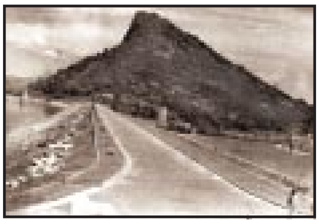
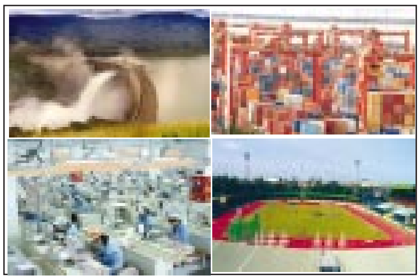
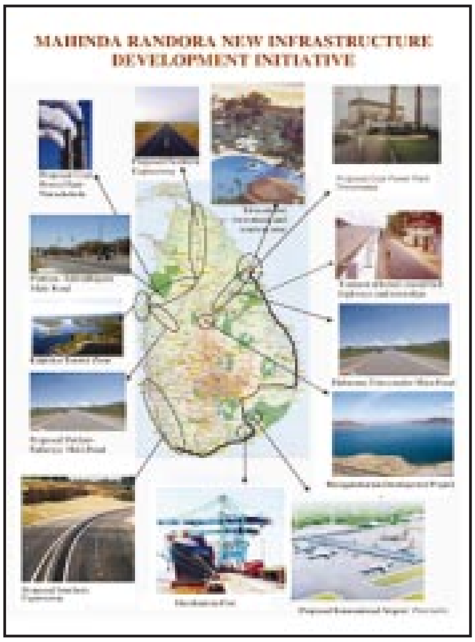






Chapter 6

FISCAL POLICY AND GOVERNMENT FINANCE

6.1 Overview

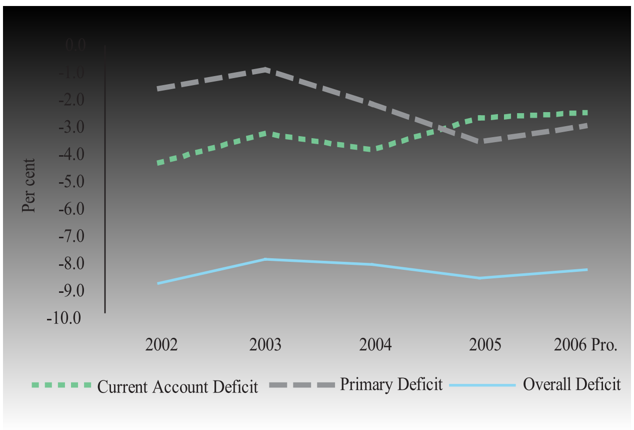
The overall fiscal policy strategy continued to focus on strengthening fiscal consolidation in 2006, while continuing with the tsunami recovery process and promoting pro-poor and pro-growth development strategy of the government to reduce poverty and regional economic disparity. The fiscal policy strategy was formulated within the overall vision enunciated in the '*Mahinda Chintana*' policy document and in the Medium Term Macro Fiscal Framework (Mid-term Framework) covering the next three years consistent with the overall macroeconomic strategy. The strategy is guided by the targets stipulated in the Fiscal Management (Responsibility) Act of 2003.

Salient features of the fiscal framework were improving revenue, rationalising recurrent expenditure, enhancing public investment, revitalising the rural economy and strengthening the financial performance of strategic public enterprises.

The achievement of fiscal targets became a challenging task in 2006. Major challenges were the high international oil prices, high inflation, high domestic interest rates and need for meeting expenditure on enhanced security and rehabilitation. To improve the overall fiscal operations, a series of measures were introduced including the rationalising of the tax and tariff systems, strengthening of tax administration, revising the administered prices, allowing the full pass-through of petroleum product price changes from July 2006 onwards and improving the utilisation of available foreign resources.

Despite those tough challenges, the fiscal performance in 2006 indicated some improvements. Government revenue continued its increasing trend and reached 17.0 per cent of GDP from 16.1 per cent in 2005, responding to strong efforts particularly in the areas of tax policy measures, tax administration and timely enactment of relevant legislation. The total revenue collected in 2006 was only marginally below the annual target. The public investment remained at 6.3 per cent of GDP as in 2005, compared to the budgetary target of 8.3 per cent. The main areas of investment were the infrastructure development and tsunami related reconstruction. Recurrent expenditure exceeded the target due to higher than budgeted expenditure on salaries and wages, pensions, fuel subsidies, national security and humanitarian relief. The decline in capital expenditure against the original target and the increase in recurrent expenditure resulted in the improvement of the overall budget deficit to 8.4 per cent of GDP compared to the original target of 9.1 per cent. However, although the budget deficit declined, the reduction in public investment and the overrun in recurrent expenditure will adversely affect the long term growth prospects of the country. The government resorted to increased domestic financing to meet additional borrowing requirement needed to finance the overrun on recurrent expenditure and the marginal decline in revenue.

Chart 6.1 **Major Fiscal Indicators (as a per cent of GDP)**



The outstanding debt to GDP ratio declined further to 93.0 per cent of GDP at end 2006 from 93.9 per cent at end 2005 due to relatively high increase in the nominal GDP. The high outstanding debt to GDP ratio underscores the necessity of strict adherence to medium term fiscal targets stipulated in the Mid-term Framework to achieve fiscal sustainability.

The government has enunciated its long term policy strategy in the Ten Year Horizon Development Framework (Ten-year Vision), which stretches the policy direction beyond the Mid-term Framework. The overall thrust of the Ten-year Vision is placed on achieving a regionally balanced economic growth to reduce poverty through the implementation of a number of projects. However, these efforts have to be complemented with timely rectification of various deficiencies in the fiscal sector, including the tax system, public enterprises, pension system and the civil service.

6.2 Fiscal Policy Direction and Measures

The focus of the overall fiscal policy strategy in 2006 continued to be on strengthening fiscal consolidation, continuing the tsunami recovery process, promoting pro-poor and pro-growth development strategy to reduce poverty and regional income disparities and revitalising the rural economy, enhancing public investment and strengthening strategic public enterprises. Measures aimed at increasing revenue and rationalising recurrent expenditure were implemented to further strengthen the fiscal consolidation process. The tsunami recovery process focused on restoring livelihoods and other infrastructure. The pro-poor and pro-growth policies which aimed at revitalising the rural economy, included the introduction and continuation of a number of regional and rural projects and programmes. On the public investment front, emphasis was given to accelerated implementation of projects with increased utilisation of available foreign resources. The Strategic Enterprise Management Agency (SEMA) continued its efforts to improve the financial performance of strategic public enterprises.

In 2006, sustaining the increasing trend in government revenue was given the highest priority, as it is a key to strengthening the fiscal consolidation process. In this connection, measures were introduced to broaden the tax base, revise tax rates, modernise the tax administration and strengthen the legal and regulatory framework to contain tax evasion and avoidance. Major measures included further strengthening of the VAT system, rationalisation of corporate income taxes and import duties, reintroduction of stamp duties, increase of the Port and Airport Development Levy (PAL) and Betting and Gaming Levy, revision of the Social Responsibility Levy (SRL), cess on non-essential imports and export of tea and rubber and excise taxes on cigarettes. The efforts to modernise the tax administration were continued with an emphasis on human resource development. Measures were taken to create a taxpayer-friendly culture so as to promote tax compliance. The government also took measures to ensure the timely enactment of revenue related legislation to reduce the uncertainty.

