Chapter 6

FISCAL POLICY AND GOVERNMENT FINANCE

6. 1 Overview

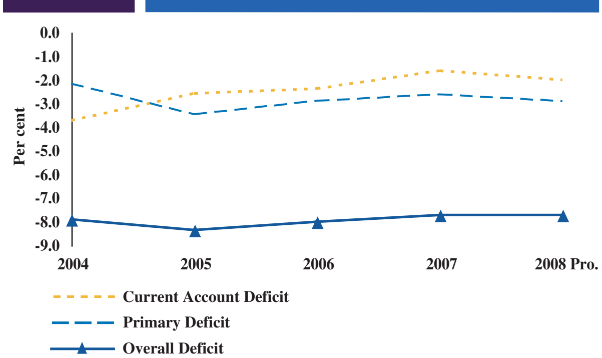
The fiscal policy strategy in Budget 2008 focused on achieving the targets stipulated in the *Medium Term Macro Fiscal Framework (MTMFF): 2008-2011*, presented along with the budget. The MTMFF has been prepared based on the overall development strategy of the government enunciated in the *"Ten Year Horizon Development Framework: 2006-2016" (Ten-year Vision)*, which aims at achieving a higher level of economic and social development. Accordingly, a number of policies were introduced with the objective of increasing revenue and rationalising recurrent expenditure to generate a surplus in the current account, while enhancing public investment to stimulate private sector economic activities.

However, achieving the targets in Budget 2008 was challenging due to several subsequent developments in the external and domestic fronts. Externally, the high international prices of petroleum, fertiliser and essential commodities that prevailed until about end July 2008 continued to pose challenges as in the previous year. More importantly, the global financial crisis, which intensified since mid-September 2008, resulted in a slowdown of economic activities leading to significant revenue shortfalls, outflow of foreign investments in government securities and virtual drying up of expected foreign commercial borrowings for budgetary financing, thereby posing serious challenges to fiscal operations. Allocating funds for intensified war against terrorism, expediting the resettlement, rehabilitation and reconstruction activities in the Eastern Province and the areas liberated in the

Northern Province and high interest expenditure on account of high interest rates that prevailed due to high inflation were among the key challenges in the domestic front. These developments led to deviate the fiscal consolidation path from the originally targeted levels, particularly during the fourth quarter of the year, thereby significantly changing the final fiscal outcome in 2008.

In the midst of the above challenges, the fiscal sector recorded a mixed performance in 2008. Fiscal performance during the first nine months in 2008 was broadly consistent with the targets, although there were deviations in some areas. The total revenue continued to increase at a relatively high rate of 22 per cent, while the total expenditure and net lending increased by 20 per cent. A fairly satisfactory financing mix was maintained between domestic and foreign financing and the government continued to repay the borrowings from the banking sector, particularly to the Central Bank, until September 2008. However, with the deepening global financial crisis gradually affecting the economic activities, this trend was reversed. Consequently, the revenue collection of 2008 ended up at a level significantly below the target, recording 14.9 per cent of GDP compared to 15.8 per cent in the previous year. The recurrent expenditure declined to 16.9 per cent of GDP, although, in nominal terms, it increased over the budgetary estimates. The public investment was maintained at 6.0 per cent of GDP, reflecting a marginal decline from 6.4 per cent in the previous year. However, it was considerably below the expected level mainly due to the issues in providing counterpart funds as a result of the

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



non-availability of foreign commercial borrowings and revenue shortfall during the latter part of the year, which led the government to prioritise the public investment programme. As a combined outcome of these developments, the overall budget deficit remained at 7.7 per cent of GDP as in the previous year compared to the original target of 7.0 per cent.

The financing mix of the overall budget deficit in 2008 reflected a significant change compared to the targets in the original Budget. The shortfall in the revenue collection, overrun in the recurrent expenditure, non-receipt of the expected foreign commercial borrowings in the wake of the global financial crisis, and the withdrawal of the foreign investments in Treasury bills and bonds led the government to rely more on domestic financing, particularly from the banking system, to finance the budget deficit. Accordingly, net financing from domestic sources increased to Rs. 310 billion from Rs. 155 billion expected in the original budget. Out of this, borrowings from the banking sector amounted to Rs. 195 billion compared to the budgetary target of Rs. 9 billion, of which about 73 per cent or Rs. 143 billion was borrowed during the fourth quarter of 2008. The total net foreign financing in 2008 amounted to Rs. 26.6 billion. Meanwhile, the government outstanding debt to GDP ratio continued to decline to 81.1 per cent from 85 per cent in 2007 mainly reflecting the higher growth of nominal GDP than the growth in nominal debt in 2008.

The meeting of targets in Budget 2009 will also be a challenging task, particularly in the midst of the continuing global financial crisis and the need for accelerating the rehabilitation and reconstruction activities in the Northern and Eastern Provinces. Any further deceleration in economic activities would lower the expected revenue collection in 2009. The potential developments as a result of the effects of the global financial crisis during the course of the year may necessitate the government to adopt decisive and properly conceived responses to provide strong demand impetus through additional fiscal policy measures to mitigate the negative effects of the crisis on the Sri Lankan economy. In such a scenario, given the limited fiscal

Table 6.1 Summary of Government Fiscal Operations

Item	2007	2008 Approved Estimates	2008 Provisional	2009 Approved Estimates
	Rs million			
Total revenue	565,051	750,741	655,259	854,999
Tax revenue	508,947	677,259	585,621	779,138
Non tax revenue	56,104	73,482	69,639	75,861
Expenditure and lending minus repayments	841,604	1,044,188	996,126	1,191,671
Current	622,758	712,894	743,710	823,511
Capital and net lending	218,846	331,294	252,416	368,161
o/w Public investment	229,274	335,672	263,860	370,765
Current account surplus(+)/deficit(-)	-57,706	37,847	-88,450	31,487
Primary account surplus(+)/deficit(-)	-93,871	-83,622	-128,391	-86,234
Overall deficit	-276,552	-293,447	-340,866	-336,672
Total financing	276,552	293,447	340,866	336,672
Foreign financing	131,415	138,645	26,579	153,547
Foreign loans (a)	100,907	109,895	-4,643	123,019
Foreign grants	30,508	28,750	31,222	30,528
Domestic financing	127,737	154,802	310,042	183,125
Market borrowings	127,077	154,802	309,669	183,125
Non bank	111,308	145,802	114,436	165,625
Bank	15,769	9,000	195,233	17,500
Monetary Authority	-13,098	-	118,403	-
Commercial banks	28,867	-	76,830	-
Non-market borrowings	660	-	373	-
Payments to be made	17,400	-	4,245	-
	As a per cent of GDP			
Total revenue	15.8	18.0	14.9	16.4
Tax revenue	14.2	16.2	13.3	14.9
Non tax revenue	1.6	1.8	1.6	1.5
Expenditure and lending minus repayments	23.5	25.0	22.6	22.8
Current	17.4	17.1	16.9	15.8
Capital and net lending	6.1	7.9	5.7	7.1
o/w Public investment	6.4	8.0	6.0	7.1
Current account surplus(+)/deficit(-)	-1.6	0.9	-2.0	0.6
Primary account surplus(+)/deficit(-)	-2.6	-2.0	-2.9	-1.7
Overall deficit	-7.7	-7.0	-7.7	-6.5
Total financing	7.7	7.0	7.7	6.5
Foreign financing	3.7	3.3	0.6	2.9
Foreign loans (a)	2.8	2.6	-0.1	2.4
Foreign grants	0.9	0.7	0.7	0.6
Domestic financing	3.6	3.7	7.0	3.5
Market borrowings	3.6	3.7	7.0	3.5
Non bank	3.1	3.5	2.6	3.2
Bank	0.4	0.2	4.4	0.3
Monetary Authority	-0.4	-	2.7	-
Commercial banks	0.8	-	1.7	-
Non-market borrowings	...	-	...	-
Payments to be made	0.5	-	0.1	-

(a) Includes rupee denominated Treasury bonds and Treasury bills issued to foreign investors.

Source : Ministry of Finance and Planning

space, it is vital to ensure that such measures are well targeted, temporary and contribute to stimulate economic activities without creating a significant fiscal slippage. The enhanced requirement of the funds for rehabilitation and reconstruction activities in the Northern and Eastern provinces will also have to be met given its importance. Therefore, taking effective measures to minimise the revenue shortfall and to create room in the recurrent expenditure to the maximum possible extent are important components of the overall strategy to face these challenges. As such, the fiscal operations of the government in this crucial period of time have to be directed towards minimising the adverse ramifications emanating from the financial crisis. Once these issues are dissipated, the government will be able to switch into the normal medium term fiscal consolidation path, announced along with Budget 2009.

6.2 Fiscal Policy Direction and Measures

The fiscal policy was formulated to achieve the targets stipulated in the medium term fiscal strategy in the MTMFF presented along with Budget 2008 and the overall policy strategy enunciated in the *Ten-year Vision.* Accordingly, measures were introduced to enhance revenue collection and to rationalise recurrent expenditure while giving the priority to fast-track the implementation of the public investment programme. Subsequent measures were also introduced to mitigate the implications of the global financial crisis.

