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GOVERNMENT FISCAL YEAR
January 1–December 31

CURRENT EQUIVALENTS
(Exchange Rate Effective as of November 30, 2004)
Currency Unit= Sri Lankan Rupee
US$ 1.00= Rs. 104.97

ABBREVIATIONS

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
BIMSTEC	Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Cooperation
BOI	Board of Investment
CBSL	Central Bank of Sri Lanka
CEB	Ceylon Electricity Board
CP	Central Province
CPC	Ceylon Petroleum Corporation
CWE	Cooperative Wholesale Establishment
EP	Eastern Province
ERP	Effective Rate of Protection
ESC	Economic Service Charge
EU	European Union
FDI	Foreign Direct Investment
FMRA	Fiscal Management (Responsibility) Act
FTA	Free Trade Agreement
FTZs	Free Trade Zones
GDP	Gross Domestic Product
GOSL	Government of Sri Lanka
GST	Goods and Services Tax
HIES	Household Income and Expenditure Survey
ICA	Investment Climate Assessment
IDPs	Internally Displaced Persons
IMF	International Monetary Fund
ISLFTA	India Sri Lanka Free Trade Agreement
IT	Information Technology
JVP	Janatha Vimukthi Peramuna
LDO	Land Development Ordinance
LECO	Lanka Electricity Company
LTGEP	Long Term Generation Expansion Plan
LTTE	Liberation Tigers of Tamil Eelam
MASL	Mahaweli Authority of Sri Lanka
MDGs	Millennium Development Goals
MFA	Multi-Fiber Arrangement
MTBF	Medium Term Budget Framework
NCOE's	National Colleges of Education
NEC	National Education Commission
NGOs	Non Governmental Organizations
NIE	National Institute of Education
NP	Northern Province
NTP	National Transport Policy
NWP	North Western Province
NWRC	National Water Resource Council
PCs	Provincial Councils
PPP	Purchasing Power Parity
PRGF/EFF	Poverty Reduction and Growth Facility/Extended Fund Facility
PRSC I	First Poverty Reduction Support Credit
PUCSL	Public Utilities Commission of Sri Lanka
RCDC	Road Construction Development Corporation
RDA	Road Development Authority
RERED	Renewable Energy for Rural Economic Development Project
RSL	Regaining Sri Lanka
RTA	Registration of Title Act
SaP	Sabaragamuwa Province
SAPTA	South Asian Preferential Trade Agreement
SEMA	Strategic Management Agency
SLFP	Sri Lankan Freedom Party
SLFEB	Sri Lanka Foreign Employment Bureau
SLIS	Sri Lanka Integrated Survey
SLT	Sri Lanka Telecom
SOE	State-Owned Enterprise
SP	Southern Province
TC's	Teacher Centers
TEWA	Termination of Employment of Workmen Act
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNP	United National Party
UPFA	United People's Freedom Alliance
UP	Uva Province
US	United States
VAT	Value Added Tax
VRS	Voluntary Retirement Scheme
WBB	Welfare Benefits Board
WP	Western Province

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EXECUTIVE SUMMARY

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

I. Development Outcomes and Underlying Causes

Social and Economic Outcomes

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

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

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

Poverty Trends 1990-91 to 2002 (%)

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

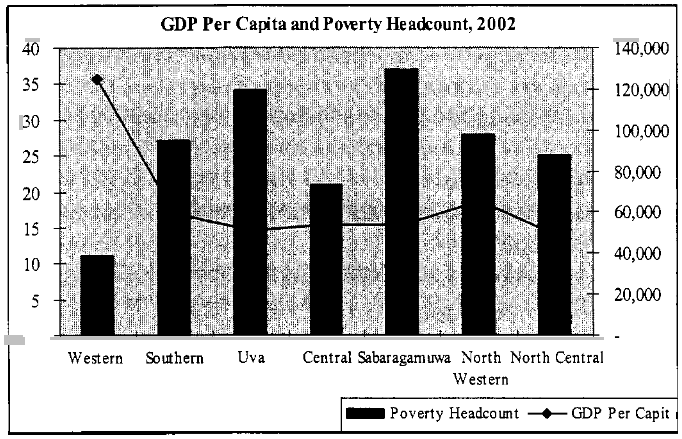
Per Capita Growth by Economic Sector (%)

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

Source: Department of Census Statistics and Central Bank Annual Reports

[1] Excludes North and East.

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



GDP Shares by Province

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

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

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

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

Early Reforms and their Impact

7. Following inward-looking policies during the 1960s and part of the 1970s, Sri Lanka liberalized its trade and investment regime —including the establishment of Free Trade Zones (FTZs)—beginning with the 'first wave' of reforms in the late1970s. These reforms unshackled the economy from stringent controls and wrought a transformation in the country's trade and industrial structure—from land-intensive, plantation exports to labor-intensive manufacturing.[2] The impact of the early reforms was amplified by a number of favorable external factors, including: (i) the massive foreign assistance in support of the reforms; which, in turn, boosted the confidence of foreign and domestic investors; (ii) the institution of the quota system under the Multi-Fiber Arrangement (MFA) by industrialized countries which helped Sri Lanka's fledgling garment export industry to take-off (and grow from nil to US$2 billion in two decades); and (iii) the upswing in world tourist trends which led to a doubling of tourist arrivals between 1978 and 1982.

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

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

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

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

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

II. Cease-Fire and Unfinished Reforms

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

- Economic growth resumed with real GDP growth reaching 4 percent in 2002 and 5.9 percent in 2003. Growth in 2003 was broad based as the textile-led industrial sector recovered from the 2001 downturn, agriculture benefited from good weather, and economic activities in the North East resumed. Notably, tourist arrivals hit a historical record of half a million.

- The inflation rate fell from 14.2 percent in 2001 to 6.3 percent in 2003; nominal interest rates were halved; and private credit increased.
- Unemployment moderated from an average of 8.8 percent in 2002 to 8.1 percent in 2003, although it remained above the 7.9 percent recorded in 2001.[3]
- Foreign direct investment, which had slumped to US$ 82 million in 2001, rebounded to US$ 242 million in 2002, but having reached US$ 170 million in first half of 2003 closed the year at US$ 229 million, amidst increased political uncertainties.

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

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

III. Towards Faster and More Equitable Growth

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

16. Addressing the structural weaknesses will require containing the burgeoning fiscal deficits, diversifying the export base, realizing the growth potential of non-plantation agriculture, strengthening the road and power infrastructure and revamping the education system. To do all will require putting in place a more conducive public investment program and encouraging foreign and domestic investment. In

[3] Excluding the North East

addition, critical for both growth acceleration and poverty reduction will be the success in attaining a durable peace settlement. It will be also essential that in managing the economy, policy reversals be avoided and that gains from past reform efforts be sustained and further strengthened.

Managing Public Finances

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

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

Civil Service Staffing in Selected Countries (per 100 population)

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

Source: World Bank (1998), Research Working Paper "Government Employment and Pay: The Global Regional Evidence."*Total civilian government includes employees from education and health sectors.

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

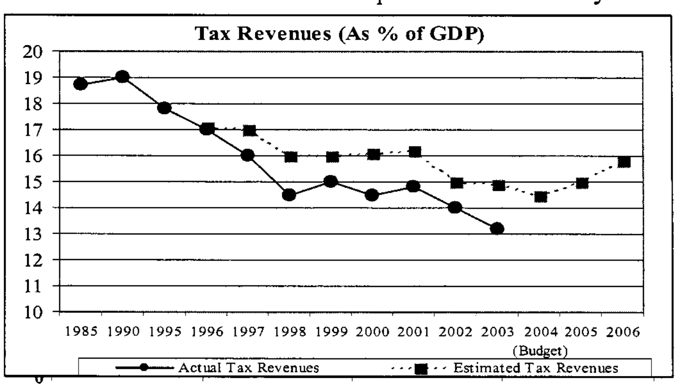
20. ***Rationalizing public spending and linking it to the poverty reduction strategy***. The scope for expenditure rationalization is significant, not least because of the need to address the duplication and overstaffing problems of the public administration. In addition, there is a serious imbalance in public spending, with the bulk of the budget being directed to fund recurrent costs (i.e., interest payments, wages, and subsidies) and very little to investment. The Ministry of Finance is developing a medium term budget framework (MTBF) which could potentially combine macro (i.e., attaining fiscal sustainability) and micro objectives (such as enhancing the development impact of public spending). Following the recent introduction of budget ceilings and of a three-year planning horizon, there is a need

to strengthen the links between priorities, resources, and outputs/outcomes. This will require a more strategic and consultative budget formulation process and the identification of trade-offs within and across sectors. For instance, there is an urgent need to increase the effectiveness of Sri Lanka's *welfare system*, notably the *Samurdhi* program which while covering almost half of the population, misses a significant proportion of the poor.[4] Improving the targeting of existing welfare programs to better reach the poor, through objective eligibility criteria, and making transfers more progressive would go a long way toward improving the lives of the poor.

21. ***Improving the performance of state-owned enterprises (SOEs).*** The financial burden of SOEs[5] is high and service delivery is poor. Most are overstaffed, incur operating loses, and have large debts (mostly to the state-owned banks). Direct subsidies alone absorb 3 percent of GDP annually, which is above the entire education budget. A program of fiscal consolidation and improved service delivery requires that these companies be substantially restructured (through privatization or other methods), be allowed to operate on a commercial basis with no political interference, and be subject to a hard budget constraint. The success of current plans to restructure twelve strategic SOEs, under the oversight of the recently established Strategic Enterprise Management Agency (SEMA), hinges on improving their autonomy and accountability.

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

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



Source: Central Bank of Sri Lanka and staff estimates.

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

5 Includes public institutions and corporations.

6 As this report was being completed, the 2005 Budget was presented including a number of revenue measures which are not discussed here.

7 The VAT introduced in 2002 to replace the Goods and Services Tax (GST) and the National Security Levy consisted of two rates (10 and 20 percent).

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

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

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

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

Policies for Faster Export Growth

24. As noted earlier, liberal external sector policies (trade, foreign investment, and emigration) have underpinned Sri Lanka's export-led strategy and explain the resilience of the economy in the face of prolonged stress and occasional shocks. In particular, these policies have contributed to bringing down the unemployment rate to single digits (from close to 20 percent in the 1970s). Notably, taking advantage of the opportunities opened by the MFA and a largely liberal trade regime, garment exports have become one of Sri Lanka's major industries, currently accounting for half of all exports and employing 5-6 percent of the labor force (mostly female) while providing indirect employment to about one million workers (15 percent of the labor force). Similarly, liberal emigration policies have contributed enormously to the generation of foreign exchange (about 10 percent of GDP) and of employment opportunities for about one million workers (also mostly female), helping to more than halve the female unemployment (from over 30 percent in the 1970s).

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

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

constraints that undermine the competitiveness of Sri Lankan firms. Some key priority issues are discussed below:

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

Key Features of the Sri Lankan Garment Industry

Strengths	**Weaknesses**
- good reputation for quality	- high lead times
- reliability in delivery	- poor road and transport infrastructure
- low wages	- low labor productivity
- high compliance with international labor norms	- highly restrictive labor laws
- duty free provision for import of yarn and fabrics	- limited local availability of raw materials
- prestigious customer base	- narrow export market, mostly US and EU
- close proximity to India for fabrics	- unreliable and high cost of power
- competitive local exchange rate	- high cost financing especially for SMEs
- low clearance charges	- lengthy clearance times

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

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

29. ***Refocusing investment policy***. A liberal investment regime has effectively complemented Sri Lanka's successful export-oriented policies, with foreign direct investment (FDI) driving the growth of the garment sector and other labor-intensive activities. However, a major policy issue relates to the provision of generous direct tax incentives to companies operating under the BOI. In addition to having an adverse fiscal impact, these incentives are highly variable (across products, sectors and scale of investment) and subject to substantial discretion. Also, contrary to original plans, many firms have become perpetual beneficiaries of tax holidays. Despite these generous incentives, however, the overall

level of foreign direct investment (FDI) to Sri Lanka has been modest (averaging less than one percent of GDP annually) by regional and international standards. Recent legislation to bring fiscal incentives into line with Inland Revenue laws and away from the BOI needs to be implemented. In addition, given fiscal considerations, some form of phasing in of a moratorium on direct tax incentives needs to be seriously considered.

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

Regulations for Labor Redundancy for Selected Asian Countries

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

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

Reviving Non-Plantation Agriculture[10]

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

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

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[9] See *Sri Lanka: Improving the Rural and Urban Investment Climate* (Draft October 2004, to be published), jointly prepared by the World Bank and the Asian Development Bank.

[10] Issues related to plantation agriculture were beyond the scope of this report. However, in light of the poverty statistics for the plantation sector, a special study of the issues is being launched.

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

Source: Central Bank of Sri Lanka and staff estimates.

33. ***Allowing full and transferable ownership rights to land.*** The transfer of state-owned land to smallholder farmers through grants and permits, initiated in the 1930s, succeeded in promoting greater equity in land distribution and food security. However, restrictions on the transferability and use of these grants/permits have led to the (informal) fragmentation of land into non-economical 'miniature' holdings,[11] with adverse equity and efficiency implications. The conversion of grant/permits into title and the ensuing development of land markets, is essential to enhance farmers' ability to expand and consolidate land into economically viable holdings as well as to *access credit* (using land as a collateral) for much needed productivity-enhancing investments. Notably, lack of access to credit (which is linked to the lack of land collateral) is regarded as a top constraint for the development of rural firms. To address concerns that many farmers may become landless if private land ownership is allowed, consideration might be given to developing appropriate safety nets and impact assessments.

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

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

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

[11] Over 40 percent of small holdings have less than one acre and over 60 percent below two acres.

[12] According to the Sri Lanka Integrated Survey (SLIS),1999/2000, only about 13 percent of agricultural households reported receiving technical assistance from a government extension agent (15 percent from all sources).

[13] Between 1980 and 1997, about Rs. 215 billion (constant 1996 rupees) in public funds were spent in irrigation.

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

Infrastructure Priorities

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

39. **Roads**. Although Sri Lanka's road density (1.4km/km2) is relatively high by regional standards, only 10 percent is in good condition because of decades of neglecting maintenance. Funding is inadequate, with public spending in maintenance and rehabilitation covering only 10-15 percent of estimated requirements. In addition, few investments have been made over the past 40 years in upgrading trunk roads and constructing new highways to provide rapid access to urban centers. This situation results in high costs for road users, high unit cost for road provision, low road utilization and low road safety compared to other countries in the region. Moreover, there exist deep disparities in road density and road condition across provinces, with the Western Province showing the best indicators and conflict-affected provinces in the North and East showing the worst. To address these inadequacies, measures need to be taken to:

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

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

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

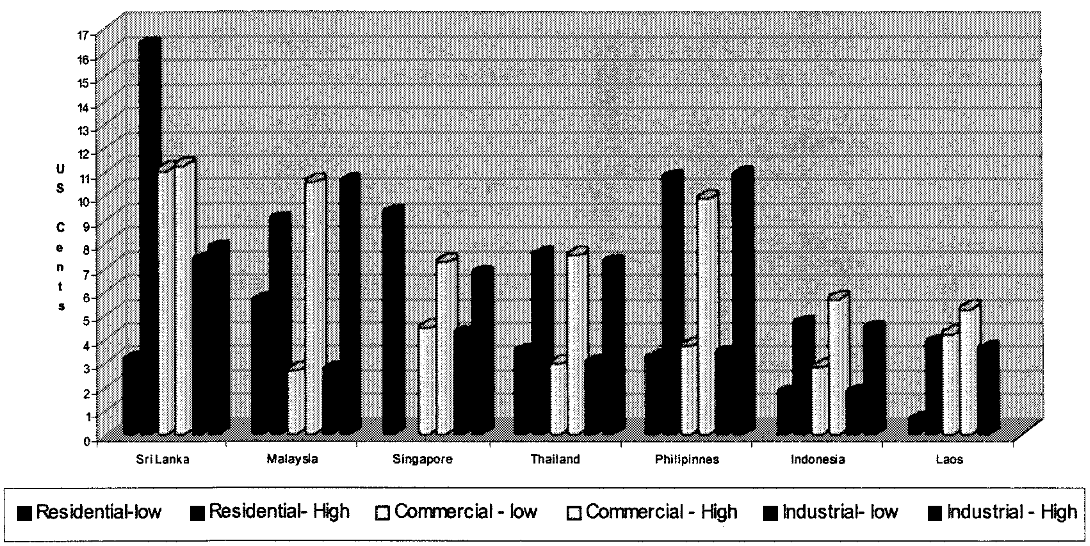
[14] World Bank (2004), "Sri Lanka: Improving the Rural and Urban Investment Climate" (to be published).

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

44. ***Expanding capacity generation***. Just keeping up with historical demand will require adding 200MW per year. Therefore, efforts need to focus on expanding generation capacity in accordance with an updated least-cost expansion plan that takes into account the full range of capacity options, including for private provision. In the long term, the independent transmission company should be allowed to procure new plants without political interference.

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

Comparison of Electricity Tariffs of ASEAN Countries



Source: ASEAN website

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

Education for Growth and Equity

47. Sri Lanka has maintained high levels of educational attainment, although with severe disruption to the school systems in the conflict-affected areas. However, disappointing learning results point to weaknesses in the quality of education. Cognitive achievement tests among primary school children, for instance, show substantial shortfalls in mastery of basic language (especially of English) and numeracy

skills.[15] Similarly, low passing rates for GCE O/l and A/L examinations, suggest poor education quality at the secondary level. In addition, there is evidence of inequities in the system as children in rural schools generally do worse than those in urban schools. Good education standards are critical for ensuring Sri Lanka's competitiveness in world markets as it enters the 21st century. The country faces the challenge of substantially enhancing the quality and equity of the education simultaneously with reducing large fiscal deficits. In this context, the following measures can be considered:

Proportion of Primary Children Mastering Language and Numeracy Skills, 2003

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

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

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

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

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

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

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

IV. Peace, Conflict and Development

53. The cease fire since February 2002 has already brought substantial gains to the Sri Lankan economy. Growth has rebounded, inflation and unemployment have declined, and foreign investment and tourism have recovered. Defense expenditure has fallen, reducing the pressure on public finances. There has been significant recovery in the conflict-depressed economy of the North East and some reintegration with the rest of the Sri Lankan economy. Thousands of war displaced refugees have

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

returned to their old homes. Much demining of land has occurred. Above all, the absence of a shooting war has become the accepted norm. Put another way, the interests vested in peace have grown.

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

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

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

V. Development Risks

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

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

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

Part I. Development Outcomes and Underlying Causes

1. Social and Economic Outcomes

1.1 Sri Lanka is justly famous for its early commitment to human resource development. It was one of the first developing countries to provide free and universal health and education services to its citizens. Together with a commitment to gender equality, social mobilization and an extensive food subsidy, they constituted the pillars of the early Sri Lankan welfare state, which had strong roots in colonial era laws and programs. As a result of these policies, Sri Lanka had achieved, by the mid-1970s, rates of school enrolment, literacy, infant mortality and life expectancy far ahead of other low income countries and better than many middle income ones (Figure 1.1).

1.2 This early impetus for strong social development policies retained substantial momentum in later decades (despite civil conflict and strained public finances). Thus, in most dimensions, Sri Lanka's performance with respect to the Millennium Development Goals has been very good (Box 1.1).

Box 1.1: Sri Lanka and the Millennium Development Goals (MDGs)

Millennium Development Goals	Sri Lanka's Position \a
Reduce the proportion of people living in extreme poverty by half between 1990 and 2015.	Poverty incidence declined from 26.1 percent to 22.7 percent between 1990-91 and 2002. • Aim is to halve extreme poverty by 2010
Enroll all children in primary school by 2015.	The net primary enrollment rate currently stands at 96 percent
Make progress towards gender equality and empowering women by eliminating gender disparities in primary and secondary school by 2015.	Gender equality achieved in primary, secondary, and even tertiary levels.
Reduce infant and child mortality rates by two-thirds between 1990 and 2015.	Between the mid-1970s and 2001, infant mortality fell from 45 to 12 per 1,000 live births; under-five mortality fell from 100 to 17.
Reduce maternal mortality rates by three-quarters between 1990 and 2015.	Maternal mortality rate of 23 per 100,000 live births in 1996, on par with middle income countries.
Provide access for all who need reproductive health services by 2015.	Contraceptive prevalence rate is high at 66 percent; poorest country in the world to have achieved below replacement fertility; 95 percent of births attended by health staff.
Implement national strategies for sustainable development by 2005 to reverse the loss of environmental resources by 2015.	Since 1994, two successive national environmental action plans have been developed and are presently under implementation.

\a Excludes the conflict-affected North and East.
Sources: Department of Census Statistics, Annual Health Bulletin 2001, and Staff Estimates

1.3 Moreover, housing conditions and access to household amenities have substantially improved during the last two decades (SA Table A31).[1] Notably, the share of houses with permanent structures has tripled from 26.2 percent in 1980/81 to 75.3 percent in 2003/04, access to electricity has increased almost five-fold from around 15.8 percent of households to 73.9 percent, access to a telephone line has gone up from virtually nil to 23.9 percent, and the proportion of households with a water seal latrine has more than doubled from 31.9 percent to around 78.4 percent

[1] See CBSL, Annual report 2003, Box 1. Have Living Conditions Improved in Sri Lanka?.

Figure 1.1: Social Development Indicators; Comparative Rankings

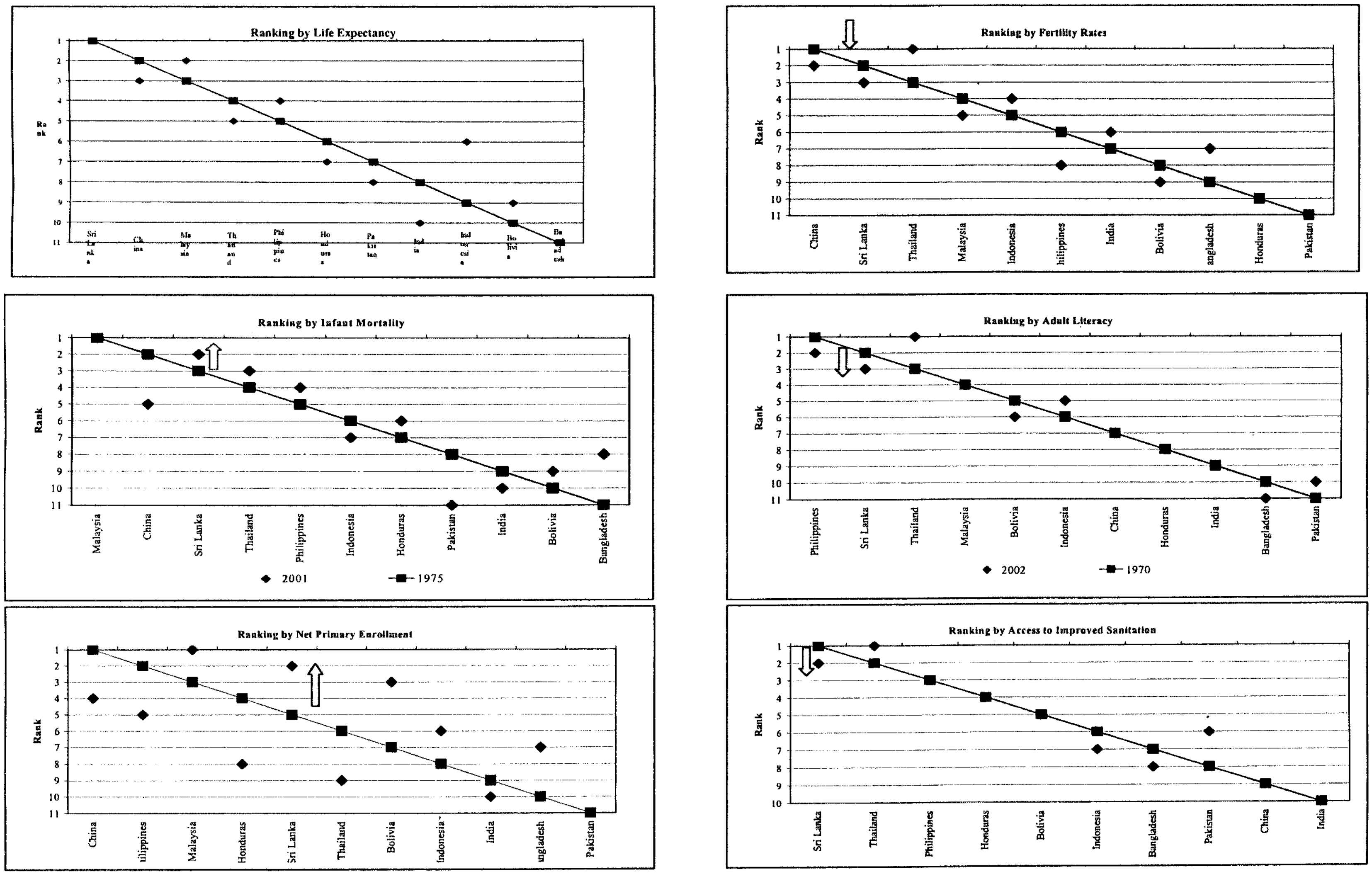


Table 1.1: Growth of GDP and Major Economic Sectors

	1951-1977	1978-2002	1981-1990	1991-2000	2001	2002	2003
Agriculture	2.8	2.3	2.9	1.9	-3.4	2.5	--
Industry	4.0	5.6	4.2	6.8	-2.1	1.0	--
Services	4.1	5.3	4.7	5.7	-0.5	6.0	--
GDP	3.7	4.7	4.3	5.2	-1.5	4.0	5.9
GDP p.c.	1.3	3.4	2.8	3.9	-2.9	2.5	4.5

Note: Column entries are simple period averages of annual growth rates (inclusive of starting and ending years) Thus 1951-1977 is the simple average of 27 year-wise annual growth rates. Figures for 2003 are estimates.
Source: Central Bank of Sri Lanka Annual Report (various issues) and Staff calculations.

1.4 In one critical area, performance has fallen well short of potential—income poverty. Surprisingly, for a country with a per capita GDP of about US$ 900, the head count ratio of poverty remains quite high at 22.7 percent. Furthermore, the rate of decline in this ratio has been modest and uneven over the last two decades despite sustained per capita GDP growth of over 3 percent per year (Table 1.1). In part this reflects a skewed distribution of economic growth across sectors and regions. It also results from a long-term growth performance significantly below the country's potential. Despite its early lead in social development, Sri Lanka has lost out in the growth stakes compared to the high-performing East Asian countries like Korea, Malaysia, and Thailand. Having being at comparable levels of per capita income in the mid-1950s (or even 1960), these countries now boast per capita US $ GDP levels some three to ten times higher than Sri Lanka's.[2] Nor does the comparison improve when conducted in PPP terms (Table 1.2).

Table 1.2: Sri Lanka in an Asian Perspective: Per capita GNP relative to the US (%)

Country / Year	1955	1960	1970	1980	1995
Sri Lanka	**12.5**	**12.5**	**9.3**	**10.4**	**13.1**
India	6.5	7.4	6.0	5.7	8.2
Pakistan	6.2	6.8	8.1	7.3	7.8
Indonesia	NA	5.8	4.8	8.4	13.2
Thailand	7.4	9.6	11.9	14.3	27.0
Malaysia	14.2	15.0	1 5.8	25.8	37.8
South Korea	8.9	8.7	12.8	19.8	48.9
Singapore	NA	16.6	24.2	44.3	85.4

Note: NA (Data not Available)
Source: National Bureau of Economic Research: Penn World Tables (web page), quoted in Athukorala (2001).

1.5 What constrained Sri Lanka's growth performance in the past? Have the constraints been released? What new problems have emerged to challenge the country's development prospects? These issues are explored in the ensuing section.

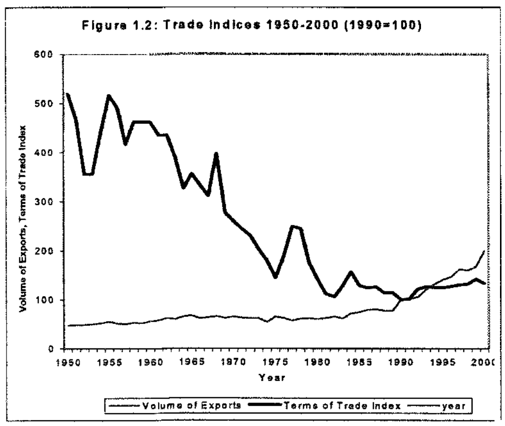
[2] Of course, Sri Lanka's per capita growth of 3.2 percent since 1980 compares favorably with other South Asian countries and many Latin American countries. But Sri Lankan authorities prefer to benchmark their country's growth performance against high growth East Asian economies (GoSL, 2003).

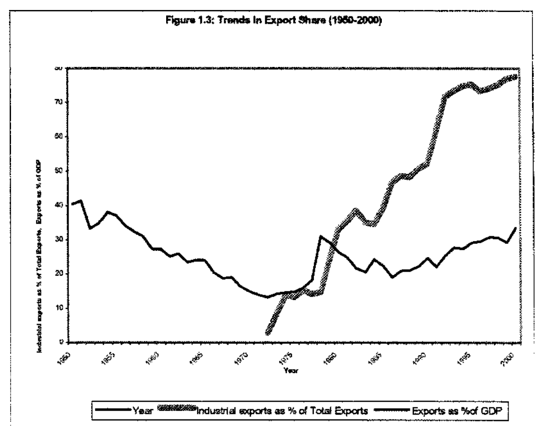
2. Underlying Causes and Trends

A. The First Three Decades (1948-77): A Capsule History

1.6 At the time of Independence in 1948, Sri Lanka was almost a textbook example of a dualistic export economy with a well-established and relatively modern plantation export sector, coexisting with a traditional, subsistence small-holder agriculture sector.[3] Tea, coconut and rubber generated over 95 percent of the country's export earnings and provided the tax base to sustain the 'welfare state' of free education and health and a generous subsidy on the consumer staple, rice. This colonial legacy of a welfarist, plantation economy with open trade and payments policies continued for nearly a decade. There were ups and downs caused largely by swings in world demand and prices for Sri Lanka's three major plantation crops.

1.7 From the mid-1950s to the mid-1970s Sri Lanka suffered a massive and sustained decline in its external commodity terms of trade, with the index (1990=100) dropping from around 500 to about 150 (Figure 1.2). Over the same period, the export volume index hardly increased by 20 percent. In common with other South Asian (and indeed, many developing) countries, Sri Lanka embarked on defensive trade and payments controls partly as a technocratic response to the worsening foreign exchange situation and partly influenced by the contemporary development paradigm favoring import-substituting industrialization and strong state intervention.[4] As the foreign exchange crisis deepened in 1961-64, trade and payments controls intensified. At the same time, industrial controls, establishment of state enterprises and nationalizations gathered steam. Unsurprisingly, economic growth in 1960-65 dropped to average only 3.6 percent.





Source: Central Bank of Sri Lankan and staff estimates.

1.8 Following a change in government, there was a brief and half-hearted attempt at liberalization of trade and industrial controls in 1965-70, along with renewed emphasis on non-plantation agriculture[5]. As a result, economic growth recovered somewhat to average 5.2 percent. However, the ensuing seven years under another government witnessed intense and extensive policies of state intervention in all economic arenas and the greatest delinking from international commerce in Sri Lanka's history (Figure 1.3). By 1977, plantation lands had been nationalized and limits imposed on land ownership, over sixty percent of manufacturing was in the public sector and accounted for half of all manufacturing employment (Athukorala and Rajapatirana, 2000). State trading corporations were established and nurtured. By 1976 public sector entities accounted for nearly 90 percent of all imports and 30 percent of exports. Part of the penchant for avowedly socialist policies was a response to the first JVP-led youth insurrection of 1971. That, in turn, may have been fed by the cumulative failure

[3] Beginning in the 1930s, land was transferred to small holder farmers through various land settlement programs.
[4] This dirigiste paradigm was especially inappropriate for Sri Lanka as a small island economy. For excellent recent assessments of the early period see Kelegama (2000) and Abeyratne and Rodrigo(2002).
[5] Cuthbertson and Athukorala (1990).

of the economy to create enough job opportunities for a rapidly growing, young labor force with rising levels of education, skills and expectations. This was also the period when Sri Lanka (like all other oil-importing nations) was buffeted by the first 'oil shock' of 1973/4. Despite growing fiscal pressures, food subsidies were continued at an unsustainable 4 percent of GDP (Table 1.3).

Table 1.3: Social Expenditure as Per Cent of GNP, 1950/1-1977

Year	Education	Health	Food Subsidies	Other Social Welfare	Total Social Expenditure
1951/2	3.0	1.9	5.3	0.4	10.6
1955/6	3.2	2.0	1.5	0.5	7.2
1960/1	4.7	2.5	3.9	0.7	11.8
1965/6	4.7	2.1	3.6	0.6	11.0
1970/1	4.3	2.1	4.5	0.4	11.3
1975	2.8	1.4	4.8	0.4	9.4

Source: Kelegama (2000)

1.9 By the mid-1970s, the intensified strategy of inward-looking import substitution and increasing state intervention was beset with serious problems. Economic growth had plummeted to average below 3 percent in 1970-77, with per capita growth amounting to a little over 1 percent a year. The unemployment rate had risen above 20 percent (the highest recorded in Sri Lanka's post-independence history), with high incidence among educated youth (Statistical Annex Table A12). Incomes of the poorest 40 percent showed little growth (Papanek, 2003). External assistance had dwindled to a trickle. The country's export basket reflected the failure of trade policy to promote meaningful diversification, with the three plantation crops still accounting for nearly 80 percent of merchandise exports in 1977. Clearly, the chosen development strategy had led the Sri Lankan economy into something of a blind alley. The gravity of the economic difficulties of the mid-1970s eased the way for the far-reaching reforms that followed.

B. Post 1977 Reforms and their Impact

1.10 The 1977-79 reforms had profound (largely beneficial) effects on the Sri Lankan economy. These reforms (bolstered by the 'second wave' in the first half of the 1990s) unshackled the economy from stringent controls and wrought a remarkable transformation of the country's trade and industrial structure. The initial reforms included phasing out of quantitative import controls, compression and reduction of the import duty structure, opening up to foreign investment, establishment of an efficient free trade zone (FTZ) scheme, freeing of credit markets, institution of a market-responsive, unified exchange rate, substantial retreat from government ownership and control of productive enterprises, withdrawal of state trading monopolies, lifting of price controls and the replacement of the highly subsidized, rice ration system by food stamps targeted to lower income groups. The reforms of the early 1990s carried forward reform of trade policies, realigned the exchange rate, freed up exchange control on current transactions, gave a major impetus to privatization and strengthened the policy framework for foreign direct and portfolio investment.

1.11 The far-reaching impact of these reforms can be readily gauged by the following summary of consequences:

- Economic growth recovered smartly to average 6.2 percent in 1977-82, the only five year period in which growth has averaged above 6 percent in Sri Lanka. This meant a tripling of the per capita GDP growth experienced in 1970-77.
- Manufactured exports (especially garments) took off, growing at 32 percent per annum between 1978 and 1995 in current US dollars (Athukorala and Rajapatirana, 2000).
- The share of industrial exports in total exports increased dramatically from 14 percent in 1977 to 72 percent in 1992 and further to 78 percent in 2000 (Figure 1.3).

- The share of exports in GDP rose steadily from a nadir of 13 percent in 1972 to 34 percent in 2000 (a ratio last attained in 1956). Sri Lanka had once again become an open economy, engaging successfully in world commerce.
- The factor content of exports changed hugely from less than 3 percent in labor-intensive manufactures in 1962-77 to nearly 60 percent in 1990-95 (Athukorala and Rajapatirana, 2000). This reflects a remarkable transformation from land-intensive, plantation exports to labor-intensive manufacturing.
- The 'export coefficient' (the ratio of exports to gross manufacturing output) increased from a mere 3 percent in the late 1970s to over 50 percent by the late 1980s and over 70 percent by the late 1990s.
- The prolonged (1955-75) terms of trade shock was overcome by this successful diversification of the export structure (Figure 1.2).
- The share of manufacturing in GDP rose from around 12 percent in the period 1950-80 to 17 percent in the late 1990s.
- The share of state enterprises in manufacturing value-added fell steadily from 66 percent in 1974 to 3 percent in 2000.
- The share of factory industry in manufactured production increased from about 50 percent in 1975 to over 80 percent in 1995, while that of processing export crops fell from 37 percent to 11 percent over the same period (Abeyratne and Rodrigo, 2002).
- Employment in the organized manufacturing sector more than tripled from about 140,000 in 1978 to over 500,000 in the mid-1990s (Statistical Annex Table A14).
- The new FTZs provided an enormous fillip to employment (mostly in manufacturing), adding over 400,000 jobs in 25 years. Since the bulk of these jobs went to women workers in garments, it had a potent influence on women's economic and social empowerment.[6]
- Foreign direct investment played a big role in the transformation of Sri Lanka's trade and industry. The share of foreign firms in manufactured exports increased from about 25 percent in 1977 to nearly 80 percent in the mid-90s. Between 1985 and 1995, 85 percent of the total increment in manufactured exports came from foreign firms (Athukorala and Rajapatirana, 2000).

1.12 It would be hard to find a more convincing case of trade and industrial transformation of a small island economy through market-friendly policy reforms. At the same time, analysts (such as Kelegama (2000)) correctly point to several external factors which may have amplified and assisted the impact of reforms in the initial years. First, there was massive foreign assistance in support of the early reforms, which supported a big boost to public investment and financed large fiscal and external account deficits. The jump in foreign aid must have also boosted confidence of foreign private investors. Second, the rapid increase in garment exports from nil to over US$ 2 billion in less than two decades may have been helped by the institution of the quota system under the Multi-Fibre Arrangement (MFA)as a protectionist device by industrial countries. Without this, it is a moot point whether Sri Lanka's fledgling garment export industry would have taken off in the manner it did. Third, the doubling of tourist arrivals between 1978 and 1982 (which boosted employment and earnings) may have had as much to do with world tourism trends as Sri Lankan policies.

