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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR

A PROPOSED CREDIT

IN THE AMOUNT OF US$ 100 MILLION

TO

DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

FOR THE

COMPETITIVENESS, TRANSPARENCY AND FISCAL SUSTAINABILITY DEVELOPMENT POLICY FINANCING

June 30, 2016

Trade & Competitiveness Global Practice
Governance Global Practice
Macroeconomics & Fiscal Management Global Practice
Finance & Markets Global Practice
South Asia Region

DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

GOVERNMENT FISCAL YEAR
January 1st to December 31st

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of June 28, 2016)

Currency Unit	Sri Lankan Rupee
US$ 1.00	145 LKR
1 LKR	US$ 0.01

ABBREVIATIONS AND ACRONYMS

ASYCUDA	Automated System for Customs Data
BOI	Board of Investment
BOP	Balance of Payments
CAS	Country Assistance Strategy
CAT-DDO	Catastrophe Deferred Drawdown Option Development Policy Loan
CBSL	Central Bank of Sri Lanka
CPF	Country Partnership Framework
CPS	Country Partnership Strategy
DeMPA	Debt Management Performance Assessment
DMU	Debt Management Unit
DPF	Development Policy Financing
DPO	Development Policy Operation
EFF	Extended Fund Facility
EIA	Environmental Impact Assessment
MDGs	Millennium Development Goals
EU	European Union
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GNI	Gross National Income
GoSL	Government of Sri Lanka
HIES	Household Income and Expenditure Survey
IBRD	International Bank for Reconstruction and Development
ICR	Implementation Completion and Results Report
ICT	Information and Communication Technology
IDA	International Development Association
IFC	International Finance Corporation
IIA	International Investment Agreement
IMF	International Monetary Fund
INTOSAI	International Organization of Supreme Audit Institutions
IRD	Inland Revenue Department
ITMIS	Integrated Treasury Management Information System
LIC	Low Income Country
LKR	Sri Lankan rupee
LMIC	Lower Middle Income Country
MDAs	Ministries, Departments and Authorities
MIC	Middle Income Country
MIGA	Multilateral Investment Guarantee Agency
MOF	Ministry of Finance
MSME	Micro Small and Medium Enterprises
MTBF	Medium Term Budget Framework
NAD	National Agency for Development
NBT	Nation Building Tax
NPC	National Procurement Commission
NTFC	National Trade Facilitation Committee
OP	Operational Policy
OSS	One-Stop-Shop
PDO	Program Development Objectives
PEFA	Public Expenditure and Financial Accountability report
PFM	Public Financial Management
PPP	Purchasing Power Parity
PPPs	Public Private Partnerships

RAMIS	Revenue Administration Management Information System
RTI	Right to Information
R&D	Research and development
SAI	Supreme Audit Institution
SAR	South Asia Region
SCD	Systematic Country Diagnostic
SDP	Strategic Development Project
SDR	Special Drawing Rights
SME	Small and medium enterprises
SOE	State-owned enterprise
STA	Secured Transactions Act
TA	Technical assistance
UMIC	Upper Middle Income Country
UNDP	United Nations Development Program
US$	United States dollar
VAT	Value Added Tax
WBG	World Bank Group
WDI	World Development Indicators
WTO-TFA	World Trade Organization Trade Facilitation Agreement

Vice President:	Annette Dixon
Country Director:	Francoise Clottes
Global Practice Senior Director:	Anabel Gonzalez
Practice Manager:	Esperanza Lasagabaster
Task Team Leaders:	Emanuel Salinas, Charles Undeland

DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

COMPETITIVENESS, TRANSPARENCY AND FISCAL SUSTAINABILITY DEVELOPMENT POLICY FINANCING OPERATION

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The World Bank greatly appreciates the close collaboration of the Government of Sri Lanka in the preparation of this Development Policy Financing (DPF). The DPF was prepared by a WBG team consisting of Emanuel Salinas (Task Team Leader), Charles Undeland (co-Task Team Leader), Ralph van Doorn (Senior Country Economist), Christine Richaud (Lead Economist), Kishan Abeygunawardana (Economist), Karim Belayachi (Senior Private Sector Specialist), Priyanka Kher (Private Sector Specialist), Sylvia Solf (Global Lead, Investment Climate), Persephone Economou (Research Officer, MIGA), Anoma Kulathunga (Senior Financial Sector Specialist), Rathnija Arandara (Operations Officer, IFC), Shanuki Gunasekera (Operations Analyst, IFC), Jiwanka Wickramasinghe (Senior Financial Management Specialist), Mohan Gopalakrishnan (Senior Financial Management Specialist), Haider Raza (Senior Procurement Specialist), Vikram Chand (Lead Governance Specialist), Leslie Kojima (Lead Financial Management Consultant) Abha Prasad (Senior Debt Specialist), Sebastian James (Senior Economist), Jose Gutierrez Ossio (Senior Public Sector Specialist), David Newhouse (Senior Economist, Poverty), Immanuel Steinhilper (Public Sector Specialist) and Saw Young Min (Public Sector Specialist).

CREDIT AND PROGRAM SUMMARY

Democratic Socialist Republic of Sri Lanka

Competitiveness, Transparency and Fiscal Sustainability Development Policy Financing

Borrower	Democratic Socialist Republic of Sri Lanka
Implementation Agency	Ministry of National Policies & Economic Affairs
Financing Data	IDA Credit Terms: IDA Scale up facility terms with 27 years final maturity including 8 years grace period Amount: US$ 100 million
Operation Type	Stand-alone single tranche operation
Pillars of the Operation And Program Development Objective(s)	Program Development Objectives: The proposed DPF will support the long-term development of the Sri Lankan economy through a renewed engagement on reforms to eliminate obstacles to private sector competitiveness, enhance transparency and public sector management and improve fiscal sustainability. Pillars: 1. Enabling private sector competitiveness 2. Enhancing transparency and public sector management 3. Improving fiscal sustainability
Result Indicators	Pillar 1. Enabling private sector competitiveness - Adoption of national action plan for the implementation of the WTO Trade Facilitation Agreement including specific roles and responsibilities, timeframe for implementation, and required human and financial resources - Average time required for foreign investment approval - Enactment of the new Secured Transactions Act repealing the Secured Transactions Act 49 of 2009, facilitating the use of movable assets as collateral for bank loans Pillar 2. Enhancing transparency and public sector management - Share of ministries that proactively disclose information as required by the RTI Act on websites - Establishment of a National Audit Office with administrative and financial independence - Submission of Public Finance Act to Parliament Pillar 3. Improving fiscal sustainability - Number of new projects with associated tax incentives approved under SDP Act - Approval and publication of a medium-term debt management strategy (MTDS) covering domestic and external debt and defining measures to develop the domestic debt market
Climate and disaster risks	There are no long-term climate and disaster risks identified relevant to the operation
Overall risk rating	*Substantial*
Operation ID	P157804

1. INTRODUCTION AND COUNTRY CONTEXT

Introduction

1. **This program document describes the Development Policy Financing (DPF) operation to the Democratic Socialist Republic of Sri Lanka as a stand-alone single tranche operation for an amount of US$ 100 million.** The proposed DPF will support the long-term development of the Sri Lankan economy through a renewed engagement on reforms to eliminate obstacles to private sector competitiveness, enhance transparency and public sector management, and improve fiscal sustainability. The actions supported by the proposed DPF represent an important initial set of reforms that will provide a platform and momentum for a longer-term policy reform package.

2. **Under its first pillar, the proposed DPF will support significant actions aimed at enabling private sector competitiveness.** Following presidential and parliamentary elections in 2015, the new coalition Government has set out an ambitious vision for Sri Lanka which focuses to a great extent on enhancing competitiveness of the private sector as a way to supporting job creation, economic diversification and strengthening the country's presence in international trade. This operation supports the attainment of the Government of Sri Lanka's vision through an initial set of actions that will contribute to enhance the ability of the country to address regulatory obstacles to trade; attract and retain FDI; and enhance access to finance to the private sector.

3. **The DPF's second pillar supports reforms to enhance transparency and public sector management.** Establishing a stronger legal framework to increase transparency through a Right to Information (RTI) framework, strengthening the audit function, and improving the management of public resources will provide for greater accountability and responsiveness of Government in carrying out its functions, particularly regulatory functions and delivery of public services. Greater transparency regarding government policies and services provides for more predictability, thereby enhancing the business environment. Improved capacity of the state to manage its resources effectively is integral to delivery of better services, including investments in human and physical capital, which are enabling factors for competitiveness. Better public financial management should also contribute to improving fiscal performance. Sound public finances are an important condition for macroeconomic stability, which in turn impacts Sri Lanka's competitiveness.

4. **The DPF's third pillar supports measures to improve fiscal sustainability.** A sustainable fiscal environment is critical for improving the investment climate and competitiveness. This pillar contributes to this result by supporting actions to reduce fiscal revenue loss from tax holidays (which is partially responsible for the low and declining tax collection) and to increase the efficiency of debt management. These actions will present a first step of a medium-term program to enhance revenue, in a simpler, fairer and more efficient way and to strengthen debt management, which will lower the cost and vulnerability to shocks of the public debt portfolio. This is expected to contribute to fiscal sustainability and create fiscal space for the delivery of public services, social spending and capital investment, which are integral to the country's competitiveness in an aging society. Strengthened debt management will also contribute to better functioning and more liquid domestic capital markets, which will support competitiveness.

5. **The actions supported by the proposed DPF represent an important initial set of actions that can be expected to be part of longer-term reform packages under consideration.** The reforms supported by

the proposed DPF address significant well-identified challenges to the country's competitiveness, transparency, and fiscal sustainability. They reflect immediate priority actions pursued by the Government of Sri Lanka (GoSL) as a starting point for structural transformation. Going forward, the structural transformation needed to achieve the country's development objectives will entail additional reforms in the medium and long term. The prioritization of those reforms is expected to be defined through the articulation of a development strategy by the Government scheduled to be finalized by the end of calendar year 2016. The Government has expressed interest in a future programmatic DPF series to accompany this development strategy.

6. **This operation is presented in a context of an expected turnaround in fiscal sustainability.** Sri Lanka has suffered from chronically low revenues as a percentage of Gross Domestic Product (GDP) over the past decade. Fiscal policy in past years has not adequately addressed this structural challenge, raising concerns on the sustainability of the fiscal path and the level of public debt, particularly given the short-term risk of significant foreign exchange outflows in 2016. Recently implemented fiscal measures and the recently approved International Monetary Fund (IMF) three-year Extended Fund Facility (EFF)[1] program will address the short-term risks, while the country is committing to a medium-term fiscal consolidation path. The prior actions in this operation are consistent and complementary to the structural reform areas in the IMF's operation. This is a prerequisite for fully realizing the impact of the broader set of reforms supported by this operation to enhance competitiveness, public sector management and fiscal sustainability.

Country Context

7. **The DPF has been prepared after nearly a year of political transition marked by major Constitutional changes.** A new president was elected in January 2015 who was backed by a broad coalition of forces supporting a platform of good governance and changing policies that were deemed to be holding back the country's competitiveness. The Constitution was amended in April 2015 to grant more powers to the Parliament, as well as to establish or revamp independent oversight commissions. Parliamentary elections in August 2015 yielded a plurality to the party most associated with the governance reform agenda. Extensive negotiations yielded the formation of a grand coalition of the two main parties and several other smaller groupings for two years. It is expected that this coalition will see through the passage of other Constitutional changes further reducing the powers of the Presidency and reforming the electoral system.

8. **This DPF operation provides an opportunity to engage with a recently formed Government that is formulating policies to facilitate structural reform and a new approach to governance**. The platform of the leading party in the Government as well as policy statements by the Prime Minister have set out a high level reform agenda in several areas. These include improving Sri Lanka's competitiveness through increased trade openness, integration into the world economy, and welcoming of efficiency-seeking FDI. The Government has focused on an ambitious "good governance" reform agenda, demonstrated by the passage of a Constitutional amendment in 2015, which strengthened institutions of accountability, including for procurement and audit, as well as affirming a basic Right to Information (RTI). The Government has also created several institutions tasked with investigation and prosecution of public sector corruption. In addition to reforms to strengthen accountability, the Government has begun reforms to

[1] The IMF Board approved the program on June 3, 2016.

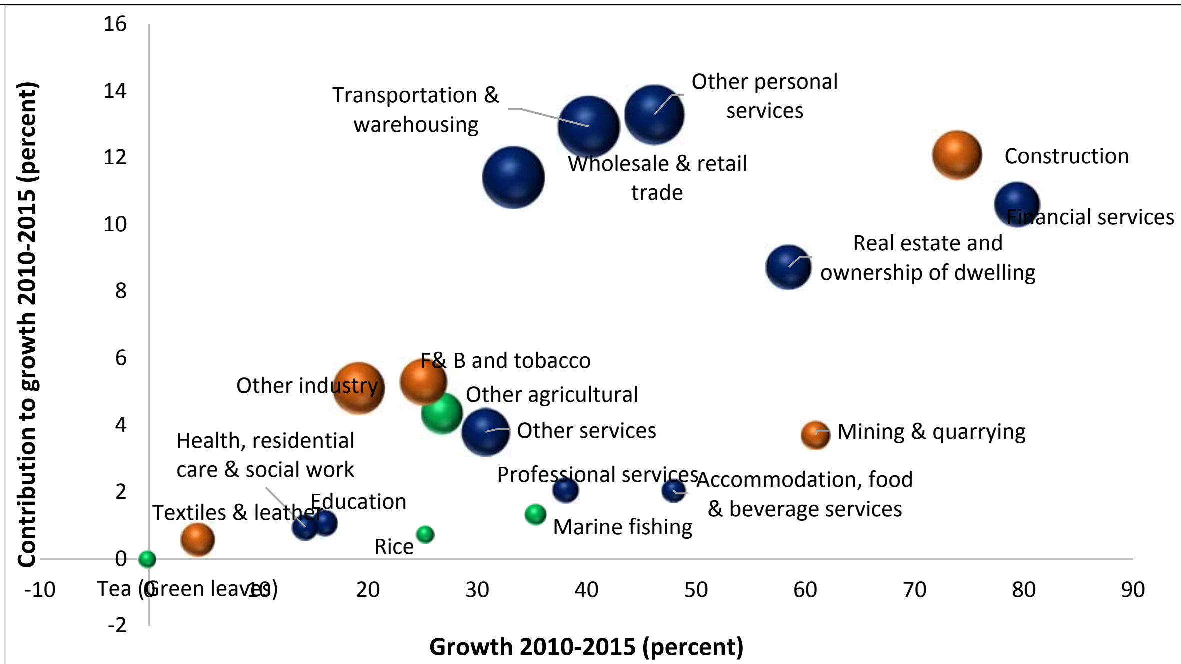
improve its own performance, including automation of revenue administration and treasury operations, regularizing public investment planning, and establishing a dedicated ministry to proactively monitor performance of select state-owned enterprises (SOEs) as well as the recent appointment by the Prime Minister of a committee charged with the development of criteria for the selection of Chairman, CEO, and board of directors of public enterprises. Finally, there have also been commitments to bring about greater inclusion, from a more proactive stance to dealing with ethnic and regional grievances that had fueled past conflict to ensuring greater participation of women in public office, with the aim to raise it from its current levels that are lower than in most South Asian peers. The short time in office and past and ongoing focus on Constitutional changes has meant that the details for operationalizing the policy reforms are largely being formulated at present.

9. **The political transition is occurring at a time where Sri Lanka needs to address new challenges if it is to sustain its strong record of economic growth and poverty reduction.** The country has in many respects been a development success story, with average growth exceeding 6 percent and a threefold decline in poverty using the national poverty line over the past 10 years. Sri Lanka has been essentially at peace for seven years following the end of its armed conflict in 2009. As an emerging middle income country (MIC), it is now facing new human development challenges, from changing healthcare needs focusing on non-communicable diseases to needing to provide skills that match market needs for a MIC. Yet, government capacity to address these challenges is constrained, by institutional capacity and severely limited fiscal space. Fiscal challenges stem in large part from poor revenue collection, but are also due to inefficiencies in some public expenditures, notably capital investments. Finally, there is a cross-cutting governance challenge. Sri Lanka has consistently scored below its South Asian peers on international measures of voice, accountability, and transparency over the past decade and recent years saw a relative decline in its control of corruption and other features of governance. Addressing these challenges are important to ensure that the public sector can effectively deliver services and carry out regulatory functions, thereby contributing to the country's competitiveness.

10. **Low competitiveness, high reliance on non-tradable sectors and a stale export basket highlight the need to enhance private sector competitiveness.** The GoSL has recognized the need to adopt a policy agenda that strengthens the competitiveness of the country's private sector in order to achieve inclusive and sustainable growth. Recent government vision statements[2] have identified the need for a revision of trade and investment policies coupled with reforms that promote innovation, entrepreneurship and skills formation, as needed to propel Sri Lanka to upper-middle-income status. The Government's vision recognizes that while the economy has grown rapidly in the last decade, the dominance of non-tradable sectors as drivers of economic growth (Figure 1) is unlikely to remain adequate for inclusive and sustainable growth in the coming decade. Authorities have identified the need to strengthen competitiveness not only in traditional sectors such as apparel, natural resources transformation, and tourism but also to establish the necessary conditions for a thriving knowledge economy, the integration of productive local companies in global value chains, and the attainment of higher value addition in the manufacturing sector.

[2] Including the Prime Minister's vision speech on November 4, 2015 as well as the speech by the Minister of Finance during the presentation of the national budget to Parliament on November 20, 2015.

Figure 1: Post-war sources of growth, 2010-15

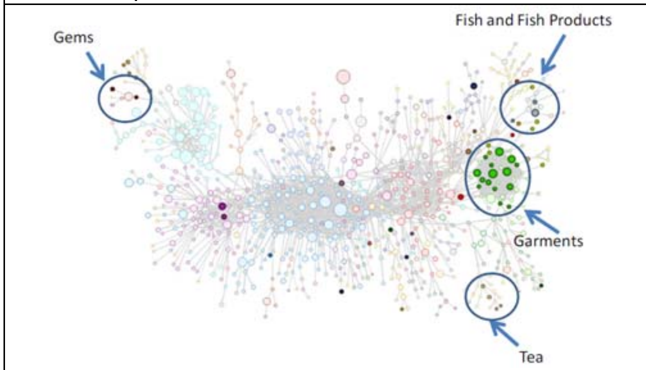


Note: Size of bubble indicates gross value added of each sector in total gross value added.
Source: Department of Census and Statistics, staff calculations

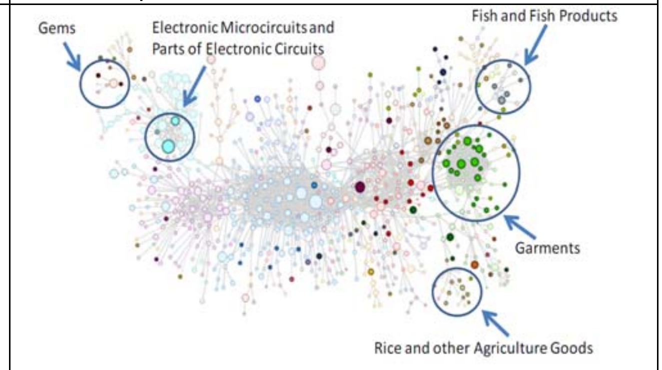
11. **The new Government has emphasized the need to realize Sri Lanka's trade potential as a way to accelerate the transformation of the economy and generate new and more attractive opportunities for Sri Lanka's labor force.** While many Asian economies benefitted from the opportunities created by trade, FDI and regional integration, Sri Lanka has largely failed to capitalize on similar opportunities. In the last few years Sri Lanka experienced significant growth in some export-oriented industries (notably garments, where the industry has moved from a commodity exports model to higher-value added production) and there are high growth companies in the nascent service sector (including information and communication technology, ICT). The dynamism of these sectors demonstrates the potential to successfully access and compete in foreign markets, but success stories remain few and relatively isolated. Exports are mainly generated by a handful of industries and there has been little change over time compared to many other Asian countries. For example, while Sri Lanka and Thailand had a similar product space (measured by their export baskets) in 1980 relying on gems, fish and fish products and garments, by 2008 machinery and electronics had become dominant activities in Thailand, while for Sri Lanka only rubber and wood products were added (Figure 2). Moreover, Sri Lankan exports remain largely linked to low added-value labor and resource-intensive products. Exploiting the value of Sri Lanka's natural resources (both in manufacturing and services) has proved elusive: tea and rubber remain commodity industries; fisheries suffer from lack of adequate value addition capacity and mismanagement of stocks; and tourism remains a low-added value sector hampered by lack of skills and investment. The Government is seeking to shift towards greater outward orientation, particularly through the creation of an agency (Agency for Development) to develop and implement a new trade policy and negotiating a deeper trade agreement with India while negotiating a free trade agreement with China.

