SRI LANKA DEVELOPMENT UPDATE

MORE AND BETTER JOBS FOR AN UPPER MIDDLE-INCOME COUNTRY

June 2018
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The Sri Lanka Development Update has two main aims. First, it reports on the key developments over the past six months in Sri Lanka’s economy, and places these in a longer term and global context. Based on these developments, and on policy changes over the period, it updates the outlook for Sri Lanka’s economy and social welfare. Second, the Update provides a more in-depth examination of selected economic and policy issues, and analysis of medium-term development challenges. It is intended for a wide audience, including policymakers, business leaders, financial market participants, think tanks, non-governmental organizations and the community of analysts and professionals engaged in Sri Lanka’s evolving economy.

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Previous editions:
- November 2017: Creating opportunities and managing risks for sustained growth, openknowledge.worldbank.org/handle/10986/28826
- June 2017: Unleashing Sri Lanka’s trade potential, openknowledge.worldbank.org/handle/10986/27519
- October 2016: Structural challenges identified in the Systematic Country Diagnostic, openknowledge.worldbank.org/handle/10986/25351

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Table of Contents

EXECUTIVE SUMMARY ........................................................................................................5

1. Recent Developments .................................................................................................... 5
2. Outlook, risks and policy priorities .................................................................................. 7
3. Special focus ..................................................................................................................... 8

A. RECENT DEVELOPMENTS ......................................................................................... 10

B. OUTLOOK, RISKS AND POLICY PRIORITIES ......................................................... 24

1. Outlook ............................................................................................................................. 24
2. Risks ................................................................................................................................... 27
3. Challenges and policy priorities ...................................................................................... 28

C. SPECIAL FOCUS: MORE AND BETTER JOBS FOR AN UPPER MIDDLE INCOME COUNTRY .................................................................................................................. 33

1. The state and structure of jobs in Sri Lanka ................................................................. 34
2. Is Sri Lanka an employment outlier in South and East Asia? ........................................ 39

D. WORLD BANK GROUP ASSISTANCE ....................................................................... 52

KEY ECONOMIC INDICATORS ......................................................................................... 54

LIST OF TABLES
Table 1: Growth prospects for key partners of Sri Lanka ................................................ 26
Table 2: Keeping employment rates constant would require massive job creation .......... 43
Table 3: South Asian countries have created large numbers of jobs ................................ 43
Table 4: The annual job creation needed in Sri Lanka depends on the age of the working population ................................................................. 44
Table 5: More jobs will be needed in particular in the post-conflict areas ......................... 48
Table 6: Balance of payments ........................................................................................... 55
Table 7: Budget and fiscal outcomes .................................................................................. 56

LIST OF BOXES
Box 1: Sri Lanka: country context ...................................................................................... 9
Box 2: Drivers of the interest bill ....................................................................................... 13
Box 3: Debt management .................................................................................................. 15
Box 4: Cost-reflective pricing of fuel .................................................................................. 18
Box 5: Global economic context ......................................................................................... 25
Box 6: Public Expenditure Review ..................................................................................... 29
Box 7: National Audit Act .................................................................................................. 31
Policy recommendations...................................................................................................... 33
Box 8: What is the informal sector in Sri Lanka? .............................................................. 36
Box 9: The job creation challenge in South Asia ................................................................ 42
Box 10: Exports and jobs ................................................................................................... 50
Executive Summary

Recent policy measures have contributed to macroeconomic stability. However, with significant risks stemming from both domestic and external fronts, the balance of risks is tilted towards downside. To sustain growth, create more and better jobs and reduce poverty Sri Lanka needs to implement and sustain structural reforms to improve competitiveness.

1. Recent Developments

Improved macroeconomic performance was masked by inclement weather.

In 2017, Sri Lanka’s improvement in its macroeconomic performance was masked by inclement weather. Fiscal and monetary policy measures contributed to stabilization; however, a prolonged drought took a toll on growth while contributing to raising inflation. Despite a widening deficit of the external current account, exports recovered after shrinking for two consecutive years. Strengthened capital flows improved external buffers. The overall improvement in macroeconomic performance was recognized by rating agencies.

Reform implementation is progressing although slower than expected.

Authorities pursued the economic reform agenda presented in the government policy statements, albeit at a slower pace, due to a complex political environment and institutional constraints on policy implementation.

- The new Inland Revenue Act passed in 2017 came into effect in April 2018, which marks a key milestone towards sustainable revenue-led fiscal consolidation.
- Fuel price reforms in May 2018 will reduce fiscal risks from SOEs.
- Government passed the Active Liability Management Law to deal with heightened external debt refinancing risks in 2019 and beyond.
- The phase-out of 1,200 para-tariffs in December 2017 is expected to make Sri Lanka more competitive.
Improvement in public finance continued; however, fiscal risks remain high.

Albeit small, the government recorded a primary surplus in 2017, in line with the IMF supported government program. The achievement that came as a first-in-decades was thanks to improved tax collection and controlled non-interest current expenditures. Nevertheless, a sharp increase in interest expenditure led to a marginal increase in overall deficit as share of GDP to 5.5 percent in 2017. Fiscal risks emanating from public debt (77.4 percent of GDP, 2017) and treasury guarantees issued mainly for SOEs and state agencies (6.8 percent of GDP, 2017) remained high in 2017 as well.

Economy suffered from continued natural disasters in 2017.

In 2017, inclement weather took a toll on real and external sectors. Despite important contributions from some service sectors, growth decelerated to 3.3 percent mainly because of weak performance of agriculture and related sectors. On the external front, the favorable impact of recovery of exports led by tea was offset by an increased petroleum bill as reservoirs ran dry due to drought while global oil prices increased. Along with the changes in VAT, inclement weather exerted upward pressure on food prices leading to relatively high inflation.

External buffers improved thanks to capital flows; however, currency pressures were seen in 2018.

Gross official reserves reached an all-time-high in April 2018 thanks to proceeds from term-financing facilities, Eurobonds issued in 2017 and 2018 and FDI inflows including the proceeds from the long lease of Hambantota port. The central bank remained a net buyer of foreign exchange in 2017 supporting the accumulation of reserves. While the Sri Lankan rupee depreciated by 2 percent in 2017, elevated pressures were seen in 2018 amid recent emerging market interest rate pressures (Argentina and Turkey) and expectations of further US rate hikes in the backdrop of a reduction of domestic policy rates.

IMF successfully completed the fourth review of the EFF program.

With the implementation of the cost-reflective fuel price formula in May 2018, the fourth review of the IMF Extended Fund Facility (EFF) program was successfully completed. The key fiscal and monetary policy measures aimed at reinstating stability were supported by this program. The program also calls for significant SOE reforms and the move towards an inflation targeting monetary management regime.

Poverty reduction continued to be strong.

Sri Lanka has seen strong poverty reduction in recent years, which continued between 2012/13 and 2016. Using the international poverty line for lower-middle income countries at USD 3.20 per day poverty between 2012/13 and 2016 fell from 16 to 9.5 percent of population.

A new single web portal for investors called SWIFT was launched to facilitate investments, and a Trade Information Portal will be available soon to provide import and export related information on regulations and processing steps.

Various additional regulatory simplification in the business environment have been carried out such as the procedures for property registration and construction permits.

Work on the Excise reform is well advanced.

A new Public Finance Act is being drafted to strengthen management of public finances.

However, some other vital reforms were lagging; these include, passing of the Audit Act, progressing on establishing a unified debt management office, SOE reforms, and reforms to improve the investment climate such as the legislation on Secured Transaction Registry, the Customs Ordinance and revisiting the Companies Act.

1 The portal is expected to go live on July 5, 2018: http://srilankatradeportal.com/
2 The reforms in the program are mainly focused on revenue led fiscal consolidation, transition to flexible inflation targeting; and reforms in SOE oversight and trade and competitiveness.
percent, lifting roughly 1.5 million persons out of poverty. There has been remarkable poverty reduction in some previously poor districts between 2012/13 and 2016. Continued structural transformation, urbanization, growth in tourism, and focus on the remaining pockets of poverty should sustain poverty reduction in the future.

2. **Outlook, risks and policy priorities**

- **A stable outlook is projected in the backdrop of policy reforms.**
  
  The outlook will remain stable, provided the government is committed to the reform agenda aimed at improving competitiveness, governance and public financial management. Together with the IMF program, these reforms will add to confidence and support fiscal consolidation efforts.

- **Growth is expected to pick up with manageable inflation.**
  
  The economy is expected to rebound from a low base and grow around 4.3 percent in the medium term, driven by private consumption and investment. Inflation will stabilize around mid-single digit level, although the upward trend in oil prices may exert some upward pressure with the implementation of fuel-price formula. The move towards flexible inflation targeting will help keep inflation in the single digits, while the exchange rate is left to adjust to market forces.

- **Fiscal consolidation will improve overall fiscal balances.**
  
  Implementation of the new Inland Revenue Act, further reforms to the VAT Act and the Excise law and improvements in tax and excise administration are expected to expand revenues. Primary surpluses supported by the implementation of revenue measures will narrow the overall fiscal deficit to 3.9 percent of GDP by 2020. Continued fiscal consolidation is projected to bring the public debt burden to a downward path from 2018. Under the baseline scenario, debt-to-GDP ratio will come down to 74.8 percent of GDP by 2020.

- **The external current account deficit will widen in 2018 and beyond in line with increase in commodity prices.**
  
  With healthy growth in the US and Euro Area and a recovery in a few key Middle Eastern countries, the external environment for Sri Lanka has improved, which would be favorable for exports. The country will continue to benefit from tourism growth and the EU’s GSP+3 in the medium-term. However, rising oil prices and external interest payments along with decelerating remittances flows will lead to a widening external current account deficit in 2018 and beyond. Foreign capital inflows to government securities and FDI inflows will help closing the external financing needs with no Eurobond falling due in 2018.

- **With emphasis on market forex purchases, external buffers are to improve in 2018.**
  
  FDI inflows and other debt creating flows in IMF EFF program, external term-financing and project loans will elevate external buffers to a historical-high in 2018 while the central bank will help accumulation of reserves with emphasis placed on purchasing foreign exchange and maintaining a more market-determined exchange rate using monetary policy. A part of the increased reserves is expected to be used for liability management purposes given refinancing risks in 2019 and beyond. However, in the medium-term, unless export and FDI growth accelerates, more external borrowing will be needed when large repayments in Eurobonds continue.

- **Risk balance is tilted towards downside; the key one being the domestic political risk.**
  
  The challenging political environment has already slowed the reform agenda and remains the key risk to a favorable medium-term outlook. With the impending election cycle, which elevates this risk, the window for further reforms is narrowing. On the fiscal and debt management front, risks include the delay in implementing revenue measures, slower than expected improvement in tax administration, and

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3 Provides duty free access for about 7,200 tariff lines to the EU
delays in implementing the Active Liability Management Act. The increasing occurrence and impact of natural disasters could have an adverse impact on growth, the fiscal budget, the external sector and poverty reduction.

External risks include disappointing growth in key countries that generate foreign exchange inflows to Sri Lanka: exports, tourism, remittances, FDI, and other financing flows. Tighter than expected global financial conditions would increase the cost of debt and make rolling over the maturing Eurobonds from 2019 more difficult; however, the Active Liability Management Act will help mitigate this refinancing risk. Faster than expected rises in commodity prices would increase pressure on the balance of payments and could make further fuel price reforms more difficult.

Sri Lanka faces a number of challenges to sustain future economic growth, create more and better jobs and reduce poverty; which must be addressed through determined reforms. These challenges can be addressed through four sets of priority reforms:

1. staying on the fiscal consolidation path and creating fiscal space for health, education, social protection and other public investments;
2. improving Sri Lanka’s competitiveness and promoting trade and FDI to facilitate a shift in the growth model driven more by private investment and exports;
3. making progress on and completing the already started governance reforms such as Right to Information, the Audit Act and the Public Finance Act and SOE reforms; and
4. reducing vulnerability and risks in the economy: (a) managing refinancing risks of Eurobonds beyond; (b) improving the debt management function with requisite institutional, legal and strategy frameworks; (c) mitigating the impact of reforms on the poor by replacing untargeted effective subsidies to the non-poor by targeted spending; and (d) enhancing the country’s resilience and disaster preparedness to deal with frequent natural disasters more pro-actively.

These key challenges are inter-linked and require a comprehensive and coordinated approach. Although domestic political considerations and institutional constraints on policy implementation make it challenging, a strong political will and support of the bureaucracy could help advance the reform agenda. Steps are needed to ensure the support of private sector, civil society and other stakeholders through improved communications on costs and benefits of its Vision 2025 agenda.

3. Special focus

Sri Lanka’s employment rate is low given its income level due mainly to low female labor force participation. As the country is ageing, it is important to increase the contribution from women and youth to sustain growth and development. Sri Lanka is also faced with high unemployment among youth. Accordingly, the country needs to create jobs opportunities appropriate for its labor force, in particular for youth and women. The government has set an ambitious target to create 1 million jobs in its Vision 2025. The Special Focus Section of this Edition is devoted to a discussion of issues and priorities in jobs creation in Sri Lanka and the Northern and Eastern Provinces.
Box 1: Sri Lanka: country context

Sri Lanka is a Lower Middle-Income country with a GDP per capita of USD 4,073 (2017) and a total population of 21.4 million people. Following 30 years of civil war that ended in 2009, Sri Lanka’s economy grew at an average 5.8 percent during the period of 2010-2017, reflecting a peace dividend and a determined policy thrust towards reconstruction and growth; although there were some signs of a slowdown in the last few years. The economy is transitioning from a predominantly rural-based economy towards a more urbanized economy oriented around manufacturing and services.

The country has made significant progress in its socio-economic and human development indicators. Social indicators rank among the highest in South Asia and compare favorably with those in middle-income countries. Economic growth has translated into shared prosperity with the national poverty headcount ratio declining from 15.3 percent in 2006/07 to 4.1 percent in 2016. Extreme poverty is rare and concentrated in some geographical pockets; however, a relatively large share of the population subsists on slightly more than the extreme poverty line. The country has comfortably surpassed most of the MDG targets set for 2015 and was ranked 73rd in the Human Development Index in 2015.

The economy’s weak competitiveness is an issue to address. Restrictive trade policies over the past decade have created a strong anti-export bias, which has been reflected in a dramatic decline in trade. While growth in Sri Lanka has been strong over the past few years, it has been inward-oriented and based on the growth of non-tradable sectors. Sri Lanka also attracts a much lower volume and quality of FDI than peer economies and the shortcomings of the investment climate pose obstacles for new firms. Moreover, significantly high state participation in the economy has implications on competitiveness in several sectors and labor market dynamics.

