

Sri Lanka

POVERTY ASSESSMENT

Accelerating Economic Transformation

Synthesis Report



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Background papers

“Informality, Job Quality, and Welfare in Sri Lanka” (2020).

“Agricultural Productivity, Diversification, and Gender” (2021).

“The Impact of COVID-19 on Livelihoods and Poverty in Sri Lanka” (2021).

“Sri Lanka Poverty Update” (2021).

“The Rural Nonfarm Sector and Livelihood Strategies in Sri Lanka” (2021).

Abbreviations

GDP	gross domestic product
HCI	Human Capital Index
HIES	Household Income and Expenditure Survey
PPP	purchasing power parity
SID	Simpson Index of Diversification

Executive Summary

Sri Lanka has an impressive track record of reducing poverty and sharing prosperity more broadly.

Between 2012/13 and 2016 alone, the \$3.20 poverty rate fell from 16.2 percent to 11 percent, continuing progress from the previous decade. There was broad-based progress in welfare, with increased access to basic services such as electricity, improved housing conditions, greater asset ownership and decreased indebtedness, particularly among poor households. However, while growth was inclusive with the average per capita consumption growth rate accelerating across the distribution, it was less pro-poor, as the growth rate of the bottom 40 of the consumption distribution remained below that of the total population.

A dynamic decade that spurred post-war growth and continued with a process of economic transformation led to a productivity boost and labor reallocation from agriculture to industry and services.

Sri Lanka witnessed a period of impressive dynamism in the last decade. Post-war infrastructure investments significantly improved access, particularly between Colombo and the south. Tourism thrived with the number of visitors quadrupling between 2009 and 2017. Sri Lanka's leading export industries, tea and garments, continued to perform well, while the coconut subsector benefited from a rise in global demand for coconut products. The "sharing economy" was introduced and popularized. These underlying currents likely helped workers become more productive and improve their earnings. The services sector experienced a particularly strong boost in productivity. However, growth in output per worker came primarily from within-sector productivity gains and much less from reallocation effects. This implies that a large share of the labor that moved out of agriculture moved into industry and services sectors of low productivity. Moreover, within-sector productivity improvements have slowed down in recent years.

The COVID-19 pandemic is expected to have resulted in a significant reversal of welfare gains.

The growth momentum had already started to fade when the COVID-19 pandemic hit Sri Lanka and the world in early 2020. The country had just emerged from the aftermath of the Easter Sunday attacks in 2019 which curtailed tourist arrivals. Following a strict nationwide lockdown between mid-March and mid-April 2020, restrictions were gradually eased; but economic activities of firms and households continued to be hampered, leading to widespread earnings losses. Sri Lanka's GDP contracted by 3.6 percent in 2020. At the same time, poverty at \$3.20 per day is expected to have increased to 11.7 percent in 2020,

up from 9.2 percent in 2019. Government mitigation efforts helped absorb the labor market impact but were likely not sufficient. With vaccines expected to be rolled out, growth is likely to slowly return in 2021 and poverty could gradually fall again.

Before COVID-19, poverty reduction was mainly driven by increased labor earnings from nonfarm sectors. New jobs were created in these sectors but there are concerns about their quality.

Gains in nonfarm earnings were the most important factor behind recent poverty reduction. Jobs were created in construction, trade, manufacturing, and transport—sectors that tend to employ less-skilled workers. While most jobs of the new jobs are salaried, there is concern about the quality of these jobs, since many are informal, with precarious contractual arrangements, few benefits, and low remuneration. Informal jobs stand in stark contrast to public sector jobs that come with significantly better earnings and superior benefits. Outside of the public sector, formal jobs tend to be concentrated in the export sectors of tea and garments, where there have been concerns about low productivity.

The impact of Sri Lanka's demographic transition on growth and poverty reduction is already tangible. Sri Lanka has reached the advanced stage of demographic transition relatively early and the population is aging. Its demographic window of opportunity opened in 1995 and is expected to close in 2025, sooner than for its regional peers. Demographic changes had a negative contribution to growth and a smaller contribution to poverty reduction compared to regional peers. Increasing labor force participation, especially among females, and enhancing the productive capacity among workers could help counter these demographic trends.

Progress in improving agricultural earnings was slow; and the performance of social protection continued to be weak—these trends held back further progress in economic transformation and poverty reduction.

A number of factors led to the slow progress in agriculture, among them a reversal of favorable export price trends, falling output levels (particularly in 2016 when an extreme drought occurred), low growth in minimum wages, and a stagnating paddy sector, which engages many poor farmers and continues to exhibit low productivity.

Weak targeting and delivery systems in the prevailing social protection scheme undermine the scheme's ability to protect the poor against shocks and help them become more productive. The Samurdhi program's expansion in 2015 led to large increases in benefit levels but had little impact on coverage. Less than half of the poor were beneficiaries of Samurdhi, and benefit amounts remain largely inadequate. Limited coverage and small benefits reduce the program's ability to effectively reduce poverty and build resilience among the poor. Nevertheless, there have been recent efforts to build better delivery and

targeting systems and refine graduation programs. Productive inclusion programs could help the poorest households graduate from social assistance and develop sustainable sources of earnings.

The main message of this poverty assessment is that to sustain further progress on poverty reduction and shared prosperity, Sri Lanka needs to accelerate its economic transformation to create better jobs for more people. The priorities for economic transformation are structured around the following four themes: (i) increasing agricultural productivity through diversification; (ii) addressing the constraints to accessing remunerative nonfarm jobs; (iii) raising the quality of jobs, especially in the informal sector; and (iv) facilitating spatial transformation and strengthening inclusion.

The main conclusions and policy recommendations under each priority area are summarized below.

Increasing agricultural productivity through diversification

- Diversification is likely to benefit poorer farmers, many of whom are engaged in low-productivity paddy farming. Increasing the productivity of paddy and shifting toward a higher-value, export-oriented crop mix would help increase productivity and earnings.
- Agricultural interventions would further benefit from a mix of programs besides the provision of fertilizer subsidies; these programs could incentivize farmers to adopt climate-smart technologies, invest in better agro-logistics, or access value chains.
- Promoting equitable access to farming resources for female farmers can help close the income gap. This includes facilitating access to land as well as other agricultural inputs.

Addressing the constraints to accessing remunerative nonfarm jobs

- Education emerged as an overall important determinant of participation in nonfarm activities. That is, greater educational attainment appears to drive households' livelihoods choices toward more remunerative opportunities (including public sector employment), while lower education results in greater reliance on farm and elementary nonfarm activities. Education does not affect the probability of engaging in farm versus unskilled nonfarm activities, likely reflecting the skills barrier to high-paying nonfarm employment. This is relevant because diversification into low-return activities will likely not help increase incomes.
- Tourism has abundant potential to support income growth in rural areas as it has job-creation potential for the less skilled and requires relatively little investment. Tourism has a long and diversified supply chain, as it includes many different inputs and output activities, such as small-scale agriculture, handicrafts, and transport and other services, all of which can contribute to poverty reduction.

Raising the quality of jobs, especially in the informal sector

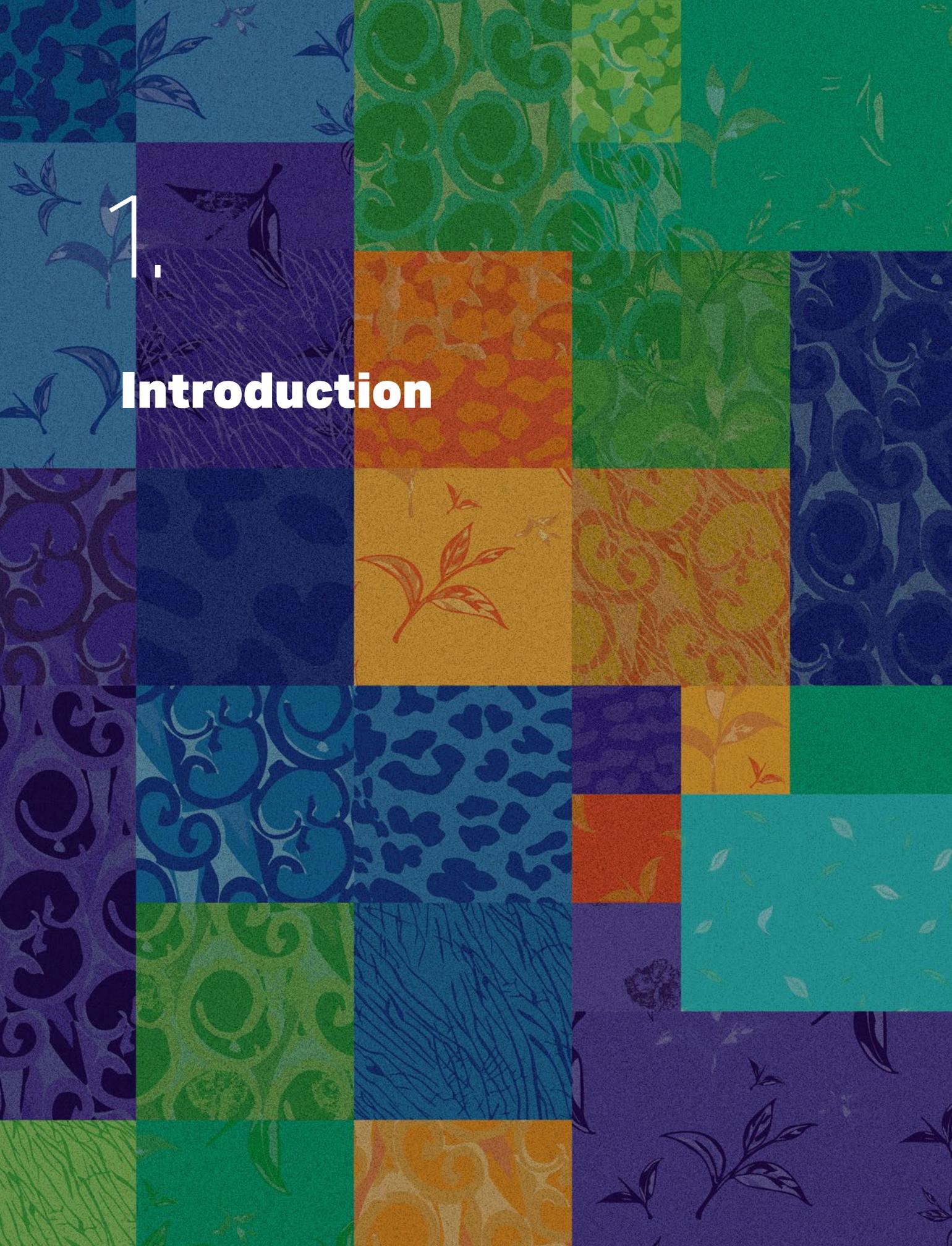
- Widespread informal employment is associated with inferior working conditions, limited job security, and heightened risk of poverty due to low earnings. Yet given the complex operating environment for firms created by stringent labor regulations, high cost of compliance, and overlapping regulations, the benefits of formalization may be low if the constraints to accessing finance are not lifted. Reforms could focus on increasing productivity and creating jobs, by addressing the causes and consequences of informality, rather than targeting informality itself. This would also support a resilient recovery in a post-pandemic world.
- Human capital can be further improved by closing the learning gaps and by investing in skills that can cater to the demands of the private sector, which can in turn help improve labor market outcomes. Education is also highlighted as a major factor that explains an overwhelming share of the wage gap between formal and informal workers.

Facilitating spatial transformation and strengthening inclusion

- Spatial transformation is intrinsically linked to economic transformation. The cornerstone of spatial transformation and inclusion lies in strengthening public service delivery, particularly in the areas of education, health care and water supply, where the biggest gaps remain. Lagging regions perform more poorly in these areas.
- A strong social protection system can contribute to economic transformation. Improving the targeting performance of the programs and making the system more adaptive can help build resilience to shocks among the poor and vulnerable.

1.

Introduction



Sri Lanka witnessed a period of dynamism and structural changes over the last decade. Following decades of resilient growth and the end of the civil war in 2009, gross domestic product (GDP) grew at an average of 6.2 percent between 2010 and 2016. Strong performance reflected a peace dividend and significant post-war investments. The process of structural transformation, defined as the shift of economic activities from agriculture to industry and services, was at the center of the changing dynamics in the economy. Tourism thrived and became a leading foreign exchange earner as the number of visitors quadrupled between 2009 and 2017. Tea and garment exports, Sri Lanka's other top tradables, continued to expand. These trends helped establish Sri Lanka as a solid middle-income country with a GDP per capita of \$3,852 in 2019. Growth led to job creation, with a marked shift in labor allocation away from agriculture.

