PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

June 4, 2016
Report No.: AB7840

Operation Name	Sri Lanka Competitiveness, Transparency, and Fiscal Sustainability Development Policy Financing
Region	South Asia
Country	Sri Lanka
Sector	General industry and trade sector (30%); Central government administration (30%); General finance sector (20%); Public administration- Industry and trade (20%)
Operation ID	P157804
Lending Instrument	Development Policy Financing
Borrower(s)	Ministry of Finance
Implementing Agency	Ministry of National Policies and Economic Affairs
Date PID Prepared	June 4, 2016
Estimated Date of Appraisal	June 4, 2016
Estimated Date of Board Approval	July 29, 2016
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

Sri Lanka has had strong growth as well as major declines in poverty over the past decade. The country's economy grew at an average 6.4 percent during 2010-2015, reflecting a peace dividend after the end of decades of internal conflict, as well as structural transformation from rural agriculture to a more urbanized economy oriented around manufacturing and services. 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, which is equivalent to about US$1.50 in PPP terms. Most of the reduction in poverty was due to higher labor incomes, and, in particular, to increased earnings. At the same time, recent years have seen an increase in inequality, with the Gini coefficient increasing from 0.36 in 2009/10 to 0.39 in 2012/13; there are also differences in non-monetary measurements of poverty, such as access to public services, in certain parts of the country. Facilitating more and better jobs is integral to continued progress in bringing more persons out of poverty and promoting prosperity among the bottom 40 percent of Sri Lanka's population.

Sri Lanka faces challenges in sustaining its solid record of growth and poverty reduction. Low competitiveness, high reliance on non-tradable sectors and a stale export basket highlight the need to enhance private sector competitiveness in order to sustain growth and generate jobs for the population. Sri Lanka's government could play a more effective role in providing public services and promoting competitiveness; enhancing transparency and public sector management practices will contribute to addressing these objectives. Finally, declining fiscal revenue and a high level of public debt are key structural challenges in Sri Lanka. Having fallen from 2009 peak, public debt has started to rise again since 2013 due to slower growth, less favorable loan terms and a widening primary deficit.

Following presidential and parliamentary elections in 2015, the new Government of Sri Lanka has articulated a commitment to strengthen competitiveness which will foster entrepreneurship and trade which in turn will yield more good jobs. The Government's reforms stem from the recognition that while the economy has grown rapidly in the last decade, the countries drivers of economic growth have been construction and non-tradables which are areas where sustaining growth over time is difficult. The Government is in the process of revising trade and investment policies to place greater emphasis on outward orientation of the economy and private sector development. The Government also seeks 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. It has undertaken steps to improve the investment climate including the establishment of a one-stop shop for FDI and the elimination of minimum investment requirements for FDI in some sectors. It has approved the ratification of the WTO Trade Facilitation Agreement and has submitted legislation to enable the use of movable assets as collateral thereby facilitating credit, especially to smaller firms.

The Government has promoted a policy of improving governance. Sri Lanka remains the only country in South Asia without a formal right to information framework and in recent years has scored below regional peers on global indicators of government accountability. The Government has moved to address governance challenges through the passage of the 19th Constitutional amendment in 2015 which changed the basis for formation of the cabinet, strengthened or created new independent oversight commissions, and established a Constitutional right to information. In addition, the Government has launched reforms to address public financial management weaknesses, particularly in budget formulation, public investment planning, revenue administration, and control over treasury transactions. The Government is moving to operationalize these reform initiatives though drafting of bills on audit right to information, audit, and public finance. These laws would firmly anchor reforms to improve the Government's capacity and responsiveness in carrying out its service delivery and regulatory functions, which in turn strengthens Sri Lanka's competitiveness.

The Government has also taken steps to address fiscal sustainability challenges. The Government has moved to tackle these fiscal issues, most notably through revenue enhancing revisions to the 2016 budget as well as reaching staff agreement with the International Monetary Fund on an US$ 1.5 billion Extended Fund Facility to support a steady reduction in the primary deficit and to implement tax and public financial management reforms.

II. Operation Objectives

The proposed Development Policy Financing (DPF) operation 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 proposed DPF is a stand-alone operation to support reforms that address significant well-identified obstacles to the country's competitiveness. The actions supported by the DPF represent an important initial set of policy reforms that are expected to be part of a longer-term policy reform package. The proposed DPF has three corresponding 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 SOEs. 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.

