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FISCAL POLICY AND GOVERNMENT FINANCE

Budgetary operations of the government showed a mixed performance during the first eight months of 2018 as reflected by improvements to some key fiscal balances amidst a significant drop in revenue collection. The revenue to GDP ratio declined to 8.6 per cent during this period from 9.0 per cent in the corresponding period of 2017 due to lower tax revenue collection, particularly from import duties and the Cess levy. Total expenditure and net lending as a percentage of estimated GDP also declined to 12.1 per cent during the first eight months of 2018, in comparison to 13.0 per cent in the same period of 2017, due to a reduction in both recurrent expenditure and public investment. Recurrent expenditure as a percentage of GDP declined mainly on account of lower expenditure outlays on subsidies, transfers, and salaries and wages. Public investment also reduced due to the slowdown in the implementation of infrastructure projects. The slowdown in expenditure is reflected in improvements to key fiscal indicators despite the weaker revenue mobilisation. Accordingly, the overall budget deficit declined to 3.5 per cent of the estimated GDP during the first eight months of 2018 from 4.0 per cent in the corresponding period of 2017, as the reduction in government expenditure was higher than the decline in government revenue. The primary account, which reflects the difference between revenue and non interest expenditure, recorded a surplus of 0.4 per cent of estimated GDP (Rs. 57.6 billion) during the period under review. Meanwhile, the primary balance target - Quantitative Performance Criteria (QPC) set under the Extended Fund Facility of the International Monetary Fund (IMF-EFF) for June 2018, was also achieved by the government. However, the current account deficit, which reflects the difference between revenue and recurrent expenditure, increased to 1.0 per cent of the estimated GDP during the first eight months of 2018 from 0.9 per cent in the corresponding period of 2017, indicating the government's dis-saving position. In financing the overall budget deficit, the government relied largely on foreign sources. In domestic financing, net borrowings from the banking sector recorded a net repayment during this period, while financing from the non banking sector increased significantly. Although improved performance was seen in some fiscal indicators during the first eight months of the year, it will be challenging to achieve fiscal targets stipulated in the 2018 Budget, unless proactive measures are taken to maintain the envisaged trajectory. The lower revenue collection from import duties and the Cess levy, together with delays in the implementation of some revenue enhancement measures such as amendments to the Finance Act, could lead to significant deviations in revenue collection compared to the stipulated revenue targets. On the expenditure front, the decline in public investment would negatively affect economic growth and development in the country. Accordingly, the government's strong commitment towards achieving the envisaged fiscal path is paramount ahead of election cycles, as imbalances in the fiscal sector may adversely affect overall macroeconomic stability of the country.

Fiscal Policy Measures

- **The government continued its revenue based fiscal consolidation path in 2018 which envisages to reduce the budget deficit to 3.5 per cent of GDP and the outstanding government debt to 70.0 per cent of GDP over the medium term.** In line with these medium term objectives, the government has taken several policy measures to enhance the revenue mobilisation and to rationalise government expenditure, while ensuring debt sustainability. The Budget 2018 proposed a number of revenue measures aimed at simplifying the existing tax system and broadening the tax base while introducing reforms to tax administration, some of which came into effect during the first eight months of 2018. In addition, measures were also taken to prioritise and rationalise government expenditure while introducing quarterly fiscal targets to keep expenditure on track. Among others, legislative measures such as the Active Liability Management Act (ALMA) No. 8 of 2018 were also introduced to improve and strengthen debt management strategies in the medium term. In moving towards such medium term targets, the government in its Budget 2018 announced a steady reduction in the deficit to 4.8 per cent of GDP from 5.5 per cent in 2017. In line with this improvement, it was also expected to maintain the current account surplus at 0.5 per cent of GDP and primary account surplus at 1.0 per cent of GDP by end 2018.

- **The Inland Revenue Act No. 24 of 2017, which came into effect from 01 April 2018, supported the revenue mobilisation effort of the government by simplifying and rationalising the existing income tax structure, broadening the direct tax base and strengthening the administrative powers, while introducing international best practices to the Sri Lankan tax system.** For employment income, the annual tax free threshold was increased to Rs. 1.2 million from Rs. 750,000 although the tax free threshold for personal income tax was maintained at the previous level of Rs. 500,000. Further, tax slabs for personal income tax including employment income were widened by Rs. 100,000 to Rs. 600,000 brackets, while the highest marginal tax rate was increased to 24 per cent from 16 per cent. In addition, the new Act streamlined the corporate income tax structure to a three tier tax structure; a 40 per cent tax rate for liquor, tobacco, and betting and gaming; a 28 per cent standard tax rate for banking, finance, insurance and trading activities; and a 14 per cent tax rate for all other sectors. Further, a Capital Gains Tax was introduced at a rate of 10 per cent on the realisation of capital assets, while the withholding tax rate on interest earnings of resident individuals was also increased to 5 per cent from 2.5 per cent. However, bank deposits of senior citizens have been exempted from the withholding tax on interest income up to Rs. 1.5 million per annum. Meanwhile, a new tax manual was published in April 2018 and training sessions for professionals in the tax field and the general public are also being held to enhance public awareness on the new Act.

- **Several changes were made to the Customs duty and Special Commodity Levy (SCL) during the year, to stabilise domestic prices in line with international prices and domestic supply of some commodities**. Accordingly, in April 2018 a Customs duty of 15 per cent was imposed on the importation of gold, with a view to discouraging gold imports and the smuggling of gold. The Customs duty and the duty waiver on the importation of petrol and diesel were revised with the introduction of the pricing formula for fuel on 11 May 2018. Accordingly, Customs duty and duty waiver on the importation of petrol (92 Octane) stood at Rs. 25.42 per litre and Rs. 7 per litre, respectively. Similarly, for auto diesel, the Customs duty and duty waiver remained at Rs. 5.85 per litre and Rs. 2 per litre, respectively. Further, Customs duties on petrol (95 Octane) and super diesel were reduced to Rs. 25.59 per litre and Rs. 10.55 per litre, respectively with the withdrawal of applicable duty waivers. Meanwhile, a SCL was introduced on the importation of grated or powdered cheese and the SCL was increased on potatoes, b'onion, black gram and lentils during the year.

