



SRI LANKA

SELECTED ISSUES

June 2024

This Selected Issues paper on 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 May 29, 2024.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: <http://www.imf.org>

International Monetary Fund
Washington, D.C.



SRI LANKA

SELECTED ISSUES

May 29, 2024

Approved By
Sanjaya Panth

Prepared by Yuanyan Sophia Zhang (APD), Dmitriy Rozhkov (FAD), Joel Turkewitz, Paula Zarazinski (both LEG), and Azar Sultanov (RES).

CONTENTS

GOVERNANCE AND GROWTH: LESSONS AND POLICY IMPLICATIONS	2
A. Introduction	2
B. Overview of Corruption Vulnerabilities and Governance Weaknesses in Sri Lanka	4
C. Channels: Macroeconomic Impact of Anti-corruption and Governance Reforms	8
D. Quantitative Illustration: Macroeconomic Impact of Governance Reforms	9
E. International Experience	17
F. Conclusions and Policy implications	21
References	23
BOX	
1. Debt, Investment and Growth (DIG Series) Model	11
FIGURES	
1. Corruption Vulnerabilities, 2012–2022/23	5
2. Fiscal Governance	6
3. Central Scenario: Macroeconomic Impact of Governance Reforms	14
4. Central Scenario: Impact of Governance Reforms on Income Distribution	15
5. Alternative Scenarios: Growth Impact of Governance Reforms	16
6. Alternative Scenarios: Growth Impact of Structural and Governance Reforms	17
7. A Turnaround Story: Tax Revenue and Control of Corruption	18
TABLES	
1. Corruption Vulnerability Indices	4
2. Mapping Governance Reforms to Economic Distortions	12

GOVERNANCE AND GROWTH: LESSONS AND POLICY IMPLICATIONS¹

The crisis uncovered Sri Lanka's deep-rooted governance issues and corruption vulnerabilities. The authorities are committed to addressing these challenges and have taken initial steps on governance reforms under the EFF program, following recommendations from the IMF Governance Diagnostic Report. General equilibrium simulations imply significant macroeconomic benefits from these reforms, especially when they are implemented in a comprehensive and coherent manner. International experience highlights that sustained anti-corruption and governance reform efforts, supported by strong political ownership, civil society engagement, and technical and financial assistance can improve the state capacity to perform core functions, fostering a conducive environment for sustainable growth.

A. Introduction

- 1. The crisis opened a window of opportunity for Sri Lanka to address its corruption vulnerabilities and governance weaknesses.** Since the economy was hit by a severe economic crisis, the authorities have adjusted macroeconomic policies and introduced important reforms in their effort to put the country on a sustainable recovery path. Despite recent signs of stabilization, the economy is still facing significant challenges that could derail its early recovery and hinder long-term growth potential. Most notably, Sri Lanka faces systemic and severe corruption vulnerabilities and governance weaknesses, which have caused economic inefficiencies in the areas of tax collection, public investment, credit allocation. Addressing these structural challenges is particularly important to lock in the hard-earned economic gains from the policy correction and to promote long run prosperity.
- 2. Important steps have been taken to kickstart a comprehensive governance reform agenda.** The authorities' IMF-supported EFF program embarked on important anti-corruption and governance reforms. For example, the new Anti-corruption Bill, enacted in August 2023, strengthens the asset declaration system and the Commission to Investigate Allegations of Bribery or Corruption (CIABOC)'s investigative powers. The Governance Diagnostic Report (GD report), the first in Asia, was published in September 2023, followed by the authorities' publication of their action plan to implement the key recommendations highlighted in the GD report. These initial steps are important to set the stage for effectively implementing more comprehensive and sustainable reforms going forward.
- 3. The literature highlights the economic benefits of improving governance and tackling corruption vulnerabilities.** Cross-country analysis (IMF 1998) shows that deterioration in corruption or governance quality is associated with lower investment and fiscal revenue, higher inequality, and

¹ Prepared by Yuanyan Sophia Zhang (APD), Dmitriy Rozhkov (FAD), Joel Turkewitz, Paula Zarazinski (LEG), and Azar Sultanov (RES). Ruihua Yang provided excellent inputs and research assistance. Authors thank Peter Breuer and Katsiaryna Svirydzenka for guidance and the authorities and participants for helpful feedback at the seminar during the Article IV Consultation and Second Review mission.

less inclusive growth. Sandri (2017) and Markevych and Marinkov (2023) estimated that if corruption is reduced to the levels seen elsewhere in the region, Ukraine and Moldova could raise per capita GDP growth by about 0.85 and 0.6 percent respectively, which could significantly contribute to speeding up economic convergence towards the European Union. Many recent papers also analyze the impact of governance reforms on the macroeconomy using the dynamic general equilibrium model (DIG-series: Debt, Investment Growth Models) which captures the channels of reform impact. For example, Gurara et al (2019), Melina (2019), and IMF policy paper (2023) show that governance reforms boost growth through enhancing public investment efficiency, revenue mobilization, and reducing firms' distortions. In the case of Congo (Melina et al 2019) and Iraq (Melina and Cantelmo 2019), depending on the magnitude of the implemented reforms, growth could increase by about 0.8 to 2 percent per year over the next 10 years, and debt could decline by 2 to 3 percent of GDP annually over the same period.

4. The literature finds that comprehensive reforms, for example fiscal and legal reforms, are associated with improving governance and reducing corruption. Cross-country empirical analysis (IMF 2023, IMF 2019) reveals that several indicators of good fiscal governance are significantly associated with improved control of corruption. For instance, indicators of fiscal transparency², quality of public financial management³, and tax administration processes⁴ are significantly correlated with a perceptions-based indicator of control of corruption. These results confirm findings from individual-level studies (usually based on information at the level of an individual country, reform, or project), which linked good practices in public financial management, procurement, audit agencies, and tax administration to lower corruption (Johnson and others, 2012; World Bank 2012, DIFD 2015). On legal reforms, Lorenzani and Lucidi (2014) found that the judicial reforms that rationalize the organization of courts, foster investment in in-court ICT and introduce incentives to reduce excessive litigation rates could enhance entrepreneurial activity and promote FDI.

5. This paper aims at quantifying the economic benefits of comprehensive governance reforms through model simulations, supported by selected case studies. Section B provides an overview of the corruption vulnerabilities and governance weaknesses in Sri Lanka. Following the discussion of a theoretical framework that illustrates the channels through which governance reforms generate economic gains in section C, Section D quantitatively simulates the macroeconomic impact of governance reforms using a dynamic general equilibrium model under alternative reform scenarios. Section E complements the simulation with case studies. Section F concludes with policy implications.

² Constructed by staff from systematic questionnaires assessing public access to comprehensive fiscal information; independence and quality of audit processes; etc.

³ From questions about the quality of expenditure controls and procurement, etc.

⁴ Based on questions about limits to personal interactions between taxpayers and officials, limits to discretionary powers of tax officials, etc.

B. Overview of Corruption Vulnerabilities and Governance Weaknesses in Sri Lanka

6. Published Governance Diagnostic Report and Third-party indicators (TPI) point to the systemic nature of corruption in Sri Lanka. Corruption encompasses various forms, ranging from petty corruption, which involves small-scale bribes to officials by individuals or firms for specific transactions, to corruption at the regime level across the political system and public institutions, involving more extensive networks of public and private actors. Perception-based TPIs from well-known sources (Figure 1) and the 2023 Governance Diagnostic Assessment suggest that corruption vulnerabilities in Sri Lanka are not limited to petty corruption but also reflects systemic abuse of public power across the political system and government agencies⁵. Systemic corruption in Sri Lanka, captured by the Regime Corruption Index (RCI), was higher than an average Asian country in 2022. In addition, corruption vulnerabilities in Sri Lanka appeared to have increased from 2012 to 2022. While comparable to lower-middle income countries and South Asian peers, corruption in Sri Lanka was perceived to be more prevalent than average higher-middle income countries and Asian peers in 2022. Sri Lanka has implemented key governance reforms recently under the EFF, but sustained change takes time to be achieved and accurately captured by TPIs after 2023.

Table 1. Sri Lanka: Corruption Vulnerability Indices

(lower value higher corruption for ICRG, CPI and WGI; higher value lower corruption for RCI)

Corruption Index from the International Country Risk Guide (ICRG) ranges between 1 and 6 and captures actual or potential corruption in the form of excessive patronage, nepotism, job reservations, 'favor-for-favors', secret party funding, and suspiciously close ties between politics and business.

Corruption Perception Index from Transparency International (CPI) ranges from 0 to 100 and is constructed by averaging 12 different data sources that capture the perceptions of businesspeople and country experts about the level of corruption in the public sector.

Control of Corruption indicator from the Worldwide Governance Indicators (WGI) ranges from -2.5 to +2.5 and is constructed by aggregating multiple underlying data sources. It captures "perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as capture of the state by elites and private interests."