Figure 2. Product space comparison[3]: Sri Lanka vs Thailand in 1980 and 2009

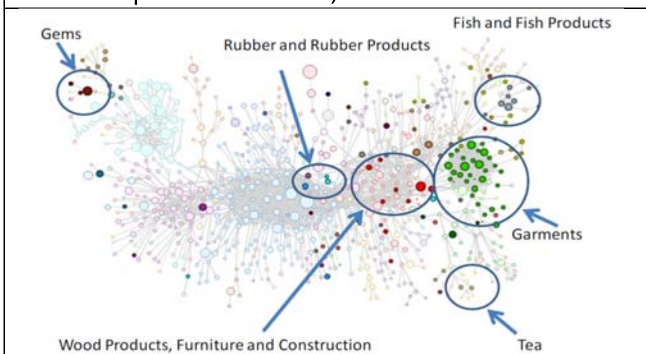
Product Space in Sri Lanka, 1980



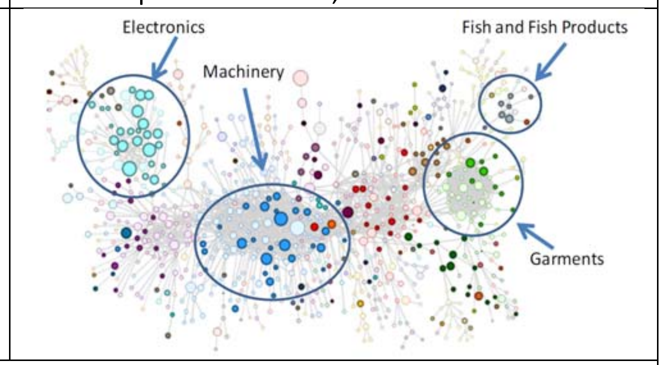
Product Space in Thailand, 1980



Product Space in Sri Lanka, 2009



Product Space in Thailand, 2009



Source: Atlas of Complexity, Harvard University, http://atlas.cid.harvard.edu/

Poverty Developments

12. **Despite strong declines in poverty over the past decade, challenges remain in boosting the shared prosperity of the bottom 40 percent and ending extreme poverty.** Poverty, measured by per capita consumption, fell from 22.7 percent in 2002 to 6.7 percent in 2012/13 using the national poverty line,[4] which is equivalent to about US$ 1.50 in purchasing power parity terms. Extreme poverty fell from 13.2 to 3.2 percent using the US$ 1.25-a-day poverty line, while moderate poverty fell from 56.2 to 32.1 percent using the US$ 2.50-a-day poverty line, commonly used across middle-income countries over the same time period (Table 1).[5] The US$ 2.50-a-day line corresponds roughly to the bottom 40 percent in the country. Most of the reduction in poverty was due to higher labor incomes,[6] and, in particular, to increased earnings. Most of the increase in labor income was, in turn, due to increased returns to work both in and outside of

[3] The Product Space is a network representation of the interrelatedness and proximity between products from a given country that are traded in the global market. Each bubble represents a sub-sector and the size of the bubble represents the intensity of exports. Clusters of bubbles of the same color can be interpreted as a high intensity in trade of various productive activities within the same industry.

[4] Owing to the previous conflict, the North and East were not included in the 2002 household survey. When looking at only regions for which data was collected in both surveys, the decline in poverty was from 22.7 percent in 2002 to 6.1 percent in 2012/13.

[5] The national poverty line is expected to be updated soon in order to: (i) update household consumption patterns (the current line assumes the 2002 consumption pattern), (ii) incorporate methodological best practice particularly with respect to the minimum calorie requirement and the appropriate amount of non-food expenditure consistent with that minimum threshold, and (iii) set a more ambitious benchmark, appropriate for a country at Sri Lanka's stage of development, to measure future progress against poverty.

[6] Growth in real per capita labor income reported here is in line with overall growth in per capita income, partly due to smaller households.

agriculture. Increased returns to agriculture accounted for about 31 percent of the decline, of which roughly two-thirds were higher returns to self-employed farmers. The other main factor was an increase in the returns to paid non-farm work, which accounted for 28 percent of the poverty decline.

13. **While much of the past decade saw consumption increase faster among the poorer half of the population, inequality increased between the last two household surveys of 2009/10 and 2013/14**. Stronger growth for the top of the distribution between 2009/10 and 2013/14 led to an increase in inequality. The Gini coefficient, a standard measure of inequality, increased from 0.36 in 2009/10 to 0.39 in 2012/13, leading to an inequality level almost as high as the one registered in 2006/07, before the end of the civil war (Table 1). In effect, rising inequality tempered the poverty-reducing impact of growth.

Table 1. Poverty and inequality trends

	Full sample				Excluding Northern and Eastern Provinces		
	2002	2006/07	2009/10	2012/13	2006/07	2009/10	2012/13
Poverty gap							
US$ 1.25/day in PPP terms (%)	13.2	6.8	3.8	3.2	6.9	3.5	2.8
US$ 2.50/day in PPP terms (%)	56.2	44.4	37.1	32.1	44.4	35.3	29.9
National poverty line (%)	22.7	15.3	8.9	6.7	15.5	8.2	6.1
Poverty gap	5.1	3.1	1.7	1.2	3.1	1.6	1.0
Severity	1.6	0.9	0.5	0.3	0.9	0.5	0.3
Inequality*							
Gini	0.402	0.397	0.361	0.387	0.330	0.308	0.328
Theil	0.323	0.325	0.268	0.317	0.212	0.186	0.234
P90-P10	5.122	4.981	4.300	4.738	3.971	3.596	3.821
Shared prosperity**		2002-2006/07	2006/07-2009/10	2009/10-2012/13	2002-2006/07	2006/07-2009/10	2009/10-2012/13
Average		1.95	3.33	4.23	1.95	3.60	4.25
Bottom 40 percent		2.59	4.91	2.84	2.59	5.40	2.83

* The second set of results (excluding Northern and Eastern provinces) is generated using a version of the consumption aggregate that excludes durables.
** The first set of results (full sample) keeps all districts available in each pair of surveys. Both sets of results use a version of the consumption aggregate that excludes durables.
Source: Sri Lanka Systematic Country Diagnostic

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

14. **After the war Sri Lanka achieved high growth, driven by construction and other non-tradable sectors.** Following the end of a three decade long civil war in 2009, Sri Lanka's economy grew at an average 6.4 percent during 2010-2015. The growth reflected a peace dividend and a determined policy thrust towards reconstruction and development which stimulated growth in non-tradable sectors (Figure 1).[7] The country is transitioning from a previously predominantly rural-based economy towards a more urbanized economy oriented around manufacturing and services.[8] Per capita GDP is estimated at US$ 3,924 in 2015, an increase of roughly 50 percent of per capita GDP since 2010.

15. **Post-conflict fiscal consolidation was interrupted between 2013 and 2015, but the Government has taken tentative steps to restart consolidation in 2016.** Declining fiscal revenue and a high level of public debt have been key structural challenges in Sri Lanka for the last two decades. While fiscal consolidation from 2009 to 2013 led to a declining public debt-to-GDP ratio, it was achieved by reducing expenditure in successive years in response to chronically lower-than-expected revenue collection. Cuts to expenditures on health, education and social protection led to a largely non-discretionary expenditure profile comprising interest payments, wages and pensions. This resulted in a lean, rigid budget with little room for critical development spending or to conduct counter-cyclical fiscal policy. Since 2013 public debt has started to rise again due to slower growth, less favorable loan terms and a widening primary deficit.

16. **The fiscal deficit rose in 2015 due in part to two successive expansionary election-time budgets.**[9] The two budgets increased current expenditures such as salaries and subsidies while revenues continued to be lower than expected. This exerted pressure on the fiscal operations and elevated interest costs for the year. Although one-off tax revenue measures implemented in late 2015 along with increased revenue from motor vehicle excise helped mitigate the impact, the deficit widened to an estimated 7.4 percent of GDP from a budgeted 4.4 percent of GDP for 2015.

17. **The current account deficit narrowed in 2015 despite a surge of non-oil imports, but significant foreign exchange outflows and low FDI resulted in a worsening of the balance of payments**. Increased disposable incomes due to the expansionary fiscal and monetary policy stance contributed to a temporary surge in imports of vehicles and other consumer goods[10] nearly offsetting the gains from lower commodity prices. Increased receipts from tourism offset the slowdown in growth of remittances, leading to an overall narrowing of the current account deficit to 2.4 percent of GDP. On the other hand, capital outflows from the local currency government securities market in the wake of rising global interest rates and heightened risk perception and lower than expected FDI inflows (0.8 percent of GDP) exerted pressure on the capital account. These factors along with scheduled external debt obligations (the redemption of a US$ 500 million

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[7] Average growth slowed down since 2013 mainly due to the slowdown in the construction sector, while other non-tradable sectors drove growth.

[8] In 2014, the service sector accounted for 62.4 percent of GDP, followed by manufacturing (28.9 percent), and agriculture (8.7 percent).

[9] A pre-presidential election budget followed by an interim budget by the new Government after the Presidential elections in 2015.

[10] Vehicle and consumable imports growth tapered off towards the end of 2015 thanks to measures to curb loan growth, vehicle imports and the currency depreciation.

Eurobond and a repayment to the IMF) contributed to heightened exchange rate pressure and more than budgeted foreign borrowings.[11]

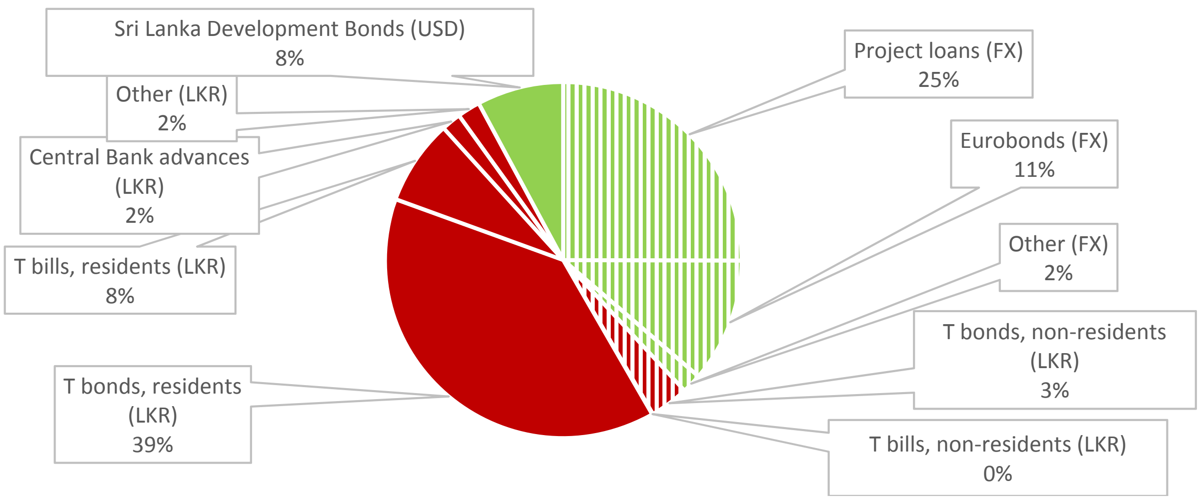
18. **Official reserves declined despite significant foreign borrowings.** The sustained currency depreciation pressures were partially offset by sustained central bank market intervention. Although the Central Bank of Sri Lanka (CBSL) eventually decided to allow the market to play a greater role in the determination of the exchange rate in September 2015, net sales of foreign exchange continued into the year 2016 as well, with its commitment to facilitate capital outflows in a thin foreign exchange market. As a result, despite borrowing more than budgeted on commercial terms and receiving support from the Reserve Bank of India (RBI) in swap arrangements amounting to US$ 1.5 billion, the gross official reserve level declined to US$ 7.3 billion in December 2015 (equivalent to 3.8 months of imports of goods and services), compared to US$ 8.2 billion at the end of 2014 (equivalent to 4.3 months). At the same time, a 10 percent depreciation against the US dollar in 2015 partially offset the past real effective exchange rate appreciation. Furthermore, while capital outflows and resultant foreign exchange sales further reduced the reserve level to US$ 6.2 billion as of end-March 2016 (equivalent to 3.3 months), non-resident holdings of government securities stabilized in April.

19. **Public debt rose as a share of GDP primarily due to rising real interest rates and currency depreciation in 2015.** Public debt increased from 70.7 percent of GDP in 2014 to 76.0 percent of GDP at year end 2015. The increase was driven by rising real interest rates on debt, the exchange rate valuation effect on foreign-currency denominated debt, followed by the persistent primary deficit. As of end-2015 foreign currency-denominated debt represented 46 percent of the total and external debt (held by non-residents) represented 42 percent (Figure 3). Despite the increased issuance of long-term Treasury bonds, a significant share of debt is in the form of Treasury bills, and about one third of domestic debt is maturing within a year, creating refinancing and interest rate risks. The large share of debt denominated in foreign currency also exposes the portfolio to exchange rate risk.

[11] After redeeming a US$ 500 million Eurobond in early January, the Government issued two Eurobonds of an amount of US$ 2.15 billion in total later in the year. The Eurobonds comprised of a US$ 650 million bond issued in June 2015 at a yield of 6.4 percent and a US$ 1.5 billion bond issued in October 2015 at a yield of 6.8 percent.

Figure 3. Composition of public debt, end-2015

Percent of total



Note: Green slices denote foreign-currency denominated debt (46 percent of total) and red slices local-currency denominated debt (54 percent). Solid slices denote debt to residents (58 percent) and striped slices denote debt to non-residents (42 percent).

Source: CBSL, staff estimates

20. **Fiscal risks emanating from state owned entities are substantial.** Debt by state-owned entities under a Treasury guarantee increased from 1.4 percent to 5.8 percent of GDP between 2006 and 2015. While this includes debt by state-owned business enterprises with own sources of revenue, guarantees have increasingly been given to entities with limited sources of revenue, such as the Road Development Authority (RDA). In addition to guaranteed debt, many of these entities have also borrowed without a guarantee.

21. **Sri Lanka's credit rating was downgraded by Fitch and put on a negative outlook by S&P and Moody's, due to growing external and fiscal vulnerabilities.** Fitch Ratings downgraded Sri Lanka's long-term credit rating by one notch to B+ from BB- with a negative outlook in February 2016. The key drivers of the downgrade are the increasing refinancing risks, significant debt maturities, weaker public finances, a decline in foreign exchange reserves and a high foreign-currency debt portion in the portfolio. At the same time, favorable economic growth, human development indicators, a clean debt service record and a smooth transition of power are identified as positive factors.[12] For similar reasons, S&P (March) and Moody's (June) changed the outlook to negative from stable, but kept Sri Lanka's long-term sovereign credit rating at B+ and B1, respectively. The recent rating actions can heighten the refinancing and interest rate risks mentioned above.

22. **The authorities have recently taken policy steps to provide for greater macroeconomic stability and fiscal sustainability.** Following sustained increases in core inflation and outflows of non-resident bond holders, the central bank raised the policy rate by 50 bps in February 2016. While the 2016 budget approved in November 2015 relied on a distortionary turnover tax (the Nation Building Tax, NBT) and an optimistic revenue projection to fund a large increase in capital expenditure, additional fiscal measures were implemented in April 2016 to contain the deficit: an increase in the VAT rate from 11 to 15 percent

[12] https://www.fitchratings.com/site/fitch-home/pressrelease?id=1000143.

and the removal of two VAT exemptions (see Box 1 for the estimated fiscal and social impact) and an increase in the corporate income rate from 15 percent (approved budget) to 17.5 percent. At the same time, the budgeted increase in the NBT was not implemented. On the expenditure side, the Government committed to containing current and capital expenditure. These decisions facilitated negotiation of a program with the IMF which is expected to further cement fiscal consolidation.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

23. **The macroeconomic framework (Table 2) is deemed adequate for this operation based on the assumption that medium-term fiscal consolidation is sustained.** The baseline medium-term outlook is mixed: positive prospects are expected from the stability following the conclusion of elections and investor confidence leading to higher investment and sustained growth in a context of low -- but gradually rising-- commodity prices and continued fiscal consolidation. The baseline outlook assumes that the Government successfully carries out its commitment to medium-term fiscal consolidation, anchored in increased revenue collection and a package of structural reforms in tax policy, tax administration, public financial management and SOEs, with the support of an IMF program (see section on IMF Relations).

24. **Growth is expected to continue with manageable inflation.** Growth is expected to reach 5.3 percent in 2016 and be maintained in the medium term, driven by investment and a reduced drag from lower imports on the demand side and by the non-tradable sectors on the activity side. The impact of past currency depreciation along with rising core inflation is expected to lead to an increase in inflation in 2016, but inflationary pressures are projected to remain under control over the medium term owing to relatively low international commodity prices and prudent monetary policy.

25. **The current account deficit is projected to widen gradually to 2.8 percent of GDP in 2020 after reaching its narrowest point in 2016 on account of the expected partial recovery of global commodity prices.** The current account is projected to improve in 2016 owing to the slowdown of imports which had been driven by an expansion of private credit in a context of a tighter monetary and fiscal policy and continued low commodity prices. However, it is projected to gradually widen as the commodity prices rebound. Remittances are projected to remain weak due to the impact of low oil prices on the Gulf economies, while exports are expected to increase slowly in line with growth in the United States and European Union, and growing tourism receipts (from Europe, East and South Asia). A slight pickup in FDI is projected to stem from regained political stability, reforms to improve competitiveness and resumption of Port City, the largest FDI project in the country, after a year of uncertainty. This evolution is expected to contribute to reduce external financing requirements. However, in the outer years, in a context of sluggish export growth, more external borrowing will be needed when large repayments on the external debt fall due.

Table 2. Key macroeconomic indicators and outlook

	2014	2015	2016p	2017p	2018p	2019p	2020p
Real economy							
GDP (LKR million, current)	10,448	11,183	12,309	13,464	14,711	16,126	17,629
GDP per capita (US$, current)	3,853	3,924	4,023	4,234	4,451	4,695	4,939
Real GDP growth (percent)	4.9	4.8	5.3	5.3	5.3	5.3	5.3
Contributions							
Consumption (percent)	…	5.2	3.5	3.8	3.8	3.8	3.7
Investment (percent)	…	1.7	0.9	3.0	2.7	2.6	2.5
Net exports (percent)	…	-2.1	0.9	-1.5	-1.1	-1.1	-0.9
Unemployment rate (percent)	4.3	5.0	…	…	…	…	…
CPI inflation (percent, annual average)	3.3	0.9	4.2	3.8	3.8	3.9	3.9
Fiscal accounts							
Revenue (share of GDP)	11.5	13.1	13.9	14.0	14.4	14.8	14.9
Expenditure (share of GDP)	17.2	20.5	19.3	18.9	18.7	18.7	18.4
Fiscal balance (share of GDP)	-5.7	-7.4	-5.4	-4.8	-4.3	-3.9	-3.5
Public debt (share of GDP)	70.7	76.0	75.3	74.6	73.5	71.8	70.0
Treasury guarantees (share of GDP)	5.4	5.4					
Balance of payments							
Current account (share of GDP)	-2.5	-2.4	-0.8	-1.6	-2.1	-2.6	-2.8
Exports (share of GDP)	13.9	12.8	12.5	12.4	12.2	12.0	12.0
Imports (share of GDP)	24.3	23.0	21.2	21.7	21.9	22.0	22.1
Foreign Direct Investment (share of GDP)	1.0	0.8	1.2	1.2	1.3	1.3	1.3
Gross official reserves (US$ billion)*	8.2	7.3	7.7	…	…	…	…
In months of imports	4.3	3.8	4.2	…	…	…	…
Exchange rate (LKR/US dollar, end of year)	131.1	144.1	…	…	…	…	…

* Held at Central Bank of Sri Lanka. 2015 data is final, except the balance
Source: CBSL, MoF, staff projections

26. **Fiscal consolidation driven by revenue increases and current expenditure restraint will put the debt-to-GDP ratio back on a declining path.** The Bank projects that the additional fiscal measures implemented in April 2016 will contain the fiscal deficit, and help bring the debt-to-GDP ratio back to a declining path. In the medium term, the Government anticipates gradually increasing capital expenditure and social spending, supported by growing tax revenue and restraint in wages and pensions expenditures. Under these assumptions, fiscal deficit will gradually narrow from 7.4 percent of GDP in 2015 (which included one-off expenditure items) to 3.5 percent of GDP in 2020 with a return to a primary surplus in 2018. This outcome would be mainly driven by Government's plans to increase tax revenue from 12.1 percent of GDP in 2015 to 13.4 percent of GDP in 2020, owing to higher rates and reduced exemptions in 2016, and further tax reforms (including a broadening of the tax base and improvements in the efficiency of tax administration leading to increased compliance). Recurrent expenditure would mainly grow to keep up with inflation. The public debt-to-GDP ratio is expected to fall from 76 percent of GDP in 2015 to 70 percent of GDP by 2020 (Table 3).

Table 3. Medium-term fiscal framework
Percent of GDP

	2014	2015	2016p	2017p	2018p	2019p	2020p
Total revenue and grants	11.5	13.1	13.9	14.0	14.4	14.8	14.9
Tax revenue	10.1	12.1	12.3	12.6	12.9	13.4	13.4
Non-tax revenue	1.4	0.9	1.4	1.3	1.3	1.4	1.4
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure	17.2	20.5	19.3	18.9	18.7	18.7	18.4
Current expenditure	12.7	15.2	14.3	13.9	13.7	13.7	13.4
Salaries and wages	4.2	5.0	4.8	4.6	4.4	4.4	4.2
Transfer payments	3.0	3.8	3.1	3.0	3.0	3.0	3.0
Other goods and services	1.2	1.9	1.7	1.6	1.5	1.4	1.3
Interest	4.2	4.6	4.7	4.6	4.8	4.8	4.8
Public investment net lending	4.5	5.3	5.0	5.0	5.0	5.0	5.0
Current account balance	-1.2	-2.2	-0.5	0.1	0.6	1.0	1.4
Primary balance	-1.5	-2.9	-0.7	-0.2	0.5	0.9	1.3
Overall deficit	-5.7	-7.4	-5.4	-4.8	-4.3	-3.9	-3.5
Total public debt	70.7	76.0	75.3	74.6	73.5	71.8	70.0
External public debt*	29.8	31.7	31.5	31.4	31.1	30.6	30.1
Domestic public debt**	40.9	44.3	43.8	43.2	42.4	41.2	39.9
Interest payments to revenue	36.5	35.0	34.3	33.0	33.6	32.8	32.4

* To non-residents, including LKR-denominated T bills and bonds held by non-residents. ** To residents, including US$-denominated Sri Lankan Development Bonds held by residents.
Source: MoF, CBSL, staff projections

27. **Refinancing of foreign exchange obligations is manageable in 2016.** Official reserves amounted to US$ 6.6 billion by end-February 2016,[13] while foreign exchange obligations for the following 12 months amount to US$ 7.7 billion, implying negative official reserves net of short-term foreign exchange liabilities. However, about US$ 3.8 billion are US dollar-denominated local bonds and currency swaps with domestic banks, which are expected to be rolled over.[14] A US$ 1.1 billion currency swap arrangement with the Reserve Bank of India due in March was rolled over into two separate arrangements: US$ 700 million was due by June or until an agreement with the IMF has been reached,[15] while US$ 400 million is due in September.[16]

28. **Beyond 2016, gross external financing needs are substantial, especially from 2019, but manageable provided that there are increases in FDI, though prudent and forward-looking debt management is needed.** Gross financing needs are projected to be around US$ 5.4 billion per year on average from 2017 to 2020, consisting of a structural current account deficit of around US$ 2.2 billion, and

[13] After settling accumulated liabilities of around US$ 500 million to Asian Clearing Union (ACU) member states, which settle payments for intra-regional transactions among the participating central banks on a net multilateral basis, usually every 2 months and often around US$ 500 million.
[14] These are: a) amortization of US dollar-denominated Sri Lanka Development Bonds (SLDBs) worth of US$ 1.6 billion, most of which are likely to be rolled over with the holding domestic banks in staff's opinion, based on past experience; and b) currency swaps with domestic banks for US$ 2.1 billion, which are expected to be rolled over, as the swaps are funded by Eurobonds issued by banks maturing after 2017.
[15] At the time of finalization of the report, it was not clear when the currency swap has been repaid.
[16] CBSL Deputy Governor and Government of India quoted by http://economynext.com/Sri_Lanka_gets_second_currency_swap_from_India;_total_US$1.1bn-3-4473-1.html

average annual external debt amortization of around US$ 3 billion. The projected sources of financing are private capital flows, including FDI, which is expected to gradually pick up as the economy becomes more attractive to investors, and loans for investment projects in the pipeline (Table 4). Bilateral and multilateral external financing is projected to contribute to about US$ 350 million per year in financing. With the expectation that commercial rates will have become less favorable by 2019, prudent and forward-looking debt management will be needed to reduce the refinancing risk on the commercial borrowing from 2019 onward.

