSM 2001 system is based on accrual accounting, the statement of sources and uses of cash has to be prepared to identify the generation and use of cash of the general government sector. Transactions are captured when cash is received or when cash payments are made. Cash generated through government current operations, transactions in non-financial assets and transactions in financial assets and liabilities other than cash itself are included in this statement.

Balances in the New System

The new GFSM system consists of several core balances and other balances as given in Table 1. These balances can be used for macroeconomic analysis.

TABLE 1
GFS 2001 Analytical Balances

Source Document	Name of the Balance/Item	Method of Derivation	Remarks
Statement of Government Operations	Net/gross operating balance) (NOB/GOB)[1]	NOB = Revenue minus expense GOB = Revenue minus expense other than consumption of fixed capital	Reflects the change in net worth of the government due to transactions during the period. It is also a summary measure of the ongoing sustainability of government operations.
	Net lending (+)/ borrowing (-) (NLB)[1]	Net operating balance minus the net acquisition of non-financial assets.	Indicates the financial impact of government activity on the rest of the economy.
Statement of other economic flows	Change in net worth resulting from other economic flows	Total value of the changes in non financial/ financial assets and liabilities	Reflects the extent of change in net worth other than transactions
Balance Sheet	Net worth position	Total value of all assets minus total value of all liabilities	The main measure that could be used to assess the solvency of a unit or a sector.
	Net financial worth	Total value of all financial assets minus total value of all liabilities	Helps to identify financial worth of the government
	Change in net worth position	Change over a period	Reflects the sustainability of government operations. This has a wider focus than the net operating balance, as it also includes non-transaction (other) flows.
	Change in net financial worth	Change over a period	Useful in analysing government's financial activities.
Statement of Sources and Uses of Cash	Cash surplus/ deficit[1]	Net cash inflows from operating activities plus net cash out flows from investments in non-financial assets	Cash flows of the government operations can be measured.
	Net change in the stock of cash	Cash surplus/ deficit plus cash flows from financing activities	

1 NOB/GOB, NLB and cash surplus/deficit are considered as core GFS balances.

Box 14 (contd.)

Migration Path to the New System

The implementation of the fully integrated GFS system will take a long time and requires a significant amount of resources, major changes in fiscal data classification and underlying accounting systems to be compatible with the accrual based system proposed in the new system. The length of time required and progress in adapting the new system depend on the needs and circumstances specific to individual countries. However, the IMF has introduced the concept of a 'migration path' to provide guidelines to the implementation stages. The major steps include the planning, approval, and the implementation of various aspects of GFSM 2001, such as classification, compilation of balance sheets, and various stages of implementing accrual accounting. Depending on the speed of progress and the situations in each individual country, one or several steps can take place at one and the same time.

Sri Lanka's Migration Path

Like many other countries, Sri Lanka is in the process of migrating to the new compiling and reporting system, which will take at least 5 years, commencing from 2003. The process will include the reclassification of fiscal data, changing the accounting system (to move towards an accrual accounting system), changing legal practices, identification of assets to be included in the balance sheet, valuation and compilation of assets and training of staff. Sri Lanka has already classified the existing cash basis fiscal data for 2002 according to the new classification. This information will be published in the IMF's Government Finance Statistics Yearbook.

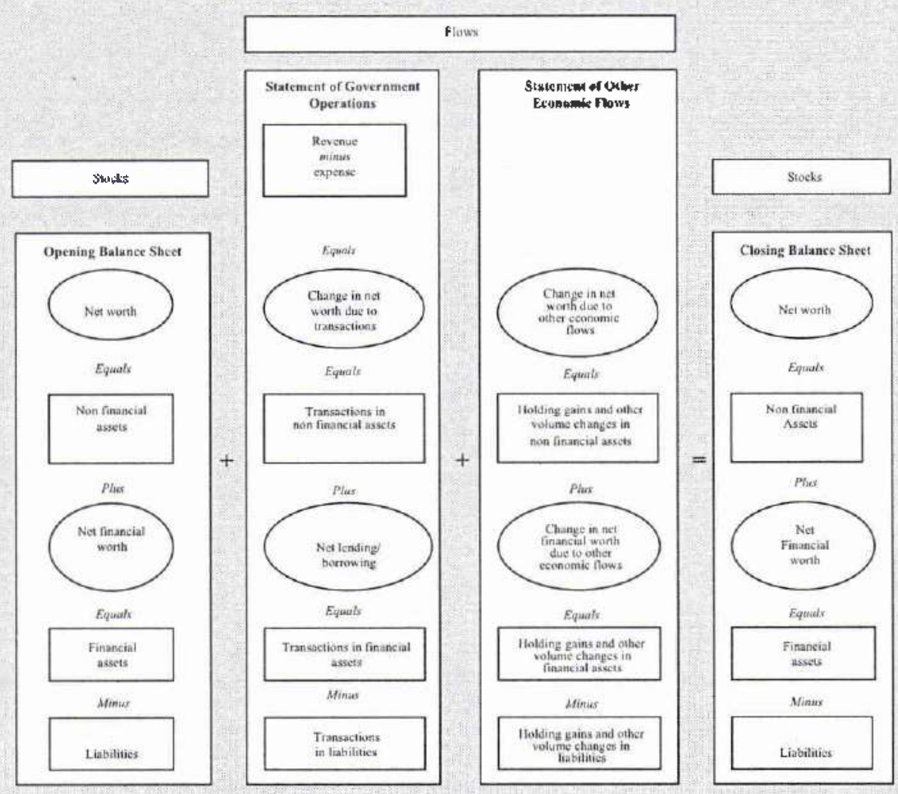
References:

1. Government Finance Statistics Manual, International Monetary Fund, 2001.

2. Tobias M. Wickens, Classification of GFSM 1986 Data to the GFSM 2001 Framework, Government Finance Statistics Manual 2001 Companion Material, International Monetary Fund, October 2002.

CHART 1

Structure of the GFS 2001 Analytic Framework



Source: IMF Government Finance Statistics Manual, 2001 under the 13th Amendment to perform these functions, was not provided with adequate legal power. As the country plans a high degree of fiscal devolution in the future, the establishment of a strong monitoring system is essential.

8.2 Budget Outturn

The fiscal consolidation process progressed further in 2003, as envisaged under the FMRA. The overall budget deficit declined to 8.0 per cent of GDP from 8.9 per cent in 2002 and 10.8 per cent in 2001. Despite slippages in revenue, significant reductions in expenditure enabled the government to lower the overall deficit. This improvement was entirely a result of the containment of recurrent expenditure including interest payments. However, the realised deficit was still 0.5 per cent of GDP higher than the original target of 7.5 per cent of GDP in Budget 2003. Inability to arrest the decline in the tax/GDP ratio was responsible for this deviation, indicating the urgent need to reverse the declining trend to achieve the fiscal consolidation targets within the stipulated time frame envisaged under the FMRA.

Following improved fiscal operations, the primary deficit, which reflects the impact of the current year's fiscal operations on the macroeconomy, and the current account deficit, which measures the level of government dis-savings, both improved considerably in 2003. Consequent to measures introduced to contain non-interest recurrent expenditure and non-priority capital expenditure, the primary deficit declined to 0.9 per cent of GDP, the second consecutive year of decline. Following the same trend, the current account deficit decreased for the second year, to 3.3 per cent of GDP. This improvement in government dis-savings was the outcome of a reduction in both interest cost and non-interest recurrent expenses. The primary deficit decreased more than the current account deficit due to a faster decline in non-interest recurrent expenditure. However, the improvement in these fiscal aggregates was below target due to a significant shortfall in tax revenue.

The public sector deficit, which is the combined deficit of the general government and public non-financial corporations, declined to 7.9 per cent of GDP. An improved performance on the part of public non-financial corporations (a deficit reduction of 0.1 per cent of GDP) also contributed to the overall improvement. CPC, CEB and CWE reduced their liabilities to the banking system in 2003. CPC was able to lower its liabilities to the banking system in 2002 with the adoption of an automatic pricing formula and improved financial management. The continuation of this strategy and the part receipt of privatisation proceeds helped CPC to reduce its liabilities further in 2003. CPC has reduced its liabilities to the banking system by Rs.3.8 billion in the last two years. In 2003, CWE commenced its restructuring programme to improve its commercial viability. Under the programme, a part of its sales network was privatised and the government settled a part of its liabilities to the banking system by issuing Treasury bonds (Rs.4.4 billion). In 2003, the total reduction of CWE liabilities to the banking system amounted to Rs.5.1 billion. CEB was able to reduce its liabilities to the banking system by about Rs.1 billion in 2003, reflecting the favourable weather conditions that prevailed during the year. However, liabilities of other public non-financial corporations to the banking system increased by about Rs.0.4 billion in 2003. There is a clear need to accelerate the reform programme in key public enterprises to improve their operational efficiency and commercial viability.

TABLE 8.1

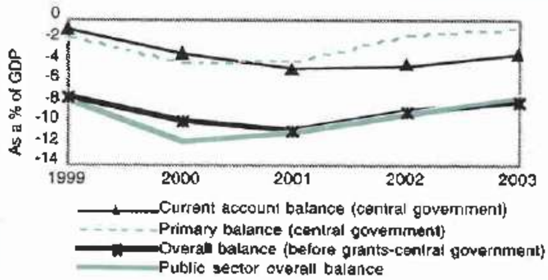
Key Fiscal Balances

As a percentage of GDP

Item	2001	2002	2003 Budget	2003 Prov.	2004 Budget
Current account deficit	-4.9	-4.4	-2.3	-3.3	-1.3
Primary deficit	-4.1	-1.6	-0.2	-0.9	-0.8
Overall deficit	-10.8	-8.9	-7.5	-8.0	-6.8
Public sector overall deficit	-11.0	-9.0	-7.1	-7.9	-6.5

Source: Ministry of Finance
Central Bank of Sri Lanka

Chart 8.3
Fiscal Indicators



Following the trend since the early 1990's, total revenue as a percentage of GDP continued to decline and reached 15.7 per cent in 2003. The revenue target for 2003 was 17.1 per cent of GDP, indicating a revenue slippage equivalent to 1.4 per cent of GDP (Rs.27 billion). The decline in the revenue/GDP ratio has been due entirely to the reduction of the tax/GDP ratio to 13.2 per cent in 2003. The total slippage in tax revenue was equivalent to about Rs.33 billion (1.9 per cent of GDP). Although Budget 2003 had envisaged a series of revenue augmenting measures to reverse the declining trend in the tax/GDP ratio, the government was not able to achieve the expected target. The shortfall in tax collection was largely in the VAT and income tax. Other taxes were on target. The vast array of exemptions, tax leakages through the refund system, low efficiency in tax administration and weaknesses in designing the VAT structure could be cited as the main causes for the slippage in VAT collections in 2003. The reduction of tax rates, investment adjustment, the tax amnesty and

