Executive Summary

1. This report provides an integrated view of Sri Lanka's long term development challenges for sustainable growth and poverty reduction. The report, which draws on existing analytical work, is intended to have some durability and is designed to contribute to the national debate on these issues. Similar reports have been completed for India, Pakistan, Bangladesh, and Nepal.

I. Development Outcomes and Underlying Causes

Social and Economic Outcomes

2. Sri Lanka's substantial achievements in human development are well known. In several dimensions-such as universal primary enrollment, gender equality, infant and maternal mortality-the country is well positioned to meet the Millennium Development Goals (MDGs). In addition, housing conditions have substantially improved relative to the early 1980s, in particular with respect to housing materials and access to electricity, safe water and sanitation facilities. Despite improved overall access to basic services, however, large disparities remain in the access to and quality of most of these services.

Selected Millennium Development Goals	Sri Lanka's Position
Enroll all children in primary school by 2015	Net primary enrollment currently at 96 percent
Eliminating gender disparity in primary and secondary schools by 2015	Gender equality achieved at all levels of education
Reduce infant and child mortality rates by two thirds between 1990 and 2015	Between 1975 and 2001, infant mortality fell from 45 to 12 per 1,000 live births; child mortality fell from 100 to 17
Reduce maternal mortality rates by three quarters between 1990 and 2015	Maternal mortality (23 per 100,000 live births), on par with middle-income countries
Reduce poverty incidence by half between 1990 and 2015	Poverty fell from 26.1 % 1990-91 to 22.7% 2002

3. Of particular concern is the fact that poverty reduction has been slow while income inequality has risen in recent years. At 22.7 percent, the national poverty headcount ratio remains high for a country with US$ 900 per capita GDP.[1] Furthermore, the rate of decline in this ratio has been modest despite sustained per capita annual GDP growth of over 3 percent per year over the last two decades. Between 1990-91 and 2002 the national poverty headcount ratio fell by only 3 percentage points. This modest decline underlies sharply unequal poverty trends across sectors and regions. Poverty incidence in urban areas was halved while rural poverty ratios declined by less than 5 percentage points and poverty in the estate sector actually increased by 50 percent. Similarly, differences in poverty ratios across provinces have been pronounced: the poverty headcount ratio was 11 percent in the Western Province and around 35 percent in Sabaragamuwa and Uva.

1. Excludes North and East.

Poverty Trends 1990-91 to 2002 (%)

	1990-91	1995-96	2002
Urban	16.3	14.0	7.9
Rural	29.4	30.9	24.7
Estate	20.5	38.4	30.0
National	26.1	28.8	22.7

Source: Department of Census Statistics and Central Bank Annual Reports

Per Capita Growth by Economic Sector (%)

	1991-96	1996-02	1990-02
Agriculture	-0.0	0.4	0.2
Industry	5.7	3.0	4.1
Services	4.4	3.3	3.8
GDP	3.9	2.5	3.2

4. Sri Lanka's highly uneven poverty record over the period reflects several factors, including a stagnant agriculture and uneven development across regions (with a heavy bias in favor of Colombo and neighboring districts). Notably, agricultural value added barely increased in real per-capita terms while that in services and industry grew by over 3 percent annually. Moreover, the share of the Western province in nominal GDP increased from 40 to 48 percent between 1990 and 2002.

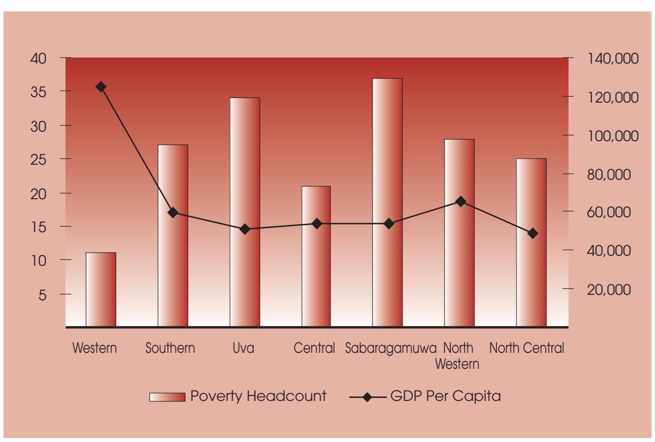
5. The disappointing trend in national poverty incidence also reflects a long-term growth performance significantly below the country's potential. Despite its early lead in social development, Sri Lanka has been left far behind by the high-performing East Asian countries like Korea, Malaysia, and Thailand. This can be largely attributed to: first, the pursuit (from the mid-50s to the mid-70s) of policies favoring widespread public sector controls over economic activity and resistance to international market forces, while the East Asian comparators pursued policies of liberalization; and second, the 20-year civil conflict which afflicted the country since 1983. The conflict retarded economic performance in two ways: (i) directly by reducing economic growth (by an estimate of 2-3 percent annually) and the average income per capita (by about 40 percent); and (ii) indirectly by diverting public resources and the attention of policy makers away from economic priorities and reforms.

6. The core theme of this report is thus the following: Sri Lanka must achieve a higher growth rate, but do so in a manner that poor people and the poor regions of the country can more fully participate in this growth.