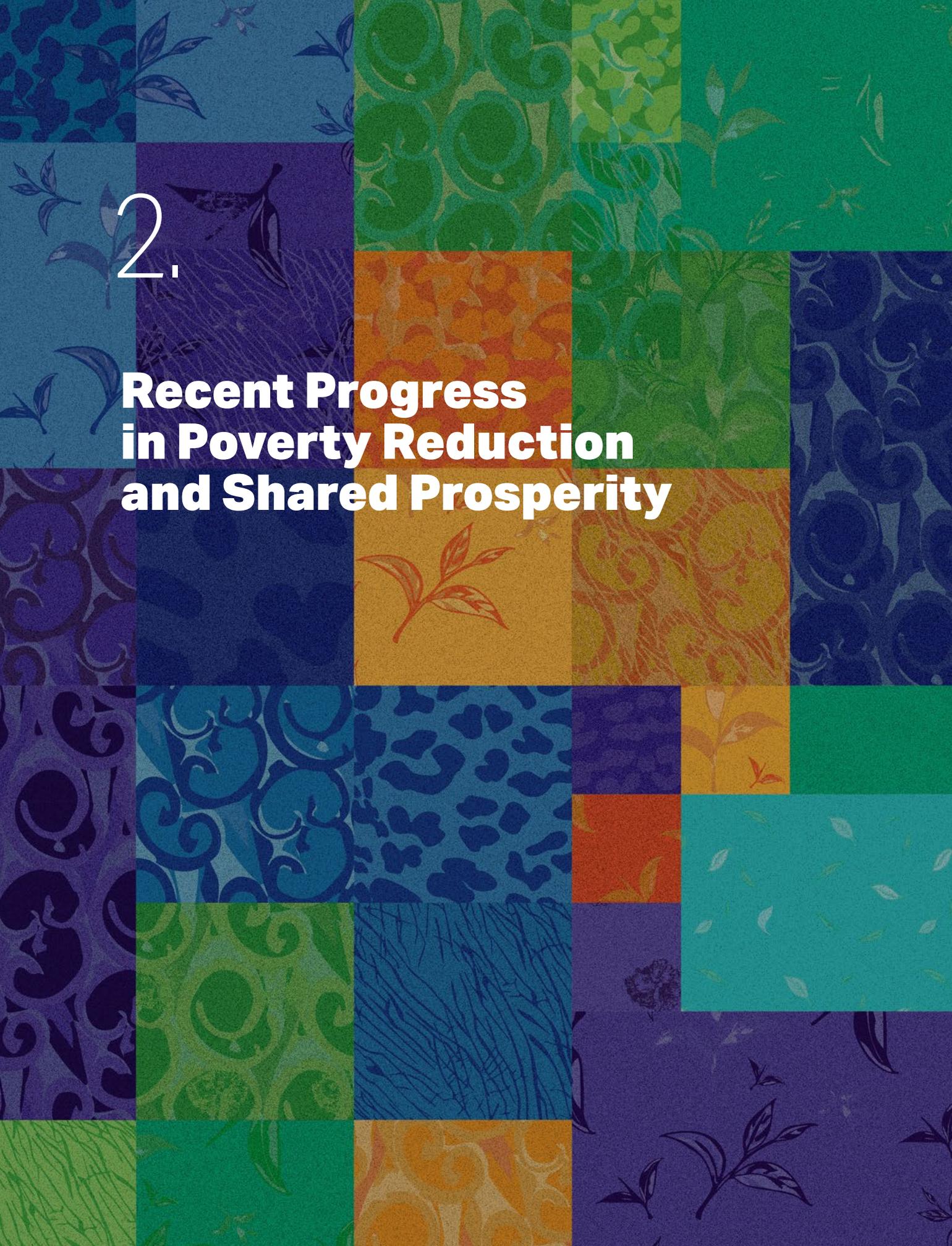
Against this backdrop, Sri Lanka achieved remarkable progress in reducing poverty and sharing prosperity, but the COVID-19 pandemic has resulted in significant welfare losses. According to the latest available data, the share of people living on less than \$3.20 per day (in 2011 purchasing power parity [PPP]) fell from 16.2 percent to 11 percent between 2012/13 and 2016, continuing progress from the previous decade during which poverty fell by more than half.¹ Extreme poverty measured at \$1.90 per day dropped below 1 percent in 2016. However, there had already been signs of a slowdown in growth before the COVID-19 outbreak, and the pandemic dealt a significant shock to the economy; GDP was estimated to have contracted by 3.6 percent in 2020. Widespread losses in livelihoods and earnings occurred. In a context of high vulnerability, large shocks can lead to quick and significant deterioration in welfare. Projections suggest that the \$3.20 poverty headcount could have increased to 11.7 percent in 2020, after having fallen to 9.2 percent in 2019. Various mitigation measures implemented by the government likely helped absorb the labor market impact and soften the impact on poverty but were insufficient to fully offset the shock.

This poverty assessment documents Sri Lanka's latest trends in welfare and explores opportunities for and challenges to more decisive progress. It is now well acknowledged that economic growth alone does not guarantee poverty reduction. The link between growth and poverty reduction through jobs relies on the poor having access to remunerative jobs in growing sectors. In Sri Lanka, poverty reduction between 2012/13 and 2016 mainly occurred through labor market improvements in nonfarm sectors. In a marked contrast to the preceding decade (2002-2012/13), agricultural incomes stagnated following a reversal of favorable commodity price trends, falling output and low productivity growth. Social assistance was not very effective at reducing poverty due to its weak targeting performance and inadequate benefit levels, though the large expansion of the Samurdhi program in 2015 appears to have benefited some poor households in lagging regions.

1. The \$3.20 poverty rate declined from 37.8 percent in 2002 to 16.2 percent in 2012/13.

The main message of this report is that *accelerating economic transformation to provide more and better jobs will be a top priority for a resilient and sustainable recovery from the current COVID-19 crisis as well as for long-term poverty reduction and shared prosperity.* The concept of economic transformation is fundamentally about moving people from low-productivity to high-productivity activities and about “changing the nature of jobs, . . . changing what people do, where they do it and how they do it” (World Bank, 2019a). This relates to how productive workers are and the impediments to becoming more productive. Structural changes and market integration are needed for people to move into higher-productivity jobs and thereby raise their incomes and improve their welfare. In Sri Lanka, while labor reallocation from farm to nonfarm employment occurred, gains in labor productivity were mainly due to increases in within-sector productivity and much less due to reallocation effects. This suggests that workers who moved out of agriculture ended up moving into other low-productivity sectors. To meet the World Bank’s twin goals of poverty reduction and shared prosperity, productivity growth is particularly needed in the type of jobs that are accessible by the poor and bottom 40 percent of the consumption distribution. This motivates the discussion of the four priorities for economic transformation: (i) increasing agricultural productivity through diversification; (ii) addressing the constraints to accessing remunerative nonfarm jobs; (iii) raising the quality of jobs, especially in the informal sector and (iv) facilitating spatial transformation and strengthening inclusion. These are discussed in further detail in section 3.

The remainder of the report is structured as follows. Section 1 documents recent progress in poverty and shared prosperity, with a focus on the period starting in 2012/13. This section also presents an assessment of the distributional impact of the ongoing COVID-19 crisis using the latest available data. Section 2 examines broader demographic and sectoral changes and then summarizes what worked and did not work in promoting economic transformation and creating more and better jobs as the linkage to poverty reduction. Section 1 and section 2 draw mainly from two World Bank reports, “Sri Lanka Poverty Update” (World Bank 2021c) and “The COVID-19 Impact on Livelihoods and Poverty in Sri Lanka” (World Bank 2021d). Section 3 unpacks the broader trends and provides a more detailed exposition of the challenges to economic transformation for the four priorities listed above. This section draws mainly from the following background papers: “Informality, Job Quality, and Welfare in Sri Lanka” (World Bank 2020b), “Agricultural Productivity, Diversification, and Gender” (World Bank 2021a) and “The Rural Nonfarm Sector and Livelihood Strategies in Sri Lanka” (World Bank 2021e). The report concludes in section 4 with a summary of the main messages and key policy recommendations.



2.

**Recent Progress
in Poverty Reduction
and Shared Prosperity**

Good progress was made in poverty reduction before COVID-19, and non-monetary well-being improved

Poverty in Sri Lanka declined strongly between 2012/13 and 2016, continuing progress from the previous decade.² The poverty rate based on the World Bank's international poverty line for lower-middle-income countries (at \$3.20 per person per day in 2011 PPP) dropped from 16.2 percent in 2012/13 to 11 percent in 2016. This was a further improvement from 2009/10, when the estimate stood at 19.9 percent (figure 1). Extreme poverty has been almost eliminated, with only 0.9 percent of the population living on less than \$1.90 per person per day in 2016 (figure 1). The depth of poverty also decreased, with improvements observed among the poorest of the poor.³ Projections indicate that the \$3.20 poverty rate likely fell further to 9.1 percent in 2019. Consistent with relatively high economic growth (figure 2), poverty reduction through 2016 was mainly the result of an increase in average consumption, rather than a redistributive effect.⁴

FIGURE 1 Poverty headcount rates



Source: World Bank staff calculation using HIES, various years.

Note: The figure shows the \$1.90 and \$3.20 per day poverty rate (in blue and yellow, respectively). Estimates for 2019 and 2020 are from microsimulation-based projections.

FIGURE 2 Real GDP growth



Sources: Department of Census and Statistics (for real GDP growth); World Bank 2020a (for BAU scenario)

Note: Figures for 2021 are based on projections. BAU = business as usual.

Poverty reduction was strong in rural areas, where an overwhelming majority of the poor continue to live. The \$3.20 poverty rate in rural areas declined from 17.6 percent to 11.5 percent between 2012/13 and 2016. Poverty declined in almost all districts, and the improvement was particularly steep in those where the poverty rate was initially high (above 30 percent) in 2012/13, such as Mannar, Mullaitivu, Batticaloa, and

2. The Household Income and Expenditure Survey (HIES) is the main source of data in this report. The HIES is conducted by the Department of Census and Statistics (DCS); surveys can be found on the DCS website at <http://www.statistics.gov.lk/page.asp?page=Income%20and%20Expenditure>. New HIES data were collected in 2019 but have not been released yet. All estimates after 2016 are based on projections.

3. This is based on a decline in the poverty gap index, which measures the average shortfall of the total population from the poverty line. The index is expressed as a percentage of the poverty line and fell from 3.4 to 2.1 percent between 2012/13 and 2016.

4. This is based on a Datt-Ravallion decomposition, which quantifies the relative contribution of growth and redistribution to changes in poverty.

Moneragala. Significant improvements in poverty reduction were also observed in the heavily rural Uva, Southern, and North Central Provinces. The overall number of districts with poverty rates above 30 percent declined, from five districts in 2012/13 to just two districts in 2016—these are Kilinochchi and Mullaitivu, both located in the Northern Province. However, the pace of progress was much slower in the estate sector where poverty remains at high levels—estimated at 25.4 percent in 2016. With over 90 percent of the poor residing in rural areas, poverty in Sri Lanka remains overwhelmingly rural, though an outdated sector classification based on administrative boundaries significantly underestimates urbanization. This makes it difficult to get a more accurate understanding of the true extent and nature of urban and rural poverty.⁵

The poor are less educated and more likely to be working in agriculture than the nonpoor. Sri Lanka has traditionally had high human capital achievements, but the gap between the poor and the nonpoor remains large; for example, less than 20 percent of the nonpoor have less than primary education, compared to nearly a third of the poor. Differences in human capital attainment lead to differences in labor market outcomes: working-age adults in poor households have lower labor market attachment and are significantly more likely to be engaged in agricultural activities that are predominantly of low productivity. Poor households are also larger in size and have higher dependency ratios than others (table 1). There are no significant differences in the gender of the household head by poverty status, though differences based on self-reported headship may not reveal the full extent of gender differences in welfare outcomes.

Agricultural households have higher poverty rates, but they do not make up the majority of the poor. Households whose head is engaged in agricultural wage work exhibit elevated poverty rates. While the national \$3.20 poverty rate is 11 percent, households have an average poverty rate of 11.9 percent if the head is in agricultural self-employment and 21.5 percent if in agricultural wage work (table 1). However, agricultural households as a group (based on household head's main activity) comprise only 27.5 percent of the poor, while non-agricultural households account for 43.2 percent. Households with an inactive head account for 29.4 percent.

TABLE 1 Profiles of the poor and nonpoor

	Total	Nonpoor	Poor
Demographic characteristics			
Household size (number of members)	4.5	4.3	5.4
Dependency ratio	0.7	0.7	0.9
Age of head	34	34.3	31.1
Female head (%)	53	53	52
Head is married (%)	48	49	43
Education			
Less than primary (%)	20.9	19.5	32.5
Primary completed (%)	50.0	49.3	56.1
O-level completed (%)	15.3	16.1	8.4
A-level completed (%)	11.1	12.1	2.7
Bachelor's and above (%)	2.7	3.0	0.3
Economic activity			
Working adults in household (%)	51.1	51.4	47.9
Adults in wage work (%)	62	61.2	68.7
Adults in self-employment (%)	38	38.8	31.3
Adults working in agriculture (%)	23	21.4	35.5
Adults working in non-agriculture (%)	77	78.6	64.5

Source: World Bank staff estimates based on HIES 2016.

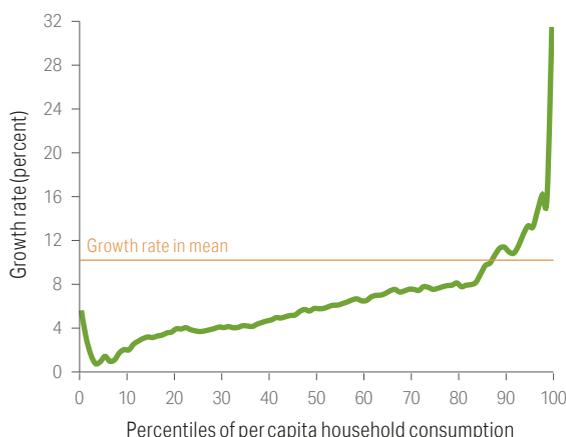
5. See World Bank (2010) for details.

Trends in non-monetary indicators of well-being are suggestive of broader progress in welfare. Access to electricity is now almost universal thanks to significant progress among the poor: for example, electricity coverage in the Northern Province increased remarkably, from 67 percent to 93 percent; coverage also surpassed 97 percent in the Eastern, Uva and North Central Provinces after improving by more than 10 percentage points between 2012/13 and 2016. This is despite electricity prices not being set according to a cost-reflective price mechanism, though the implicit subsidies are overall progressive (World Bank 2020c). Ownership of assets—such as major durables (e.g., refrigerators, washing machines) and land—increased across the broader distribution. The share of mobile phone owners increased from 85 percent to 92 percent with an even larger increase among the poor. Finally, household income sources increasingly shifted toward nonfarm sources, and household debt levels improved significantly, especially among the poor.

Recent growth was inclusive but inequality is relatively high

Growth was inclusive but less pro-poor. Per capita consumption growth of the bottom 40 percent recorded an annualized 4.2 percent after 2012/13, but this was still below the national average of 4.7 percent. This result suggests that growth was inclusive but less pro-poor. Overall, consumption growth accelerated relative to the previous period of 2009/10–2012/13 (figure 3), when per capita consumption of the bottom 40 percent increased by only 1.5 percent, compared to a 3.8 percent increase for the total population over the same period (figure 4).

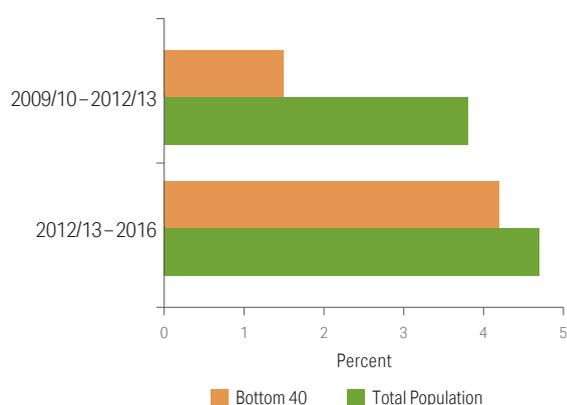
FIGURE 3 Change in per capita consumption between 2009/10 and 2012/13



Source: World Bank staff estimates based on HIES 2009/10 and 2012/13.

Note: Figure shows a Growth Incidence Curve, i.e., the growth rate in per capita consumption across percentiles of the same distribution. Calculations for 2009/10 do not include the Mannar, Kilinochchi, and Mullaitivu districts.

FIGURE 4 Per capita consumption growth, bottom 40 percent vs. total population, 2009/10–2013 and 2012/13–2016



Source: Global Database of Shared Prosperity, 2020, <https://datacatalog.worldbank.org/dataset/global-database-shared-prosperity>.