TABLE 8.2
Summary of Government Fiscal Operations

Rs. million

Item	1999	2000	2001	2002	2003 Approved Estimates	2003 Provisional[1]	2004 Approved Estimates
Total revenue	195,905	211,282	234,296	261,887	303,933	276,516	331,572
Tax revenue	166,029	182,392	205,840	221,837	264,771	231,648	301,000
Non tax revenue	29,877	28,890	28,456	40,050	39,162	44,868	40,292
Revenue adjustments	-	-	-	-	-	-	-9,720
Expenditure and lending minus repayments	279,159	335,823	386,518	402,989	438,370	417,671	469,479
Current	207,271	254,279	303,362	330,847	344,611	334,693	357,674
Capital and net lending	71,888	81,544	83,157	72,142	93,759	82,979	111,805
Public investment	71,436	80,955	82,491	72,177	94,978	87,409	107,528
Other net lending	452	589	666	-35	-1,219	-4,430	4,277
Current account surplus/deficit(-)	-11,366	-42,997	-69,065	-68,961	-40,678	-58,176	-26,102
Primary account surplus/deficit(-)	-21,131	-53,341	-57,915	-24,587	-4,259	-16,029	-16,990
Overall deficit (before grants)	-83,254	-124,541	-152,222	-141,102	-134,437	-141,155	-137,907
Financing	83,254	124,541	152,222	141,102	134,437	141,155	137,907
Foreign financing	8,245	5,640	20,038	9,057	33,678	51,022	59,898
Net borrowings	1,484	495	14,538	1,978	24,678	43,066	49,898
Grants	6,761	5,145	5,500	7,079	9,000	7,956	10,000
Domestic financing	74,875	118,500	123,595	126,352	87,259	79,660	65,009
Market borrowings	75,718	115,325	122,848	127,167	87,259	79,830	65,009
Non bank	48,426	58,797	74,294	132,003	101,259	100,735	92,009
Bank	27,292	56,528	48,554	-4,836	-14,000	-20,905	-27,000
Monetary authority	20,807	44,840	-6,434	-13,266	-	-28,559	
Commercial banks	6,484	11,689	54,988	8,430	-14,000	7,654	
Other borrowings	-842	3,175	747	-816	-	-170	-
Domestic grants	-	-	-	-	-	250	-
Privatisation proceeds	134	401	8,589	5,693	13,500	10,223	13,000
				As a percentage of GDP			
Total revenue	17.7	16.8	16.7	16.5	17.1	15.7	16.4
Tax revenue	15.0	14.5	14.8	14.0	14.9	13.2	14.8
Non tax revenue	2.7	2.3	2.0	2.5	2.2	2.5	2.0
Revenue adjustments	-	-	-	-	-	-	-0.5
Expenditure and lending minus repayments	25.2	26.7	27.5	25.4	24.6	23.7	23.2
Current	18.7	20.2	21.6	20.9	19.3	19.0	17.6
Capital and net lending	6.5	6.5	5.9	4.6	5.3	4.7	5.5
Public investment	6.5	6.4	5.9	4.6	5.3	5.0	5.3
Other net lending	...	...	...	...	-0.1	-0.3	0.2
Current account surplus/deficit(-)	-1.0	-3.4	-4.9	-4.4	-2.3	-3.3	-1.3
Primary account surplus/deficit(-)	-1.9	-4.2	-4.1	-1.6	-0.2	-0.9	-0.8
Overall deficit (before grants)	-7.5	-9.9	-10.8	-8.9	-7.5	-8.0	-6.8
Financing	7.5	9.9	10.8	8.9	7.5	8.0	6.8
Foreign financing	0.7	0.4	1.4	0.6	1.9	2.9	3.0
Net borrowings	0.1	...	1.0	0.1	1.4	2.4	2.5
Grants	0.6	0.4	0.4	0.4	0.5	0.5	0.5
Domestic financing	6.8	9.4	8.8	8.0	4.9	4.5	3.2
Market borrowings	6.8	9.2	8.7	8.0	4.9	4.5	3.2
Non bank	4.4	4.7	5.3	8.3	5.7	5.7	4.5
Bank	2.5	4.5	3.5	-0.3	-0.8	-1.2	-1.3
Monetary authority	1.9	3.6	-0.5	-0.8	-	-1.6	
Commercial banks	0.6	0.9	3.9	0.5	-0.8	0.4	
Other borrowings	-0.1	0.3	0.1	-0.1	-	...	-
Domestic grants	-	-	-	-	-	...	-
Privatisation proceeds	...	...	0.6	0.4	0.8	0.6	0.6

1 Issue of government bonds to settle CWE's liabilities to commercial banks (Rs. 4,397 mn.) has been treated as a contingent liability of the government.

Source: Ministry of Finance

weaknesses in tax administration, largely contributed to lower income tax collection in 2003. Further, the corporate income tax/GDP ratio in Sri Lanka (0.9 per cent of GDP) is reported to be the lowest rate in the Asian region, underscoring the urgency of addressing the weaknesses in the corporate tax system. Meanwhile, upward revisions in excise tax rates and the imposition of duty on a large number of duty exempted imports helped to raise revenue from these taxes. Non-tax revenue exceeded the annual target in 2003 due to higher receipts from the Strikes, Riots and Civil Commotion Fund.

Profit transfers from the Central Bank remained the main non-tax revenue source.

Policies adopted in 2002 to contain non-interest recurrent expenditure were continued and helped lower such expenses as a ratio of GDP in 2003. However, expenditure overruns in some departmental enterprises, e.g., Railway and Postal departments, and flood related expenses nullified some of the benefits. Accordingly, non-interest recurrent expenditure dropped by 1.6 per cent of GDP to 11.9 per cent of GDP in 2003. This improvement was further strengthened by the reduction in interest expenditure. Interest rates in the domestic market fell further than expected. Government replaced high cost debt with low cost debt. Both these developments helped lower the interest cost in 2003. Total recurrent expenditure declined by 1.9 per cent of GDP to 19.0 per cent of GDP in 2003. During the last two years, the reduction in non-interest recurrent expenditure, as a ratio of GDP, has been about 3 per cent. This improvement shows the possibility of further containment of non-interest recurrent expenditure in areas such as defence, transfer payments to departmental enterprises, civil service expenses and welfare programmes. In addition, prudent debt management with the development of the debt market would help to continue the downward trend in the interest cost/GDP ratio, which commenced in 2003. Further improvements in recurrent expenditure are essential to achieve the medium-term fiscal consolidation targets envisaged under the FMRA.

The government's investment policy adopted in 2002 was continued in 2003. In view of the availability of donor funds and the limited availability of domestic resources, the public investment programme in 2003 was designed to absorb the maximum available project related concessional donor funds, while limiting locally funded projects to priority sectors with high returns. As a result, total public investment expenditure in Budget 2003 was kept at 5.3 per cent of GDP as in Budget 2002. The realised public investment programme shows that the government was unable to complete the annual investment plans for 2003. Although foreign resource utilisation rate improved significantly to over 20 per cent in 2003 from 14 per cent in 2002, resource constraints on the domestic front compelled the authorities to curtail the release of funds for locally funded projects. The slippages in revenue collection and the commitment to minimise the deviation from the overall deficit under the medium-term fiscal strategy were the main factors, which restricted the issue of funds for public investment. Consequently, public investment in 2003 amounted to 5 per cent of GDP, 0.3 percentage points lower than the original target. However, the realised programme was a marginal improvement over the public investment of 4.6 per cent of GDP in 2002.

The current level of public investment is far below what is required to accelerate growth to over 6-8 per cent in the medium term or to encourage private investment. However, the government faces difficulties in increasing public investment through local funding, as high domestic borrowing would destabilise macroeconomic fundamentals. Therefore, every effort needs to be made to raise the maximum possible amount of concessional donor funding for public investment. The balance funding requirement must be met from revenue sources, to avoid the negative impact of high government domestic borrowing on the overall economy. This reiterates the need to strengthen the revenue performance of the government.

In financing the budget deficit, government's reliance on the domestic market was significantly reduced to 4.5 per cent of GDP in 2003. External resources available for the financing of budgetary operations increased sharply in 2003. Total external funds for budgetary financing (loans and grants) reached a historical high of US dollars 1 billion (gross receipts) compared to US dollars 630 million in 2002. The privatisation programme performed relatively better in 2003. With these improvements, the government's borrowing requirement from domestic sources dropped to the lowest level since 1997.

The sharp increase in foreign aid utilisation in 2003 was one of the major developments that contributed to improved performance in the fiscal sector as well as other sectors in the economy. Gross resources available from external sources for financing budgetary operations amounted to Rs.96 billion, including Rs.88 billion of loans and Rs.8 billion of grants. Total disbursements included foreign programme loans of US dollars 244 million (Rs.23.5 billion) received from multilateral and bilateral donors and US dollar 100 million (Rs.9.5 billion) from NEXI of Japan. On a net basis, external resources available for financing the budget amounted to Rs.51 billion (Rs.43 billion loans and Rs.8 billion grants). As most of these funds are concessional, the burden of servicing these debts would be low. Priority needs to be given to maintaining this higher utilisation of concessional external funding for budgetary operations, as it will serve multiple objectives such as increasing public investment, lowering the borrowing pressure in the domestic market and increasing the country's reserves.

The privatisation programme in 2003 was close to the target. Proceeds from privatisation brought in Rs.10.2 billion compared to Rs.13.5 billion envisaged in Budget 2003. The privatisation of SLIC realised Rs.6 billion. A part payment of Rs. 2.7 billion received for budgetery operations from the sale of one hundred petrol stations and one third of the common user facility of CPC in 2003. The sale of 40 per cent of the retail outlets of CWE, and the sale of the government's balance share holding in plantation companies, hotels, banks and other privatised enterprises generated the balance of Rs.1.5 billion.

Higher receipts from external sources and the privatisation programme, as well as the reduction in the total resource gap helped to lower borrowing in the domestic market in 2003. Accordingly, resources mobilised from domestic sources declined to 4.5 per cent of GDP (Rs.80 billion) in comparison to 8 per cent of GDP (Rs.126 billion) in 2002.

In 2003, the government was able to reduce its liabilities to the banking system for the second consecutive year. Total government liabilities to the banking system declined by Rs.21 billion, in comparison to Rs.5 billion in 2002. This was a net outcome of a reduction in government liabilities to the Central Bank by Rs.29 billion and an increase of liabilities to commercial banks by Rs.8 billion.

With these developments, the government was also able to retire high cost debt (such as outstanding import bills with state banks) by raising funds from the domestic market at a lower rate. Further, the first three tranches of the US dollar denominated Sri Lanka Development Bonds (SLDBs), amounting to US dollars 158.5 million (Rs.15.2 billion), which matured in November and December 2003, were retired. In addition, the government was able to retire early a significant amount of callable non-market oriented debt, i.e., Rupee loans (Rs.33 billion), by raising funds in the domestic market through marketable instruments at a lower cost. A continuation of the fiscal consolidation efforts as envisaged in the FMRA would strengthen the government's ability to manage its debt operations and improve overall fiscal management.

8.3 Revenue

The revenue/GDP ratio continued to decline further in 2003, entirely due to the continuous reduction in the tax/GDP ratio. Sri Lanka's tax effort (13.2 per cent of GDP) is significantly below the average for developing countries (18 per cent). During 2003 several factors contributed to the weak performance in the tax collection. A number of tax incentives given in the Budget and the postponement and delays in implementing a number of tax measures proposed to expand the tax base significantly eroded the tax base. Further, the tax amnesty had a negative impact on the potential collection of tax revenue in 2003. In addition, weaknesses in the tax administration, especially in the refund mechanism of VAT and income taxes, also contributed to the poor performance. Non-tax revenue collection was 2.5 per cent of GDP, as in 2002. Non-tax revenue came mainly from Central Bank profit transfers and profits and dividends from public enterprises.

Tax Revenue

Tax revenue amounted to Rs.231.6 billion in 2003, a slow growth of 4 per cent in comparison to an 8 per cent growth in 2002. The share of tax revenue to total revenue declined marginally from 85 per cent in 2002 to 84 per cent in 2003. The composition of tax revenue was the same as in 2002; taxes on consumption accounting for 83 per cent of tax revenue and income taxes accounting for the balance. The share of taxes on domestic goods and services (37 per cent), taxes on imports (46 per cent) and income taxes (17 per cent) in tax revenue remained at previous year's levels, indicating a proportionate reduction in the tax revenue/GDP ratio in all three sectors in 2003.

Revenue from income taxes declined from 2.4 per cent of GDP in 2002 to 2.2 per cent of GDP in 2003. However, in absolute terms, revenue collected increased by 5 per cent to

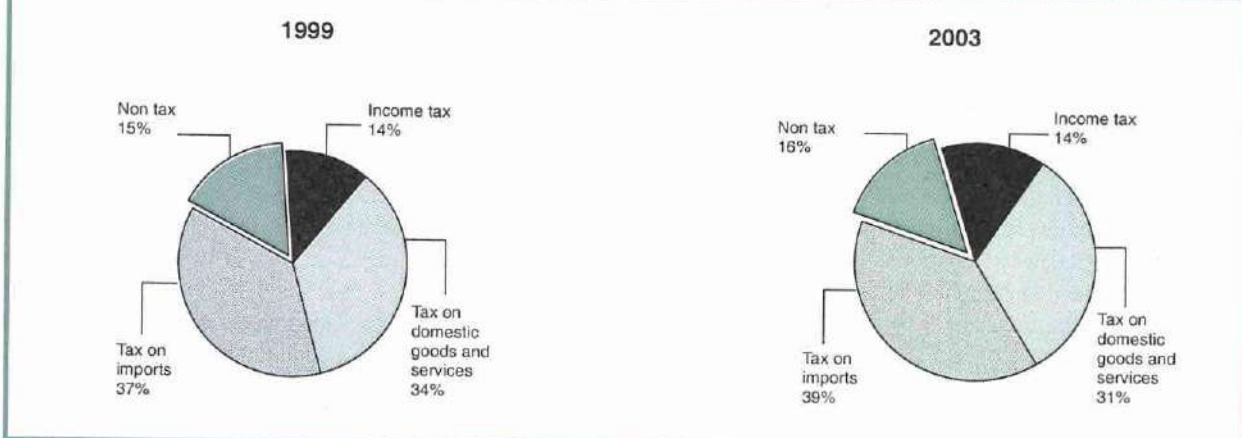
TABLE 8.3
Economic Classification of Revenue

