

Arrears Clearance Strategy for the Central Government of Sri Lanka

for the period from 2025 to 2027

1. Introduction

Persistent budget deficit driven by inadequate revenue collection has resulted in the accumulation of unpaid bills at the closure of each fiscal year of the Government of Sri Lanka. The execution of the government budget has been constrained by limited liquidity in the Treasury's cash flow and insufficient budgetary allocations, resulting in the rollover of outstanding bills into subsequent financial years. With the deteriorated fiscal situation, followed by the COVID-19 pandemic, a significant increase in government recurrent expenditure and social security costs was also noted, enhancing the risk of accumulation of unpaid bills.

By the end of 2019, the total amount of unpaid bills had reached a record high of Rs. 242.7 billion. The government's inability to access international capital markets, due to downgraded credit ratings, combined with the need to service foreign currency debt through domestic borrowing, further strained fiscal stability. Additionally, rising interest rates on government securities have contributed to a substantial increase in interest payments on domestic debt from 2019 to 2022. In this context, the increased stock of unpaid bills in hand has emerged as a critical obstacle to effective budget execution. It poses a significant risk to the implementation of ongoing reform initiatives and is likely to delay improvements in public service delivery in the coming years.

Table 1: Stock of outstanding bills reported during 2019 and 2022

Rs. Bn

Year	Recurrent	Capital	Total
2019.12.31	123.4	119.3	242.7
2020.12.31	125.0	86.8	211.8
2021.12.31	90.7	62.0	152.7
2022.12.31	52.2	54.6	106.8

Despite the deteriorated cash flow liquidity status, the government demonstrated consistent and methodical progress in reducing its outstanding expenditure arrears between 2019 and 2022 through alternative financial arrangements, including the issuance of government securities in place of cash settlements, to manage pressure arising from the creditors, in particular, goods and services Suppliers and Contractors of the government. Over this period, total arrears decreased significantly from Rs. 242.7 billion in 2019 to Rs. 106.8 billion by 2022, marking a substantial 56% reduction over three years.

1.1. Arrears clearance commitment in line with the IMF Extended Fund Facility (EFF) program

Review of unpaid bills in hand and the clearance mechanism was started in line with the agreed performance criteria outlined in the IMF Extended Fund Facility (EFF) program, with effect from the end of June 2023.

1.2. Arrears Definition

As per the Public Financial Management Act No 44 of 2024, and the IMF program “arrears” means financial liabilities unpaid at the maturity date, the latter established by written law or by contract, should the maturity not be established by either of the mechanisms described above, the maturity period shall be established as ninety days from the date of the relevant invoice or of satisfaction of the terms of the relevant contract.

1.3. Reporting arrears under the IMF (EFF) program

Accordingly, “arrears” under the above definition were recorded as Rs. 34.5 Bn as at the end of June 2023, which is driven through the government payment mechanism as per the records maintained by the Department of Treasury Operations. Similarly, arrears status under the second and third reviews of the program were also reported under the same mechanism.

However, inaccuracies in the information provided on the arrears reporting to the IMF were triggered due to weaknesses in the timely reporting of arrears by line ministries to the Ministry of Finance, as well as a misunderstanding by the authorities of the definition of “arrears” under the Technical Memorandum of Understanding. The Executive Board positively considered the proposed corrective actions, considering the ability to accommodate arrears repayments within the existing fiscal envelope, and the authorities’ commitment to improve public financial management procedures in line with the new PFM law, to reduce the risk of accruing arrears or inaccurate reporting of information going forward.

Table 2 : Stock of Central Government Expenditure Arrears

Sri Lanka: Stock of Central Government Expenditure Arrears (In billions of rupees)				
	First Review	Second Review	Third Review	
	end-June 2023	end-Dec 2023	end-June 2024	end-Dec 2024
Stock of arrears ceiling (PC)	0	0	0	0
Initially reported arrears	34.5	0	0	0
Original assessment	Not met	Met	Met	Met
Revised arrears	154.2	118.1	112.2	95.3
Current Assessment	Not Met	Not Met	Not Met	Not Met
Revised arrears (as percent of GDP)	0.6	0.4	0.4	0.3

Sources: Sri Lanka Ministry of Finance; and IMF staff calculations.
Note: Data for end-June 2024 was not assessed formally but reported as part of the Third Review.