Inequality increased slightly between 2012/13 and 2016, after a marked deterioration in previous years. The Gini index of inequality rose slightly, from 38.7 to 39.3 between 2012/13 and 2016, after a notable increase from 36.1 in 2009/10. The latter happened as consumption grew more slowly among households in the bottom of the distribution and faster among those in the top between 2009/10 and 2012/13 (figure 3). In comparison, overall consumption growth accelerated to an average of 18 percent between 2012/13 and 2016 and was also more balanced across the distribution. Increases were still strongest for the top 10 percent (figure 5).

FIGURE 5 Change in per capita consumption between 2012/13 and 2016



Source: World Bank staff estimates based on HIES 2012/13 and 2016.

Note: Figure shows a Growth Incidence Curve, i.e., the growth rate in per capita consumption across percentiles of the same distribution.

COVID-19 led to significant welfare losses

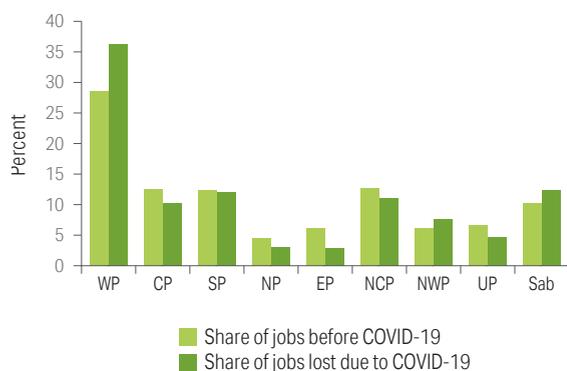
The COVID-19 pandemic has dealt a significant shock to the Sri Lanka economy. Swift containment measures helped check the domestic transmission of COVID-19, but prevailing social-distancing measures and mobility restrictions impacted almost all sectors of the economy, leading to widespread jobs and earnings losses. GDP contracted by 3.6 percent in 2020. Data at the sectoral level show that industries have been affected most severely but there are large variations across subsectors. For example, construction and textile manufacturing suffered the largest shock as the sectors are more sensitive to demand shocks and the work requires physical presence. The overall impact was relatively small in the services sector, but the aggregate number again masks significant heterogeneity across subsectors—transport, food and accommodation, and personal services experienced large output losses. Extended travel restrictions shut down most of the tourism industry through 2020, except for some domestic tourism. Meanwhile, agricultural production was largely undisrupted, partly due to government efforts to ramp up domestic production and promote import substitution, though challenges with transport and marketing were reported. The fishery sector suffered a significant shock. Weak external demand impacted export-oriented subsectors and their prevailing wages.

Because actual data are still limited, the assessment of the distributional impact of the COVID-19 crisis is informed by a macro-micro simulation and complemented with findings from a rapid phone survey. New HIES data, which are used to produce poverty estimates, were collected in 2019 but have not been released yet. However, even the latest data would not provide insights into the impact of the pandemic, since 2019 still predates the COVID-19 outbreak. For this reason, the distributional impact assessment relies on estimates from a simulation exercise using macroeconomic and household survey data to

project the impact of macroeconomic shocks on household welfare. Preliminary results from a recent World Bank COVID-19 rapid phone survey are also referenced as appropriate.⁶

The labor market shock has been unequal across the income distribution, with the poor losing the largest proportion of their earnings. Simulations suggest that job losses were concentrated in the highly urbanized Western Province. About 29 percent of jobs were located in the Western Province before COVID-19, but more than a third of COVID-19-related job losses are expected to have occurred there (figure 6). Workers who continued to be engaged in the labor market are also likely to have suffered earnings losses. In fact, preliminary findings from the COVID-19 rapid phone survey show that among respondents engaged in the labor market prior to the pandemic, more than half suffered a labor market shock, primarily in the form of earnings losses (reported by more than 30 percent), while a more modest impact occurred through temporary absence and job losses. Estimates suggest that the poorest experienced the largest proportionate earnings shock while the richest suffered from smaller proportionate income losses (figure 7). The latter are more likely to be working in the services sector which suffered the smallest contraction. They also tend to have formal, secure jobs and better access to digital technology that allows them to conduct wage work or business operations remotely.

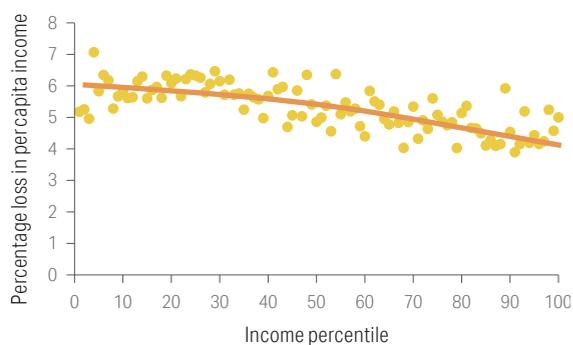
FIGURE 6 Share of jobs lost by province



Source: World Bank staff estimation using HIES 2016.

Note: WP = Western Province; CP = Central Province; SP = Southern Province; NP = Northern Province; EP = Eastern Province; NCP = North Central Province; NWP = North Western Province; UP = Uva Province; Sab = Sabaragamuwa Province.

FIGURE 7 Average income loss across the income distribution



Source: World Bank staff estimation using HIES 2016.

6. The World Bank conducted a rapid phone survey across eight South Asian countries. In Sri Lanka, the survey was implemented between September and December 2020, and primarily aimed to understand changes in the labor market among different groups. Additional questions were included on households' ability to meet basic needs, safety nets, and coping mechanisms. The sample comprised over 5,000 respondents who were reached via random digit dialing. While mobile phone ownership is quite high in Sri Lanka, at 92 percent according to the 2016 Household Income and Expenditure Survey, the modality of the phone survey does not allow for stratification by geographic units. Efforts were made during implementation to ensure a balanced sample, and characteristics of the final phone survey sample are relatively aligned with those from the 2019 Labour Force Survey. Full survey results with more detailed analysis will become available in the coming months.

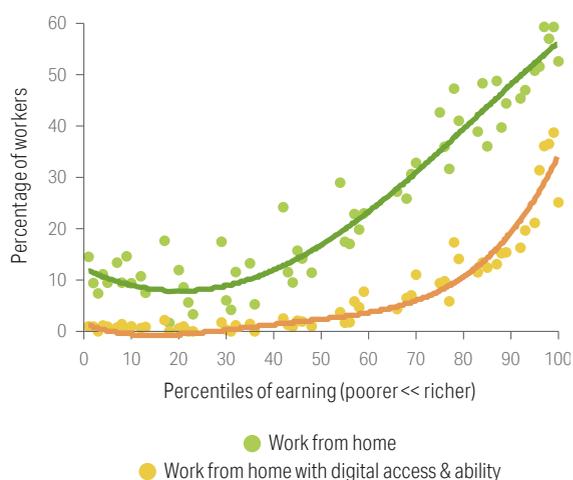
Only a small share of high-income earners work at jobs that can be done remotely and have access to digital equipment. About 27 percent of workers in Sri Lanka have jobs that could potentially be done remotely; this figure is based on the task content of occupations. While nearly half of workers in the top 20 percent could work remotely, the share is much lower in the lower end of the income distribution. However, whether the job is actually amenable to being performed from home also depends on access to digital technology and equipment. Once ownership of digital devices such as computers or tablets is taken into account, the share of potential teleworkers drops even further: very few workers in the lower half of the income distribution can work from home, and the share is still only about 30 percent among the highest income earners.⁷

With jobs and earnings lost, poverty increased significantly, and over 500,000 people are estimated to have fallen into poverty as a result of the crisis. High vulnerability implies that many workers with low earnings and without a proper safety net could quickly fall into poverty in the event of

a negative shock. In Sri Lanka, the \$3.20 poverty rate increased significantly, from 9.2 percent in 2019 to an estimated 11.7 percent in 2020, when the effects of COVID-19 were being felt. This more than reverses progress since 2016, when the poverty rate was 11 percent, and thus implies significant welfare losses. Widespread informality and precarious employment arrangements suggest a high risk of displacement or earnings losses in the event of shocks (World Bank, 2020c). A formal unemployment insurance scheme to protect workers during spells of joblessness is not in place. Low earnings lead to a higher risk of poverty and allow workers little room to accumulate savings that they can resort to during times of crisis. Meanwhile, formal workers concentrated in export-oriented sectors such as tea and garments were not spared either, with disruptions to both supply and demand sides over the course of the pandemic.⁸

The new poor—those who fell into poverty as a result of the pandemic—are more likely to be living in urban places, but the vast majority of the poor continue to live in rural areas with previously

FIGURE 8 Occupations amenable to teleworking across the income distribution



Source: World Bank 2021b.

Note: WFH = work from home.

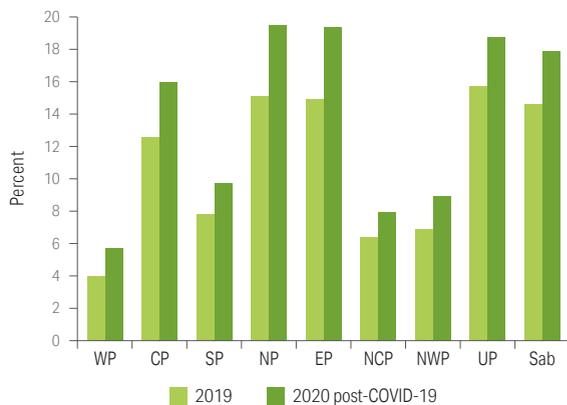
7. The share of jobs that can be done remotely is estimated based on an established methodology. For details, see the special focus section of World Bank (2021b).

8. A tripartite agreement was reached between employers and trade unions, and facilitated by the government, which stipulates that employers pay 50 percent of wages during periods employees are required to stay home. This agreement could have helped reduce employment losses.

high levels of poverty. The new poor are more urban, slightly better educated, and less likely to be in agriculture than those who were poor before the crisis. Across provinces, the poverty rate increased the most in the Northern, Eastern, Sabaragamuwa, and Central Provinces, which were the poorest provinces pre-COVID-19 (figure 9). The districts of Kandy (in North Central Province) and Ratnapura (in Sabaragamuwa Province), which had the largest number of old poor, also account for the largest share of the new poor, followed by Gampaha and Kalutara (both in Western Province). However, the COVID-19 crisis did not fundamentally shift the poverty profile or the nature of poverty in Sri Lanka.

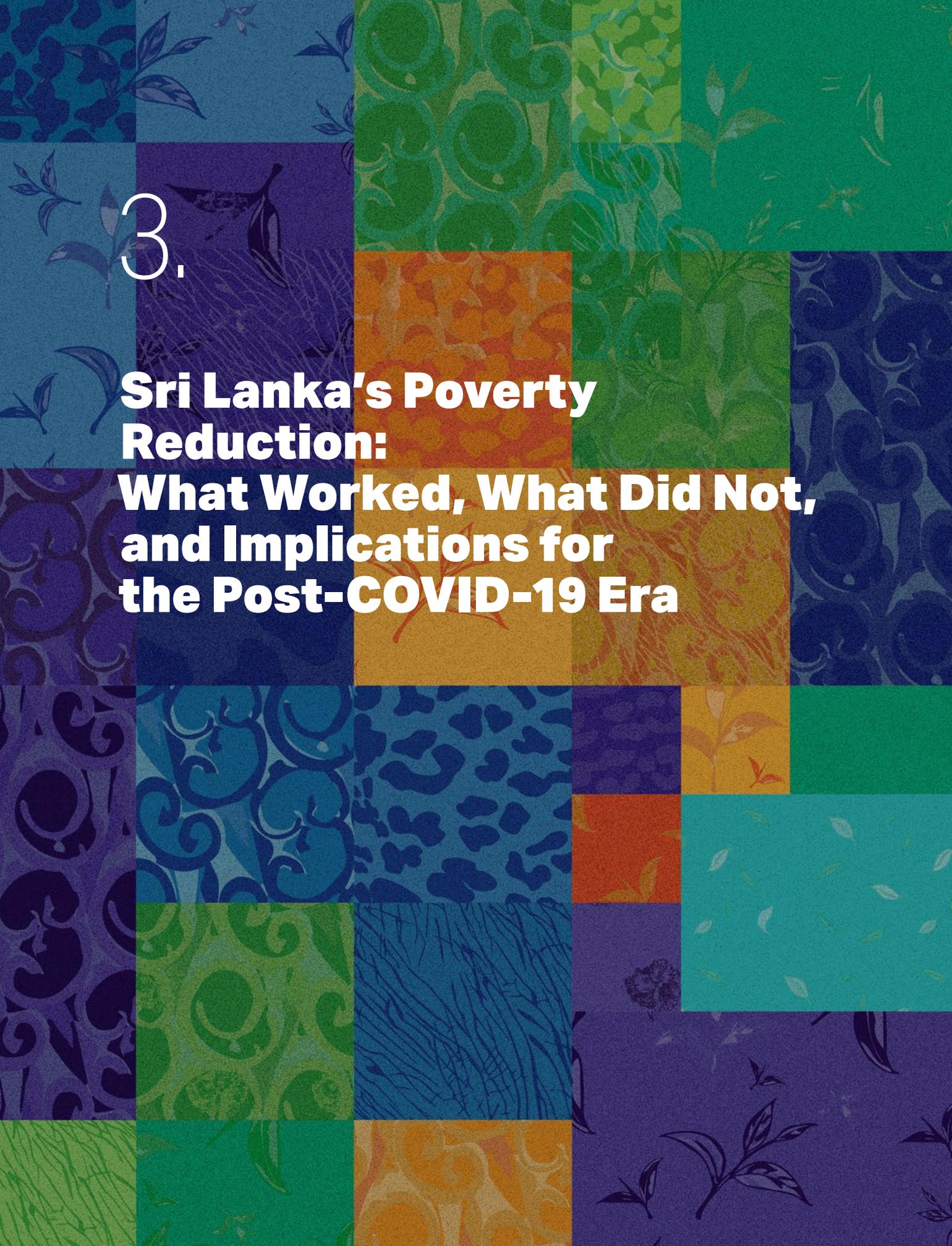
Mitigation measures in the form of cash and food assistance likely helped absorb the pandemic-induced labor market shock and soften the impact on poverty. To mitigate the impact of the pandemic on the poor and vulnerable, the government implemented several welfare measures by scaling up existing schemes. More than 4.9 million families are reported to have received a payment of Rs 10,000, administered through the Department of Samurdhi Development, during the first lockdown period. This is in addition to the individual allowances for elderly or disabled individuals or chronic kidney disease patients. Around 1.4 million families received relief payments of (or equivalent to) Rs 5,000 during the second COVID-19 wave. It is estimated that the \$3.20 poverty rate fell further as a result, by another two percentage points. While the programs were very costly and had wide coverage, mitigation was likely less effective than it could have been due to weak targeting.

