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CURRENT EQUIVALENTS

(Exchange Rate Effective as of June1, 2006)
Currency Unit= Sri Lankan Rupee
US$ 1.00= Rs. 102.33

ABBREVIATIONS

BOI	Board of Investment
CPF	Contributory Pension Fund
DHS	Demographic Health Survey
DPT	Diphtheria, Pertussis, Tetanus
FMRA	Fiscal Management Responsibility
GCE A/L	General Certificate of Education Advanced Level
GCE O/L	General Certificate of Education Ordinary Level
GDP	Gross Domestic Product
GOSL	Government of Sri Lanka
ID	Irrigation Department
IMD	Irrigation Management Division
IMF	International Monetary Fund
MASL	Mahaweli Authority of Sri Lanka
MHRECA	Ministry of Human Resource Development, Education and Cultural Affairs
MRRP	Mahaweli Restructuring and Rehabilitation Project
MTBF	Medium Term Budget Framework
NCDs	Non communicable diseases
NCOE's	National Colleges of Education
NEC	National Education Commission
NIE	National Institute of Education
NIRP	National Irrigation and Rehabilitation Project
O&M	Operation and Maintenance
OECD	Organization for Economic Cooperation and Development
PAYG	Pay-As-You-Go
PSC	Public Service Commission
PSPS	Public Service Pension Scheme
SCCBs	Consultative Committees on Budgets
SIRUP	Small Scale Integrated Rural Upgrading Project
SLR	Sri Lankan Rupee
SOEs	State Owned Enterprises
TC's	Teacher Centers
VAT	Value Added Tax
VRS	Voluntary Retirement Scheme
WB	World Bank
WBA	Welfare Benefits Act
WBB	Welfare Benefit Board

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PREFACE

This report is a summary of the series of background policy notes prepared under a process-based public expenditure review (PER) program managed by the World Bank and the Ministry of Finance from September 2003 to March 2004. The PER process and the preparation of these background notes involved close collaboration among staff from the World Bank, Ministry of Finance; Ministry of Health, Nutrition and Welfare; Ministry of School Education; Ministry of Samurdhi; Ministry of Social Welfare; Ministry of Irrigation and Water Management; Ministry of Public Administration, Management and Reforms; the Institute of Policy Studies (IPS); and the Center for Poverty Analysis (CEPA). The PER program was interrupted due to the transition that followed the change of Government in April 2004 and later the tsunami, but has resumed beginning in late 2005.

A key motivation for the publication of this report is to provide a written record of the analytical work carried out under the PER program during 2003/2004, and thereby preserving the institutional memory on this work. As such, the report is intended to provide a 'snapshot' of the state of knowledge on the issues covered at that time.

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Acknowledgements

The report was prepared by Emily Sinnott under the guidance of Rocio Castro and Ijaz Nabi. The task team leader of the 2003/2004 PER program was Alma Kanani. The original background policy notes were prepared by Mario A. Cuevas (Fiscal and Debt Sustainability), Ismail Radwan (Contingent Liabilities of State Owned Enterprises), Esperanza Lasagabaster (Pensions), Nick Manning, Robert Beschel and Princess Ventura (Public Sector Employment and Pay Issues), Institute of Policy Studies, Michele Gragnolati (Health), Harsha Aturupane (Education), Center of Poverty Analysis (Social Welfare) and Nihal Fernando, Ranjith Ratnayake (Irrigation). An annex is included with the Draft National Budget Circular prepared by Malcolm Holmes (advisor on the budget formulation process). The PER process benefited from advice of peer reviewers: Shanta Devarajan, Allister Moon.

I. INTRODUCTION

1. This note contains a summary of the background policy notes prepared in the context of the public expenditure review (PER) work carried out for the Government of Sri Lanka in 2003/2004. The PER work involved World Bank assistance at two levels: (i) the preparation of background policy notes on selected cross-cutting issues (i.e. fiscal sustainability, pay and employment, and pensions) as well as sector-specific public expenditure issues (education, health, social welfare, and irrigation); and (ii) the design of revised budget guidelines aimed at enhancing the strategic focus of the budget formulation process and the elaboration of the Medium Term Budget Framework for 2005-2007.

2. The main objective of the background policy notes was to provide the Ministry of Finance and selected line ministries with background policy analysis as an input to assist the government in improving the budget formulation to better link policies with resource allocation. Policy notes were prepared in a few selected sectors that were deemed most significant for the Government, either as major cost drivers or perceived as being inefficient. The summary given in this paper is based on the final draft policy notes prepared by March 2004. The draft budget circular drawn up by the PER team in March 2004 is also included as an annex.

3. The analysis in this report concentrates on the major expenditure issues facing the Government of Sri Lanka. The topic of government revenues is also, albeit briefly, touched on. The policy notes commence with a look at three overarching issues of concern for fiscal policy. The first focus is on the sustainability of the rapidly rising public debt and persistent fiscal deficits. Next, a potential contingent liability, the public service pension scheme, is examined. The note looks at the budgetary impact of the pension scheme and its medium- to long-term financial viability. The final cross-cutting expenditure issue investigated—public sector pay and employment—is a critical subject for Sri Lanka, a country with one of the highest per capita staffing rates in the developing world. The analysis reviews the ability of the administration to deliver services effectively to its citizens, particularly in a setting marked by the proliferation of various institutions with unclear mandates and overlapping functions.

4. The next part of the policy notes deals with expenditure issues in four specific sectors. An assessment is given of the appropriateness of expenditure patterns and policies to meet remaining and emerging challenges in the health and education sectors. For health, there is a need to consolidate the impressive gains made in health outcomes and respond to nascent trends associated with an aging population, such as a growth in non-communicable diseases, through greater focus on preventive. In education, the issues to be confronted are access beyond the primary level and the achievement of higher quality educational outcomes. Another area investigated is social welfare spending by the Ministries of Samurdhi and Social Welfare. There are some key issues of benefit incidence and emerging social protection that need to be addressed. The fourth sector turned to is irrigation and water management. In light of the diminishing amount of

public spending going towards this sector, the budget allocation and water resource management policy is examined.