Accordingly, the arrears information was restated in the above manner, and as of the end of June 2023, the arrears were recorded at Rs. 154.2 billion, which equates to approximately 0.6% of the country's gross domestic product (GDP). It is important to highlight that most of these arrears were accumulated before the commencement of the Extended Fund Facility (EFF) program, underscoring the longstanding challenges faced in fiscal management and the debt standstill arrangements announced in April 2022.

Arrears accumulation was managed through the improved fiscal performance starting from mid-2023, including....

- i) Improved cash flow liquidity through revenue-based fiscal consolidation.
- ii) Enactment of the new PFM Act aimed at improving fiscal discipline and recognizing corrective actions that helped to reduce arrears accumulation.
- iii) Prioritizing outstanding bills of more than 90 days within the arrears settlement procedure.
- iv) Monitoring of the non-moving bank balances of the respective expenditure agencies

1.4. The new arrears clearance strategy

An Arrears Clearance Strategy is designed for the period from 2025 to 2027 with the view to addressing outstanding verified claims and ensuring the continuity of essential public service delivery and effective execution of the national budget. Hence, this strategy comprises with clearance of existing arrears while preventing the accumulation of new arrears.

The arrears clearance strategy is to be published appropriately to ensure the accountability and transparency of the government payment and settlement process. The periodical arrears progress reports are to be published along with a structured feedback mechanism

1.5. General Selection Principles for Arrears Clearance Strategy

The arrears clearance process will continue to capture key elements of public financial management, which include the following;

- (a) Liquidity management over the execution of the national budget
- (b) Timeline and predictability
- (c) Adhering to the payment calendar and fast track mechanism

- (d) Strengthening systems and capacity - improve PFM system to track commitments and payments in real time.
- (e) Ensuring Fiscal discipline and accountability, and sustainability
- (f) Protecting Fairness and Equity
- (g) Ensuring continuity of mandatory/essential supplies of the Government, including the Health, Education, and Defense
- (h) Debt sustainability considerations.
- (i) Promote economic growth,
- (j) Ensure accountability, transparency, and governance through an efficient payment mechanism.

1.6. Clearance of existing arrears

The proposed arrears clearance strategy aims not only to eliminate existing arrears but also to reinforce transparency and accountability within public financial management systems. In this context, officials are actively developing an Integrated Treasury Management and Information System (ITMIS), which is expected to significantly enhance arrears collection, reduce errors, and foster greater transparency. In parallel with these measures, the government is implementing a detailed arrears clearance strategy covering the period from 2025 to 2027. The primary objectives of this strategy are to stabilize public financial management, rebuild confidence among creditors, and ensure the timely and efficient execution of public services and development projects. The plan prioritizes the settlement of long-standing arrears, while instituting stringent expenditure controls and improved monitoring mechanisms to prevent future arrears buildup. The development and implementation of this strategy have been carefully designed to secure acceptance among Contractors, Suppliers, and Vendors, with an emphasis on minimizing litigation risks and ensuring that all actions are aligned with the government's approved directives.

2. Recommended strategy to avoid accumulation of arrears

2.1. Digitalization of Government Payments Mechanism to Prevent Accumulation of Arrears

To strengthen upstream expenditure control and align with international best practices, the government proposes the following strategy for digitalizing the payments process. This approach explicitly links **commitment recording to budget availability** and incorporates **pre-commitment checks**, which are essential to preventing the accumulation of new arrears:

2.1.1. Strengthening Commitment Controls and Pre-Commitment Checks.

Effective from 01.09.2025: All commitments must be recorded through the ITMIS system, with an embedded pre-commitment control mechanism that verifies budget availability before commitments are authorized.

