6

FISCAL POLICY AND GOVERNMENT FINANCE

6.1 Overview

The government committed sturdily towards implementing revenue based fiscal consolidation measures during 2016, recognising the persistently low revenue mobilisation, which leads to high budget deficits, as the root cause of fiscal imbalances experienced for several decades in Sri Lanka. Even though Sri Lanka's per capita income has increased steadily over the last two decades, revenue collection has been well below government expenditure, and has not been adequate even to cover recurrent expenditure of the government. Weak tax revenue collection emanating from complex tax laws, various tax exemptions and tax holidays, narrow tax bases, tax evasion and weaknesses in tax administration has resulted in the government revenue to GDP ratio dropping to a level as low as 11.5 per cent in 2014 from over 20 per cent in the 1990s. The low revenue performance has resulted in the government depending more on borrowings to finance the budget deficit. Debt financing has not only crowded out funds available for private investment, but has also exerted upward pressure on market interest rates. Moreover, heavy reliance on domestic bank financing to fill the resource gap has exerted inflationary pressures in the economy while increased foreign financing has led to higher foreign exchange exposure risks. The government has tended to borrow more, even to service the debt, thereby further contributing to debt accumulation over the years. In 2015, for instance, the government spent 90.6 per cent of its total revenue on servicing debt. In this background, the government has recognised the urgent need for implementing coherent fiscal adjustments, focusing on a revenue based fiscal consolidation path, given the limitations in curbing expenditures, particularly the much needed capital spending, to meet budgetary targets. Revenue based fiscal consolidation will expand the fiscal space and allow the government to accommodate mandatory recurrent expenditure while financing public investment programmes, without prejudice to the sustainability of the government's financial position. Moreover, enhanced revenue collection eases the need for increased foreign borrowings, thereby easing the pressure on the exchange rate to depreciate. Accordingly, fiscal policy in 2016 was directed towards strengthening the fiscal consolidation process to reduce the budget deficit, and thereby curtailing debt accumulation in the medium term, mainly through domestic revenue mobilisation and rationalisation of unproductive expenditures. This policy stance of the government has been embedded into the three-year Extended Fund Facility (EFF) programme with the International Monetary Fund (IMF), which was entered into by the government in June 2016.

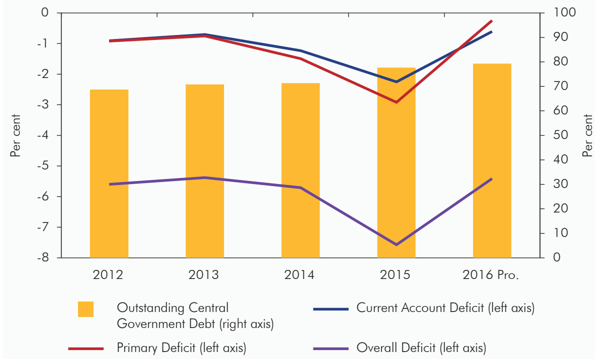
In order to rectify the structural weaknesses persistent in the government budget during the recent past, the government committed to revenue based fiscal consolidation process, rather than merely pursuing expenditure cuts. Although the declining trend in the revenue to GDP ratio observed during the recent past, which is a key concern on the fiscal front, was reversed in 2015, further measures were warranted to maintain this momentum on a sustainable basis, given the issues in the country's tax system. Accordingly, several reforms were undertaken during the year to streamline and simplify the tax system, broaden the tax base, rationalise tax exemptions and concessions, and strengthen tax administration. The measures taken during the year included the Value Added Tax (VAT) rate hike, removal of several exemptions granted on VAT and Nation Building Tax (NBT), broadening of the VAT base by introducing new items into the tax net, reducing the threshold level of NBT, rationalisation of incentives granted through the Board of Investment (BOI), upward rate revisions of other taxes, such as Economic Service Charge (ESC), and the removal of exemptions granted under several taxes. At the same time, measures were taken towards improving tax collection through the strengthening of tax administration. In this regard, the process of automating revenue agencies was expedited while commencing the operations of the Revenue Administration Management Information System (RAMIS) at the Inland Revenue Department (IRD). Sri Lanka Customs (SLC) also took initial steps to establish a National Single Window System (NSWS). Meanwhile, a tax expenditure statement was presented to the Parliament in the Budget 2017 for the first time, in line with practices of good governance, accountability and transparency. This statement provided the cost of tax exemptions, tax holidays, and other incentives granted by the government with regard to key taxes. In addition, the introduction of the new Inland Revenue Act (IRA), prepared with the technical assistance from the IMF, submission of quarterly expenditure and income reports to the Parliament as stipulated in the Budget 2017 and conducting a diagnostic review of the VAT are also expected to help enhance revenue collection.

During 2016, a number of measures were implemented by the government to rationalise expenditures. Accordingly, during the year, the government established the Welfare Benefits Board (WBB) under the Welfare Benefits Act No. 24 of 2002 that was empowered by Gazette No. 1952/22 on 02 February 2016, to develop and implement a coherent system of welfare benefit scheme, as the rationalisation of various social welfare programmes is essential to achieve the envisaged fiscal targets. In addition, the fertiliser subsidy scheme was also revised with the provision of a cash grant in place of the provision of fertiliser. Further, a commitment recording system has been established at the Ministry of Finance (MOF), which helps to track spending commitments for each line ministry on a monthly basis. Further, in December 2016, Phase I of the Integrated Treasury Management Information System (ITMIS), the budget planning module, was rolled out to all ministries. Meanwhile, in March 2017, Statements of Corporate Intents (SCIs) were signed for the five largest State Owned Business Enterprises (SOBEs) to enhance oversight and financial discipline of SOBEs, thereby improving their performance.

The government achieved the key fiscal targets for the year 2016, reducing the budget deficit to 5.4 per cent of GDP as a result of enhanced government revenue collection combined with the reduction in total government expenditure, particularly recurrent expenditure as a percentage of GDP. According to the Budget 2016 presented to Parliament in November 2015, the overall budget deficit was expected to be reduced to 5.9 per cent of GDP in 2016 from 7.6 per cent recorded in 2015. Considering subsequent developments, in March 2016, the government highlighted its commitment to further reducing the budget deficit to 5.4 per cent of GDP for the year 2016. The government revenue to GDP ratio increased for the second consecutive year in 2016, mainly due to the significant expansion in non tax revenue, driven by the profit and dividend transfers by the SOBEs, combined with the increase in tax revenue benefited by the measures taken on the taxation front. Meanwhile, recurrent expenditure as a percentage of GDP declined, amidst the increase in interest payments over and above the originally estimated amount for 2016. The capital expenditure and net lending, as well as public investment as a percentage of GDP also declined due to the prioritising of public investment activities. With these developments, the current account balance, which is a measure of the government's contribution to national savings, improved to a deficit of 0.6 per cent in 2016 from a deficit of 2.3 per cent in 2015. The primary balance, which reflects the current efforts of the government in fiscal operations, as it excludes interest payments arising due to previous deficits, also improved to a deficit of 0.2 per cent of GDP in 2016 from the deficit of 2.9 per cent in the previous year. The improved primary balance is indicative of government efforts to achieve greater fiscal sustainability. In financing the budget deficit, the government mainly relied on foreign sources, as reflected by the issuance of International Sovereign Bonds (ISBs) of US dollars 1,500 million and US dollars 700 million raised through a Foreign Currency Term Financing Facility (FTFF). Borrowings from the banking sector, amounting to Rs. 140.0 billion, reflected a significant decline during the year, in comparison to a target of Rs. 182.0 billion in budget 2016 and Rs. 291.8 billion recorded in 2015. Although the increase in central government debt in nominal terms was lower than the previous year, as a percentage of GDP, it increased to 79.3 per cent by end 2016, mainly due to lower growth in nominal GDP.

As per the Fiscal Management Report of the MOF, the medium term objective of the government is to gradually reduce the budget deficit to around 3.5 per cent of GDP by 2020. In line with this, government revenue is expected to be increased to around 16 per cent of GDP in the medium term, while public investment is envisaged to be maintained at around 5 per cent of GDP. Moreover, a surplus in the current account balance is expected in 2017 and beyond, enabling the government to discontinue borrowing for its day to day operations and contribute to the public investment programme from its own revenue. In addition, a primary surplus is also estimated from 2017, which is indicative of the government's efforts to maintain the non interest expenditure within revenue collection. Accordingly, the implementation of the already identified revenue reforms without any delay is crucial to meet the envisaged revenue targets. This process has to be complemented by rationalising recurrent expenditure to a more sustainable level. The maintenance of public investment at a desired level, complemented by private sector participation in the provision of infrastructure is also imperative to create a conducive environment for private sector economic activities and to help the country to sustain and enhance human development outcomes to improve the overall productivity of the economy. The establishment of cost reflective pricing mechanisms, such as automatic fuel and electricity pricing, is also important in preventing the creation and accumulation of financial losses of the SOBEs as such losses will ultimately be a liability of the government. The government may need additional funding in dealing with natural catastrophes, such as droughts and floods. It is important that these funding requirements are managed within the approved expenditure ceilings. The government also faces several challenges with regard to debt service payments in the medium term, including a bunching of the maturing ISBs, commencing from 2019, and upward pressure on interest payments of the government due to increasing interest rates in the domestic as well as international markets. Hence, due attention needs to be given to improving overall debt management in order to reduce the country's vulnerability related to servicing debt. Improving the knowledge of stakeholders and the general public on the intended reforms through appropriate awareness campaigns is extremely important in achieving the envisaged medium term targets.

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



Source: Ministry of Finance

6

6.2 Fiscal Policy Direction and Measures

Fiscal policy in 2016 was directed towards strengthening fiscal consolidation to curtail the budget deficit and thereby reduce the accumulation of government debt. In line with this, several policy measures were implemented by the government to enhance revenue and rationalise recurrent expenditure based on the objectives and targets laid down in the Fiscal Management (Responsibility) Act (FMRA) and government policy statements. As such, the Budget for 2016, presented in November 2015, proposed several measures targeting expanding the tax base, simplifying the tax system and improving tax administration as well as reforms in the pension system, fertiliser subsidy and SOBEs, along with a set of policies related to the improvement of other sectors in the economy. According to the original Budget for 2016, the overall budget deficit was expected to be reduced to 5.9 per cent of GDP in 2016 compared to 7.6 per cent of GDP recorded in 2015. Considering subsequent developments, in March 2016, the government announced revisions to certain taxes in the backdrop of the changing global economic climate while highlighting its commitment to reduce the budget deficit further to 5.4 per cent of GDP in 2016.

In line with the budgetary targets, several revenue measures were introduced in the Budget for 2016 to enhance revenue mobilisation. Accordingly, measures were taken to simplify the tax structure while broadening the tax base. Meanwhile, redrafting of existing tax laws also continued during the year to bring necessary improvements to the tax system to ensure simplicity, clarity and consistency. Further, tax administration was also strengthened through the automation of tax collecting agencies with the implementation of the RAMIS project at the IRD and NSWS at SLC.

Table 6.1
Summary of Government Fiscal Operations

Item	2015	2016 Approved Estimates	2016 Provisional	2017 Approved Estimates
Rs. million				
Total Revenue and Grants	1,460,892	1,837,970	1,693,558	2,020,300
Total Revenue	1,454,878	1,822,970	1,686,062	2,010,300
Tax Revenue	1,355,779	1,646,000	1,463,689	1,827,000
Non Tax Revenue	99,099	176,970	222,374	183,300
Grants	6,014	15,000	7,496	10,000
Expenditure and Lending Minus Repayments	2,290,394	2,578,119	2,333,883	2,645,300
Recurrent	1,701,658	1,717,239	1,757,782	1,946,000
Capital and Net Lending	588,737	860,880	576,101	699,300
o/w Public Investment	602,767	869,880	594,013	708,300
Current Account Surplus (+)/Deficit (-)	-246,779	105,731	-71,719	64,300
Primary Account Surplus (+)/Deficit (-)	-319,827	-219,697	-29,430	55,087
Overall Fiscal Surplus (+)/Deficit (-)	-829,502	-740,149	-640,325	-625,000
Total Financing	829,502	740,149	640,325	625,000
Foreign Financing (a)	236,803	283,149	391,914	332,000
Domestic Financing	592,699	457,000	248,411	293,000
Market Borrowings	592,699	457,000	248,411	293,000
Non Bank	300,858	275,000	108,456	261,000
Bank	291,841	182,000	139,955	32,000
Monetary Authority	80,254	n.a.	183,085	n.a.
Commercial Banks	211,588	n.a.	-43,130	n.a.
Non Market Borrowings	-	-	-	-
As a percentage of GDP (b)				
Total Revenue and Grants	13.3	14.7	14.3	15.0
Total Revenue	13.3	14.6	14.2	14.9
Tax Revenue	12.4	13.2	12.4	13.5
Non Tax Revenue	0.9	1.4	1.9	1.4
Grants	0.1	0.1	0.1	0.1
Expenditure and Lending Minus Repayments	20.9	20.6	19.7	19.6
Recurrent	15.5	13.7	14.8	14.4
Capital and Net Lending	5.4	6.9	4.9	5.2
o/w Public Investment	5.5	7.0	5.0	5.2
Current Account Surplus (+)/Deficit (-)	-2.3	0.8	-0.6	0.5
Primary Account Surplus (+)/Deficit (-)	-2.9	-1.8	-0.2	0.4
Overall Fiscal Surplus (+)/Deficit (-)	-7.6	-5.9	-5.4	-4.6
Total Financing	7.6	5.9	5.4	4.6
Foreign Financing (a)	2.2	2.3	3.3	2.5
Domestic Financing	5.4	3.7	2.1	2.2
Market Borrowings	5.4	3.7	2.1	2.2
Non Bank	2.7	2.2	0.9	1.9
Bank	2.7	1.5	1.2	0.2
Monetary Authority	0.7	n.a.	1.5	n.a.
Commercial Banks	1.9	n.a.	-0.4	n.a.
Non Market Borrowings	-	-	-	-

(a) Includes rupee denominated Treasury bills and Treasury bonds issued to foreign investors.
(b) Based on revised GDP estimates for 2015 made by the Department of Census and Statistics available on 15.03.2017.

