6

FISCAL POLICY AND GOVERNMENT FINANCE

6.1 Overview

Fiscal management in 2015 was extremely challenging given the various domestic and global developments that took place during the year. The conclusion of two key national elections and the consequential change in the administrative apparatus of the government, uncertainty that prevailed in the inter-election period and the resultant slowdown in economic activity as well as external sector related issues, including the tightened international financial market conditions and slowdown in foreign inflows, were among the key developments in 2015. The new government that took office in 2015 had to face the formidable challenge of reducing the budget deficit and the level of outstanding debt to strengthen the fiscal consolidation process. In this environment, the government presented an Interim Budget on 29 January 2015, which introduced a number of new policy measures with the view of increasing revenue and providing concessions to public sector employees, pensioners, low income families and the general public. The work on some of the ongoing mega projects was suspended until a further evaluation of environmental and related issues, while some other ongoing and planned projects were reviewed to ensure that financial terms were not detrimental to Sri Lanka.

During the year, fiscal performance reflected the challenges faced by the government leading to a notable deviation from fiscal targets announced in January 2015 in the Interim Budget for 2015 despite improvements in some areas. In 2015, the government revenue performance improved, reflecting a turnaround in the revenue to GDP ratio that was on a declining trend since 2011, mainly benefiting from several one off taxes and the significant expansion in revenue from excise duties on substantially increased motor vehicle imports. However, higher government expenditure on salaries and wages, interest payments, and subsidies and transfers to households exerted heavy pressure on government finances. Hence, despite the improvement in the revenue, which however fell short of the annual target, increased expenditure caused the overall deficit to widen to 7.4 per cent of GDP compared to the deficit of 5.7 per cent in 2014 and the targeted deficit of 4.4 per cent of GDP in the Budget for 2015. The deficit was largely financed by domestic sources given the slowdown in foreign financing during the year. Reflecting these developments, the debt to GDP ratio also increased to 76.0 per cent in 2015 from 70.7 per cent in the previous year.

The performance in the government finances during recent past reflects serious structural weaknesses in the government budget. The complex tax system, relatively low revenue base, weak tax compliance as well as the need for improving tax administration adversely affected revenue generation. As reflected in the sizable deficit in the revenue account (current account) of the budget, the country's revenue is not sufficient even to finance the maintenance expenditure of the government. Hence, the government is forced to recourse to borrowings even for its day-to-day operations. This weakness in the structure of the budget lessens the channeling of adequate expenditure for development needs, including education, health, skills development, agriculture, Small and Medium Enterprise (SME) development, poverty alleviation and strengthening social safety nets. The pressing resource needs which tend to increase the expenditure through borrowings lead to deviate fiscal targets from the desired levels. This leads to a vicious cycle of revenue shortfalls, expenditure overruns, high budget deficits, increase in government debt and debt service payments, thereby lowering the expenditure on public investment and the ability to enhance other essential expenditures while making fiscal consolidation a difficult task. Hence, there is a strong need to address each point of this vicious cycle by implementing necessary reforms to revamp budgetary operations.

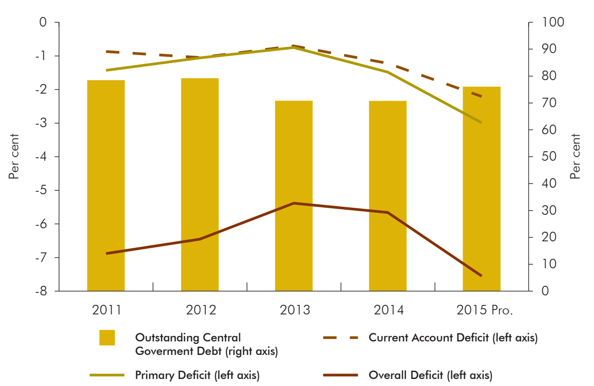
The government has taken a number of measures to address these issues, which has to be strengthened further. The ongoing redrafting of tax laws with technical assistance from the IMF to simplify the tax laws, ongoing improvements in tax administration, including the automation of revenue agencies under the Revenue Administration Management Information System (RAMIS) at Inland Revenue Department (IRD), introducing Single Window System (SWS) at Sri Lanka Customs (SLC) linking of all stakeholders, automation of the activities of the MOF under an Integrated Treasury Management Information System (ITMIS), introducing the zero based budgeting system by the MOF and setting up of Budget Implementation and Monitoring Unit (BIMU) to ensure close monitoring of expenditure programmes, are among the important initiatives in this context. Further efforts are necessary to maintain a proper balance in government revenue and recurrent expenditure, by strengthening revenue collection as well as rationalising recurrent expenditure with the view of closing the deficit in the current account balance in the medium term and creating a revenue surplus in the long run. Such policies will help reducing the pressure on budgetary resources, thereby enabling the channeling of enhanced resources to essential sectors, such as education and health. A careful review of the structure of the budget, particularly the expenditure side, is essential to understand priority areas, as the fiscal consolidation has to be a combined effort of increasing revenue as well as rationalising and prioritising of government expenditure.

The medium term objective of the government is to reduce the budget deficit to 3.5 per cent of GDP by 2020. In line with this, regressive taxes are also expected to be minimised while increasing the ratio of direct and indirect tax generation in the medium term to 40:60 per cent from 20:80 per cent. The Budget for 2016, presented in November 2015, proposed a number of measures mainly related to the tax system as well as reforms in the pension system, fertiliser subsidy and state owned enterprises (SOEs) with various policies related to other sectors in the economy. The overall deficit was expected to be reduced to 5.9 per cent of GDP in 2016. However, on 12 January 2016, the government suspended the implementation of the proposed revisions in the Value Added Tax (VAT) and Nation Building Tax (NBT) in the Budget 2016 until the necessary legislation was Gazetted and approved by the Parliament. In a subsequent development, on 08 March 2016, the government announced revisions to certain taxes in the backdrop of the changing global economic climate while highlighting the commitment of the government to reduce the budget deficit further to 5.4 per cent of GDP in 2016, instead of the originally targeted level of 5.9 per cent of GDP envisaged in the Budget 2016.

6.2 Fiscal Policy Direction and Measures

The fiscal policy in 2015 was directed towards further consolidating the budget deficit and reducing the government debt to GDP ratio. Several policy measures were proposed in the original Budget for 2015 approved by the Parliament in November 2014 with the view of enhancing government revenue through simplifying the tax system and broadening the tax base while improving public expenditure management. 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 the cost of living and income inequality, while announcing the intention to further strengthen the fiscal consolidation process. The Interim Budget focused on increasing direct tax revenue as a percentage of GDP by broadening the tax base and improving tax administration. Attention was also paid to rationalise recurrent expenditure further, while maintaining a sufficient level of public investment to stimulate private sector involvement in economic activity. The implementation of many of the other proposals introduced in the original Budget for 2015 continued. Hence, hereinafter the original Budget and Interim Budget are collectively called the Budget for 2015 in this analysis.

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



Accordingly, under the Budget for 2015, the overall budget deficit was estimated to reduce to 4.4 per cent of GDP in 2015. Revenue as a percentage of GDP was estimated to be increased to 13.3 per cent in 2015 from 11.4 per cent in 2014, while recurrent expenditure was expected to be maintained at 13.7 per cent of GDP in comparison to 12.7 per cent of GDP in the previous year. Public investment was also expected to maintain at 4.3 per cent of GDP in 2015 to facilitate the economic growth objectives of the medium term. Accordingly, as a percentage of GDP, the current account deficit and primary deficit were expected to reduce to 0.4 per cent and 0.7 per cent, respectively in 2015 from 1.2 per cent and 1.5 per cent in 2014. Meanwhile, central government debt to GDP ratio was expected to be maintained at 72.0 per cent of GDP as at end 2015.

Having identified the necessity of increasing the government revenue to GDP ratio to meet the fiscal targets while maintaining macroeconomic stability, several measures were introduced to streamline the tax system and to expand the tax base. On the direct tax front, income tax system

Table 6.1 Summary of Government Fiscal Operations

Item	2014	2015 Approved Estimates	2015 Provisional	2016 Approved Estimates
		Rs. million		
Total Revenue and Grants	1,204,621	1,534,700	1,460,892	1,837,970
Total Revenue	1,195,206	1,504,700	1,454,878	1,822,970
Tax Revenue (a)	1,050,362	1,337,000	1,355,779	1,646,000
Non Tax Revenue	144,844	167,700	99,099	176,970
Grants	9,415	30,000	6,014	15,000
Expenditure and Lending Minus Repayments	1,795,865	2,034,076	2,290,394	2,578,119
Recurrent	1,322,898	1,552,035	1,701,658	1,717,239
Capital and Net Lending	472,967	482,041	588,737	860,880
o/w Public Investment	486,610	492,341	602,767	869,880
Current Account Surplus (+)/Deficit (-)	-127,692	-47,335	-246,779	105,731
Primary Account Surplus (+)/Deficit (-)	-154,849	-74,346	-319,827	-219,697
Overall Fiscal Surplus (+)/Deficit (-)	-591,244	-499,376	-829,502	-740,149
Total Financing	591,244	499,376	829,502	740,149
Foreign Financing (b)	212,523	291,376	236,803	283,149
Domestic Financing (c)	378,721	208,000	592,699	457,000
Market Borrowings	392,084	208,000	592,699	457,000
Non Bank	265,155	138,000	300,858	275,000
Bank	126,929	70,000	291,841	182,000
Monetary Authority	35,665	n.a.	80,254	n.a.
Commercial Banks	91,264	n.a.	211,588	n.a.
Non Market Borrowings	-13,363	-	-	-
		As a percentage of GDP		
Total Revenue and Grants	11.5	13.6	13.1	14.7
Total Revenue	11.4	13.3	13.0	14.6
Tax Revenue (a)	10.1	11.8	12.1	13.2
Non Tax Revenue	1.4	1.5	0.9	1.4
Grants	0.1	0.3	0.1	0.1
Expenditure and Lending Minus Repayments	17.2	18.0	20.5	20.6
Recurrent	12.7	13.7	15.2	13.7
Capital and Net Lending	4.5	4.3	5.3	6.9
o/w Public Investment	4.7	4.3	5.4	7.0
Current Account Surplus (+)/Deficit (-)	-1.2	-0.4	-2.2	0.8
Primary Account Surplus (+)/Deficit (-)	-1.5	-0.7	-2.9	-1.8
Overall Fiscal Surplus (+)/Deficit (-)	-5.7	-4.4	-7.4	-5.9
Total Financing	5.7	4.4	7.4	5.9
Foreign Financing (b)	2.0	2.6	2.1	2.3
Domestic Financing (c)	3.6	1.8	5.3	3.7
Market Borrowings	3.8	1.8	5.3	3.7
Non Bank	2.5	1.2	2.7	2.2
Bank	1.2	0.6	2.6	1.5
Monetary Authority	0.3	n.a.	0.7	n.a.
Commercial Banks	0.9	n.a.	1.9	n.a.
Non Market Borrowings	-0.1	-	-	-

(a) Includes the amount of tax 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.
(c) Excludes restructuring bonds amounting to Rs. 13.0 billion and Rs. 23.9 billion issued to National Water Supply and Drainage Board and Ceylon Petroleum Corporation, respectively in 2015

Source: Ministry of Finance

was streamlined by applying a lower tax rate, while on the indirect tax revenue front, VAT base was expanded, although the applicable rate was reduced. Further, several new taxes, including a few one off taxes, were also introduced as revenue enhancing measures and several initiatives were made in revenue collection agencies to strengthen the tax administration. In the Budget for 2015, several measures were proposed to increase the non tax revenue as well.

Measures were taken to streamline the income tax system while improving the compliance and promoting thrust areas by giving tax concessions. Accordingly, the low income tax rate of 16 per cent on employment income, introduced for professionals in 2014, was extended to cover other employment categories as well. Moreover, as a relief to Pay-As-You-Earn (PAYE) taxpayers, the exempted amount of annual employment income of Rs. 600,000 was increased to Rs. 750,000. Further, a pioneering industry allowance was introduced by applying an income tax deduction of 10 per cent for local manufacturers who have commenced businesses of manufacturing during the 1970s. Further, a 12 per cent concessionary income tax rate was introduced for the local sugar industry with the view of expanding this sector. A Super Gain tax applicable on any company or individual who has earned profits over Rs. 2,000 million in the tax year 2013/14 was made liable to pay 25 per cent of their profit as a one off tax during the year. Further, the withholding tax (WHT) regime applicable for interest income of individuals and charitable institutions was revised by introducing a single withholding tax rate of 2.5 per cent of interest income, irrespective of the amount of interest instead of progressive tax rates based on interest income.