Low revenues and high debt as a share of GDP are key macroeconomic concerns. The major causes of low revenues as a share of GDP are the low number of number of tax payers (less than 7 percent of the labor force and formal establishments pay income tax), reductions in statutory rates without commensurate efforts to expand the tax base, inefficiencies in administration and numerous exemptions. Low revenues combined with largely non-discretionary expenditure in salary bill, transfers, and interest payments has constrained critical development spending and squeezed expenditure on health, education and social protection, which is low compared to peers.

Sri Lanka has a 3-year Extended Fund Facility (EFF) program with the IMF, which is primarily focused on increasing revenues. The program calls for fiscal consolidation, transition to flexible inflation targeting, and reforms in public financial management, state enterprises and trade and competitiveness. The IMF announced that it had reached staff-level agreement with the government on completing the fourth review of the EFF in April 2018.

The government that came to power in 2015 envisions promoting a globally competitive, export-led economy with an emphasis on inclusion. It has indicated keenness to undertake reforms in the areas of public finance, competitiveness, governance and education sectors. Recently, the government presented Vision 2025, a policy document encompassing key structural reforms to address the above challenges.

Figure 1: Growth and inflation
(Percent annual change)

![GDP growth chart]

Figure 2: Sri Lanka’s fiscal position compared to peers

![Fiscal position chart]

Source: Department of Census and Statistics and staff calculations
Source: World Economic Outlook, IMF Fiscal Monitor

Note: Bubble size corresponds to the gross debt as a share of GDP.
A. Recent Developments

Growth performance of 2017 was affected by inclement weather

Floods and drought affected growth. Growth decelerated to a 16-year low of 3.3 percent in 2017 due mainly to adverse weather conditions, with floods in May in the South and West, and prolonged drought across the country. Agriculture contributed negatively to growth for the second consecutive year, while an adverse impact on related industry and service sectors was also observed. The construction sector, which was one of the biggest contributors to growth in 2016, saw a slowdown along with the transportation sector. As in 2016, the financial services, wholesale and retail trade, real estate, and other personal services sectors contributed significantly to growth. However, this contribution was insufficient to keep overall growth from falling from 4.5 percent in 2016 (Figure 3). GDP per capita reached USD 4,073 and GNI per capita reached USD 3,851.

Capital formation was the key contributor to growth. Reflecting the impact of inclement weather and VAT reforms, the contribution to growth from private consumption remained subdued while it was negative for government consumption due to tight control over the wage bill and purchase of goods and services. Investment demand reflected by the contribution to growth from gross capital formation was high thanks to some key projects driven by FDI progressing well. Exports contributed positively to growth with strong growth in tea, garments and tourism sectors; however, increased imports in food and petroleum

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4 Despite a rebound in agriculture sector, a decline in construction decelerated the growth of the first quarter of 2018 to 3.2 percent.
5 The contribution to growth from construction fell to 0.2 percentage points in 2017 from 0.6 in 2016.
6 For 2017, the contribution to growth from private consumption and government consumption were 0.8 and -0.4 percentage points respectively.
7 The contribution to growth from gross capital formation was 7.3 percentage points in 2017. Included in this was a 6.0 percentage point contribution to growth from changes in inventories.
products amid drought resulted in a significantly large negative contribution to growth from the overall external sector\(^8\) (Figure 4).

Figure 3: Contributors to growth (production side) (Percentage points)

![Figure 3](image)

Source: Department of Census and Statistics and staff calculations

Figure 4: Contributors to growth (demand side) (Percentage points)

![Figure 4](image)

Source: Department of Census and Statistics and staff calculations

**Annual average inflation was high in 2017 due to inclement weather and VAT changes but has eased since then.**

Inflation was high in 2017 but has eased since then.

A combination of factors including food inflation due to adverse weather, past currency depreciation and increased indirect taxes contributed to a rise in inflation in 2017. Accordingly, year-on-year inflation measured by the widely-watched Colombo Consumer Price Index (CCPI, 2013=100) recorded its highest value since it was introduced in 2014 at 7.8 percent in October 2017 before closing the year at 7.1 percent. In addition to food, large contributions to the rise in prices came from health, education, restaurant and hotel segments with the increase in the VAT rate.\(^9\) However, inflation eased during the first few months of 2018, reaching 4.0 percent in May, as the effects of the weather-related food shocks and VAT changes wore off. Annual average inflation followed suit, closing the year 2017 at 6.6 and decelerating to 5.7 percent by May 2018. On a similar note, core inflation measured excluding food, energy and transport declined to 3.2 percent by May 2018 once the level effect of VAT increase dissipated amid tight monetary policy (Figure 5 and 6).

The national price index echoed the same trends.

The National Consumer Price Index (NCPI, 2013=100) that reflects price movements of all provinces in the country based on the Household Income and Expenditure Survey (HIES) also reported a similar trend. After peaking at 8.8 percent in October 2017, year-on-year inflation eased to 1.6 percent by April 2018.

\(^8\) The negative contribution to growth from the external sector was 4.6 percent, the highest negative contribution to growth in the last three years.

\(^9\) 2017 inflation reflected the first full-year impact of VAT reforms. The VAT net was broadened removing exemptions on selected private health-related items while the rate was increased to 15 percent (from 11 percent) in May 2016; the related legal process was completed in November 2016.
The fiscal improvement was masked by a sharp rise in interest cost; the new Inland Revenue Act is expected to pave the way for sustainable, revenue-led fiscal consolidation.

The government recorded a small primary surplus in 2017, in line with the IMF supported government program. The achievement that came as a first-in-decades was due to improved tax collection and controlled non-interest current expenditures. Tax revenues increased thanks to VAT reforms in its first full-year of implementation, while dividend flows to the government from State Owned Business Enterprises (SOBEs) were significantly lower compared to the previous year, leading to a lower total revenue. On the expenditure front, despite the increase in spending on natural disasters, tight control helped reduce non-interest current expenditures as a share of GDP. A lower capital budget execution ratio resulted in a lower than budgeted public investment level. These factors collectively contributed to turning a negative primary balance to a positive one in 2017. However, a sharp increase in interest expenditure led to widening of the overall deficit to 5.5 percent in 2017 from 5.4 percent of GDP in the previous year (Figure 9 and 10) (Box 2).

Foreign sources provided about 60 percent of net financing, equivalent to 3.3 percent of GDP. This consisted mainly of external commercial sources, which included sovereign bonds and foreign currency term finance facilities amounting to USD 2.5 billion, equivalent to 2.9 percent of GDP in total. The remaining 40 percent was financed through domestic sources; predominantly by the banking sector. As in the past, Employees’ Provident Fund, National Savings Bank and other savings and insurance institutions made a significant contribution to the domestic non-bank financing component.

10. Tax revenue increased to 12.6 percent of GDP in 2017, a 0.3 percentage point increase over the previous year.
11. Non-interest current expenditures reduced by 0.6 percentage points during the same period.
12. Public investment recorded a 0.1 percentage point increase to 4.9 percent of GDP in the previous year.
13. As a share of GDP, interest rose from 5.1 percent in 2016 to of 5.5 percent in 2017.
Box 2: Drivers of the interest bill

The government’s interest cost has risen fast in the past few years. Between 2014 and 2017, the interest cost grew at a compounded annual growth rate of 18 percent and reached a seven-year high at 5.5 percent of GDP in 2017, up from 4.2 percent of GDP in 2014. The interest bill, which continues to be the single largest expenditure item in the budget, was equivalent to over 40 percent of the government total revenue. Moreover, it exceeded the total public investment for the first time in more than a decade, in 2017.

Rising domestic interest costs was the key reason behind the past growth. Domestic interest payments accounted for almost 70 percent of the total growth in the interest bill for 2017. This was mainly driven by a relatively high interest environment amid a tight monetary policy aimed at stabilization. Average interest cost on domestic debt rose across maturities in 2016; for example, average interest rate of 8.9 percent on 5-year bonds issued in 2015 increased to 12 percent in 2016 – a much higher increase than the total policy rate tightening – and remained high at 11.5 percent in 2017. Meanwhile, the local currency debt stock is estimated to have grown by around 9 percent in 2016 and 4 percent in 2017. Moreover, the move towards relatively longer maturities, which is reflected by an increase in the Average Time to Maturity (ATM) in domestic debt, also contributed to the rise in average interest cost on domestic debt.

Interest cost on external debt could become challenging, going forward. On the external front, the interest bill rose by 32 percent although its contribution to growth was less important compared to the domestic bill in the year 2017. However, the interest bill on external debt will be challenging in the coming years given the country’s shift towards commercial borrowing while the global financial conditions are expected to tighten. Continued fiscal consolidation and improved debt management are even more important in the context of rising interest costs (Figure 7 and 8).

Fiscal risks remain high emanating from central government and SOE debt. The central government debt to GDP ratio declined to 77.4 percent thanks to relatively high real growth effect - albeit smaller compared to the previous year - and low real interest rates on debt effect in a year of relatively high inflation. However, the country’s debt profile highlights many important risks. Moreover, SOE debt, which is not included in the public debt, is high and has been growing in the recent past mainly due to the absence of cost reflective pricing formulae (CPC and CEB) and weak operational performance (Sri Lankan Airlines). Debt guaranteed by the Treasury for SOEs is high while the composition of guarantees highlights heightened risks (Figure 12, 14 and 15).

The new Inland Revenue Act is

The new Inland Revenue Act came into effect on April 1 of 2018. The new law that builds on international best practice, aims to broaden the tax base by removing

14 ATM of domestic debt rose from 3.2 years in 2012 to 6 years in 2016.
15 Passing of the Act was a key structural benchmark of the IMF supported government program.
expected to support revenue-led fiscal consolidation.

excessive tax exemptions; rationalize corporate tax incentives toward an investment-oriented regime; simplify the tax system; and strengthen powers of the tax administrator. If well implemented, the new law would serve as the foundation for sustained revenue-led fiscal consolidation over the medium term and provide resources for essential social services and productivity-improving public investments while making the budget more resilient to natural disasters.

Passing of a Liability Management Act is a key step but more needs to be done to improve debt management.

To deal with the refinancing risks of maturing Eurobonds starting from 2019, the government enacted the Active Liability Management Act, which provides the legal framework for active liability management operations. The Act allows raising new debt of an amount up to 10 percent of the total outstanding debt beyond maturing debt within the year, which can be used to buy back debt maturing in future years. While this is a key measure towards managing an immediate risk, many other important reforms are essential for improving the debt management function given the significant risks in the debt portfolio (Box 3).
Box 3: Debt management

Sri Lanka’s debt portfolio shows significant risks. While Sri Lanka’s debt level (total central government debt - 77.4 percent of GDP, 2017) and debt service (87.5 percent of revenue, 2017) are high compared to its peers, the debt portfolio has deteriorated in several indicators in the recent past; especially, in relation to external debt. The total external debt stood at 59.5 percent of GDP while the government external debt stock was 35.4 percent of GDP as of end 2017. Foreign-currency denominated external debt of the central government was 50 percent of its total debt, out of which 30 percent is expected to fall due within the next three years. Sri Lanka has the third largest gross financing requirement in 2018 at 20 percent of GDP among emerging market economies (IMF 2017). Moreover, as the country approaches Upper Middle-Income Country status, it is borrowing on more commercial terms with increased the cost and risk. The non-concessional and commercial component of government foreign debt rose from 1 percent in 2000 to 55 percent in 2017. The interest rate risk on foreign currency debt has risen with the share of floating-rate debt as a share of outstanding debt rising from 17 to 32 percent between 2010 to 2016. The Average time to maturity (ATM) declined while average interest rates increased. Moreover, adequacy of reserve cover of foreign currency commercial debt deteriorated (Figure 13 and 16).

Eurobonds rollover could become a key challenge starting from 2019. Sri Lanka faces external sovereign bond maturities from 2019 to 2023 and from 2025 to 2028 (USD 12.15 billion) (Figure 11). The situation is exacerbated by maturing bonds of commercial banks and Sri Lankan Airlines during the period from 2018 to 2019 (approximately USD 1.8 billion). Given that large bullet repayments of more than USD 500 million are new to Sri Lanka, such payments could expose the country to refinancing risk and could lead to higher spreads on Sri Lankan debt compared to benchmarks. Similarly, partial rollovers of the bonds would lead to loss of reserves and exchange rate pressures.

SOE debt is a key fiscal risk. Based on available data, by end 2015, total SOE debt excluding the financial institutions was estimated at over LKR 1.3 trillion or 12 percent of GDP (2015). While SOE financial institutions borrow both locally and overseas based on the strength of their respective balance sheets, non-financial SOEs receive financing predominantly from the domestic banking sector. To facilitate SOE borrowings, the Treasury issues guarantees and letters of comfort on a case-by-case basis. In the recent years, the treasury guaranteed debt rose fast, and remained high at 6.8 percent of GDP at end-2017. Moreover, the composition of guarantees has changed over time, with the share of guarantees given to commercially oriented state-owned business enterprises with revenue capacity declining from 90 percent in 2006 to 40 percent in 2017 while guarantees given to state establishments, primarily dependent on the state budget for expenditures have risen. Since the latter receive current and capital transfers to service this guaranteed debt, the government is effectively servicing this debt. On a similar note, letters of comfort issued by the Treasury have also increased in the past few years; as of end 2017, the total value of letters of comfort amounted to 0.7 percent of GDP (Figure 10).

In addition to portfolio related challenges, there are important structural challenges that require attention. The fragmented institutional framework and lack of a comprehensive debt management strategy leaves the public sector exposed to a debt portfolio with high cost and risk in the domestic market as well. The decades-old legal framework falls short in providing a comprehensive framework for modern debt management. The Private Public Partnership (PPP) agenda may move the direct fiscal cost of investment to the private sector, but may require the public sector to assume more fiscal risk.

Improvements in debt management will help develop the domestic financial market, and improve access to finance. Reforms in debt management and SOEs are crucial for macroeconomic stability. Improved debt management may better manage the interest cost and risks of government debt and support fiscal consolidation while reducing fiscal risks. Managing liabilities actively will mitigate refinancing risks, contribute to improved investor perceptions and possible upgrading of credit ratings. Improved debt management will also lead to deeper, more liquid domestic debt markets that support private capital market development. Less fiscal pressure on financial markets will reduce market interest rates and thereby the cost of financing for households and firms. Together with the expected presentation of the Secured Transactions Registry Act, which will allow firms to pledge movable collateral for loans, this would support access to finance on reasonable terms for the struggling SME sector. Improvement in SOE governance may reduce fiscal pressures and improve service delivery.

