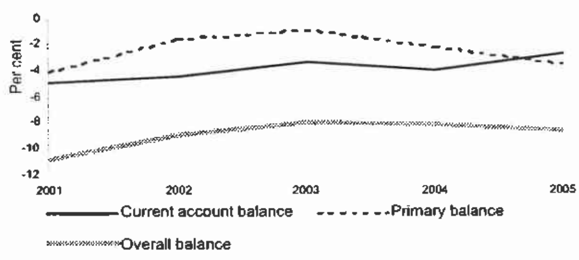
Chapter 6

FISCAL POLICY AND GOVERNMENT FINANCE

6.1 Overview

- **Fiscal policy thrust in 2005 was placed on achieving the pro-poor and pro-growth development objectives of the government while supporting a speedy recovery of the economy from the unexpected tsunami disaster and moving towards fiscal sustainability in the medium to long term.** Fiscal policy was formulated within the overall development strategy of the government aimed at achieving a higher level of economic and social development. Fiscal policy focussed on achieving targets stipulated in the Fiscal Management (Responsibility) Act (FMRA) of 2003, in the medium term, strengthening the post tsunami recovery process, increasing public investment and strengthening strategic public enterprises. The objectives of fiscal policy had to be met in the face of escalating oil prices, relatively high inflationary pressures, rising interest rates, shortfall in privatisation proceeds and lower foreign programme financing.
- **The economy recovered responding well to fiscal policy measures complemented by other macroeconomic policies, and the tsunami recovery progressed, with some positive developments in the fiscal consolidation process.** Tsunami recovery process moved forward with budgetary support as well as the support of donors, Non Governmental Organisations (NGOs), and the private sector. The declining trend in revenue to GDP ratio reversed in 2005. Public investment also increased to 6.3 per cent of the GDP from 4.8 per cent in 2004. However, the current expenditure rose higher than the revised target leading to a budget deficit of 8.7 per cent of GDP in 2005, which is higher than the revised budgetary target of 8.2 per cent. The budget deficit was financed through domestic resources (5.2 per cent of GDP) and foreign resources (3.4 per cent of GDP). The debt moratorium helped contain the expansion in the domestic borrowings.
- **The outstanding government debt as a ratio of GDP declined to 93.9 per cent from 105.5 per cent in 2004, but the level of debt increased by Rs.82.8 billion.** This decline was mainly due to the appreciation of the rupee against major foreign currencies and higher growth in nominal GDP. Though the debt as a ratio of GDP declined in 2005 it still remains high, indicating the need for measures to strengthen fiscal consolidation process in achieving fiscal sustainability in the medium to long term.
- **The government intends to continue with growth and development objectives while strengthening the fiscal consolidation process as outlined in the Medium Term Fiscal Strategy (MTFS) presented with the Budget 2006.** Key objectives are maintaining a healthy growth in government revenue, rationalising recurrent expenditure, turning around the government's current account deficit to a surplus and reducing domestic borrowings to about 2 per cent of the GDP in the medium term, thereby releasing more funds for private and public sector investment in vital sectors of the economy to realise the ultimate objectives of generating higher economic growth, creating productive employment, reducing regional disparity and alleviating poverty.

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



6.2 Fiscal Policy Direction and Measures

- **The policy thrust in 2005 was focussed on achieving the pro-poor and pro-growth development objectives of the government, supporting a speedy recovery of the economy from the unexpected tsunami disaster, strengthening the fiscal consolidation process, enhancing public investment and strengthening strategic public enterprises.** The tsunami recovery process began with the urgent relief and rehabilitation activities and the subsequent reconstruction. The strengthening of the fiscal consolidation process was attempted through measures to augment revenue, rationalise recurrent expenditure and improve debt management. Public investment policy emphasised increased allocation of resources for infrastructure and rural development while increasing the utilisation of available foreign resources. The strengthening of strategic public enterprises was continued through the Strategic Enterprise Management Agency (SEMA).
- **The pro-poor and pro-growth development objectives of the government are to be achieved through the development of**

Table 6.1

Summary of Government Fiscal Operations

Rs. million

Item	2004	2005 Approved Estimates	2005 Revised Estimates with Tsunami Expenditure (a)	2005 Provisional with Tsunami Expenditure	2006 Approved Estmates with Tsunami Expenditure
Total revenue	311,473	389,492	382,682	379,746	484,376
Tax revenue	281,552	351,119	343,309	336,829	435,292
Non tax revenue	29,921	38,373	39,373	42,917	49,084
Expenditure and lending minus repayments	476,906	560,638	574,058	584,783	731,641
Current	389,679	418,988	428,165	443,350	509,856
o/w Tsunami expenditure			11,968	9,512	3,000
Capital and net lending	87,227	141,650	145,894	141,434	221,785
o/w Public investment	97,630	144,440	148,684	148,582	225,295
o/w Tsunami expenditure			20,910	24,448	47,000
Current account surplus/deficit(-)	-78,206	-29,496	-45,483	-63,604	-25,480
Primary account surplus/deficit(-)	-45,650	-43,147	-72,670	-84,878	-96,006
Overall surplus/deficit(-)	-165,432	-171,146	-191,379	-205,037	-247,267
Financing	165,432	171,146	191,379	205,037	247,267
Foreign loans	37,071	48,684	61,318	47,773	81,983
Foreign grants	8,681	10,200	17,800	32,640	42,240
Domestic financing	117,243	104,761	104,761	123,603	123,043
Market borrowings	112,563	104,761	104,761	119,303	123,043
Non bank	69,274	104,761	104,761	93,108	123,043
Bank	43,289			26,195	
Monetary authority	65,828			-33,721	
Commercial banks	-22,539			59,916	
Other borrowings	4,680			4,300	
Privatisation proceeds	2,437	7,500	7,500	1,020	
As a percentage of GDP					
Total revenue	15.4	17.1	16.5	16.1	17.8
Tax revenue	13.9	15.4	14.8	14.2	16.0
Non tax revenue	1.5	1.7	1.7	1.8	1.8
Expenditure and lending minus repayments	23.5	24.6	24.7	24.7	26.9
Current	19.2	18.4	18.4	18.7	18.7
o/w Tsunami expenditure			0.5	0.4	0.1
Capital and net lending	4.3	6.2	6.3	6.0	8.2
o/w Public investment	4.8	6.3	6.4	6.3	8.3
o/w Tsunami expenditure			0.9	1.0	1.7
Current account surplus/deficit(-)	-3.9	-1.3	-2.0	-2.7	-0.9
Primary account surplus/deficit(-)	-2.2	-1.9	-3.1	-3.6	-3.5
Overall surplus/deficit(-)	-8.2	-7.5	-8.2	-8.7	-9.1
Financing	8.2	7.5	8.2	8.7	9.1
Foreign loans	1.8	2.1	2.6	2.0	3.0
Foreign grants	0.4	0.4	0.8	1.4	1.6
Domestic financing	5.8	4.6	4.5	5.2	4.5
Market borrowings	5.5	4.6	4.5	5.0	4.5
Non bank	3.4	4.6	4.5	3.9	4.5
Bank	2.1			1.1	
Monetary authority	3.2			-1.4	
Commercial banks	-1.1			2.5	
Other borrowings	0.2			0.2	
Privatisation proceeds	0.1	0.3	0.3	...	

(a) Revised in May 2005.

Source: Ministry of Finance and Planning

social and economic infrastructure facilities, creating employment and income generating opportunities for the poor and by minimising regional imbalances in development. These objectives and goals are to be achieved through a number of measures namely, projects and programmes to develop community water supply, rural electrification and housing, development of selected areas, upgrading rural roads, development of irrigation facilities, developing dairy villages, community development, rebuilding the conflict affected areas through rehabilitation and reconstruction of basic infrastructure facilities, speedy resettlement and support of livelihood of people affected by the conflict, promoting socio economic activities for Samurdhi beneficiaries and by encouraging economic opportunities through developing entrepreneurship.

