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FISCAL POLICY AND GOVERNMENT FINANCE

The fiscal performance deteriorated in the first seven months of 2019 due to lower than expected government revenue and a rise in government expenditure, resulting in an expansion of the budget deficit, a turnaround in the primary balance, and a rise in outstanding government debt. The revenue mobilisation of the government contracted during the year with both tax and non tax revenue declining in nominal and GDP terms. Government revenue as a percentage of estimated GDP declined to 6.7 per cent in the first seven months of 2019 from 7.5 per cent recorded in the same period of 2018. Despite the significant increase in revenue from income taxes due to the effective implementation of Inland Revenue Act, No. 24 of 2017, policy measures imposed to curtail the surge in imports of personal vehicles, deceleration in economic activity following the Easter Sunday attacks and the delay in implementation of certain revenue proposals announced in the Budget 2019 largely contributed to the lackluster revenue performance. Meanwhile, expenditure and net lending increased to 11.1 per cent of estimated GDP in the first seven months of 2019 from 10.7 per cent in the same period last year, mainly due to an increase in recurrent expenditure of the government. Recurrent expenditure as a percentage of estimated GDP rose on account of a significant increase in interest payments and higher outlays on subsidies and transfers. Consequently, the current account deficit, which reflects the difference between current expenditure and revenue, and hence the government's dis-savings position, increased to 2.0 per cent of estimated GDP from 1.0 per cent of GDP in the corresponding period of 2018. With the decline in government revenue and increase in recurrent expenditure, the primary balance, which indicates the status of current budgetary operations as it reflects the difference between revenue and non interest expenditure, turned into a deficit of 0.8 per cent of estimated GDP in the first seven months of 2019 from a surplus of 0.3 per cent of GDP in the corresponding period of the previous year. Meanwhile, capital expenditure and net lending increased marginally to 2.4 per cent of estimated GDP during the first seven months of 2019. The budget deficit increased to 4.4 per cent of estimated GDP in the first seven months of 2019 from 3.2 per cent in the corresponding period of 2018. The expansion in the budget deficit warranted higher borrowings resulting in a rise in outstanding debt to Rs. 12,646 billion as at end-July 2019 from Rs. 11,978 billion at end-2018. The subdued fiscal performance during the first seven months of the year would result in a deviation of key fiscal balances from targeted levels in 2019. Nevertheless, the government intends to achieve a smaller surplus in the primary balance in 2019 compared to the original estimates while the budget deficit and current account balance would deviate from the budget estimates. Against this backdrop, envisaged fiscal consolidation depends heavily on the timely implementation of reforms aimed at broadening the tax net, enhancing tax compliance and improving tax administration. The government's strong commitment towards adhering to the envisaged fiscal path is pivotal in maintaining fiscal discipline ahead of election cycles.

Fiscal Policy Measures

- **In 2019, the fiscal policy was geared towards a sustainable reduction of both fiscal deficit and outstanding public debt assisted by the envisaged enhancement in revenue mobilisation.** The budget deficit and government debt for 2019 were estimated at 4.4 per cent of GDP and 82.6 per cent of GDP, respectively. As proposed in the Budget 2019, several policy measures, including a revision of excise duty on motor vehicles and beverages, and an increase of fees and charges were implemented during the first seven months of the year. Certain proposals which require revisions to the Inland Revenue Act await implementation. On the expenditure front, measures were taken to reduce government expenditure with the issuance of directions to spending agencies to identify savings on capital expenditure and to reduce recurrent expenditure, particularly by rationalising expenditure on electricity, telephone, water supply, fuel consumption, stationary etc.

- **Several amendments to the Inland Revenue Act on granting tax exemptions as proposed in the Budget 2019 are expected to be implemented soon.** Interest income earned by any resident person on sovereign bonds denominated in foreign currency, including Sri Lanka Development Bonds (SLDBs) and interest income up to Rs. 5,000 per month earned by children of less than 18 years of age in relation to any deposit account maintained in a financial institution will be exempted from income tax. Further, interest income earned by any person on Non-Resident Foreign Currency (NRFC) and Resident Foreign Currency (RFC) accounts will be exempted from income tax for five years while earnings by any non-resident person on any sovereign bond denominated in local or foreign currency will also be exempted. Moreover, interest paid to any person outside Sri Lanka on loans granted by such person to any person in Sri Lanka will be exempted from income tax, although this exemption will not be applicable to loans granted by a non-resident company to its holding company or a subsidiary company in Sri Lanka. In addition, royalty payments and rent payments not exceeding Rs. 50,000 per month, subject to a limit of Rs. 500,000 for each year of assessment, made to any resident individual will be exempted from withholding tax.

- **Amendments to the Finance Act as proposed in the Budget 2019 have been approved by Parliament in October 2019.** The luxury tax on motor vehicles was amended such that the tax payable is determined purely on the cost, insurance and freight (CIF) value or the manufacturer’s price (in case of domestic production in excess of a prescribed tax free threshold) irrespective of the engine capacity, with the aim of enhancing revenue as well as curtailing the surge in import expenditure. Further, the carbon tax will be removed with effect from 01 December 2019. In addition, a Levy on Foreign Commercial Transactions was imposed at the rate of 3.5 per cent on foreign payments made using Electronic Fund Transfer Cards to purchase goods or services. The date of implementation of the Levy on Foreign Commercial Transactions will be declared by the Minister of Finance by order published in the gazette.

- **During the year, several revisions were made to excise duty in order to curtail the surge in importation of motor vehicles with a view to easing pressure on the balance of payments and discouraging the consumption of sweetened beverages and cigarettes owing to health concerns.** As announced in the Budget 2019, excise duty on motor vehicles of an engine capacity less than 2,000 cm^3 was increased with effect from 06 March 2019. However, excise duty on electric vehicles was reduced to promote environmentally friendly transport modes. Meanwhile, excise duty on beverages was increased on the basis of the sugar content of the product. Further, with effect from 06 March 2019, excise duties on cigarettes and locally

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manufactured liquor were increased based on an indexation method with a minimum annual duty increase reflecting annual inflation and GDP growth. In addition, excise duty on imported liquor was also increased with effect from March 2019.