5. We follow a similar pattern in summarizing the seven issues covered in these policy notes viz. fiscal sustainability, pensions, public sector employment, health, education, social welfare and irrigation. To begin, there is a brief review of performance, followed by an investigation of the key issues and challenges, including any relevant equity/regional considerations. Next, expenditure trends in the major program areas are covered, including analysis on the consistency of spending allocations with the stated objectives of the sector. Finally, a range of policy proposals are presented for each sector.

PART 1. CROSS-CUTTING EXPENDITURE ISSUES

II. FISCAL POLICY AND DEBT SUSTAINABILITY

The targets set out in the 2002 Fiscal Management Responsibility Act (FMRA) remain elusive, with the overall fiscal deficit and public debt in 2004 equal to 8.2 percent and 105 percent of GDP, respectively. Sri Lanka's public debt resulting from persistent and large deficits is unsustainable. In particular, the heavy reliance on domestic (non-concessional) borrowing for deficit financing has been detrimental to growth by crowding-out productive public spending and private credit. Given the heavy public debt burden—which absorbs over half of tax revenue—the public debt needs to be brought to manageable levels by eliminating the primary deficit and by limiting non-concessional borrowing.

FISCAL SUSTAINABILITY

6. **Despite recent fiscal consolidation efforts, including the enactment of the FMRA in 2002, the fiscal situation remains strained.** A period of fiscal consolidation occurred during 2002-03 when the primary fiscal deficit was cut from 4.1 percent of GDP to 1.2 percent. However, the fiscal situation worsened thereafter as the primary fiscal deficit increased to 2.2 percent of GDP in 2004. The overall fiscal deficit in 2004 remained at 8.2 percent of GDP, a similar level to 2003 (Table 1).

Table 1. Sri Lanka: Summary of Government Fiscal Operations
(as a percentage of GDP)

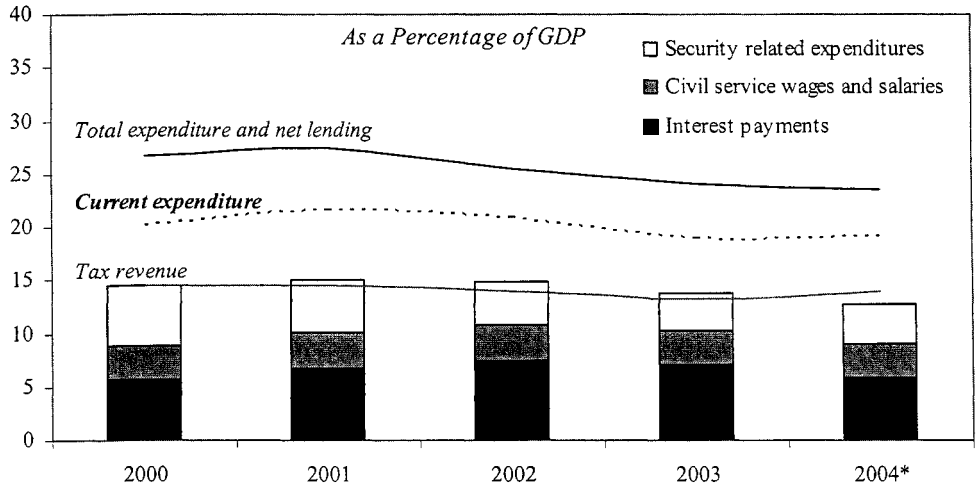
	1985	1990	1995	1998	1999	2000	2001	2002	2003	2004*
Total Revenue	22.3	21.1	20.4	17.2	17.7	16.8	16.6	16.5	15.7	15.3
Tax Revenue	18.7	19.0	17.8	14.5	15.0	14.5	14.6	14.0	13.2	13.9
Total Expenditure and Net Lending	34.0	31.0	30.5	26.3	25.2	26.7	27.5	25.4	24.0	23.5
Current Expenditure	20.1	22.3	23.1	19.6	18.7	20.2	21.6	20.9	19.0	19.2
Interest Payments	4.6	6.4	5.7	5.4	5.6	5.7	6.7	7.4	7.1	5.9
Foreign	..	..	..	..	0.8	0.8	0.7	0.7	0.7	0.7
Domestic	..	..	..	..	4.8	4.9	6.0	6.7	6.4	5.2
Subsidies and Transfers	5.5	6.5	6.1	4.6	4.2	4.2	4.6	4.7	4.0	5.2
Wages and Salaries	4.2	4.9	5.2	5.3	5.3	5.5	5.5	5.6	5.1	5.2
Civilian wages and salaries	3.6	3.9	3.4	3.0	3.0	3.2	3.4	3.4	3.2	3.2
Security	..	4.1	6.5	5.0	4.4	5.6	4.9	4.1	3.5	3.6
Capital Expenditure and Net Lending	14.0	8.7	7.4	6.7	6.5	6.5	5.9	4.6	5.0	4.3
Overall Fiscal Balance 1/	-11.7	-9.9	-10.1	-9.2	-7.5	-9.9	-10.8	-8.9	-8.3	-8.2
Primary Fiscal Balance 1/	-7.1	-3.5	-4.4	-3.8	-1.9	-4.2	-4.1	-1.6	-1.2	-2.2
Memorandum Items:										
Total public debt	80.2	96.6	95.2	90.8	95.1	96.9	103.2	105.6	105.8	105.4
Foreign	49.6	55.0	51.9	45.3	46.0	43.1	45.2	45.6	47.9	49.1
Domestic	30.6	41.6	43.3	45.5	49.1	53.8	58.0	60.0	57.9	56.3
Education and Health	..	4.5	4.5	4.0	4.0	4.1	3.3	3.9	3.9	..

