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CURRENCY EQUIVALENTS

Sri Lankan Rupee (SLR)

US \$ 1.00 = SLR 75.02 (June 9, 2000)

FISCAL YEAR (FY)

January 1 – December 31

ACRONYMS AND ABBREVIATIONS

| | | |
|--------|---|---|
| ADB | - | Asian Development Bank |
| AGD | - | Auditor General's Department |
| CENWOR | - | Centre for Women's Research |
| CFS | - | Consumer Finances Survey |
| BOI | - | Board of Investment |
| DFCC | - | Development Finance Corporation of Ceylon |
| DMS | - | Department of Management Services |
| EGI | - | Economic Governance Index |
| EPF | - | Employees Provident Fund |
| GDP | - | Gross Domestic Product |
| GNP | - | Gross National Product |
| GST | - | Goods and Services Tax |
| HDC | - | Human Development Centre |
| HEIS | - | Household Expenditure and Income Survey |
| HGI | - | Humane Governance Index |
| IDA | - | International Development Agency |
| IMF | - | International Monetary Fund |
| IPS | - | Institute of Policy Studies |
| JBIC | - | Japan Bank for International Cooperation |
| LTTE | - | Liberation Tigers of Tamil Eelam |
| NARC | - | National Administrative Reform Council |
| NGO | - | Non Governmental Organization |
| NDTF | - | National Development Trust Fund |
| PA | - | People's Alliance |
| PRA | - | Participatory Rural Appraisal |
| PSC | - | Public Service Commission |
| PERC | - | Public Enterprise Reform Commission |
| SCB | - | State Commercial Banks |
| SDO | - | Samurdhi Development Officers |
| SLCTB | - | Sri Lanka Central Transport Board |
| SRR | - | Statutory Reserve Requirement |
| SLIS | - | Sri Lanka Integrated Survey |
| SLT | - | Sri Lanka Telecom |
| TEWA | - | Termination of Employment and Workmen Act |
| UNP | - | United National Party |

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This report was prepared by Eric Bell (SASPR) and Rapti Goonesekere (SASPR) based on the work of various economic missions to Sri Lanka over the past 18 months, analysis of poverty currently underway (Manuela Ferro and Elena Glinskaya), and consultations with a broad range of stakeholders. Research assistance was provided by Princess Ventura (SASPR). Team assistance was provided by Mei-Ling Lavecchia (SASPR). Valuable comments were received from Sri Lankan officials and members of the Sri Lanka Country Team of the World Bank. Photographs on the cover of the colored version provided by Shirani Rajapakse and Suresh Peiris (SASPR).

EXECUTIVE SUMMARY

1. **Overview.** Sri Lanka is a well known outlier among developing nations. It was one of the first developing countries to understand the importance of investing in human resources and promoting gender equality. As a result, Sri Lanka has achieved human development outcomes more consistent with those of high income countries. It also liberalized its economy in the late 1970s, ahead of other developing nations. Despite acceleration of the civil conflict in the 1990s, economic growth has been healthy due to good macroeconomic management and progress in trade liberalization, privatization, and financial sector reform. Sri Lanka is today South Asia's most open economy, and has a relatively well developed capital market infrastructure. Its per capita income (US\$ 820) remains the highest in the region, after Maldives. Unemployment and inflation have fallen to historical lows, the external current account has strengthened, exports have diversified and expanded, and foreign direct investment has risen.

2. There is growing realization, however, that Sri Lanka's development has been well below its potential. In the 1960s, Sri Lanka had the same per capita income as Korea, Malaysia, and Singapore. Thirty years later these three countries have per capita incomes that are several times higher than Sri Lanka's. Several reasons explain this divergence in economic performance. The first and most obvious one is the 17-year long war. This has taken a heavy social and economic toll on the country's performance. Second, relative to the early 1970s, public institutions and governance have weakened gradually over the years. Third, Sri Lanka has for many years given the public sector a significant role in creating jobs and transferring resources across groups. The size of the public sector has declined slightly over the years, but it continues to dominate the financial sector and utilities, while owning a large number of commercial enterprises. Per capita employment in the public sector is the largest in Asia. With productivity in the public sector typically well below that of the private sector, this has meant foregone opportunities in terms of growth and employment. Regulations regarding land transfers and exit policies in the labor market have exacerbated the situation by constraining efficiency in the private sector. It is testimony to the private sector's strength that employment in the private sector has increased significantly during the last decade despite these constraints.

3. Realizing Sri Lanka's enormous potential will first require an end to the war. In addition, as indicated in the 2000 Budget speech, the country needs to engage in a second wave of reforms that will increase opportunities, put the economy on a high growth path, and improve governance. Of particular importance are initiatives highlighted in the Budget aimed at accelerating privatization and strengthening public institutions.

4. **Recent political developments.** Since late 1998 elections have slowed the momentum for introducing key structural reforms. Provincial Council elections were held in the first half of 1999, and Presidential elections in December 1999. Since her re-election, President Kumaratunga has made new efforts at resolving the conflict. The opposition United National Party (UNP) has pledged its support to the Government's peace initiatives, and Norway is assisting the process. These developments have however been overshadowed by a volatile security situation with intensified military offensives, high profile assassinations, attempted assassinations, suicide bombings and a series of smaller bus bombings. Parliamentary elections scheduled for mid-2000 add an additional layer of uncertainty to the speed of policy reforms.

5. **Resilience in the face of adversities.** Despite the difficult domestic political conditions, the intensified civil conflict, and turbulence in world financial markets, the economy has continued to show resilience over the last 18 months. The first half of 1999 was particularly testing, with exports falling for the first time by as much as 10 percent due to weak global

demand for tea and garments. This was reversed in the second half of the year. Real GDP growth for 1999 was 4.3 percent, slightly lower than the long-term trend but comparing favorably with growth performance in other developing countries. Unemployment has fallen to a historical low (8.8 percent). Foreign direct investments increased somewhat. Combined with falling domestic and international commodity prices, macroeconomic policies have reduced inflation by half relative to 1998 (4.7 percent). The favorable trends have continued during the first quarter of 2000 with exports and industrial production growing by 24 and 12 percent, respectively, and inflation continuing on a downward trend.

6. **Short-term vulnerabilities.** Despite these successes, vulnerabilities remain on the external front. Sri Lanka's current account has improved considerably over the last decade, although there was a widening of the deficit to 3.3 percent of GDP in 1999. The capital account which has weakened steadily since 1990 was further affected in 1999. Net capital flows fell to a historical low of US\$ 330 million, compared with an average of about US\$ 600 million during 1990-98. The long-term deterioration in the capital account is due to rising amortization of official debt and a reversal in short-term capital flows (which have been large and negative in the last four years). This underlying trend was aggravated in 1999 when gross disbursements of concessional aid fell to a very low level (US\$ 350 million compared with US\$ 520 million in 1990-98) due to the completion of several large donor financed projects and continued delays in procurement. Large privatization receipts (US\$ 430 million) over 1995-99 and sustained levels of long-term capital from the private sector helped mitigate the impact of this continued weakening in the capital account. As a result, external reserves have been partially protected, although falling steadily for six years. The balance of payments registered a deficit of US\$ 260 million in 1999, and gross official reserves fell to 2.9 months of imports. The challenge in the future is to maintain sustainable long-term increases in private capital as well as maximize the use of foreign concessional assistance.

7. Another vulnerability relates to the fiscal situation. The budget deficit was reduced to 7.5 percent of GDP in 1999. The 2000 Budget introduced in February aimed at maintaining the deficit at the same level as in 1999. However, the escalation of the conflict in the Jaffna peninsula since May has called for an increase in defense expenditures of about 1 percent of GDP. Additional revenue and expenditure measures were taken to offset part of these military expenditures, and the aim is to contain the deficit to below 8 percent of GDP. Realizing this objective will however remain a challenge for Sri Lanka as it is based on ambitious revenue targets and early realization of privatization receipts. A more difficult task is to reduce the deficit over the medium-term as this calls for both revenue and expenditure improvements. The deficit declined by about 2-3 percentage points of GDP over 1990-99, but was accompanied by a fall of 3-4 percentage points of GDP in revenues (due in part to tax concessions). As a result, expenditures declined by 6-7 percentage points of GDP. Half of the reduction was in capital spending in a country greatly in need of better infrastructure. On the other hand, the gains made in reducing current expenditures over the decade were undermined by the increasing share of defense outlays and debt servicing. In addition, the wage bill was reduced by about 2 percentage points of GDP between 1990-99, in the face of a large expansion in the cadre of public servants. This fiscal situation could be adversely affected if the highly positive real interest rates of 1999 continue to persist.

8. Prudent monetary policy was successful in lowering inflation in 1999. It was however unable to reduce interest rates because of the large borrowing needs of the Government to make up for the shortfall in external financing. The financial sector has benefited from several structural enhancements in recent years. However, continuing governance weaknesses at the two state banks undermine the efficiency of the sector. Their portfolios remain weak (15-20 percent non-performing assets) and their management was unable to meet the targets specified under the

performance contracts signed with the Government in July 1998. The poor performance of these two state banks remains a serious concern for the Government, and some reform initiatives have recently been launched. As in the past, exchange rate policy in 1999 aimed at protecting Sri Lanka's external competitiveness.

9. **Sri Lanka's future economic and social development** will depend not merely on maintaining sound macroeconomic management and accelerating privatization, but more importantly on the country's ability to resolve the on-going conflict and move quickly into implementing key structural reforms to enhance economic growth and reduce poverty. The most difficult long-term challenge is resolving the conflict. The civil conflict has already taken a huge toll on the economy and its society, costing at least two years of GDP. Even more important, the conflict has caused a humanitarian problem of great proportions, taken the lives of several of its political leaders, and forced a generation of children to grow up in an environment of insecurity and conflict. Sri Lanka's social fabric is under stress due to the poverty and deteriorating health and education outcomes in war-torn areas, psychological trauma associated with the conflict, displacement, as well as rising levels of crime and violence. There are serious risks to future economic and social development if the conflict persists. Experiences of other countries around the world show that prolonged civil conflicts, especially those with ethnic undercurrents, ultimately lead to economic and social decline.

10. In restoring the health of its public finances, Sri Lanka will also need to rethink its poverty reduction strategy. Poverty remains a concern in Sri Lanka. Emerging analysis shows that despite healthy economic growth, there has been slow progress in poverty reduction between 1990 and 1996. More worrisome is the persistence and exacerbation of regional disparities during that period. The conflict affected areas in the North-East are undoubtedly the most deprived, while even the North Central and North Western provinces have experienced a near doubling of poverty rates. Excluding the North-East, one-fourth of the population lives below the poverty line. While the severe drought of 1996 could partially explain this poverty trend, it is evident that income fluctuations especially in rural areas create considerable vulnerabilities. Women and children bear a disproportionate burden of the conflict and some consequences of poverty such as alcoholism, domestic violence, and child abuse.

11. The large poverty programs of the 1990s have suffered from design and implementation weaknesses which have affected their effectiveness. The political bias in the implementation of successive state sponsored poverty programs has rendered the poor very vulnerable to changes in the political climate. The programs have not created opportunities and empowered the poor to lift themselves out of poverty in a sustained manner. Most poverty programs in Sri Lanka have had poor targeting as the transfers usually cover around 50 percent of the population. Emerging evidence indicates that 44 percent of the benefits from the Government's poverty program (Samurdhi) go to the top three income quintiles. The large expenses on poorly targeted income transfers, the high long-term administrative costs of hiring poverty workers into the public sector, and the weak exit mechanisms are some examples of the problems that need to be addressed.

12. There is today also a high degree of consensus that prevailing public sector institutions are in need of fundamental reforms. Sri Lanka's public administration has some positive aspects of good governance such as a well developed human resource base and a dedicated cohort of professional staff. However, a gradual deterioration in public sector institutions and governance started in the early 1970s, which combined with the civil conflict and youth rebellions of the past, have resulted in Sri Lanka's low ranking in Asia in governance (Human Development Center, 1999). The greatest returns to economic governance would arise from reintroducing strong institutional controls and incentives in the management of the public administration which is currently oversized, costly and suffers from low efficiency. Politicization of recruitment by

successive governments has become well established and expected. Financial accountability has weakened considerably over the years due primarily to insufficient parliamentary oversight and poor institutional structures or watchdog bodies. The administrative apparatus remains very centralized despite efforts since 1987 to devolve functions to the Provincial Councils. In all these areas, there are on-going initiatives by the Government to address the fundamental problems. However much remains to be done.

13. One area where there has been considerable improvements is in reducing the role of government in certain sectors of the economy. An impressive privatization program has been implemented since 1995, with the main successes being in the plantation and telecommunication sectors. Private sector participation has been encouraged in electricity production and the ports. Large privatization proceeds have been obtained which helped contain rising government debt. Realizing the benefit of increased private sector role in the economy, the Government announced its intentions to reinvigorate the privatization and liberalization program with a strong regulatory framework in place in the 2000 Budget. It has also expressed its interest in addressing some of the structural rigidities in the labor market to facilitate the planned restructuring of the economy. By undertaking such crucial and well sequenced reforms, in the context of a transparent and consultative process, Sri Lanka will be able to recapture the missed opportunities of the past and better meet the aspirations of its people.

CHAPTER 1

RECENT ECONOMIC AND SOCIAL PERFORMANCE

Introduction

1.1 Sri Lanka has enjoyed healthy economic growth since the early 1990s (around 5 percent annually). Macro stability was maintained and considerable reforms implemented, most prominently in trade, taxation, and privatization-- including the national airline and the national telecommunications corporation. Some new initiatives have also been launched in the education and health sectors. However, the conflict has intensified and its economic and social costs have increased. Despite increased defense expenditures, efforts have been made to reduce the fiscal deficit. Sri Lanka's most pressing concerns in economic management today include accelerating privatization, particularly of banks, revitalizing public sector institutions, reducing poverty, and enhancing the flexibility of the labor market. This chapter provides an update on Sri Lanka's recent economic and social policies. Chapters 2 and 3 discuss some of the more long-term challenges of the country.

A. Recent Political Developments

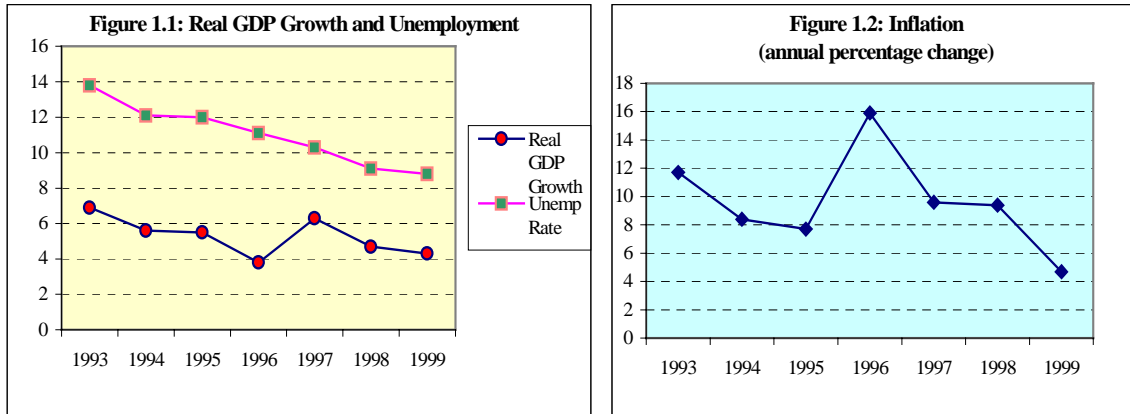
1.2 Sri Lanka has been in the midst of considerable political uncertainty as well as of a volatile security situation over the last 18 months. Since end-1998 the country has witnessed several elections which have slowed the momentum for structural reforms. Provincial Council elections were held in early 1999, and Presidential elections ended the year. The incumbent government was successful in all elections— the People's Alliance (PA) party won island-wide Provincial elections, and President Kumaratunga renewed her mandate for another six years. Parliamentary elections are expected to be held in mid-2000.

1.3 The domestic security situation was very tense throughout 1999. President Kumaratunga survived an assassination attempt during the final PA presidential election rally in Colombo, a simultaneous bomb attack at an opposition United National Party (UNP) rally took the lives of several and injured many others, and a suicide bomber assassinated an internationally renown human rights activist. In the North-East, heavy losses were experienced in the battlefields. Security tensions did not ease up with the dawn of the new millennium, and the year 2000 was heralded with more terrorist attacks— the killing of a vocal leader, a suicide bombing outside the Prime Minister's office, a series of bus bombs, and a guerrilla ambush and street fighting with security forces during Colombo's rush hour traffic. Fighting around the Jaffna peninsula intensified during March-May, 2000 with Liberation Tigers of Tamil Eelam (LTTE) efforts to capture the peninsula. As a result, the country has been placed on a war footing. A bipartisan approach to resolving the conflict is underway, and Norway is assisting in initiating discussions between the Government of Sri Lanka and the LTTE.

B. Economic Outcomes in 1999

1.4 Despite the difficult domestic political conditions, the intensified civil conflict, and turbulence in world financial markets, the Sri Lankan economy has shown considerable resilience over the last 18 months. The first half of 1999 was rather difficult with exports falling by around 10 percent. There was a turnaround starting in the second half which helped maintain the year's economic growth at 4.3 percent, slightly lower than the country's long-term growth rate, but comparing favorably with most other developing countries. The three main sectors of the economy (agriculture, industry and services) all grew by around 4.0 - 4.5 percent. Sustained growth in the private sector as well as large labor migration and recruitment in the military and the public sector over the last decade have helped reduce unemployment to 8.8 percent in 1999 (Figure 1.1).

1.5 Inflation fell to a historical low (4.7 percent) due to improved domestic supplies, low international prices for major food commodities, as well as prudent monetary policy (Figure 1.2). Replacement of the turnover and excise taxes by the value added tax in 1998 and duty concessions on rice and petroleum imports in 1999 also helped contain price increases in 1999. The external current account deficit widened to 3.3 percent of GDP, but remains well below the 1990-96 levels. The balance of payments however registered a sizeable deficit reflecting both a slowdown of net official capital inflows and higher short-term private capital outflows. Gross official reserves fell to 2.9 months of imports of goods and services in December 1999, continuing the declining trend started in 1993.



Sources: Central Bank of Sri Lanka; IMF.

1.6 Latest available data on household income and expenditures date only to the mid-1990s. These show that poverty remains high-- one fourth of the population lives below the poverty line, and poverty incidence is as much as 35 percent in some provinces. Regional disparities in poverty have also widened between 1990 and 1996. While the severe drought of 1996 could partially explain these poverty trends, it is evident that income fluctuations especially in rural areas create considerable vulnerabilities. Chapter 3 addresses the issues of poverty in Sri Lanka in greater detail.