FIGURE 9 Poverty rate by province, pre- and post-COVID-19



Source: World Bank staff estimation using HIES 2016.

Note: WP = Western Province; CP = Central Province; SP = Southern Province; NP = Northern Province; EP = Eastern Province; NCP = North Central Province; NWP = North Western Province; UP = Uva Province; Sab = Sabaragamuwa Province.



3.

**Sri Lanka's Poverty
Reduction:
What Worked, What Did Not,
and Implications for
the Post-COVID-19 Era**

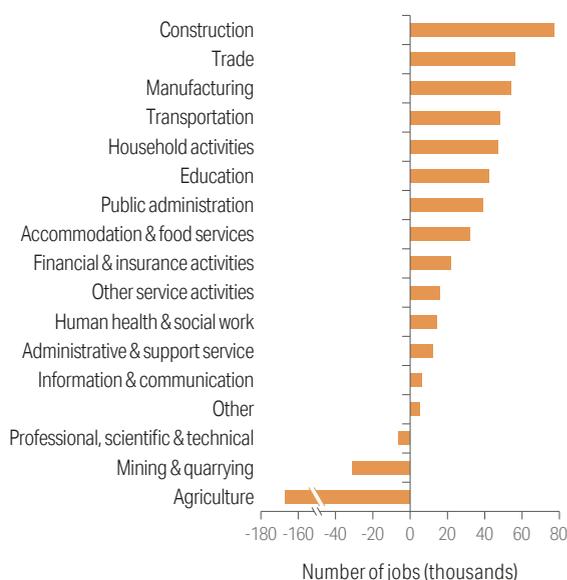
Context

Sri Lanka witnessed a period of impressive dynamism in the last decade. This dynamism spurred post-war growth that led to labor reallocation from agriculture to industry and services and that boosted productivity growth. While GDP growth rates decelerated somewhat from the initial high levels observed in the early 2010s, they were still relatively high through 2016. Among the factors enabling economic transformation, road infrastructure benefited from significant post-war investments. Improved connectivity across the country increased market accessibility and thus contributed to enhanced agglomeration along the Kandy-Colombo-Galle corridor and associated growth drivers. In particular, the Southern Expressway, which opened in 2011, halved travel time from Colombo to the south where some of the most popular tourism destinations are located. Tourism thrived, with the number of visitors quadrupling between 2009 and 2017. The “sharing economy” was introduced, and services such as Uber, PickMe, and Airbnb became popularized in urban areas. Sri Lanka’s leading export industries, tea and garments, continued to perform well. The coconut subsector experienced an export boom thanks to a rise in global demand for coconut products. Finally, Sri Lanka’s flagship social assistance program, Samurdhi, underwent a significant expansion in 2015 that effectively tripled the program budget.

Structural transformation continued during this period and productivity grew strongly, helping workers improve their earnings. Economic activities and employment shifted from agriculture to industry and services. Agriculture accounted for 24.8 percent of the employed in 2016, down from 28 percent in 2012/13. The share working in industry increased from 26.1 to 27.3 percent and the share in services from 45.9 to 47.9 percent. Many jobs were created in construction, trade, manufacturing, and transport—sectors that tend to employ poor, less-skilled workers. At the same time, the agriculture sector lost a large number of jobs (figure 10). Income growth was strong during this period, with real earnings growing at an annualized 7 percent between 2013 and 2017.

Applying an economic transformation lens makes it possible to see what worked and what did not work to support more and better jobs and to generate the higher productivity that contributed to poverty reduction. Economic transformation involves shifting from low-productivity to high-productivity

FIGURE 10 Net job creation by sector, 2013–2016



Source: Department of Census and Statistics, Labour Force Survey Annual Reports, 2013–16, <http://www.statistics.gov.lk/LabourForce/StaticInformation/AnnualReports>.

activities, across and within sectors, and is typically associated with higher urbanization. On the other hand, growth generated by higher commodity prices could stimulate income growth in the short term, but such gains might not be sustainable in the longer term. To achieve poverty reduction and shared prosperity, job and productivity gains would be most needed in the sectors where the poor and bottom 40 percent are more likely to be engaged. In addition to creating an enabling environment, constraints on both the supply and demand side of labor would need to be considered to improve the quality of jobs. Strong social safety nets can support risk management and livelihood transitions. The section concludes with a discussion on the implications of these factors in a post-COVID-19 world.

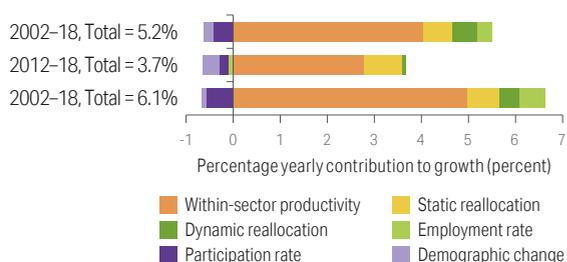
What worked: Productivity growth went hand in hand with income growth

Gains in labor productivity led real GDP growth in the last decade. Real GDP per capita grew at an annual rate of 5.2 percent between 2002 and 2018. A large share of the growth was due to increases in labor productivity, which led to better jobs and higher wages. However, productivity growth has fallen in recent years, after enjoying a boost between 2002 and 2012. The contribution of demographic change to GDP growth was negative, reflecting the decline in the share of the working-age population (figure 11).

Most of the productivity growth came from increases in within-sector productivity, particularly in the services; much less came from reallocation effects. Labor productivity increases when workers move from low- to high-productivity sectors or when productivity levels within sectors improve. In Sri Lanka, reallocation yielded little in the way of

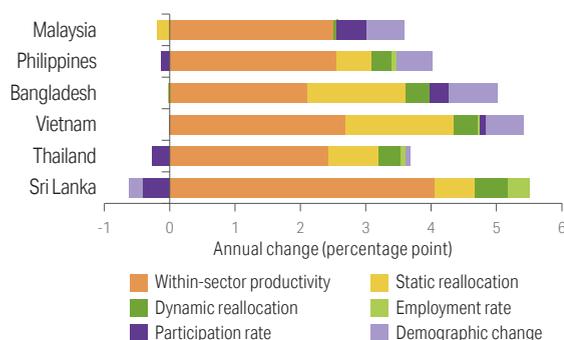
productivity gains, as most of the movement occurred from agriculture toward sectors with low productivity, such as trade. Instead, most of the productivity growth was due not to growth-promoting structural change but to improvements in within-sector productivity (Diao, McMillan, and Rodrik, 2017).⁹ In peer countries such as Vietnam and Bangladesh, productivity growth was comparably strong, but a significant share was due to reallocation, and these countries also benefited from favorable demographic trends (figure 12). In any case, within-sector productivity growth in Sri Lanka has slowed down in recent years.

FIGURE 11 Decomposition of growth in per capita value added



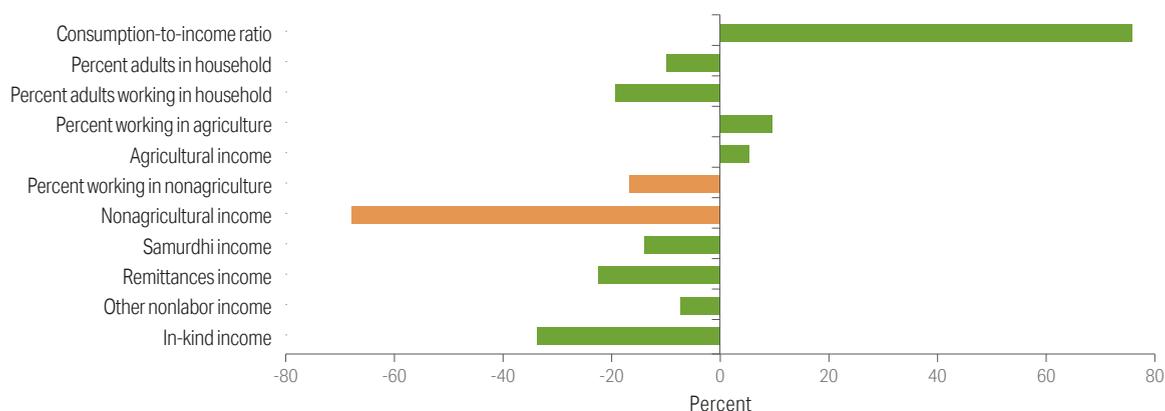
Sources: Based on World Bank Job Structure Tool and data from World Development Indicators database.

9. Diao, McMillan, and Rodrik (2017) examine the relationship between patterns of structural change and labor productivity growth within specific industries. They argue that growth accelerations were based on rapid within-sector labor productivity growth (in the case of Latin America) or growth-increasing structural change (in the case of Africa). This stands in contrast to the experience of East Asian countries, in which both components of labor productivity contributed to overall growth.

FIGURE 12 Decomposition in growth per capita value added, Sri Lanka vs peer countries

Source: Based on World Bank Job Structure Tool and data from World Development Indicators database.

Productivity growth went hand in hand with income growth, particularly in nonfarm sectors, which led poverty reduction in the last decade. Poverty reduction in Sri Lanka between 2002 and 2012/13 was previously attributed to increases in returns to nonfarm wage work (Ceriani, Inchauste, and Olivieri 2015). The change in poverty rate can be broken down into the following components that jointly determine income, consumption, and subsequently poverty: (i) share of adults in household; (ii) share of adults working; (iii) share of adults working in agriculture; (iv) share of adults working in nonagriculture; (v) income from agricultural activities; (vi) income from nonagricultural activities; (vii) nonlabor income, which includes benefits from the poverty alleviation program Samurdhi, remittances received, and all other nonlabor income; (viii) in-kind income; and (ix) the consumption-to-income ratio.¹⁰ The breakdown of the relative contribution of these factors to poverty reduction is shown in figure 13. The shares of the individual components add up to 100 percent and correspond to the 5.2 percentage point reduction in the \$3.20 poverty rate between 2012/13 and 2016, from 16.2 percent to 11 percent. The main takeaway is that about two thirds of the reduction in poverty is accounted for by a higher share of adults working in nonfarm sectors and those workers obtaining higher labor earnings.

FIGURE 13 Changes in poverty due to demographics and income sources

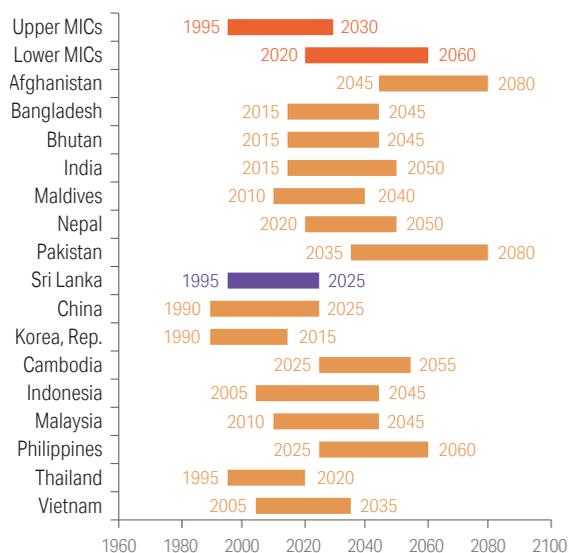
Source: World Bank staff calculation using HIES 2012/13 and 2016.

Note: The figure shows percentage contribution of different demographic factors and income sources to poverty reduction. A negative contribution means that the component helped reduce poverty. The sum of all bars amounts to 1. HH = household.

10. A Shapley-Shorrocks decomposition is employed to assess the role of changes in demographics, employment, public transfers, and remittances for poverty reduction. Poverty is a function of total household per capita consumption (which depends on household size and composition), household income, and a scaling factor that maps income to consumption. For details, see World Bank (2021c).

The impact of Sri Lanka's demographic transition on growth and poverty reduction is already tangible. Sri Lanka has reached the advanced stage of demographic transition relatively early and the population is aging. Its demographic window of opportunity opened in 1995 and is expected to close in 2025, sooner than for its regional peers (figure 14).¹¹ Among peer countries, the contribution of demographic changes to growth was negative only in Sri Lanka, whereas it occupied a notable share in Bangladesh, Vietnam, Malaysia and the Philippines (figure 12). In terms of poverty reduction, the combined contribution of demographics, measured by the share of adults and the share of adults in the household engaged in economic activities, was poverty-reducing but the magnitude was small (as shown by the relative height of the corresponding bars in figure 13).

FIGURE 14 The demographic window of opportunity

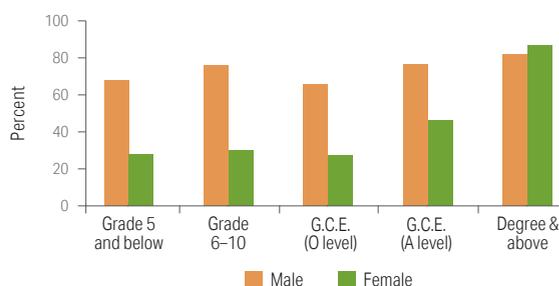


Source: World Bank, forthcoming.

Note: MIC = middle-income country.

Increasing labor force participation, especially among females, and enhancing the productive capacity among the workforce through better education and skills investments can help counter these demographic trends to sustain long-term growth and economic transformation. Human capital outcomes generally favor women, as they enjoy a longer life expectancy, more years of schooling, and better learning outcomes. The main constraint lies in their access to labor market opportunities: with the exception of those with a degree and above, where there is actually a reverse gap, females have a significantly lower labor force participation rate than men (figure 15). While women are not overrepresented in the informal sector, they occupy a large share of the workforce in leading export sectors such as textile and tea production, where productivity is low. Most unpaid family workers in agriculture are also women (Hirimuthugodage et al 2014; World Bank 2021e).

FIGURE 15 Labor force participation rate by gender and education



Source: DCS, 2019.

Note: GCE = General Certificate of Education.

11. A demographic window is opened when the share of the youth in total population falls below 30 percent and the share of the elderly remains below 15 percent; the country's young bulge has reached working age, resulting in a labor supply effect that can lift economic growth and income levels; this effect is commonly referred to as the first demographic dividend. In addition, higher income levels can lead to a virtuous circle of higher savings and investment, an effect referred to as the second demographic dividend.

The opportunity costs of being employed appear high for women compared to the average expected return. Labor force participation of women has been persistently low, at 34.5 percent in 2019 compared to 35.5 percent in 1996.¹² Social norms and the lack of child care and elderly care are some of the likely culprits behind this. In addition, ownership of labor-saving household durables remains broadly low: only 22 percent of Sri Lanka households own a washing machine, and almost half do not own a refrigerator. Given the year-round warm climate in many parts of the country, the latter means that more time is spent in cooking, since prepared food cannot be easily stored. Moreover, nearly 70 percent of households rely on firewood as their principal type of cooking fuel. All of these suggest a high burden on women's time. These challenges are compounded by the lack of good-quality jobs: the availability of formal, private salaried jobs is low, as contractual arrangements are precarious. Hence there may be a preference for public sector jobs, which usually come with superior remuneration and working conditions.¹³ In fact, in recent years better-educated women were significantly more likely than men to have taken up a public sector job. At the same time, many less-skilled women still find themselves in a weak position in the labor market—for example, about 16 percent of female workers are engaged as contributing family workers.

