NAVIGATING SRI LANKA'S ECONOMIC PRECARITY:

THE NEED TO ADDRESS FOUNDATIONAL ISSUES IN GOVERNANCE

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CENTRE FOR POLICY ALTERNATIVES

Navigating Sri Lanka's Economic Precarity: The Need to Address Foundational Issues in Governance

The Centre for Policy Alternatives (CPA) is an independent, nonpartisan organisation that focuses primarily on issues of governance and conflict resolution. Formed in 1996 in the firm belief that the vital contribution of civil society to the public policy debate is in need of strengthening, CPA is committed to programmes of research and advocacy through which public policy is critiqued, alternatives identified and disseminated.

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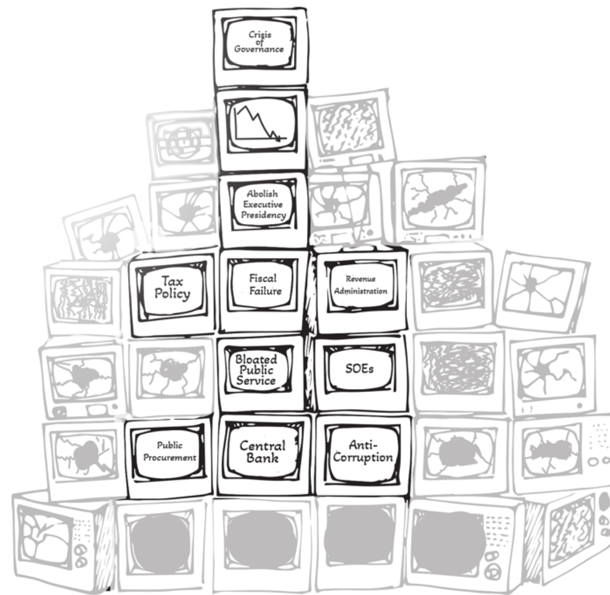

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Table of Contents

Foreword 6

Executive Summary 8

Introduction 10

The Unconstrained Presidency: Allowing Ruinous Decision-Making 12

- Following through on Reckless Election Promises 13
- Hasty Shift to Organic Farming 14
- The Fallout of a Delayed Default.. 16

Fiscal Failures: Tax Policy and Revenue Administration......................................17

- Excessive Executive Discretion in Tax Policy 17
- Complex and Inefficient Tax Policy 18
- Integrity in Revenue Administration 19
- Eroded Public Tax Morale 19

Excessive and Wasteful Expenditure: A Bloated Public Sector 21

Failures of State-Owned Enterprises..23

- Take Your Seats: Turbulence at Sri Lankan Airlines 23
- Broader SOE Management Failures 24

Poor Planning, Opaque Dealing: Public Procurement Failures 27

- The Mannar Wind Power Project 27
- Broader Procurement Failures 29

Monetary Failures: Central Bank Governance...30

- Bond Scandals... 30
- Pattern of Poor Regulation and Decision-Making 32

Inaction against Corruption: CIABOC and the Attorney General 34

Conclusion..36

Bibliography...38

Foreword

The events of 2022 plunged the country into an unprecedented crisis including defaulting on its debt. Many characterisations of this crisis have been presented with gross economic mismanagement and/or serious misgovernance being the most prevalent. What this Brief seeks to emphasise and focus on is the overarching governance dimension of the crisis to make the argument that misgovernance has been rife throughout successive post-independence governments and its accumulated burden exacerbated by certain decisions of the over last decade in particular, brought to a head the crisis of 2022. This is an argument forwarded in the Civil Society Governance Diagnostic and the IMF Governance Diagnostic of Sri Lanka — the first of its kind in Asia, in response to the crisis.

Successive governments have treated the polity as voters and not citizens, creating and perpetuating a culture of entitlement with an emphasis on rights at the expense of corresponding duties - effectively false promises of entitlement without serious consideration of the resources to provide for them. In addition, every government has swelled the public service with its supporters to an unsustainable level. Likewise, state-owned enterprises. Now sixteen years after the end of the war, demobilisation of the armed forces is yet to be implemented in earnest.

The office of the executive presidency at the apex of the structure of authority and power, is unfettered by effective checks and balances, facilitating populist, capricious, and arbitrary decision-making. The consolidation of power and authority in this single office has robbed decision-making of transparency and accountability – the key pillars of governance – from government.

What has been especially highlighted in the crisis and in the national election campaigns that followed, is corruption and the extent and manner in which it has been institutionalised in our system of governance and government. The *Aragalaya* of 2022 highlighted the need for "SYSTEM CHANGE" which was carried through into the national election campaigns which followed in 2024.

Whilst the new National People's Power (NPP) government has inaugurated a programme of Clean Sri Lanka, which aims at governance reform both in terms of institutional reform as well as popular culture, the task ahead is considerable and will require strong support from civil society. From the system of education on, we need to inculcate in the citizenry a vision of Sri Lanka, of rights and duties for a citizen in a functioning democracy in which the questions of the "what" and the "why" are as important as the "how". This vision for Sri Lanka has to embody checks and balances on the exercise of executive power, transparency and accountability in governance and government, and a society, in the words of Avishai Margalit, where institutions do not humiliate citizens and citizens do not humiliate one another.

This Brief, we hope, will help to focus our attention on the pivotal importance of governance to get us out of the current crisis and to underpin sustained growth and prosperity in the future.

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Centre for Policy Alternatives

Executive Summary

A robust economic recovery for Sri Lanka requires an understanding of how the country fell into economic precarity. The learnings of both the Civil Society Governance Diagnostic Report and the International Monetary Fund's Governance Diagnostic Assessment of Sri Lanka made it apparent that Sri Lanka's economic crisis is first a crisis of governance. In other words, Sri Lanka's economic crisis is primarily the product of issues in governance rather than economic failure. Moreover, unless the "foundational governance issues" are addressed the policies and plans for debt sustainability and economic recovery are likely to "be on shaky ground" (TISL 2023: 3). As the aforementioned reports already identify Sri Lanka's governance issues and offer recommendations, this Brief does not replicate that exercise. Instead, it intends to tangibly demonstrate how said issues contributed to the economic crisis through a selection of case studies. More specifically, the Brief demonstrates how the excessive powers and discretion held by the executive branch of government, as well as weaknesses in tax policy and revenue administration, the public sector, public procurement, central bank governance, and anti-corruption — all issues of governance — heavily contributed to Sri Lanka's economic crisis.

Of the issues and subsequent case studies examined within the Brief, a few are worth reiterating here. Firstly, the concentration of power within the executive presidency, intended to enable decisive action towards economic development, has resulted in unilateral and opaque decision-making. This has, in turn, facilitated incompetence or corruption. Presidential decisions that contributed to the crisis demonstrate this issue. For instance, in 2019, then President Gotabaya Rajapaksa disregarded economic expertise and introduced a tax policy that severely reduced government tax revenue. This adversely affected the country's capacity to repay debt and further depleted its foreign currency reserves, catalysing Sri Lanka's trajectory towards national insolvency. The lack of checks and balances on the President meant that there was no way to prevent him for following through on his reckless election promises even though the danger was foreseen. Therefore, it is essential to abolish the executive presidency and vest its powers in the collective deliberation and decision-making of Parliament. At a minimum, reducing individual discretion in decision-making will prevent the colossal errors that have resulted from the absence of checks and balances on the executive presidency.

Secondly, government expenditure in the public sector is excessive and has little impact. The large number of public sector employees burdens the government purse, nor does it have anything to show for it in the form of efficient public service delivery. The military illustrates this in having and spending on far too many personnel which does not translate to the country's defensive needs. This is unlikely to be the only example of this from the public sector. The public sector should be proportionate to each government department's needs.

Thirdly, the state must have a coherent rationale for engaging in the market. Due to its limited capacity with state-owned enterprises, the state should exit competitive markets where the private sector can deliver goods and services more cheaply, efficiently, and at better quality. Before being acquired back by the Sri Lankan government in 2008, Sri Lankan Airlines managed a profit of LKR 9.29 billion in its last year of private operation (The Sunday Times 2016). Despite increased tourism and low fuel prices over the next seven years, Sri Lankan Airlines as a state-owned enterprise experienced a loss of LKR 128.2 billion (ibid.). Privatising such state-owned enterprises would boost tax revenue, productivity, and reduce government expenses.

