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Staff Country Reports

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

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SRI LANKA

**Report on the Observance of Standards and Codes (ROSC)
Fiscal Transparency Module**

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October 18, 2002

EXECUTIVE SUMMARY

This report provides an assessment of fiscal transparency practices in Sri Lanka in relation to the requirements of the IMF *Code of Good Practices on Fiscal Transparency* based on discussions with the authorities and other organizations, the authorities' response to the IMF fiscal transparency questionnaire, and other sources of information. The IMF *Manual on Fiscal Transparency* (<http://www.imf.org/external/np/fad/trans/manual/>) should be consulted for further explanation of the terms and concepts discussed in this report.

Sri Lanka has achieved a substantial degree of fiscal transparency in several important areas, including the legal and administrative framework for fiscal management, the compilation and publication of detailed accounts for the central government, and the maintenance of separate and aggregate accounts for public corporations. The government is also undertaking additional reforms to improve transparency, including the passage of a new Public Finance Act, the development of a quantitative macroeconomic framework for budget preparation, and the establishment of a unified revenue authority.

The government would benefit from additional reforms to improve accounting and reporting procedures. In particular, more information should be provided on accounts payable and expenditure commitments. The procedures for monitoring intra-year developments and making necessary adjustments should also be more transparent. The relationships between the government and public enterprises should also be more transparent. The initiation and publication of a systematic accounting and disclosure of implicit and contingent liabilities would be a significant improvement. In addition, the strategy and implementation procedures for privatization should be improved. Finally, more attention should be given to audit and parliamentary oversight. The discretion of the cabinet to alter the parameters of tax laws or to spend money without the approval of parliament should be reduced. The Office of the Auditor General should also be strengthened, and audit results should be reviewed and published in a timely manner.

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ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
BOI	Board of Investment
CBSL	Central Bank of Sri Lanka
CEB	Ceylon Electricity Board
CPC	Ceylon Petroleum Company
CWE	Cooperative Wholesale Establishment
EPF	Employees' Provident Fund
ETF	Employees' Trust Fund
GDDS	General Data Dissemination Standards (IMF)
GFS	Government Finance Statistics
GST	Goods and Services Tax
IMF	International Monetary Fund
NSL	National Security Levy
PERC	Public Enterprise Reform Commission
ROSC	Reports on the Observance of Standards and Codes
SDDS	Special Data Dissemination Standards (IMF)
SNA	System of National Accounts (United Nations)
VAT	Value-Added Tax

I. INTRODUCTION¹

1. This draft report provides an assessment of fiscal transparency practices in Sri Lanka against the requirements of the *IMF Code of Good Practices on Fiscal Transparency*. The assessment has two parts. The first part is a description of practice, prepared by the IMF staff on the basis of discussions with the authorities and their responses to the fiscal transparency questionnaire, and drawing on other available information. The second part is an IMF staff commentary on fiscal transparency in Sri Lanka.

II. DESCRIPTION OF PRACTICE

A. Clarity of Roles and Responsibilities

2. **The general government is clearly defined in Sri Lanka.** General government is divided among central, provincial, and local governments, and noncommercial public corporations (Box 1). The classification of public corporations into government departments, noncommercial public corporations, and commercial public corporations lacks a convincing rationale.² Commercial public corporations are not considered part of general government, although they receive some budgetary support and engage in quasi-fiscal activities. The creation of noncommercial public corporations to avoid certain rules in the financial regulations is a source of nontransparency.³ There are also a number of government controlled provident funds for nongovernment workers—most important are the Employers Provident Fund (EPF) and Employees Trust Fund (ETF)—that would be classified as public financial corporations under the GFS and are not accounted for within the scope of government in Sri Lanka.

3. **Government activities are not clearly distinguished from those of public financial institutions and nonfinancial public corporations.** The presence of the state in

¹ Discussions on fiscal transparency were held in Colombo during May 13–22, 2002. The staff team, comprising R. Gillingham, D. Rehm, and A. Annett met with officials from the ministries of finance, education and defense; the Central Bank of Sri Lanka, the Board of Investment; the Inland Revenue and Customs Departments; People's Bank; the Finance Commission; the Employees' Provident Fund; the Public Service Commission; the Public Enterprise Reform Commission; the Chamber of Commerce; the Committees on Public Accounts and Public Enterprises; the Department of Census and Statistics; the Cooperative Wholesale Enterprise; the Mahaweli Authority; the Ceylon Petroleum Corporation; the Ceylon Electricity Board; and the Auditor General.

² For example, a government department administers the railways, while the Central Transport Board, which operates the bus system, is a commercial public corporation. Both receive subsidies in the recurrent budget.

³ Most noncommercial public corporations, or public institutions, function in such areas as agriculture and irrigation; transport and communications; energy and water supply; education; health; and community services. Some of the largest institutions, in terms of budgetary transfers, are the universities, the Mahaweli Authority, which undertakes rural development activities; the Road Development Authority; and the Samurdhi Authority, which oversees the provision of subsidies to households and provides rural banking services.

Box 1. Structure of Government

Government in Sri Lanka consists of central, provincial and local governments, and public corporations. Noncommercial public corporations are part of central government and included in the budget, while commercial public corporations are excluded from the budget.

Central government: There are 184 spending units that prepare their own accounts, including 57 ministries and numerous government departments. Some public corporations, including railways and the postal service, are fully integrated into the budget and form their own government departments.

