6

FISCAL POLICY AND GOVERNMENT FINANCE

6.1 Overview

The fiscal policy strategy announced in the budget for 2011 was formulated with the objective of encouraging investment to support a higher economic growth, while remaining committed to the fiscal consolidation process. The budget deficit was targeted to be reduced to 6.8 per cent of GDP from 8 per cent of GDP in 2010. In order to contain the overall fiscal deficit within the level targeted in the budget for 2011, revenue and grants were expected to increase to 15.6 per cent of GDP and recurrent expenditure was to be contained at 16.1 per cent of GDP, while capital and net lending was to be increased to 6.4 per cent of GDP.

The overall fiscal deficit in 2011 was 6.9 per cent of GDP, marginally above the deficit envisaged in the original budget. Although there was a shortfall in total revenue from that expected in the budget, a moderation in recurrent expenditure, while maintaining public investment above 6 per cent of GDP, enabled the overall deficit to be maintained close to the original budget. The setback in revenue collection despite the introduction of major tax reforms was largely due to the slower than expected progress in the implementation of some tax changes, reduction in tax rates and the granting of exemptions during the year to mitigate the pressure on the domestic market from a rise in international prices.

6.2. Fiscal Policy Direction and Measures

The key fiscal indicators in the budget for 2011 were set in line with the targets set in the medium term macro fiscal framework. Accordingly, the overall budget deficit for 2011 was estimated to be reduced further to 6.8 per cent of GDP from 8 per cent of GDP in 2010. A similar reduction was expected in the current account deficit to 0.8 per cent of GDP in 2011 from 2.1 per cent of GDP in 2010 and in the primary deficit to 1.3 per cent of GDP in 2011 from 1.7 per cent of GDP in 2010. A reduction in the debt to GDP ratio to 79.8 per cent in 2011 from 81.9 per cent in 2010 was also envisaged in the fiscal consolidation process. These favourable developments on the fiscal front were to be achieved by enhancing revenue and rationalising recurrent expenditure, while maintaining investment in strategically important infrastructure projects at a level that would support the envisaged high economic growth.

On the revenue front, far reaching reforms aimed at simplifying the tax system and broadening the tax base were introduced with the ultimate goal of enhancing revenue collection while creating an investor friendly environment. Included in the reforms was the abolition of several nuisance taxes, the reduction of tax rates and the rationalisation of tax bands as well as the expansion of the tax base. A low and simple tax system was expected to improve tax compliance and facilitate higher tax collection, while encouraging investment in selected sectors by providing various tax incentives such as concessionary tax rates, exemptions and tax holidays to support a high economic growth.

Measures were taken to rationalise the income tax structure with a view to broadening the tax base and improving tax compliance. With effect from 1 April 2011 the maximum tax rate for personal income taxes was reduced to 24 per cent from 35 per cent, while the tax free threshold was raised to Rs.500,000 from Rs.300,000. In addition, the PAYE tax was made a final tax for those with only employment income and the threshold raised to Rs.600,000. Emoluments of public sector employees which were hitherto not taxed were subject to income tax, resulting in a widening of the tax base. The corporate income tax rate was also lowered to 28 per cent from 35 per cent, except for profits and income arising from the sale, and manufacture or import of liquor and tobacco products, which were taxed at 40 per cent. Further, the concessionary tax rate applicable to selected sectors such as construction, tourism, qualified exports and companies whose taxable income does not exceed Rs.5 million was reduced to 12 per cent from 15 per cent. The threshold for applicability of the Economic Service Charge (ESC) was raised to Rs.25 million per quarter from Rs.7.5 million per quarter to assist Small and Medium Enterprises (SMEs), while the simplification of the tax rate structure and annual filing of returns with quarterly payments for the ESC was aimed at improving compliance.

The Value Added Tax (VAT) system was simplified by replacing the multiple tax rate structure with a single tax rate of 12 per cent. Further, the input VAT refund which was restricted to 85 per cent of the output tax was extended up to 100 per cent with effect from 1 January 2011 and a new set-off mechanism introduced to address unabsorbed input credit outstanding as at 31 December 2010. In addition, the suspended VAT (SVAT) scheme, hitherto implemented by the Textile Quota Board and the Export Development Board, was brought under the Commissioner General of Inland Revenue and extended to include suppliers to exporters and suppliers of value added services to exporters as well as suppliers to special projects. Financial institutions were instructed to transfer tax savings from the reduction in the VAT rate applicable on financial services from 20 per cent to 12 per cent, and the reduction of the corporate income tax rate from 35 per cent to 28 per cent, into a special fund, i.e., the Investment Fund Account (IFA) maintained at the respective financial institutions to be used for long term lending to specific sectors at concessionary interest rates.

A major policy change introduced in the budget for 2011 was the abolition of the Turnover Tax (TT) collected by the Provincial Councils (PCs) and the widening of the scope of the Nation Building Tax (NBT) to include wholesale and retail trading activity. To compensate the provincial councils for the revenue loss arising from the abolition of the TT one third of the revenue collected from the NBT was to be transferred to the provincial councils from the central government. Further, the NBT rate was reduced to 2 per cent from 3 per cent of the liable turnover. For distributors, three-fourths of the liable turnover and for wholesale and retail traders, half of the liable turnover was exempted from the NBT. In addition, the threshold for the applicability of the NBT was reduced to Rs.500,000 per quarter from Rs.650,000 per quarter and in the case of selected activities, such as operating a hotel, guest house or restaurant, processing of any locally procured agricultural produce, providing educational services and supplying manpower, the threshold was raised to Rs.25 million per quarter.

The tax system was simplified by abolishing several nuisance taxes and amalgamating multiple taxes on the same industry into one single tax. The Social Responsibility Levy (SRL), the Regional Infrastructure Development Levy (RIDL) and the Debits Tax were abolished to simplify the tax structure. In addition, a composite Telecommunication Levy of 20 per cent was introduced replacing the Cellular Mobile Subscribers' Levy, VAT, NBT and Environmental Conservation Levy applied on telecommunication services.

The government revised taxes on several commodities affected by rising international prices to ease domestic price pressures. The partial duty waiver on petrol imports was increased in January 2011 and a full customs duty waiver was granted from April 2011, leaving an excise duty of Rs.25 per litre and the PAL of 5 per cent applicable on imports of petrol. A full customs duty waiver was granted for diesel in 2011 and only an excise tax of Rs.2.50 per litre and the PAL of 5 per cent were applicable on diesel imports. In the case of milk powder, a full customs duty waiver was granted from late January 2011. Changes were made to the Special Commodity Levy (SCL) on potatoes, onions, green gram and chillies to stabilise prices in the domestic market, while SCL was imposed on millet, black gram and selected spices to encourage domestic production.

Tax incentives were provided to encourage private investment and to attract foreign direct investment to support the high growth momentum. To create a level playing field, all tax incentives were brought under the Inland Revenue Act, other than for some projects which are identified as being strategically important by the Board of Investment (BOI) and approved by the Cabinet of Ministers, which were brought under the Strategic Development Projects (Amendment) Act No.12 of 2011. Tax holidays of five years for investments in fishing, production of agricultural seeds and planting materials and three years for new undertakings with investment exceeding Rs.50 million were granted. Seven year tax holidays were also granted for new undertakings with investments more than US dollars 3 million. In addition, a depreciation allowance of one third on plant and machinery acquired after 1 April 2011 and 10 per cent on qualified buildings constructed after 1 April as well as 200 per cent of expenditure on research and development was allowed to be deducted when arriving at assessable income to encourage new investment.

Initiatives were taken to improve tax administration. A Tax Appeals Commission was set up under the Tax Appeal Commission Act No. 23 of 2011 to expedite the appeals process at the Inland Revenue Department and to address issues that prevailed under the previous system. A Committee for interpretation of tax laws has also been set up to interpret the provisions of the Acts and to issue guidelines and instructions as and when required to ensure uniformity with regard to the interpretation of tax laws. A separate Default Tax Recovery Unit (DTRU) has been set up under the Default Taxes (Special Provisions) Act to deal with tax defaults. In addition, the modernisation programmes initiated in revenue agencies under the Fiscal Management Reform Programme (FMRP) to automate the tax collection processes were continued during the year. Awareness programmes to enhance tax compliance and to bring those who are liable to tax, but who are currently not registered, into the tax net are also being carried out by the revenue agencies.

Several policy changes were made on the expenditure front. All public sector employees were given a special allowance equivalent to 5 per cent of their basic salary with effect from January 2011. In addition, the Cost of Living Allowance (COLA) of public sector employees in the non-staff grade was increased by Rs.600 to Rs.5,850 per month with effect from 1 January 2011 and for those in staff grades from 1 July 2011. For pensioners, the COLA was increased by Rs.300 to Rs.2,675 per month from 1 January 2011 and monthly pensions increased by Rs.750 for those who retired prior to 1 January 2004 and by Rs.250 for those who retired during the period 1 January 2004 to 31 December 2005 with effect from 1 July 2011. The fertiliser subsidy which was hitherto confined to the paddy sector was extended to all crops. While the subsidised price for a 50 kg bag of fertiliser to the paddy sector was maintained at Rs.350, the subsidised price of fertiliser to all other crops was set at Rs.1,200 for a 50 kg bag of unmixed fertiliser and at Rs. 1,300 for a 50 kg bag of mixed fertiliser.