- **Several measures were initiated to improve tax administration with a view to strengthening the revenue mobilisation**. Accordingly, the Revenue Administration Management Information System (RAMIS), which is being set up at the Inland Revenue Department (IRD), is being upgraded in order to incorporate the provisions of the Inland Revenue Act No. 24 of 2017. Moreover, the IRD has also started to implement organisational and business procedure reforms to modernise the tax administration. These include; restructuring the IRD along functional lines; creating a Design and Monitoring Unit; a more efficient management structure to speed up interaction with taxpayers; strengthening the Large Taxpayer Unit; introducing mandatory e-filing; and enhancing the use of taxpayer identification numbers. Meanwhile, Sri Lanka Customs has also taken steps to establish a National Single Window (NSW) to facilitate importers and exporters. The Integrated Treasury Management Information System (ITMIS), which is being set up at the Ministry of Finance and Mass Media (MOF), contributes to modernise the Public Financial Management (PFM) in Sri Lanka. Accordingly, ITMIS is being used as the primary system for the 2019 budget preparation work and ITMIS awareness workshops were conducted island-wide, in oder to educate public officials. Further, historical data from the year 2006 to 2017 have been cleansed and migrated to the ITMIS system and ITMIS interfaces with selected government institutions have already been completed and tested.

- **In the expenditure front, several measures were introduced to minimise fiscal slippages during the year**. Accordingly, the quarterly expenditure and income outcome report for the first quarter of 2018 was presented to the Parliament as announced in the Budget for 2017, in oder to strengthen the Parliamentary control on public finances. According to this report, both revenue and expenditure outcomes in the first quarter of 2018 remained below the targeted levels. Under the State Accounts Circular No. 263/2017, all spending agencies were instructed to prepare their annual budgets on a quarterly basis for 2018 in order to ensure the systematic utilisation of annual budgetary provisions. Moreover, guidelines were issued under the National Budget Circular No. 03/2018 to streamline the motor vehicle procurement process of Ministries, Departments and other government institutions. Further, a multi-purpose database is being developed by the MOF, incorporating all information relevant to development projects, in order to be used for multi-purpose development functions of the government. This facilitates a better policy making process with accurate and up to date information, and enables the MOF to respond immediately in emergency situations such as landslides and floods.

- **While strengthening the automation process of pension payments, several other measures were introduced to improve the service delivery related to pension payments**. Under the Public Administration Circular No. 07/2018, guidelines were issued to enhance the efficiency of the pension payment process. Accordingly, instructions were given to establish a Pension Division in large institutions and to prepare a data base for all the officers who are reaching the age of retirement in all public offices, if a data base had so far not been prepared. Further, under the Pension Circular No. 09/2015 (Revision III), steps were taken to provide death gratuity payments via an online system with effect from 01 June 2018, in order to strengthen the automation process of the Department of Pensions. Moreover, arrangements have been made to introduce an online system to collect applications for the Widows'/Widowers' and Orphans' contributions, with effect from 30 June 2018. Under the Public Administration Circular No. 08/2018, a decision was taken to pay compensation to dependents of any deceased public officer, irrespective of whether the officer held a permanent and pensionable post, if the officer passed away due to diseases contracted while engaged in hazardous employment or performance of official duties.

- **The Government continued with its public investment programme during the first eight months of 2018 amidst the limited fiscal space available**. Accordingly, the government invested in road construction, rehabilitation and land acquisition during the first eight months of the year, with a view to improving the transport network of the country and mitigating traffic congestion. The multi purpose development project in Moragahakanda[1] was vested to the public in January 2018, while the filling of water in to the Kalu Ganga reservoir commenced in July 2018 with the aim of facilitating agricultural activities in the Northern, North Central, North Western, Central and Eastern Provinces. Infrastructure development in the education sector during the first eight months of 2018 was channeled towards the development of both human resources and physical infrastructure under the "Nearest School is the Best School (NSBS)" Programme while rehabilitating schools affected by floods and landslides. Meanwhile, construction of two new national schools commenced in Kurunagala and Polonnaruwa during the first eight months of the year. The National Agency for Public Private Partnerships (NAPPP) engaged in drafting an Act, while reviewing and finalising the guidelines for public private partnerships (PPPs) in consultation with the MOF, with a view to promoting PPPs as a national strategy in addressing the infrastructure requirements of the country.

- **While the government continued with its welfare programmes for the socially vulnerable groups, some measures were taken to rationalise subsidies**. The main welfare schemes in Sri Lanka include the Samurdhi programme, fertiliser subsidy, financial support for elderly over 70 years of age, support for low income disabled persons, financial support for kidney patients, nutrition food programmes, free text books and free season tickets for students. With a view to improving maternal and child nutrition, programmes such as the nutritional food package for expectant mothers, the Thriposha programme and school nutrition programmes were continued during the first eight months of the year. While continuing with its welfare benefit schemes, the Department of Samurdhi Development (DSD) is expected to establish fifty model villages in order to upgrade living standards. Accordingly, the DSD has identified suitable locations to establish the model villages as well as prioritised projects to be implemented in these model villages. The Welfare Benefits Board (WBB), which was established to provide the necessary legal framework and transparent selection process for all welfare related benefits in Sri Lanka, is expected to submit draft regulations under the Welfare Benefits Act to the Cabinet of Ministers in 2018, in order to ensure the effective implementation of the Act. Further, the integrated Social Registry Information System (SRIS)[2] is expected to be completed in 2018, while a benefit payment scheme is to be drafted initially, for the four main welfare programmes[3]. Meanwhile, a decision was taken by the Cabinet of Ministers, in March 2018, to terminate the cash grant of the fertiliser subsidy programme and replace it with the provision of fertiliser to farmers, to avoid issues that arose in implementing the cash grant policy. Accordingly, an approved amount of fertiliser is provided to farmers at a concessionary price of Rs. 500 per 50 kg bag for paddy and Rs. 1,500 per 50 kg bag in respect of other crops (potatoes, onions, capsicum, corn and soya), with effect from the Yala season in 2018.