1.13 Perhaps the most valuable, though intangible, contribution of the reforms and their impact was that, over time, they won the support of both major political parties (UNP and SLFP) to a common economic policy paradigm of an open, outward-looking economy with a growing role for the private sector. Thus, when the UNP government was replaced in 1994 by an SLFP-led coalition, there was no significant change in the broad direction of economic policies. Indeed, there was some intensification of the privatization policies.

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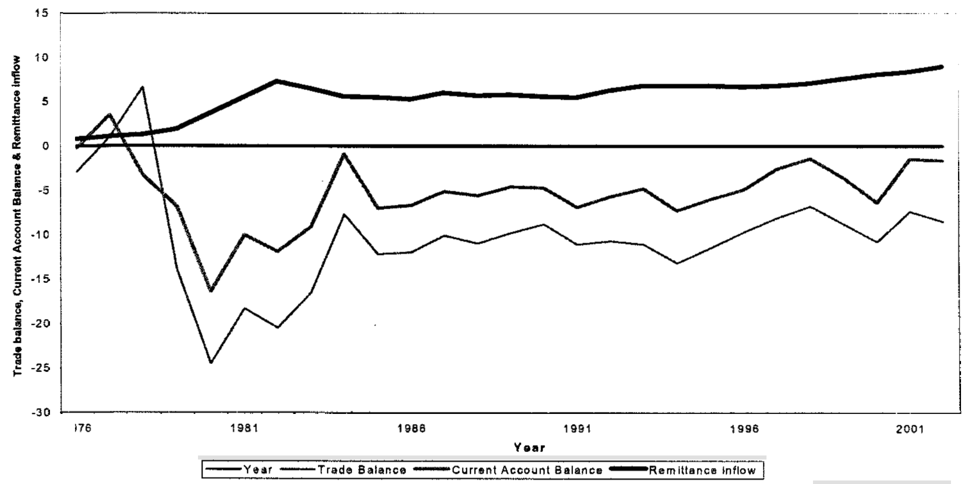
[6] The share of female workers in manufacturing employment nearly doubled to 60 percent between the early 1980s and mid-1990s (Athukorala and Rajapatirana,2000).

1.14 One other important feature of Sri Lanka's economic landscape dates back to the early reforms era. This is the important role played by large scale external migration and the return flows of remittances. Prior to 1977 both external migration and remittances were negligible. Both grew rapidly (though not steadily) in the next 25 years. By 2002, about one million Sri Lankans were working abroad and remitting nearly US$1.3 billion through official channels. That constituted 18 percent of all current external receipts and amounted to 9 percent of GDP or nearly triple the level of net foreign capital inflow (Figure 1.4 and Statistical Annex Table A15). Several factors contributed to this upsurge in migration and remittances: the opening up of the Sri Lankan economy and general relaxation of controls; the economic boom in the labor-scarce oil economies of the Mid-East; Sri Lanka's market-responsive exchange rate policy; the push-factor of the prolonged ethnic conflict and the slow growth of the rural economy.

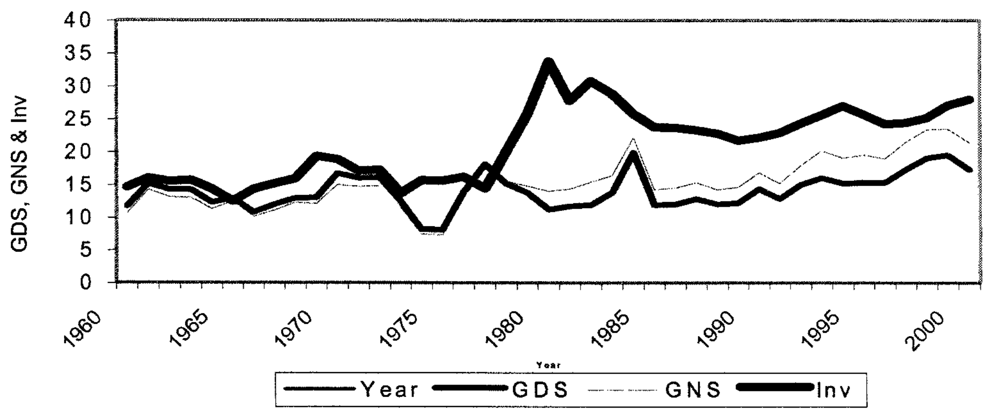
Figure 1.4: Trade Balance, Current Account Balance & Remittance Inflow (As Percent of GDP)



Source: Central Bank of Sri Lanka and staff estimates.

1.15 The economic consequences of this rising migration were substantial and generally beneficial for the domestic economy. First, the high level of remittances helped finance Sri Lanka's large trade deficits (Figure 1.4). Second, by adding to domestic savings the transfers allowed higher levels of domestic investment. This was important against a background of persistently low levels of domestic savings in the economy (Figure 1.5). Third, the large outflows of migrants (cumulatively estimated at nearly half the increment in the country's labor force between 1978 and 2002) eased domestic labor market conditions and helped reduce unemployment especially among the female labor force. Fourth, since the migrants came predominantly from low income families, the poor benefited from relatively well-paid (often temporary) overseas jobs and their remittances home may have added as much as 20 percent to household incomes back home. Fifth, Papanek (2003) stresses that "migration disproportionately benefited poor women: more than two-thirds of all migrants since 1989 have been women" of whom "88-95 percent were either housemaids or other unskilled women, overwhelmingly drawn from the poorer families".

Figure 1.5 : Gross Domestic Saving, Gross National Saving & Investment as percent of GDP, (1960-2000)



Source: Central Bank of Sri Lanka and staff estimates.

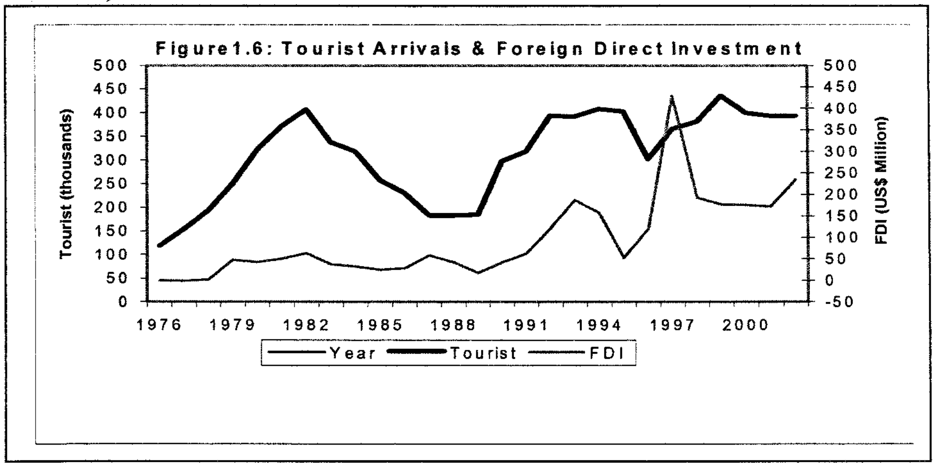
C. The Decades of Civil Conflict, 1983-2001

1.16 In the early eighties the Sri Lankan economy was on a strong upswing. Growth was robust, investment was at a peak, exports of manufactures were booming, tourist arrivals were soaring and foreign investment was rising fast (Figure 1.6). The prospects for continued buoyancy looked bright. Unfortunately, in 1983, the long-festering problem of ethnic discord flared up and plunged the country into a twenty year civil conflict, which remains unresolved despite a cease-fire since February 2002. The roots of the conflict go far back into colonial times and are largely political in nature. Some analysts (eg. Abeyratne, 2003) have stressed some of the economic causes. The basic argument is that the relatively slow growth of output and employment (1956-77) could not meet the rising expectations of the growing numbers of freshly educated entrants to the labor force, spawned by the largely successful policies of free and universal education. Unemployment was particularly high among the young and school leavers. Furthermore, during this period, the state's control over formal sector employment increased greatly (through nationalizations, new state enterprises and heavy government recruitment) and employment patronage was often dispensed on ethnic lines. The benefits of economic liberalization and heavy public investment (Mahaweli irrigation project) in 1977-82 were also unevenly distributed across communities and regions. Coupled to the discrimination embedded in language, education and social policies after 1955, it bred a volatile mix, which contributed to both the Sinhalese-Tamil ethnic conflict and the 1987-89 resurgence of JVP militancy.

1.17 While there may be considerable debate and speculation on the economic causes of the civil war, there is little doubt about the adverse consequences of the conflict on the economy. The humanitarian costs have been nothing short of disastrous (see Box 1.2). At the macro-level, the Central Bank's estimate of lost GDP growth of 2-3 percent per year (after 1983) seems as reasonable as any (CBSL, 1998). But such a summary statistic masks the multi-dimensional and pervasive costs of the war. These include:

- The massive **growth in military expenditures** from about half a percent of GDP in the 1970s to around 6 percent of GDP in 2000, as the size of the armed forces increased from less than 10,000 to around 300,000. The share of security expenditures in total government expenditure rose from about 3 percent in the early 1980s to well over 20 percent in the late

1990s. Sri Lanka spent more on the military than any other country in South Asia (Statistical Annex A30).



Source: Central Bank of Sri Lanka Annual Report, multiple years.

- The persistence of **high fiscal deficits**, typically around 10 percent of GDP, throughout the period, leading to the usual problems of crowding out of private investment and a serious public debt problem. By 2001, despite large and prolonged flows of concessional assistance, Sri Lanka's government debt exceeded 105 percent of GDP and interest payments consumed about 7 percent of GDP. Of course, war-related expenditures were only one part of a larger fiscal problem.
- The sharp rise in military expenditures constrained other civil expenditure programs. Thus, **expenditure on education and health** remained at around 4 percent of GDP through most of the period, well below the levels of 5-6 percent allocated for security in the 1990s.
- The rapid increase in **foreign investment** (1978-82) leveled off for the remainder of the 1980s as security became a major concern for potential investors. In particular, large electronics multinationals (eg. Motorala, Harris, Sony and Sanyo) which had been exploring major commitments in 1982, shifted their investment plans to South East Asia. In later years several initiatives for private infrastructure projects foundered on the excessively high returns sought by foreign investors to compensate for war risks.
- There was a similar leveling off in **tourist arrivals** after the initial boom of 1978-1982. Let alone growth, the 400,000 arrivals level attained in 1982 was only touched in a couple of years in the 1990s. Over the same period, other nearby destinations such as Maldives, Mauritius and Thailand which had started form a similar base, went on to clock several million tourists per year.
- Sri Lanka's ambitions for becoming a financial hub and an aviation hub were frustrated by the continuing **uncertainties** of the conflict (Kelegama, 2002).
- There was massive **destruction of economic and social infrastructure** facilities in the war-torn North East (and sporadic bombing of targets in Colombo and environs).
- Traditional **economic activities (agriculture, fishing) in the North-East suffered** serious decline as much of the area became an active war zone (Box 1.4).
- Outside the North East, the economic **utility of interconnecting infrastructure** (such as highways) was lost due to closure of such links because of the conflict.
- As a result of war-strained public finances and continuing focus on social and welfare policies, **public investment remained low** (around 5 percent of GDP) throughout the period, leading to the major shortages in key infrastructure sectors of power and roads.
- The conflict exacted a substantial **toll in the efficiency and integrity of institutions** of economic and social governance.

Box 1.2 : The Humanitarian Effects of the Conflict

The conflict in Sri Lanka has led to loss of life, the displacement of persons belonging to all ethnic groups and the destruction of infrastructure, health care facilities and schools. Approximately 2.5 million persons lived in areas of direct military activity--65,000 people have been killed, 800,000 were internally displaced, including 172,000 living in refugee camps and another 700,000 left the country. There are 30,000 war widows and an estimated 300,000 displaced children in the North-East where the school drop out rate is double the national average. The infant mortality rate in the North-East is twice the national average, the maternal mortality rate is thrice the national average and 92% of malaria deaths are reported from the region. There are an estimated 1.8 million landmines in the North--a per capita incidence comparable to Angola.

Selected Human Development Indicators 2001

Indicator	North and East	Sri Lanka
Child malnutrition	46.2%	29.4%
Infant mortality/1,000	30	12
Maternal mortality/100,00	81	23
Literacy	68.3%[1]	90.1%
School drop out	15%	4%
Per-capita Income (2000)	R.37,206	R.63,000

[1] Batticaloa district only.
Source: WHO and DCS.

Box 1.3 : The Economic Costs of the Civil Conflict

The Central Bank of Sri Lanka estimated that the civil conflict may have reduced the country's GDP growth by 2-3 percent per year over the twenty years of conflict (CBSL, 1998). This means that in the absence of the conflict Sri Lanka's per capita GDP in 2002 might have been around US$1500 instead of around US$ 900.

A comprehensive present value (1996) estimate of the economic costs of the war for the period 1984-1996 (discounted at 5 percent) places it at 1.7 times Sri Lanka's 1996 GDP (Arunatilake et. al., 2001) :

Direct Costs	**Percent of 1996 GDP**
Government military expenditure	41.3
LTTE military expenditure	4.1
Government expenditure on relief services	3.0
Cost of lost infrastructure	13.5
Indirect Costs	
Income lost from foregone public investment	8.6
,, ,, ,, reduced tourist arrivals	17.0
,, ,, ,, reduced foreign investment	71.2
,, ,, ,, displacement of people	5.5
,, ,, ,, human capital of dead and injured	2.5
Output foregone in Northern Province	1.3
Total	**168.0**

On the same basis, extrapolating to include the costs incurred in 1997-2001, would yield a figure in excess of twice Sri Lanka's GDP (1996).

1.18 Perhaps the most pervasive, though intangible, economic cost of the conflict was that it diverted the energy and attention of the policy-makers from the arena of economic reforms and policies. This was certainly true in the period 1983-89, when the government leadership was preoccupied with the "two wars" (against the LTTE in the north and, later, the JVP in the south) and there was very little progress in economic reforms. A similar distraction from economic priorities is discernible in the period 1995-2001, when there was an intensification of the civil conflict.

Box 1.4: Economy of the North and East

Since the fighting during the war was isolated in the North and East, these provinces have suffered the most, including a death toll estimated at over 70,000 and a halving of the provincial economy during the 1990s.

Agriculture dominated the pre-war economy of the North East accounting for 33 percent of outputs and 80 percent of employment. During the war, areas under cultivation in the North East fell by between 50 and 80 percent, while the share of the North East in paddy production dropped from 1/3rd in 1980 to just 3 percent in 2000. Farmers and fishermen of the North East were reluctant to invest in capital assets or long term enterprises. Irrigation systems were destroyed and electrification is low. Although large scale industry was never a major contributor, prior to the war, the region produced cement, caustic soda, chlorine and hydrochloric acid amongst other materials.

The long term impact of the war is reflected in the social development indicators of the North and East where child malnutrition is 46 percent, literacy 68 percent compared to national averages of 29 percent and 87 percent respectively. Teachers and doctors are understandably unwilling to serve in conflict areas, resulting in severe shortages and poor outcomes. The most affected are vulnerable groups such as those forced to drop out of school (more than 100 schools have been closed down in the North and East), war widows and their families and the disabled. Even in a post-conflict situation, mortality rates will continue to rise dramatically as public spending on health remains limited and exposure to malaria, diarrhea, respiratory infections and HIV/AIDs increase dramatically. Improving the region's human development indicators will take time and effort and will require donor support in the short term. Careful attention needs to be paid to the provision of basic social services and social protection for vulnerable groups as they form fertile recruiting grounds for guerilla movements.

The war has been a factor behind almost a million Sri Lankans leaving the island. Many continue to remit savings to their relatives in the North and East, sources of income that protect local populations from the worst ravages of war.

The North East has received small amounts of aid since the conflict began. Humanitarian assistance has been delivered by a number of NGOs that were active throughout the conflict. More recently the NEIAP and NECORD projects supported by the World Bank and ADB respectively have provided resources to rebuild village organizations, rehabilitate infrastructure and provide local employment opportunities, transferring organizational, managerial and technical skills to local communities. Last year, the World Bank also launched its North East Emergency Reconstruction Project (NERP) which will help restore primary health care, urban water schemes and provide returning families with income and employment opportunities; and the North East Housing Project was just approved late this year, which will help poor families rebuild their homes.

Source: Saravananthan, Muttukrishna. "An introduction to the conflict time economy of the North and East Province of Sri Lanka". ICES working paper No. 1 May 2003.

D. Emerging Development Issues and Problems

1.19 Against this background, a number of development issues and problems emerged as threats to Sri Lanka's long-term development potential.

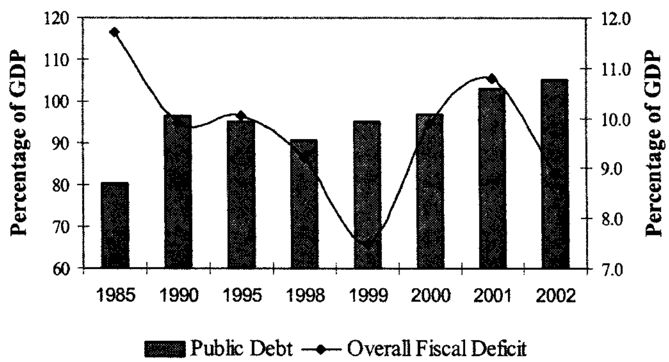
The Fiscal Problem

1.20 Sri Lanka's public finances have been subject to virtually continuous strain over the past two decades. Large fiscal deficits averaging 10 percent of GDP (and primary deficits around 3-4 percent of GDP) have led to high levels of public indebtedness and debt burden. Several factors have contributed to this situation. First, the tax-to-GDP ratio declined from around 19 percent in mid 1980s to about 14 percent in 2002, with virtually all the decline occurring after 1990. This, in turn, was due to the declining role of foreign trade taxes, the rapid growth of a virtually tax-free BOI/FTZ sector,[7] the stagnation of revenues from income taxation, proliferation of concessions and exemptions (Stat. Annex Table A20), a complex transition from turnover and excise taxes to a system of VAT with a few select excises, and persistent weaknesses in the administration of the Inland Revenue and Customs (partly exacerbated by the prevalence of the parallel revenue concession granting authority

[7] The export income from the BOI sector accounts for about 80 percent of the country's manufactured exports. The provisions of long term tax holidays and duty and tax-free status for imports have kept this important and dynamic segment of the economy virtually outside the tax net.

of the Board of Investment). Second, during these decades, defense/security expenditures rose from around 1 percent of GDP to around 6 percent. Third, government (civilian) salaries and pensions consistently absorbed 5-6 percent of GDP, reflecting a bloated and (at lower levels) overpaid bureaucracy. Repeated efforts to control the size of the government salariat and its compensation levels have produced little progress. Fourth, throughout the 1990s the role of concessional external financing of the fiscal deficit has declined steadily, with a corresponding increase in recourse to market-based domestic funding, resulting in a rising ratio of interest payments to GDP. Finally, in the face of declining public resources, priority was given to funding social and welfare policies rather than investing in economic infrastructure.

Figure 1.7: Evolution of Public Debt and Fiscal Deficit



Source: Central Bank of Sri Lanka and staff estimates.

1.21 The consequences of these long-term pressures on the fiscal system may be seen in declining ratios of public investment, constrained budgets for education and health, persistently high fiscal deficits and public debt-to-GDP ratios averaging more than 95 percent in the 1990s. The vulnerability of such high ratios was heightened in the severe economic downturn of 2001, which took the debt-to-GDP ratio above 105 percent and brought home the issue of fiscal/debt sustainability.

Table 1.4 : Indictors of Fiscal Stress (percent of GDP)

	1980	1985	1990	1995	2001
Tax Revenues		18.7	19.0	17.8	14.6
Taxes on International Trade		6.8	6.0	3.6	1.9
Gross Defense Expenditure	1.3	4.5	4.1	6.5	5.5
Public Investment		13.8	8.3	7.9	5.9
Fiscal Balance		-11.7	-9.5	-10.6	-10.8
Domestic Financing of Deficit		5.2	4.2	5.1	8.8
Interest Payments		4.6	6.4	5.7	6.7

Source : CBSL Annual Reports

Administrative Erosion

1.22 The past two decades have witnessed substantial erosion of institutional capacity and economic governance in the nation's administrative system. With 14 percent of the labor force employed in government (18 percent if the semi-government sector is included), Sri Lanka has one of the largest bureaucracies per capita in the region (Table 1.5) with a ratio of 3.9 civil servants per 100 population. This bureaucracy is large, costly and suffers from low effectiveness and efficiency. The incentive system is perverse. Government workers with the lowest levels of education on average earn almost double the wages of their private sector counterparts. Top policy-makers and professionals are insufficiently compensated. As a result, Sri Lanka's compression ratio about (8:1) is the lowest in South Asia. Controls on public recruitment have weakened over time. Despite the growing role of the private sector and increased privatization, government employees have risen in both absolute numbers and as a proportion of labor force. Since 1990 the number of employees have increased by almost 50 percent (to over 900,000) and their share in the labor force has risen from less than 11 percent to about 14 percent. Regular large scale recruitment waves have occurred, typically linked to the electoral cycle. For example, in May 1999, 10,000 unemployed university graduates were recruited without their attachment to any existing professional scheme of service (World Bank, 2000). Politicization of public recruitment has weakened the norms prevailing in the administration, bloated its numbers and reduced its effectiveness.[8]

Table 1.5: Civil Service Staffing in Selected Countries (per 100 population)

Country and Region	Central Government Employees	Non-Central Government Employees	Total Civilian Government*
South Asia Region			
• India	0.4	0.4	1.2
• Bangladesh	0.4		0.6
• Pakistan	0.4	0.6	1.5
• **Sri Lanka**	**2.3**	**1.6**	**3.9**
East Asia			
• China	0.1	1.6	2.8
• Indonesia	0.7	0.3	2.1
• Korea	0.6	0.7	2.2
• Malaysia	2.3	1.1	4.5
Asia Average	**0.9**	**0.7**	**2.6**

*Total Civilian Government includes employees from the education and health sectors.
Source: World Bank (1998), Research Working Paper "Government Employment and Pay: The Global and Regional Evidence." Staff estimates.

1.23 Rising government recruitment has gone hand in hand with the proliferation of government institutions in the past 20 years. The number of central ministries has fluctuated around a rising trend (from 28 in 1990 to 51 in 2003). There are over 40 provincial ministries and some 150 statutory boards and public corporations. The administrative apparatus has often been duplicated at the provincial level, resulting in substantial confusion and ambiguity regarding roles and responsibilities of different levels of government and between elected and administrative arms. Contrary to expectations of a decentralized system, the central government has not withdrawn from devolved functions and, in some instances, has increased centralization. Moreover, Sri Lanka's public administration continues to rely on outdated management models and procedures.

A Sluggish Rural Economy

1.24 Unlike industry, the record of reforms in agriculture and rural development was quite limited during these conflict decades (leaving aside the privatization and rehabilitation of plantations). This was so despite the fact that (even in the mid-nineties) 80 percent of the population and 90 percent of the country's poor lived in rural areas. A broad range of government policies had the unintended effect of reducing the capacity of farmers to enhance their productivity and competitiveness and respond to local and international market opportunities. These included unpredictable trade policies that increased domestic price uncertainty; highly restrictive seed and quarantine regulations which limited access to improved technologies; commodity price interventions that discouraged private sector participation; complex and restrictive land policies that hindered the efficient use of land (e.g., the fragmentation of land into non-economic holdings of less than one acre); and poorly functioning

[8] It may have had more pernicious effects. The Presidential Commission on Youth, established after the violent youth insurgency in the South of 1987-89, reported that there was a strong consensus in the country that politicization and abuse of power and injustice were the main causes of youth unrest in the country (World Bank, 2000). It singled out rampant politicization in the systems of public recruitment as a source of injustice and dissatisfaction and recommended strongly in favor of restoring the independence of the Public Service Commission.

water delivery systems. The combined effect of these measures was the creation of a complex structure of obstacles and disincentives, which damped agricultural productivity growth, impeded diversification, discouraged investments and reduced opportunities for raising agricultural and rural incomes. A continuing emphasis on input subsidies (fertilizer, water, seeds) diverted public resources away from creating critical rural infrastructure (roads, electricity, research and extension). This is despite the clear need for investments in rural infrastructure. According to the rural part of the recently completed investment climate assessment (ICA) on Sri Lanka, *transport* constitutes the single most important constraint to rural firms, followed by *cost and access to credit* and *electricity*.[9]

Table 1.6: Agriculture, Forestry and Fisheries GDP, Growth and Structure of Value Added

Subsector	Average Annual GDP growth rate (%)			Share in Agriculture, Forestry and Fisheries GDP (%)		
	1982-90	1991-00	1998-02	1982-84	1990-92	2000-02
Agriculture, Forestry and Fisheries	1.7	1.9	0.9			
				100	100	100
Agriculture	2.8	1.6	0.4	85	83	80
Tea	2.9	3.4	2.5	13	8	6
Rubber	-1.2	4.3	-2.3	3	2	1
Coconut	-3.8	2.5	-3.2	11	8	6
Rice	-0.3	-0.7	0.6	21	19	14
Other	6.3	1.9	0.8	37	46	52
Forestry	6.1	2.3	2.8	6	8	8
Fisheries	0.7	6.1	2.2	9	9	13

Source: Mission estimates.

1.25 Agriculture (including forestry and fisheries) grew at barely 2 percent per year during this period. Moreover, excluding forestry and fisheries, there has been a noticeable deceleration in agricultural growth in the 1990s (Table 1.6) down to 1.6 percent. As a result of these trends the share of agriculture in GDP declined from over 30 percent in early 1980s to 20 percent in 2000, while agriculture's share in total employment fell from 46 percent to 36 percent (Table 1.7). The growth of the rice sub-sector, a traditional mainstay in the country, has been negligible or negative over these decades despite high protection. Growth of tea and rubber improved over the 1990s (perhaps reflecting privatization of plantations), but the performance of other non-traditional crops (which had grown at 6 percent in the eighties) weakened substantially. The fisheries sub-sector showed the best growth in the 1990s, taking its share in agricultural value-added to 13 percent by 2000-02, comparable to the share of rice.

Table 1.7:Employment and Value Added by Sector

Year	Unemployment	Share in Total Employment			Share of Value Added in GDP		
		Agriculture	Industry	Services	Agriculture	Industry	Services
1963	16.6	52.6	9.1	38.3	44.4	19.9	41.5
1971	18.7	50.1	9.3	40.6	36.8	24.9	44.3
1981	17.9	45.3	10.1	44.6	32.9	23.1	47.8
1990	15.9	46.8	13.3	34.5	28.3	23.8	49.6
1995	12.3	36.7	14.7	41.6	24.4	26.0	50.1
2000	7.6	36.0	16.6	40.3	20.5	27.6	52.0

Source: Central Bank of Sri Lanka Annual Report (various issues) and Staff calculations.

[9] World Bank (2004), "Sri Lanka: Improving the Rural and Urban Investment Climate" (Draft to be published)

1.26 The slow growth of agriculture was a primary factor explaining the persistence of high levels of rural poverty and its substantial variation across provinces. In the decade between 1985/86 and 1995/96 agricultural households accounted for about 40 percent of Sri Lanka's poor. More recent estimates (using the Sri Lanka Integrated Survey—SLIS, 1999/2000) indicate that agricultural households (excluding the estate sector) comprise almost half of the poorest rural households, defined as the bottom 40 percent of the expenditure distribution.[10] More importantly, rural poverty rates are highest in provinces with the highest proportion of agricultural households. Income from agriculture was critical (as a share of total household income) in some provinces, particularly North Eastern (67%), Sabaragamuwa (60%), Uva (59%), Southern (48%) and Central (47%). These provinces have some of Sri Lanka's highest rural poverty rates.

1.27 At the same time, the possibilities for better agricultural performance were indicated by the changing composition of food expenditures resulting from rising per capita incomes, increasing urbanization, changing prices and preferences, and growth of exports and tourist consumption (Table 1.8). Despite policy obstacles, there was some diversification in production in response to changing demand. The production of maize, fruits, vegetables, spices and livestock (especially poultry) have increased in recent years. Agricultural exports grew at over 4 percent annually in the 1990s, reaching about US$950 million in the triennium ending 2002 (or almost 20 percent of total exports). This was primarily driven by tea and some non-traditional exports of fruits, flowers, vegetables, fish and spices.

Table 1.8: Household Expenditures on Food

Commodity	% Share in Food Expenditure		
	2002	1990/91	1980/81
Rice	19.3	22.4	31.5
Wheat flour & bread	5.5	5.6	7.1
Pulses	7.5	4.4	2.4
Vegetables & fruits	12.9	10.2	8.7
Meat and fish (incl. dried)	16.7	12.2	9.9
Milk & Milk products	7.9	4.7	3.3
Eggs (pieces)	0.8	1.1	0.8
Sugar	3.3	6.2	7.8
Others	20.1	15.4	12.3

Source: Department of Census and Statistics, Household Income and Expenditure Survey 2002, preliminary report.

An Infrastructure Backlog

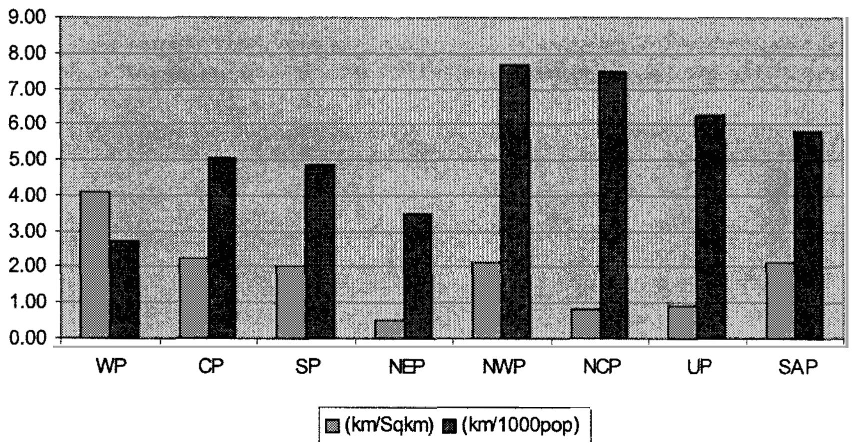
1.28 The heavy build-up of security expenditures and continuing focus on consumption spending diverted resources from public investment in economic infrastructure (power, water, transport, communications), which fell from around 14 percent of GDP in 1985 to 6-7 percent by 2000. Against this backdrop, the recently completed ICA reports that inadequate transport and electricity services constitute top constraints in doing business in Sri Lanka (World Bank, 2004).

1.29 Although the country's ***road network*** is dense (1.5 Km/Km2 of area) by regional standards, only 10% of the paved road network is in good condition due to lack of maintenance. This situation results in increased road user costs, poor quality and frequency of transport services, and low road safety. Sri Lanka has the highest road accident fatality rate in Asia. The National Transport Policy estimated in 2000 that the annual cost of road accidents is about 0.4% of GDP ($50 million per year). In addition, despite a substantial increase in traffic demand over the past four decades, there has been very little investment in improving trunk roads, upgrading (e.g. widening) of roads and construction of new national highways to provide rapid access to urban centers. Although new public investment

[10] Agricultural households are those involved in farm production, raising livestock or casual agricultural labor.

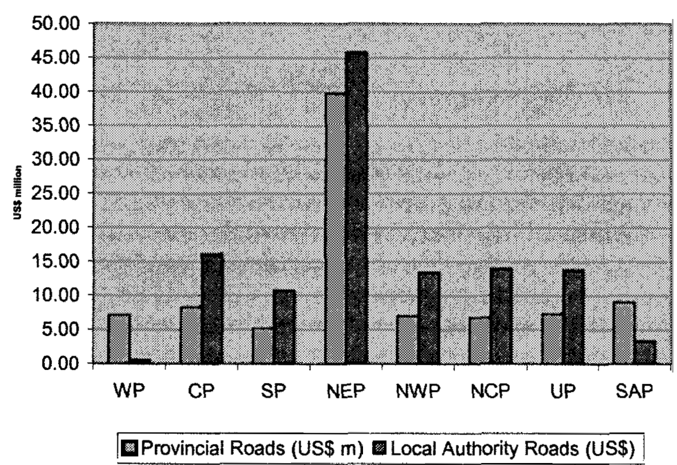
has concentrated on small, rural access roads, there remain serious regional disparities both in road density and condition of roads. The Western Province has the highest density of roads in the country (about 4 km/Sq. km) but due to its populations levels, it has the lowest number of km per inhabitant. The North Eastern Province, having the lowest road density in the country, even low by international standards, is second to the Western Province in terms of km per inhabitant. In contrast, the North Western Province has similar road density to Central, Southern and Sabaragamuwa Provinces, but has the highest number of km per inhabitant in the country (see Figure 1.8). This regional disparity in terms of access is particularly worrying, as it is the utilization of assets rather then their existence which determines the contribution of infrastructure assets to economic growth[11]. Roads in good maintainable condition with high utilization rates, such in the Western Province, yield higher returns to the economy. In contrast, maintenance backlogs for rural roads, are so severe in all other provinces (see Figure 1.9) that renders them impassable during most of the year. As a result, Sri Lankans living outside the Western Province do not enjoy the connectivity that others have. The situation is even worse in the conflict-affected areas in the North and East Provinces.

Figure 1.8: Road Density by Province, 2002



Notes: All national, provincial and local authority roads are included.
Sources: RDA for national roads and GOSL' concept paper for Road Sector, December 2003

Figure 1.9: Rehabilitation Funding Requirements for Provincial and Local Roads, 2004-2008

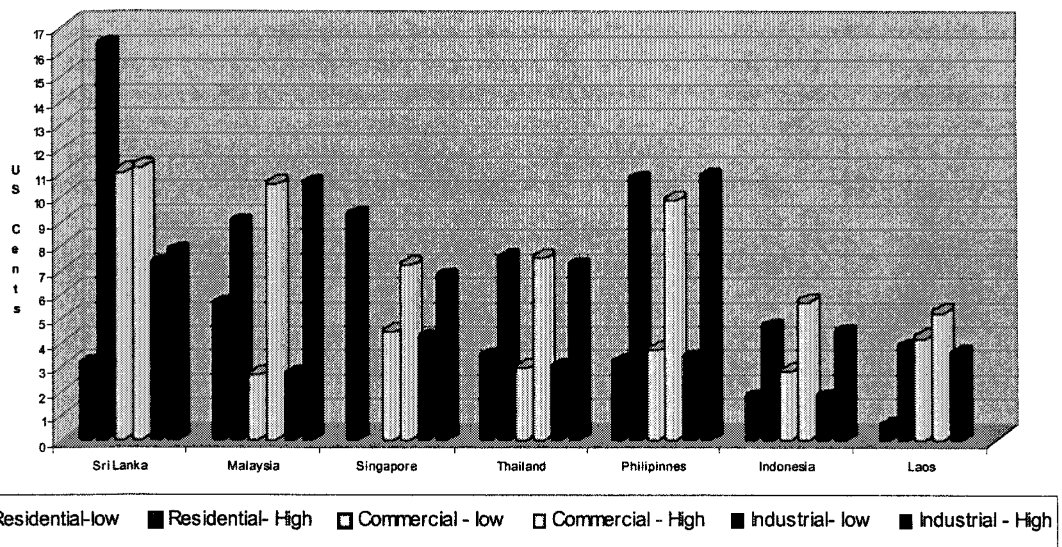


Sources: GOSL' concept paper for Road Sector, December 2003

[11] It has been documented that road density does not have a clear association with per capita income or growth rates in Asia. Source: J.M. Antle, 1983, "Infrastructure and Aggregate Agricultural Productivity" International Evidence", Economic Development and Cultural Change, vol 31, pp. 609-619.

1.30 The unreliability and cost of ***electricity*** is another major constraint to economic development. Despite an impressive expansion in access to electricity over the past two decades (from 15 percent to 74 percent of households), capacity constraints in power generation threaten to limit future growth. With a installed power generating capacity of 2002 MW (of which 59% is hydro and about 20% is privately owned), Sri Lanka has been experiencing a chronic shortage of power since the mid-1990s, stemming from frequent extreme drought conditions and rapidly growing demand, averaging 8 percent per annum during the last decade. As a result, the sector has been forced to rely on expensive emergency power generation. While generation capacity could be met by the private sector (which is allowed and has recently added 350 MW), the Government lacks an appropriate planning framework to forecast future demand and the decision making to procure new plants is extremely ineffective.

Figure 1.10: Comparison of Electricity Tariffs of ASEAN Countries



Source : ASEAN website

1.31 The use of expensive emergency generation coupled with past (uneconomic) pricing policies by the state-owned Ceylon Electricity Board (CEB) has led to large financial losses in the sector, delayed investments in new transmission and distribution facilities, and often neglected maintenance of existent infrastructure. To address these problems, the industry is undergoing a process of restructuring which involves the unbundling of the generation, transmission and distribution of the CEB and the Lanka Electricity Company (LECO)[12] as well as the establishment of an appropriate regulatory framework through the effective operation of an independent regulatory body.

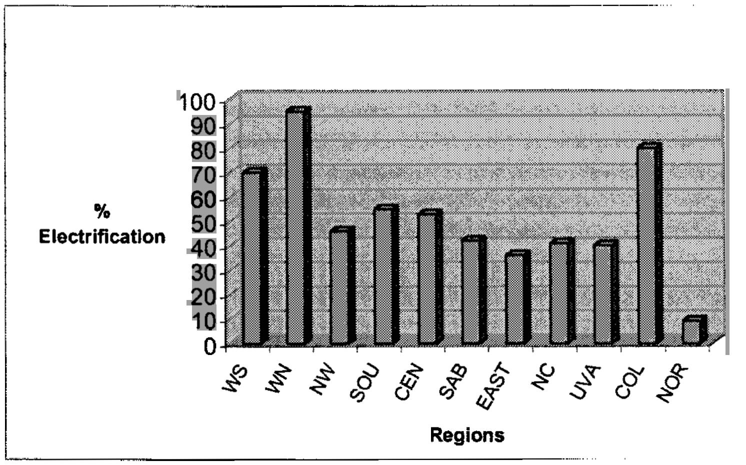
1.32 These constraints result in high cost of electricity for commercial and industrial use by international standards (see Figure 1.10). Indeed, due to increased reliance on expensive thermal emergency generation, large cross-subsidies to residential consumers, and CEB's financial and technical losses in the transmission and distribution of electricity, commercial establishments face costly and unreliable electricity supply which reduces their competitiveness in the market place. For example, about 75 percent of urban manufacturing firms own a generator in Sri Lanka compared with lower levels in competitor countries (e.g., 27 percent in China).

