

II. The Business Environment

Creating a good business environment

The business environment is crucial for innovation and entrepreneurial development. It determines whether there are strong incentives for individuals to identify market opportunities and create wealth, jobs and economic growth. An enabling environment that makes it easy for individuals to start up businesses, run them, sell them and fold them if they are not successful is one that fosters national economic growth. There are numerous indices that can benchmark Sri Lanka's standing in this area. The Economist Intelligence Unit (EIU) Global Outlook Report ranks Sri Lanka at 62 out of 82 countries surveyed. Institutional Investor indicates that Sri Lanka's country credit rating as dropped from 89th in 2006 to 100th in 2007 out of 174 countries covered. The World Bank's doing business indicators similarly rank the island at 101 out of 178 economies covered. This puts Sri Lanka behind the Maldives (60) and Pakistan (76) but ahead of other South Asian countries, most notably India at 120.

It is clear that Sri Lanka needs to improve its business environment – the question for policy makers is, “where to start on this challenging agenda?” Sri Lanka's three most problematic factors for doing business are policy instability, access to finance and the inadequate supply of infrastructure according to the World Economic Forum's Global Competitiveness Report for 2006/7. This view is supported by the World Bank's earlier work on the investment climate in 2005 which highlighted electricity, policy uncertainty and access to finance as the key issues confronting formal sector businesses in Sri Lanka. The World Bank's doing business indicators highlight reform issues around the following themes which are discussed below:

- Starting a business
- Dealing with licenses
- Hiring and firing workers
- Registering property
- Getting credit
- Protecting investors
- Paying taxes
- Trading across borders
- Enforcing a contract and
- Closing a business

Starting a business

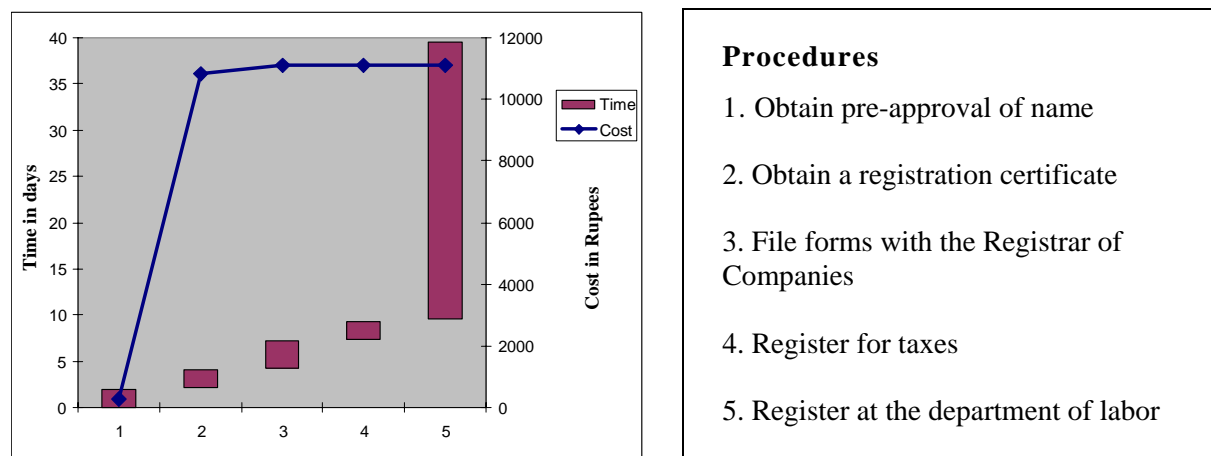
Sri Lanka ranks 29th in terms of ease of starting a new business, up significantly from last year's position 47th. It now takes just 39 days to open a business, (down from 50 days in 2007). Three-quarters of the time taken to start a new business is spent registering at the department of labor.

Although there is no minimum capital required, a new start-up still needs to go through five separate procedures (down from eight in 2007) which costs approximately US\$100. Meanwhile, the South Asian time taken to start a new business has been coming down consistently from 35 days in 2006 to 32.5 days in 2007 and now to 30 days. Sri Lanka needs to continue this reform process simply to remain competitive in Asia.

What to reform

Sri Lanka has made great strides this year in further simplifying business start-up procedures by introducing standardized memoranda and articles of association. This has removed the need for pre-approval and notarization of the documents, as well as the company seal thereby cutting 3 procedures from the process. Nevertheless, Sri Lanka can encourage more entrepreneurs to register their businesses formally by simplifying the start-up process even further. The final procedure—registering at the Department of Labor—takes 75 percent of the total start-up time (Figure 7). These delays could be reduced or even eliminated entirely if the registrar of companies was computerized and connected to the Department of Labor. Similarly, the registrar of companies could also act as a “single window” for tax registration.

