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Report No: PGD414

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A

PROPOSED CREDIT ON SHORTER TERM MATURITY LOAN TERMS

IN THE AMOUNT OF SDR 371.2 MILLION
(US$500 MILLION EQUIVALENT)

TO

DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA
FOR THE

Sri Lanka Resilience, Stability and Economic Turnaround (RESET) Development Policy Operation

May 31, 2023

Macroeconomics, Trade, and Investment Global Practice
Finance, Competitiveness, and Innovation Global Practice
Social Protection, Jobs, and Labor Global Practice
South Asia Region

Public Disclosure Authorized

Democratic Socialist Republic of Sri Lanka

GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of April 30, 2023)

Currency Unit = Sri Lankan Rupee (LKR)

US$1.00 = LKR 321.49

SDR 1 = US$1.34701

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank	IFI	International Financial Institution
AoA	Articles of Association	IMF	International Monetary Fund
AM	Accountability Mechanism	IPF	Investment Project Financing
CAD	Current Account Deficit	IRD	Inland Revenue Department
CBSL	Central Bank of Sri Lanka	JICA	Japan International Cooperation Agency
CEB	Ceylon Electricity Board	LFA	Labour Force Adjustment
CIT	Corporate Income Tax	LKR	Sri Lankan Rupee
CMC	Crisis Management Committee	MoF	Ministry of Finance
CPC	Ceylon Petroleum Company	NDC	Nationally Defined Contributions
CPF	Country Partnership Framework	NPLs	Non-Performing Loans
CT	Cash Transfer	PAL	Port and Airport Levy
DMO	Debt Management Office	PA	Prior Action
DPO	Development Policy Operation	PDM	Public Debt Management
DPs	Development Partners	PFM	Public Financial Management
DSA	Debt Sustainability Analysis	PIT	Personal Income Tax
EFF	Extended Fund Facility	PPG	Public and Publicly Guaranteed
ELA	Emergency Liquidity Assistance	RAMIS	Revenue Administration Management Information System
FA	Financing Agreement	SDR	Special Drawing Rights
FDI	Foreign Direct Investment	SLA	Sri Lankan Airlines
FHHs	Female-Headed Households	SML	Shorter Maturity Loan
FLFP	Female Labour Force Participation	SOBs	State-Owned Banks
GCRF	Global Crisis Response Framework	SOEs	State-Owned Enterprises
GDP	Gross Domestic Product	SSNs	Social Safety Nets
GFN	Gross Financing Needs	TA	Technical Assistance
GoSL	Government of Sri Lanka	USAID	United States Agency for International Development
GRS	Grievance Redress Service	VAT	Value Added Tax
HoCo	Holding Company	WBG	World Bank Group
IDA	International Development Association	WBPS	Welfare Benefits Payment Scheme
IFC	International Finance Corporation	y-o-y	Year-on-year

Regional Vice President:	Martin Raiser
Country Director:	Faris H. Hadad-Zervos
Regional Director:	Mathew A. Verghis
Practice Manager (s):	Saiyed Shabih Ali Mohib
Task Team Leader (s):	Richard Walker, Peter J. Mousley, Rene Antonio Leon Solano

DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

SRI LANKA RESILIENCE, STABILITY AND ECONOMIC TURNAROUND DEVELOPMENT POLICY OPERATION

TABLE OF CONTENTS

The Credit was prepared by an IDA team consisting of Richard Walker (Senior Economist and TTL, ESAC1), Peter Mousley (Lead Private Sector Specialist and co-TTL, ESAF1), Rene Leon Solano (Practice Leader and co-TTL, HSADR), Tae Hyun Lee (Program Leader and Lead Country Economist, ESADR), Kishan Abeygunawardana (Senior Economist, ESAC1), Shruti Lakhtakia (Young Professional, ESAC1), Sebastian James (Senior Economist, ESAC1), Gonzalo J. Varela (Senior Economist, ESAC1), Biying Zhu (Consultant, ESAC1), Miquel Dijkman (Lead Financial Sector Specialist, ESAF1), Alexander Pankov (Lead Financial Sector Specialist, ESAF1), Amila Dahanayake (Economist, ESAF1), Nandini Krishnan (Lead Economist, ESAPV), Marta Schoch (Economist, ESAPV), Francesca Lamanna (Senior Economist, HSASP), Srinivas Varadan (Senior Social Protection Specialist, HSASP), Thisuri Wanniarachchi (ET Consultant, HSASP), Shalika Subasinghe (Consultant, HSAED), James Anderson (Lead Governance Specialist, EGVPA), Mohan Gopalakrishnan (Senior Financial Management Specialist, ESAG1), Leandro Secunho (Senior Debt Specialist, EMFMD), Anula Harasgama (Senior Financial Management Specialist, ESAG1), Enoka Wijegunawardene (Senior Financial Management Specialist, ESAG1), Jari Väyrynen (Senior Energy Specialist, ISAE1), Kirsty Mason (Senior Social Development Specialist, SSAS1), Patricia Fernandes (Lead Social Development Specialist, SSAS1), Kamani Jinadasa (Consultant, SSAS1), Junko Narimatsu (Senior Digital Development Specialist, IDD06), Siddhartha Raja (Senior Digital Development Specialist, IDD06), Ximena Talero (Lead Counsel, LEGAS), Sashikala Jeyaraj (Program Assistant, SACSL), Henrike Brecht (Senior Disaster Risk Management Specialist, SSACD), Priyanka Dissanayake (Disaster Risk Management Specialist, SSACD), Mokshana Wijeyeratne (Senior Environmental Specialist, SSAEN), Nadeera Rajapakse (Environmental Specialist, SSAEN), Wei Winnie Wang (Senior Transport Specialist and Program Leader, ISAT1), Shanek Fernando (Social Development Specialist, SSAS1), and Sibel Kulaksiz (Senior Economist, SARDE).

The team gratefully acknowledges the support and guidance provided by Faris H. Hadad-Zervos (Country Director, SACNP), Mathew A. Verghis (Regional Director, ESADR), Shabih Ali Mohib (Practice Manager, ESAC1), Chiyo Kanda (Country Manager, SACSL), and Asela Dissanayake (Senior Operations Officer, SACSL). The team appreciates the close collaboration with the International Monetary Fund team for Sri Lanka, led by Peter Breuer (Division Chief) and Masahiro Nozaki (Deputy Division Chief). Finally, the team expresses its gratitude to the Government of the Democratic Socialist Republic of Sri Lanka for their cooperation in the preparation of this operation.

SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Programmatic	If programmatic, position in series
P179808	Yes	1st in a series of 2

Proposed Development Objective(s)

To support foundational reforms that restore macroeconomic stability and sustainability, mitigate the impact of current and future shocks on the poor and vulnerable, and support an inclusive and private-sector-led recovery and growth path.

Organizations

Borrower:	DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA
Implementing Agency:	Ministry of Finance, Economic Stabilization and National Policies

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	**500.00**

DETAILS

International Development Association (IDA)	500.00
IDA Shorter Maturity Loan (SML)	500.00

INSTITUTIONAL DATA

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Overall Risk Rating

High

Table 1: Results

Indicator Name	Baseline	Target
RI#1. Publication of consolidated annual debt report with comprehensive debt information on Central Government, guaranteed SOE, non-guaranteed non-financial SOEs, and CBSL debt with a time-lag smaller than 3 months from the end of the year and fiscal risk statements covering at least SOEs guaranteed and non-guaranteed debt	No (2022)	Yes (2025)
RI#2. (a) Total revenue-to-GDP (percent) (b) Use of electronic filing facilities for non-corporate tax declarations (percent) (c) Increase in revenue from income tax audits using third-party information data (LKR million)	(a) 8.3 (2022) (b) 23 (2021) (c) 0 (2022)	(a) 13.3 (2025) (b) At least 70 (2025) (c) 130 (2025)
RI#3. Exposures to SOEs of total assets of: (a) the entire banking sector (percent), and (b) the two largest SOBs (percent)	(a) 8.8 (Q2 2022) (b) 22 (Q2 2022)	(a) 5 (2025) (b) 10 (2025)
RI#4. SOEs for which divestment to private ownership is 51 percent and above (number)	0 (2023)	15 (2025)
RI#5. Trade (imports and exports) as a share of GDP (percent)	41 (2021)	46 (2025)
RI#6. Private investment in broadband networks facilitated (US$ million)	0 (2022)	100 (2025)
RI#7. (a) Beneficiaries of the new Welfare Benefits Payment Scheme (WBPS) (number of households per year) (b) Coverage of the poorest 20 percent by cash transfer programs (percent) (c) Coverage of female headed household by the new WBPS (percent)	(a) 0 (2022) (b) 43 (2022) (c) 0 (2022)	(a) 2 million (2023-2025) (b) 60 (2025) (c) 20 (2025)
RI#8. Publication of revised inspection checklist for labor compliance audits	No (2022)	Yes (2025)

IDA PROGRAM DOCUMENT FOR A PROPOSED CREDIT TO DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed development policy operation (DPO) – the first in a series of two operations – will provide US$500 million in two equal tranches to support the Government of Sri Lanka's (GoSL) reform plan.** This plan aims to restore stability through a macroeconomic adjustment in the short run, help the poor cope with the current shock, and address structural causes of the current crisis to help restart growth. The proposed operation will be on Shorter Maturity Loan (SML) terms, using resources from the Performance-Based Allocations (US$143 million) and Scale-Up Window (US$357 million).[1] The DPO's first tranche will be available for disbursement upon effectiveness of the operation after Board approval. The second tranche will be available subject to the enactment of the Banking (Special Provisions) Act, continued adequacy of the macroeconomic policy framework, and acceptable progress in carrying out the program. Satisfactory progress in restoring debt sustainability – with particular attention given to progress towards an agreement with official bilateral creditors – will be a key element in determining adequacy of the macroeconomic policy framework.[2] Sri Lanka is facing unprecedented macroeconomic challenges due to an unsustainable debt, including large gross financing needs, and a balance of payments crisis. Usable reserves are sufficient to cover only about four weeks of imports. The foreign exchange liquidity constraint has translated into shortages of essential household items and inputs needed for economic activity. Poverty is estimated to have doubled from 2021 to 2022 and is projected to increase further in 2023.

2. **The proposed programmatic DPO series seeks to address some of the root causes of the crisis and introduce measures to avoid a repetition of such a crisis through three pillars**: (i) *improving economic governance* through better fiscal and debt management, improving tax policy and administration, and addressing financial sector risks; (ii) *enhancing growth and competitiveness* through state-owned enterprise (SOE) reforms and divestment, streamlining trade and investment policies, and mobilizing private capital and competition in the broadband market; and (iii) *protecting the poor and vulnerable* through the rolling out of a new *Welfare Benefit Payment Scheme* (WBPS) and reducing gender discrimination in the labor market. The first pillar includes measures to address several governance failures which contributed to the crisis, and strengthen institutional arrangements to help stabilize the economy and ensure the sustainability of the reforms. The second pillar includes measures to level the playing field and help open the space for new entrants, Foreign Direct Investment (FDI), and a more productive economy. The third pillar seeks to help the poorest and most vulnerable through the economic adjustment, and support women to contribute more fully and equally to Sri Lanka's recovery. The DPO's proposed actions are aligned with the World Bank Group's (WBG) Global Crisis Response Framework (GCRF) and aim to enhance resilience of the economy and institutions, as well as contribute to addressing the multiple, overlapping crises faced by Sri Lanka.

3. **Given Sri Lanka is using this crisis as an opportunity for deep reforms, budget support is important for the success of government's program.** The use of a DPO instrument allows the World Bank to respond appropriately to Sri Lanka's current context given that stabilization policies and structural reforms are critical for macroeconomic adequacy and to support a growth orientated recovery. The DPO series has opened up a constructive dialogue with the government to commit to important reforms that

[1] Sri Lanka is eligible for SMLs from the Scale-Up Window.
[2] The debt relief should be consistent with the IMF program parameters.

were not on the table earlier. This dialogue has been useful for government to better articulate its vision for recovery and growth, and for the Bank to contribute to the design of the macro stabilization program and continue to support the reform momentum. Similar to the International Monetary Fund's (IMF) Extended Fund Facility (EFF), the use of budget support will help provide needed foreign exchange quickly and boost confidence in the economy in a way that investment project financing (IPF) may not be able to.

4. **The DPO is a key part of the World Bank's strategy, as outlined in the new Sri Lanka Country Partnership Framework (CPF) FY24-FY27, and is being closely coordinated with other development partners (DPs).** The upstream policy interventions supported by this DPO series are a precursor to better project-specific investments that would support Sri Lanka's recovery. These policy interventions also complement the Bank's ongoing portfolio that has pivoted to provide targeted support to help people manage the crisis and preserve essential services, as well as the social protection and financial sector safety net projects that are in the pipeline. In order to remain flexible, keep the pressure up and mitigate some of the risks, the first DPO is disbursed in tranches to enable closer monitoring of the implementation of government's reform plan and to allow staggered disbursements in line with sustained macroeconomic adequacy. Furthermore, the reforms are sequenced within the series and carefully calibrated with the IMF EFF, and coordinated with the Asian Development Bank (ADB) and other donors. Significant technical assistance (TA) and institutional capacity building is also being provided by the Bank and others to support the implementation, and ultimately, sustainability of reforms.

5. **There is now a heightened public demand to address governance weaknesses and corruption.** Discretionary approaches prevail in important areas and are manifested in complex and inconsistent trade and investment policies; tax advantages to certain industries, firms, or interest groups; conflicts of interest and opaque decision making within government, including SOEs; and a complex and poorly targeted system of social assistance. This DPO supports policies which create opportunities to make improvements in overall governance, as the proposed reforms would not only increase economic efficiency and support the poor and vulnerable, but also reduce the scope for discretion, and hence, address corruption-related issues in some key aspects of economic and public resource management.

2. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

6. **Sri Lanka's longstanding structural weaknesses, which were elevated by several exogenous shocks and ill-timed tax cuts, plunged the country into a severe economic crisis.** Poor governance, a restrictive trade regime, weak investment climate, certain episodes of loose monetary policy, and an administered exchange rate contributed to macroeconomic imbalances. Fiscal indiscipline, linked to low revenue collections, led to high fiscal deficits and large gross financing needs. These weaknesses were masked by rapid growth, particularly after the end of the civil war in 2009, spurred along by risky commercial borrowing. The tax cuts in 2019 further eroded weak fiscal buffers and led to a rapid growth in debt to unsustainable levels. Several other shocks also contributed to the significant macroeconomic deterioration, including a political crisis in 2018, the Easter bombings in 2019, the COVID-19 pandemic in 2020, and Russia's invasion of Ukraine in 2022. Despite imminent and significant external debt service obligations, Sri Lanka lost access to international financial markets in 2020 following credit rating downgrades. Amid depleted reserves, the country announced an external debt service suspension in April 2022, pending debt restructuring.

7. **As the country went into a full-blown macroeconomic crisis, GoSL sought support from the IMF, and is implementing several important structural reforms.** In March 2023, the IMF Executive Board

approved a 48-month EFF of approximately US$3 billion to support the government's reform program. This followed a Staff-Level Agreement reached between the IMF staff and Sri Lankan authorities in September 2022, and financing assurances from all major official creditors. In addition, the government is implementing several foundational structural reforms needed to regain a sustainable and resilient growth path, including reforming SOEs, implementing cost-reflective utility pricing, improving fiscal oversight and debt management, and enhancing competitiveness through integration into global value chains. The government has constructively engaged with creditors on debt restructuring.

8. **Real Gross Domestic Product (GDP) contracted by 7.8 percent in 2022, as the macroeconomic crisis deepened from the COVID-19 pandemic.** After growing by 3.5 percent year-on-year (y-o-y) in 2021, all key sectors contracted in 2022, particularly in Q3 (11.5 percent, y-o-y) and Q4 (12.4 percent, y-o-y) amid supply disruptions and lack of inputs (fertilizer, fuel, and industrial inputs). While fuel shortages subsided thanks to a QR code based digital rationing system implemented in August 2022, shortages of food, medicine and inputs for the agriculture and industry sectors persisted in the second half of the year. High frequency indicators such as cement consumption, electricity sales to industries, and purchasing managers' indices continue to show significant stress on economic activity.

9. **The crisis is estimated to have doubled the poverty rate, from 13.1 in 2021 to 25.0 percent in 2022 ($3.65 per capita, 2017 purchasing power parity).**[3] This increase has added an additional 2.5 million poor people and compounds two consecutive years of poverty increases in the country. COVID-19 had already increased poverty from 11.3 percent in 2019 to 12.7 percent in 2020, a change that translated into over 300,000 new poor people that year, followed by another 0.4 percentage point increase in poverty between 2020 and 2021. Vulnerability to income shocks has also increased with the number of households that are marginally above the poverty line increasing between 2020 and 2022.[4]

10. **Following the unprecedented high levels of inflation in 2022, there has been some easing off in early 2023.** After peaking at 69.8 percent (y-o-y) in September, inflation, measured by the Colombo Consumer Price Index, decelerated to 35.3 percent in April 2023. Partial monetization of the fiscal deficit and currency depreciation contributed to the soaring inflation in 2022. The increase in global oil prices, accompanied by implementation of a fuel pricing formula (since March 2022) that adjusts for changes in oil prices, also raised prices across all sectors. The spillover effects of the ban on chemical fertilizers in 2021 added inflationary pressures on domestic food prices. Annual average inflation was 46.4 percent in 2022.

11. **Monetary policy has been tightened significantly, although interest rates remain negative in real terms.** Rising inflation prompted the Central Bank of Sri Lanka (CBSL) to raise policy rates by 950 basis points in 2022. Another policy rate increase of 100 basis points in March 2023 raised the policy rate corridor to 15.5 percent (Standing Deposit Facility) and 16.5 percent (Standing Lending Facility). Market interest rates have increased even faster and remained significantly above the policy rate corridor, particularly since the second half of 2022, reflecting market concerns about the possibility of domestic debt restructuring and continued high inflation. Despite a reduction in recent months (from about 30 percent in December 2022), Treasury bills were auctioned at 22-26 percent in April 2023.