1.33 In addition, regional inequities in access to electricity across the country have likely exacerbated poverty in under-served areas. The diagram below shows that access to electricity among households varies widely between regions – the Colombo district is also shown. As expected, the percentage of electrification in the Western North province is 95 percent of households compared to

[12] LECO handles 15% percent of customers in the Negambo to Galle coastal strip and urban areas around Colombo.

41 percent in the North Central province. North and the East being conflict areas indicate 9 percent and 36 percent respectively.

Figure 1.11: Percentage of Electrification by Region



Source: CEB. "Medium Voltage Distribution Development Plan 1999-2007". Based on 1998 household data.

Increase in Regional Disparities

1.34 Economic activity in Sri Lanka has, for many decades, been concentrated in and around the capital city and international shipping/air gateway of Colombo. In that sense, the economic dominance of Western Province is not new. However, new estimates of provincial GDP since 1990 points to a continuing rise in this dominance and raises concerns about increasing regional disparities (Table 1.9). The share of Western Province rose from around 40 percent of the country's GDP to almost 50 percent by 2000, even though the province accounted for only 29 percent of the nation's population. Over the same period, the share of Northern Province halved from an already low level of 4.4 percent to 2.2 percent, largely reflecting the direct impact of prolonged and intense civil conflict. More broadly, the share of the four low-activity provinces (Eastern, Uva, North Central and Northern) fell from 22 percent of national GDP in 1990 to 15 percent in 2000, although about a quarter of the country's population live in these provinces.[13]

Table 1.9: GDP Shares by Province

Province/year	1990	1995	1996	1997	1998	1999	2000	2001
Western(WP)	40.2	42.3	43.7	44.3	45.3	48.7	49.6	47.3
N.Western(NWP)	11.1	9.6	11.3	12.1	12.0	10.4	10.4	10.9
Central(CP)	12.1	11.7	10.0	10.5	9.8	9.2	9.4	9.8
Southern(SP)	9.5	9.5	9.0	8.8	9.3	9.6	9.4	9.9
Sabaragamuwa(SaP)	8.1	7.7	9.0	7.6	6.7	6.4	6.7	6.3
Eastern(EP)	4.2	4.6	4.8	5.0	5.5	5.0	4.5	5.0
Uva(UP)	8.1	7.7	5.1	5.0	4.9	4.1	3.9	4.5
N.Central(NCP)	4.8	6.3	4.6	4.0	3.6	4.1	3.9	3.8
Northern(NP)	4.4	3.1	2.4	2.8	2.9	2.5	2.2	2.5
National GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: 1990-95 data from Dept. of National Planning (Sarvanantham, 2003). Data from 1996-2001 from CBSL (2002)

[13] 2000 is preferred over 2001 because the exceptional decline in real GDP was concentrated on the Western Province and biases trends.

1.35 Grouping the provinces into three regions, High activity (Western), Medium (the next four in relative shares: NWP, CP,CP and SaP) and Low (EP, UP, NCP and NP) brings out some further dimensions of the problem of regional disparity in Sri Lanka (Table 1.10). First, as expected, the High region (WP) accounted for 60 percent of the country's industry in the late nineties, while the Low region provinces had only 9 percent of national industrial value added. Second, there is a similar skew in favor of the High region in the distribution of services value added, while only 11 percent of the country's agriculture is to be found in the High region. Third, the High region enjoyed a per capita GDP twice as high as that in the Medium region and more than two and a half times the level prevailing in the Low region. Fourth, and perhaps most disquieting, the growth of nominal GDP was far higher in the High region as compared to the other two. The estimates available are for current price provincial/regional GDP. However, as noted by the Central Bank, " the average GDP deflator during this period was about 8 percent. Thus, a simple estimation of real growth indicates that region H grew at over 8 percent, region M at around 2 percent and region L at less than 1 percent..." (CBSL, 2002). These are hugely disparate rates of growth in real regional GDP and they highlight the problem of growing disparities across regions and provinces.

Table 1.10: Economic Activity by Regions

	Regional Shares (%) in 1996-2001					Per Capita Income (2001 Rs.)	Nominal GDP Growth (%) 1996-2000
	Population*	GDP	Agriculture	Industry	Services		
High	29	47	11	60	55	109,953	16.4
Medium	46	37	59	32	31	53,102	10.3
Low	25	16	30	9	14	41,734	8.7

Note: High = WP; Medium = SP, SaP, CP, NWP; Low = UP, EP, NCP, NP. *2001 Population
Source: CBSL Annual Report, 2002.

1.36 These regional disparities are also reflected in the available data on household poverty (see Figure 1.12 in Section E below). In 2002, the incidence of poverty was 11 percent in the Western Province, while it was at 25 percent or higher in all other provinces for which data was available (with the sole exception of Central province, where poverty incidence was 21 percent).

1.37 A number of factors have contributed to the problem of regional disparities, including the sluggish growth of agriculture and related activities, the concentration of the FTZs in the Western Province, regional disparities in education facilities and the persisting weaknesses in infrastructure noted earlier, especially the connectivity of lagging provinces. The underlying trends have been aggravated by the civil conflict, which has impeded economic development in several of the poorest provinces. However, to cite the Central Bank again, "early attention to this issue is critical, as widening regional disparities not only affect the achievement of a sustainable high overall economic growth directly, but also indirectly, through their potential impact on social and political stability in the country."

Quality of Education Constrained

1.38 Throughout the decades of conflict Sri Lanka maintained the high levels of educational attainment achieved by the 1970s, although there was severe disruption to school systems in the conflict-affected areas of the North-East. For the country as whole, by 2002, the net enrolment rate at grade 1 was close to 100 percent and net primary completion was around 95 percent. Of students enrolling in grade 1, about 83 percent completed grade 9 or basic education. The 17 percent of students who failed to complete the compulsory education cycle were mainly children in war affected areas, children living in remote rural and estate regions, and those in poor inner-city areas.

Table 1.11: Proportion of Primary Children Achieving Mastery of Language Skills, 2003

Skill	First Language (Sinhala or Tamil)			English Language		
	Sri Lanka %	Urban Sector %	Rural Sector %	Sri Lanka %	Urban Sector %	Rural Sector %
Vocabulary	70	81	68	35	48	30
Comprehension	45	56	43	16	33	13
Syntax	30	44	27	20	34	17
Writing	28	40	25	1	4	1
Total	37	51	34	10	23	7

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

Table 1.12: Proportion of Primary Children Achieving Mastery of Numeracy Skills, 2003

Skill	Sri Lanka %	Urban Sector %	Rural Sector %
Concepts	45	58	42
Procedures	51	56	40
Problem Solving	34	39	26
Total	38	52	35

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

1.39 In contrast to the high levels of education *attainment* at the primary and junior secondary levels, disappointing learning results point to weaknesses in the quality of education. Cognitive achievement tests among primary school children, for instance, show substantial shortfalls in mastery of basic language and numeracy skills, with mastery of English being particularly low (Tables 1.11 and 1.12). The low level of cognitive achievement among primary students is especially worrying, from a policy perspective, as primary education forms the foundation upon which higher levels of education and various types of skills training are built. It is also a concern that primary students in rural schools do relatively worse than those in urban schools in all subjects. Shortcomings in the quality of education are also evident at the secondary level. For instance, over the 1998-2002 period only 37-40 percent of students passed the GCE O/L examination and only 47-56 percent passed the GCE A/L examination. A substantial proportion of students appear to struggle with subjects such as Mathematics, English, Science and Social Studies. This is also of serious concern since the successful completion of these examinations is necessary for a variety of skills training courses or access to tertiary education programs, or for entrance into a range of labor market occupations.

E. Growth and Poverty, 1990-2002: An Overview

1.40 As mentioned earlier, Sri Lanka has lagged behind in reducing income poverty. The national poverty headcount showed a modest decline over the decade –from 26.1 percent in 1990-91 to 22.7 percent in 2002 (Table 1.13) with uneven poverty reduction across sectors and provinces.[14]

1.41 In the intervening period, national poverty increased by almost 3 percentage points between 1990-91 to 1995-96, followed by a decline of more than 6 percentage points between 95-96 to 2002. Other measures of poverty, namely depth and severity of poverty, show similar trends. Evidence presented later will show that even during the period of poverty reduction between 1995-96 and 2002, growth continued to be unevenly distributed, resulting in increasing inequality co-existing with gains in average levels of consumption.

[14] Excludes the Northern and Eastern provinces.

1.42 During the decade from 1990-91 to 2002, the poverty gap between the urban sector and the rest of the country widened. Urban poverty halved during the period, while rural poverty declined by less than 5 percentage points. Poverty in the estate sector, on the other hand, increased by about 50 percent over the decade, making this sector now the poorest.[16] The trend in rural poverty is consistent with positive trend in per-capita agricultural production during the later part of the decade (as the sector recovered from the severe drought of 1996), while per-capita growth in the preceding years was negative. A decrease in income earners per estate household during the period is likely to explain part of the increase in poverty in the sector.[17]

Table 1.13: Poverty headcounts for Sri Lanka[15]

	90-91	95-96	2002
National	26.1	28.8	22.7
Urban	16.3	14.0	7.9
Rural	29.4	30.9	24.7
Estate	20.5	38.4*	30.0

Source: HIES data for relevant years, using official poverty lines

*: Comparability of estate headcount for 95-96 with that for other years may be affected by the fact that HIES in 95-96 was sampled differently for the estate sector

1.43 In interpreting the urban and rural estimates above, it is important to note one caveat. The classification of urban and rural areas changed between the 1990/91 1995/96 HIES surveys. Town councils were considered part of the urban sector in the HIES 1990/91 survey, but were then reclassified as part of the rural sector in the HIES 1995/96 and HIES 2002 surveys.[18] As a result, the estimated proportion of urban population reduced by around 7 percentage points from the HIES 1990/91 to HIES 1995/96 and stayed almost constant since then. This suggest caution in interpreting the absolute magnitude of changes in rural and urban poverty from 1990/91 to later years. The implication of this change could result in an overestimation of the decline in poverty in the rural sector and an underestimation of the decline in poverty in the urban sector. However, this does not change the main message, which is urban poverty has reduced dramatically while rural poverty has been stagnant during the period 1990/91 to 2002. The estimates reported below (Table 1.15) also support this conclusion. Poverty in the Colombo district, which constitutes a large part of the urban sector, more than halved between 1990/91 and 2002. While, poverty reduction in predominantly rural districts has been minimal during the same period.

Table 1.14: Depth and severity of poverty

	Poverty gap			*Severity of poverty/Sqd. pov gap*		
	90-91	*95-96*	*2002*	*90-91*	*95-96*	*2002*
National	0.056	0.066	0.051	0.018	0.022	0.016
Urban	0.037	0.029	0.017	0.013	0.009	0.005
Rural	0.063	0.072	0.056	0.020	0.025	0.018
Estate	0.033	0.079	0.060	0.009	0.025	0.018

Source: HIES for relevant years, using official poverty lines

Regional Differences in Poverty Incidence

1.44 Sri Lanka is also characterized by sharp regional differences in poverty incidence. As Figure 1.12 shows, poverty incidence was by far the lowest in the Western Province in 2002, with a poverty headcount of 11 percent. There is a wide gap even between the headcount rate of the Western Province and that of North Central, which has the next lowest poverty incidence of 25 percent. In contrast, the poorest provinces of Sabaragamuwa and Uva have headcount poverty rates of around 35 percent.

[15] Based on official poverty lines (Rs. 1423, Rs. 833 and Rs. 475 for 2002, 95-96 and 90-91) respectively. The official poverty line is derived using a "cost of basic needs" method on 2002 HIES data, and deflated by Colombo CPI to obtain nominal poverty lines for the other years.

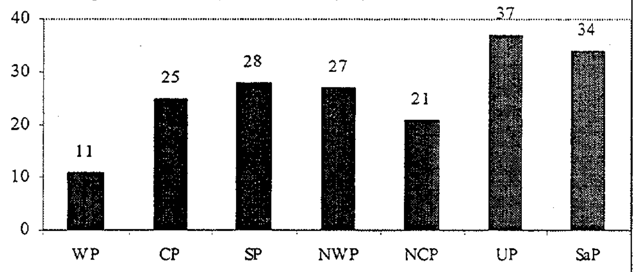
[16] Note that because the estate sector comprises of a relatively small part of the population, the HIES sample (about 4 and 7 percent of the weighted sample in 95-6 and 90-1 respectively) yields poverty estimates with a higher degree of "error."

[17] Preliminary findings of the Central Bank's Consumer Finance and Socio Economic Survey (CFS 2003/04) indicate that income receivers per household in the estate sector has declined significantly from 2.3 in 1986/87 to 1.7 in 2003/04 while the national average stayed constant at 1.6.

[18] This implies that the definition of 'urban' in 1990/91 included urban, municipal, and town councils, whereas that in 1995-96 and 2002 included only urban and municipal councils.

1.45 The low poverty incidence in the Western Province is largely due to the location of Colombo where most of Sri Lanka's economic activity is concentrated, accounting for half of the country's GDP. Since only 29 percent of the population reside in the province, it is no surprise that poverty incidence is much lower. The high incidence of poverty in some of the other provinces are consistent with the evidence on wide disparity in provincial incomes and share of GDP. The numbers underscore how poverty is concentrated geographically in Sri Lanka, and also seem to suggest that over the past decade, there has been a tendency towards wider regional disparity.

Fig. 1.12: Poverty Headcount (%) for Provinces in 2002



Source: HIES 2002.

1.46 Disaggregating poverty headcounts by districts shows even wider differences in poverty incidence (Table 1.15). The district with the lowest poverty incidence, Colombo, has only 6 percent of its population who are poor. In contrast, 37 percent of the population in the districts of Badulla and Monaragala are poor --- districts with the highest poverty incidence. The speed of poverty reduction also varies markedly among districts. Between 90-91 and 2002, gains in poverty reduction have been substantial in the Western Province and other urban areas like Kandy, while poverty incidence has been largely stagnant or increased in the rest of the country. District poverty trends also show the vulnerability of certain districts to shocks such as droughts. In 1995-96, there have been large increases in poverty incidence for districts that experienced severe drought.

Table 1.15: The headcount indices by districts (%)

Province	*District*	*90-91*	*95-96*	*2002*
Western	Colombo	16	12	6
	Gampaha	15	14	11
	Kalutara	32	29	20
Central	Kandy	36	37	25
	Matale	29	42	30
	Nuwara Eliya	20	32	23
Southern	Galle	30	32	26
	Matara	29	35	27
	Hambantota	32	31	32
North West	Kurunegala	27	26	25
	Puttalam	22	31	31
North Central	Anuradhapura	24	27	20
	Polonnaruwa	24	20	24
Uva	Badulla	31	41	37
	Monaragala	34	56	37
Sabara-gamuwa	Ratnapura	31	46	34
	Kegalle	31	36	32

Source: HIES 90-91, 95-96, and 2002

1.47 Poverty trend over the decade was also associated with increasing inequality in consumption, along with an increase in average levels of consumption. Table 1.16 shows that while mean consumption increased by 50 percent for the top quintile and 25 percent for the 4th quintile, it increased by only 2 and 6 percent for the 1st and 2nd quintiles, respectively. Increasing inequality over the decade is also reflected by the Gini coefficients (Table 1.17). The gini increased between 1990-91 and 2002 – by almost 24 percent for the country as a whole, including an increase of 19 percent for the urban sector and 30 percent for the rural sector.[19]

[19] The DCS (2004) reports that Ginis did not change much since 1990-91 (see Table H1). The Ginis reported by DCS are however different from the ones reported here in 2 ways: the DCS Ginis are based on household *income* and not consumption, and the DCS measure of income does not adjust for spatial price differences. In the context of poverty analysis, since poverty is defined in terms of consumption, gini of consumption should be considered more relevant. Moreover, household incomes are difficult to construct and therefore tend to be less reliable than consumption measures.

1.48 An analysis of pro-poor growth, using the well-known technique of Growth-Incidence Curves (GICs) provides more insights. While growth in levels of consumption had a poverty-reducing effect between 1990-91 and 2002, the benefits accrued disproportionately among the better-off.[20] During the decade, all segments of the urban distribution experienced gains in per capita consumption, but the extent of gain was higher for those at the upper end of the distribution. Similarly, in rural areas, growth in consumption was higher for the relatively better-off. Between 1990-1 and 1995-96, consumption growth was negative for the lower 50 percent of the rural consumption distribution – which can explain the increase in rural poverty. Similarly, the GICs between 1995-6 and 2001-02 can account for the fall in poverty headcount and widening of the rich-poor gap in all sectors.

Table 1.16. Mean real per capita consn. (at 2002 prices) by quintiles

Consn. quintiles	90-91	2002
Q1	1045	1068
Q2	1499	1596
Q3	1909	2168
Q4	2489	3117
Q5	4871	7325
Total	2363	3055

Source: HIES 90-91, 95-96, 2002 and CCPI

1.49 Growth-inequality decompositions: The links between poverty reduction, growth and inequality in consumption can also be explored through the exercise of growth-inequality decomposition of changes in poverty headcount. During the last decade the growth-inequality decomposition shows pronounced growth and redistribution effects. If inequality had not increased during the decade, we would have observed a significantly greater reduction in poverty. With no change in distribution, the rise in average consumption would have been enough to reduce poverty by more than 15 percent nationally between 90-91 and 2002 (by 12 and 18 percent in urban and rural areas respectively), instead of the observed reduction of only 3 percent (8 and 5 percent in urban and rural areas respectively).

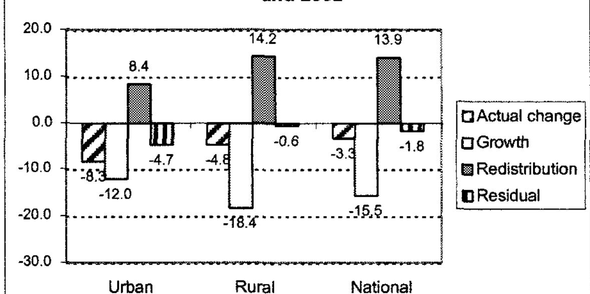
Table 1.17: Inequality: Gini coefficient of per capita expenditure*

	90-91	*2002*
Urban	0.37	0.42
Rural	0.29	0.39
Estate	0.22	0.26
National	0.32	0.40

Source: HIES 90-91, 95-96, 2002 and CCPI

1.50 A critical implication for a poverty-reduction strategy is therefore to ensure that growth is not inequality-enhancing. This would require a conscious effort in the reform program for identifying sources of growth in lagging areas and finding ways to improve productivity and employment. It will be equally important to incorporate in the strategy mechanisms for addressing vulnerability to economic shocks, through viable social protection programs that effectively target the most vulnerable. The ongoing efforts to improve the targeting efficiency of Samurdhi is a promising beginning, which can be expanded by rationalizing other programs to create a comprehensive safety net system for the country.

Fig. 1.13: Growth-inequality decomposition between 90-91 and 2002



[20] The GIC maps the average annual rate of growth of real per capita consumption between the relevant years for all centiles (1 percent quantile) of the consumption distribution (see Ravallion and Chen, 2003 for details).

Part II. Cease fire and Unfinished Reforms

2.1 The year 2001 may have reflected the old adage of it being "darkest before dawn". The emerging long term problems, outlined earlier, were severely exacerbated by several unforeseen shocks. There was an escalation of the civil conflict, including the massive surprise attack by the LTTE on Colombo Airport. The fiscal situation worsened with the deficit mounting to nearly 11 percent of GDP and government debt exceeding 100 percent of GDP. Agriculture was hit by major floods and later drought, with real value added falling by over 3 percent. The power sector suffered from brown-outs, with consequent disruptions for industries and services, both of which also registered negative growth. An already difficult situation was severely compounded by the events of September 11, heightened political uncertainty and sluggish demand for Sri Lanka's exports. Foreign investment and tourism plummeted. Aggregate investment dropped sharply from 28 percent of GDP in 2000 to 22 percent in 2001. Overall GDP fell by 1.4 percent, the first contraction in the economy since Independence in 1948. Inflation accelerated sharply to 14 percent because of drought, production shortfalls and substantial depreciation of the Rupee. Defense spending and fiscal laxity grew in the run up to the December 2001 general elections.

2.2 In the elections, the UNP-led coalition returned to power after seven years with a slender parliamentary majority and a mandate for negotiating peace and undertaking economic reforms. The new government swiftly negotiated a cease-fire with the LTTE in February 2002 and initiated a series of peace talks aimed at securing lasting peace. On the economic front, it launched a wide ranging program of fiscal consolidation and structural reforms aimed at putting Sri Lanka on a faster trajectory of growth and poverty reduction. The program was articulated in the "Regaining Sri Lanka" (RSL) document which was published in December 2002 following a preparation of four years.[21] The principal thrusts of RSL were : (i) securing lasting peace; (ii) building a supportive macroeconomic environment; (iii) accelerating economic growth, with private sector leading the effort; (iv) investing in people and creating opportunities for the poor; and (v)strengthening "governance" in the public sector to enhance the development impact of public resources.

2.3 The RSL received the broad approval of the international community at the 2003 Tokyo Donor Conference where donors pledged US$4.5 billion to support the Government's post-conflict reconstruction efforts over a period of four years. It thus provided the basis for increased support by the World Bank through its First Poverty Reduction Support Credit (PRSC I) and by the IMF through a new Poverty Reduction and Growth Facility/Extended Fund Facility (PRGF/EFF). Other major donors providing increased assistance included the Asian Development Bank (ADB) and the Japanese Bank for International Cooperation (JBIC).

A. Peace and Reform Agendas: 2002-04

2.4 The range and depth of the economic reforms undertaken and initiated in 2002 and 2003 warrant the description "third wave" (Box 2.1). Much of this agenda involved second generation reforms built on initiatives launched and developed under the preceding administration. A brief description of some of the major elements of reform follow.

Fiscal Consolidation

2.5 The 2002 budget signaled a commitment to fiscal consolidation, structural reforms and economic growth. Selective expenditure cuts were introduced, including a public sector hiring freeze. A dual rate VAT system replaced the Goods and Services Tax and the National Security Levy. The budget deficit target was set at 8.5 percent of GDP (outcome was close to 8.9 percent) reflecting over 2 percent of GDP deficit reduction in one year. The 2003 budget reflected a continuity of these

[21] Part I of the strategy laid out the "Vision for Growth" while Part II articulated the strategy for connecting growth to poverty reduction. The latter part was compiled mostly by the preceding SLPF-led administration.

initiatives. To ensure that fiscal consolidation continues, the Fiscal Management (Responsibility) Act (FMRA) was passed in January 2003. The Act sets a strict limit on borrowing from Central Bank, and fixes the deficit target for 2006 at below 5 percent of GDP and government debt at a target of 85 percent of GDP (Box 2.2). It requires regular mid-year and end fiscal year fiscal position reports to parliament and also mandates a "Pre-election Budgetary Position" report to discourage pre-election profligacy.

Box 2.1: Summary of Selected Reforms, 2002-03

Fiscal Consolidation

- *Fiscal Management Responsibility Act (January 2003)* setting targets for reducing the budget deficit (5% of GDP) and public debt (85% of GDP) by 2006.
- Budget deficit reduced from 10.8 % of GDP in 2001 to 8 percent in 2003 and net domestic financing down by 4 % of GDP in 2003.
- A two-tier VAT introduced in 2002 in place of the GTS and NST and later unified at 15% (2004 Budget).

Public Expenditure and Administration

- Hiring freeze in effect since October 2002.
- Contributory Pension scheme for new public sector workers enacted (February 2003).
- Voluntary Retirement Scheme (VRS) targeted to reduce over-staffing in the lower and middle grades announced (November 2003).
- Salary Review Committee established to review wage scales and rationalization of government agencies (March 2003).
- New, independent Public Service Commission appointed (2002).
- Medium Term Budget Framework (MTBF) initiated (2004 budget).

Infrastructure and Public Utilities

- Public Utilities Commission of Sri Lanka (PUCSL) established (October 2002) and key staff appointed.
- *Electricity Reforms Act* to unbundle CEB enacted (October 2002).
- Petroleum and electricity prices regularly adjusted to reflect cost recovery.
- Distribution of petroleum products opened to competition (2003).
- External gateway monopoly by Sri Lanka Telecom opened to private operators (28 licensed in 2002).

Welfare Reform

- *Welfare Benefit Act* passed (Sept 2002).
- Preparatory technical work completed including, application forms and formula to determine eligibility, and pilot of revised targeting (2003).

Agriculture and Land Reform

- *Land Ownership Bill* presented to Parliament (Nov 2003), but repealed by Supreme Court.
- *Amendments of Land Development Ordinance* initiated.
- *Amendments to Registration of Title Act* initiated.
- *National Seed Act* approved (May 2003), and drafting of regulations initiated.
- Preparation of liberal *phyto-sanitary* regulations initiated
- Drafting of *National Water Bill* initiated.

Labor Reform

- Compensation formula for retrenchment of workers under *TEWA (Amendment)* issued (Jan 2004).
- *Industrial Disputes Act* amended to reduce time to resolve labor disputes (Jan 2004).
- Unemployment Benefit Scheme announced (Jan 2004).

Financial Sector

- Financial adviser hired to assess options for the commercialization of People's Bank. (suspended)
- Bank's capital adequacy ratio increased to 10% (2003).
- *Amendment of Banking Act* to enhance CBSL's prudential oversight of banking system passed (Dec 2002).
- Sri Lanka Insurance Corporation privatized (April 2003).

Source: World Bank Reports

2.6 To contain the growth of government wages and pensions, several initiatives were launched, including a contributory pension scheme for new public sector workers and a Voluntary Retirement Scheme (VRS) to reduce overstaffing in lower and middle grades. Work was initiated on a Medium

Term Budget Framework (MTBF) aimed at improving public expenditure management and a Salary Review Committee was established to look at salary scales and rationalization of government agencies.

Box 2.2: The Fiscal Management (Responsibility) Act

On December 2002, Parliament approved the *Fiscal (Management) Responsibility* Act (FMRA) to be effective from fiscal year 2003. The purpose of the Act is to provide a formal framework for fiscal discipline, and to increase transparency and accountability in government fiscal operations.

A key element of the FMRA is the introduction of medium-term targets. Specifically, the fiscal deficit has to be reduced to 5 percent of GDP by 2006 and maintained under that level thereafter. The FMRA also sets ceilings on total government debt, which should not exceed 85 percent of GDP by 2006, and 60 percent of GDP by 2013. Another important characteristic of the FMRA is that it sets a limit on explicit government guarantees to 4.5 percent of GDP.

As the FMRA is also designed to improve the credibility of fiscal policy, the Act mandates the government to present a number of reports, including: (a) a Fiscal Strategy Management report, with the Budget Speech; (b) Mid-Year Fiscal Position Reports; (c) Final Budget Position Report; (d) Pre-Election Budgetary Position Reports, within three weeks of the announcement of a general election; and (e) Statements of Responsibility by the Finance Minister and Secretary, together with a Pre-Election Budgetary Position Report. Several of these reports have been presented.

2.7 Despite these initial improvements in fiscal management, tax revenues continued to fall in 2003, partly reflecting the transition to a new (two-tier) VAT system. The slippage relative to the budget was about 1.5 percent of GDP. With expenditure cuts partly offsetting revenue shortfalls, the budget deficit closed at 8.0 percent of GDP in 2003, down from 2002 but higher than the budget target (7.5 percent of GDP).

State Owned Enterprises

2.8 The provision of key utilities and economic services by state-owned enterprises (SOEs) has resulted in low quality of service delivery, politicized pricing and management, and employment decisions. This has adversely affected the competitiveness of the entire economy and created additional burdens on public finances (see Box 2.3).

2.9 Improvements in the performance of SOEs was sought through increased private sector participation and the establishment of autonomous regulatory bodies. To this effect, the Public Utilities Commission of Sri Lanka (PUCSL) was established in October 2002 to act as a multi-sector regulatory agency initially covering electricity and water and in future petroleum and railways. This followed the model of the Telecom Regulatory Commission that is successfully overseeing an unprecedented boom in the privatized telecom industry. However, since the PUCSL had not assumed regulatory functions, prices remained subject to political manipulation.

2.10 In the petroleum sector, the monopoly of the Ceylon Petroleum Corporation (CPC) in import and distribution was ended by opening the market to two additional players while two thirds of CPC's retail network was privatized. The competition resulted in visible improvements in the quality of retail services. Pending PUCSL's assumption of regulatory functions over the petroleum sector, prices were adjusted according to an automatic formula tied to world prices, but the pass-through of oil prices increases was stopped in late 2003 in the run-up to the April 2004 elections. In the power sector, the unbundling of the generation, transmission and distribution functions of the state-owned CEB into independent companies was started, but is yet to be completed. In transport and communications, the external gateway monopoly of Sri Lanka Telecom (SLT) was ended and additional shares divested, bringing about a 60 percent decline in long distance tariffs. Under the Sri Lanka Railway Authority Act, the loss-making Railways Department was moved out of the consolidated budget, albeit amidst strong political opposition. Attempts to privatize the Sri Lanka

Transport Board through the stock exchange failed to attract interest from credible buyers due to the inflexibility of sale conditions.

Box 2.3: Financial Burden of SOEs

State-owned enterprises (SOEs) pose a heavy burden on the budget, further shrinking the fiscal space for investment in physical and social infrastructure. Total transfers (including current and capital) to SOEs in 1999-2003 remained high at close to 3 % of GDP, with current transfers amounting to some 1 % of GDP. Sri Lanka Transport Board, the Railways Department, and Ceylon Electricity Board (CEB) absorb large shares of current transfers. SOEs have also racked up considerable short term debt mainly to state-owned commercial banks: the People's Bank and the Bank of Ceylon. For example, liabilities to commercial banks from the CEB alone stood at over 1% of GDP at the end of 2003. Other SOEs with large debts include the Cooperative Wholesale Establishment (CWE) and Ceylon Petroleum Corporation (CPC).

Some steps were taken in 2003 to improve the financial performance of SOEs, but with limited success. Sovereign guarantees to SOE borrowing were withdrawn and SOE borrowings were to be included in the budget as transfers. The divestiture of one third and 40% of CPC's and CWE's retail networks was completed. However, the unbundling of the CEB into independent commercial units has been delayed; so has the adjustment of electricity and fuel prices to reflect cost recovery. The latter has led to the accumulation of large losses by the CEB and the CPC, which have translated into increased budgetary subsidies and further debts with the banking system

Recognizing the urgency of reforming SOEs as viable commercial enterprises and stemming budgetary losses, one of the first actions of the UPFA administration has been to establish the Strategic Enterprise Management Agency (SEMA) by Presidential decree. Twelve SOEs in the financial, power, petroleum, transport, water, and pharmaceutical sectors have been brought under SEMA to be reformed within the state ownership structure through business plans developed by SOE management in consultation with Government and trade unions.

Agricultural Land

2.11 The incomplete transfer of property rights of state lands alienated to farmers and Sri Lanka's inefficient land administration system are major impediments to promoting investments in the rural areas and improving productivity in agriculture. Thus, the thrust of recent land reforms has been to: (b) remove restrictions for sale, mortgage, lease and transfer of land permits and grants alienated to farmers under the *Land Development Ordinance* (LDO), involving about 1.4 million hectares (35 percent of arable land); and (b) improve the cost efficiency, public confidence and transparency in the land administration system.

2.12 A *Land Ownership Bill* —to convert restricted land grants to full private ownership—was presented to Parliament in November 2003, but was challenged in the Supreme Court who ruled that the Bill violated a provision of the 13th amendment to the Constitution.[22] In view of this, work started to amend the LDO upholding the legal mandate of the Provincial Councils (PCs) in land administration. In addition, draft amendments to the 1988 *Registration of Title Act* (RTA) were prepared and activities initiated to develop a policy/institutional framework for the combined implementation of RTA and the conversion of grants to free hold title. Efforts also aimed at consolidating all agencies dealing with land administration [23]under a single Ministry to reduce the administrative burden. An important first step in this direction was the appointment of the Registrar General of Lands as the *Registrar General of Title* and the enactment of the Survey Act, which takes into consideration land titling requirements.

[22] According to this, the Provincial Councils have the authority to deal with land allocation matters.
[23] The Survey Department, the Land Settlement Department, the Registrar General's Department, and the Commissioner of Lands Department.

Labor Market

2.13 Sri Lanka's labor market has been constrained by costly processes involved in resolving labor disputes and retrenchment. Under the 1953 Termination of Employment of Workmen's Act (TEWA) —amended in 1971—firms with more than 15 workers are required to obtain the written consent of the employee and/or the permission of the Labor Commissioner for the termination of the employee on non-disciplinary grounds. By 2001, labor disputes took on average 440 days to resolve and labor tribunals had accumulated a backlog of 18,000 cases. Sri Lanka's politicized unions and often entrenched management styles have strained industrial relations, further reducing chances of quick resolutions. Employers have responded by limiting expansions and job creation, suppressing base wages, and resorting to outsourcing and subcontracting. Uncertainty and high retrenchment costs make it difficult for firms to plan exit costs and have diminished Sri Lanka's ability to attract foreign investment outside the boundaries of the FTZs which, as explained elsewhere, have been subject to a less restrictive labor regime.[24]

2.14 To begin addressing labor market rigidities, TEWA was amended to require the application of a compensation formula (effective January 2004) for job termination cases. The Industrial Disputes Act was also amended, setting timelines for tribunal cases, arbitration cases and termination applications. Although severance costs under the reformed TEWA remained very high by world and regional standards, they were made more predictable (and somewhat lower) than in the previous regime. However, the system remained subject to arbitrariness as the labor commissioner's approval of retrenchment applications was still required. Shortly after assuming office, the UPFA's government suspended the formula which is now being revised.

Financial Sector

2.15 The financial sector improved considerably during the past two decades reflecting a strengthened regulatory and legal framework and a declining share of state-owned financial institutions. Nevertheless, two state-owned banks still dominate the banking system, the Bank of Ceylon (BC) and People's Bank (PB), accounting for 46 percent of the banking assets (74 percent in 1980). After two recapitalizations in the 1990s, the PB is insolvent and both banks' continue to have high non-performing loans (15-20 percent). High intermediation costs (associated to overstaffing and loss-making branches) have contributed to high cost of funds. Political interference, including in lending decisions, account for these financial weaknesses. In view of this, options were initially developed to commercialize the PB (and thus strengthen its governance structure), including through a sale of a majority equity stake to a strategic investor. However, the UPFA government has ruled out the privatization option and plans to rely on restructuring to deal with the banks' problems. Meanwhile, the financial position of the banks is again under considerable strain owing to increased lending exposure to the state-owned CPC and CEB which, due to delayed price adjustments (for fuel and electricity) are incurring substantial losses.

Welfare System

2.16 The persistence of poverty underscores the importance of well-targeted safety nets in mitigating poverty and vulnerability. Although Sri Lanka has a long standing welfare system with a mandate to play this key role, its impact on reducing poverty and vulnerability has been below potential owing to a number of problems, including overlapping objectives (and coverage) and mis-targeting. Notably, due to a high degree of politicization, the Samurdhi program (the largest of the safety net costing 0.5 percent of GDP in 2003), covers almost half of the population but misses about

[24] For instance, CalPers, the largest US pension fund decided not to invest in Sri Lanka in 2002 citing labor market rigidities as a bigger concern than the political instability. Sri Lanka has generated large employment opportunities and attracted FDI in the FTZs where labor unions have had a limited presence.

40 percent of households from the poorest quintile, while almost 44 percent of its budget is spent on households from the top 3 quintiles.[25]

2.17 The Welfare Benefit Act enacted in October 2002 provided the legal framework for reforms aimed at rationalizing the selection of beneficiaries under *all* transfer programs in the country, starting with Samurdhi. The Welfare Benefits Board (WBB) established under the Act—has completed field testing the application form, finalized the formula for determining eligibility of Samurdhi beneficiaries, and initiated a process of consulting stakeholders. Next steps include the completion of the enrolment phase of the pilot, followed by preparations for the island-wide application and targeting process. This would need to be complemented by a widespread publicity campaign to generate awareness about the rationale and rules of the new system, before it becomes operational. The full implementation of the Welfare Benefit Act are expected to: a) limit the Samurdhi program to the bottom 30 percent of the population, b) improve the selection and identification of the poor to be covered by welfare programs through a proxy means test formula, c) make transfers more progressive, i.e. giving larger amounts to poorer households, and d) remove overlap by other public welfare programs. If implemented as planned, this reform will have direct positive implications in the lives of poor families, especially of those currently excluded from the welfare system.

Box 2.4: Improving the Targeting of Welfare Programs

An objective criteria for the selection of beneficiaries under the Samurdhi transfer program has been developed, involving *a proxy-means test formula* that assigns "scores" to households depending on certain easily observable characteristics, like household demographics, ownership of assets and durables, and quality of housing. In addition, a computerized database will be used to monitor eligibility, entry and exit and crosscheck for benefits received from multiple sources, to minimize duplications across programs.

To test the proxy-means tested application and selection process for beneficiaries of the Samurdhi program, a pilot covering 48,000 households in 114 Gram Niladhari divisions was conducted, and its results were discussed at a Workshop organized by the WBB in November 2003, with participation from all stakeholder ministries. The workshop concluded with a number of operational recommendations, including limiting eligibility to the poorest 25-28 percent of the population – in comparison to the current coverage of nearly 50 percent of the population; and a payment scheme that combines a fixed amount for all eligible households with an amount *per* vulnerable member of the household (children, disabled, elderly). Separating the Samurdhi transfers from the compulsory savings, insurance and lottery schemes, was also recommended.

