6

FISCAL POLICY AND GOVERNMENT FINANCE

6.1 Overview

The policy of the government on fiscal consolidation continued in 2014, with measures to address concerns over both revenue and expenditure aspects, while supporting economic growth. The declining trend in government revenue as a percentage of GDP during the recent past remained a key concern in the fiscal front. Therefore, tax reforms to streamline the tax system, broaden the tax base, rationalise tax exemptions and concessions and strengthen tax administration were continued in 2014. On the expenditure front, measures were introduced to promote efficient management of recurrent and capital expenditure. Further, several reform initiatives were implemented to reduce the burden of State Owned Business Enterprises (SOBEs) on the government budget. As per fiscal sector targets for 2014 that were set in line with the Medium Term Macro Fiscal Framework (MTMFF) 2014-2017 announced in the Fiscal Management Report for 2014, the government expected to reduce the budget deficit to 5.2 per cent of GDP in 2014 from 5.9 per cent of GDP in 2013 and to contain the central government debt to GDP ratio at 74.3 per cent by end 2014 compared to 78.3 per cent recorded at end 2013.

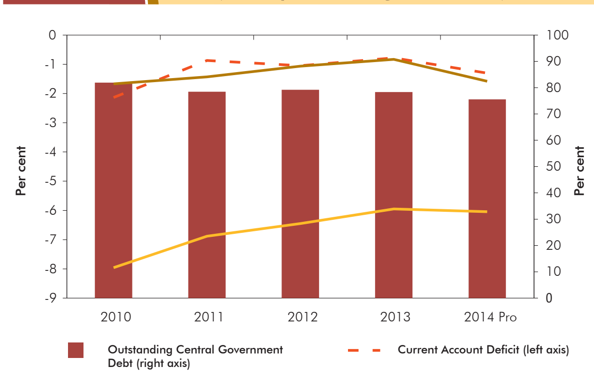
However, a notable deviation from the fiscal targets was observed with the budget deficit in 2014 rising to 6.0 per cent of GDP, reversing the declining trend experienced in the past few years. This was an outcome of the decline in government revenue to GDP ratio due to the shortfall in tax revenue. Meanwhile, recurrent expenditure as a percentage of GDP declined mainly as a result of lower interest cost on government financing, in spite of the incurrence of unexpected expenditure due to extreme weather conditions. Capital expenditure and net lending as well as public investment as a percentage of GDP declined due to rationalising the public investment programme in line with the shortfall in government revenue. In financing the budget deficit, government borrowings from the non bank sector increased significantly during the year. The borrowings from the banking sector also exceeded the original estimate for 2014, although it was lower than the borrowings recorded in 2013. However, central government debt to GDP ratio declined to 75.5 per cent by end 2014, continuing its declining trend.

6.2 Fiscal Policy Direction and Measures

The focus of the fiscal policy in 2014 was to reduce the budget deficit to 5.2 per cent and the government debt to 74.3 per cent of GDP, while supporting economic growth. Accordingly, several policy measures were introduced in the Budget for 2014 to enhance revenue and rationalise recurrent expenditure. These measures were expected to deliver a surplus of 1.1 per cent of GDP in the current account and to maintain the primary deficit at the level of 0.8 per cent of GDP recorded in the previous year. However, public investment was expected to increase to 6.7 per cent of GDP from 5.5 per cent of GDP in 2013 supporting the growth momentum.

As the declining trend in government revenue as a percentage of GDP remained a key concern in the fiscal sector, several measures were introduced in 2014 to streamline the tax system, while rationalising tax exemptions and concessions. Accordingly, measures were taken to raise both direct and indirect tax revenue. On the direct tax front, the corporate and personal income tax structure was consolidated further by introducing a lower tax regime, while improving the tax base. On the indirect tax front, the base of both Value Added Tax (VAT) and Nation Building Tax (NBT) was broadened. Further, several measures were taken to enhance the efficiency of the tax system by simplifying the existing tax structure. The existing structure of multiple taxes, especially on imports, was transformed into a single tax, under this simplification. In the meantime, emphasis was placed on the strengthening of tax administration of revenue collection agencies.

Chart 6.1 Major Fiscal Indicators (as a percentage of GDP)



The income tax structure for Small and Medium scale Enterprises (SMEs) was further streamlined, while providing concessions for professionals. Accordingly, in order to maintain the uniformity of corporate income tax rates applicable on different sectors, income tax rates on the SME sector were revised upwards to 12 per cent from 10 per cent for business undertakings with an annual turnover not exceeding Rs. 500 million. Ship operators or agents of foreign vessels who provide training on skills development in the shipping industry were allowed to deduct 10 per cent of the applicable income tax. The maximum rate applicable on profit and income from professional services was reduced to 16 per cent from 24 per cent. Further, interest on loan facilities provided by banks for the construction of residential apartments for professionals was made liable at half of the applicable income tax rate. In addition, the formation of corporate entities by professionals to provide value added services to a global clientele was also encouraged by giving a 50 per cent reduction from the applicable corporate income tax for a period of five years.

Several measures were introduced to increase revenue from VAT and NBT. Accordingly, the base of VAT and NBT was further broadened to enhance tax collection. The quarterly turnover applicable for the imposition of VAT on wholesale and retail trade was reduced from Rs. 500 million to Rs. 250 million, while the VAT exemption amount was limited to 25 per cent of total value of supplies. In addition, the removal of the exemption of the NBT granted to banks and financial institutions also supported the expansion of the tax base. Further, the exemption from NBT of goods liable to the Special Commodity Levy (SCL) was restricted to NBT payable at the point of Customs, and accordingly local supply of goods was made liable to pay NBT to support broadening the NBT tax base. Further, any headquarters or regional offices of institutions in the international network relocated in Sri Lanka were also exempted from both VAT and NBT to encourage foreign currency receipts further.

Tax structure on motor vehicles, cigarettes and liquor was further simplified to enhance the revenue collection by removing several taxes at the point of import. Accordingly, a single excise (Special Provisions) duty was imposed at a higher rate on motor vehicles replacing Customs duty, Ports and Airports Development Levy (PAL), Cess, VAT and NBT on the importation of motor vehicles. Further, a higher rate of excise duty was introduced on both importing and manufacturing of cigarettes in place of VAT and NBT. In addition, an excise (Ordinance) duty was imposed in palce of VAT and NBT on the manufacture of liquor, while Customs duty and Cess were imposed in palce of VAT and NBT on the importation of liquor.

SCL was revised from time to time during the year, providing necessary protection for domestic agricultural producers while reducing volatility in commodity prices in the domestic market. Accordingly, SCL on the importation of various commodities, including potatoes, b'onion, rice, green gram, dhal, and peas was adjusted from time to time depending on the availability of such commodities in the domestic market. SCL was imposed at a lower rate of Rs. 5 per kg on the importation of rice in April 2014, in place of the Customs duty of Rs. 20 per kg, 12 per cent of VAT, 2 per cent of NBT and 5 per cent of PAL, to encourage imports to meet the supply shortage in the domestic market. In addition, SCL was introduced for maize and grain sorghum in place of VAT, NBT, PAL, Customs duty and Cess in order to strengthen the consolidation process of the tax system on imported goods further.

Table 6.1 Summary of Government Fiscal Operations

Item	2013	2014 Approved Estimates	2014 Provisional	2015 Approved Estimates
	Rs. million			
Total Revenue and Grants	1,153,306	1,469,493	1,204,621	1,534,700
Total Revenue	1,137,447	1,437,493	1,195,206	1,504,700
Tax Revenue (a)	1,005,895	1,274,600	1,050,362	1,337,000
Non Tax Revenue	131,552	162,893	144,844	167,700
Grants	15,859	32,000	9,415	30,000
Expenditure and Lending Minus Repayments	1,669,396	1,985,619	1,795,865	2,034,076
Recurrent	1,205,180	1,328,283	1,322,898	1,552,035
Capital and Net Lending	464,216	657,336	472,967	482,041
o/w Public Investment	481,203	668,465	486,610	492,341
Current Account Surplus (+)/Deficit (-)	-67,733	109,210	-127,692	-47,335
Primary Account Surplus (+)/Deficit (-)	-72,083	-75,091	-154,849	-74,346
Overall Fiscal Surplus (+)/Deficit (-)	-516,090	-516,126	-591,244	-499,376
Total Financing	516,090	516,126	591,244	499,376
Foreign Financing (b)	123,700	286,850	212,523	291,376
Domestic Financing (c)	392,390	229,276	378,721	208,000
Market Borrowings	379,390	229,276	392,084	208,000
Non Bank	82,414	129,276	265,155	138,000
Bank	296,977	100,000	126,929	70,000
Monetary Authority	-164,836	n.a.	35,665	n.a.
Commercial Banks	461,813	n.a.	91,264	n.a.
Non Market Borrowings	13,000	-	-13,363	-
	As a percentage of GDP			
Total Revenue and Grants	13.3	14.8	12.3	13.6
Total Revenue	13.1	14.5	12.2	13.3
Tax Revenue (a)	11.6	12.8	10.7	11.8
Non Tax Revenue	1.5	1.6	1.5	1.5
Grants	0.2	0.3	0.1	0.3
Expenditure and Lending Minus Repayments	19.2	20.0	18.3	18.0
Recurrent	13.9	13.4	13.5	13.7
Capital and Net Lending	5.4	6.6	4.8	4.3
o/w Public Investment	5.5	6.7	5.0	4.3
Current Account Surplus (+)/Deficit (-)	-0.8	1.1	-1.3	-0.4
Primary Account Surplus (+)/Deficit (-)	-0.8	-0.8	-1.6	-0.7
Overall Fiscal Surplus (+)/Deficit (-)	-5.9	-5.2	-6.0	-4.4
Total Financing	5.9	5.2	6.0	4.4
Foreign Financing (b)	1.4	2.9	2.1	2.6
Domestic Financing (c)	4.5	2.3	3.9	1.8
Market Borrowings	4.4	2.3	4.0	1.8
Non Bank	1.0	1.3	2.7	1.2
Bank	3.4	1.0	1.3	0.6
Monetary Authority	-1.9	n.a.	0.4	n.a.
Commercial Banks	5.3	n.a.	0.9	n.a.
Non Market Borrowings	0.1	-	-0.1	-

(a) This includes the amount of VAT exemptions granted for specified projects and the amount of tax concessions granted on import of vehicles by public servants.
(b) Includes rupee denominated Treasury bonds and Treasury bills issued to foreign investors, the Sri Lankan diaspora and migrant workers.
(c) This excludes the funds raised for restructuring of SOBEs in 2014 amounting to Rs. 68.7 billion.