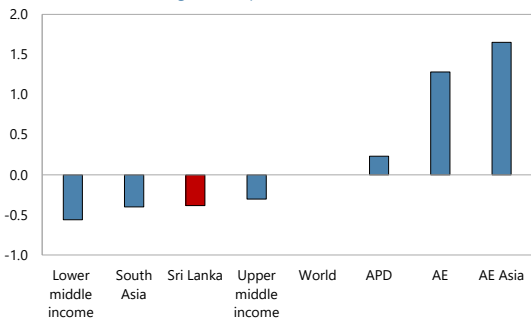
Regime corruption index from V-DEM Database (RCI), based on expert judgement from a pool of 3700 country experts, ranges from 0 to 1 and captures systemic (grand) corruption in the political system and public sector, which can be broken down to executive, judicial, legislative, and public sector corruption.

⁵ Sri Lanka Governance Diagnostic Report by IMF 2023 provides elaborate assessment of corruption vulnerabilities and governance weaknesses. [Sri Lanka: Technical Assistance Report-Governance Diagnostic Assessment in: IMF Staff Country Reports Volume 2023 Issue 340 \(2023\)](#)

Figure 1. Sri Lanka : Corruption Vulnerabilities, 2012–2022/23

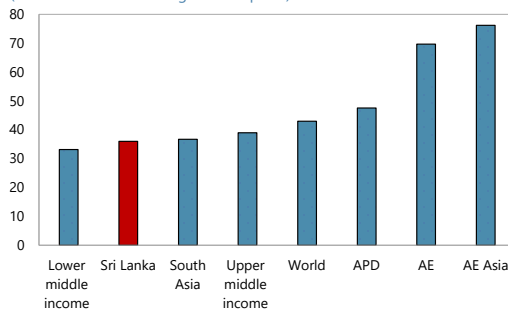
World Bank Control of Corruption, 2022

(Lower values indicate higher corruption)



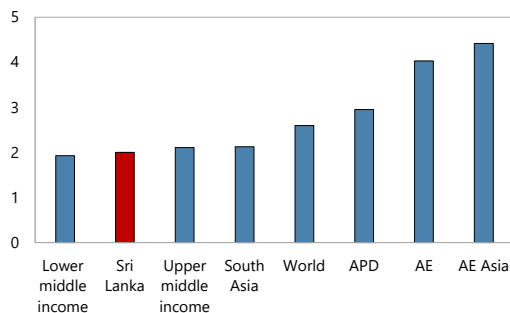
Corruption Perception Index, 2022

(Lower values indicate higher corruption)



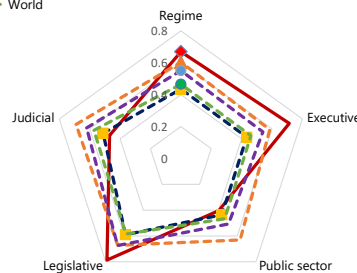
ICRG Corruption Index, 2023

(Lower value indicate higher corruption)



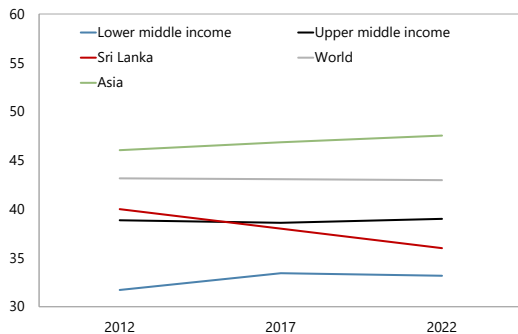
Regime Corruption

— Sri Lanka
 - - Upper Middle income
 - - World
 - - Lower Middle Income
 - - Asia



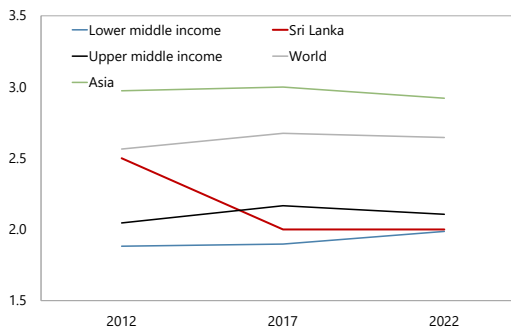
Corruption Perception Index, 2012-22

(Lower values indicate higher corruption)



ICRG Corruption Index, 2012-22

(Lower values indicate higher corruption)



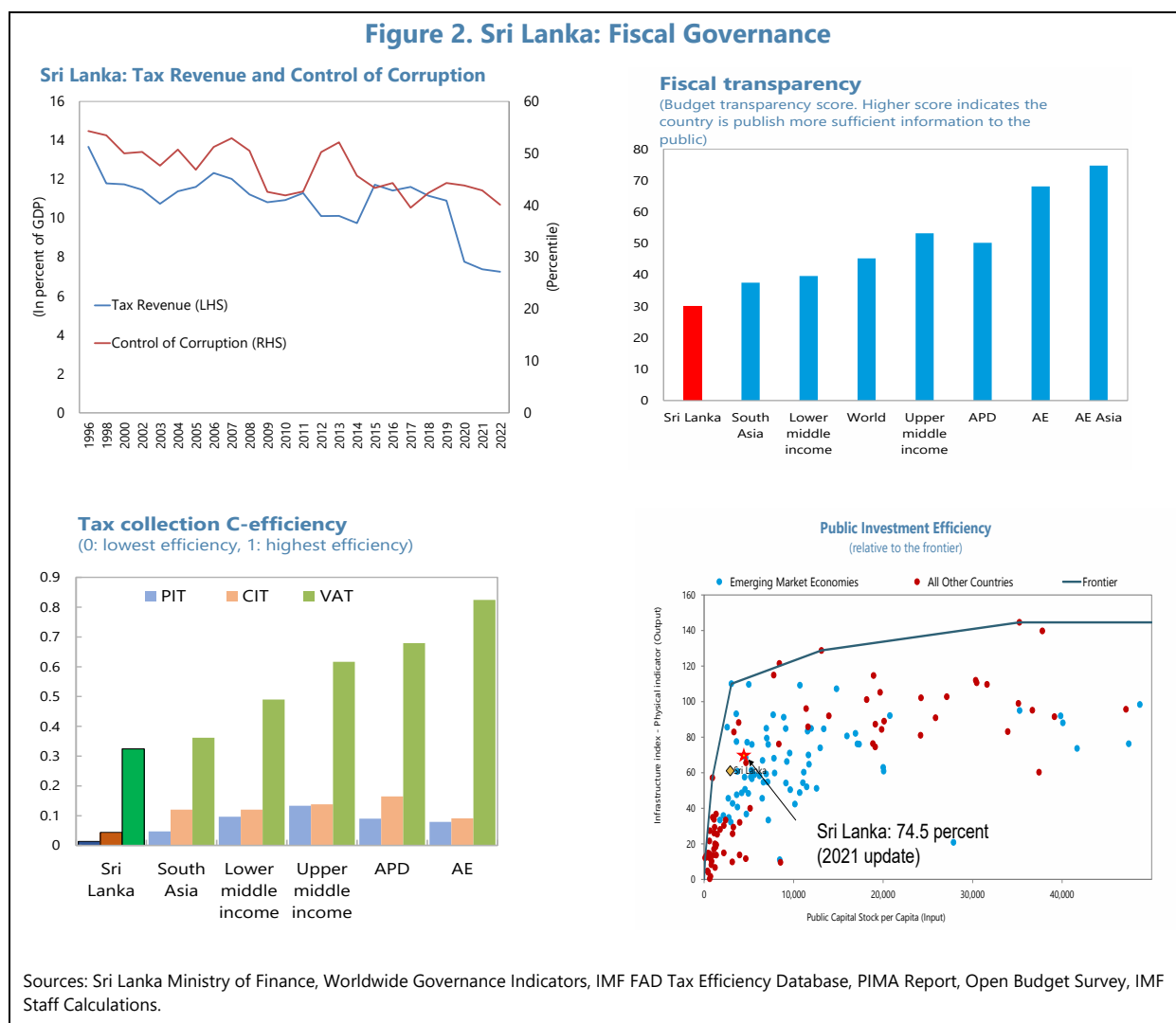
Sources: World Bank, Transparency International, PSG Group, V-DEM.

1/ Use of these indicators should be considered carefully, as they derived from perceptions-based data.

2/ The WGI aggregates information from various sources, including surveys of households and firms, commercial business information providers, non-governmental organizations, and public sector organizations. Transparency International's Corruption Perception Index (CPI) aggregates data from a variety of different sources, including expert assessments and opinion surveys from institutions such as the World Bank, World Economic Forum, and private risk assessment firms. The International Country Risk Guide (ICRG) Corruption Index combines expert analysis and survey responses, considering factors such as the presence of corruption in the political system, the degree to which government officials are held accountable for their actions, and the impact of corruption on business operations and economic stability. V-Dem gathers data from expert surveys, typically involving five experts per country-year observation, to assess various democracy indicators. These expert judgments are aggregated using a Bayesian measurement model, which accounts for biases and uncertainties, converting ordinal expert ratings into continuous latent scales to provide reliable point estimates and credible intervals for each indicator. The Regime Corruption indicator uses V-Dem data to assess to what extent do political actors use political office for private or political gain.

3/ Lower value indicates higher corruption for all indicators except for regime corruption where lower scores indicate a normatively better situation.