Source: Ministry of Finance

Several measures were taken to broaden the income tax base of which some are yet to be implemented. Accordingly, the following changes are proposed under income taxes: (1) a single corporate income tax rate of 17.5 per cent for all sectors other than banking and financial services, insurance industry, trading activities, liquor, tobacco, lottery, betting and gaming, (2) a higher income tax rate of 40 per cent for liquor, tobacco, lottery, betting and gaming, (3) a rate of 28 per cent on banking and financial services, insurance industry and trading activities and (4) the maximum tax rate applicable to individuals on profits from any activity other than financial, trading, liquor, tobacco, lottery, betting and gaming activity is 17.5 per cent. In addition, the ESC was increased to 0.5 per cent from 0.25 per cent while removing the exclusion applicable to profit making businesses and the maximum liability of Rs. 120 million per annum.

During the year amendments were introduced to the VAT with a view to broadening the tax base and enhancing revenue. Several amendments to VAT proposed on 02 May 2016, of which some, including the proposal to reduce the imposition of VAT on wholesale or retail trade to Rs. 3 million from Rs. 100 million per quarter, were not implemented. Further, implementation of VAT amendments was delayed due to a failure to follow the proper constitutional process in presenting amendment bills to the Parliament. Accordingly, a fresh VAT (Amendment) bill was approved by the Cabinet of Ministers on 13 September 2016, and the approval of the Parliament for the same was obtained on 26 October 2016. As per the VAT (Amendment) Act, the applicable VAT rate for the period from 02 May 2016 to 11 July 2016 and from 01 November 2016, is 15 per cent. Further, several goods and services, such as the supply of telecommunication services, import of and supply of telecom equipment including copper cables, issuance of licenses to local telecom operators by the Telecommunication Regulatory Commission (TRC) and supply of healthcare services, were made liable for VAT during these periods. In addition, the threshold for registration of VAT was reduced to Rs. 3.0 million per quarter from Rs. 3.75

million per quarter for the period 02 May 2016 to 11 July 2016 and from 01 November 2016 onwards. Meanwhile, several other amendments to VAT were introduced with effect from 01 November 2016. Accordingly, VAT was imposed on several items, namely, liquor, cigarettes, coal, perfumes, electrical and electronic goods and telecommunication equipment, broadening the VAT base.

Several amendments were also introduced to NBT with the view of enhancing the tax base. The liable threshold for NBT registration was reduced to Rs. 3 million per quarter from Rs. 3.75 million per quarter, for the period 02 May 2016 to 11 July 2016 and the period commencing 01 November 2016. Removal of exemptions in respect of telecommunications, supply of electricity and lubricants also applied for the same period. In addition, with effect from 11 November 2016, a number of goods such as printed books, magazines, journals or periodicals other than newspapers, solar panel modules and accessories, were exempted from the NBT. However, the rate of NBT was unchanged at 2.0 per cent in 2016.

Several policy measures were taken in the context of excise duties while minimising revenue leakages, especially on the importation of motor vehicles and production of liquor. Accordingly, a unit rate of excise duty was introduced on the basis of cubic centimeters for motor vehicles. Further, a 2.5 per cent tax deduction was granted for vehicles which are driven entirely on Solar, Hydrogen or Helium in order to encourage the usage of environmental friendly vehicles in the country. With a view to minimising illicit liquor production in the country, it was proposed to introduce a fool-proof sticker for every tax-paid liquor bottle as a visual identification for excise officers and customers.

The Customs duty structure was rationalised with the introduction of a three band tariff structure while increasing Customs duty rates on selected items. The four band tariff structure of 25 per cent, 15 per cent, 7.5 per cent and exempt category was replaced by a three band structure of 30 per cent, 15 per cent and the exempt with effect from 21 November 2015, the full impact of which was seen in 2016. In addition, the Ports and Airports Development Levy (PAL) was increased to 7.5 per cent from 5.0 per cent. However, a low rate of 2.5 per cent was introduced for certain electronic and electrical items while PAL on certain plants and machinery used for construction, dairy and agricultural industries was removed during 2016.

The Special Commodity Levy (SCL) on the importation of several food items was revised from time to time to provide necessary protection for farmers and as a supply side management measure to curtail price hikes in the domestic market. Accordingly, SCL on the importation of b'onions and potatoes increased to Rs. 25 per kg and Rs. 35 per kg, respectively in March 2016 while the domestic supply conditions necessitated the increase in SCL on both items to Rs. 40 per kg in August 2016. Further, SCL on the importation of red onions was increased to Rs. 25 per kg from Rs. 5 per kg while that on the importation of white sugar and brown sugar was increased to Rs. 13 per kg and Rs. 15 per kg, respectively, during the second half of the year. In addition, SCL on the importation of vegetable oil and seeds of fennel was also increased during the year. SCL on the importation of whole lentils was increased to Rs. 5 per kg from 25 cents per kg while SCL on the importation split lentils also increased to 10 per kg from 25 cents per kg in September 2016. In November 2016, SCL on the importation on green gram was increased to Rs. 40 per kg from Rs. 10 per kg while the same was imposed on mangoesteens (fresh and dried) at Rs. 200 per kg, oranges (dried) at Rs. 2,000 per kg, pears at Rs. 175 per kg, cherries at Rs. 250 per kg, plums and soles at Rs. 200 per kg and kiwifruit at Rs.175 per kg. In addition, SCL was introduced for Samba rice, Naadu rice and raw rice at Rs. 15 per kg with effect from 07 January 2017 and it was further reduced to Rs. 5 per kg with effect from 28 January 2017 for a period of 30 days with the decline in the supply of rice in the domestic market. Meanwhile, SCL on the importation of vegetable oils was lowered by Rs. 20 per kg for a period of six months with effect from January 2017.

Emphasis was placed on expediting the process of automation in revenue agencies to improve tax administration and enhance revenue collection. The RAMIS, which commenced its operations in 2016, enables taxpayers to register online for the payment of taxes and obtaining returns in respect of VAT, NBT, Withholding tax and Pay-As-You-Earn (PAYE) taxes. In order to improve the effectiveness of the RAMIS project, IRD conducted awareness programmes for all stakeholders, regional offices, and the staff of the IRD emphasising functional areas of the system, benefits and the prospective service of the new system. Meanwhile, SLC has also taken the initial steps to establish Customs NSWS, linking all border agencies that perform various regulatory functions in import and export of goods. The objective of this initiative was to facilitate the import and export trade and enhance the efficiency of revenue collection. The expected outcome of this initiative is yet to be achieved since some of the border agencies lack the required infrastructure. Therefore, it has been identified to implement NSWS as a priority project under the implementation of World Trade Organisation (WTO) Trade Facilitation Agreement. The blue print for NSWS in Sri Lanka will be prepared with the assistance of the World Bank during 2017 and the full implementation of NSWS is expected by 2021. In order to further improve the clearing process, SLC started to register all importers with it and created a risk profiling mechanism during the year for easy identification of low risk importers. A pre arrival processing mechanism was also started to ensure faster clearance and release of goods to the importers. Further, a container scanning system was installed at ports and airports to ensure the effectiveness and efficiency of the container and baggage clearing process, which would minimise delays and enhance revenue collection. In addition, SLC expects to reactivate the Marine Division in order to curb smuggling activities through the sea. Meanwhile the ITMIS, which is being set up at the MOF, is envisaged to modernise Public Financial Management (PFM) in Sri Lanka through automation of key functions, such as budget preparation, budget execution, accounting for public expenditure and revenue, Treasury and cash management, and to support the government in the preparation of financial statements. Under this system, a new web portal for MOF was developed and launched in April 2016. The ITMIS application is being developed under five phases. The Phase I, Budget Planning and System Administration Modules was completed and went live in October 2016. Further, Phase II, which includes Treasury Management, Revenue Management, Budget Appropriation, Purchasing Management, Expenditure Management, General Ledger and System Administration modules, was implemented for MOF and the Ministry of Health as a pilot project, while other spending agencies are also expected to join during the first half of 2017. Functions related to the other three phases are expected to be launched and initiated in 2017.

Several policy changes were implemented to encourage effective management of public expenditure in order to achieve the desired fiscal path in the medium term. In relation to the proposal of presenting the quarterly expenditure and income outcomes to the Parliament which was proposed in the Budget for 2017, preliminary activities are being taken by the MOF to monitor fiscal performance. Accordingly, the government will be presenting the quarterly expenditure and income outcomes to the Parliament within one month at the end of any quarter, strengthening the Parliamentary control of Public Finance. In line with the fiscal consolidation path, any revenue shortfall in a particular quarter will warrant the government to realign the expenditure as well with the approval of the Parliament. Meanwhile, under National Budget Circular No. 07/2015, all spending agencies were instructed to manage expenditure within the provisions allocated for the year. Under National Budget Circular No. 05/2016, instructions were issued to establish quarterly expenditure ceilings for all expenditure heads in 2017. Further, spending agencies were advised to implement necessary actions to complete procurement procedure within the first quarter of 2017 to improve the implementation process of 2017 budget proposals. Instructions were also given to settle the commitments of the previous year before requesting funds for settling new commitments in 2017. The monitoring mechanism on the utilisation of budgetary provisions, introduced in 2016 (National Budget Circular No. 06/2015), continued in 2017 as well under National Budget Circular No. 01/2017, in order to achieve efficiency in resource allocation. In addition, a Budget Review and Implementation Committee was established in the MOF to monitor the progress of projects and programmes implemented under the Annual Budget.

A new salary structure was introduced for public sector employees in 2016. As per Public Administration Circular No. 03/2016, the new salary structure is to be implemented in five phases on a step by step basis until 2020, commencing from 01 January 2016. This includes a special non pensionable allowance paid to retired public officers who have been re-employed (in terms of the Public Administration Circulars No 31/2011 and 18/2012) and the interim monthly allowance of Rs. 10,000 (in terms of the Public Administration Circulars No. 24/2014, 24/2014 (I) and 05/2015). Meanwhile, with a view to enhancing the quality of public service delivery while improving productivity, the government decided to conduct a cadre review in government institutions in terms of the budget proposals 2017.

During the year 2016, automation of the Department of Pensions was further strengthened to improve the efficiency of service delivery. In order to improve registration and expedite the process of pension payments, the Department of Pensions introduced a fully automated online application process under Pensions Circular No. 02/2016 for registration of government employees to the Widowers' and Orphans' Pension (W&OP) Fund. Under Pensions Circular No. 03/2015(I), pensioners were allowed to submit pension applications online with effect from 10 October 2016 through the Pension Management System (PMS). Pension disbursements are managed through the online payment process of the Department of Posts while the payments made by the post office network was centralised in 2016. Further, an online railway warrant system was also introduced for pensioners in collaboration with Sri Lanka Railways and Mobitel (Pvt.) Ltd. In addition, a new insurance scheme in the name of 'Agrahara Rekawarana' was introduced under Pensions Circular No. 04/2016 for retired public officers who retired after 01.01.2016.

Although public investment as a percentage of GDP declined, several major infrastructure projects continued during the year. Accordingly, work related to major irrigation schemes, such as Moragahakanda and Kaluganga projects, continued in 2016 and the impounding process of Moragahakanda is in process. Meanwhile, the development of expressways and the widening and improving of national roads continued in 2016 as scheduled. Accordingly, construction of Phase III of the Outer Circular Highway from Kadawatha to Kerawalapitiya section, and the Southern Expressway Extension Project from Matara to Hambantota, also continued. Further, investments were also made for the acquisition of lands for the construction of the Central Expressway during the same period. Construction work related to Phase II of the Central Expressway from Meerigama to Kurunegala, commenced in early 2017. In addition, the feasibility study for the Ruwanpura Expressway is in its final stages and construction work is expected to commence in 2017. The limited fiscal space available for public investments necessitates the attraction of private investment for infrastructure development projects. Thus, promoting Public Private Partnerships (PPPs) as a national strategy is important to address the infrastructure requirement in the country. PPPs, in general, will ensure higher efficiency and sustainability in service delivery while facilitating foreign investments in infrastructure development projects. Accordingly, the government will have to establish an enabling environment for PPPs including the required legal framework, necessary institutional setup and know how to deal with PPP agreements that mutually benefit the private sector and the government in providing infrastructure.

The government continued its social protection schemes for vulnerable social groups through various subsidy schemes, such as Samurdhi/ Divineguma programme, fertiliser subsidy, food nutritional programmes, elders' allowance and special grant for kidney patients. Accordingly, nutritional programmes, such as Poshanamalla, Thriposha programme, fresh milk and school nutrition programmes, were continued during the year with a view to improving child and maternal nutrition. Meanwhile, the government converted the fertiliser subsidy to an allowance of Rs. 25,000 per hectare up to a maximum of two hectares per paddy farmer per annum in place of the provision of a 50 kg bag of fertiliser at Rs. 350, to rationalise household transfers. Further, the government extended the fertiliser subsidy for tea, coconut and rubber as well in 2016 under which a cash grant of Rs. 15,000, Rs. 9,000 and Rs. 5,000, respectively was provided per hectare per annum. Furthermore, under the free school uniform programme, the government provided cash vouchers for students instead of uniform material from 2016. Steps are also being taken by the government to provide financial support to families who are affected by the drought. Accordingly, the government has decided to provide a cash grant of Rs. 10,000 per month for affected families for a period of three months.

The government appointed a WBB to develop and maintain a coherent welfare benefit scheme for vulnerable groups. The WBB which was established under the Welfare Benefits Act No. 24 of 2002 was empowered by Gazette No. 1952/22 on 02 February 2016 to develop and maintain a comprehensive welfare benefit scheme for the most susceptible segments of the society. The WBB is entrusted with the responsibility of developing and implementing a coherent system of welfare benefits management for all the welfare benefits schemes. It is important that the system ensures a transparent process of selection to include all eligible beneficiaries and make hassle free payments to them. There are 34 different welfare programmes implemented by Ministries, Departments, Provincial Councils and other agencies. At present, the management of the welfare programmes is done manually and as a result the programmes lack efficiency, equity and transparency in their operations. It is also observed that ineligible beneficiaries are included and eligible beneficiaries are excluded in the existing selection process of beneficiaries. Having recognized those issues the Board has decided to develop transparent welfare benefits schemes with objectively verifiable criteria for the selection of beneficiaries, initially for the welfare programmes implemented by the Ministry of Social Empowerment and Welfare, and gradually expand to cover the welfare programmes of the other Ministries. Moreover, action was taken to design and develop a Social Registry and Integrated Management Information System (MIS) as a one stop shop for social welfare management. The Information and Communication Technology Agency (ICTA) is entrusted with implementing this task with the support of other organisations involved. Technical support for all these activities is expected from the World Bank funded Social Safety Nets Project (SSNP) of the MOF.