Simulation exercises indicate significant welfare gains would be made from implementing the new targeting system. With the current Samurdhi transfer program budget of Rs. 9 billion (at 2004 prices) and the cutoff point set at the bottom 27.5 percent of the population, an optimum payment schedule that maximizes estimated welfare gains also generates a considerable increase in welfare over the current level.

2.18 Other major reforms initiated during the period include the areas of banking, insurance, public administration and expenditure management. (refer to Box 2.1).

Towards Securing Peace

2.19 Although peace negotiations have stalled since April 2003, the cease fire agreement has held for over two years now and progress has also been made in other peace-related fronts. Notably, Parliament passed a law in November 2003 that conferred citizenship to about 170,000 Estate Tamils, thus putting an end to fifty years of statelessness. In addition, an action plan was developed to address cases of child recruitment for military activity. In 2002, the road to Jaffna was reopened after 12 years, the economic embargo on LTTE-held areas lifted, and large tracts of land de-mined. This has facilitated the return to their homes of some 345,000 (Internally Displaced Persons (IDPs) (about 47 percent of the internally displaced population). Donor support (about US$430 million) was

[25] See Glinskaya (2000) for a detailed evaluation of the Samurdhi program.

coordinated to finance post-conflict assistance and reconstruction in the North East. Damaged schools (148) and health care centers (115) have either been repaired or are in the process of being repaired. School drop-outs (20,000) have returned to school in the North East and catch up education is provided in all districts. Land under paddy cultivation in the North increased by 35 percent leading to five-fold increase in the winter harvest of 2003. The total fish catch in the North East almost doubled in the same period.

B. Early Gains from Reforms and Peace

2.20 There have been some clear indications of initial gains from the implementation of the strong economic reform program and continuation of the cease-fire.

- Economic growth resumed with real GDP growth reaching 4 percent in 2002 and 5.9 percent in 2003. Growth in 2003 was broad based as the textile-led industrial sector recovered from the 2001 downturn, agriculture benefited from good weather, and economic activities in the North East resumed. Notably, tourist arrivals hit a historical record of half a million.
- The inflation rate fell from 14.2 percent in 2001 to 6.3 percent in 2003; nominal interest rates were halved; and private credit increased.
- Unemployment moderated from an average of 8.8 percent in 2002 to 8.1 percent in 2003, although it remained above the 7.9 percent recorded in 2001.[26]
- Foreign direct investment, which had slumped to US$ 82 million in 2001, rebounded to US$ 242 million in 2002, but having reached US$ 170 million in first half of 2003 closed the year at US$ 229 million, amidst increased political uncertainties.

2.21 While noteworthy and welcome, these gains remain fragile as the peace and reform agendas are still unfinished. On the peace front, while the cease fire is holding, negotiations have been stalled since April 2003. In the economic arena, initial gains in fiscal consolidation—which contributed to declining inflation and interest rates—have been eroded as a result of weak revenue performance and other additional fiscal pressures in the run-up to the April 2004 Parliamentary elections (including large subsidies on petroleum and fertilizer against rising world prices). Moreover, most of the structural reforms (much of them legislative) that were launched during the period have yet to be implemented. Against this backdrop, it is rather disquieting that aggregate investment continued to be at a level (22 percent of GDP in 2003) significantly below the levels seen in the late 1990s (27-28 percent). Private investment has not rebounded back from the trough of 2001. In this context, the political uncertainties since November 2003 may have exacted a significant toll on the confidence and intentions of both domestic and foreign investors. In case of the latter, the BOI has instances of several multinational firms which have placed their investment plans for Sri Lanka on hold.

Table 2.1: Recent Trends in Investment (Percent of GDP)

	1999	2000	2001	2002 (Prov.)	2003 (Proj.)
Investment	27.3	28.0	22.0	21.3	22.2
Government	3.2	3.3	3.0	2.0	2.7
Public corporations	3.5	3.2	2.8	2.6	2.3
Private	20.6	21.5	16.2	16.7	17.2

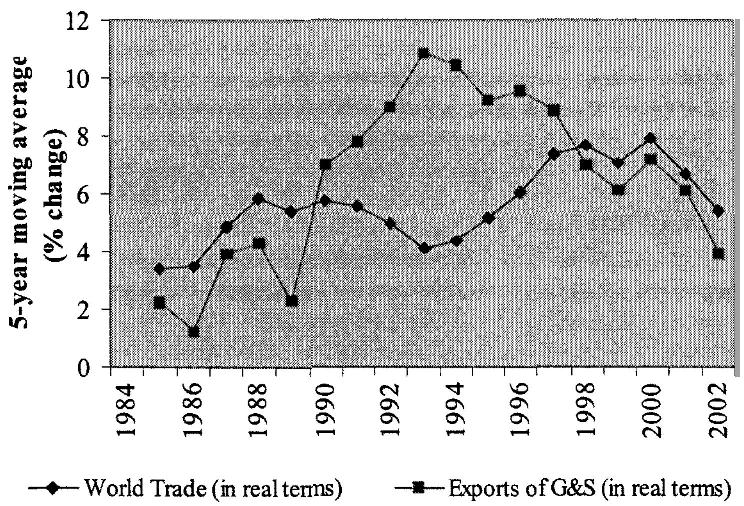
Source : CBSL (2003)

2.22 Of particular concern is that this downturn in the private investment to GDP ratio occurs at a time when export growth is showing signs of deceleration. As shown in Figure 2.1, during the early 1990s, Sri Lankan exports were growing more rapidly than world trade. However, having peaked at an annual growth rate of over 10 percent (on a five-year average basis), export growth has been on a downward trend since the mid-1990s and by 2002 it was approaching an annual rate of 3 percent, below world trade growth, indicating that the country has been losing market share. Being a small

[26] Excluding the North East

open economy, Sri Lanka's growth prospects depend critically on the country's ability to sustain rapid export growth. Therefore, while some of the recent deceleration of export growth may reflect temporary lingering effects from the 2001 shock, the downward growth trend suggest the presence of longer-term factors underlying such decline.

Figure 2.1: Real Growth of Sri Lanka Exports and World Trade



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

III. Towards Faster and More Equitable Growth

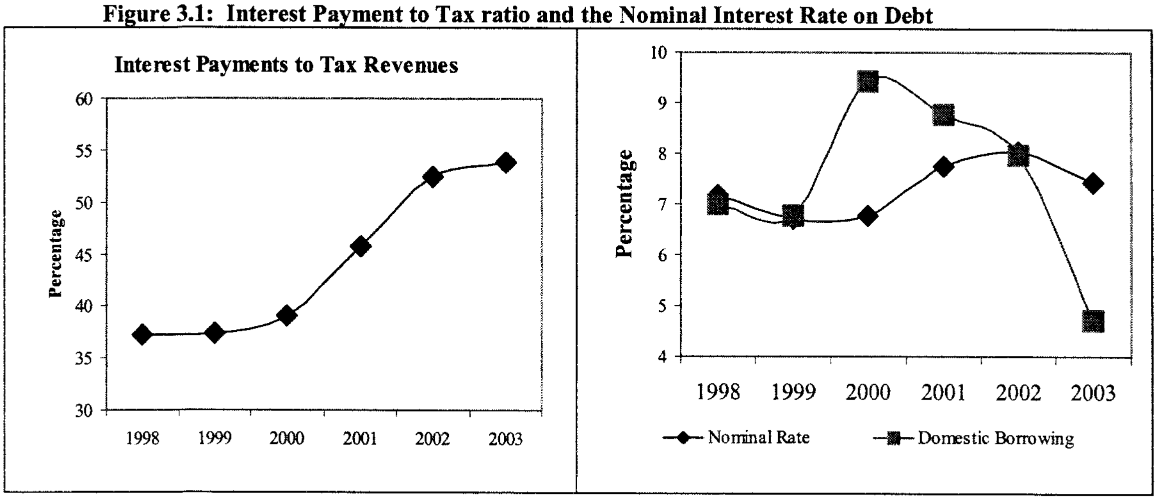
3.1 Democracy and competitive politics frequently lead to a change of government. The Sri Lankan general elections of April 2004 have demonstrated that again. The United People's Freedom Alliance (UPFA) composed of the SLFP and its new ally the Marxist-oriented JVP leads the new government of the country. The underlying political situation remains complex, with the recent split in the LTTE and the increased parliamentary strength of the JVP and the Tamil National Alliance constituting important new factors in the equation. Whichever government is in power, the basic agenda of peace, rapid development and poverty reduction are shared goals for the people of Sri Lanka. Sustaining the cease fire and securing durable peace are quintessentially political challenges on which this report must remain silent. The discussion in this section focuses on a selection of key medium-term development issues and challenges that confront the new government (indeed, any government) of Sri Lanka as it strives to meet the aspirations of the people for faster economic growth, more jobs and less poverty.

3.2 Achieving faster growth and poverty reduction will be a challenge given the country's structural weaknesses, including: high fiscal deficits and public debt, limited export diversification (against the backdrop of the imminent abolition of the MFA from January 2005), stagnating agriculture, serious infrastructure bottlenecks, and declining quality of human capital due to falling quality of education. Addressing the structural weaknesses will require containing the burgeoning fiscal deficits, diversifying the export base, realizing the growth potential of non-plantation agriculture, strengthening the road and power infrastructure, and revamping the education system. It will be also essential that in managing the economy, policy reversals be avoided and that gains from past reform efforts be sustained and further strengthened.

1. Managing Public Finances

3.3 Despite significant gains in fiscal consolidation between 2001 and 2003 and the milestone enactment of the FMRA, the fiscal situation remains under substantial stress. In 2003 the fiscal deficit was 8 percent of GDP and the public debt stood at almost 106 percent of GDP, a long way from the FMRA targets for 2006 (of 5 percent and 85 percent of GDP, respectively). Interest payments still accounted for 7 percent of GDP, absorbing more than half of total tax revenue and well in excess of the expenditure on education and health (4 percent of GDP) or public investment (less than 5 percent of GDP). High interest payments reflected high public debt and rising dependence on relatively more expensive domestic financing as compared to concessional external finance, particularly during the 1998-2002 period. Of possibly even greater concern was the poor performance of tax revenue, which dropped to a low of 13.2 percent of GDP, despite having been budgeted at 14.8 percent of GDP and despite the strong recovery of the economy in 2003.

Figure 3.1: Interest Payment to Tax ratio and the Nominal Interest Rate on Debt



3.4 The Budget 2004 had targeted a fiscal deficit of 6.8 percent of GDP and tax revenues of 14.5 percent of GDP. *The Pre-Election Budgetary Position Report* released in March 2004 (the first issued under the FMRA obligations) revised the deficit upwards to 7.3 percent of GDP, mainly on account of a weaker primary balance due to reduced revenues. The implications of these adverse trends for achieving FMRA targets for 2006 and beyond for the budget deficit and government debt to GDP ratio are explored below.

Table 3.1: Sri Lanka Summary of Government Fiscal Operations

(As Percent of GDP)

	1985	1990	1995	1998	1999	2000	2001	2002	2003	2004*
Total Revenue	**22.3**	**21.1**	**20.4**	**17.2**	**17.7**	**16.8**	**16.6**	**16.5**	**15.7**	**15.8**
Tax Revenue	18.7	19.0	17.8	14.5	15.0	14.5	14.6	14.0	13.2	13.8
Non-Tax Revenue	3.6	2.1	2.7	2.7	2.7	2.3	2.0	2.5	2.5	2.0
Total Expenditure and Net Lending	**34.0**	**30.6**	**31.0**	**26.3**	**25.2**	**26.7**	**27.4**	**25.4**	**23.7**	**23.1**
Current Expenditure	**20.1**	**22.3**	**23.1**	**19.6**	**18.7**	**20.2**	**21.6**	**20.9**	**19.0**	**18.0**
Security	4.5	4.1	6.5	5.0	4.4	5.6	4.8	4.0	3.5	--
Interest Payments	4.6	6.4	5.7	5.4	5.6	5.7	6.7	7.4	7.1	6.0
Wages and Salaries (Civilian)	3.6	3.9	3.4	3.0	3.0	3.2	3.4	3.4	3.0	--
Subsidies and Transfers	5.5	6.5	6.1	4.6	4.2	4.2	4.6	4.7	4.0	4.1
[Pensions]	--	1.4	2.2	1.9	1.7	1.7	1.9	2.0	1.8	--
[Janasaviya / Samurdhi]	--	0.9	0.8	0.8	0.7	0.8	0.9	0.6	0.5	--
Others	6.4	5.5	7.9	6.6	5.9	7.1	6.9	5.4	4.9	--
Capital Expenditure and Net Lending	**13.9**	**8.3**	**7.9**	**6.7**	**6.5**	**6.5**	**5.9**	**4.6**	**4.7**	**5.1**
Overall Fiscal Balance (ex. Grants)	**-11.7**	**-9.5**	**-10.6**	**-9.2**	**-7.5**	**-9.9**	**-10.8**	**-8.9**	**-8.0**	**-7.3**
Financed by :										
Net Foreign Financing	6.4	5.7	4.5	1.7	0.7	0.4	1.4	0.6	2.9	1.7
Net Domestic Financing	5.2	4.2	5.1	7.0	6.8	9.4	8.8	8.0	4.5	4.2
Asset Sales	0.0	0.0	0.4	0.4	0.0	0.0	0.6	0.4	0.6	--
Memorandum Items										
Primary Balance (ex. Grants)	-7.1	-3.1	-4.9	-3.8	-1.9	-4.2	-4.1	-1.6	-0.9	-1.3
Current Account Balance	2.3	-1.2	-2.7	-2.4	-1.0	-3.4	-4.9	-4.4	-3.3	-2.2
Total Wage Bill	4.2	4.9	5.2	5.3	5.3	5.5	5.5	5.6	5.2	--
Gross Defense Expenditure	4.5	4.1	6.5	5.6	4.9	6.1	5.5	4.9	--	--
Education and Health	--	4.5	4.5	4.0	4.0	4.1	3.3	3.9	3.8	--
Public Debt	80.2	96.6	95.2	90.8	95.1	96.9	103.2	105.3	105.9	--
of which Domestic Debt	30.6	41.6	43.3	45.5	49.1	53.8	58.0	59.8	57.9	--

Source: Central Bank of Sri Lanka Annual Report (various issues), IMF and World Bank Staff estimates.
*Budget as revised per Pre-Election Report

A. Fiscal and Debt Sustainability Analysis

3.5 The fiscal/debt sustainability analysis for Sri Lanka shows that achieving the FMRA medium and long term targets will be very challenging, especially given the recent increase on fiscal imbalances. Such targets include: (a) a fiscal deficit not to exceed 5 percent of GDP by 2006; (b) total public debt of 85 percent of GDP by 2006; and (c) government debt not to exceed 60 percent of GDP by 2013. Based on the estimated fiscal position in 2004, the model used for this purpose projects the path for the primary balance that would be required to meet the FMRA targets, using baseline macroeconomic assumptions and a consistency framework that allows for sensitivity analysis using alternative assumptions on growth and interest rates.

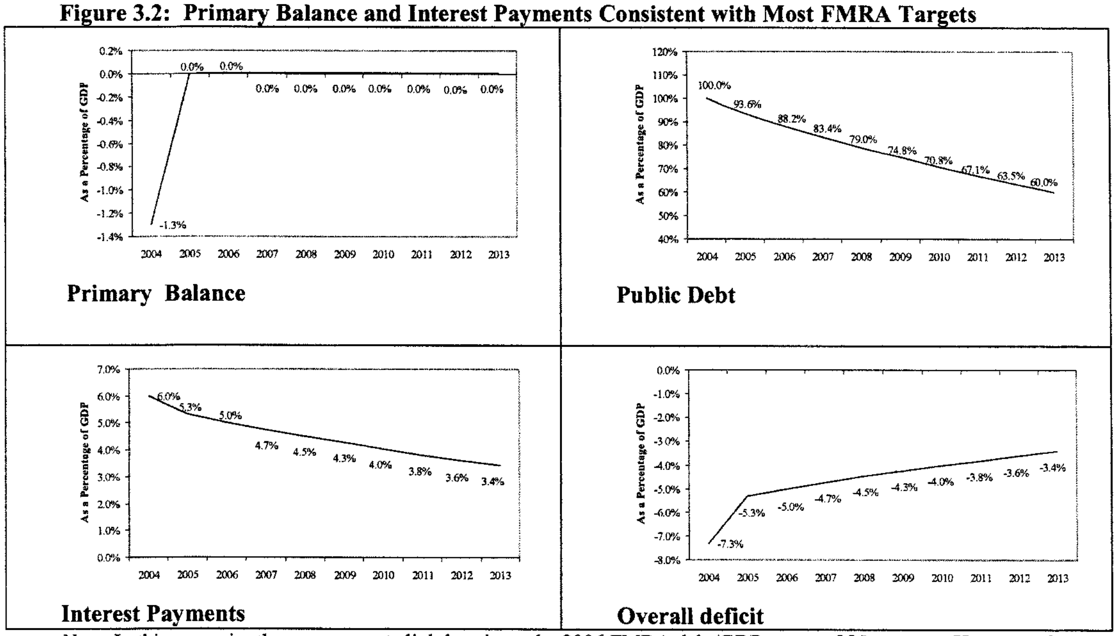
Table 3.2: Baseline Macroeconomic Assumptions

	2004	2005	2006	2007	2008-2013
GDP growth (%)	6.0	6.3	6.5	6.3	6.0
Change in GDP deflator (%)	7.0	6.0	5.0	5.0	5.0
Nominal interest rate on public debt* (%)	5.9	6.0	6.0	6.0	6.0
External financing (as % of GDP)**	0.4	2.8	1.8	1.8	1.8

* Average interest rate that applies to total government debt, expressed in nominal terms.
**Net External financing, including grants.
Note: The real exchange rate is assumed to appreciate mildly during 2004-2006 and to remain constant thereafter.

3.6 As shown in Figure 3.2, a zero primary balance between 2005-2013, will be required to bring the fiscal deficit down to 5 percent of GDP by 2006 and public debt to 60 percent by 2013. (Under this scenario, public debt is projected at 88 percent of GDP in 2006, somewhat above the FMRA target). This is based on an estimated primary deficit of 1.3 percent of GDP in 2004, as envisaged in the pre-election report, but it should be noted the deficit is currently estimated at about 3 percent, implying that a further adjustment would be needed to remain within the FMRA targets.

Figure 3.2: Primary Balance and Interest Payments Consistent with Most FMRA Targets



Note: In this scenario, the government slightly misses the 2006 FMRA debt/GDP target of 85 percent. However, the 2006 fiscal deficit target of 5 percent of GDP is met.

3.7 The projected paths of the primary balance and debt ratios are consistent with lower fiscal deficits and interest payments on public debt. Starting with interest payments on public debt equivalent to 6 percent of GDP in 2004, fiscal savings equivalent to 1 percent of GDP would accrue by 2006, and 2.6 percent of GDP by 2012-2013. Total interest payments on public debt would stabilize at around 3.5 percent of GDP by 2012. Further, the overall fiscal deficit in this scenario complies with the 2006 deficit ceiling set by the FMRA of 5 percent of GDP. Moreover, the overall deficit would fall by nearly 4 percentage points of GDP between 2004 and the end of the projection period.

3.8 *Contingent liabilities*. These calculations do not take into account the impact of explicit and implicit contingent liabilities.[27] In the case of Sri Lanka, such liabilities could include liabilities of state-owned enterprises (SOEs) and obligations associated with the pension system. Over the past two years, some measures have been taken to improve the financial position of SOEs, but a number of

[27] Explicit liabilities include state guarantees, legal disputes, and uncalled capital. Implicit liabilities include the risk of default, liabilities of entities being privatized.

enterprises continue to incur operating losses, have large debts to the financial sector, and carry substantial labor liabilities.[28] On pensions, the recently introduced contributory pension fund, may reduce the immediate fiscal burden, but long term sustainability is not guaranteed. Also, the cost of the non-contributory pension scheme may still increase by 0.5-1 percent of GDP, from about 2 percent of GDP, over the next ten years. Under the circumstances, it would be prudent to begin providing for the fiscal risks posed by contingent liabilities by targeting a primary surplus of around 1.0 percent of GDP.

3.9 *Sensitivity Analysis*. The extent of the fiscal adjustment is highly sensitive to changes in key macroeconomic assumptions (e.g., real GDP growth, the nominal interest rate, and the exchange rate. For instance, the baseline scenario assumes that annual real GDP growth stabilizes at 6 percent in the long-run. However, if real GDP growth remained at its historical level of 5 percent, *ceteris paribus*, a primary surplus closer to 0.5 percent of GDP (as opposed to a small deficit) would be required to reach a debt ratio of 60 percent in 2013. Similarly, the base line scenario assumes an average nominal interest rate of 6.0 percent, but with a one percent increase in the interest rate, a primary surplus equivalent to 0.5 percent of GDP on a permanent basis, would be required to bring the debt ratio down to 60 percent by 2013.

Table 3. 3: Target Primary Balance and Selected Long-Run Variables

	Real GDP Growth (2007-2013) *Annual Percentage Rate*				
	4.0	5.0	6.0*	7.0	8.0
Target Primary Balance** *As percentage of GDP*	0.9	0.5	0.0	-0.5	-0.9
	Nominal Interest Rate (2007-2013) *Percentage Rate*				
	4.0	5.0	6.0*	7.0	8.0
Target Primary Balance** *As percentage of GDP*	-0.9	-0.5	0.0	0.5	0.9

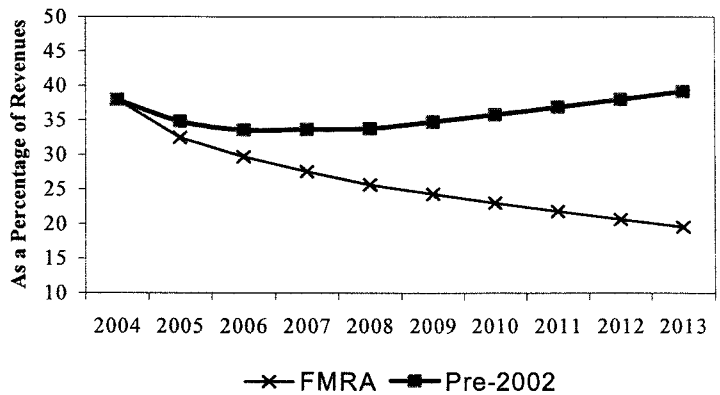
*Baseline macroeconomic scenario.

3.10 *The Impact of Fiscal Slippage*. The Pre-election Report revisions to the 2004 Budget already represented a deviation from the medium term fiscal objectives set out under the FMRA. Unfortunately, additional fiscal pressures (both on the revenue and expenditure side) in the run-up to the elections have led to a further deterioration of the fiscal position and the gains made in the last two years have been eroded. For instance, with primary deficit returning to levels seeing over the past decade, averaging 3.1 percent of GDP, it is unlikely that the economy could grow above the historical of 5 percent annually and foreign external financing of the budget would probably decline in response to the fiscal slippage. Under these circumstances, the interest-to-GDP ratio will remain high at 6-8 percent over the next ten years, absorbing over 40 percent of total revenue, even assuming a sustained increase in the tax-GDP ratio of 2-3 percent of GDP (see Figure 3.3 below).

3.11 The above analysis illustrates the vulnerability of the fiscal situation to several factors, including macroeconomic assumptions and policy shocks. Such vulnerability suggest the need to target a primary surplus in the order of one percent of GDP in the short to medium term, if Sri Lanka is to achieve a sustainable fiscal framework.

[28] Reportedly, all public enterprises in Sri Lanka are over-staffed.

Figure 3.3: Interest Payments as a Percent of Total Revenues
Return to Pre-2002 Policies vs. Full Compliance with FMRA*



*The "FMRA" adjustment scenario leads to compliance with the 2006 fiscal deficit target (5 percent of GDP) and the 2013 debt/GDP target (85 percent).

B. Priority Fiscal Reforms

3.12 A sustainable fiscal stance remains the cornerstone of any viable growth strategy. Despite recent gains, further fiscal consolidation will be needed to keep inflation and interest rates down, and ensure greater resource availability for private investment, which as mentioned earlier, has been slow to recover. In turn, the stimulus to growth of an environment of increased fiscal discipline, will help narrow fiscal imbalances. The need to tighten fiscal policy in the medium term, against mounting needs for investment in economic and social infrastructure, makes it compelling that scarce public resources be used more effectively and efficiently than hitherto. Key priorities include:

Reducing the Public Debt Burden

3.13 As discussed earlier, a key challenge for Sri Lanka is to bring the public debt to sustainable levels and thus reduce the crowding out of other (more productive) spending by the public and private sectors. This will require a steady reduction in fiscal imbalances and in domestic financing of the budget deficit. In this context, medium term limits on public debt and the budget deficit, such as those provided by FMRA, need to be an integral part of any meaningful fiscal framework.

Reforming Pay and Employment Policies

3.14 Although the size of the civil service wage bill is not at present an unmanageable burden for government, the trends are worrisome. Between 1990 and 2001, public sector employment grew at 3.6 percent annually, outpacing growth in population, labor force and real GDP (Statistical Annex Table A29). At the same time, the share of the wage bill in total revenue has increased (from 26 percent to 34 percent), suggesting that the wage bill is crowding out other government expenditure. Moreover, rapid growth in public employment (particularly at lower grades) has strained the ability of government to offer competitive salary scales for skilled, well-performing employees, with adverse consequences on the quality of services. Given overstaffing, low salary compression and serious administrative duplication and fragmentation, there is clearly ample scope for wage and employment rationalization without unduly increasing the wage bill burden. However, although these problems (and their solutions) have been known for some time,[29] little has been done to address them. Instead, successive governments have been unable (or unwilling) to de-politicize wage and employment

[29] Indeed, earlier reports, notably the Davendra Commission, had identified the need to reduce the overall size of the public service, but also to improve public sector salaries.

policies, particularly in the context of short election cycles and budget horizons. [30] It is therefore essential that governments explicitly consider the medium term implications of alternative pay and employment policy options and adopt a set of consistent measures that could be sustained overtime despite changes in leadership.

Improving Expenditure Management

3.15 Like many countries elsewhere, meeting debt sustainability and other macro/ micro objectives requires adopting a medium term approach to budgeting and planning, where the cost and benefits of particular policies can be properly assessed. For instance, provided appropriate strategies, a longer term horizon would permit a reallocation of funds from salaries and debt service (which appear fixed in the short term), toward other expenditure needed to attain desired development outcomes. The predictability of the resource constraint is a pre-requisite for effective budgets, especially when a primary policy objective is to achieve a given deficit target. This, in turn, requires increased realism in revenue estimates, including external donor financing, and a stable tax policy framework.

3.16 Sri Lanka's one-year budget system where allocations are done incrementally (previous year's budget plus or minus) provides little scope for policy makers to link the budget with government's strategies/policies. However, initial steps have been taken recently to address these shortcomings. These include (i) the adoption of budget ceilings since 2003 (as opposed to bottom-up budgeting) consistent with overall resource availability and the (ii) introduction of a Medium Term Budget Framework (MTBF), starting with the 2004 budget. The next step is the introduction of a strategic phase in the budget formulation process, involving greater consultation among government agencies, including Cabinet, on the allocation of budget ceilings.

3.17 *Intra and Inter-Sectoral Resource Allocation.* Within the parameters set at the macro level, the allocation of public expenditures (including human resources) needs to be closely linked to sector policies and objectives. However, the current administrative fragmentation (and duplication) of government agencies and functions makes it difficult to identify policy priorities, let alone public service outcomes, associated with public spending. Moreover, there are often inconsistencies between stated policies/strategies and/or serious misalignments between priorities and funding levels. In addition to the establishment of a more strategic and consultative budget formulation process, expected to underpin the MTBF, a shift toward sector ceilings (as opposed to a multiplicity of ceilings for individual spending units), could help increase the consistency between policies, resources and public service outcomes within sectors. It would also permit policy makers to consider more explicitly the potential trade-offs from shifting resources within and across sectors.

Managing SOEs and Contingent Liabilities

3.18 The fiscal burden of SOEs in Sri Lanka is high and service delivery is poor. For instance, at nearly 3 percent of GDP, direct budgetary transfers to SOEs are in excess of the entire allocation to the education sector. There are also large contingent liabilities which are increasing as a result of political interference (e.g., delays in the adjustment of fuel and electricity prices) and slow restructuring. Further efforts are needed to improve the financial viability of SOEs, particularly of enterprises with large labor and financial liabilities (such as CEB, CPC, the Railways Department, and the state-owned commercial banks), by imposing a hard budget constraint, reducing political interference, and allowing these firms to operate on a commercial basis. The Government also needs to develop regular institutional mechanisms to monitor and record explicit and implicit contingent liabilities. Pensions' policy is also an area that would need close monitoring, especially ensuring the long-term sustainability of the recently introduced contributory pension fund.

[30] For example, the newly elected government has pledged to provide employment to 30,000 new graduates within three months of taking office. In addition, there are risks that wage increases granted to health sector laborers early in the year could be extended across the civil service in response to union pressure. The latter will increase the wage bill by over 1 percent of GDP and further reduce the salary compression ratio.

Strengthening Revenue

3.19 A key priority for Sri Lanka is to increase tax revenue within a stable tax policy framework, so that revenue estimates become more realistic. Much will depend on the stability and consistency of tax policies, including measures to raise the yield of major taxes such as the VAT and income tax. These issues are discussed in more detail in the following section.

2. Tax Policies to Promote Growth and Fiscal Consolidation

3.20 The main challenge in crafting tax policies in Sri Lanka is to reverse the massive decline in the tax-GDP ratio (from 19 percent in 1990 to 13 percent in 2003) and to do so in a manner which is supportive of growth and efficiency. The challenge is daunting, given the sharp drop in trade taxes from 6 to 2 percent of GDP since 1990, stagnation of income taxes at around 2.5 percent of GDP and the incomplete transition from a complex system of turnover taxes and special levies to a consumption VAT which has lost at least one percent of GDP (Table 3.4).

Table 3.4: Medium Term Revenue Scenario

	1990	1995	2000	2002	2003 Budget	2003 Est	2004 Budget	2004 Est	2006 Proj	2008 Proj
Tax Revenue	**19.0**	**17.8**	**14.5**	**14.2**	**14.8**	**13.2**	**14.8**	**14.1**	**15.8**	**16.5**
Tax on Income	**2.3**	**2.6**	**2.2**	**2.4**	**2.7**	**2.2**	**3.0**	**2.1**	**3.2**	**3.6**
Personal Income tax	0.9	1.1	0.9	0.8	0.8	0.6	0.9	--	1.0	--
Corporate Income Tax	1.4	1.5	1.3	0.9	1.1	0.9	1.4	--	1.3	--
Tax on Interest Income	0.0	0.0	0.0	0.7	0.8	0.8	0.7	--	0.6	--
Economic Ser. Charge							0.1	--	0.3	--
Tax on Goods and Serv.	**11.5**	**10.4**	**10.4**	**10.4**	**9.9**	**8.5**	**9.4**	**9.4**	**10.3**	**11.0**
TT/GST/VAT	*6.3*	*5.5*	*3.6*	*4.3*	*6.8*	*5.5*	*6.2*	*6.0*	*7.0*	*7.8*
Manufacturing	2.1	1.5	0.9	1.1	1.4	1.2	1.3	--	1.5	--
Non Manufacturing	1.2	0.9	1.1	1.2	1.7	1.7	1.6	--	2.0	--
Imports	3.0	2.9	1.5	2.0	3.5	2.6	3.0	--	3.0	--
TT/VAT on Banking	0.2	0.1	0.1	0.0	0.2	--	0.2	--	0.2	--
VAT on Retail Sector	0.0	0.0	0.0	0.0	0.0	--	0.0	--	0.4	--
Excise Taxation	*2.5*	*2.9*	*3.4*	*3.3*	*2.8*	*2.9*	*2.9*	*3.4*	*3.2*	*3.2*
Liquor	0.8	0.9	0.8	0.7	0.6	0.6	0.7	--	0.7	--
Cigarettes	1.7	1.4	1.5	1.3	1.2	1.1	1.1	--	1.0	--
Petroleum	0.0	0.0	0.9	1.1	0.8	0.8	0.8	--	0.8	--
Other	0.0	0.6	0.3	0.3	0.2	0.4	0.3	--	0.7	--
National Security Levy	***0.0***	*2.2*	*2.7*	***1.8***	***0.0***	--	***0.0***	--	***0.0***	***0.0***
Other Taxes and Levies	**1.8**	**1.0**	**0.7**	**0.3**	**0.4**	**0.2**	**0.3**	**0.3**	**0.0**	**0.0**
Stamp Duties	0.9	0.8	0.6	0.2	0.0	--	0.0	--	0.0	--
License Fee/Vehicle tax	0.1	0.1	0.1	0.1	0.2	--	0.1	--	0.0	--
Bank Debit Tax	0.2	0.2	0.0	0.1	0.2	0.2	0.2	--	0.0	--
Tax On External Trade	**6.0**	**3.6**	**1.9**	**2.0**	**2.2**	**2.3**	**2.4**	**2.5**	**2.2**	**1.9**
Imports	5.2	3.6	1.9	1.8	1.9	1.9	2.1	--	1.9	--
Exports	0.8	0.0	0.0	0.0	0.0	--	0.0	--	0.0	--
Port Development Levy	0.0	0.0	0.0	0.2	0.3	0.3	0.3	--	0.3	--

3.21 Early projections indicate a need to raise the tax-GDP ratio to the about 16-17 percent of GDP by 2006 in order to meet the FMR goals. In principle, such revenue increase could be achievable within a broad commitment to the goal of a simple, broad based and transparent tax system, which includes: (a) a simplified income tax on a wider base, keeping concessions to a minimum, (b) a uniform, low customs tariff duty, (c) a well-focused set of excise taxes and (d) a fully consolidated, single rate retail level VAT on the widest possible base. Clearly, tax policies and their administration need greater attention if the tax-GDP ratio is to be raised to at least 16 percent of GDP by 2006. The broad direction of policy changes is indicated in the ensuing brief discussion, organized by major taxes.

Income Tax

3.22 Sri Lanka's income tax performance, at less than 2.5 percent of GDP, is quite weak by international standards. Comparable figures for recent years are 4.7 percent for Korea, 6.9 percent for Malaysia, 6.2 percent for Philippines, 4.8 percent for Thailand and 3.4 percent for Pakistan. The reasons include the provision of long term tax holidays to companies under the Board of Investment (BOI) regime (see Box 3.4), a long history of investment allowances, concessionary rates, generous depreciation allowances, as well as the exclusion of most public sector employees from the personal income tax net and weaknesses in tax administration.

3.23 The economic service charge (ESC) recently imposed on all entities with a turnover in excess of Rs.20 million or total assets in excess of Rs.10 million, should bring a large number of commercial entities into the tax net. Another important proposal is to require all companies and partnerships, or any other business registered with the Registrar of Companies or the Registrar of Business Names, to register and file annual returns with the Department of Inland Revenue regardless as to whether they are liable to pay income tax or not. All persons liable to deduct withholding tax must also required to register with the Department of Inland Revenue and furnish monthly returns. These measures, together with the new ESC, are likely to substantially broaden the base for business taxation.

3.24 In 2003, the BOI Law was amended to limit tax concessions accorded to BOI companies to those stipulated in the Inland Revenue Act. This is a step in the right direction, provided the amendment is enacted. A more radical option would be to declare a moratorium on tax holidays, including for new foreign investment. Arguments against such a proposal are: first, the revenue yield is likely to be low since transnational companies can manage their accounts to show low profits in their Sri Lankan operations; and second, the disincentive effects of such a measure could be substantial since it would bring BOI enterprises into direct and regular interface with the revenue administration. On the other hand, it would be difficult to achieve a sustained improvement in the country's direct tax to GDP ratio if the large and rapidly growing BOI sector remains indefinitely out of the tax net.

3.25 The present rate structure for business taxation is complex. There is a strong case for unifying the company tax rate at 30 percent, with a single concessional rate of 15 percent for export income.

3.26 With respect to taxation of personal income, there is really little justification for excluding incomes of public sector employees. This distortion was introduced in 1978 and partially corrected in 1997 by bringing employees in commercial enterprises into the tax net.

Value Added Tax

3.27 The VAT was introduced in 2002 in place of the Goods and Services Tax (at 12.5 percent) and the National Security Levy (at 7.5 percent and on a wider base than the GST), with the objective of reducing the cascading effect of the sales tax. However, the creation of two rates of 10 and 20 percent contributed to complexities in tax administration and led to substantial revenue leakages, which explain in part the poor revenue performance in 2003. The unification of the two rates into a single 15 percent rate in the 2004 budget was therefore a positive step. In addition to reducing exemptions, the next major step should be to extend the coverage of VAT to pharmaceutical products, life insurance policies, supply of healthcare services and, most importantly, to retail trade.

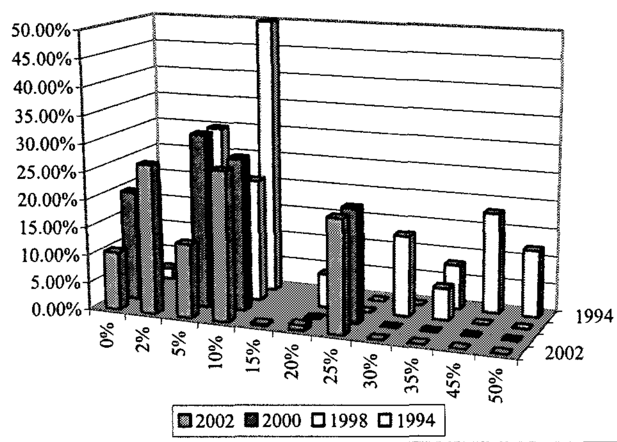
Excise Taxes

3.28 Over time the scope of excise taxation has been narrowed down to a handful of commodities such as petroleum products, liquor, cigarettes and motor vehicles. On both revenue and equity grounds there is a sound argument for expanding the coverage of excise taxation to a number of income-elastic, luxury consumer products such as air conditioners, refrigerators, washing machines, and televisions.