- **The government implemented a series of relief measures and established several institutions in 2005 to support the people affected by the tsunami disaster and to coordinate the relief, rehabilitation and reconstruction efforts of the government.** The relief measures included a grant of Rs.15,000 to the family of a person who lost his/her life, a weekly grant of Rs.200 per person in cash and a dry food ration of Rs.175 per person, a grant of Rs.2,500 per family to buy kitchen utensils, periodic allowances of Rs.5,000 for a family and Rs.2,500 for a single member family and grants of Rs.250,000 and Rs.100,000 as compensation for fully and partly damaged houses, respectively. Measures were also taken to restore livelihoods, repair and upgrade damaged infrastructure and resolve problems particularly those related to health, education and protection of tsunami victims. Several institutions were set up to coordinate and facilitate efforts of the government, private sector and the donor community. The entities established at the beginning of 2005 were the Task Force for Rebuild the Nation (TAFREN), Task Force for Relief (TAFOR) and Tsunami Housing Reconstruction Unit (THRU). In November 2005, the government replaced TAFREN, TAFOR, and THRU with the Reconstruction and Development Agency (RADA), which was mandated to accelerate reconstruction and development activities.

- **An integral part of strengthening the fiscal consolidation process was augmenting the revenue of the government.** A series of measures were introduced to augment revenue collection (both tax and non-tax), as increasing revenue is a key to achieving overall fiscal consolidation. The main measures undertaken to increase tax revenue were improving tax administration, and the implementation of measures to improve revenue from income taxes, VAT, excise taxes, import duties and other taxes. To augment non-tax revenue, administration fees and charges, and fines and penalties were revised upward. The Taxation Cluster of the National Council for Economic Development (NCED) continued its activities in 2005. The Taxation Cluster was involved in facilitating the overall tax policy reforms and their effective implementation.

- **Improvements in tax administration were achieved through a series of measures.** These measures included the improvements of internal arrangements at the Inland Revenue Department (IRD), including the appointment of a three member committee of tax commissioners to certify every refund made by the IRD, to rationalise the VAT refund mechanism, establishing an appeals unit under a separate commissioner, the introduction of a code of ethics and conduct to improve the accountability of employees at the IRD, setting up of an information centre at the IRD to collect and analyse information on tax evasion, the appointment of a tax ombudsman to address grievances of taxpayers and take necessary remedial measures, strengthening the surveillance mechanism and inaugurating four dedicated tax courts.

- **The main measures taken to raise income tax were the enhancement of the tax base, rationalisation of tax rates and exemptions, and introduction of new tax compliance measures.** To enhance the income tax base a withholding tax on the registration of motor vehicles and a presumptive tax on NGOs, other than those carrying out activities solely related to rehabilitation work in the Northern and Eastern provinces, were introduced. A Social Responsibility Levy (SRL) was also imposed on taxes other than VAT, Port and Airports Development Levy (PAL), Debit tax and withholding tax on interest.[1] Changes were introduced to the personal income tax system by increasing the number of tax slabs from four to seven while rationalising the taxation of employment benefits. Corporate income taxes were rationalised mainly through the changes introduced to the tax on dividends that are not distributed, removal of deductions allowed for VAT payments on financial services in calculating taxable income, and the rationalisation of expenses and allowances allowed in selected items. Meanwhile, the Economic Service Charge (ESC) on certain categories was reduced in consideration of the difficulties faced by wholesale and retail traders. New tax compliance measures included rewarding honest taxpayers and making the Tax Clearance Certificate mandatory for government tenders.

- **The VAT system was reformulated through the introduction of a 4-band VAT system,** which involved adding a new rate (18 per cent) from January 2005. The other VAT rates are: basic rate of 5 per cent, the general rate of 15 per cent and the zero rate for exports. With effect from August 2005, the

1 The objective of imposing the SRL is to provide necessary financial support for the National Action Plan for Children (NPC). The NPC has been launched by the government to ensure universal access to services that children require for their full and free development and to provide them with the opportunity to develop their individual capacities in a safe and enabling environment.

18 per cent VAT rate was increased to 20 per cent. The existence of multiple rates, however, could lead to complications in the VAT system. Meanwhile, to provide relief to the public, the government granted VAT exemptions on a number of consumer items and fertiliser. Concessions were also granted on the payment of VAT on donations/purchases of goods and services by organisations or persons engaged in rehabilitation work in tsunami affected areas.

- **Excise taxes were increased in line with the recommendation of the Presidential Taskforce on Alcohol, Tobacco and Illicit Drugs.** The taskforce recommended that taxation on alcohol and tobacco should be increased annually to reduce alcohol and tobacco consumption. Such reduction in consumption is expected to have a positive impact on health and labour productivity.
- **Revenue from import duties was expected to increase with the rationalisation of import duties.** The import duty structure was reformed by the reduction in the number of tariff bands from 6 to 5. The PAL on imports for processing and exports was reduced to 0.25 per cent in 2005 from 0.50 per cent. Further, a cess was imposed on a number of imported items, such as maize, chocolate and cereal products. The other main tax measure was the increase in the Betting and Gaming Levy to discourage betting and gaming activities.
- **Measures to increase non tax revenue were also implemented.** Administrative fees and charges were raised on a number of services provided by the government including charges for using official vehicles for private use and rents on properties. Fines and penalties were increased to reinforce the government's commitment to make law enforcement more effective.
- **Several measures were taken to rationalise recurrent expenditure.** Rationalisation was mainly attempted through the better allocation of funds and improved cash management by the Treasury. To reduce losses of oil companies and thereby reduce the subsidy cost on petroleum products due to escalating oil prices, the government adjusted the domestic petroleum prices on two occasions in 2005. However, these revisions were inadequate to recover the total cost and therefore led to an increase in subsidies on petroleum products. To reduce interest cost, high cost Rupee loans with call options were retired and low cost debt instruments were issued. The deferment of a part of the dues of foreign interest payments under the debt moratorium granted for 2005 by foreign donors, helped contain interest cost.
- **The government increased the salaries of the public sector employees and pensions of the retirees in 2005.** It is expected that this would motivate the public sector and thereby bring in many benefits in excess of the cost that will be reflected in the budget. The correction of prevailing anomalies in the public service salary structure was also envisaged through this salary increase. This increase, however, will lead to a further increase in the already high salary bill of the public sector. The provision of relief to pensioners was the aim of the increase in pensions.
- **The government recruited 42,588 unemployed graduates who completed their formal training at ministries to government service as a measure to alleviate the chronic graduate unemployment problem.** For this programme to be successful and generate a positive outcome to the economy, these graduates need to be employed gainfully in public institutions.
- **The fertiliser subsidy was increased to support agricultural development.** The objective of this move was to keep domestic fertiliser prices unchanged in an environment where international prices of chemical fertiliser were increasing in line with the increase in crude oil prices. This upward revision of the fertiliser subsidy will increase the expenditure on transfers of the government.
- **Debt management policy was directed towards phasing out borrowings through non-marketable debt instruments and resorting more to borrowings from Foreign Currency Banking Units (FCBUs) of commercial banks.** Accordingly, the government continued its policy of retiring Rupee securities in addition to replacing the high cost Rupee securities with low cost instruments. Borrowings from FCBUs were increased to reduce pressure on interest rates in the domestic rupee market.
- **Sri Lanka obtained debut sovereign ratings from two international rating agencies in 2005.** Fitch Ratings assigned the country rating of BB- (BB minus) while Standard & Poor's (S&P) rated Sri Lanka at B+ (B plus). Sovereign ratings like this will facilitate both the government and the private sector to mobilise financial resources in international market.
- **Public investment was directed towards supporting the pro-poor, pro-growth development strategy of the government.** Emphasis was placed on developing infrastructure facilities; both large scale and rural infrastructure projects, while giving due attention to both tsunami related reconstruction and rehabilitation of conflict affected areas. The National Procurement Agency (NPA), which was set up in 2004, continued its operations to facilitate and assist the government in developing and implementing an efficient and transparent public procurement system.
- **Measures to strengthen strategic public enterprises were continued in 2005.** The role of the private sector in pursuing economic growth facilitated by the public sector and the importance of continuing state ownership of strategically important enterprises have been recognised by the government. The SEMA continued to oversee the performance of 12

Box 12

Sovereign Rating

Sovereign credit rating is a forward-looking assessment and a formal evaluation of a sovereign government's capacity and willingness to service its external debt obligations in full and on time. Major factors of determining the credit rating in a country are political risk, income and economic structure, economic growth prospects, debt burden, off-shore contingent liabilities, external reserves, fiscal flexibility and monetary stability. Obtaining a rating is a strong signal of transparency of a country's policies. Having a universally accepted rating reduces uncertainty about the risk exposures of the country and enables improved access to international capital markets, as well as encourages foreign investment in the country.

