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The Economy, Regional Disparities, and Global Opportunities

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January 1–December 31

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(Exchange Rate Effective as of December 15, 2006)
Currency Unit= Sri Lankan Rupee
US$ 1.00= Rs. 108.09

ABBREVIATIONS

APC	**All Party Conference**
CCPI	**Colombo Consumer Price Index**
BPO	**Business Process Outsourcing**
CBSL	**Central Bank of Sri Lanka**
CEB	**Ceylon Electricity Board**
EPZs	**Export Processing Zones**
ESDFP	**Education Sector Development Framework and Program**
FDI	**Foreign Direct Investment**
FMRA	**Fiscal Management Responsibility Act**
GCEC	**Greater Colombo Economic Commission**
GCE	**General Certificate Examination**
GDP	**Gross Domestic Product**
ICICI	**Industrial Credit Investment Corporation of India**
ICT	**Information and Communications Technology**
ICTA	**Information and Communications Technology Agency**
IDPs	**Internally Displaced Persons**
IMF	**International Monetary Fund**
IT	**Information Technology**
JBIC	**Japan Bank for International Cooperation**
LDO	**Land Development Ordinance**
LIBOR	**London Interbank Offer Rate**
LTTE	**Liberation Tigers of Tamil Eelam**
MFA	**Multi-Fiber Arrangement**
MOU	**Memorandum of Understanding**
MTBF	**Medium Term Budget Framework**
NASA	**National Aeronautics & Space Administration**
NEC	**National Education Commission**
NGO	**Non Government Organization**
NTC	**National Transport Commission**
PPPs	**Public-Private Partnerships**
PUCSL	**Public Utilities Commission of Sri Lanka**
SEMA	**Strategic Enterprises Management Agency**
SLDB	**Sri Lanka Development Bonds**
SLCPI	**Sri Lanka Consumer Price Index**
SLFP	**Sri Lanka Freedom Party**
TNA	**Tamil National Alliance**
UBS	**Unemployment Benefit Scheme**
UNCTAD	**United Nations Conference on Trade and Development**
UNP	**United National Party**
UPFA	**United People's Freedom Alliance**
US	**United States**
VAT	**Value Added Tax**
WTO	**World Trade Organization**

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TABLE OF CONTENTS

List of Figures

List of Tables

List of Boxes

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INTRODUCTION

Sri Lanka's development is at a critical juncture. Thanks to relatively rapid economic growth that pushed per capita income over the US$1,000 mark in 2004, and its traditionally high levels of human development, Sri Lanka is on the verge of becoming a middle-income country. Furthermore, the country has maintained aggregate growth despite several adverse shocks, including a tsunami, a doubling of world oil prices, and increased competition for its apparel exports following the end of the Multi-Fiber Arrangement (MFA). At the same time, Sri Lanka's growth has been highly uneven. Most of it was concentrated in the Western Province. In the rest of the country, GDP growth has averaged less than 3 percent a year, and poverty remains stubbornly high. While the service sector and, to some extent, manufacturing boomed, agriculture—the main source of income for people living outside the Western Province—has stagnated. Moreover, Sri Lanka's overall growth has not been commensurate with its human development achievements. Finally, the country is facing a resumption of the ethnic conflict that has permeated economic and political life over the last quarter century.

To address these challenges by building on Sri Lanka's strengths, the Government last November issued a discussion draft of its 10-year development framework, *Mahinda Chintana: Vision for a New Sri Lanka.* The framework, along with an assessment of tsunami reconstruction[1] and the country's recent economic performance, will be the subject of the Sri Lanka Development Forum on January 29-30, 2007. This report is intended to inform the discussions of the Forum. Specifically, section I reviews recent economic performance, the status of macroeconomic management and the strategic directions outlined in *Mahinda Chintana.* It notes that the recent acceleration in Sri Lanka's growth can be partly attributed to large aid flows for tsunami reconstruction and to rapid growth in domestic demand. While Sri Lanka can sustain higher growth given its level of human development and integration with global markets, this will require addressing structural constraints and managing the downside risks associated with rising inflation and the escalating conflict.

Section II of the report addresses the regional disparities in growth and poverty reduction in Sri Lanka. Noting that differences in education levels and access to infrastructure cannot fully explain the sharp gaps in regional growth, it suggests that the limited scope of market reforms in key sectors, such as agriculture, has played a more significant role. In particular, policy reforms in agriculture have been elusive, partly due to misperceptions that they will hurt the poor. Progress in reducing regional disparities will require politically-sensitive reforms that address these misperceptions, through *inter alia* public consultations.

Finally, section III takes up the question of how Sri Lanka can accelerate growth further by taking advantage of its high levels of educational attainment and tapping global opportunities in the information technology (IT) and knowledge sectors. The recent increase in foreign direct investment in telecommunications, IT, and business process off-shoring (BPO) in banking suggest that there is potential for such growth. This potential can be enhanced by moving further on the policy agenda that removes the obstacles facing a knowledge economy.

[1] The Government is in the process of finalizing a document entitled "Post Tsunami Recovery and Reconstruction" for presentation at the Forum.

I. THE ECONOMY: OVERVIEW AND STRATEGIC DIRECTIONS

A. Introduction

1.1 The Sri Lankan economy has experienced accelerated growth over the past two years despite adverse shocks—such as oil price hikes, the tsunami, and the deterioration in internal security. Growth has averaged 6.5 percent during 2005-2006, which is above the historical average of 4-5 percent. This accelerated growth momentum has been supported by increased external financial flows for post-tsunami reconstruction and a rapid expansion in domestic demand. Sri Lanka has the potential to sustain even higher growth rates, as envisioned by the *Mahinda Chintana Vision for a New Sri Lanka*, given its well educated labor force and substantial integration with global markets. But to achieve higher economic growth and hence lower the incidence of poverty, there is a need to address remaining structural constraints and effectively manage immediate downside risks linked to rising inflation and the recent intensification of the violence.

B. Political Context

1.2 The victory of Mahinda Rajapakse, the Sri Lanka Freedom Party (SLFP) candidate in the Presidential elections of November 2005, ensured the continuity of the economic policies initiated by the United People's Freedom Alliance (UPFA) government, the coalition that took power in April 2004. In 2006, the main opposition United National Party (UNP) and the SLFP signed a Memorandum of Understanding (MOU) to collaborate closely in building consensus in critical areas.

1.3 Several rounds of talks between the government and the Liberation Tigers of Tamil Eelam (LTTE) have so far failed to produce tangible outcomes. The past year has seen an escalation of conflict-related violence particularly in the North and East. Over 3,000 people have died and over 250,000 persons have been displaced.[2] Meanwhile, President Rajapakse has established an All-Party Conference (APC) mechanism which is to submit a constitutional proposal for deliberation among key political parties.

1.4 The escalation of the conflict poses additional challenges in the short-term to macroeconomic management, given increasing fiscal pressures. It also affects the implementation of the development agenda—including tackling the key issues of raising competitiveness and reducing regional disparities. Therefore, a political consensus—both to address the resolution of the conflict and to move forward with key reforms—will be important for Sri Lanka to achieve its development objectives.

C. Overview of the Economy

1.5 **Economic Outcomes**. The Sri Lankan economy has posted impressive gains in the post-tsunami period, with a 6 percent growth rate in 2005 followed by 7.8 percent growth during the first three quarters of 2006 (Figure 1.1). With per-capita income rising above US$1,000 in 2004, Sri Lanka is on a steady path to achieving status as a middle-income country. Higher economic growth has been accompanied by a decline in unemployment, excluding the North and East, from 8.1 percent in 2004 to 7.2 percent in 2005 and 6.4 percent during the first nine months of 2006. The latest estimate for all districts was 7.7 percent in August 2005.[3]

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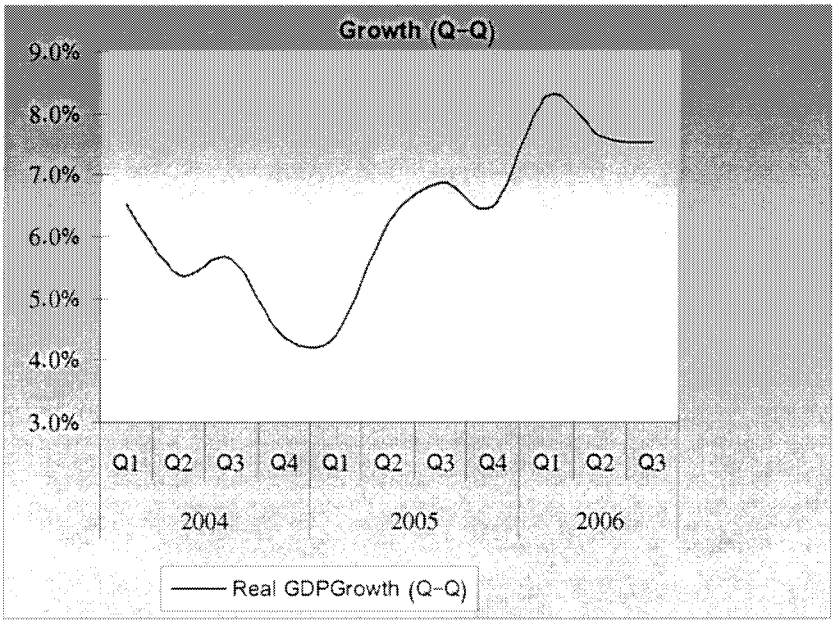
[2] The total number of internally displaced persons (IDPs) presently stands at over half a million, including those displaced by the tsunami and those displaced during earlier phases of the conflict.

[3] This figure is based on a one-off labor force survey by the Department of Census and Statistics.

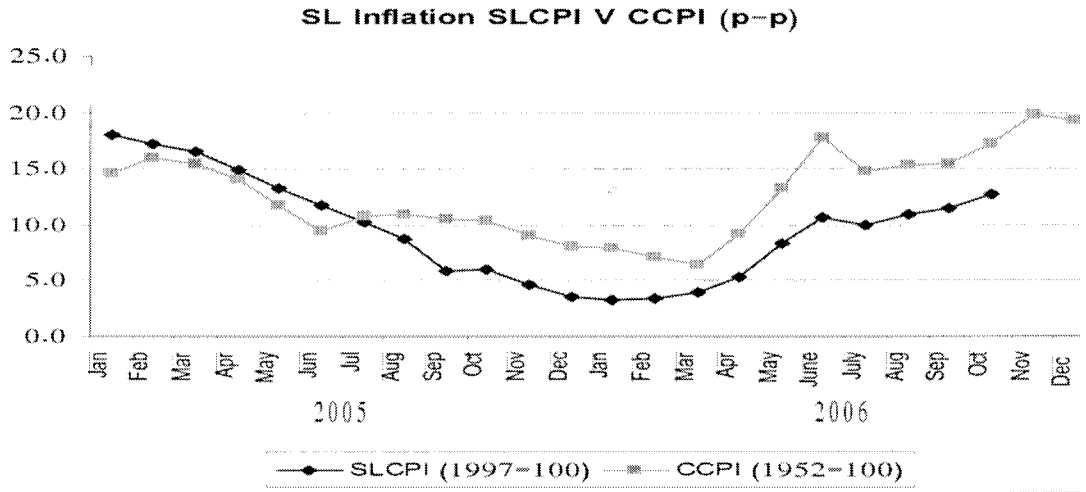
Figure 1.1: Quarterly GDP Growth 2004-06



Source: Central Bank of Sri Lanka

1.6 Meanwhile, the declining trend in inflation observed through most of 2005 and early 2006 reversed starting in April 2006 (Figure 1.2). The pass-through of higher oil prices to consumers and continued rapid growth in money supply account for the acceleration in inflation, which in November 2006 peaked at 19.8 percent as measured by the point-to-point Colombo Consumer Price Index (CCPI). Notably, administered fuel prices[4] were raised by 35 percent between April and September 2006 with subsidies for gasoline and diesel completely removed in August.

