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FISCAL POLICY AND GOVERNMENT FINANCE

6.1 Overview

Budgetary operations of the government recorded progress with an enhanced primary surplus and a lower budget deficit, despite a decline in revenue mobilisation during 2018. The surplus in the primary balance, which reflects the difference between revenue and grants, and non interest expenditure, increased to 0.6 per cent of GDP (Rs. 91.4 billion) in 2018 from 0.02 per cent of GDP (Rs. 2.1 billion) in 2017. A higher surplus in the primary balance is a salutary development, as the government managed to meet its non interest expenditure entirely out of revenue receipts with a surplus remaining. However, this was achieved largely through a compression in capital expenditure, amidst a decline in revenue.

The revenue to GDP ratio declined to 13.3 per cent in 2018 from 13.6 per cent in 2017 due to lower tax revenue collections, mainly from import duties, Value Added Tax (VAT), excise duty on importation of petroleum products and liquor, withholding tax and Cess levy, while the delay in implementing certain measures announced in the Budget 2018 also affected the revenue collections in 2018. Meanwhile, total expenditure and net lending as a percentage of GDP also declined to 18.6 per cent during the year from 19.2 per cent in the previous year due to a reduction in public investment. Recurrent expenditure at 14.5 per cent of GDP in 2018 increased marginally due to higher interest payments. Consequently, the current account deficit, which reflects the difference between government revenue and recurrent expenditure, increased to 1.2 per cent of GDP in 2018 from 0.7 per cent in 2017 reflecting dis-savings of the government.

However, the budget deficit declined to 5.3 per cent of GDP in 2018 from 5.5 per cent in 2017 due to the significant reduction in capital expenditure. Nevertheless, the budget deficit deviated from the target level of 4.8 per cent of GDP envisaged in the Budget 2018. In financing the budget deficit, the government relied largely on domestic sources which accounted for 57.5 per cent of total financing in 2018. Within domestic sources, financing from the non bank sector increased while financing from the banking sector declined. Outstanding central government debt as a percentage of GDP increased to 82.9 per cent at end 2018 from 76.9 per cent at end 2017 mainly reflecting the impact of the depreciation of the rupee, relatively low nominal GDP and higher net borrowings.

The enactment of the Active Liability Management Act (ALMA) and the formulation of a Medium Term Debt Management Strategy (MTDS) would facilitate debt management of the government, over the medium term. The sharp rise in government debt underscores the importance of the continuation of fiscal consolidation measures, particularly ahead of an election cycle. Any slippage from the envisaged fiscal consolidation path could result in an undermining of macroeconomic fundamentals thereby weakening the investor sentiment. This would intensify the refinancing risks of large debt servicing obligations due over the medium term.

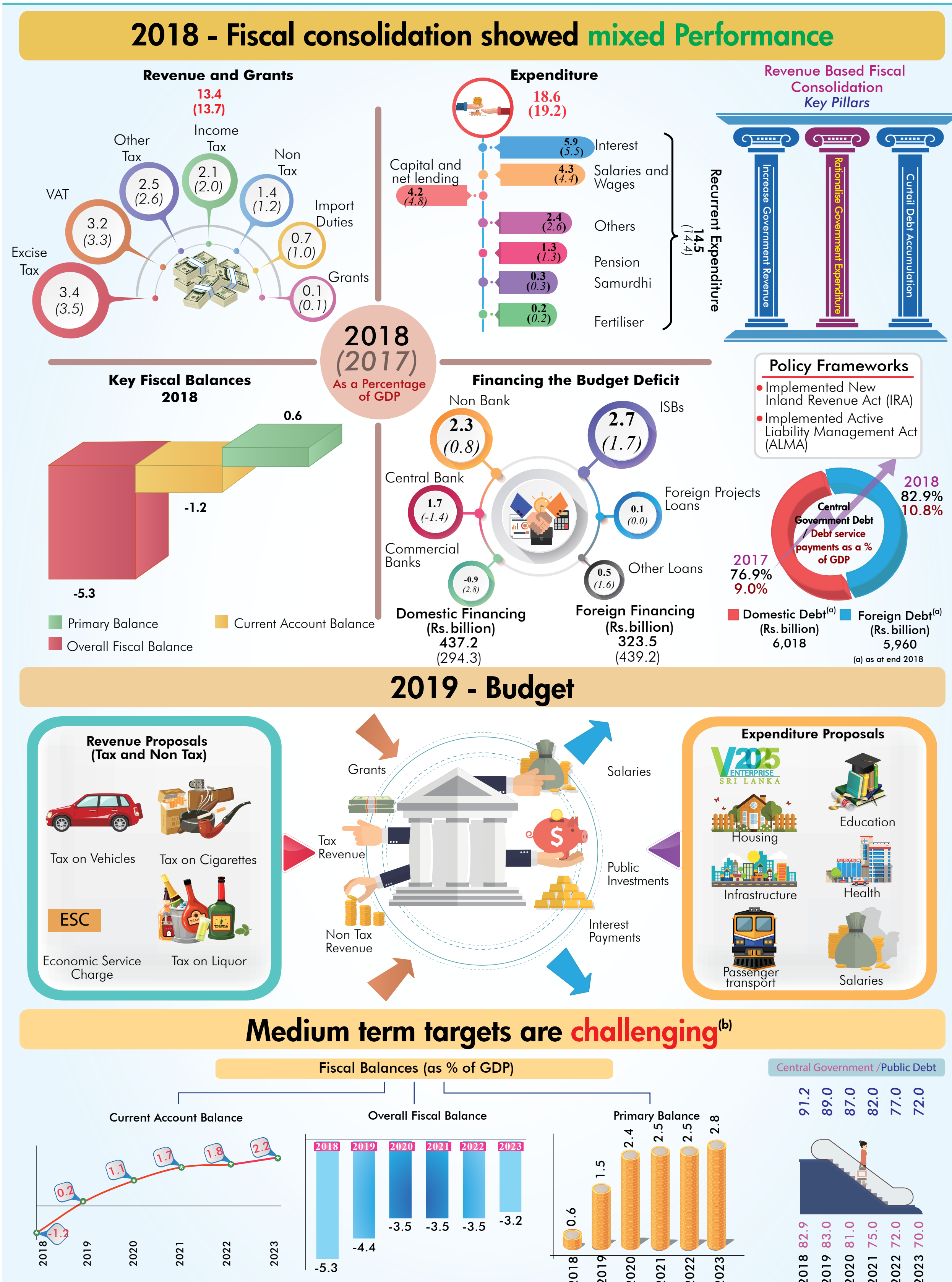
Major downside risks that emerged during 2018 include lower than expected revenue mobilisation, a notable moderation in public investment and a sharp increase in government debt, despite an improvement in the primary balance and the budget deficit. The low government revenue resulting from delays in implementing revenue enhancement measures, tax evasion, tax avoidance and poor tax administration continued to remain a major concern. As such, there is a strong need for broadening the tax base through robust revenue reforms, including the effective implementation of the new Inland Revenue Act and efforts to make revenue administration more efficient while expediting the automation process of major revenue collecting agencies. Planning and monitoring should be strengthened to improve the quality of public expenditure by focusing on maximising rates of return and promoting value for money through minimising leakages. Reforms to state owned business enterprises (SOBEs) should include the introduction of cost recovery pricing mechanisms and other appropriate measures needed to commercialise major SOBEs, thereby enhancing their financial viability.

6.2 Fiscal Policy Direction and Measures

In 2018, the fiscal policy strategy was formulated with a view to strengthening the fiscal consolidation process. Accordingly, fiscal measures were aimed at enhancing revenue collection and rationalising expenditure while reforming and restructuring SOBEs in order to contain the budget deficit and the outstanding government debt at targeted levels. Accordingly, the budget deficit and government debt for 2018 were targeted at 4.8 per cent of GDP and 77.4 per cent of GDP, respectively.

The new Inland Revenue Act, No. 24 of 2017, which came into effect from 01 April 2018, supported the revenue mobilisation effort of the government by simplifying and rationalising the existing income tax structure, broadening the direct tax base and strengthening the administrative powers, while introducing international best practices to Sri Lanka's tax system. For employment income, the annual tax free threshold was increased to Rs. 1.2 million from Rs. 750,000 although the tax free threshold for personal income tax was maintained at the same level of Rs. 500,000. Further, tax slabs for personal income tax, including employment income, were widened by Rs. 100,000 to Rs. 600,000 brackets, while the highest marginal tax rate was increased to 24 per cent from 16 per cent. In addition, the new Act streamlined the corporate income tax structure to a three tier tax structure; a 40 per cent tax rate for liquor, tobacco, and betting and gaming; a 28 per cent standard tax rate for banking, finance, insurance and trading activities; and a 14 per cent tax rate for all other sectors. Further, a Capital Gains Tax was introduced at a rate of 10 per cent on the realisation of capital assets, while the withholding tax rate on interest earnings of resident

Figure 6.1 **Fiscal Sector Performance**



(b) The medium term fiscal framework will be revised during the third quater of 2019.

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individuals was also increased to 5 per cent from 2.5 per cent. However, bank deposits of senior citizens were exempted from the withholding tax on interest income up to Rs. 1.5 million per annum. Meanwhile, a new tax manual was published in April 2018 and training and awareness programmes were conducted for professionals in the tax field and the general public in order to enhance public awareness of the new Act.

Several amendments were made to the VAT and Nation Building Tax (NBT) Acts in 2018 in order to grant tax exemptions to identified sectors with the aim of promoting activity in such sectors, while a VAT refund scheme was introduced for tourists to promote the tourism sector. Accordingly, under the Value Added Tax (Amendment) Act, No. 25 of 2018, exemptions were granted for the supply of private medical services other than hospital room charges to reduce the medical costs. Further, supply of financial services by the Sri Lanka Deposit Insurance Scheme, local sale of certain garments by export oriented companies and supply of infant milk powder, books, magazines, journals and periodicals also exempted from VAT. Further, under this VAT amendment, a VAT refund scheme was also introduced for tourists. Accordingly, the Tourist VAT Refund System (TVRS) was established at the Bandaranaike International Airport in September 2018 and thirty one companies were registered under the TVRS. In addition, several exemptions were granted under the Nation Building Tax (Amendment) Act, No. 20 of 2018 while the NBT exemption applicable on liquor was removed during 2018.

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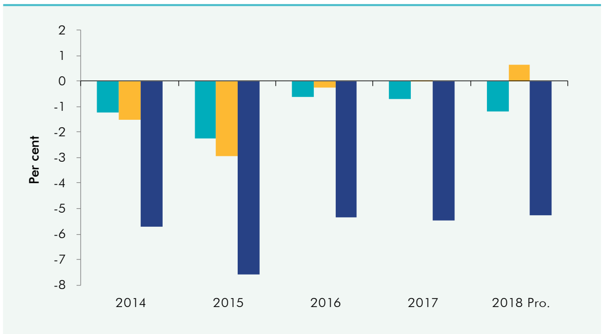
Figure 6.2
Major Fiscal Indicators
(as a percentage of GDP)



Sources: Ministry of Finance
Central Bank of Sri Lanka

Customs duty changes were made during the year to reduce the applicable duty on fuel imports in response to rising international fuel prices and to discourage gold imports which grew at a faster pace in the early part of the year. Accordingly, in April 2018 a Customs duty of 15 per cent was imposed on the importation of gold, with a view to discouraging the excessive gold imports observed in the preceding months. The Customs duty and the duty waiver on the importation of petrol and diesel were revised with the introduction of the pricing formula for fuel on 11 May 2018 and few more revisions were made in 2018 and year to date in 2019. Accordingly, Customs duty and the duty waiver on the importation of petrol (92 Octane) stood at Rs. 35 per litre and Rs. 19 per litre, respectively at the end of January 2019. Similarly, for auto diesel, the Customs duty and duty waiver remained at Rs. 5.85 per litre and Rs. 3 per litre, respectively. Further, Customs duties on petrol (95 Octane) and super diesel were reduced to Rs. 35 per litre and Rs. 10.55 per litre, respectively, with the withdrawal of applicable duty waivers. The applicable Customs duties on fuel importation were reduced to ease the adverse impact of rising international fuel prices on domestic prices. At end March 2019, Customs duties applicable on the importation of auto diesel, super diesel, petrol (92 Octane) and petrol (95 Octane) were Rs. 2.85 per litre, Rs. 10.55 per litre, Rs. 16 per litre and Rs. 35 per litre, respectively.

During the year, several revisions were made to excise duty mainly aimed at curtailing the importation of motor vehicles, which increased significantly exerting pressure on the balance of payments, and sweetened food items and cigarettes due to health concerns. Accordingly, the excise duty on motor vehicles with an engine capacity less than 1,000 cm^3 was revised upward with effect from 01 August 2018. Further, following the announcement of the Budget 2019 excise duty on motor vehicles with engine capacity less than 2,000 cm^3 was increased with effect from 06 March 2019. However, excise duty on hearses, hybrid and electric vans, single cabs and buddy trucks with cargo carrying capacity less than 2,000 kg was reduced in March 2019 to facilitate the SME sector and promote environmentally friendly transport modes. In addition to the revisions in excise duty, a luxury tax on motor vehicles was proposed on the cost, insurance and freight (CIF) value of imports or the manufacturer's price in case of domestic production in excess of a prescribed tax free threshold with the aim of enhancing revenue as well as curtailing import expenditure. Meanwhile, revisions to the carbon tax were also proposed. In 2018, an excise duty was imposed on sugar imports while the excise duty on beverages based on the sugar content of the product was revised. Meanwhile, in March 2019 excise duty on beverages was increased. With the aim of encouraging domestic industries, the excise duty on the importation of non-potable alcohol was reduced to Rs. 6 per bulk kg from Rs. 15 per bulk kg while importation of non-potable spirits by the Board of Investment (BOI) approved companies was exempted in 2018. Meanwhile, with effect from 06 March 2019, excise duties on cigarettes and liquor manufactured locally were increased based on an indexation method with a minimum annual duty increase reflecting annual inflation and GDP growth, which would enhance government revenue significantly. In addition, excise duty on imported liquor was also increased with effect from March 2019. Further, a license fee for toddy tapping was imposed while the license fee for bottling toddy was reduced to Rs. 500,000 from

