CBSL 73rd Anniversary Oration
The Way Forward: Price Stability and Prosperity Need Good Governance
Dr. Sharmini Coorey

Good afternoon, Governor, Deputy Governors, members of the Monetary Policy Board and the Governing Board, ladies and gentlemen. ***First, I would like to thank Governor Weerasinghe for inviting me to deliver the 73rd Anniversary Oration of the Central Bank of Sri Lanka.*** I am honored to address such a distinguished audience of leaders and members of the policymaking and financial community. I would also like to recognize the talented and hardworking staff of the CBSL who have had a very challenging year and a half—if not longer.

Let me start by congratulating the Governor, Deputy Governors, members of the former Monetary Board and members of the current Monetary Policy Board. Since April 2022 they have taken the bold decisions and led the demanding technical work to stabilize the economy after the deepest economic crisis that Sri Lanka has suffered since independence. It is easy perhaps to take for granted the progress so far. But let us not forget that barely 20 months ago, Sri Lanka's inflation rate was unanchored, the exchange rate was depreciating uncontrollably, foreign reserves were depleted, and the economy was collapsing with shortages of food, fuel, and essential medicine. ***Declaring an orderly foreign currency debt moratorium, raising interest rates sharply, and curtailing the monetization of fiscal deficits were essential first steps to stabilize the economy and avoid a disorderly default.*** It is no mean feat to have brought inflation down from a peak of almost 74 percent last September to less than 2 percent a year later, over-performing the IMF's projections. To have accomplished this while maintaining financial stability is all the more impressive given the deep economic contraction that, together with the preceding pandemic, has weakened financial sector balance sheets. ***Monetary policy was also responsive in lowering the policy rate when clear evidence emerged that monthly inflation was stabilizing.*** Let me say, based on my years of experience at the IMF working with countries around the world, often during economic stress, that these are by any standard impressive accomplishments. Without skilled leadership and decision-making, it could very easily have been much worse.

These monetary policy actions were successful also because of the support from the government's fiscal policies and the leeway given to the CBSL to conduct monetary policy according to its best judgment. Tax cuts during the previous government had reduced our tax ratio from almost 11 percent of GDP in 2019 to a mere 7.5 percent of GDP on average in 2020-21, one of the lowest in the world—lower even than the tax ratios of very poor countries like the Central African Republic and Burkina Faso. With interest payments taking up 73 percent of government revenue and an overall fiscal deficit of almost 12 percent of GDP on average in 2020-21, the fiscal position was simply not sustainable. ***The government took decisive and necessary action to increase tax rates, bolster tax collections, and implement cost-recovery pricing in energy.*** It has tightened spending to generate the needed improvement in the primary fiscal balance in line with the IMF-supported program. These were difficult decisions and politically unpopular. But they were necessary.

Unfortunately, the ship that is the national economy cannot be turned around quickly. So people tend to blame the corrective policies and the policymakers who are doing the right thing, rather than the reckless policies of the past that are the fundamental cause. Such is the unenviable position of policymakers who step in to rescue their countries from crises. You have my sympathies!

So what now? Significant progress has been achieved but we are in a low-level equilibrium with output well below potential. ***This crisis is not yet over. The only way out is to grow, at a rate of about 5-6 percent a year, in a sustainable inclusive way.*** Without such growth, we cannot escape our high debt burden even after a successful restructuring. And because the debt burden lies with the public sector, the public sector will need to contract not just this year, but also in the decade ahead. So growth will need to come from the private sector and be export-oriented given our foreign exchange needs. ***There is simply no other option.***

Much remains to be done to get the economy on such a dynamic growth trajectory. Nor should we take for granted, having achieved low inflation, that inflation will always stay within the CBSL's target of 5 percent or that progress in the fiscal area will continue. Our post-independence economic history is full of stop-and-go policies and brief victories over instability that are not sustained. ***We cannot afford yet another replay of that familiar script.***

Why not? Well, this time really IS different—for three reasons:

- First, in all our previous bouts of macroeconomic instability, our public debt ratios have stayed below 80 percent of GDP, tax revenues have never been as low as they were in 2020-21 and we had never defaulted on our debt. According to the IMF's Debt Sustainability Analysis, ***even if*** we successfully restructure our debt and adhere to tight policies that generate primary fiscal surpluses of 2.3 percent of GDP from 2025 to at least 2032, our public debt will decline to ***only about 95 percent of GDP by 2032***. To put this debt level in perspective, in 2022, government debt to GDP averaged 65 percent in emerging and developing economies and—looking at our neighbors—55 percent in India; 40 percent in Indonesia; and 54 percent in Thailand. So unlike in the past where we muddled through with debt to GDP ratios around 60-80 percent, the baseline debt ratio will now be much higher. ***We will be at a high risk of debt distress even after a successful debt restructuring***. If we become complacent and go slow on reforms, we can easily be back in a crisis where we are unable to pay our debts. Except next time, the adjustment will be far more painful because we would have already restructured domestic and external debt. ***More of the adjustment therefore will fall on our citizens and less on external creditors.*** This point needs to be widely understood.

