# Sri Lanka Systematic Country Diagnostic Update

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## Abbreviations

CBSL	Central Bank of Sri Lanka
CEB	Ceylon Electricity Board
EPI	Environmental Performance Index
FDI	foreign direct investment
GDP	gross domestic product
GHG	greenhouse gas
GRID	green, resilient, and inclusive development
HEC	human-elephant conflict
HIES	Household Income and Expenditure Survey
IMF	International Monetary Fund
kW	kilowatt
kWh	kilowatt-hour
LFC	licensed finance company
MSMEs	micro, small, and medium enterprises
NAO	National Audit Office
NCD	noncommunicable disease
NCRE	nonconventional renewable energy
NDC	Nationally Determined Contribution
PIMA	Public Investment Management Assessment
PPG	public and publicly guaranteed
PPP	public-private partnership
SCD	Systematic Country Diagnostic
SMEs	small and medium enterprises
SOBE	state-owned business enterprise
USc/kWh	US cents/kilowatt-hour
VAT	value added tax

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### **Executive Summary**

This Systemic Country Diagnostic (SCD) for Sri Lanka was conducted as an update of the preceding (2015) SCD, which was comprehensive and presented a broad development narrative that remains valid.<sup>1</sup> The 2021 SCD (SCD Update) (i) reflects the main developments since the SCD of 2015 by updating key indicators and incorporating new analytical work; (ii) includes in-depth analyses of key changes that exacerbate existing structural weaknesses or constrain socioeconomic inclusion; and (iii) revises the prioritization of constraints in light of the COVID-19 pandemic. The document does not intend to deliver an exhaustive analysis at the sectoral level, as the 2015 SCD did, but instead discusses key sectoral issues with a focus on recent developments. The SCD Update will serve as the reference point for consultations when developing the Country Partnership Framework.

The SCD Update recognizes Sri Lanka's strong progress toward achieving poverty reduction and shared prosperity in the last decades, but notes that this is threatened by slow reforms and the COVID-19 pandemic. The economy grew fast after the end of war in 2009, although the momentum has decelerated in recent years. Poverty fell significantly, reflecting the growth trajectory. Sri Lanka's human capital outcomes have historically compared favorably with those of other middle-income countries. The country enjoys near universal electrification, high mobile/internet penetration, and a relatively robust physical infrastructure compared to its South Asian peers. While sustained poverty reduction and shared prosperity require more and better jobs, in recent years there has been slow progress in structural reforms to shift the growth model toward wider private sector participation, export orientation, and integration into global value chains. Some reforms, including the progress toward revenue-led fiscal consolidation, have been reversed. In addition, economic activity has been disrupted by frequent macroeconomic shocks, including a political crisis in 2018 and the Easter Sunday attacks in 2019. The impact of the COVD-19 pandemic is threatening to wipe out past welfare gains and widen inequalities.

**Several challenges have become more pronounced due to the COVID-19 pandemic**. The SCD Update finds that ensuring macroeconomic stability, improving competitiveness for stronger private sector–led growth and job creation, enhancing inclusion of the poor and vulnerable, ensuring environmental sustainability, and improving governance—all priorities identified by the 2015 SCD—will be critical for Sri Lanka to reach higher growth, accelerate poverty reduction, and promote shared prosperity. It also identifies important shifts in the underlying constraints, mainly in the context of the COVID-19 crisis, which have led several challenges to gain more prominence:

- The risks to macroeconomic stability have heightened significantly. Debt sustainability has become the most critical challenge amid high fiscal deficits, constrained market access, and large refinancing requirements. Reducing debt vulnerabilities and restoring fiscal and external buffers remain front and center in the policy agenda.
- The competitiveness of the private sector has been further impeded. The impact of the COVID-19 crisis on businesses was severe. Key exports were stifled due to weak demand and shortage of inputs, while inward orientation has intensified. The emerging tourism sector and micro, small, and medium enterprises (MSMEs) were disproportionately affected. The pandemic likely exacerbated preexisting financial sector vulnerabilities.

<sup>&</sup>lt;sup>1</sup> World Bank, *Sri Lanka—Ending Poverty and Promoting Shared Prosperity: A Systematic Country Diagnostic* (Washington, DC: World Bank, 2015), <u>http://documents.worldbank.org/curated/en/363391467995349383/Sri-Lanka-Ending-poverty-and-promoting-shared-prosperity-a-systematic-country-diagnostic</u>.

- The impact of COVID-19 on human capital could have long-lasting consequences for skills and productivity, thereby affecting labor market outcomes, economic growth, and inequality. Disruptions in schooling affect the poorest the most and will be costly to remedy. A less-skilled labor force could reduce growth potential and worsen labor market outcomes. Difficulties in accessing routine health care services during the pandemic could have long-term consequences for population health outcomes. Moreover, widening disparities in human capital outcomes could decrease social mobility and increase inequality in the longer term.
- The digital divide has come to the fore during the pandemic. Disparities in digital skills and access to digital technology had an impact on numerous fronts: e.g., firms with access to digital platforms were better equipped to respond to the new operating environment; workers with digital access and a job that could be performed from home were less likely to lose incomes; and richer households with digital devices and connectivity were better positioned to help their school-age children continue their education.
- The need to reverse the degradation of natural capital and build resilience to natural disasters, including through restoration and sustainable management of forest landscapes, has become more urgent as natural capital continues to degrade. The lack of action has increased Sri Lanka's vulnerability to natural disasters in recent years.
- Agriculture and rural development could better support poverty reduction. The recent slowdown in agricultural income growth, following a decade of favorable price trends, highlights the importance of productivity-enhancing investments and incentives. Farmers remain vulnerable to droughts, and infrastructure investments are suboptimal. Paddy productivity is significantly lower than productivity for other crops. Food insecurity has been heightened since the onset of the pandemic.

The SCD Update revisits the priorities for achieving poverty reduction and shared prosperity, with a focus on the challenges highlighted during the COVID-19 pandemic. The prioritization lens is aligned with the World Bank Group crisis response framework and with the key dimensions and cross-cutting enablers of the green, resilient, and inclusive development (GRID) approach.<sup>2</sup> The prioritization exercise considers impact on the twin goals, the time horizon for impact, constraints in the operating environment on delivery of results, the strength of the evidence base, complementarities, and whether the constraint is a precondition to unlocking other constraints. Consultations with a diverse set of stakeholders helped validate the priorities. The process led to the selection of the seven priority areas shown in Box 1.

#### **Box 1: Summary of priority reforms**

#### Addressing the fiscal challenge to ensure macroeconomic stability

- Increase revenue to create more fiscal space by addressing gaps in the tax system.
- Improve debt management practices and frameworks to better manage the increasing risks of the debt portfolio.
- Implement a credible, rule-based fiscal framework to strike the right balance between supporting economic recovery and restoring fiscal sustainability/market confidence.
- Improve the efficacy of public expenditures.

#### Fostering competitiveness to accelerate growth and job creation

• Facilitate movement toward an export-oriented and private investment-led growth model by promoting trade and private investment (including foreign direct investment), establishing necessary

<sup>&</sup>lt;sup>2</sup> Under the GRID approach, the key enablers for green, resilient, and inclusive development are (i) investment in all forms of capital; (ii) macroeconomic and structural policies, institutional strengthening, and technology innovation; and (iii) mobilization of capital at scale.

conditions for a knowledge economy, integrating productive local companies into regional and global value chains, and improving value addition through innovation and standards.

- Enhance regulatory quality and transparency and address factor market rigidities (property rights, land, labor and capital markets).
- Modernize and build resilience of the financial sector while gradually exiting from the regulatory forbearance granted amid COVID-19.
- Promote rule of law and maintain policy consistency and predictability.
- Establish a level playing field that eliminates preferential treatment for state-owned business enterprises (SOBEs) and larger long-established companies.
- Improve connectivity (such as backbone infrastructure).
- Strengthen planning, coordination, and institutional frameworks for urban agglomeration.
- Facilitate public-private partnerships (PPPs) in key sectors (infrastructure, health, energy, climate resilience and mitigation), with proper control of associated fiscal risks.

# Strengthening human capital to improve productivity and social inclusion and closing the gap in access to basic services such as safe water

- Expand access to and establish proper regulatory oversight of early childhood education to build long-term foundations for better socioeconomic skills.
- Improve the quality and relevance of education to enhance productivity and help meet the needs of the private sector (by updating the curriculum, expanding demand-driven technical and vocational training offerings, improving the effectiveness of teachers).
- Mainstream soft skills such as problem solving into the school curriculum.
- Invest in digital literacy and advanced skills.
- Address the implications of the disruptions to schooling and training owing to COVID-19.
- Expand access to safe water and adequate sanitation.

#### Supporting vulnerable groups and lagging regions

- During the recovery process, offer stronger support to vulnerable groups (such as women and youth) who have weaker labor market attachment.
- Encourage child care and elderly care provision through accreditation and PPPs, and eliminate gender-based discrimination in regulations that discourage the hiring of women.
- Conduct public information campaigns to neutralize gender differences in occupations or sectors.
- Broaden career aspirations and promote a focus on entrepreneurship and personal agency to enhance the capacity of vulnerable groups, including women and youth.
- Improve the adequacy and coverage of social assistance programs.
- Implement targeted interventions to help those living in the poorest areas.
- Improve the productivity in the plantation sector to raise the wages of estate workers, and invest to improve their access to basic services.

#### Promoting productivity-enhancing investments in agriculture and sustainable rural businesses

- Support farmers to help them shift production to higher-value crops, improve the productivity of paddy, and gain better access to value chains.
- Adopt climate-resilient agriculture practices and technologies (e.g., more efficient water use), including leveraging of private sector solutions.
- Adopt new technologies, digitalization, and improved agronomic and quality standards.
- Restore natural resources within forest landscapes and biodiversity conservation and generate sustainable green jobs in rural areas.
- Build a more diversified livelihoods portfolio and asset base to support the rural poor (e.g., through tourism).

#### Managing natural capital and building resilience to climate change

- Promote participatory planning, strong implementation, institutional capacity development, and adequate funding to support better management of natural resources.
- Improve forecasting and the early warning system to conduct impact-based forecasting and warning services; improve the use of climate information and seasonal predictions for water resource management, agriculture, and other climate service users.
- Invest in risk financing and resilient infrastructure.
- Make social safety nets more shock-responsive by combining social protection interventions with disaster risk management.

# Strengthening governance and public financial management to enhance service delivery, accountability, and transparency

- Improve the public investment management processes.
- Make progress on e-procurement.
- Enhance the effectiveness and accountability of public expenditure and public financial management.
- Strengthen corporate governance of SOBEs.
- Ensure checks and balances among the three arms of the state (executive, legislature, and judiciary).
- Promote citizen-centric digital government services.

### Introduction

**Sri Lanka has made significant socioeconomic progress in the last decades, but slow reforms and the COVID-19 pandemic are threatening further progress.** After the end of the civil war in 2009, between 2010 and 2019, the economy grew at an average of 5.3 percent, though there were signs of deceleration in recent years. The US\$3.20 poverty rate fell significantly, from 16.2 percent in 2012/13 to 11 percent in 2016, and it is projected to have fallen further prior to the COVID-19 crisis. However, the COVID-19 pandemic is exerting a profound, long-lasting impact on output, the labor market, and poverty. Sri Lanka's human capital outcomes have historically compared favorably with those of other middle-income countries, but severe disruptions to education and health care systems during the pandemic could wipe out past gains and widen disparities in outcomes. Sri Lanka entered the pandemic in a challenging fiscal position due to persistently high fiscal deficits and debt. Constrained market access due to rating downgrades amid the pandemic remains a key challenge for Sri Lanka as its debt repayment profile requires the country to access financial markets frequently.

# The Systematic Country Diagnostic (SCD), completed in 2015, identified five key structural constraints: fiscal, competitiveness, inclusion, and sustainability challenges, plus governance as a cross-cutting issue:<sup>3</sup>

- Low domestic revenue mobilization is an important challenge to fiscal sustainability and sustained development. A weak fiscal position constrains the government's ability to implement countercyclical policies.
- A weak business environment, insufficient infrastructure, and limited integration into the global economy constrain competitiveness. A shift of the growth model toward wider private sector participation in commercially viable economic segments and greater export orientation could create more and better jobs. Such a growth model could also help crowd in private investments, including foreign direct investment (FDI), and integrate Sri Lanka's economy into global value chains.
- Social inclusion is constrained by weak equality of opportunity, high spatial concentration of poverty, and low inclusion of vulnerable groups such as ethnic minorities and women.
- Governance-related challenges, including distortions in factor markets, constitute a fundamental constraint to progress on the twin goals of poverty reduction and shared prosperity. Improved regulatory governance, efficient and effective public spending, and better service delivery for equal opportunities were identified as central governance challenges.
- Environmental sustainability and sustained peace were identified as sine qua non for continued investment, growth, and the well-being of the population.

**Progress on structural reforms has been slow since 2015, and the COVID-19-induced crisis has exacerbated preexisting development challenges.** The pandemic caused real gross domestic product (GDP) to contract and severely impacted livelihoods. The impacts of COVID-19 on government revenue and expenditures, along with the effect of a pre-COVID stimulus package, have elevated risks to debt sustainability. New import restrictions (imposed with a view to reduce the pressure on the exchange rate) have further weakened trade performance and increased inward orientation. The pandemic likely elevated the liquidity and solvency risks of the financial sector, although the full impact of COVID-19 cannot yet be observed due to regulatory relaxation. Relief responses revealed long-standing weaknesses of the social assistance system, including the limited capacity of the existing delivery system to expand benefits quickly and effectively to those most affected by the crisis. Overall, the structural constraints to growth and poverty

<sup>&</sup>lt;sup>3</sup> See annex 1 for details on the findings of the 2015 SCD.

reduction that were identified in the first SCD continue to be highly relevant. Moreover, the pace of climate change is more rapid and severe than previously projected.

This SCD Update refreshes the analysis of the 2015 SCD, with a focus on preexisting structural weaknesses that have become more pronounced during the COVID-19 crisis. The key narrative of the previous SCD continues to be valid: sustained poverty reduction needs to come from more and better jobs that are supported by a strong private sector. The evolution of key issues is described based on the same premise, particularly in light of the pandemic impact and implementation of the cascade approach, which aims to better leverage private sector financing for inclusive growth amid acute fiscal challenges. An important adjustment has been made to the analytical framework: it now aims to incorporate the green, resilient, and inclusive development (GRID) approach that gives greater prominence to environmental sustainability and climate change.<sup>4</sup> In addition, the priorities have been revisited using the prioritization exercise from 2015 as the baseline. Key recent developments, in particular the COVID-19 pandemic, have been assessed against this baseline, building on internal team discussions and external stakeholder consultations.

### **Country Context**

#### **Recent Political Developments**

**Political developments between 2015 and 2019 slowed down reform implementation.** As noted in the 2015 SCD, the country was in the process of major economic and governance reforms after the first Unity Government was formed (by two long-standing rival parties) in 2015. The government's medium-term strategy of 2017 sought to transform Sri Lanka into a knowledge-based, internationally competitive social market economy. The 19th Amendment to the Constitution was introduced to strengthen democratic institutions. Important reforms, such as cost-reflective fuel pricing and the elimination of 1,200 para-tariffs, were implemented.<sup>5</sup> However, disagreements between the two coalition parties led to a political crisis in 2018, which dampened the pace of policy reforms; it was impossible to complete important reforms such as the National Single Window, proposed new laws (relating to the Central Bank and public financial management), restructuring of state-owned business enterprises (SOBEs), and further liberalization of the trade regime. The Easter Sunday attacks in 2019 raised public concerns over national security.

**The presidential election in 2019 led to a change in administration.** The new president's manifesto, "Vistas of Prosperity and Splendour," emphasized the significance of national security. Important cornerstones of the manifesto include friendly and nonaligned foreign policy, a disciplined and law-abiding environment, a people-centric economy with priority for domestic business, a technology-based society, an efficient country free of corruption, and sustainable environment management.<sup>6</sup> In line with the manifesto, the new administration eliminated the fuel price formula, promoted import substitution, and lowered taxes. The 20th Amendment was promulgated to facilitate the delivery of the manifesto through strengthened powers of the president.

<sup>&</sup>lt;sup>4</sup> World Bank Group, "Saving Lives and Livelihoods While Supporting Green, Resilient and Inclusive Development," 2021. https://www.devcommittee.org/sites/dc/files/download/Documents/2021-03/DC2021-0004%20Green%20Resilient%20final.pdf.

<sup>&</sup>lt;sup>5</sup> World Bank, "Performance and Learning Review of the Country Partnership Framework for Sri Lanka for the Period FY17–FY21," Report no. 135126-LK, 2019.

<sup>&</sup>lt;sup>6</sup> The manifesto is available at <u>http://www.doc.gov.lk/images/pdf/NationalPolicyframeworkEN/FinalDovVer02-English.pdf</u>.

#### Recent Trends in Growth and Poverty Reduction

**Growth had slowed down markedly prior to the COVID-19 crisis.** The average real GDP growth rate declined to 3.7 percent between 2015 and 2019, compared to a 6.8 percent growth rate recorded between 2010 and 2014. The decline occurred as growth momentum from a peace dividend and a policy thrust toward reconstruction faded away. In addition to the structural weaknesses identified in the 2015 SCD, frequent external shocks adversely affected growth, including inclement weather in 2016 and 2017, a political crisis in late 2018, and the Easter Sunday attacks in 2019. Real GDP growth slowed to 2.3 percent in 2019, the lowest rate in two decades. The significant economic slowdown was broad-based, driven by lower production in industry and service sectors and weaker growth in private consumption and investment (Figure 1).