Sri Lanka obtained sovereign ratings from two major international rating agencies in 2005. Fitch Rating assigned BB- for both sovereign long-term foreign and local currency ratings with a stable outlook. Standard and Poor's (S & P) assigned B+ for long-term foreign currency ratings and BB- for long-term local currency. Among the regional countries, India, Indonesia, the Philippines and Vietnam have been assigned similar ratings under the speculative grade while countries like China, South Korea, Malaysia and Thailand have been assigned better ratings.

In arriving at the ratings, the rating agencies have considered several positive attributes of Sri Lanka; a long functioning democratic political system for over a half century, resilience of the economy and human capital development in the amidst of more than two decades of civil war; an unblemished debt service history, the favourable external debt position which imposes minimal stress on external liquidity, strong institutions, a dynamic and vibrant export manufacturing sector aided by the flexible exchange rate regime, and robust medium term growth prospects. Negative aspects considered by those agencies were high budget deficits averaging nearly 9 per cent of GDP over the past 10 years, weak revenue mobilization, concerns about public debt sustainability, contingent liabilities in the broader public sector, political instability and the prevailing status of peace and national security.

It is vital that Sri Lanka continues to take measures to address the weaknesses indicated by rating agencies to improve upon the sovereign rating. Many countries, which could not continue to improve the macro economic environment and the capacity to service external debt, have experienced deterioration in their sovereign rating. For example, Argentina received a BB rating in 1997 and was down graded to DDD by 2005.Rating agencies have indicated that rating could be improved with progress in fiscal consolidation, structural reforms, and further progress in peace negotiations.

Table B 12.1

Country wise Sovereign Ratings Assigned by Fitch Ratings As at 4 January 2006

Rating	Description	Countries
AAA	Highest Credit Quality	Austria, Canada, Denmark, France, Finland, Germany, Ireland, Luxembourg, Netherlands, Singapore, Spain, Sweden, Switzerland, United Kingdom, United States of America
AA+	Very High Credit Quality	Australia, New Zealand
AA	Very High Credit Quality	Belgium, Bermuda, Italy, Japan, Portugal, San Marino
AA-	Very High Credit Quality	Hong Kong, Iceland, Kuwait, Slovenia
A+	High Credit Quality	Cyprus, Korea, Taiwan
A	High Credit Quality	Chile, China, Czech Republic, Estonia, Greece, Malta, Saudi Arabia, Slovakia
A-	High Credit Quality	Bahrain, Israel, Latvia, Lithuania, Malaysia
BBB+	Good Credit Quality	Hungary, Poland, South Africa, Thailand
BBB	Good Credit Quality	Aruba, Bulgaria, Kazakhstan, Mexico, Russia, Tunisia
BBB-	Good Credit Quality	Croatia, Namibia, Romania
BB+	Speculative	Egypt, El Salvador, India, Panama
BB	Speculative	Azerbaijan, Colombia, Costa Rica, Macedonia, Peru, Philippines
BB-	Speculative	**Sri Lanka**, Brazil, Indonesia, Iran, Lesotho, Serbia, Turkey, Ukraine, Venezuela,Vietnam
B+	Highly Speculative	Cape Verde, Ghana, Mongolia, Uruguay
B	Highly Speculative	Benin, Mozambique, Papua New Guinea, Suriname, Uganda
B-	Highly Speculative	Bolivia, Cameroon, Dominican Republic, Ecuador, Lebanon, Mali, Moldova
CCC	High Default Risk	Gambia, Malawi
DDD	Default	Argentina

Source: Fitch Ratings Website - www.fitchratings.com strategic enterprises under its purview and sought to improve their management and ensure their commercial viability. During the year, the strategic enterprises coming under the SEMA prepared their action plans. Appropriate restructuring initiatives for the future development of these enterprises were agreed upon. The role of the Public Enterprises Reform Commission (PERC), which is engaged in reforming other public enterprises, was also reoriented to be consistent with this policy strategy.

- **In 2005, the Fiscal Management Reform Programme (FMRP) was in progress with assistance from the Asian Development Bank (ADB).** This programme commenced its actions to strengthen public finances by improving effectiveness of tax administration, improving expenditure management, strengthening fiscal discipline and improving fiscal coordination.
- **As enunciated in the MTFS of the government, fiscal policy in the medium term will be directed at continuing fiscal consolidation while supporting economic development objectives.** Fiscal consolidation is expected to strengthen with the increase in revenue and the rationalising of recurrent expenditure while ensuring public investment in areas critical for supporting economic growth. This process needs to be complemented by eliminating inflationary financing and rehabilitating infrastructure in conflict affected areas while improving the utilisation of foreign resources. As the importance of these factors have already been recognized by the government and planned to address them in its medium term programmes, their effective implementation is crucial in achieving medium term objectives.

6.3 Government Budgetary Operations

Revenue

- **Total government revenue increased by 21.9 per cent to Rs.379.7 billion in 2005 and amounted to 16.1 per cent of**

Chart 6.2

Composition of Government Revenue - 2005

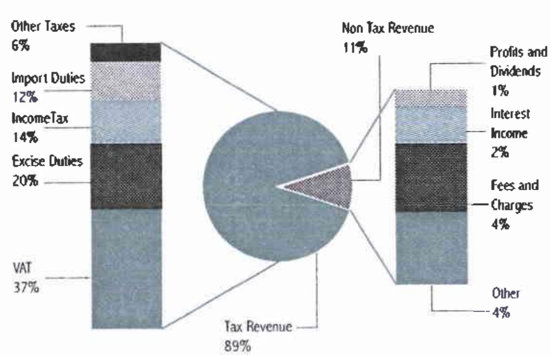


Table 6.2

Economic Classification of Revenue

Rs. million

Item	2004	2005 Approved Estimates	2005 Revised Estimates (a)	2005 Provisional	2006 Approved Estimates
Tax revenue	281,552	351,119	343,309	336,829	435,292
Income taxes	41,372	55,361	54,861	52,535	75,560
VAT	120,382	142,690	139,690	138,660	174,295
Excise Tax	65,790	76,865	74,865	76,978	85,363
Import duties	41,096	54,815	52,815	45,391	64,596
Other taxes	12,912	21,388	21,078	23,265	35,478
Non tax revenue	29,921	38,373	39,373	42,917	49,084
Total revenue	311,473	389,492	382,682	379,746	484,376
	As a percentage of GDP				
Tax revenue	13.9	15.4	14.8	14.2	16.0
Income taxes	2.0	2.4	2.4	2.2	2.8
VAT	5.9	6.3	6.0	5.9	6.4
Excise Tax	3.2	3.4	3.2	3.3	3.1
Import duties	2.0	2.4	2.3	1.9	2.4
Other taxes	0.6	0.9	0.9	1.0	1.3
Non tax revenue	1.5	1.7	1.7	1.8	1.8
Total revenue	15.4	17.1	16.5	16.1	17.8

Source : Ministry of Finance and Planning

(a) Revised in May 2005.