Table 4. Projected external financing needs
US$ millions

	2015	2016p	2017p	2018p	2019p	2020p
Current account deficit	2,051	635	1,413	2,007	2,605	3,034
FDI outflows	53	54	55	57	58	59
Amortization	3,436	3,232	2,505	3,205	3,726	2,771
Public	2,883	2,644	1,414	1,230	2,656	2,123
Private	553	588	1,091	1,975	1,070	649
Total financing needs	**5,540**	**3,920**	**3,974**	**5,269**	**6,389**	**5,865**
Total financing sources	**4,232**	**4,324**	**4,655**	**5,793**	**6,600**	**6,335**
FDI inflows	680	1,054	1,146	1,278	1,391	1,495
Private debt flows	697	43	346	1,349	853	1,257
Net grants	47	36	34	32	31	29
Project loans	470	1,238	1,610	1,732	1,780	1,803
Other external financing	1,540	1,953	1,519	1,402	2,545	1,752
Eurobonds, T bills/T bonds	949	1,297	986	944	2,278	1,652
Currency swap/IMF	591	331	333	333	167	0
World Bank DPF 2016	0	100	0	0	0	0
Other budget support	0	225	200	125	100	100
Increase in total FX reserves* (negative is increase)		**-403**	**-681**	**-525**	**-211**	**-470**
Memo: Total FX reserves (months of imports)	4.9	5.3	5.2	5.2	4.9	4.8

* Reserves held at Central Bank of Sri Lanka plus reserves held elsewhere in the economy.
Source: MoF, CBSL, staff projections

29. **There are substantial external and domestic risks to this outlook.** On the domestic side, there is a risk that fiscal consolidation is not implemented as planned, particularly if there is political pressure against measures to increase tax revenue or, conversely, to increase current expenditure in upcoming budget cycles. There is also a risk that contingent liabilities may be realized, given financial challenges among some major public enterprises. Should difficulties in carrying through with reforms lead to less domestic confidence, this could lead to reduced consumption and investment, slower growth and an increasing debt-to-GDP ratio. On the external side, Sri Lanka's growth outlook remains vulnerable to potentially adverse global developments which may affect remittances, exports, and financial flows. In particular, slower growth in the European Union (EU) and the US, Sri Lanka's main export markets, may weigh on exports. A slowdown in these countries and China could affect tourism inflows. Financial market problems in China could also affect official bilateral financing and financing through its development banks

and FDI inflows, while leading to global volatility. Faster tightening of global financial conditions could lead to further capital outflows and lock Sri Lanka out of capital markets, especially once the Eurobonds start to mature from 2019 onwards.

30. **Sustained commitment to fiscal consolidation and structural reforms will be instrumental to mitigate downside risks.** Sustained fiscal consolidation and consistent macroeconomic policies will help regain investor confidence and ensure macroeconomic stability. There is an opportunity for the Government to carry out planned fiscal consolidation while improving the investment climate though a simpler and more equitable tax system. In parallel, implementation of structural reforms and new trade agreements could facilitate access to new fast-growing export markets, and diversify exports towards higher value added products. In this respect, increased attraction of efficiency-seeking FDI would be instrumental and would also help reduce the economy's reliance on external borrowing.

Box 1: The expected fiscal and social impact of the CIT and VAT changes

The recently implemented changes to the Corporate Income Tax (CIT) and Value Added Tax (VAT) are projected to increase revenue, which will help the country return to a fiscal consolidation path with a declining public debt-to-GDP ratio in 2016. The VAT measures include an increase of the single VAT rate from 11 to 15 percent, removal of exemptions for private health services and telecommunications, a reduction and unification of the VAT threshold including wholesale and retail. On CIT the changes approved in the original 2016 budget will be implemented with a higher tax rate on all sectors (17.5 percent instead of 15 percent), while keeping the pre-2016 rates on the trading and financial sectors (28 percent), betting, liquor and tobacco sectors (40 percent). World Bank staff projects that VAT collection will increase from 2.0 percent of GDP in 2015 to 2.4 percent of GDP in 2016 and CIT collection will remain around 1.0 percent of GDP. Current and capital expenditure would be maintained at 13.9 and 5.0 percent of GDP respectively.[17]

While the increase in VAT collection is positive, the changes to the VAT system are likely to lead to a modest rise in poverty and a slight increase in inequality. Despite the limited body of evidence available in Sri Lanka to assess the distribution impacts of the proposed measures to increase revenue, it is estimated that the announced increase of the VAT rate from 11 to 15 percent will have an effect of about a third of the overall VAT impact, and would raise poverty and inequality by about 0.6 and 0.06 percentage points, respectively.[18] These figures are estimates, but suggest that the short-term impact of the increase in the VAT rates on poverty and inequality may be modest.

The exemptions on private health care services and telecommunications are regressive and not well targeted to the poor. The top four deciles of the welfare distribution accounts for about 80 percent of total consumer spending on health and about 70 percent on telecommunications. Therefore, little of the direct benefits of the current exemptions accrues to the poor. In fact, virtually all tax exemptions are an inefficient way of transferring funds to the poor, since wealthier households account for the majority of consumption on almost all specific items. Targeted spending programs, if administered even moderately well, can reach the poor much more efficiently than tax exemptions on specific goods.

[17] Government estimates at the time of the decision. Not necessarily equal to staff projections.

[18] A recently published analysis on the net distributional effect of the Sri Lankan VAT system using household survey data from 2009/10 estimates that the direct effect of the overall VAT is slightly regressive, and is estimated to increase poverty by 1.7 percentage points and increase the Gini coefficient by 0.16 percentage points. The VAT rate increase from 11 to 15 percent is estimated to have a proportionally smaller impact (World Bank and Institute for Policy Studies).

While removing these exemptions will make the tax system more progressive, removing them will have a modest negative impact on the poverty rate. Telecommunication and health care services, combined, amount to about 3 percent of the poor's budget. Therefore, removing an exemption and taxing these items at 15 percent should reduce the poor's welfare by about half a percentage point. This would lead to an increase in poverty from 6.7 percent to 6.95 percent, which would cause approximately 50,000 people to slip below the poverty line. This is also an approximation, as it only measures the direct effect of the tax increase on consumers without considering the indirect effect of higher costs on other products that will pay additional VAT on these inputs.

While there are no direct mitigating measures with regards to targeted social spending to offset the impact of the VAT increase on the poor expected within this year, improved fiscal management is expected to increase fiscal space for social, health and education spending over time. Improved fiscal sustainability and macroeconomic stability are likely to benefit the poor (e.g., high inflation typically hurts the poor more than the rich), ideally more direct fiscal measures would be used to mitigate the impact on the poor. This would range from increasing expenditure on health and education, which benefit the poor[19] and social protection. In this regard, the better the targeting of the poor under the social protection programs to compensate for tax increases, the larger the net fiscal benefit for the Government.

The WBG stands ready to give support to the GoSL to reduce the impact on the poor. As the fiscal consolidation is likely to be a multi-year effort driven by increases in revenue and more efficient expenditure, just-in-time analytical work and training into the distributional impact of tax and expenditure will be crucial to ensure a high quality adjustment that is politically feasible and avoids burdening the poor. Ongoing analysis of the incidence of taxation and expenditure and capacity building of MoF staff will help Sri Lanka design a more robust tax system that will shift the tax burden away from the poor.

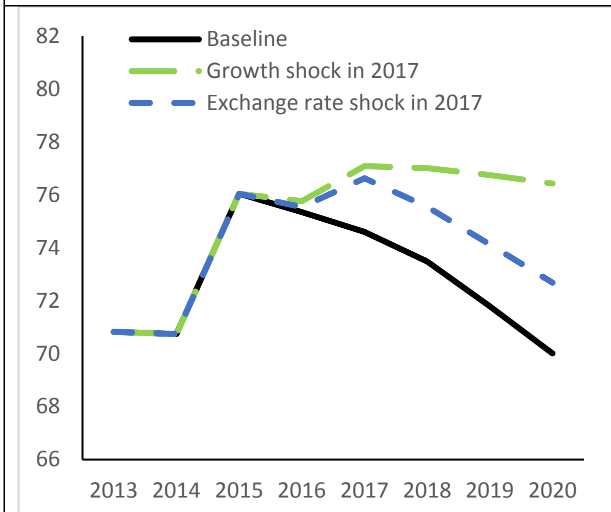
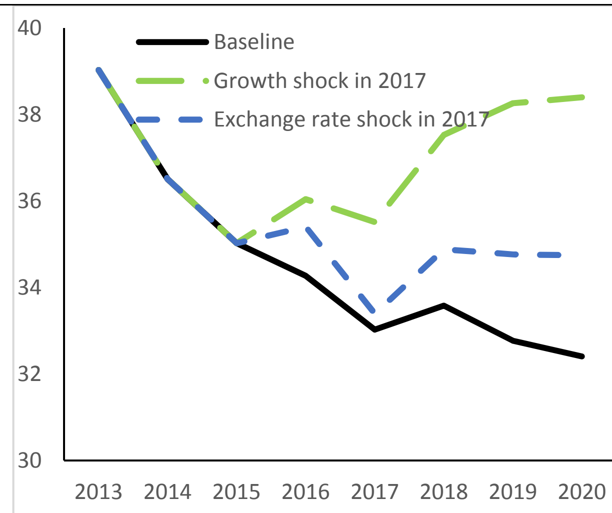
Source: World Bank staff

31. **A significantly large fiscal adjustment is needed to bring debt to a sustainable path.** In an environment of rising domestic interest rates, tightening global financial conditions and a less welcoming climate for emerging markets, a firm commitment to fiscal adjustment is warranted to reduce the fiscal deficit and reduce the level of public debt. A Debt Sustainability Analysis confirms that structural and credible revenue and expenditure measures are needed to limit the fiscal deficit in 2016 and to bring the debt burden on a downward path again. It is important that these measures raise revenue structurally in a non-distortionary way, while protecting the poor and creating space to increase social education and health expenditure and capital expenditure in the medium term.

32. **Under the baseline scenario the public debt would decline to 70 percent of GDP by 2020, but this is subject to growth and exchange rate shocks.** The debt burden, measured by the public debt-to-GDP ratio and the interest-to-revenue ratios are projected to gradually decline, provided a forward-looking debt management strategy is implemented to raise financing in an environment of reduced availability of concessional financing and tightening external and domestic financial conditions, while reducing the cost and risk of the debt portfolio. A one-off slowdown in real GDP growth by 2 percentage points relative to the baseline in 2017 would lead to reduced revenue collection, and consequently to higher fiscal deficits and a higher public debt-to-GDP ratio at 76 percent of GDP by 2020. Alternatively, an exchange rate shock

[19] CEQ analysis on 2009/10 data

with an additional 10 percentage point depreciation of the LKR against the US$ in 2017 would lead to higher deficits and a 73 percent of GDP public debt ratio as a result of the valuation effect on foreign-currency denominated interest payments and public debt (Figures 4 and 5).

Figure 4. Debt-to-GDP ratio, under baseline, shocks and alternative scenarios	**Figure 5. Interest expenditure-to-revenue ratio, under baseline, shocks and alternative scenarios**
Percent of GDP	Percent of revenue
	
Source: MoF, CBSL, staff projections	Source: MoF, CBSL, staff projections

2.3 IMF RELATIONS

33. **The IMF approved a 36-month EFF for 185 percent of Sri Lanka's IMF quota (about SDR 1.1 billion or US$ 1.5 billion) in June 2016.** The EFF supports the authorities' ambitious economic reform agenda for the next three years. The government's economic program aims at fundamental changes to tax policy and administration to reverse a two-decade decline in tax revenues as a proportion of GDP and put public finances on a sustainable medium-term footing. Stronger revenue performance will enable smaller fiscal deficits and lower borrowing, reduce the overhang of public debt, and ease pressure on the balance of payments—while at the same time providing more fiscal space for the government's key social and development spending objectives. Public enterprise reform will reduce fiscal risk, increase transparency and facilitate commercially viable operations. The macroeconomic stability and renewed market confidence expected to be obtained from this fundamental re-set of policies would reduce vulnerabilities, boost growth, and foster sustainable job creation.

34. **Important structural reforms under the EFF will also support growth and competitiveness objectives.** The Government plans to review and reform the external tariff structure to reduce effective rates of protection while simultaneously pursuing new trade agreements. The Central Bank will shift toward a flexible inflation targeting regime while also undertaking measures to help deepen foreign exchange markets and support a durable transition to a flexible exchange rate regime. Strengthening financial sector supervision and increasing the role of private credit and financial intermediation in the economy will remain important objectives.

35. **The World Bank Group and the IMF have been coordinating in the preparation of this DPF and the EFF, ensuring strong complementarities.** Most important, the EFF's quantitative targets and structural benchmarks on fiscal policy provide for sustainable fiscal consolidation, which is critical for the adequacy of Sri Lanka's macroeconomic framework. Structural benchmarks related to tax policy reforms will be complemented by planned technical assistance from the Bank to estimate the distributional impact and to mitigate the impact on the poor; benchmarks related to publishing and reducing or eliminating tax expenditure would be complemented by technical assistance from the Bank to design a new incentive regime consistent with the new tax policy regime. In addition, the EFF's prior action to suspend Board of Investment's (BOI) authority to grant tax exemptions is complemented by DPF Prior Action 7 to suspend usage of the Strategic Development Project (SDP) Act for new projects. The combined impact of the actions would be to close two incentive regimes, and to leave only one regime concentrated at the Ministry of Finance. Third, the EFF structural benchmarks on state enterprise reform (recording fiscal costs of non-commercial obligations of SOEs and publishing Statements of Corporate Intent) and public financial management (roll-out of Integrated Treasury Management Information (ITMIS) with commitment controls) are complemented by DPF Prior Actions 5 and 6 which focus on strengthening the legal framework for audit and public financial management. Finally, DPF prior actions concerning private sector competitiveness, right to information, and debt management support medium-term growth, greater transparency and effectiveness in the use of state resources. These objectives will provide indirect support for the reform package associated with the EFF.

36. **The Bank and Fund teams have worked together to provide capacity building.** Technical assistance and training on principles of debt sustainability analysis have been provided to the staff of the Fiscal Policy and Treasury Operations Departments (Ministry of Finance), Public Debt and Economic Research Departments (Central Bank of Sri Lanka) and External Resources and National Planning Departments (Ministry of National Policies and Economic Affairs). The two teams expect to coordinate support for capacity building for revenue enhancement, public financial management, and oversight of SOEs over the course of the EFF.

3. GOVERNMENT'S PROGRAM

37. **The GoSL has recognized the need to foster private sector-led growth and the export-orientation of the economy as a way to sustainably attain the overarching objective of becoming an upper-middle-income economy**. The GoSL has articulated a clear development vision for Sri Lanka[20], characterized by private sector-led growth, export competitiveness and development of higher added-value economic activities. The GoSL has set as objectives facilitating the generation of one million job opportunities in the private sector, enhancing income levels, developing rural economies, and creating a wide and a strong middle class. The policy statement further proposed consolidation of fiscal operations through raising revenue and reducing the fiscal deficit to 3.5 percent of GDP by 2020. Strategies are being developed in order to translate the GoSL's vision into action and reform plans, while the GoSL has already outlined specific directions in the Public Investment Programme 2016-2018.

38. **Additionally, the Government is carrying out a range of good governance reforms.** Both the President and Prime Minister have repeatedly emphasized the need to bring about good governance in the public sector. In particular, the Government is operationalizing features of the 19th Constitutional Amendment to provide for public sector transparency, stronger accountability mechanisms, and greater state effectiveness, including through institutional reforms and the passage of implementing legislation. At the same time the Government is undertaking reforms to improve the management of public resources, notably through a review of programs to eliminate redundancies, automation of revenue administration and treasury functions, systematizing public investment planning, and debt management, and establishing a Ministry of Public Enterprise Development tasked with improving performance of select public enterprises and the recent appointment by the Prime Minister of a committee charged with the development of criteria for the selection of Chairmen, CEOs and boards of directors of public enterprises. These measures are expected to have a cumulative effect of improving public service provision, strengthening state-society relations, and providing for greater predictability, all of which will contribute to Sri Lanka's competitiveness.

[20] This includes a statement by the Prime Minister on November 4, 2015 as well as the presentation of the Budget to the Parliament on November 19th 2015.

4. PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

39. **The prior actions and expected results supported by this DPF are in line with the strategic vision and priorities of the Government as outlined in recent policy statements.** The actions represent a package of reforms that is unprecedented in recent years. The extent and depth of the actions reflect both an approach to build momentum for reform as well as a longer term commitment of the Government to undertake further actions to effect structural change in the coming years. As such, these actions represent an important initial set of policy reforms that are expected to be part of a longer-term policy reform package. The reforms supported by the proposed DPF address significant well-identified obstacles to the country's competitiveness, transparency, and fiscal sustainability. They reflect immediate priority actions pursued by the GoSL as a starting point for structural transformation. Going forward, the structural transformation needed to achieve the country's development objectives will entail additional reforms in the medium and long-term. The prioritization of those reforms is expected to be defined through the articulation of a development strategy by the Government expected to be finalized by the end of calendar year 2016. The Government has expressed interest in a future programmatic DPF series to accompany this development strategy.

40. **The proposed pillars and the underlying prior actions supported by the proposed DPF stem from recent diagnostic work outlining key priority reform areas to attain the GoSL's development objectives.** In particular the design of the DPF leverages on the findings of the recently-concluded Systematic Country Diagnostic (SCD) as well as on specific diagnostic and policy dialogue recently conducted by the WBG's teams (see table 5).

41. **The proposed DPF will support the Government's priorities through three main pillars:**

- **Pillar 1 supports actions aimed at enabling private sector competitiveness**. These actions are grouped in three main areas, namely i) adopting a long-term reform agenda aimed at strengthening the ability of Sri Lankan enterprises to trade by streamlining trade-related regulation in line with good international practices, and setting up an institutional framework to guide reforms and enhance interagency coordination; ii) facilitating attraction and retention of FDI by streamlining processes for foreign investment establishment in the country as a first step towards elimination of unnecessary *de jure* and *de facto* obstacles to foreign investment; and iii) eliminating well-identified deficiencies in the legal framework governing the use of movable assets as collateral; as a first step towards enhancement of access to finance to the private sector and especially small and medium enterprises (SMEs). Going forward, the GoSL has recognized that enhancing private sector competitiveness will require a continued reform agenda under these three main areas, as well as reforms on other factors such as investment climate, skills and trade policy.

- **Pillar 2 supports governance reforms that enhance transparency, accountability and public sector management.** These reforms involve legislation to provide a platform for more accountable, responsive, and effective Government. The submission to Parliament and expected adoption in the near future of a Right to Information Bill will establish a new, stronger framework for public sector transparency. The National Audit Bill represents operationalization of provisions in the 19th Constitutional Amendment to strengthen the supreme audit institution, particularly through providing for greater administrative and financial independence; completion of drafting and submission to the

Cabinet of Ministers represent important steps in establishing this legal framework. A decision to move forward on drafting a comprehensive Public Finance Act will provide clarity on roles and responsibilities in the management of public assets. These changes are expected to have a beneficial effect on Sri Lanka's competitiveness. Greater transparency regarding government policies and services provides for more predictability, thereby enhancing the business environment. Improved capacity of the state to manage its resources effectively is integral to delivery of better services, including investments in human and physical capital, which are enabling factors for competitiveness. A strengthened audit function as well as improved public financial management and oversight of public enterprises could improve fiscal performance as well as public sector effectiveness, including for public enterprises. Sound public finances are an important condition for both fiscal sustainability as well as Sri Lanka's overall competitiveness.

- **Pillar 3 supports measures to improve fiscal sustainability.** A sustainable fiscal environment contributes to an improved investment climate to support competitiveness. This pillar contributes to this result by supporting actions to reduce fiscal revenue loss from tax holidays (which is partially responsible for the low and declining tax collection) and to increase the efficiency of debt management. These actions will present a first step of a medium-term program to: (1) increase tax revenue, in a simpler, fairer and more efficient way; (2) to spend more effectively; and (3) to strengthen debt management, which will lower the cost and vulnerability to shocks of the public debt portfolio. This is expected to contribute to fiscal sustainability and create fiscal space for delivery of public services, social spending and capital investment, which are integral to the country's competitiveness in an aging society. Strengthened debt management will also contribute to better functioning and more liquid domestic capital markets, which will support competitiveness.