Table 6.1
Summary of Government Fiscal Operations

Item	2017	2018 Approved Estimates	2018 Provisional	2019 Preliminary Estimates (a)
	Rs. million			
Total Revenue and Grants	**1,839,562**	**2,227,200**	**1,932,459**	**2,357,000**
Total Revenue	1,831,531	2,217,200	1,919,973	2,344,000
Tax Revenue	1,670,178	2,034,000	1,712,318	2,077,000
Non Tax Revenue	161,353	183,200	207,656	267,000
Grants	8,031	10,000	12,486	13,000
Expenditure and Net Lending	**2,573,056**	**2,902,200**	**2,693,228**	**3,042,000**
Recurrent	1,927,693	2,152,000	2,089,713	2,308,000
Capital and Net Lending	645,363	750,200	603,515	734,000
o/w Public Investment	657,386	761,000	624,970	756,000
Current Account Balance	**-96,162**	**65,200**	**-169,740**	**36,000**
Primary Balance	**2,071**	**145,000**	**91,421**	**228,000**
Overall Fiscal Balance	**-733,494**	**-675,000**	**-760,769**	**-685,000**
Total Financing	**733,494**	**675,000**	**760,769**	**685,000**
Foreign Financing (b)	439,243	360,000	323,535	235,000
Domestic Financing	294,251	315,000	437,234	450,000
Market Borrowings	249,574	315,000	329,351	450,000
Non Bank	61,841	195,000	219,885	362,000
Bank	187,733	120,000	109,466	88,000
Monetary Authority	-187,931	n.a.	246,068	n.a.
Commercial Banks	375,663	n.a.	-136,601	n.a.
Non Market Sources (c)	44,677	-	107,883	-
	As a percentage of GDP (d)			
Total Revenue and Grants	**13.7**	**15.7**	**13.4**	**15.1**
Total Revenue	13.6	15.6	13.3	15.0
Tax Revenue	12.4	14.3	11.9	13.3
Non Tax Revenue	1.2	1.3	1.4	1.7
Grants	0.1	0.1	0.1	0.1
Expenditure and Net Lending	**19.2**	**20.4**	**18.6**	**19.5**
Recurrent	14.4	15.2	14.5	14.8
Capital and Net Lending	4.8	5.3	4.2	4.7
o/w Public Investment	4.9	5.4	4.3	4.8
Current Account Balance	**-0.7**	**0.5**	**-1.2**	**0.2**
Primary Balance	**0.02**	**1.0**	**0.6**	**1.5**
Overall Fiscal Balance	**-5.5**	**-4.8**	**-5.3**	**-4.4**
Total Financing	**5.5**	**4.8**	**5.3**	**4.4**
Foreign Financing (b)	3.3	2.5	2.2	1.5
Domestic Financing	2.2	2.2	3.0	2.9
Market Borrowings	1.9	2.2	2.3	2.9
Non Bank	0.5	1.4	1.5	2.3
Bank	1.4	0.8	0.8	0.6
Monetary Authority	-1.4	n.a.	1.7	n.a.
Commercial Banks	2.8	n.a.	-0.9	n.a.
Non Market Sources (c)	0.3	-	0.7	-

(a) Based on Budget Speech 2019 (excluding revenue and expenditure transfers to Provincial Councils)
(b) Includes rupee denominated Treasury bonds and Treasury bills issued to foreign investors
(c) Includes proceeds from the long lease of Hambantota port in 2017 and 2018
(d) For 2017, revised GDP estimates were used, as released by the Department of Census and Statistics on 19 March 2019.

Source: Ministry of Finance

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Rs. 1,000,000. Meanwhile, in order to discourage the consumption of cigarettes, the excise duty on cigarettes was increased during the latter part of the year. Further, the excise duty on auto diesel was reduced to Rs. 6 per litre from Rs. 13 per litre while the excise duty on kerosene was removed in order to mitigate the volatility in fuel prices in the domestic market, in response to rising global petroleum prices.

The Special Commodity Levy (SCL) on the importation of several food items was revised from time to time during the year to provide necessary protection for domestic agricultural producers while reducing the price volatility in the domestic market. The SCL on the importation of vegetable oil was revised upward twice during the year in June and August 2018. Moreover, as a relief measure to domestic consumers, the government announced a reduction of the SCL applicable on several essential items including, dhal, chickpeas and peas with effect from November 2018, while the SCL on potatoes and b'onion was reduced with effect from December 2018. In addition, the SCL on the importation of maize and potatoes was revised upward in February 2019 in order to provide protection for domestic farmers. Further, in line with the government policy on trade liberalisation, the Cess and the Ports and Airports Development Levy (PAL) on 253 items were removed in 2018 as proposed in the Budget 2018, which would facilitate strategically important sectors, such as tourism and other value added industries. Meanwhile, the Cess on a number of items was also removed in March 2019, while the Cess on construction material was reduced to facilitate the construction industry.

Measures to strengthen tax administration, including the Revenue Administration Management Information System (RAMIS) and National Single Window (NSW) continued during the year aimed at improving revenue mobilisation through an expansion of the tax base and enhanced tax compliance. Accordingly, the RAMIS of the Inland Revenue Department (IRD) was upgraded in order to incorporate the provisions of the Inland Revenue Act, No. 24 of 2017. The RAMIS monitors all tax categories except ESC, stamp duty and the betting and gaming levy. VAT on financial services and personal income tax registrations were included in the RAMIS system during the year. Several programmes were also conducted to enhance the public awareness of RAMIS. This together with new registrations resulted in an increase in the number of registered tax files in IRD. Moreover, the IRD started to implement organisational and business procedure reforms to modernise tax administration. These included; the restructuring of the IRD along functional lines; creating a Design and Monitoring Unit; a more efficient management structure to speed up interaction with taxpayers; strengthening the Large Taxpayer Unit; introducing mandatory e-filing; and enhancing the use of taxpayer identification numbers. Meanwhile, Sri Lanka Customs initiated measures to establish a NSW to facilitate importers and exporters.

On the expenditure front, several measures were introduced to improve the monitoring process of government expenditure, ensuring better management of public expenditure given the limited fiscal space available for social expenditure and public investment. Accordingly, the quarterly expenditure and income outcome report for the first quarter of 2018 was presented to the Parliament as announced in the Budget 2017, in order to strengthen the Parliamentary control over public finances. In addition, quarterly budget estimates were presented to the Parliament for the first time in the Budget 2018. Accordingly, under the State Accounts Circular No. 263/2017, all spending agencies were instructed to prepare their annual budgets on a quarterly basis for 2018 in order to ensure the systematic utilisation of annual budgetary provisions. Moreover, guidelines were issued under the National Budget Circular No. 03/2018 to streamline the motor vehicle procurement process of Ministries, Departments and other government institutions. A Vote on Account (VoA) for the first four months of 2019 was approved by Parliament on 21 December 2018, due to the time limitation for submitting a fresh Appropriation Bill for 2019 for Parliamentary approval, following the political developments that occurred during the latter part in 2018. The Budget 2019 which was formulated based on the guidelines in the National Budget Circular No. 4/2018, within the Performance Based Budgeting (PBB) approach, was presented to Parliament on 05 March 2019. The Integrated Treasury Management Information System (ITMIS) at the Ministry of Finance (MOF) contributed to modernise the Public Financial Management (PFM) in Sri Lanka. Accordingly, ITMIS was used in the preparation of the Budget 2019. Awareness workshops were conducted island-wide in order to educate public officials on ITMIS.

During the year, efficiency of service delivery on pension payments was enhanced through an automated process, while pension anomalies are expected to be rectified and public sector salaries increased with effect from 2019. Under the Public Administration Circular No. 07/2018, guidelines were issued to enhance the efficiency of the pension payment process. Accordingly, instructions were issued to establish a Pension Division in large institutions and to prepare a database including information on employees who reach the age of retirement, if such a database was not already available. Further, under the Pension Circular No. 09/2015 (Revision III), steps were taken to provide death gratuity payments via an online system with effect from 01 June 2018. Moreover, arrangements were made to introduce an online system to collect applications for the Widows'/Widowers' and Orphans' contributions, with effect from 30 June 2018. Further, under the Pension Circular No. 01/2018, initiatives were undertaken to improve and formalise the payment procedure for pensioners who reside abroad enabling them to receive their pension payment on the due date. Under the Public Administration Circular No. 08/2018, a decision was taken to pay compensation to dependents of any deceased public officer, irrespective of whether the officer held a permanent and pensionable post, if the officer passed away while engaged in hazardous employment or carrying out official duties. The Budget 2019 proposed measures to rectify the pension anomalies as there is a disparity of pensions drawn by pensioners who have retired before 01 January 2016. Therefore, a revision will be made incorporating the first 2 phases of the Public Administration Circular No. 03/2016 to the basic salary obtained by the pensioner, at the time of retirement, with effect from 01 July 2019. Further, an interim allowance of Rs. 2,500 per month will also be paid to public sector employees with effect from 01 July 2019.

Although public investment declined during the year, the government implemented several infrastructure projects to address the critical infrastructure needs in both urban areas as well as lagging regions. Accordingly, in 2018, the government invested in road construction, rehabilitation and land acquisition with a view to improving the transport network of the country and mitigating traffic congestion. The multi purpose development project in Moragahakanda was vested to the public in January 2018, while the filling of water into the Kalu Ganga reservoir commenced in July 2018 with the aim of facilitating agricultural activities in the Northern, North Central, North Western, Central and Eastern provinces. Infrastructure development in the education sector during the year was channelled towards the development of both human resources and physical infrastructure under "the Nearest School is the Best School (NSBS)" Programme while rehabilitating the schools affected by floods and landslides. Meanwhile, the construction of two new national schools commenced in Kurunagala and Polonnaruwa in 2018. In addition, during the year the government launched a Rapid Rural Development Programme (RRDP) named "Gamperaliya" in order to improve the quality of infrastructure and to upgrade the living standards of the people, while supporting villages to become growth centers. The "Gamperaliya" programme, which commenced in 2018 covers twelve development areas[1] across the country. The National Agency for Public Private Partnerships (NAPPP) reviewed and finalised guidelines for public private partnerships (PPPs) in consultation with the MOF, with a view to promoting PPPs as a national strategy in addressing the infrastructure requirements of the country.

The government continued its welfare programmes for the economically vulnerable groups, while also taking measures to rationalise subsidy programmes. The main welfare schemes included the Samurdhi programme, fertiliser subsidy, financial support for elderly over 70 years of age, support for low income disabled persons, financial support for kidney patients, nutrition food programmes, free text books and free season tickets for students. With a view to improving maternal and child nutrition, programmes such as the nutritional food package for expectant mothers, the Thriposha programme and school nutrition programmes were continued during the year. The Welfare Benefits Board (WBB), which was established to provide the necessary legal framework and transparent selection process for all welfare related benefits in Sri Lanka, drafted welfare benefits payment schemes for the four main welfare programmes[2] and submitted it to the Cabinet of Ministers in October 2018. Further, the WBB was engaged in developing the selection methodology of the welfare payment schemes. In addition, actions were taken to establish the integrated Social Registry Information System (SRIS), which is an electronic database that will store data of welfare beneficiaries of different programmes, mainly for the purpose of selection and payment of welfare benifits. Meanwhile, a decision was taken by the Cabinet of Ministers, in March 2018, to terminate the cash grant of the fertiliser subsidy programme and replace it with the provision of fertiliser to farmers, to avoid issues that arose in implementing the cash grant policy. Accordingly, an approved amount of fertiliser was provided to farmers at a concessionary price of Rs. 500 per 50 kg bag for paddy and Rs. 1,500 per 50 kg bag in respect of other crops (such as potatoes, onions, capsicum, corn and soya) from the Yala season in 2018 onwards.

Several initiatives were taken during 2018 to improve the financial viability of major SOBEs in order to reduce the burden on the central government budget. Accordingly,

1 Tanks and anicuts, road sector infrastructure, construction of small scale bridges, school sanitary facilities, sports related infrastructure improvements, other socio-economic infrastructure development, development of "Sathi Pola", construction of children's parks, provision of electricity facilities for needy households, rehabilitation of temples, kovils, churches and mosques, setting up of solar power facilities for religious places, housing development in rural and urban areas.

2 Samurdhi programme, financial support for elderly over 70 years of age, support for low income disabled persons and financial support for kidney patients

performance reports for the first half of 2017 of the five SOBEs which had signed Statements of Corporate Intent (SCIs) in March 2017 were forwarded to the Cabinet of Ministers in May 2018. It is expected that ten more SOBEs[3] will sign SCIs in the near future in order to improve the efficiency of their operations. Further, the approval of the Cabinet of Ministers was granted in May 2018 to implement the formula based fuel pricing mechanism in order to improve the financial viability of the Ceylon Petroleum Corporation (CPC), while ensuring transparency in petroleum pricing. Consequently, the formula based price adjustments were in effect from May 2018 on a monthly basis to bring fuel prices in line with cost recovery levels. Moreover, the approval of the Cabinet of Ministers was expected to be obtained for an automatic pricing mechanism for electricity in 2019, in order to improve the financial performance of the Ceylon Electricity Board (CEB). A Bulk Supply Transaction Account (BSTA)[4] was established in May 2018 as a precondition for the implementation of the automatic pricing mechanism for electricity. Further, approval was granted by the Cabinet of Ministers in March 2019 to implement a pricing mechanism for imported milk powder in line with movements in international milk powder prices and the exchange rate while safeguarding the local milk industry. In addition, a pricing mechanism for Liquefied Petroleum (LP) gas is also expected to be established.

In order to implement a prudent debt management strategy, the Active Liability Management Act, No. 8 of 2018 (ALMA) was enacted and the formulation of a Medium Term Debt Management Strategy (MTDS) was in progress. The public debt management was further strengthened through the ALMA, which was passed by Parliament in March 2018 enabling the government to manage the public debt more proactively by addressing part of the refinancing requirements ahead of time (reducing rollover peaks) and extending the maturity duration and smoothening the repayment structure of International Sovereign Bonds (ISBs) and other debt securities. In general, liability management would help the government to diversify the investor base, provide opportunities to streamline the cost of borrowing based on market conditions, reduce refinancing risks in the near term and create a favourable price guidance on new issuances. Moreover, the ALMA would enable the Central Bank and the government to initiate liability management exercises in the domestic and foreign market in the form of building buffers, switching, buy-backs and reverse auctions. The MTDS would mainly focus on containing the foreign exposure of the central government debt profile while extending the average time to maturity in order to minimise any refinancing risks while lowering government debt to sustainable levels.

Several initiatives were taken by the Central Bank during the year to improve transparency and efficiency in the government securities market. The new Treasury bond issuance system, which was introduced in July 2017, was reviewed at the end of the first quarter of 2018 taking its performance into account and the feedback from market participants assisted in enhancing the efficiency and transparency of the issuance process. Further, in view of the increased volatility in global financial markets, the Central Bank reduced the threshold for foreign investment in rupee denominated government

3 Urban Development Authority (UDA), State Pharmaceuticals Corporation (SPC), Sri Lanka State Plantation Corporation (SLSPC), State Timber Corporation, Milco, National Livestock Development Board (NLDB), Central Engineering Consultancy Bureau (CECB), Lanka Sathosa (Pvt) Limited, Geological Survey and Mines Bureau (GSMB) and Kurunegala Planatation Company Limited.