- **Several initiatives were taken during the first eight months of 2018 to strengthen the financial position and operations of major SOBEs, in order to reduce the burden on the central government budget**. Accordingly, performance reports for the first half of 2017 of the five SOBEs[4] that had signed Statements of Corporate Intent (SCIs) in March 2017, were forwarded to the Cabinet of Ministers in May 2018. It is further expected that SCIs will be signed to

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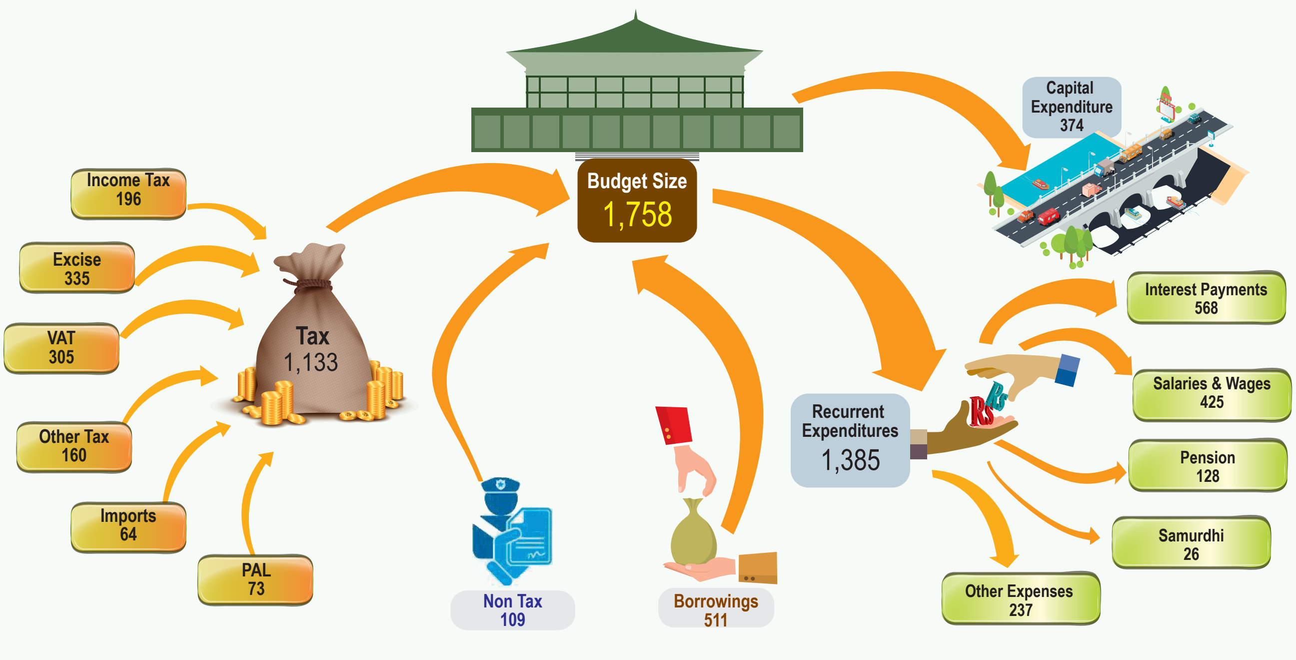
1 Moragahakanda Reservoir was renamed as the "Kulasinghe Reservoir" in July 2018 in memory of late Dr. A. N. S. Kulasinghe.

2 SRIS is an electronic data base that will store data of welfare beneficiaries of different welfare programmes mainly for the selection of and payment for welfare beneficiaries.

3 The programmes include: Samurdhi Programme, financial support for elderly over 70 years of age, support for low income disabled persons and financial support for kidney patients.

4 This includes: The Ceylon Electricity Board, Ceylon Petroleum Corporation, National Water Supply and Drainage Board (NWS&DB), Airport and Aviation Services (Sri Lanka) Ltd. and Sri Lanka Ports Authority.

Figure 6.1
Fiscal Profile Sri Lanka - 2018 January - August (Rs. Billion)



Source: Ministry of Finance and Mass Media

improve the efficiency of another ten SOBEs, namely, Urban Development Authority (UDA), State Pharmaceuticals Corporation (SPC), Sri Lanka State Plantation Corporation (SLSPC), State Timber Corporation, Milco, National Livestock Development Board (NLDB), Central Engineering Consultancy Bureau (CECB), Lanka Sathosa (Pvt) Limited, Geological Survey, Mines Bureau and Kurunagala Planatation Limited. Further, the approval of the Cabinet of Ministers was granted in May 2018 to implement the automatic fuel pricing mechanism in order to improve the financial viability of the Ceylon Petroleum Corporation (CPC), while ensuring transparency in petroleum pricing. Consequently, formula based price adjustments were in effect from May 2018 on a monthly basis to bring fuel prices back in line with cost recovery levels. Moreover, the approval of the Cabinet of Ministers is expected to be obtained for an automatic pricing mechanism for electricity by end 2018, in order to improve the financial performance and transparency of the Ceylon Electricity Board (CEB). Accordingly, a Bulk Supply Transaction Account (BSTA) was established in May 2018 as a precondition for the implementation of the automatic pricing mechanism for electricity.

- **The Active Liability Management Act (ALMA) was enacted in order to implement a prudent debt management strategy, and a Medium Term Debt Management Strategy (MTDS) is being articulated for the period 2019-2023.** Public debt management was further strengthened through ALMA No. 8 of 2018. The ALMA was passed by the Parliament in March 2018, enabling the government to manage its public debt more proactively by addressing the refinancing requirements ahead of time for ISBs, extending the maturity structure of Treasury bonds and smoothening out Treasury bond coupon payments, with a view to providing more space for managing future commercial debt liabilities and improving the underlying risk profile of the public debt stock. The MTDS is mainly focused on building an appropriate composition of debt instruments to ensure that the government budgetary needs are financed at the least possible cost while managing the risk of the debt portfolio at prudent levels.

- **The government successfully issued the 12th International Sovereign Bond (ISB) in April 2018**. This US Dollars 2.5 billion bond issue was the largest offshore bond offering ever by Sri Lanka since 2007. This issue comprised two ISBs of US dollars 1.25 billion with a 5 year maturity at a yield of 5.75 per cent and a 10 year maturity at a yield of 6.75 per cent. In addition, a Foreign Currency Term Financing Facility (FCTFF) of US dollars 1.0 billion was obtained in October 2018.