42. **There is limited experience with DPF operations in Sri Lanka, but lessons from earlier preparation of a DPF underscore the need for a robust program of analytical work to underpin the design of the operation.** In recent years, the only operation has been a Catastrophe Deferred Drawdown Option Development Policy Loan (CAT DDO) in 2011. Accordingly, this DPF is largely a new modality of engagement in the country. The proposed operation builds on recent analytics and a robust policy dialogue that was initiated over the past year in areas where previously there was limited engagement. Initial discussions around a policy operation, particularly on improving competitiveness, occurred in FY13. A decision was made to defer the operation owing to lack of consensus around the policy actions at the time, which in turn reflected to some extent on an incomplete analytical basis for agreement regarding policy priorities. Significant analytical work over the past year, combined with greater receptivity, has enabled the rapid identification of thematic areas to be supported by this DPF. While in many ways this operation represents the first steps towards deeper reforms in the areas of competitiveness, governance, and macroeconomic and fiscal management, it benefits from strong consensus on the program.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

43. **The proposed DPF will support the long-term competitiveness of the Sri Lankan economy through a first package of reforms that remove constraints to private sector competitiveness, enhance transparency and public sector management and improve fiscal sustainability**. The policy areas included in this operation and the proposed prior actions stem from analytical work conducted by the WBG and ongoing policy dialogue (Table 5). Annexes 5 to 8 include additional information on the analytical

underpinnings, while the overall relevant program of knowledge and TA is outlined in section 4.3 below (link to CPF and other Bank operations).

Pillar 1. Enabling private sector competitiveness

44. **Under its first pillar, the proposed operation will support the GoSL's reforms aimed at eliminating well-identified obstacles constraining the competitiveness of the private sector as a way to unleash the competitiveness potential of Sri Lankan enterprises.** The proposed DPF will support actions to: i) eliminate regulatory obstacles to trade by adopting a commitment of the GoSL to undertake reforms on trade facilitation and setting up an institutional coordination mechanism; ii) facilitate attraction and retention of FDI by streamlining processes for establishing foreign investment in the country; and iii) enhance access to finance to the private sector by strengthening the legal framework governing the use of movable assets as collateral. The package of reforms supported by the DPF are a sub-segment of the reforms needed to address the obstacles restricting competitiveness. However the reforms supported are substantive in themselves and represent a good starting point for a wider-reaching reform agenda that is expected to be articulated in the near term as the vision of the Government translates into specific action plans.

45. **As mentioned in the previous section, this operation is designed as a first engagement with the GoSL in a number of areas on which the World Bank's assistance had not been previously sought** and in which the GoSL's efforts have been initiated only recently. This country context, together with the stand-alone nature of this operation are important considerations in striking a balance between ambition and feasibility of the expected results. In particular, the prior actions under the competitiveness pillar pursue clear strategic objectives that are well in line with the overall development goals of the GoSL. However, these prior actions are important first steps in the right direction, rather than complete solutions to the problems they are addressing. Accordingly, the expected results for the ultimate beneficiaries (private enterprises and entrepreneurs) will not be achieved within the timeframe of the DPF, and the full effectiveness of these actions will also depend on subsequent actions and reforms pursued by the GoSL. Nevertheless, the actions supported by this operation represent critical foundations of a longer-term reform agenda.

46. **The actions supported by this DPF are part of a broader package of reforms aimed at enabling private sector competitiveness.** Other actions to enhance the ability of the country to attract and retain FDI include the elimination of minimum investment requirements in the skills, ICT and R&D sectors, and enabling Electronic Travel Authorization for business visas. Similarly other recent actions to facilitate access to finance include the establishment of a legal framework for microfinance, which is expected to translate into enhanced inclusiveness and equity in financial services for individual entrepreneurs.

<u>**Increasing the efficiency of trade facilitation**</u>

Prior Action 1. The GoSL has: (a) ratified the Protocol annexing the World Trade Organization (WTO) Trade Facilitation Agreement (TFA) to the WTO Agreement; and (b) created a National Trade Facilitation Committee (NTFC).

47. **Analytical underpinnings.** The GoSL has identified the need to unleash the trade competitiveness potential of Sri Lankan enterprises. The SCD and a recently completed World Bank diagnostic[21] highlighted

[21] Sri Lanka–WTO TFA Validation and Reform Map, September 2015, World Bank

that Sri Lanka has significant shortcomings in trade facilitation as compared to other MIC and regional peers (see Annex 5). The diagnostic also highlighted that improvements are needed across most regulatory processes to avoid unnecessary delays and costs to producers and traders and the consequent loss of competitiveness versus exporters located in other countries in the region. Bureaucratic barriers were found to account for nearly 70 percent of the total time spent on exporting or importing goods, with preparation of documents absorbing more than 50 percent of the time spent on import or export procedures. Other issues such as the lack of a risk management system and weak inter-institutional coordination (with 30 government agencies involved in trade facilitation, and absence of a single window facility) further exacerbates delays and increases costs.

48. **This prior action is an important step in setting up a foundation for trade facilitation reform.** The WTO TFA provides a framework for the implementation of simple, transparent trade procedures that enhance trade facilitation and its ratification will signal to domestic and international stakeholders the GoSL's strong commitment to the reform and modernization of its trade facilitation regime**.** The TFA sets forth a series of measures for expeditiously moving goods across borders inspired by the best practices from around the world. Once implemented[22] the TFA is expected to reduce total trade costs by more than 14 percent for low-income countries and more than 13 per cent for upper middle-income countries by streamlining the flow of trade across borders.[23] Inefficiencies in areas such as customs are roadblocks to developing countries' integration into the global economy and may severely impair export competitiveness or inflow of foreign direct investment. The ratification of the WTO TFA and the formal establishment of the NTFC (see below) can be an effective platform for a second wave of reforms that target core bureaucratic bottlenecks through digitization, increasing transparency and ensuring ease of access to trade related information as identified in, inter alia, the Trading Across Borders indicators of the Doing Business rankings (see Annex 5).

49. **The Cabinet of Ministers' approval will provide NTFC with the required mandate to oversee and coordinate all trade facilitation matters in Sri Lanka** including full and effective implementation of the WTO TFA[24]. The NTFC is expected to identify key bottlenecks and inefficiencies, provide key inputs into reform efforts to modernize trade facilitation policies, processes and reduce trade transaction costs. The NTFC will also be tasked with significantly enhancing inter-agency coordination on trade facilitation matters as well as improve dialogue between the government and the private sector.

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[22] The Trade Facilitation Agreement was adopted by the General Council in November 2014 to bring the TFA into the WTO's legal framework. The Agreement will enter into force when two-thirds of WTO members ratify the TFA and deposit their instruments of acceptance with the WTO Secretariat.

[23] The United Nations Conference on Trade and Development (UNCTAD) estimates that the average customs transaction involves 20–30 different parties, 40 documents, 200 data elements (30 of which are repeated at least 30 times) and the re-keying of 60–70 per cent of all data at least once. With the lowering of tariffs across the globe, the cost of complying with customs formalities has been reported to exceed in many instances the cost of duties to be paid. In the modern business environment of just-in-time production and delivery, traders need fast and predictable release of goods. A study by Asia-Pacific Economic Cooperation (APEC) estimated that trade facilitation programs would generate gains to APEC of about 0.26 per cent of real GDP, almost double the expected gains from tariff reductions, and that the savings in import prices would be between 1–2 per cent of import prices for developing countries in the region.
Source: WTO, https://www.wto.org/english /thewto_e/20y_e/wto_tradefacilitation_e.pdf

[24] As a WTO Member, Sri Lanka will be required to implement the WTO TFA once it comes into force. As per article 23.2 of the Agreement, Members must establish a National Trade Facilitation Committee to oversee and coordinate implementation of the Agreement. Article 23.2 states that WTO Members "shall establish a committee to establish and/or maintain a national committee on trade facilitation or designate an existing mechanism to facilitate both domestic coordination and implementation of the provisions of this Agreement".

50. **Expected results**. Within the timeframe of the operation, the expected result is the adoption of a national action plan for the implementation of the WTO TFA, including specific roles and responsibilities, timeframe for implementation, and required human and financial resources. The ratification of the WTO TFA and the formal establishment of the NTFC can be an effective platform for a second wave of reforms that target core bureaucratic bottlenecks through digitization, increasing transparency and ensuring ease of access to trade related information and that may be supported by subsequent DPF operations. Examples of future reforms to be pursued by the NTFC include establishment of a trade portal that aggregates information related to the regulatory requirements across all agencies and enables online access trade related information, and establishment of a single window facility.

51. **Longer-term reform agenda on trade facilitation**. The GoSL has recognized that enhancing trade facilitation will require the implementation of a comprehensive action plan in the short, medium and long term across several areas. Reforms to enhance trade facilitation will require actions to: a) substantially streamlining of administrative processes for imports and exports, including rationalization of the documentation required; b) enhancing efficiency in border management through better coordination between government bodies[25] to avoid unnecessary delays and enhance predictability in border clearance; c) automation (in particular, the introduction of a single window integrating the 30 government agencies involved in trade facilitation) to expedite processes, reduce paperwork and limit rent-seeking opportunities; d) improving the regulatory framework governing trade to reduce complexity and eliminate anti-export bias in policies; and, e) enhancing the accessibility of information on trade procedures through electronic portals (see Annex 5 for a more complete discussion).

<u>Removing obstacles to FDI entry and establishment.</u>

Prior Action 2. The Cabinet of Ministers has approved the establishment of a One-Stop-Shop (OSS) for foreign investors aimed at reducing the processing time for investment approval.

52. **FDI can be an important ingredient to the economic diversification that the country aspires to, but over the past years Sri Lanka has received a very low volume of FDI.** FDI (and especially efficiency-seeking FDI) can be an important mechanism not only to enhance investment, but also to: i) introduce new technologies and production processes that increase productivity and support the development of new products; ii) create positive spillovers through improvement of skills and introduction of new management practices; and iii) enhance access of Sri Lankan producers to global production networks and value chains. However, FDI in Sri Lanka has been lower than in its peers in spite of Sri Lanka's comparative advantages (*e.g.* location and access to major markets). The obstacles to attract and retain FDI are manifold (see Annex 6), ranging from deficiencies in the legal and regulatory framework and policy uncertainty to institutional shortcomings. While addressing all these obstacles will require a medium term reform program, as a first step, the GoSL mandated the inception of an OSS for FDI, as a mechanism to address regulatory deficiencies and interagency coordination issues that currently create significant obstacles and transaction costs to investors interested in establishing operations in Sri Lanka.

53. **The formal establishment of the OSS through a Cabinet decree including its Terms of Reference will provide the OSS with the mandate to undertake interagency coordination to expedite investment approval**. At present, foreign investors seeking to establish operations in Sri Lanka must seek approvals and/or permits from numerous different regulatory agencies, ministries and other bodies. These processes are conducted bilaterally between the investor and the relevant agency and translate into long

[25] Including Customs agencies and sanitary and phyto-sanitary control agencies.

lead times for investment establishment for services and manufacturing companies. The establishment of the OSS within the BOI is intended to provide investors with a single point of contact with the various regulatory agencies involved – thereby reducing transaction costs. Additionally, while the underlying approval processes by each regulatory agency will not be modified within the timeframe of preparation of this DPF, the establishment of the OSS is expected to expedite approval time by creating a mechanism to actively pursue rapid response from regulatory agencies on behalf of investors.

54. **Expected results**: The expected result during the timeframe of the operation if that average time for foreign investment approval is reduced from 63 days on average[26] to 50 days on average[27]. In order to achieve the expected results, at the request of the GoSL the WBG is currently providing technical assistance to facilitate the establishment and operation of the OSS in line with good international practices (see section on link to CPF and other Bank operations).

55. **Longer-term reform agenda to enhance Sri Lanka's ability to attract and retain FDI**. Going forward the GoSL has recognized that the ability of the country to attract and retain new foreign investors, and correspondingly to benefit from positive spillovers will depend on substantive reforms and initiatives covering a wide range of areas (see Annex 6). Among key areas are: a) addressing challenges in the legal framework by consolidating and strengthening the set of laws and regulations governing FDI, enhancing investor protection and policy predictability; b) strengthening the investment policy to ensure alignment with the development vision of the Government, other economic policies and global trends; c) re-designing investment incentives to enhance their effectiveness and rationalize the use of budgetary resources; d) strengthening investment attraction through the adoption of modern tools and techniques to enhance the effectiveness of the BOI; e) eliminating regulatory obstacles to FDI through the full implementation of the One Stop Shop as well as through reforms in the underlying regulatory processes; and f) strengthening investment retention capacity through the establishment of systemic investment response mechanism to address investors' disputes stemming from government conduct in a timely manner. A WBG technical assistance (TA) program initiated in June 2016 will support the authorities' policy reform efforts in the areas outlined above.

Enhancing access to finance

Prior Action 3. The Cabinet of Ministers has authorized the drafting of a new Secured Transactions Bill that will include provisions to facilitate the use of movable assets as collateral for bank loans, and to repeal the Secured Transactions Act 49 of 2009 (STA 2009).

56. **Access to finance is a major constraint for firms' growth in Sri Lanka** (see Annex 7). Despite the fact that there is ample liquidity in the banking sector and interest rates have decreased over the past year, many firms report difficulties in accessing financing, and credit growth has been limited. Accessing finance is particularly difficult to smaller firms and credit is often dependent on their ability to post collateral with value of more than 200 percent of the loan amount. Compounding this hurdle, at the present time, bank loans are secured mainly through real estate collateral, while movable assets are not recognized by law as sufficient security for loans. A Secured Transactions Act No. 49 was enacted in 2009

[26] Based on average time required for investment approvals in the period 2014 to 2016.
[27] The target is in line with the commitment undertaken by the GoSL during the presentation of the Budget to Parliament in November 2015.

with the purpose of enabling use of movable assets as collateral in loans. However, deficiencies in the law rendered it ineffective.[28]

57. **This prior action will help establish an adequate legal framework that will enable the use of movable assets as collateral in credit to SMEs.** Through this action the Cabinet endorses the decision to develop a new Secured Transactions Act (STA) which is intended to address the deficiencies of the existing legal framework. Its drafting, which is already advanced, benefits from WBG TA. The new STA will address the deficiencies observed in the previous law by enforcing the use of collateral registries and providing priority to registered claims in case of borrowers' default. The passing of the new STA is the first step to enable firms (especially SMEs) to access financing using movable assets as collateral. As a complement to the passage of the Act, relevant elements of the credit infrastructure (including collateral registries) will be needed in order to ensure the achievement of the overarching expected result (increased access to bank credit secured by movable assets by firms). Accordingly, the ultimate positive impact of the passage of the new STA will not be evident in the timeframe of this operation.

58. **Expected result:** Within the timeframe of the operation, the expected result is the enactment of the new Secured Transactions Act, repealing the Secured Transactions Act 49 of 2009, facilitating the use of movable assets as collateral for bank loans. A WBG operation expected in FY 17 will support the implementation of the STA, including, inter alia, by strengthening necessary elements of the credit infrastructure[29] and enhancing accompanying regulations. The ultimate expected results, namely an increase in the proportion of new bank loans that are collateralized by movable assets, will likely materialize beyond the timeframe of this operation.

59. **Longer-term reform agenda to enhance access to finance for the private sector**. The adoption of a strengthened secured transactions framework is an important step towards enhancing access to finance, particularly for SMEs. However the passage of the law will need to be complemented by substantive actions in order to ensure its effectiveness, including strengthening of movable assets collateral registries; updating relevant regulations; and ensuring adequate training to legal authorities on the new law. Beyond that, the GoSL has recognized that enhancing the effectiveness, responsiveness and inclusiveness of financial services will require substantive reforms and actions on several areas, including : a) enhancing the governance of State-Owned Banks through, inter alia, strengthening management and enhancing the capacity and independence of boards; b) introducing necessary reforms in the legal framework governing credit activities, including eliminating deficiencies in foreclosure processes; c) enhancing regulation and supervision of banks and non-bank financial institutions through adoption of risk-based approaches; e) improving financial market infrastructure including payment systems and credit bureau; f) facilitating the development of the insurance market by further enabling private participation and competition; g) enabling the development of capital markets as sources of funding to large enterprises and projects; and h) putting in place consumer protection mechanisms and financial literacy initiatives to ensure fairness on provision of financial services. A World Bank project under preparation, together with a programmatic TA program will address many of the areas outlined above.

[28] Under this Act, the lenders were given the option of registering their secured interest in a movable asset in that registry but registration was not mandatory and did not give priority against subsequent registrations. Therefore the purpose for which the law was enacted was not achieved and the banks did not participate in the registration actively. Although they understood the importance of electronic registry for registration of moveable property taken as security, they did not participate in it since the prevailing legislation did not meet their requirements.

[29] Especially the movable collateral registry.

Pillar 2: Enhancing Transparency and Public Sector Management

60. **Improving transparency and public sector management can play an important role in enhancing the overall enabling environment for competitiveness.** Although Sri Lanka has scored relatively well on most governance indicators compared to other countries in South Asia and other lower middle income countries, it is relatively weak in assessments of the transparency and accountability of government and in the management of public resources. It is presently the only country in the region to not have a Right to Information framework. Lack of transparency and responsiveness to the private sector have contributed to unpredictability in regulation and significant government intervention in the economy. A degree of uncertainty concerning future government actions and policies has in turn dampened private sector investment. In addition, lack of transparency provides an environment conducive to corruption, which distorts economic decisions and discourages investment. At the same time, the effectiveness of public expenditures on service delivery has been undermined by weak linkages between longer term planning, including investment, and annual budget allocation and execution. The government's capacity to provide goods and services, particularly those which equip Sri Lanka's citizens to participate and compete in the economy such as education, is critical to the country's competitiveness.

61. **Stronger governance contributes to greater trust in the state.** Greater transparency and effectiveness should over time contribute to higher levels of trust in the Government. Sri Lanka's past challenges with internal conflict underscore the importance of sustaining a high degree of legitimacy of the state. The need to strengthen governance was a key motivating factor in the coalition of political forces that came to power in the January 2015 presidential elections and was confirmed in the August 2015 parliamentary elections.

62. **Objective and expected results.** Prior actions under this pillar are key steps to provide for a legal framework to strengthen public sector transparency and management. The actions reflect the present stages of the legislative process, signaling policy commitment, with an expectation that all legislation will be operational within a year of the initiation of this operation. With regard to legislation to support transparency, the main objectives are to establish an institutional framework for a RTI regime, including standards of disclosure and an administrative apparatus to enforce these standards. Transparency will also be strengthened through a stronger audit function in terms of the financial and administrative independence and scope of entities which fall under the purview of the Auditor General as well as requirements for disclosure of audits. Greater scrutiny should provide for greater transparency and accountability of public authorities for their use of resources. This in turn should lead to both greater effectiveness in the use of those resources, forestalling misuse of resources, and indirectly better provision of public services and increased legitimacy of, and trust in, the state. Finally, there are gaps in roles and responsibilities for the management of public resources in the current legal framework as well as a need to anchor and institutionalize further reforms in PFM. The policy action of initiating the drafting of a Public Finance bill is expected to be followed by a consultative process to yield a sounder and clearer framework for budget formulation and execution as well as oversight of public entities, including state-owned enterprises. Strengthened PFM will also contribute to improving public sector effectiveness. Annex 8 discusses potential medium-term reforms beyond this operation.

Prior Action 4. The GoSL has submitted to Parliament a Right to Information (RTI) Bill with wide applicability, extensive proactive disclosure, an independent appeals process, and limited exceptions.

63. **This prior action supports the introduction of a legal framework mandating increased Government transparency.** Information about government operations is a crucial means for oversight

bodies as well as society in general to hold the Government accountable for performance. A RTI framework equips citizens to demand levels of public service delivery and benefits that are due to them, providing widespread leverage to improve government performance. RTI regimes in other South Asian countries have yielded numerous instances where corruption in the distribution of benefits and award of government contracts has been countered. Sri Lanka's draft RTI bill requires disclosure of information held by government with limited exceptions which themselves can be overridden on the grounds of public interest. These requirements apply to a comprehensive list of Public Authorities. The bill creates an independent Information Commission to hear appeals under the Act with the power to prosecute public officials on certain grounds. It designates the Ministry of Mass Media and Parliamentary Affairs as responsible for ensuring the effective implementation of Act in collaboration with the Commission. The bill provides a framework for filing applications to receive information while placing requirements for proactive disclosure of information relating to budget allocations and execution. The Act will become effective six months after its passage. A major reform implementation program will be needed to set up the Information Commission, appoint and orient information officers, and increase pro-active disclosure; hence technical assistance based on the experience of other South Asian countries will be provided. Results from this policy action in the coming year should be an increase in the amount of information public agencies proactively disclose as well as initiation of responses to requests for information from citizens. Over time, the establishment of an RTI framework and corresponding increase in the disclosure of government information will allow for greater citizen oversight and facilitate the delivery of public services, which should contribute to further strengthening the legitimacy of the state.

64. **Longer-term reform agenda to enhance transparency.** The imminent passage of the RTI Act will place substantial requirements on the Government to implement its provisions which in turn will radically enhance transparency. Immediate follow-up steps will be to establish the Public Information Commission, and engage in extensive capacity building within the bureaucracy to appoint and train information officers as well as the Ministry of Parliamentary Reforms and Mass Media, which is designated as the nodal agency for implementation. Implementation rules and regulations will then need to be adopted, particularly guidance to public authorities on requirements for proactive disclosure. A system for monitoring implementation, both for proactive disclosure and to respond to information requests from the public will need to be established to troubleshoot issues which arise. Finally, a program of awareness raising among the public to benefit from the RTI regime will be needed for the changes to be effective in increasing transparency. The experience of other countries suggests that there will be several years of adjustment by both the bureaucracy and the public to requirements of greater openness in Government. The World Bank intends to provide technical assistance, especially comparative experience from nearby countries, to help address implementation issues.