Figure 1.2: Sri Lanka and Colombo Consumer Price Inflation Rates: 2005-2006



Source: Department of Census and Statistics (DCS); p-p refers to point-to-point

[4] This kept pump prices below market cost.

Box 1.1: The Economic Impact of the Tsunami in 2005-2006*

The tsunami which struck Sri Lanka on 26 December 2004 caused widespread damage and loss of lives particularly in the worst-affected Southern, Northern and Eastern coastal areas. Following the disaster, the expectation was that the impact on the economy would be contained, but that fiscal and external imbalances would widen as a result of increased external aid flows.

GDP: The impact of the tsunami on the economy was largely contained given the relatively low contribution of fisheries and tourism to GDP—the sectors most affected by the tsunami. Meanwhile, an acceleration of construction activities for rebuilding had an offsetting impact. In 2005, fishing output, mostly affecting the North and East, was 60 percent of pre-tsunami levels (with a catch of 163,000 tons). However, by September 2006, the output had recovered to about 80 percent of pre-tsunami levels.

The tsunami-affected areas accounted for about 40 percent of overall tourist guest sites in the country. While the sector suffered in the immediate aftermath of the disaster, by mid-2006 most damaged hotels and guest houses had been rebuilt. In 2005, tourist arrivals fell less than expected (by about 3 percent), as increased tourists from neighboring countries, particularly India, partly made up for the decline in European tourists. Arrivals were on track to reach 600,000 in 2006. However, the recent deterioration in the security situation is likely to deter further recovery of the industry.

	Pre-tsunami		*Post-tsunami*	
	2004	2005 (est.)	2005	2006 (1st half)
Real GDP growth (%)	5.4	6.0	6.0	8.0
o/w: Fisheries (%)	1.6	4.5	-42.2	108.0
Tourism (%)	13.1	6.2	-27.5	24.1
Construction (%)	6.6	6.0	8.9	7.5
Memo items:				
Tourist arrivals	566,202	600,000	549,308	482,800 (a)

Source: Central Bank of Sri Lanka; (a)=up to October

Prices: Although increased demand for construction materials pushed up prices in related areas, the impact was not significant. More importantly, the appreciation of the rupee following the large inflow of external official and private aid had the effect of containing price increases, particularly in 2005.

Aid Flows: Aid pledges at the May 2005 Development Forum amounted to US$2.2 billion, including US$ 157.5 million in emergency assistance by the IMF and US$260 million in debt moratorium. Of this, the bulk (60 percent) was pledged by bilateral and multilateral donors and the balance by NGOs and private sector institutions. By April 2006, nearly half of the pledged assistance had been disbursed.

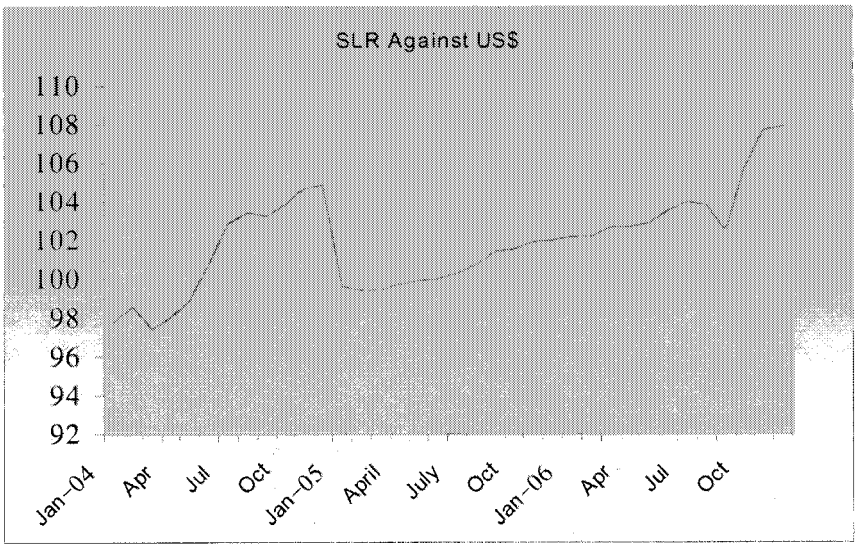
Fiscal position: The impact of the tsunami on revenue collection was marginal, and the debt moratorium provided additional fiscal space (0.4 percent of GDP in interest) in 2005. Tsunami-related expenditure amounted to 1.4 percent of GDP in 2005 (1 percent for capital and 0.4 percent for recurrent) and about 0.8 percent of GDP in 2006 (against a program of 1.7 percent of GDP). The 2007 budget has allocated a further 0.7 percent of GDP for tsunami reconstruction.

Balance of payments: The tsunami-related external inflows helped to generate a balance of payments surplus of US$500 million in 2005. As a result, official gross reserves rose from 2.2 to 2.5 months of imports.

* For further discussion of the tsunami's economic impact, see "Post Tsunami Recovery and Reconstruction".

1.7 The Sri Lanka rupee, which had been weakening in the course of 2004, appreciated in the post-tsunami period largely due to the increased inflow of official aid and private remittances. Although the nominal exchange rate depreciated marginally throughout 2005 it did not keep up with inflation differentials. By the end of the year, the rupee had appreciated by nearly 9 percent in real terms compared to the previous year. Higher inflation combined with the gradual waning of tsunami-related aid inflows has recently put the rupee under pressure despite increased sales of foreign currency by the Central Bank. (Figure 1.3)

Figure 1.3: Movement in the Nominal Exchange Rate



Source: Central Bank of Sri Lanka

1.8 **Sectoral Growth, Investment and Savings**. Economic growth during the last two years continued to be dominated by the services sector, followed by the industrial sector (Table 1.1). Agricultural growth performance was initially affected by the tsunami-related setback to the fisheries sub-sector, but it bounced back during 2006.

1.9 The services sector, which accounts for over 55 percent of GDP and close to 60 percent of economic growth during the post-tsunami period, was spurred by the continued buoyancy of the telecommunications sub-sector (growth of 27 percent in 2005 and 23 percent during the first nine months of 2006).

Table 1.1: Trends in Key Macroeconomic Indicators 1990-2006

	1990-2000 Average	2001	2002	2003	2004	2005	2006*
Agriculture Sector (% change)	2.5	-3.4	2.5	1.6	-0.3	1.5	4.8
Industrial Sector (% change)	6.8	-2.1	1	5.5	5.2	8.3	6.3
Manufacturing	8.1	-4.2	2.1	4.2	5.1	6.0	5.8
Construction	5.2	2.5	0.8	5.5	6.6	8.9	6.8
Services Sector (% change)	5.6	-0.5	6.1	7.9	7.6	6.4	8.1
Transport, Storage, and Communications	6.4	3.8	7.6	10.2	13.7	12.7	12.0
Wholesale and Retail Trade	5.5	-6.7	5.6	7.3	5.7	2.6	7.2
Banking, Insurance, and Real Estate	7.7	7.9	11.1	10.6	5.6	6.5	8.1
Public Administration and Defense	3.5	1.0	1.3	2.1	3.9	5.4	2.3
GDP	**5.3**	**-1.5**	**4.0**	**6.0**	**5.4**	**6.0**	**7.0**
National Savings (% of GDP)	19.8	20.3	19.5	21.6	21.6	23.3	25.0
Total Investment (% of GDP)	25.2	22.0	21.3	22.1	25	26.5	30.0
Public Investment (% of GDP)	6.8	5.8	4.6	5.3	5.2	6.9	6.6
Private Investment (% of GDP)	18.4	16.2	16.7	16.8	19.8	19.6	23.4

Source: Central Bank of Sri Lanka (*)Estimate for full year, based on data up to September

1.10 The industrial sector continued to sustain robust growth, despite the challenges posed by the end of the MFA in 2005. The manufacturing sub-sector, containing the vital garments industries, continued to perform strongly although at a somewhat slower pace (from 6 percent in 2005 to 5.2 percent in the first nine months of 2006). The construction sector has seen dynamic growth largely due to post-tsunami reconstruction and a rapid increase in real state development particularly in the Western Province.

1.11 Agriculture continued to lag behind industry and services, but in 2006 the growth performance of the sector improved largely on account of a bumper harvest of paddy and the recovery in fisheries–which contracted significantly in the aftermath of the tsunami. Although fishing had recovered considerably by the third quarter of 2006, it was yet to reach pre-tsunami levels.

1.12 Sri Lanka's investment and savings ratio improved somewhat in 2005, although the gap continued to widen. The improvement in the savings ratio was mainly due to an improvement in government dis-saving in 2005. The increased investment ratio in 2005 came from an increase in public investment expenditure for tsunami reconstruction. Private investment is estimated to have picked up in 2006[5], despite uncertainties about the security situation, reflecting in part the rapid credit expansion experienced during the year. The country attracted US$ 272 million in FDI in 2005 and a further US$240 million in the first half of 2006. The bulk of foreign direct investment (FDI) over the past two years has gone into the services (telecommunications, BPOs, etc.) and infrastructure sectors. Notably, Sri Lanka has made initial strides in developing a BPO industry which holds tremendous growth potential. This will be the subject of Section III.

D. Macroeconomic Management

1.13 **Fiscal management.** The post-tsunami period posed many challenges to fiscal management, with additional expenditure needed for tsunami recovery activities and increased military outlays in the face of the deteriorating security situation. In addition, higher public sector wages and pensions together with increased fuel subsidies (although eventually removed) created additional fiscal pressures. One positive aspect has been the recent improvements in revenue collection which has partly offset the increases in expenditures. Also, a large share of the tsunami expenditures has been funded through additional external aid.

1.14 The fiscal deficit (including tsunami expenditures) has remained at around 8.7 percent of GDP in 2005 and 2006. However, excluding tsunami expenditures the deficit has increased from 7.3 percent of GDP in 2005 to an estimated 7.9 percent in 2006. In 2005, improved revenue performance and savings resulting from a debt service moratorium granted by the Paris Club after the tsunami helped contain the deficit, despite a substantial overrun in fuel subsidies.

1.15 The 2006 budget envisaged an overall deficit of 9.1 percent of GDP on account of higher capital expenditure for tsunami reconstruction (Table 1.2). Budget execution was mixed. While revenues increased and were closer to target than in previous years, there was a sizable overrun in recurrent expenditures (of about 1.1 percent of GDP) reflecting higher wages, pensions and subsidies, and military expenditures. Capital spending fell short of target partly because of slower disbursement of foreign-funded projects. Domestic borrowing was higher than planned (5.7 percent of GDP) while net foreign financing was below program (3 percent of GDP).

1.16 The public debt ratio to GDP declined to 93.4 percent in 2005 largely reflecting the appreciation of the rupee vis-à-vis major foreign currencies. In December 2005, the country received its first ever

[5] This forecast appears in the government's Fiscal Management Report 2007, presented with the 2007 budget.

international sovereign debt rating from Fitch (BB-) and Standard and Poor (B+) with a stable outlook, but the ratings' outlook was revised to negative in April 2006 in view of the deteriorating security situation. Under the circumstances, the government postponed plans to raise funds in international capital markets and instead issued US$580 million in foreign currency bonds (Sri Lanka Development Bonds; SLDB).[6] These proceeds were used in part to retire more expensive debt. In December 2006, the government also raised US$100 million through a syndicated loan facility placed with several international banks. The cost of the facility (103.5 bps above 6-month LIBOR) compared favorably to that of the SLDBs.