Source: Central Bank of Sri Lanka Annual Report (various issues), IMF and World Bank Staff estimates.
Notes: *Estimated.
1/ Excluding grants

7. **Just three components of public sector spending—security related expenditures, civil service wages and salaries, and interest payments on public**

debt—are equal to total tax receipts (Figure 1). The average combined expenditure on security related outlays, civil service wages and salaries, and interest payments was 14 percent of GDP over 2000-2004, while taxation proceeds averaged 14.2 percent of GDP in this period. Average expenditure on subsidies and transfers accounts for an additional 4.5 percent of GDP over 2000-2004. There is then little room for other discretionary spending. If the level of spending on these constituents remains unchanged, then the only way to reduce the fiscal deficit will be to substantially increase revenues.

Figure 1. Sri Lanka: Components of Government Expenditure, 2000-2004



Source: Central Bank of Sri Lanka Annual Report (various issues), IMF and World Bank Staff estimates.

8. **Large fiscal imbalances and high public debt have beset the Sri Lankan economy for the past three decades.** Despite repeated attempts at reform, fiscal imbalances persisted and the public debt burden increased. The average fiscal deficit (before grants) in the 1991–2001 period exceeded 9 percent of GDP. While high public debt levels contribute to fiscal difficulties, persistent primary deficits exacerbate the situation. After a decade of running high primary fiscal deficits (around 3-4 percent of GDP), the primary account moved closer to balance in 2002 and 2003, only for a further deterioration in 2004.

Box 1. The Fiscal Management (Responsibility) Act

In view of the importance of strengthening fiscal management, Parliament approved the Fiscal (Management) Responsibility Act (FMRA) on December 10, 2002, effective from fiscal year 2003. The purpose of the Act is to provide a formal framework for fiscal discipline, and to increase transparency and accountability in government fiscal operations.

A key element of the FMRA is the introduction of medium-term fiscal targets. Specifically, the fiscal deficit has to be reduced to 5 percent of GDP by 2006 and maintained under that level thereafter. The FMRA also sets ceilings on total government debt, which should not exceed 85 percent of GDP by 2006, and 60 percent of GDP by 2013. Another important characteristic of the FMRA is that it sets a limit on explicit government guarantees of 4.5 percent of GDP.

As the FMRA is also designed to improve the credibility of fiscal policy, the Act mandates the government to present a number of reports, including: (a) a Fiscal Strategy Management report, with the Budget Speech; (b) Mid-Year Fiscal Position Reports; (c) Final Budget Position Report; (d) Pre-Election Budgetary Position Reports, within three weeks of the announcement of a general election; and (e) Statements of Responsibility by the Finance Minister and Secretary, together with a Pre-Election Budgetary Position Report. Several of these reports have been presented by the government.

9. **The fiscal/debt sustainability analysis for Sri Lanka shows that achieving the FMRA medium and long term targets will be very challenging, especially given the recent increase in fiscal imbalances.** The FMRA targets are: (a) fiscal deficit not to exceed 5 percent of GDP by 2006; (b) total government debt at 85 percent of GDP by 2006; and (c) government debt not to exceed 60 percent of GDP by 2013 (see Box 1). The fiscal/debt analysis was conducted using as a basis the estimated fiscal position of 2004 and projecting onwards the path for the primary deficit that would be required to meet the FMRA targets. The baseline macroeconomic assumptions underlying the analysis are presented in Table 2.

10. **Meeting the FMRA targets would require a zero primary balance between 2005-2013, resulting in a public debt to GDP ratio of 60 percent by 2013** (see Figure 2).[1] However, these projections are based on an estimated primary deficit of 1.3 percent of GDP in 2004, as envisaged in the pre-election report, as opposed to the currently estimated deficit of 3.1 percent. This implies that a further adjustment would be needed to remain within the FMRA targets.

Table 2. Baseline Macroeconomic Assumptions

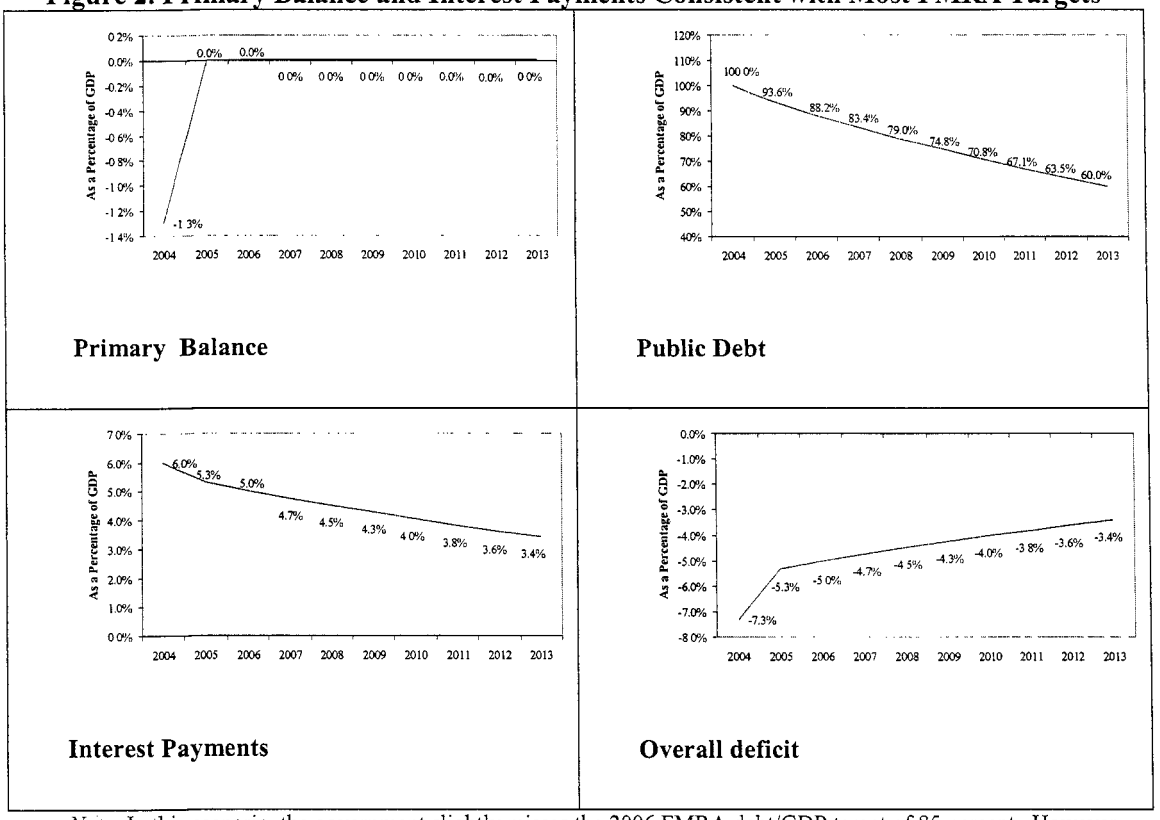
	2004	2005	2006	2007	2008-2013
GDP growth (%)	6.0	6.3	6.5	6.3	6.0
Change in GDP deflator (%)	7.0	6.0	5.0	5.0	5.0
Nominal interest rate on public debt* (%)	5.9	6.0	6.0	6.0	6.0
External financing (as % of GDP)**	0.4	2.8	1.8	1.8	1.8

