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Date }

Dr. Jim Yong Kim
President
The World Bank
Washington DC
USA.

Dear Dr.Kim,

Letter of Development Policy

With the elections in January 2015, Sri Lanka ushered in a new unity government. Our Prime Minister in November 2015, outlined the strategic outlook of the country for the next 5 years. This detailed the development trajectory of the government, requires significant reforms in governance structures, administrative systems and economic policies. We are mindful that while Sri Lanka has managed to maintain an economic growth of around 5-6 percent in the last 5 years, which in turn has been a major factor in reducing the poverty rate from 22.7 percent of the population in 2002 to 6.7 percent in 2013, that the country has missed many opportunities in the last three decades due to the internal conflict that prevailed in the country. However, now importantly, Sri Lanka is at peace and the Government is undertaking steps to ensure that the grievances which fueled problems in the past are addressed.

It is in this background that the key goals of the aforementioned strategic outlook has been identified to be as follows:

1. Generating a million jobs;
2. Increasing incomes;
3. Developing the rural economy;
4. Providing for land ownership to the rural and estate sectors, middle class, and government employees; and
5. Creating a wide and strong middle class.

Achieving these goals will require a concerted effort in many areas, but three in particular are priorities for the Government: the need to facilitate a more competitive private sector as the engine for generating jobs and increasing incomes; improving the efficiency and effectiveness of the public sector; and ensuring longer term fiscal sustainability.

Enabling Private Sector Competitiveness

Sri Lanka led the way in South Asia in opening up its economy in the 1970s to foreign trade and this has led to the country being able to achieve a relatively better standard of living in comparison to our neighbors. However, the three decades of conflict that prevailed, resulted in the country, losing many opportunities to link into the global value chains. Economic growth in the last decade has been driven by large infrastructure projects, which was required given the lack of modern facilities that is necessary to facilitate domestic industries as well as to attract foreign direct investments.

While the development of roads, electricity, and other physical infrastructure was given attention in the last few years, inadequate reforms in the administrative and legal framework has become a hindrance in attracting Foreign Direct Investments (FDI). As such the Government is now focused on addressing these challenges so as to improve the investment climate, particularly through the removal of barriers to trade.

The Government has taken measures already to build momentum for reform in these areas. First, it has set up institutions to lead and coordinate reforms that support private sector development through the establishment of an Agency for International Trade tasked with formulating a new trade policy and an Agency for Development to establish a new FDI attraction strategy. These Agencies will formulate long-term strategies; a key element within these strategies will be addressing the complex system of incentives, tariffs, and para-tariffs which has emerged over time. To complement the long-term work, the Government is making practical quick improvements to facilitate trade and investment. For instance, the Government has established an electronic visa facility to make it easier for business persons to obtain a visa. Going forward, these will be complemented by broader efforts to improve the investment climate in the country. At the same time, a high level steering committee has been set up which has been tasked with leading business environment reforms in the country, in order to identify and eliminate regulatory obstacles to entry and expansion of businesses.

Enhancing Transparency and Public Sector Management

The Government of Sri Lanka has been committed to carrying out a wide range of governance reforms. Government has taken significant steps to strengthen transparency and accountability, most notably through the passage of the 19th Amendment to the Constitution. This amendment created a greater balance between the Presidency and a Cabinet formed by a Parliamentary majority. It also strengthened the system for independent commissions to hold Government accountable, by reconstituting a Constitutional Council which is represented by diverse interests that in turn was empowered to make appointments to independent commissions. Public Service Commission and Police Commission has been reestablished so as to ensure their operational independence from external and specially political interference.

Reforms have also targeted improving Government's effectiveness, particularly in the management of its assets. The 19th Amendment also created Audit and National Procurement Commissions to provide an institutional framework that increases oversight and integrity in the use of public monies. These commissions have been appointed and are in the process of establishing updated rules on how these vital functions are carried out. The Government has also sought to increase effectiveness in its revenue and treasury operations, in particular through the development of the Revenue Administration Management Information System (RAMIS) and the Integrated Treasury Management Information System (ITMIS). The Government has also launched a preparedness assessment for introducing e-procurement to obtain greater value for money in public spending.

The Government is also committed to exercising stronger oversight to improve the performance of public enterprises. Sri Lanka has a large number of public enterprises, some of which play a significant role in the economy, such as in the banking sector. Public enterprises are major employers. Some are inefficient, causing significant financial risks. Towards this end, a dedicated Public Enterprises Development Ministry was established to provide much more direct management oversight to drive better performance, both in terms of the goods and services provided by public enterprises but also to ensure that the fiscal burden on the treasury is lowered.