- The second reason this time is different is that many people are now in poverty or very close to poverty and have little or no cushion left. The World Bank estimates that the poverty rate doubled to 25 percent of the population in 2022 while the UNDP estimates that over half the population remains "multi-dimensionally vulnerable." The World Food Program finds that almost a third of children under 5 are malnourished with 20 percent suffering from wasting. Nearly two-thirds of the population are borrowing or dipping into their savings to feed their families. Many people are foregoing basic needs such as healthcare, and progress in education has been severely hampered by both the pandemic and the economic crisis. ***The impact on people of another debt default, crisis, and adjustment would be disastrous and raises the likelihood of social unrest.***

- And third, Sri Lanka is suffering from a damaging outflow of skilled professionals who are the backbone of economic recovery and growth. These professionals are not leaving merely because of taxes as is often said. ***They have lost hope that the poor governance and pervasive corruption that Sri Lanka has been mired in for decades will be effectively addressed.*** They don't see a future in a country where the state interferes with practically every aspect of economic life, and politicians and public officials who engage in gross corruption are never punished. ***Another crisis will turn this outflow into an exodus.***

The empirical evidence clearly shows that crises cause permanent losses, both in terms of GDP and human welfare. Countries that undergo multiple crises—think Argentina—stagnate compared with countries that have steady growth over prolonged periods. Boom-bust cycles leave countries worse off. ***We should not try to get out of our current low-level equilibrium through fiscal policies that give a short-term boost but will land us in another debt crisis a few years down the road.*** We will also be vulnerable for many years to exogenous shocks, such as a rise in global food and energy prices, particularly from the ongoing wars in Ukraine and the Middle East; higher world interest rates; a poor agricultural harvest; or a natural disaster. In addition, we will need to invest considerable resources in adapting to climate change and preserving biodiversity. ***We are on a knife edge, and there is simply no room for slacking off or policy reversals. But, with focus and effort, we can set ourselves on a road to sustained growth and inclusive prosperity.***

So what is the way forward? How can we avoid repeating our history of inconsistent, stop-and-go policy making? We have discussed for years what is needed for sustained growth—fiscal discipline, an open trade regime that encourages exports, competitive markets, modernized labor laws, adequate infrastructure such as efficient electricity, transport, and ports. ***It's no mystery, so why don't these things get done?***

I believe that our fundamental problem is ***poor governance*** and that, unless we address governance problems head on, we will never durably overcome our economic problems and prosper. ***My thesis today is that when we discuss economic policies, we should focus more squarely on the governance around those policies and not only on the policies themselves.***

So what do we mean by "good governance"?

There is no standard definition, but people know bad governance when they see it. ***Certainly,*** not a day goes by in Sri Lanka without the newspapers reporting some instance of bad governance.

Let me, for today's purposes, use the definition by UNESCAP. They define ***governance*** as [quote] "the process of decision-making and the process by which decisions are implemented". And the principles of ***good*** governance include accountability, transparency, adherence to the rule of law, responsiveness, effectiveness, and efficiency.

My point today is that we need to be more explicit not just about economic policies—for instance, whether an interest rate or a tax rate should be raised or lowered or a particular public enterprise privatized or not. We also need to be explicit about ***the process*** by which those policies are decided and implemented. ***It is very likely that if we improve the process—that is, we make policymaking and implementation more accountable, transparent, adhere to the rule of law and so on—the resulting policies will improve as well. It is also likely that if we have good policymaking processes and strong institutions, good policies will continue even if the politics turn difficult.***

I do want to acknowledge that ***getting to good governance is no simple task. It requires sustained social pressure and political will to take on the vested interests who are served by poor governance.*** People sometimes complain that nothing works in Sri Lanka. That's not quite true. Actually, things work very well—for a small group of people. The challenge, if we are to avoid repeating the mistakes of the past, is to ensure that our policymaking and implementation processes and institutions obey the principles of good governance so that policies serve the interests not just of a small group, but of all members of society.

I would like to focus today on the good governance for ***three policy objectives that are—in my view—the most important*** to get us out of this crisis and lay the basis for inclusive prosperity.

