6

FISCAL POLICY AND GOVERNMENT FINANCE

6.1 Overview

The revenue based fiscal consolidation strategy continued in 2017 with emphasis placed on revenue enhancing tax reforms to reduce the budget deficit and the debt burden of the government. Accordingly, tax revenue as a percentage of GDP increased to 12.6 per cent in 2017 from 12.3 per cent in 2016 reflecting the impact of adjustments made to major tax revenue sources in the previous year. However, total revenue as a percentage of GDP declined to 13.8 per cent in 2017 from 14.2 per cent in 2016 due to a reduction in non tax revenue. The non tax revenue to GDP ratio declined mainly due to the lower revenue collection stemming from the lack of dividend transfers by State Owned Business Enterprises (SOBEs) owing to their weak financial performance. Meanwhile, total expenditure and net lending also reduced to 19.4 per cent of GDP in 2017 from 19.6 per cent of GDP in the previous year reflecting a reduction in recurrent expenditure. Recurrent expenditure reduced to 14.5 per cent of GDP in 2017 from 14.8 per cent of GDP in 2016 largely due to the subdued growth in salaries and wages, and current transfer payments. However, interest payments as a percentage of GDP increased to 5.5 per cent in 2017 from 5.1 per cent in 2016. The primary balance of the budget, which reflects the difference between revenue and non interest expenditure, was in surplus in 2017. This was a key achievement in budgetary operations in 2017 as the government was able to record a surplus in the primary balance for the first time since 1992 and only the second time since 1955. The surplus in the primary balance shows that the entire non interest expenditure of the government in 2017 was met out of revenue receipts with a surplus remaining. The primary surplus achieved in 2017 also exceeded the primary deficit target of Rs. 23.0 billion set as a Quantitative Performance Criteria (QPC) under the Extended Fund Facility (EFF) programme of the International Monetary Fund (IMF). Meanwhile, the current account deficit, which constitutes the difference between revenue and recurrent expenditure, marginally increased to 0.7 per cent of GDP in 2017 from 0.6 per cent in 2016. Further, higher outlays in respect of interest payments and disaster relief measures together with the shortfall in non tax revenue resulted to increase the budget deficit to 5.5 per cent of GDP in 2017 from 5.4 per cent in the previous year. In financing the budget deficit in 2017, the government relied mainly on foreign sources, although *borrowings from domestic sources increased their share in financing the deficit as compared to the previous year. Further, the central government debt to GDP ratio declined to 77.6 per cent at end 2017 from 78.8 per cent at end 2016 due to the deceleration in the growth of debt accumulation and the increase in nominal GDP growth.*

The government took measures to increase revenue mobilisation through hiking tax rates, broadening the tax base, rationalising tax exemptions and concessions, and strengthening tax administration during the year. The new Inland Revenue Act, No. 24 of 2017 was enacted with the expectation of simplifying and rationalising the existing income tax structure, broadening the income tax base by removing tax exemptions and strengthening tax administration with a view to enhancing revenue mobilisation from direct taxes. The new Act came into effect from 01 April 2018. Further, amendments were made to the Economic Service Charge (ESC) with effect from 01 April 2017 to expand the tax base by reducing the threshold for liable turnover to Rs. 12.5 million per quarter from Rs. 50.0 million per quarter and imposing ESC on the importation of motor vehicles. During the year, excise duty rates on liquor were revised upwards while excise duty was introduced on raw materials used for the production of ethanol in order to reduce leakages in the revenue collection. Further, several exemptions granted under the Nation Building Tax (NBT) were removed in 2017. In addition to these tax reforms, the automation process of the Inland Revenue Department (IRD) through the Revenue Administration Management Information System (RAMIS) continued in 2017. Further, a tax expenditure statement outlining the cost of tax exemptions, tax holidays and other incentives granted by the government with regard to key taxes was submitted to the Parliament for the first time through the 2017 Budget. The inclusion of a tax expenditure statement to the Budget is expected to improve fiscal transparency.

On the expenditure front, several measures were introduced during the year to rationalise government expenditure while strengthening the monitoring process of government spending. Accordingly, as announced in the Budget 2017, quarterly expenditure and income outcome reports were presented to the Parliament with a view to strengthening the Parliamentary control over public finances. Further, a quarterly budget estimate for 2018 was provided in the Budget 2018 to strengthen the monitoring process of the Budget. The performance of major capital projects of selected ministries was monitored by the Budget Review and Implementation Committee (BRIC) established under the Ministry of Finance and Mass Media (MOF) and monthly cash releases were made based on the performance. In order to ensure efficient and effective spending of budgetary allocations, the 2018 Budget was formulated on a Performance Based Budgeting (PBB) approach, which is the practice of developing budgets based on the relationship between programme funding levels and expected results from that programme. Further, automation of key Treasury operations through the Integrated Treasury Management Information System (ITMIS) at the MOF also continued during the year. Meanwhile, the National Agency for Public Private Partnerships (NAPPP) was established, in 2017, to collaborate with the private sector on investment. The NAPPP is expected to assist in addressing the challenge of implementing capital projects in a context of limited fiscal space. Further, the Welfare Benefits Board (WBB), which was established to provide the necessary legal framework for all welfare relief benefits and set out a transparent selection process, took preliminary steps to establish an integrated system for all welfare programmes of the government as a one stop shop for welfare management. Four major welfare programmes *are to be included in this system at the initial stage. During 2017, Statements of Corporate Intent (SCIs) were signed with five major SOBEs to improve the accountability, transparency and the performance of these SOBEs. These initiatives are expected to strengthen their financial positions while enhancing the viability of their operations. In addition, non commercial obligations of SOBEs, which is defined as the provision of goods and services to the consumer at a price below cost, were presented as a statement to the Parliament for the first time with the Budget 2018. This statement included the non commercial obligations of the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB) for 2017 and 2018. During 2017, the government earmarked several non strategic public assets for divestiture with the aim of utilising proceeds collected through such divestments to meet future debt service obligations. Accordingly, a concession agreement was signed with a foreign investor during the year to operate the Hambantota Port as a Public Private Partnership (PPP) and proceeds were to be used for debt service payments.*

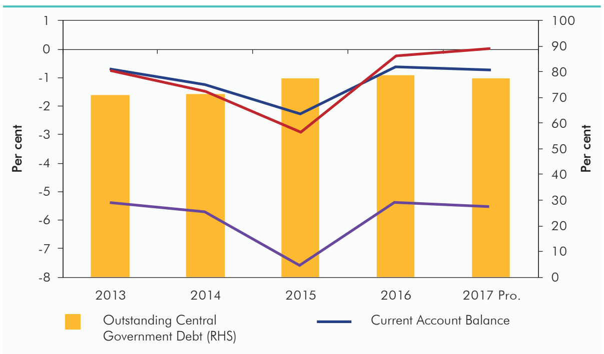
As per the Medium Term Macro Fiscal Framework, the budget deficit is estimated to reduce to 3.5 per cent of GDP by 2020 and maintain at the same level while central government debt is expected to decline to 69 per cent of GDP by 2022. However, achieving the set fiscal targets over the medium term remains challenging and requires a strong commitment from the government. Especially, the revenue to GDP ratio in Sri Lanka remains notably below the average revenue collection of peer economies. This low revenue collection limits the fiscal space thus requiring debt financing not only for public investment but also for a part of recurrent expenditure. Accordingly, the ratio of government revenue to GDP is expected to increase to around 17 per cent in the medium term while maintaining government expenditure at around 20-21 per cent of GDP. This would enable public investment to be maintained at the current level of around 5 per cent of GDP over the medium term. In line with these expected developments, the primary balance is expected to improve further, showing the government's commitment in maintaining non interest expenditure within the revenue collection. Further, the current account is also expected to record a surplus starting from 2018 enabling the government to discontinue the practice of borrowing for its day to day operations and to contribute to the public investment programme from the revenue collection. Going forward, it is vital to implement structural reforms which are already earmarked in the government's policy document titled "Vision 2025" as well as in the Budget 2018, without further delays in order to reap the maximum benefits from the outlined reforms and to achieve the envisaged fiscal targets. Although some progress was observed in revenue mobilisation in the recent past, the need to increase the revenue collection remains an unavoidable commitment for the government in order to reduce the budget deficit over the medium term. In this context, further to the tax expenditure analysis, which includes the cost of tax exemptions, a medium term plan for drafting a tax expenditure rationalisation statement is also a necessity for increasing tax revenue. Further, initial steps were taken to implement a Value Added Tax (VAT) compliance strategy for taxpayers that includes a time bound plan to implement risk based audits, which would also support strengthening tax administration. In addition, attention should be given to amend the Fiscal Management (Responsibility) Act, No. 3 of 2003 to incorporate binding fiscal rules, clearly defined escape clauses and correction mechanisms in case of a breach of fiscal targets, in order to improve fiscal discipline (See Box Article 06: Fiscal Rules). Further, foreign debt *service obligations falling due during 2019-2023 have become a serious challenge drawing urgent policy attention of the government. Accordingly, the Active Liability Management Act, No. 8 of 2018 (ALMA) was enacted in March 2018. The objective of ALMA is to manage public debt to ensure financing needs and payment obligations of the government are met at the lowest possible cost over the medium to long term consistent with a prudent degree of risk. ALMA will also allow borrowing in advance for future debt service requirements. Further, a Medium Term Debt Strategy (MTDS) for 2019-2023 is to be developed by the MOF and the Central Bank for better management of government debt. Besides these initiatives, the introduction of automatic pricing mechanisms for fuel and electricity will also improve the financial viability of CPC and CEB, respectively, thus reducing the government's burden arising from the operations of such SOBEs. Meanwhile, interest payments on outstanding government debt have become a serious challenge during the recent past, mainly due to heavy foreign commercial borrowings at higher interest rates. Expenditure on interest payments continued to be the single largest recurrent expenditure item in fiscal operations in 2017 amounting to 40.2 per cent of the government revenue collection. Heavy reliance on foreign commercial borrowings, exposes the country to higher foreign exchange risk and external shocks, thereby exerting pressure on the balance of payments of the country as well.*

6.2 Fiscal Policy Direction and Measures

The government undertook numerous measures in 2017 to continue with the revenue based fiscal consolidation process, aiming to reduce the budget deficit and the outstanding debt in the medium term. Accordingly, in order to achieve the envisaged medium term targets, several policy measures were introduced, in 2017, to enhance the revenue collection, prioritise and rationalise government expenditure, strengthen the financial performance of major SOBEs and improve debt management strategies.

On the revenue front, the new Inland Revenue Act, No. 24 of 2017, which was enacted in October 2017, was implemented with effect from 01 April 2018. The new Act was drafted with the expectation of simplifying and rationalising the existing income tax structure, broadening the income tax base by removing tax exemptions and strengthening tax administration with a view to enhancing revenue mobilisation from direct taxes. The new Act has brought about significant changes to the structure of income taxes. For employment income, the tax free threshold was increased to Rs. 1.2 million from Rs. 750,000 although the tax free threshold for personal income tax was maintained at the previous level of Rs. 500,000. Further, tax slabs for personal income tax, including employment income, were widened from Rs. 500,000 to Rs. 600,000 brackets and the highest marginal tax rate increased to 24 per cent from 16 per cent. Corporate income taxes were also streamlined with the introduction of a three tier tax structure. Accordingly, a lower income tax rate of 14 per cent

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



Sources: Ministry of Finance and Mass Media
Central Bank of Sri Lanka

BOX 06
Fiscal Rules

Introduction

Fiscal discipline[1] is essential for the achievement of the overall macroeconomic stability of a country. It provides the necessary flexibility for effective and independent monetary policy implementation. Lack of fiscal discipline, which leads to fiscal dominance in an economy, weakens the effectiveness of monetary policy in achieving price stability. Fiscal discipline needs to be achieved by meeting annual or medium term targets relating to fiscal outcomes. Meeting targeted fiscal outcomes may not be feasible unless fiscal authorities follow certain specific rules. Long term constraints that are imposed on fiscal policy are defined as fiscal rules. Often, this constraint comprises the imposition of numerical targets for fiscal outcomes, such as expenditure, revenue, government budget deficits or debt. International experience shows that the adoption of fiscal rules contributes towards maintaining fiscal discipline, preventing an economy from sliding into circumstances that lead to overall macroeconomic instability. Therefore, fiscal rules are necessary for ensuring that a country's budgetary operations are aimed at long term fiscal sustainability and solvency.

Types of Fiscal Rules

There are four key types of fiscal rules, namely debt rule, budget balance rule, expenditure rule and revenue rule. Each rule has unique characteristics depending on its objectives, operational guidance, transparency and the budgetary aggregate it seeks to constrain. The debt rule (DR) sets an explicit limit or target for public debt as a percentage of gross domestic product (GDP), while the budget balance rule (BBR) attempts to impose a rule on government expenditure so that spending cannot exceed revenue. Some countries use structural budget balance rules[2] in order to account for business cycles. Moreover, expenditure rules (ER) set limits on current and total spending. Revenue rules (RR), which set ceilings or floor limits on government revenue, aim at boosting the revenue collection and preventing an excessive tax burden on the public.

International Experience

Rules and limits, which govern fiscal policy largely tend to differ across countries. For example, Indonesia and Poland have debt ceilings of 60 per cent of GDP while in Malaysia and New Zealand debt ceilings are 55 per cent of GDP. The main objective of the debt ceiling in all these countries is to reduce or maintain the outstanding stock of debt at prudent levels. Time frames associated with these targets also tend to vary although some countries define targets for a period of several years, while others revise their targets annually. In comparison to the debt ceiling, the RR and the ER are not widely used. In Germany, however, expenditure cannot grow faster than revenue on average, while in Brazil expenditure is limited to 50 per cent of the net current revenue for the federal government and 60 per cent for states and municipalities. Only a few countries use the RR since it is directly linked to the income of people. Kenya maintains revenue at 21-22 per cent of GDP.

Adoption of fiscal rules by countries has increased over the last three decades according to the IMF. By 1990, only five countries, namely Germany, Indonesia, Japan, Luxembourg and the United States had adopted fiscal rules. Since then, the adoption of fiscal rules has been widespread and 92 countries had adopted fiscal rules by 2015 (Figure B 6.1). Of these 92 countries, 73 countries have used more than one type of fiscal rule. For example, fiscal toolkits of Australia, France, Lithuania and the Netherlands comprise a combination of the four types of fiscal rules. Among the four key fiscal rules, the BBRs are the most popular, while RRs tend to be the least popular. It is observed that low-income countries resort to the use of DRs, while advanced economies focus more on BBRs.

Figure B 6.1
Countries with Fiscal Rules (2015)

Three or more rules | Two rules | One rule | None

Source: IMF

International experience suggests that the imposition of penalties or statutory actions are important for making fiscal rules binding. For example, in Denmark, all net extra tax revenues are confiscated through a reduction in individual and general block grants in a case of violation of fiscal rules. In Poland, if outstanding stock of debt exceeds 55 per cent of GDP, the Council of Ministers must present a fiscal consolidation plan to the Parliament to lower the debt stock. If the level

1. Fiscal discipline is defined as the capacity of a government to maintain smooth financial operation and long term fiscal health.
2. Structural balances are an extension of cyclically adjusted balances, correcting for a broader range of factors such as asset and commodity prices and output composition effects. Cyclically adjusted balance can be obtained from subtracting cyclically adjusted expenditure from cyclically adjusted overall revenue (Fabian et al., 2011).