Source: Ministry of Finance

During 2014, continued emphasis was placed on improving tax administration. In line with the ongoing implementation of the Revenue Administration Management Information System (RAMIS), a unique identification number was allocated to tax payers to link external interfaces with the Inland Revenue Department (IRD). The Sri Lanka Customs also introduced a 24 hour fully automated operational system to process export documents to provide an efficient service to exporters. In addition, a Risk Management Unit (RMU) has been established by the Sri Lanka Customs to monitor tax compliance of both exporters and importers. The Ministry of Finance and Planning (MOFP) continued preparations for the introduction of the Integrated Treasury Management Information System (ITMIS), in order to support an integrated approach towards managing revenue, preparing financial plans, implementing annual budgets, ensuring control and accountability of expenditure, etc.

On the expenditure front, several measures were introduced in 2014 to improve the management of recurrent and capital expenditure. As per the National Budget Circular No.1/2014, all spending agencies were requested to limit their recurrent and capital expenditure to the provisions allocated in the Budget 2014, paying special attention to expenditure related to overtime, fuel, electricity, water, transport and foreign travel. Accordingly, overtime payments were expected to be limited only for special and essential instances and managed within the budgetary allocations. The bills on fuel, electricity and water were expected to be paid on time. Several guidelines were issued for proper management of the fuel allowance for government officers by specifying the criteria for the calculation of fuel allowance and the usage of vehicles for official travel.

Salaries and wages of public sector employees and pension payments were raised in the Budget 2014. The Cost of Living Allowance (COLA) for public servants was increased by Rs. 1,200 to Rs. 7,800 per month from January 2014. Meanwhile, the COLA paid to pensioners who retired prior to 2006 was increased by Rs. 500 to Rs. 3,675 per month and for others, by Rs. 350 to Rs. 3,525 per month. According to the Management Services Circular No. 2/2014, the research allowance paid to eligible officers in the public service was increased to 35 per cent from 25 per cent of their initial salary with effect from 01 January 2014.

The public investment programme was aimed at expediting the ongoing large scale infrastructure projects. Accordingly, the government focused on improving regional connectivity with continued investments in expressway and highway projects. In addition, public investment was directed at developing regional and national infrastructure including power and energy, ports, airports and water supply projects. With respect to social infrastructure, the development of infrastructure facilities in health and education was accelerated during the year to help improve standards of living of the people. Rural development programmes were also continued with the emphasis of developing rural roads, water supply and irrigation facilities.

The government continued to channel resources to livelihood development initiatives such as *Divi Neguma* development programme, cottage industry development programme, and backyard dairy farm activities, as well as to promote the SME sector. Funds were allocated to import high quality cows to promote small and medium scale dairy farms. A special low interest loan scheme was implemented to support the SMEs in the dairy sector and to promote dairy farms, collection centres, equipment, and the development of animal feed. A Women Micro Enterprise Credit Guarantee Scheme *(Liya Isura)* was introduced through Regional Development Banks to provide working capital assistance for female entrepreneurs without requiring security.

Several reform initiatives were taken during 2014 to strengthen the balance sheets of SOBEs, in order to reduce their burden on the central government budget. Infusion of capital, conversion of outstanding debt to government equity, settlement of long outstanding debt and buy back of non-performing investments in the SOBEs were the key measures adopted to strengthen the balance sheets of SOBEs. The financial position of the Ceylon Electricity Board (CEB) was strengthened by converting Treasury loans to equity. Further, cost reflective pricing strategies were also introduced to cover past losses of the CEB and Ceylon Petroleum Corporation (CPC). The government infused fresh capital to SriLankan Airlines and Mihin Lanka. Meanwhile, the SriLankan Airlines issued a 5-year international bond of US dollars 175 million at a yield of 5.30 per cent per annum for re-fleeting purposes and the National Savings Bank (NSB) issued a 5-year international bond of US dollars 250 million in September 2014 at a yield of 5.15 per cent per annum, mainly to lend to state-owned entities and government-related projects.

The public debt management strategy was focused on ensuring the availability of funds to meet the government's financing needs at a lowest possible cost while minimising risk. Steps were taken to maintain an optimal mix of domestic and foreign debt, and to reduce maturity mismatches in the debt portfolio. Accordingly, maturing Treasury bills were replaced with medium to long-term Treasury bonds to reduce the debt rollover risk, while increasing the Average Time to Maturity (ATM) of the domestic debt portfolio. Treasury bonds with a maturity of 30 years to the value of Rs. 82.5 billion were issued in 2014. The low interest environment supported by low and stable inflation and the high excess liquidity in the market facilitated the issue of longer tenure Treasury bonds.

The government raised US dollars 1.5 billion through International Sovereign Bonds during 2014. Under the approved International Sovereign Bond programme for 2014, the government issued US dollars 1 billion worth of International Sovereign Bonds with a 5-year maturity at a yield of 6 per cent per annum in January 2014, which was a lower yield than the previous five year issuances. Subsequently, the remainder of US dollars 500 million was raised in April 2014 at a yield of 5.125 per cent per annum. This was the lowest rate among all offerings by Sri Lanka in the international bond market.

During 2014, International rating agencies affirmed Sri Lanka's existing sovereign credit ratings. Moody's Investors Service affirmed Sri Lanka's 'B1' sovereign rating with a stable outlook. Fitch Ratings affirmed its existing rating of 'BB-' and the stable outlook for the Sri Lankan economy having observed the country's relatively high and less volatile real GDP growth compared to its peers and the level of human development, despite the relatively weak public finances. Similarly, Standard & Poor's Ratings Services affirmed its 'B+' long term and 'B' short term sovereign credit ratings citing a relatively low level of wealth, moderately weak external liquidity and higher levels of government debt and interest burden.

Meanwhile, further consolidation in the fiscal sector was envisaged in the Budget for 2015. The Budget for 2015 was approved in the Parliament in November 2014 aimed at continuing the fiscal consolidation process. Towards this end, several policy measures were proposed to enhance government revenue through simplifying the tax system and broadening the tax base while public expenditure management was expected to be improved. To support the medium term growth prospect of the country, a high level of public investment was expected. Subsequently, following the Presidential election in January 2015, the new government presented an Interim Budget for 2015 on 29 January 2015, introducing several measures to reduce cost of living and income inequality, while announcing the intention to further strengthen the fiscal consolidation. The Interim Budget focused on increasing direct tax revenue as a percentage of GDP by broadening the tax base and improving tax administration. Further measures to strengthen tax revenue as a percentage of GDP are expected to be introduced in the period ahead. Attention was also paid to rationalise recurrent expenditure further, while public investment was projected at a lower level with the expected increase in private sector involvement in economic activity. Accordingly, under the Interim Budget, the overall fiscal deficit in 2015 is estimated to reduce further to 4.4 per cent of GDP in 2015, in comparison to the 4.6 per cent expected in the original Budget for 2015.

Fiscal operations are likely to face a number of challenges in the period ahead. The declining trend in government revenue as a percentage of GDP needs to be addressed urgently as this would obstruct the continuation of the fiscal consolidation process. Further, a constrained fiscal position would make it difficult to channel a sufficient level of funds towards capital expenditure required for the country's development. Hence, crafting a progressive tax system to enhance revenue performance would be necessary, while rationalising recurrent expenditure and reducing the reliance of SOBEs on the government budget.

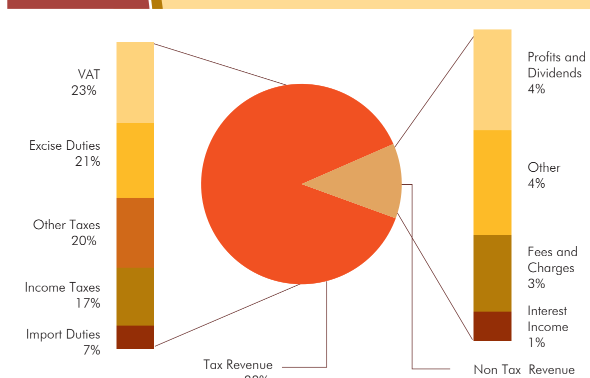
6.3 Government Budgetary Operations

Revenue and Grants

Revenue

Total government revenue as a percentage of GDP continued to decline in 2014 due to poor performance in tax revenue collection. Accordingly, total government revenue, as a percentage of GDP, declined to 12.2 per cent in 2014 from 13.1 per cent in the previous year, while tax revenue as a percentage of GDP declined significantly to 10.7 per cent from 11.6 per cent in 2013. Non tax revenue as a percentage of GDP remained unchanged at 1.5 per cent. However, total revenue in nominal terms, increased by 5.1 per cent to Rs. 1,195.2 billion in 2014 from Rs. 1,137.4 billion in 2013. This was mainly due to the increase in indirect tax revenue, while revenue generated in the form of direct taxes, such as corporate and non corporate income tax, personal income tax, withholding tax and Economic Service Charge (ESC) declined. Non tax revenue in nominal terms increased to Rs. 144.8 billion by 10.1 per cent in 2014 in contrast to the decline of 7.7 per cent in the previous year mainly due to increased profit and dividend transfers from SOBEs. Further, total government revenue in 2014 was considerably below the expected level of Rs. 1,437.5 billion in the Budget for 2014.

