Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 30-May-2023 | Report No: PIDA35880

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Sri Lanka	P179808	Sri Lanka Resilience, Stability and Economic Turnaround Development Policy Operation (P179808)	
Region	**Estimated Board Date**	**Practice Area (Lead)**	**Financing Instrument**
SOUTH ASIA	28-Jun-2023	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	**Implementing Agency**		
DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA	Ministry of Finance, Economic Stabilization and National Policies		

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.

Financing (in US$, Millions)

SUMMARY

Total Financing	500.00

DETAILS

Total World Bank Group Financing	500.00
World Bank Lending	500.00

Decision

The review did authorize the team to appraise and negotiate

B. Introduction and Context

Country Context

Sri Lanka is currently facing unprecedented macroeconomic challenges, due to unsustainable debt 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. Amid depleted reserves, Sri Lanka announced an external debt service suspension in April 2022 (pending debt restructuring), and real GDP contracted by 7.8 percent in 2022. In the financial sector, banks' solvency and liquidity is under pressure due to their sizable exposure to the distressed sovereign, including state-owned enterprises (SOEs), and weakening asset quality. Poverty is estimated to have doubled, from 13.1 percent in 2021 to 25.0 percent in 2022, and is projected to increase further in 2023.

In March 2023, the IMF Executive Board approved a 48-month Extended Fund Facility (EFF) of approximately US$3 billion to support the government's reform program. This followed a Staff-Level Agreement (SLA) between IMF staff and the Sri Lankan authorities in September 2022 and financing assurances from all major official creditors. In parallel, the government has announced and initiated several 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.

Going forward, the economy is projected to contract by 4.3 percent in 2023, due to supply disruptions and lack of inputs, which will continue to adversely affect production, and a weak global economy. The planned fiscal and external adjustments, debt relief, and adequate financial support from international partners are projected to put the economy on a narrow path to macroeconomic sustainability. Beyond 2023, the scarring effect of the crisis, depletion in human capital, and tight external financing is expected to lead to a fragile recovery. The outlook is, however, 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. On the upside, faster recovery of tourism and larger remittance flows could raise the growth path and build additional external buffers.

Relationship to CPF

The proposed Development Policy Operation (DPO) is an integral part of the new Country Partnership Framework's (CPF) crisis response support. This CPF will span a 4-year period (FY24-FY27), with a 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. Given the economic crisis and limited resources, the CPF takes an adaptable and selective approach. 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) – *protected and enhanced human and natural capital*. Activities under the DPO will also contribute to 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.

C. 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.

Key Results

The proposed DPO – the first in a series of two operations – will be disbursed 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 certain structural causes of the current crisis to help restart growth. The expected key results include *improved economic governance* (better fiscal and debt management, improved tax administration, safeguarding of financial sector stability, and a restoration of the flow of credit to the private sector); a *reduction in market distortions* (reduced role of SOEs in the economy, simplified and lower para-tariff levels, a less fragmented investment regime, and broadband infrastructure sharing) to enhance the role of the private sector; *strengthened social protection system* (better governance and targeting)*;* and *reduced gender discrimination* in the labour market. Progress will be measured using eight indicators that correspond to the reform objectives of the operation.

D. Project Description

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 by *improving economic governance*, *enhancing growth and competitiveness*, and *protecting the poor and vulnerable*. The DPO's proposed actions are aligned with the World Bank Group's 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. The reforms are also sequenced and carefully calibrated with the recently approved IMF EFF for Sri Lanka, and coordinated with the Asian Development Bank (ADB) and other development partners (DPs).

The first pillar of the operation, *Improving Economic Governance*, includes measures to strengthen the governance framework and institutional structures and coordination in fiscal and debt management, and the financial sector. This includes the removal of sector-specific concessionary *Corporate Income Tax* (CIT) rates and an increase in the fuel excise duty, which will help expand the tax base and increase domestic revenues. This will be complemented by tax administration policy reforms, such as better information sharing and mandatory e-filing, which will improve coordination across financial institutions, boost revenues from high net-worth taxpayers, and support the use of risk-based audits. Systemic risks in the financial sector, which could adversely impact sector stability, will be addressed by the approval of an Emergency Liquidity Assistance (ELA) framework and the establishment of a financial sector crisis management committee. This is to be followed by regulation on the single obligor limit and the strengthening of the corporate non-performing loans resolution process. The stability of and confidence in the banking system will be reinforced by the strengthening of the deposit insurance and problem bank resolution framework. Finally, to improve debt management, a single Public Debt Management Law will be prepared, and a Public Debt Management (PDM) Office established.