- First, ***maintaining durable price stability through sound monetary policy***
- Second, ***achieving fiscal sustainability through better taxation***
- Third, ***enabling market-oriented growth by reducing the size and role of the public sector.***

For the last two—mainly fiscal—topics, I draw extensively on three sources published in September: the IMF's Governance Diagnostic Assessment of Sri Lanka—or GDA for short; Sri Lanka Civil Society's Governance Diagnostic Report; and the World Bank's Country Update on Sri Lanka. These reports are based on thorough research; extensive interviews with officials and other stakeholders; and written or guided by experts with international experience in their respective fields.

Since this occasion marks the 73rd anniversary of the CBSL, let me start with strengthening the governance to **maintain durable price stability through sound monetary policy.**

The economics literature and central banking practice have convincingly established for decades the need for central bank independence and a sound monetary policy decision-making process to achieve low and stable inflation. Most major countries' laws safeguard central bank independence and aim to insulate monetary policy from political interference. Indeed, one of the oldest such laws, the U.S. Federal Reserve Act of 1913 recognizes this need explicitly. It specifies, to that end, that the Federal Reserve may buy and sell US Treasury securities only in the "open" or secondary market. ***It was recognized then—over a hundred years ago—as it is now, that direct financing of the government would leave decisions over monetary policy open to political interference*** and undermine the goal of low inflation while creating risks to economic and financial stability.

This year's passage of the Central Bank of Sri Lanka Act is a very significant milestone on the path to achieving good governance in the conduct of monetary policy. The Act explicitly recognizes the CBSL's independence. There is now a clear mandate that price stability is the primary objective of the CBSL with financial stability as a secondary objective. Inflation-targeting with a flexible exchange rate is established as the monetary policy regime. A critical feature is that there are no longer any government officials in the monetary policy decision making body—the Monetary Policy Board—nor on the Governing Board, which oversees everything else. ***There is also an appropriate balancing of central bank independence with accountability and transparency.*** The inflation objective is specified by the Minister of Finance, who would be an elected representative. The Monetary Policy Board is accountable to Parliament through the Minister to deliver on the inflation objective and provide a public explanation if inflation falls outside the agreed range for two consecutive quarters. The Board is also mandated to issue a public statement after each policy meeting to explain the monetary policy decision in the context of economic developments and forecasts. In addition, the CBSL has to issue a public inflation report every six months explaining its inflation projection and key risks to the projection. Contrary to the concerns that emerged during the parliamentary debate, these features of the law provide for much ***greater*** accountability than in the past. The operational independence that the central bank has been given to achieve the target assigned to it should not be confused with being unaccountable. ***Quite the opposite.***

The strong legal framework is a necessary, but not sufficient, condition for sound monetary policy. **Legislation must be reinforced by practice and the creation of a strong culture.** An important responsibility for the newly-constituted Boards—the distinguished members of which are here today—will be to create the practice and culture of good governance under the new legal framework. In particular, given Sri Lanka's past, it will be important to ensure that the Monetary Policy Board takes policy decisions on solid technical grounds with a clear focus on the price stability mandate. The technical grounds would be based on CBSL staff's economic modeling and analyses ***combined with*** the Board's collective judgment on the likely evolution of inflation. ***Insulating the conduct of monetary policy from fiscal and political pressures will be the hallmark of a good decision-making process—especially in the upcoming election year.*** And this is not only the responsibility of the CBSL. ***Everyone, including political actors, will need to create the culture of respecting the CBSL's operational independence and the integrity of its***

decision-making. Central Bank independence needs to be supported by our social and political culture.

The newly independent CBSL will also need to ***promote a culture of transparency***. The new Law includes key features such as post-meeting public statements, regular inflation reports, statements in anticipation of significant shocks, and answering to parliament. While many central banks publish inflation reports and post-meeting statements, they are not all equally illuminating. Some statements are anodyne and avoid addressing substantive issues the decision-making body grappled with. Others, such as those by the Nordic central banks, the Bank of England, and the Fed inform the public about the substance of the issues the policy committee discussed. They give a sense not only of the balance of risks to inflation, but also how the committee sees the likely stance of its policy rate looking forward. ***Transparency is a "must have"—not simply a "nice to have"—in an inflation targeting regime.*** Clear explanations of how the Monetary Policy Board sees inflation risks and how its actions will keep future inflation within the target range are needed to anchor inflation expectations of financial markets and the public so that ***actual inflation*** stays within the target range. Transparent communication may initially be met with confusion and misinterpretation. But over time, both financial markets and the public will learn how the Monetary Policy Board assesses inflation risks and how it is likely to react to shocks. ***This will help the CBSL keep inflation within its target range even when the economy is subjected to significant shocks.***