4 The BSTA is an account of CEB transmission business through which all of its transactions are carried out. Accordingly, BSTA is to be used to settle transactions of the transmission licensee with generation and distribution licensees and other transmission customers.

securities from 10 per cent of the outstanding government securities stock to 5 per cent with effect from 18 January 2019.

The government raised US dollars 4.9 billion through the issuance of ISBs during 2018 and so far during 2019. In April 2018, the government issued the 12th ISB, which was the largest offshore bond offering ever by Sri Lanka and raised US dollars 2.5 billion. This issue comprised two ISBs of US dollars 1.25 billion each with a 5 year maturity at a yield rate of 5.75 per cent and a 10 year maturity at a yield rate of 6.75 per cent. In March 2019, the 13th ISB amounting to US dollars 2.4 billion was issued with two tenures of maturity amounting to US dollars 1.0 billion with a 5 year maturity at a yield rate of 6.85 per cent and US dollars 1.4 billion with a 10 year maturity at a yield rate of 7.85 per cent per annum. In addition, a Foreign Currency Term Financing Facility (FCTFF) of US dollars 1.0 billion was obtained in October 2018.

The primary balance target - Quantitative Performance Criteria (QPC) set under the the International Monetary Fund's Extended Fund Facility (IMF-EFF) programme - was achieved by the Government for end June 2018. The three-year IMF-EFF programme was obtained in June 2016 with the aim of strengthening the country's external sector while supporting the government's economic reform agenda. The programme included a reform agenda aimed at rebuilding foreign exchange reserves and reducing the fiscal deficit to contain the debt accumulation while restoring overall macroeconomic stability. Although, the QPC in respect of the primary balance for the period January-June 2018 was achieved recording Rs. 45.6 billion, the December QPC target of Rs. 141 billion was missed by Rs. 49.6 billion.

The sovereign credit ratings for Sri Lanka were revised by international sovereign rating agencies in 2018. On 06 February 2018, Fitch affirmed Sri Lanka's long-term foreign and local currency Issuer Default Ratings (IDR) at "B+" with a "stable" outlook. Meanwhile, Moody's Investor Services also affirmed Sri Lanka's sovereign rating at "B1" and maintained the "negative" outlook on 26 July 2018, while Standard and Poor's (S&P) long term rating stood at "B+" with a "stable" outlook. However, following the increased political uncertainty towards the end of 2018, major rating agencies revised the country's sovereign ratings. Accordingly, Moody's Investor Services (Moody's) on 20 November 2018 revised Sri Lanka's sovereign rating downward to B2 (Stable) from B1 (Negative). In addition, both Standard and Poor's and Fitch Ratings lowered Sri Lanka's sovereign rating from 'B+' (Stable) to 'B' (Stable) on 04 December 2018 and 21 December 2018, respectively. Such downgrading could also be attributed to the perceived heightened external refinancing risks, an uncertain policy outlook and the risk of a slowdown in fiscal consolidation arising from the political uncertainty, which prevailed at the time.

Although some progress was made in improving fiscal balances in comparison to the previous year, the government deviated from the key fiscal targets stipulated in the Budget 2018. Despite several revenue and expenditure reform measures initiated in the recent past, underperformance in revenue collection and rigidity in expenditure rationalisation have resulted in budgetary outcomes deviating from envisaged fiscal targets. A reduction in capital expenditure on economic and social infrastructure to offset any recurrent expenditure overruns would be undesirable as it could dampen economic growth prospects. Interest payments continued to be the single largest item in recurrent expenditure, while public sector salaries and wages exerted pressure on expenditure management. The changes in the demographic profile, coupled with the substantial increase in the size of the public sector, have resulted in an increase in pension payments, which accounted for a significant share (9.3 per cent) of recurrent expenditure. The high level of transfer payments and expenditure on welfare payments also continued to weigh on the government budget. As such, persistently high recurrent expenditure resulted in deviating the fiscal performance substantially from the stipulated targets thereby highlighting the need for further rationalisation of recurrent expenditure. In addition, unplanned expenditure emanating from increased incidence of natural disasters (e.g. compensation and mitigation costs due to the floods, droughts and damage caused by the Fall Armyworm ('Sena" Catepillar) exerted additional pressure on managing public expenditure. This underscores the importance of implementing contingency budgeting against weather-related natural disasters as well as mainstreaming sustainability into planning and budgeting processes. The high level of recurrent expenditure over and above the total revenue of the government and the resultant budget deficit would expand the government's financing requirements impacting adversely on the debt management efforts of the government. Moreover, a rise in foreign borrowings will increase the country's external vulnerability to risks such as tightening global financial market conditions. At the same time, an over reliance on domestic sources could result in an upward pressure on domestic interest rates, particularly amidst tighter liquidity conditions thereby escalating the public debt level, which remains high compared to peers. In such a context, maintaining fiscal discipline by adhering to binding fiscal rules would be imperative to achieve targeted outcomes in the fiscal consolidation process.

The efforts towards increasing revenue mobilisation would be essential to achieve revenue targets over the medium term. Improving tax compliance, eliminating loopholes leading to tax evasion and tax avoidance, strengthening risk based VAT audits at the IRD and rationalisation of tax exemptions would be major priorities in broadening the tax base and thereby enhancing revenue collection. Rationalisation of ineffective public expenditure, restructuring of SOBEs and introducing market based pricing mechanisms in order to enable SOBEs to operate as commercially viable entities and efficient targeting of transfers and subsidies would be required to improve the quality of public expenditure, while making space for critical social expenditure and public investment. As an ageing population remains a key concern, it is essential to take necessary measures to ensure the sustainability of the unfunded public sector pension scheme. A bill on new Public Financial Management (PFM) is to be submitted to Parliament, aimed at improving the budget process, identifying fiscal risks, improving fiscal transparency and accountability of the government operations. Stabilising the government debt level on a sustainable path requires a sufficiently large primary surplus to be generated over the medium term. A carefully crafted medium-term debt management strategy would be needed to steer the country away from the refinancing risks. Further, developing political consensus and raising public awareness are paramount in achieving targets stipulated in the fiscal consolidation path as fiscal consolidation would invariably be politically challenging without unwavering public support.

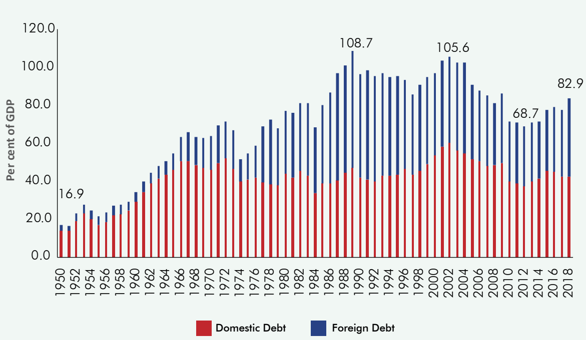
BOX 8
Maintaining a Sufficient Primary Surplus to Ensure a Sustainable Debt Level over the Medium Term

Introduction

Sri Lanka's government debt has been on a steadily rising trend since independence. The government debt to GDP ratio grew at an annual average of 2.8 per cent during 1950-2018, and compared to the growth of country's nominal income, which averaged around 4.5 per cent during the same period, such expansion of government debt is concerning. Such growth in government debt reflects the impact of sustained fiscal deficits, restricted access to concessional financing with the gradual rise in per capita income, and the depreciation of the exchange rate. Due to the limited availability of concessional funding, foreign currency financing tilted further towards commercial borrowings by means of International Sovereign Bonds, syndicated loans, and short-term borrowings from the foreign currency banking units of domestic banks, resulting in a significant increase of the share of foreign currency debt in the total outstanding debt.

As Figure B 8.1 shows government debt stock, which stood at 16.9 per cent of GDP at end 1950, increased steadily over time, peaking above 100 per cent of GDP on a few occasions before moderating to 68.7 per cent at end 2012. However, another upward trend in government debt has emerged since 2013 to reach at 82.9 per cent by end 2018.

Figure B 8.1
Debt to GDP Ratio of Sri Lanka during 1950 -2018



Source: Central Bank of Sri Lanka
Ministry of Finance

Recognising the importance of containing the level of government debt at a sustainable level, the Government has embarked on a revenue based fiscal consolidation strategy, where it aims at reducing the debt to GDP ratio below 70 per cent over the medium term. A major element in the government's medium term fiscal strategy is the envisaged surplus in the primary balance, which was achieved for the first time since 1992 and continued for the second consecutive year since 2017. The primary surplus plays a critical role in decelerating the pace of debt accumulation as it helps to fund a part of refinancing obligations instead of shifting the entire burden of debt servicing obligations on future borrowings.

The primary balance of the budget is defined as the fiscal balance net of interest payments and is considered as a key determinant of the government debt dynamics (Government Finance Statistics Manual, 2014, IMF and Panchanan, 2016, ADBI). A deficit in the primary balance is equal to the difference between revenue and non interest expenditure. It determines the extent of borrowings by the government for its expenditures other than the interest payments. The theoretical relationship between the debt level and primary balance together with other key variables can be summarised by a debt dynamic equation.

Dynamics of Government Debt

Based on the budget constraint, the change in the debt stock of a country in the current year can be expressed in the following equation (1) by combining the major variables that affect the stock of debt:

$$\Delta d_t = \left\{ \frac{1 + \hat{\imath}_t + \epsilon_t \alpha^f (1 + \hat{\imath}_t)}{(1 + g_t)(1 + \pi_t)} - 1 \right\} d_{t-1} - b_t \qquad (1)$$

where, d_t is the debt as a percentage of GDP at time t, b_t is the ratio of primary surplus as a percentage of GDP at time t, $\hat{\imath}_t$ is the effective nominal interest rate at time t,[1] ϵ_t is the exchange rate movement at time t,[2] π_t is the inflation rate at time t, α_t is the share of foreign debt and g_t is the growth rate of GDP at time t.

Defining a weighted average of domestic and foreign interest rate as $\hat{\imath}_t = \alpha^h i_t^h + \alpha^f i_t^f$ and assuming that $\hat{\imath}_t \approx i_t^h$ and foreign interest rate is fixed at i_t^f, debt dynamics for an open economy can be given as;

$$\Delta d_t = \left\{ \frac{i_t^h - \pi_t(1 + g_t) - g_t + \alpha_t \epsilon_t (1 + i_t^f)}{(1 + g_t)(1 + \pi_t)} - 1 \right\} d_{t-1} - b_t \qquad (2)$$

In the equation (2), primary balance has a strong bearing on debt dynamics. Accordingly, primary surplus helps in reducing the change in the debt to GDP ratio, whereas the primary deficit worsens the situation.

1 The effective interest rate in an open economy is a weighted average of domestic and foreign interest rates and exchange rate movements and can be presented as; $i_t = \alpha^h i_t^h + \alpha^f (i_t^f + \epsilon_t + i_t^f \epsilon_t)$ (Ley, 2010, the World Bank)

2 For simplicity, only one foreign currency is assumed.

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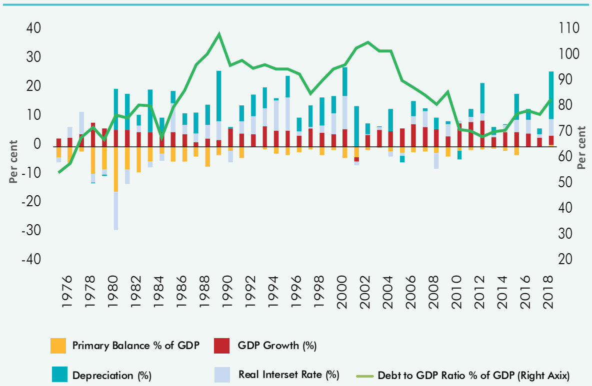
Moreover, if the government achieves a sufficient primary surplus to meet the interest payments given the other factors, then the debt to GDP ratio will be stabilised at the existing level, reflecting the fact that there would not be new borrowings beyond the roll-over requirement of capital payments. If the primary surplus further increases, then the debt to GDP ratio would be falling over time and vice versa.

Behaviour of the Debt Dynamics in Sri Lanka

In an open economy, the behaviour of major macroeconomic variables such as GDP growth, real interest rates and exchange rates provide valuable inputs for debt sustainability analysis.[3] As Figure B 8.2 depicts the subdued economic growth, high real interest rates,[4] notable depreciation of the rupee, and persistent primary deficits have resulted in an increase in the debt to GDP ratio since economic liberalisation through the early 2000s. However, the increasing trend in debt to GDP was reversed since 2001 through 2008, which could mainly be explained by relatively high GDP growth, negative or low real interest rates and relatively stable exchange rates and lower primary deficits. Meanwhile, the rise in debt to GDP ratio since 2009 is reflected by the combined impact of lower GDP growth, higher real interest rates and a higher primary deficit on account of increased non-interest expenditure in the post-conflict development activities. Further, since 2010, the primary balance improved, except in 2014 and 2015 partly contributing to the reduction of debt to GDP ratio below 80 per cent by end 2017.

Figure B 8.2
Government Debt and Key Determinants



Sources: Central Bank of Sri Lanka
Ministry of Finance

3 The relationship among real growth rate, real interest rate and debt level is derived by rearranging equation (2) as;

$$\Delta d_t = \left(\frac{\rho_t - g_t}{1+g_t}\right) \cdot d_{t-1} - b_t$$

where, ρ_t is now equal to $\rho_t = \frac{(\hat{\iota}_t - \hat{\pi}_t) + \epsilon_t\left[\alpha^f\left(1+i_t^f\right) - \beta^f\left(1+\pi_t^f\right)\right]}{1+\hat{\pi}_t + \epsilon_t \beta^f\left(1+\pi_t^f\right)}$ (3)

Further, equation (3) is analogous to $\Delta d_t = \left(\frac{r_t - g_t}{1+g_t}\right) \cdot d_{t-1} - b_t$, where r_t is real interest rate at time t and g_t is real GDP rate at time t.

4 91-day Treasury bills yield adjusted with CCPI inflation was taken as a proxy for real interest rate in the analysis.

However, in spite of the surplus in the primary balance of 0.6 per cent of GDP in 2018, the deb to GDP ratio increased to 82.9 per cent at end 2018, reflecting mainly the impact of sharp rupee depreciation, relatively low economic growth and high real interest rates.

Debt Stabilising Primary Balance for Sri Lanka over the Medium Term

A major task in the debt stabilsation exercise is the determination of the right level of primary surplus, which could deliver the envisaged reduction in the stock of debt over time. An approach has been proposed by the International Monetary Fund (IMF) using the Stress Tests developed based on the debt dynamic equation (2). Accordingly, a debt stabilising primary balance can be ascertained given the assumptions on the other variables that affect the path of debt dynamics. As such, a primary surplus that ensures a credible decline in the government's debt to GDP ratio along the path envisaged by the Government over the medium term is calculated under three scenarios of different rates of GDP growth, interest rates and currency depreciation. The projections are made for the period of 2019-2023 and assumptions of other variables based on current market conditions as shown in the Table B 8.1.