The government has taken some important steps to deal with the refinancing risks; however, the progress of other key structural reforms on debt management has been slow. To face the refinancing risks of maturing Eurobonds in 2019 and beyond, the government enacted the Active Liability Management Act and formulated a strategy. While these are important measures to mitigate a key risk of the portfolio, other reforms need to progress. An integrated risk management approach is needed for debt and contingent liabilities in relation to the central government, SOEs, PPPs and natural disasters. The establishment of a unified debt management office is an important step in this direction although it has experienced

significant delays. A comprehensive Medium-Term Debt Strategy (MTDS) – covering both external and domestic debt – is needed to provide guidance to manage the costs and risks of the portfolio.

Figure 13: External debt indicators

<table>
<thead>
<tr>
<th>Year</th>
<th>Share of foreign currency commercial debt/official reserves (LHS)</th>
<th>Average time to maturity (external)</th>
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<tbody>
<tr>
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<td>90</td>
<td>100</td>
</tr>
<tr>
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<tr>
<td>2016</td>
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<td>40</td>
</tr>
</tbody>
</table>

Source: Central Bank of Sri Lanka

Figure 14: Components of public sector debt

Source: Ministry of Finance, annual reports of respective SOEs

Note: RDA – Road Development Authority; 7 SOBEs included in the graph are Ceylon Petroleum Corporation, Ceylon Electricity Board, Sri Lankan Airlines, Sri Lanka Ports Authority, National Water Supply and Drainage Board, Ceylon Fertilizer Company, Airport and Aviation Services Company.

Figure 15: Trends in the guarantee composition

Source: Ministry of Finance, Central Bank of Sri Lanka, Sri Lankan Airlines, staff calculations

Note: RDA – Road Development Authority. RDA and other entities may not have stable revenue streams.

Figure 16: Composition of external debt stock

Mixed external sector performance, but recent capital inflows led to improvement of reserves.

A rise in imports and decelerating remittances widened the current account deficit. Rising oil prices and increased imports of food and petroleum due to the drought offset the growth in exports, which was led by a recovery of the tea industry. In fact, the non-oil trade deficit improved; however, the sharp rise in the oil bill masked this improvement and resulted in a widened trade deficit for 2017. Although growth in
tourism flows, albeit at a slower pace,$^{17}$ continued to ease external pressures, the decline in worker remittances and an elevated trade deficit led to an expanded deficit in the current account at 2.6 percent of GDP in 2017, up from 2.1 reported in 2016.$^{18}$

Although FDI reached an all-time high at USD 1.7 billion$^{19}$ from a low base thanks to the long leasing of the Hambantota port and the Colombo Port City project, loan receipts and portfolio receipts continued to be the main sources of financing the deficit. While the government securities market started attracting net inflows after a period of outflows, issuance of sovereign bonds worth of USD 1.5 billion,$^{20}$ receipts of USD 1.5 billion in project loans and foreign currency term financing of USD 1.0 billion were the key inflows to the financial account in 2017 (Table 6).

**Debt-creating flows dominated the financial account.**

Supported by increased capital inflows, the central bank continued to strengthen reserves through purchases in the forex market$^{21}$ helping the gross official reserves to reach USD 8 billion by end-December 2017.$^{22}$ With a further boost received from new sovereign bonds issued in April 2018,$^{23}$ official reserves reached an all-time-high at USD 9.9 billion by end-April. However, foreign exchange obligations for the 12 months starting from May 2018 are estimated at USD 8.0 billion (including a Eurobond of USD 1.0 billion maturing in January 2019), implying that official reserves reached an all-time-high in April 2018 on account of capital flows.

**Figure 17: External reserves (USD million)**

Reserves net of swaps and ISBs
Reserves net of short-term liabilities

**Figure 18: Exchange rate depreciation (Percent)**

2018 April (month-on-month)
January 2017 to March 2018

Source: Central Bank of Sri Lanka, staff calculations.
Source: Bank of International Settlement, Central Bank of Sri Lanka, staff calculations.

Note: Negative numbers represent depreciation.

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$^{17}$ Growth in tourism receipts decelerated to 12 percent, year-on-year, in 2017 compared to 18 percent in 2016, reportedly due to the limited access provided by the country’s main airport through to April on account of renovation activities and a Dengue breakout that kept tourists away.

$^{18}$ During the year, remittances shrank on a year-on-year basis, indicating the adverse economic conditions in the Middle East. This region generates over 50 percent of Sri Lanka’s remittances.

$^{19}$ Equivalent to 2.0 percent of GDP.

$^{20}$ Sri Lanka issued its eleventh sovereign bond worth USD 1.5 billion (10-year) in May 2017. The coupon rate of 6.20 percent reflected a spread of 380 bps over the US Treasury rate for a 10-year security. The issuance rated ‘B1’, ‘B+’ and ‘B+’ by Moody’s Investors Service, Standard and Poor’s and Fitch, attracted bids over USD 11 billion achieving an oversubscription ratio of over 7 times.

$^{21}$ Between March 2017 and April 2018, the central bank purchased over USD 2.4 billion.

$^{22}$ Equivalent to 4.6 months of merchandise imports.

$^{23}$ Sri Lanka issued its twelfth sovereign bond worth USD 2.5 billion in two tranches of 1.25 each with maturities of 5-years (coupon at 5.75 percent) and 10-years (coupon at 6.75 percent) in April 2018. The issuance rated ‘B1’, ‘B+’ and ‘B+’ by Moody’s Investors Service, Standard and Poor’s and Fitch attracted bids over USD 6.5 billion together.
reserves net of short-term liabilities are low. About USD 1.0 billion of these liabilities represent swap arrangements with domestic banks (which issued medium-term international bonds), some of which will be maturing later this year (Figure 17).24

Rating agencies revised Sri Lanka’s outlook to stable. Citing the progress made on fiscal consolidation, the continuation of the IMF program and expected reforms on liability management, Fitch and S&P revised the country’s outlook from negative to stable. Previously, both rating agencies downgraded Sri Lanka in 2016 on fiscal and external imbalances. However, Moody’s continues to have a negative outlook.

**Box 4: Cost-reflective pricing of fuel**

**Introduction of the fuel price formula is an important measure towards reducing fiscal risks.** In May 2018, the government approved a price formula, which adjusts retail fuel prices every two months, in line with a key structural benchmark of the IMF supported program. In the past, fuel retail prices were administratively fixed with the cost per liter – mainly determined by the global oil prices - often above the retail price. This led to an implicit subsidy, which mainly benefits the top-30 percent of the population through direct and indirect consumption, funded by accumulating losses at the Ceylon Petroleum Corporation (CPC).25 The losses that accumulate at the CPC have been reflected in large borrowings from the state banks, leading to implicit and explicit contingent liabilities for the government. As of end 2017, the total debt of CPC was equivalent to 2.5 of GDP, of which 1.5 percentage points of GDP was guaranteed by the state Treasury, while it had accumulated operational losses amounting to 1.6 percent of GDP.

**Cost-reflective pricing of fuel will make the CPC less vulnerable to global oil shocks and bring in additional benefits to the economy.** While it was negative due to low global prices in 2016, the CPC estimates the total subsidy on fuel products for 2017 at LKR 31.7 billion, equivalent to 0.2 percent of GDP, due to increased prices in global markets. Given global oil prices that have been on the rise since the second half of 2017,26 after three years of muted growth, the switch to cost-reflective prices that adjust every two months will result in a significantly lower subsidy (there will still be a positive subsidy as long as market prices trail continuously increasing global prices) while washing out high frequency price movements. By lowering the borrowing requirements of the CPC, the price reforms will significantly reduce the fiscal risk posed by the CPC.

**Implementation of the formula will mainly have positive externalities.** As the retail prices increase in line with the global market, producers and consumers will be encouraged to use fuel more efficiently and explore alternative sources of energy, which may reduce greenhouse gas emissions. Importantly, any reduction in the volume of petroleum imports will help reduce the import bill and the country’s vulnerability to global oil shocks. In the past, increased volumes of petroleum imports due to droughts and increased motor vehicle fleet worsened external balances. For example; in 2017, the rise in petroleum imports was the key contributor to the expansion of trade deficit leading to a larger current account deficit. Moreover, with the implementation of the formula, fiscal policy will become more progressive as the benefit accrued to the top-30 percent is removed.

**The removal of the fuel subsidy is a progressive measure, even after accounting for indirect effects, but the poor and vulnerable (the bottom 40 percent) still face an increase in the cost of living.** With the introduction of the pricing formula, prices increased by 15.6 percent for petrol 92, 14.1 percent for auto diesel, and 106 percent for kerosene, though the price of kerosene was subsequently revised downward from LKR 101 per liter to LKR 70. The overall impact of the price shocks is progressive, with higher income groups bearing a larger share of the burden, given their higher consumption

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24 The central bank has already indicated that it plans to settle some of the swaps, which were rolled over in the past. Some of the underlying Eurobonds expected to mature in the coming year include National Savings Bank USD 750 million, Bank of Ceylon USD 500 million, and DFCC Bank USD 100 million.

25 The state petroleum duopolist, which has a share of 86 percent in the retail market.

26 An agreement between most of the members of the Organization of the Petroleum Exporting Countries (OPEC) and some non-OPEC oil producers to extend production cuts to the end of 2018 boosted global oil prices in late 2017 and early 2018. Accordingly, oil prices increased above USD 65 per barrel (bbl) reaching a three-year high over the first five months of 2018. While the reinstatement of sanctions on Iran by the United States in May 2018 has already added upward pressure, geopolitical tensions in the Middle East and North Africa could further increase oil prices. Downside risks reflect the possibility of faster-than-expected U.S. shale production due to further technological improvements, or an earlier-than-anticipated end to the OPEC/non-OPEC cuts, which could be decided at the upcoming June 22 OPEC meeting.
of fuel, but there is still a welfare impact on the bottom 40 percent. For instance, while the poor consume fuel indirectly through fisheries products and public transport, public bus fares have already been increased by 12.5 percent following the fuel price increase. The overall impact of the fuel price revision is estimated to be equivalent to roughly 0.7 percent of their total consumption.

**It is important to protect the bottom 40 percent from the impact of the fuel price reforms.** Given that a substantial proportion of kerosene is consumed by the poor, the initial increase in fuel prices was accompanied by a kerosene subsidy for Samurdhi beneficiary households with no access to electricity and households in the fisheries community. This targeted subsidy was later replaced by an untargeted subsidy, with the price of kerosene reduced to LKR 70. However, even among poor households, kerosene is not the largest component of fuel consumption — petrol and kerosene account for 1.3 percent and 0.13 percent of total consumption, respectively, among bottom 40 households. This means that the poor and vulnerable still face a significant increase in their fuel bill. It is possible to divert more of the considerable subsidy savings of the CPC to keep the welfare of poor households unchanged while enjoying a net fiscal gain. Potential mechanisms include further cash transfers or subsidizing public transport for poor households. Adopting such measures to mitigate the impact of this reform will help with garnering public support and ensuring its acceptance and success.

**Figure 19: Change in refined petroleum imports by contributors (USD million)**

**Figure 20: Distribution of the burden of the fuel price increase by household consumption decile (Percent)**

The tight monetary policy maintained in 2016 and 2017 was eased in April

A tight monetary policy helped stability in 2017. The tight monetary policy helped macroeconomic stability and reduced inflationary pressures. Responding to policy tightening in 2016 and 2017, the growth of monetary aggregates decelerated on a year-on-year basis. With a view to ensure continued price stability in the medium-term, the central bank approved a roadmap for flexible inflation targeting, fulfilling a key structural benchmark of the IMF supported government program. Implementation of such a framework will now require the central bank’s commitment to provide more flexibility for the exchange rate, which in return would help the country to improve its competitiveness and act as a first line of defense for external volatilities.

The policy rate reduction in April 2018 reversed the tightening cycle. Reversing the tightening policy cycle of 2016 and 2017, the central bank reduced the upper band of the policy rate corridor by 25 basis points in April 2018, citing the favorable inflation outlook and lower than expected real GDP growth that further widened the output gap. Exacerbated by tightening financial market conditions

27 However, monetary growth remained relatively high. The year-on-year growth of credit to the private sector from banks was 15.3 percent and M2B growth was 16 percent in the month of March.
experienced by many emerging markets (Figure 18), the LKR depreciated by 1.1 percent against the US dollar in the month of April following the reduction of domestic policy rates and relatively large injections in daily market operations conducted by the central bank.28 The monetary policy review released in the month of May suggested that the central bank had intervened in the domestic foreign exchange market to mitigate excessive volatility in the exchange rate subsequent to depreciation pressures. The recent depreciation of currency has contributed to reversal of appreciation of Real Effective Exchange Rate (REER) in the past few months during which the country experienced relatively high inflation and low depreciation, with the REER reaching the same level as early 2013 (Figure 21).

The year-to-date depreciation stood at 3.4 percent by end-May.

Financial sector remained broadly stable while listed equity returns showed a gradual recovery.

The banking sector remained healthy. The banking sector remained well capitalized and adequately liquid. The regulatory Capital Adequacy Ratio (CAR) requirement under Basel II was maintained well above the required level of 10 percent and the Statutory Liquid Asset Ratio was also maintained well above the minimum statutory requirement of 20 percent during 2017. The expansion of the loan book was supported by the growth in deposits in a relatively high interest environment. Faster growth in lending rates compared to deposit rates led to increased net interest income resulting in improved Return on Assets (ROA) and Return on Equity (ROE) for the banking sector. The Non-Performing Loan (NPL) ratio remained low in 2017 thanks to fast credit growth. However, the NPL ratio will come under upward pressure in the coming months when the pace of credit growth decelerates following the last three years of rapid credit growth, a trend observed in the past. Moreover, increasing leverage, shown by the strong increase in credit relative to the size of the sector, such as in construction, tourism and financial business, warrants attention (Figure 22). Although the sector remains well-capitalized, implementation of Basel III will require the banks to strive hard to increase the capital base as required by the central bank.
Listed equity indicators improved buoyed by foreign activity.

Following negative returns in two consecutive years, listed equity returns rebounded with the benchmark All Share Price Index (ASPI) moving up by a modest 2.3 percent in 2017 driven mainly by foreign activity. Net foreign purchases reached an all-time-high on account of attractive valuations (reflected in low Price-Earnings ratios) in a relatively stable macroeconomic environment. The MSCI’s upgrading of Pakistan to the Emerging Market category also supported capital inflows to some frontier markets such as Sri Lanka when investors rebalanced exposures. Nevertheless, the domestic capital market remains small with listed equity market capitalization amounting to less than ¼ of GDP.

Despite the fast poverty reduction, there remain areas with significant poverty.