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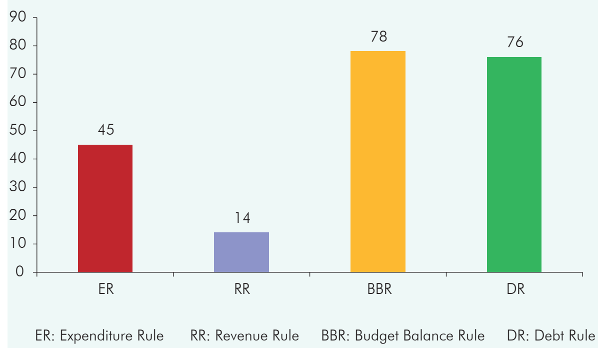
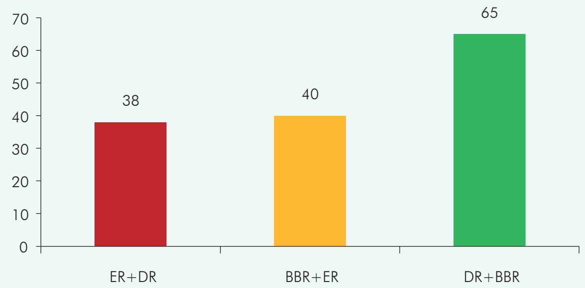
Chart B 6.1
Different types of fiscal rules adopted by countries (2017)





Source : Fiscal Affairs Department (IMF)

of public debt reaches 60 per cent of GDP, no new state guarantees may be issued and the council of Ministers must submit a fiscal consolidation plan to the Parliament, while the sub-national governments must pass balanced budgets. In four provinces in Canada, ministries and members of the executive council are subject to significant cuts in wages in case of a failure in achieving fiscal targets. In Ireland, provisions are laid down to remove defaulting authorities from office. In Italy, breaking of fiscal rules can lead to limitations being imposed on the purchase of goods and services by the rule breaking authorities with staff hiring freezes implemented alongside a barring of all new debt. In Spain, non-compliant authorities are required to submit a plan for correcting any fiscal deficit.

Although the proper implementation of fiscal rules would ensure that governments do not deviate from the outlined targets, exceptional circumstances may arise wherein it may be impossible to conform to such targets. In this context, suitable yet stringent 'escape clauses', which provide some leeway for fiscal authorities are necessary. While a rule that can be easily avoided is rather useless, excessively strict rules that do not provide sufficient flexibility may discourage compliance. Escape clauses are typically applicable to natural disasters and economic recessions. However, international experience shows that other circumstances are also cited in escape clauses. For example, Romania has incorporated change in government, change in budget coverage, and events that occur outside government control as escape clauses.[3] Further, political business cycles are also a matter of concern when assessing compliance with fiscal rules. Cristian and Olcer (2013), in their study of 68 low income countries (including Bangladesh, Cambodia, Ghana, Kenya, Malawi, Nepal and Nigeria) found that government consumption increases and leads to higher fiscal deficits during election years in low income countries. Empirical findings also show that during the two years following elections, fiscal adjustment takes place through increases in revenue via trade taxes and reductions in government investment. However, the size of the political budget cycle is much smaller in countries, that follow fiscal rules or are engaged with the IMF through fund facility programmes that span over the election period.

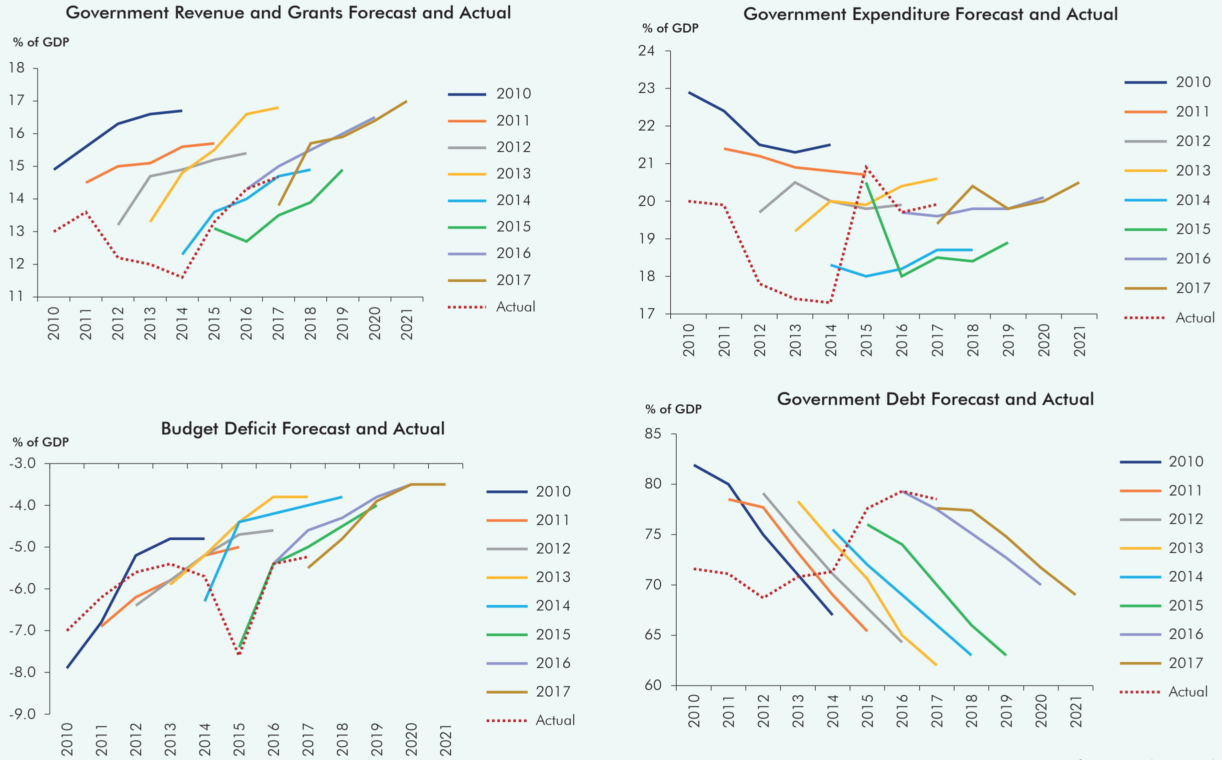
While binding fiscal rules and escape clauses are important for the proper implementation of fiscal rules, a monitoring mechanism is also required for successful implementation of fiscal rules. Countries adopting fiscal rules have established enforcement mechanisms or a separate monitoring body to observe compliance with fiscal rules. The body charged with monitoring fiscal developments also makes recommendations in cases of non-compliance.

Sri Lankan Experience

During the last 30 years, Sri Lanka has experienced large budget deficits with high debt levels. On average, budget deficits have been around 7.5 per cent of GDP and debt level at 90 per cent of GDP during the period. Revenue mobilisation in Sri Lanka, has been well below the total expenditure incurred by the government and insufficient to cover even recurrent expenses. This generated persistently high budget deficits over the years, forcing the government to rely on debt financing even to support government recurrent expenditure, which in turn contributed to the accumulation of the government debt stock. In 2001, the central government debt to GDP ratio in Sri Lanka reached 103 per cent. High budget deficits and high debt levels created strong spillover effects to the other sectors of the economy, threatening the macroeconomic stability of the country. Recognising the economic repercussions of significant fiscal outlays, which increased fiscal dominance in the economy,

3. IMF staff assessment

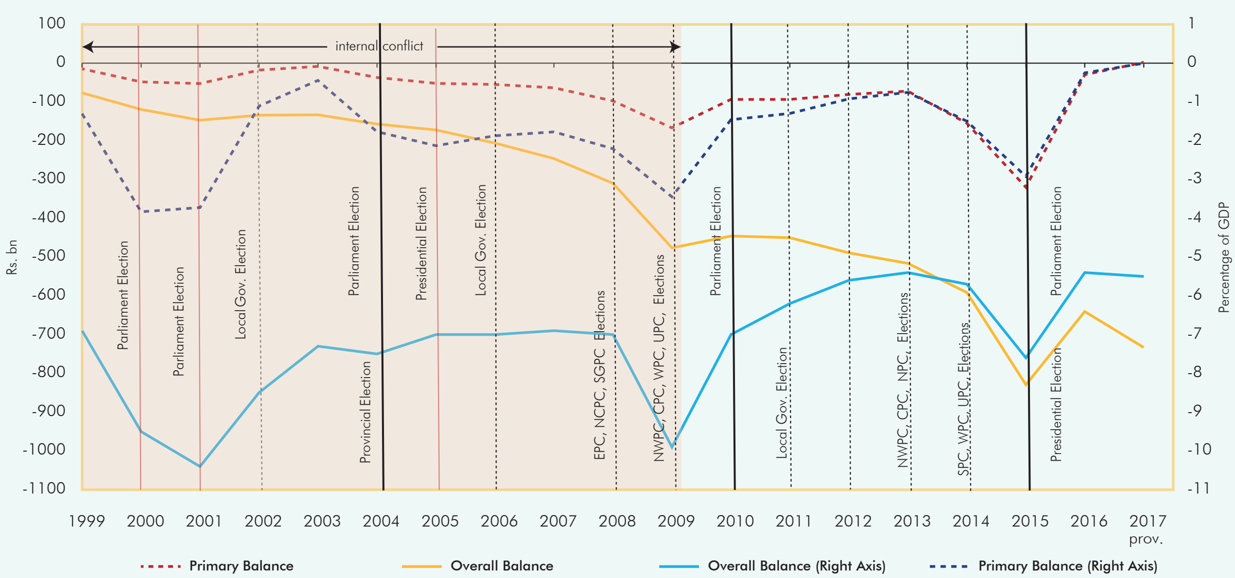
Chart B 6.2
Actual vs Forecast of government revenue, expenditure, budget deficit and the government debt 2010-2020



Sources : Ministry of Finance and Mass Media
Central Bank of Sri Lanka

successive governments made several attempts to implement fiscal rules on debt and the budget deficit in Sri Lanka aiming at achieving fiscal discipline. The Enactment of Fiscal Management (Responsibility) Act, No.3 of 2003 (FMRA) was such an attempt taken by the government to improve the fiscal discipline in the country. The debt to GDP ratio, then, declined gradually to 68.7 per cent in 2012, partly due to high economic

Chart B 6.3
Primary Balance vs Overall Balance



Sources: Central Bank of Sri Lanka
Election Commission

growth, although the country continuously and extensively deviated from the targeted fiscal path. The debt to GDP ratio reached 78.8 per cent of GDP in 2016, reflecting debt accumulation following high financing requirements generated through expanded budget deficits and slowdown in economic growth. In comparison to rating peers, Sri Lanka's budget deficit and stock of debt have remained at significantly high levels.

The FMRA outlined its main targets to be achieved by 2006, as a budget deficit of 5.0 per cent of GDP, which was to be maintained thereafter, and debt to GDP ratio of 85.0 per cent. It also outlined that the debt to GDP ratio to be curtailed further to 60 per cent by 2013. However, as fiscal deviations were quite significant, particularly at the height of the internal conflict, the FMRA was amended in 2013. Debt to GDP ratio was to be reduced to 80 per cent by 2013 and to 60 per cent by 2020. The initial target for government guaranteed debt to GDP ratio outlined in 2003 was of 4.5 per cent, for every year. It was later revised upwards to 7.0 per cent in 2013, followed by a further upward revision to 10 per cent in the 2016 amendment. Despite this legislative setting of clear targets for fiscal aggregates, there are no formal enforcement procedures outlined in the FMRA. Hence, in the recent past, Sri Lanka's fiscal performance has consistently deviated from the prescribed fiscal rules as well as the envisaged fiscal consolidation path (Chart B 6.2).

Chart B 6.3 shows movements in both the primary balance and the overall balance for the period 1999 to 2017, during which time several elections were held. Although, it may be difficult to identify a significant relationship between elections and budget balances during the period prior to 2009, as a result of the internal conflict that prevailed, the fact that the election cycles affect fiscal performance in Sri Lanka cannot be ruled out.

Way Forward

Even though Sri Lanka has fiscal rules outlined in the FMRA, the country has experienced frequent deviations from set rules mainly due to two reasons; non availability of legally binding constraints, and a lack of a proper enforcement mechanism. Such frequent deviations have not only eroded fiscal discipline but also created spillover effects on the entire macroeconomy. Therefore, it is essential to revise the existing FMRA to include binding fiscal rules with legal enforcement, facilitating the imposition of sanctions in case of deviations. Further, it may be prudent to include escape clauses for events, such as disasters and severe recessions, in order to enable the authorities to provide a safety net mechanism for affected persons in such circumstances. Furthermore, political commitment towards fiscal rules and public support is critical in achieving the stipulated targets and maintaining fiscal discipline, especially for a country like Sri Lanka, where the mindset of the public is still focused on an array of fiscal concessions. Hence, educating the public about the consequences of unsustainable fiscal policies remains paramount in building up public support.

References

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2. Bernanke B. (2010). "Fiscal Sustainability and Fiscal Rules", Speech: Board of Governors of the Federal Reserve System at the Annual Meeting of the Rhode Island Public Expenditure Council, Providence, Rhode Island
3. Fabian B., Gabriela D., Annalisa F., Jan G., & Taisuke N. (2011), "When and How to Adjust Beyond the Business Cycle? A Guide to Structural Fiscal Balances", IMF Fiscal Affairs Department

was introduced to majority of sectors including exporters, agriculture businesses, educational services and promotion of tourism. Further, a standard rate of 28 per cent was introduced for banking, finance, insurance industry and trading activities while a higher rate of 40 per cent was introduced for liquor, tobacco, and betting and gaming industries. In addition, a Capital Gains Tax (CGT) was introduced at a rate of 10 per cent upon gains on the realisation of capital assets. Further, the withholding tax rate on interest income arising from deposits maintained by resident individuals was increased to 5 per cent from 2.5 per cent,[1] while a withholding tax was introduced for service fees and contract payments with a view to broadening the tax base. Meanwhile, the 10 per cent withholding tax, which was applicable on interest income on Treasury bills and Treasury bonds, was removed in the new Act. However, the interest income from Treasury bills and Treasury bonds are subject to tax at the income tax rates applicable to the tax payer. A tax manual is being drafted and training sessions for professionals related to the tax field

1 Withholding tax on interest income received by senior citizens on bank deposits has been exempted up to Rs. 1.5 million per annum.