Rs. million

Item	2002	2003 Approved Estimates	2003 Provi-sional	2004 Approved Estimates
Tax revenue	**221,837**	**264,771**	**231,648**	**301,000**
Income taxes	37,437	48,483	39,397	61,160
Personal	12,156	14,646	10,073	18,640
Corporate	13,769	19,937	15,095	28,812
Tax on interest	11,512	13,900	14,229	13,708
Stamp duties	2,331	-	51	-
Debit tax	1,315	4,100	3,611	4,367
Taxes on goods and services	148,914	172,676	148,922	186,633
Turnover tax	678	-	-	-
GST/VAT	66,692	120,435	97,230	124,771
Manufacturing	15,677	24,845	21,525	26,749
Non-manufacturing	18,644	33,967	29,424	36,731
Imports	32,371	61,623	46,281	61,291
Excise Tax	52,114	49,406	50,972	59,311
Liquor	10,235	10,940	10,735	13,752
Cigarettes	20,579	20,713	20.065	21,832
Petroleum	16,708	13,633	13,251	16,655
Other	4,593	4,120	6,931	7,072
National Security Levy	28,859	-	79	-
Licence fees/Motor vehilce tax	571	2,835	641	2,551
Taxes on international trade	31,842	39,514	39,667	48,840
Imports	28,345	33,448	34,184	42,325
Ports and Airports Development Levy	3,497	6,066	6,483	6,515
Non tax revenue	40,050	39,162	44,868	40,292
Property income	27,760	24,259	24,750	18,945
of which: Central Bank profits	10,000	10,000	10,000	5,000
Interest income	13.232	9,548	7,963	7,172
Fees and charges	4,477	4,590	4,500	5,559
Other non-tax revenue	7,814	10,314	15,618	15,788
Revenue adjustments	-	-	-	-9,720
Total revenue	**261,887**	**303,933**	**276,516**	**331,572**
	As a percentage of GDP			
Tax revenue	**14.0**	**14.9**	**13.2**	**14.8**
Income taxes	2.4	2.7	2.2	3.0
Personal	0.8	0.8	0.6	0.9
Corporate	0.9	1.1	0.9	1.4
Tax on interest	0.7	0.8	0.8	0.7
Stamp duties	0.1	-	...	-
Debit tax	0.1	0.2	0.2	0.2
Taxes on goods and services	9.4	9.7	8.5	9.2
Turnover tax	...	-	-	-
GST/VAT	4.2	6.8	5.5	6.2
Manufacturing	1.0	1.4	1.2	1.3
Non manufacturing	1.2	1.9	1.7	1.8
Imports	2.0	3.5	2.6	3.0
Excise tax	3.3	2.8	2.9	2.9
Liquor	0.6	0.6	0.6	0.7
Cigarettes	1.3	1.2	1.1	1.1
Petroleum	1.1	0.8	0.8	0.8
Other	0.3	0.2	0.4	0.3
National Security Levy	1.8	-	...	-
Licence fees/Motor vehicle tax	...	0.2	...	0.1
Taxes on international trade	2.0	2.2	2.3	2.4
Imports	1.8	1.9	1.9	2.1
Ports and Airports Development Levy	0.2	0.3	0.3	0.3
Non tax revenue	**2.5**	**2.2**	**2.5**	2.0
Property income	1.8	1.4	1.4	0.9
of which: Central Bank profits	0.6	0.6	0.6	0.2
Interest income	0.8	0.5	0.5	0.4
Fees and charges	0.3	0.3	0.3	0.3
Other non tax revenue	0.5	0.6	0.9	0.8
Revenue adjustments	-	-	-	-0.5
Total revenue	**16.5**	**17.1**	**15.7**	**16.4**

Source : Ministry of Finance

Chart 8.4
Composition of Revenue



Rs.39.4 billion in 2003 from Rs.37.4 billion in 2002. Revenue collection from corporate income taxes and personal income tax decreased as a percentage of GDP. However, higher revenue collection from the withholding tax helped offset part of the shortfall in corporate and personal income taxes.

The corporate income tax/GDP ratio in 2003 was 0.9 per cent as in 2002. Although the Advanced Company Tax (ACT) was abolished from 2002, companies could set off any previous ACT paid against their current year's tax liability. Similarly, even though the investment allowance was abolished, unclaimed balances that could be set off when calculating taxable income are still available to companies that have made large capital investments in the past, reducing the corporate tax collection from these institutions. Tax collection from large taxpayers increased during 2003, while corporate tax collection from small and medium taxpayers decreased significantly. The corporate tax collection from the banking, insurance and telecommunication sectors also decreased during 2003. This may be due to higher provisioning in the banking sector and that investment in the telecommunication sector were eligible for investment allowances. Meanwhile, the corporate income tax rate for companies with taxable income of over Rs.5 million per annum was reduced to 30 per cent from 35 per cent, but 50 per cent of this tax cut, i.e., 2.5 per cent, was to be placed in a Human Resources Endowment Fund (HREF). Public quoted companies, with 300 or more members and taxable income over Rs.5 million per annum, was to be taxed at 30 per cent of which 2.5 per cent would be credited to the HREF. However, as this Fund has not yet been established the collection for the HREF was transferred to the consolidated fund for budgetary purposes. The tax concessions and exemptions granted in Budget 2002 and Budget 2003 have also reduced the tax base, resulting in lower tax collection. The tax amnesty also may have contributed to lower collections from corporate taxes.

Personal income tax too declined significantly in 2003. The increase of the threshold from Rs.144,000 to Rs.240,000 and the upward revision of tax slabs in 2002 were the main causes. Further, the highest tax rate of 35 per cent was reduced to 30 per cent. The income tax exemption of public sector employees was limited to employment income, and their employment income was taken into account in determining the statutory income threshold for tax purpose of other income with effect from 1 April 2003.

Revenue collection from withholding tax increased by 23 per cent in 2003 to Rs.14.2 billion. The increase came mainly from witholding tax on interest earnings from government securities, which accounted for 77 per cent of the total collection. The increase of marketable securities with longer maturities could be cited as the main reason for this. Meanwhile, the tax free limit on interest income under the 10 per cent withholding tax was raised from Rs.72,000 per annum to Rs.108,000 per annum from 1 January 2003.

Revenue from consumption taxes declined to 10.9 per cent of GDP in 2003 from 11.6 per cent of GDP in 2002. The decline was in both taxes on domestic goods and services and on imports. The combined collection from GST, VAT and NSL of 6 per cent of GDP in 2002 fell to 5.5 per cent in 2003 under a unified VAT collection. The decline in the VAT collection is partly attributed to the postponement of several measures to broaden the VAT base, the operation of multiple VAT rates, administrative weaknesses in the collection mechanism and in the refund mechanism. It was planned to extend the coverage of VAT to persons providing financial services and to restrict the input tax credit entitlement on assets acquired to be made available on lease agreements to 10 per cent to broaden the VAT base and improve the net collection of taxes. However, implementation of these measures were delayed due to delays in legislature. The practice of making refunds within one month of the claims being submitted resulted in refunds being made without comprehensive audits being conducted, resulting in possible overpayment. The proportion of refunds to total tax collection increased significantly from 12 per cent under GST to 20 per cent under VAT. The VAT collection from some of the major taxable sectors could become negative as they could claim input credit for their large investments at a higher rate of 20 per cent, while paying a VAT rate of 10 per cent on their sales. Despite the growth in imports, revenue collection from VAT on imports declined marginally to 2.6 per cent of GDP, from a combined collection of VAT/GST and NSL of 3 per cent of GDP in 2002. The main reasons for that fall was that some items, which were liable for NSL earlier, were exempted from VAT and the effective rate under GST/NSL was higher than under VAT. In the manufacturing sector, the main source of VAT revenue in 2003 was construction followed by petroleum, cigarettes and liquor. In the non manufacturing sector, the main VAT revenue collection came from the telecommunications and finance and insurance sectors.

Revenue collection from excise duty declined by 2 per cent in 2003 to Rs.51 billion due to lower collections from cigarettes and petroleum products. Excise duty collection from cigarettes declined marginally to Rs.20 billion. Although the rates were revised upward on some brands of cigarettes, a decline in domestic sales of popular products contributed to the lower collection of excise duty from cigarettes. A large influx of cigarettes smuggled into the country and the local supply of illegal white cigarettes are said to have resulted in reduced domestic sales.

Growth in both hard and soft liquor production, and an upward revision of excise taxes in 2003 contributed to the higher excise duty collection from liquor. Hard liquor production increased by 13 per cent and soft liquor production increased by 12 per cent. Further, the excise duty rates were revised upwards on molasses, palmyrah arrack, coconut arrack and processed arrack from Rs.299 per proof litre to Rs.330 per proof litre and on country made foreign spirits from Rs.399 per proof litre to Rs.440 per proof litre, with effect from September 2003. Towards the end of the year, the excise duty on malt liquor below 5 per cent strength was increased to Rs.20 per litre and for malt liquor above 5 per cent strength to Rs.35 per litre from Rs.15 per litre and Rs.25 per litre, respectively.

The excise duty collection from petroleum products declined from 1.1 per cent of GDP in 2002 to 0.8 per cent in 2003. The main reason for the decline was the comparatively high excise rate structure in operation in 2002 and payment of arrears of Rs.2 billion by the CPC in 2002. The excise duty on petrol was reduced from Rs.24 per litre to Rs.21 per litre from August 2002 and subsequently increased to Rs.22 per litre in August 2003, with the imposition of the Road Tax. In a similar manner, the excise duty on diesel was brought down from Rs.4 per litre to Rs.3 per litre and then increased to Rs.3.50 per litre from August 2003. Thus, lower excise rates were applicable for diesel and petrol during most of the year.

The excise duty collection from motor vehicles increased by 51 per cent to Rs.6.9 billion in 2003. There was a significant increase in imports of high valued motor vehicles, which contributed to this higher excise collection.

Revenue from import duties (including the 20 per cent surcharge) increased sharply by 21 per cent from Rs.28.3 billion in 2002 to Rs.34.2 billion in 2003. The import duty/GDP ratio increased marginally from 1.8 per cent in 2002 to 1.9 per cent in 2003. This increase was the combined outcome of the imposition of duty on most exempted imports, upward revision of rates and growth in imports during 2003. The main sources of import duty were motor vehicles, sugar, edible oils, potatoes, big onions and milk products. The 2 per cent tariff band, which was introduced from end 2002, was increased to 2.5 per cent with effect from September 2003. In addition, specific duties on several essential items were revised upward to protect local producers. The average duty rate (the ratio of import duty collection, excluding the import duty surcharge, to total value of imports) rose to 4.6 per cent in 2003 from 4.1 per cent in 2002 as the number of zero rated items were reduced from November 2002. However, the effective duty rate (the ratio of total import duty collection, excluding the import surcharge, to dutiable imports) decreased to 12.4 per cent in 2003 from 14.7 per cent in 2002. This was mainly due to the introduction of a lower tariff rate (2 per cent) on a large number of items, which had been exempted before.

The revenue collection from the Ports and Airports Development Levy (PAL) increased sharply by 57 per cent from Rs.3.5 billion to Rs.5.5 billion in 2003 largely due to the full year impact. The PAL was introduced from 1 May 2002. From 1 January 2003, the PAL applicable for imports solely used for exports was reduced from 0.75 per cent to 0.5 per cent. The coverage of the debits tax was extended to savings deposits with commercial banks and licensed specialised banks, with effect from 1 January 2003. The exemption from debits tax on withdrawals was increased from Rs.10,000 per month to Rs.20,000 per month from 1 January 2003. Although these two taxes were introduced to recoup the revenue loss from the abolition of stamp duty, the combined revenue collection for PAL and the debits tax in 2003 as a percentage of GDP was only 0.5 per cent in comparison to an average stamp duty collection of 0.7 per cent of GDP during 1997-2001.

Non Tax Revenue

Non tax revenue increased by 14 per cent to Rs.44.9 billion, from Rs.40.1 billion in 2002, and exceeded the target of Rs.39.2 billion. As a percentage of GDP, non tax revenue collection was 2.5 per cent, the same proportion as in 2003. The higher revenue collection came mainly from Central Bank profits transfers (Rs.10 billion), revenue collection from sales and charges (Rs.9 billion) and profits and dividends from public enterprises (Rs.5.4 billion). A higher profits transfer of Rs.1.7 billion and dividends from the Sri Lanka Insurance Corporation amounting to Rs.750 million, which were not budgeted, contributed to the increased revenue from profits and dividends from public enterprises. In addition, Rs.2 billion was collected from the Strike, Riot, Civil Commotion and Terrorism Fund. However, collection from interest dues on on-lending to public enterprises by government, and rent collection, were below budget targets.