What did not work: Agricultural productivity was low and the performance of the social protection system weak

Farmers have a higher propensity to be poor than nonfarmers, as productivity in agriculture is low. The contribution of the agriculture sector to growth has been declining but the sector remains an important source of livelihoods for the poor. While the production sector contributes a small share toward Sri Lanka's total GDP (7.4 percent in 2019), the broader agriculture and food sector is significantly larger, at around 25 percent of GDP. Food and beverage manufacturing alone account for about 6 percent of GDP. Agricultural households do not make up the majority of poor, but they are more likely than others to be living in poverty, primarily because they engage in low-productivity, low-return economic activities.

The slowdown in agricultural income growth marks a departure from trends in the previous decade, during which the sector benefited from favorable prices. Lack of improvements in the agriculture sector meant that its contribution to poverty reduction was low between 2012/13 and 2016 (figure 13). This stands in contrast to previous analysis of poverty reduction between 2002 and 2012/13, which was driven

12. World Development Indicators. Labor force participation rate, female (% of female population ages 15+). Accessed February 10, 2021.

13. A preference for public sector jobs is widely reported, especially among better-educated youth. Public sector jobs are much better remunerated, with significantly higher earnings, better benefits, and better job security than most private sector jobs. This raises concerns in several areas: on the demand side, the private sector may struggle to attract highly skilled workers in the presence of queuing; and on the supply side, skills investments could skew toward catering to the demands of the public sector.

by growth in labor income, attributed to an increase in returns to nonfarm wage workers followed by higher returns to self-employed farm workers (Ceriani, Inchauste, and Olivieri 2015). Higher commodity prices drove the boost in farm earnings in the preceding period, but this boost was not accompanied by broader productivity improvements. The slowdown in agricultural earnings growth was likely due to a number of adverse trends, including: (i) falling export prices; (ii) declining output levels, particularly in 2016 (likely a result of an extreme drought event in that year); (iii) stagnating agricultural minimum wages; and (iv) a low-productivity paddy sector, which engages many poor farmers.

Weak targeting and delivery systems in the prevailing social protection scheme undermine its ability to protect the poor against shocks and eventually help them become more productive. Samurdhi is Sri Lanka's flagship poverty alleviation program, but its cash assistance explains a relatively modest 20 percent of the overall reduction in poverty between 2012/13 and 2016 (figure 13). This result is mainly due to undercoverage and levels of leakage as high as 70 percent. The program expansion in 2015 focused on increasing benefits and had little impact on coverage. As a result, less than half of the poor are beneficiaries of Samurdhi, and benefit amounts are inadequate: among beneficiary households in the bottom 10 percent, benefits account for only around 12 percent of household monthly consumption. The COVID-19 crisis further exposed these weaknesses. Several welfare programs were implemented to mitigate the impact of the crisis on the poor and vulnerable, which helped cushion the labor market shock. But implementation relied to a large extent on existing delivery systems, and despite wide coverage, the mitigating impact on the poor was somewhat limited relative to the large resources expended on these efforts.

Implications for a post-COVID-19 era

The Sri Lanka economy is slowly recovering from the COVID-19 crisis and poverty is expected to start falling again in 2021. Following a sharp contraction in GDP of 16.9 percent in the second quarter of 2020, the economy started to gradually rebound in the third quarter. While the economy contracted by 3.6 percent in 2020, GDP is projected to grow at 3.4 percent in 2021. In line with this, the latest projection indicates that the \$3.20 poverty rate could fall to 10.9 percent.

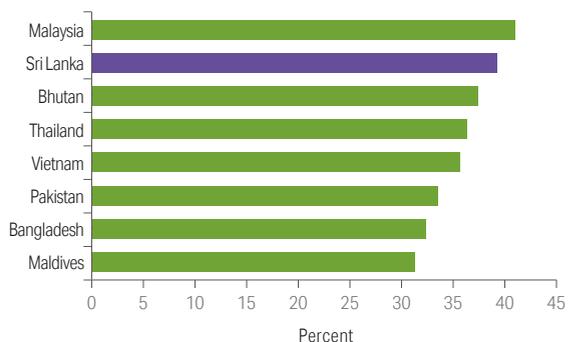
While urban areas have been disproportionately affected by the crisis, the nature of poverty and the structural challenges impeding further progress are expected to remain broadly unchanged. The profile of the poor may have slightly shifted as a result of the COVID-19 crisis, but the nature of poverty and the constraints to the livelihoods of the poor have not changed fundamentally. Because of the pandemic, some sources of livelihoods for the rural poor may take time to recover: for example, while Sri Lanka has opened up for tourism again, it will be some time until the country reaches pre-crisis levels tourists. Thus, the lessons learned from the process of poverty reduction in the previous decades, as summarized above, are expected to remain broadly valid.

Inequality is expected to widen, with potential consequences for the long term. In the short term, the pandemic will likely widen inequality through the impact on the labor market. As seen in figure 7, earnings losses were distributed unevenly across the distribution, with the richest households experiencing smaller reductions than those in the bottom of the distribution. Consistent with this, the Gini index, a commonly used aggregate measure of inequality, is expected to slightly increase, from 39.3 to 39.8. This is concerning given that Sri Lanka's Gini index was higher than its peers' even before the pandemic (figure 16).

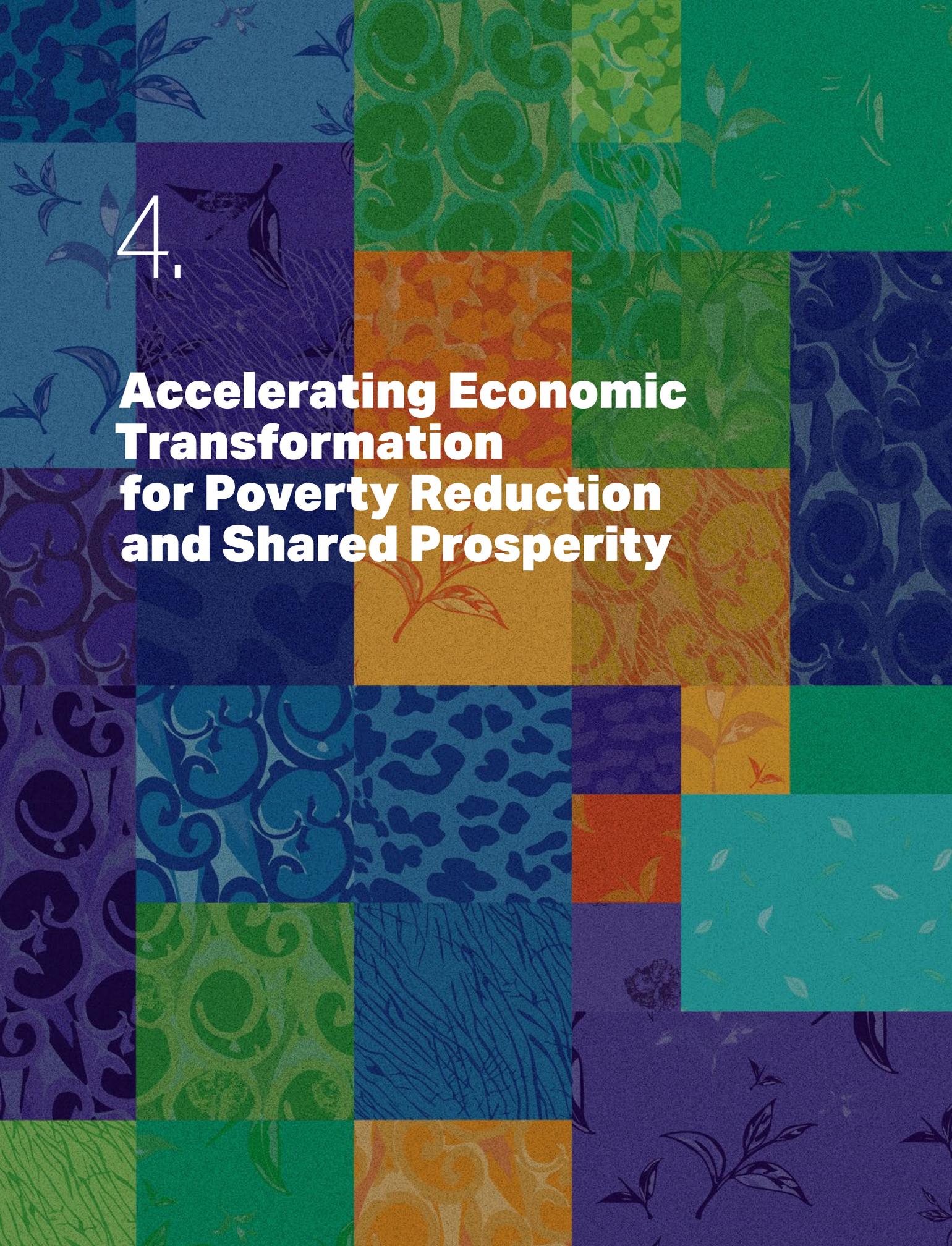
Combined with pre-existing inequalities, the potential long-term impact of the COVID-19 crisis on inequality through reduced social mobility could be significant. An area of particular concern

is access to education, as schools were closed for nearly a year during the pandemic. Widening disparities in educational outcomes due to lack of access to digital technology and e-learning content could leave long-lasting scars and exacerbate inequalities between urban and rural areas and different socioeconomic groups. The potential disparities are corroborated using computer ownership as an imperfect proxy for access to digital connectivity: according to HIES 2016, only 19.6 percent of rural households and 6.0 percent of estate households had a computer. Percentages were higher among urban households, though still low at around 34.8 percent. Access to education is generally considered an important determinant of social mobility, able to lift the poorest from the bottom of the ladder—and there is increasing evidence that that is the case in Sri Lanka, with more educated individuals being more productive and more likely to hold better jobs and earn more.

FIGURE 16 Gini index in Sri Lanka vs peer countries



Source: World Bank PovcalNet.



4.

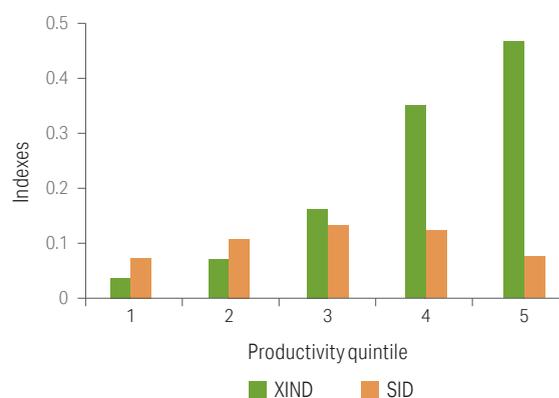
Accelerating Economic Transformation for Poverty Reduction and Shared Prosperity

Accelerating economic transformation to provide more and better jobs will be a top priority for a resilient and sustainable recovery from the current crisis, as well as for long-term poverty reduction and shared prosperity. This transformation will entail stronger productivity growth within sectors as well as continued employment shifts to more productive sectors that are accessible by the poor and bottom 40 percent. This section is structured around four priorities for economic transformation: (i) increasing agricultural productivity through diversification; (ii) addressing the constraints to accessing remunerative nonfarm jobs; (iii) raising the quality of jobs, especially in the informal sector; and (iv) facilitating spatial transformation and strengthening inclusion.

Priority 1. Increasing agricultural productivity through diversification

Diversification is key to increasing productivity and earnings. Diversification is typically referred to as the next stage in the transition from a traditional subsistence-oriented agriculture to commercially oriented, high-value-added agriculture. In Sri Lanka, most of the output is typically marketed, and pure subsistence farming is relatively rare. Diversification at this stage is likely to help many but not all farmers: as figure 17 shows, greater diversification is positively associated with productivity only up to a certain level (the middle quintile of 40–60 percent of the productivity distribution), after which productivity actually increases with greater specialization. Among poor farmers, the lack of diversification is partly due to widespread paddy farming, which contributes to low overall productivity levels. Smallholder farms keep over 40 percent of their rice production for their own consumption;¹⁴ the reasons for this are not immediately understood, given relatively high levels of market integration, the country's small size, and frequent price controls (that are beneficial for the consumer). Meanwhile, productivity monotonically increases with higher export-orientation.

FIGURE 17 Simpson Index of Diversification and export orientation index by productivity quintile



Source: World Bank staff calculation using HIES 2016.

Note: X-axis shows quintiles by farm productivity. XIND = export orientation index; SID = Simpson Index of Diversification.

Note: X-axis shows quintiles by farm productivity.

Addressing the factors behind the low paddy productivity could contribute to food security, poverty reduction, and the sector's overall productivity. The primary form of agriculture in Sri Lanka is crop

14. Estimate is from HIES 2016.

production, with about 46 percent of smallholder farmers engaged in rice cultivation.¹⁵ The share of rice farmers remains high despite productivity levels that are significantly lower than for other crops and that have seen little growth in the past decade. Crop productivity is lowest for rice and cereals and higher for other seasonal food crops (e.g., vegetables), annual crops (e.g., yams, tobacco), and export crops (e.g., tea and rubber). Paddy farmers are more likely than other farmers to be poor and are the main beneficiaries of fertilizer subsidies which appear to help increase productivity. Fertilizer subsidies have been used primarily to meet food security objectives. However, they occupy a large share in the government's agricultural budget, and more resources could be spent on programs that incentivize farmers to grow a higher-value crop mix, adopt climate-smart technologies or access value chains.¹⁶

Measures to help smallholder farmers diversify toward higher-value crops could help achieve higher agricultural productivity. Diversification toward higher-value crops and export crops is strongly associated with higher productivity, whereas paddy farming is not. This can be seen from figure 18 which shows the district-level variation in productivity (measured as the gross value of output per acre), diversification, export orientation,¹⁷ share of paddy farmers in district, and share of paddy production out of total. Diversification is measured using the Simpson Index of Diversification (SID), which takes into account the share of land devoted to different crops.¹⁸ A low index value indicates low diversification. Multivariate analysis further shows that the positive relationship between productivity and diversification holds after accounting for other factors that influence productivity, including household characteristics (such as household size to proxy own labor supply, household head's education), agricultural inputs, access to land, access to finance, and mechanization.¹⁹

Diversification strategies could be combined with value chain interventions for farmers and agribusinesses. For example, the strong export orientation in some areas shown in figure 18 is primarily associated with smallholder tea production, from which some female farmers have apparently benefited. However, the sector is facing difficulties, including falling productivity, labor shortages, and increased global competition from other tea-producing countries. The wages of estate workers remain at very low levels, often below Rs 20,000 per month. Sri Lanka's diverse agro-climatic conditions hold much potential to generate higher earnings for farmers from the cultivation of a more diversified, higher-value crop mix. Larger agribusinesses can attract private investment and create wage employment that can

15. Estimate using HIES 2016.

16. World Bank (2013) suggested that subsidies could distort market decisions by encouraging the cultivation of paddy and disincentivize movements to other types of agriculture that have more potential for value addition.

