Chapter 6

FISCAL POLICY AND GOVERNMENT FINANCE

6.1 Overview

In 2007, the fiscal policy thrust continued to be placed on achieving the pro-poor pro-growth development objective of the government, while strengthening the fiscal consolidation process. Fiscal strategy was formulated within the overall policy direction enunciated in the *"Ten-year Horizon Development Framework: 2006-2016"* (*Ten-year Vision*). Meeting the targets in Budget 2007 was endeavoured through implementing measures to enhance revenue, rationalise recurrent expenditure and thereby generate a surplus in the current account, while enhancing public investment to create an enabling environment for higher economic growth towards reducing poverty and regional economic disparities on a sustainable basis.

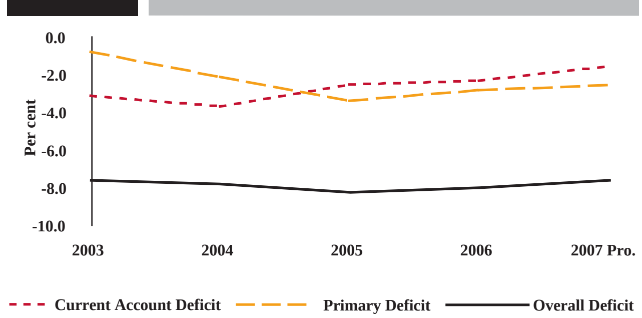
The fiscal targets were to be met in the face of several challenges. The escalated terrorist activities necessitated the government to enhance counter measures to strengthen national security. The relatively high inflation and inflationary expectations resulted in the government's taking additional fiscal measures to address the rising cost of goods and services. The high and volatile interest rates in the domestic market necessitated the government to follow a cautious approach in debt management. The exceptionally high international oil prices compelled the government to implement difficult price reforms to prevent the accumulation of large budgetary pressures. These developments also resulted in deviations in the factors associated with underlying assumptions of Budget 2007 affecting the targeted outcomes.

The fiscal sector performance continued to improve amidst the challenges faced in fiscal management. Total revenue increased by 18.3 per cent compared to 2006 benefiting from continuous efforts made by the government in further

strengthening tax administration, streamlining tax incentives and exemptions, enhancing tax compliance and strengthening enforcement. However, it was lower than the expected level mainly due to the declined revenue from international trade related taxes, particularly as a result of providing tax concessions on imported essential commodities to address the rising cost of living and lower quantity and lower value of vehicle imports due to the high effective tax rate structure maintained on fuel inefficient vehicles to contain the impact of escalating oil prices. The revenue loss due to these two factors alone has been estimated to be about Rs. 24 billion (0.7 per cent of GDP). However, the revenue from income taxes exceeded the target. Accordingly, total revenue amounted to 15.8 per cent of GDP compared to 16.3 per cent in the previous year. The recurrent expenditure, which was 17.4 per cent of GDP, exceeded the budgetary target of 16.8 per cent, but was significantly lower than that of 18.6 per cent in the previous year. Despite the heavy pressure on recurrent expenditure, public investment sustained its rising trend and reached 6.4 per cent of GDP, compared to 6 per cent in 2006 as a result of the acceleration of infrastructure projects and improvements in financing. As a combined outcome of these developments, the overall budget deficit turned out to be 7.7 per cent of GDP, a decline compared to both the original target of 8.4 per cent and the deficit of 8 per cent in 2006. The deficit in the current account declined further to 1.6 per cent of GDP compared to 2.4 per cent in 2006, while the primary deficit also declined to 2.6 per cent from 2.9 per cent in 2006.

There was a notable change in the financing mix of the budget deficit in 2007. Financing from foreign sources was higher than the domestic sources as a result of the proceeds from the successfully completed debut international bond issue of the country and foreign investments in rupee denominated Treasury bonds. Consequently, the reliance on domestic financing declined and was lower than the budgeted level. Borrowing from the banking system recorded a significant decline over the previous year. It was marginally lower than the original target as well.

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



The government debt to GDP ratio continued to decline further in 2007 demonstrating continuous improvement in debt sustainability. This improvement was due to the stabilisation of the rupee vis-a-vis major foreign currencies towards the latter quarter of the year and higher nominal economic growth, which exceeded the growth in nominal debt. It was 85.8 per cent as at end 2007 compared to 88.7 per cent at end 2006, although the nominal debt was increased by 18 per cent to Rs. 3,070 billion. It also indicated a continuous decline from 105.6 per cent of GDP in 2002. This favourable trend needs to be continued with stronger efforts to achieve targets stipulated in the Fiscal Management (Responsibility) Act.

Notwithstanding the improvements in 2007, the fiscal sector still suffers from several drawbacks. In particular, there was a revenue shortfall of Rs. 35 billion (1.0 per cent of GDP) in 2007 in comparison to the original target, while the recurrent expenditure exceeded the target by Rs. 26 billion (0.7 per cent of GDP). Public investment, though increased, was lower than the budgetary target by Rs. 74 billion (2.1 per cent of GDP).

The deviations from budgetary targets led to several adverse ramifications. The revenue shortfall and the overrun in recurrent expenditure necessitated the government to make borrowings to meet the additional fund requirement resulting in an increase in the future debt stock and the interest cost. The incurrence of recurrent expenditure over and above the target acts as an impediment for the long run growth potential of the country, as it reduces the resources available for public investment. The opportunity cost involved in such expenditures is much higher in terms of the benefits that could accrue from capital investments in the future. In addition, the slow progress in the public investment programme leads to cost escalations, requiring a higher amount of resources in the future to implement the infrastructure projects. Meanwhile, the financial performance of major State Trading Enterprises (STEs) remains as a strain on the government budget. The financial performance of some State Owned Enterprises (SOEs) also remains a concern. This situation underscores the need for strong measures to further improve fiscal consolidation process to reduce the debt burden and achieve fiscal sustainability in the medium to long run, as envisaged in the *Ten-year Vision*.

Table 6.1 Summary of Government Fiscal Operations

	2006	2007 Approved Estimates	2007 Provisional	2008 Approved Estimates
	Rs million			
Total revenue	477,834	599,817	565,051	750,741
Tax revenue	428,378	540,929	508,947	677,259
Non tax revenue	49,455	58,888	56,104	73,482
Expenditure and lending minus repayments	713,647	898,000	841,604	1,044,188
Current	547,960	596,260	622,758	712,894
Capital and net lending	165,686	301,836	218,846	331,294
o/w Public investment	177,443	303,567	229,274	335,672
Current account surplus(+)/deficit(-)	-70,126	3,652	-57,706	37,847
Primary account surplus(+)/deficit(-)	-85,035	-129,061	-93,871	-83,622
Overall deficit	-235,813	-298,183	-276,552	-293,447
Total financing	235,813	298,183	276,552	293,447
Foreign financing	72,010	141,971	131,415	138,645
Foreign loans (a)	41,939	117,896	100,907	109,895
Foreign grants	30,068	24,075	30,508	28,750
Domestic financing	163,805	156,212	127,737	154,802
Market borrowings	163,805	156,212	127,077	154,802
Non bank	83,797	139,512	111,308	145,802
Bank	80,008	16,700	15,769	9,000
Monetary Authority	38,579	-	-13,098	-
Commercial banks	41,429	-	28,867	-
Other borrowings	-	-	660	-
Payments to be made	-	-	17,400	-
	As a per cent of GDP			
Total revenue	16.3	16.9	15.8	18.0
Tax revenue	14.6	15.2	14.2	16.2
Non tax revenue	1.7	1.7	1.6	1.8
Expenditure and lending minus repayments	24.3	25.3	23.5	25.0
Current	18.6	16.8	17.4	17.1
Capital and net lending	5.6	8.5	6.1	7.9
o/w Public investment	6.0	8.6	6.4	8.0
Current account surplus(+)/deficit(-)	-2.4	0.1	-1.6	0.9
Primary account surplus(+)/deficit(-)	-2.9	-3.6	-2.6	-2.0
Overall deficit	-8.0	-8.4	-7.7	-7.0
Total financing	8.0	8.4	7.7	7.0
Foreign financing	2.5	4.0	3.7	3.3
Foreign loans (a)	1.4	3.3	2.8	2.6
Foreign grants	1.0	0.7	0.9	0.7
Domestic financing	5.6	4.4	3.6	3.7
Market borrowings	5.6	4.4	3.6	3.7
Non bank	2.9	3.9	3.1	3.5
Bank	2.7	0.5	0.4	0.2
Monetary Authority	1.3	-	-0.4	-
Commercial banks	1.4	-	0.8	-
Other borrowings	-	-	...	-
Payments to be made	-	-	0.5	-

(a) Includes Rs. 37,127 million of rupee denominated Treasury bonds issued to foreign investors.

Source : Ministry of Finance and Planning

6.2 Fiscal Policy Direction and Measures

The fiscal policy was formulated within the overall development strategy and broader targets enunciated in the *Ten-year Vision* of the government. The overall fiscal policy and fiscal operations in 2007 were steered with the objective of meeting targets in the *Medium Term Macro Fiscal Framework (MTMFF) for 2006-2009*, which was released along with Budget 2007. In moving towards the fiscal consolidation path mentioned therein, measures were introduced on all the fronts; revenue, recurrent expenditure, public investment and debt management in 2007.

The government introduced a series of measures to sustain the increasing trend in government revenue, as it is one of the key priorities in the medium term fiscal strategy. Major measures included rationalising income tax and Value Added Tax (VAT) systems, introducing changes in excise duties, rationalising import duties, revising Cess rates on non-essential imports, increasing Port and Airport Development Levy (PAL), introducing changes in stamp duties, debits tax and regional infrastructure development levy, further strengthening tax administration and prompt enacting of revenue related legislation.

A number of measures were introduced to broaden the income tax base, while providing necessary incentives for the development of selected areas. Accordingly, life insurance was made to be assessed separately from other types of insurance, while the threshold of turnover in the case of Economic Service Charge (ESC) was reduced. The ESC rates on industries engaged in producing selected value added goods and services were reduced, and the method related to the treatment of bad debt provisioning of banks and financial institutions, was revised. In addition, the laws were tightened to minimise tax evasion, and a number of revisions were introduced to provide exemptions and other development measures.