Poverty reduction continued to be strong, both using the national poverty line or the international line for lower-middle income countries

Sri Lanka has seen strong poverty reduction in recent years, which continued between 2012/13 and 2016. Extreme poverty, defined as those living on less than USD 1.90 per day, fell from 1.9 to 0.7 percent. During the same period, the national poverty rate also fell from 6.7 to 4.1 percent. Because the national poverty line has not been updated and was developed using data from 2002, it considerably underestimates the share of people who fail to meet minimum nutritional requirements in 2016. Therefore, the World Bank’s preferred measure of poverty is based on the international line for lower-middle income countries, which is USD 3.20 per day. By this measure, poverty between 2012/13 and 2016 fell from 16 to 9.5 percent, lifting roughly 1.5 million persons out of poverty.

Inequality increased slightly between 2012/13 and 2016, but the welfare of the bottom 20 percent also improved.

Gains in welfare, as proxied by real household per capita consumption, were largest for the very rich, though they were also sizeable gains at the bottom of the distribution (Figure 23). As a result, inequality increased slightly during this time. The Gini coefficient rose 6 points from 0.387 to 0.393, markedly less than the 28-point increase observed between 2009–10 and 2012–13. The bottom two quintiles saw their welfare improve an average by 3.7 percent annually between 2012–13 and 2016, slightly less than the 4.1 percent average annual growth for the total population.

Figure 23: Growth incidence curve, 2012-13 to 2016

Figure 24: Change in selected welfare indicators and assets among the poor
Non-monetary indicators also suggest gains in welfare among poor. Gains in welfare among the poor, defined as those living on less than $3.20 per day, were also apparent in non-monetary indicators. This group benefited from a remarkable expansion in access to electricity, from 78 percent in 2012/13 to 93 percent in 2016 (Figure 24). Access to sealed toilets and water taps inside the home saw a much smaller but still noticeable increase, of about 3 percentage points, as did ownership of motorcycles and refrigerators. The share of poor children aged 15 to 18 in school nudged upwards, from 61.7 to 62.2 percent.

Pockets of poverty remain in the North and East. The moderate reduction in poverty nationwide masks tremendous heterogeneity across districts (Figure 25). Mannar district, for example, enjoyed a remarkable decline in poverty from 39 to 6 percent. Poverty also declined rapidly in Monera gala, from 35 to 15 percent, as well as Mullaitivu, where poverty fell from 51 to 30 percent. On the other hand, poverty increased slightly in Kilinochchi, remaining above 30 percent.

Figure 25: Headcount poverty by district (USD 3.20 per day line), 2012/13 and 2016 (Poverty rate)

The increase in Samurdhi had a noticeable effect on poverty, but targeting is needed. One factor contributing to the observed reduction in poverty was the increase in the Samurdhi transfer program. Although a significant portion of program benefits leak to non-poor households, the tripling of benefits in 2015 had a noticeable effect on poverty. In simple accounting terms, the increase in reported Samurdhi receipts in 2016, compared with 2012/13, accounted for a percentage point decline in poverty (Figure 26). But the increase in the Samurdhi transfer played a large role in selected regions, in Jaffna, Mannar, Mullaitivu, and Trincomalee. However, with better targeting of Samurdhi to the poorest and avoid leakages to the non-poor, the impact would have been higher for the same fiscal expense.29

29 37.1 percent of the bottom 20 percent are eligible for Samurdhi, but only 39.5 percent of the total benefits goes to the bottom quintile, according to the 2016 HIES.
Poverty reduction in Sri Lanka is expected to sustain. Overall, Sri Lanka’s poor have continued to benefit from broadly favorable economic trends post-conflict, including strong growth in tourism. This has led to employment growth in the service sector and helped sustain the steady structural transformation out of agriculture, as agriculture’s share of employment fell from 31.2 percent in 2012 to 27.1 percent in 2016. Urbanization and agglomeration have also continued, especially in the major urban districts of Colombo, Galle, and Gampaha. Continued structural transformation, urbanization, growth in tourism, and focus on the remaining pockets of poverty should sustain poverty reduction in the future.

Summary of key macroeconomic developments

- Economic growth slowed down to a 16-year low in 2017 due mainly to adverse weather conditions
- Inflationary pressures remained high due to drought, VAT changes and demand pressures
- External trade balance weakened due to increased petroleum and food imports
- Official reserves hit a record high in April 2018 thanks to capital flows
- Passing of the new Inland Revenue Law is important for revenue-led fiscal consolidation
- Public debt remains high; the debt portfolio indicates some significant risks; passing of the Active Liability Management Law is a key step towards managing refinancing risks
- Poverty fell further between 2012/13 and 2016

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This can be shown as the share of total nighttime lights in the major urban districts of Colombo, Galle, and Gampaha, which increased from 43 percent in 2012 to 47 percent in 2016.
B. Outlook, Risks and Policy Priorities

1. Outlook

The outlook remains stable, conditional on reform implementation. The government is progressing on the reform agenda it announced in its Vision 2025, albeit at a slower pace than anticipated. These reforms aimed at improving competitiveness, governance and public financial management are expected to bring in long-term benefits. Continuation of the IMF program will add to investor confidence. Supported by a strengthening global growth outlook, including in some countries important to Sri Lanka (Box 5), the outlook remains stable. However, this is conditional on successful reform implementation.

Growth is expected to pick up with manageable inflation. Growth is expected to rebound in 2018 from a low base and continue to be around 4.3 percent in the medium term, driven by private consumption and investment. Although short to medium term growth will continue to be driven by non-tradable sectors, successful implementation of reforms should help the country to rely on productive tradable sectors in the long run. Inflation will stabilize around mid-single digit level, although the upward trend in oil prices may exert some upward pressure. In the medium term, the announced shift by the central bank to flexible inflation targeting will keep inflation in the single digits, while the exchange rate is left to adjust to market forces.

Fiscal consolidation will improve overall fiscal balances. In 2018 and beyond, the implementation of the new Inland Revenue Act, further reforms to the VAT law and to the Excise law and improvements in tax and excise administration are expected to expand revenues. Primary surpluses supported by the ongoing implementation of these revenue measures will reduce the overall fiscal deficit in the medium term. On the expenditure side, staff projects that the increased fiscal space will primarily benefit public investment, assuming no major additional recurrent expenditure commitments. Under this baseline, the fiscal deficit is expected to narrow to 3.9 percent of GDP by 2020.

31 Table 1 on last page
**Box 5: Global economic context**

**Growth and prices:** Global growth has softened but remains robust despite signs of moderation in trade and manufacturing activity. Global growth is projected to reach 3.1 percent in 2018, and edge down to 2.9 percent by 2020, as global slack dissipates, trade and investment soften, and financing conditions tighten. Global growth projections are above estimates of potential, suggesting that capacity constraints will become more binding and inflation will continue to rise during the forecast horizon. Growth in advanced economies is expected to decelerate towards potential with normalizing monetary policies and fading effects of fiscal stimulus. Among emerging market and developing economies, while the growth in commodity exporters has recovered amid higher commodity prices, growth in commodity importers remains robust as investment strengthens.

**Figure 27:** Projections for commodity prices

**Figure 28:** Growth projected for key economic partners

**Financial markets:** Following a prolonged period of stable and favorable global financing conditions, prospects of a faster withdrawal of monetary policy accommodation in advanced economies have led to rising global borrowing costs since the start of 2018. The increase in US long term yields, together with fears of escalating trade tensions between the US and China, and rising geopolitical risk contributed to bouts of volatility in global markets. Investor appetite for EMDE debt remains strong but capital inflows to EMDEs are likely to moderate as global financial conditions tighten. However, as long as the EMDE growth outlook continues to improve and financial commodity markets do not experience significant disruptions, capital flows should remain generally robust.

**Risks:** Risks to the outlook remain tilted to the downside. The risk of escalation of trade restrictions is particularly acute as it could derail the recovery in global trade and impact confidence and investment worldwide. The risk of disorderly tightening of global financing conditions has also heightened reflecting a possible reassessment of inflation risks amid shifting monetary and fiscal policy stances in advanced economics. Such developments could have severe consequences for more indebted EMDEs. The possibility of intensifying geopolitical tensions and heightened conflicts in some regions are among the other risks to the EMDE outlook. A further rise in oil prices might amplify external vulnerabilities in some oil-importing EMDEs while it would support oil exporters.

**Factors affecting EMDE growth prospects:** EMDEs need to rebuild monetary and fiscal buffers and restore the scope of policy support against negative external shocks such as rising global interest rates. Aside from the possible deterioration of debt dynamics as a result of monetary policy normalization in advanced economies and bouts of financial market volatility, EMDEs face various structural challenges to boost long-term prospects. These include the need to intensify economic diversification in commodity exporters, boost skills and adaptability to confront technological change, and promote regional trade integration.

**South Asia:** South Asia is once again the fastest-growing region in the world, due to the pickup in growth in India after the second half of 2017. The region is expected to remain the fastest growing region with growth forecasted to reach 6.9 percent in 2018 and stabilize around 7 percent over the medium term. Despite more favorable international conditions, domestic demand will remain the main driver of growth with private consumption and investment expected to offset the moderating public expenditures stemming from tighter fiscal policy. While escalating trade protectionism...
and tightening global financial conditions do pose risks to South Asia, the main risks for the region are related to the possibility of domestic policy slippages, such as weakening fiscal policies or setbacks in areas of reforms.

Table 1: Growth prospects for key partners of Sri Lanka

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Key financial flows to Sri Lanka

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Source: World Bank Global Economic Prospects, June 2018

Central government debt levels are projected to fall with consolidation. Risks to debt sustainability remain high. However, continued fiscal consolidation is projected to bring the public debt burden to a downward path from 2018. Fiscal discipline is even more important in an environment of high domestic interest rates, gradual tightening of global financial conditions and an expected gradual depreciation of the exchange rate, as the central bank moves to inflation targeting. Under the baseline scenario, central government debt-to-GDP ratio will come down to 74.8 percent of GDP by 2020. However, the reduction of debt will be adversely impacted by shocks. A negative shock to the growth rate or exchange rate would widen the fiscal deficit and would mainly affect the path of central government debt (Figure 30). In addition, there is a risk that guarantees and other contingent liabilities will be called.

Figure 29: Current account balance – overall deficit (Percent of GDP)

Figure 30: Central government debt (Percent of GDP)
The external current account deficit will widen in 2018 and beyond in line with increase in commodity prices.

With healthy growth in the US and Euro Area and a recovery in a few key Middle Eastern countries (Box 5), the external environment for Sri Lanka has improved, which would be favorable for exports. The country will continue to benefit from tourism growth and the EU’s GSP+ in the medium-term. A new single web portal for investors called SWIFT is expected to facilitate investment, while the phase-out of 1,200 para-tariffs in December 2017 is expected to make Sri Lanka more competitive. However, recovering global commodity prices and external interest payments will lead to a widening external current account deficit in 2018 and beyond; in particular, a shock to the oil prices could significantly deteriorate external balances (Figure 29).

The projections do not yet take into account the impact of intended structural reforms and the expected signing of trade agreements, which could provide an upick to exports.

With emphasis on market forex purchases, external buffers are to improve in 2018.

Inflows to the government and FDI inflows will help close the external financing needs with no Eurobond falling due in 2018. FDI is projected to reach a record high in 2018 with the boost from the Hambantota Port lease, the Colombo Port City project and other earmarked large investment projects. FDI inflows and other debt creating flows in IMF EFF program, external term-financing and project loans will elevate external buffers to a historical-high in 2018 while the central bank will help accumulation of reserves with emphasis placed on purchasing foreign exchange and maintaining a more market-determined exchange rate using monetary policy. A part of the increased reserves is expected to be used for liability management purposes given refinancing risks in 2019 and beyond. However, in the medium-term, unless export and FDI growth accelerates, more external borrowing will be needed when large repayments in Eurobonds continue. Emphasis, therefore, is needed to structurally improve non-debt creating forex flows such as FDI in the financial account.

2. Risks

Risk balance is tilted towards downside; the key one being the domestic political risk.

The challenging domestic political environment is the key risk to a favorable medium-term outlook. The impending election cycle could narrow the window for reforms further. On the fiscal and debt management front, risks include the delay in implementing revenue measures, slower than expected improvement in tax administration, and delays in implementing the Liability Management Act. The increasing occurrence and impact of natural disasters could have an adverse impact on growth, the fiscal budget, the external sector and poverty reduction.

External risks include disappointing growth in key countries that generate foreign exchange inflows to Sri Lanka: exports, tourism, remittances, FDI, and other

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32 SWIFT, the Single Window Investment Facilitation Taskforce, will coordinate investment approvals for the Central Environment Authority, Colombo Municipal Council, Department of Inland Revenue, Registrar of Companies, Sri Lanka Customs and the Urban Development Authority under the leadership of the Board of Investment. It will later also connect 24 agencies. The web-based portal was launched in June 2018.

33 Sri Lanka signed a trade agreement with Singapore in 2018; it is important that the country improves its competitiveness to fully reap the benefits of trade agreements.

34 This level will be equivalent to 4.7 months of imports of goods and services.
financing flows. Tighter than expected global financial conditions would increase the cost of debt and make rolling over the maturing Eurobonds from 2019 more difficult; however, the Liability Management Act will help mitigate this refinancing risk. Faster than expected rises in commodity prices would increase pressure on the balance of payments and could make further fuel price reforms more difficult.

3. Challenges and policy priorities

Tackling challenges through reforms is crucial for sustained and equitable growth.

Sri Lanka faces several challenges to sustain future economic growth, create more and better jobs and reduce poverty; and these must be addressed through macroeconomic and structural reforms. These key challenges are inter-linked and require a comprehensive and coordinated approach. Although domestic political considerations and institutional constraints on policy implementation make it challenging, a strong political will and the support of the bureaucracy could help with advancing the reform agenda. Steps need to be taken to ensure the support of the private sector, civil society and other stakeholders through improved communications on costs and benefits of the reform agenda.

1. Stay on the fiscal consolidation path

Raising more revenue structurally while controlling current expenditure is needed to reduce the fiscal deficit and bring public debt to a sustainable path. Continued fiscal consolidation – both from revenue and expenditure fronts - will help the country prepare for additional public spending on expanding pension coverage and old-age health and long-term care in the medium to long term as Sri Lanka’s demographic transition advances. Fiscal space is equally important to increase investment in human and physical capital and the provision of other public goods to sustain growth in the medium term. A reduced fiscal deficit will also limit exposure to global financial markets, which are expected to gradually become tighter, and free up credit for the private sector in the domestic market. A reduced fiscal deficit, a reduced debt level and more predictability in the markets will also reduce the burden on the central bank to provide temporary financing, which gives it more operational independence to pursue an appropriate monetary and exchange rate policy for the country.

The World Bank will publish a Public Expenditure Review shortly, which looks at allocative efficiency, prioritization, distributive impact, sustainability, and stabilization aspects of fiscal policy (Box 6).