- **Changes were made to the Customs duty structure in line with the fluctuations in international prices while the Special Commodity Levy (SCL) was revised from time to time in order to protect domestic producers.** The Customs duty waiver on the importation of petrol (92 Octane) was reduced to Rs. 18 per litre from Rs. 19 per litre in June 2019 and it was further reduced to Rs. 17 per litre in September 2019. For super diesel, Customs duty was increased to Rs. 15 per litre from Rs. 10.55 per litre in June 2019 while the applicable duty waiver of Rs. 1 per litre was withdrawn in July 2019. Meanwhile, Customs duties on petrol (95 Octane) and auto diesel stood at Rs. 35 per litre and Rs. 5.85 per litre, respectively at end July 2019. Thus, at end September 2019, Customs duties applicable on the importation of auto diesel, super diesel, petrol (92 Octane) and petrol (95 Octane) remained at Rs. 2.85 per litre, Rs. 15 per litre, Rs. 18 per litre and Rs. 35 per litre, respectively. In addition, under the Extraordinary Gazette No. 2113/2, Customs duty on undenatured ethyl alcohol and tyre tubes was increased while Customs duty on go-karts was exempted. Moreover, the unit rate of the Customs duty was increased by 10 per cent on the importation of 261 items of goods. Further, the SCL on the importation of black gram, potatoes, dates (fresh and dried), oranges (fresh), apples (fresh) and vegetable oil was revised upward during the year in order to protect domestic producers. SCL on the importation of B' onion and maize was reduced to curtail the price volatility in the domestic market. Moreover, in line with the government policy on trade liberalisation, Cess on the importation of 25 items was removed, in March 2019, while exemptions and concessionary rates were granted on the Ports and Airports Development Levy (PAL) for the importation of selected items.

- **Fees and charges were revised as proposed in the Budget 2019 in order to enhance revenue generation.** Accordingly, passport processing fees for normal processing applications, urgent basis applications and alteration fees were increased by Rs. 500, Rs. 5,000 and Rs. 500 to Rs. 3,500, Rs. 15,000 and Rs. 1,000, respectively. Under the Extraordinary Gazette No. 2116/62, the embarkation levy was also increased by US dollars 10 to US dollars 60 per passenger in March 2019. However, under the Extraordinary Gazette No. 2134/5, issued in August 2019 the effective date of the increase in embarkation levy was revised to 01 February 2020 with a view to supporting the tourism sector. In addition, the 2019 Budget proposed to increase the annual levy for gaming businesses other than rudjino to Rs. 400 million from Rs. 200 million, while introducing an annual levy of Rs. 1 million for carrying on the business of playing rudjino, and decreasing the casino entrance levy to US dollars 50 per person from US dollars 100 per person.

- **Measures to strengthen tax administration continued during the year aimed at improving revenue mobilisation through an expansion of the tax base and enhanced tax compliance.** The RAMIS of the Inland Revenue Department (IRD) was upgraded in order to incorporate the provisions of the Inland Revenue Act, No. 24 of 2017. The RAMIS monitors all tax categories except Economic Service Charge (ESC), stamp duty and the betting and gaming levy. The VAT on financial services and personal income tax registrations were included in the RAMIS system during the year. Several programmes were conducted to enhance the public awareness of RAMIS. This together with new registrations resulted in an increase in the number of registered tax files in IRD by 30,569 to 1,212,125 during the period of January to July 2019. Moreover, the IRD commenced implementation of organisational and business procedure reforms to modernise the tax administration. These mainly included restructuring of 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, the Sri Lanka Customs initiated measures to establish a National Single Window (NSW) to facilitate importers and exporters.

- **On the expenditure front, several measures were introduced to ensure better management of public expenditure.** As announced in the Budget 2019, the Ministry of Finance (MOF) instructed all ministries and departments in April 2019 to curtail their capital expenditure by 15 per cent in 2019. In addition, the MOF, in September 2019, advised all ministries and departments to curtail their capital expenditure further by 10 per cent by postponing non-priority projects, new projects and purchase of non-essential goods. Moreover, under the National Budget Circular No. 04/2019, all government institutions were advised to implement prudent expenditure control measures while rationalising recurrent expenditure, particularly on electricity, telephone, water supply, fuel consumption and stationery. In view of the forthcoming Presidential Election, a Vote on Account (VoA) for the first four months of 2020 was approved by Parliament in October 2019.

- **With effect from 01 July 2019, public sector salaries were increased and pension anomalies were rectified and the efficiency of service delivery on pension payments was enhanced through an automated process.** An interim allowance of Rs. 2,500 per month was granted to public sector employees with effect from 01 July 2019 as proposed in the Budget 2019 until the implementation of the recommendations of the Special Salary Commission appointed by HE the President. Further, approval was granted by the Cabinet of Ministers in October 2019 to increase the monthly salary of all public sector employees by a minimum of Rs. 3,000 and a maximum of Rs. 24,000 per month with effective from January 2020 to rectify the salary anomalies in the public service. As announced in the Budget 2019, measures were taken to rectify the pension anomalies as there was a disparity in pension payments of those who have retired before 01 January 2016. Therefore, a revision was made incorporating the first 2 phases of the Public Administration Circular No. 03/2016 to the basic salary of the pensioner, at the time of retirement, with effect from 01 July 2019. Under the Pension Circular No. 03/2015 (Revision III), initiatives were taken to improve the efficiency and standards of public service delivery by further strengthening the automation process of the pension payment procedure. Under the Public Administration Circular No. 02/2019, instructions were issued to prevent fraudulent payments of pension for pensioners, who have demised. Accordingly, Divisional Secretariats were instructed to update the register of persons immediately when a death or a leaving the residence or a country of a pensioner is reported, since fraudulent use of public money by other parties has been reported due to the lack of updated information.