- **Sovereign credit ratings for Sri Lanka were affirmed by international sovereign rating agencies in 2018**. On 06 February 2018, Fitch affirmed Sri Lanka's long-term foreign and local currency Issuer Default Ratings (IDR) at "B+", with a "stable" outlook, highlighting improved fiscal consolidation and maintenance of a disciplined monetary stance. Moody's Investor Services also affirmed Sri Lanka's sovereign rating at "B1" and maintained the "negative" outlook on 26 July 2018. Meanwhile, Standard and Poor's (S&P) long term rating stood at "B+" with a "stable" outlook. This reflects Sri Lanka's progress in implementing the planned reform programme, which entails fiscal consolidation and a build-up of foreign exchange reserve buffers along with moderate per capita income levels and stronger institutions, relative to many similarly rated countries.

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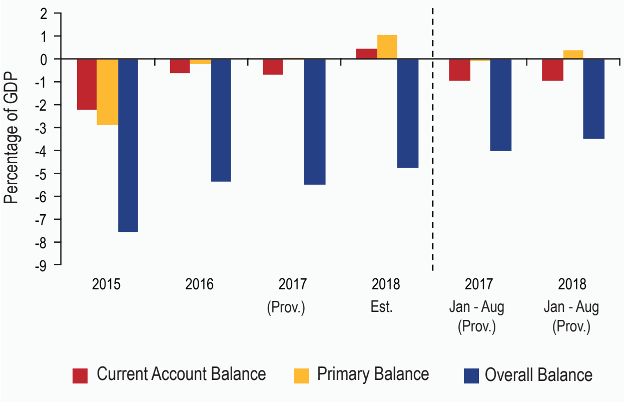
Government Budgetary Operations

Key Fiscal Balances

- **The overall budget deficit and the primary balance as a percentage of estimated GDP exhibited an improved performance during the first eight months of 2018, although the current account deficit increased marginally**. Despite the lower revenue mobilisation, the reduction in total expenditure and net lending contributed to the improved performance both in the overall budget deficit and the primary balance. Accordingly, the overall budget deficit improved to 3.5 per cent of estimated GDP during the first eight months of 2018 from 4.0 per cent of GDP in the corresponding period of the previous year.

Figure 6.2
Major Fiscal Indicators



Source: Ministry of Finance and Mass Media

Similarly, in nominal terms, the overall budget deficit declined to Rs. 510.9 billion in the first eight months of 2018 from Rs. 520.2 billion during the same period of 2017. As a per cent of estimated GDP, the primary balance (overall deficit net of interest payments) recorded a surplus of 0.4 per cent (Rs. 57.6 billion) during the period under review, in comparison to a deficit of 0.01 per cent (Rs. 1.6 billion) recorded in the same period of 2017. Nevertheless, the current account deficit, which reflects the government dis-savings, increased to 1.0 per cent of estimated GDP during the first eight months of 2018 from 0.9 per cent of GDP in the same period of 2017.

Government Revenue and Grants

Revenue

- **According to the Budget estimates for 2018, total government revenue is expected to increase by 21.1 per cent to Rs. 2,217.2 billion in 2018.** Consequently, total revenue to GDP is estimated at 15.6 per cent in 2018 comprising 14.3 per cent of tax revenue and 1.3 per cent of non tax revenue.

- **During the first eight months of 2018, government revenue as a percentage of the estimated GDP, declined to 8.6 per cent from 9.0 per cent in the corresponding period of 2017, reflecting lower tax revenue.** However, total government revenue in nominal terms increased by 6.0 per cent to Rs. 1,242.2 billion during the first eight months of 2018 from Rs. 1,172.4 billion in the corresponding period of the previous year. Government tax revenue as a percentage of the estimated GDP declined to 7.8 per cent from 8.4 per cent in the same period of the previous year, although it increased by 3.5 per cent to Rs. 1,133.7 billion in nominal terms. This was a net outcome of increase in revenue from income taxes, excise duty on motor vehicles, tobacco and cigarettes, Value Added Tax (VAT), Ports and Airports Development Levy (PAL) and SCL and decline in revenue from import duties, Cess levy, and excise duty on petroleum products. Non tax revenue as a percentage of the estimated GDP increased to 0.7 per cent from 0.6 per cent in the same period of 2017, while in nominal terms it increased by 40.2 per cent to Rs. 108.6 billion. Central Bank profit transfers and the significant increase in profit and dividend transfers from SOBEs together with increased receipts from fees and charges mainly contributed to enhance non tax revenue. Overall, the total revenue collection during this period was 56.0 per cent of the annual estimate of Rs. 2,217.2 billion, in comparison to 58.3 per cent in the corresponding period of 2017. Further, the realised average monthly revenue during this period is estimated at Rs. 155.3 billion in comparison to an average monthly revenue of Rs. 184.8 billion projected in the Budget 2018.

- **In nominal terms, revenue from income taxes increased by 14.6 per cent to Rs. 195.9 billion during the first eight months of 2018, mainly due to the increase in revenue collection from corporate and non corporate income taxes, Pay-As-You-Earn (PAYE) tax and the Economic Service Charge (ESC).** As a percentage of the estimated GDP, revenue from income taxes increased to 1.4 per cent during the first eight months of 2018 from 1.3 per cent during the corresponding period of 2017. Corporate and non corporate income taxes increased by 21.9 per cent in nominal terms to Rs. 99.0 billion during the first eight months of 2018 from Rs. 81.2 billion recorded in the same period of 2017, mainly due to the implementation of the Inland Revenue Act No. 24 of 2017 with effect from 01 April 2018 and the strengthening of the payment and return monitoring process by IRD. Meanwhile, revenue from PAYE tax also increased to Rs. 27.8 billion during the first eight months of 2018, in comparison to Rs. 22.4 billion in the first eight months of the previous year, largely due to improvements in the monitoring process related to the submission of PAYE returns and payments with the initiation of the RAMIS system. Revenue from the ESC increased to Rs. 38.2 billion during the period under review from Rs. 31.2 billion in the first eight months of 2017. However, during this period, revenue from withholding taxes declined by 14.5 per cent to Rs. 30.9 billion from Rs. 36.2 billion in the previous year, as a result of the removal of withholding tax on interest income on Treasury bills and Treasury bonds, with effect from 01 April 2018.