Chart 6.2 Composition of Government Revenue - 2014



The declining trend of tax revenue to GDP ratio continued in 2014 as well, where it dropped from 11.6 per cent in 2013 to 10.7 per cent in 2014. However, in nominal terms, tax revenue increased by 4.4 per cent to Rs. 1,050.4 billion from Rs. 1,005.9 billion recorded in 2013. Revenue from indirect taxes remained the major source of tax revenue, increasing by 6.5 per cent during the year, and accounting for 81.1 per cent of total tax revenue. Accordingly, revenue collection from major sources, including VAT on both domestic activities and imports and excise duty especially on liquor, motor vehicles and petroleum products as well as Telecommunication Levy, PAL and Cess Levy, increased in 2014. Revenue from direct taxes as a percentage of GDP as well as in nominal terms declined while the contribution to the tax revenue also declined to 18.9 per cent from 20.4 per cent in 2013. The share of tax revenue in total revenue declined marginally to 87.9 per cent in 2014 from 88.4 per cent recorded in the previous year.

Revenue from income taxes as a percentage of GDP as well as in nominal terms declined, reflecting revenue decreases in all income tax categories other than Pay-As-You-Earn (PAYE). Accordingly, income tax collection as a percentage of GDP declined to 2.0 per cent in 2014 from 2.4 per cent in 2013, while in nominal terms, it declined by 3.7 per cent to Rs. 198.1 billion in 2014 from Rs. 205.7 billion in the previous year. Revenue generated from PAYE recorded a significant growth of 20.1 per cent to Rs. 22.3 billion in 2014 from Rs. 18.6 billion in 2013. This was mainly due to the increase in PAYE tax base with the strengthening of the auditing process in IRD and the increase in PAYE tax contribution from professional services and export, import, and construction sectors. Revenue from withholding tax, which contributes 35 per cent of direct tax revenue, declined by 10.7 per cent in nominal terms to Rs. 69.6 billion lowering its share in tax revenue to 6.6 per cent in 2014 from 7.7 per cent in 2013. This was mainly due to a further decline in interest rates in the domestic market. In addition, revenue generated from ESC declined by 6.7 per cent to Rs. 6.2 billion in 2014, as a result of the declining number of companies liable to pay ESC. Income tax revenue as a share of total tax revenue declined to 18.9 per cent in 2014 from 20.4 per cent recorded in 2013. Further, as a percentage of total revenue, it declined to 16.6 per cent in 2014 from 18.1 per cent recorded in 2013.

Table 6.2 Economic Classification of Government Revenue

Item	2013	2014		2015
		Approved Estimates	Provisional	Approved Estimates
	Rs. million			
Tax Revenue (a)	**1,005,895**	**1,274,600**	**1,050,362**	**1,337,000**
Income Taxes	205,666	283,318	198,115	310,600
VAT	250,757	303,232	275,350	296,000
Excise Taxes	250,700	266,333	256,691	343,435
Import Duties	83,123	94,556	81,108	85,000
Other Taxes	215,649	327,161	239,099	301,965
Non Tax Revenue	**131,552**	**162,893**	**144,844**	**167,700**
Total Revenue	**1,137,447**	**1,437,493**	**1,195,206**	**1,504,700**
	As a percentage of GDP			
Tax Revenue (a)	**11.6**	**12.8**	**10.7**	**11.8**
Income Taxes	2.4	2.9	2.0	2.7
VAT	2.9	3.1	2.8	2.6
Excise Taxes	2.9	2.7	2.6	3.0
Import Duties	1.0	1.0	0.8	0.8
Other Taxes	2.5	3.3	2.4	2.7
Non Tax Revenue	**1.5**	**1.6**	**1.5**	**1.5**
Total Revenue	**13.1**	**14.5**	**12.2**	**13.3**

(a) This includes the amount of VAT exemptions granted for specified projects and the amount of tax concessions granted on import of vehicles by public servants.

Source: Ministry of Finance

Revenue collection from VAT, which is the highest single contributor to total tax revenue, increased in 2014, mainly due to the expansion of the VAT base by reducing the threshold level applicable to wholesale and retail trade to Rs. 250 million per quarter from Rs. 500 million per quarter. Accordingly, revenue from VAT increased by 9.8 per cent to Rs. 275.4 billion in 2014 from Rs. 250.8 billion in the previous year, mainly as a result of the increase in contribution from manufacturing and financial services. However, as a percentage of GDP, it declined marginally to 2.8 per cent in 2014 from 2.9 per cent in 2013. VAT revenue generated from domestic economic activities remained unchanged as a percentage of GDP in 2014 at 1.4 per cent, while increasing in nominal terms by 12.6 per cent to Rs. 140.1 billion. In addition, revenue from VAT on imports increased by 7.1 per cent to Rs. 135.3 billion in spite of replacing VAT (and several other taxes) on the importation of motor vehicles and cigarettes with a single tax, namely excise duty (Excise Special Provision duty or Excise Ordinance duty). Share of revenue from VAT within total tax revenue increased to 26.2 per cent in 2014 from 24.9 per cent recorded in 2013.

Revenue from excise duties as a percentage of GDP declined to 2.6 per cent in 2014 from 2.9 per cent in 2013, although in nominal terms, it increased by 2.4 per cent during the year to Rs. 256.7 billion compared to Rs. 250.7 billion in 2013. Revenue from excise duties on all categories, except on cigarettes that reduced by 2.3 per cent, increased in 2014 compared to 2013. Revenue from excise duty on motor vehicles, the largest contributor to excise duty, improved with the increase in motor vehicle imports by 54 per cent during the year. Further, excise duty revenue from liquor increased by 4.7 per cent in nominal terms as a result of the upward revisions of excise duty rates on both hard and malt liquor and the increase in production of malt liquor by 3.5 per cent during the year. The increase in the importation of petroleum products by 6.7 per cent in 2014 largely contributed to the increase in revenue generated from excise duties on petroleum products. Despite imposition of excise duties at a higher rate on both the importation and manufacturing of cigarettes in place of VAT and NBT towards the latter part of the year, revenue from excise duties on cigarettes decreased by 2.3 per cent to Rs. 57.2 billion from Rs. 58.6 billion. This was a result of the reduction of cigarette sales by 11.5 per cent. The share of excise duty revenue in tax revenue decreased to 24.4 per cent in 2014 from 24.9 per cent in 2013.

Revenue from import duties and SCL as a percentage of GDP declined to 1.3 per cent in 2014 from 1.5 per cent in 2013. Revenue from import duties declined by 2.4 per cent to Rs. 81.1 billion from Rs. 83.1 billion recorded in 2013, while revenue from SCL increased marginally by 2.7 per cent to Rs. 47.9 billion from Rs. 46.7 billion in 2013. Despite the positive performance recorded in the importation of consumer goods and intermediate goods, revenue from import duties declined mainly due to the imposition of excise (Special Provision) duty on motor vehicles in place of import duty (and several other taxes) and the introduction of SCL on rice, maize and grain sorghum instead of all other applicable taxes, including import duty. Further, exemptions and concessions granted for several infrastructure projects and general duty waivers granted on several import items also contributed to the decline in revenue from import duty during the year 2014. The share of import duties in tax revenue declined to 7.7 per cent in 2014 from 8.3 per cent recorded in 2013. Meanwhile, the share of SCL in tax revenue remained unchanged at 0.5 percent in 2014.

Revenue from NBT in nominal terms increased by 8.9 per cent in 2014 to Rs. 44.6 billion, mainly due to the increase in revenue from NBT on domestic goods and services. Accordingly, revenue generated from NBT on domestic goods and services increased by 12.9 per cent to Rs. 28.5 billion in 2014, whereas revenue from NBT on imported goods and services increased marginally by 2.5 per cent to Rs. 16.1 billion. This was despite the imposition of single taxes, namely excise duty on motor vehicles, excise duty on the importation of cigarettes and the SCL on the importation of rice, maize and grain sorghum in lieu of NBT and several other taxes. Accordingly, the share of revenue from NBT in total tax revenue increased marginally to 4.2 per cent in 2014 from 4.1 per cent recorded in 2013. The imposition of NBT on pharmaceutical preparations at the point of import, withdrawal of exemption granted to financial services and improvements in the hotels and restaurants sector also contributed to the increase in revenue from NBT in 2014.

Revenue from other taxes showed a mixed performance in 2014. Revenue from PAL, which declined by 12.3 per cent in 2013, increased by 11.6 per cent to Rs. 68.6 billion in 2014. Revenue from Cess increased by 7.2 per cent to Rs. 38.7 billion. Imposing Cess in lieu of VAT and NBT on the importation of liquor and upward revisions of Cess on selected items mainly contributed to the increase of revenue from Cess. However, revenue from Cess as a percentage of GDP remained unchanged at 0.4 per cent. Increasing the Telecommunication Levy from 20 per cent to 25 per cent mainly contributed to the significant growth of revenue from Telecommunication Levy by 28.3 per cent to Rs. 31.4 billion in 2014.

The share of non tax revenue in total government revenue increased to 12.1 per cent from 11.6 per cent in the previous year, recording a growth of 10.1 per cent to Rs. 144.8 billion. This increase was mainly attributed to the increase in profit and dividend transfers of SOBEs and income from interest and rent. Although profit transfers from the Central Bank declined to Rs. 11.5 billion in 2014 from Rs. 26.4 billion in 2013, revenue from profit and dividend transfers of other SOBEs grew considerably to Rs. 46.8 billion in 2014 from Rs. 35.2 billion in the previous year, especially from sectors such as banking and finance, telecommunication and insurance. Revenue from fees and charges and social security contributions declined by 6.0 per cent and 1.5 per cent, respectively, compared to the previous year.

Grants

Total grants received during the year declined to Rs. 9.4 billion in 2014 from Rs. 15.9 billion in 2013. This was significantly below the annual estimate of Rs. 32 billion for 2014. Grants from multilateral donors declined to Rs. 5.4 billion from Rs. 6.5 billion in 2013. However, the share of grants from multilateral sources in total grants increased to 57.7 per cent in 2014 from 41.2 per cent in 2013. Grants from bilateral sources declined significantly to Rs. 4.0 billion in 2014 from Rs. 9.3 billion in the previous year.