C. Economic Growth, Savings and Investments in 1999

1.7 **Slowdown in industry.** Manufacturing activity grew by 4.4 percent in 1999, significantly below the 9.3 and 6.3 percent growth rates recorded in 1997 and 1998, respectively. The slowdown was mainly in export oriented industries, especially textiles and apparel, and rubber and leather products. These products faced a reduction in the growth of world trade as well as strong competition especially as East Asia's recovery gathered momentum. Growth in the construction sector decelerated (to 4.8 percent) due to some slowdown in private sector investments in plant and machinery reflected in a sharp decline in the imports of investment goods (excluding aircrafts). There was some sign of recovery in industrial activity in the latter part of the year.

1.8 **Growth in services maintained.** The services sector, which accounts for half of GDP, maintained a healthy growth rate. But the growth momentum slowed in this sector as well. Value added in services grew by 4 percent, compared to 5-7 percent in previous years. The telecommunications sub-sector was in the forefront of this growth performance following continued increases in participation of the private sector in expanding the telecommunications network and provision of high value added communication services. The number of telephone lines tripled over the last two years. Electricity generation, which has benefited from incentives to small producers since 1996 and efforts to increase private sector participation in the sector, expanded by 9 percent. Tourism showed a strong recovery in 1999 (14.5 percent increase in arrivals) due largely to overseas promotional campaigns and an increase in flying frequency

between Colombo and the major tourist sources. The good performance of these three sub-sectors helped offset a slowdown in trade, which suffered from lower imports and a reduction in transshipment cargo handling. Handling of transshipment was affected by regional economic problems and emerging stronger competition in the region, especially Oman. The services sector excluding external trade performance grew by 5.4 percent.

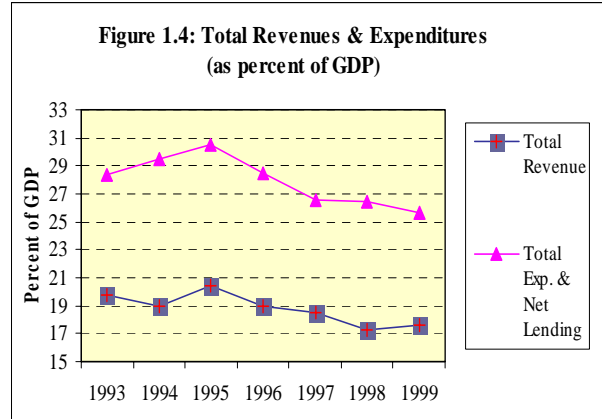
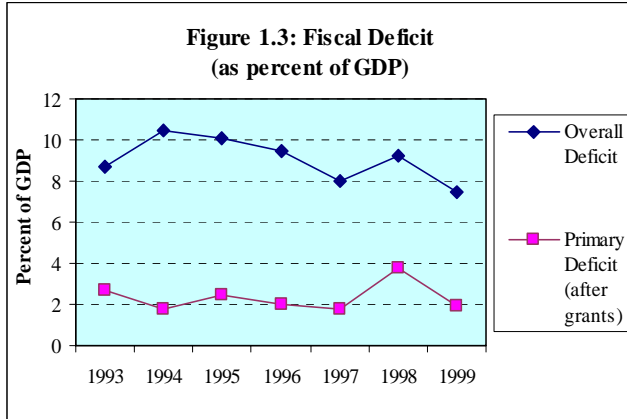
1.9 Rebound in agriculture. For the first time in many years, agriculture showed a similar growth rate as manufacturing and services. Agricultural value added grew by 4.4 percent in 1999 due to good performance in paddy, coconut, and subsidiary food crops. Paddy production recorded its highest level in the decade, benefiting from abundant rainfalls and a higher yield rate from increased fertilizer application. Fishing activity was buoyant (7.6 percent growth) owing to the resumption of fishing in the Eastern coastal belt and growth in shrimp farming. Tea production grew by 1.3 percent. Rubber production also recovered from the setback of 1998 due to good weather conditions and a small upturn in the prices of rubber.

1.10 The agricultural growth of 1999 should not mask the fundamental weaknesses of agriculture in Sri Lanka. The sector's contribution to per capita income growth has received constant attention in the country especially because approximately 75 percent of the population live outside urban areas. Official statistics on value added show an annual average growth rate of around 2 percent in agriculture between 1990-99 (but only 1 percent during 1990-98). High levels of profitability have been restored in the estate sector following privatization. Consequently, tea output and employment have increased significantly. However, growth in subsistence agriculture is insufficient, due to the concentration of workers in low-technology employment, as well as policy constraints in paddy production in particular. Restrictions on land transfers in certain areas and generous subsidies for irrigation undermine the price incentives for farmers to shift to higher value added crops or to sell land to more entrepreneurial farmers. There is nevertheless buoyant demand for off-farm rural labor due to an increase in activities financed by workers' remittances and security-related employment, among others. Improving agricultural productivity/growth would imply reducing government involvement in agricultural marketing, liberalizing land use, and establishing a fully functioning land market. Delivering better infrastructure and technology services in rural areas would also contribute to improved performance. The land market in Sri Lanka is constrained by the state's role as dominant landlord, restrictions on land sale and use in some areas, and inadequate land registry (see para 2.18). The experiences of East Asia, especially Indonesia and Thailand, have shown that land reform is a key ingredient for high growth rates in agriculture.

1.11 The savings-investments gap. Gross domestic investment rose from 25.1 percent of GDP in 1998 to 27.1 percent of GDP in 1999 reflecting primarily buoyant expansions in telecommunications services and the launching of the re-fleeting program by the privatized national airline. The fiscal incentives offered in 1997-99 also helped maintain positive inflows in other sectors, such as electricity and hotels. The Sri Lankan economy maintained its appeal to foreign investors, with net foreign direct investments increasing from US\$ 140 million in 1998 to US\$ 180 million in 1999. Gross national savings also increased from 23.4 percent of GDP in 1998 to 23.9 percent of GDP in 1999. Both the public and private sectors contributed to this rise. Public sector dissavings declined from 2.4 percent of GDP in 1998 to 1.1 percent of GDP in 1999. Private savings benefited from the growing per capita incomes, the higher positive real interest rates during the year, and increasing private remittances. Net private transfers increased by 4.6 percent over the year to US\$ 890 million, but included US\$ 110 million of compensation payments for Sri Lankan workers in Kuwait who were displaced during the Gulf war. As a result of these developments, the savings-investment gap widened from 1.7 percent of GDP in 1998 to 3.2 percent of GDP in 1999. The Colombo Stock Market however did not mirror the same investment optimism as foreign portfolio investors continued to withdraw funds. The Stock Market indices declined by 4-6 percent over the year (14 percent over the last two years). Uncertainty associated with elections, slower earnings growth of some companies during the first half of the year, and domestic security concerns are the reasons for this outflow.

D. Policies in 1998-00

1.12 **Fiscal consolidation.** The estimated fiscal deficit in 1999 has fallen back to 7.5 percent of GDP, the lowest level attained after 1992 (Figure 1.3). This reflected a modest increase in revenues as well as a sizeable reduction in expenditures. The revenue increase is a success that reverses a decade-long declining trend. The declining trend is partly a result of reduced external trade taxes and the transitory adverse impacts of tax reforms. Tax receipts in 1999 benefited from the increases in both the National Security Levy and excise taxes. These increases more than offset the decline in turnover taxes which have been on a downward trend since 1990. The Goods and Services Tax (GST) was introduced in April 1998, and is expected to reverse this trend. However, administrative difficulties in collections (e.g., documentation, computation, and refunds) have yet to be overcome to realize this objective. Early indications, based on the period April 1998 to March 2000, are that GST receipts have been on the rise. Sri Lanka has a relatively high level of tax receipts for its level of economic development, but the ratio of tax/GDP remains 3 percentage points of GDP below its level in 1990. The relatively low rate of the GST and its exemptions, as well as concessions that had been accorded to private investors over the years (especially Board of Investment companies) have constrained tax revenue performance in Sri Lanka (Figure 1.4).



Sources: Central Bank of Sri Lanka; IMF.

1.13 The revenue increase in 1999 was accompanied by a further containment of current expenditures (from 19.6 percent of GDP in 1998 to 18.7 percent of GDP in 1999). Most of the expenditure curtailment was achieved through stricter control on defense outlays-- which fell from 5 percent to 4.3 percent of GDP. Gross defense expenditures, which include deferred payments, declined from 5.6 percent of GDP to 4.9 percent. This together with additional reductions in expenditures on goods and services, and transfers more than offset a small increase in debt service (due to higher domestic borrowings in 1998 and the impact of rupee depreciation on foreign debt). These trends in revenues and current expenditures translated into a decline in public dissavings from 2.4 percent to 1.1 percent of GDP (Table 1.1). Capital expenditures and net lending were slightly lower at 6.4 percent of GDP in 1999. A disaggregated analysis of these expenditures shows that there has been a shift in 1999 away from expenditures on “economic infrastructure” (power, ports, transport and highways, irrigation, etc.) primarily in favor of expenditures on “institutional infrastructure” (i.e., cost of restructuring public corporations and government institutions under the Ministry of Finance and Planning).

1.14 Financing of the budget deficit underwent substantive compositional changes in 1999. Net foreign borrowing was lower than in 1998 by 1 percentage point of GDP, due to exceptionally low levels of project aid disbursements. Slow project disbursement as well as the completion of an unusually large number of projects during the year led to a decline in gross disbursements

from 2.8 percent of GDP in 1998 to 2.0 percent of GDP in 1999.¹ Debt amortization remained at 1.9 percent of GDP. The decline in net external financing however did not offset capital expenditures as these have relied more on domestic sources, in particular the fiscal current account balance. Net domestic financing of the budget remained at around the same level as in 1998 (around 6.7 percent of GDP). However, due to the limited availability of resources from the nonbank sector (where demand for capital by the private sector is high following privatization initiatives in recent years), the Government increased its recourse to bank financing. This reached 2.3 percent of GDP, the highest level since 1988. Total public debt rose to the equivalent of 94.7 percent of GDP in 1999 from 90.8 percent in 1998.

Table 1.1: Summary of Central Government Operations, 1995-2000 (as percent of GDP)

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|--|--------------|-------------|-------------|-------------|-------------|-------------|
| | | | | | Prov. | Budget\1 |
| Total Revenue | 20.4 | 19.0 | 18.5 | 17.2 | 17.6 | 18.7 |
| Tax | 17.8 | 17.0 | 16.0 | 14.5 | 14.9 | 16.1 |
| Non-tax | 2.7 | 2.1 | 2.5 | 2.7 | 2.7 | 2.6 |
| Total Exp. & Net Lending | 30.5 | 28.5 | 26.4 | 26.3 | 25.1 | 26.3 |
| Current | 23.1 | 22.8 | 20.8 | 19.6 | 18.7 | 18.1 |
| Civil Service wages & salaries\2 | 3.4 | 3.3 | 3.1 | 3.0 | 3.0 | 3.0 |
| Other civilian goods & services | 1.5 | 1.3 | 1.3 | 1.6 | 1.4 | 1.7 |
| Defense | 6.5 | 5.8 | 5.1 | 5.0 | 4.3 | 4.0 |
| Subsidies & transfers | 6.1 | 6.0 | 5.1 | 4.6 | 4.2 | 3.9 |
| Interest payments | 5.7 | 6.4 | 6.2 | 5.4 | 5.6 | 5.5 |
| Capital and Net Lending | 7.4 | 5.7 | 5.7 | 6.7 | 6.4 | 8.2 |
| Overall Deficit (before grants) | -10.1 | -9.4 | -7.9 | -9.2 | -7.5 | -7.6 |
| Net External Financing | 3.2 | 1.3 | 1.1 | 1.0 | 0.1 | 1.1 |
| Bank | 1.1 | 1.7 | -0.2 | 1.9 | 2.3 | 0.0 |
| Non-bank | 4.4 | 5.4 | 6.2 | 5.5 | 4.5 | 5.9 |
| <i>o/w privatization proceeds</i> | 0.4 | 0.6 | 2.5 | 0.4 | 0.0 | 2.4 |
| Grants | 1.4 | 1.0 | 0.8 | 0.7 | 0.6 | 0.6 |
| Memorandum Item: | | | | | | |
| Gross Defense Expenditure\3 | 6.5 | 6.0 | 5.4 | 5.6 | 4.9 | - |

Notes: 1\ Budget as announced in February, 2000. Allocations were revised in May, 2000 but detailed breakdown was not available at the time of preparing this report. The aim is to keep the deficit below 8 percent of GDP.

2\ excluding defense; 3\ Including settlement of deferred payments.

Source: Central Bank of Sri Lanka; Ministry of Finance; IMF.

1.15 Efforts at consolidation in 2000. In the Budget Speech of February 14, 2000, President Kumaratunga announced the Government's intention to reduce the overall budget deficit to 5 percent of GDP in 2002. A first step in this direction was taken with the 2000 Budget approved by Parliament in March, 2000. The aim was to maintain the overall deficit at 7.6 percent of GDP, but turn the fiscal current account deficit (1 percent of GDP) into a surplus of around 0.6 percent of GDP. Most of the adjustment would come from a 1 percentage point of GDP increase in GST and excise tax revenues following a rationalization of incentives given by the Board of Investment and improvements in tax administration. Allocations for recurrent expenditures have been reduced by 0.6 percent of GDP, to be achieved through imposition of a compulsory savings on all government departments and agencies, a reduction in debt service as privatization proceeds from Sri Lanka Telecom (SLT) are used to retire debt (and lower interest rates), and an improvement in the financial management of all spending agencies, especially through establishment of Audit and Management Committees. These policies would lead to an improvement in the fiscal current account that would help finance an increase in capital expenditures of almost 2 percentage points of GDP. A recovery in external financing would result in lower reliance on domestic bank financing. Prior to the Budget announcement, the

¹ Disbursements from the three main donors declined by US\$ 133 million in 1999 (JBIC US\$ 60 million, World Bank US\$ 50 million, ADB US\$ 23 million). JBIC disbursements in 1998 were unusually high (US\$ 230 million) due to the bunching of disbursements during January-March, 1998.

Government also raised the prices of several commodities such as diesel, gas, and kerosene, and bus fares.

1.16 Budgetary revisions. In the face of heightened hostilities in the Jaffna peninsula in May 2000, the Government has set Sri Lanka on a war footing. A meeting of Parliament was organized soon after and a decision was taken to increase defense expenditures by Rs. 10 - 12 billion (around 1 percent of GDP). Despite this increase, the aim is to maintain the fiscal deficit below 8 percent of GDP for 2000. Several measures have been taken to achieve this objective—the National Security Levy has been increased from 5.5 percent to 6.5 percent, and excise taxes on tobacco and alcohol have been raised (by 50 cents per cigarette and Rs. 10 per 750 ml bottle). On the expenditure side, the Government has decided to postpone all non-priority development expenditures. To finance the higher targeted deficit, the Parliament has also raised the total debt ceiling by Rs. 20 billion and the Treasury Bill ceiling by Rs. 10 billion.

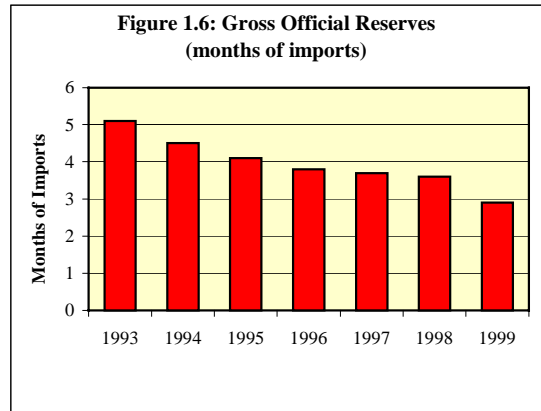
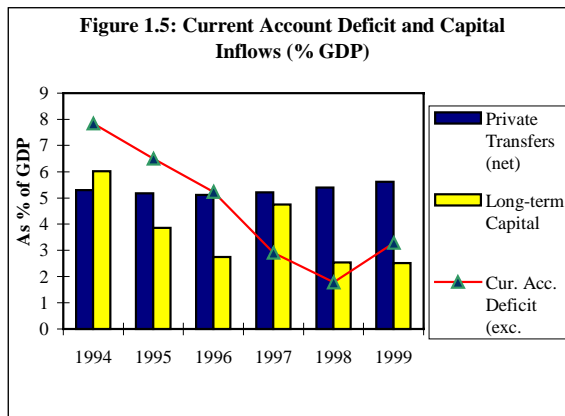
1.17 The challenge for 2000 is to successfully maintain the budget deficit as targeted (below 8 percent of GDP) in a volatile political and security situation. The revenue target is also ambitious. The planned reductions in debt servicing depends heavily on early realization of large privatization receipts. As economic developments in 1999 show, there is now huge demand for long-term capital by the private sector. Fiscal retrenchment, in particular reduced demand for bank credit by government, is important to release credit to the private sector which is taking an ever increasing role in the economy following the recent years of privatization.

1.18 Reducing the budget deficit beyond 2000 will call for both expenditure and revenue improvements. Several structural improvements were introduced in recent years, the most notable relating to tariff reductions. Duty free status was accorded to the textile industry in January 1998 (although readymade garments remain subject to a 10 percent duty); the 1999 Budget reduced tariff rates from 10, 20, and 35 percent to 5, 10, and 25 percent (except for agricultural products which remain at 35 percent); the 2000 Budget introduced a further reduction in rates and a move to a two non-zero band system (see para. 1.31). The Goods and Services Tax (GST) was introduced in April 1998. Other changes include the reduction of the turnover tax on financial services from 2 percent to 1 percent, discontinuation of the direct participation of the Employee's Provident Fund (EPF) at Treasury Bill auctions, and some restructuring of excise and specific duties. Nonetheless the deficit remains high. It was reduced from 10-12 percent of GDP in 1990-91 to 7.5-9 percent of GDP in 1998-99, but the tax/GDP ratio is well below its 1990-91 level. The large reduction in current expenditures over the decade was undermined by the increasing share of outlays in defense and debt servicing. The wage bill was reduced by around 2 percentage points of GDP during 1990-99, but there has been a considerable expansion in the cadre of civil servants. This fiscal situation could be adversely affected if the highly positive real interest rates of 1999 continue to persist.