The second pillar of the operation, *Enhancing Growth and Competitiveness*, includes reforms that are essential for Sri Lanka's medium to long-term competitiveness and growth performance. They will help reform the SOE sector, a major source of fiscal and financial sector risks, by creating the institutional structure for a SOE Holding Company and setting out the objectives, approach, and activities of an SOE reform program, including through an SOE Reform Policy Paper and SOE Reform Act. This will be followed by the implementation of a SOE restructuring and divestment program. Trade and investment policy uncertainty will be reduced through the phase-out of para-tariffs in a revenue neutral way and the consolidation of investment legislation, including for foreign direct investment. Private sector participation and investment in the broadband sector will be revitalized through the issuance of an open access and infrastructure sharing policy, as well as by competitive assignment of radio spectrum for wireless broadband services.

The third pillar of the operation, *Protecting the Poor and Vulnerable*, seeks to improve the governance, effectiveness, and efficiency of the country's social protection system, and reduce gender discrimination in the labour market. A revitalized social protection system will help the poor and vulnerable cope better with the ongoing economic crisis and price-adjustments resulting from the macro-fiscal reforms, as well as any future shocks. Reform measures under this pillar will support the design and financing of a new welfare benefit payment scheme, followed by provisions for a more widespread use of the social registry and recertification of beneficiaries. This pillar will also support measures to reduce gender discrimination in the labour market, through the removal of legal restrictions to women's work in different sectors of the economy.

E. Implementation

Institutional and Implementation Arrangements

The Presidential Secretariat, Ministry of Finance (MoF), and Central Bank of Sri Lanka (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 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 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. Throughout the program period, MoF and CBSL 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.

F. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impacts

The overall impact on poverty is expected to be neutral to positive. Prior Actions (PAs) under the first pillar of the DPO are expected to have neutral or negative effects immediately, but these can translate into positive effects in the medium-term by strengthening institutions, enhancing transparency, and creating more fiscal space, including for poverty-reduction. PAs under the second pillar are expected to have a neutral impact, but are foundational to a more sustainable growth model with private sector-led job creation. Reforms under the third pillar are expected to have a positive impact immediately, but will need to be carefully calibrated to sustain the impacts.

Environmental, Forests, and Other Natural Resource Aspects

Policy actions under this operation are not expected to have a significant direct negative impact on Sri Lanka's environment, forests, and natural resources. Each of the 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, and, in the long run, increased broadband access can lead to reduced carbon emissions and promote efficient use of resources. Further, this DPO helps to support actions that address climate change adaptation and mitigation. Finally, Sri Lanka's national environmental legal and institutional framework is broadly aligned with good international practices, and the Bank is currently supporting government to improve its Environmental & Social risk management capacity.

G. Risks and Mitigation

This engagement faces significant risks, and the overall residual risk rating of this operation is high. Political and governance risks are high, as the political environment remains fluid and further unrest could adversely impact reform implementation. The political leadership is, however, committed to making difficult and necessary reforms, which 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 and preparing a reform communication strategy to drive a much stronger outreach around the reforms, address stakeholder risks, and build a broader support base for the reform agenda. Macroeconomic risks are also high, as the economic path to recovery is narrow. There is, however, promising progress and prospects that these risks can be mitigated, including the quick preparation, approval, and endorsement of the IMF EFF. 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. Finally, there are several additional areas that present substantial risks, including *sector strategies and policies*, *technical design of projects, institutional capacity*, and *stakeholder risks*. Mitigation measures to address these risks include government-wide discussions, consultations with key stakeholders, close coordination among DPs, and monitoring of citizen awareness and perception of the fairness of key reforms. Finally, a better targeted and stronger social protection system will ensure the poorest and most vulnerable are supported during the reform and adjustment period.

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APPROVAL

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