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FISCAL POLICY AND GOVERNMENT FINANCE

Fiscal operations during the period from January to July 2020 met with significant challenges amidst the outbreak of the COVID-19 pandemic which severely affected the Government's plans for revenue mobilisation and expenditure rationalisation. In the absence of an annual budget approved by the Parliament for 2020, the Government initiated measures to carry out fiscal operations under Votes-on-Account (VoAs) and the authorisation of His Excellency the President under the provisions of the Constitution. Accordingly, fiscal operations during January - April 2020 were planned under a VoA, which was approved in October 2019, in view of insufficient time for presenting an annual budget following the presidential election in November 2019. As the Parliament was dissolved on 03 March 2020 prior to approving an annual budget or a VoA, and the general elections were delayed amidst the outbreak of COVID-19, the expenditure on public services was facilitated under the authorisation of His Excellency the President from the Consolidated Fund. Following the general elections in August 2020, the Parliament approved another VoA on 28 August 2020 for the last four months of 2020. Meanwhile, reflecting the impact of the pandemic on economic activity, government revenue moderated during the seven months ending July 2020 over the same period a year earlier. On the expenditure front, recurrent expenditure increased year-on-year, mainly on account of the increase in salaries and wages and subsidies and transfers, while capital expenditure contracted during January - July, year-on-year, on account of limited space owing to the moderation of revenue, large unpaid bills spilled over from 2019, the non implementation of new capital projects on the backdrop of the COVID-19 outbreak and the absence of budgetary provisions. This contraction of capital expenditure outpaced the rise in recurrent expenditure, thereby resulting in a decline in total expenditure and net lending during the seven months ending July 2020 over the same period of 2019. Nevertheless, the moderation of revenue outweighed the decline in government expenditure, weakening the key fiscal balances, namely, the budget balance, primary balance, and current account balance, during the period from January - July 2020, compared to the same period of 2019. The settlement of outstanding bills spilled over from 2019 added pressure on fiscal operations and contributed to widen the budget deficit during January - July 2020. The rise in net borrowing in financing the budget deficit, along with the impact of depreciation of the Sri Lankan rupee against the US dollar, resulted in an increase in the outstanding central government debt as at end July 2020, compared to end 2019. In financing the budget deficit, the Government relied on domestic sources, while foreign financing recorded a net repayment during the period from January to July 2020. The Government duly settled all the debt servicing obligations thus far in 2020 including the International Sovereign Bond (ISB), which matured in early October 2020, dispelling adverse speculation and uncertainties caused by the downgrade of Sri Lanka's sovereign ratings by international rating agencies in 2020. Reflecting the impact of the economic fallout due to the pandemic, the major fiscal balances are expected to weaken in 2020, before improving from 2021, alongside the envisaged revival of economic activity.

Fiscal Policy Measures

- **In 2020, the fiscal policy measures were influenced by the developments in the political front on the one hand, and the spread of COVID-19 on the other**. Fiscal operations during January - April 2020 were planned under a VoA as approved by the Parliament in October 2019, in view of insufficient time for presenting a national budget for 2020 following the presidential election in November 2019. Meanwhile, the Parliament was dissolved on 03 March 2020, prior to presenting an annual budget or a VoA, and the general elections were delayed amidst the outbreak of COVID-19. Hence, the expenditure on public services was facilitated under the authorisation of His Excellency the President from the Consolidated Fund from 06 March 2020 to 31 August 2020. Following the general elections in August 2020, the Parliament approved another VoA on 28 August 2020 for the last four months of 2020. Meanwhile, the Appropriation Bill for the financial year 2020 was gazetted on 06 October 2020.[1]

- **Fiscal stimulus measures introduced following the presidential election in late 2019 were challenged by the COVID-19 pandemic in realising the envisaged revival of economic activity**. The near term negative impact of such measures on government revenue was exacerbated by the contraction of economic activity amidst the lockdown due to COVID-19. Accordingly, government revenue in 2020 is expected to decline to historic low levels in GDP terms. The expected revenue slippage coupled with the rise in recurrent expenditure and the settlement of outstanding payments carried forward from the previous year, are likely to cause a notable deterioration in fiscal performance in 2020.