Noncommercial public corporations: There are 125 statutory bodies in this category, created by acts of parliament. Examples include the development authorities, research institutes, and universities. The noncommercial public corporations are allowed to take financial decisions without being bound by the code of financial regulations. Although they are mostly funded from the budget, some entities have access to their own funds, which are not included in the budget. They have no borrowing powers and are subject to government employment regulations.

Subnational government: Subnational government comprises 8 provincial councils and 310 local authorities (including 14 municipal councils and 37 urban councils). Around 80 percent of expenditure is financed by grants from the central government. On the capital side, three types of grants exist: criteria-based grants, matching grants, and province specific development grants. Over 90 percent of recurrent expenditure is in health and education, and most of this is wages and salaries. The central government determines the number of people to be hired. Local governments have no ability to borrow. There are a number of government noncommercial agencies at the level of the provincial councils.

Commercial public corporations: There are 75 public corporations—both financial and nonfinancial—in Sri Lanka, the vast majority fully owned by the government. Although they receive capital transfers channeled through the budget, they typically do not receive recurrent transfers. These enterprises are bound by the financial control mechanisms of the Finance Act, 1971. Under this act, they have the ability to borrow, within limits approved by the minister of finance. They are unable to invest surpluses outside the treasury without explicit approval, and typically have surpluses appropriated.

the economy is large, with several hundred commercial and noncommercial public corporations, as well as the government, engaging in economic activities. However, quasi-fiscal activities of public financial institutions are limited to some credit schemes providing concessional interest rates for specified purposes such as housing and self-employment. In contrast, extensive quasi-fiscal activities are undertaken by nonfinancial public corporations, many of which operate under administered prices that need not cover the costs they incur in producing services.⁴ The annual reports of these entities do not show the cost of providing noncommercial services. The scope of quasi-fiscal activities has been reduced in recent years. A cost-recovery pricing mechanism was introduced for petroleum prices, the grain

⁴ The three largest commercial public corporations—the Ceylon Petroleum Corporation (CPC), the Ceylon Electricity Board (CEB), and the Cooperative Wholesale Establishment (CWE)—incurred significant losses in recent years, owing largely to quasi-fiscal activities. CPC and CEB were forced to operate under administered prices for petroleum products and electricity, respectively. CWE lost money on the importation of grain, giving to it a monopoly grain miller, and selling it on the domestic market at subsidized prices.

milling monopoly was privatized, and flour prices were liberalized. A flexible pricing policy for electricity is being developed. Indeed, the government is planning on major structural reform and liberalization process, designed to eliminate the quasi-fiscal activities of public corporations.

4. **The privatization process is reasonably transparent, although the objectives of divestiture are complicated and the government sometimes attempts to retain influence.** The Public Enterprise Reform Commission (PERC) manages the privatization process and operates within an established and transparent framework (Box 2). Privatization proceeds are transferred to the consolidated fund. They are typically not earmarked and have been used primarily for debt reduction in the past. There is no general overarching privatization strategy, however, and decisions on how to privatize are taken on a case-by-case basis. The conflicting objectives of privatization—such as the desire to maximize the sales price, sell

Box 2. Privatization Procedures

The government established the Public Enterprise Reform Commission (PERC) in 1996 to formulate and implement the government's privatization and public corporation reform program. The following considerations guide divestiture decisions: whether the enterprise needs private sector management or investment to remain a going concern; whether market competition and private sector ownership will increase efficiency; whether there is any rationale for the government in these sectors; and whether the revenue needs to the government require enhanced privatization. The PERC publishes annual reports detailing its transactions.

Thus far, there have been two waves of privatization. Within each wave, the divestiture process has been undertaken on a case-by-case basis, with a steering committee comprising public and private sector representatives overseeing each stage in the transaction. The following procedure has been established:

- Identify reform options and strategy
- Obtain government approval
- Marketing phase (information memorandum, request for proposals, publicity campaigns)
- Calls for expression of interest by advertising in local and foreign media
- Shortlist potential bidders by a Technical Evaluation Committee
- Distribute bid documents to short-listed parties
- Due diligence: disclosure of proprietary information
- Receiving bid documents with proposed investment and business plans
- Technical and financial evaluation of proposals by a Technical Evaluation Committee (technical proposals are considered first)
- Negotiations
- Cabinet approval for the divestiture to the selected party
- Execution of documents, closure of transaction
- Report to parliament on the divestiture (within three months after the transaction)
- Post-divestiture monitoring (enforcing contracts, regulation etc).

Many enterprises slated for privatization are subject to administered prices. In these cases, the PERC has adopted a phased price correction over time, with the conditions of liberalization set down in the agreement.

the assets quickly, and protect workers and consumers—make it difficult for the government to obtain full value for privatized entities. The logic behind what control—either in the form of equity participation or other special arrangements—the government retains is also unclear. Although annual reports are published, public scrutiny is limited. The government has changed the terms of some privatization sales—for instance by issuing new regulations—after the deal has been completed.