Several initiatives were taken during 2016 to strengthen the financial position and operations of major SOBEs while meeting the economic demands of a middle income country. Accordingly, the SCIs were signed with selected five main SOBEs namely, Ceylon Electricity Board, Ceylon Petroleum Corporation, National Water Supply and Drainage Board (NWS&DB), Airport and Aviation Services (Sri Lanka) Ltd and Sri Lanka Ports Authority, in March 2017 in order to improve the oversight and financial discipline of these SOBEs. A SCI includes objectives and multilayer corporate plan, capital expenditure and financing plan, explicit financial and non financial targets and cost of non commercial obligations of selected five key SOBEs. In addition, the government expects to bring all SOBEs under a government owned holding company, which will be operated under sound financial principles. In order to cater to this purpose, the Public Enterprises Act has been drafted. Further, guidelines for appointing professionals to Director Boards of SOBEs were issued by the Ministry of National Policies and Economic Affairs as per the Cabinet Decision No. 16/0640/706/023, dated 08 April 2016, in order to strengthen the professionalism of the entities. Having considered the continuous loss making position of SriLankan Airlines (SLA), the government is currently in the process of restructuring SLA and expects to offer an equity stake and management control of the company in order to continue and strengthen the operations of the company. Further, a Letter of Support was issued to SLA, indicating that the required government financial support will be provided to the entity until the restructuring process is completed. In addition, the government directed SLA to absorb the route network operated by Mihin Lanka (Pvt) Limited (MLL) with effect from 30 October 2016, considering the deteriorated financial position of MLL. In this context the government has provided required financing support to both SLA and MLL through Letters of Comfort during 2016 and early 2017. Having considered the financial constraints of the NWS&DB, the government decided to bear 50 per cent of the debt service payment of the Urban Water Supply Projects and 75 per cent of the Rural Water Supply Projects through the General Treasury. Further, lent loans granted up to end of 2014 to the NWS&DB by the General Treasury were converted to government equity in 2016 with a view to strengthening its balance sheet. Meanwhile, a cost reflective pricing formula, which has been designed to adjust domestic market retail prices in line with international prices for two main petroleum products of the CPC, i.e. petrol and diesel, has been submitted to the Cabinet of Ministers for its approval.

The public debt management strategy was further improved in 2016 with the introduction of several new measures. Accordingly, on 04 August 2016, the Central Bank commenced releasing summary trading statistics on actual trading of government securities in the secondary market for the first time with a view of promoting transparency, price discovery and outreach of the government securities market parallel to other financial markets. In order to improve transparency in government securities, all Primary Dealers and commercial banks joined the Bloomberg Electronic Bond Trading Platform for government securities secondary market transactions as per the instructions issued by the Central Bank. As a result, all Primary Dealers are required to report all outright sales of government securities of value in excess of Rs. 50 million to investors to this platform within 30 minutes of each transaction. This will enable the Central Bank to monitor transactions on an ongoing basis thereby improving the transparency of the process. In addition, the Central Bank has commenced a procurement process for setting up a dedicated electronic trading platform along with the Central Counterparty System. This is expected to provide market information on a real time basis in line with other developed financial markets, while developing the government securities market to international standards. In June 2016, a decision was taken not to accept more than the aggregate amount offered at an auction, although the Central Bank may accept less than the amount offered, with the intention of enhancing the transparency of Treasury bill and bond auctions.

Measures were also taken to strengthen the regulation and supervision of Primary Dealers in line with international standards. Accordingly, responsibility of the regulation and supervision of the government securities market was assigned to the Department of Supervision of Non-Bank Financial Institutions of the Central Bank. Pre-bid meetings with all Primary Dealers to share information on market developments were also resumed. The Central Bank is also working towards publishing an annual auction calendar with more information in collaboration with the MOF. This will enhance the transparency and predictability of the primary auction process in the government securities market and provide information to all market participants thereby ensuring the availability of information on potential transactions to all market players. Meanwhile, measures were also taken to enable the Employees' Provident Fund (EPF) to actively participate at the primary auctions of the government securities market.

A number of measures are in the pipe line to further improve the debt management process. Accordingly, primary auction rules for government securities will be published in order to improve transparency and to standardise procedures. It is also expected to introduce certain measures to include outright secondary market sales of government securities by Non-Primary Dealer banks to their customers into the trading platform. Further, the possibility of active debt management initiatives, such as buy-backs, switching and swap arrangements, which are also a part of liability management initiatives, will be explored to improve the debt management process, with changes in relevant legislation. In order to deepen and broaden the secondary market for government securities, the Central Bank expects to establish an Electronic Trading Platform and a Central Counter Party (CCP) arrangement for government securities along with required legal reforms. Similarly, a mechanism to disseminate secondary market information on debt instruments will also be established through the proposed e-trading platform and the clearing house. This will help the Central Bank to cope with the conflict of interest of trying to conduct an independent monetary policy while at the same time, raising funds for the government as cheaply as possible.

The government successfully issued its 10th International Sovereign Bond, reflecting improved investor sentiment on Sri Lanka. Accordingly, the government was able to raise US dollars 1.5 billion in July 2016 through the first dual tranche offering of 5.5 year (US dollars 500 million) and 10 year (US dollars 1.0 billion) bonds at yield rates of 5.750 per cent and 6.825 per cent, respectively, amidst high volatility in the global markets following the impact of Brexit. In addition, the government issued a US dollars 300 million worth of FTFF in June 2016, with a maturity period of 3 years. Further, government issued another FTFF amounting to US dollars 400 million with a maturity period of 3 years in September 2016.

The government entered in to a three-year EFF programme with the IMF on 03 June 2016 to strengthen the external position of the country and to support the government's broad economic reform agenda. The programme involves a number of tax policy and tax administrations improvement measures in line with the government policy on the same. Under this programme, the primary balance has been agreed as the key Quantitate Performance Criteria (QPC) related to the government fiscal operations. The QPC in respect of the primary balance for the period January-June 2016 and January-December 2016 were deficits of Rs. 46.0 billion and of Rs. 97.0 billion, respectively. The government met the QPC for primary balance in 2016 successfully.

Some of the international sovereign rating agencies upgraded their ratings in early 2017 although few of them made downward revisions to Sri Lanka's sovereign credit ratings in 2016. On 29 February 2016, Fitch revised Sri Lanka's foreign currency rating of "BB-" to "B+", and revised Sri Lanka's sovereign rating outlook to "negative" from "stable", citing Sri Lanka's heightened vulnerabilities due to increasing refinancing risks, significant debt maturities, weaker public finances, decline in foreign exchange reserves and high foreign currency debt. However, having considered the continuous improvement in fiscal performance, improved policy coherence and credibility with the ongoing IMF-EFF programme and stable growth in the economy, Fitch affirmed Sri Lanka's long-term foreign and local currency Issuer Default Ratings (IDR) at "B+" and revised the outlook to "stable" from "negative" on 09 February 2017. Standard and Poor's (S&P) affirmed its "B+" long-term rating and "B" short-term sovereign credit rating on 26 March 2016, although its outlook on Sri Lanka's long-term foreign currency sovereign credit rating was changed to "negative" from "stable" citing the rising pressures on Sri Lanka's external liquidity and relatively weak public finances at that time. On 07 March 2017, S&P affirmed again its "B+" long-term and "B" short-term sovereign credit ratings with a "negative" outlook for Sri Lanka citing Sri Lanka's weak external sector performance and the possible vulnerabilities in public finances emanating from exchange rate shocks. Moody's Investor Services also changed the outlook on Sri Lanka's B1 sovereign rating to "negative" from "stable" on 20 June 2016, highlighting the weakening of some of Sri Lanka's fiscal metrics in an environment of subdued GDP growth, which could lead to renewed balance of payments pressure and lower than expected effectiveness of the fiscal reforms envisaged by the government.

Fiscal operations showed an improvement in 2016, despite certain drawbacks due to the time taken for implementing structural reforms in the areas of tax administration, public financial management, governance and oversight of SOBEs. The upward trend observed

BOX 09
Revenue Based Fiscal Consolidation towards Sustainable Level of Debt

Why Revenue Based Fiscal Consolidation?

Fiscal consolidation is a policy that aims at reducing government deficits and debt accumulation.[1] Correcting fiscal imbalances, reducing fiscal deficits and thereby curtailing public debt accumulation are priorities in many developing countries although there is no consensus about the best policy mix to achieve it. Fiscal consolidation can take place through curtailing of expenditure, expansion of revenue or using a combination of these two policies. Expenditure restriction should focus on curbing unproductive expenditure as well-planned productive expenditure, particularly directed towards infrastructure and human development, is vital for a country to ensure long term growth. Revenue based fiscal consolidation targets enhancing revenue through expanding the tax base, improving the tax administration, minimising tax avoidance and evasion, revising the tax rates and rationalising tax incentives. Revenue based fiscal consolidation, thus, supports spending capacity of the government although it could be challenging and sometimes politically unpopular to implement, if it excessively introduces new taxes or increases tax rates in augmenting revenue. Though revenue enhancement is the key objective of revenue based fiscal consolidation, a disciplined approach to government spending and prioritisation of public investment also complements the consolidation process.

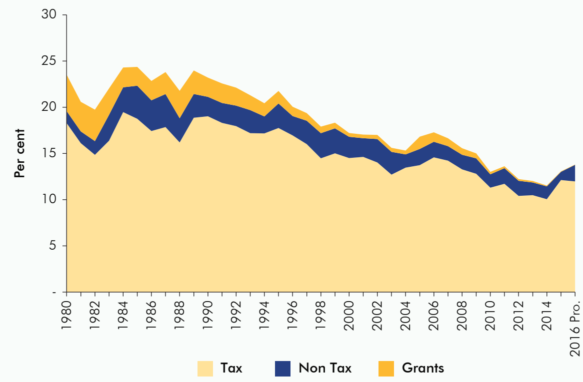
Table B 9.1
Government Revenue to GDP Ratio in Selected Countries: 2015

Country/ Region	Revenue to GDP Ratio (percentage)	Expenditure to GDP Ratio (percentage)	Revenue Expenditure Gap (percentage)
India	20.8	27.9	-7.1
Indonesia	14.8	17.4	-2.6
Malaysia	22.2	25.2	-3.0
Pakistan	14.5	19.8	-5.3
Philippines	19.4	19.4	0.0
Sri Lanka	13.3	20.9	-7.6
Thailand	22.6	22.3	0.3
Asia	26.6	29.8	-3.2

Sources: Fiscal Monitor-April 2016-IMF
Central Bank of Sri Lanka

An examination of Sri Lanka's budgetary operations with that of regional peers indicates that Sri Lanka's fiscal imbalances are largely due to the poor revenue performance. Government expenditure as a percentage of GDP in Sri Lanka is at a moderate level of 20.9 per cent when compared to the regional peers. However, on the revenue front, the lowest revenue as a percentage of GDP is recorded by Sri Lanka compared to peer countries (Table B 9.1). Accordingly, fiscal consolidation should rely mainly on measures to broaden the tax base and improve the efficiency of tax collection while ensuring the rationalisation of expenditure, rather than imposing expenditure cuts.

Chart B 9.1
Government Revenue (as a % of GDP)



Source: Ministry of Finance

The government's revenue collection over the past two decades has been persistently low (Chart B 9.1), despite the steady increase in per capita income.[2] Revenue mobilisation has been well below the total expenditure incurred by the government and insufficient to cover expenses even of a recurrent nature. Thus, the government has been a net dis-saver. The Sri Lankan tax system suffers from several drawbacks although over 80 per cent of government revenue is raised through different taxes. Various tax exemptions, long tax holidays, preferential rates, substantially high progressive taxes, significantly low ratio of direct to indirect taxes compared to regional peers,[3] tax evasion, tax avoidance and complexities of the tax system that hinder tax compliance while making tax administration difficult and costly, are constraints that contributed to erode the tax base and thereby reduced tax revenue over time.

Continuously weak tax collection in the country is mainly driven by the decline in revenue elasticity,[4] which has resulted from several factors, including various tax exemptions/ holidays, tax evasion and weak tax administration. As such, government revenue that stood at over 20 per cent of GDP in 1990s dropped

1. Organisation for Economic Cooperation and Development (OECD) – Glossary of Statistical Terms (http://stats.oecd.org/glossary/detail.asp?ID=984)

2. However, there is an encouraging performance in the government revenue collection in the past two years.
3. In the medium term, it is expected to increase the ratio of direct: indirect taxes to 40: 60 from the ratio of 19: 81 prevailed in 2015.
4. The concept of tax elasticity is used to measure the responsiveness of tax revenue to economic growth. Tax buoyancy is a crude measure which does not distinguish between discretionary and automatic growth of revenue. Elasticity is a preferred measure of tax responsiveness since it controls for automatic revenue changes (Leuthold and N'Guessan, 1986).

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to a value as low as 11.5 in 2014. Low revenue performance in Sri Lanka compels the government to rely more on debt financing even to support the government's recurrent expenditure. It contributes to crowding out of private investment in the country while exerting upward pressure on the market interest rates, thereby hindering economic growth. Moreover, the fiscal measures which tend to take place in a context of high borrowings, often result in an intergenerational transfer of benefits that favour earlier generations, is regarded as unjustifiable by many economists.

Meanwhile, debt service payments in Sri Lanka grew at a higher rate than the growth in revenue over the past few decades as reflected by the increasing debt service payments as a percentage of revenue (Table B 9.2). As such, in 2016, interest payments on the existing debt stock absorbed about 36.2 per cent of the total government revenue in Sri Lanka. In addition, debt amortisation obligations consumed a further 44.0 per cent of the revenue. Hence, 80.2 per cent of the total government revenue was absorbed by total debt service payments leaving only a small fraction of the revenue to be utilised for all other public expenditure in 2016.

Table B 9.2
Government Debt Service Payments

Item	1990	1997	2000	2003	2006	2009	2012	2015	2016
Debt Service Payments (Rs. mn)	33	84	176	345	444	826	1,017	1,318	1,352
Amortisation Payments (Rs. mn)	12	28	105	220	294	516	609	808	742
Interest Payments (Rs. mn)	21	55	71	125	151	310	408	510	611
Debt Service Payments (as % Total Revenue)	48.4	50.7	83.0	124.7	93.0	118.0	96.8	90.6	80.2

Sources: Ministry of Finance
Central Bank of Sri Lanka

Revenue based fiscal consolidation is also crucial in maintaining low and stable inflation in the economy,[5] which creates a conducive environment for investment decision making. In addition, it minimises the excess aggregate demand generated by unsustainable fiscal deficits, and thereby serves to curtail external sector vulnerabilities. Fiscal consolidation also strengthens and complements the proper conduct of monetary policy. Moreover, the expanded fiscal space resulting from enhanced revenue acts as a cushion against possible adverse shocks that could arise both on the domestic and international fronts.