Lastly, the absence of punitive action against corruption has resulted in its prevalence throughout government. It is essential that anti-corruption measures are shielded from political influence and sufficiently resourced to recover losses due to corruption, and more importantly, to serve as a deterrent to corruption. Ensuring the autonomy of the Commission to Investigate Allegations of Bribery and Corruption and establishing an independent Public Prosecutor's office are first steps in that regard.

Of course, this Brief does not exhaustively discuss Sri Lanka's issues in governance that contributed to the crisis. However, the central takeaway is that Sri Lanka is experiencing a crisis of governance and its recovery from national insolvency and overall economic precarity necessitates addressing the foundational governance issues that plague the country.

Introduction

At the height of the country's economic crisis in 2022 — Sri Lanka's worst since independence — citizens had to endure over thirteen-hour power cuts and shortages in food, medicine, and other essential imports. In May 2022, Sri Lanka defaulted on its debts for the first time in its history. Even now, many face significant economic pressures from increased inflation and currency depreciation resulting in widespread economic insecurity. Sri Lanka's recovery from national insolvency is far from complete.

A robust economic recovery depends on understanding the underlying nature of the economic crisis and addressing its root causes. The purpose of this Brief is to illustrate how Sri Lanka's economic crisis has been a crisis of governance, one that continues to have severe economic ramifications for Sri Lanka even after the acute challenges of early 2022. It is reductive to argue that the economic crisis was merely a product of economic failure.[1]

Prior to illustrating how Sri Lanka is experiencing a crisis of governance, defining governance is necessary. In this Brief, governance is understood as the "exercise of political, economic, and administrative authority in the management of a country's affairs at all levels" (UNDP 1997: iv). It includes not only government institutions at the national level, but also engagement with decentralised governments, the public and private sector, and civil society organisations (idem: v). It involves optimal and equitable resource allocation, participation, transparency, accountability, and promotion of the rule of law (idem: iv). Governance matters especially for its economic and social implications; good governance is "synonymous with sound development management" (World Bank 1992: 1).

The view that Sri Lanka's economic crisis is a crisis of governance is not unique to this Brief. The Civil Society Initiative on Anti-Corruption Reform for Economic Recovery[2] that developed an

[1] It is worth noting that the consequences of Sri Lanka's crisis of governance are not limited to the economy, and that Sri Lanka's economic crisis has social and economic drivers as well. However, all of those failures fall outside the scope of this Brief.

[2] The group comprises the Centre for Policy Alternatives (CPA), Transparency International Sri Lanka (TISL), People's Action for Free and Fair Elections (PAFFREL), Sarvodaya, Verité Research, and National Peace Council of Sri Lanka (NPC).

independent Civil Society Governance Diagnostic Report on Sri Lanka is also of the view "that the economic crisis in Sri Lanka is first a crisis of governance" (TISL 2023: 3). The report explicitly recognised the importance of anti-corruption and governance reforms to address the root causes of the economic crisis and allow for an equitable economic recovery (ibid.). Notably, it argued that unless the "foundational governance issues in Sri Lanka" were addressed, the policies and plans for debt sustainability and economic recovery would likely "be on shaky ground" (ibid.).

Additionally, the International Monetary Fund (IMF) programme that Sri Lanka entered in March 2023 includes governance and anti-corruption as a key pillar and, therefore, initiated a governance diagnostic — the first of its kind in Asia (ibid.). The resulting Governance Diagnostic Assessment made recommendations on anti-corruption, anti-money laundering and combating the financing of terrorism (AML/CFT), fiscal governance (including public financial management, tax policy and revenue administration, state enterprise management, and public procurement), central bank governance, financial sector oversight, and enforcement of contracts and protection of property rights (IMF 2023: 10). The diagnostic underscores the idea that Sri Lanka's economic crisis emanates from governance issues that must be addressed for a robust economic recovery.

Given that the aforementioned reports diagnose Sri Lanka's governance issues and provide corresponding recommendations, this Brief does not repeat that exercise. Instead, through case studies it aims to demonstrate how Sri Lanka's governance crisis unfolded and caused economic devastation. Sri Lanka faces a debt crisis because the value of its public debt became unsustainable relative to its capacity to repay that debt, in short, its annual gross domestic product (GDP) (Alphonsus 2020). At a time of slow economic growth, ineffective tax policy and revenue collection combined with wasteful government expenditure funded by debt created the conditions for national insolvency. Weak institutional checks and balances failed to constrain arbitrary decision-making throughout the system, allowing the crisis to unfold fully.

As will become apparent, the excessive powers and discretion held by the executive branch of government, as well as weaknesses in tax policy and revenue administration, the public sector, public procurement, central bank governance, and anti-corruption — all issues of governance — heavily contributed to Sri Lanka's economic crisis.

The Unconstrained Presidency: Allowing Ruinous Decision-Making

The economic rationale for establishing the executive presidential system under the 1978 Constitution, in which the President is the directly elected Head of State and Government and can only be removed through a difficult impeachment process by Parliament, was to allow the President to take control of economic development (Welikala 2024). It is worth noting that the President is also the Head of the Cabinet and appoints and dismisses the Prime Minister and the Cabinet (ibid.). However, this rationale never made the leap from theory to practice as the lack of checks and balances on the President has led to unilateral and opaque decision-making, in turn facilitating incompetence or corruption (ibid.).[3] An examination of the economic crisis of 2022 illustrates this point vividly.

Sri Lanka is nationally insolvent largely due to the decisions of presidents. Before 2007, Sri Lanka had borrowed very little from international capital markets (Alphonsus 2020). However, after the end of Sri Lanka's civil war in 2009, under then President Mahinda Rajapaksa, excessive borrowing from international capital markets fuelled high import consumption and costly infrastructure projects (ibid.). Not only did these initiatives include several vanity projects with little return on investment, but the loans taken to fund them had high interest rates (ibid.). At the same time, Mahinda Rajapaksa funded his massive and swift expansion of the public sector with sovereign bonds, exacerbating Sri Lanka's debt problem and budget deficit (ibid.).

[3] The limited accountability that the President is subjected to in the executive presidential system institutionalises "agency slack". Ideally, a system of governance should aim to minimise "agency costs" and maximise "public goods". The agent (the government) should act in the best interests of the principal (the public). However, government officials and the public have some competing interests; but government officials have more information to pursue their interests. As a result, in the absence of constraints, officials can act in their own interests rather than the public's interests, the habitual occurrence of which is agency slack. This is a situation in which agency costs are very high and come in many forms such as rent-seeking, bribery, corruption, authoritarianism, repression, lethargy, and unresponsiveness. The higher the agency costs within a system of governance, the lower its propensity to produce public goods. In relation to economic governance, public goods not only include the physical infrastructure for economic development but also efficient institutions that deliver transparent and accountable decision-making in the public interest. An unchecked executive is not conducive to a system of governance that produces public goods.

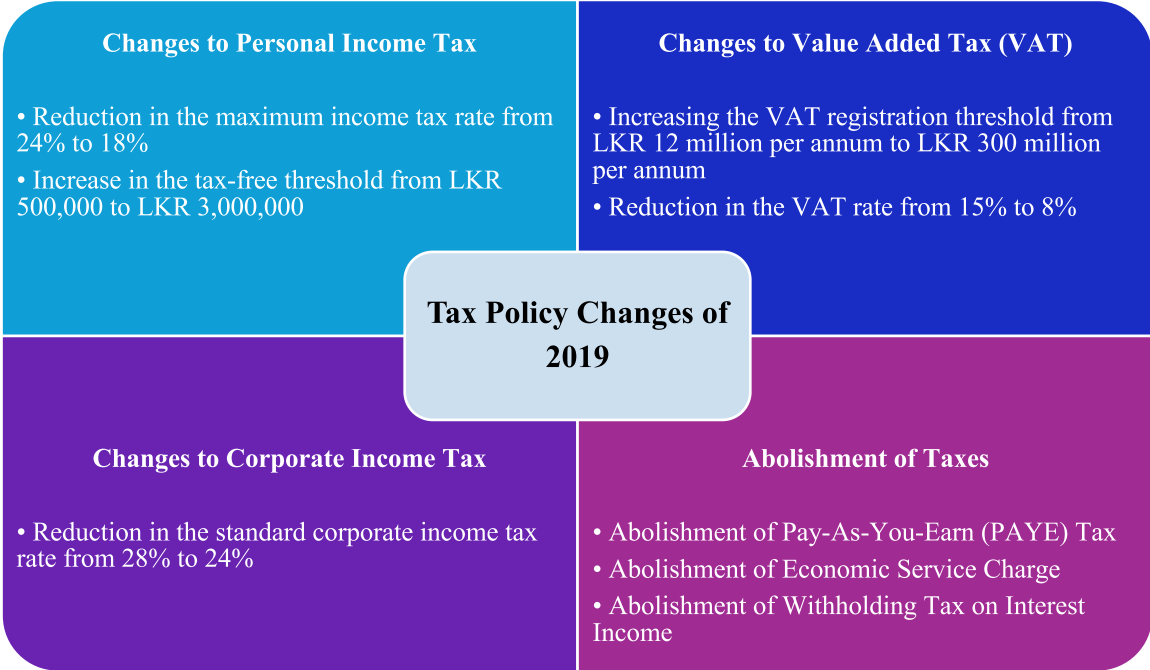
See Reid, P. and Welikala, A. (Forthcoming). "FROM CONGENITAL CRISIS TO THE COMMON GOOD IN SRI LANKA: NORMS AND INSTITUTIONS FOR A NEW CONSTITUTION". In: Visser, M. de and Yap, P.J. (eds) *Asia in Times of Crisis*.

