6

FISCAL POLICY AND GOVERNMENT FINANCE

6.1 Overview

While the country battled against the COVID-19 pandemic and multifaceted external sector challenges, budgetary operations of the Central Government weakened in 2021 reflecting the impact of deep rooted fiscal imbalances and unintended consequences of certain fiscal policy measures. Mobilisation of government revenue as a percentage of GDP, which declined sharply in 2020, further weakened to historic lows in 2021 with the revenue losses resulting from the pandemic induced subpar economic performance and the continuation of the low tax regime instituted since late 2019. Meanwhile, government expenditure remained unabated during the period under review, owing to higher expenditure on account of salaries and wages and interest expenses along with the pandemic related outlays. Although capital expenditure and net lending recorded a notable increase, public investments declined marginally in 2021. Overall fiscal deficit further widened in 2021 while significantly deviating from the budgeted level and reaching the highest level since 1988. With foreign financing avenues being limited with adverse global market developments as well as sovereign credit rating downgrades, the Government was compelled to rely mostly on the domestic banking sector, especially the Central Bank, to finance the budget deficit. The Central Bank provided a substantial amount of funds to the Government to smoothen the functioning of fiscal operations amidst the socio-economic challenges caused by the pandemic while maintaining an accommodative monetary policy stance until August 2021 to maintain the borrowing cost at a lower level. However, as excessive deficit financing through the banking sector is inflationary, a gradual phase out of central bank financing and resorting to long term foreign financing options for deficit financing in an active manner should be pursued to preserve monetary stability. Meanwhile, outstanding central government debt grew to a disconcerting level by end 2021, both in nominal terms and as a percentage of GDP, and this growth was a combined outcome of the widened fiscal deficit, increased market interest rates as well as the parity variation, which was an outcome of exchange rate depreciation. A series of sovereign rating downgrades by rating agencies occurred during 2021, in view of the deteriorating external liquidity position accentuated by the reduction in foreign exchange reserves against high forthcoming debt repayments and inadequate financing inflows. The fiscal sector outlook remains constrained with the lack of sufficient inflow of revenue, sustainability concerns related to government debt, and deficit financing through domestic banking sources amidst steady accumulation of debt, accelerated inflation, and vulnerabilities in the domestic financial *system stability and the external sector. Against this backdrop, strong fiscal consolidation measures remain more vital than ever, particularly via revenue focused measures, in terms of introducing appropriate taxes and broadening of tax base supplemented with strengthening the tax administration, in order to reverse the dismal revenue mobilisation path, on a sustainable basis, while reducing government financing requirements. Meanwhile, a tight rein on government expenses by refraining from ad hoc expenditure policies is essential to ensure not derailing the fiscal consolidation path going forward. Accordingly, reducing the deficit in the current account by streamlining recurrent expenditure while strengthening revenue mobilisation, and thereby making concerted efforts with a credible plan to reach a surplus in the primary balance in the medium term remains critical at this juncture to ensure sustainability of government debt. Implementing liability management exercises in line with the Medium Term Debt Management Strategy (MTDS), with necessary revisions, and ongoing efforts on debt restructuring are also indispensable in smoothing debt repayments, as well as lowering the near term risks to the fiscal sector.*

6.2 Fiscal Policy Measures[1]

The fiscal strategy of the Government as envisaged in the Budget 2021 focused on ensuring macroeconomic stability with the view to fostering economic growth and development of the country, though the anticipated fiscal outcomes were not fully realised during 2021 primarily due to challenging macroeconomic conditions and optimistic fiscal targets which were not sufficiently buttressed by sufficient and consistent policies. In line with the Government's fiscal strategy, the revenue collection was expected to increase to 10.7 per cent of GDP in 2021, thereby maintaining budget deficit and outstanding central government debt at 8.8 per cent of GDP and 96.3 per cent of GDP, respectively, during 2021. The medium term macro fiscal programme of the Government was aimed at poverty alleviation and economic revival, as envisaged within the 'Vistas of Prosperity and Splendour', the policy framework of the Government. With higher investments in economic and social infrastructure of the Government, disparities are expected to be minimised among the regions while safeguarding the people from unforeseen catastrophes such as the COVID-19 pandemic. Accordingly, the Medium Term Macro Fiscal Framework for 2021-2025 was aimed at increasing public investment to 5.4 per cent of GDP in 2021 while maintaining public investments of over 5-6 per cent of GDP, on average, in the medium term to facilitate high and sustained economic growth. With the continuation of the expenditure rationalisation measures, recurrent expenditure was expected to remain at around 14.2 per cent of GDP in 2021 and further reduce to 12.3 per cent of GDP by 2025. With these expected improvements, along with a higher revenue collection of 14.2 per cent of GDP, the budget deficit is expected to reduce to 4.0 per cent of GDP in 2025. Meanwhile, it was expected that the outstanding debt stock would be brought down to 96.3 per cent of GDP in 2021 and further down to 75.5 per cent of GDP in the medium term. Reforming State Owned Enterprises (SOEs) was also identified as an integral part in reducing the pressure on fiscal operations. Key fiscal targets announced for 2021 were, however, not materialised, since these targets were driven by overoptimistic assumptions in the context of a challenging economic environment and policy inconsistencies that led to lower revenue collection and rigid government expenses.

1 The key fiscal policy measures discussed in this section are detailed in Box 12, 'Major Economic Policy Measures', which includes major fiscal policy measures implemented since 01 January 2021 up to 15 March 2022.

Figure 6.1
Performance of the Fiscal Sector

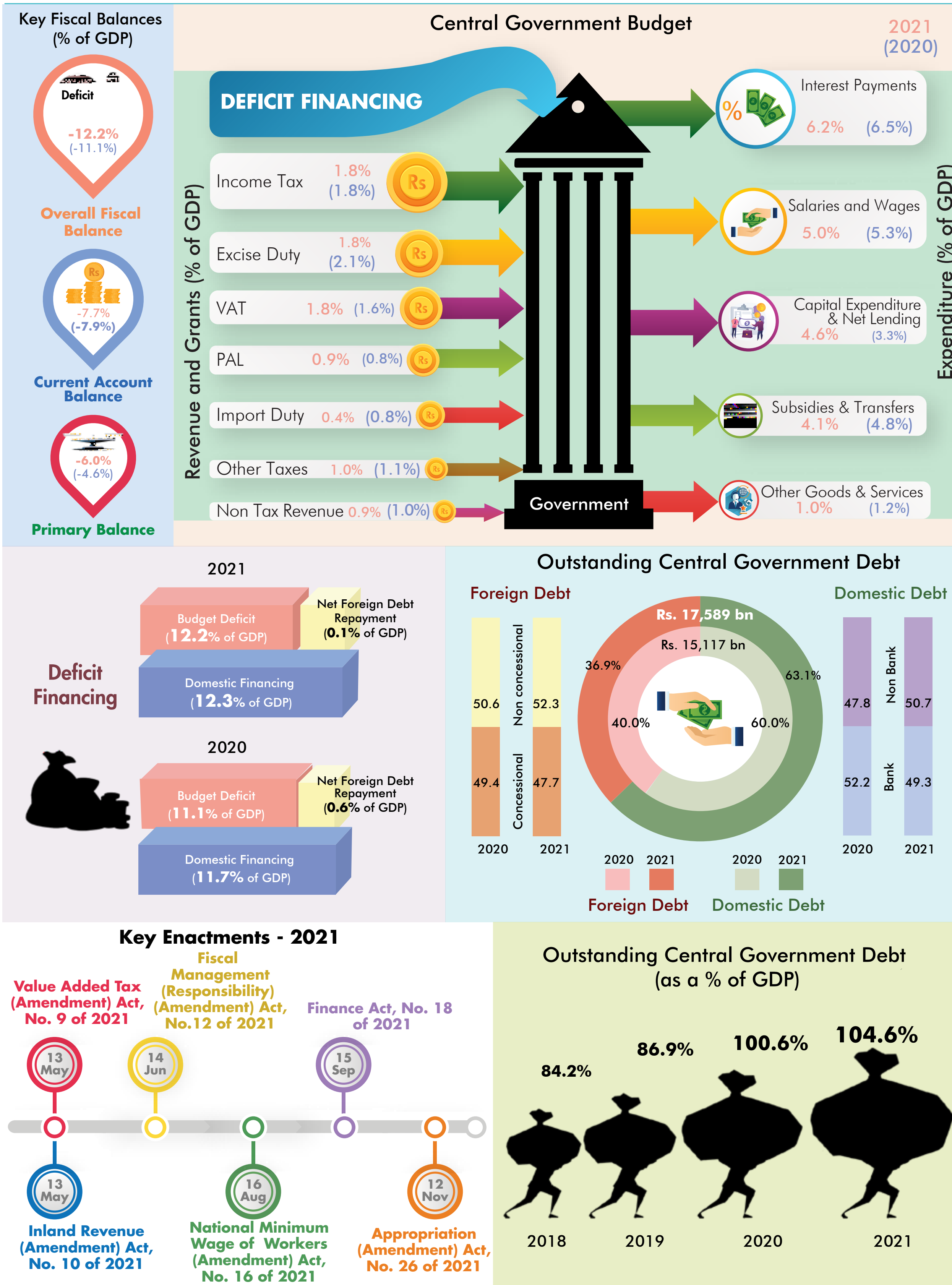

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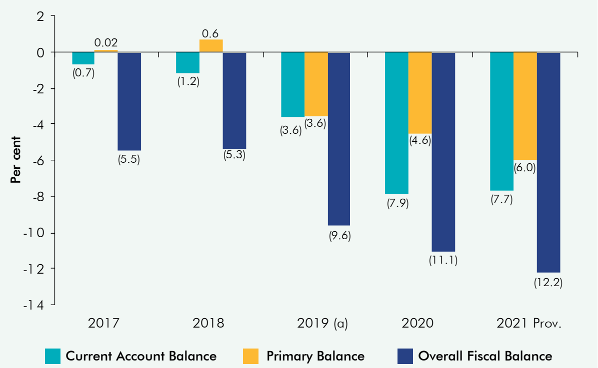
Figure 6.2
Key Fiscal Balances
(as a percentage of GDP)



(a) According to the Ministry of Finance, the fiscal sector statistics of 2019 have been restated as announced in the Budget Speech for 2020.

Source: Ministry of Finance

During the year 2021, the commitment of the Government to maintain a low tax regime to promote swift economic recovery and growth resulted in lacklustre performance in government revenue. To this end, the tax adjustments that have been instituted since late 2019 in relation to corporate income taxes, income taxes at individual levels and Value Added Tax (VAT) were maintained in 2021. Accordingly, the Inland Revenue Act, No. 24 of 2017 was amended in May 2021, incorporating revisions to taxes which were announced in November 2019 and other announcements made in January 2020 and April 2021. In addition, several tax holidays were granted on the gains and profits received by specific start-ups after the completion of a two year period from the implementation date. Accordingly, any enterprise which sells recycled construction materials in Sri Lanka, any business commenced by an individual after the successful completion of vocational education from any standardised and acceptable institution for vocational education, any enterprise set up by a resident person in manufacturing of boats or ships in Sri Lanka, any 'renewable energy project' established with a capacity to produce not less than one hundred Mega Watts solar or wind power and supplied such power to the national grid, and any enterprise initiated by a resident person who constructs and installs communication towers and related appliances using local labour and local raw materials in Sri Lanka or provide required technical services for such construction or installation are allowed to enjoy these tax holidays. Moreover, foreign currency earnings of businesses that engage in exporting gold, gems or jewellery, interest income of multi-national companies, which are deposited in foreign currency in any domestic bank, and gains made by a person from the realisation of lands or buildings, which were sold, exchanged or transferred to a Sri Lanka Real Estate Investment Trust (SLREIT) are exempted from income taxes with effect from 01 April 2021, subject to the provisions of the Inland Revenue (Amendment) Act, No. 10 of 2021. Further, in March 2022, Cabinet approval was granted to amend several provisions in the Inland Revenue Act, No. 24 of 2017 in order to remove the complexity of such provisions and accommodate requests of various parties to increase tax compliance, while providing reliefs for emerging sectors of the economy. Meanwhile, the Value Added Tax Act, No. 14 of 2002 was amended in 2021, incorporating tax revisions implemented since late 2019. During the year, several specific enterprises/projects were exempted from the Commodity Export Subsidy Scheme (CESS) levy and Ports and Airports Development Levy (PAL) to encourage exports and foreign direct investments within the country. Accordingly, any enterprise engaged in exporting scrap/waste processed through manufacture of exported goods, and the importation of goods by any enterprise or a strategic development project, with an investment of US dollars 50 million or above in each stage during the project implementation or construction period, were exempted from CESS and PAL. Further, importation of medical equipment was also exempted from PAL in order to support the COVID-19 prevention programme.

Meanwhile, the Special Commodity Levy (SCL) on the importation of several food items, such as rice, potatoes, maize, dried fish, dairy products, big onions and sprats was revised during the year to provide necessary protection for farmers and as supply side management measures to curtail the increase in prices in the domestic market. Although the aim of the aforementioned policies was to revive economic activities faster, and in turn, boost the revenue flows, the slow paced recovery in economic activities adversely affected higher government revenue in 2021.