5. **Although the central bank is not fully independent, its relationship with the government is clearly established by law and it operates in an independent manner.** The Central Bank of Sri Lanka (CBSL) is defined as an independent institution under the Monetary Law Act, which specifies its roles in connection with the government.⁵ However, the Secretary to the Treasury does serve on the three-member Monetary Board, which is the central bank's decision-making body. Furthermore, ultimate authority rests with the minister of finance, although this power has not been exercised in decades. The CBSL engages in some minor quasi-fiscal activities—including loan guarantees and unremunerated reserve requirements—the cost of which are not taken into account in the overall fiscal position. Independence has been enhanced in recent years by the reduction in quasi-fiscal activities, as it has moved away from refinancing schemes. The government is also considering an increase in private-sector representation on the Monetary Board. This change would also enhance its independence, but must be structured to avoid any conflicts of interest that might arise from the differing objectives of the private sector and the monetary authorities.

6. **Government regulation of the nonbank private sector is not transparent.** Government regulations are often archaic, inconsistent, and complex. Even if clearly defined in law, the application of regulations can lead to protracted legal proceedings and create significant uncertainty. For example, labor dismissals under the Termination of Employment Act often get mired in court cases making it extremely difficult for firms to fire workers.

7. **Government equity holdings are not published.** The government's involvement in the private nonfinancial sector is limited, restricted primarily to the remaining shares of privatized companies. These holdings are slated for eventual divestiture, but there is no timetable for completing the divestiture.

8. **The allocation of fiscal responsibilities among different levels of government is clearly defined, although areas of overlap exist.** The 13th amendment to the constitution sets out criteria for apportioning funds to lower levels of government, with the aim of balanced regional development. The constitution also allocates certain revenue collection responsibilities—chiefly the turnover tax on retail sales, stamp duties, and motor vehicle licenses—to provincial governments. With limited ability to raise revenue, the vertical imbalance between the center and provinces is met by a system of inter-governmental grants (see Box 1). The criteria for apportioning funds to the provincial governments are reasonably transparent. The central and provincial governments share responsibility for some functions,

⁵ The central bank website is www.centralbanklanka.org.

such as education, health, and agriculture, with the potential for unnecessary duplication. While the 13th amendment allows parliament to set borrowing limits for provincial councils, no such limits have ever been established and no borrowing has been undertaken.

9. **There is no clear demarcation of the roles of the executive and legislative branches with respect to fiscal management.** Article 148 of the constitution invests parliament with full control over public finance. Under the parliamentary system, the legislature typically passes the budget as introduced by the minister of finance.⁶ However, certain items—including debt service, pensions, and the salaries of the President, Chief Justice, and Auditor General—can be authorized without parliamentary approval under the provisions of the Special Law. It can also alter tax laws without explicit parliamentary approval as long as public notice is provided in the official Gazette. Parliament exercises fiscal scrutiny through the Committees on Public Accounts and Public Enterprises. These committees review the report of the Auditor General, which must be submitted to parliament within 10 months after the end of the year. There is no systematic or comprehensive parliamentary scrutiny until this stage, and even then, the reports are not debated in parliament. The role of the judiciary is limited in fiscal matters, although taxpayers can appeal to the courts as the final arbiter in tax dispute cases.

10. **A clear legal and administrative framework governs fiscal management, albeit with some weaknesses.** The framework for the budget is set down in the code of financial regulations, which spell out in detail the allocation of responsibility for the management of public finances between the ministry of finance and the spending ministries. There is no organic budget law, nor any legal mandated schedule for formulating and approving the budget.⁷ Accountability is defined in terms of financial compliance. With the exception of those items specified in the Special Law, public funds cannot be spent without appropriation by parliament, and any increase in spending requires a supplementary appropriation. As long as the Appropriations Act provides for such transfers, and with the approval of the Secretary/Deputy Secretary of Treasury, resources can be reallocated during the year (1) across the recurrent programs under each head of expenditure or (2) from the recurrent component to the capital component of a given expenditure program. No resources can be transferred out of an expenditure component of any program.⁸ A small expenditure contingency is sometimes in the budget, but the Secretary of the Treasury must approve any use of these resources. Financial management emphasizes cash control, making it difficult to track commitments. In the event that resources must be rationed to meet cash constraints, certain areas are protected, including wages, pensions, interest payments, Samurdhi (general

⁶ Article 122 of the constitution specifies that there should be no more than 1 month between the submission of the Appropriations Bill to parliament and its second reading (which is the presentation of the *Budget Speech*).

⁷ If the budget is delayed, parliament may conduct a “vote on account,” which authorizes expenditure to continue at the levels in the preceding budget for three months.

⁸ These transfers, as well as transfers within programs, are governed by the virement procedure detailed in the financial regulations.

welfare) payments, drugs, and defense expenditure. With few exceptions, appropriations lapse at the end of the year; this includes the capital budget. After the end of the year, parliament may approve “unauthorized excesses” that occur occasionally in certain programs, although the late stage of parliamentary oversight (see previous paragraph) makes this problematic.⁹ If the appropriation was available in the previous year, and the procurement process is well advanced, the treasury may authorize the transfer of funds to a deposit account, to be used to make payments for those goods and services ordered in the previous year that arrive at the beginning of the next year.