Between the end of 2009 and the end of 2014, public debt increased by 83.4% with 51.1% of that increase going towards interest payments on the accumulated debt at the start of the period (NIICE Nepal 2022). Between the end of 2014 and the end of 2019, public debt further increased by 42.8% with 89.8% of the increase going towards interest payments on the debt accumulated by the end of 2014 (ibid.). Unsustainable debt is one of the primary reasons why Sri Lanka entered an IMF programme in 2016 under the *Yahapalana* government. Especially since foreign currency reserves were falling precariously low, the *Yahapalana* government tried to reduce Sri Lanka's debt burden and dependence on international capital markets through fiscal consolidation (Alphonsus 2020). Unfortunately, this was not enough.

Following through on Reckless Election Promises

After becoming President at the end of 2019, Gotabaya Rajapaksa made economic decisions that severely restricted the country's capacity to repay debt and further depleted its foreign currency reserves. In November 2019, he followed through on major tax policy changes in his presidential election manifesto, defying economic experts in the process.

Figure 1: Overview of Changes to Tax Policy in 2019



Source: NIICE Nepal (2022)

Because of those changes, the government saw a 33.5% decline in its tax base and a sharp decline in tax revenue equivalent to 3.5% of GDP in 2020 (NIICE Nepal 2022). As a result, the IMF suspended the programme that Sri Lanka was in at the time (Bery 2022), and Sri Lanka's credit ratings fell low enough to lock the country out of borrowing international sovereign bonds (ISBs) in global markets (NIICE Nepal 2022). Moreover, the reduction in government revenue caused by the tax policy change led to the country's primary balance — meaning the government budget deficit before interest payments on debt — to fall from 0.6% to -7.4% (ibid.). To offset lost revenue, the government borrowed heavily from commercial banks and the Central Bank (Nikkei Asia 2021).

At that point, in order to avoid a crisis, Sri Lanka had two choices: improve its credit ratings and regain access to international financial markets by reducing its deficits or restructure its debt (NIICE Nepal 2022). Under Gotabaya Rajapaksa, Sri Lanka chose to do neither (ibid.). Without checks and balances, the executive was free to make the negligent decisions that caused the economy to spiral.

Hasty Shift to Organic Farming

With dwindling foreign currency reserves, Sri Lanka's government had to tighten its belt. The chemical fertiliser ban introduced in 2021 was a half-baked attempt at conserving Sri Lanka's precariously low foreign currency reserves that demonstrates the dangers of arbitrary decision-making by an unconstrained executive.

On April 22 2021, Gotabaya Rajapaksa announced his decision to ban chemical fertiliser, pesticide, and herbicide imports practically overnight (Abeysinghe et al. 2021: 1). The government justified the move by expressing its desire to make farming more sustainable and environmentally friendly (Nikkei Asia 2022). However, Gotabaya Rajapaksa may have been more motivated to avoid the USD 400 million that fertiliser and pesticide imports cost annually (ibid.).

Experts warned what would happen if the government proceeded with an immediate ban. In June 2021, in a letter to the President requesting an urgent meeting, a group of thirty agricultural scientists and professionals predicted "substantial yield losses due to lack of suitable substitutes

for chemical fertilisers and pesticides following the abrupt ban of the importation of inorganic fertilisers and other agrochemicals" (Sri Lanka Brief 2021). They warned that this could "severely impact food security, farmers' income, foreign exchange earnings and the nutrition of a vast segment of the people of the country with pernicious far-reaching social, economic and political implications" (ibid.). They also expressed concerns about the potential impact on rice and tea production, core parts of Sri Lanka's economy (ibid.). Nevertheless, the government proceeded. Additionally, when Professor Buddhi Marambe, a former Dean of the Faculty of Agriculture at the University of Peradeniya, warned of serious food shortages in a newspaper article, he was fired as a government adviser (The Telegraph 2021).

As experts predicted, the ban on chemical fertilisers and the lack of suitable substitutes for them resulted in agricultural production declining, triggering a food crisis. Previously affordable foods became significantly more expensive, exacerbating the unfolding economic crisis. Sri Lanka's *Maha* 2021 rice harvest declined by 40% from a year before, where milled rice makes up roughly 68% of the paddy harvest (ECONOMYNEXT 2022a). The shortfall forced the government to import over 800,000 metric tons of rice worth USD 400 million in 2022 (Ministry of Agriculture 2023). Never before had Sri Lanka needed to import so much (ibid.). Other crops had to be imported as well (ibid.). Moreover, tea production fell by 18% year-over-year for the period from November 2021 to February 2022 (France24 2022). In the first quarter of 2022 tea exports plunged from 69.8 million kilograms to 63.7 million kilograms, the lowest tally since the first quarter of 1999 (ibid.).

As a result, export earnings for the first quarter of 2022 declined from USD 338 million to USD 287 million (ibid.), reducing foreign currency inflows further. In the end, the ban on chemical fertiliser, pesticide, and herbicide depleted foreign currency reserves far more than if these products were imported. The ban was lifted in October 2021; but by then it was already too late. With Sri Lanka's foreign currency reserves drained, farmers were unable to access imported chemical fertiliser (ibid.).

A transition to organic farming was and is still supported by many of Sri Lanka's environmentalists and farmers (Abeysinghe et al. 2021: 1). In July 2021, an all-island survey of farmers found that

64% of respondents supported a change from chemical fertiliser and agrochemicals to organic farming (ibid.). However, in that same island-wide survey, 78% of respondents who supported the change said they would need a transition period of over a year (ibid.). Ultimately, this is not about the merits and demerits of organic farming, and it is not only about how the President did not allow for a gradual shift to organic agriculture through a transition period. It is about how the lack of institutional checks and balances on the President emboldened him to disregard expertise and take incompetent decisions that worsened the unfolding crisis.

The Fallout of a Delayed Default

Between 2019 and 2021, public debt as a percentage of GDP had risen from 95.5% to 119.4%, usable foreign currency reserves had dropped to less than one month of imports (their lowest level since 1950), and the net foreign assets of the central bank fell to a historic low of negative USD 4 billion (NIICE Nepal 2022). Unfortunately, the government was far too late to halt international debt repayments, having only declared bankruptcy in April 2022 after running out of foreign reserves (ibid.).[4]

A more proactive alternative would have been to ask Sri Lanka's creditors to suspend debt payments and enter into discussions on restructuring debt much earlier, rather than failing to honour a debt payment due to insolvency. Instead, the government continued paying international creditors until foreign currency reserves were practically zero (Samaranayake 2023). The public paid the price of the President's inaction, enduring over thirteen-hour power cuts, supply shortages, and general economic uncertainty.

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[4] While the President and government cannot not be faulted for tourism declining after the COVID-19 pandemic and Easter Sunday attacks, neither excuses their poor performance. Between the end of 2019 and the end of 2021 Sri Lanka's gross official reserves decreased by 79%. Countries like the Maldives and Thailand, more reliant on tourism than Sri Lanka is, saw their gross official reserves increase by 5% and 10%, respectively. Instead, incompetent economic decision-making by a single unconstrained executive is largely to blame.

See NIICE Nepal (2022). "What led Sri Lanka into Economic Crisis and the Way Forward - Dr. Nishan De Mel", https://www.youtube.com/watch?app=desktop&v=gMh41C2CsxI. Consulted on October 24 2024.