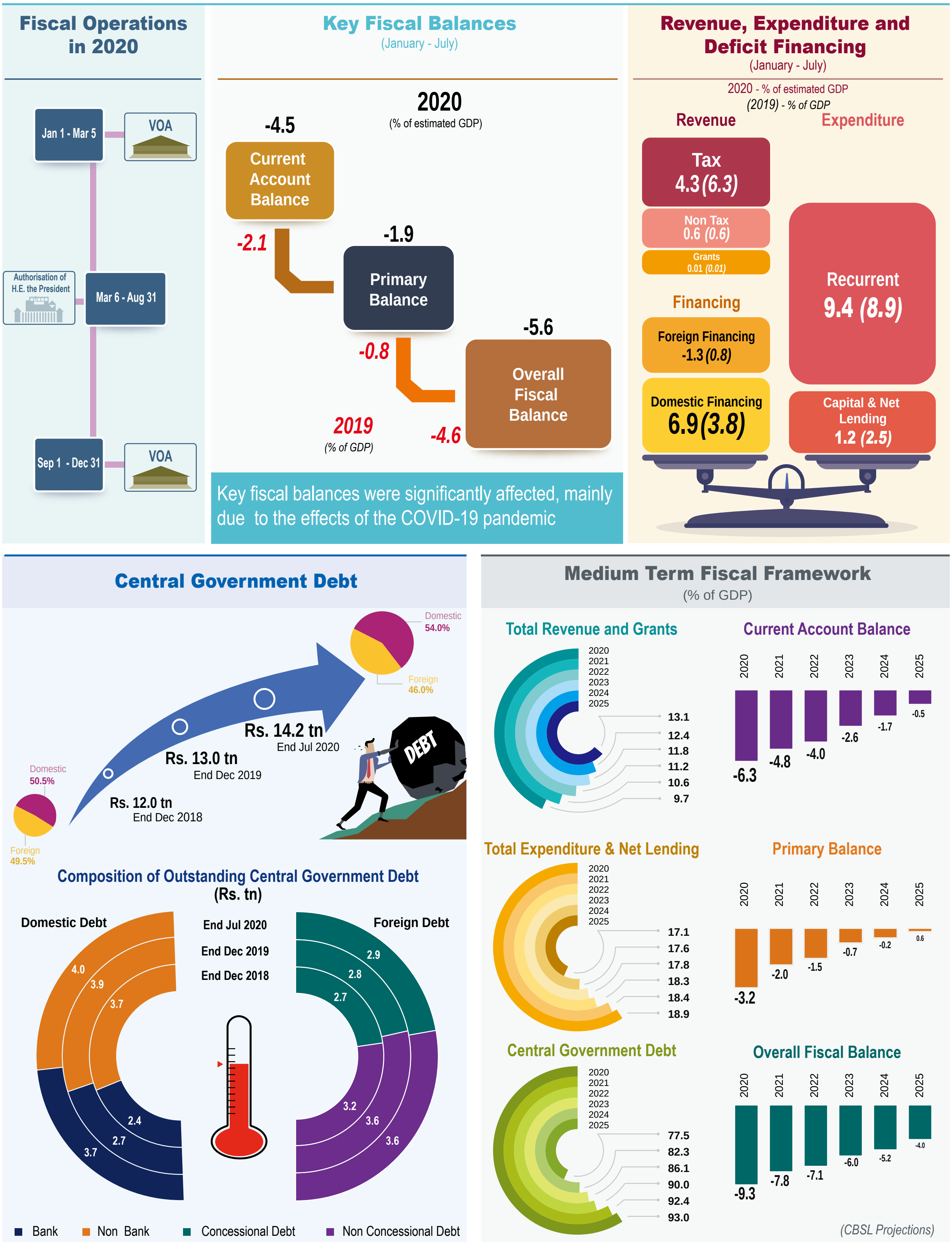
- **A range of fiscal measures was initiated with the aim of providing support to businesses and individuals affected by the COVID-19 pandemic**. Importation of selected health related equipment was exempted from the Ports and Airports Development Levy (PAL) and the Commodity Export Subsidy Scheme (CESS). Payment timelines of Withholding Tax (WHT) and Value Added Tax (VAT) for the months of February and March 2020 were extended until 30 April 2020, while directions were issued with respect to penalty payment exemptions for all taxes during the lockdown period and to commence penalty provisions for late payments from July 2020. Small and Medium Enterprises (SMEs) were granted with various tax relief measures in the form of waivers of income tax arrears on assessments issued upto the year of assessment 2018/2019, non-issuance of additional assessments for the year of assessment 2019/2020, granting a grace period to settle taxes in arrears/default, extension on seizure notices and extended timelines for tax payments and filing tax returns, thereby providing temporary cash flow relief to affected businesses.

- **Amendments to the Inland Revenue Act, No. 24 of 2017, are in progress with regard to the tax revisions implemented during 2020.** As announced by the Inland Revenue Department in late 2019, such revisions were implemented with effect from 01 January 2020, subject to the approval of the Parliament.[2] The proposed revisions were mainly aimed at simplifying the existing income tax structure and providing tax concessions to support the revival of economic activity. Accordingly, revisions were introduced to personal income tax rates, the tax free threshold and tax slabs. The tax free threshold was increased to Rs. 3.0 million per annum for any source of income from Rs. 1.2 million per annum for employment income and Rs. 500,000 per annum for personal income. The income tax slabs applicable for tax payable

1 Certain expenditure and advances made under Resolutions passed under Articles 150(2) and authorised under 150(3) of the Constitution are to be included in the First Schedule, Second Schedule and Third Schedule, of the Appropriation Act for 2020, while borrowings made in terms of Resolutions passed under Articles 150(2) are to be included under Section 2(1)(b) of the Appropriation Act for 2020. The Appropriation Bill for the financial year 2021 was also gazetted on 06 October 2020.

2 The Cabinet of Ministers approved the proposed amendments to the Inland Revenue Act, No. 24 of 2017 on 26 August 2020 and the same has been sent to the Legal Draftsman. In addition, the Economic Service Charge (Amendment) Act, No. 4 of 2020 was enacted on 12 October 2020 on the removal of the Economic Service Charge (ESC). Further, amendments to the Value Added Tax Act, No. 14 of 2002 were approved by the Cabinet of Ministers on 26 August 2020 and the same has been sent to the Legal Draftsman.

Figure 6.1
Fiscal Sector Performance



above the tax free threshold were increased to Rs. 3.0 million per annum from Rs. 600,000 per annum. Personal income tax rates were simplified and revised to 6 per cent, 12 per cent and 18 per cent, compared to the previous structure of 4 per cent, 8 per cent, 12 per cent, 16 per cent, 20 per cent and 24 per cent. Moreover, the Pay-As-You-Earn (PAYE) tax on any employment receipts to any resident or non-resident person was removed with effect from 01 January 2020. Subsequently, an Advance Personal Income Tax (APIT) was introduced in lieu of PAYE tax with effect from 01 April 2020, on an optional basis. APIT is deducted from the remuneration of resident employees with the consent of such employees and if any resident employee, who dissents to paying APIT, is liable to pay personal income tax based on the applicable tax slabs and rates. However, with regard to non-resident employees, APIT is deducted from the remuneration by the relevant employer irrespective of the consent of such employees. Meanwhile, the corporate income tax rate applicable for the construction industry was reduced to 14 per cent from 28 per cent, and the same for the banking, finance, insurance industries and trading activities was reduced to 24 per cent from 28 per cent with effect from 01 January 2020. Further, the WHT and Economic Service Charge (ESC) were removed with effect from 01 January 2020. However, the applicability of the WHT would continue on the amounts paid for winning lotteries, rewards, betting and gambling, sale of any gem at an auction conducted by the National Gem and Jewellery Authority, and payments made to any non-resident person.

- **Several changes were made to Customs duties in line with the changes in international commodity prices while also considering any pressure on the exchange rate**. Accordingly, some upward revisions were made to Customs duty and a surcharge was imposed on the importation of petrol and diesel to maintain the domestic retail prices of petrol and diesel at existing levels. In addition, considering the pressure on the BOP and the exchange rate during the COVID-19 pandemic, Customs duty on the importation of fish products, mandarins, cereal products, flour, vegetable and fruit products including juice products, tea and coffee extracts and tobacco products was increased within a range of 25-50 per cent in April 2020. The changes to Customs duties thus far in 2020 are detailed in Appendix 1 (Major Economic Policy Measures) of this Report.