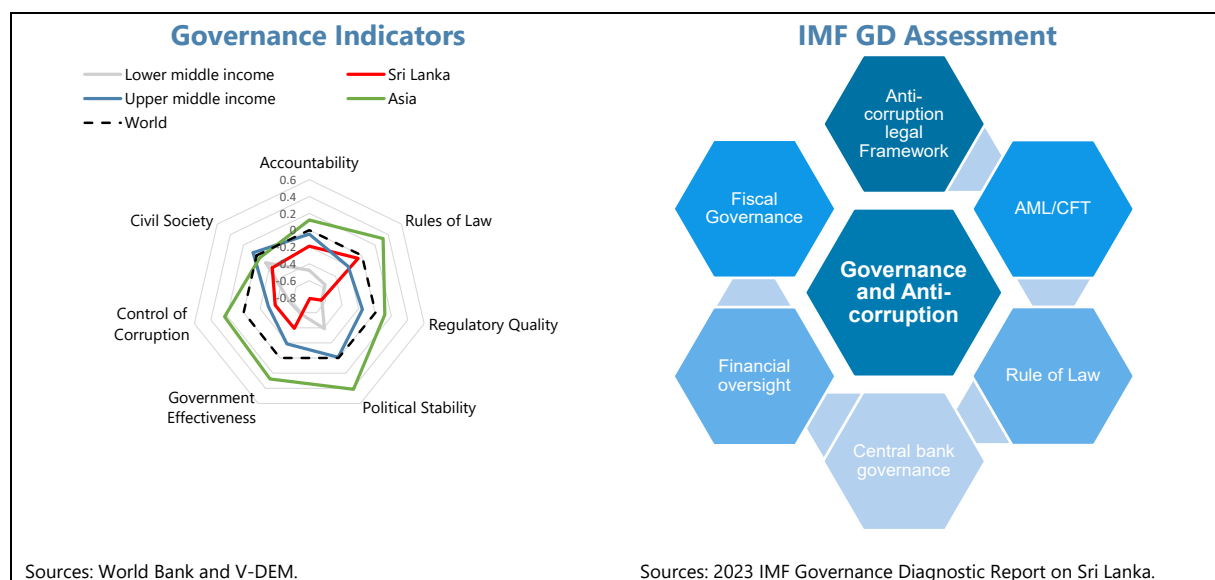
7. Pervasive corruption and fundamental governance weaknesses could imply significant fiscal and economic costs. Based on the TPis, corruption is perceived to have increased from 2012 to 2022. Tax revenue declined sharply from the pre-crisis 10-12 percent on average to less than 8 percent in 2022 as many taxpayers dropped out of the tax net (Hellwig and Vitek 2021)⁶. Weak fiscal performance can be linked to the governance challenges associated with limited transparency and low tax collection efficiency (Figure 2), that may lead to questionable policy choices, limited capacity, and weak accountability. A Governance Diagnostic Assessment (GDA) identified severe corruption vulnerabilities in revenue administration associated with weak accountability, lack of systemic approach to promote integrity, human interaction between taxpayers and tax officials, and fragmented tax expenditure management. The GDA and Public Investment Management Assessment (PIMA) 2017 also highlighted weaknesses in budget credibility and inefficient public investment management (PIM) due to lack of transparency, accountability, and competitiveness in all stages of PIM.



Sources: Sri Lanka Ministry of Finance, Worldwide Governance Indicators, IMF FAD Tax Efficiency Database, PIMA Report, Open Budget Survey, IMF Staff Calculations.

⁶ VAT registrations declined by over 70 percent and non-corporate income tax by about 30 percent in 2020.

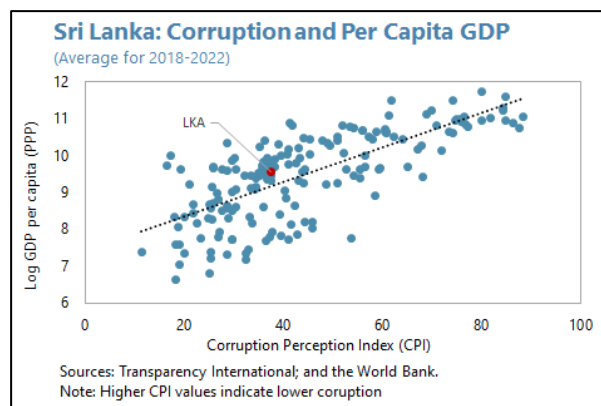
8. Addressing governance weaknesses and corruption vulnerabilities across macro-critical areas, in a comprehensive manner, is particularly important. The GDA points to key governance weaknesses and corruption vulnerabilities across six main areas (anti-corruption legal framework, AML/CFT mechanisms, fiscal governance, financial oversight, rule of law, and Central Bank governance) with important macroeconomic implications including on budget credibility and transparency, public investment management, SOE oversight, revenue administration, and financial regulation. Common themes highlight critical governance gaps in the areas of accountability, transparency, and independence in governance practices. These gaps need to be addressed with a holistic approach supported by engagements with civil society and international partners. The Worldwide Governance Indicators (WGI)⁷ and Varieties of Democracy (V-DEM) indicators also confirm governance gaps in the above areas with particular emphasis on policy continuity, accountability framework, regulatory framework, and civil society (CSO)'s participation and influence on policy decisions.



⁷ Among the governance indicators, accountability, rules of laws, control of corruption, government effectiveness, political stability, regulatory quality are from the WGI. Civil society and regime corruption are from V-DEM (1) Accountability captures perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media; (2) Regulatory quality captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. Political Stability measures perceptions of the likelihood of political instability and/or politically motivated violence, including terrorism. Rule of law captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. Government effectiveness captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. Control of corruption is explained above. Civil society captures whether major CSOs routinely consulted by policymaker; how large is the involvement of people in CSOs; are women prevented from participating; and is legislative candidate nomination within party organization highly decentralized or made through party primaries?

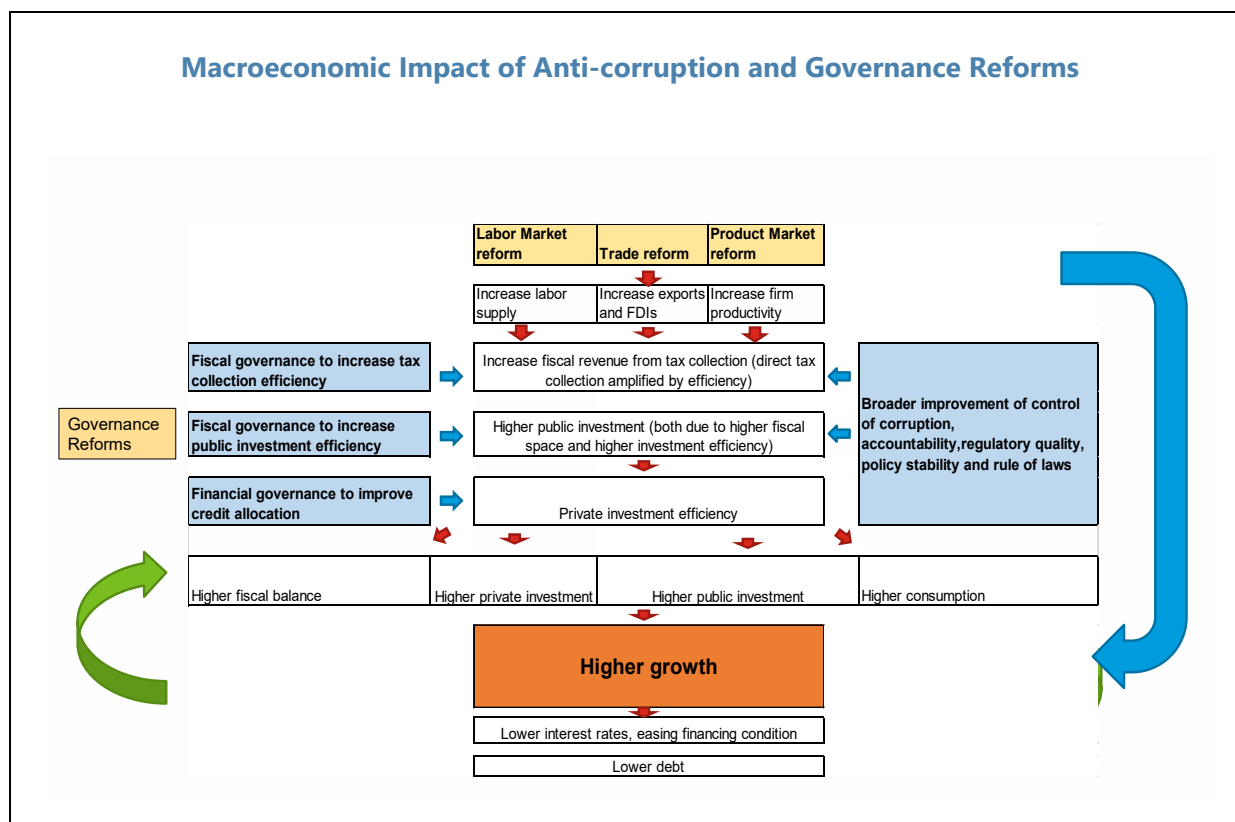
C. Channels: Macroeconomic Impact of Anti-corruption and Governance Reforms

9. Corruption is costly. Corruption reduces the government’s ability to perform core functions that are relevant to the economic activity. It can undermine taxpayers’ willingness to comply with the tax system and reduce the efficiency of spending programs. Corruption can also lead to inefficient resource allocation. For instance, it distorts the level playing field for productive firms to access credit and other public resources. Besides the economic costs, pervasive corruption weakens social cohesion and reduces trust in the government, which can result in economic, social, and political instability. The negative relationship between corruption and growth is well-documented in the literature.