Table 6.1
Summary of Government Fiscal Operations

Item	2016	2017 Approved Estimates	2017 Provisional	2018 Approved Estimates
	Rs. million			
Total Revenue and Grants	1,693,558	2,020,300	1,839,562	2,227,200
Total Revenue	1,686,062	2,010,300	1,831,531	2,217,200
Tax Revenue	1,463,689	1,827,000	1,670,178	2,034,000
Non Tax Revenue	222,374	183,300	161,353	183,200
Grants	7,496	10,000	8,031	10,000
Expenditure and Lending Minus Repayments	2,333,883	2,645,300	2,573,056	2,902,200
Recurrent	1,757,782	1,946,000	1,927,693	2,152,000
Capital and Net Lending	576,101	699,300	645,363	750,200
o/w Public Investment	594,013	708,300	657,386	761,000
Current Account Surplus (+)/Deficit (-)	-71,719	64,300	-96,162	65,200
Primary Account Surplus (+)/Deficit (-)	-29,430	55,087	2,071	145,000
Overall Fiscal Surplus (+)/Deficit (-)	-640,325	-625,000	-733,494	-675,000
Total Financing	640,325	625,000	733,494	675,000
Foreign Financing (a)	391,914	332,000	439,243	360,000
Domestic Financing	248,411	293,000	294,251	315,000
Market Borrowings	248,411	293,000	249,574	315,000
Non Bank	108,456	261,000	61,841	195,000
Bank	139,955	32,000	187,733	120,000
Monetary Authority	183,085	n.a.	-187,931	n.a.
Commercial Banks	-43,130	n.a.	375,663	n.a.
Non Market Borrowings (c)	-	-	44,677	-
	As a percentage of GDP (b)			
Total Revenue and Grants	14.2	15.0	13.8	15.7
Total Revenue	14.2	14.9	13.8	15.6
Tax Revenue	12.3	13.5	12.6	14.3
Non Tax Revenue	1.9	1.4	1.2	1.3
Grants	0.1	0.1	0.1	0.1
Expenditure and Lending Minus Repayments	19.6	19.6	19.4	20.4
Recurrent	14.8	14.4	14.5	15.2
Capital and Net Lending	4.8	5.2	4.9	5.3
o/w Public Investment	5.0	5.2	4.9	5.4
Current Account Surplus (+)/Deficit (-)	-0.6	0.5	-0.7	0.5
Primary Account Surplus (+)/Deficit (-)	-0.2	0.4	0.0	1.0
Overall Fiscal Surplus (+)/Deficit (-)	-5.4	-4.6	-5.5	-4.8
Total Financing	5.4	4.6	5.5	4.8
Foreign Financing (a)	3.3	2.5	3.3	2.5
Domestic Financing	2.1	2.2	2.2	2.2
Market Borrowings	2.1	2.2	1.9	2.2
Non Bank	0.9	1.9	0.5	1.4
Bank	1.2	0.2	1.4	0.8
Monetary Authority	1.5	n.a.	-1.4	n.a.
Commercial Banks	-0.4	n.a.	2.8	n.a.
Non Market Borrowings (c)	-	-	0.3	-

(a) Includes rupee denominated Treasury bonds and Treasury bills issued to foreign investors
(b) Based on revised GDP estimates for 2016 made available by the Department of Census and Statistics on 20.03.2018
(c) Includes divestiture proceeds in 2017

Source: Ministry of Finance and Mass Media

and the general public also commenced in March 2018 to enhance public awareness on the new Act. Meanwhile, amendments were made to the ESC with effect from 01 April 2017 to enhance the tax base. Accordingly, the ESC threshold on liable turnover was reduced to Rs. 12.5 million per quarter from Rs. 50.0 million per quarter. Further, ESC was imposed on the importation of motor vehicles.

The significant increase in the revenue collection from VAT and NBT was mainly due to amendments made to the VAT and NBT Acts in November 2016. Raising the VAT rate to 15 per cent from 11 per cent, lowering the registration threshold of VAT to Rs. 3.0 million per quarter from Rs. 3.75 million per quarter and the imposition of VAT on liquor, cigarettes, coal, perfumes, electrical and electronic goods, and telecommunication equipment were the major changes made to the VAT Act in 2016. In addition, changes to NBT included reduction in the registration threshold for NBT to Rs. 3.0 million per quarter from Rs. 3.75 million per quarter and removal of NBT exemptions on telecommunication, supply of electricity and lubricants. Further, as proposed in the Budget 2017, NBT exemptions on goods required for services of international transportation, supply of residential apartments and the supply of goods and services by any Co-operative Society or Lak Sathosa Limited were removed with effect from 01 August 2017.

In keeping with the government policy on trade liberalisation, measures were taken to phase out para tariffs in 2017. The government took a policy decision to abolish para tariffs on tariff lines that do not carry any customs duties, during the next three-year period in line with World Trade Organization (WTO) commitments. At the end of 2017, over 1,200 para tariffs in the form of Cess Levy and Ports and Airports Development Levy (PAL) were removed in addition to the removal of para tariffs of Cess Levy applicable to over 100 imported items in the previous year. In addition, measures were also taken to revise and adopt the 2017 Version of the Harmonized System of Commodity Classification and Coding System (HS Codes) of the World Customs Organization (WCO) to Customs tariff lines.

Customs duty and customs duty waivers were revised during the year to reduce the pressure on domestic market prices of several essential items as a result of developments in the international market. Accordingly, customs duty waivers were granted on the importation of diesel and petrol in February 2017 at Rs. 3 per litre and Rs. 10 per litre, respectively. Further, during the year customs duty waivers were revised several times in line with changes in international oil prices. Thus, the end of the year customs duty waiver on the importation of diesel and petrol stood at Rs. 11 per litre and Rs. 23 per litre, respectively. Accordingly, at the end of 2017, custom duties applicable on the importation of diesel and petrol were at Rs. 4 per litre and Rs. 12 per litre, respectively. In addition, in July 2017, the customs duty waiver on the importation of milk powder was increased to Rs. 223 per kg reducing the applicable custom duty to Rs. 2 per kg.

Measures were taken to increase the revenue collection from excise duties in 2017 while minimising leakages in the revenue collection. Accordingly, excise duty rates on liquor were revised upwards during the year while simplifying the process of issuing licenses on the importation of foreign liquor. An excise duty was imposed on the importation of non potable alcohol at a rate of Rs. 15 per litre to provide further assistance to local manufacturers. Meanwhile, an excise duty was imposed on raw materials used for the production of ethanol in order to monitor the production of liquor and assist in curtailing illegal liquor production. Meanwhile, the excise duty on motor vehicles used for the transportation of goods was revised downwards to Rs. 700,000 per unit from Rs. 1,000,000 per unit.

The Special Commodity Levy (SCL) on the importation of several food items was introduced and SCL for some items was revised a number of times during 2017 to provide necessary protection for domestic agricultural producers during harvesting seasons and to reduce volatility in prices in the domestic market. Accordingly, SCL of Rs. 15 per kg was introduced in place of customs duty on imported raw rice (kekulu), nadu rice and samba rice with effect from 07 January 2017. However, this SCL was reduced to Rs. 5 per kg with effect from 28 January 2017, and further to 25 cents per kg with effect from 27 July 2017 due to supply shortages that prevailed in the domestic market resulting from the drought conditions experienced in several districts of the country. In addition, SCL on the importation of vegetable oil was revised downwards three times during the year in January, February and November 2017, while it was revised upwards in December 2017. Further, SCL applicable on 12 items, including dried fish, yoghurt, butter, garlic, oranges, apples, salt and kurakkan flour was extended with effect from 02 April 2017. Meanwhile, SCL on fish, green gram, mangosteen, dried oranges, kiwifruit, pear, cherries, plums and sloes was extended twice for a period of six months with effect from 08 May 2017 and 08 November 2017, respectively. During the second half of 2017, SCL on sugar was increased twice by Rs. 10 per kg and Rs. 8 per kg. Accordingly, SCL applicable on brown sugar and white sugar was Rs. 33 per kg and Rs. 31 per kg, respectively, at the end of the year. In addition, as a relief measure to domestic consumers, the government announced a reduction of SCL applicable on several essential items including, sprats, potatoes, dried fish, b'onion and dhal with effect from 09 November 2017.

Initiatives were taken in 2017 to improve tax administration in order to strengthen revenue collecting agencies for an efficient collection of revenue. Registered taxpayers were able to make tax payments with effect from March 2017 through banks under the RAMIS System, which is being set up at the IRD. Meanwhile, VAT payments on financial services through RAMIS commenced in August 2017. In addition, online submission of returns as well as schedules of individual income tax and partnership income tax also commenced in November 2017. Meanwhile, initial steps were taken by the Sri Lanka Customs to establish a National Single Window (NSW) system linking all border agencies that perform various regulatory functions in the import and export of goods with a view to facilitating importers and exporters. Further, ITMIS is being introduced to modernise public financial management through the automation of key Treasury operations. During 2017, the development and testing of ITMIS modules such as Internal Audit Management, Cadre Management and Court-case Management modules were completed. In addition, the Budget Planning module was commissioned for all spending agencies for the submission of budget estimates for 2018 to the National Budget Department on a pilot basis. A pilot operation of ITMIS core modules was conducted in the MOF and the Ministry of Higher Education and Highways from November to December 2017. Meanwhile, the VAT compliance strategy is expected to be implemented in 2018 for large businesses on a pilot basis, which includes a time-bound plan to implement risk-based audits and key performance indicators. The VAT compliance strategy will be extended to small and medium taxpayers as well in the near term.

On the expenditure front, the government's effort in rationalising expenditure while strengthening the monitoring process continued in 2017. Accordingly, quarterly expenditure and income outcome reports for the first three quarters of 2017 were presented to the Parliament as announced in the Budget 2017 aimed at strengthening the Parliamentary control over public finances. As per these reports, both revenue and expenditure outcomes remained below the targeted levels for the first three quarters of 2017. Further, under the State Accounts Circular No. 263/2017, all spending agencies were instructed to prepare their annual budgets on a quarterly basis for 2018 in order to ensure the systematic utilisation of annual budgetary provisions. Under the National Budget Circular No. 05/2016, instructions were given to all spending agencies to set quarterly expenditure ceilings for all expenditure heads in 2017. Under the National Budget Circular No. 01/2017, a decision was taken to continue the monitoring process of the utilisation of budgetary provisions allocated to spending agencies with the objective of achieving efficiency in resource allocation. The BRIC established under the MOF monitored the performance of major capital projects of fourteen selected ministries. Subsequently, monthly cash releases were made based on their performance in order to rationalise government expenditure. Following the guidelines in the National Budget Circular No. 2/2017, the Budget 2018 was formulated under the PBB approach, in order to ensure the efficient and effective spending of every budgetary allocation. This was done based on the experience of implementing the zero based budgeting approach in the preceding years. Moreover, Cabinet approval was granted to utilise the existing budgetary provisions in 2017 for the rehabilitation and reconstruction of properties damaged as a result of adverse weather conditions in order to minimise the impact of disaster related expenditure on the central government budget amidst prevailing fiscal constraints. Such expenditure switching served to contain the impact of disaster related expenses on the overall budget deficit.

The automation process of the Department of Pensions was further strengthened in 2017 to improve service delivery through efficiency enhancing measures. Under the Public Administration Circular No. 26/2017, actions were taken to introduce an online registration process for pensioners who were registered for Widows'/ Widowers' and Orphans' Pension Scheme before 12 March 2015. Facilities were also provided to officers who have already been registered in the online system to update their information. Furthermore, actions were taken to introduce a fully automated online registration process for the Public Services Provident Fund while providing facilities to send monthly contribution details online. Public officers, who were recruited after 01 January 2016, were granted the entitlement for Widows'/ Widowers' and Orphans' Pension Scheme under the Public Administration Circular No. 21/2017. Accordingly, the Pension Circular No. 06/2017 was issued to recover contributions to the Widows'/ Widowers' and Orphans' Pension Scheme from relevant officers with effect from 01 January 2016.

The government maintained its public investment programme during the year with the continuation of several major infrastructure projects while taking necessary steps to promote PPPs due to the limited fiscal space available for public investment. On the road development front, the government invested on road construction, rehabilitation and land acquisition during the year. Further, the multi purpose development project in Moragahakanda was vested to the public, in January 2018, in order to facilitate agricultural activities in the Northern, Central and Eastern Provinces. In addition, resources were made available for the rehabilitation of infrastructure damaged due to adverse weather conditions during the year. Meanwhile, with a view to promoting PPPs as a national strategy in addressing the infrastructure requirements in the country amidst the limited fiscal space available for public investment, the NAPPP was established in 2017. The main objective of establishing the NAPPP was to create a central agency with adequate legal, administrative and financial authority to identify suitable projects that can be executed as PPPs, prepare required guidelines and invite bids and select investors, in consultation with relevant line ministries. During the year, the NAPPP shortlisted projects that were identified as high priority projects to execute as PPPs in consultation with the World Bank.

The government continued to channel resources to improve the welfare of needy groups while taking measures to rationalise several subsidy programmes. Accordingly, programmes such as the nutritional food package for expectant mothers, the Thriposha programme and school nutrition programmes were continued, in 2017, aimed at improving maternal and child nutrition. Further, actions were taken to increase the allowance granted to Chronic Kidney Disease of unknown aetiology (CKDu) patients to Rs. 5,000 from Rs. 3,000 per month. Moreover, approval was granted to provide a sum of Rs. 5,000 per month, including all monthly allowances that are already being paid to elders over 100 years of age who fall within the low income category with effect from 01 December 2017. In conducting welfare programmes of the Samurdhi Department, priority was given to improve the living standard of vulnerable persons in the poorest regions of the Northern and Eastern provinces. Further, the WBB, which was established in 2016, has taken measures to setup an integrated Social Registry Information System (SRIS)[2] for all welfare programmes of the government. Initially, information related to four welfare programmes; Samurdhi programme,

2 SRIS is an electronic database which stores information related to welfare programmes.

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financial support for elderly over 70 years of age, support for low income disabled persons and financial support for kidney patients will be included in the SRIS. Meanwhile, a decision was taken by the Cabinet of Ministers, in March 2018, to terminate the cash grant policy of the fertiliser subsidy programme while approving to provide fertiliser to farmers in order to avoid the issues which arose in implementing the cash grant policy. Accordingly, an approved amount of fertiliser will be provided for farmers at a concessionary price of Rs. 500 per 50 kg bag for paddy and Rs. 1,500 per 50 kg bag for other crops (potatoes, onions, capsicum, corn and soya) with effect from the Yala season in 2018.

The government took several policy measures to improve the performance of SOBEs in order to reduce the burden on the central government budget. Accordingly, SCIs were signed in March 2017 with selected five main SOBEs, namely CEB, CPC, National Water Supply and Drainage Board (NWS&DB), Airport and Aviation Services (Sri Lanka) Ltd. and Sri Lanka Ports Authority (SLPA) in order to improve financial and non financial performance and corporate governance practices while ensuring the usage of international best practices in their operations. Further, it is expected that SCIs will be signed with another ten SOBEs[3] by early 2018 to improve their efficiency. The SCI concept is expected to be extended to other enterprises during the year 2018. In order to improve the financial viability of SriLankan Airlines (SLA), the government, in 2017, called for a Request for Proposal (RFP) to obtain consultancy services for the restructuring process. Accordingly, lead consultants were appointed to conduct an independent assessment of SLA's current business model and to provide assistance to identify potential candidates for the proposed PPP. Meanwhile, the SLPA entered into a concession agreement with the China Merchant Port Holding Company, in 2017, to operate the Hambantota Port as a PPP. In the energy sector, a cost reflective pricing formula to adjust domestic retail prices of petrol and diesel in line with international prices is under consideration in order to improve the financial viability of the CPC while ensuring transparency in petroleum pricing. Since non-commercial obligations are identified as a part of the government committed expenditure, non-commercial obligations of CPC and CEB were presented for the first time in the Budget 2018 to improve fiscal transparency. Accordingly, Rs. 35.1 billion and Rs. 16.5 billion have been identified as non-commercial obligations of CEB for 2017 and 2018, respectively. Since the CPC was expected to generate profit in 2017 and 2018, non-commercial obligations are not incorporated for CPC in the Budget 2018.

