



SRI LANKA ENDING POVERTY AND PROMOTING SHARED PROSPERITY

A SYSTEMATIC COUNTRY DIAGNOSTIC





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SRI LANKA

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The Systematic Country Diagnostic: A New World Bank Group Tool for Country Engagement

Under its new approach to working with its country partners, the World Bank Group (WBG) requires the preparation of a Systematic Country Diagnostic (SCD) to precede the development of Country Partnership Frameworks that guide programming. The objective of an SCD is to identify the most critical constraints and opportunities facing a country in accelerating progress toward the goals of ending extreme poverty and promoting shared prosperity in a sustainable manner. The SCD is expected to produce an objective, evidence-based, candid assessment of the main challenges facing the country, without limitation to the areas where the WBG is currently engaged.

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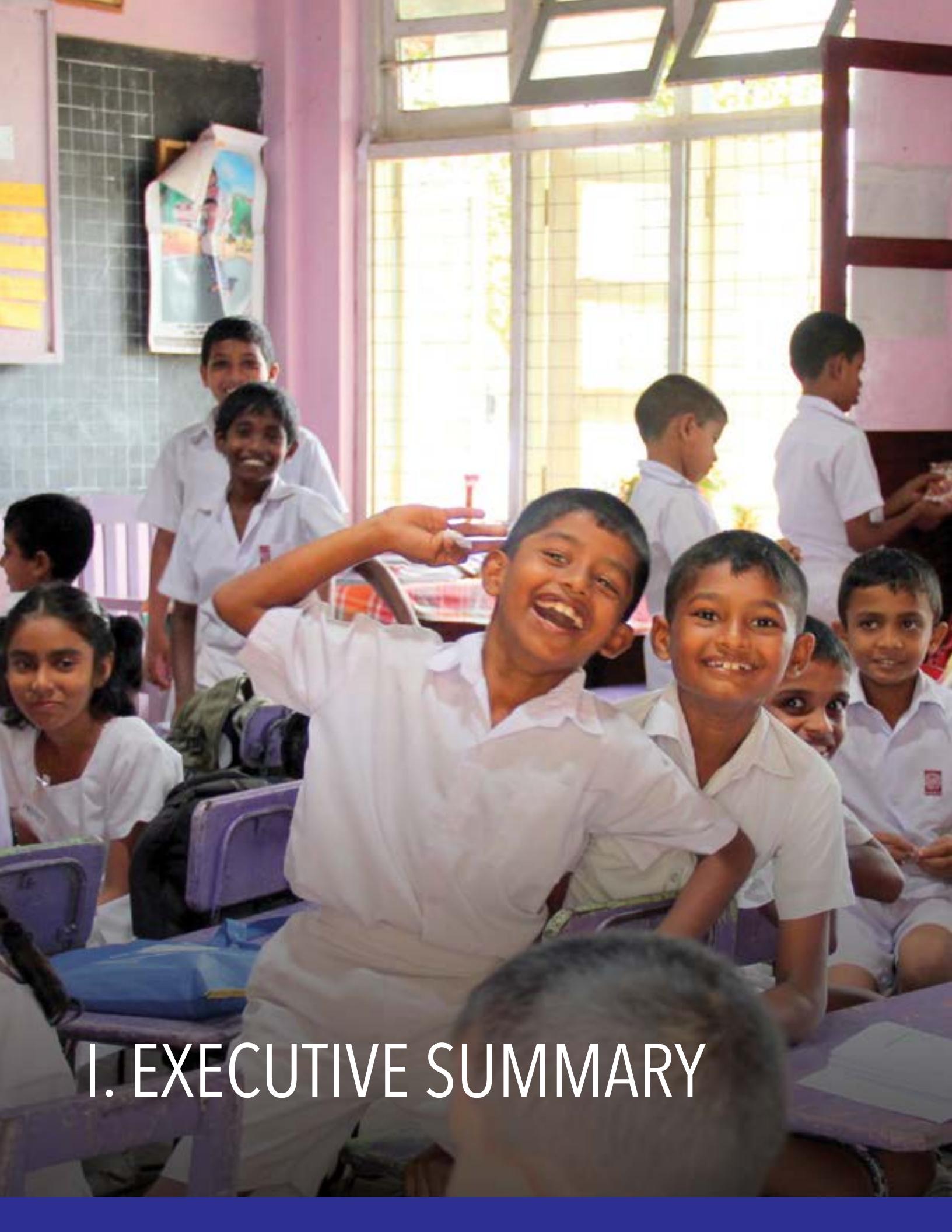
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ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank	MSME	Micro, Small and Medium Enterprise
ASYCUDA	Automated System for Customs Data	NBT	Nation Building Tax
BOI	Board of Investment	NWSDB	National Water Supply Drainage Board
CCPI	Colombo Consumer Price Index	PA	Protected Area
CEB	Ceylon Electricity Board	PEFA	Public Expenditure and Fiscal Accountability
DCS	Department of Census and Statistics	PERC	Public Enterprise Reform Commission
DHS	Demographic and Health Survey	PPP	Public-Private Partnership
EPD	External Degree Programs	PSC	Public Service Commission
EPZ	Export Processing Zone	R&D	Research and Development
EU	European Union	RWS	Rural Water Supply
FDI	Foreign Direct Investment	SAR	South Asia Region
G.C.E. A/L	General Certificate of Education – Advanced Level	SCD	Systematic Country Diagnostic
GDP	Gross Domestic Product	SEMA	Strategic Enterprise Management Agency
GIC	Growth Incidence Curve	SITC	Standard International Trade Classification
HIES	Household Income and Expenditure Survey	SME	Small and Medium Enterprise
IDP	Internally Displaced Person	SRL	Social Responsibility Levy
IFC	International Finance Corporation	SOBE	State-Owned Business Enterprise
ILO	International Labor Organization	SOE	State-Owned Enterprise
IMF	International Monetary Fund	TEWA	Termination of Employment of Workmen Act
JMP	Joint Monitoring Programme	TIMSS	Trends in International Mathematics and Science Study
LDO	Land Development Ordinance	TFP	Total Factor Productivity
LIC	Lower Income Country	UNDP	United Nations Development Programme
LLRC	Commission of Inquiry on Lessons Learned and Reconciliation	VAT	Value Added Tax
LMIC	Lower Middle Income Country	WBG	World Bank Group
LTTE	Liberation Tigers of Tamil Eelam	WGI	World Governance Indicator
MDGs	Millennium Development Goals		
MoF	Ministry of Finance		
MIC	Middle Income Country		



I. EXECUTIVE SUMMARY

1. Sri Lanka is in many respects a development success story. With economic growth averaging more than 7 percent a year over the past five years on top of an average growth of 6 percent the preceding five years, Sri Lanka has made notable strides towards the goals of ending extreme poverty and promoting shared prosperity (the “twin goals”). The national poverty headcount rate declined from 22.7 to 6.7 percent between 2002 and 2012/13, while consumption per capita of the bottom 40 percent grew at 3.3 percent a year, compared to 2.8 percent for the total population. Other human development indicators are also impressive by regional and lower middle-income country standards. Sri Lanka has also succeeded in ending decades of internal conflict in 2009 and steps have been taken towards reconciliation.

2. Increases in labor incomes account for most of the reduction in poverty over the last 10 years. Between 2002 and 2012/13, most of the reduction in poverty was due to increased earnings, as opposed to higher employment or higher transfers. Although it is hard to be certain, increases in earnings are associated with: (i) a slow structural transformation away from agriculture and into industry and services that led to productivity increases; (ii) agglomeration around key urban areas that supported this structural transformation; (iii) domestic-driven growth, including public-sector investment that led to increases in labor demand, particularly in industry and services; and (iv) a commodity boom that led to higher labor earnings for agricultural workers in the context of lower agricultural employment.

3. However, important challenges lie ahead that may hinder further progress on poverty reduction and shared prosperity. Despite the low levels of extreme poverty, roughly one quarter of Sri Lankans are nearly poor, as defined by living above the official poverty line (equivalent to about \$1.50 per day in 2005 purchasing power parity, PPP, terms) but below \$2.50 per day in 2005 PPP terms. The living standards of the near poor are closer to those of the poor than those living above \$2.50 per day. Moreover, Sri Lanka’s aspirations as a middle-income country (MIC) will differ from those of a successfully developing low-income country emerging out of conflict. Although Sri Lanka has excelled in overcoming human development challenges typical of a low-income country, its service delivery systems in education, health, and other areas must now adjust to face new and changing demands typical of a MIC. Imperatives to improve social protection programs will increase owing to an aging population that has passed its demographic peak. Finally, given increasing affluence and information, there will be higher expectations of the state to perform in order to facilitate growth, provide higher level of services, and demonstrate increasing responsiveness to a more demanding citizenry.

4. The country is at an important economic and political crossroads as it faces these challenges. Sri Lanka’s real gross domestic product (GDP) grew by 43 percent from 2009 to 2014, with the top four sectors (accounting for half of total growth) being all non-tradable sectors: construction, transport, domestic trade and banking, insurance and real estate. A substantial portion of this growth was driven by public investment to rebuild after the end of its 30-year internal conflict in 2009. These sectors, as well as the economic boost at the end of the conflict, are not likely to be sustainable sources of growth in the long run. In addition to the need to foster new sources of growth, Sri Lanka is in the process of major governance reforms following the election of a new government in early 2015. The Constitution has been amended to overhaul the structure of government by reducing the power of the presidency and providing for more internal checks and accountability mechanisms. There is also now a constitutional guarantee of citizens’ right to information. At the same time, while reforms to promote transparency and accountability in government should lead to better performance, a political settlement around the new governance structure will need to emerge.

5. Bearing in mind the challenges to Sri Lanka’s further development, this diagnostic consists of a systematic and detailed review of potential factors impacting progress on the twin goals. In line with the World Bank Group’s new approach to country engagements, this report aims to identify the most critical constraints and opportunities to advancing achievement of the twin goals. In order to organize and discipline the analysis, the report uses a framework that combines the Hausman, Rodrik and Velasco (2005) growth diagnostic and the Bussolo and Lopez-Calva (2014) asset-based approach to identify a universe of 22 potential areas that may constrain or drive progress towards the twin goals. Sri Lanka’s performance in each area was assessed for its relative impact on achieving the twin goals. This systematic analysis was then presented in set of consultations with multiple stakeholders, including government, academia, think tanks, the private sector, civil society organizations, and international organizations to validate the findings, determine the relative importance of

Poverty dropped by over two-thirds from 2002 to 2012/13

Although Sri Lanka has excelled in overcoming development challenges typical of a low income country, it must adjust to face new demands typical of a middle income country

issues identified in each of the 22 areas and identify knowledge gaps. These findings were weighted against criteria of: (i) the potential impact on ending poverty and on promoting shared prosperity; (ii) the degree to which addressing these constraints would have complementarities across different domains; (iii) the strength of the evidence base behind the impact; (iv) the time horizon of impacts; and (v) whether addressing the constraint is a precondition to unlocking wider potential. This process yielded consensus that the key priorities for sustaining progress in ending poverty and promoting shared prosperity are to address the country's fiscal, competitiveness and inclusion challenges, as well as cross-cutting governance and sustainability challenges.

The Fiscal Challenge

6. Low and declining revenues critically impact Sri Lanka's fiscal position.

Sri Lanka now has one of the lowest tax revenue-to-GDP ratios in the world, reflecting a decline from 24.2 percent in 1978 to 10.7 percent in 2014. The major causes of this decline are the low increase in the number of taxpayers, reductions in statutory rates without commensurate efforts to expand the tax base, inefficiencies in administration and numerous exemptions.

In particular, since the introduction of a value added tax (VAT) in 2002, successive changes in the tax regime have led to over 500 types of exemptions for a wide variety of goods. There are also over 40 broad types of exemptions on corporate and personal income tax depending on the source of income and the type of taxpayer. Administration is complicated by lack of coordination among entities collecting revenue as well as the Board of Investment, which provides incentives. No tax expenditure analysis is conducted before or after the introduction of incentives.

7. Low tax revenues combined with an expenditure profile that is largely non-discretionary has led to a lean, rigid budget with little room for critical development spending. Sri Lanka's overall revenues and expenditures are among the lowest in the region as a percentage of GDP. Fiscal consolidation and relative prioritization of public investment in capital infrastructure following the conflict have squeezed spending on other public goods, including health, education and social protection, which are currently below levels in other regional and emerging market comparators. Fiscal consolidation combined with declining revenues has made the budget rigid, leaving little fiscal space for the government to maneuver. Difficult-to-reduce items, such as public service remuneration,

transfers, and interest payments, have accounted for 60 percent of expenditure in recent years. Moreover, wage pressures have been rising due to a 57 percent increase in the number of public servants in the past 10 years. This has yielded a situation where public servants account for 13 percent of the labor force, comparable to the OECD average of 15 percent in 2011. At the same time, increases in recurrent expenditures in early 2015, particularly a raise in allowances to public servants, is to be financed by one-time taxes, leaving very little room to maneuver. A strong commitment to fiscal consolidation in the face of these pressures has led to Sri Lanka having extremely low levels of public spending on education, health, and social protection as a percentage of GDP. Going forward, continued commitment to fiscal consolidation is critical to ensure macroeconomic stability, but this will require long-term improvements in revenues.

The Challenge of Promoting More and Better Jobs for the Bottom 40 Percent

8. Sri Lanka has a number of advantages that can contribute to inclusive growth.

Given its relatively small domestic market, Sri Lanka will need to look outward to fulfill its ambitions to become a prosperous and competitive middle-income country. As such, the country has important strengths, such as overall strong human capital and a reliable infrastructure base, particularly when compared to other South Asian countries. Sri Lanka also enjoys an enviable location in a fast-growing region along a major trade route, opening opportunities to serve as a regional trading hub.

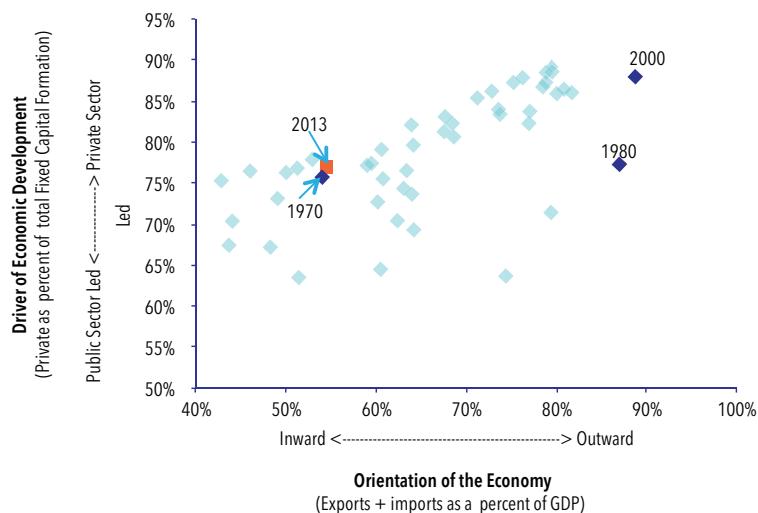
Moreover, Sri Lanka's boasts unique natural assets, with a temperate climate, diverse topography, and unique historical assets, giving it a strong basis for tourism. At the same time, the country has a track record of developing globally competitive companies, particularly in niches of the apparel and information technology (IT) sectors.

9. To capitalize on its advantages Sri Lanka will need to find an effective balance along two axes:

(i) inward vs. outward orientation of the economy; and (ii) the respective roles of the public and private sectors (Figure 1.1). The country's world market share has fallen to levels last seen in the 1980s, with a steady decline in commodity exports and an export basket that has remained largely unchanged in a context of rising production costs and weakening demand due to slow growth in some of its main markets (Europe and the Middle East). At the same

Sri Lanka has an enviable location and unique natural assets

Figure 1.1 Balancing between inward vs. outward orientation and public vs. private sector driven development; Sri Lanka 1965-2013



Source: World Development Indicators. All data refer to Sri Lanka

time, the economy has shifted towards a public-sector led model, as public investment to rebuild following the end of conflict was responsible for much of the large growth in construction as well as transport over the last decade.

Inward versus Outward Orientation of the Economy

The degree of outward orientation has wavered in the past decade

introduced a series of reforms towards deregulating the economy, accompanied by a strong focus on export orientation and foreign direct investment (FDI) promotion. The last decade has seen a noticeable shift towards protectionism. The introduction of para-tariffs has effectively doubled the protection rates, making the present import regime one of the most complex and protectionist in the world. Moreover, the para-tariffs' dispersion leads to prices that distort production and consumption patterns. Higher rates

The import regime is one of the most protectionist in the world

of protection on final products than on inputs used in their production lead to an anti-export bias, since producers have strong incentive to sell goods domestically even though their domestic costs are higher than their opportunity costs through trade. This is particularly worrying for the agricultural sector, where high protection of import-competing crops along with fertilizer subsidies have created strong disincentives for crop and export diversification. Incentives are structured to expand production of import-competing crops (rice, maize) and discourage the production of exportables through the introduction of high export taxes ('cesses') on raw materials such as tea, rubber, cinnamon, coconut and spices, with the notion that this would increase value addition of exports. Revenues from cesses were supposed to be then invested in research and development for the corresponding sectors to encourage value addition, yet this has not been implemented.

11. Foreign direct investment, a foundation for economic diversification, has been disappointing despite numerous fiscal incentives. FDI remains below 2 percent of GDP five years after the end of armed conflict, which is low relative to much higher levels of FDI in other MICs such as Vietnam or Cambodia. While FDI can enhance access of producers to global production networks and facilitate the development of new activities within existing value chains, FDI inflows to Sri Lanka have been largely focused on infrastructure (inclusive of real estate development), with a relatively small proportion reaching sectors of the economy that are associated with global networks of production. Although conclusive data is not available, the benefits from incentives in terms of attraction and retention of productivity-enhancing FDI may not outweigh the costs involved in fiscal losses and potential disruption of market dynamics (through, among other things, the creation of an unleveled playing field). Global experience suggests that the most important ways to ensure both domestic and foreign investment include measures to improve the enabling environment, including through a skilled workforce and adequate innovation policies that form the basis of a competitive economy.

12. Despite past achievements, the quality of general education lags behind higher middle-income countries and firms have difficulty accessing the skills they need. Although human development indicators are ahead of regional peers, the quality of education, as measured by periodic internationally comparable tests, lags behind that of higher middle-income countries, particularly in language and numeracy skills. Sri Lanka also lacks the

kind of vocational and technical skills in its workforce that are increasingly in demand, reflecting constraints on the quality and relevance of higher education and research.

Sri Lanka lacks vocational and technical skills that are increasingly in demand

linkages between what the private sector needs in order to innovate and research and development institutions that could meet these needs. This is particularly acute in agriculture where there is limited distribution of new technologies critical for modern farming.

The Relationship between the Public Sector and Private Sector

13. The government's performance as regulator and facilitator of economic activity has improved in recent years, though significant shortcomings remain. Given fiscal constraints, sustained growth will need to be driven by the private sector, which, in turn, calls for government regulation conducive to business. Among areas of regulation, systems for registration of property rights and land-use regimes that introduce

limitations and lead to fragmentation of land parcels are important constraints to businesses. Land ownership issues are the most common reason cited by informal firms for not registering. Moreover, the predictability

of state regulation with regard to property rights has proven to be an issue, with particular harm caused by the "Revival of Underperforming Enterprises and Underutilized Assets Act", which expropriated 37 enterprises in sectors like hotels, mixed-property development and the sugar industry. Licenses and permits are also an obstacle, particularly in the Northern Province. Finally, policy-induced barriers consisting of regulatory and institutional bottlenecks account for nearly 70 percent of the total time spent on exporting or importing goods.

14. Similarly, labor market regulations appear to be constraining the growth of employment. Although labor market regulations aim to provide job security to formal sector workers, since these represent only about 15 percent of the workforce, they have resulted in creating a deep divide between formal and informal workers. Sri Lanka's Termination of Employment of Workmen Act (TEWA)

requires that firms with 15 or more employees justify layoffs and provide generous severance pay to displaced workers, with smaller firms being exempted. These severance payments are expensive relative to regional and middle-income peers. Finally, the legal framework prevents women from taking up night work or part-time work in the growing service sector while the laws governing maternity benefits make employers bear the entire cost, potentially deterring employers from hiring women.

15. Regulatory compliance burdens prompt entrepreneurs to operate informally, which undermines competition. Most business establishments in Sri Lanka are small and hence do not benefit from economies of scale. Moreover, side-by-side operations of informal and formal firms in a market lead to unfair practices and market inefficiencies. Unfair competition from informal players is viewed as the single most important obstacle to the growth and competitiveness of established firms. At the same time, informal firms generally have no access to financial services, government contracts, and essential licenses and permits.

16. Although successive policy regimes have introduced numerous programs aimed at supporting the small and medium-sized enterprise (SME) sector, firms in this sector face multiple constraints, particularly access to finance and technology. Financing issues are driven by weaknesses of the firms to put forward bankable projects as well as failures in SME banking which relies on asset-based financing with little flexibility to provide project-based finance. SMEs also find it difficult to access technology to upgrade their businesses. Reducing the cost of operating a business along with stronger enforcement can help to reduce informality, reduce uncompetitive practices, and, by extension, create an environment more conducive to investment in productivity-enhancing activities.

17. The proliferation of small firms and informal employment has important consequences for the ability of the bottom 40 percent to share in the growth process. Most of the increase in non-agricultural employment between 2002 and 2012 was in self-employed non-farm workers. Moreover, the decline in agricultural employment coincided with an increase in workers employed in establishments with no regular employees. By 2012, 74 percent of unskilled workers (those with less than a primary education) had only temporary or casual wage employment, up

Regulatory compliance burdens prompt entrepreneurs to operate informally, an important obstacle to growth and competitiveness

from 70 percent in 2006, suggesting that these workers are increasingly working under precarious conditions. Wages of temporary workers are on average 33 percent lower than wages of permanent workers; one-third of which cannot be explained by differences in the job or individual characteristics, suggesting that workers would choose more stable reliable jobs if they could.

18. Beyond carrying out regulatory functions, the state itself is a major participant in the market through its large state-owned enterprise (SOE) sector and public service, which in turn has impacted competitiveness in a number of sectors and labor market dynamics.

A large public sector impacts competitiveness in a number of sectors and labor market dynamics

including areas where there is not a strong apparent rationale for public intervention. This is most striking in the finance sector, where major SOEs make up close to half of the market. At the same time, there is a weak framework for public-private partnerships and relatively few cases of PPPs; infrastructure development over the past 10 years has been driven by direct public spending. Finally, the state plays an outsized role as an employer. There is strong demand for public-sector jobs as public-sector workers enjoy the advantages of formal employment and other benefits such as a pension. Moreover, the evidence suggests that there is a salary premium for public-sector workers and that this premium has grown between 2006 and 2012. Workers, particularly educated women, are queuing for public-sector employment.

19. Finally, there has been a high degree of interconnectedness between the state and some segments of the private sector that motivates intervention by the government. The variation in tax and customs incentives reflects government policy but also contains specific benefits for specific sectors, many of which have a limited number of major actors. In addition, there are several high-profile cases of movement of senior officials between public and private sectors as there is no developed framework for handling conflicts of interest to separate public-sector work from private-sector interests. Given that there are frequent instances of state regulatory help to a given sector it follows that private-sector entities would seek to maintain or expand privileges, reinforcing the level of regulatory intervention into the economy. These circumstances also suggest that many private-sector entities would have to adjust considerably were Sri Lanka to open its markets to a greater extent. Changing the state's role as an employer, market actor and regulator to provide for

a more level playing field will encounter resistance from vested interests.

Social Inclusion Challenges

20. The highest numbers of people living in poverty and the bottom 40 percent are located within multi-city agglomeration areas. At the same time, urbanization in Sri Lanka has been a strong driver of growth and that trend will continue. Streamlining urban management structures and improving their capacity to ensure they have the administrative powers to deliver functional urban services and conduct integrated, strategic planning (including land use planning and transport planning) will provide local authorities with the opportunity to respond to both present and future needs. Improved connectivity across the country will further assist in raising the economic potential located outside the Kandy-Colombo-Galle agglomeration, as well as improving growth drivers within those districts. Further analysis on the constraints to participation of the bottom 40 percent in further agglomeration and spreading economic activity will be important for assessing what is needed to have urbanization facilitate inclusion.

21. The poor in more isolated regions of the country represent a different challenge. There are high rates of poverty in the Northern and Eastern Provinces, the center where the estate sector (plantation-based agriculture) is concentrated, and Moneragala in the southeast. Poverty rates are highest in portions of the Northern and Eastern provinces, which were most affected by the internal conflict. The high poverty headcount rates in these regions are associated with weak links to the labor market, particularly among the youth and educated women. People with physical disabilities and psychological problems due to conflict, in particular ex-combatants and widows, are particularly vulnerable to exclusion.

There are high rates of poverty in the Northern and Eastern Provinces, the estate sector, and Moneragala

22. Poverty measured by consumption has dropped significantly among estate workers, but non-monetary measures of poverty and vulnerability remain high. Estate workers continue to be largely dependent on the estate's management for many basic needs, particularly housing. While poverty in the estate sector fell markedly in the past decade, poverty rates continue to be higher com-

pared to both urban and rural sectors, pointing to continued vulnerability. This is particularly evident when looking at health and nutrition indicators. Estates have the highest maternal mortality rates in the country, and both estate women as well as children suffer from high rates of malnutrition that are double national averages. Estate-sector households are less likely to have drinking water, sanitary facilities or electricity within their households. Moreover, access to services and the quality of services in the estates is comparatively low. Poor outcomes in education impede the ability of the estate population to participate in Sri Lankan society. The youth are increasingly leaving the estate sector but they face difficulties in accessing salaried employment when competing with other youth. Women tend to be employed for the lowest-paying unskilled tasks that require intense labor, such as tea plucking or rubber tapping. Despite being income earners, there is substantial anecdotal evidence that the wages of estate women are often collected by their husbands or fathers who often spend it on alcohol. Alcoholism and associated abuse of women is much higher in the estate sector.

23. The estate sector faces structural challenges that will likely impact the population going forward. Wages have risen by over 10 times since privatization in 1992 – due in part to the strong collective bargaining power of estate workers, linked to a powerful political party representing them. At the same time, Sri Lankan tea producers are facing increasing competition from Kenyan and Indian producers who have lower costs of production and higher productivity. As a result, the future welfare of estate communities is at risk due to narrowing surpluses enjoyed by Regional Plantation Companies (RPCs) and a socio-economic structure that may not be tenable over the long term.

24. Beyond the locational concentration of the population, inclusion across ethnic and religious groups is critical. Although partially correlated to spatial disparities, poverty outcomes across ethnicity and religion illustrate a second important challenge for social inclusion. Differences in poverty outcomes across ethnic groups are related to employment and other opportunities. This is the case even when the North and East are excluded from comparisons. As more youth migrate across the country in search of jobs, equal opportunities will be critical. Sri Lankan Tamils and Sri Lankan Moors have relatively high levels of poverty, as detailed in Chapter V; however, empirical analysis finds that most of the difference in monetary poverty is related to inequality of opportunities. For a range of indicators, the most recent household survey shows that Sri Lankan Tamil households have lower access to basic services, including drinking water within their premises, the availability of a pipe-borne line nearby their house, a

toilet within their unit and access to electricity. Similarly, educational attainment is lower for the ethnic minority workforce, and rates of ownership of land are also uneven among the country's ethnic communities. In terms of labor market opportunities, labor force participation is low and unemployment is high for Sri Lankan Tamils and Moors. However, when focusing outside of the post-conflict regions, both Sri Lankan and Indian Tamils have higher labor force participation and employment rates relative to their Sinhalese counterparts. This suggests that different rates of participation are mostly determined by differences in employment opportunities. The conflict-affected areas face the additional challenge of integrating displaced persons: while over 700,000 have returned, they face multiple challenges in securing land rights, accessing shelter and infrastructure, and developing livelihoods.

25. Finally, gender inclusion is critical, particularly as it relates to the labor market. Women made up 53 percent of the working age population in 2012, but only 34 percent of the employed population, a figure that has remained static for decades. Women are less likely to participate in the labor market, but when they decide to look

Women's participation in the labor market has remained static for decades

for work, they are more likely to be unemployed. Social norms related to a woman's role in the household and especially as related to childcare responsibilities restrict women's opportunity to participate in the labor market. However, beyond social norms, gender wage gaps and occupational segregation dissuade and constrain women from participating in the labor force. At the same time, the formal legal framework for labor prevents women from taking up night work or part-time work in the growing service sector, and the laws governing maternity benefits make employers bear the entire cost, potentially deterring employers from hiring women.

The Cross-Cutting Governance Challenge

26. The governance challenge manifests itself in many ways which taken together constitute the fundamental constraint on progress on the twin goals. Governance issues are cross cutting and underlie in many important ways the three challenges outlined above. Governance is obviously central to the quality and probity of public expenditure as well as the government's capacity to provide for equality of opportunity for the poor and bottom 40 percent to improve their welfare. Moreover, the quality of governance is integral to addressing corruption

concerns and sustaining public trust. It is also integral to revenue performance, particularly the effectiveness of tax and customs administration. The most prominent manner in which governance acts as a constraint is in how the state carries out regulatory functions for the economy. Policies that orient the economy inward, such as the convoluted tax system, restrictive land and labor market regulation, and inefficient subsidies – and the related quality of administration thereof – reflect areas where governance is a critical constraint. This burden of government regulation has led to a large informal sector, which negatively impacts improvements in productivity. Governance weaknesses have further led to significant expansion of the public sector's role in the labor market and certain economic sectors. This expanded role in the economy contributes little to effective use of the country's resources or productivity gains, whether it is interventions in agriculture, multiplying tax incentives, or absorbing a significant portion of the labor force. Finally, ensuring the provision of key public goods such as infrastructure and public services is a core function of government; the extent to which there is inequality in access to such goods reflects areas where strengthened governance is warranted.

Sustainability Challenges

27. Sustainability of Sri Lanka's development will involve keeping momentum towards reconciliation and successful completion of institutional reforms. Achieving a lasting settlement of conflict that ensures peace and security for Sri Lankans is the *sine qua non* condition for progress. While circumstances are unique to every country

Achieving a lasting settlement that ensures peace and security for Sri Lankans is a *sine qua non* condition for progress

and conflict is not imminent, global experience suggests that Sri Lanka is "at risk" given its history of internal conflict. Achieving reconciliation and addressing issues that led to grievances that, in turn, fueled conflict in the past will be critical. Sri Lanka has taken notable steps along this path, including following up on extensive recommendations by its Commission of Inquiry on Lessons Learned and Reconciliation (LLRC). Important measures have occurred in recent months, including the appointment of a civilian as governor in the north and beginning to return some land occupied by the military after the conflict ended. This momentum will need to be sustained. Sri Lanka will also need to follow through on major institutional reforms now taking place to achieve a lasting political settlement around a government that is more transparent and accountable.

28. Other risks to sustainability are associated with economic stability in the context of an uncertain external environment and environmental issues. External risks include a chronic current account deficit and relatively low reserve adequacy metrics; a gradual but steady decline in goods exports; an already high external debt burden and a rising cost for external financing as Sri Lanka must now borrow on commercial terms; and disappointing levels of foreign direct investment. While the current account deficit has decreased in recent years, in part thanks to slow increases in remittances and tourism, it remains financed largely by debt-creating inflows. At the same time, Central Bank foreign exchange reserves are at the lower end of what is considered adequate by standard metrics.

Sri Lanka is projected to age fast in the next few decades

Moreover, Sri Lanka is in the midst of its demographic transition, and is projected to age fast in the next few decades. As the elderly typically run down their savings and require additional public spending in the form of pensions, social protection and healthcare, their increasing share in the population means that national savings will fall even further. Finally, preserving Sri Lanka's natural asset base and managing environmental impact as the country continues its structural transformation, including urbanization, will be critical to sustaining progress on the twin goals. Sri Lanka will continue to face environmental risks due to natural disasters as well as the long-term impacts of climate change, which by one accounting will result in reductions of 1.2 percent of GDP per year by 2050.

Conclusions

29. Sri Lanka's has had impressive development gains but there are strong indications that drivers of past progress are not sustainable. Solid economic growth, strong poverty reduction, overcoming internal conflict, effecting a remarkable democratic transition in recent months, and overall strong human development outcomes are a track record that would make any country proud. However, the country's inward looking growth model based on non-tradable sectors and domestic demand amplified by public investment cannot be expected to lead to sustained inclusive growth going forward.

30. A systematic diagnostic points to fiscal, competitiveness, and inclusion challenges as well as cross-cutting governance and sustainability challenges as priority areas of focus for sustaining progress in ending poverty and promoting shared prosperity (Table 1.1). The fiscal challenge is due above all to poor revenue collection, compounded by inefficiencies in public expenditures

that result in rigidity and underinvestment in human capital. The competitiveness challenge is a mix of several areas where Sri Lanka is behind comparator countries, most notably in fostering adequate skills in the labor force, but also in other areas such as FDI attraction, investment climate, and promotion of innovation. The inclusion challenge is both spatial in the urban areas and remote “pockets of poverty” as well as cross cutting across ethnic, gender and age differences in Sri Lanka’s population. Governance is a challenge in all areas, but is particularly manifested in regulatory constraints and an outsized public sector. Finally, there are important sustainability risks, including the need to: maintain peace and security; carry through with governance reforms; address longer-term economic challenges of an aging population; and balance imperatives to grow with stewardship of Sri Lanka’s natural assets as a basis for lasting prosperity and quality of life.

31. There are particularly important areas of synergy that provide for progress on inclusion, sustainability and growth. For instance, effective governance of cities will not only be critical for addressing spatial inclusion challenges, but could also improve the benefits of urban agglomeration and raise the level of overall growth and job-creation. Good governance in urbanizing areas is also important to balance social, environmental, and economic equity concerns to allow for Sri Lanka to benefit long term from its relatively unharmed natural asset base. Similarly, improving equality of opportunity (including addressing land claims) across ethnic groups is likely to be crucial for improving social stability and sustainability of peace. Closing gender gaps is not only important in terms of social inclusion, but is also critical in terms of the broader challenge of raising competitiveness and ensuring shared prosperity, particularly given that an aging population will increase the dependency rate.

32. There is a particularly strong nexus of issues around providing for skills development that meets the needs of Sri Lanka’s economy. On one hand, there are important elements of state performance needed to improve the population’s skills mix: its ability to create more fiscal space to provide quality education to the population, the efficiency of resources directed towards human capital development, its ability to listen to and partner with the private sector on ensuring that the right skills are being provided, and the impact that it has on the labor market given its outsized role as an employer. At the same time, investment in skills, particularly with public financing, is integral to equipping the bottom 40 percent with capacity to get good jobs, a fundamental means of boosting shared prosperity. A more skilled labor force in turn helps Sri Lanka become more competitive, including within global value chains, as well as a more attractive destination for FDI.

33. Addressing the constraints and sustainability risks diagnosed in this report will require effective leadership. Consultations conducted while preparing this diagnostic showed that many of the identified constraints were known, at least on an intuitive level. Indeed, with regard to several constraints, reforms or government interventions have been initiated to address problems such as equality of opportunity in underserved areas or improving Sri Lankans’ skill sets. The present government has articulated further plans to address other constraints outlined in this diagnostic. Yet there also remain interests that support the status quo, whether they are specific tax exemptions or limitations on the number of slots available in higher education institutions. Sri Lanka is at a crossroads in its economic growth model and its governance framework that will provide for an effective state to facilitate growth and ensure social inclusion. Effective leadership will be needed to steer it forward on a path that will continue its strong progress in ending poverty and promoting shared prosperity.

Table 1.1 Priorities to end poverty and promote shared prosperity in a sustainable

Priorities	Rationale
FISCAL Reform the tax regime and improve tax administration to improve revenue performance Improve the adequacy and effectiveness of spending Improve the amount of financing and efficiency of social protection	Fiscal sustainability a key precondition for progress in all areas, including macroeconomic stability. Greater fiscal space allows for addressing equality of opportunity through increased social spending, especially important for inclusion. Efficiency of social protection has direct impact on ending poverty. Evidence base is strong.
COMPETITIVENESS Review and revise the country's trade-related policies Provide more resources and quality-enhancing management in the education sector to expand skilled workforce and overcome skills mismatch Promote innovation by establishing linkages between R&D institutions and networks of entrepreneurs	Trade and adoption of new technologies promote diversification, external sustainability, and growth, which translates to good jobs. Overcoming skills mismatches contributes to growth and participation of the bottom 40 percent, including minorities and women. Evidence base is strong for skills and trade policy issues.
INCLUSION Proper urban management and effective governance of cities to address locational concentrations of poverty Multi-sector interventions to reduce poverty and promote employment opportunities in areas with the highest poverty rates (North, East, Moneragala, and estates) Improve equality of opportunity across ethnic groups, regardless of where they reside Increase labor force participation of women and ensure equal opportunity in access to jobs, political and private-sector leadership	Urbanizing areas are associated with growth and an absolute majority of poor are proximate to these areas. Ensuring continued benefits of agglomeration will help progress for the majority of the poor. For those living in more remote areas, more targeted interventions will be needed to ensure equality of opportunity through improved service delivery and greater participation in the labor force. Evidence base is very strong.
GOVERNANCE Improve the regulatory environment to allow firms to grow and enhance overall productivity in the economy Review the regulatory role and participation of the public sector in the economy Improve the efficiency of the public sector	Governance has cross-cutting impact on all other challenges. In particular, labor, land, and other regulation create major distortions in the economy. The size of the public sector leads to inefficient use of public resources and distorts labor markets. The ability of government to carry out core functions depends on effectiveness of the public sector. Evidence base is strong.
SUSTAINABILITY Sustain peace and security through long-term reconciliation efforts Develop a more accountable and effective state Place heavier emphasis on direct investment and equity portfolio flows than debt Preserve natural assets and address the impact of climate change Address the long-term fiscal sustainability concerns related to population aging	Peace is sine qua non for continued investment, growth, and personal well-being of large segment of the population. Sustaining the state's institutional capability over the long term is integral competent facilitation of private-sector-led growth. Macro-economic and environmental sustainability are preconditions for continued progress as well as capitalizing on the country's asset base. Evidence of associated risks is strong.



II. COUNTRY CONTEXT

A. Political and Social Context

34. Sri Lanka is in many respects a development success story. With economic growth averaging over 7 percent a year over the past five years on top of an average growth of 6 percent the preceding five years, Sri Lanka has made notable strides in reducing poverty and promoting shared prosperity. The national poverty headcount ratio declined from 22.7 to 6.7 percent between 2002 and 2012/13, with most of the reduction occurring in the early part of the past decade. Growth has been pro-poor for most of the past decade, with consumption per capita of the bottom 40 percent growing at 3.3 percent a year, compared to 2.8 percent for the total population. Other human development indicators are also impressive by regional and lower middle-income standards. Sri Lanka outperforms nearby country comparators on most Millennium Development Goals (MDGs), particularly with regard to poverty reduction, health, and environmental sustainability. Coverage for primary school is near universal, while secondary and tertiary enrollment has substantially increased. Maternal and infant mortality rates are now at very low levels, and life expectancy, at 74 years, has been above its regional peers for over a decade. (See Appendix 1.1 for review of Sri Lanka's performance on MDGs.)

35. The country's achievements are impressive given the complex relationships among its communities that have led to conflict in the past. Sri Lanka is home to ethnic majority Sinhala; Sri Lankan Tamils, of whom many are concentrated in the north and east; Moors (Muslims) concentrated in the east, northwest, coastal areas of the south, and urban areas; Indian origin Tamils concentrated in the highlands and estate sector; and other less numerous ethnic groups including Malays and Burghers. Urban populations, particularly the capital Colombo, have diverse ethnic composition. Providing for social inclusion and peaceful co-existence and interaction among communities has been a persistent challenge, with inter-communal grievances leading to several outbursts of violence before and after independence in 1948. These tensions were a driving force contributing to the emergence in the late 1970s

Providing for social inclusion among communities has been a persistent challenge

of armed Tamil militant formations, which in turn came to be dominated by the Liberation Tigers of Tamil Eelam (LTTE). A four-phased war between the LTTE and the Sri Lankan state spanning 26 years ended with the military defeat of the LTTE and deaths of most of its leaders in May 2009. Taken together with youth insurrections that led to

conflict in the 1970s and 1980s¹, direct and indirect costs of conflict through additional expenditures, losses in physical and human capital, and foregone investment have been estimated to be equivalent to over 5 percent of GDP per year during the period 1978-2005.² This calculation of economic costs does not include the impact of loss of life and other physical and psychological trauma.

36. The end of the conflict has led to much greater security for Sri Lankans and an opportunity to achieve lasting reconciliation. There is no longer the pervasive threat of violence that had long impacted development. The state controls law and order across the island, resulting in improvements in overall security. Security in turn provides for higher quality of life and stimulates economic activity at many levels. At the same time, the major political parties associated with the Tamil population work within Sri Lanka's institutional framework at provincial and national levels while continuing to articulate their community's issues. The main Tamil political grouping played an important role in supporting the January 2015 election of Sri Lanka's new president, Maithripala Sirisena. Security and inclusive politics provide space for coming to a lasting settlement that would overcome grievances that fueled conflict in the past.

37. There have been significant efforts to rebuild conflict-affected areas. Sri Lanka has heavily invested in developing infrastructure throughout the country over the past five years, including in the conflict-affected areas of the north and east. A total of 5.2 percent of all budget expenditures excluding interest payments were spent directly on reconstruction efforts in the Northern Province alone in the period 2009-2013.³ These efforts have included a painstaking demining effort covering targeted areas comprising over 2000 square kilometers that is 95 percent complete as of the beginning of 2014, making farming possible in many fields which had been off limits. While levels of public service provision remain lower in the north and east, there has been visible progress in improving road and rail networks and installing housing, power transmission, water supply systems and other infrastructure. The roughly 700,000 internally displaced people caused by the conflict have almost all returned to their homes or have otherwise voluntarily resettled elsewhere. The population in former conflict areas continues to face many hurdles in

1 In addition to conflict involving Sri Lankan Tamils, there were two insurrections of leftist political groups composed of mostly Sinhalese against the Sri Lankan state in 1971 and 1987-89. There was also conflict in preceding decades among Sri Lankan Tamil armed groups, ending with the LTTE virtually eliminating its rivals.

2 Institute for Policy Studies. 2012.

3 Ministry of Finance, 2014

rebuilding their lives but resettlement after the conflict has been overall positive with 93 percent resettled on their own lands.⁴

38. Particularly after the election of President Sirisena in 2015, the government has taken actions to address grievances of the Sri Lankan Tamil community.

Following the end of the conflict, the preceding government established the LLRC and implemented several of the commission's recommendations. In particular, Northern Provincial Council elections were held in 2013 and were won by the main Tamil opposition party. Steps to address grievances have been accelerated under President Sirisena, most notably: the appointment of a civilian as governor in the Northern Province; the commitment to a domestic mechanism to address issues of accountability for allegations of misconduct during and particularly at the end of the conflict; and the return of some of the lands that had been taken for military bases in the North and East. The more pro-active stance of government responds to a key LLRC finding on the causes of conflict: "Successive governments since independence have been unable to fully resolve, and in some instances actually contributed to, communal tensions, particularly those involving the Tamil community." While much remains to be done on reconciliation, these steps work towards providing for long-term sense of security, justice and jobs for all communities, all of which are critical factors for avoiding renewal of conflict.⁵

39. Sri Lanka is also at the threshold of major institutional and political reforms advocated by the new political leadership elected in 2015. Since the passage of its 1978 Constitution, Sri Lanka has been dominated by an "Executive Presidency" that enjoyed wide-ranging powers, including the unlimited right to appoint and dismiss key officers of nearly all state institutions and no accountability to other state institutions. The preponderance of the presidency created a centralized government and decision-making apparatus with weak checks and balances. Sirisena's victory in elections over two-term President Rajapaksa, the country's dominant political figure for the preceding nine years, was based on a platform of good governance that received diverse support. His government has prioritized securing passage of constitutional amendments to reduce the powers of the presidency while strengthening parliament, as well as legislation setting up a right to information regime, strengthened audit and procurement regimes, and more vigorous anti-corruption efforts.

4 GoSL and United Nations. Sri Lanka Joint Needs Assessment Final Report. 2014.

5 World Bank 2011 World Development Report.

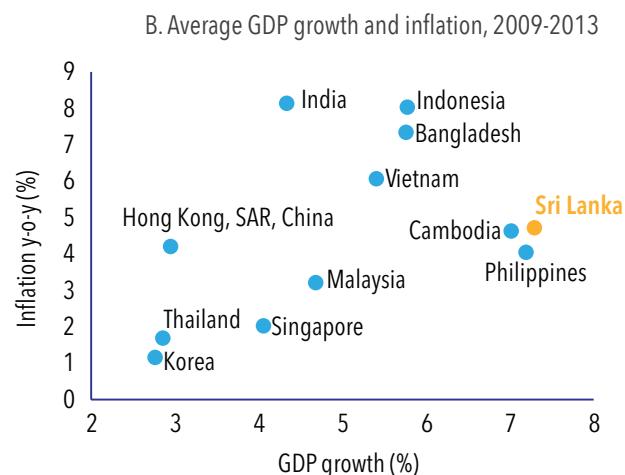
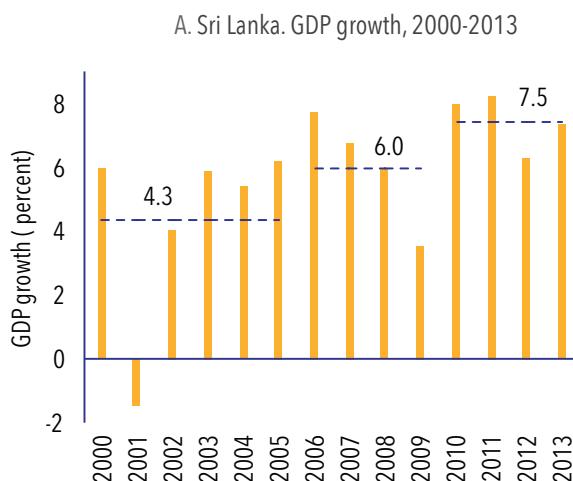
40. Institutional reforms and efforts at reconciliation are occurring against the backdrop of a fluid Sri Lankan polity. There are two major national parties and a large number of smaller parties, including several with affiliation to ethnic groups. Electoral competition has been robust at national and provincial levels, most notably in the recent presidential elections. At the same time, public figures exercise substantial autonomy – with prominent instances of switching party allegiances, most notably in the recent presidential elections. The fluid polity has prompted formal and informal coalition building as well as the need for regular attention from the country's leadership to sustain support from often diverse bases. The fluidity of the environment has been evident in securing the passage of constitutional and electoral reforms that required extensive political negotiations. A new government involving a grand coalition has been formed after the August 2015 general elections and is in the process of formulating its economic and other policies.

41. As Sri Lanka aspires to become a higher middle-income country, it will need to adjust its development model. Growth in the last five years is in substantial part due to a "peace dividend", which included significant reconstruction efforts. Going forward, economic growth will likely require continued structural changes in the economy towards greater diversification and productivity increases and a reduction in the role of agricultural employment from its present share of a third of the population. Although Sri Lanka has excelled in overcoming human development challenges typical to a low-income country, its service delivery systems in education, health and other areas must now adjust to face new and changing demands typical of a MIC. Imperatives to improve social safety nets will increase owing to an aging population that has passed its demographic peak. Finally, increasing affluence and information will lead to higher expectations for the state to perform in order to facilitate growth, provide a higher level of services, and demonstrate increasing responsiveness to a more demanding citizenry.

B. Poverty and Shared Prosperity

42. Economic growth in Sri Lanka has been among the fastest in South Asia in recent years. Growth has averaged 6.3 percent between 2002 and 2013, with per capita GDP rising from US\$869 in 2000 to US\$3,280 in 2013. Moreover, the average growth rate accelerated to 7.5 percent between 2010 and 2013, reflecting a peace dividend and an aggressive policy thrust towards growth since the internal civil conflict ended. This growth is high as compared to regional and MIC peers, and has been accompanied by low inflation (Figure 2.1). Year 2014 also saw a continuation of the momentum with the economy growing by

Figure 2.1 GDP growth and inflation over time and relative to other MICs



Sources: World Economic Outlook, Department of Census and Statistics

7.4 percent compared to a 7.3 percent growth reported in 2013 on robust growth in industry and services.

43. Strong economic growth for over a decade has led to an important decline in poverty and promoted shared prosperity. Poverty, measured by per capita consumption, fell from 22.7 percent in 2002 to 6.7 percent in 2012/13 using the national poverty line⁶, which is equivalent to about US\$1.50 in PPP terms. Extreme poverty fell from 13.2 to 3.2 percent using the US\$1.25-a-day poverty line, while moderate poverty fell from 56.2 to 32.1 percent using the \$2.50-a-day poverty line, commonly used across middle-income countries (Appendix 1.2), over the same time period (Table 1).⁷

44. Poverty reduction measured by per capita consumption is also reflected in increased per capita incomes, particularly for the poor. Between 2006/07 and 2012/2013, average per capita incomes grew only slightly, about 2 percent overall (Figure 2.2A). Growth in household income reported here is on per capita terms, and contrasts

with the figures on total household income reported by the Department of Census and Statistics (DCS), which remained roughly constant in real terms. The discrepancy arises mainly because average household size fell during this period. Because larger households require more income than smaller households to maintain the same standard of living, per-capita income is preferred to total income as a measure of household welfare. However, for poorer households measured as those with lower per capita consumption, growth in real per capita income was over twice as fast, and was in line with similar growth rates in per capita consumption.

45. The reduction in poverty for the 2002 – 2012/13 period is also reflected in multidimensional measures. Households in the bottom 40 percent were increasingly able to afford to purchase non-food items, as the food budget share for this group fell from 67 percent in 2002 to 56 percent in 2012/13. Ownership of durable assets also rose, especially among the poorest. Primary education attendance is essentially universal. Secondary school attendance is also high and continued to nudge upward during this period. Completion, on the other hand, saw a major increase, as the share of 17 and 18 year olds who completed secondary school rose from 40 to 60 percent between 2002 and 2012/13. Health indicators also improved during this period. The rate of infant mortality fell from 13 to eight children per thousand births, and the rate of under-nutrition, while still high, decreased from 30 to 25 percent (Figure 2.2B).

46. Despite the reduction in extreme poverty, living standards remain low for most Sri Lankans and a large

6 Given the ongoing conflict, a few regions were not included in the 2002 household survey. When looking at comparable regions, the decline in poverty was from 22.7 percent in 2002 to 6.1 percent in 2012/13.

7 The national poverty line is expected to be updated soon in order to: (i) update household consumption patterns (the current line assumes the 2002 consumption pattern), (ii) incorporate methodological best practice particularly with respect to the minimum calorie requirement and the appropriate amount of non-food expenditure consistent with that minimum threshold, and (iii) set a more ambitious benchmark, appropriate for a country at Sri Lanka's stage of development, to measure future progress against poverty.

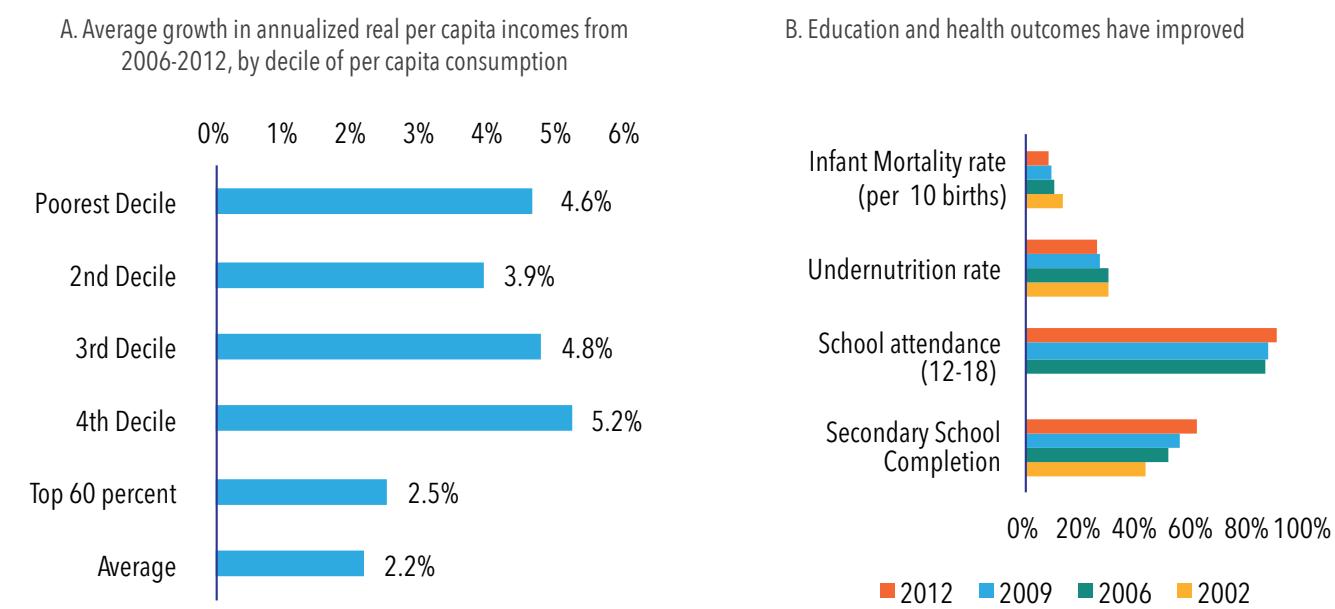
Table 2.1 Poverty and inequality trends

	Full Sample				Excluding Northern and Eastern Provinces		
	2002	2006/07	2009/10	2012/13	2006/07	2009/10	2012/13
Poverty gap							
US \$1.25 a day in PPP terms	13.2	6.8	3.8	3.2	6.9	3.5	2.8
US \$2.50 a day in PPP terms	56.2	44.4	37.1	32.1	44.4	35.3	29.9
National poverty line	22.7	15.3	8.9	6.7	15.5	8.2	6.1
Poverty gap	5.1	3.1	1.7	1.2	3.1	1.6	1.0
Severity	1.6	0.9	0.5	0.3	0.9	0.5	0.3
Inequality*							
Gini	0.402	0.397	0.361	0.387	0.330	0.308	0.328
Theil	0.323	0.325	0.268	0.317	0.212	0.186	0.234
p90/P10	5.122	4.981	4.300	4.738	3.971	3.596	3.821
Shared Prosperity**		2002-06/07	2006/07-09/10	2009/10-12/13	2002-06/07	2006/07-09/10	2009/10-12/13
Average		1.95	3.33	4.23	1.95	3.60	4.25
Bottom 40 percent		2.59	4.91	2.84	2.59	5.40	2.83

* The second set of results (excluding Northern and Eastern Provinces) is generated using a version of the consumption aggregate which excludes durables

** The first set of results (Full sample) keeps all districts available in each pair of surveys. Both set of results use a version of the consumption aggregate which excludes durables

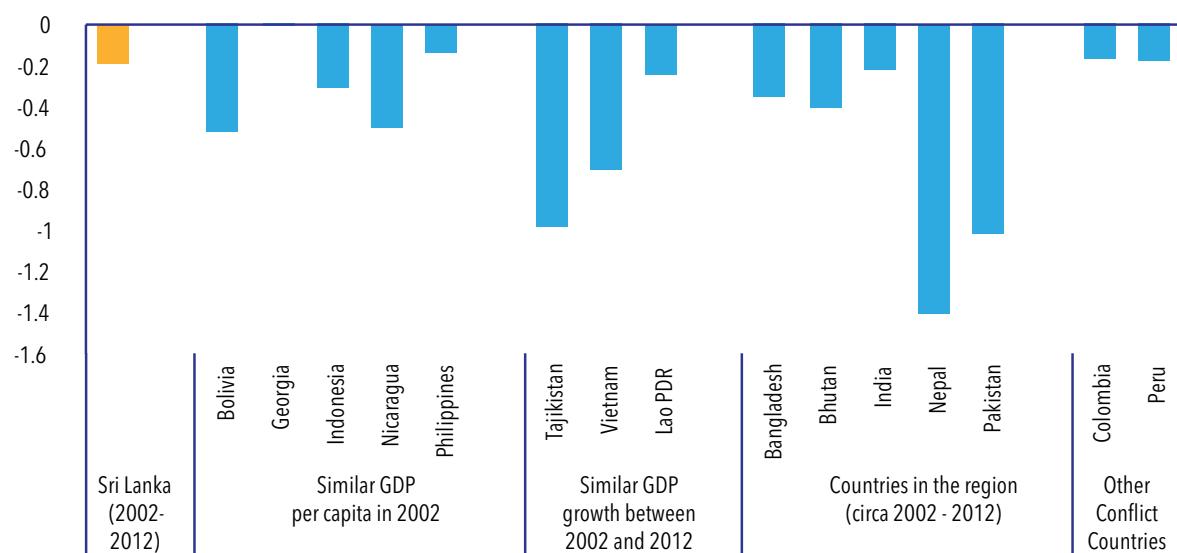
Figure 2.2 Income and multidimensional poverty measures have improved



Source: World Bank Poverty Assessment, 2015 based on 2006/7 and 2012/13 HIES

Source: FAOSTAT, WDI, and World Bank staff calculations based on HIES, DCS. School estimates exclude Northern and Eastern provinces for comparability.

Figure 2.3 Extreme poverty-growth semi-elasticity¹



Source: World Bank 2015 Poverty Assessment (forthcoming)

1/ Defined as the change in the US1.25-a-day poverty headcount rate (in percentage points) due to a 1 percent increase of per capita GDP: (Change of poverty headcount in period/number of years in period)/(Annualized increase of per capita GDP)

share of the population remains vulnerable to poverty. Despite the low levels of extreme poverty, roughly one quarter of Sri Lankans are nearly poor, as defined by living above the official poverty line but below US\$2.50 per day in 2005 PPP terms. The living standards of the near-poor are closer to those of the poor than those living above US\$2.50 per day. For example, the near-poor spend an average of 59 percent of their budget on food, only six percentage points less

Despite low levels of extreme poverty, roughly one quarter of Sri Lankans are nearly poor

than the poor, as opposed to 42 percent by households consuming more than US\$2.50 per day (2005 PPP).

47. **Moreover, while the decline in poverty was strong, it was below what one could have expected given the sustained high growth rates over the last decade** Indeed, a 1 percent increase in per-capita GDP reduced the US1.25-a-day poverty rate by only 0.2 percentage points while a similar increase in growth led to stronger reductions in extreme poverty in other regional and developing countries (Figure 2.3). It has, however, been in line with other post-conflict countries.

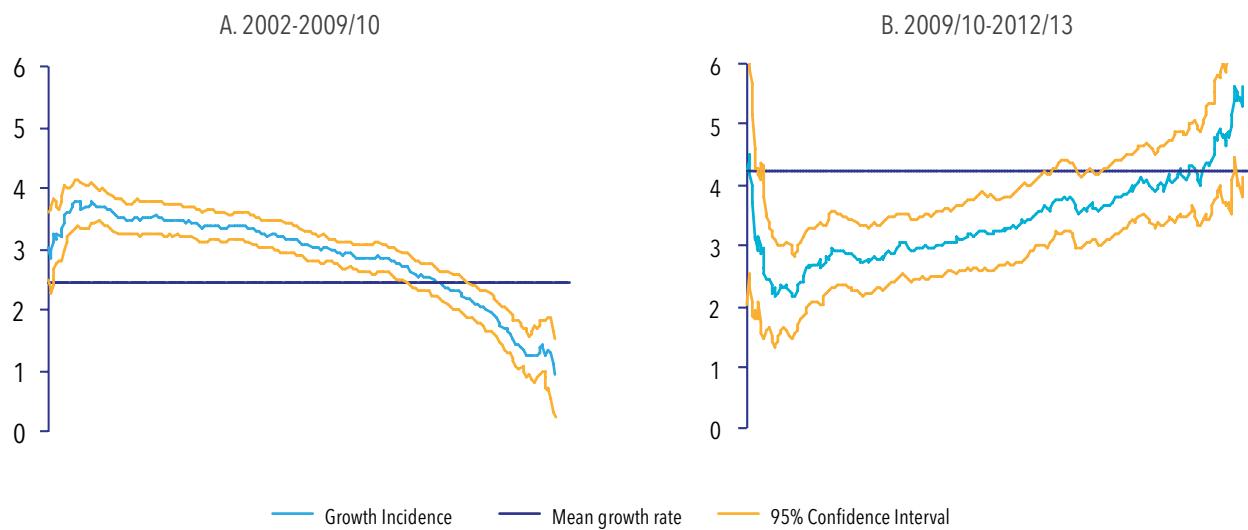
48. **Growth was higher in the post-war period but the strongest reduction in poverty and improvement in shared prosperity occurred in the early part of the 10-year period covered by the past three Household**

Income and Expenditure Surveys (HIES). Per capita consumption of the bottom 40 percent grew at a rate of 3.5 percent for the 2002-2012/13 period, considerably faster than the average growth of 3 percent for the total population over the same time period.⁸ Simple decompositions show that most of the reduction in poverty was due to strong consumption growth, which shifted the entire distribution to the right, as opposed to large changes within the distribution. However, when the decade is broken into sub-periods, growth was disproportionately in favor of the poorer half of the population ("pro-poor") up until 2009. Although poverty continued to decline between 2009/10 and 2012/13, growth of the bottom half of the distribution was slower than growth for the top half, leading to an increase in inequality. This can easily be seen in the growth incidence curves (GICs) shown in Figure 2.4. The x-axis shows households ordered from poorest to richest, while the y-axis shows growth in household consumption. Between 2002 and 2009/10, growth was faster at the bottom of the distribution, thus leading to a negatively sloped GIC – denoting pro-poor growth. In contrast,

The strongest reduction in poverty was from 2002 to 2009/10

⁸ The reported rates refer to the annualized growth rates, considering the period 2002-2012/13 as 10 ½ years long.

Figure 2.4 Growth incidence curves: per capita consumption growth



Source: Comparable regions in HIES 2002, 2009/10, 2012/13.

between 2009/10 and 2012/13, growth at the top of the distribution was faster, leading to a positively sloped GIC.

49. The most recent growth pattern has led to an increase in inequality. The corollary of stronger growth for the top of the distribution between 2009/10 and 2013/14

Growth was pro-poor up until 2009 while inequality increased between 2009/10 and 2013/14

is that inequality increased. Standard measures of inequality, such as the Gini coefficient, increased from 0.36 in 2009/10 to 0.39 in 2012/13, leading to an inequality level almost as high as the one registered in 2006/07, before the end of the civil war (Table 1 on page 13). In effect, rising inequality tempered the poverty-reducing impact of growth.

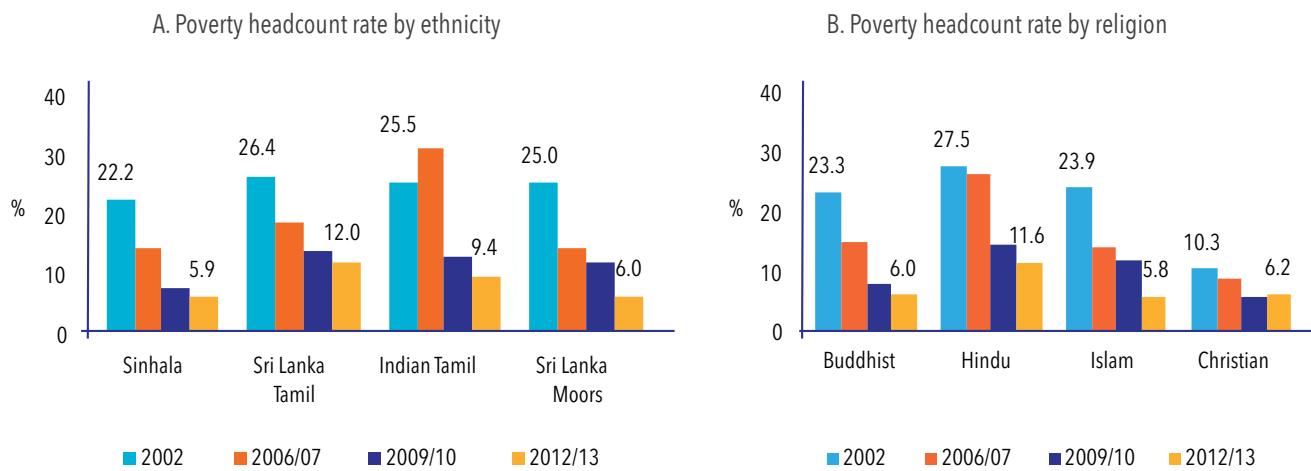
50. Inequality has not only increased, but disparities across the different ethnic and religious groups remain. Poverty declined fastest for Sri Lankan Moors (Muslims): if in 2002 one out of four Sri Lankan Moors was poor, 10 years later only about one every 18 Sri Lankan Moors was poor (or 6 percent), very close to the share of Sinhalese who are poor. In 2012/13, Sri Lankan Tamils had the highest rates of poverty among ethnic groups (Figure 2.5A). Among the different religious groups surveyed in 2012/13 (which, in most cases, have a strong correlation with ethnicity), Hindus had the highest poverty rates: 12 percent were poor, as opposed to 6 percent of Buddhists, Muslims and Christians (Figure 2.5B).

51. Other multidimensional measures also show inequality in outcomes. Sri Lanka successfully reached full enrollment in primary education (grades 1 to 9), but education attainment of higher levels of education remains strictly correlated to the well-being of households. For example, educational attainment among the poor is almost half of what it is for the non-poor. Although the level of education attainment has slowly increased both for poor and non-poor individuals, poor individuals have a very low likelihood of completing collegiate education. Similarly, the poor are characterized by having lower access to electricity, telephone, water, and sanitation and having to travel further to reach health services. These characteristics are especially true for those living on less than US\$1.25-a-day (Appendix 1.3)

52. Moreover, there is significant locational concentration of poverty in Sri Lanka. This is true both for monetary and multidimensional outcomes, including education, nutrition and access to services. The share of people living under the national poverty line, known as the headcount rate, is concentrated in three main areas (Figure 2.6). The first is the former conflict districts in the Northern Province, Mullaitivu, Manar, and, to a lesser extent, Kilinochchi District. The second is Batticaloa in the Eastern Province, and the last one is Moneragala in the Uva Province. Areas with higher poverty rates also tend to have a larger portion of the bottom 40 percent.