Table 6.1

Economic Classification of Government Revenue

Rs. billion

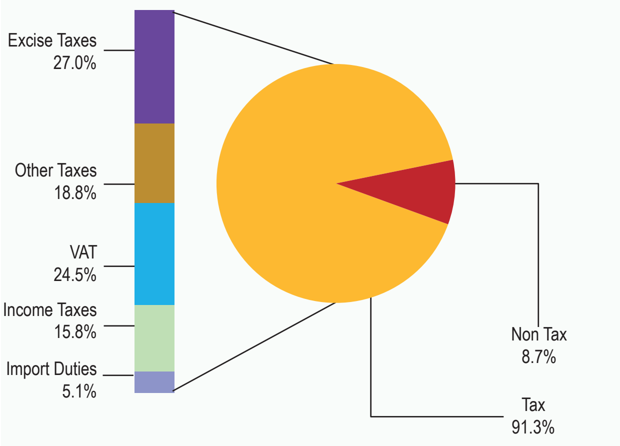
Item	2016	2017 (a)	2018 Approved Estimates	2017 Jan - Aug. (a)	2018 Jan - Aug. (a)
Tax Revenue	**1,463.7**	**1,670.2**	**2,034.0**	**1,094.9**	**1,133.7**
Income Taxes	258.9	274.6	370.0	171.0	195.9
VAT	283.5	443.8	550.0	290.0	304.8
Excise Taxes	455.0	469.5	535.0	312.5	335.2
Import Duties	156.5	136.5	175.0	92.5	63.9
PAL	88.8	102.4	115.0	65.6	73.4
NBT	57.4	69.0	87.0	45.0	46.8
SCL	55.8	71.4	80.0	49.2	51.3
Cess	61.7	59.6	49.5	39.5	35.0
Other Taxes	46.1	43.5	72.5	29.5	27.4
Non Tax Revenue	**222.4**	**161.4**	**183.2**	**77.4**	**108.6**
Total Revenue	**1,686.1**	**1,831.5**	**2,217.2**	**1,172.4**	**1,242.2**

(a) Provisional

Source: Ministry of Finance and Mass Media

- **Revenue from VAT increased by 5.1 per cent to Rs. 304.8 billion in nominal terms during the first eight months of 2018 although VAT revenue as a percentage of the estimated GDP declined to 2.1 per cent in the first eight months of 2018, from 2.2 per cent in the corresponding period of 2017.** Revenue from VAT on domestic economic activities increased by 5.3 per cent to Rs. 191.1 billion from Rs. 181.4 billion in the first eight months of the previous year. Revenue from VAT on import related activities also increased by 4.6 per cent to Rs. 113.7 billion in comparison to Rs. 108.6 billion recorded in the first eight months of 2017. Further, during the first eight months of 2018, VAT revenue as a percentage of total tax revenue increased to 26.9 per cent from 26.5

Figure 6.3
Composition of Government Revenue
(Jan-Aug 2018)



Source: Ministry of Finance and Mass Media

per cent in the corresponding period of 2017. However, the contribution of VAT revenue to the total revenue declined marginally to 24.5 per cent in the first eight months of 2018 from 24.7 per cent in the corresponding period of 2017.

- **Revenue from excise duties as a percentage of the estimated GDP declined to 2.3 per cent during the first eight months of 2018 from 2.4 per cent in the corresponding period of 2017.** However, in nominal terms, revenue from excise duty increased by 7.2 per cent to Rs. 335.2 billion in the first eight months of 2018, compared to Rs. 312.5 billion recorded during the same period of 2017, on account of the increase in excise duty revenue from motor vehicles, tobacco and cigarettes, and liquor amidst the decline in revenue from petroleum products. Revenue from excise duty on motor vehicles generated a sum of Rs. 148.6 billion, recording a year-on-year growth of 14.8 per cent due to increased importation of motor vehicles during the first eight months of 2018. Meanwhile, revenue from excise duty on tobacco and cigarettes also increased by 11.0 per cent to Rs. 60.6 billion in comparison to the previous year, owing to the higher excise tax on cigarettes imposed in November 2017. Excise tax revenue from liquor also rose by 2.3 per cent to Rs. 75.3 billion, in comparison to Rs. 73.7 billion recorded in the corresponding period of 2017. However, revenue from petroleum products declined by 10.3 per cent to Rs. 45.0 billion in the first eight months of 2018 from Rs. 50.1 billion in the same period of 2017 due to the decline in diesel imports during this period.

- **The revenue collection from import duties during the first eight months of 2018 declined significantly to 0.4 per cent of the estimated GDP, from 0.7 per cent recorded in the corresponding period of 2017 while taxes from the SCL as a percentage of estimated GDP remained unchanged at 0.4 per cent.** In nominal terms, revenue from import duties declined considerably by 30.9 per cent to Rs. 63.9 billion in comparison to Rs. 92.5 billion recorded in the first eight months of 2017, mainly due to the reduction in duty rates applicable on petrol, diesel and milk powder. Revenue from the SCL at Rs. 51.3 billion increased by 4.2 per cent from Rs. 49.2 billion in the corresponding period of the previous year as a result of higher levies imposed on several commodities to protect domestic producers and safeguard the interests of the domestic farming community.

- **In nominal terms, revenue from the Nation Building Tax (NBT) and PAL increased during the first eight months of 2018 while revenue mobilisation from the Cess Levy declined during this period**. Revenue from the NBT increased in nominal terms by 4.0 per cent to Rs. 46.8 billion due to increases in both domestic economic activities and import related activities. However, as a percentage of the estimated GDP, revenue from the NBT remained unchanged at 0.3 per cent during the period as in the corresponding period of 2017. Revenue from the NBT on domestic economic activities increased by 4.0 per cent to Rs. 33.9 billion in the first eight months of 2018. The NBT revenue collection from import related activities also increased by 4.0 per cent to Rs. 12.9 billion from Rs. 12.4 billion in the corresponding period of 2017. Revenue from PAL increased by 11.9 per cent to Rs. 73.4 billion

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during the first eight months of 2018. Revenue from the Cess levy, however, declined by 11.6 per cent to Rs. 35.0 billion during the period from Rs. 39.5 billion recorded during the same period of 2017, owing to the removal of the Cess Levy on 253 imported items in the 2018 Budget with a view to phasing out para tariffs applicable on the importation of several goods.

