



Fiscal Policy and Government Finance

The COVID-19 pandemic continued to weigh on the fiscal sector performance during the seven months ending July 2021, as revenue mobilisation moderated and government expenditure increased, resulting in a widened budget deficit and an increase in the central government debt. The fiscal policy support to attenuate the impact of the pandemic on individuals and the economy added pressures onto fiscal operations. Government revenue recorded a nominal increase during January-July 2021, y-o-y, supported by increased activity, compared to relatively large economic disruptions during the first and second waves of the pandemic in the preceding year. However, the rise in government expenditure offset the nominal increase in government revenue, reflecting the need for a sustained improvement in revenue collection. The increase in government expenditure during the seven months ending July 2021 is attributable to the increase in both capital expenditure and recurrent expenditure, mainly on account of the direct expenditure induced by the COVID-19 pandemic, together with the rise in expenditure on interest payments and salaries and wages. Accordingly, key fiscal balances deteriorated during the period from January to July 2021 over the same period in 2020, resulting in a notable increase in the outstanding central government debt. Deficit financing relied entirely on domestic sources, reflecting the limited access to global financial markets, as well as the financing strategy of the Government to reduce exposure to foreign financing over the medium term. Foreign financing recorded a net repayment during the period under consideration, compared to the corresponding period of 2020, resulting in a reduction of the relative share of foreign debt by end July 2021. The Central Bank provided an extraordinary financing support to the Government in order to meet the rising expenditure requirements and maintain the unblemished debt servicing record since the onset of the pandemic.

6.1 Fiscal Policy Direction and Measures

The fiscal policy measures initiated since the onset of the pandemic continued in the form of immediate fiscal impulse via spending measures and foregone revenue measures, in addition to liquidity provisions through the low tax regime instituted since late 2019 to revive the stagnant economy. The Government took decisive measures to contain the spread of the pandemic and to ensure the safety of the citizens while supporting the livelihoods through the existing social safety networks, quarantine measures, and the accelerated islandwide vaccination drive. The Inland Revenue Act No. 24 of 2017 and Value Added Tax Act, No. 14 of 2002 (VAT Act) were amended in 2021, incorporating tax revisions implemented from late 2019. Measures were also taken to grant several tax exemptions and tax holidays, including various tax concessions, reduction in statutory rates, and certain income tax exemptions, to the people and businesses affected by the pandemic. In line with the comprehensive tax policy package, which was announced in the Budget 2021, measures are being taken to introduce a composite tax of SGST. Also, measures were taken to enact the legislation for tax amnesty under the provisions of the Finance Act, No. 18 of 2021, which inter alia provides for persons to voluntarily report their undisclosed taxable supplies, income and assets for any taxable period ended on or prior to 31 March 2020, or in a return of income for any year of assessment ended on or prior to 31 March 2020. Several changes were made to the tax administration process, such as the mandatory use of TIN in all tax related source documents and making e-filing compulsory for all limited liability companies. Further, expenditure rationalisation measures were continued through curtailing government expenses, while prioritising public investment and improving the productivity of the public sector. The expected improvement in the delivery of public services through digitalisation and modern practices, and the efforts to improve performance of SOEs, including revisions to domestic prices of petroleum products and LP gas in line with global price movements, would help ease the financial burden on the government budget in the period ahead. Moreover, the establishment of the Management Information System to monitor the financial and operational performance of SOEs in a

systematic method and the establishment of Cabinet Appointed Management Committee on Investments are also expected to facilitate an improvement in the performance of SOEs. Meanwhile, amendments were introduced to the Fiscal Management (Responsibility) Act No. 3 of 2003 in June 2021 to shift the debt to GDP target to 2030 from 2020, and to increase the limit on guarantees issued by the Government to 15% from 10%. Recognising increased pressures of the pandemic on fiscal operations, the Parliament approved a supplementary budget of Rs. 200.0 bn to meet contingent expenditure related to the COVID-19 pandemic within the already approved borrowing limit of Rs. 2,997.0 bn for 2021. Meanwhile, considering the rising expenditure, particularly attributable to ongoing pandemic measures and additional provisions for subsidies and transfers and other expenses following the loss of revenue of the government institutions, an Appropriation (Amendment) Bill was submitted by the Government to raise the gross borrowing limit by Rs. 400.0 bn for 2021 to Rs. 3,397.0 bn in September 2021. Further, in June 2021, the Parliament approved a resolution to increase the limit on Treasury bills to Rs. 3,000.0 bn from the previous limit of Rs. 2,000.0 bn.