The VAT base was expanded and the applicable rate was lowered during the year. Accordingly, the quarterly turnover applicable for the imposition of VAT on wholesale and retail trade was reduced from Rs. 250 million to Rs. 100 million, while the applicable VAT rate was reduced to 11 per cent from 12 per cent with effect from January 2015 for all Vatable items. In addition, the threshold of liable supplies for registration for VAT purposes was increased to Rs. 15 million per annum from Rs. 12 million per annum to ease the burden on SMEs. Similarly, the threshold of liable turnover of the NBT was also increased to Rs. 15 million per annum from Rs. 12 million per annum.

Several measures were taken to increase revenue collection from excise tax in 2015. Accordingly, excise (Special Provisions) duty rates on cigarettes and excise tax rates on liquor were revised upwards during the year. In addition, excise duty on motor vehicles with less than 1000 cc was revised downwards in order to make them affordable for low income families while excise duty on hybrid motor vehicles revised upwards during the year to streamline the motor vehicle tax structure. The method of computation of the value of motor vehicles at the Customs for the purpose of calculation of excise duty payable at the time of importation was also revised in 2015.

Special Commodity Levy (SCL) on the importation of several food items was changed periodically in order to adjust the market prices and quantity imported with the view of reducing the cost of living and protecting the income of domestic farmers during the harvesting period. Accordingly, SCL on several essential goods was revised downwards as proposed in the Interim Budget with effect from 30 January 2015 to reduce market prices. SCL on the importation of rice, which was reduced to a lower level to increase the market availability of rice due to low paddy production in 2014, was increased twice during the year to Rs. 40 per kg to protect the income of paddy farmers during the harvesting period. Further, in May 2015, a Customs duty of Rs. 35 per kg, VAT at a rate of 11 per cent, Ports and Airports Development Levy (PAL) at a rate of 5 per cent and NBT at a rate of 2 per cent was introduced in place of SCL of Rs. 40 per kg of rice. Further, SCL on importation of potatoes and b'onions was changed several times considering the domestic supply conditions and SCL on several other commodities, including dhal and mackerel, was also reduced during the year.

Several changes were made in other taxes while new taxes were introduced to the tax system to enhance revenue collection. Accordingly, a number of one off levies, namely Bars and Taverns Levy, Casino Industry Levy, Mobile Telephone Operator Levy, Satellite Location Levy and Dedicated Sports Channel Levy were introduced to enhance revenue collection. In addition, Mansion Tax, which was levied on owners of any building constructed on or after 01 April 2000 for residential purpose and valued at Rs. 150 million or more or on area of above 10,000 square feet which ever is higher on an annual basis, was also introduced and to be collected on annual basis through local authorities. Further, Betting and Gaming Levy was increased while a Casino Entrance Levy was imposed on every person who enters casino entertainment places. In addition, a tax was imposed on all foreign exchange to be taken out of the country by migrants at the point of immigration. Several changes to the non tax revenue front were also proposed in the Budget for 2015.

Customs duty was simplified with the conversion of the four band structure to a three band tariff structure, while increasing Customs duty rates during the year to enhance revenue collection. Accordingly, instead of the four band customs duty tariff structure of zero, 7.5 per cent, 15 per cent and 25 per cent, a three band tariff structure of zero, 15 per cent and 30 per cent was introduced during the latter part of the year. Customs duty and several other taxes were imposed on the importation of rice in place of SCL during mid 2015 and Customs duty on alcoholic beverages and several other items were increased during the latter part of the year.

The process of automating revenue agencies was expedited during the year to improve tax administration and thereby enhance the revenue collection. The RAMIS is expected to automate the IRD to enhance the efficiency of revenue collection and strengthen overall tax administration. This project mainly includes the conversion of taxpayer services into self-services, establishment of an integrated system on taxpayer information and tax liabilities across the taxes, creation of a centralised taxpayer database, implementation of a unique identification number for both individual and corporate taxpayers and establishment of an integrated system to facilitate the exchange of information between IRD and other key stakeholders. In 2015, the new web portal of IRD was launched for the public. The project comprises two phases. Phase 1 comprises corporate income tax (CIT), VAT, Simplified VAT (SVAT), WHT, NBT and PAYE which will cover more than 95 per cent of revenue collected by IRD. Phase 2 comprises non-corporate income taxes such as individuals, partnerships, clubs, associations etc., Stamp duty, Economic Service Charge (ESC), VAT on Finance and Betting and Gaming Levy (B&G). Under the project, registering of taxpayers and sending VAT and SVAT monthly returns under the RAMIS system, on line submission of SVAT schedule, establishing a Call Center under 1944 were commenced with limited areas to answer frequently asked questions while e–registration was commenced from early 2016. During 2015, the SLC also developed a system which incorporates all the receipts within the SLC into the ASYCUDA World system so that such collections could be credited to the appropriate revenue headings under the ITMIS which is being implemented at the MOF, on the following morning via the interface provided. Further, in January 2016, SLC linked up with high tech SWS for border regulatory authorities enabling international (cross border) traders to submit regulatory documents at a single location or single entity. The SWS delivers specific benefits to the main communities and stakeholders in cross border trade governments, shipping and forwarding community, shippers and traders and banking and insurance community, while enabling the SLC to do away with the system overlapping that will otherwise require submitting and processing the same information on numerous occasions to different entities.

During the year, several measures were introduced in order to ensure the proper management of public expenditure to avoid overrun in recurrent expenditure while maintaining public investment at the expected level. Under the National Budget Circular No. 02/2015, all spending agencies were instructed to manage expenditure within provisions allocated for the year and thus maintain a proper control over the expenditure heads. It was announced that new vehicles would not be provided to government institutions during the year 2015 and vehicles available at present were expected to be managed efficiently. Expenditure on publicity and sponsorship was not allowed in order to prevent misappropriation of public funds. In terms of capital expenditure management, instructions were issued to settle the commitments of the previous year from the provisions allocated for the year 2015 and prioritise the balance provisions by looking at the possibility of implementing less priority projects through the Medium Term Budgetary Framework. Further, a BIMU was established in the Department of National Budget in the MOF and under the National Budget Circular No. 06/2015 issued in December 2015. In early 2016, the BIMU periodically and systematically monitored the budgetary process in order to ensure the requirements of the Zero Based Budgeting (ZBB) approach which will have to be followed by the line ministries and agencies. Accordingly, a monthly budget monitoring meeting was held at the General Treasury to review the financial progress against the allocated funds and physical performance of line ministries and agencies on the basis of the procurement plan, action plan and key performance indicators (KPIs) agreed upon.

Salaries and wages of public sector employees and pension payments were revised upwards during 2015. The monthly interim allowance of Rs. 3,000 per month granted for government sector employees with effect from November 2014 was increased by another Rs. 7,000, of which Rs. 5,000 was given with effect from February 2015 and the balance was granted with effect from June 2015. In addition, a special allowance was introduced for the executive category in the public service with effect from July 2015. Necessary steps were taken to implement new salary scales by five phases for the public service with effect from 01 January 2016. The interim allowance of Rs. 2,500 per month, granted for pensioners with effect from November 2014, was also increased to Rs. 3,500 per month with effect from April 2015. In addition, pension anomalies of public servants who had retired before the implementation of Public Administration Circular No. 06/2006, were rectified and the adjusted pensions were paid with effect from July 2015.

The public investment programme continued during the year, although implementation of some infrastructure development projects was slow due to Environmental Impact Assessments (EIAs) and the renegotiation of some foreign loan agreements. Ongoing irrigation schemes such as Moragahakanda and Kaluganga projects were continued during the year. Meanwhile, development of expressways, widening and improvement of national roads and bridges and expansion of railway lines continued. Accordingly, the Rehabilitation and Improvement of Priority Road Project, the Greater Colombo Urban Transport Development Project, the Northern Road Connectivity Project (NCP), and Phase I of the Matara Kataragama Railway Extension Project from Matara to Beliatta were continued during 2015. Further, Phase II of the Outer Circular Highway (OCH) from Kaduwela to Kadawatha was opened on 17 September 2015. Detailed engineering designs of Phase III of the OCH from Kadawatha to Kerawalapitiya with a link to the Colombo-Katunayake Expressway were carried out and land acquisition, supervision consultancy, survey and field testing of the project continued during the year. Meanwhile, the construction of Phase I of the Central Expressway from Kadawatha to Mirigama commenced in August 2015. The Extension of the Southern Expressway from Matara to Hambantota, linking Hambantota Port and Mattala Airport, was initiated in July 2015.

The government continued to channel resources to livelihood development initiatives through Samurdhi and Maganeguma programmes. Accordingly, the amount of Samurdhi allowance was increased by 100 per cent to Rs. 3,000 per month from Rs. 1,500 per month commencing from January 2015. This was further increased to Rs. 3,500 per month with effect from April 2015. In addition, an electronic fund transfer system was introduced to expedite the process of crediting Samurdhi subsidy to the individual accounts of the beneficiaries with effect from April 2015. Further, an islandwide survey is being carried out with the view of identifying needy beneficiaries of Samurdhi allowance. 'Divineguma Diriya Saviya', a special loan scheme that was implemented through Divineguma Community Based Banks, was strengthened further to support low income families in order to improve their living standards. Further, allocations were also made for the development of sectors, such as agriculture, livestock, fisheries and micro enterprises under the Divineguma Livelihood Development Programme. In addition, the Maganeguma Programme also continued during the year with the view of further developing rural and regional infrastructure facilities.

Several reform initiatives were introduced to improve the operations and strengthen balance sheets of major SOBEs during 2015. Accordingly, the re-fleeting programme of SriLankan Airlines (SLA) that was initiated in 2014, by replacing the entire wide body fleet with a new fleet in order to improve operational efficiency and to provide modern passenger comforts, was continued during the year. The procurement process of Ceylon Petroleum Corporation (CPC) was reformulated enabling them to enter into term contracts for refined petroleum products and select the term contract suppliers through a competitive bidding process. Further, preparation of a pricing formula to determine the domestic selling price of petroleum products was at discussion level. Meanwhile, the financial position of the Ceylon Electricity Board (CEB) and the National Water Supply & Drainage Board (NWS&DB) was strengthened by converting Treasury loans to equity. Further, electricity tariff based on Time of Use (TOU) for domestic consumers connected with 3-phase 30A or above was introduced as an optional tariff by CEB.

The government debt management strategy focused on ensuring the availability of funding for the government's financing needs at the lowest possible cost, while minimising the risks associated with the public debt appropriately. During the year, acceptance of investment in government securities through direct placements was abandoned and replaced with a fully auction based system. Steps were taken to maintain a proper mix of domestic and foreign debt and to reduce maturity mismatches in the debt portfolio. Accordingly, maturing Treasury bills were replaced by medium to long term Treasury bonds mainly to reduce the debt rollover risk, and to increase the Average Time to Maturity (ATM) of the domestic debt portfolio. Sri Lanka Development Bonds (SLDBs), which is an instrument that makes foreign currency denominated borrowing mainly through the domestic banking system, were also used largely as a regular borrowing instrument to reduce the pressure on domestic market interest rates.

The government raised US dollars 2.15 billion through the issuance of International Sovereign Bonds (ISBs) during 2015. In May 2015, the government successfully issued US dollars 650 million of ISBs with a maturity period of 10 years at a progressively lower yield rate of 6.125 per cent per annum. In addition, in October 2015, another US dollars 1.5 billion of ISBs was issued at a yield rate of 6.85 per cent per annum with a maturity period of 10 years. This was the largest offering of Sri Lanka within a year in the international bond market since the first ISB issued in 2007.

Although international sovereign rating agencies affirmed Sri Lanka's credit ratings in 2015, Fitch Ratings and Standard & Poor's Ratings Services made some revisions to their ratings in early 2016 citing increasing risks stemming from both external and domestic fronts. Accordingly, the Fitch Ratings downgraded Sri Lanka's foreign currency rating to 'B+' with a 'negative outlook' from 'BB-' and the 'stable outlook' which was affirmed by them in 2015. Increasing refinancing risks, significant debt maturities, weaker public finances, decline in foreign exchange reserves and high foreign currency debt portion were considered as areas of concern by Fitch Ratings. However, Fitch Ratings has noted that Sri Lanka's macroeconomic environment continued to remain strong as reflected by favourable GDP growth, the level of human development and clean external debt servicing record with continuing political stability. Standard & Poor's Ratings Services revised the outlook on the long term rating to 'negative' from 'stable' and affirmed its 'B+' long term and 'B' short term sovereign credit ratings in March 2016, citing rising pressure on Sri Lanka's external liquidity and weakened public finances. However, 'B1' sovereign rating with a 'stable' outlook, which was affirmed by Moody's Investors Service in 2015 supported by the high and robust growth over the rating horizon, remained unchanged.