Fiscal Failures: Tax Policy and Revenue Administration

As the tax policy change implemented in 2019 was a major catalyst for the economic crisis, tax policy and revenue administration defects deserve close inspection. Resolving these issues of fiscal governance would reduce public debt relative to the size of public repayment capacity, even if the latter remains the same due to a lack of economic growth.

Improved tax policy and revenue administration is critical to Sri Lanka's economic recovery. Between 2007 and 2019, Sri Lanka's tax to GDP ratio averaged at 11% — consistently below that of similar countries as ascertained by the IMF (IMF 2023: 81). To make matters worse, the tax policy changes implemented in 2019 reduced the tax to GDP ratio to 7.5% by 2021 while among similar countries this figure remained at an average of 15% (ibid.). Even though the tax policy changes of 2019 have been undone, Sri Lanka's tax revenue remains insufficient to reduce public debt and revenue administration remains too inefficient to make real progress.

Excessive Executive Discretion in Tax Policy

As evidenced by the tax policy change of 2019, the vast discretionary tax powers of the executive are a serious hindrance, allowing for "erratic and often irrational tax policy to prevail" (Alphonsus 2022).

These powers also create opportunities for corruption. A case in point is the Special Commodity Levy (SCL). When this unusual tax applies to a commodity no other indirect taxes, such as excises or value-added taxes (VAT), apply and the SCL Act grants the Minister of Finance the discretion to announce tax changes for immediate implementation through a Gazette notification (IMF 2023: 84; TISL 2023: 30). As a result, the Minister of Finance has the complete discretion to change the scope of the SCL and thereby the scope of all other indirect taxes. Not only is this at odds with the principle of parliamentary control over public finances set out in the constitution, but, perversely, it allows the executive branch to channel benefits to vested interests (TISL 2023: 30). The SCL and the "sugar scam", as it is colloquially known, appears to be such an instance.

In October 2020, then Minister of Finance Mahinda Rajapaksa heavily reduced the SCL on sugar imports from LKR 50 to LKR 0.25 per kilogram via Gazette notification, only for a few major

sugar importers to import unusually large amounts of sugar (The Island 2024a). These importers made enormous gains at the expense of government tax revenue (ibid.). The losses to tax revenue within the first five months were quantified at LKR 16 billion by the Auditor General (IMF 2023: 84) and by the end of 2022 at LKR 59 billion according to estimates by Verité Research (TISL 2023: 30). The Criminal Investigation Department (CID) has relaunched the investigation into this matter after a second complaint was lodged by the new government on the 9th of October 2024 (The Morning 2024a).

Executive discretion over tax policy has been a recipe for inefficiency and corruption. Furthermore, the executive's ability to arbitrarily change tax rates and the scope of existing taxes, and to grant tax incentives via Gazette notifications, is especially problematic (IMF 2023: 83-84). The "powers of taxation must move to parliament and be placed on a statutory footing" (Alphonsus 2022). In short, procedurally sound tax policy has been absent in Sri Lanka in recent years. Corruption vulnerabilities abound.

Complex and Inefficient Tax Policy

Sri Lanka's tax system has suffered from fickle, arbitrary, and unequal administration (IMF 2023: 81). Some taxpayers face complicated tax and fee obligations while others enjoy incentives with no obvious rationale (idem: 82). Such a complex system with so many exemptions and loopholes encourages rent-seeking and leaves room for officials to provide favourable tax rates or exemptions in exchange for benefits. Moreover, it results in enormous losses in government tax revenue. For example, the failure of successive governments to index excise taxes on cigarettes and tobacco to inflation has led to an LKR 85 billion loss between 2020 and 2022 alone (TISL 2023: 30-31).

Furthermore, while there is a need to significantly increase tax revenue, tax policy should not be inequitable and disincentivise consumption and investment. Heavily relying on indirect taxation, such as VAT is not equitable as everyone is taxed at the same level and, as they are taxes that are levied upon goods and services, disincentivise consumption and investment potentially catalysing growth shocks. On the other hand, increased progressive direct taxation, entailing taxes on income, property, and assets, shifts the tax burden in a more equitable direction as it is those who can afford

to pay more tax that do. Moreover, the impact of direct taxation on consumption and investment is lower relative to indirect taxation.

Integrity in Revenue Administration

Internationally, revenue collection agencies are among the government institutions most prone to corruption (IMF 2023: 89). To mitigate this risk “an explicit policy of high integrity and zero-tolerance to corruption supported by robust institutional arrangements to enforce and reinforce such a culture” is needed (ibid.). In emphasising the latter, institutionalised anti-corruption measures must be enforced to prevent a culture of impunity against unethical and corrupt practices. Regrettably, this is not the case in Sri Lanka.

Regarding administrative discipline, including issues of integrity, the three separate revenue collection departments of the Ministry of Finance, Inland Revenue, Customs, and Excise, follow the parameters of the civil service system overseen by the Public Service Commission (PSC) (idem: 89-90). However, even though corruption allegation cases must be referred to the PSC for resolution, this rarely occurs (idem: 90). Furthermore, cases involving revenue officials are rarely subjected to the independent investigation of the Commission to Investigate Allegations of Bribery and Corruption (CIABOC). The lack of accountability within revenue administration lends itself to becoming a breeding ground for corruption. Therefore, it is an imperative that institutionalised anti-corruption measures be strengthened and enforced without failure. This matter is elaborated on in the section on anti-corruption in Sri Lanka.

Eroded Public Tax Morale

The aforementioned issues within tax policy and revenue administration appear to have eroded public tax morale in Sri Lanka. Tax morale denotes the motivations for complying with taxes apart from the expected costs of detection and punishment for tax evasion (World Bank 2019: 2). Naturally, when public tax morale is low, tax collection is more difficult making it more costly.

The public is dissatisfied with paying taxes, in part due to high perceived levels of corruption in governance. In a recently conducted survey at least 85% of respondents (accounting for different age groups and urban and rural backgrounds) perceived corruption to have increased after the

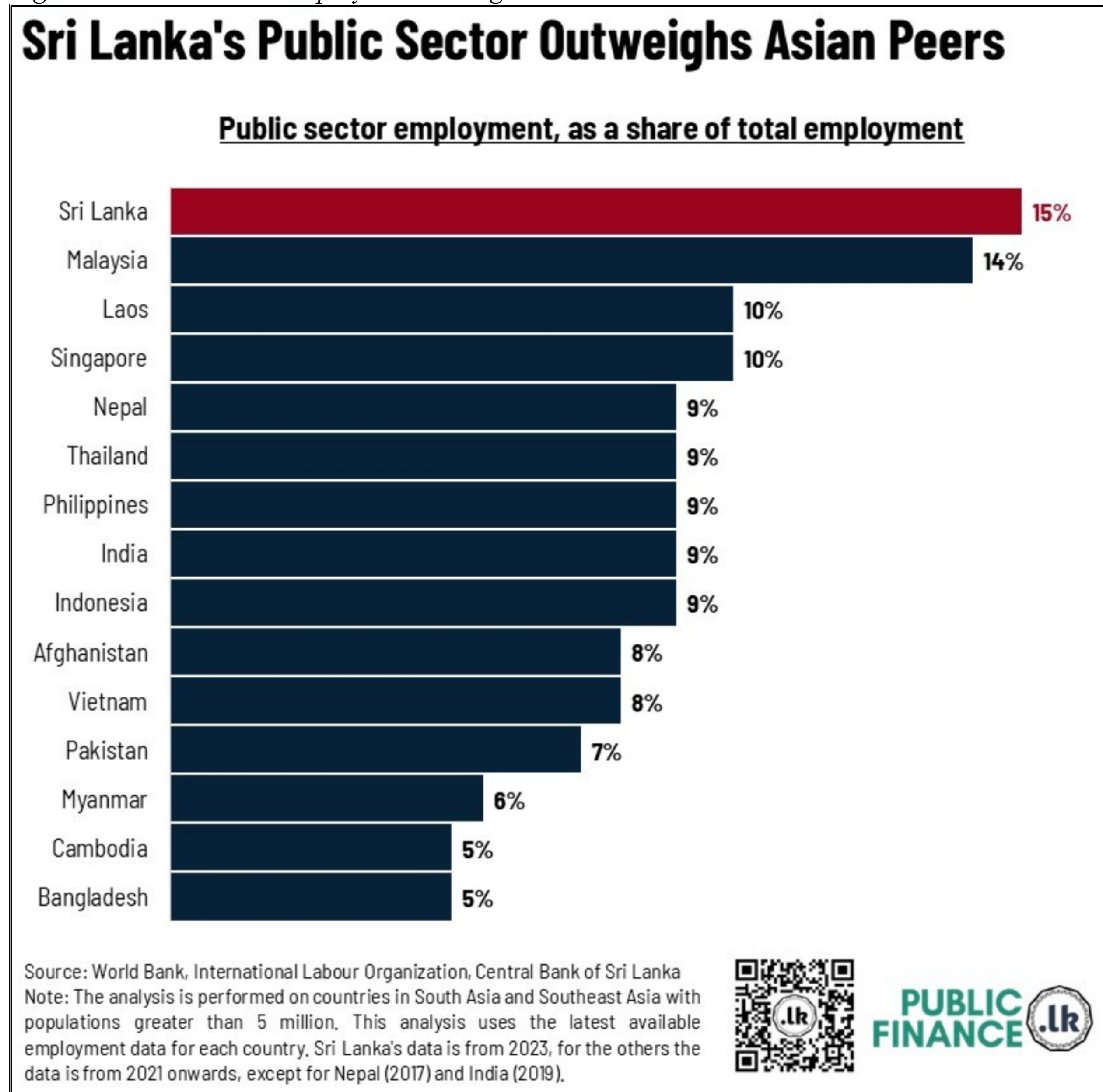
height of the economic crisis in 2022 (CPA 2024: 33). There is evidence suggesting how increasing the salience of anti-corruption efforts and punitive action taken against corrupt officials amongst the public significantly increases tax morale (World Bank 2019: 2-3). This is evidence for governments systematically punishing the abuse of public money and corruption being an important driver of tax morale (idem: 3).