Table 6.1 Summary of Government Fiscal Operations

Item	2010	2011 Approved Estimates	2011 Provisional	2012 Approved Estimates
	Rs. million			
Total revenue and grants	**834,188**	**985,920**	**949,917**	**1,126,081**
Total revenue	817,279	963,320	934,776	1,106,081
Tax revenue	724,747	861,943	812,611	1,000,559
Non tax revenue	92,532	101,377	122,166	105,522
Grants	16,909	22,600	15,141	20,000
Expenditure and lending minus repayments	**1,280,205**	**1,419,664**	**1,400,097**	**1,594,946**
Current	937,094	1,017,155	1,006,633	1,107,902
Capital and net lending	343,111	402,509	393,465	487,044
o/w Public investment	356,519	413,546	407,488	497,465
Current account surplus (+)/deficit (-)	**-119,815**	**-53,835**	**-71,856**	**-1,821**
Primary account surplus (+)/deficit (-)	**-93,425**	**-79,816**	**-93,481**	**-98,865**
Overall fiscal surplus (+)/deficit (-)	**-446,017**	**-433,744**	**-450,180**	**-468,865**
Total financing	**446,017**	**433,744**	**450,180**	**468,865**
Foreign financing (a)	243,788	143,750	218,956	197,264
Domestic financing	202,229	289,994	231,224	271,602
Market borrowings	191,999	289,994	236,022	271,602
Non bank	193,891	247,994	44,171	207,602
Bank	-1,892	42,000	191,850	64,000
Monetary Authority	-32,112	n.a.	185,848	n.a.
Commercial banks	30,220	n.a.	6,002	n.a.
Non market borrowings	10,230	-	-4,798	-
	As a percentage of GDP			
Total revenue and grants	**14.9**	**15.6**	**14.5**	**15.0**
Total revenue	14.6	15.2	14.3	14.7
Tax revenue	12.9	13.6	12.4	13.3
Non tax revenue	1.7	1.6	1.9	1.4
Grants	0.3	0.4	0.2	0.3
Expenditure and lending minus repayments	**22.9**	**22.4**	**21.4**	**21.2**
Current	16.7	16.1	15.4	14.8
Capital and net lending	6.1	6.4	6.0	6.5
o/w Public investment	6.4	6.5	6.2	6.6
Current account surplus (+)/deficit (-)	**-2.1**	**-0.8**	**-1.1**	**...**
Primary account surplus (+)/deficit (-)	**-1.7**	**-1.3**	**-1.4**	**-1.3**
Overall fiscal surplus (+)/deficit (-)	**-8.0**	**-6.8**	**-6.9**	**-6.2**
Total financing	**8.0**	**6.8**	**6.9**	**6.2**
Foreign financing (a)	4.4	2.3	3.4	2.6
Domestic financing	3.6	4.6	3.5	3.6
Market borrowings	3.4	4.6	3.6	3.6
Non bank	3.5	3.9	0.7	2.8
Bank	...	0.7	2.9	0.9
Monetary Authority	-0.6	n.a.	2.8	n.a.
Commercial banks	0.5	n.a.	0.1	n.a.
Non market borrowings	0.2	-	-0.1	-

(a) Includes rupee denominated Treasury bonds and Treasury bills issued to foreign investors, the Sri Lankan diaspora and migrant workers.

Source: Ministry of Finance and Planning

Recognising that investment in infrastructure is vital for sustainable and inclusive economic growth, the public investment programme was focused on accelerating the implementation of several strategic infrastructure projects, while investing in regional infrastructure to ensure a more regionally balanced growth. A significant investment has been made to develop the road network at the national, provincial and rural level. Under the "*Gama Neguma*", "*Maga Neguma*" and "*Uthuru Wasanthaya*" programmes, several projects are ongoing to upgrade roads and improve other infrastructure. The development of ports, expansion of capacity in the power sector and rural electrification programmes as well as projects to improve water supply and upgrade irrigation facilities also continued during the year.

The government has taken several policy measures to improve the performance of state owned enterprises (SOEs). To improve the financial viability of SOEs, a cost reflective pricing policy is being recommended to be adopted by these institutions. Further, greater responsibility will be placed on the boards of these institutions to develop innovative solutions to address challenging situations. The Ministry of State Resources and Enterprise Development is actively seeking to enhance the performance of underperforming SOEs and state assets through the restructuring of 23 SOEs under its supervision and by appointing private sector entrepreneurs and professionals to the boards of strategic SOEs. As part of this process, several enterprises namely, BCC Lanka Ltd., Kanthale and Hingurana Sugar, Ceramics Corporation, Lanka Fabrics, Salusala and Lanka Rubber Manufacturing and Export Corporation were in the process of being restructured. In addition, a holding company, State Resources Management Corporation Ltd. was set up with the objective of developing enterprises under its purview to make them suitable for public listing on the Colombo Stock Exchange. Improving the effective utilisation of assets of SOEs including land and buildings, plant and machinery which have hitherto been underutilised is another major strategy being adopted to improve the financial performance of SOEs.

The public debt management strategy focused on mobilising funds for the government at the lowest possible cost while seeking to minimise risks. To address the high rollover risk arising from the bunching of maturities, government securities with shorter maturities were replaced with longer maturities. Considering the favourable macroeconomic developments, credit rating agencies revised the country's sovereign rating in 2011: Fitch Ratings upgraded Sri Lanka's foreign currency rating to BB- with outlook 'Stable', Moody's Investor Service upgraded the outlook of Sri Lanka's B1 rating from 'Stable' to 'Positive', while Standard & Poor's upgraded the outlook of Sri Lanka's B+ rating to 'Positive'. Benefiting from improved investor confidence and low interest rates prevailing in international markets, in July 2011 the government issued an International Sovereign Bond amounting to US dollars 1 billion. The issue had a maturity of 10 years at a fixed rate yield of 6.25 per cent which was equivalent to a spread of 332 basis points over the 10-year US Treasury securities. The funds were utilised to restructure the government's outstanding debt stock with the retirement of some high cost debt and helped to reduce pressure on domestic resources and interest rates. The threshold on foreign investments in Treasury bills and Treasury bonds was raised from 10 per cent to 12.5 per cent of the total outstanding amount of each investment in order to support the growth momentum of the economy by enhancing resource availability and easing pressure on interest rates.

6.3 Government Budgetary Operations

Revenue and Grants

Revenue

The revenue to GDP ratio declined to 14.3 per cent in 2011 from 14.6 per cent in 2010 as a result of the abolition of several taxes, the lowering of tax rates and the extension of exemptions. However, in nominal terms total revenue increased by 14.4 per cent to Rs.934.8 billion in 2011 from Rs.817.3 billion in 2010 due to higher economic growth and the significant rise in imports.

Tax revenue as a percentage of GDP, declined to 12.4 per cent in 2011 from 12.9 per cent in 2010 although in nominal terms it increased by 12.1 per cent to Rs.812.6 billion due to higher revenue from income based taxes, excise duties and import related taxes. Although several major tax reforms and tax rationalisation measures were introduced in the budget for 2011 to simplify the tax system and to improve revenue mobilisation, the full impact of these measures will be realised only in the medium term. Consumption based taxes remained the major source of tax revenue in 2011 accounting for 80.6 per cent of the total tax collection. However, the share of income taxes in total taxes increased to 19.4 per cent in 2011 from 18.7 per cent in 2010. Higher corporate tax income due to improved corporate earnings and higher ESC collection contributed to the improvement in income based tax collection. Non tax revenue recorded a significant growth of 32 per cent to Rs.122.2 billion in 2011 over the previous year. Higher transfer of profits and dividends from public institutions, including the Central Bank and higher revenue from fees and charges mainly due to higher motor vehicle registrations contributed to the increase in non tax revenue.

Chart 6.1 Composition of Government Revenue - 2011

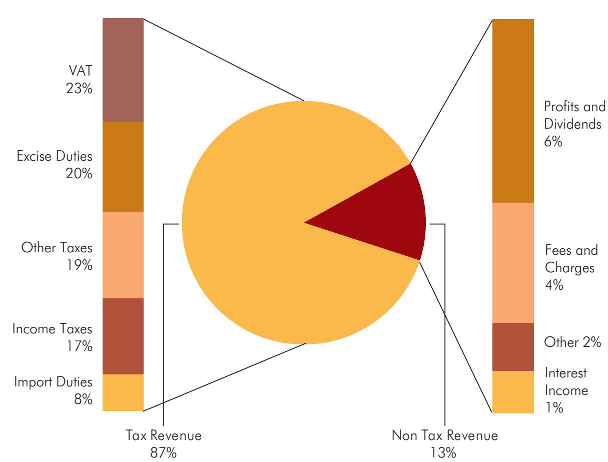


Table 6.2 Economic Classification of Revenue

Item	2010	2011 Approved Estimates	2011 Provisional	2012 Approved Estimates
	Rs. million			
Tax revenue	724,747	861,943	812,611	1,000,559
Income taxes	135,623	154,883	157,309	190,270
VAT	219,990	238,390	215,576	264,917
Excise taxes	129,864	152,250	186,010	223,125
Import duties	64,163	92,803	75,974	93,830
Other taxes	175,107	223,617	177,742	228,417
Non tax revenue	92,532	101,377	122,166	105,522
Total revenue	817,279	963,320	934,776	1,106,081
	As a percentage of GDP			
Tax revenue	12.9	13.6	12.4	13.3
Income taxes	2.4	2.4	2.4	2.5
VAT	3.9	3.8	3.3	3.5
Excise taxes	2.3	2.4	2.8	3.0
Import duties	1.1	1.5	1.2	1.3
Other taxes	3.1	3.5	2.7	3.0
Non tax revenue	1.7	1.6	1.9	1.4
Total revenue	14.6	15.2	14.3	14.7

Source: Ministry of Finance and Planning

Revenue from income taxes as a percentage of GDP remained at 2.4 per cent in 2011, although in nominal terms, it increased by 16 per cent to Rs.157.3 billion from Rs.135.6 billion in 2010. The significant increase in income taxes was due to higher earnings in 2011 supported by favourable economic conditions. Corporate taxes increased by 35.4 per cent to Rs. 77.4 billion in 2011 due to improved performance in banking and financial services, food, beverages and tobacco sectors, external trade and the construction industry. Although the PAYE tax was extended to public sector employees, non corporate taxes (including PAYE) declined by 6.2 per cent to Rs.20.4 billion in 2011 from Rs.21.7 billion in 2010 mainly due to the increase in the tax free threshold to Rs.500,000 from Rs.300,000 and the granting of an additional tax free allowance of Rs.100,000 for individuals for whom employment income is the only source of income. Revenue from the ESC increased by 18.2 per cent to Rs.21.3 billion during the year due to higher business turnover which more than offset the negative impact of the exemptions granted to some sectors and the increase in the tax free threshold from Rs.7.5 million to Rs.25 million per quarter. However, revenue from withholding taxes (WHT) in 2011 declined by 1.3 per cent to Rs.38.2 billion due to the low interest rates that prevailed during the year and the removal of withholding taxes on specified fees.