53. Notwithstanding high rates of poverty in specific remote districts, the majority of the poor and as well as the bottom 40 percent live in populous, effectively urban areas in the center of the island. The location of

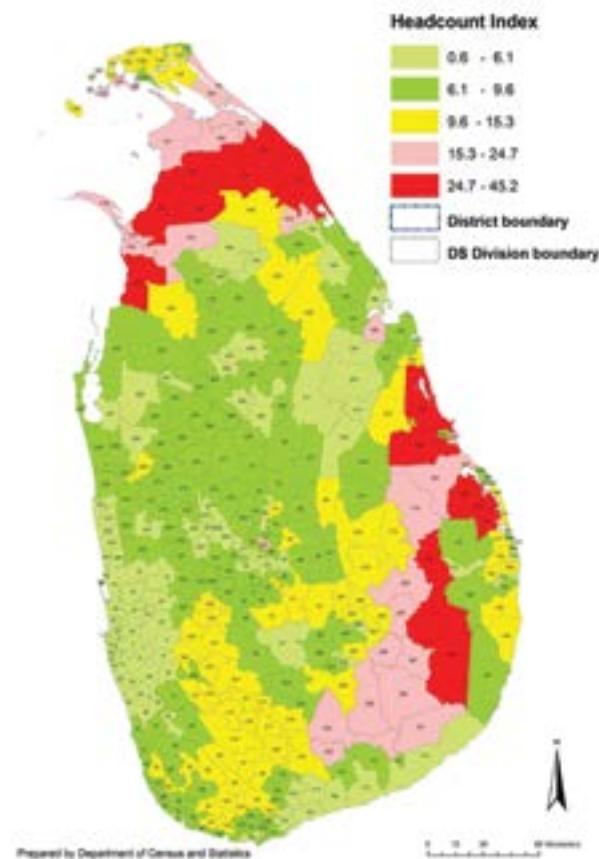
Figure 2.5 Poverty headcount rates, by ethnicity and religion (national poverty line)



Source: Own estimates based on HIES. Department of Census & Statistics

Note: Includes full samples available for each HIES. The results are similar when using comparable samples.

Figure 2.6 Poverty headcount rates, 2012/13
(by division)



Source: World Bank & DCS Poverty Map. Poverty line is Sri Lankan national poverty line.

Figure 2.7 Distribution of the poor, 2012/13
(absolute number of poor)

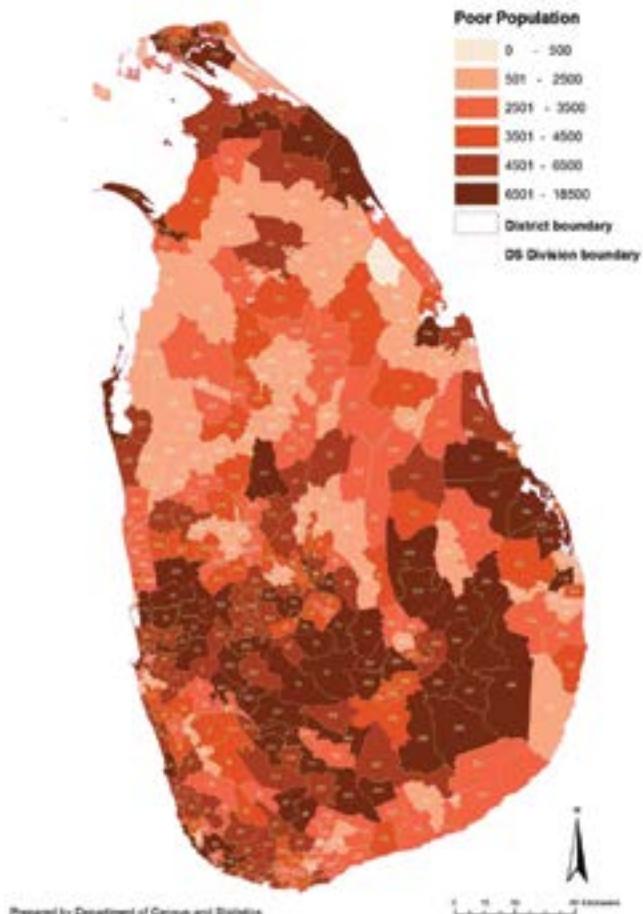
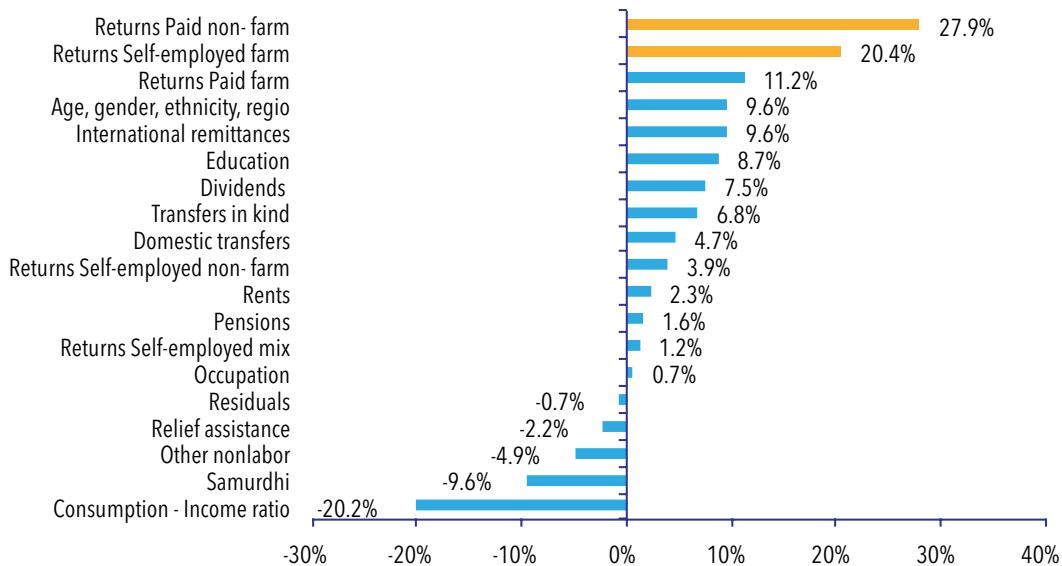


Figure 2.8 Net contributions to poverty reduction, 2002-2012/13



Source: World Bank 2015 Poverty Assessment. Estimates based on counterfactual consumption per capita distributions based on empirical models that simulate the observed change in each factor on overall household consumption per capita one at a time, thus allowing for changes in poverty.

the poor broadly corresponds to the location of Sri Lanka's population as a whole. Figure 2.7 shows estimates of the number of people living in poverty. Kurunegala in the center of the country, for instance, is home to 7.6 percent of the country's poor people even though only 7 percent of its population lives under the official poverty line. In contrast, Mullaitivu, Kilinochchi, and Mannar in the North, have very high estimated poverty rates (20.8-31.4 percent), but account for less than 5 percent of poor people nationwide due to the low population density in those regions.

C. Understanding Changes in Poverty

Increased labor incomes account for nearly 60% of reported poverty reduction

fers. Most of the increase in labor income was, in turn, due to increased returns to work both in and outside of

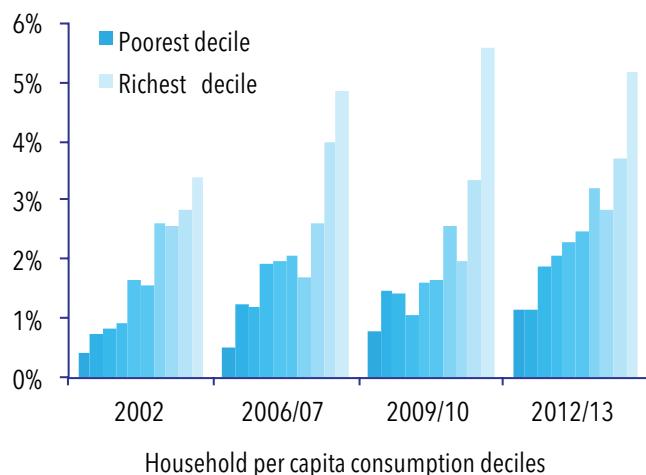
54. Between 2002 and 2012/13, most of the reduction in poverty was due to higher labor incomes,⁹ and, in particular, to increased earnings, as opposed to higher employment or higher transfers.

⁹ Growth in real per capita labor income reported here is in line with overall growth in per capita income, partly due to smaller households as discussed in paragraph 41 and footnote 6 above.

agriculture (Figure 2.8). Increased returns to agriculture accounted for about 31 percent of the decline, of which roughly two-thirds were higher returns to self-employed farmers. The other main factor was an increase in the returns to paid non-farm work, which accounted for 28 percent of the poverty decline. Combined, increases in the returns to work explain nearly 60 percent of the reported poverty reduction. These increases in returns are associated with an increase in average real wages, which could be due to either higher productivity or improved relative prices for the poor, given many are net producers. The finding of sustained increases in real wages over the decade is in line with results from alternate surveys conducted by the Central Bank, which show a sharp increase in services and government real wages from 2002 to 2013 and in industry real wages in 2013.

55. Private transfers in the form of remittances, and the increase in the working age population also helped. Between 2002 and 2012/13 remittances increased from 0.4 to 0.9 percent of total incomes and total consumption of the poorest 10 percent of households (Figure 2.9). Even though this was an increase relative to the incomes of the poor, most remittances in absolute amounts go to the richer part of the population. The age composition of the workforce also contributed to poverty reduction. The composition of the workforce in terms of gender, ethnicity and religious composition remained stable over the course of the decade. However, the share of 15-29 year-olds de-

Figure 2.9 Most remittances in absolute amounts go to the top of the distribution (percent of total household consumption)



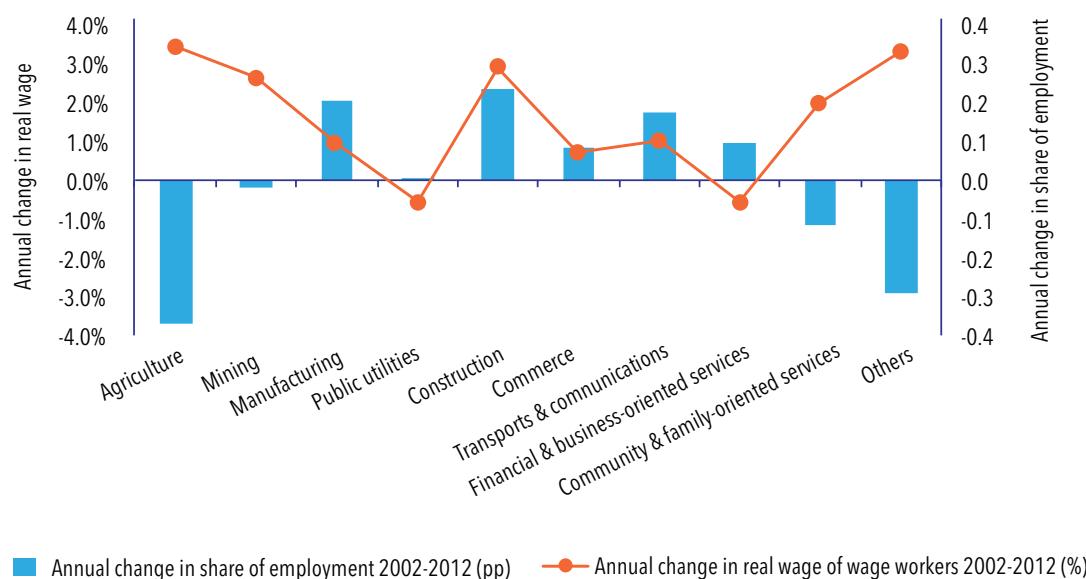
Source: Own estimates based on HIES.

clined from 26 to 20 percent between 2002 and 2012/13, making the overall workforce relatively more experienced, and thus likely to bring in higher labor incomes. It is also a strong signal that the population is aging, which raises concerns about long-term fiscal sustainability (see Chapter VI on economic sustainability and aging).

56. In contrast to private transfers, public transfers did not make a net contribution to poverty reduction over the past decade. Public transfers (particularly the Samurdhi program) declined in real terms, and as such, its net contribution to reducing poverty was negative.¹⁰ In fact, results from analysis of the HIES show that the decline in poverty would have been 10 percent greater had the real value of Samurdhi remained constant. Finally, while both the improvements in education and the demographic dividend (the larger share of working-age adults) helped to reduce poverty, these were relatively small contributors to poverty reduction (Figure 2.8).

¹⁰ That is, if nothing else had changed, poverty would have increased simply because the value of these transfers was lower in real terms in 2012/13 relative to 2002. There are multiple social programs in Sri Lanka. The main direct cash transfer program is the Samurdhi Poverty Alleviating Program, which includes an income-support scheme that grants a monthly allowance according to the number of family members in each household, an insurance scheme that provides cash allowances during births, deaths and hospitalization of family members, nutrition programs for pregnant and lactating mothers and children of beneficiary families, and scholarship programs for children.

Figure 2.10 Increased labor demand is reflected in wage and employment growth



Source: World bank Poverty Assessment, 2015. Notes: Employment is change in percentage point change in share of workers employed in each sector. Real wage increase is the increase in real wages, including only wage workers. Wages are deflated using the Colombo Consumer Price Index.

57. It is very difficult to attribute the reasons for the increase in labor incomes. To the extent that there was both an increase in employment as well as increases in wages, this is consistent with an overall increase in demand for workers. Increases in labor demand, as indicated by increases in employment and/or wages, appear to be broadly spread across many sectors rather than concentrated in a few (Figure 2.10). Despite relatively high annual changes in wages in the agriculture sector it still experienced a decline in employment, reflecting that overall returns are lower compared to other sectors. The increase in construction employment reflects the overall growth in the construction sector, especially after the end of the conflict.

58. There are four potential drivers of the increase in labor incomes and its poverty impacts over the last 10 years.

There are four potential drivers of increased labor incomes: structural transformation, agglomeration, domestic demand and food price increases

The following section focuses on these drivers: (i) a slow structural transformation away from relatively unproductive agriculture and into industry and services that led to aggregate productivity increases; (ii) agglomeration effects around key urban areas; (iii) domestic demand growth, including public-sector investment; and (iv) domestic and international food price

increases that led to higher labor earnings for agricultural workers.

Structural Transformation

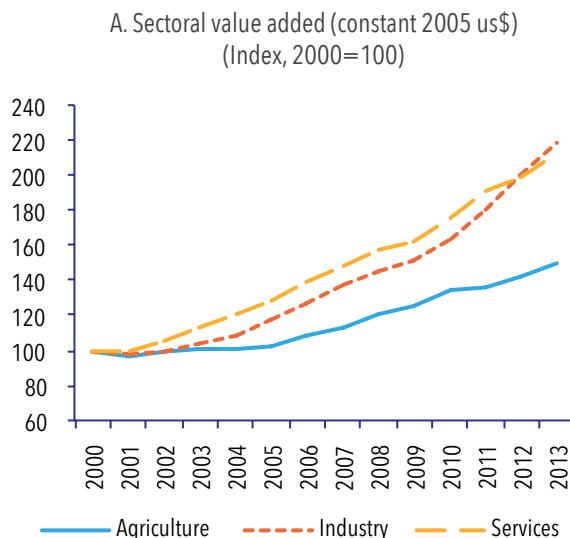
59. The economy saw a shift from agriculture to industry and services in the last 15 years (Figure 2.11A). The share of value added from agriculture fell from 19.9 percent of GDP in 2000 to 10.8 percent in 2013 and is expected to have declined to 10 percent in 2014,¹¹ while the share of value added from industries increased from 26.5 to 32.5 percent over the same period. Employment in agriculture declined from 36 to 31 percent between 2000 and 2012 and increased in industry and services over the same period (Figure 2.11B). It is noteworthy that a major part of the decline in agricultural employment (and rise in industry) occurred only in 2012, the last year measured.

60. The shift toward employment in the industry sector and the expansion in services was associated with increases in productivity. Total factor productivity (TFP) growth accounted for about half of Sri Lanka's growth over the last decade contributing on average 3½ percentage points per year, rising to about 3¾ percentage points recently.¹² A range of empirical approaches suggest that potential growth has risen by almost 1 percentage

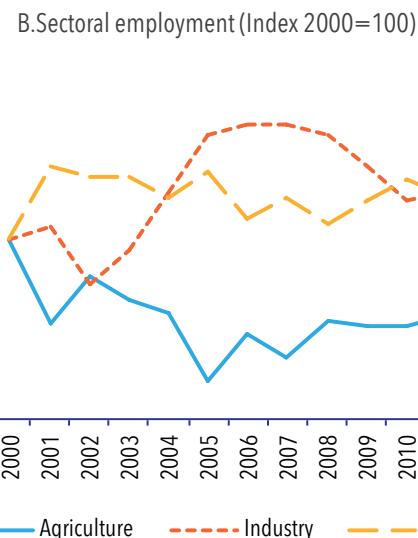
11 Central Bank of Sri Lanka, 2015

12 IMF 2014.

Figure 2.11 Sectoral value added and employment growth

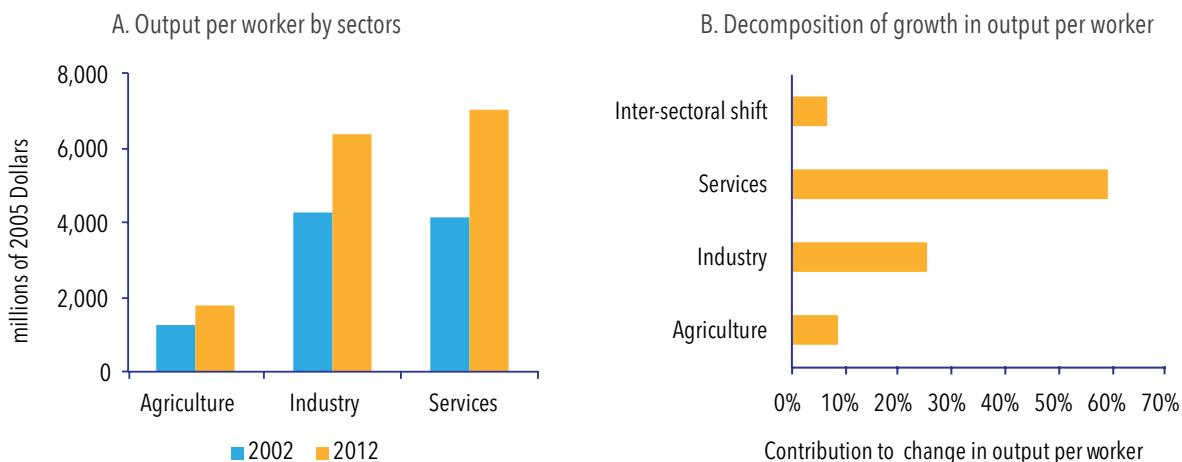


Source: World Development Indicators.



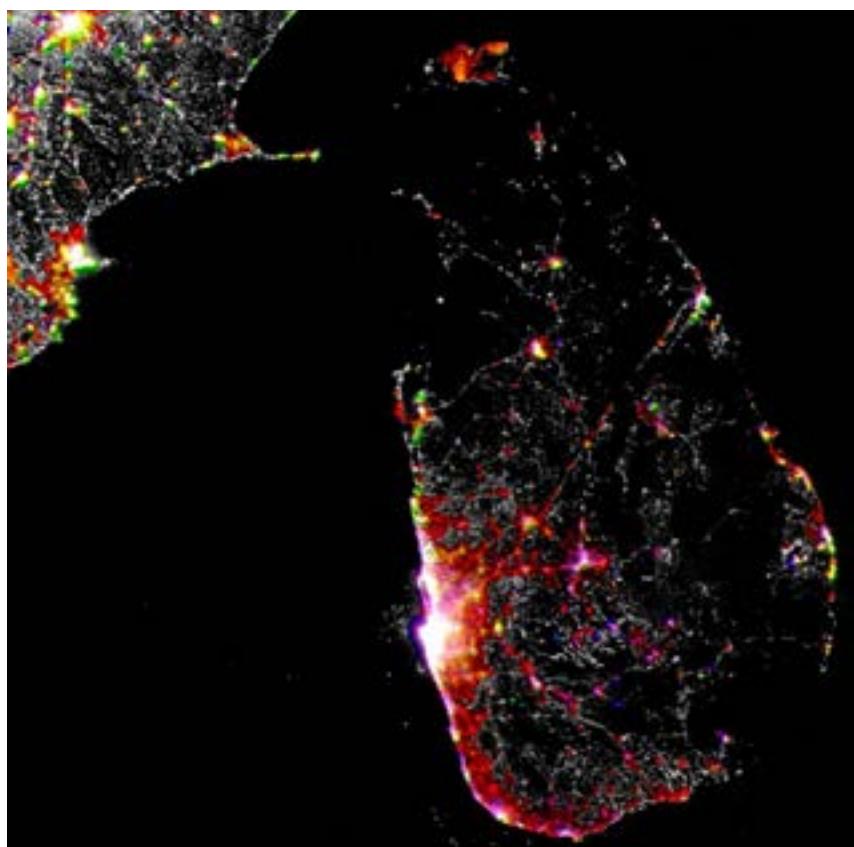
Source: Own construction using Labor Force Surveys

Figure 2.12 Sectoral productivity 2002-2012



Source: Own estimates using WDI, DCS Labor Force Surveys. Decompositions done using JoGGS decomposition method (see World Bank, 2010) and growth accounting framework following Duma, 2007.

Figure 2.13 Night lights image of Sri Lanka, 1975-2014



Note: White areas show stable areas of lighting over the period 1992-2012, whilst red areas show lights which existed in 2012, but not in 2002 or 1992.

Source: this map is produced by Chris Small, Columbia University by overlaying the tri-temporal Night Time Light images of VIIRS and DMSP-OLS imagery

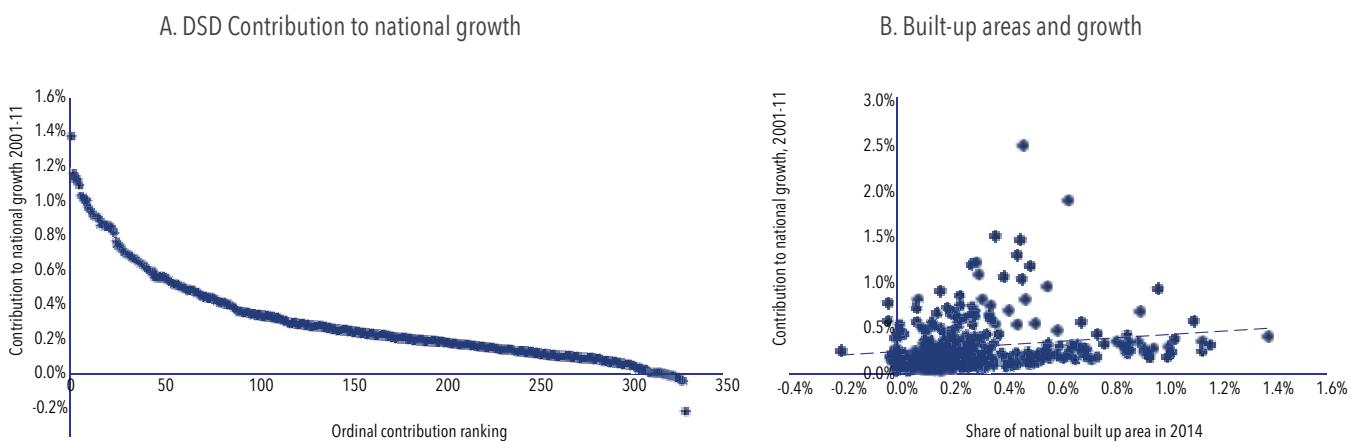
point to about 6¾ percent in recent years compared to the period 2003–08. This appears to reflect equally capital deepening (through increased investment on infrastructure and equipment) and improved factor productivity, with labor's contribution broadly unchanged. Most of the increase in productivity took place within the industry and service sectors (Figure 2.12A), but an inter-sector shift in employment away from agriculture and into industry and services also played a role and could partly explain increases in labor incomes (Figure 2.12B).

Agglomeration Effects

61. Along with this structural transformation, Sri Lanka has been experiencing a dynamic spatial transformation process of urbanization and agglomeration in the past two decades. Urbanization¹³ and ag-

13 According to official estimates, only 15.7 percent of Sri Lanka's population lives in urban areas, making it the least urbanized country in South Asia and MICs. This is due to the country's conservative definition of urban as population living in 'town' and 'municipal' administrative units last demarcated in the 1980s. This does not capture Sri Lanka's level of population agglomeration described here. A 2010 agglomeration in-

Figure 2.14 Agglomeration and growth



Note: GDP per capita is calculated on the basis of the intensity of night-time lights data.
Source: World Bank calculations.

glomeration have been occurring in two forms: one is the prime multi-city agglomeration of Kandy-Colombo-Galle in the Western Province, which is the largest in the country and has also experienced the bulk of the growth. The second form is a few localized single-city agglomerations in the eastern and northern parts of the country, mainly around Trincomalee, Batticaloa-Akkaraipattu, and Jaffna. This spatial transformation process has profound implications for both economic growth and alleviating poverty and vulnerability. The agglomeration spawning from the Colombo Metropolitan Region along the two corridors to Kandy and Galle/Matara is evolving to become a functional multi-city urban agglomeration. Recent growth, in particular, around Colombo, Kandy and Galle, including the corridors that connect those cities, is evident in the red lighting in Figure 2.13, which represents night-time lights that were present in 2012 but not in 2002 or 1992.

62. Agglomeration may have been fueling growth and partly determining national performance. Economic growth in Sri Lanka has been partly driven by highly built-up areas. Using night-time lights data as a proxy for GDP for the 2001-2011 period shows that a small number of regions are responsible for a larger share of national growth. In fact, 10 percent of Divisional Secretariat Divisions (DSDs) contributed nearly 30 percent of the country's growth over the period (Figure 2.14A). Furthermore, only 20 percent of DSDs contributed almost half of

all growth in Sri Lanka. Satellite imagery on built-up areas by DSDs can be combined with night-light information to see the correlation between built-up areas and growth. Not surprisingly, a larger share of built-up areas is positively correlated to national growth measured using night-time lights (Figure 2.14B). That is, urbanization and growth have been moving hand in hand.

Increases in Aggregate Demand, including Government Infrastructure Projects

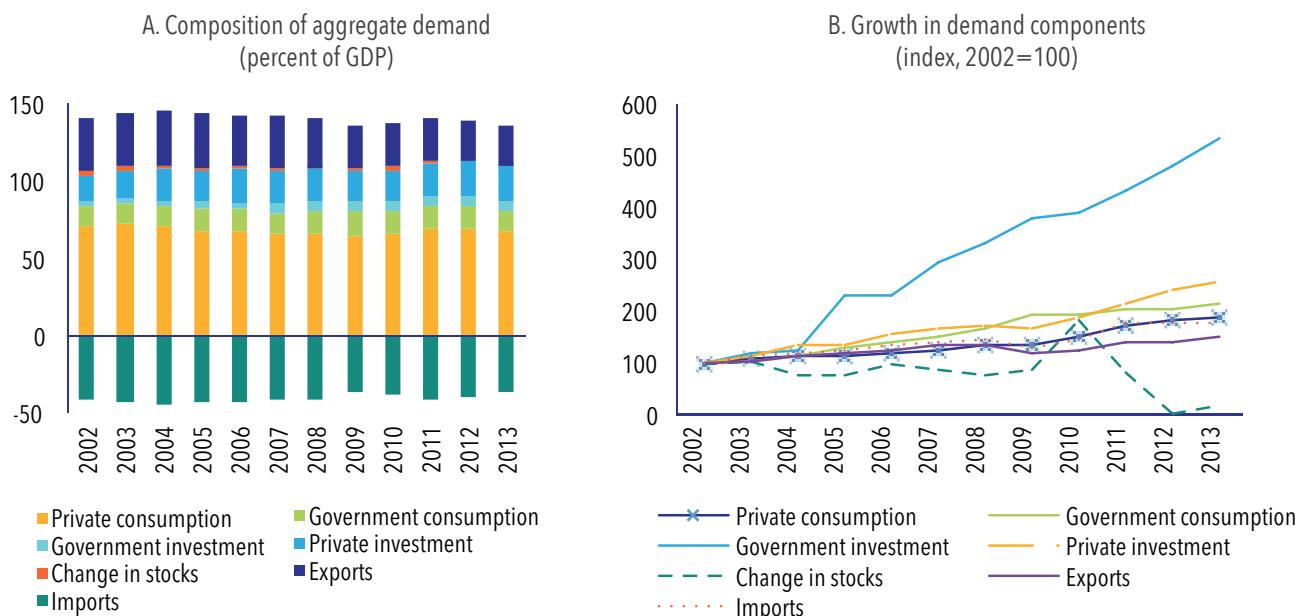
63. Domestic demand was largely responsible for growth. Private consumption accounted for 67 percent of GDP in 2013, having expanded by 6 percent a year on average between 2002 and 2013 (Figure 2.15A). Private investment, on the other hand, accounted for 23 percent of GDP in 2013, after an average growth of 9 percent a year during the same time period. In addition, public infrastructure spending grew at an average rate of 18 percent a year between 2002 and 2013, and made up 6 percent of GDP by 2013 (Figure 2.15B). The impulse coming from exports, on the other hand, was very small, with an average growth rate of 4 percent a year, so that the contribution of exports to aggregate demand declined from 35 to 26 percent of GDP between 2002 and 2013.

Increased Commodity Prices

64. Higher real wages, especially in agriculture, played a key role in reducing poverty. Although agriculture is no longer a major contributor to growth (accounting for under 11 percent of GDP), around one-third

dex which takes into consideration features associated with urbanization calculated that Sri Lanka a 47 percent rate of agglomeration.

Figure 2.15 Growth in aggregate demand



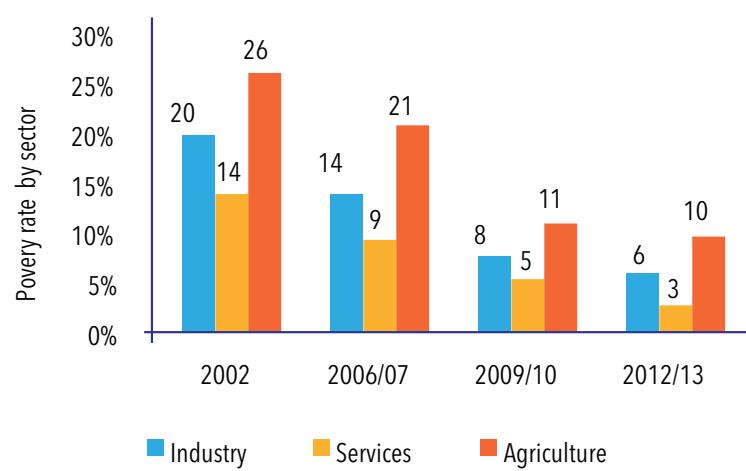
Source: World Development Indicators and Central Bank of Sri Lanka.

of the population still remains engaged in, and dependent on, agriculture. Real wage growth in the agriculture sector averaged 5.7 percent annually from 2006 to 2012/13, causing poverty to fall more rapidly among self-employed farmers and agricultural workers, ahead of workers in other sectors. Wages in the industrial sector increased by 3.6 percent annually, while wages in the service sector grew by 3.1 percent on average, led by trade (4.6 percent) and transportation (6.0 percent) (Figure 2.16). During the same time, the share of workers in agriculture continued to decline by 1.3 percentage points, from 32 to 30.7 percent, with young workers shifting out of agriculture more quickly. Minimum agriculture wages for employed farm workers rose considerably between 2009 and 2012, which may have also pushed up real agriculture wages.

65. Productivity growth in agriculture has been slow and does not sufficiently explain agricultural wage growth. Agricultural GDP per hectare of arable land grew by only 3.5 percent between 2000 and 2011, compared to 26 percent in Indonesia, 35 percent in the Philippines, and 61 percent in Bangladesh. Labor productivity has also fallen behind South-Asian comparators. Agriculture TFP growth, measuring technological progress, grew only by an average of 0.6 percent

a year since 1980 and lags behind other South and East Asian countries, although it may have picked up recently. TFP growth contributed only 53 percent to overall output growth while a large share of the agricultural output growth was achieved through the expansion of arable land that will not be sustainable in the longer term.

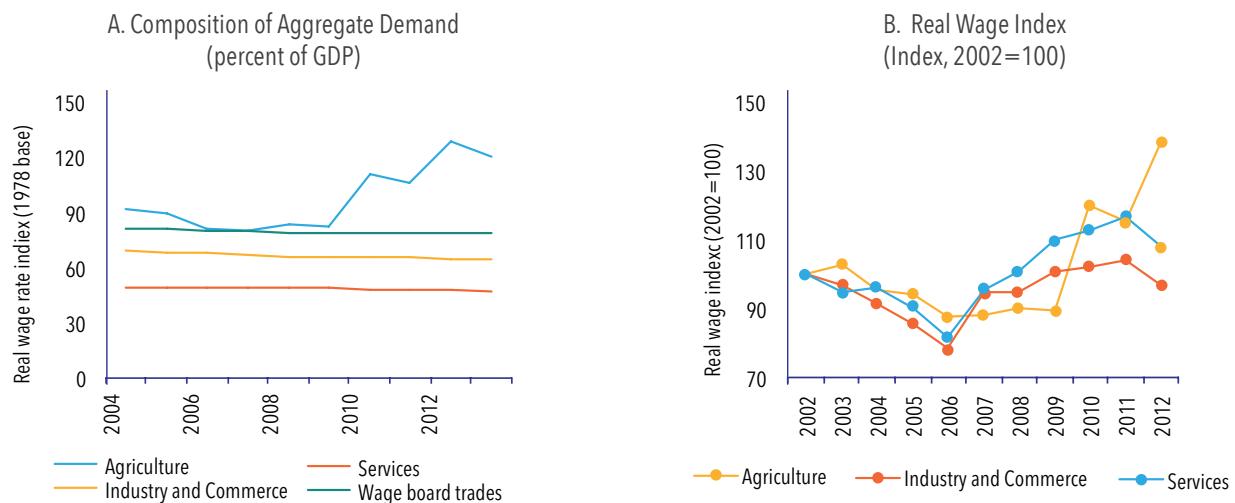
Figure 2.16 Poverty rates fell most rapidly among workers in agriculture



Note: GDP per capita is calculated on the basis of the intensity of night-time lights data.

Source: World Bank 2015 Poverty Assessment (forthcoming).

Figure 2.17 Wages by sector



Source: World Bank Poverty Assessment 2015.

66. **In contrast, rising domestic and international food prices may have provided space for the increase in the agricultural minimum wage and corresponding increases in agricultural wages.** Rising food prices, particularly from 2006 to 2009, provided additional profits to agricultural producers. In addition, international prices for tea rose more than 50 percent, from \$2.1 to \$3.3 per kg between 2006 and 2009. This occurred despite little change in yields. The increase in the price for tea provided space for increasing the real minimum wage for agricultural workers (Figure 2.17A), although they continue to be lower than wages in industry and services. Agricultural wages, unlike those for industrial and service sector wages, tracked these minimum wage increases almost exactly (Figure 2.17B).

D. Macroeconomic Challenges to Poverty Reduction and Shared Prosperity

67. **Recent growth has been mainly led by the non-tradable sectors.** Sri Lanka's real GDP grew by 43 percent from 2009 to 2014. The top four sectors contributing to 50 percent of the total growth during the period were all non-tradable sectors: construction, transport, domestic trade and banking, and insurance and real estate (Figure 2.18). Reflecting the intensity of a needed post-conflict infrastructure development thrust, the construction sector alone contributed to 16.8 percent of the total growth while growing by 109 percent in real terms. The transport sector contributed to 14 percent of the total growth, reflecting improved transportation infrastructure and increased ve-

hicle registrations. Domestic trade (11.1 percent), import trade (7.8 percent) and financial services (8.2 percent) were the other main contributors to growth. Less prominent were the agriculture sectors. These sectors contributed to 5.3 percent of the growth while all other manufacturing/service sectors collectively accounted for 44.7 percent of the growth.

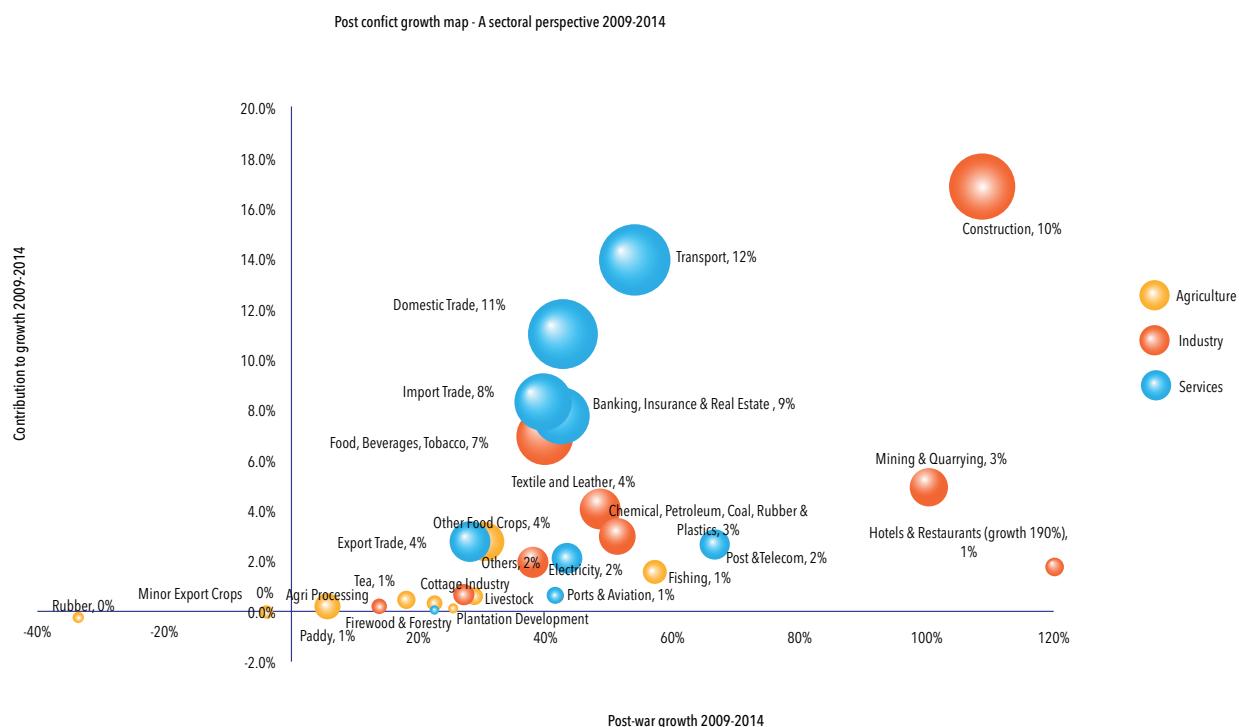
Moreover, Sri Lanka's share of manufacturing output, which was 18.7 percent in 2000, rose to 19.5 percent in 2005 and declined to 17.2 percent by 2014 due to faster growth in the services sector.

The top four sectors contributing up to 50 percent of total growth were all non-tradable sectors

68. **Reliance on non-tradable sectors for growth could make it difficult to sustain the momentum in the long run.** While data is lacking on the breakdown between private- and public-sector involvement across industries, there is strong indication that public investment to rebuild following the end of conflict is responsible for much of the proportionately large growth in construction as well as transport (which is inclusive of some transport infrastructure). It would appear unlikely that these sectors would underpin sustained growth going into the future owing to fiscal space limitations as well as a decline in the need for post-conflict reconstruction. More generally, construction and transport infrastructure are not likely to be sources of sustained, consistent growth.

69. **In contrast, there has been a steady decline in commodity exports.** Before 1977, Sri Lanka's development strategy, based on import substitution, aimed to

Figure 2.18 Sectoral growth patterns



Note: Bubble Size corresponds to size of segment

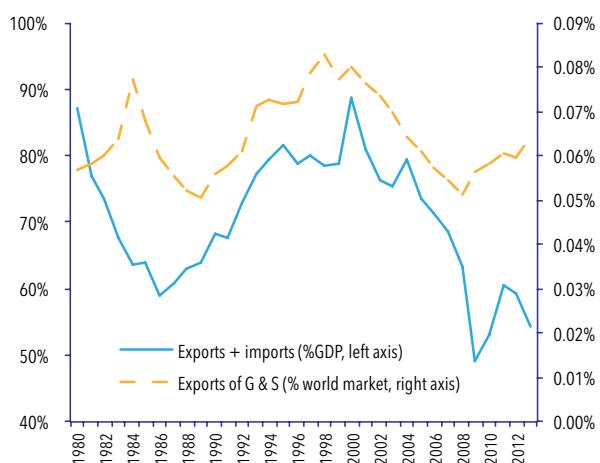
Source: World Bank 2014a, based on Central Bank of Sri Lanka.

create a comprehensive welfare state. Post-1977, reforms aimed to liberalize the foreign trade regime and Sri Lanka was seen as the first country in South Asia to significantly open its borders to trade and foreign direct investment. In the decades that followed, trade of goods and services increased to 89 percent of GDP in 2000, with tea and high-end apparel exports leading the way (Figure 2.19). However, after the beginning of the new millennium, trade steadily declined reaching 54 percent of GDP in 2013. FDI remains below 2 percent of GDP five years after the end of armed conflict. The decline in openness and stagnating FDI took place when the rest of the world was integrating more strongly and global trade was accelerating. Sri Lanka's world market share has consequently declined to levels last seen in the 1980s.

Since 2000 trade steadily declined, reaching 54 percent of GDP in 2013

economies and leveraging existing industries to move up the value chain as well as fostering the development of

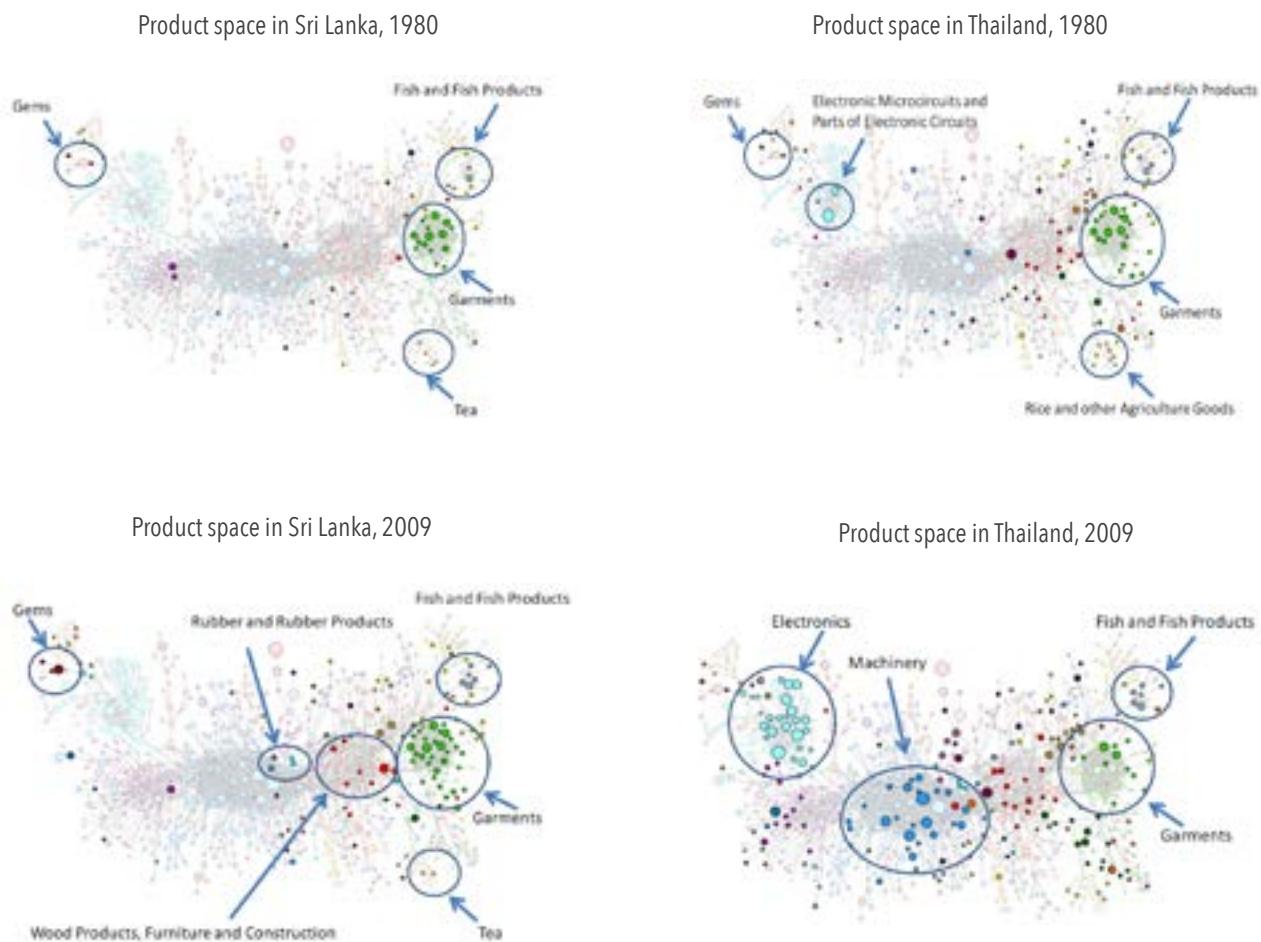
Figure 2.19 Steady decline in trade



Source: World Development Indicators, January 2015; Central Bank of Sri Lanka, Staff estimates

70. Moreover, the configuration of production in Sri Lanka has remained largely constant in the last three decades. At the same time some MIC comparators, like Thailand, have been highly successful at diversifying their

Figure 2.20 Product space comparison: Sri Lanka vs Thailand in 1980 & 2009



Source: MIT Media Lab-Macro Connections and Harvard University-Center for International Development n.d.

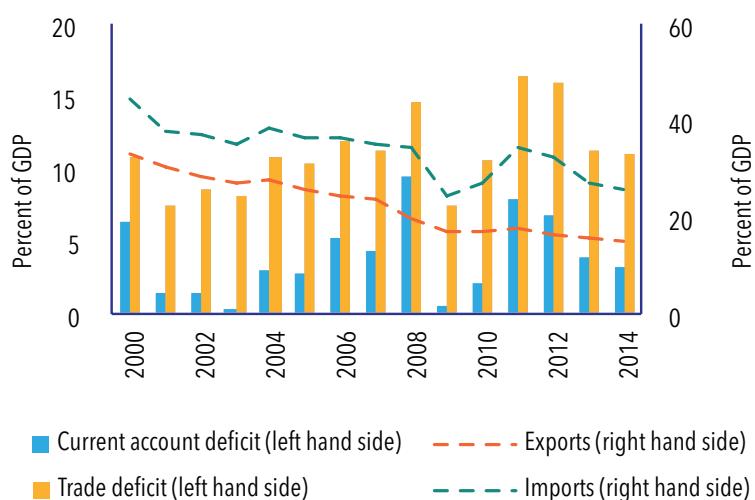
new industries. Figure 2.20 shows a comparative development of the product space¹⁴ of Sri Lanka and Thailand over the same period. Sri Lanka experienced a rather limited growth of economic activities adjacent to existing industries; lower development of new industries; and exporting sectors remained at the periphery of the economy. In contrast, Thailand had a similar export structure to Sri Lanka in 1980 but a much different one by 2009. Thailand now has much lower activity in resource-based and labor-intensive exports and instead has dense clusters in electronics, microcircuits and machinery.

71. While the trade deficit has recently improved, Sri Lankan exports face structural challenges. In particular, the tradable sectors are facing rising production costs, particularly for Sri Lanka's main agricultural exports (tea and rubber).¹⁵ Similarly, although garment exports have increased in nominal terms and there has been movement to higher added-value production, the share of garment exports relative to GDP has continuously declined. Weaker external demand from the European Union (EU) and the United States and rising relative labor costs has also affected

14 Product Space Analysis helps to illuminate the relationship between diversification and economic growth. It measures the distance between a pair of products based on the probability that they are exported by the same countries.

15 This has always been an issue as plantation workers (tea and rubber) have historically been very well organized under political leadership of the Ceylon Workers Congress. Their strong bargaining power has driven a wedge between wage and productivity trends. Many workers are paid even if they do not have work.

Figure 2.21 Steady decline in trade



Source: World Development Indicators, January 2015; Central Bank of Sri Lanka, staff estimates

ed garment exporters. Productivity growth in tea has been stagnant, and the sector has been challenged by drought and lower demand from the Middle East.

72. Pressure on Sri Lanka's balance of payments caused by persistent trade deficits has been offset partially by strong remittance inflows and a growing role for tourism. Collectively, remittances and tourism increased from 8.5 percent in 2000 to 12.4 percent of GDP in 2014 (Figure 2.21). Remittances alone grew from 7 percent to 9.5 percent of GDP during the same period. On average, these two sources covered 92 percent of the trade deficit from 2000 to 2013, and were able to cover the entire trade deficit in 2014. The current account deficit declined from 7.8 percent of GDP in 2011 to 2.7 percent of GDP in 2014.

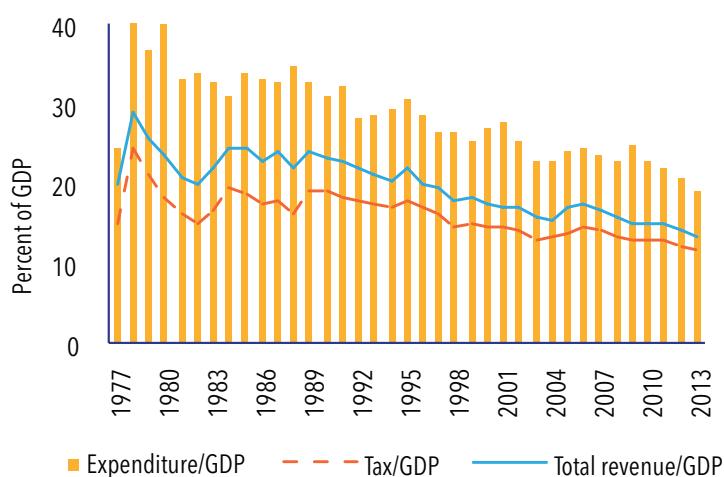
73. The current account deficit has been financed mostly by external borrowing, rather than through FDI. Much of this external borrowing by the public and private sectors went to finance the country's rebuilding following the end of the conflict. Despite this borrowing to cover current account deficits, Sri Lanka has been able to reduce its debt to GDP ratio in the past five years thanks to fast growth, relatively low real interest rates and a stable exchange rate. This also shows where the risks are: a slowdown in growth, increasingly commercial terms on new borrowing, and exchange rate volatility may reverse the decline in the level of external debt-to-GDP.

74. On the fiscal front, low and declining fiscal revenues have become a key macro-economic concern for Sri Lanka. The tax revenue-to-GDP ratio, which amounted to 24.2 percent in 1978, declined to 14.5 percent in 2000 and reached 10.7 percent in 2014 despite an annual increase in GDP per capita of 11 percent a year (Figure 2.22). This partly led to large fiscal deficits, particularly before end of conflict, when Sri Lanka averaged deficits of around 7-8 percent of GDP a year. Over the past five years, the government has made an effort towards fiscal consolidation, reducing the budget deficit from 9.9 percent in 2009 to 6 percent in 2014.

75. Despite fiscal consolidation efforts, Sri Lanka continues to face public debt risks. Although much improved from earlier years where the debt

stock was over 100 percent of GDP, public debt stood at 75.5 percent of GDP at end-2014, posing macroeconomic risks if growth slows in coming years. Increases in current spending in 2015 have been offset with one-time revenue measures, implying long-term revenue streams will be required (see Chapter III for detailed discussion). The composition of debt is also changing, moving from concessional lending to shorter-term commercial borrowings. However, during 2014 there has been a systematic conversion of short term T-bill issuance into longer term T-bonds, while foreign holdings of T-bills and bonds have been contained

Figure 2.22 Fiscal performance of Sri Lanka



Source: World Economic Outlook, Central Bank of Sri Lanka

at 12.5 percent of the outstanding value (Central Bank, 2015). About 44 percent of the public debt stock is external, so that exchange rate fluctuations and any rupee depreciation could risk deteriorating the debt indicators.

76. More generally, twin deficits in the fiscal and current accounts are mirrored by low national savings, with a persistent savings-investment gap being financed mostly through debt-creating flows over the last decade. National savings has averaged about 25 percent of GDP since 2010, while national investment was as high as 31 percent of GDP.¹⁶ Most of this gap has been covered by debt-creating flows, as opposed to FDI over the last decade. Despite strong GDP growth, the external debt amounted to about 57 percent of GDP at end-2014.

E. Identifying Drivers and Constraints to Poverty Reduction and Shared Prosperity

77. The context outlined in this section sets the stage for a systematic diagnostic of drivers and constraints to poverty reduction and shared prosperity going forward. Sri Lanka's political, social, and economic features are the result of a wide variety of factors. These same factors, particularly the more proximate factors that are in effect at present, are expected to drive or constrain continued progress on the twin goals of poverty reduction and shared prosperity. At the same time, there are new trends and emerging opportunities that will also play a role in shaping Sri Lanka's development trajectory in the coming years. The goal of this SCD is to take stock of these factors, identify their relative importance, and set out what would therefore be priorities to be addressed in order to end extreme poverty and promote shared prosperity. The SCD focuses on drivers and constraints of progress in the next five years, corresponding to the term of the new government to be formed after elections in the summer of 2015.

16 IMF Country Report No. 14/285.

78. This diagnostic is based on a systematic and detailed review of key potential factors impacting progress on the twin goals. In order to identify these constraints we used a hybrid framework that combines the Hausman, Rodrik and Velasco (2005) growth diagnostics methodology with the Bussolo and Lopez-Calva (2014) assets-based framework as detailed in Appendix 1.4. The framework was used as a way to organize and discipline the analysis by identifying a broad range of 22 areas where there were possible constraints to, or drivers of, progress on the twin goals. Sri Lanka's performance in each area was assessed and weighed for their relative impact on achieving the twin goals. This preliminary systematic analysis was then presented in a set of detailed consultations with multiple stakeholders, including government, academia, think tanks, the private sector, civil society organizations, and international organizations to validate the findings, determine the relative importance of issues identified in each of the 22 areas, and identify knowledge gaps.

79. Discussion around the preliminary analysis and ensuing consultations led to a consensus around four major themes, which form the basis for organizing this report and the major challenges to progress along the twin goals. The themes are: (i) Fiscal sustainability and the need to ensure fiscal space for development; (ii) Fostering growth and jobs for the bottom 40 percent; and (iii) ensuring spatial and social inclusion. The fourth major theme – the importance of more effective and efficient governance – is a cross-cutting issue in all three chapters, reflecting the critical roles of public-sector management, government's interface with the private sector, and governance's impact on inclusion. These four major themes were recurrent in discussions with multiple stakeholders in terms of the severity of constraints they pose for achieving the twin goals of ending poverty and promoting shared prosperity. The next three chapters describe each of these themes and discuss the priority areas. Those are followed by a chapter on economic, social and environmental sustainability concerns, which are also critical in achieving the twin goals. The final chapter summarizes the main findings and provides conclusions.



III. ADDRESSING THE FISCAL CHALLENGE

KEY PRIORITIES IN ADDRESSING THE FISCAL CHALLENGE

- Maintaining continued commitment to fiscal sustainability will require long-term revenue measures.
- Simplifying the tax regime and improving tax administration to increase the tax base could reverse the declining revenue trend.
- Low revenues and rigidity in expenditures undercut investment in human development while higher levels of financing and effectiveness thereof are needed to meet Sri Lanka's needs as it transitions to a MIC.
- Inefficiencies in social protection and management of the public service particularly undermine efficient use of resources.

The Challenge of Sustaining Fiscal Discipline

80. **Sri Lanka's government has demonstrated a strong commitment to fiscal consolidation in the recent past.** In the decade before end of conflict, the country averaged fiscal deficits of around 7-8 percent. However, over the past five years, the government has trimmed budget deficits each year, going from 9.9 percent in 2009 to an estimated 5.7 percent in 2014. The public debt, which was hovering around 106 percent of GDP in 2002, was reduced to 75.5 percent of GDP by 2014. Moreover, the government has committed to reduce the fiscal deficit to 3.8 percent of GDP by 2017 and public debt to 60 percent of GDP by 2020. With the exception of a spike in 2009 linked to massive recovery and rehabilitation needs immediately after the war's end, this has been achieved by reducing government expenditures.

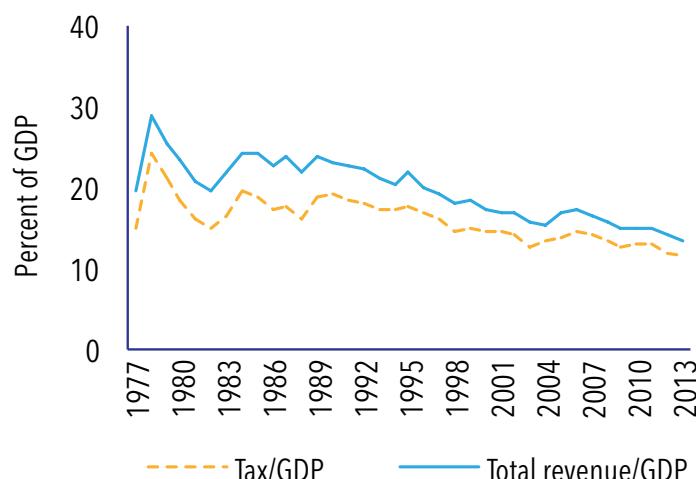
81. **This overall strong performance masks four structural weaknesses in the government's fiscal position: low, declining fiscal revenues; increasing rigidity of expenditures; insufficient spending on key public goods and services, particularly for human development; and inefficiencies in the public sector.** Preserving fiscal balance will become increasingly challenging owing to an extremely low revenue base combined with long-term-expenditure commitments including a relatively large public service. If current trends continue, the government will have limited fiscal space to facilitate development. At the same time, experience of regional and MIC comparators suggests that Sri Lanka is not investing enough in human development. The country's past success in these areas cannot be expected to continue without significant increases in spending, which in turn requires greater fiscal space.

82. **Honoring commitments initiated in 2015 while maintaining continued commitment to fiscal sustainability will require measures to secure long-term revenue increases.** Fiscal debt sustainability analysis has shown that slower-than-projected growth, higher primary deficits, or higher borrowing costs could quickly lead to sustainability concerns.

With public debt amounting to 76 percent of GDP at end-2014, continued commitment to fiscal consolidation is critical. Reflecting the government's commitment to sustainability, the budgeted fiscal deficit is expected to narrow in 2015. However, increases in recurrent expenditures are to be financed by one-time taxes, ambitious revenue targets for existing taxes, and cuts in public investment, leaving very little room to maneuver. Moreover, recurrent spending increases on

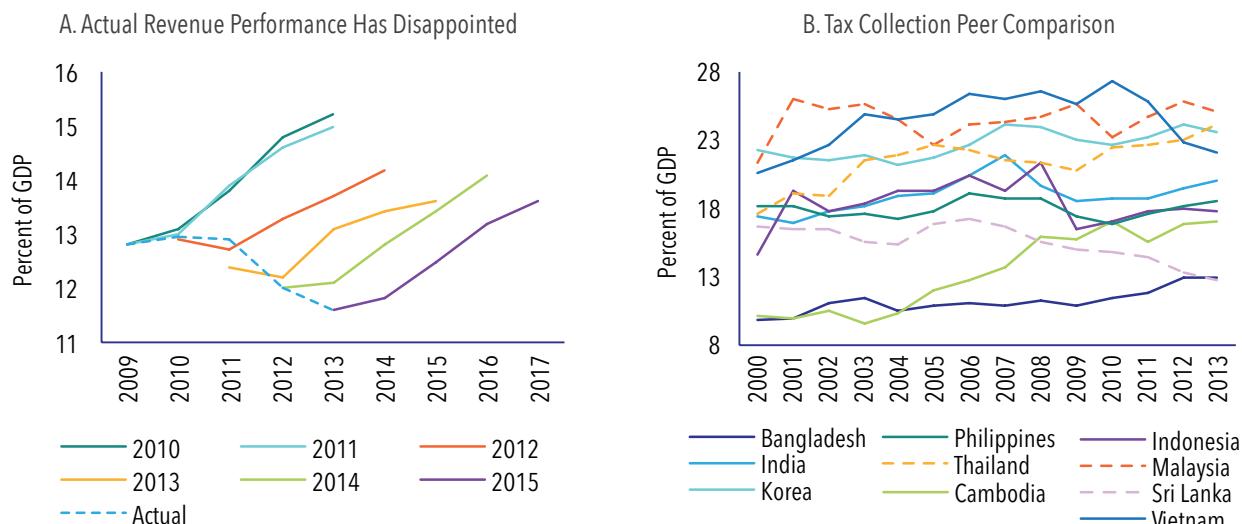
Long term increases in revenue will be needed to reduce the fiscal deficit and public debt

Figure 3.1 Revenue and expenditure trends



Source: World Economic Outlook, Central Bank of Sri Lanka

Figure 3.2 Revenue performance of Sri Lanka



Source: World Economic Outlook, Central Bank of Sri Lanka

wages and transfers initiated in 2015 will need to be sustained once the one-time revenue measures expire. Given government plans to increase expenditures on education and health from their present low levels, long-term increases in revenue will be needed in order to reduce the fiscal deficit and public debt.

A. Low and Declining Fiscal Revenues

83. Sri Lanka now has one of the lowest tax revenue-to-GDP ratios in the world, and it has been declining for decades. The country's tax revenue-to-GDP ratio amounted to 24.2 percent in 1978, after which it declined to 14.5 percent in 2000 and to 11.6 percent in 2013 (Figure 3.1). The decline is in large part a reflection of Sri Lanka's strong GDP growth¹⁷ with revenues increasing in absolute terms. Nonetheless, the fact that revenues have not kept pace with economic growth and barely kept pace with inflation in absolute terms is a continuing constraint on the budget. The government has signaled the need to reverse this trend in recent budgets, each year planning for a significant improvement in the tax revenue-to-GDP ratio over the medium term. However, projections of revenue increases have consistently failed to materialize (Figure 3.2A). In comparison, most of the other South Asian countries as well as middle-income countries have seen modest improvements in tax collection in the recent past. (Figure 3.2B).

¹⁷ During the period 2000 to 2013, the per capita GDP grew from USD 869 to 3280 at 11 percent annually.

84. Indirect taxes account for 80 percent of Sri Lanka's tax revenue. The country has lower-than-expected revenues from taxes on income, profits, or capital (direct taxes) and higher collections from international trade and from good and services (indirect taxes) than its peers, both as a share of total revenues and as a share of GDP¹⁸ (Figure 3.3). The dependency on indirect taxes, -- mostly VAT, excise and customs revenue – limits the country's capabilities to expand the tax base and raises issues regarding the equity of the system and how the tax burden is distributed among social groups.

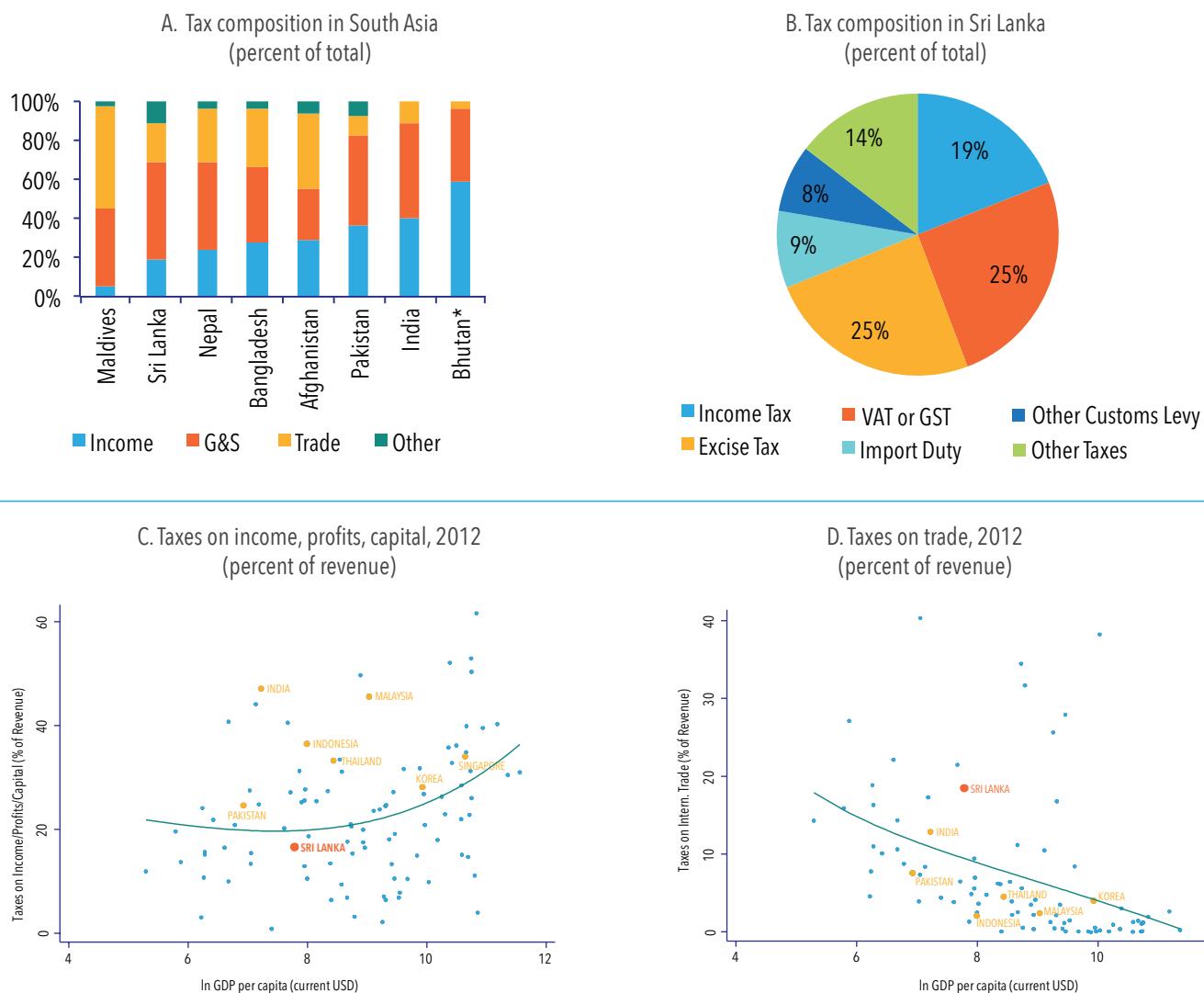
85. The decline in tax revenue can be traced to trade liberalization, shortcomings in recent tax reforms, numerous exemptions, and difficult tax administration.¹⁹ First, trade liberalization and a gradual reduction of external trade taxation have lowered tax revenues from international trade. This effect was exacerbated by measures introduced in 2012 to curb imports (see Chapter IV for a detailed discussion of trade policies). Second, tax reforms initiated in 2011 streamlined import taxes, unified VAT rates, and abolished some "nuisance" taxes to improve the transparency and efficiency

The decline in tax-revenue-to-GDP tracks with the decline in VAT

¹⁸ Collectively, these taxes accounted for 77 percent of the total tax revenue in 2013 whilst income taxes and telecommunication levy contributed to 20 and three percent of tax revenues respectively.

¹⁹ IMF (2014a and (2014b).

Figure 3.3 Tax composition in South Asia



*2011 data except Bhutan which is 2009.