[3] Poverty rates are estimated based on microsimulations on the 2019 Household Income and Expenditure Survey and updated using October 2022 Macro Poverty Outlook projections.

[4] In 2022, 5.7 percent lived on less than 10 percent above the poverty line and a further 5.6 percent between 10 and 20 percent above the poverty line, compared to 4.3 and 4.7 percent in 2019, respectively.

12. **Without market access, official reserves were depleted, and the exchange rate was allowed to float.** Official reserves declined from US$7.6 billion in 2019 to less than US$400 million (excluding a currency swap equivalent to US$1.5 billion with China)[5] in April 2022, as the country continued to service debt and finance trade deficit using reserves. The severe foreign exchange liquidity constraint was felt across the economy, with shortages of fuel, medicine, cooking gas, and other inputs needed for economic activity. To address the liquidity shortage, the exchange rate, which had been kept broadly fixed at an unsustainable level from August 2021 to March 2022, was floated on March 7, 2022. However, as the Sri Lankan Rupee (LKR) depreciated by approximately 78 percent against the US Dollar during the two-month period, the CBSL returned to a managed float on May 12, 2022.[6]

13. **The current account deficit (CAD) narrowed to 1.9 percent of GDP in 2022 from 3.7 percent in 2021 due to sharp import compression, despite a fall in remittances and relatively low tourism receipts**. The merchandise trade deficit declined to US$5.2 billion in 2022 from US$8.1 billion in 2021 with a reduction in imports and an increase in exports. Imports grew in the first half of the year due to the financial assistance from India, but they declined sharply in the second half amidst severe foreign exchange shortages and rapid exchange rate depreciation, and subdued import demand. In response, the government implemented a foreign exchange management strategy, including matching cash outflows with inflows, prioritization of imports, and rationing of foreign exchange. Overall, the import bill declined by 11.4 percent (y-o-y) to US$18.3 billion in 2022. On the other hand, merchandise exports increased by 4.9 percent to US$13.1 billion, as the garment sector rebounded. Although tourism receipts increased from a very low base, they were well below the pre-COVID levels in 2022, while remittances through official channels declined by 31.0 percent (y-o-y) or by US$1.7 billion.

14. **The external sector appears to have temporarily stabilized, albeit at a low-level equilibrium.** In the absence of large debt service payments and with the implementation of the foreign exchange management strategy, the balance of payment recorded surpluses in Q3 and Q4 of 2022, leading to an accumulation of official reserves (US$1.3 billion in March 2023, excluding the currency swap with China). Net foreign assets in the banking system also improved from US$-6.4 billion in April 2022 to US$-4 billion in February 2023. Weaker import demand from real sectors, stronger remittance flows in Q1 of 2023, relaxation of the mandatory foreign exchange sales requirement by banks to the central bank, growing expectations on the approval of an IMF program, and the unwinding of speculative US Dollar holdings contributed to improving foreign exchange liquidity. As a result, the LKR appreciated against the US Dollar (11.3 percent) between February 27 and April 28, 2023. Amid the currency appreciation, CBSL announced[7] that it will transition back to a flexible exchange rate.

15. **The overall fiscal deficit declined in 2022 owing to tightly controlled primary expenditures despite a ballooning interest bill.** Total revenue and grants remained unchanged at 8.3 percent of GDP in 2022 due to disruptions to economic activity amid the crisis.[8] The primary expenditures declined to 3.7 percent of GDP in 2022 from 5.7 percent in 2021 due to tightly controlled public investment and the reduction of wages and pensions and transfer payments as a share of GDP amid high inflation. However, the reduction of the overall deficit was limited to 1.5 percentage points to 10.2 percent of GDP in 2022,

[5] To use this currency swap, Sri Lanka needs total reserves equal to three months of import cover.
[6] The LKR depreciated by 81 percent against the US Dollar in 2022 from LKR200.4 in December 2021 to LKR363.1 in December 2022.
[7] Direction issued by the central bank on (March 3, 2023), which came into effect on March 7, 2023.
[8] These measures included a new surcharge tax, a new social security contribution levy, and an increase in VAT rate from 8 to 15 percent. The full-year impact of the social security contribution levy and the VAT rate change will come in 2023.

as interest payments rose to 6.5 percent of GDP in 2022.[9,10] With limited access to external financing and tight domestic liquidity conditions, approximately two thirds of the deficit was financed by CBSL.[11]

16. **Challenging economic conditions have translated into increasing risks for the financial sector.** While some vulnerabilities are masked due to numerous regulatory forbearances, solvency, liquidity, and profitability risks persist, particularly for state-owned banks (SOBs). Solvency is under pressure due to the banking sector's sizable exposure to the distressed sovereign and financially weak SOEs (gross domestic and foreign currency exposure at approximately 40 percent of total assets). With the sharp economic contraction, banks' asset quality has also deteriorated, with non-performing loans (NPLs) rising from 8.4 percent in Q1 2022 to 11.6 percent in end-2022. Due to increasing impairment charges, the profitability of the banking sector also declined, with the Return on Equity dropping to 10.2 percent in end-2022 from 20.4 percent in Q1 2022. While forex liquidity pressures have eased in recent months, local currency conditions have worsened, reflected by very high and rising deposit rates, further reducing banks' profits and their capital. As a result, although liquidity ratios remain within regulatory limits, banks, particularly SOBs, have relied heavily on CBSL liquidity facilities for their funding needs.

17. **Growing financial sector vulnerabilities are negatively impacting financial intermediation.** Although the exposure of the banking sector to the sovereign and SOEs remains high, credit growth to government and SOEs has slowed. Financial intermediation, measured by the Credit-to-Deposit ratio, dropped below the 5-year average, reflecting the tight monetary conditions, with average interest rates on new deposits and lending peaking at 23.6 and 26.2 percent in November 2022, and weak demand for loans. Rising NPLs increased banks' risk aversion and reduced capacity to issue new loans. As a result, credit to the private sector has been declining on a month-on-month basis in the second half of 2022.

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

18. **The economy is projected to contract by 4.3 percent in 2023 before a gradual recovery thereafter.** Supply disruptions and lack of inputs will continue to adversely affect production, particularly in the first half of 2023, until adequate financial support from IMF and other international partners kicks in. A weak global economy is expected to reduce demand for Sri Lanka's key exports, while higher taxes and lower real incomes will continue to dampen domestic demand. However, on account of the base effect and expected financial inflows in the second half of the year, the economic contraction in 2023 is projected to be lower compared to the contraction of 7.8 percent in 2022. Going beyond 2023, the scarring effect of the crisis, depletion in human capital, and tight external financing is expected to lead to a fragile recovery (Table 2).

19. **Inflation will likely stay elevated in 2023 and gradually slow down in 2024 and beyond.** Annual average inflation is projected to gradually slow down from the second quarter of 2023 – from a high base, as global commodity prices decline, monetization of the fiscal deficit falls, domestic supply improves, and the impact of currency depreciation wanes. Inflationary expectations will be muted in the next few years as demand side pressures remain weak (Table 2). Real interest rates are expected to turn positive, with credit growth remaining subdued during the forecast horizon.

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[9] From 6 percent of GDP in 2021

[10] Interest payments continued to absorb a very high share - at 77.5 percent of total revenue in 2022 - despite the suspension of external debt service, reflecting a significant increase in interest rates for government securities and the impact of currency depreciation.

[11] Measured by the change in net credit to government from the central bank as a share of the overall deficit

Table 2: Key Economic Indicators (illustrative debt restructuring scenario)

	2019	2020	2021	2022	2023p	2024p	2025p	2026p
Annual percentage change								
GDP (expenditure side, constant prices)	(0.2)	(4.6)	3.5	(7.8)	(4.3)	1.2	2.0	3.0
Private consumption	3.8	(5.8)	2.6	(9.0)	(4.4)	1.3	2.1	3.4
Government consumption	6.6	0.0	(2.8)	1.4	(3.7)	(2.2)	0.3	0.8
Gross fixed capital formation	(11.9)	(0.6)	4.5	(24.9)	(3.8)	1.3	2.1	3.5
Exports	1.7	(29.6)	10.1	10.2	(4.2)	4.6	3.0	3.8
Imports	(3.5)	(20.1)	4.1	(19.9)	(3.1)	3.1	2.3	3.2
GDP (production, constant prices)								
Agriculture	0.5	(0.9)	0.9	(4.6)	2.4	1.5	1.5	1.5
Industry	(4.1)	(5.3)	5.7	(16.0)	(5.8)	1.0	2.2	2.8
Services	2.9	(1.9)	3.5	(2.0)	(4.5)	1.2	2.0	3.3
Share of GDP, unless otherwise stated								
External sector								
Exports of goods and services	21.8	15.5	16.9	21.0	20.9	23.3	23.4	23.9
Imports of goods and services	27.6	21.6	24.3	25.0	24.8	27.1	26.9	27.6
Remittances	7.5	8.4	6.2	4.9	6.3	6.7	6.5	6.6
Current account balance	(2.1)	(1.4)	(3.7)	(1.9)	(0.8)	(0.8)	(0.8)	(0.9)
Net foreign direct investment	0.7	0.5	0.7	1.2	1.2	1.2	1.3	1.3
Official reserves (US$ million)*	7,642	5,665	1,565	465	2,655	3,897	5,885	7,650
Official reserves (months of imports)	3.7	3.7	0.9	0.3	1.9	2.5	3.6	4.4
Inflation								
GDP deflator (percent)	3.9	3.3	8.5	48.8	20.5	8.0	5.8	5.0
CPI (annual average, percent)	4.3	4.6	6.0	46.4	20.5	8.0	5.8	5.0
Money and credit								
Broad money (year-on-year, percent)	7.0	23.4	13.2	15.4				
Share of GDP								
Public Sector Finances								
Total revenue	11.9	8.8	8.3	8.3	10.6	11.9	13.3	13.5
Total expenditures	21.0	19.4	20.0	18.5	19.7	18.6	18.3	17.8
Overall fiscal balance	(9.0)	(10.6)	(11.7)	(10.2)	(9.1)	(6.8)	(5.0)	(4.3)
Primary balance	(3.4)	(4.4)	(5.7)	(3.7)	(1.2)	0.2	1.9	2.2
Public and publicly guaranteed debt	89.0	104.8	110.4	118.7	102.8	103.2	102.5	101.0
Memorandum items								
Nominal GDP (LKR billion)	15,911	15,672	17,600	24,148	27,844	30,422	32,835	35,513
GDP (US$ billion)	89.0	84.5	88.5	77.1	76.3	75.1	80.4	83.6

* Excluding the Chinese currency swap
Sources: Ministry of Finance, Central Bank of Sri Lanka (historical data) and World Bank staff calculations (projections).

20. **The CAD is projected to narrow due to import compression and the recovery of tourism and remittances over the medium-term.** Even though exports are projected to decline in 2023, largely due to weaker demand for Sri Lanka's textiles, the CAD will shrink further in 2023 amidst continued foreign exchange liquidity constraints, particularly in the first half of the year. The import bill in 2023 will be lower given the reduced demand for imported goods amid higher LKR prices, lower exports that require imported inputs, limited trade financing, and government's foreign exchange management strategy (before its gradual phase out). The recovery in tourism and remittances will cushion the CAD in the outer years as merchandise trade deficits widen with increased import demand.

21. **Multilateral and bilateral support and increased capital inflows are needed to close the financing gap in 2023 and beyond**. The baseline outlook assumes that the IMF will disburse about US$663 million in 2023, while ADB and World Bank budget support and project financing are projected at US$1.7

billion. Other inflows, such as FDI, trade financing, and portfolio and bilateral flows, are projected at US$1.8 billion due to the confidence brought by the IMF and other International Financial Institution (IFI)-supported government reform program. These inflows together are expected to help cover the financing requirement in 2023, including debt service payments (Table 3). Going beyond 2023, resumption of stronger capital inflows, particularly from trade and portfolio FDI, along with continued financial support of multilaterals, are expected to cover the financing requirement.

Table 3: External Financing Table (illustrative debt restructuring scenario)

USD million	2022	2023p	2024p	2025p	2026p
Gross external financing requirement	**(3,336)**	**(1,358)**	**(1,361)**	**(1,433)**	**(1,603)**
Current Account	(1,454)	(594)	(569)	(607)	(732)
Balance on goods	(5,185)	(5,190)	(5,377)	(5,598)	(6,175)
Balance on services	2,110	2,250	2,525	2,775	3,128
Primary and secondary income, net	1,621	2,347	2,283	2,216	2,316
Amortization payments	(1,883)	(765)	(792)	(826)	(872)
Government	(1,741)	(549)	(573)	(608)	(655)
Central Bank (incl. repayments to IMF)	(142)	(216)	(219)	(218)	(217)
Identified financing sources	**3,849**	**(454)**	**(154)**	**70**	**252**
Change in ACU liabilities	1,472	(736)	(997)	(260)	-
Indian credit lines	843	212	-	(346)	(709)
Other CBSL liabilities (incl. international swaps)	400	(200)	(400)	-	-
Other inflows	(802)	1,294	1,314	1,469	1,512
Bilateral and multilateral loans (excluding India)	836	1,166	1,172	1,195	1,214
Change in reserves	1,100	(2,190)	(1,242)	(1,988)	(1,765)
Errors and omissions	**(513)**				
Financing gap before IFI support	-	**(1,813)**	**(1,515)**	**(1,363)**	**(1,352)**
IFI support		**1,813**	**1,515**	**1,363**	**1,352**
IMF		663	665	663	652
Other IFIs		1,150	850	700	700
Shortfall (-)	-	-	-	-	-
Memo: Reserve path	465	2,655	3,897	5,885	7,650
Reserves (months of imports)	0.3	1.9	2.5	3.6	4.4

Notes:

IFI inflows in 2023 assume: (i) US$650 million from budget support operations from ADB, (ii) US$500 million of budget support from WB, and (iii) US$567 million in project financing from ADB and WB. IFI inflows in 2024 and beyond assume budget support operations including: (i) US$400 million from WB, and (ii) US$450 million in 2024 and US$ 300million each in 2025 and 2026 from ADB. Other capital flows (FDI, portfolio inflows, and trade financing) are projected to rise gradually due to the confidence brought by the IMF EFF. ACU: Asian Clearing Union.
The World Bank budget support is contingent on meeting the requirements for DPO financing (macro adequacy and good progress on reforms).

22. **A combination of new revenue measures and expenditure savings is expected to improve the primary balance significantly between 2023 and 2025.** Given Sri Lanka's very low revenue collection (8.3 percent of GDP in 2022), revenue-led fiscal consolidation through reversing the tax cuts of 2019, introducing new tax policy reforms, and strengthening tax administration will be a priority. According to the baseline, revenue is expected to increase by 2.3 percentage points of GDP in 2023 due to revenue measures such as the Value Added Tax (VAT) rate hike from 8 to 15 percent, Personal Income Tax (PIT) and Corporate Income Tax (CIT) reforms, and an increase in fuel excise taxes.[12] In 2024 and 2025, further revenue adjustments of 1.3 and 1.4 percent of GDP, respectively, are projected thanks to continued VAT

[12] Although Sri Lanka's tax buoyancy (the change in tax revenue in response to an increase in GDP) is less than 1, under an earlier IMF program, the revenue to GDP ratio increased to 13.2 percent of GDP in 2016 from 11.2 percent of GDP in 2014 given several revenue enhancing reforms.

reforms,[13] the introduction of property/wealth taxes, and tax administration reforms (Table 4). In the medium to long term, tax administration reforms could raise about 0.5 to 1 percent of GDP. On the expenditure front, rationalization of primary recurrent expenditures (limiting growth in the public sector wage bill) is projected to save 0.6 percent of GDP between 2022 and 2025.[14] Public investment is projected to remain low during the same period, contributing to the fragile recovery. Revenue and expenditure measures together will improve the primary balance by 5.9 percent of GDP between 2022 and 2025.

23. **Sri Lanka's current debt stock is split equally between debt issued under foreign and domestic law**. Approximately US$41.5 billion is issued under foreign law, including US$10.5 billion of multilateral debt, US$10.1 billion of bilateral debt, US$17.8 billion of private debt, and US$3.1 billion of central bank debt (Table 5). China, the single largest bilateral creditor, is estimated to hold approximately 18 percent of the total debt under foreign law.[15] Out of the US$42 billion worth of debt issued under domestic law, approximately 10 percent is denominated in foreign currency while the remainder represents mainly T-bills and T-bonds issued in local currency. The CBSL and private sector pension fund (managed by CBSL) hold around 25 and 29 percent of the total local currency debt, respectively. The remaining local currency debt is held by deposit taking institutions, including banks, insurance companies, other small pension funds, and private individuals and corporates. Domestic debt restructuring needs to be carefully designed, considering the need to safeguard domestic financial sector stability.

Table 4: Key Fiscal Balances (illustrative debt restructuring scenario)

Share of GDP unless otherwise stated	2021	2022	2023p	2024p	2025p	2026p
Total revenue and grants	8.3	8.3	10.6	11.9	13.3	13.5
Tax revenue	7.4	7.3	9.5	10.8	12.3	12.5
Income taxes	1.7	2.2	3.0	3.0	3.8	4.0
VAT	1.8	1.9	3.2	4.2	4.5	4.5
Excise taxes	1.7	1.4	1.7	1.7	1.7	1.7
Other trade taxes	1.6	1.1	1.0	1.2	1.3	1.3
Others	0.5	0.6	0.6	0.7	1.0	1.0
Non-tax revenue	0.9	0.9	0.9	0.9	0.9	0.9
Grants	0.0	0.1	0.1	0.1	0.1	0.1
Total expenditure	20.0	18.5	19.7	18.6	18.3	17.8
Current expenditure	15.6	14.6	16.1	15.0	14.7	14.2
Salaries and wages	4.8	4.0	3.6	3.5	3.4	3.4
Transfer payments	3.9	3.4	3.9	3.8	3.7	3.6
Purchases of goods and services	1.0	0.8	0.8	0.8	0.8	0.8
Interest	6.0	6.5	7.9	7.0	6.9	6.5
Capital and net lending	4.4	3.9	3.6	3.6	3.6	3.6
Primary balance	(5.7)	(3.7)	(1.2)	0.2	1.9	2.2
Overall balance	(11.7)	(10.2)	(9.1)	(6.8)	(5.0)	(4.3)
Net foreign financing	(0.1)	1.8	2.6	2.7	2.5	2.4
Net domestic financing	11.8	8.4	6.5	4.1	2.5	1.9
Total PPG debt	110.4	118.7	102.8	103.2	102.5	101.0
Interest (share of revenue)	72.0	77.8	74.7	59.0	51.8	48.4
Interest (share of expenditure)	29.8	35.0	40.1	37.6	37.6	36.6

Sources: Ministry of Finance, Central Bank of Sri Lanka (historical data) and World Bank staff calculations (projections).