- **Measures were taken by the government to promote Public Private Partnerships (PPPs) easing the constrained fiscal space for infrastructure development.** Accordingly, initiatives were taken to foster an enabling environment for PPPs by facilitating private sector financing of major infrastructure projects. Moreover, the National Agency for Public Private Partnerships (NAPPP) reviewed and finalised the guidelines for PPPs, in consultation with the MOF and submitted the same to the National Procurement Commission (NPC), in April 2019, for further improvements. Further, the NAPPP assisted line ministries in progressing the identified PPP projects.

- **Measures were taken to enhance the transparency of welfare benefit schemes.**

Accordingly, 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, published a selection methodology to identify low income families for welfare benefit payments in respect of four main welfare programmes[1] and the selection methodology has been submitted to Parliament for approval. Further, actions are being taken to establish the integrated Social Registry Information System (SRIS), which is an electronic database to store data of welfare beneficiaries of different programmes, mainly for the purpose of selection and payment of welfare benefits. Further, as announced in the Budget 2019, measures are being taken to expand the number of Samurdhi beneficiaries by 600,000 with a view to upgrading the living standard of the economically vulnerable people.

- **Several initiatives were taken to improve the financial viability of major State Owned Business Enterprises (SOBEs) in order to reduce the burden on the central government budget.** Performance reports for the first half of 2018 of the five SOBEs which had signed Statements of Corporate Intent (SCIs), in March 2017, were forwarded to the Cabinet of Ministers in July 2019. Further, eight SCIs were signed, in June 2019, with selected SOBEs, namely Sri Lanka State Plantation Corporation, Lanka Sathosa (Pvt.) Limited, Central Engineering Consultancy Bureau, State Timber Corporation, State Pharmaceuticals Corporation, Milco (Pvt.) Limited, National Livestock Development Board and Geological Survey and Mines Bureau in order to improve the efficiency of their operations. Further, approval was granted by the Cabinet of Ministers, in March 2019, to implement a pricing formula for imported milk powder in line with the changes in international milk powder prices and the exchange rate while also safeguarding the local milk industry. Consequently, the formula based price adjustments were implemented with effect from 15 March 2019. In addition, a market based pricing mechanism for Liquefied Petroleum (LP) gas was also implemented with effect from 04 October 2019. Moreover, the implementation of a pricing mechanism for electricity would be needed in 2020 in order to improve the financial performance of the Ceylon Electricity Board (CEB).

- **Several initiatives were introduced by the Central Bank during 2019 to improve transparency and efficiency in the government securities market.** The LankaSecure system was upgraded to deliver a real-time notification (SMS and/or email notification) to customers registered in the Central Depository System by Dealer Direct Participants (Licensed Commercial Banks and Primary Dealers) for each and every debit and credit record of scripless securities. In order to accommodate this facility, the LankaSettle System Rules were also amended with effect from February 2019. Moreover, several amendments to the directions on primary issuance of Treasury bonds were enforced with effect from July 2019 to further facilitate price discovery and increase the efficiency of the market.

- **With regard to Sri Lanka's sovereign credit ratings, Fitch reaffirmed the existing sovereign credit rating in the third quarter of 2019, while the other major international rating agencies concluded their reviews during the year.** In September 2019, Fitch affirmed Sri Lanka's long term foreign currency issuer default rating at "B" with a 'stable' outlook. The current ratings of Moody's Investor Services (Moody's) and Standard and Poor's (S&P) remain at "B2" (Stable) and "B" (Stable), respectively

- **Measures were initiated to make use of the newly enacted Active Liability Management Act (ALMA) No. 8 of 2018, while a Medium-Term Debt Management Strategy (MTDS) for the period 2019-2023 was also published in 2019.** In June 2019, a resolution was passed

1 Samurdhi programme, financial support for elderly over 70 years of age, support for low income disabled persons and financial assistance for kidney patients

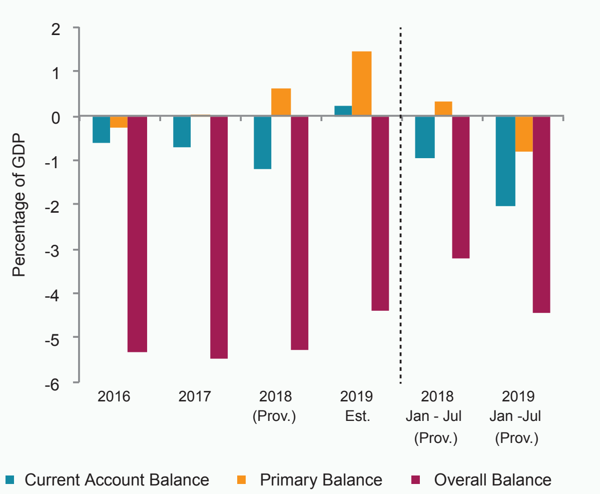
in Parliament to raise Rs. 480 billion for liability management purposes. Government and the Central Bank have initiated measures to raise funds in the bond markets in Japan (Samurai bond) for the first time in history and these funds are to be channeled for liability management purposes. The MTDS mainly focuses 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. Accordingly, the main objectives of the MTDS are: maintaining the foreign currency (FX) exposure at the level observed at end-2018, extending the average time to maturity (ATM) of the external debt portfolio, and reducing the share of short-term debt maturities from the current level. It is imperative that the government's annual borrowing plan is formulated in line with the envisaged outcome of the MTDS over the next several years.