Several measures were introduced by the government to enhance revenue collection. These included the measures for broadening the tax base, changing the tax rates while providing some exemptions as development initiatives for specific areas, and improving tax administration. Rationalisation of income taxes, Value Added Tax (VAT) system and import duties, changing excise duty rates and increasing the Ports and Airports Development Levy (PAL) were among the major revisions introduced on the revenue front. In addition, necessary legal provisions were adopted before the commencement of new revenue measures and as a result, the legislation related to all the revenue proposals in the Budget 2008 and most of the proposals made in Budget 2009 were in place when those measures became effective.

Rationalisation of income taxes was made through a number of measures. These included actions taken to broaden the income tax base and to improve tax administration while extending concessions and providing provision for exemptions for specific development activities to support economic growth. Accordingly, granting of tax holidays under the Board of Investment (BOI) Law and the Inland Revenue Act was revised, Economic Service Charge (ESC) was increased for sales of liquor and motor vehicles and ESC was limited to 0.25 per cent on the companies whose turnover comprises of foreign exchange earnings.

The VAT system was rationalised by introducing several changes. Granting exemptions for certain items, such as financial services provided by Co-operative Societies and import or supply of yarn for textile industry, reducing VAT on importation of raw materials and machinery for strategic projects, supply of goods and services by Co-operative Societies, machinery imported for development programmes under *"Neganahira Navodaya"* and supply of locally manufactured rice products, and dairy products made out of milk produced in Sri Lanka, were among them. Furthermore, the VAT law was amended to allow input credit claims only within a period of 12 months from the transaction date and the VAT rate on import or supply of petrol was reduced. The VAT rates applicable on selected imported goods were revised from time to time after considering price changes of the respective items in the international market.

A number of measures were implemented to rationalise the customs duty and excise taxes. These included imposing of a Special Commodity Levy (SCL) on eleven essential food items in place of the various taxes on them such as customs duty, VAT, PAL, Social Responsibility Levy (SRL) and other charges applicable at the customs point, increasing surcharge applicable on customs duty, removing the duty waiver granted on importation of petrol, palm oil and coconut oil, suspending the scheme on granting duty concessions for the importation of motor vehicles for public officers and increasing excise tax on cigarettes and liquor.

Several other tax revenue measures were also introduced. Regional Infrastructure Development Levy (RIDL), SRL, and stamp duty on renewal of licence fee on liquor were increased. Cess rates on selected items were increased while Cess was imposed on several new items. The Cellular Mobile Phone Subscribers Levy was extended to cover cordless phones.

Further improvement of the tax administration was attempted through the introduction of measures to improve the efficiency and effectiveness of key revenue agencies i.e., Inland Revenue Department (IRD) and Sri Lanka Customs (SLC). The measures taken by the IRD included commencement of the Revenue Administration Management Information System (RAMIS) replacing the obsolete software system used in the department for a long period, providing formal training to new recruits to develop their skills, especially in field auditing and supervising, introducing an e-filing system to enable tax payers to access the required VAT forms online, and conducting regional level awareness programmes to improve the tax compliance. Further, IRD also took measures to set up an Advisory Unit to provide necessary guidance for companies in the area of book-keeping, a separate unit at regional offices to provide guidance/advice to taxpayers, and a separate Corporate Unit to pay more attention on the compilation of revenue of the companies located outside the Colombo district. Some of the measures introduced by SLC to improve the efficiency and the effectiveness of its overall revenue collection process included regularising the appeal process, introducing a separate core valuation function to improve valuation process to reduce malpractices and ensuring standardised valuation of goods, facilitating the establishment of databases such as RAMIS within SLC, and centralising the security (guarantee) management system.

The Fiscal Management Reform Programme (FMRP) continued in 2008 with the objective of modernising Sri Lanka's revenue administration and improving fiscal management process. The FMRP focused mainly on providing the required training for employees at IRD, SLC, Department of Excise, Finance Commission and other departments under the Ministry of Finance and Planning (MOFP) as it has been identified that the attitudes of employees are important in achieving revenue targets of the government. Accordingly, a significant number of employees in those institutions were provided with foreign and local training. Preparation of detailed process maps for all the taxes, introduction of a Risk

Based Audit Selection Methodology, introduction of a Performance Management Process with incentives and rewards, and expediting e-filing of VAT returns were among the initiatives introduced within the IRD under the FMRP project. In addition, the Rolling Strategic Plan and the Action Plan, which are being implemented in the IRD, were also prepared under this project.

The government introduced several measures to rationalise recurrent expenditure. Accordingly, guidelines were issued to Ministries to curtail recurrent expenditure, retail prices of petroleum products were adjusted to reflect the cost, administered prices, such as electricity tariff, rail fares and passenger bus fares, were revised upwards in line with increased input costs and recruitments were limited only to specific categories, such as technical categories and security forces. Furthermore, the leave encashment facility granted to public servants, was terminated in 2008. The government introduced measures to cut down the recurrent expenditure on selected goods and services with a view of dealing with challenges emanating from the global financial crisis. Accordingly, the spending agencies were advised, in November 2008, to freeze all supplies and services which were not committed, and not to create any additional commitments on recurrent expenditure, and to defer incurring of all other recurrent expenditures.

The government granted the Cost of Living Allowance (COLA) of Rs. 375.00 and Rs. 187.50, which were due in January and July, for government employees and pensioners, respectively. An additional payment of Rs. 625 was also granted in July 2008 but it was limited only to the public officers whose monthly salary was less than Rs. 22,000. A significant number of graduates, registered with *Tharuna Aruna* programme, were offered with appointments in the public service at provincial level.

The resettlement of Internally Displaced Persons (IDPs) in the newly liberated areas continued with a greater emphasis. The IDPs, especially from Mannar, Kilinochchi and Mullaitivu districts were provided with basic needs and livelihoods. Programmes were also continued to resettle IDPs in the Eastern Province under the *Nagenahira Navodaya* programme while obtaining support from various domestic and international agencies.

Priority was given to provide more resources towards accelerating the public investment programme to achieve a regionally balanced economic development. Accordingly, emphasis was placed on implementation of major infrastructure development projects at national level where a significant progress was made on the development of highways, bridges and flyovers, ports and power projects. In addition, large-scale water supply schemes and sewerage systems in urban areas and improvement of public transport facilities were launched while multi-purpose mega irrigation projects such as Moragahakanda and Deduru Oya schemes were also continued. The government continued to improve provincial and rural infrastructure, through *Maga Neguma* and *Gama Neguma* projects. Meanwhile, necessary guidelines and instructions were issued to spending agencies in order to improve the effective implementation of development projects to ensure better public expenditure management.

The development activities in the Eastern Province were accelerated in order to facilitate to unleash its potential, which was hindered for a long period of time due to the decades long conflict. Accordingly, several infrastructure development projects were in progress directly under the Ministry of Nation Building and Estate Infrastructure Development under the *Neganahira Navodaya* programme, co-ordinated by other line Ministries. In the context of development activities in the Eastern Province, particularly in the areas of resettlement, economic infrastructure and social infrastructure, the government has incurred Rs.103 billion during the 2006-2008 period. Further, various incentives were also granted by the government with a view of attracting investment to the Eastern Province as well as to other lagging regions. The government has also announced that a similar programme called "*Vadakkin Wasantham*" (Florishing North) will be implemented once the

Northern Province is also liberated from the clutches of terrorism (See Box 2).

The Strategic Enterprise Management Agency (SEMA) continued its activities during the year to facilitate the State Owned Enterprises to improve their performance. In the banking cluster, performance evaluation of banks was monitored continuously based on the Key Performance Indicators on a quarterly basis. The Plantation Cluster helped to increase the profitability of several plantations with new strategic management initiatives while providing technical assistance to the National Livestock Development Board to implement an embryo transplant project. The Transport and Logistics cluster obtained Cabinet approval for a property development initiative and a fibre optic communication backbone initiative to change the revenue model in the Sri Lanka Railways (SLR) with the assistance of SEMA. Further, the National Council for Economic Development continued to meet as a forum for consultations and deliberations on key economic policies, and providing policy guidelines on economic matters.

During the year, several measures were introduced to improve the government debt management process. Accordingly, measures were taken to ease the bunching problem in the Treasury bill programme and to smoothen the maturity structure by increasing the issuance of longer maturity bills. The Treasury bill market was opened up to foreign investors as well in May 2008, which allowed them to invest in Treasury bills up to a maximum limit of 10 per cent of the outstanding stock with a view of broadening the investor base and to lower the pressure on the domestic market interest rates. Meanwhile, the policy of re-opening the existing Treasury bond series was continued thereby limiting the introduction of new bond series to the market to address the high fragmentation of the domestic debt market and to reduce the complexity in the issuance of Treasury bonds. However, it was not possible to address the issue of bunching of Treasury bond maturities effectively through the market mechanism as expected under the government debt management strategy, which was formulated in 2007, and to extend the yield curve to the expected period due to the macroeconomic conditions that prevailed in 2008. Further, the licensed commercial banks were permitted, in the secondary market, to purchase the international sovereign bond of the government, which was issued in October 2007, to enhance the liquidity of that sovereign bond.