During the year 2021 and early 2022, the Government attempted to introduce several measures aiming at reducing tax evasion and minimising complexities in the tax administration. Accordingly, measures were taken to enact the legislation for tax amnesty under the provisions of the Finance Act, No. 18 of 2021, which inter alia provides for persons to voluntarily report their undisclosed taxable supplies, income, and assets for any taxable period ended on or prior to 31 March 2020, or in a return of income for any year of assessment ended on or prior to 31 March 2020. However, in the absence of strong enforcement measures, revenue generated from tax amnesty was limited to Rs. 174.6 million in 2021. Although tax amnesties are implemented to meet short term revenue shortfalls, such policies generally do not create desirable outcomes as reflected in realised data, and these policies may disincentivise law abiding taxpayers and encourage corruption and even, money laundering. Meanwhile, a bill was presented to the Parliament in January 2022 to impose a Special Goods and Services Tax (SGST) as a composite tax in lieu of existing taxes on liquor, cigarettes, vehicles (inclusive of parts for assembling of vehicles), telecommunications, and betting and gaming. The aim of the imposition of SGST was to ensure the efficiency in tax administration through the avoidance of complexities associated with the application and administration of multiple tax regimes on specified goods and services. Nevertheless, considering the petitions submitted against the SGST bill, the Supreme Court determined that it needs to be passed with a two-thirds majority in the Parliament and a referendum due to the inconsistency of several of its clauses with the Constitution. In addition, several improvements were made to tax administration, such as the mandatory use of a Taxpayer Identification Number (TIN) in all tax related source documents and making e-filing compulsory for all limited liability companies. Revisiting and simplifying the tax structure and strengthening the tax administration remain imperative at present to address the notable decline in government revenue and improve government finances on a long term basis.

The Government continued to channel resources to offset the effects of the pandemic, while supporting economically vulnerable groups. Accordingly, the Government took decisive measures to contain the spread of the pandemic and to ensure the safety of the citizens, while supporting livelihoods through the existing social safety networks and accelerating the island wide vaccination drive. In view of the increased pressures of the pandemic on fiscal operations, the Parliament approved a supplementary budget of Rs. 200 billion in June 2021 to meet contingent expenditure on account of the containment of the COVID-19 pandemic within the already approved borrowing limit of Rs. 2,997 billion for 2021. Meanwhile, in January 2022, the Government introduced a relief package of Rs. 229 billion with the objective of minimising economic hardships faced by the people due to the increase in prices of goods and services. Under this relief package, a monthly allowance of Rs. 5,000, which was not taken into account for the calculation of pension was granted to public officers and pensioners with effect from January 2022, while a monthly allowance was granted to Samurdhi beneficiaries on a pro rata basis with a maximum limit of Rs. 1,000 per month. In addition, several relief measures are yet to be implemented, including paying an additional Rs. 25 per kg of paddy to farmers with the aim of increasing farmer income to Rs. 75 per kg of paddy to compensate the income losses associated with the expected production losses in Maha season, providing each estate sector family with 15 kg of flour at a subsidised rate of Rs. 80 per kg, paying Rs. 5,000 to those who cultivate homesteads encompassing less than 20 perches and Rs. 10,000 to those who cultivate more than 20 perches and removing all taxes on essential food items and medicinal products. Although such extrabudgetary relief measures are intended to provide assistance to the public, the granting of reliefs in the absence of either non-debt creating financing options or significant downward adjustment in other expenditure, particularly at the time of low government revenue mobilisation, may possibly exacerbate the debt sustainability concerns while instigating inflationary and external sector pressures, which may eventually aggravate, instead of ease, the burden on the public. Therefore, such relief measures should be implemented with due consideration of the impact of such policies on the fiscal sector.

Given the continued increases in government expenditure, shortfall in actual revenue mobilisation and increased domestic financing requirements, the borrowing limits as well as milestones and fiscal rules related limits were amended in 2021. Accordingly, a resolution was approved by the Parliament to increase the limit on Treasury bills to Rs. 3,000 billion from the previous limit of Rs. 2,000 billion. In addition, the Appropriation Act, No. 7 of 2020 was amended to raise the gross borrowing limit by Rs. 400 billion for 2021 to Rs. 3,397 billion in November 2021. Meanwhile, the Fiscal Management (Responsibility) Act, No. 3 of 2003 was also amended to shift the timeline for achieving the debt to GDP target of 60 per cent to 2030 from 2020, and to increase the limit on guarantees issued by the Government to 15 per cent of GDP from 10 per cent of GDP.

The Government continued to facilitate State Owned Enterprises (SOEs), despite the considerable burden on the central government budget, and in many instances passing on the burden to the state owned banks. Guidelines were issued on corporate governance with the aim of establishing a strategic framework for SOEs to ensure transparency, fairness, accountability and responsibility in line with international best practices. These guidelines included provisions pertaining to the duties of the Chairman and Boards of Directors of SOEs and formation of their relationships with stakeholders to safeguard public interest. Further, an operational manual was issued to SOEs, providing directions regarding their conduct of business to accomplish their respective objectives and improve their performance. Meanwhile, a Management Committee on Investment was appointed by the Cabinet of Ministers to facilitate investments related to SOEs. Considering the deteriorated financial performance of SriLankan Airlines (SLA) amidst the pandemic, the Government decided to infuse capital to SLA, while issuing guarantees and a letter of comfort to SLA in order to improve its financial viability. As a result, two tranches totalling Rs. 27.7 billion were issued to SLA in November 2020, and a further Rs. 18.0 billion was issued in April 2021. This was a part of the US dollar 500 million capitalisation programme approved by the Cabinet of Ministers on 26 October 2020.

Moreover, the Government approved the reissuance of all expired letters of comfort in favour of two state banks, equivalent to US dollar 205.4 million and Rs. 27.6 billion, through the General Treasury, in order to continue the provision of short term credit facilities. In addition, two state banks disbursed new working capital facilities totalling US dollar 75 million in 2021 to SLA to provide Treasury guarantees, based on the approval of the Cabinet of Ministers. Considering the mounting financial losses of the Ceylon Petroleum Corporation (CPC) and the resultant burden on the banking sector, the Government allowed revision of CPC's domestic petroleum prices in 2021 and early 2022. However, implementing cost reflective pricing mechanisms for key SOEs and restructuring SOEs in a transparent manner to enhance their efficiency remain a priority consideration for the Government in order to minimise the fiscal burden of such entities.

Recognising subpar performance in revenue mobilisation, the Government introduced short term revenue enhancement measures through the Budget 2022. Accordingly, a bill amending the Value Added Tax Act, No. 14 of 2002 to increase the VAT rate from 15 per cent to 18 per cent on the supply of financial services on financial institutions with effect from 01 January 2022 was passed by the Parliament in March 2022. Meanwhile, as proposed in the Budget 2022, excise duty on liquor and cigarettes was revised upwards in November 2021. Surcharge Tax Act, No. 14 of 2022 was enacted with the aim of imposing a retrospective one time surcharge tax of 25 per cent on individuals, partnerships, and companies, whose taxable income is calculated in accordance with the provisions of the Inland Revenue Act, No. 24 of 2017, where their taxable income exceeds Rs. 2 billion for the tax assessment year, commencing 01 April 2020. Although the proposed one off retrospective taxes would help raising government revenue for a given year, such tax policies may not generate government revenue on a sustained basis. In addition, uncertainties created by such retrospective taxes may hamper investor confidence and appetite.

In 2022, the Government introduced several measures with the aim of managing public expenditure, amidst the limited fiscal space and the foreign exchange liquidity shortage in the country. During the year, the Government attempted to rationalise expenditure by curtailing the expenses on purchasing of vehicles, buildings, and other assets, suspending new constructions of buildings for state institutions, while prioritising public investments based on the economic benefits of such investments. In line with the Budget 2022, the Government announced various measures in November 2021 to curtail expenses by reducing the provisions for electricity of government institutions by 10 per cent, reducing the telephone expenses of government institutions by 25 per cent, reducing fuel allowance provided to government ministers and government officials by 5 litres per month, and suspending the construction of new office premises for a period of two years. However, such measures may not be adequate to sizeably reduce mounting government expenditure and thereby improve government finances. Amidst the prevailing foreign exchange liquidity shortages of the country, several guidelines were issued by the Government in March 2022 to limit the consumption of electricity and fuel by the public sector by minimising the usage of vehicles, elevators, air conditioners, and other electrical appliances. Further, considering increased life expectancy and the resultant capacity to remain active in the public service, the compulsory retirement age of the public officers was extended up to 65 years with effect from 01 January 2022 with the view to strengthening the labour

Table 6.1
Summary of Government Fiscal Operations

Item	2020 (a)	2021 (b)
Rs. million		
Total Revenue and Grants	**1,373,308**	**1,463,810**
Total Revenue	1,367,960	1,457,071
Tax Revenue	1,216,542	1,298,019
Non Tax Revenue	151,417	159,052
Grants	5,348	6,740
Expenditure and Net Lending	**3,040,996**	**3,521,735**
Recurrent	2,548,359	2,747,512
Adjustment for Arrears as per the Ministry of Finance	-123,428	-
Capital and Net Lending	492,638	774,223
o/w Public Investment	811,773	789,636
Adjustment for Arrears as per the Ministry of Finance	-299,178	-
Current Account Balance	**-1,180,399**	**-1,290,441**
Primary Balance	**-687,386**	**-1,009,542**
Overall Fiscal Balance	**-1,667,688**	**-2,057,925**
Total Financing	**1,667,688**	**2,057,925**
Foreign Financing	-83,199	-13,901
Domestic Financing	1,750,887	2,071,826
As a Percentage of GDP (c)		
Total Revenue and Grants	**9.1**	**8.7**
Total Revenue	9.1	8.7
Tax Revenue	8.1	7.7
Non Tax Revenue	1.0	0.9
Grants	0.04	0.04
Expenditure and Net Lending	**20.2**	**21.0**
Recurrent	17.0	16.3
Adjustment for Arrears as per the Ministry of Finance	-0.8	-
Capital and Net Lending	3.3	4.6
o/w Public Investment	5.4	4.7
Adjustment for Arrears as per the Ministry of Finance	-2.0	-
Current Account Balance	**-7.9**	**-7.7**
Primary Balance	**-4.6**	**-6.0**
Overall Fiscal Balance	**-11.1**	**-12.2**
Total Financing	**11.1**	**12.2**
Foreign Financing	-0.6	-0.1
Domestic Financing	11.7	12.3

(a) According to the Ministry of Finance, fiscal sector statistics of 2020 have been adjusted as announced in the Budget Speech for 2020.
(b) Provisional
(c) For 2020, revised GDP estimates were used, as released by the Department of Census and Statistics on 29 March 2022.

Source: Ministry of Finance

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force of the country and reducing the expenditure related to retirement benefits. Meanwhile, the age of compulsory retirement of employees of SOEs was also extended up to 62 years with effect from 01 January 2022.

International sovereign credit rating agencies downgraded the sovereign credit ratings of Sri Lanka during 2021, in view of declining foreign exchange reserves amidst high external debt repayments and inadequate financing inflows. Standard and Poor's Global Ratings (S&P) downgraded Sri Lanka's sovereign credit rating to 'CCC+ (Negative)' from 'CCC+ (Stable)' on 27 August 2021, and further to 'CCC (Negative)' on 12 January 2022. Although Fitch Ratings maintained its rating at 'CCC' status for more than a year since 27 November 2020, they too downgraded Sri Lanka's sovereign credit rating to 'CC' on 17 December 2021. Similarly, Moody's Investor Service also downgraded Sri Lanka's sovereign credit rating to 'Caa2 (Stable)' from 'Caa1 (Stable)' on 28 October 2021. Such rating decisions were primarily driven by the assessments on fiscal imbalances, challenges faced by the country in meeting external financing requirements, uncertain policy outlook, and the risk of a slowdown in fiscal consolidation. Nevertheless, the Government repaid all its debt servicing obligations in 2021, including the International Sovereign Bond (ISB) of US dollars 1,000 million, which matured on 27 July 2021, and the ISB of US dollars 500 million, which matured on 18 January 2022.