Table 1.2: Summary of Central Government Fiscal Operations 2001-2007 (as % of GDP)

		Actuals		Budg	Est	Budg
	2001	**2004**	**2005**	**2006**	**2006**	**2007**
Total expenditures and net lending	27.5	23.5	24.7	26.9	26.1	27.6
Current expenditures	21.6	19.2	18.7	18.7	19.8	18.4
Subsidies and transfers	4.6	5.2	5.4	4.3	4.9	3.9
Wages and salaries	5.5	5.2	5.9	6.2	6.4	6.1
Interest payments	6.7	5.9	5.1	5.6	5.5	5.2
Capital expenditures and net lending	5.9	4.3	6.0	8.2	6.7	9.3a)
Memo: Tsunami-related expenditures			1.4	1.7	0.8	0.7
Total revenues	16.7	15.4	16.1	17.8	17.4	18.5
Tax	14.8	13.9	14.2	16.0	15.6	16.7
Non-tax	2.0	1.5	1.8	1.8	1.8	1.8
Current account balance	-4.9	-3.9	-2.7	-0.9	-2.4	0.1
Overall budget balance w/o grants	-10.8	-8.2	-8.7	-9.1	-8.7	-9.1
External financing	1.4	2.2	3.4	4.6	3.0	4.3
Domestic financing	8.8	5.8	5.2	4.5	5.7	4.8
Public debt	103.2	105.5	93.9	91.5	90.0	86.5

Source: Ministry of Finance and Staff estimates. (a) Includes fully-funded special projects in the amount of Rs 63.2 billion shown below the line in the 2007 budget.

1.17 **Monetary policy.** Money supply has been growing rapidly during the past two years, mainly reflecting high credit expansion (Figure 1.4). Broad money increased by 19.1 percent in 2005 and by an estimated 19.5 percent in 2006. The Central Bank of Sri Lanka (CBSL) succeeded in bringing down reserve money growth to 16 percent in 2005, mainly through open market operations. But increased financing of the budget has pushed up reserve money growth to 21.2 percent in 2006 against a target of 15 percent.[7] While upward revisions in policy rates (by 125 bps in 2005 and 2006) helped reverse the negative trend in real rates for T-bills and prime bank lending, these adjustments have been insufficient to curb private sector credit growth, which was growing by more than 20 percent through most of the year. Notwithstanding these outcomes, the Central Bank's monetary plan for 2007 envisages a curtailment of reserve money growth to 11.6 percent by year end while broad money growth is expected to be reduced to 13.2 percent.

1.18 While continued reliance on open market operations will help curb monetary expansion, further increases in policy rates might be warranted given that real domestic interest rates remain low or negative, while international interest rates are rising. More importantly, a tighter monetary policy stance will need

[6] With a 2-3 year maturity at weighted average rates of 131-158 basis points above the 6 month LIBOR.
[7] Note that the monetary program for the year assumed zero bank financing of the budget.

to be supported by consistent fiscal policies. In particular, domestic financing of the budget, which has been rising in the recent period, needs to be kept in check to ensure consistency.

Figure 1.4: Growth in Monetary Indicators, 2005-06

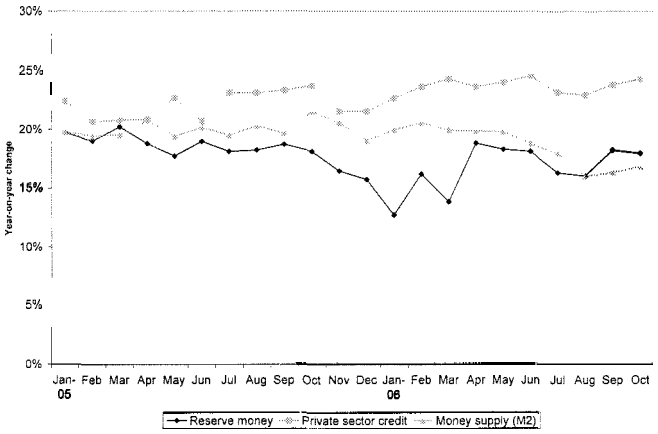
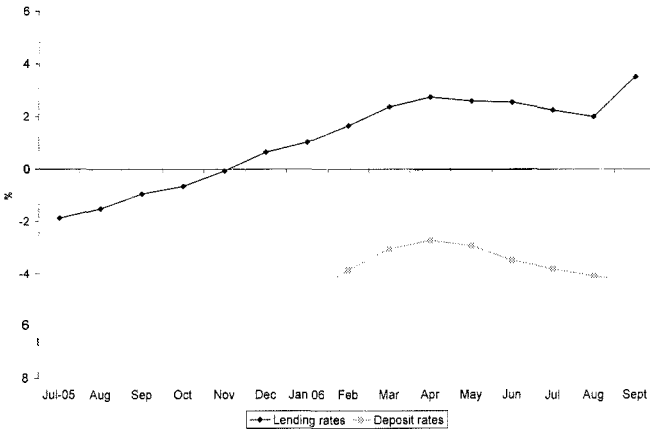


Figure 1.5: Real Interest Rates, 2005-2006



1.19 **External sector.** Sri Lanka's external position strengthened somewhat in 2005 with improvements in the trade and current account balances, higher inflows of tsunami aid (including grants), and continued buoyancy in remittances (Figure 1.6). As a result, the overall balance of payments recorded a surplus of US$500 million and gross official foreign reserves increased to 2.5 months of imports (compared to 2.2 in 2004) (Figure 1.7).

1.20 In 2006, the trade deficit has been widening (to about 13 percent of GDP) with exports growing at about 7 percent and imports at around 16 percent—reflecting a 30 percent rise in oil imports. Apparel exports are growing by only 4 percent and are projected to reach US$3 billion in the year as a whole (a level reached in 2001). The sustained momentum in remittances, which are expected to reach US$2.4 billion, once again is helping ease further pressures and the balance of payments is likely to record a small surplus. Gross official foreign reserves are expected to remain at around 2.5 months of imports of goods and services, a level which is insufficient to protect against external shocks.

Figure 1.6: Import & Exports (US$Mn) 2001-06

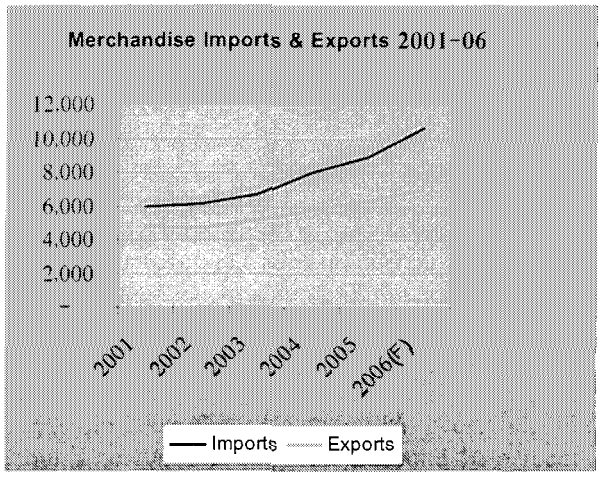
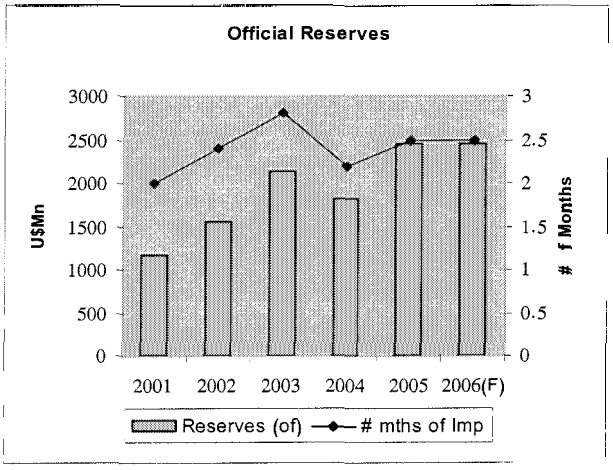


Figure 1.7: Gross Official Reserves (US$Mn) 2001-06



Source: Central Bank of Sri Lanka; (F)=forecast

1.21 **In sum**, the macroeconomic framework has deteriorated in the past year on account of continued fiscal pressures—part of which are linked to the escalation of the conflict—and accommodating monetary policies. While these policies have supported economic growth in the short term, they cannot be sustained over the long run. There is a need to tighten the fiscal and monetary policy stance to restore price stability and ultimately to support higher growth on a more sustainable basis.

E. Strategic Economic Policy Directions: Ten Year Development Framework

1.22 On November 16, 2006 the Government issued a discussion paper outlining its ten-year development framework, the *Mahinda Chintana: Vision for a New Sri Lanka*, for consultations with stakeholders. The document was produced following extensive consultations between the Ministry of Finance and Planning and line ministries. It was issued together with the 2007 Budget and the MTBF for 2006-2009 (Box 1.2).

1.23 The vision sets out ambitious growth targets (over 8 percent by 2010) aimed at reducing poverty incidence to 12 percent of the population by 2015 (from 23 percent in 2002). The rapid growth scenario assumes the continuation of a favorable external environment and implies improved security conditions. A key target is to raise total investment from 28-30 percent of GDP in 2006 to 34 percent in 2010, with the largest contribution coming from the public sector. Public sector savings (currently negative) are expected to contribute 5 percentage points of GDP to gross domestic savings by 2010. FDI is projected at around 2 percent of GDP (compared to less than 1 percent in the past decade).

1.24 Sectorally, growth in agriculture is targeted to double historical trends (reaching 4-5 percent a year), reflecting rapid growth in non-plantation agriculture, particularly livestock and fisheries (over 7 percent). Industry is expected to grow around 8-9 percent with mining and quarrying, and construction as the main drivers. In services, the fastest growing sub-sectors are expected to include tourism, telecommunications and IT. Growth in public administration and defense are expected to remain high (5.5-6.5 percent a year).

Economic Strategies

1.25 **Macroeconomic policies**. The discussion paper states that fiscal and monetary policies will aim at supporting higher growth rates through price stability while providing adequate resources for private sector growth. Fiscal policy will aim at reducing the budget deficit to 5 percent of GDP by 2010 and public debt to 85 percent of GDP by 2008.[8] A welcome objective is to turn the revenue deficit into a surplus, through an expanded tax base and higher non-tax revenue, phasing out of subsidies to state-owned enterprises, and prudent debt management. Domestic borrowing is to be contained at 3 percent of GDP and non-concessional foreign financing will be kept at 1-2 percent of GDP (US$200-400 million a year).

1.26 The fiscal framework outlined in the discussion paper could be strengthened if it were explicitly linked to the MTBF for 2006-2009. It will also be important that the implications for recurrent expenditure of the proposed large capital projects be explicitly included and that the debt management strategy be clearly articulated, especially as some of these large projects are to be financed by non-concessional borrowing.

[8] Under the 2002 FMR, these targets were to be achieved by 2006.