Revenue from VAT as a percentage of GDP declined significantly to 3.3 per cent in 2011 from 3.9 per cent in 2010 mainly due to the unification of VAT rates at the lower rate of 12 per cent. In nominal terms, revenue from VAT declined by 2 per cent to Rs.215.6 billion in 2011. Consequently, the contribution of VAT to total tax revenue declined to 26.5 per cent in 2011 from 30.4 per cent in 2010. VAT on domestic goods and services declined by 14.2 per cent compared to the previous year. The impact of the reduction in the VAT rate on financial services resulted in a revenue loss of around Rs.10.1 billion during the year. Further the relaxation of the restriction on the deduction of input VAT credits from 85 per cent to 100 per cent, the granting of exemptions to telecommunication services, educational services and for goods and services supplied to foreign funded infrastructure projects also contributed to the lower VAT collection from domestic goods and services. VAT on imports in nominal terms increased by only 12.8 per cent during the year despite the 50.7 per cent growth in total imports in 2011. The lower VAT rate and the granting of exemptions for petrol, as well as the introduction of SCL on several food items that were previously subject to VAT, lowered the VAT collection on imports in 2011.

Revenue from excise duties as a percentage of GDP increased to 2.8 per cent in 2011 from 2.3 per cent in 2010 mainly due to the significant increase in excise duty collected from motor vehicle imports. Revenue from excise duties increased by 43.2 per cent to Rs.186 billion in 2011 from Rs.129.9 billion in 2010, exceeding the budgetary target by Rs.33.8 billion. Consequently, the share of excise taxes in total tax revenue increased to 22.9 per cent in 2011 from 17.9 per cent in 2010. Excise taxes on motor vehicle imports increased by 149.2 per cent to Rs.52.8 billion in 2011 over the previous year, reflecting the 93.6 per cent growth in motor vehicle imports in 2011. Excise taxes on liquor grew by 50.8 per cent to Rs.55.3 billion during the year on account of the scaling up of excise duty rates in three steps from November 2010 to October 2011, the higher production of hard and malt liquor by 9.1 per cent and 22.5 per cent, respectively during the year due to the increase in demand with the opening up of new markets in the Northern and Eastern provinces and higher tourist arrivals. Excise taxes from cigarettes and tobacco increased by 22 per cent to Rs.49.6 billion in 2011 as a result of three consecutive upward revisions of excise tax rates during the period November 2010 to October 2011 and the opening up of new markets in the Northern and Eastern provinces. However, revenue from excise duties on petroleum products declined by 19.9 per cent to Rs.22.5 billion.

Revenue from NBT as a percentage of GDP declined to 0.5 per cent in 2011 from 0.8 per cent in 2010 due to several major changes that were made to NBT in 2011. In nominal terms as well, NBT collection declined by 22.5 per cent to Rs.35.7 billion. NBT on domestic goods and services declined by 1.4 per cent to Rs.19.0 billion mainly due to the reduction in the NBT rate from 3 per cent to 2 per cent and the transfer of one third of NBT collected to the PCs to compensate them for the abolition of the turnover tax which was hitherto collected by PCs. Despite the high growth in imports, NBT from imports declined by 37.8 per cent to Rs.16.6 billion in 2011 due to the lower NBT rate and the extension of exemptions to the importation of goods for specific projects and various raw materials. Although NBT was extended to the wholesale and retail trading sectors, the expected revenue increase from the base expansion did not materialise due to delays in the registration of new taxpayers. At the end of 2011, only around 50 per cent of liable wholesale and retail traders were registered for NBT.

Revenue from import duties and the Special Commodity Levy (SCL) as a percentage of GDP increased marginally to 1.4 per cent in 2011 from 1.3 per cent in 2010 mainly due to an increase in imports, particularly of motor vehicles and consumer goods. In nominal terms, revenue from import duties increased by 18.4 per cent in 2011 to Rs.76 billion from Rs.64.2 billion in 2010, increasing the share of import duties in total tax revenue to 9.3 per cent in 2011 from 8.9 per cent in 2010. However, the growth in import taxes was significantly lower than the growth in overall imports of 50.7 per cent in 2011. Higher duty free imports, which increased to 41.9 per cent of total imports in 2011 from 27.2 per cent in 2010, the granting of custom duty waivers for milk powder, urea and other fertiliser, the extension of exemptions to imports for foreign funded projects and telecommunications, Information and Communications Technology (ICT) and Business Process Outsourcing (BPO) sectors as well as the reduction in the duty on motor vehicles and electrical and electronic products, significantly reduced the revenue collected from import duties. Consequently, the average customs duty rate, including SCL declined to 4.1 per cent in 2011 from 4.9 per cent in 2010. However, import duties from motor vehicle imports increased significantly by 56.4 per cent to Rs.28.5 billion in 2011 from 18.2 billion in 2010 reflecting the high growth in motor vehicle imports during the year. In nominal terms, revenue from the SCL increased significantly by 53.6 per cent to Rs.15.6 billion in 2011, increasing the share of SCL in total tax revenue to 1.9 per cent in 2011 from 1.4 per cent in 2010. The SCL on five commodities namely, potatoes, big onions, sugar, canned fish and dhal accounted for 68.4 per cent (Rs.10.7 billion) of the total SCL collection in 2011, largely contributing to the higher collection from SCL during the year.

There was mixed performance in the revenue collected from other taxes. Revenue from Ports and Airport Development Levy (PAL) increased to 1 per cent of GDP in 2011 from 0.9 per cent of GDP in 2010. However, in nominal terms, PAL increased by 33 per cent to Rs.66 billion in 2011 from Rs.49.6 billion in 2010 raising the share of PAL in total tax revenue to 8.1 per cent in 2011 from 6.8 per cent in 2010. A wider tax base with fewer exemptions mainly contributed to the significant increase in the PAL collected in 2011 compared to other import related taxes. In nominal terms, revenue from Cess declined marginally by 0.3 per cent to Rs.29.7 billion, although as a percentage of GDP, it remained at 0.5 per cent in 2011. The removal of Cess applicable to most raw materials and machinery to support local industries largely contributed to the lower Cess in 2011. The Telecommunications Levy of 20 per cent, which replaced the Cellular Mobile Subscribers' Levy, VAT, NBT and Environment Conservation Levy (ECL) hitherto applied on the Telecommunications sector, raised Rs.18.6 billion in 2011. Revenue from license fees and other taxes in nominal terms declined by 47.7 per cent to Rs.8 billion from Rs.15.4 billion in 2010 mainly due to the removal of the Regional Infrastructure Development Levy (RIDL), the Social Responsibility Levy (SRL) and the ECL.

Non tax revenue increased as a percentage of GDP to 1.9 per cent in 2011 from 1.7 per cent in 2010, as revenue from non tax sources in nominal terms increased by 32 per cent to Rs.122.2 billion in 2011 from Rs.92.5 billion in 2010. Consequently, the share of non tax revenue in total revenue increased to 13.1 per cent in 2011 from 11.3 per cent in 2010.

An increase in the transfer of profits and dividends and higher revenue from fees and charges mainly contributed to the nominal increase in non tax revenue. Profit transfers from the Central Bank increased by 46.7 per cent to Rs.22 billion in 2011, while profits and dividend transfers from other state institutions increased by 9.7 per cent to Rs.34.4 billion. Fees and charges increased significantly growing by 62.7 per cent to Rs.37.3 billion mainly on account of the increase in revenue from motor vehicle registration fees and other charges. Income from interest and rent also recorded a growth of 33.4 per cent to Rs.13.4 billion in 2011.

Grants

Foreign grant receipts declined by 10.5 per cent to Rs.15.1 billion in 2011 from Rs.16.9 billion in 2010. Foreign grants from multilateral donors increased by 6.9 per cent to Rs.12.1 billion in 2011 from Rs.11.3 billion in 2010, increasing the share of grants from multilateral sources to 80 per cent of total grants in 2011 from 66.9 per cent in 2010. On the other hand, grants from bilateral donors declined by 46.1 per cent to Rs.3 billion in 2011 from Rs.5.6 billion in 2010 reflecting the gradual move of Sri Lanka towards middle income country status.

Expenditure and Net Lending

Total expenditure and net lending declined to 21.4 per cent of GDP in 2011 from 22.9 per cent of GDP in 2010 due to measures taken by the government to rationalise recurrent expenditure, while prioritising capital expenditure to strategically important infrastructure development projects. The reduction in total expenditure and net lending by 1.5 percentage points was the combined outcome of a reduction in recurrent expenditure by 1.4 percentage points and capital expenditure and net lending by 0.1 percentage points. However, in nominal terms, total expenditure and net lending increased by 9.4 per cent to Rs. 1,400.1 billion in 2011, from Rs.1,280.2 billion in the previous year, although it was lower than the original budgetary target of Rs.1,419.7 billion envisaged for the year.

Recurrent expenditure declined to 15.4 per cent of GDP in 2011 from 16.7 per cent of GDP in 2010, in keeping with the fiscal consolidation efforts of the government. In nominal terms, recurrent expenditure in 2011 increased by 7.4 per cent to Rs.1,006.6 billion compared to Rs.937.1 billion in 2010. However, recurrent expenditure in 2011 was lower than the original budgetary estimate of Rs.1,017.2 billion for the year. Although there was an increase in salaries and wages and pension payments, a slower growth in interest payments helped moderate the nominal increase in recurrent expenditure in 2011.