Sources: IMF FAD Database, MoF Annual Report, 2012; World Bank (2014)

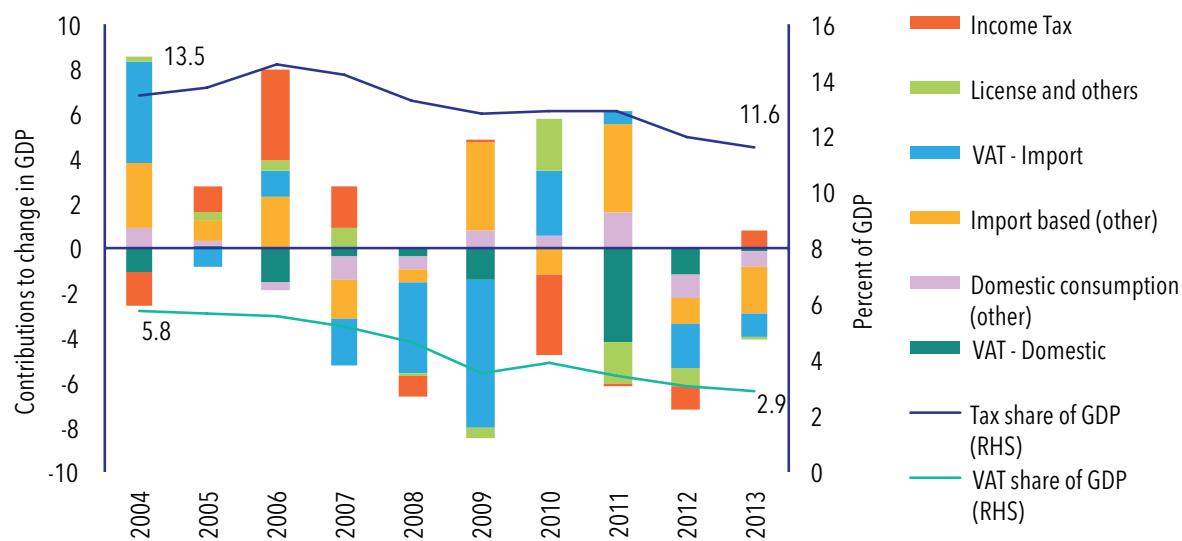
of the tax system. However, the unification of the VAT was at a lower rate, and corporate and income tax rates were lowered without a commensurate broadening of the tax base. Third, the authorities have introduced numerous tax exemptions and holidays to boost foreign investment or support specific activities, resulting in an erosion of the tax base (see below). Finally, tax exemptions have made tax administration more difficult, discouraged tax compliance, and created demand for new exemptions.

86. A decline in VAT collection is the main driver of tax-revenue-to GDP reduction in recent years. The VAT's share in total revenue has declined from 43 percent in

2004 to 25 percent in 2013, while the decline in the tax-to-GDP ratio broadly tracks that of the decline in the VAT-to-GDP ratio (Figure 3.4). VAT collection is weak at 2.9 percent of GDP in 2013 with a c-efficiency²⁰ of 25 percent, which is roughly half of the c-efficiency for lower middle-income countries. Domestic-based consumption taxes have remained at the same share over time, while there has been a marginal increase in import-based taxes, excise taxes, trade taxes, and the Nation Building Tax (NBT), a cascading

20 "C-efficiency" is the tax collection as a share of the tax base divided by the tax rate. See Ebrill, 2001 and Keen, 2013.

Figure 3.4 Trend in tax-to-GDP and drivers of changes



Source: Ministry of Finance, staff calculations

indirect tax using a similar base to the VAT, as a share of total revenue. On the other hand, the share of the corporate income tax collection increased, as did the “special taxes,” such as the Social Responsibility Levy (SRL) and devolved duties to Provincial Councils.

87. Sri Lanka's low tax revenues are caused primarily by problems with tax administration allowing for weak compliance. The country ranks 158th out of 189 countries in paying taxes due to the high number of payments (47), time taken (167 hours per year) and tax rate (55.6 percent of profits), according to Doing Business 2015 Report. A 2013 Public Expenditure and Financial Accountability report similarly identifies weaknesses in Sri Lanka's tax administration, particularly indicators for collection of gross tax in arrears, clarity and comprehensives of tax liabilities and effectiveness of penalties on non-compliance (Figure 3.5).

88. There are multiple institutions involved with tax administration. Under the MoF, there are three agencies involved in tax collection, including the Department of Customs, Department of Excise and the Inland Revenue Department (IRD), with the latter collecting less than 50 percent of total government revenues.²¹ There is high ro-

tation of staff, which results in the downgrading of specialized skills in tax administration. With regard to tax policy, there is significant influence and overlap from agencies other than the tax authorities (e.g. Board of Investment - BOI), which frequently grant tax exemptions that further undermine revenue administration capabilities. There is limited data sharing

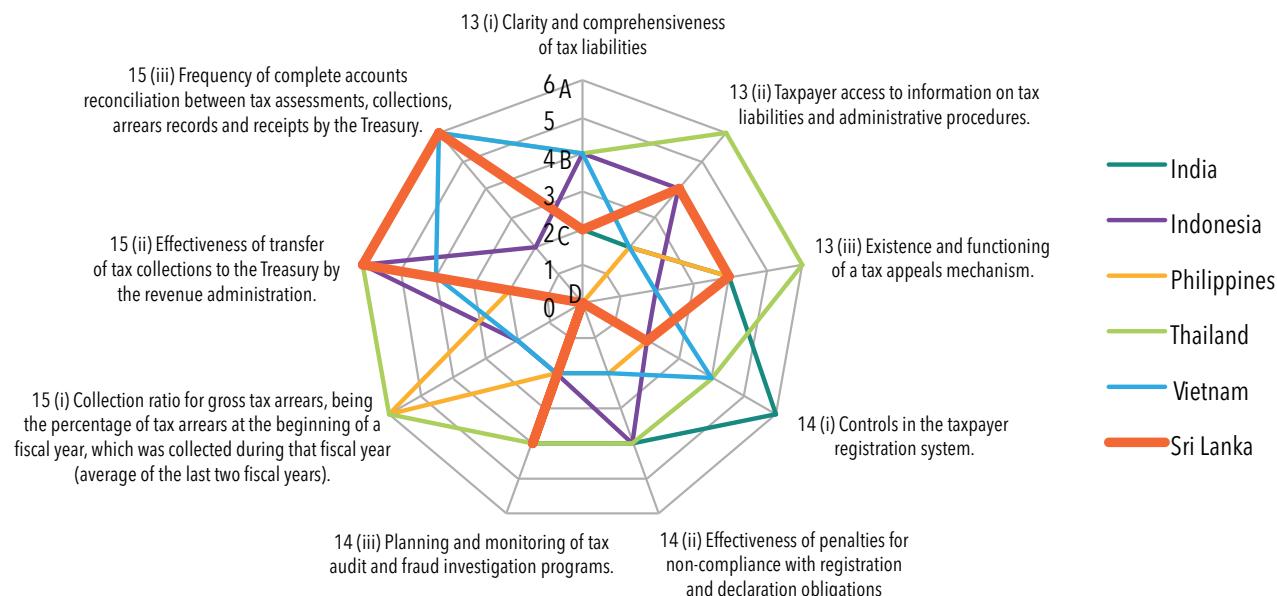
between the Customs and IRD, but not among other entities, although reforms are planned to overcome this issue.

89. Tax administration is complex and inefficient, though increased use of IT expected in the near future may lead to improvement over the medium term. At present, the system relies heavily on self-reporting for direct taxes and there is a lack of regulations covering penalties for non-compliance with registration requirements for the corporate income tax. Monitoring compliance is split by type of tax and customer segment within the IRD. In November 2015 the IRD plans to launch the first phase of a Revenue Administration Management Information System, which is designed to enable information sharing, integrate taxpayer information from 22 government institutions, and provide for online tax filing for the first time. Other countries, notably Sri Lanka's neighbor India, have been able to improve administration in recent years largely thanks to IT improvements. Yet, global experience also indicates that rolling out such systems and implementing

Tax administration is complex and inefficient

²¹ In 2012, the IRD collected Rs. 443,455 which was 44.9 percent of total government revenue according to the IRD's 2012 Performance Report.

Figure 3.5 Public Expenditure and Financial Accountability (PEFA) performance on tax-related indicators



Source: World Bank (2013)

Note: Numbers are from sequence 28 indicators. Rating from A (highest score) to D (lowest score)

them well is complex. Strong management and technical capacity within IRD will be required.

90. Tax administration relies on self-reporting of taxes, which is onerous although there has been recent progress. Sri Lanka ranks 158th on ‘paying taxes’ according to the 2015 Ease of Doing Business rankings. These rankings are comparable to South Asian comparators (India is 156th and Pakistan is 172nd), but below MIC compar-

ators Thailand and Malaysia (62nd and 32nd, respectively). A 2015 study of the administrative burdens showed a reduction of 43 hours in the number of hours required for corporate tax compliance due to improvements in electronic systems for filing and paying taxes. The number of hours endured by firms in Sri Lanka is now lower than many peers, but the number of payments remains somewhat higher (Table 3.1).

91. Sri Lanka also provides a large number of tax privileges, though a tax expenditure analysis to assess their fiscal impact has not been carried out. Since the introduction of a VAT in 2002, successive changes in the tax regime have led to an increase from around 200 to over 500 types of exemptions for a wide variety of goods. There are also over 40 broad types of exemptions on corporate and personal income tax depending on the source of income and the type of taxpayer. In addition to these statutory exemptions, the BOI provides a package of additional tax incentives to investors. While this was partially streamlined with regard to income tax exemptions in 2012, the BOI can continue to approve incentives on customs duties, VAT and other border taxes. Finally, additional ad hoc tax regimes are ap-

VAT exemptions have risen from 200 in 2002 to over 500

Table 3.1 Paying Taxes – Compliance of Corporate Income Tax

Country	No. of hours	No of payments
Sri Lanka	16	5
India	45	2
Thailand	160	2
Pakistan	40	5
Malaysia	26	2
Singapore	32	1
Bangladesh	140	5

Source: PWC World Bank Paying Taxes 2015

Table 3.2 Tax rates (2013)

Country	Individual	Corporate	Indirect
Bangladesh	25	27.5	15
Cambodia		20	10
India	33.9	33.9	13
Indonesia	30	25	10
Malaysia	26	25	10
Sri Lanka	24	28	12
Thailand	35	23	7
Vietnam	35	25	10

Note: Top rates. Sri Lanka's individual tax rates range from 4 to 24 percent and corporate tax rates are from 12 to 28 percent, with numerous exemptions and special regimes for various payers. Source: KPMG

plied to entities implementing 13 large projects thus far approved under the 2010 Strategic Development Act. Annual budgets in recent years regularly include a package of new tax incentives targeting specific sectors or types of payers. Tax expenditure analysis is not conducted before or after the introduction of incentives, and statements of tax expenditures are not compiled or published.

92. Multiple incentives regimes have also led to co-ordination problems, further undermining effective administration. Firms have been granted tax incentives by BOI generally are not monitored by the IRD (with the exception of corporate income tax since 2013) since the latter does not consider other tax matters related to BOI investors under its ambit. There has been no formal system of sharing information between the two agencies, which further complicates monitoring by IRD. Follow up to ensure that firms began to pay taxes after tax holidays ended did not occur.

93. In contrast, Sri Lanka's statutory tax rates are comparable to many middle-income countries, though features of policy concerning VAT undercut revenue mobilization because of the administrative burdens that arise. The VAT statutory tax rate is in line with other middle-income countries, while its individual income tax rates are somewhat lower and corporate income tax rates are relatively high by international standards (Tables 3.2 and 3.3). Tax policy with regard to VAT includes unusual features that create additional administrative burdens. In particular, Sri Lanka employs a "simplified VAT" regime whereby significant registered exporters are entitled to purchase goods and services from similarly registered suppliers free of VAT, obviating the need for a refund. Enforcing compliance is complicated because there is no

Table 3.3 VAT compared with other countries

Country / Category	Average VAT Rate	C-Efficiency
Sri Lanka	12	25
Bangladesh	15 (standard rate)	23.4
Low-Income	16	38
Lower Middle-Income	13	46.6
Upper Middle-income	15	51.6
High Income	20	55.6

Source: PWC World Bank Paying Taxes 2015

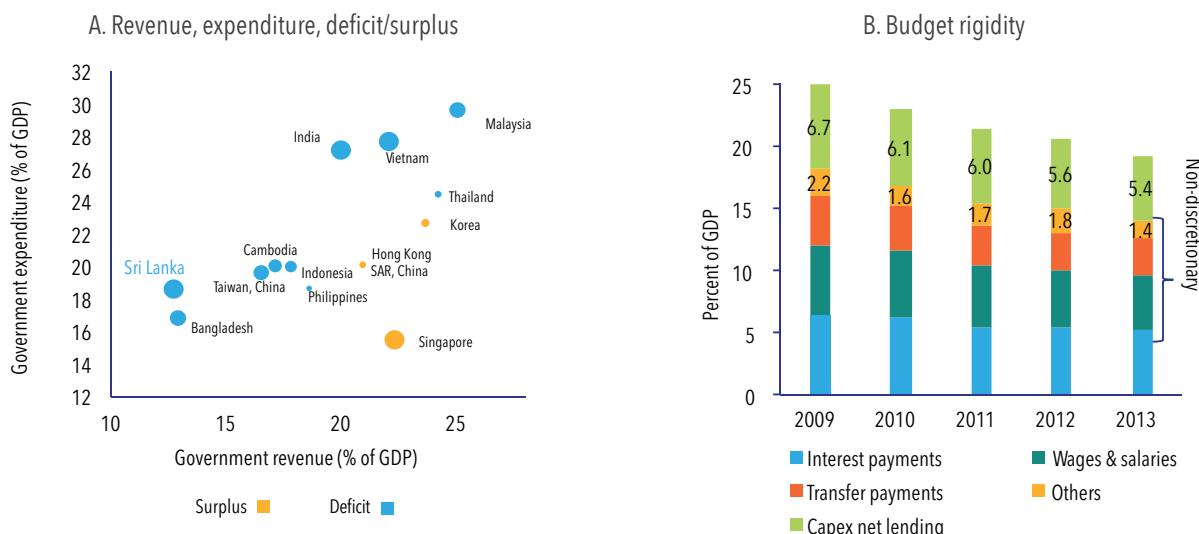
chain of transactions and hence IRD will not detect what is occurring unless businesses declare the goods and services. The over 500 exemptions to VAT pose similar disruptions and monitoring challenges for IRD. Finally, although thresholds for payment of VAT have been raised since last year, the threshold likely remains too high, given the still small number of VAT-payers (roughly 15,000 registered payers).

B. Expenditure Pressures

94. Low tax revenues combined with an expenditure profile that is effectively non-discretionary has led to a lean, rigid budget. Sri Lanka's overall revenues and expenditures are among the lowest in the region. There is little flexibility in the short term on the expenditure side of the budget. Sixty percent of expenditure in 2013 was on items that the government cannot readily reduce: interest payments, salaries, and transfer payments (Figure 3.6). Nearly two-thirds of transfer payments are pensions for civil servants, which are a commitment that must be met, with the remainder fertilizer subsidies, social protection payments and other transfers. Furthermore, Sri Lanka has had a large expansion in the number of public servants in the past 10 years, growing from 646,000 in 2004 to 1.06 million in 2013, an increase of nearly two-thirds (MoF 2014). This growth reflects explicit policies to provide public service jobs, especially for university graduates (see below). These trends will only grow the wage/allowance and pension burdens.

95. There is moderate risk in Sri Lanka's public debt profile. There has been significant accumulation of public debt in recent years, mostly from abroad. Although much improved from earlier years where the debt stock was over 100 percent of GDP, public debt stood at 75.5 percent of GDP at end-2014 and could pose macro-economic risks if growth moderates in coming years. The composition of

Figure 3.6. Fiscal indicators



Note: Bubble size corresponds to the size of the deficit/surplus, 2013 data.

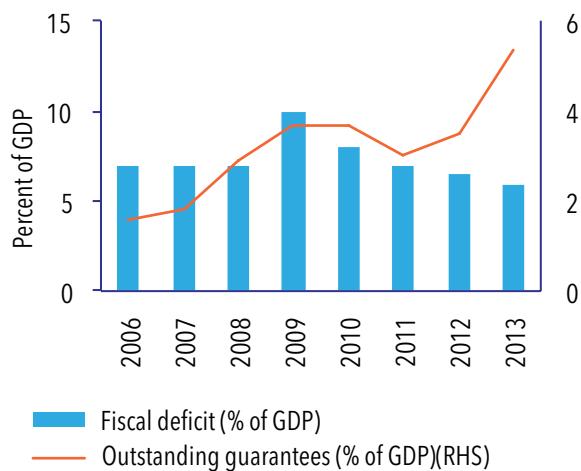
Source: World Economic Outlook

debt is also changing, moving from concessional lending to shorter-term commercial borrowings. However, during 2014 there has been a systematic conversion of short-term T-bill issuance into longer-term T-bonds, while foreign holdings of T-bills and bonds have been contained at 12.5 percent of the outstanding value (Central Bank, 2015). With about 44 percent of the public debt stock is external, exchange rate fluctuations and any rupee depreciation could risk deteriorating the debt indicators.

96. Although the fiscal deficit has been brought down, the government's contingent liabilities have

grown fast in the recent years. The outstanding amount of Treasury guarantees given to various state and non-state entities to expedite the development work increased from 1.6 percent to 5.7 percent of GDP from 2006 to 2014²², implying an annualized growth rate of 37 percent during this period. Moreover, within the mix that has been changing over time, the significance of guarantees given to institutions with stable revenue streams²³ declined from 90 percent in 2006 to 40 percent in 2014 while guarantees given to state establishments that are primarily dependent on state budget are on the rise²⁴. Monitoring these guarantees is important to strengthen public finances as they could elevate fiscal risks^{25, 26} (Figure 3.7).

Figure 3.7 Government guarantees



Source: Ministry of Finance and Treasury

C. Insufficient Spending in Key Areas

97. Fiscal consolidation and relative prioritization of public investment in capital infrastructure follow-

22 In order to facilitate guarantees for requiring entities, the ceiling imposed by Financial Management Responsibility Act No: 3 of 2003 for such contingent liabilities (at 4.5 percent of GDP) was increased to 7.0 percent by way of an amendment in 2013.

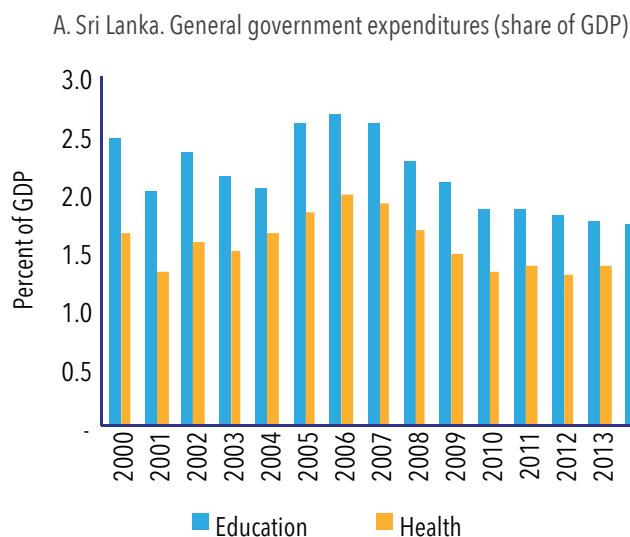
23 Primarily Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB)

24 These include Road Development Authority, Kotalawala Defense University, Urban Development Authority

25 Fiscal Adjustment in an Uncertain World, Fiscal Monitor, IMF, April 2013.

26 Often comparable estimates are not available due to existence of various forms of contingent liabilities (IMF 2005).

Figure 3.8 Health and education expenditures (share of GDP)



Source: Central Bank of Sri Lanka. Includes central and provincial government spending.

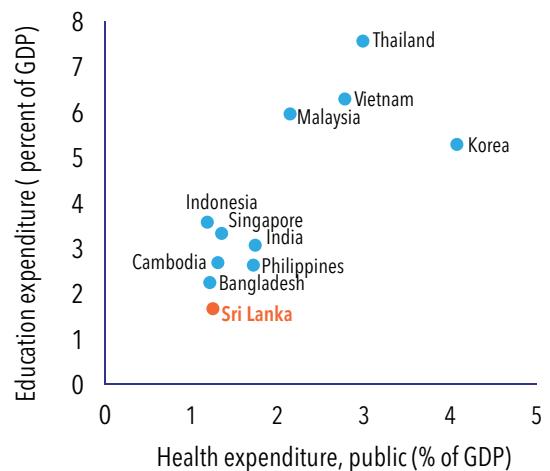
ing the conflict have squeezed expenditure on other public goods, especially with regard to human capital.
General government spending on education fell from 2.7

Spending levels on education and health are low relative to other middle income countries

come countries (Figure 3.8B), particularly given the rising costs of healthcare associated with an aging population. Moreover, Sri Lanka faces increasing demands for a more skilled workforce to be able to compete globally while meeting the aspirations of the youth, as described in the next two chapters.

98. Sri Lanka's expenditure on social protection programs has also declined steadily in recent years. The total amount of transfers has increased in absolute terms over the past decade, but has not kept pace with GDP growth (Figure 3.9A). In 2013 two-thirds of social welfare programs went to social transfers, while the remaining third was spent on health and education programs, various subsidies, and absorbed losses of SOEs (primarily the Railways, Postal Service and Transport Board) (Figure 3.9B). Moreover, growth in absolute terms has been driven by a significant increase in pensions and to a lesser extent, fertilizer subsidies. Because Sri Lanka's state pension system only encompasses public servants and the military, which

B. Sri Lanka and regional comparator countries

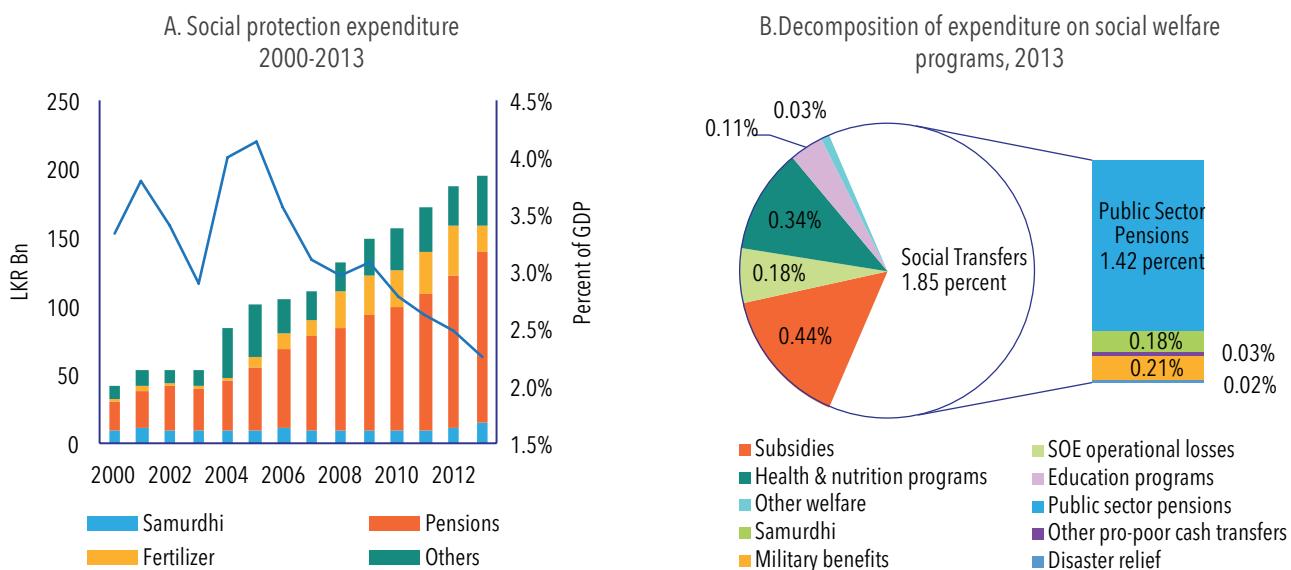


mostly represent better-off households, the poverty reduction impact of these transfers is limited. Most notably, there was no increase until 2013 in absolute expenditures on the major anti-poverty *Samurdhi* ("Prosperity") program, an integrated welfare program providing cash transfers, housing assistance, subsidized kerosene and assistance to pregnant and lactating mothers set up in 1994. Despite a small increase, only 0.22 percent of GDP was spent on anti-poverty and disaster relief programs. New cash transfer programs for the elderly and the disabled have been introduced but these amounted to only 0.03 percent of GDP in 2013.

Social transfers have not kept pace with GDP growth

99. Low levels of public spending may undercut Sri Lanka's past strong gains in human development and leave it less well equipped to face changing human development needs as a MIC. For decades Sri Lanka outperformed other lower-income countries in making steady improvement on human development outcomes, such as life expectancy, maternal health and educational enrollment (see Appendix 1.1 on achievement of the MDGs). It is much closer to average in outcomes when compared to other lower middle-income countries LMICs. Sustaining progress will involve addressing different types of challenges more typical of a MIC. For instance, whereas Sri Lanka excelled in addressing communicable diseases in the past, it now faces a bigger problem with non-communicable diseases reflecting an aging, more urban, and affluent population. Similarly, the changing economy is placing

Figure 3.9 Social protection expenditures are insufficient and inefficient (share of GDP)



Source: Ministry of Finance and Treasury

greater demands for a more skilled workforce, whereas Sri Lanka's tertiary education has enrollment rates below the LMIC and South and West Asian averages (a discussion of tertiary educational needs is in Section IV).

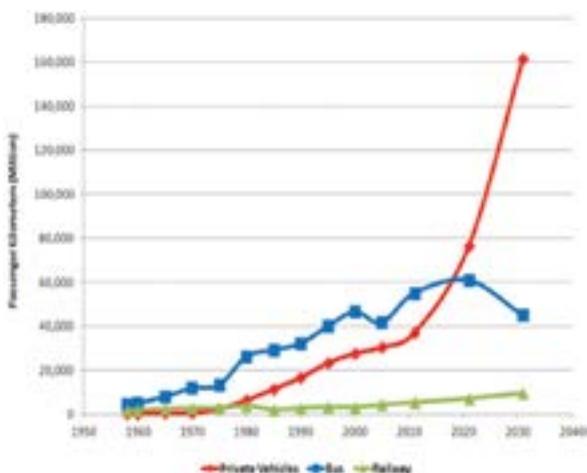
100. Sri Lanka will also need to finance infrastructure needs to keep pace with increasing demand. Sri Lanka's infrastructure compares favorably to its South Asian neighbors in terms of accessibility, and the past five years have seen a major expansion of public investment in infrastructure (see Appendix 2.1 for a more detailed review on access and management issues for various infrastructure sectors). In particular, over the past five years, the government has invested about 4.4 percent of its total expenditures (outside of interest payments) in infrastructure in the Northern Province alone in order to redress imbalances.²⁷ However, Sri Lanka's needed investment remains high in order to keep pace with the changes underway in the country. In particular, increasing urbanization will require more sophisticated infrastructure to maximize benefits from agglomeration, provide for livability, and avoid congestion. With greater affluence will come increased use of individual vehicles, currently growing at 10 percent a year and set to displace the modal share of public transport if demand management measures and public transport development are not addressed (Figure 3.10). Structural transformation that has underpinned productivity growth

Source: Ministry of Finance and Treasury

will place further demands for more, cost-effective infrastructure, particularly power.

101. In the past, the pressures on financing capital investment were eased by waves of concessionary donor funding that will not continue because Sri Lanka has reached middle-income status. Consequent to a deteriorating security situation and political instability, the international donor community substantially limited official development assistant (ODA) to Sri Lanka through-

Figure 3.10 Usage patterns of vehicles, 1960-2030



27 Ministry of Finance, 2014

Source: World Economic Outlook, Central Bank of Sri Lanka

out the 1990s. Donor aid surged following the signing of a ceasefire between the government and LTTE in 2002 and again following the Indian Ocean tsunami in December 2004. The combined effect of these was that ODA to Sri Lanka rose from US\$330 million (2 percent of GDP) in 1999 to \$1.33 billion (5 percent of GDP) in 2005 – comprising the highest level of aid to the country. Despite complications in disbursing post-tsunami aid in conflict areas due to the lack of full government control there, social and connective-infrastructure needs (roads particularly) in the East and also in the deep South of the country were met by generous donor funds, easing the pressure on public funds. Given that Sri Lanka has achieved middle-income status, this level of funding is not likely to materialize going forward, highlighting the imperative for domestic revenue mobilization.

102. Public investment will need to be applied effectively to crowd in other sources of financing. Public financing will remain important, but it will need to be supplemented by more private sources to address infrastructure needs. In recent years the government increased expenditure on energy, water supply, transport and communications from under 11 percent of total spending in

2005 to around 20 percent annually from 2009-13 (or roughly 4 percent of GDP, except 2009, which had a large fiscal deficit). Although there are some exceptions, infrastructure was built thanks to direct public financing. As is discussed at greater length in the next chapter, effort should be undertaken to

leverage public funds with private-sector investment to address infrastructure needs

leverage public funds with private-sector investment given the quantum of investment needs going forward.

D. Inefficiency in Social Transfers

103. In addition to low levels of spending, Sri Lanka's social protection system has limited effectiveness. Some of the programs classified as social transfers should not be classified as such.²⁸ Pensions account for most transfers, but not surprisingly given the public service background of pensioners, less than half of them are in the bottom 40 percent (HIES 2012/13). Less than 30 percent of

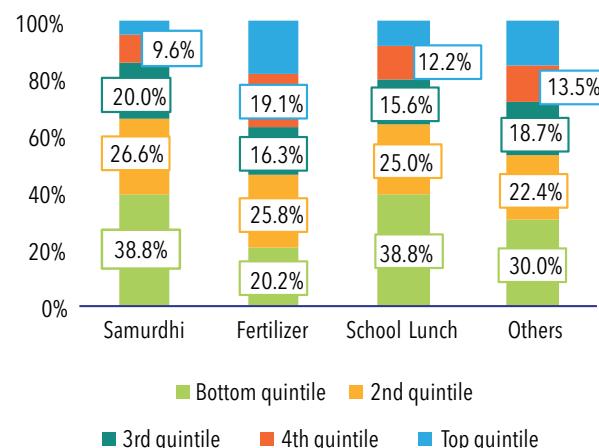
²⁸ Although the Ministry of Finance categorizes civil service pensions as part of welfare programs, they are part of total civil service compensation rather than a welfare program and cannot be considered a social protection program per se. Moreover, note that the Ministry of Finance refers to SOE losses as part of welfare spending (World Bank, 2014a).

the population over 65 drew a pension in 2013. Expanded subsidies for fertilizer are available to all farmers (with differentiation in the amount of subsidy depending on the crop); it can be argued in only the most general terms that these farmers are relatively likely to be poor.

104. Anti-poverty programs suffer from poor targeting. In fact, analysis of the HIES shows that if it were possible to perfectly target individuals below the poverty line, the amount needed to bring all poor individuals to the poverty line would have been only 0.12 percent of GDP in 2013. Programs rely on manual registration and identification, and lack a capability to actively search for excluded individuals. Although some programs have categorical eligibility criteria, more than half of Sri Lankans living below the poverty line receive no benefits from existing social assistance or social welfare programs (though they may benefit from free health and education). At the same time, a third of spending on social transfers goes to the richest 60 percent of the population. Samurdhi and School Lunch programs transfer nearly the same amount to the bottom quintile, and in both cases roughly 55 percent of benefits go to the bottom 40 percent. The other three programs, when considered as a group, distribute 53 percent of their transfers to the bottom 40 percent (Figure 3.11). By tightening eligibility criteria and making an effort to register the poor for benefits, existing spending could be more effective in combating poverty.

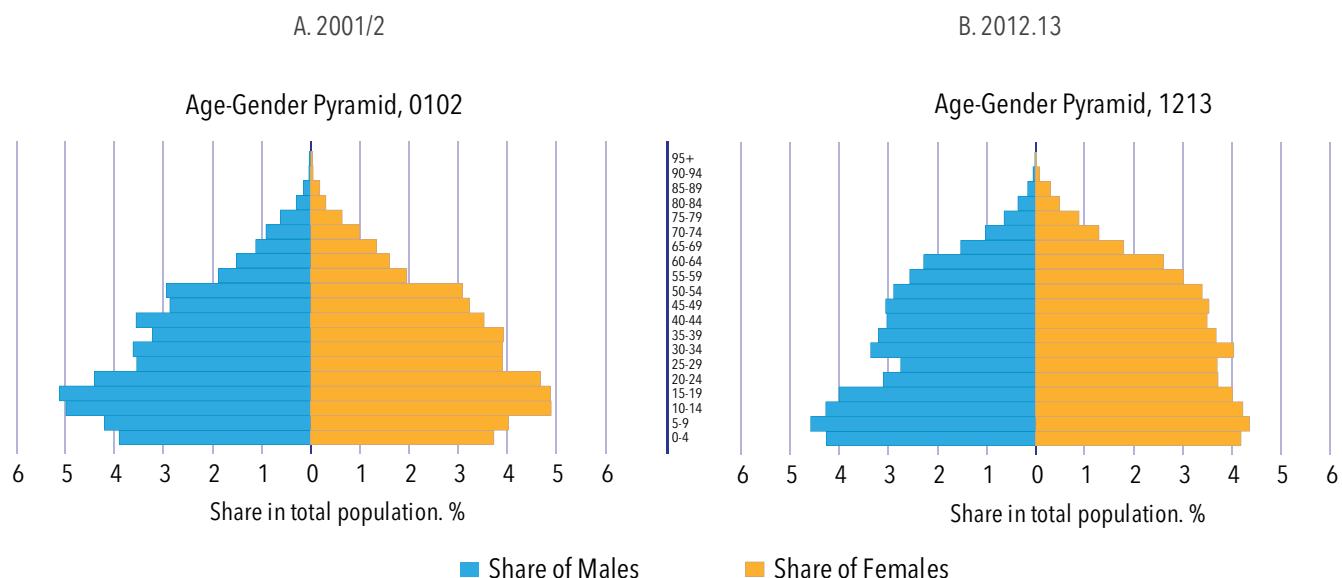
105. Fertilizer subsidies have limited impact on the poor while creating negative distortions in the agriculture sector that undermine productivity. Fertilizer

Figure 3.11 Incidence of social benefits (percentage of benefits accruing to each quintile)



Source: World Bank Poverty Assessment 2015 based on HIES 2012/13.

Figure 3.12 Age-gender pyramid



Source: HIES

subsidies are the least well-targeted transfer, with only 45 percent of the benefit being devoted to the bottom 40 percent (Figure 3.11). Furthermore, these subsidies have distorted market decisions by encouraging cultivation of certain crops, especially paddy, hindering the movement to other types of agriculture that have more potential for value addition. Even for targeted crops, these subsidies have not prompted productivity increases.²⁹ At the same time, intensive usage of cheap fertilizers lead to environmental and potential human health hazards. Thus, subsidies negatively affect those in the bottom 40 percent engage in agriculture across multiple dimensions, suggesting a need for rationalization.

106. Moreover, poverty programs are fragmented. There are the 11 major anti-poverty programs, including Samurdhi, in addition to multiple-agency programs that split the already small amount available for welfare programs. Programs rely on manual registration and identification, and lack a capability to actively search for excluded individuals. They also employ varying eligibility requirements and administrative structures, and lack modern information management systems that would allow for harmonization among programs.

107. Pressures on the healthcare system and the social protection system are expected to grow with an aging population. The proportion of the country's working age population (defined as ages 15 to 59 in Sri Lanka) reached its peak in 2006 and the overall population is expected to peak in 2016 (Figure 3.12). The child population (up to age 14) declined from 35 percent in 1981 to 23 percent in 2011, while the number of people aged 60 and above is expected to double in 2041 relative to 2011. Sri Lanka is in the midst of its demographic dividend at present and hence there is urgency to "get rich before getting old." While this fiscal burden may continue to be mitigated by the limited coverage of pension schemes to public-sector workers, Sri Lanka can expect to need to develop programs for social protection of the elderly. Furthermore, the 40 percent increase in the number of civil servants over the past 10 years, discussed below, will substantially increase the number of pensioners under the current system (see Chapter VI for a detailed discussion of fiscal issues associated with an aging population).

²⁹ Annual crop productivity figures are from Agriculture and Environmental Statistics Division; Department of Census and Statistics, Colombo, Sri Lanka.

E. Large Public Sector

108. **Despite its small fiscal footprint and relative state effectiveness,³⁰ Sri Lanka's public sector is large.** With over one million employees, public-service employment exclusive of semi-public entities, accounts for about 13 percent of the labor force.

Public-service employment accounts for 13 percent of the labor force, close to OECD levels

With over one million employees, public-service employment exclusive of semi-public entities, accounts for about 13 percent of the labor force. Although cross-country comparisons are difficult owing to different definitions of the public service, the size of the public sector in Sri Lanka is higher than comparable public services in Thailand (roughly 9 percent) and close to OECD levels (average of 15 percent in 2011). There have been also small but steady increases in semi-governmental organizations such as SOEs employment over the past 10 years, comprising a further 239,000 employees in 2013.

109. **Human resource management of the public service is complex with limited controls on the expansion of the civil service.** Public servants are either recruited to one of 28 island, combined and other services (categories of employees) or are hired in terms of respective service minutes and individual schemes of recruitment of specific departments or other agencies. The complement of staff recruited through either route is proposed by the department/agency and approved by the Department of Management Services (DMS) in the Ministry of Finance (MoF). Analysis regarding overall staffing needs is therefore effectively carried out only by the agency in question. While the MoF through its DMS plays an oversight role, decisions are made on a case-by-case basis without a holistic view of managing the size of the overall civil service. Politically important ministries have demonstrated ability to increase their staffing complement in recent years. Hiring per the approved cadre schedules is then carried out via the Public Service Commission (PSC) on the basis of examinations.

110. **There is also fragmented control of remuneration.** Wage reforms in 2006 led to the consolidation of over 100 various positions to 37 grades and corresponding salaries, which have been occasionally increased by the Ministry of Public Administration (MPA) upon recommendation of the National Pay Commission appointed by the president. There is also an extensive system of allowances that, in terms of aggregate spending, have been roughly

equivalent to the formal wage bill over the past five years. All public servants (and pensioners who receive 50 percent of the benefit) receive a cost-of-living allowance that has increased from 1,000 rupees in 2006 to a commitment of 10,000 rupees in 2015. Outside of cost-of-living allowances, there is a wide range of additional allowances and incentive payments that vary for different services and individual schemes of recruitment. The type, criteria for receipt, and the quantum of allowances are approved by the MPA's director general of establishment. For instance, preliminary medical officers may receive a base monthly wage of 26,000 rupees per their grade, but seven additional allowances account for an additional 105,000 rupees, as well as the right to earn more through private practice in the evening. Thus, the complement of staff is approved by the DMS, wages are set by the National Pay Commission and a varied system of allowances is set by the MPA's Establishment Department.

111. **Political governments have substantially influenced the size and operation of the public service.**

The government from 2005 to 2014 explicitly sought to increase public-sector employment, particularly with recent graduates through the Yovun Diriya and other programs.³¹ Particularly large recruitments were carried out in 2005 and 2012. While recruitment is carried out by an objective process of examination, the higher echelons of public service have been subject to influence by political governments. Since the 1972 Constitution, all ministry secretaries have been directly appointed and removed by the president. This has led to a small number of high-profile appointments of people without prior civil service experience. It has also meant that with every change of government, secretaries cease to hold their positions (and are often reassigned to another agency). Other transfers and promotions fall under the PSC, which, in turn, has served at the pleasure of the president for almost all of the past 30 years. This framework is conducive to senior officers developing strong political affiliations.³² New constitutional amendments are expected to provide for more autonomy of the civil service through a more independent PSC.

F. Improving Public Expenditure Management

112. **There are additional ways to address the fiscal challenge through further improvements in a generally sound system of public expenditure management.** A 2013 PEFA assessment noted relative strengths in terms

30 Sri Lanka's ranking for Government Effectiveness and Controlling Corruption according to World Governance Indicators has been consistently higher than South Asian and LMIC averages over the past 10 years.

31 See Mahinda Chintana, also 2013 budget speech.

32 Transparency International, National Integrity Assessment, 2010.

of budget process, quality of annual financial statements, legislative scrutiny, and timeliness and quality of follow up on audit findings. At the same time, Sri Lanka scores below LMIC averages on several PEFA indicators including: (i) monitoring and reducing payment arrears; (ii) oversight on aggregate fiscal risk; (iii) public access to key fiscal information; (iv) tax payer registration and tax collections; (v) internal audit and payroll controls; (vi) procurement procedures and transparency; and (vii) predictability in the availability of funds.

113. Budget planning and execution practices can have an adverse effect on sector planning and performance. There is limited linkage between long-term financing frameworks and sector plans, with the latter effectively lacking cost estimates. During annual budget preparation,

Budget adjustments are effectively carried out through cash rationing which leads to ad hoc prioritization of expenditures

ceilings provided by the MoF are often late and do not relate to medium-term financial plans. In most cases, sector plans and strategies follow an activity-based expenditure classification that is not compatible with the administrative and functional classification used for budgeting and financial reporting. These budget practices

lead to an input-oriented culture that focuses on "spending the budget" with little reward for achieving outputs or outcomes. At the same time, due to chronic shortfalls in actual revenues, budget adjustments are effectively carried out through cash rationing by the Treasury vis-à-vis ministries and other agencies. This leads to ad hoc prioritization of non-discretionary expenditures, such as salaries, to the detriment of other priority items. While Sri Lanka's government has nonetheless functioned relatively well under these circumstances, sector performance suffers as a consequence.

114. Public investment planning is further impacted by capacity and procedural issues. Capacity could be strengthened to raise the effectiveness and efficiency of public investments. A key issue is the limited capacity to assess the planned effectiveness of investments in order to prioritize among various needs. Efficiency depends on the quality of planning and life-cycle costing prepared by respective sector ministries or departments. The Department of National Planning must approve the investments, but it lacks engineers, quantity surveyors or other technical specialists to check assumptions and estimates. Recent cost requirements linked to investments are rarely factored into the assessment.

115. A weak procurement environment remains a concern, though reforms are imminent. Public procurement expenditure in Sri Lanka is approximately equivalent to 21 percent of total government spending in 2013, making up over half of total discretionary expenditures. Despite its importance, there are a number of institutional issues that undermine efficient procurement. In particular, there is no dedicated oversight and support agency after the abolition of the independent National Procurement Agency in January 2008 and the transfer of its functions to the MoF's Public Finance Department. Although the government has procurement guidelines, manuals and standard documents, there is inconsistency internally and in execution. There is no independent complaints review mechanism for public procurement. Finally, Sri Lanka is yet to take steps to introduce electronic government procurement, which in other countries in the region and beyond has made public procurement more economic, efficient and transparent. Within this fluid institutional context, the government has on several occasions made high-profile procurements on the basis of unsolicited bids, leading to allegations of cost inflation.³³ These issues are expected to be addressed through a new national Procurement Commission mandated by the 19th Constitutional Amendment, as well as through the passage of revised and consolidated financial regulations on procurement.

116. Governance within public expenditure management could be strengthened through greater transparency and accountability. There are several areas where more openness about the use of public money would be welcome, including: budget execution reports with greater frequency than the present bi-annual reports; information about contract awards and associated terms; information about resources availability to individual primary service units (e.g. schools); and presentation of audit findings. Providing for greater public awareness and understanding of the public sector's use of resources would enhance accountability. Efforts towards this objective could include making budgeting and financial information more easily understood by non-financial specialists as well as providing public access to proceedings of parliamentary committees on public accounts and public enterprises.

³³ In some cases forgoing competition was due to conditions of external financing for projects. There have been allegations of inflated cost to the government. See, for instance, Kumarage, Amal, "Road Building or Rip-Off?" Sunday Times, December 21, 2014.

G. Medium-Term Fiscal Sustainability

117. Fiscal sustainability analysis suggests high risks to slower than projected growth, higher primary deficits, or higher borrowing costs. Public debt, hovering around 106 percent of GDP in 2002, was reduced to 75.5 percent of GDP by 2014 -- reflecting relatively low borrowing costs and strong growth, supported by gradually improving primary balance. However, fiscal sustainability analysis carried out in 2014 highlighted some important risks. First, slower-than-projected growth (alone or combined with a higher primary deficit and higher borrowing costs) could stop or reverse the decline in debt ratio.³⁴ Moreover, the relatively high share of foreign currency-denominated debt (at 42 percent of the total as of 2014) also creates a vulnerability to currency depreciation. Sri Lanka's public debt was 614 percent of total government revenue and grants at end 2014, highlighting the fact that a moderate increase in borrowing costs could eat up a large share of revenues.

118. A slowdown in growth or adverse shock may reverse the downward trend in public debt to GDP. The reduction in the public debt-to-GDP ratio has been largely due to fast GDP growth and low average real interest rates on debt in the backdrop of a relatively stable currency. If growth slows, a sudden fiscal adjustment might be needed to contain the debt level. The low level of fiscal revenue, the still high level of public debt and persistent fiscal deficits leave little room for counter-cyclical fiscal policy. Government guarantees given to state-owned and private establishments have risen fast from 1.6 percent to 5.7 percent of GDP between 2006 and 2014, and could pose a risk to the fiscal position.

119. The fiscal deficit could expand in 2015, requiring long-term revenue measures to ensure sustainability going forward. The new government presented its budget for 2015 to the Parliament in January 2015. An extension to the budget presented by the previous government for 2015 in October 2014,³⁵ it includes the fiscal costs pertaining to the promises made by the losing candidate who was then in power as well as those of the winning candidate. The result has been a change in the composition of expenditures toward recurrent spending due to: increases in public-servant salaries; new and expanded subsidies, including a reduction of prices of fuel and essential goods through lower taxes and benefits to

selected niches of the society; and reduction of fuel excise taxes for 2015 and beyond. The related costs were expected to be financed by one-time taxes³⁶ and lower public investment. However it is yet unclear whether the narrowed deficit target of around 5 percent of GDP set for 2015 can be achieved. Over the medium term, the government plans to massively increase expenditures on education and health from their present low levels. Since revenue will drop in 2016 once the one-time measures expire, reducing public debt to maintain fiscal sustainability and honor medium-term commitments will require increasing tax revenue collection through permanent measures sooner rather than later.

H. Priorities in Addressing the Fiscal Challenge

120. Continued strong commitment to fiscal sustainability will require long-term domestic revenue mobilization efforts. Honoring medium-term commitments while reducing the fiscal deficit and public debt will require increasing tax revenue collection through permanent measures beyond 2015.

121. Simplify the tax regime and improving tax administration. Sri Lanka has extremely low and declining revenues driven by a complex tax regime and poor tax administration. Low revenues and rigidity in expenditures is causing the country to undercut investment in human development just when its transition to a MIC poses new challenges.

122. Improve the adequacy and effectiveness of spending. Low levels of public spending on health, education and social protection undercut Sri Lanka's past strong gains in human development and leave it less well equipped to face changing human development needs as a MIC. Sri Lanka will also need to finance infrastructure needs to keep pace with urbanization, the need for cost-effective power, and other infrastructure. Beyond increasing fiscal space for these priority projects, there is need to improve efficiency of spending, towards improved targeting of benefits, including those recently approved in 2015.

34 IMF Article IV Assessment for July 2014.

35 A month before announcing the snap presidential election

36 The most significant being a super gains tax (a 25 percent retroactive tax imposed on individuals or corporates who generated profits over LKR 2.0 Billion in 2013/14). In addition the measures include collection of tax arrears (by offering credit to those who have left tax payments in arrears at concessional interest rates from the banking sector) and levies/taxes on selected entities such as the Sri Lanka Tea Board and Telecom Regulatory Commission.

123. Improve the efficiency of spending on social protection and public-sector personnel management that undermine the effectiveness of the state. Reducing fragmentation and improving targeting of the existing social protection system can ensure that every dollar spent

on social protection has a maximum impact in reducing poverty. Similarly, improving controls on public-sector remuneration and reducing political influence in civil service management could substantially improve the efficiency of public service delivery.

KEY KNOWLEDGE GAPS

- Fiscal sustainability analysis to incorporate recent policy changes and to reflect medium-term plans.
- Tax expenditure analysis of fiscal incentives.
- Functional review of tax administration to identify collection vulnerabilities.
- Distributional analysis of alternative tax reforms options.
- Effectiveness of spending on infrastructure in terms of rate of return and impact on access and reduction of poverty.



IV. FOSTERING GROWTH AND JOBS FOR THE BOTTOM 40 PERCENT

KEY PRIORITIES

- Review and revise the country's trade-related policies.
- Invest in education and training and enhance the dialogue between private sector and education system to ensure that the population has the skills demanded by high-productivity enterprises.
- Promote innovation by establishing linkages between R&D institutions and networks of entrepreneurs that can benefit.
- Improve the regulatory environment to allow firms to grow, reducing informality and allowing for economy-wide increases in productivity as firms can reach economies of scale.
- Review the role and participation of the public sector in the economy.

A. Ample Opportunities for Success

124. Sri Lanka has a number of advantages that provide ample opportunities for further development.

Notwithstanding ongoing challenges, the country boasts overall strong human capital and a reliable infrastructure base, particularly when compared to other South Asian countries. It has ended its internal armed conflict with signs of an emerging long-lasting settlement to address grievances that fed the conflict. Although it is still too early to judge their impact, governance reforms initiated should bring about more accountability and hence more responsive and effective government. Coupled with a demonstrably democratic system, this should strengthen further public confidence in government and hence stability.

125. Sri Lanka enjoys an enviable location in a fast-growing region. Proximity to growing regional economies – at its closest point Sri Lanka is only 26 kilometers across the Palk Strait from India – provides major opportunities. Sri Lanka currently has bilateral trade agreements with both India (ISFTA) and Pakistan (PSFTA), the two largest economies in South Asia. It also has two regional trade agreements – one with the South Asian region (SAFTA) and the other with wider Asia (APTA), and a trade in goods agreement in negotiation with China. Proximity to India, with its estimated 250 million middle-class consumer population by 2016 – over 20 times Sri Lanka's own domestic market – offer a large export market for Sri Lankan producers. Already in the first 14 years of the ISFTA, exports to India have grown by 1,000 percent, and the number of product lines exported to India has grown fivefold (increasingly in higher value products). India has become Sri Lanka's third largest export market, behind the United Kingdom and the United States. There are also extensive opportunities for developing trade in electricity with India.

126. It is also located along a major trade route, opening opportunities to serve as a regional trading hub.

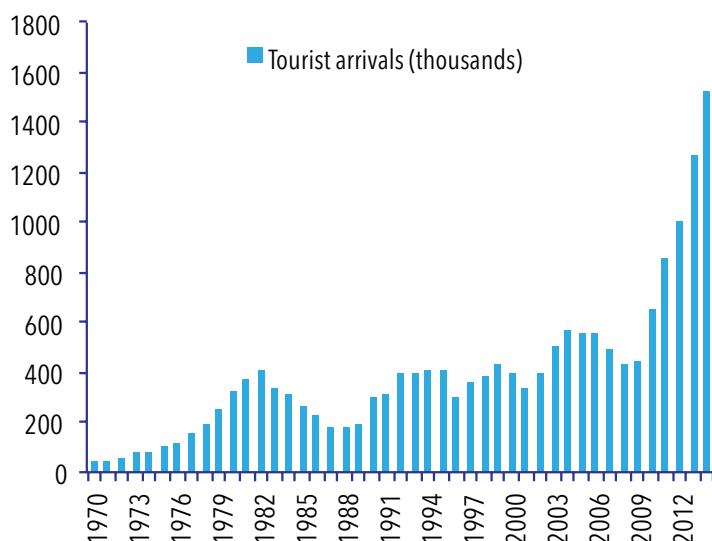
Less than 20 kilometers off its shores is the main East-West Indian Ocean shipping line, connecting East Asia to West Asia, Africa, and Europe. New investments in the country's port infrastructure – the new Colombo (South) Port extension and the Hambantota Port – have enhanced capacity for handling ship-based trade. The former has increased Sri Lanka's container handling capacity by 50 percent, making Colombo the 27th busiest port in the world, handling about one-third as many containers as Dubai and one-sixth as many containers as Singapore in 2013 (Containerization International Yearbook 2013). The latter has made Sri Lanka an important transshipment hub for the Indian car market, with around 15,000 vehicles being handled each month. The Hambantota Port is being geared as an industrial port (unlike the transshipment-only port at Colombo). Meanwhile, Sri Lanka's Katunayake airport continues to be a key passenger and cargo-handling destination in South Asia and the national airline is a leading carrier of passengers into the Indian sub-continent. The success of the new airport at Mattala remains in doubt, but the facility affords an opportunity for investments in cargo/air-freight handling and aircraft Maintenance Repair and Overhaul services. The close proximity of the airport to the seaport, together with the nearby industrial park, could make Hambantota a successful trading hub for South Asia (similar to Penang Export Hub in Malaysia), with the right investment promotion strategies.

127. Sri Lanka's boasts unique natural assets, with a temperate climate, diverse topography, and rich biodiversity. Sri Lanka has a fertile land providing for agriculture, plentiful water resources and extensive stocks of fish in its maritime waters. Its topographical variation and location as an island near the Asian mainland has led to rich biodiversity, making it one of the world's 35 biodiversity 'hotspots' (Conservation International). It boasts UNESCO's

natural World Heritage Sites and offers the unique opportunity to see in one day the 'Big Four' mammals – leopard, bear, elephant, and whale. There is considerable potential for the development of nature-based tourism. It has a high rate of endemism of flora and fauna and great genetic diversity of agricultural crops, with 3,000 varieties of rice having been recorded as well as a large variety of coarse grains, legumes, vegetables, spice crops, roots and tubers. It is renowned for its tea, coconut, and cinnamon. The country has significant potential for the export of high-value agricultural products.

128. Natural assets together with cultural and historical assets provide a strong basis for tourism, which is only beginning to grow since the end of the war. There has been a marked rise in arrivals since 2010, but there is potential for a much bigger increase (Figure 4.1). Sri Lanka has recently been recognized as one of the Top 10 global tourist destinations by National Geographic (2011), Lonely Planet (2012) and the New York Times (2013). The country's tourism assets are relatively well known and the island has a broad appeal since it offers different experiences found in other destinations in the South and Southeast Asia region (e.g. the Maldives, India, Thailand, Malaysia, Indonesia, and Vietnam). Sri Lanka has the advantage that all these experiences are available on an island roughly the size of Ireland or Costa Rica. However, tourism investments in Sri Lanka have been targeting a small part of the island, with 98 percent of tourist beds concentrated in the South and West of the island along the

Figure 4.1 Annual tourist arrivals, 1967-2013



Source: Sri Lanka Tourism Development Authority. * Provisional.

beach and in Colombo. Although some new attractions have been developed in the North -- such as the Ridiyagama Safari Park, the Pinnawela Open Zoo, the Wet Zone Botanical Garden, and a number of new national parks -- there is scope to develop tourism in the East, North and Northwest of the island (Box 4.1).

129. Globally competitive companies have emerged in Sri Lanka, particularly in the apparel and IT sectors.

Box 4.1 Tourism on the rise but constrained by capacity

The sector that picked up the fastest following the end of the war was tourism, with the country receiving global acclaim as a leading tourist nation. The unique product offering owing to the diverse attractions in a compact area gives Sri Lanka an edge over many other Asian destinations. New tourist hotels have been one of the most robust sectors for increased private investment after the conflict ended. Global chains like Shangri-La Group (Hong Kong SAR, China/Singapore), India's upscale ITC Group, Thailand's Minor Group and Banyan Tree, Spain's RIU Hotels & Resorts, Singapore's Aman Resorts and Mustafa Group have begun investing in the country. In addition, international brands such as Sheraton, Marriott, Hyatt, Movenpick and Onyx have signed management agreements with local hotel companies. Locally, several of the domestic conglomerates, including Jetwing, John Keells, Aitken Spence, Hemas, Citrus and Dilmah have expanded their tourism investments. These new additions and upgrades are increasing both the supply and quality of medium- and high-end accommodation that is needed for continued growth. However, the growth of the sector could be severely hampered by inadequate capacity. It is projected that an additional 30,000 new rooms are required across Sri Lanka to cope with growing demand. The tourism industry would need to invest in different segments of new accommodation to meet different tourist needs – from city hotels, large resorts, high-end boutique hotels and villas, as well as tented camps and rural bungalows. Alongside this, 50,000-60,000 new hospitality staff needs to be trained to support just the growth in room inventory. Sri Lanka currently has the capacity to train only around 1,800 new graduates each year. At the same time, the tourism sector requires professionals in other disciplines, such as marketing, IT and sports/recreational training. Additionally, Sri Lanka would need to develop new destinations across the country (particularly in under-developed locations with natural assets in the North and East), and diversify the product offering in order to cater to a wider variety of tourist needs, while remaining conscious of the environmental and social pressures brought on by rising tourist numbers.

Although initially facilitated by government liberalization policies in the late 1970s and the 1990s, respectively, these companies have proven resilient to changing conditions. The apparel industry has moved from a commodity exports model to successfully targeting niche markets for higher-value added production. The IT sector has also grown, with Sri Lanka most recently ranked 16th as a destination for locating Business and Knowledge Process Outsourcing services in the Global Services Location Index in 2014,³⁷ moving up from 29th in 2007. Several Sri Lankan IT companies have attained global recognition in providing software solutions for stock exchanges, mobile and internet payments/banking, human resources management, supply chain and retail management, simulation games for the defense industry, and technology product design (software and hardware integrated engineering).

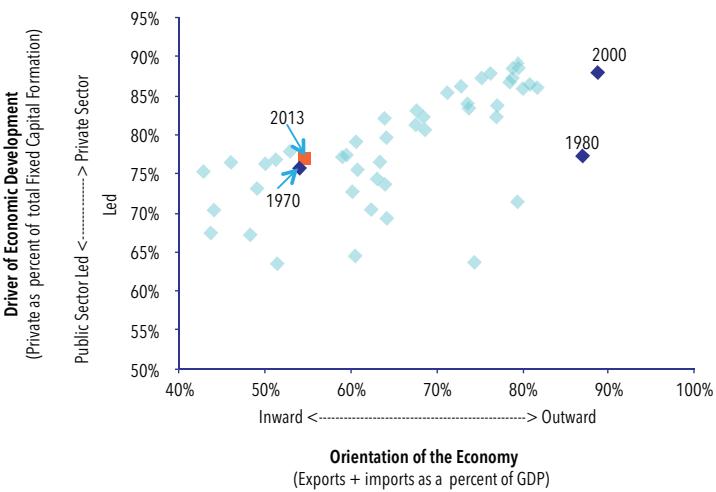
130. For Sri Lanka to capitalize on its location, human and physical assets, and demonstrated capacity to develop globally competitive firms, it will need to find an effective balance along two axes: (i) inward vs. outward orientation of the economy; and (ii) the respective roles of the public and private sectors. The story of Sri Lanka's economic development over the past 30 years has been dominated by the country's movement along these two dimensions (Figure 4.2). In the past decade, policies have moved the country towards a more inward-looking, public sector-dominated model. This model of growth led by domestic consumption, and to a lesser extent public spending, has made it an outlier compared to other fast-growing countries in Asia, which are more export oriented. Given the fiscal pressures discussed in Chapter III, it will be difficult to sustain high levels of growth by relying on the public sector alone. While there is no "right" location on either axis, Sri Lanka's progress going forward will likely involve recalibrating its economic orientation and the role of the public sector.

Sri Lanka needs an effective balance of inwards vs outward orientation and between the public and private sectors

public sector alone. While there is no "right" location on either axis, Sri Lanka's progress going forward will likely involve recalibrating its economic orientation and the role of the public sector.

131. The Global Competitive Index (GCI) suggests

Figure 4.2 Balancing between inward vs. outward orientation and public vs. private sector driven development; Sri Lanka 1965-2013



Source: World Development Indicators. All data refer to Sri Lanka

that Sri Lanka is less competitive on measures that reflect openness and the quality of government intervention. The GCI points to particular weaknesses in terms of property rights, favoritism in government policy, and labor legislation. The Index's scores for most indicators (and all indicators in the Figure 4.3) are based on assessments of business executives familiar with Sri Lanka and, as such, provide an independent qualitative assessment of the strengths and weaknesses of the business environment.³⁸

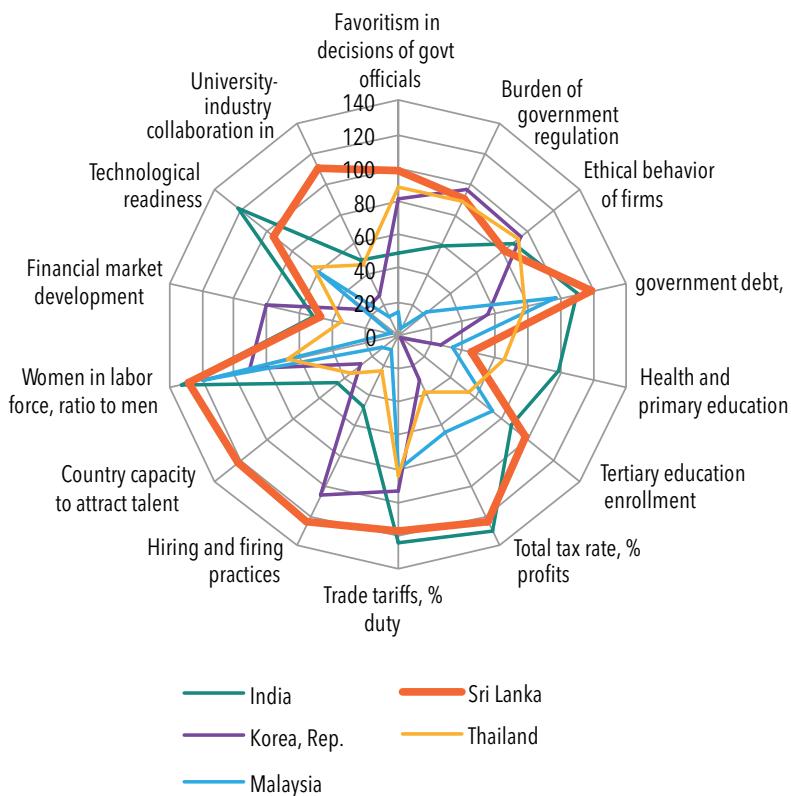
B. Inward versus Outward Orientation of Economic Activity

132. Sri Lanka is smaller and less open today than it was for most of the last 30 years. Before 1977, Sri Lanka's development strategy, based on import substitution, aimed to create a comprehensive welfare state. Post-1977, reforms aimed to liberalize the foreign trade regime and Sri Lanka was seen as the first country in South Asia to significantly open its borders to trade and foreign direct investment. In the decades that followed, trade of goods and services increased to 89 percent of GDP in 2000, with tea and high-end apparel exports leading the way. After the beginning of the new millennium, however, trade steadily declined to 54 percent of GDP in 2013. FDI remains at below 2 percent of GDP five years after the end of armed

³⁷ GSLI is released by A.T. Kearney, a technology consultancy.

³⁸ In the case of Sri Lanka there were 100 respondents to the survey.

Figure 4.3 Obstacles to global competitiveness, rankings

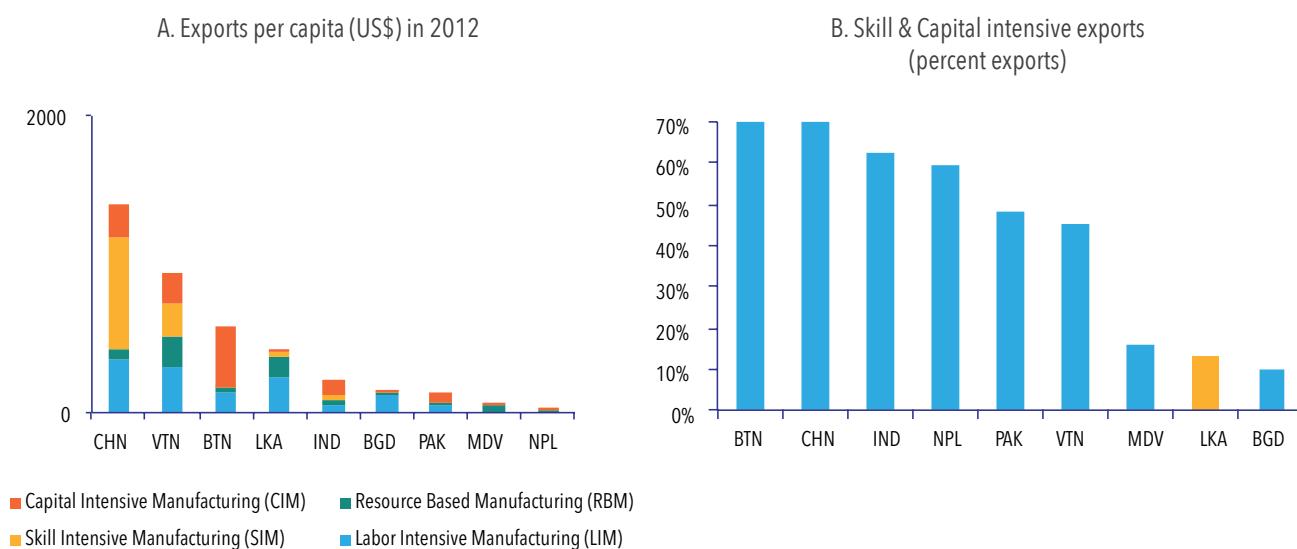


Source: World Economic Forum, 2014-15

conflict. The decline in openness and stagnating FDI took place when the rest of the world was integrating more strongly and global trade was accelerating. Sri Lanka's world market share has consequently declined to levels last seen in the 1980s.