The rationalisation of the VAT system involved broadening the base and changing the rate applicable on selected sectors to provide concessions for the development of such sectors. The key measures included imposing restrictions on input tax credit, increasing the mark-up on the CIF value to 10 per cent from 7 per cent, and reducing VAT on high-tech medical equipment and selected food items of mass consumption. Provisions were made to allow businesses, which are on the border of the VAT threshold of Rs. 1.8 million, to pay a 5 per cent non-refundable VAT. Some sectors, such as the supply of electricity, furnace oil, and machinery and equipment imported by Ceylon Electricity Board (CEB) and private power suppliers, supply of prawns, importation of cattle, buffaloes etc. and livestock breeding items, machinery to modernise factories in the plantation sector, materials for processing and manufacturing leather products, and vessels were exempted from VAT. In addition, the VAT refund process was streamlined further.

A number of excise duty changes were also introduced in 2007. Key changes included an increase of excise duty on selected brands of cigarettes and liquor, excluding beer, and imposition of a 5 per cent excise duty on polythene and paints. However, the excise duty on polythene and paints was later exempted for manufacturers with a turnover of less than Rs. 50 million with a view of supporting small and medium scale Enterprises (SMEs). In order to clear the ambiguities and to reduce tax loopholes, the Harmonised System (HS) Codes relating to vehicles were revised. The mark-up added on the CIF value for charging excise duty at the point of import was increased to 15 per cent from 10 per cent. Meanwhile, concessionary duty rates were granted for public servants for the importation of vehicles.

Measures were introduced to rationalize import duties, which included imposing specific duty rates on selected items to minimise undervaluation and exempting some items, such as machinery for modernisation of factories in the plantation sector, raw materials used in the leather and livestock sectors and buses imported by the private sector. As a measure of countering the rising cost of goods and services, duty waivers were granted on the importation of essential commodities. A single import duty rate was imposed on ten selected commodities in lieu of a number of taxes applicable on them in order to simplify the tax collection process. Furthermore, duty waivers and duty exemptions were granted to selected sectors to promote them.

In strengthening the tax administration further, emphasis was placed on institutional development and capacity building, particularly in human resources. The Inland Revenue Department (IRD) recruited about 1,000 officers to expedite the work, while steps were taken to train existing staff as well as the new recruits in computer literacy and English language. Selected staff were also sent abroad to study the systems used by other countries. The Sri Lanka Customs (SLC) was also strengthened its cadre by recruiting 107 officers in January 2008. In addition, measures were taken to promote a taxpayer friendly culture at IRD to improve tax compliance. These included "taxpayer awareness programmes" implemented through regional seminars and advertisements in the media.

The Fiscal Management Reform Programme (FMRP), continued to provide support for capacity building and institutional development at IRD, SLC, Excise Department (ED) and Ministry of Finance and Planning (MOFP). The focus was on improving the information and communication technology, establishing a comprehensive and integrated management information system, providing modern infrastructure and developing human resources. Accordingly, two fully equipped IT labs were set up in IRD and ED while a Revenue Administration Management Information System (RAMIS) was being introduced in a phased manner. The equipment required to set up a Local Area Network and Wide Area Network in IRD is in the process of being procured. In addition, the metropolitan branches of IRD were set up aiming at large taxpayers and to promote voluntary compliance. Foreign training was sponsored for the revenue departments, the Finance Commission and the Provincial Councils. Business communication training programmes for officers in IRD and knowledge enhancing seminars on the salient features of the new Companies Act were held during the year. Furthermore, measures were taken to enhance the auditing capacity and streamline procedures in IRD. Three new departments; Legal, Research and Strategic Planning, were also set up in IRD.

Several policy initiatives were implemented to rationalise recurrent expenditure. Accordingly, the interest rates on public servants' housing loans were raised to reflect current interest cost of these loans, while the rates applicable to the lower income earners in the public sector were kept unchanged. Measures were also taken to improve cadre management. The adjustment of Cost of Living Allowance (COLA) was operated under a cap of Rs. 375 for each six month period. The fuel allowance, paid to public servants, remained unchanged despite several revisions in domestic petroleum prices. As the retail price of kerosene was increased significantly since July 2007, the government commenced to provide a limited subsidy through specific schemes for Samurdhi recipients and fishermen with a view of mitigating the impact.

The recruitments to the public sector were continued, while issuing new recruitment guidelines with a view to strengthening the public sector and improving its service delivery mechanism. New recruitments in the civil sector included teachers, nurses, doctors and other positions, including the positions filled by recruiting graduates. There were new recruitments to the defence establishments as well to strengthen national security. For the new recruitments in the civil sector to be successful and generate a positive outcome to the economy, they have to be employed towards improving efficiency and productivity of the public service. The increasing recruitments will also lead to a further rise in the already high salary bill of the public sector.

Measures were taken to create an efficient fund transfer system between the Treasury and the line ministries and *vice versa.* This system is expected to reduce procurement delays, expedite reimbursement of funds and monitor the progress of foreign aided projects, on a continuous basis. Under this system, bank accounts of the government ministries and departments were linked to create a network to expedite the transfer of funds efficiently. This measure is expected to enable the utilisation of all unused cash balances in government cash accounts. As this will lower the Treasury's overdraft balances with state banks, a decline in the interest cost on overdrafts is also expected.

The Strategic Enterprise Management Agency (SEMA) continued to improve the performance of several Strategic State Owned Enterprises (SSOEs). Accordingly, SEMA assisted to improve the financial positions of SSOEs coming under different Clusters. Arranging discussions with CEB and development partners for restructuring the long-term debt and re-negotiating the terms and conditions with Independent Power Producers (IPPs), and obtaining a lubricant licence for Ceylon Petroleum Corporation (CPC) were some of the activities of the Utilities Cluster of SEMA. Initiatives by SSOEs under the Transport and Logistics Cluster focused on improving their financial positions. Several steps were taken for the development of the enterprises under the Plantation Cluster to reduce their losses including the development of Key Production Indicators (KPI) and Key Performance Indicators (KPIs) for each plantation crop sector as management tools to monitor the sector.

With the suspension of the operations of Public Enterprises Reforms Commission (PERC) as a separate entity in November 2006 in line with the government's policy of refraining from privatisation of SOEs, PERC was brought under the purview of Public Enterprises Department (PED) of the MOFP. Accordingly, in January 2007, PERC was entrusted with restructuring 25 SOEs that were deemed to be "non-functional", as commercially viable institutions, to make them less dependent on transfers from the Treasury. While some of these enterprises were in the process of being diagnosed, others were being restructured. Advice from experts was sought to make them function more efficiently and effectively, and thereby, make their products and services more competitive.

The policy and strategy to develop an efficient network of economic and social infrastructure, which has been identified as an essential requirement towards achieving a sustained high economic growth and development, have been enunciated in the policy documents of the government, including the *Ten-year Vision*. The "*Randora*", the national infrastructure development programme, aims to provide a modern infrastructure to promote nation-wide economic development, create income earning opportunities and promote new avenues of investment. In the economic infrastructure front, roads, transport, electricity, water supply and sanitation, irrigation and urban development have been given the priority. In line with this, several strategic development projects such as Norochcholai coal power plant, Upper Kotmale hydro power plant, and Kerawalapitiya combined cycle power plant, which were delayed for a long time due to various reasons, were initiated. Other major infrastructure development projects, such as the Southern Highway project and Moragahakanda irrigation project etc., were also in progress. In addition, a number of rural infrastructure development projects were continued while several special programmes were implemented with a view of restoring community infrastructure, supporting livelihood development and promoting micro enterprise development. The rebuilding of the conflict affected areas through rehabilitation and reconstruction of basic infrastructure facilities, and resettlement and the support of livelihood of people affected by the conflict were emphasised. Rural development initiatives continued to be targeted particularly on the poorest 119 Divisional Secretariat areas. The empowerment of the rural poor was also attempted through promoting socio-economic activities. In the social infrastructure front, investments were enhanced in education for increasing access to education in order to promote more opportunities, training and employment to a higher number of youth. As the priority has been given to invest in people to build a healthier human resource base for a prosperous society, investments in health was also increased. During the year, negotiations on a number of new investment projects were completed and financing for several projects was being negotiated. Tsunami reconstruction work also continued during the year.

The development of newly liberated Eastern Province gained momentum in 2007. In line with this, a large number of families who were displaced due to

Box 14

The Fiscal Cost of the Fuel Subsidy and Its Economic Implications

The international price of crude oil, surpassed US dollars 100 per barrel by December 2007, reflecting a 285 per cent increase from July 2003 when it was only US dollars 26 per barrel. By mid March 2008, the price of crude oil was fluctuating between US dollars 106 and 111 per barrel in the international markets. This rapid increase has been attributed to low global stocks, short-term supply constraints, enhanced demand emanating from emerging market countries such as China and India and other geo-political issues. Projections indicate that oil prices would remain at high levels in the immediate future as well as in the medium term.

Sri Lanka meets its entire petroleum requirement through imports. The total expenditure on petroleum imports has increased to US dollars 2,497 million in 2007 with the average import price increasing to US dollars 69 per barrel. In contrast, in 2003, the average import price was US dollars 29 per barrel and the total expenditure was only US dollars 838 million. As per current predictions, the total oil import expenditure will increase further to US dollars 3,122 million in 2008.

Similar to many other countries, the high international oil prices have had adverse economic implications for Sri Lanka. The impact has manifested in higher inflation, widened external trade account and in 2004 and 2005, in higher budget deficits. In particular, a significant impact was seen on the government fiscal operations depending on the level of subsidies that were provided to keep the domestic petroleum prices artificially low.

High oil prices could have adverse implications on the fiscal sector in Sri Lanka mainly through two channels.