Customs Duties

3.29 Since 1977, and especially after 1990, the Sri Lankan tariff structure has undergone a major reduction of levels and compression of tariff bands (Figure 3.4), reflecting the country's sustained commitment to trade liberalization. By 2000, tariffs were grouped into four bands of zero, five, ten and 25 percent, except for some agricultural items kept outside the standard structure at 35 percent. Driven largely by revenue considerations, the policy direction changed somewhat since 2001. A temporary surcharge of 40 percent (reduced to 20 percent in 2002). An additional rate band of 2 percent was introduced in 2002 and more than 1500 line items were shifted from zero to this 2 percent rate. Some items were raised from 10 to 20 percent and others from 5 to 10 percent. Furthermore specific duties were reintroduced in place of ad-valorem duties for selected agricultural and industrial products. The 2004 budget reduced the import surcharge down to 10 percent, increased the minimum positive tariff from 2 to 2.5 percent and placed a few items in the 20 percent rate.

Figure 3.4 : Recent Steps Towards a Low Tariff Regime



3.30 As a result of sustained tariff reductions (at least until 2001), the average import duty collection rate fell from 19 percent in the mid 1980s (accounting for about 30 percent of total tax revenues) to 4.6 percent in 2002 (11 percent of total tax revenues). Another factor was the rapid growth of the duty-free BOI sector and the associated decline in the share of dutiable imports (in total imports) from nearly 70 percent in the mid 1980s to below 30 percent by 2000.

3.31 Given the imperatives of trade liberalization and the medium term objective of a low, uniform tariff, a rise in the ratio import taxes to GDP (2 percent of GDP) is unlikely in the future. On the other hand, revenue considerations require no further decline in this already low ratio. A near term tactic could be to increase the minimum positive tariff rate to 5 percent to compensate for the abolition of the remaining 10 percent import surcharge. In general, the pursuit of a uniform tariff objective should be consistent with revenue neutrality, at least for the next three or four years. Administrative measures to prevent misuse of duty free concessions should also be deployed.

Box 3.1 : Tax Policies for Revenue and Growth

Type of Tax	Policy Actions	Additional Revenue/GDP (%)	Targeted Revenue/ GDP (%) 2006	2008
Income Taxation	• Include public sector income for taxation. • Impose a withholding tax on doctors fees at hospitals. • Require professionals (lawyers, doctors, teachers etc.) engaged in the provision of any services to register with the Department of Inland Revenue. • Reduce the depreciation allowance for company taxation. • Rationalize the prevailing taxes as follows; o Export Income at 15% o Others at 30% • Phase in a moratorium on tax holidays. • Set up a separate tax audit unit and carryout a tax audit on all non performing tax files and issue regular tax assessments. • Use National Identity numbers for identification purposes on all commercial transactions and taxation.	(0.6)	3.2	3.6
Value Added Tax (VAT)	Include pharmaceutical products, life insurance policies, duty free clearance under passenger baggage, supply of health care services, and wholesale and retail trade.	(1.2)	7.0	7.8
Excise Taxation	• Increase the present Excise Duty on liquor, cigarettes, motor vehicles, aerated waters to compensate the revenue loss from the reduction in VAT rate from 20% to 15% on these items. • Include air-conditioners, refrigerators, washing machines, televisions.	(0.4)	3.2	3.2
Customs Tariff	• Introduce a negative list on project related imports by BOI enterprises to prevent the misuse of duty free concessions. • Abolish the Port Levy, surcharge on import duty and fix a minimum Customs Duty at 5% and do away with lower rates. • Move towards a 2-3 band tariff structure	(revenue neutral)	1.9	1.9
Other Taxes	• Remove the Bank Debit Tax. • Do away with 'nuisance taxes'.	(-0.3)	0.3	0.0

Tax Administration

3.32 Sri Lanka's tax administration has been weak for several reasons including: the coexistence of parallel regime (particularly for customs) and the existence of legal provisions enabling the BOI to override Inland Revenue and Customs laws in granting tax concessions, the limited experiences with modern taxes such as VAT and Income Taxation which require verification, auditing and risk monitoring and lack of modernization in terms of human resources as well as technology. Reported arrears at end 2002 amounted to Rs. 69bn (7.1% of GDP), consisting of Rs.29 bn from Income Taxes, Rs.19 bn from GST and Rs.17 bn from Turnover Tax and National Security Levy. Although such amounts may not be collectable now consequent to the Inland Revenue (Special Provisions) Act of 2003 which granted a tax amnesty, the recurrence of the default needs to be addressed.

3.33 Proposed administrative measures include: First, to establish a well integrated revenue administration along the lines of the previously envisaged Revenue Authority, to realize the informational and administrative synergies from combining the two existing tax departments. Second, within income tax, there is a need to set up a separate tax audit unit for carrying out tax audits on non-performing tax files and issuing regular tax assessments. Third, the large taxpayer unit of the Inland Revenue Department could be more proactive in pursuing potential revenue; only about 400 of the 1100 or so files appear to be active currently. Fourth, there is substantial scope for much greater use of National Identity numbers for identification purposes in significant commercial transactions and taxation.

3.34 The above tax policy recommendations are summarized in Box (3.1). Taken together, they could yield a tax-GDP ratio of almost 16 percent in 2006 and 16.5 percent by 2008 (Table 3.4).

3. External Sector Policies for Faster Growth

3.35 Sri Lanka's external sector policies since 1977 (trade, exchange rate, foreign investment, emigration) have been a major success. The rewards to the (broadly) consistent and sustained liberalization of these policies have been very substantial. The returns are likely to have been much greater if not for the protracted civil conflict, which has weakened the investment climate and macroeconomic stability. On the other hand, there is little doubt that the demonstrated resilience of the economy (outside the North East) in the face of prolonged stress and occasional shocks has largely been due to the greater economic flexibility imparted by a liberal trade and investment policy regime.

3.36 Quite obviously, the most important single "policy" for injecting more dynamism in trade, investment and growth is the achievement of durable and lasting peace in the country. That said, there is scope for improvement in existing external sector policies that can contribute to Sri Lanka's development and its ability to cope with a changing external economic environment, especially as the country prepares to face the abolition of MFA in January 2005.

Trade and Tariff Polices

3.37 Sri Lanka's average (unweighted) applied tariff halved between 1995 and 2002, from 20 to 9.4 percent. Over the same period, the collection rate fell from 7.5 to 4.6 percent. These numbers are the lowest in South Asia by substantial margins, reflecting the much greater distance that Sri Lanka has traveled on the path of trade liberalization (World Bank, 2003). Indeed, the average tariff rate in Sri Lanka in 2002 was comparable with that of Indonesia, Malaysia and Philippines and somewhat lower than that of China, Thailand and Vietnam. However, the degree of dispersion of tariff rates was greater in Sri Lanka, reflecting the larger number of tariff bands (after 2001) and continued higher tariffs on agricultural products.

3.38 Official estimates indicate that the effective rate of protection (ERP) for import-competing manufacturing declined from 70 percent in 1991 to 56 percent in 2002 (SA Table A27). The decline in ERP was much smaller than the fall in nominal protection because of an increase in the degree of tariff escalation over these years. Although there are no official estimates of ERP for export oriented production, rough estimates suggest that the ERP for export production rose from 30 percent in 1991 to 37 percent in 2003 (Athukorala, 2004). These trends point to a significant reduction in the incentive bias against exporting during these dozen years.

3.39 Since 2001, the tariff structure has become somewhat more untidy because of the new tariff surcharge, reintroduction of specific duties for agricultural products, a new tariff band of minimum duty, some proliferation of ad-hoc duty exemptions and case-by-case duty adjustments and the introduction of preferential tariffs under the South Asian Preferential Trade Agreement (SAPTA) and the India Sri Lanka Free Trade Agreement (ISLFTA).

3.40 The government needs to recommit its tariff policies towards a medium term goal of a single low, uniform tariff. In the interim, the efforts should focus on clustering existing tariff bands towards a central tendency, eliminating ad-hoc exemptions and rates and gradually reducing agricultural tariffs. This program will have to contend with the problems posed by a growing number of preferential trading arrangements.

Preferential Trading Arrangements

3.41 Sri Lanka appears to have embraced the newfound global fondness for regional / bilateral economic cooperation. A bilateral free trade agreement was signed between India and Sri Lanka in December 1998 and it became operational in March 2000. In May 2003, Sri Lanka and India agreed to enter into a Comprehensive Partnership Agreement aimed at extending economic cooperation beyond trade into services and investment. A Trade and Investment Framework Agreement was signed between Sri Lanka and the US in July 2002 as part of the on-going negotiations for forming a FTA between the two countries. Negotiations are also underway for entering into FTAs with Egypt, Bangladesh, Pakistan and a number of other countries. Sri Lanka has also been a participant of three regional trading agreements: the Bangkok Agreement, the South Asian Preferential Trading Agreement (SAPTA), and the Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Cooperation (BIMSTEC

3.42) agreement.

Box 3.2: US Sri Lanka FTA

The US has been the largest single market for Sri Lanka exports over the past two decades. In 2002, the US accounted for 42% of total merchandise exports with garments alone accounting for over four-fifths of total exports. On the import side, the US was the fifth largest source of imports, accounting for about 5% of total imports. The trade balance between the two countries has been in Sri Lanka's favor (in 2002: exports $1758 million, imports $218 million).

It is believed that a FTA with the US is crucial for maintaining growth dynamism of export-oriented manufacturing in the country. A point often made is that Sri Lanka is likely to face stiff competition in the US market after abolition of the MFA because over 50% of clothing imports to the country come from developing countries which enjoys tariff concessions under FTAs or similar arrangements. There is strong support for the proposed agreement from Sri Lankan exporters of garments and other light manufactured goods. At the same time, there is no opposition from import-competing domestic manufacturers; given the composition of imports from the US, there is no potential threat of import competition. Revenue implications are also unlikely to be important because most of the imports are duty free (other than tobacco).

As in other recently-negotiated FTAs, the main emphasis of the US government is on opening the services trade. The agreement will provide an opportunity to strengthen the financial systems by bringing about improvements into the financial structure. In preparation for the negotiations, Sri Lanka has already lifted restrictions on foreign shareholding in the financial services and insurance sectors. For Sri Lanka, the most difficult demand to meet is to free capital transfers in the context of the investment regime envisaged under the FTA. Judging from the negotiations of previous FTAs, the US government may not be willing to concede exceptions to the principle of free capital transfer. Whether the recent shift in international opinion on the issue of capital account opening in developing countries (following the financial crises in emerging market economies) would lead to a change in the US position on this in Sri Lanka's favor is yet to be seen.

3.43 The India Sri Lanka FTA came into effect in March 2000 and its scope was expanded in March 2003, when the number of items on the concession list tripled. Early results indicate substantial expansion of bilateral trade (especially Sri Lanka's exports to India), although from a low base (Box 3.3). The FTA with US is still under discussion (Box 3.2). Sri Lanka's espousal of these two FTAs is driven by both political and economic considerations. Closer economic cooperation with India is considered essential for consolidating political relations between the two countries and thereby helping to resolve the civil conflict in Sri Lanka. Close economic and political relations with US are also important for improving the international environment for the peace process and for locking in both preferential access to the huge US market as well as Sri Lanka's open trade and investment policy regime.

3.44 So far, Sri Lanka's gains from participation in the three regional trading agreements (SAPTA, Bangkok Agreement and BIMSTEC) have been negligible. By the later 1990s only 6.2% of all tariff lines (at the HS six digit level) of Sri Lanka's foreign trade had come under regional tariff concessions under the three agreements. The share of intra-regional trade covered by these concessions in country's total trade was even lower (less 3 percent of imports and less than 1 percents of exports).

Box 3.3: India Sri Lanka FTA

Under the March 2000 India-Sri Lanka FTA (ISLFTA), India provided Sri Lanka duty concessions (90-100% duty exemptions) on 1351 items (at the six-digit level of the Harmonized System). However, tea and garments produced with non-Indian fabrics were subject to import quotas and could enter India only through designated ports. On 31 March 2003, 2,799 more items were added to the concession list. Port-of-entry restrictions[1] on tea and garments were relaxed and the quota on garment imports was expanded in June 2003. But there are still considerable impediments to the entry of Sri Lankan products to the Indian market. These include, stringent rules of origins, import quotas on some key products (in particular, tea and garments produced with non-Indian material) of interest to Sri Lanka, remaining port-of-entry restrictions on tea and garment imports, various informal and transaction costs involved in dealing with Indian Customs, discriminatory trade taxes imposed by some Indian states on imports from Sri Lanka, and the cumbersome procedure involved in complying with Indian Sanitary and Phytosanitary (SPS) procedures in the case of processed food exports. There are also unresolved issues involved in the harmonization of Customs valuation procedures in the two countries. Trade preferences granted by Sri Lanka to India under the Agreement are more extensive and larger in proportional terms, but concessions have been granted mostly on products for which MFN tariffs are already very low. Most of the agro-food items exported from India, which have considerable potential for rapid market penetration in Sri Lanka and are currently under high specific import duties, have so far been excluded from the concession list (Kelegama 2003, World Bank 2003).

Until the ISLFTA came in to force Sri Lankan imports outstripped exports by 20 times, but between 2000 and 2002 exports from Sri Lanka to India virtually quadrupled. Preferential imports accounted for 68% of total imports from India in 2002, up from 23% in 2001 (Kelegama, 2003). Imports have increased at a slower rate, by about 40% percent between these two years. This is understandable because the average preference margin (the difference between MFN and preference tariff) under the ISLFTA on the import side has been small, given the very low MFN tariffs in Sri Lanka. Despite rapid export growth, the balance of trade is still very much in India's favor.

Sri Lanka – India Trade, 1990-2002

	Exports to India		Imports from India		Sri Lanka-India Trade balance as % of exports
	$ mn	% of total exports	$ mn	% of total imports	
1990	21	1.1	118	4.5	-82.5
1995	32	0.8	469	9.8	-93.2
1998	38	0.8	541	9.4	-93.0
2000	57	1.1	591	9.5	-90.3
2002	169	3.6	835	13.8	-79.8

Source: Central bank of Sri lanka, *Annual Report* (various issues).

3.45 While there may be substantial justification for the US and India FTAs, there seems to be much less rational for the other FTAs under discussion and negotiation. Nor is there much evidence to suggest that Sri Lanka can gain much through active participation in existing or proposed regional trade agreements. Indeed, there are good reasons to re-assess the apparent enthusiasm for proliferating FTAs and regional trade agreements:

- The PTA approach to trade liberalization is becoming a major distraction to the process of unilateral liberalization which has served Sri Lanka so well in the past 25 years.
- Proliferation of PTAs generates a serious problem of multiple "rules of origin", which entail significant costs for both government and private economic agents. They complicate customs of administration and weaken efficiency improvements in the custom system.

- With multiple PTAs, Sri Lanka's tariff structure will become highly differentiated, depending on the country of origin, thus compromising the goal of uniformity in tariffs and giving rise to new inefficiencies in resource allocation and specialization.
- Restrictions imposed on sourcing of inputs by rules of origin embodied in FTAs can have adverse implications for export competitiveness (for example, if Sri Lanka is required to source fabrics for garment exports from US).

The MFA Challenge

3.46 By the end of 2004 the long standing Multi-Fiber Arrangement (MFA), which for decades has governed most of international trade in textiles and garments, is scheduled to come to an end. This could have massive and highly uncertain implications for production and exports of these products in many developing countries. Sri Lanka is no exception. Textiles and clothing (over 90 percent being the later) account for about half of Sri Lanka's exports, almost the same share of industrial production directly employs around 300,000 workers (5-6 percent of the labor force) and indirectly about one million workers (IPS, 2004). The industry employs mostly female workers (about 90 percent) and is concentrated in the Western Province (72 percent of the garment factories), which may partly explain the high concentration of growth and low poverty incidence in the area.

3.47 Among the many factors which will determine outcomes in the post-MFA world, will be the underlying competitiveness of the textiles/clothing sectors of exporting countries and the extent of preferential (tariff) access to major markets, notably the US and the EC. The latter goal drives Sri Lanka's strong desire to conclude an FTA with the US, especially since over half of US imports of these products already occur under various preferential arrangements with other countries.

3.48 As regards the fundamental question of competitiveness, the outlook is somewhat mixed. On the one hand, there are several factors attesting to Sri Lanka's competitiveness in this key sector:

- The concurrent liberalization of Sri Lanka's trade and FDI regime seems to have provided Sri Lanka with an environment conducive for improvements in product quality, marketing skills and rapid penetration in the brand-name dominated high end of global markets.
- Unlike other South Asian countries (where substantial segments of the domestic textiles / clothing markets are highly protected) the Sri Lankan industry has grown in a largely free trade regime for the past 25 years. Aside from the dominance of the FTZ system throughout, tariffs on textiles and clothing were mostly eliminated in 1998.
- Sri Lanka has been relatively successful in moving up to higher value segments of the market as reflected by increases in both volume and unit price (Statistical Annex Table A28).
- The share of non-quota markets in total Sri Lankan garment exports has risen appreciably (to about 40 percent) in recent years. In large part this reflects removal of quota restrictions in the EU market in 2001 (IPS, 2003). In addition, only one third of US quotas are still binding.
- Sri Lankan manufacturers have a good reputation abroad for adhering to internationally accepted labor norms as evident by Sri Lanka successfully obtaining additional GSP (20 percent in addition to standard 20 percent concession) from the EU based on labor compliance. Only Sri Lanka and Moldova have successfully obtained additional GSP concession to the EU based on labor compliance to date.
- There has been substantial consolidation already in the Sri Lankan garment industry, with about 10 percent of some 860 exporters accounting for about 70 percent of exports (IPS, 2003).

3.49 On the other hand, wages in Sri Lanka are somewhat higher than some South Asian competitors (e.g., Pakistan and Bangladesh) and labor productivity is lower than more efficient producers in East Asia and China. Moreover, several 'behind the border problems' such as poor infrastructure (power and transport), high cost of and low access to finance, and rigid labor regulations, adversely affect the cost of production and the overall competitiveness of the Sri Lankan garment industry. Electricity charges in Sri Lanka are the highest in Asia, with the exemption of Hong Kong. Lead times (time it takes from when an order is placed to when it is delivered) are also lengthy --around 100 days in Sri Lanka, whereas it is about 60 days in more competitive countries.

3.50 While the medium term prospects for Sri Lanka's garment industry remain positive, there could be significant disruption in initial stages, especially among smaller exporters (who while representing 5 percent of the value of exports account for about two thirds of all exporters and about 35 percent of employment in the sector).[31] To assist with this painful adjustment, government policies should encourage consolidation, facilitate restructuring of credit to small exporters, improve infrastructure and trade facilitation and follow through with ongoing labor reforms that would facilitate enterprise restructuring. In parallel, efforts need to continue to reach a favorable FTA with the US and thereby improve market access conditions for Sri Lankan exports.

Foreign Investment Policies

3.51 A liberal foreign investment regime has been an integral part of Sri Lanka's economic policies since 1977 and especially after 1990. The country's experience highlights the complementary role of investment liberalization for reaping the potential gains from trade liberalization. Of the BOI companies which started operations during 1978-2002, over two thirds involved foreign direct investment (FDI), mostly through joint ventures with local firms (80 percent of companies). Initially, there was a heavy concentration of foreign investment in the garment industry, but since 1990 there has been a noticeable increase of FDI in other labor intensive activities such as footwear, travel goods, plastic products, gems and jewelry, rubber-based products and ceramics. There are many cases of the local partner taking over the entire production operation and continuing to thrive in an export business after an initial joint venture state.

3.52 The BOI policy regime (see Box 3.4) has sometimes been criticized as an "enclave arrangement", breeding dualism in the Sri Lankan economy. This characterization may be somewhat harsh. Unlike many other countries which have implemented FTZ schemes as an appendage to a highly restrictive trade regime, in Sri Lanka, BOI privileges are available to both foreign and local investors who meet the approval criteria (the prime one being export orientation). Furthermore, an increasing number of BOI approved firms now operate outside the FTZs. Their geographic spread would have been greater if infrastructure and connectivity had been better outside the Western Province.

3.53 A major policy issue relates to the provision of generous fiscal incentives to BOI firms. Many studies support the view that tax incentives have little impact on foreign investors' location decision. However, when a clear distinction is drawn between "market-seeking" (tariff jumping) and "efficiency-seeking" (export oriented) investments, a number of studies find that fiscal incentives do matter, provided other determinants such as political stability, favorable geographical location and infrastructure are favorable (Wells 1985, Morisset and Prinia 2001, Guisinger and Associates 1985, Weigand 1983). In light of the latter, it might be risky to suddenly terminate direct tax incentives for all future investment. However, it should be noted that in addition to adversely impacting tax revenue, fiscal incentives offered to BOI firms are highly variable (across products and sectors and scale of investment) and subject to substantial discretion and against the original intention, many firms have become perpetual beneficiaries of tax holidays. Moreover, the experience in Sri Lanka shows that despite generous fiscal incentives, the overall level of FDI (including flows linked to privatization) has been modest (representing around one percent of GDP annually) by regional and international standards. There is therefore a case for rationalizing incentives presently offered to BOI firms. Given the fiscally-driven urgency for raising tax revenues, some form of phasing in of a moratorium on direct tax incentives needs to be seriously considered. In the meantime, recent legislation to bring such incentives into line with Inland Revenue laws is to be welcomed.

[31] It is speculated that 10 percent of jobs (or about 28,000) might be lost.

Box 3.4: The Board of Investment (BOI)

The Board of Investment (BOI) has its origins in the Greater Colombo Economic Commission established in 1978 to bypass the various laws (tax, customs, foreign exchange) and administrative systems (tax and customs) hindering foreign investment, particularly in export-oriented activities. While these laws and systems remain problematic, the BOI regime has grown in scope to cover both foreign and locally-owned firms both in and out of Free Trade Zones (FTZs). BOI approved projects account for 65% of exports, 75% of industrial employment, and almost 100% of Sri Lanka's vital garments industry. In addition to providing direct tax incentives and exemptions from foreign exchange controls, the BOI provides a separate legal and administrative systems for taxation and customs (both documents and physical logistics). Though Sri Lanka's rigid labor policies are officially in effect for BOI firms, enforcement has been less strict.

Eligibility depends on type of activity with minimum investment and export requirements. While foreign equity was never a requirement, the condition that firms have at least foreign loans has been relaxed. So too were restrictions on location. More than 80% of BOI firms operate outside FTZs.

Large non-BOI sectors of the economy, most notable SMEs, continue to face a difficult business environment. With the most profitable firms converging to BOI status with generous tax holidays, the BOI largely accounts for Sri Lanka's low income tax performance.

3.54 In addition to the adverse impact of the conflict, several 'behind the border' constraints to investment may account for low FDI in Sri Lanka. Indeed, according to a recently completed investment climate assessment (World Bank, 2004), top constraints to doing business include poor infrastructure (*electricity and transport*), *cost of and access to finance*, and *rigid labor regulations* (for urban firms). Addressing these constraints will go a long way in encouraging overall private investment and in improving Sri Lanka's ability to attract FDI.

Currency Policy and Convertibility

3.55 Since 1978 Sri Lanka has operated with an unified exchange rate for the rupee within a system of "managed float". The degree of Central Bank intervention has varied over time, reflecting the exchange rate goals of the authorities. From January 2001, currency policy ostensibly shifted to a "free float". Since then, there has been substantial nominal depreciation of the rupee, more than compensating for Sri Lanka's higher rate of inflation relative to trading partners and thus leading to modest real depreciation. By 2003 the real effective exchange rate was back to the levels of the early 1990s. After mid 2002, the Central Bank has intervened actively (despite the terminology of "free float") to build up reserves and moderate the nominal appreciation that would have otherwise occurred because of the US dollar's depreciation against major currencies. Given the sizable trade deficits in the balance of payments and the limited prospect for reducing the fiscal deficit, such policies to avoid real appreciation of the rupee seem quite appropriate.

3.56 Sri Lanka moved to full current account convertibility in 1993. The movement towards convertibility on capital account has been measured, although the abolition of the foreign exchange surrender requirement for exporters amounts to a *de facto* relaxation, to some degree, of controls on capital outflows. Especially since the 1997-98 Asian currency crisis, Sri Lankan authorities have adopted a cautious approach towards further liberalization of the capital account. Such prudence is warranted until there is more success with fiscal consolidation, reforms of the domestic financial sector and greater surety of lasting peace.

Labor Migration and Remittances

3.57 As noted earlier, since 1978 Sri Lanka has followed liberal policies towards labor outmigration. As annual outflows reached significant levels, the Department of Labor, through its newly established Sri Lanka Foreign Employment Bureau (SLFEB), developed an institutional capacity to monitor the process and to protect migrant workers from malpractices of recruitment agents and also to provide some institutional support for Sri Lankans in foreign employment. More recently, SLFEB has launched a number of schemes to promote foreign employment, including an universal insurance scheme for migrant workers and a bank credit scheme for returning migrants.

3.58 With inward remittances accounting for 18 percent of total current receipts and 9 percent of GDP in 2002, this liberal policy appears to have reaped rich dividends. The outcomes have been greatly helped by easy access to banking facilities, the pursuit of market-responsive exchange rate policies and the virtual absence of a black market for a foreign exchange.

4. Reviving Growth of Non-plantation Agriculture

3.59 More rapid agricultural productivity growth is fundamental for reducing poverty in Sri Lanka, since nearly 90 percent of the poor live in the rural sector. This would require strong commitment to removing existing policy and regulatory constraints which have stifled growth in the agricultural sector. Short to medium term priorities include adopting policies to facilitate farmer access to improved technologies, creating a more transparent and stable trade policy regime, allowing full and transferable ownership rights to land, and ensuring the sustainable use of water. Adopting policies to speed up currently lagging private sector participation and investments would also be critical to promoting growth in both the agricultural and non-farm sectors. These include rationalizing currently restrictive labor regulations and promoting a regionally equitable development strategy for rural infrastructure and services development, with increased emphasis on operation and maintenance of physical assets to ensure their longer term performance. Although several of these reforms were part of the Agricultural Policy Recommendations formulated by the National Development Council in 1996, implementation has lagged behind (see Box 3.5). Consequently, the anticipated supply response and much desired diversification of agriculture has been slow to materialize.

Box 3.5: Summary of Key Actions:1996-2004

Seed and planting material	• National Seed Policy approved in 1996, National Seed Act approved in 2003 • Government seed farms-Hingurakgoda and Pelwehera—privatized. • Plant Protection Act (1924) amended in 1999, revised phyto-sanitary regulations scheduled for 2004 • National Agricultural Research Policy approved in 2003
Land	• Agrarian Services Development Act No 46 2000: allows cultivation of other crops in paddy land subject to approval of Commissioner of Agrarian Services • Land Ownership Bill does not receive Parliamentary approval in 2003, amendment of LDO in process. • Registration of Title Act approved in 1998, amendment in process
Irrigation	• Draft National Water Policy formulated in 2000 • Interim National Water Resources Authority created • Ongoing transformation of MASL into a river basin management authority • National Water Bill under preparation
Fertilizer	• Fertilizer subsidy revised in 1997 to apply only to urea • Fertilizer subsidy increased to Rs3 billion in 2004
Trade	• Specific duties and import licenses introduced on agricultural products (rice, chilies, onions, potatoes, and edible oil) • Reduction of customs duty on maize for feed to assist livestock sector
Domestic marketing	• Paddy Marketing Board closed in 1996, price support operations taken up by CWE and multi-purpose cooperative societies • Pilot program of forward contracts • CWE restructured into 2 independent companies, with 40% of the stake of retail network sold to the private sector
Research & Extension	• Fee based extension piloted by Department of Agriculture in 1999

Source: National Development Council, 1996, "Agricultural Policy Recommendations," Report of the National Development Council Working Group, Volume 1, Colombo, Sri Lanka.; Weliwita and Epaarachchi 2002, Central Bank Annual Report, various issues.

Agricultural Technology Policy

3.60 Access to productivity-enhancing technologies by farmers has been constrained by restrictive seed and phyto-sanitary policies. Fortunately, there is increasing consensus that excessive regulation serves more as a barrier to entry than as an environmental filter. Many requirements are outdated and inadequate to meet the rapid advances in research and technology occurring worldwide, and subject to costly permit and inspection procedures. New seed and phyto-sanitary regulations have been developed, in consultations with stakeholders. Their approval will remove uncertainty and encourage greater participation of the private sector, producer organizations and other agencies in distributing improved agricultural technologies to farmers. Modernizing and streamlining the national seed certification and plant quarantine service will also be important for the effective implementation of the new seed and plant quarantine regulations.

3.61 **Agricultural research** is performed by a large number of government institutes in Sri Lanka.[32] The government's research effort has been relatively successful in raising the productivity of rice, but less successful for other crops. There is very limited private sector involvement in agricultural research owing in part to the absence of intellectual property rights protection, restrictive seed and phyto-sanitary regulations and procedures, and subsidized sale of planting materials by government agencies. Improving the effectiveness of the agricultural research system, in large part elaborated in the National Agricultural Research Policy (2003), will require fostering a pluralistic national agricultural research system, including the government, private sector, NGOs and other agencies; and institutional reforms of existing public agricultural research system to strengthen its demand orientation and improve the quality of its research activities, including through greater participation of farmers and other stakeholders in program governance, priority setting and evaluation.

3.62 **Agricultural extension** services have been severely weakened since it was devolved to Provincial Councils in the early 1990s under the 13th Amendment to the Constitution. Only about 13 percent of agricultural households reported receiving technical assistance from a government extension agent (15 percent from all sources)[33]. Improving the effectiveness of the agricultural extension system in Sri Lanka would necessitate increased focus on: (i) expanding the supply of extension services by fostering greater participation of private firms, NGOs, and producer organizations, including through government sub-contracting of services; (ii) improving the effectiveness of the public extension service - strengthening client orientation through adoption of participatory approaches in planning and implementation; (iii) linking providers to multiple sources of innovation (research and others); and (iv) expanding use of new information and communications technologies to deliver a wider array of information of value to farmers through new, innovative channels.

Agricultural Land Policy

3.63 A critical feature of Sri Lanka's land ownership pattern is Government's ownership of a large share of land in the country—1.72 million of the Sri Lanka total 2.79 million ha is state-owned. (World Bank 1996). These lands were transferred to farmers through various land settlement programs beginning in the 1930s under a number of legislations, one of the most important of which is the Land Development Ordinance (LDO).[34] While these legislations succeeded in promoting greater equity in land distribution, their highly restrictive nature hurt farmers in several ways. For LDO land, which totals about 1.4 million ha, restrictions on mortgaging preclude its use as collateral to access credit. The small size of the holdings (as over 40 percent of holdings have less than one acre

[32] These include the Department of Agriculture, plantation (tea, coconut, rubber) research institutes, several national institutes reporting to the Council for Agricultural Research Policy and universities.

[33] SLIS data (1999/2000).

[34] Other key legislations included the Sale of State Lands (Special Provision) Law 1973, Land Development (Amendment Act) 1981, Agrarian Services Act 1979, Land Reform Law 1972 and 1975, Land Reform (Special Provisions) Act 1981, and the Agrarian Services Development Act No. 46 2000

and 60 percent less than two acres), the lack of secure property rights, and legal restrictions on acquiring or leasing land, constrain efficiency in land-use and reduce incentives for productivity-enhancing investments. Those interested in shifting out of agriculture into non-farm activities, or merely moving to another location have to leave without compensation. In addition to fostering a large cadre of part-time farmers, these legal provisions limit the efficient allocation of land resources (World Bank, 2003).

3.64 Following a decision in 2002 to grant full ownership rights to farmers cultivating LDO land, a draft Land Ownership Bill (providing the legal framework to implement the policy) was sent to Parliament in November 2003, but as noted elsewhere, was withdrawn due to court challenges. To move the process forward, the LDO is being amended instead. As part of this work, due care should be taken of procedures inefficiencies embedded in the Bill, including the absence of clear criteria for approving or disapproving applications.[35] The prompt processing of the amendments to the LDO, including addressing these procedural inefficiencies, would be essential to enhance the ability of farmers to make the best use of agricultural land.

Land Administration

3.65 For private landowners, the poorly functioning land administration system hinders the operation of land markets. Most private land records take the form of deed registrations that record transactions and serve as evidence in support or proving title to land. The insufficiency of deed registration in guaranteeing ownership of land, combined with the pervasive co-ownership of land,[36] however, increases the transaction cost in the land and credit markets. Furthermore, the deeds may not agree with the actual land specifications, hence disputes are common. In case of a dispute, settlement times for land cases in courts usually take more than ten years, and lack of affordability limits the access of poor landholders to dispute resolution. Recently, the government initiated a shift to a title registration system. A registration of title system is one where the parcel has been registered, with transactions thereafter registered against the parcel. A registration of title system facilitates boundary dispute resolution, transparency of records and efficient land administration.

3.66 The Registration of Title Act (RTA) 1998, provides for unencumbered and clear title to every parcel of land in the country, establishes a system of registration of land parcels and ownership rights, and creates a new system of land-transaction registration.[37] Amendments to the Act currently being drafted aim to: (i) eliminate restrictions on the registration of co-owned land; (ii) allow the issuance of a title to people without ownership documents on the basis of occupancy; and (iii) protect interests that are difficult to register formally.

Agricultural Trade Policy

3.67 Agricultural tariffs in Sri Lanka are subject to unpredictable and frequent change. The government intermittently lowers the tariffs for major agricultural imports through duty waivers and controls import volumes through licensing during months when domestic prices rise. These frequent unpredictable changes create considerable uncertainty, heightening price risks for farmers, consumers and local entrepreneurs, and greatly dampen the incentive for private sector investments in storage.[38]

[35] For example, people obtaining new land allocations under the LDO will still be required to go through the process of receiving a permit first.

[36] Every time a parcel of land is sold, transferred or used as collateral, an extensive search -- as far back as 30 years -- of all past deeds associated with the land parcel has to be conducted to confirm ownership rights. The problem of co-ownership arises because of tradition involving dividing land among all children.

[37] This includes records containing information on parcel boundaries, name of owners and rights that third parties have over the land such as mortgages, leases and easements.

[38] For instance, in October-December 1999, the import duty on rice was cut from 35% to 10% to dampen the seasonal price rise. Many millers who bought and stored large quantities of paddy during the previous harvest found it difficult to offload their stocks, because of competition from cheaper imports. Having suffered large storage losses, this reduced their incentive to purchase paddy during the 2000 Maha harvest, which led to a sharper fall in producer prices, prompting the government to ban rice imports from mid- July and to undertake procurement operations to prop up prices. However, with the drop in

3.68 To induce private investments in agriculture, agro-industry and storage, reduce within-year price fluctuations, and improve food security, the government will need to resist the pressure to seasonal altering of tariffs. Over the medium term, tariff protection for various agricultural commodities would need to be gradually phased out to reduce the bias in favor of particular crops (e.g. rice, potatoes, chillies, onions) and thus allow improved domestic resource allocation; and to reduce the taxation of consumers who are forced to pay above-world-market prices. With the removal of price distortions, cropping patterns could adjust to changing economic incentives, including shifting from low-value and low-productivity activities (such as rice production) toward commercial production of alternative higher-value crops. The phased reduction in tariff protection will need to be accompanied by parallel measures to lift the constraints on domestic, commodity and factor (land, seeds, technology and water) markets and to improve rural infrastructure. These complementary actions will help ensure that farmers have the freedom and the capacity to alter their resource-use decisions to meet the changing needs of the market.

Box 3.6: Rice in the Sri Lanka Rural Economy

Rice is the basic staple for the large majority of the population. Paddy production (un-milled rice) is the main occupation and source of income and employment for a large number of people in rural areas, especially the poor.

Policy approach: The achievement of *self-sufficiency* in rice production has underpinned Sri Lanka's agricultural policy in the post-Independence period. Policies to increase production have comprised: public agricultural research and extension, government production and subsidized sale of paddy seeds, large investments in irrigation, costly fertilizer and credit subsidies, a land law provision restricting cultivation of designated lands to rice only, government procurement of paddy output, and high rice import tariffs to protect domestic production. (At the same time, Government sold subsidized rice through Cooperative Societies and the Cooperative Wholesale Establishment).

Outcomes: Sri Lanka has achieved nearly self-sufficiency in rice production (with higher productivity than other countries in the region), but at a high cost. Paddy production has grown by only around 2 % annually over the past three decades and growth in value-added has been at best negligible. Moreover, these policies are having adverse consequences on farmers' welfare. Forcing farmers to continue growing paddy through the paddy land's provision undercuts their income potential and prevents the use of highly productive (in most cases irrigated) lands for other more lucrative non-paddy purposes. Fertilizer subsidies for urea, which primarily benefit rice farmers (which account for about 75% of urea consumption), encourage their overuse, raising concerns about improper soil management. Ironically, while fertilizer application rates among rice producers more than doubled in the 1990s, average yields increased only by 8%. Fertilizer subsidies are primarily benefiting richer rice farmers--about 51% of total rice area is cultivated by households in the top 40% of the rural expenditure quintiles, compared to only about 25% in the case of households in the two poorest quintiles. High import tariffs, to the extent that they keep rice prices high for producers increase their cost for consumers, especially hurting the poor.

Future Prospects: As Sri Lanka enters the 21st century, several developments point to the need to reassess the strategy for the rice sector. First, rising incomes and changing consumer preferences are reducing household demand for rice. Between 1980/81 and 2002, average consumption declined by 23% (from 47 to 36 kg/household/ month) and this trend is expected to continue (DCS 2002). Second, Sri Lanka has achieved near rice self-sufficiency and the return of paddy lands to production in the North East is likely result in surplus production in the near future. Third, even with a slight supply shortfall, international trade offers an important alternative safety valve for sourcing domestic rice needs. Finally, domestic and export demand for higher value products (e.g. horticulture and livestock) is rapidly increasing, offering alternative higher income generating opportunities for farmers

Commodity Marketing

3.69 The public sector has gradually moved away from agricultural commodity marketing, including through the recent liquidation/privatization of the Cooperative Wholesale Establishment (CWE). However, in 1980 a 20-year monopoly was granted to PRIMA, a Singapore-based company, for the firm to mill and supply flour for distribution through various government outlets. The contract was extended by another five years in 2000. PRIMA benefits from duty-free imports of wheat grain and mill-related equipment as well as income-tax exemptions, while private imports of wheat flour and wheat are made uncompetitive by import tariffs. Since Sri Lanka does not produce wheat, the

producer prices, farmers had neither incentive nor resources to increase cultivation for the next harvest. According to official estimates, the area of land cultivated by farmers for the 2001 Maha harvest fell by about 30% from the 2000 harvest.

high import tariff on wheat flour and wheat does not protect farmers and only raises prices for consumers. Phasing out the wheat monopoly upon expiration of existing contract in 2006 will contribute considerably to improving the efficiency of wheat marketing and pricing in Sri Lanka.