11. Legislative reforms are forthcoming that should improve the transparency and accountability of financial management. The government intends to replace the existing code of financial regulations with a new Public Finance Act, implemented through clear and specific guidelines, to provide a broad legal framework for public finance. There are also plans to introduce a Code of Best Practices into the Finance Act, which governs the operations of public corporations.¹⁰

12. Extra-budgetary funds are limited. There are a small number of extra-budgetary funds on the list of noncommercial budget corporations. A dedicated tax levied on the export of tea finances the operations of the Tea Board.¹¹ Part of the expenditure of the Export Development Board derives from a levy on imports (see footnote 13). The vast majority of noncommercial public corporations are fully integrated into the budget. Although strictly speaking, the major provident funds are public financial corporations, they share the characteristics of extra-budgetary funds. Moreover, these funds, especially the EPF, have large revenues that the government utilizes as a captive source of budgetary financing in a nontransparent manner.¹²

13. Mechanisms for the coordination of budget and the central bank are well defined. Government deposits are maintained at the central bank and at the two large public financial institutions, the Bank of Ceylon and Peoples Bank; these deposits are managed as a single treasury account. No interest is paid on the government deposits at the central bank. At

⁹ These excesses occur when expenditure on certain programs exceeds the amount appropriated, without treasury approval to reprogram. Treasury circulars forbidding the use of unauthorized excesses are often used as a cash control mechanism.

¹⁰ The code would be mandatory for public corporations, but voluntary for the private sector. The Finance Act currently focuses solely on financial compliance.

¹¹ In the past, when commodity prices were higher, similar funds derived their own revenue from the export of rubber and coconuts. The activity of pure extra-budgetary funds represents less than 1 percent of general government operations.

¹² The EPF is a mandatory, government-controlled, defined-contribution, retirement-saving scheme for the bulk of the nongovernment sector. It is managed by the Monetary Board of the CBSL and financed by contributions of 12 percent of salaries for employers and 8 percent for employees. It invests 98 percent of its financial assets in government securities, including 72 percent in nonmarketable rupee securities. The ETF is financed by a 3 percent employer contribution for nongovernment sector employees and self-employed workers.

any one time, the government can borrow interest free, in aggregate, up to 10 percent of approved revenue for the given year from the central bank. The central bank may only purchase treasury bills in the primary market, but may purchase any government securities in the secondary market. It also manages the public debt through its Public Debt Department; however, this department does not monitor government overdrafts at the Bank of Ceylon and Peoples Bank. There is a current proposal to move the Public Debt Department from the CBSL to the ministry of finance. The CBSL transfers its profits to the treasury at the beginning of each year. However, the procedures for measuring profits, which are detailed in the *Monetary Law Act*, lack transparency.

14. **The legal basis for taxation is clear, although the tax system is complex and contains numerous preferences.** Article 148 of the constitution, which specifies that no tax should be imposed except under a law passed by parliament, provides the legal basis for all taxes.¹³ The Cabinet has the authority to alter provisions in the tax laws without parliamentary approval, however. All revenue collected is credited to the consolidated fund. The tax system is complicated, occasionally imposing multiple taxes on the same transaction, often in nontransparent ways.¹⁴ The Board of Investment (BOI) Act, 1991, grants the BOI the power to override the provisions of the tax laws to provide financial incentives to attract investment. Consequently, a wide-ranging tax incentives regime, outside the main tax laws and available to both foreign and domestic investors, has evolved.¹⁵ Although the BOI establishes criteria for granting preferences, significant discretion remains. In the 2002 budget, the government is making an effort to streamline the tax system, at the same time increasing transparency, by combining the Goods and Services Tax (GST) and the National Security Levy (NSL) into a new value-added tax (VAT), and eliminating the plethora of stamp duties. It has also harmonized the income tax incentives available to firms who do not qualify under BOI programs with those that do, significantly curtailing special treatment.

15. **The reform of tax administration is a government priority.** The responsibility for tax collection is spread among three government departments—the Inland Revenue, the Customs and Excise Departments; and the BOI. The division of responsibilities among these entities is not transparent. For example, the BOI runs a parallel customs administration for its own companies. In addition, the collection of excises on different goods is assigned to both the Excise Department and the Customs Department. The provisions of the tax law are not very well observed, and there is widespread tax evasion due to poor administration. Taxpayer rights and obligations are reasonably clear: manuals on tax laws and regulations are available

¹³ The main tax laws are the Inland Revenue Act, 2000; the Customs Ordinance; and the GST Act 1998. There is no separate tax administration law.

¹⁴ For example, the NSL, which was abolished in the 2002 budget, applied the same rate to domestic goods and services and imports. However, the calculation of the NSL on imports required a 25 percent markup on import value. A second example is the additional 10 percent surcharge on goods subject to the top tariff rate, earmarked for the Export Development Board.

¹⁵ The scale of the operation can be appreciated from the fact that the BOI firms account for 80 percent of exports from, and 65 percent of imports into, Sri Lanka.

to the public and updated regularly. Taxpayer appeal procedures are established in the statutes, and taxpayers can appeal to the courts as a final resort.¹⁶ There is no taxpayers' charter or any special code of conduct for tax officials. To improve administration, the government has decided to combine the major tax administration entities, including the BOI's revenue collection functions, into a single revenue authority.

16. Public servants are subject to a code of behavior. The Code of Conduct for public servants is laid down in the Establishment Code and has provisions related to promotions, discipline, and financial disclosure. Although there are no specific ethical standards of behavior for public servants, the constitution vests the cabinet of ministers with the power to discipline public officers. This responsibility may also be delegated to the Public Service Commission. The Establishment Code is currently being revised.