Government Budgetary Operations

Key Fiscal Balances

- **Key fiscal balances deteriorated during the first seven months of 2019, reflecting the effects of lower revenue mobilisation and relatively higher expenditure.** The overall budget deficit increased to 4.4 per cent of estimated GDP (Rs. 684.1 billion) during the first seven months of 2019 from 3.2 per cent of GDP (Rs. 461.7 billion) in the corresponding period of the previous year. The primary balance turned to a deficit of 0.8 per cent of estimated GDP (Rs. 122.5 billion) during the period under review as against a surplus of 0.3 per cent of GDP (Rs. 47.1 billion) recorded in the same period of 2018. The current account deficit, which reflects the government's dis-savings, increased to 2.0 per cent of estimated GDP during the first seven months of 2019 from a deficit of 1.0 per cent of GDP in the same period of 2018.

Figure 6.1
Major Fiscal Indicators



Source: Ministry of Finance

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Government Revenue and Grants

Revenue

- **During the first seven months of 2019, government revenue as a percentage of estimated GDP declined to 6.7 per cent from 7.5 per cent in the corresponding period of 2018 due to lower tax and non tax revenue collections.** In nominal terms, total government revenue declined by 4.4 per cent to Rs. 1,031.9 billion during the first seven months of 2019 from Rs. 1,079.9 billion recorded in the corresponding period of the previous year. This was mainly due to the decline in revenue from excise duties on the importation of motor vehicles, petroleum products, and tobacco and cigarettes, as well as SCL, Cess and VAT. However, revenue from income taxes, Debt Repayment Levy, Nation Building Tax (NBT), import duties and PAL increased in nominal terms during this period. Non-availability of distributable profits from the Central Bank and the reduction in profits and dividend transfers from SOBEs contributed to the decline in non tax revenue during the period under review. Overall, the total revenue collection during this period was 44.0 per cent of the annual estimate of Rs. 2,344.0 billion in comparison to 48.7 per cent in the corresponding period of 2018.

Table 6.1
Economic Classification of Government Revenue

Rs. billion

Item	2017	2018 (a)	2019 Approved Estimates	2018 Jan - Jul. (a)	2019 Jan - Jul. (a)
Tax Revenue	**1,670.2**	**1,712.3**	**2,077.0**	**983.3**	**944.4**
Income Taxes	274.6	310.4	385.0	158.0	184.9
VAT	443.8	461.7	529.0	269.0	265.6
Excise Taxes	469.5	484.3	593.0	299.1	225.8
Import Duties	136.5	97.0	140.0	54.2	55.2
PAL	102.4	113.9	115.0	64.2	64.5
NBT	69.0	71.4	91.0	41.5	42.2
SCL	71.4	75.8	90.0	43.9	42.2
Cess	59.6	53.4	54.0	29.3	28.3
Other Taxes	43.5	44.4	80.0	24.0	35.7
Non Tax Revenue	**161.4**	**207.7**	**267.0**	**96.7**	**87.5**
Total Revenue	**1,831.5**	**1,920.0**	**2,344.0**	**1,079.9**	**1,031.9**

(a) Provisional

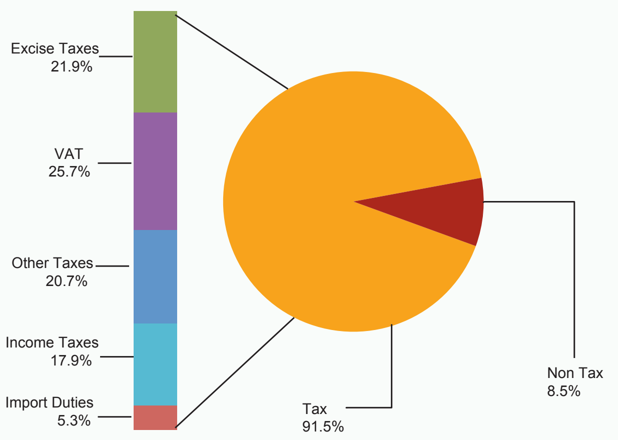
Source: Ministry of Finance

- **In nominal terms, revenue from income taxes increased significantly by 17.0 per cent to Rs. 184.9 billion during the first seven months of 2019 mainly due to the effective implementation of the Inland Revenue Act, No. 24 of 2017.** As a percentage of estimated GDP, revenue from income taxes increased marginally to 1.2 per cent from 1.1 per cent recorded during the corresponding period of 2018. In nominal terms, corporate and non corporate income taxes increased by 24.4 per cent to Rs. 85.7 billion during the first seven months of 2019 while revenue from Pay-As-You-Earn (PAYE) tax also increased to Rs. 29.7 billion during the first seven months of 2019 in comparison to Rs. 24.5 billion in the corresponding period of the previous year. Moreover, revenue from withholding tax and ESC increased by 8.6 per cent and 6.8 per cent to Rs. 29.4 billion and Rs. 40.1 billion, respectively during the period under review.

- **Revenue from VAT declined both in nominal terms and as a percentage of estimated GDP during the first seven months of 2019 reflecting the impact of moderation of activities following the Easter Sunday attacks and the VAT exemptions granted in the latter part of 2018 on healthcare services and importation of fabric.** Accordingly, in nominal terms, revenue from VAT declined by 1.3 per cent to Rs. 265.6 billion during the first seven months of 2019 while as a percentage of estimated GDP revenue from VAT declined to 1.7 per cent from 1.9 per cent in the corresponding period of 2018. Revenue from VAT on domestic economic activities declined by 2.3 per cent to Rs. 165.6 billion during the first seven months of 2019. However, revenue from VAT on import related activities increased marginally by 0.5 per cent to Rs. 100.0 billion in comparison to Rs. 99.5 billion recorded in the corresponding period of 2018. Meanwhile, during the first seven months of 2019, VAT revenue as a percentage of total tax revenue increased to 28.1 per cent from 27.4 per cent in the corresponding period of 2018 while the contribution of VAT revenue to the total revenue also increased to 25.7 per cent from 24.9 per cent recorded in the first seven months of 2019.