8.4 Expenditure

In 2003, the government continued its expenditure rationalisation measures with a view to strengthening the fiscal consolidation process. Accordingly, Budget 2003 envisaged maintaining total expenditure at 24.6 per cent of GDP, with current expenditure at 19.3 per cent of GDP and capital expenditure at 5.3 per cent of GDP. The realised total expenditure, decreased to 23.7 per cent of GDP in 2003 compared to 25.4 per cent in 2002. This decrease came mainly from a decline in recurrent expenditure, which amounted to 19 per cent of GDP in 2003, as against 20.9 per cent in 2002. As in previous years, the realised capital expenditure and net lending was below the annual target due to the curtailment of non priority rupee funded public investment and a shortfall in project related foreign resources. However, in comparison to 2002, expenditure on capital and net lending increased marginally to 4.7 per cent of GDP in 2003 from 4.6 per cent in 2002.

Current expenditure

In nominal terms, current expenditure increased marginally to Rs.334.7 billion in 2003. However, lower interest payments and the containment of non-interest recurrent expenditure helped reduce recurrent expenditure as a percentage of GDP. The reduction in interest payments was mainly due to a decline in market rates and reduced borrowing requirements. The decline in non-interest current expenditure was the outcome of several factors. Expenditure on personal emoluments and pension payments was contained by avoiding ad hoc salary and pension revisions in 2002 and 2003. The continuation of the ceasefire agreement contributed to containing defence related expenditure. In addition, welfare payments and transfers to public institutions were contained close to the budgeted level. However, there were expenditure overruns in departmental enterprises and new expenditure on flood relief that offset part of the benefits achieved through other measures.

In 2003, expenditure on salaries and wages, in nominal terms, increased marginally by 3 per cent, slightly higher than the budgeted level of Rs.91 billion. In 2002, the increase was 17 per cent due to the full year impact of the salary increase implemented towards end 2001. Salaries and wages declined to 5.2 per cent of GDP from 5.6 per cent in 2002. This was possible as a result of the continuation of the suspension of recruitment to the public sector, and the avoidance of ad hoc salary increases during 2003. Salaries and wages remained unchanged at 27 per cent of recurrent expenditure.

The signing of the peace agreement in 2002 and the continuation of the peaceful environment throughout 2003 enabled the government to contain defence related expenditure. Accordingly, defence expenditure (excluding expenditure on public order and safety) declined in 2003. In nominal terms,

TABLE 8.4
Economic Classification of Expenditure and Lending minus Repayment

Rs. million

Item	2002	2003 Approved Estimates	2003 Provi--sional	2004 Approved Estimates
Current expenditure	**330,847**	**344,611**	**334,693**	**357,674**
Expenditure on goods and services	139,891	137,820	138,661	158,678
Salaries and wages	88,804	90,709	91,784	105,015
Other goods and services	51,087	47,111	46,878	53,663
Interest payments	116,515	130,178	125,126	120,918
Foreign	10,618	14,680	11,586	15,547
Domestic	105,897	115,498	113,540	105,371
Current transfers and subsidies	74,441	76,613	70,906	78,078
To public corporations	7,998	5,412	5,705	3,507
To public institutions	12,093	12,464	11,945	12,543
To sub national governments	392	650	608	477
To households and other sectors	53,958	58,087	52,648	61,550
Food stamps, food subsidy etc.	740	985	694	800
Samurdhi	9,910	9,000	8,715	9,000
Pensions	31,123	33,553	31,150	36,810
Fertiliser subsidy	2,448	2,000	2,191	3,000
Other	9,737	12,549	9,898	11,940
Capital expenditure	**58,595**	**81,612**	**75,089**	**93,132**
Acquisition of real assets	26,501	51,403	36,580	53,012
Capital transfers	32,094	30,209	38,509	40,120
To public corporations	11,459	7,179	14,339	9,346
To public institutions	15,118	17,558	19,894	25,721
To sub national governments	5,421	5,000	4,186	4,830
Other	98	472	90	223
Lending minus repayment	**13,547**	**12,147**	**7,890**	**18,673**
Advance accounts	1,396	1,500	1,710	2,000
On lending	13,582	13,366	12,320	14,396
Restructuring cost	4,689	5,497	4,601	10,370
Loan repayments	-6,060	-8,216	-10,741	-8,093
Memorandum item:				
Transfers to Provincial Councils (a)	36,499	36,700	37,832	41,483
Current	30,574	31,700	30,462	32,253
Capital	5,925	5,000	7,369	9,230
Total expenditure and net lending	402,989	438,370	417,671	469,479
	As a percentage of GDP			
Current expenditure	**20.9**	**19.3**	**18.0**	**17.6**
Expenditure on goods and services	8.8	7.7	7.9	7.8
Salaries and wages	5.6	5.1	5.2	5.2
Other goods and services	3.2	2.6	2.7	2.6
Interest payments	7.4	7.3	7.1	6.0
Foreign	0.7	0.8	0.7	0.8
Domestic	6.7	6.5	6.4	5.2
Current transfers and subsidies	4.7	4.3	4.0	3.9
To public corporations	0.5	0.3	0.3	0.2
To public institutions	0.8	0.7	0.7	0.6
To sub national governments	...	...	...	...
To households and other sectors	3.4	3.3	3.0	3.0
Food stamps, food subsidy etc.	...	0.1	...	...
Samurdhi	0.6	0.5	0.5	0.4
Pensions	2.0	1.9	1.8	1.8
Fertiliser subsidy	0.2	0.1	0.1	0.1
Other	0.6	0.7	0.6	0.6
Capital expenditure	**3.7**	**4.6**	**4.3**	**4.6**
Acquisition of real assets	1.7	2.9	2.1	2.6
Capital transfers	2.0	1.7	2.2	2.0
To public corporations	0.7	0.4	0.8	0.5
To public institutions	1.0	1.0	1.1	1.3
To sub national governments	0.3	0.3	0.2	0.2
Other	...	...	...	...
Lending minus repayment	**0.9**	**0.7**	**0.4**	**0.9**
Advance accounts	0.1	0.1	0.1	0.1
On lending	0.9	0.7	0.7	0.7
Restructuring cost	0.3	0.3	0.3	0.5
Loan repayments	-0.4	-0.5	-0.6	-0.4
Memorandum item:				
Transfers to Provincial Councils (a)	2.3	2.1	2.1	2.0
Current	1.9	1.8	1.7	1.6
Capital	0.4	0.3	0.4	0.5
Total expenditure and net lending	25.4	**24.6**	**23.7**	**23.2**

Source : Ministry of Finance

(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.

defence expenditure declined by 4 per cent to Rs.47 billion and was close to the budgeted target. Defence expenditure in 2003, as a percentage of GDP, also declined to 2.7 per cent, from 3.1 per cent in 2002. Although new recruitments to the defence services increased expenditure on salaries and wages, a reduction in the import of military equipment and hardware helped reduce total expenditure. Further, expenditure incurred to maintain public order and safety decreased by 2.5 per cent to Rs.14.6 billion (0.8 per cent of GDP) from Rs.15 billion (0.9 per cent of GDP) in 2002. Total expenditure on defence and maintenance of law and order declined to 3.5 per cent of GDP from 4.0 per cent in 2002.

Despite the increase in the debt stock, the continuing decline in domestic market interest rates and the replacement of high cost government borrowing with marketable debt instruments helped reverse the increasing trend in interest payments. Interest payments, which amounted to Rs.125.1 billion in 2003, continued to be the single largest component of recurrent expenditure (37 per cent), an increase of 7 per cent over 2002. This was, however, much lower than the 24 per cent increase in 2002. Interest payments declined to 7.1 per cent of GDP from 7.4 per cent in 2002. Of the total, interest payments on domestic debt amounted to Rs.113.5 billion, while payments on foreign debt were Rs.11.6 billion. Interest payments on Treasury bonds became the major component of interest (Rs.50.9 billion) with almost twofold increase over 2002. This was clearly the result of moving to marketable debt securities. In contrast, interest payments on Rupee loans declined to Rs.35.6 billion as they were gradually phased out. Interest payments on Treasury bills decreased to Rs.24.1 billion from Rs.25.7 billion in 2002 because of lower interest rates. The balance amount of interest payments was in respect of SLDBs and non-instrument borrowings from the banking system.

In 2003, actual interest payments were significantly lower by (Rs.5.1 billion) than the budgetary allocation. Higher external borrowing through concessional sources reduced the borrowing requirement from the domestic market. This supported the declining trend in domestic interest rates, which, in turn, reduced interest costs. Close monitoring of the government cash flow operations, and improved debt management activities, also helped.

There was a reversal in the continuously increasing trend observed in current transfers and subsidies. These amounted to Rs.70.9 billion, a decline of 5 per cent over 2002. As a percentage of GDP too, it decreased, from 4.7 per cent in 2002 to 4 per cent.

In 2003, expenditure on pension payments remained almost unchanged at Rs.31 billion as in 2002. However, this was Rs.2.4 billion less than the budgetary allocation. This under expenditure was mainly due to delays in the implementation of recommendations of several committees on pension anomalies. However, late implementation of such recommendations may increase the pension payments in the

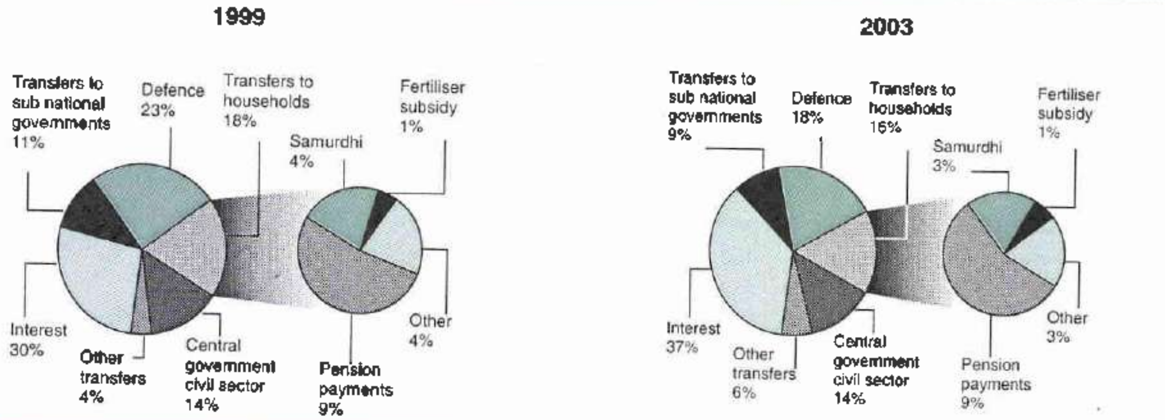
TABLE 8.5
Functional Classification of Expenditure

