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Sri Lanka: Report on the Observance of Standards and Codes—Fiscal Transparency Module—Update

This Update to the Report on the Observance of Standards and Codes on Fiscal Transparency for Sri Lanka was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on July 13, 2005. The views expressed in this document are those of the staff team and do not necessary reflect the views of the government of Sri Lanka or the Executive Board of the IMF.

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SRI LANKA

Report on the Observance of Standards and Codes Fiscal Transparency Module: An Update

July 13, 2005

I. Introduction

1. The original fiscal Report on the Observance of Standard and Codes (ROSC) was published in October 2002.[1] During the 2005 Article IV consultation, the IMF staff reviewed developments in the areas pertaining to Sri Lanka's observance of fiscal transparency practices with a view to updating, where relevant, changes in current practices, or describing the implementation of the ROSC's recommendations. For a full description of institutions and practices, and Fund staff recommendations, this update should be read in conjunction with the original report.

2. The implementation of ROSC recommendations has been affected by external and political developments. The general elections in April 2004 caused a hiatus in policy implementation while a new coalition was formed. The new government has a different approach, which has led to changes in some of the policies described in the original ROSC. Responding to the December 26, 2004 tsunami that caused widespread damage and destruction in Sri Lanka has understandably diminished the short-term priority attached to fiscal management reforms.

II. Description of Progress

A. Clarity of Roles and Responsibilities

3. *The original ROSC emphasized the importance of subjecting public corporations to market discipline, developing an overarching privatization strategy, and reforming domestic financing policies to reduce reliance on and increase the transparency of borrowing from captive sources of financing such as the Employees' Provident Fund (EPF).*

4. **The 2003 Fiscal Management (Responsibility) Act (FMRA) has improved the transparency of government fiscal policy**. The act sets specific targets for key macro-fiscal indicators—central government deficit, public debt and government guarantees—as a share of GDP. It requires the government to outline its strategy to achieve these targets annually

[1] The original report *Sri Lanka: Report on the Observance of Standard and Codes—Fiscal Transparency Module* (IMF Country Report No. 02/233, October 2002) is available on the IMF website http://www.imf.org/external/np/rosc/rosc.asp.

and to report on progress against them on a semi-annual basis and immediately prior to an election. The Act does not, however, address the legal framework for the management of public finances envisaged at the time of the original ROSC.

5. **There has been little progress made in eliminating the quasi-fiscal activities of public corporations**. Following the sharp rise in world oil prices, the authorities suspended the petroleum pricing formula that ensured domestic prices reflected market prices in 2004. Prices are now administered with periodic ad hoc adjustments. The government pays subsidies to the petroleum companies for the difference between the underlying formula price and the administered price.[2] Ceylon Electricity Board (CEB) prices continue to be administered at below-cost levels and with cross-subsidization between industrial and domestic sectors. Despite the below market pricing of their petroleum inputs, CEB continues to make substantial losses that are financed through borrowing from public financial corporations and arrears to government and other public corporations.

6. **The focus of public enterprise reform has changed from privatization to restructuring**. The Public Enterprise Reform Commission continues to manage a program of privatizations and divestitures. However, the 14 largest public corporations have now been placed under the control of the Strategic Enterprise Management Agency (SEMA) that has the objective of improving performance of these agencies through restructuring while retaining public ownership. The government has recently announced a policy that privatization of any of these agencies will require a two-thirds majority in parliament.

7. **Some progress has, however, been made in preparing key public enterprises for the introduction of market discipline**. Non-price competition in the petroleum sector has been introduced through the introduction of a foreign-owned second company and negotiations are underway to introduce a third player through further divestiture of the assets of the state-owned petroleum company. A plan is being developed to improve the efficiency of CEB through the separation of its generation, transmission and distribution functions into individual companies. An independent tariff regulator will also be established under the plan.

8. **The government continues to use public financial corporations to subsidize the cost of budgetary financing**. Rupee securities and foreign-currency denominated bonds continue to be placed with state-owned banks and financial corporations, often at below market rates. State-owned banks have often been used to provide financing to loss-making public corporations.

9. **A Revenue Board has been established to improve coordination among the three revenue-collecting agencies**. The plans for the establishment of a revenue authority noted in

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[2] Cash flow problems within the government have, however, led to the accumulation of payment arrears to the petroleum companies, which have been settled, in part, through offsetting of tax liabilities.

the original ROSC were withdrawn by the new administration. The Revenue Board, which is chaired by the Secretary to the Treasury and contains the heads of the three revenue collection agencies, intends to oversee a major program of revenue administration reform. Measures to reduce tax evasion are being implemented, including the separation of assessment and audit responsibilities within the tax administration and the announcement of objective criteria for tax registration.