GDP compared to 15.4 per cent in 2004, reversing the steady decline in revenue/GDP ratio observed since 1999. This improvement was a result of the increase in both tax and non-tax revenue collection. The increase in the tax revenue/GDP ratio, which was started in 2004, continued in 2005. The non-tax revenue/GDP ratio also increased when compared to 2004.

- **Tax revenue increased by 19.6 per cent to Rs. 336.8 billion and reached 14.2 per cent of GDP in 2005 from 13.9 per cent in the previous year.** As a per cent of GDP, revenue from income taxes increased with the lower withholding tax collection from government securities being offset by the increase in revenue from taxes on the corporate sector, which responded favourably to reforms. The revenue from VAT remained unchanged as the increase in VAT collection, particularly through improvements in the VAT refund mechanism, offset the drop in revenue arising from the VAT exemptions on several essential food items, diesel and LP gas. Total revenue from excise taxes increased compared to 2004, as a result of the upward revision of excise taxes and the increase in sales of liquor and cigarettes. The initial slowdown in import duty collection during the first several months of 2005, mainly due to the duty exemption on tsunami related imports, and a decrease in motor vehicle imports in the first quarter of the year due to the higher excise duties, caused a marginal decline in the revenue from import duties as a per cent of GDP.
- **Non-tax revenue increased by 43.4 per cent to Rs. 42.9 billion in 2005.** As a per cent of GDP it increased to 1.8 per cent

from 1.5 per cent in the previous year. Higher profit transfers from the Central Bank, higher interest payments on funds on lent to public institutions and increased revenue from fees and charges mainly contributed to this increase.

Expenditure

- **Total expenditure and net lending of the government increased by 22.6 per cent in 2005 and amounted to Rs. 584.8 billion.** As a per cent of GDP, total expenditure and net lending increased to 24.7 per cent (including tsunami expenditure) from 23.5 per cent in the previous year. Current

Chart 6.3

Composition of Government Current Expenditure - 2005

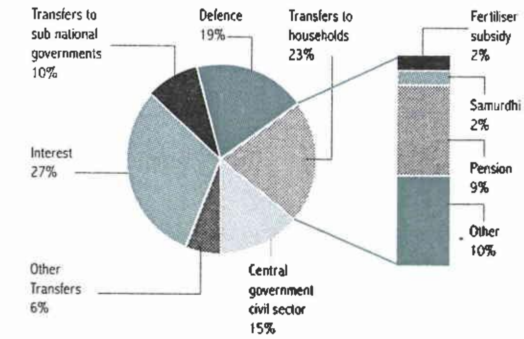


Table 6.3

Economic Classification of Expenditure and Lending Minus Repayment

Rs. million

Item	2004	2005 Approved Estimates	2005 Revised Estimates (a)	2005 Provi-sional	2006 Approved Estimates
Current expenditure	**389,678**	**418,988**	**428,165**	**443,350**	**509,856**
Expenditure on goods and services	164,529	199,453	199,653	194,860	241,419
o/w Salaries and wages	106,187	140,517	140,717	138,603	168,570
Interest payments	119,782	128,000	118,709	120,159	151,259
Foreign	13,904	18,383	7,779	6,995	19,053
Domestic	105,878	109,617	110,930	113,164	132,206
Current transfers and subsidies	105,367	92,435	109,803	128,331	117,238
o/w To households and other sectors	83,585	69,489	88,443	101,277	83,420
Samurdhi	8,498	9,635	9,635	9,161	12,200
Pensions	36,444	41,916	41,916	46,782	48,361
Fertiliser subsidy	3,572	4,200	4,200	6,846	8,500
Other	35,071	13,738	32,692	38,488	14,359
Under expenditure		-900			
Capital expenditure	**83,807**	**129,111**	**131,555**	**140,154**	**211,740**
Acquisition of real assets	40,449	75,184	78,747	88,140	133,121
Capital transfers	43,359	59,016	52,808	52,014	89,669
Provision for under expenditure	-	-5,089	-	-	-11,050
Lending minus repayment	**3,420**	**12,539**	**14,339**	**1,280**	**10,046**
Total expenditure and net lending	**476,905**	**560,638**	**574,059**	**584,783**	**731,642**
	As a percentage of GDP				
Current expenditure	**19.2**	**18.4**	**18.4**	**18.7**	**18.7**
Expenditure on goods and services	8.1	8.8	8.6	8.2	8.9
o/w Salaries and wages	5.2	6.2	6.1	5.9	6.2
Interest payments	5.9	5.6	5.1	5.1	5.6
Foreign	0.7	0.8	0.3	0.3	0.7
Domestic	5.2	4.8	4.8	4.8	4.9
Current transfers and subsidies	5.2	4.1	4.7	5.4	4.3
o/w To households and other sectors	4.1	3.1	3.8	4.3	3.1
Samurdhi	0.4	0.4	0.4	0.4	0.4
Pensions	1.8	1.8	1.8	2.0	1.8
Fertiliser subsidy	0.2	0.2	0.2	0.3	0.3
Other	1.7	0.6	1.4	1.6	0.5
Capital expenditure	**4.1**	**5.7**	**5.7**	**5.9**	**7.8**
Acquisition of real assets	2.0	3.3	3.4	3.7	4.9
Capital transfers	2.1	2.6	2.3	2.2	3.3
Under expenditure		-0.2			
Lending minus repayment	**0.2**	**0.6**	**0.6**	**0.1**	**0.4**
Total expenditure and net lending	**23.5**	**24.6**	**24.7**	**24.7**	**26.9**

(a) Revised in May 2005.

Source : Ministry of Finance and Planning

Table 6.4

Functional Classification of Expenditure

Rs. million

Item	2004	2005 Approved Estimates	2005 Provi-sional	2006 Approved Estimates
Current expenditure				
General public services	95,443	114,662	105,628	126,674
Civil administration	23,196	31,384	25,027	31,910
Defence	56,341	62,788	61,498	71,663
Public order and safety	15,906	20,490	19,103	23,101
Social services	138,820	145,545	188,651	175,158
Education	33,792	49,288	50,697	58,350
Health	25,919	27,118	34,113	40,118
Welfare	73,571	61,456	92,909	70,682
Community services	5,538	7,683	10,933	6,008
Economic services	22,100	24,841	28,725	35,487
Agriculture and irrigation	8,876	11,175	13,500	14,990
Energy and water supply	112	190	1,008	2,076
Transport and communucation	8,560	7,783	11,303	11,386
Other	4,552	5,693	2,914	7,035
Other	133,315	134,840	120,285	172,598
of which; interest	119,782	128,000	120,159	151,239
Provision for under expenditure	-	-900		
Total current expenditure	389,678	418,988	443,350	509,856
Capital expenditure and lending				
General public services	7,191	7,208	9,901	18,078
Civil administration	5,986	5,506	8,537	14,243
Public order and safety	1,205	1,702	1,364	3,835
Social services	28,996	38,320	35,992	44,740
Education	8,548	14,072	12,860	13,275
Health	8,500	12,518	10,738	15,222
Welfare	454	218	280	290
Housing	6,796	3,247	3,657	4,700
Community services	4,698	8,265	8,457	11,253
Economic services	61,271	98,614	77,540	114,684
Agriculture and irrigation	8,207	15,848	10,041	12,821
Energy and water supply	22,283	24,196	19,234	31,525
Transport and communucation	22,198	38,421	31,765	46,557
Other	8,583	20,149	16,500	23,771
Other	173	298	704	795
Tsunami expenditure			24,448	47,000
Total capital expenditure and lending	97,631	144,440	148,582	225,295
As a percentage of GDP				
Total expenditure				
General public services	5.1	5.4	4.9	5.3
Social services	8.3	8.1	9.5	8.1
Economic services	4.1	5.4	4.5	5.5
Other	6.6	5.9	6.1	8.1
of which: interest	5.9	5.6	5.1	5.6
Total expenditure and lending	24.0	24.8	25.0	27.0

Source : Ministry of Finance and Planning

Box 13

Public Investment in Sri Lanka: Developments, Issues and Prospects

Investments generate streams of future benefits. There are two major reasons for the government involvement in investment. First, the government has to make investments in producing public goods, which the private sector has no incentive to produce, or the capital outlay is too large, but is essential for economic growth. Second, public investment is necessary to supply services needed for creating a conducive environment for private investments.