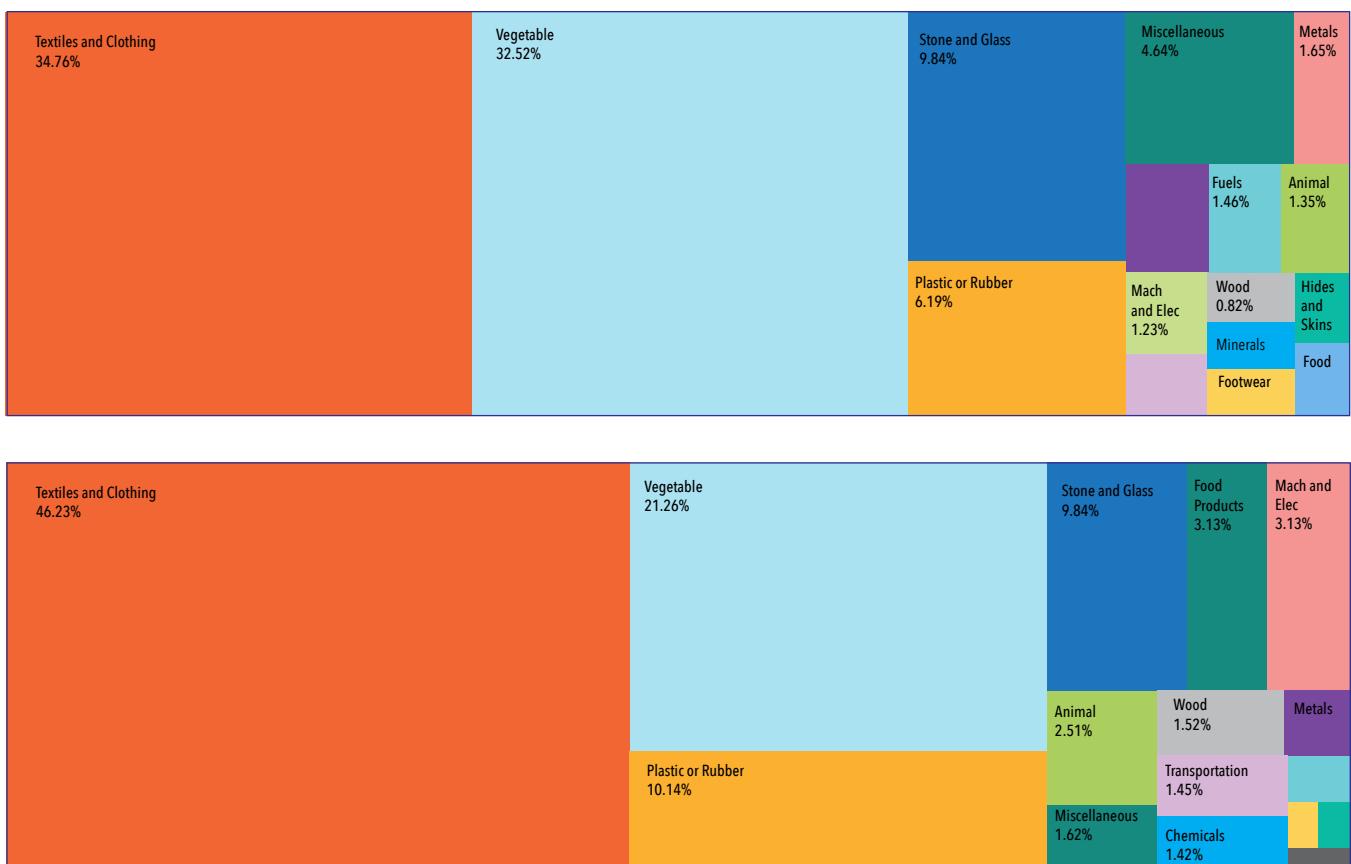
133. Overall export performance is mainly in unsophisticated product lines, notwithstanding the success of some niche companies. Sri Lanka's exports of manufactured goods per capita are only one-third and less than half of China's or Vietnam's levels, respectively (Figure 4.4A). Not much more than one-tenth of the exports are for skill- and capital-intensive production with the rest being low-added value skills and resource intensive products (Figure 4.4B). IT exports tripled between 2007 and 2014, but still make up less than 4 percent of total exports. Sri Lanka's export performance highlights the huge untapped potential in the tradable sector. It also implies that there are significant barriers holding back private creativity to realize the eco-

Figure 4.4 Exports per capita are low and Labor-intensive



Source: World Bank Poverty Assessment 2015

Figure 4.5 Sri Lanka's exports by product category in 1990 vs 2013



Source: World Integrated Trade Solution.

nomic potential of Sri Lanka's relatively educated labor force. Additionally, the export product categories have remained largely the same over two decades (Figure 4.5).

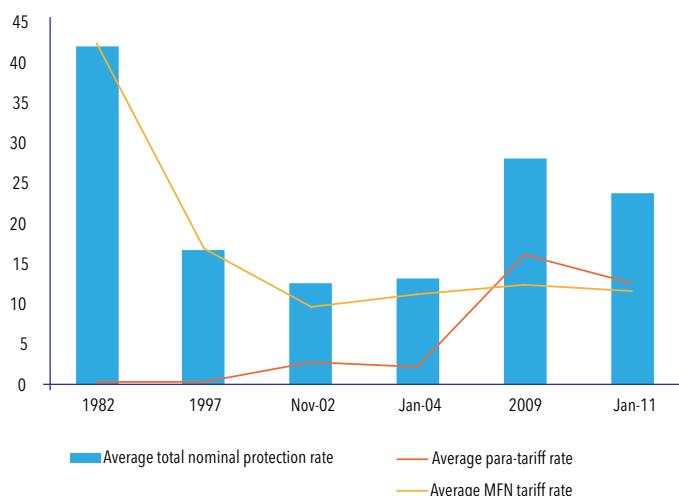
134. What explains the inward orientation and lack of diversification? This section aims to unpack the reasons for the relatively slow growth in exports and lack of dynamism in the emergence of new economic sectors. In addition to trade and industrial policies and regulatory hurdles, the focus will be on the barriers to attracting FDI, the availability of skills for a competitive economy, and innovation policies that promote diversification.

Trade and Industrial Policies

135. Sri Lanka's export production basket is still a reflection of the outward-oriented economic policies adopted in the years following the two waves of liberalization – first in 1977-79 and then in 1990-92. The government created Export Processing Zones (EPZs) – in-

dustrial parks with preferential tax treatment and specific regulatory conditions aimed at attracting manufacturing FDI. Originally adopted as a policy objective in 1978, EPZs took on greater prominence during the second phase of reform in the 1990s, with the establishment of the BOI, and continued to be used as a strategy to encourage FDI and boost manufacturing exports. The government extended incentives to industry to set up in EPZs, provided special customs facilitation, duty-free imports of intermediate inputs and equipment, tax exemptions and preferential tax rates, streamlined administration, and subsidized utilities. A parallel policy objective during this time was the industrialization of rural communities (targeting employment for rural youth) and the expansion of the apparel industry through the implementation of the 200 Garment Factories Program. This was aimed at both domestic and foreign investors, inside and outside the EPZs. Much of the early investment into the EPZs was by foreign firms and concentrated in the garments sector, taking advantage of the Multi Fiber Agreement quota for garment exports to EU

Figure 4.6 Nominal trade protection, 1982–January 2011 (percent)



Source: Kaminski and Ng 2012.

markets. This then explains part of the structural transformation described in Chapter II: whereas foreign export-oriented manufacturing firms accounted for only 24 percent of the total in 1977, they accounted for around 80 percent of all manufacturing exports in the 1990s. Firms with an agreement with the BOI accounted for half of manufacturing exports by the 1990s. The establishment of manufacturing export firms attracted international buying groups with links to these foreign firms, establishing local offices in Sri Lanka.

136. While Sri Lanka's industrial policy has been broadly market-oriented since liberalization in the 1970s, the degree of outward orientation has wavered.

There has been a noticeable slide towards protectionism in the last decade

The two rounds of economic liberalization introduced a series of reforms towards deregulating the economy, accompanied by a strong focus on export orientation and FDI promotion. These reform rounds were accompanied by incentives to promote exports, including a favorable special tax regime and favorable operating environments with easier customs facilitation and import duty cuts. But in the last decade (since the mid-2000s), there has been a noticeable slide towards protectionism and industrial policy has focused more on promoting domestic enterprises.³⁹

³⁹ Kaminski B and Ng F (2013) 'Increase in Protectionism and its Impact on Sri Lanka's Performance in Global Markets', World Bank, p3.

137. There has been an increase in para-tariffs in the past decade. This has not only significantly increased nominal protection and prices of imports, but has also added to trade policy complexity. The combined system of the Most Favoured Nation applied tariff rate and the para-tariffs has made the present import regime one of the most complex and protectionist in the world.⁴⁰ Implementing para-tariffs has effectively doubled the protection rates to 24 percent (Figure 4.6). Worse still is the para-tariffs' dispersion, which leads to prices that distort production and consumption patterns. Last, higher rates of protection on final products than on inputs used in their production lead to high effective protection rates and anti-export bias, because producers have strong incentive to sell goods domestically even though their domestic costs are higher than their opportunity costs through trade. This is particularly worrying in the case of the agricultural sector, given that a large share of the bottom 40 percent of the population continues to be agricultural producers. Trade barriers also make it more difficult for local producers to access inputs, reducing their competitiveness and ability to integrate in global value chains. Firms are also less likely to invest in capital equipment that would raise productivity and promote technology transfers.

138. Stagnating product diversification and weak export performance has come on the back of an industrial policy orientation in the past decade that does not promote competition and aims to protect domestic industry. Although successive governments after 1977 carried out ad hoc import substitution policies, these did not have a significant aggregate impact on trade policy. The decade since 2005 has seen the most extensive measures adopted, where the focus noticeably tilted towards promotion of domestic agriculture (with generous subsidies and guaranteed prices), domestic industries (with specific tax breaks and tariff protection), and wide-scale public infrastructure programs (particularly connective infrastructure like highways and ports).

139. The government has been interventionist, "tilting the playing field" in many areas through a web of tax and trade policy incentives for a large number of domestic sectors and actors. As noted in Chapter II, there are now over 500 VAT exemptions for various industries and actors and 48 various types of income-tax holidays, many of which are quite expansive (such as "new undertakings in less developed areas"). Many of the incentives appear to benefit a specific, small set of firms. For instance,

⁴⁰ Pursell 2011a,b

in 2012, the government announced fiscal measures to support import substitution industries in cement, pharmaceuticals, steel, fabric and milk powder. Without any wide scale existing local entrepreneurship in these sectors to take advantage of these concessions, it was apparent that such measures were targeted to benefit a handful of firms.

140. FDI has also been promoted through incentives for specific investors provided through BOI and under the Strategic Development Projects (SDP) Act, giving government a large, direct role. The SDP Act in particular provides fast-track approvals, exemptions from a range of income and border taxes, and special treatment on land ownership. The act allows for negotiation of individual deals and the eligibility of projects are discretionary; whether a project is strategic in nature can be left to interpretation by the subject minister, so long as it is in a sector that is specified in the act. Many of the 13 SDPs that have been approved have been unsolicited proposals. There is little reporting on their terms, particularly tax benefits and the terms for use of land, nor is it possible to determine fiscal impacts by available budget data. The upshot of these regimes is that prospective investors have a strong incentive to negotiate with government to secure privileges. This is particularly the case with SDPs where terms are decided on a case-by-case basis; BOI incentives are uniform for all investors.

141. The government has also made attempts to encourage greater domestic value-addition of manufactured exports as well as commodity exports. This was done by introducing high taxes (called ‘cesses’) on exports in “raw form” as determined by the government. The taxes are primarily imposed on exports of tea, rubber, cinnamon, coconut and spices. Revenues from cesses are supposed to be then invested in R&D for the corresponding sectors again to encourage value addition. It is yet to be seen whether this has had any significant impact on boosting value-added exports of primary commodities. These policy measures would need to be accompanied by steps to increase competitiveness and innovation of firms in these sectors to truly be able to move up the value chain. The falling prices of key commodities – like natural rubber (due to the global expansion of synthetic rubber) – have also hurt the ability of traditional firms to finance industrial upgrading in line with government policy directions.

142. Inward orientation and lack of diversification are reflected in the structural characteristics of Sri Lanka’s agriculture sector. Although, agriculture has contributed about one-third to Sri Lanka’s poverty reduction over the past decade (Chapter II), the sector has remained in a low productivity equilibrium including the plantation (tea, coconut, rubber) and field crops sectors. Achieving self-sufficiency in rice has been a success but has also meant that

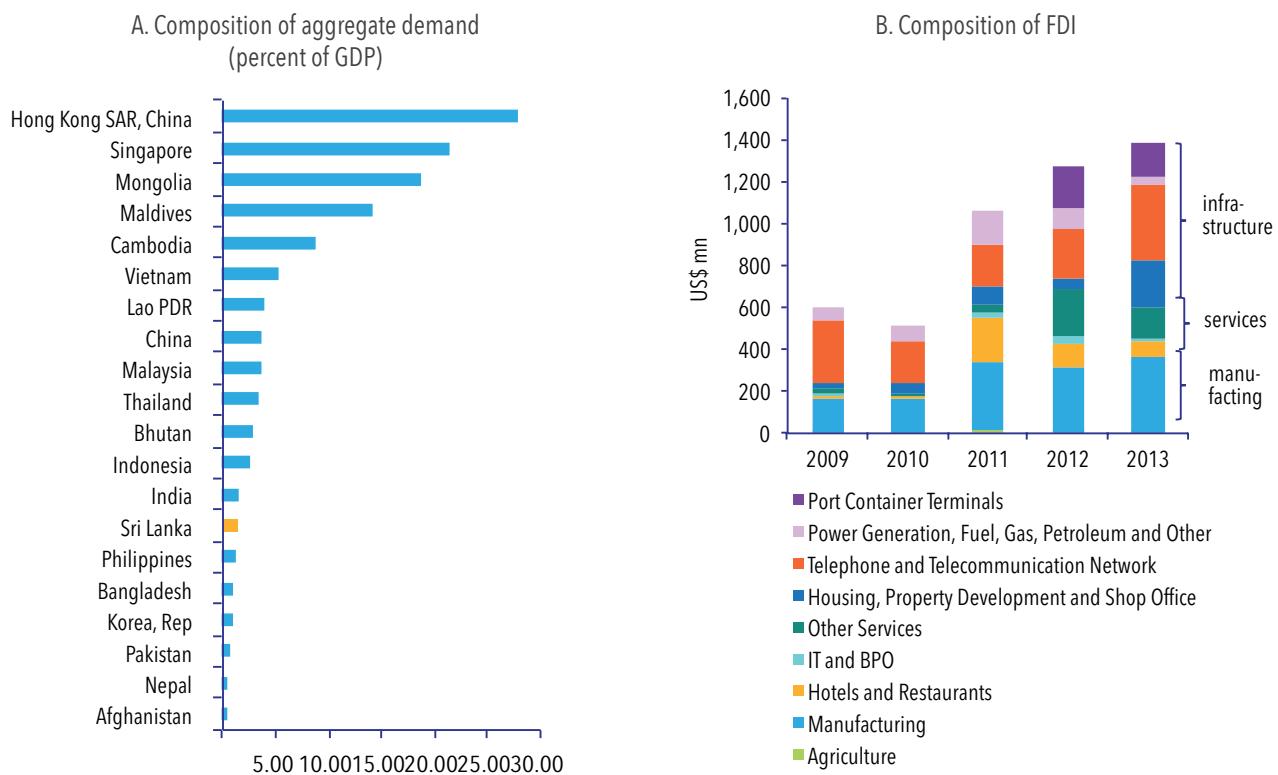
Sri Lanka’s agriculture production structure has remained concentrated in the basic and relatively low-value food crop. In 2013, about 66 percent of the cultivated area was under rice cultivation but the share of rice in the overall value of crop production was only about 20 percent. Despite growing domestic demand and potential for export growth, higher-valued crops, in particular fruits and vegetables have not expanded, while growing demand has been met by increased imports of, for example, dairy products, potatoes, onions and maize.

143. A recent EU ban on Sri Lankan fish exports further limits export potential in a sector that is important for the bottom 40 percent. In February 2015, the EU imposed a ban on fish imports from Sri Lanka over concerns on Illegal, Unreported, Unregulated fishing. The EU is the main destination of fish exports of Sri Lanka, with about 42 percent of fish exports being shipped to the EU in 2013. The fisheries sector employs an estimated one million citizens, contributing over 1.8 percent of GDP in 2014. Much of the population involved in this sector is located in the Northern and Eastern Provinces. Recent analysis using a Computable General Equilibrium model found that the overall effect of the ban on Sri Lankan fish could cause a decline in Sri Lanka’s GDP growth rate by 0.01 percentage points and a 3 percent increase in poverty from 6.74 to 6.94 percent.⁴¹ Although the ban is on the fishing sector, unskilled workers in agriculture and other sectors are likely to be the most adversely affected due to inter-sectoral linkages and because of increased competition with workers who lose their fishing jobs.

144. Sri Lanka’s new policy makers will need to review and revise the country’s trade-related policies in order to promote economic diversification and shared growth. The links between growth performance and specific trade policies are ambiguous and depend on many endogenous and exogenous factors such as factor endowments, geographical location, demography, etc. Each policy comes with its own set of challenges. For example, import substitution laid the foundation for industrialization in Brazil but at some point led the economy to collapse under the weight of accumulated inefficiencies. Some East Asian countries (e.g. Japan, South Korea) caught up with developed economies while keeping multinational corporations and FDI largely out of the country whereas others (e.g. Malaysia, Singapore, Thailand) actively sought to attract foreign investors and benefited from positive spillovers. In the case of Sri Lanka, moving from growth fueled by reconstruction and infrastructure towards growth based on a diversified and competitive economy will likely require a rethinking of the policies in place and their suit-

⁴¹ Sahin et al, 2015.

Figure 4.7 Net Inflows and composition of FDI



Source: World Bank World Development Indicators

ability as foundations for the economy of the future.

Attracting and Retaining Efficiency-Enhancing Foreign Direct Investment (FDI)

145. FDI is needed as a foundation for economic diversification, but Sri Lanka's performance has been disappointing. In addition to boosting investment necessary for growth and providing long-term balance of payments financing, FDI can help enhance the sophistication of Sri Lankan products and exports through introduction of new technologies and production processes. It can also give rise to positive spillovers through improvement of skills and introduction of new management practices. Finally, FDI can enhance access of Sri Lankan producers to global production networks and facilitate the development of new activities within existing value chains (increasing value added in production). However, FDI in Sri Lanka has been lower than in peer countries in spite of Sri Lanka's comparative advantages, such as its location and access to major markets (Figure 4.7).

Levels of FDI have been disappointing

gives rise to positive spillovers through improvement of skills and introduction of new management practices. Finally, FDI can enhance

access of Sri Lankan producers to global production networks and facilitate the development of new activities within existing value chains (increasing value added in production). However, FDI in Sri Lanka has been lower than in peer countries in spite of Sri Lanka's comparative advantages, such as its location and access to major markets (Figure 4.7).

146. Not all FDI has the same potential for positive spillovers to the economy. FDI inflows to Sri Lanka have been largely focused on infrastructure (inclusive of real estate development), with a relatively small proportion reaching sectors of the economy that are associated with global networks of production (Figure 4.7B). There are broadly three types of FDI: (i) natural-resource-seeking; (ii) market-seeking; and (iii) efficiency-seeking. When considering investment policy, it is critical to acknowledge that the factors that motivate, dissuade and impact investors are vastly different depending on the business they are in, and the markets they target. The basic motivations of an investor provide an insight into the socio-economic impacts that the firm may have in Sri Lanka. Countries often make the mistake of designing investment policies around the type of foreign investments that they already have, rather than tailoring policies to suit the type of investment that they want to grow. In that regard, it is important for authorities to identify those types of investors that are more likely to make a positive contribution to the domestic economy. In turn, this identification should be consistent with the investment policy that is developed for the country.

Box 4.2 Global experience in attracting and retaining FDI: infrastructure and incentives are not major factors

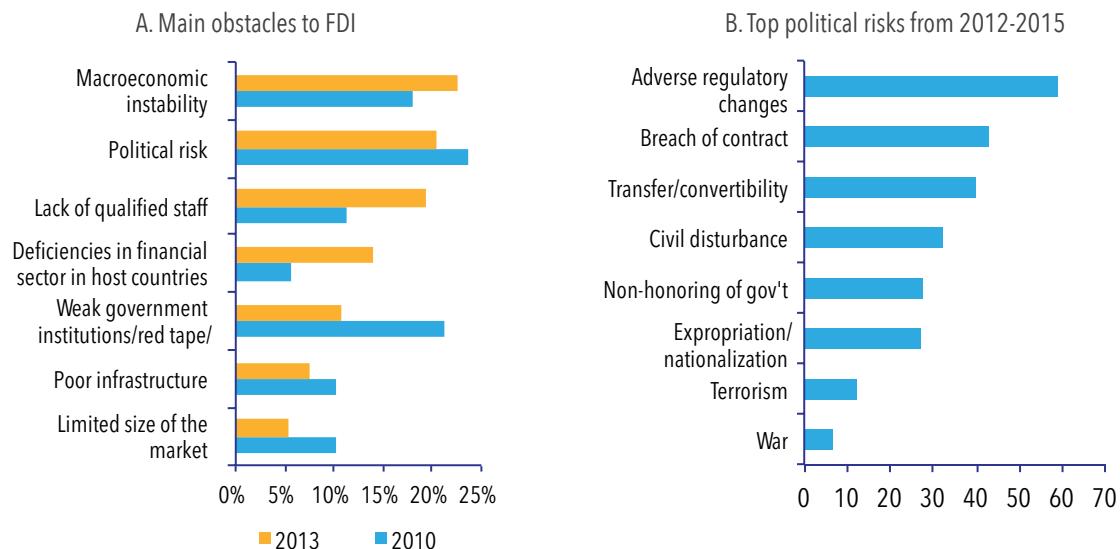
The Multilateral Investment Guarantee Agency conducted a Global Investment and Political Risk survey of investors in 2013 to identify the main factors that inform the selection of investment destinations. Global investors seek macroeconomic and political stability in the host country as a foundation. Beyond that, the availability of qualified staff is the most important decision element, and one that has grown rapidly in relevance over the past few years. Other factors, such as the availability of infrastructure, have substantially decreased in importance when investors select locations. Notably, while the size of the domestic market used to be a major decision factor, it has become less important owing to shifting interest towards efficiency and linkages to global markets. The views of global investors offer insights that can be used to determine the priorities for policies and investments aimed at attracting and retaining FDI. They also highlight the fact that bringing FDI to Sri Lanka will require much more than investment in infrastructure and incentives to investors. Research on other countries has demonstrated that: (i) incentives alone can be insufficient to attract efficiency-enhancing FDI; (ii) retention of FDI is low as incentives pose a significant fiscal strain and investors often switch investment destinations when incentives dry up; and (iii) fixing enabling-environment deficiencies can be more effective than offering incentives to cover for such deficiencies.

Sri Lanka may consider other factors to attract investment, including:

- Minimizing uncertainty and fostering investor confidence through certainty on policies and regulations.
- Eliminating unnecessary regulatory and policy obstacles to FDI.
- Investing in education to ensure that the population (and especially the youth) has the skills demanded by efficiency-enhancing enterprises (see below).
- Establishing a level playing field that fosters competition and eliminates preferential treatment for specific public or private players.
- Developing a well-functioning financial sector that can actively contribute to the development of local firms that can be part of the ecosystem around foreign enterprises.

Minimizing uncertainty and fostering investor confidence. Governments have a major role in building investor confidence through ensuring predictability and consistency in regulations that govern the activities of foreign investors, as well as protecting investor rights and ownership. Arguably, this confidence is particularly important in attracting efficiency-seeking investors, whose business model depend on productivity and reliability of production (which can be easily disrupted by regulatory changes), rather than on cheap access to natural resources. Recent actions including the appropriation of 37 "underutilized" assets, as well as the proposed/upcoming changes to land laws, significantly undermine the confidence of foreign investors on Sri Lanka, and reduce its competitiveness as a long-term investment

Factors that inform the selection of investment destinations



Source: MIGA (2013) World Investment and Political Risk Report, IBRD/World Bank.

destination in favor of jurisdictions that can provide a higher degree of certainty to foreign investors.

Investment entry barriers include both (de jure) rule-based, legal barriers and (de facto) factual barriers that arise on the ground. Although most countries in the world seek to attract foreign investment, very few countries maintain an entirely open investment regime. Some limitations may intentionally discriminate against foreign firms, such as when a country closes a sector for security or cultural reasons, or protects a domestic industry. Other limitations may arise as a substitute for regulation, or because of institutional dynamics and inefficiencies. In addition to policy obstacles, there are procedural barriers, including documentation requirements, as well as de facto barriers such as lack of enforcement or excessive discretion on the part of public officials. Research conducted on OECD countries, estimated FDI increases after the removal of specific restrictions (Table B1). While these figures may not necessarily reflect the situation in Sri Lanka, they highlight the potential of reforms in enhancing the attractiveness of a country as an investment destination. In the case of Sri Lanka, the World Bank has not undertaken a formal assessment of specific barriers. Such analysis would help in order to identify the current obstacles that may be further reducing the attractiveness of the country as an investment destination.

Table B1 FDI Flows: the hypothetical effect of removing FDI restrictions

Type of FDI restriction removed	Percent change in inward FDI
Removal of foreign equity ceilings	77.9
Removal of approval and national interest tests	21.2
Easing of nationality requirements on management	10.1

Source: OECD Research (2003)

147. Using incentives may not be an effective tool to attract efficiency-enhancing FDI to Sri Lanka. Investment incentives can be used to compete for potential investors; to encourage certain business practices; and to attract investment into priority regions and priority sectors. However, evidence from both survey and econometric studies indicate that the key determinants affecting an investor's decision on where to locate are often based on broad economic and investment climate factors such as market size, regulatory policies, natural resource endowments, infrastructure, and human capital availability (Box 4.2).⁴² Investment incentives, therefore, tend to be most relevant at the margins of investor decision-making; they are likely to be most influential when investors are wavering between similar options, and when a country already has a favorable investment climate. As Sri Lanka seeks to enhance the attraction and retention of FDI with positive

transformative potential, it should analyze the effectiveness and adequacy of incentives together with the costs involved in fiscal losses and potential disruption of market dynamics (through, *inter alia*, the creation of an unlevelled playing field).

Ensuring Human Capital and Skills for Competitiveness

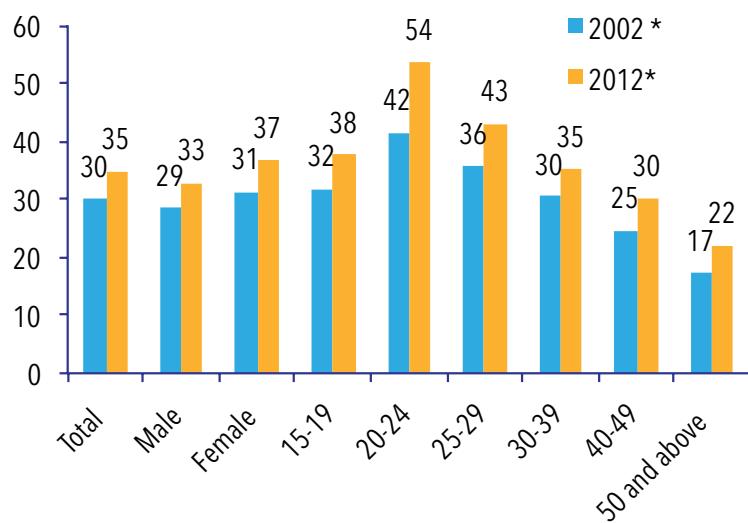
148. The challenges of competing in the global economy require not only high human capital and advanced skills but also a workforce that can adjust to shifts in domestic and global demand. Education and training are fundamental for a competitive economy, especially for the production of high-value-added goods and services.⁴³ International evidence shows that skills are key to improving the welfare of individuals and ensuring that the private sector can innovate and adjust to greater global competition, master processes that will increase productivity, and attract and retain FDI.

149. Educational attainment of the Sri Lankan work-

⁴² While many countries have sought to attract FDI through offering incentives to investors, research has demonstrated that a) incentives alone can be insufficient to attract efficiency-enhancing FDI, b) retention of FDI is low as incentives pose a significant fiscal strain and investors often switch investment destinations when incentives dry up, and c) fixing enabling environment deficiencies can be more effective than offering incentives to cover for such deficiencies.

⁴³ Ashton and Green (1996)

Figure 4.8 Completed O-levels by age group



Source: World Bank using Labor Force Survey

* Excludes Northern and Eastern Provinces.

ing age population has improved. The proportion of those who have completed O-levels has increased from 30 to 35 percent, with a higher increase for females than for males, and higher for youth than for adults (Figure 4.8). For example from 2002 to 2012, the number of 20 to 24 year olds with O-levels increased by 12 percentage points (42 to 54 percent) while for 25 to 29 year olds it increased by only 7 percentage points (from 36 to 43 percent). Younger

cohorts are not only more educated in general, but their educational attainment has increased over time. For example, the proportion of individuals with O-levels and A-levels is 11 percentage points higher for 20 to 24 year olds than for 25 to 29 year olds, while the proportion of those with degrees or more for 25 to 29 year olds are higher (5 percent) compared to older age groups (4 percent for 30 to 39 year olds and 3 percent for 40 to 49 year-olds).

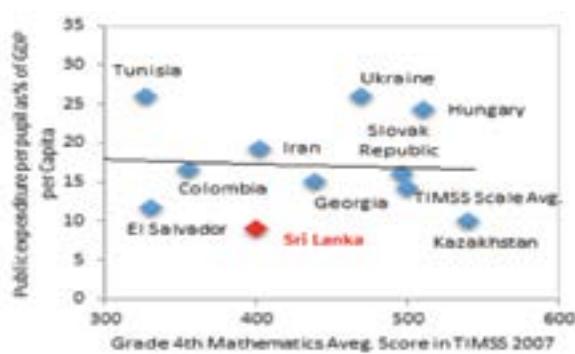
Despite the past positive achievements, the quality of general education lags that of many higher middle-income countries. Sri Lanka's quality of education, as measured by annual national assessments of learning outcomes and periodic internationally comparable tests, lags that

of several higher middle-income countries, particularly in language and numeracy skills (Figure 4.9A).⁴⁴ In particular, if Sri Lanka aims to improve its educational outcomes it will likely need to increase the resources devoted to edu-

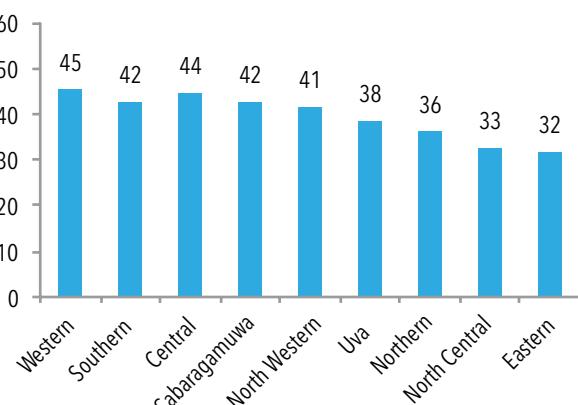
⁴⁴ Dundar et al. (2014), Aturupane et al. (2014). Country selection based on data availability.

Figure 4.9 Learning outcomes

A. Learning Outcomes in Sri Lanka and Comparator Countries, 2010



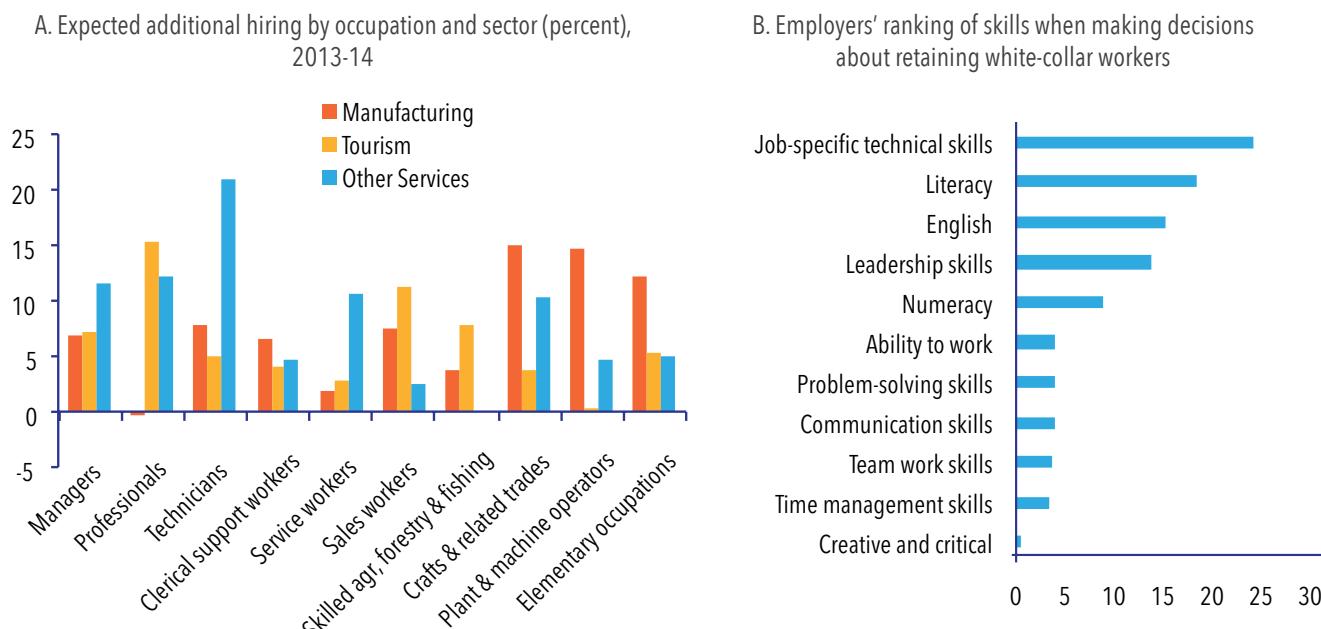
B. Cognitive Test Scores for Students in English in Sri Lanka's Provinces, 2012



Source: National Education Research and Evaluation Center, University of Colombo, 2010.

Note: TIMSS is Trends in International Mathematics and Science Study, an international assessment.

Figure 4.10 Increasing demand for workers with better skills



Source: Dundar H et al (2014).

cation. This is especially the case in rural and estate sectors, and among students from the types of schools attended by low-income households where educational outcomes are weaker.⁴⁵ Furthermore, there is significant variation in learning outcomes among provinces (Figure 4.9B).

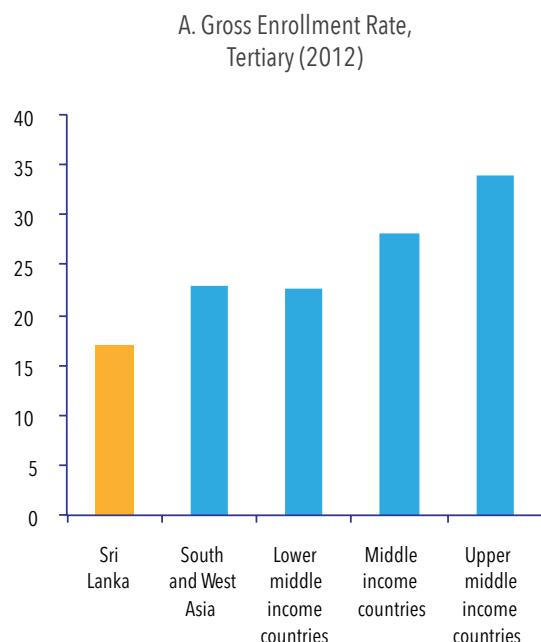
151. Moreover, Sri Lanka has a shortage of adequate vocational and technical skills in its workforce, skills that are increasingly in demand. Although there is an increasing demand for mid-level technicians, in particular in the services sector, and low-skilled workers in manufacturing, only 16 percent of workers have completed technical and vocational education and training (TVET), and only 73 percent of those have acquired few, if any, job-relevant skills (Figure 4.10). Just 16 percent of workers know how to use a computer and 24 percent have proficiency in English. Aptitude for these skills is lowest in the rural and low-skilled parts of the population. Many existing training programs in the TVET sector suffer from low quality and a lack of relevance to the skills demanded by employers. Importantly, the links between vocational training centers and industry are missing. In fact, 46 percent of employers indicate that job-specific skills are the most important factor in deciding whether to retain a high-skilled worker

and 38 percent said the same about retaining low-skilled workers.

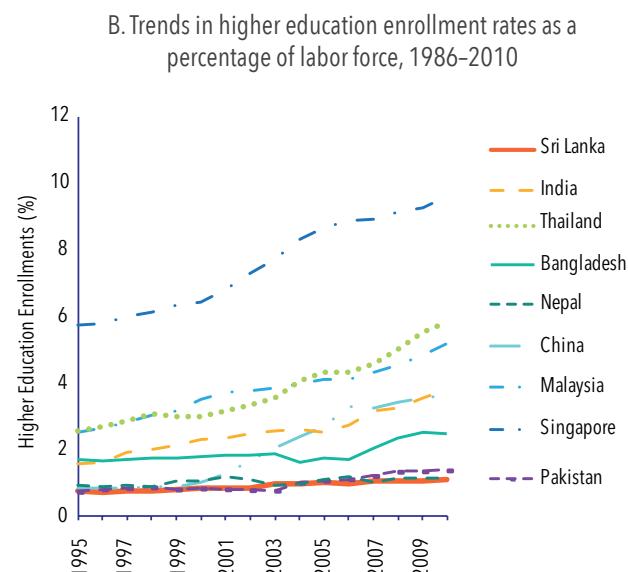
152. When it comes to advanced skills and human capital, Sri Lanka has very few highly skilled workers, and there are constraints on the quality and relevance of higher education and research.⁴⁶ Sri Lanka lags in higher education enrollment compared to other middle-income countries (Figure 4.11A). Moreover, enrollment in tertiary education as a proportion of labor force averaged just 1 percent since 1995, far below enrollment rates in other fast-growing economies in East Asia (Figure 4.11B). Overall enrollment in higher education for 20- to 24-years-olds in Sri Lanka is about 17 percent, whereas the average higher education enrollment rate for middle-income countries is about 30 percent.

Higher education enrollment is low compared to other middle income countries and has structural defects which yield a small pool of graduates with relevant advanced skills

Figure 4.11 Sri Lanka has a small stock of highly skilled workers, with trends that are not encouraging



Source: UIS <http://data UIS.unesco.org/#>



Source: Chellaraj 2012

153. The structure and composition of Sri Lanka's higher education enrollment has multiple defects.⁴⁷

First, the largest share of enrollment, nearly 60 percent, is in external degree programs (EDPs), where students are enrolled in universities and sit examinations, but do not follow lectures or classes, and receive no academic support from the university. This is a low-cost option for the government to expand higher education access and coverage: but it is at the expense of quality. The greatest proportion of unemployed graduates is drawn from these EDPs. Second, the balance between enrollment in the public sector and in the private sector is heavily skewed against the private sector, which has only 12 percent of enrollment. This is due to Sri Lanka's strongly state-centered higher education system. A major constraint to expanding private-sector participation is the absence of a clear and transparent process for private higher education institutions to register and obtain quality and accreditation assurances. A third major constraint is the relatively low public investment that has limited the expansion of the public universities, especially in the sciences, technology and engineering. In fact, the proportion of students enrolled in science and engineering has actually begun to decline since 2002.⁴⁸

Indeed, the composition of students in the conventional degree programs of the universities is still dominated by disciplines such as the liberal arts, management, commerce and law, with underrepresentation of scientific and technical fields. A middle-income country, if it is to grow fast, needs a higher proportion of skilled and competent science and technical graduates. Moreover, enrollment in employment-oriented alternative higher education institutions in the public sector is small, at only 3 percent of total higher education enrollment. Finally, leadership and communications skills are some of the non-cognitive abilities of white-collar workers that are most highly prized by Sri Lankan firms. Unfortunately, many soft skills are not learned sufficiently by Sri Lankans through the formal education system. To compete effectively in international markets Sri Lanka's workforce will need to attain a higher level of computer literacy, the ability to operate the latest equipment, and fluency in foreign languages.⁴⁹

154. The result is that Sri Lanka's firms have difficulty accessing the skills they need.

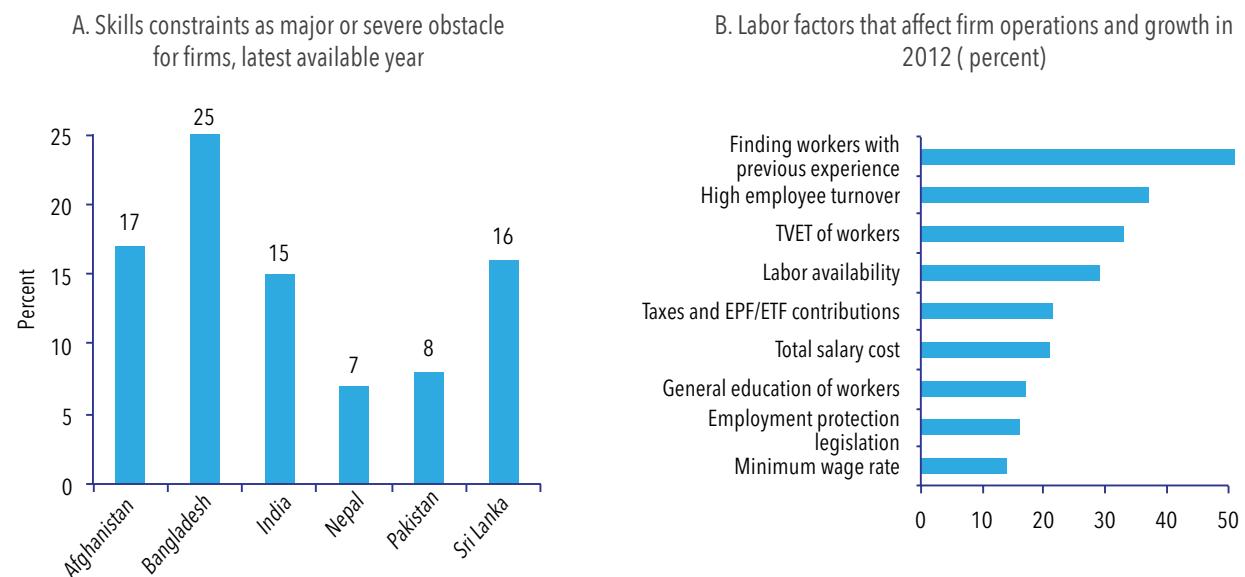
In 2010, manufacturing companies ranked the inadequate education of the labor force as the third most important constraint on their operations, with only Bangladesh and Afghanistan having higher such ratings in South Asia (Figure 4.12). Only elec-

47 See World Bank, 2009b.

48 Chellaraj, 2012

49 Dundar et al. 2014

Figure 4.12 Factors that inform the selection of investment destinations



Source: Dundar H et al (2014).

tricity supply and tax rates were greater concerns. This is a problem that affects firms across all sectors. If these firms cannot find the skills that they need, they will not be able to upgrade their processes and products to compete in a more liberalized trade regime.

155. There is a mismatch between the level and type of skills taught by the education and training system

and what potential employers value.⁵⁰ While 56 percent of employers think that high-skilled workers should pass

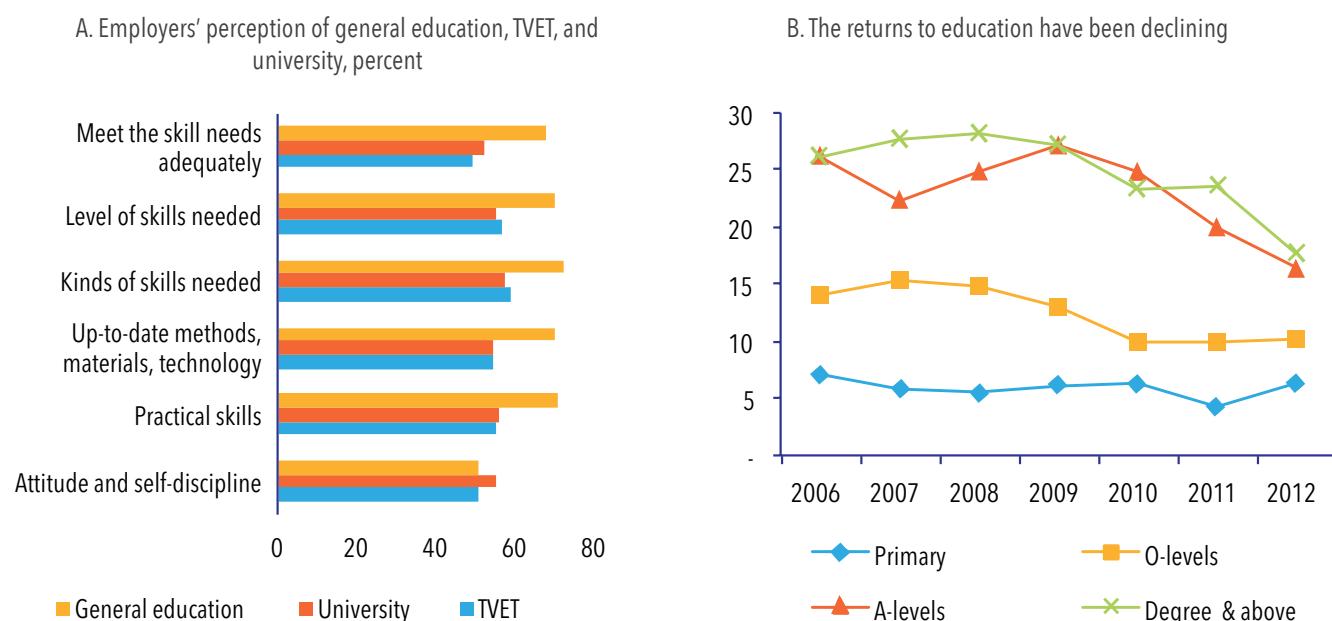
50 Dundar et al (2014). Overall skills stock of the labor force is measured from the STEP household survey of the population 15–64 years old. The employers' view of available skills is measured from the STEP employer survey and serves as a proxy for the skills demand.

Figure 4.13 Education and training mismatches



Source: Sri Lanka STEP Household Skills Measurement and Employer Surveys.

Figure 4.14 Inadequate skills lead to low returns to education



Source: World Bank calculations using Sri Lanka STEP Employers Survey.

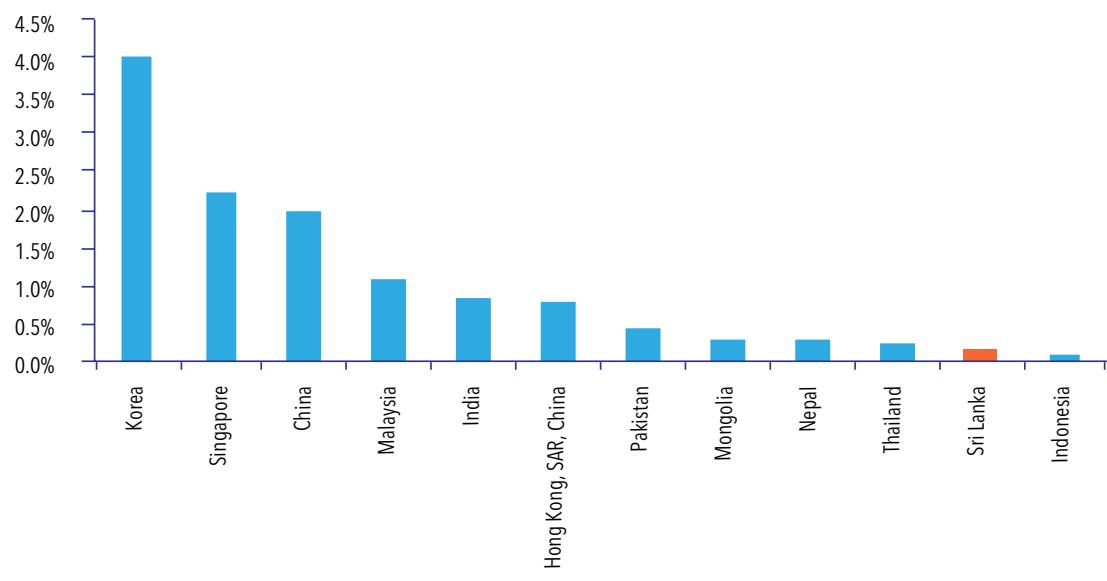
GCE A-levels, only 18 percent of the population has done so.⁵¹ Similarly, 70 percent of employers think that an average low-skilled worker should have passed GCE O-levels, but only 35 percent of low-skilled employees and 40 percent of the self-employed have done so. About 60 percent of employers responding to a survey expected that an average worker in a high-skilled occupation should have completed technical or vocational education and training, and 24 percent think the same about low-skilled workers. Yet only 16 percent of the population has that qualification (Figure 4.13). Similarly, 80 percent of employers expect a high-skilled worker to know English and 40 percent expect that of less-skilled workers while 75 percent of employers think an average higher-skilled worker should have computer skills and 38 percent expect the same of lower-skilled workers. However, only 20 percent of Sri Lankans are fluent in English and only 15 percent can use computers. The supply and demand differences are less stark in workers who are formally employed; the informal sector lags seriously behind.

156. When it comes to vocational training, many employers question the quality and relevance of education and training curricula. Employers believe that the TVET system could be critical for providing the workers they need but feel that it does not convey up-to-date knowledge (50 percent) or produce the kinds (54 percent) or levels (52 percent) of skills needed (Figure 4.14A). To compensate for skills shortages in the labor force many employers train their own workers.

157. The returns to education have been declining. Despite average educational attainment going up, the premium to additional years of education has declined over time (Figure 4.14B). This may be expected when overall average educational attainment increases without a commensurate increase in demand, leading to a decline in the premium from higher education. To demonstrate a mismatch between the demand for skills and the supply of education requires estimating returns to each type of skill under consideration, controlling for the increase in quantity of each such skill. However, to the extent that companies report shortages of well-trained workers, this decline in the returns to education is consistent with the view that Sri Lanka's educational system is not providing the skills desired by the market. This problem is particularly worrisome for the youth, who often wait for years to be admitted into university and then end up with degrees that provide relatively low returns.

51 Based on the employer survey high-skilled workers are those who work as managers, professionals, technicians, and associate professionals; low-skilled workers work in clerical support, services, sales, skilled agriculture, forestry and fishery, crafts and related trades, plant and machine operation and assembly, and low skilled occupations.

Figure 4.15 R&D expenditure (percent of GDP)



Source: World Bank WDI (Sri Lanka as of 2010).

Innovation Policies

158. Promoting innovation and entrepreneurship is essential to increase the competitiveness of Sri Lanka's private sector. While many countries have sought to enhance innovation through direct government support in the form of subsidies and grants, the results and effectiveness of such programs have been mixed at best. Enhancing innovation in Sri Lanka will likely require a long-term innovation policy that fosters linkages between domestic and foreign firms as well as between universities and R&D institutions and the private sector in Sri Lanka. An effective innovation policy will also eliminate costly barriers to imports of capital goods and be in line with policies aimed at attracting efficiency-seeking FDI.

159. Different countries have adopted different innovation policies and there is no one-size-fits-all approach. Sophisticated economies such as South Korea and Singapore have promoted R&D-driven innovation, which leads to the introduction of products and processes that are "new to the world" (Figure 4.16). However, investment in R&D may not be efficient in absence of linkages between R&D institutions and networks of enterprises that can benefit from it. Economies that have yet to catch up with more productive peers often implement policies that seek to accelerate the absorption of existing technologies that are "new to the country" as a way to enhance the productivity of existing industries (Table 4.1). Sri Lanka's ex-

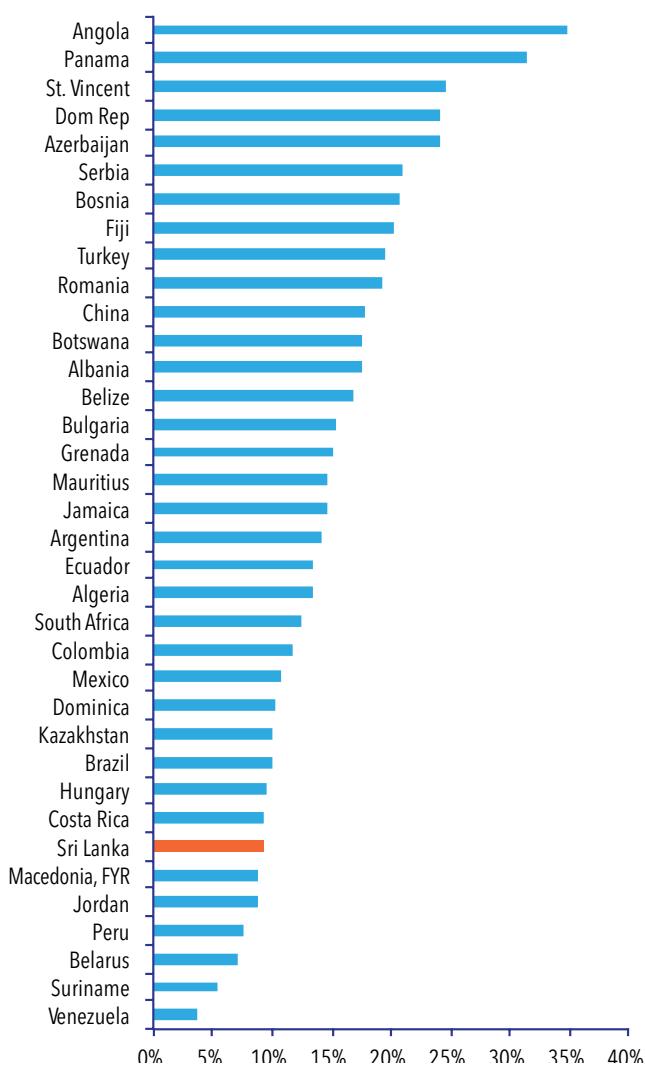
Table 4.1 Technology and development*

	Availability of latest technologies	Firm-level technology absorption	FDI and technology transfer
Bangladesh	99	108	112
China	97	68	81
India	110	102	95
Indonesia	53	42	40
Japan	14	2	55
Malaysia	33	24	8
Mauritius	48	44	57
Pakistan	85	83	90
Philippines	58	41	31
Rep. of Korea	30	28	73
Singapore	15	16	2
Sri Lanka	70	53	53
Thailand	74	55	15
Vietnam	123	121	93

Source: World Economic Forum (2015).

* See <http://reports.weforum.org/global-competitiveness-report-2014-2015/economies/#economy=LKA>

Figure 4.16 Proportion of firms using technology licensed from foreign companies (percent)



Source: World Bank WDI (Sri Lanka as of 2010).

penditure on R&D and formal transfer of technology has been modest compared to other emerging markets (Figure 4.16).

160. Strengthening research and development and promoting collaboration between academia and the private sector is critical. In the past the focus of government has largely been on income tax and VAT incentives to boost R&D, particularly through government institutions. However, two constraints quickly emerged: (i) the small number of suitable government research institutions capable of catering to industry needs; and (ii) the limited capacity in, and low-industry orientation of, government research facilities. Raising overall public and private R&D is important but should be done in the context of knowl-

edge institutions that effectively collaborate with the private sector.

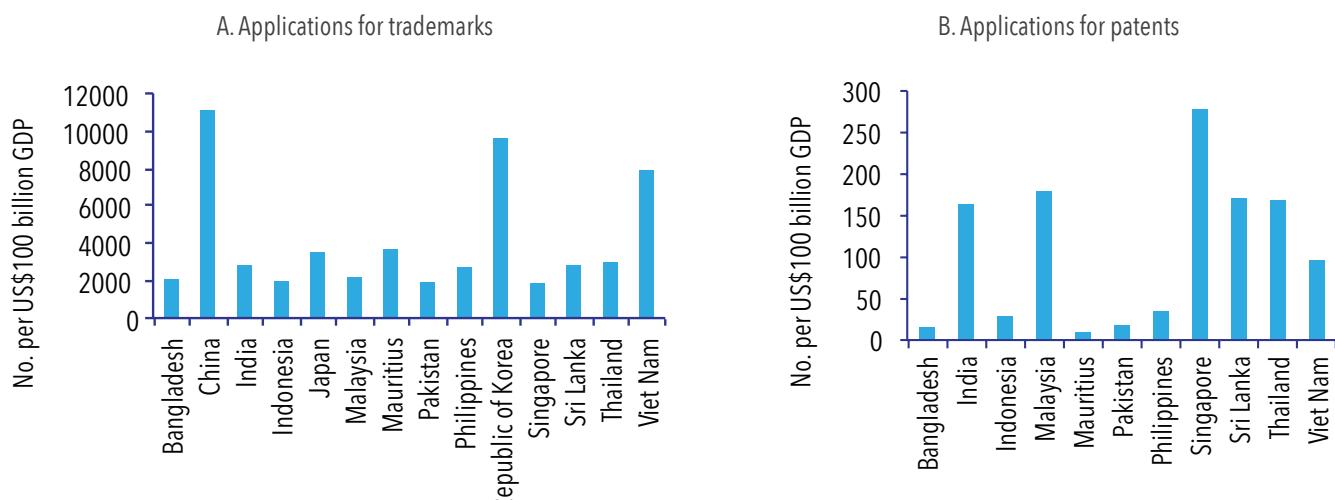
161. Investment in, and quality of, R&D has been insufficient to facilitate effective modernization of agriculture. Sri Lanka has fallen behind in the generation of new knowledge and technology as well as in the distribution of new technologies that are critical for modern farming. The percentage of the agriculture budget allocated for R&D and extension is small compared to other Asian nations. The majority of the country's 23 research institutes focus on traditional sub-sectors and crops, including fisheries, rice, and the plantation crops (tea, rubber, coconut, sugar cane). Very little funding is allocated to higher-value crops (vegetables, fruit, dairy) that are critical to driving sector modernization and exports. In fact, only a small portion of the value of export censes – which are supposed to be the industry's contributions to agricultural R&D (tea, rubber, coconut mainly) -- are given to the research institutes. These institutions focus on physical output of commodities and less explicitly on profitability for its customers. At the same time, publicly run extension services are under-resourced and do not allow for effective diffusion of new technologies. R&D must shift towards a more market-driven approach as farmers diversify their farming systems by producing more high-value crops, livestock, and related products. Sri Lanka would benefit from an overall reorganization of its R&D and extension system, including promoting more private-sector participation.

162. Sri Lanka's potential for innovation and scientific discovery is highlighted by its output of intellectual property where it lags behind some particularly dynamic countries (Figure 4.17). Countries that have moved from middle-income to high-income status tend to show higher levels of patent generation than nations that do not make the jump, and Sri Lanka is likely to need to follow the same path.⁵² Sri Lanka has an intellectual property framework in place but it has scope for improvement.⁵³ Beyond the legal and regulatory framework covering intellectual property

52 Bulman D, Eden M and Nguyen H (2014)

53 See <http://www.wipo.int/wipolex/en/profile.jsp?code=LK> and <http://reports.weforum.org/global-competitiveness-report-2014-2015/economies/#economy=LKA>

Figure 4.17 Applications for trademarks and patents per US\$100 billion GDP, 2013 (total count, by applicants origin)



Source: <http://ipstats.wipo.int/ipstatv2/?lang=en>

rights, there is also scope to strengthen financial services and support mechanisms to foster the commercialization of local inventions and improvements of technology and production techniques.

C. The Relationship between the Public Sector and Private Sector

163. The relationship between the public sector and private sector has been a critical determinant of Sri Lanka's development over the past few decades and will shape its progress going forward. Global experience points to the importance of private-sector-led growth and government regulation to facilitate such growth. Industrial, trade, and tax policies carried out by successive governments – many of them extremely granular in nature -- have shaped the contours of Sri Lanka's economy. The government has also had a major impact on the economy and jobs for the population through regulation of the private sector in terms of market entry and transactions, land use, and labor practices. While all states regulate these issues, particular features of Sri Lanka's approach have led to specific types of constraints. Finally, the state itself is a major participant in the market through its large SOE sector and large public service, which in turn has impacted competitiveness in a number of sectors and labor market dynamics. These government policies have contributed to the emergence of a large informal sector, which further distorts the market and undermines productivity. Addressing constraints evident in the present pattern of the state's interaction with the private sector – improving economic

governance -- is a priority for sustaining growth and expanding employment opportunities for the population as a whole and the bottom 40 percent in particular.

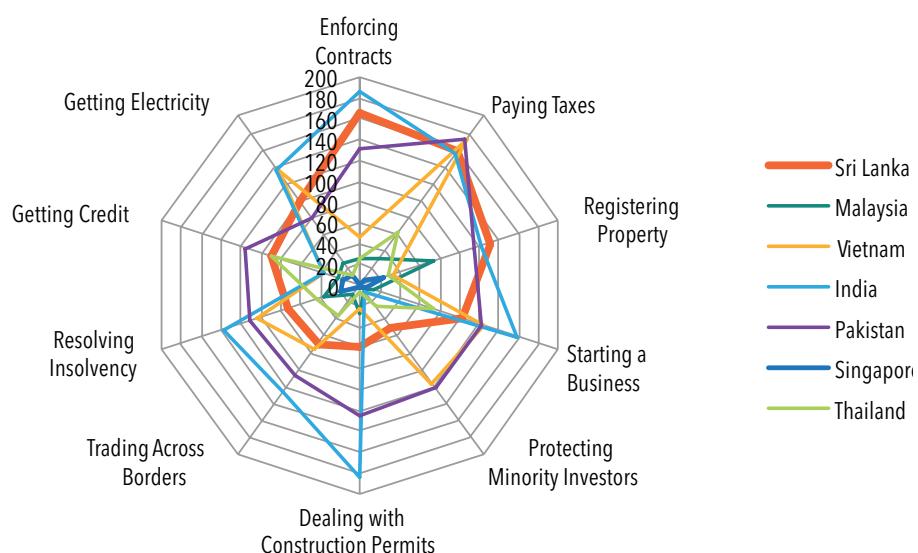
Public Sector Performance as a Regulator

164. The investment climate in Sri Lanka lags behind that of regional peers and is a significant drag on competitiveness going forward. Sri Lanka has made some important reforms over the past years that have translated into improvements in some areas of investment climate. However, most areas of the investment climate remain more challenging than in other regional and LMIC comparators by several measures, including the Ease of Doing Business indicators (Figure 4.18). Going forward, sustainable private-sector-led growth will require the ability of the country to identify and eliminate unnecessary business environment obstacles to entrepreneurship particular to Sri Lanka. This will require more intensive public-private dialogue to involve the private sector in identification of the most significant obstacles to their operations as a way to prioritize reforms. At the same time, after reforms take place on paper, their full and consistent implementation across the country is essential to ensure equal opportunities for entrepreneurs in all regions. Finally, it will be important to assess the impact of reforms to ensure that they have achieved the objective expected.

Regulatory Environment: Land

165. Issues related to regulation of land are viewed as a barrier to business development. Access to land

Figure 4.18 Comparison of rankings, Doing Business 2015



Source: World Bank Doing Business, 2015.

Note: Higher ranking implies lower comparative performance

was among the chief constraints to business cited in the 2011 Enterprise Surveys, and land ownership issues are the most common reason cited by informal firms that do not register.⁵⁴ While larger firms – through the SDP, BOI, and other special regimes – can circumvent some of the difficulties in accessing land, SMEs encounter significant difficulties. In a survey of SMEs (2014)⁵⁵, 62 percent of

Land ownership issues are the most common reason cited by firms that do not register

firms affirmed the complexity of land-acquisition procedures, 65 percent reported that these procedures involve high costs, and 65 percent also reported corruption in the procedures. Doing Business also notes the difficulty in registering a property.

166. The state owns most land, while privately owned land is often subject to disputes over claims. Around 80 percent of land is state-owned, with the state owning all plantation land and common lands (forests, beaches, etc.) and 55 percent of non-plantation cropland, mainly

in large irrigation areas. The state has consistently avoided outright sales of land. Private ownership of agricultural land is restricted to 50 acres per person. There is much anecdotal evidence of a large number of disputes over ownership claims of land in both rural and urban areas. This is caused by both incompleteness and inconsistencies in past registration systems as well as inheritance law, which mandates the partition of land among successors. The system for demarcating and registering tenure rights to land parcels is fragmented among institutions and there is a lack of provisions to resolve disputes over claims to land quickly and conclusively. For these reasons, the vast majority of civil cases in courts

taking more than five years to resolve (and in some cases stretching over decades) relate to partition and land disputes.⁵⁶ Contestation over ownership dampens investment, reduces the efficiency of land markets and ultimately undermines productive use of land assets.

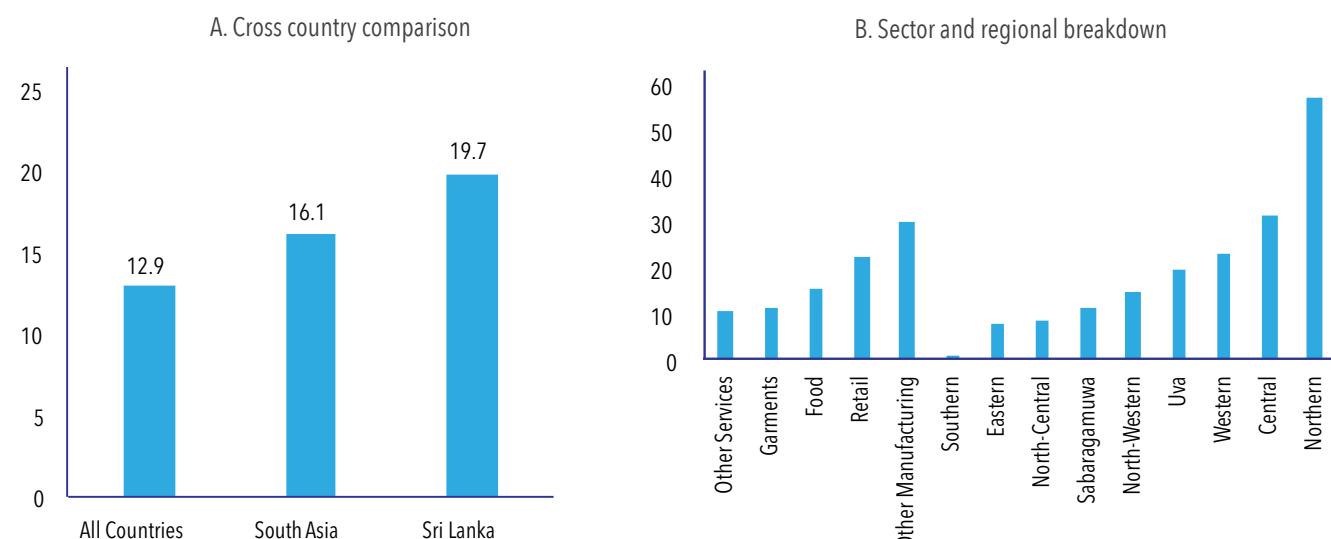
167. Tenure and use regimes of most state-owned land by private parties are regulated by the Land Development Ordinance (LDO). According to this ordinance originating from the 1930s, the state provides the right to occupy and use land in perpetuity subject to restrictions on sale, lease and mortgaging and conditions on failing to use land productively. The provision of rights is in two stages – first “permitted” for a short period of time and then “granted” as a right. Although there are few cases of the government taking back land or denying alienation of tenure rights to others, the latent possibility provides local administrators with discretion and deflates the value of the land ownership rights. Under the LDO and through other incentives associated with fertilizer subsidies, the state regulates the types of crops that should be grown, with particular attention given to ensuring rice production. Plantation land is handled through long-term concessions to large private companies or directly managed by state-owned agricultural enterprises.

54 de Mel et al (2013).

55 Wijesinha, A. and Ekanayake R. (2014), ‘Tax Policy and Enterprise Development in South Asia – Sri Lanka Country Report’, Governance Institutes Network International: Islamabad.

56 World Bank 2013

Figure 4.19 Percent of firms identifying business licensing and permits as a major constraint



Source: World Bank Enterprise Surveys 2012

168. Finally, the predictability of state regulation with regard to property rights has been impacted by a few recent cases of controversial government legislation. Most notable among these was an act introduced in late 2011 under which private-sector projects on state land deemed by the government to be abandoned, underused or being operated outside of the scope of the original agreements were returned to the state. The “Revival of Underperforming Enterprises and Underutilized Assets Act” expropriated 37 enterprises in sectors like hotels, mixed-property development and sugar industries. While the government at the time stated this would be a one-off measure, the law’s targeting of specific enterprises and language that provided for further takings spooked business confidence. Similarly, in 2013 the government abruptly introduced legislation to restrict foreign ownership of land, including legal entities with foreign equity. Consultative mechanisms for private-sector inputs on specific legislation that may affect the business climate are ad hoc at best.