These reforms in the management of public resources are in their nascent stages. Results from these reforms will require years of implementation and will doubtless encounter challenges from vested interests. The Government is committed to carrying through on all of these fronts, but recognizes that not everything can be implemented at once. Hence we are keen to take actions quickly which in turn provide a platform for carrying through with long-term systemic reforms as well as help build momentum going forward.

Improving Fiscal Sustainability

The Government recognizes that a pre-condition in macroeconomic stability is fiscal sustainability. In this regard the Government has decided to adjust revenue and expenditures to limit the fiscal deficit for 2016 and start reducing the public debt-to-GDP level to reach 60 percent by 2020. Given the impact of low commodity prices, stagnating remittances and a marked bias of capital markets away from emerging economies such as Sri Lanka towards the US, the impacts of which has begun to permeate into the country, we have decided to engage with the IMF on an Extended Fund Facility (EFF) beginning from 2016 going on till 2019. This will help to stabilize our external sector vulnerabilities while building confidence in our investment partners of our credit worthiness and the commitment to reforms.

The Government recognizes that low tax revenue is the source of many macroeconomic and fiscal problems in the country and is committed to addressing this issue having recognized its impact not only in the short term but also in the long term.

The multi-pronged strategy of the government designed to improve the tax collection of the country includes increase of the VAT and the Corporate Taxes while extending the VAT to wholesale and retail sectors and removing VAT exemptions. Government has also taken a policy decision to stop tax holidays or incentives on profit and to limit it to only investments. The proposed revision of the Inland Revenue Act with the assistance of the IMF is a key aspect of the government strategy. Given that RAMIS will in the first phase connect almost 20 institutions into one platform, the operationalizing of RAMIS is expected to improve tax collection. Government is also looking into eliminating the various tax exemptions and holidays given, replacing such incentives with more targeted incentives.

With global financial conditions tightening, the Government also seeks to improve the functioning of its domestic capital markets, which will help both the private and public sector improve access to finance on more favorable terms, and increase the national savings rate. It plans to establish a unified Debt Management Unit (DMU) in the Ministry of Finance, which will be responsible to develop a debt management strategy taking into account the costs and risks of the current debt portfolio and the financial conditions going forward.

Reforms supported by the Development Policy Financing

The Government has carried out a set of initial reforms in the 3 key areas of, enabling private sector competitiveness, enhancing transparency & public sector management, and improving fiscal sustainability as part of our medium and long-term reform agenda.

1. Enabling private sector competitiveness

The government has taken initial steps to eliminate identified obstacles constraining the competitiveness of the private sector as a way to unleash the potential of Sri Lankan enterprises. The following specific actions have been taken in this regard:

1.1 The Cabinet has approved the ratification of the WTO Trade Facilitation Agreement (TFA) and the creation of the National Trade Facilitation Committee (NTFC).

The TFA sets forth a series of measures for expeditiously moving goods across borders inspired by the best practices from around the world. The ratification of the WTO TFA by Sri Lanka will formalize our commitment to the implementation of the provisions of the agreement. This will also signal to domestic and international stakeholders our strong commitment to reform and modernization of the trade facilitation regime. The ratification of the WTO TFA and the formal establishment of the NTFC can be an effective platform for a second wave of reforms that target core bureaucratic bottlenecks through digitization, increasing transparency and ensuring ease of access to trade related information as identified in, inter alia, Doing Business rankings and Trading Across Borders indicators. The NTFC is expected to oversee and coordinate all trade facilitation matters in Sri Lanka including full and effective implementation of the WTO TFA, which provides the framework for the implementation of simple, transparent trade procedures that enhance trade facilitation. This is an important step in setting up a foundation for trade facilitation reforms. .

1.2 The Government has established a One Stop Shop to facilitate establishment and operations of foreign investors in the country.

Foreign Direct Investment (FDI) is an important ingredient to the economic diversification that Sri Lanka aspires to. But FDI, especially from efficiency-seeking investors, can be not only an important source of funding and employment generation, but also a mechanism to increase productivity, create positive spillovers and enhance access of Sri Lankan producers to global production networks and value chains.