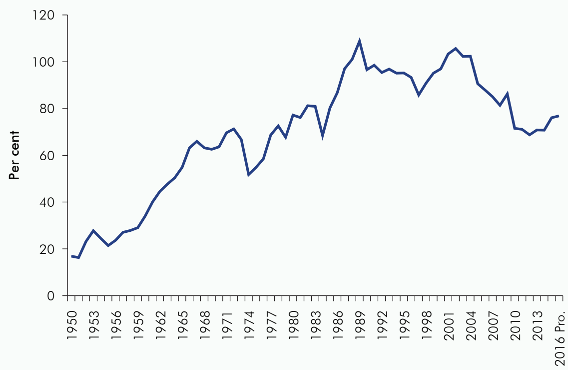
5. The question whether larger public deficits are always associated with higher inflation is answered affirmatively by Sargent and Wallace (1981) in their piece on "Some Unpleasant Monetaristic Arithmetic".

Enhanced revenue narrows down the fiscal deficits and in the medium term, helps to achieve a positive primary balance.[6] Improved fiscal balances, together with the expected economic growth trajectory, would break the vicious cycle of debt accumulation and bring the debt to GDP ratio down to comfortable and sustainable levels. These highlight why it is important to implement a revenue based fiscal consolidation process in a vigorous manner, with a sufficient level of political commitment in Sri Lanka as a top priority. This will eventually ensure debt sustainability[7] in the medium to long run.

Fiscal Imbalances and Debt Sustainability

Over the past several decades, the government debt-to-GDP ratio in Sri Lanka continued to remain high. It increased above 100 per cent during the periods 1988-1989 and 2001-2004 (Chart B 9.2).

Chart B 9.2
Government Debt (as a % of GDP)



Sources: Ministry of Finance
Central Bank of Sri Lanka

Though the government debt-to-GDP ratio is reported as 79.3 per cent in 2016, it still remains very high when compared to other frontier markets and peer countries in the region (Table B 9.3). Low revenue has led the government to rely heavily on debt creating financing instruments, which contribute to the accumulation of the government debt stock. Higher debt stock augments debt service payments, further contracting the fiscal space available for other mandatory/ productive activities. Moreover, the larger deficits resulting from heavy debt service expenditure eventually paves the way for the country to borrow more, thus creating conditions that expose it towards a 'debt trap' or the 'vicious cycle

6. Primary balance of the government is defined as the differential of revenue and expenditure excluding interest payments. It acts as an indicator of current fiscal effort, since interest payments are predetermined by the size of previous deficits (IMF(1995): Pamphlet Series - No. 49 - Guidelines for Fiscal Adjustment - How Should the Fiscal Stance Be Assessed?).
7. Debt "sustainability" is often defined as the ability of a country to meet its debt obligations without requiring debt relief or accumulating arrears.

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Table B 9.3
Government Debt-to-GDP Ratio in Selected Countries (2015)

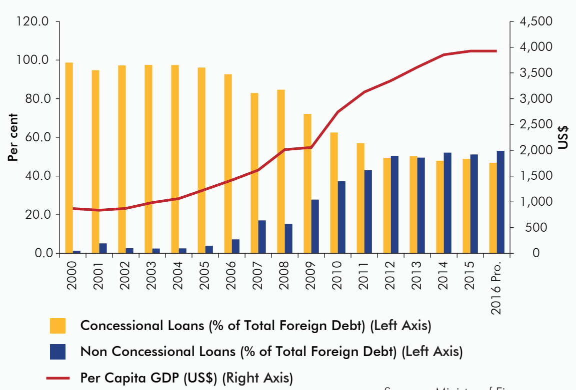
Country	The Ratio (%)
Bangladesh	34.0
India	67.2
Indonesia	27.3
Malaysia	57.4
Philippines	37.1
Sri Lanka	77.6
Thailand	43.1
Vietnam	59.2

Sources: World Economic Outlook Database-October 2016
Central Bank of Sri Lanka

of debt'. Further, following the country's graduation to lower middle income status in 2010, the availability of foreign grants and concessional financing started to deplete significantly, while increasing exposure to non-concessional and commercial borrowings. This has transformed the composition of the debt stock, with an increase in the share of external debt. Within that, the share of more expensive commercial debt has grown as well as the stock of short term debt. This shift has necessitated the country to access international capital markets through the issuance of International Sovereign Bonds at commercial interest rates, further accumulating debt stock while increasing the foreign currency exposure risk.

Accordingly, as a percentage of total foreign debt, concessional debt declined to 46.9 per cent in 2016, from over 90 per cent prior to 2007 (Chart B 9.3).

Chart B 9.3
Government Debt (as a % of GDP) vs Per Capita GDP



Sources: Ministry of Finance
Central Bank of Sri Lanka

In light of these developments, the government identified the urgent need for following a decisive revenue based fiscal consolidation path as well as implementing it in a credible and sustainable manner, to prevent any possible fiscal slippages that could pose threats to debt sustainability and eventually to macroeconomic stability. As such, the government commenced several initiatives in the past few years, with the focus of enhancing revenue and thereby ensuring debt sustainability in the medium to long term.

Strategy for Revenue Based Fiscal Consolidation towards Debt Sustainability

As highlighted above, Sri Lanka's fiscal imbalances have emanated from poor revenue performances, which have resulted in the accumulation of debt over the years. Lowering fiscal deficits to ensure sustainable debt levels in the medium to long term through domestic revenue mobilisation is crucial in the context of Sri Lanka. Accordingly, over the past few years, the government has taken several steps to revamp tax policies and bolster tax administration, focusing on the areas of: (a) broadening the tax base to ensure a tax revenue of around 15-16 per cent of GDP in the medium term (b) rationalising the tax system while minimising tax exemptions, tax holidays, and special tax rates that are detrimental to fair and effective tax administration (c) augmenting capacity for revenue administration and (d) strengthening public financial management, particularly commitment control, and financial planning and discipline. These steps will improve tax compliance and ultimately strengthen the fiscal consolidation path.

As such, the medium term target is to bring the overall central government deficit down to at least 3.5 per cent of GDP by 2020, while lowering the central government debt to about 70 per cent of GDP, mainly through enhancing tax revenue. Rationalising expenditure and reducing contingent fiscal risks from State Owned Business Enterprises (SOBEs) are also given due attention. Further, a near zero primary balance is targeted for 2017 and a primary surplus of 1 per cent of GDP is expected in 2018. Proposed revision to the Fiscal Management Responsibility Act (2003) with mandatory binding targets for the government deficit and the level of overall government debt would be an important milestone in the fiscal consolidation path beyond 2019. Medium term strategic priorities of the consolidation process also include rationalising public expenditure while eliminating unproductive expenditure, transforming SOBEs to enable them to operate as commercially viable enterprises via restructuring, improving transparency and accountability, and proper targeting of subsidy schemes. The Medium Term Debt Management Strategy provides a framework for a prudent borrowing programme ensuring the availability of adequate funding for the government's financing needs at the lowest possible cost while minimising risks.

In order to achieve the said targets, the government has already taken several initiatives and more actions are to be implemented in the near future. The

Value Added Tax (VAT) (Amendment) Act enacted in November 2016, including initiatives such as raising the rate and broadening the base by eliminating exemptions while extending VAT on the wholesale and retail trade at a higher threshold, revamping the income tax law by redrafting the Inland Revenue Act (IRA), amending of the Board of Investment Act (BOI), in May 2016, restricting its ability to grant tax exemptions and rationalising tax incentives by focusing them on upfront investment allowances, introduction of a new IT system (RAMIS) for major domestic taxes, including web based tax filings for income tax and VAT, etc., are among such initiatives.

Though the measures taken towards revenue based fiscal consolidation and the commitment of the government are noteworthy, it is crucial to continue with the necessary fiscal reforms with disciplined and determined political commitment, without deviating from the fiscal consolidation path, in order to achieve the envisaged fiscal targets in the medium to long term.

in the government revenue to GDP ratio in 2015 continued during 2016, mainly due to the imposition of several tax measures. However, some of the tax changes and tax administration reforms showed slower progress than envisaged, adversely affecting the expected performance in government revenue. Overall government expenditure increased moderately reacting positively to continuous efforts made by the government to manage government expenditure. However, recurrent expenditure including interest payments, salaries and wages and subsidies and transfers to household still remains high exerting pressure on government finances while leaving limited fiscal space for public investment. This also emphasises the need for PPPs to attract foreign and domestic private investments to the infrastructure development activities of the country. Moreover, the envisaged fiscal consolidation path is expected to bring down the government's debt to GDP ratio from 79.3 per cent in 2016 to 70 per cent in 2020. In order to improve the country's macroeconomic outlook and to reduce the rollover cost of existing debt, it is essential to achieve this target as envisaged which, however, would be challenging for the government in the current domestic and international economic environment. Moreover, the increasing cost of borrowing of the government is likely to continue in the medium term as a result of rising interest rates in the international market following the rate hike announced by the Federal Reserve in December 2016 as well as in March 2017 and the prevailing vulnerability in financial markets due to Brexit and the upward shift in domestic interest rates with the tight monetary policy stance of the Central Bank. Further, the depreciation of the rupee against major foreign currencies is also likely to exert additional pressure on government debt, although it would also affect fiscal operations by way of enhancing the tax base of customs duty and higher amount of rupees received for foreign financing disbursements. In the case of foreign debt, a substantial amount of fresh financing is required to meet the repayment of existing foreign debt of the country over the next 5-6 years, as there are several series of ISBs to mature. Hence, careful attention needs to be paid to bunching of debt maturities when raising debt in the domestic and international markets. In this context, reforms must be vigorously continued with a strong political commitment to decisively address chronic structural weaknesses in the fiscal sector.

6.3 Government Budgetary Operations

Revenue and Grants

Revenue

Total government revenue as a per cent of GDP increased for the second consecutive year in 2016. Government revenue increased to 14.2 per cent of GDP in 2016 from 13.3 per cent in 2015 as a result of continued efforts taken by the government to enhance revenue collection. This increase was led by the expansion in non tax revenue as a per cent of GDP to 1.9 per cent during the year from 0.9 per cent recorded in 2015, mainly due to the increase in profit and dividend transfers from SOBEs. However, tax revenue as a per cent of GDP in 2016 remained unchanged at 12.4 per cent as recorded in 2015, as a result of the increased revenue from VAT and import related taxes being partly setoff against the decline in tax revenue from excise duty on motor vehicles, corporate and non corporate income taxes and withholding tax.

During the year, total revenue in nominal terms increased by 15.9 per cent to Rs. 1,686.1 billion from Rs. 1,454.9 billion in 2015, reflecting increases in both tax revenue and non tax revenue. In nominal terms, tax revenue increased by 8.0 per cent to Rs. 1,463.7 billion in 2016 from Rs. 1,355.8 billion in 2015. The increased tax revenue was due to higher revenue collection from all tax categories, except excise duty on motor vehicles, withholding tax and corporate and non corporate income taxes. However, substantial growth in collection of VAT, PAL and import duties contributed significantly for the growth in tax revenue. Revenue from indirect taxes remained as the major source of tax revenue in 2016 accounting for 82.3 per cent of total tax revenue. Meanwhile, revenue from direct taxes declined marginally in 2016 accounting only for 17.7 per cent of total tax revenue owing to a decline in revenue from corporate and non corporate income taxes and withholding tax. The share of tax revenue in total revenue declined to 86.8 per cent in 2016 from 93.2 per cent recorded in the previous year reflecting a substantial increase in non tax revenue collection.

Revenue from income taxes declined both in terms of GDP and in nominal terms resulting from lower tax revenue from corporate and non corporate income tax and withholding tax. Accordingly, revenue from income taxes as a percentage of GDP declined to 2.2 per cent in 2016 from 2.4 per cent recorded in 2015 while in nominal terms, it declined moderately by 1.4 per cent to Rs. 258.9 billion from Rs. 262.6 billion in the previous year. Accordingly, revenue from corporate and non corporate income tax declined by 7.8 per cent to Rs. 154.3 billion in 2016 from Rs. 167.3 billion recorded in the previous year. This was mainly due to the capturing of profit making business into ESC liability such that ESC tax credit given against the income tax payables, thereby declining the corporate and non corporate income tax while increasing ESC revenue collection. Revenue from PAYE tax increased by 7.5 per cent in 2016 to Rs. 28.2 billion as a result of enhanced compliance with the initiation of RAMIS at IRD. Meanwhile, revenue from ESC increased substantially to Rs. 20.5 billion from Rs. 6.1 billion in 2015 as a result of the increase in the ESC rate to 0.5 per cent from 0.25 per cent combined with the extension of the ESC coverage to profit making businesses, of which the turnover of a quarter exceeds Rs. 50 million. However, revenue from withholding tax declined by 11.1 per cent to Rs. 55.9 billion, reflecting the reduction in the volume of government security issuances during the year.

Revenue from VAT increased in 2016, both as a per cent of GDP and in nominal terms. This was mainly in response to the increase in the VAT rate to 15 per cent from 11 per cent, expansion of the VAT base by removing several exemptions

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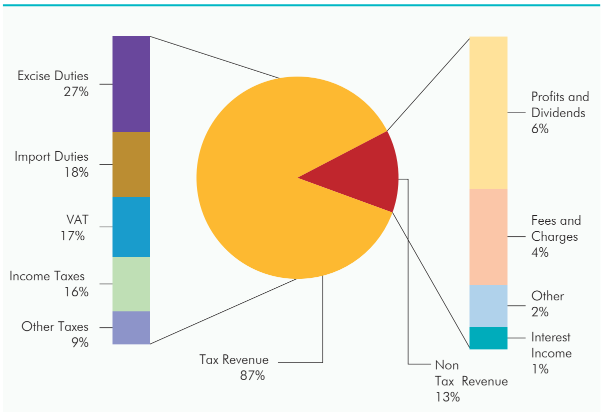
Chart 6.2
Composition of Government Revenue - 2016



Source: Ministry of Finance

granted under VAT and enhanced compliance with the initiation of RAMIS system. Accordingly, revenue from VAT as a per cent of GDP increased to 2.4 per cent in 2016 from 2.0 per cent in 2015, while in nominal terms, it increased by 29.0 per cent to Rs. 283.5 billion compared to Rs. 219.7 billion in the previous year. VAT revenue generated from domestic economic activities increased by 28.8 per cent to Rs. 168.1 billion and as a per cent of GDP it increased to 1.4 per cent from 1.2 per cent recorded in the previous year. In addition, revenue from VAT on imports also increased significantly by 29.3 per cent to Rs. 115.3 billion in 2016 from Rs. 89.2 billion recorded in the previous year, as a result of above changes.