Regulatory Environment: Licenses and Permits

169. Licenses and permits are an obstacle to a greater degree than in comparator countries, with significant differences within the country. Almost one in five companies responding to an enterprise survey in 2011 identified licensing and permitting as a major obstacle to their operations – as compared to close to one in 10 firms with similar views in other countries. These investment climate difficulties affect firms unevenly across industries and regions (Figure 4.19). While one in 10 service-sector firms

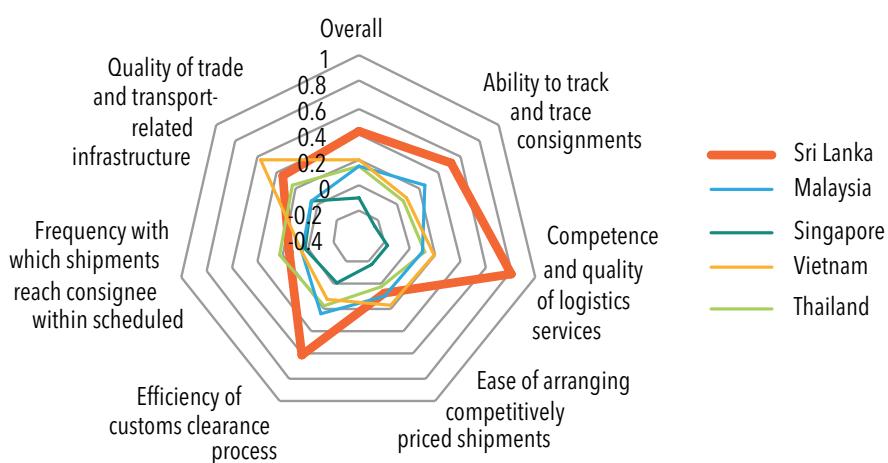
are negatively affected, almost one in three manufacturing firms are impacted. One in 100 firms in the Southern Province suffer from these difficulties, while they hamper almost six out of 10 firms in the Northern Province. The uneven impact of investment climate deficiencies highlights a potential gap between the written law and its application, which could stem from discretionary behavior of some regulatory agencies. The uneven application of laws and regulations across regions could reinforce existing regional growth imbalances and hurt employment creation in areas where more of the bottom 40 percent is located, like in the Northern Province.

Regulatory Environment: Trade Facilitation

170. Sri Lanka has seen steady improvement in its ranking on international trade facilitation indexes although its performance is still lower than the middle income and East Asian peers with which it currently competes. Sri Lanka’s performance on key international trade-facilitation indices are indicative of the strides the country has made in improving its trade facilitation in the last five years (Figure 4.20). However current challenges involve the stiff competition being posed by other middle-income and South East Asian countries that are vying for a greater share of global investments. The perceptions identified in international indices point to significant improvements that could be made to the regulatory and institutional infrastructure that currently exist in Sri Lanka.

171. Bureaucratic bottlenecks have given rise to high trade transaction costs. Policy-induced barriers consist-

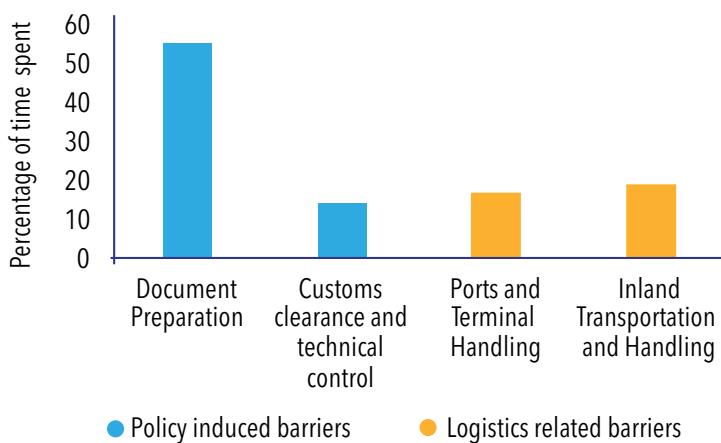
Figure 4.20 Logistics performance index scores (2010-2014)



Source: World Economic Outlook, Central Bank of Sri Lanka

ing of regulatory and institutional bottlenecks account for nearly 70 percent of the total time spent on exporting or importing goods (Figure 4.21). The preparation of documents is the most significant component, absorbing more than 50 percent of the time spent on import or export procedures. The existence of two processes for BOI companies and non-BOI companies, onerous documentation requirements and the failure to update the outdated customs ordinance are key issues that increase the complexity of the regulatory framework governing trade in Sri Lanka.

Figure 4.21 Duration of procedures for imports/exports



Source: WBG calculations based on data from www.doingbusiness.org

Reform efforts (such as upgrading to the ASYCUDA World system) are also undermined by insufficient information and communication technology capacity among the agencies and failure to integrate the 30 government agencies involved in trade facilitation through a single window facility.

172. Trade facilitation efforts will benefit from increased coordination among all government agencies involved in the trade transaction process. In particular, alignment with the World Trade Organization-Trade Facilitation Agreement, which will ensure a reduced documentation burden for businesses, more streamlined procedures, application of risk-based controls, increased transparency of information, regular stakeholder consulta-

tion and increased automation. Increasing coordination among agencies -- with a focus on streamlining, harmonizing and simplifying border clearance, legislation, policy and procedures from a "whole of government" perspective through standard operating procedures, memoranda of understanding, and coordinated decision-making -- will improve the

Increasing coordination among agencies handling trade will improve the business environment

business environment. The establishment of the National Trade Facilitation Committee is a positive step in that regard. Moreover, clearance times are affected by a heavy inspection burden. There is no legal provision for risk management as there is a government decision that mandates 100 percent examination, a legacy from the conflict period. Removing the regulation and applying risk-based controls along with implementation of a streamlined and automated trade transaction system (single window) will facilitate trade. Finally, given the complexity involved in regulating imports and exports, increasing transparency in the information provided both electronically through a trade portal and through regular consultations with trading firms would enhance accountability and improve information flow among stakeholders, leading to better trade-facilitation performance.

Regulatory Environment: Labor Market

173. Labor market regulations appear to be constraining the growth of employment. Labor market regulations aim to provide job security to formal-sector workers but, since these workers represent only about 15 percent of the labor force, the regulations instead result in a deep divide between formal and informal workers. While it is relatively easy to hire workers in Sri Lanka, it remains difficult for formal firms to downsize during downturns. Sri Lanka's Termination of Employment of Workmen Act (TEWA) requires that firms with 15 or more employees justify layoffs and provide generous severance pay to displaced workers, with smaller firms being exempted. Moreover, severance payments are expensive relative to regional and middle-income peers. Although formally subject to TEWA, firms in EPZs may have been partially exempt from TEWA due to lax enforcement in that sector. Empirical work⁵⁷ has shown that TEWA restrictions retard the growth of non-EPZ firms below the threshold of 15 workers, only atypically productive firms pass the threshold, and once they do, they grow faster than EPZ firms, suggesting that the TEWA failed to lower unemployment. Instead, it slowed employment growth of non-EPZ firms and induced firms to seek the EPZ sector in order to evade the law.

174. In addition, the legal framework governing work in the private sector reduces female employment. Legislation prevents women from taking up night work or part-time work in the growing service sector.⁵⁸ This not only promotes exclusion of women from some economic sectors, such as the growing tourism industry, but it also reduces overall potential employment. Similarly, the laws

57 Abidoye, Orazem and Vodopivec (2009).

58 The Shop and Office Employees Act No. 19 of 1954 states under paragraph 10(2) that „a person who has attained the age of fourteen years and who [...] is a female, shall not be employed in or about the business of a shop or office before 6 am or after 6pm on any day”. Exception included in the act include: (i) women from the age of eighteen years may be employed in or about the business of a hotel or restaurant for the period between 6pm and 10pm; (ii) women from the age of eighteen may be employed in a residential hotel before 6am or after 6pm; and (iii) women from the age of eighteen may be employed in or about the business of a shop or office for the period between 6pm and 8pm. See Shop and Office Employees Act accessed at: http://www.ilo.org/dyn/travail/docs/1350/Shop_percent20and_percent20Office_percent20Employees_percent20Act.pdf (April 1, 2015).

governing maternity benefits⁵⁹ make employers bear the entire cost, potentially deterring employers from hiring women.⁶⁰

Regulatory Environment: Enforcement of Contracts

175. Sri Lanka's commercial justice system is prone to delays, though there have been improvements in recent years. The country's justice system suffers from a relatively small number of judges and corresponding high caseloads, and lax enforcement of civil procedure, which leads to frequent continuations and gaps in law that make resolution of land and land inheritance disputes very difficult. Recent controversies over leadership in the judiciary and executive influence have further undermined the sector. There is a backlog of over 25,000 civil cases lasting more than five years (and, in some instances, more than 30 years), the vast majority of which are land and partition (land inheritance) cases. Alternative dispute resolution has not taken root, with the exception of community level mediation boards. However, the introduction of a specialized commercial high court in Colombo to hear higher value commercial cases has improved adjudication in terms of timeliness and quality of judgments.⁶¹

Regulatory Environment and Informality

176. Regulatory compliance burdens prompt entrepreneurs to operate informally, which in turn undermines competition. Moreover, the level of informality is much higher in some sectors (such as non-garment manufacturing, where one in three firms reportedly start operations informally and stay informal for three years on average) and in some regions of the country (notably Eastern region where more than 60 percent of firms surveyed start operations informally and remained informal for almost seven years on average (Figure 4.22A). Informality affects the ability of firms to grow and enhance productivity due, inter alia, to limited investment, limited access to finance and inadequate business processes.

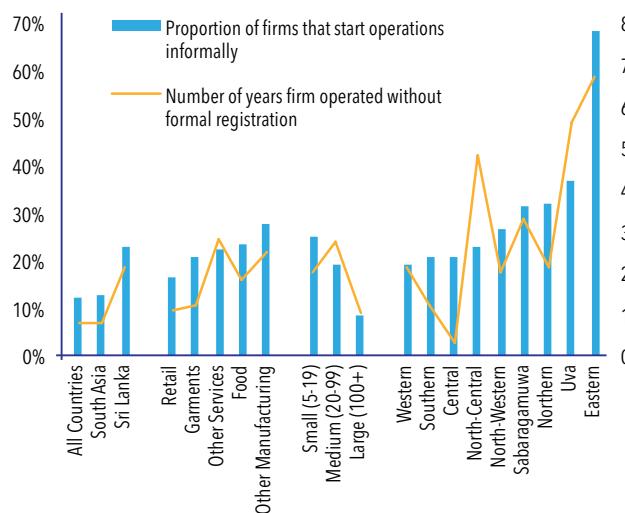
59 Maternity benefits in Sri Lanka's private sector are governed by the Maternity Benefits Ordinance No. 32 of 1939 (for women employed in any trade) and the Shop and Office Employees Act No. 19 of 1954 (for women employed in shops and offices) (Abeykoon et al. 2014). In 1993, Sri Lanka ratified the ILO Maternity Protection Convention (Revised) 1952 (No. 103). However, there remain shortcomings between the national legislation and the ILO convention. One of the shortcomings is that maternity benefit payments are financed through employer liability.

60 Gunatilaka 2013

61 Doing Business methodology uses a case which would fall under regular district court jurisdiction rather than the Colombo High Court. For broader discussion see World Bank *Sri Lanka Trustee Sector Review* (2013)

Figure 4.22 Regulatory compliance prompt entrepreneurs to operate informally

A. The proportion of firms operating informally is high, particularly in non-garment manufacturing and in the North, East and Uva Province



Source: World Bank Enterprise Surveys 2011

B. Informal practices are a major obstacle to the growth and competitiveness of established firms

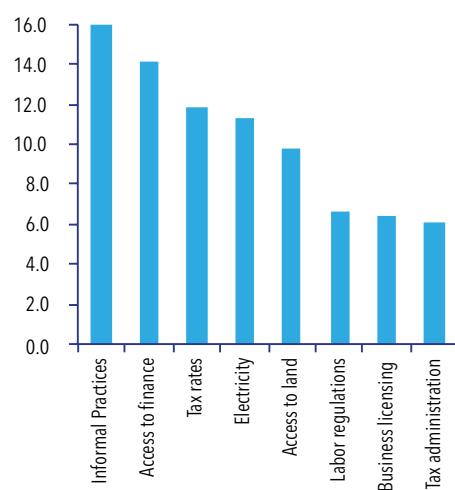
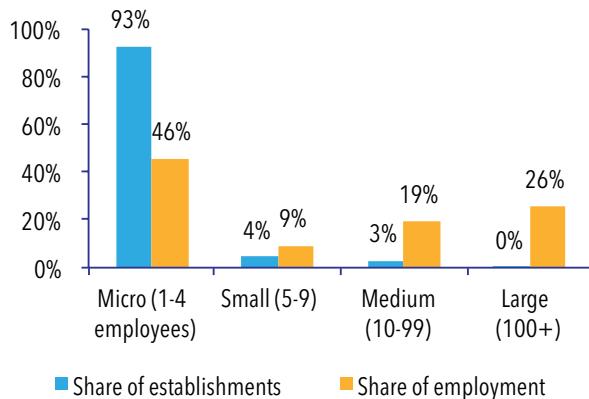


Figure 4.23 Distribution of industries by number of establishments and persons engaged



Source: DCS, 2015 Economic Census listing sheets.

177. Side-by-side operations of informal and formal firms in a market lead to unfair practices and market inefficiencies. Unfair competition from informal players is viewed as the single most important obstacle to the growth and competitiveness of established firms (Figure 4.22B). Formal firms may find themselves at a disadvantage as they face higher marginal costs, such as for labor and taxes, than informal firms. At the same time, informal firms generally have no access to financial services, government contracts, and essential licenses and permits, and there is local evidence that greater formalization can

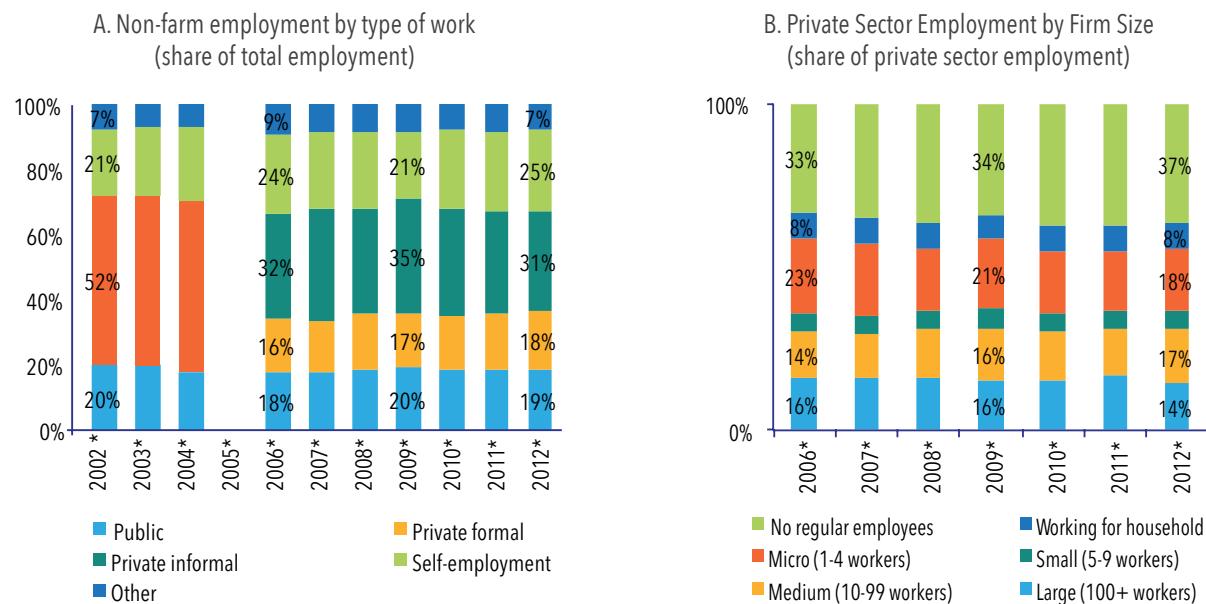
stimulate collaboration between smaller informal firms and formal firms, investment in operational efficiency and business growth.⁶²

178. Most business establishments in Sri Lanka are small, with profound implications for productivity. An important obstacle to improving firm-level productivity is the extent to which firms can take advantage of economies of scale. The 2014 Economic Census found that 93 percent of private economic establishments had fewer than 5 employees (Figure 4.23). Nearly 22 percent of those establishments are in manufacturing, while 70 percent are in the service industry, including 40 percent in wholesale and retail trade, and 8 percent in hotel and food services. While the link between firm size and productivity is not documented in Sri Lanka, developing-country experience would suggest that small firms tend to be less productive. Moreover, these micro firms are younger than large enterprises, with an average of 10 years since beginning commercial operations against an average of 20 years for medium and large firms. SMEs are particularly prevalent in regions outside the Western Province.

There have been overall increases in informal employment over the past decade

62 de Mel et al (2012).

Figure 4.24 Non agricultural employment



Source: Arunatilake et al (2015) based on Labor Force Survey data. Excludes Northern and Eastern provinces.

179. The proliferation of informal employment and small firms has important consequences for the ability of the bottom 40 percent to share in the growth process. Most of the increase in non-agricultural employment between 2002 and 2012 was among self-employed non-farm workers (accounting for 48 percent of the increase). Self-employed workers increased from 21 to 25 percent of non-agricultural workers between 2002 and 2012, while the share of informal-wage workers⁶³ hovered above 30 percent of the non-farm workers (Figure 4.24A). Moreover, the decline in agricultural employment coincided with a sharp increase in workers employed in establishments with no regular employees. By 2012, 37 percent of non-farm workers were employed in establishments with no regular employees, up from 33 percent in 2006 (Figure 4.24B).⁶⁴ Similarly, by 2012, 74 percent of unskilled workers (those with less than a primary education) had only temporary or casual wage employment, up from 70 percent in 2006, suggesting that these workers are increasingly working under precarious conditions. Wages of temporary workers are on average 33 percent lower than wages of

permanent workers; one-third of that gap cannot be explained by differences in the job or individual characteristics, suggesting that to some extent workers would choose more stable jobs if they could.⁶⁵

180. Under these circumstances, a key question is why firms stay informal in the first place and what can be done to encourage formalization. A standard hypothesis has been that reducing the cost of operating a business could reduce informality, reduce uncompetitive practices, and, by extension, create an environment more conducive to investment in productivity-enhancing activities. However, existing evidence indicates that lowering the costs of formalizing on businesses would have only limited impact.⁶⁶ In fact, it appears that most informal firms will not formalize unless forced to do so via increased enforcement, suggesting formality offers little private benefit to informal firms. Similarly, rigorous evaluations of business training programs show limited to no effects on actual firm outcomes and performance.⁶⁷ Even providing business training and grants have not yet been shown to

63 Informal workers were defined as by DCS as workers in companies not registered, those without accounts, or those with less than 10 regular employees. This data is only available beginning in 2006.

64 Although calculations presented here exclude the Northern and Eastern province for comparability purposes, the share of workers in establishments with no regular employees was also 47 percent in 2012 when the North and East are included.

65 Arunatilake et al (2015).

66 See Bruhn and McKenzie (2013), Bruhn (2013), Mullainathan and Schnabl (2010) and de Mel et al (2013) for evidence from Brazil, Mexico, Peru, and Sri Lanka.

67 For a recent review of the literature, see McKenzie and Woodruff (2012).

encourage firms to formalize.⁶⁸ Given this evidence, what policies should Sri Lanka focus on?

181. There are several compelling reasons to try and bring larger and more profitable informal firms into the formal system. First, collecting taxes from relatively well-off owners of informal firms would widen the tax base, while the revenue collected is likely to justify the costs of greater inspections to ensure that they do become formal. Secondly, these larger and more successful informal firms are more likely to be the ones competing with formal firms for customers. Ensuring that such firms also become formal may cut back on unfair competition that prevents more efficient formal firms from growing faster. The challenge is how to encourage formalization of such firms. Based on the evidence described above, lowering the cost and complexity of registration seems a necessary, but not sufficient, step. Policymakers could also experiment with innovative approaches to encourage suppliers or customers to demand formality. One such example being tried in several countries is to link each tax receipt number to a lottery, so that customers have an incentive to demand a tax receipt on each transaction. Such a system has been used in Taiwan, China; Korea; China; and Puerto Rico. Wan (2010) compares changes in tax revenues in districts in China that introduced this reform to those that did not, and finds the introduction of this tax receipt lottery increased sales tax revenue by 17 percent.

182. For subsistence enterprises, the existing evidence seems to suggest that such firms see no benefits from formalizing, and would typically contribute very little to taxes if they did formalize. They may still compete with larger firms, but in the absence of other job opportunities for these individuals, the government may prefer to leave them alone rather than have them close down. The only remaining public rationale for trying to bring them into the formal sector is that the presence of so many informal firms may send a message to the public that obeying the law is optional, and also dissuade more prosperous informal firms from formalizing. An alternative approach used in some countries is to write the law in a way that does not require informal firms with income below a certain threshold to register, putting them in compliance with the law. But unless such a threshold is set very high, there are still likely to be many firms above the threshold who choose not to register.

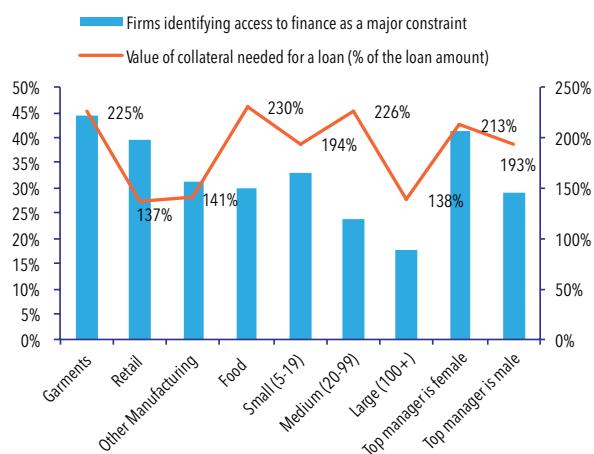
Access to Finance

183. Despite ample liquidity in the banking sector and declining interest rates, access to finance continues to be a constraint reported by SMEs. Stalled growth

Larger firms have easy access to loans and lower collateralization requirements while accessing finance is particularly difficult for smaller firms and firms managed by women

In credit to the private sector can be tied to crowding out by the needs of the public sector – which utilizes almost 50 percent of the domestic resources in the country. To improve the efficient allocation of resources in Sri Lanka, the banking sector will need to become more competitive and efficient, and the non-banking financial sector will need to be developed to provide much-needed alternative options to the SME sector. In particular, accessing finance appears to be particularly difficult for smaller firms, those operating in specific sectors (including garments and retail), and firms managed by women. For those firms, accessing credit is often dependent on their ability to post collateral with a value of more than 200 percent of the loan amount, a substantial obstacle for many firms (Figure 4.25). On the other hand, larger firms appear to have relatively easy access to loans and much lower collateralization requirements. Although a movable collateral registry is available, it is limited in its operations, severely curtailing the ability of firms and entrepreneurs to use moveable collateral (e.g. machinery, inventory, accounts receivable) as security to their loans. As

Figure 4.25 Access to finance difficulties driven by high collateral requirements



Source: DCS, 2015 Economic Census listing sheets.

68 See McKenzie and Woodruff (2012) for a review of the literature and de Mel et al (2012) for evidence on Sri Lanka.

a result, despite the high penetration of regulated financial institutions in Sri Lanka, an estimated 64 percent of micro, small and medium enterprises remain without checking or savings accounts (World Bank, 2014e).

184. Access to finance is most impacted by weaknesses in the financial system and the bankability of projects, while availability of funds per se is not a problem.

Past strategies to address this challenge have relied on directed lending and concessional credit rather than improving financial intermediation for, and bankability of, SMEs. Sri Lanka has had numerous programs to enhance access to finance targeting specific sectors (including nine for agriculture, 11 for SMEs, and seven for microfinance)⁶⁹, yet SMEs continue to highlight access to finance as a major constraint. Weaknesses in intermediation include: deficiencies in Sri Lanka's credit infrastructure (the lack of a movable collateral registry and an incomplete credit information system); limited financial innovation (e.g. the lack of factoring, operational leasing of equipment); limited ability of, or incentive for, commercial banks to serve new markets segments (lack of cash-flow-based lending practices); and deficiencies in the legal framework governing lending activities (costly and long judiciary procedures for foreclosure, and an outdated Secured Transactions Law)⁷⁰. The disconnect between extensive penetration of banking institutions across the island and ample liquidity with the difficulties that SMEs have in accessing finance points to a lack of competitiveness in the banking sector overall. Financial institutions appear to be complacent with their current client base and do not face market pressure to go after the SME segment. However, further analysis is merited to identify specific bottlenecks reducing the ability of creditworthy firms and economically viable projects from getting financing, especially among SMEs (see Appendix 2.2. for more analysis of potential constraints).

185. Access to technology and business-development services are additional constraints on SMEs. SMEs find it difficult to access technology to upgrade their businesses. A 2015 study showed that while access to finance was the foremost constraint (49 percent), the second most-cited constraint by SMEs (23 percent) was access to technology⁷¹. Much of the public and private technology transfer institutions operate primarily or exclusively in Colombo and there are rigidities in accessing project-based

funding from banks to finance investments in technological upgrading. There are also market failures in providing business development services (BDS), to support improvements of SMEs' management and business practices (accounting, auditing, business planning, marketing, energy efficiency, etc.). While multiple public, private and donor-funded initiatives have begun providing BDS across the country, the majority of SMEs still indicate a lack of awareness of such services, while certain critical needs of SMEs (taxation advisory, market intelligence, digital technology, etc.) are not being met by existing BDS providers⁷². Rigorous evaluations focused on intensive technical assistance and subsidized consulting services find positive and significant impacts on productivity and return on assets in the short run, and employment in the long run.⁷³

The State as Market Participant

186. Beyond its role as a regulator, the state has increasingly become a direct participant in Sri Lanka's economy. As described in the following two sections, the state is an important participant through its SOE sector, as well as through its role as an employer. Both of these roles have an impact on the ability of the private sector to participate in the economy and have affected competitiveness in a number of sectors as well as labor market dynamics.

187. In playing its role in ensuring the provision of public services and infrastructure, Sri Lanka's government has primarily used traditional procurement rather than seeking partnerships with the private sector in the past decade. Investment in infrastructure over the past decade has been driven by public spending. While in some cases this was tied to the terms of external financing for infrastructure, there was a policy of directly spending to build assets to be owned by the state. Of course, private investment was not discouraged and there is cooperation in many sectors. Yet there are very few public-private partnerships (PPPs), especially for the building or operation of infrastructure, under which the government would seek to share risks and take advantage of private-sector financing know-how, and innovation. Even in instances where the government has recognized the need for private sec-

69 Central Bank of Sri Lanka

70 For example, long judiciary processes to foreclose collateral in case of borrowers' default usually leads banks to request higher collateralization levels to cover for the additional costs associated.

71 Wijesinha, A. and N. Perera (2015), 'Banking on SME Growth: Concepts, Challenges, and Policy Options to Improve Access to Finance in Sri Lanka', March 2015, Working Paper Series No. 20, IPS: Colombo.

72 Attygalle, K., D. Hirimuthugodage, S. Madurawala, A. Senaratne, A. Wijesinha, and C. Edirisinghe (2014), 'Female Entrepreneurship and the Role of Business Development Services in Promoting Small and Medium Women Entrepreneurs in Sri Lanka', May 2014, IPS and OXFAM International: Colombo.

73 See Valdivia (2012), Bruhn et al (2013), Bloom et al (2011) for evidence on Peru, Mexico and India respectively. See McKenzie and Woodruff (2012) for a review of the literature.

Box 4.3 Defining State-Owned Enterprises (SOEs)

State-owned enterprises are a subset of what are legally defined as public enterprises. The Parliamentary Committee on Public Enterprises identifies six categories of institutions that fall under its oversight: regulatory bodies, promotional agencies, state-owned enterprises, educational agencies, development agencies and research institutions. There are about 240 entities that fall under the committee's ambit, many of which are financed by the budget. Regular monitoring and reporting is carried out by the MoF for 55 larger SOBEs, which have commercial income. For the purposes of the SCD, the 55 SOBEs are referred to as SOEs.

tor involvement and ownership, it is rare for the private sector to receive more than 50 percent ownership, which is often needed to attract quality operators wary of undue state interference. Notably, private-sector power-generation projects require partnership with the state.

188. To date Sri Lanka lacks robust PPP legislation, an institutional mechanism and capacity to plan, structure and implement PPP projects, and regulatory structures to ensure public interests and investor concerns are balanced. Sri Lanka continues to lack the necessary technical expertise to enter into large-scale PPP projects in a transparent and mutually beneficial manner,

Sri Lanka lacks robust PPP legislation and an institutional mechanism to manage and regulate PPP projects

and many infrastructure needs continue to be met by borrowed capital. Previous attempts at creating institutional mechanisms for PPPs have been shut down. For instance, the National Procurement Agency set up in 2004 with the aim of eliminating corrupt practices and the wasting of time and resources, and improving transparency and efficiency in infrastructure activities did not provide a framework for PPPs and in any case was eventually shut down in 2008. Similarly, although a dedicated PPP unit in the BOI was set up in 2006, it did not become a robust entity. As a result, Sri Lanka lacks robust PPP legislation and an institutional mechanism to manage and regulate PPP projects. In fact, since 2009 publicly led investment was financed through commercial borrowing in the form of Sri Lanka Development Bonds, sovereign bond issues, and other syndicated loans, along with bilateral loans at near-commercial rates, particularly from China. Much of the infrastructure completed post-war – two new ports, a new airport, roads and bridges island wide, two new expressways, and two new power plants – have been financed through these channels.

189. At the same time, the state is a major participant in economic activities through a substantial SOE sector. There are 55 major SOEs enterprises covering a wide

range of sectors (Box 4.3). The 10 most important SOEs, which account for about 90 percent of the asset base of all major SOEs, are financial institutions (Bank of Ceylon, People's Bank, National Savings Bank, and Sri Lanka Insurance Corporation), major public utilities (Ceylon Petroleum Corporation, Ceylon Electricity Board, and the National Water Supply and Drainage Board) and logistics/transport service providers (Sri Lanka Ports Authority, Airport and Aviation Services, and Sri Lankan Airlines). There are other smaller SOEs in banking, public utilities and logistics as well. Finally, the government has major SOEs in other sectors, including construction, livestock, lotteries, media, marketing and distribution, plantations, pharmaceuticals, industrial estates, mineral extraction, general trading and timber sales. Major SOEs accounted for nearly 17 percent of GDP in 2013 (Table 4.2).

190. SOEs play a significant role in Sri Lanka's fiscal balance. Transfers from the budget to public enterprises have averaged about 3 percent of total expenditures (around 50 billion LKR), mainly driven by direct transfers and on lending to the Ceylon Electricity Board (CEB). The total debt of the 55 major SOEs accounted for approximately 4.8 percent of total public debt in 2013. This number reflects reductions in debt thanks to conversions of debt to government equity and capital infusions to strategic State-Owned Business Enterprises (SOBEs), which have regularly occurred and were particularly large in 2013 (Ministry of Finance and Treasury).

191. Moreover, SOEs account for a significant share of lending. The two largest banks in the country continue to lend a significant share of their funds to SOEs, including several that are loss-making or non-revenue-generating enterprises. In 2013, Bank of Ceylon (the largest bank by asset base and lending portfolio, holding 20 percent of market share) lent 38 percent of its total portfolio to SOEs (primarily to Ceylon Petroleum Corporation, Sri Lanka Ports Authority and Road Development Authority); and People's Bank (the second largest bank with 15.6 percent market share) lent 28 percent of its total portfolio to SOEs (with high exposure to Ceylon Electricity Board, Ceylon Petroleum Corporation, and Ceylon Fertilizer Company Ltd). Since these banks account for a large share of the

Table 4.2 Sector wise performance of asset base of state owned business enterprises

Sector	No. of SOBEs	Asset Size (Rs. Billion)	Percent of GDP	Year on Year Growth (percent)	Market Share (percent)
Energy	2	1,007.25	7.99	6.6	94
Water	1	242.60	0.21	9.5	44
Port	1	299.80	0.42	20	60
Commuter Transportation	1	14.52	0.31	9.2	23
Aviation	3	45.74	1.62	3.12	61
Construction	3	30.96	0.30	(17.24)	2.9
Banking & Finance	9	3,102.50	4.04	14.2	41
Insurance	4	154.60	0.39	8.6	27
Lotteries	2	7.77	0.28	1.97	100
Livestock	2	7.63	0.09	10.74	13
Plantations	7	12.63	0.11	(15.97)	3.72
Non-renewable energy	3	3.31	0.02	11.07	0.9
Health	4	18.62	0.28	(1.59)	27
Media	3	8.86	0.07	2.67	32
Marketing & Distribution	10	77.47	0.49	5.43	4.3
TOTAL	55	5,132.26	16.62	11.60	-

Source: Annual Report 2013, Ministry of Finance & Planning

banking industry, this high SOE exposure could reduce funding available to the private sector and expose the banking sector to systemic risks given the precarious financial positions of the concerned SOEs.

192. SOEs have a significant market share in many sectors, including areas where there is not a strong apparent rationale for public intervention. While public ownership of utilities and major infrastructure can be warranted to oversee natural monopolies or address free/easy rider problems, a significant number of major SOEs remain in sectors that do not obviously have these features (Table 4.2). This is most striking in the finance sector, where major SOEs make up close to half of the market. While the overall market shares are less significant, SOEs also are important in several agricultural subsectors. One rationale commonly provided for commercial SOEs is that state intervention is warranted to ensure service or provide employment to remote populations where the private sector is not active, but there is little evidence to demonstrate this necessity.

193. The large SOE sector is largely a legacy issue. Most major SOEs were established in the 1960s and 1970s, with some -- notably the largest state bank, the Bank of Ceylon -- founded prior to independence. In the past 15 years, the state has set up six new enterprises: three small banks, one insurance company, a trading company, and a new airline (which recently was merged with the other state-owned airline, Sri Lankan Airlines). Thus, while the SOE sector is large, it has not been growing substantively, with the partial exception of entrants in the finance sector. Many of the SOEs reflect earlier, more statist policies, such as the state plantations that were nationalized in the early 1970s.

194. Efforts to restructure SOEs were undertaken during the 1990s and early 2000s and reversed after 2005. In the mid-1990s, the government launched an effort to reform underperforming SOEs, setting up the Public Enterprise Reform Commission (PERC) to carry out this work. Under the aegis of PERC, privatization took place

in varying degrees, affecting 86 SOEs in the electricity industry, telecoms industry, ports, agriculture, and the national airline.⁷⁴ The post-2005 government had an explicit anti-privatization policy that in some cases led to reversals of past privatizations.⁷⁵ The government of the past nine years sought to make SOEs perform better, including through the establishment of the Strategic Enterprise Management Agency (SEMA), which focused on 20 of the most important SOEs.

195. Following the end of the conflict in 2009, the military initiated business enterprises, though the scale of this activity is difficult to measure and its future is unclear. Most notable among these are tourism and associated businesses that are widely advertised. The Sri Lanka Army⁷⁶ now runs at least six tourist hotels across the country, while the Sri Lanka Air Force⁷⁷ runs a golf course, two tourist hotels, and two banquet and convention halls. It also operates a civilian passenger airline service, a veterinary service, and a hair salon in Colombo. Meanwhile, the Sri Lanka Navy⁷⁸ operates a whale-watching boat service, a restaurant in Colombo, three wedding and convention halls, and seven tourist hotels across the country. In addition to tourist activities, the armed forces have been engaged in agricultural farming (specifically in lands belonging to families in the North), vegetable distribution, running small shops and cafes (mainly along transport routes to the North), civil construction works (mainly for Colombo urban upgrading projects), and conducting “leadership training” at military camps for university entrants. These initiatives were tied to the 2005-14 government, calling into question the extent to which they will be continued under a new government.

74 The Public Enterprise Reform Commission, established by Act No. 1 of 1996, was mandated to improve efficiency in the economy, increase government revenue and motivate the private sector, but not explicitly to divest from and privatize SOEs. Nevertheless, divestiture did generate over \$500 million between 1995 and 1998, attracted a further \$400 million in foreign inflows, and private investments in the gas, steel, telecoms, plantations and civil aviation sectors.

75 Sri Lankan Airlines Sri Lanka Insurance, Waters Edge and Shell Gas were some of the key privatizations that were reversed, with the government re-acquiring full ownership.

76 Lagoon's Edge (Nanthikandal), Thalsevana (Jaffna), Laya Safari (Yala), Laya Waves (Kalkudah), Laya Beach (Wadduwa), Laya Leisure (Kalutara)

77 Marble beach (China Bay, Trincomalee), Eagles' Golf Links (Trincomalee), Eagles' Heritage Golf Club (Anuradhapura), Eagles Lakeside Banquet and Convention Hall (Colombo), Eagles' Lagoon View Banquet Hall (Katunayake)

78 Lagoon Cabanas (Panama/Arugam Bay), Sober Island Resort (Trincomalee), Weligambay Villas (Mirissa), Club House (Uswetikeyyawa), Dambakolapatuna Rest (Dambakolapatuna), Fort Hammehil (Jaffna), Golf Link Hotel (Trincomalee), Reception Hall (Ranminithenna), Reception Hall (Poonewa), Lake Front Rest (Kantale)

196. Sri Lanka has had a diffuse arrangement for overseeing SOEs, complicating strategic management. At the highest level, the Parliamentary Committee on Public Enterprises oversees financial and operational performance of SOEs through an annual review mechanism. More operational oversight responsibility for major SOEs has been shared between line ministries and MoF, through its Department of Public Enterprises. The line ministries have in turn appointed members of boards of directors of SOEs in accordance with the relevant legislation for governance of a given SOE (i.e. the Companies Act or act establishing the SOE). SEMA and a similar Strategic Resource Management Committee were separately set up to provide managerial support, although reforms are mooted to bring SEMA into the MoF. None of these entities appear to have had oversight over enterprises launched by the military.⁷⁹ This decentralized model complicates holistic oversight of SOEs' performance and management of financial risk. In particular, critical information on economic and financial performance, such as return to equity and overall contingent liabilities of SOEs, are not systematically tracked. SOEs have de facto considerable discretion to set their own policies and strategies, including in sensitive personnel areas. The system also does not easily provide for making strategic decisions to maximize value to the state of SOEs or management changes such as restructuring. The new government has indicated a change of course through consolidation of oversight by establishing a specialized ministry for SOEs, but its impact remains to be seen.

197. There is strong political involvement with SOE management. SOEs have requirements for the profile of its board directors spelled out either in their founding cct or more general guidelines, with a MoF representative always present. But given the direct subordination to particular ministries, practice is that a change of government automatically triggers the resignation of boards and the appointment of a new board. The political connections of SOEs can lead to management decisions based on non-commercial criteria. Most important, the closeness of political connections increases the likelihood of SOEs receiving preferable treatment.

198. The size, profile, and management framework for SOEs can negatively impact Sri Lanka's competi-

The system of SOE oversight does not easily provide for making strategic decisions

79 For instance the most recent 2013 COPE report does not cover military enterprises.

tiveness. The concentration of assets under management that is prone to politicization can lead to unproductive utilization of the country's assets. It also likely dampens competition in key sectors; even if there has been basis for the state's involvement owing to the absence of market actors, SOEs will discourage future entrants. There is no formal mechanism to verify that there is a public purpose rationale for individual SOEs. In the context of the no-privatization policy in recent years this has meant that the sector continues to play an outsized role.

The Public Sector as Employer

199. Strong demand for public-sector jobs has met the increased supply of such jobs. As was discussed in Chapter II, there has been a 57 percent increase in public-sector employment (public service and semi-public entities) over the past 10 years. This has met with steady demand from the population for public-sector jobs, despite the private-sector growth and the consequent demand for labor. Data on the total applicant pool for various public-sector jobs is not available,

There has been a 57 percent increase in public-sector employment over the past 10 years

of 163 people per year from an average pool of over 20,000 applicants, of which slightly more than half actually sat for exams. Only the engineering and scientific services experience difficulties in recruiting staff. Moreover, the vast majority of public servants stay in the service until retirement.

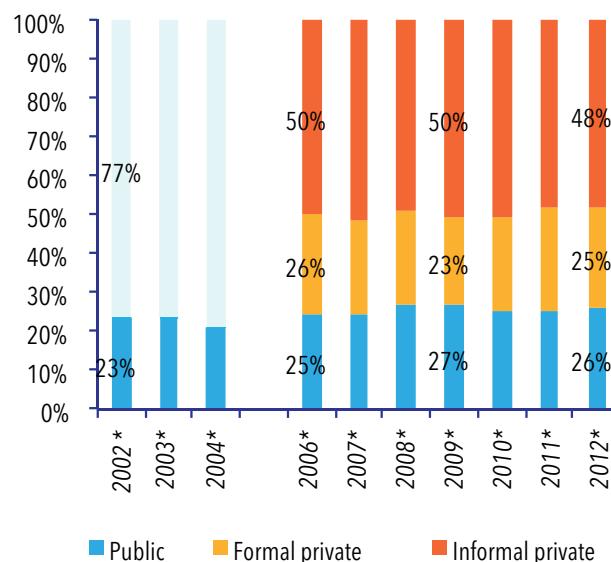
200. While overall wage employment has declined in favor of self-employment, the composition of wage employment has shifted towards the public sector. Overall wage employment declined from 58 to 56.4 percent of the workforce between 2002 and 2012 in favor of self-employment. This decline in wage employment was accompanied by a decline in the share of private-sector wage employment throughout the decade; it fell from 77 to 74 percent of total wage employment between 2002 and 2012 (Figure 4.26). In contrast, public employment increased from 23 to 26 percent of wage employment when looking at comparable districts. Given the growth of the workforce, this seemingly small percentage increase meant an increase of over 95,000 non-farm public workers between 2006 and 2012, peaking at 27 percent of total wage employment in 2009 when large numbers of men joined the armed forces (Figure 4.26). Since then, public employment relative to all formal-wage employment has declined somewhat, but it

continues to represent the largest share of formal workers.

201. Public-sector workers not only enjoy the benefits of formal employment, but they also tend to earn more than their private-sector counterparts. Public-sector workers have access to a non-contributory public pension system (see Chapter III), paid vacations, and importantly, reduced work hours relative to private-sector counterparts. Moreover, public sector hourly wages were on average 40 percent higher than private sector wages in 2012. Part of the wage gap can be explained by differences in individual characteristics, since public-sector workers tend to be more educated. However, decompositions show that there continues to be a wage premium for public workers that cannot be explained by observable individual characteristics. In fact, 14 percent of the difference in wages between public and private workers cannot be explained by observable differences (Figure 4.27A). The evidence suggests that there is a premium to public-sector work, and that this premium has grown between 2006 and 2012.

202. To the extent that public-sector employment is a growing share of total formal employment, this has repercussions for the wage premium for private-sector formal workers. Indeed, private formal wages were on average 35 percent higher than informal wages. Decompositions again show that there is a 6 percent premium to formal-sector employment, after accounting for differences in characteristics and the types of jobs typical

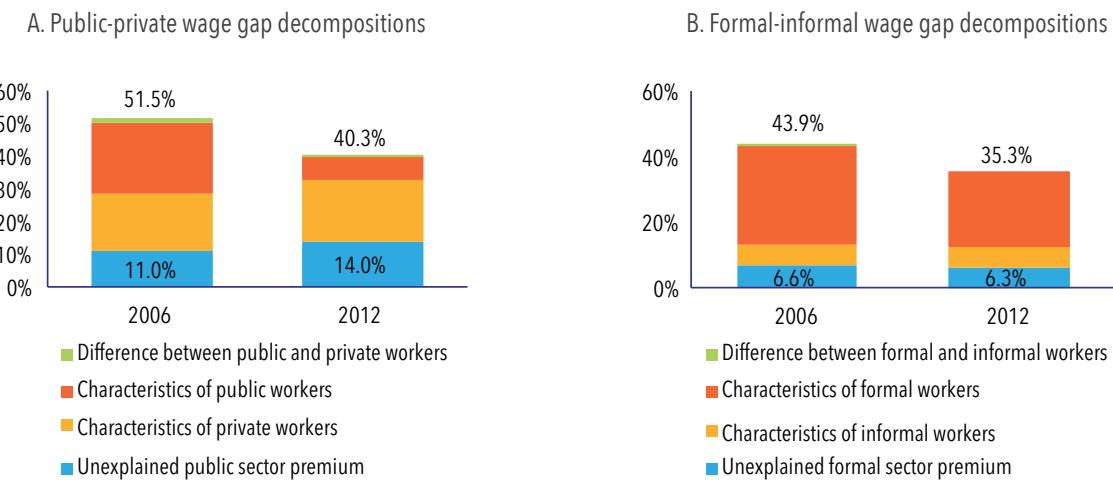
Figure 4.26 The composition of wage employment has shifted towards the public sector (share of total wage workers)



Source: Arunatilek et al (2015) using LFS

*Excludes Northern / Eastern provinces for comparability.

Figure 4.27 Public and formal sector workers earn more than their private sector counterparts

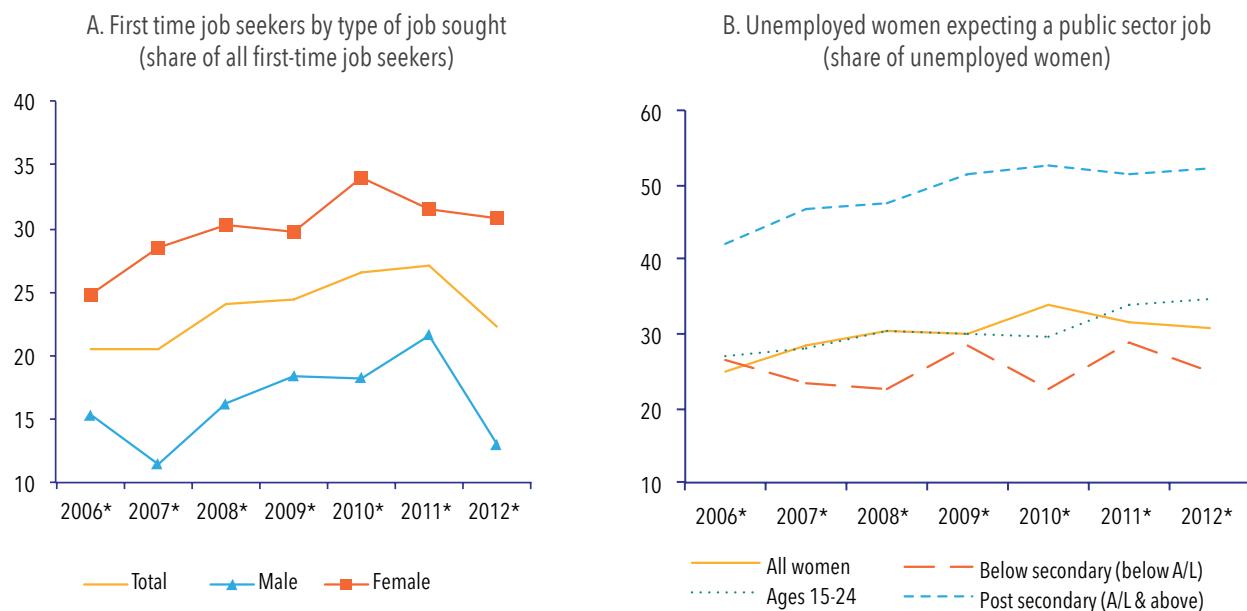


Source: Arunatilake et al (2015) based on Labor Force Survey data. Excludes Northern and Eastern provinces.

of formal and informal workers (Figure 4.27B). Together this lends some credence to the argument that markets are segmented, particularly for wage workers who would likely prefer formal public sector jobs but are rationed out or excluded. To the extent that public-sector employment offers better working conditions for certain types of workers, the private sector will find it difficult to compete for the best workers.

203. **In fact, the evidence shows that workers, particularly educated women, are queuing for public-sector employment.** The share of new job seekers looking for public-sector work increased between 2006 and 2012, mostly on account of women. The share of women looking for work for the first time who specifically sought public-sector employment increased from 25 to 31 percent between 2006 and 2012 (Figure 4.28A). Most of this increase

Figure 4.28 Workers are queuing for public sector jobs



Source: Arunatilake et al (2015) based on Labor Force Survey data. Excludes Northern and Eastern provinces.

Box 4.4 State intervention in agriculture

Sri Lanka's government plays a particularly large role in agriculture, consistent with inward-oriented policies, inefficient land markets, and a large SOE sector, which, together, create distortions.

Agricultural trade and price policies. Sri Lanka's agricultural policies have encouraged import substitution of basic agricultural commodities. Border taxes on imports and exports of agricultural products and tradable agricultural inputs have to generate fiscal revenue, support farmers engaged in import-competing activities and tax producers of export-oriented products. Import duties, and other taxes at the border yield nominal protection rates for importables for most agricultural products in the order of 30–50 percent. For rice, the total protection rate was 34 percent in 2011, making it a highly protected crop, mainly as result of fertilizer subsidies. Maize, potatoes and milk are highly protected as well. Exports of tea and rubber are taxed at low rates.

The high protection of importables has created strong disincentives for crop and export diversification, providing support to expand production of import-competing crops (rice, maize) and discouraging the production of exportables. While agricultural export promotion is highlighted in various policy statements, Sri Lanka's trade policy is overly complex and slows rather than accelerates export growth. Protection also results in inefficient use of public resources, and does not benefit smallholders as intended. Additional distortions are created by land-use restriction and policies that target subsidized fertilizers for particular sectors, such as paddy.

The distortions affect producers and consumers. Rice producers gain at the expense of consumers. Income from paddy farming is estimated to be 36 percent higher than what it would be without government intervention. Similarly, incomes from potato and milk production are significantly higher while the policy impact on incomes from tea and rubber production is insignificant. Coconut farmers, on other hand, experience significant income reductions due to export taxes. The aggregate effect on agricultural income in absolute terms depends on the levels of production of all crops and the crop mix fostered by the incentive structure. Current policies represent an implicit tax on consumers of about 300 percent on maize and chili, 96 percent on milk, 54 percent on potatoes and 12 percent on rice.

Land tenure and rural land markets. Sri Lanka's current land tenure policy, which restricts use rights and transferability, depresses returns to land and the absence of a functioning rural land market constrains long-run sector performance. Smallholder farmers are, in essence, prevented from mobilizing one of their most important assets for promoting much-needed investment into an under-funded under-invested sector.

While government policy has aimed at equitable distribution of land, it has also fostered and perpetuated smallholder agriculture. Land legislation and settlement administration have successively limited farm size and constrained the rights of both owners and operators. Population pressure and inheritance practices have caused substantial fragmentation, leaving average farm-size well below the public-sector-irrigation-scheme norm of one hectare. Overall, 72 percent of farms are below one hectare. In the absence of a rural land market, irrigation-scheme settlers wishing to exit agriculture face a choice of abandoning a valuable farm or entering the uncertain informal market while market-based land consolidation necessary for productivity growth remains depressed.

Functioning land markets would allow farmers to adjust size to respond to changing commodity prices and increased risks. The key to making this work is secure tenancy agreements and a stronger leasehold market. For public-sector land, long-term leases with provision for easy transfer would be a major improvement. For private-sector land, mechanisms to resolve title disputes through administrative and legal means as well as incentive systems are an immediate necessity. Legislation and programs to establish public- and private-sector institutions and professions to facilitate development of land markets are also required.

The government should seek to unlock productivity potential in rural areas, particularly given the importance of the sector for poverty reduction. Sri Lanka's low productivity levels – and the lack of incentives for farmers to improve productivity – call for renewed attention to basic investments in technology, extension services, irrigation, and market infrastructure. They also call for adjustments in the broader enabling policy framework to foster diversification and productivity and improve export competitiveness. This will not only include investments in restoring and further upgrading the country's productive infrastructure, facilitating market linkages, and introducing modern agricultural technologies but also creating a policy environment that favors the expansion of the private sector, especially SMEs, and allowing for more flexibility in the rural land, labor and capital markets.

is due to women with post-secondary training looking for public employment. That size of that group increased from 42 to 52 percent of all women looking for employment between 2006 and 2012, when looking at comparable samples (Figure 4.28B). If the Northern and Eastern provinces are included, this share increases to about 54 percent. Indeed, many workers, particularly women, are

Educated women in particular are increasingly looking for public sector employment

in fields of study that put them on a path to public-sector employment. Since science and mathematics pass rates are poor in secondary schools and there is relatively little access to schools offering A-level science streams, many are compelled to study humanities if they want to go on to do A-levels. As a result, the most popular career streams are often not the ones where there is the highest demand for labor. For instance, there are too many studying humanities instead of subjects that would position them for jobs in the booming areas of tourism, finance, etc.).

Interconnectedness of Public and Private Sectors

204. There is a high degree of interconnectedness between the state and at least segments of the private sector that contributes to the degree of intervention by the government. The variation in tax and customs incentives reflects government policy but those varying incentives also contain specific benefits for specific sectors, which have a limited number of major actors. In addition, there are several high-profile cases of senior officials moving between public and private sectors. For instance,

There is no developed framework for handling conflict of interest

the state frequently uses its various shareholdings in commercial banks to appoint members to boards of directors, and in the process, several current government officials and former central bankers have been appointed. Meanwhile, pension funds managed by the Central Bank – the banking regulator – began investing in several financial sector firms in recent years. At the same time, major business figures have in a few instances taken up senior positions in government in recent years. There is no developed framework for handling conflict of interest to police the boundary between public sector employment and private sector interests. The politically appointed boards of SOEs also serve to reinforce networks of influential public and private sector players.

205. This interconnectedness points to political economy factors that support a continued large role for government in the market. Given that there are frequent instances of state regulatory help to a given sector, it follows that private sector entities would seek to maintain or expand privileges, reinforcing the level of regulatory intervention into the economy. At the same time, it also suggests that many private-sector entities would have to adjust considerably to succeed in a more open, competitive market. Combined with broader expectation of public-sector employment, a reduction of the state's role or an attempt to "level the playing field" will encounter resistance from vested interests.

D. Priorities for Fostering More and Better Jobs for the Bottom 40 Percent

Promote Export-Led Growth

206. Review and revise the country's trade-related policies to promote economic diversification and shared growth. This could include reforming the para-tariff regime to encourage more foreign trade. It also likely would entail revisions to the tax system, in line with addressing fiscal constraints, to reduce the degree of protectionism, particularly for targeted small sectors. This would include simplification of the VAT and corporate-income-tax regimes and the reduction or elimination of cesses on agricultural commodities. Reductions would need to be considered in the context of whether the incentives are achieving the desired objective. Finally, a continued focus on improving the trade facilitation and logistics environment, including streamlining licenses and permits required to export, would help to promote export-led growth.

207. Provide for more resources and quality-enhancing management in the education sector to ensure that the population (and especially the youth) has the skills demanded by efficiency-enhancing enterprises. This could include steps to: ensure high-quality general education and development of soft skills; enable greater private-sector participation in higher education, improvements in technical and vocational training and better coordination with potential employer needs; and ensure that young people are inclined to pursue degrees in the industries where demand is highest.

208. Promote innovation by establishing linkages between R&D institutions and networks of entrepreneurs

that can benefit. Development adaptation and better dissemination of technologies that fit Sri Lanka's economy is important for productivity growth. R&D institutions need to be oriented towards filling this role. This may, in part, be helped by encouraging more private-sector involvement directly in R&D as well as in setting priorities for public-sector institutions. This is a particularly important issue for agriculture.

Rebalance the Role of Public and Private Sectors to Promote Private-Sector Led Growth

209. Improve the regulatory environment to allow firms to grow, reducing informality and allowing for economy-wide increases in productivity and allow firms to reach as firms can reach economies of scale. Some aspects of the regulatory environment that appear to be significant obstacles are: upgrading the systems for land tenure and land use planning in both agricultural and rural areas; modernizing labor legislation to encourage easier movement of labor and female labor participation; ensuring that the burden of business licensing and permitting is minimal, particularly in regions where this is a problem, such as the North; and providing for speedier resolution of commercial disputes and enforcement of contracts in court or using alternative dispute mechanisms. Bringing larger and more profitable firms into the formal system and improving enforcement could help formalization efforts. However, the definition of priorities

for investment-climate reforms to unleash firms' potential should stem from regular dialogue between the public and private sectors.

210. Review the role and participation of the public sector in the economy. Stronger management and strategic oversight of the SOE sector is important to ensure that state involvement is serving a public purpose, does not create unwarranted fiscal risk and public assets are effectively utilized. The state should also take steps to ensure that the public service is "fit for purpose" to carry out public-sector functions and not as a mechanism for job creation. The state can play a role that facilitates greater private-sector involvement through the establishment of a robust institutional framework for public-private partnerships to ensure public interests and investor concerns are balanced while crowding in private-sector investment and skills. Finally, measures to address conflict of interest could reduce negative impacts of the interconnectedness of government with specific businesses.

211. These measures together will help provide an environment conducive to efficiency- and productivity-enhancing FDI, allowing for less emphasis on targeted incentives. A predictable, private-sector-friendly regulatory environment and a skilled labor force can contribute to attracting and retaining FDI. Sri Lanka's incentives regime may need to be revamped as its competitiveness improves and as streamlined investment policies and regulations are adopted and implemented.

KEY KNOWLEDGE GAPS

- Analysis of the tradeoffs in reducing tariff protection given the low revenue base. This analysis should also include potential impacts on employment in the absence of concurrent changes in labor legislation and other measures to reduce the cost of doing business.
- Analysis of firm productivity, entry and exit, and survival of firms, taking advantage of the results of the first economic census of economic establishments. Such analysis could allow for a better understanding of the main barriers to the establishment and growth of firms.
- Analysis of the school-to-work transitions of young workers, with an emphasis on cognitive and non-cognitive skills, aimed at identifying policy options to bolster employment and labor force participation.
- Analysis of bottlenecks reducing the ability of creditworthy firms and economically viable projects from getting financing, especially among SMEs.
- Analysis of migration and mobility – both internal and external -- to identify potential constraints to labor mobility. Analysis of remittances, their sustainability, and their use.
- Analysis of regional trade opportunities and steps to take advantage of such opportunities to capitalize on Sri Lanka's comparative advantages.



V. SOCIAL INCLUSION FOR SHARED PROSPERITY AND POVERTY REDUCTION

KEY PRIORITIES ON INCLUSION

- Using urbanization to drive inclusion. This is enhanced if there is a governance framework that empowers local decision-making responsive to the needs of the poor and bottom 40 percent for public services and infrastructure.
- Multi-sector interventions to improve public service provision and promote employment opportunities in areas where poverty is localized -- including the Northern and Eastern provinces, Moneragala and the Estates; emphasis should also be devoted to reducing nutritional deprivation.
- Promoting reconciliation and efforts to improve equality of opportunity across ethnic groups. This includes promoting employment opportunities, addressing land claims in the former conflict areas, providing assistance to new and former internally displaced persons (IDPs), and integrated efforts to assist widows and ex-combatants.
- Increasing female labor force participation by: increasing education and better aligning the education women pursue and the demands of the market; making changes to legislation that prevents or deters women from being hired; and promoting greater participation of women in leadership positions.

Dimensions of Inclusion

212. **As is true with many countries, there are four dimensions of social inclusion that are important in Sri Lanka: inclusion across space, ethnicity, gender and youth. Constraints in each of these areas preclude the ability of large population groups from fully participating in shared prosperity.** More generally, intersecting identities can produce a multiplication of disadvantage. For instance, the intersection of ethnicity, gender and location (or youth and location) can lead to increased negative effects. This section seeks to define areas where lack of inclusiveness is evident. It must be noted that these problems can be addressed through specific interventions and especially by actions to provide for equal opportunity of participation for all segments in society, the economy and politics. Opportunities for participation should be promoted alongside efforts to provide for effective public-sector management and growth through competitiveness described in the previous two chapters.

213. **The importance of addressing exclusionary constraints is heightened by Sri Lanka's recent history of internal conflict.** Conflict negatively affected the entire country and specific segments of the poor and bottom 40 percent in particular. As noted earlier, it is estimated that the cost of internal conflict in the period 1978-2002 was roughly 5 percent of GDP per annum. Not surprisingly, the highest levels of poverty and weakest equality of opportunity are in the areas most affected by conflict, the Northern and Eastern Provinces. Not all ways in which exclusion has occurred in Sri Lanka directly fed past internal conflicts, nor was exclusion the only driver of conflict. However, many observers, including the LLRC, have noted that manifestations of exclusion played an important role in sustaining internal conflict in the country. Addressing the need for an inclusive society, economy, and polity is crucial for sustaining peace and security.

A. Inclusion across Space

Spatial Concentration of Poverty

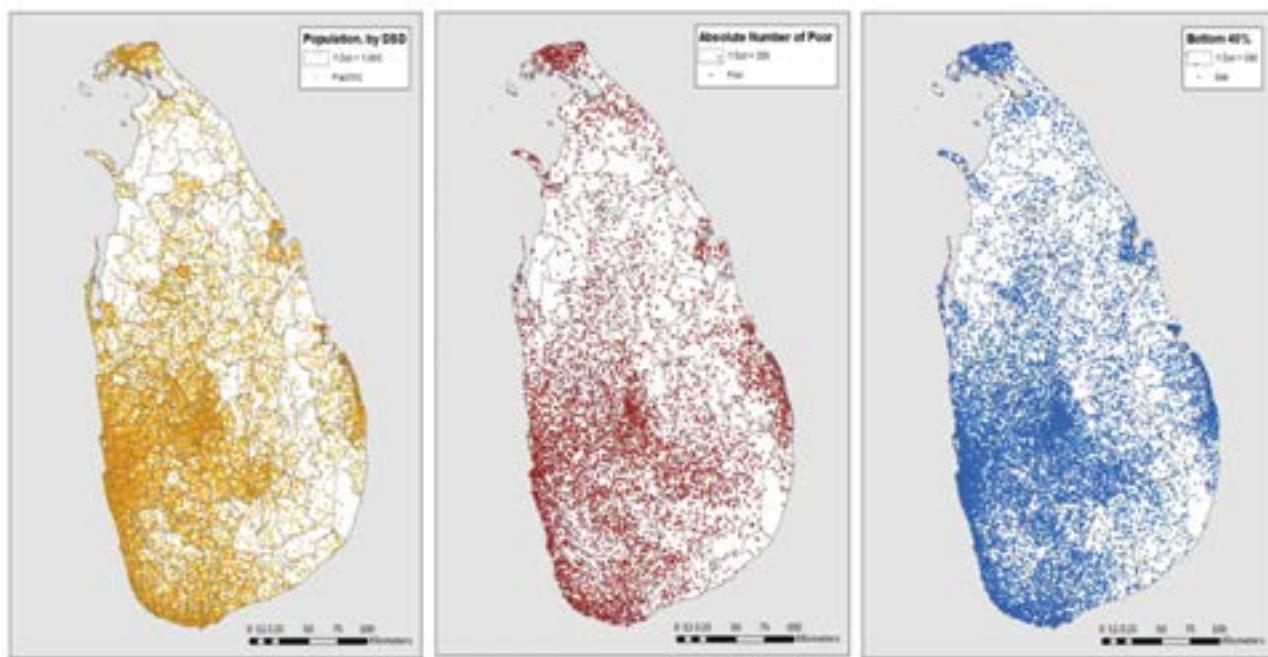
214. **The highest numbers of people living in poverty and the bottom 40 percent are located within the Kandy-Colombo-Galle multi-city agglomeration, followed by the other single city agglomerations.** In fact, the spatial distribution of the poor and vulnerable -- in absolute numbers – across Sri Lanka has come to more closely mirror the spatial distribution of the overall population, leading to an increase in the relative concentration of poverty around the country's main urban areas. The highest numbers of people living in poverty and vulnerable to poverty are located within the Kandy-Colombo-Galle multi-city agglomeration, followed by other single city agglomerations (Figure 5.1).

215. **The concentration of poor in more dynamic areas of agglomeration point to the importance of cities in further poverty reduction.** Almost 50 percent of both

Almost 50 percent of both poor and vulnerable populations are within 30 kilometers of an urbanized area

⁸⁰ Poverty measurement is based on per capita consumption and the national poverty line. Note that the poverty line will need to be updated soon given that the basket of goods being used corresponds to the 2002 basket. Similarly a more ambitious poverty line may be desired in line with Sri Lanka's middle income status.

Figure 5.1 Spatial location of overall population, poverty and the bottom 40 percent



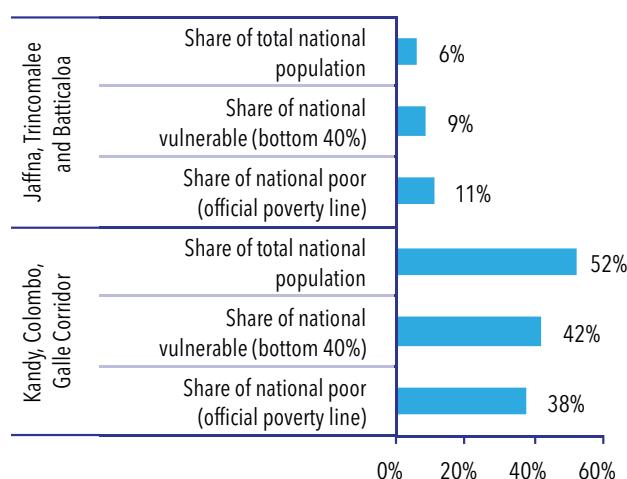
Source: World Bank staff and GIS analysis using 2012 Census and HIES 2012/13.

the growth of the Kandy-Colombo-Galle agglomeration, in particular, the Metropolitan Colombo Region, and how to increase other single-city agglomerations, given their potential and implications for economic growth, competitiveness and poverty reduction. Streamlining urban management structures and improving their capacity to ensure they have the administrative powers to deliver functional urban services and conduct integrated, strategic planning (including land-use planning and transport planning) will provide local authorities with the opportunity to respond to both present and future needs.