“ Notwithstanding the limited fiscal space, extraordinary fiscal stimulus measures were implemented by the Government to help businesses stay afloat, support households, preserve employment and revive the economy in the face of the economic and social catastrophe created by the pandemic... ”

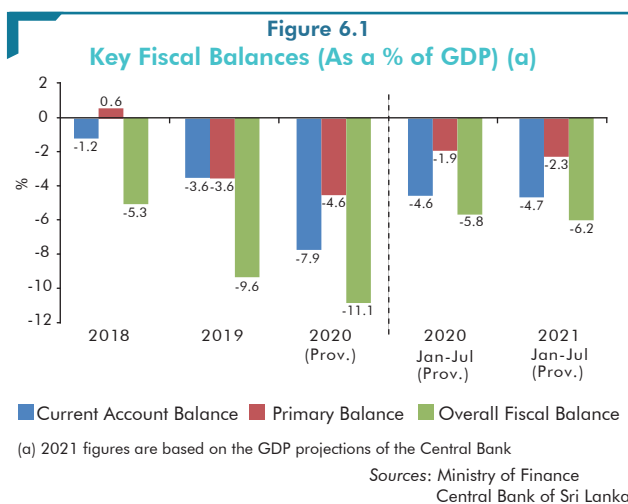
Sovereign rating downgrades by international credit rating agencies have made foreign financing a challenging task during 2021 amidst increased funding requirements with the pandemic. Moody's Investors Service, which placed the rating under "review for downgrade" in July 2021, downgraded the rating from "Caa1" to "Caa2" with stable outlook in October 2021. S&P Global Ratings, which kept Sri Lanka's rating at "CCC+" since December 2020, changed the outlook from stable to negative in August 2021. However,

Fitch Ratings maintained its credit rating of "CCC" during the year up to end October 2021. Despite the adverse speculation of the rating agencies, the Government continued to honour all its debt servicing, along with the assistance of the Central Bank, including the ISB of USD 1.0 bn, which matured in July 2021, thereby maintaining its impeccable record of timely debt servicing. The Government and the Central Bank are in the process of making necessary arrangements to improve the country's sovereign rating in the future through coordinated efforts.

6.2 Government Budgetary Operations¹

Key Fiscal Balances

Reflecting the impact of the pandemic on the fiscal sector, key fiscal balances deteriorated during the period from January to July 2021, both in nominal terms and as a % of estimated GDP, driven by the increase in government expenditure that offset the increase in government revenue. The budget deficit increased to Rs. 1,014.5 bn (6.2% of estimated GDP) during the period from January to July 2021 from Rs. 872.6 bn (5.8% of GDP) in the corresponding period of 2020. The current account deficit, which reflects the dissavings of the Government, increased to Rs. 779.1 bn (4.7% of estimated GDP) during the seven months ending July 2021 from Rs. 694.5 bn (4.6% of GDP) recorded in the same period of 2020. The primary balance increased its deficit to Rs. 377.2 bn (2.3% of estimated GDP) during the period under review from the deficit of Rs. 288.9 bn (1.9% of GDP) recorded in the corresponding period of 2020.



¹ In the absence of detailed breakdown of fiscal data for 2020 subsequent to restatement, fiscal statistics for 2021 have been compared against corresponding data in 2020 prior to restatement.

