Conflict and Structural Adjustment in Sri Lanka

In a difficult environment of war and conflict, Sri Lanka made substantial progress in its adjustment program during 1989-95. The program sought to continue the reorientation of the economy begun in 1977, a process disrupted by the ethnic and civil conflicts that had dominated most of the policy decisions of the late 1980s. Sri Lanka's second period of adjustment opened the economy to competition and the private sector, enabling growth to resume in very difficult circumstances. By 1993-95, the economy was experiencing robust growth, a lower deficit, and a smaller external current account balance. Privatization of manufacturing enterprises also largely succeeded. But attempts to stabilize the economy failed again, as they had during 1977-87, mostly because hostilities made the implementation of many of the stabilization measures difficult. Moreover, civil service reform, a cornerstone of fiscal reform, failed. By 1995, the principal measures taken to scale down the civil service had been reversed, making it even larger than it was at the start of the reforms.

A recent OED audit* notes that if growth with equity is to continue in Sri Lanka, the government must pursue stabilization. This means improving the quality of public expenditures, and hence a renewed effort to rationalize the civil service. For the Bank, the audit recommends supporting smaller, less ambitious adjustment programs in highly aid-dependent and strife-torn countries like Sri Lanka, with support extended over a longer period and disbursements timed to actual implementation of reform measures and in careful coordination with other donors.

Overview and project goals

Sri Lanka was one of the first countries to attempt structural adjustment in the late 1970s. Since independence in 1948 the country had achieved impressive social gains in basic health, education, and other quality of life indicators. The country's literacy and life expectancy rates, for example, were among the highest in the developing world. But the achievements had also come at high and increasing cost to the economy. Massive social security and welfare expenditures, financed by taxes on the export sector, had turned Sri Lanka into one of the most inward-looking welfare states in the world. By the early 1970s the government had taken over many productive sectors (e.g., tea, rubber, many industrial enterprises) and the economy had slid into decline with low growth, high unemployment, and rationing, resulting in growing popular discontent.

In 1977 a new government initiated reforms to shift the economy from a closed to an open, market-friendly one. Trade liberalization and partial liberalization of financial markets breathed life into the stagnating economy, spurring economic growth and higher incomes. In turn, higher incomes allowed cuts in welfare expenditures, which had been among the highest in the world. But ethnic strife, which erupted into armed conflict in 1983 and the southern rebellion in 1987-89, disrupted the economy. Coupled with the existing macroeconomic imbalances, the disruptions slowed economic growth, and in the ensuing volatile environment, policy paralysis and crisis management replaced efforts at stabilization and further liberalization.

By the late 1980s, reserves had dwindled to only three weeks' worth of imports, the budget deficit had reached 27 percent of GDP, inflation had shot up to 26 percent annually, and the external debt had quadrupled over its 1977 level. In early 1989, under a newly elected president, the government embarked on a program to complete the liberalization of the economy, seeking to rationalize the public

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The role of the financial sector in economic growth in Sri Lanka

An important factor in affecting Sri Lanka's economic growth was a deepening of the financial sector over the 1980s. No other adjusting country with such an extensive government role in the economy enjoyed the advantage of such a system.

Through a series of eight financial intermediary loans, beginning in 1979, the World Bank helped the government to conduct studies and carry out policy reforms that strengthened and deepened Sri Lanka's financial sector even though they failed to improve performance of the two largest (government owned) commercial banks. The policy reforms helped establish real positive interest rates, an auction market for Treasury securities, and a credit rating agency, and supported the privatization of two leading development finance institutions. As a result of these efforts, the financial sector's funding for private borrowers grew from less than 50 percent of the domestic credit in 1979 to more than 70 percent by 1993. The deeper financial sector was able to help the economy weather the price changes more resiliently. With such a system in place, lenders were able to allocate resources in response to the adjustment-related price changes. They could discriminate between firms with liquidity problems (due to the new price environment) and those with solvency problems.