Expenditure and Net Lending

Total expenditure and net lending as a percentage of GDP declined to 18.3 per cent in 2014 from 19.2 per cent in 2013, reflecting the measures taken to improve the management of recurrent expenditure as well as the streamlining of capital expenditure. The decline in total expenditure and net lending was a combined outcome of the reduction in recurrent expenditure by 0.4 percentage points to 13.5 per cent of GDP and capital expenditure and net lending by 0.6 percentage points to 4.8 per cent of GDP. However, in nominal terms total expenditure and net lending increased by 7.6 per cent to Rs. 1,795.9 billion in 2014 from Rs. 1,669.4 billion in 2013, although it was lower than the original budgetary target of Rs. 1,985.6 billion envisaged for the year. Public investment, which amounted to 5.0 per cent of GDP in 2014, was significantly below the annual estimate of 6.7 per cent of GDP as a result of rationalising capital expenditure in the midst of shortfall in government revenue.

Recurrent expenditure as a percentage of GDP continued to decline to 13.5 per cent from 13.9 per cent recorded in 2013 with the government's commitment to maintain recurrent expenditure within the target stipulated in the Budget. In nominal terms, recurrent expenditure was maintained below the budgetary target, although it increased by 9.8 per cent to Rs. 1,322.9 billion from Rs. 1,205.2 billion in 2013. Strict control of expenditure on other goods and services and the reduction in interest payments on domestic debt contributed to maintain recurrent expenditure below the budgetary target. However, expenditure on salaries and wages was significantly above the budgetary target as the government increased salaries and wages of public servants during the year.

Table 6.3 Economic Classification of Expenditure and Lending Minus Repayments

Item	2013	2014 Approved Estimates	2014 Provisional	2015 Approved Estimates
	Rs. million			
Recurrent Expenditure	1,205,180	1,328,283	1,322,898	1,552,035
Expenditure on Goods and Services	512,624	591,697	603,634	756,351
o/w Salaries and Wages	393,228	410,614	440,982	570,000
Interest Payments (a)	444,007	441,035	436,395	425,030
Foreign	100,985	76,000	108,461	76,000
Domestic	343,022	365,035	327,934	349,030
Current Transfers and Subsidies	248,549	295,551	282,868	370,654
o/w To Households and Other Sectors	195,288	233,526	216,860	310,805
Samurdhi	15,256	15,000	15,042	41,000
Pensions	122,813	136,210	126,136	159,890
Fertiliser Subsidy	19,706	38,000	31,802	35,000
Other	37,512	44,316	43,880	74,915
Capital Expenditure	454,303	641,123	459,855	472,928
Acquisition of Real Assets	252,535	406,697	252,303	226,571
Capital Transfers	201,768	234,426	207,551	246,357
Lending Minus Repayments	9,913	16,213	13,112	9,113
Total Expenditure and Net Lending	1,669,396	1,985,619	1,795,865	2,034,076
	As a percentage of GDP			
Recurrent Expenditure	13.9	13.4	13.5	13.7
Expenditure on Goods and Services	5.9	6.0	6.2	6.7
o/w Salaries and Wages	4.5	4.1	4.5	5.0
Interest Payments (a)	5.1	4.4	4.5	3.8
Foreign	1.2	0.8	1.1	0.7
Domestic	4.0	3.7	3.4	3.1
Current Transfers and Subsidies	2.9	3.0	2.9	3.3
o/w To Households and Other Sectors	2.3	2.4	2.2	2.7
Samurdhi	0.2	0.2	0.2	0.4
Pensions	1.4	1.4	1.3	1.4
Fertiliser Subsidy	0.2	0.4	0.3	0.3
Other	0.4	0.4	0.4	0.7
Capital Expenditure	5.2	6.5	4.7	4.2
Acquisition of Real Assets	2.9	4.1	2.6	2.0
Capital Transfers	2.3	2.4	2.1	2.2
Lending Minus Repayments	0.1	0.2	0.1	0.1
Total Expenditure and Net Lending	19.2	20.0	18.3	18.0

(a) Interest paid in respect of the ongoing infrastructure projects amounting to Rs. 18.9 billion and Rs. 7.2 billion has been capitalised in 2013 and 2014 (provisional), respectively as per the State Account Circular No. 230/2013, dated 29.11.2013.

Source : Ministry of Finance

In 2014, interest payments as a percentage of GDP declined considerably to 4.5 per cent from 5.1 per cent in the previous year, as a result of declining interest rates in the domestic market. The interest expenditure declined marginally in nominal terms to Rs. 436.4 billion in 2014 from Rs. 444 billion in 2013 contributing 33.0 per cent of total recurrent expenditure. The interest payments on domestic debt declined in nominal terms by 4.4 per cent in 2014 to Rs. 327.9 billion from Rs. 343 billion in 2013, mainly due to lower interest rates in 2014 despite the increased outstanding domestic debt by 11.6 per cent to Rs. 4,277.8 billion as at end 2014. Interest payments on Treasury bonds declined by 18.3 per cent to Rs. 207.7 billion in 2014 from Rs. 254.1 billion in 2013 as a result of the decline in average interest rates on Treasury bonds to 7.3 per cent in 2014 from 10.4 per cent in 2013. Interest payments on Treasury bills rose moderately by 13.1 per cent to Rs. 78.8 billion in 2014 from Rs. 69.7 billion in 2013. In addition, the interest payments on Rupee loans and Sri Lanka Development Bonds (SLDBs) amounted to Rs. 5.9 billion and Rs. 18.8 billion, respectively, in 2014. However, the share of interest payments on domestic debt in total interest payments declined to 75.1 per cent in 2014 compared to 77.3 per cent in the previous year. Meanwhile, interest payments on foreign debt increased by 7.4 per cent to Rs. 108.5 billion in 2014 from Rs. 101 billion in 2013, and this could be largely attributed to the increase in the foreign debt stock and the gradual transition to non concessional loans from concessional loans. The average interest rate on foreign debt increased to 3.5 per cent in 2014 from 3.4 per cent in the previous year.

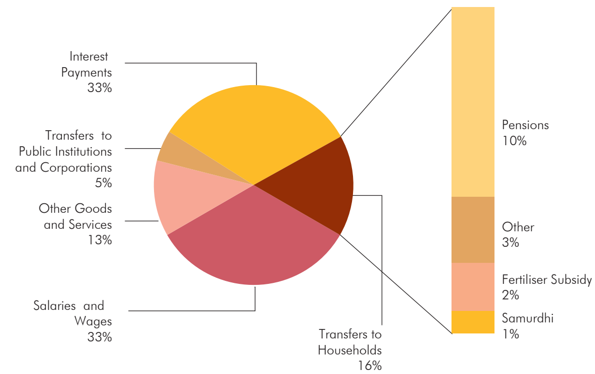
Expenditure on salaries and wages increased by 12.1 per cent to Rs. 441 billion in 2014 from Rs. 393.2 billion in 2013, mainly due to the increase in allowances including COLA granted to government employees. Increase in COLA by Rs. 1,200 to Rs. 7,800 per month, increase in the research allowance of eligible officers in the public service to 35 per cent of their initial salary, and granting an interim allowance of Rs. 3,000 per month to all public servants largely contributed to the increase in expenditure on salaries and wages in 2014. Further, absorbing casual and contractual employees to the permanent cadre also contributed to the increase in expenditure on salaries and wages. However, as a percentage of GDP, salaries and wages remained unchanged at 4.5 per cent in 2014. Salaries and wages paid to central government employees, including defence personnel, increased by 10.8 per cent to Rs. 319.2 billion, while the central government contribution to salaries and wages of the provincial council employees increased by 16 per cent to Rs. 121.8 billion in 2014. The share of salaries and wages in total recurrent expenditure accounted for 33.3 per cent in 2014 compared to 32.6 per cent in 2013. This was the second largest recurrent expenditure item during the year.

Recurrent expenditure on other goods and services as a percentage of GDP increased to 1.7 per cent in 2014 from 1.4 per cent in 2013, mainly due to increased expenditure on defence. In nominal terms, expenditure on other goods and services increased considerably by 36.2 per cent to Rs. 162.7 billion in 2014 from Rs. 119.4 billion recorded in the previous year. Expenditure incurred on other goods and services by the central government including defence increased considerably by 36.9 per cent to Rs. 158.2 billion in 2014 from Rs.115.6 billion in 2013. This accounted for 97.3 per cent of total outlays on other goods and services during the year. However, expenditure on other goods and services was significantly below the budgetary estimates due to close monitoring of expenditure.

With the efforts of the government to rationalise current transfers and subsidies to public corporations and public institutions, total current transfers and subsidies as a percentage of GDP remained broadly unchanged in 2014. However, current transfers and subsidies in nominal terms increased by 13.8 per cent to Rs. 282.9 billion in 2014 in comparison to Rs. 248.5 billion in 2013. Current transfers to households and other sectors accounted for 76.7 per cent of total current transfers, while transfers to public institutions and public corporations accounted for 16.5 per cent and 6.9 per cent, respectively, during the year 2014.

Current transfers to households including pension payments declined marginally to 2.2 per cent of GDP in 2014 from 2.3 per cent in 2013, even though an increase was recorded in nominal terms due to increased fertiliser

Chart 6.3 Composition of Government Recurrent Expenditure - 2014



subsidy. Current transfers to households increased by 11.0 per cent in nominal terms to Rs. 216.9 billion in 2014 from Rs. 195.3 billion in 2013. Increase in COLA for pensioners and the addition of 7,376 new pensioners in 2014 led to an increase in pension payments by 2.7 per cent to Rs. 126.1 billion in 2014. The fertiliser subsidy increased significantly by 61.4 per cent to Rs. 31.8 billion in 2014 from Rs. 19.7 billion in 2013, mainly due to the repayment of arrears due in last quarter of 2013 to fertiliser companies. Further, expenditure on welfare programmes for disabled soldiers increased by 13 per cent to Rs. 18.2 billion from Rs. 16.1 billion in the previous year. Expenditure on the Samurdhi programme declined marginally by 1.4 per cent to Rs. 15 billion in 2014 from Rs. 15.3 billion in 2013. Programmes targeting school children, such as providing school text books, uniforms, season tickets and dhamma school books were among the other major subsidies to households during 2014.

