PROPOSAL FOR A GOVERNANCE-LINKED BOND IN RESTRUCTURING SRI LANKA'S DEBT (VERSION 3)

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Summary

Sri Lanka's ability to sustainably recover from its debt crisis will depend on its ability to improve governance and reduce corruption vulnerabilities. This has been the view of Sri Lankan civil society, as well as the IMF as reflected in the current IMF program in Sri Lanka. If governance in Sri Lanka improves, there will be a risk-reduction dividend for bond-holders as well.

Therefore, adding to Sri Lanka's restructuring portfolio **a governance-linked (ESG) bond,** where there is a coupon step-down in response to defined governance improvements, **aligns the interests of both bond-holders and citizens of Sri Lanka.**

- The governance-linked bond would offer the government a transparent, popularly visible financial incentive to implement a set of measures that will foster improved financial governance and reduce corruption. The country's efforts to meet the criteria set out in the bond will tend to de-risk bond-holders and thereby contribute to an increase in bond prices.
- Fifteen governance criteria, drawn from Sri Lanka's current IMF program, are set out in Annex 1, on page 8, from which a governance-linked bond can be structured.
- This approach mitigates the risk of weakening governance and unsustainable economic policies leading to a reduction in the secondary market value of the bonds, allowing Sri Lanka to also benefit by splitting the benefit of lowered risk (and therefore higher secondary market prices) between the government and the bond-holders.
- Bond-holders would gain a "de-risking dividend" simply by the creation of such a governance-linked ESG bond for the restructure. This is because, even if the governance improvements don't fully achieve the set criteria, the partial attempts towards achieving those benchmarks will still have the effect of reducing the counterfactual risk of deteriorating governance.
- Sri Lanka's governance score at present, as measured by the Worldwide Governance Indicators, is on the borderline between countries that have had only one restructure and countries that needed two or more restructurings.[1] The direction of the country's governance would be pivotal in determining whether Sri Lanka is able to emerge from the present economic crisis with a single restructure.[2]
- The structure of a governance-linked bond as set out in page 5 offers two options for triggering the coupon step-down: a binary evaluation of "success" or "failure" to implement the governance measures, on which the full coupon step-down is contingent; or a ternary evaluation that includes an additional criteria of "partial success" leading to a partial coupon step-down. If the governance criteria are small in number (five or less), the binary evaluation could suffice. But if not, the ternary evaluation could be more appropriate as explained in that section.

[1] The data shows that 59 percent of countries that underwent debt restructuring from 1975-2020 had to go through multiple episodes of restructuring before getting on the path of debt sustainability. Conference papers also show a strong correlation between countries that go through multiple restructurings and countries that had a lower average score on the Worldwide Governance Indicators during their first restructure.

[2] Verité Research, DebtCon 2023 Conference Plenary Session: "Sovereign Debt Architecture: Where Are We, and How Did We Get Here?", New Jersey, United States. Slides 7-8, available at: https://debtcon6.princeton.edu/sites/g/files/toruqf3611/files/documents/20230423_slidesfordebtcon_nishan_de_mel.pdf

Introduction

Following the suspension of debt payments in April 2022, Sri Lanka is yet to complete the restructuring of its debt. A restructure will result in sovereign bond-holders accepting a reduction in the net present value of the bonds they currently hold. The terms of this reduction are a function of, among other things, perceptions of how well the Sri Lankan economy will perform during the lifetime of the bond, a subject about which there is great uncertainty. A major source of uncertainty, in turn, is the country's governance situation. Not only did weak governance cause the debt crisis of 2022-23, but if not addressed, it will compromise Sri Lanka's debt sustainability in the future as well.