Water Resources Management and Irrigation

3.70 During the last five decades, irrigation development was as a major pillar of the government's rural development strategy. Between 1980 and 1997, about Rs 215 billion (constant 1996 rupees) in public funds were spent on irrigation infrastructure development. Most of these investments focused on the construction of new dams for power generation and surface irrigation systems,. The most important program was the Mahaweli Project, initiated in the late 1970s and managed by the Mahaweli Authority of Sri Lanka (MASL).

3.71 The long term sustainability of past huge investments in expanding surface irrigation infrastructure is threatened on several fronts. Inadequate priority and funding for operations and maintenance led to the rapid deterioration of canal systems and to poor quality of services. This explains the need for repetitive (often every 5 years) and costly rehabilitation. Institutional weaknesses in the water-agencies combined with minimal involvement of farmers impeded greater improvement in the quality of and "user-orientation" in service delivery. Poor reliability of water delivery and frequent lack of access to water by tail-enders, combined with lack of access to agricultural extension and improved technologies, contributed to low crop yields. Inadequate farmers' involvement in decisions on water delivery (both in terms of quantity and timing), has constrained their ability to diversify to higher value crops or alternative crops besides paddy.[39] Providing water for free also reduced the incentive for farmers to save and use water efficiently.

3.72 The Government is now faced with tightening inter-sectoral competition for water among various users (agriculture, drinking water, industry, etc). The fragmentation of functional responsibilities among about 40 water agencies, makes coordination difficult. Although the National Water Resource Council (NWRC) has been established to manage water resources at national level, not much has been achieved in the absence of a national water policy. The outgoing Government began drafting a National Water Policy and National Water Bill. Finalizing the Bill, however, has been complicated and delayed by the social and political sensitivity of water issues in the country and overlapping jurisdictions between the Central and Provincial governments. Building consensus and approval of the National Water Bill will be essential to any strategic vision for the sustainable development, management of water resources. In finalizing the Bill, priority would need to given to: (i) shifting from supply-driven goals to comprehensive planning, allocation and management within a river-basin framework; (ii) formulating an appropriate regulatory framework and reprioritizing expenditures (from the creation of new assets to demand-driven maintenance and rehabilitation investments) to support such a shift; and (iii) reforming institutional structures and procedures, building on increased participatory management of systems, to improve the management of water resources in Sri Lanka.

Rural Infrastructure and Services

3.73 Improving rural infrastructure beyond the Western Province is essential for rural development. Limited access by rural households to essential basic infrastructure and services (e.g. telecommunications, roads, electricity, banks), contribute to increasing transaction costs in the marketing of agricultural produce and in sourcing inputs, thus significantly affecting the competitiveness and profitability of Sri Lankan agriculture. Regression analysis using the SLIS 1999-2000 data also show that access to rural infrastructure in addition to land owned, the size of the household, and education, are significant determinants of household participation in rural non-farm activities. It shows that lack of access to roads (the distance from the nearest main road) is negatively correlated with the probability of participating in non-farm employment. According to the rural part

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[39] Current water delivery schedules are still designed for paddy cultivation.

of the Investment Climate Assessment (ICA) on Sri Lanka (World Bank 2004), *transport* constitutes the single most important constraint to rural firms, followed by *cost and access to credit, demand* and *electricity*. Improved access and quality of rural infrastructure would contribute not only to raising the quality of rural life, but also to the successful implementation of government development plans for the modernization of agriculture and improving the investment climate for rural industries and services. Participatory planning and implementation of rural infrastructure projects, which involves government and targeted users, would be valuable to ensure the appropriateness of investments undertaken.

Table 3.5: Rural household Access to Infrastructure and Financial Services by Region.

Average Distance (km)	Western	Southern	Central	North Western	Sabaragamuwa	North_ Central	Uva	North Eastern	Total
To a main road in communities without access to a main road	1.9	3.3	3.1	2.8	5.7	5.9	12.9	3.7	4.0
To a market in communities without access to a market	4.6	5.5	5.1	5.2	15.7	9.4	9.8	6.7	6.8
To a phone in communities without access to a phone	3.4	4.0	4.0	4.5	5.8	5.8	9.9	7.9	5.5
To a bank in communities without access to a bank	4.5	6.7	5.6	6.8	7.2	9.2	11.8	7.7	6.7
Households with Access to Electricity,%	80	64	54	52	47	27	37	48	56
Poverty Rate (head count) 2002,%	**11**	**27**	**21**	**28**	**37**	**25**	**34**	**n.a.**	**23**

Source: SLIS 1999-2000, Gunewardena 2000, 2002 HIES.

5. Infrastructure Priorities for Growth, Connectivity and Equity

3.74 For a country like Sri Lanka, approaching rapidly middle income levels, reliable infrastructure is paramount for further economic development, especially of export-oriented activities such as manufacturing and tourism. These services require reliable power supply at international prices, port and air facilities, world-class telecommunications capability, and a transport system that works in a seamless fashion. Although Sri Lanka has made progress in some of these areas, substantial challenges remain to bring them up to world standards and to reduce regional inequities in the access and quality of these services. In particular, as reported in the ICA (World Bank 2004), shortcomings in the provision of adequate power and electricity services represent major impediments to investment in Sri Lanka.

Roads Sector Challenges

3.75 The transport sector needs to correct years of misallocation of public resources that have left Sri Lanka's relatively extensive road network seriously under-maintained, and cater for additional demands arising from a growing economy and from the integration of the northeast to the rest of the country. Against these challenges, the government needs to (i) balance carefully the urgent needs for repair and maintenance against proposals for new investment; (ii) concentrate scarce public resources exclusively on those activities where the private sector cannot operate and/or invest effectively; and (ii) focus on continuing the efforts regarding transport commercialization and restructuring.

3.76 According to official estimates, about US$870 million will be required during 2004-08 for the rehabilitation and maintenance of Sri Lanka's road network and a further US$655 million for new planned expressways. Against these requirements, RDA spent only US$13 million for rehabilitation of national roads in 2003[40] and US$ 16 million for periodic and routine maintenance, representing about 10-15 percent of estimated needs.

[40] Excluding $15 million for land acquisition for the proposed Colombo-Katunayake highway.

3.77 **Efficiency of Road Utilization**. Despite Sri Lanka's relatively high road density, network utilization is inadequate. As Table 3.6 shows, Sri Lanka has less than half the number of vehicles per Km of road than the average for the South Asia Region and less than 2 per cent of the average in Latin America. Also, although the number of vehicles per capita is high compared to the South Asia region, it is low compared to all other regions of the world (except East Asia). Increasing the efficiency of utilization of the existing road infrastructure will require substantially improving the condition of the roads, through regular maintenance and rehabilitation of deteriorated road networks, as well as building express corridors connecting major cities. Priorities to achieve these goals include:

- Provision of adequate funding for road maintenance and rehabilitation. This would require raising funding two-fold (from current budgetary allocations) by increasing the revenues of the recently established Road Fund[41] and mobilizing further funds from other sources including user charges and fees. In the medium term, Sri Lanka would need to develop an overall pricing policy for the transport sector.[42]
- Improving the balance between recurrent and capital investments, with a focus on addressing the maintenance backlog and improving the condition of the national highways which carry 70 percent of road traffic.
- Strengthening the capacity of agencies responsible for formulating and implementing policies in the transport sector.

Table 3.6: International Comparison of Sri Lanka's Road Transport

Indicators	Sri Lanka	East Asia and The Pacific	Europe and Central Asia	Latin America and Caribbean	Middle East and North Africa	South Asia	Sub-Saharan Africa
Investment by private sector (US$ millions), 1995-2000	240	35,946	3,258	43,104	1,220	1,714	1,937
Total No. of Motor Vehicles /km road network	7	138	511	399	72	15	158
Country Average No. of Motor Vehicles /1,000 people	34	16	205	158	58	8	46

Source: World Bank estimations using World Development Indicators, 2002. Most data is for 2000.

3.78 **Economic and Financial Sustainability**. The unit cost of road provision is very high in Sri Lanka as a result of relatively higher rehabilitation costs[43], due to lack of periodic maintenance and cost overruns and other inefficiencies in the provision of road works. While the cost of routine and periodic maintenance for national roads is about US$2,000 per km, rehabilitation can amount to as much as US$400-500 thousand per km[44]. Priorities to ensure the economic and financial sustainability of the system, especially to reduce currently high unit costs of road provision, include:

- Increasing private sector participation in transport infrastructure and service provision, at all stages, including policy setting. This is particularly important given the winding up of the Road Construction Development Corporation (RCDC). The Government should create and adopt appropriate structures to ensure the efficient functioning of public-private partnerships.
- Raising the efficiency of public sector agencies by introducing competition, making public sector management more-market sensitive, and restructuring pricing and financing systems.

[41] The Road Fund is currently raising revenues from a national fuel cess introduced in 2003 at 1Rp/liter for petrol and 0.5Rp/liter for diesel.

[42] This would involve a comprehensive assessment of all sector-related charges, fees, taxes, cess, etc where pricing normally reflects true economic costs.

[43] After twelve and eighteen years, rehabilitation costs are 2-3 times the costs to maintain a road if it has not been periodically maintained.

[44] Source: SL, Concept Paper: Road Sector (Expressways, National Highways, Provincial and Local Authority Roads), December 2003.

3.79 **Equity and Environmental Sustainability**. Roads have been maintained relatively better in the Western Province, creating inter-province inequality. Reversing this bias and improving connectivity in other provinces could substantially ameliorate the growing problem of regional economic inequality. Main priorities include:

- Integrating the needs of the poor, (particularly in rural areas) for access and mobility in transport strategy and policy setting. To this end, mechanisms to ensure the participation of rural communities in the setting of policy need to be created. So far, it has been assumed that the mobility needs of the poor can all be resolved by improving transport networks and public transport services in rural areas. Given that transport services do not penetrate all rural areas, and as a result problems of mobility and access are acute in the most disadvantaged areas, attention needs to focus on promoting non-motorized transport modes and providing appropriate local rural roads for such transport.

- Increasing the participation of stakeholders, including the rural poor, in the planning and implementation of investments in the sector. Where poverty alleviation programs exist and unemployment levels are high, participation of rural labor to improve roads can provide a least cost option for carrying out such works.

- Improving the management of congestion, pollution, and safety. The degree of congestion and associated cost in Sri Lanka can be as high US$18 million[45]. As for a 6 percent increase in GDP, the demand for road space has been estimated to increases by 8 percent[46], it is paramount that the measures outlined in the Clean Air 2000 are implemented in order to control the effects of congestion.

Power Sector Challenges

3.80 Sri Lanka will have to expand power generation capacity to keep up with growing demand, against serious inefficiencies in the sector. Unfortunately, progress with the on-going industry restructuring, which could begin to address the existing inefficiencies, is slow and the results uncertain. The vesting of the new companies, initially planned for October 2003, has been delayed pending the conclusion of negotiations with trade unions on the terms and conditions of workers' transfers. In addition, the independent Public Utilities Commission of Sri Lanka (PUCSL), created in 2002 to regulate the sector, is not yet fully operational.

3.81 **Adequate Generation Capacity.** Just to keep up with the historical growth in electricity demand (of 8 percent annually), Sri Lanka will need to add to the system approximately 200 MW each year. Despite the existence of a Long Term Generation Expansion Plan (LTGEP), prepared by the CEB, decisions on the procurement of scheduled plants has been subject to long delays, while plants not included in the plan have been implemented. Efforts need to focus on expanding generation capacity in accordance with an updated least-cost expansion plan that takes into account the full range of capacity options, including for private provision. Main priorities include:

- Accelerate the decision making process for implementing the updated least-cost expansion plan. In the event of delays, early plans should be made to address resulting shortages.

- In the longer term, allow the single buyer, the Transmission Company, the independent procurement of plants without political interference while avoiding short term uneconomic plants.

[45] The cost of congestion in the Western Province (Colombo Metropolitan Region) was estimated as around Rs. 550 million (US$ 9 million) in 1995. Source: World Bank, 1997, Sri Lanka Transport Sector Strategy Study, Vol 1: Main Report, January (Washington DC).
[46] Source: Ibid.

- Implement the loss reduction program and other energy efficiency and demand side management initiatives. This would contribute to the optimization of the existing generation capacity.

3.82 **Efficiency of Electricity Provision.** Technical and economic inefficiencies in the system have resulted in consumers paying higher electricity tariffs than in East Asian countries. Sri Lankan residential consumers using more than 300 kWh/m pay 16 US cents per kWh compared to about 10 US cents per kw charged to Filipino and Malaysian consumers. Commercial and industrial consumers are equally at a disadvantage. These tariffs reflect, amongst other things: (i) dependency on expensive thermal sources for the generation and purchase of power[47]; (ii) operating inefficiencies in the CEB that result in high technical and financial losses; and (iii) lack of a transparent and competitive environment to minimize the cost of electricity and to pass efficiency gains to the consumers.

Box 3.7: CEB's Long Term Generation Expansion Plan*

According to the base case of the LTGEP (2003 to 2017) the following plants are planned:

- A 200 MW diesel power plant (already awarded) to be commissioned in early 2005.
- A 300 MW Combined cycle power plant to be commissioned in 2006. Studies by the Asian Development Bank (Nov 2003) indicate that power supply shortages would occur if this plant is delayed only beyond January 2007.
- A 300 MW Coal power Plant. The plant has been on the cards for 15 years. If the commissioning of this plant (or alternative least-cost option) is delayed beyond early 2005, it would result in a deficit of about 640 GWh by 2009.
- A 150 MW hydro power plant at Upper Kothmale, being developed by the CEB, to be commissioned in 2009
- A second Coal plant, for which planning needs to commence by 2011.

Source: CEB

3.83 Despite the relatively high tariffs by regional standards, the CEB is still unable to pass on to the consumers the full cost of electricity due to political interference. A moderate tariff increase in June 2000 followed by a 61 percent increase April 2002 raised CEB's cost recovery to approximately 90%. CEB's inefficiencies coupled with high losses have contributed to the high electricity costs. CEB's technical and non technical losses in distribution add to around 17.2%, with non-technical losses are estimated at 8% reflecting tampering of meters, illicit connections and defective (lack of) metering.[48] In this context, main priorities include:

- Accelerating the restructuring of the sector, including the effective operation of the PUCSL as an independent regulatory body and ensuring that successor companies operate based on commercial principles.

- Enable the PUCSL to: (i) regulate the successor companies to promote competition and efficiency improvements; (ii) phase out cross subsidies from General purpose and Industrial consumers to residential consumers over a reasonable period of time and implementation of tariff regulations that enable full recovery of costs[49]; and (iii) overseeing the implementation of generating capacity.

3.84 **Access and Regional Equity**. Access to electricity varies greatly from 95 percent in the Western Province to 9 percent in the conflict-affected are in the North Province. This access should

[47] Presently the average cost of thermal generation is Rs. 6.79 KWh compared to Hydro of Rs. 1.81 kWh. The average cost of purchase from IPPs is Rs. 6.74 kWh, while the cost of emergency power ranges Rs 9.79.kWh to Rs 10.61.kWh – calculated at US$28/bbl..

[48] In contrast, LECO has a distribution loss of around 6% today, reduced from 28% since 1994.

[49] Due to the progressive rate structure of the block type residential tariff, residential consumers over 300 kWh/m pay double the rate of the small and medium sized residential consumers.

be expanded in the most economically efficient manner, including connection to the main grid and, where this is not feasible, off-grid services at the village or household level[50]. Main priorities include:

- Utilizing more efficiently existing programs to provide off-grid connections, eg the IDA-funded Renewable Energy for Rural Economic Development Project (RERED). This facility has been underutilized because of governments' politically-motivated tendency to offer connections to the CEB grid, for example under the Deepaloka program, which in the end do not materialize.[51] Moreover, RERED could facilitate the coordination between the CEB and the Solar Industry Association for the identification of areas for rural electrification.

- To the extent that rural electrification cannot be undertaken on a commercial basis, Government assistance through the provision of direct subsidies may be considered.

6. Education Reforms for Growth and Equity

3.85 The government faces several key challenges to substantially increase the quality of education, enhance equity of public spending, strengthen service delivery within the system, and improve the economic and social relevance of education institutions at all levels. These challenges exist at a time when public education spending has been declining in real terms and the state experiences a large fiscal deficit which compels it to adopt a conservative fiscal policy.

Table 3.7: Education Expenditure in Sri Lanka and Other Countries

Country	As a % of National Income	As a % of Government Expenditure	Rec. Expenditure per Student as a % of National Income per capita	Average Teacher Salaries as a % of National Income per capita
Sri Lanka	2.9	6.8	9.7	1.5
India	4.1	12.7	16.3	3.0
Bangladesh	2.5	15.7		3.3
Pakistan	1.8	7.8		
Malaysia	6.2	26.7	20.7	2.9
Thailand	5.4	31.0	25.3	3.1
South Korea	3.8	17.4		4.1
Phillipines	4.2	20.6		
South Asia	3.2	11.2	14.5	2.8
Low Income	3.2		16.3	
Lower Middle Income	4.1		18.5	
Upper Middle Income	5.0		23.0	

Sources: Sri Lanka, calculations from CBSL Annual Reports, various issues; Other Countries, World Development Indicators (World Bank) and UNESCO Statistics, various issues. The information above for Sri Lanka is computed from 2002 data. Other countries and regions are from the closest available year in the late 1990's and early 2000's.

3.86 Sri Lanka's Public spending in education is relatively low by international standards, particularly in terms of recurrent expenditures per student and teachers' salaries, even in comparison with other South Asian countries (Table 3.7). Given the tight budget situation, efforts need to focus on improving the efficiency and equity of public spending by correcting current misallocations within the sector and increasing cost-effectiveness. In this context, the government can consider the following set of measures.

[50] Consistent with the current National Rural Electrification Strategy.

[51] An example, is the unrealistic program to connect 288,000 in 290 days under the Deepaloka program

Increasing private sector investment and participation

3.87 Increasing private sector participation in education, particularly in tertiary, could produce important benefits. First, it would increase the overall volume of resources invested in the education sector. Second, since the students attending private schools and tertiary education institutions tend to be drawn from upper income families, it would release more public resources, on a per student basis, for students from poorer families. Third, it would stimulate economic activity in a sector where investment has been artificially restricted and contribute to higher growth. Fourth, it would provide an alternative mode of service delivery, which would be compelled to offer high quality services to compete with free public education institutions.

3.88 Creating a favorable environment for private investment in school education would require developing a new education act and repealing the legislation, passed in the early 1960's, which act as a barrier to the establishment of private schools. The National Education Commission (NEC 2003), recognizing the importance of private sector participation in education recommends three types of private schools: (a) fee-levying private schools, which finance their entire expenses, teach the national curriculum and prepare students for national examinations; (b) fee-levying international schools, which finance all their expenses, teach foreign curricula and prepare students for overseas examinations, within an accreditation framework set by the education authorities; and (c) non-fee levying assisted schools, which teach the national curriculum and prepare students for national examinations, but where there is cost-sharing between the state and the schools, with the government typically paying teacher salaries and the schools bearing capital expenditures.

3.89 While past attempts at establishing private universities have met with strong resistance, including student violence, it would be important to open the debate with the public at large and ensure sufficient understanding that public funding of tertiary education is not only very costly but also regressive (see below). In the meantime, options to expand private participation in tertiary level non-university education need to be further explored, especially in professional and technical fields where the demand for labor, both within and outside the country, is strong.

Enhancing the equity of public education spending

3.90 The pattern of student enrolment over major grade cycles, and the unit costs of education by grade level, show that investment in primary education and secondary education are relatively progressive and benefit students from low and middle income households, while investment in tertiary education tends to benefit students from upper-income households. In consequence, there is a strong case for allocating the major share of any increase in public resources for the education sector to primary and secondary schooling, while carefully controlling the expansion of the public university system and allowing enrolment expansion in tertiary education take place mainly in the private sector. Opportunities for poorer students to access tertiary education could be expanded through schemes such as student vouchers and student loans, rather than through direct provision.

Increasing cost-effectiveness of the education system

3.91 The tight resource constraint faced by the government makes it extremely important that limited public resources, including those for education, be used in a cost-effective manner that may generate internal savings. In this context, three important policy measures are available.

i. *School rationalization*. The cost-effectiveness of operating the school system can be enhanced by consolidating and amalgamating the large number of small, uneconomical schools, where this can be accomplished without reducing access to schooling and affecting enrolment and attendance. This is feasible given that a sizable proportion of small schools are located close to other, larger government schools. MHRECA and the provincial councils designed and implemented a successful school rationalization program, during 1998-2002, but the program was temporarily suspended due to intense political pressure. The government could consider re-opening this school rationalization program, but with careful safeguards to protect access for poor and vulnerable groups.

ii. *Increasing the student-teacher ratio*. The student teacher ratio in schools is 21:1, which is low compared with countries with outstanding education systems and far higher income levels, such as South Korea, Singapore and Hong Kong. The current teacher employment and deployment policy is based on a target student-teacher ratio of 22:1 for secondary grades and 26:1 for primary grade. The government could consider increasing the target student-teacher ratio to at least 23:1 for secondary grades and 27:1 for primary grades in the fist stage of reform. In addition, the student-teacher ratio in the public universities which tends to be very low, at 14:1, could be raised to about 18:1, so that cost savings can be generated within the system.

iii. *Rationalization of administrative staffing*. The roles, functions and responsibilities of staff within the multi-tiered education administrative system tends to be rather unclear. A careful analysis of work loads, and *de jure* and *de facto* roles, functions and responsibilities of staff in the various education ministries, provincial councils, zonal education offices, division education offices and tertiary education institutions is likely to identify both duplication of roles and functions, and gaps and shortages of staff. Overall, there may be an excess of staff, which a carefully designed voluntary retirement scheme could decrease, reducing pressure on the budget and releasing more resources for investment.

3.92 In order to provide incentives for the implementation of the cost saving measures proposed above, it is vitally important that the Ministry of Finance permits funds saved to be channeled back into the education system and be re-oriented, for instance, to meet quality-enhancing objectives.

Intra-budget shifts in resource allocation

3.93 Over time, the balance of capital and recurrent spending within the education budget needs to shift to allocate a greater share of resources to capital expenditure. Within the capital budget, a higher proportion of resources needs to be invested in quality inputs such as IT centers, science laboratories, libraries, activity rooms, multi-purpose rooms, equipment, technology and tools. The construction and expansion of buildings, which absorbs the highest share of the capital budget, needs to be rationalized, prioritizing the urban school system which is facing rising demand. Within the recurrent budget, too, resources need to be reallocated from salaries and administrative expenses to quality processes, such as teacher education and training, management and academic training of school principals, and the purchase of teaching material and learning resources.

Protecting and gradually increasing public investment in education

3.94 Improving the quality of education would necessitate measures and resources to modernize the curricula, enhance teacher training and salaries, strengthen school leadership by principals, increase the use of equipment and technology at schools and other institutions. Higher public funding levels will not necessarily guarantee improved quality, unless current misallocations and inefficiencies in the system are addressed. However, given the relatively low level of public education spending, and the major challenges Sri Lanka faces in improving the quality and economic and social relevance of the education system, it is important that the government preserve the current level of real expenditure in the short-term and increase public investment in education gradually over the medium-term, provided that progress is also made in improving the allocation of existing resources.. The possibility of at least maintaining the real value of the education budget in 2005, and gradually raising expenditures from 2006 onwards, needs to be considered in the context of competing requirements by other sectors and the target budget deficits.

Increasing the quality of service delivery: decentralizing of education management

3.95 Key policy proposals to improve service delivery within the school system include the establishment of school boards and decentralization of education management to schools. The objective of this policy initiative is to empower principals, section heads and teachers, enable schools to forge links with local communities to improve resource mobilization and public accountability, increase the efficiency of decision making by decreasing administrative layers, and improve service delivery. The school board model is to be pilot tested in about 80 schools around the country. A proper evaluation of this pilot program would be extremely helpful for future policy making on the structure of school governance. The government could also consider applying the principle of decentralization to other education institutions, such as National Colleges of Education (NCOEs) and Teacher Centers (TCs). Increasing the managerial autonomy of these institutions (on curriculum design, recruitment of academic staff, administration etc.) would greatly enhance their operational efficiency and quality of service delivery.

Increasing the Economic Relevance of the Education System

3.96 Several measures have been adopted to improve the linkages of the education system to the world of work. These include: (i) introducing student centered and activity based learning approaches that promote work ethics and team building; (ii) increasing the use of technology, especially IT, in education; (iii) expanding and strengthening the teaching and learning of English, including allowing English to be used as a medium of instruction; and (iv) making provision for career guidance and counseling in schools and universities. In addition, efforts have been made to strengthen the labor market relevance of vocational training and technical education by increasing reliance on the private sector for skills development activities. These are positive initiatives that need to be further strengthened and developed. Key initiatives to strengthen these policy measures would be: (a) reallocating resources through cost savings in the education sector to investment in equipment and technology; and (b) permitting schools to offer English medium education from grade 1 onwards, instead of just the GCE A/L cycle, as at present.

7. Peace, Conflict and Development

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

3.98 Although these gains are real, they have been constrained by the absence of durable peace, of the kind entailed in a formal peace accord. Uncertainty still weighs heavy on both domestic and foreign investors, accentuated by the political twists and turns since November 2003. More generally, international experience suggests that ending a long-drawn civil conflict is a necessary but not sufficient condition for realizing the full peace dividend (Box 3.8). Typically, private investment and government revenue are slow to recover and security expenditures cannot be reduced quickly for various reasons. It takes time and resources to restore damaged or neglected economic infrastructure. The damage to institutional infrastructure is even harder to overcome. The transition to peace poses fresh problems and challenges that have to be managed.

3.99 What if the current quasi-peace continues for several years ? Can the economy recover close to its full potential? The answer has to be: very unlikely. The single greatest obstacle will be the uncertainty inherent in such a situation. High levels of uncertainty are antithetical to the high and sustained investment that the country needs to accelerate growth, expand employment and reduce poverty. Furthermore, an uncertain peace will entail high levels of security expenditures, continued large fiscal deficits and their associated adverse consequences. Perhaps as important, the political management of a quasi-peace would continue to distract government and policy makers from focusing on the agenda for economic reforms necessary to realize the progressive vision in Sri Lanka's poverty reduction strategy.

Box 3.8: Realizing the Peace Dividend

The "peace dividend" refers to the improved economic and social outcomes that are expected to materialize in the transition to peace. In particular, a transformation to a peace-time economy would be expected to result in reduced military spending and reduced budget deficits with a corresponding reduction in interest rates and inflation. Government can once again focus on its development agenda including increased social and welfare spending as well as promoting economic growth. The cessation of hostilities is also expected to usher in an era of growth resulting from increased tourism, FDI, trade and exports. It is also likely to result in increased donor funds for reconstruction in the North East and poverty alleviation throughout the country.

The end of the war should also result in the re-integration of the economy of the North and East with the rest of the country. This will result in counter cyclical agricultural production (given the complementarity of the agricultural seasons in the North and South), and recovery of the fishing industry. Most of the internally displaced and some refugees will be able to return to their homes and take up economic activities. Children will be able to return to their schools and doctors will no longer fear working in former conflict zones, thus social indicators will begin to recover.

However, ending the war is a necessary but not sufficient condition for realizing the peace dividend. The benefits of the peace dividend will not materialize automatically and they are notoriously difficult to achieve in the short term. Private investment and government revenue are slow to recover and military expenditure is not easily reduced as soldiers cannot be demobilized easily and government will have to continue to make debt payments for military hardware purchased during the conflict. In this context, it would be useful to examine alternative uses for the military that could contribute to economic revival and improved security. Some options worth considering include allowing the military to take part in peace-keeping missions overseas that would earn valuable foreign currency and playing a role in domestic development brigades that could undertake reconstruction projects such as de-mining, rebuilding housing and infrastructure.

Realizing the peace dividend will also require a conscious effort to identify and address the vested interests in prolonging the war. Several groups within Sri Lankan society are currently "benefiting" from the war and may feel threatened, were the peace process to progress beyond a certain point. These groups include; soldiers in the Sri Lankan army receiving a wage premium, LTTE cadres receiving substantial funds from overseas remittances and ad hoc tax revenues, and profiteers distributing goods and services during the economic embargo on the North.

To end a violent conflict, it is vital to understand, and change, the incentives that have made violence a viable strategy during the conflict. The transition to peace in Sri Lanka should be seen as an opportunity to discuss and resolve long-standing issues that have led to conflict and have the potential to lead to conflict in the future. For instance, this may be a good time to consider a new devolution arrangements that might be required to restore and secure peace. It may also be appropriate to reconsider a larger role for the use of English as a medium of instruction (dropped in the late 1950s), given its importance as a link language between ethnic groups as well as its importance for IT related development and international business linkages.

Throughout this process, it is important that government communicates these messages clearly to the relevant populations and manages the expectations of all stakeholders.

Sources: Azam et. al., Breaking the Conflict Trap : Civil War and Development Policy, World Bank Policy Research Paper 2003.

3.100 However significant are these challenges and costs for managing the transition to peace, they are obviously to be preferred over any resumption of conflict. Sri Lanka's twenty year history of civil war bears eloquent testimony to the direct social and economic costs of conflict and the possibly even more substantial (though less tangible) indirect costs of missed opportunities and distracted policies.

Furthermore, there is little chance that Sri Lanka could sustain the 5 percent growth of the 1990s if there is a resumption of conflict. In contrast to the early 1990s, the fiscal situation today is much more fragile, infrastructure is suffering from decades of neglect, agriculture is in doldrums, trade and industry face novel external challenges and external assistance has dwindled (and will not increase if conflict flares up).

3.101 In brief, for Sri Lanka's economy to achieve sustained growth at 6 percent plus (let alone the 8 to 10 percent aspirations sometimes voiced), durable peace is a prerequisite. The country's economic history supports this assessment: the only five year period when economic growth averaged above 6 percent was in 1977-82, when economic reforms held center stage in policy-making and the civil war had not begun.

8. Development Risks

Resurgence of Conflict

3.102 Today, more than ever before, Sri Lanka is at a crossroads on its development path. As discussed in the earlier section, any resumption of conflict poses a major risk to Sri Lanka's development prospects. Indeed, since the events of September 11, 2001, the world is much more sensitive to conflict and terrorism. Even if the cease fire holds, without a durable peace settlement the threat of a resurgence of conflict will continue to linger, weakening the investment climate and diverting limited public resources away from development needs.

External Vulnerabilities

3.103 Being a small economy, Sri Lanka's growth prospects hinge critically on its ability to remain competitive in a rapidly changing global economy, especially in the post-MFA era. The external environment offers opportunities but also poses risks. Proximate examples of the latter are the economic downturn after 9/11, the recent surge in oil prices and the challenge of the post-MFA trading environment. No country enjoys immunity from such adverse developments in the international economy. History has shown, decisively, that closing off from the world economy is not a viable alternative for Sri Lanka, or indeed, for any country. As a small open economy, Sri Lanka's best insurance against unforeseen external events and trends lies in building a more diversified export base and a flexible economic structure (with easy conditions for entry and exit), as well as sound investment in education and skills. The policy reforms suggested in this report should help Sri Lanka strengthen its economic flexibility.

Political Economy of Reforms

3.104 Perhaps the greatest risk to realizing Sri Lanka's development aspirations is the country's legacy of civil strife and complex politics. It is very clear that economic reforms in Sri Lanka (like everywhere else) are deeply political. The challenge lies in building the requisite support in favor of reforms among the political leadership and the public in general. This needs to be accompanied by a genuine effort to implementing poverty-reducing strategies, i.e., revamping the rural economy and improving the effectiveness of safety nets to protect the poor.

3.105 **Short Election Cycles and Perspectives.** Unfortunately, the current volatile political environment, characterized by a fragile balance of power among the main political forces and the ensuing short election cycles, poses serious hurdles to sensible economic policies. In this situation, national economic interest can often be compromised by actions taken for short term political gains. The short election cycle spawns populist measures, which undermine fiscal health and feed unrealistic expectations. As long as the expectations of ordinary citizens continue to be unmet in the short term, there is a real risk of even worse political scenarios --such as in Latin America-- where opportunistic political figures win favor among a population disenchanted with traditional political groups.

3.106 **Welfare State vs. Market**. Beyond the differences in policy stance and the struggle for power of the two leading political parties, a major challenge is to manage the relatively high expectations of Sri Lanka's population which, by and large, continues to regard the state as the main provider of economic welfare. This expectation, which is deeply rooted in Sri Lanka's socialist tradition, is clearly depicted in Joan Robinson's commentary in 1958 on the constraining effect of labor relations on the country's effort to design a national development strategy to absorb a rapidly growing labor force:

> *Ceylon has imported from the advanced capitalist countries (along with a modernized death-rate) ...the ideals of the welfare state, and her trade union movement has imported the conception that belong to unions in a developed economy, whose business is to keep profits in check and secure an acceptable share of national output for the workers. These advanced capitalist economies were under-developed once, and they have behind them a long history of enterprise and accumulation (not to mention ruthless exploitation of labor). They did not evolve their present relatively humane and relatively egalitarian philosophy until after the industry was well rooted and until after birth rates had come down to manageable levels .* ***Ceylon has tasted the fruit before she has planted the tree. Her trade unions are anxious to share in profits but the energetic, enterprising and thrifty capitalist for them to share have not yet appeared*** (Robinson 1958, pp 40-41) (emphasis added).

3.107 Interestingly, despite policy reforms over the years, Robinson's characterization of Sri Lanka's labor market situation still rings true. This view of the state as a prime benefactor seems to underlie the wide-spread resistance to privatization, the expectation that the state should be employer of first resort, and explains why in some areas, such as university education, people refuse to even consider private sector participation. Related deep-rooted beliefs include the paternalistic approach toward farmers (who are not really trusted to make sound decisions on the use of their land) and the view that 'self-sufficiency', and not higher incomes, is the best way to ensure food security. Seemingly well-intentioned policies may have backfired. The agricultural subsidies leading to concentration in low-value paddy production is a case in point. Another may be the policy of Swabasha, making Sinhala and Tamil the medium of instruction. Originally introduced to correct the perceived unfair advantage accruing to upper-income groups sending children to English-medium schools, the policy appears to have contributed to declines in quality of education without reaping significant improvement in equity.

3.108 Against this backdrop, Sri Lanka's own experience clearly shows that market-oriented policies have succeeded in bringing substantial economic growth and poverty reduction in urban areas while heavy state intervention in agriculture has stifled the rural economy with seriously adverse implications for the poor. Therefore, there is enough evidence in Sri Lanka to show that there is no trade-off between market-driven growth and poverty reduction. However, a well functioning market economy is usually associated with a well functioning public sector. Indeed, the state has a very important role to play on several fronts: in establishing an appropriate regulatory framework; addressing market failures; providing public goods and services; and, very importantly, in protecting the poor.

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Box A 1: A List of Policy Options for Consideration

Managing Public Finances

- Public debt to be reduced to a manageable level by reducing the primary fiscal deficit and limiting reliance on non-concessionary borrowing.
- Public expenditures to be rationalized by establishing a policy driven, output based and consultative budget formulation system under a medium term budget framework.
- Financial burden of state-owned enterprises on the budget to be reduced by limiting transfers and contingent liabilities and subjecting them to a hard budget constraint.
- Effectiveness of existing *welfare programs*, including Samurdhi, to be increased by improving targeting to better reach the poor and making payments more progressive.
- Public sector wage and recruitment policies to be de-politicized addressing overstaffing, and correcting inappropriate salary scales and administrative fragmentation
- Tax administration to be strengthen by establishing a well integrated revenue administration, establishing a separate tax audit unit, and making the large tax payer unit more proactive.
- Income tax yield to be raised by phasing in a moratorium on existing tax holidays, exclusions, and concessions.
- Extending excise taxes to income-elastic luxury consumer goods to be explored
- VAT coverage to retail trade and reduce exemptions to be considered.

Trade Policy

- A competitive real exchange rate to be maintained
- Tariff reversals especially in the agricultural sector to be avoided and move made towards a single, low, uniform tariff.
- In bilateral Free Trade Agreements (FTA) the cost of trade diversions, capital account concessions, and distractions to the unilateral trade liberalization agenda that bilateral FTAs entail to be reviewed.

Investment Policy

- Foreign investment policy regime to be made attractive by making effective recently legislated laws and bringing fiscal incentives in line with Inland Revenue Laws.
- A liberal emigration policy to be pursued and migrant worker households provided easy access to bank facilities and a market responsive exchange rate policy.
- Recent *labor reforms* to be implemented, along with encouraging consolidation, improving infrastructure, and facilitating credit to small garment exporters to assist with the post MFA adjustment.

Non plantation Agriculture

- Full and transferable ownership rights of land be allowed through appropriate legislation and institutional setting.
- More liberal seed and phyto-sanitary regulations to be allowed
- Scope of research and extension services through private sector participation, including NGOs, to be pursued.
- Sustainable use of water through the enactment of an appropriate National Water Bill to be ensured.

Infrastructure

- Funding to be increased for road maintenance and rehabilitation focused on improving national highways.
- Public institutions in transport sector to be strengthened and private sector participation in transport infrastructure and service provision increased.
- Participation of stakeholders (rural poor and environment groups) in formulating transport strategy to be increased.
- CEB to be restructured and regulatory functions transferred to independent PUCSL.
- Electricity generation capacity to be expanded in accordance to an updated least-cost expansion plan and without political interference.
- Provision of off-grid connections to rural households to be accelerated (e.g., IDA financed RERED Project).