- **Non tax revenue during the first eight months of 2018 increased to 0.7 per cent of the estimated GDP from 0.6 per cent in the same period of 2017.** In nominal terms, non tax revenue increased by 40.2 per cent to Rs. 108.6 billion from Rs. 77.4 billion in the corresponding period of 2017. This increase was largely due to Central Bank profit transfers, higher profit and dividend transfers from SOBEs and increased revenue from fees and charges. Revenue generated through Central Bank profit transfers was Rs. 14.2 billion during the first eight months of 2018. In addition, profit and dividend transfers from SOBEs also increased significantly by 58.9 per cent to Rs. 19.8 billion during the period under review, from Rs. 12.5 billion recorded in the same period of 2017. Meanwhile, revenue from fees and charges increased by 13.0 per cent to Rs. 47.0 billion during the period from Rs. 41.6 billion during the same period in 2017, due to upward revisions to fees and charges in the 2018 Budget. Further, revenue from social security contributions increased by 7.7 per cent to Rs. 16.5 billion during the period under review. Non tax revenue from interest income also increased by 27.9 per cent to Rs. 5.4 billion, while non tax revenue from rent income declined by 12.3 per cent to Rs. 2.2 billion in the first eight months of 2018.

Grants

- **Disbursement of foreign grants during the first eight months of 2018 was limited to Rs. 5.1 billion compared to the annual estimate of grants of Rs. 10.0 billion for 2018.** However, foreign grants during the first eight months of 2018 was higher than the Rs. 2.3 billion recorded in the same period of 2017.

Expenditure and Net Lending

- **As per the budget estimates for 2018, total expenditure and net lending is estimated to increase to 20.4 per cent of GDP from 19.3 per cent of GDP in 2017.** Recurrent expenditure is estimated to increase to 15.2 per cent of GDP from 14.5 per cent in 2017, while capital expenditure and net lending are estimated to increase to 5.3 per cent of GDP in 2018 from 4.8 per cent recorded in 2017. In nominal terms, total expenditure and net lending in 2018 are estimated to increase by 12.8 per cent to Rs. 2,902.2 billion in comparison to Rs. 2,573.1 billion recorded in 2017. Recurrent expenditure is expected to increase by 11.6 per cent to Rs. 2,152.0 billion in 2018, while capital expenditure and net lending are also expected to increase by 16.2 per cent to Rs. 750.2 billion.

- **Total expenditure and net lending during the first eight months of 2018 declined to 12.1 per cent of estimated GDP from 13.0 per cent in the corresponding period of 2017, due to the slowdown in both recurrent and capital expenditure, and net lending.** However, in nominal terms, government expenditure and net lending increased by 3.7 per cent to Rs. 1,758.2 billion during the first eight months of 2018 from Rs. 1,694.9 billion during the corresponding period of 2017. Total expenditure and net lending in the first eight months of 2018 accounted for 60.6 per cent of the annual estimate for 2018, in comparison to 64.1 per cent in the first eight months of 2017.

Table 6.2

Economic Classification of Expenditure

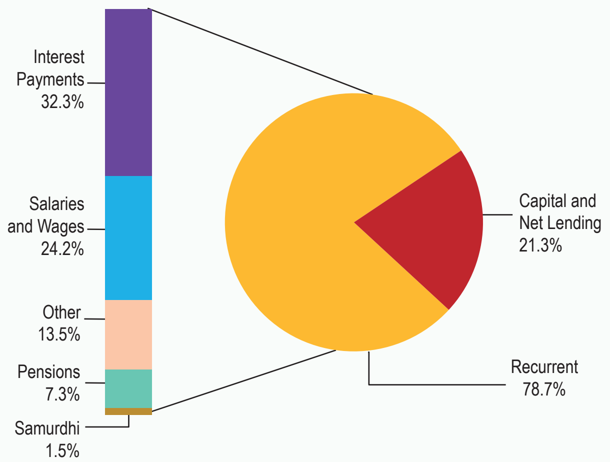
Rs. billion

Item	2016	2017 (a)	2018 Approved Estimates	2017 Jan - Aug. (a)	2018 Jan - Aug. (a)
Recurrent Expenditure	**1,757.8**	**1,927.7**	**2,152.0**	**1,294.4**	**1,384.6**
o/w Salaries and Wages	576.5	588.5	630.0	392.5	425.3
Interest Payments	610.9	735.6	820.0	518.6	568.5
Foreign	126.7	164.9	170.0	97.6	117.1
Domestic	484.2	570.6	650.0	421.0	451.3
Samurdhi	40.7	39.7	44.0	26.6	26.2
Pensions	171.9	181.1	197.7	120.3	127.6
Fertiliser Subsidy	27.8	30.4	32.0	16.8	13.3
Capital and Net Lending	**576.1**	**645.4**	**750.2**	**400.5**	**373.7**
Total Expenditure and Net Lending	**2,333.9**	**2,573.1**	**2,902.2**	**1,694.9**	**1,758.2**

(a) Provisional

Source: Ministry of Finance and Mass Media

Figure 6.4
Composition of Government Expenditure
(Jan-Aug 2018)



Source: Ministry of Finance and Mass Media

- **Recurrent expenditure as a percentage of estimated GDP declined to 9.5 per cent during the first eight months of 2018 from 10.0 per cent in the same period of 2017 mainly due to the reduction in expenditure on subsidies and transfers, and salaries and wages**. However, in nominal terms, recurrent expenditure increased by 7.0 per cent to Rs. 1,384.6 billion during the first eight months of 2018 from Rs. 1,294.4 billion in the same period of 2017. Expenditure on interest payments in nominal terms, increased by 9.6 per cent to Rs. 568.5 billion during the first eight months of 2018 from Rs. 518.6 billion in the corresponding period of 2017. This was mainly due to relatively higher interest rates in the international markets. The rise in interest rates adversely impacted interest payments of loans obtained at variable interest rates. In addition, the higher debt stock, in particular the increase in outstanding commercial loans such as ISBs, also contributed to the rise in expenditure on interest payments. Although, expenditure on salaries and wages declined marginally to 2.9 per cent of estimated GDP during the first eight months of 2018 from 3.0 per cent in the same period of 2017, salaries and wages increased by 8.3 per cent to Rs. 425.3 billion in nominal terms. Further, expenditure on subsidies and transfers, as a per cent of estimated GDP, declined to 2.1 per cent from 2.2 per cent in the corresponding period of 2017, mainly due to the reduction in expenditure on the fertiliser subsidy, transfers to public corporations and the Samurdhi programme. However, in nominal terms, expenditure on subsidies and transfers increased by 5.2 per cent to Rs. 306.3 billion in comparison to Rs. 291.2 billion recorded in the same period of the previous year. Pension payments also increased by 6.1 per cent to Rs. 127.6 billion mainly due to the increase in the number of pensioners during this period.