Under the IMF-supported program, Sri Lanka committed to publishing a Governance Diagnostic Assessment (GDA), the first for an Asian country.[3] The underlying reason was the recognition that Sri Lanka's governance weaknesses were macro-critical. The GDA was published in September 2023 and had the following over-arching observation:

> "The GDA revealed **systematic and severe governance weaknesses and corruption vulnerabilities across state functions**, with particular macroeconomic impact in: budget credibility; expenditure control; public investment management and control of spending; public procurement; management and oversight of State-Owned Enterprises (SOEs); transparency of revenue policy and the integrity of revenue administration... the application of financial sector regulations; and... the integrity of the judicial sector." (IMF-GDA, p. 11)

Very similar sentiments and recommendations were echoed in the governance diagnostic published and endorsed by a large coalition of civil society organisations in Sri Lanka.[4]

Overview of the Proposal

To address the governance risk to debt sustainability and provide incentives for the Government of Sri Lanka to implement governance reforms, this proposal sets out the structure of a novel sovereign debt instrument that can be used for countries with significant country risk in terms of future default, where the risk is likely to be correlated with the trajectory of governance. It is termed a "Governance-Linked Sovereign Bond" (GLSB). This short proposal is derived from a working paper by Verité Research that sets out the technical basis for the GLSB described here.

We explain the design and application of such a GLSB for the present process of restructuring Sri Lanka's International Sovereign Bonds. This GLSB instrument is designed to help de-risk Sri Lanka's bonds by reducing the probability of Sri Lanka relapsing into a second debt default in the medium to longer term. Reducing this probability is of obvious benefit to Sri Lanka as well.

The GLSB would be structurally similar to the macro-linked bond proposed earlier by Sri Lanka's bond-holders. It would trigger a step-down in the coupon payment if Sri Lanka meets a set of specified criteria related to improving governance. This allows Sri Lanka to share with the bond-holders the benefit of the reduced risk—and therefore higher secondary market value of the bonds—arising from improved governance.

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[3] International Monetary Fund. 'Sri Lanka: Technical Assistance Report - Governance Diagnostic Assessment.' IMF Country Report, 29 Sep. 2023, https://www.imf.org/en/Publications/CR/Issues/2023/09/29/Sri-Lanka-Technical-Assistance-Report-Governance-Diagnostic-Assessment-539804

[4] Transparency International Sri Lanka. "Civil Society Governance Diagnostic Report on Sri Lanka 2023." 14 September 2023, https://www.tisrilanka.org/civil-society-governance-diagnostic-report-on-sri-lanka-2023/

Design Framework of GLSBs

The basic design of a GLSB is to have a coupon step-down, which is triggered when specific governance criteria are achieved by a certain date. To incentivise the bond-holders to take up the GLSB, it is proposed to also have a smaller coupon step-up (relatively to a Plain Vanilla Bond) in the issuing of the GLSB. This would continue up to the evaluation date of the step-down.

Such a one-time coupon step-down structure will pave the way for the bond to be **index eligible**, as opposed to a Value Recovery Instrument (VRI), which has been mentioned in a press release by the Sri Lankan government.[5]

A good set of governance criteria will be transparent and measurable and have high public support within the country, so as to foster increased government accountability for meeting the criteria. A possible set of criteria is set out in Annex 1.

Incentive compatible

The proposed GLSB design for Sri Lanka is also incentive compatible in three ways:

(1) It incentivises country performance by tying it to lower debt-servicing costs, not higher costs as in the macro-linked bond proposed by bond-holders;

(2) It aligns the interests of bond-holders with those of Sri Lanka by tying reduced debt service costs to meeting governance criteria, which would then improve the secondary market price of the bonds; and

(3) It aligns political and societal incentives within Sri Lanka, provided the governance criteria are chosen to be tangible, transparent, trackable, and popular. These features tend to generate strong public interest as well as political competition and accountability for achieving those governance improvements. This is particularly important as Sri Lanka expects to hold elections in the last quarter of 2024.

Mutually Welfare Improving

The proposed GLSB design is different from other ESG bonds. It has the unique feature of being welfare improving for the country and its creditors, in relation to standard sovereign bonds and standard non-ESG bonds.

By incentivizing the political leadership to deliver on governance improvements so that the country gets a coupon step-down, it also reduces the risk for bond-holders that the country's governance could deteriorate in the future – thereby improving the secondary market value of the bond, against the counterfactual of completing the debt restructure without a GLSB instrument.

Data shows that improvements in governance (as measured by the Worldwide Governance Indicators) are significantly correlated with increased credit ratings as well.

