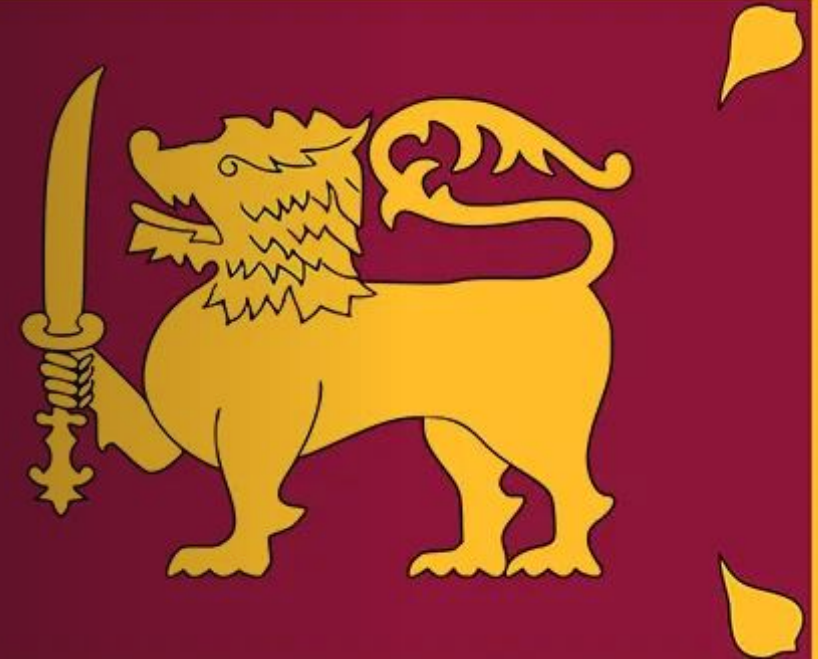


Sri Lanka's IMF Status: Lost or Leading?



First Capital
A Janashakthi Group Company

October 2023



IMF Timeline



The IMF timeline has consistently aligned with the projections made by First Capital Research. We expect the 2nd tranche to be disbursed in early Dec 2023.

ECONOMY

Sri Lanka tax officials acknowledge "rampant state of corruption": IMF report

Section VI. – Revenue Administration – Tax and Customs

Fiscal Governance – Revenue Administration

Governance Weaknesses and Corruption Vulnerabilities in Sri Lankan Revenue Administration

205. Sri Lankan revenue administration has a reputation of being highly prone to corruption and rent-seeking. Such perceptions are acknowledged by both insiders and external stakeholders to have progressively worsened in recent years, given the impunity of action against unethical and corrupt behavior. Three separate revenue collection departments of the Ministry of Finance (Inland Revenue, Customs, and Excise) operate within the government framework of the public service commission (PSC). Despite responsibility for an overlapping pool of taxpayers/traders, each revenue department broadly operates separately with little interaction other than the sharing of import/export data by Customs with Inland Revenue.

206. Corruption vulnerabilities occur at points of interaction between revenue officials and the public. This is magnified when revenue officials exercise discretion without adequate safeguards with opportunities when assessing income or expenses, classifying goods and tax rates, or granting concessions. Cumbersome procedures that are open to abuse, along with collusion between officials⁴²,

Sunday October 1, 2023 3:32 pm

Sri Lanka has high import and excise tax rates, which critics have said is a blueprint to boost corruption in tax authorities as well as illegal manufacture of alcohol and smuggling of cigarettes.

"While corruption vulnerabilities appear to permeate Sri Lankan revenue administration,

there appears to be little, if any, accountability, or consequence for such actions," the report noted.

"There is virtually no culture of integrity observed, with corruption allegedly found at every level – including top management.

Other critics have also also pointed that Sri Lanka has high import protection where potential taxes are legally channeled (tax is arbitrated) to the pockets of politically influential 'domestic producers' of goods, through higher than world prices.



Sri Lanka's Central Bank Chief confident of completing IMF review

Written by Zulfiq Farzan
04 Oct, 2023 | 1:03 PM

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On Tuesday (3), Reuters reported that Sri Lanka's major creditors such as Japan, India and France are likely to reach a broad agreement this month on debt reduction steps including extending repayments.