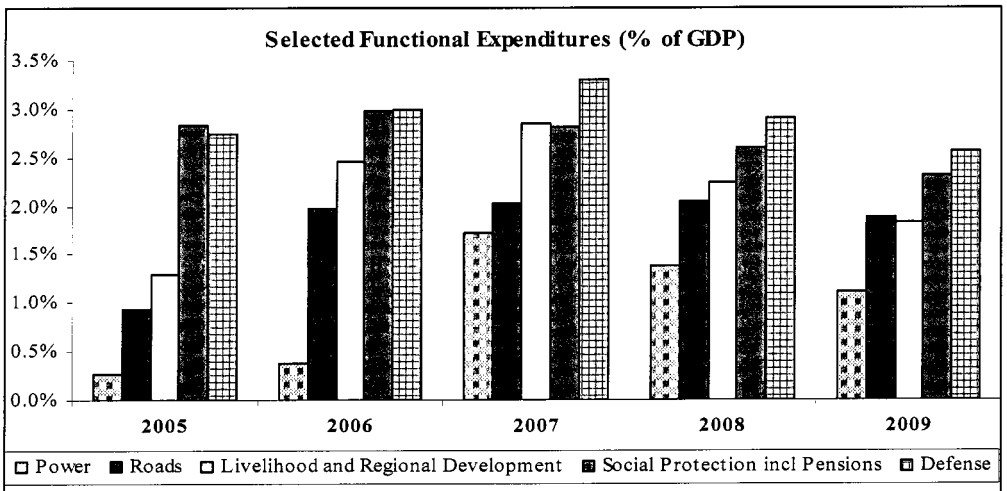
Box. 1.2: Budget 2007 and Medium-Term Budget Framework

The 2007 Budget issued last November was presented in the context of a medium-term budgetary framework (MTBF) for 2006-2009. Both documents are consistent with the revised targets under the Fiscal Management Responsibility Act (FMRA), which envisages a reduction in the budget deficit to 5 percent of GDP by 2009.

In 2007, the overall deficit is expected to reach 9.1 percent of GDP, reflecting a very ambitious public investment program amounting to 9.3 percent of GDP (from 6.7 percent of GDP in 2006). In contrast, recurrent expenditures are expected to decline sharply from 19.8 to 18.4 percent of GDP, due to substantial decreases in fuel subsidies and household transfers. Financing of the deficit from domestic sources is expected to drop somewhat in 2007 while net external financing rises to 4.4 percent of GDP.

Revenue collection is expected to continue to increase in the medium term starting with a substantial (1.1 percent of GDP) increase in 2007 on account of higher expected tax revenue collection. Non-tax revenues are expected to remain at the 2006 levels (1.8 percent of GDP).

In terms of sectoral expenditures, the planned higher capital expenditure will be driven by a four-fold increase in expenditures in the power sector (0.4 to 1.7 percent of GDP). Key power projects to be implemented starting in 2007 include the Chinese-government-funded Norochcholai coal power plant project, the Kerawalapitiya combined cycle power plant project and the Japan Bank for International Cooperation (JBIC)-funded Upper Kotmale Hydropower Project. Allocations to the roads sector are expected to remain at around 2 percent of GDP during 2007-2009.



Source: GoSL Budget Estimates 2007.

On account of the escalation of the conflict, defense spending is expected to continue to increase to 3.3 percent of GDP in 2007 and gradually decline thereafter. In human development, education (3 percent of GDP) and health (2.3 percent of GDP) spending are expected to continue at the 2006 levels until 2009.

Social protection expenditures are expected to decline gradually in the medium term from 3 percent of GDP in 2006 to 2.3 percent of GDP in 2009, from lower spending on cash transfer payments to households notably through the Samurdhi program. Although a number of programs were introduced in the 2007 Budget in livelihood and regional development, expenditures are expected to increase only slightly in 2007 and then return to 2005/2006 levels thereafter.

1.27 On monetary policy, it is stated that policy interest rates will remain the main instrument and broad money growth is expected to be slightly above nominal GDP growth—implying a gradual decline

in the GDP deflator from about 10 percent in 2007 to 6.5 percent in 2009.[9] The exchange rate will continue to be subject to a floating foreign exchange regime and official gross foreign reserves will be maintained at around 3 months of imports. [10]

1.28 While the macroeconomic framework described above is broadly consistent with a sustainable growth path in the medium term, tighter fiscal and monetary policies may be warranted in the short term to restore price stability. The implementation of the 2007 monetary program, as recently announced by the CBSL, would be instrumental in reaching this goal, but will need to be supported by appropriate fiscal tightening. It will also be desirable that the target for gross foreign reserves be revised upwards so as to reduce the country's vulnerability to external shocks.

1.29 **Public sector**. The overall thrust is to make the public sector more efficient and modern through rationalization of functions of public agencies to ensure they remain relevant and transparent. The vision notes the need to: (i) devolve power to communities to improve accountability of public institutions; (ii) avoid overlap and duplication of various structures; and (iii) strengthen the capacity and authority of local institutions in service delivery. The role of the central government is expected to focus on facilitating the environment for private sector growth and investments by setting national policies and regulation, and providing public infrastructure. The discussion paper recognizes the need for reforms in training and development, selection and recruitment, compensation and management of civil servants, but does not spell out specific issues and measures in these areas. Additional areas of public sector reform on which further clarification is warranted include the envisioned roles of Provincial Councils and local authorities vis-à-vis the district secretariats, especially in service delivery; how the reforms of public enterprises will be implemented, and the role of the Strategic Enterprises Management Agency (SEMA).

1.30 **Agricultural sector policies**. The vision for agriculture gives particular emphasis to achieving food security and raising incomes of small farmers. The strategies to be adopted include: (i) increasing competitiveness through modern technology; (ii) shifting to commercial agriculture; and (iii) promoting diversification into higher value products (fruits, vegetables, livestock, and fisheries). The public sector is envisaged to have a strong role, including in areas where the private sector could potentially be more appropriate and efficient, such as production and distribution of improved seeds, land use and planning. Planned public expenditures appear somewhat biased toward the provision of subsidies (34 percent of proposed spending for non-plantation agriculture) in relation to productivity enhancing investments such as research, extension, and irrigation. Section II of this report further discusses key issues related to agriculture reform and its impact on lagging regions.

1.31 **Social protection**. The vision predicts a shift in thrust from cash grants to the provision of livelihood opportunities. It notes that the *Samurdhi* program is now undergoing reform, with particular attention to the introduction of efficient entry and exit mechanisms. Greater emphasis is to be given to: (i) enhancing livelihood opportunities; (ii) supporting savings-based micro-finance; and (iii) improving coordination among existing programs at the Divisional level. Implementation is envisioned to take place through the *Gama Neguma* ('village upliftment') program that aims to convert villages into small centers of growth.

1.32 **In sum**, many strategies outlined in the discussion paper are consistent with the achievement of faster economic growth over the long horizon. These include: (i) maintaining macroeconomic stability through further fiscal consolidation; (ii) scaling up public investment in power and roads; and (iii) raising the efficiency of public institutions for improved service delivery. In addition, the document also provides for private sector participation in the delivery of key services. Agricultural policies, which will

[9] This assumes an increase in the money multiplier.
[10] Based on imports of goods only. If imports of services are included the ratio would be 2.5 months.

be critical to unleash growth in lagging regions, including the North and East, contain a welcome focus on diversification into high value products and the use of modern technologies to increase competitiveness. Going forward, further consideration needs to be given to increasing the role of the private sector in other areas and placing greater emphasis on linking production with markets (demand side), particularly exports.

1.33 The document rightly identifies downside risks which include a less favorable external environment, particularly in the context of high oil prices and rising world inflation, and the risk of delays in implementing proposed large infrastructure projects. However, the document is silent on perhaps the biggest downside risk, continued internal insecurity.

1.34 Given its long term nature, the discussion paper needs further elaboration to provide a road map for implementation. It will be important that such a road map be developed and reflected in future public sector budgets and in the MTBF, so that specific policies can be linked to monitorable outputs and outcomes.

E. Conclusion

1.35 Sri Lanka is once again at a crossroads. The country has the potential to achieve higher growth and faster poverty reduction, as envisaged under *Mahinda Chintana*, given its level of human development and integration with global markets. However, to achieve this will require addressing remaining structural constraints and managing immediate downside risks associated with the escalation of the conflict and rising inflation.

II. UNDERSTANDING REGIONAL DISPARITIES

A. Introduction

2.1 At first glance, Sri Lanka's experience seems to confirm the worst fears of globalization. Following market reforms in the 1970s and 1980s, per capita GDP grew at over 3 percent between 1990 and 2002. Yet, during the same period, the share of people living in poverty fell by only 3 percentage points. Inequality rose sharply. GDP in the Western Province, the wealthiest province, grew at a rate nearly three times faster than the rest of the country. Although urban poverty fell, rural poverty hardly changed, and estate poverty actually increased.

2.2 However, a closer look suggests that Sri Lanka is in fact a textbook example of how market-oriented policies can unleash economic growth and prosperity, while the lack of such policies can lead to economic stagnation and persistent poverty. Most of the reforms of the 1970s and 1980s affected the Western Province, which proceeded to generate a supply response in the industrial and service sectors, cutting its poverty rate in half. Meanwhile, market reforms have not reached the rest of the country, which remains predominantly rural. In agriculture in particular, reforms in land markets and paddy cultivation, as well as policies to improve the marketability of agricultural products, have been elusive. Rural incomes have stagnated. Furthermore, growth in Sri Lanka has been pro-poor. The Western Province, which had the fastest growth and poverty reduction in the country, also saw the smallest rise in inequality. This section takes a closer look at these regional growth patterns and their underlying causes.

B. Regional Growth and Poverty Differentials

2.3 **Growth and poverty outcomes among regions have been sharply uneven.** For instance, during 1997-2003, GDP in the Western Province grew by an average of 6.2 annually, while the rest of country grew on average by only 2.3 percent. With population growth of about 2 percent annually in the Western Province, this translated into a significant increase in per capita incomes and consumption, averaging 4 percent annually over the period.[11] As a result, the per-capita income of the Western Province by 2002 was two to three times higher than in the rest of the country.

Table 2.1: Poverty Headcount by Province, 1990/91-2002

Province	1990/91	2002
Western	19	11
North Central	24	21
Central	31	25
North Western	26	27
Southern	30	28
Sabaragamuwa	31	34
Uva	32	37
Sri Lanka	**26**	**23**

Source: Department of Census and Statistics

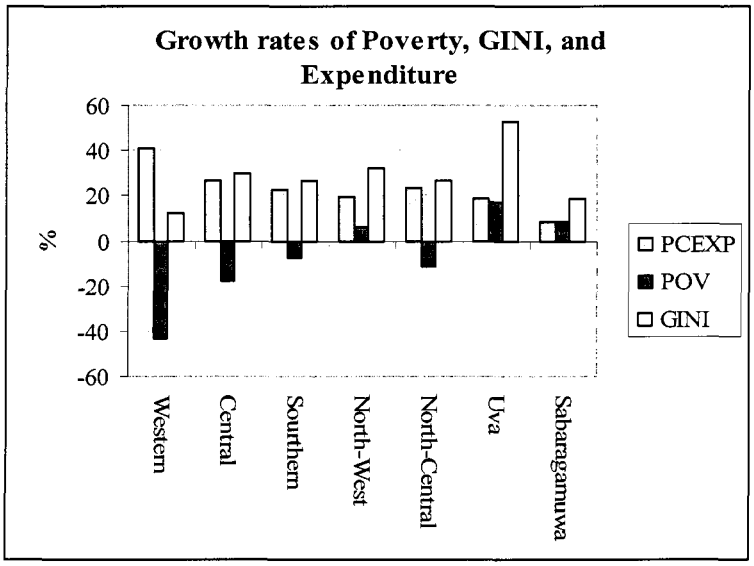
2.4 **Growth in the Western Province has been pro-poor**. Not only has the Western Province been the fastest growing region in Sri Lanka, but it has also experienced the steepest reduction in poverty (from 19 to 11 percent between 1990/91 and 2002).[12] As illustrated in Figure 2.1, the poverty headcount in the Western Province decreased by over 40 percent alongside a similar proportional increase in real per-

[11] Population growth in the Western Province reflects the impact of internal migration. Population growth in most other provinces either declined or remained stagnant during the period.