Initiatives were taken by the Central Bank during the year to improve transparency and efficiency in the government securities market. The Central Bank mandated primary dealers (PDs) and licensed banks to use the Bloomberg electronic bond trading platform for secondary market transactions in government securities from April 2017. Further, PDs were also required to quote and engage in repurchase transactions (repos) through the trading platform and report repos of Rs. 100 million or above carried out over-the-counter with investors through the trading platform, within 30 minutes of the completion of each repo transaction. A daily summary of trade information on repo volumes and yield rates is being published by the Central Bank for the information of market participants. These measures are expected to help improve transparency while facilitating price discovery, increasing market liquidity and outreach, thereby reducing the cost of borrowing in the medium term. A new primary issuance

3 Urban Development Authority (UDA), State Pharmaceuticals Corporation (SPC), Sri Lanka State Plantation Corporation (SLSPC), State Timber Corporation, Sri Lanka Transport Board (SLTB), MILCO Ltd., National Livestock Development Board (NLDB), Central Engineering Consultancy Bureau (CECB), Lanka Sathosa Ltd. and Lankaputhra Development Bank (LDB)

BOX 07
Introduction of a New Issuance System for Treasury bonds

The Central Bank of Sri Lanka (CBSL) introduced a new primary issuance system for Treasury bonds (T-bonds) with effect from July 27, 2017, replacing the fully auction based issuance system that was in practice since February 2015. The new issuance system has been in response to a strong need for an efficient and transparent issuance system of government securities, in line with international best practices.

The new T-bond issuance system, opened for primary dealers (PDs) and non dealer bidders, as approved by the Monetary Board (presently Employees' Provident Fund is the only non dealer bidder eligible to take part in primary issuances of T-bonds), comprises three phases and includes regular monthly T-bond auctions, with each auction offering two T-bond series of different maturities. For each series being offered, issuance under Phase I involves a multiple price auction system whereas the volume of issuance under phase II/III depends on the outcome of preceding phase/s, as detailed below.

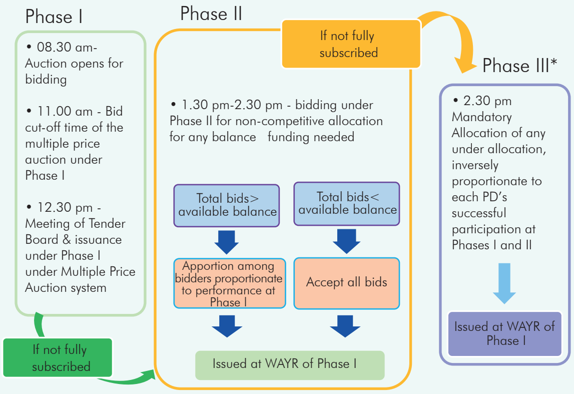
Phase I: The competitive issuance of T-bonds under the multiple price auction system and acceptance of bids up to reaching an acceptable level to the Tender Board in terms of Weighted Average Yield Rate (WAYR) and cut- off rate within the amount offered at the auction.

Phase II: Voluntary volume based bidding for any under allocation at Phase I, where issuances are made at WAYR determined at Phase I. In the event of oversubscription, allocation at this stage takes effect proportionate to the performance of each bidder at Phase I.

Phase III: Mandatory issuance at WAYR (to PDs only) of any further under allocation based on each PD's performance at Phases I and II. However, execution of Phase III is limited to instances where accepting 60 per cent of the offered amount in minimum takes place at Phase I. Issuance at Phase III to any PD is inversely proportionate to its ratio of success at Phase I and Phase II.

In brief, the new system could be viewed as a hybrid of competitive auction and performance based non-competitive allocation at weighted average yield rates arrived at the Phase I of the auction. Such non-competitive allocations would act as rewards for deserving auction participants for active participation in competitive auctions. Further, such a scheme of performance based allocation is expected to serve as a tool to reduce the risk of collusive behaviour by PDs. The new system encourages PDs to broaden their investor base and improve competitiveness at auctions for business sustainability.

Chart B 7.1
Flowchart of the New Issuance System



*Allocation under Phase III is subject to acceptance of 60 per cent in minimum of the offerred volume at Phase I.

A noticeable feature of the new issuance system is the limiting of volume acceptable under each T-bond series to the volume offered under such series by the CBSL in its auction announcement, and thereby improving the transparency of the issuance process and building confidence among bidders over the issuance process.

Other salient features of the new bond issuance system include the following:

(i) Ensuring coupon interest rates of new T-bonds to be offered to commensurate with prevailing market interest rates and thereby not accommodating the issuances of deep discounted T-bonds;

(ii) Fixing the maturity date of new bond issuances to 15th of the calendar month, that would eventually coincide with new issuances upon such maturities, thereby, ensuring more predictability;

(iii) Setting the minimum bidding by each PD to the per PD average of the volume tendered; and

(iv) Introducing quarterly minimum performance criteria for PDs, requiring each PD to maintain a minimum success ratio of 50 per cent of the average volume issued to PDs under Phase I within the corresponding quarter.

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The new primary issuance system is expected to increase competitiveness among bidders and cost efficiency to the issuer, while enhancing transparency of the issuance process. In this respect, it is important that the amounts raised through T-bond primary auctions are determined taking into consideration the resources available in the market. Communication of the issuance volumes and corresponding tenors in advance, by way of an auction calendar, which is another improvement in the annual T-bond issuance process, would support the market participants to better prepare themselves and thereby, contribute positively towards the success of the new system, in terms of cost effectiveness and participation.

system for Treasury bonds was introduced, in July 2017, replacing the fully auction based issuance system that had been in practice from February 2015. Regular monthly Treasury bond auctions are carried out through this new system. Under the new system there are three standard phases for each issuance of Treasury bonds. Phase I explores the issuance of the entire announced volume in a competitive multiple price auction system through reasonable market bids and Phase II opens for voluntary, volume based bidding while Phase III issues any under allocation during Phases I and II on a mandatory basis to PDs (See Box Article 07: *Introduction of a New Issuance System for Treasury Bonds*). A performance review mechanism has also been introduced to assess the effective participation of PDs with the implementation of the new primary issuance system for Treasury bonds. Further, in order to improve the investment planning of PDs and investors at large, a quarterly Treasury bond auction calendar is published in advance. Accordingly, the newly introduced system is expected to further enhance the efficiency and transparency of domestic borrowings of the government. Transparency has also been enhanced through regular pre-bid briefings. Moreover, several other measures are in the pipeline to further improve the government securities market. Accordingly, the Central Bank continues the process of establishing an Electronic Trading Platform (ETP) and a Central Counter Party Clearing House (CCP) while taking measures to further improve the existing payment and settlement systems infrastructure in order to deepen and broaden the secondary market for government securities. Additionally, in line with the new Treasury bond primary issuance system, the possibility of introducing a new primary issuance system for Treasury bills is being explored.

Management of public debt has been further strengthened with the enactment of the Active Liability Management Act. The ALMA, which provides legal provisions to conduct liability management activities, was enacted in March 2018. A country's ability to effectively institutionalise a liability management framework is regarded by the international rating agencies and the investor community as credit positive. The execution of liability management exercises, such as buying back of existing debt and switching existing debt with new debt and prefunding arrangements, are expected to improve the underlying risk profile of both domestic and foreign debt stocks of the government. Amongst the benefits of such an exercise, minimisation of rollover risk of the underlying debt stock by smoothening the maturity profile is foremost. Additionally, a buffer fund will be established to further minimise the rollover risk of the debt stock.

The government successfully issued the 11th and 12th International Sovereign Bonds (ISBs) in May 2017 and April 2018, respectively, reflecting the continued confidence of investors. Accordingly, the government was able to raise US dollars 1.5 billion in May 2017 with a 10-year maturity at a yield of 6.20 per cent per annum. Further, the 12th ISB was issued in April

2018, which was the largest offshore bond offering ever by Sri Lanka, to raise US dollars 2.5 billion. Accordingly, US dollars 1.25 billion each worth of ISBs was issued with a 5-year maturity at a yield of 5.75 per cent and a 10 year maturity at a yield of 6.75 per cent. In addition, a Foreign Currency Term Financing Facility (FCTFF) of US dollars 1.0 billion was obtained during the year and funds were received in two tranches; US dollars 450 million in May 2017 and US dollars 550 million in August 2017.

The government successfully met the key QPC of the IMF-EFF programme relating to fiscal operations during 2017. The three-year IMF-EFF programme was obtained in June 2016 with the aim of strengthening the country's external sector while supporting the government's economic reform agenda. The programme includes a reform agenda aimed at rebuilding foreign exchange reserves and reducing the fiscal deficit to contain the debt accumulation while restoring overall macroeconomic stability. The QPC selected in relation to government's fiscal operations is the primary balance. The realised primary balance for the period January-June 2017 and January-December 2017 were surpluses of Rs. 16.1 billion and Rs. 2.1 billion, respectively. Accordingly, the government successfully met the QPC for the primary balance in 2017.

The sovereign credit rating outlook for Sri Lanka was upgraded by two international rating agencies in 2017. Fitch upgraded the rating outlook to "stable" from "negative" and affirmed Sri Lanka's long-term foreign and local currency issuer default ratings at "B+" on 09 February 2017. In their assessment, Fitch highlighted improving fiscal finances, improved policy coherence and credibility and stable growth in Sri Lanka. Further, Standard and Poor's (S&P) upgraded its outlook to "stable" from "negative" and affirmed its B+ long term rating on 20 November 2017 highlighting the strengthening of Sri Lanka's institutions and governance practices in a sustainable manner. Earlier, on 07 March 2017, S&P affirmed its "B+" long-term rating and "B" short-term sovereign credit rating, highlighting improvements in the fiscal performance. However, the outlook was maintained at "negative", citing weak external sector performance and the rising exchange rate pressure on public debt. Moody's Investor Services also affirmed Sri Lanka's sovereign rating at "B1" with a "negative" outlook on 13 July 2017. Again, on 12 December 2017, Moody's Investor Services affirmed the sovereign rating at "B1" with a "negative" outlook. Recently, on 07 February 2018, Fitch affirmed Sri Lanka's sovereign rating at "B+" with a "stable" outlook highlighting improved fiscal consolidation and maintenance of a disciplined monetary stance.

Amidst the measures taken towards revenue based fiscal consolidation, fiscal sector performance in 2017 deviated from the envisaged targets. Avoiding deviations from fiscal targets and achieving fiscal discipline are imperative to make the fiscal consolidation programme a success. Maintaining fiscal discipline by adhering to fiscal rules is important to achieve overall macroeconomic stability. Revenue shortfall, expenditure overruns, high budget deficits and increase in government debt will lead to a fall in expenditure on public investment while making fiscal consolidation a difficult task. Given the current debt dynamics, fiscal slippage can lead to a serious economic crisis. Though the government has taken several rigorous measures towards increasing revenue mobilisation, the continuation of such efforts is imperative to achieve revenue targets. Rationalisation of ineffective public expenditure, restructuring of SOBEs to operate them as commercially viable entities, improving fiscal transparency and accountability in public financial management and proper targeting of subsidies would improve the quality of public expenditure by aligning its composition with national priorities within the medium term budgetary framework. Interest payments continued to be the single largest item in recurrent expenditure, while the salary bill as a percentage of GDP is also high in comparison to peer countries as the size of government sector employment has been increased by 33.7 per cent to 1.1 million during the period 2006-2015. During this period, the public sector was the main source of employment generation. Further, rapid changes in the demographic profile, coupled with the substantial increase in the size of the public sector, has resulted in an increase in pension payments, which currently accounts for a significant share of recurrent expenditure (9.4 per cent). As ageing is expected to remain a key concern in the future, it is essential to take necessary steps to ensure the sustainability of the public sector pension scheme which is currently unfunded. In this context, expediting the implementation of the contributory pension scheme, as proposed in Budget 2017, is important while raising the retirement age for the public sector employees could also be another option. Moreover, the high level of transfer payments and expenditure on welfare payments continue to weigh down on the government budget. These developments have limited the fiscal space available for prioritised expenditures, such as education and health, creating several challenges to the socio-economic development of the country. Excessive and continuous reliance on foreign borrowings, particularly of a commercial nature, increases the country's exposure to foreign exchange risk and risks associated with increasing international interest rates. Liability management activities on the foreign debt portfolio, if prudently managed, would help smoothen the rollover plan of the government debt. Fiscal consolidation is invariably politically challenging, particularly in a country which has been characterised by populist policies and an entitlement culture. Hence, developing a political consensus and raising public awareness are paramount in achieving targets stipulated in the fiscal consolidation path.

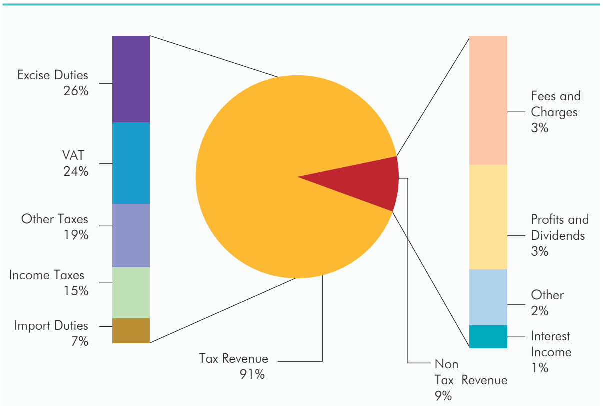
6.3 Government Budgetary Operations

Revenue and Grants

Revenue

The increasing trend in the collection of tax revenue continued in 2017, although total revenue as a per cent of GDP declined as a result of lower revenue from non tax sources. Accordingly, tax revenue increased to 12.6 per cent of GDP in 2017 from 12.3 per cent in 2016 reflecting the revenue based fiscal consolidation measures adopted by the government. The notable increase in the VAT revenue collection as a result of several amendments made to the VAT Act, including the rate hike to 15 per cent during the latter part of 2016, led to the improvement in tax revenue during 2017. However, total government revenue declined to 13.8 per cent of GDP in 2017 from 14.2 per cent in 2016 as a result of the deceleration in non tax revenue to 1.2 per cent of GDP in 2017 from 1.9 per cent in 2016 due to the decline in dividend transfers from major SOBEs.

Chart 6.2
Composition of Government Revenue - 2017



Source: Ministry of Finance and Mass Media

Total revenue in nominal terms increased by 8.6 per cent to Rs. 1,831.5 billion in 2017 from Rs. 1,686.1 billion in 2016. Tax revenue increased by 14.1 per cent to Rs. 1,670.2 billion from Rs. 1,463.7 billion in 2016 reflecting a substantial growth in VAT proceeds followed by the increased revenue collection from excise duty on petroleum products, ESC, SCL, PAL and NBT. However, the revenue collection from import duties, corporate and non corporate income taxes, withholding tax, excise duty on liquor and cigarettes, Telecommunication Levy and the Cess Levy declined during the year. Revenue from indirect taxes continued to be the major contributor to government revenue, accounting for 83.6 per cent of total tax revenue in 2017. The share of revenue from direct taxes out of total tax revenue declined to 16.4 per cent during the year in comparison to 17.7 per cent in the previous year mainly due to the higher growth recorded in indirect taxes as a result of the significant increase in the collection of VAT revenue. Meanwhile, reflecting the decline in the collection of non tax revenue to Rs. 161.4 billion in 2017 from Rs. 222.4 billion in 2016, the share of tax revenue in total revenue substantially increased to 91.2 per cent in 2017 from 86.8 per cent in 2016.