Weaker fiscal performance shown during 2015 is likely to continue in 2016 as well unless necessary fiscal adjustments are introduced immediately to address fundamental weaknesses in the fiscal sector. Although the declining trend of government revenue to GDP ratio was reversed in 2015, the sustainability of revenue collection is at a risk in the absence of the one off levies introduced in 2015, which amounted to around 0.4 per cent of GDP and possible slow down in motor vehicle imports, which generated a significant amount of revenue in 2015. Meanwhile, the size of the wage bill of government employees, which is the single largest item of the recurrent expenditure, provides only a limited fiscal space for other government expenditure, including much needed public investment. Further, a contributory pension scheme has been proposed in the Budget for 2016 for the new recruits to the government which would ensure pension at their retirement in an environment of rising ageing population in the country, while reducing the pressure on annual budgetary allocations. The cost of borrowings of the government is likely to increase in the medium term as a result of the rising international interest rates with the rate hike announced by the US Federal Reserve in December 2015 and other international developments and rising domestic interest rates. In this background, the necessity of reducing the budget deficit to 5.4 per cent of GDP in 2016, instead of the targeted level of 5.9 per cent of GDP in the Budget for 2016 was announced in March 2016, while proposing several changes to the tax measures introduced in the original Budget for 2016 to enhance revenue collection. The effective implementation of these policies is essential in the process of strengthening fiscal consolidation.

6.3 Government Budgetary Operations

Revenue and Grants

Revenue

In 2015, total government revenue to GDP ratio reversed its declining trend reported since 2011 with its increase to 13.0 per cent from 11.4 per cent in 2014. This increase was entirely due to the increase in tax revenue amidst the decline in non tax revenue collection in 2015. It was only marginally below the annual target of 13.3 per cent of GDP stipulated in the Budget for 2015. Tax revenue as a percentage of GDP increased to 12.1 per cent in 2015 from 10.1 per cent in 2014 while non tax revenue declined to 0.9 per cent of GDP in 2015 from 1.4 per cent in 2014. In nominal terms, total revenue increased by 21.7 per cent to Rs. 1,454.9 billion in 2015 from Rs. 1,195.2 billion in 2014 mainly due to the increase in revenue collection from excise duties, income tax and import duties. The decline in non tax revenue was mainly attributed to the decline in profit and dividend transfers of SOBEs and declined interest and rent income although revenue from fees and charges increased during the year.

The declining trend of tax revenue to GDP ratio also reversed in 2015, where it increased to 12.1 per cent of GDP in comparison to 10.1

Chart 6.2 Composition of Government Revenue - 2015

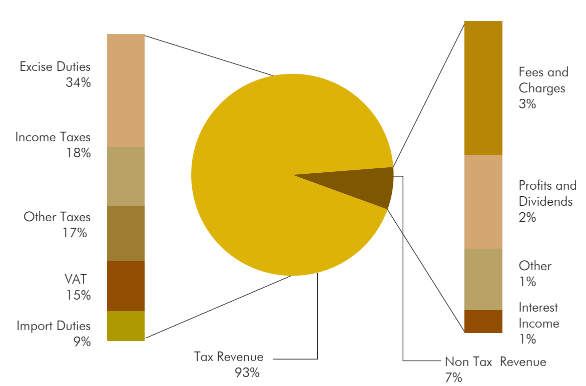


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Table 6.2 Economic Classification of Government Revenue

Item	2014	2015 Approved Estimates	2015 Provisional	2016 Approved Estimates
	Rs. million			
Tax Revenue (a)	1,050,362	1,337,000	1,355,779	1,646,000
Income Taxes	198,115	310,600	262,583	251,700
VAT	275,350	296,000	219,700	240,000
Excise Taxes	256,691	343,435	497,652	556,235
Import Duties	81,108	85,000	132,189	125,000
Other Taxes	239,099	301,965	243,655	473,065
Non Tax Revenue	144,844	167,700	99,099	176,970
Total Revenue	1,195,206	1,504,700	1,454,878	1,822,970
	As a percentage of GDP			
Tax Revenue (a)	10.1	11.8	12.1	13.2
Income Taxes	1.9	2.7	2.3	2.0
VAT	2.6	2.6	2.0	1.9
Excise Taxes	2.5	3.0	4.4	4.4
Import Duties	0.8	0.8	1.2	1.0
Other Taxes	2.3	2.7	2.2	3.8
Non Tax Revenue	1.4	1.5	0.9	1.4
Total Revenue	11.4	13.3	13.0	14.6

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

Source: Ministry of Finance

per cent of GDP recorded in 2014. In nominal terms, tax revenue increased by 29.1 per cent to Rs. 1,355.8 billion in 2015 from Rs. 1,050.4 billion in 2014 exceeding the budgetary target of Rs. 1,337.0 billion. This was mainly attributed to higher revenue collection from import related taxes, especially motor vehicles, and increase in corporate and non corporate income tax. Accordingly, revenue collection from major sources, i.e. excise duty, corporate and non corporate income tax and import duties increased significantly during the year. Revenue from other sources, such as Cess levy, SCL and Telecommunication levy, also increased during the year. However, revenue collection from VAT on both domestic activities and imports, PAL and WHT declined compared to the previous year. The share of tax revenue in total revenue increased to 93.2 per cent in 2015 from 87.9 per cent in the previous year reflecting increased tax revenue at a higher rate and declined non tax revenue. Revenue from indirect taxes increased by 28.3 per cent during the year though it accounted only for 80.6 per cent of the total tax revenue in comparison to 81.1 per cent recorded in the previous year. Meanwhile, the share of revenue from direct taxes in the total tax revenue increased to 19.4 per cent from 18.9 per cent recorded in 2014 benefitting from revenue collection from one off income taxes, including the one off Super Gain tax, introduced in 2015.

Revenue from income taxes as a percentage of GDP increased to 2.3 per cent mainly due to increase in corporate and non corporate income taxes, including PAYE, although a decline showed in revenue collection from WHT. In nominal terms, revenue from direct taxes increased by 32.5 per cent to Rs. 262.6 billion from Rs. 198.1 billion in the previous year. Revenue generated from corporate and non corporate income tax increased significantly by 67.2 per cent to Rs. 167.3 billion from Rs. 100.0 billion in the previous year, mainly due to revenue collection from one off taxes introduced in 2015, including Super Gain tax, which generated Rs. 50.0 billion during the year. Further, continuous increase in domestic economic activities relating to the manufacturing products and tobacco sectors contributed to the increase in corporate tax revenue. Revenue generated from PAYE recorded a growth of 17.5 per cent to Rs. 26.2 billion from Rs. 22.3 billion in 2014, with the strengthening of the auditing process in IRD, although the tax free threshold for annual employment income was increased to Rs. 750,000 per annum from Rs. 600,000 per annum. Revenue from WHT declined by 9.6 per cent in nominal terms to Rs. 62.9 billion, lowering its share in tax revenue to 4.6 per cent in 2015 from 6.6 per cent in 2014. This was mainly due to the imposition of 2.5 per cent of single WHT rate on interest on deposits instead of multiple tax rates up to 10.0 per cent based on the interest income and relatively lower interest rates that prevailed in the domestic market. Revenue generated from ESC also declined marginally to Rs. 6.1 billion. The share of income tax revenue within total tax revenue increased to 19.4 per cent in 2015 from 18.9 per cent in 2014 reflecting government efforts to increase direct tax revenue to total tax revenue. Further, as a percentage of total revenue also, it increased to 18.0 per cent in 2015 from 16.6 per cent in 2014.

Revenue collection from VAT declined significantly mainly due to the reduction of the VAT rate from 12 per cent to 11 per cent with effect from January 2015 and the removal of VAT on excisable items, such as motor vehicles, cigarettes and liquor. Accordingly, revenue from VAT as a percentage of GDP declined to 2.0 per cent in 2015 from 2.6 per cent recorded in 2014. In nominal terms also, the revenue from VAT declined by 20.2 per cent to Rs. 219.7 billion from Rs. 275.4 billion in the previous year. Accordingly, VAT revenue generated from domestic economic activities declined by 6.8 per cent to Rs. 130.5 billion, while revenue from VAT on imports also declined by 34.1 per cent to Rs. 89.2 billion compared to the previous year. Revenue collection from VAT as a share of total tax revenue declined to 16.2 per cent in 2015 from 26.2 per cent in the previous year, which was the highest single contributor to tax revenue in previous years. Further, as a percentage of total revenue also, revenue from VAT declined to 15.1 per cent in 2015 from 23.0 per cent in 2014.

Revenue from excise duties became the highest single contributor to total tax revenue in 2015, mainly reflecting the impact of imposing composite higher excise tax rates on motor vehicles, liquor and cigarettes. This contributed to 36.7 per cent of total tax revenue and 34.2 per cent of total revenue during the year. Accordingly, revenue from excise duties as a percentage of GDP also increased to 4.4 per cent in 2015 from 2.5 per cent in 2014, while in nominal terms it increased significantly by 93.9 per cent recording Rs. 497.7 billion compared to Rs. 256.7 billion recorded in the previous year. Revenue from excise duty on motor vehicles, the largest contributor to the excise tax revenue, increased by 167.4 per cent to Rs. 263.5 billion. This was a combined outcome of imposing a higher rate of excise tax in lieu of VAT, NBT, Cess, Customs duty and PAL on motor vehicles with effect from the latter part of 2014 and increase in importation of motor vehicles by 51.6 per cent benefiting from the reduction in taxes on motor vehicles less than 1000 cc, relatively low interest rates, increased disposable income and depreciation of Japanese yen during the year. Further, imposition of higher excise duty on the manufacture of liquor in place of VAT and NBT from the latter part of 2014, the upward revisions of excise duty rates on both hard and malt liquor and the increase in production of hard liquor by 17.7 per cent during the year contributed to the increase in excise duty revenue from liquor by 52.3 per cent during the year. Enhanced surveillance by relevant authorities also helped to obtain this increase. Revenue generated from excise duties on cigarettes increased by 39.8 per cent to Rs. 80.0 billion mainly due to imposition of excise duties at a higher rate on both importation and manufacturing of cigarettes in place of VAT and NBT towards the later part of 2014 and increase in cigarettes sales by 10.1 per cent in 2015 compared to the volume base decline that prevailed during the last three years. Revenue generated from excise duties on petroleum products also increased by 56.9 per cent to Rs. 45.1 billion.

In 2015, revenue collection from import duties and SCL increased to 1.6 per cent of GDP in 2015 from 1.2 per cent in 2014. In nominal terms, revenue from import duties increased by 63.0 per cent to Rs. 132.2 billion in 2015 from Rs. 81.1 billion recorded in 2014, while revenue from SCL increased by 9.0 per cent to Rs. 52.3 billion from Rs. 48.0 billion in 2014. Imposition of import duty and Cess on the import of liquor in lieu of VAT and NBT and increase in imports which import duty is applicable contributed to increase in revenue from import duties. Increase in revenue from SCL was mainly accounted for time to time revision of SCL considering the domestic market supply conditions. The share of import duties in tax revenue increased to 9.8 per cent in 2015 from 7.7 per cent recorded in 2014. However, revenue collection from SCL as a percentage of total tax revenue declined to 3.9 per cent from 4.6 per cent recorded in the previous year mainly due to the slower progress in revenue collection from SCL compared to other taxes.

Revenue from NBT as a percentage of GDP remained unchanged at 0.4 per cent in 2015 as in the previous year, while in nominal terms it increased marginally in 2015 to Rs. 45.0 billion during the year. This was a combined outcome of increased imports which NBT is applicable despite the removal of NBT on motor vehicles, liquor and cigarettes from the latter part of 2014 and increase in the threshold of liable turnover of NBT to Rs. 3.75 million per quarter from Rs. 3 million per quarter. Accordingly, revenue from NBT on imports increased by 5.4 per cent to Rs. 17.0 billion although revenue generated from NBT on domestic goods and services declined marginally by 1.6 per cent to Rs. 28.0 billion in 2015. Meanwhile, the share of revenue from NBT in total tax revenue declined to 3.3 per cent in 2015 from 4.2 per cent recorded in 2014.