10. Comprehensive anti-corruption and governance reforms can improve growth potential through several channels (Diagram 1).

- **Tax collection efficiency.** Fiscal governance and anti-corruption reforms that aim at improving tax revenue collection efficiency (for example on-line tax portal, anticorruption measures across revenue agencies) help increase fiscal revenue to support inclusive and growth-enhancing expenditures (e.g., capital expenditure or targeted social support). The rest can be used to pay down debt. Improved fiscal sustainability in turn lowers sovereign risk premium and borrowing costs.
- **Public investment efficiency.** By improving the public investment efficiency (for example through PFM reform), more public infrastructure can be built to support economic activity for example by attracting tourism, improving labor mobility, and increasing industrial production capacity.
- **Efficient access to credit and public resources.** Reforms that aim at facilitating a level playing field for the private sector to access credit and public resources (e.g., strengthening the anti-corruption legal framework and Commission to Investigate Allegations of Bribery and Corruption (CIABOC)’s operational capacity, improving governance structure of state-owned banks and creating rules for allocations of rights on public assets) can help promote private investment.
- **Better business environment.** Comprehensive governance reform package, including to strengthen contract enforcement and property rights protection, helps rebuild public trust in the government and improve the business environment. This can help attract foreign investment and facilitate technology transfer through trade and FDI, leading to higher productivity and more opportunities to integrate in the global value chain and upgrade value added.



D. Quantitative Illustration: Macroeconomic Impact of Governance Reforms

11. The macroeconomic implications of governance reforms can be assessed using the Debt, Investment, Growth (DIG-series) model. The general equilibrium model, which captures interactions across economic agents, estimates the impact of governance reforms on macroeconomic outcomes (Box 1) by reducing economic distortions in three main areas: (i) a reduction in bribes and other distortions that discourage private firms from investing and expanding; (ii) an improvement in public investment efficiency that facilitates an increase in the public capital stock; and (iii) an improvement in tax revenue mobilization that reduces evasion and widens the tax base.

12. The model, including three main economic distortions, is calibrated based on Sri Lanka's country-specific conditions. Steady states are set to historical averages before the start of the COVID period. Three distortions are calibrated in the following ways. First, private investment distortion is calibrated to reflect the difference between actual and benchmark private-investment-to-GDP ratio (average for EMs based on Aligishiev et al. 2023) conditional on steady state of other variables). Second, public investment efficiency is 74.5 percent based on 2017 PIMA report. Third, tax collection efficiency is estimated at 32 percent for VAT based on IMF FAD tax efficiency database. Key indicators of economic structure, such as exports-to-GDP ratio and the share of consumption tax in total fiscal revenue, are based on the latest available data.

13. The model demonstrates how comprehensive governance reforms could contribute to reducing economic distortions. The model does not simulate the impact of specific governance reforms; rather, it considers a set of governance reforms that could jointly contribute to lowering the economic distortions to benchmark levels. For example, a combination of fiscal governance reforms that improves revenue administration and reduces corruption across revenue agencies supported by a stronger legal framework and accountability of public institutions serves to improve the tax collection efficiency (specific mapping methodology in Table 2). The model then simulates the macroeconomic impact of improving tax collection efficiency to the benchmark level assuming these reforms are successfully implemented. Table 2 is not an exclusive list of reforms that would contribute to reducing economic distortions; for example, institutional challenges associated with human capacity across revenue agencies, regulatory and administrative challenges, and technology adoption are not captured in the model. However, governance reforms play crucial roles.

14. Multiple scenarios illustrate the economic gains from different types of governance reforms that are phased in at different paces and depths.

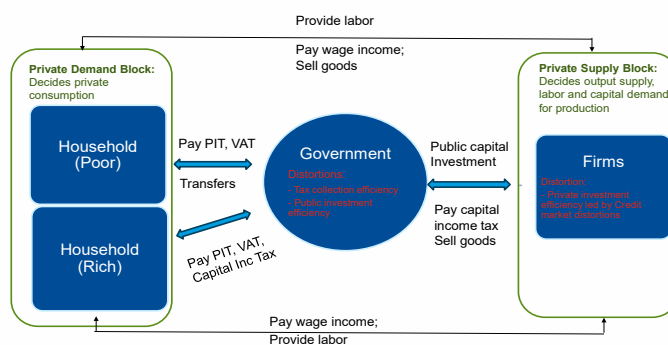
- **Central scenario** assumes that reforms are gradually phased in over 5 years with economic distortions reduced to benchmark levels. That is, tax collection efficiency is improved to higher-middle income class, public investment efficiency increased to 95 percent, and private investment distortion reduced by half.
- **Alternative scenario 1 (Alt S1)** assumes slower reform progress; that is, distortions are gradually reduced over 10 years rather than 5 years (the central scenario).
- **Alternative scenario 2 (Alt S2)** simulates deeper and more ambitious reforms that close all private investment distortion gaps and increase the tax collection efficiency to advanced economy level.
- **Alternative scenario 3 (Alt S3)** assumes immediate partial reversal, reversing half of the reform efforts in the first 5 years.

Box 1. Debt, Investment and Growth (DIG Series) Model

The Debt, Investment, Growth (DIG model) is extended to analyze macroeconomic impact of governance reforms accounting for country-specific characteristics.¹ Over the past decade, the DIG model and its extensions such as DIGNAR and DIGNAD² have been widely used among emerging and developing countries (over 70 countries) to analyze the macroeconomic impact of governance and other structural reforms.

The DIG-series model captures the channels through which reforms affect economic outcomes by capturing the interactions among the main economic players. Two types of households decide the amount of consumption and labor supply. The hand-to-mouth or poor households' budget is constrained by wage income and government transfers net of tax payable; and the Ricardian or rich households have access to capital markets on top of wage income. Firms optimally choose their private capital and labor inputs and leverage public capital to produce tradable and non-tradable goods. The government levies income taxes to finance public investment and pay off debt.

Model: Building Blocks



Three economic distortions generate economic loss, which can be mitigated by governance reforms.

- First, standard profit maximization implies that the return to private capital equals to the marginal product of capital, which can be distorted (private investment distortion is (κ)) by the additional cost associated with the time and resources wasted by entrepreneurs to bribe government officials to obtain access to credit and public resources (e.g., electricity, infrastructure, etc.). $R_t^k = (1 - \kappa) \frac{\partial f(\cdot)}{\partial K_t}$
- Second, public investment efficiency (ϵ_t) determines the fraction of government capital expenditures that translates into productive public capital. Weak governance reduces the efficiency of public investment which translates into a lower stock of public capital being accumulated and lower output. $K_{t+1}^G = (1 - \delta^G)K_t^G + \epsilon_t I_t^G$
- Third, inefficiencies in revenue administration and tax policies lead to loss of tax revenue. Tax collection inefficiency (ϑ) reduces government resources for financing growth enhancing expenditures such as capital investment and targeted social transfers, and to improve debt dynamics.

$$B_{t+1} = R_t B_t + I_t^G - (1 - \vartheta) \tau_t^C C_t$$

¹ DIGNAR (Debt, Investment, Growth and Natural Resources) was based on Debt, Investment, Growth (DIG) model developed by Buffie et al. (2012).

² DIGNAD (Debt, Investment, Growth and Natural Disasters) builds on the extension of the DIG model of Buffie et al. (2012) to natural disasters following Marto, Papageorgiou and Klyuev (2018) that captures the challenges of closing infrastructure gaps in developing countries that frequently face natural disasters.

Table 2. Sri Lanka: Mapping Governance Reforms to Economic Distortions		
Distortions	Governance Reform Goal	Priority Recommendation Under GDA and Current EFF Program
Tax Collection Efficiency	Strengthen rule of laws	Restrict ministerial authority to make discretionary changes to tax policy.
	Enhance accountability	Institute anti-corruption measures across revenue agencies (IRD, custom, and excise).
	Strengthen revenue administration	Rollout of RAMIS 2.0 Implement, track and report KPIs on tax compliance.
Public Investment Efficiency	Strengthen transparency	Enact public financial framework (PFM) law. Enact public procurement Law.
	Enhance fiscal governance framework	Publish public procurement contracts and tax exemption information online. Implement SOE reforms. Abolish and suspend SDP Act until transparent process is in place.
Private Investment Distortion	Strengthen financial oversight.	Revise the Banking Act and the regulations, including strengthening corporate governance of state-owned banks.
	Strengthen transparency, accountability, and rule of law	Develop a government policy to regulate allocations of public assets. Establish digital land registry. Enact revised Central Bank Act to ensure CBSL independence. Strengthen mandate and functions of the Judicial Services Commission
Apply to all distortions	Strengthen anti-corruption legal framework.	Publish asset declarations for senior officials. Enact Proceeds of Crime legislation.
	Strengthen accountability, transparency, and rule of laws	Amend and National Audit Act levy surcharges for misuse of public assets. Implement regulations to support the provision of beneficial ownership information and establish registry. Establish and operationalize independent CIABOC to fulfill new mandates. Establish and implement plan to expand resources for Judicial Services Commissions.