Revenue from excise duties, which is the largest single contributor to the total tax revenue, declined in 2016 mainly due to the decline in excise tax revenue from motor vehicle imports. The share of excise tax revenue to total tax revenue in 2016 reduced to 31.1 per cent in comparison to the 36.7 per cent recorded in 2015 led by the decline in importation of motor vehicles. Accordingly, in nominal terms, revenue from excise duties declined by 8.6 per cent to Rs. 454.9 billion in 2016 from Rs. 497.7 billion in 2015 while as a per cent of GDP, it declined significantly to 3.8 per cent from 4.5 per cent in 2015. However, excise tax on liquor, cigarettes and petroleum products increased by 14.2 per cent to Rs. 120.2 billion, 11.0 per cent to Rs. 88.8 billion and 23.6 per cent to Rs. 55.7 billion, respectively as a result of upward revision of excise tax rates on those products. However, revenue from excise tax on motor vehicles declined significantly by 29.2 per cent in 2016 to Rs. 186.5 billion from Rs. 263.5 billion responding mainly to policy measures adopted by the government to curtail vehicle imports. These include increasing taxes on selected motor vehicles and introducing a new valuation method for motor vehicles for the purpose of calculating excise duty, and imposing a maximum loan to value ratio (LTV) on loans and advances granted for the purpose of purchase or utilisation of motor vehicles starting from the latter part of 2015.

Table 6.2
Economic Classification of Government Revenue

Item	2015	2016 Approved Estimates	2016 Provisional	2017 Approved Estimates
	Rs. million			
Tax Revenue	1,355,779	1,646,000	1,463,689	1,827,000
Income Taxes	262,583	251,700	258,857	334,550
VAT	219,700	240,000	283,470	380,000
Excise Taxes	497,652	556,235	454,952	579,035
Import Duties	132,189	125,000	156,487	165,500
Other Taxes	243,655	473,065	309,924	367,915
Non Tax Revenue	99,099	176,970	222,374	183,300
Total Revenue	1,454,878	1,822,970	1,686,062	2,010,300
	As a percentage of GDP (a)			
Tax Revenue	12.4	13.2	12.4	13.5
Income Taxes	2.4	2.0	2.2	2.5
VAT	2.0	1.9	2.4	2.8
Excise Taxes	4.5	4.4	3.8	4.3
Import Duties	1.2	1.0	1.3	1.2
Other Taxes	2.2	3.8	2.6	2.7
Non Tax Revenue	0.9	1.4	1.9	1.4
Total Revenue	13.3	14.6	14.2	14.9

(a) Based on revised GDP estimates for 2015 made by the Department of Census and Statistics available on 15.03.2017.

Source: Ministry of Finance

Revenue collection from import duties and SCL also increased to 1.8 per cent of GDP in 2016 compared to 1.7 per cent in 2015. In nominal terms, revenue from import duties increased by 18.4 per cent to Rs. 156.5 billion, while revenue from SCL increased by 6.8 per cent to Rs. 55.8 billion from Rs. 52.3 billion recorded in the previous year. Increase in import duty rates applicable on certain articles, changes made to Customs duty waivers and the introduction of a three band tariff structure in 2015 caused the increase in import duty collection. Increase in revenue from SCL was mainly attributable to the extension of SCL liability and time to time revisions made by the government to the SCL considering domestic

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market demand and supply conditions. The share of import duty in tax revenue increased to 10.7 per cent in 2016 from 9.8 per cent recorded in 2015 while, the share of SCL in tax revenue declined marginally to 3.8 per cent during the year from 3.9 per cent recorded in the previous year.

Revenue from all other taxes increased in nominal terms in 2016. Accordingly, revenue from PAL increased significantly by 51.5 per cent to Rs. 88.8 billion due to the increase in the PAL rate to 7.5 per cent from 5.0 per cent with effect from 01 January 2016. Revenue from Cess increased by 33.4 per cent to Rs. 61.7 billion owing to the increase in Cess rates applicable on several products, including garments and footwear. Revenue from NBT in nominal terms increased significantly by 27.6 per cent to Rs. 57.4 billion reflecting the increase in revenue from both NBT on domestic economic activities and NBT on import related activities. Removal of exemptions granted on several services and improvements in economic activities together with higher import volumes, contributed to the growth in revenue from NBT. Revenue from the Telecommunication levy increased in nominal terms by 7.8 per cent to Rs. 35.9 billion during the year, on account of the expansion in telecommunication related activities and the rate increase in both Telecommunication levy on internet services and International Telecommunication Operators' Levy. Further, revenue from PAL as a percentage of GDP increased to 0.8 per cent from 0.5 per cent in 2015, while revenue from Cess increased to 0.5 per cent of GDP from 0.4 per cent of GDP in 2015. Revenue from NBT also increased to 0.5 per cent of GDP during the year from 0.4 per cent of GDP in the previous year.

Non tax revenue to GDP ratio increased to 1.9 per cent in 2016 from 0.9 per cent recorded in 2015, while in nominal terms, it increased by more than two fold to Rs. 222.4 billion from Rs. 99.1 billion in 2015. The increase in profit and dividend transfers from SOBEs, followed by fees and charges, mainly contributed to this increase. Revenue collection from profit and dividend transfers of SOBEs increased significantly during the year by more than threefold to Rs. 108.2 billion from Rs. 29.8 billion in 2015 as a result of the improved performance of SOBEs in banking and insurance, Ceylon Petroleum Corporation (CPC), Ceylon Electricity Board (CEB) and TRC. Meanwhile, revenue from fees and charges increased to Rs. 68.4 billion from Rs. 42.4 billion in 2015 mainly due to increase in embarkation levy, passport and visa fee. Non tax revenue from other sources, such as social security contribution, interest and rent, also increased in 2016. Consequently, the share of non tax revenue in total revenue increased significantly to 13.2 per cent from 6.8 per cent recorded in 2015.

Grants

Total foreign grants disbursed during the year increased to Rs. 7.5 billion in 2016 from Rs. 6.0 billion in 2015, although it was considerably below the annual estimate of Rs. 15.0 billion. Grants received from multilateral development partners increased by 16.4 per cent to Rs. 5.1 billion in 2016 from Rs. 4.4 billion recorded in 2015. Meanwhile, the share of grants from multilateral sources in total grants declined to 68.4 per cent in 2016 from 73.2 per cent in 2015. However, grants from bilateral sources increased significantly to Rs. 2.4 billion in 2016 from Rs. 1.6 billion in the previous year. Major development partners who also provided grants during the year were International Development Association (IDA), World Bank and Germany.

Expenditure and Net Lending

Total expenditure and net lending as a percentage of GDP declined to 19.7 per cent in 2016 from 20.9 per cent in 2015 due to the decline in both recurrent expenditure, and capital expenditure and net lending. This was an outcome of continuous efforts taken by the government to curtail recurrent expenditure as well as to streamline capital expenditure. Accordingly, the decline in total expenditure and net lending was a combined outcome of the decline in both recurrent expenditure by 0.7 percentage points to 14.8 per cent and capital expenditure and net lending by 0.5 percentage points to 4.9 per cent of GDP. However, in nominal terms, total expenditure and net lending increased by 1.9 per cent to Rs. 2,333.9 billion in 2016 from Rs. 2,290.4 billion in 2015. Public investment, which amounted to 5.0 per cent of GDP in 2016, was significantly lower than 5.5 per cent of GDP recorded in 2015.

Recurrent expenditure as a percentage of GDP declined to 14.8 per cent in 2016 from 15.5 per cent in 2015. A decline in all major recurrent expenditure categories contributed to this development except interest payments. However, in nominal terms, recurrent expenditure increased by 3.3 per cent to Rs. 1,757.8 billion in 2016 from Rs. 1,701.7 billion in 2015. Increase in interest payments mainly contributed to the increase in recurrent expenditure in nominal terms, followed by increase in expenditure on salaries and wages.

In 2016, interest payments as a percentage of GDP increased to 5.2 per cent from 4.7 per cent in the previous year. In nominal terms, interest expenditure increased by 19.9 per cent to Rs. 610.9 billion in 2016 from Rs. 509.7 billion in 2015 mainly due to the relatively higher interest rates that prevailed in the domestic as well as in the international markets and the depreciation of the Sri Lankan rupee against major foreign currencies. The interest payments on domestic debt increased by 22.8 per cent in 2016 to Rs. 484.2 billion from Rs. 394.3 billion in 2015, mainly due to an increase in outstanding domestic debt stock by 7.7 per cent to Rs. 5,341.5 billion as at end 2016, coupled with the increase in average interest rate on domestic debt. Meanwhile, interest payments on Treasury bonds increased by 20.6 per cent to Rs. 356.8 billion in 2016 from Rs. 295.8 billion in 2015 as a result of the increase in domestic market interest rates and the increase in Treasury bond stock by 12.4 per cent as at end 2016. Interest payments on Treasury bills increased by 36.5 per cent to Rs. 78.8 billion in 2016 from Rs. 57.7 billion in 2015, mainly due to the increase in interest rates in the domestic market. In addition, interest payments on Sri Lanka Development Bonds (SLDBs) and Rupee loans amounted to Rs. 33.4 billion and Rs. 2.9 billion, respectively, in 2016. Consequently, the share of interest payments on domestic debt in total interest payments increased to 79.3 per cent in 2016 compared to 77.4 per cent in the previous year. Meanwhile, interest payments on foreign debt increased by 9.8 per cent to Rs. 126.7 billion in 2016 from Rs. 115.4 billion in 2015 mainly due to the increase in the foreign debt stock by 14.2 per cent as at end 2016. Interest payments became the single largest recurrent expenditure item, accounting for 34.8 per cent of total recurrent expenditure and 36.2 per cent of government revenue during 2016.

Expenditure on salaries and wages declined to 4.9 per cent of GDP in 2016 from 5.1 per cent of GDP in 2015, although in nominal terms it increased by 2.6 per cent to Rs. 576.5 billion. Salaries and wages paid to central government employees, including defence personnel, increased by 5.3 per cent to Rs. 432.7 billion mainly due to increase in overtime and other allowances as a result of the commencement of the conversion

Table 6.3
Economic Classification of Expenditure and Lending Minus Repayments

Item	2015	2016 Approved Estimates	2016 Provisional	2017 Approved Estimates
	Rs. million			
Recurrent Expenditure	1,701,658	1,717,239	1,757,782	1,946,000
Expenditure on Goods and Services	772,563	757,722	746,250	838,336
o/w Salaries and Wages	561,730	581,341	576,471	615,000
Interest Payments	509,674	520,452	610,895	680,087
Foreign	115,386	79,233	126,713	123,291
Domestic	394,289	441,219	484,182	556,796
Current Transfers and Subsidies	419,420	439,065	400,637	427,577
o/w To Households and Other Sectors	345,483	371,392	317,153	358,613
Samurdhi	39,994	43,950	40,740	43,950
Pensions	155,320	167,845	171,903	180,830
Fertiliser Subsidy	49,571	35,000	27,771	36,500
Other	100,598	124,597	76,739	97,333
Capital Expenditure	588,175	859,482	577,036	697,780
Acquisition of Real Assets	313,260	622,066	328,202	502,035
Capital Transfers	274,916	237,416	248,834	195,745
Lending Minus Repayments	561	1,399	-934	1,520
Total Expenditure and Net Lending	2,290,394	2,578,119	2,333,883	2,645,300
	As a percentage of GDP (a)			
Recurrent Expenditure	15.5	13.7	14.8	14.4
Expenditure on Goods and Services	7.1	6.1	6.3	6.2
o/w Salaries and Wages	5.1	4.7	4.9	4.6
Interest Payments	4.7	4.2	5.2	5.0
Foreign	1.1	0.6	1.1	0.9
Domestic	3.6	3.5	4.1	4.1
Current Transfers and Subsidies	3.8	3.5	3.4	3.2
o/w To Households and Other Sectors	3.2	3.0	2.7	2.7
Samurdhi	0.4	0.4	0.3	0.3
Pensions	1.4	1.3	1.5	1.3
Fertiliser Subsidy	0.5	0.3	0.2	0.3
Other	0.9	1.0	0.6	0.7
Capital Expenditure	5.4	6.9	4.9	5.2
Acquisition of Real Assets	2.9	5.0	2.8	3.7
Capital Transfers	2.5	1.9	2.1	1.4
Lending Minus Repayments	...	...	...	...
Total Expenditure and Net Lending	20.9	20.6	19.7	19.6

(a) Based on revised GDP estimates for 2015 made by the Department of Census and Statistics available on 15.03.2017.

Source : Ministry of Finance

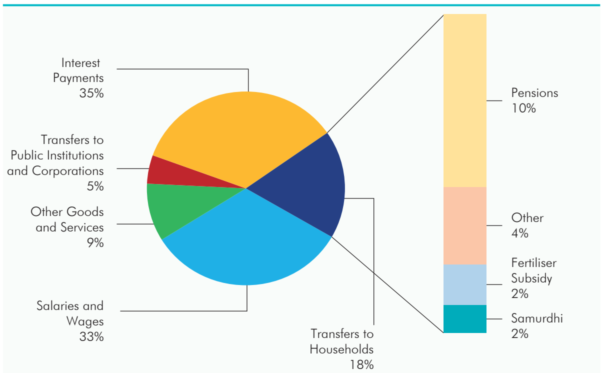
of interim allowance to the basic salary with the implementation of the new salary structure from 01 January 2016 for public sector employees. The share of salaries and wages in total recurrent expenditure accounted for 32.8 per cent in 2016 compared to 33.0 per cent in 2015 and accounted for the second largest recurrent expenditure item.