Revenue from other taxes showed a mixed performance in 2015. Accordingly, revenue from PAL declined to 0.5 per cent of GDP in 2015 from 0.7 per cent of GDP in 2014, while revenue from Cess and Telecommunication levy as a percentage of GDP remained unchanged during the year compared to the previous year at 0.4 per cent and 0.3 per cent, respectively. Revenue from PAL declined by 14.6 per cent to Rs. 58.6 billion in 2015, mainly due to imposition of excise tax as a composite tax on motor vehicles instead of PAL and other taxes. However, revenue from Cess increased by 19.6 per cent to Rs. 46.3 billion mainly on account of imposing Cess on new items and increasing Cess rates on selected items. Further, revenue from Telecommunication levy in nominal terms increased by 6.4 per cent to Rs. 33.4 billion during the year, mainly due to expansion in telecommunication related activities.

Non tax revenue collection declined as a percentage of GDP as well as in nominal terms mainly due to decline in profit and dividend transfers from SOBEs as well as the Central Bank. Accordingly, non tax revenue to GDP ratio declined to 0.9 per cent in 2015 from 1.4 per cent recorded in 2014. The share of non tax revenue in total government revenue declined significantly to 6.8 per cent from 12.1 per cent in the previous year, recording a decline of 31.6 per cent to Rs. 99.1 billion in nominal terms. Profit and dividend transfers of SOBEs in non tax revenue declined by 36.3 per cent to Rs. 29.8 billion in 2015 from Rs. 46.8 billion in 2014. Revenue from interest and rent also declined by 46.3 per cent to Rs. 7.3 billion during the year mainly due to the low interest rates that prevailed in the market. However, revenue from fees and charges, and social security contributions increased by 19.4 per cent and 2.0 per cent, respectively compared to the previous year.

Grants

Total foreign grants received during the year declined to Rs. 6.0 billion in 2015 from Rs. 9.4 billion in 2014. This was significantly below the annual estimate of Rs. 30.0 billion for 2015. Grants received from multilateral donors declined to Rs. 4.4 billion from Rs. 5.4 billion in 2014, though the share of grants from multilateral sources in total grants increased to 73.2 per cent in 2015 from 57.7 per cent in 2014 since grants from bilateral sources declined significantly to Rs. 1.6 billion in 2015 from Rs. 4.0 billion in the previous year. Foreign grants were mainly received from International Development Association (IDA), Government of Japan and World Food Programme.

Expenditure and Net Lending

Total expenditure and net lending as a percentage of GDP increased to 20.5 per cent in 2015 from 17.2 per cent in 2014 due to increase in both recurrent expenditure, and capital expenditure and net lending. Accordingly, the increase in total expenditure and net lending was a combined outcome of the increase in recurrent expenditure by 2.5 percentage to 15.2 per cent, while capital expenditure and net lending increased by 0.8 percentage points to 5.3 per cent of GDP. In nominal terms total expenditure and net lending increased by 27.5 per cent to Rs. 2,290.4 billion in 2015 from Rs. 1,795.9 billion in 2014. Public investment, which amounted to 5.4 per cent of GDP in 2015, was significantly higher than 4.7 per cent of GDP recorded in 2014.

Recurrent expenditure as a percentage of GDP increased to 15.2 per cent in 2015 from 12.7 per cent recorded in 2014 reflecting increases in all major recurrent expenditure items. In nominal terms, recurrent expenditure increased by 28.6 per cent to Rs. 1,701.7 billion in 2015 from Rs. 1,322.9 billion in 2014 exceeding the target of Rs. 1,552.0 billion given in the Budget for 2015. Increase in salaries and wages mainly contributed to the increase in recurrent expenditure, while interest payments and current transfers and subsidies also increased compared to the previous year as well as to the target for 2015.

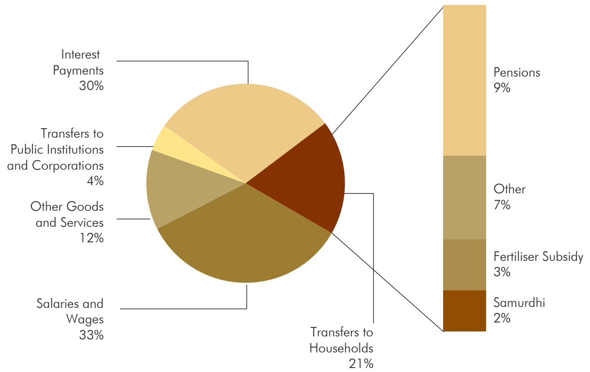
Expenditure on salaries and wages, the single largest expenditure item in recurrent expenditure, increased to 5.0 per cent of GDP in 2015 from 4.2 per cent of GDP in 2014. In nominal terms also, it increased by 27.4 per cent to Rs. 561.7 billion reflecting the increase in salaries and wages at all levels of employment in the government sector. This was mainly due to the granting of an interim allowance of Rs. 3,000 per month with effect from November 2014 and increasing it further by Rs. 5,000 per month with effect from February 2015 and by another Rs. 2,000 per month with effect from June 2015. Accordingly, the total increase was Rs. 10,000 per person per month which caused an additional cost of around Rs. 160.0 billion in the government Budget. Further, granting of executive allowances for executive officers category also contributed to this increase. Salaries and wages paid to central government employees, including defence personnel, increased by 28.7 per cent to Rs. 410.9

Table 6.3 Economic Classification of Expenditure and Lending Minus Repayments

Item	2014	2015 Approved Estimates	2015 Provisional	2016 Approved Estimates
	Rs. million			
Recurrent Expenditure	1,322,898	1,552,035	1,701,658	1,717,239
Expenditure on Goods and Services	568,829	716,351	772,563	757,722
o/w Salaries and Wages	440,982	570,000	561,730	581,341
Interest Payments	436,395	425,030	509,674	520,452
Foreign	108,461	76,000	115,386	79,233
Domestic	327,934	349,030	394,289	441,219
Current Transfers and Subsidies	317,674	410,654	419,420	439,065
o/w To Households and Other Sectors	251,665	350,805	345,483	371,392
Samurdhi	15,042	41,000	39,994	43,950
Pensions	126,136	159,890	155,320	167,845
Fertiliser Subsidy	31,802	35,000	49,571	35,000
Other	78,685	114,915	100,598	124,597
Capital Expenditure	459,855	472,928	588,175	859,482
Acquisition of Real Assets	252,303	226,571	313,260	622,066
Capital Transfers	207,551	246,357	274,916	237,416
Lending Minus Repayments	13,112	9,113	561	1,399
Total Expenditure and Net Lending	1,795,865	2,034,076	2,290,394	2,578,119
	As a percentage of GDP			
Recurrent Expenditure	12.7	13.7	15.2	13.7
Expenditure on Goods and Services	5.4	6.3	6.9	6.1
o/w Salaries and Wages	4.2	5.0	5.0	4.7
Interest Payments (a)	4.2	3.8	4.6	4.2
Foreign	1.0	0.7	1.0	0.6
Domestic	3.1	3.1	3.5	3.5
Current Transfers and Subsidies	3.0	3.6	3.8	3.5
o/w To Households and Other Sectors	2.4	3.1	3.1	3.0
Samurdhi	0.1	0.4	0.4	0.4
Pensions	1.2	1.4	1.4	1.3
Fertiliser Subsidy	0.3	0.3	0.4	0.3
Other	0.8	1.0	0.9	1.0
Capital Expenditure	4.4	4.2	5.3	6.9
Acquisition of Real Assets	2.4	2.0	2.8	5.0
Capital Transfers	2.0	2.2	2.5	1.9
Lending Minus Repayments	0.1	0.1	...	...
Total Expenditure and Net Lending	17.2	18.0	20.5	20.6

Source : Ministry of Finance

Chart 6.3 Composition of Government Recurrent Expenditure - 2015



billion, while the central government contribution to salaries and wages of the Provincial Council employees increased by 23.8 per cent to Rs. 150.8 billion during the year. The share of salaries and wages in total recurrent expenditure accounted for 33.0 per cent in 2015 compared to 33.3 per cent in 2014.

Expenditure on other goods and services as a percentage of GDP increased to 1.9 per cent from 1.2 per cent in 2014, while in nominal terms it increased by 64.9 per cent to Rs. 210.8 billion in 2015. Expenditure incurred on other goods and services by the central government and defence, including public order and safety, increased by 54.6 per cent to Rs. 190.9 billion in 2015 from Rs. 123.4 billion in 2014. This accounted for 90.5 per cent of total expenditure on other goods and services during the year.

In 2015, interest payments as a percentage of GDP increased to 4.6 per cent from 4.2 per cent in the previous year, as a result of higher borrowings due to slowdown in government revenue and depreciation of the rupee against other foreign currencies. The interest expenditure increased in nominal terms by 16.8 per cent to Rs. 509.7 billion in 2015 from Rs. 436.4 billion in 2014 contributing to 30.0 per cent of total recurrent expenditure. The interest payments on domestic debt increased by 20.2 per cent in 2015 to Rs. 394.3 billion from Rs. 327.9 billion in 2014, mainly due to increased outstanding domestic debt by 15.9 per cent to Rs. 4,959.2 billion as at end 2015. Meanwhile, interest payments on Treasury bonds increased by 42.4 per cent to Rs. 295.8 billion in 2015 from Rs. 207.7 billion in 2014 as a result of the increase in average interest rates to 9.0 per cent in 2015 from 7.3 per cent in 2014 and the increase in Treasury bond stock by 16.2 per cent as at end 2015. Interest payments on Treasury bills declined by 26.8 per cent to Rs. 57.7 billion in 2015 from Rs. 78.8 billion in 2014 reflecting reduced reliance on Treasury bills and decline in average interest rate to 8.8 per cent from 11.3 per cent in the previous year. In addition, interest payments on SLDBs and Rupee loans amounted to Rs. 23.4 billion and Rs. 4.6 billion respectively, in 2015. Consequently, the share of interest payments on domestic debt in total interest payments increased to 77.4 per cent in 2015 compared to 75.1 per cent in the previous year. Meanwhile, interest payments on foreign debt increased by 6.4 per cent to Rs. 115.4 billion in 2015 from Rs. 108.5 billion in 2014. This was a combined outcome of the increase in the foreign debt stock by 13.8 per cent as at end 2015 and the decline in the average interest rate on foreign debt to 3.3 per cent in 2015 from 3.5 per cent in 2014.

Total current transfers and subsidies as a percentage of GDP increased to 3.8 per cent in 2015 from 3.0 per cent in 2014 with a significant increase in current transfers to households and other sectors. Current transfers and subsidies in nominal terms also increased by 32.0 per cent to Rs. 419.4 billion in 2015 in comparison to Rs. 317.7 billion recorded in 2014. Current transfers to households and other sectors accounted for 82.4 per cent of total current transfers, while transfers to public institutions and public corporations accounted for 11.0 per cent and 6.7 per cent respectively, during 2015.

Current transfers to households including pension payments, increased to 3.1 per cent of GDP in 2015 from 2.4 per cent in 2014. In nominal terms, current transfers to households increased by 37.3 per cent to Rs. 345.5 billion in 2015 from Rs. 251.7 billion in 2014. Out of this, pension payments increased by 23.1 per cent to Rs. 155.3 billion compared to 2014 with the increase in monthly allowance for pensioners by Rs. 2,500 with effect from November 2014 and Rs. 1,000 per month with effect from April 2015. Further, the rectification of pension anomalies of public servants who retired before the implementation of Public Administration Circular No. 06/2006, with effect from July 2015, and increase in the number of pensioners during the year by 14,120 to 560,499 as at end 2015 also contributed to the increase in the pension bill. Expenditure on fertiliser subsidy also increased significantly by 55.9 per cent to Rs. 49.6 billion in 2015 from Rs. 31.8 billion in 2014 mainly due to overdue payments made to fertiliser companies. Expenditure on Samurdhi programme increased significantly by 165.9 per cent to Rs. 40.0 billion during the year compared to Rs. 15.0 billion recorded in the previous year mainly due to the increase in the allowance despite the decline in Samurdhi beneficiaries. In addition, expenditure on welfare programmes for disabled soldiers increased by 28.4 per cent to Rs. 23.4 billion in 2015 from Rs. 18.2 billion in 2014. Programmes targeting school children, such as providing school textbooks, uniforms and dhamma school books, were among the other major subsidies provided to households during 2015.