Figure 1: Growth deceleration (expenditure side)

Figure 2: Trends in poverty and inequality

Sources: Department of Census and Statistics; World Bank staff calculations. Source: World Bank staff calculation using Household Income and Expenditure Survey (HIES) data.

*Note:* The HIES is conducted by the Department of Census and Statistics (DCS); annual surveys can be found on the DCS website at <a href="http://www.statistics.gov.lk/page.asp?page=Income%20and%20Expenditure">http://www.statistics.gov.lk/page.asp?page=Income%20and%20Expenditure</a>.

Labor reallocation from agriculture to industry and services has continued, but job creation has been slow. Between 2012 and 2019, the share of workers engaged in agriculture declined from 31.2 percent to 25.3 percent, whereas there was an increase in the share employed in industry (from 25.9 percent to 27.6 percent) and in services (from 42.9 percent to 47.1 percent). Average earnings grew at over 11 percent per year between 2013 and 2016. While the economy added nearly 100,000 jobs per year between 2012 and 2019, labor force participation was stagnant and particularly low among females. The quality of jobs also remains low; around 70 percent of all jobs are informal, with more precarious employment arrangements, inferior working conditions, and significantly lower earnings that elevate the risk of poverty.<sup>7</sup>

**Reflecting the improvements in labor incomes, poverty fell significantly between 2012/13 and 2016, and further improvements are estimated to have taken place through 2019**. The US\$3.20 poverty headcount, which was 19.4 percent in 2009/10, fell to 16.2 percent in 2012/13 and to 11 percent in 2016 (Figure 2).<sup>8</sup> Growth was relatively inclusive, though not pro-poor: average per capita consumption growth

<sup>&</sup>lt;sup>7</sup> World Bank, "Informal Employment, Job Quality, and Welfare in Sri Lanka," World Bank, Washington, DC, 2020, <u>https://openknowledge.worldbank.org/handle/10986/34399</u>.

<sup>&</sup>lt;sup>8</sup> World Bank, "Sri Lanka Poverty Assessment," World Bank, Washington, DC, forthcoming.

of the bottom 40 percent increased by an annualized 4.2 percent between 2012/13 and 2016, a level slightly lower than that of the total population. Improvements in welfare conditions mainly reflected within-sector productivity improvements, which likely led to earnings growth from nonfarm sources,<sup>9</sup> while agricultural earnings growth slowed down. Projections using the latest available household survey data (from 2016) suggest that poverty further decreased in the years leading up to the COVID-19 crisis, reaching 9.2 percent in 2019.

The poor are highly likely to live in rural areas, and tend to be less educated, with inferior labor market outcomes. About 92 percent of the poor live in rural areas, though an outdated sector classification that relies on administrative boundaries likely underestimates the true extent of urbanization in Sri Lanka. The country has historically excelled in human capital outcomes, but the gap in education between the poor and nonpoor remains large: among working-age adults, nearly 90 percent of the poor achieved primary education or less, compared to less than 70 percent of the nonpoor. Poor households have proportionately fewer working adults, who are also more likely to be working in the low-paying agriculture sector. Poor households are also larger on average, with a higher dependency ratio than nonpoor households.

#### Box 2: COVID-19

**Sri Lanka contained two waves of COVID-19 between March 2020 and April 2021 relatively well.** When the first domestic cases of COVID-19 were reported in March 2020, the government rapidly scaled up containment measures. Tourist arrivals were suspended, and an island-wide curfew was implemented from mid-March through June 2020. These measures, combined with rigorous case finding, contact tracing, and quarantine and isolation, contained the first wave successfully, with only 3,380 cases and 13 deaths reported by September 30, 2020. The country faced a second wave of infections from the last quarter of 2020 through the first quarter of 2021. During this second wave, the government resorted to targeted lockdowns instead of island-wide curfews to minimize the impact on economic activity.



The country has been struggling to contain the spread of the virus since the Delta variant began spreading in June 2021. By end-2021, the total number of COVID-19 cases and COVID-19 deaths stood at 587,245 and 14,979 respectively. The government is focused on an expeditious vaccination process. Above 63 percent of the total population had been fully vaccinated by end-2021.

<sup>&</sup>lt;sup>9</sup> World Bank, "Sri Lanka Poverty Assessment," World Bank, Washington, DC, forthcoming.

The COVID-19 crisis caused a significant economic contraction and welfare losses. In 2020, Sri Lanka's economy contracted by 3.6 percent, the worst performance on record, due to declining export earnings (tourism, textiles, tea) and subdued private consumption and investment. Mobility restrictions, weak demand, and input shortages together severely affected activities in most sectors. Losses in jobs and earnings were widespread: a rapid phone survey conducted in late 2020 found severe short-term labor market impacts, with almost 60 percent of workers facing deteriorating labor market conditions.<sup>10</sup> While various livelihood support measures by the government likely helped buffer the shock, the US\$3.20 poverty rate is expected to have increased to 11.7 percent in 2020. Short-term inequality is expected to have deteriorated as poor households suffered disproportionately larger income losses. The pandemic also revealed a significant digital divide: disparities in digital skills and access to digital technology led to very different responses of businesses and households, many of whom were ill-equipped to deal with mobility restrictions and social distancing. Widespread disruptions to education and training are expected to worsen existing inequalities and have long-term consequences for social mobility. With the third wave still ongoing (Box 2), the full impact of the pandemic on the economy, livelihoods, and welfare is yet to be seen.

### **Constraints to Ending Poverty and Promoting Shared Prosperity**

#### 1. Challenges to Promoting Fiscal Sustainability

#### Sri Lanka was faced with a challenging fiscal and debt situation prior to the COVID-19 pandemic.

Sri Lanka's weak government revenue mobilization, the major source of fiscal vulnerability, has not significantly improved since 2015. Despite low public expenditures, fiscal deficits in Sri Lanka are relatively high due to very low revenue generation (Figure 3 and Figure 4).<sup>11, 12</sup> Between 2015 and 2019, Sri Lanka was in around the 94th percentile globally in average revenue collection. The country collects much less than its potential of almost 16 percent of GDP.<sup>13</sup> Although tax collection as a share of GDP increased to 12.0 percent in 2018 (from 10.1 percent in 2014) thanks to VAT (value added tax) amendments<sup>14</sup> and a new Inland Revenue Act, it declined back to 11.6 percent of GDP in 2019, partially reflecting the impact of the Easter Sunday attacks.<sup>15</sup> The revenue structure remained broadly unchanged from 2015, with the tax system characterized by (i) a reliance on distortionary taxes; (ii) comparatively low redistributive effects of fiscal policy, driven by low direct tax revenue and a substantial incidence of indirect taxes on the bottom 40 percent; (iii) an eroded base and a compliance gap in VAT; and (iv) low income tax thresholds.<sup>16</sup>

<sup>&</sup>lt;sup>10</sup> The World Bank conducted a rapid phone monitoring survey in Sri Lanka between September and December 2020. The primary aim of the survey was 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.

<sup>&</sup>lt;sup>11</sup> Sri Lanka's revenue collection as a share of GDP averaged 13.4 percent between 2015 and 2019. For Thailand, Malaysia, and Vietnam, this same metric stood at 21.6 percent, 20.3 percent, and 19.4 percent, respectively. The country's expenditure as a share of GDP averaged 20.2 percent between 2015 and 2019. For Thailand, Malaysia, and Vietnam, this metric stood at 21.7 percent, 23.2 percent, and 22.3 percent, respectively. The government debt as a share of GDP was 86.8 percent in 2019 for Sri Lanka. For Thailand, Malaysia, and Vietnam, this metric stood at 41.1 percent, 57.2 percent, and 43.4.3 percent, respectively.

<sup>&</sup>lt;sup>12</sup> Between 2015 and 2019, the annual average fiscal deficit remained high, at 6.7 percent of GDP.

<sup>&</sup>lt;sup>13</sup> World Bank, "Sri Lanka Public Expenditure Review (Public finance)," 2019.

<sup>&</sup>lt;sup>14</sup> The VAT rate was increased by four percentage points and some exemptions were removed in 2016.

<sup>&</sup>lt;sup>15</sup> The IMF (International Monetary Fund) Extended Fund Facility (EFF) Program, which supported Sri Lanka's efforts on revenueled fiscal consolidation between 2016 and 2019, expired in June 2020 without renewal.

<sup>&</sup>lt;sup>16</sup> World Bank, "Sri Lanka Public Expenditure Review (Public finance)," 2019.

Figure 3: Average revenue and primary expenditure, 2015–19

Figure 4: Interest cost, fiscal balance, and debt level





Sources: IMF Fiscal Monitor; World Bank staff calculations. Note: L = low-income; LM = lower-middle-income; UM = upper-middle-income; H = high-income.

Sources: Trading Economics; IMF World Economic Outlook; staff calculations.

*Note:* Bubble size corresponds to the government debt–to-GDP ratio, and bubble color shows the credit rating category.

**Debt vulnerability worsened between 2015 and 2019**. Sri Lanka continued to be among the most highly indebted developing nations (90th percentile).<sup>17</sup> As a share of GDP, the public and publicly guaranteed (PPG) debt further rose, from 86.1 percent in 2016 to 94.3 percent in 2019, due to a combination of fiscal deficits, SOBE losses, currency depreciation, high real interest, and decelerating growth. <sup>18</sup> The nonconcessional and commercial component in the foreign currency–denominated debt increased from 47 percent to 58 percent between 2015 and 2019 (Figure 5), elevating fiscal risks from increased refinancing requirements,<sup>19</sup> shortened maturities,<sup>20</sup> higher borrowing costs,<sup>21</sup> and increased exposure to exchange risk.<sup>22</sup> Foreign currency debt service rose from 2.8 percent of GDP in 2014 to 6.3 percent of GDP in 2019 (Figure 6).

<sup>&</sup>lt;sup>17</sup> World Bank, "Sri Lanka Public Expenditure Review (Public finance)," 2020.

<sup>&</sup>lt;sup>18</sup> As a share of GDP, foreign currency-denominated debt increased from 29.4 percent in 2014 to 44.3 percent in 2019.

<sup>&</sup>lt;sup>19</sup> Of the foreign exchange debt outstanding as of end-2020, over a third is expected to fall due within the next four years. Cumulative maturities of bullet repayments on eurobonds from 2021 to 2025 will amount to US\$7.4 billion.

<sup>&</sup>lt;sup>20</sup> Average time to maturity of the external debt declined from 9.2 years in 2010 to 6.3 years in 2019.

<sup>&</sup>lt;sup>21</sup> Average interest cost of foreign currency-denominated debt increased from 3.2 percent in 2015 to 4.2 percent in 2020.

<sup>&</sup>lt;sup>22</sup> Share of foreign currency commercial debt to official reserves increased from 52.1 percent in 2010 to 267.7 in 2019.

# Figure 5: Rising foreign currency-denominated commercial debt



Sources: Central Bank of Sri Lanka; World Bank staff calculations. Note: SLDB = Sri Lanka Development Bond; FM = financial markets.

Sources: Central Bank of Sri Lanka; World Bank staff calculations.

#### The government implemented a fiscal stimulus package in November 2019, right before the COVID-

**19 pandemic.** The stimulus package included a reduction of the VAT rate to 8 percent from 15 percent and an increase of the annual VAT registration threshold on turnover from Rs 12 million to Rs 300 million a year. In addition, the employment income tax–free threshold was increased from Rs 1.2 million to Rs 3.0 million a year, accompanied by additional personal and corporate income tax concessions. The tax measures reversed some important revenue reforms implemented between 2016 and 2019. The government also announced plans to recruit 100,000 low-income earners and 50,000 unemployed graduates to the government service,<sup>23</sup> which would expand the civil service headcount by more than 10 percent.

#### The impact of COVID-19 was a major blow to fiscal and debt sustainability.

The COVID-19 pandemic, together with the adverse impacts on revenue from the stimulus package and lower imports, further worsened Sri Lanka's already fragile fiscal situation. Revenue collection declined to 9.2 percent of GDP in 2020, down from 12.6 percent in 2019, with significant drops in major taxes, including value-added, income, and import taxes.<sup>24</sup> Expenditures increased due to rising public health costs, cash transfers to COVID-19-affected households, and a rising wage bill.<sup>25</sup> Meanwhile, a rigid expenditure structure continued to constrain fiscal space, with interest payments absorbing 71.7 percent of total revenues. Low revenues and rising expenditures sharply widened the fiscal deficit to 11.1 percent of GDP in 2020, further increasing PPG debt to 109.7 percent of GDP (Figure 7 and Figure 8).<sup>26</sup> Total debt service (excluding the Treasury bill rollover) reached an unprecedented level of 141.4 percent of total revenue in 2020.

# Figure 6: Foreign currency–denominated debt service of the central government

<sup>&</sup>lt;sup>23</sup> During 2020, the public service expanded by 100,000 new recruits.

<sup>&</sup>lt;sup>24</sup> As a share of GDP, tax collection declined: VAT from 3.0 percent to 1.6 percent, income tax from 2.8 percent to 1.8 percent, and import taxes from 3.5 percent to 3.1 percent.

<sup>&</sup>lt;sup>25</sup> The government spent an estimated 0.7 percent of GDP in cash transfers to displaced daily workers, affected senior citizens, persons with a disability, and kidney patients, among others. The wage bill increased by 16 percent to 5.3 percent of GDP.

<sup>&</sup>lt;sup>26</sup> Percentages are from World Bank staff calculations based on Central Bank of Sri Lanka, "Annual Report 2020," <u>https://www.cbsl.gov.lk/en/publications/economic-and-financial-reports/annual-reports/annual-report-2020</u>.



**Figure 7: Fiscal balances** 

Figure 8: Drivers of PPG debt



Sources: Central Bank of Sri Lanka; World Bank staff calculations.

Heightened fiscal risks during the COVID-19 crisis have further elevated macroeconomic vulnerabilities. Continued monetization and increasing reliance on the banking sector to finance large deficits have raised concern about inflationary and exchange rate pressures. In 2020, the banking sector, including the Central Bank of Sri Lanka (CBSL), financed 84 percent of the total budget deficit, and CBSL credit to government reached 11.3 percent of GDP (2021) by October 2021 (Error! Reference source not found.). Constrained market access, after a series of sovereign credit downgrades,<sup>27</sup> adds to fiscal vulnerability and elevates debt sustainability concerns, with government's annual foreign currency debt service amounting to approximately US\$6.0–6.5 billion in the coming years. As of end-November 2021, official reserves had already declined to an 11-year low of US\$1.6 billion<sup>28</sup> (equivalent to 1.5 months of imports of goods and services, estimated as of November), due to financial inflows insufficient to meet debt services and other outflows (Figure 10). The Sri Lanka rupee depreciated by 7.5 percent in 2021. However, the parallel market premia have been rising. The CBSL has taken several measures to address a severe liquidity shortage in the foreign exchange market.<sup>29</sup> Depleted net foreign assets in the banking system, including the CBSL, at -US\$4.5 billion by November, suggests increasing challenges in meeting foreign exchange demand.

<sup>&</sup>lt;sup>27</sup> Rating downgrades in 2020 included: (i) Moody's by two notches to Caal with a stable outlook in September; (ii) S&P to B- in September and to CCC+ with a stable outlook in December; and (iii) Fitch to B- in April and to CCC in November. Rating downgrades in 2021 included: (i) Moody's to Caa2 with a stable outlook in October; and (ii) Fitch to CC in December. In January 2022, S&P downgraded to CCC with a negative outlook.

<sup>&</sup>lt;sup>28</sup> This excludes a currency swap of ¥10 billion (US\$1.5 billion equivalent) approved by the People's Bank of China.

<sup>&</sup>lt;sup>29</sup> These include several swap facilities with regional central banks, mandatory conversion requirements for export earnings, and strict capital controls.





Sources: Central Bank of Sri Lanka; World Bank staff calculations.

### Sri Lanka's fiscal rules framework has been ineffective, and its debt management system remains

**weak.** The Fiscal Management Responsibility Act sets limits on the GDP ratio of public debt, fiscal deficit, and sovereign guarantees on a rolling basis. The legal framework also requires responsible fiscal management, prudence in debt management, and public scrutiny of fiscal management (Table 1). However, the ceilings on the fiscal deficit have not been adhered to since the adoption of the act in 2003, and frequent amendments have been made to the fiscal rules on public debt and guarantees to avoid a breach of the ceilings. Meanwhile, Sri Lanka's debt management is inadequate to manage the rising costs and risks of its debt portfolio, which has increasingly relied on commercial external financing. The decades-old legal framework is neither comprehensive nor unified, with fragmented debt management responsibilities across multiple institutions and departments. As a result, debt management lacks a holistic view, covering all related functions from planning to risk management. There is no systematic monitoring and control of the fiscal risks from public-private partnership (PPP) schemes.

Rule	Fiscal Management	Amendment 2013	Amendment	Amendment	
	2003		2016	2021	
Fiscal deficit (as a share of GDP)	Less than 5 percent by 2006 and beyond	Unchanged	Unchanged	Unchanged	
Public debt (as a share of GDP)	Less than 85 percent by 2006 and less than 60 percent by end- 2013	Less than 80 percent by end-2013 and less than 60 percent by 2020	Unchanged	Target of 60 percent extended to 2030	
Treasury guarantees (as a share of GDP based on three-year moving average GDP)	Less than 4.5 percent	7.5 percent	10 percent	15 percent	

#### Table 1: Fiscal rules framework

Moreover, a fast-aging population adds important challenges to growth and fiscal sustainability. Sri Lanka's demographic transition has started earlier than that of its regional peers; the country faces the risk

of getting old before getting rich, as its demographic window is expected to close by 2025.<sup>30</sup> The share of the working age population peaked in 2005 and is gradually declining. The old-age dependency ratio is expected to increase substantially between 2020 and 2050, from 17 percent to 38 percent. The reduction in the number of people engaged in economic activity could lower economic growth and government revenues. Health care spending is expected to gradually increase with age,<sup>31,32</sup> whereas spending on education, concentrated at younger ages, may fall.<sup>33</sup> An unfunded (noncontributory) public sector pension scheme will exert pressure on the government budget in the medium to long term. More resources would also be required to fund old-age income protection for the vast majority of the population, who lack retirement coverage; existing schemes are inadequate to protect them from old-age poverty.<sup>34</sup>

#### 2. Challenges to Fostering Competitiveness for Growth and Job Creation

# Strong inward orientation and lack of a level playing field are not conducive to a resilient and sustained recovery from the COVID-19 crisis led by private sector.