Public investment is often seen in the areas of physical infrastructure, human capital formation, and research and development. Improved physical infrastructure such as roads, power, transportation, telecommunications and other facilities, enable the expansion in private investment and lower the private sector cost of producing goods and services. Improved human capital, particularly education and training, increases the availability of skilled workers and improves labour productivity. Research and development lead to innovative products and production processes that lower the costs.

Successive governments in Sri Lanka have been promoting public investment, but the magnitude has not been sufficient to promote economic growth. The level of public investment peaked in mid 1980s reaching 14-15 per cent of GDP especially with the implementation of accelerated Mahaweli development project (Table B13.1). The major portion of the public investment was in the economic services sector, followed by social services and general public services. Public investment has since declined gradually reaching a level of 4.8 per cent of GDP in 2004. It increased to 6.3 per cent of GDP in 2005 with tsunami expenditure.

Budgetary constraints emanating from the increased defence expenditure, debt service payments and current transfers necessitated the government to prioritise and curtail public investment. As a result, public investment in economic infrastructure has not been sufficient to maintain the existing infrastructure and to improve their capacity, service quality and reliability during the last few years. Consequence is particularly reflected by the under developed nature and unsatisfactory quality of infrastructure facilities.

The public investment is mainly financed through foreign assistance by way of concessional loans and grants (60-70 per cent). Problems in releasing the domestic counterpart funds have affected the effective implementation of foreign funded projects. In addition, the utilisation of available foreign financing for investment projects has not been at acceptable level due to problems in procurement procedures, administrative barriers, inadequate coordination and implementation, weaknesses in project monitoring, delays and issues in getting reimbursement of foreign funds, problems in acquiring land, and excessive environmental concerns.

To overcome the implementation bottlenecks in public investment, the government has established the National Procurement Agency (NPA) in 2004. Through NPA, the government expects to oversee procurement monitoring, capacity building and resolving policy related matters and strengthen and streamline the government procurement system. The mandate of the NPA also includes preventing delays and inefficiencies through the formulation of simplified and harmonised procurement policies, guidelines and standards. To ensure the expected progress, other bottlenecks related to project implementation are also being addressed by the government on priority basis.

The government has planned to increase the public investment to about 6.6 per cent of GDP in 2006 without tsunami expenditure (8.3 per cent of GDP with tsunami expenditure of 1.7 per cent) and to 7.7 per cent of GDP (with tsunami expenditure) by 2008. This will complement the private sector investment in realising the total investment target of 30 per cent of GDP in 2008 and achieving 6-8 per cent growth in the medium term. To support this investment effort further, the government also expects to promote public-private partnerships (PPP) to implement large-scale infrastructure development projects.

The effective implementation of the proposed public investment programme depends on many factors. Removing the bottlenecks mentioned above is critical in achieving the set targets. In addition, commitment of the stakeholders, generating a surplus in the government current account, continuation of donor support, effective implementation of already identified reforms and promoting public awareness are also important in this context. The successful implementation of the programme will lead accelerating the economic growth, creating an enabling environment for private investments, and creating employment opportunities thereby helping reduce the regional disparities and poverty on a more sustainable basis. However, any drawback would lower the expected benefits, requiring very high level of investments in the future.

Table B13.1

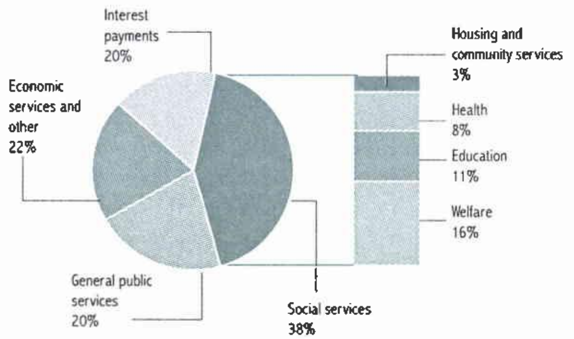
Functional Classification of Public Investment

% of GDP

Item	1986	1990	2000	2004	2005 Pro.
General public services	0.7	1.1	0.6	0.4	0.4
Civil administration	0.5	0.5	0.4	0.3	0.4
Public order and safety	0.2	0.6	0.1	0.1	0.1
Social services	1.0	0.9	1.3	1.4	1.5
Education	0.7	0.3	0.6	0.4	0.5
Health	0.2	0.4	0.4	0.4	0.5
Housing	0.1	0.1	0.2	0.3	0.2
Welfare and community services	..	0.1	0.2	0.3	0.4
Economic services	11.1	5.9	4.3	3.0	3.3
Agricultural and irrigation	4.3	1.6	0.5	0.4	0.4
Energy and water supply	0.7	2.0	1.1	1.1	0.8
Transport and communication	5.4	1.3	2.0	1.1	1.3
Other	0.7	1.0	0.8	0.4	0.7
Other (a)	1.7	0.5	0.2	...	1.0
Total	14.4	8.4	6.4	4.8	6.3

(a) Includes tsunami expenditure in 2005

Chart 6.4
Total Expenditure by Function - 2005



expenditure increased to Rs.443.4 billion (18.7 per cent of GDP) from Rs.389.7 billion (19.2 per cent of GDP) in 2004. Capital expenditure and net lending increased to Rs.141.4 billion (6.0 per cent of GDP) from Rs.87.2 billion (4.3 per cent of GDP) in the previous year. Of the total expenditure, the tsunami expenditure was Rs.34 billion (1.4 per cent of GDP).

- **In current expenditure, the salary bill and transfers to households increased considerably in 2005.** The salary bill, which accounts for about a third of current expenditure increased by 30.5 per cent to Rs.138.6 billion due to salary increases granted in 2005 and the increased recruitments to the government service. Transfers to households increased largely due to the higher subsidy on petroleum products (Rs. 26 billion) as a result of the inadequate adjustment of domestic petroleum prices, higher pension payments and higher expenditure on the fertiliser subsidy. Transfers to public institutions also increased as a result of salary increases coupled with their various inefficiencies. Total defence expenditure amounted to Rs.82 billion (3.5 per cent of GDP), compared to Rs.73.4 billion (3.6 per cent of GDP) in the previous year. The interest payments remained almost unchanged compared to the previous year owing to the debt moratorium granted by foreign donors in 2005.
- **Public investment increased in 2005.** This was due to efforts made by the government to fast track the implementation of development projects as well as tsunami related capital expenditure. As a per cent of GDP, public investment increased to 6.3 per cent from 4.8 per cent in 2004, including tsunami related investments of 1 per cent.
- **Investment in the economic services (3.3 per cent of GDP) continued to dominate public investment accounting for 52 per cent of the total public investment in 2005.** Within the economic services sector, transport and communication, and energy and water supply were the main areas, which absorbed 34 per cent of the total public investments in 2005.
- **Public investment in social services showed an increase to 1.5 per cent of GDP.** The share of education and health sub sectors increased in 2005. The investments in the education and health sectors were mainly for construction of schools and hospitals and their quality improvements. The investment in community services was to finance various community development and empowerment programmes.