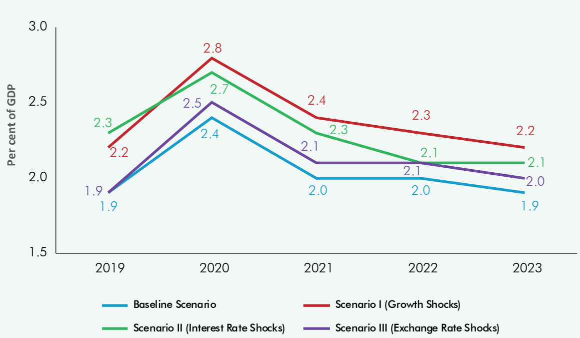
Table B 8.1
Debt Stablising Primary Balance over the Medium Term under the Baseline Scenario

Variables	Baseline Scenario (%)				
	2019	2020	2021	2022	2023
Primary Balance (p_t)	**1.9**	**2.4**	**2.0**	**2.0**	**1.9**
Domestic Interest Rate (i_t^h) (a)	11.4	11.5	11.6	11.7	11.8
Foreign Interest Rate (i_t^f) (b)	3.0	3.0	3.0	3.0	3.0
GDP Growth (g_t) (c)	4.0	4.5	5.0	5.0	5.0
Inflation Rate (π_t) (c)	5.0	5.0	5.0	5.0	5.0
Exchange Rate Depreciation (ϵ_t)	0.5	3.0	3.5	3.5	3.5
Portion of Foreign Debt (α_t)	50.0	48.0	45.0	43.0	42.0
Debt to GDP Ratio (d_t)	**83.0**	**81.0**	**75.0**	**72.0**	**70.0**

(a) Defined as domestic interest payments divided by domestic debt stock
(b) Foreign interest rate is kept fixed for all periods (assuming the current LIBOR and a fixed margin). Anyway, results are robust across marginal variations of the foreign interest rate.
(c) Based on Central Bank projections

The results indicate that the Government needs to maintain a primary surplus in the range of 1.9-2.4 per cent of GDP during 2019-2023 to bring the debt to GDP ratio below 70 per cent of GDP by end 2023, under the baseline scenario that assumes a modest rate of depreciation of the rupee. In addition, three different scenarios were considered, giving a 10 per cent shock on the growth rate (scenario I), interest rate (scenario II) and exchange rate depreciation (scenario III) (Figure B 8.3). Under the scenario I, in the event of a negative growth shock the required primary surplus to reduce the government debt to 70 percent of GDP increases to the range of 2.2 – 2.8 per cent of GDP. Under the scenario II, following the shock to the interest rate, the required primary surplus increases to the range of 2.1 – 2.7 percent of GDP. Under the scenario III, the shock to the rate of depreciation increases the required primary balance to the range of 1.9 – 2.5 percent of GDP. As such, results indicate that the impact of shocks to economic growth on the required primary balance is more significant, than the shocks to interest rate and exchange rate. Hence, the results underscore the importance of the role of the interest rate and growth differential in determining the required level of primary balance for debt stabilisation. In such context, the Government may need to maintain a large primary surplus, if the gap between the interest rate and GDP growth widens over time. According to the IMF Country Report (Article IV) - June 2018, the projected primary surplus target in the medium term is 2.0-2.1 per cent of GDP. As per the medium term fiscal framework (2018-2023) of the government, the Government aims to maintain a primary surplus in the range of 1.5-2.8 per cent over 2020-2023. Hence, the values derived from Stress Tests are comparable with the IMF and Government projections.

Figure B 8.3
Debt Stablising Primary Balance over the Medium Term under Different Scenarios

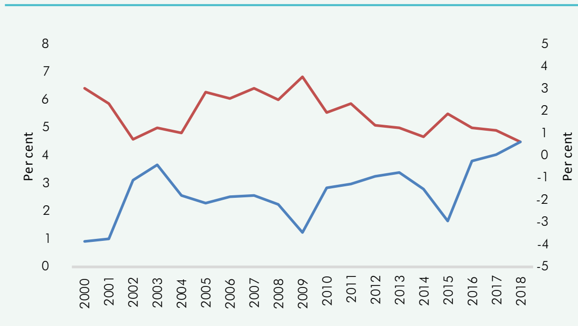


Way Forward

Stabilisation of the government debt to GDP ratio and subsequently putting it on a declining path requires a sufficiently large primary surplus to be generated over the medium term if the interest rate-growth differential is positive. Such a primary surplus should be driven mainly by robust revenue enhancement, in line with the ongoing revenue based fiscal consolidation framework. However, the progression along the envisaged primary balance path would appear challenging, if the actual collection of government revenue falls short of estimates, as was mostly seen in the recent years. On the expenditure front, rationalisation of non-interest recurrent expenditure is often challenging due to the growing recurrent expenditure, on the heel of large commitment on public sector salaries and wages, subsidies and social welfare programmes, and the costs associated with natural disasters.

It is also observed that the recent experience of ensuring a primary surplus amidst falling government revenue and rigid non-interest recurrent expenditure has been made possible by a significant deceleration in public investment. As Figure B 8.4 shows, the public investments as a share of GDP has been falling during the recent years, from 5.5 per cent in 2015 to 4.3 per cent in 2018 while the primary surplus has been improving from a deficit of 2.9 percent in 2015 to 0.6 per cent in 2018. If the primary surplus is mainly supported by a reduction in public investment instead of robust revenue reforms, such an outcome would compromise the growth prospects of the economy, hence would be unsustainable over the medium term. The lower level of public investment would hamper the economic growth, thereby affecting the debt dynamics, through interest rate and growth differential, among other factors. Hence, targeting a higher primary surplus while also planning for large public investment would be challenging for Sri Lanka over the medium term. Therefore, a right level of primary balance needs to consider a more realistic level of revenue mobilisation and a prudent level of expenditure management, aimed at gradual deceleration of government debt level.

Figure B 8.4
Primary Balance vs Public Investment as a per cent of GDP



Source: Central Bank of Sri Lanka
Ministry of Finance

As such, it is imperative that the improvements in fiscal operations of the government need to be achieved through the revenue based fiscal consolidation. In this regard, it is required to increase the government revenue further by way of broadening the tax base and structural reforms in tax administration while taking measures for rationalizing recurrent expenditure. The government's continuous commitment towards the revenue based fiscal consolidation will expand the fiscal space and allow for more spending on growth drivers in the medium term, while increasing infrastructure spending and effective fiscal outlay for key social spending categories and thereby influencing economic growth. In addition to the gradual increase in the path of envisaged economic growth, maintaining the interest rates and exchange at relatively stable levels would be essential to secure a sufficient primary surplus, thereby ensuring a sustainable debt level over the medium term.

References

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Panchanan., (2016), "Debt Dynamics, Fiscal Deficit, and Stability in Government Borrowing in India: A Dynamic Panel Analysis", ADBI Working Paper Series, ADB Institute

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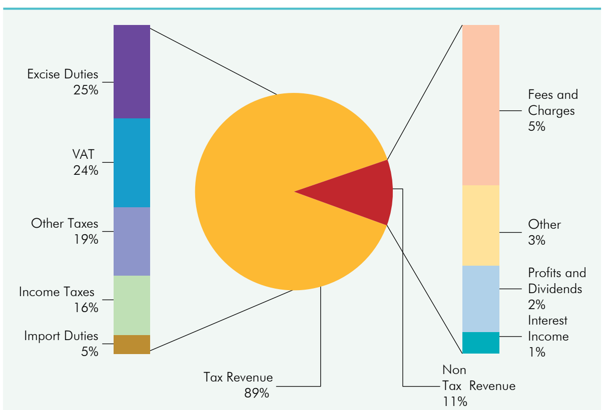
6.3 Government Budgetary Operations

Revenue and Grants

Revenue

During 2018, total revenue as a per cent of GDP declined due to the reduction in tax revenue despite an increase in non tax revenue. Accordingly, total government revenue declined to 13.3 per cent from 13.6 per cent in 2017. Tax revenue declined to 11.9 per cent of GDP in 2018 from 12.4 per cent in 2017 as a result of the lower revenue collection from import duties, VAT, excise duty on petroleum products and liquor, withholding tax and Cess levy and the delay in implementing certain revenue measures in the Budget 2018, particularly revisions related to the Finance Act. However, non tax revenue increased to 1.4 per cent of GDP in 2018 from 1.2 per cent recorded in the previous year due to the Central Bank profit transfers and the increase in revenue from fees and charges.

Figure 6.3
Composition of Government Revenue - 2018



Source: Ministry of Finance

In nominal terms, total revenue increased by 4.8 per cent to Rs. 1,920.0 billion in 2018 from Rs. 1,831.5 billion in 2017. Tax revenue increased by 2.5 per cent to Rs. 1,712.3 billion from Rs. 1,670.2 billion in 2017 reflecting a growth in revenue from corporate and non corporate income taxes, Pay-As-You-Earn (PAYE) tax, Economic Service Charge (ESC) and PAL. The revenue collection from VAT, NBT and excise duty on motor vehicles, cigarettes and liquor also increased in nominal terms, although revenue as a percentage of GDP declined in these categories. However, the revenue collection from import duties, excise duty on petroleum products, withholding tax and the Cess levy declined during the year in nominal terms. Revenue from indirect taxes continued to be the major contributor to the government coffers accounting for 81.9 per cent of total tax revenue in 2018. However, the share of revenue from direct taxes increased to 18.1 per cent during the year from 16.4 per cent in the previous year, reflecting mainly the impact of the implementation of the new Inland Revenue Act with effect from 01 April

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Table 6.2
Economic Classification of Government Revenue

Item	2017	2018 Approved Estimates	2018 Provisional	2019 Preliminary Estimates (a)
		Rs. million		
Tax Revenue	1,670,178	2,034,000	1,712,318	2,077,000
Income Taxes	274,562	370,000	310,449	385,000
VAT	443,760	550,000	461,740	529,000
Excise Taxes	469,500	535,040	484,287	593,000
Import Duties	136,501	175,000	96,991	140,000
Other Taxes	345,855	403,960	358,851	430,000
Non Tax Revenue	161,353	183,200	207,656	267,000
Total Revenue	1,831,531	2,217,200	1,919,973	2,344,000
		As a percentage of GDP (b)		
Tax Revenue	12.4	14.3	11.9	13.3
Income Taxes	2.0	2.6	2.1	2.5
VAT	3.3	3.9	3.2	3.4
Excise Taxes	3.5	3.8	3.4	3.8
Import Duties	1.0	1.2	0.7	0.9
Other Taxes	2.6	2.8	2.5	2.8
Non Tax Revenue	1.2	1.3	1.4	1.7
Total Revenue	13.6	15.6	13.3	15.0

(a) Based on Budget Speech 2019 (excluding revenue transfers to Provincial Councils)
(b) For 2017, revised GDP estimates were used, as released by the Department of Census and Statistics on 19 March 2019.

Source: Ministry of Finance

2018. Meanwhile, non tax revenue increased to Rs. 207.7 billion in 2018 from Rs. 161.4 billion in 2017 resulting in the share of tax revenue in total revenue declining to 89.2 per cent in 2018 from 91.2 per cent in 2017.

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Revenue from income taxes increased during the year both in terms of GDP and in nominal terms due to the increase in revenue collection from corporate and non corporate income taxes, PAYE tax and ESC. Accordingly, as a percentage of GDP revenue from income taxes increased marginally to 2.1 per cent in 2018 from 2.0 per cent in 2017 while in nominal terms the income tax revenue collection increased significantly by 13.1 per cent to Rs. 310.4 billion during the year from Rs. 274.6 billion in the previous year. Revenue from corporate and non corporate income taxes increased by 18.1 per cent to Rs. 169.6 billion in 2018 from Rs. 143.6 billion in 2017 mainly due to the implementation of the Inland Revenue Act, No. 24 of 2017 with effect from 01 April 2018 and the strengthening of the payment and return monitoring process by the IRD. Revenue from PAYE tax also improved during the year by 25.7 per cent to Rs. 41.4 billion from Rs. 32.9 billion in 2017, largely due to improvements in the monitoring process related to the submission of PAYE returns and payments with the initiation of the RAMIS system. Moreover, revenue from ESC increased by 18.5 per cent to Rs. 53.0 billion in 2018 due to the imposition of ESC on the importation of motor vehicles based on the payable excise duty and the imposition of ESC on a share of one tenth of the turnover of the wholesale supply of fuel since September 2018. Further, the revenue collection from Capital Gains Tax (CGT) amounted to Rs. 104.0 million in 2018. However, revenue from withholding tax declined by 13.0 per cent to Rs. 46.4 billion in 2018 from Rs. 53.3 billion in 2017 as a result of the removal of withholding tax on interest income of Treasury bills and Treasury bonds, with effect from 01 April 2018.

Although revenue from VAT as a percentage of GDP declined marginally in 2018, it increased in nominal terms during the year. Accordingly, as a per cent of GDP, revenue from VAT declined to 3.2 per cent of GDP, while in nominal terms VAT revenue increased by 4.1 per cent to Rs. 461.7 billion mainly as a result of the rise in imports such as coal, milk powder, cement and lubricants and the removal of VAT exemptions on a number of items. Further, monitoring of payments and receipts with the implementation of RAMIS, increased tax audits strengthening the tax administration process of the IRD which supported this growth in nominal terms. The revenue collection from VAT on domestic economic activities increased by 2.6 per cent to Rs. 282.6 billion in 2018 from Rs. 275.4 billion in 2017. Meanwhile, revenue from VAT on import related activities also increased during the year by 6.4 per cent to Rs. 179.2 billion. Accordingly, VAT revenue as a per cent of total tax revenue increased marginally during the year to 27.0 per cent from 26.6 per cent in 2017. However, the contribution of VAT revenue to total revenue declined marginally to 24.0 per cent in 2018 from 24.2 per cent in 2017.

Revenue from excise duties declined as a per cent of GDP in 2018 although reflecting an increase in nominal terms. Accordingly, revenue from excise duties as a percentage of GDP declined to 3.4 per cent during the year from 3.5 per cent in the previous year. However, in nominal terms, the revenue collection from excise duties increased by 3.1 per cent to Rs. 484.3 billion from Rs. 469.5 billion mainly due to the increase in the revenue from excise duty on motor vehicles and cigarettes amidst the decline in revenue from the excise duty on petroleum products. During early 2018, excise duty from the importation of motor vehicles increased substantially compared to 2017 as a result of a rise in the importation of motor vehicles, although during the latter part of the year vehicle imports declined on account of measures taken by the government and the Central Bank to reduce imports. Accordingly, annual revenue collection from the excise duty on motor vehicles increased to Rs. 204.1 billion in 2018 from Rs. 189.7 billion in 2017. Moreover, revenue from excise duty on cigarettes and tobacco increased by 7.3 per cent to Rs. 92.2 billion mainly due to the increase in excise duty rates on cigarettes in mid 2018. Revenue from excise duty on liquor recorded a marginal increase of 0.2 per cent to Rs. 113.9 billion in 2018 due to the increase in soft liquor production. Meanwhile, revenue from the excise duty on petroleum products declined by 10.4 per cent to Rs. 66.3 billion due to the decline in diesel imports during the year and the reduction of excise duty on the importation of auto diesel during the latter part of 2018. Revenue collection from excise duties remained the single largest contributor to total tax revenue in 2018, while the share of excise tax revenue in total tax revenue increased to 28.3 per cent in 2018 from 28.1 per cent recorded in the previous year.