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Revenue from income taxes as a percentage of GDP declined marginally to 2.1 per cent in 2017 from 2.2 per cent in 2016. However, revenue from income taxes in nominal terms increased by 6.1 per cent to Rs. 274.6 billion during the year from Rs. 258.9 billion collected in the previous year. Revenue from ESC recorded a notable improvement during the year due to the lowering of the ESC liability threshold to Rs. 12.5 million per quarter from Rs. 50.0 million per quarter and the imposition of ESC on the importation of motor vehicles. Accordingly, revenue from ESC increased by 118.6 per cent to Rs. 44.7 billion in 2017 from Rs. 20.5 billion recorded during 2016. Moreover, revenue from the Pay-As-You-Earn (PAYE) tax also improved during the year by 16.9 per cent to Rs. 32.9 billion from Rs. 28.2 billion in 2016 as a result of enhanced compliance with the initiation of RAMIS. However, revenue from corporate and non corporate income taxes declined to Rs. 143.6 billion in 2017 from Rs. 154.3 billion in 2016 mainly due to the capturing of profit making businesses into the ESC tax net while granting ESC tax credit against income tax payable which was implemented from the second quarter of 2016. Meanwhile, revenue from withholding tax also declined by 4.6 per cent to Rs. 53.3 billion in 2017 from Rs. 55.9 billion in 2016 reflecting a decline in the issuance of Treasury bills and Treasury bonds for deficit financing purposes and the lower interest rates in comparison to the previous year.

Table 6.2
Economic Classification of Government Revenue

Item	2016	2017		2018
		Approved Estimates	Provisional	Approved Estimates
	Rs. million			
Tax Revenue	1,463,689	1,827,000	1,670,178	2,034,000
Income Taxes	258,857	334,550	274,562	370,000
VAT	283,470	380,000	443,760	550,000
Excise Taxes	454,952	579,035	469,500	535,040
Import Duties	156,487	165,500	136,501	175,000
Other Taxes	309,924	367,915	345,855	403,960
Non Tax Revenue	222,374	183,300	161,353	183,200
Total Revenue	1,686,062	2,010,300	1,831,531	2,217,200
	As a percentage of GDP (a)			
Tax Revenue	12.3	13.5	12.6	14.3
Income Taxes	2.2	2.5	2.1	2.6
VAT	2.4	2.8	3.3	3.9
Excise Taxes	3.8	4.3	3.5	3.8
Import Duties	1.3	1.2	1.0	1.2
Other Taxes	2.6	2.7	2.6	2.8
Non Tax Revenue	1.9	1.4	1.2	1.3
Total Revenue	14.2	14.9	13.8	15.6

(a) Based on revised GDP estimates for 2016 made available by the Department of Census and Statistics on 20.03.2018

Source: Ministry of Finance and Mass Media

Responding to amendments made to the VAT Act during the latter part of 2016, revenue from VAT improved substantially in 2017. Accordingly, revenue from VAT increased, both in terms of GDP and in nominal terms, as a result of the increase in the VAT rate to 15 per cent from

11 per cent, the expansion of the VAT base through the removal of several exemptions granted under the VAT Act, lowering of the registration threshold of VAT to Rs. 3.0 million per quarter from Rs. 3.75 million per quarter and improved compliance with the initiation of RAMIS. Accordingly, as a per cent of GDP, revenue from VAT increased to 3.3 per cent in 2017 from 2.4 per cent in 2016, while in nominal terms VAT revenue increased by 56.5 per cent to Rs. 443.8 billion. The revenue collection from VAT on domestic economic activities increased by 63.8 per cent to Rs. 275.4 billion in 2017 from Rs. 168.1 billion in 2016. Meanwhile, revenue from VAT on import related activities also increased during the year by 46.0 per cent to Rs. 168.4 billion. VAT revenue as a per cent of total tax revenue also increased substantially during the year to 26.6 per cent from 19.4 per cent in 2016. In addition, the contribution of VAT revenue to total revenue also increased to 24.2 per cent in 2017 from 16.8 per cent in 2016.

Revenue from excise duties declined as a per cent of GDP in 2017, although it increased in nominal terms. The revenue collection from excise duties remained the single largest contributor to total tax revenue in 2017, although the share of excise tax revenue in total tax revenue declined to 28.1 per cent in 2017 from 31.1 per cent in 2016. In nominal terms, the revenue collection from excise duties increased by 3.2 per cent to Rs. 469.5 billion from Rs. 455.0 billion mainly due to the increase in the revenue from excise duty on petroleum products and motor vehicles amidst the decline in revenue from the excise duty on liquor, cigarettes and tobacco. However, revenue from excise duties as a percentage of GDP declined to 3.5 per cent during the year from 3.8 per cent in the previous year. Meanwhile, revenue from the excise duty on petroleum products increased by 32.8 per cent to Rs. 74.0 billion reflecting the increase in the importation of petroleum products during the year and the increase in the excise duty on diesel during the latter part of 2016. Though vehicle imports declined due to the imposition of the Loan to Value (LTV) ratio by the Central Bank on credit extended by financial institutions, the increase in applicable excise duty rates resulted in a marginal increase in the revenue collection from the excise duty on motor vehicles to Rs. 189.7 billion in 2017. However, revenue from excise duty on liquor recorded a decline of 5.5 per cent to Rs. 113.7 billion in 2017 mainly due to the reduction in the sales of hard and malt liquor. Revenue from excise duty on cigarettes and tobacco declined by 3.1 per cent to Rs. 86.0 billion mainly due to the deceleration in cigarette sales in 2017. The decline in liquor and cigarette sales was largely due to the increase in applicable excise duties and the advertising campaign launched by the government to reduce the consumption of cigarettes and liquor.

The revenue collection from import duties was lower in 2017 while revenue from SCL increased in comparison to 2016. Accordingly, revenue from import duties, both in nominal terms and as a per cent of GDP, declined during the year as a result of duty waivers granted, especially on petrol, diesel and milk powder. Revenue from import duties as a per cent of GDP declined to 1.0 per cent, in 2017, from 1.3 per cent in 2016 and in nominal terms, revenue from import duties declined by 12.8 per cent to Rs. 136.5 billion in 2017. The share of import duty in tax revenue decelerated during 2017 to 8.2 per cent from 10.7 per cent recorded in 2016. Meanwhile, revenue from SCL increased significantly in nominal terms by 27.9 per cent to Rs. 71.4 billion from Rs. 55.8 billion as a result of the increase in SCL rates applicable on several commodities to safeguard the farming community. The share of SCL in tax revenue increased to 4.3 per cent from 3.8 per cent in the previous year.

Revenue from all other taxes showed a mixed performance during the year. Accordingly, revenue from PAL recorded an increase of 15.2 per cent to Rs. 102.4 billion in 2017 from Rs. 88.8 billion in 2016 in response to the increase in the importation of several goods that are subject to PAL. However, revenue from the Cess Levy declined during the year by 3.5 per cent to Rs. 59.6 billion, in 2017, from Rs. 61.7 billion in 2016 owing to the removal of Cess Levy on a number of imported items in the budgets 2017 and 2018 with a view of phasing out para tariffs applicable on the importation of several goods. Revenue from NBT increased in nominal terms by 20.2 per cent to Rs. 69.0 billion during the year mainly due to the increase in revenue from domestic economic activities. Accordingly, NBT revenue from domestic economic activities increased by 27.4 per cent to Rs. 49.7 billion while revenue from import related activities increased by 5.0 per cent to Rs. 19.3 billion during the year. The improvement in revenue from NBT on domestic economic activities is mainly due to the removal of exemptions granted on several services from November 2016. Revenue from the Telecommunication Levy declined by 7.2 per cent to Rs. 33.4 billion in comparision to Rs. 36.0 billion in 2016, mainly due to the removal of the 10 per cent Telecommunication Levy, which was applicable to internet services, with effect from 01 September 2017.

Non tax revenue declined in 2017 both as a per cent of GDP and in nominal terms. Accordingly, non tax revenue as a per cent of GDP declined to 1.2 per cent from 1.9 per cent in 2016 mainly due to the weakened financial performance of major SOBEs during the year. In nominal terms, non tax revenue declined by 27.4 per cent to Rs. 161.4 billion, in 2017, from Rs. 222.4 billion in 2016. Profit and dividend transfers from major SOBEs in 2017 declined by 50.1 per cent to Rs. 54.0 billion from Rs. 108.2 billion in the previous year. Meanwhile, revenue from rent income declined by 59.5 per cent to Rs. 4.5 billion, in 2017, while revenue from interest income increased by 53.2 per cent to Rs. 7.4 billion. Revenue from social security contributions increased by 27.1 per cent to Rs. 22.9 billion, in 2017, from Rs. 18.0 billion in 2016 mainly due to the increase in the basic salary of public servants with the inclusion of the interim and non pensionable allowances to the basic salary. Further, revenue from fees and charges declined marginally to Rs. 66.6 billion from Rs. 68.4 billion in 2016. Accordingly, the share of non tax revenue in total revenue declined during the year to 8.8 per cent from 13.2 per cent in 2016.

Grants

Total foreign grants received from multilateral and bilateral sources during the year increased to Rs. 8.0 billion from Rs. 7.5 billion in 2016. Grants from multilateral sources increased by 6.8 per cent to Rs. 5.5 billion in 2017 compared to 2016. However, the share of grants from multilateral sources out of total grants broadly remained at around the same level of 68.0 per cent in 2017 vis-a-vis 2016. Meanwhile, grants from bilateral sources increased by 7.9 per cent to Rs. 2.6 billion in 2017. The major development partners who provided grants during the year were the International Development Association (IDA), the World Food Programme (WFP) and the Government of Japan.

Expenditure and Net Lending

Total expenditure and net lending as a per cent of GDP declined to 19.4 per cent in 2017 from 19.6 per cent in 2016 reflecting efforts taken to rationalise recurrent expenditure. Accordingly, as a per cent of GDP, recurrent expenditure declined to 14.5 per cent while capital expenditure and net lending increased marginally to 4.9 per cent during the year. Public investment, which includes capital expenditure and lending of the government, declined to 4.9 per cent in 2017 from 5.0 per cent in 2016. In nominal terms, total expenditure and net lending increased by 10.2 per cent to Rs. 2,573.1 billion in 2017 from Rs. 2,333.9 billion in 2016.

Recurrent expenditure as a per cent of GDP declined to 14.5 per cent in 2017 from 14.8 per cent in 2016. However, in nominal terms, recurrent expenditure increased by 9.7 per cent to Rs. 1,927.7 billion in 2017 from Rs. 1,757.8 billion in 2016. Increase in interest payments and expenditure incurred on disaster relief measures mainly contributed to this increase in recurrent expenditure in nominal terms. As a percentage of GDP, lower salaries and wages as well as current transfers and subsidies contributed to the reduction in recurrent expenditure amidst the considerable increase in interest payments.

Interest payments as a percentage of GDP increased to 5.5 per cent, in 2017, from 5.1 per cent in 2016. In nominal terms, interest expenditure increased by 20.4 per cent to Rs. 735.6 billion in 2017 from Rs. 610.9 billion, in 2016, mainly due to higher interest payments on Treasury bonds and outstanding foreign debt. Interest payments on domestic debt, which increased by 17.9 per cent to Rs. 570.6 billion, in 2017, from Rs. 484.2 billion in 2016, accounting for 77.6 per cent of total interest payments in 2017. The interest expenditure on Treasury bonds at

Table 6.3
Economic Classification of Expenditure and Lending Minus Repayments

Item	2016	2017 Approved Estimates	2017 Provisional	2018 Approved Estimates
	Rs. million			
Recurrent Expenditure	1,757,782	1,946,000	1,927,693	2,152,000
Expenditure on Goods and Services	746,250	838,336	756,591	862,954
o/w Salaries and Wages	576,471	615,000	588,518	630,000
Interest Payments	610,895	680,087	735,566	820,000
Foreign	126,713	123,291	164,942	170,000
Domestic	484,182	556,796	570,623	650,000
Current Transfers and Subsidies	400,637	427,577	435,536	469,046
o/w To Households and Other Sectors	317,153	358,613	350,420	392,632
Samurdhi	40,740	43,950	39,707	43,950
Pensions	171,903	180,830	181,059	197,659
Fertiliser Subsidy	27,771	36,500	30,361	32,000
Other	76,739	97,333	99,293	119,023
Capital Expenditure	577,036	697,780	638,343	746,863
Acquisition of Real Assets	328,202	502,035	360,333	528,499
Capital Transfers	248,834	195,745	278,010	218,364
Lending Minus Repayments	-934	1,520	7,021	3,336
Total Expenditure and Net Lending	2,333,883	2,645,300	2,573,056	2,902,200
	As a percentage of GDP (a)			
Recurrent Expenditure	14.8	14.4	14.5	15.2
Expenditure on Goods and Services	6.3	6.2	5.7	6.1
o/w Salaries and Wages	4.8	4.6	4.4	4.4
Interest Payments	5.1	5.0	5.5	5.8
Foreign	1.1	0.9	1.2	1.2
Domestic	4.1	4.1	4.3	4.6
Current Transfers and Subsidies	3.4	3.2	3.3	3.3
o/w To Households and Other Sectors	2.7	2.7	2.6	2.8
Samurdhi	0.3	0.3	0.3	0.3
Pensions	1.4	1.3	1.4	1.4
Fertiliser Subsidy	0.2	0.3	0.2	0.2
Other	0.6	0.7	0.7	0.8
Capital Expenditure	4.8	5.2	4.8	5.3
Acquisition of Real Assets	2.8	3.7	2.7	3.7
Capital Transfers	2.1	1.4	2.1	1.5
Lending Minus Repayments	...	...	0.1	...
Total Expenditure and Net Lending	19.6	19.6	19.4	20.4

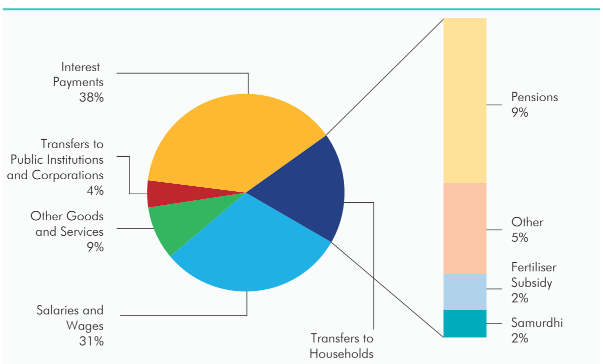
(a) Based on revised GDP estimates for 2016 made available by the Department of Census and Statistics on 20.03.2018

Source : Ministry of Finance and Mass Media

Rs. 438.2 billion, in 2017, rose by 22.8 per cent mainly due to the increased net issuances of Treasury bonds in 2016 at higher interest rates. Interest payments on Treasury bills increased marginally by 3.2 per cent to Rs. 81.3 billion in 2017 from Rs. 78.8 billion in 2016. In addition, interest payments on Sri Lanka Development Bonds (SLDBs) and Rupee loans amounted to Rs. 33.8 billion and Rs. 2.9 billion, respectively, in 2017. Interest expenditure on foreign debt increased significantly by 30.2 per cent to Rs. 164.9 billion in 2017 from Rs. 126.7 billion in 2016 mainly due to the rise in the foreign debt stock in the recent past, especially the increase in outstanding commercial loans including ISBs. Interest payments continued to be the single largest recurrent expenditure item, accounting for 38.2 per cent of total recurrent expenditure and 40.2 per cent of government revenue in 2017.