1.19 Monetary stability but high real interest rates. Monetary policy in 1999 aimed at stabilizing financial markets in the context of a sharp decline in inflation, a significant deficit in the balance of payments, and an increase in government borrowing. The Central Bank reduced the statutory reserve requirement (SRR) from 12 to 11 percent in August 1999. This helped mitigate the contractionary impact on liquidity of outflows resulting from the balance of payments, and satisfy government borrowing needs without creating undue inflationary pressures. Beyond reducing the effective cost of funds for commercial banks, the reduction in the SRR is designed to facilitate the move towards more market oriented instruments of monetary policy. Credit to the private sector grew by around 10 percent over the year, in line with the slower overall growth in the economy. The lower inflation and costs of funds however did not translate fully into lower interest rates as expected inflation remained high. For example, the maximum 12-month deposit rate only fell from 13 to 12.5 percent, and the average weighted lending rate of commercial banks was 18.9 percent in September 1999, compared with 19.6 percent in September 1998. These interest rate movements imply a large rise in real rates, and indicate the difficulty of mobilizing financial resources even though inflation has fallen significantly. The

high level of real interest rates together with wage increases of around 12 percent in 1998 partly explain slow earnings growth in the corporate sector especially in the first half of 1999. These developments provide an additional illustration of the high costs of large fiscal deficits on growth and the cost of resources to the private sector.

1.20 Weakening balance of payments. Sri Lanka's external current account has improved considerably over the last decade, although there was a widening of the deficit (excluding grants) in 1999 to 3.3 percent of GDP (Figure 1.5). The decade-long improvement owes to strong export growth, especially garments, and to the doubling of private remittances. Exports earnings fell by about 10 percent in the first half of 1999, but recovered strongly during the second half. This resulted from the lagged effect of depressed global demand and declining commodity prices. In fact, export volume increased significantly throughout the year. In the end, export earnings contracted by 4 percent over the year-- compared with an annual average growth rate of 8 percent during 1995-1998. The import bill remained at the 1998 level, but included the purchase of three aircrafts (US\$ 298 million); non-aircraft imports declined by 5 percent. Part of this reduction represents the lower need for intermediate goods for exports (investment good imports excluding aircrafts declined by 14 percent),² and declining commodity prices. Increased tourist receipts together with higher inflows of private transfers (due mainly to compensation to Sri Lankan workers displaced during the Gulf war) helped mitigate the deterioration in the trade account and the income account, which suffered from lower investment income.



Sources: Central Bank of Sri Lanka; IMF.

1.21 The real setback in the balance of payments in 1999 came in the capital account which has been weakening steadily since 1990. Net capital flows fell to a historical low of US\$ 330 million during the year, compared with an average of about US\$ 600 million during 1990-98. The long-term deterioration in the capital account is due to rising amortization of official debt and a reversal in short-term capital flows (which turned negative in the last four years).³ The impact of this was mitigated by large privatization receipts (US\$ 430 million) during 1995-99. The underlying deterioration was aggravated in 1999 when gross disbursements of concessional aid fell to a very low level (US\$ 350 million compared with an average of US\$ 520 million in 1990-98) due to the completion of several large donor financed projects and continued delays in procurement. In addition, there was substantial amortization of foreign debt as well as the repayment of Floating Rate Notes issued by Government in 1997 (US\$ 34 million). Commercial banks too reduced their foreign liabilities by US\$ 120 million. Although stock markets in the rest of South Asia recovered from the adverse impact of the nuclear explosions in mid-1998, short-term capital outflows persisted in Sri Lanka.

² Imports of cars and motor cycles increased by 37 percent largely due to the duty-waiver granted for public sector employees to import motor vehicles.

³ The year 1997 was exceptional because of the privatization of Sri Lanka Telecom.

1.22 On the other hand, Sri Lanka continued to receive sustained levels of long-term capital from the private sector due to two reasons. First, the airlines, telecommunications and power sectors have been opened partially to foreigners in recent years, and the textile and apparel sector continues to have strong appeal due to the availability of skilled labor. Second, there was increased borrowing by Sri Lanka Telecom (SLT) and the Development Finance Corporation of Ceylon (DFCC) for infrastructure projects. The refueling program of Air Lanka was also financed without government guarantee. The final balance of payments outcome was a large deficit (US\$ 263 million), and gross official reserves declined to 2.9 months of goods and services (Figure 1.6). It is a concern that reserves have been falling steadily since 1993 despite large inflows of privatization receipts.

1.23 Total external debt increased slightly to the equivalent of 57.4 percent of GDP due to both the increased disbursements mentioned above and the Yen appreciation. Debt service payments as a percentage of receipts of goods and services increased from 13.3 percent in 1998 to 15.2 percent in 1999. The rupee depreciated in nominal terms by 6 percent over 1999, about the average annual depreciation over the last five years. Due mainly to the bilateral movements between the US dollar, the Yen and the Euro, this represented a 7 percent real effective depreciation of the Sri Lanka rupee.

1.24 **Mixed results in the financial sector.** There have been significant improvements in the financial sector over the last 18 months. Banking supervision has been strengthened with enhanced rules of financial disclosure imposed on financial institutions and staffing at the Central Bank. Other improvements include: (i) the reduction in the statutory reserve requirements imposed on banks; (ii) minor EPF investments in domestic equities; (iii) development of a longer-term capital market with the issue of 2-, 4-, 5-, and 6-year maturity Treasury Bonds; and (iv) establishment of a credit rating agency in 1999 in a joint venture with foreign partners.

Box 1.1. Pakistan's Experience with Bank Restructuring

In December 1997, Pakistan started implementation of a large program of bank restructuring designed to arrest the flow of bad loans, curtail loss-making, and conserve the assets of its main financial institutions, while preparing for privatization. Prudential regulations and financial disclosure standards have been brought to international levels to increase transparency. And legal and judicial processes have been strengthened to enable a more effective enforcement of financial contracts.

A key feature of the reform program was the strengthening of governance. The management and boards of the three institutions concerned were replaced. The process of their appointment and removal was changed through an amendment in the law to insulate them from political interference. This reform resulted in the appointment of expatriate Pakistani bankers, working in reputable banks, as presidents, and professionals from the private sector as board members. Given full autonomy in recruitment, the new management succeeded in bringing in second and third layer managers from the private sector to revamp the whole management team.

These changes produced very good results. Moody's report on Banking System Outlook of June 1999 underscored the role of these governance changes and noted that the three institutions in question had benefited from a significant upgrading of their franchises, corporate culture, and earnings capacity. The chief executives' international experience and the independent stance of the State Bank of Pakistan helped them withstand political pressures to grant new, uneconomic loans. More than 400 unprofitable branches have been closed and staff numbers have been cut. Moody's also noted that a shift in the Government's approach to labor unions had curbed their capacity to disrupt the functioning of these institutions, allowing for a more productive relationship between the banks and their employees.

Source: Moody's Investors Service (June, 1999). "Global Credit Research."

1.25 The Government made a special effort in July 1998 to address the governance problems at the two State Commercial Banks (SCBs), i.e., low operational efficiency, weak portfolios, worsening profitability, etc. Performance contracts were signed between the Government and the management of these two banks spelling out clear performance targets. Unfortunately, both banks have not been able to meet some of the key performance indicators, and their high levels of nonperforming loans remain a serious concern (15-20 percent), especially since they have already

benefited from two recapitalization operations in 1993 and 1996 costing 5 percentage points of GDP. Actions are needed at the earliest regarding governance in these two banks to avoid unjustified intensification of concerns on the health of the country's financial sector. Sri Lanka would benefit greatly from Pakistan's experience in this regard (Box 1.1 above).

1.26 Initiatives in education and health. The Government has taken initial steps to address some of the longstanding problems in the education sector. A reform program was launched in 1996 focused on the reform and deployment of teacher education. In 1998 the Government targeted teaching and learning outcomes through teacher training and curriculum reform, innovations in pedagogical methods, and a revision in examinations and assessment systems. Employment of untrained teachers was also ceased. In line with its policy to privatize textbook preparation and production and to improve ethnic and social cohesion in the country, a process is being put in place to help ensure that curricula and school textbooks are devoid of ethnic or other forms of bias. The Government has proposed to implement a new language program to teach the Tamil language to Sinhalese students and the Sinhala language to Tamil students starting in January 2000. In addition, with assistance from the donor community, the Government is also exploring avenues to improve tertiary education. An increased emphasis is being placed on decentralization of the education system, especially in the delivery of quality inputs to schools.

1.27 These reforms are encouraging and there is no doubt that they will help resolve some of the problems in the education sector over the long term. Nevertheless, many challenges remain in addressing some of the more fundamental problems within the education system. Much effort and attention will be needed to address these core issues which include: (i) low learning outcomes of students, especially among poorer and regionally isolated groups; (ii) the separate but equal system of education based on the two national languages (Sinhala and Tamil) which in practice implies segregation of the student population by ethnic/language origin; (iii) inadequate financing of the sector due to the prevailing government monopoly⁴— expenditures have remained below 3 percent of GDP since the mid-1970s; (iv) inequities in teacher deployment; and (v) the highly restricted access to university education (only 2-3 percent of students in the relevant age cohort) which explains the growing frustration among the youth population with secondary school qualifications. In these circumstances, it has now become apparent that Sri Lanka should consider relaxing the legislation which prevents establishment of private education institutions, develop a reflective/evaluative capacity in the system and a comprehensive policy framework for tertiary education reform which would include good accreditation and quality assurance mechanisms.

1.28 The Government is also at an early stage of identifying possible improvements in the health sector. A Presidential Task Force on Health Policy was appointed in 1997, but progress in policy formulation has been slow. Sri Lanka now has difficulty in maintaining its enviable health record due to the completion of its epidemiological transition. With the country's changing demographic pattern, there has been a rise in chronic diseases (e.g., heart diseases, hypertension, diabetes), while communicable diseases such as malaria, encephalitis, and dengue fever are still prevalent in some parts of the country and show seasonal increases. The civil conflict and rapid economic transition have been accompanied by a high incidence of mental disorder, psychological trauma, and drug addiction. Sri Lanka's rising per capita income has also resulted in increasing demand for better quality health care and more modern and expensive medical services (Hsiao and Li, 2000). On the other hand, competing demands on the Government's budget have prevented the necessary increases in health expenditure allocations which have remained below 2 percent of GDP for the last three decades.

⁴ With the exception of international schools, which are not considered a part of the country's formal education system, approximately 95 percent of all schools are government owned and/or managed.

E. Economic Performance in 2000

1.29 It is too early to provide an assessment of economic developments in 2000. Based on available information, the economic recovery started in the second half of 1999 continues. Growth is expected to be in the range of 4 - 5.5 percent; inflation is likely to increase somewhat. Exports are expected to rise given the recent favorable trends in world trade and growth (export earnings increased by 24 percent and industrial activity by 12 percent during the first quarter of 2000). On the other hand, imports also are recovering and the import bill for crude oil is rising. Regular capital inflows (excluding financing for the three aircrafts) are not expected to increase significantly. Uncertainties remain regarding weather conditions in water catchment areas in Sri Lanka, interest rates in the United States, movements of the Yen, competition from East Asian countries, and the volatile security and political situation in Sri Lanka (the conflict has intensified since May, and Parliamentary elections are expected to be held mid year). The external current account is likely to widen sharply in 2000 due to the re-fleeting program of Air Lanka, but external financing is secured for this operation. The Sri Lanka rupee has depreciated by around 5 percent over January to May. As mentioned in para. 1.16, the Government has taken some early measures to mitigate the impact of the rising defense expenditures.

1.30 The Government's medium-term economic program was presented in August 1999 in *Vision for the 21st Century*, a document that was presented on the occasion of the 5th Anniversary of the People's Alliance party. The vision for the new millennium is based on building a modern and prosperous economy achieving growth rates of 7-8 percent and raising the income levels of the poor by raising their share of income from the current 4 percent to 15 percent by the year 2010. The main policy commitments include reduction of the fiscal deficit to 3 percent by 2010, containing inflation to around 3 percent, raising national savings, developing inter-city linkages, modernizing agriculture, and promoting skills needed for future economic progress.

1.31 The Budget for the year 2000 and its medium-term framework has reiterated these policy objectives and intentions. In addition to reducing the budget deficit, several initiatives have been taken to liberalize the economy further. Both the maximum standard tariff rate and the number of bands have been reduced, and these reductions have been made on a revenue neutral basis by adjusting the excise duty rates for major revenue items such as motor vehicles. The previous standard tariff rates of 5, 10, and 30 percent were reduced to two rates of 10 and 25 percent (the 35 percent special rate for strategic agricultural products remains in place). In the context of the recently signed Free Trade Agreement between Sri Lanka and India, Sri Lanka is implementing a zero duty rate on 300 items (primarily raw materials) and a 50 percent margin of preference for about 900 items. Duties will be reduced on the remaining items, except those on the negative list. Just like the trade liberalization of the early 1990s, these tariff improvements will help Sri Lanka maintain its edge in the trade regime in South Asia and further develop its economic resilience.

1.32 The most important measures of financial liberalization articulated in the 2000 Budget are: (i) relaxation of restrictions on foreign ownership in banking and insurance (up to 60 percent in banks and 90 percent in insurance, subject to standard regulatory requirements); (ii) authorization for 100 percent foreign ownership in stock broking firms; and (iii) authorization for non-residents to invest in equity/growth unit trusts and for overseas Sri Lankans to use the Share Investment External Rupee Account. The Government and the Public Enterprise Reform Commission (PERC) have also announced their intention to continue their divestiture program in respect of hotels, Bogala graphite, and agricultural and livestock farms. While retaining ownership, the Government will also undertake the restructuring of the operations of the Ceylon Electricity Board, the Ports Authority, and the Airport and Aviation Authority, as well as state banks. Preparations are already underway for the sale of another 30-40 percent government stake in Sri Lanka Telecom recently listed on the Colombo Stock Exchange, and to be listed on foreign stock exchanges. A memorandum of understanding has been signed between the Government and the Asian Development Bank in March 2000 which defines the main areas of ADB assistance over the next few years. This will cover privatization, competition policy and consumer protection,

labor mobility and financial sector reform. The World Bank will also assist the Government in initiatives for further private sector development. These new policies are encouraging and will undoubtedly strengthen the economy.

Table 1.2: Key Economic Indicators

| Indicator | 1995 | 1996 | 1997 | 1998 | 1999 Prov. | 2000* Proj. |
|---|-------|------|------|------|---------------|----------------|
| <u>Output and prices</u> | | | | | | |
| Real GDP Growth rate (percentage) | 5.5 | 3.8 | 6.3 | 4.7 | 4.3 | 5.5 |
| GNP deflator | 8.4 | 12.2 | 8.7 | 8.4 | 4.4 | 7.0 |
| Consumer price index (period average) | 7.7 | 15.9 | 9.6 | 9.4 | 4.7 | 5.5 |
| <u>Investment and savings (% of GDP)</u> | | | | | | |
| Gross domestic investment | 25.7 | 24.2 | 24.4 | 25.1 | 27.1 | 32.5 |
| National savings | 19.5 | 19.0 | 21.5 | 23.4 | 23.9 | 24.3 |
| <u>Government budget (% of GDP)</u> | | | | | | |
| Total revenue (exc. Grants) | 20.4 | 19.0 | 18.5 | 17.2 | 17.6 | 18.7 |
| Total Expenditure (incl. net lending) | 30.5 | 28.5 | 26.4 | 26.3 | 25.1 | 26.3 |
| Overall deficit (excl. grants & privtz. proceeds) | -10.1 | -9.4 | -7.9 | -9.2 | -7.5 | -7.6 |
| <u>Money sector (% changes)</u> | | | | | | |
| Broad money (M2) | 21.1 | 11.3 | 15.6 | 13.2 | 13.4 | 13.1 |
| Credit to private sector | 28.2 | 27.6 | 14.5 | 11.8 | 9.9 | 11.2 |
| <u>External sector</u> | | | | | | |
| Current account balance/GDP | -6.5 | -5.2 | -2.9 | -1.7 | -3.3 | -8.2 |
| Gross official reserves (in months of imports) | 4.1 | 3.8 | 3.7 | 3.6 | 2.9 | 2.5 |
| Total External Debt/GDP | 77.4 | 67.5 | 54.3 | 56.5 | 57.4 | 57.2 |
| Debt Service Ratio (receipts GNFS)/1 | 16.5 | 15.3 | 13.3 | 13.3 | 15.2 | 13.2 |
| <u>Unemployment Rate</u> | 12.1 | 11.1 | 10.3 | 9.1 | 8.8 | - |

Note: 1/ Includes FCBU's;

* IMF estimates, March 2000.

Sources: Central Bank of Sri Lanka; Ministry of Finance; IMF.

CHAPTER 2

MEETING SRI LANKA'S PRIORITY CHALLENGES

Introduction

2.1 As described in Chapter 1, Sri Lanka has made considerable progress in maintaining macroeconomic stability and achieving reasonable economic growth. These are the result of continued reforms over the last decade. Nonetheless, vulnerabilities persist as shown by the balance of payments outcome of 1999 and the difficulties in reducing the budget deficit. In addition, there continues to be a large gap between the country's actual economic and social performance and the aspirations of its people, especially the youth. From a longer term perspective, Sri Lanka's past growth performance is below what the country's human capital would predict. The annual GDP growth rate of around 4.5 percent over the last 15 years is low in comparison to its East Asian neighbors, many of whom were at the same levels of per capita income as Sri Lanka in the 1960s and with less impressive social indicators.⁵ Several factors explain Sri Lanka's performance: the civil conflict; the excessive role of government in the economy; and a weakening of public sector institutions and governance since the early 1970s.

A. Resolving the Civil Conflict

2.2 Sri Lanka has thus far been resilient in the face of one of the harshest adversities to development, i.e., civil conflict. Despite the protracted nature of the conflict, now entering its 17th year, a healthy average GDP growth rate has been maintained. Looking beyond the macro and financial aggregates to the human and social costs of the conflict however, it is clear that Sri Lanka faces the same misfortunes and challenges of any other country trapped in conflict. Apart from its immediate impacts, the conflict is also causing considerable longer-term social and psychological wounds to society as a whole.

2.3 **Economic costs of the conflict.** A study conducted by the Institute of Policy Studies (IPS)⁶ estimates the present value cost of the conflict during 1984-96 at nearly 170 percent of Sri Lanka's total GDP for 1996. The Central Bank of Sri Lanka, in its *1999 Annual Report*, estimates that the conflict has reduced Sri Lanka's economic growth by about 2 to 3 percentage points a year. The most obvious direct cost is in terms of defense expenditures, which increased from 1.3 percent of GDP in 1980 to 4-6 percent of GDP over recent years. Government expenditures on relief services, damaged infrastructure, and military expenditures by the LTTE, are some of the other direct costs. In addition, there are many invisible costs, of which the most important is the crowding-out of public investment due to the large defense outlays. This has had adverse impacts on both domestic and foreign private investment, and the country's long-term growth prospects. The IPS study estimates that the costs of foregone foreign investment flows during 1984-96 amount to 71 percent of Sri Lanka's GDP in 1996. Other important indirect costs include foregone tourist arrivals, tightening of the labor market for certain categories of the population, high risk premia on international trade, and disruptions in economic activity, infrastructure bottlenecks and reduction in social welfare due to the tight domestic security system in place. Finally, a less obvious but important impact of the conflict is the distraction of Government from administration and economic policy making.

