

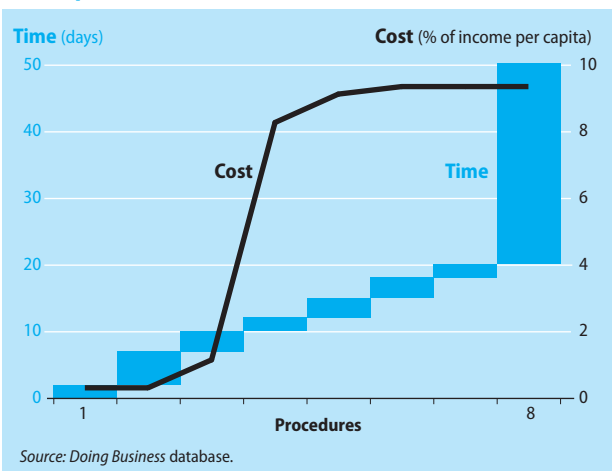
Sri Lanka ranks 89th on the ease of doing business, the same as last year. This places Sri Lanka 4th in the South Asia region behind Maldives at 53rd, Pakistan at 74th and Bangladesh at 88th.

**Starting a business**

Sri Lanka ranks 44th in terms of ease of starting a new business, down slightly from last year’s position of 39th. In absolute terms it remains just as easy, or difficult, as it was last year to open a new business in Sri Lanka, but during the past year other countries have improved.

Although there is no minimum capital required, a new start-up still needs to go through 8 separate procedures which takes 50 days and costs approximately \$100. Meanwhile, other countries in South Asia have continued to reduce the number of days to start a new business from 35 days on average last year to 32.5 days this year.

FIGURE 2.19  
**Start-up time and cost in Sri Lanka**



**What to reform**

Sri Lanka can encourage more entrepreneurs to register their businesses formally by simplifying the start-up process. The final procedure—registering at the Department of Labor— takes 60% of the total start-up time (figure 2.19). These delays could be reduced or even eliminated entirely if the registrar of companies were computerized and connected to the Department of Labor. Similarly, the registrar of companies could also act as a “single window” for tax registration. Start-up could be further simplified by introducing standardized memoranda and articles of association. With these, there would be no need for pre-approval and notarization of the documents, cutting 2 procedures from the process.

**Dealing with licenses**

Sri Lanka ranks 71st in the world in terms of dealing with licenses, up from 77th last year. Despite a reduction in the number of procedures from 18 to 17, the process remains cumbersome, lengthy (167 days) and costly (151% of income per capita). In South Asia, only Bhutan and India have more procedures. Obtaining the building permit alone takes 75 days on average and accounts for almost one-third of the cost.

**What to reform**

Reforms should focus on speeding the procedures to issue building permits and 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 \$400. Many other countries charge no fees to issue a building

permit. Finally, reforms can target the cost of connecting to utilities. It costs more than \$550 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.

## Employing workers

Sri Lanka ranks 98th in terms of employing workers, unchanged from last year. Employing workers in Sri Lanka remains straight forward with the difficulty of hiring index at zero. Recent changes in the legislation governing overtime also provide Sri Lanka with a flexible and accommodative environment when it comes to rigidity of hours.

Although it is easy to hire it is almost impossible to fire a worker. Sri Lanka remains at the bottom of the rankings in terms of difficulty of firing workers. The cost of firing is higher in only three countries compared to Sri Lanka, where it costs 178 weeks of wages (table 2.8).

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 fallback.

## What to reform

Reforming labor law is an urgent priority. 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 trading terms for commodity exports. As such businesses in Sri Lanka need to respond regularly and swiftly

to changes in market conditions. But Sri Lanka's rigid labor regulations prevent such responses and lead to several unforeseen outcomes. Firstly, firms 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, since the cost of reducing staff levels is prohibitive, employers that are hit especially hard in downturns are forced to declare bankruptcy, thereby letting their entire workforce go.

But perhaps the two most significant impacts of Sri Lanka's rigid labor laws are to push workers into the informal sector and stifle new job creation. 62% of jobs in Sri Lanka remain in the informal sector. There, workers have no health or social benefits and are not protected by any contracts. Resilient growth in recent years has not been matched by more jobs or higher wage rates. Young workers are forced to seek opportunities overseas, mostly in menial jobs in the Middle East.

Sri Lanka can 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 intervention of the Commissioner of Labor should not be required every time a company seeks to make an employee redundant. These are all stroke-of-the-pen reforms that can be accomplished quickly if the government has the political will to do so.

## Registering property

Sri Lanka ranks 125th in terms of the cost of registering property. Registering property requires 8 different procedures and takes 63 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 property 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

TABLE 2.8

### Expensive to fire workers in Sri Lanka

Cost to dismiss a redundant worker (weeks of wages)

Lowest		Highest	
New Zealand	0	Argentina	139
United States	0	Mozambique	143
Italy	2	Ghana	178
Romania	3	<b>Sri Lanka</b>	<b>178</b>
Australia	4	Zambia	178
Singapore	4	Egypt	186
Georgia	4	Sierra Leone	329
Jordan	4	Zimbabwe	446

Source: Doing Business database.

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. Although Sri Lanka has not made any changes in this area over the past year, other countries have, and so Sri Lanka has slipped from 96th to 101st in the global getting credit ranking.

Sri Lanka's credit information bureau, a public-private partnership between the Central Bank of Sri Lanka and several commercial banks, has started to extend its reach by increasing the percentage of adults covered 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 transaction and bankruptcy laws to provide lenders with clear priority to the proceeds from collateral. Improving the quality of credit information is also important. Banks currently submit credit information on paper, which is later entered electronically into a database. This two-step process can result in errors. The credit bureau needs to 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 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 credit bureau records.