Table 6.1 Summary of Government Fiscal Operations

	2005	2006 Approved Estimates	2006 Provisional	2007 Approved Estimates
	Rs. Million			
Total revenue	379,746	484,376	477,334	599,817
Tax revenue	336,829	435,292	428,378	540,929
Non tax revenue	42,917	49,084	48,956	58,888
Expenditure and lending minus repayments	584,783	731,641	713,147	898,000
Current	443,550	509,856	547,460	596,165
Capital and net lending	141,434	221,785	165,686	301,836
o/w Public investment	148,582	225,295	177,443	303,567
Current account surplus (+)/deficit(-)	-63,604	-25,480	-70,126	3,652
Primary account surplus (+)/deficit(-)	-84,878	-96,006	-85,035	-129,061
Overall surplus (+)/deficit(-)	-205,037	-247,267	-235,813	-298,183
Total Financing	205,037	247,267	235,813	298,183
Foreign Financing	80,413	124,223	72,007	141,971
Foreign loans	47,773	81,983	41,939	117,896
Foreign grants	32,640	42,240	30,068	24,075
Domestic financing	123,603	123,043	163,805	156,212
Market borrowings	119,303	123,043	163,805	156,212
Non bank	93,108	123,043	83,797	139,512
Bank	26,195	-	80,007	16,700
Monetary authority	-33,721	-	38,579	-
Commercial banks	59,916	-	41,428	-
Other borrowings	4,300	-	-	-
Privatisation proceeds	1,020	-	-	-
	As a per cent of GDP			
Total revenue	16.1	17.8	17.0	18.5
Tax revenue	14.2	16.0	15.3	16.7
Non tax revenue	1.8	1.8	1.7	1.8
Expenditure and lending minus repayments	24.7	26.9	25.4	27.7
Current	18.7	18.7	19.5	18.4
Capital and net lending	6.0	8.2	5.9	9.3
o/w Public investment	6.3	8.3	6.3	9.4
Current account surplus (+)/deficit(-)	-2.7	-0.9	-2.5	0.1
Primary account surplus(+) /deficit (-)	-3.6	-3.5	-3.0	-4.0
Overall surplus (+)/deficit (-)	-8.7	-9.1	-8.4	-9.2
Total Financing	8.7	9.1	8.4	9.2
Foreign Financing	3.4	4.6	2.6	4.4
Foreign loans	2.0	3.0	1.5	3.6
Foreign grants	1.4	1.6	1.1	0.7
Domestic financing	5.2	4.5	5.8	4.8
Market borrowings	5.0	4.5	5.8	4.8
Non bank	3.9	4.5	3.0	4.3
Bank	1.1	-	2.9	0.5
Monetary authority	-1.4	-	1.4	-
Commercial banks	2.5	-	1.5	-
Other borrowings	0.2	-	-	-
Privatisation proceeds	...	-	-	-

Source: Ministry of Finance and Planning

Several changes were introduced to strengthen the VAT system further. Streamlining of the VAT refund system, opening of a special account at the Central Bank to cater to refunds while avoiding delays in payments, increasing VAT on the financial sector to 20 per cent from 15 per cent, increasing the mark-up applicable on VAT at the point of import to 7 per cent from 5 per cent in January 2006 and to 10 per cent in November 2006, reducing the VAT rate applicable on locally manufactured soft drinks and exempting some items from VAT to encourage local production were the key measures implemented in this respect. To prevent fraudulent actions in VAT refunds, the provision of a bank guarantee within a stipulated period was made necessary, while the applicable limit on refunds for the items in the 20 per cent VAT band was fixed at 15 per cent.

Major measures introduced to rationalise corporate income taxes included the reduction of the tax rate on Co-operative Societies and on Small and Medium Enterprises (SMEs), increase of the rate applicable to companies of which taxable income exceed Rs. 5 million, fixing of the tax rate applicable to income and profit from the businesses of gaming and auto lotteries at 40 per cent and applying a 33 1/3 rate for newly quoted companies as an incentive for capital market development. Meanwhile, the maximum personal income tax rate was increased to 35 per cent creating a new slab of Rs.500,000 for the 30 per cent tax rate. The 15 per cent income tax on income from exporting agriculture produce was removed to encourage this activity. Profits from processing primary agriculture produce were exempted from income tax to promote the processing of fruits and vegetables. The professional services extended by Sri Lankan professionals, in or outside Sri Lanka for foreign currency, were also exempted from income tax as an incentive for fast emerging global professional service providers.

Import duties were rationalised through a number of measures. Accordingly, import duty rates on selected items were revised and some items were exempted from import duty with a view to increasing their domestic production. New measures were introduced to remove the anomalies in tariff rates as recommended by the Trade and Tariff Cluster under the National Council for Economic Development (NCED). Specific duties were introduced on certain commodities to curb under-valuation. Towards the end of the year, tariffs on selected essential food items were removed or reduced for a specified period of time with a view to reducing the cost of living. In order to complement these efforts, improved valuation methods were applied by Sri Lanka Customs (SLC) to value imported items and measures were taken to improve the customs surveillance mechanism. The SLC also adopted a Human Resource Development Plan to improve its efficiency.

Modernsation efforts of the tax administration were continued in 2006 in a number of ways. The corporate structure of the Inland Revenue Department (IRD) was reconstituted to strengthen the senior management to improve tax administration, develop audit and surveillance, analyse policies, use new technology and develop human resources. In addition, the revision of the time limit for lodging tax returns, acknowledgement of appeals within 30 days of receipt, granting of a discount for taxpayers who pay taxes in advance and imposing a penalty on late payments were also introduced to strengthen tax administration.

The Fiscal Management Reform Programme (FMRP), funded by a loan from the Asian Development Bank (ADB), continued in 2006. The FMRP aims at modernising and strengthening the fiscal and revenue administration in the country through the adoption of improved processes, enhanced human resource capabilities and complementing information technology improvements. The programme focused on the restructuring and modernisation of the IRD, SLC, Excise and the Treasury Departments and the Finance Commission. Key areas in which improvements were carried out included human resource development through local and foreign training, creating a taxpayer-friendly culture and enhancing public awareness, institutional development through the restructuring of organisational structures and improving information technology facilities and audit systems.

The government introduced several measures to rationalise recurrent expenditure. Domestic petroleum prices were adjusted in line with rising oil prices in the international market in April and May 2006 to contain the subsidy cost on fuel. Further, in July 2006, the government allowed Ceylon Petroleum Corporation (CPC) and Lanka IOC Limited (LIOC) to determine retail prices of petroleum products and discontinued provision of fuel subsidies on petrol and diesel, which was a major step taken to reduce fiscal vulnerability. The fertiliser subsidy was rationalised by targeting small scale low income farmers. Under the new scheme, all paddy farmers and other field crops growers received fertiliser at Rs.350 per 50 kg bag of urea, Triple Super Phosphate (TSP) and Muriate of Potash (MOP). The scheme was further extended to provide Urea at a subsidised rate for the smallholder plantation sector. Other measures included the provision of instructions to adhere to strict cadre assessment and approval procedures and to verify budgetary availability of provisions before filling the vacancies and improving cash management through the transfer of public servants' loans and advances to the banking system.

On the public debt management front, measures were taken to diversify and broad base the government securities market, strengthen the Primary Dealer (PDs) system, phase out non-marketable debt instruments, while resorting more on domestic foreign currency denominated commercial borrowings. With a view to broadening the investor base and increasing the market competition, the Rupee denominated Treasury bond market was opened to foreign investors. Accordingly, foreign investors were allowed to invest up to 5 per cent of the outstanding amount of Treasury bonds. Furthermore, the minimum capital requirement applicable to PDs was increased further to Rs.300 million from Rs.250 million to provide a cushion for the rising market risk. With a view to maintaining adequate capital levels to cover PDs risks, the Risk Weighted Capital Adequacy Framework was introduced. The government continued its policy of retiring Rupee securities to phase them out. In this regard, the restructuring bonds of commercial banks that matured in 2006 were replaced with Treasury bonds. The government also resorted more to domestic foreign currency denominated commercial borrowings with a view to diversifying the domestic debt's high exposure to rising domestic interest rates.

Post tsunami reconstruction and development activities were continued by the government during the year under Reconstruction and Development Agency (RADA), the agency that was established in 2005 by incorporating all tsunami reconstruction related organisations to accelerate reconstruction and development activities. The agency played an important role in coordinating housing programmes such as relocation of houses and the home owner driven housing programme. The livelihood restoring programmes were also coordinated by RADA.The activities in other relevant sectors such as education, health, road and bridges, water supply and sanitation, power supply, ports, postal and tele communications were handled by the relevent line Ministries and departments.