Financing the Budget Deficit

- **The overall budget deficit of the government in 2005 amounted to 8.7 per cent of GDP, compared with the revised deficit target of 8.2 per cent of GDP.** The budget deficit excluding tsunami expenditure was 7.3 per cent of GDP. The current account deficit, which mirrors the savings position of the government declined to 2.7 per cent from 3.9 per cent in 2004 while the primary deficit, which reflects the outcome of the current year's fiscal operations increased to 3.6 per cent from 2.2 per cent in the previous year.
- **The overall budget deficit of Rs. 205.0 billion was financed through net domestic borrowings (Rs.123.6 billion), net foreign borrowings (Rs.47.8 billion), foreign grants (Rs.32.6 billion) and privatisation proceeds (Rs.1.0 billion).** As a per cent of GDP, total net domestic financing decreased to 5.2 per cent from 5.8 per cent in 2004 while net foreign financing (loans and grants) increased to 3.4 per cent from 2.2 per cent in the previous year.
- **The debt dependency ratio (the ratio of total net borrowings to total government expenditure) declined to 29.3 per cent in 2005 from 32.3 per cent in 2004.** The relatively lower recourse to debt to finance the deficit was due to the tsunami related foreign grants. Dependence on foreign assistance, i.e., loans and grants, for budgetary financing increased to 39.2 per cent of the total deficit in 2005 from 27.7 per cent in the previous year. This too was mainly due to inflows of tsunami related foreign grants and debt moratorium.
- **Government borrowings from the banking system declined to Rs.26.2 billion (1.1 per cent of GDP) from Rs.43.2 billion**

Chart 6.5
Deficit Financing (as a % of GDP)

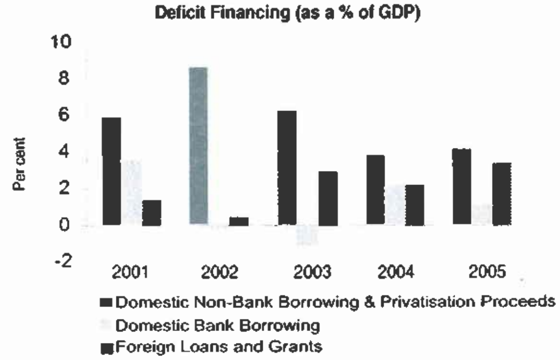


Table 6.5

Sources of Domestic Financing

Rs. billion

	2002	2003	2004	2005 Provisional
By Instrument	126.4	79.7	117.2	123.6
Treasury bonds	109.0	137.1	156.6	108.1
Treasury bills	39.8	14.9	25.0	-9.4
Rupee loans	-5.1	-39.3	-83.7	-24.2
Sri Lanka Development Bonds	8.8	-15.2	16.4	0.0
Central Bank provisional advances	0.9	0.2	3.6	4.9
Other	-27.1	-18.1	-0.7	44.2
By Source	126.4	79.7	117.2	123.6
Bank	-4.8	-20.9	43.3	26.2
Non Bank	131.2	100.7	73.9	97.4

Sources : Central Bank of Sri Lanka
Ministry of Finance and Planning

(2.1 per cent of GDP) in 2004. In 2005, the government borrowed Rs.59.9 billion from commercial banks and repaid Rs.33.7 billion to the Central Bank.

- **Net borrowings from the domestic non-bank sector increased to Rs. 97.4 billion (4.1 per cent of GDP) from Rs.74.0 billion (3.5 per cent of GDP) in 2004.** The Employees' Provident Fund (42.2 per cent) and National Savings Bank (18.4 per cent) continued to be the major sources of non-bank financing.
- **Net domestic borrowings through debt instruments declined to Rs.74.5 billion in 2005 from Rs. 98 billion in 2004.** The entire amount of net domestic borrowings through debt instruments was made through Treasury bonds (Rs.108 billion), as there were net repayments of Treasury bills (Rs.9.4 billion) and Rupee loans (Rs.24.2 billion).
- **The maturity structure of instrument based borrowings skewed towards the shorter end of the market.** This reflected investor preference for short-term commitment of funds in an environment of rising interest rates. For the first time, to securitise a part of the outstanding overdrafts, the government issued Index-linked Treasury bonds of Rs. 22 billion to the two state banks in 2005.
- **Total non debt instrument borrowings in 2005 amounted to Rs. 49.1 billion.** There were borrowings from FCBUs of state owned commercial banks amounting to Rs. 41.7 billion (US dollars 415 million). In 2005, total non-debt instrument borrowings increased to 39.7 per cent of the total net domestic borrowings from 16.4 per cent in 2004.
- **The disbursement of foreign loans, on a gross basis, amounted to Rs.75.2 billion in 2005 compared to Rs.78.3 billion in 2004.** A major part of the foreign loans was received by way of project loans that amounted to Rs. 62.7 billion while receipts of programme loans amounted to Rs. 2 billion. In 2004, gross disbursements of loans through project and programme loans amounted to Rs.68.3 billion and Rs.3.0 billion, respectively. Japan, the ADB, and International Development Association (IDA) were the major donors of project loans. The balance consisted of commercial loans amounting to Rs.10.5 billion including the syndicated foreign commercial loan of Rs.10.2 billion (US dollars 100 million) obtained by the government in December 2005.
- **Net foreign borrowings increased to Rs. 47.8 billion (2.0 per cent of GDP) compared to Rs.37 billion (1.8 per cent of GDP) in 2004.** This was entirely due to the lower amortisation payments of Rs.21.4 billion. The amortisation payments on outstanding foreign loans declined by about a half as a result of the deferment of a part of the amortisation payments (Rs.18.4 billion) due to the debt moratorium granted by foreign donors in 2005.
- **Foreign grants received by the government increased to Rs.32.6 billion (1.4 per cent of GDP) from Rs. 8.7 billion (0.4 per cent of GDP) in 2004.** This increase was largely due to tsunami related inflows. Bilateral donors such as Japan and the USA and multilateral donors such as the ADB, the United Nations Children's Fund (UNICEF), United Nations Development Programme (UNDP) and the Food and Agricultural Organisation (FAO) were the major donors of foreign grants.

6.4 Sub National Government Budgetary Operations

- **Sri Lanka's sub national government (SNG) system consists of Provincial Councils (PCs) and Local Governments (LGs).** The PCs, (8 PCs at present) have been established under the 13th Amendment to the Constitution to decentralise the decision making process by the devolution of powers to sub-national level governments. The LG system as at end 2005 comprised

Table 6.6

Budget Outturn for Provincial Councils

Rs. million

Item	2002	2003	2004	2005 Provisional
Total revenue	9,366	11,625	13,522	16,132
Tax revenue	7,952	9,968	11,544	13,818
Non-tax revenue	1,414	1,656	1,978	2,314
Total expenditure	44,314	49,224	56,964	73,009
Current expenditure	38,268	39,800	46,308	59,132
o/w Personal emoluments	29,993	30,582	36,079	46,479
Capital expenditure	6,046	9,423	10,656	13,877
Central government transfers	36,499	37,832	45,848	59,696
Block grants	30,574	30,462	35,892	47,107
Criteria based grants	1,000	607	803	817
Matching grants	307	246	311	273
PSDGs (a)	3,405	3,332	3,854	5,561
Foreign grants for special projects	1,213	3,184	4,988	5,937

(a) Province Specific Development Grants

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

of 311 units, consisting 18 Municipal Councils (MCs), 37 Urban Councils (UCs) and 256 Pradesheeya Sabhas (PSs).

- **SNGs rely heavily on central government transfers for their operations as their scope for collecting revenues is limited and the resource mobilising powers granted to them are inadequate.** Thus, the government provides various types of grants to finance the resource gap. This has led to the SNGs continuing to exist without making strong efforts to collect the revenues.

- **The SNG system played an important role in the tsunami recovery process.** The impact of the tsunami included damages caused to properties of 7 MCs, 14 UCs and 49 PSs. The damage was estimated to be Rs.2.8 billion. The Ministry of Provincial Councils and Local Governments (MPCLG) was involved in rehabilitation and reconstruction in the affected LGs, the reinstallation of LG management and information systems including the retrieval of damaged legal and other documents.

- **SNGs faced a number of problems in rendering their services.** The limited devolution of power to mobilise required resources, the weak institutional framework, inadequate financial and human resource management and the lack of technical skills were among the key problems. In 2005, the MPCLG established a Monitoring Unit to monitor the progress of PCs.

