6 FISCAL POLICY AND GOVERNMENT FINANCE

The realised fiscal outcome for the first eight months of 2008 and the projections for the balance period of the year indicate that revenue will increase reflecting the government's efforts mainly through broadening the tax base, revising tax rates and improving tax administration, while providing required concessions for selected sectors. Nevertheless, the revenue will be considerably lower than the original target due to a number of reasons. Meanwhile, the recurrent expenditure will exceed the budgetary estimates due to higher expenditure on salaries and wages, interest payments, and subsidies and transfers, particularly on fertilizer subsidy. Public investment is estimated to increase over 2007, but, it would be lower than the original estimate. Resulting from these developments, the overall budget deficit as a per cent of GDP could be maintained within the budgetary estimates, which is a decline over the previous year. Although declined, the budget deficit still remains at a relatively high level requiring further efforts to strengthen the fiscal consolidation process.

Fiscal Policy Direction and Measures

- **On the revenue front, a series of measures was introduced to broaden the tax base, changing the tax rates while providing some exemptions as development measures for specific areas, and improving tax administration.** Rationalising income taxes, Value Added Tax (VAT) system and import duties, changing excise duty rates and increasing Ports and Airports Development Levy (PAL) were among the major measures introduced. The government also took measures to ensure the timely enactment of revenue related legislations for the fourth consecutive year. As a result, the legislations related to all the revenue proposals in the Budget 2008 were in place when those policies became effective.

- **Under the rationalisation of income taxes, new measures were introduced particularly to broaden the tax base while extending concessions and exemptions for specific development activities to drive the economic growth.** Accordingly, the basis of providing tax holidays under the Board of Investment (BOI) law and the Inland Revenue Act as well as calculating personal income taxes were revised.

- **Major measures introduced to rationalize the VAT system included granting exemptions for certain items such as financial services provided** by Co-operative Societies and import or supply of yarn for textile industry, and reducing VAT on importation of raw materials and machinery for strategic projects, supply of goods and services by Co-operative Societies, machinery imported for development programmes under *"Neganahira Navodaya"* and products made out of rice produced in Sri Lanka. Considering the prevailing high prices of fuel, VAT on petrol was reduced to 5 per cent from 15 per cent with effect from 1 January 2008.

- **Several measures were introduced to rationalise customs duty and excise taxes.** Imposition of a Special Commodity Levy (SCL) on eleven essential food items in place of varying taxes namely customs duty, VAT, PAL and Social Responsibility Levy and other charges applicable at the customs point, increasing surcharge applicable on customs duty, removing duty waiver granted on importation of petrol, suspending the scheme on granting duty concessions for importation of motor vehicles for public officers and increasing excise duty on cigarettes were the major measures introduced to import duties and excise taxes.

- **Several other revenue measures were also introduced.** These included the limiting of Economic Service Charge (ESC) to 0.25 per cent on the turnover which comprises of export earnings in foreign exchange, increasing ESC on turnover of liquor and motor vehicle sales, increasing Regional Infrastructure Development Levy (RIDL), introducing an Environment Conservation Levy and allowing to pay stamp duty on leases and mortgages by affixing a receipt obtained from a bank or affixing a stamp.

- **Tax administration was further strengthened.** The measures taken by the Inland Revenue Department (IRD) included initiating replacement of the obsolete software system used in Revenue Administration Management Information System (RAMIS), providing formal training to new recruits to develop their skills, especially in field auditing and supervising, and conducting awareness programmes in regional level to improve the tax compliance. The IRD also took measures for setting up of an Advisory Unit to provide necessary guidance for companies in the area of book keeping, a separate unit in regional offices of IRD to provide guidance/ advice to taxpayers, and a separate corporate unit to give more attention on the compilation of revenue of companies located outside the Colombo district. Sri Lanka Customs also introduced several measures to improve tax administration, efficiency and the effectiveness of overall revenue collection process. Regularizing appeal process, introducing a separate core valuation function for operation valuation process to reduce valuation related malpractices and ensure standardized valuation of goods, facilitating the establishment of databases such as RAMIS, and centralizing security (guarantee) management were prominent among those measures.

- **In line with the fiscal consolidation process, actions were taken to contain recurrent expenditure.** Accordingly, retail prices of petroleum products were continued to adjust to reflect the cost, while administered prices, such as electricity tariff, rail fares and passenger bus fares, were revised upwards in line with increased input costs. Further, leave encashment facility granted to public servants was terminated.