Measures focused on the development of social and economic infrastructure facilities, creation of employment and income generating opportunities for the poor and minimisation of regional imbalances in development were implemented with a view of achieving the pro-poor and pro-growth development objectives of the government and revitalising the rural economy. Accordingly, a considerable amount of resources was spent to implement a series of projects and programmes to address the gaps in the economically less affluent segments to accelerate economic and social progress, and thereby reduce poverty in a sustainable manner. In line with this, a number of projects were implemented mainly in five major areas: roads, electricity, irrigation and water, housing and livelihood. The development of community water supply, upgrading rural roads, rural electrification, development of rural irrigation facilities, provision of housing facilities for the rural poor, special area and community based development projects were integral parts of these projects. Special attention was also given to rebuilding the conflict affected areas through rehabilitation and reconstruction of basic infrastructure facilities in those areas, and resettlement and support of the livelihood of people affected by the conflict. The empowerment of the rural poor was also attempted through promoting socio-economic activities for Samurdhi beneficiaries. In addition, increased resources were channelled to the poorest 119 Divisional Secretariat Divisions to accelerate their development activities. The economic opportunities for the poor segments were expected to be enhanced through encouraging their entrepreneurship.

The government presented a comprehensive public investment programme, particularly aimed at addressing infrastructure bottlenecks that hamper the growth prospects of the country. During the year, priority was given to accelerate the project implementation with increased utilisation of available foreign resources. In line with this, efforts were continued to reduce procurement delays and expedite reimbursement of funds. Main investment areas included power, roads, transport, airports, ports, communication, water supply, sewerage and housing.

Efforts to improve the financial performance of public enterprises through SEMA were continued in 2006 as the government has recognised the importance of continuing state ownership of strategically important enterprises. The scope of SEMA was expanded by a Presidential Directive during the year under which 8 new strategic enterprises[1] were brought into the purview of SEMA. Furthermore, SEMA obtained Cabinet approval to continue its functions independently. In 2006, the enterprises under SEMA were grouped into five clusters namely, banking, transport and logistics, plantation, trading and utility[2]. Furthermore, measures were initiated by SEMA to generate multi-purpose revenue sources in each enterprise by using their available resources. New business models for all strategic enterprises were prepared to find out new income sources and thereby increase their contribution to government non-tax revenue.

In 2006, the Ministry of Finance and Planning (MOFP) introduced several measures aimed at improving government finance operations. Accordingly, a Fiscal Policy Committee was set up at the MOFP to formulate fiscal policy framework for the country, monitor fiscal performance and ensure discipline in the preparation of the Budget through a constant review process. In addition, a Government Asset Management System (GAMS) was introduced to provide a monitoring mechanism for disbursement and recovery of lending activities of the government. Final steps were also being taken to introduce a modified Single Accounting System on Treasury operations to improve the management of government funds.

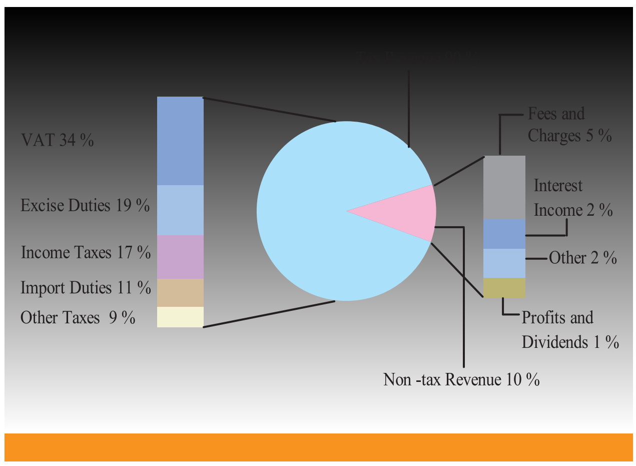
6.3 Government Budgetary Operations

Revenue

Total government revenue in 2006 increased by 26 per cent to Rs. 477 billion, while the total revenue to GDP ratio continued its increasing trend and reached 17.0 per cent compared to 16.1 per cent in 2005. Total revenue was only marginally below the target of Rs. 484.4 billion in the original budget. The improved performance was attributed to increase in revenue from both tax and non-tax revenue.

Tax revenue increased by 27 per cent to Rs.428.4 billion and the tax revenue to GDP ratio increased for the third consecutive year amounting to 15.3 per cent compared to 14.2 per cent in 2005. The increase in tax revenue was mainly driven by increases in revenue from income taxes, Value Added Tax (VAT), excise taxes and import duties. Revisions introduced to both corporate and personal income

Chart 6.2 Composition of Government Revenue - 2006



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1 The 8 new enterprises include Lanka Puthra Bank, Janatha Estates Development Board, National Livestock Development Board, Sri Lanka Cashew Corporation, Sri Lanka State Plantations Corporation, Chilaw Plantations Ltd., Elkaduwa Plantations Ltd. and Kurunegala Plantations Ltd. With this move, the total number of enterprises under SEMA was increased to 20.

2 The Banking Cluster includes Peoples Bank, Bank of Ceylon, National Savings Bank, State Mortgage & Investment Bank and Lanka Puthra Bank. The Plantation Cluster includes Janatha Estates Development Board, Sri Lanka State Plantations Corporation, Kurunegala Plantations, Chilaw Plantations, Elkaduwa Plantations, Cashew Corporation and National Livestock Development Board. The Transport and Logistics Cluster includes Sri Lanka Transport Board, Sri Lanka Railways, Sri Lanka Ports Authority and Airports and Aviation Authority of Sri Lanka. The Trading Cluster includes State Pharmaceuticals Corporation. The Utilities Cluster includes Ceylon Electricity Board, Ceylon Petroleum Corporation and National Water Supply and Drainage Board.

tax rates, restrictions imposed on carry forward losses, closing loopholes through amendments to tax legislations, revisions introduced to the Economic Service Charge (ESC) and improved tax administration and enforcement contributed to increased revenue from income taxes. The revenue from VAT was increased due to increase in the mark-up on imports, rate increase on financial services, increased imports of high valued items such as motor vehicles, high international commodity prices, growth in services sector, particularly the telecommunication sub-sector, and measures introduced to streamline VAT refunds. The increase in revenue from excise duties was mainly due

Table 6.2 **Economic Classification of Revenue**

	2005	2006 Approved Estimates	2006 Provisional	2007 Approved Estimates
	Rs. million			
Tax revenue	336,829	435,292	428,378	540,929
Income taxes	52,535	75,560	80,483	102,124
VAT	138,660	174,295	164,555	202,272
Excise tax	76,978	85,363	92,845	107,580
Import duties	45,391	64,596	52,681	70,530
Other taxes	23,265	35,478	37,814	58,423
Non tax revenue	42,917	49,084	48,956	58,888
Total revenue	379,746	484,376	477,334	599,817
	As a per cent of GDP			
Tax revenue	14.2	16.0	15.3	16.7
Income taxes	2.2	2.8	2.9	3.2
VAT	5.9	6.4	5.9	6.2
Excise tax	3.3	3.1	3.3	3.3
Import duties	1.9	2.4	1.9	2.2
Other taxes	1.0	1.3	1.3	1.8
Non tax revenue	1.8	1.8	1.7	1.8
Total revenue	16.1	17.8	17.0	18.5

Source: Ministry of Finance and Planning

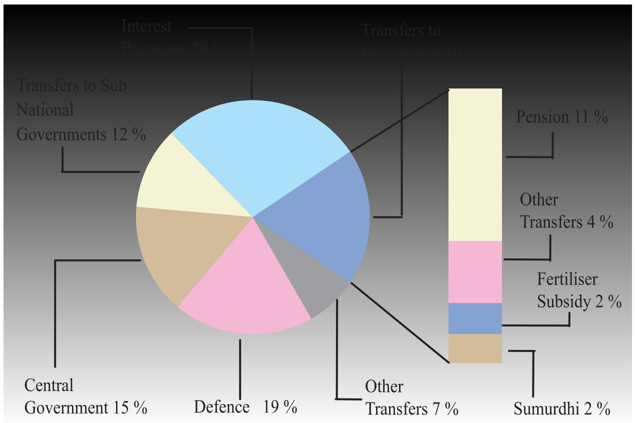
to increase in cigarette sales and liquor production and rate increases. The revenue from import duties increased due to higher motor vehicle imports, intensified countervailing measures and improved surveillance, valuation methods and enforcement of SLC.