Expenditure on other goods and services as a percentage of GDP declined to 1.4 per cent in 2016 from 1.9 per cent in 2015. Similarly, in nominal terms also, it declined by 19.5 per cent to Rs. 169.8 billion in 2016. This was mainly due to government efforts to rationalise recurrent expenditure on other goods and services. Expenditure incurred on other goods and services by the central government and defence, including public order and safety, declined by 24.3 per cent to Rs. 144.4 billion in 2016 from Rs. 190.9 billion in 2015. This accounted for 85.1 per cent of total expenditure on other goods and services during the year.

Total current transfers and subsidies as a percentage of GDP declined to 3.4 per cent in 2016 from 3.8 per cent in 2015 mainly due to the decline in current transfers to households. Similarly, in nominal terms, current transfers and subsidies also declined by 4.5 per cent to Rs. 400.6 billion in 2016 in comparison to Rs. 419.4 billion recorded in 2015, partly due to the streamlining of welfare programmes in line with ongoing fiscal consolidation efforts. Current transfers to households and other sectors accounted for 79.2 per cent of total current transfers, while transfers to public institutions and public corporations accounted for 12.5 per cent and 8.3 per cent, respectively, during 2016.

Current transfers to households, including pension payments, declined to 2.7 per cent of GDP in 2016 from 3.2 per cent in 2015. In nominal terms, current transfers to households declined by 8.2 per cent to Rs. 317.2 billion in

Chart 6.3
Composition of Government Recurrent Expenditure - 2016



Source: Ministry of Finance

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2016 from Rs. 345.5 billion in 2015. Out of this, pension payments, the largest item under transfers to households, increased by 10.7 per cent to Rs. 171.9 billion compared to Rs. 155.3 billion in 2015 due to the conversion of the salary of the government employees to new salary scales as per Public Administration Circular No. 03/2016 and increase in the number of pensioners during the year by 18,915 to 579,414. Expenditure on fertiliser subsidy declined significantly by 44.0 per cent to Rs. 27.8 billion in 2016 from Rs. 49.6 billion in 2015 mainly due to government efforts to rationalise expenditure by converting the fertiliser subsidy to an allowance of Rs. 25,000 per hectare up to a maximum of two hectares per paddy farmer per annum in place of the provision of 50 kg bag of fertiliser at Rs. 350. Expenditure on providing school uniforms declined by 4.6 per cent to Rs. 2.2 billion due to cost streamlining measures implemented by the government in 2016. Providing cash vouchers from 2016 instead of the provision of uniform material reduced the cost incurred by the government for packaging, storing and delivering material. Expenditure on Samurdhi programme increased marginally by 1.9 per cent to Rs. 40.7 billion during the year compared to Rs. 40.0 billion recorded in the previous year. In addition, expenditure on welfare programmes for disabled soldiers increased by 13.9 per cent to Rs. 26.7 billion in 2016 from Rs. 23.4 billion in 2015. Programmes targeting school children, such as the provision of school textbooks and the nutrition programme, were among the other major subsidies provided to households during 2016.

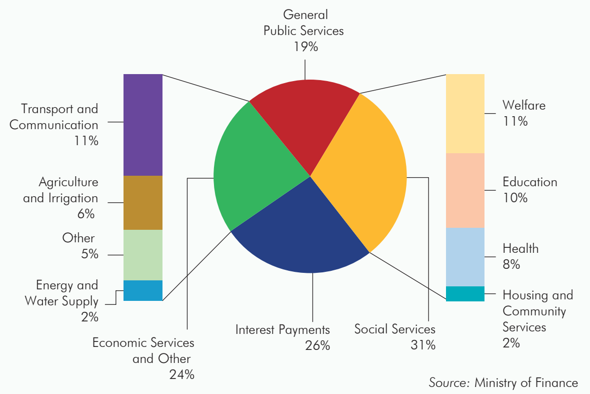
Table 6.4
Functional Classification of Expenditure

Item	2015	2016 Approved Estimates	2016 Provisional	2017 Approved Estimates
	Rs. million			
Recurrent Expenditure	1,701,658	1,717,239	1,757,782	1,946,000
General Public Services	414,275	434,415	408,176	464,881
Civil Administration	105,661	113,983	104,519	154,085
Defence	233,733	237,040	224,315	231,081
Public Order and Safety	74,881	83,392	79,343	79,715
Social Services	564,190	606,323	607,626	620,903
Education	169,600	178,938	179,319	175,097
Health	140,560	155,202	155,402	152,860
Welfare	230,035	247,650	251,490	264,585
Community Services	23,995	24,532	21,415	28,361
Economic Services	173,430	133,621	129,435	131,054
Agriculture and Irrigation	91,267	70,047	63,787	73,989
Energy and Water Supply	5,479	1,343	1,334	2,940
Transport and Communication	57,028	49,839	48,959	33,856
Other	19,656	12,391	15,354	20,269
Other	549,763	542,881	612,544	729,161
o/w Interest Payment	509,674	520,452	610,895	680,087
Capital Expenditure and Lending	602,767	869,880	594,013	708,300
General Public Services	48,699	52,779	50,504	86,087
Civil Administration	44,886	46,314	46,128	74,539
Public Order and Safety	3,813	6,465	4,376	11,548
Social Services	124,369	289,355	117,297	183,170
Education	55,447	156,492	58,971	90,873
Health	37,230	78,950	30,747	46,843
Housing	7,811	9,939	7,152	9,263
Community Services	23,882	43,975	20,426	36,191
Economic Services	429,030	525,578	424,021	437,428
Agriculture and Irrigation	54,447	128,993	68,990	79,121
Energy and Water Supply	55,499	49,529	48,840	32,685
Transport and Communication	239,279	207,413	200,478	165,827
Other	79,805	139,643	105,713	159,795
Other	668	2,167	2,191	1,615
Total Expenditure and Lending	2,304,425	2,587,119	2,351,795	2,654,300
	As a percentage of GDP (a)			
General Public Services	4.2	3.9	3.9	4.1
Social Services	6.3	7.2	6.1	6.0
Economic Services	5.5	5.3	4.7	4.2
Other	5.0	4.4	5.2	5.4
o/w Interest Payment	4.7	4.2	5.2	5.0
Total Expenditure and Lending	21.0	20.7	19.9	19.7

(a) Based on revised GDP estimates for 2015 made by the Department of Census and Statistics available on 15.03.2017.

Source : Ministry of Finance

Chart 6.4
Total Expenditure by Function - 2016



Source: Ministry of Finance

Current transfers to public institutions as well as public corporations increased during the year. Current transfers to public institutions increased by 9.2 percent to Rs. 50.3 billion during

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the year due to the increase in current transfers to the education sector. Further, current transfers to public corporations also increased by 18.9 per cent to Rs. 33.2 billion due to transfers provided to cover operational losses of the Department of Sri Lanka Railways and the Department of Posts.

Capital expenditure and net lending as a percentage of GDP declined to 4.9 per cent from 5.4 per cent in the previous year, due to the slowdown in public investments during the year. In nominal terms, capital expenditure and net lending declined by 2.1 per cent to Rs. 576.1 billion during the year in comparison to Rs. 588.7 billion recorded in the previous year. Meanwhile, public investment, which includes capital expenditure and lending of the government, declined to 5.0 per cent of GDP in 2016 from 5.5 per cent of GDP in 2015, while in nominal terms, it declined by 1.5 per cent to Rs. 594.0 billion in 2016 in comparison to Rs. 602.8 billion recorded in 2015. Expenditure incurred by Ministries and Departments on the acquisition of real assets (purchase of capital assets, and construction and development of fixed assets) increased by 4.8 per cent to Rs. 328.2 billion in 2016 from Rs. 313.3 billion in 2015. Capital transfers declined by 9.5 per cent mainly due to the significant decline in capital transfers to public corporations. Meanwhile, on lending of the government to public corporations increased by 16.3 per cent to Rs. 17.0 billion in 2016 in comparison to Rs. 14.6 billion recorded in 2015

Public investment in economic and social services continued during the year and amounted to Rs. 424.0 billion and Rs. 117.3 billion, respectively in 2016. A significant amount of investments was made in the areas of roads, bridges, railways, water supply, power and energy and irrigation projects. Further, public investment in education was directed towards the development of education infrastructure, specially under the "1000 secondary school development programme" and "The Nearest School is the Best School Programme", upgrading and modernising secondary education, improving of general education in Northern and Eastern provinces and uplifting university infrastructure. Meanwhile, public investment in the health sector focused mainly on the construction and improvement of hospitals and supply of lab equipment during the year. Further, the government continued the implementation of several regional and rural infrastructure development projects in order to reduce regional disparities.

Key Fiscal Balances

Reflecting a notable improvement in the fiscal sector, the overall budget deficit, as a per cent of GDP, declined to 5.4 per cent in 2016 compared to 7.6 per cent recorded in the previous year. Improvements in both revenue and expenditure fronts contributed to this noteworthy achievement. There was a sustainable increase in government revenue, while overall expenditure was maintained close to the 2015 level thereby narrowing the government's resource gap and reducing the government's financing requirement. These favourable developments were also reflected in other fiscal indicators as well. Accordingly, the current account deficit, which indicates the government's dissaving position, declined to 0.6 per cent of GDP in 2016, which was significantly below the deficit of 2.3 per cent recorded in 2015. This achievement was attributable to the higher growth in revenue collection compared to the marginal increase in the recurrent expenditure. In line with this, the primary deficit, which is calculated excluding interest payments from the overall deficit that reflects the discretionary fiscal policy component of the government, also declined to 0.2 per cent of GDP from 2.9 per cent recorded in 2015. The negative growth of 3.3 per cent in the non interest expenditure, together with high growth of 15.9 per cent in revenue and grants contributed to this significant decline.

Financing the Budget Deficit

In 2016, the overall budget deficit of Rs. 640.3 billion was largely financed through foreign sources. Accordingly, foreign financing contributed to around 61.2 per cent of the total financing requirement in 2016 compared to 28.5 per cent in the previous year, while the balance was financed through domestic sources. Consequently, net domestic financing in 2016 amounted to Rs. 248.4 billion compared to Rs. 592.7 billion in the previous year and net foreign financing amounted to Rs. 391.9 billion compared to Rs. 236.8 billion recorded for 2015.

With respect to the composition of net domestic financing, the government relied more on banking sector borrowings than borrowings from the non banking sector in 2016. However, borrowings from both banking and non banking sectors declined significantly in 2016 in comparison to the previous year due to greater reliance on foreign financing. Government financing from the banking sector, which accounted for 56.3 per cent of net domestic financing, reflected a decline of 52.0

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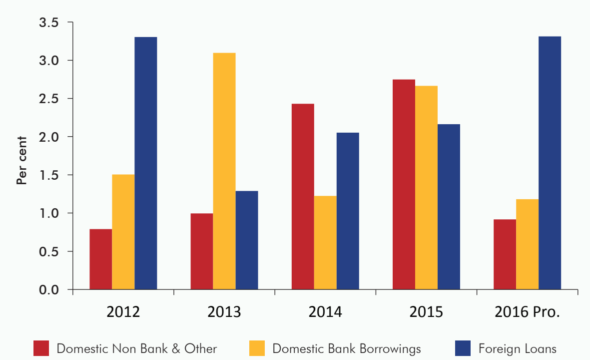
Chart 6.5
Deficit Financing
(as a percentage of GDP)



Sources: Ministry of Finance
Central Bank of Sri Lanka

Table 6.5
Sources of Domestic Financing

Rs. billion

Item	2013	2014	2015	2016 Provisional
By Instrument	**392.4**	**378.7**	**592.7**	**248.4**
Treasury Bonds (a)	252.1	369.1	442.6	349.8
Treasury Bills (b)	53.5	26.1	-26.4	98.5
Rupee Loans	-2.9	-	-31.4	-
Sri Lanka Development Bonds	140.3	21.0	223.0	-120.5
Central Bank Provisional Advances	-2.1	34.7	7.2	-67.8
Other	-48.5	-72.2	-22.3	-11.5
By Source	**392.4**	**378.7**	**592.7**	**248.4**
Bank	297.0	126.9	291.8	140.0
Non Bank	95.4	251.8	300.9	108.5

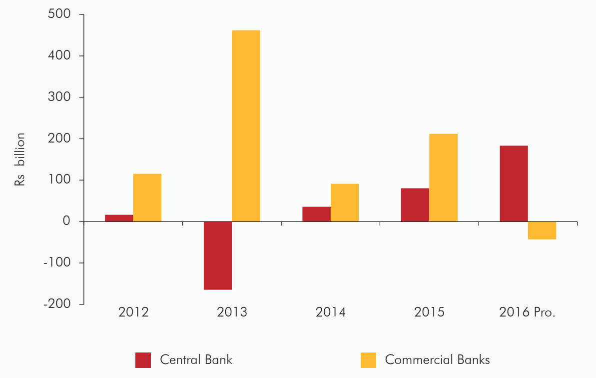
(a) Excludes rupee denominated Treasury bonds issued to foreign investors and funds raised for restructuring of SOBEs in 2014 and 2015.
(b) Excludes rupee denominated Treasury bills issued to foreign investors.

Sources: Ministry of Finance
Central Bank of Sri Lanka

per cent to Rs. 140.0 billion in 2016 in comparison to Rs. 291.8 billion in 2015 and the annual estimate of Rs. 182.0 billion for 2016. There was a net repayment of Rs. 43.1 billion to the commercial bank sector in comparison to the borrowing of Rs. 211.6 billion in 2015. Borrowings from commercial banks through Treasury bills and SLDBs declined significantly while borrowings through Treasury bonds increased significantly. The decline in borrowings from commercial banks was offset by the notable increase in borrowing from the Central Bank, amounting to Rs. 183.1 billion compared to Rs. 80.3 billion in the previous year. Net borrowings from the Central Bank increased mainly through Treasury bills amidst a net repayment recorded in provisional advances. Meanwhile, financing from the non banking sector amounted to Rs. 108.5 billion in 2016, representing a lower share of 43.7 per cent of total net domestic financing, compared to Rs. 300.9 billion recorded in 2015.