As a relatively small but strategically located country, Sri Lanka needs to move toward an exportoriented and private investment–led growth model to sustain growth. The inward orientation of past growth is unlikely to remain adequate for sustainable growth in the coming decade, as seen in the main drivers of the recent growth performance.<sup>35</sup> The inward-oriented growth model has been unable to generate adequate exports and build foreign currency reserves. On the other hand, the government is unable to drive growth through public investment due to limited fiscal space, warranting a more vibrant and resilient private sector as the main driver of growth.

However, private sector-led growth has been impeded by several challenges, including a weak business environment, and there has been little improvement on this front. Major constraints hindering private sector growth include (i) excessive regulation and trade barriers against market entry and foreign direct investments, (ii) absence of a modern insolvency framework for efficient private sector debt and enterprise restructuring, (iii) high cost of business for outsiders due to policy discretion favoring entrenched players, (iv) rigid labor market regulations and high regulatory compliance costs that undermine formalization, (v) weak contract enforcement and the absence of modern property registration and a secured transactions framework, which undermines property rights and constrains access to finance for small and medium enterprises (SMEs); (vi) limited access to banking finance,<sup>36</sup> (vii) crowding out of the private sector and SMEs by SOBEs, and (viii) misalignment of quality and availability of skills with private sector needs.

<sup>&</sup>lt;sup>30</sup> The demographic window of opportunity refers to a period during which an expanding working-age population generates a labor supply effect that can propel economic growth and lift income levels higher. The United Nations defines this window as opened when the proportion of youth in the total population falls below 30 percent and the proportion of elderly is below 15 percent.

<sup>&</sup>lt;sup>31</sup> The increase in health care spending with age is a consequence of the increasing share of old-age population and the higher demand and relative cost for health care services toward the end of the life cycle.

<sup>&</sup>lt;sup>32</sup> While the number of deaths among the working-age population has been falling, the share of noncommunicable diseases (NCDs) as causes of death and morbidity is on the rise, with 66 percent of adult deaths due to NCDs in 2017 (World Bank, "Sri Lanka Country Economic Memorandum," forthcoming.).

<sup>&</sup>lt;sup>33</sup> In the short to medium term, there is a need to improve the overall quality of education and also address existing challenges related to higher education. Meeting these needs may require additional spending to help increase human capital accumulation and better prepare the working population for the challenges facing an upgraded workforce as Sri Lanka progresses in the income ladder.

<sup>&</sup>lt;sup>34</sup> World Bank, "Sri Lanka Country Economic Memorandum," forthcoming.

<sup>&</sup>lt;sup>35</sup> Real GDP expanded by 56 percent from 2010 to 2019, and the top-six sectors contributing to two-thirds of the total growth were nontradables: construction, transport, other personal services, financial services, wholesale and retail, and real estate.

<sup>&</sup>lt;sup>36</sup> Two-thirds of MSMEs consider access to finance as a key constraint for business growth. The absence of a modern secured transactions framework, along with deficiencies in the bankruptcy system, lack of business and credit history, and limited record keeping, are important impediments for SMEs' access to finance.

Limited access to land is another major constraint for private investors, one that also constrains the availability of immovable collateral when applying for credit.<sup>37</sup>

**Moreover, the private sector was severely affected by the COVID-19 crisis in 2020.** The tourism industry, which was recovering from the Easter Sunday attacks in 2019, was hit hard; its earnings plummeted from US\$3.6 billion in 2019 to US\$700 million in 2020.<sup>38</sup> The apparel industry contracted by 11.9 percent, while export earnings from the sector declined by 21.0 percent, to US\$4.4 billion. Firms operating in construction, mining, and several other manufacturing sectors suffered, as the respective sectors contracted by over 10 percent amid weak demand and strict lockdowns. Across sectors, SMEs reported larger contractions than large establishments.<sup>39</sup> Many SMEs also experienced widespread business impacts, including a reduction in demand and sales, and faced difficulty in meeting operating expenses and debt service obligations.<sup>40</sup> Formal businesses received some concessions, including debt moratoria and working capital loans at concessionary rates from banks, but informal businesses, including those in the value chains, received limited support.

Most firms are micro-size or small and characterized by low productivity, while large established firms dominate in the economy. Many micro-size or small firms (mainly operating in the agriculture and service sectors) struggle to compete with old, established firms and grow.<sup>41</sup> Some impediments to growth— such as limited use of technology/innovation, weak market linkages, and inadequate investment—may be inherent to firms' production activities and hence limit their productivity potential. But there may be other impediments related to an unlevel playing field.<sup>42</sup> The large firms are generally more efficient, and some operate at the global production frontier. They are active in key sectors such as transport, apparel, retail, light manufacturing, and tourism. Many are long-established companies that have significant market shares and sometimes have protected positions in their sectors; as a result, they are less affected by complex regulations and competition. In addition, many globally competitive firms, including foreign-owned corporations, operate in export processing zones, allowing them to circumvent restrictive labor regulations and access more efficient trade regimes. In this environment, new firms face extremely tough odds to compete and grow. An unlevel playing field is contributing to low private investment—both foreign and domestic—compared to aspirational peers, despite favorable performance of the apparel, garment, and tourism sectors.<sup>43</sup>

**Trade performance remains below its full potential, further exacerbated by the COVID-19 shock.** Although exports of goods and services increased from 21.0 percent of GDP in 2015 to 23.1 percent of GDP in 2019, the economic contribution of exports remains low relative to Sri Lanka's past performance (Figure 11) and to that of aspirational peers.<sup>44</sup> Weak global demand and domestic supply chain disruptions amid the COVID-19 pandemic further reduced the share of exports in GDP in 2020.<sup>45</sup> The exports basket remains stagnant and the complexity of exports relatively low, with key merchandise exports concentrated

http://www.statistics.gov.lk/Resource/en/NationalAccounts/Special\_note2\_Q2\_2020.

 $\label{eq:https://www.ifc.org/wps/wcm/connect/region__ext_content/ifc_external_corporate_site/south+asia/resources/gendered+impacts+of+covid19+on+small+and+medium+sized+enterprises+in+sri+lanka.$ 

<sup>&</sup>lt;sup>37</sup> The state owns over 80 percent of land. Obtaining land leases is time consuming. The Land Alienation Act of 2014 prohibits foreign individuals and companies from full ownership of land.

<sup>&</sup>lt;sup>38</sup> Tourism receipts were equivalent to 4.3 percent of GDP in 2019.

<sup>&</sup>lt;sup>39</sup> Department of Census and Statistics, "Further Explanation about GDP and the Economic Growth Rate in the Second Quarter of 2020," Department of Census and Statistics, 2020,

<sup>&</sup>lt;sup>40</sup> International Finance Corporation, "Gendered Impacts of COVID-19 on Small and Medium-Sized Enterprises in Sri Lanka," International Finance Corporation, Washington DC, 2020,

<sup>&</sup>lt;sup>41</sup> World Bank, "Sri Lanka Country Economic Memorandum," forthcoming.

<sup>&</sup>lt;sup>42</sup> World Bank, "Jobs Diagnostic Sri Lanka," World Bank, Washington, DC, 2020.

<sup>&</sup>lt;sup>43</sup> World Bank Group, "Country Private Sector Diagnostic," forthcoming.

<sup>&</sup>lt;sup>44</sup> Exports as a share of GDP in 2019 were as follows: Thailand, 59.7 percent; Malaysia, 65.3 percent; Vietnam, 106.8 percent.

<sup>&</sup>lt;sup>45</sup> Exports as a share of GDP declined to 12.4 percent in 2020.

in textiles, tea, and rubber; the country's exports are thus vulnerable to both sector-specific and global shocks (Figure 12, Figure 13, and Figure 14). Despite its proximity to large markets and global maritime trade routes, Sri Lanka is yet to reap the benefits of regional integration, cooperation, and engagement in value chains, trade, FDI, and marine resources.

A highly restrictive trade regime is a key reason behind Sri Lanka's limited integration into regional and global value chains and its poor export performance. Para-tariffs significantly increase the effective rate of protection because they are predominantly applied on final goods rather than intermediates, creating an anti-export bias and limiting diversification by channeling private investments into protected sectors.<sup>46</sup> When para-tariffs are included, Sri Lanka's nominal rate of protection is much higher (23.6 percent, 2016) than that observed in aspirational peers such as Thailand, Vietnam, and Malaysia. Foreign-sourced inputs, which account for about US\$4 out of US\$5 in imports, are more costly because of excessive taxation and controls at the border. Meanwhile, Sri Lanka's apparel sector has grown to include several moresophisticated product categories, such as knitted apparel and women's apparel. Apparel exports now represent nearly half of the country's total merchandise exports. ICT, specialized manufacturing, and highvalue agribusiness could be better harnessed to grow and diversify the export base.<sup>47</sup> Import restrictions, which were imposed on motor vehicles, agricultural products, and consumer durables in 2020 in response to the severe liquidity shortage in the foreign exchange market, added to the restrictive trade regime. Easing trade restrictions and opening up to regional and global markets will help improve firms' productivity and encourage export market participation and investment decisions, with direct positive implications for sustainable growth and macroeconomic stability.



Sources: Central Bank of Sri Lanka; World Bank staff calculations.

Source: Atlas of Economic Complexity, https://atlas.cid.harvard.edu/.

<sup>&</sup>lt;sup>46</sup> Trade taxes account for approximately 45 percent of the total tax collection.

<sup>&</sup>lt;sup>47</sup> World Bank Group, "Country Private Sector Diagnostic," forthcoming.

Figure 13: Composition of exports as percentage of GDP, 2000





Sources: Central Bank of Sri Lanka; World Bank staff calculations.

Sources: Central Bank of Sri Lanka; World Bank staff calculations.

#### The COVID-19 pandemic has exposed weaknesses in an underdeveloped financial sector.

**Sri Lanka's financial sector grew rapidly but remains underdeveloped.** The GDP share of private credit from the banking sector rose from 31.4 percent in 2015 to 38.6 percent in 2019 but remains low compared to aspirational peers.<sup>48</sup> Banks dominate the financial sector, accounting for two-thirds of the total financial sector assets. Total market capitalization of the Colombo Stock Exchange stood at 19.8 percent of GDP in 2020, which is low relative to aspirational peers.<sup>49</sup> Both corporate debt and equity markets remain underdeveloped, with a limited pool of instruments, issuers, and institutional investors. As a result, the supply of long-term financing for development (for example, for infrastructure) remains weak. An underdeveloped insurance market is an impediment to addressing growing climate and other catastrophic risks as well as economic risks. Broadly, the exposure of the financial sector to the government and to the SOBEs remains high.<sup>50</sup>

**Several reforms that were initiated to deepen and diversify the financial sector still remain incomplete.** These include (i) amendments to the Monetary, Banking, and Insurance Acts; (ii) the Credit Authority Act; (iii) the Securitization Act; (iv) the Secured Transaction Act; (v) institutional reforms for financial regulators; (vi) upgrading of the banking sector's legal, regulatory, and supervisory framework; and (vii) consolidation in the banking sector. The absence of a modern resolution framework for failed financial institutions increases the cost of resolution, undermining market confidence.

Given the limited fiscal space, Sri Lanka significantly relied on the banking sector to support the economy amid the pandemic. The CBSL implemented considerable monetary easing and additional measures to increase liquidity in the market,<sup>51</sup> including the relaxation of financial regulatory measures and a debt moratorium for COVID-19-affected businesses and individuals. Despite these measures, bank lending to the real sector remained low, with private credit from banks growing by only 6.5 percent (year-

<sup>&</sup>lt;sup>48</sup> Private credit as a share of GDP in 2019 stood at 111 percent for Thailand, 121 percent for Malaysia, and 138 percent for Vietnam.
<sup>49</sup> Market capitalization as a share of GDP in 2020 stood at 108 percent for Thailand, 130 percent for Malaysia, and 69 percent for Vietnam.

<sup>&</sup>lt;sup>50</sup> Approximately 42 percent of the assets of the financial sector (banks, nonbank financial institutions, other specialized financial institutions, and contractual savings institutions) were exposed to the government and public corporations as of end-2020.

<sup>&</sup>lt;sup>51</sup> These included a concessionary refinancing facility to support SMEs and a credit guarantee scheme to support COVID-19affected businesses.

on-year) by end-2020. The subdued credit growth reflects deteriorating access to finance for SMEs due to the rising risk aversion of lenders and low demand from both exporters and importers. As access to finance deteriorated, the share of the private sector among banking credit further declined in 2020 (Figure 15).<sup>52</sup> Meanwhile, credit growth to the government and SOBEs climbed to 53.0 and 22.5 percent (year-on-year), respectively, making the public sector the key beneficiary of monetary easing. Of the total bank credit issued in 2020, the private sector absorbed only 20.4 percent, while the government and SOBEs received 79.6 percent.

The pandemic likely exacerbated preexisting financial sector vulnerabilities, although the full impact of COVID-19 cannot yet be observed due to regulatory relaxation. While the regulatory relaxation aimed to support credit supply, it also likely weakened the sector's resilience through lower profitability, rising nonperforming loans, and capital erosion. The moratorium and further extensions on debt repayments and asset foreclosures are likely to elevate liquidity and solvency risks. High exposure limits to group companies concentrate risk, as some large conglomerates borrow up to 30 percent of capital from multiple banks.<sup>53</sup> Stress tests suggest that the banking sector became less resilient during the COVID-19 pandemic, and several banks need to raise capital.<sup>54</sup> Nonbank financial institutions were already weak before the crisis. The problems of licensed finance companies (LFCs) and specialized leasing companies grew in 2020 with rising nonperforming loans (Figure 16), tighter liquidity, and weak financial performance. To support the sector, CBSL relaxed regulatory requirements further and improved LFCs' access to a special liquidity facility under the deposit insurance, managed by the CBSL. While the aggregate capital adequacy indicators of LFCs seem to have improved since June 2020, nonperforming loans and earnings indicators show increased financial stress for LFCs.





Source: Central Bank of Sri Lanka.

<sup>&</sup>lt;sup>52</sup> The share of private credit in total banking sector credit gradually declined, from 75 percent at the beginning of 2000 to 62 percent in 2019, and it reached 53 percent by the end of 2020.

<sup>&</sup>lt;sup>53</sup> These factors call for revisiting the classification of nonperforming assets and related distressed asset recovery programs, along with strengthening capital buffers and leveraging capital market instruments for risk management.

<sup>&</sup>lt;sup>54</sup> Central Bank of Sri Lanka, *Financial System Stability Review 2020* (Colombo: Central Bank of Sri Lanka, 2020), <u>https://www.cbsl.gov.lk/sites/default/files/cbslweb\_documents/publications/fssr/fssr\_2020e1.pdf</u>. This finding was confirmed by the stress test conducted by the World Bank.

# *Physical infrastructure remains underdeveloped, mainly due to lack of investments and low private sector participation, while digital connectivity is relatively robust but could be better harnessed.*

Constraints in logistics and transport connectivity prevent the country from making the most of its strategic location. Sri Lanka's rank in the Logistics Performance Index marginally deteriorated between 2014 and 2018, falling to 94 from 89 out of 160 countries, with lower scores in logistics quality, competence, and timeliness (Figure 17).<sup>55</sup> Inadequate warehousing and transport infrastructure have been key constraints to the development of supply chains. The lack of an integrated strategy to address inefficiencies in the domestic supply chain, low adoption of digital technologies, lack of multimodal connectivity, limited capacity of ports, and the highly fragmented governance structure impede the competitiveness of the logistics sector. Public transport service is weak due to aging fleets, improper service optimization, inadequate use of technology, lack of cost-reflective pricing, and absence of integrated and coordinated urban mobility planning. Weak public transport service incentivizes the use of private vehicles, affecting the environment and increasing congestion and road fatality rates. Road transport accounts for 95 percent of passenger transport and 98 percent of freight. Yet with only 67 percent of provincial roads and 13 percent of local authority roads paved and in good condition, maintenance remains a major challenge due to chronic underfunding and capacity constraints.<sup>56</sup> Private participation in logistics and transportation remains suboptimal, as infrastructure projects are mainly driven by the public sector with external funding. The COVID-19 pandemic is expected to have negatively impacted the transport sector, leading to substantial losses for state and private sector bus operators, port operators, and the national air carrier.

#### Figure 17: Logistics performance: Sri Lanka versus Figure 18: Computer literacy and ownership regional peers (score) Vietnam 2018 Thailand 2018 50 Malaysia 2018 Sri Lanka 2018 45 Sri Lanka 2014 40 Customs 3.5 35 30 Percent Timeliness Infrastructure 25 20 15 10 Tracking and International 5 tracing shipments 0 Urban Rural Estate Logistics quality and competence Computer literacy Ownership of a computer

Source: World Bank, Logistics Performance Index, https://lpi.worldbank.org/. Source: Department of Census and Statistics.

**Meeting the growing energy needs requires mobilizing very large investments.** Between 2015 and 2019, electricity demand grew at an annual rate of 5.7 percent. As generation is at capacity, the latest approved Long-Term Generation Expansion Plan of the Ceylon Electricity Board (CEB) called for additional capacity of 7,222 MW by 2037. In addition, CEB foresees significant investments in the

<sup>&</sup>lt;sup>55</sup> World Bank, Logistics Performance Index, https://lpi.worldbank.org/.