Expenditure on goods and services declined to 5.7 per cent of GDP in 2017 from 6.3 per cent in 2016. However, in nominal terms expenditure on goods and services increased by 1.4 per cent to Rs. 756.6 billion from Rs. 746.3 billion in 2016. Salaries and wages, the largest expenditure item in this category, declined to 4.4 per cent of GDP in 2017 from 4.8 per cent of GDP in 2016, although in nominal terms it increased by 2.1 per cent to Rs. 588.5 billion. Salaries and wages paid to central government employees, including defence personnel, increased by 1.4 per cent to Rs. 438.8 billion, while the central government contribution to salaries and wages of Provincial Council (PC) employees increased by 4.2 per cent to Rs. 149.7 billion during the year. This was mainly due to the continuation of the conversion of interim allowance to the basic salary with the implementation of the new salary structure from January 2016 for public sector employees. Salaries and wages continued to be the second

Chart 6.3
Composition of Government Recurrent Expenditure - 2017



Source: Ministry of Finance and Mass Media

largest recurrent expenditure item with its share in recurrent expenditure marginally reducing to 30.5 per cent in 2017 from 32.8 per cent in 2016. Further, expenditure on other goods and services, as a per cent of GDP, declined marginally to 1.3 per cent in 2017 from 1.4 per cent in 2016. Similarly, in nominal terms, expenditure on other goods and services declined by 1.0 per cent to Rs. 168.1 billion in 2017.

Total current transfers and subsidies, as a percentage of GDP declined to 3.3 per cent in 2017 from 3.4 per cent in 2016 mainly due to the reduction in current transfers to public corporations and households. However, in nominal terms, current transfers and subsidies rose by 8.7 per cent to Rs. 435.5 billion in 2017 in comparison to Rs. 400.6 billion in 2016. This was the combined outcome of an increase in both current transfers to public institutions and households. Current transfers to households and other sectors accounted for 80.5 per cent of total current transfers, while transfers to public institutions and public corporations accounted for 12.5 per cent and 7.1 per cent, respectively, in 2017.

Current transfers to households which include pension payments, declined marginally to 2.6 per cent of GDP in 2017 from 2.7 per cent of GDP in 2016. However, in nominal terms, current transfers to households increased by 10.5 per cent to Rs. 350.4 billion in 2017 from Rs. 317.2 billion in 2016. Pension payments, the largest item under transfers to households, increased by 5.3 per cent to Rs. 181.1 billion in 2017 due to the increase in the number of pensioners during the year by 21,338 to 600,752. However, the expenditure on the Samurdhi programme at Rs. 39.7 billion declined marginally by 2.5 per cent from Rs. 40.7 billion in the previous year. In addition, expenditure on welfare programmes for disabled

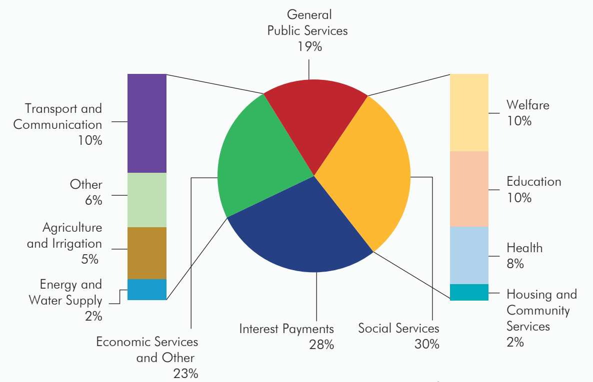
Table 6.4
Functional Classification of Expenditure

Item	2016	2017 Approved Estimates	2017 Provisional	2018 Approved Estimates
	Rs. million			
Recurrent Expenditure	1,757,782	1,946,000	1,927,693	2,152,000
General Public Services	408,176	464,881	424,975	484,732
Civil Administration	104,519	154,085	113,175	153,432
Defence	224,315	231,081	228,013	239,091
Public Order and Safety	79,343	79,715	83,787	92,209
Social Services	607,626	620,903	640,368	709,535
Education	179,319	175,097	187,628	205,049
Health	155,402	152,860	161,312	180,977
Welfare	251,490	264,585	264,510	303,369
Community Services	21,415	28,361	26,919	20,139
Economic Services	129,435	131,054	126,310	132,288
Agriculture and Irrigation	63,787	73,989	71,460	71,997
Energy and Water Supply	1,334	2,940	1,478	1,589
Transport and Communication	48,959	33,856	34,657	41,729
Other	15,354	20,269	18,715	16,973
Other	612,544	729,161	736,040	825,445
o/w Interest Payment	610,895	680,087	735,566	820,000
Capital Expenditure and Lending	594,013	708,300	657,386	761,000
General Public Services	50,504	86,087	46,348	55,853
Civil Administration	46,128	74,539	41,362	47,445
Public Order and Safety	4,376	11,548	4,986	8,408
Social Services	117,297	183,170	135,306	207,371
Education	58,971	90,873	69,752	105,707
Health	30,747	46,843	35,509	52,867
Housing	7,152	9,263	9,553	24,006
Community Services	20,426	36,191	20,493	24,791
Economic Services	424,021	437,428	474,118	494,333
Agriculture and Irrigation	68,990	79,121	66,663	77,550
Energy and Water Supply	48,840	32,685	54,872	49,204
Transport and Communication	200,478	165,827	228,847	176,199
Other	105,713	159,795	123,736	191,380
Other	2,191	1,615	1,614	3,443
Total Expenditure and Lending	2,351,795	2,654,300	2,585,079	2,913,000
	As a percentage of GDP (a)			
General Public Services	3.9	4.1	3.5	3.8
Social Services	6.1	6.0	5.8	6.5
Economic Services	4.6	4.2	4.5	4.4
Other	5.2	5.4	5.6	5.8
o/w Interest Payment	5.1	5.0	5.5	5.8
Total Expenditure and Lending	19.8	19.7	19.5	20.5

(a) Based on revised GDP estimates for 2016 made available by the Department of Census and Statistics on 20.03.2018

Source : Ministry of Finance and Mass Media

Chart 6.4
Total Expenditure by Function - 2017



Source: Ministry of Finance and Mass Media

soldiers increased by 4.2 per cent to Rs. 27.8 billion in 2017 from Rs. 26.7 billion in 2016. Provision of uniforms, textbooks and the nutrition programme for school children were among the other major subsidies provided to households during 2017. Meanwhile, expenditure on the fertiliser subsidy increased by 9.3 per cent to Rs. 30.4 billion in 2017 from Rs. 27.8 billion in 2016. Further, recurrent expenditure incurred on disaster relief measures was around 0.1 per cent of GDP.

Current transfers to public institutions in 2017 remained unchanged at 0.4 per cent of GDP as in the previous year, while current transfers to public corporations declined marginally to 0.2 per cent of GDP during the year. However, in nominal terms, current transfers to public institutions increased while current transfers to public corporations declined during the year. Current transfers to public institutions increased by 8.2 per cent to Rs. 54.4 billion during the year due to the increase in current transfers to the education sector. However, current transfers to public corporations declined by 7.5 per cent to Rs. 30.7 billion reflecting efforts taken by the government to improve the efficiency in public corporations, although transfers provided to cover operational losses of the Department of Sri Lanka Railways and the Department of Posts increased marginally.

Amidst the limited fiscal space available, capital expenditure and net lending as a percentage of GDP increased marginally to 4.9 per cent in 2017 from 4.8 per cent in 2016. However, in nominal terms, capital expenditure and net lending increased by 12.0 per cent to Rs. 645.4 billion during the year in comparison to Rs. 576.1 billion in the previous year. Meanwhile, public investment, which includes capital expenditure and lending of the government, declined to 4.9 per cent in 2017 from 5.0 per cent in the previous year. In nominal terms, public investment increased by 10.7 per cent to Rs. 657.4 billion in 2017 from Rs. 594.0 billion in 2016. Expenditure incurred by Ministries and Departments on the acquisition of real assets, including the purchase of capital assets and construction and development of fixed assets, increased by 9.8 per cent to Rs. 360.3 billion in 2017 from Rs. 328.2 billion in 2016. Capital transfers increased by 11.7 per cent to Rs. 278.0 billion due to the increase in capital transfers to public institutions by 16.7 per cent. Meanwhile, on lending of the government to public corporations at Rs. 19.0 billion in 2017 increased by 12.2 per cent from Rs. 17.0 billion recorded in 2016.

The government continued its investments in economic and social services during the year. Accordingly, public investments in economic and social services amounted to Rs. 474.1 billion and Rs. 135.3 billion, respectively in 2017. Public investments in economic services were mainly directed towards developing the transportation network of the country while public investments in social services focused mainly on improving infrastructure in education and health sectors. Accordingly, a significant amount of investments was made in road development of the country. Further, efforts were taken to upgrade the infrastructure in the education sector through “The Nearest School is the Best School Programme”, while rehabilitating schools affected by floods and landslides. Meanwhile, public investments in the health sector focused mainly on constructing and improving ward complexes, establishing kidney dialysis centers and modern pharmaceutical laboratories while upgrading training schools in order to enhance the quality of service delivery of the health sector.

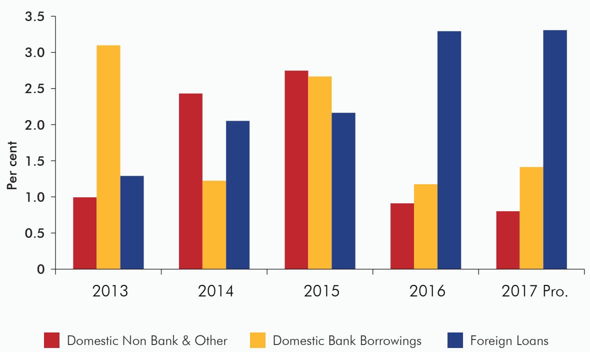
Key Fiscal Balances

Reflecting improvements in non interest expenditure, the primary balance recorded a surplus during the year although the budget balance and the current account balance deteriorated marginally due to the slippages in the total revenue collection. Accordingly, the primary balance which excludes interest payments recorded a surplus of Rs. 2.1 billion in 2017 as against the deficit of Rs. 29.4 billion observed in 2016 reflecting improved expenditure management through budgetary operations during the year. The reduction in the revenue collection to 13.8 per cent of GDP, in 2017, from 14.2 per cent in 2016 contributed to the increase in the overall budget deficit to 5.5 per cent in 2017 from 5.4 per cent in the previous year despite the decline in government expenditure and net lending. In line with this, the current account deficit, which indicates the government’s dissavings, also increased to 0.7 per cent of GDP in 2017 from 0.6 per cent of GDP in the previous year.

Financing of the Budget Deficit

The overall budget deficit was financed largely through foreign sources in 2017. Accordingly, financing through foreign sources accounted for 3.3 per cent of GDP in 2017 as against the budgetary target of 2.5 per cent of GDP. In terms of the overall budget deficit, 59.9 per cent of the resource requirement (Rs. 439.2 billion) was financed through foreign sources in 2017 compared to 61.2 per cent (Rs. 391.9 billion) in 2016. Consequently, the share of financing through domestic sources increased to 40.1 per cent (Rs. 294.3 billion) in 2017, while as a percentage of GDP financing through domestic sources increased to 2.2 per cent in 2017 from 2.1 per cent in 2016.

Chart 6.5
Deficit Financing (as a percentage of GDP)



Sources: Ministry of Finance and Mass Media
Central Bank of Sri Lanka

Funds mobilised through foreign sources increased in 2017 mainly due to the issuance of International Sovereign Bonds and the raising of the Foreign Currency Term Financing Facility. Accordingly, financing of the budget deficit through foreign borrowings increased to Rs. 439.2 billion or 59.9 per cent of the overall budget deficit in 2017 in comparison to Rs. 391.9 billion or 61.2 per cent in 2016. Net foreign financing comprised Rs. 228.5 billion (US dollars 1.5 billion) of ISBs, Rs. 152.7 billion (US dollars 1.0 billion) of FCTFF, Rs. 43.7 billion of foreign investments in Treasury bonds, Rs. 13.6 billion of foreign investments in Treasury bills and Rs. 779.0 million of net borrowings through foreign project loans. Borrowings through foreign project loans on a gross basis amounted to Rs. 220.1 billion as against the repayment of a sum of Rs. 219.4 billion in 2017. The Export-Import Bank of China (Exim Bank), IDA, the Government of Japan and Asian Development Bank (ADB) were the main sources of foreign project financing in 2017.

In financing the budget deficit through domestic sources, the government relied more on domestic banking sources in 2017 while the contribution from the non bank sector declined. Accordingly, borrowings from banking sources accounted for 63.8 per cent (Rs. 187.7 billion) of net domestic financing, in 2017, compared to 56.3 per cent (Rs. 140.0 billion) in 2016. The increase was due to the significant rise in commercial bank financing amounting to Rs. 375.7 billion, in 2017, as against a net repayment of Rs. 43.1 billion in 2016. The increase in financing through commercial banks was mainly due to the rise in Treasury bill holdings of commercial banks to Rs. 200.9 billion and the rise in holdings of SLDBs to Rs. 53.3 billion. However, the impact of commercial bank financing on government domestic financing was partly offset by the net repayment to the Central Bank of Rs. 187.9 billion. Financing from the Central Bank reduced mainly due to the retirement of Treasury bill holdings of the Central Bank of Rs. 304.5 billion in 2017. Meanwhile, financing from the non bank sector reduced to Rs. 61.8 billion in 2017 from Rs. 108.5 billion in 2016.