Early Reforms and their Impact

7. Following inward-looking policies during the 1960s and part of the 1970s, Sri Lanka liberalized its trade and investment regime -including the establishment of Free Trade Zones (FTZs) - beginning with the 'first wave' of reforms in the late 1970s. These reforms unshackled the economy from stringent controls and wrought a transformation in the country's trade and industrial structure-from land-intensive, plantation exports to labor-intensive manufacturing.[2] The impact of the early reforms was amplified by a number of favorable

GDP Per Capita and Poverty Headcount, 2002



GDP Shares by Province

Province/ Year	1990	1996	2002
Western	40.2	43.7	48.1
N. Western	11.1	11.3	10.1
Central	12.1	10.0	9.4
Southern	9.5	9.0	9.7
Sabaragamuwa	8.1	9.0	6.9
Eastern	4.2	4.8	4.9
Uva	8.1	5.1	4.3
N. Central	4.8	4.6	3.9
Northern	4.4	2.4	2.6
National GDP	100.0	100.0	100.0

Sources: 1990-95 data from Dept. of National Planning

2. The transition to a more liberalized regime was painful for several import-substituting firms which were wiped out in the process, without appropriate safety nets.

external factors, including: (i) the massive foreign assistance in support of the reforms; which, in turn, boosted the confidence of foreign and domestic investors; (ii) the institution of the quota system under the Multi-Fiber Arrangement (MFA) by industrialized countries which helped Sri Lanka's fledgling garment export industry to take-off (and grow from nil to US$2 billion in two decades); and (iii) the upswing in world tourist trends which led to a doubling of tourist arrivals between 1978 and 1982.

8. Sri Lanka suffered a devastating blow in 1983 when the civil conflict broke out. It is remarkable, however, that despite a raging armed conflict, Sri Lanka continued to register economic growth rates of 4-5 percent per annum. This resilience is owed largely to the continuity of the liberalization reforms initiated in the late 1970s. It also shows the high potential of the economy if the risk of the conflict were eliminated and further reforms to liberalize the economy were to be implemented.

9. The success of liberalization policies over time won the support of the two main political parties -the United National Party (UNP) and the Sri Lanka Freedom Party (SLFP)-to a more open, outward-looking economy with a growing private sector. Thus, when the SLFP-led coalition replaced the UNP government in 1994, there was no significant change in the broad direction of economic policies. Indeed, privatization efforts were intensified during this period.

10. However, despite the increased role of the private sector, little progress was made in fundamentally redefining the role of the state, partly owing to Sri Lanka's strong attachment to a large public sector. The state continued to dominate important economic activities (public utilities, transport, and financial sector), it maintained significant controls on key agricultural commodity and factor markets (agricultural input subsidies, land, labor, and financial services) and remained, in some ways, the employer of first resort (absorbing about 14 percent of the labor force). At the same time, the budget continued to reflect a preference for public consumption (including subsidies) over much needed investment in economic infrastructure.

11. An important message of this report is that much of Sri Lanka's skewed growth record and ensuing increased income inequality, spanning through alternate governments, is a reflection of the unfinished reform agenda. More liberal trade and industrial policies spurred higher growth in industry and services, while pervasive controls and weak infrastructure stifled the dynamism of agriculture. A corollary of this uneven economic management also is that income growth has become heavily skewed in favor of Colombo and neighboring districts while poverty persists in rural areas where 90 percent of the poor live. The economy's development was also constrained by the severe war damage to the economy of the North East and the negative impact of conflict on foreign investment and tourism. Importantly, the conflict contributed to growing fiscal deficits and rising interest payments, declining public investment (and maintenance) in roads and power infrastructure, falling quality of education, and weakening of administration and governance as the state system diverted its resources and energies to coping with the ongoing civil conflict.

II. Cease-Fire and Unfinished Reforms

12. In 2001, the Sri Lankan economy was hit by a number of adverse shocks (escalation of the conflict, floods and droughts, a major attack on the international airport by the Liberation Tigers of Tamil Eelm (LTTE), and declining demand for Sri Lanka's exports following September 11). These factors, combined with the country's structural weaknesses, brought a sharp deterioration in the macroeconomic situation, including a 1.4 percent contraction in real GDP-the first since Independence in 1948. Against this backdrop a new government took over in December 2001. The cease fire agreement, which was swiftly negotiated in February 2002 and still holds today, paved the way for economic recovery and the rapid implementation of wide-ranging reforms encompassing fiscal consolidation, tax system, labor laws, land markets, banking, electric power, privatization, public sector reform and the welfare system. Many of these were second generation reforms that built on reforms initiated and developed under the preceding administration. Some of the early gains, mostly of a macroeconomic

nature, from implementing these reforms and the continuation of the cease fire include:

- Economic growth resumed with real GDP growth reaching 4 percent in 2002 and 5.9 percent in 2003. Growth in 2003 was broad based as the textile-led industrial sector recovered from the 2001 downturn, agriculture benefited from good weather, and economic activities in the North East resumed. Notably, tourist arrivals hit a historical record of half a million.
- The inflation rate fell from 14.2 percent in 2001 to 6.3 percent in 2003; nominal interest rates were halved; and private credit increased.
- Unemployment moderated from an average of 8.8 percent in 2002 to 8.1 percent in 2003, although it remained above the 7.9 percent recorded in 2001.[3]
- Foreign direct investment, which had slumped to US$ 82 million in 2001, rebounded to US$ 242 million in 2002, but having reached US$ 170 million in first half of 2003 closed the year at US$ 229 million, amidst increased political uncertainties.

13. While noteworthy and welcome, these gains remain fragile as the peace and reform agendas are still unfinished. On the peace front, while the cease fire is holding, negotiations have been stalled since April 2003. In the economic arena, initial gains in fiscal consolidation-which contributed to declining inflation and interest rates-have been eroded as a result of weak revenue performance and mounting fiscal pressures that began in the run-up to the April 2004 Parliamentary elections (including large subsidies on petroleum and fertilizer against rising world prices). Moreover, most of the structural reforms (much of them legislative) that were launched during the period have yet to be implemented. Against this backdrop, it is rather disquieting that aggregate investment continued to be at a level (22 percent of GDP in 2003) significantly below the levels seen in the late 1990s (27-28 percent). This happens at a time when export growth is showing signs of deceleration, raising concerns as to the durability of the sector as an engine of growth.