- Firstly, if the Government were to refrain from adjusting the prices of petroleum products, in line with the international market prices, it would have to incur an additional expenditure on higher subsidies to fill the differences between the actual costs and the domestic retail prices of the same. Hence, additional funds will be necessary to provide subsidies on a continuous basis. The additional resource requirement can be met through a number of ways;
  - Increasing taxes in other areas: This will create an additional burden on the tax payers and the general public.
  - Holding back on other types of expenditures: The provision of subsidies would crowd out resources that are available for other priority spending, especially capital expenditure. Since it is the capital expenditures that generate future income streams, the petroleum subsidy may affect the future income generating capacity of the country.
  - Resorting to higher borrowings: If the government finances oil subsidies through higher borrowings, it will either crowd out credit available for other productive purposes or would create inflationary pressures in the economy, if such borrowings were from the banking system.
- Secondly, when the Government reduces or exempts taxes on petroleum products to maintain arbitrarily low prices in the domestic market, the Government would incur revenue losses, which would widen the budget deficit further.

Accordingly, the subsidies compromise the fiscal position of the Government by way of excessive and unpredictable outlays, and revenue losses. In addition, subsidies essentially distort market prices. The price of a good generally provides a signal to the market to ensure the optimum allocation of limited resources. Thus, by making petroleum products available in the market at an artificially lower price, the Government encourages an over consumption of petroleum products, which results in a misallocation of resources.

If the Government is concerned about the poorer segments of petroleum product users, it would be more efficient to address the issue through targeted subsidies, as blanket subsidies tend to be more expensive and misused. It has been found that the benefits of energy subsidies are enjoyed mostly by the non-poor (Devarajan and Ghani, 2006). The cost of the subsidies will have to be financed by the government through taxes and inflationary borrowing. Hence, ultimately, the costs of the subsidies are shared by the general public, including the poor. Therefore, the adjustment of fuel prices could be considered as an appropriate policy measure, since any delay in adjusting prices would require more abrupt and larger adjustments at a later stage.

In line with this, the government introduced a formula based pricing mechanism to rationalize the pricing of petroleum products in 2003 with a view to reducing the fiscal cost. It was also expected to pass any benefit or cost arising from the changes in the cost of petroleum products to consumers in a transparent manner. However, even though the international oil prices continued to rise since 2003, the adjustment of domestic petroleum prices according to this pricing formula was abandoned in 2004 and allowed only a partial pass-through on ad-hoc basis. As a result, the government had to compensate oil companies with subsidies (Chart B 14.1).

Chart B 14.1 **Price of Petroleum Products**

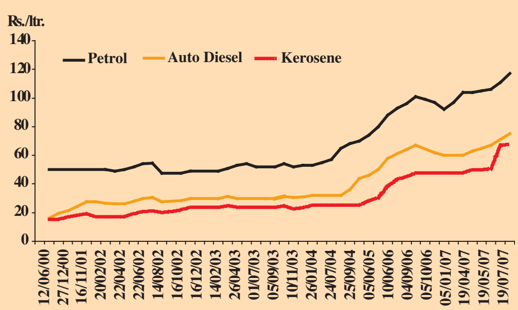
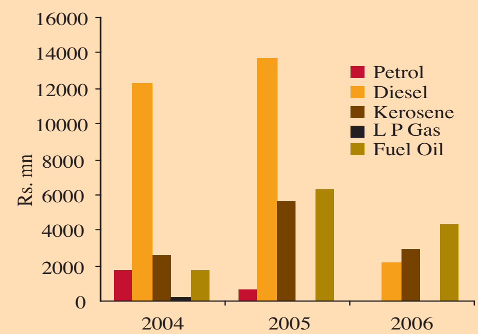


Chart B 14.2 **Cost on Fuel Subsidy 2004-2006**



Consequently, the fiscal cost of subsidies increased substantially, amounting to Rs. 18 billion in 2004, Rs. 26 billion in 2005 and Rs. 9.4 billion in 2006 (Chart B 14.2). About 53 per cent of the subsidy was on diesel. The amount spent by the government as fuel subsides, particularly in 2005, amounted to about 58 per cent of the expenditure on health and about 41 per cent of the expenditure on education.

Meanwhile, the VAT on diesel was eliminated in August 2005 and the Ceylon Electricity Board (CEB) was exempted from the payment of excise duty of Rs. 2.50 per litre on diesel for power generation causing a revenue loss to the government. In addition, CEB was provided with a cross subsidy on diesel by supplying diesel at a lower rate until end December 2007.

The non-adjustment of prices exerted a huge burden on the budget, particularly in 2004 and 2005, leading to higher government borrowings from the banking system. During these two years, higher borrowings were also recorded by the state owned enterprises (SOEs) such as Ceylon Petroleum Corporation (CPC) and CEB. Higher borrowings by both, the government and SOEs, resulted in a larger monetary expansion during these years, contributing towards a build up of inflationary pressures in the economy.

Since then, CPC has improved its financial position through a variety of measures. These include increasing the efficiency of refineries, hedging oil purchases against adverse price movements, improving its financial management and internal controls, importing refined products on a more competitive basis and negotiating for more favourable terms on suppliers' credit, etc. However, it still faces cash flow problems due to an accumulation of arrears by CEB, which continues to make losses, mainly due to non-adjustment of electricity tariff to reflect the costs and hence, poses a threat to the budget. In order to remedy this situation, electricity tariff was revised from March 2008. This would be an appropriate move as far as the fiscal cost is concerned, since evidence indicates that distortions arising due to non-adjustment of electricity prices could get worse unless remedial measures are taken promptly.

From July 2006, the government allowed oil distributing companies to adjust domestic petroleum prices in line with the oil prices in the international market. With this, the fuel subsidy given to CPC and Lanka Indian Oil Company Ltd. (LIOC) was discontinued with a view of reducing the fiscal cost of subsidies.

In order to cushion the burden of the removal of subsidy on the poor and vulnerable groups, the government introduced targeted subsidies. Accordingly, the government has been providing an allowance of Rs. 100 per month as a subsidy for kerosene to Samurdhi recipients. A one off payment of Rs. 4,000 was also made to fishing boat owners in August 2007. The estimated cost of these measures in 2007 was about Rs. 632 million. The Government also reduced the Value Added Tax (VAT) on petrol from 15 per cent to 5 per cent since January 2008, which is expected to reduce the government revenue by Rs. 7,400 million in 2008. The Budget 2008 has also indicated that if this reduction is deemed to be insufficient in the context of changing international oil prices, the removal of excise duty on petrol would be considered. As the international prices remained high, the government revised the petroleum prices on 13 January 2008 as well. Nevertheless, any benefit accruing due to a decline in the international prices is expected to be provided to the general public by reducing domestic prices.

An upward movement in the cost of living was observed since mid 2007 largely due to the removal of the fuel subsidy and increases in prices of imported food products. The pass through of international price increases, though it leads to a one time increase in prices, will have a favourable impact on containing future inflation by eliminating the need for subsidising same, through expansionary borrowings of the government.

Reference:

Devarajan, S. and Ejaz Ghani (2006), "Oil Price Shocks, Fiscal Adjustment and Poverty Reduction in South Asia", Proceedings of the SAARCFINANCE Seminar on "Oil Price Hike: Implications for SAARC Countries", January 20, Central Bank of Sri Lanka.

the conflict in the Eastern Province were resettled. Initial measures were taken to resettle the remaining families. In addition, the provision of dry rations to conflict affected families and maintenance and upkeep of welfare centres were also continued. A "Three Year Eastern Province Development Plan: 2007-2010" (*Neganahira Navodaya*) was initiated by the government with a view of developing the Eastern Province and upgrading the living standards of the people in the province (Box 2).

A number of measures were introduced in the government debt management front. Efforts were taken to minimise the interest cost of the domestic borrowing programme by maintaining an appropriate mix between domestic and foreign sources of financing. Accordingly, reducing the pressure on domestic market interest rates and dealing with unfavourable conditions in the domestic rupee denominated debt market were emphasised. In line with this, the maximum limit applicable on foreign investments in Treasury bonds was increased to 10 per cent of the outstanding Treasury bonds from the initial limit of 5 per cent and foreign currency denominated domestic borrowings were increased. The entry barriers for foreign investors, such as the minimum holding period of Treasury bonds, were also removed.

Further measures to diversify the deficit financing options were introduced during 2007. The government successfully completed Sri Lanka's debut international sovereign bond issue of US dollars 500 million (Rs. 56 billion) in October, 2007 (Box 15). A part of the proceeds received from this bond issue was utilised to settle high cost borrowings made to implement several infrastructure projects that were included in Budget 2007. The diversification of the financing mix has become imperative in a situation where Sri Lanka's per capita income is gradually increasing, which in turn would limit the country's access to concessionary foreign financing in the future.

The search for alternative methods of financing rather than relying on debt financing, gained a momentum with the government continuing to actively promote public-private partnerships (PPPs) in large infrastructure projects. Through PPPs, increased private sector involvement in infrastructure development is envisaged. Accordingly, the process of selecting prospective private sector development partners for the Colombo South Harbour Expansion project was in progress. Some of the projects such as Weerawila International Airport Project and Colombo - Katunayake Expressway Project are expected to be implemented as PPPs.

A new medium term debt management strategy (MTDMS) for 2007 and beyond was also formulated. This included a number of initiatives in line with the government's medium term borrowing programme and medium term macro fiscal framework. The strategies in MTDMS include the implementation of a debt consolidation programme, developing a credible and liquid debt market, introducing diversified debt instruments, restructuring primary dealer system and reducing debt financing in the budget by implementing investments in economic sectors through other alternative financing methods.

The lack of financial viability in several State Trading Enterprises (STEs) continued to be a strain on the government budget. Two major STEs namely; Sri Lanka Railways (SLR) and the Department of Posts (DOP), continued to report operating losses. The non-revision of railway fares since August 2005 and the steep increase in international oil prices weakened the financial position of SLR. The DOP continued to report operating losses despite the revision of postal charges with effect from April 2007. Therefore, the government had to provide a significant amount of transfers (Rs. 6.6 billion) to these STEs in 2007 in order for them to continue their operations.

