

## Chapter 6

# FISCAL POLICY AND GOVERNMENT FINANCE

### 6.1 Overview

The fiscal policy in 2004 was directed at achieving the targets stipulated in the Fiscal Management (Responsibility) Act (FMRA) and the objectives laid down in the Economic Policy Framework of the Government of Sri Lanka (EPF-GOSL) released in July 2004. Thus, the fiscal policy thrust was placed on continuing the fiscal consolidation process, increasing public investment, strengthening debt management, developing debt markets, restructuring public enterprises, providing relief to the general public, while enhancing transparency and accountability in conducting fiscal operations.

The overall fiscal management and the maintenance of fiscal targets, however, became challenging in 2004, due to adverse external and domestic shocks that led to a slippage in revenue collection and an over run in expenditure. In addition, the delays and lower than the expected foreign financing and privatisation proceeds aggravated the difficulty in managing public finances.

It is encouraging that the declining trend in tax/GDP ratio reversed in 2004 reflecting the impact of widening the tax base and improving the tax collection. However, the annual tax collection recorded a shortfall of 0.9 per cent of GDP compared to the budgetary target of 14.8 per cent in 2004. Similarly, the expenditure overrun was about 0.3 per cent of GDP increasing the central government overall fiscal deficit from the target of 6.8 per cent of GDP (which was subsequently changed to 7.3 per cent with the Pre Election Budgetary Position Report in February 2004) to 8.2 per cent. The concomitant public sector deficit increased to 8.4 per cent of GDP as a result of operational losses of non-financial public corporations, mainly, the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB).

The increased public sector deficits were financed largely through borrowings from domestic sources. The total net domestic borrowing of the government increased to Rs. 117 billion (5.8 per cent of GDP) compared to the original target of Rs. 65 billion (3.2 per cent of GDP). Similarly, the outstanding banking debt of public corporations rose by Rs. 5 billion to Rs. 41.2 billion in 2004. Consequently, the central government debt and the public sector debt accounted to 105.5 and 107.5 per cent of GDP, respectively, by end 2004.

In 2004, the government introduced a series of measures to improve the fiscal performance. Major measures included the followings: reforming the tax and tariff systems; strengthening tax administration, inter alia, by setting up of the Revenue Board, introducing Economic Service Charge (ESC), rationalising recurrent expenditure, and revising administrative prices; strengthening public enterprises by setting up the Strategic Enterprises Management Agency (SEMA); strengthening administrative reforms by establishing the Administrative Reforms Committee (ARC) and the National Council for Administration (NCA), and enhancing transparency and accountability in government operations by adhering to reporting requirements of the FMRA and setting up of the National Procurement Agency (NPA). Priority was also given to public investment to stimulate sustainable and regionally balanced economic growth. These measures would help resolve several major drawbacks on the fiscal front, such as declining revenue/GDP ratio, under performance of the public investment programme, consistently high budget deficits and high public debt burden. The timely rectification of those drawbacks is important, as their impact could spill over to the rest of the macroeconomic management efforts through high demand pressures, excessive resources requirement, and crowding out of private investment.

The Budget 2005 has outlined the expected medium term macroeconomic framework, aiming at a steady improvement in fiscal performance, high savings and investment and high economic growth, moderate inflation, and improved external balances. The medium term macroeconomic framework will be affected particularly by the tsunami disaster as the country has to incur relief, rehabilitation and reconstruction (RRR) expenditure. The key macroeconomic targets, i.e., GDP growth, inflation and reserve build-up are expected to be maintained. The RRR would require an estimated resources requirement of about US dollars 1.8 billion in the medium term. In view of the domestic resource constraints, it is essential to ensure the pledged foreign assistance is received, timely, for the government to make steady progress in this effort.

Chart 6.1  
Major Fiscal Indicators (as a % of GDP)