However, FDI in Sri Lanka has been lower than in regional peers in spite of Sri Lanka's comparative advantages. The obstacles to attract and retain FDI are manifold, ranging from deficiencies in the legal and regulatory framework to institutional shortcomings. While addressing all these obstacles will require a medium term reform program, as a first step, the Government of Sri Lanka has mandated the inception of a One Stop Shop (OSS) for FDI, as the mechanism to address regulatory deficiencies and interagency coordination that currently create significant obstacles and transaction costs to investors interested in establishing operations in Sri Lanka.

The Cabinet of Ministers approved the establishment of the OSS together with its Terms of Reference (TOR). The OSS's primary mandate is to undertake interagency coordination to expedite investment approval. In this regard the OSS is expected to reduce lead times for investment approval by reducing the number of bilateral interactions needed between investors and regulatory agencies and creating a mechanism to proactively track the status of applications and prompt response from regulatory agencies.

1.3 The Cabinet has approved the drafting of a new Secured Transactions Act (STA) which includes provisions to enable the use of movable assets as collateral for bank loans, repealing the Secured Transactions Act 49 of 2009 (STA 2009).

Access to finance is identified as a major constraint for firms' growth in Sri Lanka. It is particularly difficult in the case of smaller firms and credit is often dependent on their ability to post collateral with significant value mainly through real estate, while movable assets are not recognized by law as sufficient security for loans. A Secured Transactions Act No. 49 was enacted in 2009 with the purpose of enabling the use of movable assets as collateral in loans. However, deficiencies in the law rendered it ineffective. As such the Cabinet of Ministers has approved the repealing of the existing Act and drafting of a new Act to address the deficiencies identified in the existing Act, by enforcing use of collateral registries and providing priority to registered claims in case of borrowers' default. The expected passage of the new STA by Parliament is expected to enable firms better access to financing, using movable assets as collateral.

2. Enhancing Transparency and Public Sector Effectiveness

The Government is keen to sustain its effort to bring about good governance. We are of the view that a Government that is transparent, responsive, and effective can provide better public services, foster a stable conducive environment for private sector development, and ensure overall stability. These are all key ingredients for competitiveness. The government has taken the following steps to build an institutional framework that would improve the operations of Government.

2.1 Cabinet has submitted to Parliament a Right to Information (RTI) Bill with wide applicability, extensive proactive disclosure, an independent appeals process, and limited exceptions.

The RTI bill requires disclosure of information held by government with limited exceptions which themselves can be overridden on the grounds of public interest. These requirements apply to comprehensive list of Public Authorities. The bill creates an independent Information Commission to hear appeals under the Act with the power to prosecute public officials on certain grounds. It designates the Ministry of Mass Media and Parliamentary Affairs as responsible for ensuring the effective implementation of the Act in collaboration with the Commission. The Bill provides a framework for filing applications to receive information while placing requirements for proactive disclosure of information relating to budget allocations and execution. The Bill has been submitted to Parliament and is under debate. The Supreme Court has also submitted their views on the draft bill. The Bill once passed in Parliament will become effective six months after its passage. Steps will need be taken to set up the Information Commission. The government believes that this initiative provides for greater citizen oversight, together with more open deliberation of government regulation, and strengthens feedback between citizens and government in the delivery of public services.

2.2 Drafting of the National Audit Bill that establishes a National Audit Office as the Supreme Audit Institution of the country and operationalizes reforms introduced in the 19th Constitutional Amendment.

The enactment of the 19th Constitutional Amendment greatly strengthened the administrative independence of the audit function by providing for the establishment of an Audit Service Commission. It also clarified the mandate of the Auditor-General to audit the accounts of State Owned Business Enterprises registered under the Companies Act with majority government ownership, thus improving oversight and transparency. The National Audit Bill is expected to operationalize the reforms included in the 19th Amendment. It establishes the National Audit Office, and the Audit Service Commission. The legislation also defines other important aspects such as the scope of audit services provided by the Auditor-General, the auditing standards to be followed, the Auditor-General's powers to access information, time frames for submitting audit reports to Parliament. It requires the audit reports to be published on the official website of the National Audit Office. This action is intended to address weaknesses in the legal framework which limited the independence of and scope of oversight exercised by the Auditor General and contributes to improved transparency, better oversight over the use of public resources.

2.3 Cabinet of Ministers has authorized the Ministry of Finance to draft a Public Finance Bill strengthening preparation, execution and oversight of the budget, as well as oversight of public enterprises.