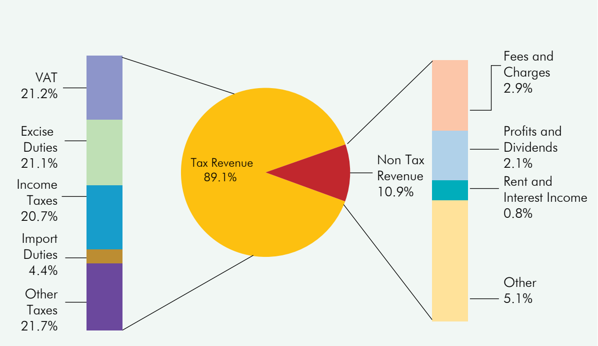
6.3 Government Budgetary Operations

Revenue and Grants

Revenue

Government revenue recorded a sluggish growth in 2021 yielding the historically lowest tax to GDP ratio amidst the low tax regime instituted since late 2019. In 2021, in nominal terms, government revenue grew by 6.5 per cent, year-on-year, to Rs. 1,457.1 billion, benefiting mainly from the higher tax revenue collection from VAT, income taxes, PAL, and CESS. Tax revenue increased by 6.7 per cent to Rs. 1,298.0 billion in 2021 from Rs. 1,216.5 billion in the preceding year. Meanwhile, in 2021, non tax revenue increased to Rs. 159.1 billion in 2021 from Rs. 151.4 billion in 2020 due to the rise in revenue collection from profit and dividend transfers from SOEs and social

Figure 6.3
Composition of Government Revenue - 2021



Source: Ministry of Finance

security contributions, despite the reduction in fees and charges, rent income, interest income and distributable profits transferred from the Central Bank. However, government revenue as a percentage of GDP declined to 8.7 per cent in 2021 from 9.1 per cent in the previous year. Tax revenue as a percentage of GDP, which stood at a low level of 8.1 per cent of GDP in 2020, further declined to 7.7 per cent during 2021. Both government revenue and tax revenue as a percentage of GDP declined to a record low since independence, owing to the impact of the continuation of the low tax regime, import restrictions imposed to ease external sector pressure, and the modest pickup of the economy. Meanwhile, non tax revenue as a percentage of GDP declined to 0.9 per cent in 2021 compared to 1.0 per cent recorded in 2020, whereas grants received by the Government recorded a marginal improvement to Rs. 6.7 billion in 2021 in comparison to Rs. 5.3 billion registered in 2020.

Revenue from income taxes increased by 12.6 per cent, in nominal terms, to Rs. 302.1 billion in 2021 from Rs. 268.2 billion in 2020. This reflects of increased revenue mobilisation from all income tax categories, except for the Economic Service Charge (ESC) which was abolished in early 2020. With the increased revenue from income taxes, the share of direct tax revenue in the total tax revenue collection improved to 23.3 per cent in 2021 over 22.1 per cent recorded in 2020. Revenue from corporate and non corporate income taxes increased notably to Rs. 273.6 billion in 2021 compared to Rs. 228.3 billion recorded in the previous year, indicating the recovery of economic activities in 2021 compared to the preceding year and improved performance mainly in corporates. Revenue collection from Advance Personal Income Tax (APIT) and Withholding Tax (WHT) increased slightly during the period under review to Rs. 15.4 billion and Rs. 12.4 billion, respectively, compared to Rs. 15.0 billion and Rs. 10.0 billion, respectively, in 2020. Meanwhile, the arrears collected on ESC amounted to Rs. 0.7 billion in 2021, following the removal of ESC in January 2020. As a percentage of GDP, revenue generated from income taxes remained at 1.8 per cent in 2021, broadly unchanged from 2020.

Revenue collection from VAT increased supported by the revival in economic activity during the year. Accordingly, revenue collection from VAT increased to Rs. 308.2 billion in 2021 compared to Rs. 233.8 billion in 2020. As a percentage of GDP, VAT revenue increased to 1.8 of per cent in 2021 from 1.6 per cent in 2020. VAT revenue generated on account of domestic economic activities increased to Rs. 185.5 billion in 2021 from Rs. 148.1 billion in 2020, while revenue from VAT on imports related activities increased to Rs. 122.8 billion in 2021 from Rs. 85.7 billion in 2020. During the year, the share of revenue from VAT on total revenue and total tax revenue increased to 21.2 per cent and 23.7 per cent, respectively, compared to 17.1 per cent and 19.2 per cent, respectively, recorded in 2020. Meanwhile, the arrears collected on Nation Building Tax (NBT) amounted to Rs. 0.4 billion in 2021, following the abolition of NBT in December 2019.

Table 6.2
Summary of Government Revenue

Item	2020 (a)	2021 (b)
	Rs. million	
Tax Revenue	**1,216,542**	**1,298,019**
Income Taxes	268,249	302,115
VAT	233,786	308,213
Excise Taxes	321,932	306,861
Import Duties	114,183	64,339
Other Taxes	278,392	316,490
Non Tax Revenue	**151,417**	**159,052**
Total Revenue	**1,367,960**	**1,457,071**
	As a Percentage of GDP (c)	
Tax Revenue	**8.1**	**7.7**
Income Taxes	1.8	1.8
VAT	1.6	1.8
Excise Taxes	2.1	1.8
Import Duties	0.8	0.4
Other Taxes	1.9	1.9
Non Tax Revenue	**1.0**	**0.9**
Total Revenue	**9.1**	**8.7**

(a) According to the Ministry of Finance, the fiscal sector statistics of 2020 have been adjusted as announced in the Budget Speech for 2020.
(b) Provisional
(c) For 2020, revised GDP estimates were used, as released by the Department of Census and Statistics on 29 March 2022.

Source: Ministry of Finance

Revenue collection based on excise duties declined in 2021, reflecting the weakening of excise revenue sources with the continuation of restrictions on motor vehicle imports that were imposed in view of foreign exchange liquidity issues in the country. Accordingly, in nominal terms, revenue from excise duties declined to Rs. 306.9 billion in 2021 from Rs. 322.0 billion in 2020, while as a percentage of GDP, excise duties mobilisation declined to 1.8 per cent in 2021 compared to 2.1 per cent in the preceding year. Revenue collection from excise duty on motor vehicles declined to Rs. 18.1 billion in 2021 from Rs. 48.8 billion in 2020 and Rs. 130.4 billion in 2019. Meanwhile, revenue from excise duty on cigarettes and tobacco also declined to Rs. 88.5 billion in 2021 from Rs. 94.3 billion in 2020. Revenue from excise duty on petroleum products increased to Rs. 55.3 billion in 2021 from Rs. 53.1 billion in 2020 due to increased refined petroleum imports during the period under review. In addition, revenue from excise duty on liquor also increased by 14.6 per cent to Rs. 138.6 billion in 2021 due to increased liquor production, reflecting the recovery in hotel/ restaurant/tourism related services amidst the pandemic related disturbances.

Revenue from international trade related taxes showed a mixed performance in 2021, amidst the restrictions on the importation of several nonessential items. Revenue collection from Customs duties declined to Rs. 64.3 billion in 2021, from Rs. 114.2 billion recorded in 2020. Apart from the import restrictions, reduction of the Customs duty rate from 30 per cent to 15 per cent on selected items that was implemented in November 2020 in line with the simplification of the Customs duty structure, also contributed to the decline in revenue generated from international trade activities. Meanwhile, revenue collection from SCL also declined by 32.5 per cent to Rs. 55.8 billion in 2021 compared to Rs. 82.7 billion in 2020. Import restrictions on several non-essential items, tax rate reductions on dried fish, big onions and potatoes, and the imposition of duty waivers on salt, rice, desiccated coconut and maize caused the decline in revenue mobilisation from SCL. On the other hand, revenue from PAL and CESS levy increased during the year, despite the import restrictions on various non-essential items and exemptions granted on medical equipment, projects related goods, and selected items. Accordingly, revenue from PAL increased to Rs. 154.1 billion in 2021 from Rs. 115.4 billion in 2020, while revenue from CESS levy increased by 53.2 per cent to Rs. 75.5 billion in 2021 over 2020. Increase in rates on CESS levy for selected items in line with the simplification of the Customs duty structure in November 2020, contributed to the rise in revenue collection from CESS levy.

During the year, non tax revenue increased, in nominal terms, reflecting the rise in revenue collection from profit and dividend transfers

of SOEs and social security contributions. Accordingly, non tax revenue increased to Rs. 159.1 billion in 2021 from Rs. 151.4 billion in 2020. Profit and dividend transfers of SOEs increased by 73.6 per cent to Rs. 30.6 billion in 2021 compared to 2020, reflecting the impact of the recovery of economic activities. Revenue from social security contributions increased by 6.8 per cent, year-on-year, to Rs. 34.6 billion during the period under review. However, revenue from interest and rent income declined to Rs. 11.6 billion in 2021 in comparison to Rs. 19.4 billion in 2020, while revenue from fees and charges declined by 10.0 per cent to Rs. 42.6 billion in 2021. The distributable profits of the Central Bank that were transferred to the Government in 2021 amounted to Rs. 15.0 billion compared to Rs. 24.0 billion in 2020.

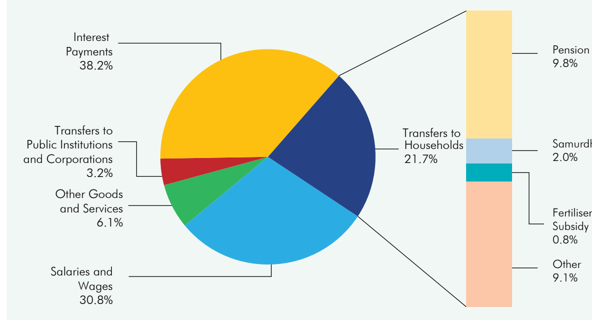
Grants

Foreign grants received from bilateral and multilateral sources increased to Rs. 6.7 billion in 2021 from Rs. 5.3 billion in 2020. Foreign grants from bilateral sources increased to Rs. 3.2 billion in 2021 from Rs. 2.8 billion in 2020, while foreign grants from multilateral sources increased to Rs. 3.5 billion in 2021 from Rs. 2.5 billion in 2020. The Government of Japan, the Asian Development Bank (ADB), and the Department of Agriculture of the United States were among the major development partners who provided grants during 2021.

Expenditure and Net Lending

During the year, total expenditure and net lending increased owing to the increases in both the recurrent expenditure, and capital expenditure and net lending. Accordingly, total expenditure and net lending increased significantly by Rs. 480.7 billion to Rs. 3,521.7 billion (21.0 per cent of GDP) in 2021 compared to Rs. 3,041.0 billion (20.2 per cent of GDP) recorded in 2020. In 2021, total expenditure and net lending accounted for 99.9 per cent of the annual estimate for 2021 and 105.9 per cent of the revised annual estimate for 2021. Recurrent expenditure increased to Rs. 2,747.5 billion in 2021 compared to Rs. 2,548.4 billion recorded in 2020, reflecting higher expenses on account of salaries and wages, and interest payments. During the period under review, capital expenditure and net lending also increased notably to Rs. 774.2 billion from Rs. 492.6 billion in 2020.

Figure 6.4
Composition of Government Recurrent Expenditure - 2021



Source: Ministry of Finance

In 2021, higher expenditure incurred on account of salaries and wages and interest payments contributed to the rise in recurrent expenditure. Expenditure on salaries and wages increased by Rs. 51.5 billion to Rs. 845.7 billion in 2021, compared to Rs. 794.2 billion in 2020, partially due to the recruitment of low skilled individuals from low income families and unemployed graduates and the diploma holders in September 2020, on top of the impact of the annual increments in salaries and wages. Expenditure on salaries and wages for 2021 accounted for 58.0 per cent of the government revenue, and 30.8 per cent of the total recurrent expenditure. Interest payments also rose by 6.9 per cent to Rs. 1,048.4 billion in 2021 from

Rs. 980.3 billion in 2020 reflecting the impact of the rise in domestic interest payments, following the increased interest payments on Treasury bonds. Interest paid on Treasury bonds amounted to Rs. 593.4 billion in 2021 compared to Rs. 550.5 billion in 2020 due to the increase in borrowings through Treasury bond issuances by Rs. 1,248.4 billion to Rs. 6,968.0 billion in 2021. Interest payments

Table 6.3
Economic Classification of Expenditure and Lending Minus Repayments

Item	2020 (a)	2021 (b)
Rs. million		
Recurrent Expenditure	**2,548,359**	**2,747,512**
Expenditure on Goods and Services	974,351	1,014,612
o/w Salaries and Wages	794,158	845,680
Interest Payments	980,302	1,048,382
Foreign	266,679	253,750
Domestic	713,623	794,633
Current Transfers and Subsidies	717,133	684,518
o/w: Households and Other Sectors	610,486	595,696
Samurdhi Recipients	52,434	55,400
Pensions	257,833	269,827
Fertiliser Subsidy	36,687	21,235
Other	263,532	249,233
Adjustment for Arrears as per the Ministry of Finance	-123,428	-
Capital Expenditure	**795,368**	**767,606**
Acquisition of Real Assets	483,543	438,753
Capital Transfers	307,917	326,578
Other	3,907	2,275
Net Lending	**-3,552**	**6,617**
Adjustment for Arrears as per the Ministry of Finance	-299,178	-
Capital Expenditure and Net Lending	**492,638**	**774,223**
Total Expenditure and Net Lending	**3,040,996**	**3,521,735**
As a Percentage of GDP (c)		
Recurrent Expenditure	**17.0**	**16.3**
Expenditure on Goods and Services	6.5	6.0
o/w Salaries and Wages	5.3	5.0
Interest Payments	6.5	6.2
Foreign	1.8	1.5
Domestic	4.7	4.7
Current Transfers and Subsidies	4.8	4.1
o/w: Households and Other Sectors	4.1	3.5
Samurdhi Recipients	0.3	0.3
Pensions	1.7	1.6
Fertiliser Subsidy	0.2	0.1
Other	1.8	1.5
Adjustment for Arrears as per the Ministry of Finance	-0.8	-
Capital Expenditure	**5.3**	**4.6**
Acquisition of Real Assets	3.2	2.6
Capital Transfers	2.0	1.9
Other	0.03	0.01
Net Lending	**-0.02**	**0.04**
Adjustment for Arrears as per the Ministry of Finance	-2.0	-
Capital Expenditure and Net Lending	**3.3**	**4.6**
Total Expenditure and Net Lending	**20.2**	**21.0**

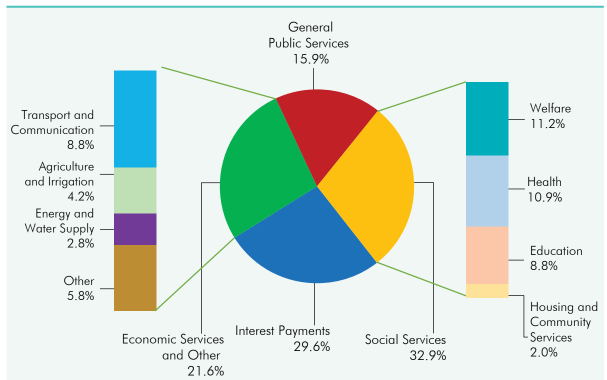
(a) According to the Ministry of Finance, the fiscal sector statistics of 2020 have been adjusted as announced in the Budget Speech for 2020.
(b) Provisional
(c) For 2020, revised GDP estimates were used, as released by the Department of Census and Statistics on 29 March 2022.