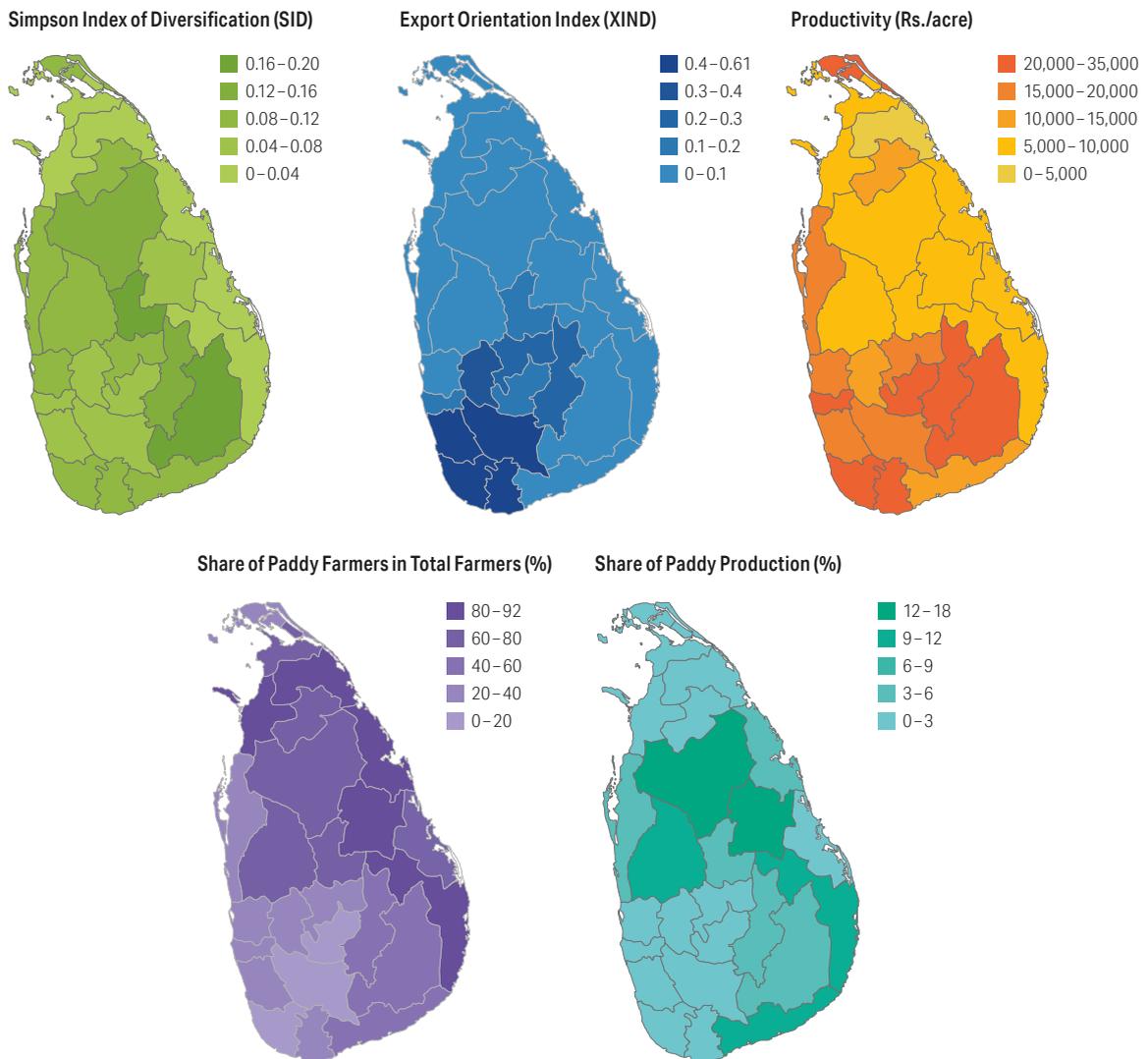
17. Export-orientation is expressed as the relative weight of domestic-oriented and export-oriented crops in a farmer's portfolio. Domestic-oriented crops include paddy and most other food crops, whereas export crops include tea, rubber, and coconut, among others.

18. Livestock activities are excluded.

19. For details of the multivariate analysis, see World Bank (2021a).

be accessed by low-skilled groups, including some youth and women. The boom in the coconut sector coincides with the rise in global demand for various coconut products and could be an example of successful integration into global value chains. Forging better linkages with the tourism sector also holds promise; the benefits to local development can be enhanced if food can be sourced locally and sustainably, and in a way that meets the demands for high-quality foods in the sector.

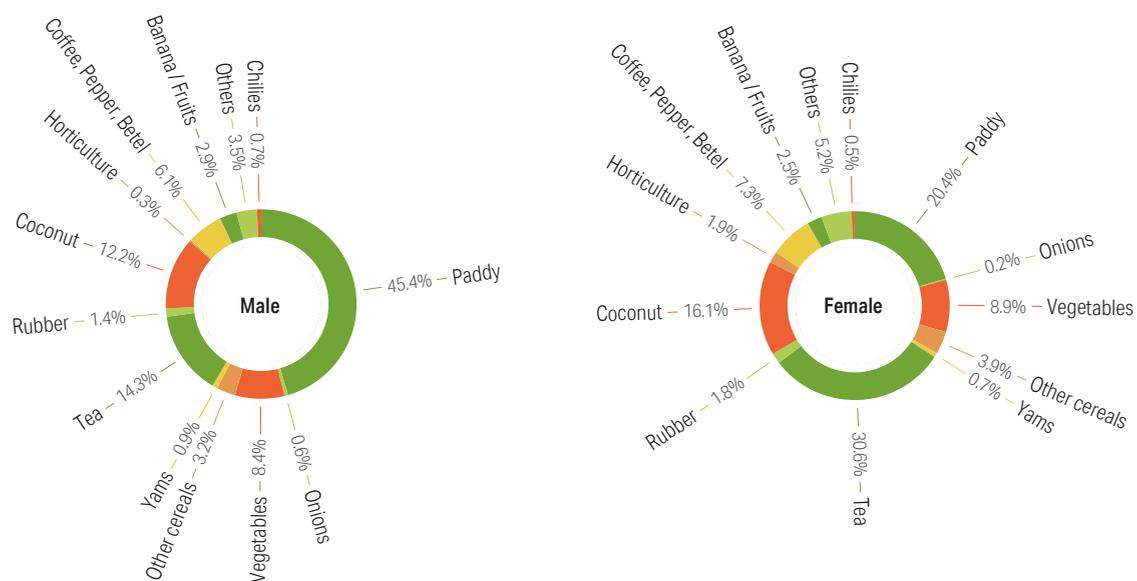
FIGURE 18 District level variation in diversification, export orientation, productivity, share of paddy farmers and share of paddy production in national production



Source: World Bank staff estimation using HIES 2016.

Promoting equitable access to resources can help close the income gap between male and female farmers. Female farmers have higher productivity, but this is mainly attributed to their lower access to land and selection of a more profitable crop mix. Specifically, the inverse relationship between land area and productivity that is commonly found in the literature also applies to Sri Lanka—that is, farmers with less land exhibit higher average productivity.²⁰ As female farmers have less access to land (one acre on average, compared to two acres for male farmers), their productivity measured in output per acre is higher, but this advantage does not translate into higher total earnings because they cultivate less land. This situation suggests that earnings gains can be narrowed by reducing disparities in access to land, inputs, and other resources. With regard to land ownership, besides barriers related to social norms, the land law can be discriminatory against women who opt to be governed by personal laws (Zainudeen 2016). The grant of state land in agricultural settlement schemes under the Land Development Ordinance of 1935 and its subsequent amendments continue to favor men over women because grants are generally made to the male head of the household (Ranaraja 2020). Another issue is that female farmers tend to select crop mix that is less diversified, but more heavily concentrated in export crops such as tea, whereas almost half of male farmers cultivate paddy, making them appear more diversified even though their crop mix is not productivity-enhancing (figure 19). This implies that diversification needs to be promoted selectively.

FIGURE 19 Crop mix by farmers' gender



Source: World Bank staff estimations using HIES 2016.

20. Numerous studies have found this relationship to hold in a variety of contexts. However, the reason for this relationship is not entirely clear, and the literature has not reached a consensus so far: family labor, differences in land quality, and measurement error have all been explored as possible drivers.

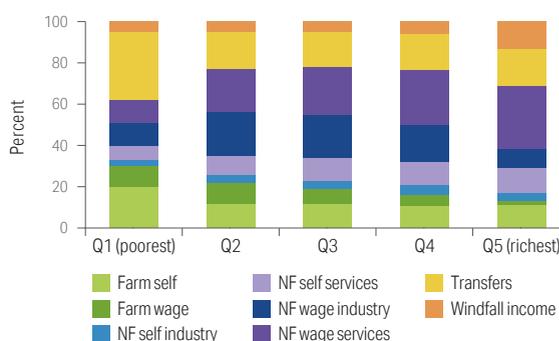
Priority 2. Addressing the constraints to accessing remunerative nonfarm jobs

Increasing access to well-paying nonfarm jobs, particularly in rural areas, will further help poverty reduction and shared prosperity. Livelihoods in rural areas have been increasingly shifting toward industry and services activities, and the growth in nonfarm jobs has occurred mainly in skilled and semi-skilled employment.²¹ Nonfarm income growth was found to have driven recent poverty reduction. This has important implications for the role of the rural nonfarm sector since over 90 percent of the poor live in rural areas and the majority of rural households earn their living from nonfarm sources.

The nature of rural nonfarm activities is quite heterogeneous, while opportunities to diversify within the farm sector appear limited for the poor. The range of economic activities among rural nonfarm workers is diverse, with 17.5 percent engaged in trade-related activities, 11.4 percent in construction, 9.9 percent each in textiles/apparel and public administration, and 8 percent in transport. The distribution of women is slightly different from that of men, with the largest share of working women found in textile/apparel (21.2 percent), followed by trade (17.4 percent), and with a relatively high share in public administration (11.3 percent), education (12 percent), and health care (3.7 percent). This distribution occurs because women are more likely to be employed in the public sector than in the private sector.

Poor households are much more likely to be engaged in wage employment in industries and significantly less likely to be in services than nonpoor households. Poor households tend to specialize in farm activities, and opportunities for off-farm wage employment are rather limited. In terms of income sources, households in the bottom quintile have a high reliance on transfers, also reflecting their lower participation in the labor market. In comparison to poor households, households in the top quintile draw a much higher share and amount of income from nonfarm employment, particularly in the services sector, and from non-labor sources such as windfalls and transfers (figure 20 shows income shares from various sources; figure 21 shows income levels from various sources). Transfers in the top quintile are mainly from pensions, whereas those in the bottom quintile are

FIGURE 20 Income shares from different sources by income quintile

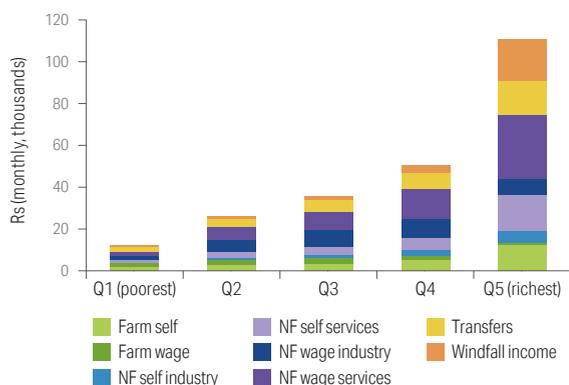


Source: World Bank staff calculation using HIES 2016.

Note: X-axis displays household income quintiles. NF = nonfarm; self = self-employment; wage = wage employment.

21. Skilled employment refers to jobs that are not elementary occupations as per the ISCO classification.

FIGURE 21 Income levels from different sources by income quintile



Source: World Bank staff calculation using HIES 2016.

Note: X-axis displays household income quintiles. NF = nonfarm; self = self-employment; wage = wage employment.

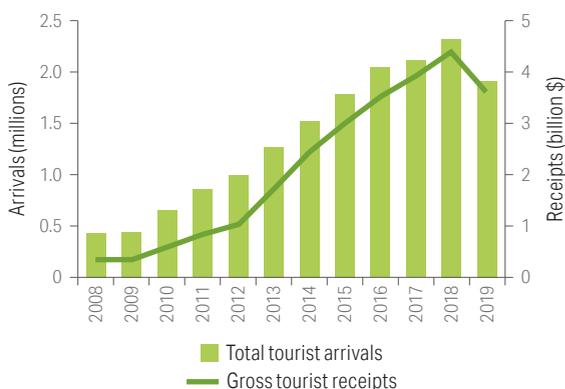
self-employment or wage employment) or unskilled nonfarm employment. This likely reflects a skills barrier to high-paying nonfarm employment. This result echoes findings in the literature from other countries and highlights that not all nonfarm jobs are considered better alternatives to farming. Further, female workers are less likely to participate in nonfarm activities than male workers, while access to land and higher average agricultural productivity in the residing district are also associated with lower nonfarm participation.²²

Among alternatives to farming in rural areas, the tourism sector experienced remarkable growth and became an important source of livelihoods in the last decade. Tourist arrivals more than quadrupled after 2009 (figure 22) and employment in the tourism industry exceeded 400,000 in 2019 (figure 23). To put this in perspective, the export-oriented textile/garment industry employs around half a million workers. Riding this trend, the role of the “sharing economy” has also become more prominent in Sri Lanka, as seen from the rising number of Airbnb rental units available in key tourist destinations and the wide availability of ride-sharing services in major cities. In fact, tourism had become

from various social assistance programs. Notably, incomes from nonfarm self-employment (enterprises) are not necessarily higher than those from wage employment, which is likely due to the prevalence of firms that are small in size and have low productivity levels.