- **The MPCLG expects to intervene in several areas related to SNGs in the future.** The key areas include providing budgetary funds to ensure financial stability of the SNGs, improving their administrative capacity and capabilities, increasing investment at SNG level for the development of provincial and rural roads, the development of Northern and Eastern provinces, and the rehabilitation and reconstruction of infrastructure and services destroyed by the tsunami.

Performance of Provincial Councils

- **The overall budgetary performance of PCs in 2005 did not reflect a significant improvement compared to 2004.** Revenue collection remained at 0.7 per cent of GDP as in the previous year. Total expenditure increased to 3.1 per cent of GDP from 2.8 per cent in 2004.

- **The increase (19 per cent) in revenue from turnover taxes and licence fees mainly contributed to the higher nominal increase in revenue of PCs.** About 58 per cent of the total revenue was collected from these two sources. As a result of the high concentration of industrial and commercial activities and a large population, the Western Provincial Council (WPC) accounted for 68 per cent of the total revenue collection. The other major revenue collecting PCs were those of the Central, Southern and North Western Provinces.

- **Recurrent expenditure of PCs increased to 2.5 per cent of GDP in 2005 from 2.3 per cent in 2004.** This was mainly due to the increase in public sector salaries and wages. The major portion of the personal emoluments (90 per cent) of PCs was absorbed by education (67 per cent) and health (23 per cent) sectors. The balance was used for other non-wage expenses in relation to goods and services.

- **Investment expenditure of PCs increased to 0.6 per cent of GDP in 2005 from 0.5 per cent in 2004.** Their investment expenditure was mainly in respect of Province Specific Development Projects (PSDP) and foreign funded special projects.

- **Transfers from the central government to PCs amounted to Rs.54 billion in 2005.** These transfers were in the form of block grants, matching grants, criteria based grants and Province Specific Development Grants (PSDG). Foreign grants for special projects amounted to Rs.6 billion.

Performance of Local Governments

- **In 2005, LGs continued their operations in the midst of a number of constraints that affected their effective functioning.** The devolved revenue and transfers from the central government were the major sources of finance for their operations. PCs worked as the agent for LGs in collecting some of the devolved revenues such as property transfer taxes and court fines as assigned under the 13th Amendment to the Constitution. Personal emoluments, other current expenses and capital expenses comprised the outlays of LGs. The weak financial systems and human resource management, weaknesses in regulation and monitoring, lack of competent technical staff, non-availability of proper record keeping systems, lower revenue collection and lack of legal powers continued to be the major constraints for the effective functioning of LGs.

6.5 Financial Performance of Selected Public Enterprises

- **The two public enterprises, which have a significant impact on the government budget at present, are the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB).** In 2005, the financial position of CPC improved. However, the financial position of CEB continued to weaken.

- **The financial position of the CPC improved in 2005.** The contributory factors are the progress made in financial management, internal controls, external financial support, importing refined products on a more competitive basis, negotiating more favourable terms on suppliers credit, receipt of an extended suppliers credit facility from Iran and a long-term credit facility under the Indian Line of Credit, and the fuel subsidy received from the government. The credit facilities obtained from Iran and India helped improve the liquidity position of the CPC and reduce short-term advances taken from commercial banks. Though the credit facility obtained under the Indian Line of Credit shifted a part of the CPC's short term liabilities to medium to long term liabilities, overall outstanding high debt still remains a concern. Non-adjustment of domestic prices adequately and in time according to the formula introduced in January 2002 was the major reason for accumulation of debt. The sharp rises in international prices have led to a higher subsidy from the government.

- **The financial position of CEB continued to weaken.** Delays in implementing new low cost power plants, non implementation of proposed reforms, non adjustment of electricity prices to reflect the cost and the delay in addressing the high system losses were the main contributory factors for the weakening financial position of the CEB.
- **The total amount of subsidies for petroleum products amounted to Rs. 26 billion in 2005 (1.1 per cent of GDP).** This underscores the unsustainability of continuing the policy of providing subsidies on untargetted basis. A strong commitment to the implementation of the necessary measures to reduce the burden on the government budget is urgently needed.

6.6 Public Sector Debt and Debt Service Payments

Government Debt

- **The total outstanding government debt increased by 3.9 per cent to Rs. 2,222.3 billion in 2005 but as a per cent of GDP, it declined to 93.9 per cent from 105.5 per cent in 2004, benefiting from the appreciation of the rupee and the higher growth in nominal GDP.** The total debt consisted of 56.9 percent of domestic debt (Rs.1,265.7 billion) and 43.1 per cent of foreign debt (Rs.956.6 billion). These shares were 53.4 per cent and 46.6 per cent, respectively in 2004. As a per cent of GDP, domestic debt was 53.5 per cent and foreign debt was 40.4 per cent. The corresponding ratios in the previous year were 56.4 per cent and 49.1 per cent, respectively.

Chart 6.6
Government Debt (as a % of GDP)

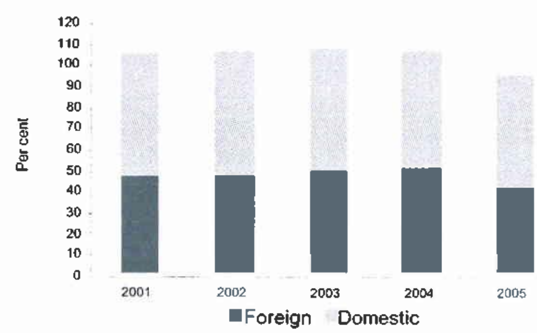


Table 6.7
Outstanding Public Sector Debt (at end year)

Rs. million

Item	2002	2003	2004	2005 Provisional
1. Central Government Debt	1,670,342	1,863,851	2,139,526	2,222,341
Domestic Debt (a)	948,386	1,019,969	1,143,389	1,265,721
By maturity period				
Short term	259,205	249,621	269,784	262,153
Medium and long term	689,181	770,348	873,605	1,003,568
By institution				
Banks (b)	247,743	228,411	272,981	298,411
Non bank sector	700,643	791,559	870,408	967,310
Foreign debt	721,956	843,882	996,138	956,620
By type				
Concessional loans	702,369	822,839	970,299	919,030
Non concessional loans	19,588	21,043	25,838	37,590
By currency				
SDR	297,848	359,844	420,459	401,615
US dollars	128,952	134,538	152,562	161,632
Japanese yen	218,921	260,706	310,311	286,673
Deutsche mark (c)	53,606	63,500	83,579	76,060
Other	22,630	25,294	29,227	30,640
Memo: Exchange rate variation	74,044	67,691	106,502	-100,751
2. Non Financial Public Corporations Debt	43,031	36,192	41,171	31,377
Ceylon Electricity Board	5,261	14,411	12,529	9,841
Ceylon Petroleum Corporation(d)	16,232	14,909	23,326	15,823
Cooperative Wholesale Establishment	7,514	2,402	1,400	983
Other	4,024	4,470	3,916	4,730
3. Total public sector debt (1+2)	1,713,373	1,900,043	2,180,697	2,253,718

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. 29,570 million at end 2002, Rs.29,406 million at end 2003,Rs.31,596 million at end 2004 and Rs.73,492 million in 2005.

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

(d) In 2005 liabilities include the outstanding balance of Rs.14,705 million (US dollars 144 million) to Indian Line of Credit.

- **In nominal terms, total outstanding debt increased by Rs.82.8 billion in 2005.** This increase was the result of the increase in domestic debt by Rs.122.3 billion and a decline in foreign debt by Rs.39.5 billion. The decline in the foreign debt stock was entirely due to the appreciation of the rupee vis-à-vis major foreign currencies. The total impact of the exchange rate variation in 2005 was a decline of the foreign debt stock by Rs.100.7 billion.
- **The share of medium and long-term debt in the total domestic debt stock increased to 79 per cent from 76 per cent in 2004.** Treasury bonds continued to dominate the

outstanding domestic debt portfolio and its share in the total domestic debt increased to 59.4 per cent from 56.3 per cent in the previous year. As the retirement of Rupee loans was continued, their share in the total outstanding domestic debt stock declined to 11.1 per cent. This share was 24.4 per cent and 14.4 per cent in 2003 and 2004, respectively. Of the short-term debt stock (20.7 per cent of the total domestic debt), Treasury bills accounted for 89 per cent.