14. It is also noteworthy that the gains made over the period did little to impress important segments of the population, particularly the rural poor, and the last elections turned power over to the United People's Freedom Alliance (UPFA) - comprising the SLFP, the Janatha Vimuktti Peramuna (JVP), and other political parties. While the details of the new government's economic reform program are still being worked out, it is clear from their manifesto that there will be areas of continuity as well as of departure from previous regimes. Notably, the UPFA will rely on restructuring rather than privatization as a means of improving the performance of remaining strategic state-owned enterprises. The new government has also pledged to give greater emphasis to addressing regional inequalities and fostering rural development. The sections that follow address some of these difficult challenges and raise a number of key issues that would need to be considered in defining a more pro-poor growth strategy for Sri Lanka. It is noted from the outset that such a strategy must combine investment, i.e., in the transport and power sectors, as well as policy reforms to increase farmers' incentives and rural productivity.

III. Towards Faster and More Equitable Growth

15. Sri Lanka's recent poverty trends underscore the need for faster and more broad-based economic growth. This will be a challenge in light of the country's structural weaknesses, including: high fiscal deficits and public debt that constrain private sector development, limited export diversification (against the backdrop of the imminent abolition of the MFA from January 2005), continued stagnation of agriculture, serious infrastructure bottlenecks and declining quality of human capital due to falling quality of education.

16. Addressing the structural weaknesses will require containing the burgeoning fiscal deficits, diversifying the export base, realizing the growth potential of non-plantation agriculture, strengthening the road and power infrastructure and revamping the education sys-

3. Excluding the North East

Civil Service Staffing in Selected Countries (per 100 Population)

Country and Region	Central Gov 't. Employees	Non-Central Gov 't. Employees	Total Civilian Gov 't.*
South Asia Region			
India	0.4	0.4	1.2
Bangladesh	0.4		0.6
Pakistan	0.4	0.6	1.5
Sri Lanka	2.3	1.6	3.9
East Asia			
China	0.1	1.6	2.8
Indonesia	0.7	0.3	2.1
Korea	0.6	0.7	2.2
Malaysia	2.3	1.1	4.5
Asia Average	**0.9**	**0.7**	**2.6**

Source: *World Bank (1998), Research Working Paper "Government Employment and Pay: The Global Regional Evidence."*

* *Total Civilian Government includes employees from education and health sectors*

tem. To do all will require putting in place a more conducive public investment program and encouraging foreign and domestic investment. In addition, critical for both growth acceleration and poverty reduction will be the success in attaining a durable peace settlement. It will be also essential that in managing the economy, policy reversals be avoided and that gains from past reform efforts be sustained and further strengthened.

Managing Public Finances

17. A sustainable fiscal stance remains the cornerstone of any viable growth strategy. Despite progress in fiscal consolidation during 2002-03 and the 2002 enactment of the Fiscal Management Responsibility Act (FMRA), the fiscal situation remains under substantial stress. In 2003 the fiscal deficit still exceeded 8 percent of GDP and the public debt stood at over 105 percent of GDP, a long way from the FMRA targets for 2006 (of 5 and 85 percent of GDP, respectively). The extent of the problem is illustrated by the fact that interest payments, defense, and civilian wages account for almost all of tax revenues (13 percent of GDP in 2003)-which have been decreasing since 1990. Key priorities include:

18. ***Reducing public debt to manageable levels.*** Given the heavy public debt burden - absorbing over half of tax revenue - it is imperative to bring the public debt to manageable levels by at least eliminating the primary deficit and by limiting non-concessional borrowing

19. ***Reforming wage and recruitment policies.*** Sri Lanka has one of the largest bureaucracies in the region, with a ratio of 3.9 civil servants per 100 population. Although the size of the (civilian) wage bill is not unmanageable at present (around 3 percent of GDP), the trends are worrisome. Between 1990 and 2001, public sector employment grew at 3.6 percent annually, outpacing growth in population and labor force. While keeping the wage bill in check, strong political commitment will be needed to address well-known constraints to public service delivery. These include overstaffing (particularly at the lower grades); excessive salary compression (8:1) which limits the public sector's ability to attract skilled staff; administrative fragmentation, duplication, and wastage (partly exacerbated by the ineffective devolution of functions); and outdated processes and procedures.

20. ***Rationalizing public spending and linking it to the poverty reduction strategy.*** The scope for expenditure rationalization is significant, not least because of the need to address the duplication and overstaffing problems of the public administration. In addition, there is a serious imbalance in public spending, with the bulk of the budget being directed to fund recurrent costs (i.e., interest payments, wages, and subsidies) and very little to investment. The Ministry of Finance is developing a medium term budget framework (MTBF) which could potentially combine macro (i.e., attaining fiscal sustainability) and micro objectives (such as enhancing the development impact of public spending). Following the recent introduction of budget ceilings and of a three-year planning horizon, there is a need to strengthen the links between priorities, resources, and outputs/outcomes. This will require a more strategic and consultative budget formulation process and the identification of trade-offs within and across sectors. For instance, there is an urgent need to increase the effectiveness of Sri Lanka's *welfare system*, notably the Samurdhi program which while covering almost half of the population, misses a significant proportion of the poor.[4] Improving the targeting of existing welfare programs to better reach the poor, through objective eligibility criteria, and making transfers more progressive would go a long way toward improving the lives of the poor.