During the year, current transfers to public corporations increased while current transfers to public institutions declined marginally. Current transfers to public corporations increased by 43.7 per cent to Rs. 28.0 billion due to increase in transfers to cover operational losses of the Department of Sri Lanka Railways and the Department of Posts. However, current transfers to public institutions declined marginally by 1.2 per cent to Rs. 46.0 billion during the year reflecting efforts taken by the government to improve the efficiency of public institutions.

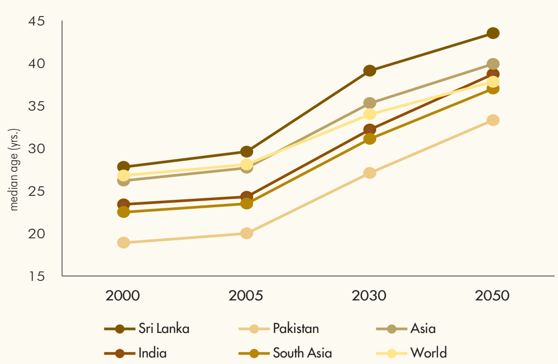
Capital expenditure and net lending increased to 5.3 per cent of GDP from 4.5 per cent in the previous year due to continuation of selected projects. In nominal terms, capital expenditure and net lending increased by 24.5 per cent to Rs. 588.7 billion during the year in comparison to Rs. 473.0 billion recorded in the previous year. Meanwhile, public investment, which includes capital expenditure and lending of the government, increased to 5.4 per cent of GDP in 2015 from 4.7 per cent of GDP in 2014, while it increased by 23.9 per cent to Rs. 602.8 billion in 2015 in comparison to Rs. 486.6 billion recorded in 2014. Expenditure incurred by Ministries and Departments on the acquisition of real assets (purchase of capital assets and construction and development of fixed assets) increased by 24.2 per cent to Rs. 313.3 billion in 2015 from Rs. 252.3 billion recorded in 2014. Capital transfers increased by 32.5 per cent mainly due to higher capital transfers to public institutions. Meanwhile, the on lending of the government declined by 45.5 per cent to Rs. 14.6 billion in 2015 in comparison to Rs. 26.8 billion recorded in 2014.

Public investment in economic services amounted to Rs. 429.0 billion, accounting for 71.2 per cent of total public investment during the year, while remaining as the key component of the public investment programme as in the previous year. A significant amount of investments was made on roads, bridges, railways, water supply and irrigation projects. Accordingly, Phase II of the OCH from Kaduwela to Kadawatha was opened during the year, while continuing a number of road projects throughout the country. Investments were also made to improve the railway sector. Ongoing irrigation schemes such as Moragahakanda and Kaluganga projects were continued during the year, in addition to the continuation of the development of minor irrigation projects.

BOX 9 Population Ageing: Challenges and the Way Forward

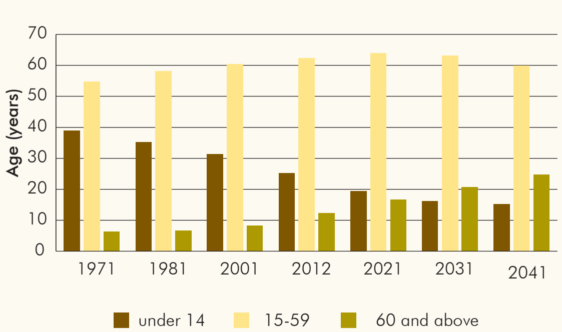
Sri Lanka's population is the oldest in South Asia and is also one of the fastest ageing populations in the world (UN, 2015). In 2015, the population of Sri Lanka reached 20.96 million, out of which 13.9 per cent was estimated to be over 60 years old. This figure is anticipated to increase rapidly to 28.6 per cent and 40.0 per cent by 2050 and 2100, respectively (UN, 2015). The unique demographic dynamics of Sri Lanka, featuring a sharp decline in the fertility rate and an increase in life expectancy driven by several decades of investments made on welfare, education and health, has made it an outlier in the South Asian region. The age structure transition has created a demographic dividend today, where the share of working age population (aged 15-64) is significantly larger than the share of the dependents (aged less than 15 and older than 64 years), which is favourable for economic growth. However, this will disappear before long, due to rapid population ageing.[1]

Chart B 9.1 Median Age of the Population in Selected Countries/Regions



Source: UN (2015)

Chart B 9.2 Population Distribution by Broad Age Group



Sources: Department of Census and Statistics and De Silva (2015)

1 The demographic dividend is expected to exist for the period 1991-2031, if working age population is considered to be until 65 years whereas it lasts only until 2017, if mandatory retirement age is considered to be 60 years (De Silva, 2015).

Ageing Leads to Multidimensional Challenges

Contrary to developed countries, Sri Lanka is facing multidimensional challenges emanating from this unprecedented demographic transition while having a relatively low level of per capita GDP and less developed welfare facilities for elderly. Vodopivec and Arunatilake, (2008) report that only one tenth of the elderly population in Sri Lanka receive pensions as their major source of income and this remains approximately the same in 2015. Therefore, family support for the elderly will continue to be important in the next few decades as well. However, with rapid urbanisation that favours small families, family support for the elderly tend to decline in Sri Lanka. Rural-urban migration together with increased women's participation in the labour force further stretches the elderly support even in rural areas. In addition, depleting savings as well as escalation of pension and health expenditures will eventually exert inevitable pressure on the government budget and the spillover effects of these conditions remain serious concerns. The tendency that an elderly individual would dis-save more compared to an average working-age individual will have a significant negative effect on capital formation. Decline in the share of working age population due to ageing could translate to a labour force contraction which would hinder economic growth. It could also reduce the income tax base, and household income, and thereby further erode the government tax revenue.

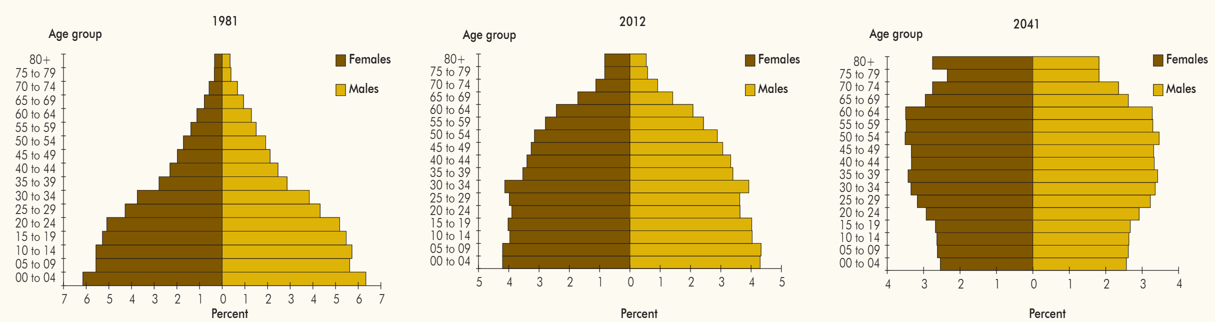
Since different age groups have different needs and productive capacities, a country's economic characteristics are likely to change as its population ages. With increasing longevity and ageing populations, retirement policy, pension and health-care finance, the efficiency of labour and capital markets, and the structure of regional and global economic systems are likely to adjust. The magnitude of these shifts may in turn depend on the voting power and other political behaviour of an ageing electorate whose needs and interests may differ from those of younger people. Individuals over 60 years of age tend to work and save less, implying that they would offer less number of working hours and little capital to the economy. They also require more healthcare and rely on social pensions for a large part of their income. Those aged 80 or over also have specific needs and with declining health, the need for fulltime care also prone to increase. In many cases, this also increases the need for financial support, as private savings tend to vanish rapidly for individuals with long life spans. However, if people advancing into their 60s and 70s are healthier than preceding generations, the demands for healthcare will be less intense and many will be able to work and contribute to the economy for longer than expected.

Sri Lanka is already facing labour shortages in some sectors including construction, agriculture, health and hotel/tourism. On top of labour migration, population ageing is also partly attributable for the labour shortage and this trend would be more visible in the next few decades. With rising education and income levels, local youth tend to seek white collared jobs mainly due to comparatively higher wages and recognition. As a result, it is observed that foreign migrant labour is engaged in certain agricultural activities and in the construction sector. Hence, a comprehensive labour market policy needs to be drawn and implemented taking in to account the demographic transition, aspirations of the new generation, labour migration, fiscal implications and domestic needs.

to improve as parents and tax-payers can invest more in less number of children. A fifth channel by which society can adjust to age structure change is by enabling elders to take part in business activities. Owing to the fact that the present older generation is healthier than past generations, they can work longer productively. Private sector can encourage elderly workers to continue with work and in return benefit from their experience.

The population ageing process in Sri Lanka is nearly irreversible, however, it may not necessarily affect economic growth if proper counterbalancing measures are implemented. Strategies and policies aimed at increasing overall productivity, raising labour force participation particularly among women and elderly workers, and enhancing labour quality are broadly useful

Chart B 9.3 **Age-Sex Structure of the Sri Lankan Population in 1981, 2012 and 2041**



Sources: Department of Census and Statistics, De Silva (2015)

It is also noted that the ageing population in Sri Lanka is becoming increasingly feminised, owing to their increased life expectancy compared to males (De Silva, 2015). Though the female life expectancy today exceeds male life-expectancy by a wide margin of about 6 years, a majority of this female elderly category are economically inactive, contrary to males in the same category. Accordingly, proactive policy action focused on these vulnerable aged female dependents is also needed.

Behavioral adjustments in response to population ageing and way forward

Research findings suggest that individual behaviour can be expected to change along several dimensions in response to low fertility and improved life expectancy (Bloom et al., 2010). First, with better health, as reflected by higher life expectancy, elderly workers tend to work more without retiring early. Second, though the individuals do not intend to work longer, increased life expectancies necessitate higher savings over the working life to support old age. Third, low fertility rates as reflected by small family sizes allow more women to enter the labour force. Fourth, demographic structure transformation can enhance human capital formation since school enrolment and educational attainment tend

in this sense (Vodopivec and Arunatilake, 2008). In addition to formal contribution to economic growth, the elderly population take part in many domestic activities including childcare, household supportive activities, financial support to the households through irregular work and pension while helping the society through sharing knowledge and experience, and engaging in social services. Meanwhile, it is important to make sure that right to work, right to security and right to choose are secured for elderly workers. Though some studies have been contributed to certain aspects of population ageing, it is crucial to conduct ageing specific in-depth surveys and research studies in Sri Lanka to better understand the needs of the elderly while uncovering ways and means by which they can actively contribute to the growth of the country, and thereby ensuring a smooth demographic transition.

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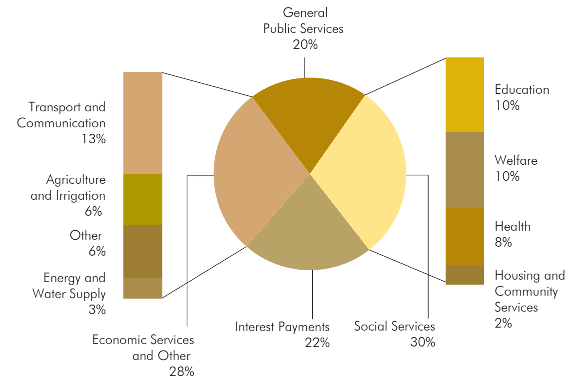
Table 6.4 Functional Classification of Expenditure

Item	2014	2015 Approved Estimates	2015 Provisional	2016 Approved Estimates
	Rs. million			
Recurrent Expenditure	1,322,898	1,552,035	1,701,658	1,717,239
General Public Services	334,354	451,453	414,275	434,415
Civil Administration	73,282	81,974	105,661	113,983
Defence	195,401	300,352	233,733	237,040
Public Order and Safety	65,671	69,127	74,881	83,392
Social Services	446,440	552,952	564,190	606,323
Education	139,787	166,922	169,600	178,938
Health	116,151	137,726	140,560	155,202
Welfare	165,467	224,848	230,035	247,650
Community Services	25,036	23,457	23,995	24,532
Economic Services	105,030	99,758	173,430	133,621
Agriculture and Irrigation	46,782	61,029	91,267	70,047
Energy and Water Supply	394	716	5,479	1,343
Transport and Communication	41,129	21,799	57,028	49,839
Other	16,726	16,215	19,656	12,391
Other	437,073	447,872	549,763	542,881
o/w Interest Payments	436,395	425,030	509,674	520,452
Capital Expenditure and Lending	486,610	492,341	602,767	869,880
General Public Services	43,620	53,504	48,699	52,779
Civil Administration	40,282	47,833	44,886	46,314
Public Order and Safety	3,338	5,671	3,813	6,465
Social Services	112,338	133,891	124,369	289,355
Education	50,363	45,807	55,447	156,492
Health	22,252	41,357	37,230	78,950
Housing	7,769	9,828	7,811	9,939
Community Services	31,954	36,898	23,882	43,975
Economic Services	330,136	304,400	429,030	525,578
Agriculture and Irrigation	57,099	66,305	54,447	128,993
Energy and Water Supply	51,314	22,607	55,499	49,529
Transport and Communication	177,471	201,047	239,279	207,413
Other	44,252	14,441	79,805	139,643
Other	516	547	668	2,167
Total Expenditure and Lending	1,809,508	2,044,376	2,304,425	2,587,119
	As a percentage of GDP			
General Public Services	3.6	4.5	4.1	3.9
Social Services	5.3	6.1	6.2	7.2
Economic Services	4.2	3.6	5.4	5.3
Other	4.2	4.0	4.9	4.4
o/w Interest Payments (a)	4.2	3.8	4.6	4.2
Total Expenditure and Lending	17.3	18.1	20.6	20.7

Source : Ministry of Finance

Public investment in social services increased by 10.7 per cent to Rs. 124.4 billion in 2015, of which Rs. 55.4 billion was spent on education, while Rs. 37.2 billion was incurred on health services. Public investment in the education sector was mainly on 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 and equipment with the financial assistance of multinational development partners.