On the other hand, the lack of efficient public service delivery partly explains why public tax morale in Sri Lanka is low. This is because the public does not feel as though they get anything out of paying their taxes. In the context of Latin America, there is evidence for how improvements in public service delivery result in higher public tax morale (Ortega et al.: 2016: 74-75). This demonstrates how improving government performance in public service delivery, through improvements to the public sector, have positive spillover effects for tax collection and revenue.

Excessive and Wasteful Expenditure: A Bloated Public Sector

It is no secret that Sri Lanka's public sector is incredibly bloated. In fact, 15% of Sri Lanka's total workforce was employed in the public sector in 2023, far exceeding South and Southeast Asian peers (PUBLICFINANCE.LK 2024a).

Figure 2: Public Sector Employment amongst South Asian and Southeast Asian Countries



Source: PUBLICFINANCE.LK (2024a)

With such a large public sector, one might expect Sri Lanka's government to provide more services to the public than its counterparts across South Asia. It does not. Public sector costs in Sri Lanka have long been unsustainable, contributing significantly to Sri Lanka's debt crisis. As mentioned earlier, after the war's end in 2009 then President Mahinda Rajapaksa funded a massive and swift expansion of the public sector through sovereign bonds (Alphonsus 2020). The annual cost of public sector salaries alone is enormous. Consistent with spending patterns over the past decade, in 2023, the government spent LKR 940 billion — 20% of the recurrent budget and 31% of its revenue — on public sector salaries (PUBLICFINANCE.LK 2024a). Evidently, the number of people in the public sector is an impediment to reducing excessive expenditure, a necessity for Sri Lanka's recovery from its debt crisis. As such, Sri Lanka cannot afford a public sector of this size, nor does it need to. Despite there being a public sector employee for every 16 persons in Sri Lanka, the delivery of services is incredibly inefficient in Sri Lanka (Advocata Institute 2023).

Military spending after the war's end is a powerful reminder of excessive and wasteful government expenditure in the public sector. Despite the war having ended in 2009, Sri Lanka's defence expenditure remains large and highly inefficient. Sri Lanka's defence expenditure as a percentage of central government expenditure is significantly greater than states which: have a similar population, are post-conflict states, and belong to South Asia (Alphonsus 2021: 21-22). In fact, Sri Lanka's defence expenditure remains similar to that of fragile and conflict affected states despite the civil war having ended in 2009 (ibid.).

Regardless of whether Sri Lanka's defence budget is too big or too small, the bigger problem is that Sri Lanka pays more and gets less. A majority of Sri Lanka's defence expenditure is wastefully spent on manpower that does not translate to greater defence capabilities. Spending on personnel accounted for 60% of defence expenditure between 2010 and 2017 — comparable to spending from 2005 to 2009 (idem: 25). Nor has that number changed significantly in recent years (Grevatt and MacDonald 2021). By contrast, states on average spend 40% of their defence budget on personnel, while Indian Ocean Rim Association (IORA) and Association of Southeast Asian Nations (ASEAN) states spend a little over 50% (Alphonsus 2021: 26). Sri Lanka's inflated personnel spending stems primarily from the fact that there are too many active-duty troops and too few reserves (idem: 29-30). In 2018, Sri Lanka's armed forces as a percentage of the population

were double that of the ASEAN, IORA, and world averages, and its reserve contribution to total manpower was less than 4% relative to the world average of almost 60% (ibid.).

A reduction in the number of active-duty troops would have saved Sri Lanka a large amount of money in recent years. In 2023, according to budget estimates, the Ministry of Defence alone accounted for 36.75% of public sector salaries (PUBLICFINANCE.LK 2023). Fewer personnel would mean a significant reduction in how much the government must pay in public sector salaries alone, let alone the other costs of maintaining so many active-duty troops: food, lodging, pensions, uniforms, and so on. Then there is the non-trivial macroeconomic benefit of freeing many of Sri Lanka's most able people to go into productive employment, helping resolve labour shortages in sectors such as construction and tourism (Alphonsus 2021: 48-49). Instead, the huge amount that goes into Sri Lanka's defence spending accomplishes remarkably little.

Inefficiency in other government departments has not been studied nearly as extensively — an enormous problem in itself (The Morning 2024b) — but there is reason to believe that Sri Lanka's wasteful military spending is no outlier.

Failures of State-Owned Enterprises

Take Your Seats: Turbulence at Sri Lankan Airlines

Sri Lankan Airlines has had a tumultuous history. After struggling for years following its founding in 1979, Emirates partially acquired the carrier in 1998. Sri Lankan Airlines sputtered along for a few years but managed a profit of LKR 9.29 billion in its last year of private operation (The Sunday Times 2016).

Then, in 2008, Sri Lanka's government removed the private CEO of Sri Lankan Airlines and acquired all of its shares back from Emirates (ibid.). Then President Mahinda Rajapaksa gave little justification for the move, but his decision appears to have resulted in part from the airline's refusal to drop fare-paying business-class passengers to economy and provide the seats to Rajapaksa's family instead (The Daily Star 2016). In place of aviation experts, the government appointed a new board of directors with little to no experience in the industry (ibid.).

Despite increased tourism and low fuel prices over the next seven years, Sri Lankan Airlines posted a loss of LKR 128.2 billion (The Sunday Times 2016). Throughout the 2010s, the airline procured some planes 30% more expensive than their market price, reached a staff-to-plane ratio far exceeding industry standards, instituted extremely weak accountability and anti-corruption mechanisms, and looked to the Treasury, the Bank of Ceylon, and other SOEs (state-owned enterprises) like the Ceylon Petroleum Corporation consistently for heavy assistance. A "lot of people ask me whether we are selling Sri Lankan," Public Enterprises Development Minister Kabir Hashim said. "I tell them no, we may have to bury it" (ibid.).

The government brought in numerous consultants in the 2010s to stabilise the airline (ibid.). None of them succeeded. In 2021 alone, Sri Lankan Airlines losses amounted to roughly 1% of Sri Lanka's GDP (ECONOMYNEXT 2022b). Therefore, in 2023, as part of a larger attempt to sell stakes in SOEs, the government announced plans to sell 51% of Sri Lankan Airlines (Tamil Guardian 2024). Under Sri Lankan law, however, non-Sri Lankan companies could only purchase 49% of the struggling carrier. However, in 2024, despite bids from six outside parties, aviation minister Nimal Siripala de Silva instead announced vague plans to restructure the airline instead of selling ownership to entities he did not deem "worthy" (ibid.). Sri Lankan Airlines posted a modest profit of LKR 3.8 billion for the first time in many years in 2024 (Sri Lankan Airlines 2024). Nonetheless, the airline remains bloated and is highly unlikely to ever recoup the hundreds of billions of rupees lost since 2008 without significant reorganisation.