- **The Special Commodity Levy (SCL) on selected items was revised in order to support domestic producers, while reducing volatility in domestic market prices**. The SCL on the importation of fish (fresh, chilled or frozen), yoghurt, potatoes, red onion, b'onion, garlic, peas (split), chickpeas, red and yellow lentils (whole and split), dates (fresh and dried), grapes (fresh), apples (fresh), pears, cherries (other), plums and sloes, chillies (neither crushed nor ground), maize, ground nut (shelled), margarine, canned fish, beet and cane sugar was revised upward, while SCL was imposed on clementines (fresh and dried), grapefruit (including pomelos – fresh and dried), lemons (fresh and dried), quinces, apricots, sour cherries, peaches (including nectarines), vegetable fats and oils and their fractions, margarine (other), disinfectants and face masks. In addition, both upward and downward revisions were made to the SCL on fish (jack and horse mackerel), oranges (fresh and dried), grapes (dried) and vegetable oils during the period from February to July 2020.

- **Several measures were introduced to strengthen tax administration during 2020, in order to enhance the efficiency and effectiveness of revenue collecting agencies**. Accordingly, several modifications were introduced to the Automated System for Customs Data (ASYCUDA) of the Sri Lanka Customs (SLC) with the view of expediting the automation process. In order to facilitate the paperless clearing process while adhering to the social distancing guidelines of the Government, the ASYCUDA system was modified enabling importers to submit documents to SLC without being physically present. Further, modifications were also made to the ASYCUDA Container Pass e-document, enabling the officers to check details without being physically present in office. With the aim of enhancing efficiency and effectiveness of the work related to customs clearance, a mechanism was developed to incorporate scanned images ('RAPISCAN') to the ASYCUDA Container Pass e-document, while the selectivity module of the ASYCUDA system was re-engineered by introducing an auto update selectivity list based on the data available in the system. Moreover, a revenue reporting module was developed at the SLC in order to report daily revenue collections to the Ministry of Finance (MOF) under the Integrated Treasury Management Information System (ITMIS).

- **The Government implemented several measures to encourage effective management of public expenditure during the year**. Accordingly, considering the weakened revenue mobilisation caused by the COVID-19 pandemic, all ministries and departments were strictly advised to limit expenditure within the allocated provisions, while avoiding non-essential expenses. Further, the National Pay Commission was established in February 2020, to revisit all remuneration structures of the public sector as well as the private sector, and to advise and assist the Government in formulating and implementing a national wage policy.

- **Several measures were taken to streamline the pension payment process while supporting pensioners during the outbreak of COVID-19**. Accordingly, the digital life certificate project commenced during the first half of 2020, allowing pensioners to provide their life certificate using their fingerprint in lieu of the existing documentation process. This project is expected to simplify and automate the pension payment process as it eliminates the need for the life certificate being sent to Divisional Secretariats every year in order to verify the life/residence of the pensioners. With the aim of enhancing the accuracy and credibility of the pension payments process, facilities were provided to pensioners to appoint a guardian whenever the pensioner is unable to receive the pension in person due to difficulties arising from serious physical or mental health issues. Further, the W&OP pension activation was entrusted to Divisional Secretaries by introducing a new web based programme in order to ensure accuracy and efficiency of the payment process. Moreover, the Public Administration Circular No. 08/2020 was issued to ministries, departments and provincial councils to provide a monthly allowance of Rs. 25,000 in April and May 2020 for recently retired public officers whose pension payments were not finalised due to the delays caused by the COVID-19 pandemic.

- **The Government launched a new recruitment programme with the view of uplifting the living standards of underprivileged households, while ensuring their productive contribution to the economy**. Accordingly, the Government commenced the programme in January 2020 to recruit 100,000 unskilled individuals from low income families. Moreover, the Government commenced another recruitment programme in February 2020 to provide employment opportunities for 50,000 unemployed graduates and diploma holders, who had remained unemployed during the preceding three years. These recruitments, which were suspended in March 2020 following the announcement of the general election, recommenced in early September 2020 and approval was also granted by the Cabinet of Ministers to recruit 10,000 additional graduates.

- **The Government's welfare programmes focused on supporting the needy segments of the society affected by the COVID-19 pandemic, while measures were also taken to strengthen the operations of the Welfare Benefits Board (WBB).** Accordingly, considering the difficulties faced by economically vulnerable people during the COVID-19 pandemic, measures were taken to provide a cash allowance of Rs. 5,000 to senior citizens, differently-abled persons, kidney patients, farmers and displaced daily workers in April and May 2020. Further, actions were taken to provide an interest free advance of Rs. 10,000 to Samurdhi beneficiaries during the lockdown period, while a one month grace period was granted to the general public for the payments of utility bills. In addition, Agrahara insurance benefits were doubled for police officers, tri-forces and government employees and officers in the health sector, who are engaged in COVID-19 prevention activities. During the year, the WBB signed a MoU with the Department of Samurdhi to obtain data required for the commencement of activities in the Social Registry Information System (SRIS), which is an electronic database that stores information related to welfare programmes. The SRIS is expected to be finalised and extended into an Integrated Welfare Management System (IWMS) in order to enhance the selection procedure of beneficiaries for various welfare programmes. Moreover, a monitoring system is expected to be established to observe daily operations of the SRIS, while strengthening the institutional structure of the WBB.

- **The Government took several policy measures to improve the financial viability of State Owned Business Enterprises (SOBEs), thereby reducing the burden on fiscal operations**. Accordingly, a special committee was established in early 2020 to appoint suitable personnel for key positions of SOBEs, in order to strengthen the financial viability of those institutions. Moreover, the Fuel Price Stabilisation Fund (FPSF) was established to reduce fluctuations of domestic petroleum prices, while sharing the benefits of low oil prices in global markets in a more economically viable and equitable manner. Accordingly, the Fund was established with an initial capital of Rs. 50 billion (on face value basis) by issuing Treasury bills to the Central Bank on 23 March 2020. Meanwhile, the revenue collected from the surcharges on petrol and diesel imports gets transferred to the FPSF. During the year thus far, the FPSF has been partly utilised to settle the dues of the Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC).

- **Sri Lanka's sovereign credit rating, which remained unchanged in 2019, was downgraded in 2020**. In April and May 2020, Fitch Ratings and S&P Global Ratings downgraded Sri Lanka's sovereign rating to "B-", while asserting the outlook at "Negative" and "Stable", respectively. In September 2020, Moody's Investors Service, which had placed Sri Lanka's rating of "B2" under review for "downgrade" in April 2020, downgraded the rating by two notches to "Caa1", and changed the outlook to "Stable" from "Negative" highlighting the challenge of forthcoming external debt service obligations. However, the Government duly settled all debt servicing obligations thus far in 2020, including the matured International Sovereign Bond (ISB) of US dollars 1 billion, which was settled in early October 2020.