21. ***Improving the performance of state-owned enterprises (SOEs).*** The financial burden of SOEs[5] is high and service delivery is poor. Most are overstaffed,

4. Specifically, Samurdhi misses 40 percent of households in the two poorest quintiles, while almost 44 of its budget is spent on households from the top three quintiles.
5. Includes public institutions and corporations.

incur operating loses, and have large debts (mostly to the state-owned banks). Direct subsidies alone absorb 3 percent of GDP annually, which is above the entire education budget. A program of fiscal consolidation and improved service delivery requires that these companies be substantially restructured (through privatization or other methods), be allowed to operate on a commercial basis with no political interference, and be subject to a hard budget constraint. The success of current plans to restructure twelve strategic SOEs, under the oversight of the recently established Strategic Enterprise Management Agency (SEMA), hinges on improving their autonomy and accountability.

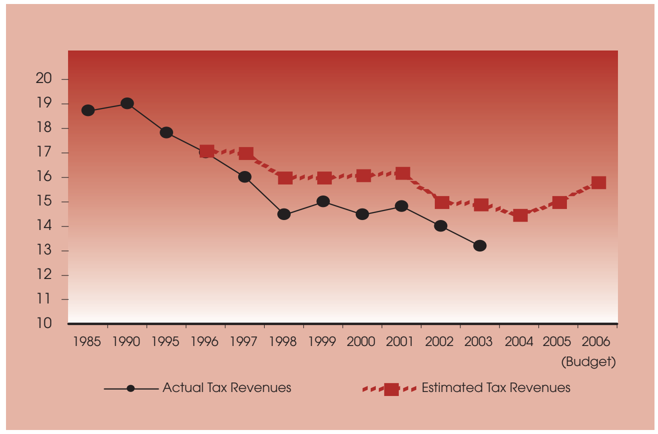
22. Efforts need to focus on reversing the decline in revenue by strengthening tax administration and expanding the tax base for major taxes (VAT and income tax). Greater realism in projecting future revenue and a more stable tax policy framework are also essential to support fiscal consolidation.

23. ***Tax policy for growth and fiscal consolidation.***[6] The challenge in designing tax policies to promote growth and fiscal consolidation is to reverse the massive decline in the tax-to-GDP ratio (from 19 percent in 1990 to 13 percent in 2003)[7] and to do so in a manner which is supportive of growth and efficiency. The challenge is daunting, given the sharp drop in trade taxes (from 6 to 2 percent of GDP since 1990); the stagnation of income taxes at around 2.5 percent of GDP, which is very weak by international standards; and the incomplete transition from a complex system of turnover taxes and special levies to a Value Added Tax (VAT) which has recently lost at least one percent of GDP (to 5.4 percent in 2003).[7] Increased revenue in the order of 2-3 percent of GDP may be achievable through:

- *Strengthening VAT.* While the 2004 unification of the two VAT rates into a single rate of 15 percent facilitated administration and reduced leakages, its immediate impact was revenue-reducing. (The introduction of a three-tier VAT system in the 2005 Budget will likely complicate revenue collection, but its overall impact is yet to be seen). Going forward, additional revenue will be possible if the VAT coverage is extended to retail trade and exemptions are reduced.

- *Raising the income tax yield.* Underlying reasons for low collection include: the provision of long term tax holidays for the rapidly growing Board of Investment (BOI) sector, a long history of investment allowances, concessionary rates, generous depreciation, and exclusion of most public sector employees from personal income tax. The scope for substantially raising the income tax yield is limited in the short term, but significant gains could be made if a moratorium on tax holidays were to be gradually phased in and existing exclusions and concessions are pared down.

Tax Revenues (As % of GDP)



Source: Central Bank of Sri Lanka and staff estimates.

- *Excise taxes.* On both revenue raising and equity grounds, there is a good case for expanding the coverage of excise taxation to a number of income-elastic, luxury consumer products (e.g., air conditioners, refrigerators, washing machines and televisions).

- *Improving tax administration.* For several reasons, including the coexistence of parallel systems (for customs and BOI firms), Sri Lanka's tax administration has limited experience in administering modern taxes (e.g., VAT and income tax) that require verification, audit and risk monitoring. A well integrated revenue administration, along the lines of the originally envisaged Revenue Authority, needs to be established as soon as possible. Complementary measures include the establishment of a separate tax audit unit and making the large tax payer unit more proactive.

Policies for Faster Export Growth

24. As noted earlier, liberal external sector policies (trade, foreign investment, and emigration) have underpinned Sri Lanka's export-led strategy and explain the resilience of the economy in the face of prolonged stress and occasional shocks. In particular, these policies have

6. As this report was being completed, the 2005 Budget was presented including a number of revenue measures which are not discussed here.
7. The VAT introduced in 2002 to replace the Goods & Services Tax (GST) and the National Security Levy consisted of two rates (10 and 20 percent).

contributed to bringing down the unemployment rate to single digits (from close to 20 percent in the 1970s). Notably, taking advantage of the opportunities opened by the MFA and a largely liberal trade regime, garment exports have become one of Sri Lanka's major industries, currently accounting for half of all exports and employing 5-6 percent of the labor force (mostly female) while providing indirect employment to about one million workers (15 percent of the labor force). Similarly, liberal emigration policies have contributed enormously to the generation of foreign exchange (about 10 percent of GDP) and of employment opportunities for about one million workers (also mostly female), helping to more than halve the female unemployment (from over 30 percent in the 1970s).