Table 6.5
Sources of Domestic Financing

Rs. billion

Item	2014	2015	2016	2017 (a)
By Instrument	**378.7**	**592.7**	**248.4**	**294.3**
Treasury Bonds (b)	369.1	442.6	349.8	109.1
Treasury Bills (c)	26.1	-26.4	98.5	-81.7
Rupee Loans	-	-31.4	-	-
Sri Lanka Development Bonds	21.0	223.0	-120.5	53.3
Central Bank Provisional Advances	34.7	7.2	-67.8	116.5
Other (d)	-72.2	-22.3	-11.5	97.0
By Source	**378.7**	**592.7**	**248.4**	**294.3**
Bank	126.9	291.8	140.0	187.7
Non Bank (d)	251.8	300.9	108.5	106.5

(a) Provisional
(b) Excludes rupee denominated Treasury bonds issued to foreign investors and funds raised for restructuring of SOBEs in 2014 and 2015
(c) Excludes rupee denominated Treasury bills issued to foreign investors
(d) Includes divestiture proceeds in 2017

Sources: Ministry of Finance and Mass Media
Central Bank of Sri Lanka

Domestic borrowings of the government by way of instruments, in net terms, further declined, in 2017, whereas non instrument borrowings increased significantly. Accordingly, borrowings by way of domestic instruments declined to Rs. 80.8 billion in 2017 from Rs. 327.8 billion in 2016 while non instrument borrowings increased by Rs. 213.5 billion in 2017 compared

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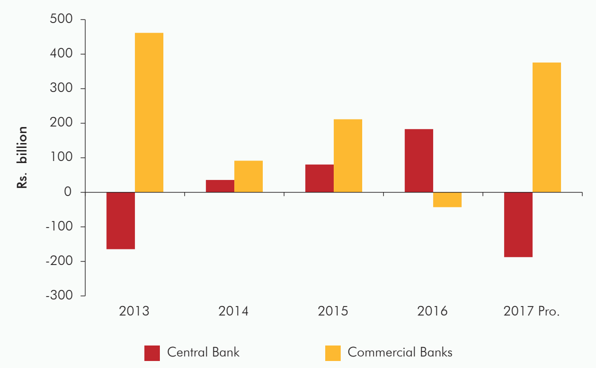
Chart 6.6
Sources of Bank Financing



Sources: Ministry of Finance and Mass Media
Central Bank of Sri Lanka

to the net repayment of Rs. 79.4 billion in 2016, mainly due to higher borrowings through provisional advances and commercial bank overdrafts. Borrowings through Treasury bonds declined to Rs. 109.1 billion in 2017 from Rs. 349.8 billion in 2016. Meanwhile, a net repayment of Treasury bills amounting to Rs. 81.7 billion was recorded in 2017 as against a net borrowing of Rs. 98.5 billion in 2016. Borrowings through SLDBs in net terms amounted to Rs. 53.3 billion as against a net repayment of Rs. 120.5 billion in 2016.

6

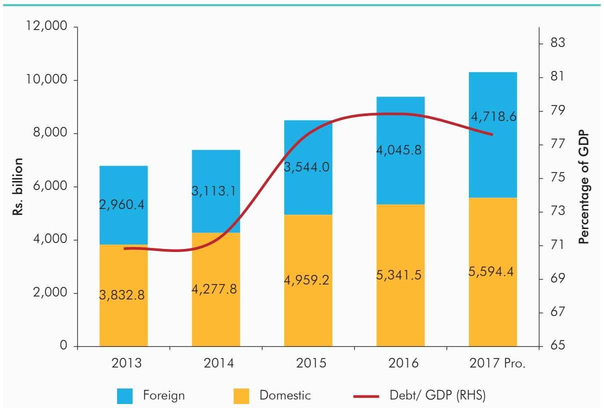
Foreign currency denominated domestic borrowings increased, in 2017, due to higher borrowings from both SLDBs and offshore banking units (OBUs). Accordingly, borrowings through SLDBs increased on a net basis to Rs. 53.3 billion while borrowings through OBUs increased more than threefold, on a net basis, to Rs. 33.3 billion in 2017. The increase in borrowings through SLDBs was the difference between gross borrowing of Rs. 338.5 billion (US dollars 2.2 billion) and gross repayment of Rs. 285.2 billion (US dollars 1.9 billion). On a net basis, foreign currency borrowings from domestic sources amounted to Rs. 86.6 billion in 2017 compared to the net repayment of Rs. 112.9 billion in 2016, while rupee denominated net domestic financing amounted to Rs. 207.7 billion compared to Rs. 361.3 billion in 2016.

6.4 Government Debt and Debt Service Payments

Central Government Debt

The central government debt to GDP ratio declined to 77.6 per cent at end 2017 from 78.8 per cent at end 2016. A reduction in the debt to GDP ratio was observed in 2017 as a result of the higher growth in nominal GDP relative to the nominal growth in the debt stock. However, in absolute terms, the total outstanding central government debt stock increased by 9.9 per cent to Rs. 10,313.0 billion at end 2017. Increase in the central government debt stock by Rs. 925.7 billion was mainly due to the increase in net borrowings and the depreciation of the rupee against foreign currencies. Domestic debt as a percentage of GDP declined notably to 42.1 per cent by end 2017 from 44.9 per cent at end 2016, while foreign debt increased to 35.5 per cent of GDP at the end of 2017 from 34.0 per cent of GDP at end 2016. Of this increase, Rs. 225.2 billion was due to the depreciation of the rupee against major foreign

Chart 6.7
Outstanding Central Government Debt



Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

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

Rs. million

Item	2014	2015	2016	2017 (a)
Total Government Debt	**7,390,899**	**8,503,227**	**9,387,303**	**10,313,045**
Domestic Debt (b)	**4,277,783**	**4,959,196**	**5,341,507**	**5,594,427**
By Maturity Period				
Short Term	941,162	913,291	968,396	1,031,181
Medium and Long Term	3,336,620	4,045,905	4,373,111	4,563,246
By Institution				
Bank	1,669,882	1,924,036	2,114,901	2,328,544
Non Bank	2,607,901	3,035,160	3,226,606	3,265,883
Foreign Debt	**3,113,116**	**3,544,031**	**4,045,796**	**4,718,618**
By Type				
Concessional Loans	1,490,978	1,729,895	1,897,680	2,130,482
Non Concessional Loans	457,668	507,047	538,859	560,207
Commercial (c)	1,164,470	1,307,089	1,609,257	2,027,928
By Currency				
SDR	679,835	734,552	755,614	829,537
US Dollars	1,292,052	1,733,790	2,207,431	2,650,431
Japanese Yen	429,638	470,109	496,852	516,218
Euro	162,743	181,084	183,561	208,075
Other	548,848	424,495	402,338	514,356
Memo: Exchange Rate Variation	-90,230	228,731	161,697	211,868

(a) Provisional
(b) Excludes (i) rupee denominated Treasury bonds held by foreign investors, (ii) Treasury bonds amounting to Rs. 78,447 million issued to settle dues to CPC in January 2012. Due to maturing of some of those bonds in January 2017, the outstanding amount from January 2017 was Rs. 56,662 million and (iii) Treasury bonds amounting to Rs. 13,125 million issued to capitalise SriLankan Airlines
(c) Includes outstanding amounts of foreign investments in rupee denominated Treasury bills and Treasury bonds

Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

currencies. Meanwhile, the discount factor (which is the net amount of the difference between the book value and the face value of issuances and maturities of Treasury bills and Treasury bonds) contributed to decline the debt stock by Rs. 17.2 billion due to the net repayment of government securities issued at a discount during 2017.

The share of domestic debt in the total outstanding debt stock declined consecutively for the second year to 54.2 per cent at end 2017 from 56.9 per cent at end 2016 mainly due to lower borrowings from domestic sources. In nominal terms, the domestic debt stock increased only by 4.7 per cent in 2017 to Rs. 5,594.4 billion at end 2017 in comparison to an increase of 7.7 per cent in 2016. The share of short term debt in total domestic debt increased marginally to 18.4 per cent at end 2017 from 18.1 per cent at end 2016. The outstanding on account of provisional advances increased significantly to Rs. 199.8 billion at end 2017 from Rs. 83.3 billion at end 2016. However, the impact of the increase in provisional advances on short term debt stock was largely negated by the decline in the Treasury bill stock held by domestic investors to Rs. 697.2 billion, in 2017, from Rs. 779.6 billion in 2016. Meanwhile, the share of medium to long term debt in the domestic debt stock declined marginally to 81.6 per cent in 2017. Treasury bonds, a medium term debt instrument, accounted for 68.3 per cent of the total domestic debt stock at end 2017, increasing its outstanding amount to Rs. 3,822.6 billion at end 2017 from Rs. 3,714.8 billion at end 2016. Meanwhile, the stock of SLDBs rose to Rs. 637.9 billion at end 2017.

The debt obligation of the central government to the domestic banking sector increased to Rs. 2,328.5 billion at end 2017, although debt owed to the Central Bank reduced significantly to Rs. 209.4 billion at end 2017 from Rs. 415.0 billion at end 2016. Accordingly, the share of the banking sector debt in total domestic debt increased to 41.6 per cent by end 2017

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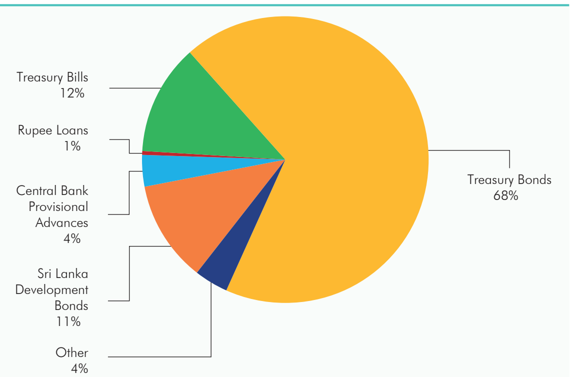
Chart 6.8
Composition of Outsanding Central Government Domestic Debt - 2017



Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

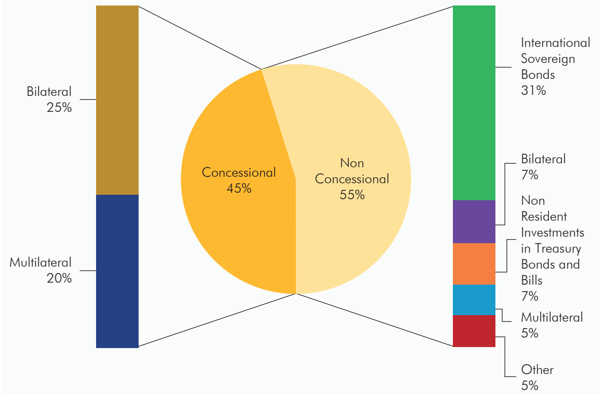
from 39.6 per cent at end 2016. The reduction in the debt held by the Central Bank was driven by the repayment of Treasury bills amounting to Rs. 321.5 billion during the year 2017. However, the debt stock on account of provisional advances increased during the year to Rs. 199.8 billion. The outstanding debt owned by commercial banks increased to Rs. 2,119.1 billion at end 2017 mainly due to higher investments in Treasury bills by commercial banks. The stock of Treasury bills held by commercial banks rose to Rs. 463.2 billion at end 2017. The share of non bank sector debt in total domestic debt reduced further to 58.4 per cent, in 2017, from 60.4 per cent in the previous year, although the non bank sector owned debt increased marginally in 2017 recording an outstanding of Rs. 3,265.9 billion.

Foreign currency denominated domestic debt increased substantially in 2017 recording an outstanding debt of Rs. 702.1 billion at end 2017. The debt stock on account of SLDBs rose to Rs. 637.9 billion (US dollars 4.17 billion) at end 2017 while loans obtained from OBUs increased to Rs. 64.2 billion (US dollars 420 million) at end 2017. Meanwhile, rupee denominated domestic debt at Rs. 4,892.3 billion at end 2017 increased by Rs. 153.0 billion during 2017.

6

Total stock of foreign debt of the central government continued to increase in 2017 with higher borrowings from foreign sources. The outstanding stock of foreign debt increased to Rs. 4,718.6 billion at end 2017 from Rs. 4,045.8 billion at end 2016. The financing of the budget deficit largely through foreign sources, especially non concessional loans, was the main reason for the rise in foreign debt. Non concessional loans, including commercial loans, increased to Rs. 2,588.1 billion in 2017 mainly due to the issuance of ISBs (US dollars 1.5 billion), issuance

Chart 6.9
Composition of Outsanding Central Government Foreign Debt - 2017

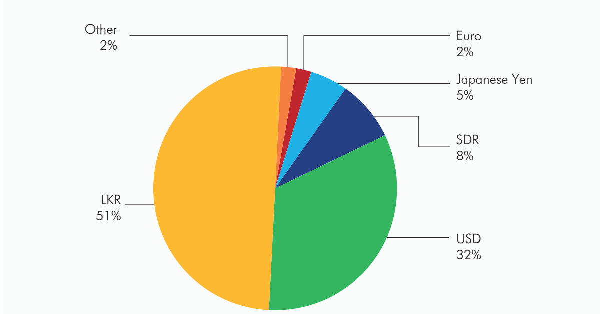


Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

of FTCFF (US dollars 1.0 billion) and increase in outstanding foreign holdings of Treasury bills and Treasury bonds (Rs. 62.6 billion). Accordingly, the share of non concessional loans in the foreign debt portfolio increased to 54.8 per cent from 53.1 per cent in 2016. Meanwhile, with the issuance of ISBs in 2017, the outstanding stock of ISBs increased to Rs. 1,475.0 billion (US dollars 9.65 billion) at end 2017.

The depreciation of the Sri Lankan rupee against several major currencies increased the total debt stock, in rupee terms, by Rs. 225.2 billion at end 2017. The Sri Lankan rupee depreciated by 2.0 per cent, 5.1 per cent,

Chart 6.10
Currency Composition of Total Outstanding Central Government Debt - 2017



Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

7.5 per cent, 7.5 per cent, 10.5 per cent and 13.5 per cent, respectively, against the US dollar, the Japanese yen, the Indian rupee, Special Drawing Rights (SDR), the pound sterling and the euro during the year. The government foreign debt stock consisted of debt denominated in US dollars (56.2 per cent), SDR (17.6 per cent), Japanese yen (10.9 per cent), euro (4.4 per cent) and other currencies (10.9 per cent) as at end 2017. Consequently, the outstanding stock of foreign debt increased by Rs. 211.9 billion mainly due to the depreciation of the Sri Lankan rupee against major foreign currencies, while foreign currency denominated domestic debt stock (SLDBs and loans from OBUs) increased by Rs. 13.4 billion due to the depreciation of the Sri Lankan rupee against the US dollar. Although the depreciation of the Sri Lankan rupee would be reflected as an increase in the government foreign currency debt stock in rupee terms, the accumulated debt stock denominated in foreign currency would remain unchanged in terms of foreign currency, irrespective of such depreciation. As this debt stock denominated in foreign currency would be serviced using foreign currency inflows to the government, the impact of its increase in rupee terms will be negated. Therefore, the change in the value of debt stock in rupee terms due to depreciation or appreciation of the rupee can neither be considered as an additional real expenditure nor be considered as a real savings on net basis for the government.