Rs. million

Item	2002	2003 Approved Estimates	2003 Provi-sional	2004 Approved Estimates
Current expenditure				
General public services	**80,970**	**87,534**	**86,361**	**89,536**
Civil administration	17,473	23,019	24,755	22,738
Defence	49,163	49,721	47,005	51,978
Public order and safety	14,334	14,794	14,601	14,820
Social services	**106,096**	**110,247**	**104,812**	**107,771**
Education	31,162	32,309	31,673	32,341
Health	20,234	20,132	22,073	21,871
Welfare	47,503	52,575	45,849	48,505
Community services	7,198	5,231	5,217	5,054
Economic services	**17,190**	**15,681**	**14,417**	**19,900**
Agriculture and irrigation	7,635	7,006	7,002	8,268
Fisheries	435	623	573	303
Manufacturing and mining	736	414	460	433
Energy and water supply	385	8	9	913
Transport and communucation	6,749	3,472	4,614	4,601
Trade and commerce	349	366	297	443
Other	901	3,792	1,462	4,940
Other	**126,591**	**131,150**	**129,104**	**140,467**
of which; interest	116,515	130,178	125,126	120,918
Total current expenditure	**330,847**	**344,611**	**334,693**	**357,674**
Capital expenditure and lending				
General public services	**4,714**	**4,311**	**5,203**	**7,138**
Civil administration	4,075	4,087	4,826	5,908
Public order and safety	638	225	377	1,230
Social services	15,690	24,590	19,189	28,101
Education	6,048	9,736	7,443	9,610
Health	4,713	7,098	5,403	7,755
Welfare	212	996	841	538
Housing	3,505	3,560	3,249	4,175
Community services	1,212	3,200	2,254	6,023
Economic services	**51,678**	**60,604**	**58,742**	**72,065**
Agriculture and irrigation	6,936	9,584	8,420	10,232
o/w Mahaweli Project	2,663	2,874	3,005	2,048
Fisheries	743	1,304	653	2,125
Manufacturing and mining	863	302	188	698
Energy and water supply	17,732	12,113	23,801	15,458
Transport and communucation	18,916	19,537	20,238	25,158
Trade and commerce	151	256	196	642
Other	6,337	17,509	5,246	17,753
Other	**96**	**5,472**	**4,276**	**223**
Total capital expenditure and lending	**72,177**	**94,978**	**87,409**	**107,528**
As a percentage of GDP				
Total expenditure				
General public services	**5.4**	**5.2**	**5.2**	**4.8**
Civil administration	1.4	1.5	1.7	1.4
Defence	3.1	2.8	2.7	2.6
Public order and safety	0.9	0.8	0.8	0.7
Social services	**7.7**	**7.6**	**7.0**	**6.7**
Education	2.3	2.4	2.2	2.1
Health	1.6	1.5	1.6	1.5
Welfare	3.2	3.1	2.8	2.6
Housing	0.2	0.2	0.2	0.2
Community services	0.5	0.5	0.4	0.5
Economic services	**4.4**	**4.3**	**4.2**	**4.5**
Agriculture and irrigation	0.9	0.9	0.9	0.9
Fisheries	0.1	0.1	0.1	0.1
Manufacturing and mining	0.1	...	...	0.1
Energy and water supply	1.1	0.7	1.4	0.8
Transport and communucation	1.6	1.3	1.4	1.5
Trade and commerce	...	...	...	0.1
Other	0.5	1.2	0.4	1.1
Other	**7.9**	**7.7**	**7.6**	**6.9**
of which: interest	7.4	7.3	7.1	6.0
Total expenditure and lending	**25.4**	**24.7**	**24.0**	**22.9**

Source : Ministry of Finance

Chart 8.5
Composition of Current Expenditure



future. The new contributory pension system is expected to lower the unfunded pension liability of the government in the long term.

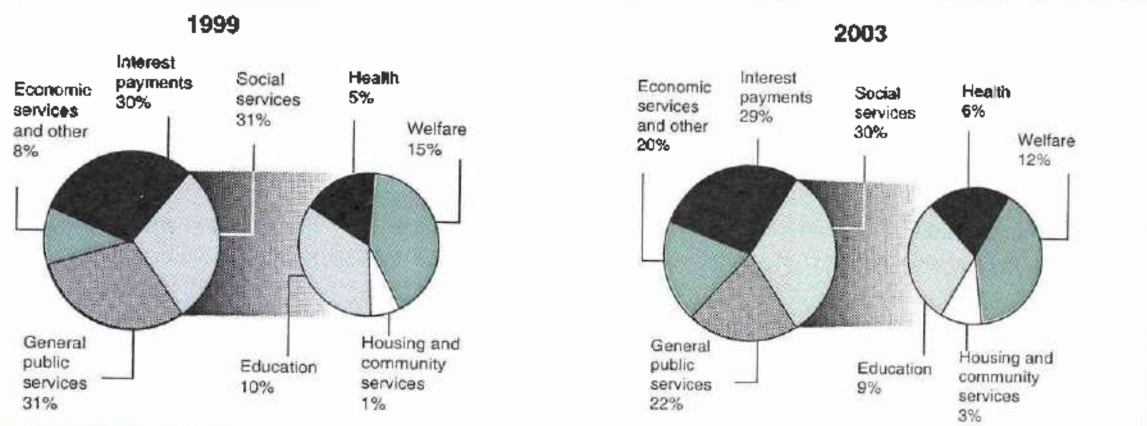
Expenditure incurred on the Samurdhi programme was Rs.8.7 billion in 2003, 12 per cent less than in 2002. This was mainly due to the strong commitment of the government to continue the screening mechanism to select only the most needy, and the continuation of the empowerment programme. The enactment of the Welfare Benefit Act in 2002 provides an opportunity to implement entry and exit criteria for Samurdhi beneficiaries in the future.

Expenditure on the fertiliser subsidy in 2003 amounted to Rs.2.2 billion, compared to Rs. 2.4 billion in 2002. However, this was a 10 per cent increase over original estimates. Despite the reduction in the usage of urea in 2003 the payment of arrears of Rs.1.1 billion carried forward from 2002 was the main reason for this increase. A quantity based fixed fertiliser subsidy scheme (Rs.300 per 50 kg bag or Rs.6,000 per metric ton), which was introduced in October 2002, continued in 2003.

Among the other welfare transfers to households, expenditure on school uniforms declined by 25 per cent to Rs.0.6 billion, mainly due to the programme introduced by the government to improve the targeting of the distribution of school uniforms to needy people. Expenditure on the provision of flood relief in May 2003 amounted to Rs.0.8 billion, for which there were no budgetary provisions in 2003. Meanwhile, expenditure on school textbooks and bus season tickets for children was maintained at the budgeted level.

Expenditure on transfers to public institutions amounted to Rs.11.9 billion, a marginal decrease over 2002. The University Grants Commission (Rs.4.6 billion), the Samurdhi Authority of Sri Lanka (Rs.2.9 billion) and the Mahaweli Authority of Sri Lanka (Rs.0.8 billion) were the major recipients of these transfers.

Chart 8.6
Expenditure by Function



Transfers to public corporations declined by 29 per cent to Rs.5.7 billion in 2003. This was mainly due to the containment of transfers to public corporations despite the higher losses incurred by Sri Lanka Railways (SLR) (Rs.2.2 billion), Regional Transport Companies (RTCs) (Rs.0.7 billion), Department of Posts (Rs.0.8 billion) and CWE (Rs. 1.8 billion). Higher fuel prices, failure to adjust railway fares to reflect operational costs, and management inefficiencies were identified as reasons for the higher losses of SLR. In 2003, the government transformed the SLR to a Railway Authority, to provide better services to rail commuters, and to minimise losses by restructuring the railway service, while making the industry viable. The increased losses of RTCs were due to management inefficiencies, the relatively large number of employees and the failure to adjust passenger fares on a cost recovery basis. Of these, the deferment of the implementation of the fare increase agreed on by the National Transport Commission in 2003 was the most important reason. The losses in the Department of Posts were mainly due to inadequate revisions in postal rates. These continuing losses in public corporations reiterates the necessity for continuing restructuring plans with regard to these public entities.

Public Investment

The public investment programme expanded in 2003. Total expenditure on public investment increased to 5.0 per cent of GDP (Rs.87.4 billion) from 4.6 per cent of GDP (Rs.72.2 billion) in 2002. However, the realised investment programme was below the annual planned programme of 5.3 per cent of GDP (Rs.95 billion) envisaged in Budget 2003. This reduction was a result of the curtailment of non-priority rupee funded capital expenditure and a shortfall of donor funded project loans linked to the investment programme. The policy adopted by successive governments to curtail planned public investment to contain the overall deficit has the negative effect of hampering the long-term growth prospects in the economy. The allocation of funds for public investment in the recent past has been below the required level, underscoring the urgency of increasing resource allocation for public investment with high return to accelerate the growth momentum, while financing this investment as far as possible through concessional foreign sources and government revenue.

Expenditure incurred by the central government (ministries and departments) for purchase of capital assets, and construction and development of fixed assets increased to 2.1 per cent of GDP (Rs.36.6 billion) compared to 1.7 per cent (Rs.26.5 billion) in 2002. These investments were mainly concentrated on education, health, agriculture, irrigation and rural development programmes. Total central government transfers for investment programmes in public non-financial corporations and institutions rose to 1.9 per cent of GDP (Rs.34.2 billion) from 1.7 per cent (Rs.26.6 billion) in 2002. Major investment programmes were reported in the Road Development Authority (RDA) (Rs.13.2 billion), Ceylon Electricity Board (CEB) (Rs.5.2 billion), National Water Supply and Drainage Board (NWSDB) (Rs.7.8 billion) and Mahaweli Development Authority (Rs.3.0 billion).

Investment activities of PCs through rupee funded programmes (Rs. 4.2 billion) reported a decline in 2003. This was a result of reduced allocation of funds from the original budget as well as further controls on releasing rupee funds from the central government due to significant shortfalls in revenue.

The central government continued its on-lending programmes to channel government guaranteed foreign funds to commercially oriented public enterprises. In 2003, the on-lending programme was limited to 0.7 per cent of GDP (Rs. 12.3 billion) compared to 0.9 per cent (Rs. 13. 6 billion) in 2002. As in the past, CEB (Rs.6.5 billion), SLPA (Rs.1.3 billion), CPC (Rs.3.7 billion) and Sri Lanka Telecom (Rs.0.2 billion) continued to be the main recipients that benefited from the programme. In comparison to the original budgetary target, the resource utilisation ratio of the on-lending programme, decreased to 92 per cent compared to 95 per cent in the previous year.

On a functional basis, public investment in economic services amounted to 3.3 per cent of GDP (Rs.58.7 billion) and accounted for 67 per cent of the total public investment programme in 2003. In comparison to the total budgetary provisions (Rs.60.6 billion), the realised programme reached 97 per cent. The shortfall was mainly due to the curtailment of funds allocated for rupee funded projects and the shortfall in the foreign funded programme.

Under the public investment on economic services, expenditure incurred in the transport and telecommunication sectors increased to 1.1 per cent of GDP (Rs.20.2 billion) and accounted for 34 per cent of investment in economic services in 2003. RDA (Rs.13.2 billion) and Sri Lanka Railways (Rs.1.7 billion) were the major investors, accounting for 74 per cent of this sectoral investment in 2003. Public investment in the energy and water supply sector reported an increase to 1.4 per cent of GDP (Rs.23.8 billion) and accounted for 41 per cent of total investment in economic services. CEB (Rs 11.7 billion) and NWSDB (Rs.7.8 billion) accounted for 82 per cent of the investment in this sector in 2003. Public investment in the agriculture and irrigation sectors (Rs.8.4 billion) and the fisheries sector (Rs.0.7 billion) accounted for 16 per cent of total investment in economic services. As in the past, the Mahaweli Authority (Rs. 3.0 billion) continued to be the main recipient. In addition, direct investment in the agriculture, irrigation and fisheries sectors by relevant ministries and departments (Rs.5.5 billion) accounted for 65 per cent of the investment in these sectors in 2003.

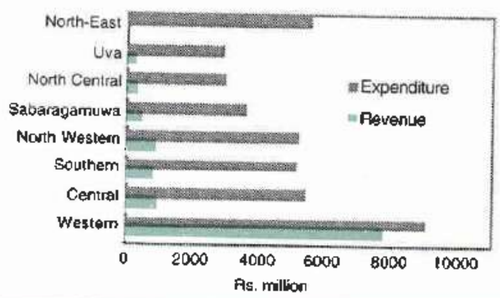
Public investment in social services, at 1.1 per cent of GDP (Rs. 19. 2 billion), showed a marginal increase compared with the 1 per cent in the previous year. This increase was seen in two major sectors, i.e. the education and health sectors. Investment in the education and health sectors was mainly for construction of schools and hospitals and improvement of their services. Investment in the housing sector (Rs.3.2 billion) was mainly focussed on the development of housing facilities for public sector employees, plantation housing and urban housing programmes. Of the total investment in community services (Rs 2.2 billion), 9 per cent was provided for the Samurdhi Authority (Rs.0.2 billion) to finance various community development and empowerment programmes.

8.5 Provincial Councils

The overall budgetary operations of PCs showed an improvement in 2003. Revenue collection increased by 24 per cent in rupee terms to 0.7 per cent of GDP. This increase reflected the revival of economic activities in the country. Expenditure was maintained at 2.8 per cent of GDP as in the previous year. Current expenditure was reduced by 0.2 percentage points to 2.3 per cent of GDP, while expenditure on provincial investment activities increased to 0.5 per cent of GDP. With these improvements, the dependence of PCs on central government grants declined to 2.1 per cent of GDP from 2.3 per cent in 2002. This improvement in budgetary operations of PCs has contributed to the consolidation of fiscal operations of the central government.

The major issues with regard to the operations of the PC system remained in 2003. Some of the major issues were the limited scope for resource allocation, inadequate power to mobilise resources, high dependence on the central government to finance the resource gap and a weak relationship with the central government due to the lack of a strong institutional framework for regulation and monitoring. The strengthening of the Finance Commission to regulate and monitor the functions

Chart 8.7
Fiscal Perfomance of Provincial Councils - 2003



of PCs could be recognised as one of the priority actions to be implemented by enacting the Finance Commission Act. However, the resolution of other requires more comprehensive reforms in the overall devolution system, which could only be implemented through constitutional amendments.