Government Revenue

Against the backdrop of the revival of economic activity, government revenue partially recovered in nominal terms during the period from January to July 2021, compared to the previous year. Government revenue increased by 4.7% to Rs. 798.9 bn (4.9% of estimated GDP) during the seven months ending July 2021 from Rs. 763.2 bn (5.1% of GDP) recorded in the corresponding period of 2020. Tax revenue increased by 6.9% to Rs. 716.7 bn during the period under review from Rs. 670.4 bn in the corresponding period of 2020, benefiting from the high tax revenue collection from VAT, PAL and CESS. Revenue from VAT increased significantly by 46.6% during this period, compared to the corresponding period of 2020, due to the gradual normalisation of economic activity. Overall revenue

Tax revenue increased, in nominal terms, benefiting from the high revenue collection from VAT, PAL and CESS levy, while non tax revenue declined...

from excise duties declined by 7.1%, mainly on account of the drop in excise duties from importation of motor vehicles. However, excise duties on liquor increased by 30.1% during the period under review from a year earlier with increased liquor sales, particularly during the festive season. Revenue from PAL and CESS levy also increased during the period from January to July 2021, by 27.7% and 62.5%, respectively, over the same period of 2020. Revenue from PAL grew

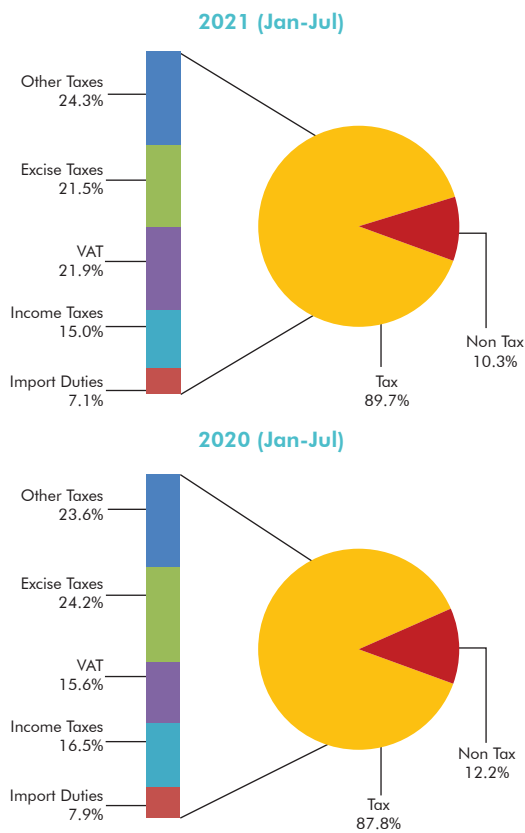
Table 6.1
Economic Classification of Government Revenue

Item	Rs. bn			
	2019	2020 (a)	2020 Jan - Jul (a)	2021 Jan - Jul (a)
Tax Revenue	1,734.9	1,216.5	670.4	716.7
Income Taxes	427.7	268.2	126.0	119.6
VAT	443.9	233.8	119.3	174.9
Excise Taxes	399.5	321.9	184.9	171.8
Import Duties	98.4	114.2	60.4	56.4
PAL	112.2	115.4	62.4	79.7
CESS	50.7	49.3	28.1	45.6
SCL	70.4	82.7	46.5	33.8
Other Taxes	132.2	30.9	42.8	34.9
Non Tax Revenue	156.0	151.4	92.8	82.2
Total Revenue	1,890.9	1,368.0	763.2	798.9

(a) Provisional

Source: Ministry of Finance

Figure 6.2
Composition of Government Revenue



Sources: Ministry of Finance
Central Bank of Sri Lanka

mainly due to the increase in imports of certain items, in particular some investment goods, while revenue from CESS increased due to the upward adjustment of CESS on certain import items. However, revenue collection from income tax and several import related taxes declined during this period, mainly reflecting certain tax relief measures given to affected individuals and businesses. During the seven months ending July 2021, non tax revenue declined to Rs. 82.2 bn from Rs. 92.8 bn in the corresponding period of 2020, mainly due to the reduction in the revenue collection from rent, interest income, and fees and charges.

Foreign grants during the seven months ending July 2021 were limited to Rs. 898.2 mn, in comparison to Rs. 2,146.7 mn recorded in the corresponding period of 2020.