Government net borrowings by way of both instruments and non instruments declined significantly during 2016. Accordingly, net borrowings by way of debt instruments declined by 46.1 per cent to Rs. 327.8 billion in 2016 from Rs. 607.7 billion recorded in 2015. Borrowings

Chart 6.6
Sources of Bank Financing



Sources: Ministry of Finance
Central Bank of Sri Lanka

through Treasury bills increased to Rs. 98.5 billion in 2016 from a net repayment of Rs. 26.4 billion recorded in 2015, while borrowings through Treasury bonds declined to Rs. 349.8 billion from Rs. 442.6 billion recorded in the previous year. Meanwhile, net borrowings through SLDBs during the year amounted to a net repayment of Rs. 120.5 billion in comparison to Rs. 223.0 billion recorded in 2015. However, there were no borrowings through rupee loans in 2016 compared to a net repayment recorded in 2015 amounting to Rs. 31.4 billion. The non instrument borrowings in the total net borrowings recorded a net repayment of Rs. 79.4 billion during the year mainly due to the net repayments recorded in provisional advances and commercial bank overdrafts.

Foreign currency denominated domestic borrowings declined substantially in 2016 due to the significant repayment of SLDBs. Gross borrowings from SLDBs with maturity periods ranging from 1 to 2 years amounted to Rs. 197.0 billion (US dollars 1,365.9 million), while gross repayment was Rs. 317.5 billion (US dollars 2,186.2 million), resulting in a net repayment of Rs. 120.5 billion. Meanwhile, borrowings from offshore banking units (OBUs) of commercial banks recorded a net repayment of Rs. 7.3 billion during the year. Overall, net foreign currency borrowings from domestic sources recorded a repayment of Rs. 127.8 billion in 2016 compared to the borrowings of Rs. 223.0 billion in 2015. Meanwhile, rupee denominated net domestic financing amounted to Rs. 376.2 billion in 2016 compared to Rs. 369.7 billion recorded in the previous year.

Net financing from foreign sources increased during 2016 largely due to the issuance of 10th ISB, FTFF loans and a few programme loans obtained during the year. Accordingly, net foreign financing increased significantly by 65.5 per cent to Rs. 391.9 billion in 2016 from Rs. 236.8 billion in 2015. Consequently, the share of net foreign financing in total financing increased notably to 61.2 per cent in 2016 from 28.5 per cent in 2015. Net borrowings through ISBs amounted to Rs. 217.9 billion (US dollars 1,500 million) in comparison to Rs. 232.8 billion (i.e. the difference between US dollars 2.15 billion borrowings and US dollars 500 million repayment) recorded in the previous year. The funds raised from FTFF loans was Rs. 101.8 billion (US dollars 700 million), while programme loans amounted to Rs. 42.3 billion (Us dollars 286.8 million) in 2016. However, net financing from foreign project loans from bilateral and multilateral sources declined significantly to Rs. 67.0 billion in 2016 compared to Rs. 131.3 billion in the previous year. Gross borrowings from project loans amounted to Rs. 212.3 billion, while repayments were Rs. 145.3 billion. On gross basis, Export-Import Bank of China (Exim Bank), IDA, the government of Japan and Asian Development Bank (ADB) were the major sources of foreign financing in 2016. A net outflow of Rs. 44.3 billion was recorded in respect of foreign holdings of Treasury bonds, while net foreign investments in Treasury bills amounted to Rs. 7.2 billion during the year.

6.4 Government Debt and Debt Service Payments

Government Debt

As at the end of 2016, government debt to GDP ratio increased to 79.3 per cent from 77.6 per cent recorded at the end of 2015. Increased net borrowings and lower nominal GDP growth rate were the main reasons for the increase in debt to GDP ratio in 2016 despite the substantial decline in the overall budget deficit as a percentage of GDP. The domestic debt to GDP ratio declined marginally to 45.1 per cent by end 2016 from 45.3 per cent recorded as at end 2015, while the foreign debt to GDP ratio increased to 34.2 per cent by end 2016 from 32.4 per cent in 2015. In nominal terms, total outstanding government debt increased only by 10.4 per cent to Rs. 9,387.3 billion in 2016 compared to the high growth of 15.0 per cent in 2015 and the last five year's average growth of 13.1 per cent. The increase in the total debt stock due to exchange rate variations amounted to Rs. 186.6 billion. The discount factor (which is the net difference in the book value and the face value of issues and maturities of Treasury bills and Treasury bonds) also contributed to the increase in the debt stock by Rs. 88.6 billion, due to the issuance of government securities largely at a discount during 2016.

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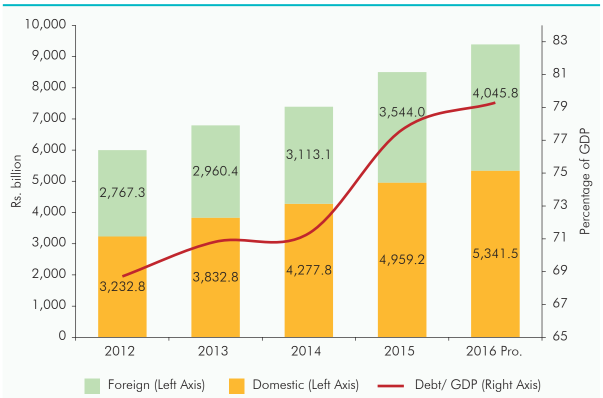
Chart 6.7
Outstanding Central Government Debt



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

The share of domestic debt in total government debt declined to 56.9 per cent at end 2016 from 58.3 per cent at end 2015 mainly due to the lower borrowings from domestic sources in 2016. Accordingly, the outstanding domestic debt increased only by 7.7 per cent to Rs. 5,341.5 billion as at end 2016 compared to the increase of 15.9 per cent in 2015. The share of short term debt to total domestic debt declined to 18.1 per cent at end 2016 from 18.4 per cent at end 2015, reflecting a decline in provisional advances from the Central Bank despite the increase in Treasury bills. Outstanding amount of provisional advances declined to Rs. 83.3 billion at end 2016 from Rs. 151.1 billion at end 2015, while Treasury bills held by domestic investors increased to Rs. 779.6 billion from Rs. 658.2 billion at end 2015, owing to the increase in the purchasing of Treasury bills by the Central Bank during the latter part of the year. In contrast, the share of medium to long

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

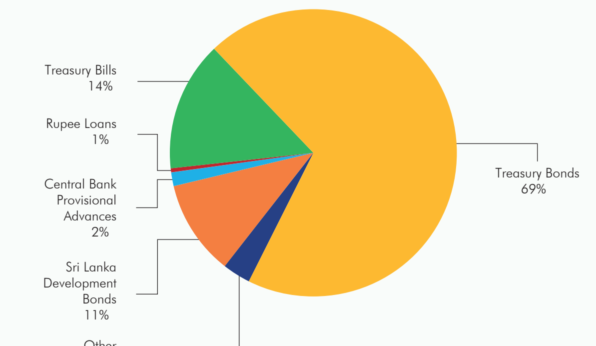
Rs. million

Item	2013	2014	2015	2016 Provisional
Total Government Debt	6,793,249	7,390,899	8,503,227	9,387,303
Domestic Debt (a)	3,832,825	4,277,783	4,959,196	5,341,507
By Maturity Period				
Short Term	909,156	941,162	913,291	968,396
Medium and Long Term	2,923,670	3,336,620	4,045,905	4,373,111
By Institution				
Bank	1,433,773	1,669,882	1,924,036	2,114,901
Non Bank	2,399,053	2,607,901	3,035,160	3,226,606
Foreign Debt	2,960,424	3,113,116	3,544,031	4,045,796
By Type				
Concessional Loans	1,492,842	1,490,978	1,729,895	1,897,680
Non Concessional Loans	460,475	457,668	507,047	538,859
Commercial (b)	1,007,107	1,164,470	1,307,089	1,609,257
By Currency				
SDR	711,935	679,835	734,552	755,614
US Dollars	1,009,937	1,292,052	1,733,790	2,207,431
Japanese Yen	485,325	429,638	470,109	496,852
Euro	185,606	162,743	181,084	183,561
Other	567,621	548,848	424,495	402,338
Memo: Exchange Rate Variation	-25,498	-90,230	228,731	161,697

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

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

Chart 6.8
Composition of Outstanding Domestic Debt - 2016



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

term debt to total domestic debt stock increased marginally to 81.9 per cent by end 2016 from 81.6 per cent recorded at end of 2015. Within the domestic debt category, the outstanding amount of Treasury bonds, which accounted for 69.5 per cent of total domestic debt in 2016, increased by 12.4 per cent to Rs. 3,714.8 billion at end 2016 from Rs. 3,305.2 billion at end 2015, reflecting higher reliance on Treasury bonds as a financing instrument compared to other medium to long term borrowings. Among other medium to long term debt instruments, rupee loan stock remained unchanged at Rs. 24.1 billion, while stock of SLDBs declined by 14.4 per cent to Rs. 572.2 billion at end 2016.

Reflecting higher reliance on bank borrowings, the share of banking sector debt increased while non bank sector debt decreased marginally. Accordingly, the share of banking sector and non bank sector debt as a percentage of total domestic debt amounted to 39.6 per cent and 60.4 per cent, respectively at end 2016, compared to 38.8 per cent and 61.2 per cent, respectively at end 2015. In nominal terms, outstanding banking sector in domestic debt increased by 9.9 per cent to Rs. 2,114.9 billion at end 2016, reflecting an increase in outstanding debt owned by the Central Bank and commercial banks by 62.1 per cent to Rs. 415.0 billion and by 1.9 per cent to Rs. 1,700.0 billion, respectively during the year. Treasury bills held by the Central Bank increased by more than two fold, while provisional advances declined significantly. Meanwhile, Treasury bonds held by commercial banks increased substantially by 41.4 per cent to Rs. 731.9 billion, while the stock of all other debt instruments declined.

Foreign currency denominated domestic debt declined to Rs. 602.2 billion (US dollars 4,019.8 million) by end 2016 from Rs. 690.1 billion (US dollars 4,790.1 million) at end 2015. The decline in net borrowings through SLDBs mainly contributed to the reduction in the foreign currency denominated domestic debt in 2016. Net borrowings through SLDBs declined by 14.4 per cent to Rs. 572.2 billion, while borrowings from OBUs increased by 38.6 per cent to Rs. 30.0 billion during the year. Meanwhile, rupee denominated domestic debt increased to Rs. 4,739.3 billion at end 2016 from Rs. 4,269.1 billion at end 2015.

Total outstanding foreign debt increased significantly by 14.2 per cent to Rs. 4,045.8 billion at end 2016. Increased borrowings from foreign sources to finance the budget deficit and the depreciation of the Sri Lanka rupee against major foreign currencies during the year were the main contributory factors for this increase. As

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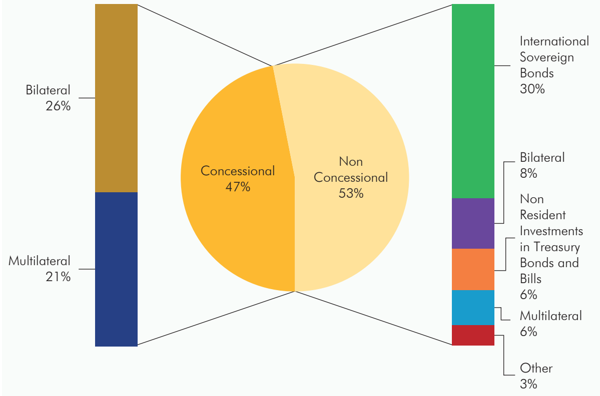
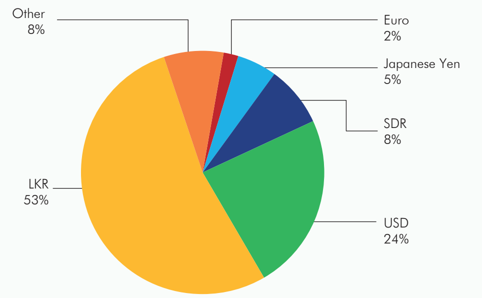
Chart 6.9
Composition of Outstanding Foreign Debt - 2016



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

Chart 6.10
Currency Composition of Total Outstanding Debt - 2016



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

at end 2016, concessional debt increased at a lower nominal rate of 9.7 per cent to Rs. 1,897.7 billion, accounting for 46.9 per cent of the total foreign debt stock compared to 48.8 per cent at end 2015. In contrast, non concessional debt increased at a higher nominal rate of 18.4 per cent to Rs. 2,148.1 billion. Consequently, the respective share of non concessional debt in the total foreign debt increased to 53.1 per cent at end 2016 from 51.2 per cent at end 2015. Increased commercial borrowings, largely on account of ISBs, contributed to the increase in non concessional debt in 2016.

The depreciation of the rupee against several major currencies resulted in an increase in the debt stock by Rs. 186.6 billion by end 2016. The Sri Lankan rupee depreciated by 3.8 per cent, 7.0 per cent, 1.7 per cent, 0.3 per cent and 0.9 per cent, respectively, against the US dollar, Japanese yen, Indian rupee, Euro and Special Drawing Rights (SDR), while it appreciated against the Sterling Pound by 16.0 per cent, during the year. The total outstanding foreign debt stock consisted of debt denominated in US dollars (54.6 per cent), SDR (18.7 per cent), Japanese yen (12.3 per cent), Euro (4.5 per cent) and other currencies (9.9 per cent) as at end 2016. Consequently, the outstanding foreign debt stock increased by Rs. 161.7 billion mainly due to the depreciation of the Sri Lankan rupee against major foreign currencies, while foreign currency denominated domestic debt (SLDBs and loans from OBUs) also increased by Rs. 24.9 billion due to the depreciation of the Sri Lanka rupee against the US dollar.