24. **While Sri Lanka's debt would become sustainable after the planned debt restructuring, debt would remain high and would still be subject to significant downside risks.** Following the authorities'

[13] Further rationalization of VAT exemptions

[14] At less than 20 percent of GDP, Sri Lanka's expenditures are not high by international standards. Salaries, pensions, and interest payments account for about 60 percent of total expenditure. However, efficiency gains can be achieved by improving public investment management.

[15] Chinese debt includes both bilateral and commercial debt.

request for an IMF program, IMF staff carried out a debt sustainability analysis (DSA), using market-access thresholds. This analysis suggested that Sri Lanka's debt was not sustainable without restructuring, and set targets (i.e., debt level, gross financing requirement, and external debt service) for the debt restructuring in the context of the IMF EFF.[16] The World Bank's DSA takes these targets as given, as they underpin the debt restructuring discussions and Sri Lanka was not subject to a joint Low-income countries' DSA when EFF discussions commenced. According to the Bank's illustrative scenario[17] – one among possible scenarios to achieve the IMF's debt sustainability targets – post-restructuring, the public and publicly guaranteed (PPG) debt to GDP ratio is projected to decline from 118.7 percent in 2022 to 102.8 percent in 2023, and gradually decline towards 95 percent in the outer years (Table 6 and Figure 1). Although Gross Financing Needs (GFN) will remain high in the short-run (on average, approximately 19.7 percent between 2023 and 2027), with reductions in the outer years, average GFN is projected to remain below the IMF target – an average of 13 percent of GDP in 2027–32 (Figure 2). Due to restructuring of private debt, the foreign exchange share of debt service is projected to remain well below the IMF target of 4.5 percent of GDP. Stress tests suggest that a real GDP or real exchange rate shock could adversely affect the path of debt reduction (Figures 1 and 2).

25. **The macroeconomic policy framework is considered adequate for this operation, but downside risks are very high.** Given the likely parameters of external debt restructuring and available financing from the IFIs, Sri Lanka's path to recovery remains narrow. The projected fiscal and external adjustment path, debt relief, and adequate financial support from international partners are expected to put the economy on a sustainable macroeconomic trajectory and the external financing gap is projected to be closed for 2023-26. However, the adjustment path has limited buffers, allowing no deviation from agreed policies, and requiring timely conclusion of debt discussions and provision of IFI support. The outlook is consequently subject to significant downside risks, including: (i) protracted external debt restructuring, (ii) lower-than-expected external financing or larger financing requirements, (iii) delay in or weaker than expected fiscal adjustment; (iv) further escalation of political instability and social unrest, and (v) a further deterioration of financial sector stability. Materialization of downside risks could lead to disorderly adjustments. On the upside, faster recovery of tourism and larger remittance flows could raise the growth path and build additional external buffers. Moreover, the recent tax policy changes that go beyond restoring the pre-2019 tax regime,[18] and improved tax administration could support a stronger revenue adjustment.[19] The Bank's assessment of macroeconomic adequacy is broadly aligned with the IMF's assessment. However, the Bank's framework is conservative on the growth path, the revenue adjustment, external financing flows, and the reserve accumulation path.

[16] Key debt targets of the EFF are: (i) level of debt should decline below 95 percent of GDP by 2032; (ii) average GFN should remain below 13 percent of GDP in 2027–2032 and remain on a downward trajectory thereafter; and (iii) foreign exchange debt service should not exceed 4.5 percent of GDP in any year.

[17] Our illustrative scenario assumes: (i) a principal reduction of external private debt, along with a significant grace period (leading to an approximately 35 percent Net Present Value (NPV) reduction at a 5 percent discount rate); (ii) a maturity extension for official bilateral debt, with a similar debt relief to external private debt in NPV terms; (iii) T-bills held by the central bank are exchanged into longer term debt instruments; and (iv) a reprofiling of select categories of remaining domestic debt (while limiting the impact on the financial sector).

[18] In 2019, government implemented several tax policy changes, including a VAT rate reduction from 15 to 8 percent, that eroded tax revenue.

[19] The projected revenue path reaches 13.5 percent of GDP in 2025. Under an earlier IMF EFF, revenues increased to 13.2 percent of GDP in 2016.

Table 5: Debt composition (end-2022)

	Foreign Currency					Local currency			Total	
	Foreign Law		Domestic law			Local law				
US$ million	Debt stock[1]	o.w. arrears	Debt stock	o.w. arrears	Total	Debt stock[1]	o.w. arrears	Toal	US$ Mn	% of total
Central Government Debt	**36,730**	**2,691**	**3,708**	**156**	**40,438**	**36,321**		**36,321**	**76,759**	**88**
Multilateral	9,923				9,923				9,923	12
Bilateral	9,856	602			9,856				9,856	12
Private	16,951	2,089	3,708	156	20,659	35,672		35,672	56,331	63
Bonded	13,183	1,633	1,103	156	14,286	35,384		35,384	49,671	57
Non-bonded	3,768	456	2,604		6,372	288		288	6,660	6
ECA-Backed	937	126			937				937	1
Non ECA-Backed	2,831	331	2,604		5,435	288		288	5,723	5
CBSL Advances						649		649	649	1
Guaranteed SOEs Debt	**1,646**	**311**	**361**	**74**	**2,008**	**1,731**		**1,731**	**3,739**	**8**
Multilateral	510				510				510	1
Bilateral	288	19			288				288	0
Commercial	848	292	361	74	1,210	1,731		1,731	2,941	7
ISBs	181	6			181				181	0
ECA-Backed	339	28			339				339	0
Other private	329	259	361	74	690	1,699		1,731	2,421	7
Central Bank of Sri Lanka	**3,098**				**3,098**				**3,098**	**4**
Multilateral	1,062				1,062				1,062	1
Bilateral[2]	2,036				2,036				2,036	3
	41,474	**3,002**	**4,069**	**230**	**45,544**	**38,052**		**38,052**	**83,596**	**100**

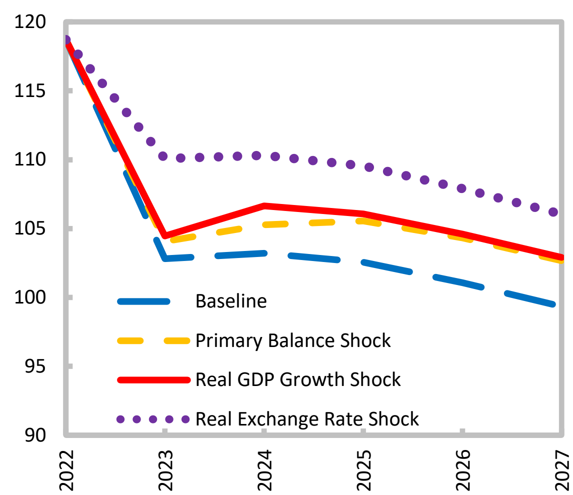
Notes: (1) Outstanding debt stock incl. arrears; (2) Bilateral swap lines with the People's Bank of China (conditional), Bangladesh Bank, Reserve Bank of India, this figure excludes Asian Clearing Union (ACU) liabilities amounting to US$1.9bn as at end-June 2022; and (3) ECA – Export Credit Agency. ISBs: International Sovereign Bonds.
Source: Ministry of Finance

Table 6: Debt Sustainability Analysis – illustrative debt restructuring scenario
(in percent of GDP unless otherwise indicated)

	Actual			Projections					
	2011-2019	2020	2021	2022	2023	2024	2025	2026	2027
Nominal gross public debt	76.6	104.8	110.4	118.7	102.8	103.2	102.5	101.0	99.2
Public gross financing needs	19.0	22.5	28.4	27.3	28.7	19.0	18.5	16.8	15.5
Real GDP growth (in percent)	5.1	-4.6	3.5	-7.8	-4.3	1.2	2.0	3.0	3.0
Inflation (GDP deflator, in percent)	5.0	3.3	8.5	48.8	20.5	8.0	5.8	5.0	5.0
Nominal GDP growth (in percent)	10.3	-1.5	12.3	37.2	15.3	9.3	7.9	8.2	8.1
Effective interest rate (in percent)	7.2	6.9	6.4	8.0	7.7	7.4	7.2	6.9	6.6

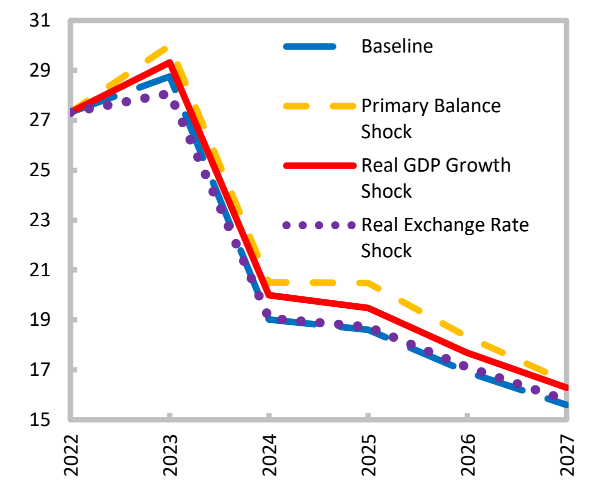
Contribution to Changes in Public Debt	Actual			Projections					
	2011-2019	2020	2021	2022	2023	2024	2025	2026	2027
Change in gross public sector debt	2.2	15.9	5.6	8.3	-15.9	0.4	-0.7	-1.5	-1.7
Identified debt-creating flows	0.6	13.2	3.4	-19.8	-6.6	-2.0	-2.6	-3.4	-3.6
Primary deficit	0.7	4.4	5.7	3.7	1.2	-0.2	-1.9	-2.2	-2.2
Primary (noninterest) revenue and grants	12.3	8.8	8.3	8.3	10.6	11.9	13.3	13.5	13.5
Primary (noninterest) expenditure	13.1	13.1	14.1	12.0	11.8	11.6	11.4	11.3	11.3
Automatic debt dynamics	-0.2	8.9	-2.3	-23.5	-7.9	-1.7	-0.7	-1.2	-1.4
Interest rate/growth differential	-1.9	7.6	-5.5	-23.5	-7.9	-1.7	-0.7	-1.2	-1.4
Of which: real interest rate	1.4	3.4	-2.3	-29.8	-12.3	-0.6	1.2	1.7	1.4
Of which: real GDP growth	-3.3	4.2	-3.3	6.3	4.5	-1.1	-1.9	-2.8	-2.8
Residual, including asset changes	1.6	2.6	2.2	1.8	-12.0	-0.1	0.0	0.0	0.0

Figure 1: PPG debt scenarios
(Percent of GDP)



Source: Ministry of Finance; World Bank

Figure 2: Gross financing needs scenarios
(Percent of GDP)



Source: Ministry of Finance; World Bank

2.3. IMF RELATIONS

26. **In March 2023, the IMF Executive Board approved a 48-month EFF of approximately US$3 billion to support the government's reform program.** This followed the Staff-Level Agreement in September 2022 and sufficient financing assurances from all major official creditors. The EFF aims to restore macroeconomic stability and debt sustainability, safeguard financial stability, enhance governance, and step-up structural reforms to unlock Sri Lanka's growth potential.

27. **The Bank has collaborated closely with the IMF to support the government's reform program, including on reform dialogue and TA for structural reforms**. There are several complementarities between the IMF's EFF and the Bank's DPO, especially in areas such as debt management, public financial management (PFM), tax administration, and the financial sector, where joint missions have been fielded (Table 7). The IMF has also relied extensively on the Bank's work around mitigating the impact of the crisis on the poor and vulnerable through the strengthening of the social protection system. In addition to the complementarities and additionalities with the IMF program, the Bank's engagement is closely coordinated with other DPs, such as the ADB, through the *MDB+ Coordination Platform*, as shown in Table 8 and further described in paragraph 69.[20]

Table 7: Complementarities between IMF EFF and World Bank DPO

Area	IMF EFF	World Bank DPO
Tax Policy and Administration	• Tax policy reforms (PIT, CIT, and VAT) • Reinstatement of mandatory withholding taxes on employment income, services payments, capital income	• Tax policy reforms (CIT, fuel excise taxes) • Tax administration reforms including establishment of systematic third-party information sharing with IRD, mandatory e-filing for non-corporate taxpayers, use of risk-based filters in tax audits

[20] ADB is aligning its program for Sri Lanka in 2023 and beyond with the government's plan and key elements of the IMF EFF. ADB is planning to support the country's efforts to stabilize the economy, provide social protection, meet other immediate needs, and address the fundamental causes of the crisis to lay the foundation for a sustained recovery. ADB will continue support for imports, especially essential items, through a trade and supply chain finance program. ADB will also explore opportunities to actively support private sector development. Policy-based lending in the financial and power sectors is also planned for this year.

	• Diagnostics of revenue administration; abolishment of the Simplified VAT and VAT refund reform; and introduction of the property, gift, and inheritance taxes • Publication of tax expenditures related to corporate tax incentives	• Publication of tax expenditure statements
Fiscal and Debt Management	• PFM Law • PDM Law and establishment of unified DMO • Medium-term Fiscal Framework • Expenditure rationalization measures • Prohibiting monetary financing	• PDM Law and establishment of unified DMO
Financial Stability	• Revision of Banking Act to modernize the bank resolution law and new Central Bank Act • Comprehensive asset quality review	• Establishment of a financial sector CMC and updated ELA framework • Enactment of Banking (Special Provisions) Act to strengthen deposit insurance and problem bank resolution framework • Adoption and implementation of restructuring plans for SOBs • Limiting the maximum exposure of banks to single/group of connected borrowers • Standardized workout process to further strengthen the enabling environment for corporate NPL resolution
Structural and Governance Reforms	• Restoration of flexible exchange rate • Support for phased removal of import restrictions, exchange restrictions, multiple currency practices, and capital flow management measures • Implementation of automatic fuel and electricity pricing mechanisms • Support to restructuring balance sheets of four key SOEs (including CPC and CEB) • Anti-Corruption Bill • Governance diagnostic assessment	• Simplification of tariff structure and elimination of key para-tariffs • Publication and implementation of National Tariff Policy • Unified Investment Law • Mobilization of private capital and competition in broadband market • Operational transfer of SOEs to MoF in phases • Approval of SOE Reform Policy and SOE Reform Act, and alignment of SOEs HoCo AoA with the new Act
Social Protection and Vulnerability	• Safeguards on total social spending • New WBPS and eligibility criteria for beneficiaries	• Safeguards on total social spending • New Social Registry • New WBPS and eligibility criteria for beneficiaries • Use of scheme for all poverty-targeted programs, and eventual recertification of welfare program beneficiaries • Legislation to reduce gender discrimination in the labour market

3. GOVERNMENT PROGRAM

28. **Government's priority is to enable economic stabilization and revival through structural reforms and debt restructuring.** The reform program rests on the following key pillars: (i) an ambitious and primarily revenue-based fiscal consolidation, accompanied by institutional reforms and cost-recovery based energy pricing, aimed at restoring fiscal sustainability and strengthening fiscal discipline; (ii) a stronger social safety net to protect the most vulnerable; (iii) debt restructuring aimed at restoring public debt sustainability; (iv) a multi-pronged strategy to restore price stability and rebuild international reserves under greater exchange rate flexibility; (v) policies to safeguard financial stability; (vi) focused reforms to address governance and corruption issues; and (vii) broader structural reforms to unlock Sri Lanka's growth potential. Several of these reforms have already been announced or initiated through the *2022 Interim Budget*, *2023 Budget speech* and *EFF* Memorandum of Economic and Financial Policies, including new revenue measures, the reform of SOEs, cost-reflective pricing of utilities, establishment of a national debt management agency, and some important legal frameworks such as a new central bank law, a PFM law and SOE law, all of which aim to improve economic governance and enhance competitiveness. These measures are in line with recommendations of the technical staff of the Bank and the IMF. The Parliament endorsed the policy reform framework underpinning the EFF on April 28, 2023.

4. PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

29. **The program development objective is to support foundational reforms that restore macroeconomic stability and sustainability, mitigate the impact of current and future shocks on the poor and vulnerable, and support an inclusive private-sector-led recovery and growth path, through three pillars**: (i) improving economic governance, (ii) enhancing growth and competitiveness, and (iii) protecting the poor and vulnerable. The operation is closely aligned with the reform direction and measures that government has already announced and addresses some of the immediate adjustment needs of the country. It also supports policies that create opportunities to make meaningful improvements in overall governance.

30. **The design of the operation builds on lessons from previous DPOs in Sri Lanka and the region.**[21] *First*, a programmatic approach is proposed, as the implementation of Sri Lanka's reform program will take several years. A series of two operations also allows the Bank to support the most critical reforms, but leaves flexibility to adjust mid-term given the high risks. *Second*, to fully achieve expected outcomes, Cabinet approval of policy measures is insufficient to ensure that proposed bills successfully go through the parliamentary process. Thus, this operation focuses on the last-mile issuance of implementing regulations post-parliamentary approval of legislations. *Third*, lack of government ownership, including alignment with its reform program, limits implementation. To address this, the operation is closely coordinated by a team in the Office of the President, Ministry of Finance (MoF), and CBSL, who are implementing the reforms. *Finally*, close support is required to ensure effective reform implementation. As a result, the Bank, alongside other partners, is providing TA in important reform areas (Table 8). This TA will be scaled up as the series of DPOs is rolled out.