Reuters quoting the Sankei newspaper reported that Sri Lanka has held multiple rounds of talks with bondholders and bilateral creditors including Japan, China and India on reworking its foreign debt after suspending repayments in May last year.

It said that a group of Sri Lanka's major creditors including the United States, Japan and India want to sign a memorandum of understanding with the country around the time of the International Monetary Fund and World Bank meetings later this month in Morocco.

China has resisted joining the group but it remains an observer.

A senior Japanese finance ministry official told Reuters that they are aiming to reach an agreement among creditor nations with or without China.

At the same time, the US government said a bondholder's lawsuit against Sri Lanka over the country's historic debt default should be put on hold, reported Bloomberg.

In a statement of interest filed in the New York federal court, the US backed the Sri Lankan government's request to delay a lawsuit by Hamilton Reserve Bank Ltd, seeking full payment and accrued interest on more than \$250 million in bonds that came due in July 2022.

The US said the delay would help with ongoing restructuring talks between the South Asian country and other creditors.

IMF SL visit: May not lead to renewed pact on \$3 Bn bailout

27 Sep 2023



Sri Lanka will now have to hold more discussions with the multilateral lender to ensure it can meet targets, said the person who asked not to be identified as the matter is not public. The talks could be held in Morocco on the sidelines of the annual IMF meetings next month, or in Washington shortly after, the person added.

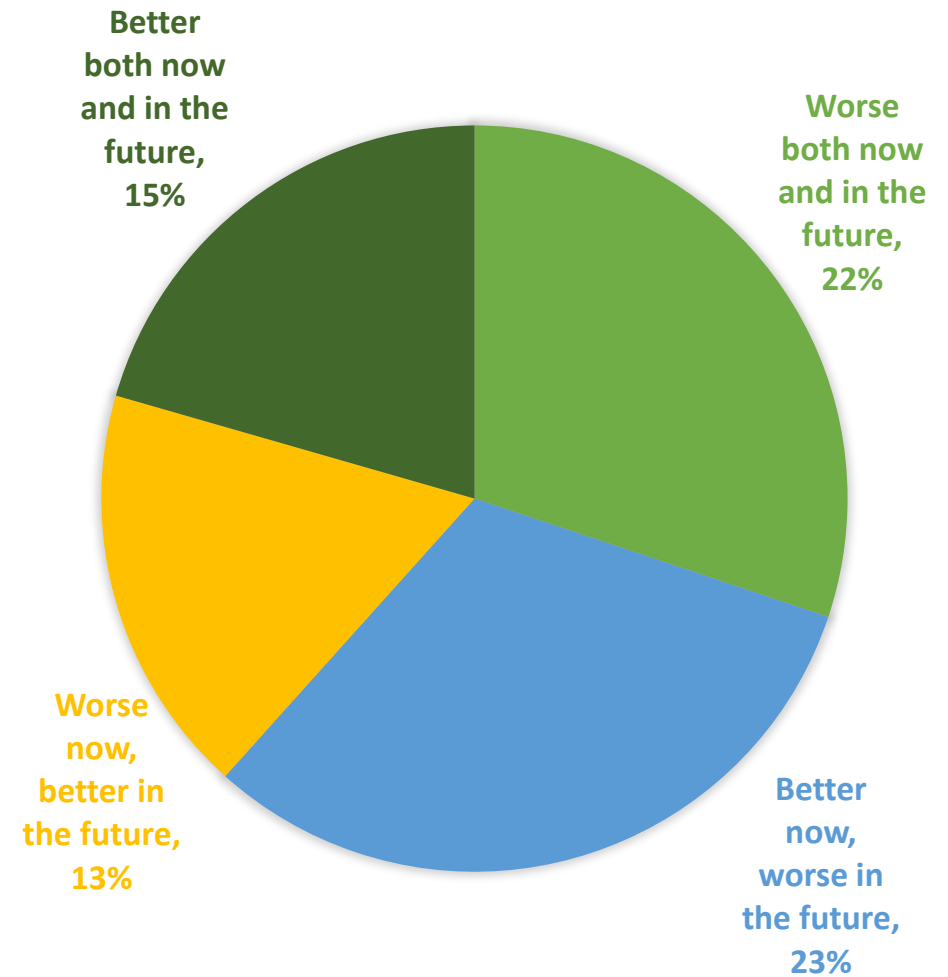
IMF lists 16 Priority
Recommendations to
Improve Nation's
Governance in the 1st
Review