III. Rationale for Bank Involvement

Addressing these challenges are critical to achieving progress towards the goals of ending extreme poverty and promoting shared prosperity. The Government has recognized these challenges and has launched initial reforms to put the country on a more sustainable path towards inclusive growth. Notably, the Government has also reached staff agreement with the IMF on an US$ 1.5 billion three-year Extended Fund Facility to support economic reforms.

The prior actions 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.

The actions supported by the proposed DPF 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. They reflect immediate priority actions pursued by the GoSL as a starting point for carrying out policies to achieve 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. Finally, the areas of reform supported by the DPF correspond to the objective of promoting investment and competitiveness set out in the present World Bank Group Country Partnership Strategy, while competitiveness, transparency, and fiscal sustainability challenges are some of the key priorities identified in the recently completed Systematic Country Diagnostic for Sri Lanka.

IV. Tentative Financing

		(US$ mln.)
Source:		
BORROWER/RECIPIENT		0.00
International Development Association (IDA)		100.00
	Total	100.00

V. Institutional and Implementation Arrangements

The External Resources Department (ERD) of the Ministry of Policy Planning will be responsible for overall implementation of the proposed operation and for coordinating actions among other concerned ministries and agencies. Other agencies involved include the Ministry of Development Strategies and International Trade, the Ministry of Finance, the Ministry of Parliamentary Reforms and Mass Media, the Auditor General's Department, the Board of Investment and the Central Bank of Sri Lanka. The Bank will monitor actions, review progress of the implementation of the proposed operation and track results through frequent interaction with implementing agencies and constant communication with the authorities. An Implementation Completion Report (ICR) will be completed within 12 months of the closing date of the DPF.

VI. Risks and Risk Mitigation

The overall risk rating for this operation is substantial. This is due primarily to uncertainty on the actions that will be taken to address macroeconomic vulnerabilities and risks with the engagement nature of this operation. It will be important to sustain fiscal consolidation over the medium term.

The proposed operation is the first policy support operation in a decade, with the exception of the CAT DDO. The authorities will need to familiarize themselves with the process and operational requirements, particularly in monitoring for results, in DPF operations. 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.

Political and governance risks are substantial. These risks lie primarily in the Government maintaining 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 Development Projects Act, measures to improve financial management and oversight over public enterprises may encounter political resistance. Some of the new institutional arrangements, particularly triggered by governance reforms, will encounter a "settling in" period as new staff and procedures are put in place.

Sector 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 technical assistance programs supporting competitiveness reforms, implementation of the Right to Information 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 Auditor General's Department.

Stakeholder risk is substantial. Changes in the trade regime which may flow from the adherence to greater openness may be perceived as having adverse impact to specific sectors and enterprises, triggering resistance. There may be some interests in the bureaucracy which would resist reforms to increase transparency and oversight. The experience in other countries, particularly South Asia, has pointed to discomfort among some in government with a full-fledged Right to Information regime.

VII. Poverty and Social Impacts and Environment Aspects

Poverty and social impact

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 better service delivery.

Prior actions aimed at enhancing trade facilitation are not expected to have any direct 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.

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. It is important to note that 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.

The long-term effects of increasing FDI are likely to be positive and significant for the poor. The majority of the 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. To monitor the effect of these prior actions on poverty, the World Bank could track changes in FDI at the firm level and relate these to wage and employment outcomes.

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.

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 capacity 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, although the hoped-for reduction in public outlays may fail to materialize. A legal framework empowering citizens to request information about government programs and requiring public authorities to disclose such information proactively has led to better performance of such programs. RTI frameworks have proven particularly important in providing for transparency in the administration of social benefits in South Asia, helping to counter leakages.

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.

Environmental impact

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 direct negative environmental impacts. The actions under this DPF are expected to have neutral environmental impacts. Sri Lanka has a very strong regulatory framework to ensure investments and developments are environmentally sustainable.

Any potential environmental impacts not identified at the preparation of this operation may also be mitigated by the quality of the institutional and legal framework. The current environmental and environmental impact assessment (EIA) legislation will serve as a good mechanism to address environmental aspects that could arise through the above policy actions supported by the DPF. 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.

VIII. Contact point

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