[12] Poverty headcount does not cover the North and East.

capita consumption.[13] Moreover, the sharp reduction in poverty occurred with the lowest proportional increase in the (consumption) Gini coefficient compared to other provinces.[14]

Figure 2.1: Regional Variations, 1990/91-2002



Source: Staff calculations based on HIES 1990-91 and 2002
Notes: "PCEXP" refers to real per capita consumption expenditure (at 2002 prices); "POV" refers to poverty headcount rates; "GINI" refers to Gini coefficients of real per capita consumption expenditure.

2.5 **Meanwhile, other regions experienced modest growth and poverty reduction and in some provinces, such as North West, Uva and Sabaragamuwa, poverty even increased** as modest growth was combined with higher income inequality. In these cases, the positive effect of growth was more than offset by a worsening in distribution. It should be noted, however, that while the relationship between growth and poverty is unambiguous, that between income distribution and poverty is not.

2.6 **The pattern of income distribution has converged and is very similar across regions.** While the Western Province, the richest region in the country, had the lowest proportional increase in the Gini coefficient (12 percent), Uva Province, the poorest region, recorded the highest proportional increase (53 percent).[15] As a result of these variations, the Gini coefficients for the richest and the poorest regions in the country in 2002 stood at about the same level (0.4).

C. Why did the Western Province Grow Faster than the Rest of the Country?

2.7 **The sharp differences in growth between the Western Province and the rest of the country cannot be explained entirely by differences in literacy rates or education attainment.** While these indicators are somewhat better in the Western Province, they are not significantly different from those in other provinces. Quality indicators such as mastery of language and mathematics skills at primary schools and pass rates at the GCE ordinary level and advanced level examinations present a similar

[13] It should be noted that income levels in the Western Province in 2002 were just recovering from a significant contraction in real GDP the previous year.
[14] These findings suggest that the elasticity of growth to poverty reduction in the Western Province is significantly higher than one.
[15] From 1990/91 to 2002, the (consumption) Gini coefficient for the Western Province increased from 0.356 to 0.4, while the Gini coefficient for the Uva Province increased from 0.257 to 0.392.

pattern. For example, in Sabaragamuwa, the GCE advanced level exam pass rate is even higher than the national average (and the Western Province) (see Table 2.2).

Table 2.2: Literacy Rate and Educational Attainment by Province: 2003

	WP	South	Sabara	Central	Uva	East	NW	NC	North	All
Literacy rate	96	93	92	89	88	87	94	93	93	93
Educational attainment										
No schooling	4	8	9	11	12	14	7	8	8	8
Primary	24	32	31	32	36	38	30	31	32	29
Secondary	46	38	43	40	39	31	42	44	32	41
Tertiary	27	22	17	18	14	17	21	17	29	21

Source: Central Bank Annual Report

2.8 **Although regional gaps in terms of access to economic infrastructure are more acute, these differences cannot account fully for the sharp differences in growth outcomes either**. For example, while over 90 percent of households in the Western Province have access to electricity, the coverage in other regions ranges around 60-80 percent, Uva being the least endowed province with only 57 percent coverage. In terms of access to markets, the accessibility index[16] for the Western Province is only 25 percent higher than that of Uva, which has the worst accessibility index in the country.

Table 2.3: Access to Economic Infrastructure

Provinces	Average accessibility index	% of households with electricity	% of firms with electricity	% of firms with a land line/mobile phone	% of firms located in a community with a bank
Western	3.8	92	79	24	70
Central	3.1	73	80	7	47
Southern	3.1	78	68	18	62
North Western	3.1	69	61	15	70
North Central	2.9	66	61	8	75
Uva	2.8	57	62	23	78
Sabaragamuwa	3.3	62	76	15	70

Source: World Bank (2006), Sri Lanka: Poverty Assessment (forthcoming)

2.9 **The conflict has been an additional factor constraining growth particularly in the North and East, but its impact has been mitigated by significant remittances**. Although it is estimated that the conflict has reduced overall GDP growth by 2-3 percent[17] for the country as a whole, the North and East have suffered the brunt of its impact, particularly in terms of access to basic economic infrastructure which according to available statistics is worse than in other poor provinces. However, per-capita incomes in the North and East have remained at similar levels to those outside the Western Province thanks to significant remittances accounting for 37 percent of incomes in the North and 24 percent in East (compared to a national average of 18 percent).[18]

2.10 **Market reforms triggered rapid growth of manufacturing and services in the Western Province.** Thanks to its proximity to ports, the Western Province was able to take advantage of the opportunities from market reforms adopted since the late 1970s (see Box 2.1) and better integrate with global markets. The services sector (wholesale and retail trade, transport, communications) dominates

[16] The accessibility index measures at each point the sum of the population totals of surrounding cities and towns, inversely weighted by the road network travel time to each town.
[17] Central Bank of Sri Lanka. Annual Report 2001.
[18] Central Bank of Sri Lanka. Consumer Finance and Socio-Economic Survey 2003/04.

economic activity in the Western Province, accounting for 65 percent of provincial GDP and over 55 percent of employment. Particularly notable is the recent rapid expansion of the telecom sector following the opening of the sector to competition and the privatization of Sri Lanka Telecom. Manufacturing accounts for one-third of GDP and employment in the province. Much of the dynamism of the sector reflects the rapid expansion of labor-intensive garment exports, following the liberalization reforms in the late 1970s and establishment of export processing zones (EPZs). Over 70 percent of garment factories are located in the Western Province, mainly the Colombo and Gampaha districts, employing about 200,000 workers (or about 65 percent of employment in the garment industry).

Box 2.1. Economic Reforms since the 1970s

In the post-independence period most economic activities including manufacturing, trade, transport, telecommunications and financial services were dominated by state monopolies and subjected to state controls. The initial phase of reforms from 1977-82 focused mainly on liberalization of trade and investment regimes. Quantitative restrictions on imports were removed and a more uniform tariff structure established. A highly overvalued currency, which was largely the result of trade suppression, was realigned in 1978. On the investment front, several impediments to FDI were relaxed. The Greater Colombo Economic Commission (GCEC)—the forerunner to the Board of Investments (BOI)—was established in 1978 to promote investments into export-oriented activities. The GCEC, while establishing several export processing zones (EPZ's) was also responsible for formulating and implementing an incentives package for foreign investments.

These early reforms led to higher economic growth and the transformation of the country's export base from agriculture to manufacturing. Although the country was riddled with the civil conflict since 1983, the benefits of reforms continued and growth was sustained during the 1980s.

The 1990s witnessed another wave of reforms spanning two successive governments. Notably, the administration taking office in 1994 continued reforms initiated by the previous administration. Key reforms included the removal of exchange control restrictions on current account transactions (i.e., the opening up of the current account) and the privatization of large state-owned enterprises in the plantation, insurance, telecom, and airlines sectors. Steps were also taken to further lower and simplify the tariff structure and strengthen the policy framework for FDI and portfolio investment.

The results of these initiatives were considerable. The country's industrial exports expanded rapidly and gained market share, particularly toward the end of the 1990s. By 2000, garment exports reached US$3 billion, contributing 50 percent of total exports. In addition, the increased privatization efforts saw Sri Lanka attracting much FDI. In 1997, FDI reached the record level of US$430 million.

2.11 **By contrast, market reforms have been more limited outside the Western Province, which has remained predominantly rural.** In particular, agricultural policies have been geared toward the achievement of self-sufficiency in paddy production rather than the development of high-value agricultural markets.[19] As a result, private investment in commercial agriculture and agro-business has been limited. The shortcomings in the provision of economic infrastructure in rural areas, which have no doubt further constrained the development of high-value agricultural markets, are themselves a reflection of lack of progress in reforming public sector entities delivering these services. These issues are further discussed in the section below.

[19] Although the privatization of estate companies in the mid-1990s contributed to unleash growth in the sector (tea, rubber), poverty among estate-dependent families has increased due to complex socio-economic factors, including: (i) high income dependency ratios, as many youth have remained unemployed because of the stigma associated with working as tea pluckers and lack of alternative employment outside the estate; (ii) the delivery of basic social and economic services (education, health, water, roads), which until recently was the responsibility of plantation companies, has been ineffective; (iii) high level of alcoholism among the estate population.

D. Pro-poor Reforms: Myth or Reality

2.12 If the Western Province could grow so rapidly and reduce poverty to almost single digits, what is stopping the rest of the country from doing so? The previous section suggested that market-oriented reforms undertaken by Sri Lanka in the 1980s and 1990s were pro-poor. These reforms were primarily in trade, industrial and investment areas which disproportionately benefited the Western Province. Thanks to its proximity to the port of Colombo and its services and manufacturing base, the Western Province was able to take advantage of these reforms, to unleash a private-sector-led boom that substantially improved the welfare of its residents.

2.13 One reason why the rest of the country has not grown as rapidly is the absence of agricultural reforms and lack of private sector investment in the sector, particularly in commercial agriculture and agro-businesses. This point is clearest in the case of agriculture where, as noted earlier, the poverty rate is 40 percent. The cause is slow growth in agricultural GDP in general (barely 2 percent a year in the 1990s), and in rice value added in particular, which has been negligible or negative over the past two decades (Table 2.4).

Table 2.4: Agricultural GDP Growth Rate (%)

	1982-90	1991-00	1998-02
Agriculture	2.8	1.6	0.4
Tea	2.9	3.4	2.5
Rubber	-1.2	4.3	-2.3
Coconut	-3.8	2.5	-3.2
Rice	-0.3	-0.7	0.6
Other	6.3	1.9	0.8

Source: Central Bank of Sri Lanka and staff estimates

2.14 The lack of policy convergence in Sri Lanka reflects misperceptions, partly rooted in Sri Lanka's longstanding socialist tradition, that certain market-oriented reforms may have a negative social impact. Therefore, the state has continued to play an important role in key economic areas such as agricultural commodities, factor markets (land, labor), and the provision of economic infrastructure, with the result that related markets often do not work well.

2.15 While the immediate intention of policies in these areas has been to achieve seemingly sound social objectives, these policies have ultimately hurt the poor. Below are some examples:

2.16 **Agricultural policies aimed at self-sufficiency in rice production, have not helped farmers rise out of poverty**. Sri Lanka has a legacy of policies, such as land provisioning, fertilizer subsidies and protective import tariffs, aimed at achieving self-sufficiency in rice. While they have helped the country achieve self-sufficiency, the cost has been extremely high, especially for the poor. For example, the paddy land's provision makes it difficult for farmers to use highly productive, irrigated land to cultivate more lucrative crops. Fertilizer subsidies mainly benefit rice farmers—and the richer ones at that—while undermining soil conditions without much impact on yields. In the 1990s, fertilizer application rates more than doubled while average yields increased by only 8 percent. Finally, unpredictable and frequent changes to agricultural tariffs heighten price risk to farmers and dampen incentives to invest. Furthermore, these import tariffs increase costs to consumers, while keeping farmers in low-value crops such as rice.

2.17 If these policies are undermining Sri Lanka's agricultural performance, why do they persist, especially since over 80 percent of the population and 90 percent of the poor live in rural areas? There

are a number of reasons. First, while import tariffs may be harmful to the poor, removing them may leave farmers exposed to unfamiliar competitive pressures. There is also a possibility that, in the absence of complementary actions to lift constraints on land, seeds, technology and water, the removal of tariff protection alone may not lead to increased production in higher value added crops. Secondly, most of these farmers are poor. Yet, the needed reforms involve reducing subsidies or protection which, in the short-run, may leave them worse off. But perhaps the most compelling reason is related to the fluid nature of politics in Sri Lanka and the historical experience that agricultural reforms have often been contentious. For instance, farmers granted land through the Land Development Ordinance (LDO) cannot use the land as collateral to access credit, nor can they lease or sell the land. Relaxing any of these constraints would benefit farmers and permit a more efficient allocation of land resources. Yet efforts at introducing mortgage rights to farmers or a lease market for land are attacked as the first step on a slippery slope towards privatization. A draft Land Ownership Bill granting full ownership rights to farmers cultivating LDO land, which was submitted to parliament in November 2003, was withdrawn due to court challenges.