- **The government provided the increase in Cost of Living Allowance (COLA) of Rs. 375 and Rs. 187.50, which was due in January and July for government employees and pensioners respectively.** An additional payment of Rs. 625 was also granted in July 2008 only to the public officers whose monthly salary is less than Rs. 22,000 per month, considering the increasing cost of living.

- **Special attention was given to enhance public investment by expediting the implementation of mega infrastructure development projects while paying greater attention to rural infrastructure development projects**. Construction work of mega projects, such as Kerawalapitiya Combined Cycle Power Plant, Norochcholai Coal Power Plant, Upper Kothmale Hydro Power Plant, Southern Highway Project, Colombo Port Expansion Project and Hambantota Port, was continued. Rural infrastructure development initiatives included Maga Neguma, Gama Neguma, Small Irrigation Projects, Jana Pubuduwa, Gami Diriya, Gami Pubuduwa, Neganahira Navodaya, Kirigammana, Rajarata Navodaya and Pubudamu Wellassa projects. In addition, projects related to improving infrastructure facilities in rural health sector, strengthening educational facilities in rural and estate sectors and expansion of rural water supply and sanitation facilities were also continued.

- **Implementation of mega infrastructure projects under public private partnerships (PPP) was encouraged by the government to reduce the burden on the government budget**. Development projects that are planned to be implemented under the PPP arrangements include Colombo Port Expansion Project, Information Technology Park in Malambe, Colombo Kandy Expressway, Development of Trade Processing Zone in Horana, Knowledge City in Henagama, Development of a Mass Rapid Transport System in Colombo Metropolitan Area and implementation of a Mixed Development Project in Battaramulla.

- **During the period under review, sources of deficit financing were further diversified.** Accordingly, non-residents were allowed to invest in rupee denominated Treasury bills not exceeding 10 per cent of the outstanding Treasury bill stock. Meanwhile, the government borrowing programme was managed with an appropriate mix between domestic and foreign debt to reduce the interest cost of the budget and prevent bunching of debt repayments.

- **Several strategies were introduced to develop the domestic debt market.** The improvement of the secondary market operations, reduction of number of bond series and restructuring Primary Dealer system were among them. Accordingly, more funds were targeted to raise through domestic sources and the reliance on the medium to long term debt instruments was increased with a view to minimizing the rollover risk and bunching issues. Moreover, borrowing through non tradable instruments such as Rupee securities was restricted further. External borrowing programme mainly focused on mobilizing funds through concessional loans, while obtaining commercial type foreign currency borrowings appropriately as and when necessary.

Government Budgetary Operations

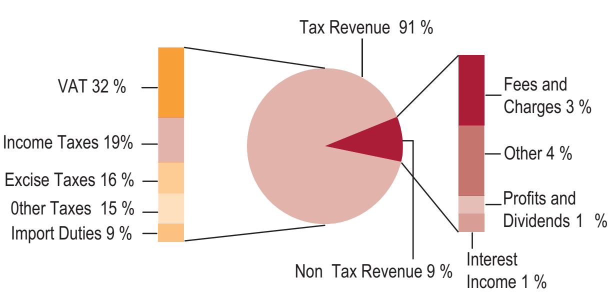
Revenue

- **Government revenue continued to increase during the first eight months of 2008, reflecting the positive impact of policy measures taken in the recent past.** During this period, total revenue increased by 21 per cent to Rs. 416.9 billion from Rs. 345.7 billion recorded in the same period of the previous year. This was contributed by increases in both tax revenue (20 per cent) and non-tax revenue (32 per cent). However, as a per cent of projected GDP for 2008 it declined slightly from 9.7 per cent to 9.2 per cent.

- **The main source of higher tax revenue during the first eight months of 2008 was the income taxes.** During the first eight months of 2008 income taxes grew by 18 per cent over the same period of the previous year. This was attributed to the tax collections from the non-corporate sector that largely propelled by enhanced collections from the personal income tax and withholding tax. Revenue collection from ESC was also increased by 13 per cent during this period.