Revenue

The total revenue collection of PCs rose by 24 per cent in 2003 in comparison to an 8 per cent increase in 2002, a 25 per cent increase in tax revenue being the major cause. Increased revenue from turnover taxes and stamp duties mainly contributed to this increase and accounted for 71 per cent of total revenue. Turnover taxes grew by 14 per cent and continued to be the main revenue source of PCs. The collection from stamp duties grew by 63 per cent, reflecting the increase in property transactions with the revival of economic activity. Other revenue sources such as licence fees and sales and charges also showed moderate increases in 2003.

As in the past, the Western Provincial Council (WPC) had the largest revenue collection, accounting for 67 per cent (Rs.7,820 million) of total revenue collection in PCs in 2003. The concentration of commercial and industrial activities and the high population in the WPC helped to mobilise higher revenues there. The Central Province, the Southern Province and the North Western Province were the other major revenue collectors. The collection of provincial taxes in the Northern and the Eastern provinces has been a function of the central government due to the war situation.

Current Expenditure

The policies adopted by the government to contain non-interest recurrent expenditure helped to restrict the increase in recurrent expenditure in PCs. Accordingly, although the current expenditure increased marginally in 2003 in rupee terms, as a percentage of GDP, it declined by 0.2 percentage points of GDP to 2.3 per cent in 2003. The WPC accounted for 23 per cent of the total current expenditure of the PCs. About 70 per cent of the balance had been incurred by the Central, Southern, North East, and North West provincial councils.

TABLE 8.6
Budget Outturn for Provincial Councils

Rs. million

	2000	2001	2002	2003 Provisional
Total revenue	**7,534**	**8,674**	**9,366**	**11,625**
Tax Revenue	6,478	7,539	7,952	9,968
Non-Tax Revenue	1,056	1,135	1,414	1,656
Total expenditure	**37,328**	**40,094**	**44,314**	**49,224**
Current expenditure	28,856	33,425	38,268	39,800
o/w Wages	22,199	26,169	29993	30,582
Capital expenditure	8,472	6,669	6,046	9,423
Central government transfers	**31,543**	**30,948**	**36,499**	**37,832**
Block grants	23,220	24,699	30,574	30,462
Criteria based grants	1,323	596	1,000	607
Matching grants	665	282	307	246
Province Specific Development Grants	5,523	4,208	3,405	3,332
Grants for Special Projects	812	1,163	1,213	3,184

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

Based on the economic classification, expenditure on personal emoluments in the provincial councils increased marginally in rupee terms, but decreased by 0.2 percentage points in GDP terms to 1.7 per cent in 2003. The continuation of the government policy of the suspension of recruitment to the provincial service and avoidance of ad hoc salary increases for employees in PCs helped to contain the expenses on personal emoluments within the targeted level. The education (69 per cent) and health (22 per cent) sectors continued to be the main absorbers of personal emoluments, accounting for 91 per cent of the total personal emoluments. The balance emolument expenditure has been distributed among the other sectors such as provincial administration, community service and economic infrastructure. Other current expenditure was used for other non-wage expenses on goods and services.

Based on the functional classification, recurrent expenditure incurred by the provincial administration, economic services and social services amounted to Rs.3,264 million, Rs.1,715 million, and Rs.34,821 million, respectively. Education and health sectors continued as two main sub-sectors, representing social services and spending Rs.21,947 million and Rs.8,125 million, respectively. In view of the consolidated expenditure on education and health services by the central government and provincial councils, PCs play a major role in these two functions sharing 65 per cent and 45 per cent of total consolidated expenses, respectively.

Capital Expenditure

Total expenditure incurred by PCs for investment activities in 2003 amounted to Rs.9,423 million (0.5 per cent of GDP). This was a 56 per cent increase over the 2002. The provincial investment programme included foreign funded special projects, Provincial Specific Development Projects (PSDP), acquisition of capital goods and capital transfers. Expenditure incurred under foreign funded special projects increased. These projects include the North East Emergency Reconstruction Projects, North-East Community Restoration Project, North-East Irrigated Agricultural Project and the Southern Provincial Roads Improvement Project.

Expenditure on PSDP declined by 5 per cent, mainly due to restriction in funds released by the central government under PSDG. PSDP projects primarily focused on regional investment programmes relating to education, health and roads.

Central Government Transfers

Central government transfers to PCs include block grants, criteria based grants, matching grants, provincial specific development grants (PSDG) and foreign grants for special projects. Block grants amounting to Rs.30,462 million were provided to finance the recurrent expenditure of the PCs in 2003 compared to Rs.30,574 million in 2002. Meanwhile, criteria based grants decreased by Rs.393 million to Rs.607 million. As indicated above, funds released under the PSDG declined to Rs.3,332 million in 2003. With the inauguration of rehabilitation and reconstruction activities in the North and the East, funds transferred for foreign funded project recorded a significant increase to Rs.3,184 million in 2003. As in the past, shortfalls in revenue collections and resource constraints at the central government have restricted the transfer of funds for investment through the grant system.

8.6 Public Enterprise Reforms

As stated in the medium term policy strategy, the government's goal is to move out from all commercial activities that can be more efficiently undertaken by the private sector. Some commercial services provided by the government can be more efficiently provided through the private sector or a public-private partnership. The privatisation programme in 2003 addressed these broader objectives. The government expected to raise Rs.13.5 billion from the privatisation programme. The actual proceeds at end December 2003 amounted to Rs.10.5 billion (if the final payment for the divestiture of 100 petrol stations and one third of the common user facility of the CPC by Indian Oil Corporation (IOC) received in January 2004, is included, total privatisation proceeds amounts to Rs.14.9 billion).

The government took several further steps in its policy of liberalising the petroleum sector, announced in Budget 2002. An automatic pricing formula was introduced, the bunkering service was privatised and the Petroleum Products (Special Provisions) Act No. 33 of 2002 was enacted enabling the entry of multiple private players to the sector. In 2003, the second player to the petroleum sector, IOC, entered the market. One hundred petrol stations and a one third stake in the common user facility of the CPC was sold to IOC's local venture, Lanka Indian Oil Corporation (LIOC) at a price of US dollars 75 million. The final agreement was signed in December 2003 and part payment for the transaction, amounting to US dollars 30 million was received in December 2003 (inclusive of the US dollars 2 million advance payment in February 2003). The balance US dollars 45 million was received in January 2004. The China Bay petroleum tank farm was leased for 35 years for US dollars 100,000 per annum to the LIOC as part of the long-term plan to develop petroleum product storage facilities. The third player in the petroleum sector is expected to enter the market in 2004. The prospective investors have been short-listed and they have submitted binding bids and technical proposals for evaluation to the Technical Evaluation Committee and the Cabinet Appointed Negotiation Committee.

The other major privatisation completed in 2003 was the sale of the SLIC. Government started major reforms in the government owned insurance enterprises in 2001. Accordingly, National Insurance Corporation (NIC) was first sold in two transactions in 2001 and 2002. The process of privatisation of SLIC began in 2001 and was finalised in April 2003. The SLIC, a fully government owned company, was privatised with the sale of 90 per cent of the shares to a private sector consortium. The balance 10 per cent of the shares were distributed among

TABLE 8.7
Privatisation Proceeds Received in 2003

Name of the Enterprise	% Divested	Method of Privatisation	Privatisation Proceeds (Rs. million) (a)		
			Local	Foreign	Total
Sri Lanka Insurance Corporation	100	Tender	6,050.0	-	6,050.0
Ceylon Petroleum Corporation (b)	33	Invitation from GOSL	-	2,896.7	2,896.7
NDB	2.5	Colombo Stock Exchange	594.7	-	594.7
NDB Bank	7.2	Colombo Stock Exchange	32.7	-	32.7
Sathosa Retail Limited	40	Negotiation	680.0	-	680.0
Taj Lanka Hotels	2.7	Colombo Stock Exchange	59.7	-	59.7
Hotel Galadari	0.2	Colombo Stock Exchange	4.4	-	4.4
Colombo International School	39	Negotiation	69.0	-	69.0
Kitchen and Bakery of Department of Food		Tender	2.0	-	2.0
Plantation Companies					
Hapugastenna Plantations Limited	8.2	Colombo Stock Exchange	55.5	-	55.5
Udapussellawa Plantations Limited	9.2	Colombo Stock Exchange	17.9	-	17.9
Watawala Plantations Limited	0.2	Colombo Stock Exchange	0.1	-	0.1
Namunukula Plantations Limited	0.04	Colombo Stock Exchange	0.1	-	0.1
Kahawatta Plantations Limited	7.6	Colombo Stock Exchange	24.4	-	24.4
Total			7,590.6	2,896.7	10,487.3

(a) The government accounts show net receipts from divesture proceeds after paying commission to Colombo Stock Exchange, other service charges etc.

(b) With the full payment in January 2004 the sales proceeds from the hundred petrol stations and one third of the common user facility of CPC amounted to Rs. 7,340.8 million (USD 75 million).

Source: Public Enterprise Reform Commission

the employees. The transaction yielded Rs.6 billion. With the privatisation of the SLIC, government has almost completely moved out of the insurance sector.

Government continued its programme of selling minority shares in plantation companies in 2003. Shares in Hapugastenna Plantations Ltd. (8.2 per cent of shares for Rs.32.7 million), Udapussellawa Plantations Ltd. (9.2 per cent of shares for Rs.17.9 million), Kahawatta Plantations Ltd. (7.6 per cent of shares for Rs. 24.4 million), Namunukula Plantations Ltd. and Watawala Plantations Ltd. were sold during 2003, on the Colombo Stock Exchange.

A comprehensive restructuring programme was introduced to overcome the debt burden of the CWE and improve its service. Under the restructuring programme, government issued special government securities amounting to Rs.4.4 billion on behalf of the CWE to settle liabilities to the banking system. The CWE agreed to hand over the rights it has in property plus a 40 per cent share of Sathosa Retail Ltd., which is a subsidiary of CWE to the government. A 40 per cent stake in Sathosa Retail Ltd., and full management rights were sold to a private consortium in 2003. The transaction resulted in a net inflow of Rs.680 million.

The government gradually sold out its holdings in National Development Bank (NDB), Colombo International School, Taj Lanka Hotels, Hotel Galadari and the kitchen and bakery of the Food Department. The entire government holding in NDB (2.5 per cent of the share capital) was sold on the Colombo Stock Exchange in 2003 and yielded Rs.595 million. A part of the government holdings in NDB Bank was sold during 2003 for Rs.32.7 million. The 39 per cent of the shareholding of the government in the Colombo International School was sold to Ceyko Projects Ltd. through negotiations, for Rs.86.7 million. An amount equivalent to 10 per cent of the share of the company (Rs.17.7 million) was distributed among the employees, who were in employment on the date of transfer of the majority shareholding in November 1993. The balance Rs.69 million were the actual privatisation proceeds received for budgetary financing. The remaining shares of Taj Hotels (2.7 per cent of share capital) and a minority stake in Galadari Hotel (0.2 per cent of the share capital) were sold on the Colombo Stock Exchange in 2003 for Rs.59.7 million and Rs.4.4 million, respectively. The assets of the kitchen and bakery owned by the Food Department were sold in 2003 for Rs.1.9 million.

The liquidation process of several enterprises, which started prior to 2003 were concluded during 2003. A number of public enterprises were identified for closure, namely, Janatha Fertiliser Enterprises Ltd., Sri Lanka Rubber Manufacturing and Export Corporation, Sri Lanka National Freedom from Hunger Campaign Board, Sri Lanka Institute of Co-operative Management, Agriculture Development Authority, Sri Lanka Press Council, Sri Lanka Television Training Institute, Colombo Sack Makers and Sri Lanka Sugar Company Ltd.

The government identified several public enterprises to be restructured of which the Sugar Cane Research Institute and the Sri Lanka Cement Corporation listed for restructuring in 2004. Cabinet approval was obtained for the privatisation of State Timber Corporation, National Paper Co. Ltd, State Pharmaceutical Manufacturing Corporation, State Engineering Corporation, 4-farms of National Livestock Board and Kahatagaha Graphite. All 13 cluster bus companies, and the remaining shareholding in Sri Lanka Telecom and Shell Gas Lanka Ltd. are also listed for privatisation.