Expenditure and Net Lending

In nominal terms, total expenditure and net lending during the period from January to July 2021 increased by 10.8% to Rs. 1,814.4 bn (11.0% of estimated GDP) from

Rs. 1,637.9 bn (10.9% of GDP) during the corresponding period of 2020, due to the rise in both recurrent and capital expenditure. During the period under review, recurrent expenditure rose by 8.3% to Rs. 1,578.0 bn over the corresponding period of 2020. Recurrent expenditure increased, mainly due to the pandemic related direct expenditure, including relief and livelihood support extended to the needy segments of the society



Escalating recurrent expenditure largely contributed to the rise in government expenditure...

and expenditure on measures to contain the spread of the virus. Further, the increase in expenditure on interest payments, and salaries and wages also contributed to the rise in recurrent expenditure.

Expenditure on salaries and wages increased by 8.7% to Rs. 490.8 bn during the period from January to July 2021 over the same period in 2020, reflecting the addition of public sector annual salary increments and new recruitments to the public sector, including the recruitment of unemployed graduates and unskilled individuals from low-income households. Absorbing 79.8% of total government revenue, interest expenditure increased by 9.2% to Rs. 637.4 bn during the period under consideration. This increase in interest expenditure was mainly due to the rise in interest payments on increased

Table 6.2
Economic Classification of Government Expenditure

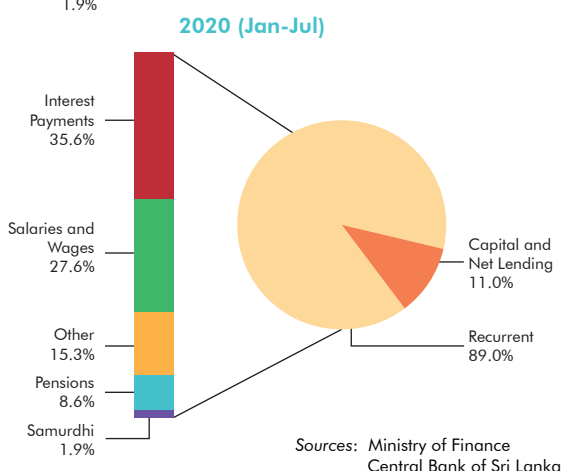
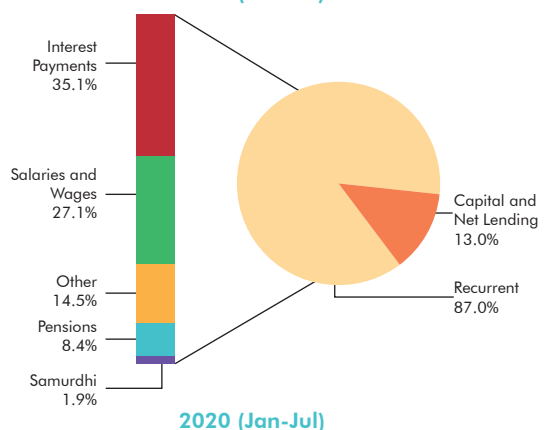
Item	Rs. bn			
	2019 (a)	2020 (b)	2020 Jan - Jul (b)	2021 Jan - Jul (b)
Recurrent Expenditure	2,424.6	2,548.4	1,457.7	1,578.0
Expenditure on Goods and Services	848.3	974.4	534.0	575.6
o/w Salaries and Wages	686.5	794.2	451.4	490.8
Interest Payments	901.4	980.3	583.6	637.4
Foreign	234.0	266.7	170.8	157.8
Domestic	667.4	713.6	412.8	479.6
Current Transfers and Subsidies	551.5	717.1	340.1	365.1
o/w Pensions	227.7	257.8	140.7	153.2
Samurdhi	44.7	52.4	30.7	34.6
Fertiliser Subsidy	35.0	36.7	18.6	8.8
Capital Expenditure and Net Lending	913.3	492.6	180.2	236.3
Total Expenditure and Net Lending	3,337.9	3,041.0	1,637.9	1,814.4

Source: Ministry of Finance

(a) Government expenditure and net lending in 2020 were adjusted by the Ministry of Finance by shifting a sum of Rs. 422.6 bn to 2019 in view of accounting for the payment of arrears spilled over from 2019. Accordingly, of the recurrent expenditure incurred in 2020, a sum of Rs. 123.4 bn was shifted to 2019, and of the capital expenditure and net lending in 2020, a sum of Rs. 299.2 bn was shifted to 2019.