25. Although the medium term prospects for Sri Lanka's garment industry in the post-MFA era seem positive - as larger firms have been able to move up to higher value segments of the market - there could be significant disruptions among smaller exporters who account for about two-thirds of all exporters and around 35 percent of employment in the sector.[8] There is, therefore, an urgent need to strengthen Sri Lanka's ability to compete in a changing world environment, especially after the MFA ends (January 2005), by improving existing external sector policies and addressing remaining 'behind the border' constraints that undermine the competitiveness of Sri Lankan firms. Some key priority issues are discussed below:

26. ***Avoiding trade policy reversals.*** The pursuit of a competitive real exchange rate, which has been central to Sri Lanka's export-led strategy to date, will need to be continued. In addition, further efforts are needed to meet the medium term goal of a single low, uniform tariff. While the country has low average tariffs, modest effective rates of protection, and a declining incentive bias against exports, the tariff regime has become less tidy since 2001 due to a new tariff surcharge, reintroduction of specific duties for agricultural products, a new tariff band of minimum duty, some proliferation of ad-hoc duty exemptions, case-by-case duty adjustments and the introduction of preferential tariffs under several trade agreements. In the short run, significant progress towards a low, uniform tariff can be achieved by increasing the minimum rate to 5 percent, eliminating ad hoc exemptions and rates, and gradually reducing agricultural tariffs.

Key Features of the Sri Lankan Garment Industry

Strengths	Weaknesses
Good reputation for quality	High lead times
Reliability in delivery	Poor road and transport infrastructure
Low wages	Low labor productivity
High compliance with international labor norms	Highly restrictive labor laws
Duty free provision for import of yarn and fabrics	Limited local availability of raw materials
Prestigious customer base	Narrow export market, mostly US and EU
Close proximity to India for fabrics	Unreliable and high cost of power
Competitive local exchange rate	High cost financing especially for SMEs
Low clearance charges	Lengthy clearance times

27. ***Preferential trade liberalization.*** Sri Lanka has concluded the India Sri Lanka Free Trade Agreement (FTA) and has initiated FTA negotiations with the US and several other countries. While there are substantial economic and political benefits to be reaped from FTAs with India and the US, a proliferation of such bilateral agreements could distract from Sri Lanka's successful program of unilateral trade liberalization, incur sizable administrative and economic costs of complex rules of origin of multiple FTAs, and complicate the tariff structure. In the post-MFA era, an FTA with the US would help Sri Lankan garment exports to compete since half of US imports of these products occur under various preferential arrangements. These benefits would have to be balanced against the costs of possible requirements to free the capital account and to source inputs from the US. It is also important to note that preferential access to markets cannot substitute for needed improvements in labor productivity, lead time, and cost effectiveness.

28. ***Sustaining a liberal emigration policy.*** With workers remittances accounting for about 10 percent of GDP, Sri Lanka has reaped enormous benefits from following liberal labor emigration policies. Aside from its contribution in strengthening the external position, labor migration has played a key role in raising the incomes of the poor, as migrant workers (mainly female) come primarily from low-income families. These positive outcomes have been greatly helped by easy access to bank facilities and a market-responsive exchange rate policy, which need to continue.

29. ***Refocusing investment policy.*** A liberal investment regime has effectively complemented Sri Lanka's successful export-oriented policies, with foreign direct investment (FDI) driving the growth of the gar-

8. While smaller firms account for 5 percent of total export value, it is speculated that about 10 percent of jobs (or about 30,000) might be lost.

Regulations for Labor Redundancy for Selected Asian Countries

Country	Administrative Authorization Required	Statutory Redundancy Payment Per Year of Service
Sri Lanka	Yes, if over 15 employees	Not fixed, case by case
India	Yes, if over 100 employees. Not applicable to managerial and administrative employees.	15 days
Pakistan	Yes, if closing down or retrenching more than half of workers	20 days
Malaysia	No	10-20 days
Thailand	No	Approximately 30 days; capped at 180 days total
Vietnam	No	2 weeks

Source: World Bank (October 2004) Investment Climate Assessment.

ment sector and other labor-intensive activities. However, a major policy issue relates to the provision of generous direct tax incentives to companies operating under the BOI. In addition to having an adverse fiscal impact, these incentives are highly variable (across products, sectors and scale of investment) and subject to substantial discretion. Also, contrary to original plans, many firms have become perpetual beneficiaries of tax holidays. Despite these generous incentives, however, the overall level of foreign direct investment (FDI) to Sri Lanka has been modest (averaging less than one percent of GDP annually) by regional and international standards. Recent legislation to bring fiscal incentives into line with Inland Revenue laws and away from the BOI needs to be implemented. In addition, given fiscal considerations, some form of phasing in of a moratorium on direct tax incentives needs to be seriously considered.

30. In addition to the conflict, several *'behind the border'* constraints to investment may account for low FDI in Sri Lanka. Indeed, according to a recent investment climate assessment (ICA), top constraints include poor infrastructure *(electricity and transport), cost of and access to finance,* and *rigid labor regulations* (for urban firms).[9] There is therefore a need to refocus investment policy towards removing these constraints while reducing excessive reliance on overly generous tax incentives. In particular, to assist garment firms in adjusting to a more competitive environment in the post-MFA period, policies should encourage consolidation, facilitate restructuring of credit to small exporters, improve infrastructure and trade facilitation, and follow through with labor reforms that would facilitate enterprise restructuring.

	Average Annual GDP growth rate %		
	1982-90	1991-00	1998-02
Agriculture	2.8	1.6	0.4
Tea	2.9	3.4	2.5
Rubber	-1.2	4.3	-2.3
Coconut	-3.8	2.5	-3.2
Rice	-0.3	-0.7	0.6
Other	6.3	1.9	0.8

Source: Central Bank of Sri Lanka and staff estimates.

Reviving Non-Plantation Agriculture[10]

31. The slow growth of non-plantation agriculture is a primary factor explaining the persistence of poverty in Sri Lanka. The modest decline in rural poverty between 1990 and 2002, is consistent with a barely positive growth trend in per capita agricultural value added over the period. Heavy public sector interventions in agricultural commodity and input/factor markets-primarily geared toward the attainment of self-sufficiency in paddy production-have hampered growth in the sector. Although many of these interventions (e.g., subsidies, land, technology, trade, irrigation policies) have sought to protect the interest of paddy farmers, their unintended outcome has been to squeeze the returns from agricultural production, limit productivity and income-enhancing investments, hold back diversification to higher value activities, and "pushed" many into low-paying, casual non-agricultural wage labor.