<sup>&</sup>lt;sup>56</sup> World Bank, "Sri Lanka Transport InfraSAP," 2018.

transmission and distribution systems. In total, these investments would need funding of up to US\$7 billion in 2018–26.<sup>57</sup> Public financing has historically been the primary source of financing for power plants owned by the CEB. Larger thermal power projects developed by independent power producers on a build-own-operate-transfer (BOOT) scheme have been mobilizing international financing, but they typically required a sovereign guarantee for CEB's payment obligations. Institutional inefficiencies, lack of cost-reflective pricing, insufficient transparency, and weak implementation capacity make it difficult to promote private participation in the sector. The power transmission and distribution network need to be strengthened to allow for reliable and efficient delivery of power, and to integrate the planned increased power generation, notably nonconventional renewable energy (NCRE) in line with the government's ambitious renewable energy targets. The significant potential for energy efficiency (energy savings in buildings, appliances, and industry, and to lower demand growth) is not fully harnessed yet.

A large share of electricity generation is based on expensive imported fuels, which undermines the financial viability of the sector. NCRE has not been able to scale up utility levels to achieve significantly lower unit costs.<sup>58</sup> Consequently, the cost of electricity generation is high by regional standards (~10.0 USc/kWh in 2019 compared with ~5.5 USc/kWh in India (2016) and ~7.4 USc/kWh in Bangladesh (2019)), reflecting inadequate base load power generation, high share of diesel/heavy fuel oil generation, emergency power procurement, and uncompetitive power purchase agreements with independent power producers or privately managed plants. The CEB is unable to fully recover costs and faces unsustainable losses, creating fiscal contingent liabilities.<sup>59</sup> While there have been several proposals to add liquified natural gas (LNG) as a source to diversify the generation mix and develop gas infrastructure for sectors such as industry and transport, implementation has been slow. Sri Lanka is not connected to regional power markets, though this connection would allow it to benefit from the generation capacity of the region, help it manage and stabilize the power system, and reduce the need for expensive peaking power from liquid fuels.

**Digital connectivity is relatively robust but could be better harnessed to raise growth, diversify the economy, and create better jobs.** Sri Lanka's internet penetration rate (including mobile internet connections) increased from 16 percent in 2014 to 62 percent in 2019.<sup>60</sup> However, fixed broadband penetration<sup>61</sup> remains low at 7.8 percent of the population, and there is a significant urban-rural divide with respect to digital coverage, digital skills, and adoption of more advanced digital services. For example, digital literacy was 61.7 percent in the urban sector, while in the rural and estate sectors it was 43.8 percent and 23.7 percent respectively in 2019.<sup>62</sup> A similar trend is observed for ownership of a computer (Figure 18). Expanding digital connectivity and access, including in rural areas, can help with access to markets,

<sup>&</sup>lt;sup>57</sup> World Bank, "Sri Lanka Transport InfrasSAP," 2018.

<sup>&</sup>lt;sup>58</sup> Hydro and NCRE accounted for approximately one-third of the total generation in 2019 and 2020. As most of the country's hydropower potential has been developed, the share of NCRE needs to grow significantly from the current level of about 5 percent to meet the government's target of 70 percent renewable energy (including hydro) by 2030.

<sup>&</sup>lt;sup>59</sup> In 2018, the average tariff was 11.4 USc/kWh, while the cost of generation and transmission was 11.89 USc/kWh. World Bank and International Finance Corporation, "Sri Lanka Energy InfraSAP," World Bank, Washington, DC, 2019, https://documents1.worldbank.org/curated/zh/843901561438840086/Sri-Lanka-Energy-Infrastructure-Sector-Assessment-

Program-Executive-Summary.docx. IMF estimated that the unrecovered cost amounted to 0.8 percent of GDP (Rs 120 billion) over 2016–18. CEB losses amounted to 0.6 percent of GDP in 2019, and the total debt was of 3.7 percent of GDP (Rs 533 billion). <sup>60</sup> Central Bank of Sri Lanka, "Economic and Social Statistics 2020,"

https://www.cbsl.gov.lk/sites/default/files/cbslweb\_documents/statistics/otherpub/ess\_2020\_e1.pdf.

<sup>&</sup>lt;sup>61</sup> Fixed broadband encompasses any high-speed data transmission to a residence or a business—i.e. a fixed location—using a variety of technologies, including cable, DSL, fiber optics, and wireless. Fixed broadband is usually faster and more stable than mobile broadband, with lower latency. It is the preferred mode of internet connection for businesses and users that require faster and more reliable data transfers.

<sup>&</sup>lt;sup>62</sup> Department of Census and Statistics, "Computer Literacy Statistics–2019 (Annual)," 2019, <u>http://www.statistics.gov.lk/Resource/en/ComputerLiteracy/Bulletins/AnnualBuletinComputerLiteracy-2019</u>.

jobs, and public and private services. A digitally skilled workforce is important to drive innovation, productivity growth, and competitiveness. Moreover, it could catalyze the development of artificial intelligence, machine learning, and data science, building on Sri Lanka's success in the IT-BPO sector.

**Urban agglomeration could drive growth, promote more efficient labor markets, and support knowledge and technology spillovers.** Sri Lanka's urbanization is manifested by the emergence of the economically dominant Western Province and the Kandy–Colombo–Galle multicity agglomeration. Despite covering less than 6 percent of the country's total land area, the Colombo Metro Region houses over 28 percent of Sri Lanka's population and accounts for almost 40 percent of GDP. Yet limited financial and human resources available to municipal and local authorities in the Western Province, combined with poor coordination among agencies, absence of integrated urban planning, and institutional fragmentation and overlapping mandates, hinder the effective delivery of urban public services. Addressing the bottlenecks that inhibit the competitiveness of urban and metropolitan areas could help harness the benefits of agglomeration, spur productivity gains, and lead to the creation of many job opportunities for the rural poor, thereby contributing to inclusive growth.

**Enhancing private financing in key sectors such as infrastructure and urban services is critical in a constrained fiscal environment.** Though there is a long tradition of PPPs in Sri Lanka, an effective PPP model and framework has not been fully implemented. PPPs have been conducted under a set of guidelines, with relatively large discretion in implementation, especially regarding competitive bidding. There is room for improvement in transparency and consistency, especially in processing unsolicited proposals. Implementation of PPPs has also suffered from weak capacity and lack of visibility for potential private investors due to the relatively ad hoc nature of contracting. A national level agency on PPPs could play a critical role to address key constraints in the sector.<sup>63</sup> At the sector level, there have been delays in finalizing project pipelines and setting up PPP projects, constraining the ability to attract private funds.<sup>64</sup> Private sector solutions could be leveraged under urban development engagement to scale up activities for development of efficient and resilient cities.

# Improving human capital and skills is critical to meet the demands of the private sector; but the quality of education remains a key challenge.

A child born in Sri Lanka today will be 60 percent as productive when she grows up as she could be if she enjoyed complete education and full health. These human capital achievements, as measured by the Human Capital Index, are higher than the average for South Asia and lower-middle-income countries.<sup>65</sup> However, there are some persistent challenges: while enrollment in education through grade 10 and 11 is quite high, there is a sharp decline at the advanced level. Only about 4 percent of the population had a bachelor's degree in 2016, reflecting inadequate university education opportunities. Learning outcomes are lagging, and more investments in socio-emotional skills are required to produce a skilled workforce. Children are expected to complete 13.2 years of schooling, but this figure drops to 8.5 years once adjusted for what they learn. Socio-emotional skills help build relationships, solve problems, and resolve conflicts, and they are developed from early childhood to young adulthood. Yet less than half of three- to five-year-

<sup>&</sup>lt;sup>63</sup> Established in 2018, the National Agency for Public Private Partnerships was dissolved in 2020.

<sup>&</sup>lt;sup>64</sup> World Bank Group, "Country Private Sector Diagnostic," forthcoming.

<sup>&</sup>lt;sup>65</sup> World Bank, *The Human Capital Index 2020 Update: Human Capital in the Time of COVID-19* (Washington, DC: World Bank, 2020), <u>https://openknowledge.worldbank.org/handle/10986/34432?cid=GGH e hcpexternal en ext</u>. The Human Capital Index consists of three components that are intended to measure the overall health environment: (i) child survival through age five; (ii) learning-adjusted years of schooling; and (iii) stunting rates and adult survival rates.

old children were enrolled in early childhood education in 2016.<sup>66</sup> While Sri Lanka has a well-established program for maternal and child health with near universal coverage, access to pre-primary education is a challenge that worsened during the pandemic. On health and nutritional outcomes, updated 2016 data revealed improvements in key indicators among children and women over the last decade, but deep-rooted challenges in stunting reflect chronic undernutrition, especially in the estate sector.<sup>67</sup>

There is a significant lack of qualified workers with technical skills. 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, with the majority of respondents pointing to applicants' lack of required skills or competencies.<sup>68</sup> Consultations with education specialists highlighted the need to reform the curriculum, which was perceived to be too prescriptive and exam-oriented. Vocational and technical skills trainings could be more demand-driven and reoriented toward globally marketable jobs. Gender selection into different credential categories unnecessarily restricts the labor market options that female graduates seek, and these effects carry over into persistent segregation in the labor market.<sup>69</sup> There is also a lack of graduates in STEM fields, which is attributed to a shortage of science teachers qualified to teach advanced science subjects and to a lack of resources. The linearity of the education system, which prevents students from pursuing other skills development programs, was identified as a challenge, and the regulatory environment is unable to adequately monitor the quality of private institutions. While other countries permit the private sector to play an important role in the tertiary and vocational education system, in Sri Lanka these segments of the education system are dominated by the state, which is not able to ensure that the labor force has the skills required by the labor market. Proposals to introduce private universities have been met with strong resistance from education professionals.<sup>70</sup>

**COVID-19-related disruptions to education and training are widening disparities in human capital outcomes, with potential long-term consequences for social mobility and inequality**. Schools and universities were closed early in the pandemic. As of February 2021, schools had remained fully closed for 141 out of 220 instruction days (64 percent of planned school time) and partially closed for another 37 days (or 17 percent).<sup>71</sup> These disruptions have wider implications beyond learnings losses—they can lead to early dropout, loss of nutrition, and reductions in future earnings.<sup>72</sup> Distance learning was adopted in various forms, but access to distance learning varied significantly and was especially challenging for less well-off students who had neither a digital device nor connectivity. One survey suggested that only 34 percent of children under 18 had a connected device, and the share among poor rural households was even lower, at

<sup>&</sup>lt;sup>66</sup> World Bank, "Sri Lanka Poverty Assessment," World Bank, Washington, DC, forthcoming.

<sup>&</sup>lt;sup>67</sup> Department of Census and Statistics and Health Sector Development Project, "Demographic and Health Survey 2016," 2017, http://www.statistics.gov.lk/Health/StaticalInformation/DemographicAndHealthSurvey-2016FullReport. The estate sector consists of tea and rubber plantations that were originally set up by British colonists. The sector accounts for 4.4 percent of the population and (Department of Census and Statistics, "Population Housing Census. 2011." http://www.statistics.gov.lk/pophousat/cph2011/index.php?fileName=FinalReportE&gp=Activities&tpl=3) and used to operate in the form of self-sufficient enclaves. Housing is still provided by plantation management, though the provision of social services has been taken over by the government.

<sup>&</sup>lt;sup>68</sup> Department of Census and Statistics, "Sri Lanka Labour Demand Survey 2017," <u>http://repo.statistics.gov.lk/bitstream/handle/1/756/Labour Demand Survey 2017 Report%20%281%29.pdf?sequence=1&isAll</u> owed=y.

<sup>&</sup>lt;sup>69</sup> World Bank, "Jobs Diagnostic Sri Lanka," World Bank, Washington, DC, 2020.

<sup>&</sup>lt;sup>70</sup> World Bank Group, "Country Private Sector Diagnostic," forthcoming.

<sup>&</sup>lt;sup>71</sup> UNICEF database on COVID-19 and School Closures (accessed May 27, 2021), <u>https://data.unicef.org/resources/one-year-of-covid-19-and-school-closures/</u>. Numbers are calculated for the period between March 11, 2020, and February 2, 2021.

<sup>&</sup>lt;sup>72</sup> Talking Economics, "Distance Education During and After COVID-19: Long Road Ahead for Sri Lanka," July 13, 2020, <u>https://www.ips.lk/talkingeconomics/2020/07/13/distance-education-during-and-after-covid-19-long-road-ahead-for-sri-lanka/</u>.

21 percent.<sup>73</sup> Widening inequalities can have significant societal costs and long-term consequences to the extent that education is an important factor for social mobility. These costs and consequences will require more data and analysis to be fully understood.

**COVID-19 has disrupted access to essential health care services, which may further undermine human capital.** Significant resources have been directed toward the response to the COVID-19 pandemic, reducing the capacity to provide routine health care services. Access to non-emergency health care fell due to travel restrictions, reduced service provision, and self-postponement due to fear of contracting the virus at health facilities. Reduced utilization has been particularly prominent in preventive services such as child immunizations and antenatal and postnatal care. Maternal and child nutrition programs could have been missed by around 40 to 65 percent of the eligible population during the lockdown.<sup>74</sup>

#### 3. Challenges to Enhancing Social Inclusion

Progress has been slow in expanding access to economic opportunities to vulnerable groups, who were also disproportionately affected by the COVID-19 crisis.

The COVID-19 crisis had disparate impacts across different population groups amid heightened vulnerabilities. While actual data on recent welfare dynamics are still scarce, simulation-based projections and a rapid monitoring survey conducted in late 2020 suggest that the poor were affected by a disproportionately larger labor market shock, mostly in the form of reduced earnings rather than outright unemployment. This result is not surprising given the large size of the informal workforce. Food insecurity was heightened owing to concerns around the availability and cost of essential items: around 44 percent of households who were part of a COVID-19 phone monitoring survey in late 2020 reported having worried about running out of food in the previous week. The weaknesses of the prevailing social protection system came to the fore during the pandemic: targeting is weak, benefit amounts are inadequate, and the system is not equipped to scale up much-needed assistance during times of crisis. The pandemic also exacerbated long-standing challenges faced by the most vulnerable and disadvantaged groups, in particular women, youth, and those living in lagging regions. Understanding how COVID-19 has shifted their challenges, including in the long term, will be important to support an inclusive recovery process.

Uneven access to economic opportunities is a central constraint to gender inclusion, and the current crisis is expected to widen existing gender gaps. Human capital outcomes in Sri Lanka generally favor women, as they enjoy a longer life expectancy, more years of schooling, and better learning outcomes. However, there are large disparities in accessing labor market opportunities, and female labor force participation has been significantly lower than male participation for decades (Figure 19). Of women in the labor force, many were in low-paid, precarious positions even before the crisis; women's hourly earnings were about 37 percent lower than men's, after controlling for observable characteristics such as education, experience, and sector of activity. Over 80 percent of this gap is driven by different returns to similar characteristics.<sup>75</sup> Strong social norms require women to shoulder most of the burden of household responsibilities; though this role places significant demands on women's time, such unpaid work is often

<sup>&</sup>lt;sup>73</sup> LIRNEasia, "Internet Access for Households with Children under 18 in Sri Lanka Is 34%," May 20, 2020, <u>https://lirneasia.net/2020/05/internet-access-for-households-with-children-under-18-is-34/</u>.

<sup>&</sup>lt;sup>74</sup> UN Sri Lanka, "COVID-19 Crisis Household Impact Telephone Survey Round 1," <u>https://www.unicef.org/srilanka/media/1626/file/UNICEF%20UNDP%20Covid%20Impact%20Telephone%20Survey%20Round</u> <u>%201.pdf</u>.

<sup>&</sup>lt;sup>75</sup> The estimation is based on a Blinder-Oaxaca-type decomposition with Heckman selection. Controls include education, experience, employment status, firm size, sector, occupation, etc.

not recognized.<sup>76</sup> Low access to tap water and low ownership of labor-saving household durables increase the opportunity cost of women's time—e.g., only 53 percent of households owned a refrigerator and only one in five owned a washing machine in 2016. This situation also limits the type of work women can take on, leading them to engage in unpaid family work or small livestock activities that have low returns. With extended school closures, the COVID-19 crisis has increased the care burden of women. However, social norms and attitudes appear to go beyond gendered roles in family care activities and to steer girls and female graduates toward more limited job opportunities.<sup>77</sup>

Access to economic opportunities is highly correlated with the education level of women—for example, highly educated women have a good chance of obtaining prestigious public sector jobs; and labor force participation in this group is almost at parity with men's. However, the unemployment rate for this group tends to be significantly higher than the average (Figure 20), reflecting a widespread preference for secure, well-paying, and safe public sector jobs with pension coverage, and the lack of similarly attractive private sector jobs. Different forms of exclusion are sometimes overlapping: women in the north and east, where opportunities are already fewer than in the rest of the country, have a significantly lower labor force participation rate and are more likely to be heads of the household.