Notes: The real exchange rate is assumed to appreciate mildly during 2004-2006 and to remain constant thereafter.
* Average interest rate that applies to total government debt, expressed in nominal terms.
**Net External financing, including grants.

[1] Under this scenario, public debt is projected at 88 percent of GDP in 2006, somewhat above the FMRA target.

11. **An early convergence towards FMRA targets would bring substantial fiscal savings due to sharply reduced debt servicing costs.** The baseline projections show that meeting the primary balance and debt ratios FMRA targets would result in annual fiscal savings equivalent to 1 percent of GDP by 2006, and 2.6 percent of GDP by 2012-2013. Total interest payments on public debt would stabilize at around 3.5 percent of GDP by 2012.

Figure 2. Primary Balance and Interest Payments Consistent with Most FMRA Targets



Note: In this scenario, the government slightly misses the 2006 FMRA debt/GDP target of 85 percent. However, the 2006 fiscal deficit target of 5 percent of GDP is met.

12. **However, the magnitude of the fiscal adjustment is highly sensitive to changes in key macroeconomic assumptions, such as real GDP growth, the nominal interest rate, and the exchange rate.** For instance, the baseline scenario assumes that annual real GDP growth stabilizes at 6 percent in the long-run. But, if real GDP growth remained at its historical level of 5 percent, ceteris paribus, a primary surplus closer to 0.5 percent of GDP would be required to reach a debt ratio of 60 percent in 2013.

KEY CHALLENGES

13. **Reversing the decline in tax revenue.** Government revenues have declined over time in Sri Lanka, falling as a share of GDP from 22.3 percent in 1985 to 20.4 percent in 1995 to 15.3 percent in 2004. At the same time, while there has been a decline in total expenditures since 1995, government spending has remained high relative to revenues at 23.5 percent in 2004. In particular, tax revenue losses would seem to be driving the recent

deficit growth, with tax revenues having fallen from 19 percent of GDP in 1990 to 13.9 percent of GDP in 2004.

14. **The rapid rise in public debt resulting from persistent and large deficits is unsustainable.** Aggregate public debt increased from about 95 percent of GDP in 1999 to over 105.4 percent in 2004—a rise in the total public debt-GDP ratio of more than 10 percentage points of GDP in just two years. The government's financing needs were primarily met by issuing domestic debt, with the result that the domestic debt ratio increased by 7 percent of GDP, going from 49 in 1999 to almost 56.3 in 2004. While the burden of external interest payments remained low between 2000 and 2004 (under 1 percent of GDP), domestic interest payments rose by 2 percent of GDP between 1999 and 2004 (to 5.2 percent of GDP).

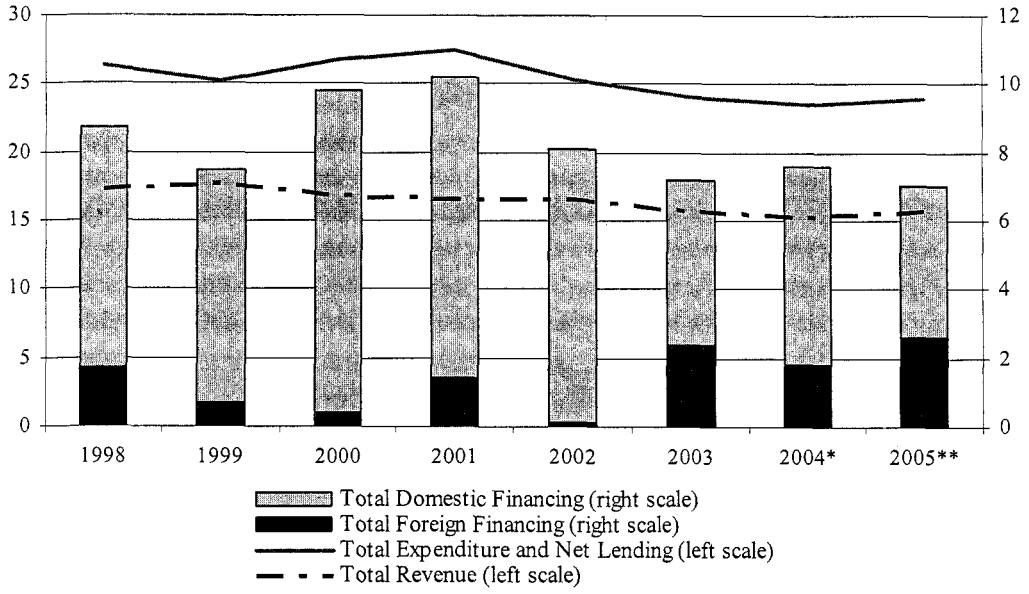
Table 3. Sri Lanka: Sources of Government Financing