32. More rapid agricultural productivity growth and rural development will require stronger commitment to removing existing policy and regulatory constraints which stand in the way of a more diversified production base. Some of the issues that the report discusses are:

33. ***Allowing full and transferable ownership rights to land.*** The transfer of state-owned land to small holder farmers through grants and permits, initiated in the 1930s, succeeded in promoting greater equity in land

9. See *"Sri Lanka: Improving the Rural and Urban Investment Climate"* (Draft October 2004, to be published), jointly prepared by the World Bank and the Asian Development Bank.
10. Issues related to plantation agriculture were beyond the scope of this report. However, in light of the poverty statistics for the plantation sector, a special study of the issues is being launched.

distribution and food security. However, restrictions on the transferability and use of these grants/permits have led to the (informal) fragmentation of land into non-economical 'miniature' holdings,[11] with adverse equity and efficiency implications. The conversion of grant/permits into title and the ensuing development of land markets, is essential to enhance farmers' ability to expand and consolidate land into economically viable holdings as well as to *access credit* (using land as a collateral) for much needed productivity-enhancing investments. Notably, lack of access to credit (which is linked to the lack of land collateral) is regarded as a top constraint for the development of rural firms. To address concerns that many farmers may become landless if land ownership is allowed, consideration might be given to developing appropriate safety nets and impact assessments.

34. ***Facilitating farmer access to improved technologies.*** Currently farmers are faced with restrictive seed and phyto-sanitary regulations and limited extension[12] and research services (which have primarily focused on paddy for the domestic market). Farmers' access to improved technologies could be facilitated by adopting more liberal seed and phyto-sanitary regulations, as envisaged under National Seed Policy and 1999 Plantation Act, as well as by expanding the scope of research and the supply of extension services through increased private sector participation, including of NGOs.

35. ***Phasing out trade distortions.*** High tariff protection is still given to selected commodities (i.e., rice, potatoes, chillies and onions) and tariffs are frequently changed to off-set domestic market fluctuations. These policies lead to price distortions and create considerable uncertainty for farmers, consumers and local firms, discouraging private investment (e.g., in storage). The correction of ensuing inefficiencies in the allocation of resources will require a more stable trade regime and a gradual reduction in tariff protection.

36. ***Ensuring the sustainable use of water.*** Substantial public resources have been invested in irrigation infrastructure (including the Mahaweli program launched in the early 1980s).[13] However, the sustainability of large past investments is threatened by the lack of maintenance, leading to the rapid deterioration of canal systems and costly rehabilitation requirements as well as poor quality of services. Also, the provision of free water has reduced the incentive for farmers to save and use water more efficiently. Building consensus on a national water policy, -which effectively addresses maintenance, rehabilitation, and water management issues to deal with growing competition for water- will be essential for the sustainable development and management of water resources. This will need to be supported by suitable legal and institutional arrangements.

37. The removal of policy and regulatory constraints will need to be accompanied by ***increased investments in basic rural infrastructure***. According to the rural ICA, *transport* constitutes the single most important constraint to rural firms, followed by *cost and access to credit and electricity*.[14] Given scarce public resources, public spending needs to focus on designing and promoting a regionally equitable strategy for rural infrastructure development; funding maintenance and rehabilitation that cannot be covered by communities (which are likely to yield higher returns than input subsidies, for example); and encouraging private sector participation and investments. The following section deals with some of these issues.

Infrastructure Priorities

38. For rapidly approaching middle income level countries like Sri Lanka, reliable infrastructure is paramount for further economic development, especially of export-oriented activities including manufacturing and tourism. These activities require reliable power supply at internationally competitive prices, adequate port and air facilities, world-class telecommunications capability, and a transport system that works in a seamless fashion. Although Sri Lanka has made progress in some of these areas, substantial challenges remain to bring them up to world standards and to reduce inequities in the access and quality of these services, particularly in the provision of roads and electricity. As mentioned earlier, transport and electricity represent a barrier to entry and a significant operational costs to both urban and rural firms.

39. **Roads.** Although Sri Lanka's road density (1.4km/km2) is relatively high by regional standards, only 10 percent is in good condition because of decades of

11. Over 40 percent of small holdings have less than one acre and over 60 percent below two acres.
12. According to the Sri Lanka Integrated Survey (SLIS),1999/2000, only about 13 percent of agricultural households reported receiving technical assistance from a government extension agent (15 percent from all sources).
13. Between 1980 and 1997, about Rs. 215 billion (constant 1996 rupees) in public funds were spent in irrigation.
14. See *"Sri Lanka: Improving the Rural and Urban Investment Climate"* (to be published).

neglecting maintenance. Funding is inadequate, with public spending in maintenance and rehabilitation covering only 10-15 percent of estimated requirements. In addition, few investments have been made over the past 40 years in upgrading trunk roads and constructing new highways to provide rapid access to urban centers. This situation results in high costs for road users, high unit cost for road provision, low road utilization and low road safety compared to other countries in the region. Moreover, there exist deep disparities in road density and road condition across provinces, with the Western Province showing the best indicators and conflict-affected provinces in the North and East showing the worst. To address these inadequacies, measures need to be taken to:

40. ***Increase the efficiency of road utilization.*** Given the huge maintenance backlog, funding for road maintenance and rehabilitation (estimated at US$ 870 million over the 2004-08 period) needs to be substantially increased, with a focus on improving the national highways which carry 70 percent of road traffic. In particular, a functioning Road Fund to cover maintenance expenditures should be in place, financed with petroleum taxes. There is also a need to strengthen the capacity of public sector agencies responsible for formulating and implementing transport policies.