Some elements of the institutional and regulatory framework further aggravate gender disparities, and there has been little progress in voice and agency. There are legal impediments to the equality of property rights, and some labor laws are not supportive of women's access to opportunities: for example, there are no provisions for part-time employment in the labor regulations, and maternity benefits are entirely borne by the employer.<sup>78</sup> Outdated provisions require employers to seek written consent to hire women for nighttime work.<sup>79</sup> Women also continue to be underrepresented in public decision-making domains: Sri Lanka women have the lowest representation in political bodies in South Asia: only 5.3 percent of Sri Lanka legislators are female, compared to 18 percent in neighboring countries. Finally, gender-based violence is widely expected to have worsened in the past year, and before the crisis over 20 percent of women reported having experienced intimate partner violence in their lifetime.<sup>80</sup>

Youth educational attainment and aspirations are rising, but there is a mismatch between career expectations and reality. Youth have increasingly better schooling outcomes, and those with more education have higher labor force participation rates: in 2019, the participation rate of those with a post-secondary qualification and above was around 85 percent and about equal for men and women. However, a strong preference for formal jobs, combined with insufficient interest in upskilling opportunities and entrepreneurship, was identified as a challenge. Youth in lagging regions are further discouraged by the

<sup>&</sup>lt;sup>76</sup> The 19th International Conference of Labour Statisticians (ICLS) standards revised the definitions of employment and unemployment and established a much wider framework for statistics on paid and unpaid work and on labor underutilization. Among others, additional definitions also account for own-use provision of services. A joint International Labour Organization (ILO)-World Bank pilot study of these revised recommendations was conducted in Sri Lanka and found that measuring different forms of work provides a clearer perspective on gender differences than statistics on employment alone. See ILO and World Bank, *Measuring Women's and Men's Work: Main Findings from a Joint ILO and World Bank Study in Sri Lanka* (Washington, DC: World Bank, 2021).

<sup>&</sup>lt;sup>77</sup> World Bank, "Jobs Diagnostic Sri Lanka," World Bank, Washington, DC, 2020.

<sup>&</sup>lt;sup>78</sup> While the majority of the population is covered by the general law, individuals may instead opt to be covered by personal laws, which sometimes favor men over women in matters of inheritance and property rights. Shyamali Ranaraja, "Assessment of Gender Equality and the Legal Framework of Sri Lanka," unpublished background paper. Some researchers have argued that the state and not employers should fund maternity leave benefits to reduce potential discrimination against women in the labor market. Verite Research, "Improving Youth Employment & Entrepreneurship in Sri Lanka: Insights and Strategies," 2020, <u>https://iesc.org/wp-content/uploads/2020/10/Improving-Youth-Employment-Entrepreneurship-in-Sri-Lanka-Insights-and-Strategies-2019\_30.09.2020.pdf</u>.

<sup>&</sup>lt;sup>79</sup> World Bank, "Women, Business, and the Law," https://wbl.worldbank.org/en/data/exploreeconomies/sri-lanka/2021.

<sup>&</sup>lt;sup>80</sup> Social Sustainability and Inclusion GP South Asia, "Sri Lanka Social Inclusion Background Paper," World Bank, 2021.

lack of opportunities available outside of the traditional sectors such as agriculture. Consultations with youth groups brought out the importance of providing training that is better tailored to the needs of the youth and that translates into employable skills (e.g., digital literacy skills, English language proficiency, problem-solving skills), along with support for placement in employment upon completion. High youth unemployment rates, at above 20 percent prior to the pandemic, indicate great difficulties with labor market transitions even before the pandemic. COVID-19 has made accessing employment opportunities more challenging, and better-targeted support may be required for the labor market integration of youth.

#### Spatial disparities persist, as public service delivery and access to economic opportunities remain uneven.

**Inclusive and sustainable spatial development remains a significant challenge due to uneven access to basic services, insufficient opportunities in rural areas, and low connectivity**. Areas of deep poverty continue to exist, particularly in the Northern and Eastern Provinces, with US\$3.20 poverty rates in the districts of Mullaitivu and Kilinochchi exceeding 30 percent in 2016 (Figure 21). This reflects the continued lagging economic performance of these regions and their lack of opportunities—the two provinces combined contribute about 10 percent of Sri Lanka's total GDP. While the share of the population below the poverty line is high in these provinces, their contribution to the absolute number of poor is relatively low due to the small population. In fact, many of the poor live in and around the deeply rural Highlands, with the districts of Ratnapura, Kandy, and Badulla together accounting for more than a quarter of all poor.



Source: Department of Census and Statistics, Labour Force Survey, various years, http://www.statistics.gov.lk/LabourFor ce/StaticalInformation/AnnualReports. Source: Department of Census and Statistics, Labour Force Survey, various years, <u>http://www.statistics.gov.lk/LabourFor</u> ce/StaticalInformation/AnnualReports. *Note:* A/L = A-levels completed. *Source*: World Bank staff estimation using HIES 2016.

**Unequal opportunities shape unequal outcomes**. There is significant variation in human capital outcomes across the country, with the subnational Human Capital Index ranging from 50.7 in the Eastern Province to 63.3 in the Southern Province. Coverage of basic services tends to be lower in the Northern and Eastern Provinces than elsewhere—e.g., while access to potable drinking water remains an acute challenge more broadly across the country, about 70 percent of households in the Northern Province source their drinking

water from wells. Electricity coverage is nearly universal at the national level, surpassing 99 percent in 2016, but is lowest in the Northern Province (93 percent) and Eastern Province (94 percent). Connectivity— an important pillar of regional development—is constrained, as accessibility and roads conditions are significantly worse in rural areas.

The estate sector continues to be characterized by high levels of poverty, poor housing conditions, and low human development outcomes; progress is taking place only slowly. Around 40 percent of estate residents have less than primary education. Updated data from 2016 show that undernutrition remains a chronic challenge, with 32 percent of estate children under five considered stunted and 30 percent underweight.<sup>81</sup> About 22 percent of estate women are classified as thin with a body mass index (BMI) of less than 18.5. The US\$3.20 poverty rate in the estate sector is high, at 25.4 percent; but less than 10 percent of estate households received assistance through Samurdhi in 2016. There was little improvement in access to safe water supply for estate residents, half of whom collect drinking water from rivers and tanks. Housing provided by plantation management companies is severely overcrowded. Declining productivity in the majority of tea plantations makes it challenging to raise the wages of estate workers.

The majority of the poor reside in rural areas, where welfare outcomes continue to lag behind the urban sector. Nearly a quarter of all employed are engaged in agriculture, which is an important source of livelihoods in rural areas. The sector contributes less than 10 percent to overall GDP, but the combined contribution along with the broader food and beverages manufacturing sector is around 15 percent. Farmers have a higher propensity to be poor than others due to low productivity and low incomes. The agriculture sector benefited from favorable commodity prices through the early 2010s, which supported strong earnings growth. However, the trend has shifted since then: declining output levels, falling export prices, stagnating agricultural minimum wages, and low productivity in the paddy sector have all contributed to a recent slowdown in agricultural earnings growth. Interventionist policies have constrained farmers' opportunities to diversify into higher-value products and kept the sector concentrated in low-value food crops.

#### Improving agricultural productivity and supporting nonfarm livelihoods can help rural income growth.

Agricultural activities were permitted throughout the pandemic, but infrastructure gaps, low diversification, and vulnerability to climate events are important constraints to the sector's growth. Although agricultural activities continued during the pandemic, issues with fertilizer supply and supply chain disruptions hurt farmers. As a result, agricultural output contracted by 2.4 percent in 2020. Irrigation remains a key infrastructure gap, which if addressed could help boost yields, value addition, and income; it could also reduce yield variability associated with climate risks if the command areas in the irrigation scheme's watershed are ecologically stable with intact forest and vegetative cover. Investments in climate-smart agriculture can help manage landscapes to address the interlinked challenges of food security and climate change.

A recent policy decision to ban the import of synthetic fertilizer and pesticides could have farreaching consequences for food security, agricultural livelihoods, and output. This policy, aimed at dismantling the established system of conventional agriculture within a short period, is likely to hit an economy already affected by the global pandemic shock. While there are few quantitative assessments of the exact impact, yield drops of 20–35 percent have been predicted by various stakeholders for major crops such as paddy, vegetables and other food crops, and export crops such as tea and coconut. Productivity

<sup>&</sup>lt;sup>81</sup> Estimates are from Department of Census and Statistics and Health Sector Development Project, "Demographic and Health Survey 2016," 2017, <u>http://www.statistics.gov.lk/Health/StaticalInformation/DemographicAndHealthSurvey-2016FullReport</u>.

drops of such magnitudes could result in high levels of food insecurity while incurring income losses to over a million small farmers and agricultural workers who live on the brink of poverty. Meanwhile, to convert agricultural production into a completely organic system, several critical challenges must be addressed, such as supplying organic fertilizers and crop protection materials within a short period of time, transferring technology on organic agriculture to a large number of farmers engaged in conventional agriculture,<sup>82</sup> and bridging the demand for labor to fill the gap created by substitution of organic farming practices.

A sustainably managed marine and coastal fisheries sector could better contribute to food security and exports and support rural livelihoods. The sector directly or indirectly employs about 7 percent of workers and accounts for around 50 percent of the country's animal protein intake.<sup>83</sup> However, increased fishing effort and degradation of stocks have been driving down catch and hence revenues. The COVID-19 restrictions caused fish harvest and exports to decline by 20 percent and 26 percent, respectively, in 2020, negatively impacting the livelihoods of fishing communities. Sustainable management of stock combined with livelihood diversification through reskilling and creation of opportunities along the fishing value chain could help reduce pressure on stocks and make fishing communities more resilient to climate-related and other risks. Coastal species hold promise for higher export revenues through access to higher-value market segments. Development of sustainable and commercially viable coastal aquaculture could deliver good jobs, in particular in the Northern and Eastern Provinces.

Addressing the skills constraints to accessing remunerative nonfarm jobs could help improve rural incomes. Improvements in the rural sector could come in part from higher earnings from nonfarm activities. While farmers have a higher poverty rate than others, the majority of the rural poor engage in nonfarm activities, the nature of which is quite heterogeneous: about 17.5 percent are engaged in trade-related activities, followed by 11.4 percent in construction, 9.9 percent each in textiles/apparel and public administration, and 8 percent in transport. Rural women are more likely than men to be working in the textiles industry (21.2 percent), public administration (11.3 percent), and education and health care (15.7 percent). Better education is strongly associated with higher participation in and payoff from nonfarm activities, though it does not seem to influence the choice between engaging in farm and unskilled nonfarm employment. This suggests that there are possible skills barriers to moving to better-paying nonfarm jobs. More productive jobs in urban areas can promote urban-rural migration and thereby contribute to poverty reduction.<sup>84</sup>

**Tourism has become an important source of livelihoods in the last decade and can provide significant opportunities for job creation and poverty reduction, especially in rural areas**. The shift in employment from agriculture to industry and services was partly underpinned by the tourism industry, which underwent remarkable growth in the last decade before the pandemic hit in 2020 (Figure 22). Due to its long, diversified supply chain, tourism has a high job creation potential, including for the low-skilled, women, and youth, and could help households supplement their primary livelihood sources. Nature-based tourism is an important part of rural tourism—Sri Lanka's wildlife parks received 2.1 million visitors in 2019, of whom nearly 860,000 were foreigners, and sustainably managing these parks can help local communities improve their livelihoods. However, the industry suffered a shock following the Easter attacks

<sup>&</sup>lt;sup>82</sup> Helga Willer et al., eds., "The World of Organic Agriculture: Statistics and Emerging Trends 2021," Research Institute of Organic Agriculture FiBL and IFOAM Organics International, 2021, <u>https://www.fibl.org/fileadmin/documents/shop/1150-organic-world-2021.pdf</u>. According to this source, Sri Lanka had only 2,338 organic producers in 2019 with 70,436 ha of land under organic production.

<sup>&</sup>lt;sup>83</sup> Ministry of Fisheries and Aquatic Resources Development, "Fisheries Statistics 2019,"

https://www.fisheriesdept.gov.lk/web/images/pdf/downloads/FISHERIES\_STATISTICS\_-\_2019\_FINAL\_PDF\_compressed.pdf. <sup>84</sup> Migration data are very limited in Sri Lanka.

in 2019, and the COVID-19 crisis has dealt a further blow to the industry. A post-pandemic recovery plan could include strategies to revive the industry and opportunities to include vulnerable workers.

# Social safety nets remain inadequate, and the COVID-19 crisis has highlighted the weaknesses of the prevailing social protection schemes.

**Social safety nets remain inadequate despite a significant expansion of the Samurdhi program**. Sri Lanka's social protection spending is among the lowest in the region, while programs are fragmented and offer inadequate coverage (Figure 23). A large share of social transfers is for public sector pensions, which are skewed toward better-off households. Cash transfer programs for the elderly and the disabled amounted to only 0.07 percent of GDP in 2019. Given the prevalence of informal employment, the vast majority of the population lacks old-age income protection, and the state may need to rely on sources other than payroll taxes to finance basic old-age protection.<sup>85</sup> Given the high levels of informality in Sri Lanka and a demographic transition that is significantly more advanced than in peer countries, old-age poverty could increasingly become an issue. In 2019, the government expanded the coverage of the program by around 50 percent. However, leakages are high and targeting performance remains weak, with only about 40 percent of the US\$3.20-per-day poor receiving benefits in 2016. Adequacy is also low; average benefits were around Rs 2,500 per month per beneficiary in 2016, which amounts to 12 percent of the consumption level needed to reach the US\$3.20 poverty line for a household of four persons.

**COVID-19 has further exposed the weaknesses of the existing social protection system**. Social insurance programs could help households cope with the impact of shocks if households had access to such programs. However, social insurance coverage is limited beyond the formal sector. The lack of a formal unemployment insurance program led the government to rely on ad hoc support schemes during the COVID-19 crisis. As the crisis unfolded, the lack of a registry of informal workers complicated targeting. The existing schemes served as the main vehicle to deliver cash support but did not reach all those in need. Cash transfers and livelihood support measures implemented after the crisis helped cushion the labor market shock, but the resources could have achieved much greater impact had they been better targeted toward the poor and vulnerable. While the mitigation measures had wide coverage, the short-term needs were still very high: this finding was also borne out by the results from the COVID-19 phone survey, which showed that many households were in need of further assistance in the form of cash transfers and distribution of food or other basic necessities.

The government has made progress in its efforts to build better delivery systems and strengthen graduation programs. The government has incorporated the beneficiary data for the major welfare programs into a social registry, which should help improve long-standing issues with coverage, targeting, and beneficiary identification. Efforts are underway to pilot new approaches to empowerment and graduation of the poor through the Samurdhi program, and the government has begun preparing a National Social Protection Strategy. Further advances in these directions will improve the impact and sustainability of Sri Lanka's welfare programs.

<sup>&</sup>lt;sup>85</sup> World Bank, "Sri Lanka Country Economic Memorandum," forthcoming.



Source: Sri Lanka Tourism Development Authority.

Source: World Bank staff calculations using HIES 2016.

#### 4. Challenges to Environmental Sustainability and Climate Change

Sri Lanka's rich natural capital is being degraded, putting at risk some key economic sectors that depend on them such as tourism, agriculture, hydropower generation, and fisheries.

Sri Lanka faces significant environmental challenges and climate-related risks, warranting a green, resilient, and inclusive development (GRID) strategy. The country's natural capital requires sustainable management to better contribute to economic growth. Sri Lanka is ranked 109th of 180 countries on the 2020 Yale Environmental Performance Index (EPI), which ranks countries on environmental health and ecosystem vitality.<sup>86</sup> The score has steadily worsened over the past decade, and significant investments are needed to reverse the trend. Natural capital (including biodiversity) and ecosystems services are also vital for both climate mitigation and adaptation. However, Sri Lanka's 2020 EPI subscore on ecosystem vitality, which includes biodiversity, was ranked 139th.

Sri Lanka's natural capital is poorly managed despite evidence that it could provide great economic value. Natural assets can offer a range of benefits, including flood protection and integrity of landscapes to support agricultural production and cultivation of medicinal plants, as well as hydropower and diversified tourism offerings. Watershed benefits from domestic water supply services and agricultural irrigation in the 10 major river basins have an estimated net present value of US\$350–545 million.<sup>87</sup> But ecosystem integrity has been severely compromised by infrastructure development, deforestation, agricultural expansion, and poor water resources management and farming practices, resulting in increased erosion, soil loss, pollution, and loss of ecosystem services. This trend is partly attributed to a lack of integrated natural resource management, institutional fragmentation, weak capacity, and inadequate policies.

<sup>&</sup>lt;sup>86</sup> Yale University's Environmental Performance Index, calculated every two years, "provides a data-driven summary of the state of sustainability around the world. Using 32 performance indicators across 11 issue categories, the EPI ranks 180 countries on environmental health and ecosystem vitality. These indicators provide a gauge at a national scale of how close countries are to established environmental policy targets. The EPI offers a scorecard that highlights leaders and laggards in environmental performance and provides practical guidance for countries that aspire to move toward a sustainable future." Environmental Performance Index, "About the EPI," <u>https://epi.yale.edu/about-epi</u>.

<sup>&</sup>lt;sup>87</sup> FAO Aquastat, "Country Profile—Sri Lanka," Food and Agriculture Organization of the United Nations (FAO), Rome, 2011.

Forest ecosystem services have significant economic value, but deforestation and forest degradation place them at risk, undercutting economic development potential. Natural forest landscapes rich in biodiversity occupy about 30 percent of the total land area of Sri Lanka<sup>88</sup> and contribute to key economic sectors such as tourism (by providing nature-based tourism destinations),<sup>89</sup> hydropower generation (by reducing erosion and maintaining watershed functions), and agriculture (by regulating water flows and microclimates and providing habitats to pollinators). However, fragmented policy and institutional responsibilities, inadequate planning, and limited budget for monitoring<sup>90</sup> have led to encroachment into existing forest areas. Degradation, fragmentation, and conversion of forest lands for other land uses has increased water runoff, soil erosion, and siltation rates, in turn reducing agricultural productivity and threatening sustainable economic development in rural areas. Transitions in the agriculture and food system, along with cross-sectoral and integrated land use and forest landscape management and restoration approaches already piloted in the country, could help prevent further degradation of forests, water resources, and natural habitats and provide significant incremental socioeconomic benefits and immediate green jobs.