Towards the end of 2008, the government announced a proactive economic stimulus package with the objective of easing the impact on the economy from the global financial crisis. This package includes some specific measures aimed at providing relief particularly to industrialists, and plantation and tourism sectors that undergo difficulties in the backdrop of the intensified global financial crisis. In addition, a reduction of the domestic prices of petroleum products and LP gas, in line with the declining international prices, was also included in this stimulus package. The total cost to the government to implement this package in 2009 is estimated at Rs. 16 billion, which will increase the planned recurrent expenditure of the Budget 2009 by this amount.

Meanwhile, the lack of financial viability in several State Trading Enterprises (STEs) continued to be a strain on the government budget. Sri Lanka Transport Board (SLTB), SLR and the Department of Posts (DOP), the three major STEs in the country, continued to operate with huge operating losses. The railway fares, which were increased in June 2008 to compensate for the steep increase in international oil prices was reduced in December 2008 in line with the declined domestic fuel prices. However, the net impact of these changes was not sufficient to recover its operational losses and therefore, the financial position of SLR weakened further. In the meantime, government took steps to strengthen the rolling stock position of SLR. Although passenger bus fares were increased in May 2008, it was not sufficient to cover the escalated cost in SLTB. However, with the reduction in domestic petroleum prices, passenger bus fares were also reduced. SLTB continued to report high operating losses, broadening the government budget deficit through increased current transfers. However, the government commenced a programme to improve the service delivery of SLTB in the medium term. The DOP also 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 to these STEs in 2008 to continue their operations.

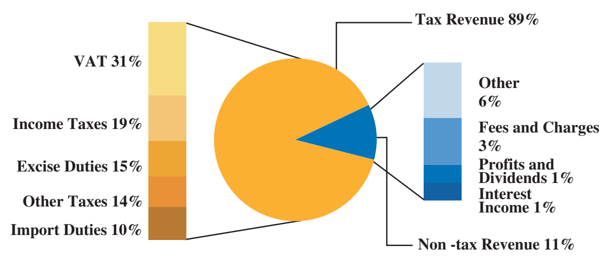
The financial performance of the key State Owned Enterprises (SOEs); Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB), continued to remain as a serious concern. In 2008, the CPC made an operating loss. The operation of the CPC as a commercially viable institution has been largely threatened by non–realisation of outstanding bills from several government institutions, in particular the CEB. Meanwhile, the financial position of the CEB weakened further in 2008 with its increased operating losses. The increase in operating losses was mainly attributable to the increased expenditure as a result of the high petroleum prices during the first half of 2008 and the insufficient adjustment of electricity tariff. The fragility of the financial position of the CEB was manifested in its accumulated short-term borrowings from banks, outstanding liabilities to the CPC and to Independent Power Producers (IPPs), and government continued to service CEB's long-term loans having a direct impact on the budget. This highlights the urgent need of rectifying financial management of these institutions with appropriate rational pricing policy in place. In the meantime, the Parliament has passed the new Sri Lanka Electricity Bill, which would help improving operational efficiency and regulatory aspects of the electricity sector.

6.3 Government Budgetary Operations

Revenue

Total government revenue in 2008 increased by 16 per cent to Rs. 655.3 billion from Rs. 565 billion in 2007. The tax revenue increased by 15 per cent and non-tax revenue increased by 24 per cent. However, the total revenue collection

Chart 6.2 Composition of Government Revenue - 2008



in 2008 was Rs.95 billion below the original target of Rs.751 billion mainly due to the sharp drop in the revenue from international trade related taxes, especially due to the lower quantity and value of vehicle imports and the slowdown in domestic economic activities, particularly during the latter part of 2008. As a per cent of GDP, total government revenue in 2008 declined to 14.9 per cent from 15.8 per cent recorded in 2007. Of the total revenue, 89 per cent was from tax revenue while the balance 11 per cent was from the non-tax revenue.

The increase in total revenue was mainly driven by the relatively high growth of 18 per cent recorded in the revenue from income taxes. The enhanced revenue collection from the personal and corporate income taxes, ESC and withholding tax on interest earnings in line with the policy and administrative measures taken to broaden the tax base and to strengthen the legal framework were mainly attributed for this improvement.

The revenue from VAT increased by a lower rate of 9 per cent in 2008 over the previous year. This slower growth was mainly attributed to the impact of granting VAT exemptions for development activities and to selected thrust industries to promote them, reduction of VAT on petrol, removal of VAT on selected essential goods coming under SCL to curtail cost of living, decline in the liquor and cigarette sales, decline in motor vehicle imports, continuation of a concessionary duty scheme for importation of motor vehicles for public officers and comparatively less import prices and import volume, particularly during the fourth quarter of 2008. However, the improvements in tax administration and higher performance in the telecommunications and financial

Table 6.2 Economic Classification of Revenue

Item	2007	2008 Approved Estimates	2008 Provisional	2009 Approved Estimates
	Rs million			
Tax revenue	**508,947**	**677,259**	**585,621**	**779,138**
Income taxes	107,169	143,291	126,541	166,703
VAT	187,452	248,670	203,646	221,947
Excise tax	96,675	113,639	89,903	134,965
Import duties	55,986	73,436	63,844	90,592
Other taxes	61,665	98,223	101,687	164,931
Non tax revenue	**56,104**	**73,482**	**69,639**	**75,861**
Total revenue	**565,051**	**750,741**	**655,259**	**854,999**
	As a per cent of GDP			
Tax revenue	**14.2**	**16.2**	**13.3**	**14.9**
Income taxes	3.0	3.4	2.9	3.2
GST/VAT	5.2	6.0	4.6	4.3
Excise tax	2.7	2.7	2.0	2.6
Import duties	1.6	1.8	1.4	1.7
Other taxes	1.7	2.4	2.3	3.2
Non tax revenue	**1.6**	**1.8**	**1.6**	**1.5**
Total revenue	**15.8**	**18.0**	**14.9**	**16.4**

Source : Ministry of Finance and Planning

sector coupled with the limitations on VAT input tax credit partly offset the revenue loss due to above measures.

The revenue from excise duties in 2008 declined by 7 per cent compared to the previous year. The decline in vehicle imports, duty concessions granted for public officers to import motor vehicles, downward trend of cigarette sales and drop in liquor sales were mainly attributable for this shortfall. However, the increase in excise duty rates on liquor, higher growth in the sale of beer and upward rate revision of some categories of cigarettes helped partly recoup the revenue loss. Meanwhile, the revenue from the excise duty on petroleum imports recorded a marginal increase while the revenue from excise duty on the local petroleum sales declined by about 10 per cent.

In 2008, the revenue from import duties registered a 14 per cent increase over the previous year. This increase was achieved despite duty waivers granted for several commodities, removal of import duty on items coming under SCL, decline in motor vehicle imports, continuation of concessionary duty scheme for public officers to import vehicles until April 2008, placement of most of the tariff lines at lower customs duty rates under free trade agreements with India and Pakistan and impact of the global financial crisis on the imports during the latter part of the year. The increase in the surcharge on imports applicable to a number of imported items also helped increase the revenue from customs duty to a certain extent.

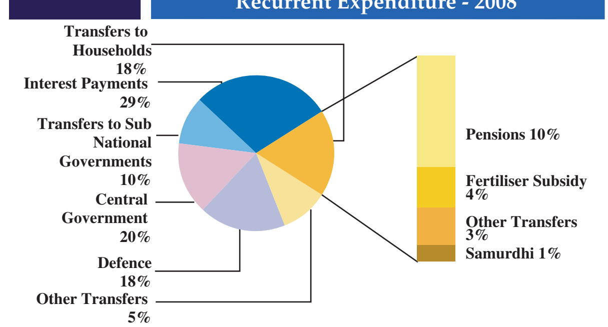
Tax revenue from other sources, such as PAL, Cess Levy and SCL, was also increased in 2008. This was mainly attributable to the curtailing of duty free concessions at the duty free shops, increased Cess rates and imposition of Cesses on several new items. In addition, increases in RIDL, debit tax and PAL also contributed for the growth in the revenue from other taxes.

The 24 per cent increase recorded in the non-tax revenue was a combined outcome of several factors. The increase in fees and charges, which represents a greater part of the non-tax revenue, and increase in rent income were the major factors of this performance. Further, the profit transfers of Rs. 8 billion from the Central Bank also contributed to the increase in the non-tax revenue collection. However, the revenue from profits and dividends recorded a decline compared to the previous year.

Expenditure and Net Lending

In 2008, total expenditure and net lending increased by 18 per cent to Rs. 996 billion. It was below the budgetary target of Rs. 1,044 billion by Rs. 45 billion mainly due to the lower than expected capital expenditure. As a per cent of GDP, total expenditure and net lending amounted to 22.6 per cent, which was lower than 23.5 per cent recorded in 2007.

Chart 6.3 Composition of Government Recurrent Expenditure - 2008



Total recurrent expenditure in 2008 exceeded the budgetary target but continued to decline as a per cent of GDP. In nominal terms, recurrent expenditure increased by 17.8 per cent to Rs.744 billion, which was higher than the budgeted target by Rs. 31 billion despite the efforts to reduce the recurrent expenditure. However, as a per cent of GDP, recurrent expenditure declined to 16.9 per cent from 17.4 per cent in the previous year.