Debt Service Payments

Total debt service payments increased by 2.6 per cent in nominal terms to Rs. 1,352.4 billion in 2016 from Rs. 1,317.8 billion in 2015, reflecting a notable decline in particularly foreign amortisation payments. This decline was mainly attributable to the fact that there were no ISB maturities in 2016, as against the ISB maturity of US dollars 500 million in January 2015. Total amortisation payments, which accounts for 54.8 per cent of total debt service payments declined by 8.2 per cent (Rs. 66.6 billion) to Rs. 741.5 billion in 2016 compared to Rs. 808.1 billion in 2015. The interest payments increased by 19.9 per cent (Rs. 101.2 billion) to Rs. 610.9 billion in 2016 from Rs. 509.7 billion in 2015, mainly reflecting the relatively high interest rates. Debt service payments to domestic sources increased by 15.1 per cent (Rs. 138.5 billion) to Rs. 1,056.6 billion in 2016 compared to

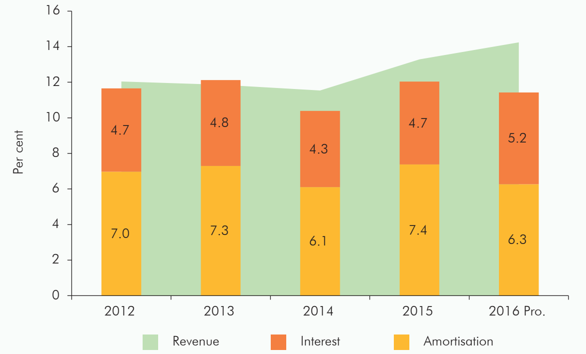
Table 6.7
Government Debt Service Payments

Rs. million

Item	2013	2014	2015	2016 Provisional
Debt Service Payments	**1,162,900**	**1,076,257**	**1,317,791**	**1,352,443**
Domestic	850,748	777,488	918,112	1,056,624
Foreign	312,152	298,769	399,679	295,820
Amortisation Payments	**700,035**	**632,662**	**808,117**	**741,549**
Domestic	496,042	449,554	523,824	572,442
Foreign	203,993	183,109	284,293	169,107
Interest Payments	**462,865**	**443,595**	**509,674**	**610,895**
Domestic	354,706	327,934	394,289	484,182
Short Term	69,712	78,811	57,728	78,787
Medium and Long Term	284,994	249,123	336,561	405,394
Foreign	108,159	115,660	115,386	126,713

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

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



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

Rs. 918.1 billion in 2015. This was a combined outcome of the increase in amortisation payments by Rs. 48.6 billion to Rs. 572.4 billion, driven by the higher repayments on SLDBs and the increase in interest payments by Rs. 89.9 billion to Rs. 484.2 billion owing to increased interest payments on Treasury bonds. However, debt service payments to foreign sources declined significantly by 26.0 per cent (Rs. 103.9 billion) to Rs. 295.8 billion in 2016, with the decline in amortisation payments on foreign loans by Rs. 115.2 billion to Rs. 169.1 billion. Interest payments on foreign debt increased by 9.8 per cent to Rs. 126.7 billion in 2016 mainly due to the increase in the stock of non concessional foreign borrowings.

Most of the debt service indicators showed improvements in 2016. Total debt service payments declined to 11.4 per cent of GDP in 2016 from 12.0 per cent of GDP in the previous year. Domestic amortisation payments to GDP ratio remained unchanged at 4.8 per cent in 2016, while foreign amortisation payments declined to 1.4 per cent in 2016 from 2.6 per cent in 2015. The total interest payments to GDP ratio increased to 5.2 per cent in 2016 from 4.7 per cent in 2015. Interest payments for domestic sources to GDP ratio increased to 4.1 per cent in 2016 from 3.6 per

Table 6.8
Central Government Debt Indicators

Indicator	2013	2014 (a)	2015 (a)	2016 Provisional
Central Government Debt/GDP	70.8	71.3	77.6	79.3
Domestic Debt/GDP	40.0	41.3	45.3	45.1
Foreign Debt/GDP	30.9	30.0	32.4	34.2
Total Foreign Debt/Exports (b)	151.9	142.5	154.4	159.3
Total Debt Service/GDP	12.1	10.4	12.0	11.4
Total Debt Service/Government Revenue (c)	102.2	90.0	90.6	80.2
o/w Domestic Debt Service/Government Revenue (c)	74.8	65.1	63.1	62.7
Total Debt Service/Government Expenditure (d)	49.1	44.3	42.5	44.0
o/w Domestic Debt Service/Government Expenditure (d)	35.9	32.0	29.6	34.4
Foreign Debt Service/Exports (b)	16.0	13.7	17.4	11.6
Total Interest/GDP	4.8	4.2	4.7	5.2
Domestic Interest/GDP	3.7	3.2	3.6	4.1
Domestic Interest/Government Recurrent Expenditure	29.4	24.8	23.2	27.5
Foreign Interest/Exports (b)	5.5	5.0	5.0	5.0

(a) Based on revised GDP estimates for 2014 and 2015 made by the Department of Census and Statistics available on 15.03.2017.
(b) Export of goods and services
(c) Government revenue is in economic format
(d) Government expenditure includes amortisation payments

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

cent in 2015, while the foreign interest payments remained unchanged at 1.1 per cent of GDP in 2016 compared to the previous year. Moreover, the ratio of debt service payments to government revenue has also declined significantly to 80.2 per cent in 2016 from 90.6 per cent in 2015, reflecting the increase in government revenue during 2016.

Outstanding Debt of Major Public Nonfinancial Corporations

Outstanding debt of major public nonfinancial corporations, which includes outstanding debt to domestic banking sector and project related foreign debt, declined in 2016 with improved financial management in the respective institutions. Accordingly, total outstanding debt of major public nonfinancial corporations declined by 3.9 per cent to Rs. 827.4 billion at end 2016 from Rs. 861.1 billion at end 2015. Domestic debt of public nonfinancial corporations to domestic commercial banks declined by 5.3 per cent to Rs. 495.1 billion, which accounts for 59.8 per cent of the total outstanding debt of major nonfinancial corporations. Project related foreign debt also declined by 1.7 per cent to Rs. 332.3 billion. However, the relative share of project related foreign debt to total outstanding debt of major public nonfinancial corporations increased marginally to 40.2 per cent as at end 2016 from 39.3 per cent at end 2015. As a percentage of GDP, outstanding debt of major public nonfinancial corporations amounted to 7.0 per cent by end 2016, in comparison to 7.7 per cent in the previous year.

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

Corporation	2014	2015	2016 (a)
	Rs. million		
Domestic Debt (b)	**446,047**	**522,966**	**495,114**
Ceylon Electricity Board	47,384	35,812	30,875
Ceylon Fertiliser Corporation	30,593	23,833	27,861
Ceylon Petroleum Corporation	245,618	264,471	192,601
Colombo Commercial Fertiliser	13,342	10,208	13,655
National Housing Development Authority	4,777	4,739	4,134
Paddy Marketing Board	5,574	13,772	13,926
Road Development Authority	58,325	74,912	81,792
Sri Lankan Airlines	9,055	33,040	49,696
Sri Lanka Ports Authority	11,801	14,642	12,356
Other Corporations	19,578	47,537	68,217
Foreign Debt (c)	**308,673**	**338,064**	**332,305**
Airport and Aviation Services (Lanka) Ltd.	25,909	26,284	23,791
Ceylon Electricity Board	160,195	173,874	166,613
Sri Lanka Ports Authority	122,568	137,906	141,901
Total Debt of Public Nonfinancial Corporations	**754,720**	**861,030**	**827,419**
	As a percentage of GDP (d)		
Domestic Debt	**4.3**	**4.8**	**4.2**
Foreign Debt	**3.0**	**3.1**	**2.8**
Total Debt	**7.3**	**7.9**	**7.0**

(a) Provisional
(b) Outstanding amounts to domestic commercial banks
(c) Includes outstanding foreign project related loans.
(d) Based on revised GDP estimates for 2014 and 2015 made by the Department of Census and Statistics available on 15.03.2017.

Sources: Ministry of Finance
Central Bank of Sri Lanka

6.5 Budgetary Operations in Sub National Governments

Policy Direction and Measures taken by Sub National Governments

As in the previous years, the Ministry of Provincial Councils and Local Government (MPCLG) continued to play an important role in governance and development at the sub national government level in 2016. The sub national government system in Sri Lanka consists of nine Provincial Councils (PCs) and 335 Local Government authorities (LGs). As at end 2016, the LG system comprised of 23 Municipal Councils, 41 Urban Councils and 271 Pradesheeya Sabhas. The MPCLG continued to work closely with sub national government authorities while monitoring and effectively addressing their provincial level development needs. Accordingly, the MPCLG facilitated provincial level investments through effective donor coordination while providing enhanced management and development support to the PCs and LGs.

In the sub national government level, priority was given to continue road development projects and upgrading education and health facilities during the year. The Local Government Enhancement Sector Project (Pura Neguma programme) continued in 2016 with the objective of improving infrastructure services in selected local authority areas, with the implementation of water supply projects and improvement of Pradeshiya Sabha roads. Further, under this project, information technology based new systems were introduced in order to provide an upgraded service delivery to the general public in a timely manner. The Northern Roads Connectivity Project was implemented with a view to improving the connectivity of provincial roads. Project of Transforming School Education as the Foundation of a Knowledge Hub, Library

6

Development Programme and Second Health Sector Development Project were continued during the year in order to improve educational and health facilities. In addition, Greater Colombo Wastewater Management Project, Strengthening of Local Government – Pradeshiya Sabhas, North East Local Services Improvement Project, and several Township Development Programmes were also continued during the year. Moreover, the Construction of Rural Bridges programme and Iranamadu Irrigation Development Project were also continued during the year 2016.

The Finance Commission initiated several measures to enhance revenue collection at provincial level. Accordingly, a nine member Committee, headed by the Secretary of the Finance Commission, was established in order to develop an action plan for the enhancement of revenue in local authorities. The committee agreed to proceed with some workable solutions for matters such as strengthening procurement process, secretariat service at local level, tax avoidance, introducing new taxes, rates, acreage tax, transferring court fines, collection of arrears of income and new act on provincial and local government. Further, in 2016, the Finance Commission has agreed in principle to re-introduce a grant system in order to incentivise province wise revenue collection.

Budgetary Operations in Provincial Councils

Tax revenue collection of PCs continued to increase in 2016 as well. Total revenue of PCs increased by 13.4 per cent to Rs. 77.1 billion in 2016 from Rs. 68.0 billion in 2015 mainly due to increased stamp duty and NBT revenue transferred from the central government, while as a percentage of GDP, it increased to 0.7 per cent in 2016 from 0.6 per cent in 2015. Tax revenue increased by 12.7 per cent to Rs. 69.3 billion, while non tax revenue increased significantly by 20.0 per cent to Rs. 7.8 billion in 2016 compared to Rs. 6.5 billion in 2015. Revenue from stamp duty, which is the largest contributor to the total tax revenue of PCs, increased by 20.9 per cent to Rs. 32.6 billion in 2016 from Rs. 27.0 billion in 2015, reflecting the increased revenue collection from stamp duty on transferring deeds. NBT revenue transferred from the central government also increased by 14.7 per cent to Rs. 25.0 billion, on account of the removal of exemptions granted on several services and improvement in economic activities, while the revenue from license fees declined by 10.0 per cent to Rs. 9.6 billion in 2016. Revenue from stamp duty and NBT revenue transfers from the central government accounted for 47.1 per cent and 36.1 per cent of total tax revenue of PCs, respectively. The relative share of the Western Provincial Council on revenue collection increased marginally to 53.1 per cent in 2016 from 52.4 per cent in 2015. The Western Province was followed by the North Western and Central provinces accounting for 9.4 per cent and 8.7 per cent, respectively of the total revenue collection of PCs. Meanwhile, the relative share of the revenue collection of Southern Province declined notably to 8.3 per cent from 9.0 per cent during 2016.

Although recurrent expenditure of PCs increased by 5.2 per cent to Rs. 233.7 billion in 2016 from Rs. 222.2 billion in 2015, as a percentage of GDP, it remained unchanged at 2.0 per cent in 2016. The increase in recurrent expenditure was mainly due to the increase in personal emoluments by 6.5 per cent to Rs. 183.0 billion, which continued to be the single largest item in recurrent expenditure accounting for 78.3 per cent of the total recurrent expenditure of PCs. The education and health sectors absorbed nearly 90 per cent of the personal emoluments of PCs. On a functional basis, recurrent expenditure

Table 6.10
Budget Outturn for Provincial Councils

Item	2013	2014	2015 (a)	2016 Provisional
				Rs. million
Total Revenue	**49,648**	**59,133**	**67,972**	**77,063**
Tax Revenue	42,569	52,569	61,476	69,269
Non Tax Revenue	7,079	6,564	6,496	7,793
Total Expenditure	**185,241**	**216,824**	**269,586**	**273,615**
Recurrent Expenditure	156,066	172,131	222,223	233,698
o/w Personal Emoluments	117,806	131,162	171,871	183,039
Capital Expenditure	29,175	44,693	47,363	39,917
Central Government Transfers	**135,593**	**157,691**	**201,614**	**196,552**
Block Grants	108,801	126,144	167,551	169,106
Criteria Based Grants	2,264	3,392	3,753	3,035
Province Specific Development Grants	6,429	8,343	13,345	12,177
Foreign Grants for Special Projects	18,100	19,812	16,965	12,234

(a) Revised
Sources: Ministry of Finance
Ministry of Provincial Councils and Local Government

on social services increased by 5.2 per cent to Rs. 210.2 billion, while recurrent expenditure on Provincial administration and economic services also increased by 4.5 per cent and 4.6 per cent to Rs. 19.1 billion and Rs. 4.4 billion, respectively in 2016. In terms of total recurrent expenditure, the three highest spending PCs were Western, Central and Southern, accounting for 22.3 per cent, 12.4 per cent and 11.9 per cent, respectively.

In line with the ongoing fiscal consolidation process, with the prioritisation of public investment programmes, capital expenditure of PCs declined by 15.7 per cent to Rs. 39.9 billion in 2016 from Rs. 47.4 billion in 2015, mainly due to the decline in acquisition of capital goods and special projects by 36.9 per cent and 27.9 per cent, respectively. Similarly, as a percentage of GDP, capital expenditure of PCs declined to 0.3 per cent in 2016 from 0.5 per cent in 2015. Capital expenditure incurred on special projects in 2016 amounted to Rs. 12.2 billion, while Rs. 12.2 billion was also incurred on Province Specific Development Projects (PSDPs). Other provincial level investments were made mainly in the areas of acquisition of capital assets and capital transfers to local governments.

In 2016, central government transfers to PCs declined by 2.5 per cent to Rs. 196.6 billion. These transfers were in the form of block grants, Criteria Based Grants (CBGs), Province Specific Development Grants (PSDGs) and grants for special projects. Block grants, the major form of central government transfers to PCs, amounted to Rs. 169.1 billion, representing 86.0 per cent of the total transfers. These grants have been provided to meet the resource gap in the recurrent expenditure programme of PCs. Transfers under grants for special projects, PSDGs and CBGs amounted to Rs. 12.2 billion, Rs. 12.2 billion and Rs. 3.0 billion, respectively. Meanwhile, nearly 71.8 per cent of the expenditure of PCs was financed by transfers from the central government due to the limited scope available for PCs to raise revenue. Therefore, efforts for revenue mobilisation by PCs need to be encouraged to reduce the reliance of PCs on the central government budget.