Implementing the new Inland Revenue Act is a good start to be followed by VAT and excise reforms.

The new Inland Revenue Act should be followed up by further reforms to widen the tax base, make the current tax system simpler and more stable, and make administration more efficient. The incentives structure in the new law, which relies on investment allowances is expected to promote investment and job creation instead of offering fiscally expensive tax holidays, exemptions and special rates. Although there is room for improvement through sector targeting, investment allowance based incentives could be helpful for simplification and reduce leakages while preserving competitiveness. Improving the VAT Act and its administration will be a key step in the direction of revenue-led fiscal consolidation, going forward. The excise reform presents another opportunity to improve revenue and public health at the same time.

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35 See June 2017 SLDU for a discussion
as the affordability of tobacco and alcohol has improved with income rising faster than excises.

**Box 6: Public Expenditure Review**

Sri Lanka’s budget is faced with too many challenges to offer strong support to policy objectives. Fiscal position is characterized by high deficits, high debt levels and large gross financing requirements. The total expenditure envelope is relatively small as a share of GDP by international standards given the income level of the country. This is mainly due to the government’s efforts to maintain the deficit at acceptable levels in the wake of low and declining revenues as a share of GDP experienced in the last two decades. The expenditure-focused consolidation efforts have led to a lean and rigid budget with non-discretionary expenditures. Limited fiscal space, which is linked to the budget rigidity, has reduced allocations for important economic sectors including health education and social protection over time and across countries. A large SOE sector creates significant fiscal risks to the budget in various ways. Resource allocation decisions has much room for improvement in terms of value-for-money.

Expenditure management should be a key priority going forward, in order to support achieving overall policy objectives of the government policy objectives enshrined in Vision 2025. The World Bank’s analytical work points to the need to (a) improve allocative efficiency given evidence of poorly designed allocation mechanisms; (b) prioritize demands of a middle-income country including improved education and health and infrastructure; (c) protect the poor and vulnerable when implementing policy measures; (d) plan ahead for medium to long-term sustainability with an aging society while increased investment is needed to increase the capital stock in an environment of dissaving; (e) play a role in stabilization of the economy, when needed. The country also has room to improve budget execution with a view to enhance effectiveness of allocated expenditures. Likewise, the procurement reform and adoption of e-procurement are needed to improve competition and transparency of the public procurement, while reducing costs.

The World Bank is preparing a Public Expenditure Review (PER) will help the Ministry of Finance to prioritize and improve overall allocative efficiency with a focus on value-for-money. The budget is expected to reinforce government medium-term objectives and prepare to cater to demands of a middle-income country with an ageing society in the long-run while addressing its present structural weaknesses. PER could help the budget to evaluate trade-offs related to competing policy choices and present the issues in a comprehensive medium-term fiscal framework for the consideration of the Ministry of Finance. Recent Bank work – that often aims at line ministries with limited focus on the entire budget - provides a strong platform for the PER to build on.

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2. **Change to more private investment, tradable sector-led growth model**

Sri Lanka’s march towards Upper-Middle-Income status hinges on the economy’s competitiveness and its ability to pursue an export-led growth model.

While Sri Lanka has grown rapidly in the past, the non-tradable drivers of such growth are unlikely to remain adequate for inclusive and sustainable growth in the coming decade.\(^{36,37}\) Given the context of continued weak external liquidity, foreign exchange generated through tradable sectors is even more important for Sri Lanka. To benefit from an export-led growth model, which is necessarily based on trade, it is important that Sri Lanka strengthens its competitiveness in order to promote trade and FDI, leverage its locational advantage of geographical proximity to the global powerhouses, establish the necessary conditions for a thriving knowledge economy, integrate productive local companies in global value chains, and attain higher value addition in

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\(^{36}\) Real GDP expanded by 45 percent from 2010 to 2017 with the top six sectors, contributing to approximately 70.0 percent of the total growth, all being non-tradables: construction, transport, other personal services, financial services, wholesale and retail trade, and real estate. Agriculture that employs around 28 percent of the total labor force contributed to only 3.5 percent of growth while all other manufacturing/service sectors collectively accounted for 26.5 percent of growth.

\(^{37}\) In general, shifting resources into tradable sectors, led by manufacturing, is desirable for emerging markets because productivity gains are higher in tradable sectors than in non-tradable sectors. (World Bank (2013), ‘Island of Prosperity? Ideas for Accelerating Inclusive Economic Growth in Sri Lanka’, Washington, DC.) In Sri Lanka, the share of manufacturing output, which was 18.7 percent in 2000, rose to 19.5 percent in 2005, and declined to 17.3 percent by 2017 due to faster growth in the services sector.
the manufacturing sector and in services. A World Bank Sector Scan identified the following high potential sectors that can be expected to create productivity gains and generate jobs: tourism, logistics, high-value-added agri-processing and apparel, IT-enabled services. This reform process will be key for Sri Lanka’s sustained economic prosperity.

Policy recommendations to improve trade and business environment and FDI:

- Trade policy: (1) implement the trade policy with a gradual but firm liberalization schedule, including further phasing out para-tariffs (import and export cess and Port Airport Development Levy, PAL), allowing time for adjustment to avoid a sudden shock to fiscal revenue and the balance of payments; and (2) make progress on bilateral trade agreements while carefully evaluating the costs and benefits to Sri Lanka, with a particular focus on non-tariff barriers and Mutual Recognition Agreements.
- Formulate a legal framework and policies for trade adjustment assistance to help firms and workers adjust to the impact of trade policy reforms and allow them to seize new opportunities.
- Conduct awareness campaigns and adopt an effective communication strategy to dispel concerns regarding preferential trade agreements.
- Trade facilitation: (1) adopt a systematic and effective risk management system, the absence of which imposes a huge burden in terms of time and cost, adversely impacting competitiveness; and (2) complete creation of a Trade Information Portal and a National Single Window for trade facilitation, which will help meet the informational needs of businesses.
- Promote the efficiency and effective functioning of factor markets (land, labor, capital) to facilitate private sector operation.
- Innovation: improve the innovation landscape in Sri Lanka especially for SMEs and start-ups.
- FDI attraction: (1) implementing the SWIFT single window for investment facilitation under Board of Investment leadership as a ‘one-stop shop’ for investors; (2) strengthen BOI’s investment attraction capabilities by adopting modern tools and techniques in sector targeting, investor outreach, and investor facilitation; (3) strengthen investment retention capacity through ‘after sales services’ for existing investors; and (4) address regulatory barriers to FDI in backbone sectors to promote exports.
- Ensure coherence and coordination between investment policy and trade policy with a clear indication of future policy direction.
- Enhance institutional capacity of GoSL to address the shortcomings in the investment climate undermining the competitiveness of the private sector.

38 This is discussed in Box 5 of the November 2017 Sri Lanka Development Update.
39 See June 2017 SLDU for a discussion. 
40 The portal is expected to go live on July 5, 2018: https://srilankatradeportal.com/.
3. Improve governance, transparency and accountability

Governance reforms will support fiscal sustainability and overall competitiveness. It is important that the government takes steps to implement the Right to Information Act in full, the passing of which reflected a landmark improvement to transparency and governance. The Constitutional Amendment to strengthen the supreme audit institution was a key first step; however, this needs to be followed by passing of the Audit Bill, providing for greater administrative and financial independence, a broader mandate covering SOEs as well as more modern audits such as performance audits and participatory audits involving citizen (Box 7). While Sri Lanka has gained 5 points in the latest Open Budget Index from 39 to 44 out of 100, it can further improve through the adoption of an Open Budget Portal and more transparency in the selection of public investments. The adoption of a comprehensive Public Finance Act will provide clarity on roles and responsibilities in the management of public investments, assets and SOEs, which should improve budget credibility and efficiency. A more stringent and integrated oversight of public enterprises could improve fiscal performance as well as public sector effectiveness.

Box 7: National Audit Act

The 19th Amendment to the Constitution is aimed at strengthening the country’s governance framework and checks and balances. A key provision was the creation of an independent Audit Commission and Audit Service to strengthen the financial oversight and accountability of the public sector, to be implemented through the adoption of the National Audit Act.

The draft National Audit Bill strengthens the independence of the existing Auditor General’s Department and transforms it into an independent supreme audit institution, in line with the core principles of the International Organization of Supreme Audit Institutions [INTOSAI]. It does expand the mandate of the Auditor General to the entire public sector and foresees notably the annual audit of State-owned Enterprises and agencies. It further establishes an independent Audit Service Commission with powers to (i) approve rules pertaining to the schemes of recruitment, the appointment, transfer, disciplinary control and dismissal of the members belonging to the Sri Lanka State Audit Service, and (ii) prepare annual estimates of the National Audit Office established by law. Furthermore, it introduces the concept of performance audits to assess the performance of public bodies beyond their compliance with financial and administrative rules.

The National Audit Act is expected to complement important reforms. This reform complements the other reforms introduced to increase Government transparency and accountability, such as the establishment of the National Procurement Commission, the Anti-Bribery Commission, the Information Commission and Right to Information Act. While the draft National Audit Bill exempts the National Audit Office and Audit Service Commission from the Right to Information Act. As full transparency would strengthen both institutions as well as the implementation of the audit recommendations, it is thus expected that they adhere to the RTI in spirit and use it to leverage more citizen engagement including in Audits.

Implementing the Act is important to achieve expected results of the constitutional reforms. The Auditor General is gearing up to implement this enhanced mandate and has undertaken a performance review, that will inform its strategic development plan. The World Bank and the European Union are keen to support the implementation of this act and the AG, through the Public Sector Efficiency Program, in order to achieve the expected transparency and efficiency gains.

4. Manage risks and create opportunities

Managing risks is important for sustainability. The new growth model will open new opportunities for development. It will make Sri Lanka more resilient to many risks, but will expose it to new ones. Increasingly frequent natural disasters also demand more preparedness. It is important to manage
risks well at different levels of society—households, firms, the public sector and the macroeconomy. In particular, it is important to focus on:
(a) managing refinancing risks of Eurobonds;
(b) improving the debt management function with requisite institutional, legal and strategy frameworks to manage the costs and risks of domestic and external debt portfolios;
(c) mitigating the impact on the poor by replacing untargeted effective subsidies to the non-poor (such as VAT exemptions and regulated fuel and electricity prices) by targeted spending for human capital, social protection, and other public investments to the poor; it is also important to complete the reform of social safety targeting system and make it more adaptive to make subsidy reform more feasible; and
(d) enhancing the country’s resilience and disaster preparedness to deal with frequent natural disasters more pro-actively.

Summary of outlook

- Growth expected to rebound in 2018 and remain around 4.3 percent
- Inflation will stabilize around single mid-digit levels in 2018 and beyond
- Fiscal consolidation will continue towards a deficit of 3.5 percent of GDP in the medium-term
- Debt is likely to stabilize and start to fall, but is sensitive to growth, fiscal and exchange rate shocks
- External sector will benefit from tourism and GSP+; however, rising oil prices will adversely impact external sector performance
- Reserves will reach an all-time high thanks to capital flows, a part will need to be reserved for liability management given large refinancing requirements in 2019 and beyond

41 See November 2017 SLDU for a discussion
C. Special Focus: More and better jobs for an Upper Middle Income Country

This Special Focus section looks at the state of jobs and the job creation challenge in Sri Lanka compared to the South Asian Region and zooms in on labor force participation of women and in Sri Lanka’s post-conflict areas.

Policy recommendations

Policy recommendations to create more and better jobs:

- Implement the reform agenda to move to tradeable-sector led growth model, as changes in trade regime and openness to FDI are expected to lead to more productive and higher-paid jobs. A trade adjustment assistance program will be important to provide technical and financial assistance to firms and workers to find new jobs as a result to changes in the trade regime, to ensure that this does not increase inequality (see Challenges and Policy Priorities section); update the labor laws to enhance flexibility of the private sector to renew skills in response to changing market demands.

- Improve opportunities for innovation and entrepreneurship by addressing fragmentation of R&D institutions, improving the intellectual property rights regime, and creating an ecosystem with early-stage finance and incubation facilities.

- Strengthen the links between growth and jobs: for FDI and investment promotion, focus on sectors that, amongst others, are expected to generate many jobs – including jobs for women; and implement the investment climate reform agenda to reduce obstacles to growth and job creation of Small and Medium-sized Enterprises (SMEs), and provide incentives to formalize for larger informal firms.

- Create a more level playing field between the public and private sectors and increase portability of pension schemes for a more mobile labor force, provide protection for formal and informal workers, and reduce the bias to public sector employment.

- Improve quality and access to education to reduce the skills mismatch: improve Technical and Vocational Education and Training (TVET) and make sure that graduate training prepares students better for private sector jobs.
1. The state and structure of jobs in Sri Lanka

Despite a stable official unemployment rate, Sri Lanka’s labor market shows many challenges. While the official unemployment rates in Sri Lanka have hovered around 4.3 percent between 2011 and 2016, there are employment challenges. Sri Lanka’s labor market is characterized by a high share of the service sectors across the country, high informality, absence of many working-age women from both the informal and formal labor market (i.e., low female labor force participation), a high share of workers in the public sector including state-owned enterprises, low average productivity in agriculture sector, and a high unemployment rates amongst young people and those with advanced degrees.

### Figure 31: Structure of the labor market.

<table>
<thead>
<tr>
<th>Percent of working-age population (over 15 years old)</th>
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</thead>
<tbody>
<tr>
<td>100%</td>
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<tr>
<td>80%</td>
</tr>
<tr>
<td>60%</td>
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<td>40%</td>
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<td>20%</td>
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<td>0%</td>
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</tbody>
</table>

Source: Department of Census and Statistics, staff calculations.

Sri Lanka needs to create more and

Why is it important to discuss the labor market in Sri Lanka now? The Sri Lankan economy needs to create more and better jobs to sustain growth and optimally use its...
better jobs to sustain growth

Working-age population including women, youth and young graduates. This means that both sides of the jobs market—the supply of jobs and the supply of labor—need to be addressed, while also reducing skills mismatches. Structural reforms to increase competitiveness are essential to create better jobs.

Vision 2025 recognizes the challenges and sets out ambitious targets.

The government’s key policy document, Vision 2025, aspires to transform Sri Lanka into the hub of the Indian Ocean, with a knowledge-based, highly competitive, social market economy focused on inclusion. Among the intermediate targets set for the next three years is the goal to create 1 million new jobs. This is an ambitious target, in light of the growth rates required to facilitate this level of job creation. Facilitating higher female labor force participation and ensuring that the labor force is equipped with the skills and competencies required by the private sector are important for making the most of the existing working-age population in the short run. In the long run too, these measures will be essential for increasing productivity and enhancing international competitiveness as Sri Lanka moves towards a new model of economic growth. How can these targets be met?