2.4 **Social costs of the conflict.** Even more important than the above economic costs, Sri Lanka's protracted conflict has caused a humanitarian problem of significant proportions. At least 60,000 people have lost their lives, around 700,000 have been repeatedly displaced, and an

⁵ See IMF "Recent Economic Developments and Selected Issues," 1997, for a comparative study of Sri Lanka and South East Asia.

⁶ Arunatilake, N., Jayasuriya, S. and Kelegama, S. (2000). *The Economic Costs of the War in Sri Lanka*. Institute of Policy Studies, Colombo.

estimated 172,000 persons are living in government welfare centers. About half a million persons are part of the Sri Lankan Tamil diaspora (UNHCR, January 2000). The conflict has taken the lives of many political leaders, and rendered a generation of children growing up in an environment of conflict and insecurity. The long-term impacts of the conflict are worst on children in the North-East and surrounding areas. There are an estimated 400,000 children displaced in the region, with a large proportion suffering from serious psychological trauma from war and displacement, and stress-related physical symptoms (Perera, 1998). Apart from the day to day stresses of coping in an uncertain and violent environment, children in this region have to bear an added trauma (with life-long impacts) of being forcibly conscripted or lured into direct military combat by the LTTE (de Silva, 1997). Amnesty International, the University Teachers for Human Rights in Jaffna, and the UN Special Representative on Children in Armed Conflict confirm the prevalence of strong pressure on school children to join militant groups like the LTTE. Child combatants have been victims of clashes between the security forces and the LTTE in the areas of Welioya in 1995, Mankulam in 1998, and Ampakamam in 1999.

2.5 Sri Lanka's social fabric is under stress due to poverty in the war-torn areas, displacement camps, and surrounding border villages; deteriorating health conditions (rising malnutrition, malaria and infant and maternal mortality); disruption of education as evidenced by rising school dropout rates in some districts of the North; and increasing numbers of female-headed households throughout the country as more young men go into combat. The conflict also affects economic and social life even in the rest of the island. Because of its prolonged nature, the conflict has polarized Sri Lankan society across ethnic and religious divides, and entrenched troubling stereotypes among a generation of children. For instance, a small scale informal survey of children's perception of "the other" revealed that Tamil children in the East perceived Sinhalese as "people wearing khaki, people carrying guns," while Sinhalese children surveyed in the Southern part of the country described Tamils as "tigers and enemies" (Perera, 1998). Finally, the conflict has increased the militarization of society, as evidenced in the increase in the surge in violent crimes often attributed to army deserters, and a significant deterioration of law and order. The murder and armed robbery rates in Sri Lanka in 1996 is far higher than in the rest of South Asia (Human Development Center, 1999).

2.6 These negative impacts of the conflict on the economy and society in Sri Lanka are consistent with the **international evidence on the damage of wars**. The experiences of Sub-Saharan African countries have shown that protracted conflicts, especially those that have ethnic undertones, lead to economic and social decline. Such conflicts destroy physical capital, erode human capital, reduce trust, destabilize social institutions and political processes, and create conditions for corruption and rent-seeking. Ethnic conflicts and polarization also affect the economy in subtle ways, like increasing the likelihood of adopting sub-optimal policies and underproviding growth-enhancing public goods like physical and social infrastructure (Easterly and Levine, 1997). International experience demonstrates that countries such as Sri Lanka in the midst of protracted conflicts have as much to fear from the longer term impacts on society, the economy, and political health of the country, as from the short-term direct impacts of war.

2.7 Recent initiatives towards resolving the conflict. The political leadership and civil society in Sri Lanka are increasingly realizing these long-term pressures created by the conflict. Resolving the conflict is at the forefront of newly elected President Kumaratunga's political agenda. More recently, the opposition UNP has offered its support to the Government's package of constitutional reforms for further devolution in the country, and the Norwegian government is initiating talks with the Government of Sri Lanka on facilitating negotiations with the LTTE. The Government has also initiated a broad-based effort to develop a Framework for Relief, Rehabilitation and Reconciliation. The Framework seeks to develop common policies, strategies and mechanisms to enable assistance to more effectively match the challenges of a fluid situation, and promote peace-building and sustainable development country-wide. Technical support for the preparation of the Framework is provided by international donor agencies, led by the World Bank, in cooperation with local civil society organizations. A World Bank assisted project --

North-East Irrigated Agriculture Project-- was also launched in March 2000 to jumpstart agricultural and economic activities in the North-East. In addition, the World Bank is supporting the Ministry of Education's efforts at: (i) fostering greater ethnic and social harmony through the education process; and (ii) revising textbooks to ensure they are free of ethnic stereotypes and biases. It is heartening that such efforts are underway to enhance trust in a society which has witnessed eruptions of ethnic unrest throughout its post independence history. Achieving long lasting reconciliation and trust is undoubtedly the most difficult of tasks for Sri Lanka, but one with the greatest of payoffs.

B. Reducing the Role of Government in the Economy

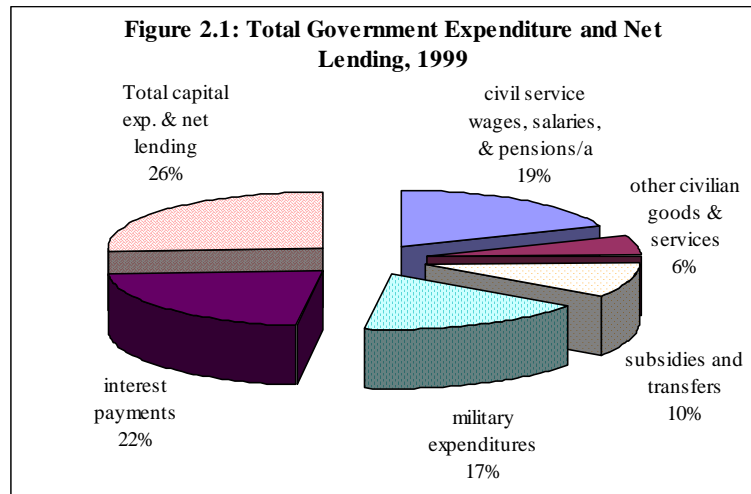
2.8 Sri Lanka has a long history of strong state control over the economy. The State owns the majority of land in the country (around 80 percent), and is an active employer in the labor market having today the largest administration per capita in Asia. It has an excessive number of statutory boards and corporations (including the petroleum corporation and the electricity board). The two state commercial banks dominate the banking sector. The Government holds a quasi-monopoly in education (around 95 percent of schools are government run), and labor laws restrict the scope and range of labor contracts. The fiscal deficit has traditionally been large, consuming a substantial volume of domestic financial resources. There has been some reduction in state control over recent years through the divestiture of state-owned enterprises and fiscal retrenchment.

(i) Reducing the fiscal deficit and improving the structure of expenditures

2.9 As described in Chapter 1, the fiscal deficit is a concern for Sri Lanka. Budgetary expenditures are high (Figure 2.1), and for the most part do little to promote economic growth or human development. Especially restrictive of growth performance has been the fact that about 23 percent of current outlays is spent on defense, and an additional 30 percent on interest payments— a legacy of past fiscal excesses. Civil service salaries (excluding defense) and pensions take up another 25 percent of current expenditures. Many years of massive recruitment in government has made Sri Lanka one of the countries with the highest number of public sector employees per capita in the developing world (Table 2.2). Another 13 percent of current outlays is spent on subsidies and transfers, which in several cases have tended to create micro-economic distortions. For example, the subsidy to irrigation has encouraged rice production at a time when the relative price of rice has been on a steady declining trend; rice rations in the 1970s adversely affected labor supply. The remaining 8 percent of current outlays is on goods and services to all 35 civilian ministries, and is obviously insufficient to maintain or expand the existing capital stock -- railroad transport and water supply, where 50 percent of water distributed is unaccounted for, offer the most glaring examples of a poor capital stock.

2.10 The most undesirable dimension of the prevailing structure of expenditures is their insufficient impact on human development. From this perspective also, the war imposes a binding constraint, with 4-6 percent of GDP expended on defense expenditures annually. This compares with annual allocations of between 4-5 percent of GDP for health and education combined. These social expenditures are especially low given the epidemiological transition of Sri Lanka's aging population and the calls for higher quality public services across all sectors. The poor in particular do not seem to draw their fair share of benefits from public expenditures. For example, most interest payments go to the Employees' Provident Fund (EPF), a lumpsum withdrawal contributory provident fund scheme, which in practice very partially covers the less privileged who are concentrated in the informal sector. The largest proportion of civil servants are teachers who are not typically from the poorest section of the population. The government pension bill (Rs. 19 billion in 1999) serves around 360,000 former government employees while the rest of the population is not covered by any formal retirement income arrangement. Several transfer programs, such as textbooks and school uniforms are universal, while the large poverty alleviation program (Samurdhi) covers around 50 percent of the population. Preliminary analysis

of the household data shows that 44 percent of Samurdhi benefits go to households in the top three income quintiles (see Chapter 3, para. 3.28).



Note: a/ excludes defense. Source: Central Bank of Sri Lanka; IMF.

2.11 It is reassuring that the Government has announced its intention to reduce the fiscal deficit in the medium term. While the precise mechanisms to achieve this objective have yet to be defined, it is clear that the planned large fiscal retrenchment will not be possible without a restructuring of revenues and expenditures. Resolution of the conflict will undoubtedly provide some fiscal space. However, measures to reform and improve the allocative efficiency of salaries, pensions, and transfers to public enterprises and households will also be needed. On the revenue side, the priority should be to restore a more appropriate level of the GST rate and extend its base to the retail sector. Another priority is to eliminate the numerous tax incentives in place. Sri Lanka has traditionally relied considerably on special incentives to promote investments (as reflected in the Budgets of 1997 and 1998). This reliance indicates structural problems in the general investment environment, obviously impacted by the war and excessive bureaucratic hurdles, as evidenced by the dual regimes for offering investment incentives and their administration, i.e., Customs and Tax departments versus Board of Investment(BOI). As the experience of other countries show, tax incentives are not as successful as expected (Box 2.1). In this context, the Government's decision to rationalize BOI incentives in the Budget 2000 is a welcome step.

Box 2.1: International Experience on Tax Incentives

There have been numerous studies on the subject of tax incentives to promote investments. The most well-known of these (Shah, 1995) concluded that countries find it necessary to offer tax holidays to make up for other shortcomings such as poor infrastructure or administrative procedures, poorly trained work force, or in response to neighboring countries' offering holidays. Shah's study also demonstrated that concessionary tax rates in general and tax holidays in particular are not cost effective in a wide variety of countries, i.e., the benefits received from the induced investment are less than the loss in tax revenue. For example, the study shows that 70 percent of BOI-approved projects in Thailand would have been done in the absence of the concessions.

The main reasons for the ineffectiveness of tax holidays and concessionary rates are: (i) for many foreign companies investing in developing countries, direct tax incentives simply result in transfer of tax revenue to foreign treasuries without reducing the tax burden on the company; this is because most capital exporting countries tax the foreign income of their resident companies but provide a credit for foreign taxes; and (ii) investors do not expect to make profits during the holiday period because of the high costs of startup. Lastly, investors rank relief from indirect taxes above direct tax concessions because indirect taxes act to increase costs whether a company is profitable or not.

Source: Shah ed. (1995). *Fiscal Incentives for Investment and Innovations*.

(ii) *Removing policy distortions in the labor market*

2.12 Sri Lanka has nearly 50 labor statutes, of which only 10-15 are operational. The Termination of Employment and Workmen Act (TEWA) is among those regulations that are operational, and is one of the most restrictive job security regulations in the world. The TEWA protects all workers who have job tenure of at least one year in establishments with 15 or more staff. According to this legislation termination of employment is possible only with prior written consent of the employee or the Commissioner of Labor. As damaging is the fact that the process leading to the consent of the Commissioner of Labor is non-transparent, with dispute resolution taking several months and sometimes even years, during which time the firm has to continue paying the salary of its redundant worker.

2.13 These restrictions and administrative tangles impose a high risk and high cost environment on both domestic and foreign investors. The most detrimental impact is on domestic enterprises which perceive the restriction as a hindrance to exploiting potential economies of scale. Because of this regulation, enterprises are disinclined to expand beyond 15 workers, and are thus forced to operate in the informal sector at very low levels of productivity and wages. The impact of these regulations is somewhat alleviated by the weak institutional capacity of the Labor Department⁷ to monitor and enforce labor laws— but this is a poor palliative to the distortions created by the regulatory framework. An additional constraint is the development of several small and often adversarial trade unions due to outdated trade union legislature dating to 1935. For instance, a union can be legally established with a membership of only seven persons; the positions of union officers and leaders are not restricted to persons employed in the industry or trade, thus leaving room for outsiders with political motivations to hijack the agenda of the union (Kelegama and Gunatilaka, 1996). Both these factors have inhibited job creation and led to the development of short-term jobs as evidenced by the large increase in casual, sub-contracted, temporary employment in the informal sector.

2.14 While the supply of formal sector jobs is restricted as a result of the policy environment mentioned above, the demand for such employment is strong in Sri Lanka due to the high levels of education and aspirations of labor force participants. In this context, successive governments have resorted to regular recruitment drives into the public sector. What is unusual is that the state also pays public sector employees with high school (A/Level) qualifications and below significantly more in cash wages than the equivalent market rate. These ad hoc recruitment practices as well as the wage incentives provide unemployed youth with a rationale to wait for public sector employment (see World Bank, 1999a for more details).

2.15 Due to these labor market restrictions, Sri Lanka's reasonable growth performance over the last two decades has fallen short of expectations in creating employment opportunities in the private sector. Sri Lanka's experience is in contrast with that of Mauritius and Chile for example, which with similar levels of sustained economic growth, succeeded in eliminating unemployment. In fact, Sri Lanka seems to be in the same conundrum as other Latin American countries which experienced prolonged periods of high unemployment between the late 1980s and early 1990s despite relatively healthy growth rates. The situation was initially interpreted in these Latin American countries as a specific consequence of the early stages of the reform process; it however soon turned out to be permanent, even in cases where the reform process was at an advanced stage. Their experiences contrasted sharply with that of East Asia, and showed that while the main engine of employment generation is undoubtedly economic growth, job creation is greatly affected by the conditions of the labor market (Box 2.2).

⁷ For example, the Department of Labor has only around 300 labor officers, a number that has not changed significantly from the mid-1960s. Labor Officers are insufficiently trained. While prior to 1977 university graduates, lawyers/proctors, and similarly qualified Sri Lanka Administrative Officers were hired as Labor Officers, after 1977 about 50 percent of recruits were from the Clerical Services. The training received by these officers are inadequate, in many cases amounting to only a few days of training in labor law (Kelegama and Gunatilake, 1996).

Box 2.2: Impact of Labor Market Conditions and Institutional Setting on Job Creation

The relationship between economic growth and employment generation is greatly affected by the functioning, efficiency, and institutional structure of the labor market. This is best illustrated by the striking differential in job creation over the last two decades between on the one hand the United States and European countries, and on the other hand East Asian versus Latin American countries. Empirical studies show that the labor cost elasticity (-0.8 to -0.3) usually tends to be twice the value of the output elasticity (0.15 to 0.5), and this latter response is also favorably affected, in terms of size and speed, by increases in the flexibility of labor markets. Thus labor reforms have a powerful impact on employment, especially when coupled with sustainable GDP growth.

The objective of labor market reforms is therefore *not* to lower wages, but to eliminate inefficiencies and waste, reduce transaction costs, better align costs and benefits of labor taxes, and introduce contractual and wage flexibility. In the process, distributional impacts such as a lower rate of wage growth for the protected sector and increased wage dispersion may occur, but the overall result is an increase in social welfare. Chile and Peru have been leaders in Latin America in undertaking bold labor market reforms over the last two decades. Both countries made union representation contestable, extended the freedom to organize unions, and reduced the costs (or procedure related uncertainties) of dismissals. They also reformed their labor codes to internalize the costs of labor disputes to parties directly involved. In addition, Peru replaced the tradition of tripartite negotiations for “final offer” arbitration, eliminated job security regulations, and reduced both the level and variance of severance payment packages for displaced workers. The significant growth in labor demand, reduction in unemployment, real wage increases, and improvements in employment conditions subsequently witnessed in Chile and Peru in the 1990s can be largely attributable to the implementation of these reforms.

Source: Guasch (1999). Labor Market Reform and Job Creation.

2.16 Labor market constraints pose a considerable impediment to Sri Lanka achieving a higher growth rate more fitting with its human capital and the aspirations of its people. The two youth insurrections in 1971 and 1987-89 are powerful examples of the damage caused by brewing social frustrations. The existing labor regulations and government’s employment and pay policies in fact protect those who are already protected, while perpetuating insecurity among the majority of the labor force not protected by the regulations or the state. In this light, it is important that Sri Lanka considers a long-term process to improve the conditions and institutional structure of its labor market. This is unquestionably a difficult task in the Sri Lankan context, given the level of political and social sensitivity to reforms of this nature. One possible point of entry is dissemination of information and engaging public debate on the topic of labor market and public administration reform, involving not only those stakeholders with vested interests, but also the large number of disempowered stakeholders who do not benefit from the prevailing status quo. While a long time horizon is needed to arrive at a politically and socially acceptable labor reform program through a consultative process, a few short-term interventions could also be considered which would ease some of the existing constraints on the labor market. The introduction of a more flexible, expeditious and transparent separation regime, especially through improvements in the labor dispute resolution/arbitration process appears as the most promising short-term intervention to mitigate the adverse impacts of the TEWA and assure a “win-win” situation for both employers and employees.

(iii) Improving land markets

2.17 Successive measures of land tenure, particularly in the paddy sector, were introduced in Sri Lanka since the early 1950s. These have established strong state control over land. Unfortunately, the land distribution program did not always establish clearly defined property rights. Land distribution was done to improve access to land and food production, and as a means of income generation for indentured workers. Two Land Reform Acts were passed in 1972 and 1975 that vested a total of one million acres of private and plantation lands with the State. About 20 percent of these lands were distributed to the landless in small blocks of 1/4 to 1 acre in size. In addition, between 1920 and 1985, 1.8 million acres of state land were also distributed under various forms of land settlement projects to landless families. Another 250,000 acres were added

under the Mahaweli Program and other irrigated settlement projects in the form of village expansion and regularization of spontaneous settlements. Today the State dominates land ownership in Sri Lanka (i.e., about 80 percent of the total land in the country). Of this, two-thirds is owned by the State but farmed by private farmers under varying tenure arrangements. Strict restrictions on land sales apply to less than 20 percent of total land parcels which fall under the Land Development Ordinance. As of March, 2000, about 80 percent of these lands have been converted to Jayaboomi grants. Hence, tenancy arrangements vary in degrees of restrictions on land use and transfer, ranging from very restrictive leases to land grants. Even land grants, while being permanent titles, have transfer restrictions in the form of prior permission required from government (World Bank, 1996a).