216. However, these interventions will need to be complemented with others targeted to assist the poor in more isolated regions of the country. As noted in Chapter II, portions of the Northern and Eastern Provinces stand out as regions with high concentrations of poverty (Figure 5.3). This is true both for monetary and non-monetary measures of poverty such as education, nutrition, and access to services. Areas with higher poverty rates also tend to have a high share of the bottom 40 percent. In addition, two districts (Nuwara Eliya and Badulla), which make up a large portion of the estates, are home to 10.7 percent of the poor population. The analysis and recommendations in the preceding chapters are especially important for highly populated regions that can benefit the most from opening of markets and higher competitive-

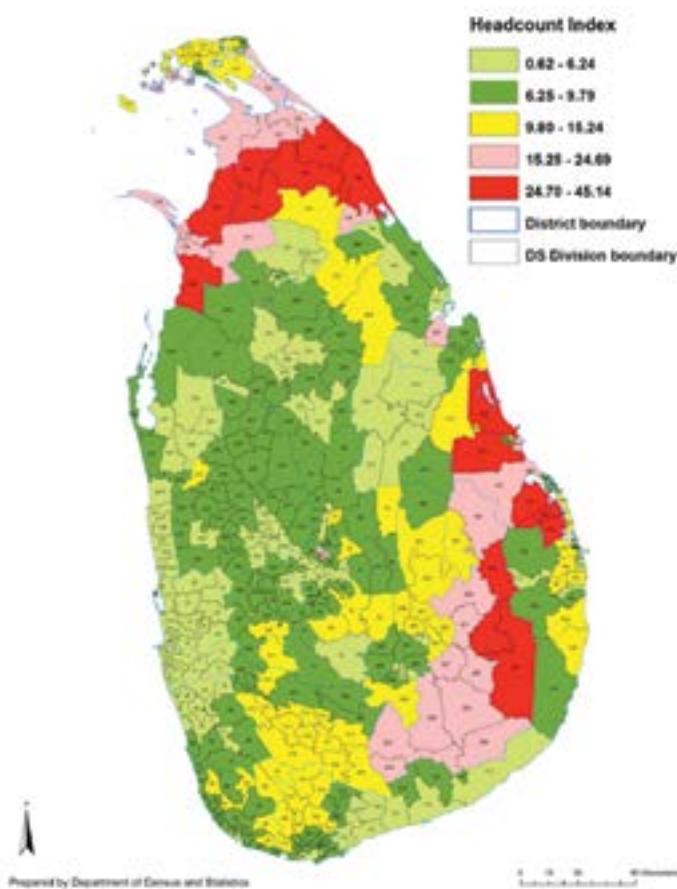
ness given their proximity to markets. This chapter focuses on the North and East, the estate sector, and Moneragala district. These are areas with a long-term inclusion challenge that is different from the one confronting poor areas located near centers of economic activity.

Figure 5.2 Share of national poor and vulnerable within 30km of all agglomerations



Source: World Bank staff based on HIES 2012/13.

Figure 5.3 Poverty headcount rate in Sri Lanka



Source: World Bank & DCS Poverty Map. Poverty line is Sri Lankan national poverty line.

Table 5.1 Poverty in post-conflict areas is high

	National poverty line	\$1.25 a-day	\$2.50 a-day
Districts outside of Northern and Eastern Provinces	6.1	2.8	29.9
Eastern Province	11.0	5.5	47.3
Northern Province	10.9	6.1	45.5
Jaffna	8.3	4.7	42.6
Vavuniya	3.4	1.6	23.1
Mannar	20.1	12.4	60.9
Mullaitivu	28.8	17.3	74.4
Kilinochchi	12.7	5.9	57.2
Sri Lanka	6.7	3.2	32.1

Source: World Bank (2015) using HIES 2012/13.

Conflict Affected Areas

217. **Poverty rates are highest in portions of the Northern and Eastern provinces, which were at the center of the conflict.** As pointed out above, the highest poverty headcount ratios at the district level are found in Mannar, Mullaitivu, and Kilinochchi at both the national poverty line and international poverty lines of \$1.25 a day and \$2.50 a day (Table 5.1).

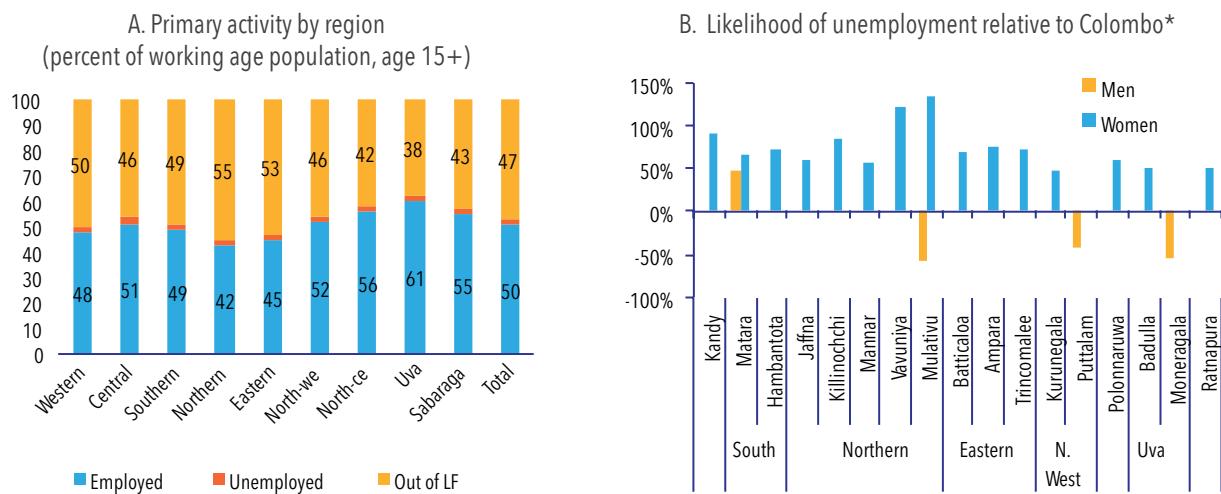
218. **In these districts, poverty rates are highest for the youth and those with no education.** About 47 percent of people living in poverty in the Eastern and Northern provinces are younger than 25 – 50 percent if the more affluent districts of Jaffna and Vavuniya are excluded – as compared to only 40 percent in the other provinces. In particular, in Mannar, Mullaitivu, and Kilinochchi, poverty rates among the youth are especially high, reaching 28 percent for 6 to 14 year olds and 22 percent for 15 to 24 year olds.⁸¹ These high monetary poverty rates are correlated with multidimensional measures of welfare to the extent that poverty rates are disproportionately high among those with no education. Interestingly, poverty rates are twice as high for those with secondary than primary education, suggesting that even reasonably well-educated workers suffer from a lack of job opportunities in these districts.

219. **High poverty headcount rates in these regions are associated with weak links to the labor market.** This is reflected in low labor force participation rates. Across provinces, labor force participation rates are the lowest for the Northern and Eastern provinces (Figure 5.4A), but in the absence of panel data that follows individuals over time it is difficult to see whether this is improving. When looking at the country by sub population groups, the Northern province stands out for its low labor force participation among males, adults, urban residents, rural residents, and those with below O-level education. Similarly, the Eastern province stands out as having the lowest labor force participation among youth and females.

220. **In addition to low participation, the North and East also have high unemployment rates, particularly among the youth and among educated women.** Youth

⁸¹ World Bank, 2015 (Poverty Assessment, forthcoming)

Figure 5.4 The North and East have weak links to the labor market



Source: Arunatilake et al (2015) using 2012 Labor Force Survey; includes all districts.

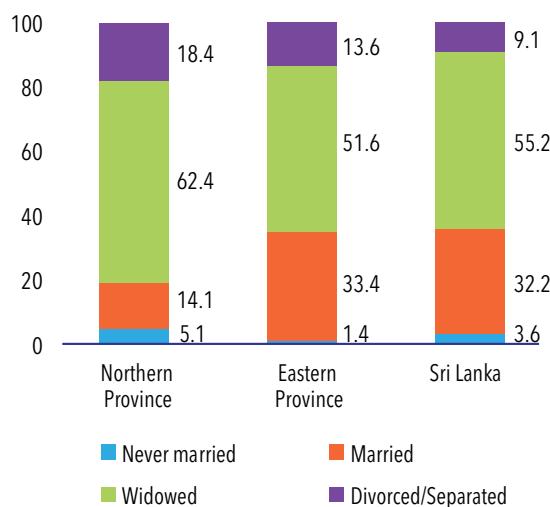
* Results from a Probit regression estimating the likelihood of being unemployed. The model controls for age, education, marital status, ethnicity, the number of children and the elderly. For women it controls for whether she has children and whether there are other adult women in the household

Box 5.1 Female-Headed households in the northern and eastern provinces

Female heads of household are particularly vulnerable in the post-conflict setting of the Northern and Eastern Provinces. Most of these household are headed by widows (see figure). However female-headed households are quite heterogeneous. First, childcare requirements may prohibit younger widows with small children from generating income, while older female heads of households are less able to do certain types of manual work. Second, widows whose husbands served in the national army receive their husbands' pension or 50 percent of his salary, while widows of men fighting in the LTTE receive a one-time payment only if they can produce a death certificate. Third, the application of family law according to different communities' legal codes can create varying outcomes. Sinhalese female heads may enjoy the benefits of a more women-friendly Sinhalese legal code, while Muslim female heads may face restrictions on their activities and become particularly vulnerable when these prevent them from seizing income-earning opportunities. Finally, the loss of assets during the civil war can make it difficult to marry daughters as land and house assets are commonly used as dowry. This is particularly important in Tamil communities.

Source: Schmidt and Canpolat (2015) based on Vasudevan (2013), Jayatilaka and Amirthalingam (2015), and Ruwanpura and Humphries (2004).

Female-heads of household in the Northern and Eastern Province by marital status



Source: Own calculations using HIES 2012/13

Box 5.2 Inclusion of ex-combatants

Persons with physical disabilities and psychological problems due to conflict, in particular ex-combatants, are particularly vulnerable to exclusion. An estimated 10 to 15 percent of the population in the Northern Province – a large portion of them ex-combatants -- suffers from a physical disability related to the conflict. In addition, epidemiological studies conducted among conflict-affected populations in Northern Sri Lanka show that the conflict has led to increased psychosocial problems among these populations. Although mental health issues are prevalent among ex-combatants, there is a lack of psychological assistance programs specifically designed for ex-combatants. Notwithstanding government programs to integrate former combatants, they still struggle to enter into the labor market and have relatively high levels of unemployment and underemployment. Social stigma -- fears of being associated with ex-combatants or perceptions that they are still violent -- contributes to their marginalization. In a qualitative study conducted with young female ex-LTTE fighters in the Eastern district of Batticaloa, Krishnan (2011) notes that job opportunities are more restrictive for female ex-combatants than their male counterparts, with the biggest barrier being that they are not able to use the clerical, engineering, or other non-combat skills they had learned. Ex-combatants face surveillance, which prompts fears that they have not been fully rehabilitated.

Source: Schmidt and Canpolat (2015) based on Perera (2011, 2014), Siriwardhana and Wickramage (2014), Immigration and Refugee Board of Canada (2015), and Krishnan (2011).

unemployment rates⁸² in the North and East were as high as 27 percent in Ampara and 25 percent in Kilinochchi compared to 12.5 percent in Colombo in 2012. Moreover, the percentage of those looking for a job for more than a year was highest (65 percent) in the Eastern province. Over 90 percent of the unemployed in the Northern and Eastern provinces were first-time job seekers, compared to 57 percent in the Western Province. Much of the reason for high unemployment in these two provinces is explained by high female unemployment, particularly among those with A-level education or more. However, the probability of being unemployed is significantly higher for women in the North and East relative to Colombo, even after controlling for educational and other individual characteristics (Figure 5.4B). For men, no significant difference in the likelihood of unemployment is detected. The most common search method in the North and East is to register for a government job (48 and 45 percent, respectively), compared to Colombo where advertisements and informal family networks are more common. This difference is especially large among well-educated workers. Together, this evidence points to very high aspirations in the North and East to be employed in the public sector. However, in the absence of panel data that follows individuals over time it is difficult to see whether aspirations are changing. To the extent that these unmet aspirations are persistent, they could lead to further discontent. It is also important to note that female-headed households and ex-combatants are particularly vulnerable in a post-conflict setting (Boxes 5.1 and 5.2).

The Estate Sector⁸³

221. In addition to the populations in the North and East, estate workers have long had high poverty rates. Because the majority of them descended from indentured labor brought from India in the early 1900s and began to receive citizenship only in the 1980s, they lived for decades without state provision of social services. Large inequalities continue to exist in their access to, and utilization of, health services. Estate workers are largely dependent on the estate's management for their basic needs, particularly housing.⁸⁴ Since nationalization in 1975, the state has retained responsibility for providing education in the estate sector. In 1994, the Ministry of Health was requested to take over estate hospitals and had successfully taken over hospitals and maternity wards and dispensaries by 2000.⁸⁵ Housing and land on the estates are under the control of plantation management.

222. Poverty in the estate sector fell markedly in the past decade. Although the estate sector has traditionally been the poorest in Sri Lanka, poverty rates typically have been only moderately higher in the estate sector than the

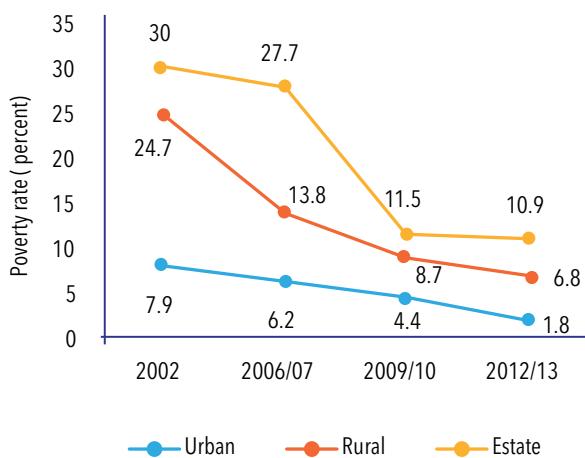
⁸³ The estate sector consists of state-owned plantations which comprise over 170,000 ha, most of which is devoted to tea and rubber cultivation. The plantations were originally set up by British colonists who brought in Indian origin Tamils as laborers. Housing and land on the estates remains under the control of plantation management while the state took over provision of social services and public infrastructure in the mid-2000s. The particular social and economic features of the estates have led to it being treated as a separate category from the rural and urban sectors.

⁸⁴ Jayawardena, 2013.

⁸⁵ Gunetilleke et al. 2008

82 Defined as the share of unemployed individuals ages 15-24.

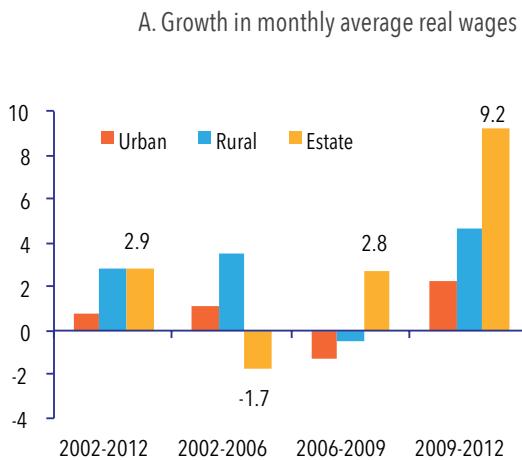
Figure 5.5 Most of the reduction in estate poverty happened during 2006-2009



Source: World Bank (2015).

rural sector. In 2002, headcount poverty was estimated to be 30 percent in the estate sector, as compared to 25 percent in rural areas (Figure 5.5). A gap between the rural and estate sectors emerged in 2006/07, after poverty fell rapidly in rural areas but changed little in the estate sector. By 2009/10, however, the estate sector had largely caught up to the rural sector, and by 2012/13 the estimated headcount poverty rate in the estate sector was 10.9 percent, compared with 6.8 and 1.8 percent in rural and urban areas, respectively (Figure 5.5). In fact, most of the decrease in estate poverty during the period of 2002-2012/13 occurred between 2006 and 2009 (from 28 to 11 percent).

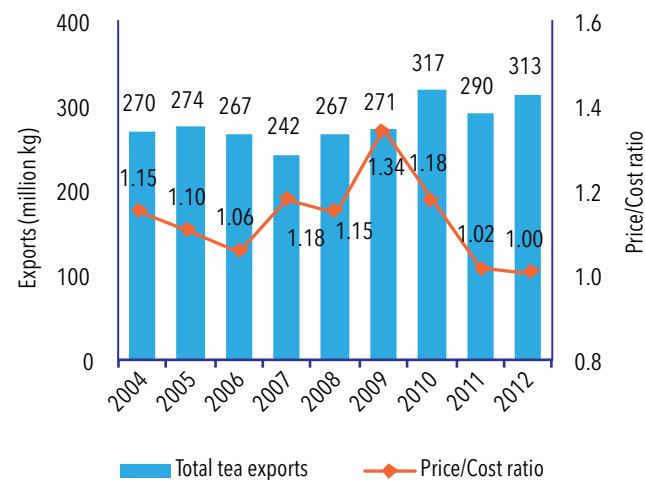
Figure 5.7 Real wage increases have been largest in the estate sector



Source: Arunatilake et al (2015) using LFS data.

Note: Calculations exclude Northern and Eastern provinces. CCPI (2002=100) and CCPI (2006/7=100) are used to convert nominal wage to real wages.

Figure 5.6 Higher tea prices led to larger profit to the tea industry



Source: World Bank (2015).

The large reduction in estate poverty is corroborated by other welfare indicators, such as the multidimensional welfare index reported by United Nations Development Programme (2012), which show a decline in multidimensional poverty from 21.1 percent to 11.4 percent between 2006 and 2009.

223. One potential explanation for this sharp decline in estate sector poverty is the substantial increase in the price of tea, which is the major output of the estate sector as well as Sri Lanka's largest exported commodity by export value. The Colombo auction price for tea surged

B. Wage premiums relative to urban sector

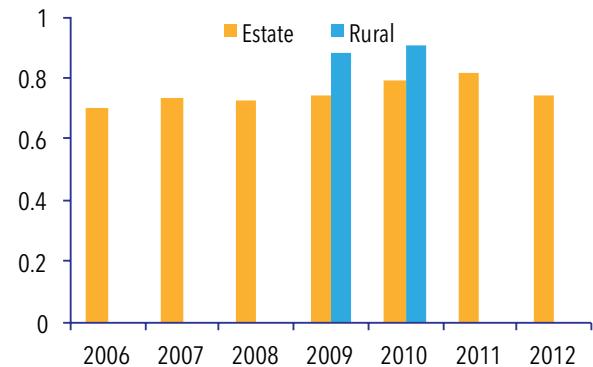
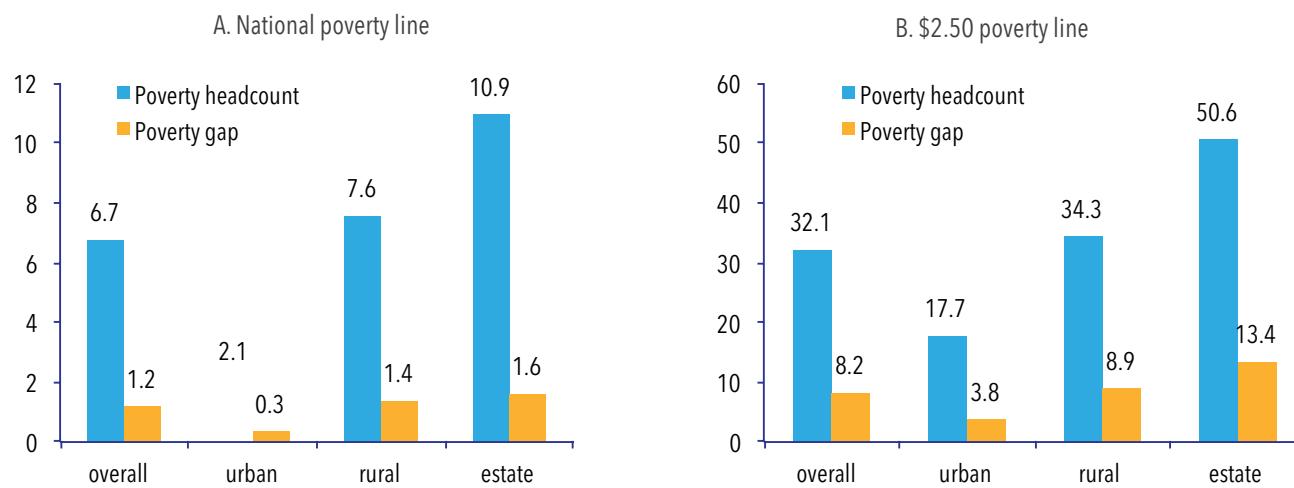


Figure 5.8 Poverty headcount and poverty gap by location, 2012 /2013



World Bank (2015) using all districts in HIES 2012/13.

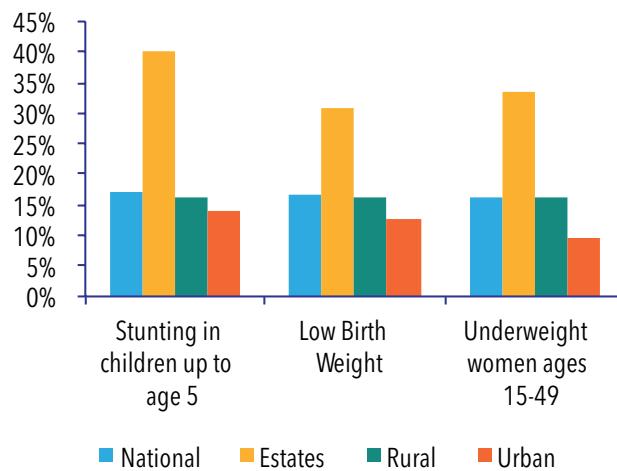
while the quantity of total tea exports remained stable. This resulted in much higher profit margins and revenue for the tea industry, as reflected by higher ratio of auction price and production cost (Figure 5.6), along with higher wages for estate workers.

224. In fact, wage increases were larger in the estate sector when compared to the agricultural sector as a whole (Figure 5.7A). This may be partly because estate workers had negotiated minimum wage increases between 2009 and 2010. When controlling for individual characteristics, the premium for being an estate-sector worker relative to an urban worker has significantly increased over time (Figure 5.7B). Although real wages in the rural sector have been statistically the same as what an observationally equivalent worker would earn in the urban sector, they were significantly higher than real earnings in the estate sectors in 2009 and 2010. This highlights a large increase in profitability during that time period for own-account farmers compared to estate worker earnings, despite the increase in minimum wages. However, rural-sector worker premiums have since fallen, in line with commodity prices.

225. Despite recent improvements, poverty rates continue to be higher in the estates when compared to both urban and rural sectors,

pointing to continued vulnerability. As shown in Chapter II, the poverty headcount is 10.9 percent in the estates, compared to 7.6 percent in the rural sector and 2.1 percent in the urban sector poverty (Figure 5.8). At

Figure 5.9 Nutrition indicators



Source: DHS, 2007.

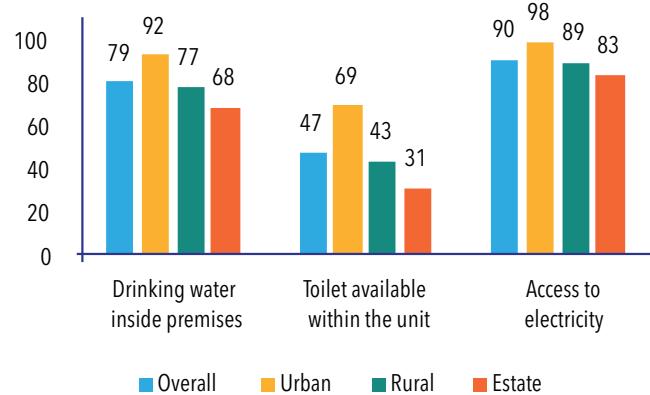
the \$2.50 poverty line, the poverty headcount is 50.6 percent in the estates compared to 34.3 percent in rural and 17.7 percent in urban areas. In fact, about 40 percent of the population in the estate sector still lives between the national poverty line and \$2.50 a day (2005 PPP). This indicates that a large share of the estate sector population is nearly poor and is vulnerable to adverse shocks. Moreover, the poverty gap index, measuring how far people are from the poverty line, is also considerably higher in the estates, at 13.4 percent compared to 8.9 percent in rural areas at the \$2.50 poverty line (Figure 5.8). Moreover, 62.7 percent of the population in the estate sector is in the bottom 40 percent of the distribution, compared to 42.5 percent for rural and 23.3 percent for urban populations.

226. Non-monetary indicators of poverty, health and nutrition are worrisome, especially in the estates. Island-wide 21 percent of children under 5 are underweight, 16 percent of babies born have low birth weight and 16 percent of women of reproductive age (15-49) are malnourished. Estates have the highest maternal mortality rates in the country, and both estate women and children suffer from severe malnutrition. About 30 percent of children below 5 are underweight, nearly one in three babies born have low birth weight, and one-third of women of reproductive age are malnourished (Figure 5.9). A significant reason for child and maternal malnutrition in the estate sector was intake of the “wrong” kind of foods, specifically those lacking in protein.⁸⁶ The fact that estate women traditionally eat whatever remains after men and children have been fed is considered a contributing factor to women’s malnourishment.⁸⁷ Being undernourished and overworked, mothers in the estates give birth to weak children and have inadequate breast milk, both of which contribute to high levels of infant mortality.

227. Housing provided for the estate workers is often described as inadequate. Estate-sector households are less likely to have drinking water, sanitary facilities or electricity within their households. The differences are particularly large for availability of drinking water; only 68.1 percent of households in the estates have drinking water available inside their premises, compared to 77.3 percent of households in rural areas (Figure 5.10). Similarly, less than one-third of estate households have a toilet available in their unit, compared to 43.2 percent of households in rural areas. Philips (2005) argues that the lack of toilets and running water implies that mothers and daughters need to wake up early in the morning and go to bushes for bathing and other needs, exposing them to all kinds of threats. Often, entire families live in so-called line rooms – barrack-type single rooms that are roughly 12 by 10 feet and described as crowded, damp, smoky and dark with leaking roofs and inadequate light and ventilation.⁸⁸ Housing, education, health care and childcare are often provided as non-monetary “welfare packages” to estate workers. It is argued these create a total dependency of workers on the management for all aspects of their lives.⁸⁹

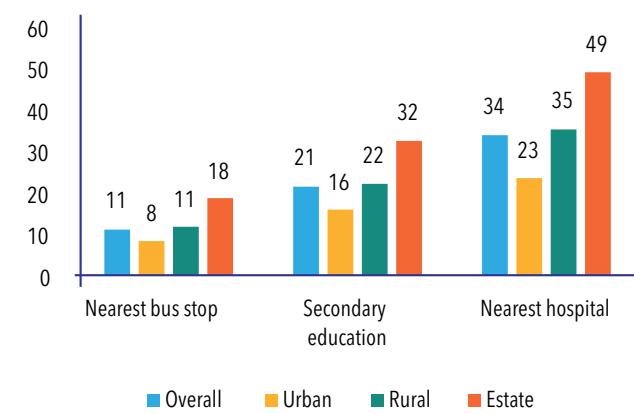
228. Moreover, access to services and the quality of services in the estates is comparatively low. Travel times generally mean that estate workers are isolated in terms of access to health and education. Estate workers need

Figure 5.10 Housing conditions in estate sector (percentage of households with access)



Source: World Bank (2015), all districts in HIES 2012/13.

Figure 5.11 Access to health and education services (average time to travel, in minutes)



Source: World Bank (2015), all districts in HIES 2012/13.

to travel longer to reach a bus stop, secondary education and the nearest hospital (Figure 5.11). Most schools in the estates are primary schools and upon completion of primary education, students have to travel to nearby villages to continue with secondary education. Poor roads and lack of transport facilities may contribute to the low enrollment rates at the secondary schools among the estate population.⁹⁰ Health facilities in the estates do not meet

⁸⁶ Jayawardena, 2014.

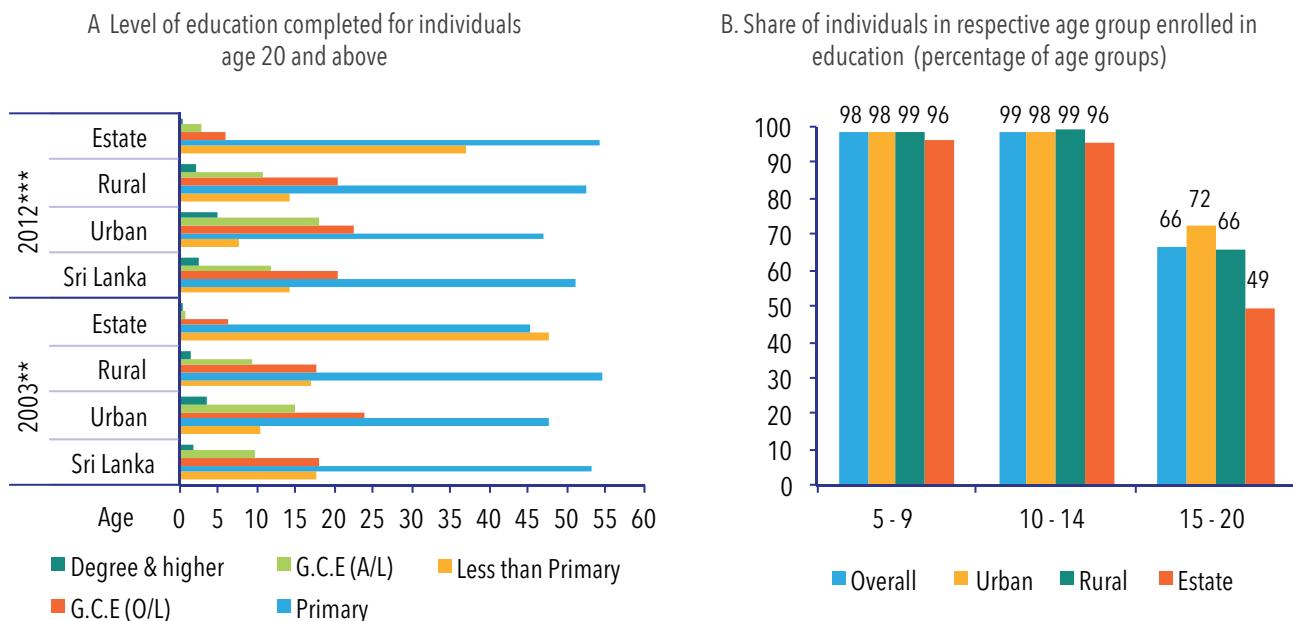
⁸⁷ Aheeyar 2011, Philips 2005

⁸⁸ Little 1999; Aheeyar 2011:10

⁸⁹ Gunetilleke et al. 2008:53

⁹⁰ UNFPA 2014: 24; Aheeyar 2011:11

Figure 5.12 Educational levels and enrollment



Source: Arunatilake et al (2015) using Labor Force Survey

Note: *** All districts, ** excludes Northern Province

national standards; hospitals in the estate sector are less well equipped and there are fewer trained health staff and medicine.⁹¹ Poor quality of health services pushes estate workers to obtain private health services at higher prices.⁹² Estate hospitals were taken over by the government in 2007, but it has been difficult to send doctors to staff those hospitals due to their remote locations. Estate schools are also run by the public sector, and, again, allocation of teachers (especially Tamil-speaking teachers) has been difficult. Successive governments have changed teacher recruitment policies (including school-based recruitments rather than national level recruitments) to improve the situation.

229. Poor outcomes in education impede the ability of the estate population to participate in Sri Lankan society. Across sectors, the greatest improvement in education attainment is seen in the estate sector, but it still remains low compared to other sectors.⁹³ For instance, the proportion of those who have completed primary level education improved from 82 percent to 86 percent in Sri Lan-

ka as a whole, with the corresponding improvement in the estate sector from 53 percent to 63 percent. The proportion of those who have completed O-levels improved from 7 percent to 9 percent in the estate sector. However, the proportion of the estate-sector working-age population with at least A-levels remains low at 3 percent, although improved from 1 percent in 2003. The estates not only have low levels of education for adults relative to the rest of the country (Figure 5.12A), but more importantly, they have lower enrollment rates, particularly among 15 to 20 year olds, of which only 49 percent are enrolled compared to 66 percent in rural areas (Figure 5.12B).

230. The youth are increasing leaving the estate sector. Between 2003 and 2012, the share of population in the estate sector increased from about 660,000 to about 682,000, an average growth of 0.4 percent a year, compared to an average growth of 1.3 percent per year for the country as a whole. However, the number of youth ages 15 to 24 actually declined (Figure 5.12B), particularly among those aged 15-20. In contrast, the share of adults aged 60 and above increased by 8 percent a year

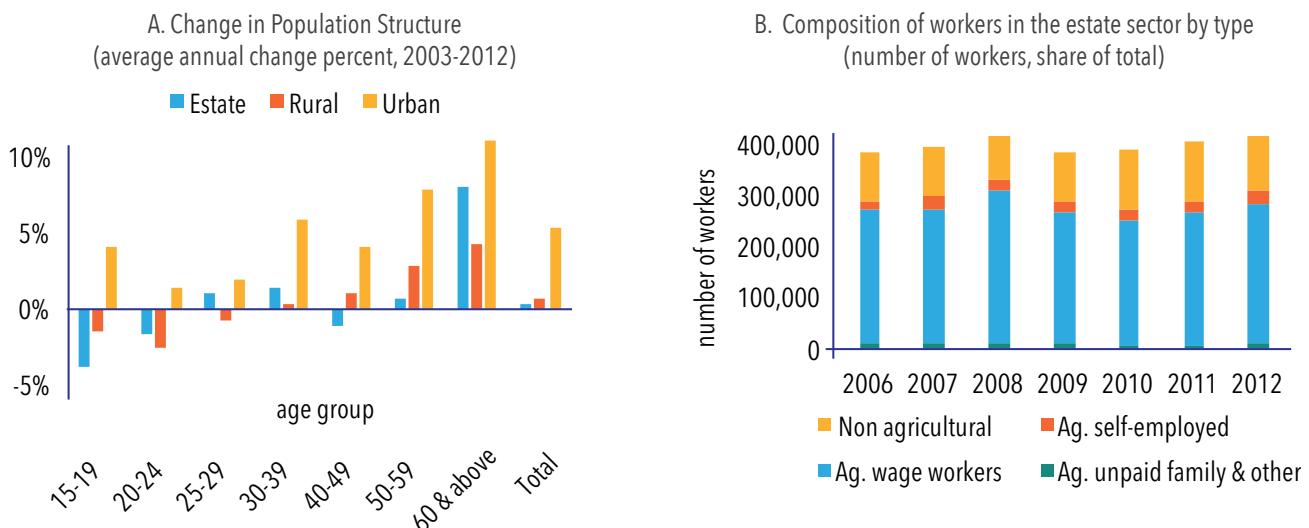
The number of youth ages 15 to 24 in the estate sector has declined while the share of adults aged 60 and above has increased

91 Ahmed 2014; Gunetilleke et al. 2008

92 Gunetilleke et al. 2008

93 In this paragraph, 2003 does not include the Northern Province, while 2012 includes the Northern Province.

Figure 5.13 The youth are leaving the estate sector and the share of agricultural workers is in decline

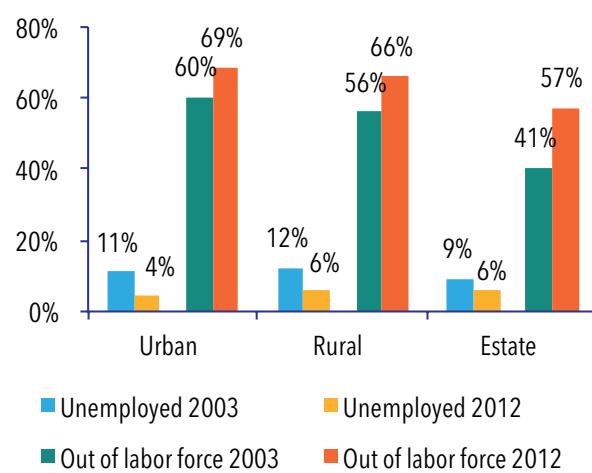


Source: Arunatilake et al (2015) using Labor Force Survey data. Data exclude Northern province for comparability

on average. This shift in the population structure also coincided with a movement away from agriculture wage work among those who live in the estates, while the share of workers engaged in non-agricultural activities – primarily manufacturing, transport, commerce and community services – increased from 24 to 30 percent between 2006 and 2010, but then declined somewhat in 2012 (Figure 5.13).

231. The educated estate youth face difficulties in accessing salaried employment outside the estate sector. While opportunities for estate youth to work in service-sector industries, such as retail stores and communication centers, are expanding in nearby villages, the opportunities to work in professional, salaried occupations are not easily available to the estate youth. Despite their preference to work in such occupations, estate youth has to compete with better educated and socialized peers from the rural and urban sectors who are preferred by employers.⁹⁴ Due to this situation many estate youth take on lower-level job openings, such as domestic workers, shop assistants or construction workers, and relatively few are able to secure jobs as semi-skilled workers, such as drivers or mechanics. According to a qualitative study conducted by Gunetilleke et al. (2008), most of the estate youth reported facing stigmatization and discrimination due to their Indian Tamil ethnicity and estate worker identity, both of which constitute a barrier in accessing non-estate job opportunities. While youth unemployment is low and declining relative to the rest of the country (Figure 5.14),

Figure 5.14 Labor force participation and unemployment rates for youth, ages 15-24



Source: Arunatilake et al (2015) using LFS. Data exclude Northern province for comparability.

the share of estate youth who are out of the labor force has increased by over 40 percent, compared to an 18 percent growth in rural areas. Although this may be correlated with a higher share of youth being enrolled in school, it also suggests “voluntary” inactivity due to the mismatch of job opportunities and aspirations.

232. Women in the estates face additional layers of exclusion. Women tend to be employed for the lowest-paying unskilled tasks that require intense labor such

94 Gunetilleke et al. 2008

Box 5.3 Gender-based violence: one of the most extreme forms of exclusion

GBV is one of the most extreme interferences with women's dignity, and it impacts their opportunities to participate in society. The forms of violence faced by the women in Sri Lanka range from rape and domestic violence to sexual harassment in public transportation. All these prevent women's access to health, education and employment opportunities. Legal consequences for rapists are rare and, in a UN-led survey, only 34 percent of those who admitted rape felt worried or guilty about their actions, suggesting that social norms are permissive of this extreme form of violence against women.

Several studies argue that violence against women has increased due to conflict and disaster. The presence of military forces, the setting of displacement camps, the loss of male household members to war and alcohol abuse caused by war-related trauma increase insecurity for women. The tsunami additionally contributed to this environment of insecurity for women, who became victims of sexual and domestic violence both in the immediate aftermath of the disaster and during the post-tsunami rehabilitation and reconstruction process. Finally, due to instability caused by the conflict and natural disaster, girls were rushed into child marriages to tsunami widowers who sought government subsidies for marrying and starting a family, creating vulnerability.

Gender-based violence is linked to cultural norms and attitudes about masculinity. In a survey conducted in Colombo, Hambantota, Nuwara Eliya and Batticaloa districts, de Mel et al (2013) argue that male perpetration of gender-based violence is linked to cultural attitudes about how to be a man. The study found that majority of men as well as women linked manhood to dominance, toughness and violence. Men who reported committing sexual violence often were motivated by sexual entitlement – as men they perceive themselves as having right to have sexual relations with women. Fifty five percent of men in the sample agreed that in case of rape one would have to question whether the victim is promiscuous or has a bad reputation. Regarding intimate partner violence (IPV), 41 percent of male respondents agreed with the statement that a woman should tolerate violence in order to keep the family together. Around 78 percent of men affirmed the view that women should obey their husbands, while 58 percent of men stated that women could not refuse their husbands. Women also contribute to the persistence of inequitable gender norms: 58 percent of women (a higher percentage than men) believed that a woman should tolerate IPV in order to keep the family together. Moreover, 75 percent of women agreed that, "some women ask to be raped by the way they dress and behave.". According to the study, male attitudes on reproductive issues, equal wages, children's education, women associations and entry into politics were more equitable. Seventy percent of men agreed that women should be in public decision-making roles and 62 percent supported the greater participation of women at the elections. Lastly, the study emphasized particular vulnerabilities that men face throughout their lives, which increases their risk of perpetration of violence against women. Economic pressures resulting from inadequate income, lack of economic assets, and financial responsibilities as breadwinners are found to be among the primary causes of male stress and lack of well-being. Male respondents are also found to have moderate level of depression and suicidal thoughts.

Source: Schmidt and Canpolat (2015) based on Hettige et al. (2012), Save the Children (2006), Fisher (2010); Immigration and Refugee Board of Canada (2012); Perera et al. (2011), Solotaroff and Pande (2014), Rush (2011), UNHCR (2004); Freedom House (2011); Biermann (2006); and de Mel et al (2013)

as tea plucking or rubber tapping.⁹⁵ According to Kotikula and Solotaroff (2006), approximately 86 percent of female estate workers are fieldworkers and estate women face obstacles in moving up to higher-level positions. Gender segregation varies by the type of estate management as well as the type of crop; it is found to be less severe in rubber estates, where 25 percent of supervisors are women, compared to 5 percent in tea estates. Despite being income earners, there is substantial anecdotal evidence that estate women's wages are often collected by their husbands or fathers who, in turn, often spend it on alcohol.⁹⁶ Their status in the estates makes women vulnerable to gender-based violence (GBV), and not only at home; there are also frequent reports of harassment, rape and abuse of es-

tate workers by male supervisors in the fields. According to a qualitative study commissioned by United Nations Population Fund (UNFPA) in 2003 with 350 women in estates in Hatton, 83 percent of women were found to be victims of GBV (Box 5.3).⁹⁷

233. More generally, alcoholism is found to be an issue in the estates.⁹⁸ Poor housing and infrastructure are seen as one of the reasons behind high levels of alcoholism in the estates. In the qualitative study conducted by the Center for Poverty Analysis in 2005 with the estate population, alcoholism was identified as a major community problem, especially by female and young respondents, and it was perceived as a primary cause of poverty. According to a baseline survey conducted in 2005 in the estates,

95 Kotikula and Solotaroff 2006; Philips 2005; Jayawardena 1984

96 Aheeyar 2011; Ahmed 2014; Daniel 1993; Jayawardena 1984

97 Perera et al. 2011

98 Gunetilleke et al. 2008; World Bank 2007; Aheeyar 2011

Figure 5.15 Moneragala labor force characteristics and travel times to facilities



Source: Arunatilake et al (2015) using LFS 2012.

the number of working men who regularly consume alcohol was found to range between 50 to 75 percent.⁹⁹ The same survey also revealed that 25 to 50 percent of daily earnings were spent on alcohol. Alcoholism in estates has number of effects, including draining household income and diverting funds from basic needs. Alcoholism is also associated with abuse of, and violence against, women in the estates.¹⁰⁰

234. Over the longer term, RPCs face major challenges which, given their extensive role in providing services, may impact the estate population. RPCs historically provided social support “from womb to tomb” and continue to provide some services as well as guaranteed lifetime employment. While the youth seek to leave the estates in general, there is still a large population, including a significant number of elderly dependents. The RPCs’ business model is under pressure from a combination of factors: declining profitability due to relatively higher wages after several increases over the past decade while facing stiff competition from more productive growers in Kenya and India; declining prices for estate commodities (tea, coconut products, and rubber); and reduced demand from key historical consumers in Russia and the Middle East. There are estimates that up to half of tea plantations’ acreage requires replanting. The difficult prospects for the sector may translate into profound socio-economic chal-

lenges, including loss of jobs and social support mechanisms, for the estate population.

Moneragala

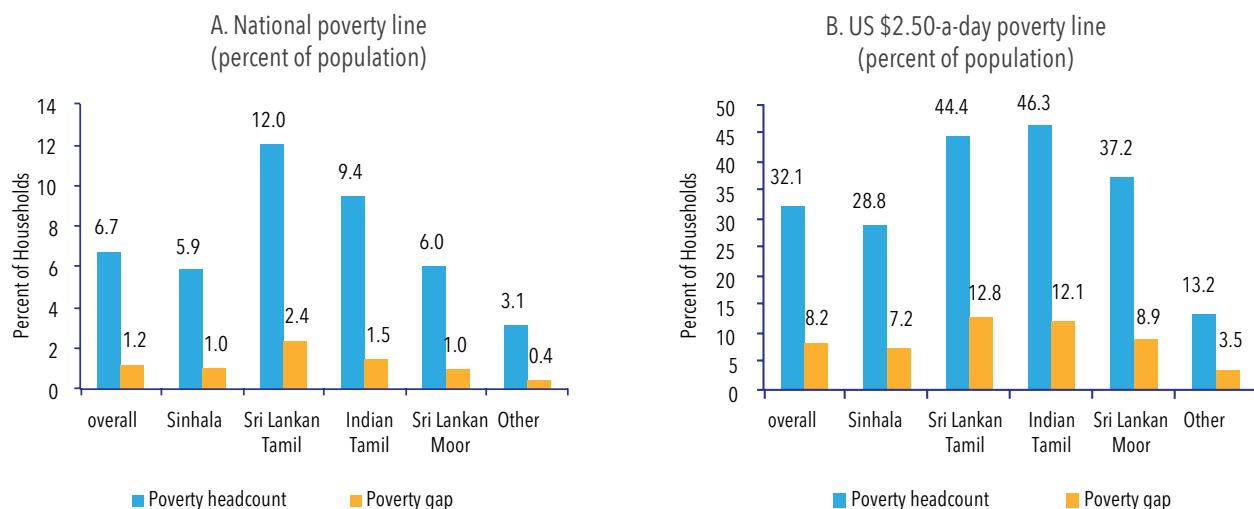
235. Persistent high poverty rates in Moneragala are related to its strong reliance on agriculture and relatively little diversification within households to other industries. Moneragala is the second largest of the 25 districts in Sri Lanka, with relatively low population density (82 per square kilometer compared to an average of 331 for the country as a whole in 2014¹⁰¹). Moneragala is home to tea, rubber and coconut plantations and a large number of small holders, with 34 percent of households cultivating paddy land compared to 18 percent for the country as a whole. As such, it is mostly an agricultural district; 57 percent of the workforce engaged in agricultural activities, compared to 31 percent for the country as a whole, while only 32 percent of workers are in services compared to 43 percent for the country as a whole (LFS, 2012). Moreover, it has a relatively high share of self-employed agricultural workers and unpaid family workers, and relatively fewer non-farm or wage employees. The relatively low density of the population coupled with the high reliance on agriculture suggests that households in Moneragala are less diversified, and as such, are especially vulnerable to agricultural price fluctuations and have few alternative sources of income (Figure 5.15A).

99 Aheeyar 2011

100 Gunetilleke et al. 2008; Jayawardena 1984

101 DCS, Mid-year population estimates, 2012-2014.

Figure 5.16 Sri Lankan Tamils and Moors have higher levels of poverty



Source: Arunatilake et al (2015) using LFS 2012.

236. Persistent high poverty rates in Moneragala are also related to relatively low access to services. Average levels of education are below the national average, with about eight years of education compared to the national average of nine. Access to services is in line with the national average, with the exception of electricity and sanitation, which are well below the country average. Travel times to secondary schools, hospitals and agricultural centers are also higher than for the rest of the country (Figure 5.15B). Approximately one-third of total area in the district is covered by natural forests under natural parks and/or sanctuaries that are not available for human development. However, there is increasing encroachment of forests, a growing human-wildlife conflict, and soil degradation from gem mining in its granite deposits.¹⁰² Further analysis on the determinants of poverty in Moneragala would be useful to design multi-sector interventions that could help to reduce the relatively high levels of poverty prevalent in the district.

B. Inclusion of Ethnic Communities

237. There are differences in poverty rates among Sri Lanka's ethnic communities. Sri Lankan Tamils and Sri Lankan Moors constitute the two largest ethnic minority groups and have higher levels of poverty. Using the national poverty line, Indian Tamils and Sri Lankan Tamils have poverty rates that are 3.3 and 5.3 percentage points higher than the Sinhala population, respectively. Using the \$2.50

Source: World Bank (2015), all districts in HIES 2012/13.

poverty line, the poverty headcount for Indian Tamils is 46.3 and for Sri Lankan Tamils is 44.4 percent, compared to an overall poverty headcount of 32.1 percent. Using both poverty lines, the poverty gap for the Sri Lankan and Indian Tamils is above the average (Figure 5.16).

238. Empirical analysis finds that most of the differences in monetary poverty is related to inequality of opportunities. The likelihood of being poor is not statistically different for ethnic minorities relative to the Sinhala majority if one controls for education, ownership of assets, and access to services.¹⁰³ Estimates from a multivariate profile of risk-of-poverty

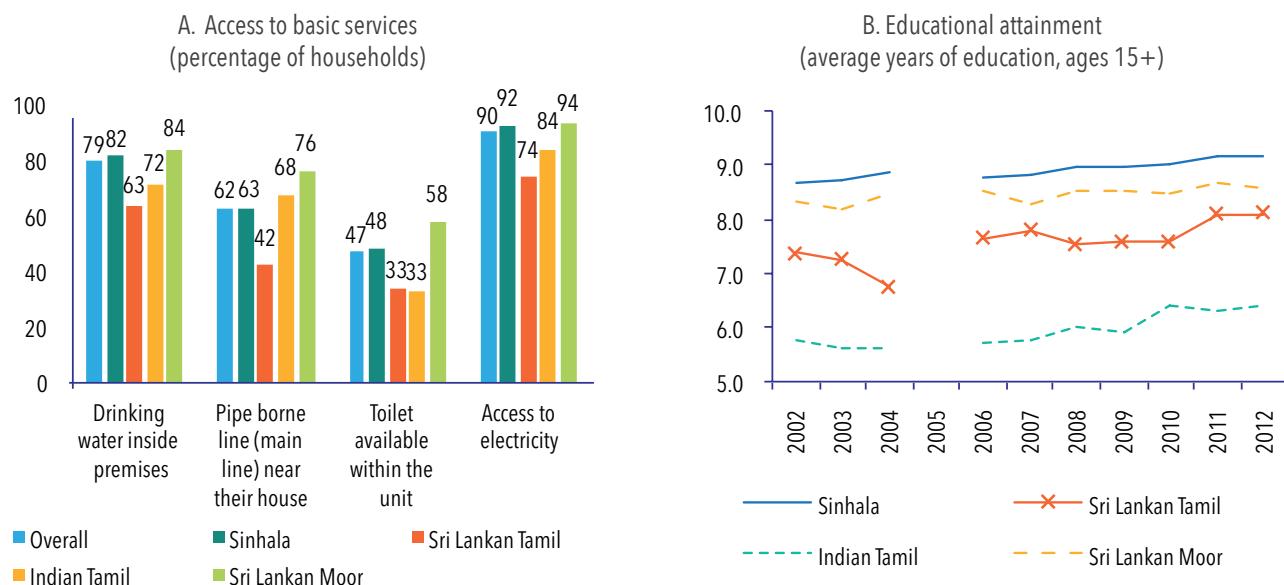
show that the likelihood of being poor increases with the number of family members, particularly children. With respect to the location of the households, rural households have a higher probability of being poor as opposed to urban households, while there is a high premium for living in the Western province. Any level of education attained after compulsory education (junior secondary, O-levels) decreases the chances of being poor. Meanwhile, living in a household where the head has no education or just primary education is linked to higher

Most of the differences in monetary poverty have to do with inequality of opportunities particularly with respect to education and access to services

102 Attanpola et al.

103 World Bank Poverty Assessment, 2015.

Figure 5.17 Access to services and educational attainment by ethnicity



Source: Arunatilake et al (2015) using LFS 2012.

chances of being poor compared to households where the head has completed compulsory education. Ownership of assets such as mobile phones, a sewing machine, or a television lowers the probability of being poor, as does access to services, particularly having running water within premises. Age, gender, and sector of activity of the household head, once controlling for all other covariates, are not statistically significant in assessing the risk of poverty of an individual. Moreover, the probability of being poor is statistically the same for Sri Lankan and Indian Tamils, once individual, household, and locational characteristics are controlled for. This points to the fact that most of the differences in monetary poverty have to do with inequality of opportunities, particularly with respect to education and access to services.

239. Access to services is particularly low for Tamils. For a range of indicators, the most recent household survey shows that Sri Lankan Tamil households have lower access to basic services, --including drinking water within their premises, the availability of a pipe borne line nearby their house a toilet within their unit, or access to electricity (Figure 5.17A). Despite increased spending on infrastructure across the country, this evidence points to remaining infrastructure needs, particularly related to improving housing services. At the same time, Sri Lankan Moors, have higher access to basic services than the majority Sinhala population.

240. Educational attainment is lower for the ethnic minority workforce. While educational attainment has

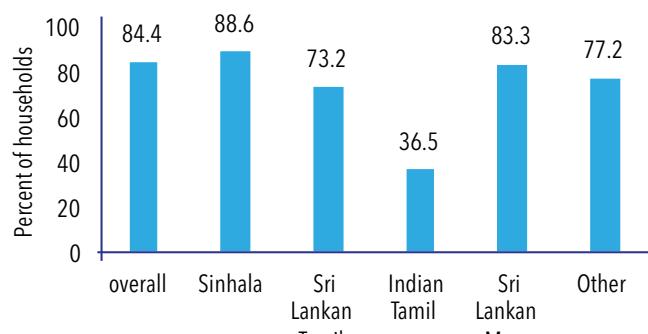
Source: World Bank (2015), all districts in HIES 2012/13.

improved for all population groups, the average level of education for Tamils is lower than that of other ethnic groups, even when excluding the most war-affected regions. For instance, comparable data over the last decade (excluding the North and Eastern Provinces) finds that 22 percent of Sri Lankan Tamils had less than primary education (compared to 12 percent for the Sinhalese workforce) and only 10 percent had completed A Levels, compared to 13 percent for the Sinhalese workforce. This has meant that, on average, the Sinhalese workforce has had consistently higher levels of education when compared to the Tamil or Moor workforce (Figure 5.17B).

241. Rates of ownership of land are also uneven among the country's ethnic communities. According to the 2012/13 HIES, 88.6 percent of Sinhalese households owned land, compared to 83.3 percent of Sri Lankan Moor households, 73.2 percent of Sri Lankan Tamil households, and 36.5 percent of Indian Tamil households (Figure 5.18). The lower rates of ownership among Sri Lankan Tamils, may be due, in part, to difficulties in restoring ownership rights following the destruction of property registries and loss of documentation owing to the conflict. The lower rates of ownership among Indian Tamils reflect the continued provision of housing by many estates, although recent years have seen cases where ownership of houses and associated plots has been transferred.

242. Empirical analysis using labor force surveys finds no statistical differences in unemployment rates across ethnic groups, while Sinhalese are more likely

Figure 5.18 Share of households owning some land, by ethnicity



Source: World Bank (2015), all districts HIES 2012/13.

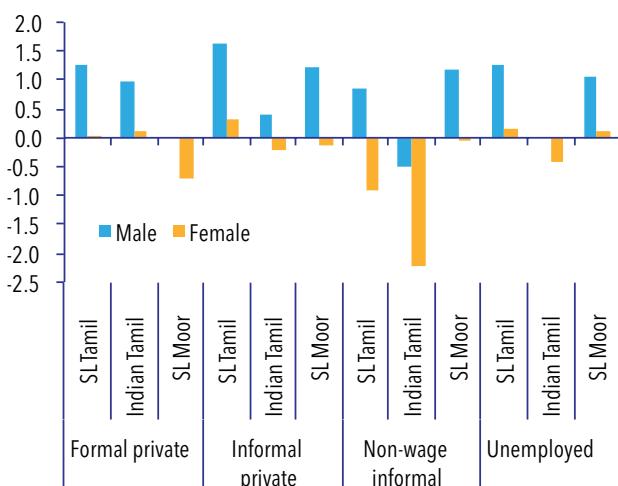
to be employed in the public sector. Labor force participation is low and unemployment is high for Sri Lankan Tamils and Moors, relative to the Indian Tamil and Sinhalese populations. However, much of this has to do with individual characteristics and the locational concentration of these populations. When focusing outside of those regions, both Sri Lankan and Indian Tamils have higher labor force participation and employment rates relative to their Sinhalese counterparts. This suggests that different rates of participation are mostly determined by differences in employment opportunities. Moreover, quantitative analysis shows that there are no statistical differences in the likelihood of being unemployed across ethnic groups, once you control for age, education and other individual and household characteristics. The only exception is that Indian Tamil males are more likely to be unemployed relative to their Sinhalese counterparts, in line with higher male unemployment in the estate sector.¹⁰⁴ In terms of the activity across population groups, empirical analysis using the labor force surveys finds that Sinhalese workers are more likely to work in the public sector than other ethnic groups (Figure 5.19). This empirical result cannot be corroborated against administrative employment data because the ethnic make-up of the public service is not tracked.

There are no statistical difference in the likelihood of being employed across ethnic groups once one controls for age, education, and other individual and household statistics

more likely to be unemployed relative to their Sinhalese counterparts, in line with higher male unemployment in the estate sector.¹⁰⁴ In terms of the activity across population groups, empirical analysis using the labor force surveys finds that Sinhalese workers are more likely to work in the public sector than other ethnic groups (Figure 5.19). This empirical result cannot be corroborated against administrative employment data because the ethnic make-up of the public service is not tracked.

104 Arunatilake et al, 2015.

Figure 5.19 Likelihood of activity relative to public sector employment and Sinhalese counterpart (individuals age 15 and over)



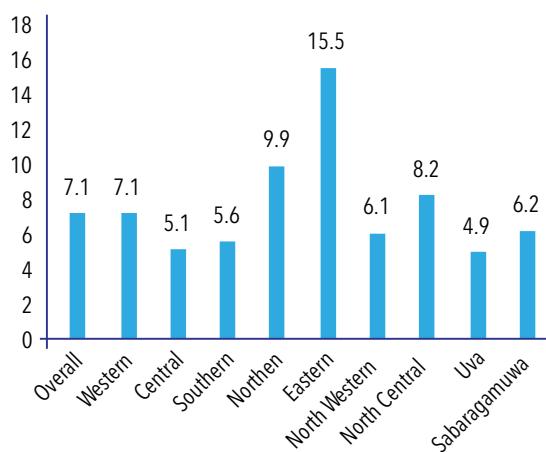
Source: World Bank (2015), all districts HIES 2012/13.

243. **The evidence suggests that non-Sinhalese men are more likely to be associated with private informal-sector jobs relative to their Sinhalese counterparts.** Even after controlling for individual characteristics, such as age, education, and marital status, as well as household characteristics, such as the number of children and the district in which they are located (Figure 5.19), ethnic minorities seem to be more likely to work in informal jobs. Tamil men are generally more likely to work in private activities relative to their Sinhalese counterparts, and within the private sector, Sri Lankan Tamils are more likely to work in informal private wage work. In contrast, Indian Tamil men are more likely to work in private wage work or to be unemployed than to work in the public sector compared to their Sinhalese counterparts. Finally, Sri Lankan Moor men are more likely to be informal private-sector wage workers, informal self-employed workers, or to be unemployed than to work in the public sector relative to their Sinhalese counterparts. Non-Sinhalese women, in contrast, are less likely to work as private self-employed workers compared to their Sinhalese counterparts, while Sri Lankan Moor women are more likely to work in the public sector compared to their Sinhalese counterparts. For women, there seems to be a stronger likelihood of participating in the public sector, particularly for Sri Lankan Moors. However, this may be associated with their relatively low participation in general (see below).

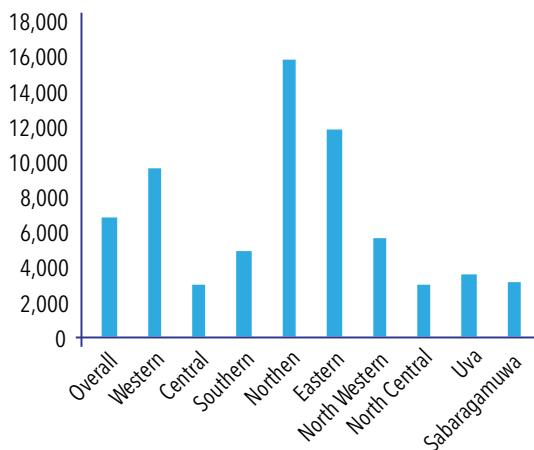
244. **Beyond these quantitative measures, perceptions of fairness, particularly when it comes to job opportunities, can be an important aspect in assessing**

Figure 5.20 Household debt to money lenders by province

A. Share of households indebted to money lenders, percent



B. Average amount of debt of households by region, Sri Lankan Rupees



Source: World Bank (2015), all districts in HIES 2012/13.

the success of efforts towards social inclusion. A perception survey carried out by the Asia Foundation (2011) suggests that, compared to Buddhists, Hindus and Muslims are less optimistic about improvements in minority rights and equal treatment in the government job market. Religious minorities were also less likely to think that the country is moving in the right direction.

Internally Displaced Persons and Returnees: An Additional Axis of Exclusion

245. An additional dimension of exclusion across ethnic lines concerns internally displaced persons. The post-war period has seen the return of over 700,000 displaced persons to their place of origin in the Northern and Eastern Provinces. Although basic material needs have largely been met,¹⁰⁵ returnees nonetheless face multiple challenges in accessing shelter, food and infrastructure and developing livelihoods. There are particular difficulties in securing land rights owing to the lack of an effective claims dispute mechanism and the loss of documentation owing to conflict and displacement. At the same time, there is migration into the North and East of other ethnic groups -- particularly Sinhala, some of whom were displaced decades earlier -- which creates tension over access to land. Finally, there are also a number of long-time IDPs, comprised mainly of Sri Lankan Tamils and Moors, who are excluded from the official statistics on IDPs and

have received lower levels of assistance. Their protracted displacement is sometimes hidden due to factors including deregistration of IDPs based on whether one's family place of origin is open for return, but they still live in displacement.

246. Families returning to their place of origin in the North are faced with problems of indebtedness. According to a mixed-methods study, which compares the amount of debt between groups who differ only in whether they engage in housing construction, households that engage in housing construction have significantly higher debt despite the housing assistance they received.¹⁰⁶ About 73 percent of housing beneficiaries in the sample reported borrowing money on top of the housing assistance provided to them. Reasons for doing so included the desire to build larger and better houses. As most of the returnee families engage in casual labor and lack sufficient and stable income to repay their loans, they become indebted. In addition, Romeshun et al. (2014) argue that most of the households lack financial literacy, such as knowledge about interest rates, and they have poor management of grant money, which worsens their debt situation. Female-headed households and households with disabled members are found to be particularly vulnerable. Anecdotal evidence suggests that there are cases of suicides and attempted suicides linked to indebtedness.¹⁰⁷ The high share of households indebted to money lenders and the average amount owed by households to money

105 UNOPS and Government of Sri Lanka. Joint Needs Assessment, 2015

106 Romeshun et al. 2014

107 Kadirgamar 2014; Romeshun et al. 2014

lenders in the Northern and Eastern Provinces (Figure 5.20) indicates both the comparatively high levels of indebtedness as well as the resort to this less institutionalized form of money lending in these provinces. While high rates of indebtedness in the North and East do not only affect IDPs, their particular circumstances appear to be the main driver of the problem.

247. Local empowerment in areas with concentrations of minorities remains an issue. Some empowerment has occurred, notably through the holding of elections to provincial councils and, more recently, the return of some lands occupied by the military and the appointment of a civilian governor to the Northern Province. While there are reports of easing, the high number of security forces in the conflict-affected areas has been cited as one of the main obstacles for IDP returnees and others in rebuilding their livelihoods and achieving durable solutions.¹⁰⁸ Reported continued surveillance and engagement by the military in local economic activities also have negatively affected IDP returnees and communities affected by the conflict.¹⁰⁹ Settlement and implementation of a division of authority between national, provincial, and local governments, especially in the North and East, remains an outstanding challenge. In addition, ensuring that further reconstruction and development projects proceed in a participatory manner will be important for inclusion.

C. Gender Inclusion

Low Female Labor Force Participation

248. Sri Lanka faces a low and slightly declining rate of female labor force participation. Sri Lanka's female labor participation had been stable at slightly below 40 percent for the past few decades up until the 2000s, when it started to decline. Although participation of women in the labor force is higher in Sri Lanka than its South Asian comparators, it is lower than comparable middle-income countries,

despite decades of low levels of fertility and good educational outcomes (Figure 5.21A). In 2013, female labor force participation stood at 35.6 percent, compared to a male participation rate of 74.9 percent. Moreover, participation has been

Female labor force participation has been static with a slight decline in the 2000s

¹⁰⁸ Internal Displacement Monitoring Centre 2012; Keerawella 2013; Raheem 2013; Saparamadu et al. 2014; Fonseka and Raheem 2010

¹⁰⁹ Internal Displacement Monitoring Centre 2012

slightly declining over the last decade. Across age groups, the drop in labor force participation rates was highest for the youth (Figure 5.21B). To a large extent, this is due to more young women continuing their education. In fact this is the main reason for non-participation among young women in 63 percent of cases in the 2012 labor force survey, up from 57.6 percent in 2002. In contrast, labor force participation for 60 to 69 year olds has increased over time.