(b) Provisional

Figure 6.3
Composition of Government Expenditure
2021 (Jan-Jul)



Sources: Ministry of Finance
Central Bank of Sri Lanka

domestic borrowing, particularly on account of Treasury bills and Treasury bonds. During the period from January to July 2021, subsidies and transfers grew by 7.3% to Rs. 365.1 bn over the corresponding period of 2020. Capital expenditure and net lending increased by 31.1% to Rs. 236.3 bn during the period from January to July 2021 from Rs. 180.2 bn in the corresponding period of 2020.

Financing of the Budget Deficit

The budget deficit was entirely financed through domestic sources during the seven months ending July 2021, reflecting the limited access to global capital markets and the explicit preference of the Government to reduce the share of foreign debt. Net domestic financing amounted to Rs. 1,204.6 bn during the seven months ending July 2021, compared to Rs. 1,067.0 bn during the corresponding period of 2020, while net foreign repayment amounted to Rs. 190.1 bn in the seven months ending July 2021, compared to a net foreign repayment of Rs. 194.5 bn recorded in the corresponding period of 2020. In net domestic financing, Treasury bonds accounted for a large share

Table 6.3
Sources of Deficit Financing

Item	Rs. bn	
	2020 Jan - Jul (a)	2021 Jan - Jul (a)
Domestic Financing (b)	1,067.0	1,204.6
Bank	867.0	932.5
Non Bank	200.0	272.1
Foreign Financing	-194.5	-190.1
Project Loans & Programme Loans	-140.3	-86.0
Commercial Loans	29.2	-99.9
Treasury Bonds (c)	-63.4	-3.8
Treasury Bills (c)	-20.0	-0.4
Total Financing	872.6	1,014.5

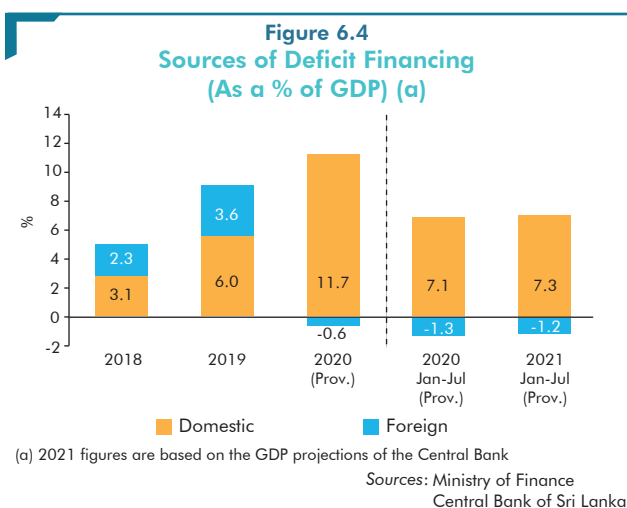
(a) Provisional
(b) Excludes funds raised through bonds for restructuring of SOEs
(c) Includes non-resident holding of government securities
Sources: Ministry of Finance
Central Bank of Sri Lanka

and mobilised Rs. 932.5 bn (77.4% of total domestic borrowing) from the domestic banking sector during the seven months ending July 2021, compared to Rs. 867.0 bn (81.3% of total domestic borrowing) recorded during the corresponding period of the previous year. Net

The budget deficit was financed through domestic sources during the seven months ending July 2021, while foreign financing recorded a net repayment...

financing from the Central Bank increased considerably to Rs. 549.1 bn during the seven months ending July 2021, from Rs. 187.0 bn during the same period of the previous year. However, a notable decline (43.6%) in financing from the commercial banking sector was recorded during the seven months ending July 2021, compared to the previous year. Meanwhile, borrowing from the non-bank sector increased to Rs. 272.1 bn during the seven months ending July 2021, from Rs. 200.0 bn during the same period of the previous year, accounting for 22.6% of the total domestic financing requirement.