2.18 In addition to ill-defined property rights, several deficiencies prevail in land administration, especially in the areas of documentation, transfers and their use as collateral for mortgages. The Colombo Land Registry has very limited physical capacity and is unable to cope with a rapidly growing volume of transactions. Land market restrictions limit the transferability of leases and freeholdings, cause distortions, encourage illegal rent-seeking behavior, and increase transaction costs. Land administration problems also affect the system of property taxation, limiting potential municipal revenue and availability of land required for infrastructure and other development purposes. An additional detrimental effect of the ill-defined property rights and weak land administration is the constraints they impose on labor mobility. The Government has started addressing some of these problems. The aim is to transform the land administration system from one based on deeds and documents permitting private use of state land to one based on registration of titles. The establishment of a legal framework and development of capacity for implementing land titling would lay the foundation for increased tenure security, efficient land transactions and administration, and effectively functioning land markets.⁸

(iv) Continuing the program of privatization

2.19 Successes in privatization during the last decade have reduced the Government's control over the economy. A permanent institutional structure was established through the Public Enterprises Reform Commission (PERC) Act of 1996 to carry out privatization transactions. The list of divested enterprises includes the Colombo Gas Company, the Ceylon Steel Corporation, a 35 percent stake in SLT, the National Development Bank, a 40 percent stake in Air Lanka, and the long-term leasing of almost all plantation companies. The divestiture program during 1995-98 generated Rs. 34.7 billion (US\$ 525 million) to the Government from domestic and foreign investors. It has also generated stronger and more permanent revenue sources for government in the form of lease rentals and income tax/dividends, as well as encouraged large private investments in vital sectors such as gas, steel, telecommunications, etc.

2.20 The privatization program slowed in 1999 in terms of revenue collection. Privatization receipts were negligible (around US\$ 1 million), compared with 2.5 percent of GDP in 1997 and an average of 0.5 percent annually during 1994-96 and in 1998. There was some progress in restructuring statutory boards and public enterprises. These include the voluntary retrenchment of almost 7,000 workers from the Mahaweli Authority, the Sri Lanka Central Transport Board (SLCTB), the Sri Lanka Broadcasting Corporation, and the National Development Trust Fund (NDTF) through the provision of severance packages. The most noticeable advance in the last 18 months is the increased private sector participation in infrastructure. The Queen Elizabeth Quay of the state-run Colombo Port was handed over to South Asia Gateway Terminal (Pvt) Limited on a 30-year lease in a build, operate and transfer deal. In addition several small power generation projects came to financial closure (a total of 73.5 MW with Asia Power Ltd. and Lakdhanavi, and agreement with Mitsui for a 60 MW barge mounted power plant). Negotiations are underway with AES Ltd., for a 163 MW combined cycle power plant in Kelanitissa, and Letters of Intent for two 20 MW diesel power plants have been issued to Aitken Spence. Under the small

⁸ Draft World Bank Project Appraisal Document for the Land Titling and Related Services Project, January 1999.

capacities power purchase program, the Government has signed on a total of approximately 15 MW of grid connected mini hydro power projects, with an additional 10 MW of mini hydro projects in preparation. In February 2000, the Government approved a plan that is being supported by the Asian Development Bank (ADB) and IDA to restructure power sector institutions. This would involve the unbundling of the Ceylon Electricity Board into separate companies to handle power generation, transmission and distribution. This restructuring will be preceded by the establishment of an independent regulator. While the timetable for these reforms is prolonged, the fact that reforms are being envisaged in the power sector is in itself a breakthrough.

2.21 The successes described above demonstrate that despite the unfavorable domestic security situation, Sri Lanka can still attract both foreign and local investors. The privatization program implemented since 1995 is commendable and has benefited the Sri Lankan economy as a whole. About one-third of the sale proceeds was used to retire government debt. The privatized tea estates helped Sri Lanka to recapture its first place as world tea exporter. The sector continues to grow and employment opportunities have increased. Privatization of Sri Lanka Telecom and the liberalization of telecommunications services such as wireless loops explain the high growth rate of the sector in 1998-99 (45 percent annually). While the above successes are uncontested, some questions have been raised on the overall privatization process, i.e., the prices at which entities have been sold; the practice of according certain monopoly rights; and the constraints regarding labor retrenchment. These concessions are common in the privatization experiences of other countries and were needed to enhance the interest of reputable international bidders in the context of Sri Lanka's civil conflict and strident trade unions. Questions regarding transparency of privatization transactions should not devalue the successes achieved. Queries of this kind are common in most countries carrying out privatization, and point to the need for government to more widely communicate the objectives and policies of privatization.

2.22 The Government is presently preparing speedily for a new wave of privatization with ADB and World Bank assistance. In this context, it is important that the pace and scope of the privatization program be strengthened to encompass public banks and other areas still under the public sector (e.g., power, higher education, railways). As important is the need to avoid expansion of the public sector in areas where private sector activity is strong. The Ministry of Plantations has in recent years established a few factories under the "Tea Shakthi Program" in order to strengthen the policy of ensuring minimum guarantee prices for tea small holders. The Samurdhi Authority has established garment factories. The privatization of the Jaya terminal at the Port of Colombo has remained blocked for lack of support within the Port Authority; and the corporatization of the Postal Department is stalled.

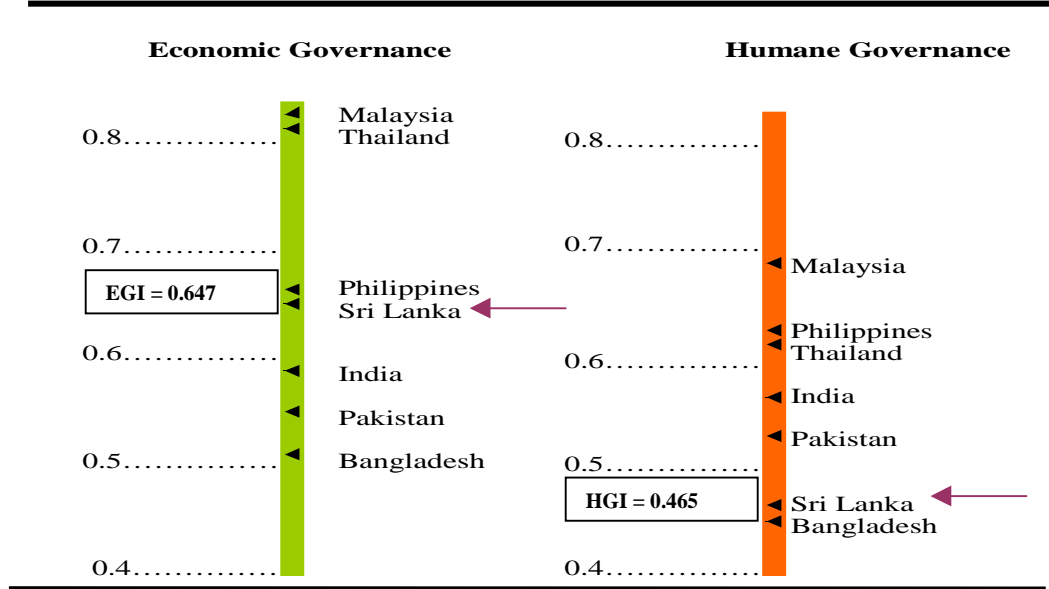
C. Strengthening Institutions and Governance in the Public Sector

(i) Overall Governance in Sri Lanka

2.23 Sri Lanka has several elements of good governance that has distinguished it from the rest of the region. It is a democracy with frequent elections and high participation of people in the political process; it also has a culture of judicial activism which resulted in a strong and far sighted legal framework at an early stage of its development process (e.g., laws in compulsory education and child labor were formulated as early as the 1930s). It was also the first country in South Asia to move to an open, market economy. The basic day-to-day operations of the economic system are relatively free of corruption, incentives for investment are transparent, and tariffs are low. Despite these early endowments and positive achievements, Sri Lanka is still ranked very low on the Humane Governance Index (HGI) developed by the Human Development Centre (Figure 2.2) in its 1999 report on "*Human Development in South Asia: The Crisis of Governance.*" The HGI comprises three pillars-- economic, political and civic governance. The ongoing conflict (as well as other internal uprisings in the past) is at the heart of this low ranking. The protracted conflict has rendered the administrative apparatus in the North-East non-

functional, contributed to rising violence and degradation of social and physical capital, destroyed trust between communities, and undermined the legitimacy of the State. Similarly, the violent Marxist insurrection of 1987-89 in the Southern part of the country and the State's repressive response contributed to civil disorder, gross human rights violations, and an overall breakdown of political and economic management. Sri Lanka has improved its record on human rights since 1994, but continues to be high on the list of countries with a poor record (U.S. State Department Country Report on Human Rights Practices, February, 2000). Similarly, while media freedom has improved somewhat since 1994, strict censorship of both domestic and foreign media over the recent months has elicited protest from international and local media groups.

Figure 2.2: Economic and Humane Governance Indices



Notes: The Humane Governance Index (HGI) comprises of three pillars: economic, political, and civic governance. The Economic Governance Index (EGI) ranges from 0.4 to 1.0; the HGI ranges from 0.38 to 0.94.
Source: Human Development Centre (1999).

2.24 Sri Lanka has also suffered from a gradual erosion of institutional capacity and economic governance in the public sector. Although ranked highest in South Asia in economic governance in 1999 by the Human Development Centre, looking beyond the Sub-continent, Sri Lanka is still ranked very low, i.e., 47th in a group of 58 countries. The relatively high ranking in South Asia is due to the open economic system, most liberal trade regime in the region, and several successes in privatization. However, the poor performance by international standards is due to the gradual weakening in public sector institutions and governance, especially characterized by increased politicization, a bloated bureaucracy, insufficient decentralization, and weak financial controls and public accountability.

2.25 The gradual erosion in economic governance in Sri Lanka started in the 1970s as institutions, the regulatory framework, and human resource capacity did not adapt adequately to the liberalization of the economy which began in 1977. Legislature governing land tenure, commercial law, and education, among others are outdated. The public sector's influence on the economy, in areas where it competes with the private sector, is still excessive while its role in areas where it complements the private sector needs adjustment. The intensification of the conflict since 1994 has added another dimension to this problem by diverting much needed resources away from infrastructure and human resource development. Sri Lanka should however be commended for maintaining reasonable macroeconomic stability and economic growth in the face of such obstacles. Nevertheless, Sri Lanka's fiscal deficit and per capita expenditures on defense are the highest in South Asia (Table 2.1). Corruption does not appear to be as serious an

issue as in many developing countries, but there has been increasing public discussion over the issue recently, especially with regard to government transactions and procurement.⁹

Table 2.1. Key Economic Governance Data, 1998

| Indicator | India | Pakistan | Bangladesh | Nepal | Sri Lanka |
|--|-------|----------|------------|-------|-----------|
| 1. GNP per capita (US\$) | 420 | 490 | 360 | 210 | 810 |
| 2. Total government employees (as % of total labor force) 1996-97 | 4.7 | 8.0 | 1.8 | 1.0 | 12.0 |
| 3. Central government finances (as % of GDP): | | | | | |
| Total revenue | 8.5 | 16.0 | 9.3 | 11.1 | 17.2 |
| Total expenditure | 15.3 | 21.5 | 13.3 | 18.9 | 26.3 |
| Overall budget deficit (including grants) | -6.8 | -5.5 | -4.1 | -7.8 | -8.4 |
| 4. Expenditure on health and education (% GDP) | 3.8 | 3.6 | 3.8 | 4.5 | 4.8 |
| 5. Per capita expenditure on defense (1997 Prices) US\$ | 14.0 | 28.0 | 5.0 | 2.0 | 51.0 |

Sources: World Bank; Human Development Center (1999); Central Bank of Sri Lanka; IISS, The Military Balance 1999-2000.

2.26 International experience has demonstrated the adverse impacts of weak governance on the business climate. Distortion of economic incentives, provision of poor quality public services, revenue losses, and erosion of public confidence in government, among others all have a negative effect on private investment. In Sri Lanka too, deteriorating economic governance has affected trust in public institutions as reflected by the findings of a Citizen's Survey carried out by the HDC (Human Development Centre, 1999). According to the survey, 75 percent of the respondents expressed reservations with the political system of the country, and only 18 percent felt that their political party represented public interest. Sri Lanka received the lowest scores for both these indicators in the five South Asian countries in which the survey was carried out (Technical Annex B of the HDC report). The following sections focus on three key institutional weaknesses in public sector management.

(ii) Reducing the size and number of institutions in the public sector

2.27 Sri Lanka's move to an open, market economy as early as 1977 has not been accompanied by similar transformations in the public administration (IPS, 1999). Sri Lanka's public sector is large, costly, and suffers from low effectiveness and efficiency. With 12 percent of its labor force employed in government in 1999 (17 percent if the semi-government sector is included), the country has the largest bureaucracy per capita in Asia (Table 2.2). Moreover, public sector workers with the lowest levels of education on average earn almost double that of their equivalents in the non-public sector (World Bank, 1999a). Top policymakers and professionals are insufficiently compensated, and Sri Lanka has the lowest salary compression ratio in South Asia. An inevitable fallout of this situation is the inability to attract and retain skilled expertise/talent in the public sector. There has also been a proliferation of government institutions over the last 20 years. The number of central ministries increased from 33 to 46 between 1980-85, reduced to 28 in 1990, and is now at 35. In addition, there are 40 provincial ministries. Sri Lanka also has 150 statutory boards and public corporations employing 170,000 people (compared with about 10 such organizations in Singapore, for example).

⁹ An independent Bribery Commission was established under a Parliamentary Act in 1994. Unfortunately, this Commission has been mostly inoperative. The Commission has recently received a fresh lease of life with the appointment of a new Bribery Commissioner to investigate allegations of corruption, fraud, and financial mismanagement in state transactions and activities.

Table 2.2: Size of the Public Sector^a in Asia

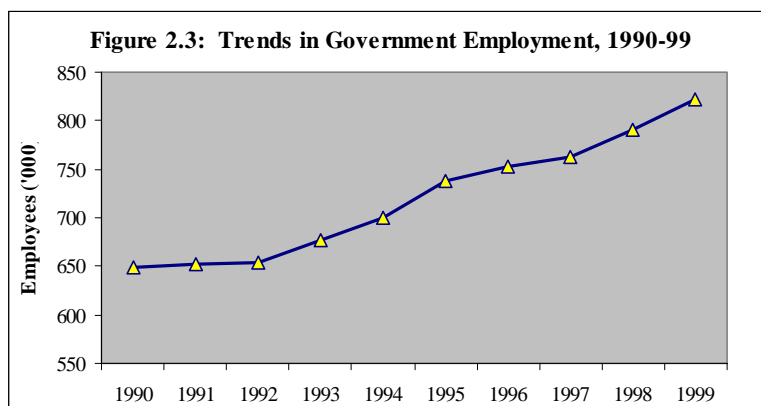
| Country | Public Sector Workers ^b (per thousand population) |
|------------------|---|
| Bangladesh | 10 |
| India | 19 |
| Indonesia | 21 |
| Malaysia | 45 |
| Pakistan | 19 |
| Philippines | 23 |
| Singapore | 37 |
| Sri Lanka | 57 |
| Thailand | 31 |

Notes: a. Includes public corporations and semi-govt. institutions.

b. The size of the entire public sector in each of these countries is based on most recent available data for the 1990s.

Sources: Schiavo-Campo (1997); World Bank staff estimates.

2.28 The large privatization program of recent years (especially in the plantation sector) has helped reduce the number of semi-government employees. Nevertheless, recruitment in government has increased both in absolute terms (Figure 2.3) and as a proportion of the labor force (from 10.8 percent in 1990 to 12.4 percent in 1999). This illustrates the difficulty of resisting political pressures in the absence of strong institutional mechanisms of control. The need to insulate the bureaucracy from political interference remains as pressing as ever. This would be best achieved by implementing the necessary constitutional reforms for restoring the independence of the Public Services Commission (PSC). The PSC suffered serious setbacks under the 1972 constitutional changes (Box 2.3 below). Its independence was abolished and the power of appointment, transfer, dismissal, and disciplinary control of all state officers was transferred to the Cabinet of Ministers.¹⁰ In its reconstituted form, the PSC is now merely an advisory body. The public service lost much of its institutional safeguards with this relegation of the PSC to an advisory body. Similarly, the 1978 constitutional change discontinued the practice of having a specific and permanent position for the Minister of Finance.



Source: Central Bank of Sri Lanka.

2.29 It is within this weakened administrative structure that public policies have taken a short-term and politically motivated bias, particularly damaging in an environment of frequent electoral cycles. The most obvious example of this is the regular large scale recruitment waves into the public sector, particularly common during election periods. For example, in May 1999, 10,000 unemployed university graduates were recruited into the public administration without their attachment to any of the existing professional schemes of service. The Sri Lankan Port

¹⁰ The weak management of the public sector is also due to the absence of a strong framework for decisionmaking at the Cabinet and executive levels. There is little prior scrutiny of proposals submitted for Cabinet approval by individual ministers (in most Parliamentary systems, this function is exercised by a strong Privy Council). Many critical decisions are approved without discussions as they are considered "Other Business."

Authority, which has consistently suffered from excessive personnel, has been recruiting new workers at a rate of 100 persons per month over the last two years (the present cadre of workers is around 19,000) at a time when the Colombo Port is faced with greater competition from other ports in the region. Therefore, in Sri Lanka's context of frequent electoral cycles and a polarized political environment, where implementation of policy reforms is difficult, large scale privatization and competition offer best opportunities. Encouraging regular forums for policy dialogue and discussions (e.g., Cabinet Sub-committees) as well as providing a strong incentive structure for attracting talent into the public sector would also contribute to improving the technical capacities and policy making processes.

Box 2.3: Depoliticizing the Public Service— Essential for Maintaining Social Stability

Recent cross-country evidence shows that meritocratic recruitment and promotion linked to performance are the most important structural features for improving bureaucratic performance, e.g., reducing delays and corruption. The Presidential Commission on Youth, appointed in late 1989 to examine the causes of youth discontent and unrest which led to the Marxist rebellion of 1987-89, has brought an additional dimension in this analysis. The report prepared by this Commission highlights that such meritocratic processes are also critical for maintaining social and political stability. The Commission reported in no uncertain terms that there was a strong consensus within the country that politicization and abuse of power and injustice were the main causes of youth unrest in Sri Lanka. In particular, the Commission felt that the politicization of employment, an extreme manifestation of which is the use of the "chit system" (the practice of receiving a letter from one's Member of Parliament in order to find public sector employment), was deemed by youth as incompatible with the basic norms of fairness, equity and merit. This was based on the representations made by civil society before the Commission suggesting an alarming degree of public dissatisfaction in this sphere of recruitment to the public service.