- **VAT collection grew by 16 per cent to Rs. 133.9 billion during the first eight months of 2008 compared to Rs. 115.9 billion during the corresponding period of 2007.** This was a combined outcome of 39 per cent increase of VAT on domestic goods and services and slight decline of VAT on imports, which was largely due to the decline in importation of motor vehicles, and import of essential commodities liable for VAT coming under the SCL. In addition, VAT exemptions granted for the import of machinery and equipment for selected 'thrust' industries to promote them as well as for the *"Neganahira Navodaya"* programme and the reduction of VAT on petrol were also contributed to this trend.

Chart 6.1
Composition of Government Revenue - 2008



- **Revenue from excise duty increased by 9 per cent during the first eight months of 2008 mainly due to increase in revenue from liquor and tobacco/cigarettes.** The revenue from excise taxes on liquor and tobacco/cigarettes increased by 20 percent and 16 per cent, respectively during this period despite the drop in liquor production and the decline in the smoker base and the consumer's average daily consumption of cigarettes.

- **Further, law enforcement in curbing the growth of counterfeit and smuggled cigarettes was also contributed for the increase of revenue from excise tax on cigarettes.** Excise tax on motor vehicles declined by 35 per cent during this period mainly due to the facility granted to public officers to import motor vehicles at concessionary rates.

- **Revenue collection from import duties and SCL increased only marginally during the first eight months of 2008.** This was mainly due to allowing public officers to import motor vehicles under concessionary rates. However, this is expected to increase in the latter part of the year since the facility granted to public officers has already been terminated with effect from 31 March 2008.

- **The non-tax revenue collection increased by 32 per cent in the first eight months of 2008 over the same period of 2007.** This was mainly attributable to Central Bank profit transfers, increase in revenue from fees and charges and higher receipt from interest payments for loans on lent to government institutions.

Table 6.1

Economic Classification of Government Revenue

Rs. billion

Item	2007 (Prov.)	2008 Approved Estimates	2008 Revised Estimates[(a)]	2007 Jan - Aug.	2008 Jan- Aug. (Prov.)
Tax revenue	508.9	677.3	643.5	313.9	375.0
Income taxes	107.2	143.3	138.3	67.5	79.7
VAT	187.5	248.7	228.5	116.0	133.9
Excise taxes	96.7	113.6	111.4	59.3	64.4
Import duties	56.0	73.4	61.3	36.5	38.1
Other taxes	61.7	98.2	104.0	34.6	58.9
Non tax revenue	56.1	73.5	65.9	31.8	41.9
Total revenue	**565.1**	**750.7**	**709.3**	**345.7**	**416.9**

Source: Ministry of Finance and Planning

(a) Based on the information available as at mid October 2008.

- **According to the revised estimates, total government revenue in 2008 would be Rs. 709.3 billion (16.0 per cent of GDP), reflecting a shortfall of about Rs. 41 billion compared to the original target of Rs. 750.7 billion.** The shortage would be a combined outcome of decline in revenue collection from VAT (Rs. 20.2 billion), excise taxes (Rs. 2.2 billion), import duty (Rs. 12.1 billion) and non tax revenue (Rs. 7.6 billion) and increase in revenue from Cess levy (Rs. 10.4 billion), PAL (Rs. 4.1 billion), and SCL (Rs. 17.3 billion). However, total tax revenue is projected to increase by 26 per cent to Rs. 643 billion while non tax revenue is also expected to increase by 17 per cent to Rs. 66 billion compared with the performance recorded in the previous year.

Expenditure and the Lending

- **Total expenditure and net lending amounted to Rs. 645.4 billion during the first eight months in 2008 indicating a 20 per cent increase over the same period in the previous year.** However, as a per cent of projected GDP for 2008, it declined to 14.2 per cent during this period compared with the 15.0 per cent recorded in the same period in 2007.

- **Recurrent expenditure increased by 19 per cent to Rs. 474.9 billion during this period compared with that of Rs. 399 billion in 2007.**

The increase in recurrent expenditure was mainly due to the increase in salaries and wages (12 per cent), pension payments (12 per cent) and interest payments (16 per cent). The expenditure on salaries and wages increased mainly due to the increase in new recruitments to the government in the areas of defence and other sectors. High interest rate prevailed in the domestic market was the main reason for the increase in interest payments. Meanwhile, expenditure on fertilizer subsidy was also significantly increased in the first eight months of 2008 compared to corresponding period of the previous year. Nevertheless, recurrent expenditure as a per cent of projected GDP for 2008 declined considerably to 10.4 per cent from 11.2 per cent in the first eight months of 2007.