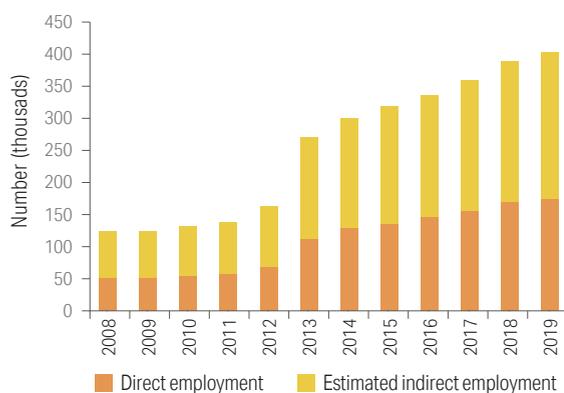
Education emerges as an overall important determinant of participation in nonfarm activities; moreover, there appears to be a skills barrier in moving from farm to better-paying skilled employment. Workers with higher education are more likely to work in skilled nonfarm sectors, while those with lower education are similarly likely to be engaged in farm work (in the form of

FIGURE 22 Tourist arrivals and gross tourist receipts, 2008-19



Source: Central Bank, Economic and Social Statistics of Sri Lanka, various years, <https://www.cbsl.gov.lk/en/publications/other-publications/statistical-publications/economic-and-social-statistics-of-sri-lanka>.

22. Details on this analysis can be found in World Bank (2021e).

FIGURE 23 Employment in the tourism industry, 2008–19

Source: Central Bank, Economic and Social Statistics of Sri Lanka, various years, <https://www.cbsl.gov.lk/en/publications/other-publications/statistical-publications/economic-and-social-statistics-of-sri-lanka>.

cultural heritage, inspiring landscapes, and abundant biodiversity—factors that are particularly apparent in Sri Lanka’s rural areas. Tourism has a long and diversified supply chain, as it includes many different inputs and output activities. Spending by tourists can benefit a wide range of sectors such as small-scale agriculture, handicrafts, and transport and other services, all of which can contribute to poverty reduction (Avilla and Kim 2019). Flexible, part-time jobs can be created in tourism, which would particularly benefit women and help increase Sri Lanka’s persistently low female labor force participation.²³

Priority 3. Raising the quality of jobs, especially in the informal sector

Informal employment is widespread and comes with low job security and inferior working conditions. About 70 percent of workers in Sri Lanka are employed informally as defined by their access to social security. Very few informal workers—less than 4 percent—have permanent contracts, even when working full-time, leaving them in a precarious and vulnerable position. Entitlement to benefits such as paid leave is extremely limited among informal workers. Time-related underemployment is less common, but excessively long work hours pose a significant problem for both formal and informal workers: nearly 20 percent of workers work more than 60 hours per week. This practice is widespread despite regulations that prescribe otherwise. A particularly high incidence of long work hours is found among

the third-largest source of foreign exchange earnings before the COVID-19 outbreak and an important source of livelihoods in rural areas.

The tourism sector has the potential to create a large number of jobs, including for less-skilled groups, and can further propel poverty reduction.

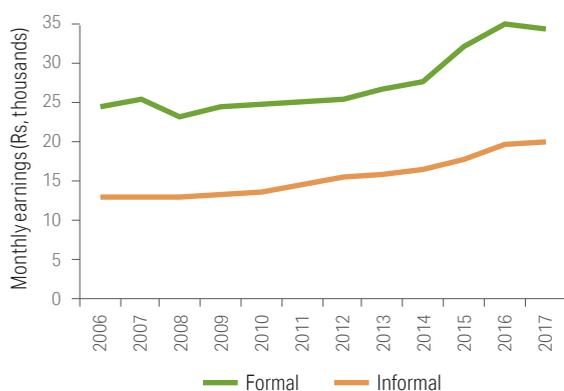
As a labor-intensive industry that requires relatively less capital, tourism provides a range of different employment opportunities across the skills spectrum, especially for the less-skilled groups in the labor force. Tourism-related activities could help households complement their primary source of livelihood, especially in rural areas. Tourism tends to thrive in places that have a warm climate, rich

23. The Ministry of Labour has initiated a discussion with stakeholders regarding the relaxation of restrictions to women’s night time work, which have long been considered a constraint to women’s labor force participation, including in the tourism industry.

the self-employed. While employees working over 45 hours per week can receive overtime payment, it is not clear whether informal workers are entitled to the same.

Informal workers are at higher risk of poverty, but even formal workers face relatively low earnings if they work in the private sector. There is a wide gap in average earnings between formal and informal workers, which has persisted over time (figure 24), and remains even when comparing workers of similar characteristics using multivariate analysis. An Oaxaca decomposition shows that education accounts for an overwhelming share of the wage gap between formal and informal workers, whether it is owing to differences in educational attainment or the returns to the same. The risk of extremely low or inadequate pay is significantly higher for informal workers.²⁴ Open unemployment is not very common in Sri Lanka, and in the absence of a formal unemployment scheme, workers may be pushed into subsistence jobs with very low pay. As of 2017, 27.1 percent of informal workers earned less than the stipulated monthly minimum wage. Among formal workers, 5.8 percent fell under the same threshold. Moreover, averages mask great variation in wages among formal workers, particularly between the private sector and the public sector. The wage distribution of formal private sector workers is actually closer to that of informal workers than public sector workers (figure 25).

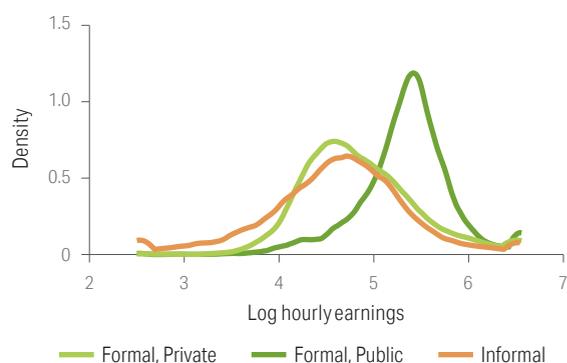
FIGURE 24 Formal-informal wage gap



Source: World Bank staff calculation using Department of Census and Statistics, Labour Force Surveys, 2006–17, <http://www.statistics.gov.lk/LabourForce/StaticInformation/AnnualReports>.

Note: Monthly earnings are in 2017 rupees.

FIGURE 25 Distribution of log hourly earnings of formal and informal employees



Source: World Bank staff calculation using Labour Force Survey 2017.

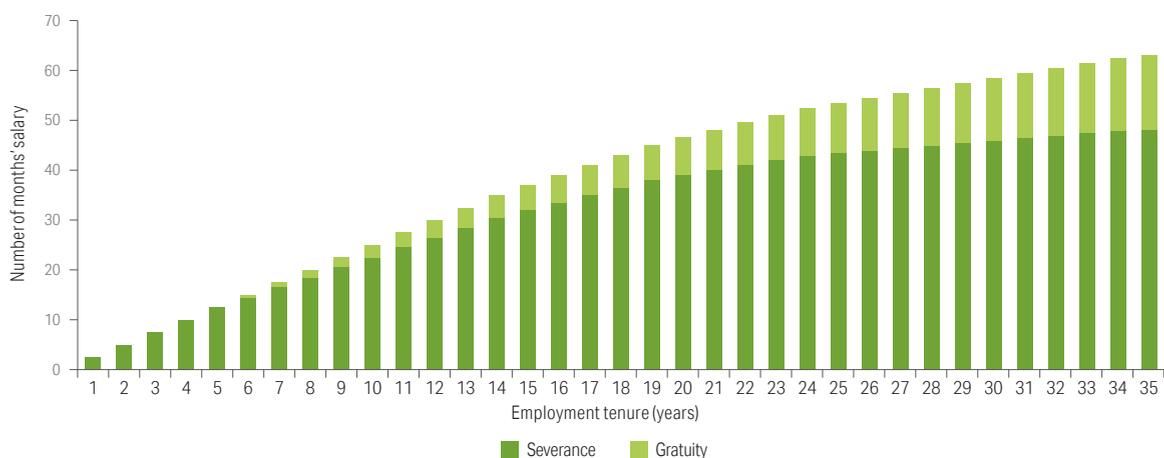
Note: Outliers are excluded.

Stringent labor laws have encouraged informality. The high cost of compliance and complex regulations have been criticized for making it difficult and expensive to dismiss employees (figure 26). The level of compensation payable upon separation presents a heavy burden to employers: for example, a worker

24. Extremely low pay is defined using a cut-off of Rs 12,500 which corresponds to the national minimum wage plus a mandated allowance.

with two years of service would be entitled to a separation payment equivalent to five months' of salary. In fact, Sri Lanka has the second-highest redundancy cost in the world, at 234 weeks of salary, which is significantly higher than Singapore (12 weeks), Malaysia (96 weeks) or Vietnam (98 weeks) (World Bank 2020b). Multiple and overlapping types of coverage for workers create a complex operating environment for firms, making compliance difficult and costly. For example, regulations that govern paid leave and holidays differ depending on whether the workers are covered by the Shop and Office Employees Act (SOEA) or Wages Board Ordinance (WBO) or are employed in the public sector. As a result, the total number of holidays can range from 72 days to 129 days per year. Application and coverage are not always clear.

FIGURE 26 Cumulative compensation payable as severance and gratuity upon dismissal



Source: World Bank 2020b.

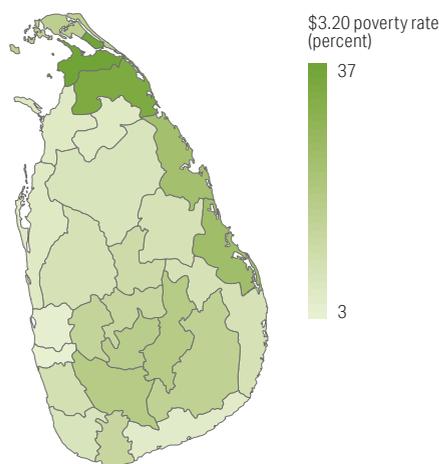
Formalization does not necessarily ease other constraints such as access to credit, reducing the incentive to formalize. The prevalence of the informal sector can be explained by a trade-off between firms' costs for labor and capital: that is, informal firms have higher capital costs and lower labor productivity but can avoid certain labor costs associated with mandated taxes and benefits. While being informal likely precludes firms' access to formal credit institutions, formalization itself does not guarantee easier access because of high collateral requirements and other bureaucratic constraints. The Enterprise Survey for Sri Lanka (World Bank 2012) ranks access to finance as one of the most important challenges to conducting business, second only to "practices of the informal sector." Commercial banks still rely on traditional lending processes, which have different approval stages and require substantial collateral, rather than applying cash flow-based lending processes. The lengthy loan approval process, and the inability of many small and medium enterprises to provide collateral and reliable book records, make lending either unattractive or inaccessible to many creditworthy firms. This means that streamlining the business registration process or reducing registration costs will not suffice to decrease informality. Land tenancy was also cited as a major issue (de Mel, McKenzie, and Woodruff 2011).

Rather than targeting informality itself, reforms could focus on increasing productivity and jobs growth by investing in human capital and building an adequate social protection system. While Sri Lanka performs well on social indicators, there are gaps in human capital achievements. Access to pre-primary education remains a challenge, and investments in socio-emotional skills are relatively low. Learning outcomes are lagging: Sri Lanka children are expected to complete 13.2 years of schooling, but their learning-adjusted years of schooling average only 8.5 years (World Bank 2019b). The skills of the workforce need to better suit the needs of the private sector. Employer surveys show that over 30 percent of first-time job seekers with secondary or technical education are perceived as ill-prepared for their jobs, mainly because they lack required skills or competencies. The workforce also lacks the digital skills needed to compete and become productive in a digitalized economy. Finally, in a context where social safety nets are weak, informal jobs are likely to offer a necessary survival strategy. A well-conceived mix of policies could aim to tackle the causes and consequences of informality together and thereby encourage the creation of high-quality jobs. This effort could also support a resilient post-COVID-19 recovery, as issues related to disruptions in human capital attainment and challenges faced by new labor market entrants will need to be addressed.

Priority 4. Facilitating spatial transformation and strengthening inclusion

Spatial transformation is intrinsically linked to economic transformation, but spatial disparities are high across Sri Lanka. The most lagging provinces, as measured by the level of provincial GDP, are the Northern and Eastern Provinces, which combined contribute less than 10 percent to total GDP. The \$3.20 poverty rates are significantly higher in these regions, with Mullaitivu and Killinochchi in the Northern Province recording poverty rates of over 30 percent. Meanwhile, districts in the North Western and Western Provinces recorded the lowest poverty rates (figure 27). The spatial dimensions of development are closely related to sectoral transformation and the sources of livelihoods. Agriculture accounts for more than 15 percent of provincial GDP in the Northern and Eastern Provinces, which is about double the national average. Smallholder farmers in these regions are more likely to engage in paddy farming and livestock activities than

FIGURE 27 \$3.20 poverty rate in 2016 by district



Source: World Bank staff calculation using HIES 2016.

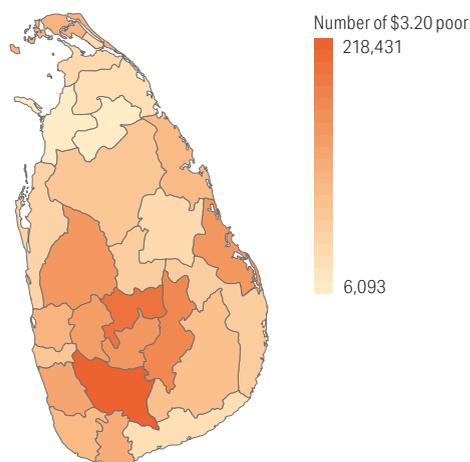
farmers in other regions. Meanwhile, a large number of the poor live in and around the highly rural Highlands. The districts with the highest poverty rates are located in the Northern and Eastern Provinces, but the absolute number of poor is relatively small because of the sparse population in these provinces. On the other hand, the three districts of Ratnapura, Kandy, and Badulla combined account for over a quarter of all the poor (figure 28).

While poverty is predominantly rural in Sri Lanka, urban poverty is less well understood. With an urbanization rate of 18.6 percent in 2019, Sri Lanka would appear to be one of the least urbanized countries in the world.²⁵ However, this figure rests on an

outdated sector classification that relies on administrative boundaries to define urban, rural, and estate sectors and that significantly underestimates the current extent of urbanization. Evidence based on satellite imagery shows that over time, people and economic activities have become increasingly concentrated around a mass of urban agglomerations, particularly along the Kandy-Colombo-Galle corridor (Newhouse et al 2016).²⁶ In practice, this implies that some areas that are currently classified as rural are in fact peri-urban areas with patterns of economic activities and spatial production that resemble those in urban areas. The underestimation of urban poverty could risk overlooking some pockets of poverty that exist in large urban areas and could affect urban and rural planning more broadly.

Market integration has been constrained by lower accessibility in poor regions, though connectivity—an important pillar of regional development—remains a wider issue in predominantly rural places. Road density, defined as the total length of roads per km², is lowest in the Eastern Province (0.24), followed closely by the North Central (0.32), Northern (0.41), and Uva (0.42) Provinces.²⁷ Accessibility and road conditions generally decline with distance from the Western Province. Mobility is further constrained by suboptimal road maintenance and weak public transport services. Release of surplus labor from rural areas and their shift into urban employment is a critical driver of economic transformation behind the scale and agglomeration in urban centers.