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[5] Ministry of Finance Sri Lanka, Press Release "Sri Lankan government's statement on the Ad Hoc Group of Bondholders' communique dated October 13th 2023". 18th October 2023, https://www.treasury.gov.lk/api/file/8b9cf8b4-e22d-4e9a-9008-3a0065469692

Specific Structure of GLSB for Sri Lanka

Holders of Existing Bonds will be offered a new security, which is the GLSBs, alongside fixed-income Plain Vanilla Bonds (PVBs). The GLSBs and PVBs will have the same haircuts in relation to the originally issued bonds. In an ideal scenario, to reduce free-riding, every bond-holder should receive the same proportion of GLSBs to PVBs in their portfolio of restructured bonds.

Structure with Binary (two state) Evaluation

The binary evaluation design framework for the GLSB gives a contingent cash flow based on two possible future states.

State S1 is where at least one of the criteria is not met by an evaluation date – in which case the coupon C_1 reverts to be the same as for the PVB for the remaining period until maturity.

State S2 is where all the criteria are met by the reference date – in which case a lower coupon C_2, with step-down from C_1 is applied for the remaining period until maturity.

The initial coupon rate on the GLSB is proposed as $C_0 = b + \delta y$, where b is the coupon rate of the corresponding PVB; y is the coupon step-down that the country would expect to receive upon being evaluated at a certain reference date (RD) as having successfully met the governance criteria; and the fractional parameter δ is the initial coupon step-up, that rewards the take-up of the GLSB by bondholders.

Therefore, post-RD, if the country is in S2, it triggers a reduced coupon of $C_2 = b - y$; and if the country is in S1, instead it shifts to $C_1 = b$, which is the benchmark coupon of the PVB, which then continues until maturity.

In this structure, the positive incentive to the country increases to the extent that the number of coupon payments due on the bond prior to the evaluation at RD, as a ratio of the number of coupon payments due on the bond post RD, is less than 1. That is because a lower ratio implies a relatively smaller number of payments on the step-up coupon C_0 and a relatively larger number of payments on the step-down coupon C_2 (if the step-down is achieved). If the ratio is set at 0.5, then RD would be triggered at one-third of the total coupon payments.

Likewise, in this structure, the benefit to the country increases to the extent that δ is less than 1, which makes the ex-ante (prior to RD) step-up smaller than the ex-post (after RD) step-down in relation to the benchmark coupon of the PVB.

Applied example for the case of Sri Lanka: let us assume that b is 6.5%, which is close to the weighted average coupon rate of Sri Lanka's ISB portfolio being restructured. If we set y to 200 basis points (2%) and $\delta = 0.5$, applying the above equations: C_0 will be 7.5%. The set governance criteria will be observed on the reference date, RD. If the criteria are not met (S1), then the coupons' step-down is only to C_1, which will be 6.5%. If the criteria are fully met (S2), the coupons step-down to C_2, which will be 4.5%; and either of the step-downs will remain so till maturity.

This is a simple binary evaluation of "success" or "failure" in meeting the set governance criteria, on which the coupon step-down is made contingent.

Structure with Ternary (three state) Evaluation

In the binary evaluation structure, the coupon step-down below the level of the PVB is triggered **only if all of the governance criteria are met**. There is no reward for partial success.

A ternary three-state evaluation that includes the case of "partial success" could be more suitable for Sri Lanka. This would award a partial coupon step-down contingent on the partial fulfilment of the governance criteria.

This has the benefit of avoiding an all-or-nothing outcome from the perspective of the country; especially if there are a significant number of governance criteria as proposed in Annex 1. When the number of criteria is large, it would make sense for the country to have such additional incentives to continue to achieve other governance criteria, even if it became evident in the initial years leading up to the evaluation on RD that a few criteria have been missed. This would lead to a modified definition of the states as follows:

State S1 is where less than the benchmark level of the criteria is met by RD – in which case the coupon C_1 reverts to being the same as for the PVB for the remaining period until maturity.

State S2 is where all the criteria are met by RD – in which case a lower coupon C_2, with step-down from C_1 is applied for the remaining period until maturity.

State S3 is where all the criteria are not met, but at least the benchmark level of the criteria is met by RD – in which case a lower coupon C_3, with a step-down from C_1 (but less of a step-down than for C_2) is applied for the remaining period until maturity.

Therefore, **if Sri Lanka fails to complete all but still completes at least the benchmark level of the commitments** by RD, then the coupon step-down would be smaller with $C_3 = b - \sigma y$; where σ is in the range $\delta < \sigma < 1$ ensuring that the partial step-down from the PVB coupon exceeds the initial step-up, but is less than the full step-down awarded on achieving all the criteria.