Table 8: Mapping of Macro-Critical Reforms and TA Support across DPs

Area	ADB	Asian Infrastructure Investment Bank (AIIB)	IMF	Japan International Cooperation Agency (JICA)	United States Agency for International Development (USAID)	World Bank
Revenue			o			o
Expenditure	o		o	o	o	o
Debt Management			o		o	o
Trade and Investment	o			o	o	o
SOE Reforms	o		o		o	o
Financial Sector	o		o	o		o
Energy	o	o	o	o	o	o
Social safety nets	o		o			o
Governance	o		o		o	o

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar I: Improving Economic Governance

31. **The first pillar includes measures to both address governance problems which contributed to the crisis and ensure better governance to help stabilize the crisis.** Specific prior actions (PAs) focus on policies to increase tax revenues and strengthen debt management, improve tax administration, and

[21] This includes the *Catastrophe Deferred Drawdown Option* in 2014, and *Competitiveness, Transparency and Fiscal Sustainability* DPO in 2016.

reduce systemic risks in the financial and banking sector. Strengthening the governance framework, institutional structures and coordination in these macro-critical areas is essential for Sri Lanka's medium to long-term macroeconomic stabilisation and development path. The measures under this pillar also closely complement the EFF program.

Reform objective 1: *improve fiscal and debt management*

DPO1 PA#1: To strengthen domestic revenue mobilization, the Recipient has: (i) removed sector specific concessionary corporate income tax rates, as evidenced by publication in the Recipient's official gazette of the Inland Revenue (Amendment) Act, No. 45 of 2022 as certified by the Speaker of Parliament; and (ii) increased the fuel excise duty, as evidenced by (a) publication in the Recipient's official gazette on December 31, 2022, of the order (the "Order") issued by the Minister of Finance under the Excise (Special Provisions) Act, No. 13 of 1989, and (b) letter dated May 23, 2023, issued by the Secretary General to the Parliament to the Minister of Finance confirming approval by Parliament of such Order.

32. ***Rationale:*** **Fiscal and debt management and revenue mobilization efforts need to be significantly improved to better manage the current crisis and prevent similar crises in the future.** Sri Lanka's tax revenue has continuously underperformed over the past three decades. Tax revenue as a share of GDP reached a low of 7.3 percent in 2022, compared to 10.9 percent in 2019. Sri Lanka performs poorly compared to countries at similar levels of income, and to the region (which had an average tax-to-GDP ratio of 13.7 percent in 2019). To strengthen domestic revenue mobilization, the government has initiated a package of tax reforms, including new taxes and higher tax rates, beginning in mid-2022, including policy changes to CIT[22] and fuel excise taxes ***(PA#1)***. Government is committed to introducing further reforms to broaden the tax base and ensure a more progressive approach to revenue mobilisation (e.g., introducing a property tax and gift and inheritance tax before 2025).

33. **The legal and institutional set up for debt management needs to be transformed.** The current fragmented institutional arrangement and lack of consolidated strategic planning constrains debt management and has led to the accumulation of debt from all sources with suboptimal transparency and limited considerations of cost and risk. ***Trigger 1*** (see Annex 1) will consolidate public debt management into a single *Public Debt Management (PDM) Office*, regulated by an overarching PDM Law,[23] including specific requirements on debt transparency. It will also put in place a well-defined legal and operational framework for the provision of guarantees and on-lending operations and the monitoring of associated risks and other contingent liabilities.[24]

34. ***Expected results:*** Implementation of PA#1 tax measures is expected to result in additional annual revenues of 0.6 percent of GDP, on average. Consolidation of debt management activities under a single entity as per the trigger will ensure that borrowing takes place under a cohesive and accountable organizational structure – one that is less dependent on multiple coordination committees, and free of potential conflicts of mandates, including in relation to monetary policy management. This will facilitate decision-making, accountability, debt recording and reporting, auditing, and the consistent design and implementation of medium-term debt management strategies and annual borrowing plans. A well-

[22] CIT concessionary rates on several large sectors were removed. These include agro-processing, exports, construction, manufacturing, tourism, education, healthcare, gems and jewelry, supply of electricity to the national grid using renewable energy, SMEs (turnover less than LKR 500 million), and concessions available for listed corporates.
[23] The new PDM Law would (i) mandate the integration of all debt management functions into a single Debt Management Office (DMO), (ii) define public debt and authorized debt instruments, (iii) require the annual update and publication of a Medium-Term Debt Strategy, an Annual Borrowing Plan, and a Quarterly Debt Report (iv) outline the process of providing sovereign guarantees and on-lending operations to SOEs and other public entities, and (v) mandate the publication of a consolidated annual debt report (with a time-lag smaller than 3 months) and fiscal risk statements covering at least SOEs guaranteed and non-guaranteed debt.
[24] This includes the relevant rules and regulations on credit risk assessment, monitoring process, and risk mitigation measures.

defined legal and operational framework for the provision of guarantees and on-lending operations, will improve transparency and monitoring of public sector debt and fiscal risks.

***Reform objective 2**: improve governance of tax administration*

DPO1 PA#2: To strengthen governance of tax administration and its enforcement capability, the Recipient has enacted amendments to the Inland Revenue Act requiring: (i) financial institutions, government procurement departments, stock exchange, registrar of companies, motor vehicle authority, and land registrar to submit taxpayer transaction information at the individual level to the IRD in a systematic and time-bound manner; and (ii) non-corporate taxpayers to file their income tax returns through an electronic system (e-filing of income tax returns), as evidenced by publication in the Recipient's official gazette of the Inland Revenue (Amendment) Act, No. 4 of 2023 as certified by the Speaker of Parliament.

35. ***Rationale:*** **Tax administration reforms will complement the tax policy measures with critical administration reforms that strengthen tax compliance and enforcement capability of IRD** (***PA#2***). The first component supports *strengthening third party reporting by agencies that collect taxpayer and potential taxpayer information*. Information shared by third party agencies can help identify transactions with liability for taxation and hence provide useful inputs for compliance risk management. Currently, the IRD obtains information through Memorandums of Understanding (MOUs) with agencies such as banks and property registration authorities in local government, but compliance is weak. This PA creates a legal obligation for financial institutions to share taxpayer transaction-level information with IRD in a systematic and time-bound manner, and in a format prescribed by IRD. The second component of the PA aims to *capture non-corporate taxpayer returns electronically,* to enable efficient processing by IRD and subsequent quick selection of cases for auditing. E-filing would reduce the errors in data entry and time to obtain refunds, and also enhance transparency. The IRD successfully implemented mandatory e-filing of tax returns by companies in 2021. However, only 23 percent of individual taxpayers e-filed in 2021, as paper returns continue to be allowed.

36. **With better information that is more easily available in an electronic form, tax administration can be further enhanced, whilst the authorities take steps to improve the transparency around tax exemptions**. The current system of tax audits, led by a single jurisdictional field officer with limited information, is vulnerable to discretion in the selection of cases, and will be replaced by a system that centralizes the information needed to select tax returns for audit using risk-based filters (***Trigger 2***). The trigger builds on PA#2 to ensure that data collected from third parties and e-filed returns is cross-checked in the *Revenue Administration Management Information System* (RAMIS) against tax returns (or their lack thereof). The data will be integrated into RAMIS, and tax audit compliance reports will be published regularly to enhance transparency and compliance. A second component of the trigger supports government's efforts to increase transparency through the publication of an Annual Statement of Tax Expenditures, including information on revenue foregone due to tax exemptions.

37. ***Expected results:*** The PA and trigger are expected to measurably improve the efficiency of tax administration and collection through better compliance and reporting, more tax returns being filed, better targeted tax audits, and more information being available to verify tax compliance. The use of e-filing facilities for non-corporate tax declarations is expected to increase by 2025, as is the revenue from income tax audits, due to third-party information being shared. Overall, these measures are expected to raise revenues by about 0.5 to 1 percent of GDP in the medium to long term.

***Reform objective 3**: safeguard financial sector stability and restore the flow of credit to private sector*

DPO1 PA#3: To reduce systemic risks in the financial sector: (i) the CBSL's Monetary Board has approved an ELA framework that articulates the CBSL's policies and operational and procedural modalities for ELA provision to liquidity-distressed but solvent banks, as evidenced by a certified extract of the minutes of the meeting of the Monetary Board approving and attaching

the ELA framework; and (ii) Cabinet has approved the establishment of a financial sector crisis management committee that sets out crisis management responsibilities and provides an institutional basis for CBSL–MoF policy coordination, as evidenced by minutes of the meeting of the Cabinet approving the establishment of the financial sector crisis management committee.

38. ***Rationale:* In the near term, financial sector risk reduction and crisis response policies are the first priority.** The DPO prioritizes enhancements to the financial sector safety net, including through the adoption of an Emergency Liquidity Assistance (ELA) operational framework (that sets out the internal policies and procedures for the CBSL's lender of last resort function to liquidity-distressed but solvent financial institutions); and the establishment of a high-level financial sector crisis management committee (CMC) to ensure proper MoF-CBSL coordination on crisis management policies (***PA#3***). The CMC would address issues such as bank recapitalization, bank resolution strategies, deposit insurance, and urgent legal and operational enhancements to strengthen Sri Lanka's capacity to respond to systemic stress, which involve a combination of regulatory and fiscal decision making and where lack of coordination could lead to consequential delays.

39. **Following the initial stabilization phase, additional work is envisaged to reposition the financial sector to better serve the financial needs of the economy.** Trigger 3 aims to address the root causes that enabled the build-up of financial sector vulnerabilities. It also aims to lay the foundations for a robust, more inclusive financial sector that is more effective in channeling resources to meet the financial service demands of the real economy, as opposed to financing the government and stop-gapping loss-making SOEs. The rewriting of the regulation on single borrower exposure limits (***Trigger 3***) aims to address shortcomings that have enabled banks to perpetuate the flow of funds to financially weak SOEs. In addition, the depth of Sri Lanka's current recession puts a high premium on efforts to ensure that distressed, but potentially viable, borrowers are given an opportunity to restructure their debt and continue to operate. This will be supported by the issuance of amendments to an existing circular to strengthen the enabling environment for corporate NPL resolution in accordance with international best practices (***Trigger 3***). In parallel, a TA program, jointly with the International Finance Corporation (IFC) and USAID, is being prepared to exchange international practice and support capacity building to initiate voluntary out-of-court processes and deal with the potential increase in NPLs.

40. ***Expected results:*** These policy actions aim to contribute to the stabilization of the financial sector and its repurposing from a financing tool for the state and its affiliated companies to providing funding for the needs of the real economy. The planned measures are expected to contribute to a significant lowering in lending volumes to SOEs (currently 8.8 percent of total banking assets and 22 percent of SOBs' assets) and in lending to the government more broadly.

DPO1 PA#4. To maintain stability and confidence in the banking system, the Minister of Finance has submitted to Parliament the Banking (Special Provisions) bill aimed at strengthening the deposit insurance and problem bank resolution framework, as evidenced by (a) minutes of the meeting of the Cabinet held on May 2, 2023 (Cabinet paper No 23/0832/604/086) approving the submission to Parliament of the Banking (Special Provisions) bill, and (b) "order paper" of Parliament for May 23, 2023, evidencing submission of the respective bill to Parliament.

DPO1 Second Tranche Release Condition: Sri Lanka has enacted the Banking (Special Provisions) Act aimed at strengthening the deposit insurance and problem bank resolution framework.

41. ***Rationale:* In the near term, another priority is to support the authorities in their efforts to safeguard financial sector stability and enhance their powers to deal with growing risks in a timely and efficient manner.** Sri Lanka urgently needs to upgrade its currently inadequate legal and institutional framework for problem bank resolution and deposit insurance (***PA#4 and second tranche release condition***). As shown in the experience from other recent emerging market and developing economies' crises, the authorities need to have the full range of powers and instruments to be able to resolve

problematic financial institutions in a prompt and cost-effective fashion. A financially and institutionally strong deposit insurance scheme plays a key role in maintaining the public's confidence in the banking system and protecting the savings of depositors in failed institutions. To this end, the authorities are in the process of overhauling the primary legislation for bank resolution and deposit insurance in line with international good practice, with support from the World Bank and IMF. The IMF, in addition to the PA on bank resolution, requires an *Asset Quality Review* (being sponsored by ADB), as well as an overhaul of the existing Banking Law.[25] The Bank is also preparing an IPF to strengthen the financial and institutional capacity of the financial sector safety net, with a focus on the deposit insurance scheme.

42. **Following the initial stabilization phase, the restructuring of dominant SOBs will be critical to reposition the financial sector to better support private sector-led growth.** Sri Lanka's banking system has one of the highest shares of state ownership in the South Asia region (close to 50 percent of total assets). While the entire banking sector has been heavily hit by the combination of the sharp economic slowdown and prospects of losses on their portfolios of government securities, SOBs – which include three large systemically important banks – are particularly at risk given their comparatively weak financial condition and sizable exposures to large loss-making SOEs. The sector needs a thorough financial, operational, and governance restructuring aimed at reducing the sovereign/SOE/bank nexus, addressing likely recapitalization needs, and redirecting SOB lending and other activities in support of a sustainable, private sector-led economic recovery (***Trigger 4***). In the longer-term, the authorities could consider divesting the state's ownership stake in SOBs (to strategic investors that meet fit and proper criteria) to boost competition and attract fresh funding/technical know-how.

43. ***Expected results:*** Together with the financial sector policy actions under PA#3 and subsequent trigger, PA#4 and the subsequent trigger also contribute to the stabilization of the financial sector, reducing its accumulated vulnerabilities, and repurposing the sector away from just a financing tool for the state and its affiliated companies. This will contribute to a significant lowering in lending volumes to SOEs and in lending to government more broadly.

Pillar II: Enhancing Growth and Competitiveness

44. **The second pillar includes measures to level the playing field by restructuring and divesting SOEs, reforming the trade and investment regimes, and mobilizing private capital and competition in the broadband market.** A fragmented and inward-oriented trade and investment regime, as well as a large public sector footprint in the domestic market, and weakened export competitiveness are binding constraints to growth.[26] The reforms under this pillar are essential for improving the cost and quality of goods and services, opening opportunities for private sector investment and, ultimately, Sri Lanka's medium to long-term competitiveness and growth performance.

***Reform objective 4**: restructure and divest SOEs*

DPO1 PA#5. To improve the commercial performance, financial transparency, and private-sector participation in the SOE sector, the Recipient has: (i) approved the SOE Reform Policy Paper, as evidenced by the minutes of the meeting of the Cabinet held on May 15, 2023 (Cabinet paper No. 23/0858/604/090) approving and attaching the respective policy paper; and (ii) re-

[25] PA#4 has helped accelerate the pace of adoption and contributed to further enhancements of the in-preparation bank resolution law.

[26] The World Bank's internal policy note on *Priority Reforms for Boosting Sri Lanka's Growth* (2023) lays out the growth-orientated policies and structural reforms needed to accompany the macroeconomic adjustment. Structural reforms that improve microeconomic efficiency, enhance productivity growth, and increase exports can counter the contractionary effects of stabilization and help facilitate growth. Hence, the reforms in PAs#5-7 are prioritized in this DPO. Other important structural reforms that are discussed in the note, but require further time and/or analysis (such as access to land and credit, transport and logistics, and the agricultural sector), are not addressed by the current DPO.

assigned the operational control of selected SOEs to the Ministry of Finance, as evidenced by the publication in the official gazette of the respective transfer decision made by HE the President under Article 44 of the Sri Lankan Constitution.

45. ***Rationale:*** **A key factor in Sri Lanka's poor productivity and competitiveness is the dominance of SOEs in the economy.** Many have monopoly or dominant market positions, receive public subsidies, and compete directly with the private sector. Misallocation of resources in favour of SOEs, along with market advantages and weak governance and management, has resulted in labour and capital inefficiencies, and financial losses. By crowding out the private sector, SOEs diminish the scope for new investment and innovation that can drive productivity and service delivery improvements. SOEs have also been a major source of fiscal and financial sector risks.

46. **This set of reform actions focuses on creating a robust legal, regulatory, and institutional arrangement for the SOE reform program initiated by GoSL**. ***PA#5*** aims to put in place a transparent governance framework around SOE reforms, based on international good practices. The *first* component of *PA#5* is *the approval of the SOE Reform Policy paper* that will serve to inform and obtain Cabinet's endorsement of the objectives, approach, and activities of the SOE reform program and set out the foundational elements of the legislation that will subsequently be prepared. The *second* component entails the President issuing a gazette order to *transfer the operational control of a select number of SOEs from different line ministries to the MoF*. This will – for those entities that are gazetted over to MoF – effectively end the status quo, whereby the MoF owns all the shares of a SOE, whilst line ministries and agencies have management control of its resources and assets. This dual model approach has exacerbated the commercial, financial, and corporate governance performance of SOEs, to the detriment of the shareholder (MoF) and the consumers. In parallel, GoSL is preparing Articles of Association (AoA) to set up a SOE Holding Company (HoCo) to manage the restructuring and divestment process.

47. **Subsequent reform actions aim to ensure continued implementation of the SOE reform program. *Trigger 5***, which entails the approval of implementing regulations of a new SOE law, will serve to give legislative force to the SOE Reform Policy and ensure broad political consensus on the reform program. To enhance the HoCo's corporate governance and operational arrangements, the trigger will also require that the AoA are aligned with the objectives and principles set out in the SOE Reform Policy and new SOE law. This may include the establishment of a high-level political advisory body to help the MoF address, among other things, political challenges, and vested stakeholder interests. The operational control of additional SOEs will also be transferred to MoF as part of this trigger. In addition to the reform of SOEs through the HoCo, the government is drafting a new comprehensive Electricity Act to reform the energy sector and, *inter alia*, provide the legal basis for unbundling of Ceylon Electricity Board (CEB) and incorporating several successor companies.[27] The divestment of an initial set of eight SOEs was already approved by Cabinet on March 13, 2023, along with an authorization to engage IFC as a transaction advisor for three of these, including Sri Lankan Airlines (SLA).[28] Given the complexity and scope of the SOE Reform program and the resources required to ensure its successful implementation, the World Bank is considering additional institutional, technical and transaction advisory support to this program. The Bank's support complements what ADB and USAID are doing to support the restructuring of the CEB and Ceylon Petroleum Corporation (CPC). Other actions on SOE policy and legislation, including the corporate

[27] The Ministry of Power is setting up a *Power Sector Reforms Secretariat* to coordinate activities pertaining to the implementation of the power sector reform process. The Ministry has asked DPs, including ADB, USAID and the World Bank to provide TA to support the reforms. Currently the Bank is providing TA to support the drafting of the Act and CEB financial strengthening.