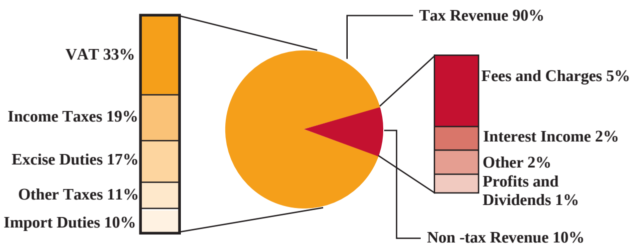
The financial performance of the key State Owned Enterprises (SOEs), CPC and CEB, also remained a concern. The financial performance of CPC was improved in the recent years mainly as a result of the adjustment of petroleum prices in line with the international oil prices, and improvements in the financial management and internal controls of CPC. However, CEB continued to operate with losses due to a number of reasons including the increased fuel cost, delays in implementing planned reforms in the electricity sector, inflexible pricing policy, implementation delays of the planned low-cost, large-scale power projects and the delays in addressing the high system losses.

6.3 Government Budgetary Operations

Revenue

In 2007, the government revenue increased by 18.3 per cent to Rs. 565 billion, responding positively to the continuous efforts made by the government in the revenue front. Both tax and non-tax revenue contributed for this increase. However, total revenue collection was Rs. 35 billion below the budgetary estimate of Rs. 600 billion, mainly due to the provision of tax concessions on essential imported

Chart 6.2 Composition of Government Revenue - 2007



commodities for countering the rising cost of goods and services and the lower quantity and total value of vehicle imports in 2007. As a per cent of GDP, it declined to 15.8 per cent compared to 16.3 per cent in 2006. During the year, tax revenue increased by 18.9 per cent to Rs. 509 billion and as a per cent of GDP, it declined to 14.2 per cent from 14.6 per cent in 2006. Non-tax revenue increased by 12.8 per cent to Rs. 56 billion and declined marginally to 1.6 per cent of GDP.

Higher growth in income taxes (33 per cent) was the main driving force of the enhanced revenue from taxes. The improved economic activities, modernisation of tax administration, improved enforcement and public awareness campaigns, and changes to tax policy were attributed to the growth in income taxes. The increase in the revenue from VAT (14 per cent) was mainly attributed to improvements in the VAT refund mechanism and increased mark-up on CIF values for the calculation of VAT on imports. Import duties grew only by 6 per cent mainly due to the duty waivers granted on essential food items. Among the major tax revenue sources, revenue collection from excise duties recorded the lowest growth of 4 per cent when compared to the previous year mainly due to the relatively lower growth in revenue collection from cigarettes. This moderate growth in the revenue from liquor and cigarettes was mainly attributed to higher applicable excise duty rates, strict implementation of legislative provisions with regard to the abuse of excise rules and regulations, higher growth in production, intensified detections of illicit items and government policy on controlling liquor and cigarette consumption. Meanwhile, the revenue from excise duties on other items, including motor vehicles, recorded a marginal decline in 2007 compared to the previous year.

Several reasons were attributed to the increase in non-tax revenue. The transfer of profits from the Central Bank, the increase in revenue from fines and forfeitures and higher profit and dividend receipts were among the major reasons.

Table 6.2 Economic Classification of Revenue

	2006	2007 Approved Estimates	2007 Provisional	2008 Approved Estimates
	Rs million			
Tax revenue	428,378	540,929	508,947	677,259
Income taxes	80,483	102,124	107,168	143,291
VAT	164,555	202,272	187,452	248,670
Excise Tax	92,845	107,580	96,675	113,639
Import duties	52,681	70,530	55,986	73,436
Other taxes	37,814	58,423	61,666	98,223
Non tax revenue	49,455	58,888	56,104	73,482
Total revenue	477,833	599,817	565,051	750,741
	As a per cent of GDP			
Tax revenue	14.6	15.2	14.2	16.2
Income taxes	2.7	2.9	3.0	3.4
VAT	5.6	5.7	5.2	6.0
Excise Tax	3.2	3.0	2.7	2.7
Import duties	1.8	2.0	1.6	1.8
Other taxes	1.3	1.6	1.7	2.4
Non tax revenue	1.7	1.7	1.6	1.8
Total revenue	16.3	16.9	15.8	18.0

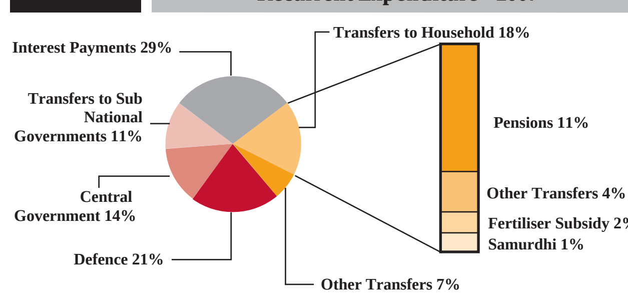
Source : Ministry of Finance and Planning

Expenditure and Net Lending

In 2007, total expenditure and net lending of the government remained below the budgetary target. Although there was a 18 per cent increase to Rs. 842 billion in the total expenditure and net lending, it was below the budgetary estimate of Rs. 898 billion by Rs. 56 billion mainly due to the lower than the budgeted capital expenditure. As a per cent of GDP also, it declined to 23.5 per cent from 24.3 per cent in 2006.

Total recurrent expenditure, in nominal terms, exceeded the budgetary target in 2007 but declined as a per cent of GDP compared to 2006. The recurrent expenditure, which increased by 14 per cent to Rs. 623 billion, was higher than the original target by Rs. 26 billion. However, as a per cent of GDP, it

Chart 6.3 Composition of Government Recurrent Expenditure - 2007



amounted to 17.4 per cent, which was considerably lower than 18.6 per cent recorded in 2006. The overrun in the recurrent expenditure was mainly due to the increases in salaries and wages, pension payments, interest payments and security related expenditure. Salaries and wages increased by 22.4 per cent to Rs. 214 billion mainly due to the full impact of the recruitments made under the graduate employment scheme in 2006 and the new recruitments to the public sector, including defence establishments, payment of incentive allowance in lieu of leave not availed by public officers and higher expenditure on COLA. The share of salaries and wages in recurrent expenditure increased to 34.3 per cent compared with 32 per cent recorded in 2006. The increase in pension payments by 18.6 per cent was mainly attributed to the increase in COLA to pensioners, correction of anomalies and the impact of the entry of around 18,000 new pensioners in 2007. The interest payments increased by 21 per cent compared to the previous year mainly due to the higher and more volatile interest rates that prevailed in the domestic market and the shift in investor preference towards the shorter end of the maturity spectrum. Additional funds were required for defence related activities as the government had to intensify counter terrorism measures to ensure national security. These were mainly to meet the expenditure on salaries and wages and other needs of security personnel, including the new recruits, and the replenishment and procurement of security related equipment. The IDPs were provided with shelter, foods and medical needs while developing infrastructure to create economic activities to bring life back to normal in the respective areas. The welfare expenditure on the provision of free text books, season tickets, nutritional food to school children, bursaries, assistance to disabled soldiers etc., continued to increase. The government continued to provide budgetary assistance to STEs (which include SLR and DOP) as they continued to incur operating losses.

Chart 6.4 **Total Expenditure by Functions - 2007**

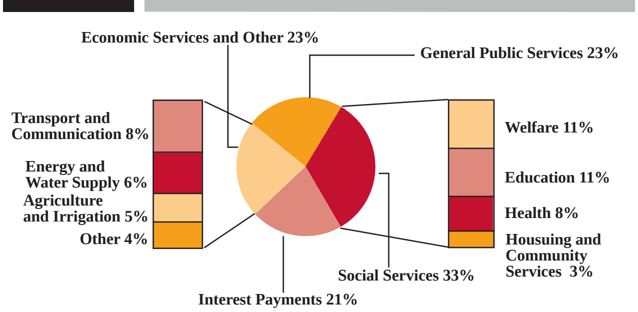


Table 6.3 **Economic and Lending Minus Repayment**

	2006	2007 Approved Estimates	2007 Provisional	2008 Approved Estimates
	Rs million			
Current expenditure	547,960	596,260	622,758	712,894
Expenditure on goods and services	253,026	295,761	292,632	343,852
o/w Salaries and wages	175,031	204,508	214,160	233,393
Interest payments	150,777	169,122	182,681	209,825
Foreign	16,990	21,149	21,311	30,000
Domestic	133,787	147,973	161,370	179,825
Current transfers and subsidies	144,157	131,377	147,445	159,217
o/w To households and other sectors	104,842	102,632	110,910	121,546
Samurdhi	10,789	9,600	9,200	10,850
Pensions	58,006	62,500	68,822	73,060
Fertiliser subsidy	11,867	11,000	11,000	15,000
Other	24,180	13,196	21,888	22,636
Capital expenditure	162,214	259,642	206,161	282,894
Acquisition of real assets	88,209	167,254	111,510	199,905
Capital transfers	74,005	122,138	94,651	108,075
Provision for under expenditure	-	-29,750	-	-25,085
Lending minus repayment	3,473	42,098	12,684	48,400
Total expenditure and net lending	713,646	898,000	841,604	1,044,188
	As a per cent of GDP			
Current expenditure	18.6	16.8	17.4	17.1
Expenditure on goods and services	8.6	8.3	8.2	8.2
o/w Salaries and wages	6.0	5.8	6.0	5.6
Interest payments	5.1	4.8	5.1	5.0
Foreign	0.6	0.6	0.6	0.7
Domestic	4.6	4.2	4.5	4.3
Current transfers and subsidies	4.9	3.7	4.1	3.8
o/w To households and other sectors	3.6	2.9	3.1	2.9
Samurdhi	0.4	0.3	0.3	0.3
Pensions	2.0	1.8	1.9	1.7
Fertiliser subsidy	0.4	0.3	0.3	0.4
Other	0.8	0.4	0.6	0.5
Capital expenditure	5.5	7.3	5.8	6.8
Acquisition of real assets	3.0	4.7	3.1	4.8
Capital transfers	2.5	3.4	2.6	2.6
Provision for under expenditure	-	-0.8	-	-0.6
Lending minus repayment	0.1	1.2	0.4	1.2
Total expenditure and net lending	24.3	25.3	23.5	25.0

Source : Ministry of Finance and Planning

In 2007, public investment continued to increase. In nominal terms, it increased by 27 per cent to Rs. 229 billion and as a per cent of GDP also it increased to 6.4 per cent from 6 per cent in the previous year. This improvement was a result of the strenuous efforts made by the government to accelerate the implementation of development projects through local funds and foreign aid disbursements. In particular, the government took measures to ensure the availability of bridging financing and counterpart funds, particularly through the issuance of a debut international bond issue, to implement development projects as planned.