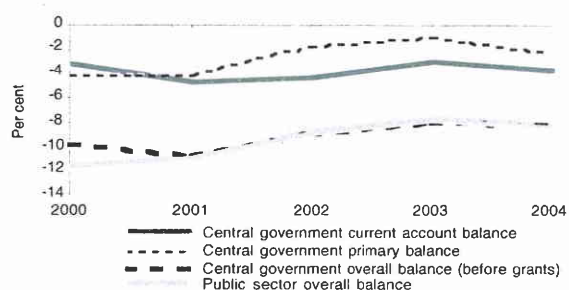


Table 6.1  
Summary of Government Fiscal Operations

Item	Rs. million			
	2003	2004 Approved Estimates	2004 Provisional	2005 Approved Estimates
Total revenue	276,516	331,572	311,473	389,492
Tax revenue	231,648	301,000	281,552	351,119
Non tax revenue	44,868	40,292	29,921	38,373
Revenue adjustments	-	-9,720	-	-
Expenditure and lending minus repayments	417,671	469,479	476,905	560,638
Current	334,693	357,674	389,678	418,988
Capital and net lending	82,979	111,805	87,227	141,650
o/w Public investment	87,409	107,528	97,631	144,440
Current account surplus/deficit(-)	-58,176	-26,102	-78,205	-29,496
Primary account surplus/deficit(-)	-16,029	-16,990	-45,650	-43,146
Overall deficit (before grants)	-141,155	-137,907	-165,432	-171,146
Financing	141,155	137,907	165,432	171,146
Foreign loans	43,066	49,898	37,071	48,684
Foreign grants	7,956	10,000	8,681	10,200
Domestic borrowings	79,660	65,009	117,243	104,761
Market borrowings	79,830	65,009	112,563	104,761
Non bank	100,735	92,009	69,274	104,761
Bank	-20,905	-27,000	43,289	-
Monetary Authority	-28,559	-	65,828	-
Commercial banks	7,654	-	-22,539	-
Other borrowings	-170	-	4,680	-
Domestic grants	250	-	-	-
Privatisation proceeds	10,223	13,000	2,437	7,500
As a Percentage of GDP				
Total revenue	15.7	16.4	15.4	17.1
Tax revenue	13.2	14.8	13.9	15.4
Non tax revenue	2.5	2.0	1.5	1.7
Revenue adjustments	-	-0.5	-	-
Expenditure and lending minus repayments	23.7	23.2	23.5	24.6
Current	19.0	17.6	19.2	18.4
Capital and net lending	4.7	5.5	4.3	6.2
o/w Public investment	5.0	5.3	4.8	6.3
Current account surplus/deficit(-)	-3.3	-1.3	-3.9	-1.3
Primary account surplus/deficit(-)	-0.9	-0.8	-2.2	-1.9
Overall deficit (before grants)	-8.0	-6.8	-8.2	-7.6
Financing	8.0	6.8	8.2	7.6
Foreign loans	2.4	2.5	1.8	2.1
Foreign grants	0.5	0.5	0.4	0.4
Domestic borrowings	4.5	3.2	5.8	4.6
Market borrowings	4.5	3.2	5.5	4.6
Non bank	5.7	4.5	3.4	4.6
Bank	-1.2	-1.3	2.1	-
Monetary Authority	-1.6	-	3.2	-
Commercial banks	0.4	-	-1.1	-
Other borrowings	...	-	0.2	-
Privatisation proceeds	0.6	0.6	0.1	0.3

Source : Ministry of Finance and Planning

## 6.2 Fiscal Policy Measures and Policy Direction

The fiscal policy in 2004 aimed at fiscal consolidation, enhancing public investment, reforming public enterprises, strengthening debt management, developing debt markets, and improving fiscal transparency and accountability, while providing relief to the general public. Fiscal consolidation was

attempted through implementing measures to enhance revenue, while rationalising expenditure. The public investment programme was formulated to absorb maximum possible amount of concessional foreign funds, while streamlining the rupee funded investments on a priority basis. New strategies were adopted to increase commercial viability of public enterprises under the EPF-GOSL. Fiscal transparency and accountability was strengthened by adhering to reporting requirements of the FMRA, and setting up of the NPA. Tax and expenditure policies were also used to provide relief to the general public in 2004.

Several policy measures were taken to increase tax revenue, as revenue augmentation is the main contributor in the envisaged fiscal consolidation process in Sri Lanka. Major policy measures include the reforming of the Value Added Tax (VAT) system, introduction of ESC, and strengthening tax administration. Measures were also taken to improve revenue by strengthening the income tax system, revising excise taxes upwards and reforming the tariff system. In addition, a new law was introduced in 2004 limiting the coverage of the tax amnesty granted under the Inland Revenue (Special Provisions) Acts in 2002 and 2003 in order to minimise potential revenue slippages. Accordingly, tax amnesty was made applicable only for income taxes.

Reforms in VAT include unifying the two-band VAT rates (10 per cent and 20 per cent) to a single rate (15 per cent), and streamlining the tax collection and refunds process through administrative reforms. Compensating changes were made to import and excise duties to neutralise revenue losses due to unification of VAT rates. During the year, excise duty on selected motor vehicles were raised substantially to discourage the import of fuel inefficient vehicles. In addition, duty concessions were granted on several food items and inputs to provide relief to the general public.

The purpose of imposing ESC on April 1, 2004 was to bring the corporate entities which were not paying corporate taxes into the tax net. In addition, income tax exemptions were rationalised, withholding and income tax bases were widened, and tax compliance was improved through revisions made to non compliance of registration requirements of the Inland Revenue Department (IRD).

The tax administration was strengthened by appointing a Revenue Board (RB) comprising Secretary to the Treasury, and heads of IRD, Sri Lanka Customs, Excise Department and the Board of Investments (BOI). The RB is entrusted with improving the revenue administration system by addressing the fragmented and compartmentalised nature of the existing system, improving its effectiveness and improving labour relations. A taxation cluster was appointed in 2004 under the National Council for Economic Development (NCED) to facilitate the implementation of tax policies outlined in the budget and to formulate the overall tax reforms in line with the developments in the economy. The establishment of the Appeal Unit at the IRD and a

proposed Tax Charter would help create a taxpayer friendly environment and a community healthy taxpayers. Furthermore, the establishment of Dedicated Tax Courts and proposed appointment of an independent Tax Ombudsman would facilitate fair and expeditious settlement of taxpayers' grievances and speedy dispensation of tax related cases. A Code of Conduct has been circulated among employees in the IRD to improve accountability of employees.

To further strengthen the process of fiscal consolidation, efforts were taken to contain in recurrent expenditure. A gradual reduction of defence expenditure, as a per cent of GDP, was envisaged along with the continuation of ceasefire agreement. Improved fiscal management and low interest rates were expected to be helpful in reducing the interest cost. The government took initiatives to correct the administrative prices and fees and charges to a certain degree during the year to reduce the budgetary transfers arising from factors such as escalating oil prices. The public investment programme was directed towards increasing foreign funded programmes, while limiting the rupee funded non priority programmes.