Prior Action 5. The National Audit Bill has been submitted to the Cabinet of Ministers.

65. **This prior action is an important step in passing legislation to operationalize a legal framework that will strengthen the independence of the Auditor General (AG) and confirm the AG's oversight overall all public enterprises where the state has at least majority ownership.** The effectiveness of a country's Supreme Audit Institution (SAI) in providing for accountability of government is substantially conditioned by its functional, financial and administrative independence from the public sector entities that it is supposed to audit as well as the clarity and breadth of its mandate to audit the use of all public monies, resources and assets. International Organization of Supreme Audit Institutions (INTOSAI) standards stipulate that the independence of the SAI be laid down in the Constitution, with details set out in legislation. The adoption of the 19th Constitutional Amendment set out principles to strengthen

the Sri Lanka's SAI: (i) the Auditor General is empowered to audit the accounts of public enterprises that are 50 percent or more owned by the Government or public corporations, including those which are registered under the Companies Act, and (ii) an Audit Service Commission is to be established, which is responsible and answerable to the Parliament, with powers to prepare (a) annual budget estimates of the National Audit Office, established by legislation; and (b) rules pertaining recruitment, appointment, transfer and disciplinary control of members of Sri Lanka State Audit Service. Operationalization of these principles is to occur through a National Audit Act, passage of which has been a prominent policy commitment of both the President and Prime Minister. The National Audit Bill has been drafted and submitted to the Cabinet. Extensive consultations on the draft have been conducted, resulting in minor adjustments. The text of the Bill is now being finalized with the expectation that the Cabinet will take a decision to submit the Bill to Parliament by the end of July 2016. Once the Bill is passed, it is expected that a National Audit Office with substantial administrative and financial independence will be established. The resulting strengthened audit function will contribute significantly to improved transparency, better oversight over the use of public resources, and is at the core of the Government's Good Governance reform agenda. The impact should over time be a change in accountability and hence incentives for better performance of public authorities, including administration and public enterprises.

66. **Longer-term reform agenda.** Following the near term submission to Parliament and subsequent adoption, steps will be undertaken to allow the newly formed National Audit Office to carry out its expanded scope. This will require substantial capacity building to take on responsibility for a number of additional public enterprises as well as exercise greater oversight of privately contracted audits for major public enterprises. In addition, performance and other audits in addition to financial compliance audits will be expanded. Finally, the increased autonomy should be accompanied by continued emphasis on strong transparency of the audits and measures undertaken by public authorities to respond to audits.

Prior Action 6. The Cabinet of Ministers has authorized the Ministry of Finance to draft a Public Finance Bill strengthening preparation, execution and oversight of the budget, as well as oversight of public enterprises.

67. **This prior action represents a first step in overhauling legislation to provide a framework for greater effectiveness, efficiency, and accountability in the use of public resources.** Sri Lanka faces a combination of low revenues and several weaknesses in ability to control expenditures. A 2013 Public Expenditure and Fiscal Accountability (PEFA) assessment noted that Sri Lanka scores below low and middle income country averages on several indicators most notably: (i) monitoring and reducing payment arrears; (ii) oversight on aggregate fiscal risk; (iii) public access to key fiscal information; (iv) tax payer registration and tax collections; (v) internal audit and payroll controls; and (vi) predictability in the availability of funds. Other analysis, including in the recently completed SCD, has noted weaknesses in how the state carries out its ownership role with regard to public enterprises, especially for financial risks and in ensuring service delivery functions. The GoSL has assessed financial commitments of public enterprises to exceed 10% of GDP. Addressing weaknesses in public financial management will be important to putting the country on a more sustainable fiscal path, ensuring better usage of public resources to facilitate development, and provide for greater probity of government. Strengthening the institutional framework for management of public expenditure will also complement the fiscal consolidation efforts supported by the IMF's EFF.

68. **The Public Finance Act is expected to provide a sound legal footing for greater discipline and accountability in the Government's management of public resources.** A draft Public Finance Bill was prepared in 2003, and work was renewed in 2015 to finalize it. The formal approval by the Cabinet of the

drafting of the Public Finance Act, provides MoF with the necessary enabling authority, to take a lead role in drafting the Public Finance Bill, with due consultations with various stakeholders and consider good international practices relevant to Sri Lanka. Consistent with the guidance in the Cabinet decision to draft the Bill, the Public Finance Act is expected to provide the appropriate legal framework for financial management in the public sector, with the aim of covering the full public financial management cycle, including budget management i.e. preparation, approval and execution, borrowings, public debt and guarantees, public investment, cash management, accounting and reporting, internal control and internal audit, system development & procedures and oversight of public enterprises. The Government mandate to draft a Public Finance Bill underscores its intent to anchor the reforms within a sound legal framework to provide greater clarity on roles and responsibilities. The draft is expected to undergo consultations among stakeholders involved and reflect both consensus regarding roles and responsibilities as well as put recently initiated changes and improvements on a stronger legal footing.

69. **Longer term public sector management reform agenda.** The passage of a Public Finance Act will be an important step in providing a framework for implementing a broad range of reforms to improve public financial management. The Act is expected to underpin several ongoing improvements, including the implementation of the ITMIS and Revenue Management Information System (RAMIS) and planned initiatives such as steps to ensure greater transparency and efficiency in budgeting and execution of budgets, and initial steps to strengthen appraisal processes for public investment management and further enhance financial reporting and internal controls & internal audit. It will also help address institutional roles in the oversight of public enterprises, building on recent steps, such as the creation of a Public Enterprise Development Ministry. There are also initial steps towards automation and information sharing which would strengthen tax administration, as described under the revenue enhancement component below. Finally, there will also be a major institutional and procedural overhaul of the procurement framework, with the appointment of a National Procurement Commission, establishment of a central procurement oversight entity, carrying out steps to introduce e-procurement, and additional streamlined procurement procedures. It is expected that the passage of the bill will enable implementation of a comprehensive & sequenced set reforms, some of which are underway. Many of these initiatives are expected to be part of a PFM strategy that is currently being developed by the Ministry of Finance.

Pillar 3: Improving Fiscal Sustainability

70. **A sustainable fiscal environment is an important condition for an improved investment climate to support competitiveness.** The third pillar supports actions to: (1) slow down the narrowing of the tax base by avoiding new long-term tax holidays; and (2) take the first step towards more efficient debt management.

71. **Objective and results.** The ultimate objective is to improve fiscal sustainability. The expected main results of the program supported by the DPF include: (1) no new projects with tax holidays will be approved by Cabinet under the Strategic Development Projects Act; and (2) a medium-term debt management strategy covering domestic and external debt and defining measures to develop the domestic debt market will be approved by the Cabinet and published.

<u>**Reducing granting of new tax holidays and clarifying investment regime**</u>

Action 7. The Cabinet of Ministers has decided to submit to Parliament a proposal to repeal the Strategic Development Projects Act No 14 of 2008.

72. **This prior action will contribute to a closing down of one avenue for granting long-term tax holidays.** The Strategic Development Projects (SDP) Act of 2008 allows the Cabinet to grant tax holidays and exemptions on other taxes[30] of up to 25 years on investment projects according to loosely defined criteria.[31] Eighteen projects have been approved between 2008 and 2014, at a substantial cost in terms of projected tax revenue foregone.[32] No projects have been approved since the new Government came into power on January 9, 2015, and the Minister of Finance announced publicly in the 2016 budget speech that no more new projects will be approved under the SDP Act. Recently a formal Cabinet decision has been taken to repeal the Act, clarifying that this will happen through the Parliamentary process, while preserving the tax treatment for projects that had been approved by Parliament before the new Government came into power, and for projects that have been approved by the previous Cabinet and are in the process of approval by Parliament. This effectively closes the Act for any new projects starting January 1, 2016.

73. **The immediate result will be that no new projects are approved under the SDP Act, thereby avoiding tax base erosion and enabling the introduction of a more transparent investment framework within the Ministry of Finance.** As a consequence of this action, it is expected that the only source of tax incentives will be the Inland Revenue Act and other tax laws actively monitored by the tax agencies. This will reduce discretion and enhance the transparency on the revenue impact of incentives (through the use of tax expenditure statements). The medium-term result will be higher revenue, and more investment thanks to a clearer and more targeted incentives framework. While the prior action supports efforts to close a loophole to grant new tax holidays, more tax policy and administration reforms are needed and may be supported by future operations.

74. **Longer-term reform agenda**. In the longer term, ambitious reforms are needed to structurally increase revenue in a non-distortionary way and to make the system simpler, fairer and more efficient. Some of these reforms, in particular revisions and simplification of the tax laws and removal of exemptions, will be covered by the IMF program. The World Bank's support in FDI and trade policy (including through Actions 1 and 2) will play an important role in ensuring that tax and tax incentives reforms are consistent with the competitiveness of the economy, while its work on social protection and measuring poverty will be essential to ensure the poor are protected and to improve the distributional impact of the fiscal consolidation process. Structural reforms in tax administration beyond the adoption of the RAMIS revenue administration system are needed to make the tax system fairer, more efficient and more business-friendly, and would allow Customs to focus more on facilitating trade, rather than collecting revenue. A functional review at the Inland Revenue and Customs Departments will provide benchmark for tax administration against international standards and provide a baseline for further reforms.

Increasing the efficiency of debt management

[30] The original 2008 Act and 2013 amendment allowed exemptions on the Inland Revenue Act, No. 10 of 2006, Value Added Tax Act, No. 14 of 2002, Excise (Special Provision) Act, No. 13 of 1989, Economic Service Charge Act, No. 13 of 2006, Debits Tax Act, No. 16 of 2002, Customs Ordinance (Chapter 235) and the Betting and Gaming Levy Act. No. 40 of 1988, and other laws.

[31] A "Strategic Development Project" means a project which is in the national interest and which is likely to bring economic and social benefit to the country and which is also likely to change the landscape of the country, primarily through— (a) the strategic importance attached to the proposed provision of goods and services, which will be of benefit to the public ; (b) the substantial inflow of foreign exchange to the country; (c) the substantial employment which will be generated and the enhancement of the income earning opportunities; and (d) the envisaged transformation in terms of technology (Article 6 of the SDP Act)

[32] Using publicly available data and simple assumptions, the Present Value of corporate income tax (CIT) foregone due to tax holidays could be as high as 62 percent of the CIT theoretically raised in the absence of the tax holidays, and could amount to 0.2 percent of GDP of CIT revenue foregone per year.

Prior Action 8. The Cabinet of Ministers has approved setting up a Debt Management Unit (DMU) in the Ministry of Finance.

75. **This operation aims to address the fragmentation and weak coordination in debt management by supporting the establishment of a DMU.** There are several entities involved in debt management in Sri Lanka, leading to fragmentation and posing challenges for coordination. As a first step, the Government has created a Debt Management Committee composed of senior staff of all relevant departments at the MOF, Ministry of National Policies and Economic Affairs and the Central Bank of Sri Lanka,[33] tasked with overseeing the establishment of a unified DMU at the MoF, including proposing the structure of the unit, the terms of reference, the cadre, reporting structures and other necessary resources required for its operations. It is expected that this DMU will be responsible for development of the debt management strategy and have a leading role in international bond issuance and domestic debt management, including the preparation of an annual borrowing plan and an auction calendar, which would increase the predictability of the Government in the financial markets, which benefits market development, while CBSL will continue to perform the agency function, for example in the conduct of the auctions.

76. **The expected results are that a DMU will be established according to the parameters defined by the Committee and that a medium-term debt management strategy covering domestic and external debt and defining measures to develop the domestic debt market will be approved by Cabinet and published.** The DMU will ensure a comprehensive approach to debt management and the formulation of a medium-term debt management strategy (MTDS).[34] These together will facilitate informed decision making, thereby managing effectively the cost and risk of the debt portfolio. Over the longer term, measures to support the development of the domestic debt market would ensure government access to a stable and cost effective source of funding and provide benchmarks for the overall financial markets. In the medium-term outcomes, it is expected that the reform will contribute to increased fiscal space thanks to lower borrowing costs, a budget less vulnerable to financial shocks because of better risk management, and a deeper, more liquid domestic debt market that supports private capital market development.

77. **Longer-term reform agenda to improve debt management**. Further reforms are needed to strengthen debt management and to develop the domestic markets. This would include improving operational risk management outside the CBSL and establishing a policy for issuing loan guarantees. The newly established DMU could be further developed as a center for risk management of government liabilities, and record, report and manage fiscal risk more generally, including loan guarantees, non-guaranteed SOE borrowing and risks emanating from PPP arrangements. Structural reforms in the primary dealer system, the government securities market and the relationship between the MoF and CBSL and measures to improve price discovery are needed to further develop the government bond market.

Table 5. DPF Prior actions and analytical underpinnings

Prior Actions	Analytical underpinnings
Pillar 1. Enabling private sector competitiveness	

[33] This will include the following departments: Treasury Operations, Fiscal Policy, Public Finance, State Accounts, National Budget (MoF), External Resources, National Planning (MoNPEA) and Public Debt and Economic Research (CBSL), headed by the Deputy Governor for public debt and Deputy Secretary of the Treasury.

[34] The WB will provide capacity building training and TA on developing and implementing an MTDS to support this action.

Action 1. The Government of Sri Lanka has: (a) ratified the Protocol annexing the World Trade Organization Trade Facilitation Agreement to the WTO Agreement; and (b) created a National Trade Facilitation Committee (NTFC).	The World Bank Group conducted a *Sri Lanka–WTO TFA Validation and Reform Map*, which was finalized in September 2015. The report outlines in detail the reforms needed in order to strengthen trade facilitation in the country, highlighting the need for the WTO TFA ratification and the creation of the NTFC as critical foundations for long term reforms.
Action 2. The Cabinet of Ministers has approved the establishment of a one-stop-shop (OSS) for foreign investors aimed at reducing the processing time for investment approval.	The World Bank Group conducted a diagnostic of the obstacles constraining private sector development and competitiveness in the country ("*Sri Lanka Competitiveness Report*"). This diagnostic identified various obstacles restricting foreign and local investment and highlighted the potential facilitation role that an OSS could undertake as well as providing recommendations for its successful implementation.
Action 3. The Cabinet of Ministers has authorized the drafting of a new Secured Transactions Bill that will include provisions to facilitate the use of movable assets as collateral for bank loans, and to repeal the Secured Transactions Act 49 of 2009.	The Financial Sector Assessment Program (FSAP) conducted in 2015 outlined short, medium and long-term reform priorities in order to enhance access to finance and financial inclusion. The inability of firms to use movable assets as collateral for loans, and the shortcomings in the legal framework are well documented in the FSAP.
Pillar 2: Enhancing Transparency and Public Sector Management	
Action 4. The Government of Sri Lanka submitted to Parliament a Right to Information (RTI) Bill with wide applicability, extensive proactive disclosure, an independent appeals process, and limited exceptions.	The 2015 Systematic Country Diagnostic (SCD) noted that Sri Lanka scores relatively low on international indicators of accountability and transparency. Technical assistance from the WBG provided comparative experience with RTI legislation and implications for implementation to strengthen the bill.
Action 5. The National Audit Bill has been submitted to the Cabinet of Ministers.	The WBG conducted a Public Expenditure and Financial Accountability (PEFA) assessment in 2013. The PEFA assessed public financial management performance in Sri Lanka, providing a foundation for evidence-based measurement of the country's PFM system, processes and institutions and their ability to contribute to the achievement of aggregate fiscal discipline; strategic allocation of resources, and efficient service delivery. The PEFA identified opportunities to addressing the fiscal challenges in the country by strengthening audit functions, along with public access to key fiscal information and strengthening procurement procedures and transparency.
Action 6. The Cabinet of Ministers has authorized the Ministry of Finance to draft a Public Finance Bill strengthening preparation, execution and oversight of	The PEFA conducted in 2013 identified institutional constraints to effective management of the budget process which are to be addressed through the Public Finance Bill.

the budget, as well as oversight of public enterprises.	
Pillar 3: Improving fiscal sustainability	
Action 7. The Cabinet of Ministers has decided to submit to Parliament a proposal to repeal the Strategic Development Project Act of 2008.	Two recent World Bank studies of revenue collection and opportunities for attracting FDI concluded that tax base erosion through the granting of tax holidays was an important reason for declining revenue and that incentives are not the most effective way to attract FDI (Sri Lanka, Analysis of tax revenue and incidence, World Bank, June 2015 and Sri Lanka, Opportunities and constraints to Foreign Direct Investment, World Bank, June 2015).
Action 8. The Cabinet of Ministers has approved setting up a debt management unit in the Ministry of Finance.	An analysis of debt management performance conducted in 2015 found that a key weakness was the fragmentation of debt management across different departments (Sri Lanka Debt Management Performance Assessment, World Bank, July 2015).

Source: World Bank staff

4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

78. **Following the recent election the GoSL expressed strong interest in undertaking the preparation of this agreed instrument in order to support the initiation of reforms aimed at enhancing competitiveness**. While the proposed DPF was agreed as an instrument for collaboration under the Country Partnership strategy (CPS) for fiscal years 2013 to 2016, the main areas for policy reform to be supported by this operation had not been articulated by the previous Government. Given the fact that the attainment of the overarching goals of the government (creation of more and better jobs, enhancing exports, and strengthening productivity) will require a medium to long-term program of reforms, the GoSL has expressed interest in the continuation of this instrument in the next CPF, which will cover the period from 2017 to 2020. The articulation of a medium to long-term development strategy by the GoSL will be critical in defining the scope of the reforms pursued, policy priorities and timing. A programmatic DPF series would help to accompany a broader package of reforms when GoSL's strategies are in place.

79. **The proposed DPF is well in line with the priorities for WBG-GoSL collaboration in the Country Partnership Framework (CPF) covering fiscal years 2017 to 2020**. Leveraging on the main findings of the SCD and further informed by the ongoing policy dialogue with authorities, the DPF is at the core of the structural reform agenda needed in order to achieve the development objectives of the country – characterized by creation of more and better jobs through sustainable and equitable private sector-led growth, and a more effective public sector. The CPF has three pillars: (1) improving macro-fiscal stability and competitiveness; (2) promoting inclusion and opportunities for all; and (3) seizing green growth opportunities, improving environmental management, and enhancing adaptation and mitigation potential, while strengthening governance and improving gender equality are cross-cutting objectives. The first pillar include four objectives: (1) improving public financial management; (2) improving the enabling environment for private investment and trade; (3) scaling up infrastructure through PPP solutions; and (4) enhancing financial inclusion and financial sector efficiency. The proposed DPF contributes primarily to objectives under the first pillar, particularly the first two sub-objectives, as well as to the cross-cutting governance objective.

80. **The proposed DPF is aligned with the WBG's strategy.** The SCD highlighted the fact that poverty reduction and enhanced prosperity in Sri Lanka has been closely linked with labor-related income. The proposed operation supports actions to enable the growth of the private sector (and thus its ability to create more and better jobs), while enhancing transparency and fiscal sustainability – necessary conditions for lasting prosperity.

81. **The ongoing and planned WBG program is aligned to support a medium term reform program in the policy areas supported by this DPF.**

- Investment climate: The WBG recently prepared a Doing Business Reform Memorandum[35] that identified key obstacles on the business environment. Subsequently the WBG has provided on-going TA to the GoSL in support of preparation of an investment climate reform strategy and establishment of the institutional framework needed to guide and implement reforms. Going forward, the GoSL has requested programmatic TA aimed at supporting the implementation of the investment climate reform strategy.
- Investment policy: the WBG conducted a diagnostic of obstacles to attraction and retention of FDI[36] and has subsequently provided just in time TA to the GoSL on impending policy issues. Going forward, the GoSL has requested TA to address reforms needed in key policy issues (including tax incentives reform) and well as on enhancing efficiency of relevant institutions. In particular, the WBG has initiated TA to support the establishment of the OSS for FDI and will continue the support to this function through its implementation.
- Trade facilitation: The WBG finalized a WTO TFA Validation and Reform Map[37], which outlines key priorities for reform in trade facilitation. Going forward the GoSL has requested TA to support implementation of the reforms identified in this report.
- Access to finance: The WBG conducted a Financial Sector Development Program (FSAP) Development Module[38] which identified a number of reforms needed in order to enhance access to financial services for enterprises and improve financial inclusion for the population at large. Subsequently the CBSL has requested WBG assistance to implement the FSAP recommendations through a lending operation and programmatic TA that is under preparation and is expected to be presented to the Board in FY 17.
- Governance: The WBG is providing analytical support on governance and public financial management through Non-Lending Technical Assistance to support the drafting of the PFM strategy and the Public Finance Bill, including benchmarking against analogous legislation in other countries, support for consultations among stakeholders, and advice on the draft itself. Support is additionally being provided through the same Non-Lending TA to the Auditor General and his office regarding fulfilling its enhanced role under the new legal framework. The WBG will continue to provide just in time support for legal issues and regional comparative experience with RTI legislation. The Bank team is also committed to supporting implementation of the Act after its passage. This assistance is provided through a regional RTI trust fund, covering a set of workshops on comparative experience as well as support for developing an implementation plan. Finally, an E-procurement readiness assessment, an important element of the expenditure reforms, is to be updated in the coming year as per GoSL request.
- Tax: The WBG is updating an analysis of the distributional impact of tax and fiscal spending, which will help the assessment and the mitigation of the impact of tax reforms on poverty.