As the CBSL Law gets established and the Bank's practices evolve, a further ***strengthening*** of the legislation could be considered to safeguard the CBSL's independence. ***In my view, three features of the law could be re-examined in that context, the last of which is the most important:***

— (i) ***First, we need to reconsider the description of the powers, duties, and the functions of the central bank.*** Article 7 (j) states the CBSL will [quote] "act as financial advisor and banker to the government" while Article 7 (k) states it will "act as fiscal agent of the Government". Given the context in Sri Lanka where the government has relied on the central bank for expertise, the reference to "financial advisor" is understandable, but not desirable. To safeguard more securely the CBSL's independence, there needs to be a sharper line between its activities and the activities of government. Also, given Sri Lanka's history of money-financed deficits, it is best to avoid describing the CBSL as "banker to the government". In common understanding, a "banker" gives credit and liquidity to its clients. ***However, a main point of the CBSL Law is to ensure that the CBSL does neither!*** In my view therefore, Article 7 (j) should be eliminated altogether, and Article 7(k) amended to describe the CBSL as "fiscal agent and depository" of the government so that it can carry out normal central banking functions, such as holding government deposits and effecting payments through government accounts held at the Bank. Eliminating this reference would also help people understand that ***the primary function of the central bank is to serve the public by protecting the value of the currency***—that is the amount of goods and services they can buy with their money—which is what price stability achieves. Let me make clear that protecting the value of the currency shouldn't be misunderstood to mean keeping the nominal exchange rate constant. A flexible exchange rate is essential to absorb shocks to the economy and facilitate adjustment of relative prices—the so-called real exchange rate. The focus of the central bank needs to be on the price level as a whole, not just the traded component of it.

- (ii) A second strengthening given Sri Lanka's history is to consider ring fencing even more tightly the requirement imposed by the Supreme Court that the government should have access to direct central bank financing in emergency circumstances. ***The central bank's job, including in emergency situations, is to provide liquidity to the market as a whole, not to the government in particular.*** For instance, the US Federal Reserve intervened in financial markets during the September 11 terrorist attacks in 2001, the Global Financial Crisis in 2008 and when the Covid pandemic hit in early 2020. If the government has an emergency financing need it can and should issue short-term treasury bills in the market. If the market is short of liquidity, the central bank can provide liquidity to the market through various means such as reverse repo operations with the banking system and/or the Liquidity Support Facility to stabilize financial conditions. This is different from providing direct financing to the government.

  (iii) Third, and ***most importantly, the size of the Monetary Policy Board should be reduced, in my view, to five or seven members and not include members of the Governing Board.*** Let me hasten to add that this has nothing to do with the current members of these Boards, all of whom are enormously qualified and distinguished. ***My point is about the structure of the decision-making bodies from a good governance point of view.*** Why do I say this? ***First, the conduct of monetary policy should be seen as a mainly technical function carried out by people with specific expertise in economics and finance.*** With the exception of the Governor, having the same membership across the two boards mixes this very specific function with oversight functions, which belong to the Governing Board and which require a broader range of expertise including banking, legal, accounting and audit, and risk management. ***Second, it is important to isolate the monetary policy decision, which affects the entire country, from the governance function which is specific to the central bank.*** To give an example, monetary policy decisions should not be influenced—or even ***appear*** to be influenced—by how it might impact the balance sheet or profitability of the central bank, which comes under the purview of the Governing Board. ***Third, a large monetary policy-making body dilutes the transparency and accountability*** that is critical for an effective inflation targeting regime. It is difficult, in my view, to hold a group as large as eleven people accountable for a policy decision. A five-member board headed by the Governor and comprising two Deputy Governors and two independent experts from outside the central bank would be more nimble and cohesive. ***Finally, and most critically, it is highly unusual for the externally appointed members of a monetary policymaking body to outnumber members from the central bank staff.*** In fact, I couldn't find a single example of such a structure in a major central bank. ***This feature potentially opens the CBSL to political interference.*** A more common structure where the number of central bank staff is matched by outside members allows the Governor to cast the deciding vote if there is an even split between insiders and outsiders on a monetary policy decision. It thus places a greater degree of accountability on the Governor when reporting to the Parliament and the public. The current structure of the Monetary Policy Board where, other than the Governor, there are two central bank staff members and as many as eight outside members is in my view problematic given that policy decisions are taken by a majority vote. A future government could exert political influence over monetary policy decisions by swamping the Board with political appointees. ***This, in my view, seriously threatens the independence of the CBSL and needs to be rectified.***

Let me now turn to good governance to meet the second policy objective that I said I would address—namely, ***achieving fiscal sustainability***.