B. Public Availability of Information

17. Budgetary activities of the central government are covered comprehensively in the budget documents.¹⁷ Transfers to provincial councils are also included in the central government budget. Although the budgetary position of the provincial councils is published in the CBSL Annual Report, it is not consolidated with that of the central government, nor is it included in the budget documents.¹⁸ No systematic records of local governments' fiscal activity are maintained. The budget provides no financial statements for public corporations or extra-budgetary funds.¹⁹ Central government fiscal data are available quarterly.

18. There have been problems with the reporting of defense expenditures in the budget. All defense expenditure is channeled through the budget. The accurate recording of defense is hampered, however, by the fact that many of the expenditures involve large purchases, often on a deferred payment schedule (this is especially true when military conflict escalates, as it did in 2000). Budgeting for deferred payments has been a problem, with payments frequently postponed for lack of cash. Some deals have been entered into without opening a letter of credit, and thus without the knowledge of the ministry of finance. Letters of credit were also opened without treasury approval.²⁰ To ensure all outlays are

¹⁶ In the appellate procedures, the onus of proof falls on the taxpayer. Cases that end up in court often take years to be decided. Under the Customs Ordinance, but not the Inland Revenue Act, the taxpayer has the right to appeal to the Minister of Finance after exhausting the internal appeals process, before taking the case to court.

¹⁷ The budget documents comprise the *Budget Speech*, the three-volume Budget Estimates, and the annual Appropriations Act. The *Budget Speech* is published on the ministry of finance website: www.eureka.lk/fpea.

¹⁸ Provincial councils publish monthly budgetary data for revenue and expenditure, with a two-month lag, although the information is not provided in the standard budget classification.

¹⁹ Although they are not published, the Finance Act (1971) specifies that all accounts of public corporations must be submitted to the Auditor General and reviewed by parliament.

²⁰ There was a particular problem in 2001. In 2000, the authorized provisions were not fully spent because, although the goods were in transit, they did not arrive by the end of the year. In line with the financial regulations, the treasury approved the transfer of these funds into a deposit account, to be used in 2001. This

(continued)

authorized and monitored through the budget in the future, the government has set up a defense spending monitoring committee, responsible to the Prime Minister and minister of finance.²¹

19. **The budget document discloses the main fiscal aggregates for three years prior to the budget year but include no detailed forecasts beyond the budget year.** A complete budget outturn—including revenue, expenditure, financing, and a table of public debt—is published for the past four years. The classification of items changes regularly, and this is not always documented.²²

20. **There is no quantification of contingent or implicit liabilities.** The CBSL compiles, but does not publish, aggregated accounts of the commercial public corporations. However, no attempt is made to evaluate the contingent liabilities that these enterprises impose on the government. The State Accounts Department in the ministry of finance does maintain information relating to contingent liabilities, although it is incomplete and available with a considerable lag. The budget includes only outlays for public service and military pensions, but includes no explicit contributions, by either public servants or the government, to recognize the accrual of new liabilities. Moreover, no attempt is made to quantify the stock of future pension liabilities.

21. **There is no quantification of either quasi-fiscal activities or tax expenditures.** The major quasi-fiscal activities occur through the loss-making activities of the largest commercial public corporations. The CBSL compiles aggregated accounts of the commercial public corporations, and the Committee on Public Enterprises in parliament reviews treasury reports on public corporations. These data provide only indirect evidence of quasi-fiscal activities, however. Qualitative assessments of tax proposals indicating the public policy purpose of each provision, its duration and intended beneficiaries are occasionally provided.²³ Public servants are also exempt from income taxation, and do not typically file returns.

22. **Information on gross public debt of the government is published in the budget.** The level of outstanding gross public debt is presented by instrument, institution, and type. The CBSL Annual Report presents detailed data on gross government debt, by maturity,

amount, Rs 12 billion, was not included in any of the budget documents in 2001, or in any of the tables presenting the overall budget deficit.

²¹ The committee informed IMF staff that that the safeguards in the system are working. No letter of credit can be issued without treasury authorization, and a full schedule of deferred payments on past purchases has been incorporated into the budget. Moreover, no approval for any deferred payment purchases had been granted in 2002 to date.

²² For example, in the 2002 budget, transfers to universities were removed from “other recurrent” and placed in “subsidies and transfers.”

²³ Quantification of tax expenditures is complicated by the fact that many of those who receive tax preferences, especially under the BOI provisions, do not file tax returns.

instrument, institution, and type. It also provides details on foreign loans, as well as ownership of outstanding foreign debt, treasury bills, treasury bonds, and rupee securities.

23. **Formal commitments for more regular publication of fiscal data have been made, but scheduled release dates are not announced.** The Monetary Law Act specifies that before April 30 of each year, economic data, including data related to public finances, should be published in the *Central Bank Annual Report*. There is no pre-announced schedule for the release of fiscal information. However, the *Central Bank Annual Report* is published by April 30 each year. The fiscal data for the previous year used in this report are provisional, even though final expenditure figures are available from Department of State Accounts very soon after publication. Sri Lanka subscribes to the IMF's GDSS data dissemination standards.

C. Open Budget Preparation, Execution, and Reporting

24. **The budget process in Sri Lanka is relatively open.**²⁴ The exception to this characterization is that the existing legal framework does not contain a specific timetable for budget preparation. Rather, the budget calendar is specified in the budget circular issued by the Budget Department of the ministry of finance. This circular also includes spending ceilings for the respective ministries and agencies.²⁵ Recent crises have contributed to delays in presenting the budget to parliament for 2001 and 2002 until after the fiscal year had begun.