Chart 6.4 Total Expenditure by Function - 2015



The government continued the implementation of a number of regional and rural infrastructure development projects aiming at reducing regional disparities. Accordingly, expenditure on Divi Neguma Development programme, which is aimed at developing a self-reliant household economy, amounted to Rs. 848 million in 2015. Gama Neguma programme also continued during the year incurring Rs. 4.4 billion and several other provincial development programmes were also continued during the year.

Key Fiscal Balances

In 2015, all key fiscal indicators deviated significantly from the annual targets mainly reflecting the expansion in recurrent expenditure coupled with the shortfall in the revenue. Accordingly, the overall budget deficit increased to 7.4 per cent of GDP (Rs. 829.5 billion) in 2015 in comparison to the annual target of 4.4 per cent of GDP envisaged in the Budget for 2015 and 5.7 per cent recorded in 2014. The lower than expected government revenue and overrun in recurrent expenditure due to increase in salaries and wages of the public sector, high welfare expenditure and the higher than estimated interest payments have exerted the pressure on the budget deficit over the year. Consequently, the current account deficit, which indicates the government's dissaving, increased to 2.2 per cent of GDP in 2015 from 1.2 per cent of GDP in the previous year, deviating considerably from the targeted deficit of 0.4 per cent of GDP in the Budget for 2015. This trend showed the necessity of increasing government revenue and further rationalising recurrent expenditure to generate a surplus in the current account (government saving) 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 is calculated excluding the interest payments from the overall deficit and reflects the discretionary fiscal policy component of the government budget, also increased to 2.9 per cent of GDP from 1.5 per cent recorded in 2014 and the 0.7 per cent expected in the Budget for 2015. The high growth of 34.5 per cent in the non interest recurrent expenditure, which outpaced the 21.3 per cent growth in revenue and grants, was the main reason for the higher primary deficit in 2015.

Financing the Budget Deficit

The budget deficit of Rs. 829.5 billion was largely financed through domestic sources in 2015. Accordingly, net domestic financing amounted to Rs. 592.7 billion during the year in comparison to the annual estimate of Rs. 208.0 billion and Rs. 378.7 billion in the previous year. However, net foreign financing stood at Rs. 236.8 billion, below the estimate of Rs. 291.4 billion for 2015. Consequently, domestic financing accounted for 71.5 per cent of the total financing in 2015 in comparison to 64.1 per cent in 2014, while foreign financing accounted for 28.5 of total financing in comparison to 35.9 per cent in 2014.

Reliance on financing from both domestic banking and non banking sectors increased significantly during the year in comparison to the previous year. Financing from the non banking sector amounted to Rs. 300.9 billion in 2015, representing 50.8 per cent of total net domestic financing, compared to Rs. 251.8 billion recorded in 2014. Government financing from the banking sector, which accounted for 49.2 per cent of net domestic financing reflected an increase of 129.9 per cent to Rs. 291.8 billion in 2015 in comparison to Rs. 126.9 billion in 2014. Substantial increase in financing from the commercial banking sector by 131.8 per cent to Rs. 211.6 billion in 2015 from Rs. 91.3 in 2014 and the notable increase in borrowing from the Central Bank by 125.0 per cent to Rs. 80.3 billion contributed to the significant increase in financing from the banking sector. Borrowings from commercial banks increased largely through Treasury bills and SLDBs, although borrowings through Treasury bonds recorded a net repayment

Chart 6.5 Deficit Financing (as a percentage of GDP)

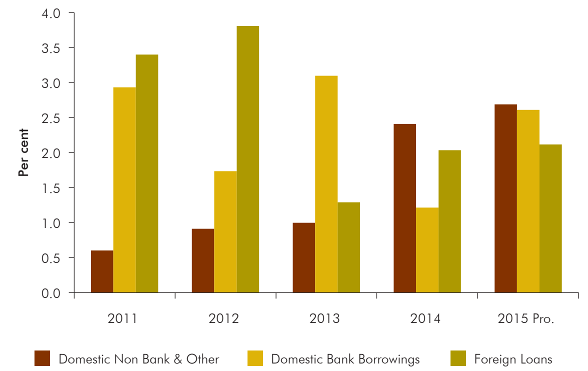


Table 6.5 Sources of Domestic Financing

Rs. billion

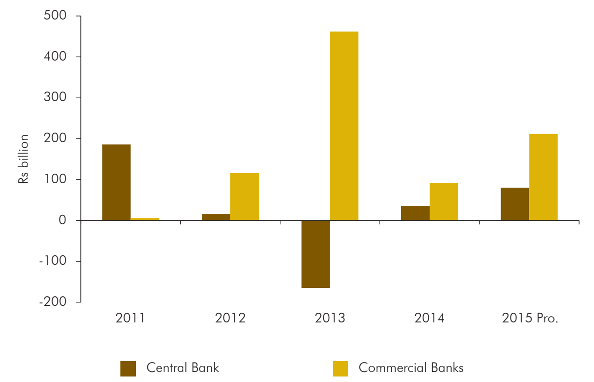
Item	2012	2013	2014	2015 Provisional
By Instrument	**200.4**	**392.4**	**378.7**	**592.7**
Treasury Bonds (a)	154.5	252.1	369.1	442.6
Treasury Bills (b)	16.8	53.5	26.1	-26.4
Rupee Loans	-3.6	-2.9	-	-31.4
Sri Lanka Development Bonds	18.4	140.3	21.0	223.0
Central Bank Provisional Advances	16.5	-2.1	34.7	7.2
Other	-2.2	-48.5	-72.2	-22.3
By Source	**200.4**	**392.4**	**378.7**	**592.7**
Bank	131.5	297.0	126.9	291.8
Non Bank	68.9	95.4	251.8	300.9

(a) Excludes rupee denominated Treasury bonds issued to foreign investors and funds raised for restructuring of SOBEs in 2012, 2014 and 2015

(b) Excludes rupee denominated Treasury bills issued to foreign investors.

Sources: Ministry of Finance
Central Bank of Sri Lanka

Chart 6.6 Sources of Bank Financing



during the year. Net borrowings from the Central Bank, mainly through Treasury bills increased, although net borrowings from provisional advances declined in comparison to the previous year. However, net borrowings from the banking sector were also significantly higher than the annual estimate of Rs. 70.0 billion in the Budget for 2015.

The government net domestic borrowings by way of medium and longer term marketable debt instruments increased significantly by 46.0 per cent to Rs. 607.7 billion in 2015. Accordingly, out of the total net domestic borrowings, Rs. 665.6 billion was raised through Treasury bonds and SLDBs during the year. However, the borrowings through Treasury bills and Rupee loans recorded a net repayment of Rs. 57.8 billion in 2015. The non instrument borrowings in the total net domestic borrowings recorded a net repayment of Rs. 15.0 billion during the year.

Foreign currency denominated domestic borrowings increased substantially in 2015 largely driven by SLDBs. Gross borrowings from SLDBs amounted to Rs. 334.5 billion (US dollars 2,491.4 million), while repayments were Rs. 111.6 billion (US dollars 835.6 million). Meanwhile, the government repaid Rs. 542.8 million of its liabilities to offshore banking units (OBUs) of commercial banks during the year. Overall, net foreign currency borrowings from domestic sources increased significantly to Rs. 222.4 billion in 2015 from Rs. 20.4 billion in 2014.

Net financing from foreign sources was relatively high in 2015 despite significant outflows in foreign holdings of rupee denominated Treasury bonds and Treasury bills. Accordingly, net foreign financing increased by 11.4 per cent to Rs. 236.8 billion in 2015 from Rs. 212.5 billion in 2014. However, the share of net foreign financing in total financing declined to 28.5 per cent in 2015 from 35.9 per cent in 2014. Net financing from project loans from bilateral and multilateral sources increased significantly to Rs. 131.3 billion in 2015 compared to Rs. 14.6 billion in the previous year. Gross borrowings from project loans amounted to Rs. 257.9 billion, while repayments were Rs. 126.6 billion. On gross basis, Export-Import Bank of China (Exim Bank), IDA, the government of Japan and Asian Development Bank (ADB) were the major sources of foreign project loans in 2015. Net borrowings through ISBs increased to Rs. 232.8 billion during 2015, which is the difference between Rs. 298.5 billion (US dollars 2.15 billion) borrowings and Rs. 65.8 billion (US dollars 500 million) repayments in comparison to Rs. 197.2 billion (US dollars 1,500 million) recorded in the previous year. A net outflow of Rs. 127.2 billion was recorded in respect of foreign holdings of government securities compared to Rs. 790.3 million of inflows in the previous year.

6.4 Government Debt and Debt Service Payments

Government Debt

Total government debt to GDP ratio increased to 76.0 per cent as at end 2015 from 70.7 per cent at end 2014, reflecting the weak fiscal performance during the year and relatively low economic growth. Increasing borrowing requirement resulting from lower than expected revenue collection and significant depreciation of the rupee against major foreign currencies has largely contributed to the increase of the debt to GDP ratio during the year. The domestic debt to GDP ratio increased to 44.3 per cent by end 2015 from 40.9 per cent recorded as at end 2014, while the foreign debt to GDP ratio also increased to 31.7 per cent by end 2015 from 29.8 per cent in 2014. In nominal terms, total outstanding government debt increased by 15.0 per cent to Rs. 8,503.2 billion as at end 2015 from Rs. 7,390.9 billion at end 2014. The total debt stock increased by Rs. 285.1 billion due to exchange rate variations on account of the depreciation of the rupee against major foreign currencies. Meanwhile, the debt stock declined by Rs. 935.2 million, driven by the difference of values due to issuance of government securities at a premium or a discount.

The outstanding domestic debt increased by 15.9 per cent to Rs. 4,959.2 billion as at end 2015, reflecting greater reliance on domestic sources to finance the budget deficit during the year. The share of domestic debt in total government debt stood at 58.3 per cent at end 2015, registering a slight increase when compared to 57.9 per cent as at end December 2014. However, the share of short term debt to total domestic debt declined to 18.4 per cent at end 2015 from 22.0 per cent at end 2014, mainly due to the issuance of medium to long term debt instruments to replace the maturing Treasury bills. Accordingly, the share of Treasury bills in short term domestic debt to total domestic debt declined to 13.3 per cent as at end 2015 from 16.2 per cent at the end of the previous year. In contrast, the share of medium to long term debt to total domestic debt stock increased to 81.6 per cent by end 2015 from 78.0 per cent recorded at the end of the previous year. Within this category, the share of Treasury bonds, which dominated the outstanding domestic debt portfolio, declined to 81.7 per cent of the total medium to long term debt by end 2015 from 85.2 per cent recorded at end 2014, whereas the share of SLDBs in total medium to long term debt category increased significantly to 16.5 per cent by end 2015 from 11.7 per cent at end 2014 reflecting increased reliance on this instrument to finance the budget deficit during the year. At the same time, the average time to maturity of the domestic debt stock increased to 6.28 years by end 2015 from 5.75 years in the previous year, indicating the higher issuance of medium and long term securities.