	Implementation Timeline	Recommendations (These play a role in improving the legal and institutional frameworks, governance and anti-corruption reforms as outlined in the Staff Level Agreement for an Extended Credit Facility Arrangement for Sri Lanka)	Strengthen Accountability	Strengthen Rule of law	Enhance Transparency	Strengthen Oversight	Reduce Conflict of Interest
1	Nov-23	Establish an Advisory Committee	✓	✓			
2	Dec-23/Dec-24	Implement short-term anti-corruption measures within each revenue department and issue a public report on progress and outcomes	✓				
3	Mar-24	Publish on a designated website: (i) all public procurement contracts above LKR 1Bn; (ii) firms receiving tax exemptions via the Board of Investment and the SDP, estimating exemption value, and (iii) firms receiving tax exemptions on luxury vehicle imports			✓		
4	Apr-24	Enact Proceeds of Crime legislation	✓	✓			
5	Apr-24	Enforce regulations to support the provision of beneficial ownership information and establish a public beneficial ownership registry	✓		✓		
6	Jun-24	Produce a Cabinet policy paper outlining options for new management of the EPF terminating direct CBSL control					✓
7	Jul-24	Publication of Asset Declarations for senior officials	✓		✓		
8	Dec-24	Establish an online digital land registry and publish a website report on the progress in implementing the state land registering/titling plan			✓		
9	Dec-24	Enact a Public Procurement Law reflecting international good practice			✓		
10	Dec-24	Release a website report on the progress in increasing competitive tendered procurement contracts in the 10 agencies with the lowest competitive tenders in 2022			✓		
11	N/A	Amend the National Audit Act to empower the Auditor General to levy surcharges on officers for negligence in overseeing and managing public resource utilization	✓		✓		
12	N/A	Implement the SOE Reform Policy			✓		
13	N/A	Abolish/suspend application of the Strategic Development Projects Act			✓		
14	N/A	Amend tax legislation to eliminate/restrict ministerial authority to enact tax changes without prior parliamentary approval		✓			
15	N/A	Revise legislation, regulations, and process relating to financial sector oversight in the banking sector				✓	
16	N/A	Establish and implement a plan to expand Judicial Services Commission's resources and skills and define potential options for modifying governance arrangements in the Justice sector		✓			

Public Skepticism on IMF Bailout

45% of Sri Lankans believe IMF's USD 3.0Bn EFF will make things worse in future and 28% believe that it will improve Sri Lanka's economy in the future.



Source: Verite Research



IMF Funding for Sri Lanka: Delays on the Horizon?



#mbT

IMF's New Funds for Sri Lanka Face Holdup Amid Revenue Shortfall in 1st Review

IMF fails to reach staff-level agreement in the 1st review

IMF failed to reach a staff-level agreement for the 2nd tranche with Sri Lanka in its 1st review of a USD 2.9Bn bailout package as Sri Lanka is expected to fall short of initial projections by nearly 15% by end of 2023, despite witnessing year-over-year gains in revenue mobilization.

Second tranche release hinges on government reforms and debt repayment

Release of the 2nd tranche of about USD 330.0Mn is contingent upon reaching a staff-level agreement with the IMF which depends on whether the government could sustain reforms and make progress on paying its debt.

IMF calls for tax reform and revenue boost in Sri Lanka

IMF has advised Sri Lanka *to strengthen tax administration, remove tax exemptions, and actively eliminate tax evasion* to boost revenues and improve governance. IMF also stated that it expects one more tax reform in the very near future.