As a Percentage of GDP

Source of Financing			1985	1990	1995	1998	1999	2000	2001	2002	2003	2004*
Foreign	Project Loans		4.4	3.8	2.1	1.9	1.0	0.9	.	.	.	.
	Non-Project Loans		0.0	-0.2	1.0	-0.9	-0.8	-0.9	.	.	.	.
	Grants		2.0	2.1	1.4	0.7	0.6	0.4	0.4	0.4	0.5	0.4
	Total Foreign		6.4	5.7	4.5	1.7	0.7	0.4	1.0	0.1	2.4	1.8
Domestic	Market	Bank	4.6	1.5	1.1	1.4	2.4	4.2	3.5	-0.3	-0.9	2.1
		Non-Bank	6.5	4.0	3.9	5.2	4.5	4.9	5.3	8.3	5.7	3.6
		Total	7.9	5.6	5.1	6.6	6.9	9.2	8.7	8.0	4.5	5.5
	Non-Market		-1.2	0.1	0.1	-0.1	-0.1	0.3	0.1	-0.1	0.0	0.2
	Use of Cash Balances		-1.5	-1.5	-0.1	0.5	0.0	0.0	.	.	.	.
	Total Domestic		5.2	4.2	5.1	7.0	6.8	9.4	8.8	8.0	4.8	5.8
Privatization			0.0	0.0	0.4	0.4	0.0	0.0	0.6	0.4	0.6	0.1
Total Financing			11.6	9.9	10.1	9.2	7.5	9.9	10.8	8.9	8.3	8.2

Source: Central Bank of Sri Lanka Annual Report (various issues), IMF and World Bank Staff estimates.
*Estimated.

Figure 3. Sri Lanka: Financing of the Fiscal Deficit, 1998-2005



**Estimated, **Projected.*

15. **The heavy reliance on domestic financing of public sector deficits is detrimental to growth.** (Table 3 and Figure 3). A significant consequence of the government's reliance on domestic borrowing to finance the deficit has been the implicit taxation of public pension funds and the domestic banking system. Sri Lanka finances domestic public debt through two sources. The first are rupee loans issued at below market rates. The use of this type of financing has declined from 62 percent (total rupee securities/total domestic debt) in 1997 to 14 percent in 2004. The main supply of domestic financing is now pension/other social security funds, e.g. Employee's Provident Fund (EPF). These funds are required to invest largely in government paper. For example, the EPF is restricted to mostly rupee securities and a small amount of treasury bills. The result is that an implicit tax is imposed on non-civil service workers. One estimate puts the after tax real rate of returns over the past three decades for rupee loans at 0.25 percent (IMF, 2002).[2]

REFORM PRIORITIES

16. **Reducing public debt to manageable levels.** Given the heavy public debt burden, which absorbs over half of tax revenue, it is imperative to bring the public debt to manageable levels by at least eliminating the primary deficit and by limiting non-concessional borrowing.

17. **Reforming wage and recruitment policies.** Sri Lanka has one of the largest bureaucracies in the region, with a ratio of 3.9 civil servants per 100 people. Although the size of the (civilian) wage bill is not unmanageable at present (around 3 percent of GDP), the trends are worrisome. Between 1990 and 2001, public sector employment grew at 3.6 percent annually, outpacing growth in population and labor force. While keeping the wage bill in check, strong political commitment will be needed to address well-known constraints to public service delivery. These include overstaffing (particularly at the lower grades); excessive salary compression (8:1); administrative fragmentation, duplication, and wastage (partly exacerbated by the ineffective devolution of functions); and outdated processes and procedures.

18. **Rationalizing public spending and linking it to the poverty reduction strategy**. The scope for expenditure rationalization is significant, not least because of the need to address the duplication and overstaffing problems of the public administration. In addition, there is a serious imbalance in public spending, with the bulk of the budget being directed to fund recurrent costs (i.e., interest payments, wages, and subsidies) and very little to investment. The Ministry of Finance is developing a medium term budget framework (MTBF) which could potentially combine macro (i.e., attaining fiscal sustainability) and micro objectives (such as enhancing the development impact of public spending). Following the recent introduction of budget ceilings and of a three-year planning horizon, there is a need to strengthen the links between priorities, resources, and outputs/outcomes. This will require a more strategic and consultative budget formulation process and the identification of trade-offs within and across sectors.

[2] The implicit tax is measured as the gap between interest rates on rupee securities and market-based instruments.

19. **Improving the performance of state-owned enterprises (SOEs).** The financial burden of SOEs is high and service delivery is poor. Most are overstaffed, incur operating loses, and have large debts (mostly to the state-owned banks). Direct subsidies alone absorb 3 percent of GDP annually, which is greater than the entire education budget. These companies should be substantially restructured (through privatization or other methods), be allowed to operate on a commercial basis with no political interference, and be subject to a hard budget constraint.

20. **Reversing the decline in revenue by strengthening tax administration and expanding the tax base for major taxes (VAT and income tax).** The challenge in designing tax policies is to reverse the massive decline in the tax-to-GDP in a manner that is supportive of growth and efficiency. The task is daunting given the sharp drop in trade taxes (from 6 to 2 percent of GDP since 1990); the stagnation of income taxes at about 2 percent of GDP, which is very weak by international standards; and the incomplete transition from a complex system of turnover taxes and special levies to a Value Added Tax (VAT). Increased revenue in the order of 2-3 percent of GDP may be achievable through:

- **Strengthening VAT.** While the 2004 unification of the two VAT rates into a single rate of 15 percent facilitated administration and reduced leakages, its immediate impact was revenue-reducing. Going forward, additional revenue will be possible if the VAT coverage is extended to retail trade and exemptions are reduced.