Chart 6.7 Outstanding Central Government Debt

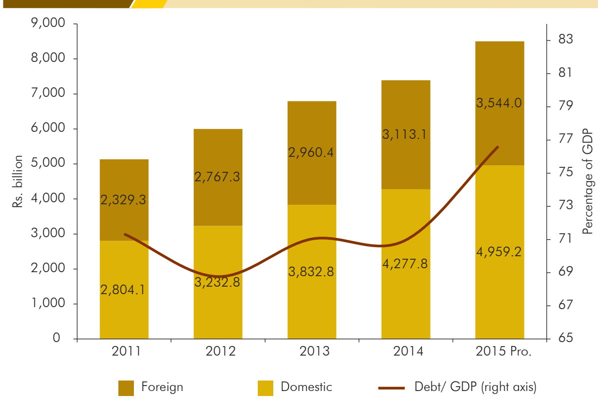


Table 6.6 Outstanding Central Government Debt (as at end year)

Rs. million

Item	2012	2013	2014	2015 Provisional
Total Government Debt	**6,000,112**	**6,793,249**	**7,390,899**	**8,503,227**
Domestic Debt (a)	**3,232,813**	**3,832,825**	**4,277,783**	**4,959,196**
By Maturity Period				
Short Term	813,272	909,156	941,162	913,291
Medium and Long Term	2,419,541	2,923,670	3,336,620	4,045,905
By Institution				
Bank	1,060,317	1,433,773	1,669,882	1,924,036
Non Bank	2,172,495	2,399,053	2,607,901	3,035,160
Foreign Debt	**2,767,299**	**2,960,424**	**3,113,116**	**3,544,031**
By Type				
Concessional Loans	1,369,568	1,492,842	1,490,978	1,729,895
Non Concessional Loans	455,069	460,475	457,668	507,047
Commercial (b)	942,662	1,007,107	1,164,470	1,307,089
By Currency				
SDR	682,065	711,935	679,835	734,552
US Dollars	853,832	1,009,937	1,292,052	1,733,790
Japanese Yen	575,196	485,325	429,638	470,109
Euro	174,563	185,606	162,743	181,084
Other	481,643	567,621	548,848	424,495
Memo: Exchange Rate Variation	207,389	-25,498	-90,230	228,731

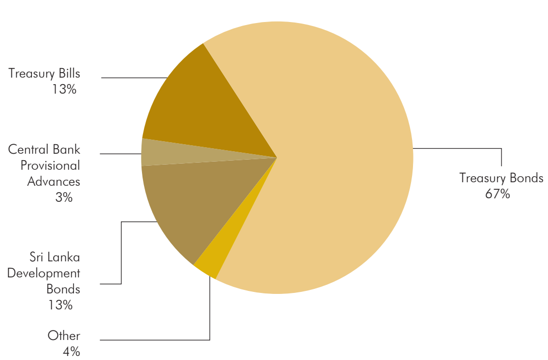
(a) Excludes government bonds of Rs. 4,397 million issued to CWE in November 2003, Rs. 78,447 million issued to settle dues to CPC in January 2012 and Rs. 13,125 million issued to capitalise SriLankan Airlines in March 2013.
(b) Includes outstanding amounts of foreign investments in rupee denominated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

Sources: Ministry of Finance
Central Bank of Sri Lanka

Domestic debt held by the non bank sector increased by 16.4 per cent to Rs. 3,035.2 billion at end 2015 from Rs. 2,607.9 billion as at end 2014, mainly due to significant borrowings through Treasury bonds during the year. However, the share of domestic debt held by the non bank sector increased slightly to 61.2 per cent at end 2015 from 61.0 per cent as at end 2014. Borrowings from the non bank sector by way of Treasury bonds increased by 24.0 per cent to Rs. 2,787.6 billion by end 2015, while its relative share increased to 91.8 per cent by end 2015 from 86.2 per cent by end 2014, exhibiting increased investor preference for longer tenure maturities. Treasury bills held by the non bank sector declined considerably by 27.4 per cent to Rs. 212.8 billion at end 2015, accounting for 7.0 per cent of the total debt held by non bank sector investors compared to 11.2 per cent recorded as at end 2014. The Employees' Provident Fund (EPF) and the National Savings Bank (NSB) continued to be the major holders of the total government domestic debt held by the non bank sector accounting for 53.2 per cent and 14.1 per cent, respectively.

The outstanding government debt to the domestic banking sector increased by 15.2 per cent to Rs. 1,924.0 billion at end 2015. However, the share of the banking sector debt in total domestic debt declined marginally to 38.8 per cent by end 2015 from 39.0 per cent at end 2014. Of

Chart 6.8 Composition of Outsanding Domestic Debt - 2015

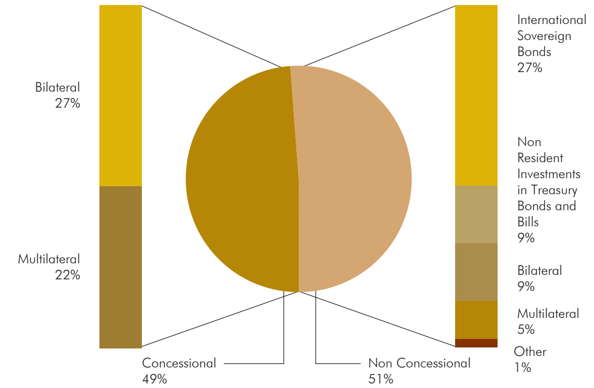


the domestic banking sector debt, the outstanding debt owned by the Central Bank declined by 4.3 per cent to Rs. 256.1 billion at end 2015 owing to the decline in the outstanding Treasury bills held by the Central Bank to Rs. 104.8 billion at end 2015 from Rs. 123.5 billion at end 2014. Consequently, the relative share of the outstanding debt owned by the Central Bank also declined to 13.3 per cent by end of 2015 from 16.0 per cent at the end of the previous year. In contrast, at the end 2015, the outstanding government debt held by commercial banks increased by 19.0 per cent to Rs. 1,668.0 billion compared to the same by the end of the previous year. The significant increase in SLDBs holdings (by 70.9 per cent) and Treasury bills holdings (by 22.4 per cent) of commercial banks mainly contributed to increase the outstanding debt held by commercial banks.

Foreign currency denominated domestic debt increased to Rs. 690.1 billion (US dollars 4,790.1 million) by end 2015 from Rs. 410.7 billion (US dollars 3,134.3 million) at end 2014. The significant increase in net borrowings through SLDBs, which amounted to Rs. 277.4 billion (by 70.9 per cent) coupled with the depreciation of the Sri Lanka rupee against the US dollar largely contributed to this increase. Foreign currency denominated domestic debt consisted of outstanding borrowings from SLDBs amounting to Rs. 668.5 billion (US dollars 4,640.1 million) and OBUs amounting to Rs. 21.6 billion (US dollars 150.0 million).

Total outstanding foreign debt increased by 13.8 per cent to Rs. 3,544.1 billion at end 2015. In addition to the absolute increase in foreign debt stock, significant increase in rupee value of the foreign debt owing to the depreciation of the rupee against major foreign currencies contributed to increase in outstanding foreign debt. During the year, concessional debt increased by 16.0 per cent to Rs. 1,729.9 billion, raising the share of concessional debt in the total foreign debt stock to

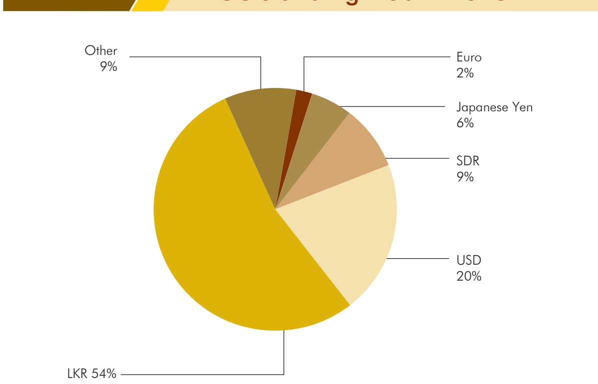
Chart 6.9 Composition of Outsanding Foreign Debt - 2015



48.8 per cent at end 2015 from 47.9 per cent as at end December 2014. Although non concessional debt increased by 11.8 per cent to Rs. 1,814.1 billion, the share of non concessional debt in the total foreign debt declined slightly to 51.2 per cent at end 2015 from 52.1 per cent at end 2014. This was mainly due to the decline in foreign investments in government securities although the outstanding amount of ISBs increased during the year.

The depreciation of the rupee against several major currencies has resulted in an increase in the total debt stock by Rs. 285.1 billion by end 2015. The Sri Lanka rupee depreciated by 9.03 per cent, 8.20 per cent and 4.89 per cent respectively, against the US dollar, Japanese yen and Special Drawing Rights (SDR), while it appreciated against euro by 1.30 per cent during the year. The total outstanding foreign debt stock consisted of debt

Chart 6.10 Currency Composition of Total Outstanding Debt - 2015



denominated in US dollars (48.9 per cent), SDR (20.7 per cent), Japanese yen (13.2 per cent), euro (5.1 per cent), Sri Lanka rupee (8.6 per cent) and other currencies (3.5 per cent) at end 2015. Consequently, the outstanding foreign debt stock increased by Rs. 228.7 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. 56.4 billion due to the depreciation of the Sri Lanka rupee against the US dollar.

Debt Service Payments

Total debt service payments in 2015 amounted to Rs. 1,317.8 billion, recording a notable increase of 22.4 per cent (Rs. 241.5 billion) compared to Rs. 1,076.3 billion in 2014. Increase in both amortisation payments and interest payments largely contributed to the increase in total debt service payments in 2015. Accordingly, amortisation payments increased by 27.7 per cent (Rs. 175.5 billion) to Rs. 808.1 billion in 2015 compared to Rs. 632.7 billion in 2014. Amortisation payments accounted for 61.3 per cent of total debt service payments in 2015. The increase in the maturing debt stock in both domestic and foreign debt and depreciation of the rupee, which increased the rupee value of foreign debt repayments, contributed to the increase in total amortaisation payments during the year. The interest payments also increased by 14.9 per cent (Rs. 66.1 billion) to Rs. 509.7 billion in 2015 from Rs. 443.6 billion in 2014, reflecting the relatively higher domestic borrowings in 2015. Debt service payments to domestic sources increased by 18.1 per cent (Rs. 140.6 billion) to Rs. 918.1 billion in 2015 compared to Rs. 777.5 billion in 2014. This was a combined outcome of the increase in amortisation payments of Rs. 74.3 billion to Rs. 523.8 billion, largely driven by the higher repayments on SLDBs, Rupee loans and Treasury bonds and the increase in interest payments by

Table 6.7 Government Debt Service Payments

Rs. million

Item	2012	2013	2014	2015 Provisional
Debt Service Payments	**1,017,468**	**1,162,900**	**1,076,257**	**1,317,791**
Domestic	733,100	850,748	777,488	918,112
Foreign	284,368	312,152	298,769	399,679
Amortisation Payments	**608,970**	**700,035**	**632,662**	**808,117**
Domestic	415,441	496,042	449,554	523,824
Foreign	193,529	203,993	183,109	284,293
Interest Payments	**408,498**	**462,865**	**443,595**	**509,674**
Domestic	317,659	354,706	327,934	394,289
Short Term	65,049	69,712	78,811	57,728
Medium and Long Term	252,610	284,994	249,123	336,561
Foreign	90,839	108,159	115,660	115,386

Sources: Ministry of Finance
Central Bank of Sri Lanka

Rs. 66.4 billion to Rs. 394.3 billion owing to increased interest payments on Treasury bonds and SLDBs. Similarly, debt service payments to foreign sources also increased significantly by 33.8 per cent (Rs. 100.9 billion) to Rs. 399.7 billion in 2015, with the increase of amortisation payments on foreign loans by Rs. 101.2 billion to Rs. 284.3 billion. Meanwhile, repayment of ISB amounted to Rs. 65.8 billion (US dollars 500 million) which was issued in 2009. Foreign interest payments declined marginally by 0.2 per cent to Rs. 115.4 billion in 2015.