Total foreign financing recorded a net repayment during the seven months ending July 2021. Net foreign financing comprised net repayments of Rs. 199.9 bn of ISBs, Rs. 86.0 bn of foreign project and programme loans, Rs. 4.1 bn of foreign holding of Treasury bills and Treasury bonds, and net borrowing of Rs. 100.0 bn on account of FCTFFs. Access to foreign capital markets remained constrained due to tight financial conditions globally as well as the downgrades of the country's sovereign credit ratings, amidst the pandemic related uncertainties.



Government Debt and Debt Service Payments

Government Debt

Central government debt, which stood at Rs. 15,117.2 bn at end 2020, increased to Rs. 16,751.7 bn by end July 2021. Total domestic debt witnessed an increase of Rs. 1,252.4 bn to Rs. 10,317.5 bn, while the rupee value of foreign debt increased by Rs. 382.0 bn to Rs. 6,434.2 bn from the levels recorded at end 2020. The increase

The increase in net financing owing to the expansion in the budget deficit during the seven months ending July 2021 along with the depreciation of the exchange rate contributed to the increase of the rupee value of the outstanding debt...

in net financing owing to the expansion in the budget deficit during the seven months ending July 2021 mainly contributed to this increase in central government debt. The depreciation of the exchange rate also resulted in an increase in the rupee value of the outstanding debt by Rs. 577.9 bn by end July 2021. The relative share of outstanding foreign debt of the central government remained at 38.4% of total central government debt by end July 2021, compared to 40.0% recorded at end 2020.

The share of short term domestic debt in the total central government debt increased, while the medium and long term domestic debt stock decreased at end July 2021, compared to end 2020, highlighting increased

rollover risk. The increase in the share of short term debt, as a % of total domestic debt, to 29.0% at end July 2021 from 24.2% at end December 2020 was mainly due to higher borrowings through Treasury bills and the increase in overdraft balances of the Government with state banks amidst the market preference towards shorter tenure domestic debt instruments. Consequently, the share of medium and long term debt declined to 71.0% at end July 2021 from 75.8% at end 2020.

Outstanding foreign currency denominated domestic debt decreased to Rs. 673.1 bn at end July 2021 from Rs. 719.3 bn at end 2020, due to net repayments to OBUs and on account of SLDBs. Accordingly, the outstanding stock of SLDBs amounted to Rs. 467.6 bn (USD 2,339.3 mn), while the outstanding debt on OBUs amounted to Rs. 205.5 bn (USD 1,028.0 mn) at end July 2021. The share of foreign currency denominated domestic debt in total domestic debt decreased to 6.5% at end July 2021 from 7.9% at end December 2020.

The share of non concessional debt of the total foreign debt of the central government increased to 51.4% by end July 2021 from 50.6% at end 2020. In nominal terms, the outstanding balance of non concessional debt of the central government increased to Rs. 3,310.0 bn at end July 2021 from Rs. 3,064.1 bn at end 2020.

Table 6.4
Outstanding Central Government Debt (a)

Item	Rs. bn			
	2019	2020 (b)	2020 End Jul (b)	2021 End Jul (b)
Domestic Debt (c)	6,830.3	9,065.1	7,708.0	10,317.5
By Maturity Period				
Short Term	1,270.4	2,197.6	1,860.2	2,997.1
Medium and Long Term	5,559.9	6,867.5	5,847.8	7,320.4
By Institution (d)				
Banks	2,888.5	4,735.7	3,663.6	5,580.4
Non Bank Sector	3,941.8	4,329.3	4,044.3	4,737.1
Foreign Debt	6,201.3	6,052.2	6,553.1	6,434.2
Concessional	2,767.5	2,988.1	2,911.6	3,124.2
Non Concessional	3,433.8	3,064.1	3,641.4	3,310.0
Total Government Debt	13,031.5	15,117.2	14,261.0	16,751.7

Sources: Ministry of Finance
Central Bank of Sri Lanka

(a) As per the guidelines of compiling government debt statistics in the Manual of Government Finance Statistics published by the IMF in 2014, non resident holdings of outstanding SLDBs and outstanding ISBs have been classified under foreign debt and resident holdings of outstanding of SLDBs and outstanding ISBs of the Sri Lankan Government have been classified under domestic debt.

