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PRESS RELEASE

Measures to Improve Governance and Address Corruption Vulnerabilities in Sri Lanka

Sri Lanka's recent economic crisis is the result of longstanding macroeconomic vulnerabilities, due to persistent policy driven budget deficits and current account deficits, which were exposed by domestic policy errors, including the end 2019 tax cuts and exogenous shocks, such as the COVID-19 pandemic, exacerbated by the geopolitical tensions in the global arena. However, deep-rooted governance issues and corruption vulnerabilities also have contributed to economic challenges and social issues in the country. Corruption has been identified as a macro critical component in Sri Lanka's economic management and growth process. According to the International Monetary Fund (IMF), "*Corruption undermines growth and economic development, its economic and social costs are high, and transparency, effective institutions, and leadership are key factors of success. By vigorously reducing corruption, countries can improve economic stability and boost growth and development*"¹. Furthermore, "*Corruption comes with substantial costs. By undermining taxpayers' willingness to comply with the tax system and reducing the efficiency of spending programs, corruption reduces a government's ability to efficiently deliver its policy objectives. But the indirect effects are potentially even more severe. Pervasive corruption weakens social cohesion and reduces trust in the state, which can result in economic, social, and political instability*"².

¹IMF Survey: Fighting Corruption Critical for Growth and Macroeconomic Stability – IMF, 11 May 2016
<https://www.imf.org/en/News/Articles/2015/09/28/04/53/sores051116a#:~:text=The%20paper%20shows%20that%20the%20topic%20is%20E%20%80%9Cmacro-critical%20%80%9D%20%80%94that,the%20economic%20costs%20of%20corruption%20could%20be%20substantial.>

² Ozlem Aydin , Sebastian Beer, Cindy Negus , "Rebuilding Trust - Toward Good Fiscal Governance in Sri Lanka, IMF, 18 December 2023.
<https://blog-pfm.imf.org/en/pfmblog/2023/12/18/rebuilding-trust-toward-good-fiscal-governance-in-sri-lanka>

Therefore, whilst addressing governance and corruption vulnerabilities is not a sufficient condition to address Sri Lanka's economic weakness, it is an important reform component to enhance Sri Lanka's economic and social development. It is in this context that the government has embarked on a committed journey to decisively address corruption and governance issues in the country in a comprehensive and coherent manner.

As a first step, the government requested the IMF to conduct a governance diagnostic assessment, which would identify weaknesses in the governance framework and identify key corruption vulnerabilities. This report, "*Sri Lanka - Governance Diagnostic Assessment*", which is the first such governance diagnostic report in Asia, was published in September 2023 outlining priority areas for governance reform (see <https://www.treasury.gov.lk/news/article/221>).

Taking ownership of these findings, by February 2024, the government published an Action Plan (see <https://www.treasury.gov.lk/api/file/5e0c54aa-62cd-4ac3-846a-9073dfc653c6>) outlining the key steps for implementation of the recommended reform measures. These reforms are now in process and several measures have already been completed.

Fiscal Transparency

In addition to fiscal disclosures arising from existing legal obligations such as the Fiscal Management (Responsibility) Act (FMRA) No. 3 of 2003, among others, the government has commenced several additional fiscal disclosures in the recent past. A few examples are as follows;

- a. Even prior to the IMF programme approval in March 2023, Sri Lanka began publishing detailed debt statistics which was developed into a comprehensive quarterly debt bulletin (see <https://www.treasury.gov.lk/api/file/1f884c2c-71db-4058-9b99-a9cb7f0690b7>).
- b. The government has regularly published the following;
 - Detailed information on tax exemptions and incentives (see <https://www.treasury.gov.lk/web/tax-certificates-issued-under-boi>),
 - Procurement contracts through Electronic Government Procurement (eGP) System (see <https://promise.lk/>),
 - Details of vehicle permits (see <https://www.treasury.gov.lk/web/luxury-tax-exemptions>), and

- A comprehensive tax expenditure statement (see <https://www.treasury.gov.lk/api/file/461faa52-f42b-4d22-ac57-37073e2435e7>).

Whilst long unaddressed, these are initial steps in improving transparency, the government intends to build on this through continuous improvement going forward.

Institutional Reform

The revenue collecting agencies - Inland Revenue Department (IRD), Sri Lanka Customs, and Excise Department - have long unaddressed corruption vulnerabilities. Hence, specific Action Plans and Anti-corruption Units are being established at each of these entities to ensure a focused approach to this challenge. Greater digitalization of all three revenue agencies will further reduce corruption vulnerabilities as human interaction will gradually be minimized. Efforts are particularly being made to strengthen the Revenue Administration Management Information System (RAMIS) at the IRD, which has been delayed for around 10 years, adding to serious legacy issues for the government's revenue administration. This is a good example of how governance related reforms that have been neglected for several years, if not decades, will not produce results over-night. Institutional reforms of this nature take a long time to bear fruit since there is substantial change management is required in terms of personnel, systems, and practices that have been long entrenched. Experience from other countries indicates that the measures that have been introduced recently by the government must be carried through over the medium to long term in order to see meaningful positive outcomes.