- **Raising the income tax yield.** Underlying reasons for low collection include: the provision of long term tax holidays for the rapidly growing Board of Investment (BOI) sector, a long history of investment allowances, concessionary rates, generous depreciation, and exclusion of most public sector employees from personal income tax. The scope for substantially raising the income tax yield is limited in the short term, but significant gains could be made if a moratorium on tax holidays were to be gradually phased in and existing exclusions and concessions pared down.

- **Improving tax administration.** For several reasons, including the coexistence of parallel systems (for customs and BOI firms), Sri Lanka's tax administration has limited experience in administering modern taxes (e.g., VAT and income tax) that require verification, audit and risk monitoring. A well-integrated revenue administration, along the lines of the originally envisaged Revenue Authority, needs to be established as soon as possible. Complementary measures include the establishment of a separate tax audit unit and making the large tax payer unit more proactive.

III. PENSION SCHEMES FOR PUBLIC SECTOR EMPLOYEES

While the ratio of retirees to active civil servants is high, expenditures on the Public Service Pension Scheme (PSPS) are not estimated to grow substantially in future years, following the introduction of a Contributory Pension Fund scheme. A major problem with the PSPS benefits design is that the flow of pension payments to an individual retiree is heavily skewed towards early years of retirement, in part due to the ad-hoc indexation of benefits at rates below inflation. International experience suggests that, optimally, real benefit value should remain constant over time. However, a full indexation of benefits could be quite costly if other parameters of benefits design are not changed. Another critical issue is the need to increase the investment return on pension assets by diversifying away from low-return government bonds.

OVERVIEW OF SYSTEM

21. There are currently two old-age pension schemes for permanent employees of government and public enterprises in Sri Lanka. Until 2002, all such employees have been insured through the previous non-contributory pay-as-you-go (PAYG) Public Service Pension Scheme (PSPS). Expenditures of the PSPS totaled 1.8 percent of the country's GDP (7.1 percent of the total government expenditure) in 2002. Starting January 1, 2003, a new contributory, funded defined-benefit scheme (Contributory Pension Fund, CPF) was introduced for the new employees of public sector. The workers who joined before 2003 remained insured through the PSPS.

22. Due to confusion about its legal status, not all new workers have been shifted to the CPF. The law that introduced the CPF, while approved by parliament, was never signed. This creates some uncertainty regarding the pension rights of new recruits. This note presents model-based analysis of the PSPS and the CPF—assuming that all entrants into the civil service after November 2003 are transferred to the new scheme—and suggests policy options regarding future development of the pension schemes.

Table 4. Sri Lanka: Pension Expenditures, PSPS and Widows and Orphans Scheme, 1998-2002, Millions of Rupees

Year	Expenditures on civil pensions*	Expenditures on widows and orphans	Contributions for widows and orphans	Total expenditures	Pension expenditures as percent of GDP
1998	15,151	4,277	1,816	19,428	1.9
1999	15,199	3,857	2,284	19,056	1.7
2000	17,592	4,360	3,045	21,952 1/	1.7
2001	20,217	5,631	2,655	25,847	1.8
2002	25,728	5,094	2,541	30,823	2

Source: Department of Pensions, Ministry of Public Administration

Notes. * Includes gratuities

1/ Based on the data provided by the Pensions Department to the World Bank in September 2003. According to another source, Department of Pensions Annual Performance Report and Accounts, 2002, total expenditures in 2000 amounted to SLR20336.5 million.

23. Since 1947, the PSPS has constituted the primary pension program for civil servants, armed services, provincial and local government employees, and teachers. The PSPS is a non-contributory scheme directly financed from the public budget. Together with the contributory scheme for widows and orphans, its expenditures amounted to about 2 percent of GDP in 2002 (Table 4).

24. **The ratio of retirees to active civil servants (dependency ratio) is high.** As of 2002, this program covered an estimated 506,000 government employees and 389,000 pensioners (Table 5). Minimum retirement age is 55 years, and mandatory retirement age is 60 years. Even though the effective retirement age is close to 60 years, it is low compared to countries with similar life expectancy. The current demographic profile of the insured workers is skewed towards younger and middle-age cohorts: about 90 percent of them are younger than age 50. The program provides for a lifetime unreduced pension representing between 85-90 percent of the last salary at the time of retirement for 30 years of service. Alternatively, a retiree could receive a pension equal to 75-85 percent of the last salary, increased by 5-10 percentage points of the last salary after 10 years of retirement and complemented by commuted gratuity—a lump-sum payment at retirement, worth 24 months of initial pension. Almost all retirees chose the second option. The benefit diminishes by two percentage points for each year short of 30 years of service.

Table 5. Sri Lanka: Evolution of Pensioners, 1998-2003

Year	Number of civil pensioners	Number of widows and orphans	Total number of pensioners	Rate of growth of total pensioners, %
1998	269,645	88,583	358,228	1.7
1999	274,345	90,127	364,472	2.0
2000	279,802	91,920	371,722	3.0
2001	288,276	94,704	382,980	1.8
2002	297,041*	97,584*	394,625	1.3