- **Capital expenditure and net lending declined both in nominal terms and as a per cent of GDP during the first eight months of 2018**. Accordingly, as a per cent of estimated GDP, capital expenditure and net lending declined to 2.6 per cent during the first eight months of 2018 from 3.1 per cent of GDP in the corresponding period of 2017, while in nominal terms, it declined by 6.7 per cent to Rs. 373.7 billion. The realised capital expenditure and net lending in the first eight months of 2018 accounted for 49.8 per cent of the annual estimate for the year, in comparison to a share of 57.3 per cent recorded in the corresponding period of 2017.

Financing of the Budget Deficit

- **The overall budget deficit was largely financed through foreign sources during the first eight months of 2018**. Accordingly, net foreign financing increased to Rs. 271.3 billion from Rs. 246.7 billion in the corresponding period of 2017. Meanwhile, net domestic financing

Table 6.3
Sources of Financing

Rs. billion

Item	2016	2017 (a)	2017 Jan - Aug. (a)	2018 Jan - Aug. (a)
Domestic Financing	**248.4**	**294.3**	**273.5**	**239.5**
Bank	140.0	187.7	236.5	28.6
Non Bank	108.5	106.5	37.0	210.9
Foreign Financing	**391.9**	**439.2**	**246.7**	**271.3**
Loans	109.3	0.8	15.1	-10.8
Commercial Loans	319.7	381.2	224.6	321.0
Non Resident Investments in Treasury Bonds	-44.3	43.7	7.1	-34.2
Non Resident Investments in Treasury Bills	7.2	13.6	...	-4.7
Total Financing	**640.3**	**733.5**	**520.2**	**510.9**

(a) Provisional

Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

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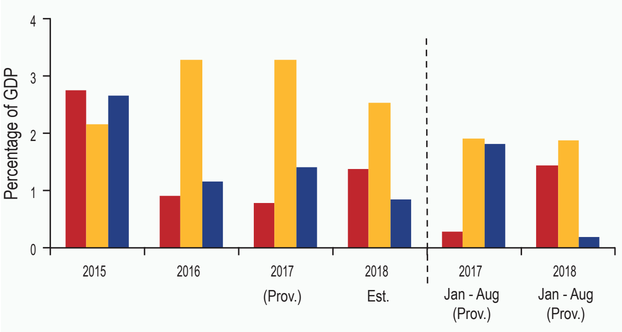
declined to Rs. 239.5 billion during the period under consideration, in comparison to Rs. 273.5 billion in the same period of 2017.

- **Domestic borrowings for financing the budget deficit were mainly sourced from the non banking sector, reducing the reliance placed on the banking sector signifintly**. Accordingly, net financing from the domestic non banking sector increased significantly to Rs. 210.9 billion from Rs. 37.0 billion in the same period of 2017. This includes divestiture proceeds of Rs. 41.3 billion from the Hambantota Port, received through the concessional agreement signed with a foreign investor in 2017 to operate the Hambantota Port as a Public Private Partnership (PPP). Bank financing declined to Rs. 28.6 billion during the first eight months of 2018 from Rs. 236.5 billion in the same period of 2017. This was due to the significant reduction in sourcing funds from commercial banks by way of Treasury bills and repayments in respect of Sri Lanka Development Bonds (SLDBs). However, financing from the Central Bank increased to Rs. 20.7 billion in the first eight months of 2018 as against a repayment of Rs. 119.5 billion recorded during the first eight months of 2017.

- **Domestic borrowings were made mainly through debt instruments, particularly from Treasury bills and Treasury bonds, during the period under review**. Net borrowings from Treasury bills increased to Rs. 81.5 billon in the first eight months of 2018 in comparison to Rs. 7.4 billion in the same period of the previous year. Net borrowings from Treasury bonds also increased to Rs. 157.8 billion in the first eight months of 2018 from Rs. 48.7 billion in the same period of 2017. Borrowings by way of SLDBs recorded a net repayment of Rs. 81.6 billion during the period under consideration in comparison to Rs. 53.3 billion in the first eight months of 2017.

Figure 6.5
Deficit Financing



Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

- **Foreign financing increased during the first eight months of 2018 with the issuance of ISBs**. During the first eight months of 2018, foreign borrowings to finance the budget deficit increased to Rs. 271.3 billion in comparison to Rs. 246.7 billion recorded in the corresponding period of 2017. Net foreign financing comprised borrowings through ISBs and net repayments with respect to foreign project loans, FCTFF and foreign investments in Treasury bills and Treasury bonds.

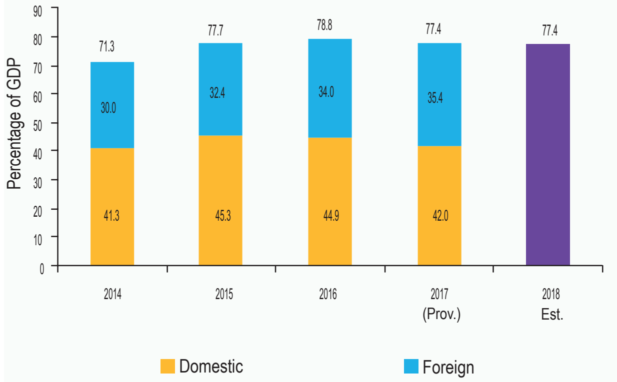
Government Debt and Debt Service Payments

Government Debt

- **The central government debt stock increased by Rs. 739.0 billion to Rs. 11,052.0 billion as at end August 2018.** Accordingly, domestic debt increased by Rs. 181.9 billion during the first eight months to Rs. 5,776.3 billion, while foreign debt increased by Rs. 557.1 billion to Rs. 5,275.7 billion. The relatively high budget deficit and the depreciation of the Sri Lankan rupee against major foreign currencies contributed to the increase in the debt stock in rupee terms.