The Cabinet has authorized the Ministry of Finance to take the lead in drafting of the Public Finance Act,. This work will be carried out in conjunction with various stakeholders and consider good international practices relevant to Sri Lanka. The Public Finance Bill will provide the appropriate legal framework for financial management in the public sector, with the aim of covering the full public financial management cycle, including budget management i.e. preparation, approval and execution, borrowings, public debt and guarantees, public investment, cash management, accounting and reporting, internal control and internal audit, system development & procedures and oversight of public enterprises. The Bill will complement the Finance Act no 38 of 1971 and other legislations. It is expected that the passage of the bill will enable the implementation of a comprehensive and sequenced set of reforms, some of which are already underway. These detailed actions are part of a Public Finance Strategy that is currently being developed by the Ministry of Finance.

3. Improving fiscal sustainability

The government is of the view that sustainable fiscal environment is an important condition for an improved investment climate to support competitiveness. It has taken a few key steps in the direction of achieving the policy target of 3.5 percent of GDP fiscal deficit by 2020. The specific measures taken include:

3.1 Cabinet has decided to increase the rates for VAT and Corporate Income Tax rates and remove some of the VAT exemptions.

In order to limit the fiscal deficit in 2016 to 5.4 percent of GDP, the Cabinet has decided to a) VAT: increase the single rate from 11 to 15 percent, remove exemptions for private health services and telecommunications, reduce and unify the threshold, while expanding it to encompass the whole sale and the retail sectors; b) Corporate Income Taxes: the changes approved in the original 2016 budget will be implemented with a higher tax rates on all sectors (17.5 percent instead of 15 percent), while keeping the pre-2016 rates on the financial sector at 28 percent and 40 percent on betting, liquor and tobacco sectors On the expenditures, the government will engage in a strict management of commitments and expenditures. To this end, we have already initiated discussions with the World Bank to rationalize our social safety networks and welfare schemes, which has grown haphazardly over the years becoming a strain on the government's fiscal resources. We are also mindful that these schemes have also significant leakages, duplications and inefficiencies that if

addressed will have a positive impact on the government finances, while facilitating a better and a targeted and a more enhanced social welfare mechanism.

3.2 Cabinet has decided to permanently suspend the approval of new projects under the Strategic Development Project Act of 2008 (SDP Act), as a first step towards repealing the Act.

Previously, the SDP Act allowed the granting of tax holidays and exemptions on income and other taxes on identified large investment projects leading to significant foregone tax revenues due to erosion of the tax base. The 2016 budget announced that there will not be any more projects approved under the SDP Act. While preparations are made to repeal the law to give effect to this announcement, a formal Cabinet decision has been published stating that it would no longer approve new projects under the Act. While the removal of exemptions will have a positive impact on the fiscal space of the government, recognizing that investors also require incentives, in the alternative the government is looking into mechanisms of providing investors with incentives based on the quantum of investment rather than profits as was the case.

3.3 Cabinet has established a Debt Management Committee tasked with defining the terms of reference of a unified Debt Management Unit (DMU) in the Ministry of Finance

The government is planning to set up a unified debt management unit by merging the debt and guarantee management responsibilities of the Department of Treasury Operations, Department of External Resources of the Treasury and the Public Debt Department of the Central Bank of Sri Lanka. In this context given the complexity involved in the setting up of a unified debt management unit at the Ministry of Finance, the Cabinet has sanctioned the establishment of a Debt Management Committee composed of all stakeholders at the Ministry of Finance, Ministry of National Policies and Economic Affairs and the Central Bank of Sri Lanka tasked with defining the parameters of this DMU. It is expected that this DMU will be responsible for development of the debt management strategy and play a leading role in international bond issuance and domestic debt management, including the preparation of an annual borrowing plan. The government believes that this initiative will improve the overall debt management through better coordination and reduce borrowing costs in the medium to long term.

Conclusion

We are mindful that if we do not reform our institutions, and our systems so as to strengthen its competitiveness Sri Lanka will be a victim of the “middle income trap”. As such, it is expected that the implementation of above activities as identified to be prior

actions under the Development Policy Loan will help the country realize its development goals by enabling private sector competitiveness; enhancing transparency and public sector effectiveness; improving fiscal sustainability.

Hence we would appreciate if the World Bank considers the granting of a Development Policy based Loan so as to facilitate the aforementioned reforms and the development programme outlined by the government.

Thank you,

Yours faithfully

R.H.S.Samaratunga,
Secretary to the Treasury

Copy : Country Director - World Bank - Colombo Office