[28] SLA is one of the three SOEs, along with CPC and CEB, to have caused the largest drain on the government budget and the financial system.

governance of SOEs retained as HoCo subsidiaries, and implementation of a planned *Labour Force Adjustment (LFA)* program, will be undertaken by government.

48. ***Expected results*****:** These policy measures will enable GoSL to successfully divest to majority private sector ownership (51 percent share ownership, or greater) a targeted 15 commercial SOEs by 2025 out of the 130 currently assessed to have commercial potential and able to attract private investment. These former SOEs will then be required to comply with the Companies Act in terms of commercial performance, financial management, and reporting requirements.

Reform objective 5*: reduce trade and investment policy uncertainty and increase the economy's competitiveness*

DPO1 PA#6. To simplify the tariff structure, the Recipient has adopted: (i) order issued by the Minister of Investment Promotion under the Sri Lanka Export Development Act No. 40 of 1979 implementing the phasing out over a period of 3 years of the Export Development Board Cess by reducing the Cess by 33 percent from April 1, 2023, as evidenced by (a) the publication in the Recipient's official gazette of the relevant order, and (b) letter dated May 9, 2023, issued by the Secretary General to the Parliament to the Ministry of Finance confirming approval by Parliament of the order issued by the Minister of Investment Promotion, and; (ii) order issued by the Minister of Finance under Section 03 of the Ports and Airport Development Levy Act No. 18 of 2011 to phase out PAL over a period of five (5) years commencing from 2023 and exempt PAL applicable on 20 percent of tariff items as phase I from April 4, 2023, as evidenced by (a) the publication in the Recipient's official gazette of the relevant order, and (b) letter dated May 9, 2023, issued by the Secretary General to the Parliament to the Ministry of Finance confirming approval by Parliament of the order issued by the Minister of Finance.

49. ***Rationale:* Sri Lanka has become a much more inward-looking economy since the turn of the century with serious implications for the balance of payments.** Over the 2000-2022 period, the share of trade to GDP more than halved from 88 to 43 percent and that of exports to GDP from 39 to 18 percent. The inward turn has been caused by a steady real appreciation of the exchange rate and a surge in import barriers. Increased para-tariffs raised effective rates of protection, reducing incentives for exports. The World Bank estimates untapped merchandise exports of Sri Lanka at US$10 billion annually. This PA will first support an initial reduction of para-tariffs (***PA#6***), whilst ensuring revenue neutrality is maintained through compensating increases in customs tariffs, which are less distortionary. The Bank is also working with government on proposals to streamline tariff exemptions (in particular, those granted to inward-oriented firms) that represent an important tax expenditure, and loss of revenue. As a complement to the reform, the Bank will provide TA to set up an *Import Tariff Advisory* body. This body will be equipped with expertise on trade and tariff policy analysis and provide an advisory role to decision makers on the revenue and competitiveness impact of trade and tariff policy decisions.

50. **The inward orientation of the economy is also evident in the weak performance of FDI which, in the last 40 years, averaged only 1.1 percent of GDP, compared to a global average of 3.9 percent.** Sri Lanka's investment regime is characterized by a fragmented legislative and discretion-based regulatory framework with restrictions across different sectors. Going forward, this operation will support the Sri Lankan economy to pivot towards greater openness to international capital and competitiveness. ***Trigger 6*** will support the legal and regulatory reform of the FDI regime to consolidate legislative arrangements and streamline coordination across different FDI-relevant agencies and support the promulgation of a new National Tariff Policy designed to reduce the effective rates of protection.

51. ***Expected results:*** The PA is expected to decrease trade policy uncertainty and trade costs (through lower import costs) and increase incentives to export and export competitiveness. Further, the adoption of a consolidated *Investment Law* will remove key constraints to investment and boost investor confidence, leading to more FDI in the longer-term. It would also bring about greater consistency between

Sri Lanka's international investment agreements and domestic legal framework, providing a level playing field for both domestic and foreign investors.

***Reform objective 6**: mobilize private capital and competition in the broadband market*

DPO1 does not propose a PA, considering that additional time is needed to prepare for the critical policy reforms.

52. ***Rationale:* Digital services offer the potential for creating new jobs, and better and more efficient public services, but poor broadband coverage and high access prices are key challenges.** Sri Lanka's digital sector is relatively advanced in the region, yet only about 9 percent of households subscribe to fiber optic fixed broadband and two-thirds cannot yet access a fiber optic network. Despite 95 percent coverage in 4G mobile broadband, many rural areas are yet to be connected, 5G has not started at scale, and internet services remain unaffordable for the poor. A lack of open access and infrastructure sharing policies and regulations has led to duplication of network investments and high costs for deployment, inhibiting operators' decisions to invest particularly in rural and remote areas. Newer mobile broadband technologies will require more radio spectrum and more efficient mechanisms to assign and share radio spectrum among operators. This will facilitate innovation and promote access to digitized services.

53. **Policy and regulatory changes are required to mobilize private capital and competition in the broadband market.** The World Bank estimates that an investment of US$1.3 billion is needed to connect all Sri Lankans to high quality internet services by 2030. Improving relevant policies and regulations that mandate open access to and sharing of infrastructure within and across sectors will increase competition in the broadband market, create efficiencies in network deployment, and reduce prices for consumers (***Trigger 7***).[29]

54. ***Expected results:*** The trigger will support private investment and innovation in technology and service offerings, open new markets, reduce the costs of service provision, improve service coverage (including public services, e-health, or online learning), and lower entry barriers for competitive service providers. Overall, these measures will ensure a more competitive broadband market and provide a predictable regulatory environment to attract investments, supporting GoSL's efforts to make internet accessible and affordable across the entire country.

Pillar III: Protecting the Poor and Vulnerable

55. **The third pillar seeks to strengthen the social protection system and reduce gender discrimination in the labour market.** This will involve improving the governance, effectiveness, and efficiency of the country's social protection system, to help the poor and vulnerable cope better with the ongoing economic crisis and price-adjustments resulting from macro-fiscal reforms, as well as future shocks, including those related to climate change.[30] Furthermore, legal restrictions to women's work in different sectors of the economy will be removed.

***Reform objective 7**: strengthen social protection institutions, delivery systems, and targeting*

DPO1 PA#7. To enhance social protection, the Recipient has: (i) adopted the FY23 Budget for a new welfare benefit payment scheme targeted at low-income and vulnerable households in the amount of LKR 187 billion, as evidenced by (a)

[29] The Telecommunications Regulatory Commission of Sri Lanka (TRCSL), with the World Bank's TA, is making progress on the trigger, with possible early implementation of a new spectrum policy in late 2023/early 2024. Given the importance of competition-related issues, the legal framework needs further examination. The Ministry of Technology has asked for assistance to assess how the Telecom Act, 1996 could be updated.

[30] *Samurdhi* is the largest CT program, providing support to the poorest households. There are also three main categorical CT programs: the Elderly Benefit program (persons over 70 years), Disability Benefit program (DB), and the Chronic-Kidney-Disease (CKD) Benefit program.

Appropriations Act, No. 43 of 2022, (b) minutes of the meeting of the Cabinet held on 2023.01.16 (Cabinet paper No. 23/0101/604/008), and (c) letter dated May 9, 2023 (reference BD/CBP/02/01/02/2023) from the Director General National Budget to the Secretary to the President confirming allocated budgetary provisions; and (ii) issued a gazette notification by the Minister of Finance under Article 9 of the Welfare Benefit Act No. 24 of 2002 for a new welfare benefit payment scheme, as evidenced by (a) the publication in the Recipient's official gazette of the notification issued by the Minister of Finance, and (b) letter dated May 12, 2023, issued by the Secretary General to the Parliament to the Ministry of Finance confirming approval by Parliament of the notification issued by the Minister of Finance.

56. ***Rationale:*** **COVID-19, the ongoing economic crisis, as well as structural adjustments have had a significant negative impact on the poor and most vulnerable.** Social assistance is characterized by: (i) poor governance; (ii) low spending; (iii) poor coverage of the poor and overall ineffective targeting; (iv) inadequacy of cash transfer (CT) benefits; and (v) limited system capacity to adapt and respond to crises. On (i), the delivery of social assistance has been highly politicized, which has in turn prevented cash transfers from being provided to all those in need. On (ii), Sri Lanka spent 0.6 percent of GDP on Social Safety Nets (SSN) in 2019. In comparison, the average South Asian country spends over 1 percent of GDP on SSN. On (iii), only 43 percent of households in the poorest income quintile received CTs in 2019, while close to 12 percent of households in the richest income quintile received CTs. This underscores the existence of significant inclusion and exclusion errors, limiting the program's potential impact on poverty (Household Income and Expenditure Survey, 2019). On (iv), CT amounts are very low, especially in light of high levels of inflation. For example, Samurdhi provides over five times less cash to its beneficiaries than the average poverty-targeted program in South Asia (ASPIRE, 2022). Finally, the social protection system is not designed to be scaled up in the event of a shock, negatively affecting the government's response to affected populations. Several of these issues are addressed by ***PA#7***, which ensures that sufficient budget is allocated to provide adequate targeted assistance to an increased number of poor, a new WBPS is established, and a robust social registry is operationalized. This PA is also supported by the new *Social Protection Project* (P178973), which aims to provide better targeted income support and livelihood opportunities for the poor and vulnerable, while strengthening the transparency, robustness, and adaptability of the country's social protection system.

57. **In addition to the cash transfer programs, the country has a number of social assistance programs whose poverty-targeting can be improved.** These include a food and in-kind transfer, nutrition program, and scholarships. Despite efforts to target the poor, these programs too have significant inclusion and exclusion errors, with less than half of the poorest households receiving social assistance (exclusion error) and twenty percent of the top two quintiles receiving support (inclusion error). Moreover, there is no system to identify whether beneficiaries are receiving benefits from more than one such program. The use of the social registry for these programs (***Trigger 8***) would lead to improved efficiency. Given the poverty and vulnerability situation of families evolves constantly, their eligibility for poverty targeted programs will need to be regularly reassessed. This operation proposes to regularly update families' situations by conducting a recertification for all the families periodically, such that families that are still deemed poor will continue to receive benefits, while others who have grown out of poverty will graduate from the program and their benefits will cease.

58. **The re-certification program will also cover single-parent households that are primarily female-headed and aim to address targeting errors that may have resulted in their exclusion from social assistance programs**.[31] The registry is expected to support the enrolment of vulnerable and marginalized groups into social assistance programs – including female-headed households (FHHs). Increasing access

[31] Over 25 percent of households in Sri Lanka are headed by women. These households are poorer and more vulnerable than male headed-households and likely to have been pushed deeper into poverty by the combined effects of COVID 19 and the current economic crisis.

to benefits for this group is critical as FHHs have been disproportionately impacted by the combined effects of COVID-19 and the current economic crisis.[32] Cash transfer programs can yield important benefits – particularly in terms of smoothing consumption for women. They can also help households build resilience and cope with climatic shocks by facilitating savings, improving food security, and establishing transparent delivery systems that allow safety net programs to scale up as necessary in the event of a climate shock. *Progress in closing gaps in access by FHHs will be tracked through indicator #8.*

59. ***Expected results:*** The PA is expected to lead to the establishment of a revamped social protection system: (i) with sufficient budget for the new WBPS; (ii) that provides adequate and targeted support to WBPS beneficiaries; (iii) with a robust, credible and resilient social registry that enables effective implementation of the WBPS for the 2 million targeted beneficiaries, and (iv) improved coverage of the poorest 20 percent of the population. Thus, the new WBPS will ensure that the poorest and the most marginalized groups are enrolled in social assistance programs. Furthermore, setting a 20 percent target for FHHs as beneficiaries is a critical attempt to capture those in the poorest quantile – many of the FHHs fall under this category.

***Reform objective 8**: level the playing field and reduce barriers for female labour force participation*

DPO1 does not propose a PA, considering that additional time is needed to prepare for the critical policy reforms.

60. ***Rationale:*** **Women have high unemployment rates, low wages, and their work is concentrated in the informal sector.** Over the last three decades, the female labour force participation (FLFP) rate has been around 34.5 percent and unemployment 4 percent.[33] The 2021 Labour Force Survey showed a decrease in FLFP to 31.8 per cent in 2021. Women's unemployment rate is twice as high as that of men and their earnings systematically lower, making them more vulnerable to the impacts of the current crisis.

61. **A key constraint to women's employment is the restriction on their employment at night and on their ability to work flexible hours, which is particularly relevant given their burden of care.** The *Employment of Women, Young Persons and Children Act (1956)* requires employers who want to hire women to work after 10 pm to get written sanction from the *Commissioner General of Labour*. Employers also need to hire female wardens to ensure the safety of female employees at night, and no woman can be employed for more than ten days per month of work at night. Furthermore, the *Shop and Office Employees Act (1954)* restricts the number of hours a day female employees can work and their ability to work at night in specific businesses. These legal restrictions discourage women from seeking employment in fields such as ICT and tourism.

62. **Since December 2022, there has been considerable progress, spearheaded by the government**. The President, who is also the *Minister of Women and Child Affairs*, has prioritized three bills that advance the rights of women and sexual minorities, including the: (i) Gender Equality Bill, (ii) Empowerment of Women Bill, and (iii) National Commission on Women Bill.[34] All three have been drafted with extensive consultation with civil society and are scheduled to be presented to Parliament this year. The recently approved *National Policy on Gender Equality and Women's Empowerment (2023-2032)* aims to increase women's participation in formal sector employment and to recognize women's role in care work.

[32] Based on World Bank simulations using Household Income and Expenditure Survey 2019.
[33] Ministry of Finance, Department of Census and Statistics, Sri Lanka Labour Force Survey, Annual Reports of 2012 and 2019.
[34] *https://www.presidentsoffice.gov.lk/index.php/2022/12/01/an-act-on-gender-equality-and-women-empowerment-to-be-presented-to-parliament-soon-president/* (accessed 22nd February 2023).

63. **Increasing women's participation in formal sector employment requires addressing legal discrimination in the workforce on the grounds of gender.** In the short-term, this entails the approval of the *Gender Equality Bill*. The Bill creates mechanisms to enforce Sri Lanka's obligations on the *Convention on the Elimination of all Forms of Discrimination Against Women* and requires government and the private sector to address workplace gender inequalities. This early-stage, foundational reform, will require further system changes to apply the principle of non-discrimination through: (i) the amendment of key pieces of legislation placing restrictions on women's ability to work flexible hours and at night; and (ii) an effective system of monitoring and compliance through labour inspection that takes into account updated regulations on women's work (***Trigger 9***).

64. ***Expected results***: In the short-term, the passage of the *Gender Equality Bill* represents a significant policy commitment to promote gender equality in the workplace. Reforms supported by the trigger are expected to lower barriers for women's access to formal employment and address constraints faced by businesses in employing women in key sectors.

Table 9: DPO Prior Actions and Analytical Underpinnings

PA	Analytical Underpinnings
	Pillar I: Improving Economic Governance
PA#1.	**Summary of Findings:** At around 7.3 percent of GDP (2022), Sri Lanka's tax-to-GDP ratio is low and had been decreasing even before the pandemic. A narrow base, numerous exemptions, and low rates have contributed to the low collection. • World Bank TA notes and presentations to GoSL (2022, 2023). • World Bank technical note on tax policy and administration issues in Sri Lanka (2023). • IMF technical report on Revenue-Raising Tax Policy Reform Options (2022).
PA#2.	**Summary of Findings:** The TADAT assessment, covering CIT, PIT, VAT, Excise and Pay As You Earn (PAYE) (overall about 75 percent of tax revenues), found that tax administration in Sri Lanka was particularly weak and well below basic TADAT standards on several counts. • Sri Lanka Tax Administration Diagnostic Assessment Tool (TADAT, 2023). • World Bank technical note on tax policy and administration issues in Sri Lanka (2023). • IMF technical report on Revenue-Raising Tax Policy Reform Options (2022).
PA#3.	*Crisis Management Committee* – **Summary of Findings:** Following the global financial crisis, several countries have established commissions for financial stability in order to overcome the considerable inter-agency coordination challenges that manifest during economic, financial, debt, and banking crises. This involves laying the institutional basis for crisis management policy coordination among relevant actors and establishing information-sharing arrangements, as well as mechanisms for coordinated decision-making. • World Bank TA notes and presentations to GoSL (2022, 2023). *ELA Framework* – **Summary of Findings:** All central banks should be ready to act as lenders of last resort, by providing ELA to solvent banks facing temporary liquidity stress, and, thereby, preserving stability. • World Bank TA notes and presentations to GoSL (2022, 2023).
PA#4.	**Summary of Findings:** Sri Lanka's existing regulatory and institutional framework for deposit insurance and problem bank resolution is materially non-compliant with international good practice. The framework could be enhanced in many ways given the high financial sector stability risks. • World Bank technical assessment of Sri Lanka's regulatory and institutional framework for problem bank resolution and deposit insurance (2023).
	Pillar II: Enhancing Growth and Competitiveness[35]
PA#5.	**Summary of Findings:** SOEs are faced with fundamental governance weaknesses at a corporate and sector level; a lack of market discipline and contributing price and cost distortions; systematically poor financial management and performance, which has significant fiscal costs; and, in many sectors, the crowding out of private sector investment and service delivery in commercially viable markets. A successful reform program would have significant positive impacts on productivity, reducing fiscal risks, the quality of goods and services provided and, over the medium-term, sustainable job creation.

[35] Selectivity and sequencing issues are addressed in greater detail in the World Bank's internal policy note on *Priority Reforms for Boosting Sri Lanka's Growth* (2023).