Applied modification to the previous example: using the same values: b as 6.5%, y as 2%; and δ as 0.5; we define the new parameter $\sigma = 0.75$; and define the partial achievement level as 80%. Then, the ex-ante evaluation C_0 will still be 7.5%, but ex-post is modified as follows:

If less than 80% of the governance criteria are met (S1), then the coupon step-down is only to C_1, which will be 6.5%. If the criteria are fully met (S2), the coupons step-down to C_2, which will be 4.5%. If more than 80% but less than all the criteria are met, then the coupons have a smaller step-down to $C_3 = b - \sigma y$, which will be 5%.

This structure for the GLSB has a single review (observation point) with a one-time coupon step down to three possible rates. This design eases index eligibility by reducing the computational complexity of a structure with multiple reviews at different future points in time.

An argument for more complex structures with multiple reviews at different points in time is that it could reinforce the incentives for positive governance actions over a longer period of time. Note 3 points to some reasons why even a single future point-in-time review can result in dynamics that generate a 'sticky' path dependent momentum for improvements in governance.

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Mutually Welfare Improving Dynamics

In contrast to a typical ESG bond with a zero-sum outcome — where financial benefits to the country come at the expense of the bond-holder or a third party, the GLSBs have a positive-sum outcome when governance criteria are achieved, which is structured for mutual welfare improvement.

There is an underlying non-controversial assumption that gives the GLSBs this unique mutually welfare improving feature. It can be stated as follows:

> *Ceteris paribus, the secondary market price of a sovereign bond is correlated with the market perception of country risk associated with signals of its financial governance.*

- Positive news regarding the country meeting the governance criteria of a GLSB, on the above assumption, leads to an increase in the secondary market price of its sovereign bonds through being perceived to be de-risked.
- The price impact due to the coupon step-down on the GLSB has an NPV offset through the higher coupon prior to the reference date and a trading value offset through the price increase due to the perception of being de-risked.
- The holders of the PVBs will have a free-rider benefit (receive a positive externality) from the increased probability of the PVBs also being de-risked by the incentives created through the GLSB, without taking a coupon cut in the case of S1. This relative advantage of the PVBs is offset by offering a higher coupon on the GLSB prior to the reference date and all the way to maturity in the case of S1.

GLSBs as a restructuring instrument should be preferable not only to typical ESG bonds but also to restructuring exclusively with PVBs. The GLSB is mutually welfare improving in state S2 (criteria are met). In state S1 (criteria are not met), the GLSB still has higher payoffs relative to the PVBs for bond-holders; but has lower payoffs for the country. That sets up a strong incentive for the country to ensure the criteria are met, which increases the probability of the mutually welfare improving outcome. All this is shown in Exhibit 1, which compares the payoffs of a GLSB to those of a typical ESG bond that doesn't have this mutually welfare improving feature.

Exhibit 1: The mutually welfare improving dynamics of a GLSB

		Payoffs on Standard ESG Bond	Payoffs on GLSB
S1 Governance criteria **not** achieved*	Bond-holder	**No-Change**: Receives the same as the PVB	**Improve**: Receives a higher coupon PVB
	Country	**No-Change**: Pays out the same as the PVB	**Reduce**: Pays out a higher coupon PVB
S2 Governance criteria achieved**	Bond-holder	**Reduce**: Receives a reduced price due to the step-down coupon	**Improve**: Receives higher price even with coupon step-down due to de-risking signal ***
	Country	**Improve**: Pays out less due to step-down in coupon	**Improve**: Pays out less due to step-down in coupon

*Assume no (punishment) coupon step-up | **With one-time (reward) coupon step-down
*** the price increases comparison should be against a PVB with no de-risking.

Annex 1: Options for Governance Criteria

The performance criteria on the governance-linked bonds are suggested based on the following features: (a) improves the macro-stability of the country, (b) serves the public interest (c) likely to have popular support within Sri Lanka's political economy context; and (d) observable and verifiable for compliance. The reference date (RD) for meeting the criteria is set to be the end of December 2026. The evaluation of it will be due by end of March 2027. The impact on coupon payments can be triggered after June 2027. These are presented in three groups.