Education

- Allocation for primary and secondary education to be increased by reallocating funds from tertiary education.
- Private sector participation in education, especially in tertiary education, to be encouraged by developing a new education act and securing access by the poor to tertiary education through a voucher system.
- Cost effectiveness of education to be increased by rationalizing schools, administration and staffing; and raising the student-teacher ratio.
- Service delivery to be improved by decentralizing education management to schools.
- Relevance of education to be increased with a focus on IT and allowing English as medium of instruction.

Table A1: Social Indicators

	Latest single year			Same region/income group	
	1970-75	1980-85	1995-03	South Asia	Lower-middle-income
POPULATION					
Total population, mid-year (millions)	13.5	15.8	19.4	1,355.1	2,047.6
Growth rate (% annual average for period)	1.5	1.4	1.3	1.9	1.1
Urban population (% of population)	22.0	21.1	23.6	28.4	42.0
Total fertility rate (births per woman)	3.9	2.9	2.1	3.3	2.1
POVERTY					
(% of population)					
National headcount index	..	..	22.7	..	..
Urban headcount index	..	..	7.9	..	..
Rural headcount index	..	..	24.7	..	..
INCOME					
GNI per capita (US$)	310	380	930	440	1,130
Consumer price index (1995=100)	12	34	154	142	146
Food price index (1995=100)	..	34	159	..	..
INCOME/CONSUMPTION DISTRIBUTION					
Gini index	..	..	34.4	..	..
Lowest quintile (% of income or consumption)	..	..	8.0	..	..
Highest quintile (% of income or consumption)	..	..	42.8	..	..
SOCIAL INDICATORS					
Public expenditure					
Health (% of GDP)	..	..	1.7	0.9	2.3
Education (% of GDP)	2.7	2.6	3.4	3.0	4.6
Social security and welfare (% of GDP)	6.1	3.0	2.9	..	..
Gross primary school enrollment rate					
(% of age group)					
Total	..	..	110	..	91
Male	..	..	111	..	91
Female	..	..	110	..	91
Access to an improved water source					
(% of population)					
Total	..	..	83	87	80
Urban	..	..	91	92	95
Rural	..	..	80	85	69
Immunization rate					
(% under 12 months)					
Measles	..	20	99	53	89
DPT	..	70	98	57	89
Child malnutrition (% under 5 years)	..	..	33	49	11
Life expectancy at birth					
(years)					
Total	66	69	74	62	69
Male	65	67	72	62	67
Female	68	71	76	63	72
Mortality					
Infant (per 1,000 live births)	45	24	12	73	33
Under 5 (per 1,000 live births)	100	48	17	96	41
Adult (15-59)					
Male (per 1,000 population)	214	200	244	227	192
Female (per 1,000 population)	196	152	124	212	125
Maternal (per 100,000 live births)	..	..	23	..	..
Births attended by skilled health staff (%)	..	..	97	..	..

CAS Annex B5. This table was produced from the CMU LDB system.

Note: 0 or 0.0 means zero or less than half the unit shown.

Table A2: Key Economic Indicators

Indicator	Actual				Estimate	
	1998	1999	2000	2001	2002	2003
National accounts (as % of GDP)						
Gross domestic product[a]	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture	21.1	20.7	19.5	19.5	19.8	19.0
Industry	27.5	27.3	27.5	26.7	26.6	26.5
Services	51.4	52.1	53.0	53.8	53.6	54.5
Total consumption	80.9	80.5	82.6	84.7	85.5	84.3
Gross domestic fixed investment	25.1	27.3	28.0	22.1	21.3	22.3
Government investment	3.3	3.2	3.3	3.0	2.0	2.3
Private investment	21.8	24.1	24.7	19.0	19.3	20.0
Exports (GNFS)[b]	36.2	35.5	39.7	37.0	36.1	35.8
Imports (GNFS)	42.2	43.3	50.5	43.7	42.9	42.4
Gross domestic savings	19.1	19.5	17.4	15.3	14.5	15.7
Gross national savings	23.4	23.5	21.4	19.5	19.5	21.3
Memorandum items						
Gross domestic product (US$ million at current prices)	15795	15657	16305	15669	16545	18237
GNI per capita (US$, Atlas method)	810	860	890	840	850	930
Real annual growth rates (%)						
Gross domestic product at market prices	4.7	4.3	6.0	-1.4	4.0	5.9
Gross domestic income	9.6	3.6	3.6	-0.3	4.1	6.4
Real annual per capita growth rates (%)						
Gross domestic product at market prices	3.5	2.8	4.3	-2.9	..	..
Total consumption	5.7	3.8	3.3	-1.1	..	..
Private consumption	5.7	3.8	2.7	16.9	..	..
Balance of Payments (US$ millions)						
Exports (GNFS)[b]	5712	5578	6475	6183	5967	6539
Merchandise FOB	4798	4610	5522	4817	4699	5131
Imports (GNFS)[b]	6659	6800	8235	7135	7080	7681
Merchandise FOB	5889	5980	7320	5974	6106	6669
Resource balance	-947	-1222	-1760	-952	-1111	-1143
Net current transfers	900	912	998	960	1128	1234
Current account balance	-227	-564	-1066	-272	-236	-101
Net private foreign direct investment	193	177	176	172	181	171
Long-term loans (net)	398	397	297	354	91	515
Official	376	155	154	184	112	548
Private	22	242	143	170	-21	-33
Other capital (net, incl. errors & ommissions)	-135	-351	-26	16	302	-83
Change in reserves[c]	-229	340	619	-270	-338	-502
Memorandum items						
Resource balance (% of GDP)	-6.0	-7.8	-10.8	-6.1	-8.5	-8.4
Real annual growth rates						
Merchandise exports (FOB)	13.2	4.5	9.8	2.4	3.4	7.4
Merchandise imports (CIF)	9.9	3.7	13.7	1.3	11.0	11.7

Table A2: Key Economic Indicators

(Continued)

Indicator	Actual 1998	Actual 1999	Actual 2000	2001	Estimate 2002	Projected 2003
Public finance (as % of GDP at market prices)[d]						
Current revenues	17.2	17.7	16.8	16.5	16.5	15.7
Current expenditures	19.6	18.7	20.2	21.4	20.8	19.0
Current account surplus (+) or deficit (-)	-2.4	-1.0	-3.4	-4.9	-4.3	-3.3
Capital expenditure	5.3	5.5	5.4	4.8	4.6	4.9
Foreign financing	1.7	0.7	0.7	1.6	0.6	2.9
Monetary indicators						
M2/GDP	37.1	38.7	38.5	39.2	40.1	40.2
Growth of M2 (%)	13.2	13.4	12.8	13.6	13.4	15.3
Price indices(YR82 =100)						
Merchandise export price index	91.4	84.0	91.7	78.1	79.0	84.0
Merchandise import price index	94.7	97.0	108.2	87.1	85.7	84.9
Merchandise terms of trade index	96.4	86.6	84.7	89.6	92.0	99.0
Real exchange rate (US$/LCU)[e]	126.2	117.4	115.5	116.4	116.6	114.2
Consumer price index (% change)	9.4	4.7	6.2	14.2	9.6	6.3
GDP deflator (% change)	9.2	4.2	6.2	13.2	8.4	5.1

a. GDP at factor cost.
b. "GNFS" denotes "goods and nonfactor services."
c. Includes use of IMF resources.
d. Consolidated central government.
e. "LCU" denotes "local currency units." An increase in US$/LCU denotes appreciation.

Table A3: Gross Domestic Product at Current Factor Cost Prices

In Rs. Million

Year	GDP	Agriculture	Industry	Services	GNP at Current Factor Costs
1978	40,479	12,332	11,030	17,117	40,547
1979	49,782	13,412	14,047	22,323	49,880
1980	62,246	17,151	18,450	26,645	62,229
1981	79,337	21,977	22,206	35,154	77,913
1982	94,679	24,964	24,887	44,828	92,925
1983	113,878	32,180	29,992	51,706	110,758
1984	140,039	40,138	36,856	63,045	136,321
1985	148,321	41,069	38,859	68,393	144,811
1986	163,713	44,355	43,548	75,810	160,204
1987	177,731	47,923	48,763	81,045	174,106
1988	203,516	53,600	54,300	95,616	199,107
1989	228,138	58,462	61,041	108,635	223,280
1990	290,615	76,488	75,555	138,572	284,907
1991	337,399	90,257	86,284	160,858	330,667
1992	386,999	100,080	99,218	187,701	379,834
1993	453,092	111,659	116,007	225,426	447,954
1994	523,300	124,370	137,005	261,925	515,574
1995	598,327	137,678	158,764	301,885	592,310
1996	695,934	156,108	184,056	355,770	684,676
1997	803,698	175,774	216,177	411,747	794,120
1998	912,839	192,665	251,401	468,773	901,283
1999	994,730	205,599	271,388	517,743	976,899
2000	1,125,259	223,926	306,977	594,356	1,102,177
2001	1,245,598	249,790	333864	661,944	1,221,768
2002	1,403,309	287,840	368695	746,774	1,378,151
2003	1,560,806	296,510	410082	854,214	1,541,985

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

Table A4: Gross Domestic Product at 1996 Prices

In Rs. Million

Year	GDP	GNP	Real GDP Growth (%)
1978	302,426	302,931	8.2
1979	321,543	322,179	6.3
1980	340,209	340,114	5.8
1981	359,862	353,402	5.8
1982	378,113	371,109	5.1
1983	396,867	385,994	5.0
1984	416,915	405,846	5.1
1985	437,582	427,227	5.0
1986	456,316	446,535	4.3
1987	462,950	453,508	1.5
1988	475,442	465,143	2.7
1989	486,141	475,789	2.3
1990	516,153	506,016	6.2
1991	539,955	529,182	4.6
1992	563,062	552,637	4.3
1993	602,172	595,343	6.9
1994	636,061	626,670	5.6
1995	670,742	663,997	5.5
1996	695,934	684,676	3.8
1997	739,763	730,947	6.3
1998	774,796	764,908	4.7
1999	808,340	794,340	4.3
2000	857,035	840,200	6.0
2001	843,794	829,056	-1.5
2002	877,248	862,712	4.0
2003	929,038	918,261	5.9

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

Table A5: Gross Domestic Product at Current Market Prices

In Rs. Million

Year	Gross Domestic Product at Market Prices	Net Imports of GNFS	Net Factor Income From Abroad	Net Private Transfers	Private Consumption	Public Consumption	Private Investment	Public Investment	Domestic Savings Ratio (% of GDP)	National Savings Ratio (% of GDP)
1978	42,665	2,037	-246	342	32,105	4,043	5,831	2,723	15.3	15.5
1979	52,387	6,309	-219	754	40,371	4,798	9,783	3,744	13.8	14.8
1980	66,527	15,022	-389	2,260	53,399	5,685	16,776	5,689	11.2	14.0
1981	85,005	13,666	-1,706	3,918	68,751	6,310	19,604	4,006	11.7	14.3
1982	99,238	18,757	-1,981	5,494	79,226	8,242	25,583	4,944	11.9	15.4
1983	121,601	18,365	-3,265	6,441	94,945	9,889	29,234	5,898	13.8	16.4
1984	153,746	9,132	-3,475	7,031	111,235	11,935	32,693	7,015	19.9	22.2
1985	162,375	19,409	-3,428	7,212	126,503	16,599	30,890	7,792	11.9	14.2
1986	179,474	20,839	-3,583	7,983	139,370	18,480	32,879	9,584	12.0	14.5
1987	196,723	20,664	-4,363	9,226	151,949	19,538	34,726	11,174	12.8	15.3
1988	221,982	23,886	-5,342	10,187	173,457	21,849	37,437	13,125	12.0	14.2
1989	251,891	23,921	-5,865	11,840	194,680	26,410	40,331	14,391	12.2	14.6
1990	321,784	25,364	-6,685	14,518	244,288	31,405	58,790	12,665	14.3	16.8
1991	372,345	37,658	-7,367	16,623	288,214	36,633	69,273	15,883	12.8	15.2
1992	425,283	39,394	-7,821	20,253	320,466	40,972	89,557	13,682	15.0	17.9
1993	499,565	47,686	-5,979	27,090	373,785	45,791	106,920	20,755	16.0	20.2
1994	579,084	68,361	-8,310	30,989	434,933	56,002	138,849	17,661	15.2	19.1
1995	667,772	69,714	-6,958	34,820	489,057	76,604	148,180	23,645	15.3	19.5
1996	768,128	68,573	-11,258	39,242	569,416	81,021	162,761	23,503	15.3	19.0
1997	890,272	62,866	-9,409	46,472	643,839	92,196	187,150	29,953	17.3	21.5
1998	1,017,986	61,154	-11,556	54,785	723,506	99,745	221,879	34,010	19.1	23.4
1999	1,105,963	86,090	-17,831	62,438	790,379	99,851	266,593	35,230	19.5	23.5
2000	1,257,636	133,373	-23,083	73,810	906,188	132,189	311,480	41,152	17.4	21.5
2001	1,407,398	87,768	-23,830	87,902	1,041,041	144,441	267,318	42,366	15.8	20.3
2002	1,582,655	108,555	-25,159	104,938	1,214,117	139,311	305,860	31,922	14.5	19.5
2003	1,760,280	115,824	-18,821	116,307	1,343,896	139,268	352,174	40,766	15.7	21.3

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

Table A6: Index of Real Value Added in Industry

1978=100

Year	Food & Beverage	Textiles & Apparel	Wood & Wood Products	Paper & Paper Products	Chemicals, Petroleum, Rubber and Plastic	Non-Metallic Mineral Products	Basic Metal Products	Metal, Machinery & Transport Equipment	Total
1978	100	100	100	100	100	100	100	100	100
1979	90	80	112	98	113	98	132	80	95
1980	96	114	192	117	174	114	106	74	114
1981	84	128	163	84	242	92	88	84	117
1982	91	110	117	74	202	122	14	149	119
1983	247	1 014	399	227	1 089	181	265	186	436
1984	260	1 275	418	195	1 121	193	149	205	467
1985	313	1 588	456	253	1 016	194	91	222	503
1986	342	1 909	386	260	812	203	197	232	509
1987	342	2 277	387	259	923	199	201	247	557
1988	195	635	237	127	235	108	42	168	217
1989	219	694	232	115	198	92	41	199	226
1990	217	721	189	131	113	299	87	231	242
1991	244	775	201	135	135	278	100	246	268
1992	275	1 206	216	147	153	305	96	250	323
1993	292	1 430	242	184	165	337	93	227	356
1994	300	1 372	288	202	184	400	109	250	371
1995	329	1 582	290	200	203	387	98	241	402
1996	333	1 765	274	187	236	374	113	228	420
1997	331	2 117	254	175	260	379	138	258	454
1998	348	2 284	245	158	319	375	152	272	484
1999	366	2 547	248	157	296	398	159	284	514
2000	378	3 001	260	155	356	385	184	279	563
2001	373	2 741	244	152	343	385	224	281	537
2002	390	2 774	241	149	363	393	230	286	553
2003	415	2 809	252	148	392	407	215	307	575

Source: Central Bank of Sri Lanka Annual Report (multiple issues) and Staff calculations.

Table A7: Selected Tourism Statistics

Year	Tourist Arrivals in Thousands	Number of Hotel Rooms
1978	196	5,347
1979	250	5,599
1980	322	6,042
1981	371	6,891
1982	407	7,539
1983	338	8,852
1984	318	9,627
1985	257	9,826
1986	230	9,794
1987	183	9,921
1988	183	9,977
1989	185	9,459
1990	298	9,556
1991	318	9,679
1992	394	10,214
1993	392	10,365
1994	408	10,742
1995	403	11,255
1996	302	11,600
1997	366	12,370
1998	381	12,772
1999	436	12,918
2000	400	13,311
2001	337	13,626
2002	393	13,818
2003	501	--

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

Table A8: Selected Energy Statistics

Year	Electricity		Fuels		
	Installed Capacity (MW)	Power Generation (GWh)	Consumption (MT '1000s)		
			Petrol	Diesel	Kerosene
1978	402	1,385	130	309	245
1979	402	1,525	115	349	230
1980	422	1,668	108	398	188
1981	522	1,872	109	421	168
1982	562	2,066	114	465	174
1983	592	2,114	117	464	162
1984	812	2,261	119	481	151
1985	1,016	2,464	122	489	154
1986	1,010	2,653	131	489	154
1987	1,138	2,708	140	497	156
1988	1,208	2,800	177	499	164
1989	1,240	2,858	189	484	160
1990	1,289	3,150	179	513	167
1991	1,289	3,376	160	540	173
1992	1,409	3,540	165	606	189
1993	1,409	3,979	173	666	192
1994	1,409	4,364	184	728	207
1995	1,409	4,783	190	728	222
1996	1,409	4,530	198	1,048	228
1997	1,575	5,145	193	1,295	225
1998	1,636	5,683	204	1,224	236
1999	1,691	6,184	213	1,377	243
2000	1,779	6,644	220	1,715	229
2001	1,901	6,627	244	1,675	228
2002	1,930	6,951	278	1,752	229
2003	2,223	7,612	--	--	--

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

Table A9: Selected Transport Statistics

Year	Rail Transport		Road Transport				Port Services	
	Locomotives	Operated Kilometerage (millions)	Public Sector		Private Sector	Vehicle Stock (thousands)	No. of Vessels Arrived	Cargo Handled MT (thousands)
			Operated Kilometerage (millions)	Passenger Kilometerage (millions)	Passenger Kilometerage (millions)			
1978	197	10.75	456	17,507	--	232	--	5,693
1979	197	10.90	482	19,265	--	274	--	5,183
1980	225	10.76	517	19,774	--	337	--	6,013
1981	202	10.83	494	13,801	--	374	--	5,949
1982	231	10.48	482	18,260	--	403	--	6,422
1983	209	8.38	457	16,119	--	440	--	4,880
1984	193	8.51	417	14,722	--	478	--	7,622
1985	193	8.47	390	14,495	--	524	--	8,534
1986	192	7.89	375	15,149	--	569	--	9,867
1987	193	8.20	371	15,974	--	588	--	10,216
1988	193	6.32	334	15,413	--	630	--	12,517
1989	196	5.74	261	12,980	--	714	--	11,827
1990	193	7.40	245	13,327	18,616	820	3,089	13,052
1991	193	7.80	247	11,454	19,591	904	3,178	13,691
1992	195	8.87	268	12,840	22,013	1,003	3,438	13,331
1993	195	8.96	276	13,608	24,214	1,087	3,631	16,498
1994	215	8.68	307	15,613	22,751	1,162	3,568	18,097
1995	190	8.59	353	19,305	20,679	1,247	3,612	19,517
1996	186	8.02	347	20,322	21,747	1,324	3,857	22,722
1997	155	7.79	332	19,154	22,844	1,408	4,087	26,832
1998	180	8.53	322	17,749	24,273	1,511	4,233	26,847
1999	167	8.90	344	17,956	28,626	1,614	4,339	26,995
2000	177	8.59	387	19,864	26,805	1,706	4,232	27,535
2001	127	8.86	420	21,204	--	1,778	4,014	27,062
2002	133	8.47	397	21,067	--	1,892	4,062	28,363
2003	--	8.08	--	--	--	2,074	4,032	30,500

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

Table A10: Selected Telecommunications Statistics

Year	No. of fixed Telephone Lines	Cellular Phones	Wireless Phones
1978	58,987	--	--
1979	59,617	--	--
1980	60,070	--	--
1981	62,193	--	--
1982	68,201	--	--
1983	71,112	--	--
1984	80,770	--	--
1985	87,686	--	--
1986	92,065	--	--
1987	97,832	--	--
1988	104,108	--	--
1989	105,007	--	--
1990	121,388	1,010	--
1991	125,834	1,973	--
1992	135,504	4,000	--
1993	157,774	6,242	--
1994	180,724	29,182	--
1995	204,350	51,316	--
1996	254,500	71,028	527
1997	315,241	114,888	26,381
1998	455,598	174,202	67,931
1999	580,199	256,655	91,717
2000	653,144	430,202	114,267
2001	708,200	667,662	121,082
2002	768,620	932,000	114,488
2003	823,000	1,393,000	116,000

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

Table A11: Key Employment Statistics

In Thousands

Year	Source	Total	By Industry				
			Agriculture	Manufacturing	Mining	Construction	Services
1978/79	Consumer Finance and Socio-Economic Survey	4,647	2,415	582	56	234	1,360
1981	Census of Population	4,119	1,864	417	38	125	1,675
1981/82	Consumer Finance and Socio-Economic Survey	4,673	2,361	574	78	238	1,422
1985/86	Labour Force & Socio-Economic Survey	5,132	2,531	648	67	227	1,659
1986/87	Consumer Finance and Socio-Economic Survey	5,271	2,515	706	100	300	1,650
1990	Quarterly Labour Force Survey	5,047	2,361	669	80	197	1,740
1991	Quarterly Labour Force Survey (a)	5,015	2,130	751	56	237	1,842
1992	Quarterly Labour Force Survey (a)	4,962	2,089	650	80	238	1,906
1993	Quarterly Labour Force Survey (a)	5,201	2,159	684	81	227	2,051
1994	Quarterly Labour Force Survey (a)	5,281	2,085	756	43	216	2,181
1995	Quarterly Labour Force Survey (a)	5,357	1,967	788	86	285	2,230
1996	Quarterly Labour Force Survey (a)	5,537	2,072	807	87	297	2,274
1997	Quarterly Labour Force Survey (a)	5,608	2,032	920	92	312	2,274
1998	Quarterly Labour Force Survey (a)	6,005	2,436	856	74	296	2,342
1999	Quarterly Labour Force Survey (a)	6,083	2,205	902	76	322	2,578
2000	Quarterly Labour Force Survey (a)	6,310	2,274	1,045	67	348	2,545
2001	Quarterly Labour Force Survey (a)	6,236	2,033	1,057	110	324	2,711
2002	Quarterly Labour Force Survey (a)	6,467	2,204	1,084	--	279	2,899
2003	Quarterly Labour Force Survey (b)	6,946	2,412	1,117	--	374	3,043

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

(a) Excluding North & East

(b) Excludes the North, but includes the East. Average of first three quarters.

Table A12: Selected Unemployment Statistics

Year	Source	Total ('000)	Unemployment (%)	As % of Labour Force by sex		By Age Group (years) ('000)			By Education ('000)		
				Male	Female	15-24	25-55	>55	<Grade 10	O/L	A/L and above
1963	Census of Population	265	16.6	15.3	20.0	109	150	6	209	56	--
1968/69	Socio-Economic Survey	559	14.3	11.2	20.1	455	104	0	--	--	--
1971	Census of Population	839	18.7	14.3	31.1	504	324	11	715	113	11
1973	Suvey of Labour Force Participation	793	18.3	13.7	26.8	--	--	--	--	--	--
1975	Land and Labour Utilisation Survey	984	19.7	14.3	33.1	922	63	--	--	--	--
1978/79	Consumer Finance and Socio-Economic Survey	874	14.8	9.2	24.9	641	234	--	593	234	47
1981	Census of Population	895	17.9	13.3	31.0	515	368	12	743	126	26
1981/82	Consumer Finance and Socio-Economic Survey	609	11.7	7.8	21.3	464	143	1	346	200	63
1985/86	Labour Force & Socio-Economic Survey	840	14.1	10.8	20.8	495	337	8	552	210	78
1986/87	Consumer Finance and Socio-Economic Survey	967	15.5	11.3	23.6	747	216	4	562	310	95
1990	Quarterly Labour Force Survey	954	15.9	7.6	20.2	627	309	18	598	222	134
1991	Quarterly Labour Force Survey (a)	862	14.7	9.9	23.4	546	314	2	477	242	143
1992	Quarterly Labour Force Survey (a)	846	14.6	9.4	23.1	482	361	3	530	202	114
1993	Quarterly Labour Force Survey (a)	831	13.8	9.7	21.7	477	347	7	389	242	200
1994	Quarterly Labour Force Survey (a)	798	13.1	9.7	20.1	461	330	6	435	231	131
1995	Quarterly Labour Force Survey (a)	749	12.3	9.0	18.7	441	301	7	450	177	122
1996	Quarterly Labour Force Survey (a)	705	11.3	8.2	17.7	460	249	--	387	184	134
1997	Quarterly Labour Force Survey (a)	658	10.5	7.7	16.1	421	233	4	332	185	141
1998	Quarterly Labour Force Survey (a)	611	9.2	6.5	14.0	383	224	4	302	165	140
1999	Quarterly Labour Force Survey (a)	591	8.9	6.7	13.0	380	205	6	236	149	125
2000	Quarterly Labour Force Survey (a)	517	7.6	5.8	11.1	330	181	6	258	143	123
2001	Quarterly Labour Force Survey (a)	537	7.9	6.2	11.4	358	176	3	238	147	152
2002	Quarterly Labour Force Survey (a)	626	8.8	6.6	12.9	417	206	--	285	157	184
2003	Quarterly Labour Force Survey (b)	648	8.6	6.1	13.5	418	225	--	300	165	183

Source: Central Bank of Sri Lanka Annual Report (multiple issues)
(a) Excluding North & East *Provinces*

(b) Excludes the North, but includes the East. Average of first three quarters.

Table A13: Employment and Unemployment in Selected Survey Years

	Sectoral share of employment as % of total				
	Agriculture[a]	Manufacturing	Services[b]	Participation rate (%)	Unemployment rate(%)
1963	52.6	9.1	38.0	32.7	16.6
1971	50.1	9.3	40.2	35.4	18.7
1973	54.6	9.2	35.7	33.9	24.0
1978/79	52.0	12.5	34.3	38.0	14.8
1981/82	50.5	12.3	35.5	34.3	11.7
1986/87	47.7	13.4	37.0	38.1	15.5
1990	46.8	13.3	38.4	61.9	15.9
1992[c]	42.1	13.1	43.2	48.2	14.6
1994[c]	39.5	14.3	45.4	48.7	13.1
1996[c]	37.4	14.6	46.5	48.7	11.3
1998[c]	40.3	14.2	43.6	51.7	9.2
2000[c]	35.7	16.8	46.8	50.7	7.7

[a]:Agriculture includes forestry and fishing.
[b]: Services include construction.
[c]: Data exclude Northern and Eastern Provinces.
Source: CBSL (2000), except for 1973. Data for this year from CBSL(1973).

Table A14: Manufacturing Employment and Related data

	Employment (no of workers)				Real earning per worker	Labour productivity (1980-=100)	Wage share in value added (%)
	CDS QLS	CDS-MFS	SOE	BOI		RLP	E/Vad
1978		142347	63530	261	118.3	96.6	26.6
1979		160816	75150	5876	111.8	85.7	28.01
1980		161844	70371	10538	100.0	100.0	25.7
1981		151549	66355	19727	95.0	112.2	24.2
1982			71255	24926	80.9	97.3	19.4
1983		202100	70182	27805	81.1	121.3	17.9
1984		212332	64292	32725	83.6	110.4	17.6
1985	648000	210465	58446	35786	101.5	135.1	17.3
1986		217146	54332	45047	101.7	131.5	17.2
1987		212223	54049	50743	105.8	130	16.7
1988		219278	52050	54626	105.9	137.3	17.6
1989		243705	52611	61429	100.1	134.2	17.5
1990	669000	281114	45283	71358	95.0	137.8	17.6
1991	751000	315582	40066	85457	102.5	142.7	19.5
1992	650000	289155	41394	104220	100.4	160.1	19.3
1993	684000	356950	39902	122165	106.6	165.0	20.8
1994	756000	520596	36714	205660	92.3	149.6	20.5
1995	788000	514561	40436	223367	94.0	148.0	20.0
1996	807000	499052	40175	241970	88.6	151.8	19.1
1997	920000	458032	38804	285663	87.7	165.2	17.7
1998	858000	462358	37698	294381	88.4	173.6	17.8
1999	902000	469132	36154	327059	92.5	181.3	17.5
2000	1045000	500366	33947	367849	93.6	164.7	19.5
2001	1057000		33513	386034			
2002	1092000		32614	416756			

Sources and Notes
CDS QLS: Data from the quarterly labour force survey conducted by the Department of Census and Statistics (cover entire manufacturing employment)
CDS ASI: Data from the Annual Survey of Industry conducted by the Department of Census and Statistics (cover employment in firms employing more than 5 workers)
SOE: Employment in state-owned manufacturing enterprises, from Central bank Annual Report (various issues).
BOI: Employment in firms set up under section 17 of the BOI Law.

Real earning per worker, real labour productivity and wage share in value added were compiled from the CDS *Annual Survey of Industry*

Table A15: Labour Migration and Remittance, 1976-2002

	Total gross out-migration (number workers)		Remittance inflow			
	Official data	Estimates	US$ million	% of GNP	% of Current account receipts	% of net capital inflow
	(1)	(2)	(3)	(4)	(5)	(6)
1976	0.5	0.7	11	0.8	1.1	
1977	5.6	7.9	13	1.1	1.6	37.4
1978	8.1	11.3	22	1.3	2.2	13.2
1979	9.4	26.7	48	1.9	4.0	22.8
1980	7.6	28.6	137	3.7	9.2	34.3
1981	14.2	57.4	204	5.5	12.9	50.9
1982	22.4	73.1	264	7.3	16.4	50.2
1983	17.8	60	274	6.5	16.3	60.7
1984	15.7	52.6	276	5.6	13.3	80.3
1985	12.4		266	5.5	13.9	79.6
1986	16.5		285	5.3	15.2	87.8
1987	16.1		351	6.0	16.4	114.0
1988	18.4		358	5.7	15.9	137.0
1989	24.7		356	5.8	15.3	121.4
1990	42.6	94.7	401	5.6	13.7	84.8
1991	65.0	144.4	443	5.5	14.4	67.4
1992	44.7	99.3	542	6.3	14.7	101.3
1993	48.8	108.4	627	6.8	14.8	73.8
1994	60.2	133.8	707	6.8	14.7	70.0
1995	172.5		790	6.8	14.0	133.5
1996	162.6		832	6.7	14.6	225.0
1997	150.2		922	6.8	14.3	212.9
1998	159.8		999	7.1	14.8	300.0
1999	179.7		1056	7.6	15.9	300.5
2000	182.2		1160	8.1	15.4	318.7
2001	184.0		1155	8.4	15.8	329.6
2002	203.7		1287	9.0	17.7	298.2

Sources and Notes:

Column 1: Ministry of Labour, Sri Lanka Labour Gazette, various issues (for 1976-1985) and SLBFE (2003). These data provides a comprehensive coverage of total migration from 1995. It that year SLBFE introduced a compulsory registration system (backed by a comprehensive passport inspection procedure at the Colombo airport) was introduced by the Ministry of labour for migrant workers. For the years 1976-1994, the data cover only workers sent though the Department of labour and registered private employment agencies ('formal channels'). According to an airport survey of out-migration conducted by the Department of Labour during 1991-94, workers went though formal channels accounted for only 45% of total out-migration.

Column 2: Figures for 1976-1984 are from Athukorala (1990). Figures 1990-1994 are estimates by SLBFE based on an airport survey of out migration conducted during 1991-94 (see above).
Columns 3 through 6: complied from Central bank of Sri Lanka, *Annual Report* (various years).

Table A16: Employment in Manufacturing

Year	BOI industries ('000s)	Total Manufacturing Sector ('000s)
1978	0	119
1979	6	125
1980	11	132
1981	20	164
1982	25	171
1983	29	174
1984	33	176
1985	36	175
1986	45	--
1987	51	--
1988	55	--
1989	61	--
1990	71	669
1991	85	751
1992	104	650
1993	122	684
1994	135	756
1995	233	789
1996	242	838
1997	258	807
1998	294	920
1999	327	902
2000	368	1,045
2001	386	1,057
2002	417	1,084
2003	431	1,117

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

Table A17: Selected Formal Sector Wage Rates

December 1978=100

Year	Agriculture		Industry and Commerce		Services		Central Government	
	Nominal Wage Rates Index	Real Wage Rates Index	Nominal Wage Rates Index	Real Wage Rates Index	Nominal Wage Rates Index	Real Wage Rates Index	Nominal Wage Rates Index	Real Wage Rates Index
1978	94.2	--	98.8	--	--	--	100.0	--
1979	123.1	--	111.3	--	113.9	--	117.2	--
1980	153.6	--	138.8	--	130.5	--	129.1	--
1981	153.9	--	151.0	--	146.4	--	146.1	--
1982	181.2	--	161.0	--	169.7	--	187.8	--
1983	198.7	--	163.1	--	177.8	--	215.7	--
1984	250.2	--	183.3	--	190.7	--	246.6	--
1985	273.5	--	203.9	--	190.7	--	284.3	--
1986	288.1	--	224.3	--	190.7	--	297.4	--
1987	302.3	--	256.3	--	196.6	--	297.4	--
1988	378.4	--	271.7	--	229.5	--	390.0	--
1989	435.9	--	334.9	--	245.9	--	421.8	--
1990	517.2	122.7	379.5	89.9	267.8	63.5	476.8	113.2
1991	577.7	122.2	459.6	97.1	336.5	71.1	534.6	113.2
1992	664.1	126.1	510.8	97.1	365.9	69.6	557.6	106.0
1993	803.7	136.6	528.7	89.8	365.9	62.2	675.5	114.8
1994	821.5	128.8	555.8	87.2	431.4	67.6	735.5	115.4
1995	830.9	121.1	651.6	94.8	456.7	66.5	792.5	115.4
1996	907.9	113.9	682.8	85.9	487.2	61.3	818.2	103.0
1997	971.8	111.4	710.8	81.4	487.2	55.9	906.5	104.0
1998	1097.7	115.0	807.7	84.6	506.2	53.0	1001.4	104.9
1999	1116.0	111.7	829.2	83.0	559.7	56.0	1001.4	100.2
2000	1142.7	107.7	857.2	80.8	559.7	52.8	1084.7	102.1
2001	1176.4	97.1	919.7	75.9	657.6	54.3	1310.8	108.1
2002	1269.6	95.6	986.5	74.4	678.0	51.1	1525.0	115.0
2003	1382.2	98.0	1009.4	71.6	678.0	48.1	1525.0	108.1

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

Table A18: Colombo Consumers' Price Index

1952=100

	All Items	% Change	Food	Clothing	Fuel & Light	Rent	Miscellaneous
1978	227.8	--	237.5	226.2	262.1	109.8	224.8
1979	252.3	10.8	263.3	231.2	328.5	109.8	252.4
1980	318.2	26.1	339.7	239.9	563.9	109.8	293.6
1981	375.4	18.0	399.6	257.8	767.9	109.8	345.7
1982	416.1	10.8	450.4	273.8	816.4	109.8	377.1
1983	474.2	14.0	506.3	291.1	1,087.6	109.8	433.7
1984	553.1	16.6	598.0	307.5	1,282.7	109.8	496.9
1985	561.2	1.5	598.4	324.2	1,332.1	109.8	524.4
1986	606.0	8.0	641.6	374.5	1,347.6	109.8	599.7
1987	652.8	7.7	697.0	400.9	1,358.7	109.8	650.7
1988	744.1	14.0	802.0	419.8	1,535.1	109.8	742.6
1989	830.2	11.6	884.3	490.0	1,718.9	109.8	860.1
1990	1,008.6	21.5	1,090.9	610.2	1,934.2	109.8	1,021.0
1991	1,131.5	12.2	1,220.3	678.4	2,252.2	109.8	1,146.0
1992	1,260.4	11.4	1,366.0	723.6	2,334.3	109.8	1,318.7
1993	1,408.4	11.7	1,519.4	782.7	2,730.0	109.8	1,490.4
1994	1,527.4	8.4	1,654.1	795.7	3,131.6	109.8	1,578.7
1995	1,644.6	7.7	1,768.1	803.9	3,322.4	109.8	1,800.6
1996	1,906.7	15.9	2,107.6	821.8	3,591.6	109.8	1,994.7
1997	2,089.1	9.6	2,236.9	844.0	3,752.8	109.8	2,157.8
1998	2,284.9	9.4	2,592.1	852.3	3,872.8	109.8	2,319.9
1999	2,392.1	4.7	2,695.4	863.3	3,929.7	109.8	2,558.1
2000	2,539.8	6.2	2,815.8	872.9	4,660.9	109.8	2,802.4
2001	2,899.4	14.2	3,244.7	909.6	5,328.9	109.8	3,131.1
2002	3,176.4	9.6	3,589.9	950.5	5,795.8	109.8	3,327.9
2003	3,377.0	6.3	3,798.4	974.4	6,674.6	109.8	3,497.5

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

Table A19: Summary of Government Fiscal Operations

As a Percentage of GDP

	1985	1990	1995	1998	1999	2000	2001	2002	2003	2004 (Budget)
Total Revenue	22.3	21.1	20.4	17.2	17.7	16.8	16.6	16.5	15.7	16.4
Tax Revenue	18.7	19.0	17.8	14.5	15.0	14.5	14.6	14.0	13.2	14.5
Total Expenditure and Net Lending	34.0	31.0	30.5	26.3	25.2	26.7	27.5	25.5	23.7	23.1
Current Expenditure	20.1	22.3	23.1	19.6	18.7	20.2	21.6	20.9	19.0	17.6
Interest Payments	4.6	6.4	5.7	5.4	5.6	5.7	6.7	7.4	7.1	6.0
Wages and Salaries	4.2	4.9	5.2	5.3	5.3	5.5	5.5	5.6	5.2	5.2
Subsidies and Transfers	5.5	6.5	6.1	4.6	4.2	4.2	4.6	4.7	4.0	3.9
Capital Expenditure and Net Lending	14.0	8.7	7.4	6.7	6.5	6.5	5.9	4.6	4.7	5.5
Overall Balance (excluding grants)	-11.7	-9.9	-10.1	-9.2	-7.5	-9.9	-10.8	-8.9	-8.0	-6.8
Primary Balance (excluding grants)	-7.1	-3.5	-4.4	-3.8	-1.9	-4.2	-4.1	-1.5	-0.9	-0.8
Memorandum Items										
Security	--	4.1	6.5	5.0	4.4	5.6	4.9	4.1	3.5	3.5
Education and Health	--	4.5	4.5	4.0	4.0	4.1	3.3	3.9	3.8	--

Source: Central Bank of Sri Lanka Annual Report (various issues), IMF and World Bank Staff estimates.