- **Revenue from excise duties declined significantly both in nominal terms and as a percentage of estimated GDP due to the reduction in revenue from excise duties on motor vehicles, petroleum products, and tobacco and cigarettes.** In nominal terms, revenue from excise duty declined substantially by 24.5 per cent to Rs. 225.8 billion while as a percentage of estimated GDP revenue from excise duties declined to 1.5 per cent from 2.1 per cent recorded in the same period of 2018. Revenue from excise duty on motor vehicles declined significantly by 47.1 per cent to Rs. 71.0 billion during the first seven months of 2019 reflecting mainly the impact of policy measures introduced to contain the increasing trend of motor vehicle imports in 2018. Meanwhile, revenue from excise duty on petroleum products also declined to Rs. 35.3 billion in the first seven months of 2019 from Rs. 39.2 billion in the corresponding period in 2018, mainly due to the reduction of excise duty to Rs. 6 per litre from Rs. 13 per litre on the importation of auto diesel with effect from November 2018. Excise duty on tobacco and cigarettes also declined in comparison to the previous year by 7.0 per cent to Rs. 51.0 billion, owing to the decline in cigarette sales during the

Figure 6.2
Composition of Government Revenue
(Jan-Jul 2019)



Source : Ministry of Finance

first seven months of 2019. However, excise tax revenue from liquor increased marginally by 0.4 per cent to Rs. 66.2 billion compared to Rs. 65.9 billion recorded in the corresponding period of 2018.

- **During the first seven months of 2019, revenue collection from Debt Repayment Levy, import duties, NBT and PAL increased in nominal terms while revenue from SCL and Cess declined compared to the same period in 2018.** Debt Repayment Levy which was introduced under the Finance Act, No. 35 of 2018 contributed to collect Rs. 9.6 billion up to July 2019. Revenue from import duties increased by 1.9 per cent to Rs. 55.2 billion from Rs. 54.2 billion recorded in the first seven months of 2018, supported mainly by an increase in Customs duty by 10 per cent for 261 identified goods with effect from 06 March 2019 and a rise in applicable duty rates on petrol (92 Octane) and super diesel with effect from 12 June 2019. Moreover, revenue from NBT and PAL rose by 1.8 per cent and 0.4 per cent, respectively to Rs. 42.2 billion and Rs. 64.5 billion during the period under review. However, revenue from Cess declined to Rs. 28.3 billion from Rs. 29.3 billion partly due to the removal of Cess on selected consumer goods with effect from 06 March 2019 while revenue from SCL also declined by 3.9 per cent to Rs. 42.2 billion during the period under consideration.

- **Non tax revenue declined both in nominal terms and as a percentage of estimated GDP during the period under review compared to the previous year.** Accordingly, in nominal terms, non tax revenue declined by 9.5 per cent to Rs. 87.5 billion while as a percentage of GDP non tax revenue declined to 0.6 per cent from 0.7 per cent recorded in the corresponding period of 2018. This was due to the non-availability of distributable profits from Central Bank and the reduction in profit and dividend transfers from SOBEs by 31.8 per cent to Rs. 12.1 billion during the period under review. However, in nominal terms, revenue from fees and charges increased by 14.0 per cent to Rs. 46.4 billion during the period under review mainly due to the increase in revenue from embarkation levy and charges and fines and forfeits. Further, revenue from interest income increased to Rs. 7.5 billion from Rs. 4.4 billion while revenue from social security contributions increased by 12.1 per cent to Rs. 16.2 billion. In addition, rent income also increased to Rs. 2.6 billion from Rs. 2.0 billion during the period under consideration.

Grants

- **Disbursement of foreign grants during the first seven months of 2019 was significantly below the estimate for 2019.** Accordingly, the realised amount of foreign grants in the first seven months of 2019 was Rs. 1.1 billion in comparison to the annual estimate of Rs. 13.0 billion for 2019 and Rs. 5.0 billion recorded in the first seven months of 2018.

Expenditure and Net Lending

- **Total expenditure and net lending during the first seven months of 2019 increased to 11.1 per cent of estimated GDP from 10.7 per cent in the corresponding period of 2018 due to the increase in both recurrent and capital expenditure.** In nominal terms, government expenditure and net lending increased by 11.0 per cent to Rs. 1,717.1 billion during the first seven months of 2019. Total expenditure and net lending in the first seven months of 2019 accounted for 56.4 per cent of the annual estimate for 2019.

Table 6.2
Economic Classification of Expenditure

Rs. billion

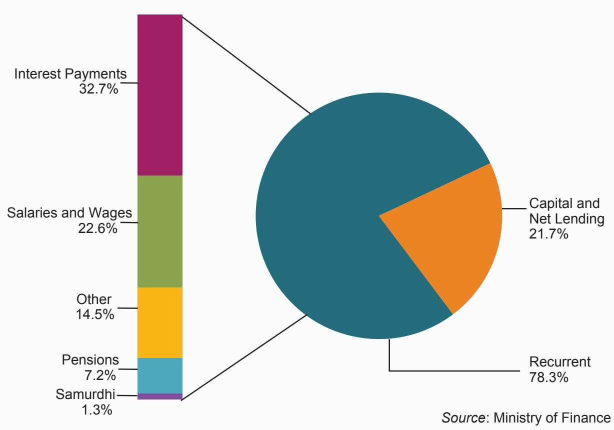
Item	2017	2018 (a)	2019 Approved Estimates	2018 Jan - Jul. (a)	2019 Jan - Jul. (a)
Recurrent Expenditure	**1,927.7**	**2,089.7**	**2,308.0**	**1,218.8**	**1,343.7**
o/w Salaries and Wages	588.5	626.0	690.0	371.0	388.2
Interest Payments	735.6	852.2	913.0	508.8	561.6
Foreign	164.9	212.7	220.0	114.5	154.2
Domestic	570.6	639.5	693.0	394.3	407.4
Samurdhi	39.7	39.2	50.0	23.0	22.7
Pensions	181.1	194.5	215.0	111.2	124.3
Fertiliser Subsidy	30.4	26.9	35.0	11.8	25.3
Capital and Net Lending	**645.4**	**603.5**	**734.0**	**327.8**	**373.4**
Total Expenditure and Net Lending	**2,573.1**	**2,693.2**	**3,042.0**	**1,546.6**	**1,717.1**