The new government institution, SEMA, was established to restructure strategic public enterprises while retaining the government ownership. The objectives of restructuring were to improve management and efficiency in strategic enterprises so that they would be commercially viable, financially self-supporting and free from political interferences, while ensuring freedom for commercial pricing, human resource management and procurement decisions. The operations of 12 major strategic enterprises have been brought under the supervision of the SEMA.<sup>1</sup> The Public Enterprise Reform Commission (PERC) continued the reform process of other public enterprises, facilitating the efficiency and competitiveness of these enterprises.

As a measure to alleviate the chronic unemployment problem among graduates, 42,588 unemployed graduates were provided with training opportunities, with an understanding, once they successfully complete training, they could be absorbed into the public service to fill the existing vacancies. The government's function, as the employer of last resort, has been resorted to by many previous governments in view of the high socio- political well-being it would generate. However, for the program to be successful in the long run without being a burden on the future tax payers, it is necessary that the improvements in the efficiency of the public sector as a result of the new recruitments should be positively contributed to the future economic growth thereby expanding the tax base. This could be attained by organising the training programme to make an attitudinal

change in these graduates, while enabling them to acquire new technical skills and competencies to perform better. In this connection, the three step recruitment process, first, training of graduates in general skills development, second, providing them on the job training and finally, recruiting them to fill specific vacancies in the public sector, can be considered as a proper strategy to address this issue.

As stipulated under the FMRA, the medium term fiscal policy of the government was presented in three statements, viz, Fiscal Strategy Statement - 2005, Budget Economic and Fiscal Position Report, and Medium Term Macroeconomic Framework for 2005-2008 along with the Budget 2005 in November 2004. According to these statements, the medium term policy is directed at continuing the fiscal consolidation process mainly by enhancing revenue and rationalising recurrent expenditure, while refraining from compressing capital expenditure to maintain budgetary targets. This process needs to be complemented by the continuation of tax reforms, public enterprises reform, pension reforms through contributory pension system, civil service reforms and the development of the domestic bond market to improve the sustainability of the fiscal consolidation programme. Further, the fiscal adjustments will be directed aiming at achieving a surplus in the current account and eliminating inflationary financing, promoting public expenditure on human resources development and quality public investments in infrastructure and rural development, while giving priority to pro-poor-pro-growth development strategy with a strong focus on reducing rural and urban poverty as well as lowering regional income disparities.

### 6.3 Central Government Budgetary Operations

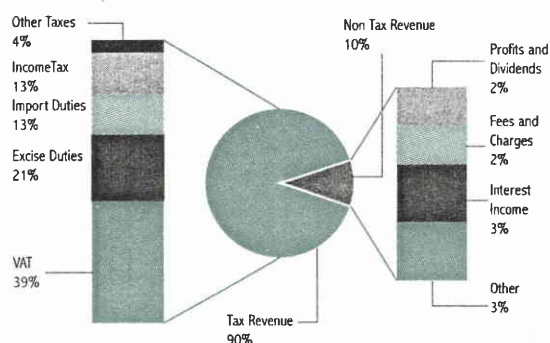
The budget deficit increased from 8.0 per cent of GDP in 2003 to 8.2 per cent in 2004, a considerably higher deficit than the target of 6.8 per cent planned in Budget 2004, as a result of revenue slippages and additional expenditure on subsidies. The current account deficit increased to 3.9 per cent from 3.3 per cent of GDP and primary deficit increased to 2.2 per cent from 0.9 per cent of GDP in 2003, revealing significant deviations from targets of 1.3 per cent and 0.8 per cent of GDP envisaged in Budget 2004. As a result, the debt dependency ratio, the ratio of total net borrowings relative to the total expenditure of the government, increased to 32 per cent from 29 per cent in 2003.

#### Revenue

The government revenue declined to 15.4 per cent of GDP in 2004, from 15.7 per cent in 2003. It also declined against the budgetary target of 16.4 per cent of GDP in 2004. The revenue was composed of 90 per cent tax revenue and 10 per cent non-tax revenue. Thus, the decline in revenue as a percentage of GDP was due to a substantial decline in non-tax revenue, although the tax revenue as a percentage of GDP increased reversing the historical trend.

<sup>1</sup> The 12 strategic enterprises are Bank of Ceylon, People's Bank, National Savings Bank, State Mortgage and Investment Bank, Ceylon Electricity Board, Ceylon Petroleum Corporation, Sri Lanka Ports Authority, Airports and Aviation Authority of Sri Lanka, Sri Lanka Railways, Central Transport Board and all regional Cluster Bus Companies, National Water Supply and Drainage Board and State Pharmaceutical Corporation.

Chart 6.2  
Composition of Government Revenue - 2004



The non-tax revenue declined from 2.5 per cent to 1.5 per cent of GDP in 2004, reflecting the non implementation of some of the budget proposals. These included the transfer of funds from dormant EPF accounts and sale of government lands, and lower than expected profit transfers from the Central Bank.

The tax revenue increased to 13.9 per cent from 13.2 per cent of GDP in 2003, reflecting increases in revenue from VAT, import duty and excise duty, despite the reduction in the revenue from the income tax. The revenue from VAT increased due to both improvements in VAT administration and the refund mechanism. Upward revisions of excise taxes and import duties coupled with increased values of production and imports which are subject to such taxes contributed to the increases in revenue.