But just as the improvements in the financial sector facilitated the adjustment process, so too did the remaining distortions constrain it. A major concern is the inefficiencies of the two large state commercial banks whose high interest rate margins are a major impediment to private investment. Failure to restructure these banks can be expected to significantly constrain the economy. Sri Lanka's savings rate is far too low and the government's presence in markets too high for the economy to be able to withstand the inefficiencies of these institutions.

sector and to make the private sector the engine of growth. At the same time, the government sought to preserve Sri Lanka's edge in human development by ensuring that the benefits of growth would be widely shared, especially by the poor. In many respects, then, the adjustment program of the late 1980s had its roots in the reforms that began 10 years earlier. A Policy Framework Paper, agreed with the Bank and the IMF and supported through the Fund's Structural Adjustment Facility, outlined the macroeconomic targets for 1989-93. The recommendations of two commissions established earlier, one on tax reform and the other on civil service reform, were also to be integrated into the adjustment program.

The World Bank supported the adjustment program through two operations: the $106.6 million Economic Recovery Credit (ERC), with cofinancing provided by Japan, and the $120 million Public Manufacturing Enterprises Adjustment Credit (PMEAC). Both were approved in 1990 and closed in 1995 and 1996 respectively, the latter two years later than planned. The ERC, which aimed at reorienting the economy while achieving stabilization in a charged political environment, was particularly ambitious. In addition to the macroeconomic stabilization objectives, it also sought to:

- develop the private sector by reducing and rationalizing tariffs and deregulating, privatizing, and restructuring plantations, transport, air freight operations, and the Paddy Marketing Board;
- streamline the civil service, making it more professional and efficient (a more professional civil service, one that was insulated from narrow political concerns and responsive to rapid market development, was considered key to effective management of public expenditures, which in turn was essential for affecting stabilization); and
- improve the consumption levels of the poor.

The PMEAC sought to:

- remove the remaining tariff protections, market privileges, and fiscal support for public manufacturing enterprises.
- provide a new institutional framework for the public enterprises.
- convert them into commercial companies and privatize them where possible.

Outcome

By the end of 1993 the reforms had achieved most of the Policy Framework Paper's targets, except those for stabilization (see table). Growth, spurred by increases in foreign and private investment, was considerably higher, the deficit only slightly higher, and the external account balance much better than the targets. Sri Lanka's economic performance was remarkable in that it was one of the few reforming economies not to experience negative growth in any year during adjustment. Moreover, its long- and medium-term growth rates were among the highest of all reforming countries. Even with the targets that the government failed to realize (inflation and a lower deficit), the improvements were significantly better than those realized in the strongest performing transition economies. An important factor facilitating adjustment was the financial sector, which having gone through partial liberalization during the 1980s had deepened, enabling the economy to weather the price changes brought about by the adjustment program (see box).
**Trouble with stabilization**

Extending the perspective to 1995, however, shows a different picture. Political disruptions, including the assassination of the president in 1993 and the intensification of ethnic strife in the north, diverted attention from economic management and reduced government ownership of the program. Once again, crisis management directed policy. By 1995, most of the gains on deficit reduction had been lost, and attempts at stabilization had again failed. The reasons were fourfold.

- Civil service reform failed. In Sri Lanka, reform of the civil service lies at the heart of building an effective governance structure. In the event, the number of civil service employees increased so that there were 10 percent more in 1992 than in 1989, and instead of fewer ministries the number doubled during the adjustment period. Finally, nothing was done to implement a professional selection system.

- The budgetary implication of these actions was enormous. The cost for a generous severance package designed to encourage retirement alone caused the budget deficit to exceed the Policy Framework Paper’s targets in 1993. Moreover, because civil service employment increased, no savings accrued from salaries forgone while pensions increased threefold. The Civil Service Commission had warned in 1989 that piecemeal implementation of reform measures would create confusion and set the system back, and it did.

- Subsidy targeting eventually deteriorated and transfers increased. The adjustment program sought to improve the targeting of assistance to those most in need at a time when the prices of many basic services were rising. But the targeting of subsidies ultimately deteriorated. The total level of subsidies (targeted for 3.5 percent of GDP) exceeded 3.7 percent of GDP, and decreases in subsidy expenditures came largely through inflationary erosion of benefits to the poor rather than through the elimination of ineligible people from the program. Thus, although targeting improved for a time, the gains were not maintained.