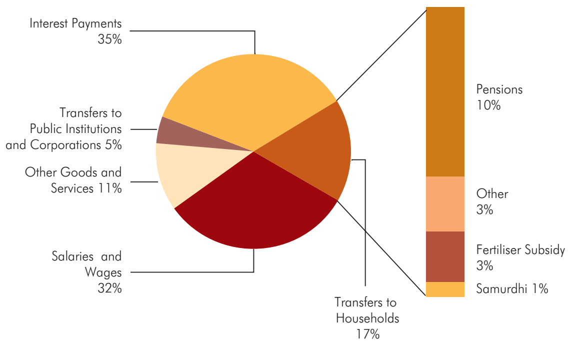
Expenditure on salaries and wages for public sector employees increased by 6.3 per cent to Rs.319.6 billion in 2011, mainly on account of

Table 6.3 Economic Classification of Expenditure and Lending Minus Repayments

Item	2010	2011 Approved Estimates	2011 Provisional	2012 Approved Estimates
	Rs. million			
Current expenditure	**937,094**	**1,017,155**	**1,006,633**	**1,107,902**
Expenditure on goods and services	388,286	455,686	433,331	501,503
o/w Salaries and wages	300,558	344,023	319,601	367,980
Interest payments	352,592	353,928	356,699	370,000
Foreign	55,464	44,528	68,565	48,000
Domestic	297,127	309,400	288,134	322,000
Current transfers and subsidies	196,216	207,541	216,602	236,400
o/w To households and other sectors	156,194	165,182	171,438	186,336
Samurdhi	9,241	9,300	9,044	12,900
Pensions	90,995	98,000	99,936	111,353
Fertiliser subsidy	26,028	20,000	29,802	33,800
Other	29,931	37,882	32,656	28,283
Capital expenditure	**302,087**	**351,899**	**363,001**	**448,732**
Acquisition of real assets	158,488	199,579	202,627	264,289
Capital transfers	143,599	168,975	160,374	214,678
Provision for under expenditure	-	-16,654	-	-30,235
Lending minus repayments	**41,025**	**50,609**	**30,464**	**38,312**
Total expenditure and net lending	1,280,205	1,419,663	1,400,097	1,594,946
	As a percentage of GDP			
Current expenditure	16.7	16.1	15.4	14.8
Expenditure on goods and services	6.9	7.2	6.6	6.7
o/w Salaries and wages	5.4	5.4	4.9	4.9
Interest payments	6.3	5.6	5.5	4.9
Foreign	1.0	0.7	1.1	0.6
Domestic	5.3	4.9	4.4	4.3
Current transfers and subsidies	3.5	3.3	3.3	3.1
o/w To households and other sectors	2.8	2.6	2.6	2.5
Samurdhi	0.2	0.1	0.1	0.2
Pensions	1.6	1.5	1.5	1.5
Fertiliser subsidy	0.5	0.3	0.5	0.4
Other	0.5	0.6	0.5	0.4
Capital expenditure	**5.4**	**5.6**	**5.5**	**6.0**
Acquisition of real assets	2.8	3.1	3.1	3.5
Capital transfers	2.6	2.7	2.5	2.9
Provision for under expenditure	-	-0.3	-	-0.4
Lending minus repayments	**0.7**	**0.8**	**0.5**	**0.5**
Total expenditure and net lending	22.9	22.4	21.4	21.2

Source: Ministry of Finance and Planning

Chart 6.2 Composition of Government Current Expenditure - 2011



the salary increases granted during the year, although as a percentage of GDP it declined to 4.9 per cent in 2011 from 5.4 per cent in 2010. Salaries and wages paid to central government employees, including defence and public order and civil security personnel, increased by 4.6 per cent to Rs. 228.8 billion in 2011, while salaries and wages of provincial council employees increased by 10.9 per cent to Rs.90.8 billion. The introduction of a special allowance equivalent to 5 per cent of the basic salary to all public servants from January 2011, an increase in the monthly Cost of Living Allowance (COLA) for public sector employees, as well as an increase in allowances paid to certain categories of public sector employees contributed to the nominal increase in salaries and wages in 2011. Expenditure on salaries and wages was the second largest recurrent expenditure item accounting for 31.7 per cent of total recurrent expenditure in 2011.

The favourable impact of the low interest rate environment prevailing since 2010, the slower growth in the debt stock in 2010, coupled with initiatives taken by the government to restructure its debt portfolio by shifting from high cost domestic debt to low cost foreign debt helped contain interest payments in 2011. Interest expenditure increased by only 1.2 per cent to Rs.356.7 billion in 2011, which was significantly lower than the increase of 13.9 per cent recorded in 2010. In line with this, interest expenditure as a percentage of GDP declined to 5.5 per cent in 2011 from 6.3 per cent in the previous year. However, interest payments continued to be the single largest recurrent expenditure item, accounting for 35.4 per cent of total recurrent expenditure in 2011.

Interest payments on domestic debt which accounted for 80.7 per cent of total interest payments in 2011 declined by 3.0 per cent to Rs.288.1 billion, while interest payments on foreign debt increased by 23.6 per cent to Rs.68.6 billion in 2011. The decline in interest payments on domestic debt was mainly due to the decline in the average interest rate on domestic debt to 11.2 per cent in 2011 from 12.4 per cent in the previous year. Interest payments on Treasury bonds increased by only 3.6 per cent to Rs.216.5 billion in 2011, despite the increase in the outstanding Treasury bond stock by 18.1 per cent in 2009 and by 8.6 per cent in 2010, as lower coupon rates offered in 2010 and 2011 helped contain interest payments during the period under review. Interest payments on Treasury bills declined significantly by 21.5 per cent to Rs.46.3 billion in 2011. Despite the increase in the outstanding stock of Treasury bills by Rs.76.4 billion in 2011, the re-issuance of maturing Treasury bills at lower yield rates reduced interest payments on Treasury bills in 2011. Interest payments on Rupee securities and SLDBs amounted to Rs.11.2 billion and Rs.8.2 billion, respectively. Meanwhile, a marginal increase in the average interest rate on foreign debt to 3.4 per cent in 2011 from 3.2 per cent in the previous year, due to the higher share of foreign commercial debt including foreign investments in Treasury bills and Treasury bonds in the total foreign debt stock in 2010, coupled with the increase in the foreign debt stock by 15 per cent in 2010 mainly contributed to the increase in interest payments on foreign debt in 2011.

Government purchases of other goods and services increased by 29.6 per cent to Rs.113.7 billion in 2011. As a percentage of GDP, expenditure on other goods and services increased to 1.7 per cent in 2011 from 1.6 per cent in 2010. The increase in other goods and services was mainly on account of higher expenditure on energy, utilities and medical supplies. Expenditure incurred by the central government on other goods and services accounted for 47 per cent of the total outlay on other goods and services in 2011.

Table 6.4 Functional Classification of Expenditure

Item	2010	2011 Approved Estimates	2011 Provisional	2012 Approved Estimates
	Rs. million			
Current expenditure	937,094	1,017,155	1,006,633	1,107,902
General public services	228,136	256,745	245,266	266,174
Civil administration	37,895	42,236	43,076	49,646
Defence	145,243	163,486	159,553	164,785
Public order and safety	44,998	51,024	42,637	51,743
Social services	267,636	306,506	314,137	357,383
Education	85,195	99,278	99,043	107,988
Health	60,506	70,788	74,443	82,153
Welfare	107,690	121,172	123,122	146,912
Community services	14,245	15,269	17,529	20,330
Economic services	85,440	97,476	88,233	99,652
Agriculture and irrigation	44,081	51,678	46,290	51,471
Energy and water supply	3,492	4,125	3,533	3,706
Transport and communication	31,246	33,856	31,823	32,078
Other	6,621	7,817	6,587	12,398
Other	355,882	356,427	358,996	384,694
o/w Interest payments	352,592	353,928	356,699	370,000
Capital expenditure and lending	356,519	413,546	407,489	497,465
General public services	21,510	24,897	32,484	27,851
Civil administration	20,212	23,657	28,668	26,795
Public order and safety	1,298	1,240	3,816	1,057
Social services	56,205	69,122	62,953	92,500
Education	19,053	21,129	22,326	33,307
Health	13,329	16,939	14,774	27,878
Housing	5,489	9,237	6,712	10,896
Community services	18,334	21,817	19,141	20,418
Economic services	278,803	335,721	311,594	406,764
Agriculture and irrigation	24,865	40,521	28,568	51,187
Energy and water supply	66,569	75,537	74,028	89,962
Transport and communication	165,505	182,781	186,342	237,539
Other	21,804	36,881	22,656	28,076
Other	1	460	459	585
Under expenditure	-	-16,654	-	-30,235
Total expenditure and lending	1,293,613	1,430,701	1,414,122	1,605,367
	As a percentage of GDP			
General public services	4.5	4.4	4.2	3.9
Social services	5.8	5.9	5.8	6.0
Economic services	6.5	6.8	6.1	6.7
Other	6.4	5.6	5.5	5.1
o/w Interest payments	6.3	5.6	5.5	4.9
Total expenditure and lending	23.1	22.6	21.6	21.4

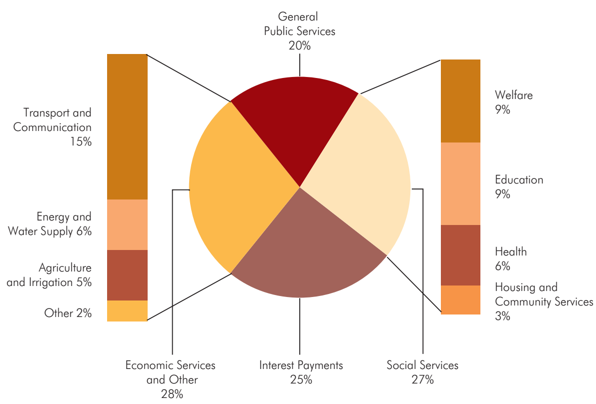
Source: Ministry of Finance and Planning

Although current transfers and subsidies increased by 10.4 per cent to Rs. 216.6 billion in 2011, as a percentage of GDP, it declined to 3.3 per cent in 2011 from 3.5 per cent in 2010. Households continued to be the largest beneficiaries accounting for 79.1 per cent of total current transfers in 2011, while public institutions and public corporations accounted for 14.8 per cent and 6.0 per cent of total current transfers in 2011, respectively.