FIGURE 28 Number of \$3.20 poor by district



Source: World Bank staff calculation using HIES 2016.

25. World Development Indicators database, “Urban Population (% of total population),” World Bank, Washington, DC (accessed February 10, 2021), <https://data.worldbank.org/indicator/SP.URB.TOTL.IN.ZS>.

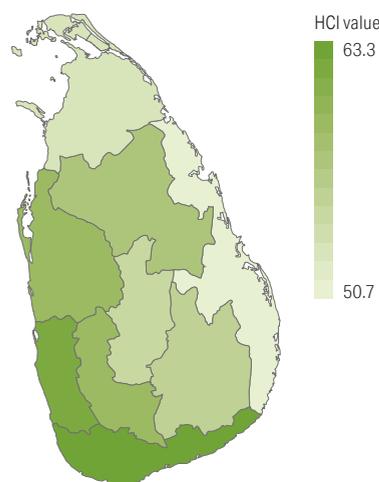
26. Independent studies have suggested that the actual level of urbanization would be around 44 percent (for example, UN Habitat [2018]).

27. Data on road length by province are from National Transport Commission (2017). Data on land area by province are from Central Bank (2019). Roads refer mainly to paved roads and do not include rural roads.

Limited access to opportunities has contributed to out-migration, providing a survival strategy for some poor households, but migration prospects are uncertain in the pandemic context. While migrants originate from all parts of the country, an increasing share has been coming from the Eastern Province in recent years. This out-migration has helped reduce poverty and may be a survival strategy for some households. For example, female migrants look for opportunities overseas to finance the building of a house and to meet education and health needs of their children (ILO 2018). The migration of an adult male household member can come with an additional cost as women’s vulnerabilities are intensified by the breakdown of families. Over 40,000 migrants have reportedly returned since the onset of the pandemic. As re-integration in the local labor market could be uncertain and most of the world is still facing uncertain prospects for the recovery process, these households may be left vulnerable.

Spatial transformation can be supported by better access to basic services, particularly in the areas of education, health care, and water supply, where large gaps remain. Growth can be unbalanced but development still inclusive – as per the conclusion of the World Development Report (World Bank 2009), which emphasizes equitable access to basic services as the cornerstone of spatially inclusive growth. However, there is considerable variation in subnational human capital achievements in Sri Lanka. The Southern Province had the highest Human Capital Index (HCI) value at 63.3 percent, followed by the Western Province at 61.8 percent.²⁸ The lowest scores were observed in the Northern (52.2 percent) and Eastern (50.7) Provinces. The HCI value is inversely correlated with the distance to the Western Province (figure 29). On population health, there has been good progress on mortality-related outcomes, but malnutrition remains an acute issue, particularly in the estate sector: for example, 32 percent of estate children under the age of five were stunted in 2016. Sri Lanka has a universal healthcare system, but public spending on health is low, around 1.5 percent of GDP in 2018. This is lower than Singapore (2.2 percent), Vietnam (2.7 percent), Malaysia (1.9 percent), and Thailand (2.9 percent).²⁹ Increased spending since the COVID-19 pandemic has exerted an additional strain on the system.

FIGURE 29 Human Capital Index by province



Source: World Bank staff illustration using subnational Human Capital Index (HCI) data from World Bank 2019b.

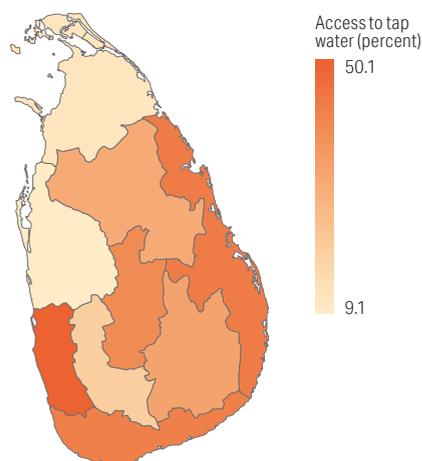
28. The HCI aggregates information from five indicators: child survival, expected years of schooling, harmonized learning outcomes, adult survival and fraction not stunted. The index is expressed in percentage units.

29. Figures for public spending on health are from World Health Organization Global Health Expenditure Database “Domestic General Government Health Expenditure as % of GDP,” <https://apps.who.int/nha/database/Home/Index/en> (accessed February 12, 2021).

Water- and sanitation-related issues remain acute and are a broader challenge across the country.

There are low levels of access to tap water; as of 2016, only 35 percent of the population and 21 percent of the poor had access. The urban-rural gap is particularly large, as almost 80 percent of the urban population have access, compared to only 27 percent of the rural population. Across provinces, access is lowest in the North Western Province (9 percent) and the Northern Province (11 percent), while it is highest in the Western Province (50 percent), followed by the Southern (42 percent) and Eastern (43 percent) Provinces (figure 30). The most common source of drinking water is wells. Absolute water shortages remain a challenge for some households. Almost 11 percent of the poor did not have enough water to drink in the previous year, and about 14 percent of them did not have enough water for bathing and washing.³⁰ Almost all Sri Lankans have access to adequate sanitation, but only 4 percent are connected to a drainage system. Relatedly, waste management remains a significant issue, as almost 80 percent of Sri Lankans burn or dump their garbage. Addressing these gaps can support sustainable and green growth, while also providing opportunities for job creation.

FIGURE 30 Access to tap water by province



Source: World Bank staff estimation using HIES 2016.

The estate sector remains marginalized, with high poverty, poor housing conditions, and less access to basic services than other sectors, and it requires more targeted interventions. Estate sector residents remain one of the most marginalized group in Sri Lanka. The \$3.20 per day poverty rate in the estate sector fell only gradually, from 28.3 percent in 2009/10 to 28 percent in 2012/13 and 25.4 percent in 2016. Estate sector households are behind in virtually all nonmonetary aspects of well-being: housing conditions are poor, with 62 percent living in row houses or line rooms; only 13 percent have tap water at home, and the quality of drinking water is poor, with high levels of contamination; access to education and health services is low—for example, only about half of women who gave birth received prenatal care

30. The slow progress in the water sector has been attributed to institutional complexity and low public expenditure. The National Water Supply and Drainage Board (NWSDB), a state-owned enterprise, is responsible for the provision of water supply in most urban areas. Tariffs are not sufficient to recover costs. Water supply in rural areas is managed by around 4,500 community-based organizations, which suffer from sustainability issues and lack of technical capacity. Water is affordable due to low tariffs: households commit, on average, less than 1 percent of their total budget to water payments. About 20 percent of the urban population does not pay for water. Water subsidies accrue proportionately more among poor households as a share of their budget and are thus progressive, but richer households consume more water and benefit more from them in absolute terms (World Bank 2020c). Priorities would include increasing technical capacity and rationalizing the tariff structure to improve sustainability and support investments in the sector.

(compared to 69 percent among urban women). Child health outcomes continue to underperform, with higher infant mortality rates, malnutrition, and incidence of low birth weight among estate children. Despite high poverty rates, only 8 percent of estate sector residents were covered by Samurdhi. Given the overlapping and complex nature of the challenges and slow progress in the past, concerted efforts and targeted interventions could help make decisive progress.

Finally, economic transformation and inclusion need to be supported by a strong social protection system. The targeting performance of social assistance programs is weak and leakages are high. Pandemic-related mitigation efforts relied mostly on existing delivery systems and further exposed some of the weaknesses of the existing system. Adaptive social protection systems can help build resilience to shocks by investing in the capacity to prepare, cope, and adapt. There have been recent efforts by the government to build better delivery and targeting systems and refine graduation programs. Productive inclusion programs can help the poorest households graduate from social assistance and develop sustainable sources of earnings. Further, while poverty among the elderly is currently low, likely due to high levels of cohabitation with adult children, aging trends and high levels of informality will intensify concerns about the lack of old-age security going forward.



5.

Conclusion and Policy Implications

Sri Lanka has an impressive track record of reducing poverty and sharing prosperity more broadly.

Between 2012/13 and 2016 alone, the \$3.20 poverty rate fell from 16.2 percent to 11 percent, continuing progress from the previous decade. Trends in a range of non-monetary indicators of well-being, such as increased access to basic services like electricity, wider asset ownership, and decreased indebtedness, are suggestive of broader progress, particularly among poor households. However, while growth was inclusive it was less pro-poor: the average per capita consumption growth rate accelerated across the distribution over the same period, but the growth rate of the bottom 40 percent remained below that of the total population.

COVID-19 has led to significant welfare losses and continues to present a formidable challenge to Sri Lanka's economy and people.

Sri Lanka had just started to recover from the Easter Sunday attacks of 2019 when the COVID-19 pandemic hit. The shock came primarily through the labor market, as many vulnerable workers without job security and proper safety nets experienced jobs and earnings losses. Poverty is expected to have increased to 11.7 percent in 2020, though extensive mitigation efforts likely helped absorb some of the impact of the shock. The largest impact was experienced in the services sector, but there was wide variation across subsectors. While the new poor—those who fell into poverty as a result of the pandemic—are more likely to be urban, the COVID-19 crisis does not fundamentally shift the nature of poverty in Sri Lanka.

The potential impact of the COVID-19 crisis on inequality could be significant, particularly as the pandemic likely widened gaps in access to education.

In the short term, the labor market impact has been more severe for poor households and is likely to raise inequality. Moreover, there are still many areas where the impact of the crisis is not well understood. In addition to a widening of gaps in access to education—the result of the closure of schools for much of 2020—the pandemic could reduce social mobility to the extent that better education serves as a ladder out of poverty. In fact, analysis has repeatedly pointed to education as a key determinant of higher productivity and access to better jobs.

Before the COVID-19 outbreak, Sri Lanka experienced a dynamic decade that further transformed the structure of the economy and sources of livelihoods, and the process provides clues about where further economic transformation could come from.

Poverty reduction in recent years was mainly driven by improvements in nonfarm earnings, which is consistent with trends in jobs and earnings growth. Economic transformation entails the movement of workers from low- to high-productivity sectors and could help reinforce the drivers behind progress. However, the increase in productivity in Sri Lanka came primarily from increases in within-sector productivity and much less from reallocation effects, implying that workers moved out of agriculture into other sectors of low productivity. Education was highlighted as a key correlated of being engaged in remunerative nonfarm activities and is generally closely associated with access to better jobs. Given this track record, the constraints to economic transformation and poverty reduction are expected to remain broadly valid in a post-COVID-19 world, though some challenges could intensify.

The main message of this report is that maximizing the potential of economic transformation to create more and better jobs will contribute to sustainable poverty reduction and shared prosperity. The priorities for economic transformation are structured around the following four themes: (i) increasing agricultural productivity through diversification; (ii) addressing the constraints to accessing remunerative nonfarm jobs; (iii) raising the quality of jobs, especially in the informal sector; and (iv) facilitating spatial transformation and strengthening inclusion.

The main conclusions and policy recommendations are summarized below.

Increasing agricultural productivity through diversification

- Diversification could benefit poorer farmers, many of whom are engaged in low-productivity paddy farming. Increasing the productivity of paddy and shifting toward a higher-value, export-oriented crop mix would help increase productivity and earnings.
- Agricultural interventions would further benefit from a mix of programs besides the provision of fertilizer subsidies; these programs could incentivize farmers to adopt climate-smart technologies, invest in better agro-logistics, or access value chains.
- Promoting equitable access to farming resources for female farmers can help close the income gap. This includes facilitating access to land as well as other agricultural inputs.

Addressing the constraints to accessing nonfarm jobs

- Education emerged as an overall important determinant of participation in nonfarm activities. That is, greater educational attainment drives households' livelihoods choices toward more remunerative opportunities (including public sector employment), whereas less education results in greater reliance on farm and elementary nonfarm activities. This is relevant because diversification into low-return activities will likely not help increase incomes. Addressing the skills barrier to high-paying nonfarm employment could contribute to better welfare among the poor.
- Tourism has abundant potential to support income growth in rural areas, as it has job-creation potential for the less skilled and requires relatively little investment. Tourism has a long and diversified supply chain, as it includes many different inputs and output activities, such as small-scale agriculture, handicrafts, and transport and other services, all of which can contribute to poverty reduction.

Raising the quality of jobs, especially in the informal sector

- Widespread informal employment is associated with inferior working conditions, limited job security, and heightened risk of poverty due to low earnings. Yet given the complex operating environment for firms created by stringent labor regulations, high cost of compliance, and overlapping regulations, the benefits of formalization may be low if the constraints to accessing finance are not lifted. Reforms could focus on increasing productivity and creating jobs, by addressing the causes and consequences of informality, rather than targeting informality itself. This would also support a resilient recovery in a post-pandemic world.
- Human capital can be further improved by closing the learnings gaps, improving access to higher education, and by investing in skills that can cater to the demands of the private sector, which can in turn help improve labor market outcomes. Education is also highlighted as a major factor that explains an overwhelming share of the wage gap between formal and informal workers.

Facilitating spatial transformation and strengthening inclusion

- Spatial transformation is intrinsically linked to economic transformation. The cornerstone of spatial transformation and inclusion lies in strengthening public service delivery, particularly in education, health care and water supply, where the biggest gaps remain. Lagging regions perform more poorly in these areas.
- A strong social protection system can contribute to economic transformation. Improving the targeting performance of the programs and making the system more adaptive can help build resilience to shocks among the poor and vulnerable.

Sri Lanka faces a challenging road ahead with the country and the world still in the midst of the COVID-19 pandemic. Containing the health crisis remains a prerequisite for returning to normalcy, and as uncertainties about the path to recovery could be a long one. Sri Lanka's economy is expected to gradually recover, with a projected GDP growth rate of 3.4 percent in 2021. The share of people living on less than \$3.20 per day is expected to decline accordingly to 10.9 percent. While the newly poor in Sri Lanka are more urban and slightly more educated than the old poor, COVID-19 did not fundamentally change the nature of poverty in the country.

Restoring lost livelihoods and creating new ones will be critical for a resilient and sustainable recovery, which can be facilitated by the priorities to accelerate economic transformation. While the new poor are more urban and slightly more educated, the nature of poverty did not fundamentally change since COVID-19. An immediate priority for resilient recovery will likely be to bring back jobs and livelihoods.

Policy measures could aim to strike a balance between those that support the recovery and those that aim to include the most vulnerable in the recovery process. The latter could be supported by efforts to reverse the impact of the pandemic and mitigate its consequences for long-run inequality. The crisis is also occurring at a time when several other mega trends are emerging in Sri Lanka—these include the demographic transition to an aging society and anticipated changes to the nature of work brought about by digital technology. These underlying trends reinforce the imperative for establishing conditions to create more and better jobs and thus contribute to sustainable poverty reduction and shared prosperity.

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