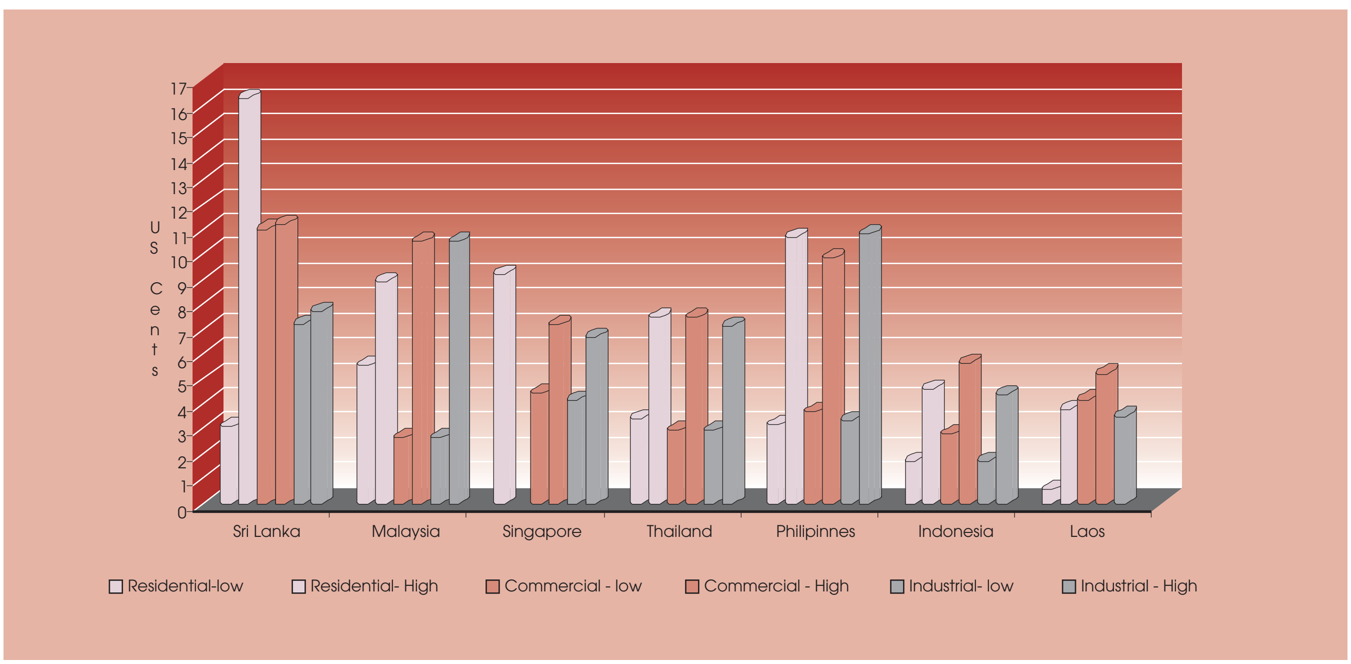
41. ***Improve the economic and financial sustainability of the road network.*** In addition to carrying out timely road maintenance, this could be achieved by increasing private sector participation in transport infrastructure and service provision; and making public sector agencies more market sensitive through restructuring pricing and financing systems.

42. ***Improve equity and environmental sustainability.*** Increased efforts are needed to integrate the needs of the poor in transport strategy and policy setting; increase participation of stakeholders (particularly the rural poor) in the planning and implementation of investments; and improve the management of congestion.

43. **Electricity.** While access to electricity has increased dramatically since the early 1980s (from 16 percent to 74 percent of households), generation capacity has not kept up with growing demand. Increased reliance on expensive emergency supply as well as large technical and financial losses by the state-owned public utility, the Ceylon Electricity Board (CEB) have led to relatively high cost of electricity in Sri Lanka relative to other Asian countries. Disparities in access across provinces have likely exacerbated poverty in underserved areas, especially in the North and East where electrification rates are the lowest. Efforts need to concentrate on:

44. ***Expanding capacity generation.*** Just keeping up with historical demand will require adding 200MW per year. Therefore, efforts need to focus on expanding

Comparison of Electricity Tariffs of ASEAN Countries



Source: ASEAN website.

generation capacity in accordance with an updated least-cost expansion plan that takes into account the full range of capacity options, including for private provision. In the long term, the independent transmission company should be allowed to procure new plants without political interference.

45. ***Raising the efficiency of electricity provision.*** This will require moving forward with the restructuring of the sector. Key measures include: the unbundling of CEB into independent companies operating on a commercial basis; the effective operation of the Public Utilities Commission of Sri Lanka (PUCSL) as an independent regulatory body; and phasing out cross subsidies to residential consumers.

46. ***Addressing inequities.*** Priorities to address inequalities in the provision of power include: providing off-grid connections to rural households (e.g., through more effective utilization of existing facilities under the IDA-supported Renewable Energy and Rural Economic Project); and granting direct subsidies in cases when rural electrification cannot be provided on a commercial basis.