Hence, the Commission states that the 1972 Constitution, which removed the power of appointment vested in the Public Service Commission (PSC) and brought such appointments within the purview of the Cabinet of Ministers, triggered the politicization process which has had far reaching social repercussions. The Commission was strongly of the view that the reversal of this "pernicious process" is an urgent necessity, and the PSC, together with similar Commissions, should be given full autonomy to work out their internal systems of regulation with regard to appointment, promotion, transfer, disciplinary control and dismissal, and appeals with regard to these matters. Unfortunately, these recommendations have yet to be implemented. At present, the only recourse available to persons who perceive injustice in the public sector is the judicial process through the filing of Fundamental Rights petitions in the Supreme Court— a phenomenon which has been increasing over the years.

Source: "Report of the Presidential Commission on Youth," March, 1990.

2.30 Recent initiatives in public administration reform. There is today a high degree of consensus within Sri Lanka that the prevailing administrative system is in need of radical reforms. The Government has taken a few steps to address some of the problems mentioned above. These include: (i) the establishment of the Department of Management Services (DMS) to manage the cadre of official positions in the public sector, conduct institutional reviews, and review public sector salaries and incentives; (ii) establishment of the National Administrative Reform Council (NARC) to provide political leadership and commitment for administrative reforms; and (iii) some retrenchment in public corporations (see para 2.20). These initial efforts are commendable, but there is need for stronger actions with institutional content.

2.31 There are high expectations regarding the NARC's role in initiating reforms in the public administration. It is critical however that the lessons of past reforms are extensively drawn upon before any new comprehensive reform program is designed and implemented. There have been six attempts at public administration reform since the 1970s, and several reports have laid out possible reform options. Each of these attempts failed due to the lack of sustained political commitment, the piecemeal approach used, and the absence of permanent institutional settings to entrench the reform process. The most important lesson however is that real, in-depth administrative reform will not be possible unless the agenda is fully owned by the country, and backed by strong and sustained political commitment. This calls for wide stakeholder consultation (including all political parties) on the content of the reform program, and implies a

highly participatory consultation process which presents the pros and cons of proposed interventions, identifies possible winners and losers, and suggests politically-acceptable steps for implementing reform in a manner that is beneficial to all groups. These consultations should include interest-groups that are resistant to the reforms.

(iii) *Improving financial controls and public accountability*

2.32 Financial controls and public and administrative accountability have weakened over time. This has adversely affected timely and transparent decisionmaking within the public sector, as well as the delivery of services and implementation of programs/projects. The weakening of accountability is due primarily to the insufficient Parliamentary oversight and poor institutional structures/watchdog bodies. Sri Lankan institutions have not evolved much since the British colonial period, and the capacity and effectiveness of these institutions have deteriorated for lack of modernization and a reform of the accountability process. Legislative scrutiny of public finances is weak at all levels of government, and internal controls and accounting and auditing systems have not been sufficiently modernized in line with international best practice and the changing needs of the economy. The persistent tendency for underestimation of future current expenditures is an illustration of this weak parliamentary oversight function. Actual expenditures have exceeded annual projections almost every year since 1981 (Hulme and Sandaratne, 1996). The volume of supplementaries have also been quite large, reflecting the insufficient priority that successive governments have accorded to expenditure monitoring and control. There has however been some strengthening of expenditure control and monitoring over recent years (see World Bank, 1998b).

2.33 The two Parliamentary oversight committees (Committee on Public Accounts and Committee on Public Enterprises) which have ultimate control over public finances are largely ineffective, as no serious consideration is given to the recommendations of these committees. Compliance is weak and there is lax application of sanctions to officers who have committed misdemeanors. The worst that public officials fear from these committees is mild embarrassment. Moreover, the watchdog bodies do not function effectively due to a lack of transparency regarding Committee hearings, the infrequent convening of important Parliamentary Committees, as well as the inadequate capacity and administrative independence of the Auditor General's Department to support the work of Parliamentary committees. Meetings are held "in camera" and not accessible to the public, and committees such as the Finance Committee and the Defense Committee have not met for several years. The other important watchdog for the public—the media—has also performed poorly in Sri Lanka. State control over all forms of media since the 1970s (unlike in other countries in the region like India and Pakistan) has reduced its effectiveness over time. As a result, commentaries on public expenditures, bribery and corruption, for example are less common than in other South Asia countries. Polarization of the media is extreme (at present, about half of the country's newspapers are state-owned and the remainder are largely overseen by the opposition). Journalism training is poor, and almost non-existent in the area of investigative journalism-- Sri Lanka does not have a tradition of investigative journalism which would help explore important cases of abuse of public funds, and follow-through on reports of the Auditor General and Parliamentary Committees (Hulme & Sandaratne, 1996).

2.34 Additional weaknesses in financial control and public accountability are also obvious with regard to public sector procurement, especially in heavy infrastructure sectors. Procurement requires far more time in Sri Lanka than in other countries. The tender evaluation process and referral system involve numerous stages and required passes, which result in excessive delays in obtaining final approval. Sri Lanka is unique in using such a complex system and in having extensive delays in awarding contracts. Ironically, despite the efforts made to ensure transparency, the outcomes are often unsatisfactory in terms of the shortlisted and selected consultants/contractors. The final consequence of this tortuous procurement process is the country's reduced capacity for aid absorption and increased inefficiency in project

implementation. The ADB is assisting in the establishment of the Procurement Support Bureau which is expected to speed up government contracting and procurement, and strengthen the capacity of the Tender Boards and Tender Evaluation Committees to efficiently carry out their tasks.

2.35 Recent initiatives in strengthening financial controls. There is consensus today among stakeholders that an effective government is a priority for Sri Lanka. The Government realizes the importance of increasing public awareness on the adverse consequences of waste, fraud, and abuse of public funds. In this context, first steps have been taken to create broad alliances with key stakeholders including parliamentarians, civic society organizations, and the private sector. This approach is based on the recognition that such reforms require not only wide ownership by all stakeholders, but must also represent “home grown” solutions to the specific problems of Sri Lanka. The Government has also recently initiated a process to develop a strategy for strengthening and improving the effectiveness/capacity of critical financial accountability institutions such as the Auditor General’s Department (AGD) and Parliamentary oversight committees. For instance, there is commitment for improving and modernizing capacity in the AGD in areas such as performance report auditing, procurement assessments, enhancing revenue collection etc. To build capacity in areas of economic and investigative journalism, a series of “business and economics” and “investigative journalism” workshops are being planned with World Bank assistance. Finally, the Government is preparing a Legal Reform Project with the assistance of the World Bank which will revise the commercial law curricula, improve efficiency in the court system, and modernize institutions like the Registrar of Companies. While all of the above efforts are commendable, it is also important to obtain stronger commitment from stakeholders to move forward with a more ambitious program to include, for example, measures such as legislation on public right to information, media freedom, stronger incentives for reducing corruption, better controls on entry and exit in the public service etc.

(iv) More effective decentralization

2.36 Sri Lanka has not realized the potential benefits of a decentralized system of economic management. In particular, the decentralization implemented in Sri Lanka has not permitted high quality demand-driven service delivery to local populations. This is not surprising given that the first round of devolution in 1987 was introduced to the country more as a potential solution to the conflict in the North-East, than from a firm commitment to improve mechanisms for better service delivery and public administration to the provinces. A consequence of this ad hoc decentralization was the inadequate attention devoted to economic incentives in the initial design of the decentralized system, in particular the system of intergovernmental transfers. About 90 percent of Central Government resources to provinces is for recurrent expenditures (salaries), while capital expenditures of provinces are only around 7-8 percent of the total capital budget. Block grants are provided on a historical basis, as opposed to needs based, and no incentives are provided for revenue mobilization at the provincial level.

2.37 In this context, Sri Lanka has developed a highly complex and fragmented administrative system. The administrative apparatus has been duplicated at the provincial level, and there is confusion and ambiguity regarding roles and responsibilities of both elected and administrative arms of government. Contrary to the expectations of a decentralized system, the Central Government has not withdrawn from devolved functions, and has in some instances increased the centralization of functions. The increase in centrally managed National Schools and Hospitals over the years, and the use of Central Government agents (Divisional Secretaries) in implementing the Samurdhi program at the village level are examples of persisting centralization. In addition, there has been a tendency to centralize at the Provincial level, thus leaving the third-tier local governments (Pradeshiya Sabhas, Municipal Councils, and Urban Councils) with less resources and capacity than previously.

2.38 Sri Lanka is in the midst of preparing for a second round of devolution as a political solution to the on-going conflict. It is hoped that Sri Lanka's past experience will be taken into account in the design of the new system. In the meantime, several new initiatives have been taken by government to improve the functions of the existing decentralized administrative system. These include: (i) a Province Specific Development Grant introduced in early 2000 to replace the previous Medium Term Investment Program (MTIP) and ensure that capital expenditures are transferred directly from the center to the provinces;¹¹ (ii) the initiation of a joint effort between the National Planning Department of the Ministry of Finance and the Finance Commission to monitor implementation of capital investment projects at the provincial level; (iii) preparation of a technical study to propose new criteria for grant awards to provinces by the Finance Commission; and (iv) establishment of a Commission on Local Government Reform to provide recommendations for strengthening the third tier of government.

(v) *Addressing the governance weaknesses*

2.39 The problems highlighted above should not mask some of the positive aspects of governance in the country, i.e., reductions in human rights abuses/state sponsored violence and somewhat improved media freedom over the last five years, a fairly well developed human resource base, a relatively strong and independent judiciary, a cadre of dedicated professional staff in government, and genuine efforts to address some of the fundamental economic problems — as evidenced by further privatization, trade liberalization, etc. Nonetheless, the challenges at hand are daunting, and the task is even harder for Sri Lanka which is steeped in a lingering civil conflict and an increasingly politicized environment. In this context, the most urgent task is to define clear priorities in removing the most potent bottlenecks constraining good governance in the country. Sri Lanka also needs to formulate consistent policies which will help build the confidence of the private sector for long-term investment.

2.40 Strengthening the public administration system is an obvious necessity. However, war being the biggest enemy of development and a governance problem of significant proportions, achieving peace and reconciliation in the country is the priority area of action. It is in this effort that the Government has been preparing a package of constitutional reforms aimed at devolving more power to Provincial Councils, especially in the North-East. Although such a reform package is crucial, it is also important that the suboptimal policies, which may have in the past created inequities between specific ethnic communities and social groups, be identified, with efforts made to redress the resulting adverse impacts. As Easterly and Levine (1997) show, political instability, rent-creating economic policies and poor public goods may reflect a more fundamental country characteristic, namely ethnic divisions. The authors draw on empirical findings from a cross section of economies to suggest that ethnic conflicts affect the economy in more subtle ways than stimulating inter-ethnic violence. These cross country findings suggest that it is in understanding the complexities of ethnic and social divisions that greater assurances of preventing armed conflict or insurrections in the future may emerge. Hence, efforts should be made to remove poor policies of the past and rebuild trust among all segments of the population in Sri Lanka.

¹¹ MTIP grants were channeled to the provinces through central line ministries, a system which created delays and inefficiencies.

CHAPTER 3

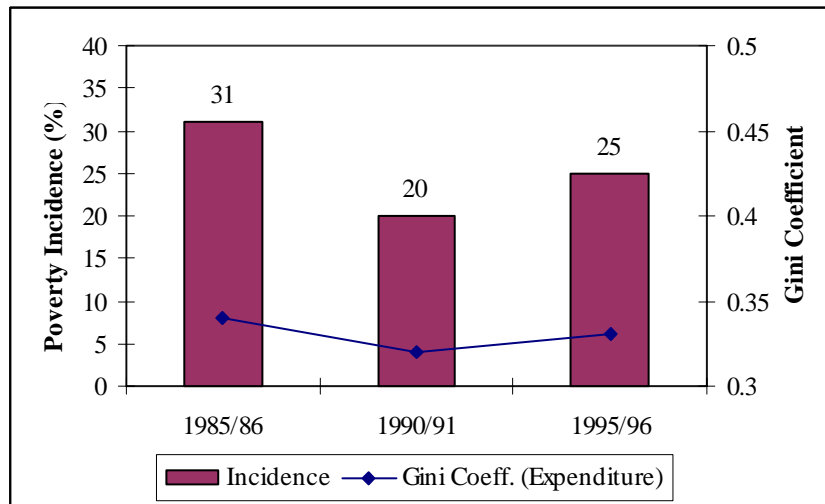
REDUCING POVERTY

Introduction

3.1 In keeping with its long tradition of addressing social equity concerns, Sri Lanka has always put efforts to reduce poverty at the top of the governmental agenda. It was one of the first developing countries to understand the multi-dimensional nature of poverty, and has strongly emphasized policies aimed at promoting free health and education as early as the 1930s. Thanks to large state investments in such social programs and early efforts at universal suffrage and female empowerment, Sri Lanka's impressive achievements in social development have had positive impacts on even the poorest. Since the 1980s, the Government has also added large programs of income support in the form of food stamps and other transfers, maintaining policies that set Sri Lanka apart from the rest of South Asia and the developing world. In addition to its strong social indicators, Sri Lanka has virtually eliminated starvation and destitution.

3.2 The relationship between overall economic performance and the reduction of poverty in Sri Lanka is currently the focus of new analytical work that promises additional insights. Sri Lanka has had healthy economic growth over the last 15 years, and poverty has declined. Despite the commendable long-term trend in poverty reduction from the mid-1980s to mid-1990s however, a large part of the population remains vulnerable to income fluctuations. This is most evident in the rise in poverty levels in 1995/96, which can be attributed primarily to the severe drought in 1996. As shown in Figure 3.1, the percentage of households below the poverty line declined from 31 percent in 1985/86 to 20 percent in 1990/91 but rose again to 25 percent five years later. The decline is likely to have resumed to some extent after 1996.

Figure 3.1: Incidence of Poverty and Consumption Inequality, 1985-96



Notes: Poverty incidence estimates exclude the North-East and are based on a local consumption poverty threshold of 2,500 calories and 53 grams of protein per day and male adult (20-39 years) equivalent. Reference poverty line is Rs. 791.67 per person per month at 1995/96 prices.

Sources: Datt and Gunewardena (1997) based on 1985/86-1990/91 HEIS; Gunewardena (2000) based on 1995/96 HEIS.

3.3 The following sections draw on ongoing poverty-related analyses by the Government of Sri Lanka and the World Bank. They present the preliminary findings on income poverty (trends and profile) and their relations with the patterns and distribution of growth. Sri Lanka's poverty programs are discussed briefly.

A. Income Poverty in Sri Lanka

3.4 Over the last two years the Government has made a strong effort to understand the nature of poverty in Sri Lanka with a view to formulating a policy framework for poverty reduction. As a result, today there are several sources of information on poverty in Sri Lanka. This report draws primarily on three information bases: (i) the Department of Census and Statistics' Household Expenditure and Income Surveys (HEIS) of 1985/86, 1990/91 and 1995/96— three high quality, comparable datasets based on a large sample size of around 20,000 households in all provinces of the country except the North-East;¹² (ii) a 1998/99 pilot qualitative survey using techniques of Participatory Rural Appraisal (PRA) and Rapid Rural Assessment (RRA) carried out in all provinces of the country including the North-East (Shanmugaratnam, 1999); and (iii) existing research on various aspects of poverty in Sri Lanka, including the war-affected areas. Wherever possible, the report also draws on the findings of the Central Bank's Consumer Finances Survey (CFS) of 1996/97— a dataset of much smaller sample size and with no strict comparability with the HEIS (unfortunately, and contrary to standard practices in South Asia, the CFS data are not in the public domain). In late 1999, an integrated quantitative and qualitative survey (Sri Lanka Integrated Survey--SLIS) was launched with World Bank assistance in all provinces including the North-East. The SLIS, which is scheduled to be completed end of 2000, will provide a wide range of additional indicators on the current state of poverty in Sri Lanka. This report draws only on some preliminary findings of the qualitative component of the SLIS.

3.5 The poverty estimates presented in this report are calculated using poverty lines based on the value of a food basket that provides the required minimum calorie and protein intake, as well as allows for a certain empirically determined proportion of expenditures on non-food items. Poverty lines are adjusted for regional variation in prices and reflect temporal changes in cost of living of low-income households (see Datt and Gunewardena (1997) for the methodology, and Ravallion (1994) for issues in poverty measurement practices).¹³ Five important findings on poverty trends between 1985-96 emerge from the analysis of the HEIS datasets:

- Income poverty remains high in Sri Lanka with at least one-fourth of the population living below the poverty line. This estimate does not capture the North-East, where poverty and social development are deemed to have worsened with the escalation of the war.
- The long-term trend in overall poverty levels (measured in terms of incidence, depth, and severity) shows a decline over the period 1985-96. This long-term trend is also supported by the findings of the 1986/87 and 1996/97 CFS data of the Central Bank. The HEIS data show that there has been slower progress in poverty reduction and greater volatility in poverty levels between 1990-96. The depth, severity and incidence of poverty in the period have all followed the same pattern, as has inequality (Figure 3.1 and Annex Table 15).
- Urban poverty declined during 1985/86-1995/96. There has been an even more significant drop in rural poverty over the period, although with greater fluctuations. In the estate sector, poverty rose during 1985-96 (Figures 3.2a-c).¹⁴
- Income poverty in Sri Lanka is primarily a rural phenomenon (Figure 3.2b), with approximately 85 percent of poor households located in rural areas whereas the total rural population is around 75 percent. As in most developing countries, poverty levels are particularly high among casual laborers employed in agriculture, mining, construction, and the informal sector.
- Acute regional disparities in poverty persist and widened between 1990 and 1996. Some

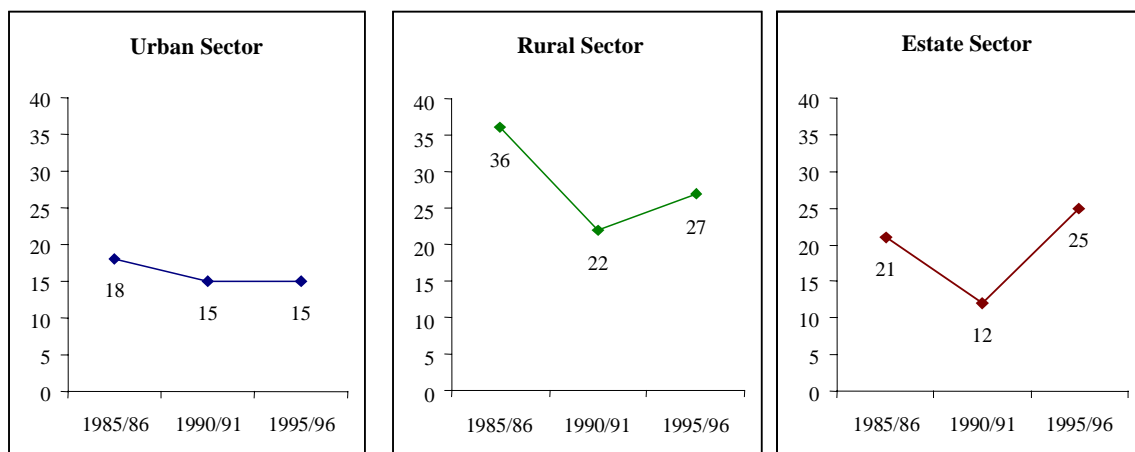
¹² The next HEIS of the Department of Census and Statistics is scheduled for 2001/02, and would provide more comprehensive information on poverty during the decade of the 1990s.