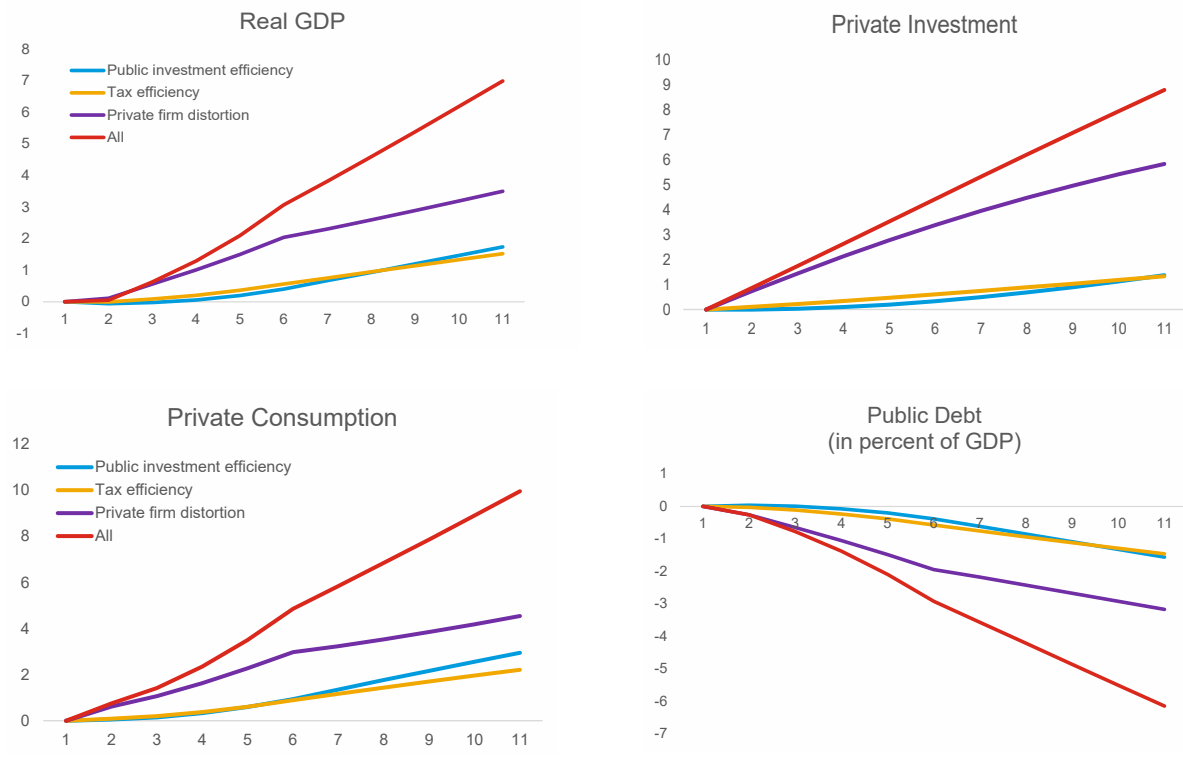
Results

15. Simulation results suggest that governance reforms help improve fiscal performance and stimulate private consumption and investment; and the impact is optimized with coherent reform efforts.

- By improving the tax collection efficiency, the government gains more resources to spend on public capital and social transfers which benefit firms and households, stimulating private investment and consumption by about 1-2 percent and reducing debt-to-GDP ratio by about 1 ppts from the steady state over 10 years (Figure 3). The magnitude of economic gains is relatively small, but comparable to cross-country analysis (IMF 1998) due to near-term dampening effect of higher tax collection on economic activity.
- Higher public investment efficiency allows government to build more infrastructure that supports business production, which in turn promotes private investment and consumption by 1-2 percent from the steady state over 10 years.
- Mitigating private investment distortion effectively increases firm productivity and hence the potential to hire, expand and contribute to fiscal revenue. The impact is more sizable than individual fiscal reforms, with private investment and consumption up by about 6 and 4 percent respectively over 10 years, possibly reflecting large private investment gaps and more direct impact on business and household activity featured in the model.
- Individual reform efforts may not generate notable impact quantitatively, but combined reforms could increase growth by more than 7 percent and reduce debt-to-GDP ratio by more than 6 percent over 10 years.

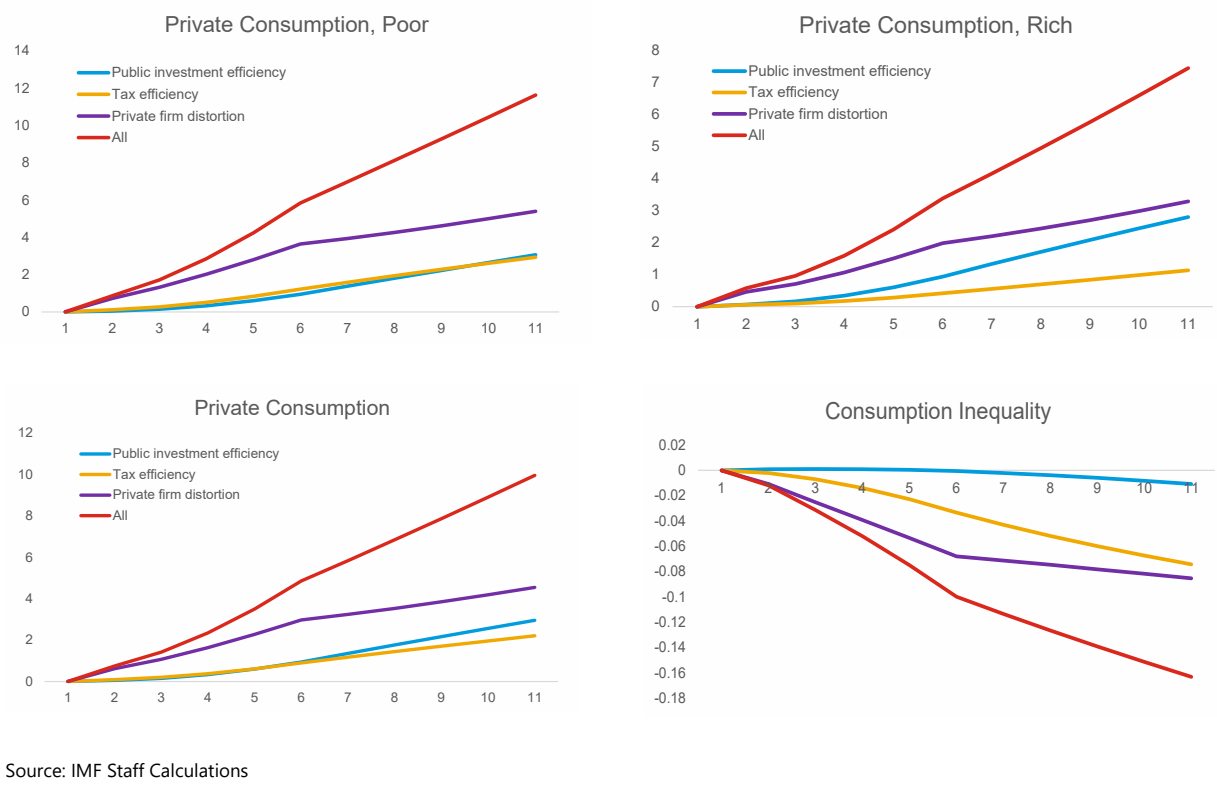
16. Governance reforms also contribute to reducing inequality. Two types of households captured in the model face different dynamics in response to the governance reforms. For instance, rising tax collection efficiency benefits the poor households (2-3 percent) more than the rich (1-2 percent) as the latter pay higher marginal tax, which dampens consumption temporarily while the poor would benefit from higher targeted social transfers (Figure 4). Higher private efficiency also benefits poor households (around 5 percent) more due to better job market and higher government transfers, while gains in wage incomes are partially offset by higher taxes paid on consumption and capital gains for the rich (around 3 percent). Private income efficiency improvement generates most distributional benefits, followed by improvements in tax collection and public investment efficiency. Combined reforms can generate an aggregate decline in consumption inequality by more than 15 percent over 10 years.