Chart 6.2

Composition of Government Recurrent Expenditure - 2008

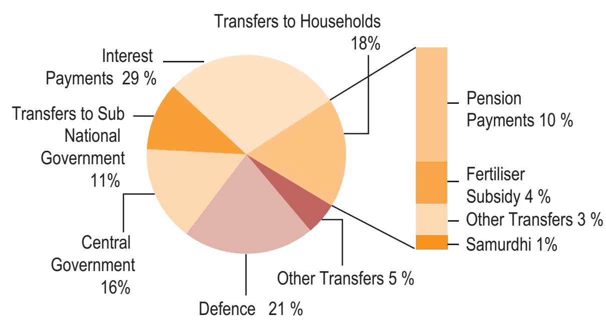


Table 6.2

Economic Classification of Government Expenditure

Rs. billion

Item	2007 (Prov.)	2008 Approved Estimates	2008 Revised Estimates[(a)]	2007 Jan- Aug.	2008 Jan - Aug. (Prov.)
Recurrent expenditure	622.8	712.9	743.4	399.1	474.9
o/w Salaries and wages	214.2	233.4	243.9	135.1	151.2
Interest payments	182.7	209.8	215.9	118.2	139.8
Foreign	21.3	30.0	30.5	13.0	16.5
Domestic	161.4	179.8	185.4	105.1	123.3
Samurdhi relief payments	9.2	10.7	10.0	7.1	6.9
Pensions	68.8	73.0	73.0	43.9	49.2
Fertiliser subsidy	11.0	15.3	26.0	8.5	21.8
Capital Expenditure and Net lending	218.8	331.3	273.3	138.7	170.5
Total expenditure and Net lending	**841.6**	**1,044.2**	**1,016.7**	**537.9**	**645.4**

Source: Ministry of Finance and Planning

(a) Based on the information available as at mid October 2008.

- **Capital expenditure and net lending increased by 23 per cent to Rs. 170.5 billion during the first eight months in 2008 reflecting the government's commitment to enhance capital expenditure.** Increases in both foreign and domestic financing helped achieve this performance. However, as a per cent of GDP it declined marginally to 3.8 per cent from 3.9 per cent in the corresponding period of the previous year.

- **According to the revised estimates, total expenditure and net lending in 2008 is estimated to decline by about Rs. 27 billion to Rs. 1,017 billion compared to Rs. 1,044 billion expected in the original budget.** This will be a combined outcome of the expected increase in recurrent expenditure and the decline in capital expenditure and net lending. Several reasons could be cited for the likely increase in recurrent expenditure in 2008. Main reasons include increase in payments of fertilizer subsidy and COLA, payments on ministerial expenditure on fuel, electricity, and stationary etc. and expenditure on humanitarian operations and resettlement activities in Northern and Eastern areas. Major reason for the decline in capital expenditure and net lending would be slow progress in project implementation due to procurement delays, delayed releases of funds, as a result of revenue lags and expenditure leads, complex and time consuming administrative procedures and delays in acquisition of land.

Key Fiscal Balances

- **The overall budget deficit during the first eight months of 2008 was Rs. 228.6 billion compared to Rs. 192.2 billion recorded in the same period of the previous year.** However, as a per cent of GDP, it declined to 5.0 per cent from 5.4 per cent in the previous year. The current account deficit as a per cent of GDP declined to 1.3 per cent from 1.5 per cent in the first eight months of 2007 due to higher increase in revenue than the recurrent expenditure during this period. The primary deficit (overall deficit net of interest payments), which indicates the discretionary impact of government fiscal operations in the current year, was also lower than the previous year at 2.0 per cent of GDP.

- **According to the revised estimates, the overall budget deficit as a per cent of GDP in 2008 is expected to be around 7.0 per cent as expected in the original budget, which would be lower than 7.7 per cent recorded in 2007.** The current account deficit is expected to be 0.8 per cent of GDP in the revised budget in contrast to the marginal surplus expected in the original budget. The primary deficit is expected to be improved to 2.1 per cent of GDP compared to that of 2007.