25. **The annual budget presentation is more focused on macroeconomic constraints than performance.** The budget presentation contains only administrative and economic classifications, although a functional presentation is prepared. The approach to budget preparation is largely incremental. Budget coverage is fairly comprehensive, and includes all statutory funds. Significant omissions include lending to small and medium-scale enterprises in the economic classification and a statement on contingent liabilities.

26. **The Budget Speech contains a detailed discussion of major policy objectives, particularly with respect to new programs.** In general, however, reporting focuses on financial compliance, with less attention to actual progress in meeting these objectives. This shortcoming should be mitigated with the development and implementation of the medium-term expenditure framework (see paragraph 30).

27. **The overall balance of the central government is the main indicator of the fiscal position in the budget.** The annual budget presentation uses the central government overall balance as the main summary indicator of the government's financial position.²⁶ Information

²⁴ The existing legal framework comprises Constitution of the Socialist Republic of Sri Lanka (1978), the annual Appropriations Act, the Finance Act (1971), and the Financial Regulations (1992).

²⁵ The fiscal year runs from January 1–December 31.

²⁶ However, no analytical table is included in the budget presentation that clearly shows the derivation of the overall balance from the budget estimates.

on provincial governments is limited to a statement of transfers from the central government budget.²⁷ The government considers the financial position of the major enterprises in addition to the central government balance when formulating fiscal policy. The government provides an array of fiscal indicators in addition to the overall balance of the central government, including the primary balance and the level of public debt.

28. Key budget forecasts and macroeconomic assumptions are disclosed in the budget documentation available to parliament. Budget documentation includes data for the three preceding years and projections for key fiscal aggregates for two to three years.²⁸ There is no consolidated list of key macroeconomic assumptions, other than in the budget circular provided to ministries and agencies as part of the budget preparation process. The assumptions are the responsibility of the ministry of finance, although the ministry coordinates with the CBSL in their preparation.

29. A broad statement on medium-term fiscal policy objectives is included in the budget documents. While clear fiscal targets are set for the current year, there is at present no overall medium-term expenditure framework to support formal rolling multi-year estimates. As a result, discussions of fiscal sustainability are generally limited to qualitative statements.

30. Plans call for the development and implementation of a medium-term expenditure framework by 2003. A project supported by the Asian Development Bank (ADB) is providing guidance in improving the budget process starting in 2003, and includes provisions for the development of a comprehensive medium-term framework, which support the integration of the current and capital budgets, as well as the development of more detailed budget categories.

31. A stricter borrowing limit has been implemented for the 2002 budget. The Appropriations Act specifies a borrowing limit for which parliamentary approval is required, and passage of the budget encompasses approval of the borrowing requirement. Prior to this year, the limit applied only to formal borrowing. Beginning this year, however, the limit will apply to all borrowing, even through bank overdraft facilities.

32. Estimates of the impact of new revenue initiatives are clearly distinguished in the annual budget speech. While the budget estimates include provisions for new programs, there is no explicit discussion of the cost of ongoing programs, compared with new policy initiatives, nor are tax expenditures systematically quantified.

33. The budget encompasses all capital expenditure, but it is not well integrated with the recurrent budget. The ministry of finance is responsible for both the current and capital

²⁷ While subnational governments are relatively small at this stage, the legal framework for more devolution of responsibilities has been put into place, and the issue of consolidation will become more important.

²⁸ The projections are published in supporting document entitled *Highlights of the Budget*.

budget. Externally financed expenditure is fully integrated into the budget process as no foreign aid can be utilized without a budgetary provision.²⁹ The capital budget, along with the associated operation and maintenance costs, is based on a public investment plan prepared by the National Planning Department of the ministry of finance. There is no coordination between the recurrent and capital budgets in the preparation stage.

34. No explicit analysis of fiscal risks is performed as part of the budget process. Similarly, information on contingent liabilities is not included as part of the budget package.

35. Internal control procedures are broadly effective, but the accounting system is not capable of generating reports on arrears. The accounting system and payment process are well developed and generally hold actual cash expenditures in line with appropriations (see paragraph 10). Only limited shifts of resources are permitted within the budget year, including from nonsalary recurrent outlays to salaries, and from recurrent spending to capital. In both cases, however, approval from the Secretary of the Treasury is required. Accounting procedures and monitoring focus almost entirely on the cash budget. No direct control is exercised over commitments.

36. Legal frameworks for hiring and procurement are established and followed. Regulations requiring open tendering for public supply contracts are clear, and tender regulations for the procurement of goods and services by the government and the disposal of state assets have been streamlined and strengthened.³⁰ Ongoing efforts in this area focus on ensuring that the tender process is free from political interference, and on making procedures less cumbersome. Procedures governing employment in the public sector are clearly specified, with oversight from the Public Service Commission. The power of the cabinet to place personnel and rescind Public Service Commission orders was revoked with the adoption of the 17th amendment to the Constitution in October 2001.³¹ Vacancies and terms and conditions of employment are advertised by gazette notification, competition in the employment market for positions in the public service has become increasingly competitive.

37. The accounting system produces reasonably complete and accurate in-year reports on central government budget outturn. The consolidated financial accounts of the government are published quarterly and annually. Fiscal reports based on a GFS framework are published with the budget half-yearly and annually, and monthly reports are provided to

²⁹ Loans to small and medium enterprises, typically from the World Bank or the ADB, are excluded from the on-lending part of the capital budget in the economic classification of the budget, even though the government is responsible for servicing them.