In nominal terms, the revenue collection from import duties was lower in 2018 while revenue from SCL increased in comparison to 2017. Revenue from import duties declined during the year reflecting the reduction in applicable duty rates on petrol, diesel and milk powder and the decline in diesel imports. Accordingly, revenue from import duties as a per cent of GDP declined to 0.7 per cent in 2018, from 1.0 per cent in 2017 and in nominal terms, revenue from import duties declined by 28.9 per cent to Rs. 97.0 billion in 2018. The share of import duty in tax revenue decelerated during 2018 to 5.7 per cent from 8.2 per cent recorded in 2017. Meanwhile, revenue from SCL increased in nominal terms by 6.2 per cent to Rs. 75.8 billion from Rs. 71.4 billion as a result of the increase in SCL rates applicable on several commodities. The share of SCL in tax revenue increased to 4.4 per cent in 2018 from 4.3 per cent in the previous year.

The revenue collection from other taxes showed a mixed performance during the year. Accordingly, revenue from PAL recorded an increase of 11.3 per cent to Rs. 114.0 billion in 2018 from Rs. 102.4 billion in 2017 in response to the increase in the importation of several intermediate goods which were subject to PAL. However, revenue from the Cess levy decreased during the year by 10.4 per cent to Rs. 53.4 billion in 2018 from Rs. 59.6 billion in 2017 owing to the removal of Cess on 253 imported items in the 2018 Budget with a view of phasing out para tariffs applicable on the importation of several goods. Revenue from NBT increased in nominal terms by 3.4 per cent to Rs. 71.4 billion during the year due to the increase in both domestic economic activities and import related activities. Accordingly, NBT revenue from import related economic activities increased by 4.4 per cent to Rs. 20.2 billion while revenue from domestic economic activities increased by 3.0 per cent to Rs. 51.2 billion during the year. However, as a percentage of GDP, revenue from NBT remained unchanged at 0.5 per cent as in the previous year. Revenue from the Telecommunication Levy declined by 15.2 per cent to Rs. 28.3 billion in comparison to Rs. 33.4 billion in 2017, due to the removal of taxes on internet services coupled with the drop in call duration.

Non tax revenue increased in 2018 both in terms of GDP and in nominal terms. Accordingly, non tax revenue as a per cent of GDP increased to 1.4 per cent in 2018 from 1.2 per cent in 2017, while in nominal terms, non tax revenue increased by 28.7 per cent to Rs. 207.7 billion in 2018 from Rs. 161.4 billion in 2017 mainly due to Central Bank profit transfers and increased revenue from fees and charges. In 2018, revenue generated through Central Bank profit transfers was Rs. 15.0 billion. In addition, revenue from fees and charges increased by 51.8 per cent to Rs. 101.1 billion from Rs. 66.6 billion recorded in 2017 due to upward revisions of fees and charges in the 2018 Budget. Meanwhile, revenue from rent and interest income increased by 15.9 per cent to Rs. 13.7 billion in 2018. Revenue from social security contributions increased by 9.9 per cent to Rs. 25.2 billion in 2018 from Rs. 22.9 billion in 2017 mainly due to the increase in the basic salary of public servants. However, profit and dividend transfers from major SOBEs declined by 22.5 per cent to Rs. 41.8 billion during 2018 from Rs. 54.0 billion in the previous year. Overall, the share of non tax revenue in total revenue increased during the year to 10.8 per cent from 8.8 per cent in 2017.

Grants

Total foreign grants received from multilateral and bilateral sources during the year increased to Rs. 12.5 billion from Rs. 8.0 billion in 2017. However, grants from multilateral sources declined significantly by 30.3 per cent to Rs. 3.8 billion in 2018 compared to Rs. 5.5 billion recorded in 2017. Accordingly, the share of grants from multilateral sources declined significantly to 30.6 per cent from 68.2 per cent recorded in 2017. Meanwhile, grants from bilateral sources increased significantly to Rs. 8.7 billion in 2018 from Rs. 2.6 billion in 2017. The major development partners who provided grants during the year were the Government of Japan, the Government of India and the World Bank.

Expenditure and Net Lending

The total expenditure and net lending as a per cent of GDP declined to 18.6 per cent in 2018 from 19.2 per cent in 2017 mainly due to the moderation of public investment. Accordingly, as a per cent of GDP, recurrent expenditure increased marginally to 14.5 per cent in 2018 from 14.4 per cent in 2017 while capital expenditure and net lending declined significantly to 4.2 per cent in 2018 compared to 4.8 per cent recorded in the previous year. Public investment, which includes capital expenditure and on lending of the government, declined to 4.3 per cent of GDP in 2018 from 4.9 per cent of GDP in 2017. However, in nominal terms, total expenditure and net lending increased by 4.7 per cent to Rs. 2,693.2 billion in 2018 from Rs. 2,573.1 billion in 2017, while capital expenditure and net lending declined, even in nominal terms, to Rs. 603.5 billion in 2018 from Rs. 645.4 billion in 2017.

The recurrent expenditure as a per cent of GDP increased marginally to 14.5 per cent in 2018 from 14.4 per cent in 2017. However, in

Table 6.3
Economic Classification of Expenditure and Lending Minus Repayments

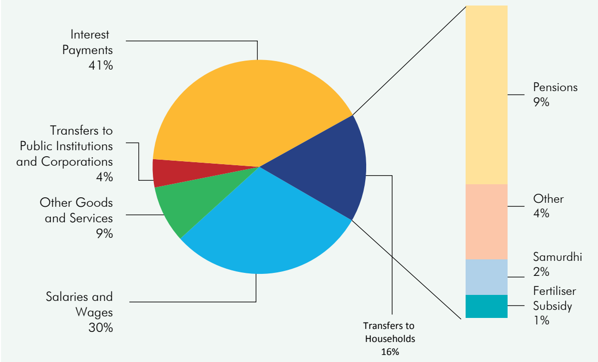
Item	2017	2018		2019
		Approved Estimates	Provisional	Preliminary Estimates (a)
	Rs. million			
Recurrent Expenditure	**1,927,693**	**2,152,000**	**2,089,713**	**2,308,000**
Expenditure on Goods and Services	756,591	862,954	806,002	849,000
o/w Salaries and Wages	588,518	630,000	626,045	690,000
Interest Payments	735,566	820,000	852,190	913,000
Foreign	164,942	170,000	212,708	220,000
Domestic	570,623	650,000	639,482	693,000
Current Transfers and Subsidies	435,536	469,046	431,521	546,000
o/w To Households and Other Sectors	350,420	392,632	342,546	445,000
Samurdhi	39,707	43,950	39,239	50,000
Pensions	181,059	197,659	194,495	215,000
Fertiliser Subsidy	30,361	32,000	26,948	35,000
Other	99,293	119,023	81,864	145,000
Capital Expenditure	**638,343**	**746,863**	**612,561**	**741,000**
Acquisition of Real Assets	360,333	528,499	355,763	463,000
Capital Transfers	278,010	218,364	256,798	278,000
Lending Minus Repayments	**7,021**	**3,336**	**-9,046**	**-7,000**
Total Expenditure and Net Lending	**2,573,056**	**2,902,200**	**2,693,228**	**3,042,000**
	As a percentage of GDP (b)			
Recurrent Expenditure	**14.4**	**15.2**	**14.5**	**14.8**
Expenditure on Goods and Services	5.6	6.1	5.6	5.4
o/w Salaries and Wages	4.4	4.4	4.3	4.4
Interest Payments	5.5	5.8	5.9	5.9
Foreign	1.2	1.2	1.5	1.4
Domestic	4.3	4.6	4.4	4.4
Current Transfers and Subsidies	3.2	3.3	3.0	3.5
o/w To Households and Other Sectors	2.6	2.8	2.4	2.9
Samurdhi	0.3	0.3	0.3	0.3
Pensions	1.3	1.4	1.3	1.4
Fertiliser Subsidy	0.2	0.2	0.2	0.2
Other	0.7	0.8	0.6	0.9
Capital Expenditure	**4.8**	**5.3**	**4.2**	**4.8**
Acquisition of Real Assets	2.7	3.7	2.5	3.0
Capital Transfers	2.1	1.5	1.8	1.8
Lending Minus Repayments	**0.1**	**...**	**-0.1**	**...**
Total Expenditure and Net Lending	**19.2**	**20.4**	**18.6**	**19.5**

Source : Ministry of Finance

(a) Based on Budget Speech 2019 (excluding expenditure transfers to Provincial Councils)
(b) For 2017, revised GDP estimates were used, as released by the Department of Census and Statistics on 19 March 2019.

nominal terms, recurrent expenditure increased by 8.4 per cent to Rs. 2,089.7 billion in 2018 from Rs. 1,927.7 billion in 2017. The increase in interest payments mainly contributed to the increase in recurrent expenditure in nominal terms. As a percentage of GDP, an increase in interest payments contributed to the marginal increase in recurrent expenditure amidst the lower expenditure on salaries and wages and current transfers and subsidies.

Figure 6.4
Composition of Government Recurrent Expenditure - 2018



Source: Ministry of Finance

The interest payments as a percentage of GDP increased to 5.9 per cent in 2018 from 5.5 per cent in 2017. In nominal terms, interest expenditure increased by 15.9 per cent to Rs. 852.2 billion in 2018 from Rs. 735.6 billion in 2017 due to the increase in interest rates and borrowings. The interest payments on domestic debt, which increased by 12.1 per cent to Rs. 639.5 billion in 2018 from Rs. 570.6 billion in 2017 accounted for 75.0 per cent of total interest payments in 2018. The interest expenditure on Treasury bonds amounted to Rs. 501.5 billion in 2018, an increase of 14.4 per cent mainly due to the increased net issuances of Treasury bonds in 2018. Interest payments on Treasury bills declined by 8.3 per cent to Rs. 74.5 billion in 2018 from Rs. 81.3 billion in 2017 due to the lower interest rates that prevailed in the first half of 2018 although the interest rates rose during the latter part of the year. In addition, interest payments on Sri Lanka Development Bonds (SLDBs) and Rupee loans amounted to Rs. 41.0 billion and Rs. 2.9 billion, respectively, in 2018. Interest expenditure on foreign debt increased by 29.0 per cent to Rs. 212.7 billion in 2018 from Rs. 164.9 billion in 2017 due to the elevated interest rates in the international markets and the significant rise in the foreign borrowings in the recent past. Interest payments continued

Table 6.4
Functional Classification of Expenditure (a)

Item	2017	2018 Approved Estimates	2018 Provisional
	Rs. million		
Recurrent Expenditure	**1,927,693**	**2,152,000**	**2,089,713**
General Public Services	424,975	484,732	422,432
Civil Administration	113,175	153,432	107,847
Defence	228,013	239,091	228,235
Public Order and Safety	83,787	92,209	86,350
Social Services	640,368	709,535	685,739
Education	187,628	205,049	195,168
Health	161,312	180,977	180,568
Welfare	264,510	303,369	276,773
Community Services	26,919	20,139	33,230
Economic Services	126,310	132,288	127,052
Agriculture and Irrigation	71,460	71,997	63,451
Energy and Water Supply	1,478	1,589	1,483
Transport and Communication	34,657	41,729	41,805
Other	18,715	16,973	20,313
Other	736,040	825,445	854,490
o/w Interest Payment	735,566	820,000	852,190
Capital Expenditure and Lending	**657,386**	**761,000**	**624,970**
General Public Services	46,348	55,853	50,261
Civil Administration	41,362	47,445	44,275
Public Order and Safety	4,986	8,408	5,986
Social Services	135,306	207,371	133,233
Education	69,705	105,707	71,748
Health	35,509	52,867	37,893
Housing	9,553	24,006	9,493
Community Services	20,493	24,791	14,098
Economic Services	474,118	494,333	437,897
Agriculture and Irrigation	66,663	77,550	58,895
Energy and Water Supply	54,872	49,204	39,107
Transport and Communication	228,847	176,199	216,147
Other	123,736	191,380	123,748
Other	1,614	3,443	3,579
Total Expenditure and Lending	**2,585,079**	**2,913,000**	**2,714,683**
	As a percentage of GDP (b)		
General Public Services	3.5	3.8	3.3
Social Services	5.8	6.5	5.7
Economic Services	4.5	4.4	3.9
Other	5.5	5.8	5.9
o/w Interest Payment	5.5	5.8	5.9
Total Expenditure and Lending	**19.3**	**20.5**	**18.8**

(a) Preliminary estimates for 2019 are not available.
(b) For 2017, revised GDP estimates were used, as released by the Department of Census and Statistics on 19 March 2019.

Source : Ministry of Finance

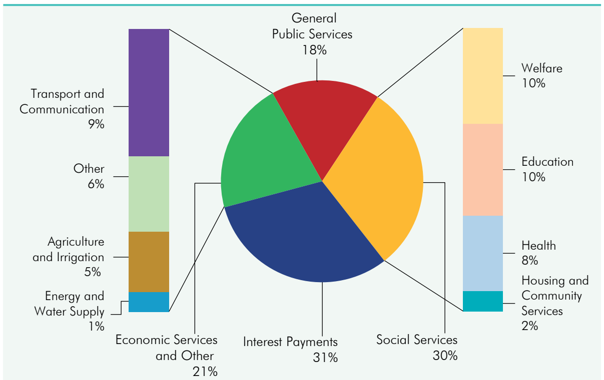
to be the single largest recurrent expenditure item, accounting for 40.8 per cent of total recurrent expenditure and 44.4 per cent of government revenue in 2018.