The rate of human-elephant conflict (HEC) in Sri Lanka is among the highest in the world; over the last decade, HEC has worsened and spread into new areas, with more human and elephant lives lost.<sup>91</sup> The practice of translocating elephants or driving elephants into protected areas has had limited success in mitigating HEC. Research suggests that relocating fences from the administrative boundary of the protected areas to the ecological boundaries of contiguous forest would increase elephant habitat by about 70 percent and thereby reduce conflict,<sup>92</sup> while also restoring the carbon storage potential of intact forests.<sup>93</sup>

**High levels of waste and pollution threaten the sustainable use of coastal resources.** Approximately 6,000–7,000 tons of municipal solid waste are generated daily.<sup>94</sup> Of this, about 60 percent is organic and thus needs to be processed sooner in the solid waste management stream than recyclables and other forms of waste.<sup>95</sup> Waste segregation at source, waste reduction, and composting are not extensively practiced. A household survey suggests that only 22 percent of households have their waste collected and that the remaining waste is dumped or burned.<sup>96</sup> Openly dumped municipal solid waste is often transported by rivers to the coast, where it pollutes beaches and marine waters. Sri Lanka generates about 775 tons of plastic and polythene waste per day.<sup>97</sup> but lacks the capacity to process and recycle it. Solving the solid waste

<sup>&</sup>lt;sup>88</sup> REDD+ Sri Lanka, "National REDD+ Investment Framework and Action Plan," 2017, Sri Lanka UN REDD Programme, <u>https://www.unredd.net/documents/un-redd-partner-countries-181/national-redd-strategies-1025/16263-national-redd-investment-framework-and-action-plan-nrifap-12.html?path=un-redd-partner-countries-181/national-redd-strategies-1025.</u>

<sup>&</sup>lt;sup>89</sup> Sri Lanka's beaches, oceans, forests, and biodiversity harbored in protected areas contribute significantly to its tourism sector, but they are increasingly vulnerable. The recent severe water and beach pollution caused by chemical spills from a cargo ship off the western coast illustrates the devastating impact of environmental disasters and highlights the need for improved risk management as well as improved water quality management and monitoring.

<sup>&</sup>lt;sup>90</sup> The Forest Department's annual budget is about US\$18 million, including recurrent and investment costs to manage natural resources on one-third of the country's area.

 <sup>&</sup>lt;sup>91</sup> T. G. Supun Lahiru Prakash, A. W. Wijeratne, and Prithiviraj Fernando, "Human-Elephant Conflict in Sri Lanka: Patterns and Extent,"

 ResearchGate,
 2020,

 <u>https://www.researchgate.net/publication/341150414\_Human-Elephant\_Conflict\_in\_Sri\_Lanka\_Patterns\_and\_Extent/link/5ee9c39a92851ce9e7ea49b0/download.</u>

<sup>&</sup>lt;sup>92</sup> Prithiviraj Fernando, Peter Leimgruber, Tharaka Prasad, and Jennifer Pastorini, "Problem-Elephant Translocation: Translocating the Problem and the Elephant?," *PLoS One* 7, no. 12 (2012;): e50917, https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3517608/.

<sup>&</sup>lt;sup>93</sup> Ralph Chami, Connel Fullenkamp, Thomas Cosimano, and Fabio Berzaghi, "The Secret Work of Elephants," IMF, 2020, https://www.imf.org/external/pubs/ft/fandd/2020/12/how-african-elephants-fight-climate-change-ralph-chami.htm.

<sup>&</sup>lt;sup>94</sup> Japan International Cooperation Agency (JICA), "Data Collection Survey on Solid Waste Management in Democratic Socialist Republic of Sri Lanka: Final Report," 2016, <u>https://openjicareport.jica.go.jp/pdf/12250213.pdf</u>.

<sup>95</sup> Ibid.

<sup>&</sup>lt;sup>96</sup> World Bank, "Sri Lanka Poverty Assessment," World Bank, Washington, DC, forthcoming.

<sup>&</sup>lt;sup>97</sup> IMC Worldwide Ltd. and Seureca, "Baseline Assessment for Plastic Debris Flowing into Rivers and Seas of South Asia—Annex
8: Country Profile for Sri Lanka," May 2021.

management problem will require stronger policy commitment, integrated planning, identification of appropriate technologies, institutional capacity, and enforcement.

Air pollution is becoming a serious concern across Sri Lanka and has stagnated at undesirable levels in the major urban centers in recent years. Sri Lanka compares relatively favorably to other South Asian countries in terms of air pollutant concentration levels, but air quality has decreased with growing urbanization. Ambient pollutant concentration in the greater Colombo area remains above World Health Organization guidelines ( $20mg/m^3$  for PM10) and the Clean Air 2025 Action Plan target ( $50 \mu g/m^3 PM10$ annual average). The transport sector contributes about 60 percent to the atmospheric pollution in the greater Colombo area. In other urban centers such as Kurunegala and Galle and their peripheries, air quality has also deteriorated due to the increasing number of vehicles and industrial activities. The impact from air pollution on human health and productivity can be severe. In response, the government banned lead in petroleum for cars, introduced a nationwide vehicle emissions inspection program, and developed an air quality management action plan. However, a directive from 2016 increased taxes on hybrid vehicles, which are more emission-friendly.

The poor and vulnerable are disproportionately affected by air pollution. Exposure to indoor air pollution is high in Sri Lanka, mainly because of biomass fuels used in cooking stoves. The health impact can be detrimental; smoke from the burning of firewood generates harmful substances such as particulates, carbon monoxide, and other carcinogens. These have a disproportionate impact on women and children, who spend more time around cookstoves, and on the poor, who are much more likely than the nonpoor to rely on wood-burning stoves. Indoor exposure could be reduced by shifting from biomass to other fuels (e.g., gas) and by disseminating improved cookstoves and kitchen designs, but a national strategy is not in place.

Access to improved drinking water remains relatively low. Only about 35 percent of households had access to piped water in 2016, with wide variation across districts (Figure 24). The most common source of drinking water is wells; about 43 percent of households get their water from wells located either within or outside the premises. Absolute water shortages remain a challenge for some households: almost 11 percent of the poor did not have enough water to drink. There is little monitoring of drinking water quality at the national level. The Kelani River, the second largest watershed in the country and the primary source of drinking water in Colombo, is also the most polluted watershed in the country.

**The gap between basic sanitation and safely managed sanitation is substantial.** Over 90 percent of the population uses on-site sanitation through pit latrines and septic tanks, which in the absence of proper containment and disposal pose an environmental hazard; they may overflow into drainage canals and pollute surface water and groundwater. The resulting coastal pollution poses a particular risk to the tourism industry and marine health. Spending in the water sector is low and concentrated in the Western Province. Long-standing governance issues constrain progress: rural water supply, managed by around 4,500 community-based organizations, suffers from sustainability issues because economies of scale, technical capacity, and legal status are all lacking.

#### Sri Lanka is highly vulnerable to climate change and disasters.

Sri Lanka is highly vulnerable to hydrometeorological disasters, which are occurring with increased frequency and at greater scale. The most frequent climate-related hazards are floods, droughts, landslides,

storm surges, and cyclones. Sri Lanka ranked 30th in the world in the Global Climate Risk Index for 2021.<sup>98</sup> Floods and landslides primarily affect areas in and around the Kelani River basin, which hosts Colombo, an area that is responsible for about 40 percent of GDP.<sup>99</sup> Overall, the reported number of people affected by various disasters has been increasing in recent years (Figure 25). Approximately 87 percent of the population lives in climate hot spots.

**The economic and household impact of disasters is already significant.** The annual average fiscal loss associated with disasters in Sri Lanka is very high, estimated at more than US\$380 million.<sup>100</sup> Flooding is the most frequent natural disaster, causing an estimated annual loss of US\$240 million, or almost two-thirds of total disaster losses on average. The estimated direct impact due to floods and landslides was US\$723 million in 2016 and US\$468 million in 2017.<sup>101</sup> The 2016 drought led to the worst agricultural harvest in 40 years, causing large income drops and increased food insecurity among the estimated 4 million affected people.

**Disasters and climate change impacts could further undermine economic growth and poverty reduction**. Infrastructure losses and damages require significant financial resources following a disaster. Agriculture, tourism, and hydropower are among the key sectors expected to be most affected. Risks to agriculture will be acutely reflected in declining agricultural yields, which present a risk to farmers' livelihoods and to the domestic food requirement, including rice as a staple grain, a large share of which is produced in drought-prone regions of the country. The COVID-19 pandemic has further highlighted the need to be prepared for increasing impacts from extreme events. Climate extremities coupled with input shortages and restricted movement due to COVID-19 have led to output and earnings losses in rural areas.

The poor bear a disproportionate share of climate risks. The poor lack the ability to self-insure and adapt due to their low asset base and low human capital. They are also locationally disadvantaged: they are more likely to own degraded land and live closer to hazardous, polluted areas, and at the same time are more dependent on climate-sensitive sectors such as agriculture and forestry for their livelihoods. Insufficient access to safety nets and services such as early warning systems make them further vulnerable. Poor households have limited capacity to prepare for or cope with shocks, making them among the hardest hit by shock impacts. An impact-based early warning and emergency response system as well as an adaptive social protection system could help build resilience to shocks among the poor and vulnerable, particularly in relation to disasters and climate change. Mainstreaming climate resilience in urban planning as well as in building approval regulations is critical for enhancing the resilience of vulnerable populations living in marginal lands in urban areas.

**Climate change is expected to increase water stress, which is already severe**. Water resources serve multiple needs—for drinking water, agriculture, and power generation, among others. Water scarcity and prolonged dry periods are a growing problem, requiring coping strategies that build on alternative water sources, traditional community knowledge, and social dynamics. Climate change–induced sea-level rise

<sup>&</sup>lt;sup>98</sup> GermanWatch, "Global Climate Risk Index 2021," 2021.

<sup>&</sup>lt;sup>99</sup> Central Bank of Sri Lanka.

<sup>&</sup>lt;sup>100</sup> David Rogers, Geoff Love, and Bruce Stewart, "Meteorological and Hydrological Services in Sri Lanka: A Review," Global Facility for Disaster Reduction and Recovery,

https://www.gfdrr.org/sites/default/files/publication/Sri%20Lanka%20Hydromet%20Roadmap.pdf.

<sup>&</sup>lt;sup>101</sup> Ministry of National Policies and Economic Affairs and Ministry of Disaster Management, "Sri Lanka Post-Disaster Needs Assessment: Floods and Landslides–May 2016," 2016,

https://www.lk.undp.org/content/srilanka/en/home/library/environment\_energy/publication4.html; Ministry of National Policies and Economic Affairs and Ministry of Disaster Management, "Sri Lanka Rapid Post-Disaster Needs Assessment: Floods and Landslides," 2017, https://www.lk.undp.org/content/srilanka/en/home/library/environment\_energy/SriLanka-Rapid-Post-Disaster-Needs-Assessment-2017.html.

and salinity intrusion are impacting drinking water supply and the availability of agricultural lands. Intermittent droughts are already leading to competition for water between agriculture and domestic water supply in dry areas, increasing the risk of overexploitation of limited groundwater. Climate change models predict that the dry zones in the central and northern areas of Sri Lanka will become drier and that the wet zone in the southwest of the country will become wetter, with rainfall projected to increase by 48 percent for the southwest monsoon by 2050 and to decrease by 28 percent for the northeast monsoon.<sup>102</sup> In fact, households in the Northern, North-Central, and Eastern Provinces have reported low levels of water for agriculture, drinking, and household use in recent years.<sup>103</sup> In addition, droughts pose a significant risk to energy supply due to Sri Lanka's reliance on hydroelectricity; this source accounts for 30 percent of the total electricity generation capacity.<sup>104</sup> Given that the extreme variability of rainfall and drought is already a defining feature of Sri Lanka's climate, water resources management and investments are an especially important component of efforts to reduce the impacts of extreme weather events and adapt to climate change.

# Significant investments in risk reduction and adaption are needed to support green, resilient, and inclusive development.

While Sri Lanka's contribution to global greenhouse gas (GHG) emissions is less than 0.1 percent, mitigation efforts are crucial given Sri Lanka's high climate risks. Energy supply comes primarily from oil and coal. The energy sector (including transport) accounted for the largest share of total GHG emissions, at around 64 percent in 2018, due to its heavy dependence on fossil fuels. The agriculture sector was the second highest GHG emitter, representing 16 percent of total emissions.<sup>105</sup> A transition away from fossil fuels and toward renewable sources such as solar and wind would make the energy mix more sustainable. This direction is consistent with the 2019 Sri Lanka Energy Policy and the Long-Term Generation Expansion Plan 2020–2039 of the Ceylon Electricity Board. Better solid waste management could also help Sri Lanka address health hazards, pollution, and GHG emissions.<sup>106</sup>

Agriculture is the most climate-sensitive sector and could greatly benefit from adaptation efforts. The vulnerability of the agriculture sector to climate variability and the risks to food security pose important challenges to poverty reduction. Rice is a staple food item in Sri Lanka, crucial to food security and rural livelihoods. However, increases in temperature during the rice-growing season have negative consequences for yields. Coconut, tea, and rubber are also highly sensitive to temperature and rainfall variability.<sup>107</sup> Concerning food systems, climate change is modifying the distribution and productivity of agroecological zones and marine and freshwater species, thereby altering food webs. Saltwater intrusion into croplands and flooding are among the factors that lead to crop failure. Paddy is a main crop cultivated by many farmers, but limited water supply and inefficient practices continue to threaten rural livelihoods. Climate resilience measures could help minimize the impact of climate change on food security, enhance the resilience of crops to weather events, and reduce the impact of sea-level rise and saltwater intrusion on

<sup>&</sup>lt;sup>102</sup> World Bank Group, "Sri Lanka Climate Change Action Plan," forthcoming.

<sup>&</sup>lt;sup>103</sup> UN Office for the Coordination of Humanitarian Affairs, "Asia and the Pacific: Weekly Regional Humanitarian Snapshot (16–21 August 2017)," August 21, 2017, <u>https://reliefweb.int/report/nepal/asia-and-pacific-weekly-regional-humanitarian-snapshot-16-21-august-2017</u>.

<sup>&</sup>lt;sup>104</sup> International Monetary Fund, Sri Lanka: Selected Issues, IMF Country Report 18/176 (Washington, DC: IMF, 2018).

<sup>&</sup>lt;sup>105</sup> Climate Change Secretariat, Ministry of Mahaweli Development & Environment, Readiness Plan for Implementation of Intended Nationally Determined Contributions (INDCs) 2017 – 2019.

<sup>&</sup>lt;sup>106</sup> GHG emissions from waste amount to 9 percent of Sri Lanka's total emissions.

<sup>&</sup>lt;sup>107</sup> World Bank Group and Asian Development Bank, "Climate Risk Country Profile: Sri Lanka," 2020.

agriculture in the coastal zone. Private sector capabilities can be leveraged to maximize climate change mitigation and adaptation, for example, through private investments in green agriculture logistics (such as warehousing facilities) and the adoption of climate-smart agricultural practices and standards. Integration of climate actions into the regular planning framework of all sectors will ensure that the Nationally Determined Contribution (NDC) under the Paris Agreement is prioritized for financing (see Box 3). Four priority areas have been identified for engagement due to their catalytic and complementary impacts on advancing climate change action in Sri Lanka: infrastructure resilience; integrated landscape management for agriculture, water resources, and forests; clean energy; and resilient livelihoods.

**Investing in resilient infrastructure is important to mitigate and adapt to rising climate changerelated risks.** Large urban regions such as the greater Colombo area and other suburban areas have grown tremendously, with high density of population, private houses, and business establishments. There are several steps Sri Lanka could take that would go a long way in reducing impacts, including retrofitting infrastructure to become greener and withstand disasters, carrying out risk-sensitive land use planning, and strengthening urban resilience through building codes, proper drainage, and waste management. Ensuring low-carbon urban development and climate-resilient and sustainable infrastructure (for water, sanitation, transport, and power, among others) can have high economic returns despite higher up-front costs, and private sector solutions can also be leveraged. A physical investment program is urgently needed to mitigate floods in the areas around the Kelani Ganga, Attanagalu Oya, Kalu Ganga, Gin Ganga, Nilwala Ganga, and Mundeni Aru basins. An accelerated risk mitigation program is necessary to support the relocation of families from high hazard zones along with other risk-mitigating interventions.<sup>108</sup>

**Finally, a robust risk financing strategy could reduce the substantial financial resources needed each year to respond to climate change–induced disasters and help adaptation.** Sri Lanka's annual disaster losses in the housing, roads, and relief sectors are estimated at Rs 50 billion (approximately US\$250 million).<sup>109</sup> In the absence of a national disaster fund or disaster risk financing strategy, the national budget channels scarce fiscal resources to the implementing line ministries for disaster-related expenditure. A national disaster risk financing strategy—one that relies on a risk-layering approach to promote the use of a mix of instruments—could greatly help Sri Lanka withstand the shocks to its economy. Effective residual risk management is key to enhance preparedness, to reduce losses when a disaster strikes, to facilitate a rapid recovery, and to minimize long-term damages. Relevant instruments could retain risk (e.g., reserves or contingency budget and contingent credit lines) or transfer risk (e.g., insurance). Private sector financing could be better leveraged in sustainable energy and climate-smart agribusiness. Climate-themed instruments (such as green and blue bonds) could be used to attract and diversify private investments.