	• GoSL and MoF publications: MoF annual report for 2021; PED presentation on SOE performance, June 2022; PED Performance Report for 2018, 2019 and 2020; CBSL Statistics Department. • Target SOEs Financial Statements and Annual Reports: CEB, CPC and SLA Financial Statements for 2021; Bank of Ceylon and People's Bank Annual Reports for 2021; Financial Statements (when available) of all SOEs prioritized for divestment by SRU (initial list of 102). • World Bank Data and reports: World Bank, Sri Lanka Macro fiscal Brief. April 2021; World Bank Report "Integrated State-Owned Enterprise Framework", Sri Lanka, 2020; World Bank Policy Note on Priority Reforms for Boosting Sri Lanka's Growth, 2023.
PA#6.	**Summary of Findings:** High tariffs reduce competition, productivity, and export orientation across countries and in Sri Lanka. The use of para-tariffs exacerbates the anti-export bias of trade policy. Ad hoc introduction of taxes and frequent revisions to rates have made the tax structure complex and unpredictable. Para-tariffs exacerbate the sheltering of the domestic market from import competition, and add to policy uncertainty, distorting long-term business plans of firms. Sri Lanka's experience suggests this is a key binding constraint to growth. • World Bank Note on Trade Competitiveness Outcomes & Challenges in Sri Lanka, 2022. • World Bank Note on Sri Lanka's Export Potential and on Sri Lanka's Export Competitiveness, 2022. • Fernandes et al, 2022. Sri Lanka's Import Bans. Working Paper.
Pillar III: Protecting the Poor and Vulnerable	
PA#7.	**Summary of Findings:** The poor targeting and inadequacy of existing CT programs, and the worsening poverty and urgent need for social assistance, point towards the need for a strengthened and more effective social protection system. • Sri Lanka Development Update, October 2022.

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

65. **The proposed DPO is an integral part of the new CPF's crisis response support.** The operation is consistent with the WBG Country Partnership Framework FY24-FY27 (Report No. 182326-LK), which is being discussed by the WBG Board of Executive Directors on June 28, 2023. The CPF will focus on urgently helping to restore economic stability and build a stronger foundation for green, resilient, and inclusive development and recovery, while protecting poor and vulnerable populations. The DPO's focus on economic governance, growth and competitiveness, and social protection is aligned with the CPF's goals. Specifically, the DPO supports progress on the CPF's first high-level outcome (HLO-1) – *improved economic resilience and access to jobs*, and PA#7 is at the heart of the second high-level outcome (HLO-2) on *protected and enhanced human and natural capital*. Activities under the DPO will contribute to fulfilling several CPF objectives, including those centered on improving fiscal and debt sustainability, increasing the resilience and efficiency of the financial sector, and strengthening the investment climate. Several successive crises have weakened service delivery in health and education, which are pre-requisites to a resilient economy. The DPO provides general budget support which allows government to allocate more resources to ensure that service delivery in healthcare and education is improved. These sectors are further supported by projects in the current portfolio and some planned new operations.[36]

66. **The proposed operation complements several other World Bank projects that are ongoing and under preparation to support implementation and maximize impact.** IPF operations and TA programs will accompany the implementation of the DPO across all the pillars. *PAs#1* and *#2* are supported by the *Sri Lanka Public Financial Management Strengthening Project* (P178432), and additional TA on tax administration reforms is envisaged. The *Sri Lanka Debt Management Performance Assessment* (P179443) and the *Debt Reform Plan TA* (P180519) will provide TA for the preparation of the draft law on debt management and establishment of the DMO. The financial sector actions in *PAs#3* and *#4* are supported

[36] Ongoing projects include the General Education Modernization Project, Primary Health Care System Strengthening Project, Accelerating Higher Education Expansion and Development Operation, the Sri Lanka COVID-19 Emergency Response and Health Systems Preparedness Project, and the Early Childhood Development Project. Pipeline projects include the Global Partnership for Education, Trust-funded grants for Education, Japan Social Development Fund grant to improve Sri Lanka's maternal and early childhood nutrition. The CPF (FY24-FY27) provides additional details.

by the *Sri Lanka Financial Sector Safety Net Project* (P180861, IPF under preparation) – which aims to strengthen the financial and institutional capacity of the Sri Lankan financial sector safety net – and *Sri Lanka Financial Sector Modernization Project* (P159303). TA is already being provided to the financial sector, trade, and investment reforms (*PAs#3, 4, 5* and *6*) through the *Sri Lanka Maldives Post COVID-19 Competitiveness Recovery* Trust Fund (P175642). Advisory support to the Ministry of Technology is being provided under the *Digital for Grid in Maldives, Nepal, and Sri Lanka* ASA (P177824). Finally, *PA#7* is supported by the new *Social Protection Project* (P178973), as discussed in paragraph 56.

67. **The operation is also closely aligned with and contributes to several World Bank corporate strategies**. These include the framework for WBG's operational response to address the multiple and compounding crises in development (GCRF). The DPO's proposed actions aim to enhance resilience of the economy and institutions, by combining short-term support to crisis response with long-term development. *PAs#1, 2, 6* and *7* contribute to Pillar 4 on *Strengthening Policies, Institutions and Investments for Rebuilding Better*, while *PAs#3, 4* and *5* contribute to Pillar 3 on *Strengthening Resilience*.

4.4. CONSULTATIONS AND COLLABORATION WITH DPs

68. **Consultations are ongoing and government plans to scale-up further in the next few months.** Government has been communicating key elements of the reform program, including the importance of: increasing taxes, maintaining financial sector stability, SOE and trade reforms, and protecting the poor and vulnerable. This has largely been undertaken by the President, through the various Budget speeches, and with the support of DPs. For example, the government is preparing a SOE reform communications strategy with TA from USAID. Government is also developing a communications plan to raise awareness and garner support among the general public for the reform efforts. In addition, at the sector-level, government-wide discussions will be held to ensure buy-in of reforms, and plan for their implementation. Consultations are also scheduled with key stakeholders to provide design and implementation details of specific reforms. The World Bank continues to engage with parliamentarians, think-tanks, civil society, the private sector, and academia. Some of these consultations have taken place together with those for the new CPF. There have also been consultations with relevant stakeholders in areas that have significant implications for the poor and vulnerable, on financial sector risks, and on private sector development.

69. **In order to support Sri Lanka's urgent reform agenda and improve the sustainability of the reforms, DPs are working together to identify priorities and opportunities for coordination.** An *MDB+ Coordination Platform*, which includes participation from ADB, AIIB, IMF, JICA, USAID and the Bank, has been set up to coordinate on the complementarity and sequencing of macro- and growth-critical TA (as described in paragraph 27), policy advisory support, and budget support. The Bank worked closely with the IMF during the preparation of the EFF and this DPO and, as a result, the reforms supported by this operation are carefully sequenced and calibrated with the EFF reforms. The Bank also hosts monthly briefings with DPs to present analysis, share experiences with TA, discuss priority reforms, and understand the ongoing and potential role of the wider DP community.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

70. **The overall impact on poverty is expected to be neutral to positive.** PAs under Pillar I are expected to have neutral or negative effects immediately, but can translate into positive effects in the medium-term by strengthening institutions, enhancing transparency, and creating more fiscal space, including for poverty-reduction. Pillar II PAs are expected to have a neutral impact, but are foundational

to a more sustainable growth model with private sector-led job creation. Reforms under Pillar III are expected to have a positive impact immediately, but need to be carefully calibrated to sustain the impacts.

71. **Revenue-mobilizing efforts, such as removal of exemptions in sector-specific concessionary CIT, are expected to have neutral poverty impacts, whereas increases in fuel excises will have adverse poverty impacts in the immediate term (*PA#1*).** The removal of sector-specific concessions in corporate taxes is unlikely to affect small and medium sized enterprises, which tend to be informal and unincorporated.[37] On the other hand, increases in fuel excises will adversely impact costs of living, including for the poor. Analysis prepared by the World Bank has documented the poverty impacts of increased inflation and costs of living between 2019 and 2021, including the increases in fuel prices. In the medium-term, revenue generation from this reform can and should be effectively redirected to strengthen household resilience and improve welfare outcomes.

72. **Revenue-mobilizing amendments to the Inland Revenue Act (*PA #2*) are expected to have a neutral to positive impact on poverty.** Electronic filing and payments can on average reduce tax-filing time by 25 percent in the five years after a digital system was introduced, increase taxable sales and VAT liabilities, and significantly reduce invoicing costs for small and medium enterprises.[38] Depending on the e-filing regulations, resources may be needed to compensate the costs of adopting new digital technologies by socio-economically disadvantaged households. Beyond generating revenues that can be invested to mitigate the impact of the crisis on the poor, timely electronic tax data can be used to inform fiscal reforms and improve targeting of social protection measures.[39] While sharing tax data between tax authorities and other policy actors can raise confidentiality concerns, methods are available to ensure the anonymization of taxpayers' information. **Institution-strengthening and transparency-enhancing measures** such as the establishment of the CMC and the Banking Act **(*PA#3, PA#4*) are expected to have welfare improving impacts in the medium to longer-term.**

73. **The divestment of SOEs (*PA#5*) is expected to have a neutral impact on poverty, as a LFA program, led by government, is envisaged under the accompanying draft policy.** Although the impact of the reform will depend on the profile of the employees of affected enterprises, those working in the sector are relatively well-off, better educated, and less likely to be disadvantaged. Reform-induced layoffs could, however, cause income losses if employees move to lower-paying jobs in the private sector and contribute to rising unemployment in the industry and services sector.[40] For those remaining employed, the reduction in wages from restructuring would further aggravate the estimated 22 percent wage erosion among semi-public employees between 2019 and 2022. These negative impacts could be mitigated by the LFA program. If adopted, this program would help mitigate the impact among more vulnerable groups, including those older than 55 and in the bottom 40 percent of the national consumption distribution.

74. **The phasing out of para-tariffs under (*PA#6*) is expected to have a neutral impact on poverty.** A simpler import duty structure is expected to lower trade costs and enhance competitiveness. Maintaining

[37] The 2013/14 Economic Census enumerated 1,019,681 establishments in Sri Lanka, including formal and informal establishments. Of these, 94 percent engaged 5 or fewer workers, and only 0.8 percent of establishments had more than 10 workers. Sri Lanka had 5,616 formal industrial establishments (i.e, enterprises with a documented account and engaging either more than 10 persons or being incorporated), of which 91 percent were manufacturing establishments. In contrast, there were 963,669 informal establishments enumerated in the Economic Census.
[38] For literature on the impact of e-filing on fiscal policy see: Bellona et al., 2022; Ndung'u, 2019; World Development Report 2016: Digital Dividends; Yilmaz and Coolidge, 2013; Okunogbe and Santoro, 2022.
[39] For example, firm-level tax data was used to help target a cash-transfer program as part of the COVID-19 response in South Africa (Poverty and Shared Prosperity Report, World Bank 2022).
[40] Arnold, David. 2022. "The Impact of Privatization of State-Owned Enterprises on Workers." American Economic Journal: Applied Economics, 14(4):343-80.

the same import duty slabs ranking (low/high categories), passed through to households' and producers' costs, is also expected to have a neutral impact on the distribution of welfare.

75. **The new WBPS (*PA#7)* is expected to have a poverty-reducing impact, given higher transfers to more deserving low-income families**. This ex-ante assessment compares the distribution of household expenditure under the proposed scheme for the first year (assuming roll out after July) and the second and third years (with the ultra-poor and poor categories covered for the duration of the two years) against the status-quo distribution.[41] The poverty impact, calculated as the difference between the poverty rates, is between 0.8 and 1.2 percentage points in the first year.[42] The impact in the second and third years is muted by projected increases in inflation between 2023 and 2024, and by the removal of benefits of the transitory poor category (after 6 months of program implementation) and the vulnerable category (after 9 months). In effect, these changes imply lower program coverage of the bottom 10 percent of the welfare distribution and reduced benefit adequacy in years two and three.

76. **Key risks exist that could lower the poverty impact of the new welfare benefit scheme (*PA#7)*.** The final design of the scheme could tradeoff benefit generosity towards the least well-off against expanded coverage. Higher than projected inflation would reduce the real value of benefits further. Moreover, the planned number of beneficiaries of some categorical allowances may underestimate the number of eligible beneficiaries under the proposed scheme. The scheme defines district quotas based on the 2019 distribution, which risks under-budgeting districts where new poor have been added, for example, in urban areas.[43] Lastly, the removal of short-term support to the transitory and vulnerable category in year two and three will need to be compensated by improved targeting and benefit adequacy to the poorest 10 percent to maintain the poverty impacts of the program. A sustained and positive poverty impact is thus dependent on the final design of the scheme, a well-functioning grievance redressal process, and regular recertification and assessments of eligibility.[44]

5.2. CLIMATE, ENVIRONMENTAL, FORESTS, AND OTHER NATURAL RESOURCE ASPECTS

77. **Sri Lanka's high temperatures, unique and complex hydrological regime, and exposure to extreme climate events make it highly vulnerable to climate change**.[45] The most frequent climate hazards are floods, droughts, landslides, storm surges and cyclones. They pose a significant threat to economic and social development, and impact the poorest and most marginalized communities the hardest. Without adaptative action, the projected increase in the frequency and intensity of extreme events may put lives, livelihoods, and infrastructure at risk.[46] The uncertain economic situation, which can be exacerbated by a climate or geophysical hazard, poses further risks. The limited fiscal space to facilitate post-disaster relief services and disaster risk reduction is also a constraint to increasing resilience. The

[41] The new draft WBPS covers 4 categories identified based on a multi-deprivation score, and would cover 400,000 "ultra-poor", 800,000 "poor", 400,000 "vulnerable" and 400,000 "transitory-poor" households. Within this set of eligible households, additional top-ups are envisaged for categorically identified vulnerable groups.

[42] Depending on whether the assessment is done on the 2019 expenditure distribution, which assumes a pre-crisis welfare distribution, or on the 2023 simulated expenditure distribution. 2019 expenditure distribution implies a lower pre-crisis poverty rate of 11.3 percent at US$3.65 per person per day in 2017 purchasing power parity, while the simulated 2023 expenditure distribution considers the crisis impact and implies a higher poverty rate of 27.4 percent at the same line.

[43] Urban poverty is expected to have tripled in 2022 (Sri Lanka Development Update 2022).

[44] The latter are critical to limit the tendency to get locked into an entitlement and ensure there are mechanisms for new registrants who qualify to enter the program.

[45] World Bank Climate Risk Country Profile: Sri Lanka, 2021.

[46] The total recorded direct economic damage due to recurring disasters during the 1990-2018 period is estimated to be almost US$7 billion. United Nations Office for Disaster Risk Reduction, 2019. Disaster Risk Reduction in Sri Lanka, Status Report.

overall climate risk to the outcome of the project is Moderate. The DPO has been subject to the Bank's climate and disaster risk screening.

78. **This DPO supports actions that address climate change adaptation and mitigation.** *PA#1* will contribute to progress with a low-carbon pathway by promoting the use of public transport and development and implementation of renewable energy and energy efficiency programs that reduce GHG emissions. It will also support the implementation of Sri Lanka's *Nationally Defined Contributions* (NDCs) in the energy and transport sectors, including NDC 6 on introducing taxes and other instruments to promote public transport, and NDC 13.2 on introducing a fuel-based carbon tax. *PAs#1, 2, 3, 4 and 5* will help enhance fiscal resilience and sustainability, manage contingent liabilities arising from disasters better, and support climate resilience through the implementation of the NDCs and CPP. *PA#7* will allow safety net programs to scale up as necessary due to climate shocks, delivering rapid and well-targeted assistance to affected households in need. Finally, building on the findings of the recent *Fiscal Disaster Risk Assessment and Risk Financing Options* (2016) and *Contingent Liabilities from Natural Disasters* (2020) reports, the operation supports the country's capacity to prepare for and manage shocks related to natural disasters.

79. **Policy actions under this operation are not expected to have significant direct negative impact on Sri Lanka's environment, forests, and natural resources.** Reforms under the DPO could lead to potentially positive environmental outcomes as a result of better fiscal discipline, economic stability, and support to the poor. While the expansion of the broadband network may involve civil works with associated negative environmental impacts, these are not considered serious and irreversible. In the long run, increased broadband access can lead to reduced carbon emissions and promote efficient use of resources. SOE reform is expected to lead to greater efficiency, accountability, and compliance with environmental and social policies. The proposed new investment law could be a gateway to promoting environmentally sound technologies. The country has a well-established environmental legal and institutional structure, including a strong Environmental Impact Assessment framework and import control regulations and surveillance systems, to protect and manage environmental risks. The World Bank is currently supporting government to improve its environmental and social risk management capacity.

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

80. **The PFM framework and the formal mechanisms and rules for financial accountability are generally sound.** Strengths include: (i) a budget preparation process that ensures adequate time for preparation, approval, and publication; (ii) a relatively robust accounting system, and (ii) timely annual audited financial statements. Government's budget is publicly available, both in print and on an external website. The audit mandate is wide, covering financial, compliance and performance aspects. Despite the above strengths, the PFM framework has several areas that require improvement. GoSL is committed to addressing the PFM framework, which requires improvement, including through the 21st amendment to the constitution, preparation of a new PFM law, and strengthening of Public Investment Management. Some of these initiatives are being supported by DPs such as JICA, IMF, the United Nations Development Programme, and the World Bank through a Multi-Donor Trust Fund.

81. **An IMF Safeguards Assessment in 2023 showed that CBSL had a relatively strong safeguards framework, especially in the external audit and financial reporting areas.** CBSL's internal control environment is anchored in a strong compliance culture, however some functions require continued modernization, including through an expanded scope for financial risk management. Therefore, no

additional fiduciary arrangements, such as dedicated foreign or local currency bank accounts subject to audits, need to be put in place.

82. **Disbursement and audit arrangements.** GoSL has requested a DPO as the lending instrument. GoSL and the World Bank have agreed that the US$500 million will be disbursed in two tranches. The first tranche of US$250 million will be available for disbursement following successful completion of the PAs and upon effectiveness of the operation after Board approval. The second tranche of US$250 million will be available upon fulfillment of the second tranche release conditions, as detailed in paragraph 1. Following submission of an authorized signatory letter and a request for withdrawal, the Bank may disburse the DPO proceeds into an US$ account that forms part of GoSL's official foreign exchange reserves held by CBSL. GoSL, through MoF, may then use the proceeds to: (i) make foreign currency payments; (ii) transfer amounts to a local currency bank account of GoSL, which is then used for budget expenditures; or (iii) undertake a combination of these approaches. GoSL will confirm, within 30 days, receipt of proceeds of each tranche and their credit in the treasury account and availability to finance budget expenditures as stated in the Financing Agreement (FA). Once the funds enter GoSL's foreign exchange reserves and the budget, they will be commingled with other GoSL funds. Thereafter, the Bank will not require the use of these funds to be tracked. However, GoSL will not use the loan proceeds to pay for expenditures in the Bank's standard negative list. If any portion of the credit is used to finance expenditures in the negative list as defined in the FA, the Bank shall require GoSL to refund the amount.