The expenditure on goods and services remained unchanged at 5.6 per cent of GDP in 2018 as in the previous year. However, in nominal terms expenditure on goods and services increased by 6.5 per cent to Rs. 806.0 billion from Rs. 756.6 billion in 2017. Salaries and wages, the largest expenditure item in this category, declined to 4.3 per cent of GDP in 2018 from 4.4 per cent of GDP in the previous year. However, in nominal terms outlays on salaries and wages increased by 6.4 per cent to Rs. 626.0 billion in 2018 from Rs. 588.5 billion in 2017. Salaries and wages paid to central government employees, including defence personnel, increased by 5.7 per cent to Rs. 464.0 billion, while the central government contribution to salaries and wages of employees of PCs increased by 8.3 per cent to Rs. 162.1 billion during the year. This was mainly due to the continuation of the inclusion of interim allowance to the basic salary with the implementation of the new salary structure from January 2016 onwards for public sector employees. Salaries and wages continued to be the second largest recurrent expenditure item with its share in recurrent expenditure marginally reducing to 30.0 per cent in 2018 from 30.5 per cent in 2017. Expenditure on other goods and services increased by 7.1 per cent to Rs. 180.0 billion in nominal terms, although declining to 1.2 per cent in 2018 from 1.3 per cent in 2017 as a per cent of GDP.

Total current transfers and subsidies declined during the year both in nominal terms and as a percentage of GDP. Accordingly, total current transfers and subsidies, as a percentage of GDP declined to 3.0 per cent in 2018 from 3.2 per cent in 2017 due to the decline in current transfers to the household sector. Similarly, in nominal terms, current transfers and subsidies declined by 0.9 per cent to Rs. 431.5 billion in 2018 from Rs. 435.5 billion in 2017 due to the reduction in current transfers to households and public corporations. Current transfers to households and other sectors accounted for 79.4 per cent of total current transfers, while transfers to public institutions and public corporations accounted for 14.3 per cent and 6.3 per cent, respectively, in 2018.

Current transfers to households which include pension payments, declined to 2.4 per cent of GDP in 2018 from 2.6 per cent of

Figure 6.5
Total Expenditure by Function - 2018



Source: Ministry of Finance

GDP in 2017. Similarly, in nominal terms, current transfers to households declined by 2.2 per cent to Rs. 342.5 billion in 2018 from Rs. 350.4 billion in 2017. Pension payments, the largest item under transfers to households, increased by 7.4 per cent to Rs. 194.5 billion in 2018 due to the increase in the number of pensioners during the year by 22,986 to 622,508 and the increase in the monthly pension as a result of the hike in basic salaries of government employees. Expenditure on the Samurdhi programme amounted to Rs. 39.2 billion in 2018 which is a marginal decline of 1.2 per cent in comparison to the previous year. Expenditure on welfare programmes for disabled soldiers increased by 9.2 per cent over the previous year to Rs. 30.4 billion in 2018. Meanwhile, expenses incurred on the fertiliser subsidy declined by 11.2 per cent to Rs. 26.9 billion in 2018 from the previous year due to the reduction in paddy cultivation which resulted from the drought condition. Further, the recurrent expenditure incurred on disaster relief measures was around 0.1 per cent of GDP in 2018.

Current transfers to public institutions and public corporations as a percentage of GDP remained unchanged as in the previous year. Accordingly, current transfers to public institutions and public corporations remained at 0.4 per cent of GDP and 0.2 per cent of GDP, respectively. However, in nominal terms, current transfers to public institutions increased while current transfers to public corporations declined during the year. Accordingly, current transfers to public institutions increased by 13.3 per cent to Rs. 61.6 billion during the year, mainly due to the increase in current transfers to the education sector, particularly for government universities. However, current transfers to public corporations declined by 11.1 per cent to Rs. 27.3 billion due to the reduction in current transfers to the transport sector which reflected the measures taken by the government to improve efficiency of public corporations. Transfers provided to cover operational losses of the Department of Sri Lanka Railways and the Department of Posts declined during the year to Rs. 7.0 billion and Rs. 5.2 billion, respectively.

Capital expenditure and net lending declined both in nominal terms and as a percentage of GDP due to the slowdown in the implementation of capital projects. Accordingly, as a percentage of GDP, capital expenditure and net lending declined significantly to 4.2 per cent in 2018 from 4.8 per cent in 2017. Similarly, in nominal terms, capital expenditure and net lending declined by 6.5 per cent to Rs. 603.5 billion during the year from to Rs. 645.4 billion in the previous year. Meanwhile, public investment, which includes capital expenditure and on lending of the government, declined in GDP terms to 4.3 per cent in 2018 from 4.9 per cent in the previous year. In nominal terms, public investment declined by 4.9 per cent to Rs. 625.0 billion in 2018 from Rs. 657.4 billion in 2017. Expenditure incurred by Ministries and Departments on the acquisition of real assets, including the purchase of capital assets and construction and development of fixed assets, also declined by 1.2 per cent to Rs. 355.8 billion in 2018. Moreover, capital transfers declined by 7.7 per cent to Rs. 256.8 billion due to the reduction in transfers to public institutions by 7.1 per cent. Meanwhile, on lending of the government to public corporations amounted to Rs. 12.4 billion in 2018, a decline of 34.8 per cent from Rs. 19.0 billion recorded in 2017.

Amidst the limited fiscal space available, investments in economic and social services declined significantly during the year. Accordingly, public investments in economic services decreased to Rs. 437.9 billion in 2018 from Rs. 474.1 billion in 2017. Similarly, public investments in social services amounted to Rs. 133.2 billion in 2018 in comparison to Rs. 135.4 billion in 2017. Public investments in economic services were mainly channelled towards improving the transportation network of the country while facilitating agricultural activities through upgrading of irrigation systems. Public investment in social services focused largely on improving the quality of education and health sectors. Accordingly, during the year, measures were taken to upgrade the infrastructure in the education sector with the aim of providing equal education opportunities to every child in the country. Meanwhile, public investments in the health sector focused mainly on constructing and upgrading hospitals and improving laboratory facilities to enhance the quality of service delivery in the health sector.

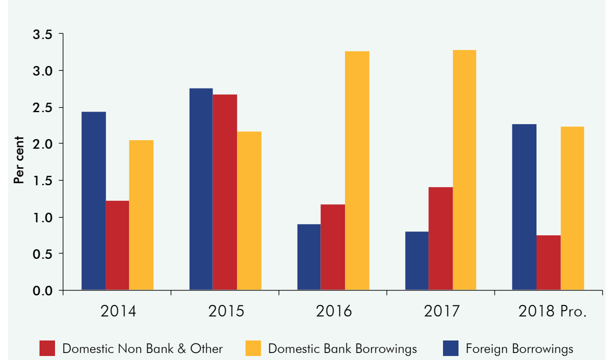
Key Fiscal Balances

The budget deficit and primary surplus improved during the year, while the current account deficit increased marginally. The overall budget deficit as a percentage of GDP improved to 5.3 per cent in 2018 from 5.5 per cent in the previous year, supported by the moderation in total expenditure despite a decline in revenue as a percentage of GDP. However, the budget deficit deviated from the target of 4.8 per cent envisaged in the Budget 2018. Meanwhile, the primary surplus increased to 0.6 per cent (Rs. 91.4 billion) in 2018 from 0.02 per cent (Rs. 2.1 billion) in 2017, reflecting mainly the reduction in capital expenditure during the year. However, the current account deficit increased to 1.2 per cent in 2018 from 0.7 per cent in 2017, reflecting slippages in the revenue collection and an overrun in recurrent expenditure, largely due to higher than estimated interest payments.

Financing of the Budget Deficit

The overall budget deficit was financed largely through domestic sources in 2018. Financing through domestic sources accounted for 3.0 per cent of GDP in 2018 when compared to 2.2 per cent of GDP in 2017. In terms of the overall budget deficit, 57.5 per cent of the resource requirement (Rs. 437.2 billion) was financed through domestic sources in 2018 in comparison to 40.1 per cent (Rs. 294.3 billion) in 2017. Consequently, the share of financing through foreign sources declined notably to 42.5 per cent (Rs. 323.5 billion) in 2018 from 59.9 per cent (Rs. 439.2 billion) in 2017. Accordingly, financing through foreign sources as a percentage of GDP declined to 2.2 per cent in 2018 from 3.3 per cent in 2017.

Figure 6.6
Deficit Financing (Net)
(as a percentage of GDP)



Sources: Ministry of Finance
Central Bank of Sri Lanka

Table 6.5
Sources of Domestic Financing (Net)

Rs. billion

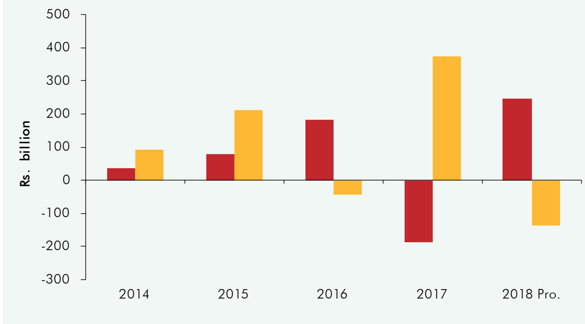
Item	2015	2016	2017	2018 (a)
By Instrument	**592.7**	**248.4**	**294.3**	**437.2**
Treasury Bonds (b)	442.6	349.8	109.1	374.5
Treasury Bills (c)	-26.4	98.5	-81.7	52.9
Rupee Loans	-31.4	-	-	-
Sri Lanka Development Bonds	223.0	-120.5	53.3	-129.5
Central Bank Provisional Advances	7.2	-67.8	116.5	-1.2
Other (d)	-22.3	-11.5	97.0	140.4
By Source	**592.7**	**248.4**	**294.3**	**437.2**
Bank	291.8	140.0	187.7	109.5
Non Bank (d)	300.9	108.5	106.5	327.8

(a) Provisional
(b) Excludes rupee denominated Treasury bonds issued to foreign investors and funds raised for restructuring of SOBEs in 2015
(c) Excludes rupee denominated Treasury bills issued to foreign investors
(d) Includes proceeds from the long lease of Hambantota Port in 2017 and 2018

Sources: Ministry of Finance
Central Bank of Sri Lanka

In the domestic sources of financing the budget deficit, dependence on the domestic banking sector reduced significantly, while the reliance on domestic non bank sources increased substantially in 2018. Accordingly, financing from the banking sector reduced considerably to Rs. 109.5 billion (25.0 per cent of domestic financing) in 2018 from Rs. 187.6 billion (63.8 per cent) in 2017. Financing from the Central Bank increased notably to Rs. 246.1 billion in 2018 from a net repayment of Rs. 187.9 billion in 2017. Purchase of Treasury bills by the Central Bank entirely contributed to the net increase in borrowings from the Central Bank during 2018. However, financing from commercial banks recorded a net repayment of Rs. 136.6 billion during the year compared to net borrowings of Rs. 375.7 billion in 2017. Repayments to commercial banks were largely on account of SLDBs and Treasury bonds owing to the retirement of Treasury bonds and SLDBs during the year, while borrowings through Treasury bills declined significantly. However, financing from non bank sources accounted for 75.0 per cent (Rs. 327.8 billion) of total net domestic financing in 2018 in comparison to 36.2 per cent (Rs. 106.5 billion) in 2017. The financing from non bank sources included Rs. 107.9 billion of proceeds from the long lease of Hambantota Port in 2018.

Figure 6.7
Sources of Bank Financing (Net)



Sources: Ministry of Finance
Central Bank of Sri Lanka

Funds mobilised through foreign sources declined in 2018 with significant outflows in foreign holdings of rupee denominated Treasury bonds and Treasury bills. Accordingly, financing of the budget deficit through foreign borrowings reduced to Rs. 323.5 billion in 2018 from Rs. 439.2 billion in 2017. Net borrowings through ISBs amounted to Rs. 390.4 billion (US dollars 2.5 billion) in 2018, in comparison to Rs. 228.5 billion (US dollars 1.5 billion) in 2017. A net outflow of Rs. 141.1 billion was recorded in respect of foreign holdings of government securities compared to a net inflow of Rs. 57.3 billion in the previous year. Meanwhile, net borrowings through the FCTFF amounted to Rs. 66.6 billion in 2018 as compared to Rs. 152.7 billion in 2017. Net borrowings through foreign project loans increased to Rs. 7.7 billion in comparison to Rs. 779 million in 2017. The Export-Import Bank of China (Exim Bank), IDA, the Government of Japan and Asian Development Bank (ADB) were the main sources of foreign project financing in 2018.

Domestic borrowings of the government by way of instruments, namely Treasury bills, Treasury bonds and SLDBs, in net terms,

increased significantly in 2018. Accordingly, domestic instrument based borrowings increased to Rs. 298.0 billion in 2018 from Rs. 80.8 billion in 2017 mainly due to higher borrowings through government securities. Borrowings through Treasury bonds increased significantly to Rs. 374.5 billion in 2018 from Rs. 109.1 billion in 2017. Meanwhile, borrowings through Treasury bills amounted to Rs. 52.9 billion in 2018 as against the net repayment of Rs. 81.7 billion in 2017. Borrowings through SLDBs recorded a net repayment of Rs. 129.5 billion compared to net borrowings of Rs. 53.3 billion in 2017. Meanwhile, non instrument borrowings declined to Rs. 139.3 billion in 2018 compared to Rs. 213.5 billion in 2017 due to the decline in Central Bank provisional advances during the year.

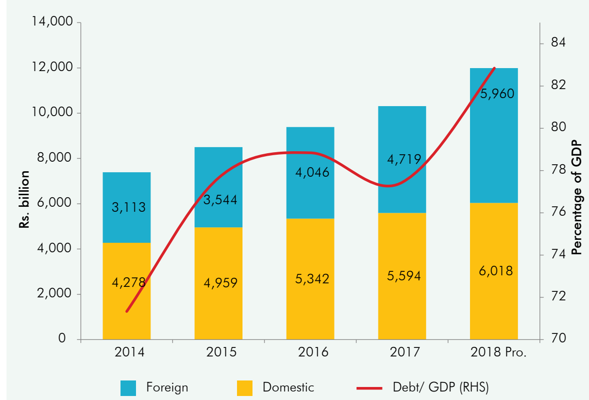
Foreign currency denominated domestic borrowings, which include SLDBs and short term loans from foreign currency banking units (FCBUs) recorded an overall net repayment during 2018. Accordingly, borrowings through SLDBs amounted to a net repayment of Rs. 129.5 billion, while borrowings through FCBUs declined, on a net basis, to Rs. 19.1 billion in 2018. The net repayment of SLDBs during the year was the difference between gross borrowings of SLDBs amounting to Rs. 234.1 billion (US dollars 1.5 billion) and the repayments of SLDBs amounting to Rs. 363.6 billion (US dollars 2.3 billion). On a net basis, foreign currency borrowings from domestic sources recorded a net repayment of Rs. 110.4 billion in 2018 compared to a net borrowing of Rs. 86.6 billion in 2017, while rupee denominated net domestic financing amounted to Rs. 547.6 billion compared to Rs. 207.7 billion in 2017.