Figure 7 Starting a business in Sri Lanka (time in days and cost in Rupees)



Source: Doing Business Database 2008.

Dealing with Licenses

Sri Lanka ranks 160th in the world in terms of dealing with licenses, down from 156th last year. The number of procedures has not changed at 22 neither has the duration (214 days) or the cost. Obtaining the building permit alone takes 75 days on average and accounts for almost one-third of the cost. This makes Sri Lanka the worst performer in the South Asia region and among the worst in the world in dealing with licenses.

What to reform

Reforms should focus on speeding the issuance of building permits and the procedures to ensure conformity, as these are the biggest bottlenecks. Reducing the time to process documents for the permit and the certificate of conformity is a start. Cutting costs is the next step. In Colombo, obtaining the building permit costs more than US\$450. Many other countries charge no fee to issue such a permit. Finally, reforms can target the cost of connecting to utilities. It costs more than US\$600 to connect to electricity and \$220 to get a telephone line in Colombo. Builders should be permitted to install the basic connection themselves if they choose to.

Hiring and firing workers

Sri Lanka ranks 111 in terms of employing workers, up one from 112 in 2007. Employing workers in Sri Lanka remains straight forward but it is the difficulty of firing workers that remains problematic. Recent changes in the legislation governing overtime have provides Sri Lanka with a more flexible and

accommodative environment when it comes to rigidity of hours. Although in large part the change in legislation simply mirrored existing practices and therefore is not likely to have a significant impact in the real economy.

Table 1 : Difficulty to fire workers in Sri Lanka

Cost to dismiss a redundant worker (weeks of wages)			
Lowest		Highest	
New Zealand	0	Mozambique	143
United States	0	Ghana	178
Marshall Islands	0	Zambia	178
Micronesia	0	Sri Lanka	178
Puerto Rico	0	Egypt	186
Palau	0	Sierra Leone	329
Tonga	0	Zimbabwe	446

Source: Doing Business database 2007.

Although it is easy to hire it is almost impossible to fire. Sri Lanka remains at the bottom of the global tables in terms of difficulty of firing workers. In 2007, only three countries in the world paid more than the Sri Lankan mandated severance payment of 178 weeks of wages.

On top of the difficulty of firing, Sri Lanka’s broader labor regulations are extremely complex and rigid. The country has more than 48 labor laws, many of which date to the 1970s—a period in which Sri Lanka had a closed and statist economy. Labor regulations mandate more holidays and leave

than almost any other country in the world. National holidays include every full moon and eight other festivals. Workers also receive 21 days annual leave and 21 days sick leave, which are often taken as an entitlement rather than a fall back.

What to reform

Reforming labor law is perhaps the most important initiative that any government can take to encourage firms to provide more formal sector jobs. The Sri Lankan economy is characterized by repeated shocks including natural disasters and civil conflict and is highly vulnerable to exogenous factors such as the price of oil and terms of trade for commodity exports. As such businesses in Sri Lanka need to respond regularly and swiftly to changes in market conditions. Not being able to take on and shed excess labor easily in such a situation leads to several unforeseen outcomes. Firstly, firms are tempted to recruit more staff on a contract basis implying reduced training and productivity levels. Secondly, employers are driven to pay a lower equilibrium wage-rate than would otherwise prevail. Thirdly, in a down-turn some employers that are hit especially hard and do not have the option of reducing staffing levels are forced to declare bankruptcy thereby letting the entire workforce go.

But perhaps the two most significant impacts are the high level of informality that this creates with more than 85% of jobs in Sri Lanka remaining in the informal sector and the low level of job creation in the country. Resilient growth in recent years has not been matched by a growth in employment or wage rates and more and more young workers are forced to seek opportunities overseas mostly in menial jobs in the Middle East.

Sri Lanka must reverse this trend immediately by reforming the Termination of Workers Act of 1971. Mandated severance payments should be reduced in line with international best practice. The discretion of the Commissioner of Labor should not be required in every separation. These are all stroke-of-the-pen reforms that can be accomplished quickly if government has the political will to do so.