Source: Department of Pensions, Ministry of Public Administration
* Estimate

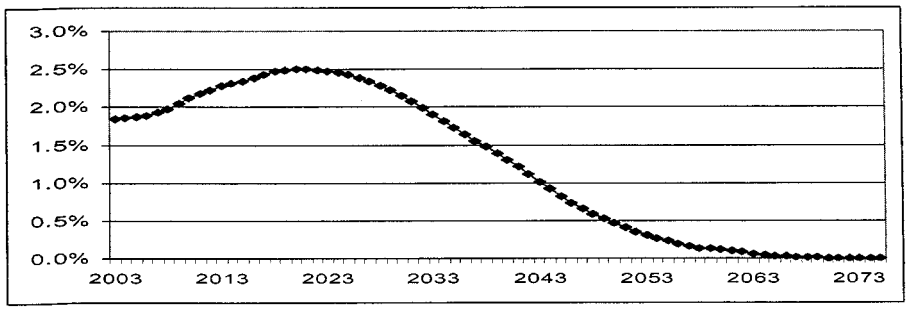
KEY CHALLENGES

25. **The expenditures of the PSPS are estimated to grow as a percentage of GDP over the next two decades, peaking at about 2.5 percent around 2025.** The driving force behind this growth will be the increasing size of the cohorts retiring from Sri Lanka's public sector. This will occur because of rapid aging of the public sector current and former labor force. After reaching the peak, the liabilities will decline as the scheme is being gradually phased out. Figure 4 gives the estimated stream of PSPS expenditures over 2003-2075 in baseline simulations done in a background paper for this note. The baseline scenario assumes 3 percent annual growth in wages, 3 percent annual inflation and indexation by 20 percent of the inflation rate.

26. **Liabilities of the PSPS could be reduced if the retirement age is increased.** However, the retirement age increase should be gradual, because of another government's objective—elimination of surplus labor in the public sector through the

Voluntary Retrenchment Scheme (VRS). Since the increase in retirement age could act in the opposite direction, the timeframe for implementation of this measure should allow for the VRS to take hold.

Figure 4. PSPS expenditures, % of GDP, 2003-2075 in the baseline scenario



27. **The major problem with the PSPS benefits design is that the flow of pension payments to an individual retiree is heavily skewed towards early years of retirement.** This is due to two factors. The first one is commuted gratuities paid at retirement. The second one is an ad-hoc indexation of benefits, on average below the inflation level, leading to a substantial fall in the real value of an individual's pension over time.

28. **Indexation of benefits could be quite costly if other parameters of benefits design are not changed.** For full indexation by inflation to be feasible without increase in the scheme's outlays, the average replacement rate at retirement for the retirees opting for commuted gratuity should be reduced from about 80 percent to 65–70 percent if the commuted gratuities are to be paid at their current levels, to 70–75 percent if they are cut in half, and to 75-79 percent if they are abolished.

EMERGING POLICY OPTIONS

29. **Establishment of the CPF has been a positive development for at least two reasons: introduction of employee contributions and some reduction of the benefits levels compared to the PSPS.** These allow for gradual reduction of the financial burden imposed by the pension system on the government budget.

30. **There are three areas for improvement in the CPF design:**

(a) like any fully funded defined-benefit arrangement, it is exposed to a large number of risks, and its financial sustainability is highly sensitive to the values of economic, financial, and demographic parameters, which could be quite volatile in the long term. The value of the scheme's reserves in the two most distant scenarios of our simulations differs by over 30 percent of GDP after 2050.

(b) in the long run, when the scheme matures, the still generous benefits it promises may not be covered by its revenues. For the first decades of its

operation, the CPF will have few or no retirees and will rapidly accumulate reserves, which will peak around 2040–2050. After this point, however, the financial status of the scheme will rapidly deteriorate and value of its reserves is likely to become negative.

(c) benefits design (largely the same issues as for the PSPS).

31. Depending on the political and other constraints, three options of the CPF reform could be suggested.

Option 1: change the parameters of the scheme without changing its structure. Increase in the retirement age (synchronically with PSPS) and decrease in the effective replacement rate and/or amount of gratuity paid at retirement would enhance financial position of the scheme. However, it would not eliminate inherent volatility of the funded defined-benefit arrangements.

Option 2: introduce a defined-contribution component into the CPF. Under this strategy, the replacement rate provided by the scheme on the defined-benefit basis should be reduced. In exchange, the scheme's participants would be offered additional benefits based on the defined-contributions principle. Shifting to this "multipillar" structure would diversify the risks and improve the long-term financial performance of the scheme.

Option 3: unify as much as possible design of the pension schemes covering private and public sectors of the economy. This would allow for portability of benefits between the two schemes and remove labor market distortions (in particular, obstacles for the labor mobility between private and public sectors) caused by the fragmentation of the country's pension system.

32. Whichever of the three strategies is chosen, there is a need **to increase the yield rate by diversification of investment of pension assets**. Currently, the bulk of funds of all funded pension schemes in Sri Lanka is invested in government bonds. Historically, real returns on government bonds in Sri Lanka were low, which puts financial sustainability of the scheme at risk.

33. Last, but not least, **development of the effective governance structure for the CPF** is a necessary condition of its successful performance. Design of this structure should depend on the choice of reform strategy. If pension schemes for public and private sector have similar designs, they could be managed by the same government agency; otherwise, development of a separate governing body for the CPF is desirable.

IV. PUBLIC SECTOR EMPLOYMENT AND PAY ISSUES

Sri Lanka's share of public employees to population is among the highest in the world. Since 1998, the government has added about 10 percent more individuals to the public sector workforce. Shortcomings in the devolution process, numerous and overlapping ministries and political patronage have contributed to the excess number of public employees. A further problem faced by the public sector is the low compression ratio of wages. Targeting wage increases to higher-level staff would ease difficulties in recruiting staff with skills highly sought-after by the private sector and increase incentives for advancement in the public service.

OVERVIEW AND CHALLENGES

34. During the decades immediately after independence, the Government of Sri Lanka was able to achieve impressive gains in leading social indicators. Even now, Sri Lanka's public administration retains certain elements of good governance, such as a dedicated professional staff, a transparent regulatory system, and levels of corruption that are among the lowest of South Asian states. However, the last three decades have witnessed increasing politicization, patronage and fragmentation in administration, leading to an overall decline in civil service standards, capacity and work ethos. Sri Lanka's public administration suffers from tremendous over-staffing, an excessive number of institutions, an excessive reliance on administrative procedures, weak institutional control mechanisms and politicization.