Non-tax revenue increased by 14.0 per cent to Rs.49 billion though as a per cent of GDP, it declined marginally to 1.7 per cent in 2006 from 1.8 per cent in 2005. This was achieved mainly due to the increase in sales and charges, fines and penalties, profits and dividends from public enterprises, and interest income received from loans to government corporations.

Expenditure

Total expenditure and net lending of the government in 2006 reached Rs.713 billion recording a 22 per cent increase compared to the previous year. This was lower than the total expenditure of Rs. 731.6 billion expected in

Chart 6.3 **Composition of Government Current Expenditure - 2006**



the original budget for 2006. Higher than budgeted expenditure on non-interest recurrent expenditure including salaries and wages, pensions and subsidies and transfers resulted in an overrun in total recurrent expenditure in 2006. Expenditure on salaries and wages increased by 26.3 per cent to Rs.175 billion mainly due to the increase of public sector salaries in 2006, correction of salary anomalies, introduction of a monthly cost of living allowance for public servants, new recruitment of nurses, clerical staff, technical staff and home guards and the full impact of recruitment of over 40,000 graduates to the public service. It was the highest single expenditure item, which accounted for 32 per cent of the total recurrent expenditure. Correction of pension anomalies and the increase granted in 2006 were attributed for the increase in pension payments by 24 per cent to Rs.58 billion. Salary increases, inadequate revisions in administered prices and inefficiencies in some public corporations led to increased current transfers to public corporations and institutions to Rs.39 billion in 2006 from Rs.26.5 billion in 2005. Meanwhile, interest payments, in nominal terms, grew by 25.5 per cent compared to the

Chart 6.4 **Total expenditure by Function-2005**

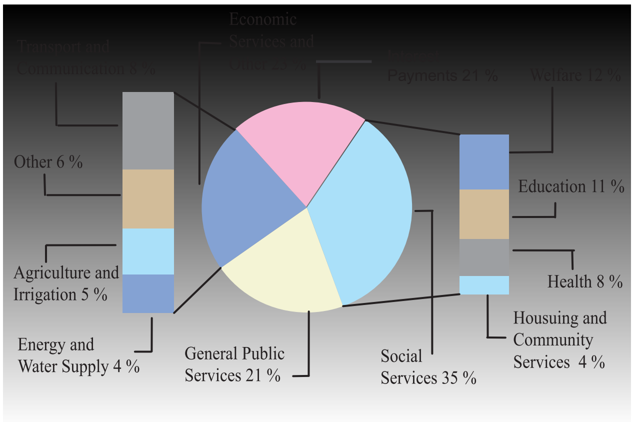


Table 6.3 **Economic Classification of Expenditure**

	2005	2006 Approved Estimates	2006 Provisional	2007 Approved Estimates
	Rs. million			
Current expenditure	443,350	509,856	547,460	596,165
Expenditure on goods and services	194,860	241,419	253,026	299,324
o/w Salaries and wages	138,603	168,570	175,031	198,743
Interest payments	120,159	151,259	150,777	169,122
Foreign	6,995	19,053	16,990	21,149
Domestic	113,164	132,206	133,787	147,973
Current transfers and subsidies	128,331	117,238	143,658	127,719
o/w To households and other sectors	101,277	83,420	104,342	94,450
Samurdhi	9,161	12,200	10,789	9,600
Pensions	46,782	48,361	58,006	61,654
Fertiliser subsidy	6,846	8,500	11,867	10,000
Other	38,488	14,359	23,680	13,196
Capital expenditure	140,154	211,740	162,214	259,642
Acquisition of real assets	88,140	133,121	88,208	179,004
Capital transfers	52,014	89,669	74,005	122,138
Under expenditure	-	-11,050	-	-41,500
Lending minus repayment	1,280	10,046	3,473	42,194
Total expenditure and net lending	584,783	731,642	713,147	898,000
	As a per cent of GDP			
Current expenditure	18.7	18.7	19.5	18.4
Expenditure on goods and services	8.2	8.9	9.0	9.2
o/w Salaries and wages	5.9	6.2	6.2	6.1
Interest payments	5.1	5.6	5.4	5.2
Foreign	0.3	0.7	0.6	0.7
Domestic	4.8	4.9	4.8	4.6
Current transfers and subsidies	5.4	4.3	5.1	3.9
o/w To households and other sectors	4.3	3.1	3.7	2.9
Samurdhi	0.4	0.4	0.4	0.3
Pensions	2.0	1.8	2.1	1.9
Fertiliser subsidy	0.3	0.3	0.4	0.3
Other	1.6	0.5	0.8	0.4
Capital expenditure	5.9	7.8	5.8	8.0
Acquisition of real assets	3.7	4.9	3.1	5.5
Capital transfers	2.2	3.3	2.6	3.8
Under expenditure	-	-0.4	-	-1.3
Lending minus repayment	0.1	0.4	0.1	1.3
Total expenditure and net lending	24.7	26.9	25.4	27.7

Source: Ministry of Finance and Planning

previous year. Domestic interest payments increased by 18 per cent to Rs. 133.8 billion while foreign interest payments increased by 143 per cent to Rs. 17 billion compared to 2005. High interest payments on domestic debt and the increase in interest payments on foreign debt due to the ending of the debt moratorium granted in 2005 were the reasons for this increase. As a per cent of GDP also interest payments rose to 5.4 per cent from 5.1 per cent in 2005.

There is an oppotunity cost involded in higher recurrent expenditure. The incurrance of recurrent expenditure over and above the target reduces the resources available for public investment that would lead to higher economic growth in the future.

Public investment continued with a view to improving the economic and social infrastructure in the country.

Table 6.4 **Functional Classification of Expenditure**

	2005	2006 Approved Estimates	2006 Provisional	2007 Approved Estimates
	Rs. million			
Total current expenditure	443,350	509,856	547,460	596,165
General public services	105,628	126,674	133,105	169,060
Civil administration	25,027	31,910	29,912	33,531
Defence	61,498	71,663	81,243	100,286
Public order and safety	19,103	23,101	21,950	35,243
Social services	188,651	175,158	204,635	202,900
Education	50,697	58,350	61,144	65,503
Health	34,113	40,118	44,069	45,044
Welfare	92,909	70,682	86,753	78,688
Community services	10,933	6,008	12,669	13,665
Economic services	28,725	35,487	50,586	52,366
Agriculture and irrigation	13,500	14,990	22,163	21,487
Energy and water supply	1,008	2,076	2,766	3,345
Transport and communcation	11,303	11,386	19,038	21,050
Other	2,914	7,035	6,619	6,484
Other	120,285	172,598	159,135	171,838
o/w Interest payments	120,159	151,239	150,777	169,122
Total capital expenditure and lending	148,582	225,295	177,443	303,567
General public services	9,901	18,078	21,357	27,710
Civil administration	8,537	14,243	18,109	24,305
Public order and safety	1,364	3,835	3,247	3,405
Social services	35,992	44,740	48,375	66,606
Education	12,860	13,275	17,188	23,209
Health	10,738	15,222	13,969	20,715
Welfare	280	290	310	350
Housing	3,657	4,700	4,021	8,830
Community services	8,457	11,253	12,887	13,502
Economic services	77,540	114,684	106,801	249,852
Agriculture and irrigation	10,041	12,821	12,434	19,989
Energy and water supply	19,234	31,525	26,376	73,873
Transport and communcation	31,765	46,557	37,988	111,430
Other	16,500	23,771	30,003	44,560
Other (a)	25,152	47,795	912	900
Under expenditure				-41,500
	As a percent of GDP			
General public services	4.9	5.3	5.5	6.1
Social services	9.5	8.1	9.0	8.3
Economic services	4.5	5.5	5.6	9.3
Other (a)	6.1	8.1	5.7	5.3
of which: Interest payments	5.1	5.6	5.4	5.2
Total expenditure and lending	25.0	27.0	25.9	27.8

(a) In 2005 actuals and 2006 approved estimates, tsunami related expenditure is included.