The increase in recurrent expenditure, in nominal terms, was mainly due to the increase in expenditure on salaries and wages, pension payments, interest payments, fertiliser subsidy, and counter terrorism activities. During the year, expenditure on salaries and wages increased by 12 per cent to Rs. 239 billion mainly due to the new recruitments to the public service including the police and security forces and to the provincial government services, increase of COLA to public servants of lower grades and revision of allowances for public officers particularly to those attached to the health sector and judiciary. The termination of the payment in lieu of leave not availed by public officers with effect from January 2008 reduced the burden to a certain extent. Meanwhile, the share of salaries and wages in the total recurrent expenditure declined to 32.1 per cent compared with 34.4 per cent recorded in 2007. The increase in pension payments by 9 per cent was mainly due to the increase in COLA to pensioners and the impact of the entry of 4,783 new pensioners in 2008. The interest payments increased by 16 per cent to Rs. 212.5 billion mainly due to the high domestic interest rates. The defence expenditure, including the salaries and wages to defence personnel, showed a considerable increase mainly due to the new recruitments to the armed forces, increase in fuel expenditure and the expenditure on other goods and services related to defence activities.

The current transfers and subsidies increased by 16 per cent in 2008. Out of which, transfers to public corporations increased by 22 per cent mainly due to the increase in transfers to SLR and DOP. The current transfers to institutions also increased by 3 per cent. Meanwhile, the expenditure on fertiliser subsidy was more t han doubled to Rs. 26 billion compared to 2007 owing to high international fertiliser prices prevailed during the first half of 2008. The expenditure on other welfare programmes also increased by 10 per cent in 2008 with the introduction of rice subsidy for the plantation sector, continuation of Kerosene subsidy for Samurdhi beneficiaries, enhancement of the coverage of the School Nutritional Food Programme, increase in the number of students who obtained the bursaries and grade 5 scholarships, and the higher expenditure related to IDPs, mainly for the provision of basic needs and livelihoods, and resettlement.

Table 6.3 Economic Classification of Expenditure and Lending Minus Repayment

Item	2007	2008 Approved Estimates	2008 Provi-sional	2009 Approved Estimates
	Rs million			
Current expenditure	**622,758**	**712,894**	**743,710**	**823,511**
Expenditure on goods and services	292,632	343,852	360,327	378,554
o/w Salaries and wages	214,160	233,393	239,078	268,356
Interest payments	182,681	209,825	212,475	250,438
Foreign	21,311	30,000	30,277	32,000
Domestic	161,370	179,825	182,198	218,438
Current transfers and subsidies	147,445	159,217	170,908	194,519
o/w To households and other sectors	110,910	121,546	131,342	149,062
Samurdhi	9,200	10,850	9,995	10,850
Pensions	68,822	73,060	74,920	86,000
Fertiliser subsidy	11,000	15,000	26,450	25,000
Other	21,888	22,636	19,977	27,212
Capital expenditure	**206,161**	**282,894**	**232,607**	**312,383**
Acquisition of real assets	111,510	199,905	128,946	212,513
Capital transfers	94,651	108,075	103,661	170,941
Provision for under expenditure	-	-25,085	-	-71,071
Lending minus repayment	**12,684**	**48,400**	**19,809**	**55,778**
Total expenditure and net lending	**841,604**	**1,044,188**	**996,125**	**1,191,671**
	As a per cent of GDP			
Current expenditure	**17.4**	**17.1**	**16.9**	**15.8**
Expenditure on goods and services	8.2	8.2	8.2	7.3
o/w Salaries and wages	6.0	5.6	5.4	5.1
Interest payments	5.1	5.0	4.8	4.8
Foreign	0.6	0.7	0.7	0.6
Domestic	4.5	4.3	4.1	4.2
Current transfers and subsidies	4.1	3.8	3.9	3.7
o/w To households and other sectors	3.1	2.9	3.0	2.9
Samurdhi	0.3	0.3	0.2	0.2
Pensions	1.9	1.7	1.7	1.6
Fertiliser subsidy	0.3	0.4	0.6	0.5
Other	0.6	0.5	0.5	0.5
Capital expenditure	**5.8**	**6.8**	**5.3**	**6.0**
Acquisition of real assets	3.1	4.8	2.9	4.1
Capital transfers	2.6	2.6	2.4	3.3
Under expenditure	-	-0.6	-	-1.4
Lending minus repayment	**0.4**	**1.2**	**0.4**	**1.1**
Total expenditure and net lending	**23.5**	**25.0**	**22.6**	**22.8**

Source: Ministry of Finance and Planning

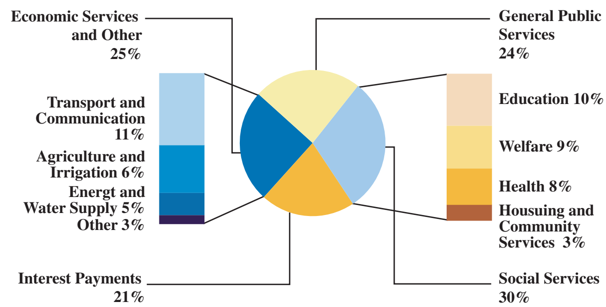
Public investment, in nominal terms, increased by 15 per cent to Rs. 264 billion in 2008. This increase was mainly due to the continuation of several major infrastructure development projects as well as provincial and rural infrastructure developments through *Gama Neguma* (Village Development), *Maga Neguma* (Road Development), *Gami Diriya,* Southern Province Rural Economic Advancement Project (Southern REAP), rehabilitation of minor irrigation projects and projects implemented by Provincial Councils. However, the performance was considerably below the expectations mainly due to the lower inflow of foreign financing and the shortfall in the government revenue, which necessitated the prioritisation of the projects and the disbursement of funds. Nevertheless, the public investment as a per cent of GDP was maintained at 6.0 per cent, which was below the 6.4 per cent recorded in the previous year.

Table 6.4 Functional Classification of Expenditure

Item	2007	2008 Approved Estimates	2008 Provi-sional	2009 Approved Estimates
	Rs million			
Total current expenditure	**622,758**	**712,894**	**743,710**	**823,511**
General public services	162,102	179,548	207,348	218,598
Civil administration	31,481	38,719	36,150	43,213
Defence	101,856	108,086	134,710	134,260
Public order and safety	28,765	32,743	36,487	41,125
Social services	226,271	245,494	240,768	266,168
Education	72,592	78,476	77,141	81,827
Health	51,741	56,537	55,874	60,726
Welfare	91,747	97,315	94,789	109,878
Community services	10,191	13,166	12,963	13,736
Economic services	49,573	60,559	80,303	84,148
Agriculture and irrigation	22,849	28,177	41,579	41,566
Energy and water supply	3,647	3,872	3,323	4,154
Transport and communucation	18,983	22,306	29,587	30,065
Other	4,094	6,204	5,814	8,363
Other	184,812	227,293	215,291	254,597
o/w Interest payment	182,681	209,825	212,475	250,438
Capital expenditure and lending	**229,273**	**335,672**	**263,860**	**370,765**
General public services	32,143	40,088	34,404	39,693
Civil administration	28,438	34,612	29,675	36,685
Public order and safety	3,705	5,476	4,728	3,008
Social services	54,986	75,835	60,236	97,738
Education	19,948	31,207	22,942	36,269
Health	16,961	23,309	18,674	25,953
Housing	4,481	7,190	4,826	9,659
Community services	13,596	14,129	13,794	25,857
Economic services	141,244	244,075	168,879	304,054
Agriculture and irrigation	14,736	26,156	17,681	34,255
Energy and water supply	47,850	79,201	48,783	80,326
Transport and communucation	50,995	100,170	82,916	148,934
Other	27,663	38,548	19,499	40,539
Other	900	760	341	350
Under expenditure	-	-25,085	-	-71,071
Total expenditure and lending	**852,031**	**1,048,565**	**1,007,569**	**1,194,276**
As a per cent of GDP				
General public services	5.4	5.3	5.5	5.0
Social services	7.9	7.7	6.8	7.0
Economic services	5.3	7.3	5.6	7.4
Other	5.2	5.5	4.9	4.9
o/w interest payments	5.1	5.0	4.8	4.8
Total expenditure and lending	**23.8**	**25.1**	**22.8**	**22.9**

Source : Ministry of Finance and Planning

Chart 6.4 Total Expenditure by Functions - 2008



Public investment in economic services continued to increase in 2008 due to the implementation of projects mainly, in the areas of transportation, communication, energy and water supply (See Box 8). The expenditure on these areas increased by 22 per cent to Rs. 169 billion over the previous year. Meanwhile, public investment in social services increased by 9.5 per cent from Rs. 55 billion to Rs.60 billion giving high priority to health and education sectors with a view of promoting human resource base in the country. Accordingly, the investment in education was directed towards upgrading infrastructure, eradicating inequality among primary schools and developing IT knowledge among students. Public investment in the health sector was mainly directed towards improving access to health care, focusing vulnerable people, particularly in the lagging regions, through improvement of estate hospitals, while developing health infrastructure and facilities.