Source: Ministry of Finance

accounted for 72.0 per cent of government revenue in 2021 compared to 71.7 per cent in 2020, underlining the pressing concern of lack of adequate revenue mobilisation at least to cover the rigid recurrent expenditure of the Government. Meanwhile, expenditure on subsidies and transfers declined to Rs. 684.5 billion in 2021 from Rs. 717.1 billion in 2020 due to the reduction in subsidies to the household sector because of the removal of the fertiliser subsidy granted for chemical fertiliser since the Yala season of 2021 and the reduction in expenditure on subsidy programmes such as subsidy for school and higher education season tickets, financial support for elderly over 70 years of age, etc. However, pension payments increased by 4.7 per cent to Rs. 269.8 billion in 2021, while expenditure in relation to Samurdhi payments increased by 5.7 per cent to Rs. 55.4 billion in 2021 compared to 2020. Recurrent expenditure, as a percentage of GDP, declined to 16.3 per cent in 2021 compared to 17.0 per cent in 2020.

During 2021, capital expenditure and net lending increased both in nominal terms and as a share of GDP. Accordingly, capital expenditure and net lending increased by 57.2 per cent to Rs. 774.2 billion in 2021 over 2020, while capital expenditure and net lending as a percentage of GDP increased to 4.6 per cent in 2021 over

Figure 6.5
Total Expenditure and Lending by Function - 2021



Source: Ministry of Finance

Table 6.4
Functional Classification of Expenditure

Item	2021 (a)
Rs. million	
Recurrent Expenditure	**2,747,512**
General Public Services	499,629
Civil Administration	134,930
Defence	257,918
Public Order and Safety	106,782
Social Services	974,821
Education	261,716
Health	275,165
Welfare	397,343
Community Services	40,597
Economic Services	164,590
Agriculture and Irrigation	68,206
Energy and Water Supply	1,385
Transport and Communication	47,255
Other	47,744
Other	1,108,472
o/w Interest Payment	1,048,382
Capital Expenditure and Lending	**789,636**
General Public Services	61,675
Civil Administration	54,624
Public Order and Safety	7,051
Social Services	189,733
Education	48,897
Health	111,956
Housing	18,333
Community Services	10,547
Economic Services	537,370
Agriculture and Irrigation	79,463
Energy and Water Supply	96,520
Transport and Communication	263,042
Other	98,346
Other	858
Total Expenditure and Lending	**3,537,148**
As a Percentage of GDP	
General Public Services	3.3
Social Services	6.9
Economic Services	4.2
Other	6.6
o/w Interest Payment	6.2
Total Expenditure and Lending	**21.0**

(a) Provisional

Source: Ministry of Finance

3.3 per cent registered in 2020. However, capital expenditure declined to Rs. 767.6 billion in 2021 from Rs. 795.4 billion in 2020, in the absence of the adjustment of arrears payments of capital expenditure in 2020.

Key Fiscal Balances and Financing the Budget Deficit

The key fiscal balances remained weak in 2021 owing to lower government revenue collection and the unabated government expenditure. According to the fiscal sector statistics of the Ministry of Finance, the overall budget deficit as a percentage of GDP further weakened to 12.2 per cent (Rs. 2,057.9 billon) in 2021 from 11.1 per cent (Rs. 1,667.7 billion) reported in 2020. The current account deficit that reflects the dissavings of the Government also remained high at 7.7 per cent of GDP (Rs. 1,290.4 billion) in 2021, broadly unchanged from 7.9 per cent of GDP (Rs. 1,180.4 billion) reported in 2020. Meanwhile, the primary deficit, which reflects the effects of discretionary fiscal policy of the current year and computed by excluding interest payments from the overall budget deficit, also weakened to 6.0 per cent of GDP (Rs. 1,009.5 billion) in 2021, compared to 4.6 per cent of GDP (Rs. 687.4 billion) registered in 2020.

The Government mainly relied on domestic sources to finance the overall budget deficit in 2021, reflecting its preference of the Government to reduce the exposure to foreign financing alternatives, amidst the limited access to foreign sources. As per the Ministry of Finance, net financing through domestic sources, which includes all net borrowing through Treasury bills and Treasury bonds, Offshore Banking Units (OBUs) and Sri Lanka Development Bonds (SLDBs), amounted to Rs. 2,071.8 billion and accounted for 12.3 per cent of GDP in 2021 compared to 11.7 per cent of GDP in 2020. Meantime, the net foreign repayment that includes net repayment of ISBs stood at Rs. 13.9 billion.

During 2021, the deficit financing from domestic sources, especially through the banking sector, resulted in an upward pressure on the yields on government securities and short term money market rates. Government borrowings from the banking sector accounted for 63.0 per cent (Rs. 1,304.3 billion) of total net domestic financing. Out of this quantum, the net central bank financing stood at Rs. 1,225.2 billion.

Net financing from commercial banks amounted to Rs. 79.1 billion in 2021. Meanwhile, financing from the non-bank sector, which are considered noninflationary sources, amounted to Rs. 767.5 billion with a share of 37.0 per cent of total net domestic financing in 2021. In terms of instruments, 62.8 per cent (Rs. 1,301.5 billion) of the domestic financing was sourced from Treasury bonds followed by 30.7 per cent (Rs. 635.1 billion) and 16.6 per cent (Rs. 343.0 billion) from Treasury bills and overdraft facilities, respectively. However, borrowings from OBUs and SLDBs recorded net repayments during 2021.

Total foreign financing recorded a repayment of Rs. 13.9 billion, on net basis, during 2021 along with the repayment of Rs. 199.9 billion (US dollar 1 billion) for ISBs. The net financing through the Foreign Currency Term Financing Facility (FCTFF) were recorded at Rs. 146.7 billion (US dollar 0.7 billion) during 2021, as a result of new borrowings of Rs. 164.9 billion (US dollar 0.8 billion) and repayment of Rs. 18.2 billion (US dollar 0.1 billion) during 2021.

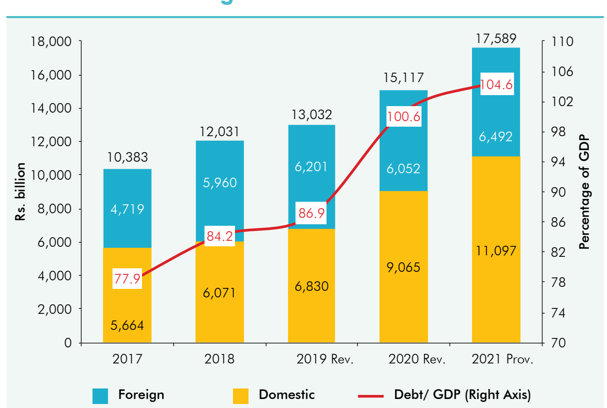
6.4 Government Debt and Debt Service Payments

6

Central Government Debt

Continued high budget deficit resulting from persistently weak fiscal performance, which exacerbated during the pandemic times, led to a substantial increase in outstanding central government debt by end 2021. In nominal terms, the total outstanding central government debt stock increased to Rs. 17,589.4 billion at end 2021 from Rs. 15,117.2 billion recorded by end 2020. With the increased financing requirements amidst limited global market access due to unfavourable international market conditions, global appetite for safe haven assets and unappealing sovereign credit ratings of Sri Lanka, and the reliance on domestic sources for financing the budget deficit triggered a notable change in the composition of outstanding stock of central government debt. Consequently, the share of domestic debt increased to 63.1 per cent of the total outstanding debt of the Central Government by end 2021 compared to 60.0 per cent recorded in the previous year. Meanwhile, the quantum of foreign debt as a share of total outstanding central government debt declined to 36.9 per cent by end 2021 compared to 40.0 per cent recorded at end 2020. Reflecting the subpar performance in the key fiscal variables, the central government debt to GDP ratio increased to 104.6 per cent by end 2021 from 100.6 per cent at end 2020. The share of domestic debt as a percentage of GDP increased notably to 66.0 per cent by end 2021 from 60.3 per cent at end 2020, while the share of foreign debt as a percentage of GDP decreased to 38.6 per cent at end 2021 from 40.3 per cent reported at end 2020. Moreover, the level of foreign currency denominated debt as a share of total outstanding central government debt declined to 42.4 per cent by end 2021 from 47.5 per cent that prevailed at end 2020, reflecting a higher concentration towards financing budget deficit through domestic sources as well as settlement of foreign debt obligations including the ISB which matured in 2021. However, the Average Time to

Figure 6.6
Outstanding Central Government Debt



Sources: Ministry of Finance
Central Bank of Sri Lanka

Maturity (ATM) of the outstanding total debt stock declined to 5.2 years at end 2021 compared to 5.7 years at end 2020 due to increased borrowings raised through short term debt instruments.

The total domestic debt of the Central Government witnessed an increase of Rs. 2,032.2 billion from end 2020, reaching Rs. 11,097.2 billion by end 2021.[2] With increased reliance on short term financing amidst less market appetite for longer tenure maturities of government securities, particularly at the preannounced maximum yield rates as well as the market expectations for interest rate hikes, short term domestic debt stock increased by 42.9 per cent to Rs. 3,139.8 billion by end 2021 from Rs. 2,197.6 billion reported at end 2020. Accordingly, the share of short term debt in total domestic debt stock also increased to 28.3 per cent towards end 2021 from 24.2 per cent at end 2020. In nominal terms, the increase in the short term debt stock was largely driven by the increase in the outstanding stock of Treasury bills, with a growth of 40.1 per cent, to Rs. 2,270.5 billion at end 2021, compared to Rs. 1,620.7 billion recorded at end 2020. Consequently, the share of Treasury bills in total domestic debt stock as at end 2021 increased to 20.5 per cent from 17.9 per cent at end 2020. However, the outstanding debt stock on account of provisional advances to the Government by the Central Bank witnessed a marginal reduction to reach Rs. 150.1 billion by end 2021 from Rs. 153.1 billion at end 2020. As the Government was compelled to depend more on short term instruments for deficit financing during 2021, the share of medium and long term debt in the total domestic debt stock declined to 71.7 per cent from 75.8 per cent recorded at end 2020. However, in nominal terms, the medium and long term domestic debt stock also increased by 15.9 per cent to Rs. 7,957.4 billion by end 2021 from Rs. 6,867.5 billion recorded at end 2020. Treasury bonds, which continued to dominate the outstanding domestic debt portfolio, accounted for about 62.8 per cent of the total outstanding domestic debt stock during the year in comparison to 63.0 per cent recorded at end 2020. In nominal terms, Treasury bonds in the domestic debt increased by 21.9 per cent to Rs. 6,966.2 billion compared to Rs. 5,713.3 billion recorded at end 2020. Meanwhile, SLDBs holdings of the residents declined to Rs. 455.2 billion (US dollars 2,271.1 million) from Rs. 486.9 billion (US dollars 2,611.9 million) reported at end 2020. In addition, the ISBs owned by the domestic residents also declined from Rs. 415.8 billion (US dollars 2,230.4 million) at end 2020 to Rs. 372.6 billion (US dollars 1,859.0 million) by the end of 2021. This was mainly due to the maturing of the ISB amounting to US dollars 1 billion, of which US dollars 371.3 million was repaid to domestic bond holders. Moreover, outstanding debt from OBUs recorded a decline of Rs. 88.1 billion from end 2020 to Rs. 139.3 billion (US dollars 695.0 million) by the end of the year 2021. The outstanding foreign currency denominated domestic debt at end 2021 decreased by Rs. 162.9 billion to Rs. 967.1 billion (US dollars 4,825.1 million) from Rs. 1,130.0 billion (US dollars 6,062.2 million) at end 2020.[3] Meanwhile, debt obligation of the Central Government to the domestic banking sector

2 As per the guidelines of compiling government debt statistics in the Manual of Government Finance Statistics published by the IMF in 2014, resident holdings of central government debt are classified under domestic debt.

3 Outstanding foreign currency denominated domestic debt includes SLDBs holding and ISBs holding of residents and the outstanding government debt held by the OBUs.