¹³ Nanayakkara's (2000) estimates of poverty based on the same datasets indicate that the proportion of poor households has fallen from 30 percent in 1995/96 to 27 percent in 1996/97. However, his estimates are based on a different methodology using per equivalent food expenditure as a measure of poverty. This definition of poverty imposes little restriction on total expenditure, and instead declares households with food expenditures below those of the households just achieving required calorie intake as poor.

¹⁴ In 1989/90, the classification of urban, rural and estate was changed to urban and rural only, but analyses of economic trends have continued to distinguish among the three sectors.

districts in the North-East province are likely to suffer the worst deprivation, but several other regions also experience severe poverty — e.g., Uva, North Western, Sabaragamuwa, and North Central provinces. In these areas economic activities are predominantly non-irrigation paddy farming, rubber production, minor export crops, and subsidiary food crops. The economic hub of Sri Lanka — the Western Province -- has the largest number of modern industrial and commercial enterprises and its poverty incidence of 14 percent is about half that of other provinces in Sri Lanka (Figure 3.3).

Figures 3.2a-c: Disaggregated Trends in Poverty Incidence, 1985-96



Sources: Datt and Gunewardena (1997) based on 1985/86-1990/91 HEIS; Gunewardena (2000) based on 1995/96 HEIS.

Box 3.1: What has Happened to Poverty Since 1996?

The above poverty trends should be interpreted in the context of the severe drought that affected the entire economy, but especially the agriculture/paddy sector in 1996. Unfortunately, at this stage there is no comparable data available beyond 1996 to assess the temporary nature of this shock on poverty incidence. It should be noted however that even if the 1995/96 poverty incidence is an aberration in Sri Lanka's long-term poverty trend, it is a puzzle that given the country's strong growth performance since the early 1980s, a significant proportion of the population remained highly vulnerable to income fluctuations.

In the view of the Government of Sri Lanka, the poverty level is likely to have fallen back to its long-term trend after 1996. This view is based on the improved performance in the agriculture sector (both output and prices), falling unemployment and increased female labor force participation, declining real food prices, and increases in calorie intake (CFS, 1996/97). The calculation of poverty incidence based on 1996/97 CFS data will provide additional insights on the poverty incidence in Sri Lanka.

Several government initiatives over the last decade may also have reduced poverty in the second half of the 1990s and into the 21st century. These include a strong expansion in rural electrification; rehabilitation of irrigation tanks, including in the North-East; establishment of industrial estates and garment factories in rural areas; and expansion of telecommunication services, among others. In the 2000 Budget, measures have been introduced to increase the effectiveness of development assistance in rural areas-- a Province Specific Development Grant is now allocated directly to the provinces to meet urgent development needs. The Government's development program, as spelled out in *Vision for the 21st Century*, aims at raising the income levels of the poorest 8 million by increasing their share of income from the current 4 percent to 15 percent by the year 2010.

B. Additional Dimensions of Poverty

(i) Human development outcomes in poorest regions

3.6 Poverty in Sri Lanka is highly correlated with levels of human development that reflect gaps in the provision of publicly provided goods and services. The poorest provinces (excluding the North-East on which data is presently unavailable) of Uva, North Western, Sabaragamuwa, North Central and Central, for instance, have the highest proportions of inhabitants without

access to safe water and sanitation (30-50 percent), and electricity (65-75 percent) in the country. They also have the highest rates of adult illiteracy, premature deaths, and out of hospital births (Table 3.1).

Table 3.1: Income and Human Poverty by Province (percentage of population)

| | Population, 1994 (millions) | Income poverty incidence | Deaths before age 40 | Adult Illiteracy | No access to safe water | children not fully immunized | Births not in institutions | No access to electricity | No access to safe sanitation |
|--------------|-----------------------------------|--------------------------------|----------------------------|---------------------|-------------------------------|------------------------------------|----------------------------------|--------------------------------|---------------------------------------|
| Western | 4.7 | 13.6 | 0.09 | 6.2 | 18.2 | 14.4 | 3.0 | 35.3 | 11.2 |
| Central | 3.9 | 27.9 | 0.10 | 15.3 | 26.1 | 13.8 | 21.5 | 65.0 | 24.4 |
| Southern | 2.6 | 26.5 | 0.07 | 11.2 | 35.0 | 10.4 | 8.6 | 59.2 | 20.3 |
| N.Western | 2.0 | 33.9 | 0.09 | 8.1 | 34.6 | 3.8 | 12.8 | 68.7 | 30.3 |
| N.Central | 1.3 | 31.2 | 0.15 | 9.6 | 48.0 | 2.1 | 20.0 | 72.2 | 31.7 |
| Uva | 1.0 | 37.0 | 0.10 | 17.1 | 44.6 | 12.1 | 36.1 | 73.5 | 34.1 |
| Sabaragamuwa | 1.1 | 31.6 | 0.07 | 11.2 | 32.1 | 12.0 | 16.9 | 74.4 | 22.7 |

Sources: Gunewardena (2000) based on 1995/96 HEIS; UNDP (1998).

3.7 The poor suffer mostly from low-quality social services, with disparities especially prominent in the rural and estate areas where health, education, housing and safe water and sanitation services are far below the national average. Although access to social facilities is generally broad, education and health outcomes of the poor are well below the national average. Malnutrition, reflected in low birth weights, stunting, wasting, and anemia is high. Educational opportunities are lacking in poor communities, as evidenced by teacher shortages, insufficient school infrastructure, and low quality of educational inputs such as textbooks and other teaching material in remote rural areas (Aturupane, 1997). The HEIS 1995/96 data show that poverty incidence by education level of household head is highest among those with no schooling (38 percent) and only primary schooling (34 percent). The private rates of return to primary and secondary schooling are also very low in Sri Lanka (4 percent for both levels), unlike in most other countries (Aturupane, 1998). This could reflect a low return on assets arising from structural constraints in the economy which affect the poor disproportionately, and/or inappropriate quality of education provided, especially to the poor, to generate sustainable incomes. These explanations are supported by the fact that the poor and the non-poor in Sri Lanka have on average around the same number of years of schooling (8-9 years), which is very high by developing country standards.

(ii) *Human poverty in the North-East and border villages*

3.8 The extent of social and economic deprivation in the North-Eastern province is not precisely known as the security situation has precluded the inclusion of the province in island-wide household surveys carried out since the mid-1980s. The Sri Lanka Integrated Survey, currently being carried out throughout the country, will for the first time provide comprehensive qualitative and quantitative data on poverty in the North-East. Despite the lack of data, available information and small scale surveys show that healthcare, education, and local economic conditions are worse in the areas torn by the civil conflict than in the rest of the island.¹⁵ The Government of Sri Lanka has consistently delivered assistance in the form of food, medicine, and essential supplies to the conflict-affected areas, as well as conducted relief and rehabilitation work in the North-East. As a result, the civilian population in the area has been somewhat protected. Despite these efforts on the part of government and the NGO community, the people in the conflict-affected areas and border villages face numerous hardships.

3.9 The most pervasive deprivation in the North-East arise from the loss of civilian lives, physical and psychological trauma, internal displacement, the breakdown of community and

¹⁵ The information in this section is based on numerous sources: Ministry of Health (1998); UNDP (1998); Rienhard and Kraemer (1999); Medecins Sans Frontieres (1999); Shanmugaratnam (1999); Thiruchandran (1999).

institutional networks, the disruption of children's education, and deteriorating health conditions (UNDP, 1998). The proportion of female-headed households in the region has increased and a large number of young widows with children depend heavily on state or NGO assistance (Thiruchandran, 1999).

3.10 Delivery of health services has deteriorated in the conflict areas, border villages and welfare camps. Three immediate health risks have recently been identified. The first is the rise in the most virulent form of malaria (*P. Falciparum*) due to an absence of proper control activities. Respiratory infections and water borne diseases are also on the rise due to inadequate shelter, damage to sewage systems, and unsanitary conditions in welfare camps. The second is the worsening in maternal and child health, especially the nutritional status of children, due to food shortages and the deterioration of health services. The third and most challenging concern relates to the psychological trauma associated with the conflict, displacement and disintegration of community and family structures. Containing these health risks are difficult due to the problems in recruiting and retaining qualified medical personnel as well as in obtaining required equipment and pharmaceuticals (Ministry of Health, 1998; information from WHO, World Bank, UNDP, UNICEF initiatives on rolling back malaria).

3.11 Education also has suffered from the frequent relocation and destruction of school buildings and equipment. Despite these adversities, state-run universities and many schools continue to function. However, Jaffna, once a center of educational excellence and achievement, today has the highest school drop-out rates in the country. Children from families displaced by the conflict have their schooling interrupted, many schools remain closed, and children are forcibly recruited or lured into the LTTE movement. School attendance among poor children is irregular and they are often obliged to sacrifice schooling for work that contributes to family income. Schools in war-torn areas and border villages also experience difficulties in recruiting and retaining qualified teachers (UNDP, 1998).

3.12 Finally, the conflict has a strong impact on the local economy and on all communities living in the area. Farmers and fishermen are reluctant to invest in capital assets or any long-term enterprises. Irrigation systems have been destroyed, and electrification is low. Among the equally adverse indirect constraints of the war are the high cost of transporting goods to and from the North-East region, inefficiencies created from regular security checks, and restrictions on fishing time and the horsepower of boat engines. The mobility of communities in the conflict-affected areas, especially of those in welfare camps, is restricted, thus affecting their access to economic opportunities.

(iii) Vulnerability, insecurity and marginalization

3.13 Recent information has helped create a more comprehensive perspective on poverty in Sri Lanka. The pilot PRA survey conducted between 1998 and 1999 in 19 villages, including some in the North-East, as well as existing research studies provide an important complement to the "income poverty" findings of the quantitative surveys. They show, for instance, that many of Sri Lanka's poor experience some of the same life challenges that face their counterparts in other developing countries. These *sociological aspects of poverty* that often typify low-income households and communities in Sri Lanka are described below.

3.14 **Women and children in poor households face barriers to upward mobility.** Sri Lanka is unique in South Asia in that there is no significant gender inequality either in access to health and education services, or in economic welfare and income poverty levels. Except in urban areas, HEIS data (which exclude the North-East) do not reveal significant differences in poverty levels between female-headed and male-headed households. The data suggest that informal social security systems (especially the extended family network) as well as formal support from both NGO and government programs, which do not discriminate on the basis of gender, provide relatively good protection to rural and estate households headed by women. The absence of such

gender disparities, however, does not preclude the adverse effects of other socio-economic forces on women from poor households. The PRA qualitative survey as well as existing research highlight some factors affecting the welfare of poor women in Sri Lanka. First, responses from the pilot PRA qualitative survey show that women in casual non-plantation agricultural labor earn 50-60 percent lower daily wages than their male counterparts. Second, while government and NGO/donor-sponsored poverty programs do not discriminate on the basis of gender in the distribution of benefits, responses from the PRA survey indicated that women from poor households continue to encounter barriers in achieving leadership roles and decision-making prerogatives in community organizations/traditional associations (Shanmugaratnam, 1999; Parker, 1999). Third, increasing evidence indicate that women face physical insecurity arising from the conflict and problems of domestic violence and spousal abuse associated primarily with alcoholism (Wijayatilake, 1995; Silva, 1998). Finally, according to most recent data available from the Department of Census and Statistics, the number of female headed households has increased from 16 percent in 1981 to 21 percent in 1994 (DCS, 1995; Thiruchandran, 1999). This number is considered an underestimation by the Centre for Women's Research since available surveys do not include many parts of the North-East where female headed households are on the rise.

3.15 As with women, the opportunities and well-being of children in Sri Lanka on average compare favorably with that of children in the rest of South Asia. Access to education is high, the problems of street children and child labor are reasonably low in comparison to other developing countries, and few children live in absolute destitution. Nonetheless, Sri Lankan children, particularly from poorer households, do face some of the risks common in developing countries. For instance, child malnutrition is high throughout the country, but especially in the poorer regions. Children are also prone to physical and psychological trauma associated with the conflict, as well as abuse and exploitation linked to dysfunctional family environments (e.g., single parent households due to migration; alcoholism; domestic violence) and commercial sex tourism (Seneviratne, 1998; de Silva, 1996). Recognizing these risks facing children, the Government has appointed a Presidential Task Force on Prevention of Child Abuse, and created a National Child Protection Authority under the purview of the President.

3.16 **Some poor communities are marginalized or excluded.** The results of the PRA pilot survey indicate that as in other developing countries, the poor in Sri Lanka suffer from various types of social exclusion and marginalization. Although the caste discrimination that is common elsewhere in the region has little impact today in most parts of Sri Lanka, various displaced communities are often kept on the fringes of the social mainstream. Among them are groups affected by the conflict, by village expansion schemes and by the irrigation schemes of the last three decades. Cut off from their accustomed networks of personal relationships, these communities have lost social capital. The mobility and access to economic opportunities of many estate workers are constrained due to language barriers, social status, or lack of national identity cards (Silva and Shankar, 1999). Such factors have impeded access to employment outside the estate sector, especially when several estates were abandoned as non-viable after the privatization program. Respondents from poor households captured in the pilot PRA survey expressed feelings of vulnerability and insecurity, the sense that they were excluded from decision-making processes, and were powerless to control their economic and social lives or overcome political and ethnic discrimination. Geographical and social isolation, especially in remote, traditional ("purana") villages,¹⁶ as well as chronic indebtedness and lack of access to credit are some of the other important disadvantages that the survey identified as factors preventing certain groups from participating in mainstream economic opportunities and escaping poverty (Silva, 1998; Parker, 1999).

¹⁶ Purana in Sinhalese means Ancient. About half of the 15,000 villages of Sri Lanka are of the Purana type, and 5-10 percent of them suffer from geographical isolation.

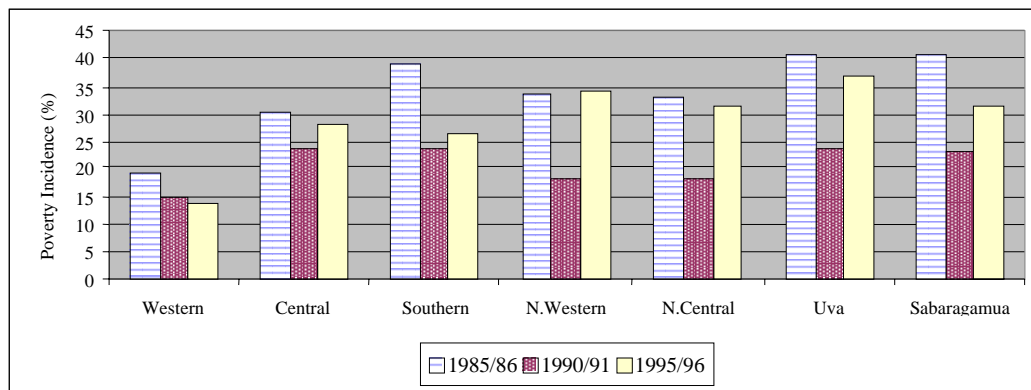
C. 1990-96: Progress in Poverty Reduction Slows and Regional Disparities Widen

3.17 The reduction in poverty in Sri Lanka from 31 percent in 1985/86 to 25 percent in 1995/96 (Figure 3.1) reflects improved growth across sectors and regions following economic liberalization reforms and heightened investment in non-farm activities. The more prominent decline in poverty between 1985/86 and 1990/91 is the lagged effect of sustained levels of high economic growth during the 1980s and the relatively low intensity of the civil conflict. It should also be noted that the year 1990 was somewhat unusual because overall economic growth rebounded from a very low base after the slow growth years of 1987-89 and agriculture growth (especially paddy) was the highest in the decade (Figure 3.4).

3.18 The latest HEIS data show that poverty increased from 20 percent in 1990/91 to 25 percent in 1995/96. They also point to an increase in regional disparities despite good macroeconomic performance during the early 1990s. Most noticeably, the Western province has seen a decline in poverty, while all other provinces have experienced a worsening between 1990-96 (Figure 3.3). The poverty trend between 1990-96 is somewhat puzzling given that during the period economic growth averaged around 5 percent, with the impetus coming from manufacturing and services; inflation slowed despite some volatility in 1996 (peaking at 16 percent); unemployment fell from 16 percent in 1990 to 11 percent in 1996; and private remittances, mostly from housemaids working in the Middle East, doubled in US dollar terms. Another positive feature is that despite higher defense expenditures and efforts to consolidate the fiscal deficit, allocations on education and health services were maintained; subsidies/transfers to households were however slightly eroded due to the consolidation of food stamps and the removal of the wheat subsidy (see Annex Table 16).

3.19 Analysis currently underway seeks a better understanding of the link between poverty and economic policies/performance during the last decade. HEIS data provide a useful source of information, but the availability of only two data points calls for caution in interpreting trends. In addition, the year 1996 was very unusual in that it saw the most severe drought of many years. Nonetheless, the significant increase in poverty incidence in 1995/96 shows that the poor remained highly vulnerable to income shocks and were thus unable to take advantage, in a sustained manner, of the opportunities generated by the growth in the early 1990s. The acceleration of the civil conflict and the need for higher defense expenditures also diverted much needed resources away from development purposes— an important factor undoubtedly contributing to the slower progress in poverty reduction. Other explanatory factors include disparities in the level of human capital (paras. 3.6-3.7) and structural impediments in the economy (especially in the areas of land and labor).

Figure 3.3: Incidence of Poverty by Province, 1985-96



Sources: Datt and Gunewardena (1997) based on 1985/86-1990/91 HEIS; Gunewardena (2000) based on 1995/96 HEIS.