Source: Ministry of Finance and Planning

It recorded an increase of 19.4 per cent to Rs.177.4 billion due to efforts made by the government to speed up implementation of projects. Increased allocation of funds for development projects, improved government revenue

Box 8

Public Private Partnerships for Infrastructure Development

The government is involved in providing "public" goods and services such as maintaining the law and order and controlling pollution. The government is also involved in providing goods and services, particularly economic and social infrastructure facilities, that need a large initial capital and entails a large gestation period. To finance those projects, the government has been regularly borrowing from various lending agencies such as Asian Development Bank (ADB), World Bank and Japan Bank for International Co-operation (JBIC) and other bilateral sources as well as from commercial sources through Sri Lanka Development Bonds, borrowings from Offshore Banking Units and international capital markets.

The continuation of the existing practice of borrowing to finance government infrastructure projects tends to widen the budget deficit and increase outstanding government debt. If those projects are implemented solely by the public sector they tend to suffer from typical public sector ailments such as rent seeking and principal agent problem. Hence, there is a need for an alternative strategy to finance and operate infrastructure development projects.

In a Private Public Partnership (PPP), the private sector investors, foreign or domestic, join hands with the government through a "partnership" arrangement to undertake development projects. The government could contribute to the arrangement by investing in land and providing licences, safeguards and sovereign guarantees, facilitating the fund raising processes and creating an enabling environment. The private sector could undertake part of financing and implementation and operation of the project.

PPPs are fast becoming a popular method of financing infrastructure projects in developing and emerging market economies. According to Public-Private Infrastructure Advisory Facility (PPIAF) during 1990-2004, South Asia's 224 infrastructure projects with private participation attracted about US dollars 55.4 billion in investment commitments compared to leading PPP regions such as Latin America and East Asia where investment commitments amounted to about US dollars 400 billion and US dollars 200 billion, respectively. India accounted for 76 per cent of South Asia's activity. Table B 8.1 lists a few PPP projects in Asian countries.

The proposed Colombo Port Expansion Project (CPEP) is one of the recent examples of the PPP model being used in Sri Lanka. The major elements of the CPEP are dredging an approach channel and inner harbour basin and the construction of a breakwater sufficient to accommodate three new terminals. The terminals are to be constructed by operators chosen through open competitive bidding under a build-operate-transfer (BOT) concession agreement. The civil works will be carried out by the government through the Sri Lanka Ports Authority (SLPA). The project cost is estimated at US dollars 1,406 million including the construction of three terminals. Total investment cost of the initial phase of the CPEP is estimated at US dollars 781 million, which includes the construction of a terminal. Of the total cost on initial phase, the public sector component is estimated at US dollars 480 million, which is to be financed by a loan of US dollars 300 million from ADB and the balance by the government of Sri Lanka. Potential private sector investors for the private sector component of US dollars 301 million are to be identified.

The above example highlights the benefits accruing to the country through PPPs. If this entire project were to be financed through the government budget, it would widen the budget deficit, increase the government's borrowing and the outstanding debt creating difficulties in fiscal management and severely impacting on inflation. The projects implemented under PPPs are a future source of government revenue by way of dividends and capital gains. The comparative advantage of the private investors to manage projects will lead to increased efficiency, productivity and higher quality. A properly designed and executed PPP enhances access to international finance, increases competitiveness of service delivery, enables pooling of diverse risk profiles and promotes technology development.

Table B 8.1 : Key PPP Projects in Asian Countries

Country	Projects
India	• Kerala Sustainable Urban Development Project • Karnataka 18 Cities and Towns Development Project • Nhava Sheva International Container Terminal • Tirupur Area Water Supply and Sanitation, Chennai
Pakistan	• Balochistan Rural Development and Drought Mitigation Programme • Malakand Rural Development Project • Punjab Resource Management Programme
Indonesia	• Gas Transportation Project
Malaysia	• North South Corridor BOT project • Sustainable Penang Initiative

and higher utilisation of foreign resources were the major contributory factors to increased public investment. Total public investment in 2006 includes the expenditure incurred on the reconstruction of infrastructure damaged due to the tsunami disaster. As a per cent of GDP, public investment remained at 6.3 per cent as in 2005.

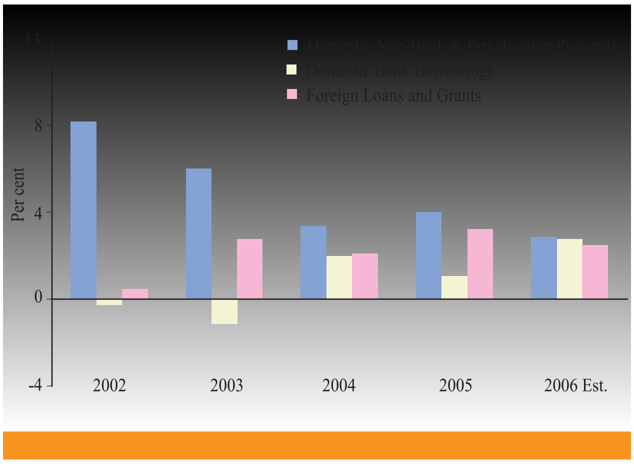
The economic services continued to be the major area of public investment. Transport and communication and energy and water supply were the major sub-sectors in this category as in the pervious years. In line with the government's continuous focus on pro-poor, livelihood and regional development activities, a large amount of funds were also spent on rural infrastructure development. Furthermore, mega projects such as the Southern Highway project and Bandaranaike International Airport development project were among the key infrastructure development projects in progress.

Public investment in social services increased in 2006 reflecting the government's high priority for overall human resource development with emphasis on education and health sectors. The share of social services sector within the total public investment was 27 percent in 2006. Investments in education were mainly on development of human resources and improvement of school infrastructure. Health sector investments were directed towards the improvement of general health services and hospital services while providing high tech medical equipment.

Key Fiscal Balances

The overall budget deficit in 2006 was Rs. 235.8 billion and amounted to 8.4 per cent of GDP. This was lower than the deficit of 9.1 per cent of GDP planned in the original Budget. This was a result of the higher decline in capital expenditure and net lending than the overrun in recurrent expenditure. The current account deficit (government dis-savings) as a per cent of GDP declined to 2.5 per cent in 2006 from 2.7 per cent in 2005 showing the impact of improved revenue though there was an overrun in recurrent expenditure. The primary deficit (overall deficit net of interest payments) declined to 3.0 per cent of GDP in 2006 from 3.6 per cent in 2005 as the increase in revenue outpaced the increase in non-interest expenditure. In 2006, the increase in total revenue was 26 per cent while the increase in non-interest expenditure was 21 per cent.

Chart 6.5 **Deficit Financing (as a per cent of GDP)**



Financing the Budget Deficit

The budget deficit of Rs.235.8 billion was largely financed through domestic sources in 2006. Total net domestic financing (NDF) was Rs.164 billion compared to the original target of Rs.123 billion while net foreign financing (NFF) was Rs.72 billion (net foreign loans of Rs.42 billion and foreign grants of Rs.30 billion) compared with the original target of Rs.124.2 billion. Higher than expected NDF led the government to rely more on borrowings from the banking system. As a per cent of GDP, total NDF increased to 5.8 per cent from 5.2 per cent in 2005 while NFF declined to 2.6 per cent from 3.4 per cent of GDP in 2005. In 2006, the Debt Dependency Ratio (the ratio of total net borrowings to total government expenditure) declined to 28.8 per cent from 29.3 per cent in 2005.