- The recommendations of the Tax Commission to be adopted under the ERC were largely ignored, and government revenues as a share of GDP fell due to the implementation of a range of ad hoc tax relief provisions.

- Defense expenditures rose. With continued war in the north and east, defense expenditures rose from 9 percent of total expenditures in 1990 to 21 percent in 1995. Together with the cost of rehabilitating refugees, the demands on the government budget were substantial.

**Success in privatization**

By contrast, most of the efforts to shift to a private-sector-driven economy succeeded. All of the 14 manufacturing enterprises targeted by PMEAC were converted into commercial companies, and most were fully or substantially privatized. The project also supported regulatory incentives and trade law reforms designed to force public manufacturing enterprises to become more competitive and operate like commercial companies. These steps must be viewed in the broader context of Sri Lanka’s attempts toward privatization. In the late 1980s, there were 100 state-owned enterprises; by 1994, 41 had been either fully or substantially divested, with many more in the process of being privatized. This is a significant achievement given that in all of Asia only 122 state-owned enterprises were privatized over the 1980-91 period.

Despite these successes, little progress was made in other sectors (particularly the banking sector and agriculture, for example tea) and two weaknesses in the process may have slowed the pace of privatization in manufacturing. First, most of the enterprises were sold through tenders or negotiated private offerings rather than unrestricted public offerings in the equity market. This approach, while necessary because of the undeveloped state of the equities market in Sri Lanka during the period of the credit, led to perceptions of undervaluation and concerns over the lack of transparency of the privatization process. In addition, the stock transfer program for workers of privatized companies benefited only about 1 percent of the national workforce, and wide disparities in the value of the stocks distributed raised concerns about equity.

Second, the program’s impetus derived more from the government’s need to address its budgetary problems than from the importance of raising productivity—a strategy that is still being pursued by the new government. The pri-
mary benefits of privatization accrue more through improved economic performance than the budgetary gains achieved through divestiture of public companies.

Lessons

Sri Lanka's adjustment program helped open the economy, making it subject to more competitive pressures and governed by private sector investment decisions. The result was high rates of growth. But stabilization failed, as it had during the 1980s. Several lessons can be drawn from Sri Lanka's adjustment experience, among them:

• For Sri Lanka, achieving continued growth with equity requires addressing the stabilization problems that it has twice failed to resolve. The key to successful stabilization is effective management of public expenditures, which in turn requires a sound professional civil service. Thus, civil service reform remains at the heart of a sustainable adjustment program. And in the Sri Lankan context reform of the civil service means streamlining the force and improving its professionalism. In a society disrupted by deep and lasting political conflicts, such reforms are very difficult to achieve and even harder to maintain.

• A deeper financial sector acts like a shock absorber, permitting countries undergoing adjustment to weather price changes more easily. Fortunately, Sri Lanka had partially liberalized the financial sector during the 1980s, and this liberalization proved to be an important factor in facilitating the initial successes of the adjustment program. But the inefficiencies of two large state commercial banks remain of major concern. The high interest margins that these institutions charge impede investment, and the resulting high cost of borrowing can encourage the government to resort to ad hoc tax relief measures.

• The purpose of privatization should be to shift resources to bring about a more effective governance structure. As in other economies with government control over production, Sri Lanka's publicly owned industries have been unresponsive to market incentives. Moreover, the productivity of the private sector has been considerably higher than that of the public sector. Consequently, the future of Sri Lanka's relatively successful privatization program depends on greater attention to efficiency brought about by privatized firms rather than the immediate budgetary gains from the divestiture of public enterprises.

• Policy-based lending can be very productive but it requires proper timing. In light of the imbalances generated by the ongoing hostilities and the loss of program ownership as time passed, it may have been a mistake for the Bank to disburse such large amounts of credit, which totaled 4.5 percent of GDP, over such a short time. In strife-torn, aid-dependent countries, such as Sri Lanka, support for adjustment measures may be more effective when the objectives are narrower, credits smaller and carefully timed, and provided over a longer period.