Professor Lawrence Summers of Harvard University likes to say that IMF stands for "It's Mostly Fiscal." That could certainly be said of Sri Lanka. ***The source of almost all of our economic problems is our collective inability to impose fiscal discipline and adequate standards of governance on both the central government and the larger public sector.*** Our successful Asian neighbors who have had IMF-supported programs—India, Korea, Thailand, Malaysia—have avoided resorting repeatedly to the IMF. We, on the other hand, have gone 17 times to the world's lender of last resort. They say cats have nine lives, Sri Lanka seems to have at least 17!

The bottom line is that we need to stop relying on the lender of last resort. We are like a diabetes patient who refuses to give up their sugar-laden diet and repeatedly ends up in the emergency room. And then some people even blame the emergency room doctor, the IMF, for the severity of the treatment needed to save us. Having achieved some semblance of macro stability, ***the biggest danger now is that we will do what we have often done in the past—that is, as soon as some stabilization is achieved, abandon or drag our feet on the serious restructuring needed to address the underlying fiscal and governance problems.*** Many of the reforms promised under the current program are similar to what we have promised before but never consistently implemented. We need to change our diet by strengthening governance to achieve fiscal sustainability—not because the IMF or external creditors require it, but because if we don't, we ***will*** be in crisis again.

To achieve fiscal sustainability, we need better taxation.

Adam Smith in his treatise on the Wealth of Nations wrote that tax policy should adhere to four principles: fairness, certainty, convenience, and efficiency—principles that are consistent with the principles of good governance. The OECD has established similar criteria, with the added criterion of neutrality—meaning a tax system should raise revenue without distorting incentives vis-à-vis any particular economic activity or choice. Although Sri Lanka's tax regime was improved by the 2022 tax reforms, it is fair to say that it still violates all five of these principles. ***Let me provide three examples to illustrate the point:***

- (i) First example, ***Sri Lanka relies excessively on indirect taxes rather than direct taxes and on taxing labor rather than capital.*** Both aspects violate the principle of fairness as indirect taxes shift the tax burden towards the poor who spend more of their income on goods and services, while capital income accrues mainly to the rich. In 2021, Sri Lanka collected 77 percent of its taxes through indirect taxes such as VAT, excise, and trade taxes, which is notably more than the regional average of 66 percent and the global average of 53 percent. The recent increases in personal and corporate taxes, which are direct taxes, are a step in the right direction, but indirect taxes still account for 11 percent of pre-tax income for households in the bottom income decile—more than the 8 percent share for households in the top decile. Personal tax collections rely on the PAYE system which ensures many professionals pay taxes, but most income from business profits remains outside the tax net because IRD has only a very small number of personal tax files. Capital income from capital gains, interest, and dividends is subject to lower flat tax rates, instead of progressive rates. And capital gains on property other than stocks are taxed at a very low rate of 10 percent.

- (ii) Second example, ***corporations have for decades enjoyed extensive tax holidays, which violate all five principles of good taxation.*** Commendably, with the tax reform of October 2022, most companies are now subject to a standard 30 percent corporate tax rate. ***However,*** projects continue to receive wide-ranging tax exemptions under the Strategic Development Projects Act. Under this Act, based on vague criteria, ***projects can negotiate exemptions from eight different tax laws,*** including corporate, personal, VAT, excise, and customs for as long as 25 years. The 17 beneficiary projects so far enjoy corporate income tax exemptions for ***10 to 25 years***, typically followed by time-bound reduced rates and exemptions from many other taxes and fees. Moreover, tax concessions can be granted to companies operating in three zones—Colombo Port City, a pharmaceutical manufacturing zone, and a textile manufacturing zone. ***The Port City Act allows exemptions from 13 different tax acts,*** covering casinos, the betting and gaming levy, and practically all other taxes, ***for up to 40 years without the approval of parliament***, which raises the question of the constitutionality of these exemptions.