Figure 3. Sri Lanka: Central Scenario: Macroeconomic Impact of Governance Reforms

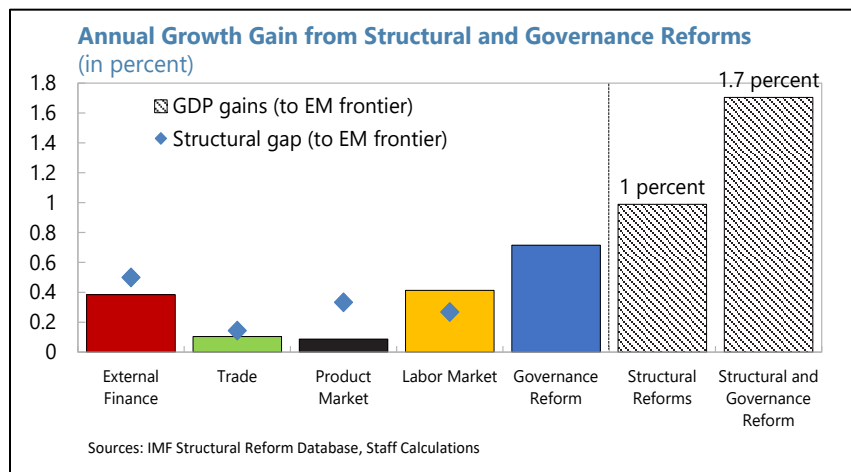


Source: IMF Staff Calculations

Figure 4. Sri Lanka: Central Scenario: Impact of Governance Reforms on Income Distribution



17. Besides the direct channels, governance reforms also support other structural reforms indirectly by creating a conducive environment. An IMF structural reform database (Alesina and others 2020, IMF 2023) provides the indices that reflect the degree of regulatory stance in several policy areas across countries. Blue dots show the position of the regulatory system between the open/liberal and closed/conservative stances. Using Panel regressions, the database estimates an average annual growth increase of around 1 ppt for Sri Lanka (bars), if structural gaps in the areas of external finance, trade, product market and labor market are reduced to the EM frontier level. With governance reforms, combined growth gain amounts to 1.7 percent, thanks to better business environment to attract foreign investors and trading partners, and stronger legal and accountability framework to facilitate domestic reforms (e.g., labor and product market). The caveat to the growth gain estimate is that the amplifying effect from the interaction of



governance and other structural reforms are not captured here; therefore, the estimate is on the conservative side.

18. While the economic gains vary with the depth and pace of reforms, the key is the commitment to sustain the reform efforts. Alternative scenarios with deeper (Alt S2) and faster reforms (Central Scenario) show higher growth gains than otherwise (Alt S1) (Figure 5). In Alt S2, governance reforms can increase medium term growth from 3.1 percent in the baseline to 4.2 percent and facilitate faster transition to higher income status. In ten years, GDP per capita could increase to 7000 US\$, almost 1000 US\$ higher than the baseline. In the meantime, sustained reform effort is more important than speeding up ambitious yet unrealistic reforms without a coherent strategy supported by strong political ownership and international partners. In a scenario with reforms reversed in half (Alt S3), efforts in the first five years would be mostly wasted. The economic loss would be even larger if the reforms are fully reversed. Accounting for the economic impact of other structural reforms, the growth potential can be increased by another 1 ppts (Figure 6, ¶17).

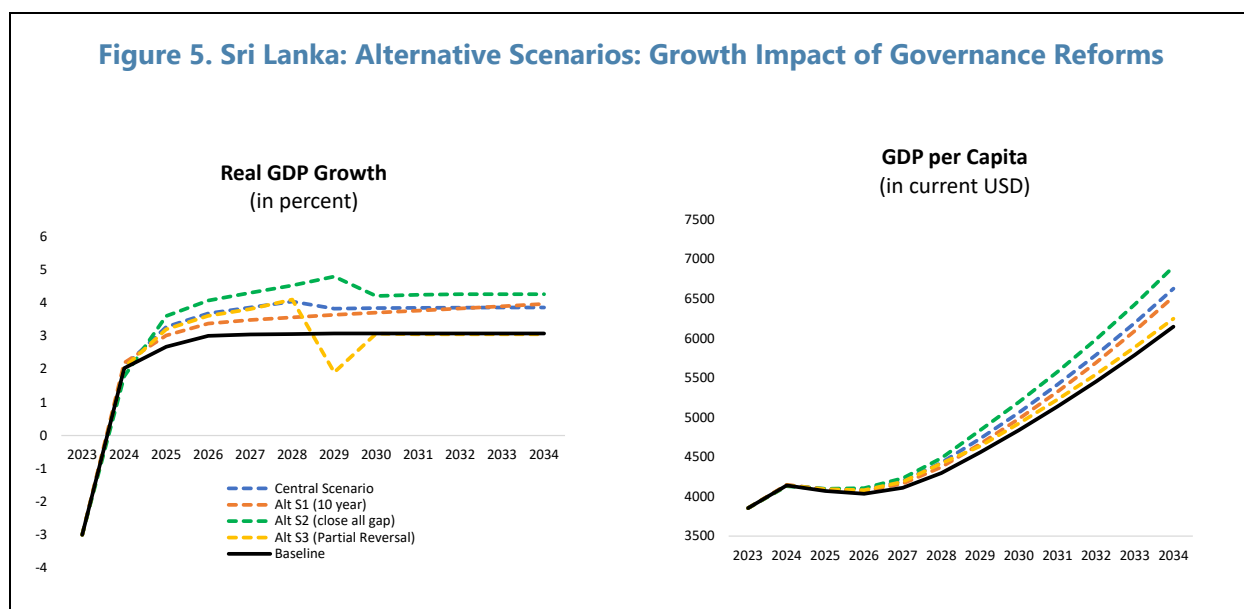
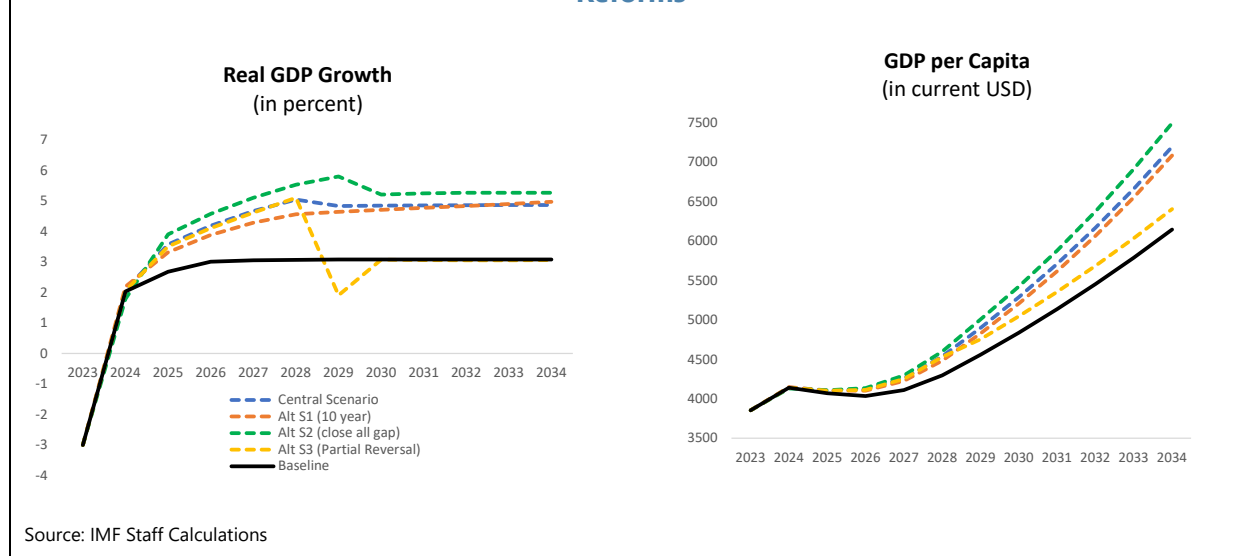


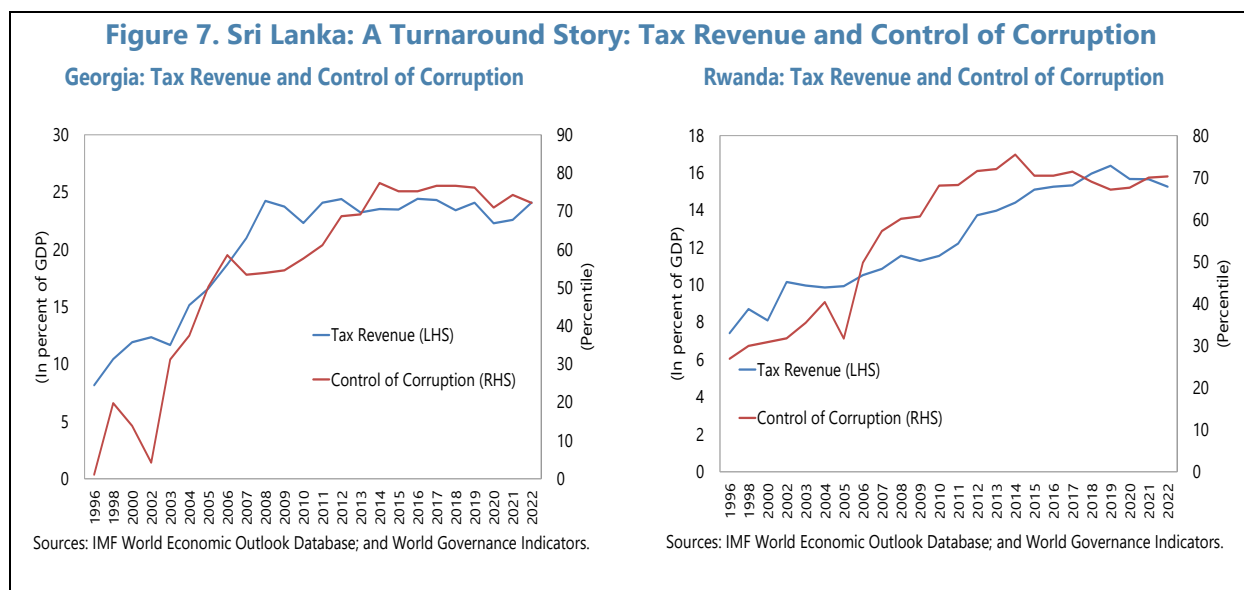
Figure 6. Sri Lanka: Alternative Scenarios: Growth Impact of Structural and Governance Reforms



E. International Experience

This section draws key lessons from the cross-country experience of some governance reforms listed in Table 1, with a focus on reforms that strengthen fiscal governance, Anti-Corruption Commissions, and asset declaration systems.