2.18 A similar syndrome afflicts other reform areas as well. Two of the more prominent pertain to power and labor regulations.

2.19 **Power subsidies aim at social protection, but have led to high electricity costs and benefit the upper-income groups**. Sri Lanka has some of the highest electricity costs in Asia. Yet the Ceylon Electricity Board (CEB) loses about Rs. 50 million – the cost of constructing one rural hospital – each day. The reasons have to do with management weaknesses and the tariff structure. But reforms such as the introduction of corporate management principles to the CEB have been resisted by some of the most powerful unions for fear that they will lead to privatization and job losses. In actuality the poor financial performance of CEB has hurt the poor by restricting the expansion of access to electricity of poorer areas such as Uva and Sabaragamuwa (only 57 percent of households in Uva and 62 percent in Sabaragamuwa have access to electricity compared to 92 percent of households in the Western Province).

2.20 **Labor regulations aim at protecting workers, but discourage job creation and productivity gains**. Sri Lanka has some of the most restrictive labor regulations in Asia, including one of the most generous severance pay clauses in the world. The consequence is that firms are reluctant to hire workers, thereby discouraging job creation. In terms of productivity, a number of firms restrict their staffing to less than 15 employees or rely heavily on casual labor in a bid to avoid falling under the ambit of labor laws, which prevent them from benefiting from possible economies of scale of production. In addition, the restrictive labor laws only protect employees in the formal sector since they only apply to permanent employees of firms with 15 or more employees. Therefore, one can argue that in addition to labor laws restricting job creation and productivity, they are also not pro-poor.

2.21 **Past public road programs emphasized the expansion of rural roads, but links to markets remain weak**. Road expansion since post-independence has focused on building rural roads, which account for about 70 percent of the road network in Sri Lanka. Although the number of kilometers of roads in Sri Lanka is internationally comparatively high, most are poorly maintained and do not connect remote areas to main markets. Road programs in Sri Lanka have not paid due attention to the economic return of investments in this area.

2.22 It may seem therefore that Sri Lanka (outside the Western Province) is "stuck" in a low-level equilibrium, from which it is unable to emerge because of misguided opposition to pro-poor reforms. But the recent experience with controversial reforms in education, as discussed below, offers hope that some of these difficult problems could be resolved with sufficient public consultations and knowledge awareness campaigns.

E. Education Reforms in Sri Lanka: Lessons Learned

2.23 Sri Lanka's education system has been celebrated around the world for having achieved universal primary education and high levels of literacy at very low per-capita income and with relatively low levels of public spending (around 3 percent of GDP). Towards the end of the 1990s, however, it was becoming clear that Sri Lanka's education system was facing serious "second-generation" challenges. First, although schooling was compulsory up to grade 9, net enrolment and survival rates in grades 6-9 were only 81 and 78 percent, respectively. Second, despite universal primary enrolment, the learning outcomes of primary school children were disappointing.[20] Third, the pass rate in the GCE ordinary level examination was only 37 percent.

2.24 The problems facing Sri Lanka's education system can be traced back to the reasons for its success. Central government financing and provision of education was successful in achieving high enrolment rates because these outcomes are relatively easy to monitor. Quality, on the other hand, is harder to monitor and often requires local knowledge about the school's and student's circumstances. Likewise, the abandonment of English and introduction of Sinhala and Tamil as the medium of instruction in the late 1950s probably contributed to achieving universal access to primary and secondary education in the country (when English was the medium of instruction, urban elites had an advantage in education). But this same policy has resulted in only 10 percent of 4th grade students mastering English. To compete in the global marketplace, Sri Lankans are finding that English skills are essential.

2.25 The apparently successful public education system has created enough vested interests, such as among teachers' unions, to resist necessary reforms which would involve giving greater power to local entities, including school districts and the schools themselves. Also, the reintroduction of English in the curriculum from grade 1, and as a medium of instruction, could be portrayed by opponents as a reversion to the elitist education system of the pre-*Swabasha* era.

2.26 Despite these obstacles, Sri Lanka has embarked on a reform program, the Education Sector Development Framework and Program (ESDFP), which includes devolving managerial authority to schools, enabling schools to forge links with local communities to improve resource mobilization and public accountability, strengthening the teaching of English at all levels and reintroducing English as a medium of instruction in government schools in a phased manner. The five-year program includes a series of monitorable indicators which, if achieved, will leave Sri Lanka with a significantly changed education system by 2010. Notably, this reform program was initiated by the previous UNP-led coalition government, but was continued and approved by the current SLFP-led coalition government.

2.27 In trying to understand how these reforms were achieved, at least two aspects are worth highlighting. First, many of the accountability-changing reforms, such as devolving responsibility to schools and local communities, included a major initiative to enhance the training of and support to teachers, thus making it difficult for teachers to oppose reforms that offered them a scaled-up program of development. Second, the National Education Commission (NEC) developed the reform framework in a highly consultative manner, including consultations with civil society, the private sector, donors, teachers, parents and the general public. During the consultations, opponents of reforms were heard. As has been the experience in other countries (Devarajan, Dollar and Holmgren, 2001) these consultations increased the chance that reforms would survive political transitions.

2.28 The experience with education reforms suggest the following ways to break the deadlock on other pro-poor reforms, namely: (i) adequately address the concerns of those who lose out in reforms; (ii)

[20] Of the children completing grade 4, only 37 percent had mastery of their first language, 38 percent mastery of mathematics and 10 percent had the required mastery of English.

reforms should include systematic consultations; and (iii) consultations and implementation of reforms need to be given sufficient time.

F. Conclusion

2.29 The rapid growth and poverty reduction in the Western Province over the past twenty-five years shows that Sri Lanka has the potential to sharply reduce, if not eliminate, poverty. The reasons for the Western Province's rapid growth, including trade and industrial reforms undertaken since the 1970s, indicate that Sri Lanka is a country where reform works. These reasons also suggest how to get the rest of the country growing—by reforming agriculture so that the same market forces that propelled industrial Sri Lanka can propel the rural sector. However, the politics of reform are such that it is difficult to build a winning coalition that will support these reforms. Nevertheless, the recent experience with the education sector shows that it is possible to make progress with seemingly intractable problems. One can only hope that the forces behind trade, industrial and now education reforms will rally behind the remaining reforms, thereby enabling Sri Lanka to achieve its true potential.

III. GLOBAL OPPORTUNITIES IN THE KNOWLEDGE ECONOMY

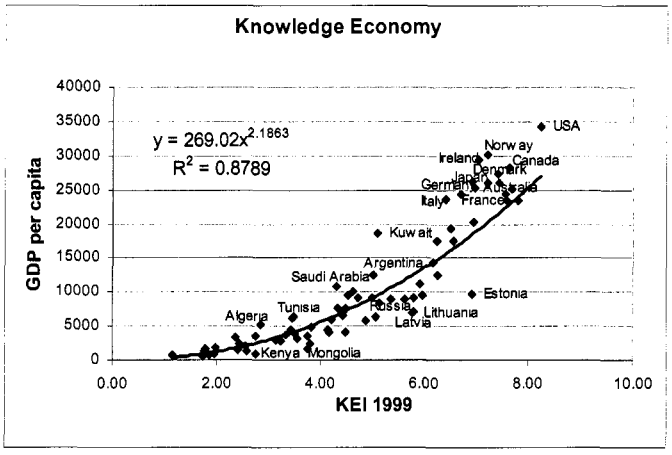
A. Introduction

3.1 Sri Lanka's sustained economic growth over the past twenty five years has had much to do with its ability to tap into emerging opportunities in global markets. This was certainly the case of the boom in garment exports that took place when opportunities opened by the quota system under the MFA were supported by appropriate domestic policies. The country has thus far been able to withstand tougher competition in world markets following the abolition of the MFA in January 2005. However, as in other sectors of the economy, maintaining market share will require further improvements in productivity, as well as the quality and cost of domestic economic infrastructure. Meanwhile, new opportunities should be explored. The provision of services in the IT and knowledge sector also offers opportunities for growth, particularly given Sri Lanka's good track record in literacy and secondary education enrolment, and its established global reputation for quality in garments. This chapter briefly surveys the knowledge economy, and Sri Lanka's prospects in one of the knowledge economy's most vibrant sectors, offshoring.

B. Sri Lanka and the Knowledge Economy

3.2 Growth based on knowledge and innovation has become an important driver behind rising living standards and poverty reduction the world over. At the start of the 21st century, with the increasing reach of the internet and digital communication technologies, the world has witnessed a tremendous acceleration in the creation and dissemination of knowledge. The knowledge revolution manifests itself in a variety of ways: (i) there is greater importance attached to education and life-long learning; (ii) a shift in investment towards intangibles (research and development, software, and education) rather than fixed capital; (iii) an increased emphasis on the application of science and technology and the role of innovation in economic growth; and (iv) the explosion of information communication technology (ICT) in the form of worldwide interdependency and connectivity. The concept of a knowledge economy (KE) has been introduced to describe economies in which "organizations and people acquire, create, disseminate, and use knowledge more effectively for greater economic and social development".[21] Figure 3.1 illustrates a strong link between income level and the knowledge economy globally.

Figure 3.1: Link between Income Level and the Knowledge Economy



Source: World Bank (2002).

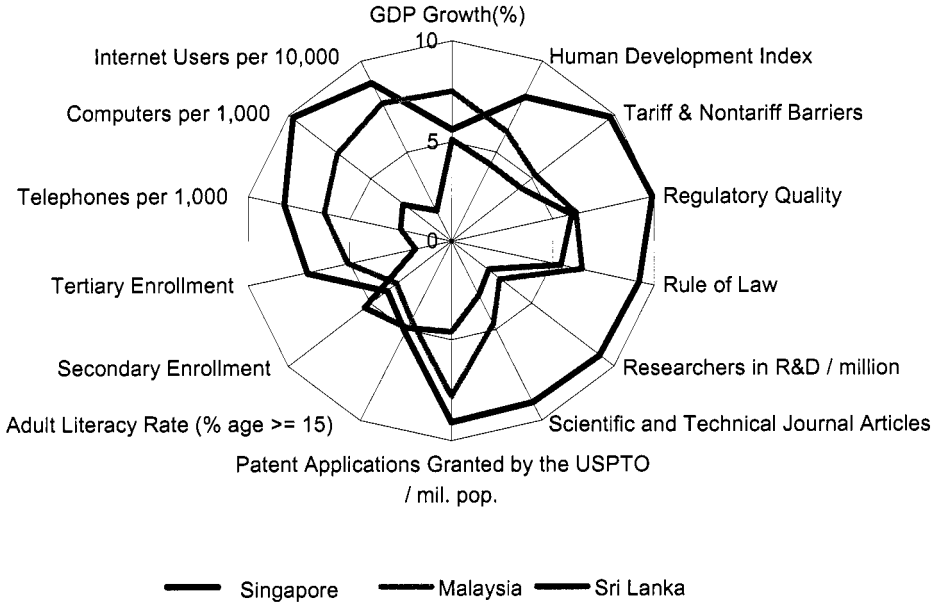
[21] World Bank Institute (2006).

3.3 Successful economies of the future will be those that can harness knowledge in an increasingly competitive and global world economy. Four elements of a successful strategy in such an environment include: (i) a solid base of educated, skilled and creative people; (ii) a dynamic information infrastructure that reaches all sectors of the population; (iii) an effective national innovation system; and (iv) an economic and institutional regime that creates incentives for the efficient use of knowledge.