Broader SOE Management Failures

As already noted, Sri Lanka's fundamental challenge in recent years has been debt sustainability. SOE management might have been part of the problem. The government's relationship with SOEs has compounded the problem of debt sustainability in every way possible: decreasing state revenue, increasing expenditure, and hindering growth.

It was not always this way. Sri Lanka faced similar problems in the 1990s, when sources of international credit were hard to come by and the banking sector was overexposed to SOEs (ECHELON 2022). In that instance, Sri Lanka's government tried to extricate itself from competitive industries, streamline management structures, limit partisan influence over SOE

management, and tap into the country's private sector resources (ibid.). It worked, broadly speaking. Sri Lanka Telecom (SLT), for one, expanded rapidly after partial privatisation introduced Japanese management (Rafi 2022). Moreover, the telecom industry's liberalisation and resulting competition made Sri Lanka a regional industry leader (ibid.). Similar success stories abound. However, in the mid-noughties, the government reversed course on SOEs, placing formerly privatised companies like Sri Lanka Insurance back under state ownership (ECHELON 2022). Since then, many SOEs have consistently been in the red (ibid.).

Reasonable minds can disagree about the extent to which SOEs should feature in the public sector. Some countries limit SOE ownership to certain natural monopolies — trains, for example (Kikeri 2022). There is little sense in multiple railway companies laying down sets of tracks next to each other, even if the state must bear additional cost as a result of nationalisation. The bigger issue is that Sri Lanka has no obvious principle to determine when and how the state will nationalise. Its SOEs have become significantly more numerous and more complex, with no rhyme or reason for that expansion (ECHELON 2022). Some SOEs operate in highly competitive markets, like hotels and retail. Others crowd out small firms in emerging industries. Some, like building companies, have billions of rupees in assets in land, complicating construction in urban areas like Colombo (ibid.). Few justifications exist for the government to meddle in sectors that would thrive on their own.

In 2022 alone, Sri Lankan SOE losses reached LKR 744.6 billion, or roughly LKR 141,809 per household (PUBLICFINANCE.lk 2024b). Ceylon Petroleum Corporation's losses in the first four months of 2022 alone amounted to more than Sri Lanka's 2023 education and health budgets combined (Observer Research Foundation 2024). At any point in the past two decades, and especially as the crisis worsened, Parliament could have created a legislative framework to guide divestment. Alternatively, the executive could have easily withdrawn from specific sectors in which private actors provide cheaper, better, more innovative goods and services than their public counterparts. The executive could have pursued a partial privatisation strategy: packaging some SOE assets for sale in the market without dissolving the SOEs themselves or allowing private ownership to jumpstart the most troubled enterprises. It could have only privatised in the case of

SOEs already listed on the stock exchange, providing a stable sale price. It could have established an independent SOE holding company (ibid.). None of that happened.

The current SOE system lends itself to enormous conflicts of interest. The Ports Authority is a stark example: it regulates the port sector, operates terminals, and owns the land beneath them (ECHELON 2022). In other cases, the government extends subsidies to SOEs with competitive commercial operations and provides few constraints on those subsidies, giving SOEs a leg up on their competition. Today, almost every SOE looks for some sort of capital infusion from the Treasury to stay afloat (The Sunday Times 2021). SOE executives no longer worry so much about meeting market price, achieving full cost recovery, or innovating to keep up (ibid.). Perhaps because they know they have a safety net.

Transparency issues also afflict SOEs. Many are not subject to the Colombo Stock Exchange Disclosure and Audit Guidelines, and do not follow International Financial Reporting Standards (ECHELON 2022). Few are private limited companies making it difficult for outside observers to track SOEs' net assets. The big players — entities like Sri Lankan Airlines, the CEB, the National Water Supply and Drainage Board, and the Ceylon Petroleum Corporation, responsible for most SOE losses — also operate with extremely opaque governance structures. Some even owe billions to state banks or other SOEs (ibid.).

Furthermore, leadership seldom punishes misbehaving SOE management (Rafi 2022). SOEs typically have no holding companies, which might allow for more independent appointments to SOE boards than the current politicised process run by ministers. The Public Enterprise Department (PED) in the Finance Ministry is too weak to do much. The junior PED officers that get appointed to SOE boards are drowned out by board chairs. As a result, many PED employees spend their days on menial tasks like approving vehicle purchases, rather than issuing directives regarding key performance indicators (KPIs), profit, or SOE strategy (ibid.).

That same top-down structure results in dysfunction in the context of privatisation strategy. The National Planning Department (NPD) in the Finance Ministry used to play a larger role in privatisation policy (ECHELON 2022). Now, the NPD is weak, and no specialised privatisation

units exist to fill the gap. Unlike in the 1990s, management has done a poor job keeping shareholders in the loop about privatisation strategy. Many pundits and bureaucrats condemn any privatisation as improper foreign intervention — even when the underlying "asset" is mostly a liability, and the sale could lead to larger profit in the short and long term through tax revenue and productivity gains. Alternatively, they claim that foreign capital is unlikely to offer much for Sri Lankan assets, even though the privatisation of the 1990s occurred amid civil war (ibid.).

The result: Sri Lanka's SOEs are bloated, opaque, and riddled with conflicts of interest. Even if reform-minded officials wanted to streamline an SOE through privatisation, they would face resistance at every turn. Sri Lanka's government and its market alike are worse for it.

Poor Planning, Opaque Dealing: Public Procurement Failures

The Mannar Wind Power Project

In February 2023, Adani Green Energy (Sri Lanka) Ltd received provisional approval for two wind power projects in Mannar and Pooneryn (Daily Mirror 2024). The project in Mannar alone is expected to generate 1,048 gigawatt hours of energy annually, equal to 6% of Sri Lanka's annual energy requirement (ibid.). In theory, the project could save LKR 18 billion and reduce greenhouse gas emissions by 800,000 metric tons annually (ibid.). However, upon closer inspection, the agreement is cause for concern.

Firstly, the legitimacy of the bidding process for the project is questionable. The Adani Group does not appear to have engaged in a competitive tender process. Then Chairman of the Ceylon Electricity Board (CEB) M.M.C. Fernandino informed the Parliamentary Committee on Public Enterprise that in November 2021, then Prime Minister Mahinda Rajapaksa instructed him to recognise the project "as a proposal from the Indian Government to the Government of Sri Lanka", reportedly under pressure from Indian Prime Minister Narendra Modi (The Sunday Times 2022). Ferdinando was forced to resign shortly thereafter (ibid.). Since then, Sri Lanka's renewable energy sector has urged the government to offer transparent and competitive tenders to all (The Sunday Times 2024).

In partnering with the Adani Group, the government overlooked Sri Lanka's numerous domestic renewable energy firms, many of which might have offered a better price. Instead, the government is to purchase power generated from Sri Lanka's own wind from a foreign company at a premium (News First 2024a). The final power purchase agreement with Adani Green Energy (Sri Lanka) Ltd. is USD 0.0826 per kilowatt hour at an exchange of rate of USD 1 equalling LKR 300 (ibid.). This more than quadruples the United States Department of Energy price estimate of USD 0.02 per kilowatt hour for wind energy (Pethiyagoda 2024). Sri Lanka has many needs that foreign direct investment would address but the Mannar and Pooneryn wind farm projects do not appear to fall in that category.

Secondly, the project threatens environmental conservation efforts offsetting the benefit from reduced greenhouse gas emissions. Mannar Island is surrounded by protected areas like Adam's Bridge Marine National Park, Madu National Park, Vankalai Ramsar Sanctuary, Giant's Tank Sanctuary, and Vidataltivu Nature Reserve because millions of birds of over 120 species migrate southwards to Mannar every winter from the Northern hemisphere (ibid.). Therefore, the Ministry of Environment has declared the entire region to be environmentally sensitive (ibid.). The 52 wind turbines, each 220 meters tall, will be installed in the busiest bird flyway in South Asia, and will be detrimental to the lives of these birds as wind turbines kill thousands of birds every year (ibid.). Moreover, given how delicate Mannar Island's ecosystem is, noise pollution will affect bird migratory patterns, underwater cables will impact marine ecosystems, and turbine installation will disrupt land animals' habitats (Daily Mirror 2024).

Thirdly, local communities are also likely to face challenges. The wind turbines are likely to disrupt agricultural practices, while burdened marine ecosystems will hinder local fisheries (ibid.). Residents have already complained about the project's effects on coastal waters (ibid.). Making matters worse, dozens of wind turbines are likely to hinder what has been a productive tourism industry (Pethiyagoda 2024). Any public infrastructure project involves tradeoffs. However, in awarding the project to the Adani Group, Sri Lanka's government does not even appear to have engaged in a proper cost benefit analysis before proceeding.