19. Sustained efforts to tackle corruption and strengthen fiscal governance are crucial to break the vicious circle that undermines fiscal performance. Corruption reduces the public's willingness to pay taxes (there is a common perception that public assets get stolen), while weak fiscal governance facilitates corruption, making it easier to divert public funds. Reforms therefore need to tackle corruption and fiscal governance simultaneously, helping to turn this vicious circle into a virtuous one. *Georgia* is a prime example of a country that successfully tackled both corruption and fiscal governance in a reform drive that started in 2003 (IMF 2019). Prior to that, *Georgia* was generally considered one of the most corrupt countries in the world, where corruption was aided by the complex tax system, with numerous special regimes, exemptions, and loopholes. The anti-corruption campaign focused on eliminating corruption in the civil service, reducing the number of regulations, and improving the business environment. At the same time, significant reforms were implemented in tax administration. As a result, tax revenues increased significantly over a short period of time, from 12 percent of GDP in 2003 to 22 percent in 2007 (Figure 7). These reforms were followed by improvements in fiscal transparency and public investment management, which helped to preserve the gains of improved tax collection. *Rwanda* is another country that achieved remarkable success in improving control of corruption, strengthening fiscal governance and reforming tax administration to raise tax revenues over a relatively short period of time.



20. Fiscal governance reforms often require significant efforts across several dimensions.

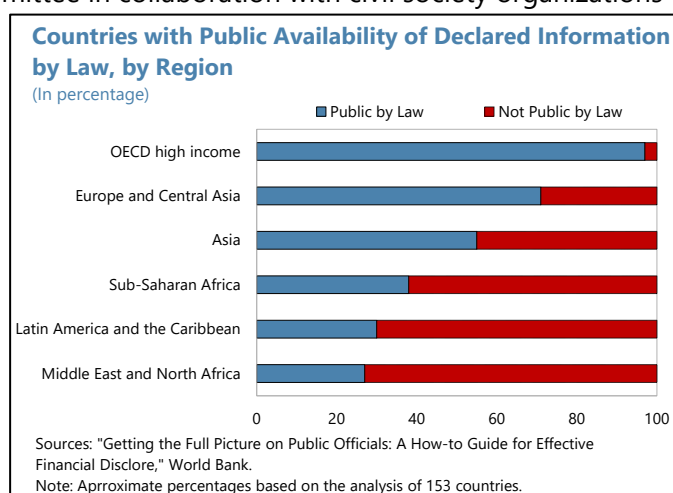
Georgia addressed many aspects of fiscal governance weaknesses simultaneously. There are also other countries that have successfully implemented fiscal governance reforms on a more selective basis:

- Tax Policy and Revenue Administration.** A key element of the 2003 reforms in *Georgia* was simplifying the tax code and procedures and removing exemptions. This helped to level the playing field and eliminate the incentive to lobby for tax exemptions and special regimes, which was a major source of corruption. In parallel, broadening the tax base by shutting down unlicensed vendors, requiring cash registers and opening one-stop windows for businesses to deal with tax authorities contributed to a sharp increase in tax collection. Other examples of countries that undertook reforms of revenue institutions include *Rwanda and Liberia*.
- Fiscal Transparency.** Reforms in this area generally focus on better disclosing the budget information and promoting accountability, both of which are essential to reduce corruption. Many countries go further in improving their budgetary frameworks, by developing government balance sheets and income statements, introducing the medium-term budget frameworks (MTBF) and publishing detailed statements on fiscal risks. The MTBF, fiscal risks statement and scenario analysis are then included in the budget documents, which improves transparency and helps show the public that the budget is well justified and thought through. Examples of successful reforms in this area are *Georgia, Chile, and Brazil*.
- Public Investment Management.** Having a strong public investment management system strengthens public confidence that tax revenue is not misused and can also improve predictability of public funding. Many countries found that well-functioning and transparent e-procurement systems help track spending and assure the public that the procurement process is fair and not biased in favor of politically connected businesses (*Chile, Bangladesh, North*

Macedonia). Experience also shows the importance of having a sound process for project appraisal (*Mexico, Slovakia, Timor-Leste*).

21. Effective and independent Anti-corruption Commissions (ACCs) play a pivotal role in combating corruption. Inspired by the successes in *Hong Kong Special Administrative Region and Singapore*, many economies have established anti-corruption commissions (ACCs). They function as independent institutions with a specialized mandate to investigate, prosecute, and prevent corruption. Effective models often have a clear legal framework, independence, adequate resources, transparency in operations, and collaborative efforts with other domestic and international entities. These are widely recognized practices reflected in the United Nations Convention Against Corruption (UNCAC) as well as the Jakarta Principles for anti-corruption agencies.

- **Selection and Recruitment Process.** Based on international good practice, commissioners are appointed through a merit-based and independent process. For some cases, initial recruitment can be conducted by a pre-selection committee in collaboration with civil society organizations and/or experts with international experience.
- **Institutional and Operational Framework.** *Bhutan* Anti-Corruption Commission (ACC) has a well-structured institutional and operational framework (World Bank 2020) including a well-articulated mandate, strong institutional capacity, and a development strategy focused on education, investigation, and prevention, real time analysis of evidence from investigation, and an accessible and open management approach with detailed and documented procedures.
- **Public Support and Political Ownership.** The ACC in *Bhutan* gained wide trust and support from the Bhutanese society following significant outreach and awareness raising campaigns, including through public opinion surveys. World Bank studies show that its success can be challenged by political resistance to changing elite privileges and traditional norms (World Bank 2020). *Bhutan* is not an isolated case, highlighting the importance of political ownership and aligned incentives to sustain anti-corruption reforms.



22. The publication of comprehensive public officials' asset declarations has been an important vehicle to increase transparency and accountability. Since 1996, asset declaration systems have been implemented in over 160 countries, reflecting a global trend towards greater public accountability and transparency. However, these systems are often underutilized. International frameworks, such as the UNCAC, recognize asset declaration systems as a critical element of anticorruption efforts. Additionally, regional, and international documents have provided

valuable guidance for implementation, including the G-20 high level principles on asset disclosure by public officials.. *Ukraine and Romania's* experience suggests the importance of public access, and institutional autonomy for the success of asset declaration systems.

- Public access.** The benefits of publication have been well-documented in literature (Kotlyar and Pop 2017, Djankov et al. 2009). Indeed, 97 percent of OECD high-income countries as well as 70 percent of countries in Europe and Central Asia require publication of asset declarations. In *Romania*, mandatory public access to asset declarations has been critical to the success of ANI (National Integrity Agency)'s system, which established a large and regularly updated database. According to the European Commission, ANI has taken important steps towards more efficient disclosure and verification of asset declarations. By end 2022, more than 10 million asset and interest disclosures were published. In *Ukraine*, the asset declaration system ensures comprehensive data coverage, strong sanctions for non-compliance and wide public access to disclosed information. By 2019, four million e-declarations have been made available to the public in Ukraine (World Bank 2021). Public access to asset declarations has been reinstated despite the ongoing war, including through IMF conditionality and public demands for transparency.⁸ By early 2024, more than 1,5 million asset declarations had been submitted for 2021-22 according to the National Agency on Corruption Prevention (NACP).⁹ The level of transparency has empowered civil society groups and journalists to conduct investigations on public officials' assets that strengthens authorities' accountability, as well as provided banks and other regulated entities useful information in complying with AML/CFT obligations. Public participation and engagement have also helped build public trust in the system.
- Preventive Measures in Procurement Process.** PREVENT, launched in *Romania* in 2017, is an automated system designed to flag potential conflicts of interest in the procurement processes. During the initial phase from June 2017 to December 2019, PREVENT reviewed more than 43,000 procurement procedures and gave 117 integrity warnings.
- Institutional Autonomy.** Additionally, institutional autonomy of *Romania's* ANI is important. Integrity inspectors are selected through a competitive process and provided with full autonomy and independence to conduct their investigations. Their work is subject to annual evaluation by an independent external auditor as well as judicial scrutiny. ANI's president and vice-president are also appointed following a merit-based competitive process. Moreover, because ANI has the mandate to proactively start investigations ex-officio, the institution does not need to rely on law enforcement or the judiciary to sanction corruption or impose disciplinary measures on public officials. Similarly in *Ukraine*, efforts to revamp the NACP with a revamped organization set up in 2019 and new leadership selected (in 2020 and now in 2024) through a highly competitive process has also contributed to building a more effective system.