- **The buffers built in 2019 under the Active Liability Management Act (ALMA) No. 8 of 2018 were utilised in the early part of 2020, while the benchmarks set under the Medium Term Debt Management Strategy (MTDS) for the period 2019-2023 recorded improvements thus far in 2020**. Measures were taken in 2019 under ALMA to build buffers by executing the first liability management based Treasury bonds issuance amounting to Rs. 15 billion in October 2019 followed by another Rs. 15 billion issuance in December 2019. The buffers built in 2019 were utilised for the settlement of debt service obligations during early 2020. The MTDS mainly focuses on building an appropriate composition of debt instruments to ensure that budgetary needs are financed at the least possible cost, while managing the risk of the debt portfolio at prudent levels. The indicators of debt dynamics recorded improvements in 2020 compared to the baseline, which was identified as at end 2018. By end August 2020, foreign currency (FX) exposure as a percentage of total debt declined to 50.8 per cent from the baseline level of

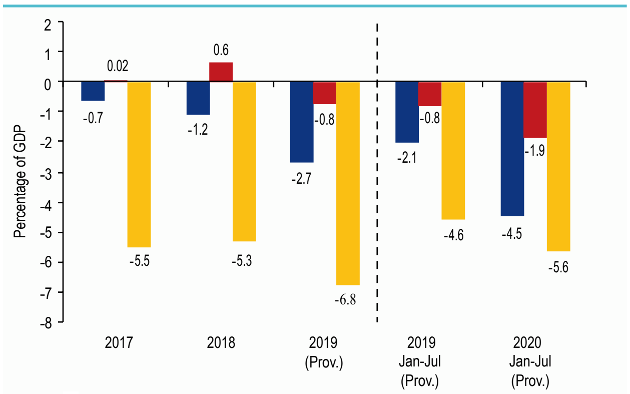
54.0 per cent, while the Average Time to Maturity (ATM) of foreign currency debt portfolio increased to 7.3 years at end August 2020 from the baseline level of 6.6 years. However, short term debt maturities as a percentage of total debt increased to 18.6 per cent from the baseline level of 16.4 per cent.

Government Budgetary Operations

Key Fiscal Balances

- **Key fiscal balances were significantly affected by the impact of low revenue mobilisation and the rise in recurrent expenditure during the period from January to July 2020**. The budget deficit increased to 5.6 per cent of estimated GDP[3] (Rs. 872.6 billion) during the period from January to July 2020 from 4.6 per cent of GDP (Rs. 684.1 billion) in the corresponding period of the previous year. The primary deficit increased to 1.9 per cent of estimated GDP (Rs. 288.9 billion) during the period under review from 0.8 per cent of GDP (Rs. 122.5 billion) recorded in the same period of 2019. The current account deficit, which reflects the dissavings of the Government, increased to 4.5 per cent of estimated GDP (Rs. 694.5 billion) during the period from January to July 2020 from 2.1 per cent of GDP (Rs. 311.8 billion) in the same period of 2019.

Figure 6.2
Key Fiscal Indicators (a)



Sources: Ministry of Finance
Central Bank of Sri Lanka

(a) 2020 figures are based on the GDP projections of the Central Bank.

3 Based on the GDP projections of the Central Bank.

Government Revenue and Grants

Revenue

- **During the period from January to July 2020, government revenue as a percentage of estimated GDP declined to 4.9 per cent from 6.9 per cent of GDP in the corresponding period of 2019 due to a notable decline in the tax revenue collection.** The decline in government revenue largely reflected the impact of the subdued economic activity following the COVID-19 outbreak amidst the tax concessions granted after the presidential election to stimulate economic activity. In nominal terms, government revenue declined by 26.0 per cent to Rs. 763.2 billion during the seven months ending July 2020 from Rs. 1,031.9 billion recorded in the corresponding period of 2019. This decline in revenue mobilisation was observed in major tax categories of income taxes, excise duties, VAT, Nation Building Tax (NBT), PAL and CESS. However, non tax revenue increased by 6.1 per cent to Rs. 92.8 billion during the period under review, mainly due to the transfer of distributable profits of the Central Bank to the Government based on the financial statements of 2019, amounting to Rs. 24.0 billion.

- **Revenue from income taxes declined significantly by 31.9 per cent to Rs. 126.0 billion during the period from January to July 2020, compared to the same period of 2019**. Revenue from income taxes declined to 0.8 per cent of estimated GDP during the seven months ending July 2020 from 1.2 per cent of GDP recorded during the corresponding period of 2019. The abolition of PAYE tax and ESC effective from January 2020 mainly contributed to this decline in income tax revenue during January - July 2020. Accordingly, revenue from PAYE tax collected for the financial year 2019 and remitted in 2020, along with the revenue on account of APIT, which was introduced since 01 April 2020 in lieu of PAYE tax, recorded at

Rs. 9.1 billion during the period from January to July 2020, compared to PAYE tax revenue of Rs. 29.7 billion in the same period of 2019. Revenue from ESC mainly collected for the financial year 2019 and remitted in 2020 recorded at Rs. 13.6 billion during the period from January to July 2020, compared to Rs. 40.1 billion in the corresponding period of 2019. Following the amendment made to WHT, revenue collection from WHT also declined by 77.8 per cent, in nominal terms, to Rs. 6.5 billion during the period under review. However, revenue collection from corporate and non corporate income tax increased to Rs. 96.7 billion during the seven months ending July 2020, compared to Rs. 85.7 billion in the corresponding period of 2019, reflecting the impact of payment of final taxes relating to the preceding financial year.

- **During the period from January to July 2020, revenue from VAT declined both in nominal terms and as a percentage of estimated GDP, mainly due to the economic fallout from the COVID-19 pandemic and the revisions made to VAT in the latter part of 2019**. Revenue from VAT declined by 55.1 per cent to Rs. 119.3 billion during the seven months ending July 2020, and it declined to 0.8 per cent of estimated GDP from 1.8 per cent of GDP in the corresponding period of 2019. Revenue from VAT on domestic economic activities declined by 54.9 per cent to Rs. 74.7 billion during the period from January to July 2020, while revenue from VAT on import related activities declined by 55.3 per cent to Rs. 44.7 billion, compared to Rs. 100.0 billion recorded in the same period of 2019. During the period from January to July 2020, VAT revenue as a percentage of total tax revenue declined to 17.8 per cent from 28.1 per cent in the corresponding period of 2019, while the contribution of VAT revenue to total revenue also declined to 15.6 per cent from 25.7 per cent recorded during the period from January to July 2019.