Current transfers to public institutions and public corporations increased during the year with increased transfers to education and health sector institutions and transfers to cover operational losses mainly of institutions in the transport sector. Current transfers to public institutions increased considerably by 18.2 per cent to Rs. 46.6 billion, while current transfers to public corporations increased by 40.3 per cent to Rs. 19.4 billion. The increase in current transfers

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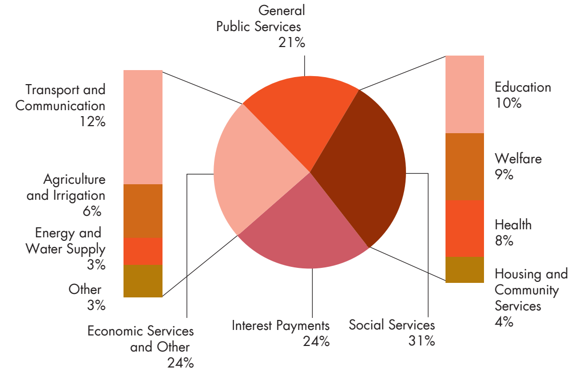
to public institutions was mainly due to the increase in transfers to institutions in education and health sectors, while the increase in current transfers to public corporations was due to an increase in transfers to cover operational losses of the Department of Sri Lanka Railways and the Department of Posts.

Capital expenditure and net lending and public investment were below the expected level in 2014. Capital Expenditure and net lending as a percentage of GDP declined to 4.8 per cent in 2014 from 5.4 per cent in the previous year. However, in nominal terms, it increased marginally by 1.9 per cent to Rs. 473.0 billion in 2014 compared to Rs. 464.2 billion recorded in the previous year. Meanwhile, public investment as a percentage of GDP was significantly below the annual target of 6.7 per cent, as it declined to 5.0 per cent in 2014 compared to 5.5 per cent in 2013. In nominal terms, public investment increased to Rs. 486.6 billion, which was considerably lower than Rs. 668.5 billion envisaged in the Budget for 2014. Expenditure incurred by Ministries and Departments on the acquisition of real assets (purchase of capital assets and construction and development of fixed assets) declined by 0.1 per cent to Rs. 252.3 billion in 2014. Meanwhile, capital transfers increased by 2.9 per cent as a result of the increase in capital transfers to public institutions (by 2.6 per cent), provincial councils (by 6.2 per cent) and public corporations (by 4.2 per cent). On-lending programme amounted to Rs. 26.8 billion in 2014 compared to Rs. 26.9 billion in the previous year.

Public investment in economic services remained the key component of the public investment programme in 2014, and amounted to Rs. 330.1 billion, accounting for 67.8 per cent of total public investment during the year. A significant amount of investments

Chart 6.4 Total Expenditure by Function - 2014



was made on roads, ports, power and energy, railways and water supply and irrigation projects. Accordingly, the Southern Expressway Phase II extension project and the Outer Circular Highway Phase I were completed during 2014. Investments were also made to improve the railway sector, and the reconstruction of the Northern railway line from Omanthai to Jaffna was completed in 2014. In addition, investments were made on the construction and development of power projects, ports and airport development as well as on the water supply and irrigation sectors during 2014.

Public investment in social services increased by 44.7 per cent to Rs. 112.3 billion in 2014, of which Rs. 50.4 billion was spent on education, while Rs. 22.2 billion was utilised for health services. Public investment in the education sector was used mainly for the improvement of capital assets in schools, the improvement of vocational and technical education and the uplifting of university infrastructure. Meanwhile, public investment in the health sector mainly focused on the construction and improvement of hospitals as well as the supply of lab apparatus with multilateral donor assistance.

With a view to reducing regional disparities, the government continued to engage in a number of regional and rural infrastructure development projects. Accordingly, expenditure

Table 6.4 Functional Classification of Expenditure

Item	2013	2014 Approved Estimates	2014 Provisional	2015 Approved Estimates
	Rs. million			
Recurrent Expenditure	1,205,180	1,328,283	1,322,898	1,552,035
General Public Services	270,554	313,946	334,354	451,453
Civil Administration	54,303	73,036	73,282	81,974
Defence	170,150	183,027	195,401	300,352
Public Order and Safety	46,101	57,883	65,671	69,127
Social Services	399,666	445,973	446,440	552,952
Education	119,819	127,004	139,787	166,922
Health	99,609	120,612	116,151	137,726
Welfare	159,787	173,942	165,467	224,848
Community Services	20,451	24,414	25,036	23,457
Economic Services	82,146	115,304	105,030	99,758
Agriculture and Irrigation	29,899	58,769	46,782	61,029
Energy and Water Supply	4,001	409	394	716
Transport and Communication	36,810	40,153	41,129	21,799
Other	11,435	15,973	16,726	16,215
Other	452,814	453,060	437,073	447,872
o/w Interest Payments (a)	444,007	441,035	436,395	425,030
Capital Expenditure and Lending	481,203	668,465	486,610	492,341
General Public Services	32,804	74,386	43,620	53,504
Civil Administration	31,631	67,701	40,282	47,833
Public Order and Safety	1,173	6,685	3,338	5,671
Social Services	77,643	121,335	112,338	133,891
Education	31,982	44,870	50,363	45,807
Health	19,920	41,523	22,252	41,357
Housing	8,014	9,487	20,569	29,828
Community Services	17,727	25,455	19,154	16,898
Economic Services	369,377	472,223	330,136	304,400
Agriculture and Irrigation	36,721	80,532	57,099	66,305
Energy and Water Supply	87,517	58,967	51,314	22,607
Transport and Communication	210,398	259,587	177,471	201,047
Other	34,741	73,137	44,252	14,441
Other	1,379	521	516	547
Total Expenditure and Lending	1,686,384	1,996,748	1,809,508	2,044,376
	As a percentage of GDP			
General Public Services	3.5	3.9	3.9	4.5
Social Services	5.5	5.7	5.7	6.1
Economic Services	5.2	5.9	4.4	3.6
Other	5.2	4.6	4.5	4.0
o/w Interest Payments (a)	5.1	4.4	4.5	3.8
Total Expenditure and Lending	19.4	20.1	18.5	18.1

(a) Interest paid in respect of the ongoing infrastructure projects amounting to Rs. 18.9 billion and Rs. 7.2 billion has been capitalised in 2013 and 2014 (provisional), respectively as per the State Account Circular No. 230/2013, dated 29.11.2013.

Source : Ministry of Finance

on the *Divi Neguma* Development Programme, which aimed at developing a self-reliant household economy, amounted to Rs. 3.3 billion in 2014. In addition, a sum of Rs. 37.3 billion was incurred as expenditure on the *Gama Neguma* programme and provincial infrastructure development programmes, which aimed at reducing regional disparities and uplifting the living standards in the rural sector.

Key Fiscal Balances

In 2014, a number of key fiscal indicators recorded deviations from annual targets, mainly as a result of the significant shortfall in government revenue. The overall fiscal deficit as a percentage of GDP increased to 6.0 per cent in 2014 compared to 5.9 per cent recorded in the previous year and the annual target of 5.2 per cent envisaged in the budget for 2014. The current account deficit, which reflects government dissaving, increased to 1.3 per cent of GDP in 2014 from 0.8 per cent of GDP in the previous year, deviating considerably from the targeted surplus of 1.1 per cent of GDP in the original budgetary estimates for 2014. This trend showed the necessity of increasing government revenue and further rationalising recurrent expenditure to generate a surplus in the current account (government savings) to support the public investment programme, which needs to be strengthened to meet the medium term growth objectives of the economy. Meanwhile, the primary deficit, which excludes interest payments from the overall deficit and reflects the discretionary fiscal policy component of the government, deteriorated to 1.6 per cent of GDP in 2014 from 0.8 per cent of GDP in the previous year.

Financing the Budget Deficit

The government relied more on domestic sources for financing the overall deficit of Rs. 591.2 billion in 2014. Net domestic financing amounted to Rs. 378.7 billion in 2014 in comparison to the original estimate of Rs. 229.3 billion and Rs. 392.4 billion in the previous year. Meanwhile, net foreign financing at Rs. 212.5 billion, was below the original estimate of Rs. 286.8 billion. Accordingly, domestic financing contributed 64.1 per cent of the total financing requirement in 2014 in comparison to 76.0 per cent in 2013, while foreign financing contributed 35.9 per cent in 2014 in comparison to 24.0 per cent in 2013.

Chart 6.5 Deficit Financing (as a percentage of GDP)

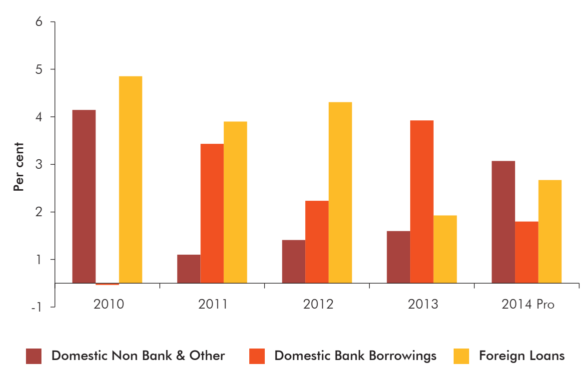
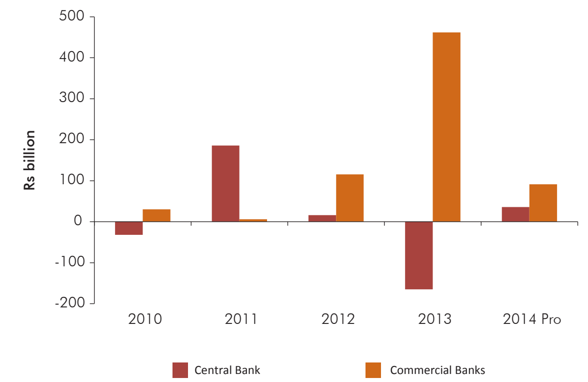


Chart 6.6 Sources of Bank Financing



Domestic borrowings to finance the budget deficit were mainly from non expansionary sources, while the reliance placed on the domestic banking sector declined during the year. Accordingly, borrowings from the non banking sector increased significantly to Rs. 251.8 billion, amounting to 66.5 per cent of net domestic financing, from Rs. 95.4 billion in 2013. Borrowings from the banking sector amounted to Rs. 126.9 billion in 2014, representing 33.5 per cent of total net domestic borrowing, compared to Rs. 297.0 billion recorded in 2013. Although financing from the Central Bank increased to Rs. 35.7 billion in 2014 from a net repayment of Rs. 164.8 billion in 2013, a significant decline in financing from commercial banks to Rs. 91.3 billion during the year from Rs. 461.8 billion at end 2013, helped a reduction in financing from the banking sector. Purchases of Treasury bills by the Central Bank and provisional advances to the government from the Central Bank contributed to the net increase in borrowings from the Central Bank during 2014. Borrowings from commercial banks were mainly through Treasury bonds and SLDBs since most of the maturing Treasury bills were converted to Treasury bonds. However, net borrowings from the banking sector were higher than the annual estimate of Rs. 100 billion in the budget for 2014.