Group 1: IMF program commitments at present

(see Exhibit 2 for precise phrasing in program document)

1. IMF Structural Benchmark on rules for appointing Commissioners to the Corruption Investigation Office is formulated and duly implemented, with all further structural benchmarks introduced by the IMF in relation to this structural benchmark also being confirmed as met by IMF reviews by end 2026. *(Exhibit 2 - #1)*

2. IMF Structural Benchmark to publish online semi-annually all public procurement contracts above Rs. 1 billion, along with comprehensive information in a searchable format on contract award winners, is confirmed by IMF reviews as met with at least 4 satisfactory semi-annual updates after the first date of publication, being confirmed as met by IMF reviews by end 2026. *(Exhibit 2 - #2)*

3. IMF Structural Benchmark to "publish on a semi-annual basis on a designated website" "a list of firms" that have imported vehicles "using tax exemptions", is confirmed by IMF reviews as met with at least 4 semi-annual updates after the first date of publication, being confirmed as met by IMF reviews by end 2026. *(Exhibit 2 - #2)*

4. IMF Structural Benchmark to publish online semi-annually a list of all firms receiving tax exemptions through various legal provisions, alongside the estimation of the value of the tax exemption, is confirmed by IMF reviews as met with at least 4 semi-annual updates after the first date of publication, being confirmed as met by IMF reviews by end 2026. *(Exhibit 2 - #2)*

5. IMF structural benchmark to publish "government action plan for implementing recommendations in the Governance Diagnostic report", is confirmed by IMF reviews as met in 2024. *(Exhibit 2 - #3)*

6. IMF Structural Benchmark to enact a comprehensive Asset Recovery Law to harmonize it with the United Nations Convention Against Corruption, in consultation with IMF staff, with all further structural benchmarks introduced by the IMF in relation to this structural benchmark also being confirmed as met by IMF reviews by end 2026. *(Exhibit 2 - #4)*

7. IMF Structural Benchmark to publish a Cabinet approval framework "to strengthen the governance of public banks, requiring their boards to have a majority of independent members" is confirmed by the IMF review in end 2024 and with all further structural benchmarks introduced by the IMF in relation to this structural benchmark also being confirmed as met by IMF reviews by end 2026. *(Exhibit 2 - #5)*

8 IMF Structural Benchmark for the operationalized Anticorruption Commission to publish asset declarations for senior officials in line with the Anticorruption Act is confirmed by IMF reviews as met in 2024 and also in each subsequent year up to the end of 2026. *(Exhibit 2 - #6)*

9 IMF program commitment to amend the tax legislation "to impose further discipline on the ministerial authority to introduce tax policy changes without prior parliamentary approval" is confirmed by IMF reviews as met in 2024. *(Exhibit 2 - #10)*

10 IMF program commitment to "update our fiscal reporting framework to the Government Finance Statistics Manual 2014 standard by end-2024" is confirmed by IMF reviews as met in 2025. *(Exhibit 2 - #11)*

11 IMF program commitment "to enact a Public Procurement Law that reflects international good practice" is confirmed by IMF reviews as met in 2025. *(Exhibit 2 - #13)*

Group 2: Quantitative targets with reasonable expectations.

12 A quantitative target of increasing government revenue to GDP to 15% is confirmed as achieved by the end year IMF review in 2026. See Note 2 for reasoning and feasibility.

13 A quantitative target of increasing the total number of registered productive (payments making) individual income taxpayers to 2 million in 2026 is confirmed as achieved by the end year IMF review in 2026. See Note 1 for reasoning and feasibility.

Group 3: Agreed in the Governance Diagnostic of the IMF program.

14 GDA recommendation to "operationalise the National Procurement Commission, with a clear mandate, authority, and responsibilities, including oversight of unsolicited proposals" is confirmed as met.

15 GDA recommendation to "publish on a government website a list of funded projects that have originated as unsolicited proposals every 6 months, along with information on lead contractor for the proposals, contract cost, and implementation progress" is confirmed as met in 2024 and also in each subsequent year up to the end of 2026.