- **The share of short term domestic debt increased marginally while the share of medium and long term debt declined**. The share of short term debt in total domestic debt increased to 19.4 per cent at the end of August 2018 from 18.4 per cent at the end of 2017. In contrast, the share of medium and long term debt

Figure 6.6
Outstanding Central Government Debt



Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

in total domestic debt declined marginally to 80.6 per cent at the end of August 2018 from 81.6 per cent at the end of 2017. The share of Treasury bills in domestic debt at end August 2018 increased to 13.4 per cent from 12.5 per cent at end 2017 due to the increase in Treasury bill holdings of the banking sector. However, Treasury bonds, which constitute the largest share in the domestic debt portfolio, decreased its share marginally to 68.0 per cent as at end August 2018 from 68.3 per cent at end 2017. Further, the share of SLDBs in the domestic debt stock as at end August 2018 reduced to 10.2 per cent from 11.4 per cent at end 2017 due to the higher retirement over the issuance of SLDBs during the period under review.

Table 6.4
Outstanding Central Government Debt

Rs. billion

Item	2016	2017 (a)	2017 End Aug. (a)	2018 End Aug. (a)
Domestic Debt (b)	**5,341.5**	**5,594.4**	**5,659.4**	**5,776.3**
By Maturity Period				
Short Term	968.4	1,031.2	1,135.0	1,117.8
Medium and Long Term	4,373.1	4,563.2	4,524.4	4,658.6
By Institution				
Banks	2,114.9	2,328.5	2,605.2	2,422.3
Non Bank Sector	3,226.6	3,265.9	3,054.3	3,354.0
Foreign Debt (c)	**4,045.8**	**4,718.6**	**4,626.5**	**5,275.7**
Concessional	1,897.7	2,130.5	2,061.0	2,197.5
Non Concessional	2,148.1	2,588.1	2,565.5	3,078.2
Total Government Debt	**9,387.3**	**10,313.0**	**10,285.9**	**11,052.0**

Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

(a) Provisional
(b) Excludes (i) rupee denominated Treasury bonds held by foreign investors, (ii) Treasury bonds amounting to Rs. 78,447 million issued to settle dues to CPC in January 2012. Due to maturity of some of those bonds in January 2017, the outstanding amount from January 2017 was Rs. 56,662 million
(c) Includes outstanding amounts of foreign investments in rupee denominated Treasury bills and Treasury bonds

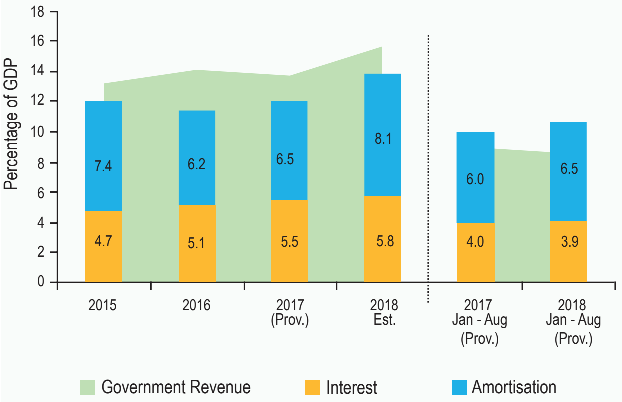
- **The foreign currency denominated outstanding domestic debt declined marginally to Rs. 690.5 billion (US dollars 4,517.8 million) at the end of August 2018 from Rs. 702.1 billion (US dollars 4,593.2 million) at end 2017.** Accordingly, the debt stock of SLDBs amounted to Rs. 590.4 billion (US dollars 3,862.8 million), while the outstanding debt on Offshore Banking Units (OBUs) amounted to Rs. 100.1 billion (US dollars 655.0 million) as at end August 2018. The share of foreign currency denominated domestic debt to total domestic debt declined to 12.0 per cent at end August 2018 from 12.6 per cent at end 2017. Meanwhile, rupee denominated domestic debt increased by Rs. 193.5 billion to Rs. 5,085.9 billion at end August 2018.

- **The share of non concessional debt in the foreign debt stock increased to 58.3 per cent by end August 2018 from 54.8 per cent at end 2017.** Accordingly, concessional foreign debt as a share of total foreign debt declined to 41.7 per cent by end August 2018 from 45.2 per cent at end 2017. Non concessional debt increased by 18.9 per cent to Rs. 3,078.2 billion mainly due to the issuance of the 12th ISB (US dollars 2.5 billion) in April 2018.

Debt Service Payments

- **During the first eight months of 2018, domestic and foreign debt service payments totaled to Rs. 1,511.8 billion.** This consists of amortisation payments of Rs. 943.3 billion (62.4 per cent) and interest payments of Rs. 568.5 billion (37.6 per cent). Further, debt service payments to domestic and foreign sources amounted to Rs. 1,180.2 billion and Rs. 331.6 billion, respectively. Up to August 2018, total debt service payments accounted for 76.7 per cent of the original budget estimate for annual debt service payments.

Figure 6.7
Government Debt Service Payments vs Revenue



Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

Expected Developments

- **It would be extremely challenging to achieve the medium term budget deficit target of 3.5 per cent of GDP by 2020 and the debt to GDP ratio of 69 per cent by 2021, without focused efforts by the government and all other stakeholders.** According to the latest available information, government revenue collection in 2018 is expected to be lower than its original estimates, mainly due to the reduced revenue collection from import duties and the Cess Levy, and delays in the implementation of revenue proposals envisaged in the Budget 2018. Further, in 2018, total expenditure and net lending would also be lower than the original estimate as a result of the significant decline in capital expenditure and net lending. The budget deficit is expected to increase mainly due to the slippage in revenue collection amidst the decline in government expenditure. Meanwhile, the central government debt to GDP ratio is also expected to increase by end 2018 as a result of higher net deficit financing, depreciation of the rupee against major foreign currencies and lower nominal GDP growth. Therefore, substantial revenue enhancing measures are required in order to avoid curtailing or postponing public investment that which would affect negatively on economic growth. Moreover, these challenges highlight the necessity to maintain a firm commitment towards achieving the envisaged medium term fiscal targets, particularly through the speedy implementation of planned reforms.

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