5.4. MONITORING, EVALUATION AND ACCOUNTABILITY

83. **The Presidential Secretariat, MoF, and CBSL are responsible for overall oversight and implementation of the operation**. The Presidential Secretariat chairs inter-ministerial and agency meetings to oversee the progress of key reforms regularly and make swift decisions to resolve bottlenecks that require high level interventions. The Presidential Secretariat is supported by a technical team responsible for following up on reform implementation. Through these meetings and follow up, ministries and agencies will be held accountable for the progress of individual reform measures and will also be able to escalate bottlenecks that require political or inter-ministerial decisions. The World Bank will monitor the status of implementation through quarterly implementation support missions and tracking of results indicators. This will be augmented by regular engagement of World Bank staff implementing TA and investment operations in support of the reforms in this DPO. Throughout the program period, MoF will be responsible for providing information to the World Bank to assess the adequacy of the macroeconomic framework and implementation of the policy reform framework.

84. **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 Financing may submit complaints to the responsible country authorities, appropriate local/national grievance mechanisms, or the Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Project affected communities and individuals may submit their complaint to the Bank's independent Accountability Mechanism (AM). The AM houses the Inspection Panel, which determines whether harm occurred, or could occur, as a result of Bank non-compliance with its policies and procedures, and the Dispute Resolution Service, which provides communities and borrowers with the opportunity to address complaints through dispute resolution. 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 GRS,

please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the Bank's AM, please visit https://accountability.worldbank.org.

6. SUMMARY OF RISKS AND MITIGATION

85. **This engagement faces significant risks**. There are considerable uncertainties surrounding the debt restructuring, an economic adjustment process is underway that is likely to put a heavy burden on the population, and the political environment remains challenging. As a result, the overall residual risk rating of this operation is high. Several sources of risk could potentially impact the expected outcomes and benefits of this operation. These and associated mitigation measures are outlined below.

86. **Political and governance risks are High**. The political environment remains fluid and further unrest could adversely impact reform implementation. Local government elections were postponed in February 2023, which added to the political uncertainty. National elections in 2024 could potentially slow the reform progress. The political leadership is, however, committed to making difficult and necessary reforms, including those in this DPO. This is evidenced by the policy actions already undertaken and announcements made since mid-2022. The reforms are supported by a broad consensus among a core group of Parliamentarians, senior public sector employees, civil society, and the general public that difficult reforms are needed to restore a sustainable growth path. Government is working on a more comprehensive consultation mechanism (to be rolled out progressively from May 2023) to encourage the inputs of all stakeholders into the reform program. In parallel, government is preparing a reform communication strategy to drive a much stronger outreach around the reforms and address stakeholder risks. Given the political uncertainty, however, the World Bank is limiting its current engagement to two operations in this series – allowing an assessment of reform progress before committing to further DPOs – and, where possible, focusing on last-mile implementation of reforms.

87. **Macroeconomic risks are High**. The economic path to recovery is narrow and a worsening of the crisis is possible. The absence of fiscal and external buffers makes Sri Lanka highly vulnerable to further global or domestic shocks. External debt restructuring could be protracted. Domestic debt restructuring could have negative implications for domestic financial sector stability. There is, however, promising progress and prospects that these risks can be mitigated. Preparation of the IMF EFF was concluded and approved relatively quickly. The EFF was also endorsed by Parliament on April 28, 2023, which shows broad legislature support for the reform program. All major bilateral creditors provided financing assurances and there seems to be international support to conclude the restructuring process as soon as possible. The authorities have also signaled their commitment to transparency and equity, as well as their intention to implement critical reforms anchored in the IMF EFF and this DPO series. Upside potential could materialize from faster than expected growth, driven by a more rapid recovery in remittances and tourism. Accelerated progress in ongoing structural reforms to promote competition, economic diversification and private sector participation will also help mitigate these risks.

88. **There are several additional areas that present Substantial risks, including *sector strategies and policies*, *technical design of projects, institutional capacity*, and *stakeholder risks***. The government is yet to develop and release a consolidated multi-year program of reforms, and sector strategies and policies have previously been prone to ad hoc changes. The reforms supported by this DPO are complex, institutional capacity gaps exist, government's implementation record is poor, and inter-ministerial coordination is weak. Some reforms may face resistance from interest groups, including the SOE reforms, enhancing the outward orientation and openness of the economy, and overhauling the current social protection system. To address these risks, government-wide discussions will be held to ensure buy-in for

the reforms and a plan for their implementation. Consultations are also scheduled with key stakeholders to provide design and implementation feedback for specific reforms. The SOE reform is subject to additional risks arising from the establishment of a HoCo, set up under a general AoA, that may not be fit for purpose. This risk will be mitigated through a carefully designed SOE law. The World Bank will continue to work closely with other DPs and sustain the dialogue (e.g., through the MDB+ Platform) to support and help sequence the reform agenda and, ultimately, prevent any reform reversal – this includes significant TA and institutional capacity building. The Bank will also review the outcomes of periodic phone surveys that aim to capture citizen awareness and perception of the fairness of key reforms.[47] These surveys will further inform additional communication and outreach efforts on the part of government. Finally, a better targeted, stronger and more shock responsive WBPS will ensure the poorest and most vulnerable are supported during the reform and adjustment period.

Table 10: Summary Risk Ratings

Risk Categories	Rating
1. Political and Governance	● High
2. Macroeconomic	● High
3. Sector Strategies and Policies	● Substantial
4. Technical Design of Project or Program	● Substantial
5. Institutional Capacity for Implementation and Sustainability	● Substantial
6. Fiduciary	● Moderate
7. Environment and Social	● Moderate
8. Stakeholders	● Substantial
9. Other	
Overall	● High

[47] This household-level data on perceptions will be collected every six months by phone, either as part of the World Bank Welfare Monitoring Survey or ongoing UN survey instruments.

ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions and Triggers			Results		
Objective	**Prior Actions under DPO 1**	**Triggers for DPO 2**	**Indicator Name**	**Baseline**	**Target**
Pillar 1: Improving Economic Governance					
Improve fiscal and debt management	**Prior Action #1.** To strengthen domestic revenue mobilization, the Recipient has: (i) removed sector specific concessionary corporate income tax rates, as evidenced by publication in the Recipient's official gazette of the Inland Revenue (Amendment) Act, No. 45 of 2022 as certified by the Speaker of Parliament; and (ii) increased the fuel excise duty, as evidenced by (a) publication in the Recipient's official gazette on December 31, 2022, of the order (the "Order") issued by the Minister of Finance under the Excise (Special Provisions) Act, No. 13 of 1989, and (b) letter dated May 23, 2023, issued by the Secretary General to the Parliament to the Minister of Finance confirming approval by Parliament of such Order.	**Trigger 1.** To improve debt management, Sri Lanka, has enacted a new Public Debt Management Law, established a single Debt Management Office (DMO), and issued rules and regulations for the granting of sovereign guarantees and on-lending.	**Results Indicator #1.** Publication of consolidated annual debt report with comprehensive debt information on Central Government, guaranteed SOE, non-guaranteed non-financial SOEs, and CBSL debt with a time-lag smaller than 3 months from the end of the year and fiscal risk statements covering at least SOE's guaranteed and non-guaranteed debt	No (2022)	Yes (2025)
Improve tax administration	**Prior Action #2.** To strengthen governance of tax administration and its enforcement capability, the Recipient has enacted amendments to the Inland Revenue Act requiring: (i) financial institutions, government procurement departments, stock exchange, registrar of companies, motor vehicle authority, and land registrar to submit taxpayer transaction information at the individual level to the IRD in a systematic and time-bound manner; and (ii) non-corporate taxpayers to file their income tax returns through an electronic system (e-filing of income tax returns), as evidenced by publication in the Recipient's official gazette of the Inland Revenue	**Trigger 2.** To enhance the quality of tax audits and tax transparency, (i) the IRD has issued notified tax forms for reporting information and receives data from third parties into their RAMIS risk system and has published the first annual report on compliance of tax audits using their centralized risk-based systems; and (ii) Sri Lanka, through MoF, has issued a statement of tax expenditures that estimates revenue foregone on tax exemptions and tax reductions for all the major taxes.	**Results Indicator #2.** (a) Total revenue-to-GDP (percent)[48] (b) Use of electronic filing facilities for non-corporate tax declarations (percent)[49] (c) Increase in revenue from income tax audits using third-party	(a) 8.3 (2022) (b) 23 (2021) (c) 0 (2022)	(a) 13.3 (2025) (b) At least 70 (2025) (c) 130 (2025)

[48] The World Bank's macroeconomic framework shows an increase in the total revenue-to-GDP ratio by 5 percentage points, from 8.3 percent in 2021 to 13.3 percent by 2025, as a result of the full package of tax reforms implemented. Of this increase, tax administration reforms are expected to raise about 0.5 to 1 percent of GDP. This would be in addition to the removal of the CIT exemption and fuel excise that each contribute an additional 0.3 percent of GDP. As a result, the contribution from the DPO-supported reforms (in PAs#1 and 2, and trigger 2) is expected to be 1.6 (2025) percentage points of the total change in the revenue-to-GDP ratio.
[49] In 2021, the weighted average of non-corporate taxpayers filing electronic returns was 23 percent, leading to a score of "D" in the indicator for POA 4-14 in the TADAT Assessment made by the Joint IMF-World Bank-ADB team in January 2023. To move to a score of "B" for electronic filing of returns, at least 70 percent of declarations are to be filed electronically by non-corporate taxpayers by 2025.

	(Amendment) Act, No. 4 of 2023 as certified by the Speaker of Parliament.		information data (LKR million)[50]		
Safeguard financial sector stability and restore the flow of credit to the private sector	**Prior Action #3.** To reduce systemic risks in the financial sector: (i) the CBSL's Monetary Board has approved an ELA framework that articulates the CBSL's policies and operational and procedural modalities for ELA provision to liquidity-distressed but solvent banks, as evidenced by a certified extract of the minutes of the meeting of the Monetary Board approving and attaching the ELA framework; and (ii) Cabinet has approved the establishment of a financial sector crisis management committee that sets out crisis management responsibilities and provides an institutional basis for CBSL–MoF policy coordination, as evidenced by minutes of the meeting of the Cabinet approving the establishment of the financial sector crisis management committee.	**Trigger 3.** To reduce systemic risks, strengthen financial sector stability, and enhance the enabling environment for corporate NPL resolution, (i) the CBSL's Monetary Board has approved a revised regulation that stipulates prudential limits for the maximum exposures that banks can have vis-à-vis single borrowers and to a group of connected borrowers, including SOEs, and (ii) the CBSL has issued an amendment to Circular No.1 of 2022, providing for the revival of viable businesses through a standardized workout process in accordance with international best practices.	**Results Indicator #3.** Exposures to SOEs of total assets of:[51] (a) the entire banking sector (percent), and (b) the two largest SOBs (percent)	(a) 8.8 (Q2 2022) (b) 22 (Q2 2022)	(a) 5 (2025) (b) 10 (2025)
	Prior Action #4. To maintain stability and confidence in the banking system, the Minister of Finance has submitted to Parliament the Banking (Special Provisions) bill aimed at strengthening the deposit insurance and problem bank resolution framework, as evidenced by (a) minutes of the meeting of the Cabinet held on May 2, 2023 (Cabinet paper No 23/0832/604/086) approving the submission to Parliament of the Banking (Special Provisions) bill, and (b) "order paper" of Parliament for May 23, 2023, evidencing submission of the respective bill to Parliament. **DPO1 Second Tranche Release Condition:** Sri Lanka has enacted the Banking (Special Provisions) Act aimed at strengthening the deposit insurance and problem bank resolution framework.	**Trigger 4.** To enhance banking sector stability and performance, the CBSL and MoF have endorsed, and SOB's Boards of Directors have adopted, time-bound restructuring plans based on comprehensive diagnostic audits conducted by a reputable third-party entity.			
Pillar 2: Enhancing Growth and Competitiveness					
Restructure and divest SOEs	**Prior Action #5.** To improve the commercial performance, financial transparency, and private-sector participation in the SOE sector, the Recipient has: (i) approved the SOE Reform Policy Paper, as evidenced by the minutes of the meeting of the Cabinet held on May 15, 2023 (Cabinet paper No. 23/0858/604/090) approving and attaching the respective policy paper; and (ii) re-assigned the operational control of	**Trigger 5.** To establish the objectives of the SOE reform program, institutional and governance arrangements – including the guiding principles of the HoCo, transparent divestment procedures, and use of divestment proceeds – and expand the coverage of the program: (i) the Cabinet has issued	**Results Indicator #4.** SOEs for which divestment to private ownership is 51 percent and above (number)[52]	0 (2023)	15 (2025)

[50] The Annual Performance Report of the IRD publishes detailed information on the audits, including the total amount of additional tax assessed during a given year. A ten percent increase in the revenue from income tax audits (that specifically use third-party information data) over three years, starting from a base of LKR 1,300 million (IRD, 2021), would result in an additional LKR 130 million in revenue.
[51] This has been informed by the World Bank's ongoing technical work on overhauling the regulation of the single borrower exposure limit. This work is underpinned by a bank-level data analysis aimed to ensure that banks will be able to meet the new, tighter requirements that are currently being designed. Banks' total exposure to SOEs is one of the key areas that the new regulation seeks to contain.
[52] This target is based on a preliminary review of the SOEs to be transferred to the HoCo and is informed by discussions with the SOEs Restructuring Unit.

	selected SOEs to the Ministry of Finance, as evidenced by the publication in the official gazette of the respective transfer decision made by HE the President under Article 44 of the Sri Lankan Constitution.	regulations to implement a new SOE Reform Act; (ii) the Ministry of Finance has revised the Articles of Association for the HoCo to be consistent with the new SOE law; and (iii) the President has gazetted the operational control of a further set of SOEs to the Ministry of Finance.			
Reduce trade and investment policy uncertainty and increase the economy's competitivenes s	**Prior Action #6.** To simplify the tariff structure, the Recipient has adopted: (i) order issued by the Minister of Investment Promotion under the Sri Lanka Export Development Act No. 40 of 1979 implementing the phasing out over a period of 3 years of the Export Development Board Cess by reducing the Cess by 33 percent from April 1, 2023, as evidenced by (a) the publication in the Recipient's official gazette of the relevant order, and (b) letter dated May 9, 2023, issued by the Secretary General to the Parliament to the Ministry of Finance confirming approval by Parliament of the order issued by the Minister of Investment Promotion, and; (ii) order issued by the Minister of Finance under Section 03 of the Ports and Airport Development Levy Act No. 18 of 2011 to phase out PAL over a period of five (5) years commencing from 2023 and exempt PAL applicable on 20 percent of tariff items as phase I from April 4, 2023, as evidenced by (a) the publication in the Recipient's official gazette of the relevant order, and (b) letter dated May 9, 2023, issued by the Secretary General to the Parliament to the Ministry of Finance confirming approval by Parliament of the order issued by the Minister of Finance.	**Trigger 6.** To address the regulatory and policy obstacles to increase private investment and encourage export orientation, Sri Lanka has: (i) through the Board of Investment (BOI), issued the implementation regulations for a new unified Investment Law, and (ii) through the MoF, issued a National Tariff Policy that commits to a predictable path of reduction of import duty protection over a four-year period.	**Results Indicator #5.** Trade (imports and exports) as a share of GDP (percent)[53]	41 (2021)	46 (2025)
Mobilize private capital and competition in the broadband market	N/A	**Trigger 7.** To expand access to affordable broadband services, Sri Lanka has, (i) through the Ministry of Technology (MoT), issued an open access and infrastructure sharing policy for broadband networks; and following [orders] issued by the MoT, (ii) through the Telecommunications Regulatory Commission of Sri Lanka (TRCSL), established implementing regulations and procedures, through an open and consultative process, to support competitive markets through (a) sharing of telecom-ready infrastructure; and (b) competitive assignment of radio spectrum for	**Results Indicator #6.** Private investment in broadband networks facilitated (US$ million)[54]	0 (2022)	100 (2025)

[53] This PA entails reducing uncertainty around the import duty structure through the phasing out the para-tariffs. The trigger entails adding predictability through the implementation of a National Tariff Policy. Both actions will lead to the reduction of trade costs, an increase in the export orientation of the country, and an increase in trade as a share of GDP.