Exhibit 2: IMF – Sri Lanka Structural Benchmarks as updated as at 12th December 2023

No	Type of Commitment	Governance Related Structural Benchmark	Due Date
1	Structural Benchmark	In line with requirements under the 21st Amendment to the Constitution, the Constitutional Council will develop rules for appointing CIABOC Commissioners that will establish an open and transparent process to ensure selected candidates meet the highest levels of professionalism, ethical conduct, and integrity. These rules will be published in the Gazette by end-December.	Dec-23
2		Publish on a semi-annual basis on a designated website (i) all public procurement contracts above Rs. 1 billion, along with comprehensive information in a searchable format on contract award winners; (ii) a list of all firms receiving tax exemptions through the Board of Investment and the SDP, and an estimation of the value of the tax exemption; and (iii) a list of firms receiving tax exemptions on luxury vehicle import.	Dec-23
3		Publication of a government action plan for implementing recommendations in the Governance Diagnostic report.	Feb-24
4		Enact a comprehensive Asset Recovery Law to harmonize it with the United Nations Convention Against Corruption, in consultation with IMF staff.	Apr-24
5		Cabinet approval and publication of a framework prepared in consultation with IMF [and WB] staff to strengthen the governance of public banks, requiring their boards to have a majority of independent members, and nominations for board and senior management to be made by the banks' nomination committees following open search procedures with clear requirements for independence and professional experience.	Jun-24
6		The operationalized Anticorruption commission shall publish asset declarations for senior officials in line with Anticorruption Act.	Jul-24
7	Program Commitments	Publishing implementation plans for the Anti-corruption act by December 2023	Dec-23
8		We will also no longer approve new projects under the SDP Act as of December 2023	Dec-23
9		The IRD will fully implement a staff Code of Conduct by December 2023	Dec-23
10		Amend the tax legislation (in particular, the Special Commodity Levy) to impose further discipline on the ministerial authority to introduce tax policy changes without prior parliamentary approval by end-June 2024	Jun-24
11		Update our fiscal reporting to the Government Finance Statistics Manual 2014 standard by end-2024	Dec-24
12		The IRD will publish a public report on steps taken and results obtained on the staff code of conduct by December 2024	Dec-24
13		Enact a Public Procurement Law by December 2024 that reflects international good practice and will coordinate with the WB to provide needed technical support	Dec-24

Note 1: Rationale on increasing productive individual income taxpayers

Sri Lanka's ratio of individuals registered for income tax reduced to just 246,103 individuals in 2022, the year that Sri Lanka also suspended debt repayments.[6] As a ratio of the labour force, that is only 2.8%. The average of this ratio for Sri Lanka's South Asian counterparts is 28.8%.[7] The number of tax files has already increased by about 3-4 fold in 2023. [8] The targeted increase is significant, but achievable, in addition to being consistent with regional norms.

Productive tax files are defined as tax files that result in actual tax payments rather than existing merely as registration records without taxes being paid. At present, the government has initiated measures to broaden the tax base.[9] Published research and policy notes have also proposed various constructive measures to increase the number of productive tax files.[10] Implementing these measures provides the government with a path to meeting this governance criterion.

The outcome is likely to have public support because the alternative to the collection of income taxes has been the expansion of consumption taxes, which have more than doubled since May 2022. Consumption taxes are now seen as substituting for tax evasion by rich individuals. Public support can increase further if the expansion of the tax base allows the government to make some reductions in consumption and income taxes. It can do so without compromising revenue targets as the tax base is increased. The highest marginal rate of income taxes has also doubled since Jan 2023, and higher marginal rates are due at lower income brackets. Those currently paying income taxes see this as an unfair burden placed on them, while taxes are avoided by wealthy individuals.

Note 2: Rationale on increasing total revenue to GDP

For the past 23 years, Sri Lanka has consistently failed to achieve its revenue targets as outlined in its national budgets.[11] This trend of underperformance extends to the current IMF program, under which Sri Lanka has again fallen short of its tax revenue target.[12] Notably, the country's tax-to-GDP ratio was one of the lowest globally in 2022.[13] This makes the task of increasing revenue to GDP critical for rebuilding macroeconomic stability.