Registering Property

Sri Lanka ranks 134th in terms of the cost of registering property. Registering a property requires 8 different procedures and takes 83 days – while the registration itself costs around 5% of the property

value. Government stamp duties account for 80% of the cost. No reforms to property registration have taken place for several years.

What to reform

The government can encourage formal registration of properties by reducing the 4% stamp duty. Typically reductions in fees lead to more revenues, as more properties are registered and there is less underreporting of property values. In Pakistan the transfer fee is only 2%; in Bhutan, 1%. Procedures can also be simplified by cutting documentation. Currently a business spends at least a third of the time to register just obtaining documents from the municipality. Beyond this, the government can focus on increasing the security of property rights by improving the way that the registry functions. Potential areas of reform include automating the land registry to improve processing time and the accuracy of records.

Getting credit

Access to credit is consistently rated by small and medium Sri Lankan firms as one of the greatest barriers to doing business. Here again Sri Lanka has slipped from 80th to 97th over the past year in the global rankings.

However, Sri Lanka's credit information bureau, a public-private partnership between the Central Bank of Sri Lanka and several commercial banks has started to deepen credit information in the country increasing its percentage coverage from 2.2% of all adults to 3.1% in the past year.

What to reform

Access to credit can be expanded by reforming secured transactions and bankruptcy laws to provide lenders with clear priority to the proceeds from collateral. Improving the quality of credit information is also a priority. Banks currently submit credit information on paper, which is later electronically entered, a process which allows for errors. The credit bureau should require data to be submitted electronically. Moreover, 40% of the bureau's records are missing unique national identification numbers, which makes it difficult for lenders to use the information and also allows for individuals to be attributed with the wrong information. Since banks are required to see an identification or passport number to issue a loan, banks should be required to include this information in bureau records.

The CRIB Board has approved legal amendments in order to; (i) collect data from various new sources (utility providers, retailers, insurers, public domains etc. (ii) extend CRIB services to such data providers, (iii) provide other services such as credit scoring and fraud prevention, (iv) dispute settlement and consumer protection, and (v) purchase the latest ICT and consolidation with software providers. These amendments need to be fully implemented.

Protecting investors

Sri Lanka ranks 64th in terms of protecting investors which places it towards the lower end of South Asian countries, behind India, Bangladesh and Pakistan. Only Bhutan and Afghanistan are lower. In comparisons outside the region, Sri Lanka is behind Indonesia, Thailand and Malaysia. Sri Lanka scores lowest in the disclosure measurements, receiving only 4 out of 10 points on the extent of disclosure index. There are no requirements to immediately disclose transactions with conflicts of interest to shareholders or the general public, nor are inside dealings required to be reviewed by an outside body. Scores are only modestly better on the director liability index, showing that investors have few powers to hold a director liable for misconduct towards the company. The highest score (7 out of 10) for Sri Lanka comes on the ease of shareholder suit—reflecting relative ease with which an investor can take his case through court.

What to reform

Sri Lanka can improve its investor protections by providing greater transparency for company operations. This will encourage investors to take equity stakes in more companies, and will lower the premium on holding a controlling share. The first step toward this could be imposing an immediate disclosure requirement for large, related-party transactions (between a company and individual members of its management). Mandating external audits on suspicious transactions can also reduce improper activities within a company.

It is encouraging that the Sri Lankan authorities are considering undertaking a ROSC report on Corporate Governance. The objective of the ROSC module is to capture the formal and informal dimension of corporate governance; both will determine how corporate governance works in practice. The assessment focuses on shareholder rights, equitable treatment of shareholders, role of stakeholders, disclosure and transparency, and duties of the board of companies. Completing such a study and publishing its results in an open and transparent manner as well as implementing those results will go a long way to improving investor protections.

Paying Taxes

Sri Lanka ranks 158 in the world, and well below the South Asian average in terms of the ease of paying taxes. Investors have to contend with 62 different taxes and spend an average of 256 days to complete the average tax return. But perhaps the biggest sting is the cumulative effective tax rate which at 64% is exceeded by only a dozen countries worldwide. The result is significant tax evasion and avoidance.

In recent years the tax situation has deteriorated considerably. The corporate tax code is now much more burdensome than last year when it took only 42 separate payments and close to 50% of gross profits payable in tax. Additional measures introduced recently include a Social Responsibility Levy at 0.25% of profits and a stamp duty reintroduced in April 2006. Deductible expenses for advertising were reduced to 50% deductible during the past year. Unfortunately the current situation is set to worsen following a recent budget passed in November 2006 which further complicates the tax code and introduces a number of new taxes and reduced exemptions.