In financing the overall deficit, 51 per cent of the NDF or Rs.84 billion (3 per cent of GDP) was raised from domestic non-bank sources. Total financing from non-bank sources in 2006 recorded a decline of Rs.9 billion from Rs.93 billion in 2005. The Employees' Provident Fund (EPF) was the major source of non-bank financing as in the previous years.

Government borrowings from the banking system accounted for 49 per cent of the NDF. In 2006 Total bank

Table 6.5 **Sources of Domestic Financing**

Rs. billion

	2003	2004	2005	2006 Provisional
By Instrument	79.7	117.2	123.6	163.8
Treasury bonds	137.1	156.6	108.1	97.4
Treasury bills	14.9	25.0	-9.4	20.3
Rupee loans	-39.3	-83.7	-24.2	-23.8
Sri Lanka Development Bonds	-15.2	16.4	-	34.3
Central Bank provisional advances	0.2	3.6	4.9	9.2
Other	-18.1	-0.7	44.2	26.4
By Source	79.7	117.2	123.6	163.8
Bank	-20.9	43.3	26.2	80.0
Non bank	100.7	73.9	97.4	83.8

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

borrowings amounted to Rs.80 billion (2.9 percent of GDP) in 2006 compared to Rs.26.2 billion (1.1 per cent of GDP) in 2005. Borrowings from the Central Bank and commercial banks in 2006 amounted to Rs.39 billion and Rs.41 billion, respectively.

The government relied increasingly on foreign currency denominated domestic borrowings for budgetary financing as a measure of minimising pressure on domestic market interest rates and diversifying the instruments to reduce interest cost. The total value of Sri Lanka Development Bonds (SLDBs) issued in 2006 was US dollars 580 million in which a part of the proceeds was utilised to repay maturing SLDBs of US dollars 250 million. There were borrowings from Offshore Banking Units (OBUs) of US dollars 305 million with repayments of US dollars 241 million resulting in a net borrowing of US dollars 64 million. In addition, some loans due to OBUs in 2006 were rolled over.

Net domestic borrowings through debt instruments increased to Rs.128.2 billion in 2006 from Rs.74.5 billion in 2005. The net contribution of the domestic debt instruments to the domestic financing mainly came from Treasury bonds (Rs.97.4 billion), Treasury bills (Rs.20.3 billion) and SLDBs (Rs.34.2 billion) as there was a net repayment of Rupee loans (Rs.23.8 billion). Treasury bonds amounting to Rs.16 billion, issued on two occasions in 2006 to the two state banks to securitise a part of outstanding overdrafts and the conversion of the matured restructuring bonds of state banks into Treasury bonds were also contributed to the increase in net borrowings from debt instruments.

The maturity structure of the instrument based rupee borrowings was more towards the shorter end of the market reflecting the investor preference. The rising interest rate structure fuelled by rising inflation and high inflation expectations coupled with the uncertainty that prevailed particularly during the second half of the year were the major factors that shifted the investor preference to the shorter end of the market.

Total non-instrument borrowings declined to Rs.36 billion in 2006 from Rs.49.1 billion in 2005. This included borrowings through provisional advances (Rs.9.2 billion), overdrafts (Rs.23.7 billion), and borrowings from OBUs (Rs.6.9 billion). Non-instrument borrowings amounted to 22 per cent of the total NDF in 2006 compared to 40 per cent in 2005.

In 2006, gross foreign loans received for budgetary financing increased by 29 per cent. On gross basis, the government was able to disburse Rs.97.6 billion (US dollars 912.5 million) through foreign loans compared to Rs.75.2 billion (US dollars 746.3 million) in the previous year. Japan, ADB and International Development Association (IDA) continued to be the major lenders of project loans accounting for 38 per cent, 20.3 per cent and 14.3 per cent of the total project loans, respectively. Total foreign loans also included the two foreign commercial loans totalling US dollars 150 million (Rs.16 billion), which were raised in November (US dollars 50 million) and December (US dollars 100 million) 2006 as syndicated loans with a view to reducing the pressure on the domestic debt securities market and to stabilising the domestic interest rate structure.

Net financing through foreign loans declined in 2006. Net foreign borrowings declined to Rs.41.9 billion in 2006 from Rs.47.8 billion in 2005. This was due to higher foreign amortisation payments of Rs.45.9 billion in 2006 compared to the lower foreign amortisation payments of Rs.21.4 billion recorded in 2005 as a result of the deferment of a part of the foreign amortisation payments under the debt moratorium granted by foreign lenders.

Foreign grants received in 2006 declined marginally to Rs.30.0 billion from Rs. 32.6 billion in 2005. Bilateral lenders such as Japan and the USA and multilateral lenders such as ADB, United Nations Children's Fund (UNICEF), United Nations Development Programme (UNDP) and Food and Agricultural Organisation (FAO) were the major lenders of foreign grants.

Financing the budget deficit could have serious macroeconomic implications. If the deficit was highly financed through domestic sources, It would crowed out private investment. Borrowings from domestic banking system will create inflationary pressures in the economy. High foreign non-concessional borrowings could increase the vulnerability of the external sector to various shocks. Hence, to minimise these macroeconomic implications, a proper balance has to be maintained in the borrowing mix to finance the budget deficit.

6.4 Sub National Government Budgetary Operations

The sub national government (SNGs) system in Sri Lanka consists of Provincial Councils (PCs) and Local Governments (LGs). There are 9 PCs that have been established under the 13th Amendment to the Constitution in the process of decentralisation of the decision making process by the devolution of powers to PCs. A total of 330 units comprising 18 Municipal Councils (MCs), 40 Urban Councils (UCs) and 272 Pradesheeya Sabhas (PSs) constituted the local government system in the country as at end 2006.

In rendering the services assigned to them, SNGs faced a number of problems. The key problems were inadequate powers to mobilise resources, the large gap between revenue and expenditure of provinces making highly dependent upon transfers from the central government to finance the resource gap, lack of a strong institutional framework that has resulted in a weak relationship with the central government, lack of technical skills and inadequate financial and human resource management. Therefore, they continued to function largely as administrative arms of the central government rather than devolved fiscal structures.

The Ministry of Local Government and Provincial Councils (MLGP) continued to maintain a close coordination with SNGs. The MLGP provided guidance and assistance to SNGs to ensure good governance, promote access to management support, improve service delivery and achieve development objectives of SNGs while continuing to play an important role in the tsunami recovery process.

The Finance Commission (FC) continued its key role of recommending apportionment of available resources among PCs. In this process, socio-economic indicators of the provinces (such as population of each province and per capita income of each province etc.) were considered as criteria for apportioning resources. The role of the FC needs to be more pro-active by promoting the utilisation of available resources in the regions to address regional economic disparities.

Performance of Provincial Councils

The overall budgetary operations of PCs improved marginally in 2006. The increased revenue of PCs was mainly due to the 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) continued as the dominant revenue collecting province and accounted for 68 per cent of the total revenue

Table 6.6 Budget Outturn for Provincial Councils

Rs. million

	2003	2004	2005	2006 Provisional
Total revenue	11,625	13,522	16,132	19,481
Tax revenue	9,968	11,544	13,818	16,586
Non-tax revenue	1,656	1,978	2,314	2,895
Total expenditure	49,224	56,964	73,009	94,470
Current expenditure	39,800	46,308	59,132	76,428
o/w Personal emoluments	30,582	36,079	46,479	60,497
Capital expenditure	9,423	10,656	13,877	18,042
Central government transfers	37,832	45,848	59,696	79,029
Block grants	30,462	35,892	47,107	62,342
Criteria based grants	607	803	817	790
Matching grants	246	311	273	221
PSDGs	3,332	3,854	5,561	7,345
Foreign grants for special projects	3,184	4,988	5,937	8,331

a/ Province Specific Development Grants

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

collection. High concentration of commercial and industrial activities and the high population in the WPC was attributed to the higher revenue collection of the WPC. The Central, Southern and North Western Provinces were the other major revenue collecting PCs.