#### **Box 3: Nationally Determined Contribution**

Sri Lanka submitted its initial NDC in September 2016 as a country that ratified the Paris Agreement. The Climate Change Secretariat updated the NDC and submitted it to the United Nations Framework Convention in July 2021. Sri Lanka's NDC comprises the following four areas:

**1. Mitigation.** The revised NDC has 2030 mitigation targets, including unconditional GHG emission reduction of 4.0 percent in power, transport, industry, waste, agriculture and livestock, and forestry. The conditional NDC actions account for an additional 10.5 percent of GHG emissions reduction respective to the "business as usual"

<sup>&</sup>lt;sup>108</sup> The National Building Research Organization has identified more than 12,000 families living in landslide zones of moderate to high risk.

<sup>&</sup>lt;sup>109</sup> World Bank, "Fiscal Disaster Risk Assessment and Risk Financing Options: Sri Lanka," World Bank, Washington, DC, <u>http://hdl.handle.net/10986/24689</u>.

scenario for the period 2021–30. Sri Lanka expects to achieve carbon neutrality by 2060. It is expected that the implementation of updated NDCs will result in GHG emissions reduction against the business as usual scenario by 25 percent in the electricity sector (5 percent unconditionally and 20 percent conditionally).

**2.** Adaptation. It is critical to build resilience to adverse effects of climate change among vulnerable communities, sectors, and areas. Adaptation will focus on human health, food security (agriculture, livestock, and fisheries), water, coastal and marine life, biodiversity, urban infrastructure and human settlement, and tourism and recreation. Sri Lanka will prioritize adaptation activities that offer climate co-benefits. In 2016, Sri Lanka launched its National Adaptation Plan for Climate Action 2016–2025, which identifies priority actions for climate adaptation.

**3.** Loss and damage. The recommended approach for managing climate-related loss and damage builds on the current technical investments and operational framework for disaster risk management and operationalizes the Sendai Framework for Disaster Risk Reduction (2015–2030) and the Warsaw International Mechanism; this approach includes understanding the full spectrum of risk. Future damage and losses due to climate change require a broader process and greater data availability.

**4. Means of implementation.** In implementing plans under the NDC, Sri Lanka will consider external support for finance, technology development and transfer, and capacity building for the sectors mentioned above. To meet its conditional contribution, Sri Lanka needs to mobilize substantial climate finance from mechanisms set up by the United Nations Framework Convention on Climate Change (UNFCCC) and the Paris Agreement and to leverage bilateral agreements for low-carbon development.

Source: Ministry of Mahaweli Development and Environment, "Updated Nationally Determined Contributions," July 2021,

https://www4.unfccc.int/sites/ndcstaging/PublishedDocuments/Sri%20Lanka%20First/NDCs%20of%20Sri%20Lanka-2021.pdf.



Figure 24: Access to piped water, by district

#### Figure 25: People affected by natural disasters



Source: World Bank staff calculation using HIES 2016.

Source: DesInventar data.

#### The Cross-Cutting Governance Challenge

An improved regulatory environment could facilitate private sector-led growth.

With limited progress since 2015, regulatory governance continues to constrain market competition, formalization, and growth. According to the Global Competitiveness Index (GCI), <sup>110</sup> burden of government regulation in Sri Lanka was ranked around the 70th percentile of the 141 countries surveyed in 2019, reflecting a deterioration from the 45th percentile of the 140 countries surveyed in 2015. Regulatory burden continues across factor markets and the operating environment. Weaknesses in land administration remain deep-rooted; the 2018 Global Competitiveness Report found Sri Lanka to be the worst performer in the world in the quality of land administration, and the country improved only marginally in 2019.<sup>111</sup> The country does poorly in labor redundancy costs (around the 97th percentile), property rights (closer to the 77th percentile), and insolvency framework (72nd percentile). Performance of fiscal regulatory burden indicators—such as trade tariffs (90th percentile), complexity of tariffs (77th percentile), and distortive effects of taxes and subsidies (55th percentile)-is weak. Sri Lanka falls around the 60th percentile in control of corruption, political stability, and voice and accountability in the World Governance Indicators (Figure 26).<sup>112</sup> The country ranks below the 50th percentile in government effectiveness, while it does a little better-at the 44th percentile-in rule of law. Weaknesses in regulatory governance have contributed to the emergence of a large informal sector, which further distorts the market and undermines competition, productivity growth, and the potential of unlocking private capital mobilization in key sectors. Frequent changes, for example in taxation, negatively affect the predictability of the policy regime, discouraging private investment and growth.<sup>113</sup>

# Heavy state involvement in businesses distorts competition, creates fiscal risks, and leads to weak public service delivery.

**Strong state participation in the economy poses challenges to unlocking private sector potential.** The state has been a major participant in economic activities through 54 strategic SOBEs in many sectors, including power, energy, aviation, trading, higher education, and banks.<sup>114</sup> The turnover of SOBEs as a share of GDP increased between 2015 and 2019 (Figure 27).<sup>115</sup> While the existence of SOBEs itself is not problematic, SOBEs can distort market competition; this occurs (i) when SOBEs occupy a significant market position (in at least 16 out of 23 sectors and markets in which SOBEs operate, they hold a more than 50 percent market share); (ii) when SOBEs are protected from competition by regulation or policies (e.g., electricity transmission, postal services, bulk water supply); and (iii) when the private sector could provide goods or services in an efficient manner (there are at least 16 sectors in which SOBEs compete with the private sector ranging from bus transport to fuel, plantations, and hotels). SOBEs receive state support in the form of tax exemptions, subsidized loans, better access to land and finance, and debt guarantees,<sup>116</sup> all of which distort competition. Almost half of the banking credit issued by end-2020 went

<sup>&</sup>lt;sup>110</sup> World Economic Forum, Global Competitiveness Index, <u>https://www.weforum.org/reports</u>.

<sup>&</sup>lt;sup>111</sup> A fragmented legal and institutional framework, lack of flexibility in land use, and limited use of information technology have all contributed to a weak land administration.

<sup>&</sup>lt;sup>112</sup> World Bank, World Governance Indicators, <u>http://info.worldbank.org/governance/wgi/</u>.

<sup>&</sup>lt;sup>113</sup> Online consultations with the general public highlighted governance and corruption as important challenges.

<sup>&</sup>lt;sup>114</sup> For example, the two state commercial banks accounted for 48 percent (in 2020) of the total assets held by all licensed commercial banks. The government and related institutions held an average 27 percent of the ownership in the top-six private licensed commercial banks as of September 2020.

<sup>&</sup>lt;sup>115</sup> World Bank, "Integrated State-Owned Enterprise Framework," 2020.

<sup>&</sup>lt;sup>116</sup> The total of Treasury-guaranteed debt and foreign loans outstanding of the nonfinancial SOBEs was equivalent to 8.7 percent of GDP in 2020.

to the government and SOBEs, and increased financing to SOBEs would further crowd out private sector credit.

**SOBEs play an important role for the delivery of essential services and products, while the welfare impact of subsidies is small**. SOBEs are dominant in the provision of energy (e.g., fuel, electricity), water (primarily in urban areas), and public transport services. Electricity coverage is nearly universal, though some gaps remain in poorer provinces. Access to tap water is relatively high in urban areas, at nearly 80 percent, but the figure is much lower in the Central and Uva Provinces, for example. The distributional impact can be assessed through the incidence of various implicit subsidies—for example, previous analysis has shown that fuel subsidies are regressive after accounting for indirect effects. Water subsidies tend to be progressive, but tariffs are heavily subsidized, threatening the sustainability of the National Water Supply and Drainage Board, which is largely responsible for urban water supply.<sup>117</sup>

**Commercial and financial viability of SOBEs is undermined by major corporate governance challenges, leading to weak service delivery and additional fiscal risks.** The introduction of a statement of corporate intent for key SOBEs in 2017 was encouraging. However, major corporate governance challenges remain, including (i) fragmented legal frameworks with no clear rationale for the state's ownership; (ii) divided ownership and oversight of SOBEs between the Ministry of Finance and other line ministries; (iii) limited control by boards over operational and managerial decisions; (iv) lack of systematic mechanisms to monitor financial and operational performance; and (v) lack of cost-reflective pricing. Even though electricity is more expensive from the consumers' perspective in Sri Lanka than in other South Asian countries, CEB is unable to recover cost, resulting in operational losses that are financed through debt or inter-SOBE arrears. Ceylon Petroleum Corporation owed approximately US\$2.0 billion, or 2.5 percent of GDP, to state banks by end-2020. Many other SOBEs also rely on state banks and the Treasury to cover their losses. Combinations of policy options—ranging from improving legal frameworks and enhancing corporate governance to making selective ownership reforms—could improve performance of SOBEs and uplift service delivery.

#### Public resources and digital technologies could be better utilized to improve service delivery.

Weak public investment management constrains the government's capacity to manage scarce fiscal resources for development. The 2018 Public Investment Management Assessment (PIMA) estimated an efficiency gap of 36 percent for Sri Lanka compared to countries achieving higher infrastructure quality with a similar per capita stock.<sup>118</sup> The PIMA also highlighted several major weaknesses in the current system, including (i) limited project screening and prioritization, allowing projects without readiness; (ii) lack of linkage between public investment plans and fiscal planning; (iii) limited transparency in contract management and appraisal; and (iv) fragmented responsibilities for public investment management. The first Public Investment Plan, prepared in 2017 for 2017–2020, was not integrated into the legal institutions. Despite some steps taken to enhance performance through revised project appraisal guidelines and a newly introduced evaluation policy in 2019, implementation has been slow.

**Progress toward digital government has been slow.** Several e-governance initiatives have been introduced in recent years, such as the online vehicle revenue license service and the acceptance of e-documents in the export and import process. However, Sri Lanka's rank in the United Nations E-Government Development Index declined from 74 in 2014 to 85 in 2020 (out of 193 countries), mainly

<sup>&</sup>lt;sup>117</sup> World Bank, "Integrated State-Owned Enterprise Framework," 2020.

<sup>&</sup>lt;sup>118</sup> International Monetary Fund and World Bank, "Public Investment Management Assessment," 2018.

reflecting persistent gaps in telecommunication infrastructure, particularly in rural areas.<sup>119</sup> Many of the digital systems are functioning without interconnectivity, so that information, services, and digital documents are not shared across organizations. Progress has been slow in building the National Data and Interoperability Platform, which is expected to enable various digital systems to interoperate on the basis of a unique digital identifier for users. Other important challenges to harnessing the potential for efficiency, inclusion, and innovation through digital government include a fragmented institutional framework, legal and regulatory concerns about cybersecurity and data protection, and weak data infrastructure.<sup>120</sup>

**Weak public procurement and external audit capacity hinders the effectiveness and transparency of public financial management.** Significant delay in procurement is common<sup>121</sup> due to cumbersome procedures and to lack of capacity and empowerment, which elevates procurement decisions to senior management. In the absence of procurement plans and an e-procurement system, the government cannot sufficiently leverage economies of scale and enhance competition and transparency. With the adoption of the National Audit Act (2018), the independence and mandate of the National Audit Office (NAO) were enhanced, including the audits of SOBEs. However, significant gaps in professional capacity—i.e., limited staff having appropriate skills—keep the NAO from properly implementing the expanded mandate.



*Source:* World Governance Indicators, http://info.worldbank.org/governance/wgi/.

Sources: Central Bank of Sri Lanka; Ministry of Finance; World Bank staff calculations.

*Note:* Debt of nonfinancial SOBEs includes foreign loans and guaranteed debt by Treasury (excluding banks).

**Constitutional amendments have had implications for accountability and transparency.** The 19th Amendment to the Constitution, which was introduced in 2015, aimed to create checks and balances across the three arms of the state: executive, judiciary, and legislature. It scaled down the powers of the president, introduced the citizen's right to access information, and aimed to strengthen the governance framework and accountability of institutions, including in audit and procurement. However, the implementation of these

 <sup>&</sup>lt;sup>119</sup> United Nations, E-Government Index, <u>https://publicadministration.un.org/egovkb/en-us/About/Overview/-E-Government-Development-Index</u>.
 <sup>120</sup> The cybersecurity bill and the data protection bill are at advanced stages before they are presented to the Parliament, according

<sup>&</sup>lt;sup>120</sup> The cybersecurity bill and the data protection bill are at advanced stages before they are presented to the Parliament, according to the Information and Communication Technology Agency.

<sup>&</sup>lt;sup>121</sup> Procurement data from World Bank–funded projects shows a time lag of up to one year between the invitation for bids and the contract signing.

legal and institutional reforms was limited, partially due to continued political uncertainty. The promulgation of the 20th Amendment to the Constitution (October 2020) reversed key elements of the 19th Amendment. The 20th Amendment strengthens the executive powers of the president with a view to efficiently deliver on the development agenda in the president's manifesto. It allows the president to appoint key members of the executive arm, the judiciary, and the independent commissions,<sup>122</sup> and to dissolve the Parliament one year after the parliamentary election. The amendment also strengthens the immunity of the president and allows the government to bring in urgent bills regarding national security and emergencies.

**Empowering local government agencies through capacity, institutional, and financial means could improve service delivery.** Broadly, service delivery and local governance are challenged by a dual local administration system.<sup>123</sup> The 13th Amendment demarcates the role of the provinces. However, unclear and overlapping functions and structures among the decentralized administrative units and the devolved governance units continue to restrict the activities of local governments. Although local government agencies are closer to the communities they serve, they have limited capacity to respond to the needs of their constituents. Funding could be enhanced and its base broadened by focusing on own resource generation, establishing the frameworks supportive of revenue augmentation, and strengthening the intergovernmental transfer system. Improved citizen engagement through digital platforms, including in planning and budgeting, could contribute to better service delivery at the local level.

#### **Prioritization**

The set of structural constraints identified in the 2015 SCD remains largely valid, but some challenges have become more pronounced over the course of the COVID-19 pandemic. The SCD Update finds that ensuring macroeconomic stability, improving competitiveness for stronger private sector–led growth and job creation, enhancing inclusion of the poor and vulnerable, and fostering environmental sustainability will be critical for Sri Lanka to reach higher growth, accelerate poverty reduction, and promote shared prosperity. The SCD Update identifies important shifts in the underlying constraints, mainly in the context of the COVID-19 crisis, which have led several challenges to gain more prominence:

- The risks to macroeconomic stability have heightened significantly. The combined effects of a pre-COVID stimulus package and the impact of COVID-19 on revenues and expenditures pose substantially elevated risks to fiscal sustainability. With significant increase in the debt service burden, debt sustainability has become the most critical challenge for Sri Lanka amid high fiscal deficits, constrained market access, and large refinancing requirements. Reducing debt vulnerabilities and restoring fiscal and external buffers remain front and center in the policy agenda.
- The COVID-19 crisis further impeded the competitiveness of the private sector. The impact on businesses was severe. Key exports were stifled due to weak demand and shortage of inputs, while inward orientation was intensified. The emerging tourism sector was severely affected with

<sup>&</sup>lt;sup>122</sup> The 20th Amendment allows the president to appoint and remove the prime minister, cabinet ministers, judges of the superior courts, attorney general, auditor general, and members of key commissions such as the Election Commission, Public Service Commission, National Police Commission, Human Rights Commission, and Bribery or Corruption Commission. These appointments were made by a Constitutional Council on the recommendation of the President under the 19th Amendment. Under the 20th Amendment, the Constitutional Council is replaced by the Parliamentary Council, which could provide observations on the appointments.

<sup>&</sup>lt;sup>123</sup> The system consists of (i) the devolved local governance system, comprising 341 elected local government authorities (276 pradeshiya sabhas, 41 urban councils, and 24 municipal councils) that fall institutionally and legally under the provincial governments; and (ii) the decentralized system of public administration, comprising a three-tier structure of vertically integrated, deconcentrated national government administrations at the district, division, and grama niladhari levels.

a near-halt in international tourism. MSMEs, with less ability to adjust their operations and more limited access to working capital loans, were disproportionately affected. While the full impact of COVID-19 is yet be observed due to regulatory relaxation, the pandemic likely exacerbated preexisting financial sector vulnerabilities.

- The impact of COVID-19 on human capital could have long-lasting consequences for skills and productivity, thereby affecting labor market outcomes, economic growth, and inequality. Disruptions in schooling affect the poorest the most and will be costly to remedy. A less-skilled labor force could reduce growth potential and worsen labor market outcomes. Difficulties in accessing routine health care services during the pandemic could have long-term consequences for population health outcomes. Moreover, widening disparities in human capital outcomes could decrease social mobility and increase inequality in the longer term.
- The COVID-19 crisis amplified the weakness and inadequacy of the social assistance schemes. Relatively substantial resources were spent on livelihood support measures, but the benefits were spread across many households and were not well targeted, reducing the measures' effectiveness in mitigating the impact of the shock.
- The digital divide has come to the fore during the current crisis. Disparities in digital skills and access to digital technology had an impact on numerous fronts: e.g., firms with access to digital platforms were better equipped to respond to the new operating environment; workers with digital access and a job that can be performed from home were less likely to lose incomes; and richer households with digital devices and connectivity were better positioned to help their school-age children continue their education with distance learning programs.
- The need to reverse the degradation of natural capital and build resilience to natural disasters, including through restoration and sustainable management of forest landscapes, has become more urgent. Natural capital, including fisheries, watersheds, biodiversity, and coastal resources, continue to degrade, while the lack of action has increased Sri Lanka's vulnerability to natural disasters in recent years.
- Agriculture and rural development could better support poverty reduction. The recent slowdown in agricultural income growth, following a decade of favorable price trends, highlights the importance of productivity-enhancing investments and incentives. Farmers remain vulnerable to droughts, and infrastructure investments are suboptimal. Paddy productivity is significantly lower than productivity for other crops, and little improvement has been observed in this regard. Food insecurity has been heightened since the onset of the pandemic.