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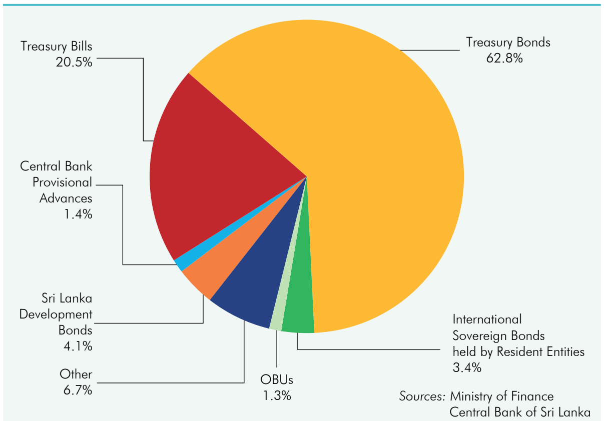
Figure 6.7
Composition of Outstanding Central Government Domestic Debt - as at end 2021



Sources: Ministry of Finance
Central Bank of Sri Lanka

increased notably to Rs. 5,467.1 billion at end 2021 due to the increase in outstanding government debt owed to commercial banks and the Central Bank reaching Rs. 3,901.6 billion and Rs. 1,565.5 billion, respectively. The significant increase in the central government debt held by the Central Bank was due to the increased Treasury bills holding amounting to Rs. 1,391.3 billion during 2021 in comparison to Rs. 654.6 billion in 2020. This was a result of the subscription of Treasury bills by the Central Bank at primary auctions amidst subdued market subscription and administrative special allocations of Treasury bills to the Central Bank. Meanwhile, the outstanding debt owned by commercial banks increased to Rs. 3,901.6 billion at end 2021 mainly due to higher investments in Treasury bonds by commercial banks in 2021. The stock of Treasury bonds held by commercial banks increased to Rs. 1,646.8 billion at end 2021 from Rs. 1,513.3 billion reported at end 2020. However, the share of the banking sector debt in total domestic debt declined to 49.3 per cent by end 2021 from 52.2 per cent at end 2020. Meanwhile, the outstanding government debt stock held by the nonbank sector amounted to Rs. 5,630.1 billion at end 2021 as against Rs. 4,333.4 billion at end 2020.

The total foreign debt liability of the Central Government, in nominal terms, increased from Rs. 6,052.2 billion at end 2020 to

Table 6.5
Outstanding Central Government Debt (end period)

Rs. million

Item	2018	2019 (a)(b)	2020 (a)(b)	2021 (a)(c)
Outstanding Central Government Debt	**12,030,548**	**13,031,543**	**15,117,247**	**17,589,373**
Domestic Debt (d)	**6,071,001**	**6,830,260**	**9,065,068**	**11,097,223**
By Maturity Period				
Short Term	1,134,553	1,270,374	2,197,594	3,139,794
Medium and Long Term	4,936,447	5,559,887	6,867,473	7,957,430
By Institution (e)				
Bank	2,321,802	2,887,739	4,731,652	5,467,126
Non Bank	3,749,199	3,942,521	4,333,416	5,630,097
Foreign Debt	**5,959,547**	**6,201,283**	**6,052,179**	**6,492,150**
By Type				
Concessional Loans	2,705,836	2,767,459	2,988,113	3,097,585
Non Concessional Loans	3,253,711	3,433,824	3,064,066	3,394,565
Multilateral	58,586	112,943	156,252	324,112
Bilateral	209,970	198,733	184,051	171,327
Commercial	2,985,156	3,122,148	2,723,763	2,899,126
International Sovereign Bonds	2,220,411	2,531,493	2,203,279	2,243,049
Foreign Currency Term Financing Facilities	330,174	242,191	279,612	445,521
Non Resident Investment in Treasury Bills	11,909	23,727	670	204
Non Resident Investment in Treasury Bonds	146,914	80,294	6,204	1,710
Other	275,747	244,444	233,997	208,643
By Currency				
SDR	954,761	927,372	970,714	986,072
US Dollars	3,781,626	4,076,588	3,875,950	4,275,471
Japanese Yen	622,852	624,956	664,291	623,206
Euro	225,831	228,713	251,406	240,521
Other	374,477	343,653	289,818	366,880
Outstanding Central Government Debt/GDP (f)	84.2	86.9	100.6	104.6
Memorandum Items				
Total Exchange Rate Variation	1,063,218	12,401	355,663	500,206
On Foreign Debt	963,181	16,857	329,895	474,322
On Foreign Currency Denominated Domestic Debt	100,037	-4,456	25,767	25,884

(a) As per the guidelines of compiling government debt statistics in the Manual of Government Finance Statistics published by the IMF in 2014, non resident holdings of outstanding SLDBs have been classified under foreign debt and resident holdings of outstanding ISBs of the Sri Lankan Government have been classified under domestic debt.
(b) Revised
(c) Provisional
(d) Includes Government Treasury bonds of Rs. 78,441 million issued for CPC in January 2012 of which Rs. 21,778 million matured on 01 January 2017 and the current outstanding is Rs. 56,662 million
(e) The composition of domestic debt held by the banking and non banking sectors was revised from 2017 due to the adjustment for holdings of SLDBs by businesses and individuals
(f) For 2019 and 2020, revised GDP estimates were used, as released by the Department of Census and Statistics on 29 March 2022.

Sources: Ministry of Finance
Central Bank of Sri Lanka

6

Rs. 6,492.2 billion by end 2021.[4] However, due to the limited access to foreign sources, the explicit financing strategy of the Government to rely primarily on domestic sources, and net repayment of ISBs, the share of foreign debt in the total outstanding debt stock declined to 36.9 per cent at end 2021 from 40.0 per cent witnessed at end 2020. Within the total foreign debt portfolio, the share of non-concessional debt increased to 52.3 per cent by end 2021 from 50.6 per cent at end 2020 on account of increased receipt of multilateral loans and foreign currency term financing facility as well as the impact of the depreciation of the rupee. In nominal terms, the outstanding balance of the non-concessional debt stock increased by 10.8 per cent to Rs. 3,394.6 billion at end 2021 from Rs. 3,064.1 billion recorded at end 2020. Despite the repayment of US dollars 1.0 billion worth of ISB to both resident (US dollars 371.3 million) and nonresident investors (US dollars 628.7 million), the rupee value of the ISBs holding held by nonresidents increased by Rs. 39.8 billion due to the depreciation of the Sri Lankan rupee against the US dollar. Meanwhile, outstanding concessional debt increased by Rs. 109.5 billion during 2021 to Rs. 3,097.6 billion by the end of the year though the share of

4 As per the guidelines of compiling government debt statistics in the Manual of Government Finance Statistics published by the IMF in 2014, non resident holdings of central government debt are classified as foreign debt.

Figure 6.8
Composition of Outstanding Central Government Foreign Debt - as at end 2021

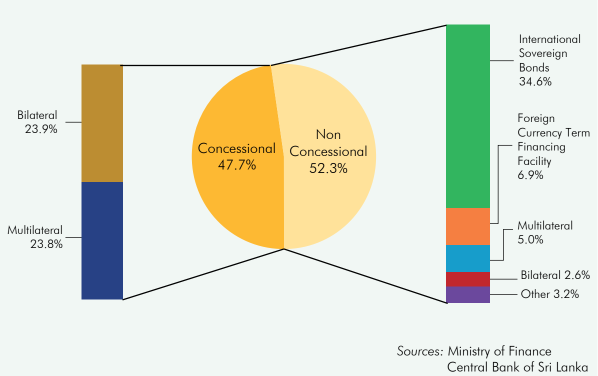
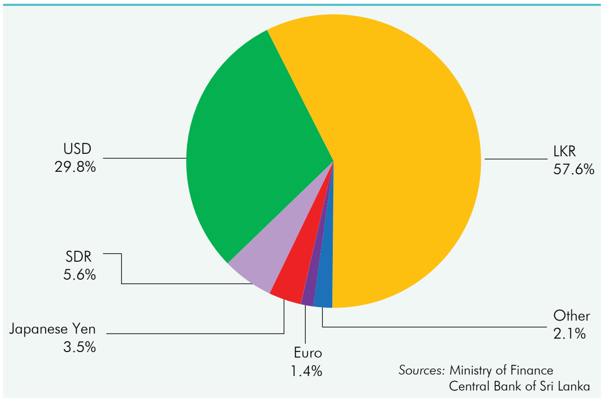


Figure 6.9
Currency Composition of Total Outstanding Central Government Debt - as at end 2021



concessional debt of the total foreign debt stock declined marginally to 47.7 per cent by end 2021 compared to 49.4 per cent reported by end 2020.

Foreign currency denominated outstanding debt, which stood at US dollars 38,492.7 million at end 2020 declined to US dollars 37,206.1 million by end 2021. Due to the parity variation caused by the depreciation of the Sri Lankan rupee against debt denominated foreign currencies, the rupee value of foreign currency debt increased by around Rs. 500.2 billion at end 2021. The parity variation on the outstanding foreign project loans, FCTFF and ISBs amounted to Rs. 474.3 billion, while the same on the outstanding SLDBs and OBUs stood at Rs. 25.9 billion. If the debt denominated in foreign currency is serviced using foreign currency inflows to the Government, the impact of the nominal increase in the outstanding debt stock in rupee terms due to parity change would be less material. However, utilisation of a substantial amount of rupee funds to meet foreign currency debt servicing payments by the Government and financing the resultant increase in government borrowing requirements heavily through the banking sector, amidst the decline in foreign exchange inflows to the Government, remain concerns.

Central government debt of Sri Lanka elevated to disconcerting levels during the past two years, reflecting the impact of

6

persistent fiscal deficits, restricted access to concessional financing and adverse implications driven by interest rate and exchange rate movements. Although foreign debt as a percentage of GDP marginally declined to 38.6 per cent in 2021 from 40.3 per cent in 2020, risks related to foreign debt servicing in the near term heightened due to the depletion of gross official reserves to low levels in the backdrop of the challenging domestic macroeconomic developments, uncertainties in the international capital markets triggered by the COVID-19 pandemic as well as unfavourable sovereign credit rating downgrades. Unless augmented by foreign currency inflows under a creditable anchor, foreign currency debt service payments, which are falling due over US dollars 5 billion annually, on average, from 2022 onwards would be an extremely challenging task for Sri Lanka. Prudent fiscal policy measures and resource augmentation are required immediately, along with a reprofiling of debt portfolio. Meanwhile, the medium term policy priority should be to use debt financing mainly for the repayment of both domestic and foreign currency debt, without capitalising interest payments to avoid further accumulation of debt. Although foreign currency debt could be raised to meet near term foreign currency debt servicing obligations, further borrowings should be gradually reduced over the medium term, once non-debt creating inflows are in place, while aligning new financing requirements arising from overall fiscal deficit in line with resource availability. Given the heightened debt related vulnerabilities, the country needs sound liability management practices in line with the Medium Term Debt Management Strategy (MTDS), with necessary revisions, to guide effective debt management operations towards debt stabilisation. Current efforts on debt restructuring are also critical to reduce the debt burden in the near term by smoothing the debt service payments over a longer period. In the meantime, reducing the deficit in the current account by streamlining recurrent expenditure while strengthening revenue mobilisation with a credible and consistent commitment is of utmost importance in order to record a surplus in the primary balance in the medium term, thereby ensuring sustainability of government debt.

Central Government Debt Service Payments

Total debt service payments increased by 22.4 per cent in nominal terms to Rs. 2,375.6 billion in 2021 with the rise in both debt amortisation and interest payments. Domestic debt repayments, i.e., domestic amortisation payments, increased by 74.5 per cent to Rs. 795.5 billion in 2021, mainly due to the increase in maturing of Treasury bonds and SLDBs. Foreign debt repayments increased by 5.3 per cent to Rs. 531.7 billion in 2021, primarily reflecting the settlement of Rs. 199.9 billion (US dollars 1 billion) worth of ISB maturities in July 2021 and the repayments in FCTFF amounting to Rs. 330.6 billion during the year. Consequently, total amortisation payments, which accounted for 55.9 per cent of total debt service payments, increased by 38.1 per cent to Rs. 1,327.2 billion in 2021 from Rs. 961.1 billion in the preceding

Table 6.6
Central Government Debt Service Payments

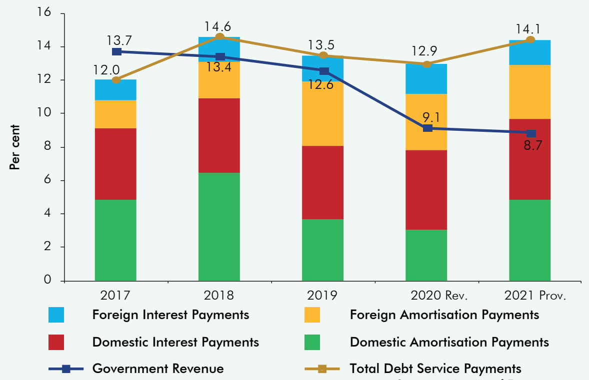
Rs. million

Item	2018	2019	2020	2021 (a)
Debt Service Payments	**2,088,551**	**2,022,507**	**1,941,373**	**2,375,599**
Domestic	1,561,363	1,213,698	1,169,522	1,590,131
Foreign	527,188	808,809	771,851	785,468
Amortisation Payments	**1,236,361**	**1,121,155**	**961,071**	**1,327,216**
Domestic	921,881	546,315	455,899	795,498
Foreign	314,480	574,839	505,172	531,718
Interest Payments	**852,190**	**901,353**	**980,302**	**1,048,383**
Domestic	639,482	667,383	713,623	794,633
Short Term	74,525	81,029	77,965	98,694
Medium and Long Term	564,957	586,354	635,658	695,939
Foreign	212,708	233,970	266,679	253,750

(a) Provisional

Sources: Ministry of Finance
Central Bank of Sri Lanka

Figure 6.10
Central Government Debt Service Payments (as a percentage of GDP)



Sources: Ministry of Finance
Central Bank of Sri Lanka

year. Meanwhile, interest payments on central government debt increased by 6.9 per cent to Rs. 1,048.4 billion in 2021 on account of increased interest payments on domestic outstanding debt.