Table 6.5 Sources of Domestic Financing

Rs. billion

Item	2011	2012	2013	2014 Provisional
By Instrument	231.2	200.4	392.4	378.7
Treasury Bonds (a)	168.4	154.5	252.1	369.1
Treasury Bills (b)	79.6	16.8	53.5	26.1
Rupee Loans	-25.7	-3.6	-2.9	-
Sri Lanka Development Bonds	5.3	18.4	140.3	21.0
Central Bank Provisional Advances	16.9	16.5	-2.1	34.7
Other	-13.2	-2.2	-48.5	-72.2
By Source	231.2	200.4	392.4	378.7
Bank	191.9	131.5	297.0	126.9
Non Bank	39.4	68.9	95.4	251.8

(a) Excludes rupee denominated Treasury bonds issued to foreign investors, Sri Lankan diaspora and migrant workers, and funds raised for restructuring of SOBEs in 2012 and 2014.
(b) Excludes rupee denominated Treasury bills issued to foreign investors and to the Sri Lankan diaspora and migrant workers.

Sources: Ministry of Finance
Central Bank of Sri Lanka

The government relied increasingly on longer term marketable debt instruments to finance the budget deficit in 2014. Accordingly, out of the total net borrowings amounting to Rs. 416.2 billion through marketable instruments, Rs. 390.1 billion was raised from Treasury bonds and SLDBs and the balance of Rs. 26.1 billion was raised from Treasury bills. However, when compared to the previous year, borrowings through marketable instruments declined by 6.1 per cent, while borrowings through non instruments recorded a net repayment of Rs. 37.5 billion during 2014.

Foreign currency denominated domestic borrowings declined in 2014. Gross borrowings from SLDBs with a maturity period ranging from 2 to 5 years amounted to Rs. 95.5 billion (US dollars 731.5 million), while repayments were Rs. 74.5 billion (US dollars 571 million). Meanwhile, the government repaid Rs. 612.6 million of its liabilities to offshore banking units

(OBUs) of commercial banks during the year. Hence, net foreign currency borrowings from domestic sources declined significantly to Rs. 20.3 billion from Rs. 143.0 billion in 2013.

With the issuance of the International Sovereign Bond during the year, net financing from foreign sources increased significantly by 71.8 per cent to Rs. 212.5 billion from Rs. 123.7 billion in 2013. The share of foreign financing in total financing increased on a net basis to 35.9 per cent in 2014 from 24.0 per cent in 2013. Net financing from project loans from bilateral and multilateral sources was lower in 2014 at Rs. 14.6 billion compared to Rs. 67.9 billion in the previous year, due to the completion of several major infrastructure projects. Asian Development Bank (ADB), International Development Association (IDA), Export-Import Bank of China and the government of Japan were the major sources of foreign financing in 2014. Gross borrowings from project loans amounted to Rs. 132.2 billion, while repayments were Rs. 117.6 billion. Under the approved International Sovereign Bond Programme for 2014 amounting to US dollars 1.5 billion, the government issued US dollars 1 billion International Sovereign Bonds in January 2014, and the remaining US dollars 500 million in April 2014. Accordingly, financing from International Sovereign Bonds amounted to Rs. 197 billion. Meanwhile, net foreign investments in rupee denominated Treasury bonds amounted to Rs. 15 billion, while a net repayment of Rs. 14.2 billion was made in respect of foreign investments in Treasury bills during 2014. Hence, foreign investments in government securities in 2014 were considerably lower in comparison to the Rs. 55.8 billion received in 2013.

6.4 Government Debt and Debt Service Payments

Government Debt

The declining trend in the government debt to GDP ratio continued in 2014. The total government debt to GDP ratio declined to 75.5 per cent from 78.3 per cent at end 2013, with nominal GDP growing at a higher rate than the increase in the debt stock. As a percentage of GDP domestic debt declined marginally to 43.7 per cent by end 2014 from 44.2 per cent at end 2013, while foreign debt declined to 31.8 per cent by end 2014 from 34.1 per cent in the previous year. In nominal terms, total outstanding government debt increased by 8.8 per cent to Rs. 7,390.9 billion by end 2014 from Rs. 6,793.2 billion at end 2013. The total debt stock declined by Rs. 89.3 billion due to exchange rate variations as the Sri Lanka rupee appreciated against major foreign currencies except the US dollar during 2014. The discount factor (which is the net difference in the book value and the face value of issues and maturities of Treasury bills and Treasury bonds) also contributed to the decline in the debt stock by Rs. 25.5 billion, due to the issuance of government securities at a premium during 2014.

The domestic debt stock increased by Rs. 445 billion to Rs. 4,277.8 billion as at end 2014, due to greater reliance on domestic sources to finance the budget deficit. The share of domestic debt in total government debt increased to 57.9 per cent at end 2014 from 56.4 per cent at end 2013. However, the share of short term debt to total domestic debt declined to 22.0 per cent at end 2014 compared to 23.7 per cent as at end 2013. Within this, the share of Treasury bills in short term domestic debt declined to 73.8 per cent at end 2014 from 77.0 per cent at end 2013, mainly due to the issuance of medium to long term debt to replace the maturing

Chart 6.7 Outstanding Central Government Debt

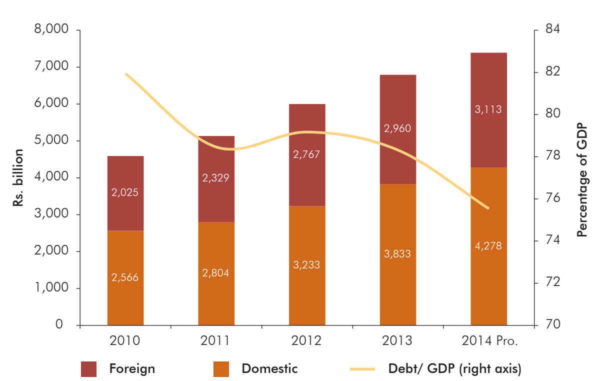


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Table 6.6 Outstanding Central Government Debt (as at end year)

Rs. million

Item	2011	2012	2013	2014 Provisional
Total Government Debt	**5,133,365**	**6,000,112**	**6,793,249**	**7,390,899**
Domestic Debt (a)	**2,804,085**	**3,232,813**	**3,832,825**	**4,277,783**
By Maturity Period				
Short Term	698,190	813,272	909,156	941,162
Medium and Long Term	2,105,895	2,419,541	2,923,670	3,336,620
By Institution				
Bank	886,221	1,060,317	1,433,773	1,669,882
Non Bank	1,917,864	2,172,495	2,399,053	2,607,901
Foreign Debt	**2,329,280**	**2,767,299**	**2,960,424**	**3,113,116**
By Type				
Concessional Loans	1,328,797	1,369,568	1,492,842	1,490,978
Non Concessional Loans	235,923	455,069	460,475	457,668
Commercial (b)	764,560	942,662	1,007,107	1,164,470
By Currency				
SDR	601,691	682,065	711,935	679,835
US Dollars	678,983	853,832	1,009,937	1,292,052
Japanese Yen	560,456	575,196	485,325	429,638
Euro	146,711	174,563	185,606	162,743
Other	341,439	481,643	567,621	548,848
Memo: Exchange Rate Variation	85,573	207,389	-25,498	-90,230

(a) Excludes government bonds of Rs. 4,397 million issued to CWE in November 2003, Rs. 78,447 million issued to settle dues to CPC in January 2012 and Rs. 13,125 million issued to capitalise SriLankan Airlines in March 2013.
(b) Includes outstanding amounts of foreign investments in rupee denominated Treasury bills and Treasury bonds.

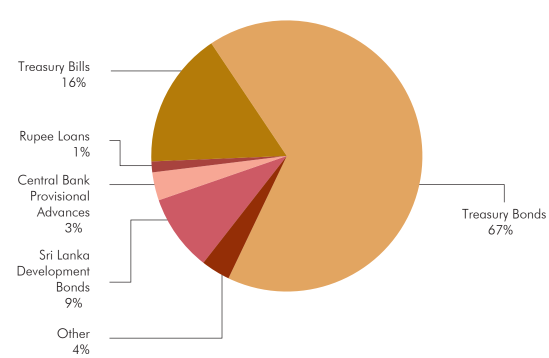
Sources: Ministry of Finance
Central Bank of Sri Lanka

short term debt. Accordingly, the share of medium to long term debt to total domestic debt stock also increased to 78.0 per cent by end 2014 from 76.3 per cent in the previous year. The share of Treasury bonds in total medium to long term debt increased marginally to 85.2 per cent by end 2014 from 83.9 per cent recorded at end 2013. At the same time, the average time to maturity of the domestic debt stock increased to 5.74 years by end 2014 from 4.8 years in the previous year, which reflected the issuance of medium and long term securities, including 30-year Treasury bonds.