3.4 The Government's ten-year development framework, *Mahinda Chintana: Vision for a New Sri Lanka*, recognizes the importance of the knowledge economy. Building IT infrastructure, improving the IT literacy of the workforce, and strengthening the science and technology sectors are all recognized as important priorities. An overall improvement in the knowledge economy can also help contribute to the achievement of several goals, including those related to growth, exports, employment, and FDI.

3.5 Figure 3.2 demonstrates that although Sri Lanka is ahead on some measures of developing a knowledge economy, most notably high secondary school enrolment and literacy, it is still some way behind the more dynamic economies of East Asia. A few areas stand out in need of more attention including tertiary enrolment and access to "knowledge infrastructure" including the use of computers, telephones and the internet. Closely tied to low tertiary enrolment is the limited scientific research and development that currently takes place in Sri Lanka.

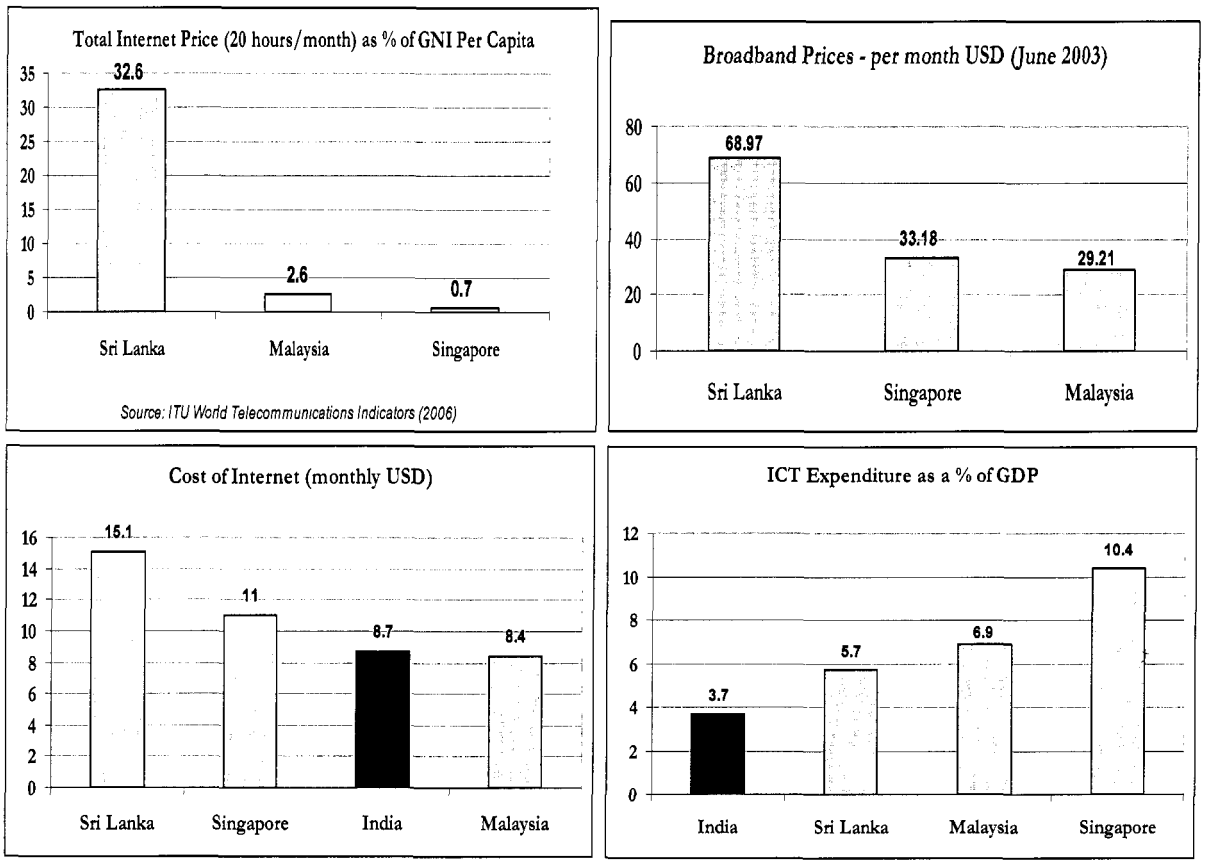
Figure 3.2: Benchmarking Sri Lanka and the Knowledge Economy



Source: World Bank Institute (2006)

3.6 A key aspect of building a knowledge economy in developing countries is the task of bridging the digital divide: that is, providing access to information and communication technology at an affordable price to all citizens. Sri Lanka is currently at a disadvantage, with limited access to the internet and very high prices for connectivity when compared to competitors in South and Southeast Asia, as indicated in Figure 3.3. This shortcoming needs to be addressed in order to benefit from knowledge economy opportunities.

Figure 3.3: Global ICT indicators



Sources: ITU (2006) and World Bank (2006b)

3.7 Against this broad overview of Sri Lanka and the knowledge economy, the section now shifts its focus to a key sector within this economy, offshoring.

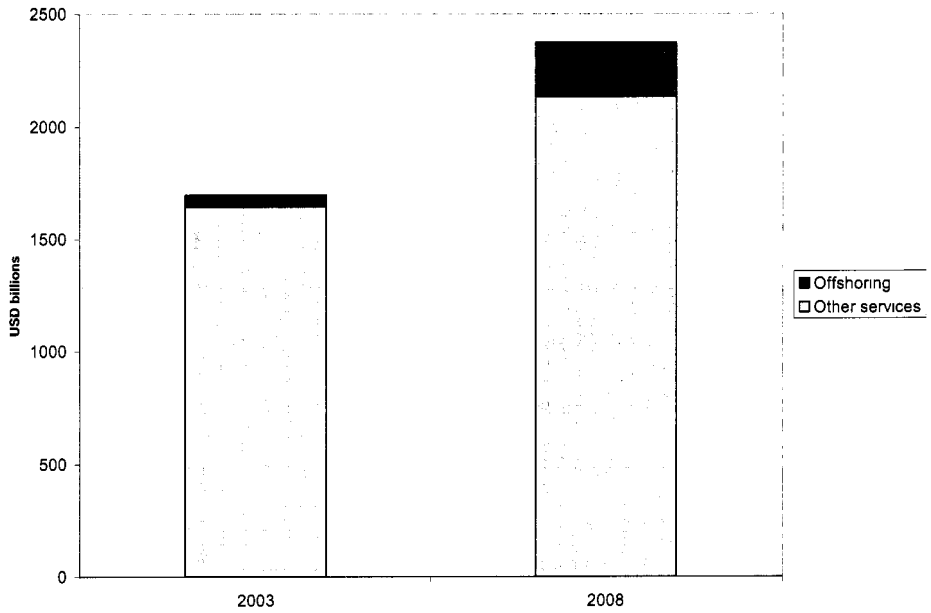
C. Global Trends in Offshoring

3.8 A key characteristic of the knowledge economy is that it has opened up opportunities for growth that did not previously exist. One of the most important features of the twenty-first century is that the service sector has increasingly become tradable. In the past, goods and capital could be exported relatively easily while services and labor could not. However, recent technological advances including cheap mobile connectivity and high-speed internet access mean that is no longer true. These have helped to create a truly global marketplace for services, especially those that are labor intensive and can be commoditized and digitized. Such services include legal advice, accounting and management consulting services, ICT services, software development, IT training and call centers. In the industrial era, such services were delivered domestically and often produced very close to the point of demand. Increasingly, they are being produced in locations that are able to deliver the lowest cost and the highest quality. This trend is just beginning and will continue to grow rapidly for the foreseeable future, offering excellent opportunities for developing countries.

3.9 Offshoring, the process whereby a company contracts out a function or series of tasks to another company abroad, now represents a US$100 billion market. World trade has been expanding at a rate of 6.9 percent annually over the last twenty years, while offshoring of services to developing countries, although still small in absolute terms, has been growing at a much faster rate. McKinsey projects annual growth of 30 percent from 2003 to 2008, raising the offshore market's share of services trade from 3 percent to 10 percent during this five year period (see Figure 3.4). Almost all the current demand for offshore services comes from developed countries. On the supply-side, India is by far the largest player. Other large players include China, Mexico and Brazil.[22]

3.10 The nature of offshoring is changing rapidly. Initially firms moved parts of their operations to offshore locations to reduce operating costs, reduce their capital requirements and to increase productivity. Increasingly firms are also moving offshore to gain access to skills that are in short supply domestically, reduce their time to market, and deepen their local knowledge. Countries wishing to attract offshore investments must therefore offer a stable political and economic climate, a low cost structure, an educated workforce that is open to innovation, and sound infrastructure. Services that will be offshored in the future will go far beyond the traditional call centers and back-office functions and will include: investment and financial services, human resources, health services, retail functions, logistics and customer support functions. It is estimated that this will result in 18 million jobs being offshored with a multiplier effect that could in turn create a further 60 million jobs in developing countries.[23]

Figure 3.4: BPO/IT Offshoring to Low-Wage Locations vs. Total Global Service Exports



Source: WTO and McKinsey Global Institute

3.11 **Current global trends highlight the potential contribution of offshoring to GDP growth, employment, and FDI. Specifically:**

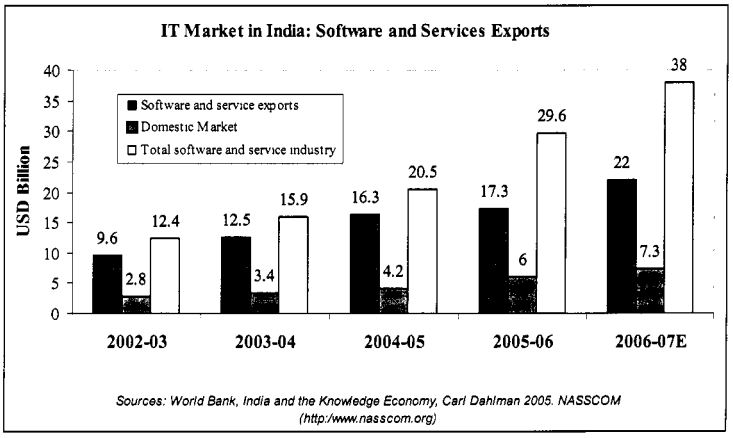
- The contribution of services offshoring to *GDP growth* of provider countries has increased substantially over the last few years. As a pioneer and leader within the offshoring market, India's

[22] McKinsey (2005).
[23] World Bank (2005).

growth in this area has exceeded all expectations. "In the fiscal year that ended March 2003, India's IT industry revenue was US$12 billion, and US$9.5 billion of this was from offshore IT projects and services".[24] It is predicted that the country's IT-enabled services exports will reach US$20 billion by 2007 and make up over half of all Indian IT exports.[25] International Data Corporation predicted that the global IT-enabled services market would account for revenues of US$1.2 trillion by 2006.[26]

- Services offshoring expands *employment opportunities* in developing countries. IT-enabled services are projected to employ up to 1.1 million people in India by 2008 and 3.3 million by 2015. In the Indian software services industry alone, direct job creation is forecast to reach 2.2 million by 2008.[27] There is also evidence that since many IT-related jobs are relatively well paid, each new position generates a further three jobs in the rest of the economy. The ability to carry out responsibilities from remote locations that might be located in (or closer to) homes has also allowed more women to enter the workforce. For instance, 49 percent of Wipro's (a large Indian offshoring company) workforce is female, while ICICI OneSource's workforce is 60 percent female.[28] With female education and literacy at par with that of males and high unemployment among women in Sri Lanka, the country is well positioned to take advantage of this potential.