Starting with the supply of jobs, the investment climate for domestic firms needs to be improved to encourage formalization and create more productive jobs

Sri Lanka’s investment climate can be improved to encourage more investment and job creation by large domestic firms, micro, small- and medium-sized enterprises (MSMEs) and by foreign firms. 93 percent of private sector establishments are micro enterprises (1-4 employees, accounting for 46 percent of private sector employment), compared to only 7 percent small (5-9) and medium (10-99) enterprises (28 percent of employment) and large enterprises (100+) are close to zero percent (26 percent of employment). Informal employment (60 percent of total labor force) is prevalent in the MSME sector, and in certain sectors and types of jobs of the economy (Box 8). The informal sector is typically constrained in increasing productivity due to the lack of economies of scale and lack of access to finance. At the same time, formal firms perceive informal practices as a major obstacle to their growth, so there is public policy rationale to encourage formalization, especially larger informal firms, where the benefits of formalization (such as improved access to finance) may outweigh the costs (such as taxes, regulations and social insurance). On the other hand, for subsistence enterprises formalization may never be an option, and it is important to assess if there are ways in which public policy can support them. While some important regulatory reforms have been implemented, including the launch of a Single Window Counter to facilitate construction permits at the Colombo Municipal Council and Cabinet has approved the Secured Transactions Registry Act to allow the use of movable collateral to obtain loans to increase access to finance on more favorable terms, the 2016 Investment Climate Roadmap needs further implementation to improve the business climate for SMEs and create jobs. It is also important to update the labor laws to enhance flexibility of the private sector to renew skills in response to changing market demands.

42 DCS, 2014 Economic Census, discussed in the Systematic Country Diagnostic.
43 Source: Discussed more extensively in the Systematic Country Diagnostic.
Box 8: What is the informal sector in Sri Lanka?

It is not easy to define the informal sector in Sri Lanka, as there is not a single economic sector or type of job that is 100 percent informal or 100 percent formal. The Department of Census and Statistics identifies the informal sector as follows: an organization is considered part of the informal sector if:

- it is not registered with the Employment Provident Fund and with the Department of Inland Revenue; and
- it does not keep formal accounts; and
- the total number of regular employees of the organization is less than 10.

All other organizations are considered formal.

Accordingly, there are certain characteristics of the informal sector (as of 2016):

- Out of total employment, 60 percent are informal workers and 40 percent formal
- Own account workers (94 percent) and workers with an education level below grade 6 (82 percent) tend be in informal organizations
- Employment in the agriculture, forestry and fishing sectors and in the construction, utilities and water sectors tends to be informal: over 80 percent, with many other sectors with an informal share of around 50 percent.
- Difference between informal employment of male (63 percent) and female workers (54 percent) is smaller than that of the total employment

Figure 32: Key characteristics of the informal sector in Sri Lanka

Percent informal employment compared to total of formal and informal employment

(By Employment Type) (By Education Status)

(By Sector) (By Gender)

Encourage innovation and entrepreneurship.

Encouraging more innovation and entrepreneurship is also important. Sri Lanka investment in research and development (R&D) is only 0.16 percent of GDP (dominated by public spending), which is lower than in peer countries, such as Vietnam (0.18 percent), Thailand (0.25 percent), and Malaysia (1.0 percent). It is important to improve public and private funding, address fragmentation of R&D institutions, improve the intellectual property rights regime and create an ecosystem with early-stage finance and incubation facilities.

FDI can improve the supply of jobs.

FDI provides a great opportunity to create better jobs, as foreign firms can bring technology and better management practices. But not all FDI creates the same jobs. The World Bank undertook a sector scan with the Board of Investment and found that amongst a list of potential sectors to promote for FDI, certain sectors (e.g., IT enabled services) create more jobs than others (e.g., high value-added rubber products), while certain sectors (high value-added apparels and textiles) create more jobs for women than other sectors (e.g., logistics). These and other considerations could be taken into account when deciding where to dedicate public resources for investment promotion.

Trade liberalization with trade adjustment assistance will allow firms and workers to seize new opportunities.

The trade liberalization agenda will create new opportunities for better-paid jobs, especially through plugging into regional and global supply chains, but also create risks for workers, especially for female, unskilled and informal workers, who typically have more trouble moving for jobs for geographic or other reasons. Indeed, evidence in a forthcoming report (Box 10) suggest that while increases in exports are associated with lower informality, it is also shown that in Sri Lanka it tends to lead to more inequality. This should not be seen as an argument against exporting more, but as an opportunity to address structural obstacles in Sri Lanka that are preventing other segments of the labor market from benefitting from the new opportunities. Improvements in the investment climate and targeted trade adjustment assistance will also help firms and workers cope with the change and seize the opportunities presented by new markets.

It is important to create a more level playing field between the public and private sector job markets.

Out of the labor force, 14 percent is employed in the public service and 3 percent by SOEs.\(^45\) Part of imbalances in the labor market can be explained by a persistently strong demand for public sector jobs over private sector jobs, especially amongst female graduates. This is driven by more flexible hours, more generous (maternity) leave, safer work environment and a non-contributory pension system, compared to the defined contribution schemes available to the private sector. Moreover, there is also a persistent wage premium for public sector employees over private sector employees, which cannot be explained by differences in individual worker characteristics.\(^46\) Additionally, the revenue-led fiscal consolidation program and the need to make the budget more flexible, greatly limit the ability to expand the civil service greatly. A gradual move to expand pension coverage and to increase portability


On the supply of labor, while Sri Lanka’s population is aging, it still has pools of underutilized labor. The unemployment rate is the highest amongst the group with Advanced Level and above educational qualifications (8.3 percent), especially graduates and university graduates (32.5 and 26.0 percent, respectively) compared to the overall unemployment rate (4.4 percent), suggesting a skills mismatch (Figure 33). This is supported by both the Sri Lanka STEP employers’ perception survey, which shows that the university and TVET system does not convey up-to-date knowledge and skills. The recently completed Labor Demand Survey from 2017, finds that nearly half a million vacancies exist in the private sector, with most of the labor demand stemming from the industry, services and trade sectors.

Improvements in TVET and higher education are important to educate workers with more skills. Ensuring that the labor force is equipped with the skills and competencies required by the private sector are important for making the most of the existing labor demand in the short run. In the long run too, these measures will be essential for increasing productivity and enhancing international competitiveness as Sri Lanka moves towards a new model of economic growth, with the continued shift of jobs from agriculture.

of pension schemes will facilitate a more mobile labor force, provide protection of formal and informal workers, and reduce the bias to public sector employment.

As Sri Lanka is aging, its population between 15 and 64 is expected to start shrinking from 66 percent of the total population in 2015 to 61 percent in 2050, while the old-age dependency ratio is expected to increase from 14 percent to 33 percent over the same period. While population between 15 and 64 years will be shrinking in absolute terms from 2035, the low labor force participation of women, the low statutory retirement age, the low average productivity of workers (mostly informal) in agriculture (with 26 percent of the labor force generating 7.7 percent of GDP), and a substantial number of Sri Lankans working abroad, mean that there are still pools of underutilized labor that could be unlocked with the right policy measures.

Figure 33: Overall unemployment compared to GCE A/L & above and university graduates. (Percent)


There is a skills mismatch leading to unemployment

Improvements in TVET and higher education are important to educate workers with more skills.
relevant skills for the private sector

into services. While Sri Lanka is a regional leader in terms of primary and secondary education, it lags in tertiary education with only 20 percent out of about 450,000 Ordinary Level (O/Level) cohort attending a higher education institution (HEI) and only 33 percent attending Technical and Vocational Education and Training (TVET) programs, leaving the remainder with no option other than exiting the education sector, entering the labor market or going abroad for further studies. Besides low enrollment rates in HEIs compared to peers, relatively few students in Sri Lanka are enrolled in science-related programs. The TVET sector is important to ease the shortage of technically skilled labor, but it is fragmented with more than 30 statutory boards and 15 ministries, with a shortage of qualified teaching staff and limited quality assurance. Reforms to TVET could offer high returns, and given the funding constraints, TVET institutions should be encouraged to diversify their funding sources and connect them with external partners. A more results-oriented funding formula for universities could encourage them to prioritize their fields of study and improve the allocative efficiency of higher education funding.\(^{51}\) It is important to work with the private sector to ensure skills compatibility with jobs.

The remainder of this section looks at Sri Lanka in the regional context and links between growth, income and jobs, then it discusses the challenges of increasing female labor participation in more detail, followed by an analysis of labor market conditions in the post-conflict Northern and Eastern Provinces of Sri Lanka.

2. Is Sri Lanka an employment outlier in South and East Asia?

Sri Lanka’s employment rate is lower than in countries of similar levels of development.

The relationship between employment rates and income per capita across countries follows a U-shaped curve (Figure 34). In Sri Lanka, a little more than half of the working age population is employed and the distance to the estimated U-shaped curve is over 7 percentage points. Sri Lanka is not unique among South Asian countries in this respect. Bangladesh, India, and Pakistan, all have employment rates below what can be expected given their income per capita.

Figure 34: Sri Lanka’s employment rate is low given its GDP per capita.


Note: Everyone older than 15 years is considered part of the working age population (consistent with ILO definition).

\(^{51}\) Sri Lanka Education Sector Assessment, Dundar et al., World Bank, 2017.
Low employment is entirely due to low female employment. In Sri Lanka, the low employment rate compared to other countries is mainly due to low female employment. The employment rate among men is higher than that of countries with similar levels of income, but the employment rate of women is much lower. The gap between the actual employment rate of women and the one predicted given its GDP per capita, is over 15 percentage points. The difference between male and female employment rates is large in all South Asian countries (Figure 35) and in most of them, including in Sri Lanka, female employment rates are less than half of male employment rates.

Figure 35: The employment rate of women is less than that for men in Sri Lanka.

Employment rate by gender (Percent of working-age population)

The service sector is the most important source of jobs. In Sri Lanka, the service sector employs more people than any other sector: 24 percent of the working age population is in services, 9 percentage points more than in agriculture (Figure 36). As a percentage of total employment, Sri Lanka has the largest share of service and manufacturing employment in South Asia (24 percent and 9 percent respectively). In the rest of the region, the main source of jobs is still the agricultural sector. In Nepal and Bhutan, for example, close to 40 percent of the working age population still works in agriculture.

Source: Afghanistan 2015 (ILO estimate), Bangladesh 2015/16 LFS; Bhutan 2012 LSS; India 2011/12 NSS-Thick; Pakistan 2015/16 HIICS; Nepal 2011 LSS; and Sri Lanka 2015 LFS. World Development Indicator data is based on modeled ILO estimates.
Figure 36: In Sri Lanka most jobs are in the service sector.
Employment rate by sector (Percent of working-age population)


Regular employment is the exception in South Asia.

Sri Lanka has the lowest share of unpaid family workers and the biggest share of regular and casual employment across South Asia. Although Sri Lanka is in a better position than the rest of the region, the regular employment ratio is still low with only 13 percent of the working age population holding a regular job. In the rest of the region, self-employment and unpaid family work – which are not easy to separate and compare across countries – account for most of the jobs (Figure 37).

Figure 37: Less than one in five employed Sri Lankans is a regular employee.
Employment rate by type (Percent of working-age population)


Increases in working age population have been offset by declining employment rates.

During the last decade, the employment rate in Sri Lanka decreased on average by 0.5 percent every year. In other South Asian countries, the decline has been even stronger. As a result, not all countries have transformed their demographic transition into a demographic dividend. For both South and East Asian countries, the U-shaped curve described above suggests that employment rates were bound to decline with economic growth. But in East Asian countries, employment rates either declined less than the U-shaped curve would have implied or increased. In South Asian countries, they declined much more than can be explained by rising living standards (Figure 38).
The disparities in employment rate growth between the two regions can be attributed to the different development of female employment rates. In Sri Lanka, male employment decreased on average by only 0.1 percent per year between 2005 and 2015, but female employment by 0.8 percent. In many East Asian countries, on the other hand, female employment rates increased during the last decade.

Figure 38: Increases in working age population have been offset by declining employment rates

Working age rate, employment rate and predicted employment rate (Annual change in percent, 2005-2015)


Box 9: The job creation challenge in South Asia

Job creation is one of the main concerns of politicians and policymakers around the world and especially in South Asia. Although the region is again the fastest growing region in the world, there is an increasing concern about job creation as more and more young people are reaching the working-age every year. The latest South Asia Economic Focus, a bi-annual World Bank publication on the macroeconomic situation in the region, asks whether rapid economic growth alone can generate the massive numbers of additional jobs needed and analyzes the state of jobs in South Asia.

Economic growth can have different effects on employment in the short and long term. In the short term, higher growth increases employment, as inactive and unemployed people start working due to greater labor demand. In the long term, on the other hand, higher growth can also lead to lower employment rates. As countries become richer and living standards improve, families can afford to keep their children longer in school, the ill and the disabled can stay home, and women may withdraw from the labor force. Preventing a decline in the employment rate in the face of an increase in the working age population is a major challenge. A useful benchmark for the job creation challenge is to assess what it would take to keep the employment rate constant (Table 2).

Economic growth in South Asia is not jobless. To identify the impact of economic growth on job creation, a procedure was applied where (after the standardization of the employment variables) the annual changes in employment were divided by the annual percentage change in GDP over the corresponding period. In South Asia, one percentage point of economic growth has led, on average, to a 0.34 percent increase in employment (Table 3). Using data on jobs created from 2001 to 2015 (or for the closest years for which there is comparable data) leads to a somewhat smaller estimate of job creation. By this metric, Bangladesh generates 110 thousand jobs per percentage point of GDP growth, India 750 thousand, and Pakistan 200 thousand.
Table 2: Keeping employment rates constant would require massive job creation.

<table>
<thead>
<tr>
<th></th>
<th>Annual increase in population</th>
<th>Employment rate</th>
<th>Annual job creation needed to keep employment rate constant</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2015-2025 (in thousands)</td>
<td>2015 (most recent)</td>
<td>2015-2025 (in thousands)</td>
</tr>
<tr>
<td>Bangladesh (15+)</td>
<td>2,039</td>
<td>53</td>
<td>1,075</td>
</tr>
<tr>
<td>Bhutan (15+)</td>
<td>10</td>
<td>60</td>
<td>6</td>
</tr>
<tr>
<td>India (15+)</td>
<td>15,828</td>
<td>50</td>
<td>7,948</td>
</tr>
<tr>
<td>Maldives (15+)</td>
<td>6</td>
<td>66</td>
<td>4</td>
</tr>
<tr>
<td>Nepal (15+)</td>
<td>420</td>
<td>68</td>
<td>287</td>
</tr>
<tr>
<td>Pakistan (15+)</td>
<td>2,943</td>
<td>48</td>
<td>1,407</td>
</tr>
</tbody>
</table>


Table 3: South Asian countries have created large numbers of jobs.