This ensures that no commitments are made unless sufficient budget allocations exist, aligning with fiscal discipline and international best practices.

2.1.2. Digitalization of Procurement Processes

Effective from 01.07.2026: All purchase orders and contract awards will be generated through the ITMIS system, fully integrated with commitment control and pre-commitment checks to ensure compliance with budget allocations.

2.1.3. Timely Processing of Payments

Effective from 01.10.2025: All payment vouchers must be generated within 15 days of receiving valid invoices through the ITMIS. This step ensures the timely processing of payments while maintaining alignment with recorded commitments.

2.1.4. Settlement of Payments through ITMIS

During Q3 2026: All payments/settlements will be processed through ITMIS, ensuring full traceability, integration with upstream processes, and consistency with available cash and budget.

2.1.5. Arrears Reporting

With effect from 01.10.2025, all arrears information will be reported through the ITMIS, providing timely, accurate, and system-based tracking of outstanding obligations.

Table 3: Gantt chart

Action item	Time duration							
	2025		2026				2027	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
1. Update commitment recording through ITMIS								
2. Raising purchase orders through ITMIS								
3. Raise Payment vouchers within 15 days through the ITMIS								
4. Payment/settlement through the ITMIS								
5. Reporting arrears information through ITMIS								

The Digitalization of payment mechanisms is planned to span from the fourth quarter of 2025. During this period, several key activities will be undertaken sequentially. Initially, the update of commitment recording through ITMIS will be carried out in the fourth quarter of 2025. Following this, the process of raising purchase orders through the ITMIS system is scheduled to start from the third quarter of 2026. Subsequently, payment vouchers to finance the respective procurement will be raised through ITMIS from Q3 of 2025, leading into the payment and settlement processes also managed via ITMIS from Q3 2026. Further, reporting arrears information through ITMIS is planned to be executed from the fourth quarter of 2025, ensuring comprehensive payment management and oversight throughout the process duration.

3. General Selection Principles for payments and settlements

The liquidity status of Treasury cash flow matters to the arrears accumulation in the process of budget execution. Hence, the prioritization of limited resources is to be based on the following general selection criteria.

3.1. Proposed Hierarchy of Payments and Settlements under the Arrears Clearance Strategy

Tier 1: High Urgency and High Impact

Payments that are legally binding, politically sensitive, or directly impact public welfare and government credibility.

- a) **Legal/ statutory Obligations** - This includes statutory payments and the payments arising as per the litigations, including salary arrears, pensions, and obligations causing public unrest or undermining livelihoods. Those help to restore the trust in government and prevent social instability.
- b) **Social Welfare Program Arrears** - Including cash transfer programs, health care, education, subsidies, or social protection schemes. Ex: Aswesuma, Suwaseriya, which protects vulnerable populations and maintains social cohesion.

Tier 2: Essential Services and Economic Continuity

Payments, critical to public service delivery and economic infrastructure.

- a) **Defense, Utility, and Energy Sector Arrears**

Defense payments, Electricity, water, fuel suppliers, etc., which are required to ensure the national security & stability, continuity of public services, and support business operations.

- b) **Private Sector Contractor Payments**

Begin with **smaller and high-impact contracts**, such as the construction of schools, hospitals, and roads. These are to support job creation, reduce unemployment and eliminate youth unrest, improve SME liquidity and expose the infrastructure delivery.

Tier 3: Strategic Financial Obligations/ Debt service payments

Obligations relevant to macro-fiscal stability and access to external financing.