Central Government Debt Service Payments

Total debt service payments rose by 18.5 per cent in nominal terms to Rs. 1,603.0 billion in 2017 from Rs. 1,352.4 billion in 2016 due to increases in both amortisation and interest payments. Debt service payments to domestic sources increased by 14.8 per cent to Rs. 1,213.5 billion while debt service payments to foreign sources rose significantly by 31.7 per cent to Rs. 389.6 billion during 2017. Amortisation payments increased by 17.0 per cent to Rs. 867.5 billion in 2017 mainly due to the higher amortisation payments on Treasury bonds by 44.9 per cent to Rs. 355.9 billion as well as the increased amortisation payments on foreign loans by 32.8 per cent to Rs. 224.5 billion. Meanwhile, total interest payments increased by 20.4 per cent to Rs. 735.6 billion in 2017 compared to the previous year. Increase in

Table 6.7
Central Government Debt Service Payments

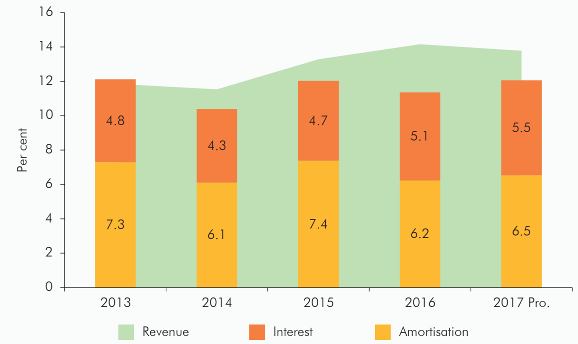
Rs. million

Item	2014	2015	2016	2017 (a)
Debt Service Payments	**1,076,257**	**1,317,791**	**1,352,443**	**1,603,049**
Domestic	777,488	918,112	1,056,624	1,213,498
Foreign	298,769	399,679	295,820	389,551
Amortisation Payments	**632,662**	**808,117**	**741,549**	**867,484**
Domestic	449,554	523,824	572,442	642,875
Foreign	183,109	284,293	169,107	224,609
Interest Payments	**443,595**	**509,674**	**610,895**	**735,566**
Domestic	327,934	394,289	484,182	570,623
Short Term	78,811	57,728	78,787	81,275
Medium and Long Term	249,123	336,561	405,394	489,348
Foreign	115,660	115,386	126,713	164,942

(a) Provisional

Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

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



Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Central Bank of Sri Lanka

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Table 6.8
Central Government Debt Indicators

Indicator	2014	2015 (a)	2016 (a)	2017 (b)
Central Government Debt/GDP	71.3	77.7	78.8	77.6
Domestic Debt/GDP	41.3	45.3	44.9	42.1
Foreign Debt/GDP	30.0	32.4	34.0	35.5
Total Foreign Debt/Exports (c)	142.5	154.0	159.3	161.9
Total Debt Service/GDP	10.4	12.0	11.4	12.1
Total Debt Service/Government Revenue (d)	90.0	90.6	80.2	87.5
o/w Domestic Debt Service/Government Revenue (d)	65.1	63.1	62.7	66.3
Total Debt Service/Government Expenditure (e)	44.3	42.5	44.0	46.6
o/w Domestic Debt Service/Government Expenditure (e)	32.0	29.6	34.4	35.3
Foreign Debt Service/Exports (c)	13.7	17.4	11.6	13.4
Total Interest/GDP	4.2	4.7	5.1	5.5
Domestic Interest/GDP	3.2	3.6	4.1	4.3
Domestic Interest/Government Recurrent Expenditure	24.8	23.2	27.5	29.6
Foreign Interest/Exports (c)	5.0	5.0	5.0	5.7

(a) Based on revised GDP estimates for 2015 and 2016 made available by the Department of Census and Statistics on 20.03.2018
(b) Provisional
(c) Export of goods and services
(d) Government revenue is in economic format
(e) Government expenditure includes amortisation payments

Sources: Ministry of Finance and Mass Media
Ministry of National Policies and Economic Affairs
Department of Census and Statistics
Central Bank of Sri Lanka

domestic interest payments was mainly due to higher interest payments on Treasury bonds by 22.8 per cent amounting to Rs. 438.2 billion in 2017. This was largely due to the higher interest rates that prevailed in the market until mid 2017. Interest payments on foreign loans rose by 29.6 per cent (Rs. 37.4 billion) to Rs. 164.0 billion in 2017 in comparison to 2016 mainly due to the increase in interest payments on account of foreign commercial borrowings.

6

The main indicators on debt service payments displayed a weak performance in 2017 reflecting the increase in debt service payments. Total debt service payments increased to 12.1 per cent of GDP in 2017 from 11.4 per cent of GDP in the previous year. Amortisation payments for domestic debt as a percentage of GDP remained unchanged at 4.8 per cent in 2017 while amortisation payments on foreign debt increased to 1.7 per cent of GDP in 2017 from 1.4 per cent of GDP in 2016. Total interest payments as a percentage of GDP increased to 5.5 per cent in 2017 from 5.1 per cent in 2016. Interest payments for domestic sources increased to 4.3 per cent of GDP in 2017 from 4.1 per cent of GDP in 2016 while interest payments on foreign debt increased to 1.2 per cent of GDP in 2017 from 1.1 per cent of GDP in the previous year. Moreover, the ratio of debt service payments to government revenue increased to 87.5 per cent in 2017 from 80.2 per cent in 2016.

Outstanding Debt of Major Public Non Financial Corporations

The outstanding debt of major public non financial corporations[4], which includes debt to the domestic banking sector and project related foreign debt declined as a percentage of GDP in 2017. Accordingly, the debt to GDP ratio of major public non financial corporations declined to 6.4 per cent by end 2017 from 6.9 per cent in the previous year. However, in nominal terns, total outstanding debt of major public non financial corporations increased to Rs. 844.6 billion at end 2017 from Rs. 827.4 billion at end 2016. Domestic debt of public non financial corporations to domestic commercial banks increased to Rs. 514.4 billion from Rs. 495.1 billion, accounting for 60.9 per cent of the total outstanding debt of major non financial corporations. Meanwhile, project related foreign debt increased to Rs. 330.2 billion. The relative share of project related foreign debt to total outstanding debt of major public non financial corporations declined to 39.1 per cent at end 2017 from 40.2 per cent at end 2016.

4 This includes outstanding debt related to Hambantota Port of SLPA.

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

Corporation	2014	2015	2016	2017 (a)
Rs. million				
Domestic Debt (b)	**446,047**	**522,966**	**495,114**	**514,360**
Ceylon Electricity Board	47,384	35,812	30,875	27,057
Ceylon Fertiliser Corporation	30,593	23,833	27,861	22,634
Ceylon Petroleum Corporation	245,618	264,471	192,601	177,058
Colombo Commercial Fertiliser	13,342	10,208	13,655	11,177
National Housing Development Authority	4,777	4,739	4,134	3,264
Paddy Marketing Board	5,574	13,772	13,926	11,534
Road Development Authority	58,325	74,912	81,792	100,745
SriLankan Airlines	9,055	33,040	49,696	57,405
Sri Lanka Ports Authority	11,801	14,642	12,356	14,622
Other Corporations	19,578	47,537	68,217	88,865
Foreign Debt (c)	**308,673**	**338,064**	**332,305**	**330,221**
Airport and Aviation Services (Lanka) Ltd.	25,909	26,284	23,791	23,955
Ceylon Electricity Board	160,195	173,874	166,613	155,535
Sri Lanka Ports Authority	122,568	137,906	141,901	150,730
Total Debt of Public Non Financial Corporations	**754,720**	**861,030**	**827,419**	**844,581**
As a percentage of GDP (d)				
Domestic Debt	**4.3**	**4.8**	**4.2**	**3.9**
Foreign Debt	**3.0**	**3.1**	**2.8**	**2.5**
Total Debt	**7.3**	**7.9**	**6.9**	**6.4**

(a) Provisional
(b) Outstanding amounts to domestic commercial banks
(c) Includes outstanding foreign project related loans
(d) Based on revised GDP estimates for 2015 and 2016 made available by the Department of Census and Statistics on 20.03.2018

Sources: Ministry of Finance and Mass Media
Central Bank of Sri Lanka

6.5 Budgetary Operations in Sub National Governments

Policy Direction and Measures taken by Sub National Governments

The Ministry of Provincial Councils and Local Government (MPCLG) continued to play a vital role in providing policy guidance to the sub national governments in 2017. The sub national government system in Sri Lanka comprises nine PCs and 341 Local Government authorities (LGs). At end 2017, the LG system comprised 22 Municipal Councils, 43 Urban Councils and 276 Pradesheeya Sabhas. The MPCLG continued to work closely with sub national government authorities, in order to identify the development needs at the sub national level and to facilitate investments with a view to achieving balanced regional development.

At the sub national government level, priority was given to infrastructure development projects in order to uplift the living standards of the people. The Local Government Enhancement Sector Project (Pura Neguma programme) continued in 2017 with the objective of improving social services such as health facilities, library facilities and day care centres while implementing water supply projects and improving Pradeshiya Sabha roads. Moreover, in order to enhance the quality of the service delivery of Pradeshiya Sabhas, measures were taken to automate their activities. Transforming School Education as the Foundation of a Knowledge Hub project and Library Development Programme were continued during the year in order to improve educational facilities. The Health Sector Development Project also continued during the year with the objective of controlling and preventing communicable and non communicable diseases while improving maternal and child health care facilities. In addition, Greater Colombo Water and Waste Water Management Programme, Strengthening of Local Governments-Pradeshiya Sabhas, Jaffna-Killinochchi Water Supply and Sanitation Project and the Construction of Rural Bridges Project, Supply of Garbage Collecting Compactors to Local Authorities, Rural Infrastructure Development Project in Emerging Regions and Development of 1,000 km of road length in rural areas were also continued during the year. Several infrastructure development projects related to sub national government level were completed during the year including, North East Local Services Improvement Project, Northern Roads Connectivity Project, Iranamadu Irrigation

Development Project and "Dorin Dorata-Gamin Gamata" Programme. Further, in order to protect the environment while creating a healthy atmosphere, the National Solid Waste Management Project commenced in 2017. Under this project, actions have been taken to promote household composting and waste segregation while constructing compost yards and waste collecting centers.

The Finance Commission recommended several measures during the year for implementation in 2018, with the objective of achieving balanced regional development. Accordingly, the Commission recommended to establish a Management Information System (MIS) which caters for national and sub national level information requirement for planning and monitoring in order to improve the effectiveness of the decision making process. Further, the Commission recommended that funds disbursed for development activities coming under the devolved subjects should be channeled through the PCs, in order to ensure the effective utilisation of funds and to maintain transparency and accountability of investments. Moreover, recommendations were made to enhance provincial revenue mobilisation through untapped revenue sources such as private schools, tutorial classes, local and foreign colleges of higher education, health service providers and professional service providers while allowing the PCs to collect NBT from business entities which earn quarterly income up to Rs. 3.0 million. The Commission made further recommendations on introducing an incentive package which includes interest subsidies, tax holidays, concessional tax rates and loan schemes for private investors who are willing to invest in rural areas. This initiative is expected to create more space in the public investment programme which would enable the government to invest in other priority sectors. In addition, a proposal was made to introduce a Revenue Performance Grant, which is based on the incremental devolved revenue collection in order to incentivise the province wise revenue collection.

Budgetary Operations in Provincial Councils

Tax revenue of PCs continued to increase in nominal terms in 2017 although as a percentage of GDP, tax revenue remained at the same level as in 2016. Total revenue of PCs increased by 7.0 per cent to Rs. 85.2 billion in 2017 from Rs. 79.6 billion in 2016 mainly due to increased NBT revenue transferred from the central government. However, as a percentage of GDP, total revenue declined marginally to 0.6 per cent in 2017 from 0.7 per cent in 2016. In nominal terms, tax revenue increased by 8.0 per cent to Rs. 76.6 billion, while non tax revenue declined by 1.0 per cent to Rs. 8.6 billion in 2017 from Rs. 8.7 billion in 2016. Transfers of NBT revenue from the central government, which became the single largest contributor to the total tax revenue of PCs in 2017, increased by 27.4 per cent to Rs. 32.3 billion. This was mainly due to the removal of exemptions granted on several goods and services in November 2016 and August 2017 and the reduction in the registration threshold for NBT to Rs. 3.0 million per quarter from Rs. 3.75 million per quarter with effect from November 2016. However, revenue from stamp duty declined by 3.3 per cent to Rs. 31.5 billion in 2017 from Rs. 32.5 billion in 2016 reflecting the lower revenue collection from stamp duty on transferring deeds. Revenue from license fees increased by 5.9 per cent to Rs. 10.9 billion in 2017. Transfers of NBT revenue from the central government and revenue from stamp duty accounted for 42.1 per cent and 41.1 per cent of total tax revenue of PCs, respectively. The relative share of the Western Provincial Council on the revenue collection increased marginally to 51.9 per cent in 2017

Table 6.10
Budget Outturn for Provincial Councils

Rs. million

Item	2014	2015	2016 (a)	2017 (b)
Total Revenue	**59,133**	**67,972**	**79,595**	**85,172**
Tax Revenue	52,569	61,476	70,942	76,607
Non Tax Revenue	6,564	6,496	8,653	8,565
Total Expenditure	**216,824**	**269,586**	**276,147**	**286,031**
Recurrent Expenditure	172,131	222,223	237,664	236,575
o/w Personal Emoluments	131,162	171,871	182,497	187,018
Capital Expenditure	44,693	47,363	38,483	49,457
Central Government Transfers	**157,691**	**201,614**	**196,552**	**200,860**
Block Grants	126,144	167,551	169,106	166,348
Criteria Based Grants	3,392	3,753	3,035	3,236
Province Specific Development Grants	8,343	13,345	12,177	20,250
Foreign Grants for Special Projects	19,812	16,965	12,234	11,025

(a) Revised
(b) Provisional

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

from 51.8 per cent in 2016. The Western Province was followed by the Southern and North Western provinces accounting for 9.5 per cent and 9.4 per cent, respectively of the total revenue collection of PCs. Meanwhile, the relative share of the Sabaragamuwa Province in the revenue collection declined notably to 4.4 per cent in 2017 from 5.3 per cent in 2016.

Recurrent expenditure of PCs in 2017 declined marginally both in nominal terms and as a percentage of GDP. Accordingly, in nominal terms, recurrent expenditure declined by 0.5 per cent to Rs. 236.6 billion in 2017 from Rs. 237.7 billion in 2016 while as a percentage of GDP, recurrent expenditure declined to 1.8 per cent in 2017 from 2.0 per cent in 2016. The reduction in recurrent expenditure was mainly due to lower outlays in all major categories including maintenance and travelling expenses except personal emoluments. Personal emoluments at Rs. 187.0 billion increased by 2.5 per cent and continued to be the single largest item in the recurrent expenditure accounting for 79.1 per cent of the total recurrent expenditure of PCs. Education and health sectors absorbed nearly 90 per cent of the personal emoluments of PCs. On a functional basis, recurrent expenditure on social services increased by 1.4 per cent to Rs. 214.5 billion, while recurrent expenditure on provincial administration and economic services declined by 15.4 per cent and 14.4 per cent to Rs. 18.1 billion and Rs. 4.0 billion, respectively in 2017. In terms of total recurrent expenditure, the three highest spending PCs were the Western, the Central and the North Western accounting for 21.3 per cent, 12.5 per cent and 11.8 per cent, respectively.

Capital expenditure as a percentage of GDP, increased to 0.4 per cent in 2017 from 0.3 per cent in 2016, while in nominal terms capital expenditure increased by 28.5 per cent to Rs. 49.5 billion in 2017. This was mainly due to the increase in Province Specific Development Projects (PSDPs) by 66.3 per cent to Rs. 20.3 billion in 2017 from Rs. 12.2 billion in 2016. Both acquisition of capital assets and capital expenditure on Special Projects declined during the year. However, capital transfers to local governments increased by 28.1 per cent to Rs. 2.3 billion in 2017.

In 2017, transfers from the central government to PCs through block grants, grants for special projects, Province Specific Development Grants (PSDGs) and Criteria Based Grants (CBGs) increased by 2.2 per cent to Rs. 200.9 billion. Block grants, the major form of central government transfers to PCs, amounted to Rs. 166.3 billion, representing 82.8 per cent of the total transfers that were provided to meet the resource gap in the recurrent expenditure programme of PCs. Transfers under grants for special projects, PSDGs and CBGs amounted to Rs. 11.0 billion, Rs. 20.3 billion and Rs. 3.2 billion, respectively. During the year 70.2 per cent of the expenditure of PCs was financed through central government transfers which emphasises that more efforts and policy direction are needed in order to enhance the revenue mobilisation of PCs.