Current transfers to households increased by 9.8 per cent to Rs.171.4 billion in 2011 mainly due to an increase in government spending on pensions and social welfare payments. Pension payments, which account for 58.3 per cent of transfers to households, increased by 9.8 per cent to Rs.99.9 billion in 2011. The increase in the monthly COLA to pensioners by Rs.300 to Rs.2,675 per month with effect from January 2011, and the full impact of the addition of 16,366 new pensioners in 2010 together with the partial impact of the addition of 23,447 new pensioners in 2011 contributed to this increase. The fertiliser subsidy increased by 14.5 per cent to Rs.29.8 billion in 2011 mainly on account of the high price of fertiliser in the world market which increased the average government subsidy for a 50 kg bag of Urea, Triple Super Phosphate (TSP) and Muriate of Potash (MOP) in excess of Rs.3,000 in 2011. The extension of the fertiliser subsidy to all crops with effect from May 2011 will further increase expenditure on the fertiliser subsidy. Expenditure on welfare programmes for disabled soldiers amounted Rs.13.3 billion in 2011 compared to Rs.10.5 billion in 2010. Meanwhile, expenditure on the Samurdhi programme declined marginally to Rs.9 billion in 2011 from Rs.9.2 billion in 2010 with the gradual decline in the number of families entitled to the income supplementary programme, reflecting the reduction in overall poverty. Transfer payments for welfare programmes targeting school children such as the distribution of free school text books and uniforms and the school nutritional food programme, and transfer payments for welfare programmes addressing the nutritional status of expectant mothers and children, increased by 19 per cent to Rs.10.3 billion in 2011.

Current transfers to public institutions and public corporations increased in 2011. Accordingly, current transfers to public institutions increased by 16.3 per cent to Rs.32.2 billion in 2011, mainly due to an increase in transfers to institutions engaged in higher education and tertiary education. Current transfers to public corporations increased moderately by 5.2 per cent to Rs.13.0 billion in 2011, on account of transfers to cover operational losses of the Department of Posts (Rs.3.3 billion), the Department of Sri Lanka Railways (Rs.4.1 billion) and the Sri Lanka Transport Board (Rs.3.9 billion). The absence of a cost reflective pricing policy and

Chart 6.3 Total Expenditure by Function - 2011



operational inefficiencies were the main reasons for the losses incurred by key public enterprises.

Capital expenditure and net lending increased by 14.7 per cent to Rs.393.5 billion in 2011, reflecting the government's commitment to continue much needed investments to spur economic growth. Public investment increased by 14.3 per cent to Rs.407.5 billion in 2011, although as a percentage of GDP it declined to 6.2 per cent in 2011 from 6.4 per cent in the previous year. Public investment in 2011 was also lower than the 6.5 per cent of GDP envisaged in the original budget for 2011, mainly due to the curtailing of non priority capital expenditure by the government. On an economic basis, expenditure incurred by ministries and departments for the purchase of capital assets, and the construction and development of fixed assets increased significantly by 27.9 per cent to Rs.202.6 billion in 2011. Capital transfers increased by 11.7 per cent to Rs.160.4 billion during the period under review on account of an increase in transfers to public corporations (31.2 per cent), provincial councils (14.6 per cent) and public institutions (6.5 per cent). Meanwhile, the on-lending programme which provides foreign funds to commercially oriented public enterprises was limited to Rs.44.5 billion in 2011 compared to Rs.54.4 billion in the previous year.

The momentum gathered in respect of key national infrastructure development projects continued in 2011 while several regional and rural infrastructure development projects were implemented to reduce the rural-urban divide. On a functional basis, public investment in economic services continued to be the main component of the government's investment programme accounting for 76.5 per cent of total public investment in 2011. In nominal terms this amounted to Rs.311.6 billion in 2011, an 11.8 per cent increase over the previous year. Roads, ports, power and energy, railways, water supply and irrigation were the key infrastructure projects undertaken by the government in 2011. Completion of the Southern Highway and the first phase of the Hambantota harbour were major milestones in the public investment programme in 2011. The government made a continuous effort to develop the national and the regional road networks in the country. Accordingly, substantial investments were made in 2011 on projects such as the Colombo-Katunayake Expressway Project, the Outer Circular Highway Project, the Road Network Development for Hambantota International Hub Development Project, the Southern Transport Development Project, Maintenance of Roads and Bridges Project, the National Highway Sector Project and the Widening and Improvement of Roads Programme. In the area of port development, a significant investment was made on the Bunkering Facility Development Project of the Hambantota harbour and the Colombo Port Expansion Project. The Upper Kotmale Hydropower Project and the Rehabilitation of the New Laxapana and Wimalasurendra Hydro Power Plant Project were the major investments undertaken in power and energy in 2011. Meanwhile, a significant investment was made to upgrade railway lines in 2011 focusing on the Northern and Eastern provinces such as the Madhu-Talaimannar Line (Rs.5.4 billion), the Omanthai-Pallai Line (Rs.5.3 billion), the Medawachchiya-Madhu Line (Rs.4.2 billion) and the Coastal Railway Line (Rs.9.3 billion). In addition, investments to improve water supply were made through projects such as the Secondary Towns Rural Community Based Water Supply Project and the Integrated Water Supply Scheme for the Unserved Areas Project, while investments continued on major irrigation systems such as the Uma Oya Diversion Project.

Public investment in social services increased by 12.0 per cent to Rs.63.0 billion in 2011, mainly on account of higher expenditure on education and health. The investment in education amounted to Rs.22.3 billion in 2011, and was focused on construction and improvement of schools, uplifting of university infrastructure, enhancing and upgrading advanced technological education and modernisation of secondary education. Public investment in the health sector, which amounted to Rs.14.8 billion in 2011, mainly focused on the construction and improvement of hospitals, supply of lab apparatus and bio-medical equipment and epidemic prevention programmes. Meanwhile, investments in housing and other community services also increased during the period under review, especially with the ongoing reconstruction activities in the Northern Province such as the Conflict Affected Region Emergency Project, the Emergency Northern Recovery Project, the North East Local Services Improvement Project, the North East Housing Reconstruction Project, the North East Costal Community Development Project and the North East Community Restoration and Development Project.

The government continued its commitment towards resolving infrastructure bottlenecks in the country with special emphasis on reconstruction activities in the conflict affected regions. Accordingly, the Ministry of Economic Development implemented several development programmes with a view to achieving balanced regional development. Expenditure on Infrastructure Development in Lagging Regions Project, which is dedicated to promote specific provincial development initiatives, amounted to Rs.18.3 billion in 2011 compared to Rs.8 billion in 2010. Investments on the '*Gama Neguma*' programme amounted to Rs.9.8 billion in 2011. In addition, the '*Maga Neguma*' programme continued in 2011 with a view to enhancing the rural road network of the country. Meanwhile, infrastructure improvement projects in the conflict affected areas were expedited in 2011 with increased investments for projects such as the North East Housing Reconstruction Programme (Rs.2.7 billion), the Emergency Northern Recovery Project (Rs.2.8 billion) and the Improvement of National Road Network in Northern Province Project (Rs.15.1 billion).

Key Fiscal Balances

The government's commitment to fiscal consolidation was evident in the reduction of the overall fiscal deficit in 2011 to 6.9 per cent of GDP from 8 per cent of GDP in 2010, marginally higher than the original target of 6.8 per cent of GDP. Despite the shortfall in revenue collection, rationalisation of expenditure enabled the overall fiscal deficit to be maintained close to the original estimate. There was a corresponding decline in the current account deficit to 1.1 per cent of GDP in 2011 from 2.1 per cent of GDP in 2010 due to the reduction in recurrent expenditure. However, it was higher than the budgetary estimate of 0.8 per cent of GDP due to the lower than expected performance in revenue. The primary deficit also declined to 1.4 per cent of GDP in 2011 from 1.7 per cent of GDP in 2010, marginally above the budgetary estimate of 1.3 per cent of GDP, reflecting the ongoing fiscal consolidation process.

Financing the Budget Deficit

The fiscal deficit in 2011 was mainly financed through domestic sources. Accordingly, domestic financing accounted for 51.4 per cent of total financing, while foreign sources contributed the balance 48.6 per cent. However, the contribution from foreign sources to financing the deficit was higher than the original estimate, while domestic

Chart 6.4 Major Fiscal Indicators (as a percentage of GDP)

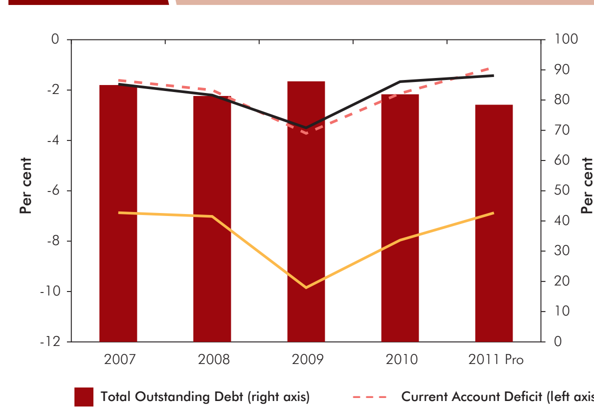
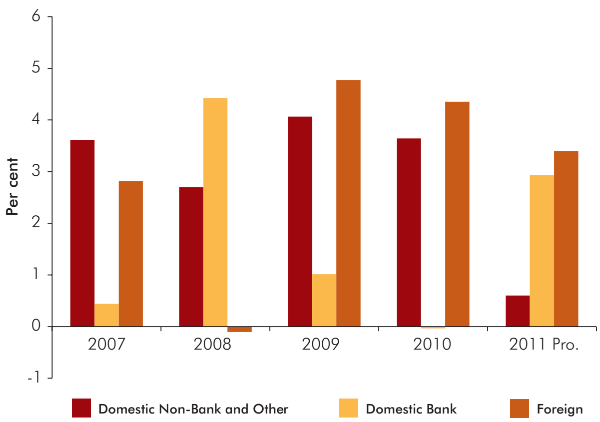


Chart 6.5 Deficit Financing (as a percentage of GDP)



financing was less than envisaged in the budget for 2011. Consequently, net foreign financing (NFF) amounted to Rs. 219 billion compared to the original estimate of Rs. 143.8 billion, while net domestic financing (NDF) amounted to Rs. 231.2 billion compared to the original estimate of Rs. 290 billion.