B. Public Availability of Information

10. *The original ROSC emphasized supplementing budget information through the quantification of quasi-fiscal activities, contingent liabilities, and tax expenditures, and incorporating the activities of local governments and public corporations in fiscal information.*

11. **Some information is now published on contingent liabilities**. The FMRA requires that the government publish information on contingent liabilities; at present, only information on government guarantees is presented, together with analysis of possible external shocks. The government is committed to further improving the availability of this information under its Fiscal Management Reform Program. The budget documentation does not contain systematic quantification or analysis of tax expenditures. However, the government did prepare an internal report in 2003 that estimated the impact of existing exemptions.

12. **Information on the operations of local governments and public enterprises is variable**. The Central Bank of Sri Lanka (CBSL) annual report continues to report summary information on both provincial governments and public enterprises. In 2004, the Budget Estimates document included detailed information on actual and projected revenue, grants, and expenditures of provincial councils. These however were not consolidated with information on central government activities. Information was also provided on transfers to public enterprises, but not on their overall financial position. However, the 2005 budget documentation did not include any of this detail. The budget documentation only contains information concerning central government debt and does not address overall public sector debt. Central government borrowing that is on-lent to development banks for private sector lending (PDI loans) is included in budget estimates, but excluded from the economic classification of the budget outturn even though it adds directly to the stock of central government debt.

13. **Some tsunami reconstruction expenditure will be undertaken outside the budget**. The magnitude of the tsunami-related reconstruction has placed exceptional demands on the implementation capacity of the government. As a result, some grant-financed reconstruction of public facilities will be undertaken outside of the budget. The expenditure is to be coordinated by a specially created agency, the Task Force for Rebuilding the Nation (TAFREN). The authorities are committed to transparent reporting of both on and off budget expenditures related to tsunami construction.

C. Open Budget Preparation, Execution, and Reporting

14. *The original ROSC emphasized the importance of budget estimates within a medium-term framework, showing the medium-term fiscal cost of new and ongoing expenditure programs and tax expenditures, and improving the availability of intra-year fiscal information.*

15. **Analysis of the medium-term macroeconomic framework and fiscal strategy is presented alongside the budget**. The FMRA requires that the government publish a medium term macroeconomic framework and fiscal strategy statement each year that outlines progress towards the targets for public debt and overall fiscal balance and justifies deviations from them. A statement of risks must be included in the fiscal strategy statement. At present, however, the content of this statement has been restricted to quantitative information on government guarantees and a broad overview of possible external shocks.

16. **Budget estimates are now presented in a medium-term framework**. The 2004 budget estimates document that accompanies the budget speech, presents the detailed revenue and expenditure estimates consistent with the medium term macroeconomic framework for the budget year and the two following years. In 2005, only budget year information is presented in this document but a companion medium-term budget framework document presents detailed program-by-program estimates for each government department/ministry.

17. **The FMRA requires a mid-year fiscal position report to be provided to parliament**. This report provides an opportunity to adjust budget appropriations in a transparent manner. This information is supplemented by monthly data posted on the Ministry of Finance website.

18. **The National Procurement Agency was established in 2004 to enhance transparency and accountability in procurement**. The agency has assumed the regulatory functions of the Ministry of Finance over procurement. It is responsible for setting and overseeing standards of public procurement, including externally financed procurement.

D. Assurances of Integrity

19. *The original ROSC emphasized the importance of augmenting the cash accounting system and regular and timely publication of audit reports and moving beyond compliance auditing to an assessment of performance.*

20. **Accounting information is now published regularly on the Ministry of Finance website**. The accounts continue to be prepared on a cash basis without augmentation for accounts payable and expenditure commitments. Annual accounts are externally audited in a timely manner but audit reports are not regularly published.

III. Staff Commentary

21. **There has been considerable progress in a number of areas since the original ROSC**. In particular, the adoption of the FMRA and the regular publication of medium-term macroeconomic and fiscal frameworks is a substantial step forward in terms of fiscal transparency. The development of a detailed medium-term budget framework and the improvements in reporting of intra-year fiscal data are also welcome. However, the gains remain fragile, as demonstrated by the reduction in information provided alongside the budget in 2005. The staff encourages the authorities to continue developing the breadth and quality of budget information in line with the original ROSC recommendations.

22. **However many of the most important issues highlighted by the original ROSC, in particular in the area of reforming relations between the government and public enterprises, remain to be addressed**. Particular priority should be given to developing and publishing a systematic accounting of implicit and contingent liabilities, moving away from using public corporations for quasi-fiscal activities and reducing the reliance of the government on captive sources of cheap budget and public enterprise financing. Producing consolidated accounts of central and provincial governments should also be pursued, in particular if the government is planning further reforms to the system of intergovernmental fiscal relations.