6.4 Government Debt and Debt Service Payments

Central Government Debt

The central government debt to GDP ratio increased to 82.9 per cent at end 2018 from 76.9 per cent at end 2017. The increase in the

Figure 6.8
Outstanding Central Government Debt



Sources: Ministry of Finance
Central Bank of Sri Lanka

debt to GDP ratio in 2018 was the combined effect of the depreciation of the rupee against major foreign currencies, relatively low nominal GDP and higher net borrowings to finance the budget deficit. In absolute terms, the total outstanding central government debt stock increased by 16.1 per cent to Rs. 11,977.5 billion at end 2018. This increase includes the impact of exchange rate variations amounting to Rs. 1,063.2 billion due to the sharp depreciation of the rupee against foreign currencies in 2018. Meanwhile, the debt stock increased by Rs. 81.2 billion due to the discount factor, which is the net amount of the difference between the book value and the face value of issuances of Treasury bills and Treasury bonds during the year. The share of domestic debt as a percentage of GDP decreased marginally to 41.6 per cent by end 2018 from 41.7 per cent at end 2017, while the share of foreign debt increased notably to 41.2 per cent of GDP at the end of 2018 from 35.2 per cent of GDP at end 2017.

The share of domestic debt in the total outstanding debt declined for the third consecutive year to 50.2 per cent at end 2018 from 54.2 per cent at end 2017. In nominal terms, the domestic debt increased by 7.6 per cent in 2018 to Rs. 6,018.0 billion at

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

Rs. million

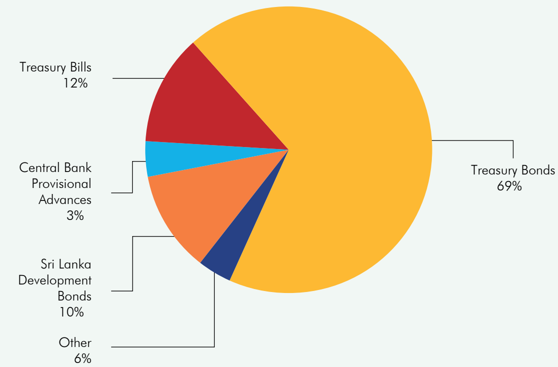
Item	2015	2016	2017	2018 (a)
Total Government Debt	**8,503,227**	**9,387,303**	**10,313,045**	**11,977,539**
Domestic Debt (b)	**4,959,196**	**5,341,507**	**5,594,427**	**6,017,992**
By Maturity Period				
Short Term	913,291	968,396	1,031,181	1,134,553
Medium and Long Term	4,045,905	4,373,111	4,563,246	4,883,439
By Institution				
Bank	1,924,036	2,114,901	2,328,544	2,315,320
Non Bank	3,035,160	3,226,606	3,265,883	3,702,671
Foreign Debt	**3,544,031**	**4,045,796**	**4,718,618**	**5,959,547**
By Type				
Concessional Loans	1,729,895	1,897,680	2,130,482	2,705,836
Non Concessional Loans	507,047	538,859	560,207	268,556
Commercial (c)	1,307,089	1,609,257	2,027,928	2,985,156
By Currency				
SDR	734,552	755,614	829,537	954,761
US Dollars	1,733,790	2,207,431	2,650,431	3,781,626
Japanese Yen	470,109	496,852	516,218	622,852
Euro	181,084	183,561	208,075	225,831
Other	424,495	402,338	514,356	374,477
Memo: Total Exchange Rate Variation	285,091	186,650	225,223	1,063,218
On Foreign Debt	228,731	161,697	211,868	963,181
On Foreign Currency Denominated Domestic Debt	56,360	24,953	13,355	100,037

(a) Provisional
(b) Excludes rupee denominated Treasury bonds held by foreign investors, and Treasury bonds amounting to Rs. 78,447 million issued to settle dues to CPC in January 2012. Due to maturing of some of those bonds in January 2017, the outstanding amount remained as Rs. 56,662 million
(c) Includes outstanding amounts of foreign investments in rupee denominated Treasury bills and Treasury bonds

Sources: Ministry of Finance
Central Bank of Sri Lanka

end 2018 in comparison to an increase of 4.7 per cent in 2017. The share of short term debt in total domestic debt increased to 18.9 per cent at end 2018 from 18.4 per cent at end 2017. The increase in short term debt is largely reflected in the increase in the overdraft balances of the government and the outstanding stock of Treasury bills. Treasury bills in short term domestic debt also increased to Rs. 746.9 billion by end 2018 from Rs. 697.2 billion at end 2017. However, the outstanding debt on account of provisional advances declined marginally to Rs. 198.6 billion at end 2018 from Rs. 199.8 billion at end 2017. Meanwhile, the share of medium to long term debt in the domestic debt stock declined marginally to 81.1 per cent in 2018 from 81.6 per cent in 2017. Within this category, Treasury bonds amounting

Figure 6.9
Composition of Outsanding Central Government Domestic Debt - 2018



Sources: Ministry of Finance
Central Bank of Sri Lanka

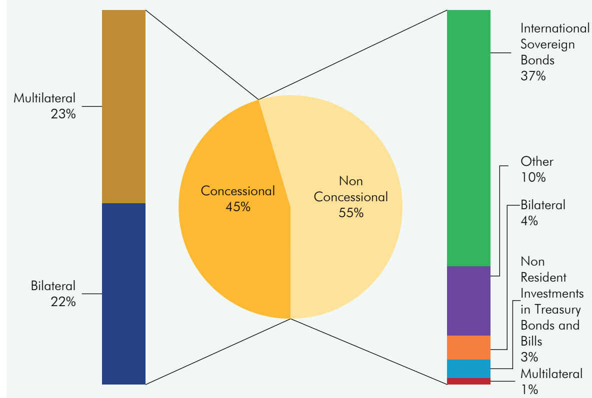
to Rs. 4,140.7 billion at end 2018, dominated the outstanding domestic debt portfolio, accounting for 68.8 per cent of the total domestic debt at end 2018, in comparison to 68.3 per cent or Rs. 3,822.6 billion at end 2017. However, the stock of SLDBs declined by 3.7 per cent to Rs. 614.2 billion at end 2018, reflecting the lower reliance on SLDBs to finance the budget deficit during the year.

The debt obligation of the central government to the domestic banking sector declined marginally to Rs. 2,315.3 billion at end 2018 due to the decline in outstanding debt owned by commercial banks, despite the increase in the outstanding debt owned by the Central Bank to Rs. 244.1 billion. The share of the banking sector debt in total domestic debt declined to 38.5 per cent by end 2018 from 41.6 per cent at end 2017. The significant increase in the debt held by the Central Bank was due to Treasury bills amounting to Rs. 45.8 billion during the year in comparison to Rs. 9.9 billion in 2017. However, the outstanding balance of provisional advances declined marginally at end 2018 to Rs. 198.6 billion. Meanwhile, the outstanding debt owned by commercial banks declined to Rs. 2,071.2 billion at end 2018 mainly due to lower investments in Treasury bonds by commercial banks in 2018. Accordingly, the stock of Treasury bonds held by commercial banks declined to Rs. 658.1 billion at end 2018 from Rs. 803.5 billion at end 2017. The share of non bank sector debt in total domestic debt increased to 61.5 per cent in 2018 from 58.4 per cent in the previous year, recording an outstanding of Rs. 3,702.6 billion due to higher investments in Treasury bonds by the non bank sector at end 2018.

The foreign currency denominated domestic debt increased marginally to Rs. 714.7 billion (US dollars 3,911.0 million) at end 2018 from Rs. 702.1 billion (US dollars 4,593.2 million) at end 2017. The outstanding balance on account of FCBUs rose notably to Rs. 100.5 billion (US dollars 550 million) at end 2018, while loans obtained from SLDBs declined to Rs. 614.2 billion (US dollars 3,361 million). Meanwhile, rupee denominated domestic debt increased by Rs. 410.9 billion to Rs. 5,303.3 billion at end 2018.

The total stock of foreign debt of the central government in rupee terms continued to increase in 2018 with the depreciation of the rupee against major foreign currencies. The outstanding balance of foreign debt increased significantly to Rs. 5,959.5 billion at end 2018 from Rs. 4,718.6 billion at end 2017. Non concessional loans, including commercial loans, increased to Rs. 3,253.7 billion in 2018 mainly due to the issuance of ISBs (US dollars 2.5 billion) and issuance of FCTFF (US dollars 1.0 billion). Within this category, the outstanding foreign holdings of Treasury bills and Treasury bonds declined significantly by Rs. 163.8 billion to Rs. 158.8 billion mainly reflecting significant outflows of foreign investments from the government securities market with the policy rate hikes of the Federal Reserve of the USA. Meanwhile, with the issuance of ISBs in 2018, the outstanding

Figure 6.10
Composition of Outsanding Central Government Foreign Debt - 2018

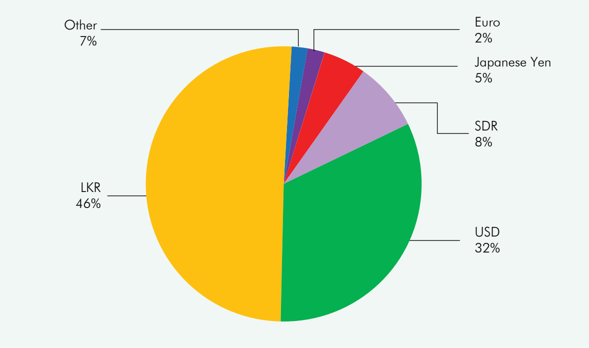


Sources: Ministry of Finance
Central Bank of Sri Lanka

stock of ISBs increased notably to Rs. 2,220.4 billion (US dollars 12.2 billion) at end 2018. However, the share of non concessional loans in the foreign debt portfolio declined marginally to 54.6 per cent at end 2018 from 54.8 per cent at end 2017. The outstanding stock of concessional debt increased to Rs. 2,705.8 billion at end 2018 from Rs. 2,130.5 billion at end 2017.

The depreciation of the Sri Lankan rupee against several major currencies resulted in an increase in the total debt stock, in rupee terms, by Rs. 1,063.2 billion at end 2018. The Sri Lankan rupee depreciated notably by 16.4 per cent, 18.1 per cent, 14.1 per cent, 12.7 per cent, 11.4 per cent and 8.7 per cent, against the US dollar, the Japanese yen, Special Drawing Rights (SDR), the euro, the pound sterling and the Indian rupee, respectively, during the year. The government foreign debt stock consisted of debt denominated in US dollars (63.5 per cent), SDR (16.0 per cent), Japanese yen (10.5 per cent), euro (3.8 per cent) and other currencies (6.3 per cent) as at end 2018. Consequently, the outstanding stock of foreign debt increased by Rs. 963.2 billion mainly due to the depreciation of the Sri Lankan rupee against major foreign currencies, while

Figure 6.11
Currency Composition of Total Outstanding Central Government Debt - 2018



Sources: Ministry of Finance
Central Bank of Sri Lanka

the foreign currency denominated domestic debt stock (SLDBs and loans from FCBUs) increased by Rs. 100.0 billion due to the depreciation of the Sri Lankan rupee against the US dollar. Although the impact of depreciation of the Sri Lankan rupee would be reflected as an increase in the government foreign currency debt stock in rupee terms, the outstanding debt stock denominated in foreign currency would remain unchanged in terms of foreign currency, irrespective of such depreciation. As the debt denominated in foreign currency would be serviced using foreign currency inflows to the government, the impact of such a nominal increase in the outstanding balance due to the depreciation of the rupee would be less material in the context of foreign currency debt servicing.

Central Government Debt Service Payments

Total debt service payments in 2018 amounted to Rs. 2,088.6 billion in nominal terms, recording a substantial increase of 30.3 per cent (Rs. 485.5 billion) in comparison to Rs. 1,603.0 billion in 2017. An increase in both amortisation payments and interest payments contributed to the increase in total debt service payments during the year. Amortisation payments, which accounted for 59.2 per cent of total debt service payments

Table 6.7
Central Government Debt Service Payments

Rs. million

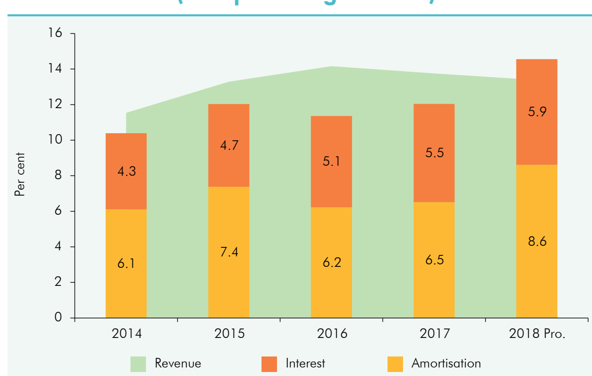
Item	2015	2016	2017	2018 (a)
Debt Service Payments	**1,317,791**	**1,352,443**	**1,603,049**	**2,088,551**
Domestic	918,112	1,056,624	1,213,498	1,561,363
Foreign	399,679	295,820	389,551	527,188
Amortisation Payments	**808,117**	**741,549**	**867,484**	**1,236,361**
Domestic	523,824	572,442	642,875	921,881
Foreign	284,293	169,107	224,609	314,480
Interest Payments	**509,674**	**610,895**	**735,566**	**852,190**
Domestic	394,289	484,182	570,623	639,482
Short Term	57,728	78,787	81,275	74,525
Medium and Long Term	336,561	405,394	489,348	564,957
Foreign	115,386	126,713	164,942	212,708

(a) Provisional

Sources: Ministry of Finance
Central Bank of Sri Lanka

increased considerably by 42.5 per cent to Rs. 1,236.4 billion in 2018 from Rs. 867.5 billion in 2017. The increase in the maturing of Treasury bonds and SLDBs, and repayment of loans obtained through FCBUs and FCTFF mainly contributed to the increase in amortisation payments during the year. The amortisation payments on Treasury bonds and SLDBs increased by 43.3 per cent and 27.5 per cent, respectively to Rs. 510.0 billion and Rs. 363.6 billion in 2018. Similarly amortisation payments to FCBUs also increased notably by Rs. 46.0 billion to Rs. 47.8 billion during 2018 due

Figure 6.12
Central Government Debt Service Payments (as a percentage of GDP)



Sources: Ministry of Finance
Central Bank of Sri Lanka

to the repayment of loans obtained from FCBUs. Meanwhile, repayment of foreign loans rose by 40.1 per cent to Rs. 314.5 billion mainly due to the repayment of the part of the FCTFF. The total interest payments also increased by 15.9 per cent to Rs. 852.2 billion in 2018 from Rs. 735.6 billion in 2017. High domestic interest payments were mainly due to a 14.4 per cent increase in interest payments on Treasury bonds amounting to Rs. 501.5 billion in 2018 reflecting increased issuances. Interest payments on foreign loans rose by 29.0 per cent (Rs. 47.8 billion) to Rs. 212.7 billion in 2018 in comparison to 2017 mainly due to higher interest payments on foreign commercial borrowings and the depreciation of the rupee against major foreign currencies. Debt service payments to domestic sources increased by 28.7 per cent to Rs. 1,561.4 billion, while debt service payments to foreign sources rose by 35.3 per cent to Rs. 527.2 billion during 2018.