The SCD Update revisits the priorities for poverty reduction and shared prosperity based on the latest developments and updated evidence, with a focus on the challenges highlighted during the COVID-19 pandemic. The exercise is conducted using the same criteria as in the previous SCD: impact on the twin goals, the time horizon for impact, constraints in the operating environment on delivering results, the strength of the evidence base, complementarities, and whether the constraint is a precondition to unlocking other constraints. New developments and updated evidence were taken into account, and the constraints were validated during consultations with a diverse set of stakeholders.<sup>124</sup> The consultations similarly focused on understanding the impact of recent developments, and particularly how the COVID-19 crisis affected the challenges of and opportunities for accelerating inclusive and sustainable growth in Sri Lanka. Significant data and knowledge gaps that remain are listed in Annex 4. The COVID-19 prioritization lens is aligned with the World Bank Group crisis response framework, which aims to support

<sup>&</sup>lt;sup>124</sup> These consultations included a public online survey and face-to-face/virtual consultations with government, private sector, development partners, thinks tanks, civil society organizations, and community groups. Consultations were also held on the thematic areas of youth, gender, labor, and education.

relief, restructuring, and resilient recovery, and with the key dimensions and the cross-cutting enablers of the GRID approach.<sup>125</sup> The process led to the selection of the following seven priority areas.

- 1. Addressing the fiscal challenge to ensure macroeconomic stability. Sri Lanka needs more fiscal space, better debt management practices, and more efficient spending. With opportunities for debt financing limited, domestic revenue mobilization is central to anchor fiscal and debt sustainability. This priority has not changed for more than a decade, as ad hoc and suboptimal policy choices and the slow tax administration reforms have constrained revenue collection at sustainable levels. In the short run, the government will need to use scarce fiscal resources on the public health, social, and economic emergencies created by the COVID-19 pandemic. Moving forward, the VAT system can be consolidated in phases to widen the VAT tax base and reduce distortions, with a uniform rate at an appropriate level, rationalized exemptions, and a lower threshold for registration. Reducing corporate tax exemptions and lowering personal income tax thresholds could widen the very narrow tax base. The resulting increased revenue could be used to enhance equity through improved social protection and human capital development. Simplifying the customs regime, upgrading the Revenue Administration Management Information System, and strengthening risk-based audits are important to improved tax administration. Sri Lanka also needs to improve debt management practices and frameworks to better manage the increasing risks of its debt portfolio and maintain a sustainable debt trajectory. A credible, rule-based fiscal framework is important to striking the right balance between supporting economic recovery and restoring fiscal sustainability/market confidence.
- 2. Fostering competitiveness to accelerate growth and job creation. Moving toward an export-oriented and private investment-led growth model requires facilitating trade and private investment, including FDI, as well as establishing the necessary conditions for a knowledge economy, integrating productive local companies into regional and global value chains, and improving value addition through innovation and standards. Policy efforts are needed to enhance regulatory quality and transparency, address factor market rigidities (property rights, land, labor and capital markets), and modernize and build resilience of the financial sector while gradually exiting from the regulatory forbearance granted amid COVID-19. Focusing on rule of law and maintaining policy consistency and predictability are critical to catalyzing private investment. Establishing a level playing field that eliminates preferential treatment for SOBEs and larger long-established companies would promote competition and entrepreneurship. Improved connectivity (such as backbone infrastructure) could support access to markets and global integration. Strengthened planning, coordination, and institutional frameworks could help harness the benefits of urban agglomeration, which could generate better jobs and thereby contribute to poverty reduction. Facilitating PPPs in key sectors (infrastructure, health, energy, climate resilience and mitigation), with proper control of associated fiscal risks, could help improve infrastructure gaps amid fiscal constraints.
- 3. Strengthening human capital to improve productivity and social inclusion and closing the gap in access to basic services such as safe water. Expanding access to early childhood education can help build long-term foundations for better socioeconomic skills but requires proper regulatory oversight. Improving the quality and relevance of education can contribute to higher productivity and help meet the needs of the private sector. This improvement entails updating the curriculum to reflect the demands of the marketplace, expanding demand-driven technical and vocational training offerings, and improving the effectiveness of teachers. Mainstreaming soft skills such as problem solving into the school curriculum can improve workers' employability, support a better transition to employment, and

<sup>&</sup>lt;sup>125</sup> Under the GRID approach, the key enablers for green, resilient, and inclusive development are (i) investment in all forms of capital; (ii) macroeconomic and structural policies, institutional strengthening, and technology innovation; and (iii) mobilization of capital at scale.

help youth meet their rising aspirations. Investing in digital literacy and advanced skills among the ICT workforce to boost absorptive capacity could promote innovation and job creation. The implications of the disruptions to schooling and training owing to COVID-19 need to be carefully understood and remedied to prevent further widening of inequalities. Access to safe water and adequate sanitation remains a broader challenge across Sri Lanka, requiring large investments and improvements in the operational efficiency of water supply services.

- 4. Supporting vulnerable groups and lagging regions. Given the extent and severity of the COVID-19 crisis, vulnerable groups such as women and youth who have weaker labor market attachment could benefit from stronger support during the recovery process. Encouraging child care and elderly care provision through accreditation and PPPs, and eliminating gender-based discrimination in regulations that discourage the hiring of women, could improve women's labor market outcomes, including their labor force participation. Public information campaigns to neutralize gender differences in occupations or sectors could help change norms. Broadening career aspirations and focusing on entrepreneurship and personal agency could enhance the capacity of vulnerable groups, including women and youth, to achieve better labor market outcomes. The adequacy and coverage of social assistance programs could be improved, and establishing a social registry will be an important step toward that effort. Targeted interventions are needed to help those living in the poorest areas of the country, such as the Northern and Eastern Provinces. Efforts to improve the productivity in the plantation sector could help raise the wages of estate workers, while further investments will be needed to improve their access to basic services.
- 5. Promoting productivity-enhancing investments in agriculture and sustainable rural businesses. The income of many farmers could be improved by supporting their efforts to shift production to higher-value crops, improving the productivity of paddy, and promoting better access to value chains. Adopting climate-resilient agriculture practices and technologies (e.g., more efficient water use) could help mitigate the risks to output, and thus to income and food security. New technologies, digitalization, and improved agronomic and quality standards could lead to productivity improvements, streamline the supply chain, and inform the design of policies and programs. Restoration of natural resources within forest landscapes and biodiversity conservation could offer incremental benefits across several sectors of the economy and generate sustainable green jobs in rural areas. The rural poor would benefit from support to build a more diversified livelihoods portfolio and asset base. For example, tourism has much potential to contribute to rural income growth; this potential could be realized by an improved investment climate with tourism-specific incentives and trainings in hospitality skills and management. It should be noted that the administrative urban/rural classification is outdated, and some rural areas are in fact urban or semi-urban with regard to their functionalities.
- 6. Managing natural capital and building resilience to climate change. A comprehensive approach is needed to sustainably manage natural assets, strengthen disaster preparedness, and reduce climate risks. Participatory planning, strong implementation, institutional capacity development, and adequate funding could support better management of natural resources. The forecasting and early warning system could evolve into impact-based forecasting and warning services; the system could focus on translating weather and hydrological hazards into sector- and location-specific impacts, and on developing mitigation responses.<sup>126</sup> Improvements are also needed in the use of climate information and seasonal predictions for water resource management, agriculture, and other climate service users. Investing in risk financing and resilient infrastructure could reduce fiscal costs for climate change– induced disasters. Social safety nets could be made more shock-responsive by combining social

<sup>&</sup>lt;sup>126</sup> Landslide warnings are in practice already impact-based warnings, since the warning depends on rainfall, slope, soil saturation, and vegetation cover change, among other factors, including the exposure of communities.

protection interventions with disaster risk management; this would allow programs to be scaled up quickly following extreme climate events and would enhance the resilience of households by helping them better prepare for and cope with natural disasters.

7. Strengthening governance and public financial management to enhance service delivery, accountability, and transparency. Strong public institutions and governance constitute a cross-cutting enabler for all key structural issues. Improvements in public investment management could catalyze private investments by addressing key institutional bottlenecks to investment and identifying public infrastructure that can leverage private sector participation. E-procurement could enhance healthy competition in the bidding process, eventually contributing to efficiency and quality in procurement and to budgetary savings. Effectiveness and accountability of public expenditures and public financial management could be strengthened by improving the capacity and functions of the national audit office. Improved corporate governance of SOBEs could improve service delivery and reduce fiscal risks. Checks and balances among the three arms of the state (executive, legislature, and judiciary) could be enhanced at all levels to promote accountability. Citizen-centric digital government services are important to improve public service delivery and provide a platform to develop smart cities.

## Annex 1. 2015 SCD: Priorities Identified and Key Findings

Driavities	Dationala
Priorities	Kationale
<ul> <li>Fiscal</li> <li>Reform the tax regime and improve tax administration to improve revenue performance</li> <li>Improve the adequacy and effectiveness of spending</li> <li>Improve the amount of financing and efficiency of social protection</li> </ul>	Fiscal sustainability is a key precondition for progress in all areas, including macroeconomic stability. Greater fiscal space allows for addressing equality of opportunity through increased social spending, especially important for inclusion. Efficiency of social protection has direct impact on ending poverty.
<ul> <li>Competitiveness</li> <li>Review and revise the country's trade-related policies</li> <li>Provide more resources and quality-enhancing management in the education sector to expand skilled workforce and overcome skills mismatch</li> <li>Promote innovation by establishing linkages between R&amp;D institutions and networks of entrepreneurs</li> </ul>	Trade and adoption of new technologies promote diversification, external sustainability, and growth, which translate to good jobs. Overcoming skills mismatches contributes to growth and participation of the bottom 40 percent, including minorities and women.
<ul> <li>Inclusion</li> <li>Foster proper urban management and effective governance of cities to address locational concentrations of poverty</li> <li>Carry out multi-sector interventions to reduce poverty and promote employment opportunities in areas with the highest poverty rates (north, east, Moneragala, and estates)</li> <li>Improve equality of opportunity across ethnic groups, regardless of where they reside</li> <li>Increase labor force participation of women and ensure equal opportunity in access to jobs and political and private sector leadership</li> </ul>	Urbanizing areas are associated with growth, and an absolute majority of poor are proximate to these areas. Ensuring continued benefits of agglomeration will help progress for the majority of the poor. For those living in more remote areas, more targeted interventions will be needed to ensure equality of opportunity through improved service delivery and greater participation in the labor force.
<ul> <li>Governance</li> <li>Improve the regulatory environment to allow firms to grow and enhance overall productivity in the economy</li> <li>Review the regulatory role and participation of the public sector in the economy</li> <li>Improve the efficiency of the public sector</li> </ul>	Governance has cross-cutting impact on all other challenges. In particular, labor, land, and other regulations create major distortions in the economy. The size of the public sector leads to inefficient use of public resources and distorts labor markets. The ability of government to carry out core functions depends on effectiveness of the public sector.
<ul> <li>Sustainability</li> <li>Sustain peace and security through long-term reconciliation</li> <li>Develop a more accountable and effective state</li> <li>Place heavier emphasis on direct investment and equity portfolio flows than debt</li> <li>Sustainably manage (and restore/rebuild where applicable) natural assets and address the impact of climate change</li> <li>Address the long-term fiscal sustainability concerns related to population aging</li> </ul>	Peace is sine qua non for continued investment, growth, and the population's personal well-being. Sustaining the state's institutional capability over the long term is integral to facilitating private sector–led growth. Macroeconomic and environmental sustainability are preconditions for making continued progress as well as capitalizing on the country's asset base.

Source: World Bank, Sri Lanka—Ending Poverty and Promoting Shared Prosperity: A Systematic Country Diagnostic (Washington, DC: World Bank, 2015), <u>http://documents.worldbank.org/curated/en/363391467995349383/Sri-Lanka-Ending-poverty-and-promoting-shared-prosperity-a-systematic-country-diagnostic</u>.

### **Annex 2. Selected Economic Indicators**

Macroeconomic Indicators								
	2015	2016	2017	2018	2019	2020		
Real sector								
GDP (current, Rs billion)	10,951	11,996	13,328	14,291	15,013	14,973		
GDP per capita (current, US\$)	3,842	3,886	4,077	4,059	3,852	3,682		
Real GDP grow th (%)	5.0	4.5	3.6	3.3	2.3	-3.6		
CCPI inflation (year-on-year, %)	4.6	4.5	7.1	2.8	4.8	4.2		
Percent of GDP, unless otherw ise indicated								
External sector	_							
Exports of goods	13.1	12.5	13.0	13.5	14.2	12.4		
Imports of goods	23.5	23.3	24.0	25.3	23.7	19.9		
Trade balance	-10.4	-10.8	-11.0	-11.8	-9.5	-7.4		
Tourism receipts	3.7	4.3	4.5	5.0	4.3	0.8		
Remittances	8.7	8.8	8.2	8.0	8.0	8.8		
Current account balance	-2.3	-2.1	-2.6	-3.2	-2.2	-1.3		
Official reserves (USD billion)	8.0	6.9	7.6	5.7	1.6	-0.7		
Official reserves (months of imports of goods and services)	3.8	3.1	3.8	3.1	3.7	3.7		
Exchange rate (end period, Rs/USD)	144.1	149.8	152.9	182.7	181.6	186.4		
Fiscal accounts								
Total revenue and grants	13.3	14.1	13.8	13.5	12.6	9.2		
Tax revenue	12.4	12.2	12.5	12.0	11.6	8.1		
Total expenditure		19.5	19.3	18.8	22.2	20.3		
Current expenditure	15.5	14.7	14.5	14.6	16.1	17.0		
Capital and net lending	5.4	4.8	4.8	4.2	6.1	3.3		
Primary balance	-2.8	-0.2	0.0	0.6	-3.6	-4.6		
Overall fiscal balance	-7.6	-5.3	-5.5	-5.3	-9.6	-11.1		
Central government debt	78.5	79.0	77.9	84.2	86.8	101.0		
Total public debt	85.3	86.1	84.8	92.2	94.3	109.7		
Monetary/financial sector								
Standing deposit facility rate (December, % per annum)	6.0	7.0	7.3	8.0	7.0	4.5		
Standing lending facility rate (December, % per annum)	7.5	8.5	8.8	9.0	8.0	5.5		
Private sector credit grow th (M2b <sup>2</sup> , year-on-year, %)	25.0	21.6	15.7	15.3	4.3	6.4		
Regulatory capital to risk w eighted assets - Banking sector	15.4	15.6	16.4	16.2	17.2	16.5		
Gross non-performing loans to gross loans & advances - Banking sector		2.6	2.5	3.4	4.7	4.9		
Poverty								
International poverty rate (\$1.9 in 2011 PPP) <sup>a,b</sup> (percent)	1.1	0.9	0.9	0.7	0.6	1.2		
Low er-middle-income poverty rate (\$3.2 in 2011 PPP) <sup>a,b</sup> (percent)		11.0	10.3	9.6	9.2	11.7		
Upper-middle-income poverty rate (\$5.5 in 2011 PPP) <sup>a,b</sup> (percent)		42.0	40.8	39.5	38.6	42.3		

Sources: Central Bank of Sri Lanka, Ministry of Finance, World Bank staff calculations.

*Note:* CCPI = Colombo Consumer Price Index; FDI = foreign direct investment; M2b = broad money supply; PPP = purchasing power parity.

a. Calculations using 2016 HIES. Actual data are from 2016.

b. Projections for 2020 are from a microsimulation.

### Annex 3. Key Analytical Products Completed in Recent Years and Background Reports for the SCD Update

- IMF and World Bank, Public Investment Management Assessment (2018)
- United Nations Development Programme, Human Development Report (2020)
- World Bank, "Assessment of Ethnic and Religious Inclusion in Sri Lanka" (unpublished background paper)
- World Bank, "Assessment of Sri Lanka's Legal Framework and Gender Equality" (unpublished background paper)
- World Bank, "Contingent Liability from Natural Disasters in Sri Lanka" (2020)
- World Bank, Financial Sector Assessment Program–Development Module (2016)
- World Bank, "Informal Employment, Jobs Quality, and Welfare in Sri Lanka" (2020)
- World Bank, "Integrated State-Owned Enterprise Framework" (2020)
- World Bank, "Jobs Diagnostic Sri Lanka" (2020)
- World Bank, "Sri Lanka Country Economic Memorandum" (forthcoming)
- World Bank Group, "Sri Lanka Country Private Sector Diagnostic" (forthcoming)
- World Bank, Sri Lanka Education Sector Assessment (2017)
- World Bank, "Sri Lanka Poverty Assessment" (forthcoming)
- World Bank, "Priorities for Sustainably Managing Sri Lanka's Coastal Fisheries and the Ecosystems That Support Them" (forthcoming)
- World Bank, Public Expenditure Reviews: Public Finance (2019), Transport (2018), Water (2019), Energy (2019)
- World Bank, South Asia's Hotspots (2018)

### Annex 4. Key Data and Knowledge Gaps

- Cost of restrictive trade regime. This refers to the impact of a restrictive trade regime, including the new import controls, as well as the lack of competition policy in the domestic market. The restrictions will likely have implications for prices, exports, employment, and productivity.
- Comprehensive review of agriculture sector, including analysis of constraints to improving agricultural productivity (e.g., technology adoption, irrigation, input and output market efficiency).
- Assessment of the distributional impact of the mitigation and adaptation measures needed to transition to a green economy.
- External and internal migration:
  - Changes in external migration patterns amid COVID-19. These affect remittances and thus have implications for income and balance of payments.
  - Data on internal migration patterns to understand the distribution of economic opportunities (including the pandemic impact); agglomeration patterns; and changes in the demand for basic services and housing.
- COVID-19 impact on education and training to understand the extent of the disruptions to education and training and initiate holistic interventions to address learning losses and social and emotional needs of students.
- Renewable energy feasibility studies to understand the feasibility of different sources, in particular emerging solutions such as battery storage, offshore wind, floating solar, and the transmission and distribution grid investments needed.