- **The outstanding debt liabilities to commercial banks increased by 9.3 per cent in 2005.** It accounted for 23.6 per cent of the total domestic debt stock. Of the total liability to commercial banks, the outstanding foreign currency denominated domestic debt increased to US dollars 965 million (Rs.98.5 billion) from US dollars 550 million (Rs.57.5 billion) in 2004. This consisted of borrowings from FCBUs amounting to US dollars 715 million and outstanding Sri Lanka Development Bonds (SLDBs) of US dollars 250 million. The growth in foreign currency denominated domestic debt has increased the vulnerability of the domestic debt stock to exchange rate variations.
- **The share of outstanding concessional loans in the total foreign debt stock declined to 96.0 per cent from 97.4 per cent in 2004.** This was due to increased foreign commercial borrowings. The non concessional debt consisted mostly of foreign commercial debt (96.9 per cent), that increased by 55.3 per cent to Rs. 36.4 billion in 2005. The shares of bilateral and multilateral debt accounted for 45.3 per cent and 50.9 per cent, respectively. Japan continued to be the major bilateral donor, accounting for 29.0 per cent of the total foreign debt stock, followed by the USA (5.8 per cent) and Germany (5.1 per cent). The main multilateral donors were the ADB (24.0 per cent) and IDA (22.4 per cent).
- **The government debt as a per cent of GDP still remains high, though it declined somewhat in 2005.** This situation poses several threats including high interest payment commitments, which will increase the pressure on the government's ability to meet its other commitments and leave little room for other essential expenditure and development-oriented investment. This could also have adverse implications on monetary management and could reduce the country's ability to withstand external shocks. Thus, there is a need for strong measures to strengthen the fiscal consolidation process and move towards achieving fiscal sustainability in the medium to long term.

Non Financial Public Corporation Debt

- **The outstanding liabilities of non financial public corporations (NFPC) to the banking system and their foreign long-term liabilities amounted to Rs.31.4 billion compared to Rs.41.2 billion in 2004.** The debt liabilities of NFPCs to the banking system declined by Rs.24.5 billion to Rs.16.7 billion in 2005. The main NFPCs that recorded decreased liabilities to the banking sector were the CPC (Rs. 6.8 billion) and the CEB (2.7 billion). These two institutions accounted for 68 per cent of the total outstanding NFPC debt to the banking system. The outstanding long term liabilities of the NFPCs amounted to Rs.14.7 billion (US dollars 144 million) which included the credit line obtained by the CPC from India.

Public Sector Debt

- **The outstanding debt stock of the public sector, which includes the government and NFPCs, increased by 3.4 per cent to Rs.2,253.7 billion as at the end of 2005.** It was Rs.2,180.7 billion at the end of 2004. However, the public sector debt as a per cent of GDP, declined to 95.3 per cent from 107.5 per cent at the end of the previous year. CPC and CEB continued to be the major debtors among the NFPCs.

Debt Service Payments

- **The total domestic and foreign debt service payments, which consist of interest and amortisation payments, increased to Rs. 344.9 billion in 2005.** Of the total, interest payments amounted to Rs.120.2 billion (35 per cent) and amortisation payments amounted to Rs.224.7 billion (65 per cent). Debt service payments to domestic and foreign sources amounted to Rs.316.5 billion and Rs.28.4 billion, respectively.
- **The debt moratorium granted by foreign donors resulted in the deferment of debt service payments of Rs.26.3 billion (US dollars 258.6 million) in 2005.** This comprised Rs.8.0 billion in interest payments and Rs.18.3 billion in amortisation payments. Japan was the main creditor, accounting for 71 per cent of the total deferred debt service payments, followed by the USA and Germany accounting for 13.2 per cent and 6 per cent, respectively of the total amount deferred. The deferred debt service payments would have to be paid within a period of four years (8 equal semi annual instalments). Repayments will commence from December 2006, after the grace period of about a year. Further, the debt written-off by creditors in 2005 amounted to Rs.0.8 billion (US dollars 8.2 million). Italy, China

Chart 6.7

Government Debt Service Payments (as a % of GDP)

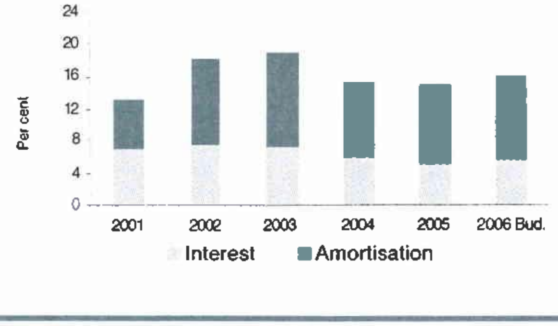


Table 6.8
Government Debt Service Payments

Rs. million

	2003	2004	2005 Provisional	2006 Estimates
Debt service payments	344,634	300,563	344,866	434,187
Amortisation payments	219,508	180,781	224,707	282,928
Domestic	185,083	147,740	203,347	230,738
Foreign	34,425	33,041	21,360	52,190
Interest payments	125,126	119,782	120,159	151,259
Domestic	113,540	105,878	113,164	132,206
Short term	25,147	20,474	20,300	21,858
Medium and long term	88,393	85,404	92,864	110,348
Foreign	11,586	13,904	6,995	19,053

Sources : Central Bank of Sri Lanka
Ministry of Finance and Planning

and the UK were the countries that wrote off the debt service payments.

- **Total debt service payments as a per cent of government revenue declined to 90.8 per cent in 2005 from 96.5 per cent in 2004.** The ratio of total foreign debt service payments to exports of goods and services also declined to 3.6 per cent from 6.4 per cent in the previous year, due to the debt moratorium and growth in exports.

Table 6.9
Government Debt Indicators

Indicator	2002	2003	2004	2005 Pro.	2006 Est.(d)
Government Debt/GDP	105.4	105.8	105.5	93.9	89.5
- Domesitc Debt/GDP	59.8	57.9	56.4	53.5	50.9
- Foreign Debt/GDP	45.6	47.9	49.1	40.4	38.6
Total Foreign Debt/Exports (a)	126.4	133.7	134.9	120.7	116.8
Total Debt Service/GDP	17.9	19.6	14.8	14.6	16.0
Total Debt Service/Government Revenue (b)	108.6	124.6	96.5	90.8	89.6
o/w Domestic Debt Service/ Government Revenue (b)	90.4	108.0	81.4	83.3	74.9
Total Debt Service/ Government Expenditure (c)	49.8	54.1	45.7	42.6	41.7
o/w Domestic Debt Service/ Government Expenditure (c)	41.5	46.9	38.6	39.1	34.9
Foreign Debt Service/Exports (a)	8.3	7.3	6.4	3.6	7.9
Domestic Interest/GDP	6.7	6.4	5.2	4.8	4.9
Domestic Interest/Government Current Expenditure	32.0	33.9	27.2	25.5	25.9
Foreign Interest/Exports (a)	1.9	1.8	1.9	0.9	2.1

(a) Exports of goods and services Source: Central Bank of Sri Lanka
(b) Government revenue is in economic format
(c) Government expenditure inclusive of amortisation payments
(d) Based on original budget

- **The debt service payments in 2006 are estimated to be Rs. 434.2 billion.** This comprises the interest payments of Rs.151.3 billion and amortisation payments of Rs. 282.9 billion and includes the first instalment of the debt service payments that were deferred under the debt moratorium granted in 2005.