Key Fiscal Balances

The overall budget deficit in 2008 remained at 7.7 per cent of GDP (Rs. 340.9 billion) as recorded in the previous year. However, this was significantly above the 7.0 per cent of GDP expected in the original budget. The significant shortfall in the government revenue and overrun in the recurrent expenditure more than the decline in capital expenditure and net lending during the year were the main reasons for this increase. The current

Box 8

Public Investment Programme: Progress, Issues and Way Forward

The government's economic policy strategy announced in the 'Ten Year Horizon Development Framework: 2006-2016' (Ten-year Vision) envisages the achievement of a sustainable broad-based economic growth of 6-8 per cent in the medium term, thereby raising the living standards of the people to a higher level. The projected growth requires a total investment of 30-33 per cent of GDP in the medium term, including a public investment of around 6-8 per cent of GDP[1]. Having identified the need for increasing the public investment to achieve the expected higher economic growth, the government announced a comprehensive public investment programme in 2007 titled *'Randora'*, the national infrastructure development programme, aimed at providing modern infrastructure to promote nationwide economic development.

Implementation Progress

Under the *Randora* programme, a sum of Rs. 1,636 billion is expected to be invested in various projects during the ten year period at national and regional levels. These projects could be broadly categorised into two sectors, i.e., Economic services and Social services.

The Economic services such as transport, energy, water supply, agriculture and irrigation projects have been accorded the highest priority by allocating 85.2 per cent (Rs. 1,367 billion) of the total estimated investment. Of this, about 62 per cent (Rs. 845 billion) has been allocated for the development of the transport sector. The construction of highways and flyovers under this programme will contribute significantly to the reduction of travel time and fuel wastage, while minimising traffic congestion in and around Colombo and other metropolitan areas. The construction and rehabilitation of inter-connectivity roads and rural roads will improve the living standards of the rural masses. Meanwhile, several port construction, development and expansion projects have been undertaken aiming at becoming a leading navigational, trading and commercial hub in South Asia.

About 29 per cent (Rs. 396 billion) of the total investment of Economic services has been allocated to the energy and water supply sectors, for the next 10 years under the *Randora* Programme. Accordingly, the government aims to provide a reliable and sustainable supply of electricity to the entire population at the least cost with necessary environmental safeguards. Since access to safe drinking water and adequate sanitation facilities is a universal need and a basic human right, the government has targeted to improve further the current status of access to safe drinking water which remains at 78 per cent of total population in 2008.

Social services sector has been allocated 14.4 per cent (Rs. 232 billion) of the total investment in the *Randora* Programme, consisting mainly of health, education and housing. The government has prioritised the need for investing in people by increasing access to education and the quality of education in the entire country. The health policy of the government envisages building a healthier human resource, preserving the free health service and safeguarding the rights of every citizen ensuring that they receive respective benefits. In addition, the government has initiated the construction of houses for selected needy communities such as the armed forces, Tsunami affected families, Internally Displaced Persons (IDPs), estate workers, urban under-served families and the fishing community. Details of the selected mega infrastructure development projects are given in Table B 8.1.

[1] In the long-term, the Ten-year Vision expects an economic growth of 8-10 per cent, which would need an annual total investment of 33-36 per cent of GDP.

Table B 8.1
Selected Mega Infrastructure Development Projects in Sri Lanka

Project	Total Estimated Cost (Rs. million)	Source of Funding	Expected Year of Completion	Remarks
Southern Expressway	67,195	ADB & JBIC	2011	Construction of a 128 km highway with 4 lanes and 11 flyovers from Kottawa to Matara. **Approximately 50 per cent of project has been completed.**
Hambantota Port	42,212	EXIM Bank of China	2011	Construction of a breakwater with 1 km length, two berths, an approach channel and a harbour basin that is dredged upto 16 m. **The construction of the cofferdam and the half of the construction of breakwater has been completed.**
Upper Kotmale Hydropower Project	38,219	JBIC	2011	Establishment of a low cost hydro power plant holding a capacity of 150 MW. **Construction is in progrees.**
Coal Power Project - Norochcholai	51,550	EXIM Bank of China	2011	Adding 300 MW to the national grid in the first stage and 600 MW in the second and the third stages. **Construction of foundation of the power plant has commenced.**
Colombo Port Expansion	85,910	ADB	2012	Construction of a new harbour basin area of 285 hectares with 570 metre wide approach channel, a new large breakwater, a new small breakwater and three container terminals. **Construction of the large breakwater has commenced.**
Coal Power Plant - Trincomalee	60,000	Joint Venture – India & Sri Lanka	2012	Construction of a 500 MW coal power plant generating electricity at low cost. **Location has been identified.**
Jaffna Water Supply Scheme	11,800	ADB	2012	Construction of a water treatment plant and a storage reservoir to provide safe drinking water to about 250,000 residents in the Jaffna Peninsula. **Feasibility study completed.**
Colombo-Katunayake Expressway	27,000	EXIM Bank of China	2012	Construction of a 25 km, four lane expressway from Colombo to Katunayake Airport with 5 flyovers. **Land acquisition and major utility shifting works are in progress.**
Southern International Airport	19,250	Domestic Funds & PPP	2013	Construction of a 4 km runway and an aircraft parking apron etc. **Surveying work is in progress.**
Moragahakanda and Kalu Ganga Development	48,950	JBIC & Kuwait	2013	Increase cultivation lands by 3,000 ha, provide domestic and industrial water to Matale, Anuradhapura, Trincomalee and Polonnaruwa Districts, etc. **Preliminary works such as, land acquisition and construction of infrastructure facilities for displaced persons are in progress.**
Kalpitiya Tourist Zone	15,000	Investment Potential	2013	Construction of 3,000 rooms of 4 to 5 star class facilities, a world class yacht-marina and a underwater world etc. **Preliminary works for land acquisition are in progress.**
Greater Dambulla Development	39,000	Domestic Funds and Investment Potential	2016	Development of town centres, industrial parks and an administrative complex at Dambulla. **Construction of administrative complex (Phase I) has been completed.**

Source: Ministry of Finance and Planning

Financial Progress : 2005-2008

Total public investment as a per cent of GDP remained around 6 per cent during the 2005 -2008 period (Table B 8.2), which is relatively a satisfactory performance compared to the lower level of 4.5-5.0 per cent of GDP recorded during the 2002-2004 period. Maintaining public investment at this level is appreciable given the various fiscal constraints and the thin fiscal space available to the government. However, in order to sustain the growth momentum and supplement and facilitate private investments and reach the desired level of economic growth, public investment needs to be increased further. It is encouraging that during the period 2006-2008, the public investment in economic services has significantly increased, especially in the transport sector. Investments in energy and water supply sectors recorded the highest increase, while the investment in education also recorded a considerable growth. Of the total public investment, the inve stment in regional development through Provincial Councils has also increased since 2005 by 77.6 per cent to Rs. 24.6 billion in 2008.

Table B 8.2
Progress of Public Investment Programme: 2005 - 2008

Item	2005	2006	2007	2008 Provisional
Rs. billion				
Total Public Investment	148.6	177.4	229.3	263.9
o/w Economic services	77.5	106.8	141.2	168.9
o /w Transport and communication	31.8	38.0	51.0	82.9
Energy and water supply	19.2	26.4	47.9	48.8
Agriculture and irrigation	10.0	12.6	14.7	17.7
Social services	36.0	48.4	55.0	60.2
o /w Education	12.9	17.2	19.9	22.9
Health	10.7	14.0	17.0	18.7
Housing	3.7	4.0	4.5	4.8
As a per cent of GDP				
Total Public Investment	6.3	6.0	6.4	6.0
o/w Economic services	3.3	3.6	3.9	3.8
Social services	1.5	1.6	1.5	1.4

Source: Ministry of Finance and Planning

Issues and Way Forward

Despite the encouraging achievements in the public investment programme in the recent past due to renewed efforts of the government, several issues remain to be addressed to expedite the implementation process. These include issues relating to land acquisition, high cost of compensation and settlement, capacity limitations of contractors, administrative and procurement delays, delays in releasing the domestic counterpart funds, weak evaluation and monitoring systems etc. Therefore, there is a need for strengthening the monitoring system of the implementation process to complete the planned infrastructure projects within the stipulated periods to reduce cost escalations and to achieve the expected benefits.

The possible slow-down in the expected foreign commercial financing to implement the infrastructure projects as a result of the global financial crisis would be the major challenge in achiving the expected progress in the public investment programme. This requires making every effort to disburse the already committed concessional financing from bilateral and multilateral development partners.

In order to continue with the resettlement, rehabilitation and reconstruction work in the Northern province, and the continued rapid development of the Eastern province, expenditure in large quantums will have to be incurred, particularly under programmes such as '*Vadakkin Wasantham*' (Florisihing North) and '*Nagenahira Navodaya*' (Eastern Revival). This will be an important area of intensifying the revival of economic activities in these two provinces.