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Table 6.1

Economic Classification of Government Revenue

Rs. billion

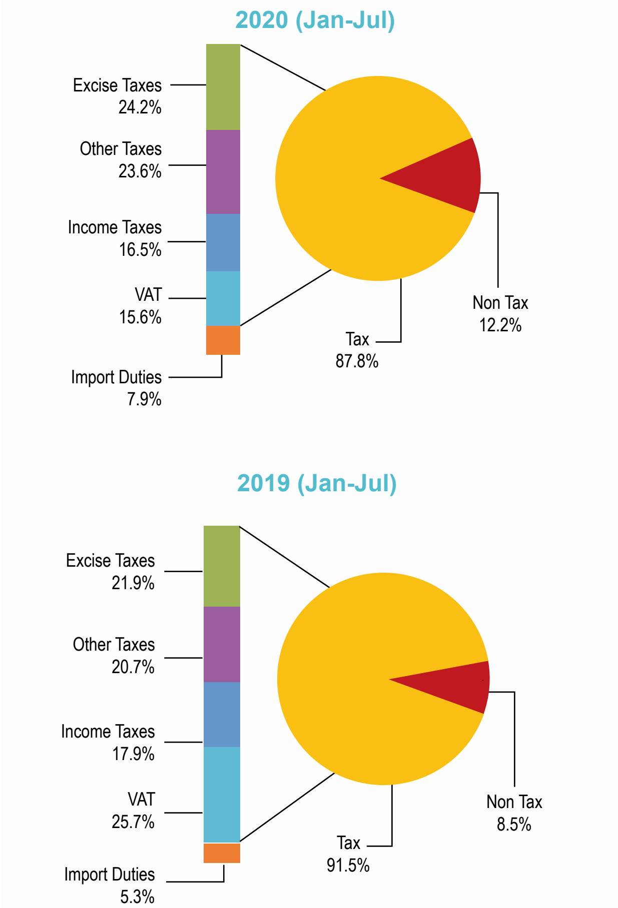
Item	2018	2019 (a)	2019 Jan - Jul (a)	2020 Jan - Jul (a)
Tax Revenue	**1,712.3**	**1,734.9**	**944.4**	**670.4**
Income Taxes	310.4	427.7	184.9	126.0
VAT	461.7	443.9	265.6	119.3
Excise Taxes	484.3	399.5	225.8	184.9
Import Duties	97.0	98.4	55.2	60.4
PAL	113.9	112.2	64.5	62.4
NBT	71.4	70.7	42.2	1.8
SCL	75.8	70.4	42.2	46.5
CESS	53.4	50.7	28.3	28.1
Other Taxes	44.4	61.5	35.7	41.0
Non Tax Revenue	**207.7**	**156.0**	**87.5**	**92.8**
Total Revenue	**1,920.0**	**1,890.9**	**1,031.9**	**763.2**

(a) Provisional

Source: Ministry of Finance

- **Revenue from excise duties declined significantly, both in nominal terms and as a percentage of estimated GDP, mainly owing to the reduction in revenue from excise duties on motor vehicles, liquor, cigarettes and petroleum products**. Revenue from excise duties declined by 18.1 per cent to Rs. 184.9 billion and as a percentage of estimated GDP, it declined to 1.2 per cent from 1.5 per cent of GDP recorded in the same period of 2019. Revenue from excise duty on motor vehicles declined significantly by 39.8 per cent to Rs. 42.7 billion during the period from January to July 2020, compared to the same period of 2019, reflecting the impact of policy measures implemented to curtail the importation of motor vehicles to address pressures in the external sector. Meanwhile, revenue from excise duty on petroleum products declined to Rs. 31.2 billion during the period from January to July 2020, compared to Rs. 35.3 billion in the corresponding period of 2019, due to the decline in imports of petroleum products. In addition, during the period from January to July 2020, revenue from excise duty on liquor also declined to Rs. 60.1 billion from Rs. 66.2 billion in the corresponding period of 2019. Meanwhile, revenue from excise duty on tobacco and cigarettes declined by 5.3 per cent to Rs. 48.3 billion, in comparison to the corresponding period of previous year.

Figure 6.3
Composition of Government Revenue



Sources: Ministry of Finance
Central Bank of Sri Lanka

- **Revenue collection from several import related taxes declined, in nominal terms, during the period from January to July 2020, compared to the same period in 2019, mainly due to the curtailment of non-essential imports aimed at mitigating the pressure on the exchange rate and the BOP.** In addition to the decline in import related excise duties, revenue from PAL declined by 3.2 per cent to Rs. 62.4 billion during the period from January to July 2020 from Rs. 64.5 billion recorded in the same period of 2019. Further, revenue from CESS declined marginally to Rs. 28.1 billion during the seven months ending July 2020 from Rs. 28.3 billion recorded in the corresponding period of 2019. However, revenue from import duties increased to Rs. 60.4 billion from Rs. 55.2 billion during the period under review, mainly due to the increase in duties on importation of petrol and diesel. Revenue from SCL also increased to Rs. 46.5 billion during the period from January to July 2020 from Rs. 42.2 billion recorded in the same period of 2019, mainly supported by upward revisions to SCL on the importation of selected items. The NBT, which was abolished in December 2019, recorded a revenue collection of Rs. 1.8 billion during January - July 2020, due to the revenue collected for 2019 and remitted in 2020.

- **During January - July 2020, non tax revenue increased in nominal terms, while as a percentage of estimated GDP, it remained unchanged, compared to the corresponding period of 2019.** Non tax revenue increased to Rs. 92.8 billion from Rs. 87.5 billion recorded in the corresponding period of 2019, mainly due to transfers of the distributable profits of the Central Bank to the Government amounting to Rs. 24.0 billion based on the financial statements of 2019. In addition, rent and interest income increased by 33.7 per cent to Rs. 13.5 billion, while social security contributions increased by 9.2 per cent to Rs. 17.7 billion during the period under review. However, fees and charges and transfers of profits and dividend declined by 36.3 per cent and 57.8 per cent to Rs. 29.6 billion and Rs. 5.1 billion, respectively.

Grants

- **Disbursement of foreign grants during the period from January to July 2020 increased year-on-year, mainly reflecting the impact of COVID-19 related assistance.** Accordingly, foreign grants during the seven months ending July 2020 amounted to Rs. 2.1 billion, in comparison to Rs. 1.1 billion recorded in the corresponding period of 2019.