8.7 Financing the Deficit

The total resource gap in budgetary operations during 2003 declined to 8 per cent of GDP (Rs.141 billion). Although the realised resource gap exceeded the original target of 7.5 per cent of GDP (Rs.134 billion), it was 0.9 per cent of GDP less than in 2002 (8.9 per cent of GDP). In financing the resource gap, net resources available from external sources (loans and grants) amounted to 2.9 per cent of GDP (Rs.51 billion). Total privatisation proceeds realised for the financing of budgetary operations amounted to 0.6 per cent of GDP (Rs.10.2 billion). These relatively higher receipts from external sources and the privatisation programme, as well as the reduction in the total resource gap during the year contributed to lower borrowing in the domestic market. Total amount of resources raised in the domestic sector in 2003 decreased substantially to 4.5 per cent of GDP (Rs.79.7 billion) in comparison to 8.0 per cent of GDP (Rs.126.4 billion) in the previous year. This helped to reduce pressure on the domestic financial market, facilitating reductions in domestic interest rates and increasing resources available for private sector investment.

In the government borrowing strategy there was an increased dependence on market oriented debt instruments. Accordingly, the entire borrowing requirement from the domestic market was raised through marketable instruments. With the improvement in overall fiscal operations, the debt dependency, which is measured as the ratio of total borrowings relative to the total expenditure of the government, declined to 29 per cent in 2003 from 32 per cent in 2002. The combined impact of the reduction in the resource gap, improved liquidity conditions in the market and the reduction in the Central Bank policy rates (Repo and Reverse Repo) helped reduce interest rates on government securities significantly in 2003. Repayments to the banking system reduced the crowding out of private sector investment, and prevented expansionary pressure on money growth.

Domestic Borrowing

The government policy of financing its borrowing through market based instruments and reducing non-marketable debt stock continued in 2003. Accordingly there was a net repayment of Rupee loans amounting to Rs.39.3 billion in 2003 in comparison to the net repayment of Rs.5 billion in 2002. The policy of issuing Rupee loans with an optional retirement facility was also continued, allowing the government to retire them early, in a declining interest rate environment. Rupee loans amounting to Rs.48.1 billion were issued to the market in 2003, with maturity periods ranging from 2-6 years, at different interest rates. In line with the significant reduction in market interest rates, interest on Rupee loans was also reduced gradually. Institutional investors such as EPF, NSB, ETF and PSPF continued to be the main investors in the Rupee loan programme, accounting for 93 per cent of the total investment in 2003.

In 2003, the borrowing strategy of the government was formulated to raise funds mainly through medium and long-term marketable debt instruments. As a result, net borrowings through Treasury bonds increased considerably to Rs.137 billion from Rs.109 billion in 2002. As in the previous year, the policy of retiring high cost borrowings and replacing them with low cost borrowings continued in 2003. Optional Rupee loans amounting to Rs.33 billion were retired and outstanding import bills of Rs.12 billion were settled during the year and replaced with domestic rupee borrowings, mainly through Treasury bonds, at a lower interest rate. The maturity period of Treasury bonds issued in 2003 varied from 2-20 years with weighted average yield rates between 6.65 per cent and 10.89 per cent. The gap between the weighted average yield rates and coupon rates narrowed markedly due to improved liquidity in the market. Consequently, the cash shortfall in the Treasury bond programme declined significantly to 2.4 per cent of total gross receipts in comparison to the relatively high cash shortfall of 7.5 per cent and 8.5 per cent in 2002 and 2001, respectively. The domestic non-bank sector, including institutional investors, continued to dominate investments in Treasury bonds in 2003. Net borrowing through Treasury bill issues, on cash value basis amounted to Rs.14.9 billion.

Government liabilities to the banking system in 2003 declined by Rs.21 billion compared to the previous year's

Chart 8.8
Deficit Financing

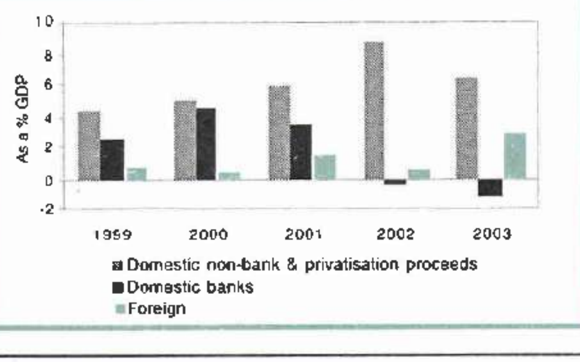


TABLE 8.8
Domestic Financing

Rupees billions

	2000	2001	2002	2003
By Instrument	**118.5**	**123.6**	**126.4**	**79.7**
Treasury bonds	90.6	21.0	109.0	137.1
Treasury bills	6.1	30.0	39.8	14.9
Rupee loans	1.8	28.9	-5.1	-39.3
Sri Lanka Development Bonds	-	14.6	8.8	-15.2
Central Bank provisional advances	4.2	3.0	0.9	0.2
Other	15.8	26.1	-27.1	-18.1
By Source	**118.5**	**123.6**	**126.4**	**79.7**
Bank	56.5	48.6	-4.8	-20.9
Non Bank	62.0	75.0	131.2	100.7

Source : Central Bank of Sri Lanka

reduction of Rs.4.8 billion. The availability of funds from domestic non-bank sources, decreased borrowing requirement and the overall improvement in the economy were the main reasons for this improvement. The reduction in net credit to government by the banking sector was the net outcome of a reduction in liabilities to the Central Bank by Rs.29 billion and an increase in liabilities of Rs.8 billion to the commercial banks. The reduction of government liabilities to the Central Bank appeared in a decline in Central Bank holdings of Treasury bills (Rs.28.4 billion), a marginal increase in provisional advances (Rs.0.2 billion) and a build up of government deposits with the Central Bank (Rs.0.4 billion). The increase in net borrowing from commercial banks (Rs.7.7 billion) was a net outcome of increased investments in government securities and reduced other liabilities to the commercial banks. Commercial banks' investments in Treasury bills and Treasury bonds in 2003 amounted to Rs.15.7 billion and Rs.25.1 billion, respectively. Government's overdraft with commercial banks decreased by Rs.1.7 billion in 2003, while the outstanding government import bills payable to the domestic units of the commercial banks decreased by Rs.12.6 billion in 2003. There was a repayment of administrative borrowings in 2003 amounting to Rs.0.2 billion in comparison to Rs.0.8 billion in 2002.

Foreign Borrowing

Utilisation of concessional funds from foreign sources to finance the budgetary operations increased significantly in 2003. A Committee was appointed in 2002 to monitor progress on foreign funded projects. A target of US dollars 1 billion was given to the Committee by the government to be raised in 2003. The government was able to raise US dollars 995 million (Rs.96 billion) for budgetary purpose. Of the total, foreign loan disbursements, on a gross basis, amounted to Rs.88 billion (US dollars 912 million). Total disbursements included US dollars 100 million (Rs.9.5 billion) from the NEXI of Japan and US dollars 344 million of concessional programme loans (Rs.33 billion), received from multilateral and bilateral donors. Total repayment of foreign borrowing amounted to Rs.34.4 billion, including deferred payments of Rs.9 billion for defence related imports in the past. Accordingly, net borrowings from foreign sources used for central government operations amounted to Rs.43.1 billion, a significant increase when compared with the Rs.2 billion in the previous year. The higher level of foreign loan disbursements was a result of the increased utilisation of available foreign resources. The rate of foreign loan utilisation, as measured by the ratio of total gross disbursements in a year to the total committed undisbursed balance, increased to 20 per cent in 2003 when compared with 14 per cent in the previous year.

Foreign Grants

The amount of foreign grants received for budgetary purposes in 2003 was Rs.7.9 billion. In absolute terms, this was an increase in contrast to the decreasing trend in the recent past. As a percentage of GDP, the amount of grants increased to 0.5 per cent when compared with 0.4 per cent in the previous year. The governments of Japan, the Netherlands and Germany continued to be the leading donors in 2003.

8.8 Government Debt

Unlike in the recent past, there has been a containment of the increasing trend in the government's outstanding debt stock as a percentage of GDP in 2003. The debt to GDP ratio increased marginally to 105.9 per cent from 105.4 per cent of GDP in 2002. The total outstanding government debt stock in nominal terms increased by 12 per cent to Rs.1,864 billion at end 2003 in comparison to Rs.1,670 billion at end 2002. The reduction of government debt was recognised as a priority in the government's policy statement and in the FMRA. Fiscal consolidation is being implemented to arrest the increasing debt and public debt management is being strengthened to support the consolidation process. The depreciation of the rupee, especially in the latter part of the year against major foreign currencies, and the increase in the net borrowing requirement had an expansionary impact on the outstanding debt stock in 2003.

In 2003, the main determinants of the debt/GDP ratio, i.e., the primary deficit of the budget and nominal interest rates, were significantly lower than in 2002. Declining interest rates helped contain the domestic debt accumulation process and decreased the domestic debt to GDP ratio to a certain extent. As in the recent past, exchange rate variation continued to be the most important factor, determining the rupee value of external debt.

Domestic Debt

The deceleration in domestic borrowing helped lower the government liability to the domestic sector in 2003 to 58 per cent of GDP, in comparison to 60 per cent at end 2002. In rupee terms however, the government domestic debt stock increased by 7.5 per cent to Rs.1,020 billion, compared to a 16 per cent increase in 2002. Following the market based borrowing policy with longer-term maturity, the share of medium and long-term debt to total domestic debt increased to 76 per cent from 73 per cent in 2002. These developments will help reduce the volatility of the debt stock and the bunching of repayment obligations as well as rollover problems in debt management in the future.

With the continuation of the market oriented borrowing policy in 2003, the share of the Treasury bond stock to the outstanding medium and long-term debt stock increased to 63 per cent from 50 per cent in the previous year. In addition, its share to total outstanding domestic debt increased to 47 per cent from 37 per cent in 2002. In contrast, there was a net reduction of the Rupee loans stock by Rs.39 billion to Rs.248 billion, which accounted for 32 per cent of medium and long-term debt and 24 per cent of the total domestic debt in 2003. The EPF and NSB continued as leading institutional investors and accounted

TABLE 8.9

Outstanding Central Government Debt (at end year)

Rs. million

	2000	2001	2002	2003 Provisional
Total Domestic Debt(a)	676,660	815,965	948,386	1,019,969
Short term	208,017	278,624	259,205	249,621
Medium and long term	468,643	537,341	689,181	770,348
By debt instrument	676,660	815,965	948,386	1,019,969
Rupee securities	263,888	292,813	287,701	248,414
Treasury bills	134,996	170,995	210,995	219,295
Treasury bonds	204,124	229,174	347,128	483,107
Sri Lanka Development Bonds	-	14,749	24,177	8,816
Other	73,652	108,234	78,385	60,337
By institution	676,660	815,965	948,386	1,019,969
Banks	199,030	256,808	247,743	228,411
Central Bank	97,778	92,871	76,342	44,587
Commercial banks(b)	101,252	163,937	171,901	183,824
Sinking fund	100	100	100	100
Non bank sector	477,530	559,057	700,043	791,459
National Savings Bank	87,263	95,976	116,632	138,939
Employees' Provident Fund	211,742	245,028	283,655	323,182
Other	178,525	218,053	299,756	329,338
Total foreign debt	542,040	636,741	721,956	843,882
Project loans	477,845	542,942	640,354	769,559
Non project loans	64,195	93,799	81,602	74,323
By type	542,040	636,741	721,956	843,882
Concessional loans	535,129	603,571	702,369	822,839
Non concessional loans	6,911	33,170	19,588	21,043
By currency	542,040	636,741	721,956	843,882
SDR	214,471	249,852	297,848	359,844
US dollars	98,130	137,401	128,952	134,538
Japanese yen	172,932	185,079	218,921	260,706
Deutsche mark(c)	28,484	33,101	53,606	63,500
Other	28,023	31,308	22,630	25,294
External supplier's credit	217	269	n.a.	n.a.
Total outstanding govt. debt	1,218,700	1,452,706	1,670,342	1,863,851
Total outstanding govt. debt net of sinking fund	1,218,600	1,452,606	1,670,242	1,863,751
Memorandum item:				
Exchange rate variation	24,104	48,844	74,044	67,691

Source: Central Bank of Sri Lanka

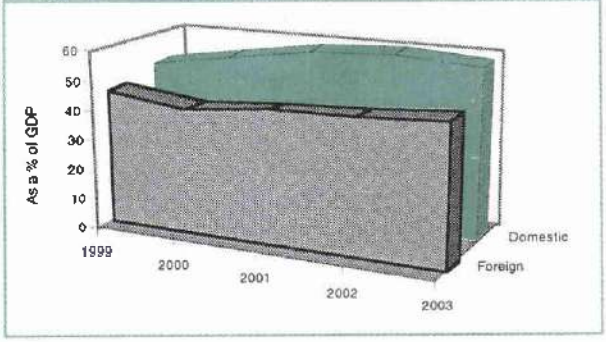
(a) Includes long term bonds of Rs. 24,088 million and Rs.23,873 million issued in 1993 and 1996, respectively.