Table 6.2  
Economic Classification of Revenue

Rs. million			
Item	2003	2004 Approved Estimates	2004 Prov. 2005 Approved Estimates
Tax revenue	231,648	301,000	281,552
Income taxes	39,397	61,160	41,372
VAT	97,230	124,771	120,382
Excise Tax	50,972	59,311	65,790
Import duties	34,184	42,325	41,096
Other taxes	9,865	13,433	12,912
Non tax revenue	44,868	40,292	29,921
Revenue Adjustment	-	-9,720	-
Total revenue	276,516	331,572	311,473
As a Percentage of GDP			
Tax revenue	13.2	14.8	13.9
Income taxes	2.2	3.0	2.0
VAT	5.5	6.2	5.9
Excise Tax	2.9	2.9	3.2
Import duties	1.9	2.1	2.0
Other taxes	0.3	0.3	0.6
Non tax revenue	2.5	2.0	1.5
Revenue Adjustment	-	-0.5	-
Total revenue	15.7	16.4	15.4

Source : Ministry of Finance and Planning

The income tax revenue declined due to the low withholding tax collection from government securities. The imposition of ESC partially compensated for the reduction in the income tax revenue, as it resulted in the corporates' paying a tax even when they were showing accumulated losses. Any further reduction in income tax revenue was checked by the introduction of measures to rationalise the tax incentives and concessions, which are the major slipping sources of tax revenue.

## Expenditure

The total expenditure, composed of recurrent expenditure, and capital expenditure and net lending, decreased marginally to 23.5 per cent in 2004 from 23.7 per cent of GDP in the previous year. The recurrent expenditure as a per cent of GDP increased to 19.2 per cent from 19 per cent in 2003 and the original budgetary target of 17.6 per cent. The capital expenditure and net lending declined from 4.7 per cent of GDP in 2003 to 4.3 per cent in 2004.

The increase in recurrent expenditure was largely due to the significantly increased transfers to households and public corporations in 2004 and the marginal increase in the salary bill. Inadequate revisions in administered prices, inefficiencies in some public corporations and the cost of living alleviation measures were attributed to the increase in transfers. The marginal decrease in expenditure on Samurdhi programme was mainly due to the slight decrease in the number of beneficiaries under the programme. The revisions introduced to the fertiliser subsidy scheme led to an increase in the expenditure related to it. Among the other welfare transfers to households, expenditure on school uniforms increased mainly due to the recommencement of the system of providing uniforms to all school students, instead of the targeting only the needy children. The interest payments declined in 2004 benefited by the low interest rate regime, and the premium collected from issuing government Treasury bonds.

This increase in expenditure coupled with a revenue slippage in 2004 compelled the government to reduce the rupee funded public investment programme thereby reducing the total

Chart 6.3  
Composition of Government Current Expenditure - 2004

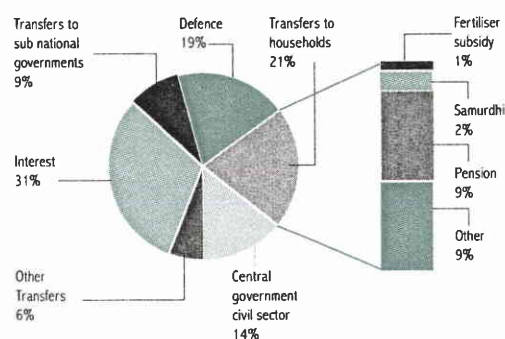




Table 6.3

**Economic Classification of Expenditure and Lending Minus Repayment**

Item	Rs. million			
	2003	2004 Approved Estimates	2004 Prov.	2005 Approved Estimates
Current expenditure	334,693	357,674	389,678	418,988
Expenditure on goods and services	138,661	158,678	164,529	199,453
o/w Salaries and wages	91,784	105,015	106,187	140,517
Interest payments	125,126	120,918	119,782	128,000
Foreign	11,586	15,547	13,904	18,383
Domestic	113,540	105,371	105,878	109,617
Current transfers and subsidies	70,906	78,078	105,367	92,435
o/w To households and other sectors	52,648	61,550	83,585	69,489
Samurdhi	8,715	9,000	8,498	9,635
Pensions	31,150	36,810	36,444	41,916
Fertiliser subsidy	2,191	3,000	3,572	4,200
Other	10,592	12,740	35,071	13,738
Under expenditure	-	-	-	-900
Capital expenditure	75,089	93,132	83,807	129,111
Acquisition of real assets	36,580	53,012	40,449	75,184
Capital transfers	38,509	40,120	43,359	59,016
Under expenditure	-	-	-	-5,089
Lending minus repayment	7,890	18,673	3,420	12,539
Total expenditure and net lending	417,671	469,479	476,905	560,638
As a percentage of GDP				
Current expenditure	19.0	17.6	19.2	18.4
Expenditure on goods and services	7.9	7.8	8.1	8.8
o/w Salaries and wages	5.2	5.2	5.2	6.2
Interest payments	7.1	6.0	5.9	5.6
Foreign	0.7	0.8	0.7	0.8
Domestic	6.4	5.2	5.2	4.8
Current transfers and subsidies	4.0	3.9	5.2	4.1
o/w To households and other sectors	3.0	3.0	4.1	3.1
Samurdhi	0.5	0.4	0.4	0.4
Pensions	1.8	1.8	1.8	1.8
Fertiliser subsidy	0.1	0.1	0.2	0.2
Other	0.6	0.6	1.7	0.6
Under expenditure	-	-	-	...
Capital expenditure	4.3	4.6	4.1	5.7
Acquisition of real assets	2.1	2.6	2.0	3.4
Capital transfers	2.2	2.0	2.1	2.5
Under expenditure	-	-	-	-0.2
Lending minus repayment	0.4	0.9	0.2	0.6
Total expenditure and net lending	23.7	23.2	23.5	24.6

Source : Ministry of Finance and Planning

public investment to 4.8 per cent of GDP from 5 per cent in 2003. However, the low public investment by successive governments has led to a poor and dilapidated infrastructure that has been the main constraint for high growth momentum in the past and regional income disparity.