Considering the composition of domestic financing, the trend of moving from banking sources to non bank sources witnessed in 2010 was reversed in 2011. Consequently, net borrowings from the banking sector in 2011 amounted to Rs. 192 billion (83 per cent of NDF) exceeding the original estimate of Rs.42 billion and a net repayment of Rs.1.9 billion in 2010. Accordingly, borrowings from the non bank sector amounted to Rs. 39.4 billion, significantly lower than the Rs.248 billion expected in the original budget. Of the total bank financing, borrowings from the Central Bank accounted for 97 per cent, amounting to Rs. 185.8 billion compared to a net repayment of Rs. 32.1 billion in 2010. The shift from non bank to bank sources in financing the budget deficit in 2011 was due to relatively lower interest rates prevailing in the government securities market up to the third quarter of the year, which motivated the non bank sector to seek alternative sources of investments giving a higher return. However, from the beginning of the fourth quarter of 2011, primary market yield rates started to move up mainly due to the tight rupee liquidity conditions in the domestic money market. These market developments led to an increase in purchases of government securities by the Central Bank from the primary market. This together with the open market operations carried out by the Central Bank, ownership of government securities by the Central Bank increased to Rs. 169.8 billion at end 2011 from Rs.2.1 billion at end 2010.

Government relied more on marketable debt instruments to finance the budget deficit. Accordingly, net borrowing by way of instruments amounted to Rs.227.5 billion. This comprised net borrowings by way of Treasury bonds amounting to Rs.168.4 billion, Treasury bills amounting to Rs. 79.6 billion and Sri Lanka Development Bonds (SLDBs) amounting to Rs. 5.3 billion, while there was a net repayment of Rupee loans amounting to Rs. 25.7

Table 6.5 Sources of Domestic Financing

Rs. billion

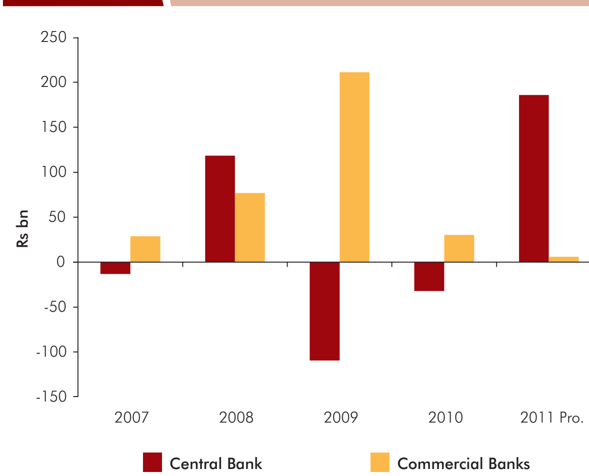
Item	2008	2009	2010	2011 Provisional
By Instrument	**314.3**	**245.6**	**202.2**	**231.2**
Treasury Bonds (a)	192.4	201.9	140.4	168.4
Treasury Bills (b)	69.8	49.0	82.8	79.6
Rupee Loans	-1.5	-17.7	-24.6	-25.7
Sri Lanka Development Bonds	65.5	7.6	11.1	5.3
Central Bank Provisional Advances	15.6	-2.4	4.0	16.9
Other	-27.5	7.1	-11.5	-13.3
By Source	**314.3**	**245.6**	**202.2**	**231.2**
Bank	195.2	49.0	-1.9	191.9
Non Bank	119.0	196.5	204.1	39.4

(a) Excludes rupee denominated Treasury bonds issued to foreign investors since 2007 and to the Sri Lankan diaspora and migrant workers since 2009.

(b) Excludes rupee denominated Treasury bills issued to foreign investors since 2008 and to the Sri Lankan diaspora and migrant workers since 2009.

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

Chart 6.6 Sources of Bank Financing



billion. Net borrowing by way of other sources amounted to Rs. 3.7 billion. This mainly consisted of provisional advances from the Central Bank (Rs.17 billion) and import bills (Rs. 2.3 billion).

Foreign sources contributed more than originally expected in the budget to bridge the resource gap. Total gross borrowings from foreign sources amounted to Rs. 322.8 billion, while total net foreign financing (NFF) was Rs. 219 billion during the year. Total gross borrowings consisted of Rs. 61.5 billion (19.1 per cent) of concessional borrowings compared to Rs. 58.4 billion (17.8 per cent) in the previous year, while the balance was obtained from non concessional sources. Further, project loans from bilateral and multilateral development partners amounted to Rs. 174.5 billion (54.1 per cent of total gross foreign financing) compared to Rs. 163.9 billion (50 per cent of total gross foreign financing) received in the previous year. The Asian Development Bank (ADB), Japan and China were the major sources of project financing. However, the share of NFF in total financing declined to 48.6 per cent in 2011 from 54.7 per cent in 2010. Other than project financing, NFF included the proceeds from the International Sovereign Bond issue of Rs. 109.5 billion (US dollars 1 billion) and net borrowings from Treasury bills and Treasury bonds issued to foreign investors and the Diaspora of Rs. 12.4 billion and Rs. 12.6 billion, respectively. Foreign investments in government securities in 2011 were considerably less than the Rs. 48.9 billion received in 2010, as the threshold for foreign investments in government securities was reached.

6.4 Government Debt and Debt Service Payments

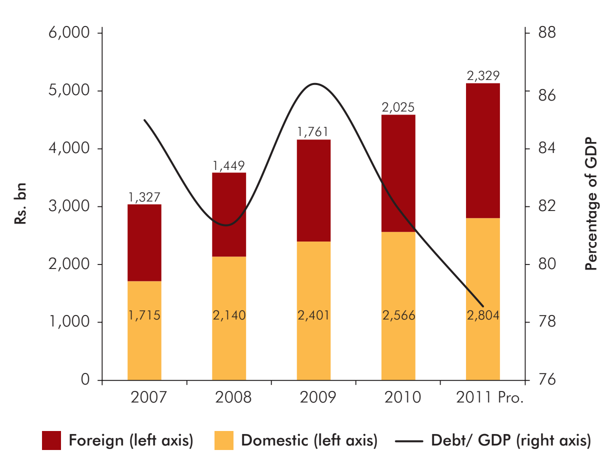
Government Debt

Continuing improvement in government debt sustainability was reflected in the outstanding debt to GDP ratio, which declined to 78.5 per cent at end 2011 from 81.9 per cent in the previous year. Fiscal consolidation efforts together with higher economic growth contributed to the reduction in the debt burden, although the depreciation of the rupee against major foreign currencies had a negative impact on the outstanding debt stock. Accordingly, domestic debt declined by 2.9 per cent of GDP to 42.9 per cent of GDP while foreign debt declined by 0.5 per cent of GDP to 35.6 per cent of GDP in 2011. In nominal terms, total outstanding government debt increased by 11.8 per cent to Rs. 5,133.4 billion at end 2011.

The share of domestic debt in total government debt declined to 54.6 per cent in 2011 from 56 per cent in 2010. This was mainly due to the repayment of some high cost domestic debt including Rupee loans. Accordingly, the share of medium to long term debt to total domestic debt stock also declined marginally to 75 per cent in 2011 from 76 per cent in the previous year. A major proportion of medium to long term debt consisted of Treasury bonds (86.4 per cent), while SLDBs and Rupee loans accounted for 8.7 per cent and 2.9 per cent of medium to long term debt, respectively. Treasury bills, accounted for 84.6 per cent of the short term debt, while provisional advances from the Central Bank accounted for 13.6 per cent of short term debt.

Reflecting market developments in 2011, the share of the outstanding debt stock held by the non bank sector declined to 68.4 per cent from 73 per cent in the previous year. This was mainly due to the decline in holdings of Treasury bills by the non bank sector by 19.2 per cent to Rs. 235.3 billion. The low yield rates on government securities prevailing during 2011 reduced demand for government securities from the non bank sector.

Chart 6.7 Outstanding Government Debt



However, there was an increase in borrowings from the non bank sector by way of Treasury bonds by 9 per cent to Rs. 1,612.7 billion, resulting in a marginal increase of 2.3 per cent in the holdings of government debt by the non bank sector. The EPF (49.6 per cent) and the NSB (16.4 per cent) continued to be the major holders of government debt in the non bank sector.

Government debt held by the banking sector increased by 28 per cent to Rs. 886.2 billion in 2011 due to heavy reliance on resources from the banking sector to finance the government's resource gap. Consequently, the share of banking sector debt to total domestic debt also increased to 31.6 per cent in 2011 from 27 per cent in 2010. The outstanding debt held by the Central Bank increased significantly to Rs. 263.3 billion in 2011 from Rs. 78.4 billion in 2010, while the Central Bank's ownership of government debt as a proportion of total domestic debt held by the banking sector increased to 29.7 per cent in 2011 from 11.3 per cent in the previous year. In 2011, the major portion of debt held by the Central Bank consisted of Treasury bills (64.5 per cent), while the balance was on account of provisional advances.

Table 6.6 Outstanding Government Debt (as at end year)

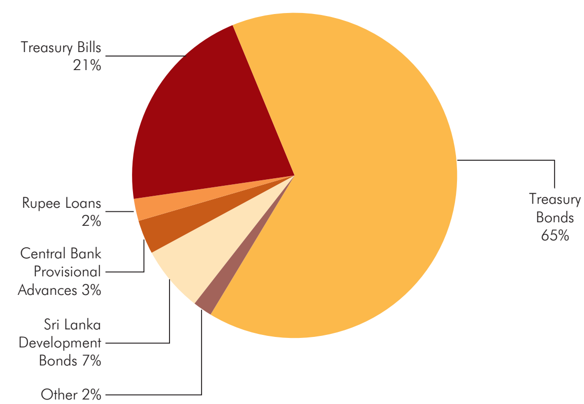
Rs. million

Item	2008	2009	2010	2011 Provisional
Total government debt	**3,588,962**	**4,161,422**	**4,590,245**	**5,133,365**
Domestic debt (a)	**2,140,228**	**2,400,955**	**2,565,662**	**2,804,085**
By maturity period				
Short term	516,365	560,646	619,549	698,190
Medium and long term	1,623,863	1,840,309	1,946,113	2,105,895
By institution				
Bank (b)	657,424	705,765	691,716	886,221
Non bank	1,482,704	1,695,089	1,873,845	1,917,864
Foreign debt	**1,448,734**	**1,760,467**	**2,024,583**	**2,329,280**
By type				
Concessional loans	1,227,222	1,271,142	1,266,910	1,328,797
Non concessional loans	57,491	78,649	147,240	235,923
Commercial	164,020	410,677	610,433	764,560
By currency				
SDR	531,849	567,502	572,354	601,691
US dollars	280,435	330,842	476,490	678,983
Japanese yen	445,596	452,758	508,802	560,456
Euro	132,047	143,566	142,371	146,711
Other	58,807	265,799	324,566	341,439
Memo: Exchange rate variation	117,785	23,114	-4,653	85,573

(a) Excludes Treasury bonds amounting to Rs. 4,397 million issued to commercial banks on behalf of CWE in November 2003.
(b) Includes outstanding balance to OBUs.