Interest payments on central government domestic debt increased by 11.4 per cent to Rs. 794.6 billion in 2021, due to the notable increase in domestic borrowings during the year compared to the previous year amidst limited access to foreign financing and rise in domestic interest rates, particularly towards the latter half of 2021. With the reduction in interest payments on ISBs, FCTFF and project loans, interest payments on foreign debt decreased to Rs. 253.8 billion in 2021 in comparison to Rs. 266.7 billion recorded in 2020. Overall, domestic debt service payments increased by 36.0 per cent to Rs. 1,590.1 billion, while foreign debt service payments marginally increased by 1.8 per cent to Rs. 785.5 billion during 2021.

With the mounting debt stock and the resultant high interest payments, the main indicators related to debt service payments elevated in 2021. Total debt service payments increased to 14.1 per cent of GDP in 2021 from 12.9 per cent of GDP in the previous year. Amortisation payments on domestic debt as a

Table 6.7
Central Government Debt Indicators

Per cent

Indicator	2018	2019 (a)	2020(a)	2021 (b)
Central Government Debt/GDP	84.2	86.9	100.6	104.6
Domestic Debt/GDP (c)	42.5	45.5	60.3	66.0
Foreign Debt/GDP	41.7	41.3	40.3	38.6
Domestic Debt/Central Government Debt	50.5	52.4	60.0	63.1
Foreign Debt/Central Government Debt	49.5	47.6	40.0	36.9
Foreign Debt/Exports (d)	181.0	178.6	250.2	217.8
Debt Service/GDP	14.6	13.5	12.9	14.1
Debt Service/Government Revenue	108.8	107.0	141.9	163.0
o/w Domestic Debt Service/ Government Revenue	81.3	64.2	85.5	109.1
Debt Service/Government Expenditure (e)	53.1	45.4	48.5	49.0
o/w Domestic Debt Service/ Government Expenditure (e)	39.7	27.2	29.2	32.8
Foreign Debt Service/Exports (d)	16.0	23.3	31.9	26.4
Interest Payments/GDP	6.0	6.0	6.5	6.2
Interest Payments/Government Expenditure (e)	21.7	20.2	24.5	21.6
Domestic Interest Payments/GDP	4.5	4.5	4.7	4.7
Foreign Interest Payments/GDP	1.5	1.6	1.8	1.5
Interest Payments/Government Recurrent Expenditure	40.8	37.2	38.5	38.2
Foreign Interest Payments/Exports (d)	6.5	6.7	11.0	8.5

(a) For 2019 and 2020, revised GDP estimates were used, as released by the Department of Census and Statistics on 29 March 2022.
(b) Provisional
(c) Includes Government Treasury bonds of Rs. 78,441 million issued for CPC in January 2012 of which Rs. 21,778 million matured on 01 January 2017 and the current outstanding is Rs. 56,662 million
(d) Export of goods and services
(e) Government expenditure includes amortisation payments.

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

percentage of GDP increased to 4.7 per cent in 2021 from 3.0 per cent in 2020, while amortisation payments for foreign debt as a percentage of GDP declined marginally to 3.2 per cent in 2021 from 3.4 per cent in 2020. However, total interest payments as a percentage of GDP decreased to 6.2 per cent in 2021 from 6.5 per cent in 2020. Interest payments on domestic debt as a percentage of GDP remained broadly unchanged at 4.7 per cent in 2021, while interest payments on foreign debt decreased to 1.5 per cent of GDP in 2021 from 1.8 per cent of GDP in the previous year. Meanwhile, the ratio of central government debt service payments to government revenue deteriorated to 163.0 per cent in 2021 from 141.9 per cent in 2020, underscoring the gravity of the government debt burden, as the total debt service payment of the Government significantly exceeded government revenue. Moreover, the ratio of foreign debt service payments to exports of goods and services declined to 26.4 per cent in 2021 from 31.9 per cent in 2020, on account of steady growth in exports of goods and services in comparison to the growth in debt service payments in 2021.

Outstanding Public Debt

The outstanding public debt stock, which includes outstanding central government debt stock, foreign project loans received by State-Owned Business Enterprises (SOBEs), and public guaranteed debt, increased notably during 2021 largely due to the rise in central government debt stock. As a percentage of GDP, the outstanding public debt stock increased to 115.5 per cent of GDP by end 2021 from 109.4 per cent of GDP recorded at end 2020. In absolute terms, the outstanding public debt witnessed a substantial increase of 18.1 per cent to Rs. 19,407.3 billion by end 2021 from Rs. 16,427.1 billion reported at end 2020. The total outstanding central government debt stock accounted for 90.6 per cent of the outstanding total public debt. Meanwhile, in absolute terms, public guaranteed debt witnessed an increase of 52.8 per cent reaching Rs. 1,506.7 billion at end 2021 compared to Rs.986.4 billion at end 2020 accounting for 7.8 per cent of total outstanding public debt. Of the total outstanding public guaranteed debt, 62.1 per cent was denominated in foreign currency. Moreover, the outstanding debt relating to foreign project loans received by the SOBEs declined to Rs. 311.2 billion at end 2021 from Rs. 323.5 billion at end 2020 due to the repayment of outstanding loans by the Sri Lanka Ports Authority and the

Table 6.8
Outstanding Public Debt (as at end year)

	2018	2019	2020	2021 (a)
Rs. million				
Total Outstanding Central Government Debt (b)	**12,030,548**	**13,031,543**	**15,117,247**	**17,589,373**
Outstanding Balance of Foreign Project Loans Received by SOBEs without Public Guarantee	**366,130**	**345,453**	**323,510**	**311,191**
Airport & Aviation Services (Sri Lanka) Ltd.	24,964	22,317	22,189	21,833
Ceylon Electricity Board	168,649	150,418	136,720	128,026
Sri Lanka Ports Authority	172,517	172,717	164,602	161,332
Public Guaranteed Debt (c) (d)	**781,741**	**778,305**	**986,391**	**1,506,743**
Airport & Aviation Services (Sri Lanka) Ltd.	10,829	16,532	34,801	115,332
Bank of Ceylon & People's Bank	n.a.	n.a.	n.a.	36,540
Ceylon Electricity Board	21,376	25,212	70,559	89,311
Ceylon Petroleum Corporation	333,869	297,220	345,500	561,267
Ceylon Shipping Corporation Ltd.	13,098	12,613	12,505	12,263
General Sir John Kotelawala Defence University	36,843	35,311	35,562	35,738
Lanka Coal Company (Pvt.) Ltd.	11,000	5,398	9,692	13,899
National Water Supply & Drainage Board	85,541	102,339	138,180	200,851
Paddy Marketing Board	11,436	11,420	2,023	1,313
Road Development Authority	189,022	206,563	262,015	349,895
SriLankan Airlines Ltd.	31,981	32,083	43,530	60,336
Other Corporations	36,746	33,615	32,023	29,998
Public Debt	**13,178,418**	**14,155,301**	**16,427,148**	**19,407,307**
As a Percentage of GDP (e)				
Total Outstanding Central Government Debt (b)	84.2	86.9	100.6	104.6
Outstanding Balance of Foreign Project Loans Received by SOBEs without Public Guarantee	2.6	2.3	2.2	1.9
Public Guaranteed Debt (c) (d)	5.5	5.2	6.6	9.0
Public Debt	**92.2**	**94.4**	**109.4**	**115.5**

(a) Provisional
(b) Includes Government Treasury bonds of Rs. 78,441 million issued for CPC in January 2012 of which Rs. 21,778 million matured on 01 January 2017 and the current outstanding is Rs. 56,662 million
(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. This was matured in June 2019 and reissued for a period of 05 years
(e) For 2019 and 2020, revised GDP estimates were used, as released by the Department of Census and Statistics on 29 March 2022.

Sources: Ministry of Finance
Central Bank of Sri Lanka

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BOX 7

Restrategising State Owned Enterprises as Growth Facilitators

Since long, State Owned Enterprises (SOEs)[1] have played a key role in the socioeconomic development of countries. Healthy SOEs have made significant contributions to employment creation, poverty alleviation, fiscal stability, development of a sector or geographical area, environmental protection and even sector regulation as witnessed in several countries, including Asian peers such as Singapore, Japan, China and Korea.

Although during recent decades there has been a growing consensus in favour of privatisation and deregulation, the role of SOEs has not diminished, especially in developing countries. This is primarily because SOEs continue to be the providers of essential infrastructure and public services which have the highest impact on economic growth, development and overall wellbeing of the population. However, SOEs in the developing world generally tend to be straddled by low productivity, while distorting competition and being afflicted by corruption. This has resulted in them being a significant burden on the budget and the government, and in some cases leading to fiscal and economic crises. It is essential that Sri Lanka remains wary of the performance of its own SOEs in this context.

Evolution of SOEs in Sri Lanka

The development of public sector enterprises in Sri Lanka dates back to the Second World War period of 1939 – 1945, when several SOEs were set up to provide essential goods whose supply had been curtailed during the war. In the mid 1950s, the interest in socialism piqued with the successes in the Soviet Union and the adoption of a socialist ideology of development in India during the same time. Accordingly, the Government of the time considered central planning as essential for the development of the country.

During this period, two key enactments catalysed the development process of SOEs, i.e. the Government Sponsored Corporations Act No. 19 of 1955 and the State Industrial Corporations Act No. 49 of 1957, respectively. The former sought to incorporate existing industrial undertakings, while the latter empowered the Government to set up and carry out any industrial activity. By 1957, several important SOEs had commenced operations, including those related to cement, paper, ceramics, leather and footwear. Another key development during this period was the nationalisation of bus companies leading to the formation of the *Ceylon Transport Board* in 1958.

1 There is no commonly accepted definition for an SOE (European Commission, 2013; IMF 2014; OECD 2015). However, some characteristics of SOEs are as follows: (1) the entity has its own, separate legal personality; (2) the entity is at least partially controlled by a government unit; and (3) the entity engages predominantly in commercial or economic activities (IMF, 2020). The *Government Financial Statistics Manual 2014* (IMF, 2014) states that assessing government control of any entity involves judgment. Accordingly, a government may exercise significant influence over corporate decisions even when it owns a small number of shares.

In 1959, a *Ten Year Plan* which emphasised import substituting industrialisation was introduced – although the plan was not entirely operational, it closely guided the economic policies of the following years. Accordingly, ‘basic industries’ such as cement, steel, paper, tyres, mineral sands, salt, flour milling, plywood, petroleum refining and fertiliser, were to be undertaken by the Government. However, some areas which were of interest to the Government were also open for private enterprise participation, such as footwear, ceramics, textiles and leather products. This inward oriented development strategy was warranted by the persistent deficits in the balance of payments and the resultant introduction of a series of stringent import controls from 1960 onwards.

The 1970s saw a fresh slew of measures towards autarky, including the setting up of several monopolies in the public sector through both establishment of new enterprises and a series of nationalisations and acquisition of private ventures. The creation of SOEs was expected to be beneficial as it was premised that, as natural monopolies, they would supply services or products at costs which were below than what potential private players could offer and that they would also be able to meet the demand of the entire market, perhaps also with export potential. Accordingly, in subsequent years, there was nationalisation of privately owned business undertakings such as those engaged in port services, passenger transport and plantations, among others. By the mid 1970s, major economic and social activities such as banking, plantations, large scale industries, transport, insurance, telecommunications, postal services, ports, electricity, import and distribution of petroleum, roads, health and education were either public sector monopolies or were largely undertaken by public enterprises. The numbers of SOEs rose rapidly from 14 in 1962 to over 280 public enterprises by the mid 1980s.

By the mid 1980s, it was noted that public enterprises were facing a multitude of issues. These included operational inefficiencies translating into poor financial performance, subpar quality of products and services and supply shortages, recruitments driven by political considerations rather than the needs of the SOEs, inability to mobilise resources to meet large investment requirements, and, excessive dependence on the government budget. The growing burden of SOEs on the budget alongside multilateral donor agencies highlighting the urgent need for macroeconomic stabilisation led to the Government announcing privatisation as a state policy in 1988. The divestiture programme commenced in 1989 and, over the period till 1993, partial or full divestitures of about 43 commercial enterprises were undertaken. However, this divestiture programme came under much criticism in the period thereafter. Many of Sri Lanka’s experiences with privatisation highlight that the weaker the economy and governing institutions, the more arduous it is to reap the benefits of privatisation.