Tax Incentives

Tax incentives and tax holidays have been a matter of significant public debate. Given weaknesses in Sri Lanka's investment climate, such incentives have been required to attract investment to the country. However, these incentives have material fiscal costs. Although many of the exemptions under the Value Added Tax (VAT) and Corporate Income Tax (CIT) were removed recently, tax incentives for Strategic Development Projects (SDP) and Board of Investments (BOI) projects remain sizable. Since these incentives are subject to legally binding investment agreements, they cannot be unilaterally revoked without significant consequences, both legally and in terms of adverse investment sentiments. Such tax holidays create a higher tax burden on non-exempt parties. Hence, the government has decided to refrain from new tax exemptions, incentives, and from approving new projects under the SDP Act. As an alternative, amendments to the SDP Act will be submitted

to parliament by end-February 2025, introducing transparent and rules-based, eligibility criteria for granting time-bound investment incentives. In parallel, ongoing measures to improve the investment climate, such as providing easier access to government owned land, improving access to skilled labour, and addressing capital market bottlenecks, will be accelerated.

Legislation: Anti-Corruption Act and Public Financial Management Act

The Anti-Corruption Act which was passed by Parliament in 2023 provides a broader legislative framework to address corruption vulnerabilities in the country. Accordingly, the Commission to Investigate Allegations of Bribery or Corruption (CIABOC) is being fully operationalized to effectively fulfill its broadened mandate under the new Anti-corruption Act. In the meantime, the CIABOC will publish asset declaration of senior officials' by end-July 2024 while working towards fully operationalizing the Online Asset Declaration System.

In May 2024, the government submitted the Public Financial Management bill to Parliament. This landmark legislation will improve the transparency, accountability, and efficiency of managing public finances in Sri Lanka. This Bill provides a comprehensive legislative framework to address fiscal governance related issues. The PFM Bill includes a comprehensive framework and provides clarity on the budget process, revenue and expenditure management, fiscal information transparency requirements, increasing the frequency of disclosures, procurement disciplines, and others. Once approved by Parliament, the PFM law will be an overreaching piece of legislation to ensure disciplined and prudent fiscal management in Sri Lanka. Forthcoming legislation on Public Private Partnerships and State-Owned Enterprises will address governance issues pertaining to those entities.

Procurement

In assuring an expeditious and efficient public procurement process that ensures value for money and fairness, the adherence to procurement best practices has been emphasized at every level of government to safeguard the public interest. In terms of Article 156 B (1) of the Twenty First Amendment to the Constitution, the defunct National Procurement Commission (NPC) was re-established in 2023 vesting power for policy making and oversight relating to public procurement. The re-establishment of the NPC as one of the five independent Commissions under the Constitution demonstrates government's strong commitment towards good governance in public procurement. The NPC is currently in the process of drafting a

new Procurement Law which is to be enacted by the end of 2024 which is also a commitment under the IMF EFF programme.

The NPC has drafted new Procurement Guidelines as an interim measure and the process of obtaining approval of the Cabinet of Ministers for the same is ongoing. Moreover, the PFM bill also clearly articulates the need for all budgetary entities and SOEs to adhere to the Procurement guidelines issued by the NPC.

The Electronic Government Procurement (e-GP) Platform, which was initiated in 2019, is being expedited and expanded with grant assistance received from the EU and the World Bank. The eGP has set its target to roll out all three procurement methods i.e. Shopping, National Competitive Bidding (NCB) and International Competitive Bidding (ICB) by end 2025. Currently, the eGP facilitates public procurement under the Shopping procedure.

Asset Recovery Legislation

The anti-corruption legal framework will be further strengthened by new asset recovery legislation. Towards this end, the government appointed an expert committee in March 2023 to prepare the policy framework for a law on proceeds of crime³. In April 2024, the Cabinet of Ministers instructed the Legal Draftsman to commence drafting the legislation based on the recommendations of the expert committee⁴. It is expected to enact the Proceeds of Crime Bill by November 2024.