Broader Procurement Failures

While the Adani Group's deal occurred after the height of the economic crisis in 2022, the scandal reflects that Sri Lanka's longstanding procurement failures persist to this day. Procurement constitutes at least 25% of total government expenditure, and involves huge sums of money and regular engagement with private sector actors primarily motivated by profit (Verite Research 2017). Therefore, even small amounts of waste and corruption significantly threaten public resources, hinder competition, and raise contract prices. Regulation — blacklisting or debarring misbehaving firms, for example — might have helped. However, as presently constructed, Sri Lanka's regulatory framework has not protected public funds from being misused or stolen.

The existing laws and regulations are too narrow to deter procurement misbehaviour. The 2006 procurement guidelines Sri Lanka currently has do not suggest that firms engaging in fraud or corruption be blacklisted (Verite Research 2023). Such punishment is reserved for those that default or otherwise significantly fail to meet obligations: withdrawal of the bid during the specified bid validity period, refusal to accept correction of errors, or failure or refusal to execute the contract form once notified of acceptance of the bid (ibid.). During the contract implementation stage, contractors or suppliers can be blacklisted for failing to carry out the contract after award, submit the performance security, render unsatisfactory performance, abandon the project, or otherwise engage in improper conduct. In any of those cases, a noncompliant party can be blacklisted or suspended from government procurement bidding for up to three years. Any party that offers gifts during the bidding stage can be disqualified from that particular bidding process but cannot be removed from consideration for any other project (ibid.).

Even where the law is broad enough, government actors have not demonstrated a willingness to comply. In 2019, the National Procurement Commission circulated draft guidelines to government agencies.[5] While those provisions are not presently enforced — having been gazetted but not approved by Parliament — they provide more discretion to government actors to blacklist misbehaving firms with little guidance other than that. However, there is reason to believe that even approval of those draft guidelines would not change much. Government officials have a poor

[5] Refer Extraordinary Gazette No. 2144/68 – October 12, 2019

track record of reporting even the defaulting contractors already covered under the 2006 procurement guidelines (Ministry of Finance 2024). Technically, they are required to promptly notify the Department of Public Finance (DPF) of any large defaulting contractor. The DPF can then suspend or blacklist that contractor at its discretion and must publish that entity in an online database. However, since 2006, only two suppliers have been listed in that database, which only went live in 2020, and which currently has no companies listed. The DPF has not received notifications about defaulting contractors from government officials (ibid.). Without punishment in the event of noncompliance, many government officials see no good reason to sound the alarm.

In the case of procurement integrity, Sri Lanka lags behind even its peers in South Asia. For example, Indian regulators include corruption as a reason for blacklisting and operate online databases of blacklisted firms. The reestablishment of the National Procurement Commission under the 21st Amendment in 2022 could have been a moment to make real progress on procurement issues. Instead, procurement regulation and compliance remain out of reach.

Monetary Failures: Central Bank Governance

A central bank should be insulated from the rest of the public sector. Such power over a country's currency and monetary policy demands independence. The Central Bank of Sri Lanka (CBSL), however, has been ravaged by conflicts of interest and regulatory failures in recent years. It hardly comes as a surprise that many of the CBSL's most infamous scandals came in the run-up to the crisis in 2022.

Bond Scandals

The Employees' Provident Fund (EPF) is a social security scheme operated by the Central Bank. It is both Sri Lanka's largest fund and the largest single holder of the country's treasury bonds. The Central Bank is both the EPF's administrator and an entity with the power to restructure local currency sovereign bonds — the same bonds owned by the EPF.

That conflict of interest has left the EPF open for abuses like the infamous 2015 bond scam. Arjuna Mahendran, a Singaporean businessman, was appointed governor of the Central Bank due in part to his strong personal relationships within Sri Lanka's government (News First 2024b). He and

others facilitated auctions in which private secondary market dealers purchased government debt in larger amounts and at higher yields than had previously been announced (The Morning 2024c). Many of those dealers, in turn, immediately resold that debt at significantly lower yields to the EPF. In Mahendran's case, the bonds appear to have directly benefited members of his own family: Perpetual Treasuries, one of the primary dealers in the sale, was owned by Mahendran's son-in-law (The Nation 2016). By some estimates, losses amounted to LKR 9.6 billion rupees (ECONOMYNEXT 2020). Mahendran subsequently fled the country, allegedly to attend a wedding, and the government at the time allowed his departure. Only in 2018 was an international warrant issued for his arrest (The Morning 2024c).

In 2019, a presidential commission's audit revealed that structural failings leading to such abuses were common at the Central Bank, with nearly LKR 20 billion in EPF losses due to misappropriation and similar scams from 2002 to 2015 (PUBLICFINANCE.lk 2024c). Although Mahendran was the most conspicuous official feeding inside information to private actors, other central bank dealers had received payments from Perpetual Treasuries and other private actors well before his tenure (News First 2024b). Conversely, at other times when the EPF had sufficient cash on hand to purchase securities in the market, it declined to do so for no obvious reason. It all fits into a history of mismanagement at the EPF. The fund's returns were less than 5% in 2009 and 2010, while the All Share Price Index (ASPI) indicated overall stock market returns of around 100% (Verite Research 2024). Unfortunately, other important details of the scams and their perpetrators remain unavailable to the public as the audit will remain confidential in the Department of National Archives until 2048 (News First 2024b). Those findings are likely to be a significant underestimate, failing to account for EPF losses in 2015 and the years thereafter (ibid.).

Other scandals involving questionable investment decisions also rocked the CBSL in the years leading up to the crisis. In 2012, Governor Ajith Nivard Cabraal made questionable investments into Greek treasury bonds, despite the Greek government's dire economic straits at the time (Ada Derana 2024). The Central Bank lost LKR 1.8 billion on the deal (ibid.). In October 2024, the Bribery Commission filed new charges against Cabraal and four co-defendants, after previous courts failed to corroborate the public's initial allegations of corruption (NEWSWIRE 2024; The Island 2024b). Whether malfeasance or negligence was the primary cause of the scandal remains

to be seen. Nevertheless, the decision to invest in such risky assets is hard to justify in light of the Central Bank's primary objective of stabilising the Sri Lankan market.

Pattern of Poor Regulation and Decision-Making

The Central Bank's poor track record on transactions suggests deeper issues in an institution that sits at the helm of the financial sector. The Central Bank is supposed to play a key role in overseeing Sri Lanka's banks, nonbank financial institutions (NBFIs), primary dealers, and microfinance institutions. Perhaps most critically, the CBSL should offer stability and direction to Sri Lanka's thirty licensed commercial and specialised banks, including development banks, savings banks, and housing finance banks.

Failures in the financial sector are rife, however, and have been for some time. Sri Lanka's non-performing loan (NPL) ratio rose to 4.7 percent of all loans by the end of 2019, a shaky floor even before the turmoil of the last few years (International Banker 2022). Even now, the NPL ratio is at double-digit levels. However, for several years a post-pandemic moratorium and other concessions associated with loan repayment masked deeper issues (ibid.). In 2022, though, banks had few ways to resolve the large number of nonperforming loans they had, suffering from insufficient built-in asset restructuring opportunities (ADB 2023). Particularly in the case of microfinance loans — especially vulnerable to non-performance — many commercial banks had no plan to handle failing investments (ibid.).

Banks also need financial assets to cushion themselves in the event of financial hardship. However, capital formation rates had been low for years in Sri Lanka, the direct result of long-term instability, a small local private equity market, and foreign worries about Sri Lankan asset security (ibid.). Making matters worse, after the Central Bank pegged the rupee at 200 to the USD in 2021, large numbers of Sri Lanka's many expats switched to informal wire exchanges when sending home remittances rather than go through official channels (International Banker 2022). In the first five months of 2022, the Central Bank reported just USD 1.3 billion in foreign remittances, less than half the USD 2.8 billion in the same stretch a year before (ibid.). Commercial banks lost out on much of the shortfall. Without stronger support from capital markets and depositors, banks could no longer make long-term investments in critical areas like digitisation without assuming

significant risk (ADB 2023). To top it all off, according to the Chairman of the Ways and Means Committee Patali Champika, some commercial banks appear to have been complicit in misinvoicing schemes (Kulatunga 2024). Financial institutions making bad deals with undeserving debtors took on additional risk and drained their coffers for no good reason.