  Such extensive tax holidays cannot be justified. Let's be perfectly clear that tax exemptions are the equivalent of ***a cash payment from the government to special interests.*** It's as if the corporation paid the standard tax and the government gave an equivalent amount to the corporation instead of spending it on social needs or repaying public debt. Tax exemptions mainly benefit the shareholders of corporations who I would guess are not merely rich, but super rich. ***So in Sri Lanka we have welfare for the rich and the super-rich that far outweighs the small amounts the government transfers to the poor through programs like Aswesuma.*** Although tax concessions are often claimed to be necessary to encourage investment, particularly foreign direct investment, there is plenty of survey evidence to show that foreign companies ***do not*** choose their location based mainly on tax considerations. ***Factors that truly matter*** include a stable macro-economic environment, reliable electricity and physical infrastructure, the rule of law, an efficient dispute resolution system, secure access to land, and a high-quality labor force. As the IMF's GDA points out, tax exemptions also create opportunities for corruption—after all someone has to grant them and the selection criteria, amounts, and beneficiaries are not transparent.

- (iii) A third example of poor governance in taxation is the ***reliance on Gazette notifications for implementing major policy changes.*** This makes the tax system uncertain and increases opportunities for corruption. In principle, the primary tax laws that Parliament enacts should contain all the necessary provisions to ensure taxes can be calculated and collected fairly and efficiently. All subsidiary instruments, such as Ordinances, Gazette notifications and other regulations, should merely provide technical details to ensure effective administration of the law. ***In Sri Lanka, however, tax rates, the scope of existing taxes, and the granting of tax concessions can be implemented through Gazette notifications.*** Take, for instance, the Special Commodity Levy. A Minister can change this levy arbitrarily with immediate effect without parliamentary approval— which one would think is a violation of the Constitution which vests the power of taxation exclusively with the Parliament. Customs duties can also be changed without parliamentary approval. Such arbitrary changes in the Special Commodity Levy and import duties—not to mention quantitative restrictions on imports—***not only create uncertainty, but also opportunities for corruption, for instance through temporary reductions that create rents for connected individuals.***

So how can we have better governance around taxation?

Transparency and simplicity of the tax system are critical for ensuring good governance. Complex tax systems with multiple rates, exemptions, and scope for arbitrary decision-making open room for the abuse of power and mainly serve vested interests. By contrast, a tax system that is uniform, rules based, and grounded in clear, simple principles promotes not only fairness, but also fiscal sustainability through higher tax revenues because of limited leakages and increased compliance. Two aspects of the tax system—tax policy and tax administration—need to be considered. But generalizations are not enough, we need specifics. So here are 10 proposals! 6 on tax policy and 4 on tax administration.

To improve governance on **tax policy***, we should:*

(i) First, ***pass an overarching tax law requiring tax rates to be set in a uniform, non-distortionary manner. Any deviations or exemptions from standard schedules would need to be justified through an impartial cost-benefit analysis by the Ministry of Finance that is published and presented to Parliament for approval.*** All corporations—foreign and domestic—including those operating in special zones such as Port City, should be ***subject to the internationally-agreed Global Minimum Tax rate of 15 percent. It is time to end Sri Lanka's misguided and irrational addiction to tax holidays.*** The legislation should eliminate ministerial authority to introduce tax changes, including of customs and commodity levies, through Gazettes and other regulations without prior parliamentary approval. It should require revenue losses from tax changes to be matched by offsetting fiscal measures. The legislation should also mandate a single tax policy department within the Ministry of Finance. This department should be the unique tax policy arm of the government with the responsibility to recommend rates of taxation and any exemptions or deviations from standard tax schedules. ***Bodies such as the BoI and the Port City Commission should not be given power over tax or tariff exemptions.***

Until such legislation is passed, ***in the immediate term***:

(ii) —And this is the second proposal—sunset existing tax exemptions to end in 3-5 years. If performance criteria—in terms of investment and job creation—had been set at the time the exemption was granted, discontinue the exemption until the corporation has proved it has met all criteria.

(iii) Third, abolish the Strategic Development Projects Act and the Special Commodity Levy Act. ***They are both terrible pieces of legislation.***

(iv) Fourth, suspend granting tax concessions under the Colombo Port City Act and bring any proposals for new tax concessions under the Ministry of Finance. Amend the Port City Act to make this a permanent feature.

(v) Fifth, create a single tax policy department within the Ministry of Finance even before formal legislation is passed. Transfer authority to that department to design and evaluate customs duties, excise taxes, and any new tax concessions, including in Port City, based on clearly defined criteria. Require the department's prior approval for any tax change implemented through Gazettes or other regulations until the overarching tax law is passed. Also publish on a public website the department's impartial cost-benefit assessment of every tax law amendment, concession, or new tax Act.

(vi) Sixth, the Ministry of Finance should independently quantify all existing and new tax expenditure under the various tax acts every year, including revenue foregone in each Port City or other project, and report them in a transparent, disaggregated format on a public website.