Domestic debt held by the non bank sector increased by 8.7 per cent to Rs. 2,607.9 billion at end 2014 from Rs. 2,399.1 billion in the previous year with the increase in net financing from non bank sources to finance the budget deficit in 2014. However, the share of domestic debt held by the non bank sector declined to 61.0 per cent by end 2014 from 62.6 per cent in the previous year. Nevertheless, Treasury bills held by the non bank sector increased significantly by 15.7 per cent to Rs. 293 billion and the relative share of Treasury bills increased to 11.2 per cent by end 2014 from 10.6 per cent in the previous year. Further, borrowings from the non bank sector by way of Treasury bonds increased by 8.9 per cent to Rs. 2,249 billion, while the relative share increased marginally to 86.2 per cent by end 2014 displaying increased investor preference for longer tenure maturities. The Employees' Provident Fund (EPF) and the National Savings Bank (NSB) were the major holders of government debt in the non-bank sector, with shares of 56.5 per cent and 14.6 per cent, respectively.

The outstanding debt obligation of the government to the domestic banking sector increased by 16.5 per cent to Rs. 1,669.9 billion at end 2014. Accordingly, the share of the banking sector debt in total domestic debt increased to 39.0 per cent by end 2014 from 37.4 per cent at end 2013. The outstanding debt held by the Central Bank increased significantly by 138.2 per cent to Rs. 267.7 billion at end 2014, while the relative share increased to 16.0 per cent from 7.8 per cent at the end of the previous year due to significant increase in Treasury bill holdings of the Central Bank to Rs. 123.5 billion at the end of 2014 from Rs. 3.1 billion in the previous year. Outstanding government debt held by commercial banks increased by 6.1 per cent to Rs. 1,402.2 billion compared to end

Chart 6.8 Composition of Outsanding Domestic Debt - 2014



2013 mainly due to increased holdings of Treasury bonds by commercial banks by 54 per cent to Rs. 595.1 billion. However, the Treasury bills held by commercial banks declined by 37.3 per cent to Rs. 278.3 billion at end 2014 reflecting the preference for government securities with longer maturities.

Foreign currency denominated domestic debt increased to Rs. 410.7 billion (US dollars 3,134.3 million) by end 2014 from Rs. 388.8 billion (US dollars 2,973.8 million) at end 2013. The increase in net borrowings through SLDBs amounted to Rs. 21.9 billion coupled with the depreciation of the Sri Lanka rupee against the US dollar contributed to this increase. Foreign currency denominated domestic debt consisted of outstanding borrowings from SLDBs amounting to Rs. 391.1 billion (US dollars 2,984.3 million) and OBUs amounting to Rs. 19.7 billion (US dollars 150 million).

Total outstanding foreign debt increased by 5.2 per cent to Rs. 3,113.1 billion at end 2014. Concessional debt decreased marginally by 0.1 per cent to Rs. 1,491 billion at end 2014 from Rs. 1,492.8 billion at end 2013, while non concessional debt increased by 10.5 per cent to Rs. 1,622.1 billion, raising the share of non concessional debt in the total foreign debt stock to 52.1 per cent at end 2014 from 49.6 per cent at end 2013. The increase in non concessional debt was mainly due to higher foreign commercial borrowings, which includes the International Sovereign

Chart 6.9 Composition of Outsanding Foreign Debt - 2014

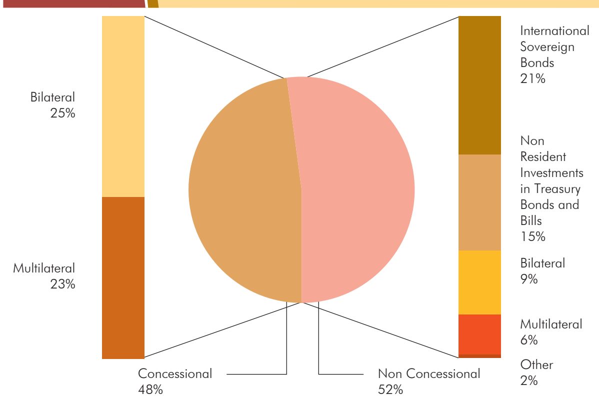
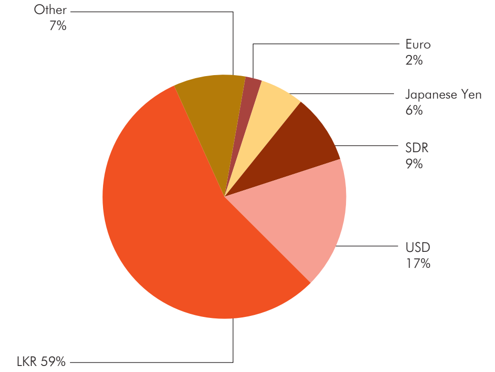


Chart 6.10 Currency Composition of Total Outstanding Debt - 2014



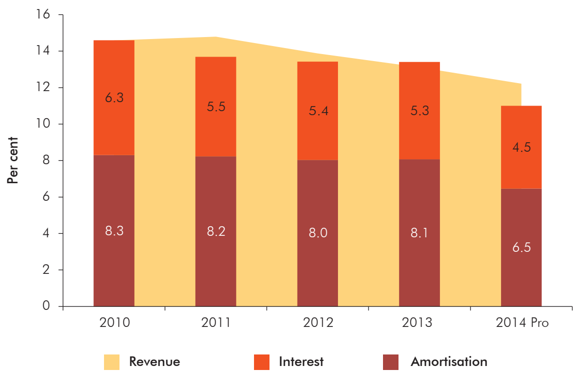
Bonds and foreign investments in Treasury bills and Treasury bonds, which increased by 15.6 per cent to Rs. 1,164.5 billion by end 2014.

The appreciation of the Sri Lanka rupee against several major currencies during the year resulted in a reduction in the debt stock by Rs. 89.3 billion. The Sri Lanka rupee appreciated against the Japanese yen, the Indian rupee, euro and Special Drawing Rights (SDR) by 13.5 per cent, 2.1 per cent, 13.2 per cent and 6.1 per cent, respectively, while depreciating against the US dollar by 0.23 per cent during the year. Meanwhile, the total outstanding foreign debt stock consisted of debt denominated in US dollars (41.5 per cent), SDR (21.8 per cent), Japanese yen (13.8 per cent), euro (5.2 per cent), Sri Lanka rupee (14.7 per cent) and other currencies (3.0 per cent). Consequently, the outstanding foreign debt stock declined by Rs. 90.2 billion due to variations in the exchange rate of the Sri Lanka rupee against major foreign currencies, while foreign currency denominated domestic debt (SLDBs and loans from OBUs) increased by Rs. 0.9 billion due to the depreciation of the Sri Lanka rupee against the US dollar.

Debt Service Payments

Debt service payments declined by Rs. 86.6 billion to Rs. 1,076.3 billion in 2014 from Rs. 1,162.9 billion in 2013, as both amortisation and interest payments declined over the previous year. Accordingly, amortisation

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



payments declined by Rs. 67.4 billion to Rs. 632.7 billion, while interest payments declined by Rs. 19.3 billion to Rs. 443.6 billion during the year. Amortisation payments accounted for 58.8 per cent of total debt service payments. Debt service payments to domestic sources declined significantly by Rs. 73.3 billion to Rs. 777.5 billion in 2014 compared to Rs. 850.7 billion in 2013. This was a combined outcome of the decline in amortisation payments of Rs. 46.5 billion and decline in interest payments by Rs. 26.8 billion compared to the previous year. Debt service payments to foreign sources declined by Rs. 13.4 billion to Rs. 298.8 billion in 2014, with the reduction of amortisation payments on foreign loans by Rs. 20.9 billion to Rs. 183.1 billion. However, foreign interest payments increased by Rs. 7.5 billion to Rs. 115.7 billion in 2014 as a result of increased interest payments in relation to Treasury bills and Treasury bonds.

Debt service indicators improved during 2014. Debt service payments, which include amortisation and interest payments declined to 11.0 per cent of GDP in 2014 from 13.4 per cent of GDP in the previous year. The ratio of total interest payments to GDP declined to 4.5 per cent in 2014 from 5.3 per cent in 2013, mainly due to the decline in domestic interest payments with lower interest rates in the market. Domestic interest payments to GDP declined to 3.4 per cent in 2014 from 4.1 per cent in 2013. Further, the ratio of debt service payments to government revenue declined to 90.0 per cent in 2014 from 102.2 per cent in 2013 due to the decline in debt service payments by 7.5 per cent in 2014, despite the moderate increase in the revenue collection by 5.1 per cent in 2014.

Table 6.7 Government Debt Service Payments

Rs. million

Item	2011	2012	2013	2014 Provisional
Debt Service Payments	895,382	1,017,468	1,162,900	1,076,257
Domestic	728,028	733,100	850,748	777,488
Foreign	167,354	284,368	312,152	298,769
Amortisation Payments	538,683	608,970	700,035	632,662
Domestic	439,894	415,441	496,042	449,554
Foreign	98,789	193,529	203,993	183,109
Interest Payments	356,699	408,498	462,865	443,595
Domestic	288,134	317,659	354,706	327,934
Short Term	46,257	65,049	69,712	78,811
Medium and Long Term	241,877	252,610	284,994	249,123
Foreign	68,565	90,839	108,159	115,660

Sources: Ministry of Finance
Central Bank of Sri Lanka

Table 6.8 Central Government Debt Indicators

Indicator	2011	2012	2013	2014 Provisional
Central Government Debt/GDP	78.5	79.2	78.3	75.5
Domestic Debt/GDP	42.9	42.7	44.2	43.7
Foreign Debt/GDP	35.6	36.5	34.1	31.8
Total Foreign Debt/Exports (a)	154.4	159.9	151.9	142.5
Total Debt Service/GDP	13.7	13.4	13.4	11.0
Total Debt Service/Government Revenue (b)	92.5	96.8	102.2	90.0
o/w Domestic Debt Service/ Government Revenue (b)	75.2	69.7	74.8	65.1
Total Debt Service/Government Expenditure (c)	45.4	47.0	49.1	44.3
o/w Domestic Debt Service/ Government Expenditure (c)	36.9	33.9	35.9	32.0
Foreign Debt Service/Exports (a)	11.1	16.4	16.0	13.7
Total Interest/GDP	5.5	5.4	5.3	4.5
Domestic Interest/GDP	4.4	4.2	4.1	3.4
Domestic Interest/Government Recurrent Expenditure	28.1	28.1	29.4	24.8
Foreign Interest/Exports (a)	4.5	5.2	5.5	5.3

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

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

Outstanding Debt of Major Public Nonfinancial Corporations

Outstanding debt of major public nonfinancial corporations (outstanding debt to domestic banking sector and project related foreign debt) increased by 17.8 per cent to Rs. 754.7 billion at end 2014, compared to the increase of 26.1 per cent in 2013. Domestic debt of public nonfinancial corporations to domestic commercial banks increased by 22.2 per cent at end 2014 to Rs. 446.0 billion, while project related foreign debt increased by 11.9 per cent to Rs. 308.7 billion. As a percentage of GDP, outstanding debt of major public nonfinancial corporations amounted to 7.7 per cent by end 2014, in comparison to 7.4 per cent in the previous year.