The CBSL was ill-equipped to respond to these converging issues. Bank officials lacked the ability to recognise the early signs of delinquency when they saw them, and did not have realistic exposure caps or functional early warning systems in place to minimise risks (ibid.). Lax standards in banking and the lack of oversight by the Central Bank have allowed USD 53.5 billion in export proceeds that should have been repatriated over the last 22 years to remain abroad. As Wijeyadasa Rajapakshe has said: "The Central Bank was not even regulated as much as a small tobacco stall in Pettah" (ibid.). By failing to tamp down rising inflation and even continuing to print money over the objections of the Monetary Board, the CBSL contributed to forex shortages and excessive foreign borrowings (ECHELON 2023). As a result, Sri Lanka suffered higher interest rates, while the Treasury lacked the ability to borrow money locally at a lower cost.

The CBSL's structural deficiencies played a part, too. The CBSL did not have enough assets on hand to help offset capital deficiencies and loan failures (Samarasinghe and Lakmal 2024). The CBSL's Sri Lanka Deposit Insurance and Liquidity Support Scheme includes licensed commercial and specialised banks, as well as finance companies but it only covers up to a maximum of LKR 1,100,000 per depositor, per institution since April 2021 (ADB 2023). Pandemic-driven delays on loan repayments are not a long-term solution. After moratoriums were removed in December 2022, banks had to expand loan-loss provisions resulting from the difficult environment created by the economic crisis (ibid.).

Recent reforms have helped somewhat. The Public Debt Management Act will limit conflicts of interest at the highest levels of the CBSL (TISL 2023). Meanwhile, the new Central Bank Act promotes greater transparency and independence, removing the treasury secretary from the Monetary Board and setting firmer guidelines for inflation targets (Jayasinghe 2023). Still, structural failures remain. The Central Bank Act, for example, suggests that "The Central Bank shall be autonomous and accountable", without defining what that means (Kulatunga 2024). The

CBSL's new appointment structure still lends itself to abuse: the governor and deputy governors are now picked by the Minister of Finance, rather than an independent governing board or the Constitutional Council, and cannot be removed for poor performance (ECONOMYNEXT 2023). To top it all off, the CBSL has come under fire for giving low-interest loans to staff and raising all salaries by between 29.53% (for junior assistants) and 76.97% (for senior officials) without formal approval in 2024, despite the bank posting net losses (ECHELON 2024).

Inaction against Corruption: CIABOC and the Attorney General

The pervasiveness of corruption in Sri Lanka is partly due to a culture of impunity. In Sri Lanka, investigations and prosecutions relating to bribery, corruption, assets, and asset declaration-related offenses are the purview of CIABOC. Primarily, the Commissioners of CIABOC make decisions to prosecute based on cases prepared for their consideration by CIABOC investigators and prosecutors (IMF 2023: 133). However, CIABOC's track record leaves much to be desired.

Between the 1st of January and the 31st of August 2022, 43 of the 71 cases filed by CIABOC were withdrawn, many because of mere technicalities (The Morning 2022). One prominent case against then Minister of Highways Johnston Fernando alleged the deployment of 153 workers from a state-run institution (Cooperative Wholesale Establishment) for electoral activities in 2010 and 2014, incurring a loss of LKR 40 million to the state. However, in January 2022, CIABOC withdrew the case because its investigators had not obtained approval from three Commissioners prior to filing (ibid.).

CIABOC appears especially reluctant to proceed with investigations against senior government officials. In fact, "available statistics do suggest that the majority of CIABOC investigations and prosecutions focus on defendants who do not occupy (or did not previously occupy) senior positions within government" (IMF 2023: 36). Given that track record, CIABOC does not appear to be adequately insulated from political influence to fulfil its purpose.

CIABOC's exposure to political influence stems from how the Commissioners of Sri Lanka's independent commissions are appointed. Much like the National Procurement Council Commissioners, the appointment of CIABOC Commissioners requires the recommendation or

approval of a Constitutional Council. However, that Council consists of seven members of parliament (MPs) and only three politically independent civil society representatives (CPA 2023). Consequently, it cannot ensure that these key commissions are led by competent and politically independent individuals as the majority of the Council's members are themselves politicians (ibid.).

Aside from acting on its own, CIABOC can, and in some cases has, exercised its power to seek the view of the Attorney General and ask his or her department for prosecutorial assistance (IMF 2023: 133). However, the independence of the Attorney General's Department is questionable given its multiple functions that are at odds with each other. In Sri Lanka, the Attorney General provides legal advice to the government, defends the government in court, and serves as chief prosecutor (idem: 131-132). If the government is the object of prosecution, how can the same entity prosecute the government and act as its legal defence? This constitutes a conflict of interest — or at least a perceived one, undermining public faith in government (IMF 2023: 129-130; PSC 2019: 170-171).

In 2016, Monica Pinto, then UN Special Rapporteur on the Independence of Judges and Lawyers, studied the role of Sri Lanka's Attorney General's Department (UNGA 2017: 10-11). She expressed concern about its aforementioned conflicts of interest and the general perception that it defends the interests of the government and not the people (ibid.). Making matters worse, the Attorney General's Department is a department of the Ministry of Justice, and both the department and the office of Attorney General are closely linked to the executive (IMF 2023: 131-132). Overall, there is a lack of prosecutorial independence in Sri Lanka.

A Public Prosecutor's office separate and independent of the government, having the sole responsibility to indict and prosecute, would have served as a better check on corruption and helped ensure that public funds are used properly. The conflict of interest in the Attorney General as legal counsel to government and prosecutor has been resolved in common law jurisdictions like England and Wales, Kenya, and Trinidad and Tobago in this manner (idem: 134-136). A depoliticised CIABOC would have done the same. Instead, without punitive action, corruption has festered throughout Sri Lanka's government.

Conclusion

Ending Sri Lanka's economic misfortunes requires an understanding of their root causes. The purpose of this Brief is to advance the argument that the economic crisis is primarily the product of failures in governance. A view of the economic crisis as primarily a product of economic failure is reductive.

There are many reasonable disagreements to have about government policy in Sri Lanka. However, the failures in Sri Lanka's government go beyond policy debates. There is no obvious argument that the dysfunction discussed at length in this Brief serves the public interest. The inspection of so many cases of fiscal and monetary misgovernance, and weak institutional checks and balances failing to constrain arbitrary decision-making across government, leads to the inevitable conclusion that the reasons for Sri Lanka's economic downfall lie in its dysfunctional governance.

As mentioned prior, this Brief does not intend to provide a comprehensive set of recommendations to resolve Sri Lanka's crisis of governance. However, the many cases examined within this Brief reveal a few key issues worth reiterating. Firstly, the concentration of power in the executive presidency, intended to allow for decisive action towards economic development, has led to unilateral and opaque decision-making, in turn facilitating incompetence or corruption. The decisions of presidents that partly set the crisis in motion is proof of this. Therefore, abolishing the executive presidency and vesting its powers in the collective deliberation and decision-making of Parliament is crucial. At the very least, the reduction of individual discretion in decision-making will prevent the massive missteps that the lack of checks and balances on the executive presidency have allowed for.

Secondly, government expenditure in the public sector is excessive and achieves little. The number of people in the public sector is an immense burden on the government purse, nor does it translate to efficient public service delivery. The military is an example of this, but it is unlikely to be the only one. Ultimately, the public sector must be sized according to the need of each government department and ministry. On the other hand, the state must have principles to determine when it will be involved in the market. As a start, given the state's lack of capacity in relation to SOEs, the state should withdraw from competitive markets where the private sector would provide those

goods and services at cheaper prices, more efficiently, and at better quality. The subsequent privatisation of such SOEs would benefit the state in increased tax revenue, productivity gains, and significantly reduced government expenditure.

Lastly, the lack of punitive action against corruption has led to its pervasiveness throughout government. Anti-corruption measures must be insulated from political influence and adequately capacitated to recover losses because of corruption and, more importantly, to act as a deterrent to corruption. Insulating CIABOC from political influence and establishing an independent Public Prosecutor's office is a start.

It goes without saying that this Brief only discusses some of the main issues in governance that led to the crisis and that need to be addressed. However, again, the central takeaway is that Sri Lanka's crisis is a crisis of governance and, unless the foundational governance issues are addressed, debt sustainability and a robust economic recovery for Sri Lanka may be a foregone conclusion.

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