(i) Fluctuating economic performance

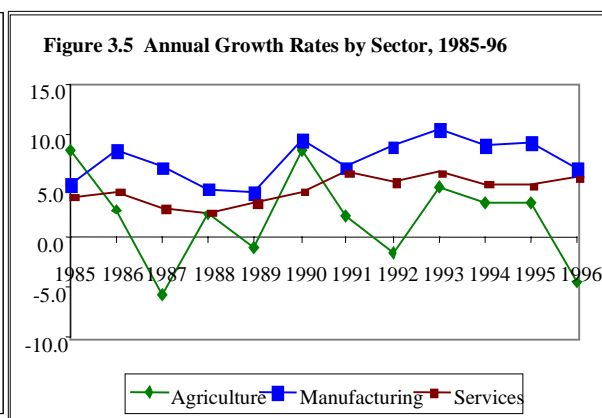
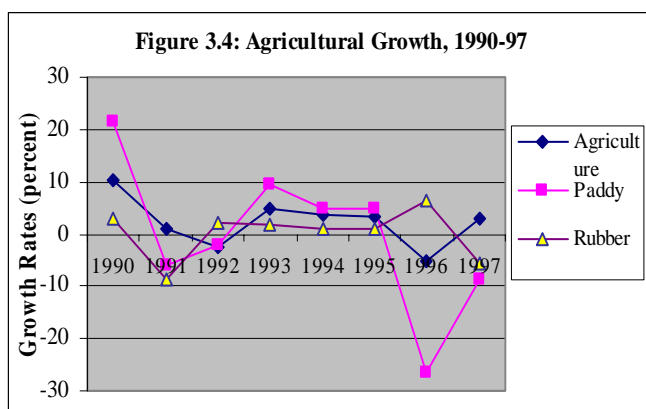
3.20 Emerging international evidence on the relationship between economic growth and poverty reduction reveal that macroeconomic crises cause large increases in poverty. The poor are very vulnerable to such instability and to negative shocks in particular. Sri Lanka is no different than other countries in this regard. Overall macroeconomic performance during 1990-96, although relatively good, was marked by some positive and negative external shocks that impacted strongly on certain regions and sectors in some years. Due to an impressive recovery in agriculture, for instance, economic growth recovered robustly in 1990 (6.2 percent) from the stagnation experienced in 1988-89 (1.3 percent) as a result of the crippling Marxist youth rebellion. On the other hand, the setbacks of 1996 included both a prolonged drought that affected agriculture and manufacturing, and a worsening of national security due to the conflict (e.g., the bombing of the Central Bank that affected business confidence, tourism, and foreign investments). Agriculture and paddy production contracted in 1996 by 5 and 27 percent, respectively, and economic growth fell to 3.8 percent— the lowest in the decade.

3.21 The 1995/96 HEIS data show the significant effect of fluctuating income growth on poverty trends. A significant proportion of the population is clustered around the poverty line and is vulnerable to small changes in income. This is reflected by the fact that a 20 percent increase in the poverty line raises the incidence of poverty in 1995/96 from 25 percent to 39 percent. Yet such a rise in the poverty line represents only a slight increase in consumption expenditures, only the minimum needed to provide a little discretionary spending. Insufficient mechanisms for risk management in agriculture, the large increase in casual and temporary employment in recent years (Central Bank, 1999b), and the poor targeting of beneficiaries through poverty programs (see Section D below) contribute to the vulnerability and insecurity of Sri Lanka's poor.

(ii) Insufficient distribution of growth and structural rigidities

3.22 International evidence also show that both the pattern and the distribution of growth are important in determining whether economic growth translates into equivalent reductions in poverty. In countries like Sri Lanka, where the majority of the poor live in rural areas, agricultural growth can lead to significant poverty reduction. The 1995/96 HEIS data confirm that the incidence of poverty is highest among households deriving their income primarily from agriculture (32 percent).¹⁷ Consequently, insufficient per capita growth in agriculture was undoubtedly a contributing factor to the slow progress in poverty reduction between 1990-96 (Figures 3.4 and 3.5). Official statistics show that agriculture grew by an annual average of only 1 percent during 1990-96. The paddy sub-sector contracted by an annual average of 4 percent during this period, while growth in the smaller rubber and mining sub-sectors was only 1-2 percent. As mentioned previously, the devastating drought of 1996 and the resulting sharp contraction in paddy production (27 percent) and overall agricultural production (5 percent) are other important factors explaining the increase in poverty in 1995/96, especially in the rural and estate sectors. The restructuring of estates in the early stages of privatization would also have contributed to the increase in poverty in the estate sector (e.g., abandonment of non-viable estates, wages linked to productivity, reduction in state provision of social services, etc.).

¹⁷ The incidence of poverty is highest in mining— 44 percent— but the contribution of this sector to overall poverty is insignificant.



Source: Central Bank of Sri Lanka.

3.23 Growth has been slowest in the three poorest provinces of Uva, North Western, and the North (Table 3.2). In contrast, the Western province, with its large concentration of industrial and higher-level service sector activities, achieved impressive growth and the lowest incidence of poverty. It is also the only province to experience a decline in poverty between 1990 and 1996. The Uva province has remained a poor region due mainly to its fairly extensive dry zone and weak infrastructure facilities. The economic contraction between 1990 and 1995 in the Northern province is a direct consequence of the civil conflict. More surprising is that poverty levels remain high even in some of the good growth performing provinces like North Central and Western, indicating that the poor are unable to take full and sustained advantage of gains from economic growth. Starting from a low base, growth has been impressive in the North Central province due to relatively strong agricultural performance in areas where irrigation water is available. Many parts of the province, however, remain poor, especially the non-irrigation and border areas affected by the conflict. Both the North Central and North Western provinces suffered the worst from the drought, while the areas bordering the North were affected by the conflict. As a result, poverty rates more than doubled in these two provinces during the period.

Table 3.2: GDP Growth and Poverty Incidence by Region

| Province | Ann. Ave Growth 1990-95 (%) | Growth Ranking | Poverty Incidence (%) | | Poverty Ranking | |
|---------------|-----------------------------|----------------|-----------------------|---------|-----------------|---------|
| | | | 1990/91 | 1995/96 | 1990/91 | 1995/96 |
| North Central | 9.9 | 1 | 18.2 | 31.2 | 3 | 4 |
| Western | 6.4 | 2 | 15.2 | 13.6 | 1 | 1 |
| Southern | 6.1 | 3 | 23.7 | 26.5 | 6 | 2 |
| Sabaragamuwa | 5.3 | 4 | 23.1 | 31.6 | 4 | 5 |
| Central | 5.0 | 5 | 23.5 | 27.9 | 5 | 3 |
| Eastern | 5.0 | 5 | N/A | N/A | N/A | N/A |
| North Western | 4.3 | 6 | 18.0 | 33.9 | 2 | 6 |
| Uva | 3.5 | 7 | 23.7 | 37.0 | 7 | 7 |
| Northern | -6.2 | 8 | N/A | N/A | N/A | N/A |

Sources: UNDP (1998); Datt & Gunewardena (1997) and Gunawardane (2000).

3.24 On-going poverty analysis is already looking into the role of several other structural factors that could also explain the persistence of poverty in some regions. Such factors include assets, human capital, credit and financial markets, existence of income earning opportunities, etc. Some preliminary conclusions suggest that regional imbalances in growth and poverty reduction are due to both the dependence on agriculture and the inadequate availability of infrastructure facilities in rural areas. For instance, electricity reaches 55-60 percent of the total population, but is available to only about one in four households in the economically depressed regions of Uva and Sabaragamuwa (Table 3.1). In addition to having the highest proportion of households without electricity, these areas also have weak rural-urban road linkages, partly due to under-investment in a rationally planned, inter-urban road network (Kumara, 1998). On the other hand capital

grants (the criteria-based and the medium-term investment program grants) provided to provinces for the purposes of alleviating regional disparities have remained at less than 0.2 percent of GDP over the years. These constraints partly explain why the benefits of growth have not always trickled out to the countryside, while urban poverty levels by contrast have consistently fallen, even in the low growth year of 1996 (Figure 3.2a; Annex Table 15).

3.25 Urbanization has been slow in Sri Lanka, and the majority of the population remains in agriculture and rural areas. Distortions in land and labor markets (as described in Chapter 2) have worked against the poor by constraining mobility or by increasing low quality jobs, especially in the informal sector where the largest proportion of poor people are trapped. There is evidence that job creation in Sri Lanka in recent years has been increasingly in the form of casual, subcontracted or temporary employment (Central Bank, 1999b).¹⁸ These structural rigidities, combined with differences in environmental factors (e.g., climate and proximity with conflict affected areas) and a low human resource base explain the disparities in poverty incidence across regions (e.g., Western Province versus all other provinces) and sectors (urban versus rural; agriculture versus non-agriculture).

D. Governance Issues in Poverty Programs

3.26 Given Sri Lanka's impressive human capital base from an early stage, the country's performance in economic growth and poverty reduction are below expectations. As mentioned previously, the most probable explanation relates to the constraints imposed by the war, inadequate economic policies, and weakening institutions/governance. Similarly, the large government poverty programs in the 1990s such as the Janasaviya program (1989-95) and the on-going Samurdhi program (1995- present) have suffered from design and implementation weaknesses that have curbed their effectiveness. There are three specific flaws in the programs that explain why they have neither been effective in creating opportunities nor empowered the poor to overcome economic and social barriers.

3.27 First is the political bias in implementing state-sponsored poverty programs. It is widely acknowledged that successive poverty alleviation programs in Sri Lanka have been designed and implemented more as vehicles for political leverage/patronage at the grassroots level than as mechanisms to create opportunities for the poor. Both the Janasaviya and the Samurdhi programs utilize an extensive network of poverty administrators/mobilizers. While this strong network of administrators at the grassroots helps identify beneficiaries, the political bias in the implementation of poverty programs makes the poor highly vulnerable to changes in the political climate. The 20,000 Samurdhi Development Officers (SDOs) and 10,000 "Govi Niyamakas" (agriculture extension assistants) in charge of identifying beneficiaries in villages are most often politically appointed. Documented research as well as the findings of the recent qualitative survey of the SLIS indicate that party affiliation and voting patterns influence the allocation of income transfers to beneficiaries (Gunatilake et al, 1997; Parker and Silva, 2000). Although they work at the local level, SDOs are part of the Central Government's outreach at the local level and report to the central Samurdhi Authority. Cross-country evidence show that for poverty programs to be most effective in reaching the poor, the poor themselves must participate actively and freely in the political process (Box 3.2) far more prominently and easily than they have been able to in the past in Sri Lanka.

3.28 A related issue is the poor allocative efficiency of poverty programs. Both the Janasaviya and Samurdhi have been large income transfer programs covering over 50 percent of the population or twice the percentage actually living in poverty. The HEIS 1995/96 data show that the transfers from poverty programs (Janasaviya, Samurdhi, food stamps) reach 66 percent of households in the poorest decile and 14 percent of households in the top three deciles (Nanayakkara, 2000). This inadequate targeting is also confirmed by the preliminary findings of

¹⁸ Casual and sub-contracted employment accounted for almost one third of those employed in 1996/97 (Central Bank, 1999b).

the SLIS which reveal that only 60 percent of households in the lowest expenditure quintile receive the Samurdhi transfers. Moreover, around 56 percent of the total Samurdhi Food Stamp budget accrues to the two lowest quintiles, while the remaining 44 percent is distributed across the top three income quintiles (World Bank, 2000). Even with the strong administrative apparatus currently in place to identify beneficiaries, the targeting outcome of poverty programs in Sri Lanka is comparable with outcomes of other untargeted programs like health and primary education (Grosh, 1994). The thin spread of income transfers across the population and poor targeting divert resources away from the most needy segment of the population. This is also reflected by the fact that only Rs. 200-300 million is provided annually under the Public Assistance Program -- a program meant to protect the most vulnerable groups such as orphans, widows, the disabled, among others.

Box 3.2: Voices of the Poor in Decisionmaking

In preparing for the 2000/01 *World Development Report* on the theme of Poverty and Development, the World Bank undertook an extensive exercise of *Consultations with the Poor* in 23 countries around the world to hear from them their experiences, priorities, reflections, and recommendations. Below are some of the findings of the consultations on the role of the poor in decision-making processes.

Even when “participation” occurs in the context of people’s own organizations, by and large the poor are excluded from decision-making and from sharing equally in the benefits of both government and NGO programs. The poor want desperately to have their voices heard, to participate, to make decisions instead of having them being handed down from above. They are tired of being asked to take part in other people’s projects on other people’s terms. In El Gwayaber, Egypt, the poor said, “we are tired of self-help initiatives. These initiatives need money, and people are indebted and have other priorities like feeding and educating the children. Organizing is useless and things take a long time to get solved.” In Kaoeseng, Thailand, the poor said their exclusion meant that decision-making became only “discussion, meetings, and news announcement.” Both poor women and men said, “they consult with the powerful individuals,” while the poor only found out about decisions when announcements were made.

Poor people were also asked in the study to list and rank the institutions that played important roles in their lives. Countries in which government institutions were relatively significant included Brazil, India, Malawi, Sri Lanka, and Vietnam. In other countries and sites, government institutions were considered important but ineffective and rarely anywhere near the top ranks. In many countries, the poor listed government-provided social assistance as important, if not always honest or effective. This included, for example, Plan Vida in Argentina, fair-price ration shops in India, Samurdhi in Sri Lanka and entitlements for the elderly, children, and the disabled in the former Soviet Union countries.

Source: Quoted from “*Global Synthesis: Consultations with the Poor,*” Poverty Group, World Bank, September, 1999.

3.29 Second, whereas the decentralization introduced in 1987 should have improved the quality of local public services as well as increased the State’s accountability to the poor, neither of these hoped-for outcomes have materialized. The Central Government’s control over the delivery of poverty programs and social services devolved to the provinces has inhibited the development of local institutions better able to represent the needs of the poor. For instance, certain organizational features of the Samurdhi poverty alleviation movement, which is a Central Government function, may have: (i) unnecessarily restricted the development and innovative potential of more indigenous forms of social mobilization; and (ii) hampered growth of community social capital or the trust, norms, and collaborative social relations which facilitate coordinated action by society.¹⁹ One robust social mobilization organization that has shown resilience over the years and has attracted a high rate of participation among the poor is the Death Donation Society, which is prevalent in all villages of Sri Lanka. This organization is not concerned with economic development, but its sustainability and the high participation of the poor in its activities is indicative of the latent social capital for community development which has yet to be tapped.

¹⁹ The concept of social capital and its role in economic development is the topic of a recent World Bank Publication. See Dasgupta & Serageldin (2000).

3.30 Third, Sri Lanka's excessively large and costly poverty programs have traditionally accounted for as much as 1 percent of GDP and have not given sufficient attention to creating opportunities for the poor. The Samurdhi program alone had a budgetary cost of 0.7 percent of GDP in 1999 – around 80 percent of it for income transfers-- while the entire budget for education represented about 2.5 percent of GDP. The large expenses on poorly targeted income transfers, the lack of sustained rural works programs, the high long-term administrative costs of hiring poverty workers into the public sector (e.g., the 20,000 SDOs and 10,000 agricultural assistants),²⁰ and the weak exit mechanisms are some of the inadequacies that need to be addressed. Resource misallocation in Sri Lanka's poverty programs is due in part to the political concerns that drive such programs, and to a historical bias that has favored social infrastructure at the expense of economic and physical infrastructure.

E. Main Issues for a Future Poverty Strategy

3.31 Looking to the future, Sri Lanka needs to rethink its poverty strategy so as to maximize the benefits of the economic liberalization renewed in the early 1990s. Completion of the on-going poverty analysis will undoubtedly provide a better foundation for redefining that strategy. However, based on the experience of the 1990s, a few priority issues need to be addressed in any future poverty strategy. First, and most obviously, resolving the conflict will have the greatest payoffs to reducing human misery in the conflict affected areas. The spillover effects will also enable faster poverty reduction in the rest of the country by freeing up much needed resources to help redress the regional disparities (especially in infrastructure needs) currently evident.

3.32 Second, it will be important to improve economic policies, strengthen overall governance, and enhance the allocative efficiency of current poverty programs. Cross country experiences have shown that improvements in economic institutions and policies in developing countries are key to a quantum leap in poverty reduction (see World Bank, 1998c). Sri Lanka will always face resource constraints of some form or another. It is thus critical that an appropriate and strong policy framework is in place and that available funds are used in the most efficient and effective way, especially with regard to the needs of the poor. As mentioned in the previous chapters, past economic policies and weakened governance in certain areas have held back Sri Lanka's long-term growth performance. The current large poverty program suffers from poor targeting. Special attention needs to be given to the efficient allocation of poverty program resources as well as effective mechanisms for service delivery through a more decentralized system. An important objective should be to reduce the disparities across regions in access to physical and social infrastructure.

3.33 Finally, given the undeniable link between robust economic growth and sustainable poverty reduction, Sri Lanka needs to pursue strong macroeconomic and sectoral policies that would help the country move to a higher and more stable growth path similar to that achieved by East Asian countries during their early stages of development. In Sri Lanka today, liberalization of agriculture and factor markets in particular would offer considerable opportunities in this regard.

²⁰ This compares with 24,000 workers in the whole postal department.

CONCLUSION

ENSURING WIDE CONSULTATIONS IN THE DESIGN OF REFORMS

Sri Lanka's economy has been very resilient to both internal and external shocks over the last two decades. The biggest concern today is the prolonged nature of the civil conflict. In addition, social discontent is high among younger Sri Lankans who feel excluded from the country's economic benefits and processes. In sum, Sri Lanka's past development performance, although good by the standards of developing countries, has consistently fallen well below its potential and the needs and aspirations of its people. The experiences of other countries demonstrate that achieving economic and social development in a well-educated and multi-ethnic population is a hard task. In particular, success requires some of the most difficult talents to muster-- smooth coalition building, delicate political maneuvering, managerial capacity and technical expertise.

The priority issues discussed in this report-- resolving the conflict, strengthening public institutions and governance, and implementing better economic policies for growth and poverty reduction-- are the most critical for long-term performance. Addressing these priorities in an appropriate way would have the greatest impact on Sri Lankan society as a whole. To succeed however, they need to be designed with the full collaboration of all stakeholders, including the poor and civil society. Past experiences even within Sri Lanka already provide good examples of how success can be achieved when stakeholder support has been won for the implementation of tough reforms (e.g., privatization of plantations, telecommunications). Stakeholder consultations, even though often long and complicated, are critical. Discussion of reform options among stakeholders should be guided by a clear understanding of the costs of inaction, especially to those who bear them the most. Deference to the demands of the most vocal and already well-protected groups comes at the high cost of marginalizing the under-privileged segments of the population. Inaction could therefore be more damaging for Sri Lanka than a bold implementation of reforms. The educated unemployed and other disenfranchised groups are likely to feel greater dissatisfaction (as evidenced by past insurrections) as the gap between the protected and unprotected widens, and as Sri Lanka continues to lag behind its comparator countries. It is hence time to replenish and revitalize Sri Lanka's wealth of capital stock, i.e., its educated people, lush natural resources, long cultural heritage, and strategic location in the Indian Ocean, among others.

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ANNEX TABLES

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