Tier 4: Internal Settlements and Lower Urgency Obligations

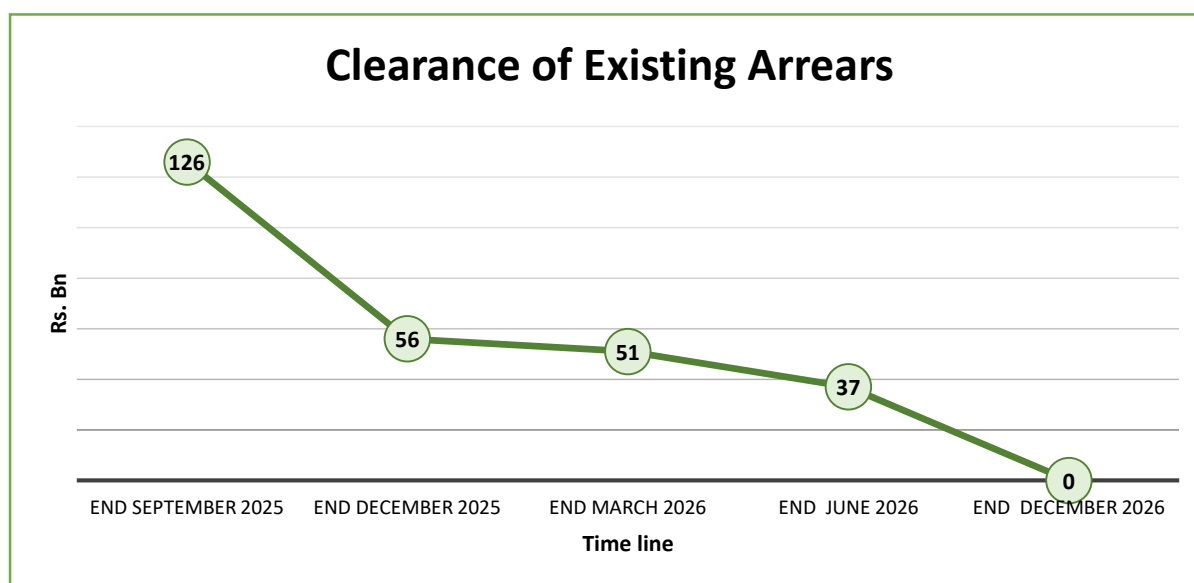
- a) **State-Owned Enterprises (SOEs) & Inter-Governmental Arrears**

Includes dues among government entities and between central and local governments which can be managed through internal adjustments and offsetting arrangements.

4. Arrears recorded as at the end of June 2025

Table 4: Agreed indicative targets

Time line	End September 2025 (IT)	End December 2025 (QPC)	End March 2026 (IT)	End June 2026 (QPC)	End December 2026
Amount Rs. Bn	126	56	51	37	0



Between September 2025 and June 2026, a structured timeline has been established to monitor and achieve specific financial targets. By the end of September 2025, the indicative target is set at Rs. 126 billion. This target is subsequently adjusted to Rs. 56 billion by December 2025. Moving into the first quarter of 2026, the focus shifts to quantitative performance criteria (QPCs), with a target of Rs. 51 billion by March 2026. The target is further reduced to Rs. 37 billion by the end of June 2026, and by the end of 2026, total arrears recorded as of now will be fully settled. This phased-out approach aims to ensure progressive fiscal discipline and effective monitoring of performance over the specified period. Further, actions will be taken to avoid future accumulation of arrears through a proper implementation and monitoring mechanism as described below.

5. Implementation Framework and Monitoring Mechanisms

5.1. High-Level Arrears Clearance Oversight Committee

An Arrears Clearance Oversight Committee (ACOC) is to be established to provide strategic oversight, transparency, and accountability in the identification, verification, prioritization, and clearance of arrears. The Committee ensures that arrears are managed in line with fiscal responsibility principles, legal obligations, and stakeholder expectations. They shall report to the Secretary to the Treasury.

5.1.1. The objectives of the ACOC are

- To oversee the process of arrears verification and classification.
- To ensure transparency and fairness in the arrears clearance process.
- To monitor the implementation of arrears clearance strategies and plans.
- To recommend policy measures to prevent recurrence of arrears.
- To ensure compliance with legal, regulatory, and financial frameworks.