Public investment programme continued in 2004 to improve the economic and social infrastructure in the country. On a functional basis, economic services continued as a major sector in terms of fund allocation amounting to 63 per cent of total public investment followed by social services sector

Chart 6.4

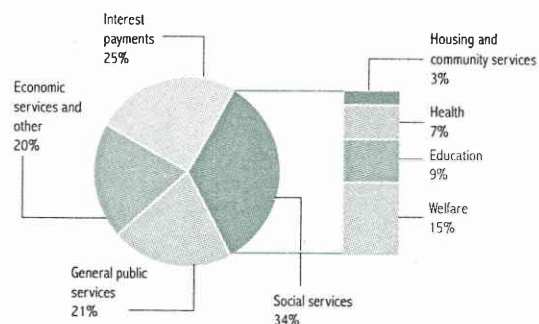
**Total Expenditure by Function - 2004**

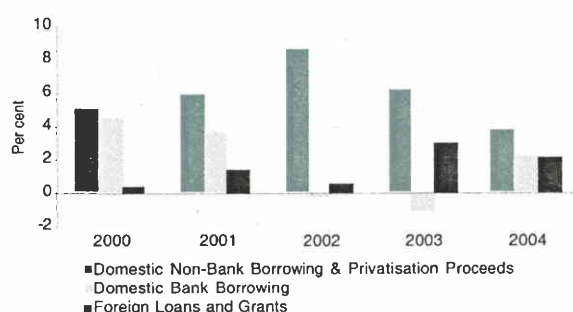
Table 6.4

**Functional Classification of Expenditure**

Item	Rs. million			
	2003	2004 Approved Estimates	2004 Prov.	2005 Approved Estimates
Current expenditure				
General public services	86,361	89,536	95,443	114,662
Civil administration	24,755	22,738	23,196	31,384
Defence	47,005	51,978	56,341	62,788
Public order and safety	14,601	14,820	15,906	20,490
Social services	104,812	107,771	138,820	145,545
Education	31,673	32,341	33,792	49,288
Health	22,073	21,871	25,919	27,118
Welfare	45,849	48,505	73,571	61,456
Community services	5,217	5,054	5,538	7,683
Economic services	14,417	19,900	22,100	24,841
Agriculture and irrigation	7,002	8,268	8,876	11,175
Energy and water supply	9	913	112	190
Transport and communication	4,614	4,601	8,560	7,783
Other	2,792	6,118	4,552	5,693
Other	129,104	140,467	133,315	134,840
of which; interest	125,126	120,918	119,782	128,000
Under expenditure	-	-	-	-900
Total current expenditure	334,693	357,674	389,678	418,988
Capital expenditure and lending				
General public services	5,203	7,138	7,191	7,208
Civil administration	4,826	5,908	5,986	5,506
Public order and safety	377	1,230	1,205	1,702
Social services	19,189	28,101	28,996	38,320
Education	7,443	9,610	8,548	14,072
Health	5,403	7,755	8,500	12,518
Welfare	841	538	454	218
Housing	3,249	4,175	6,796	3,247
Community services	2,254	6,023	4,698	8,265
Economic services	58,742	72,066	61,271	98,614
Agriculture and irrigation	8,420	10,232	8,207	15,848
Energy and water supply	23,801	15,458	22,283	24,196
Transport and communication	20,238	25,158	22,198	38,421
Other	6,283	21,218	8,583	20,149
Other	4,276	223	173	298
Total capital expenditure and lending	87,409	107,528	97,631	144,440
As a percentage of GDP				
Total expenditure				
General public services	5.2	4.8	5.1	5.4
Social services	7.0	6.7	8.3	8.1
Economic services	4.2	4.5	4.1	5.4
Other	7.6	6.9	6.6	5.9
of which; interest	7.1	6.0	5.9	5.6
Total expenditure and lending	24.0	22.9	24.0	24.8

Source : Ministry of Finance and Planning

Chart 6.5  
Deficit Financing (as a % of GDP)



sharing 30 per cent of fund allocations in 2004. In the economic services sector, energy and water supply and transport and communication were the major investment areas while education and health continued as major investment areas in social services sector.

### Financing the Budget Deficit

In financing the overall deficit of Rs. 165.4 billion, the government relied more on the domestic sources due to lower foreign inflows and privatisation proceeds. Net domestic borrowings amounted to Rs. 117.2 billion, net foreign financing amounted to Rs. 45.7 billion, and privatisation proceeds amounted to Rs. 2.4 billion, as against expected budgeted financing of Rs. 65 billion, Rs. 59.9 billion and Rs. 13 billion, respectively.

In the domestic front, the government borrowed from both non-bank (Rs. 74 billion) and bank sources (Rs. 43 billion). Major sources of non-bank financing were Employees' Provident Fund (EPF) (52 per cent) and National Savings Bank (NSB) (20 per cent). The Central Bank was the only source of bank financing, as there was a net repayment to the commercial banks amounting to Rs. 23 billion.