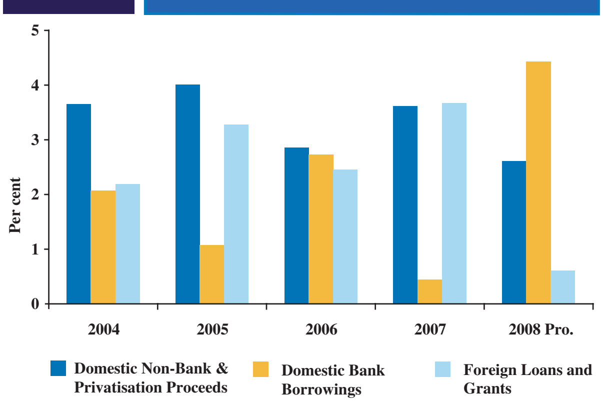
The introduction and promotion of other alternative methods to finance infrastructure projects is also another important area to be considered. In this context, the public-private partnerships (PPPs) would be encouraged in infrastructure development, which would help to reduce the burden on the government budget to a considerable extent.

account deficit, which indicates the government's dis-savings, increased to 2.0 per cent of GDP compared to 1.6 per cent recorded in 2007 and the surplus of 0.9 per cent expected in the original budget. The primary deficit, which is the overall deficit net of interest payments, increased to 2.9 per cent of GDP from 2.6 per cent recorded in 2007 and the 2.0 per cent expected in the original budget. The higher growth in the non-interest recurrent expenditure, which outpaced the growth in revenue was the main reason for the higher primary deficit.

Financing the Budget Deficit

The overall budget deficit of Rs. 340.9 billion was largely financed through domestic resources, as the net inflow of foreign resources decelerated significantly in 2008. Total Net Domestic Financing (NDF) was Rs. 310.0 billion compared to the original estimate of Rs. 154.8 billion and to the corresponding amount of Rs. 127.7 billion recorded in 2007. Total Net Foreign Financing (NFF) was only Rs.26.6 billion, against its original estimate of Rs 138.6 billion and the Rs. 131.4 billion recorded in the previous year. As a percentage of GDP also, NDF in 2008 increased significantly to 7.0 per cent from 3.6 per cent in 2007 while there was a considerable decline of NFF to 0.6 per cent from 3.7 per cent recorded in the previous year and 3.3 per cent expected in the original budget. The debt dependency ratio, which is measured as the ratio of net borrowings relative to the total government expenditure, increased to 31 per cent in 2008 from 29.2 per cent in 2007.

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



The net inflow of foreign resources to finance the budget deficit was significantly lower in 2008 and contributed only to finance 8 per cent of the total resource gap in the final budget outturn. The global financial crisis, which was intensified during the later part of the year, resulted in a net outflow of foreign investments in Treasury bills and Treasury bonds and did not permit the government to mobilise expected foreign commercial borrowings. These reasons, coupled with the increased borrowing requirement due to lower revenue collection and overrun in the recurrent expenditure, necessitated the government to shift the borrowing programme more towards domestic financing. In addition, the relatively slow progress in the public investment programme due to the prioritisation of projects as a result of the lack of counterpart funds also affected the deceleration of the disbursement of foreign concessional financing. Accordingly, total gross foreign concessional borrowings amounted only to Rs. 98.5 billion compared to Rs. 137 billion in 2007. Gross foreign commercial borrowings amounted only to Rs. 16.2 billion (US dollars 150 million). During the year, the outflows of foreign investment in Treasury bonds amounted to Rs. 32.5 billion (US dollars 300.5 million). Meanwhile, the amount of foreign grants received in 2008 continued to be relatively high at Rs. 30.3 billion (US dollars 280 million) despite the stressed international financial conditions.

In financing the deficit, about 91 per cent of the overall budget deficit or Rs. 310 billion

Table 6.5 **Sources of Domestic Financing**

Rs billion

Item	2005	2006	2007	2008 Provisional
By Instrument	**123.6**	**163.8**	**127.7**	**310.0**
Treasury bonds (a)	108.1	97.4	52.8	192.4
Treasury bills (b)	-9.4	20.3	37.1	69.8
Rupee loans	-24.2	-23.8	10.3	-1.5
Sri Lanka Development Bonds	0.0	34.3	23.6	65.5
Central Bank provisional advances	4.9	9.3	11.7	15.6
Other	44.2	26.3	-7.8	-31.8
By Source	**123.6**	**163.8**	**127.7**	**310.0**
Bank	26.2	80.0	15.8	195.2
Non Bank	97.4	83.8	112.0	114.8

(a) Excludes rupee denominated Treasury bonds issued to foreign investors in 2007 and 2008.
(b) Excludes rupee denominated Treasury bills issued to foreign investors in 2008.

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

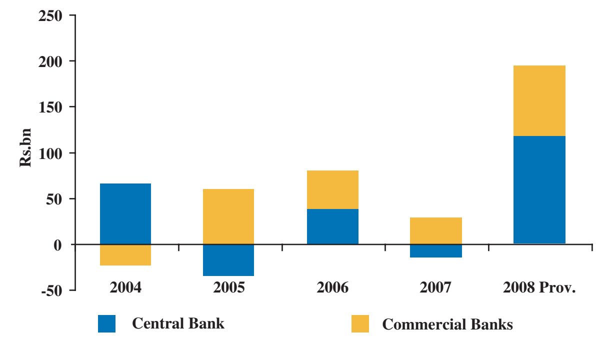
was raised through domestic sources in 2008, compared to 46 per cent recorded in the previous year. Of the total NDF, the share of non-bank sector borrowings declined to 37 per cent in 2008 compared with 88 per cent recorded in 2007 as the limited resources available in the non-bank sector necessitated the government to borrow more from the banking system. The Employees' Provident Fund (EPF) and National Savings Bank (NSB) continued to be the major institutional investors in the non-bank sector.

Government borrowings from the banking system increased significantly to Rs. 195 billion (including the valuation impact of exchange rate variation) in 2008. In contrast, the bank financing in the original estimate for 2008 was Rs. 9 billion while that in 2007 was Rs. 15.8 billion. The bank financing accounted to 63 per cent of the total NDF against 12 per cent recorded in 2007. Total net borrowings from the banking system in 2008 comprised of Rs.118.4 billion from the Central Bank and Rs. 76.8 billion from commercial banks.

Majority of the NDF was made through instrument based borrowings in 2008. Net borrowings through debt instruments increased to Rs. 326.2 billion from Rs.123.8 billion in the previous year. This consisted of borrowings from Treasury bonds (Rs. 192.4 billion), Treasury bills (Rs. 69.8 billion), SLDBs (Rs.65.5 billion) and a repayment (Rs. 1.5 billion) of Rupee loans. The maturity structure of the instrument based borrowings was more towards the short and medium end of the structure. As the domestic interest rates were relatively high during 2008, in line with high inflation experienced since 2007, the government had to issue debt instruments for such maturity periods rather than issuing them for a longer-term. There was a repayment of Rs.16.2 billion in the total net domestic non-instrument borrowings.

The foreign currency denominated domestic borrowings of the government for budgetary financing increased by Rs. 8.1 billion (US dollars 74.9 million) in 2008. During the year, the gross borrowings from Offshore Banking Units (OBUs) amounted to US dollars 75 million while there was a repayment of US dollars 608.5 million including the conversion of US dollars 593 million worth of borrowings from OBUs into SLDBs. Consequently, there was a net repayment of US dollars 533.5 million to OBUs. In addition, some of the maturing loans of OBUs were rolled over. Total net borrowings through SLDBs in 2008 was US dollars 608.4 million. This consisted of gross borrowings of US dollars 928 million, including the SLDBs worth US dollars 593 million issued to convert borrowings from OBUs and the repayments of US dollars 320 million.

Chart 6.6 Sources of Bank Financing



The gross receipt of foreign loans for budgetary financing declined in 2008 mainly due to the non-receipt of expected foreign commercial borrowings. Total disbursed gross foreign loans amounted to Rs. 129.6 billion (US dollars 1,197 million) in 2008 compared to Rs. 193.7 billion (US dollars 1,751 million) in the previous year. Major lenders of project loans continued to be Japan, International Development Association (IDA) and Asian Development Bank (ADB) accounting for 25 per cent, 9 per cent and 23 per cent of the total project loans, respectively. The total disbursements of foreign loans included a foreign commercial loan of Rs. 16.2 billion (US dollars 150 million), and gross foreign investment in Treasury bills and Treasury bonds of Rs. 15 billion (US dollars 138.2 million) in 2008.

Total NFF was considerably low in 2008. Out of the total deficit financing, the share of NFF declined significantly to 12 per cent from 47 per cent in the previous year. Total NFF of Rs. 26.6 billion in 2008 comprised of Rs.12.9 billion of net foreign loans, net borrowings of Rs. 5.9 billion through foreign investments in Treasury bills, net repayments of Rs. 23.5 billion to foreign investors in Treasury bonds and Rs. 31.2 billion of foreign grants.

The amount of foreign grants received in 2008 indicated a continuation of the trend that prevailed in the recent past. As in the previous years, foreign grants received were 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.

6.4 Budgetary Operations in Sub National Governments

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. The LG system in the country constitutes of 330 institutions comprising 18 Municipal Councils (MCs), 42 Urban Councils (UCs) and 270 Pradesheeya Sabhas (PSs) as at end 2008.