Debt service indicators showed mixed performances in 2015. Debt service payments

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

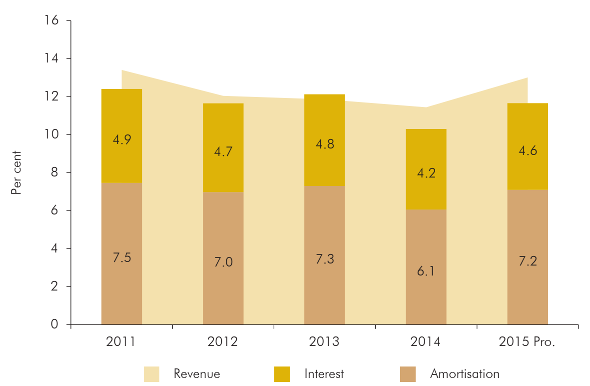


Table 6.8 Central Government Debt Indicators

Indicator	2012	2013	2014	2015 Provisional
Central Government Debt/GDP	68.7	70.8	70.7	76.0
Domestic Debt/GDP	37.0	40.0	40.9	44.3
Foreign Debt/GDP	31.7	30.9	29.8	31.7
Total Foreign Debt/Exports (a)	159.9	151.9	142.5	154.4
Total Debt Service/GDP	11.7	12.1	10.3	11.8
Total Debt Service/Government Revenue (b)	96.8	102.2	90.0	90.6
o/w Domestic Debt Service/ Government Revenue (b)	69.7	74.8	65.1	63.1
Total Debt Service/Government Expenditure (c)	47.0	49.1	44.3	42.5
o/w Domestic Debt Service/ Government Expenditure (c)	33.9	35.9	32.0	29.6
Foreign Debt Service/Exports (a)	16.4	16.0	13.7	17.4
Total Interest/GDP	4.7	4.8	4.2	4.6
Domestic Interest/GDP	3.6	3.7	3.1	3.5
Domestic Interest/Government Recurrent Expenditure	28.1	29.4	24.8	23.2
Foreign Interest/Exports (a)	5.2	5.5	5.0	5.0

(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

increased to 11.8 per cent of GDP in 2015 from 10.3 per cent of GDP in the previous year. Domestic and foreign amortisation payments to GDP increased to 4.7 per cent and 2.5 per cent, respectively in 2015 from 4.3 per cent and 1.8 per cent in 2014. The ratio of total interest payments to GDP increased to 4.6 per cent in 2015 from 4.2 per cent in 2014. Although interest payments on domestic sources to GDP increased to 3.5 per cent in 2015 from 3.1 per cent in 2014, foreign interest payments to GDP declined marginally to 1.0 per cent in 2015 from 1.1 per cent in 2014. Moreover, the ratio of debt service payments to government revenue also increased to 90.6 per cent in 2015 from 90.0 per cent in 2014, reflecting the higher growth in debt service payments compared to the increase in government revenue during 2015.

Outstanding Debt of Major Public Nonfinancial Corporations

Outstanding debt of major public nonfinancial corporations, which includes outstanding debt to domestic banking sector and project related

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

Corporation	2013	2014	2015 (a)
Rs. million			
Domestic Debt (b)	**365,098**	**446,047**	**522,966**
Ceylon Electricity Board	46,974	47,384	35,812
Ceylon Fertiliser Corporation	21,920	30,593	23,833
Ceylon Petroleum Corporation	223,433	245,618	264,471
Colombo Commercial Fertiliser	10,088	13,342	10,208
National Housing Development Authority	3,386	4,777	4,739
Paddy Marketing Board	6,700	5,574	13,772
Road Development Authority	23,324	58,325	74,912
SriLankan Airlines	9,233	9,055	33,040
Sri Lanka Ports Authority	7,074	11,801	14,642
Other Corporations	12,967	19,578	47,537
Foreign Debt (c)	**275,850**	**308,673**	**338,064**
Airport and Aviation Services (Lanka) Ltd.	25,469	25,909	26,284
Ceylon Electricity Board	153,429	160,195	173,874
Sri Lanka Ports Authority	96,953	122,568	137,906
Total Debt of Public Nonfinancial Corporations	**640,948**	**754,720**	**861,030**
As a percentage of GDP			
Domestic Debt	3.8	4.3	4.7
Foreign Debt	2.9	3.0	3.0
Total Debt	6.7	7.2	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

foreign debt increased by 14.1 per cent to Rs. 861.0 billion at end 2015, compared to the increase of 17.8 per cent in 2014. Domestic debt of public nonfinancial corporations to domestic commercial banks increased by 17.2 per cent to Rs. 523.0 billion, which accounts for 60.7 per cent of the total outstanding debt of major public nonfinancial corporations. Project related foreign debt also increased by 9.5 per cent to Rs. 338.1 billion. The relative share of project related foreign debt to total outstanding debt of major public nonfinancial corporations was 39.3 per cent as at end 2015. As a percentage of GDP, outstanding debt of major public nonfinancial corporations amounted to 7.7 per cent by end 2015, in comparison to 7.2 per cent in the previous year.

6.5 Budgetary Operations in Sub National Governments

Policy Direction and Measures of Sub National Governments

The Ministry of Provincial Councils and Local Government (MPCLG) continued a close coordination with the Sub National Governments (SNGs), while enhancing its support to the development process in SNG system in Sri Lanka. The SNG system of the country consists of Provincial Councils (PCs) and Local Governments (LGs). As at end 2015, there were nine PCs established under the 13th Amendment to the Constitution. The LG system in the country constitutes 335 institutions, which includes 23 Municipal Councils, 41 Urban Councils and 271 Pradesheeya Sabhas. The MPCLG continued effective coordination with donor agencies to facilitate investment needs of SNGs, while providing support in the process of prioritisation of the development needs at the Provincial level and Local Government level. In addition, efforts were made to improve infrastructure facilities and managerial skills to provide a better service to the public. Several programmes were continued by the MPCLG to provide an upgraded service delivery and to address the needs of the general public in a timely manner. Waste management programmes were also continued during 2015.

Priority was given to continue road development under regional infrastructure development activities. In view of this, the MPCLG implemented the Provincial Roads Project in the Eastern, Uva, Northern, North Central, Sabaramaguwa and Central provinces with funding assistance from the World Bank, ADB and Japan International Cooperation Agency (JICA). In addition, the Northern Roads Connectivity Project was implemented with the view of improving the connectivity of provincial roads with funding from ADB. Greater Colombo Wastewater Management Project, Upgrading the Disaster Response Network (Phase II), Project of Transforming School Education as the Foundation of a Knowledge Hub, Health Sector Development Project, Local Government Enhancement Sector Project (Pura Neguma Programme) and several Township Development Programmes were also continued during the year. In addition, the Construction of Rural Bridges programme and Iranamadu Irrigation Development Project were also initiated during the year 2015.

In addition, the MPCLG, from 01 January 2016 also implemented a programme to minimise direct and indirect health, environmental and social impact caused due to the usage of plastic and polythene. Under this programme, manufacturing and sale of shopping bags and food wrapping sheets below 20 microns (20μ) will be prevented and several actions will be taken to lessen the usage of plastic and polythene in public and public affiliated organisations. Accordingly, MPCLG issued a Circular for all provinces to take necessary action to make the staff of the institutions affiliated to PCs and Local Authorities aware of the above matter.

A new programme was introduced by the Finance Commission for capacity development of Municipalities covering all provinces. Accordingly, each province has been allocated by Rs. 1 million under Province Specific Development Grants (PSDGs). The programme is expected to be implemented in suitable Municipalities, which are selected focusing on issuing Municipal Bonds, assessing of real estate using new technology, making payments through internet and attending the complaints without delay. Further, a Circular was issued to provinces by the Finance Commission to avoid reserve funds for any expenses relating to the administration of capital projects under capital allocations with effect from 01 January 2015 as incurring recurrent expenditure from the allocations provided for capital expenditure is contradictive to accounting standards. Accordingly, administrative cost for capital projects should be allocated under the recurrent budget in the particular year. Further, the Finance Commission instructed the relevant provinces to deviate from the current practice of depositing income earned from the production related industries in their accounts, and to reinvest the income earned for further development of the particular industries instead.

Budgetary Operations in Provincial Councils

Tax revenue collection of PCs continued to increase in 2015 as well. Total revenue of PCs increased by 11.8 per cent to Rs. 66.1 billion in 2015 from Rs. 59.1 billion recorded in 2014, while as a percentage of GDP, it remained unchanged at 0.6 per cent in 2015. Tax revenue increased by 13.2 per cent to Rs. 59.5 billion in 2015, while non tax revenue increased marginally by 0.5 per cent to Rs. 6.6 billion. Revenue from stamp duty, which is the largest contributor to the total tax revenue of PCs, increased by 22.9 per cent to Rs. 26.8 billion in 2015, reflecting the increased revenue collection from stamp duty on transferring deeds. NBT revenue transferred from the central government also increased by 1.5 per cent to Rs. 21.9 billion, while license fees increased by 15.8 per cent to Rs. 9.5 billion in 2015. The continuous increase in motor vehicle registrations within PCs have positively contributed to increasing revenue from license fees. Revenue from stamp duty and NBT revenue transfers from the central government accounted for 45.0 per cent and 36.7 per cent, respectively of total tax revenue of PCs. The relative share of the Western Provincial Council on revenue collection increased marginally to 53.3 per cent in 2015 from 53.2 per cent in 2014. The Western Province was followed by the North Western and Southern provinces accounting for 9.5 per cent and 9.1 per cent, respectively of

Table 6.10 Budget Outturn for Provincial Councils

Rs. million

Item	2012	2013	2014	2015 Provisional
Total Revenue	**49,235**	**49,648**	**59,133**	**66,082**
Tax Revenue	41,657	42,569	52,569	59,482
Non Tax Revenue	7,578	7,079	6,564	6,600
Total Expenditure	**161,341**	**185,241**	**216,824**	**267,696**
Recurrent Expenditure	139,121	156,066	172,131	215,386
o/w Personal Emoluments	108,246	117,806	131,162	168,760
Capital Expenditure	22,220	29,175	44,693	52,310
Central Government Transfers	**112,106**	**135,593**	**157,691**	**201,614**
Block Grants	91,892	108,801	126,144	167,551
Criteria Based Grants	2,861	2,264	3,392	3,753
Province Specific Development Grants	5,901	6,429	8,343	13,345
Foreign Grants for Special Projects	11,452	18,100	19,812	16,965

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

the total revenue collection of PCs. Meanwhile, the relative share of revenue collection of North Central province increased notably to 4.0 per cent from 3.3 per cent during 2015.

Recurrent expenditure of PCs increased significantly by 25.1 per cent to Rs. 215.4 billion in 2015 from Rs. 172.1 billion in 2014. As a percentage of GDP, recurrent expenditure of PCs stood at 1.9 per cent in 2015 compared to 1.6 per cent in 2014. The increase in recurrent expenditure was mainly due to the increase in personal emoluments by 28.7 per cent to Rs. 168.8 billion, which continued to be the single largest item in recurrent expenditure accounting for 78.4 per cent of the total recurrent expenditure of PCs. The education and health sectors absorbed a major portion of the personal emoluments of PCs accounting for nearly 90 per cent of the total expenditure on personal emoluments. On a functional basis, recurrent expenditure on social infrastructure increased by 26.7 per cent to Rs. 194.2 billion, with education and health sectors accounting for 90.2 per cent of the total recurrent expenditure in 2015. The balance 9.8 per cent of recurrent expenditure was on account of expenses in relation to provincial administration and economic infrastructure. In terms of total recurrent expenditure, the three highest spending PCs were Western, Central and North Western accounting for 22.6 per cent, 12.5 per cent and 12.0 per cent, respectively.

Capital expenditure of PCs increased by 17.0 per cent to Rs. 52.3 billion in 2015 from Rs. 41.4 billion in 2014. As a percentage of GDP, capital expenditure of PCs increased slightly to 0.5 per cent in 2015 from 0.4 per cent in 2014. In 2015, capital expenditure incurred on special projects amounted to Rs. 17.0 billion, while Rs. 13.3 billion was incurred on PSDPs. Other provincial level investments incurred were mainly in the areas of acquisition and improvement of capital assets and capital transfers to local governments.

In 2015, central government transfers to PCs increased to Rs. 201.6 billion registering a significant growth of 27.9 per cent. These transfers were in the form of block grants, Criteria Based Grants (CBGs), PSDGs and grants for special projects. Block grants, the major form of central government transfers to PCs amounted to Rs. 167.6 billion, representing 83.1 per cent of the total transfers. These grants have been provided to meet the resource gap in the recurrent expenditure programme of PCs. Transfers under grants for special projects, PSDGs and CBGs amounted to Rs. 17.0 billion, Rs. 13.3 billion and Rs. 3.8 billion, respectively. Meanwhile, 75.3 per cent of the expenditure of PCs was financed by transfers from the central government in comparison to 72.7 per cent in the previous year. This indicates that proactive policy measures are needed to increase revenue collection of PCs to reduce their reliance on the central government budget.