What to reform

Several countries have shown that low corporate tax rates can attract potential investors. Two decades ago, Ireland realized that by having a lower corporate tax rate it could position itself as a gateway to Europe. Sri Lanka has a similar opportunity to position itself as a gateway to Asia and re-establish its historical role as a regional entrepot. This would require a considerable streamlining of the Sri Lankan tax code. The number of payments can be reduced by consolidating taxes and eliminating minor ones that significantly increase hassle but not revenues. To be competitive in today's environment the total tax rate payable should be significantly below current rate.

Despite consistent increases in tax rates the total revenue to GDP ratio has dropped from around 22% to as low as 14% in 2005. This is clearly an indication of increased tax avoidance. Larger companies have found ways to avoid paying Sri Lanka's high taxes by establishing themselves in one of the island's numerous export processing zones, run by the Board of Investment, which offers generous tax holidays and concessions - 75% of manufacturing now takes place in the zones. This practice reduces revenues and it creates a non-level playing field between large domestic and international investors in the zones and smaller domestic entrepreneurs that are struggling with government's bureaucratic and punitive tax regime. It also creates numerous opportunities for rent-seeking behavior by domestic and international companies vying for Board of Investment (BOI) status.

Trading Across Borders

A recent investment climate study conducted jointly by the World Bank and the Asian Development Bank demonstrated that Sri Lanka's ports were more efficient than many of its South Asian neighbours. This competitive advantage is being built on as the island made considerable improvements in this area during 2007 climbing from 94th to 60th place in the global rankings. The number of days required to import goods has dropped from 27 to 21, and the number of documents required has been halved to 6. Exporting is in a similar situation requiring 21 days and 8 documents.

Sri Lanka remains at the top of the South Asian league with only the Maldives ahead in terms of port competitiveness. However as a small island economy dependent on a thriving export sector, it is important that Sri Lanka continues to improve its trade performance to world class levels. Singapore takes only 6 days for imports and 3 days for exports and its container shipments to the United States cost less than half those from Sri Lanka.

What to reform

In improving port efficiency, Sri Lanka need look no further than Colombo for inspiration. The privately built and operated South Asia Gateway Terminal (SAGT) has operated alongside the publicly owned Jaya

Table 2 : Trading Across Borders in Sri Lanka

Rank	60
Documents to export (number)	8
Time to export (days)	21
Cost to export	810
Documents to import	6
Time to import (days)	21
Cost to import (US\$ per container)	844

Source: Doing Business Database 2008

Container Terminal of the Sri Lanka Port Authority for some years now. The private sector terminal has spurred increased competition and efficiency within the public sector, although the publicly run terminals remain behind their private sector counterparts in all metrics. Most importantly labor relations continue to plague the public sector operations. A high profile strike at the Jaya Container Terminal in 2006 threatened to seriously damage Sri Lanka's key export sectors. The privately run SAGT came to the rescue operating round the clock to ensure that as many shipments as possible went out on time.

Sri Lanka can boost trade and reduce corruption in customs by cutting red tape in the import and export process. More efficient customs and ports are especially important for the garments sector, which depends heavily on imported textiles. There is much scope to improve. Port tariffs remain high, resulting in burdensome shipping costs. Moves per hour could also be significantly increased. One potential reform is to adopt the landlord port model to sharpen the distinction between the management of the port and the operations of the terminals and thereby introduce private sector management without a transfer of assets to the private sector. Another area to improve is customs administration, which remains outdated. Large gains can be made with simple reforms, such as standardizing paperwork and eliminating unnecessary documentation requirements.

Enforcing contracts

Sri Lanka ranks 133rd in terms of the ease of enforcing a contract. It takes 1,318 days and 40 procedures to enforce a contract. Although this is a long time compared to the OECD average which is less than 1 year, in South Asian terms, Sri Lanka is at the mid-point. South Asia is the worst region in the world on

this score. Such a system has two perverse effects on the way business is conducted. Since it will take years to enforce a contract, many businesses will prefer not to resort to the courts even for the simplest matters. On the other hand, some businesses knowing that this is the case are often tempted to bring frivolous court cases against their competitors knowing that although they cannot win they can often effectively tie up their competition for years in acrimonious disputes which will have the desired effect. Such practices result in the formation of large conglomerates that would prefer to internalize such risks by extreme vertical integration thereby forgoing the potential benefits of specialization and contracting out business functions. Lengthy delays in court procedures also throw open the opportunity for rent seeking behaviour amongst the South Asian judiciary.