The financing instruments were Treasury bonds (Rs. 157 billion), Treasury bills (Rs. 25 billion), and Sri Lanka

Development Bonds (SLDBs) (Rs. 16 billion). The reliance on non marketable debt instruments was minimised in 2004 with a retirement of Rupee loans up to Rs. 84 billion, including an early retirement of callable Rupee loans amounting to Rs. 60 billion.

The issue of Treasury bonds played a key role in the domestic borrowing programme in 2004. On a net basis, borrowings from Treasury bonds increased significantly from Rs. 137 billion in 2003 to Rs. 157 billion in 2004. However, the maturity structure of Treasury bonds largely was leading to the shorter end of the market reflecting the market preference for such instruments in a background of rising inflationary expectations. As the leeway in the Treasury bill programme reached Rs. 9.7 billion at end November 2004, the borrowing limit applicable to Treasury bills was revised upwards by the Parliament by Rs. 50 billion to Rs. 300 billion.

The value of SLDBs issued in 2004 was US dollars 250 million. A part of the proceeds was utilised to repay maturing SLDBs of US dollars 91.5 million. The US dollar denominated loans (US dollars 100 million) obtained from foreign currency banking units (FCBUs) and matured in mid 2004 were rolled over in 2004.

In 2004, the government was able to raise, on a gross basis, US dollars 772 million (Rs. 78.3 billion) from foreign sources in comparison to US dollars 912 million (Rs. 88 billion) in the previous year. Of this, a major part was received by way of project loans from bilateral and multilateral donors (US dollars 683 million). The receipts by way of programme financing were only US dollars 30 million (Rs. 3 billion) in comparison to US dollars 344 million (Rs. 33 billion) in 2003. The balance consisted of foreign commercial loans. As the repayment of foreign loans amounted to Rs. 33 billion, including deferred payments of Rs. 2.8 billion, the net receipts amounted to Rs. 37.1 billion. The utilisation rate of available foreign assistance decreased considerably to 18 per cent from 24 per cent in the previous year, highlighting the necessity for continuing with related efforts at expediting the implementation of foreign funded projects and the implementation of structural reforms in time.

The amount of foreign grants received for budgetary purposes, as a per cent of GDP, decreased marginally in 2004. The governments of Japan, Germany and USA continued as the major bilateral donors for Sri Lanka.

### 6.4 Sub National Government Budgetary Operations

In Sri Lanka, the sub national government (SNG) system consists of Provincial Councils (PCs) and Local Governments (LGs). There are 8 PCs that have been established under the decentralisation of the decision making process by the devolution of powers to PCs. The local government system consists of 311 units comprising 18 Municipal Councils (MCs), 37 Urban Councils (UCs) and 256 Pradesheeya Sabhas (PSs).

Table 6.5  
Sources of Domestic Financing

	2001	2002	2003	2004 Provisional
By Instrument	123.6	126.4	79.7	117.2
Treasury bonds	21.0	109.0	137.1	156.6
Treasury bills	30.0	39.8	14.9	25.0
Rupee loans	28.9	-5.1	-39.3	-83.7
Sri Lanka Development Bonds	14.6	8.8	-15.2	16.4
Central Bank provisional advances	3.0	0.9	0.2	3.6
Other	26.1	-27.1	-18.1	-0.7
By Source	123.6	126.4	79.7	117.2
Bank	48.6	-4.8	-20.9	43.3
Non Bank	75.0	131.2	100.7	73.9

Source : Central Bank of Sri Lanka

Table 6.6  
Budget Outturn for Provincial Councils

Item	2001	2002	2003	Rs. million
				2004 Provisional
Total revenue	8,674	9,366	11,625	13,522
Tax revenue	7,539	7,952	9,968	11,544
Non-tax revenue	1,135	1,414	1,656	1,978
Total expenditure	40,094	44,314	49,224	56,964
Current expenditure	33,425	38,268	39,800	46,308
o/w Personal emoluments	26,169	29,993	30,582	36,079
Capital expenditure	6,669	6,046	9,423	10,656
Central government transfers	30,948	36,499	37,832	45,848
Block grants	24,699	30,574	30,462	35,892
Criteria based grants	596	1,000	607	803
Matching grants	282	307	246	311
PSDGs <sup>a/</sup>	4,208	3,405	3,332	3,854
Foreign grants for special projects	1,163	1,213	3,184	4,988

a/ Province Specific Development Grants

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

Under the current system, PCs and LGs enjoy only a limited devolution of power to mobilise required resources, and they suffer from a weak institutional framework. They also function largely as administrative arms of the central government rather than devolved fiscal structures. Thus, they rely heavily on central government transfers for their operations, without making efforts to build-up their resource base adequately.

### Performance of Provincial Councils

The overall budgetary operations of PCs in 2004 remained as in 2003. The revenue collection of PCs, as a per cent of GDP, remained at 0.7 per cent as in the previous year, while total expenditure also remained at 2.8 per cent as in the previous year.

The increased revenue of PCs, in nominal terms, was mainly due to the significant increase in revenue from turnover taxes and stamp duties. About 72 per cent of the total revenue was collected from these two sources. Western Provincial Council (WPC) accounted for 67 per cent of the total revenue collection, due to high concentration of commercial and industrial activities and the high population in the WPC. The Central, Southern and North Western Provinces were the other major revenue collecting PCs. The central government collects the provincial taxes in the North and East PC due to the problems related to ethnic conflict.

Of the total expenditure, the recurrent expenditure remained unchanged at 2.3 per cent of GDP as in 2003. The major portion (92 per cent) of personal emoluments was absorbed by the education (67 per cent) and health (25 per cent) sectors. Other current expenditure was used for other non-wage expenses on goods and services.