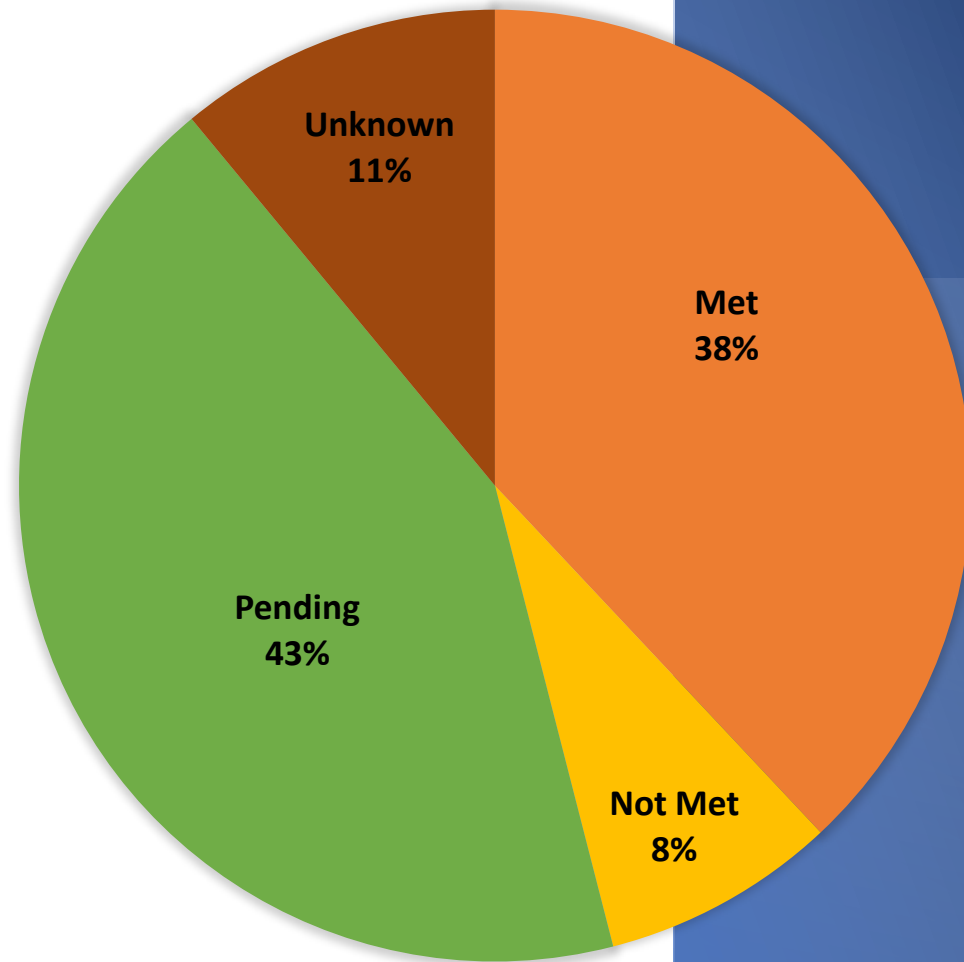
Preserving Financial Stability: A Key Pillar of IMF's Restructuring Program

IMF noted that banks will suffer from the restructuring due to their exposure to the government, both in terms of domestic and external foreign exchange instruments and therefore financial stability constitutes an important part of the program with its own pillar.