Turning to tax administration,

Sri Lanka will never achieve fiscal sustainability and inclusive prosperity without much better tax administration, including tackling tax evasion. ***Like better tax policies, better tax administration is largely a matter of political will to take on vested interests.***

To quote the GDA: "Sri Lankan revenue administration has a reputation of being highly prone to corruption and rent-seeking… Both Customs and IRD officials acknowledge the rampant state of corruption in their institutions with little risk or consequence of exposure, and similarly few if any consequences when corruption allegations are made." The report goes on to say [quote] "There is virtually no culture of integrity observed, with corruption allegedly found at every level. The revenue departments—that is, IRD, Excise, and Customs— are predominantly closed institutions with little, if any, employment mobility into and out…(they) are reluctant to change, particularly given strong union influences.... (and) hamstrung from building skills and expertise needed for the modern economy, with IRD unable to recruit specialist information technology staff and data analysts needed to move away from the corruption-prone embedded work practices." Given that IRD and Customs together employ more than 4,000 staff, it is not a matter of staffing levels, but a question of modernizing skill and expertise levels. ***This assessment is probably hard for some to hear, but it is critical for the nation's future that corrective action is not postponed.***

Such corrective action should include—continuing with the 10 proposals:

—Seven, ***strengthening the management of the revenue departments*** and oversight by the Treasury Secretary and the Auditor General. The three revenue departments—IRD, Customs, and Excise—are after all departments within the Ministry of Finance. It is, ultimately, the responsibility of the Minister of Finance and the Secretary to the Treasury to supervise them properly.

—Eight, ***prioritizing the Large Taxpayer's Unit***. Staffing and empowering this unit with the skills needed to track and minimize tax evasion by the super-rich is essential. Sri Lanka is not short of the skilled accountants, auditors, IT and finance professionals that are needed, but successive governments have for years dragged their feet on this matter.

—Nine, ***reducing opportunities for corruption by digitizing tax collections by Customs, Excise, and IRD, including by fully operationalizing the RAMIS system.*** Tax audits should be required to be based on transparent compliance risk criteria.

—And finally, ***passing a Tax Administration Act*** that applies to all taxes and contains provisions to effectively deter corruption by imposing strict penalties, ***including criminal charges,*** on taxpayers as well as tax officials for offering or taking bribes or aiding tax evasion.

Let's move on to good governance on the third policy objective of enabling market-oriented growth by reducing the size and role of the public sector.

Sri Lanka's public sector is large ***and two areas in particular—public procurement and state-owned enterprises—hinder growth by distorting relative prices and obstructing market competition.*** They also divert fiscal resources from social and anti-poverty needs.

The government is the largest purchaser of goods and services in the domestic market and ***public procurement*** affects the pricing and availability of key items, such as fuel, electricity, and medicines. It also accounts for a significant part of government spending, estimated at over 5 percent of GDP. ***Yet, shockingly, Sri Lanka has no public procurement law.*** Instead, in principle, all government procurement needs to be carried out in line with the Cabinet-approved 2006 Procurement Guidelines. But given ad hoc and frequent revisions, there is no unified, updated version of the Guidelines and Manual. The National Procurement Commission is mandated to formulate effective procedures and monitor their implementation, but it has started to function only recently after being reinstated last year. Procurement processes are complex, but in the end, Cabinet essentially has ***unconstrained*** discretion on procurement.

The practice of accepting unsolicited Private-Public Partnership (PPP) proposals for large infrastructure projects also contributes to poor governance. These are often approved outside the budget process without assessing the fiscal implications and outside the four-year Public Investment Program that is supposed to reflect the government's policy priorities. Unsolicited proposals typically involve a single bidder while the Procurement Guidelines do not cover PPPs.

The GDA notes that procurement irregularities include [quote] "(the) lack of procurement planning, not using relevant procurement procedures stipulated by the Procurement Guidelines, inadequate competitiveness in the selection procedure, accepting unsolicited proposals for high value projects, poor contract management, lack of knowledge and capacity of the officials in procurement, poor monitoring and weak external oversight, and the incomplete coverage of independent complaints mechanisms." [unquote] Procurement irregularities by state-owned enterprises have also been identified by COPE.

All these governance deficiencies not only create significant corruption opportunities, but also thwart the development of competitive markets and firms.

Some steps to improve governance in procurement would be to:

- Most importantly, enact a ***Public Procurement Law*** that reflects international good practice.

- Move all public procurement transactions to ***an e-Government Procurement System by end-2024.***

- ***Empower the National Procurement Commission*** with a clear mandate, authority, and responsibilities, including oversight of unsolicited PPP proposals.