Current Status of SOEs in Sri Lanka

Over the last three decades, successive governments have alternated between attempts at privatisation and nationalisation. Currently, there are over 400 SOEs operating in several key sectors including power, energy, finance and insurance, water, aviation, health and education, among others. While a large majority of SOEs are regulated by the 'Administer Part II' of the Finance Act No. 38 of 1971, of recent times, several have been established under the Companies Act No. 07 of 2007. Of these, 52 SOEs have been identified as State Owned Business Enterprises (SOBEs) as they are regarded to be strategically important to the functioning and transformation of the economy. SOBEs in Sri Lanka include the Bank of Ceylon, People's Bank, Sri Lanka Insurance Corporation Ltd, Ceylon Electricity Board (CEB), Ceylon Petroleum Corporation (CPC), Sri Lanka Ports Authority, SriLankan Airlines, Sri Lanka Transport Board and State Pharmaceuticals Corporation, among others.

Despite their pivotal role in the economy across strategic sectors, the poor financial performance of SOEs has become a heavy fiscal burden with significant macroeconomic implications. The excessive reliance of SOEs on the banking system to fund their losses has not only crowded out productive investments but has also rendered the financial system vulnerable to their weak financial performance. Macroeconomic stability is also threatened as their burgeoning financial losses weigh down on their ability to smoothly fulfill domestic demand for essential goods and services. Recognising the issue, in recent years, the Government undertook several initiatives to reform SOEs. Key reforms in this regard are the introduction of a Statement of Corporate Intent (SCI) as a tripartite Memorandum of Understanding signed by the respective enterprise, line Ministry and Ministry of Finance and the introduction of a regulatory framework for SOEs that provides commercial freedom, while increasing their level of accountability. Policy reforms have also been identified to amalgamate or consolidate SOEs with similar objectives and those at similar stages of the value chain thereby creating 'economies of scale' for these enterprises. Further, the Government also recently formed *Selendiva Investments Ltd,* a fully state owned company, to manage and consolidate several high end real estate assets in a bid to capitalise on the success of 'holding company' models, as seen in Singapore and Malaysia.

In the post COVID-19 recovery process of the economy, where an urgent correction of the course of the economy has become necessary, there is a dire need to expedite such reforms and further focus on the rigorous and rapid transformation of SOEs as growth facilitators. This is essential to improve their efficiency, productivity and profitability and thereby empower them to contribute to the economy's recovery process in an effective and sustainable manner, without being a persistent economic issue. A few such key reforms that may be considered are discussed.

Proposed Major SOE Reforms

a. Introduction of Cost Reflective Pricing Policies

Often SOEs have to strike a fine balance between helping the Government achieve its socioeconomic objectives while ensuring the enterprise's financial viability. This challenge stems from the engagement of SOEs in the provisioning of essential products and services, which are sometimes not commercially viable; for instance, the provision of public transport to rural communities or electricity in geographically challenging areas such as in mountainous regions. Despite this element of 'essentiality' associated with the portfolio of goods and services provided by Sri Lanka's SOEs, establishing a cost reflective pricing mechanism is a key priority to ensure sustainable and uninterrupted provisioning of these goods and services.

In the recent past, Sri Lanka has struggled with the implementation of cost reflective pricing policies, especially in relation to the pricing of fuel products and utilities such as water and electricity. Despite a brief episode of frequent price adjustments of fuel products in line with global developments, no price revisions were undertaken between September 2019 and June 2021, after which three rounds of upward price revisions were undertaken to compensate for both the rising global prices of crude oil and the financial losses incurred by the CPC over several years. Tariffs for water and electricity continue to remain unrevised since 2012 and 2014, respectively. It must be reiterated that, in the case of enterprises such as the CPC and the CEB that rely on imported intermediate goods, their exposure to changes in global commodity prices as well as exchange rate fluctuations warrants regular price revisions. Hence, long periods of unchanged prices or tariffs are unacceptable as evidently losses on account of these external shocks cannot be absorbed by the relevant enterprises.

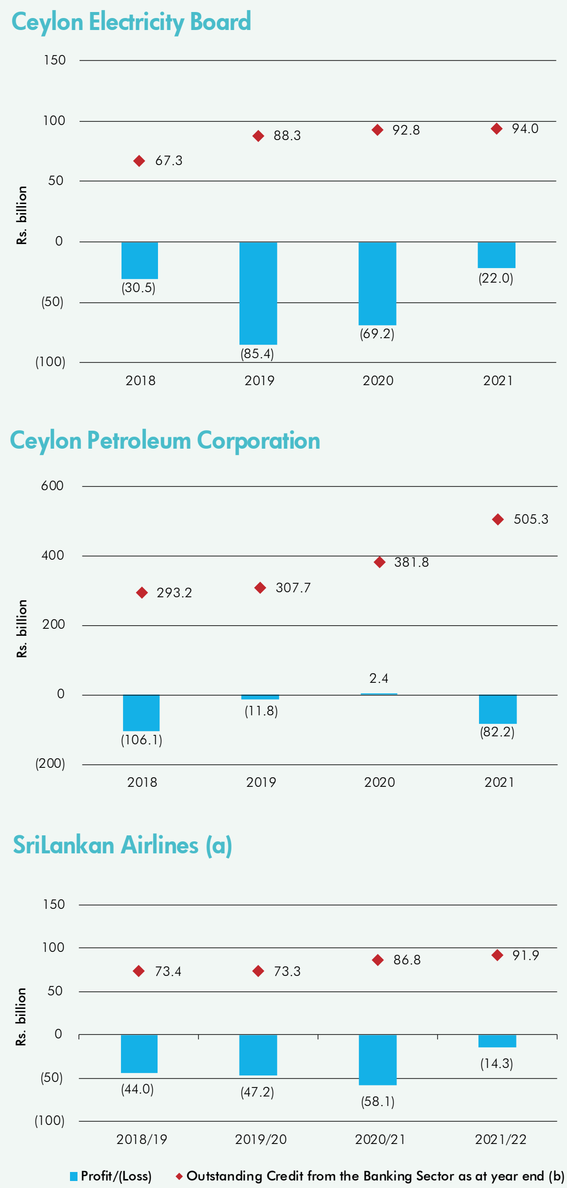
Accordingly, the implementation of transparent and depoliticised pricing rules are an urgent need. While subsidised prices may provide some financial benefits and leeway to consumers in the short term, it should be recognised that the related expenditure burden of below cost provisioning is borne by the Government. Subsidised prices cause price distortions and misallocation of resources that entail significant macroeconomic costs which could translate into insurmountable disruptions in the economy, as depicted by the power and energy crisis that emerged in early 2022. A cost reflective pricing mechanism will also ensure that SOEs pass on benefits of lower costs to consumers in a transparent and timely manner without negative implications on bottom line profits. Such a mechanism can greatly boost transparency and accountability of SOEs with positive spillover effects across the economy.

b. Improvement of Strategic Direction

The primary task of SOEs is not just to generate financial returns to the Government in the short term but also to deliver strategic value to all stakeholders of the economy by facilitating and uplifting their productive potential and overall wellbeing. Accordingly, it is imperative for

6

Figure B 7.1
Comparison of Profits/Losses and Credit Obtained from the Banking Sector for Selected SOBEs



(a) Financial performance of Sri Lankan Airlines is for the financial year ending 31st of March. Data for 2021 is for the nine months ending 31st March 2022.
(b) As per the Monetary Statistics compiled by the Central Bank of Sri Lanka

Sources: Ceylon Petroleum Corporation
Ceylon Electricity Board
SriLankan Airlines
Ministry of Finance
Central Bank of Sri Lanka

these entities to have a transparent and unambiguous strategy that is well connected to the overall vision of the Government. This will ensure a clear purpose and mission for SOEs.

As seen in the recent past, SOEs have been unable to leverage their resources to create value for stakeholders and catalyse growth. This has been evidenced by the lack of strategic planning causing bottlenecks in the economy wherein SOEs have often failed to proactively identify and address opportunities and challenges emanating, not only from domestic developments but also global developments. The poor strategic planning of SOEs is evident from the supply side shocks that the economy is experiencing in the wake of adverse developments in global energy and food commodity prices and the lack of any robust buffers to tide over such volatilities.

Therefore, to improve strategic direction, it is important for SOEs to minutely assess their operations. Breaking down the entire value chain of a product or service can enable enterprises to assess the areas in which they have natural advantages. Private sector participation can, therefore, be facilitated through such unbundling of activities. Accordingly, operational inefficiencies are borne neither by the Government nor consumers nor other relevant stakeholders.

c. Enhancement of Financial Transparency and Accountability

SOEs are often under pressure to be competitive and commercially viable, while trying to fulfil non-commercial objectives, the latter of which may necessitate compromising financial performance. In order to keep track of whether SOEs are effectively balancing their social obligations with their commercial obligations, it is important to establish a sound performance monitoring framework that incorporates principles of accountability, transparency and governance.

In this regard, one of the key aspects that is urgently needed is the identification and development of Key Performance Indicators (KPIs) to measure and evaluate results of SOEs. While such KPIs should assess financial results, it is also important to consider the impact on social, human and environmental capitals as SOEs have a wider purpose than simply being profit generators for the Government.

Another aspect that needs to be addressed is the improvement of disclosure and transparency of SOEs. Accordingly, SOEs must observe high standards and be subject to the same high quality accounting, disclosure, compliance, and auditing standards as listed companies. Time and again, concerns have been raised that numerous SOEs do not prepare year-end financial statements or annual progress reports in a timely manner; some entail delays of several years. A stringent mechanism is essential to ensure timely periodic reporting with disclosures of financial and nonfinancial information to assess the status of SOEs and whether they are performing in a financially viable and economically sustainable manner.

d. Strengthening Corporate Governance

The success of SOEs hinges on efficient and professional management by a competent Board. The Board needs to take full responsibility for stewardship and performance of the enterprise and should be competent enough to steer it in a strategic manner that is conducive to the vision of the Government and thereby, the progress of the economy. Inefficiencies on the part of the Board can result in a lack of strategic direction leading to the colossal mismanagement of state resources, as has been seen in the case of certain SOEs in Sri Lanka.

The composition of Boards plays a crucial role in the quality of corporate governance. It is vital that the Government promotes the appointment of competent, experienced and professional individuals to Boards to ensure strong accountability. Appointments should be on the basis of fixed term contracts that are independent of election cycles. This can ensure efficacious strategic planning suited for transformation over the medium term rather than the implementation of transient fixes.

It is also essential that Boards and the senior management of SOEs act diligently and with extreme care considering that the resources entrusted to them are ultimately the resources of the general public. The recent issuance of *Guidelines on Corporate Governance* and an *Operational Manual for State Owned Enterprises* in late 2021 by the Ministry of Finance is a timely initiative in this regard. Rigorous monitoring on the part of the Ministry of Finance to ensure that all SOEs are operating in line with these guidelines can catalyse the transformation process of these entities. Regular reviews of the guidelines are also necessary to continuously align SOE corporate governance standards in line with best international practices.

Good corporate governance helps to operate SOEs more efficiently, improve access to capital, and mitigate risk while safeguarding against mismanagement. Research findings reveal several direct advantages for SOEs that have undergone governance reforms. Such benefits include improved operational performance, increased access to alternative sources of financing through domestic and international capital markets, financing for infrastructure development, reduced fiscal burden of SOEs and increased net contribution to the budget through higher dividend payments, and reduced corruption and improved transparency.

Reforms in SOEs: International Experiences

Countries across the world have made attempts across several decades to turnaround the performance of their SOEs. Selected SOE reform experiences, as could be pertinent to Sri Lanka, are described below.

Singapore

In the case of Singapore, the investment holding company *Temasek* has seen much success. It was established in 1974 to own and commercially manage investments and assets previously held by the Government of Singapore. Following independence in 1965, the lack of raw natural resources drove Singapore to commence an aggressive industrialisation and economic development programme. As the Government established startups in several strategic sectors, *Temasek* was established to relieve relevant ministries from the commercial management of these enterprises in which the Government had a controlling stake. With time, the fund encouraged portfolio companies to expand into other markets as well as to pursue mergers and acquisitions to become more internationally competitive. Revisions to the charter over several rounds led *Temasek* to evolve into a global investment company with the mission of generating sustainable returns beyond the present generation. The portfolio value of *Temasek* stood at US dollars 283 billion as at end March 2021, having generated a group net profit of US dollars 42 billion during the same year. Notably, there are no government representatives on the Boards of portfolio companies under *Temasek*. Further, the Government of Singapore does not have any influence over the appointment of key personnel and operations of *Temasek* or other SOEs.

China

China's SOEs have seen a series of reforms since the 1970s, driven by market oriented economic reforms aimed at opening up the economy to foreign trade. In 2003, *the State-owned Assets Supervision and Administration Commission* (SASAC) was established to fund and regulate SOEs. From 2013 onwards, China focused on the merging of large SOEs and expanded mixed ownership programmes. Currently, China's SOE reform agenda is focused on making SOEs 'stronger, better and bigger'. Accordingly, SASAC's *zhuada fangxiao* (grasp the big, release the small) approach seeks to reduce the number of small SOEs through privatisation and asset sales, while strengthening SOEs that are deemed to be strategically important for the state economy. It is opined that the companies held by SASAC have superior governance even in comparison to their private sector counterparts. Chief Executive Officers and Directors are appointed under performance based contracts with detailed dividend targets. Boards also comprise professional independent Directors to improve accountability.