⁸ See IMF Staff Report 2023 AIV and 2nd EFF Review (end-October 2023 Structural Benchmark).

⁹ <https://nazk.gov.ua/en/news/almost-1-5-million-declarations-submitted-for-2021-and-2022-results-of-the-declaration-campaign/>

23. Engagement of civil society and support from international partners play an important catalytic role in facilitating the reform progress. Civil society played a key role in the adoption and implementation of *Ukraine's* electronic asset and interest disclosure system in 2014, which has been recognized as one of the most comprehensive models worldwide. Support from international partners, including the IMF, UNDP, and the World Bank through technical and financial assistance was also important in ensuring the successful design and implementation of the system. Civil society also played important roles in appointing anticorruption commissioners (e.g., *Bhutan*), and investigating published asset declarations (e.g., *Ukraine and Bhutan*). The electronic publicly accessible asset declaration system allowed civil society organizations to leverage the information to create a Politically Exposed Persons database (pep.org.ua), which used other publicly databases to verify the information in the asset declaration and identify discrepancies. However, owing to the war, the PEP database is temporarily closed.

F. Conclusions and Policy implications

24. Corruption vulnerabilities reflect fundamental challenges to Sri Lanka's governance framework, which need to be tackled by a comprehensive set of reforms. Various indicators point to severe and systemic corruption vulnerabilities affecting the economy in Sri Lanka. The GDA highlighted key governance weaknesses associated with transparency and accountability in the areas of fiscal governance, financial oversight, AML/CFT, anti-corruption legal framework, rule of law, and Central Bank independence. In response, the authorities set out a reform agenda, including as part of the EFF program, taking on board important recommendations from the GDA. Some early steps have been taken. Going forward, reforms need to be designed and implemented in a coherent approach that account for reinforcing effects across reform areas (e.g., fiscal reforms supported by anti-corruption measures, etc.), prioritization from near-term to medium-term horizon, and corresponding resource allocations.

25. Dynamic general equilibrium simulations suggest significant macroeconomic gains from governance reforms through various channels. Comprehensive reforms are found to increase the growth potential by improving the state capacity to perform core functions, the business environment, service delivery, and human capital, which reflects better fiscal performance (by enhancing tax collection and public investment efficiency), and more efficient resource allocation (by reducing private investment distortions). Depending on the pace and depth of the reforms, real growth gain could increase from 0.6 to 1.2 percent per year, accelerating Sri Lanka's move to higher income status. Governance reforms can also improve Sri Lanka's income distribution and debt dynamics.

26. International experience highlights the macro-criticality of these governance reforms and the importance of civil society engagement and international support. Success stories underscore the importance of tackling fiscal governance challenges using a multi-pronged approach, supported by anti-corruption efforts. Good practices for anti-corruption commissions are normally guided by common principles, exemplified by international standards; and the commissioner appointment and staff recruitment process follow a merit-based and independent process. Effective asset declaration system ensures transparency, institutional autonomy, and

preventive measures during procurement process. International experience also underscores the importance of civil society and international partners in facilitating the implementation process.

27. Reforms need to be phased in systematically, with strategies in place to address implementation challenges. Empirical evidence highlights the importance of adopting the reforms in a coherent manner, which requires strategic planning and prioritization. While initial reforms help stimulate the momentum and start establishing important anti-corruption and governance legal frameworks, sustaining the reform efforts remains the key to success. Most importantly, effective implementation requires capacity development, broader and stronger commitment to transparency and accountability, and consistent support by multiple stakeholders.

28. Efforts to improve governance need to be sustained over the long run to bear fruit. History is full of examples of short-lived, one-off anti-corruption drives that end without making a perceptible impact on governance. As shown by the simulation exercise, reform reversal can be quite costly. Successful governance reforms typically continue for long periods of time. Addressing multiple aspects of governance in a coherent manner requires time. In all successful country examples that we mentioned, there are still governance improvements to be implemented, and further governance reforms are still underway. Time is also needed to ensure that reforms are entrenched and the level of tolerance for corruption in society has fallen to a sufficiently low levels, so that a full reversal is difficult, even with political changes.

29. Support from the highest political level is crucial to ensure durable success of governance reforms. In countries with widespread corruption, many groups may feel that they are benefitting from it. If anti-corruption efforts are limited to fighting petty theft and small bribes by low-level officials, while high-level corruption remains unabated, it may contribute to the feeling of injustice. Active involvement by the highest level of government can help create a perception that the rules of the game have changed, and corruption is no longer tolerated at any level. Efforts to strengthen fiscal governance are helpful in this regard, as they show that the government budget is becoming clean and transparent, reducing opportunities for high-level theft. The case studies show the importance of leading the governance reforms from the top.

References

- Alesina, Alberto F., Davide Furceri, Jonathan D. Ostry, Chris Papageorgiou and Dennis P. Quinn, 2020, "Structural Reforms and Elections: Evidence from a World-Wide New Database," NBER Working Paper No. 26720.
- Aligishiev, Zamid, Gabriela Cugat, Romain Duval, Davide Furceri, Joao Tovar Jalles, Margaux MacDonald, Giovanni Melina, Futoshi Narita, Chris Papageorgiou, and Carlo Pizzinelli, 2023, "Market Reforms and Public Debt Dynamics in Emerging Market and Developing Economies," IMF Staff Discussion Note 23/005.
- Buffie, Edward E., Andrew Berg, Catherine Pattillo, Rafael Portillo, and Luis-Felipe Zanna, 2012, "Public Investment, Growth, and Debt Sustainability: Putting Together the Pieces," IMF Working Paper 12/144.
- DIFD, 2015, "Why Corruption Matters: Understanding Causes, Effects and How to Address Them," *Evidence Paper*.
- Djankov, Simeon, Rafael La Porta Florencio Lopez-de-Silanes Andrei Shleifer, 2009, "Disclosure by Politician," National Bureau of Economic Research.
- Gurara, Daniel, Giovanni Melina, and Luis-Felipe Zanna, 2019, "Some Policy Lessons from Country Applications of the DIG and DIGNAR Models," IMF Working Paper 19/062.
- Markevych, Maksym, and Mariana Marinkov, 2024, "Corruption and Economic Growth in Moldova: A Reexamination," IMF Selected Issues Paper 24/003.
- Marto, Ricardo, Chris Papageorgiou, Vladimir Klyuev, 2017, "Building Resilience to Natural Disasters: An Application to Small Developing States," IMF Working Paper 17/223.
- Melina, Giovanni, Hoda Selim, and Concha Verdugo Yepes, 2019, "Macro-Fiscal Gains from Anti-Corruption Reforms in the Republic of Congo," IMF Working Paper 19/121.
- Melina, Giovanni, and Alessandro Cantelmo, 2019, "Quantifying the Macroeconomic Benefits of Improved Governance," IMF Country Report No. 19/248, Box 1.
- Melina, Giovanni, Shu-Chun S. Yang, and Luis-Felipe Zanna, 2014, "Debt Sustainability, Public Investment, and Natural Resources in Developing Countries: the DIGNAR Model," IMF Working Paper 14/50.
- International Monetary Fund (IMF), 1998, "Review of 1997 Guidance Note on Governance – A Proposed Framework for Enhanced Fund Engagement," IMF Policy Paper.
- , 2019, *Fiscal Monitor: Curbing Corruption*.

- , 2023, "Review of Implementation of the 2018 Framework for Enhanced Fund Engagement on Governance," IMF Policy Paper.
- , 2023, "Sri Lanka: Technical Assistance Report-Governance Diagnostic Assessment, ", IMF Country Report No. 23/340.
- Johnson, Mark, Graeme Gunn, and Emma Scott, 2012; "Improving Co-operation between Tax Authorities and Anti-Corruption Authorities in Combating Tax Crime and Corruption," *OECD and World Bank Joint Paper*.
- Kotlyar, Dmytro, and Laura Pop, 2016, "Asset Declarations: A Threat to Privacy or A Powerful Anti-corruption Tool?," *Ukrainska Pravda*.
- Lorenzani, Dimitri, Federico Lucidi, 2014, "The Economic Impact of Civil Justice Reforms", *European Commission, Economic Papers 530*.
- Rossi, Ivana M., Laura Pop, Tammar Berger, 2017, "Getting the Full Picture of Government Officials- A How-To Guide for Effective Financial Disclosure," *World Bank and UNODC*.
- Sandri, Damiano, 2017, "Ukraine, Selected Issues: Corruption and Growth," IMF Country Report No.17/84.
- Wickberg, Sofia, 2013, "Best Practices for Anti-Corruption Commissions," *Transparency International*.
- World Bank, 2012; "Fighting Corruption in Public Services: Strengthening Tax Collections," World Bank Paper 2012, Chapter 3.
- , 2020, "Enhancing Government Effectiveness and Transparency – the Fight Against Corruption," *Global Report*.
- , 2021, "Enhancing Effectiveness of Asset Declarations in Romania," *Chapter 8*.