(a) Provisional

Source: Ministry of Finance

- **During the first seven months of 2019, recurrent expenditure as a percentage of estimated GDP, increased to 8.7 per cent from 8.4 per cent recorded in the same period of 2018 mainly due to the increase in interest payments and subsidies and transfers.** In nominal terms, recurrent expenditure increased by 10.2 per cent to Rs. 1,343.7 billion during the first seven months of 2019 compared to the same period of 2018. Expenditure on interest payments, in nominal terms, rose by 10.4 per cent to Rs. 561.6 billion during the first seven months of 2019 while as a per cent of estimated GDP, interest payments increased to 3.6 per cent from 3.5 per cent during the period under consideration mainly due to higher interest payments on foreign debt. Interest payments on foreign debt increased by 34.7 per cent to Rs. 154.2 billion during the first seven months of 2019 due to relatively higher interest rates, an increase in outstanding commercial loans including ISBs and the depreciation impact of the exchange rate as at end July 2019 compared to the corresponding period of the previous year. Interest payments on domestic debt also increased by 3.3 per cent to Rs. 407.4 billion during the period under review, as a result of higher interest rates in the domestic debt market and an increase in the outstanding domestic debt stock by 7.2 per cent as at end-July 2019. Expenditure on subsidies and transfers, in nominal terms, rose by 18.0 per cent to Rs. 312.8 billion while as a per cent of estimated GDP such outlays increased to 2.0 per cent during the period under review from 1.8 per cent due to higher expenditure on fertiliser subsidy and pension payments. Expenditure on the fertiliser subsidy increased due to the rise in subsidy provided for crops other than paddy by Rs. 500 per 50 kg bag while pension payments increased due to the revisions made effective from 01 July 2019 and the rise in the number of pensioners. However, expenditure on Samurdhi payments declined marginally by 1.1 per cent to Rs. 22.7 billion during the first seven months of the year. Moreover, salaries and wages rose by 4.6 per cent to Rs. 388.2 billion during this period.

Figure 6.3
Composition of Government Expenditure (Jan-Jul 2019)



Source: Ministry of Finance

- **During the first seven months of 2019, capital expenditure and net lending increased both in nominal terms and as a percentage of estimated GDP.** Accordingly, in nominal terms, capital expenditure and net lending increased by 13.9 per cent to Rs. 373.4 billion while as a percentage of estimated GDP, capital expenditure and net lending increased to 2.4 per cent from 2.3 per cent recorded in the corresponding period of 2018. The realised capital expenditure and net lending in the first seven months of 2019 accounted for 50.9 per cent of the annual estimate for the year in comparison to a share of 43.7 per cent recorded in the corresponding period of 2018.

Financing of the Budget Deficit

- **The budget deficit was financed largely through domestic sources during the first seven months of 2019.** Net domestic financing during this period amounted to Rs. 571.4 billion compared to Rs. 187.6 billion recorded in the same period of 2018. Net foreign financing declined to Rs. 112.7 billion during the period under consideration, in comparison to Rs. 274.1 billion in the same period of 2018.

- **Domestic financing increased due to higher borrowings from both the non-banking sector and banking sector during the first seven months of 2019 compared to the same period of 2018.** Net financing from the domestic non banking sector increased to Rs. 400.5 billion during the period under consideration from Rs. 187.8 billion in the same period of 2018, accounting for 70.1 per cent of the total domestic financing requirement. Net bank financing stood at Rs. 170.9 billion during the first seven months of 2019 compared to net repayment of Rs. 0.2 billion recorded in the same period of 2018. This was mainly due to a significant increase in financing from commercial banks through Treasury bills and Treasury bonds. However, financing from the Central Bank recorded a net repayment of Rs. 126.4 billion in the first seven months of 2019 due to the maturity of Treasury bills held by the Central Bank, in comparison to the net financing of Rs. 31.6 billion recorded during the first seven months of 2018.

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Table 6.3
Sources of Financing

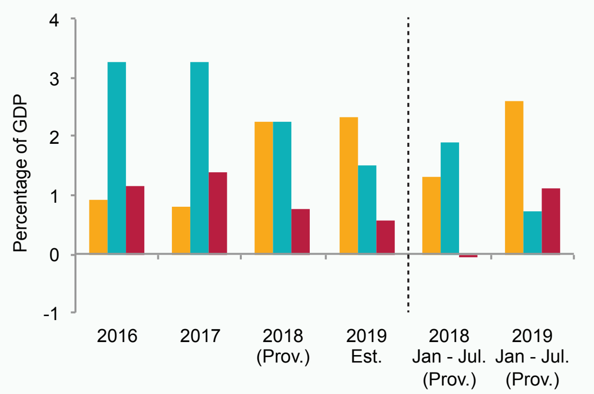
Rs. billion

Item	2017	2018 (a)	2018 Jan - Jul. (a)	2019 Jan - Jul. (a)
Domestic Financing	**294.3**	**437.2**	**187.6**	**571.4**
Bank	187.7	109.5	-0.2	170.9
Non Bank	106.5	327.8	187.8	400.5
Foreign Financing	**439.2**	**323.5**	**274.1**	**112.7**
Project Loans	0.8	7.7	-20.0	-5.4
Commercial Loans	381.2	456.9	321.9	136.2
Non Resident Investments in Treasury Bonds	43.7	-126.4	-22.4	-18.3
Non Resident Investments in Treasury Bills	13.6	-14.6	-5.5	0.2
Total Financing	**733.5**	**760.8**	**461.7**	**684.1**