Brazil

Despite grappling with underperforming SOEs, Brazil has created extremely successful SOEs such as *Petrobras* which is featured on the *Fortune Global 500 list*. In *2010, Petrobras* was transformed from a purely state owned company into a mixed company. To date, the share democratisation that ensued this transformation is one of the largest capital-increase transactions in the history of capital markets. This created an increase in the market value of the company, while creating opportunities for the company to mobilise investments to support its growth. Listing of the company on the stock exchange also paved way for significantly improved corporate governance as the state's participation as a sole proprietor was significantly curbed, thereby preventing the risk of political influence and lack of commitment by the board and management.

India

India has followed a strategy of disinvestment in recent years to address the issue of inefficient SOEs. This has entailed the sale of a substantial portion of the government shareholding of enterprises, including transfer of management control. Today, India has the second largest number of SOEs, after China, in the *Fortune Global 500* list of companies. A recent move in its reform agenda has been the privatisation of *Air India* with the government of India receiving about US dollars 360 million in equity and a private conglomerate taking over US dollars 2 billion of debt. India is also to establish

6

a company, *National Land Monetisation Corporation,* to hold, manage and monetise surplus land and buildings of government agencies and public sector undertakings. This is to be set up as an entirely government owned company under the Ministry of Finance.

Successful SOE Turnaround in Sri Lanka: *Case of Sri Lanka Telecom PLC*

The telecommunications sector is one of the most successful service sectors in Sri Lanka, in terms of quality, reliability and pricing of services. Today, Sri Lanka boasts mobile penetration of over 135 per cent and has one of the lowest mobile and internet charges in the region. A key player in this industry is Sri Lanka Telecom PLC which has emerged as a successful SOE over the last two decades.

Following economic liberalisation, in the early 1980s Sri Lanka took a significant step in restructuring the telecommunications sector by instituting the Department of Telecommunications, which later handed over the operational functions to a public corporation, namely *Sri Lanka Telecom*. In 1996, *Sri Lanka Telecom* was reconstituted as a government owned Limited Liability Company. A turning point for the SOE was the sale of 25 per cent of the share capital to *Nippon Telegraph & Telephone Corporation* for US dollars 225 million in the following year. This was followed by the successful listing of *Sri Lanka Telecom PLC* on the Colombo Stock Exchange in 2003. As at end 2020, the two major shareholders of *Sri Lanka Telecom PLC* were the Government, holding a 49.50 per cent stake through the Secretary to the Treasury and, *Global Telecommunications Holdings N.V.* with a 44.98 per cent stake and the remainder being held by other shareholders and publicly traded on the Colombo Stock Exchange. Accordingly, dividends from *Sri Lanka Telecom* stood at approximately Rs. 947 million in 2020 and dividends amounting to Rs. 1.4 billion are expected in 2022 and beyond.

The case of *Sri Lanka Telecom* highlights the innate potential that exists in SOEs and how the undertaking of timely reforms, such as through divestiture can help the economy harness this potential. It is also important to note that in this case, the setting up of the *Telecommunications Regulatory Commission of Sri Lanka* as an independent regulator facilitated the progress of Sri Lanka Telecom as it ensured the overall dynamic development of the sector through the creation of a regulatory environment that is committed towards ensuring competition and contestability.

Considering the success seen with *Sri Lanka Telecom,* going forward, the Government may consider the sale and/or divestiture of SOEs. In this regard, it is vital for successive governments to maintain a consistent policy stance in relation to the sale of government assets, while also addressing the concerns of stakeholders in a timely and proactive manner during such processes.

Way Forward

Going forward, as Sri Lanka progresses on its post COVID-19 recovery journey and transitions to the upper middle income status, it is crucial that the Government expeditiously implements the reforms that are underway, especially in relation to mergers and consolidation and the strengthening of corporate governance, which have also been proposed above. Reforms relating to the implementation of a transparent pricing mechanism, improvement of strategic direction and enhancement of financial accountability are also imperative to improve the performance of SOEs in the short term. These not only ensure improved government revenue but also reduces the need for loss financing through budget transfers or as borrowings from the banking system. This can help release substantial volumes of resources to be channeled to more productive income generation or asset creation by households and enterprises. Accordingly, there will be a multiplier effect on government revenue in the short run and on growth in the medium to long run.

With due consideration to the key role that SOEs play in the economic development process, especially with their wide presence in strategic sectors, it is crucial that these enterprises perform effectively and deliver favourable socioeconomic outcomes without financially burdening the state. In this regard, the Government must conduct individual feasibility studies of SOEs and initiate timely action regarding the sale of some of their assets to domestic or foreign entities. Subsequently, the Government may also consider restrategizing these SOEs without politicizing them to ensure sustainable and viable operations. The Government must also recognise that although such reforms may require some unpopular policy initiatives at the outset, these can pave way for the creation of SOEs that are financially viable and economically beneficial over the medium to long run. The transformation of existing SOEs from 'fiscal burdens' and into 'value creators,' through such reforms, is vital for them to emerge as facilitators of Sri Lanka's progress onto a high growth trajectory, rather than serve as stumbling blocks.

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Ceylon Electricity Board, recording a year-on-year decline of 2.0 per cent and 6.4 per cent, respectively. By end 2021, the outstanding public guaranteed debt of the CPC and the National Water Supply and Drainage Board witnessed a substantial increase of 62.5 per cent and 45.4 per cent, respectively, reaching Rs. 561.3 billion and Rs. 200.9 billion, respectively, compared to 2020. Meanwhile, at end 2021, the CPC and the Road Development Authority accounted for a major portion of the public guaranteed debt stock of SOBEs, with shares of 37.3 per cent and 23.2 per cent, respectively.

6.5 Budgetary Operations in Sub National Governments

Policy Directions and Measures taken by Sub National Governments

During 2021, several projects were implemented at the sub national government level with the aim of regional infrastructure development and public sector service delivery enhancement, thereby upgrading living standards of the people.[5] Accordingly, several infrastructure related projects were implemented during the year, including the Local Government Enhancement Sector Project, Construction of Rural Bridges Project, Rural Infrastructure Development Project in Emerging Regions (RIDEP Project), Provincial Road Development Project (PRDP), Greater Colombo Waste Water Management Project, and Local Development Support Project (LDSP). Meanwhile, the Primary Health Care System Strengthening Project and the General Education Modernisation Programme were also in progress in 2021 with the objective of raising the quality of health and education service delivery at the sub national government level.

With the view to achieving a balanced regional development and shared prosperity in the country, the Finance Commission (FC) recommended several measures to be implemented in 2021, with funds allocated from the National Budget, in the areas of balanced regional development, inter-agency coordination, devolved revenue generation, and private sector participation. The FC recommended allocating sufficient funds to Provincial Councils (PCs) to accomplish their expenditure needs including delivery of services in terms of education and health at the sub national level. Further, recommendations were made to ensure the effective utilisation of resources and to reduce regional disparities by disbursing funds directly to PCs, preparing a consolidated annual implementation plan for development activities, and maintaining a balanced resource allocation among PCs. As most of the disaster response and mitigation activities and community based interventions are channeled through PCs and Local Authorities (LAs), the Commission recommended allocating a special grant to PCs under the National Budget for delivery of services for LAs and for environment protection activities. In line with this recommendation, the FC highlighted the need to discontinue the allocations for other ministries and departments on such activities. Moreover, the FC recommended empowering PCs and LAs with higher revenue generation in order to reduce the dependency of PCs and LAs on the central government budget. The FC recommended establishing a common framework for planning, budgeting, and reporting of public investments in the national and sub national governments to strengthen the intergovernmental financial coordination. The recommendations were also

5 The sub national governments comprised of nine Provincial Councils (PCs) and 341 Local Governments (LGs) that include 24 Municipal Councils, 41 Urban Councils and 276 Pradeshiya Sabhas.

made to encourage private investments in the relevant sectors and regions to enhance the quality of delivery of services, while maintaining balanced development in the country, while posing less of a burden on the government budget.

Budgetary Operations in Provincial Councils

Revenue collection of PCs improved in 2021, reflecting the increased economic activities during the year compared to 2020. Total revenue of PCs increased to Rs. 58.1 billion in 2021 from Rs. 52.2 billion in 2020 due to the increase in tax revenue collection. Tax revenue increased to Rs. 51.1 billion in 2021 from Rs. 43.1 billion in 2020 due to higher revenue collection from stamp duty, which continued to be the key source of revenue of PCs and increased to Rs. 38.8 billion in 2021 compared to Rs. 27.4 billion in 2020. However, revenue earned from license fees declined to Rs. 10.8 billion in 2021 in comparison to Rs.11.2 billion recorded in 2020, mainly due to the reduction in motor vehicle registrations amidst the prevailing import restrictions. With the removal of NBT in December 2019, NBT revenue transferred from the Central Government declined significantly to Rs. 0.3 billion in 2021 compared to Rs. 2.7 billion recorded in 2020. Accordingly, the share of revenue from stamp duty on tax revenue of PCs increased to 76.0 per cent in 2021 from 63.5 per cent in 2020, while the share of revenue from NBT on tax revenue of PCs declined to 0.5 per cent in 2021 from 6.3 per cent in 2020. Meanwhile, non tax revenue declined to Rs. 7.1 billion in 2021 from Rs. 9.1 billion in 2020. Revenue in all other provinces declined during 2021 in comparison to the previous year, except the Western Province. Accordingly, the share of revenue of the Western Provincial Council out of the total revenue collection by all PCs increased to 53.6 per cent in 2021 from 46.8 per cent in 2020 due to increased revenue collection from stamp duty and interest income. Among other PCs, the North Western and Southern Provinces accounted for 10.3 per cent and 10.0 per cent of the total revenue, respectively.

The total expenditure of PCs increased mainly due to the rise in recurrent expenditure in 2021 compared to the preceding year. In nominal terms, total expenditure increased to Rs. 376.4 billion in 2021 from Rs. 337.0 billion in 2020, while as a percentage of GDP, it broadly remained unchanged at 2.2 per cent in 2021. Recurrent expenditure increased to Rs. 317.0 billion in 2021 from Rs. 289.7 billion in 2020, mainly due to the rise in expenditure on personal emoluments, which increased to Rs. 251.5 billion in 2021 from Rs. 228.6 billion in 2020. Personal emoluments remained the largest component of recurrent expenditure accounted for about 79.4 per cent in the total recurrent expenditure of PCs. Meanwhile, about 90 per cent of personal emoluments of PCs were spent on the education and health sectors. The Western, Central and Southern PCs remained the highest spending authorities accounting for 20.6 per cent, 12.8 per cent, and 12.5 per cent of total recurrent expenditure of PCs. Meanwhile, capital expenditure of PCs increased to

6

Table 6.9
Budget Outturn of Provincial Councils

Rs. million

Item	2018	2019	2020 (a)	2021 (b)
Total Revenue	**88,689**	**91,344**	**52,245**	**58,141**
Tax Revenue	82,228	81,499	43,096	51,067
Non Tax Revenue	6,461	9,845	9,149	7,075
Total Expenditure	**292,265**	**310,124**	**337,006**	**376,447**
Recurrent Expenditure	251,552	286,884	289,667	316,969
o/w Personal Emoluments	198,129	219,698	228,561	251,525
Capital Expenditure	40,713	23,240	47,339	59,478
Central Government Transfers	**203,576**	**218,780**	**284,761**	**318,306**
Block Grants	180,095	199,968	265,593	284,602
Criteria Based Grants	2,462	2,205	1,752	2,559
Province Specific Development Grants	13,536	11,376	11,004	12,632
Foreign Grants for Special Projects	7,483	5,230	6,412	18,513

(a) Revised
(b) Provisional

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

Rs. 59.5 billion in 2021 from Rs. 47.3 billion in 2020, mainly due to the rise in expenditure in relation to special projects.

Despite the higher revenue collection of PCs, transfers from the Central Government to PCs increased significantly to meet higher expenditure incurred by the PCs during the year. Accordingly, transfers from the Central Government to PCs increased by 11.8 per cent to Rs. 318.3 billion in 2021, mainly due to the increase in block grants and grants for special projects. Transfers from the Central Government remained at 1.9 per cent of GDP in 2021, unchanged from 2020. Block grants to PCs amounted to Rs. 284.6 billion during 2021, representing 89.4 per cent of the total transfers. In addition, grants for special projects increased to Rs. 18.5 billion in 2021 from Rs. 6.4 billion in 2020. During 2021, the transfers under the Province Specific Development Grants and Criteria Based Grants amounted to Rs. 12.6 billion and Rs. 2.6 billion, respectively. At the same time, during the period under review, about 84.6 per cent of expenditure of PCs was financed through central government transfers reflecting the necessity of building regional level strategies that encourage revenue mobilisation within PCs to reduce the pressure on the budget of the Central Government. It may also be noted that the continuation of an enlarged local and provincial government system has been a significant financial burden on the central government budget. It is suggested that a strict governance code to be implemented within the provincial and local government system, ensuring accountability and public scrutiny over their finances.