The relatively higher recurrent expenditure of PCs than the revenue was mainly attributed to higher expenditure on salaries and wages. Of the total recurrent expenditure, the major portion (79 per cent) was on personal emoluments. The education (69 per cent) and health (21 per cent) sectors absorbed the major portions of personal emoluments.

The expenditure incurred by the investment programme of PCs increased in 2006. The investment programme consisted of the Province Specific Development Projects (PSDP) and foreign funded special projects. There was an increase in the central government transfers to PCs in terms of block grants, criteria based grants, matching grants, and Province Specific Development Grants (PSDG) to Rs.71 billion from Rs.54 billion in 2005. Foreign grants received for special projects amounted to Rs.8 billion.

There is a need for PCs to become more pro-active in their activities. In particular, the use of their own resources has to be improved without depending more on the central government to fill their resource gap. PCs also could take their own initiatives to attract investments to infrustructure development and various other improvements.

Performance of Local Governments

The LGs continued to perform the functions assigned to them despite a number of constraints. The devolved revenue and transfers from the central government were used to finance their operations. In collecting some of the devolved revenues such as property transfer taxes and court fines as assigned under the 13th Amendment to the Constitution, PCs worked as the agent for LGs. The outlays of LGs comprised personal emoluments, other current expenses and capital expenses. The effective functioning of LGs has been hampered by weak financial systems, lack of efficient human resource management systems, lack of competent technical staff, lack of strong regulation and monitoring systems.

6.5 Financial Performance of Selected Public Enterprises

The Ceylon Electricity Board (CEB) and Ceylon Petroleum Corporation (CPC) continued to be the two public enterprises which are still posing a significant burden on government fiscal operations. In 2006, the financial position of CEB deteriorated further while CPC's financial position did not show a noteworthy improvement.

Despite the increase in low cost hydro power generation and tariff adjustments in 2006, the financial position of CEB deteriorated due to a number of factors. These include the inflexible pricing policy, increased fuel cost, delays in implementation of planned reforms in the electricity sector, delays in implementation of planned low cost large-scale power projects and the delay in addressing the high system losses. The continuation of the operating losses of CEB will lead to increase its liabilities to the banking system leading to adverse monetary implications. It has also led to adverse fiscal implications as the government is servicing CEB's foreign debt.

Several factors were attributed to the less favourable financial position of CPC in 2006. These include the delays in price adjustments during July and August and net loss of oil refinery during the latter part of the year. However, CPC continued to improve its financial management and internal controls while importing refined products on a more competitive basis and negotiating more favourable terms on supplier's credit. Furthermore, it also entered into hedging part of its oil purchases for the first time in early 2007 with the view of maintaining stable retail prices and fuel cards were introduced to assure the market share. Though the credit facility obtained under the Indian Line of Credit in 2005 shifted a part of the CPC's short-term liabilities to medium to long term liabilities, high short-term liabilities continued to be a concern.

6.6 Public Sector Debt and Debt Service Payments

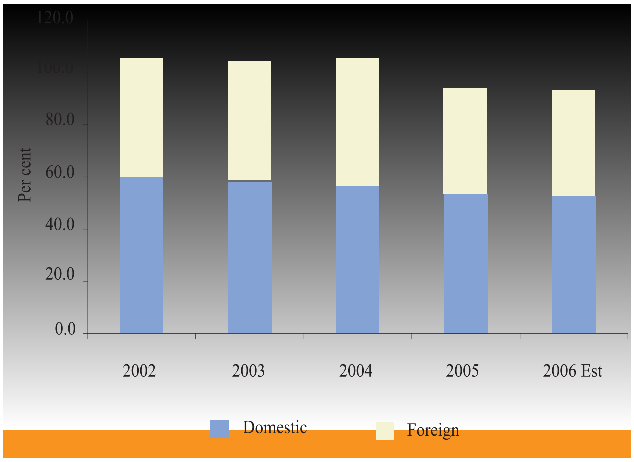
Government Debt

The government total outstanding debt increased by 17 per cent to Rs.2,606.5 billion as at end 2006, but as a per cent of GDP, it declined to 93 per cent from 93.9 per cent as at end 2005. The lower debt to GDP ratio was due to the relatively higher growth in nominal GDP than the growth in the outstanding debt.

Of the total debt, 56.7 per cent was domestic debt (Rs.1,475.5 billion) while 43.3 per cent was foreign debt (Rs.1,131.0 billion). The corresponding shares in 2005 were 56.9 per cent and 43.1 per cent, respectively. The domestic debt to GDP ratio was 52.6 per cent while foreign debt to GDP ratio was 40.4 per cent in 2006 compared to 53.5 per cent and 40.4 per cent, respectively in the previous year.

Total outstanding debt, in nominal terms, increased by Rs. 384.2 billion in 2006 compared to the increase of Rs. 82.8 billion in 2005. Total domestic debt increased by Rs.209.8 billion and total foreign debt increased by Rs.174.4 billion. The increase in foreign debt was mainly due to depreciation of the rupee vis-à-vis major foreign currencies. The impact of exchange rate variation in 2006 was an increase of the foreign debt by Rs.108.6 billion. In contrast, there was a decline in the foreign debt by Rs.100.7 billion in 2005 due to appreciation of the rupee. The higher increase in domestic debt was attributed to increased domestic borrowings, exchange rate variation in respect of foreign currency denominated domestic debt and the increased

Chart 6.6 Outstanding Government Debt (as a per cent of GDP)



difference between the face value and the book value of Treasury bonds issued in 2006.

Table 6.7 Outstanding Public Sector Debt (as at end year)

Rs. million

	2003	2004	2005	2006 Provisional
1. Central Government Debt	1,863,851	2,139,526	2,222,341	2,606,594
Domestic Debt [a]	1,019,969	1,143,389	1,265,721	1,475,520
By maturity period				
Short term	249,621	269,784	262,153	314,868
Medium and long term	770,348	873,605	1,003,568	1,160,652
By institution				
Banks[b]	228,411	272,981	298,411	362,977
Non bank sector	791,559	870,408	967,310	1,112,442
Foreign debt	843,882	996,138	956,620	1,131,074
By type				
Concessional loans	822,839	970,299	919,030	1,045,346
Non concessional loans	21,043	25,838	37,590	85,728
By currency				
SDR	359,844	420,459	401,615	465,679
US dollars	134,538	152,562	161,632	188,228
Japanese yen	260,706	310,311	286,673	317,220
Euro	63,500	83,579	76,060	123,387
Other	25,294	29,227	30,640	36,560
Memo: Exchange rate variation	67,691	106,502	-100,751	108,579
2. Non Financial Public Corporations Debt	36,192	41,171	31,377	46,095
Ceylon Electricity Board	14,411	12,529	9,841	10,329
Ceylon Petroleum Corporation[c]	14,909	23,326	15,823	30,148
Cooperative Wholesale Establishment	2,402	1,400	983	754
Other	4,470	3,916	4,730	4,864
3. Total public sector debt (1+2)	1,900,043	2,180,697	2,253,718	2,652,689

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 OBUs: Rs.29,406 million at end 2003, Rs.31,596 million at end 2004 , Rs.71,859 million in 2005 and Rs 83,927 million at end 2006.

[c] In 2005 and 2006 liabilities include the outstanding balance of Rs.14,705 million (US dollars 144 million) and Rs.12,925 million(US dollars 120 million) respectively to Indian line of Credit.