Government Expenditure and Net Lending

- **Total expenditure and net lending during the period from January to July 2020 declined to 10.6 per cent of estimated GDP from**

11.4 per cent of GDP in the corresponding period of 2019 due to the sharp reduction in capital expenditure, despite an increase in recurrent expenditure. Government expenditure and net lending declined to Rs. 1,637.9 billion during the seven months ending July 2020 from Rs. 1,717.1 billion during the corresponding period of 2019.

- **During the seven months ending July 2020, recurrent expenditure as a percentage of estimated GDP increased to 9.4 per cent from 8.9 per cent of GDP recorded in the same period of 2019, mainly due to the increase in salaries and wages, and subsidies and transfers.** In nominal terms, recurrent expenditure increased by 8.5 per cent to Rs. 1,457.7 billion during the period from January to July 2020, compared to Rs. 1,343.7 billion recorded in the same period of 2019. Expenditure on interest payments rose by 3.9 per cent to Rs. 583.6 billion during the period from January to July 2020, mainly due to the increase in interest payments on foreign debt by 10.8 per cent during the period under review. Accordingly, interest payments on foreign debt increased to Rs. 170.8 billion during the seven months ending July 2020 from Rs. 154.2 billion in the corresponding period of 2019, mainly due to the increase of interest payments on outstanding commercial debt during January - July 2020. Interest payments on domestic debt also increased to Rs. 412.8 billion during the period from January to July 2020 from Rs. 407.4 billion recorded in the corresponding period of 2019, mainly due to the increase in the outstanding domestic debt stock by 16.3 per cent as at end July 2020, despite a reduction in borrowing costs as observed in the downward adjustment of yields on government securities beginning from early 2020. Interest payments increased to 3.8 per cent of estimated GDP during the period from January to July 2020 from 3.7 per cent of GDP recorded in the corresponding period of 2019. Expenditure on salaries and wages increased to Rs. 451.4 billion during the period from January to July 2020, in comparison to Rs. 388.2 billion in the corresponding period of 2019, mainly due to the introduction of a monthly interim allowance of Rs. 2,500 to public sector employees with effect from July 2019 under the Public Administration Circular No. 09/2019. With effect from 01 January 2020, the completion of the adjustment of public sector salaries as per the Public Administration Circular No 03/2016 also contributed to the increase in salaries and wages during the period under consideration. Expenditure on subsidies and transfers, in nominal terms, rose by 8.7 per cent to Rs. 340.1 billion, while it increased to 2.2 per cent of estimated GDP during the seven months ending July 2020 from 2.1 per cent of GDP in the corresponding period of 2019, mainly due to higher expenditure on pension and Samurdhi payments. Accordingly, expenditure on pension payments increased to Rs. 140.7 billion during the period from January to July 2020, in comparison to Rs. 124.3 billion in the corresponding period of 2019, mainly reflecting the rectification of pension anomalies with effect from July 2019. Expenditure on the Samurdhi programme also increased to Rs. 30.7 billion during the seven months ending July 2020 from Rs. 22.7 billion recorded in the corresponding period of 2019. However, expenditure on the fertiliser subsidy declined by 26.5 per cent to Rs. 18.6 billion during the period under review, mainly due to recording delays owing to the arrangement of a term loan facility to settle fertiliser related expenditure.

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Table 6.2
Economic Classification of Expenditure

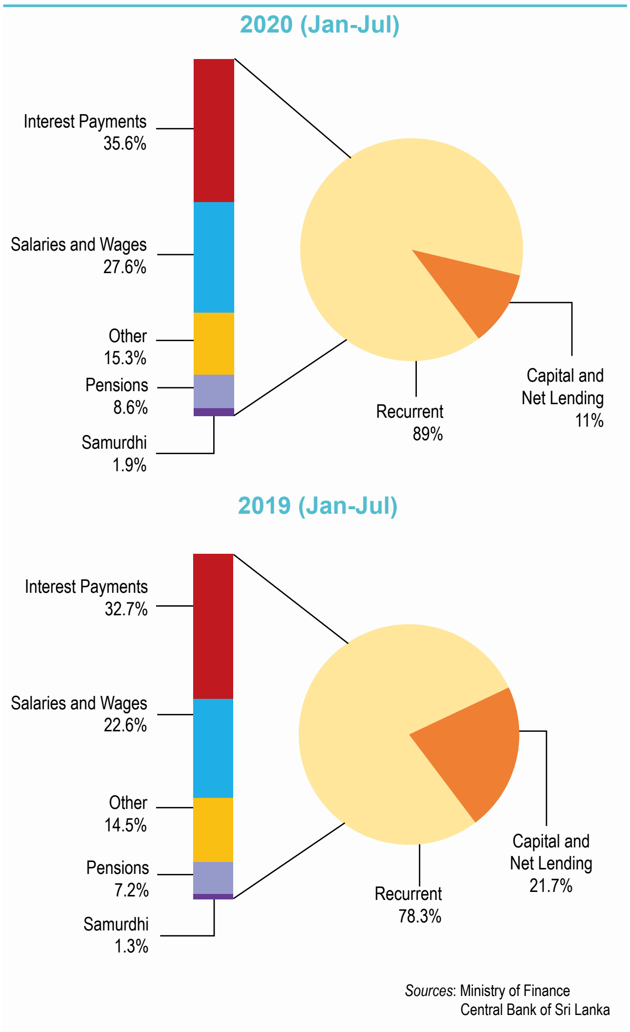
Rs. billion

Item	2018	2019 (a)	2019 Jan - Jul (a)	2020 Jan - Jul (a)
Recurrent Expenditure	**2,089.7**	**2,301.2**	**1,343.7**	**1,457.7**
o/w Salaries and Wages	626.0	686.5	388.2	451.4
Interest Payments	852.2	901.4	561.6	583.6
Foreign	212.7	248.6	154.2	170.8
Domestic	639.5	652.8	407.4	412.8
Samurdhi	39.2	44.7	22.7	30.7
Pensions	194.5	227.7	124.3	140.7
Fertiliser Subsidy	26.9	35.0	25.3	18.6
Capital Expenditure and Net Lending	**603.5**	**614.1**	**373.4**	**180.2**
Total Expenditure and Net Lending	**2,693.2**	**2,915.3**	**1,717.1**	**1,637.9**

(a) Provisional

Source: Ministry of Finance

Figure 6.4
Composition of Government Expenditure



- **Capital expenditure and net lending declined sharply both in nominal terms and as a percentage of estimated GDP during the period from January to July 2020.** This reduction in capital expenditure was mainly due to the streamlining of capital expenditure amidst the large unpaid bills carried forward from 2019 and the non implementation of new capital projects under VoAs. Accordingly, in nominal terms, capital expenditure and net lending declined by 51.7 per cent to Rs. 180.2 billion during the seven months ending July 2020, compared to Rs. 373.4 billion recorded in the same period of 2019. Meanwhile, the Government incurred a substantial amount of expenditure due to the Covid-19 pandemic during the year thus far.