Financial safety net: IMF sets minimum threshold for social spending

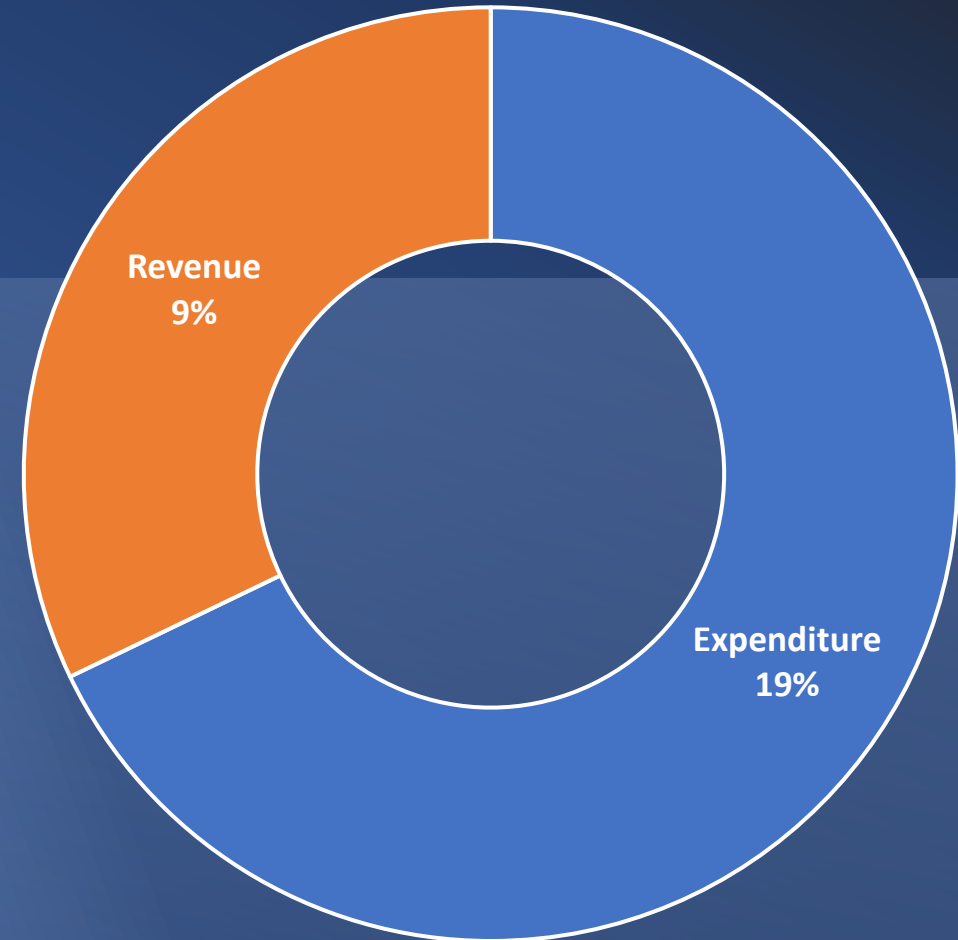
IMF established a minimum threshold on 4 major cash transfers, totaling approximately LKR 187.0Bn or equivalent to 0.6% of GDP in 2023. Looking ahead, it expects to see that this minimum level of social spending is continued into the next year.

IMF TRACKER



As of Aug 2023, Sri Lanka has met 38 out of 100 IMF commitments and has failed to meet 8 commitments.

(% of GDP)



IMF stated that Sri Lanka's expenditure accounts for 19% of its GDP and its revenue stands at just 9% of GDP, highlighting a significant gap that needs to be addressed through more efficient tax collection.

One of the IMF's targets for Sri Lanka is to achieve revenue generation equivalent to 12% of GDP in 2024.

The 2020 tax cuts widened the disparity in Corporate Income Tax (CIT) rates among different sectors and resulted in sizeable revenue losses. This made it easier for businesses to engage in tax avoidance practices, complicated tax administration, and exacerbated economic imbalances.

The IRA of 2017 (effective from 2018) maintained the standard CIT rate at 28% but introduced sector-specific rates for tourism, education, export income, small and medium-sized enterprises (SMEs), and agriculture.

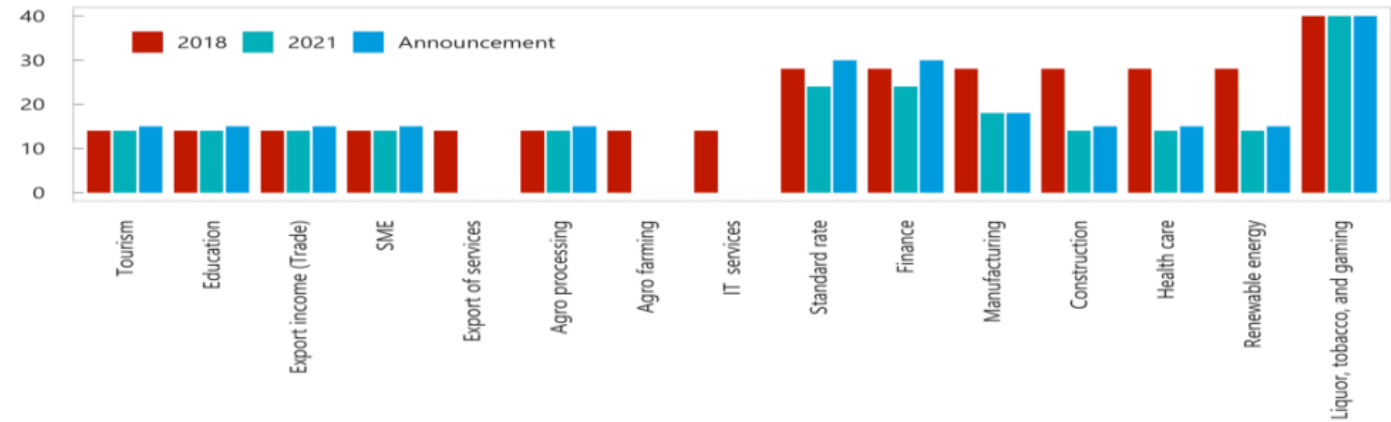
By 2020, some of these reduced rates had been further reduced to zero for sectors like service exports, Agro-farming, and IT services, while new reduced rates were introduced for construction, healthcare, and renewable energy (as shown in the Figure).