(a) Provisional

Sources: Ministry of Finance
Central Bank of Sri Lanka

Figure 6.4
Deficit Financing



Source : Ministry of Finance

- **Treasury bills and Treasury bonds continued to be the major source of domestic borrowings during the first seven months of 2019.** Net borrowings from Treasury bills increased to Rs. 149.9 billon in the first seven months of 2019 from Rs. 81.3 billion in the same period of the previous year. Meanwhile, net borrowings from Treasury bonds increased to Rs. 331.8 billion in the first seven months of 2019 from Rs. 124.9 billion in the same period of 2018. Borrowings from SLDBs recorded a net repayment of Rs. 47.2 billion during the period under consideration in comparison to a sum of Rs. 81.6 billion net repayments in the first seven months of 2018.

- **Net foreign financing declined during the first seven months of 2019 reflecting large repayments on account of ISBs.** Net foreign financing declined to Rs. 112.7 billion during the period under review in comparison to Rs. 274.1 billion in the corresponding period of 2018. Net foreign financing comprised net borrowings of Rs. 219.7 billion of ISBs and Rs. 0.2 billion of foreign investments in Treasury bills, and net repayments of Rs. 83.5 billion of Foreign Currency Term Financing Facility (FCTFF), Rs. 5.4 billion of foreign project loans and Rs. 18.3 billion of foreign investments in Treasury bonds.

- **The government raised US dollars 4.4 billion through the issuance of ISBs in two steps during 2019.** The government issued its 13th ISB and raised US dollars 2.4 billion in March 2019. This issuance comprised two tenures of maturities of US dollars 1.0 billion with a 5 year maturity at a yield rate of 6.85 per cent and US dollars 1.4 billion with a 10 year maturity at a yield rate of 7.85 per cent. In June 2019, another ISB was issued amounting to US dollars 2.0 billion, which comprised US dollars 500 million with a 5 year maturity at a yield rate of 6.35 per cent and US dollars 1.5 billion with a 10 year maturity at a yield rate of 7.55 per cent per annum.

Government Debt and Debt Service Payments

Government Debt

- **The central government debt stock, which stood at Rs. 11,977.5 billion at the end of 2018, expanded by Rs. 668.4 billion to Rs. 12,645.9 billion as at end of July 2019.** Domestic debt increased by Rs. 435.1 billion to Rs. 6,453.1 billion, while foreign debt increased by Rs. 233.2 billion to Rs. 6,192.8 billion. The increase in net financing owing to the expansion in the budget deficit contributed significantly to the increase in the debt stock at end July 2019. Meanwhile, the appreciation of the exchange rate as at end July 2019 contributed to lower the rupee value of the outstanding debt by Rs. 190.9 billion. However, the debt stock increased by Rs. 58.3 billion due to the discount factor, which is the net amount of the difference between the book value and the face value of issuance of Treasury bills and Treasury bonds.

Table 6.4
Outstanding Central Government Debt

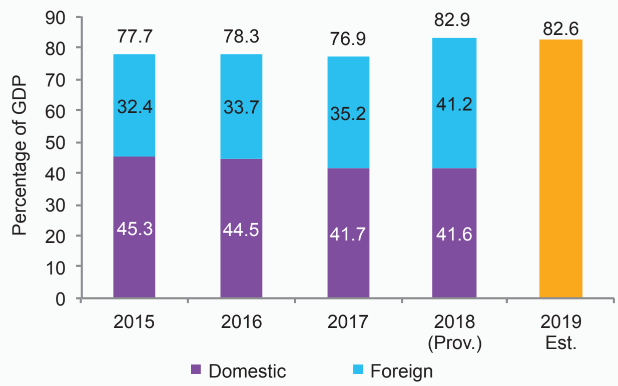
Rs. billion

Item	2017	2018 (a)	2018 End Jul. (a)	2019 End Jul. (a)
Domestic Debt (b)	**5,594.4**	**6,018.0**	**5,737.7**	**6,453.1**
By Maturity Period				
Short Term	1,031.2	1,134.6	1,100.9	1,277.1
Medium and Long Term	4,563.2	4,883.4	4,636.8	5,176.0
By Institution				
Banks	2,328.5	2,315.3	2,385.2	2,702.1
Non Bank Sector	3,265.9	3,702.7	3,352.5	3,751.0
Foreign Debt (c)	**4,718.6**	**5,959.5**	**5,221.3**	**6,192.8**
Concessional	2,130.5	2,705.8	2,163.3	2,620.3
Non Concessional	2,588.1	3,253.7	3,058.0	3,572.5
Total Government Debt	**10,313.0**	**11,977.5**	**10,959.0**	**12,645.9**

Sources: Ministry of Finance
Central Bank of Sri Lanka

(a) Provisional
(b) Excludes (i) rupee denominated Treasury bills and 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 remained as Rs. 56,662 million
(c) Includes outstanding amounts of foreign investments in rupee denominated Treasury bills and Treasury bonds

Figure 6.5
Outstanding Central Government Debt



Sources : Ministry of Finance
Central Bank of Sri Lanka

- **The shares of short term domestic debt increased as at July 2019 while the share of medium to long-term domestic debt declined.** The percentage of short term debt in total domestic debt increased to 19.8 per cent at end July 2019 compared to 18.9 per cent at the end 2018. The share of Treasury bills in domestic debt as at end July 2019 increased to 14.0 per cent from 12.4 per cent at end 2018 due to the increase in Treasury bill holdings of the banking sector. Meanwhile, the ratio of medium to long-term debt in the total domestic debt stock declined to 80.2 per cent at end July 2019 in comparison to 81.1 per cent at end 2018. The percentage of Treasury bonds, which comprises the largest share in the domestic debt portfolio increased marginally to 69.0 per cent as at end July 2019 from 68.8 per cent at end 2018. However, the ratio of SLDBs in total domestic debt stock as at end July 2019 reduced to 8.5 per cent from 10.2

per cent at end 2018, reflecting the net repayment of SLDBs and appreciation of rupee against the US dollar during the period under review.