[35] Delivered in October 2015
[36] Delivered in September 2015
[37] Delivered in September 2015
[38] Finalized in August 2015

- Debt Management: The WBG stands ready to support the authorities during the formulation of the terms of reference of the new unified Debt Management Unit. The WBG may provide (at the request of the GoSL) training and advisory support on formulating a medium-term debt management strategy and a debt sustainability analysis. A Debt Management Performance Assessment (DeMPA), a diagnostic assessment of the functions, practices and policies for debt management, was conducted in 2015, and on the basis of the findings, a detailed reform action plan will be provided. The WBG has regularly trained staff from the relevant departments, and has hosted a debt management officer from CBSL for 3 months at headquarters to obtain exposure to good practices in other countries and at the World Bank, in particular related to debt markets, primary dealers and debt strategy. In addition, issues of debt management are being covered through TA on the Public Finance Bill.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

Consultations

82. **The GoSL has conducted consultations with public and private sector stakeholders in defining the overall strategic directions and priorities for short-term reforms to facilitate private sector competitiveness.** A monthly Doing Business Forum hosted by the Ministry of Finance has created an incipient platform for expression of the views of the private sector. Similarly, the Ministry of National Policies and Economic Affairs convened representatives of private sector and business associations to consult on areas including investment climate, FDI attraction and access to finance. Key issues raised in those fora have been reflected in recent policy statements and in the prior actions supported by the proposed DPF. These include the need to streamline FDI approval processes, reduce the cost of doing business through streamlined regulation and enhanced interagency coordination, and strengthening the ability of smaller enterprises to access finance from commercial banks.

83. **Consultations around reforms to enhance transparency and public sector management have been most active around the RTI Bill.** The original bill had been drafted in 2003-4 and been subjected to intense public scrutiny at that point. Following the recommitment to establishing an RTI framework, the Government convened a team of experts from ministries as well as leading civil society advocates, media figures, and legal professionals to update the draft. A series of public consultations were held by the Government around the draft in the spring and summer of 2015. The inclusion of constitutional amendments to strengthen audit and procurement were reflected in the election platform of the current president; with regard to audit provisions and the Audit Bill multiple stakeholders in government were consulted in the spring and summer of 2015. In particular, a meeting of senior officials from most ministries was held concerning the operationalization of the 19th Amendment through the draft Audit Bill. Broad consultations are anticipated concerning the Public Finance Bill following the preparation of a complete bill following authorization of the Ministry of Finance to prepare the same. The Bill will build on a draft of the bill and associated consultations which were held much earlier.

84. **Prior Actions in the fiscal sustainability pillar have been prominent in the Government's public statements.** In his 2016 budget speech the Minister of Finance publicly confirmed the understanding that the current Cabinet would not approve any new projects under the Strategic Development Projects (SDP) Act, stating that the granting of tax concessions should be strictly under the supervision and monitoring of the Ministry of Finance. A commitment to not negotiate special deals under the SDP Act is consonant with the Government's overall platform of Good Governance. The election manifesto of one of the two current Government coalition parties includes the plan to establish a "National Debt Bureau", which has led to the

Cabinet decision to establish a Debt Management Unit (DMU). There has been discussion among Government stakeholders, primarily within the Ministry of Finance and the Central Bank, about the modalities for establishing the DMU.

Collaboration with development partners

85. **The Government of Japan (GoJ) has expressed willingness to provide budget support to the GoSL** to support the implementation of policy reforms in the areas covered by the proposed DPF. At the request of the GoSL, the WBG has worked in close collaboration with JICA, converging to a joint policy reform matrix that will be supported both by JICA's and the WBG's budget support operations. The team has frequently consulted with the IMF on macroeconomic and revenue issues.

86. **The Australian Department of Foreign Affairs and Trade (DFAT) has partnered with the WBG** on the provision of technical assistance to the GoSL aimed at supporting reforms in areas related to trade and competitiveness. The assistance will cover, but is not limited to, the actions included in this operation.

87. **The WBG conducts ongoing communication with other development partners in order to ensure coordination in the policy areas included in this operation**. Current and planned programs by development partners include a European Union-funded trade facilitation program expected to start in 2017, US Agency for Development's planned assistance to the BOI and Asian Development Bank's assistance to the Securities and Exchange Commission.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

88. **The prior actions supported by this DPF operation are not expected to have adverse impact on the poor.** The program supported by this DPF is expected over time to contribute to enhanced competitiveness, public sector management and transparency, which would benefit the poor through job creation and improved performance of government, which in turn should lead to better service delivery and fulfillment of regulatory functions. The systemic reforms supported by the operation are expected to have overall positive effects for gender inclusion.

89. **Prior actions aimed at enhancing trade facilitation are not expected to have any adverse impact on the poor.** While trade agreements modifying tariffs may affect specific sectors of the economy, the WTO-TFA does not focus on tariff reduction but on reducing trade costs. In this regard, research conducted by the World Bank Group modeling the welfare impacts of the TFA has found substantial welfare gains worldwide, so this would be expected in Sri Lanka as well.

90. **Prior actions aimed at removing obstacles to FDI are not expected to have any direct adverse impact on the poor.** The action supported by the DPF aims at reducing the time it takes for foreign investors to receive investment approval through enhancement of interagency coordination and responsiveness. This action does not contemplate the modification of any of the existing regulations governing business activities and observance of safeguards for environmental and social aspects.

91. **The long-term effects of facilitating FDI are likely to be positive and significant for the poor.** The majority of poverty reduction over the last decade in Sri Lanka has come from increased labor earnings, which in turn resulted from increased productivity and movement out of agriculture. Increases in FDI are generally associated with increased technology adoption and poverty reduction in developing countries.[39] However, the impact of FDI on overall development goals in Sri Lanka has not been assessed. Assessing and monitoring the effect of FDI on poverty, employment and productivity will be important area for policy dialogue and possibly support from the WBG.

92. **Actions to enhance access to finance are expected to have a significant positive impact on the poor.** Access to credit in the country is usually limited by the lack of availability of real estate collateral, which is exacerbated by deficiencies in land cadaster and titles. Enabling the use of movable collateral is likely to enable smaller borrowers to access credit from a formal financial institution, thereby reducing reliance on informal credit sources which usually carry higher cost of credit and pose concerns on consumer protection. The greater flexibility in use of collateral by the formal sector is expected to increase access to finance among women since, as documented in the SCD, women in general tend to face higher threshold requirements for collateral.

93. **Efforts to improve transparency and accountability in the management of public finances will have, if anything, beneficial effects on the poor.** In particular, improvements in the ability of citizens to monitor Government can benefit the poor by reducing delays and improving the quality of service provision and public goods such as roads.[40] A legal framework empowering citizens to request information about

[39] Kemeny et al, 2010, Gohou et al, 2012.
[40] Lewis-Faupel, et al, 2014.

government programs and requiring public authorities to disclose such information proactively has led to better performance, including more equitable treatment of less socially powerful groups, including in many cases women.[41] For instance, RTI frameworks have proven particularly important in improving transparency in the administration of social benefits in South Asia, helping to counter leakages and ensure equal access to services, including for women.

94. **Similarly, improvements in public sector management should lead to more resources for delivery of public services.** The less well-off tend to rely on public services to a greater extent than more wealthy segments of the population, which are more likely to be able to afford services such as education and health provided by the private sector.

95. **The prior action on repealing the SDP Act is unlikely to have a negative impact on the poor.** While the repeal will have no impact on ongoing SDPs, at the margin it may make certain future projects less attractive. However, closing this avenue to long-term tax holidays will positively affect tax revenue and fiscal sustainability, which in the long run may benefit the poor.

96. **The prior action on the debt management unit will not directly impact the poor.** To the extent that the DMU is effective in managing fiscal risk to the government and improving fiscal sustainability, the poor will benefit indirectly.

5.2 ENVIRONMENTAL ASPECTS

97. **The proposed operation has been screened against OP 8.60 and none of the policy reforms to be supported by the DPF are expected to result in significant environmental impacts.**

98. **Sri Lanka has a very strong regulatory framework to ensure investments and developments are environmentally sustainable**. If any unexpected impact arises, the current environmental and environmental impact assessment (EIA) legislation would serve as a good mechanism to address these issues. Sri Lanka is making sustained efforts to align its legislation and practices to international standards and to effectively implement and enforce the use of EIAs based on an assessment carried out by the World Bank in 2012.

99. **No long-term climate change or environmental impacts have been identified on areas directly related to this operation**. The climate and disaster risk screening undertaken for the DPF revealed that the reforms proposed by the project under the three pillars (focused on enabling private sector competitiveness, enhancing transparency and public sector management and improving fiscal sustainability) have overall low vulnerability to climate and disaster physical risks or to related policies and programs that are currently in place. Some of the policy actions such as streamlining the investment establishment system, proactive disclosure of information and strengthening public financial management may further reduce potential future vulnerabilities by indirectly contributing towards ensuring effectiveness of implementing climate and disaster related policies and financing of well-designed and targeted programs that are beneficial to Sri Lanka's economy.

[41] Dokeniya, 2013. Implementing Right to Information: Lessons from Experience. The World Bank. Washington.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

100. **The country's PFM system has a number of key strengths that have been identified in the Public Expenditure and Financial Accountability (PEFA)** assessment of January 2013 and continue to be maintained as verified by recent discussions. These include: i) a consistent and consultative budget preparation process which ensure adequate time for budget preparation and timely approval of the budget; (ii) a complete set of budget documentation being made available to the public when it is submitted to the legislature;[42] iii) high quality financial information and annual financial statements; iv) thorough legislative scrutiny of the annual budget law; and v) timely audit of the country's annual financial statements.

101. **Notwithstanding these positive elements, there are a number of areas in Sri Lanka's PFM systems and policy that can be improved.** Sector strategies exist, though these are not fully costed and determined within realistic fiscal forecasts, while sector budget ceilings are not communicated at the start of the budget preparation process. Budget predictability and controls in its execution are impacted by weaknesses in revenue administration, public procurement, payroll management and internal audit. In particular, line ministries do not receive sufficiently timely information on the actual resource availability to plan and manage the procurement-expenditure cycle. These factors create a challenging environment to implement sector budgets in an effective and efficient manner. These have in the past led to a build-up of arrears in payments, while there is no reliable system in place to monitor the consolidated position of payment arrears. Public access to key fiscal information is another area for improvement. The GoSL has shown commitment to addressing these weaknesses through a number of PFM strengthening initiatives noted in the section outlining the link to the CPS and World Bank Operations.

102. **In conclusion, it can be determined that GoSL PFM systems together with GoSL's commitment to improve PFM performance through various planned and ongoing initiatives gives reasonable assurance that it is capable of managing the country's budget resources appropriately.** Hence, it is deemed that there are no unaddressed weaknesses in budget and finance management that will require additional arrangements to support the successful implementation of the proposed operation.

103. **The Bank has reasonable assurance that the control environment for foreign exchange in the CBSL is satisfactory for the purposes of this operation.** This assessment is based on the CBSL audit report and the satisfactory outcomes of other operations, which have been disbursed and managed through the CBSL. The last IMF Safeguard Assessment of the CBSL was carried out in July 2009. An update is scheduled for completion before the first review of the EFF program in November 2016. Nevertheless, the CBSL is subject to an external audit by the Auditor General of Sri Lanka under the Monetary Law Act sections 42 & 43. The Auditor General in turn has obtained the services of a reputed firm of Chartered Accountants to carry out an audit under International Standards of Auditing (ISA) to ensure compliance with International Financial Reporting Standards (IFRS). As part of the appraisal for the DPF operation, the CBSL audit report and published annual financial statements for the year ended 31st December 2015 and the preceding two years were reviewed by the Bank. The audit reports have been issued by the Auditor General of Sri Lanka and have clean, unqualified opinions. Therefore, it is deemed that no additional fiduciary arrangements need to be put in place for the DPF.

104. **After credit effectiveness, the GoSL will be able to access funds from the Bank upon satisfactorily achieving the prior actions and maintaining a satisfactory macroeconomic policy framework.** Following

[42] Available through external website.

a request for withdrawal through Form 2380, the Bank will disburse the proceeds into an account denominated in foreign currency that forms part of the GoSL's official foreign exchange reserves held by the central bank. The GoSL can use the proceeds as follows: i) make budgeted foreign currency payments directly from this foreign currency bank account; ii) transfer amounts from the foreign currency bank account to a local currency bank account of the GoSL, which the GoSL then uses to make payments for its budget expenditures; or, iii) a combination of these approaches. The Ministry of Finance is to provide within 30 days of disbursement of the credit written confirmation of the receipt in U.S. dollars, Sri Lankan Rupee amount, account number and name, date of receipt and exchange rate applied.

105. **Once the funds enter the GoSL's foreign exchange reserves and the budget, they will be commingled with the GoSL's other funds.** Therefore, the Bank will not require tracking the end use of DPF funds. This means that disbursements of the loan will not be linked to any specific purchases and no procurement requirements have to be satisfied, except that the borrower is required to comply with the standard negative list of excluded items that may not be financed with Bank loan proceeds, as defined in the loan agreement. If the Bank at any time determines that any amount withdrawn under the Bank Loan has been used for expenditures excluded under the legal agreement, the Bank will require the Member Country to refund the amount to the Bank. The amount so refunded is credited to the loan account and cancelled.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

106. **The Department of Project Management and Monitoring at the Ministry of National Policies and Economic Affairs has been recently mandated by the Cabinet to coordinate and monitor the implementation of the actions supported by this operation.** In undertaking this task, the Department of Project Management and Monitoring will coordinate actions among other concerned ministries and agencies, including: the Ministry of Development Strategies and International Trade, the MOF, AG, BOI and CBSL. The World Bank will monitor actions and review progress of the implementation of the proposed operation and tracking of results through frequent interaction with implementing agencies by staff in country and constant communication with authorities, on the basis of the policy matrix. An Implementation Completion and Results Report (ICR) will be completed within 12 months of the closing date of the DPF.

107. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS

108. **The overall risk rating for this operation is substantial**. This is due primarily to: (i) uncertainty on the actions that will be taken to address macroeconomic vulnerabilities; (ii) risks pertaining to the lack of familiarity of the counterparts with the DPF instrument; (iii) political and governance risks owing to the sensitivity of some of the reforms; (iv) institutional risks related to the newness of several of the institutions; and (v) stakeholder risks as reforms are perceived to go against favorable current circumstances. As mentioned previously, there are still significant vulnerabilities in the macroeconomic framework, which raise questions concerning risks to Sri Lanka's macroeconomic and fiscal sustainability. Substantive short and medium-term actions are needed to address these vulnerabilities. The IMF program anchors medium-term fiscal consolidation and key reforms and is expected to provide the catalysts for such actions. If the IMF program targets are not met or key expected reforms are not implemented as planned, the macroeconomic framework underpinning this DPF may become inadequate and the program may be derailed.

109. **The proposed operation is the first policy support operation in a decade, with the exception of the CAT DDO**. The authorities need to familiarize themselves with the process and operational requirements of the DPF, particularly in monitoring for results. In order to mitigate this risk the team has worked closely with the GoSL throughout the preparation of this operation and has conducted knowledge sessions to inform authorities of the relevant processes and policies. While this close collaboration has helped to enhance collaboration, delays observed throughout initial stages of the preparation of this operation highlight the potential for unexpected additional shortcomings in future steps.

110. **Political and governance risks are substantial.** These risks lie primarily in the ability of the coalition Government to have sufficient cohesion to move forward efficiently with the reform agenda and be effective in ensuring that the state apparatus carries through with reforms. There remains considerable internal debate around some issues of trade facilitation as well as fine tuning around the accountability mechanisms envisaged in the governance reforms. While there is broad support for strengthening debt management and not providing ad hoc tax privileges under the Strategic SDP Act, measures to improve financial management and oversight over public enterprises may encounter political resistance. While the GoSL is relatively effective, some of the new institutional arrangements, particularly triggered by governance reforms, will also encounter a "settling in" period as new staff and procedures are put in place.

111. **Sector policy and institutional risks and operational design, implementation, and sustainability risks are also substantial.** The reform program involves implementing new laws and establishing new departments, and institutional rules. There will be organizational issues in setting up the mechanisms to ensure implementation of new laws. The uncertainties about institutional strength, capacity to implement, and coordination make these risks substantial. These risks will be mitigated through non-lending TA programs supporting competitiveness reforms, implementation of the RTI Act, support for the PFM strategy, support for the setting up the of the DMU and developing a debt management strategy, as well as targeted technical support for the AG's Department.

112. **Stakeholder risk is substantial.** Changes in the trade regime may be perceived as having an adverse impact on specific sectors and enterprises, triggering resistance. There may also be some interests in the bureaucracy which would resist reforms to improve transparency and oversight. The experience in other countries, particularly South Asia, has pointed to a degree of discomfort among some

members of Government with a full-fledged Right to Information regime. Expanded audit coverage of all public enterprises by the supreme audit institution may also not be welcomed by those entities which were not previously covered, those these enterprises had usually already undergone regular audits. The Bank will aim to mitigate these risks through active engagement of stakeholders throughout the implementation of the actions supported by this DPF as part of the related technical assistance outlined in section 4.3.

113. **Fiduciary, environmental and social risks are low as outlined in the relevant sections above.**

Table 6. Summary Risk Ratings

Risk Categories	**Rating**
1. Political and governance	Substantial
2. Macroeconomic	Substantial
3. Sector strategies and policies	Substantial
4. Technical design of project or program	Substantial
5. Institutional capacity for implementation and sustainability	Substantial
6. Fiduciary	Low
7. Environment and social	Low
8. Stakeholders	Substantial
9. Other	NA
Overall	Substantial

ANNEX 1. POLICY AND RESULTS MATRIX

Areas of Intervention	Prior Actions	Indicator	Baseline and target[43]
Pillar 1. Enabling private sector competitiveness			
Increasing the efficiency of trade facilitation	**Action 1.** The Government of Sri Lanka has: (a) ratified the Protocol annexing the World Trade Organization Trade Facilitation Agreement to the WTO Agreement; and (b) created a National Trade Facilitation Committee.	Adoption of national action plan for the implementation of the WTO Trade Facilitation Agreement including specific roles and responsibilities, timeframe for implementation, and required human and financial resources	Baseline: No Target: Yes
Removing obstacles to foreign investment entry and establishment	**Action 2.** The Cabinet of Ministers has approved the establishment of a one-stop-shop (OSS) for foreign investors aimed at reducing the processing time for investment approval.	Average time required for foreign investment approval	Baseline: 63 days on average Target: 50 days on average
Enhancing access to finance	**Action 3.** The Cabinet of Ministers has authorized the drafting of a new Secured Transactions Bill that will include provisions to facilitate the use of movable assets as collateral for bank loans, and to repeal the Secured Transactions Act 49 of 2009.	Enactment of the new Secured Transactions Act repealing the Secured Transactions Act 49 of 2009, facilitating the use of movable assets as collateral for bank loans	Baseline: No Target: Yes

[43] Baseline is set as of June 1, 2016. The target is to be achieved by September 30, 2017.

Areas of Intervention	Prior Actions	Indicator	Baseline and target
Pillar 2: Enhancing Transparency and Public Sector Management			
Transparency			
Establishing a Right to Information Framework	**Action 4.** The Government of Sri Lanka submitted to Parliament a Right to Information (RTI) Bill with wide applicability, extensive proactive disclosure, an independent appeals process, and limited exceptions.	Share of ministries that proactively disclose information as required by the RTI Act on websites.	Baseline: 0% Target: 50%
Strengthening Audit Oversight	**Action 5.** The National Audit Bill has been submitted to the Cabinet of Ministers.	Establishment of a National Audit Office with administrative and financial independence.	Baseline: No Target: Yes
Public Sector Management			
Strengthening Public Financial Management	**Action 6.** The Cabinet of Ministers has authorized the Ministry of Finance to draft a Public Finance Bill strengthening preparation, execution and oversight of the budget, as well as oversight of public enterprises.	Submission of Public Finance Act to Parliament.	Baseline: No Target: Yes

Areas of Intervention	Prior Actions	Indicator	Baseline and target
Pillar 3: Improving fiscal sustainability			
Reducing granting of new tax holidays and clarifying investment regime	**Action 7.** The Cabinet of Ministers has decided to submit to Parliament a proposal to repeal the Strategic Development Project Act of 2008.	Number of new projects with associated tax incentives approved under SDP Act.	Baseline: 18 (between 2008 and 2015) Target: 0 (from January 1, 2016)
Increasing the efficiency of debt management	**Action 8.** The Cabinet of Ministers has approved setting up a debt management unit in the Ministry of Finance.	Approval and publication of a medium-term debt management strategy (MTDS) covering domestic and external debt and defining measures to develop the domestic debt market.	Baseline: No Target: Yes

ANNEX 2. LETTER OF DEVELOPMENT POLICY

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நிதி அமைச்சு
MINISTRY OF FINANCE

RECEIVED
09 JUN 2016

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செயலகம், கொழும்பு 01. இலங்கை
The Secretariat, Colombo 01. Sri Lanka

කාර්යාලය / அலுவலகம் / Office: (94)-11-2484500, (94)-11-2484600, (94)-11-2484700
ෆැක්ස් / பெக்ஸ் / Fax: (94)-11-2449823
වෙබ් අඩවිය / வெப் சைட் / Website: www.treasury.gov.lk

මගේ අංකය / எனது இல. / My No.: ERD/WB/DPL
ඔබේ අංකය / உமது இல. / Your No.:
දිනය / திகதி / Date: 07.06.2016

Dr. Jim Yong Kim
President
The World Bank
Washington DC
USA.

Dear Dr.Kim,

Letter of Development Policy

With the elections in January 2015, Sri Lanka ushered in a new unity government. Our Prime Minister in November 2015, outlined the strategic outlook of the country for the next 5 years. This detailed the development trajectory of the government, requires significant reforms in governance structures, administrative systems and economic policies. We are mindful that while Sri Lanka has managed to maintain an economic growth of around 5-6 percent in the last 5 years, which in turn has been a major factor in reducing the poverty rate from 22.7 percent of the population in 2002 to 6.7 percent in 2013, that the country has missed many opportunities in the last three decades due to the internal conflict that prevailed in the country. However, now importantly, Sri Lanka is at peace and the Government is undertaking steps to ensure that the grievances which fueled problems in the past are addressed.