Figure 3.5: India's Offshore Services Growing Rapidly



- Offshoring provides a significant contribution to FDI. In turn, FDI is often directly linked to economic growth because of the increased income sources and jobs generated. FDI can also increase the productivity of the recipient country through the adoption of managerial and technical best practices from foreign countries.[29] In recent years, there has been a documented shift of FDI towards the services sector. The world's inward stock of FDI in services quadrupled between 1990 and 2002 while the share of services in the world's total FDI stock rose from 25 percent in the 1970s to about 60 percent in 2002.[30]

3.12 In view of these potential benefits, developing ICT offshoring opportunities should be a priority for Sri Lanka. Its international position and policy imperatives are the subject of the next section.

[24] Kim (2004),
[25] Mauritius Board of Investment (2003).
[26] International Data Corporation.
[27] UNCTAD (2003).
[28] Ibid.
[29] World Bank (2001).
[30] Ibid.

D. Turning Sri Lanka into an Offshoring Hub

3.13 As a small island economy, developing export markets will be critical to Sri Lanka's growth prospects. When past governments have embraced this view and sought to promote greater export orientation, rapid economic growth has followed. For example, the economy took off in the late 1970s when government enacted a series of trade reforms. In the 1990s, the privatization of the plantations led to a remarkable rise in tea exports. The same imperative applies to the potential offshoring market today.

3.14 Sri Lanka's many strengths should make the country attractive to companies looking to offshore: a productive and well-trained labor force, some of the cheapest office rental costs in the region, and a relatively welcoming business environment. Even highly skilled and well-qualified workers in Sri Lanka are paid low salaries relative to other Asian countries. Despite its small size, the country turns out a significant number of technically qualified individuals especially in IT, accounting and business management. Tax incentives in Sri Lanka have also been successful in attracting business process outsourcing (BPO) investments, particularly foreign investments. A study by the Information and Communications Technology Agency (ICTA) found that the country's geographical situation and resulting time/distance considerations to be an advantage.[31]

3.15 Figure 3.6 presents a summary of an assessment of Sri Lanka as an offshoring destination for IT and professional services. It compares Sri Lanka with other Asian countries. The figure illustrates that Sri Lanka performs relatively well in terms of pure financial costs, i.e., the cost of labor, rent and other input costs. For many companies, this is the primary driver for offshoring. However, there is clearly room to improve the island's people skills and business environment.

3.16 With regard to reputation and worldwide recognition, some of Sri Lanka's neighboring competitors have already developed brand names and broadly marketed their comparative advantages in certain sectors of the global offshoring services market. For example, India has established its position as a leader in software development based on an early start and extensive IT experience. The Philippines has leveraged its large English-speaking population and rapid telecommunication and technological advances to develop a prominent call center industry.[32] Sri Lanka, on the other hand, has yet to establish itself as a high-caliber services offshore location.

3.17 **Sri Lanka can build on its current strengths as an offshore destination.** Offshore manufacturing already exists in Sri Lanka and has been particularly successful within the garments industry. Although the offshoring of professional services is quite different from manufacturing exports, the existence of this export sector could potentially provide insight into appropriate policies. It could also serve as a platform for establishing a reputation for Sri Lanka as a viable offshoring destination.

3.18 **There are signs that India's advantage is being eroded.** Increasingly, factors that offset the advantages of India's reputation are emerging as certain cities are now experiencing congestion, rising wages, staff turnover and increased insecurity of property rights. These negative effects give additional hope for countries like Sri Lanka that have not yet developed mature offshoring markets as firms look for additional locations to disperse their service outsourcing requirements.

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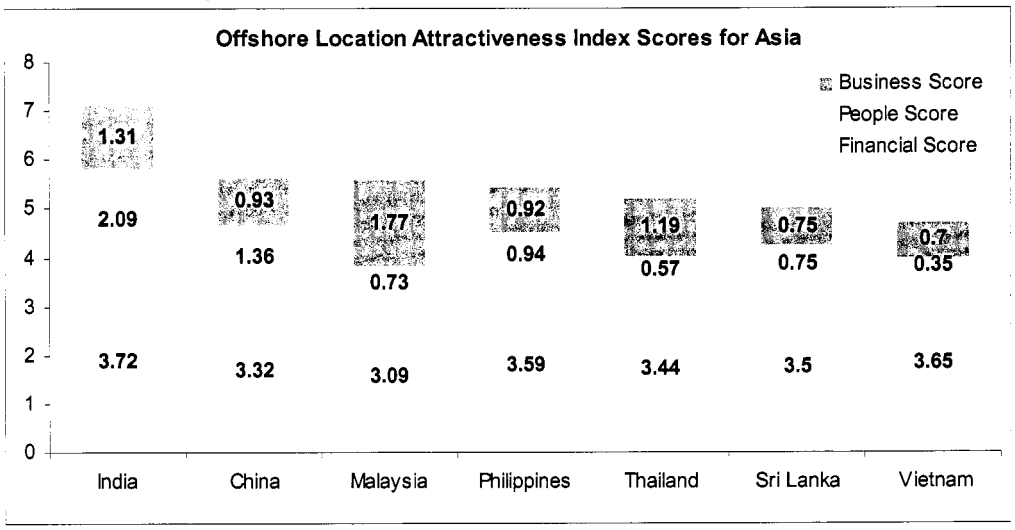
[31] Lirneasia (2006).
[32] A.T.Kearney (2004).

Figure 3.6: Sri Lanka – Already Competitive but More can be Done



Source: AT Kearney (2004), except for Sri Lanka (World Bank 2005).

3.19 **Sri Lanka has a world class legal framework for ICT development and e-commerce** that protects copyright and intellectual property. The IT industries in countries with advanced IT developments are extremely protective of intellectual property rights and will want to operate in environments where such rights are respected.[33] Most countries in Asia face significant challenges in establishing strong intellectual property protection to fight rampant piracy. In Sri Lanka, several intellectual property agreements have been signed in the last few years, although enforcement and public awareness still pose significant challenges.[34]

3.20 **However, Sri Lanka's weaknesses, including the ongoing conflict, have kept it from becoming the ideal location for BPOs**. The ICTA BPO study found that the most significant obstacle to operations and growth in Sri Lanka is the weaknesses in English language skills of available employees. The survey found that almost all BPOs considered the ability to communicate in English to be the most important skill requirement for their work.

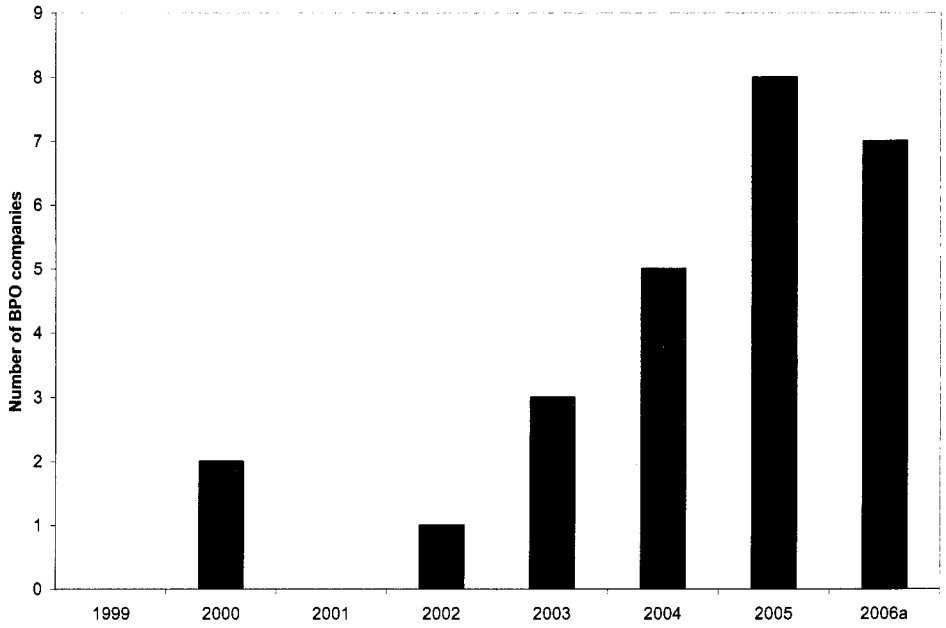
3.21 Unfortunately, after a successful start at the turn of the century, Sri Lanka's ability to attract additional players to the BPO space has waned in recent months given the deteriorating security situation (see Figure 3.7). Inward FDI in the BPO/IT sector fell from US$29.6m in 2004 to US$2.2m in 2005 and US$2.7m in 2006.[35] A survey has shown that interest from international investors for Sri Lanka's BPO industry has declined for a number of reasons. Limited suitable land is proving to be a bottleneck as are weak telecommunication capabilities and services, high electricity costs, shortage of available skilled workers, and long delays associated with the large number of agencies to be visited in order to obtain required approvals.

3.22 What do these strengths and weaknesses imply? Due to its population size, Sri Lanka cannot offer the large numbers of ICT and professional employees that India and China can, and as such it may be more difficult to compete in terms of developing large generic call centers or R&D facilities. Instead, the most promising strategy for Sri Lanka lies in developing a niche market for common corporate functions including legal, finance and accounting, human resource, and IT services. Sri Lanka is also

[33] Kim (2004).
[34] US Trade Representative (2004)
[35] Board of Investment of Sri Lanka (2007).

well poised to provide disaster recovery and business continuity services to companies currently offshoring to India.

Figure 3.7: BPO Entry by Year (1999-2006)



Source: Lirneasia (2006). (a)=Approved or pending as of August.

3.23 The main policy imperatives for Sri Lanka to promote its offshore industry may be broadly grouped under two headings: business climate and education.

- *A successful business climate* strategy to promote offshore services would include: (i) completing the unfinished telecom reform agenda; (ii) improving regulation, quality and competition to reduce telecom connectivity prices (as Pakistan has done); (iii) expanding internet access and usage by rolling out a reliable fibre-optic network (as India has done); (iv) increasing electricity generation and reducing tariffs; and (v) in the long term expanding access to scientific and technical tertiary education (as realized in both India and China). Government can also consider mobilizing the Sri Lankan diaspora interested in investing in the island, providing tax incentives to the industry (e.g., removal of VAT on software products), providing incentives for training and supporting the branding and marketing efforts of the local industry. Less rigid labor laws would also be beneficial for the nascent industry. Concerted government and industry action can overcome these various challenges and help turn Sri Lanka into an offshoring destination of choice.

- As noted in Section II, Sri Lanka's *education system* has achieved one of the highest literacy rates in the region. However, the ICTA study revealed that Sri Lanka needs to improve English language skills, if the country is to take advantage of the export oriented nature of the BPO industry. Improved use of the English language is not just necessary to communicate with much of the rest of the world. It is also vital for knowledge since the vast majority of information available on the internet and in scientific and technical journals is in English. Improving science training as well as linking academia to industry to make education more relevant is also needed. Achieving a higher rate of tertiary education enrolment will also be important in this regard. Finally, the country will need to work on making the internet more readily available to the general population.

E. Conclusion

3.24 Successful economies of the future will be those that can harness knowledge in an increasingly competitive and global world economy. Sri Lanka is ahead on some measures of developing a knowledge economy, most notably high secondary school enrolment and literacy, but it is still someway behind the more dynamic economies of East Asia. Offshoring is a key component of the knowledge economy in which Sri Lanka is poised to compete internationally in view of its strengths. Prospects for success would be much enhanced by pursuing a policy agenda tailored to improving certain aspects of the business climate, tertiary enrolment, and access to "knowledge infrastructure" including the use of computers, telephones and the internet.

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