Table 6.4 **Functional Classification of Expenditure**

	2006	2007		2008
		Approved Estimates	Provisional	Approved Estimates
	Rs million			
Total current expenditure	547,960	596,260	622,758	712,894
General public services	133,105	169,613	162,102	179,548
Civil administration	29,912	48,153	31,481	38,719
Defence	81,243	96,863	101,856	108,086
Public order and safety	21,950	24,597	28,765	32,743
Social services	204,635	202,870	226,271	245,494
Education	61,144	65,503	72,592	78,476
Health	44,069	45,004	51,741	56,537
Welfare	86,753	82,279	91,747	97,315
Community services	12,669	10,084	10,191	13,166
Economic services	50,612	52,583	49,573	60,559
Agriculture and irrigation	22,173	23,269	22,849	28,177
Energy and water supply	2,766	3,745	3,647	3,872
Transport and communucation	19,038	19,429	18,983	22,306
Other	6,635	6,140	4,094	6,204
Other	159,609	171,194	184,811	227,293
o/w Interest payment	150,777	169,122	182,681	209,825
Capital expenditure and lending	177,443	303,567	229,273	335,672
General public services	21,356	36,110	32,143	40,088
Civil administration	18,109	32,995	28,438	34,612
Public order and safety	3,247	3,115	3,705	5,476
Social services	48,386	68,574	54,986	75,834
Education	17,200	29,732	19,948	31,207
Health	13,969	18,256	16,961	23,309
Housing	4,021	7,174	4,481	7,190
Community services	13,197	13,412	13,596	14,129
Economic services	106,789	227,732	141,244	244,075
Agriculture and irrigation	12,615	18,662	14,736	26,156
Energy and water supply	26,376	78,886	47,850	79,201
Transport and communication	37,988	96,043	50,995	100,170
Other	29,810	34,141	27,663	38,548
Other	912	900	900	760
Under expenditure	-	-29,750	-	-25,085
Total expenditure and lending	725,403	899,826	852,031	1,048,565
	As a per cent of GDP			
General public services	5.3	5.8	5.4	5.3
Social services	8.6	7.7	7.9	7.7
Economic services	5.4	7.9	5.3	7.3
Other	5.5	4.9	5.2	5.5
o/w interest	5.1	4.8	5.1	5.0
Total expenditure and lending	24.7	25.4	23.8	25.1

Source : Ministry of Finance and Planning

Public investment in economic services remained high in 2007 as well. Within this sector, transport and communication, and energy and water supply were the main areas of investment. The initial work on mega infrastructure development projects, continuation of the development work related to roads, electricity, water supply and irrigation projects, acceleration of rural infrastructure development projects and reconstruction of tsunami affected areas were attributed to this improvement.

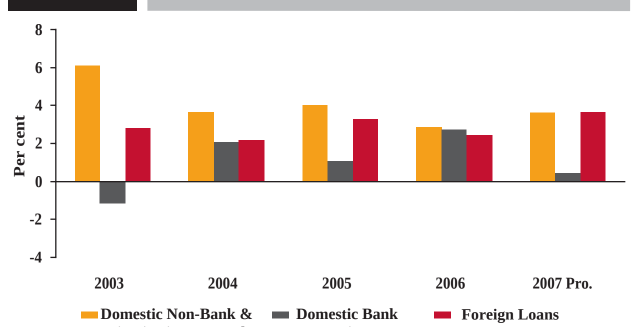
Public investment in social services also increased in line with the government policy on human resource development towards a healthier and knowledge-based economy in the medium to long run. The share of social services was about 24 per cent of the total public investment in 2007. Education and health continued to be the priority sectors in this category. The investment in education was mainly in the areas of enhancing school infrastructure facilities and access to education, improving the quality of the education, and developing the institutional abilities in educational institutions. Public investment in health sector was mainly on the development of health infrastructure, particularly at the regional and rural levels, and the development of human resources in the health sector.

Nevertheless, the performance of the public investment programme was below the expectations due to a number of reasons. These included capacity limitations, administrative and procurement delays, issues in land acquisition, and high cost of compensation and settlement etc. This situation calls for further efforts to complete the planned infrastructure projects within the stipulated periods to reduce cost escalations.

Key Fiscal Balances

The overall budget deficit declined to 7.7 per cent of GDP (Rs. 277 billion) in 2007 from 8 per cent recorded in the previous year. This was also below the budgetary target of 8.4 per cent of GDP, as the decline in the revenue collection and the overrun in recurrent expenditure was offset by the decline in capital expenditure and net lending. The current account deficit, which measures the government dis-savings, declined further to 1.6 per cent of GDP compared to 2.4 per cent in 2006 reflecting the higher growth in revenue relative to recurrent expenditure. However, the original budget expected a small positive balance in 2007. Meanwhile, the primary deficit (overall deficit net of interest payments), which reflects the impact of current year's fiscal operations on the macroeconomy, also declined to 2.6 per cent from 2.9

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



per cent in 2006. The higher growth in revenue (18.3 per cent), which outpaced the growth in non-interest expenditure (17.1 per cent) was mainly attributed to this improvement.

Financing the Budget Deficit

The diversification of the deficit financing options was continued during 2007. The debut international bond issue was the most recent deficit financing source introduced by the government. Consequently, the financing mix of the government budget expanded to six sources; domestic rupee and foreign currency denominated borrowings, foreign borrowings through Treasury bonds, sovereign bonds and other loans (including concessional loans), and foreign grants.

In financing the overall budget deficit of Rs. 277 billion in 2007, the amount of resources raised from the domestic sources was lower than the foreign resources. Total net domestic financing (NDF) was Rs.128 billion compared with the original estimate of Rs. 156.2 billion as well as Rs.164 billion recorded in 2006. Net foreign financing (NFF) was Rs. 131 billion compared to the original estimate of Rs. 142 billion in 2007. This consisted of Rs. 56 billion from international bond issue, Rs. 37 billion from foreign investments in rupee denominated Treasury bonds, Rs. 7.4 billion from other foreign loans and Rs. 30.5 billion from foreign grants. As a per cent of GDP, total NFF increased to 3.7 per cent from 2.5 per cent in 2006 while total NDF declined to 3.6 per cent from 5.6 per cent. As at end 2007, an amount of Rs.17.4 billion remained to be paid. Meanwhile, the debt dependency ratio (the ratio of total net borrowings to total government expenditure) increased marginally to 29.2 per cent in 2007 from 28.8 per cent in 2006.

Table 6.5 Sources of Domestic Financing

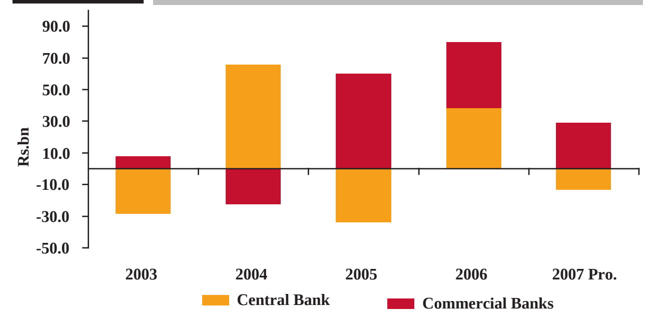
Rs billion

	2004	2005	2006	2007 Provisional
By Instrument	117.2	123.6	163.8	127.7
Treasury bonds (a)	156.6	108.1	97.4	52.8
Treasury bills	25.0	-9.4	20.3	37.1
Rupee loans	-83.7	-24.2	-23.8	10.3
Sri Lanka Development Bonds	16.4	0.0	34.3	23.6
Central Bank provisional advances	3.6	4.9	9.3	11.7
Other	-0.7	44.2	26.3	-7.8
By Source	117.2	123.6	163.8	127.7
Bank	43.3	26.2	80.0	15.8
Non bank	73.9	97.4	83.8	112.0

(a) Excludes Rs. 37,127 million of rupee denominated Treasury bonds issued to foreign investors in 2007.

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

Chart 6.6 Sources of Bank Financing



Of the budget deficit, about 47 per cent was financed through domestic sources compared to 69 per cent in 2006. Within the total NDF, about 87.1 per cent (Rs. 112 billion) was from domestic non-bank sources, which indicated an increase of Rs. 28 billion compared to Rs.84 billion in 2006. The major source of non-bank financing was the Employees' Provident Fund (EPF) as in the previous years.

The borrowing from banking sector declined significantly in 2007 compared to 2006. The bank financing of Rs. 15.8 billion in 2007 recorded a sharp decline from Rs. 80 billion in 2006, while the budgetary target was Rs. 16.7 billion in 2007. The increasing trend observed in bank financing during the first three quarters of the year was eased in the last quarter with the receipt of the proceeds from the international bond issue, as a part of it was utilised to retire Treasury bills held by Central Bank that were issued to fund for infrastructure projects. Total amount of bank financing in 2007 was the outcome of the net repayment of Rs. 13 billion to Central Bank and borrowings of Rs. 29 billion from commercial banks. In 2007, bank financing accounted only for 12.3 per cent of the total NDF against that of 48.8 per cent in 2006.