249. Female labor force participation rates are higher for those with either low or high levels of education. Women with A-levels had participation rates that were 17 percentage points higher than those with O-levels (the next highest level of education) in 2012, and those with a degree or more had a participation rate 36 points higher than those with A-levels (Figure 5.21C). However, the difference in participation rates between highly educated women and those with less education is narrowing, albeit slowly. This is seen by the flattening of the curve in Figure 5.21C over time and holds true even when controlling for other regional and individual characteristics. Between 2003 and 2012, the difference in the likelihood of participating declined by 8 and 7 percent for women with incomplete primary and completed primary education, respectively, relative to those with university degrees or higher.¹¹⁰

250. As in most countries, labor force participation is lower for married women and for those with children.

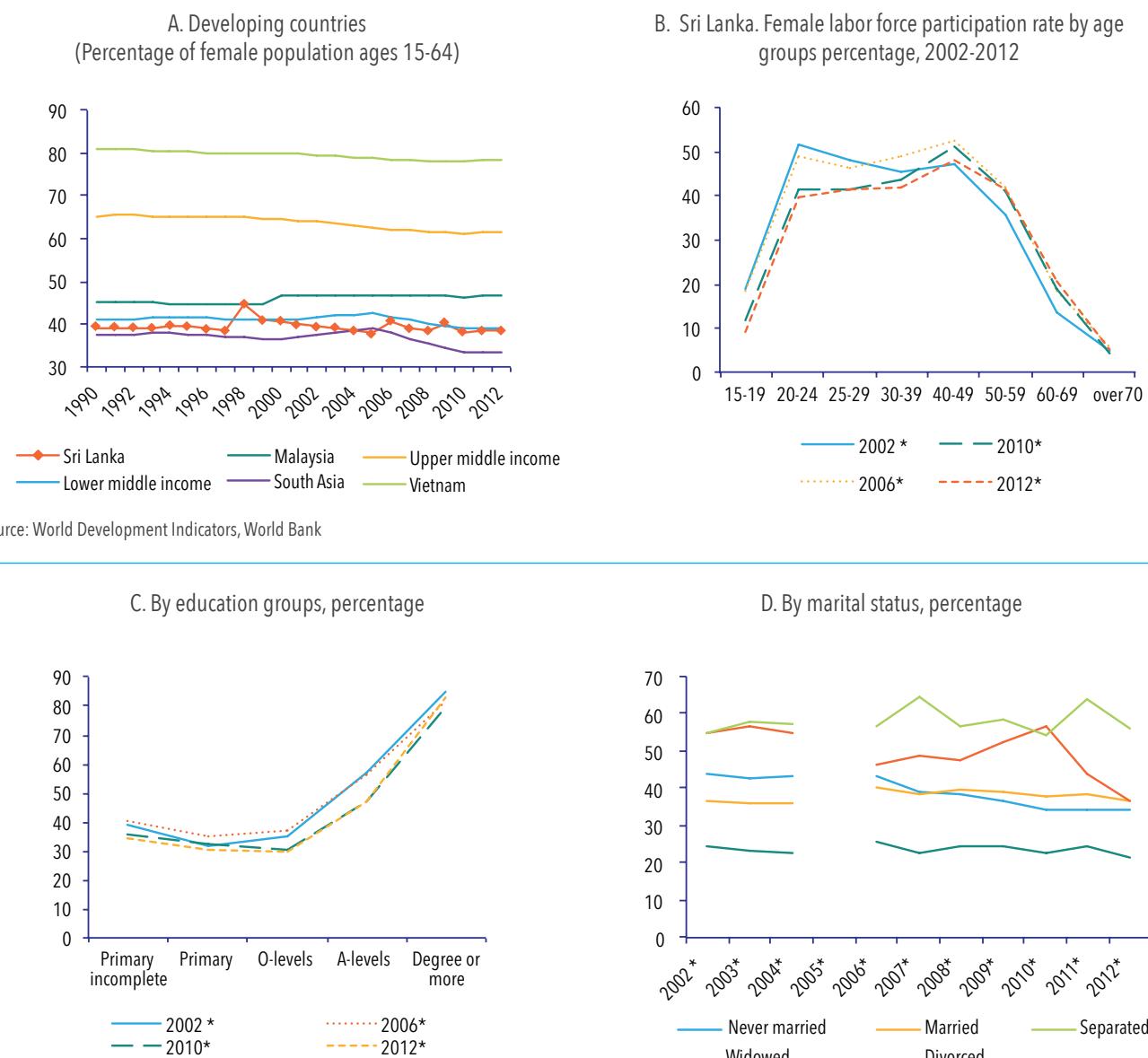
Indeed, the labor force survey confirms that separated or divorced women have the highest rates of labor force participation, while participation for married and never married females is similar (Figure 5.21D). Married women were less likely to participate than similar single women, who in turn were less likely to participate than separated or divorced women once we control for age, education, regional and other individual and household characteristics, in line with previous analysis.¹¹¹ Similarly, women with children under 5 were less likely to participate. On the other hand, the presence of other adults in the household who presumably can take care of children is commonly found to increase labor force participation by women. This suggests that better access to affordable quality childcare facilities could stimulate female labor force participation.¹¹² Furthermore, marriage changes the definitions of what

¹¹⁰ Results from a Probit regression estimating the likelihood of women participating in the labor force. The model controls for age, marital status, being household head, ethnicity, region and district fixed effects, whether she has children, and the number of adults age 80+. Estimates based on Labor Force Surveys excluding the Northern province for comparability over time. See Arunatilake et al. (2015).

¹¹¹ Gunatilaka, 2013; Sinha, 2012

¹¹² Premaratne 2011, Madurawala 2009, Dias 1990, Jayaweera and Sanmugam 1993, Gunatilaka 2013

Figure 5.21 Female labor force participation



Source: World Development Indicators, World Bank

Source: Arunatilake et al, 2015. Labor Force Survey data, excluding North and Eastern provinces for comparability and Eastern provinces for comparability

qualifies as appropriate employment conditions and opportunities.¹¹³

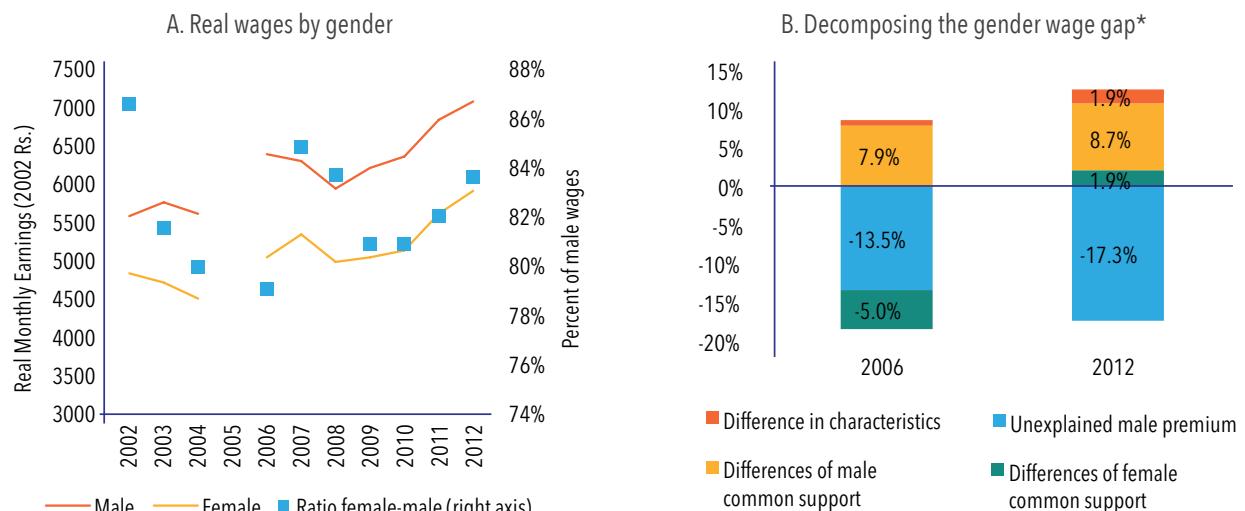
251. Social norms related to women's role in the household and especially as related to childcare responsibilities restrict women's opportunity to participate in the labor market. About 66 percent of women who did not participate cited "household activities" as the

main reason for non-participation in 2012, in line with earlier years. This is similar across urban and rural regions, but less common for young women (who are most often studying) and those in the estate sector (who more often cite old age/retirement). Interestingly, 71 percent of women with higher levels of education (A levels or more) cite "household activities" compared to 64 of cases for women with lower level of education¹¹⁴. Indeed, "marriage de-

113 Malhotra and DeGraff 2000: 149

114 Arunatilake et al (2015) using the 2012 Labor Force Survey.

Figure 5.22 Understanding the gender wage gap



Source: Arunatilake et al (2015) using Labor Force Survey data. Data excludes Northern province for comparability.

* Decomposition of the gender wage gap using matching, following Nopo (2008).

fines culturally appropriate behavior beyond economic need, individual ability, and individual preference".¹¹⁵ Most notably, once married, women traditionally carry care responsibilities for children and elderly in the household. In a survey conducted on attitudes towards gender norms in four districts of Sri Lanka, more than half of the male and female respondents agreed that childcare is primarily the mother's responsibility and that women's most important role is to take care of her home and cook for the family.¹¹⁶ More generally, perceptions of culturally appropriate employment as opposed to the actual opportunities available may leave women unemployed.¹¹⁷ According to the National Youth Survey 2013, 64 percent of young women mention respectability as an important factor in their job selection.¹¹⁸ Finally, the type of degrees completed could play a role, especially when looking at arts degrees.¹¹⁹

Gender Wage Gap and Occupational Segregation

252. Beyond social norms, gender wage gaps and occupational segregation dissuade and constrain women from participating in the labor force. Female educational achievement is higher and has been growing faster than that of men. For instance, the O-level completion rates

were about four percentage points higher for females than for males in 2012, reflecting a widening over the 2002-to-2012 period. Despite higher levels of education for women, wages for women continue to be lower than wages for men, with women earning 84 percent of male wages in 2012 (Figure 5.22A). Even when taking differences in the types of jobs where men and women tend to be employed into account, the wage gap in 2012 cannot be explained by observable characteristics or by differences in the types of work that men and women typically engage in. Moreover, this unexplained share has increased since 2003 (Figure 5.22B), which is likely to reduce the willingness of women to work. As Sinha (2012) highlights, public-sector jobs have less of a problem in this regard, with the relatively better gender parity in earnings in the public sector, making it more attractive for women to seek employment there. In addition, the public sector typically offers shorter workdays – which allow working mothers and wives to attend to their household duties while maintaining the perception of respectability – as well as other monetary and non-monetary benefits (maternity leave, vacations, sick leave, pension benefits, etc.).

253. Discrimination in hiring practices is hard to prove. However, a Marga Survey conducted in the 1980s, for instance, pointed to biases against married women due to the perceived need for extra facilities and higher costs in the form of absenteeism and maternity leave.¹²⁰ Finally, due to a high degree of occupational segregation based

115 Malhotra and DeGraff 2000, p. 145.

116 de Mel et al. 2013

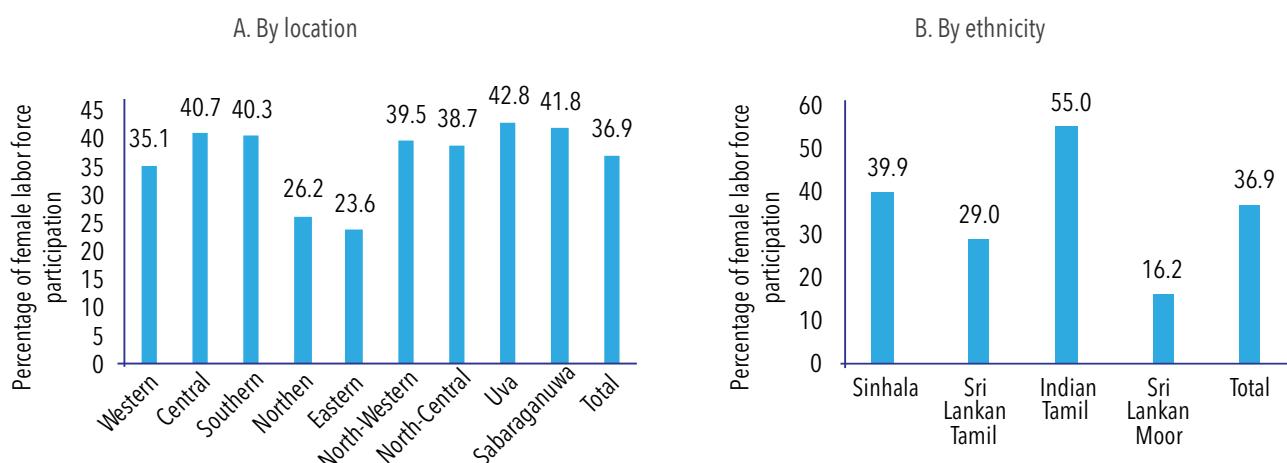
117 Amarasuriya 2010

118 UNDP 2014:42

119 Ibarguen 2004

120 Malhotra and DeGraff 2000: 152

Figure 5.23 Female labor force participation by location and ethnicity, 2012



Source: Arunatilake et al (2015) using Labor Force Survey data.

on social attitudes about appropriate jobs for women, relatively few occupations, such as teaching, semi-skilled and unskilled production work (often in textiles) and domestic service, are available to Sri Lankan women.¹²¹ Some of these jobs, such as working in garment factories in free trade zones, are associated with exploitation and stigmatization, which may deter women from entering into the labor market.¹²² In addition, the legal framework governing work in the private sector prevents women from taking up night work or part-time work in the growing service sector.¹²³ Moreover, the laws governing maternity benefits¹²⁴

make employers bear the entire cost, potentially deterring employers from hiring women.¹²⁵

254. Finally, there are notable differences in female labor force participation among provinces and ethnic groups (Figure 5.23). Participation in the Northern and Eastern Provinces is particularly low at 26.2 percent and 23.6 percent, respectively. The special circumstances for women due to war and effects of the 2004 tsunami in these regions – including high levels of gender-based violence and early marriage to war widowers – may contribute to the problem. Indian Tamil women are much more likely to participate in the labor force – their participation rate lies at 55 percent – and the participation by Sri Lankan Moor women is lowest, at 16.2 percent. While the high participation rate by Indian Tamil women can be explained by their location in the estate sector and the special labor conditions there, cultural and social norms in the household are likely to play a key role in determining the labor force participation of Sri Lankan Moor women.¹²⁶

Female Labor Migrants and Their Families: The Inclusion Challenges of Migration

255. One way that women participate in labor has been through migration, which poses particular inclusion challenges. A significant body of literature focuses

or might become pregnant (Abeykoon et al. 2014:4). Furthermore, maternity benefits financed through employer liability are difficult to enforce (Abeykoon et al. 2014:4).

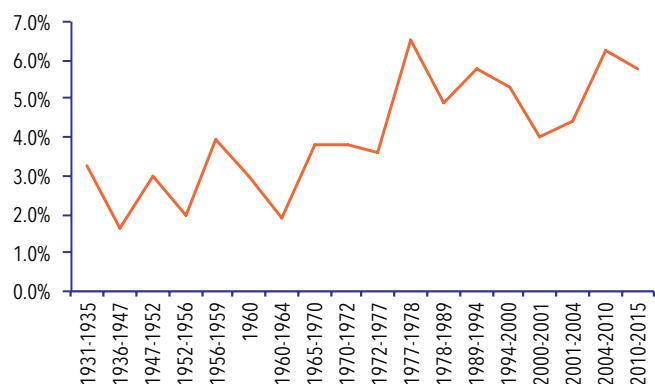
125 Gunatilaka 2013

126 Malthotra and DeGraff 1997

on the well being of female migrants outside Sri Lanka and the situation of the families they leave behind.¹²⁷ While the share of women in departures for foreign employment has declined overall since the mid-1990s, women still constituted 49 percent of departures in 2012.¹²⁸ Out of the women migrating for foreign employment in 2012, 86 percent were to be employed as housemaids. Most female migrants are married, have children and come from lower income groups.¹²⁹ Poverty, lack of employment in Sri Lanka with adequate wages, the desire to improve the economic status of their families (including building a permanent home and acquiring land), better education for their children, and overcoming economic difficulties like indebtedness are often cited as reasons for women's departures.¹³⁰

256. Women's migration has impacts on the family that is left behind, most notably on the children in the household, with implications for society more broadly. In the absence of the mother, the extended family and husbands take up care responsibilities for children in female migrant households.¹³¹ With the primary care giver being absent, children are sometimes found to be more exposed to abuse, including sexual abuse and incest.¹³² Poor financial management at home can put the benefits of migration at risk. Some studies find the educational performance and attendance of children of migrant mothers to be lower.¹³³ Upon the return of the migrating mother, family relationships are often disrupted due to the long absence of the mother, her exposure to a different context, her newly gained economic power deriving from her income and changing the power dynamics at home, and the non-acceptance of all this by other family members, especially by spouses.¹³⁴ This can ultimately lead to the separation of spouses, additionally impacting children's opportunities. In response to the realization of these potential social costs of migrating mothers, the government has put in place regulations, including minimum age re-

Figure 5.24 Female representation in parliament



Source: Parliament of Sri Lanka. Available at: <http://www.parliament.lk/en/lady-members>

quirements for mother and child, insurance schemes and scholarships for children of migrant workers.¹³⁵

Women in Leadership Roles

257. Women are under-represented in political life. Sri Lanka boasts having produced the world's first woman prime minister in 1960, and women have been enjoying the right to vote since 1931. However, despite the fact that women make up nearly 53 percent of the population, they are under-represented in political and public decision-making bodies. Women make up only 5.8 percent of parliamentarians in the current National Parliament, 4.1 percent in Provincial Councils and a negligible 1.8 percent in local government, among the lowest in the world, and certainly in South Asia.¹³⁶ The percentage of women in parliament between the 1930s and the present has never exceeded 7 percent (Figure 5.24). A shift in 1989 to an electoral system based on proportional representation, which elsewhere has generally proven more favorable to women, has not led to a significant change in the numbers of women elected over the years.

258. Women are also under-represented on private-sector boards. Ratwatte (2012) noted that of the country's 25 top corporate entities, which have a total of 198 directors, only 10 are women.¹³⁷ Although women on

127 Sri Lankan Bureau of Foreign Employment et al. 2013; IOM 2009; Perera and Rathnayaka 2013; Save the Children 2006; Ukwatta 2010

128 Sri Lankan Bureau of Foreign Employment 2012 and 2013

129 Sri Lanka Bureau of Foreign Employment et al. 2013: 14, Sri Lanka Bureau of Foreign Employment 2013, Save the Children 2006, Gamburd 2008, Jayaweera and Dias n.d., International Labor Organization 2013

130 Kotegoda 2006: 56, Hettige et al. 2012: 27, Save the Children 2006: 12, Gamburd 2008, Jayaweera and Dias n.d., International Labor Organization 2013

131 International Labor Organization 2013, Jayaweera and Dias n.d., Ukwatta 2010, Kotegoda 2006

132 Save the Children 2006, Perera and Rathnayaka 2013

133 Save the Children 2006, Hettige et al 2012, Sarma and Parinduri 2013

134 Hettige et al. 2012: 23, Gamburd 2008

135 Central Bank 2014

136 Kodikara, 2011. Available at <https://www.opendemocracy.net/5050/chulani-kodikara/sri-lanka-where-are-women-in-local-government>

137 Ratwatte, 2011. Available at <http://dbsjeyaraj.com/dbsj/archives/11707>

Sri Lankan corporate boards are valued for what they can contribute and in every sense are considered no less equal to the job than their male counterparts, they take only 5 percent of leadership roles in the private sector. Similarly, a study using 2009 data found that only 13 percent of top management positions in nine commercial banks in Sri Lanka are held by women.¹³⁸

D. Priorities on Inclusion

259. The significant locational concentration of monetary poverty in urban areas points to harnessing the urbanization process to benefit the poor and the bottom 40 percent. The highest numbers of people living in poverty and the bottom 40 percent are located within multi-city agglomeration areas and can benefit from efforts to increase competitiveness discussed in Chapter IV. Providing for effective governance of cities to allow for responsiveness to changing social and economic conditions and addressing inclusion challenges will be important. Local officials will need to have sufficient administrative authority, financial resources and capacity to delivery services and conduct integrated, strategic planning. An empowered local government could be more responsive to addressing gaps in service delivery and infrastructure, particularly in addressing connectivity and other constraints to agglomeration that will affect the bottom 40 percent's ability to secure good jobs.

260. Key priorities to address the inclusion challenges across space, ethnicity and gender include concerted efforts to reduce poverty, improve public-service provision and promote employment opportunities in

the North, East, Moneragala, and the estates. Multi-sector interventions that address lack of job opportunities in the North and East would help to reduce poverty and ensure shared prosperity. This could include small works programs aimed at improving market accessibility, incentives to promote entrepreneurship among educated youth and direct programs to help ex-combatants and female-headed households would go a long way to ensuring inclusion of the most vulnerable. In the estates, multi-sector interventions to improve nutrition outcomes, enhance job opportunities for the youth and prepare for a growing number of aging estate workers would help in ensuring their inclusion in shared growth.

261. Concerted efforts need to be continued to improve equality of opportunity across ethnic groups, regardless of where these populations reside. This mainly requires an improvement in job opportunities for ethnic minorities. However, it also points to the need to address land claims in the former conflict areas, providing assistance to new and "old" IDPs, equalizing assistance to widows whose families are victims of the conflict regardless of which side they were on and integrated efforts to assist ex-combatants. These efforts, in addition to improved social protection systems (Chapter III) and better job opportunities (Chapter IV), will help to provide equality of opportunity and foster inclusion.

262. Critical emphasis is needed on increasing labor force participation of women and ensuring that they enjoy equal opportunity accessing jobs as well as political and private sector leadership positions. Priorities in this area include improving women's education and incentives for participation through a better alignment of the education women pursue and the demands of the market; reforming legislation that prevents or deters women from being hired; and fostering greater participation of women in leadership positions.

138 Gunawaredena, Kennedy (2010).

KEY KNOWLEDGE GAPS

- Updating the poverty line to better reflect the basket of essential commodities.
- Analysis of spatial spread of economic activity and potential constraints to further spreading, including to underserved areas. This could include analysis of how the Colombo- Kandy-Galle corridor evolved and what should learned from that process.
- Analysis of poverty trends at the district level.
- Adding a panel component to future labor force surveys, tracking a representative sample of households and individuals over time. This will substantially enhance ability to better understand changes in employment, mobility, and structural transformation.
- Updating nutritional outcome data to better monitor progress in the estate sector.
- Analysis of drivers of persistent poverty in Moneragala.



VI. SUSTAINABILITY

KEY PRIORITIES FOR SUSTAINABILITY

- Sustaining peace and security through long-term reconciliation efforts among Sri Lanka's heterogeneous society is the *sine qua non* for progress towards the twin goals.
- Developing a more accountable and effective state to follow through on recently initiated governance reforms.
- Putting heavier emphasis on direct investment and long-term private-sector flows will be needed to sustain Sri Lanka's external fiscal position.
- Balancing imperatives to preserve its natural assets, provide for health and livability to its citizens (especially in urban areas), and foster growth.
- Managing the impact of climate change through adaption, mitigation, as well as strategies that reduce the carbon footprint.
- Addressing long-term fiscal sustainability concerns related to population aging.

Sustaining Sri Lanka's Development

263. The prospects for progress towards eradicating poverty and promoting shared prosperity depend on the sustainability of Sri Lanka's impressive development trajectory. As with any country, there are risks that external or internal conditions that have facilitated progress to date do not continue to hold true. There are also risks of the emergence of new factors that can meaningfully impact progress.

264. Some key risks in Sri Lanka's recent pattern of growth and progress towards the twin goals have already materialized and are important constraints reviewed in previous sections. These risks include the challenges of sustaining growth based on internal consumption growth and increased public investment; the fiscal challenge of declining revenues and increasing needs for investment in human and physical capital; the lack of diversification and the need to develop a more competitive, open economy that encourages formality and innovation; and providing for equality of opportunity and inclusion of all segments of the population. Risks to social sustainability – in particular higher levels of disaffection coupled with higher unemployment and levels of distrust in government among the youth – are evident in the inclusion section. For the most part, these areas reflect the manner in which government policies have shaped the contours of the country's economy and opportunities for its citizens.

265. There are four other issues important to sustainability and fundamental to continued progress. The first area is the necessity to achieve a lasting settlement that ensures peace and security for Sri Lankans. This is the *sine qua non* condition for progress. The second area involves the challenges inherent in the major institutional

overhaul now taking place. The third area is economic stability in the context of the external environment. Finally, Sri Lanka will continue to face environmental challenges, particularly the risk of climate change.

A. Social Risks to Sustainability

Peace and Security

266. Global experience indicates that countries that have recently been in internal conflict are much more prone to outbreaks of new conflict, suggesting that Sri Lanka is an “at risk” country. The 2011 World Development Report found nine out of 10 outbreaks of new conflicts in the 2000s occurred in countries that had recently previously experienced conflict and all civil wars that occurred since 2003 occurred in countries that previously had been in civil war. Of course, every country has its unique circumstances that may or may not make it vulnerable to conflict. In Sri Lanka's particular case, the combatants who challenged the state in previous decades – the LTTE and, earlier, leftist groups in the south – are no longer direct threats following their comprehensive defeat or integration into the political mainstream. However, the lack of an evident armed threat at present does not ensure no new outbreak of conflict in the future. Having won the war, Sri Lanka needs to secure the peace.

267. The quantum of impact from conflict makes it a serious risk even if the likelihood of a new outbreak appears low. Conflict inflicts direct and indirect costs at national, local and personal levels and lack of security undermines the well-being of all Sri Lankans. As noted earlier in Chapter II, one estimate of the cost of Sri Lanka's internal conflicts was nearly 5 percent of GDP from 1978 to 2002. Conflict would impair the country's ability to address the

constraints outlined above, from dealing with the fiscal challenge to diversification of the economy.

268. Sri Lanka's Commission of Inquiry on Lessons Learned and Reconciliation (LLRC) identified in 2011 a broad array of steps to achieve reconciliation among the country's communities. These steps focus on: ensuring rule of law; addressing citizens' grievances; devolving power; upholding language policy allowing for official use of multiple languages; providing for equality of opportunity; and strengthening inter-communal and inter-personal ties. Most important, political consensus to work towards reconciliation by political leaders representing all communities, in and outside of government, is needed to underpin these efforts. These recommendations are consonant with successful experience in breaking the cycle of violence in other countries, namely the need for rebuilding confidence in the state by providing an institutional framework that provides citizens with security, justice, and jobs.¹³⁹

269. Much has been done to implement LLRC recommendations but much remains to be done. The government carried out a far-reaching program of resettlement of

those displaced by conflict: demilitarization, rehabilitation and reintegration of ex-combatants; de-mining of nearly all land; and rapid reconstruction of social and connective infrastructure destroyed by conflict. Progress in these areas has been substantial in the short six

years since the end of the war, though infrastructure and other public goods that provide for equality of opportunity are still at lower levels than the rest of the country. Other issues have been partially addressed. These include implementing a trilingual public service policy and holding Eastern and Northern Provincial Council elections, as well as organizing North-South exchange programs for students and civil society and making efforts to recruit Tamil-speaking local police officers.

270. There have been recent renewed efforts to promote inter-communal harmony. Since the change of government in January 2015, several steps have been taken to address Tamil grievances, such as quickly moving to appoint a civilian governor, expediting domestic mechanisms to address accountability in connection with allegations of crimes during the conflict, and, more slowly, re-

leasing land used by the military in the North and East. The new president was elected with the tacit support of the leading Tamil party and contains leaders from the main Muslim parties. Symbolic steps have been taken, including having Tamil party leaders participate in national celebrations for the first time in decades. An international inquiry into accountability issues delayed its reporting in recognition of the policy intent and steps undertaken by the government to address reconciliation. There have been no notable episodes of inter-communal violence since the new government was elected.

271. Yet challenges remain to achieving lasting reconciliation. A political settlement on the institutional framework that addresses issues of voice of local communities is still to be worked out. In particular, incoherence in the assignment of powers between the central government and provincial government is a source of continuing tension in the North. There is still a large, albeit lessening, military presence that interferes with localities through its surveillance, economic activities, and occupation of land. There has been little progress towards closure on social justice, particularly accountability in connection with allegations of crimes committed during the conflict, as well as resolution of cases of disappearances. The sensitivity of this issue is heightened by the considerable international attention it attracts. Equality of opportunity that will provide the conditions for citizens of all communities to find rewarding jobs is critical to inclusion. While there has been progress in recent years, there is still a gap in opportunities, particularly in more rural, isolated areas. Sustained efforts will be needed to address these sensitive issues.

Much has been done to implement LLRC recommendations but much remains to be done

Other Social Risks

272. High levels of unemployment for youth – particularly educated youth – pose risks to social sustainability. Declining employment prospects for youth can lead to frustration and ultimately, tensions.¹⁴⁰ Youth seeking government jobs frequently report the influence of social networks in obtaining them. In the National Youth Survey 2013, 54.4 percent pointed to "political connections" and 30 percent to "family connections" in obtaining public-sector employment, signaling an uneven playing field and causing exclusion. In the past, frustrations with social hierarchy, patronage systems and the unavailability of appropriate employment opportunities are argued to have played a role in tumult involving large numbers of youth in Sri Lanka since the early 1970s.¹⁴¹ The same youth survey points to pessimistic views about the political situation

139 World Development Report 2011. World Bank.

140 Amarasuriya 2010

141 Amarasuriya 2010; UNDP 2014

of the country and low trust towards public institutions among other issues; in 2013, 89 percent said they have little trust in political parties, up sharply from 47 percent in 1999-2000.¹⁴² Continuing disparities in income, consumption and access to services, which affect ethnic minorities and create mutual suspicion, can constitute another risk to cohesion. Finally, displacement resulting from conflict and natural disasters has created tensions around land.¹⁴³ With the return of IDPs, land ownership is contested between returnees and late occupants. In several conflict-affected areas, land rights are being used as a tool to promote political patronage. This can exacerbate inter-ethnic tensions, particularly in areas where minority communities long displaced are returning.¹⁴⁴ Land disputes can also threaten to undermine the relations between government officials and communities.¹⁴⁵

Institutional Change

273. The 19th Constitutional Amendment reflects consensus to reducing the powers of the presidency, but is a major overhaul in the country's institutional framework and will require a period of adjustment. The passage of the 19th Amendment in April 2015 creates stronger accountability mechanisms through the introduction of a presidential-parliamentary form of government and strengthening the autonomy and role of independent commissions. Additional reforms are expected to institute a right to information regime and strengthened audit and procurement oversight mechanisms. There is a large degree of political consensus around the need to reduce the perceived excessive concentration of power in the presidency and lack of accountability and transparency. Enacting these institutional changes was a core campaign promise, which helped secure President Sirisena's election in January 2015. Despite contentious debate, the 19th Amendment eventually was nearly unanimously adopted by Parliament. Notwithstanding this consensus and the goal of ensuring greater accountability, it remains to be seen how the new framework will operate. There will be a "working in" period as the newly formed Cabinet and independent commissions undertake their roles in a changed institutional framework.

274. Any such major change is complex and affects the interests of many who may respond in unexpected ways. The prior government was in power for nine years

and was widely thought likely to continue for several more years. Public servants and entrepreneurs alike had adapted to the policies, institutional framework and governance style of the previous government, and will need to adjust to new circumstances.

B. Economic Risks to Sustainability

External Risks

275. Achieving a more sustainable external position will require a heavier emphasis on direct investment and long-term private sector flows. In line with the analysis presented in Chapter IV, recent external debt sustainability analysis¹⁴⁶ has highlighted potential vulnerabilities to external sustainability including: (i) a chronic current account deficit and relatively low reserve adequacy metrics; (ii) a gradual but steady decline in goods exports as a share of GDP; (iii) a similar decline in Sri Lanka's share of world exports; (iv) an already high external debt burden and a rising cost for external financing as Sri Lanka shifts to middle-income status and bilateral concessional debt is replaced with borrowing on commercial terms; and (v) modest increases in foreign direct investment, which would otherwise alleviate the need for debt financing. While the current account deficit has decreased in recent years, it remains financed largely by debt-creating inflows and central bank foreign exchange reserves are at the lower end of what is considered adequate by standard metrics.

276. With the country's shift to middle-income status, concessional borrowing sources are drying up and are being replaced by borrowing on commercial terms. The authorities have been successful in tapping international markets consistently with sovereign bond issues and lengthening the average maturity of the debt portfolio.¹⁴⁷ Between 2007 and 2014, the government sold USD 7 billion of sovereign bonds. As a result of increased commercial borrowings, the non-concessional and commercial component of the government foreign debt rose from 1 percent in 2000 to 50 percent in 2013. Recently, the banking sector was also borrowing overseas at relatively high yields.¹⁴⁸

142 UNDP 2014

143 Raheem 2013; Internal Displacement Monitoring Centre 2012

144 Fonseka 2010; Raheem 2013

145 Raheem 2013

146 IMF, 2014.

147 Average Time to Maturity of domestic debt increased from 2.3 to 6.0 years during 2009 to 2013, for foreign debt it increased from 9.3 to 10.4 years during the same period.

148 For example, National Savings Bank borrowed USD 750 million at 8.875 percent in the year 2013.

Long-Term Risks to Fiscal Sustainability

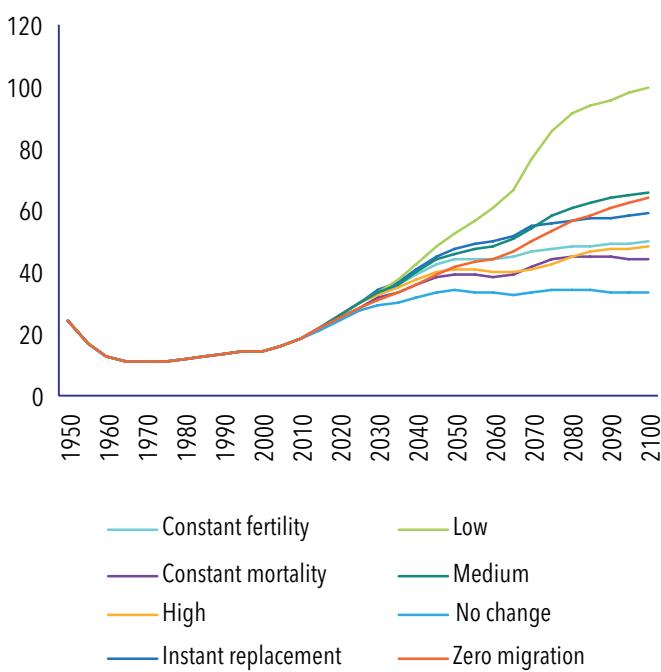
277. **Beyond the fiscal and external risks pointed out throughout this report, an aging population will strain public and external finances in the long term.** Sri Lanka is in the midst of its demographic transition, and is projected to age fast in the next few decades. The elderly dependency ratio reached its minimum in the 1970s and 1980s and, thanks to increases in life expectancy, has been rising steadily since then. Under likely population projection scenarios, the elderly dependency ratio is set to rise further to about 25 percent by 2020, and could then stabilize around 33 percent under the no-change scenario or rise to 99 percent under the low-fertility scenario (Figure 6.1). Private-sector savings are expected to fall, as the elderly draw down their savings, while increased current fiscal expenditure on aging (health, pensions, and long-term care) will negatively affecting public-sector savings. As a result, the already low national savings rate would further undermine the negative savings-investment balance.

278. Population aging will likely impact the fiscal accounts through three channels: tax revenue, fiscal expenditure, and GDP growth.

In the absence of a tax reform, a decline in the labor force will lead to falling revenue from income tax. An increase in the share of elderly will lead to higher expenditure on pensions, health and long-term care, much of which would be expected to be covered by the national budget. There may be savings in education expenditure to the extent that only the young receive education, though from the perspective of improving educational outcomes to increase Sri Lanka's competitiveness, more public expenditure on education may be needed instead. The combination of falling income taxes and increased expenditures will lead to persistent deficits and consequent accumulation of public debt. Increased debt, in turn, will lead to further increases in expenditure through interest payments. Finally, a slowdown in labor growth and potentially lower investment (as discussed above) will lead to a slowdown in GDP growth, which will worsen the capacity of the economy to sustain high debt. There may also be feedback effects, where government fiscal policy may affect the decision of the elderly whether to retire or stay in the labor force.

279. **Moreover, Sri Lanka is relatively older and poorer compared to other countries facing an aging population.** Sri Lanka is already a relatively old country, especially compared to other South Asian countries, although its population is still younger than countries in Europe and Central Asia and a number of middle-income East Asian

Figure 6.1 Elderly dependency ratios, for different demographic scenarios



Source: UN population projections, Bank staff calculations

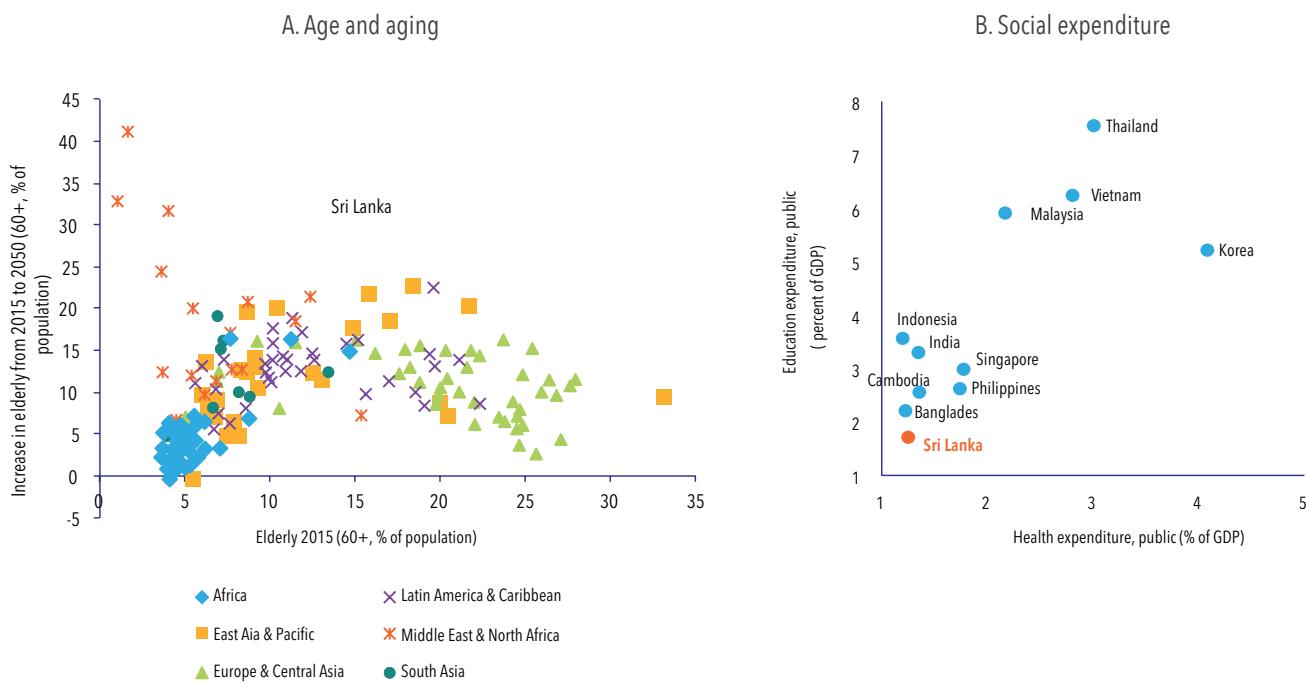
countries (Figure 6.2A). The projected share of 60+ in total population as of 2015 is 13.4 percent, but the share of elderly is projected to increase to 25.7 percent of total population by 2050, an increase of 12.3 percentage points. Sri Lanka is also relatively poor given its age. Compared to

other Asian countries with a similar elderly dependency ratio, Sri Lanka's GDP per capita is low; hence there is urgency to "get rich before getting old." Moreover, Sri Lanka's social expenditure (most of which is age-related) is relatively small compared to other similar-age countries. As shown earlier, expenditure on health is relatively low and has been declining over time (Figure 6.2B). Expenditure on pensions is 1.4 percent of GDP -- reflecting its limited scope, which comprises only retired public-sector workers.

Sri Lanka faces a challenge to "get rich before getting old"

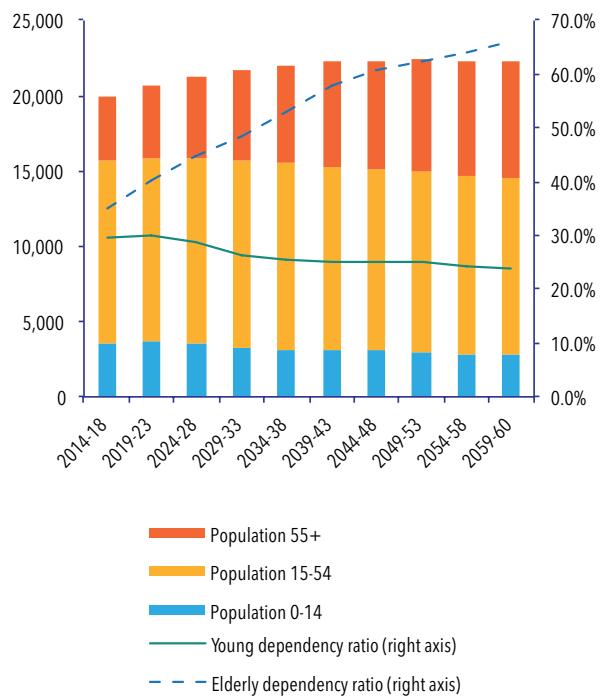
280. **Between now and 2060, the elderly dependency ratio is projected to rise sharply, while the young dependency ratio is projected to fall.** The population is projected to peak in the mid-2040s before starting to fall (Figure 6.3). Life expectancy at birth has increased from 60 years for the cohort born in 1960 to 74 years for the 2012 cohort. The share of the population above 60 will increase from 13 percent to 27 percent by 2060 under the medium-fertility scenario.

Figure 6.2 Aging and social expenditures in international perspective



Source: UN population projections, medium fertility scenario, staff calculations

Figure 6.3 Population projections in Sri Lanka



Source: Parliament of Sri Lanka. Available at: <http://www.parliament.lk/en/lady-members>

281. Illustrative simulations of the long-term impact of aging on the fiscal accounts can help shed light on the constraints and policy space available to the government.¹⁴⁹ A baseline scenario of no tax reform and a policy of bringing public health and education expenditure to levels closer to other middle-income countries would lead to a steady rise in primary (non-interest) expenditure from 14 percent of GDP in 2013 to 20 percent of GDP by 2060. This widening primary deficit combined with a slowing GDP growth would lead to a rapidly growing level of public debt-to-GDP from 78 percent of GDP at end-2013 surpassing 150 percent of GDP within two decades. Interest payments would form the majority of public spending, which would be clearly unsustainable.

¹⁴⁹ Simulations based on publicly available information by Bank staff available upon request. These simulations do not constitute official World Bank projections. While the current numbers are based on actual data as of end-2013, the projected numbers are based on simple projections of the tax base (revenue) and projected trends in demographics and cost inflation (expenditure). It should be noted that these simulations do not take into account the fact that many (informal sector) workers are not covered by either the public nor the private sector pension scheme, and in the future there may be pressure to extend coverage to those workers as well. Neither do they include possible future public expenditure on long-term care.

282. Public policy action may help avert this scenario through tax reforms and increasing the retirement age in line with rising life expectancy.

A major tax reform to gradually lift revenue could offset the projected increases in expenditure, contain the fiscal deficit, and put public debt back on a declining path

Major tax reform that would gradually lift revenue to 22 percent of GDP over time could offset the projected increase in expenditure on education, health and public-sector pensions sufficiently to achieve a primary surplus and contain the fiscal deficit, and put public debt back on a declining path.

283. Extending the retirement age could temporarily boost GDP growth, but its impact would not be enough to reverse the debt dynamics, due to inertia in the labor market and demographics. Gradually extending the retirement age for public-sector workers could help stabilize public pension expenditure, but it would have only a small effect on labor market dynamics and GDP growth. Due to inertia, it would not fix the fiscal deficit as fast as tax reform would. If people work longer across the board, it would temporarily reverse the declining labor force and income-tax revenue as more people would enter than exit during the transition. This temporary boost to GDP and revenue would make the debt dynamics look more favorable, but it would not make it sustainable by itself.

284. Any reform of this nature will be politically sensitive and needs to be gradual, but delaying reform will force more painful actions to be taken later. Tax reform will not increase tax revenue at once, and such reforms will face political economy challenges. However, the sooner tax revenue increases, the more space there will be for expenditure later. Similarly, increases in the retirement age can be implemented only slowly, so preparation has to start soon.

C. Environmental Risks to Sustainability

285. Sri Lanka has a significant advantage in its rich natural asset base that can be a long-term contributor to growth and quality of life. The country has a rich tra-

dition of conservation dating back over 2,000 years when ancient edicts called for the preservation of wildlife in defined areas. Its extraordinary variety of landscapes and biodiversity is today relatively unaffected with low levels of air, water, and land pollution. For instance, its air quality is the best in South Asia, in large part thanks to its effective vehicle emissions control system, though the anticipated doubling of private vehicle traffic between 2010 and 2020 and an increase in use of coal for power generation will pose an increasing challenge. Sri Lanka's natural assets provide for high levels of livability and contribute to Sri Lanka's attractiveness for tourism.

286. However, there are environmental challenges to be managed. There has been an increase in arable land due to the expansion of agriculture at a rate of 2.7 percent per year between 2006 and 2011, the years for which information is available¹⁵⁰. Correspondingly there has been a reduction in forest cover from 33.2 percent in 2000 to 29.7 percent in 2010 (which does not take into account likely losses in the conflict affected north). Sri Lanka had the fifth highest rate of deforestation (15 percent) in the world during the period 2000-2005, with consequences for watersheds and soil loss, and leading to a panoply of economic and environmental damages. A recent 2010 World Bank study found that economic losses from land and environmental degradation far exceed (by orders of magnitude) the revenue from agriculture, suggesting that limits to land conversion have likely been reached.

This has contributed to high and rising levels of species extinction; according to a recent survey, 33 percent of inland vertebrate fauna and 61 percent of its flora are nationally threatened. Fresh water resources are at risk due to encroachment that occurs in the absence of adequate watershed planning and enforcement.

Economic losses from land and environmental degradation far exceed revenue from expansion of agriculture, suggesting that limits to land conversion have been reached

287. Soil conservation is critical for agricultural productivity and particularly for poorer households who are most dependent on agriculture for their livelihoods. The clearing of forests for new lands that cause increased runoff and siltation rates in steeply sloped lands as well as intensive farming practices are linked to declining productivity. The Global Assessment of Soil Degradation

150 FAO 2013

suggests that nearly 33 percent of Sri Lanka's land area is severely or very severely degraded in terms of reduced agricultural productivity. A Bank study found that the potential cost savings of better nutrient management is between US\$50 million to 100 million over a 20-year period, suggesting high economic returns to soil conservation.

288. Protection of watersheds is vital for agricultural irrigation, domestic water use, flood attenuation, forestry, fishing, recreation and other services to the population and environment. The total annual value of watershed services in the Southern Province is estimated to range from US\$2,128 per hectare (ha) in the Muthurajawela Marsh to US\$12,494 for mangrove forests and to US\$622,845 for coral reefs. In contrast, the estimate by the Millennium Ecosystem Assessment (MEA) of the average annual global value of watershed benefits stands at US\$3,274/ha. Moreover, the average revenue from paddy cultivation in Sri Lanka is estimated at only US\$750/ha. Thus the payoffs from watershed benefits far exceed the marginal financial returns from paddy cultivation – the default option in agriculture. Protection of water resources is also vitally important for human health. There are strong indications that chronic kidney disease, a disease afflicting over 10,000 persons, stems from high chemical concentrations in domestic and irrigation water supply¹⁵¹.

289. Sri Lanka's solid waste management challenge is linked to the rapid pace of urbanization. Waste generation is characterized by distinct geographic patterns in Sri Lanka, with higher volumes being generated in more prosperous urban areas and provinces. Collection rates average 31 percent whereas other middle-income countries have average collection rates of 68 percent.¹⁵² The bulk of waste is organic, suggesting there is scope for reducing the pollution load of wastes requiring ultimate disposal, and for employment generation through complementary composting activities. Poor management of solid wastes in Sri Lanka is a direct consequence of under-investment and corresponding policies. A 2011 World Bank study identified a funding gap that is estimated to rise to LKR 1.6 billion (\$16 million) by 2015 and a further LKR. 4.2 billion (\$42 million) by 2020.

290. Sri Lanka will be well served in seeking to obtain environmentally, socially and economically equitable growth – or green growth -- now and long into the future, especially in urban areas. The large Colombo metropolitan region in particular will need to balance these priorities in order to have sustainable urban growth

while enhancing its livability and quality of life for its inhabitants. This will require holistic, long-term planning across sectors, coordination among agencies and a broad range of stakeholders – including the government, non-governmental organizations, the private sector, and the general public – and may be served by access to green financing. This will involve seeking to allocate public funding and crowd in private-sector funding in pursuit of green growth as well as institutional capacity. An important part of capacity would involve the ability to assess the value of sustainable benefits as well as a monitoring, reporting, and verification methodology.

291. The human-elephant conflict exemplifies environmental sustainability challenges. Protected areas are of insufficient size and quality to sustain the country's elephant population as evidenced by data showing that over two-thirds of the wild elephant population can be found outside the protected area system. Wild elephants are compelled to graze on agricultural lands to survive, resulting in a vicious spiral of conflict with agriculturalists. This has reached alarming proportions in many parts of the dry zone in Sri Lanka, with around 70 humans and over 200 elephants killed annually due to the conflict. With increased development and the inevitable erosion of habitats, the problem is set to worsen unless immediate remedial action is taken.

292. In addition to imperatives to have growth be green, the country will need to manage disaster risks.

Sri Lanka's has a disaster risk profile characterized by high frequency/low severity events and a number of single large-loss events. Disaster risks are associated with several factors, including climate change discussed below (though impacts cannot be assessed with specificity), as well as land usage patterns that lead to greater vulnerability. Annual average disaster loss is estimated to be USD 380 million, with floods accounting for an annual expected loss of USD 240 million. Legislation calls for the establishment of a Disaster Fund as an insurance mechanism, but de facto disaster-related expenditure is provided in an ad hoc manner through supplementary budget allocations. Although the state-owned Sri Lanka Insurance Corporation is the designated insurer for public assets like infrastructure, there is very little insurance of private property

Holistic, long term planning across sectors is needed to obtain environmentally socially and economically equitable growth

Annual average losses from disasters is estimated to be USD 380 million

151 Paranagama et al, 2013

152 World Bank, 2011.

Table 6.1 Impact of climate change on rice yield in Sri Lanka

Agro Climatic Zone	Current Rice Yield (kilogram/hectare)		% Change in 2030		% Change in 2050		% Change in 2080	
	Maha	Yala	Maha	Yala	Maha	Yala	Maha	Yala
Dry-Low	3,498	3,863	(4.2)	(6.5)	(16.1)	(19.8)	(29.1)	(34.2)
Intermediate-Low	4,865	4,612	(2.7)	(3.5)	(10.6)	(15.1)	(24.8)	(31.5)
Intermediate-Mid	4,992	4,761	(1.9)	(3.1)	(9.3)	(12.7)	(22.5)	(30.3)
Intermediate-Upland	3,492	2,955	(1.3)	(2.7)	(7.5)	(11.4)	(20.3)	(27.5)
Wet-Low	3,910	3,711	(0.9)	(1.5)	(6.0)	(10.4)	(19.4)	(25.1)
Wet-Mid	3,538	2,795	(0.8)	(1.4)	(3.6)	(8.2)	(18.3)	(23.6)
Wet-Upland	3,134	2,706	5.7	3.1	2.1	(2.0)	(8.6)	(12.4)

() = negative.

Source: Adopted from Ahmed and Suphachalasai, 2014

(less than 1 percent of residential property is insured), and crop insurance is not widespread either.¹⁵³ The government is working to improve relevant data collection and develop a national disaster risk financing strategy. It is also looking to link with social protection benefit distribution programs to provide benefits quickly to deal with disaster impacts, though this hinges on overall improvement of the social protection system.

Climate Change

293. The country will be exposed to long-term effects of climate change. Model simulations under different scenarios indicate a significant past warming trend of about 0.75°C per century in annual mean temperatures over the South Asia region.¹⁵⁴ Future temperature projections indicate a steady increase in temperatures across the three periods, with anomalies reaching 4°C–5°C for high-emission scenarios by the 2080s. Warming will be widespread throughout the region by end of the 21st century. Spatial patterns of rainfall change indicate future increases over eastern and northeastern areas.

294. Low-end estimates show Sri Lanka suffering a 1.2 percent loss of annual GDP by 2050 due to climate change, even if measures are taken to address it.¹⁵⁵ Changes of temperature and rainfall variation will directly impact

many sectors of the economy, including power, transport, agriculture and aquaculture, with further impacts on health, human settlements, and tourism. Climate change will lead to more occurrences of natural disasters, such as droughts, floods and landslides, due to extreme weather events.¹⁵⁶ Much of the impact will be on agricultural yields, with a decline in rice yield of as much as 23 percent by 2080 (Table 6.1). Farming districts with heavy reliance on primary agriculture, few infrastructural and socioeconomic assets (or low adaptive capacity), and high level of exposure to historical hazards are the most vulnerable.¹⁵⁷ The vulnerability of rice crops to droughts is expected to increase, especially in the dry and intermediate zones. Tea plantations at low and medium elevations are more vulnerable to impacts of climate change than those at high elevations. Reduction of monthly rainfall by 100 mm could reduce productivity by 30–80 kg of tea per hectare.¹⁵⁸ Extended dry spells and excessive cloudiness during the wet season can reduce coconut yield, with annual losses of US\$32 million to US\$73 million. However, during a high rainfall year, the economy could gain by US\$42 million to US\$87 million due to high coconut yields. Future projections on coconut yield suggest that production after 2040 may not be sufficient to cater to local consumption.¹⁵⁹

¹⁵³ World Bank, 2014

¹⁵⁴ Ahmed, M. and Suphachalasai 2014

¹⁵⁵ Ahmed and Suphachalasai, 2014

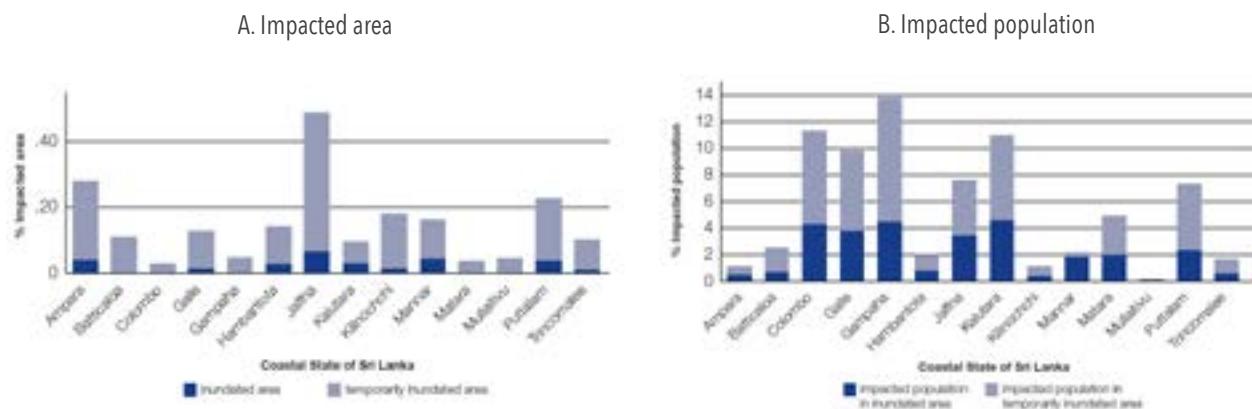
¹⁵⁶ Statement of Sri Lanka to 18 session of Conference of Parties to the United National Framework Conference on Climate Change-COP UNFCCC, 2012

¹⁵⁷ Eriyagama et al 2010

¹⁵⁸ Coast Conservation Department 2006

¹⁵⁹ De Zoysa and Inoue 2014

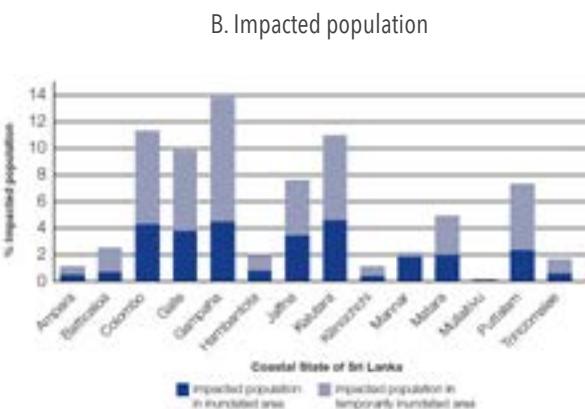
Figure 6.4 Impacts of a 1-meter sea level rise



Source: Ahmed and Suphachalasai, 2014.

295. Marine and coastal areas are projected to be similarly affected. Sri Lanka's coastal region covers about 23 percent of the island's land area.¹⁶⁰ It also accommodates about 25 percent of the population, and includes a heavy concentration of urban areas, tourism infrastructure and industries that are vulnerable to the impact of sea level rise and increased frequency of storms and the intensification of coastal erosion due to climate change (Figure 6.4). The impacts on marine and coastal areas have been observed in the alteration of ocean circulation, coral reef ecosystems, ocean and estuarine salinity, fisheries and recreation and tourism activities. The effects also include dryland and wetland losses, which impose both physical and economic risks on coastal communities.

296. Climate change will impact other areas, such as availability of water, energy, public health. The availability of irrigation water is highly vulnerable, especially in the dry zone, due to the increase in droughts and the high dependence of agriculture. Vulnerability of drinking water to drought is also widespread. The South/South Central, North Western, and North Central regions of the country are particularly vulnerable. Drinking water vulnerability to floods is prevalent in many areas of the country. Such areas have limited access to piped water and rely heavily on groundwater, resulting in high incidence of water-borne diseases.¹⁶¹ Second, hydropower generation will be impacted over time. Annual average rainfall has decreased over the last 57 years at about 7 mm per year, resulting



in water scarcities in the dry zone.¹⁶² Third, climate and anomalous weather events are expected to cause a general increase in the number of cases of both vector- and water-borne diseases. The region's mortality rate – influenced by dengue, malaria and diarrhea – would increase over time as a consequence of climate change. Morbidity and deaths from such diseases could increase in the future under all scenarios.¹⁶³

D. Priorities on Sustainability

297. Sustaining peace and security through sustained reconciliation among Sri Lanka's heterogeneous communities is a *sine qua non* for progress towards the twin goals. Closure regarding difficult chapters in Sri Lanka's past is needed to forestall the possibility of new tensions emerging. Governments at all levels will need to maintain focus on overcoming issues among the country's ethnic communities that have fueled past violence. This will likely include sustained implementation of mechanisms to address these issues, including domestic mechanisms for assessing accountability as well as following through on the many LLRC recommendations. It also calls for consistent consideration of promoting inclusion and reconciliation across all public programs.

298. Sustaining momentum to carry through with institutional and political reforms will be needed to

160 Rathnayake et al 2009

161 Ahmed and Suphachalasai, 2014

162 Coast Conservation Department 2006

163 De Zoysa and Inoue 2014

ensure government effectiveness and stability. At the time of writing this SCD, the new institutional framework embodied in the 19th Amendment has not yet been implemented. Electoral reforms have not yet been finalized and legislation regarding right to information and the audit function are awaiting consideration in Parliament. August 2015 general elections have led to the formation of a new government, which is now setting policies for the coming years. There will need to be sustained commitment by Sri Lanka's political leaders to carrying through with the new model, overcoming any transitional issues that may emerge, and providing for smooth operation of government.

299. A heavier emphasis on direct investment and long-term private-sector flows will be needed to sustain Sri Lanka's external fiscal position. Past reliance on remittances and external borrowing to maintain the country's balance of payments will become harder to sustain. Remittances are likely to remain at comparable levels while there is limited scope for continued borrowing, since it will be at commercial rates and the country's low revenue-to-debt ratios. FDI is important for competitiveness but also to help with balance of payments.

300. Long-term sustainability concerns related to an aging population need to be addressed sooner rather than later. Having passed its demographic peak, Sri Lanka faces an urgency to get rich before it gets old. In addition to addressing the present acute fiscal challenge, tax reform to structurally increase fiscal revenue over the long term is needed to create room for increased public expenditure on education, health and pensions. Increasing the retirement age in line with increasing life expectancy would also help temporarily reverse the decline in the labor force.

301. Sri Lanka will be well served in seeking to ensure environmentally sustainable growth and better manage disaster risk. This could include soil conservation efforts, protection of watersheds, and improved solid waste management. This will require holistic, long-term planning across sectors, coordination among stakeholders, and seeking to allocate public funding and crowd in private-sector funding in pursuit of green growth. In addition, a national disaster risk financing strategy will be needed, along with better integration of disaster relief with social protection benefit distribution programs.

VII. CONCLUSIONS



Identifying a Path Forward

302. Sri Lanka's development trajectory has shown impressive gains but there are strong indications that drivers of past progress are not sustainable. The country has experienced strong growth and a rapid reduction in poverty over the past decade. It has ended a 30-year debilitating internal conflict and rapidly addressed many of the needs of the conflict-affected population. It has just gone through a remarkable democratic transition and has embarked on far-reaching institutional reforms to provide for greater effectiveness and probity of government. Its human development outcomes remain impressive, even if continued improvement is becoming more challenging. However, the country's inward-looking growth model based on non-tradable sectors and domestic demand amplified by public investment cannot be expected to lead to sustained inclusive growth going forward.

303. The systematic diagnostic set out in this report points to fiscal, competitiveness, and inclusion challenges as well as governance and sustainability cross-cutting challenges as priority areas of focus for sustaining progress in ending poverty and promoting shared prosperity. These overarching challenges were identified through the SCD's systematic "leave-no-stone-unturned" review of the many possible factors that constrain or drive progress on the twin goals (Box 7.1). The identified challenges represent an aggregate of discrete constraints identified by the analysis, filtered by five criteria: the potential impact on twin goals, the time horizon for this impact, strength of the evidence base, complementarities, and whether addressing the constraint is a precondition for dealing with other constraints. The extent to which criteria have been met is derived from observation of where Sri Lanka's current performance falls below that of appropriate comparator countries (mainly in South and Southeast Asia) and/or the country's own past, and where Sri Lankan stakeholders have identified major issues over the course of drafting the SCD. The resulting list of areas may not be an exhaustive tracking of all of the country's development challenges, but it sets out what is most significant in relation to the twin goals.

Priority Areas of Focus to End Poverty and Promote Shared Prosperity in a Sustainable Way

304. The fiscal challenge is marked above all by constraints brought about by poor revenue collection. Chronically disappointing revenue performance and the persistently narrow tax base despite growth is a first order issue. Continued strong commitment to fiscal sustainability urgently requires long-term domestic revenue mobiliza-

tion efforts. This diagnostic identifies a range of tax administration and policy issues that may be driving low revenue performance, but substantial additional analysis into many areas, most notably tax exemptions and enforcement, is required. Greater effectiveness and efficiency on the expenditure side through improvements in public-sector management can also help increase fiscal space. Ultimately, more fiscal space is a precondition for addressing other constraints. Low revenue has led to a lean and rigid budget where low levels of public spending on health, education and social protection undercut Sri Lanka's past strong gains in human development and leave it less well equipped to face changing human development needs as a MIC. This is especially important in light of the need to reduce inequality of opportunity and invest in skills to enhance competitiveness. Beyond increasing fiscal space for these priority projects, there is room to improve efficiency of spending on social protection and public-sector personnel management that undermines the effectiveness of the state. Reducing fragmentation and improving targeting of the existing social protection system can ensure that every dollar spent on social protection has a maximum impact in reducing poverty.¹⁶⁴ Similarly, improving controls on public-sector remuneration and reducing political influence in civil service management could substantially improve the efficiency of public-service delivery.

305. The competitiveness challenge involves many areas where Sri Lanka can improve performance, with improving the skill sets of the labor force emerging as a major constraint for growth and good jobs for the bottom 40 percent. Sri Lanka's educational system, particularly at tertiary levels, is not providing a sufficient volume of workers of the quality and skills demanded by the market. This, in part, reflects low public spending on the area, but also points to bottlenecks in expanding the availability of university slots, and the adequacy and quality of the curricula. Efforts in this regard could include steps to ensure: high-quality general education and development of soft skills; greater private-sector participation in higher education, improvements in technical and vocational training; better coordination with potential employer needs; and that youth are inclined to pursue degrees in the industries where demand is the highest.

306. Trade policy and a host of land, labor and other regulatory barriers further hamper the country's development. It will be important to review and revise the country's trade-related policies, including the para-tariff regime to encourage more foreign trade, simplify the VAT and corporate income tax regimes, and reduce or elimi-

164 Rathnayake et al 2009

Box 7.1 Approach to prioritization

This Systematic Country Diagnostic was compiled in three phases: (i) a comprehensive gathering and review of existing evidence of constraints and factors towards progress on ending extreme poverty and promoting shared prosperity (the twin goals); (ii) identification of main themes and further research based on knowledge gaps identified in the initial review; and (iii) organizing and prioritizing areas of focus for achieving progress towards the twin goals.

A systematic review of potential opportunities and constraints that could affect the twin goals led to the identification of main themes. This SCD is based on a systematic and detailed review of key potential factors impacting progress on the twin goals by using a hybrid framework that combines the Hausman, Rodrik and Velasco (2005) growth diagnostics methodology with the Bussolo and Lopez-Calva (2014) assets-based framework. The systematic review of Sri Lanka's performance on the 22 factors identified by this framework led to four major themes, which formed the basis for organizing this report: (i) fiscal sustainability and the need to ensure fiscal space for development; (ii) fostering growth and jobs for the bottom 40 percent; (iii) ensuring spatial and social inclusion; and (iv) the importance of more effective and efficient governance.

Prioritization was then conducted in two steps. First, throughout the report, prioritization was based on technical factors, including comparisons of Sri Lanka to other countries that are similar or aspirational as a means of prioritizing areas. Areas where Sri Lanka demonstrated relatively strong performance for an LMIC, such as overall access to infrastructure and basic health outcomes were assessed as having less importance as a constraint, but rather reflected opportunities for Sri Lanka to capitalize on in making progress on the twin goals. These opportunities are summarized briefly at the beginning of Chapter IV. The first six chapters of this volume represent the result of analysis that was made against the general criteria of:

- **The potential impact on ending poverty and on promoting shared prosperity:** This assessed its potential impact on ending poverty and ensuring a sustainable increase in the welfare of the less well off. The overall impact on achieving the twin goals will obviously have the highest weighting.
- **Complementarities:** This refers to the degree to which addressing these constraints would have influence across different domains (growth, inequality, sustainability) and/or would magnify the positive impact of addressing other constraints.
- **Strength of the evidence base behind the impact.** This refers to the extent to which there is a compelling argument for particular reforms, with the stronger cases scoring higher priority.
- **Time horizon of impacts:** This refers to the timeframe under which the impact can be expected to be realized, and would seek to balance short- and longer-term impacts.
- **Preconditions:** These are constraints that need to be addressed to unlock wider potential.

The second step in the prioritization process involved consultations with a broad set of stakeholders after the completion of a first working draft. These consultations validated the analysis and served to assess the relative importance of the diagnosed constraints and drivers. Over 120 persons from various spheres participated in consultations. Discussions at the consultations were complemented by surveys to ensure a broad range of inputs. On the basis of the consultations and completed analysis, prioritization of areas against the criteria was finalized. A summary of this prioritization is below; for a fuller treatment, please see Annex 1.4.

nate export taxes (cesses) on agricultural commodities. Continued focus on improving trade facilitation and the logistics environment, including streamlining licenses and permits required to export would help to promote export-led growth. Similarly, greater linkages between R&D institutions and networks of entrepreneurs can help competitiveness and a more outward-oriented economy, particularly for agriculture. Moreover, there is need to improve the regulatory environment to allow firms to grow, reducing informality and allowing for economy-wide increases in productivity and allowing firms to reach economies of scale. Some aspects of the regulatory environment that appear to be significant obstacles are: upgrading the systems for land tenure and land-use planning in both

agricultural and rural areas; modernizing labor legislation to encourage easier movement of labor and female labor participation; ensuring that the burden to business licensing and permits is minimal, particularly in regions where this is a problem, such as the North; and providing for speedier resolution of commercial disputes and enforcement of contracts in court or using alternative-dispute mechanisms. Bringing larger and more profitable firms into the formal system and improving enforcement could help formalization efforts. The definition of priorities for investment climate reforms to unleash firms' potential should stem from regular dialogue between the public and private sectors.