Debt service payments related indicators weakened in 2018. Total debt service payments increased to 14.5 per cent of GDP in 2018 from 11.9 per cent of GDP in the previous year. Amortisation payments on domestic debt as a percentage of GDP increased to 6.4 per cent in 2018 from 4.8 per cent in 2017, while amortisation payments on foreign debt also increased to 2.2 per cent of GDP in 2018 from 1.7 per cent of GDP in 2017. Total interest payments as a percentage of GDP increased to 5.9 per cent in 2018 from 5.5 per cent in 2017. Interest payments on domestic debt increased to 4.4 per cent of GDP in 2018 from 4.3 per cent of GDP in 2017 while interest payments on foreign debt increased to 1.5 per cent of GDP in 2018 from 1.2 per cent of GDP in the previous year. Moreover, the ratio of debt service payments to government revenue increased substantially to 108.8 per cent in 2018 from 87.5 per cent in 2017, indicating that the total debt service payment of the government is larger than the government revenue in 2018. The ratio of foreign debt service payments to exports increased to 16.0 per cent in 2018 from 13.4 per cent in 2017.

Table 6.8
Central Government Debt Indicators

Indicator	2015	2016 (a)	2017 (a)	2018 (b)
Central Government Debt/GDP	77.7	78.3	76.9	82.9
Domestic Debt/GDP	45.3	44.5	41.7	41.6
Foreign Debt/GDP	32.4	33.7	35.2	41.2
Total Foreign Debt/Exports (c)	154.0	159.3	162.2	181.0
Total Debt Service/GDP	12.0	11.3	11.9	14.5
Total Debt Service/Government Revenue (d)	90.6	80.2	87.5	108.8
o/w Domestic Debt Service/Government Revenue (d)	63.1	62.7	66.3	81.3
Total Debt Service/Government Expenditure (e)	42.5	44.0	46.6	53.1
o/w Domestic Debt Service/Government Expenditure (e)	29.6	34.4	35.3	39.7
Foreign Debt Service/Exports (c)	17.4	11.6	13.4	16.0
Total Interest/GDP	4.7	5.1	5.5	5.9
Domestic Interest/GDP	3.6	4.0	4.3	4.4
Domestic Interest/Government Recurrent Expenditure	23.2	27.5	29.6	30.6
Foreign Interest/Exports (c)	5.0	5.0	5.7	6.5

(a) Based on revised GDP estimates for 2016 and 2017 released by the Department of Census and Statistics on 19 March 2019
(b) Provisional
(c) Export of goods and services
(d) Government revenue is in economic format
(e) Government expenditure includes amortisation payments

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

Outstanding Public Debt

The outstanding public debt, which includes central government debt, outstanding Treasury bonds issued for restructuring of SOEs, foreign project loans received by SOEs, public guaranteed debt and outstanding international bonds issued by SOEs increased notably in 2018. The total outstanding public debt (excluding state owned banking institutions) increased to 91.2 per cent of GDP by end 2018 from 84.2 per cent of GDP in the previous year, mainly due to the depreciation of the rupee against major foreign currencies, relatively low nominal GDP and higher net borrowings in the public sector. In absolute terms, the total outstanding public debt increased to Rs. 13,182.1 billion at end 2018 from Rs. 11,303.5 billion at end 2017. The outstanding central government debt, which is the largest subset of the total public debt, increased by

Table 6.9
Outstanding Public Debt (as at end year)

	2015	2016	2017	2018 (a)
	Rs.million			
Total Outstanding Central Government Debt	**8,503,227**	**9,387,303**	**10,313,045**	**11,977,539**
Outstanding Treasury Bonds Issued for Restructuring of SOEs (b)	**95,963**	**91,566**	**69,788**	**56,662**
Foreign Project Loans Received by SOEs	**338,064**	**332,305**	**330,221**	**366,130**
Airport & Aviation Services (Sri Lanka) Ltd.	26,284	23,791	23,955	24,964
Ceylon Electricity Board	173,874	166,613	155,535	168,649
Sri Lanka Ports Authority	137,906	141,901	150,730	172,517
Public Guaranteed Debt (c)	**382,218**	**497,059**	**563,742**	**749,760**
Airport & Aviation Services (Sri Lanka) Ltd.	158	1,386	9,330	10,829
Ceylon Electricity Board	2,937	19,927	15,153	21,376
Ceylon Petroleum Corporation	157,836	74,363	207,622	333,869
Ceylon Shipping Corporation Ltd.	7,575	11,331	11,436	13,098
General Sir John Kotelawala Defence University	15,852	20,187	28,060	36,843
Lanka Coal Company (Pvt.) Ltd.	5,000	6,000	5,886	11,000
National Water Supply & Drainage Board	9,130	20,365	63,836	85,541
Paddy Marketing Board	6,377	5,377	11,087	11,436
Road Development Authority	135,574	141,948	162,701	189,022
Other Cooperations	41,780	196,176	48,631	36,746
Outstanding International Bonds issued by SOEs (d)	**25,211**	**26,215**	**26,750**	**31,981**
Public debt	**9,344,682**	**10,334,448**	**11,303,545**	**13,182,072**
	As a % of GDP (e)			
Total Outstanding Central Government Debt	77.7	78.3	76.9	82.9
Outstanding Treasury Bonds Issued for Restructuring of SOEs (b)	0.9	0.8	0.5	0.4
Foreign Project Loans Received by SOEs	3.1	2.8	2.5	2.5
Public Guaranteed Debt (c)	3.5	4.1	4.2	5.2
Outstanding International Bonds issued by SOEs (d)	0.3	0.2	0.2	0.2
Public debt	**85.3**	**86.1**	**84.2**	**91.2**

(a) Provisional
(b) Includes (i) Treasury bonds amounting to Rs. 4,397 million issued to settle dues to CWE in November 2003, which matured in 2016 (ii) Treasury bonds amounting to Rs. 78,447 million issued to settle dues to CPC in January 2012. Due to maturing of some of those bonds in January 2017 the outstanding amount remained as Rs. 56,662 million and (iii) Treasury bonds amounting to Rs. 13,125 million issued to capitalise SriLankan Airlines, which matured in 2018
(c) Includes only non financial public corporations
(d) Includes an international bond amounting to US dollars 175 million issued by the SriLankan Airlines in June 2014
(e) Based on revised GDP estimates for 2016 and 2017 released by the Department of Census and statistics on 19 March 2019

Sources: Ministry of Finance
Central Bank of Sri Lanka

16.1 per cent to Rs. 11,977.5 billion at end 2018, accounting for 90.9 per cent of the total public debt. Public guaranteed debt increased by 33.0 per cent to Rs. 749.8 billion at end 2018 from Rs. 563.7 billion at end 2017, accounting for 5.7 per cent of the total outstanding public debt. Meanwhile, foreign project loans received by SOEs and outstanding international bonds issued by SOEs increased to Rs. 366.1 billion and Rs. 32.0 billion, respectively at end 2018 from Rs. 330.2 billion and 26.8 billion, respectively reported at end 2017. However, outstanding Treasury bonds issued for restructuring of SOEs declined to Rs. 56.7 billion at end 2018 from Rs. 69.8 billion at end 2017 due to the retirement of Treasury bonds in August 2018, which were issued to raise capital of SriLankan Airlines.

6.5 Budgetary Operations in Sub National Governments

Policy Direction and Measures taken by Sub National Governments

As in the previous years, the Ministry of Internal and Home Affairs and Provincial Councils and Local Government continued to play a vital role in the development process of the sub national governments in 2018. The sub national government system in Sri Lanka comprises nine Provincial Councils (PCs) and 341 Local Government authorities (LGs). At end 2018, the LG system comprised 22 Municipal Councils, 43 Urban Councils and 276 Pradesheeya

Sabhas. Accordingly, the Ministry maintained a better coordination with sub national government authorities during the year, in order to identify the development needs at the sub national level and facilitate investments through effective donor coordination thereby enhancing balanced regional development.

At the sub national government level, priority was given to develop infrastructure facilities including the upgrading of education and health sectors. Accordingly, the Local Government Enhancement Sector Project (Pura Neguma programme) continued in 2018 with the objective of improving access to safe and affordable drinking water.The Transforming School Education as the Foundation of a Knowledge Hub project continued during the year in order to improve the facilities of selected schools while ensuring equal access to education. The Health Sector Development Project also continued during the year with the aim of improving maternal and child health care facilities. Further, in order to protect the environment while creating a healthy atmosphere, the National Solid Waste Management Project continued while actions were taken to promote household composting and waste segregation with the help of constructing compost yards and waste collecting centers. In addition, the Greater Colombo Water and Waste Water Management Programme and Construction of Rural Bridges Project also continued during the year.

The Finance Commission recommended several measures during the year with a view to achieving balanced regional development. Accordingly, the Commission recommended to establish a common framework which includes required national and sub national level information for planning and monitoring in order to improve the effectiveness of the decision making process. Further, the Commission recommended that funds disbursed for development activities coming under devolved subjects should be channelled through the PCs, in order to ensure the effective utilisation of funds and maintain transparency and accountability of investments. Further, the Commision recommended to ensure a strong coordination between national and sub national authorities in order to utilise scarce resources effectively. In addition, advice was given to strictly adhere to the Commission's recommendations in distributing capital funds among PCs in order to achieve balanced regional growth.

Budgetary Operations in Provincial Councils

The total revenue of PCs continued to increase in nominal terms in 2018, although as a percentage of GDP it remained unchanged as in the previous year. Total revenue of PCs increased by 4.6 per cent to Rs. 90.9 billion in 2018 from Rs. 87.0 billion in 2017 due to the increase in tax revenue while a decline was recorded in non tax revenue. However, as a percentage of GDP, total revenue remained unchanged at 0.6 per cent as in the previous year. In nominal terms, tax revenue increased by 6.0 per cent to Rs. 82.4 billion while non tax revenue declined by 7.7 per cent to Rs. 8.6 billion in 2018. The transfers of NBT revenue from the central government increased by 3.5 per cent to Rs. 33.9 billion due to the higher NBT revenue

Table 6.10
Budget Outturn of Provincial Councils

Rs. million

Item	2015	2016	2017 (a)	2018 (b)
Total Revenue	**67,972**	**79,595**	**86,978**	**90,937**
Tax Revenue	61,476	70,942	77,691	82,362
Non Tax Revenue	6,496	8,653	9,287	8,576
Total Expenditure	**269,586**	**276,147**	**287,838**	**294,513**
Recurrent Expenditure	222,223	237,664	241,338	252,206
o/w Personal Emoluments	171,871	182,497	187,367	197,395
Capital Expenditure	47,363	38,483	46,500	42,307
Central Government Transfers	**201,614**	**196,552**	**200,860**	**203,576**
Block Grants	167,551	169,106	166,348	180,095
Criteria Based Grants	3,753	3,035	3,236	2,462
Province Specific Development Grants	13,345	12,177	20,250	13,536
Foreign Grants for Special Projects	16,965	12,234	11,025	7,483

(a) Revised
(b) Provisional

Sources: Ministry of Finance
Ministry of Internal and Home Affairs and Provincial Councils and Local Government

collection following the removal of the exemption applicable on the importation and manufacture of liquor in July 2018. Revenue from stamp duty increased by 11.5 per cent to Rs. 35.1 billion in 2018 due to the imposition of stamp duty on liquor licenses and license for the sale of bottled toddy in October 2018. Revenue from license fees increased to Rs. 11.7 billion in 2018 from Rs. 11.0 billion in 2017. Revenue from stamp duty and the transfers of NBT revenue from the central government accounted for 42.6 per cent and 41.2 per cent of total tax revenue of PCs, respectively. The share of revenue of the Western Provincial Council of the total revenue collection by all PCs increased to 51.8 per cent in 2018 from 51.2 per cent in 2017. Of the revenue collection by the other PCs, the North Western and Southern provinces accounted for 9.4 per cent and 9.3 per cent of the total revenue, respectively. Meanwhile, the share of revenue collected from the Sabaragamuwa province declined to 4.3 per cent in 2018 from 4.9 per cent in 2017.

Recurrent expenditure of PCs in 2018 increased in nominal terms while declining marginally as a percentage of GDP during the year. Accordingly, in nominal terms, recurrent expenditure increased by 4.5 per cent to Rs. 252.2 billion in 2018 while as a percentage of GDP, recurrent expenditure declined to 1.7 per cent in 2018 from 1.8 per cent in the previous year. The increase in recurrent expenditure was mainly due to higher expenditure on personal emoluments. Accordingly, personal emoluments during 2018 amounted to Rs. 197.4 billion recording an increase of 5.4 per cent and continued to be the single largest item in the recurrent expenditure accounting for 78.3 per cent of the total recurrent expenditure of PCs. The education and health sectors absorbed around 90 per cent of the personal emoluments of PCs. On a functional basis, recurrent expenditure on social services and economic services increased to Rs. 227.4 and Rs. 4.5 billion, respectively while outlays on provincial administration declined to Rs. 20.3 billion in 2018. The three highest spending PCs, in 2018 were the Western, the Central and the North Western accounting for 21.3 per cent, 12.6 per cent and 11.9 per cent of total recurrent expenditure, respectively.

Capital expenditure of PCs as a percentage of GDP remained unchanged over the previous year, although a decline was reported in nominal terms. Accordingly, capital expenditure in nominal terms declined by 9.0 per cent to Rs. 42.3 billion in 2018. This was mainly due to the decline on expenditure in Province Specific Development Projects (PSDPs) by 33.2 per cent to Rs. 13.5 billion, capital expenditure on special projects by 32.1 per cent to Rs. 7.5 billion and capital transfers to local governments by 5.1 per cent to Rs. 3.6 billion amidst the increase in acquisition of capital goods by 38.7 per cent to Rs. 14.2 billion, in 2018. However, as a percentage of GDP, capital expenditure remained unchanged at 0.3 per cent as in the previous year.

In 2018, transfers from the central government to PCs mainly through block grants increased by 1.4 per cent to Rs. 203.6 billion while grants for special projects, Province Specific Development Grants (PSDGs) and Criteria Based Grants (CBGs) declined during the year. Block grants, the major form of central government transfers to PCs, amounted to Rs. 180.1 billion, representing 88.5 per cent of the total transfers that were provided to meet the resource gap in the recurrent expenditure programme of PCs. The transfers under grants for special projects, PSDGs and CBGs amounted to Rs. 7.5 billion, Rs. 13.5 billion and Rs. 2.5 billion, respectively. During the year, a share of 69.1 per cent of the expenditure of PCs was financed through central government transfers which underscores the urgent need to strengthen PCs by way of enhancing their revenue generation and rationalising expenditure, in line with the fiscal consolidation efforts of the central government.