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

Chart 6.8 Composition of Outstanding Domestic Debt - 2011

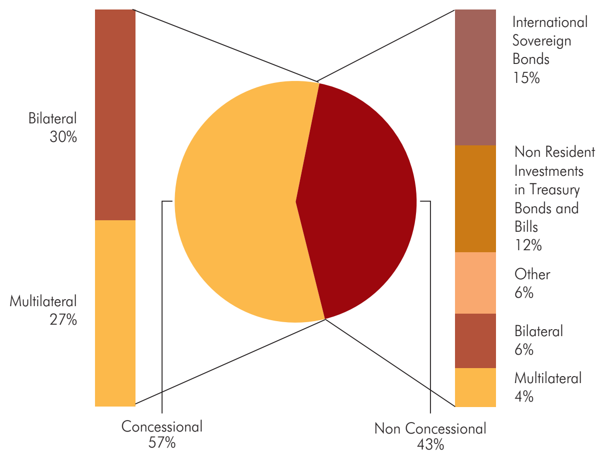


Outstanding government debt held by commercial banks increased only marginally by 1.6 per cent to Rs. 623 billion compared to 2010 with the increase in holdings of Treasury bonds (by 27.3 per cent) and SLDBs (by 5.7 per cent), while the holdings of Treasury bills (by 15.7 per cent) declined from the previous year.

Foreign currency denominated domestic debt increased to Rs.201 billion (US dollars 1,764 million) by end 2011 from Rs.190.5 billion (US dollars 1,717 million) at end 2010. This was the combined outcome of the issue of SLDBs and the depreciation of the Sri Lanka rupee against the US dollar. SLDBs amounting to Rs. 60.2 billion were issued with maturities ranging from 3 to 5 years at interest rates of six months LIBOR plus a spread ranging from 365 basis points to 390 basis points, while commercial banks were the major investors in SLDBs. Foreign currency denominated domestic debt included outstanding borrowings from offshore banking units (OBU) of Rs.17.1 billion (US dollars 150 million) and SLDBs amounting to Rs.183.8 billion (US dollars 1,614 million).

Total outstanding foreign debt as a percentage of GDP declined marginally to 35.6 per cent from 36.1 per cent in 2010, while increasing in nominal terms by 15 per cent to Rs. 2,329.3 billion in 2011. Higher borrowings from non concessional sources and the depreciation of the rupee against major foreign currencies during the latter part of the year mainly contributed to the increase in the foreign debt stock. Non concessional

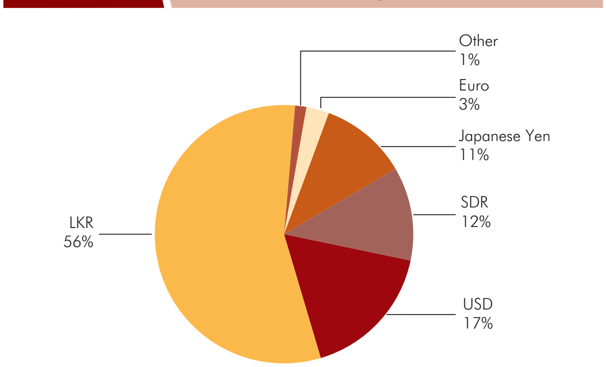
Chart 6.9 Composition of Outstanding Foreign Debt - 2011



borrowings increased by 32 per cent to Rs. 1,000.5 billion raising the share of non concessional debt in the total foreign debt stock to 43 per cent in 2011 from 37.4 per cent in 2010. Commercial borrowings increased by 25.2 per cent to Rs.764.6 billion mainly on account of the issuance of an International Sovereign Bond of US dollars 1 billion.

The debt stock increased by Rs. 85.6 billion (1.3 per cent of GDP) due to the depreciation of the Sri Lanka rupee against major foreign currencies. The Sri Lanka rupee appreciated against the Indian rupee by 15 per cent and the euro by 0.1 per cent, while it depreciated against the Japanese yen, the US dollar and Special Drawing Rights (SDR) by 7.2 per cent, 2.6 per cent and 2.3 per cent, respectively. Further, the total outstanding foreign debt stock consisted of US dollars (29.1 per cent), SDR (25.8 per cent), Japanese yen (24.1 per cent), euro (6.3 per cent), Sri Lanka rupee (11.6 per cent) and other currencies (3.1 per cent). Consequently, the outstanding foreign debt stock increased by Rs. 80.4 billion due to the depreciation of the Sri Lanka rupee against major foreign currencies, while US dollar denominated domestic debt (SLDBs and FCBUs) increased by Rs. 5.2 billion due to the depreciation of the Sri Lanka rupee against the US dollar.

Chart 6.10 Currency Composition of Total Outstanding Debt-2011



Debt Service Payments

Debt service payments increased by Rs. 74.9 billion to Rs. 895.4 billion in 2011 compared to 2010. Amortisation payments increased by Rs. 70.8 billion to Rs. 538.7 billion accounting for 60.2 per cent of total debt service payments, while interest payments increased by Rs. 4.1 billion to Rs.356.7 billion accounting for the balance. Debt service payments to domestic sources increased by Rs.41.2 billion to Rs. 728 billion over 2010. This was the combined outcome of an increase in amortisation payments by Rs.50.2 billion to Rs. 440 billion and a decline in interest payments by Rs. 9 billion to Rs. 288.1 billion over the previous year. The favourable interest rates prevailing in the market compared to the previous year helped to reduce interest costs in 2011, while the bunching of debt repayments as well as the repayment of some high cost domestic debt in line with the government's public debt management strategy increased domestic amortisation payments during the year. With regard to foreign debt service payments, both amortisation and interest payments increased mainly due to the

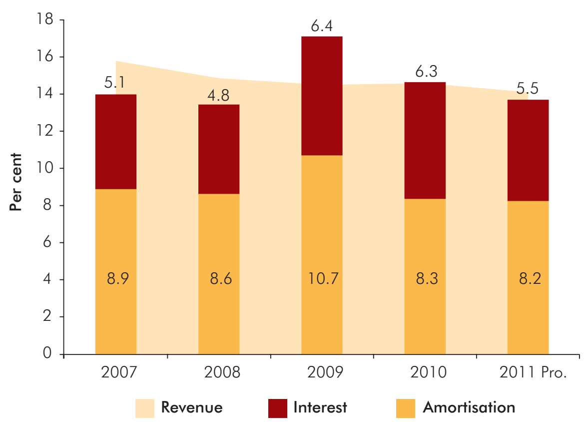
Table 6.7 Government Debt Service Payments

Rs. million

Item	2008	2009	2010	2011 Provisional
Debt service payments	**592,804**	**825,687**	**820,448**	**895,382**
Domestic	440,918	675,274	686,800	728,028
Foreign	151,886	150,414	133,648	167,354
Amortisation payments	**380,330**	**516,012**	**467,856**	**538,683**
Domestic	258,720	401,296	389,672	439,894
Foreign	121,609	114,716	78,184	98,789
Interest payments	**212,475**	**309,675**	**352,592**	**356,699**
Domestic	182,198	273,978	297,127	288,134
Short term	65,364	72,364	58,943	46,257
Medium and long term	116,834	201,613	238,185	241,877
Foreign	30,277	35,698	55,464	68,565

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

Chart 6.11 Government Debt Service Payments (as a percentage of GDP)



depreciation of the Sri Lanka rupee against major foreign currencies. Accordingly, foreign amortisation payments increased by Rs.20.6 billion to Rs.98.8 billion, while foreign interest payments increased by Rs.13.1 billion to Rs. 68.6 billion from 2010.

Debt service indicators further improved in 2011 due to high economic growth and the significant increase in exports. The ratio of debt service payments to GDP improved to 13.7 per cent in 2011 from 14.6 per cent in 2010, while the ratio of total interest to GDP improved from 6.3 per cent in 2010 to 5.5 per cent in 2011 and domestic interest

Table 6.8 Government Debt Indicators

Indicator	2008	2009	2010	2011 Provisional
Government debt/GDP	81.4	86.2	81.9	78.5
Domestic debt/GDP	48.5	49.7	45.8	42.9
Foreign debt/GDP	32.8	36.5	36.1	35.6
Total foreign debt/exports (a)	132.2	170.7	161.4	154.4
Total debt service/GDP	13.4	17.1	14.6	13.7
Total debt service/government revenue (b)	90.5	118.0	100.4	95.8
o/w Domestic debt service/ government revenue (b)	67.3	96.5	84.0	77.9
Total debt service/government expenditure (c)	43.1	48.1	46.9	46.2
o/w Domestic debt service/ government expenditure (c)	32.0	39.3	39.3	37.6
Foreign debt service/exports (a)	13.9	14.6	10.7	11.1
Total interest/GDP	4.8	6.4	6.3	5.5
Domestic interest/GDP	4.1	5.3	5.3	4.4
Domestic interest/Government current expenditure	24.5	31.1	31.7	28.6
Foreign interest/exports (a)	2.8	3.5	4.4	4.5

(a) Export of goods and services
(b) Government revenue is in economic format
(c) Government expenditure includes amortisation payments

Sources: Ministry of Finance & Planning
Department of Census and Statistics
Central Bank of Sri Lanka

payments to GDP from 5.3 per cent in 2010 to 4.4 per cent in 2011. Further, the ratio of debt service payments to government revenue also improved from 100.4 per cent in 2010 to 95.8 per cent in 2011 due to the increase in revenue collection by 14.4 per cent compared to the increase in debt service payments by 9.1 per cent in 2011.