Borrowings from domestic rupee denominated instruments accounted for 78.5 per cent of the NDF in 2007. It indicated a increase to Rs.100.2 billion from Rs. 93.9 billion in 2006. Net borrowings from debt instruments consisted of Treasury Bonds (Rs. 52.8 billion), Treasury bills (Rs. 37 billion) and Rupee loans (Rs, 10.3 billion). The amount of Treasury bonds excludes the Rs. 37 billion (on book value basis) received from foreign investors.

The maturity structure of the borrowings through domestic rupee denominated instruments was more towards the shorter end of the market reflecting the investor preference in an environment of rising interest rates. The rising interest rate structure fuelled by high inflation and inflationary expectations was the major factor that shifted the investor preference to the shorter end of the market. The tight monetary policy measures adopted by the Central Bank and heavy borrowing programme of the government were also attributed to the rising interest rates in the market. Although some moderation of the interest rates was experienced in the market after the international bond issue in October 2007, the trend reversed to a certain extent in the last month of the year.

The reliance on foreign currency denominated domestic borrowings continued in 2007 as a measure to reducing the pressure on domestic market interest rates. There were borrowings of Rs. 23.6 billion (US dollars 215.3 million) through Sri Lanka Development Bonds (SLDBs), while there was a net repayment of Rs. 2.2 billion (US dollars 20.8 million) of the borrowings from Offshore Banking Units (OBUs). Moreover, some of the borrowings from OBUs were rolled over in 2007. In addition, there were foreign currency denominated borrowings of Rs.6.0 billion (US dollars 55 million) from National Savings Bank (NSB), including a loan of Rs. 5.4 billion (US dollars 50 million) arranged by NSB through ICICI Bank of India. A part of the proceeds from these borrowings were used to repay high interest foreign currency borrowings. As the average maturity of these borrowings was 2.8 years, their maturity structure needs to be lengthened to avoid a bunching of repayments.

The government was able to mobilise a record amount of foreign resources for financing the budget deficit in 2007. On a gross basis, the government received US dollars 2,036 million (Rs.224 billion) from foreign sources in comparison to US dollars 1,219 million (Rs. 127.7 billion) in the previous year. Of this, about 32 per cent was on concessional terms while the balance was on non-concessional terms and conditions. About 38 per cent of the total foreign loans was received by way of project loans (US dollars 785 million) from bilateral and multilateral development partners. The government of Japan, Asian Development Bank (ADB) and International Development Association (IDA) were the major donors of project loans. Meanwhile, China became an emerging development partner. Non-concessional loans of US dollars 1,376 million raised during the year mainly included the proceeds from the international bond issue and the investments in Treasury bonds by foreigners.

Total NFF was also increased substantially in 2007. As the repayment of foreign loans amounted to Rs.64 billion, including defence related deferred payments of Rs. 10 billion, the NFF amounted to Rs. 131.4 billion compared to Rs.67 billion in 2006. Since there was a substantial increase in new aid commitments which will be disbursed in the next few years received by the government during 2007, the utilisation rate of available foreign assistance declined to 21.2 per cent in 2007 from 22.5 per cent in the previous year. Further efforts are necessary to improve the utilisation of available concessional foreign financing in the future.

The amount of foreign grants received for budgetary purposes continued to be high compared to pre-tsunami levels. A total amount of Rs. 30.5 billion was received as foreign grants in 2007 mainly from bilateral donors, such as the governments of Japan, Federal Republic of Germany and the USA, and multilateral agencies, such as IDA and ADB, as in the previous years.

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 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. Under this amendment, a Finance Commission (FC) has also been set-up with a key role of recommending apportionment of available resources among PCs. The LG system in the country constituted of 330 units comprising 18 Municipal Councils (MCs), 42 Urban Councils (UCs) and 270 Pradesheeya Sabhas (PSs) as at end 2007.

The activities of SNGs continued with resources obtained mainly from two sources; their own revenue and transfers received from the central government to finance the resource gap. The inadequacy of the powers granted in mobilising resources, relatively narrow tax base, weak information systems and limited administrative capacities made it difficult to generate adequate revenues for them to provide even the basic services. This revenue – expenditure gap makes these spheres of governance heavily dependent on financial transfers from the central government.

SNGs rendered their services amidst several other problems. The relatively low share of capital expenditure, large and increasing share of personal emoluments, shortage of trained staff in several areas, lack of strong regulation and monitoring systems and inadequate financial and human resource management were among them.

6

FISCAL POLICY AND GOVERNMENT FINANCE

As in the previous years, Ministry of Local Government and Provincial Councils (MLGPC) maintained a close coordination with SNGs. The MLGPC functioned as the government agency representing SNGs at the centre. It also continued to provide budgetary funds to ensure financial capability of SNGs, extended the guidance and support for strengthening and facilitating provincial governance while organising various forums, conferences and workshops to coordinate and promote development orientation of SNGs.

During the year, FC made an effort, in collaboration with Central Bank, for encouraging PCs to work towards achieving a balanced regional development. Accordingly, a series of discussions were held with PCs. As an outcome of these deliberations, FC was able to make allocations through Budget 2008 for two key projects in each province dedicated for strengthening regional economy (Box 6). This pro-active role of FC needs to be continued in association with other stakeholders in order to reap the expected outcome of reducing regional economic disparity gradually.

Performance of Provincial Councils

In 2007, the overall budgetary operations of PCs improved. Total revenue collection increased by 33 per cent mainly due to the increase in revenue from turnover taxes (TT) and stamp duties. The increase in revenue from TT was substantial as the government allowed the PCs to increase the TT rate applicable on tobacco and cigarettes to 5 per cent from 1 per cent. About 87 per cent of the total revenue was collected from the above two sources. The Western Provincial Council (WPC) continued as the dominant revenue collecting province in 2007 due to the high concentration of commercial and industrial activities and the high population in this region. Total revenue of WPC accounted for 66 per cent of the total revenue collection while Central, Southern and North Western were the other major revenue collecting provinces.

Table 6.6 Budget Outturn for Provincial Councils

Rs. million

	2004	2005	2006	2007 Provisional
Total revenue	13,522	16,132	19,481	23,876
Tax Revenue	11,544	13,818	16,586	21,473
Non-Tax Revenue	1,978	2,314	2,895	4,395
Total expenditure	56,964	73,009	94,470	122,414
Current expenditure	46,308	59,132	76,428	101,149
o/w Personal emoluments	36,079	46,479	60,497	82,111
Capital expenditure	10,656	13,877	18,042	21,265
Central government transfers	45,848	59,696	79,029	88,317
Block grants	35,892	47,107	62,342	70,742
Criteria based grants	803	817	790	1,208
Matching grants	311	273	221	205
PSDG (a)	3,854	5,561	7,345	6,995
Foreign grants for special projects	4,988	5,937	8,331	9,167

(a) Province Specific Development Grants

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

The recurrent expenditure of PCs increased by 21 per cent in 2007 over the previous year. The recurrent expenditure consisted of personal emoluments (80 per cent) and other expenditures (20 per cent). A major portion of the personal emoluments was absorbed by education and health sectors while other non-wage expenses in relation to goods and services accounted for the balance.

Investment expenditure of PCs increased in 2007. Their investment expenditure was mainly in respect of Province Specific Development Projects (PSDP) and foreign funded special projects.

In 2007, transfers from the central government to PCs amounted to Rs. 83 billion. These were in the form of block grants to fund recurrent expenditure needs, criteria based grants to fund discretionary expenditure requirements, matching grants to fund incentives for revenue collection of PCs and Province Specific Development Grants (PSDG) to continue PSDPs. In addition, foreign grants received by PCs for special projects amounted to Rs. 9 billion while there were transfers of Rs. 2.7 billion for health and education sector development projects.

It appears that government's attempt at fiscal decentralisation has not yielded the desired results of enhancing regional growth through addressing the needs of the people at the provincial and the local levels. There is a considerable overlap of functions of PCs with those of the central government, especially with respect to providing basic education, healthcare and road facilities, wherein the decisions continue to be taken by the central government and the PCs are merely functioning as the implementing agencies. This has severely affected the quality of services rendered by them while hampering the efficiency with which these services were delivered. Also, the limitations in financial transfers from the central government have resulted in a slow progress in their development activities. Hence, PCs have to come up with renewed efforts to increase the utilisation of their own resources for the benefit of the provincial population instead of relying increasingly on funds from the centre.

Performance of Local Governments

Local authorities financed their expenditures through revenues from several sources and faced a number of constraints that affected their effective functioning. The revenue sources of LGs include rates, other revenue, assigned revenue (stamp duty and court fines), and government transfers. PCs worked as the agent for LGs in collecting the two sources of devolved revenues, namely stamp duty and court fines, as assigned under the 13th Amendment to the Constitution. Meanwhile, the outlays of LGs comprised of personal emoluments, other current expenses and capital expenses. The weak financial systems and human resource management, lack of competent technical staff, weaknesses in regulation and monitoring, 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 CPC and CEB are the two public enterprises, which could impose a significant impact on the government budgetary operations. During the year, the financial position of CPC improved while that of CEB continued to weaken due to several reasons.

The financial position of CPC improved in 2007. This was mainly a result of the adjustment of petroleum prices in line with the international prices, and improvements in the financial management and internal controls (Box14), though the provision of diesel and furnace oil by CPC to CEB at a subsidised rate had a significant impact on its financial operations. In addition, the entering into hedging oil purchases against adverse price movements has had a positive impact on the financial position of CPC. With these improvements, CPC's burden on the government budget as fuel subsidies was gradually phased out. However, as CPC had to borrow foreign exchange from the banking system to settle their import bills, its liabilities to the banking sector increased in 2007. Meanwhile, CPC received an enhanced suppliers' credit facility to the value of around US dollars 700 million from Iran in January 2008, which will help improve its financial operations further.

CEB's financial position continued to deteriorate in 2007 as well. Despite the receipt of diesel and furnace oil at a subsidised rate from CPC, the increased fuel cost, delays in implementing planned reforms in the electricity sector, inflexible pricing policy, implementation delays of the planned low cost large-scale power projects and the delay in addressing the high system losses contributed to the weak financial position of CEB. The government continued to service CEB's foreign debt in 2007 as well. Nevertheless, its liabilities to the banking system declined in 2007. The electricity tariff revision, which was implemented in March 2008, is expected to help improve the financial position of CEB.