However, even the most effective asset recovery provisions will not eliminate the need for the government's tax revenues to be enhanced. Experiences of other countries indicate that asset recovery takes an exceedingly long time. In the case of the Philippines, it took over 18 years for recovery of a small component of estimated ill-gotten gains since Ferdinand Marcos was ousted in 1986⁵. Therefore, whilst the government is putting in place the necessary legislation and processes to facilitate asset recovery, Sri Lanka would still need to enhance government revenue in order to meet mandatory public expenditure requirements and restore debt sustainability.

Concluding Remarks

Whilst governance and corruption related issues have been longstanding factors that have hampered Sri Lanka's economic and social development, they have long been unaddressed by policy measures. The government has taken the initial steps to

³<https://www.moj.gov.lk/images/2024/Legal/Propossed-law-on-Proceeds-of-crime.pdf>

⁴http://www.cabinetoffice.gov.lk/cab/index.php?option=com_content&view=article&id=16&Itemid=49&lang=en&dID=12513

⁵ "Stolen Asset Recovery (StAR) Initiative: Challenges, Opportunities, and Action Plan", p.21, The International Bank for Reconstruction and Development / The World Bank, 2007.

<https://www.unodc.org/documents/corruption/StAR-Sept07-full.pdf>

address these policy gaps through a comprehensive legislative and institutional reform process. In many instances, these are complex and time-consuming reforms, most of which require legislative changes which have to go through a rigorous procedure which often face delays due to various factors beyond the full control of the executive arm of government.

Whilst measures taken thus far are initial steps, there is a long way to go in terms of ensuring continuity and for positive results to materialize. Contrary to some informal assessments, the IMF has also indicated a positive review of the governance related actions taken thus far as evidenced by the outcome of the recently concluded second review of the Extended Fund Facility (EFF) Programme (Table 1).

Whilst addressing governance gaps and minimizing corruption vulnerabilities is an important policy priority, it should not be considered a panacea for all of Sri Lanka’s economic weaknesses. Even if Sri Lanka had eliminated corruption fully, the country would have still gone through the recent economic crisis due to the flawed fiscal and monetary policy decisions that led to the crisis. Therefore, whilst measures to improve governance and address corruption vulnerabilities are implemented, this does not mean other economic reform measures can be set aside. As indicated above, efforts to improve government revenue in particular should be continued without any compromise to ensure the fiscal issues are addressed on a sustainable manner.

Table 1: Key Indicators and their Performance – Sri Lanka’s Second Review of the Extended Fund Facility (EFF), supported by the IMF: June 2024⁶

Indicator	IMF Review
Prior Action: Submission to parliament of the Public Finance Management Bill	Met in May 2024
Structural Benchmark: Parliamentary approval of Anti-Corruption Act harmonized with UNCAC	Met in July 2023
Structural Benchmark: Publication of Governance Diagnostic Report	Met in September 2023
Structural Benchmark: Constitutional Council to develop rules to appoint members to CIABOC which	Met in December 2023

⁶ Sri Lanka: 2024 Article IV Consultation and Second Review Under the Extended Fund Facility, Request for Modification of Performance Criterion, and Financing Assurances Review-Press Release; Staff Report; and Statement by the Executive Director for Sri Lanka, IMF, 13 June 2024. <https://www.imf.org/en/Publications/CR/Issues/2024/06/13/Sri-Lanka-2024-Article-IV-Consultation-and-Second-Review-Under-the-Extended-Fund-Facility-550261>

would be published in gazette by December 2023	
Structural Benchmark: Publication of all procurement contracts above Rs. 1 billion with searchable format of contract winners	Met in February 2024
Structural Benchmark: List of firms receiving tax exemptions through BoI and SDP legislation	Met in February 2024
Structural Benchmark: List of firms receiving luxury vehicle import tax exemptions	Met in February 2024
Structural Benchmark: Publication of government action plan for implementing recommendations in the Governance Diagnostic Report	Met in February 2024
Structural Benchmark: Cabinet approval of governance reforms for state owned banks	Met in May 2024

The above mentioned efforts are a committed attempt of the government to decisively address corruption in the country. It is something that goes against entrenched comfort zones that some in society have been accustomed to over many decades. When it comes to corruption, there are always two sides to a transaction. It follows that fighting corruption requires changes in behavior and practice both from the government, and from society as well. The public call for system change requires not just the ongoing efforts to reform laws, institutions, and their implementation, but also the norms and practices built up in society over many decades.

It is important to understand that fighting corruption is a medium to long term process and it is necessary to stay on course unabated for the intended outcomes and benefits to be realized. In this context, economic reform measures must be considered in a holistic and comprehensive manner. In Sri Lanka's case, this includes fiscal reform, monetary policy reform, financial sector reform, welfare reform, SOE reform and debt restructuring, with governance reform being another important component of this broader effort to prevent a repetition of the debilitating economic crisis.