- And finally, ***increase transparency by publishing information***—updated every 6 months—***on public procurement contracts*** above a certain threshold, identifying those that were assigned without a competitive tendering process.

Turning to restructuring state-owned enterprises,

There are over 400 state-owned enterprises that engage—some would say interfere— in practically every sphere of economic life, employ a sizable part of the labor force, constitute a significant drain on public finances, and pose risks to the financial system because of non-performing loans. Four SOEs in particular, the CPC, the CEB, Sri Lankan Airlines, and the Road Authority, have required large subsidies from the budget. About 130 SOEs are engaged in commercial activities that are likely better done in the private sector.

There is general agreement that the large SOE sector inhibits the development of competitive private markets and the proper allocation of public resources. Quoting the National Transformation Road Map of June 2023 "***Many of these enterprises have garnered a monopolistic position in the market, hindering private investment. Price fixing, inefficient management, and poor entrepreneurship have weakened public finances,*** turning these institutions into national burdens that are dependent on the taxpayer." [unquote] And as the Secretary to the Treasury said in a recent public speech, [quote] "***SOEs are vulnerable to mismanagement and corruption*** as well because of potential conflicts of interest between the ownership and policy-making functions of the government, and the undue political influence on their policies, appointments, and business practices. It is observed that their internal control, monitoring and governance frameworks are inadequate to deal with these problems."

The GDA also notes [quote] "***(e)xtensive government regulation in core sectors, such as agriculture, electricity, and construction, restricts market-based accountability*** and generates extensive opportunities for top officials to direct state resources to privileged private parties." [unquote]

Fundamental reform of the governance of SOEs is urgently needed to durably address these problems. The SOE Reform Policy that Cabinet approved earlier this year establishes a sound basis to improve SOE governance. It envisages a two-prong approach to divest majority shares in commercially oriented SOEs while operating those that need to remain in government ownership under a holding company on a fully commercial basis. The key priority now is to implement this reform policy without delay, including by enacting the corresponding SOE Law. The proposed reforms should not be diluted as they go through the parliamentary process.

Some areas of the envisaged SOE Law are worth close consideration:

(i) The first is to define very strictly when the government would retain a majority stake in an SOE. Objective and specific criteria will need to be developed to determine whether there is a national security interest. It might also be better to use the criterion of an "economic externality"—which can be clearly defined—rather than whether a product or service is deemed "essential," which could be interpreted too broadly.

(ii) Second, the expected norm should be that SOEs that engage in commercial activities are fully divested so that the government doesn't end up holding minority stakes in companies without a strong reason.

(iii) Third and most critically, the SOE law should ***ensure the political independence, professional competence, and personal integrity of the Holding Company Board and the Advisory Committee that would oversee the Board.*** It would also be important to ensure that ***line ministries cannot be involved in managing and influencing SOEs or in any privatization process.*** Requiring SOEs to float at least some shares in the Colombo Stock Exchange, or even stock exchanges abroad, may be an effective way to ensure that they conform to governance and financial reporting norms required of listed private companies.

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In conclusion, I have discussed today ***the importance of good governance to achieve durable price stability and prosperity, which is an aspiration of all Sri Lankans.*** A main point I want to make is that this crisis really is different. The path ahead is narrow because our debt will remain high for many years. It is fraught with risks of political backsliding, resistance from vested interests, reform fatigue, and exogenous shocks. There is no room for complacency and slacking off on reforms if we are to avoid another, potentially more devastating crisis. ***As we mark the 73rd anniversary of the CBSL, we can be encouraged by the progress*** made in achieving price stability and good governance over the conduct of monetary policy. But the Central Bank Law and fostering an independent transparent CBSL culture ***do not guarantee that the CBSL's independence will be safeguarded in the future.*** It needs to be supported by a sustainable fiscal position and a market-oriented economy that delivers strong inclusive growth. ***I have focused today on three areas where I believe progress is critical.*** I have suggested 17 practical actions to strengthen governance—3 on central bank independence, 10 on the tax system, and 4 on public procurement—in addition to implementing the 2023 SOE Reform Policy. That might seem like a lot. Well, think of it as only one action for each time we have resorted to the world's lender of last resort.

I do believe though that this crisis is also an opportunity. It is an opportunity to take on vested interests that have blocked good governance for so long and to undertake the reforms needed to achieve inclusive prosperity. The challenge is to strengthen our economic institutions and governance so that ***economic policies will remain sound even when the country is subject to exogenous and political shocks.*** Other countries—like India, Thailand, and Korea—have suffered crises and emerged stronger and more resilient by strengthening their institutions and governance. ***We must do so as well!***

Thank you very much for your attention.