(b) Provisional

(c) Includes Treasury bonds of Rs. 78,441 mn issued to CPC in January 2012 (of which Rs. 21,778 mn matured on 01 January 2017 and the current outstanding is Rs. 56,662 mn).

(d) The composition of domestic debt held by the banking and non banking sectors was revised from 2017 due to the adjustment for holdings of SLDBs by businesses and individuals.

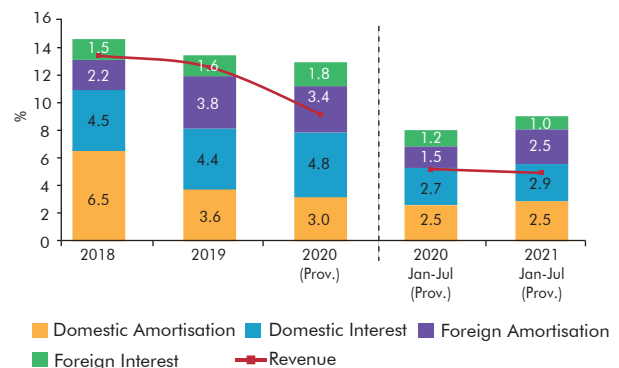
Debt Service Payments

Total debt service payments during the seven months ending July 2021 increased to Rs. 1,455.1 bn from Rs. 1,191.0 bn recorded in the corresponding period in 2020. During the seven months ending July 2021, amortisation payments increased to Rs. 817.7 bn from Rs. 607.3 bn in the corresponding period in

During the seven months ending July 2021, amortisation payments increased in comparison to the corresponding period in 2020, primarily due to the repayments on account of SLDBs, ISBs and Treasury bonds...

2020, primarily with the repayments on account of ISBs, SLDBs and Treasury bonds. Interest payments increased to Rs. 637.4 bn during the seven months ending July 2021 from Rs. 583.6 bn in the corresponding period in 2020, mainly due to high interest payments on domestic debt. This increase was mainly in line with the increase

Figure 6.5
Government Debt Service vs Government Revenue
(As a % of GDP) (a)



(a) 2021 figures are based on the GDP projections of the Central Bank

Sources: Ministry of Finance
Central Bank of Sri Lanka

in domestic debt of the central government, particularly on account of Treasury bills and Treasury bonds. During the seven months ending July 2021, total domestic debt servicing on outstanding central government debt amounted to Rs. 892.3 bn, compared to Rs. 783.3 bn in the corresponding period of 2020, while debt servicing on outstanding foreign debt of the central government amounted to Rs. 562.8 bn, in comparison to Rs. 407.7 bn in the corresponding period of the previous year.

Abbreviations and Acronyms

bn	: Billion
CESS	: Commodity Export Subsidy Scheme
CPC	: Ceylon Petroleum Corporation
FCTFFs	: Foreign Currency Term Financing Facilities
GDP	: Gross Domestic Product
IMF	: International Monetary Fund
ISBs	: International Sovereign Bonds
LP	: Liquid Petroleum
mn	: Million
OBUs	: Offshore Banking Units

PAL	: Ports and Airports Development Levy
SDGs	: Sustainable Development Goals
SGST	: Special Goods and Services Tax
SLDBs	: Sri Lanka Development Bonds
SOEs	: State Owned Enterprises
SRR	: Statutory Reserve Ratio
TIN	: Tax Identification Number
USD	: United States Dollar
VAT	: Value Added Tax