5.1.2. Further, the Committee shall have oversight over:

- Public sector arrears (e.g., government payments to suppliers, contractors, employees, pensions, etc.).
- Arrears arising from budgetary shortfalls, procurement delays, or administrative inefficiencies.
- Reconciliation of disputed payments or pending obligations.
- Any other financial obligations deemed relevant by the Committee.

5.1.3. The Committee shall comprise the following:

- Deputy Secretary to the Treasury (Chairperson)
- Director General and other relevant officers of the TOD
- Director General of the Department of National Budget
- Director General of the Department of State Accounts

The Committee shall meet at least **once per quarter** or more frequently as required and shall submit **quarterly and annual reports** to the Secretary to the Treasury including data on arrears cleared, outstanding amounts, challenges encountered, and recommendations for improvement. The Committee members shall maintain confidentiality of sensitive financial and personal information and shall manage in accordance with public ethics standards.

5.2. Regular Monitoring and Evaluation:

Monthly and quarterly review meetings will be institutionalized to assess progress against set targets, review the effectiveness of implemented measures, and adjust strategies as necessary. These reviews will be supported by real-time data collected through the Integrated Treasury Management and Information System (ITMIS), which will form the backbone of data-driven decision-making. KPIs such as reduction in arrears amounts, timeliness of payments, system integration milestones, and stakeholder satisfaction will be regularly monitored to ensure accountability.

In addition, a formal verification process for arrears claims will be established. This process will define the responsible verifying authority, such as the Internal Audit Department, and will specify that verification will occur every quarter. Verification criteria will include supporting documentation, payment authorization records, and alignment with approved budgets. Monitoring reports, including both progress and verification updates, will be compiled and submitted quarterly to relevant oversight bodies, ensuring timely and accurate reporting for decision-making and external review.

5.3. Stakeholder Engagement and Communication:

Effective communication channels will be maintained with creditors, suppliers, contractors, and internal government agencies to foster transparency and trust. A dedicated stakeholder engagement plan will facilitate feedback collection, address grievances, and promote cooperation. Regular updates and consultations will be conducted to ensure alignment and buy-in, especially from key sectors such as health, education, and public utilities.

5.4. Capacity Building and System Enhancement:

To integrate the arrears clearance process seamlessly, substantial investments will be made in strengthening the capacity of relevant institutions. This includes training personnel in digital payment systems, enhancing data accuracy, and ensuring that the ITMIS platform functions efficiently. Continuous system upgrades and audits will be conducted to prevent technical failures and data discrepancies, which are critical for maintaining credibility and trustworthiness.

5.5. Strategic Measures and Risk Management

Given the complexities inherent in managing arrears, several strategic measures will be adopted to mitigate risks and enhance the robustness of the process:

5.6. Liquidity Management and Fiscal Discipline:

Maintaining adequate liquidity remains paramount. The government will prioritize revenue collection efforts, including tax reforms and broadening the tax base, to strengthen cash inflows. Contingency reserves will be established to cushion against external shocks or unforeseen fiscal pressures. The treasury will adopt a conservative approach to expenditure, emphasizing the clearance of legally and morally imperative obligations first.

5.7. Prioritization of Payments:

Payments will follow a structured hierarchy based on urgency, legal obligations, social impact, and systemic importance. Critical sectors such as utilities, social welfare, and essential public services will receive priority to prevent social unrest and ensure continuity of services.

5.8. Structural Reforms and Policy Measures:

To sustain progress, the government will pursue comprehensive fiscal reforms, including improving public financial management, strengthening expenditure controls, and enhancing revenue policies. These reforms aim to reduce the likelihood of future arrears accumulation and create a resilient fiscal environment.

6. Conclusion:

The outlined arrears clearance strategy for 2025-2027 adopts a holistic approach that combines digital transformation, strategic prioritization, robust monitoring, and structural reforms. By adhering to these principles, Sri Lanka aims to restore fiscal stability, rebuild confidence among creditors and the public, and lay a resilient foundation for sustainable economic growth. Continuous evaluation and adaptive management will be vital to navigate challenges and achieve long-term fiscal discipline.