Education for Growth and Equity

47. Sri Lanka has maintained high levels of educational attainment, although with severe disruption to the school systems in the conflict-affected areas. However, disappointing learning results point to weaknesses in the quality of education. Cognitive achievement tests among primary school children, for instance, show substantial shortfalls in mastery of basic language (especially of English) and numeracy skills.[15] Similarly, low passing rates for GCE O/L and A/L examinations, suggest poor education quality at the secondary level. In addition, there is evidence of inequities in the system as children in rural schools generally do worse than those in urban schools. Good education standards are critical for ensuring Sri Lanka's competitiveness in world markets as it enters the 21st century. The country faces the challenge of substantially enhancing the quality and equity of the education simultaneously with reducing large fiscal deficits. In this context, the following measures can be considered:

Proportion of Primary Children Mastering Language and Numeracy Skills, 2003

Skill	Sri Lanka	Urban Sector	Rural Sector
Sinhala or Tamil Language Skills	37	51	34
English Language Skills	10	23	7
Numeracy Skills	38	52	35

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

48. ***Increasing cost-effectiveness.*** Considerable savings could be generated by rationalizing schools, especially of small uneconomic schools; raising the student-teacher ratio (currently 21:1) at all levels of education; and rationalizing administration and staffing.

49. ***Increasing private sector participation.*** The volume of resources devoted to education and quality could be increased through private sector provision, particularly at the tertiary level which tends to benefit students from upper income families. Main recommendations include: developing a new education act and repealing the 1960s legislation which acts as a barrier for the establishment of private schools; and increasing the understanding among the public at large that public funding of tertiary education is regressive and costly, and that international trends are strongly in favor of private investment in tertiary education.

50. ***Shifting public resources within the sector.*** Public spending on tertiary education should be contained in favor of expanding allocations for primary and secondary education. Access by the poor to tertiary education could be secured through a voucher system. Over time, the balance of recurrent and capital spending needs to shift toward capital investments, and within investments toward technology and science equipment rather than construction of buildings.

51. ***Decentralizing education management.*** International experience shows that the quality of service delivery could be greatly enhanced by decentralizing education management to schools. This principle could also be applied to other education institutions such as the National Colleges of Education and Teachers' Centers.

52. ***Increasing the economic relevance of the education system.*** To improve the linkage of education to the world of work, several initiatives have been adopted, including increasing the use of technology, especially information technology (IT), and allowing the use of English as a medium of instruction. These measures could be strengthen by reallocating resources toward technology and equipment and permitting schools to offer English medium education from grade 1 onwards.

15. The elimination of English as a medium of instruction in the 1950s until 2001 accounts for poor learning outcomes in the English language.

IV. Peace, Conflict and Development

53. The cease fire since February 2002 has already brought substantial gains to the Sri Lankan economy. Growth has rebounded, inflation and unemployment have declined, and foreign investment and tourism have recovered. Defense expenditure has fallen, reducing the pressure on public finances. There has been significant recovery in the conflict-depressed economy of the North East and some reintegration with the rest of the Sri Lankan economy. Thousands of war displaced refugees have returned to their old homes. Much demining of land has occurred. Above all, the absence of a shooting war has become the accepted norm. Put another way, the interests vested in peace have grown.

54. Although these gains are real, they have been constrained by the absence of durable peace of the kind entailed in a formal peace accord. Uncertainty still weighs heavy on both domestic and foreign investors. More generally, international experience suggests that ending a long drawn-out civil conflict is a necessary but not sufficient condition for realizing the full peace dividend. Typically, private investment and fiscal revenue are slow to recover and security expenditures cannot be reduced quickly for a variety of reasons. While it takes time and resources to restore damaged or neglected economic infrastructure, the damage to institutional infrastructure is even harder to overcome. The transition to peace poses fresh problems and challenges that have to be managed.

55. However significant these challenges and costs may be for managing the transition to peace, they are obviously to be preferred over any resumption of conflict. Sri Lanka's twenty year history of civil war bears eloquent testimony to the direct social and economic costs of conflict and the possibly even more substantial (though less tangible) indirect costs of missed opportunities and distracted policies. Furthermore, there is little chance that Sri Lanka could sustain the 5 percent growth of the 1990s if there is a resumption of conflict. In contrast to the early 1990s, the fiscal situation today is much more fragile, infrastructure is suffering from decades of neglect, agriculture is in the doldrums, trade and industry face novel external challenges and external assistance has dwindled (and will not increase if conflict flares up).

56. In brief, for Sri Lanka's economy to achieve sustained growth at 6 percent plus (let alone the 8 to 10 percent aspirations sometimes voiced), durable peace is a prerequisite. Key economic reforms will be also needed to resume the path of rapid development since peace is a necessary but not a sufficient condition. The country's economic history supports this assessment: the only five year period when economic growth averaged above 6 percent was in 1977-82, when economic reforms held center stage in policy-making and the civil war had not yet begun.

V. Development Risks

57. Sri Lanka is at a cross-roads in its development path. As noted above, any resumption of the conflict poses a major risk to the country's development prospects, especially in a world which since 9/11 is much more sensitive to conflict and terrorism.

58. Being a small open economy, Sri Lanka is also vulnerable to external shocks. The best insurance against unforeseen external events and trends lies in building a more diversified export base, a flexible economic structure (with easy conditions for entry and exit), and sound investment in education and skills. The policy reforms suggested in this report should help Sri Lanka strengthen its economic flexibility.

59. Finally, a lingering risk to sustained economic and social development is the country's legacy of civil strife and complex politics. It is very clear that economic reforms in Sri Lanka (like everywhere else) are deeply political. The challenge lies in building the requisite support in favor of reforms which can weather the instability caused by short election cycles. Sri Lanka's own experience clearly shows that market-friendly policies have succeeded in bringing substantial economic growth and poverty reduction in urban areas, while heavy state intervention in agriculture has stifled the rural economy with seriously adverse implications for the poor. Therefore, there is enough evidence in Sri Lanka to show that there no trade-off between market-driven growth and poverty reduction. However, a well functioning market economy is usually associated with a well functioning public sector. Indeed, the state has a very important role to play on several fronts: in establishing an appropriate regulatory framework; addressing market failures; providing public goods and services; and, protecting the poor.