6.6 Public Sector Debt and Debt Service Payments

Government Debt

Total outstanding government debt increased by 18 per cent to Rs. 3,070 billion in 2007. However, as a percent of GDP, it declined for the fifth consecutive year to 85.8 per cent. This was mainly due to the stabilisation of the rupee vis-a-vis major foreign currencies towards the end of the year and the higher growth in nominal GDP than the growth in nominal debt. As a per cent of GDP, both domestic and foreign debt ratios improved to 47.9 per cent and 37.9 per cent, respectively in 2007.

In nominal terms, total outstanding debt increased by Rs. 462 billion in 2007. Of this, the increase in total domestic debt was Rs. 236 billion and the increase in foreign debt was Rs. 226 billion. Domestic debt increased mainly due the net borrowings and the issuance of debt instruments on a discount basis. Increased net foreign borrowings and the depreciation of the Rupee against major foreign currencies were the main reasons for the increased foreign debt. However, the impact of exchange rate variation at Rs. 71 billion was lower in 2007 compared to Rs. 109 billion recorded in the previous year, reflecting the relatively lower depreciation of the Rupee vis-a-vis major foreign currencies.

Of the total domestic debt, the share of the medium to long term debt remained almost unchanged at 78.8 per cent in 2007. Treasury bonds continued to remain as the key domestic borrowing instrument accounting for 77.4 per cent of total outstanding medium to long term debt and 60 per cent of the total outstanding domestic debt. Within the medium and long term debt, the share of rupee securities declined further to 9.7 per cent. Since there were issues of SLDBs in 2007, the total outstanding SLDBs increased to 6.4 per cent of the total of the domestic medium and long term debt. Meanwhile, within the total short term debt, the share of Treasury bills increased to 84 per cent due to the higher reliance on this instrument compared to other short-term borrowings.

Chart 6.7 Outstanding Government Debt (as a per cent of GDP)

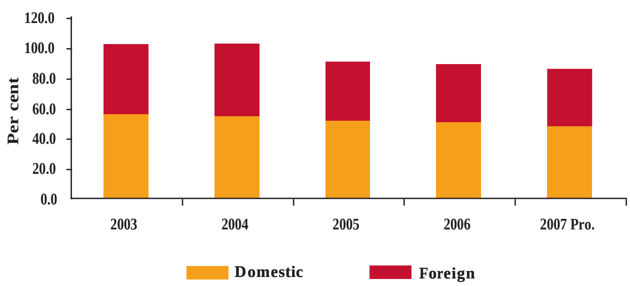
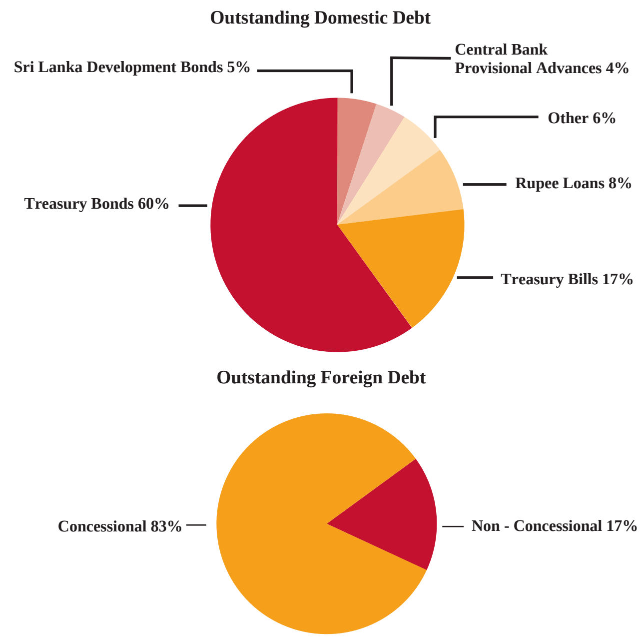


Chart 6.8 Composition of Outstanding Government Debt - 2007



In 2007, the outstanding debt liabilities to the banking sector increased at a relatively lower rate. The increase was only Rs. 19 billion in 2007 compared to that of Rs. 97 billion in 2006. The share of the banking sector liabilities to total domestic outstanding debt declined to 24.2 per cent from 26.7 per cent in the previous year. During the year, the outstanding debt to Central Bank declined by Rs.13 billion, while the debt held by commercial banks increased by Rs. 32 billion.

The outstanding government debt held by the non-bank sector increased by Rs. 217 billion to Rs.1,300 billion. The EPF and NSB continued to be the major investors in this category and accounted for 44 per cent and 15 per cent of the domestic non bank outstanding debt, respectively. The outstanding foreign currency denominated domestic debt increased to Rs.180.3 billion (US dollars 1,659 million) as at end 2007. Total outstanding foreign currency debt increased marginally to 10.5 per cent of the total domestic debt from 10.3 per cent in the previous year.

Of the total government foreign debt, the share of concessional debt declined to 83.3 per cent in 2007 from 93 per cent in 2006. The increased foreign commercial borrowing was the major reason for this decline. However, this situation is in line with the situation of Sri Lanka as a lower middle income country with reduced access to concessional financing in the medium term. Nevertheless, there is a need to maintain non-concessional borrowings at a manageable level to minimise the adverse implications associated with them.

As in the previous years, project loans dominated the outstanding foreign debt accounting for 80 per cent with non-project loans accounting for the balance. The corresponding values were 87 per cent and 13 per cent in 2006. The increased amount of commercial borrowings was the major reason for this change. During the year, the outstanding debt to bilateral sources declined to 43.8 per cent of the total foreign debt. The governments of Japan (24.2 per cent), Germany (7.0 per cent) and the USA (3.9 per cent) were the major bilateral development partners. The outstanding multilateral debt declined to 42.8 per cent of the total foreign debt. The ADB (21.3 per cent) and IDA (19.3 per cent) continued as the major multilateral development partners in this category.

The outstanding debt was in four major foreign currencies. About 37.5 per cent of the debt was in Special Drawing Rights (SDR). This was followed by the Japanese yen (25 per cent), US dollars (19.7 per cent) and Euro (11 per cent). The balance (6.8 per cent) was in other currencies.

The gradual decline in the outstanding debt to GDP ratio is encouraging. However, strong efforts are necessary to continue with this trend to accomplish the targeted debt to GDP ratio of 60 per cent by 2013, as stipulated in the Fiscal Management (Responsibility) Act. Hence, further improvements are necessary in containing recurrent expenditure, budget deficits, borrowings, outstanding debt and interest payments to further strengthen the fiscal situation. The fiscal consolidation path, which has already been announced by the government in its policy documents, would be the way towards this direction.

Non-Financial Public Corporation Debt

In 2007, the outstanding liabilities of non-financial public corporations (NFPC) to the banking system and their foreign liabilities under credit

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

Rs. million

	2004	2005	2006	2007 Provisional
1. Central Government Debt	2,139,526	2,222,341	2,607,723	3,070,069
Domestic Debt (a)	1,143,389	1,265,721	1,479,230	1,715,198
By maturity period				
Short term	269,784	262,153	313,218	363,199
Medium and long term	873,605	1,003,568	1,166,012	1,351,999
By institution				
Banks (b)	272,981	298,411	395,470	414,688
Non bank sector	870,408	967,310	1,083,660	1,300,409
Foreign debt	996,138	956,620	1,128,493	1,354,871
By type				
Concessional loans	970,299	919,030	1,048,152	1,128,296
Non concessional loans	25,838	37,590	80,341	226,575
By currency				
SDR	420,459	401,615	465,679	508,241
US dollars	152,562	161,632	185,647	266,645
Japanese yen	310,311	286,673	317,220	338,621
Euro	83,579	76,060	123,387	149,845
Other	29,227	30,640	36,560	91,520
Memo:				
Exchange rate variation	106,502	-100,751	108,579	70,961
2. Non Financial Public Corporations Debt	41,171	31,377	44,480	59,604
Ceylon Electricity Board	12,529	9,841	10,329	7,318
Ceylon Petroleum Corporation (c)	23,326	15,823	28,533	48,499
Cooperative Wholesale Establishment	1,400	983	754	475
Other	3,916	4,730	4,864	3,312
3. Total public sector debt (1+2)	2,180,697	2,253,718	2,652,203	3,129,673

Source: Central Bank of Sri Lanka

(a) Includes long term bonds of Rs. 24,088 million issued in 1993. This excludes the government Treasury bonds amounting to Rs. 4,397 million issued to commercial banks on behalf of CWE in November 2003 and Rs. 49,646 billion issued to foreign investers.

(b) Includes outstanding balances to Offshore Banking Units (OBUs): Rs.31,596 million at end 2004,Rs.71,859 million at end 2005, Rs.89,288 million at end 2006 and Rs.88,871 million at end 2007.

(c) In 2005, 2006 and 2007 liabilities include the outstanding balances of Rs. 14,705 million (US dollars 144 million), Rs. 12,925 million (US dollars 120 million) and Rs. 10,437 million (US dollars 96 million) respectively, to the Indian Line of Credit.

lines increased to Rs. 60 billion, compared to Rs. 45 billion in the previous year. The debt liabilities of NFPCs to the banking system increased by Rs.17.6 billion to Rs. 49.2 billion. Two SOEs, namely CEB and CPC, accounted for 93.6 per cent of the total outstanding NFPC debt to the banking system. The outstanding balance of the Indian line of credit obtained by CPC was Rs.10.4 billion (US dollars 96 million) by end 2007.

Public Sector Debt

Total outstanding public sector debt, which includes the outstanding government debt, liabilities of NFPCs to the banking system, and the outstanding balance of credit lines, increased by Rs. 477 billion to Rs. 3,130 billion at end 2007. The increases recorded in both government debt by Rs. 462 billion and NFPCs debt by Rs. 15 billion were attributed to this growth. As a per cent of GDP, the outstanding public sector debt, as defined in this section, declined further to 87.5 per cent as at end 2007 from 90.3 per cent at end 2006.