<table>
<thead>
<tr>
<th></th>
<th>Elasticity</th>
</tr>
</thead>
<tbody>
<tr>
<td>25th percentile</td>
<td>0.10</td>
</tr>
<tr>
<td>Median</td>
<td>0.20</td>
</tr>
<tr>
<td>75th percentile</td>
<td>0.60</td>
</tr>
<tr>
<td>Mean</td>
<td>0.34</td>
</tr>
<tr>
<td>Long-run</td>
<td>0.19</td>
</tr>
</tbody>
</table>


The question asked in the report is how fast countries would need to grow to address their job creation challenge. The answer to this question depends on the employment target. The growth rates needed under the constant scenario, where the current employment rate is maintained, are not too far off from recent growth performances. To catch up with comparable countries, however, high growth alone will not suffice. To close the gap to the U-shaped employment-income curve within a period of 20 years, Bangladesh and India would need to grow by over 15 percent a year and Pakistan by 10 percent a year (Figure 38). These growth rates are unreasonably high, which means that these countries need to create more jobs per percentage point of growth to catch up.

Figure 39: More than high growth is needed to close gap with other developing countries

![Graph showing annual growth needed (Percent) for Bangladesh, India, and Pakistan]


Another concern is related to the quality of the jobs generated. The picture is not very encouraging. As economies develop, it is expected that individuals will move out of agriculture into more productive, non-agricultural employment. However, from a sectoral point of view, it appears that structural transformation has been slow in some South Asian countries. The same happens in terms of the employment type transformation; while regular jobs are generally considered better, there has only been a modest growth in regular employment.

Reference:

To catch up with other countries, Sri Lanka needs much more jobs. Since Sri Lanka has an aging population, the job creation challenge should be examined using different definitions of the working age population. First, the job creation challenge is described in terms of population above 15 to compare with other countries in South Asia (and to follow international standards). Second, the job creation challenge is described in terms of the population between 15 and 64 to account for the fact that Sri Lanka has a large share of people aged 65 and above. To keep employment rates constant, Sri Lanka needs to create, on average, 63,000 additional jobs every year using the first definition, and 16,000 jobs using the second (Table 4). To catch up with other countries at similar levels of development, Sri Lanka needs 114,000 and 50,000 additional jobs every year respectively.

Table 4: The annual job creation needed in Sri Lanka depends on the age of the working population.

<table>
<thead>
<tr>
<th>Annual increase in population</th>
<th>Employment rate</th>
<th>Annual job creation needed to</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2015</td>
<td>keep employment rate constant</td>
</tr>
<tr>
<td>15+</td>
<td>122</td>
<td>(in thousands)</td>
</tr>
<tr>
<td>15-64</td>
<td>29</td>
<td>catch-up with other countries</td>
</tr>
<tr>
<td></td>
<td>51</td>
<td>by 2035 (in thousands)</td>
</tr>
<tr>
<td></td>
<td>63</td>
<td></td>
</tr>
<tr>
<td></td>
<td>114</td>
<td></td>
</tr>
</tbody>
</table>


High growth will not suffice to catch up with other countries. The growth rates needed to keep employment rates constant or to catch up with other countries are higher if the population aged 15 and above is considered rather than the population between 15 and 64.\(^\text{52}\) Since some, but not all, people aged 65 will stop working upon reaching that age, the actual growth needed will be somewhere in the middle. To keep employment rates constant, Sri Lanka needs to grow by 3 percent if only the population aged 15 to 64 is considered and by 7 percent if all above the age of 15 are considered (Figure 40). Hence, keeping the employment rate constant seems feasible. However, to catch up with other countries at similar levels of development (even over 20 years) would require economic growth of 8 percent and 13 percent respectively, which is clearly out of reach. Like other countries in South Asia, Sri Lanka will, therefore, have to increase the job elasticity of its growth.

Figure 40: Constant and catch-up scenario are more feasible if people above 65 are excluded from the working age population group

\(^\text{52}\) The team estimated the elasticity of employment with respect of GDP growth, or the percentage change in employment per percentage point of GDP growth. It estimates a time series of employment multiplying employment rates calculated from censuses, household surveys and labor force surveys by working-age population estimates from population censuses. This methodology is further explained the justified in the South Asia Economic Focus (2018).
3. Unlocking Women's Potential in Sri Lanka's Labor Force\(^3\)

**Sri Lanka’s female labor force participation is low.**

Sri Lanka’s female labor force participation (LFP) rates declined from 41 percent in 2010 to 36 percent in 2016. This trend stands in contrast to the country’s achievements in human development outcomes that favor women, such as high levels of female education and low total fertility rates, as well as its status as a middle-income country. Women’s experience in Sri Lanka’s labor market remains characterized by: (1) low LFP; (2) high unemployment, especially for women under age 30; and (3) persistent wage disparities between the sexes, though these are shrinking over time (Figure 41 and 42).

**Different hypotheses could help explain the gender gap.**

There are three possible hypotheses to explain gender gaps in labor market outcomes: (1) household roles and responsibilities, which fall disproportionately on women, and the associated socio-physical constraints on women’s mobility; (2) a human capital mismatch, whereby women are not acquiring the proper skills demanded by job markets; and (3) gender discrimination in job search, hiring, and promotion processes.

**Household roles and responsibilities fall disproportionately on women**

Marriage continues to penalize women’s participation in labor markets, though less so than before 2010. As of 2015, marriage lowers odds of FLFP by 4.4 percentage points, while boosting men’s odds by 11 percentage points. Having young children is associated with even lower odds of FLFP, lower chances of becoming a paid employee, and lower earnings compared to these odds before 2010—and compared to men’s odds. Social norms against women’s mobility outside the home, especially for commuting, exacerbate the gender gap in LFP.

Women are not acquiring the proper skills demanded by job markets

Since the end of civil conflict, women at all levels of educational attainment are even more challenged than men in securing high-skill and higher-paying jobs. Qualitative research reveals women’s preference for humanities and arts in their educational training, rather than in technical skills that better match with private sector jobs in growth industries. These educational and occupational choices are also strongly influenced by what girls and their parents consider to be gender appropriate—e.g., women with the highest educational attainments (university level or higher) still queue for a limited number of public sector jobs—which, unlike the private sector, uniformly offer regular working hours, maternity leave, and other women-friendly benefits—and thus contribute to elevated rates of female youth unemployment. Multivariate analysis confirms that in spite of women’s advancements (even exceeding those of men, as with years of education), endowments are not sufficient to close gender gaps in LFP and wages.

Gender discrimination in job search, hiring and promotion processes

Discrimination appears to determine large shares of gender gaps in LFP and earnings, though to a diminishing degree over time, especially since 2009. Primary research confirms that employers actively discriminate by gender to a much smaller degree than employees suspect. Yet, stubborn occupational segregation across industries suggests that this may not be the case for promotions—especially into high-skill and management jobs, in which men continue to dominate. Raw gender wage gaps are shrinking, but the portion of these gaps that is determined by gender discrimination—rather than endowments—is increasing over time and is especially pronounced in the public sector.

Reforms are need to improve FLP to achieve its growth and equity goals

It is important to focus on four priority areas for addressing the multiple supply- and demand-side factors to promote women’s entry into and continued employment in the labor market. This is important for preparing for an aging population and to achieving the country’s growth and equity goals.
1. Reduce barriers to women’s participation in paid work, particularly (a) lack of child care services, and (b) socio-physical constraints on women’s mobility, which undermines their ability to travel to work.

2. Strengthen girls’ early orientation to career development and to acquiring the types of education and skills (e.g., STEM courses) that prepare them for labor markets.

3. Improve the job orientation of education providers; and expand provision of job matching services and TVET that respond to employers’ needs.

4. Ensure gender equity in labor legislation and non-discriminatory workplace environments, which includes zero tolerance for sexual harassment in—and traveling to—the workplace and provision of safe transportation for women; undertake affirmative action and ethical branding initiatives to expand women’s share of employment and firm ownership in emerging sectors.

4. The job creation challenge is stronger in the post-conflict areas

The post-conflict areas face special challenges.

Labor force participation in the Northern and Eastern Provinces is below the national average.

The consequences of the conflict are still visible in the labor outcomes in the Northern and Eastern Provinces. For example, the employment rate in these provinces is still below the national average. This is mainly driven by low participation rates in these provinces rather than differences in unemployment (Figure 43). In the Northern and Eastern Provinces, the employment rates are 44 and 42 percent, respectively, while employment rates in the Western Province and other provinces, are 50 and 54 percent, respectively.

Figure 43: Employment rates are lower in the Northern and Eastern provinces.


Post-conflict provinces need the strongest job creation. The employment rate of the Eastern Province is 12 percentage points lower than that of the other provinces, while the employment rate in the Northern Province is 10 percentage points lower. To reach the same employment rate as that of the other provinces, the Eastern Province would need 180,000 additional jobs while the Northern Province would need 100,000 (Table 4).

Table 5: More jobs will be needed in particular in the post-conflict areas.

<table>
<thead>
<tr>
<th>Sri Lanka</th>
<th>Population (15+)</th>
<th>Employment rate (2015)</th>
<th>Job creation needed to match employment rate of other provinces</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2015</td>
<td>Survey estimate</td>
<td>Survey estimate</td>
</tr>
<tr>
<td>Eastern</td>
<td>1,577,557</td>
<td>42</td>
<td>175,940</td>
</tr>
<tr>
<td>Northern</td>
<td>1,076,357</td>
<td>44</td>
<td>100,443</td>
</tr>
<tr>
<td>Western</td>
<td>5,934,060</td>
<td>50</td>
<td>204,052</td>
</tr>
<tr>
<td>Other provinces</td>
<td>12,060,027</td>
<td>54</td>
<td>0</td>
</tr>
</tbody>
</table>


Workers in the post-conflict provinces tend to be employed in more productive sectors than other provinces outside the Western Province. While the service sector employs the most people, the largest proportion of service employment is in the Western Province – over 60 percent. In the Eastern and Northern Provinces, around 48 percent are employed in services while the service sector accounts for 38 percent of all employment in the remaining provinces (Figure 44). In terms of type of employment, paid employment in the North and East is more common than in the other provinces accounting for 64 and 59 percent of those employed, respectively (Figure 45).

These findings suggest that while employment rates are lower in the post-conflict areas, those working are generally employed in more productive sectors. Consistent with this interpretation, among wage earners, median wage earnings in these regions, especially in the Eastern Province, are higher than in the other provinces.

Figure 44: Workers in the Northern and Eastern provinces are less likely to be in agriculture and in paid employment than provinces other than Western


Low employment rates in the North As mentioned earlier, low female employment is a challenge in all of Sri Lanka, but especially in the post-conflict areas. The gender differences are especially severe in
and East are largely due to low rates of female employment.

the North and East: in the Eastern Province, where the disparity is most extreme, 69 percent of men work, while only 19 percent of women are employed (Figure 12). It is also worth mentioning the low level of female jobs in agriculture in these areas. For the Northern and Eastern provinces to reach the national average female employment rate in 2015, 132,000 more women would have had to have been employed. Low rates of participation of the youth and those with lower education also contribute to this gap.

Demand and supply factors are likely contributing to the gender gap in employment.

It is likely that both labor supply (e.g., skills, propensity to work) and job supply factors (e.g., access to finance), contribute to the low female employment in the Northern and Eastern Provinces. Skills seem a greater constraint for women, while less access to formal finance could also impinge on employment opportunities. There is also suggestive evidence that the demographic and economic circumstances of the family play a larger role in women’s labor force participation in post-conflict areas compared to the rest of the country. It is also possible that there is a social stigma attached to women working outside of the home.

Overall, most of employment gap between the Northern and Eastern provinces and the rest of the country is due to low female labor force participation.

Most of employment gap between the post-conflict provinces and the rest of the country is due to low female labor force participation, although low rates of participation of the youth and those with lower education also contribute to this gap. These depressed rates of labor force participation in the post-conflict provinces are not driven by systematic differences in observed worker characteristics, but instead reflect both weak labor demand and a greater propensity for women not to work. Women in these provinces score poorly on reading, literacy, and numeracy skills, which likely contributes to low rates of female labor force participation. Households in these provinces have less access to formal finance, which may also contribute to a lack of self-employment opportunities. However, more work needs to be done to understand better the role of factors that could affect women’s decisions to participate in the labor market, such as fertility rates, availability of childcare, responsiveness to husband’s income, transfer income, substitutes for women’s time such as household appliances (Goldin, 2006), and preferences for work (Figure 45).

Figure 45: Low Employment rates in the Northern and Eastern Provinces largely due to less women working

Employment rate by Gender (Percent)

Sri Lanka’s exports as a share of GDP reached a high of 39 percent in 2000, following the second wave of economic liberalization but this share has since declined - in 2015 exports were only 21 percent of GDP. A forthcoming World Bank report on “Exports to Jobs: Boosting Trade in South Asia” shows that more exports can improve labor market outcomes in South Asia. Previous research on trade and local labor markets focuses on negative shocks, such as increasing competition due to the growth of China, automation, exchange rates, or tariff reduction. This report follows the methodology of Topalova (2010), Autor et al. (2013), and Hakobyan and McLaren (2016) in applying the “Bartik” approach to understanding the local labor market effects of exports on workers.

The report finds increases in exports per worker over the 2002-2013 period increased the wage bill significantly for most worker types with export shocks operating primarily through wages rather than employment in Sri Lanka. For instance, estimates indicate that average wages increase by about LKR 975 following a USD 100 increase in exports per worker (statistically significant at the 95 percent level) while the impact of exports on employment is ambiguous. These results imply that an increase in exports per worker to USD 1,500 over a 10-year period would increase average wages by approximately LKR 14,600.

The largest impact of exports on wages is for high skilled workers in both rural and urban areas and there are no marked differences in the impact on wages between men and women or between young and old workers. However, shocks to labor-intensive manufacturing sectors are most likely to benefit male workers. Positive export shocks widen the wage inequality among workers, as measured by the standard deviation of wages. The report finds a significant impact of trade shocks on the formality of workers in India, but not in Sri Lanka, but this is likely to be a result of the data limitations in Sri Lanka.

Consistent with these findings is the notion that exports usually require more skilled workers and that when workers are immobile – whether by barriers to higher productivity at a worker, firm, and locality-level – export shocks only benefit those in the sector directly facing the shock. Sri Lanka should, therefore, push for freer trade, implement safety nets for trade shocks (trade adjustment interventions), and improve skills and access to employment opportunities in the export sector.