“An economies’ resources should be allocated such that the marginal return of those resources to society is equalized. Otherwise, reallocation could increase total output while leaving costs unchanged. The tax system drives a wedge between a taxpayer’s marginal net return and the marginal return to society. Where sectors are subject to different rates, those wedges differ across sectors, too, leading to resources misallocation: too much capital and labor is used in undertaxed sectors and too few resources are used in overtaxed sectors. The resulting efficiency losses increase in the variation of marginal effective tax rates. In addition, the rate variation implies social costs due to increased avoidance opportunities (for instance, due to multi-sector companies) and associated administrative costs (to curb domestic profit shifting).”

- IMF

Variation in Corporate Income Tax Rates

Sector Specific Rates in 2018, 2021, and announced in 2021



Source: IRA 2017 and consolidated IRA of 2021, IMF staff computations



Sri Lanka's IMF Review: Overcoming Two Key Hurdles for Approval

Sri Lanka must satisfy 2 key targets to secure IMF board approval



Establish an agreement on a set of policies and reforms to achieve the IMF objectives. It should be focused on the staff level agreement hardening performance criteria, such as the domestic primary deficit, reserve collection, inflation, and reform timelines (*currently there is a revenue shortfall, and the government needs to work on that*).



Establish a clear plan to restore debt sustainability. Sri Lanka has already completed the restructuring of its domestic debt but still needs to address its external debt with the Paris Club, China, and private creditors. China, its largest single creditor, accounts for 42% of Sri Lanka's overall external debt, followed by Japan at 24%, India at 15% and France at 4% (*currently the government needs to achieve the debt targets set by the IMF in Mar 2023*).

Diving Deeper: Unveiling the Essence of Two Key Targets

1st Target

- IMF has warned Sri Lanka about the slowing pace of foreign reserve collections and reiterated concerns about printing money, among other warnings regarding liberal reverse repo injections.
- IMF stated that the nation's stability hinges on rebuilding external reserves through strong reserve accumulation, refraining from monetary financing to maintain inflation at manageable levels, and maintaining cost recovery of electricity pricing.
- However, Sri Lanka has faced challenges in boosting its revenue, and it is expected that further actions will be implemented in the upcoming budget scheduled for Nov 2023. Sri Lanka's Jun 2023 revenue shortfall prompted IMF consideration of tax increases in the Nov budget.
- Sri Lanka is expected to request a waiver on the Net International Reserves (NIR) performance criteria in the next review due to its failure to meet two June IMF targets.

2nd Target

- IMF stated that a Financing Assurances Review is required to address the debt issue.
- This process applies to both official creditors (countries that have lent to Sri Lanka on a bilateral basis) and commercial creditors (such as bondholders).
- The goal is to ensure adequate progress in negotiations with creditors, instilling confidence that the debt restructuring will be completed in a timely manner and in line with the program's debt targets.
- The decision of whether and when the IMF can proceed ultimately rests with the executive board.



Positive Progress in Securing 2nd IMF Tranche



Shehan Semasinghe, the Acting Finance Minister, has reported that negotiations aimed at obtaining the second tranche of funds from the IMF are progressing favorably.

He also highlighted that discussions to conclude the staff-level agreement necessary for receiving the 2nd tranche are expected to occur under the President's chairmanship.



“

Comparing to the previous year, the government revenue has seen a remarkable growth of 43%... Last year, the interest rate on treasury bills in the domestic market was as high as 30%. Today, it has reduced to 13%. This reduction is a significant advantage for our treasury. Furthermore, our foreign reserves have increased, and we are witnessing an upturn in tourism. Additionally, remittances from Sri Lankans abroad have resumed their normal flow. With the on-going economic development, we have laid out plans to continue our economic growth roadmap for the upcoming year without any hindrances.

”

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