The investment programme of PCs, which mainly consisted of Province Specific Development Projects (PSDP)

and foreign funded special projects, declined in 2004 from 0.5 per cent of GDP to 0.4 per cent of GDP. The central government transfers to PCs in terms of block grants, criteria based grants, matching grants, and Province Specific Development Grants (PSDG) amounted to Rs. 40.9 billion, while foreign grants for special projects amounted to Rs. 5 billion.

### Performance of Local Governments

The LGs continued to perform the functions assigned to them mainly using their devolved revenue and transfers from the central government. In collecting some of the devolved revenues such as property transfer taxes and court fines as assigned under the 13<sup>th</sup> Amendment to the Constitution, PCs worked as the agent for LGs. The outlays of LGs included personal emoluments, other current expenses and capital expenses.

The effective functioning of LGs has been hampered by a lack of competent technical staff and an inappropriate administration structure. The ineffectiveness is manifested in the non-availability of effective record keeping systems, and weaknesses in regulation and monitoring.

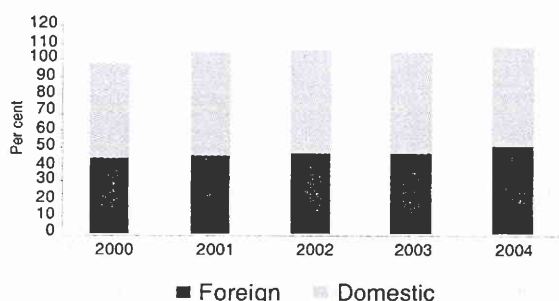
## 6.5 Public Sector Debt and Debt Service Payments

### Central Government Debt

The total outstanding government debt stock remained at around 106 per cent of GDP in 2004 due to the increased deficit and the depreciation of the rupee against major foreign currencies. The debt was composed of 53 per cent of domestic debt (Rs. 1,143.4 billion or 56.4 per cent of GDP) and 47 per cent of foreign debt (Rs. 996.1 billion or 49.1 per cent of GDP).

Of the total domestic debt stock, the share of medium and long term debt increased to 76 percent. Treasury bonds dominated the outstanding domestic debt portfolio accounting for 56 per cent. In line with the policy of reducing the non-marketable debt, the outstanding Rupee securities continued to decrease to

Chart 6.6  
Government Debt (as a % of GDP)





14.4 per cent of the total domestic debt from 24.4 per cent in 2003. Of the short-term debt stock, Treasury bills represented 90.4 per cent. Meanwhile, the outstanding borrowings from the banking system grew by 19.5 per cent and accounted for 24 per cent of domestic debt.

The share of concessional loans of the total foreign debt declined marginally to 97 per cent in comparison to 98 per cent in 2003. Of the total external debt stock, bilateral and multilateral loans accounted for 47 per cent and 51 per cent, respectively. Japan continued to be the major bilateral donor accounting for 30.4 per cent of the total foreign debt followed by USA and Germany accounting for 5.8 per cent and 5.7 per cent of the total foreign debt stock, respectively. International Development Association (IDA) and Asian Development Bank (ADB), which accounted for 23 per cent and 24 per cent of the total outstanding foreign debt, respectively were the major multilateral donors.

Table 6.7  
Outstanding Public Sector Debt (at end year)

Item	2001	2002	2003	Rs. million 2004 Provisional
1. Central Government Debt	1,452,706	1,670,342	1,863,851	2,139,526
Domestic Debt (a)	815,965	948,386	1,019,969	1,143,389
By maturity period				
Short term	278,624	259,205	249,621	269,784
Medium and long term	537,341	689,181	770,348	873,605
By institution				
Banks (b)	256,808	247,743	228,411	272,981
Non bank sector	559,157	700,643	791,559	870,408
Foreign debt	636,741	721,956	843,882	996,138
By type				
Concessional loans	603,571	702,369	822,839	970,299
Non concessional loans	33,170	19,588	21,043	25,838
By currency				
SDR	249,852	297,848	359,844	420,459
US dollars	137,401	128,952	134,538	152,562
Japanese yen	185,079	218,921	260,706	310,311
Deutsche mark (c)	33,101	53,606	63,500	83,579
Other	31,308	22,630	25,294	29,227
Memo: Exchange rate variation	48,844	74,044	67,691	106,502
2. Non Financial Public Corporations Debt	40,811	43,031	36,192	41,171
Ceylon Electricity Board	10,491	15,261	14,411	12,529
Ceylon Petroleum Corporation	18,674	16,232	14,909	23,326
Cooperative Wholesale Establishment	8,162	7,514	2,402	1,400
Other	3,484	4,024	4,470	3,916
3. Total public sector debt (1+2)	1,493,517	1,713,373	1,900,043	2,180,697

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. This excludes the government Treasury bonds amounting to Rs. 4,397 million issued to commercial banks on behalf of CWE in November 2003.

(b) Includes outstanding balance to FCBUs: Rs. 29,462 million at end 2001, Rs. 29,570 million at end 2002, Rs. 29,406 million at end 2003 and Rs. 31,596 million at end 2004.

(c) Since January 2002, outstanding debt in Deutsche Mark, French Frank and Italian Lira has been converted in to euro.