Source: “Exports to Jobs: Boosting Trade in South Asia”, World Bank, 2017 (forthcoming)
D. World Bank Group Assistance

The World Bank Group is committed to supporting Sri Lanka’s transition to an upper middle-income country.

The World Bank Group has been supporting Sri Lanka’s development for close to six decades. Sri Lanka is in many ways a development success story, and yet faces a number of critical challenges as it pursues its goal of becoming an upper middle-income country. The Systematic Country Diagnostic (SCD)\(^\text{56}\) carried out in 2015 identifies critical constraints and opportunities that Sri Lanka faces in accelerating progress toward the goals of ending extreme poverty and promoting shared prosperity in a sustainable manner. They include: (i) achieving fiscal sustainability; (ii) enhancing competitiveness and promoting more and better jobs for the bottom 40 percent; (iii) providing for social inclusion for disadvantaged segments of the population; and (iv) attaining longer term sustainability, especially of the environment, political stability, and an aging population. In addition, strengthening governance is a cross-cutting challenge. The SCD anchors the World Bank Group Country Partnership Framework (CPF) for FY2017–20.\(^\text{57}\)

The Country Partnership Framework is anchored by the Systematic Country Diagnostic.

Under the CPF, the World Bank Group will contribute to Sri Lanka’s transition to a more competitive, inclusive, and resilient upper-middle income country. Main areas of support include macro-fiscal stability and competitiveness; promoting inclusion and opportunities for all; and seizing green growth opportunities, improving environmental management, and enhancing adaptation and mitigation potential. Sri Lanka has graduated from IDA and is receiving IDA transition financing during IDA 18 (FY2018–20). IFC gives priority to sustainable infrastructure (through PPP’s), financial inclusion, and access to input/output markets, products, services and jobs. MIGA is ready to provide guarantees where possible to support foreign investment projects across sectors.

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\(^{57}\) The CPF is available at: CPF: [https://openknowledge.worldbank.org/handle/10986/24682](https://openknowledge.worldbank.org/handle/10986/24682)
The World Bank portfolio covers a range of areas to support Sri Lanka’s transition.

Current active World Bank portfolio (as of 31st May 2018) comprises 15 projects with a total net commitment value of USD 1.82 billion (13 IDA, 1 IBRD, and 1 IBRD-IDA blend). The World Bank’s financing to Sri Lanka has mainly been for investment projects. It is financing one program-for-results project, approved in May 2017, to support the government’s program to improve higher education. The sustainable development cluster (consisting of urban operations, climate resilience, agriculture, environment and water sectors) accounts for the largest share of the portfolio with 7 operations and 56% of the financing. The WB provides significant financing support for urban development (23 percent of the total commitment), and climate resilience (8 percent of total commitment). The human development cluster (i.e., education, health and social protection) also has 7 operations and represents 40 percent of total commitments. The education sector alone consists of 5 operations and represents nearly 25 percent of the portfolio. In addition to lending, the World Bank is carrying out analytical work and technical assistance across various sectors, funded through both trust funds and own budget. The World Bank has extended its support in close coordination and collaboration with development partners, including through co-financing projects and leveraging private sector resources where opportunities arise.

In line with the CPF, IFC’s strategy in Sri Lanka is aimed at promoting better, efficient and sustainable growth. It focuses on the country’s biggest development gaps, especially in: inclusion; infrastructure and productivity; and sustainability. To foster inclusion, IFC is working on increasing access to finance, especially to MSMEs, smallholder farmers, and women. IFC is also working on gender inclusion such as the “Women in Work” program which aims to improve women’s participation in private sector economic activities from board representation to corporate employment and supply chains. IFC’s support for infrastructure aims to improve electricity provision, generation mix and efficiency. IFC is also focused on critical last mile infrastructure including in logistics and value chain services. In sustainability, IFC is working on renewable solutions, narrowing the green/affordable housing gap, supporting climate change mitigation and adaptation measures, and improving resource efficiency. IFC is also targeting sectors with significant job creation impacts especially agribusiness and tourism.

As of April 30, 2018, IFC’s total committed investment portfolio stood at about USD 349 million. In addition, IFC has an advisory program comprising 12 portfolio projects with a combined portfolio value of USD 13.4 million. IFC’s advisory projects are helping to boost access to finance especially for SMEs and women, and strengthening business skills and supply chains particularly in tourism sector. IFC is also enabling the government in the development of sustainable infrastructure such as water and solar.

MIGA stands ready to support FDI, in projects aligned with the CPF and the WBG’s goals.

MIGA is open to supporting foreign investment in projects with positive development impacts, consistent with the CPF and the World Bank Group’s goals of ending extreme poverty and promoting shared prosperity in a sustainable manner. Through its political risk guarantee products, MIGA stands ready to support foreign investors, including in partnership with the World Bank and IFC.
### Key Economic Indicators

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Real sector</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP, (current, LKR billion)</td>
<td>11,907</td>
<td>13,317</td>
<td>14,499</td>
<td>15,897</td>
<td>17,425</td>
</tr>
<tr>
<td>GDP per capita, (current, US$)</td>
<td>3,857</td>
<td>4,073</td>
<td>4,298</td>
<td>4,490</td>
<td>4,690</td>
</tr>
<tr>
<td>Real GDP growth (%)</td>
<td>4.5</td>
<td>3.3</td>
<td>4.4</td>
<td>4.3</td>
<td>4.3</td>
</tr>
<tr>
<td>CCPI inflation (%)</td>
<td>4.0</td>
<td>6.6</td>
<td>5.0</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td><strong>External sector</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exports of goods</td>
<td>12.6</td>
<td>13.0</td>
<td>13.2</td>
<td>13.3</td>
<td>13.3</td>
</tr>
<tr>
<td>Imports of goods</td>
<td>23.5</td>
<td>24.0</td>
<td>24.4</td>
<td>24.5</td>
<td>24.6</td>
</tr>
<tr>
<td>Trade balance</td>
<td>-10.8</td>
<td>-11.0</td>
<td>-11.3</td>
<td>-11.2</td>
<td>-11.3</td>
</tr>
<tr>
<td>Tourism receipts</td>
<td>4.3</td>
<td>4.5</td>
<td>4.6</td>
<td>4.8</td>
<td>5.0</td>
</tr>
<tr>
<td>Remittances</td>
<td>8.9</td>
<td>8.2</td>
<td>8.0</td>
<td>7.9</td>
<td>7.9</td>
</tr>
<tr>
<td>External Current Account</td>
<td>-2.1</td>
<td>-2.6</td>
<td>-3.1</td>
<td>-3.2</td>
<td>-3.3</td>
</tr>
<tr>
<td>FDI inflows</td>
<td>0.8</td>
<td>1.5</td>
<td>2.0</td>
<td>1.2</td>
<td>0.9</td>
</tr>
<tr>
<td>Official reserves (USD billion)</td>
<td>6.0</td>
<td>8.0</td>
<td>9.8</td>
<td>9.2</td>
<td>9.6</td>
</tr>
<tr>
<td>Official reserves (months of imports of goods and services)</td>
<td>3.1</td>
<td>3.8</td>
<td>4.3</td>
<td>3.8</td>
<td>3.7</td>
</tr>
<tr>
<td>Exchange rate (end period, LKR/USD)</td>
<td>149.8</td>
<td>152.9</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Fiscal accounts</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total revenue and grants</td>
<td>14.2</td>
<td>13.8</td>
<td>14.9</td>
<td>15.3</td>
<td>15.5</td>
</tr>
<tr>
<td>Tax revenue</td>
<td>12.3</td>
<td>12.5</td>
<td>13.3</td>
<td>13.8</td>
<td>13.9</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>19.6</td>
<td>19.3</td>
<td>19.8</td>
<td>19.6</td>
<td>19.4</td>
</tr>
<tr>
<td>Current expenditure</td>
<td>14.8</td>
<td>14.5</td>
<td>14.7</td>
<td>14.5</td>
<td>14.3</td>
</tr>
<tr>
<td>Capital and net lending</td>
<td>4.8</td>
<td>4.8</td>
<td>5.1</td>
<td>5.1</td>
<td>5.1</td>
</tr>
<tr>
<td>Primary Balance</td>
<td>-0.2</td>
<td>0.0</td>
<td>0.6</td>
<td>1.2</td>
<td>1.5</td>
</tr>
<tr>
<td>Overall fiscal balance</td>
<td>-5.4</td>
<td>-5.5</td>
<td>-5.0</td>
<td>-4.3</td>
<td>-3.9</td>
</tr>
<tr>
<td>Central government debt&lt;sup&gt;1&lt;/sup&gt;</td>
<td>78.8</td>
<td>77.4</td>
<td>77.4</td>
<td>76.2</td>
<td>74.8</td>
</tr>
<tr>
<td>Treasury guarantees</td>
<td>7.1</td>
<td>6.8</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td><strong>Monetary/ Financial sector</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standing deposit facility rate (December, % per annum)</td>
<td>7.0</td>
<td>7.25</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standing lending facility rate (December, % per annum)</td>
<td>8.5</td>
<td>8.75</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private sector credit growth (M2b&lt;sup&gt;2&lt;/sup&gt;, %)</td>
<td>21.9</td>
<td>14.7</td>
<td>15.2</td>
<td>16.9</td>
<td>15.8</td>
</tr>
</tbody>
</table>

### Notes:
1. Central government debt number excludes: debt contracted by SOEs and state agencies with or without a Treasury guarantee, overdrafts at the state banks of LKR 150 billion (2017), and restructuring bonds amounting to LKR 102.5 billion issued to settle dues from SOEs to CPC (LKR 53.9 billion), to recapitalize Sri Lankan Airlines (LKR 11.7 billion), National Water Supply and Drainage Board (LKR 13.0 billion) and CPC (LKR 23.9 billion) (Central Bank of Sri Lanka annual report 2017).
2. Includes currency, demand deposits, and savings deposits held by the public with commercial banks

Sources: Central Bank of Sri Lanka, Ministry of Finance, staff projections.
Table 6: Balance of payments  
(Percent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Account</strong></td>
<td>-2.3</td>
<td>-2.1</td>
<td>-2.6</td>
</tr>
<tr>
<td>Exports</td>
<td>13.1</td>
<td>12.6</td>
<td>13.0</td>
</tr>
<tr>
<td>Imports</td>
<td>23.5</td>
<td>23.5</td>
<td>24.1</td>
</tr>
<tr>
<td>Oil</td>
<td>3.4</td>
<td>3.0</td>
<td>3.9</td>
</tr>
<tr>
<td>Non-oil</td>
<td>20.2</td>
<td>20.4</td>
<td>20.1</td>
</tr>
<tr>
<td>Trade balance</td>
<td>-10.4</td>
<td>-10.8</td>
<td>-11.0</td>
</tr>
<tr>
<td>Non-oil</td>
<td>-7.1</td>
<td>-7.8</td>
<td>-7.1</td>
</tr>
<tr>
<td>Services inflows</td>
<td>7.9</td>
<td>8.7</td>
<td>8.9</td>
</tr>
<tr>
<td>Tourism receipts</td>
<td>3.7</td>
<td>4.3</td>
<td>4.5</td>
</tr>
<tr>
<td>Services outflows</td>
<td>5.1</td>
<td>5.2</td>
<td>5.1</td>
</tr>
<tr>
<td>Services net</td>
<td>2.9</td>
<td>3.5</td>
<td>3.8</td>
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<tr>
<td>Primary income (net)</td>
<td>-2.5</td>
<td>-2.7</td>
<td>-2.7</td>
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<tr>
<td>Secondary income (net)</td>
<td>7.7</td>
<td>7.9</td>
<td>7.3</td>
</tr>
<tr>
<td>Remittances</td>
<td>8.7</td>
<td>8.9</td>
<td>8.2</td>
</tr>
<tr>
<td><strong>Current and Capital Account</strong></td>
<td>-2.3</td>
<td>-2.1</td>
<td>-2.6</td>
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<tr>
<td>FDI inflows</td>
<td>0.8</td>
<td>1.1</td>
<td>1.6</td>
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<tr>
<td>Portfolio Investment</td>
<td>0.9</td>
<td>1.2</td>
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<tr>
<td>Other Investment</td>
<td>1.7</td>
<td>0.1</td>
<td>2.2</td>
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<tr>
<td>Receipts to the government</td>
<td>0.6</td>
<td>1.6</td>
<td>1.4</td>
</tr>
<tr>
<td>Gross Official Reserves (months of merchandise imports)</td>
<td>4.6</td>
<td>3.8</td>
<td>4.6</td>
</tr>
</tbody>
</table>

Source: Central Bank of Sri Lanka and staff calculations
### Table 7: Budget and fiscal outcomes
(percentage of GDP)

<table>
<thead>
<tr>
<th></th>
<th>2015 Actual</th>
<th>2016 Provisional</th>
<th>2017 Provisional</th>
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</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
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<tr>
<td>Tax revenue, of which</td>
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<tr>
<td>Income tax</td>
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<td>2.1</td>
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<tr>
<td>VAT</td>
<td>2</td>
<td>2.4</td>
<td>3.3</td>
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<tr>
<td>Excise taxes</td>
<td>4.5</td>
<td>3.8</td>
<td>3.5</td>
</tr>
<tr>
<td>Non-tax revenue</td>
<td>0.9</td>
<td>1.9</td>
<td>1.2</td>
</tr>
<tr>
<td><strong>Expenditure</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recurrent, of which</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries</td>
<td>5.1</td>
<td>4.8</td>
<td>4.4</td>
</tr>
<tr>
<td>Interest payments</td>
<td>4.8</td>
<td>5.1</td>
<td>5.5</td>
</tr>
<tr>
<td>Transfers and subsidies</td>
<td>3.8</td>
<td>3.4</td>
<td>3.3</td>
</tr>
<tr>
<td>Capital Expenditure and Net Lending</td>
<td>5.4</td>
<td>4.8</td>
<td>4.9</td>
</tr>
<tr>
<td><strong>Primary balance</strong></td>
<td>-2.8</td>
<td>-0.2</td>
<td>0</td>
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<tr>
<td><strong>Overall balance</strong></td>
<td>-7.6</td>
<td>-5.4</td>
<td>-5.5</td>
</tr>
<tr>
<td>Total Net Financing</td>
<td>-7.6</td>
<td>5.4</td>
<td>5.5</td>
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<tr>
<td>Foreign financing</td>
<td>5.4</td>
<td>3.3</td>
<td>3.3</td>
</tr>
<tr>
<td>Domestic financing</td>
<td>2.2</td>
<td>2.1</td>
<td>2.2</td>
</tr>
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</table>

Source: Central Bank of Sri Lanka