(b) Includes outstanding balance to FCBUs: Rs.12,820 million at end 2000, Rs. 29,462 million at end 2001, Rs. 29,570 million at end 2002 and Rs. 29,406 million at end 2003.

(c) Since January 2002, outstanding debt in Deutsche mark, French franc and Italian lira have been converted into euro.

for 50 per cent of the total outstanding amount of Treasury bonds, and 72 per cent of the total Rupee loan stock. SLDBs amounting to US dollars 158.5 million (Rs.15.2 billion) were retired in 2003. As a result, the outstanding stock of SLDBs denominated in US dollars, amounted to US dollars 91.5 million at end 2003. Treasury bills continued to be the major instrument to raise short-term funds from the domestic debt market and accounted for 22 per cent of the total domestic debt stock in 2003 (Rs.219 billion). Although the borrowing policy was expected to rely more on medium to long-term marketable debt, the share of Treasury bills as a percentage of the outstanding domestic debt stock remained almost unchanged due to new issues of Treasury bills. The outstanding amount of provisional advances to the government by the Central Bank at end 2003 amounted to Rs.31.2. billion, in comparison to the available ceiling of Rs.33 billion. This was an increase of Rs.0.2 billion from end 2002. These advances are provided free of interest to the government by the Central Bank.

Chart 8.9
Composition of Government Debt



Government outstanding liabilities to the banking system declined by 8 per cent to Rs.228 billion and accounted for 22 per cent of the total domestic debt stock in comparison to 26 per cent in the previous year. The decline was mainly driven by a 42 per cent decrease in government liabilities to the Central Bank after the release of its holding of government securities to the market in open market operations. In contrast, the government's liability to commercial banks increased by 7 per cent to Rs.184 billion in 2003, as commercial banks increased their investments in government securities. Government liabilities to commercial banks by way of overdraft facilities (Rs.2 billion) and import bills (Rs.0.2 billion) declined. The share of government liability to commercial banks as a percentage of the domestic debt stock was 18 per cent. Total outstanding non-instrument debt to commercial banks decreased to Rs.38 billion in 2003 from Rs.54 billion in 2002. Of this, FCBU borrowing amounted to Rs.29 billion.

Foreign Debt

In 2003, the outstanding stock of foreign debt increased by 17 per cent to Rs.844 billion, mainly due to exchange rate variations. The sharp depreciation of the rupee against the Japanese yen and the IMF's Special Drawing Rights (SDR), increased the rupee value of the foreign debt stock by Rs.68 billion (3.9 per cent of GDP). As a percentage of GDP, the outstanding stock of government foreign debt increased to 47.9 per cent in 2003, from 45.6 per cent in 2002.

Of the total foreign debt stock, the share of concessional loans increased to 98 per cent from 97 per cent in the previous year. The outstanding stock of non-concessional loans decreased mainly due to lower outstanding defence related loans, as there were no new loans contracted due to the ceasefire. Japan continued to be the major bilateral donor and

Box 15

Public Debt Management – Events of Historical Significance

The management of public debt is an important agency function performed by the Central Bank on behalf of the Government of Sri Lanka since 1950. Highlighted below are the major events in the history of public debt management in Sri Lanka.

1923 - Issue of loans commenced under the Colonial Treasury Bills Ordinance by Crown Agents in U.K.

1937 - Issue of Rupee Loans commenced under RSSO No.7 of 1937.

1941 - Issue of Treasury bills commenced under LTBO (Chapter 287).

1950 - Public debt management was vested with the Central Bank under the Monetary Law Act.

1981 - A secondary market window was opened for Treasury bills, by the CBSL.

1986 - Weekly Treasury bill auctions commenced.

1992 - Primary Dealers were appointed.

1993 - Repo window for Treasury bills was introduced by the CBSL.

1994 - Primary Dealer system was recognised.

1995 - Non-competitive bidding at primary auctions was phased out.

1995 - Reverse Repo window was introduced by CBSL.

1995 - RSSO, LTBO and MLA were amended to enable scripless issue of Treasury bills and Treasury bonds.

1997 - Issue of Treasury bonds commenced.

2000 - Dedicated Primary Dealers were appointed.

2000 - Primary Dealer supervision commenced.

2001 - US dollar denominated Sri Lanka Development Bonds were issued.

2002 - Fiscal Management Responsibility Act was enacted.

2003 - Issue of 10, 15 and 20 year Treasury bonds commenced.

2003 - Bloomberg bond trading system for Primary Dealers was introduced.

2004 - RSSO, LTBO and MLA was amended to enable the trading of scripless securities.

2004 - Scripless Securities Settlement System (SSSS) and Central Depository System (CDS) commenced operations.

RSSO - Registered Stocks and Securities Ordinance.
LTBO - Local Treasury Bills Ordinance.
MLA - Monetary Law Act.

provider of concessional loans, accounting for 32 per cent of the total foreign debt. Japan 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. Project loans, from bilateral and multilateral sources, constituted the major part of the total foreign debt portfolio, accounting for 91 per cent of the total foreign debt stock.

Exchange rate variations have been the most critical issue in increasing the foreign debt stock in the past. Although the value of rupee depreciated only marginally against the US dollar in 2003, the amount of government foreign debt denominated in US dollars was only 15 per cent, limiting its favourable impact on debt. As the amount of foreign debt denominated in Japanese yen and SDR was 75 per cent (34 per cent and 41 per cent, respectively), the higher rate of depreciation of the rupee against these two currencies (12.7 per cent and 10.1 per cent, respectively) increased the rupee value of foreign debt significantly in 2003.

Debt Service Payments

Total debt service payments in 2003 amounted to Rs.345 billion (Rs.125 billion of interest payments and Rs.220 billion of amortisation payments), an increase of 21 per cent over 2002. As a percentage of GDP, the increase was from 17.9 per cent in 2002 to 19.6 per cent in 2003. Total debt service payments exceeded total government revenue for the second consecutive year, reflecting the declining trend in revenue and increased debt service payments. This large increase in debt service payments was mainly due to the weak fiscal performance and high cost borrowing with relatively short maturity periods seen in the recent past. In addition, the early retirement of high cost debt also contributed to increase current debt service payments although this would have long-run benefits. After debt service payments, all other expenses of the government were paid by borrowing. The high level of debt service payments restricted fund allocation for the public investment programme of the government, reducing the future growth prospects of the economy.

The increase in debt service payments was mainly on account of higher amortisation payments on domestic debt, which increased by Rs.52 billion when compared with the previous year. The significantly higher amount of amortisation payments, in 2002 as well as in 2003, was mainly a result of the bunching of maturities of high cost borrowing in 2000 and early 2001, when domestic market interest rates were at very high levels and the early retirement of high cost debt. However, this problem will ease from 2004, with measures to smoothen the maturity structure of the outstanding debt.

In 2003, interest payments amounted to Rs.125 billion (7.1 per cent of GDP), a 7.3 per cent increase when compared with the previous year. Interest payments are the single largest expenditure item, accounting for about 45 per cent of government revenue in 2003. As a result, only half the government revenue was available for other expenditure items of the government. However, interest payments on short-term debt decreased by 17 per cent, from the previous year, reflecting the reduction in short-term debt and the declining interest rates during the year. Interest payments on medium to long-term debt increased by 16 per cent in 2003. Treasury bonds issued during the period of high interest rates in 2000 and 2001, and scheduled to mature in 2003, were the main reasons for the increase in interest payments on medium and long-term debt.

Foreign debt service payments, as a ratio of export of goods and services decreased to 7.3 per cent in 2003 from 8.3 per cent in 2002 due to lower amortisation payments in 2003. The reduction in foreign amortisation payments was mainly due to a reduction in deferred payments on defence imports in 2003. Government policy of higher dependence on concessional borrowing will help to lower foreign debt service payments 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.1,905 billion at end 2003. Of this, Rs.40.6

TABLE 8.10
Government Debt Service Payments

Rs. million

	1999	2000	2001	2002	2003 Provisional	2004 Estimates
Debt service payments	**103,885**	**175,726**	**179,072**	**284,358**	**344,634**	**316,731**
Amortisation payments	41,762	104,526	84,765	167,843	219,508	195,813
Domestic	20,322	81,244	56,844	130,786	185,083	164,048
Foreign	21,440	23,282	27,921	37,057	34,425	31,765
Interest payments	62,123	71,200	94,307	116,515	125,126	120,918
Domestic	53,371	62,185	84,560	105,897	113,540	105,371
Short term	13,085	12,767	26,109	29,422	25,147	17,304
Medium and long term	40,837	49,418	58,451	76,475	88,393	88,067
Foreign	8,752	9,015	9,747	10,617	11,586	15,547

Source: Central Bank of Sri Lanka

TABLE 8.11
Government Debt Indicators

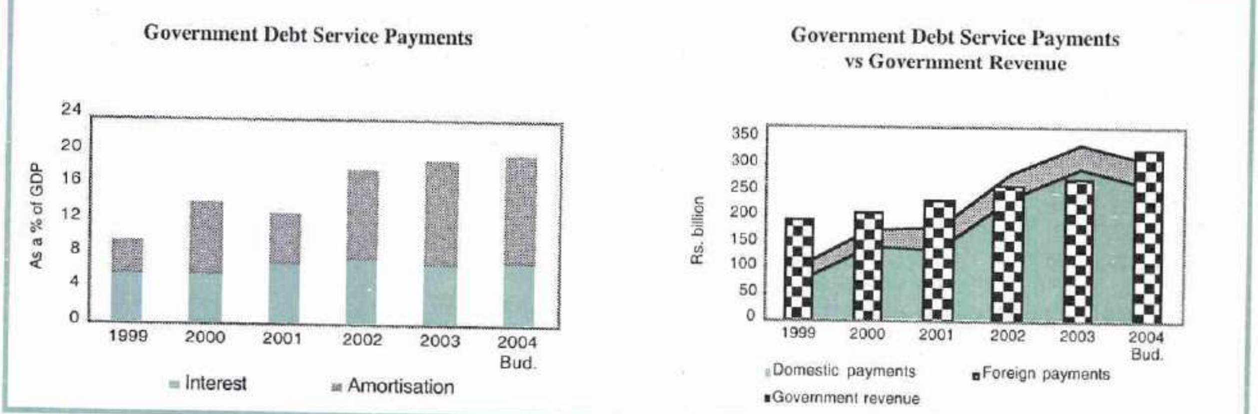
Per cent

	1999	2000	2001	2002	2003 Provisional	2004 Estimates
Government debt/GDP	95.1	96.9	103.2	105.4	105.9	98.9
- Domesitc debt/GDP	49.1	53.8	58.0	59.8	57.9	53.5
- Foreign debt/GDP	45.9	43.1	45.3	45.6	47.9	45.4
Total foreign debt/Exports[1]	129.1	110.1	115.5	126.4	133.7	129.8
Total debt service/GDP	9.4	14.0	12.7	17.9	19.6	15.6
Total debt service/Government revenue[2]	53.0	83.2	76.4	108.6	124.6	95.5
o/w Domestic debt service/Government revenue[2]	37.6	67.9	60.4	90.4	108.0	81.3
Total debt service/Government expenditure[3]	31.3	38.7	38.0	49.8	54.1	47.6
o/w Domestic debt service/Government expenditure[3]	22.2	31.6	30.0	41.5	46.9	40.5
Foreign debt service/Exports[1]	7.7	6.6	6.8	8.3	7.3	6.7
Domestic interest/GDP	4.8	4.9	6.0	6.7	6.4	5.2
Domestic interest/Government current expenditure	25.7	24.5	27.9	32.0	33.9	29.5
Foreign interest/Exports[1]	2.2	1.8	1.8	1.9	1.8	2.2

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

Source: Central Bank of Sri Lanka

Chart 8.10
Debt Service Payments



billion (2.3 per cent of GDP) was held by public corporations. The total outstanding debt stock of the public sector amounted to 108.2 per cent of GDP at end 2003, in comparison to 108.1 per cent at end 2002. This was a combined outcome of an increase of central government debt by 0.5 per cent of GDP and a reduction of non-financial public corporation debt by 0.4 per cent of GDP. CEB, CPC and CWE, continued to be major public corporation debtors, accounting for 67.4 per cent of the total public corporations' debt. The debt stock of CWE has significantly decreased due to the issue of government bonds, worth Rs.4.4 billion to the commercial banks towards the end of the year. During the year, the liability of CEB, CWE and CPC to the banking system decreased by 6 per cent, 68 per cent and 8 per cent, respectively.