[54] The World Bank has estimated that US$1.3 billion in investment would be needed to ensure universal access to basic broadband. The target of US$100 million reflects the timing and the risks of the investments that will follow a rising curve over time, but outside of the window that tracks the DPO results.

		wireless broadband services.			
Pillar 3: Protecting the Poor and Vulnerable					
Strengthen social protection institutions, delivery systems, and targeting	**Prior Action #7.** To enhance social protection, the Recipient has: (i) adopted the FY23 Budget for a new welfare benefit payment scheme targeted at low-income and vulnerable households in the amount of LKR 187 billion, as evidenced by (a) Appropriations Act, No. 43 of 2022, (b) minutes of the meeting of the Cabinet held on 2023.01.16 (Cabinet paper No. 23/0101/604/008), and (c) letter dated May 9, 2023 (reference BD/CBP/02/01/02/2023) from the Director General National Budget to the Secretary to the President confirming allocated budgetary provisions; and (ii) issued a gazette notification by the Minister of Finance under Article 9 of the Welfare Benefit Act No. 24 of 2002 for a new welfare benefit payment scheme, as evidenced by (a) the publication in the Recipient's official gazette of the notification issued by the Minister of Finance, and (b) letter dated May 12, 2023, issued by the Secretary General to the Parliament to the Ministry of Finance confirming approval by Parliament of the notification issued by the Minister of Finance.	**Trigger 8.** To ensure increased impact and sustainability of the social protection system, Sri Lanka has, through its Cabinet of Ministers, (i) mandated that poverty-targeted programs use the social registry developed for the new welfare benefit payment scheme; (ii) approved and adopted regulations for recertification of welfare program beneficiaries.	**Results Indicator #7.**[55] (a) Beneficiaries of the new WBPS (number of households per year) (b) Coverage of the poorest 20 percent by cash transfer programs (percent) (c) Coverage of female headed household by the new WBPS (percent)	(a) 0 (2022) (b) 43 (2022) (c) 0 (2022)	(a) 2 million (2023-2025) (b) 60 (2025) (c) 20 (2025)
Level the playing field and reduce barriers for female labour force participation	N/A	**Trigger 9.** To reduce gender discrimination in the labor market; (i) legal restrictions against women working flexible hours and at night are removed through the amendment of the Shop and Office Employees Act No. 19 of 1954 in line with the non-discriminatory principles outlined in the Gender Equality Bill; and (ii) implementing regulations for labor compliance audits are revised to include checks on new legislation.	**Results Indicator #8.** Publication of revised inspection checklist for labor compliance audits	No (2022)	Yes (2025)

[55] These indicators are derived from the design of the new WBPS and estimates of the number of poor and vulnerable across various categories. Although readjustments in the number of beneficiaries across different categories are expected to take place every year, based on poverty and vulnerability of families, the overall coverage is expected to remain around 2 million for the 2023-2025 period.

ANNEX 2: FUND RELATIONS ANNEX

IMF Executive Board Approves US$3 Billion Under the New EFF Arrangement for Sri Lanka

March 20, 2023

- The IMF Board approved a 48-month extended arrangement under the EFF of Special Drawing Rights (SDR) 2.286 billion (about US$3 billion) to support Sri Lanka's economic policies and reforms.
- The objectives of the EFF-supported program are to restore macroeconomic stability and debt sustainability, safeguarding financial stability, and stepping up structural reforms to unlock Sri Lanka's growth potential. All program measures are mindful of the need to protect the most vulnerable and improving governance.
- Close collaboration between Sri Lanka and all its creditors will be critical to expedite a debt treatment that will restore debt sustainability consistent with program parameters.

Washington, DC: The Executive Board of the IMF approved today a 48month extended arrangement under the EFF with an amount of SDR 2.286 billion (395 percent of quota or about US$3 billion).

Sri Lanka has been hit hard by a catastrophic economic and humanitarian crisis. The economy is facing significant challenges stemming from pre-existing vulnerabilities and policy missteps in the lead up to the crisis, further aggravated by a series of external shocks.

The EFF-supported program aims to restore Sri Lanka's macroeconomic stability and debt sustainability, mitigate the economic impact on the poor and vulnerable, safeguard financial sector stability, and strengthen governance and growth potential. The Executive Board's decision will enable an immediate disbursement equivalent to SDR 254 million (about US$333 million) and catalyze financial support from other development partners.

Following the Executive Board discussion on Sri Lanka, Ms. Kristalina Georgieva, Managing Director, issued the following statement:

"Sri Lanka has been facing tremendous economic and social challenges with a severe recession amid high inflation, depleted reserves, an unsustainable public debt, and heightened financial sector vulnerabilities. Institutions and governance frameworks require deep reforms. For Sri Lanka to overcome the crisis, swift and timely implementation of the EFF-supported program with strong ownership for the reforms is critical.

"Ambitious revenue-based fiscal consolidation is necessary for restoring fiscal and debt sustainability while protecting the poor and vulnerable. In this regard, the momentum of ongoing progressive tax reforms should be maintained, and social safety nets should be strengthened and better targeted to the poor. For the fiscal adjustments to be successful, sustained fiscal institutional reforms on tax administration, public financial and expenditure management, and energy pricing are critical.

"Having obtained specific and credible financing assurances from major official bilateral creditors, it is now important for the authorities and creditors to make swift progress towards restoring debt sustainability consistent with the IMF-supported program. The authorities' commitments to transparently achieve a debt resolution, consistent with the program parameters and equitable burden sharing among creditors in a timely fashion, are welcome.

"Sri Lanka should stay committed to the multi-pronged disinflation strategy to safeguard the credibility of its inflation targeting regime. As the market regains confidence, the authorities' recent introduction of greater exchange rate flexibility will help to rebuild the reserve buffer.

"Maintaining a sound and adequately capitalized banking system is important. Implementing a bank recapitalization plan and strengthening financial supervision and crisis management framework are crucial to ensure financial sector stability.

"The ongoing efforts to tackle corruption should continue, including revamping anti-corruption legislation. A more comprehensive anti-corruption reform agenda should be guided by the ongoing IMF governance diagnostic mission that conducts an assessment of Sri Lanka's anti-corruption and governance framework. The authorities should step up growth-enhancing structural reforms with technical assistance support from development partners."

IMF Communications Department

MEDIA RELATIONS

PRESS OFFICER: TING YAN

PHONE: +1 202 623-7100**EMAIL:** MEDIA@IMF.ORG

@IMFSpokesperson

ANNEX 3: LETTER OF DEVELOPMENT POLICY

මුදල්, ආර්ථික ස්ථායීකරණ සහ ජාතික ප්‍රතිපත්ති අමාත්‍යාංශය
நிதி, பொருளாதார உறுதிப்பாடு மற்றும் தேசியக் கொள்கைகள் அமைச்சு
MINISTRY OF FINANCE, ECONOMIC STABILIZATION AND NATIONAL POLICIES

මහලේකම් කාර්යාලය, කොළඹ 01, ශ්‍රී ලංකාව	செயலகம், கொழும்பு 01, இலங்கை.	The Secretariat, Colombo 01, Sri Lanka.
කාර්යාලය / அலுவலகம் / Office: 011-2484500, 011-2484600, 011-2484700	ෆැක්ස් / தொலைநகல் / Fax: 011-2449823	වෙබ් අඩවිය / இணையத்தளம் / Website: www.treasury.gov.lk
මගේ අංකය / எனது இல / My No: ERD/WB/DPO	ඔබේ අංකය / உமது இல / Your No:	දිනය / திகதி / Date: May 31, 2023

Mr. David R. Malpass
President
The World Bank Group
Washington, D.C. 20433

Dear Mr. Malpass,

Letter of Development Policy (LDP) – Sri Lanka Resilience, Stability and Economic Turnaround (RESET) Development Policy Operation (DPO)

Sri Lanka is facing an existential economic crisis due to several economic and global shocks, and ill-timed policy choices due to serious governance lapses. The public debt levels have risen to unsustainable levels and our liquidity situation is precarious. With virtually depleted foreign exchange reserves, the population is suffering from acute shortages of food, pharmaceuticals, and inputs for economic activity. We have taken measures to stabilize the situation and abandon price caps for electricity and fuel, moved from a pegged exchange rate to a managed float, increased interest rates by 1050 basis points since January 2022, and reversed tax cuts which had resulted in a high fiscal deficit. These measures and the global price shocks led to a sharp depreciation of the rupee in March/April 2022 and rising prices for food and fuel, with inflation peaking at 70 percent in September 2022. With growth and revenues weakening, the government has faced acute cash flow problems. Poverty is rising sharply and the effects of the crisis on the poor and most vulnerable are dire.

We thank the World Bank for the continued, strong support to Sri Lanka during the current crisis. At the onset of the crisis, the World Bank moved quickly to protect the people of Sri Lanka, by repurposing US$325 million through the activation of the Contingent Emergency Response Component (CERC) of the Inclusive Connectivity Development Project (ICDP) for cash transfers, and the purchase and distribution of liquefied petroleum gas (cooking gas) and fertilizer. In addition, funds from existing operations in the World Bank portfolio are being repurposed to support imports of essential medicine, sustain the provision of school meals, and provide tuition waivers to preschool children from poor households.

Overall reform program

We are determined to use the current crisis as an opportunity to durably address the underlying governance issues, which have led to macroeconomic imbalances and institutional weaknesses, through foundational structural reforms. Our reform program rests on the following key pillars: (i) an ambitious and primarily revenue-based fiscal consolidation, accompanied by institutional reforms and cost-recovery based energy pricing, aimed at restoring fiscal sustainability and strengthening fiscal discipline; (ii) a stronger social safety net to protect the poor and most vulnerable; (iii) a sovereign debt restructuring process aimed at restoring public debt sustainability; (iv) a multi-pronged strategy to restore price stability and rebuild international reserves under greater exchange rate flexibility; (v) policies to safeguard financial stability; (vi) focused reforms to address governance and corruption issues; and (vii) broader structural reforms, including on trade and investment, to unlock Sri Lanka's growth potential.

In support of this program, we have entered into a 48-month Extended Arrangement under the IMF's EFF of SDR 2,286 million (395 percent of quota) for balance of payments and budget support. As part of the IMF EFF, we committed to restore Sri Lanka's fiscal and public debt sustainability. We announced a debt restructuring plan in May 2023 and are committed to a transparent and equitable debt restructuring process.

Several important reforms have already been announced and initiated through the 2022 Interim Budget, 2023 Budget speech, and the EFF, including new revenue measures, the reform of SOEs, cost-reflective pricing of utilities, the establishment of a national debt management agency, and the enactment of important legal frameworks such as a new central bank law and a public financial management law, all of which aim to improve economic governance and enhance competitiveness. We welcome the World Bank's support for some of these and further foundational reforms that strengthen macroeconomic stability and sustainability, mitigate the impact of current and future shocks on the poor and vulnerable, and support an inclusive private-sector-led recovery and growth path.

Reforms to enhance fiscal and debt sustainability

To restore macroeconomic stability and fiscal and debt sustainability, our government has undertaken an ambitious revenue-based fiscal consolidation and has implemented a tax reform package in 2022 and 2023, which includes measures to boost revenues through personal income, corporate income, and value-added taxes. To improve the efficiency and equity of the revenue collection process and address significant institutional weaknesses in tax administration, we have reinstated the mandatory withholding of certain taxes, and enacted amendments to improve third-party information sharing and implement mandatory e-filing. Going forward, we plan to strengthen tax audits by using risk-based filters, and tax transparency by publishing detailed tax expenditure statements, starting in 2024.

These measures will be accompanied by policy and institutional reforms that improve fiscal oversight and debt management, including the enactment of a new PFM Law by December 2023; the enactment of a new Parliamentary Budget Support Office bill and subsequent establishment of a Parliamentary Budget Office (including appointment of a Parliamentary Budget Officer supported by adequate technical staff, and allocation of physical office space and budgetary resources) by December 2023; the enactment of a new Public Debt Management Law by December 2023; and the establishment of a unified Debt Management Office by March 2024. We are also committed to clearing all outstanding spending arrears by end-June 2023, while undertaking further expenditure rationalization, raising the efficiency of public investment, updating fiscal reporting standards, and developing a medium-term fiscal framework to provide binding multi-year fiscal policy guidance.

Reforms to enhance financial sector stability

We are committed to safeguarding financial sector stability, reducing systemic risks in the financial and banking sector, and restoring the flow of credit to the private sector to support medium-term growth and investment. To manage current and future risks to financial stability, we have established a financial sector crisis management committee and updated the ELA framework. Furthermore, we are seeking to urgently upgrade the regulatory framework for problem bank resolution and deposit insurance through approval of the new Banking (Special Provisions) Act, to be followed by a full revision of the Banking Act, with planned enactment by December 2023. The new legislation will be consistent with international good practice and provide the authorities with the tools needed to manage any potential failures of financial institutions in a timely, transparent and cost- efficient manner. The CBSL is overseeing a comprehensive asset quality review and will develop a roadmap for financial sector restructuring and recapitalization to address capital and liquidity shortfalls by July 2023.

Building on these actions, time-bound restructuring plans for SOBs' will be endorsed by the CBSL and the MoF, and adopted by SOBs' Boards of Directors by March 2024 and implemented by March 2025. The regulatory and governance framework for SOBs will be strengthened in order to reduce financial sector distortions and the sector's exposure to the sovereign. The government is committed to putting in place prudential limits for the maximum exposures that banks can have vis-à-vis single borrowers and to a group of connected borrowers, including State-Owned Enterprises (SOEs), by March 2024. Clear mandates will be defined to ensure that SOBs are run at arm's length and lend to SOEs on a commercial basis. The CBSL has already taken steps to tighten non-performing loan classification and capital requirements in line with requirements for banks.

Reforms to improve the trade and investment regime

To reduce trade and investment policy distortions and uncertainty, and restore the economy's competitiveness and growth, the government is preparing a plan for the phased removal of import restrictions, exchange restrictions, MCPs, and CFM measures (to be completed by June 2023). We have already restored a flexible exchange rate. We are also undertaking reforms to simplify the tariff structure, with a view to eliminating two key para-tariffs the Export Development Board Cess (by 2025) and the Port and Airport Levy (by 2027). The first annual reduction for an initial set of goods is already affective. The government will publish and implement a National Tariff Policy that reduces the effective rate of protection, by March 2025.

To put in the place the conditions for a strong private sector-led recovery, we will work to address various regulatory and policy obstacles that inhibit private investment through the enactment of a new unified Investment Law by March 2024. As espoused in the 2023 Budget, we intend to build a new economy that is export-oriented, competitive, and digitally driven. Regarding the latter, government is working towards reforms that support the mobilization of private capital and competition in the broadband market.

Reforms to improve the performance and governance of SOEs

The government is committed to undertaking a transformative reform of SOEs, which will contribute to better macro-fiscal management, improved competitiveness, and greater financial transparency. The government will incorporate an SOE Holding Company (HoCo) under the ownership and control of MoF to implement the reform program, having already adopted a Cabinet approved SOE Reform policy paper that sets out the objectives, principles and scope of the ongoing reform process. This is complemented by the operational transfer of an initial set of SOEs to MoF which, together with the SOEs already under MoF operational control, provides a significant portfolio of companies to be restructured and/or divested.

The government is committed to following through on these foundational steps to enact and implement a new SOE Reform Act, which will give legislative force to the SOE Reform Policy and reinforce the legal authority of the HoCo. The HoCo's initial Articles of Association may need to be revised once the SOE Reform Act is passed to improve its effectiveness. The government is also committed to gazetting to MoF an additional set of SOEs thereby bringing an end to the "dual model" approach that has historically been a principal source of poor SOE performance. The government has already implemented cost-reflective energy pricing and is committed to approving a comprehensive strategy to restructure the balance sheets of the Ceylon Petroleum Corporation, the Ceylon Electricity Board, the Road Development Authority, and Sri Lankan Airlines by June 2023. We have called for proposals for transaction advisors for divestment of an identified set of SOE's and the IFC have also agreed to assist.

Reforms to strengthen the social protection system and enhance gender equality

We are cognizant of the potential impact of the current crisis and macroeconomic adjustments on the poor and vulnerable. We will ensure that we safeguard social spending and strengthen social safety nets (SSNs). We are implementing broader institutional reforms to improve the governance, efficiency, coverage, and targeting of SSNs through: (i) the operationalization of a new Social Registry as a tool to select beneficiaries of cash transfers and other poverty targeted programs in a more objective and better targeted manner; and (ii) the redesign of the ongoing cash transfer programs, through the approval of the new WBPS, a scheme designed to provide support to the poor, but also to vulnerable households during difficult times (shock responsive).

The first payments under the new welfare benefits payment scheme, approved by Parliament in May 2023, will be made in July 2023. By March 2024, the social registry developed for selecting beneficiaries for the new WBPS will also be used for other poverty-targeted programs. Regulations for recertification of welfare program beneficiaries will also be approved and implemented, to minimize exclusion and inclusion errors and thus ensure those receiving benefits are indeed the most in need. This program will help guard against politicization of welfare benefits, enhance transparency, improve coverage to the most vulnerable, and reduce leakages.

Furthermore, the government is committed to upholding the principles of gender equality and women's empowerment. We have drafted three significant pieces of legislation – the Gender Equality Bill, the Empowerment of Women Bill, and the National Commission on Women Bill – that will help enforce Sri Lanka's obligations to the *Convention on the*

Elimination of all Forms of Discrimination Against Women and require government and the private sector to address gender inequalities, including in the workplace.

Reforms to improve overall governance

A significant part of our reforms focus on improving governance and transparency, and fighting corruption. We are committed to enacting and fully implementing the proposed *Anti-Corruption Bill*, by ensuring independence of investigations and prosecutions, and adequate budget for the *Commission to Investigate Allegations of Bribery or Corruption* (CIABOC), as commensurate with its expanded mandate. The government makes a renewed commitment to reassert the primacy of transparency, as enshrined in the *Right to Information Law*, by ensuring that any new legislation does not explicitly or implicitly reduce the power of this *Law*. Finally, the government plans to strengthen the assets and liabilities declarations system and would be happy to receive support on this and on the new *Proceeds of Crime Bill* through the Stolen Asset Recovery initiative (StAR), in joint partnership with the UN Office on Drugs and Crime (UNODC).

Conclusion

We believe that the reforms we have already undertaken and committed to will help restore a sustainable growth path for Sri Lanka. In a break from the past, we intend to fully implement these measures – not just in letter but in spirit – and use this crisis as an opportunity to bring about a positive transformation for the country. We will take any additional measures that may become appropriate for this purpose.

We look forward to our continued cooperation with the Bank in this endeavour. We will also share all necessary information with World Bank staff to monitor progress of reform implementation and the result indicators of this operation, as well as progress towards achieving a more sustainable fiscal and macroeconomic environment.

On behalf of the Government of Sri Lanka, I again take this opportunity to thank the World Bank for the continued support during this difficult time. I trust that this request for financing of US$500 million will be considered favourably.

Yours Sincerely,

K.M. Mahinda Siriwardana
Secretary to the Treasury

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
Pillar 1: Improving Economic Governance		
PA#1.	Positive	Negative/Neutral
PA#2.	Neutral	Neutral/Positive
PA#3.	Neutral	Neutral
PA#4.	Neutral	Neutral
Pillar 2: Enhancing Growth and Competitiveness		
PA#5.	Neutral/Positive	Neutral
PA#6.	Neutral	Neutral
Pillar 3: Protecting the Poor and Vulnerable		
PA#7.	Positive	Positive