The share of medium and long-term debt in the total domestic debt stock declined marginally to 78.7 per cent from 79.3 per cent in the previous year. Treasury bonds dominated the outstanding domestic debt portfolio accounting for 60 per cent compared to 59.4 per cent in 2005. In line with the policy of continuously reducing non-marketable debt, Rupee securities amounting to Rs.23.8 billion were repaid in 2006. Consequently, the share of Rupee securities in the total domestic debt stock declined to 7.9 per cent in 2006 from 24.3 per cent in 2003, 14 per cent in 2004 and 11 per cent in 2005. Of the short-term domestic debt, the share of Treasury bills declined to 81.8 per cent in 2006 from 89 per cent in 2005 as the share of other short-term borrowings was increased.

In 2006, total outstanding debt liabilities to the banking sector increased by 21.6 per cent. As a share of total outstanding domestic debt, it increased to 24.6 per cent (8 per cent to the Central Bank and 16.6 per cent to commercial banks) compared to 23.6 per cent in 2005. The outstanding foreign currency denominated domestic debt of the government, in which commercial banks are the major subscribers, increased to Rs.145 billion (US dollars 1,359 million) in 2006 from Rs.98.5 billion (US dollars 965 million) in 2005. This consisted of borrowings from OBUs of Rs.83 billion (US dollars 779 million) and SLDBs of Rs.62 billion (US dollars 580 million).

Total liabilities to the non-bank sector also increased by 15 per cent. As a per cent of outstanding total domestic debt, these liabilities accounted for 75.4 per cent. Major contributors were EPF and NSB accounting for 42 per cent (Rs.469 billion) and 15 per cent (Rs.166 billion) of the total non bank sector dedt, respectively.

The share of outstanding foreign concessional debt to the total foreign debt declined to 92.4 per cent in 2006 from 96.1 per cent in 2005. This decline was mainly attributed to the increased foreign commercial borrowings. The outstanding bilateral debt increased to Rs. 508.8 billion in 2006 from Rs. 433.3 billion in 2005. The main bilateral lenders were Japan (27.1 per cent), the USA (5.1 per cent) and the Federal Republic of Germany (7.7 per cent). The ADB and IDA were the major multilateral lenders, which accounted for 23.9 per cent and 21.6 per cent of the foreign debt, respectively.

The government debt to GDP ratio still remains high though it indicated some improvement in the recent past. High interest payments associated with high outstanding debt provides only a limited room to manoeuvre fiscal operations thereby increasing the pressure on non-interest expenditure of the budget while reducing development oriented expenditure. Adverse implications on the macroeconomic stability and decline in the country's ability to withstand against external shocks also are among the negative aspects of the high debt burden. This situation underscores the necessity of intensifying the efforts in the medium to long run towards strengthening the fiscal consolidation process to achieve the debt reduction path that has already been announced by the government in its policy documents.

Non-Financial Public Corporation Debt

The total outstanding liabilities of non-financial public corporations (NFPC) to the banking system and their long term foreign liabilities increased by Rs. 14.7 billion in 2006. Total of these liabilities amounted to Rs.46.1 billion at end 2006 compared to Rs.31.3 billion in the previous year. Debt liabilities of NFPC to the banking system increased to Rs.33.2 billion in 2006 from Rs.16.7 billion in 2005. The CPC and CEB were the major debtors who accounted for 83 per cent of the total outstanding liabilities to the banking system amounting to Rs.17.2 billion and Rs.10.3 billion, respectively. Total outstanding NFPC debt included the remaining balance of Rs.12.9 billion (US dollars 120 million) of the credit line obtained by CPC from India in 2005.

Public Sector Debt

Total outstanding public sector debt, which includes the government debt stock and liabilities of the NFPCs to the banking system, increased by Rs. 399 billion to Rs.2,652.6 billion at end 2006. The increases recorded in both government's debt by Rs.384.2 billion and NFPCs debt by Rs.14.6 billion contributed to this. As a per cent of GDP, the outstanding public sector debt declined marginally to 94.7 per cent as at end 2006 from 95.3 per cent at end 2005.

Debt Service Payments

In 2006, total debt service payments increased by 28.8 per cent to Rs.444.3 billion. This consisted of amortisation payments of Rs.293.5 billion (66 per cent) and interest payments of Rs.150.8 billion (34 per cent). Debt service payments to domestic sources amounted to Rs. 381.3 billion

Chart 6.7 Debt Service Payments (as a per cent of GDP)

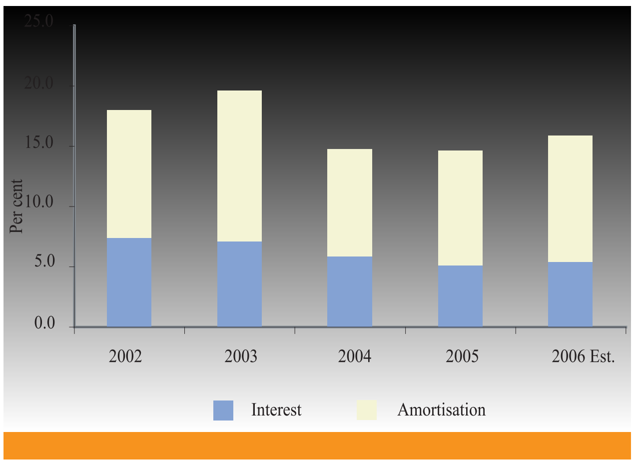


Table 6.8 Government Debt Service Payments

Rs. million

	2003	2004	2005	2006 Provisional	2007 Estimates
Debt service payments	344,634	300,563	344,866	444,303	505.913
Amortisation payments	219,508	180,781	224,707	293,525	336,791
Domestic	185,083	147,740	203,347	247,536	276,136
Foreign	34,425	33,041	21,360	45,989	60,655
Interest payments	125,126	119,782	120,159	150,778	169,122
Domestic	113,540	105,878	113,164	133,788	147,973
Short term	25,147	20,474	20,300	24,558	28,885
Medium and long term	88,393	85,404	92,864	109,230	119,088
Foreign	11,586	13,904	6,995	16,990	21,149

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

while that for foreign sources was Rs.63 billion. The regular foreign debt service programme was continued in 2006 as the one-off decline in payments due to the debt moratorium granted by foreign lenders for 2005 was ended in November 2005. The debt service payments in 2006 also included a part of the foreign interest and repayments deferred in 2005.

The debt service indicators reverted to the previous levels in 2006 with the ending of debt moratorium. Nevertheless, a number of debt service indicators, including total debt service payments to government revenue and expenditure, improved compared to pre-tsunami levels.

The future debt management policy has to be formulated considering several factors. In particular, the bunching of maturities has to be minimised through an appropriate machanism. It would help smoothen the maturity profile of the domestic debt thereby, minimising the pressure on government fiscal operations. In addition, a long term yield curve also has to be established to develop debt securities market.

Table 6.9 Government Debt Indicators

Indicator	2003	2004	2005	2006 Pro	2007 Est.(d)
Government Debt/GDP	105.8	105.5	93.9	93.0	88.0
- Domesitc Debt/GDP	57.9	56.4	53.5	52.7	50.6
- Foreign Debt/GDP	47.9	49.1	40.4	40.4	37.4
Total Foreign Debt/Exports (a)	133.7	134.9	120.7	127.7	117.4
Total Debt Service/GDP	19.6	14.8	14.3	15.9	15.6
Total Debt Service/ Government Revenue (b)	124.6	96.5	91.0	93.1	84.3
o/w Domestic Debt Service/ Government Revenue (b)	108.0	81.4	83.3	79.9	70.7
Total Debt Service/ Government Expenditure (c)	54.1	45.7	42.6	44.1	41.0
o/w Domestic Debt Service/ Government Expenditure(c)	46.9	38.6	39.1	37.9	34.3
Foreign Debt Service/Exports(a)	7.3	6.4	3.6	7.1	7.9
Domestic Interest/GDP	6.4	5.2	4.8	4.8	4.6
Domestic Interest/ Government Current Expenditure	33.9	27.2	25.5	24.1	24.5
Foreign Interest/Exports(a)	1.8	1.9	0.9	1.9	2.0

(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

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