The board of the Credit Registry Information Bureau (CRIB) has approved legal amendments in order to (i) collect data from various new sources (utility providers, retailers, insurers, etc.), (ii) extend CRIB services to such data providers, (iii) provide other services such as credit scoring and fraud prevention, (iv) provide dispute settlement and consumer protection, and (v) purchase the latest information and communications technology. These amendments need to be fully implemented.

### Protecting investors

Sri Lanka ranks 60th in terms of protecting investors, which places it behind India, Bangladesh and Pakistan and on a par with Nepal and the Maldives. Afghanistan and Bhutan rank lower than Sri Lanka on the strength of investor protection. In comparisons to countries outside the region, Sri Lanka is on a par with Indonesia but still behind Thailand and Malaysia. Sri Lanka scores the 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 higher on the director liability index, showing that investors have little power to hold a director liable for misconduct towards the company. The Sri Lanka's highest score (7 out of 10) is in the shareholder suit index—reflecting the relative ease with which an investor can have his dispute resolved in 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 to impose 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.

The Sri Lankan authorities are considering requesting a Report on Observance of Standards and Codes (ROSC) for their country. The objective of the ROSC is to determine how corporate governance works in practice. The assessment focuses on shareholder rights, equitable treatment of shareholders, the 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 the recommendations will go a long way to improving investor protections.

## Paying taxes

Sri Lanka ranks 157th in the world and well below the South Asia average on the ease of paying taxes. Businesses must make 61 different payments per year and spend an average of 256 hours to comply with tax rules. But perhaps the biggest obstacle is the cumulative effective tax rate which at 74.9% of commercial profits is exceeded by only 18 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 close to 71.7% of commercial profits were payable in tax. Additional measures introduced in 2005 include a Social Responsibility Levy at 0.25% of profits and a stamp duty made effective in April 2006. Deductible expenses for advertising were reduced to 50% during the past year. Businesses will face even more difficulties paying tax following a budget passed in November 2006, which further complicates the tax code, introduces a number of new taxes and limits 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 reestablish its historical role as a regional entrepôt. This would require considerable simplification of the Sri Lankan tax code. The number of payments can be reduced by consolidating some taxes and eliminating other 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 the current rate.

Despite consistent increases in tax rates Sri Lanka's 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 offer generous tax holidays and concessions—75% of manufacturing now takes place in the zones. This practice reduces revenues and creates a non-level playing field between large investors in the zones and smaller domestic entrepreneurs that are struggling

with government's bureaucratic and onerous tax regime. It also creates numerous opportunities for rent-seeking behavior among domestic and international companies vying for Board of Investment status.

## Trading across borders

A recent investment climate study conducted by the World Bank and the Asian Development Bank found that Sri Lanka's ports were more efficient than many of its South Asian neighbors. However, that competitive advantage is gradually eroding as its competitors improve efficiency. Sri Lanka dropped to 99th from 90th on the ease of trading across borders during the last year. It takes 27 days and 13 documents to import goods. Exporting is only marginally better taking 25 days and 8 documents.

While competitors have narrowed the gap, Sri Lanka remains at the top of the South Asian league with only the Maldives and Pakistan ahead in terms of port competitiveness. However as a small island economy dependent on a thriving export sector, it is important that Sri Lanka continue to improve its trade performance to world class levels. Singapore takes only 3 days for imports and 6 days for exports and its container shipments 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 Container Terminal of the Sri Lanka Port Authority for some years now. The private sector terminal has spurred competition and efficiency within the public sector, while the publicly run terminals remain behind. Most importantly difficult labor relations continue to plague the public sector operations. A high profile strike at the Jaya Container Terminal in 2006 threatened Sri Lanka's key export sectors. The privately run SAGT mitigated the damage, operating around 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, thereby introducing 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 90th in terms of the ease of enforcing a contract. It takes 837 days and 20 procedures to enforce a contract (table 2.9). Such delays have several perverse effects on the way business is conducted. First, many businesses will prefer not to resort to the courts even for the simplest matters. Other businesses are tempted to bring frivolous court cases against their competitors, knowing that they can effectively tie up their competition for years in lengthy and costly disputes. Such practices encourage businesses to trade with a narrow group of known business partners, or simply internalize the risks and avoid trade altogether. Either way, growth is seriously hindered. Lengthy delays in court procedures also create the opportunity for rent-seeking behavior among 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 the appeal is resolved. Not surprisingly, defendants use appeals as a delay tactic. Sri Lanka can follow other reformers—most recently Brazil in 2005—by removing 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.

TABLE 2.9

### Enforcing a contract in Sri Lanka

Number of procedures	20	Judgement period (days)	595
Time (days)	837	Enforcement period	180
Filing period (days)	62	Cost (% of claim)	21.3

Source: Doing Business database.

## Closing a business

When a firm becomes insolvent in Sri Lanka, the average creditor receives around 36 cents on the dollar. It takes 2 years and costs about 18% of the estate value to go through bankruptcy. This places Sri Lanka in 59th place globally and far ahead of South Asian rivals where creditors can spend on average 4 years and recover only 20 cents on the dollar. India in particular has the most inefficient bankruptcy practices in the world—it takes over 10 years to recover just 13 cents on the dollar. Figure 2.20 shows that although bankruptcy is fairly quick in Sri Lanka, the cost for failed entrepreneurs to go through bankruptcy is the highest in South Asia.

## 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 that 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.

FIGURE 2.20

### Closing a business in Sri Lanka—short time, high cost