It is in this background that the key goals of the aforementioned strategic outlook has been identified to be as follows:

1. Generating a million jobs;
2. Increasing incomes;
3. Developing the rural economy;
4. Providing for land ownership to the rural and estate sectors, middle class, and government employees; and
5. Creating a wide and strong middle class.

Achieving these goals will require a concerted effort in many areas, but three in particular are priorities for the Government: the need to facilitate a more competitive private sector as the engine for generating jobs and increasing incomes; improving the efficiency and effectiveness of the public sector; and ensuring longer term fiscal sustainability.

Enabling Private Sector Competitiveness

Sri Lanka led the way in South Asia in opening up its economy in the 1970s to foreign trade and this has led to the country being able to achieve a relatively better standard of living in comparison to our neighbors. However, the three decades of conflict that prevailed, resulted in the country, losing many opportunities to link into the global value chains. Economic growth in the last decade has been driven by large infrastructure projects, which was required given the lack of modern facilities that is necessary to facilitate domestic industries as well as to attract foreign direct investments.

While the development of roads, electricity, and other physical infrastructure was given attention in the last few years, inadequate reforms in the administrative and legal framework has become a hindrance in attracting Foreign Direct Investments (FDI). As such the Government is now focused on addressing these challenges so as to improve the investment climate, particularly through the removal of barriers to trade.

The Government has taken measures already to build momentum for reform in these areas. First, it has set up institutions to lead and coordinate reforms that support private sector development through the establishment of an Agency for International Trade tasked with formulating a new trade policy and an Agency for Development to establish a new FDI attraction strategy. These Agencies will formulate long-term strategies; a key element within these strategies will be addressing the complex system of incentives, tariffs, and para-tariffs which has emerged over time. To complement the long-term work, the Government is making practical quick improvements to facilitate trade and investment. For instance, the Government has established an electronic visa facility to make it easier for business persons to obtain a visa. Going forward, these will be complemented by broader efforts to improve the investment climate in the country. At the same time, a high level steering committee has been set up which has been tasked with leading business environment reforms in the country, in order to identify and eliminate regulatory obstacles to entry and expansion of businesses.

Enhancing Transparency and Public Sector Management

The Government of Sri Lanka has been committed to carrying out a wide range of governance reforms. Government has taken significant steps to strengthen transparency and accountability, most notably through the passage of the 19th Amendment to the Constitution. This amendment created a greater balance between the Presidency and a Cabinet formed by a Parliamentary majority. It also strengthened the system for independent commissions to hold Government accountable, by reconstituting a Constitutional Council which is represented by diverse interests that in turn was empowered to make appointments to independent commissions. Public Service Commission and Police Commission has been reestablished so as to ensure their operational independence from external and specially political interference.

Reforms have also targeted improving Government's effectiveness, particularly in the management of its assets. The 19th Amendment also created Audit and National Procurement Commissions to provide an institutional framework that increases oversight and integrity in the use of public monies. These commissions have been appointed and are in the process of establishing updated rules on how these vital functions are carried out. The Government has also sought to increase effectiveness in its revenue and treasury operations, in particular through the development of the Revenue Administration Management Information System (RAMIS) and the Integrated Treasury Management Information System (ITMIS). The Government has also launched a preparedness assessment for introducing e-procurement to obtain greater value for money in public spending.

The Government is also committed to exercising stronger oversight to improve the performance of public enterprises. Sri Lanka has a large number of public enterprises, some of which play a significant e role in the economy, such as in the banking sector. Public enterprises are major employers. Some are inefficient, causing significant financial risks. Towards this end, a dedicated Public Enterprises Development Ministry was established to provide much more direct management oversight to drive better performance, both in terms of the goods and services provided by public enterprises but also to ensure that the fiscal burden on the treasury is lowered.

These reforms in the management of public resources are in their nascent stages. Results from these reforms will require years of implementation and will doubtless encounter challenges from vested interests. The Government is committed to carrying through on all of these fronts, but recognizes that not everything can be implemented at once. Hence we are keen to take actions quickly which in turn provide a platform for carrying through with long-term systemic reforms as well as help build momentum going forward.

Improving Fiscal Sustainability

The Government recognizes that a pre-condition in macroeconomic stability is fiscal sustainability. In this regard the Government has decided to adjust revenue and expenditures to limit the fiscal deficit for 2016 and start reducing the public debt-to-GDP level to reach 60 percent by 2020. Given the impact of low commodity prices, stagnating remittances and a marked bias of capital markets away from emerging economies such as Sri Lanka towards the US, the impacts of which has begun to permeate into the country, we have decided to engage with the IMF on an Extended Fund Facility (EFF) beginning from 2016 going on till 2019. This will help to stabilize our external sector vulnerabilities while building confidence in our investment partners of our credit worthiness and the commitment to reforms.

The Government recognizes that low tax revenue is the source of many macroeconomic and fiscal problems in the country and is committed to addressing this issue having recognized its impact not only in the short term but also in the long term.

The multi-pronged strategy of the government designed to improve the tax collection of the country includes increase of the VAT and the Corporate Taxes while extending the VAT to wholesale and retail sectors and removing VAT exemptions. Government has also taken a policy decision to stop tax holidays or incentives on profit and to limit it to only investments. The proposed revision of the Inland Revenue Act with the assistance of the IMF is a key aspect of the government strategy. Given that RAMIS will in the first phase connect almost 20 institutions into one platform, the operationalizing of RAMIS is expected to improve tax collection. Government is also looking into eliminating the various tax exemptions and holidays given, replacing such incentives with more targeted incentives.

With global financial conditions tightening, the Government also seeks to improve the functioning of its domestic capital markets, which will help both the private and public sector improve access to finance on more favorable terms, and increase the national savings rate. It plans to establish a unified Debt Management Unit (DMU) in the Ministry of Finance, which will be responsible to develop a debt management strategy taking into account the costs and risks of the current debt portfolio and the financial conditions going forward.

Reforms supported by the Development Policy Financing

The Government has carried out a set of initial reforms in the 3 key areas of, enabling private sector competitiveness, enhancing transparency & public sector management, and improving fiscal sustainability as part of our medium and long-term reform agenda.

1. Enabling private sector competitiveness

The government has taken initial steps to eliminate identified obstacles constraining the competitiveness of the private sector as a way to unleash the potential of Sri Lankan enterprises. The following specific actions have been taken in this regard:

1.1 The Cabinet has approved the ratification of the WTO Trade Facilitation Agreement (TFA) and the creation of the National Trade Facilitation Committee (NTFC).

The TFA sets forth a series of measures for expeditiously moving goods across borders inspired by the best practices from around the world. The ratification of the WTO TFA by Sri Lanka will formalize our commitment to the implementation of the provisions of the agreement. This will also signal to domestic and international stakeholders our strong commitment to reform and modernization of the trade facilitation regime. The ratification of the WTO TFA and the formal establishment of the NTFC can be an effective platform for a second wave of reforms that target core bureaucratic bottlenecks through digitization, increasing transparency and ensuring ease of access to trade related information as identified in, inter alia, Doing Business rankings and Trading Across Borders indicators. The NTFC is expected to oversee and coordinate all trade facilitation matters in Sri Lanka including full and effective implementation of the WTO TFA, which provides the framework for the implementation of simple, transparent trade procedures that enhance trade facilitation. This is an important step in setting up a foundation for trade facilitation reforms. .

1.2 The Government has established a One Stop Shop to facilitate establishment and operations of foreign investors in the country.

Foreign Direct Investment (FDI) is an important ingredient to the economic diversification that Sri Lanka aspires to. But FDI, especially from efficiency-seeking investors, can be not only an important source of funding and employment generation, but also a mechanism to increase productivity, create positive spillovers and enhance access of Sri Lankan producers to global production networks and value chains.

However, FDI in Sri Lanka has been lower than in regional peers in spite of Sri Lanka's comparative advantages. The obstacles to attract and retain FDI are manifold, ranging from deficiencies in the legal and regulatory framework to institutional shortcomings. While addressing all these obstacles will require a medium term reform program, as a first step, the Government of Sri Lanka has mandated the inception of a One Stop Shop (OSS) for FDI, as the mechanism to address regulatory deficiencies and interagency coordination that currently create significant obstacles and transaction costs to investors interested in establishing operations in Sri Lanka.

The Cabinet of Ministers approved the establishment of the OSS together with its Terms of Reference (TOR). The OSS's primary mandate is to undertake interagency coordination to expedite investment approval. In this regard the OSS is expected to reduce lead times for investment approval by reducing the number of bilateral interactions needed between investors and regulatory agencies and creating a mechanism to proactively track the status of applications and prompt response from regulatory agencies.

1.3 The Cabinet has approved the drafting of a new Secured Transactions Act (STA) which includes provisions to enable the use of movable assets as collateral for bank loans, repealing the Secured Transactions Act 49 of 2009 (STA 2009).

Access to finance is identified as a major constraint for firms' growth in Sri Lanka. It is particularly difficult in the case of smaller firms and credit is often dependent on their ability to post collateral with significant value mainly through real estate, while movable assets are not recognized by law as sufficient security for loans. A Secured Transactions Act No. 49 was enacted in 2009 with the purpose of enabling the use of movable assets as collateral in loans. However, deficiencies in the law rendered it ineffective. As such the Cabinet of Ministers has approved the repealing of the existing Act and drafting of a new Act to address the deficiencies identified in the existing Act, by enforcing use of collateral registries and providing priority to registered claims in case of borrowers' default. The expected passage of the new STA by Parliament is expected to enable firms better access to financing, using movable assets as collateral.

2. Enhancing Transparency and Public Sector Effectiveness

The Government is keen to sustain its effort to bring about good governance. We are of the view that a Government that is transparent, responsive, and effective can provide better public services, foster a stable conducive environment for private sector development, and ensure overall stability. These are all key ingredients for competitiveness. The government has taken the following steps to build an institutional framework that would improve the operations of Government.

2.1 Cabinet has submitted to Parliament a Right to Information (RTI) Bill with wide applicability, extensive proactive disclosure, an independent appeals process, and limited exceptions.

The RTI bill requires disclosure of information held by government with limited exceptions which themselves can be overridden on the grounds of public interest. These requirements apply to comprehensive list of Public Authorities. The bill creates an independent Information Commission to hear appeals under the Act with the power to prosecute public officials on certain grounds. It designates the Ministry of Mass Media and Parliamentary Affairs as responsible for ensuring the effective implementation of the Act in collaboration with the Commission. The Bill provides a framework for filing applications to receive information while placing requirements for proactive disclosure of information relating to budget allocations and execution. The Bill has been submitted to Parliament and is under debate. The Supreme Court has also submitted their views on the draft bill. The Bill once passed in Parliament will become effective six months after its passage. Steps will need be taken to set up the Information Commission. The government believes that this initiative provides for greater citizen oversight, together with more open deliberation of government regulation, and strengthens feedback between citizens and government in the delivery of public services.

2.2 Drafting of the National Audit Bill that establishes a National Audit Office as the Supreme Audit Institution of the country and operationalizes reforms introduced in the 19th Constitutional Amendment.

The enactment of the 19th Constitutional Amendment greatly strengthened the administrative independence of the audit function by providing for the establishment of an Audit Service Commission. It also clarified the mandate of the Auditor-General to audit the accounts of State Owned Business Enterprises registered under the Companies Act with majority government ownership, thus improving oversight and transparency. The National Audit Bill is expected to operationalize the reforms included in the 19th Amendment. It establishes the National Audit Office, and the Audit Service Commission. The legislation also defines other important aspects such as the scope of audit services provided by the Auditor-General, the auditing standards to be followed, the Auditor-General's powers to access information, time frames for submitting audit reports to Parliament. It requires the audit reports to be published on the official website of the National Audit Office. This action is intended to address weaknesses in the legal framework which limited the independence of and scope of oversight exercised by the Auditor General and contributes to improved transparency, better oversight over the use of public resources.

2.3 Cabinet of Ministers has authorized the Ministry of Finance to draft a Public Finance Bill strengthening preparation, execution and oversight of the budget, as well as oversight of public enterprises.

The Cabinet has authorized the Ministry of Finance to take the lead in drafting of the Public Finance Act,. This work will be carried out in conjunction with various stakeholders and consider good international practices relevant to Sri Lanka. The Public Finance Bill will provide the appropriate legal framework for financial management in the public sector, with the aim of covering the full public financial management cycle, including budget management i.e. preparation, approval and execution, borrowings, public debt and guarantees, public investment, cash management, accounting and reporting, internal control and internal audit, system development & procedures and oversight of public enterprises. The Bill will complement the Finance Act no 38 of 1971 and other legislations. It is expected that the passage of the bill will enable the implementation of a comprehensive and sequenced set of reforms, some of which are already underway. These detailed actions are part of a Public Finance Strategy that is currently being developed by the Ministry of Finance.

3. Improving fiscal sustainability

The government is of the view that sustainable fiscal environment is an important condition for an improved investment climate to support competitiveness. It has taken a few key steps in the direction of achieving the policy target of 3.5 percent of GDP fiscal deficit by 2020. The specific measures taken include:

3.1 Cabinet has decided to increase the rates for VAT and Corporate Income Tax rates and remove some of the VAT exemptions.

In order to limit the fiscal deficit in 2016 to 5.4 percent of GDP, the Cabinet has decided to a) VAT: increase the single rate from 11 to 15 percent, remove exemptions for private health services and telecommunications, reduce and unify the threshold, while expanding it to encompass the whole sale and the retail sectors; b) Corporate Income Taxes: the changes approved in the original 2016 budget will be implemented with a higher tax rates on all sectors (17.5 percent instead of 15 percent), while keeping the pre-2016 rates on the financial sector at 28 percent and 40 percent on betting, liquor and tobacco sectors On the expenditures, the government will engage in a strict management of commitments and expenditures. To this end, we have already initiated discussions with the World Bank to rationalize our social safety networks and welfare schemes, which has grown haphazardly over the years becoming a strain on the government's fiscal resources. We are also mindful that these schemes have also significant leakages, duplications and inefficiencies that if addressed will have a positive impact on the government finances, while facilitating a better and a targeted and a more enhanced social welfare mechanism.

3.2 Cabinet has decided to permanently suspend the approval of new projects under the Strategic Development Project Act of 2008 (SDP Act), as a first step towards repealing the Act.

Previously, the SDP Act allowed the granting of tax holidays and exemptions on income and other taxes on identified large investment projects leading to significant foregone tax revenues due to erosion of the tax base. The 2016 budget announced that there will not be any more projects approved under the SDP Act. While preparations are made to repeal the law to give effect to this announcement, a formal Cabinet decision has been published stating that it would no longer approve new projects under the Act. While the removal of exemptions will have a positive impact on the fiscal space of the government, recognizing that investors also require incentives, in the alternative the government is looking into mechanisms of providing investors with incentives based on the quantum of investment rather than profits as was the case.

3.3 Cabinet has established a Debt Management Committee tasked with defining the terms of reference of a unified Debt Management Unit (DMU) in the Ministry of Finance

The government is planning to set up a unified debt management unit by merging the debt and guarantee management responsibilities of the Department of Treasury Operations, Department of External Resources of the Treasury and the Public Debt Department of the Central Bank of Sri Lanka. In this context given the complexity involved in the setting up of a unified debt management unit at the Ministry of Finance, the Cabinet has sanctioned the establishment of a Debt Management Committee composed of all stakeholders at the Ministry of Finance, Ministry of National Policies and Economic Affairs and the Central Bank of Sri Lanka tasked with defining the parameters of this DMU. It is expected that this DMU will be responsible for development of the debt management strategy and play a leading role in international bond issuance and domestic debt management, including the preparation of an annual borrowing plan. The government believes that this initiative will improve the overall debt management through better coordination and reduce borrowing costs in the medium to long term.

Conclusion

We are mindful that if we do not reform our institutions, and our systems so as to strengthen its competitiveness Sri Lanka will be a victim of the "middle income trap". As such, it is expected that the implementation of above activities as identified to be prior actions under the Development Policy Loan will help the country realize its development goals by enabling private sector competitiveness; enhancing transparency and public sector effectiveness; improving fiscal sustainability.

Hence we would appreciate if the World Bank considers the granting of a Development Policy based Loan so as to facilitate the aforementioned reforms and the development programme outlined by the government.

Thank you,

Yours faithfully

R.H.S.Samaratunga,
Secretary to the Treasury

Copy : Country Director – World Bank – Colombo Office

ANNEX 3. FUND RELATIONS ANNEX

International Monetary Fund

IMF Executive Board Approves Three-Year US$1.5 Billion Extended Arrangement under EFF for Sri Lanka

Press Release No. 16/262
June 3, 2016

The Executive Board of the International Monetary Fund (IMF) today approved a 36-month extended arrangement under the Extended Fund Facility (EFF) with Sri Lanka for an amount equivalent to SDR 1.1 billion (about US$1.5 billion, or 185 percent of quota) to support the country's economic reform agenda.

The IMF arrangement aims to meet balance of payments needs arising from a deteriorating external environment and pressures that may persist until macroeconomic policies can be adjusted. It is also expected to catalyze an additional US$650 million in other multilateral and bilateral loans, bringing total support to about $2.2 billion (over and above existing financing arrangements).

The Executive Board's decision will enable an immediate disbursement of SDR 119.894 million (about US$ 168.1 million), and the remainder will be available in 6 installments subject to quarterly reviews.

During the same meeting, the Board also concluded the 2016 Article IV consultation. A separate press release will be issued shortly.

Following the Executive Board discussion on Sri Lanka, Mr. Min Zhu, Deputy Managing Director and Acting Chair, issued the following statement:

"Despite positive growth momentum, Sri Lanka's economy is beginning to show signs of strain from an increasingly difficult external environment and challenging policy adjustments. The new government's economic agenda, supported by the Extended Fund Facility, provides an important opportunity to re-set macroeconomic policies, address key vulnerabilities, boost reserves, and support stability and resilience.

"A return to fiscal consolidation, targeting a reduction in the overall fiscal deficit to 3.5 percent of GDP by 2020, is the linchpin of the reform program. Rebuilding tax revenues through a comprehensive reform of both tax policy and administration will be key in this regard, supplemented by steps toward more effective control over expenditures and putting state enterprise operations on a more commercial footing.

"Medium-term growth prospects also need to be supported through a greater role for market forces and a decisive shift toward an outward orientation. A clear commitment to exchange rate flexibility will enable adjustment to a shifting external environment while allowing the central bank to rebuild foreign exchange reserves and focus more closely on its key mandate of price stability. The economic program also supports the government's objective of boosting competitiveness and greater integration with regional and global markets through comprehensive trade reform and improvements to the investment environment. Steadfast implementation of these reforms should strengthen Sri Lanka's ability to attract investment, improve prospects for sustained medium-term growth, and reduce fiscal risks."

ANNEX

Recent Economic Developments

Macroeconomic performance in 2015 reflected a positive underlying growth momentum mitigated by the negative impact of unbalanced domestic policies and an increasingly difficult external environment. Real GDP growth was 4.8 percent in 2015 (broadly unchanged from 2014), on the basis of strong growth in services (particularly tourism), continued growth in agriculture, and a positive (albeit declining) contribution from manufacturing. The negative growth in construction and weaker growth in manufacturing were indicative of a slowdown in public and private investment, as well as the negative effects of slowing world trade. The economy is currently estimated to be operating slightly below its potential, while the unemployment rate remains at 4.3 percent in end 2015, close to the historical norm.

The government fiscal deficit expanded to 6.9 percent of GDP in 2015. While revenue increased by 1.5 percentage points to 13.1 percent of GDP, this mostly reflected one-off measures and tax collections from a temporary surge in vehicle imports. Expenditures rose by 2.1 percentage points to 19.9 percent of GDP, on account of a post-election wage hike, a higher interest bill, additional spending on goods and services, and an increase in income transfer programs.

The overall balance of payments deteriorated significantly in 2015 despite an improvement in the terms of trade. The current account deficit was contained at 2.5 percent of GDP in 2015—the same level as in 2014. Capital flows have also been a key driving force behind the deterioration in the balance of payments. The capital and financial account position has weakened due to foreign exit from government securities, lower FDI inflows, and slow implementation of externally financed public and private projects. Investor sentiment has worsened, reflecting global market volatility and concern over domestic policies.

Tougher external conditions in the wake of China rebalancing and unwinding of unconventional monetary policies were not outside Sri Lanka's past experience.

However, spillovers were magnified by domestic imbalances, as evidenced by higher volatility around the two elections (January and August 2015), and the official budget passed in November 2015. The rupee continues to face downward pressure—largely reflecting capital flow developments. The foreign exchange and government bond markets were volatile in March 2016. highlighting rigidities in both systems.

Program Summary

The proposed new IMF-supported program aims to provide a policy anchor for macroeconomic stability and structural reforms, while strengthening external resiliency in a challenging global environment.

The key objectives of the program relate to fiscal policy and the balance of payments, and measures to: (a) implement a structural increase in revenues, facilitating a reduction in the fiscal deficit; (b) reverse the decline in central bank foreign exchange reserves; (c) reduce public debt relative to GDP and lower Sri Lanka's risk of debt distress; and (d) enhance public financial management and improve the operations of state owned enterprises. The program also aims to transition toward inflation targeting with a flexible exchange rate regime and to promote sustainable and inclusive economic growth.

To achieve these objectives, the program would envisage implementation of a set of reforms under six pillars:

(i) Fiscal consolidation;

(ii) Revenue mobilization;

(iii) Public financial management reform;

(iv) State enterprise reform;

(v) Transition to flexible inflation targeting under a flexible exchange rate regime; and

(vi) Reforms in the trade and investment regime.

Background

Sri Lanka, which became a member of the IMF on August 29, 1950, has an IMF quota of SDR 578.8 million.