The activities of SNGs continued with resources obtained mainly from two sources; their own revenue and transfers received from the central government. 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. The resultant gap between the revenue and expenditure makes these institutions heavily dependent on financial transfers from the central government. However, with the enhanced efforts, the revenue of PCs has been increased considerably in 2008, which is an encouraging development.

Several other structural limitations also continued to constrain the effective performance of PCs thereby limiting their contribution to overall development. The higher share of recurrent expenditures, which account to about 81 per cent of provincial expenditures resulting in only 19 per cent being available for capital investments, has significantly limited their capacity to improve the quantity and quality of the services provided. In addition, the limited financial space has made the financing of provincial services essentially a maintenance oriented exercise and hence, lacks in orientation towards quantity and quality.

The duplication of the work by the central government and PCs, especially with respect to providing basic education, healthcare and road facilities, have also become an important area to be addressed. In this context, there is a need to identify the provincial needs and central government allocations for those provinces properly to avoid duplications and overlapping of activities with regard to projects and programmes undertaken by the central government and PCs to ensure that sectoral allocations are distributed appropriately. This requires better coordination of development activities at rural and provincial levels, which will be addressed through the setting up of a Presidential Task Force as proposed in Budget 2009.

Ministry of Local Government and Provincial Councils (MLGPC) continued to monitor the activities in SNGs in 2008. The MLGPC continued to provide budgetary funds to the provinces and functioned as a centre between the government and the SNGs and worked with the aim of ensuring the efficient and effective utilisation of such funds. During the year, MLGPC also engaged in improving the administrative capacity and capabilities of SNGs, increasing investment at SNG level for the development of provincial and rural roads and activities related to the development of the Northern and Eastern provinces.

The Finance Commission continued its operations with a close dialogue with PCs and other stakeholders with the objective of achieving a balanced regional development. The Finance Commission is mainly responsible in recommending apportionment of available resources among PCs, through the national budget to achieve this objective. During the year, the

Finance Commission, through a Special Committee, evaluated a number of project proposals submitted by PCs to be implemented towards achieving a balanced regional development. In order to reap the expected outcome of reducing regional economic disparity gradually, there is a need to continue with this pro-active role of Finance Commission in association with other stakeholders.

Performance of Provincial Councils

The overall budgetary performance of PCs in 2008 indicated some improvement compared to the previous year. The total revenue collection of PCs increased by 21 per cent to Rs. 31 billion in 2008 from Rs. 26 billion in 2007. Total expenditure of PCs in 2008 was Rs.127.8 billion, which was a 13 per cent increase over the previous year.

The higher revenue collection from turnover taxes and licence fees mainly attributed to the increase in total revenue of PCs. Due to the centralisation of most of the commercial activities in the Western Province, the Western Provincial Council (WPC) continued to be the major contributor to the revenue collection of PCs. However, total revenue collection of WPC amounted to 64 per cent of the total revenue collection of PCs in 2008 compared with 66 per cent in 2007. This decline in the share partly indicates the improvement of the revenue collection by other provinces. Southern, Central and North Western provinces continued to be the other larger contributors to the revenue in 2008.

Table 6.6 Budget Outturn for Provincial Councils

Rs million

Item	2005	2006	2007	2008 Provisional
Total revenue	**16,132**	**19,481**	**25,868**	**31,370**
Tax Revenue	13,818	16,586	21,473	25,994
Non-Tax Revenue	2,314	2,895	4,395	5,376
Total expenditure	**73,009**	**94,470**	**113,067**	**127,848**
Current expenditure	59,132	76,428	92,721	103,199
o/w Personal emoluments	46,479	60,497	74,711	79,878
Capital expenditure	13,877	18,042	20,346	24,649
Central government transfers	**59,696**	**79,029**	**88,317**	**88,942**
Block grants	47,107	62,342	70,742	76,773
Criteria based grants	817	790	1,208	2,304
Matching grants	273	221	205	-
PSDGs (a)	5,561	7,345	6,995	7,262
Foreign grants for special projects	5,937	8,331	9,167	2,603

(a) Province Specific Development Grants

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

Recurrent expenditure of provincial councils increased by 11 per cent in 2008 compared to the previous year. The increase in recurrent expenditure was mainly due to increased personnel emoluments which contributed to 77 per cent of total recurrent expenditure. The education and health sectors absorbed a major portion of the personal emoluments of PCs. The balance was used for other non-wage expenses in relation to purchase of goods and services.

The investment programme of PCs mainly consisted of Province Specific Development Projects (PSDP) and foreign funded special projects. The total investment expenditure in 2008, in nominal terms, increased by 21 per cent to Rs. 24.6 billion.

In 2008, the central government transfers to PCs amounted to Rs. 88.9 billion. These transfers were in the form of block grants, criteria based grants, Province Specific Development Grants (PSDG) and foreign grants for special projects.

Performance of Local Governments

LGs continued their operations as important institutions of governance in the country affecting the lives of people at grassroot level in the midst of a number of constraints that affected their effective functioning. The devolved revenue and transfers from the central government were the major sources of finance for their operations. 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.

In order to improve the operations of LGs further, a number of issues need to be addressed. These include the human resources development, upgrading the planning skills in local authorities, proper directing of networks and procedures, better coordination at the grass-root and Provincial levels and enhancing revenue generation to make local authorities more self-sustaining. In addition, there is a need to introduce programmes to reduce the distance between public and the local authorities further and to increase people's participation in management and development activities by LGs.

6.5 Government Debt and Debt Service Payments

Government Debt

The total outstanding government debt increased by 18 per cent to Rs. 3,578 billion in 2008, but as a per cent of GDP, it declined to 81.1 per cent from 85.0 per cent in the previous year, benefiting from the higher growth in nominal GDP. The decline of the debt to GDP ratio in 2008 recorded the sixth consecutive annual decline from the peak of 105.6 per cent recorded in 2002. The total debt consisted of 60 per cent of domestic debt (Rs. 2,129.3 billion) and 40 per cent of foreign debt (Rs. 1,448.7 billion). As a per cent of GDP, domestic debt was 48.3 per cent and foreign debt was 32.8 per cent. The corresponding ratios in the previous year were 47.9 per cent and 37.1 per cent, respectively.

The higher reliance on domestic borrowings in financing the budget deficit resulted in a significant increase of the domestic debt by Rs. 414 billion to Rs. 2,129 billion in 2008. Of the total domestic debt, the share of medium to long-term

Table 6.7 Outstanding Government Debt (as at end year)

Rs. million

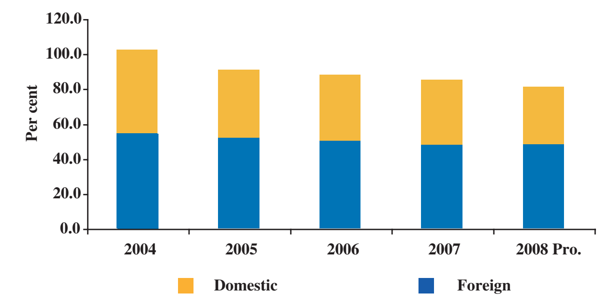
Item	2005	2006	2007	2008 Provisional
Total Government Debt	**2,222,341**	**2,582,648**	**3,041,685**	**3,578,064**
Domestic Debt (a)	**1,265,721**	**1,479,230**	**1,715,198**	**2,129,331**
By maturity period				
Short term	262,153	313,218	363,198	505,468
Medium and long term	1,003,568	1,166,012	1,351,999	1,623,863
By institution				
Banks (b)	298,411	395,470	415,318	646,527
Non bank sector	967,310	1,083,660	1,299,779	1,482,703
Foreign debt	**956,620**	**1,103,418**	**1,326,487**	**1,448,734**
By type				
Concessional loans	919,430	1,023,077	1,099,911	1,227,222
Non concessional loans	37,190	80,341	226,576	221,511
By currency				
SDR	401,615	465,679	508,241	531,849
US dollars	161,632	185,647	266,645	280,435
Japanese yen	286,673	317,220	338,621	445,596
Euro	76,060	98,312	121,460	132,047
Other	30,640	36,560	91,520	58,806
Memo: Exchange rate variation	-100,751	108,579	71,646	117,785

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.

(b) Includes outstanding balance to OBUs; Rs.71,859 million at end 2005, Rs.89,288 million at end 2006 , Rs.88,871 million at end 2007 and Rs. 3,060 million as at end 2008.