Table 6.9 Outstanding Debt of Major Public Nonfinancial Corporations (as at end year)

Corporation	2012	2013	2014 (a)
Rs. million			
Domestic Debt (b)	292,477	365,098	446,047
Ceylon Electricity Board	43,590	46,974	47,384
Ceylon Fertiliser Corporation	11,521	21,920	30,593
Ceylon Petroleum Corporation	201,378	223,433	245,618
Colombo Commercial Fertiliser	4,284	10,088	13,342
National Housing Development Authority	1,625	3,386	4,777
Paddy Marketing Board	4,693	6,700	5,574
Road Development Authority	5,167	23,324	58,325
SriLankan Airlines	2,853	9,233	9,055
Sri Lanka Ports Authority	5,370	7,074	11,801
Other Corporations	11,998	12,967	19,578
Foreign Debt (c)	216,001	275,850	308,673
Airport and Aviation Services (Lanka) Ltd.	20,861	25,469	25,909
Ceylon Electricity Board	135,937	153,429	160,195
Sri Lanka Ports Authority	59,203	96,953	122,568
Total Debt of Public Nonfinancial Corporations	508,478	640,948	754,720
As a percentage of GDP			
Domestic Debt	3.9	4.2	4.6
Foreign Debt	2.9	3.2	3.2
Total Debt	6.7	7.4	7.7

(a) Provisional
(b) Outstanding amounts to domestic commercial banks
(c) Includes outstanding foreign project related loans.

Sources: Ministry of Finance
Central Bank of Sri Lanka

6.5 Budgetary Operations in Sub National Governments

Policy Direction and Measures of Sub National Governments

The sub national government system in Sri Lanka consists of provincial councils (PCs) and local governments. Accordingly, there are nine PCs established under the thirteenth amendment to the Constitution and the local government system in Sri Lanka is made up of 335 institutions. As at end 2014, the local government system comprised of 23 municipal councils, 41 urban councils and 271 pradesheeya sabhas.

The Ministry of Local Government and Provincial Councils played a vital role in development process at the sub national government level in 2014. The Ministry continued effective coordination with donor agencies to facilitate investment needs of sub national government authorities, while providing support in the process of prioritisation of the development needs at the provincial level and local government level. Further, infrastructure facilities and managerial skills were improved to provide a better service to the public during 2014. Several programmes were initiated by the Ministry to provide an upgraded service delivery and to address timely needs of the public. Accordingly, the Waste Management and Dengue Eradication Programme was continued during 2014 through the National Solid Waste Management Support Centre with the support of the Ministry of Health. In addition, the Ministry carried out awareness programmes to educate the public on waste management.

The Local Government Enhancement Sector Project (*Pura Neguma* programme) continued in 2014 with the objective of improving infrastructure services in selected less developed local authority areas. Accordingly, 108 local authorities have been identified. The project intends to support the development of the institutional capacity of local authorities for improved and sustained service delivery through business process reengineering and the development of their information technology systems.

Under regional infrastructure development activities in 2014, priority was given to road development. Accordingly, the Ministry of Local Government and Provincial Councils implemented the Provincial Roads Project in the Eastern, Uva, Northern, North Central, Sabaramaguwa and Central provinces with funding assistance from the World Bank, Asian Development Bank (ADB) and Japan International Cooperation Agency (JICA). The Northern Roads Connectivity Project was implemented with a view to improving connectivity of provincial roads with funding from ADB. In addition, Greater Colombo Wastewater Management Project, Upgrading of the Disaster Response Network (Phase II), Project of Transforming School Education as the Foundation of a Knowledge Hub and several Township Development Programmes were continued during the year.

The Finance Commission played an important role in recommending central government transfers to PCs to meet their budgetary requirements, with a view to achieving a balanced and equitable socioeconomic development in all provinces. In 2014, a policy decision was taken by the Finance Commission to divide the allocation of Province Specific Development Grants (PSDG) to several subsectors starting from 2015 in order to make allocation decisions at the provincial level clearer. Further, it was decided by the Finance commission to cancel the provision of administrative costs (maximum of 5 per cent of the contract value) under capital funds allocated to the provinces. According to the Finance Commission, inadequacy of resource allocation to capital projects and lower disbursement of funds against the allocations were the key constraints relating to provincial council operations.

Budgetary Operations in Provincial Councils

Tax revenue collection of PCs continued to increase in 2014. Total revenue increased by 18 per cent to Rs. 58.6 billion in 2014 from Rs. 49.6 billion in 2013, while as a percentage of GDP it remained unchanged at 0.6 per cent in 2014. Tax revenue increased by 22.5 per cent to Rs. 52.1 billion in 2014, while non tax revenue declined by 9.3 per cent to Rs. 6.4 billion. NBT revenue transferred from the central government increased by 28.9 per cent to Rs. 22.3 billion. Revenue from stamp duty increased significantly by 23.3 per cent to Rs. 21.7 billion in 2014. Similarly, revenue from license fees increased by 12.1 per cent to Rs. 7.4 billion in 2014 as a result of the increase in motor vehicle registrations. NBT revenue transfers from the central government accounted for 42.7 per cent of total tax revenue of PCs followed by stamp duties of 41.7 per cent of total tax revenue during 2014. The relative share of the Western Provincial Council on revenue collection declined to 53.2 per cent from 60.5 per cent reflecting the increase in revenue in other provincial councils with the expansion of economic activities in these provinces. The Western Province was followed by the North Western, the Southern and the

Table 6.10 Budget Outturn for Provincial Councils

Rs. million

Item	2011	2012	2013 Revised	2014 Provisional
Total Revenue	40,990	49,235	49,648	58,562
Tax Revenue	34,658	41,657	42,569	52,145
Non Tax Revenue	6,332	7,578	7,079	6,418
Total Expenditure	157,373	161,341	185,241	212,967
Recurrent Expenditure	129,600	139,121	156,066	180,209
o/w Personal Emoluments	101,886	108,246	117,806	129,466
Capital Expenditure	27,773	22,220	29,175	32,759
Central Government Transfers	116,383	112,106	135,593	154,405
Block Grants	94,603	91,892	108,801	126,144
Criteria Based Grants	3,854	2,861	2,264	2,299
Province Specific Development Grants	9,953	5,901	6,429	9,136
Foreign Grants for Special Projects	7,973	11,452	18,100	16,826

Sources: Ministry of Finance
Ministry of Public Administration, Provincial Councils, Local Government and Democratic Governance

Central provinces accounting for around 9.9 per cent, 9.1 per cent and 8.9 per cent, respectively, of the total revenue collection of PCs.

Recurrent expenditure of PCs increased by 15.5 per cent to Rs. 180.2 billion in 2014 from Rs. 156.1 billion in 2013. As a percentage of GDP, recurrent expenditure of PCs remained at 1.8 per cent in 2014 as in the previous year. Personal emoluments continued to be the single largest item under recurrent expenditure accounting for 71.8 per cent of total recurrent expenditure of PCs in 2014. Personal emoluments in education and health sectors accounted for nearly 90 per cent of the total personal emoluments bill. On a functional basis, recurrent expenditure on social infrastructure increased by 16.6 per cent to Rs. 161.2 billion, with education and health sectors accounting for 89.5 per cent of total recurrent expenditure in 2014. The balance 10.5 per cent of recurrent expenditure was on account of expenses in relation to provincial administration and economic infrastructure. Meanwhile, the Western Provincial Council continued to be the largest spending unit, accounting for 22.6 per cent of total recurrent expenditure.

Capital expenditure of PCs increased by 12.3 per cent to Rs. 32.8 billion in 2014 from Rs. 29.2 billion in 2013. As a percentage of GDP, capital expenditure of PCs remained unchanged at 0.3 per cent in 2014. In 2014, capital expenditure incurred on special projects amounted to Rs. 16.8 billion, while Rs. 9.1 billion was incurred on Province Specific Development Projects (PSDPs). Other provincial level investments incurred were mainly in the areas of acquisition and improvement of capital assets and capital transfers to local governments.

Central government transfers to PCs increased by 13.9 per cent to Rs. 154.4 billion in 2014 from Rs. 135.6 billion in 2013. These transfers were in the form of block grants, Criteria Based Grants (CBGs), Province Specific Development Grants (PSDGs) and grants for special projects. Block grants, the major form of central government transfers amounting to Rs. 126.1 billion (81.7 per cent of total transfers), were provided to meet the resource gap in the recurrent expenditure programme of PCs. Transfers under PSDGs amounted to Rs. 9.1 billion in 2014. CBGs, which fund discretionary expenditure requirements, amounted to Rs. 2.3 billion in 2014. Meanwhile, 72.5 per cent of expenditure of PCs was financed by transfers from the central government in comparison to 73.2 per cent in the previous year. As such, appropriate measures are needed to increase revenue by PCs in order to reduce the reliance of PCs on the central government budget.