Financing the overall Budget Deficit

- **The budget deficit of Rs. 228.6 billion during the first eight months of 2008 was mainly financed through domestic sources.** The net domestic financing (NDF) amounted to Rs. 154.2 billion and it helped to finance about 68 per cent of the budget deficit during this period. Major portion (60 per cent) of this was raised through debt instruments, especially from Treasury bonds. Accordingly, net borrowings from Treasury bonds increased to Rs. 83.7 billion during the first eight months in 2008 from Rs. 53.9 billion during the same period in 2007.

Chart 6.3
Key Fiscal Indicators

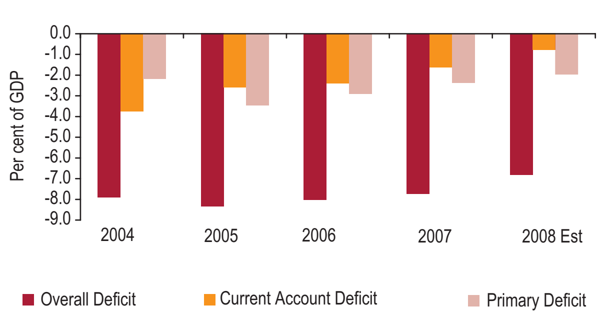
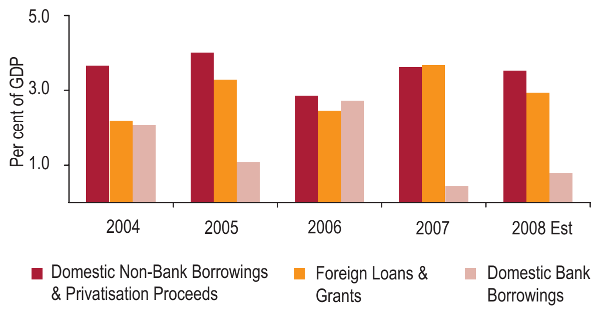


Chart 6.4
Deficit Financing



- **Government borrowings from the banking sector were Rs. 34.1 billion during this period.** This was a result of net borrowings of Rs. 59.9 billion from the commercial banks and net repayments of Rs. 25.8 billion to the Central Bank.

- **According to the revised estimates, total NDF in 2008 will be Rs. 30 billion higher than the original estimate of Rs. 154.8 billion.** Of this, net non-bank borrowing is estimated to increase by Rs. 13 billion and bank financing is estimated to increase by Rs. 17 billion.

- **Total net foreign financing (NFF) amounted to Rs. 74.4 billion during the first eight months of 2008.** This consisted of Rs. 44.0 billion of net foreign loans, Rs. 12.2 billion of foreign grants and Rs. 18.2 billion of Treasury bills and Treasury bonds issued to foreign investors. NFF covered 32 per cent of the overall budget deficit during the first eight months of 2008.

Government Debt and Debt Service Payments

Government Debt

- **The outstanding government debt increased by Rs. 259.5 billion to Rs. 3,301 billion at end August 2008 compared to that of end 2007.** Domestic debt increased by Rs. 201 billion to Rs. 1,916 billion, while foreign debt increased by Rs. 58.5 billion to Rs. 1,385 billion.

- **Of the total domestic debt, the short term debt and medium and long term debt increased by 21 per cent and 9 per cent respectively during this period.** The share of Treasury bills in the total short term debt decreased to 76 per cent from 85 per cent as at end 2007, indicating the high

Table 6.3
Sources of Financing

Rs. billion

Item	2007 Jan-Aug.	2007 (Prov.)	2008 Jan - Aug (Prov.)
Domestic financing	118.7	127.7	154.2
By instrument			
Treasury bonds	53.9	52.8	83.7
Treasury bills	25.9	37.1	12.0
Rupee loans	-6.5	10.3	-1.5
Sri Lanka Development Bonds	23.6	23.6	66.6
Provisional advances	12.9	11.7	16.0
Other	8.9	-7.8	-22.6
By source			
Bank	22.5	15.8	34.1
Non bank	96.2	111.9	120.2
Other			
Foreign financing	73.5	131.4	74.4
Loans	25.3	63.8	43.9
Treasury bonds [a]	29.2	37.1	2.5
Treasury bills [b]	-	-	15.7
Grants	19.0	30.5	12.2
Total financing	**192.2**	**276.5**	**228.6**

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

(a) Treasury bonds issued to foreign investors.
(b) Treasury bills issued to foreign investors.