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

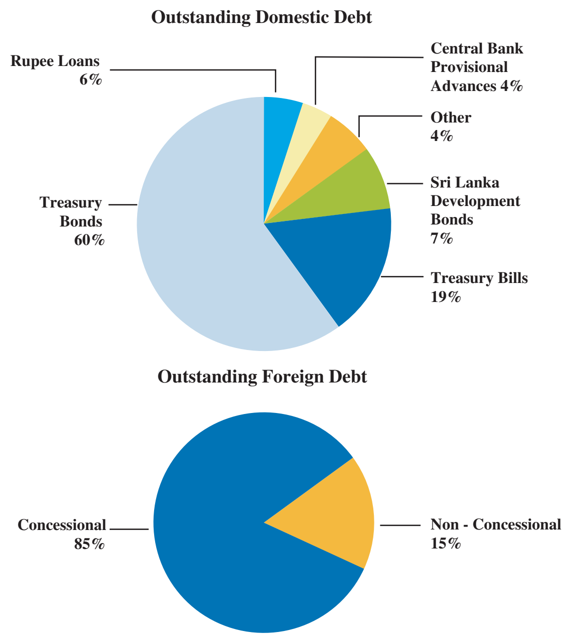


debt declined to 76 per cent in 2008, compared to 79 per cent in the previous year. Treasury bonds continued to be the principal instrument in the outstanding domestic debt accounting for 79 per cent of the total medium to long-term domestic debt and 60 per cent of the total outstanding domestic debt. As the Rupee securities were not issued and there was a repayment during the year in line with the policy of gradually phasing out non-marketable debt instruments, the share of Rupee securities in the medium to long-term domestic debt further declined to 8 per cent from 10 per cent in the previous year. The outstanding amount of Treasury bills, which is the major instrument of short term domestic borrowings, increased by Rs. 95.6 billion during 2008. However, within the short-term debt, the share of Treasury bills declined to 80 per cent compared to 85 per cent in 2007 mainly due to the sharp increase in the share of government overdraft with state banks within this category.

Meanwhile, the outstanding debt held by t he non-bank sector increased by Rs. 114 billion to Rs. 1,482.7 billion in 2008. The EPF and NSB continued to be the major investors in this group representing 46 per cent and 14 per cent of the total outstanding debt held by the non-bank sector, respectively.

Reflecting the higher borrowings from the banking system for budgetary financing in 2008, the outstanding debt liabilities to the domestic banking sector increased significantly by Rs. 231.2 billion to Rs. 646.5 billion. In comparison, it was increased only by Rs. 19.8 billion during the previous year. The share of the banking system liabilities to total domestic outstanding debt also increased to 30 per cent compared to 24 per cent in 2007. The outstanding domestic debt owned

Chart 6.8 **Composition of Outstanding Government Debt - 2008**



by the Central Bank increased by Rs. 134 billion to Rs. 239.2 billion while the share of commercial banks increased by Rs. 97 billion to Rs. 407.3 billion. Of the total outstanding debt of the commercial banks, the outstanding amount of foreign currency denominated domestic debt increased to US dollars 1,686.2 million from US dollars 1,659.2 million in 2007. This consisted of borrowings from OBUs of US dollars 282.5 million and outstanding SLDBs of US dollars 1,403.6 million. The growth in foreign currency denominated domestic debt in recent years increased the vulnerability of the domestic debt stock to exchange rate variations.

During 2008, the total outstanding foreign debt increased by 10 per cent to Rs. 1,448.7 billion. However, as a percentage of GDP, total outstanding foreign debt declined further to 32.8 per cent from 37.1 per cent in 2007. The share of concessional debt of the total foreign debt increased to 85 per cent while that of non-concessional debt declined to 15 per cent as the government repaid a significant part of the commercial borrowings. About 74 per cent of the total non-concessional debt consisted of foreign commercial debt. Meanwhile, the share of project loans of the total foreign debt increased to 87 per cent in 2008 from 82 per cent in 2007.

The outstanding foreign debt, in 2008, composed of four major currencies; Special Drawing Rights (SDR) (37 per cent), Japanese yen (31 per cent), US dollars (19 per cent) and Euro (9 per cent). The balance 4 per cent consisted of other currencies. In 2008, the Sri Lankan Rupee depreciated against the US dollar, SDR and Japanese yen by 3.9 per cent , 1.5 per cent and 22.4 per cent, respectively, while it appreciated against Euro by 0.5 per cent. The impact of the exchange rate variations in 2008 was an increase in the Rupee value of the outstanding foreign debt by Rs. 117.8 billion.

Despite the steady decline observed in the outstanding debt to GDP ratio in the recent past, strong efforts are necessary to continue with this trend to achieve the targeted level stipulated in the Fiscal Management (Responsibility) Act (FMRA). Under the FMRA, the debt to GDP ratio has to be reduced to 60 per cent by 2013. The fiscal performance in 2009 in the midst of global financial crisis is likely to experience lower than planned amount of foreign borrowings due to the tight liquidity conditions in the international financial markets. Hence, in facing the challenges emanating from the financial crisis, efforts have to be made to avoid significant undue deviations in the recurrent expenditure, budget deficit and borrowings. Once the pressures of the financial crisis are eased, it is necessary to switch into the normal fiscal consolidation path, which has already been announced by the government in its policy documents. In addition, being an emerging middle income country, Sri Lanka will have to face the challenge of accessing foreign concessional loans in the years to come. Therefore, there is a need to promote alternative project financing methods, such as Public Private Partnerships (PPPs), to reduce the burden on the government budget.

Debt Service Payments

Total debt service payments of the government, which include the amortisation and interest payments to domestic and foreign creditors, increased by 17 per cent to Rs. 592.8 billion in 2008. Total amortisation payments amounted to

Rs. 380.3 billion amounting to 64 per cent of the total debt service payments. Total interest payments of Rs. 212.5 billion represented the balance 36 per cent. Debt service payments to domestic sources stood at Rs. 440.9 billion while that for foreign sources was increased to Rs. 151.9 billion in 2008 mainly due to increased repayments of foreign commercial loans. Total amortisation payments to domestic sources were below the estimated level in the Budget 2008 as a part of the maturing foreign currency denominated domestic loans was rolled over during the year. Total debt service payments in 2008 included a part of the debt repayments, which was postponed under the voluntary debt moratorium received in 2005 from the development partners, and the repayment of defence loans, which had been obtained under deferred conditions.

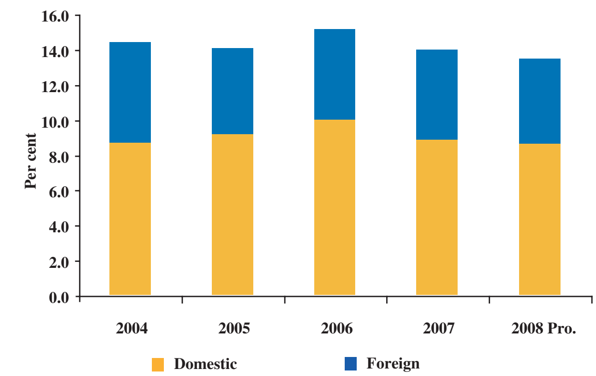
In 2008, some debt service indicators continued to show an improving trend. Accordingly, the total debt service payments as a per cent of GDP declined further to 13.4 per cent from 14 per cent in the previous year. Total interest payments as a per cent of GDP also declined to 4.8 per cent from 5.1 per cent

Table 6.8 Government Debt Service Payments

Item	2005	2006	2007	2008 Provisional	2009 Estimates
					Rs. million
Debt service payments	344,866	444,303	500,514	592,804	725,438
Domestic	316,511	381,324	415,089	440,918	593,938
Foreign	28,355	62,979	85,425	151,886	131,500
Amortisation payments	224,707	293,525	317,833	380,330	475,000
Domestic	203,347	247,536	253,719	258,720	375,500
Foreign	21,360	45,989	64,114	121,609	99,500
Interest payments	120,159	150,778	182,681	212,475	250,438
Domestic	113,164	133,788	161,370	182,198	218,438
Short term	20,300	24,558	53,874	65,364	89,246
Medium and long term	92,864	109,230	107,496	116,834	129,192
Foreign	6,995	16,990	21,311	30,277	32,000

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

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



in 2007. Meanwhile, the ratio of total foreign debt to export of goods and services increased to 131.9 per cent in 2008 from 127.4 per cent in the previous year mainly due to the relatively slower growth of earnings from export of goods and services in 2008.

Table 6.9 Government Debt Indicators

Indicator	2005	2006	2007	2008 Provisional	2009 Estimates(a)
Government Debt/GDP	90.6	87.9	85.0	81.1	77.1
-Domesitc Debt/GDP	51.6	50.3	47.9	48.3	45.6
-Foreign Debt/GDP	39.0	37.5	37.1	32.8	31.5
Total Foreign Debt/Exports (b)	120.6	124.6	127.4	131.9	153.4
Total Debt Service/GDP	14.1	15.1	14.0	13.4	13.9
Total Debt Service/ Government Revenue (c)	90.8	93.0	88.6	90.5	84.8
o/w Domestic Debt Service/ Government Revenue (c)	83.3	79.8	73.5	67.3	69.5
Total Debt Service/Government Expenditure (d)	42.6	44.1	43.2	43.1	43.5
o/w Domestic Debt Service/ Government Expenditure (d)	39.1	37.9	35.8	32.0	35.6
Foreign Debt Service/Exports (b)	3.6	7.1	8.2	13.8	12.3
Total Interest/GDP	4.9	5.1	5.1	4.8	4.8
Domestic Interest/GDP	4.6	4.6	4.5	4.1	4.2
Domestic Interest/Government Current Expenditure	25.5	24.4	25.9	24.5	26.5
Foreign Interest/Exports (b)	0.9	1.9	2.0	2.8	3.0

(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
Ministry of Finance and Planning