For additional information on the IMF and Sri Lanka, see: http://www.imf.org/external/country/LKA/index.htm

ANNEX 4. ENVIRONMENT AND POVERTY / SOCIAL ANALYSIS

Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
Pillar 1. Enabling private sector competitiveness		
Action 1. The Government of Sri Lanka has: (a) ratified the Protocol annexing the World Trade Organization Trade Facilitation Agreement to the WTO Agreement; and (b) created a National Trade Facilitation Committee.	No negative impact	No negative impact
Action 2. The Cabinet of Ministers has approved the establishment of a one-stop-shop (OSS) for foreign investors aimed at reducing the processing time for investment approval.	No negative impact	No negative impact
Action 3. The Cabinet of Ministers has authorized the drafting of a new Secured Transactions Bill that will include provisions to facilitate the use of movable assets as collateral for bank loans, and to repeal the Secured Transactions Act 49 of 2009.	No negative impact	Positive impact
Pillar 2: Enhancing Transparency and Public Sector Management		
Action 4. The Government of Sri Lanka submitted to Parliament a Right to Information (RTI) Bill with wide applicability, extensive proactive disclosure, an independent appeals process, and limited exceptions.	No negative impact	No negative impact
Action 5. The National Audit Bill has been submitted to the Cabinet of Ministers.	No negative impact	No negative impact
Action 6. The Cabinet of Ministers has authorized the Ministry of Finance to draft a Public Finance Bill strengthening preparation, execution and oversight of the budget, as well as oversight of public enterprises.	No negative impact	No negative impact
Pillar 3: Improving fiscal sustainability		
Action 7. The Cabinet of Ministers has decided to submit to Parliament a proposal to repeal the Strategic Development Project Act of 2008.	No negative impact	No negative impact
Action 8. The Cabinet of Ministers has approved setting up a debt management unit in the Ministry of Finance.	No negative impact	No negative impact

Source: World Bank staff

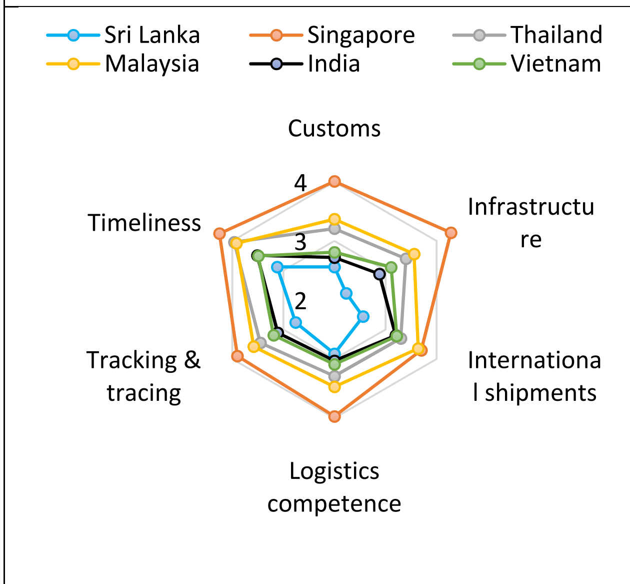
ANNEX 5. OBSTACLES TO TRADE FACILITATION

1. **This annex summarizes the obstacles to trade facilitation in Sri Lanka.** Prior action 1 of this program aims at setting the basis for an enhanced trade facilitation – as characterized by simpler and less time consuming regulatory processes to import and export goods.

2. **The competitiveness of Sri Lankan products depends to a great extent on the ability of producers to reach foreign markets in a timely and cost effective manner.** Improving access to enabling infrastructure and the reduction of costly and time consuming trade-related procedures are essential to maximize the movement of merchandise trade. The GoSL has stated that trade facilitation is a priority with the intention for Sri Lanka to follow best practice countries in the region.

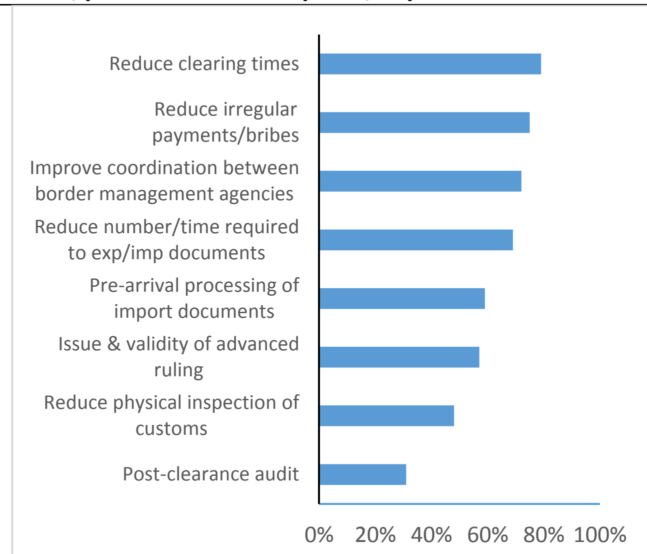
3. **However significant gaps exist between practices in Sri Lanka and other benchmark countries in Asia**. Sri Lanka's performance in trade facilitation is lower than that of middle income and East Asian peers. Notably, a comparison of all areas related to trade facilitation (see Figures A5.1 and A5.2) highlights the need for improvements not only in infrastructure but also on regulatory processes. A recently conducted diagnostic[44] concluded that if a revamping of scheduling and process oriented efficiencies are not undertaken soon, the unnecessary delays and costs to producers and traders, will continue to erode the competitiveness of local producers versus exporters located in other countries in the region.

Figure A5.1 Logistics Performance Index (2014)



Source: World Bank Logistics Performance Index

Figure A5.2 High priority areas related to rules/procedures for imports/exports



Source: IPS Survey (2014)

4. **Bureaucratic bottlenecks give rise to high trade transaction costs.** Bureaucratic barriers (or policy induced barriers) account for nearly 70 percent of the total time spent on exporting or importing goods. The preparation of documents is the most significant component absorbing more than 50 percent of the duration spent on import or export procedures. Key issues such as the lack of a risk management system (where only select containers which fall under pre-defined high risk categories are examined) further exacerbates delays and increases costs.

[44] Sri Lanka–WTO TFA, Validation and Reform Map, September 2015, World Bank

5. **Delays and costs have also increased due to weak inter-institutional linkages not yet fully resolved by reform efforts.** The introduction and upgrade of the Automated System for Customs Data (ASCYUDA) system at the Sri Lanka Customs Department has been an important though delayed step towards reducing transaction costs and processing time. However, the failure to fully integrate the 30 government agencies involved in trade facilitation, into a single window facility undermines the reforms undertaken. Delays and manual processing still occur upstream (before traders/agents submit the final documentation electronically to the Customs Department). This prevents cost and schedule efficiencies form being realized in the electronic processing downstream (see Table A5.1).

6. **The ratification of the World Trade Organization Trade Facilitation Agreement (WTO–TFA) is an important step in setting up a foundation for trade facilitation reform.** The WTO-TFA (to which Sri Lanka is already a signatory) provides a framework for the implementation of simple, transparent trade procedures that enhance trade facilitation. The ratification of the WTO- TFA by Sri Lanka will signal to domestic and international stakeholders its strong commitment to the reform and modernization of its trade facilitation regime.

7. **Trade facilitation reforms can be further strengthened through the formal establishment of the National Trade Facilitation Committee (NTFC).** As a WTO Member, Sri Lanka will be required to implement the WTO TFA once it comes into force. As per article 23.2 of the Agreement, Members must establish a National Trade Facilitation Committee to oversee and coordinate implementation of the Agreement. Obtaining cabinet approval for the formal establishment of the NTFC will provide it with the required mandate to oversee and coordinate all trade facilitation matters in Sri Lanka. This will include full and effective implementation of the WTO-TFA. Once fully operational the NTFC is expected to identify key bottlenecks and inefficiencies, provide key inputs into reform efforts to modernize trade facilitation policies, processes and reduce trade transaction costs. The NTFC will also significantly enhance inter-agency coordination on trade facilitation matters as well as improved dialogue between the government and the private sector.

8. **Both the ratification of the WTO-TFA and the formal establishment of the NTFC are important first step for a wider series of required trade facilitation reforms.** The ratification of the WTO TFA and the formal establishment of the NTFC can be an effective platform for a second wave of reforms that target core bureaucratic bottlenecks through digitization, increasing transparency and ensuring ease of access to trade related information The establishment of a trade portal that aggregates information related to the regulatory requirements across all agencies and enables online access to; and the rapid dissemination of; trade related information will lower transaction costs. A key feature of the trade portal can be the a single window facility that enables the one time only submission of documents thus reducing time and cost associated with the preparation of the same documentation on multiple occasions. Both of the portal and the single window facility will also streamline the interagency transfer of data. These measures will increase transparency and also allow for the monitoring and evaluation.

Table A5.1. Costs related to regulations and logistics in Sri Lanka in 2014 (dollars, days, and percent)

	Export procedures		**Share of Composition**		**Import procedures**		**Share of Composition**	
	Duration (days)	Cost (US$)	Duration (days)	Cost (US$)	Duration (days)	Cost (US$)	Duration (days)	Cost (US$)
Policy induced Barriers								
Document Preparation	9	135	56%	24%	7	140	54%	20%
Customs clearance and technical control	2	160	13%	29%	2	285	15%	41%
Logistics related barriers								
Ports and Terminal Handling	3	150	19%	27%	2	150	15%	22%
Inland Transportation and Handling	2	115	13%	21%	2	115	15%	17%
Total	16	560	100%	100%	13	690	100%	100%

Source: WB staff calculations based on data from www.doingbusiness.org, accessed on March 26, 2015

ANNEX 6. OBSTACLES TO ATTRACTION AND RETENTION OF FDI

1. **This annex summarizes obstacles to attraction and retention of FDI.** Prior action 2 aims to address important obstacles to foreign investment entry and establishment. This annex highlights the fact that the action supported by this operation is an important first step, but additional efforts and actions will be needed going forward in order to address other obstacles to FDI identified through WBG analytical work as listed below.

2. **Lack of a clear and modern Investment Vision**: In Sri Lanka, investment, trade and other policies are not fully aligned and compatible. In addition, Sri Lanka does not have a modern overarching regulatory and legal framework clarifying in a single instrument the role of the different agencies interacting with investors as well as specific guarantees applicable to both foreign and domestic investors. The BOI Act focuses predominantly on the structure, roles and responsibilities of the BOI and does not explicitly address FDI. In addition, there is no defined monitoring and evaluation (M & E) framework to regularly assess results emanating from the existing policies. The creation of a National Agency for Development, with the mandate to address these shortcomings is a positive initial step.

3. **Lack of focus on Investment Promotion**: BOI is a large and complex organization as compared to regional and global peers and has become one of the largest national investment promotion intermediaries in the world. This is as a result of the wide ranging functions vested with them. In addition to investment promotion, BOI is required to carry out regulatory functions, economic zone management and trade facilitation services. The multiplicity of the functions undermines its critical role as the investment promotion agency. Going forward, the BOI has identified the need to strengthen investment promotion activities and the WBG is providing technical assistance in this regard.

4. **Lack of an Effective Investment Incentive System**: Sri Lanka offers multiple support measures to investors across sectors incurring significant costs in granting incentives both by the BOI and IRD. The global surveys of investors reveal that incentives provide mixed results. However, no systematic evaluation of the effectiveness of these incentives has been taken so far by the authorities.

5. **Barriers to Entry identified by investors**

(i) *Investment approval process* – The process for entering and establishing for foreign companies is complex and time consuming. While the BOI undertakes facilitation, the multiplicity of regulatory agencies involved creates high transaction costs for investors.

(ii) Difficulties in gaining access to land – The recent Land (Restriction on alienation) Act of 2014 prohibits sale of land to foreigners and the process for leasing land to foreigners is still somewhat cumbersome. However, recent reforms such as elimination of taxes on long-term land leases may facilitate access to land to foreign enterprises for productive purposes

(iii) Existence of restrictions on foreign investments – The existing ceilings for foreign investments (imposed through exchange control regulations) in certain sectors deter investors looking for opportunities to invest large volumes in such sectors. (I.e. Education, freight forwarding, travel agency, shipping agency and mass communication are restricted to 40 percent).

6. **Barriers to Retain Foreign Investment:** Both domestic and foreign investors consistently report lack of regulatory transparency, corruption and excessive discretion as deterrents to their investment operations and expansion. Persistent existence of corruption and lack of transparency reported by the private sector

indicate the low levels of implementation of investor protection principles provided in Sri Lanka's international investment agreements (IIAs). It has also been observed that many government agencies are not fully aware of obligations towards investors under IIAs and other laws and regulations of the country. In addition, there is no systematic grievance mechanism for the foreign investors.

7. **Inadequate Linkages between FDI and the local economy**: Linkages with the existing foreign direct investors will increase training, technology and knowledge transfer leading to enhancement of the capabilities and competitiveness of the domestic enterprises. In order to derive these linkages, Sri Lanka has not developed specific and targeted investment policy initiatives. The linkages are limited due to non-availability of skilled workers. Given the limited labor pool in Sri Lanka, Government needs to develop more competitiveness in high value added and technologically sophisticated activities. Recently initiated collaboration between the BOI and the WBG is expected to address shortcomings in this area.

8. **Lack of effective implementation of Doing Business Reforms**: Government of Sri Lanka is highly motivated to create an enabling environment for businesses, however more can be done on predictability in the creation and enforcement of the regulations encountered by businesses. The government created a number of working groups to lead reforms in all areas of the business environment covered by the Doing Business rankings and is currently implementing a number of system upgrades for regulatory agencies with a focus on streamlined processes and ICT solutions. Their impact will depend on efforts to prepare officials and private sector stakeholders in implementing these changes. (e.g. SMEs lack capacity to take advantage of the proposed single window of customs clearance)

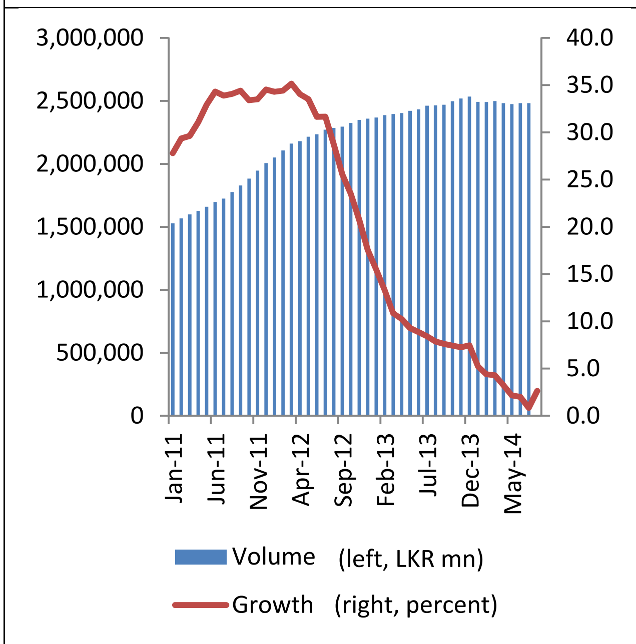
ANNEX 7. OBSTACLES TO ACCESS TO FINANCE

1. **This annex summarizes obstacles to access to finance for enterprises in Sri Lanka.** This annex provides additional information substantiating the relevance of prior action 3, but emphasizing that lasting and comprehensive access to finance to enterprises will likely require additional efforts beyond those supported by this program.

2. **A strong financial sector is essential for sustainable growth of the private sector, economic diversification, and creation of more and better jobs.** The experience worldwide has shown that economic growth and diversification that is employment-generating, volatility reducing and productivity enhancing cannot take place in absence of robust, adequate and accessible financial sector. A healthy and sound financial sector needs access to long term funding to make productivity enhancing investments, and is critical to ensure the quality and pace of capital flows, avoiding the imbalances experienced in the past.

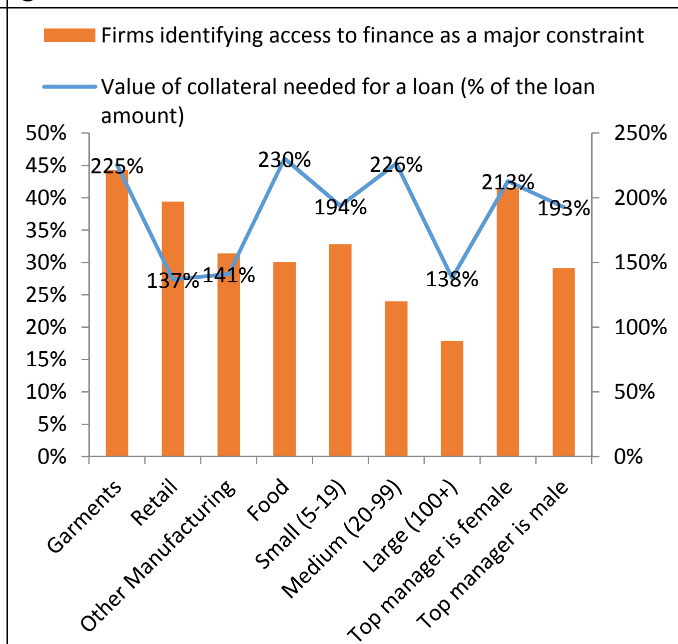
3. **Access to finance is a constraint for firms' growth in Sri Lanka.** Despite the fact that there is ample liquidity in the banking sector and interest rates have decreased over the past year (Figure A7.1), many firms report difficulties in accessing financing and credit growth has been limited. Accessing finance appears to be particularly difficult to smaller firms, those operating in specific sectors (including garments and retail), and firms managed by women. For those firms, accessing credit is often dependent on their ability to post collateral with value of more than 200 percent of the loan amount – which can be a high hurdle for many firms (Figure A7.2). Compounding this hurdle, at the present time bank loans are secured mainly through real estate collateral, while movable assets are not recognized by law as sufficient security for loans. These two factors have a disproportionately high impact on MSMEs, which frequently lack sufficient real estate collateral to access bank loans.

Figure A7.1. Growth in bank lending to the private sector



Source: Central Bank of Sri Lanka.

Figure A7.2. Access to finance as an obstacle to firms' growth



Source: World Bank Enterprise Surveys.

4. **A Financial Sector Assessment Program (FSAP) highlighted the fact enabling sustainable access to financial services to enterprises and entrepreneurs will require addressing numerous obstacles.** In recognition of the insufficient access to credit to the private sector (and SMEs in particular), the GoSL has put in place numerous support programs, many of which are in the form of subsidized credit and directed lending to priority sectors. These instruments have had limited effectiveness, created significant market distortions, and failed to enhance sustainable credit to SMEs. The FSAP identified various areas where reform is required. These areas include strengthening the legal framework governing credit operations; strengthening credit infrastructure; improving governance and effectiveness of state-controlled banks; enabling the development of the insurance sector through elimination of barriers to private investment; enhancing regulatory oversight of financial institutions and developing a regulatory framework for microfinance.

5. **Authorities have welcomed the FSAP recommendations and requested WBG's assistance to undertake a long-term reform program that will cover all the areas identified under the FSAP**. This request is a strong signal of the commitment of authorities towards a reform agenda that will focus on lasting solutions to enhanced access to financial services required to enable private sector competitiveness.

ANNEX 8. POTENTIAL MEDIUM-TERM GOVERNANCE AND PUBLIC SECTOR REFORM ACTIONS

1. **This annex summarizes Bank recommendations on potential longer term reforms concerning transparency and public sector management which have been discussed with counterparts in respective Government agencies.** The longer term reforms listed below are indicative actions, which would logically follow from the prior actions supported by this DPF that relate to transparency and public sector management. The prior actions reflect important stages in developing laws which will strengthen the frameworks for transparency and public sector management. Once these laws are in place, implementation will be critical in order to obtain benefits from the enhanced frameworks for transparency and public sector management.

Reform Area	Potential Reform Actions
Transparency	
Right to Information	• Adopt an RTI Implementation Strategy. • Appoint RTI Commission with adequate human and financial resources. • Adoption of rules pursuant to the Act to cover procedural issues, appointing and providing orientation for Information Officers/Designated Officers in Public Authorities. • Strengthen capacity of information officers and records management, proactive disclosure, and monitoring.
Strengthened Audit Function	• Ensure publication of all audit reports tabled in Parliament on the official website of the National Audit Office. • Audit oversight & disclosure of audit reports of all major state owned corporate entities by National Audit Office and their submission to the Parliament • Increase use of performance audits for budget institutions
Public Sector Management	
Public Financial Management	• Strengthen framework for budget preparation: o Establish clear links between the Medium-Term Budget Framework (MTBF) and the annual budget. o Provide indicative ceilings for all expenditures to Ministries, Departments, and Authorities (MDAs) at the start of budget preparation. o Identify recurrent cost implications of capital investments. • Roll out ITMIS modules on budget planning, budget execution, accounting, purchasing, treasury management, payroll management, cadre management, asset management.
Public Procurement	• Clarify respective roles of the National Procurement Commission and Ministry of Finance in developing and enforcing procurement regime. • Issue updated procurement guidelines and manuals. • Complete e-procurement system readiness assessment; development and roll-out of e-procurement • Adopt a framework contracting mechanism.
Tax Administration	• Integrate/restructure tax administration along the lines of taxpayer segments and tax administration core functions. • Establish a compliance risk management approach commencing with large taxpayer unit. • Improve the control of VAT refunds.

	• Conduct business process reengineering to facilitate the roll out of the Revenue Administration Management Information System (RAMIS). • Implement a change management program.
Public Investment Management (PIM)	• Develop a Public Investment Management Policy Framework and supporting implementing rules for MDAs • Design a comprehensive framework for prioritizing, appraising, selecting and implementing public investments.
Oversight of-Public Enterprises	• Strengthen the institutional framework for public enterprises oversight through enhanced coordination and consolidation of the state oversight function. • Develop a performance monitoring system to monitor public enterprises' financial and non-financial indicators. • Intensify monitoring of financial flows between public enterprises and the Government and public enterprises' financial flows. • Expand good oversight practices, audit, and aggregated reporting to other major public entities beyond state-owned business enterprises.