The value of increasing revenue to this benchmark level has been argued elsewhere, claiming that "tax revenues above 15 percent of a country's gross domestic product (GDP) are a key ingredient for economic growth".[14]

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[6] Includes individuals and Employees Registered under the PAYE/APIT scheme for income tax
[7] Countries selected include: Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Malaysia and Singapore
[8] "Personal income tax-payers in IRD books better than doubles" Available at: http://bit.ly/4blhGz2
[9] Ministry of Finance, Budget Speech 2024, pg: 51, available at: ed037ac8-9727-4292-ae9b-edac08c7a314 (treasury.gov.lk)
[10] Verité Research, "The Alternatives to Universal Tax Registration in Sri Lanka", available at: https://www.veriteresearch.org/publication/the-alternatives-to-universal-tax-registration-in-sri-lanka/
[11] Verite Research. 'Debt Update: Issue 4 - December 2023.' Verite Research, Dec. 2023, Exhibit 2, https://www.veriteresearch.org/wp-content/uploads/2023/12/Debt-Update_Issue-4-December-2023.pdf.
[12] International Monetary Fund. 'Sri Lanka: IMF Executive Board Completes First Review Under EFF Arrangement.' IMF News, 12 Dec. 2023, https://www.imf.org/en/News/Articles/2023/12/12/pr23439-sri-lanka-imf-executive-board-completes-first-review-under-eff-arrangement.
[13] International Monetary Fund. 'Sri Lanka: Selected Issues.' IMF Staff Country Reports, vol. 2022, no. 341, 2022, https://www.elibrary.imf.org/view/journals/002/2022/341/article-A001-en.xml.
[14] Junquera-Varela, Raul Felix and Bernard Haven. 'Getting to 15 Percent: Addressing the Largest Tax Gaps.' World Bank Blogs, 18 Dec. 2018, https://blogs.worldbank.org/governance/getting-15-percent-addressing-largest-tax-gaps.

In alignment with this perspective, the current IMF program sets a target for Sri Lanka to achieve a total revenue equivalent to 15 percent of its GDP by 2026.[15] Therefore, the goal is to reach this 15 percent revenue-to-GDP ratio by the reference date.

Exhibit 2 lists the thirteen governance-related commitments which are in the current IMF program and have been used in setting out the governance criteria in Annex 1.

Note 3: Path dependency of early governance improvements

The IMF, during its visit to Sri Lanka in January 2024, emphasized not only that "timely implementation of all program commitments are critical" but also that "sustaining the reform momentum" was important.[16]

A governance-linked bond with a one-time coupon step-down has the advantage of simplicity and ease of index eligibility by minimising computational complexity. However, there can be a concern of sustaining these improvements because, it might be thought, that the incentives to improve governance hold only up to the point of the review date but not after that.

Therefore, it is valuable to consider the sustaining path dependency of the governance criteria that are selected. For instance, governance criteria can be selected such that they tend to:

Quality of path dependency in the criterion	Example from criteria in Annex 1
1. Entrench governance institutions/ structures that can be difficult to dismantle	National Procurement Commission with clear mandate, responsibilities and oversight
2. Make changes to laws that would be hard to unwind without political costs	Regularly publish asset declarations for senior officials in line with the Anticorruption Act.
3. Have self-sustaining features once done	Increase the total number of registered individual income taxpayers to 2 million
4. Shape public expectations that increase the demand for their continuation	Publish semi-annually all public procurement contracts above Rs. 1 billion
5. Increase transparency and the threat of future transparency, which would continue	Publish all firms receiving tax exemptions, alongside an estimation of their value
6. Have enduring dividends, such as by reducing deficits and debt during the period	Achieve the quantitative target of increasing government revenue to GDP to 15%
7. Increase the political legitimacy of those who would want to sustain the changes	Reduce ministerial authority to introduce tax changes without prior parliamentary approval

[15] International Monetary Fund. 'Sri Lanka: First Review Under the Extended Arrangement Under the Extended Fund Facility.' IMF Country Report, 12 Dec. 2023, https://www.imf.org/en/Publications/CR/Issues/2023/12/12/Sri-Lanka-First-Review-Under-the-Extended-Arrangement-Under-the-Extended-Fund-Facility-542441.
[16] International Monetary Fund. "IMF Staff Concludes Visit to Sri Lanka." 19 January 2024, https://www.imf.org/en/News/Articles/2024/01/18/pr2414-sri-lanka-imf-staff-concludes-visit.