Table 7.1 Determination of priorities

Priorities	Rationale
FISCAL	
Reform the tax regime and improve tax administration to improve revenue performance	Fiscal sustainability a key precondition for progress in all areas, including macroeconomic stability. Greater fiscal space allows for addressing equality of opportunity through increased social spending, especially important for inclusion. Efficiency of social protection has direct impact on ending poverty. Evidence base is strong.
Improve the adequacy and effectiveness of spending	
Improve the amount of financing and efficiency of social protection	
COMPETITIVENESS	
Review and revise the country's trade-related policies	
Provide more resources and quality-enhancing management in the education sector to expand skilled workforce and overcome skills mismatch	
Promote innovation by establishing linkages between R&D institutions and networks of entrepreneurs	Trade and adoption of new technologies promote diversification, external sustainability, and growth, which translates to good jobs. Overcoming skills mismatches contributes to growth and participation of the bottom 40 percent, including minorities and women. Evidence base is strong for skills and trade policy issues.
INCLUSION	
Proper urban management and effective governance of cities to address locational concentrations of poverty	
Multi-sector interventions to reduce poverty and promote employment opportunities in areas with the highest poverty rates (North, East, Moneragala, and Estates)	
Improve equality of opportunity across ethnic groups, regardless of where they reside	Urbanizing areas are associated with growth and absolute majority of poor are proximate to these areas. Ensuring continued benefits of agglomeration will help progress for the majority of the poor. For those living in more remote areas, more targeted interventions will be needed to ensure equality of opportunity through improved service delivery and greater participation in the labor force. Evidence base is very strong.
Increase labor force participation of women and ensure equal opportunity in access to jobs, political and private sector leadership	
GOVERNANCE	
Improve the regulatory environment to allow firms to grow and enhance overall productivity in the economy	
Review the regulatory role and participation of the public sector in the economy	Governance has cross-cutting impact on all other challenges. In particular, labor, land, and other regulation create major distortions in the economy. The size of the public sector leads to inefficient use of public resources and distorts labor markets. The ability of government to carry out core functions depends on effectiveness of the public sector. Evidence base is strong.
Improve the efficiency of the public sector	
SUSTAINABILITY	
Sustain peace and security through long-term reconciliation efforts	
Develop a more accountable and effective state	Peace is sine qua non for continued investment, growth, and personal well-being of large segment of the population. Sustaining the state's institutional capability over the long term is integral competent facilitation of private-sector-led growth. Macro-economic and environmental sustainability are preconditions for continued progress as well as capitalizing on the country's asset base. Evidence of associated risks is strong.
Place heavier emphasis on direct investment and equity portfolio flows than debt	
Preserve natural assets and address the impact of climate change	
Address the long-term fiscal sustainability concerns related to population aging	

307. The role and participation of the public sector in the economy poses further competitiveness constraints. Stronger management and strategic oversight of the SOE sector is important to ensure that state involvement is serving a public purpose, does not create too much fiscal risk, and is not crowding out the private sector. The state should take steps to ensure that the public service is “fit for purpose” to carry out public-sector functions and not as a mechanism for job creation. The state can play a role that facilitates greater private-sector involvement through the establishment of a robust institutional framework for public-private partnerships that would ensure public interests and investor concerns are balanced while crowding in private-sector investment and skills. Finally, measures to address conflict of interest could reduce negative impacts of the interconnectedness of government with specific businesses. These measures together will help provide an environment conducive to efficiency- and productivity-enhancing FDI, allowing for less emphasis on targeted incentives.

308. The inclusion challenge is two-fold, recognizing that absolute numbers of the poor and bottom 40 percent are in urbanizing population centers while relative concentrations of poverty are in specific, relatively remote districts. Forty-three percent of the poor are in the districts directly along the Kandy-Colombo-Galle corridor, which has seen significant agglomeration and associated growth over the past two decades. The challenge will be to ensure that the poor and bottom 40 percent are able to participate in this growth going forward as a means to lift themselves out of poverty. Priority efforts in this respect include proper urban management in addition to adequate access to services to ensure the poor living in these areas of agglomeration can benefit from economic activity in these areas. At the same time, there are “pockets” of high rates of poverty in the North, East, estate sector and Moneragala where equality of opportunity in terms of access to services and linkages to the labor market are lower. Efforts to ensure inclusion of these communities could include small works programs aimed at improving market accessibility, incentives to promote entrepreneurship among educated youth and direct programs to help ex-combatants and female-headed households. In the estates, multi-sector interventions to improve nutrition outcomes, enhance job opportunities for the youth, and prepare for a growing number of aging workers would help in ensuring their inclusion in shared growth. In addition, there is need to address land claims in the former conflict areas, providing assistance to new and “old” IDPs. The lack of increase in female participation in the labor force despite decades of high educational attainment, caused in part by labor practices, is a major cross-cutting issue. Efforts to address this could entail both reforms to the legal

and regulatory environment, as well reforms of the public sector to ensure that the private sector can compete, more targeted interventions that could ensure women are able and willing to pursue careers that are in line with the demands in the labor market, and fostering greater participation of women in leadership positions.

Cross-Cutting Challenges

309. The governance challenge manifests itself in many ways, which taken together constitute the fundamental constraint on progress on the twin goals. Governance issues are cross cutting and underlie in many important ways the three challenges outlined above. Governance is obviously central to the quality and probity of public expenditure as well as to the government’s capacity to provide for equality of opportunity for the poor and bottom 40 percent to improve their welfare. Moreover, the quality of governance is integral to addressing corruption concerns and sustaining public trust. It is also integral to revenue performance, particularly the effectiveness of tax and customs administration. The most prominent manner in which governance acts as a constraint is in how the state carries out regulatory functions for the economy. Policies that orient the economy inward, such as the convoluted tax system, restrictive land and labor market regulation, and inefficient subsidies -- and the related quality of administration thereof -- reflect areas where governance is a critical constraint. This burden of government regulation has led to a large informal sector, which negatively impacts improvements in productivity. Governance weaknesses have further led to significant expansion of the public sector’s role in the labor market and certain economic sectors. This expanded role in the economy contributes little to effective use of the country’s resources or productivity gains, whether it is interventions in agriculture, multiplying tax incentives, or absorbing a significant portion of the labor force. Finally, ensuring the provision of key public goods, such as infrastructure and public services, is a core function of government; the extent to which there is inequality in access to such goods reflects areas where strengthened governance is warranted. The transparency and accountability reform agenda of the present leadership is an important opportunity to strengthen governance, though this will be a long-term process.

310. Sustainability risks should be borne in mind while addressing constraints to progress on the twin goals. The longer-term risks of security and institutional reform, as well as economic and environmental sustainability, will require adequate planning and mitigating policies sooner rather than later. Above all, the *sine qua non* for progress on all fronts is a sustained focus on overcoming grievances that have fed past conflict and, more generally,

carrying through on good governance reforms is integral to providing stability. This will likely include sustained implementation of mechanisms to address these issues, including domestic mechanisms for assessing accountability as well as following through on the many LLRC recommendations. It also calls for consistent consideration of promoting inclusion and reconciliation across all public programs. External sustainability is integral to macroeconomic stability, and will require structural reforms that allow for increases in FDI and long-term private-sector flows instead of external borrowing. Long-term fiscal sustainability given the aging population will require planning in order to meet declining revenues and increasing expenditures due to this demographic change. Long-term improvement in revenue and increasing the retirement age in line with increasing life expectancy would help to avoid major adjustment in the future. Finally, Sri Lanka will be well served in seeking to ensure environmentally sustainable growth and better manage disaster risk. This could include soil conservation efforts, protection of watersheds, improved solid waste management, and holistic, long-term planning to promote green growth. In addition, a national disaster risk financing strategy will be needed, along with better integration of disaster relief with improved social protection distribution programs.

311. These challenges are in many cases areas of opportunity for the next five years. The constraints identified in this diagnostic are issues that can realistically begin to be addressed in the coming years through policy changes and improvements in capacity. Raising revenues is much easier than cutting expenditures, and there is significant global experience to draw upon. Trade liberalization is possible, as Sri Lanka itself demonstrated in the late 1970s and 1990s, though this will need to be accompanied by regulatory reforms in land and labor markets to ensure that the private sector can truly be competitive. Sri Lanka has advantages that should make it attractive for FDI; the administrative steps to become more attractive have been demonstrated by many of its MIC competitors in Southeast Asia. More granular understanding of the specific needs of the poor and how they can participate in labor markets should allow for more efficient use of resources in providing of infrastructure and services that lead to equality of opportunity. There is much that Sri Lanka can realistically accomplish that will allow for it to capitalize more fully on its location, natural endowments, and human capital.

Synergies

312. The areas of priority identified above are highly interrelated. Because the constraints go to the core of how Sri Lanka's government and economy function, progress in reducing these constraints can be expected to have

significant indirect effects for the country as a whole and the bottom 40 percent in particular. At a basic level, greater fiscal space and efficiency of expenditure will allow government to be more effective. A growing economy can be expected to provide jobs for the bottom 40 percent and an environment conducive to addressing specific inclusion challenges, which, in turn, provides for sustainability.

313. There are particularly important areas of synergy that provide for progress on inclusion, sustainability and growth. For instance, effective governance of cities will not only be critical for addressing spatial inclusion challenges, but could also improve the benefits of urban agglomeration and raise the level of overall growth and job creation. Good governance in urbanizing areas is also important to balance social, environmental, and economic equity concerns to allow for Sri Lanka to benefit long term from its relatively unharmed natural asset base. Improving partnership between the public and private sectors will facilitate more private-sector-led growth and can crowd in financing of public goods to lessen the fiscal burden on the state. Similarly, improving equality of opportunity (including addressing land claims) across ethnic groups is likely to be crucial for improving social stability and the sustainability of peace. Moreover, closing the gender gap in labor force participation is not only important in terms of social inclusion, but is, in effect, critical in terms of the broader challenge of raising competitiveness and ensuring shared prosperity, particularly given an aging population will increase the dependency rate.

314. There is a nexus of issues around providing for skills development that meets the needs of Sri Lanka's economy going forward. On the one hand, there are important elements of state performance that need addressing to improve the population's skills mix: its ability to create more fiscal space to provide quality education to the population; the efficiency of resources directed towards human capital development; its ability to listen to and partner with the private sector on ensuring that the right skills are being provided, both by public and private institutions; and the impact that the state has on the labor market given its outsized role as an employer. At the same time, investment in skills, particularly with public financing, is integral to equipping the bottom 40 percent with capacity to get good jobs, a fundamental means of boosting shared prosperity. A more skilled labor force in turn helps Sri Lanka become more competitive, including within global value chains, as well as a more attractive as a destination for FDI.

315. Addressing the constraints and sustainability issues diagnosed in this report will require effective leadership. Consultations conducted while preparing this diagnostic showed strong consensus around Sri Lan-

ka's development challenges as they are articulated herein. Indeed, with regard to some constraints, reforms or government intervention have been initiated to address problems such as equality of opportunity in underserved areas or improving Sri Lankans' skill sets. The government has articulated further plans to address other constraints outlined in this diagnostic. However, enacting reforms and

carrying through with strong governance to implement them will be challenging, as vested interests are likely to resist change. While the challenges are clear, effective leadership will be needed to address them and put Sri Lanka on a path that will revitalize its progress in ending poverty and promoting shared prosperity.

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APPENDIXES



APPENDIX 1

PERFORMANCE ON THE MILLENNIUM DEVELOPMENT GOALS, INTERNATIONAL COMPARISON

Goals and Targets	Indicators	Sri Lanka Base Year		Sri Lanka Latest Year		Sri Lanka Country Progress (as of 2014)	SAR (latest data)		South Eastern Asia (latest data)		Vietnam (latest data)		India (latest data)	
		Value	Year	Value	Year		Value	Year	Value	Year	Value	Year	Value	Year
GOAL 1: ERADICATE EXTREME POVERTY AND HUNGER														
Reduce extreme poverty by half	Proportion of population living below \$1.25 (PPP) per day (percent)	15	1991	4.1	2010	low poverty	29.7	2010	14.3	2010	16.9	2008	32.7	2010
Reduce hunger by half	Proportion of population below minimum level of dietary energy consumption (percent)	30.6	1991	24.6	2013	Moderately high hunger	16.8	2011-2013	10.7	2011-2013	12.89	2013	15.2	2013
GOAL 2: ACHIEVE UNIVERSAL PRIMARY EDUCATION														
Universal primary schooling	Net enrollment ratio in primary education (enrollees per 100 children)	99.8	2001	93.9	2012	High enrollment	94.4	2012	93.9	2012	98.2	2012	98.9	2011
GOAL 3: PROMOTE GENDER EQUALITY AND EMPOWER WOMEN														
Equal girls' enrolment in primary school	Ratio of girls to boys in primary education	0.97	1990	1	2012	Parity	1	2012	0.99	2012	1.01	2012	1.02	2011
Women's share of paid employment	Share of women in wage employment in the non-agricultural sector	30.2	1997	30.4	2012	Medium share	19.8	2012	38.5	2012	40.4	2004	19.3	2010
Women's equal representation in national parliaments	Proportion of seats held by women in national parliament (single or lower house only - percent)	4.9	1990	5.8	2014	Very low representation	16	2014	18.4	2014	24.3	2014	11.4	2014
GOAL 4: REDUCE CHILD MORTALITY														
Reduce mortality of under-five-year-old by two thirds	Under-five mortality rate (deaths of children per 1,000 births)	21.3	1990	9.6	2013	Low mortality	55	2013	29	2013	23.8	2013	52.7	2013
GOAL 5: IMPROVE MATERNAL HEALTH														
Reduce maternal mortality by three quarters	Maternal mortality ratio (maternal deaths per 100,000 live births)	49	1990	29	2013	Low mortality	190	2013	140	2013	49	2013	190	2013
Access to universal reproductive health	Contraceptive prevalence rate (percentage of women aged 15-49, married or in union, using contraception)	66.1	1993	68.4	2007	High access to reproductive health	57	2012	63.1	2012	77.8	2011	54.8	2008
	Unmet need for family planning (percentage of women aged 15-49, married or in union, with unmet need for family planning)	18.2	2000	7.3	2007		14.4	2012	12.5	2012	4.3	2011	20.5	2008

Goals and Targets	Indicators	Sri Lanka Base Year		Sri Lanka Latest Year		Sri Lanka Country Progress (as of 2014)	SAR (latest data)		South Eastern Asia (latest data)		Vietnam (latest data)		India (latest data)	
		Value	Year	Value	Year		Value	Year	Value	Year	Value	Year	Value	Year
GOAL 6: COMBAT HIV/AIDS, MALARIA AND OTHER DISEASES														
Halt and begin to reverse the spread of HIV/AIDS	HIV incidence rate (number of new HIV infections per year per 100 people aged 15-49)	0.01	2001	0.01	2012	Low incidence	0.02	2012	0.03	2012	0.02	2012		
Halt and reverse spread of tuberculosis	Number of new tuberculosis cases per 100,000 population	66	1990	66	2012		178	2012	202	2012	147	2012	176	2012
	Number of tuberculosis deaths per 100,000 population	7.5	1990	1.1	2012		24	2012	25	2012	20	2012	22	2012
GOAL 7: ENSURE ENVIRONMENTAL SUSTAINABILITY														
Reverse loss of forests	Proportion of land area covered by forest (percent)	36.4	1990	28.8	2010	Medium forest cover	14.5	2010	49.3	2010	44.5	2010	23	2010
Halve proportion without improved drinking water	Proportion of population using an improved drinking water source (percent)	67.6	1990	93.8	2012	High coverage	91	2012	89	2012	95.2	2012	92.6	2012
Halve proportion without sanitation	Proportion of population using an improved sanitation facility (percent)						42	2012	71	2012	75	2012	36	2012
Improve the lives of slum-dwellers	Proportion of urban population living in slums (percent)						35	2012	31	2012	35.2	2009	29.4	2009
GOAL 8: DEVELOP A GLOBAL PARTNERSHIP FOR DEVELOPMENT														
Internet users	Internet users per 100 inhabitants	0	1990	21.9	2013	High usage	12.3	2012	24.9	2012	43.9	2013	15.1	2013

Note : The MDG Country Progress Snapshot provides an overview of the progress achieved at country level since 1990 towards the Millennium Development Goals. The snapshot is intended mainly to provide the international community easy access to the information and are not meant to replace in any way the country profiles produced at the national level in several countries. They are also meant to reflect the contribution of country-level progress to the global and regional trends on progress towards the MDGs.

The data used in the snapshot are from the MDG global database (<http://mdgs.un.org/unsd/mdg/Data.aspx>). The metadata and responsible agencies can be found on <http://mdgs.un.org/unsd/mdg/Metadata.aspx>. Sources of discrepancies between global and national figures are due to, among others, different methodology and definitions or different choice of data sources. At the global level, the monitoring of the progress aims to ensure better comparability of data among countries.

Sources: <http://mdgs.un.org/unsd/mdg/Resources/Static/Products/Progress2014/Snapshots/IND.pdf>; <http://mdgs.un.org/unsd/mdg/Resources/Static/Products/Progress2014/Snapshots/VNM.pdf>; <http://mdgs.un.org/unsd/mdg/Resources/Static/Products/Progress2014/Snapshots/LKA.pdf>

APPENDIX 1.2

POVERTY INDICATORS FOR SRI LANKA

How is Poverty measured?

The official poverty figures in Sri Lanka refer to the share of individuals whose per capita consumption falls below the official poverty line. This indicator is usually defined in the literature as headcount index and it is a measure of the incidence of poverty. The data used for the analysis are drawn from the Household Income and Expenditure Survey (HIES), which has been collected every three to five years since 1995. The 2012/13 HIES covers all 25 districts for the first time in the history of the Sri Lanka household budget survey.

The consumption aggregate is the sum of the consumption expenditures of all food and nonfood items of each household. The consumption aggregate is spatially deflated to take into account differences in the cost of living of the different districts. To get the per capita consumption, the spatially deflated consumption aggregate is divided by the number of household members (excluding the persons who are member of the household but usually live elsewhere in the country or abroad). Once per capita household consumption is calculated, it is then compared to the national poverty line, which was set to Rs 1,423 in 2002, equivalent to the minimum necessary to consume 2,030 kilocalories per capita per day (using the Cost of Basic Needs approach). The poverty line has been subsequently updated using the Colombo Consumer Price Index.

The World Bank uses as extreme poverty line \$1.25 a day in 2005 ppp terms, which represents the mean of the poverty lines found in the poorest 15 countries ranked by per capita consumption among 88 surveyed countries over the period 1990-2005 (Ravallion, Chen and Sangraula, 2009). The Sri Lanka national poverty line is about \$1.50 a day in 2005 ppp. Other commonly used poverty lines for international comparisons across middle-income countries are \$2.50 a day and \$4 a day in 2005 ppp, which correspond to, in turn, Rs 6,058 and Rs 9,692 a day in 2012/13 prices. In addition to the national poverty line, The SCD will use the US \$1.25, US \$2.50 poverty lines.

The poverty gap and severity of poverty

Although the headcount index is the most widespread measure of poverty, it has a serious shortcoming in that it does not take into account the intensity of poverty, i.e. how far from the poverty line the poor are. A measure of poverty that overcomes this problem is the poverty gap index. The poverty gap index is the average shortfall of the total population from the poverty line as a share measured as a percentage of the poverty line itself. The severity of poverty is a measure that puts a higher weight on households furthest away from the poverty line. Both of these measures will complement the analysis of headcount poverty in the context of the SCD.

What is the consumption cut-off line for the bottom 40 percent?

Finally, the SCD will focus on the bottom 40 percent to discuss the welfare of the less well-off more broadly. The consumption cut-off line for the bottom 40 percent (the threshold below which the poorest 40 percent of population lays) in 2012/13 is Rs 6,765, or \$ 2.79 a day in 2005 ppp.

Key issues with consumption calculations in Sri Lanka

There are three main concerns about the methodology followed for building the official consumption aggregate. First, the consumption aggregate includes some items that are usually excluded, in particular: expenditure on durable goods, rarely incurred expenses (e.g. weddings, funerals, ceremonies, litigations, purchased properties), and expenses on provident funds, insurances, payment of debts, money lending and income taxes are typically excluded (see Deaton and Zaidi, 2002). Second, to guarantee comparability across surveys, the consumption aggregate should exclude items that were not included in previous years' questionnaires, or those for which the recall period has changed over time. Third, since the survey is conducted over a period of 12 months, the use of a temporal price adjustment would be recommended.

APPENDIX 1.3

SRI LANKA. CHARACTERISTICS OF THE POOR

	Overall	Bottom 40 percent	Top 60 percent	Poor		
				National	US1.25	US2.50
Average age	33.0	31.0	34.3	29.1	28.4	30.7
Average household size	3.9	4.4	3.6	4.9	5.0	4.5
(percent of individuals)						
Industry¹						
Agriculture	30.7	41.9	23.0	48.8	47.9	43.2
Industry	23.8	24.9	23.1	23.8	21.4	24.5
Services	45.3	32.8	53.9	27.2	30.7	31.9
Education						
Average years of education for						
Head	8.2	6.6	9.1	5.5	5.4	6.4
Individuals age 20 or more	8.9	7.5	9.7	6.5	6.3	7.3
Health						
Average distance (Km)						
Clinic	2.4	2.9	2.1	3.5	3.5	3.0
Dispensary	2.1	2.8	1.6	3.5	3.4	2.9
Hospital	6.6	7.5	6.0	8.2	8.5	7.6
Maternity clinic	5.2	6.0	4.7	6.3	6.1	6.0
Access to services						
Share of households with:	(percent of households)					
Electricity	90.2	82.2	94.5	69.2	65.5	80.4
Landline telephone	36.7	21.7	44.8	13.0	9.5	19.8
Mobile telephone	81.1	71.4	86.4	56.5	50.4	70.1
Pipe borne line nearby their house	62.2	54.9	66.2	49.8	48.6	53.7
Tap water	30.9	22.5	35.5	17.8	16.2	22.0
Toilet available within the unit	47.0	36.2	52.9	32.2	31.4	35.9
Sealed toilet connected to sewage	3.6	2.1	4.5	2.4	2.8	2.1
Sealed toilet connected to pit/tank	93.1	92.6	93.4	87.1	85.2	91.9

Source: Own estimates, HIES 2012/13

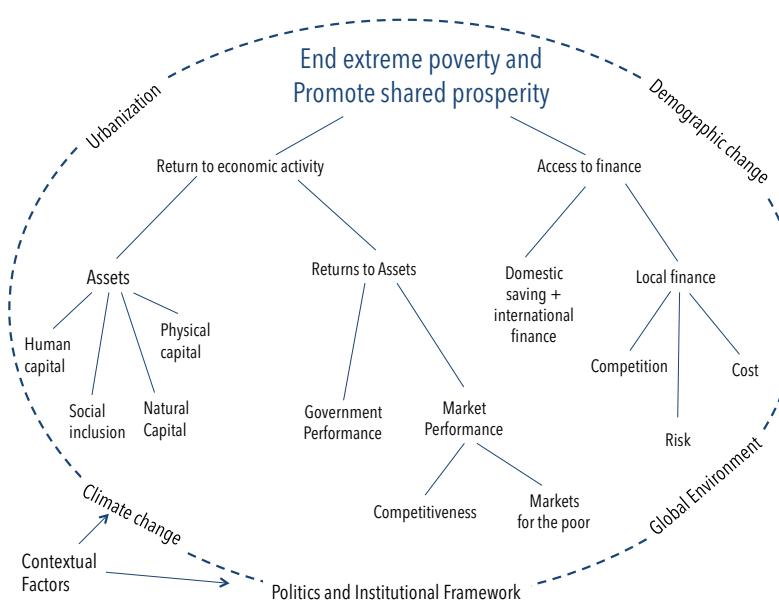
1/ Refers to the industry where the Household Head is employed. All unclassified industry sectors are assigned to Services

APPENDIX 1.4

METHODOLOGY

This Systematic Country Diagnostic was compiled in three phases: (i) a comprehensive gathering and review of existing evidence of constraints and factors towards progress on ending extreme poverty and promoting shared prosperity (the twin goals); (ii) identification of main themes and further research based on knowledge gaps identified in the initial review; and (iii) organizing and prioritizing areas of focus for achieving progress towards the twin goals. A guiding principle was to have broad participation and feedback from the World Bank Group's Sri Lanka country team as well as external experts and stakeholders to ensure completeness of data collection and analysis. Thus, following an initial desk review of evidence, a series of brainstorming sessions were held with a broad team of stakeholders. Ultimately an additional 14 background papers and notes were also either commissioned independently or completed in parallel and utilized for the SCD.

Figure A1 Diagnostic framework

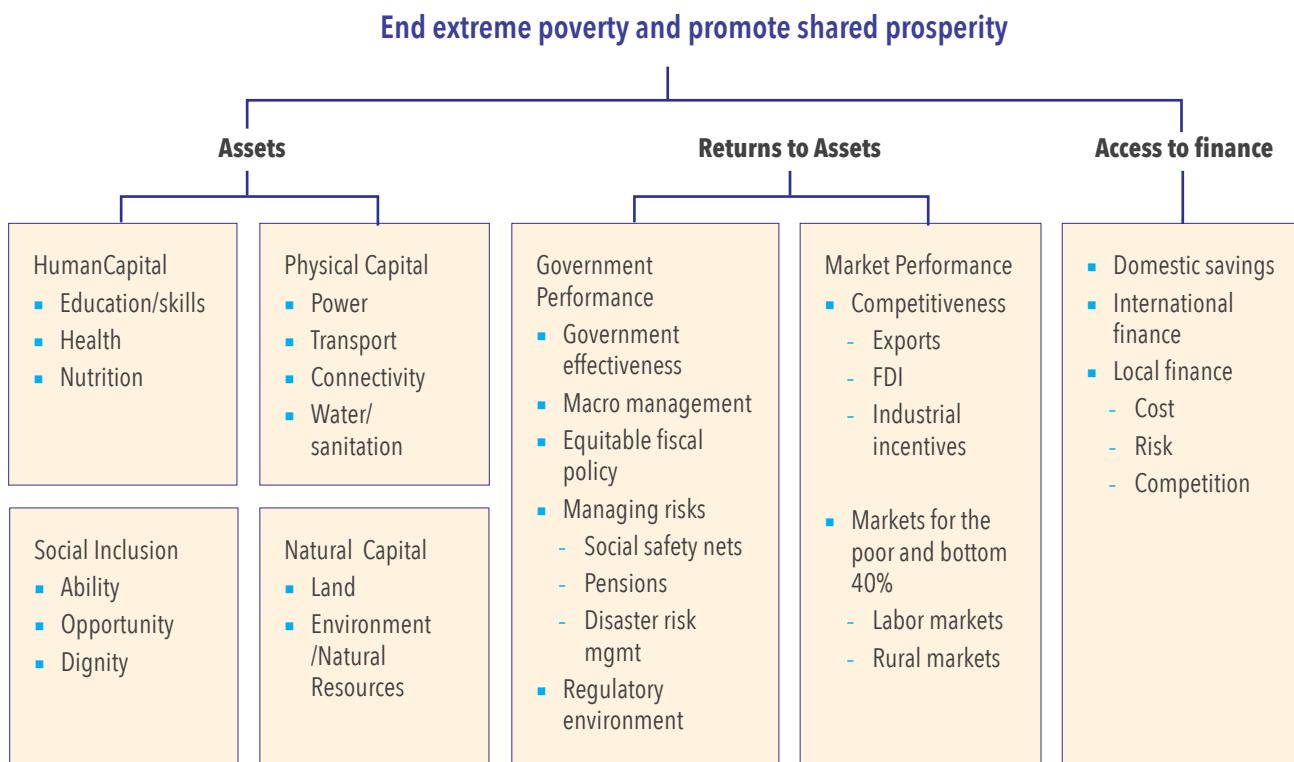


Marshalling evidence

A hybrid framework combining the Hausman, Rodrik and Velasco (2005) growth diagnostics methodology with the Bussolo and Lopez-Calva (2014) assets-based framework was used to identify a set of possible constraints and drivers towards progress on the twin goals. The Hausman, Rodrik and Velasco (2005) growth diagnostic is a top-down approach based on a simplified growth model that identifies several potential distortions.¹⁶⁵ In order to focus on the ability of the bottom 40 percent to latch on to the growth process, this top-down approach was combined with the prin-

¹⁶⁵ Following Dixit (2007) we do not use the framework as a decision tree, but rather as a way to organize and discipline the analysis by identifying the range of possible constraints and drivers.

Figure A2 Digging deeper



ples of the Bussolo and Lopez-Calva assets framework. The Bussolo/Lopez-Calva framework postulates that the incomes of the bottom 40 percent depend on the level of assets – human, physical, financial, social and natural capital – that people own and accumulate, the intensity with which they are used, and the returns associated to those assets. The method aims to consider the constraints as well as facilitating factors to asset accumulation and their use. These have a direct impact on the income generation capacity of all households in an economy, but particularly on the poor and those belonging to the bottom 40 percent of the income distribution. The framework in Figure A1 thus places shared prosperity as the desired goal, which in turn depends on economic growth and the ability of the bottom 40 percent to benefit from growth. The framework provides a breakdown of the range of possible factors contributing or constraining achievement of this outcome.

The returns to economic activity depend on the availability of assets and the returns to those assets. Assets include human, social, natural and physical capital, with a focus on the bottom 40 percent. Human capital includes health, education and nutrition (Figure A1). While “social capital” refers to a specific concept and attendant literature, in fact issues of social inclusion are central to acquiring and using assets. Social inclusion is defined as “improving the terms of individuals and groups, disadvantaged on the basis of their identity, to take part in society”.¹⁶⁶ This can be achieved by improving the ability, opportunity, and dignity of such people, who are disadvantaged, inter alia, on the basis of their gender, age, disability status, caste, ethnicity, marital status or sexual orientation. Natural capital refers to access to land, a clean environment, and natural resources such as forests and fisheries. Physical capital refers to access to basic infrastructure, including roads, ports, electricity, water, and sanitation. It is also important to note that there is a strong non-monetary dimension to “shared prosperity”. That is, the growth impact of health, education, social inclusion and natural capital may not be very

large, but their impact on “well-being” may be huge.¹⁶⁷ Health, education, social inclusion and the environment matter for their intrinsic value, not just for their instrumental value to boost growth.

The returns to economic activity also depend on the returns to those assets, which in turn depend on government performance and performance of the market. Government performance is reflected in its ability to (i) maintain macro-economic stability; (ii) ensure the effective provision of public goods and services; (iii) provide a regulatory environment that provides a level playing field that facilitates economic activity; and (iv) mitigate individual risks through a social protection system and addressing systemic risks. Market performance depends on whether there are barriers to competition in domestic markets as well as export competitiveness of the economy as a whole, the ability to innovate, and whether there are distortions in markets that constrain growth of the bottom 40 percent. Special attention was paid to the labor and agricultural markets given their effects on the bottom 40 percent. Each of these potential constraints or areas of strength was considered, evaluating the relative strength of each as a threat to future efforts to end poverty and ensure shared prosperity.

Access to finance depends on the availability of domestic savings and access to international finance. It also depends on whether there are bottlenecks in local finance with respect to high cost of finance, high risk (or poor risk management), insufficient competition, issues with banking intermediation, or lack of financial literacy.

The framework provides a means to “leave no stone unturned” while also unbundling interrelated issues, which in turn allows for greater specificity as well as comprehensiveness. Many of the possible constraints or drivers are inter-related or cross cutting. This is particularly the case with government performance. For instance, the government’s ability to finance (or attract private-sector financing) and organize the delivery of public goods and services has a direct impact on the quality and quantity of assets held by the poor, and its performance as a regulator affects markets and the cost of finance. For the purposes of this SCD, performance of government was reviewed in terms of core government functionality and capacity whereas its specific impacts in areas such as improving human capital were addressed in those respective sections. Similarly, social inclusion concerns are cross cutting. They are, however, distinct in their core interest in individuals and groups disadvantaged on the basis of their distinguishing features and how their ability, opportunity and dignity to own, accumulate and use assets and generate returns from them can be improved.

Identification of main themes and prioritization

Prioritization was conducted in two steps. First, analysis of technical issues and outputs/outcomes among possible constraints or, conversely, strong performance along each of the 22 dimensions identified in the framework pointed to the relative importance of a given issue. Where possible, this analysis was complemented by comparisons of Sri Lanka to its past performance as well as to other countries that have similarities and/or are aspirational for the country, primarily in South and Southeast Asia. While differences in Sri Lanka’s performance compared to others did not necessarily mean the presence of a constraint, in cases where the country was an outlier often did indicate areas of relative weakness. This process led to the identification of four main themes in the context of wide consultation, both within the Bank as well as through brainstorming sessions with multiple stakeholders in Sri Lanka.

The information and analysis gathered were then weighed against five criteria:

- **The potential impact on ending poverty and on promoting shared prosperity:** This assessed its potential impact on ending poverty and ensuring a sustainable increase in the welfare of the less well off. The overall impact on achieving the twin goals will obviously have the highest weighting.
- **Complementarities:** This refers to the degree to which addressing these constraints would have influence across different domains (growth, inequality, sustainability) and/or would magnify the positive impact of addressing other constraints.
- **Strength of the evidence base behind the impact.** This refers to the extent to which there is a compelling argument for particular reforms, with the stronger cases scoring higher priority.
- **Time horizon of impacts:** This refers to the timeframe under which the impact can be expected to be realized, and

¹⁶⁷ Becker, 1964, 2007

would seek to balance short and longer-term impacts.

- **Preconditions:** This would identify constraints that need to be addressed in order to unlock wider potential.

The second step in the prioritization process involved consultations with a broad set of stakeholders after the completion of a first working draft. The team carried out several rounds of consultations among focal points representing global practices, cross-cutting solutions areas, and IFC operations regarding the draft of the analysis and solicited input on priorities, based on the above criteria. External consultations on the analysis in the text and to identify priorities were held with a broad range of stakeholders in government ministries and departments, think tanks, other civil society groups, representatives of the private sector, and development partners. Consultations were held in Colombo and in Jaffna to capture a broader range of views. The consultations both helped to validate the analysis in the SCD and to help assess the relative importance of the diagnosed constraints and drivers.

On the basis of feedback from all consultations, the team substantiated priorities against the five criteria. The finalization of priorities against criteria is articulated in the tables below.

Matrix of Identified Priorities

1. FISCAL

Key Priorities in Fiscal	Reforming the tax regime and improving tax administration to improve revenue performance	Improve the adequacy and effectiveness of spending	Improve the amount of financing and efficiency of social protection
IMPACT ON TWIN GOALS	Ensures fiscal sustainability, and therefore macroeconomic stability, a precondition for poverty reduction. Reduces the risk of undercutting, and increases the ability to increase, investment in human development.	More rational public spending will allow for greater resources to be directed at improving human capital and enhance and spending on social welfare needs, thereby reducing poverty.	An increase in the amount of funding and better targeting of existing social protection can ensure maximum impact in reducing poverty for relatively low levels of financing.
TIME HORIZON	Short to Medium-term Short-term: Reforming tax regime, including rationalizing exemptions and streamlining tax policy, could improve revenue more quickly Medium-term: Reforms to tax administration and expanding the tax base would strengthen tax collection and help sustainable revenue generation in the medium-term.	Medium-term	Short-term An even modest increase in the amount of financing and better social protection targeting will reduce poverty among the most vulnerable.
COMPLEMENTARITIES	Reforming tax regime and administration could improve business climate and enhance competitiveness.	Frees up fiscal space to enhance spending on human capital investments.	Improved social protection will allow for greater participation of the poor in the economy
EVIDENCED-BASED	<i>Moderate.</i> Visible decline in tax collection and proliferation of exemptions. However, additional analysis into revenue impact of tax exemptions and compliance issues and collection vulnerabilities is merited.	<i>Strong.</i> Evidenced by emerging gaps in health and education provision. More evidence required on effectiveness of spending on infrastructure in terms of rate of return and impact on access and poverty reduction.	<i>Strong.</i> Evidenced by the undesirable distributional impact of poorly targeted social protection schemes.
ESSENTIAL PRE-CONDITION	Yes	Yes	Yes

2. COMPETITIVENESS

Key Priorities on Competitiveness	Review and revise the country's trade-related policies	Provide more resources and quality-enhancing management in the education sector to expand skilled workforce	Promote innovation by establishing linkages between R&D institutions and networks of entrepreneurs
IMPACT ON TWIN GOALS	Greater trade openness would enable export growth and diversification of the economy, thereby generating more and better jobs and promoting shared growth.	Improving the skills of the labor force can improve opportunities for the bottom 40 percent, particularly among youth, to access good jobs in industries that will grow in a competitive economy.	By enhancing firm-level efficiency and competitiveness, innovation can create jobs in industries that will grow in a competitive economy. Agricultural innovation can particularly benefit the poor.
TIME HORIZON	Medium-term	Medium-to long-term Medium-term: Expanding vocational training and matching skills with industry needs can address the skills shortage in the medium-term Long-term: Reforms to education management and expanding tertiary education will foster a more competitive workforce with long-term impacts.	Medium- to -long-term Medium-term: Connecting entrepreneur networks to existing R&D facilities will benefit competitiveness in the medium-term Long-term: A sustained increase in R&D spending and promoting innovation will have longer-term competitiveness impacts
COMPLEMENTARITIES	A more outward-oriented trade policy can amplify the gains from rebalancing towards a stronger private sector role in the economy, and enhance overall economic growth.	A skilled labor force can enhance competitiveness and efficiency of firms, promoting overall growth. It will also be important complement to greater trade openness and promoting exports.	Greater innovation among firms will amplify gains from trade openness, in promoting competitiveness in exports and economic diversification.
EVIDENCED-BASED	<i>Very strong.</i> Evidenced by the stagnant economic and export diversification alongside the recent slide towards inward-looking policies.	<i>Very strong.</i> As evidenced by the substantial number of firms reporting lack of skilled labour as a constraint.	<i>Moderate.</i> R&D and innovation lag well behind comparator economies, and is influencing the visible stagnation of export and economic diversification.
ESSENTIAL PRE-CONDITION	Yes	Yes	No

3. INCLUSION

Key Priorities in Inclusion	Proper urban management and effective governance of cities to address locational concentrations of poverty	Multi-sector interventions to reduce poverty and promote employment opportunities in the North, East, Moneragala, and estates	Improve equality of opportunity across ethnic groups, regardless of where they reside	Increasing labor force participation of women and ensuring equal opportunity in accessing jobs as well as political and private sector leadership positions
IMPACT ON TWIN GOALS	As most of the poor and bottom 40 percent are located within multi-city agglomeration areas, proper urban management and adequate access to services will be important for the poor living in these areas to benefit from agglomeration.	Improving job opportunities and better access to markets and services would reduce poverty and promote shared prosperity in isolated regions. In the estates, improving nutrition outcomes, better job opportunities for the youth, and preparing for an aging population will ensure inclusion.	Improving economic opportunities for ethnic minorities, as well addressing post-conflict issues related to land, IDPs, war widows and ex-combatants, would reduce poverty and foster inclusion, towards more shared growth.	Enables women to access better jobs and improve overall inclusion of women in the economy.
TIME HORIZON	Medium- to long-term	Medium-term	Short- to medium-term <i>Short-term:</i> Addressing pressing issues, such as access to basic services in post-conflict communities can have short-term impacts on poverty reduction <i>Medium-term:</i> Impacts from improving job opportunities for ethnic minorities will be seen over a more medium-term horizon.	Medium- to long-term <i>Medium-term:</i> Reforming labor laws that disincentivize female participation can have short-term positive impacts <i>Long-term:</i> Impacts of better alignment of the education women pursue and the demands of the market would be seen in the longer-term.
COMPLEMENTARITIES	Improved governance of cities and better urban management can boost competitiveness and promote shared growth.	Improving human development outcomes in the North, East and estates can improve human capital required for enhancing competitiveness of these provinces.	Improving job and income opportunities among ethnic minorities would ensure social sustainability.	Given an aging population, greater female labor force participation would be important to increase overall growth.
EVIDENCED-BASED	<i>Strong.</i> Substantial evidence on the location concentration of poverty around urban agglomerations, as well as potential for enhancing growth in urban corridors.	<i>Very strong.</i> Substantial evidence on high poverty and exclusion in the North, East, Moneragala and estates, across multiple indicators.	<i>Moderate.</i> Evidence on lagging human development outcomes of some minorities, and also international evidence on need to address post-conflict needs to prevent return to conflict.	<i>Strong.</i>
ESSENTIAL PRE-CONDITION	Yes	Yes	Yes	Yes

4. GOVERNANCE

Key Priorities on Governance	Improve the regulatory environment to allow firms to grow and enhance overall productivity in the economy	Review the regulatory role and participation of the public sector in the economy	Improve the efficiency of the public sector
IMPACT ON TWIN GOALS	<p>Providing a more conducive business climate with business-friendly regulatory systems would allow formal firms to grow and reduce informality, thereby creating more and better jobs.</p> <p>Land management could allow for better use of agricultural lands, and greater certainty over property rights could induce greater investment and job creation.</p>	<p>Reducing the distortionary impact of the state's role in the economy can ensure private sector is not crowded out and can grow, generating more and better jobs for the bottom 40 percent.</p>	<p>Improving controls on public sector remuneration and reducing political influence in public service management could improve service delivery, with particular impacts on lagging regions.</p>
TIME HORIZON	Medium-to Long-term <i>Medium term:</i> trade facilitation; <i>Long term:</i> Labor legislation Land management	Medium-term	Medium-to Long-term: Gains from improvements to public sector efficiency and better service delivery to people will be seen in the medium and long term.
COMPLEMENTARITIES	Removing regulatory obstacles will amplify the gains from greater innovation and from greater trade openness, by enhancing competitiveness and growth of the private sector.	Better management and reduced budgetary burden of SOEs can free up resources for increasing social spending.	Increased efficiency of the public sector will help address the fiscal challenge. Freed up resources for new investments in human capital as well as meeting infrastructure needs of a middle-income country.
EVIDENCED-BASED	<i>Strong.</i> Substantial evidence on the low performance on ease of doing business, regulatory barriers faced by firms, and high and growing informality among firms.	<i>Moderate</i> Loss-making SOEs are a substantial drag on public finances. Large public-sector employment that is generously remunerated poses unfair competition to private sector businesses wishing to find and retain the best possible candidates.	<i>Strong</i> Several detailed analyses of shortcomings in public financial management, particularly procurement and Sri Lanka has been an outlier in terms of accountability and transparency of public sector operations. High opportunity costs of large, inefficient public sector.
ESSENTIAL PRE-CONDITION	Yes	No	Yes

5. SUSTAINABILITY

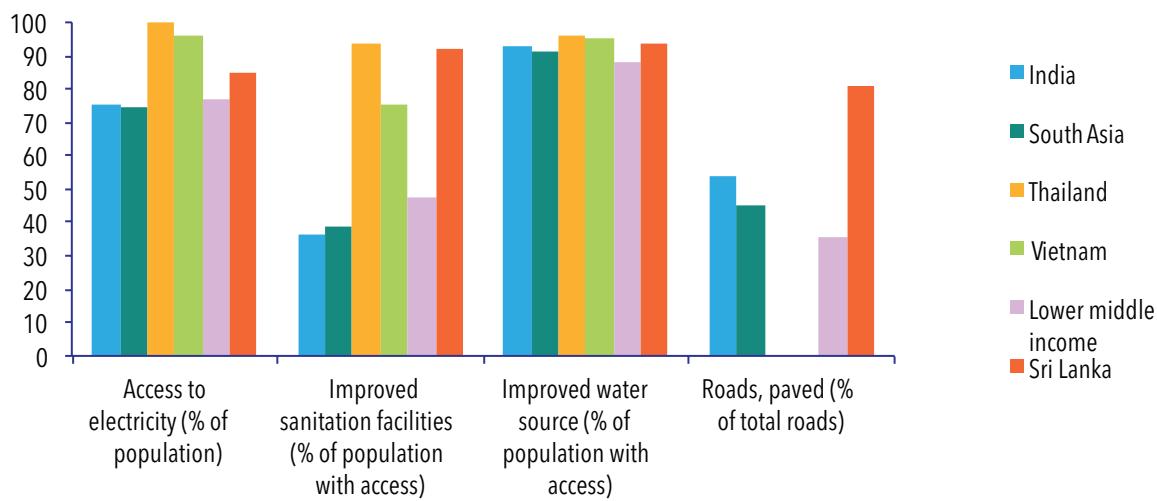
Key Priorities on Sustainability	Sustaining peace and security through long term reconciliation efforts	Developing a more accountable and effective state	Placing heavier emphasis on direct investment and equity portfolio flows than debt	Preserve natural assets and address the impact of climate change	Addressing long-term fiscal sustainability concerns related to population aging
IMPACT ON TWIN GOALS	As a country with a history of violent conflict, long-term reconciliation among the country's ethnic communities, and preventing new fissures along religious lines from emerging, are essentially for creating a climate of inclusivity and promoting shared prosperity.	Governance reforms that improve accountability to citizens can improve efficacy of state programs in meeting the twin goals. Recent governance reforms must be seen as a beginning in a wider effort to improve effectiveness and accountability of the state.	Reliance on debt to finance growth constrains the available public finances to meet social needs and tackle extreme poverty as more money is utilized on debt repayment. Attracting FDI will contribute to growth of the private sector and create jobs for the bottom 40 percent.	Tackling environmental challenges will reduce vulnerability of communities at most risk of droughts, sea level rise, crop loss and agricultural land degradation, water pollution, landslides due to deforestation, etc. Environmental management will also influence poverty in urban areas.	Without a robust and well-financed pension scheme, Sri Lanka would leave older populations in poorer groups more vulnerable. Lack of fiscal space to support healthcare and elderly care needs would also hurt inclusion and reverse gains made on reducing poverty.
TIME HORIZON	Medium- to long-term	Medium- to long-term	Medium- to long-term	Long-term	Long-term
COMPLEMENTARITIES	Forging a sustainable political settlement to long-standing fissures along ethnic and religious lines can improve inclusion, improve competitiveness of the economy, and make Sri Lanka an attractive investment destination.	A more accountable and effective state can ensure better utilization of public finances and greater transparency and better governance can provide a more conducive environment for private sector activity.	Enhancing FDI and equity flows can improve competitiveness with expanding productive capacity, opening to new markets, job creation, and technology transfer.	Preserving Sri Lanka's natural assets and environmental quality will have a positive spillover effect on improving competitiveness in economic sectors that rely on them, such as, tourism and agriculture.	Decreasing tax revenues due to a smaller working age population would further constrain public finances. Sustainable financing for pensions would help ease the fiscal burden brought on by an ageing population.
EVIDENCED-BASED	<i>Strong.</i> Substantial evidence on the impact of conflict on growth and human development outcomes. International evidence on risks of returning to conflict.	<i>Moderate</i>	<i>Strong</i> Substantial international evidence on the risks of reliance on external debt financing.	<i>Moderate</i>	<i>Strong</i>
ESSENTIAL PRE-CONDITION	Yes	Yes	Yes	Yes	No

Notes: Short-term defined as 1-2 years; Medium-term as 3-5 years; Long-term as more than 5 years.

APPENDIX 2.1

INFRASTRUCTURE

Figure A3 Access to infrastructure



Source: World Development Indicators, 2012; note roads percentage for Sri Lanka is 2003

Sri Lanka has taken significant strides in recent years to upgrade the amount and accessibility of infrastructure. Whereas South Asian comparators continue to have infrastructure gaps that profoundly limit access for large segments of the population, Sri Lanka has a solid infrastructure base (Figures A3 and A4). Going forward, the main issues for Sri Lanka's infrastructure development lie primarily in terms of efficiency of operations and maintenance and the lack of an effective framework for soliciting private investment or more generally setting up public-private partnerships. Infrastructure has largely been financed by the budget, with the exception of some independent power generation plants and telecommunications networks. Access issues according to 2012/13 HIES data are concentrated in conflict-affected areas in the North, though there has been visible improvement in that region. The government has invested over 220 billion rupees, or about 4.4 percent of its total expenditures (outside of interest payments) in infrastructure in the Northern Province alone over the past five years (Ministry of Finance 2014).

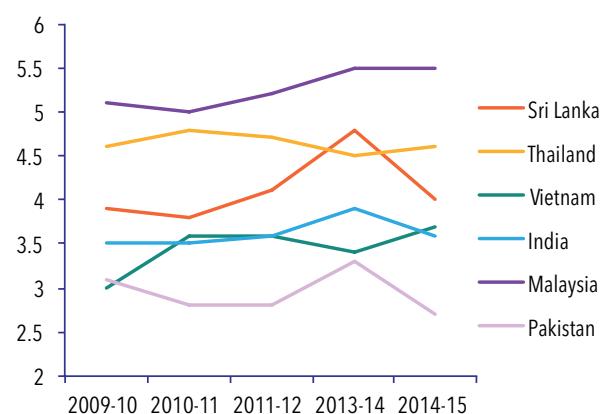
Nearly all households have regular access to electricity and power supply is expected to keep pace with an annual increase in demand of close to 10 percent, though this increase will need to be balanced to minimize environmental impacts. Thanks in part to increased private-sector participation, there have been strong gains in recent years in reliability and accessibility of electricity (Figure A5). Recently added capacity has yielded a 94 percent electrification rate according to the Ceylon Electricity Board (CEB). HIES data for 2012/13 shows 96.6 percent of the population in general (94.2 percent for the bottom 40 percent) had access to electricity, with post-conflict areas of Mullaitivu (58.3 percent) and Kilinochchi (40.3 percent) as the major outliers (Figure 29). Of greater issue is the cost of electricity, which appears to be driving the identification of power as a constraint as per the last enterprise survey in 2011, though recent tariff reductions of 25 percent have eased this burden. Costs are driven mostly by fuel imports for thermal generation. System losses have gone down from over 20 percent in 2000 to roughly 12 percent in 2011 (World Bank 2013). Notwithstanding this record, there is scope for improving efficiency in the power sector through optimizing dispatch from generation plants into the grid. Thanks to tariff reforms and a write-down of liabilities, the state-run CEB turned a net profit in 2013. Future demand for energy is expected to be met almost entirely from coal-fired plants with a reduction in the use of fuel oil and hydropower staying level at around 4000 GWh per year and renewable sources modestly increasing from their current levels (Figure 30). How-

ever, there is substantial potential and political willingness to develop the renewable energy sector through significant public and private investments with the aim to source a large share of the country's future energy demand from renewable sources, focusing on wind, hydro and pumps-storage.

Transport infrastructure has also been enhanced in recent years. Roads now account for 95 percent of passenger travel and 98 percent of freight transport. Sri Lanka has a high density of roads providing for good accessibility to the population. Expanded efforts to devote more resources to rehabilitation have improved the condition of the overall network, though maintenance remains a primary concern. Increasing congestion in urban areas is a growing issue owing to an expected doubling in modal share of private vehicles from 2010 to 2030 coupled with limitations on available road

space as well as poor condition of public transport. Sri Lanka has built expressways connecting the Southern and Western Provinces and has plans to build an expressway network connecting the rest of the island. Capital expenditure on roads has been financed through foreign borrowing (over half of which is from the Chinese Government) and government resources; private financing is expected to be sought for construction of the Northern Expressway. The major issues facing the roads sector are deferring maintenance in a tight budget environment, contracting issues, and attracting private-sector financing. A 2013 report found in a sample of road rehabilitation contracts variations resulting in cost elevation from 38 percent to 53 percent and contract time extensions from the initial period up to completion from 7.5 percent to 180 percent (World Bank 2013). In addition, there are multiple cases of contracting without competitive selection, often owing to financing conditions from external lenders.

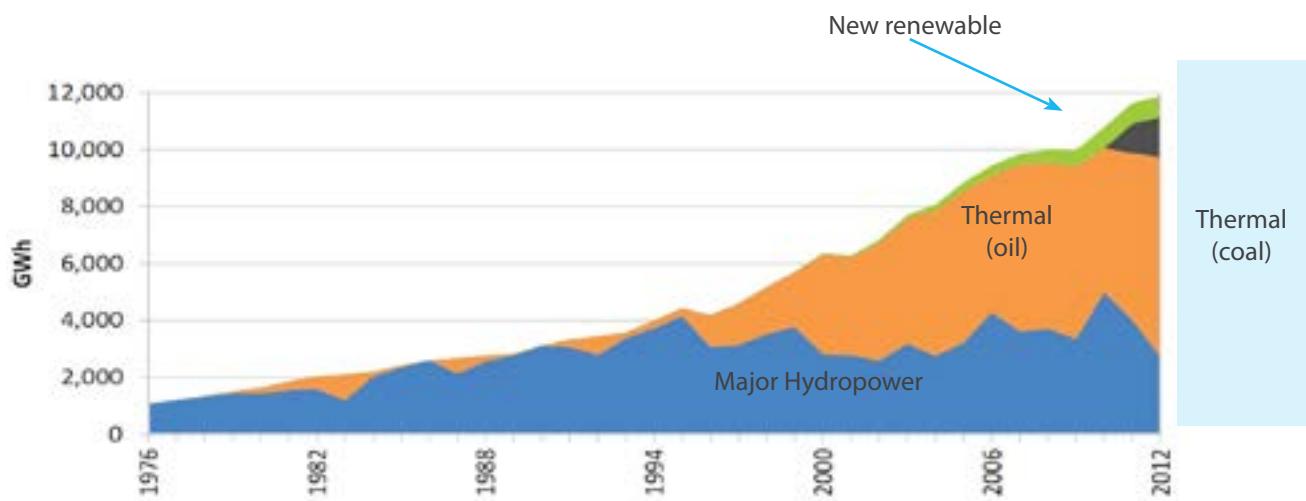
Figure A4 Assessment of overall infrastructure by firms



Note: Data based on an opinion survey of business executives. Scale ranges from 1 to 7, where 7 is the best

Source: World Economic Forum Global Competitiveness Index

Figure A5 Electricity generation of grid power plants, 1976-2012

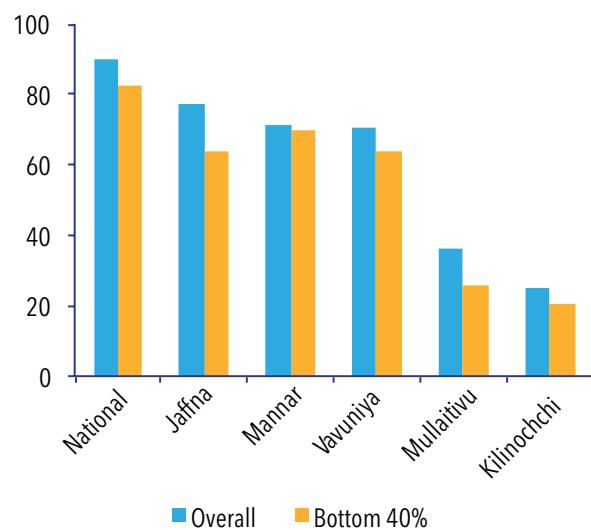


Source: Sri Lanka Sustainable Energy Authority

Port capacity has been increased substantially in the past five years. The expansion of the Colombo port increased capacity by 50 percent, including a recently completed new terminal under a build-operate-transfer arrangement and the construction of a deep draft port in Hambanthota. Colombo is currently the 27th busiest port in the world, handling about one-third as many containers as Dubai and one-sixth as many containers as Singapore in 2013 (Containerization International Yearbook 2013).

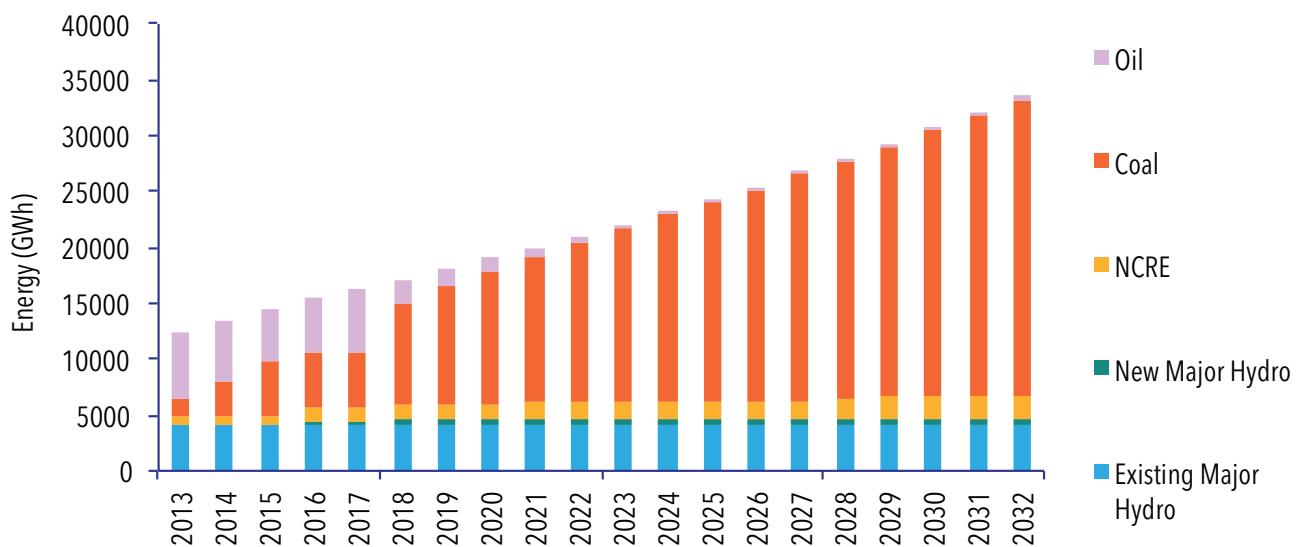
Sri Lanka has had rapid growth in telecommunications infrastructure, making it a leader in the South Asia in Internet use and broadband take-up. At the same time, Sri Lanka still lags behind many MIC competitors in use of ICT. Internet penetration stands at nearly 22 percent, the highest among large SAR countries, but lower than MIC competitors in Southeast Asia, such as Thailand or Vietnam. Similarly, mobile telephony penetration rate is 95.5 percent, which is higher than the rest of larger SAR countries, but lower than other MICs or the Asia Pacific region as a whole, which is 120.3 percent (Figure A8). Third-generation (3G) services as a percentage of the entire mobile market is 4.4 percent compared to 41.2 percent in the Asia Pacific region. The mobile telephony market has five major companies of which two are dominant. Competition has led to some of the lowest data and voice rates in the world. However, the dynamics in Sri Lanka's market are such that there is limited incentive for players to invest in increased broadband services in rural areas and new services, which in turn may delay the introduction of new, innovative services in the sector. Despite concerns regarding broadband quality and cost, IT-enabled services and the software industry have grown rapidly in recent years, now accounting for \$500 million in export receipts and around 70,000 employed. Despite this success, there remains a workforce deficit in the ICT industry.

Figure A6 Share of households with access to electricity



Source: Own estimates, HIES 2012/13.

Figure A7 Projected growth of electricity generation, 2013-2032



Source:Sri Lanka Sustainable Energy Authority

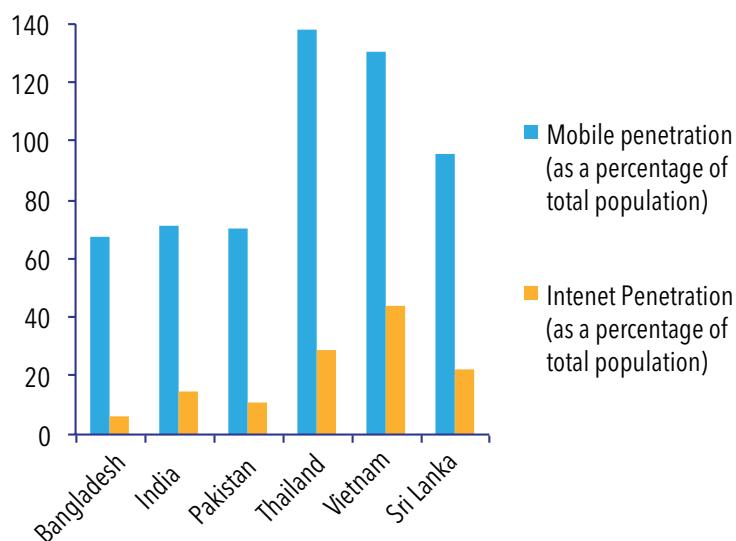
While sector liberalization has supported the expansion of mobile services across the country, there are areas where ICT policy and regulation could be strengthened.

These areas include enforcing stronger compliance to high-quality standards for voice services and data speeds, encouraging faster broadband roll out in rural areas, and regulating equal and open access to essential facilities such as submarine landing stations and backbone networks. Sri Lanka is also one of the few countries in the region that has not leveraged telecommunications infrastructure rollout by other utility providers such as the power transmission, railways and roads authorities. An infrastructure sharing policy would help expand broadband services across the country, lower costs of service provision and provide for domestic network redundancies.

Sri Lanka overall outperforms its South Asian comparators in providing for water and sanitation, but there is substantial differences within the country between urban, rural, and estate sectors.

As shown in Figure 26, Sri Lanka has slightly better indicators than South Asian peers and is comparable to LMICs in East Asia. Pipe borne water supply coverage stands at 44 percent (2013, National Water Supply Drainage Board (NWSDB)) nationally; of which 34 percent is managed by the NWSDB and the rest are mainly community managed Rural Water Supply (RWS) schemes or schemes managed by the local authorities. The technical capacity for the operation and maintenance of an estimated 40 percent of the over 4,000 RWS schemes in the country remains low, prompting the government to establish a new National Community Water Supply Department in the past year. Approximately 75 percent of the urban population has access to pipe borne water while around 20 percent of the rural population has such access. The quality of service is also lower for communities in small towns and rural areas, where continuous 24-hour supply is a rarity. The water and sanitation service levels in the plantations (estate sector) remain far below the national average, with only sporadic investments having been made in these areas over the past few decades. Yet overall access to safe drinking water, which includes protected wells, is high and reported to be 85 percent of the total population (NWSDB 2013) and 94 percent according to WHO/UNICEF Joint Monitoring Programme (JMP) figures of 2012 for water and sanitation released in 2014. Similarly, the NWSDB estimates that 85.7 percent of the population has access to adequate sanitation; with 83.2 percent having onsite sanitation and 2.5 percent a piped system. The 2012/13 HIES data point to lower levels of access to water (62.2 percent of all households and 55.2 percent of the bottom 40 percent) and sanitation (47 percent of the overall population and 36.2 percent of the bottom 40 percent having a toilet on premises), with much lower levels of access in the Northern districts of Kilinochchi, Mulaitivu, and Vavuniya. The discrepancy is due in large part to the HIES not accounting for protected wells and RWS as access to water.

Figure A8 Mobile telephony and internet penetration



Source: World Telecommunication/ICT Development Report, 2014

APPENDIX 2.2

OPPORTUNITIES AND OBSTACLES IN ACCESS TO FINANCE

Opportunities	Obstacles
Commercial banks have limited ability and to serve MSMEs.	<ul style="list-style-type: none"> ▪ Financial innovation among commercial banks (which dominate the financial sector in Sri Lanka) has been limited, with lending practices based on collateral and limited interest in development of other credit processes such as cash-flow-based lending and financial instruments beyond loans. Anecdotal evidence suggests that lack of competition (in spite of a large number of banks in the sector) has reduced incentives for innovation to target underserved economic segments. ▪ Despite the high penetration of regulated financial institutions in Sri Lanka, an estimated 64 percent of micro, small and medium enterprises (MSMEs) remain without checking or savings accounts (World Bank, 2014e), highlighting the need for both higher bank penetration, as well as opportunities for complementary non-bank financial institutions to target underserved market segments.
Credit infrastructure deficiencies limit the ability of lenders to identify creditworthy borrowers.	<ul style="list-style-type: none"> ▪ Credit bureau covers 44.5 percent of the population, and 30 percent of registered firms¹. However important sources of information on creditworthiness, such as payment history with microfinance institutions and utilities, are not included in the information. ▪ Movable collateral registries do not exist in Sri Lanka. This severely curtails the ability of firms and entrepreneurs to use non-real estate assets (eg. vehicles, machinery, inventory, accounts receivable) as security to their loans. This, together with the bank practices based on collateralization lead to major de-facto obstacles to borrowers, especially smaller ones, which account for 93 percent² of the enterprise sector.
Legal framework deficiencies enhance lenders' risk aversion, increase cost of credit and reduce availability of finance.	<ul style="list-style-type: none"> ▪ Banks experience significant difficulties in case of borrowers' default. Despite the existence of a separate Commercial Court, resolution of legal disputes takes on average 44 months, creates costs of more than 20 percent of the disputed value and requires more than 40 individual steps. Moreover, anecdotal evidence suggests significant discretion in the application of laws resulting in unpredictability of judiciary processes. These deficiencies enhance banks' risk aversion, which limits incentives to expand the borrower base, and fosters increasing collateralization requirements. The high cost of disputes resolution is passed on to borrowers as a higher cost of credit. ▪ The existing Secured Transactions law in the country does not support the operationalization of the collateral registry in an enforceable manner.
Limited development of financial instruments beyond traditional bank loans leaves important sectors and financial services needs underserved.	<ul style="list-style-type: none"> ▪ Factoring can enhance the ability of MSMEs to obtain financing for working capital by leveraging their otherwise idle accounts receivable. However, shortcomings in secured transactions framework hamper the viability of factoring as a financial product. ▪ Operational leasing of equipment (an alternative to longer-term bank loans) has been hampered by deficiencies in secured transactions (see above) and the lack of a well-functioning movable collateral registry. ▪ Microfinance Institutions (MFIs) can be an important source of financing for micro entrepreneurs, especially in rural areas. However, the lack of regulation and supervision of the MFI sector has led to a proliferation of lenders (estimated at more than 1,000) with anecdotal evidence of abuses on pricing and loan recovery practices. The lack of regulation of deposit-taking MFIs also creates significant risks for savers. ▪ Insurance is significantly underdeveloped for an economy with the income and aspirations of Sri Lanka, leaving enterprises and individuals vulnerable to unforeseen events. Less than less than 15 percent of SMEs and less than 1 percent of micro enterprises used any form of insurance. Personal insurance premiums account for 1.22 percent of GDP, well below the proportion in India, Malaysia and Thailand (4.10 percent, 4.92 percent and 4.07 percent, respectively).

<p>Lack of consumer protection, financial literacy, and business development services expose the population to significant risks.</p>	<ul style="list-style-type: none"> ■ Lack of a well-defined consumer protection framework (including appointment and empowerment of an agency in charge of its enforcement) leave users of financial services unprotected against unfair practices by lenders. ■ Lack of financial literacy initiatives and business development services, especially targeting micro entrepreneurs and low-income individuals in urban and rural areas enhance the risk of over-indebtedness.
<p>Lack of financial innovation around remittances restricts their potential mobilization for investment.</p>	<ul style="list-style-type: none"> ■ Remittances represented about 10 percent of GDP and 86 percent of reserves in 2014³. But Sri Lanka has not leveraged fully the potential of remittances due to factors including: <ul style="list-style-type: none"> - High cost of formal channels with an average fee for remittances of more than 10 percent of the principal. This discourages the use of formal channels in favor of informal mechanisms, thereby limiting the flow and permanency within the financial sector. - Use of innovative cross-border money-transfer technologies through mobile phone platforms has not been developed in Sri Lanka, while it has proved a way to enhance accessibility and affordability of formal remittance channels in other countries in the region - Financial Innovation leveraging remittances flows has not taken place in Sri Lanka, while in other countries this has led to investment instruments linked to remittances including housing and larger investments (diaspora bonds).

1 Doing Business 2015

2 Statistics Committee and IFC estimations.

3 Source: Central Bank of Sri Lanka.

MAP OF SRI LANKA