Table 6.4
Outstanding Government Debt

Rs. billion

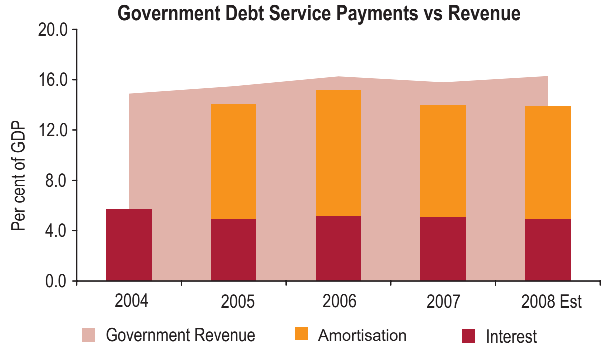
Item	2007 End Aug	2007 End Dec. (Prov.)	2008 End Aug (Prov.)
Domestic Debt [a]	1,663.3	1,715.2	1,916.2
By maturity period			
Short term	364.4	363.2	439.1
Medium and long term	1,298.9	1,352.0	1,477.1
By institution			
Banks	422.7	415.3	385.0
Non bank sector	1,240.5	1,299.8	1,531.2
Foreign debt	1,276.7	1,326.5	1,385.0
Concessional [b]	1,123.6	1,099.9	1,112.3
Non concessional [c]	153.1	226.6	272.8
Total outstanding government debt	**2,939.9**	**3,041.7**	**3,301.2**

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

(a) This excludes the government Treasury bonds amounting to Rs. 4.4 billion issued to commercial banks on behalf of CWE in November 2003.
(b) Data related to foreign debt has been adjusted to clear the arrears.
(c) Includes foreign Treasury bonds and Treasury bills issued to foreign investors.

Chart 6.5
Outstanding Government Debt

Chart 6.6
Government Debt Service Payments vs Revenue



reliance on other short term non-instrument borrowings. Also, there was a decline in the share of outstanding medium and long term domestic debt to 77 per cent of the total domestic debt from 79 per cent as at end 2007.

- **The outstanding foreign currency denominated domestic debt as at end August 2008 increased by Rs. 7.9 billion (US dollars 86.9 million) to Rs. 188 billion (US dollars 1,746 million) from end December 2007.** However, the share of foreign currency denominated debt to total domestic debt declined to 9.8 per cent from 10.5 per cent recorded in 2007.

- **The impact of exchange rate variation on outstanding foreign debt resulted in a decline of outstanding debt.** During the first eight months in 2008, the rupee appreciated against the US doller, SDR and Euro by 0.8 per cent, 1.3 per cent, and 1.6 per cent, respectively, while it depreciated against the Japanese Yen by 2.5 per cent. Consequently, the outstanding foreign debt stock declined by Rs. 4.7 billion during this period.

- **The share of concessional debt of the government foreign debt continued to decline during the first eight months of 2008.** Accordingly, the share of concessional loan declined further to 80 per cent from 83 per cent recorded as at end of previous year. This reflected the higher reliance on foreign commercial borrowings in the wake of reduced access to concessional borrowings with increase in per capita income of the country.

Debt Service Payments

- **Total domestic and foreign debt service payments during the first eight months of 2008 amounted to Rs. 322 billion.** This consisted of amortization payments of Rs. 182 billion (57 per cent) and interest payments of Rs. 140 billion (43 per cent). Debt service payments to domestic and foreign sources amounted to Rs. 268 billion and Rs. 54 billion, respectively.

- **Total debt service payments for 2008 in the revised estimates amount to Rs. 610 billion.** This consists of amortization payments of Rs. 394 billion and interest payments of Rs. 216 billion. Accordingly, total debt service payments in 2008 are estimated to increase by Rs. 8 billion against the original estimate of Rs. 602 billion.

Outlook for 2009

- **The government, as announced in the policy documents including the Medium Term Macro Fiscal Framework (MTMFF), envisages to strengthen the fiscal consolidation process further.** Accordingly, the overall budget deficit as a per cent of GDP in 2009 would be contained around 6.5 per cent, which is in line with the expected medium term fiscal targets. The MTMFF also expects to generate a surplus in the current account gradually thereby make borrowings only to finance capital expenditure. In order to achieve these targets, fiscal consolidation has to be strengthened further by enhancing revenue and further rationalizing recurrent expenditure. Such a prudential fiscal management is necessary to support the expected high economic growth path in the medium term.