Financing of the Budget Deficit

- **The budget deficit was financed through domestic sources during the period from January to July 2020, while foreign financing recorded a net repayment.** Net domestic financing during this period amounted to Rs. 1,067.0 billion, compared to Rs. 571.4 billion recorded in the same period of 2019. Financing through foreign sources recorded a net repayment of Rs. 194.5 billion during the period under consideration, in comparison to a net borrowing of Rs. 112.7 billion in the same period of 2019.

- **Domestic financing increased due to higher borrowings from the banking sector, including a significant portion from the Central Bank during the seven months ending July 2020, compared to the same period in 2019.** Accordingly, net bank financing increased significantly to Rs. 867.0 billion during the seven months ending July 2020 from Rs. 170.9 billion recorded in the same period of 2019. This included a significant increase in net financing from the Central Bank through Treasury bills of Rs. 186.0 billion, in comparison to a net repayment of Rs. 165.4 billion in the corresponding period of 2019. Meanwhile, financing from commercial banks through Treasury bills and Treasury bonds increased to Rs. 436.6 billion during the seven months ending July 2020, from Rs. 341.1 billion in the same period of 2019. Net financing from the domestic non banking sector decreased to

Table 6.3
Sources of Financing of the Budget Deficit

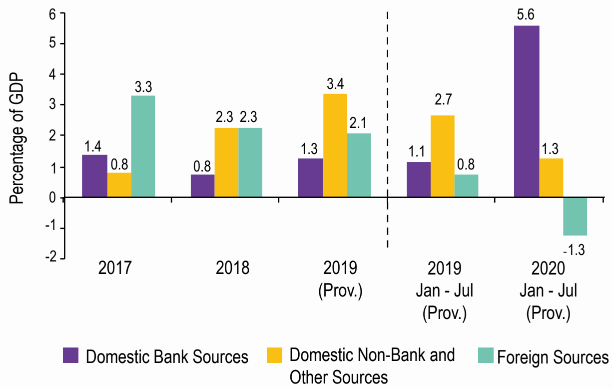
Rs. billion

Item	2018	2019 (a)	2019 Jan - Jul (a)	2020 Jan - Jul (a)
Domestic Financing	**437.2**	**702.4**	**571.4**	**1,067.0**
Bank	109.5	193.1	170.9	867.0
Non Bank	327.8	509.3	400.5	200.0
Foreign Financing	**323.5**	**314.1**	**112.7**	**-194.5**
Project Loans & Programme loans	7.7	-15.2	-5.4	-140.3
Commercial Loans	456.9	377.9	136.2	29.2
Non Resident Investment in Treasury Bonds	-126.4	-59.3	-18.3	-63.4
Non Resident Investment in Treasury Bills	-14.6	10.6	0.2	-20.0
Total Financing	**760.8**	**1,016.5**	**684.1**	**872.6**

(a) Provisional

Sources: Ministry of Finance
Central Bank of Sri Lanka

Figure 6.5
Sources of Deficit Financing (a)



Sources: Ministry of Finance
Central Bank of Sri Lanka

(a) 2020 figures are based on the GDP projections of the Central Bank

Rs. 200.0 billion during the period under consideration from Rs. 400.5 billion in the same period of 2019, accounting for 18.7 per cent of the total domestic financing requirement.

- **Issuances of Treasury bills and Treasury bonds continued to be the major source of domestic borrowing during January - July 2020.** Net borrowings from Treasury bills increased to Rs. 276.9 billion in the seven months ending July 2020 from Rs. 149.9 billion in the same period of the previous year. Meanwhile, net borrowings from Treasury bonds increased to Rs. 536.1 billion in the seven months ending July 2020 from Rs. 331.8 billion in the same period of 2019. Financing in the form of overdrafts from State Owned Licensed Commercial Banks recorded a net borrowing of Rs. 296.7 billion in the seven months ending July 2020, in comparison to a net repayment of Rs. 64.2 billion in the same period of the previous year. Borrowings through Sri Lanka Development Bonds (SLDBs) recorded a net repayment of Rs. 99.7 billion during the period under consideration, in comparison to a net repayment of Rs. 47.2 billion in the seven months ending July 2019. Foreign currency liquidity constraints faced by the banking sector during the period concerned contributed to this net repayment of SLDBs.

- **Foreign financing recorded a net repayment during the seven months ending July 2020, reflecting repayments on account of project loans and the decline in the holdings of Treasury bills and Treasury bonds by non residents.** Net foreign borrowings to finance the budget deficit recorded a net repayment of Rs. 194.5 billion during the period under review, in comparison to a net borrowing of Rs. 112.7 billion in the corresponding period of 2019. Net foreign financing comprised net repayments of Rs. 140.3 billion of foreign project loans and Rs. 83.3 billion of foreign investment in Treasury bills and bonds, and net borrowing of Rs. 29.2 billion of Foreign Currency Term Financing Facilities (FCTFFs).

Government Debt and Debt Service Payments

Government Debt

- **The central government debt stock, which stood at Rs. 13,031.5 billion at end 2019, expanded by Rs. 1,229.5 billion to Rs. 14,261.0 billion by end July 2020.** Domestic debt increased by Rs. 1,078.9 billion to Rs. 7,708.0 billion, while foreign debt increased by Rs. 150.6 billion to Rs. 6,553.1 billion at end July 2020, compared to end 2019. The increase in net financing owing to the expansion in the budget deficit contributed significantly to this increase in central government debt at end July 2020. Meanwhile, the depreciation of the exchange rate also contributed to increase the rupee value of the outstanding debt by Rs. 281.2 billion, as at end July 2020.