- **The outstanding foreign currency denominated domestic debt in rupee terms declined marginally to Rs. 700.5 billion (US dollars 3,967.6 million) at end July 2019 from Rs. 714.7 billion (US dollars 3,911.0 million) at end-2018.** Accordingly, the outstanding debt on SLDBs amounted to Rs. 546.2 billion (US dollars 3,094.1 million), while the outstanding debt on Offshore Banking Units (OBUs) amounted to Rs. 154.2 billion (US dollars 873.5 million) as at end July 2019. The share of foreign currency denominated domestic debt to total domestic debt declined to 10.9 per cent at end July 2019 from 11.9 per cent at end 2018. Meanwhile, rupee denominated domestic debt increased by Rs. 449.4 billion to Rs. 5,752.7 billion at end July 2019.

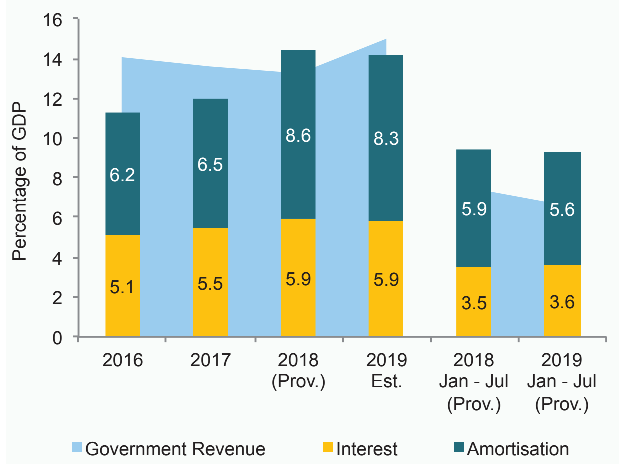
- **The share of non concessional debt in the foreign debt stock increased to 57.7 per cent by end July 2019 from 54.6 per cent at end 2018.** Accordingly, concessional foreign debt as a share of total foreign debt declined to 42.3 per cent by end July 2019 from 45.4 per cent at end 2018. Non concessional debt increased by 9.8 per cent to Rs. 3,572.5 billion mainly due to the two issuances of the ISBs during the first seven months of 2019.

6

Debt Service Payments

- **Debt service payments during the first seven months of 2019 increased by 5.5 per cent to Rs. 1,435.5 billion in comparison to the corresponding period of 2018.** This consists of amortisation payments of Rs. 873.9 billion (60.9 per cent) and interest payments of Rs. 561.6 billion (39.1 per cent). Further, debt service payments to domestic and foreign sources amounted to Rs. 781.2 billion and Rs. 654.3 billion, respectively. Debt service payments during the first seven months of 2019 accounted for 61.2 per cent of the annual budget estimate of 2019.

Figure 6.6
Government Debt Service Payments Vs Revenue



Sources : Ministry of Finance
Central Bank of Sri Lanka

Expected Developments

- **The medium term fiscal strategy of the government would focus on reducing the budget deficit and the outstanding public debt to a sustainable level assisted by enhanced revenue mobilisation in the medium term.** According to the Budget Speech 2019, the budget deficit was estimated at 4.4 per cent of GDP in 2019, and it is expected to consolidate at 3.5 per cent of GDP by 2020 and beyond. In line with such reduction in the budget deficit, the debt to GDP ratio is expected to reduce to around 72 per cent of GDP by 2022. Further, the government aims to strengthen the surplus in the primary balance to a sizable and sustainable level over the medium term assisted by improved government revenue and expenditure management. However, the achievement of the envisaged fiscal targets for 2019 and beyond would be challenging unless appropriate measures are in place to strengthen the performance in fiscal operations. Government revenue collection in 2019 is expected to be lower than the original estimate, mainly due to the contraction of import related taxes, particularly on motor vehicles and the slowdown in economic activity following the Easter Sunday attacks. On the expenditure front, additional pressure on government expenditures could be expected during the remaining period of 2019 and 2020 due to expected higher recurrent expenditure mainly driven by salary increases, subsidies and transfers and election related expenditure, despite the measures introduced to curtail government expenditure in 2019. The budget deficit and the debt to GDP ratio are likely to deviate from the targeted levels in 2019. Therefore, further measures would be needed to reinforce revenue mobilisation efforts going forward. Meanwhile, improvements are required in government expenditure management so as to complement the revenue mobilisation efforts over the medium term. Further, in view of the limited fiscal space of the government, it would be essential to promote PPPs in meeting the infrastructure requirement of the country in order to ease the burden on the central government budget. As such, appropriate measures ought to provide an adequate space for social and capital expenditure, thereby maintaining the envisaged medium term growth prospects. Further, in view of the large foreign commercial amortisation payments due in the coming years, implementation of liability management activities by means of smoothening the maturity profile of debt portfolio and prefunding the maturity payments would be essential to minimise the cost of refinancing and manage the risks prudently. The government's fiscal strategy would need to ensure a sizable and sustainable primary surplus to facilitate the envisaged reduction of government debt over the medium term.