Debt Service Payments

In 2007, total debt service payments increased by 12.6 per cent to Rs. 500.5 billion. This consisted of loan repayments of Rs. 317.8 billion (63.5 per cent) and interest payments of Rs. 182.7 billion (36.5 per cent). Debt service payments to domestic sources amounted to Rs. 415 billion, while that for foreign sources was Rs. 85.5 billion. The domestic loan repayments increased at a lower rate in 2007 as a part of the foreign currency denominated domestic borrowings which fell due in 2007 were rolled over. However, domestic interest payments exceeded the original estimate by Rs. 13.6 billion in 2007 due to higher domestic market interest rates. Foreign debt service payments included four instalments (Rs. 8.4 billion) of interest and repayments, which were postponed under the voluntary debt moratorium received in 2005. It also included the repayment of defence loans, which had been obtained under deferred conditions.

Some debt service indicators continued to improve in 2007 as well. The ratio of total debt service payments to government revenue declined to 88.6 per cent from 93 per cent in 2006. Total debt service as a per cent of GDP also declined to 14.0 per cent from 15.1 per cent in the previous year. Total interest payments as a per cent of GDP remained unchanged at 5.1 per cent. However, the ratio of total foreign debt service payments to exports of goods and services increased to 8.2 per cent in 2007 from 7.1 per cent in 2006. Nevertheless, the debt service payments remain at a comfortable level given the relatively concessional nature of the foreign debt with long repayment periods and continuous growth in earnings from export of goods and services.

Chart 6.9 **Debt Service Payments (as a per cent of GDP)**

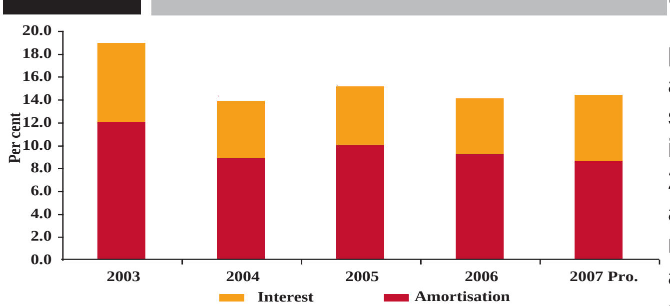


Table 6.8 Government Debt Service Payments

Rs. million

	2004	2005	2006	2007 Provisional	2008 Estimates
Debt service payments	300,564	344,866	444,303	500,514	602,139
Domestic	253,619	316,511	381,324	415,089	467,324
Foreign	46,945	28,355	62,979	85,425	134,815
Amortisation payments	180,781	224,707	293,525	317,833	392,314
Domestic	147,740	203,347	247,536	253,719	287,499
Foreign	33,041	21,360	45,989	64,114	104,815
Interest payments	119,783	120,159	150,778	182,681	209,825
Domestic	105,878	113,164	133,788	161,370	179,825
Short term	20,474	20,300	24,558	53,874	70,027
Medium and long term	85,404	92,864	109,230	107,496	117,001
Foreign	13,904	6,995	16,990	21,311	30,000

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

Table 6.9 Government Debt Indicators

Indicator	2004	2005	2006	2007 Provisional	2008 Estimates (a)
Government Debt/GDP	102.3	90.6	88.7	85.8	82.3
- Domesitc Debt/GDP	54.7	51.6	50.3	47.9	44.6
- Foreign Debt/GDP	47.6	39.0	38.4	37.9	37.7
Total Foreign Debt/Exports (b)	134.8	120.6	127.5	129.5	134.8
Total Debt Service/GDP	14.4	14.1	15.1	14.0	14.4
Total Debt Service/ Government Revenue (c)	96.5	90.8	93.0	88.6	80.2
o/w Domestic Debt Service/ Government Revenue (c)	81.4	83.3	79.8	73.5	62.2
Total Debt Service/Government Expenditure (d)	45.7	42.6	44.1	43.2	41.9
o/w Domestic Debt Service/ Government Expenditure (d)	38.6	39.1	37.9	35.8	32.5
Foreign Debt Service / Exports (b)	6.4	3.6	7.1	8.2	11.5
Domestic Interest /GDP	5.1	4.6	4.6	4.5	4.3
Domestic Interest /Government Current Expenditure	27.2	25.5	24.4	25.9	25.2
Foreign Interest/Exports (b)	1.9	0.9	1.9	2.0	2.6

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

Source: Central Bank of Sri Lanka

The government debt management strategy, which was formulated in 2007, has to be implemented without further delay to improve the debt management process. In implementing this strategy, emphasis has to be made on smoothening the maturity profile of the domestic debt to minimise the pressure on government fiscal operations. It is also necessary to encourage and promote alternative deficit financing sources to reduce debt creating financial flows in the future.

Box 15 Sri Lanka's Debut International Sovereign Bond Issue

The Government of Sri Lanka issued its debut US dollar denominated international sovereign bonds in the international market in October 2007 to mobilize US dollars 500 million from international investors. The main purpose of the bond issue was to finance Sri Lanka Government's stake in development partner-funded major infrastructure projects and provide bridging finance to ensure timely and smooth implementation of such projects. Development partners do not finance 100 per cent of the project costs relating to infrastructure projects. They usually finance around 70 per cent of the project cost, and that too, in stages. Therefore, the government, has to fund about 30 per cent of the project cost, as its stake and, in many instances, provide bridging finance to ensure timely implementation of the projects, as many project loans are disbursed or reimbursed on an expenditure basis.

In view of the urgent need to implement several infrastructure projects in a timely manner, and thereby minimise cost escalations and support higher economic growth, the bond issue was considered as an important source of financing.

Advantages and risks associated with sovereign bond issues

With the bond issue, Sri Lanka has marked its presence in the global financial market and enhanced its access to the market which is particularly useful in view of the declining access by Sri Lanka to concessional financing from the World Bank and ADB with its achievement of middle income status. It also provides a good opportunity for the Sri Lanka authorities to convey the Sri Lanka's credit story to the international investor community.

Another advantage is that the funds mobilized through the bond issue could be invested by the government in any key projects on a priority basis without conditions being attached to the funding of projects. Such a situation will be quite unlike in the case of projects financed by the development partners, where the government has to adhere to numerous conditions including conditions on procurement of goods and services from the selected countries or organizations. Those types of conditions are often not financially beneficial and, in fact, in many instances even offset the apparent benefit that is seen as being derived from the concessionary interest rate charged by the development partner, or the longer tenure of the loan.

The bond issue has established a benchmark reference rate which would enable the private sector to mobilize funds in the international markets at competitive rates through the issuance of corporate bonds.

The main risk associated with a bond that has a single bullet repayment is that a large sum of money has to be paid out in one payment on a fixed future date, when the repayment becomes due. However, such risk could always be addressed quite adequately, by ensuring that overall debt ratios continue to improve so that the repayment of such debt would not be a major burden in the future. Moreover, in the case of the issue under reference, the proceeds of the issue were used for financing infrastructure projects which would lead to higher economic activities, thereby enhancing the repayment capacity through increased tax revenue.

Outcome of the Bond Issue

Sri Lanka successfully completed the debut international bond issue of a benchmark size of US dollars 500 million in October 2007. The bond issue was oversubscribed with total subscription amounting to 3.2 times the offer (over US dollars 1.6 billion). The bond has a maturity period of 5 years and carries a coupon rate of 8.25 per cent per annum. The issue was distributed among investors in Asia (30 per cent), Europe and the Middle East (30 per cent), and the USA (40 per cent). It attracted 136 investors comprising of Asset Managers (53 per cent), Banks (25 per cent), Insurance/Pension Funds (7 per cent), Retail/Private Banks (5 per cent) and other funds (10 per cent). The country's sound economic fundamentals, conducive investment climate and future growth potentials and the unblemished debt servicing record played a major role in the success of the bond which was issued at a time when the global financial markets were in turmoil due to sub-prime issue. The bond issue was adjudicated as the 'Best Sovereign Bond of the Year' by three international financial magazines, namely, Asiamoney, Finance Asia and Asset Magazine on the ground that even being a debut, the issue was oversubscribed by several fold despite the US sub-prime crisis that completely changed the market conditions.

Use of Bond Proceeds

During January to October, 2007, the Government had invested approximately Rs. 28 billion on account of a large number of infrastructure development projects, including the Hambantota Sea Port, Puttalam Coal Power, Upper Kotmale Hydropower, Southern Highway, National Highways, Water Sector, Walawe Left Bank Irrigation and Extension, Secondary Towns and Rural Community Water Sanitation, Moragahakanda, Weheragala, and several other irrigation and provincial development projects. Such sums had been expended in accordance with the amounts earmarked as per the Budget 2007 and had been temporarily financed through Bank borrowings, Treasury bills and Treasury bonds.

Of the Rs. 56 billion (US$ 500 million) bond proceeds, approximately Rs. 20 billion was used to settle Bank borrowings,which were used for financing infrastructure projects during the first ten months of the year. and another Rs. 8 billion was used for the retirement of Treasury bills. A further sum of Rs. 6 billion was utilized to settle payments falling due in November 2007 in relation to the above stated ongoing infrastructure projects. As a prudential debt management strategy, the Government has also utilized the balance sum of approximately Rs. 22 billion to reduce the Treasury bill stock, in order to gain the advantage of the interest rate differential while having the option of issuing Treasury bills as and when funds are required to meet the future funding requirements of the infrastructure projects.

Accordingly, the bond issue did not increase the overall debt burden above the desirable level, as it was used to settle more expensive domestic debt that was raised to finance infrastructure during the year. It also helped improve the stability of both interest rates and exchange rates.

Future Direction

With Sri Lanka's limited access to concessionary foreign financing in the future, international sovereign bonds will be an important debt instrument to mobilize foreign funds in the international markets. As short-term maturity would lead to bunching of loan repayments and increase the external vulnerability, it would be prudent to issue future sovereign bonds with longer maturity periods. This, in turn, would warrant maintaining sound macroeconomic fundamentals to contain the yield at a reasonable level.