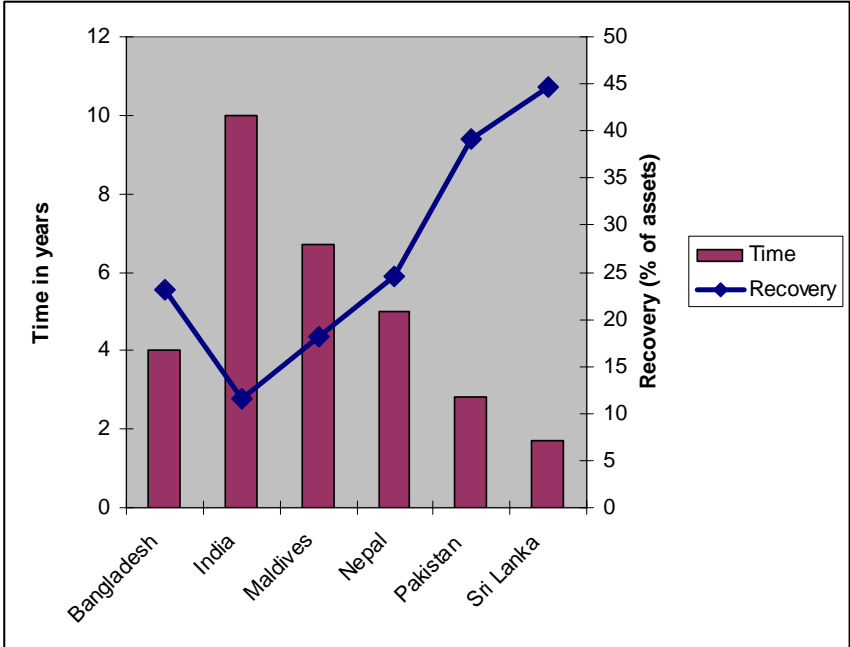
What to reform

Lengthy procedures and limited capacity of the judiciary in commercial law matters are the biggest obstacles to faster contract enforcement in Sri Lanka. The government can start by reforming the appeals process. In Sri Lanka, appeals on procedural matters are allowed at any point during the trial, there is a comprehensive review upon appeal, and once an appeal is made, enforcement is suspended until it is resolved. Not surprisingly, debtors use appeals as a delay tactic. Sri Lanka can follow other reformers—most recently Brazil in 2005—by cutting opportunities for frivolous appeals and allowing cases to continue upon appeal. As a next step, establishing specialized commercial sections of the court or training judges to specialize in commercial matters could also cut delays and cost.

Closing a business

When a firm becomes insolvent in Sri Lanka, the average creditor receives around 45 cents on the dollar, after a process that usually takes 1.7 years on average. This places Sri Lanka in 39th place globally and far ahead of South Asian rivals that take on average 3.6 years and recover only 19.5 cents on the dollar. India in particular exhibits the most inefficient bankruptcy practices in the world taking over 10 years to recover just 12 cents on the dollar. Figure 8 highlights Sri Lanka’s good practice in South Asia with the shortest times to go through bankruptcy as well as the highest recovery rates.

Figure 8 : Sri Lanka leads South Asia in closing a business



What to reform

Terminating employees' contracts is the biggest obstacle, both in terms of time and cost, to winding up a company in Sri Lanka. The government can significantly cut delays in bankruptcy by amending the Termination of Employment Act to speed up the dismissal process and to reduce the severance package that has to be offered at the termination. Reforms to cut opportunities for frivolous appeals as well as provide incentives for bankruptcy administrators to maximize the value of the estate will also increase recovery rates in bankruptcy—and expand access to finance as a result.

Policy Recommendations

Sri Lanka's standings in the global rankings on ease of doing business have been slipping every year since the index was created. It is time that government moved quickly to remove the shackles from private sector activities. This year Sri Lanka has made it easier to start a business and to trade across borders. Both initiatives are important and more needs to be done to ensure that individuals will take advantage of these opportunities.

In particular, government needs to improve labor market flexibility and reduce the difficulties associated with down-sizing labor. Government can reduce the effective tax rate for businesses and streamline the system and process of payments to broaden the tax base and raise additional revenue whilst also providing increased incentives for private sector participation in the economy. Finally government can make it easier to register property to allow developers to take control of urban and rural spaces and develop them commercially.