³⁰ Improvements include detailed guidelines for the evaluation of tenders, selection of consultants and selection of tenderers, and for identifying exceptions and deviations from the tender procedure. New guidelines and procedures have also evolved for private sector financed infrastructure projects.

³¹ New procedures will be fully implemented once the new commissioners for the Public Service Commission are nominated.

parliament within two months of end-period.³² Outturn data is readily available by economic and administrative classifications. A functional presentation for the year as a whole is published by the central bank. Issues arising from reconciliation of fiscal and monetary accounts can result in classification problems, as discrepancies are posted to “other recurrent” as a residual category.

38. **The primary tax and customs administrations are part of the ministry of finance.** Although no legal guarantee of independence is provided for these agencies, they operate independently as a practical matter.

39. **The legislature does not undertake a mid-year review.** If additional resources are required or desired in a particular program, they can be financed either through supplementary appropriations or savings within other areas of the budget. Except in the limited circumstances discussed in paragraph 35, parliamentary approval is required in both these instances.

40. **The Constitution requires that the Auditor General provide reports to parliament within 10 months of the end of the fiscal year on the final accounts.**³³ The reports of the Auditor General are supposed to be published and made widely available; the 1992 report is the latest available from the Government Printing Office.

D. Assurances of Integrity

41. **Budget estimates are generally unreliable, and the variance between these estimates and the actual outturn is neither analyzed nor explained.** Over the last few years in particular, actual expenditure and revenue have differed significantly and systematically from budget estimates, with capital expenditures generally falling well short of budget estimates.

42. **Although accounting procedures are broadly consistent with international standards, no formal policy statement is provided.** However, a report has been prepared on the proposed modified accrual accounting system and submitted to the Auditor General for comment. The Auditor General has passed on his comments to the State Accounts and Public Finance Departments of the ministry of finance, who are presently studying the proposed changes.

43. **Accounting reports are reconciled with budget appropriations and bank accounts, although at times with a considerable lag.** The same is true for auditing of accounting reports. The State Accounts Department releases budget appropriations and the

³² The relevant websites for semi-annual and annual GFS and budget reports are www.centralbanklanka.org and www.eureka.lk/fpea. Monthly information is also available but has not been updated since mid 2001.

³³ At times, delays in obtaining complete information on expenditures has delayed these submissions to 12 months or more after the end of the fiscal year.

spending units record monthly expenditure data. Monthly budgetary outturns are prepared and checked for internal consistency. Financing is checked with the monetary survey data, and the reconciliation is rigorous: fully reconciled accounts are available, but with a lag of several months.³⁴ Consistency checks are also done with BOI data at regular intervals.

44. **The Auditor General is appointed by the President and answers directly to parliament.** While the Constitution contains no assurances of independence, it does severely restrict the conditions under which the Auditor General can be removed, particularly by the executive branch.³⁵ Reports from the Auditor General are to be provided directly to parliament, and the latter is also responsible for making recommendations to government based on the report, and for ensuring that appropriate follow-up actions are implemented in the review of subsequent reports. The report of the Auditor General is supposed to be published after it is considered by parliament. The relatively passive stance of the legislature is evidenced by the limited efforts to ensure timely publication by the Government Printing Office: the latest published report is for 1992. The Auditor General is considering whether his office should directly disseminate future reports on its own website.

45. **The office of the Auditor General lacks sufficient resources to permit an assessment of government performance against stated objectives.** The Auditor General is required to audit all accounts of government, the offices of cabinet ministers, the judicial services commission, public service commission, parliamentary commissioner for administration, the secretary general of parliament, commissioner of elections, local authorities, and public corporations. The Auditor General has a staff of about 1,000, including 9 fully qualified auditors, and 900 examiners. While the mission was not provided with copies of recent audits, its understanding is that the audit approach, like that of budget monitoring, focuses solely on financial compliance.

46. **External scrutiny of macroeconomic models and assumptions is not invited.** The medium-term framework is only now being established, and the informal approach to projections used to date has not been made generally available. Some information is available, however, in the annual budget speech and background papers.

47. **The national statistics office is given legislative assurance of independence.** Although the Census Ordinance and Statistics Ordinance provide technical independence for the Census and Statistics Department, fiscal data is exclusively compiled and disseminated by the CBSL, and the Fiscal Policy and Economic Affairs Department compile and

³⁴ Monthly differences between expenditures recorded by the State Accounts Department, and that implied by the monetary accounts are generally posted to "other recurrent spending" until additional information is available from ministries.

³⁵ The Auditor General is appointed for an indefinite term, conditional on "good behavior." The power of the executive branch to remove the Auditor General is largely limited to cases of illness and disability, as stated in Article 153 of the Constitution.

disseminate fiscal data—both departments come under the purview of the ministry of finance.

III. IMF STAFF COMMENTARY

48. **Sri Lanka has achieved a substantial degree of fiscal transparency in a number of important areas, including:**

- The legal and administrative framework for fiscal management is reasonably well developed and appears to be closely observed in practice. This framework covers not only the activities of the central government, but also those of provincial governments and public corporations.
- The government compiles and publishes detailed fiscal accounts for the central government. These accounts provide comprehensive coverage of the government's fiscal transactions with the full array of public corporations. In addition, all inflows from donor organizations are funneled through the budget, and detailed information is published on the structure of government debt.
- Separate and aggregate accounts are maintained for public corporations. These accounts clarify the extent of explicit public-sector liabilities.