- **The share of short term domestic debt in the total central government debt increased, while that of medium to long term debt declined marginally at end July 2020, compared to end 2019.** Accordingly, the share of short term debt in total domestic debt increased to 24.1 per cent at end July 2020 from 19.2 per cent at end of 2019, mainly due to the increase in the outstanding stock of Treasury bills. The share of Treasury bills

Table 6.4

Outstanding Central Government Debt

Rs. billion

Item	2018	2019 (a)	2019 End Jul (a)	2020 End Jul (a)
Domestic Debt (b)	**6,071.0**	**6,629.1**	**6,509.8**	**7,708.0**
By Maturity Period				
Short Term	1,134.6	1,270.4	1,277.1	1,860.2
Medium and Long Term	4,936.4	5,358.7	5,232.6	5,847.8
By Institution				
Banks	2,351.9	2,739.6	2,702.1	3,695.4
Non Bank Sector	3,719.1	3,889.5	3,807.7	4,012.5
Foreign Debt (c)	**5,959.5**	**6,402.4**	**6,192.8**	**6,553.1**
Concessional	2,705.8	2,767.5	2,620.3	2,911.6
Non Concessional	3,253.7	3,635.0	3,572.5	3,641.4
Total Government Debt	**12,030.5**	**13,031.5**	**12,702.6**	**14,261.0**

Sources: Ministry of Finance
Central Bank of Sri Lanka

(a) Provisional
(b) Excludes outstanding amounts of foreign investment in rupee denominated Treasury bills and Treasury bonds and includes Rs. 13,125 million issued to capitalise SriLankan Airlines in March 2013 (matured on 01 June 2018) and Rs. 78,441 million issued to CPC in January 2012 (of which Rs. 21,778 million matured on 01 January 2017 and the outstanding as at end July 2020 is Rs. 56,662 million)
(c) Includes outstanding amounts of foreign investment in rupee denominated Treasury bills and Treasury bonds

in domestic debt as at end July 2020 increased to 14.9 per cent from 13.2 per cent at end 2019, mainly due to the increase in Treasury bills holdings by the banking sector. Meanwhile, the ratio of medium to long term debt in the total domestic debt stock declined to 75.9 per cent at end July 2020 from 80.8 per cent at end 2019. The percentage of Treasury bonds, which comprises the largest share in the domestic debt portfolio, decreased to 66.4 per cent as at end July 2020 from 69.5 per cent at end 2019. The ratio of SLDBs in total domestic debt stock as at end July 2020 reduced to 6.1 per cent from 8.5 per cent at end 2019, reflecting the net repayment of SLDBs during the period under review.

- **Foreign currency denominated domestic debt declined to Rs. 705.1 billion at end July 2020 from Rs. 728.2 billion at end 2019**. The outstanding balance of SLDBs was recorded at Rs. 473.9 billion (US dollars 2,552.3 million), while the outstanding loans from Foreign Currency Banking Units (FCBUs) amounted to Rs. 231.2 billion (US dollars 1,245 million) at end July 2020. The ratio of foreign currency denominated domestic debt to total domestic debt declined to 9.1 per cent at end July 2020 from 11.0 per cent at end 2019. Meanwhile, the rupee denominated domestic debt increased significantly by Rs. 1,102.0 billion to Rs. 7,002.9 billion at end July 2020.

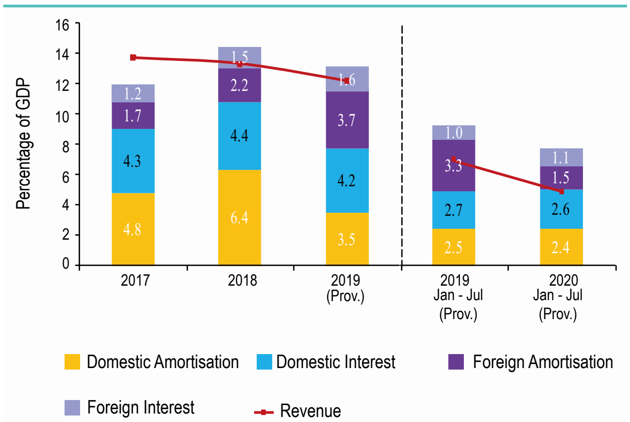
- **The share of non concessional debt in the central government foreign debt stock decreased marginally to 55.6 per cent by end July 2020 from 56.8 per cent at end 2019**. In nominal terms, the outstanding balance of non concessional debt increased marginally by 0.2 per cent to Rs. 3,641.4 billion, mainly due to the issuance of the FCTFF during the seven months ending July 2020. The share of concessional foreign debt in total foreign debt increased to 44.4 per cent by end July 2020 from 43.2 per cent at end 2019.

Debt Service Payments

- **Debt service payments decreased by 17.0 per cent to Rs. 1,190.9 billion during the seven months ending July 2020, in comparison to the corresponding period of 2019**. Amortisation payments during January - July 2020 declined to Rs. 607.3 billion from Rs. 873.9 billion in the corresponding period of 2019, mainly due to the absence of a repayment of an ISB in the seven months ending July 2020, compared to the same period last year. Interest payments during the seven months ending July 2020 increased

Figure 6.6

Government Debt Service Payments Vs Government Revenue (a)



Sources: Ministry of Finance
Central Bank of Sri Lanka

(a) 2020 figures are based on the GDP projections of the Central Bank

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to Rs. 583.6 billion from Rs. 561.6 billion in the corresponding period of 2019, in line with the increase in debt stock during the period under review. Of the total debt service payments, domestic and foreign debt servicing amounted to Rs. 783.4 billion and Rs. 407.6 billion, respectively.

Expected Developments

- **The key fiscal balances are expected to underperform in 2020, compared to 2019, mainly reflecting the impact of the economic fallout due to the COVID-19 pandemic**. Nevertheless, the overall fiscal performance is expected to improve in 2021 and thereafter, alongside the envisaged revival of economic activity supported by the unprecedented level of fiscal as well as monetary policy stimuli provided for businesses and households amidst the pandemic. The fiscal policy strategy of the Budget for 2021, which is scheduled to be announced in mid-November 2020, is expected to aim at strengthening the medium term fiscal consolidation path through tax policy reforms, while further rationalising recurrent expenditure and prioritising public investment to stimulate the economy as enunciated in the national policy framework, "Vistas of Prosperity and Splendour". Meanwhile, the Government took steps to review the foreign funded projects that are in the pipeline, in order to streamline the same according to the priorities of the Government, while also identifying projects, which can be implemented through foreign investment, thereby to lessen the future debt burden of the Government. With such developments, the overall budget deficit is expected to improve in 2021, along with the current account and primary balances. The resulting moderation in deficit financing could lead to an improvement in the outstanding central government debt. Further, despite adverse speculation and uncertainties caused by the downgrade of sovereign ratings by international rating agencies, the Government is expected to duly settle all forthcoming debt servicing obligations and take measures to ensure fiscal sustainability.

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