Table A20: Economic Classification Of Government Revenues

As a Percentage of GDP

	1985	1990	1995	1998	1999	2000	2001	2002	2003	2004 (Budget)
TOTAL REVENUE	22.3	21.1	20.4	17.2	17.7	16.8	16.7	16.5	15.7	16.4
Tax Revenue	18.7	19.0	17.8	14.5	15.0	14.5	14.6	14.0	13.2	14.5
Taxes on Income & Profits	3.4	2.3	2.6	2.0	2.6	2.2	2.5	2.4	2.1	3.0
Property Taxes	0.3	1.0	0.8	0.7	0.7	0.6	0.6	0.2	..	..
Taxes on Goods & Services	8.2	9.8	10.8	9.0	9.3	9.8	9.7	9.5	..	..
Turnover Tax	6.3	6.3	5.5	1.6	0.2	0.1	0.1	0.0	0.0	0.0
GST/VAT	..	..	..	2.3	3.2	3.5	3.3	4.2	5.5	6.0
Excises	1.8	2.5	2.9	3.0	3.2	3.4	3.2	3.3	2.9	2.8
National Security Levy	..	..	2.2	2.1	2.5	2.7	3.1	1.8	0.0	0.0
Taxes on International Trade	6.8	6.0	3.6	2.8	2.5	1.9	1.9	2.0	1.9	2.1
Non-Tax Revenue	3.6	2.0	2.6	2.7	2.7	2.3	2.0	2.5	2.5	1.8
Property Income	2.6	1.3	2.0	1.8	1.8	1.5	1.2	1.6	1.4	..

Source: Central Bank of Sri Lanka Annual Report (various issues), IMF and World Bank Staff estimates.

Table A21: Sources of Government Financing

As a Percentage of GDP

Source of Financing			1985	1990	1995	1998	1999	2000	2001	2002	2003	2004 (Budget)
Foreign	Project Loans		4.4	3.8	2.1	1.9	1.0	0.9	1.3	1.8	--	--
	Non-Project Loans		0.0	-0.2	1.0	-0.9	-0.8	-0.9	-0.3	-1.7	--	--
	Grants		2.0	2.1	1.4	0.7	0.6	0.4	0.4	0.4	0.5	0.5
	Total Foreign		6.4	5.7	4.5	1.7	0.7	0.4	1.4	0.6	2.9	2.2
Domestic	Market	Bank	4.6	1.5	1.1	1.4	2.4	4.2	3.4	-0.3	-1.2	-1.3
		Non-Bank	6.5	4.0	3.9	5.2	4.5	4.9	5.3	8.3	5.7	4.5
		Total	7.9	5.6	5.1	6.6	6.9	9.2	8.7	8.0	4.5	3.2
	Non-Market		-1.2	0.1	0.1	-0.1	-0.1	0.3	0.1	-0.1	--	--
	Use of Cash Balances		-1.5	-1.5	-0.1	0.5	0.0	0.0	0.0	0.0	--	--
	Total Domestic		5.2	4.2	5.1	7.0	6.8	9.4	8.8	8.0	4.5	3.2
Privatization			0.0	0.0	0.4	0.4	0.0	0.0	0.6	0.4	0.6	0.5
Total Financing			11.6	9.9	10.1	9.2	7.5	9.9	10.8	8.9	8.0	6.8

Source: Central Bank of Sri Lanka Annual Report (various issues), IMF and World Bank Staff estimates.

Figure A1: Composition of Government Expenditure

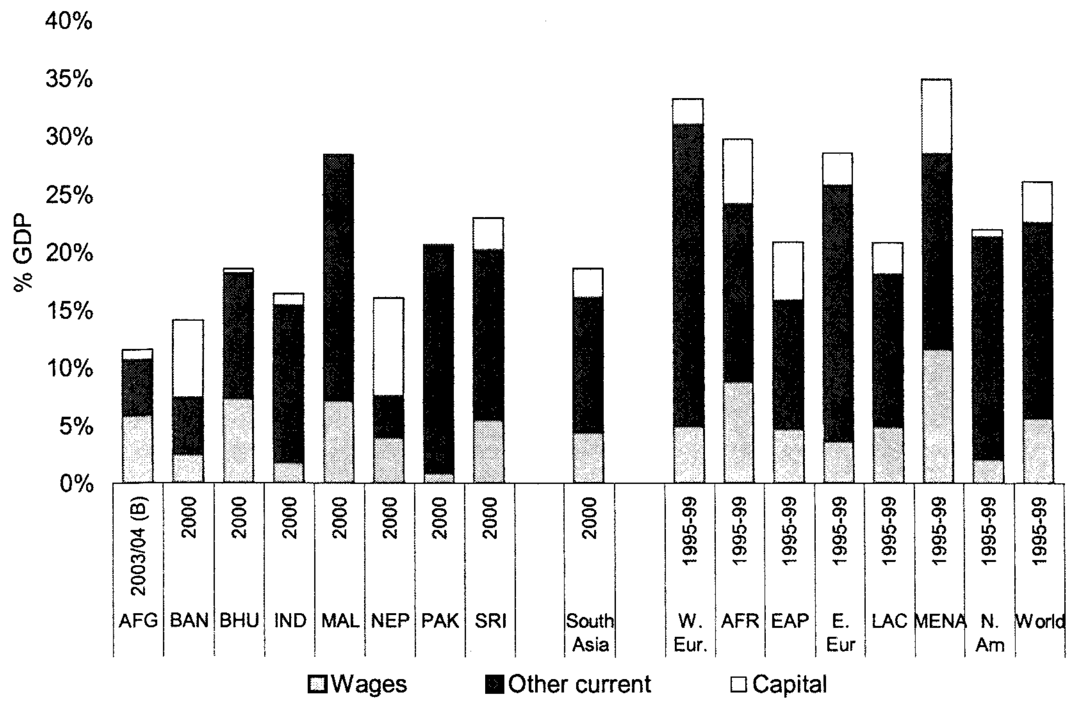


Table A22: Government Debt Indicators

	1997	1998	1999	2000	2001	2002	2003	Budget 2004
Gov't. debt/GDP	85.8	90.8	95.1	96.9	103.2	105.4	105.9	98.9
Domestic Debt/GDP	43.6	45.5	49.1	53.8	58.0	59.8	57.9	53.5
Foreign Debt/GDP	42.3	45.3	45.9	43.1	45.3	45.6	47.9	45.4
Total foreign debt/Exports	192.9	168.2	129.1	110.1	115.5	126.4	133.7	129.8
Total debt service/GDP	9.4	11.3	9.4	14.0	12.7	17.9	19.6	15.6
Total debt service/Gov't. revenue	50.7	65.6	53.0	83.2	76.4	108.6	124.6	95.5
o/w Domestic debt service/Gov't. revenue	38.6	51.0	37.6	67.9	60.4	90.4	108.0	81.3
Total debt service/Gov't. expenditure	30.7	33.7	31.3	38.7	38.0	49.8	54.1	47.6
o/w Domestic debt service/Gov't. expenditure	23.4	26.2	22.2	31.6	30.0	41.5	46.9	40.5
Foreign debt service/Exports	10.2	9.4	7.7	6.6	6.8	8.3	7.3	6.7
Domestic interest/GDP	5.5	4.7	4.8	4.9	6.0	6.7	6.4	5.2
Domestic interest/Gov't. current expenditure	27.0	23.8	25.7	24.5	27.9	32.0	33.9	29.5
Foreign interest/Exports	3.4	2.7	2.2	1.8	1.8	1.9	1.8	2.2

Source: Central Bank of Sri Lanka Annual Report (various years).

Table A23: Nominal and Real Exchange Rates

Year	Rp./US$ Exchange Rate e.o.p.	Rp./US$ Exchange Rate (average)	REER (1990=100) + = Depreciation
1978	15.51	15.61	90.38
1979	15.45	15.57	92.21
1980	18.00	16.53	86.03
1981	20.55	19.25	89.43
1982	21.32	20.81	89.99
1983	25.00	23.53	85.85
1984	26.28	25.44	77.25
1985	27.41	27.16	90.20
1986	28.52	28.02	97.06
1987	30.76	29.45	98.73
1988	33.03	31.81	97.16
1989	40.00	36.05	102.25
1990	40.24	40.06	100.00
1991	42.58	41.37	95.80
1992	46.00	43.83	95.01
1993	49.56	48.32	95.78
1994	49.98	49.42	94.41
1995	54.05	51.25	95.08
1996	56.71	55.27	87.38
1997	61.29	58.99	85.45
1998	67.78	64.59	85.78
1999	72.12	70.39	93.56
2000	80.06	75.78	100.01
2001	93.16	89.36	102.73
2002	96.73	95.66	99.94
2003	96.74	96.52	--

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

Table A24: Structure of Merchandise Exports

US Dollars Million

Year	Industrial Exports					Agricultural Exports				Gems	Other	Total Exports
	Total Industrial	Of Which				Tea	Rubber	Coconut Products	Minor Agricultural Products			
		Textiles and Garments	Petroleum Products	Rubber Products	Diamonds							
1985	526	293	143	...	...	442	94	114	50	21	74	1,333
1990	1,036	628	99	30	92	495	77	69	80	73	140	1,984
1991	1,226	804	79	30	68	432	64	63	82	57	110	2,039
1992	1,763	1,214	63	60	107	340	68	84	113	57	30	2,461
1993	2,102	1,412	79	71	142	413	64	58	121	71	30	2,864
1994	2,399	1,552	80	102	146	424	72	76	129	79	21	3,209
1995	2,889	1,853	85	153	163	481	111	103	134	78	21	3,807
1996	3,006	1,902	104	169	157	616	104	110	132	86	41	4,103
1997	3,436	2,274	97	178	125	719	79	118	145	83	59	4,648
1998	3,607	2,460	73	178	121	780	44	94	170	56	47	4,735
1999	3,551	2,425	74	161	161	621	33	129	165	61	51	4,610
2000	4,283	2,982	98	196	179	700	29	121	155	93	141	5,522
2001	3,710	2,543	68	172	166	690	24	82	136	82	93	4,817
2002	3,631	2,424	73	182	192	660	27	84	168	86	41	4,699
2003	3,977	2,575	65	231	216	683	39	93	150	79	108	5,133

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

A25: Structure of Imports

US Dollars Million

Year	Consumer Goods						Intermediate Goods					Investment Goods				Other	Total Imports
	Food and drink	Rice	Sugar	Wheat (i)	Other	Other Consumer goods	Petroleum	Fertiliser	Chemicals	Textiles and clothing	Other Intermediate Goods	Machinery & Equipment	Transport Equipment	Building Materials	Other Investment Goods		
1985	217	40	73	109	-	.....	404	58	33	.....	.....	176	92	33	.....	142	1,990
1990	390	44	129	129	182	319	359	74	119	336	410	247	113	159	66	3	2,689
1991	405	38	124	80	242	377	312	59	88	498	517	287	184	165	84	6	3,061
1992	420	65	113	104	242	315	318	54	94	766	549	390	180	181	100	34	3,503
1993	416	49	116	128	238	359	309	64	109	865	691	464	311	194	78	36	4,011
1994	484	13	180	118	291	447	296	63	121	1,038	789	559	454	241	113	45	4,767
1995	720	2	170	198	349	461	387	86	143	1,159	928	503	304	272	110	240	5,311
1996	801	91	145	204	361	433	479	76	134	1,168	910	649	179	263	113	234	5,439
1997	781	73	184	139	385	442	539	66	136	1,386	969	742	208	272	103	220	5,864
1998	723	42	129	127	425	532	345	62	143	1,397	1,033	786	264	303	124	176	5,890
1999	661	46	106	111	398	581	500	66	136	1,320	1,035	678	523	260	105	115	5,980
2000	693	4	141	127	421	696	901	80	147	1,471	1,190	787	529	305	116	406	7,320
2001	654	11	115	110	419	581	731	67	142	1,320	1,061	610	129	249	93	337	5,974
2002	696	18	132	130	415	623	789	76	155	1,321	1,151	640	151	272	108	125	6,105
2003	701	8	116	137	440	779	838	88	170	1,372	1,344	698	206	328	88	60	6,672

Source: Central Bank of Sri Lanka Annual Report (multiple issues)

(I) Includes wheat & flour from 1985-1994

Table A26: The Expansion of Tax Concessions 1978 – 2002

Year	Tax Withdrawals/ New Concessions	Tax GDP Ratio (%)
1978	Provision of long term tax holidays (10-20 years with provision for extension) for foreign investments and setting up of industries in tax free export processing zones.	24.2
1979	Exemption of public sector employees from income tax and reduction in export taxes.	19.7
1986-7	Abolition of Estate Duty and Gift Tax. Implementation of the recommendations of the second Presidential Tariff Commission of 1985.	17.4 - 17.8
1989-91	Expansion of BOI incentives and separate Customs arrangements to BOI industries to promote the apparel industry in backward areas.	18.9 – 18.3
1992	Abolition of Wealth Tax and Exports Duty on tea, rubber and coconut. Commencement of the phased reduction of Stamp Duty on Letters of Credit, Turnover Tax on banking and financial instruments and government debt instruments.	18.0
1993-4	Implementation of the recommendations of the third Presidential Tariff Commission of 1992. The tariff structure which had rates ranging from 10 – 500 % and more than 19 tariff bands was reduced to 13 bands in 1990 and 4 bands in 1991.	17.2
1995	Increase of the tax free threshold for income taxation and the introduction of a three band tariff structure with 10, 20 and 30 % rate bands.	17.8
1996	Exemption of share market transactions and unit trust transactions from Turnover Tax, exemption of machinery and equipment for gem and jewellery from income tax, provision of 10 – 20 year tax holidays for large scale projects and exemption of project specific imports from other taxes, 5 year tax holiday for investment in advance technology and increasing the tax free threshold to Rs. 100,000/-	17.0
1997	Investment tax allowance to set off 75 percent of investments against 50 percent of assessable income, duty free imports of machinery and equipment for existing companies, increase of the tax threshold to Rs. 144,000/- and tax slabs.	16.0
1998	Duty free status to the textile and apparel Industry. Exemption of gold, gem and jewellery industry from Income Tax. Tax incentives for thrust industries and software, reduction in the Income Tax rate to 15 % for agriculture, fisheries and livestock.	14.5
1999	Tax holidays for large scale housing projects, duty free concessions for importation of buses and permission to deduct capital expenditure on transportation from income tax, reduction of income tax to 15%, duty free imports of machinery and equipment for the construction industry and the removal of stamp duty on debt instruments.	15.0
2001	Removal of stamp duties and Turnover Tax on banking transactions.	14.5
2002	One year depreciation for investments in information technology and reduced rate of taxation for housing banks.	14.0

Source: Compiled from Budget Speeches (Various Issues)

Table A27: Nominal and Effective Protection to Import-Competing Manufacturing

ISIC No	Industry	1981	1991		1994		2002	
		ERP	NRP	ERP	NRP	ERP	NRP	ERP
31	Food, beverages and tobacco	72	50	61	47	68	21	36
32	Textiles, wearing apparel and leather products	78	45	58	46	84	25	54
33	Wood, wood products and furniture	79	43	96	37	52	25	57
34	Paper, paper products and printing		50	93	46	106	22	53
35	Chemicals, rubber and plastic products	56	38	118	42	69	25	125
36	Non-metallic mineral products		32	91	35	59	18	41
37	Basic metal products	28	40	273	41	104	22	85
38	Fabricated metal products, machinery and transport equipment	107	48	132	45	95	25	86
39	Other manufacturing		55	122	50	115	20	25
3	Total manufacturing	90	45.3	77.2	43	70	23	56

Notes:

--- Not available.

NRP Nominal protection rate – the difference between domestic price and border equivalent (world) price as a percentage of the latter.

EPR Effective protection rate - the percentage increase in value added under the existing trade policy intervention over value added at boarder price.

Source: Ministry of Finance (1994), (Table 5.4) (data for 1981 and 1994) and estimates provided by the Tariff Advisory Committee.

Table A28: Value, Volume and Unit value of Garments Exports from Bangladesh, China, Indonesia, Sri Lanka and Thailand, 1985-2001[1]

	Bangladesh			China			Indonesia			Sri Lanka			Thailand		
	Value	Volume	Unit value	Value	Volume	Unit value	Value	Volume	Unit value	Value	Volume	Unit value	Value	Volume	Unit value
1985	16	---	---	---	---	---	17	30	58	47	71	66	34	64	54
1986	19	42	46	---	---	---	27	42	64	55	93	59	44	73	60
1987	46	69	66	57	126	45	34	44	78	72	103	70	67	89	76
1988	66	65	102	68	149	46	44	51	87	73	95	77	78	93	84
1989	67	77	86	83	97	86	70	88	79	84	97	86	89	96	92
1990	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
1991	119	109	109	129	87	148	138	123	112	121	110	110	124	106	116
1992	146	135	108	174	276	63	190	157	121	177	147	120	117	113	103
1993	194	194	100	190	316	60	207	187	111	201	180	112	121	111	110
1994	205	218	94	248	387	64	185	168	110	219	204	107	119	124	96
1995	269	275	98	239	386	62	182	174	105	214	195	110	108	140	77
1996	294	318	92	248	398	62	200	188	106	221	188	118	83	140	59
1997	408	584	70	304	449	68	164	182	90	250	201	125	82	142	58
1998	603	569	96	294	490	60	142	155	92	291	227	128	88	124	71
1999	---	---	0	308	524	59	205	264	78	325	249	130	89	120	75
2000	---	---	0	370	652	57	263	289	91	359	271	133	96	118	82
2001	682	717	95	378	754	50	246	300	82	337	271	124	103	106	96
Growth[4] (%)	24.0[2]	21.2[2]	0.2[2]	13.5[3]	15.1[3]	-1.5[3]	11.3	11.6	0.2	12.2	8.3	3.8	0.6	2.2	-1.6
(t ratio)	(2.9)*	(20.9)**	(0.1)	(13.6)**	(8.1)**	(0.8)	(5.2)**	(8.1)**	(0.3)	(14.2)**	(12.0)**	(6.6)**	(0.5)	(3.2)*	(-1.3)

Notes

(1) The data reported in the Table cover exports of garments belonging to three SITC 3-digit categories (Men's and Boy's outwear, textile fabrics not knitted or crocheted (SITC 842), Women, girls, infants outwear, not knitted or crocheted (843), and Outwear knitted or crocheted (845)).

(2) For the period 1986-99.

(3) For the period 1987-2001.

(4) Growth rate estimated by fitting a logarithmic trend line. T-ratios are given in bracket, with the statistical significance denoted as: * 5-percent, ** one-percent.

--- Data not available.

Source: Compiled for data extracted from UN COMTRADE database

Figure A2: Number of Ministries by Country

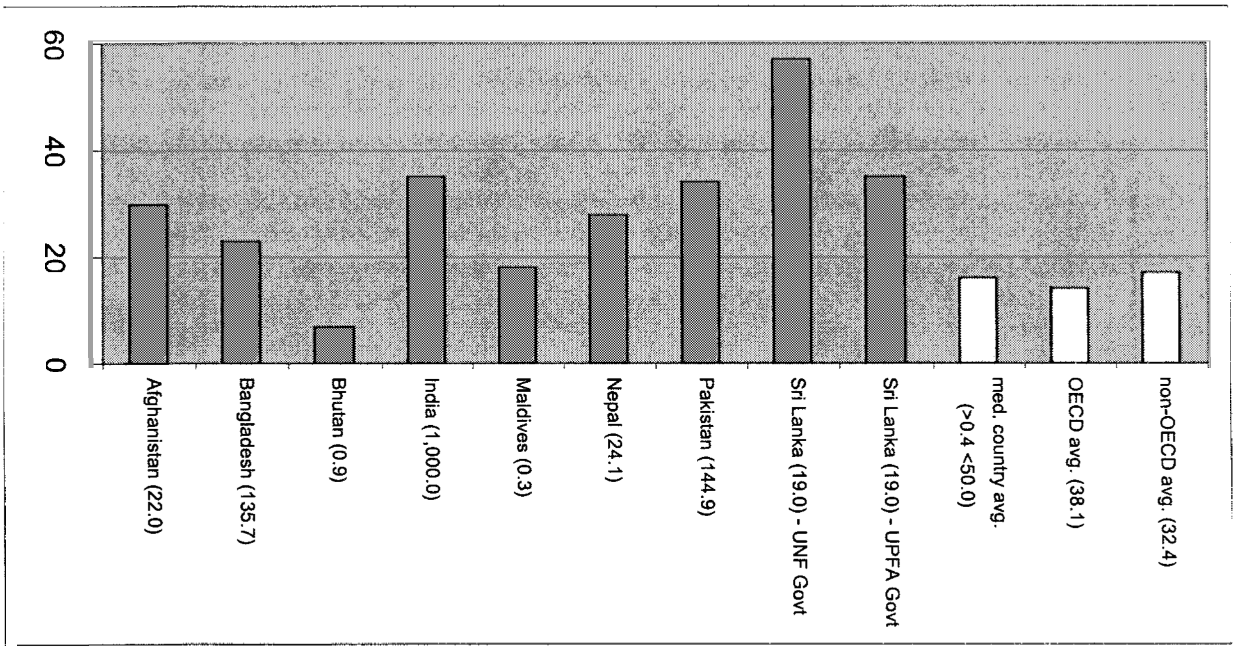


Table A29: Growth in Public Sector Employment, 1990-2001

Sector	1990	2001	Increase	%	Annual Growth
Public Service	198,425	303,331	104,906	52.9%	3.93%
Provincial Public Service	222,584	286,461	63,877	28.7%	2.32%
Treasury Funded Statutory Boards & Corporations	60,000	118,000	58,000	96.7%	6.34%

Table A30: Military Spending In South Asia

	India	Pakistan	Bangladesh	Nepal	**Sri Lanka**
Defense expenditure 1998 (US$m 1993)	10,600	2,810	450	40	**730**
Defense expenditure 1985-1998 annual % increase	3.0	2.3	3.0	4.7	**9.9**
Defense expenditure 1998 as % of GNP	2.5	4.6	1.0	0.8	**4.8**
Defense expenditure per capita 1998 (US$)	10.8	21.5	3.6	1.7	**39.2**
Armed forces personnel % increase (1985-1998)	-7.2	17.5	24.8	45.7	**80.5**
Number of solders per 1,000 1998	1.18	4.5	0.98	2	**6.1**
Military holding index 1998* (1985=100)	142	144	198	160	**926**

Source: Mahbub ul Haq, Human Development in South Asia 2001 also quoted in Sarvanathan 2003.

Table A31: Housing Conditions and Amenities

Category	1981/82	1986/87	1996/97	2003/04[1]
Brick or cement block walls	26.2	35.1	62.5	75.3
Cement, tiled or better flooring	52.6	58.8	74.1	81.5
Tiled or asbestos roofing	46.5	54.7	73.2	78.8
Own well or pipeborne water inside home	38.7	32.6	46.9	62.2
Water seal latrine	31.9	43.7	70.1	78.4
Without latrine	29.9	16.9	6.5	5.4
Electricity	15.8	26.5	56.8	73.9
LP gas for cooking	1.1	2.6	10.8	14.5
Firewood for cooking	n/a	95.1	86.6	83.1
Radio	60.7	67.2	73.6	77.2
TV	3.8	19.6	50.6	68.2
Sewing machine	30.7	37.2	41.5	44.9
Refrigerator	2.9	8.1	16.8	28.7
Telephone (land or cellular)	0.9	1.4	4.5	23.9
Motorised transport[2]	4.4	8.5	15.4	25.4

Source: Central Bank Annual Report 2003

[1] Preliminary findings from Round 1 October to December 2003.

[2] Scooters, motorcycles, three wheelers or cars.

Table A32: Education

Year	General Education: Govt. Schools (No.)	General Education: Students (a) (No.)	General Education: Teachers (a) (No.)	University Education: Students (No.)	University Education: Lecturers (No.)	University Education: Graduated (No.)	University Education: New Enrolments (No.)	Literacy Rate (b) (%)	Education Expenditure / GDP Ratio
1950	3,188	1,349,345	38,066	2,036	157	302	n.a.	–	2.50
1951	3,266	1,410,514	40,020	2,210	183	304	n.a.	–	2.36
1952	3,379	1,476,146	44,553	2,232	183	320	n.a.	–	2.91
1953	3,449	1,548,197	47,428	2,392	193	312	514	65.4	2.90
1954	3,561	1,553,881	49,283	2,434	201	354	507	–	2.71
1955	3,675	1,637,008	48,342	2,491	200	475	658	–	2.87
1956	3,735	1,690,679	50,186	2,534	231	487	658	–	3.50
1957	3,921	1,833,074	55,410	2,718	227	549	750	–	3.41
1958	4,035	1,896,139	58,548	2,950	228	531	763	–	3.59
1959	4,152	2,098,941	66,113	3,181	264	533	896	–	3.94
1960	4,394	2,192,879	69,658	3,684	269	598	890	–	4.40
1961	4,572	2,313,852	70,499	4,655	237	633	925	–	4.33
1962	4,592	2,268,064	76,253	5,117	350	742	947	–	4.43
1963	4,936	2,482,613	81,109	5,706	485	973	n.a.	71.6	4.43
1964	5,508	2,540,913	93,789	12,485	545	2,184	n.a.	–	4.59
1965	5,660	2,556,191	91,881	14,139	563	2,143	1,865	–	4.44
1966	8,409	2,563,691	88,664	15,046	548	3,494	3,990	–	4.20
1967	8,433	2,568,502	87,471	14,512	585	3,281	n.a.	–	4.06
1968	9,773	2,639,637	92,982	13,005	650	4,614	n.a.	–	4.01
1969	9,845	2,668,392	95,273	12,535	890	4,317	3,457	–	3.49
1970	9,928	2,716,187	96,426	11,913	1,163	3,735	n.a.	–	3.53
1971	8,585	2,628,070	94,858	12,299	1,109	3,489	n.a.	78.5	4.15
1972	8,551	2,625,241	96,466	11,963	1,297	3,941	3,336	–	5.16
1973	8,571	2,669,700	102,649	11,526	1,398	4,087	3,420	–	3.60
1974	8,573	2,611,925	102,656	12,064	1,490	3,325	3,653	–	2.89
1975	8,822	2,560,479	104,048	12,843	1,261	3,146	3,482	–	2.66
1976	8,855	2,571,984	110,585	12,178	1,324	3,279	3,854	–	3.02
1977	8,673	2,566,391	117,735	14,347	1,596	2,965	4,366	–	2.68
1978	9,072	3,089,725	129,971	16,253	1,690	3,850	4,717	–	2.67
1979	9,052	3,208,191	142,207	16,401	1,604	3,372	4,286	–	2.65
1980	9,117	3,389,775	141,185	17,308	1,539	3,252	4,588	–	2.77
1981	9,521	3,451,358	135,869	17,656	1,609	3,197	4,806	87.2	2.38
1982	9,544	3,484,661	133,802	18,103	1,667	3,678	5,119	–	2.50
1983	9,575	3,553,027	134,299	18,009	1,767	3,562	5,463	–	2.33
1984	9,556	3,625,897	140,190	18,496	1,758	4,393	5,630	–	2.02
1985	9,634	3,738,633	147,518	18,217	1,828	4,481	5,707	–	2.74
1986	9,657	3,864,187	149,039	18,913	1,908	4,179	6,044	–	2.80
1987	9,709	3,974,605	146,712	19,966	1,849	845	6,201	–	2.47
1988	9,771	4,058,843	147,578	24,668	1,825	589	6,149	–	2.88
1989	9,805	4,179,520	153,243	24,640	1,811	1,277	6,483	–	3.23
1990	9,864	4,232,356	184,822	29,471	2,040	4,476	6,143	–	2.97
1991	9,998	4,258,698	177,291	28,260	2,090	5,406	6,463	86.9	2.45
1992	10,042	4,285,295	182,756	31,447	2,285	4,564	8,970	–	2.95
1993	10,160	4,303,493	193,924	30,637	2,384	5,056	8,900	–	2.82
1994	10,191	4,327,959	195,182	30,784	2,525	5,472	7,849	90.1	3.06
1995	10,239	4,351,022	195,210	32,084	2,808	5,309	8,015	–	2.83
1996	10,312	4,265,076	193,720	32,800	2,027	5,216	8,669	–	2.65
1997	10,358	4,260,999	187,939	36,578	3,050	6,737	9,787	91.8	2.50
1998	10,313	4,278,290	196,305	38,584	3,200	6,758	11,315	–	2.62
1999	10,058	4,277,104	196,728	41,584	3,228	8,787	11,896	–	2.65
2000	9,978(c)	4,340,412	194,773	48,296	3,241	9,374	11,805	91.6	2.46
2001	9,891(c)	4,337,259	198,297	48,212	3,268	8,895	11,962	–	2.01
2002	9,829(c)	4,179,217	196,407	48,666	3,390	9,027	12,144	–	2.35
2003(e)	9,790(c)	4,097,335	194,920	59,724	3,543	n.a.	25,147(d)	–	2.22

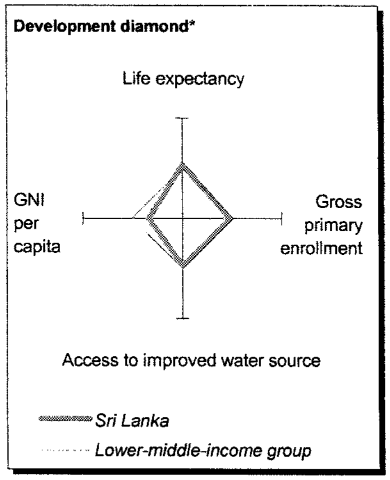
(a) Including Government and Private educational institutions.
(b) Data available only in census years and some survey years.
(c) Excluding non-functioning schools.
(d) Qualified students from GCE (A/L) exam in August 2001 and April 2002 (13,040) were admitted to Universities.
(e) Provisional.

Sources : Department of Census and Statistics
Central Bank of Sri Lanka
Ministry of Human Resources Development, Educational and Cultural Affairs
University Grants Commission

Sri Lanka at a glance

6/28/04

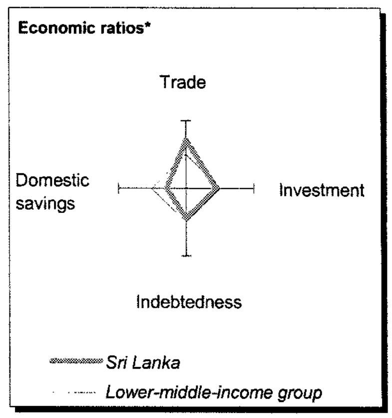
POVERTY and SOCIAL	Sri Lanka	South Asia	Lower-middle-income
2003			
Population, mid-year *(millions)*	19.3	1,401	2,408
GNI per capita *(Atlas method, US$)*	930	460	1,400
GNI *(Atlas method, US$ billions)*	17.9	638	3,372
Average annual growth, 1997-03			
Population *(%)*	1.4	1.8	0.9
Labor force *(%)*	2.1	2.3	1.2
Most recent estimate (latest year available, 1997-03)			
Poverty *(% of population below national poverty line)*	23	..	..
Urban population *(% of total population)*	24	28	49
Life expectancy at birth *(years)*	74	63	69
Infant mortality *(per 1,000 live births)*	17	68	32
Child malnutrition *(% of children under 5)*	33	48	9
Access to an improved water source *(% of population)*	77	84	81
Illiteracy *(% of population age 15+)*	8	44	13
Gross primary enrollment *(% of school-age population)*	106	95	112
Male	107	103	113
Female	104	88	111



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

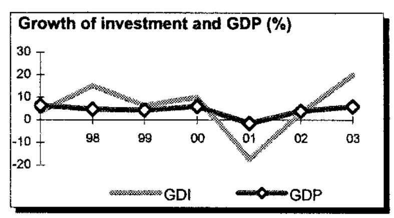
	1983	1993	2002	2003
GDP *(US$ billions)*	5.2	10.4	16.5	18.5
Gross domestic investment/GDP	28.9	25.6	21.3	22.3
Exports of goods and services/GDP	26.3	33.8	36.1	35.8
Gross domestic savings/GDP	13.8	16.0	14.6	15.7
Gross national savings/GDP	19.7	20.7	19.9	21.5
Current account balance/GDP	-9.1	-4.8	-1.4	-0.5
Interest payments/GDP	1.8	1.3	1.3	1.2
Total debt/GDP	55.8	66.7	58.1	56.2
Total debt service/exports	..	9.6	9.8	11.4
Present value of debt/GDP	..	..	..	..
Present value of debt/exports	..	..	.	..

	1983-93	1993-03	2002	2003	2003-07
(average annual growth)					
GDP	4.0	4.3	4.0	5.9	6.1
GDP per capita	2.9	2.9	2.5	4.6	5.1
Exports of goods and services	6.8	5.7	6.3	4.8	7.8

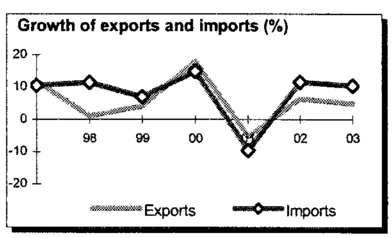


STRUCTURE of the ECONOMY

	1983	1993	2002	2003
(% of GDP)				
Agriculture	28.3	24.6	20.5	19.0
Industry	26.3	25.6	26.3	26.3
Manufacturing	14.0	15.2	15.8	15.5
Services	45.4	49.7	53.2	54.7
Private consumption	78.1	74.8	76.7	76.3
General government consumption	8.1	9.2	8.8	7.9
Imports of goods and services	41.4	43.3	42.9	42.4



	1983-93	1993-03	2002	2003
(average annual growth)				
Agriculture	1.6	1.3	2.5	1.5
Industry	5.5	5.0	1.0	5.5
Manufacturing	7.1	5.5	2.1	4.4
Services	4.8	5.1	6.1	7.7
Private consumption	2.9	4.7	7.7	5.3
General government consumption	12.4	8.0	-0.3	11.4
Gross domestic investment	0.4	4.4	3.1	20.0
Imports of goods and services	3.3	6.9	11.6	10.4



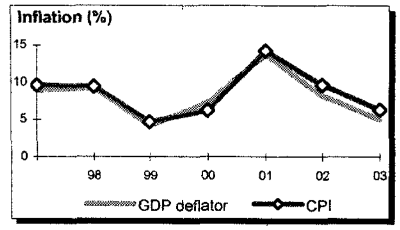
Note: 2003 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

Sri Lanka

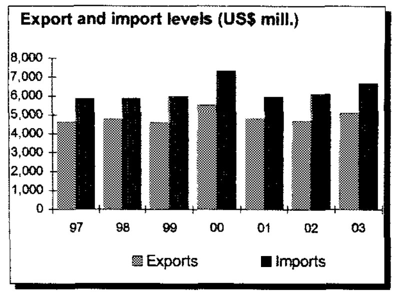
PRICES and GOVERNMENT FINANCE

	1983	1993	2002	2003
Domestic prices				
(% change)				
Consumer prices	..	11.7	9.6	6.3
Implicit GDP deflator	16.9	9.9	8.2	5.0
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	21.3	17.0	16.2
Current budget balance	..	0.8	-3.9	-2.9
Overall surplus/deficit	-10.6	-7.1	-8.5	-7.6



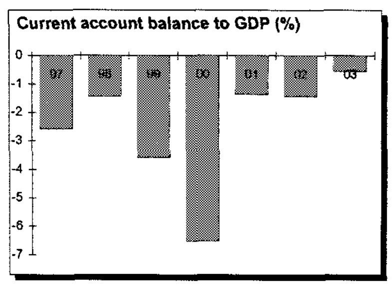
TRADE

	1983	1993	2002	2003
(US$ millions)				
Total exports (fob)	..	2,864	4,699	5,133
Tea	..	413	660	683
Other agricultural goods	..	272	319	390
Manufactures	..	1,412	2,424	2,575
Total imports (cif)	..	4,011	6,105	6,672
Food	..	532	696	701
Fuel and energy	..	309	789	838
Capital goods	..	1,047	1,170	1,320
Export price index *(1995=100)*	..	83	173	184
Import price index *(1995=100)*	..	82	161	159
Terms of trade *(1995=100)*	..	102	107	115



BALANCE of PAYMENTS

	1983	1993	2002	2003
(US$ millions)				
Exports of goods and services	..	3,492	5,967	6,541
Imports of goods and services	2,133	4,475	7,080	7,969
Resource balance	..	-983	-1,113	-1,143
Net income	-137	-124	-253	-192
Net current transfers	445	612	1,128	1,234
Current account balance	-473	-495	-238	-101
Financing items (net)	466	1,156	576	603
Changes in net reserves	7	-661	-338	-502
Memo:				
Reserves including gold *(US$ millions)*	..	1,675	1,700	2,329
Conversion rate *(DEC, local/US$)*	23.5	48.3	95.7	95.0



EXTERNAL DEBT and RESOURCE FLOWS

	1983	1993	2002	2003
(US$ millions)				
Total debt outstanding and disbursed	2,884	6,902	9,611	10,412
IBRD	44	58	4	2
IDA	237	1,222	1,734	1,948
Total debt service	265	409	716	927
IBRD	5	15	5	2
IDA	3	15	44	47
Composition of net resource flows				
Official grants	184	197	0	..
Official creditors	241	266	179	806
Private creditors	58	-39	-36	-123
Foreign direct investment	38	195	0	..
Portfolio equity	0	0	0	..
World Bank program				
Commitments	57	86	75	200
Disbursements	75	130	91	247
Principal repayments	4	15	36	35
Net flows	72	115	55	212
Interest payments	4	15	13	14
Net transfers	67	100	42	198