## Non Financial Public Corporation Debt

The outstanding debt stock of non financial public corporations (NFPC) to the banking system increased from Rs 36.2 billion to Rs. 41.2 billion (2 per cent of GDP) at end 2004. The CPC, CEB and Cooperative Wholesale Establishment (CWE) were the major debtors, accounting for 90 per cent of the total NFPC debt. This reflected the accumulated losses of NFPCs mainly due to delays and inadequacies in adjustment of their prices at least to cover the cost of production.

## Public Sector Debt

The outstanding debt stock of the public sector, which includes the central government and NFPCs, increased from Rs 1,900 billion as at end 2003 to Rs. 2,181 billion at the end 2004. As a percentage of GDP, the public sector debt decreased marginally from 107.9 to 107.5 per cent of GDP in 2004. Although the debt level was marginally declined in 2004, this level of public debt poses serious issues, in the form of a growing public debt over-hang at the expense of private sector growth, rising interest payment commitments, adverse implications of monetary policy, and a real reduction in the country's ability to withstand external shocks. Hence, it is necessary for the government to actively pursue to attain the targets set out in FMRA.

## Debt Service Payments

Total debt service payments composed of government amortisation payments (Rs. 180.8 billion) and interest payments (Rs. 119.8 billion) to domestic and external sectors in 2004 amounted to Rs. 300.6 billion. Of this total, payments to the domestic sector amounted to Rs. 253.6 billion, while that to the external sector was Rs. 47 billion.

The total debt service payments decreased by 12.8 per cent in 2004 due to a decline in the domestic debt service payments. However, the foreign debt service payments increased due to increased interest payments on foreign debt.

The ratio of total debt service payments to government revenue was high at 96.5 per cent. Even though this ratio showed a relative improvement

Chart 6.7

### Government Debt Service Payments (as a % of GDP)

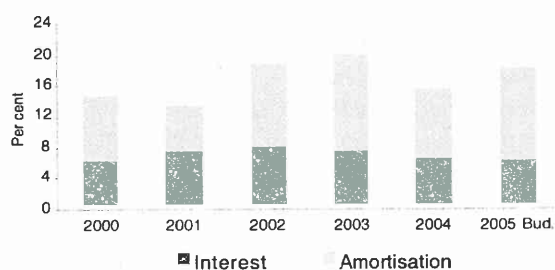




Table 6.8  
Government Debt Service Payments

	Rs. million				
	2001	2002	2003	2004 Prov.	2005 Est.
Debt service payments	179,072	284,358	344,634	300,563	395,418
Amortisation payments	84,765	167,843	219,508	180,781	267,418
Domestic	56,844	130,786	185,083	147,740	225,102
Foreign	27,921	37,057	34,425	33,041	42,316
Interest payments	94,307	116,515	125,126	119,782	128,000
Domestic	84,560	105,897	113,540	105,878	109,617
Short term	26,109	29,422	25,147	20,474	16,944
Medium and long term	58,451	76,475	88,393	85,404	92,673
Foreign	9,747	10,617	11,586	13,904	18,383

Source: Central Bank of Sri Lanka

in 2004 over the period of last two years (108.6 in 2002 and 124.6 in 2003), it still limits the manoeuvring abilities of fiscal operations. Following the same trend, the total foreign debt service payments to exports of goods and services declined to 6.4 per cent in 2004 from 7.3 per cent in 2003. The highly concessional nature of the outstanding foreign debt was the reason for this lower rate, although the foreign debt to GDP ratio was 49 per cent in 2004.

In 2005, total debt service payments of the government is estimated at Rs. 395.4 billion. This consists of Rs. 334.7 billion payments to the domestic sector and Rs. 60.7 billion payments to the external sector. A debt moratorium was granted by the donors in the Paris Club (which includes G-7 countries) for 2005 as a relief to the country to assist the nation rebuilding programme in tsunami affected areas. Debt service payments due in 2005 were capitalised and

Table 6.9  
Government Debt Indicators

Indicator	2001	2002	2003	2004 Prov.	2005 Est.(d)
Government Debt/GDP	103.2	105.4	105.8	105.5	100.8
- Domestic Debt/GDP	58.0	59.8	57.9	56.4	54.6
- Foreign Debt/GDP	45.3	45.6	47.9	49.1	46.2
Total Foreign Debt/Exports (a)	115.5	126.4	133.7	134.9	131.6
Total Debt Service/GDP	12.7	17.9	19.6	14.8	17.4
Total Debt Service/ Government Revenue (b)	76.4	108.6	124.6	96.5	101.5
o/w Domestic Debt Service/ Government Revenue (b)	60.4	90.4	108.0	81.4	85.9
Total Debt Service/Government Expenditure (c)	38.3	49.8	54.1	45.7	47.8
o/w Domestic Debt Service/ Government Expenditure (c)	30.0	41.5	46.9	38.6	40.4
Foreign Debt Service/Exports (a)	6.8	8.3	7.3	6.4	7.6
Domestic Interest/GDP	6.0	6.7	6.4	5.2	4.8
Domestic Interest/ Government Current Expenditure	27.9	32.0	33.9	27.2	26.2
Foreign Interest/Exports (a)	1.8	1.9	1.8	1.9	2.2

Source: Central Bank of Sri Lanka

- (a) Exports of goods and services  
(b) Government revenue is in economic format  
(c) Government expenditure inclusive of amortisation payments  
(d) Based on original budget

rescheduled to be serviced over a four year period with a one year grace period. The total debt relief under this scheme is expected to be about US dollars 300 million in 2005. Accordingly, the ratio of external debt service payments to total exports of goods and services would decline temporarily from the original estimate of 7.6 per cent to 3.8 per cent in 2005.