49. **The government has announced its intention to undertake the following reforms—to which the staff would assign high priority—that will further improve transparency:**

- The proposed new *Public Finance Act* would rigorously codify the rules for the formulation and execution of the budget. It should provide a vehicle for rectifying existing shortcomings, such as the lack of a legally specified calendar for budget preparation.
- Starting with the 2003 budget, the authorities plan to *prepare and present the budget within a quantitative macroeconomic framework*. This framework should be used as the basis for systematically integrating the capital and recurrent budgets, which, in turn, would support the development of a programmatic budget. This should also improve the reliability of budget estimates and reduce the need for intra-year adjustments.³⁶
- The proposed *new revenue authority* would combine the functions of the Inland Revenue, Customs and Excise Departments, as well as the revenue collection

³⁶ It should be noted that this initiative will require improved capacity within the ministry of finance to both formulate and implement the budget within a multi-year, macroeconomic framework.

functions of the BOI into a single revenue authority to make revenue collection both more transparent and more efficient.

- A number of measures to subject public corporations to market discipline and streamline their regulation have been proposed. These measures range from liberalization of the market for imported petroleum products to the establishment of a new energy regulatory agency to regularize and depoliticize the procedures for setting the prices charged by government-owned energy monopolies.
- *Proposed amendments to existing labor laws* would streamline the settlement of labor disputes and make outcomes more predictable.

50. **Additional reforms will be needed to achieve the basic requirements for fiscal transparency.** These reforms fall into the areas of accounting and oversight, relations between the government and public enterprises, parliamentary oversight, and audit. Within each group, the recommended reforms are listed in order of priority.

51. **With respect to accounting and reporting, the following measures are recommended:**

- **The budget should provide explicit estimates of the cost of ongoing programs as well as the revenue cost of new and existing tax preferences.** As noted in paragraph 49, the proposed multi-year budget framework should facilitate the development of a programmatic budget. This, in turn, will facilitate the estimation and reporting of the cost of ongoing programs and tax expenditures.
- **The current cash accounting system should be augmented to provide information on both accounts payable and expenditure commitments.** The additional information should be used to eliminate the current use of deposit transfers for treating pending orders. The cash accounting system should also be modified to allow the settlement of pending accounts within a reasonable time after the end of the fiscal year to be included in the accounts for that year.
- **A transparent system for intra-year adjustments to the budget should be developed.** Instead of ad hoc supplementary budget appropriations, a mid-session review of the budget should be introduced, supported by a detailed compilation and dissemination of information on year-to-date budget execution.
- **Additional intra-year budget data should be published in a timely fashion.** The latest update currently available on the ministry of finance's website is for November of 2001.

- **A set of consolidated accounts for the central and provincial governments should be compiled and disseminated on a timely basis.** Eventually, the consolidated accounts should also reflect the fiscal activities of local governments.³⁷

52. **Relations between the government and public enterprises can be further clarified by adopting the following measures:**

- **A systematic accounting of implicit and contingent liabilities should be initiated and published.** In particular, the government should quantify the accrual of implicit pension liabilities for public servants and the military. In addition, the information on contingent liabilities currently maintained by the State Accounts Department should be compiled and disseminated on a regular basis. Finally, any quasi-fiscal activities should be clearly identified, quantified where possible, and subject to public scrutiny.
- **An overarching strategy for privatization should be developed.** Those functions that should be transferred to the private sector and those that should remain the purview of the government should be clearly identified. A timetable should be established, and criteria for determining the residual role of the government (including the ultimate level of public ownership and whether the government should retain any special prerogatives), as well as any transitional regulations (including with respect to pricing policies) should be clearly specified. Finally, ex post modifications of the terms of privatization should be avoided to the maximum extent possible.
- **The process of weaning the government from captive sources of financing—especially the EPF—should be given high priority.** Steps toward that end include (1) the establishment of a separate board of directors for the EPF, (2) a transparent tie between the interest rate paid on rupee loans to that paid on marketable securities, (3) explicit recognition of implicit subsidies and taxes when the rupee interest rate is not tied to marketable rates, and (4) consideration of permission for the EPF to diversify at least a portion of its portfolio internationally.

53. **Parliament should pursue its oversight role more actively.** In particular, it should reduce the discretion of the Cabinet to alter the parameters of tax laws or to spend money without the approval of parliament. Tax laws should not be changed without an open, public hearing. The lists of exemptions to parliamentary approval in the Special Law should be reduced as much as possible.

54. **The audit process should be strengthened in two important areas:**

- **Official audits should assess the degree to which government programs and performance are consistent with the objectives outlined in the budget speech.**³⁸

³⁷ A survey of local governments has been planned to determine the extent of own revenue and expenditure at this level of government.

Additional staff will be required in the Office of the Auditor General to meet this additional requirement.

- **The reports of the Auditor General, as well as the recommendations made by parliament in response to the reports, must be published in a timely fashion. In addition, the response of the government to any recommended changes in procedures should be systematically monitored and evaluated.**

³⁸ To promote this goal, an audit act is currently being formulated with the assistance of the World Bank.