6.5 Budgetary Operations in Sub National Governments

Policy Direction and Measures of Sub National Governments

Provincial councils (PCs) and local governments (LGs) constitute the sub national government system in Sri Lanka. There are nine PCs established under the thirteenth amendment to the constitution. With the addition of five new local authorities in 2011 the local government system was made up of 335 institutions as at end 2011, which comprises 23 municipal councils (MCs), 43 urban councils (UCs) and 269 pradesheeya sabhas (PSs). During the year, four local authorities were upgraded to either municipal council or urban council status.

The Ministry of Local Government and Provincial Councils continued to play an important role in governance and development at the sub national government level in 2011. The Ministry continued to work closely with sub national government authorities while effectively addressing their provincial level development needs. Accordingly, the Ministry facilitated provincial level investments through effective donor coordination and by providing enhanced management, legal and development support to the PCs and LGs.

Various projects and programmes were implemented by the Ministry of Local Government and Provincial Councils to strengthen the sub national government system. The Local Government Election Act, the Municipal Councils Ordinance, the Urban Councils Ordinance and the Pradeshiya Sabha Act were amended in 2011, while a draft bill for establishing the Metropolitan Corporation was formulated. The Ministry also formulated the '*Pura Neguma*' programme to address the issues of lagging local authorities, which is to be implemented from 2012. In addition, projects to upgrade waste water management systems and the disaster response network were implemented in several selected provinces.

Road development and small and medium town development were given priority under the regional infrastructure development activities of the Ministry of Local Government and Provincial Councils in 2011. Accordingly, the Ministry implemented the Provincial Roads Development Project with a view to improving connectivity and reliability of provincial roads, including those in conflict affected provinces. In addition, the Northern Road Connectivity Project was implemented to specifically improve the transport network in the Northern Province. Meanwhile, the Ministry continued with its initiative to develop small and medium scale towns, which are being rapidly urbanised, in close coordination with the respective PCs, local authorities, Urban Development Authority and Sri Lanka Land Reclamation and Development Corporation.

The Finance Commission continued to play a strategic role in recommending Central Government transfers to the PCs to meet their budgetary requirements. The Finance Commission's recommendations on resource allocations were aimed at reducing regional disparities and thereby achieving balanced regional growth. In order to rationalise the allocation and apportionment of government transfers to provinces, a new approach was introduced by the Finance Commission from 2011. Accordingly, four major sectors namely economic infrastructure development, social infrastructure and services development, production sector development and special projects to achieve balanced regional development have been identified to simplify resource allocation as well as planning and monitoring activities. Meanwhile, the Finance Commission continued its efforts on Result Based Planning and Monitoring, which requires all investment programmes of the PCs to focus on pre-defined deliverables. In addition, the Finance Commission continued to play a leading role as a coordinator and facilitator among the PCs. Accordingly, the Commission introduced cost effective construction technology to the provinces with the assistance of National Engineering Research Development Center (NERDC).

The TT, which was the major revenue source of the PCs was abolished in the budget for 2011 and the revenue sources of the PCs were changed accordingly. One third of the revenue collected from the NBT by the Central Government, the entire stamp duty collected and 70 per cent of revenue generated from motor vehicle registration fees were transferred to the PCs to cover the revenue loss arising from the abolition of the TT. Out of the total NBT and stamp duty transferred by the Central Government, 48 per cent is given to the Western Province, 9 per cent each is given to the Central, Southern and North Western provinces, while the remaining provinces receive 5 per cent each.

Budgetary Operations in Provincial Councils

Total revenue collection of PCs increased by 14.2 per cent to Rs.42.1 billion in 2011 compared to a growth of 24 per cent in 2010. Tax revenue increased by 16 per cent to Rs.36 billion, while non tax revenue increased by 4.7 per cent to Rs.6.1 billion. However, as a percentage of GDP, revenue declined to 0.6 per cent in 2011 from 0.7 per cent in 2010. Revenue from licence fees and stamp duties increased during the period under review, reflecting the expansion in domestic economic activity and the increase in motor vehicle registrations. The NBT transferred from the central government amounting to Rs.17.8 billion in 2011 was lower than the total TT collected by PCs in the previous year. The tax base for NBT should be expanded by expediting the registration of retail and wholesale traders to ensure that the new tax system remains tax neutral. Meanwhile, the Western Province continued to be the major source of revenue accounting for 54 per cent of the total revenue collected by PCs in 2011, due to the heavy concentration of business enterprises in the Western Province. The Central, Southern and the North Western provinces each accounted for around 9 per cent of total revenue collection.

Recurrent expenditure of PCs increased by 6.4 per cent to Rs.126.8 billion in 2011 mainly due to an increase in salaries and wages. The introduction of a special allowance equivalent to 5 per cent of the basic salary to public sector employees from the beginning of the year, and an increase in the monthly COLA of public sector employees contributed towards the increase in salaries and wages. Personal emoluments accounted for 80 per cent of the total recurrent expenditure of PCs in 2011, while the balance was on account of other recurrent expenses. Salaries and wages in the education and health sectors accounted for a major proportion of the total salary bill. On a functional basis, current expenditure on social infrastructure, mainly education and health, accounted for 88 per cent of total recurrent expenditure amounting to Rs.112 billion. The Western Province continued to be the largest spending unit accounting for 22 per cent of total recurrent expenditure.

Table 6.9 Budget Outturn for Provincial Councils

Rs. million

Item	2008	2009	2010	2011 Provisional
Total revenue	31,368	29,433	36,829	42,065
Tax revenue	25,992	24,907	31,049	36,014
Non tax revenue	5,376	4,526	5,780	6,051
Total expenditure	120,011	130,260	145,491	154,838
Current expenditure	103,199	111,336	119,162	126,772
o/w Personal emoluments	79,717	86,547	91,644	101,374
Capital expenditure	16,812	18,924	26,329	28,066
Central government transfers	88,942	93,999	107,032	115,856
Block grants	76,773	77,386	85,299	94,602
Criteria based grants	2,304	2,276	2,612	3,871
PSDGs (a)	7,262	10,945	11,683	9,409
Foreign grants for special projects	2,603	3,393	7,439	7,973

(a) Province Specific Development Grants

Sources: Ministry of Local Government and Provincial Councils
Ministry of Finance & Planning

Total capital expenditure of PCs increased by 6.6 per cent to Rs.28.1 billion in 2011. As a percentage of GDP, it amounted to 0.4 per cent in 2011 compared 0.5 per cent in the previous year. Province Specific Development Projects (PSDPs) accounted for a major portion of provincial level investments in 2011, amounting to Rs.9.4 billion. In addition, Rs.8.0 billion was spent on foreign funded special projects during the year under review. The Provincial Roads Project, the Education Sector Development Project (ESDP) and the Health Sector Development Project (HSDP) were the major foreign funded special projects implemented at the provincial level in 2011. International development agencies, such as the Asian Development Bank (ADB), the Japan International Cooperation Agency (JICA) and the World Bank continued to fund these projects with a view to developing rural roads and improving social infrastructure. Other provincial level investments incurred in 2011 amounted to Rs.10.7 billion, and were mainly in the areas of acquisition and improvement of capital assets and capital transfers.

Central Government transfers to PCs increased by 8.2 per cent to Rs.115.9 billion in 2011. Nearly 75 per cent of the expenditure of PCs was financed by transfers from the Central Government due to the limited scope available for PCs to raise revenue. Block grants continued to be the major form of Central Government transfers amounting to 82 per cent of total transfers. Accordingly, Rs.94.6 billion was transferred in 2011 under block grants to meet the resource gap in the current expenditure programme of PCs. In addition, transfers under Province Specific Development Grants (PSDGs) to continue specific provincial development programmes, Criteria Based Grants (CBGs) to fund discretionary expenditure requirements and grants for special projects amounted to Rs.9.4 billion, Rs.3.9 billion and Rs.8.0 billion, respectively.

BOX 12 Implications of the European Sovereign Debt Crisis

There are rising concerns about the spillover of the Eurozone debt crisis to other countries in the region as well as to other parts of the world. Although, policy actions have attempted to reassure markets and mitigate the possibility of contagion, there is widespread agreement that actions taken have not been adequate and have been too slow to be implemented. European countries still need to take some bold steps to increase competitiveness and to improve the state of their public finances.

In an increasingly interdependent global environment, developing countries are unlikely to remain immune to the Eurozone debt crisis. Developing countries will be affected through trade and financial channels while those that are heavily dependent on European economies and with limited fiscal space, are more at risk than others.

Fragile financial markets and weak investor confidence have also caused a reversal of capital flows to developing countries. Therefore, continuing issues in the Eurozone could result in the drying up of credit lines and delays or the cancellation of investments in developing countries. In addition, austerity measures introduced by European governments are likely to weaken demand for developing country exports.

The Eurozone debt crisis has implications for the Sri Lankan economy mainly in terms of its impact on trade, capital inflows and worker remittances. Even though nearly one third of Sri Lanka's exports are directed towards the European Union (EU), the impact on Sri Lankan exports are likely to remain at a low level as Sri Lanka's major trading partners in the EU such as the United Kingdom and Germany are less affected by the crisis. However, the policy to diversify export markets and products should be actively pursued to reduce dependence on traditional markets. Further, although uncertainty in financial markets and negative investor sentiment in Europe caused some capital outflow from developing markets, this was not seen in the case of Sri Lanka. The weak economic environment in Europe may also lead to a reduction in workers' remittances. However, since Europe accounts for only about 17 per cent of remittances to Sri Lanka, the impact of the Eurozone crisis is not expected to have a significant impact on the flow of remittances to Sri Lanka.