35. **Within Central Government, autonomous agencies also have been growing in number**—including regulatory bodies, research institutes, and service delivery organizations. Table 6 reveals the growth in agencies and their total number of employees. As with ministries, there are evident cases of unnecessary balkanization among statutory boards, as illustrated by the Coconut Cultivation Board, Coconut Development Authority, and Coconut Research Institute.

Table 6. Sri Lanka: Number of Autonomous Agencies and Their Employees

	1994	1998	2002
No. of Agencies 1/	111	130	161
Employees 1/	60,209	65,551	106,654
Central Govt. Current Transfers to Public Institutions (Rs. mn.) 2/	.	4,320	12,091*

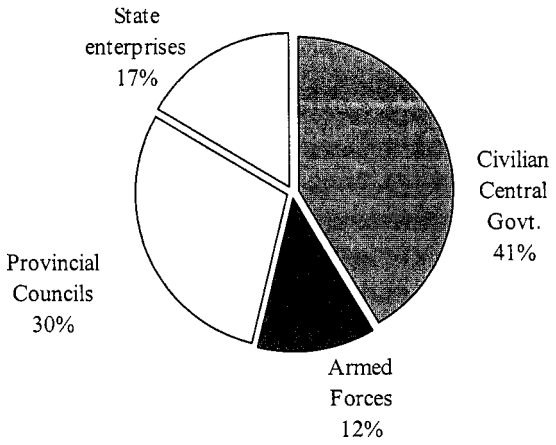
Sources:
1/ Public employee census documents, various years.
2/ Central Bank of Sri Lanka, Annual Report 2002. These transfers are not all dedicated to salaries.
* provisional

36. **Devolution has led to an expansion of the central government's administrative structure**, as seen in the establishment of ministries for regional development (e.g., Ministry of Southern Region Development, Ministry of Western

Region Development). The functions of these central government development ministries clearly overlap with those of the Provincial Council governments. Coordination is complicated by the fact that the geographical coverage of the central government's regional development ministries is not coterminous with the boundaries of the Provincial Councils. It has been suggested, however, that these development ministries of central government compensate for a shortcoming in Sri Lanka's devolution design. Devolution did not establish effective policy linkages between central government and the provincial councils, but the Secretary of the relevant development ministry may provide a channel for provincial councils to raise policy concerns with central government.

37. **Sri Lanka's share of public employees to population is among the highest in the world.** Public employment exceeds 1 million out of a population of little more than 19 million. The problem of excessive employment is long-standing. Yet, the situation has worsened in recent years. In 1998, there were roughly 930,000 public employees in Sri Lanka—already a worrisome number. Today, there are an additional 100,000. Figure 5 presents the relative share of Civilian Central Government, Provincial Council, state-owned enterprises (SOEs), and armed forces employment. Three related factors clearly have contributed to the excess number of public employees: (1) shortcomings in the devolution process, (2) numerous and overlapping ministries, and (3) political patronage.

Figure 5. Sri Lanka: Shares of Total Public Employment, 2002



38. **Despite having such a large share of public employees to population, Sri Lanka's expenditure on public sector wages and salaries is not higher than other countries in Asia.** Table 7 presents data on the evolution of the central government wage bill from 1995-2001 in Sri Lanka and three comparator countries.

39. **On average, monetary allowances constituted roughly 40 percent of employees' total pay in 2002.** All employees were entitled to two interim cost-of-living allowances, which combined accounted for nearly two-thirds of the total expenditure on allowances (excluding the armed forces). The remaining third is difficult to account for in detail, as apart from the two cost-of-living allowances already mentioned, there is considerable variation in the allowances different employees receive. Indeed, the 2000

Salaries Commission identified as a significant problem the pay disparities arising from allowances.

Table 7. Wages and Salaries of Consolidated Central Government

		1995	1997	1999	2001
Sri Lanka	GDP	667,772	890,272	1,108,845	1,397,453
Rs. mn.	Current Revenue	136,161	164,779	195,895	231,420
	Current Expenditure	195,880	228,732	267,611	367,966
	o/w Wages & Salaries	**34,909**	**44,676**	**58,532**	**78,056**
	% current exp.	17.8	19.5	21.9	21.2
	% current revenue	25.6	27.1	29.9	33.7
	% GDP	5.2	5.0	5.3	5.6
India	**Wages & Salaries**	**170**	**266**	**322**	**373**
Rs. billion	% current exp.	9.7	11.5	10.6	9.4
	% current revenue	11.6	14.4	13.8	12.6
	% GDP	1.4	1.7	1.7	1.6
Malaysia	**Wages & Salaries**	**12804**	**14494**	.	.
Ringgit mn.	% current exp.	33.3	33.9	.	.
	% current revenue	23.6	22.3	.	.
	% GDP	5.8	5.1	.	.
Thailand	**Wages & Salaries**	**223168**	**262316**	**289511**	**302269**
Baht mn.	% current exp.	51.6	49.4	48.5	38.3
	% current revenue	28.6	30.1	39.2	33.7
	% GDP	5.3	5.5	6.2	5.9

Source: IMF, Government Finance Statistics Yearbook, 2002.
Note. Excludes Armed Forces.

POLICY OPTIONS

40. **Changes to the Administrative Structure.** The "Report of the Salaries Commission 2000" recommends limiting by statute the overall number of central government ministries. Provincial Councils must comply with such a limit; the 13th amendment restricts the number of ministries to five. However, a restriction of this sort should not be necessary to reduce the number of central government ministries to a more reasonable number. Moreover, the statute is unlikely to succeed unless policy makers are convinced of the fiscal dangers created by an expansive administrative apparatus. Rather than devote energy toward agreeing an arbitrary cap on the number of ministries, efforts might be better devoted to studying which of the current ministries ought to be slated for elimination.

41. **Employment Reductions via Attrition.** Given the enormous number of public employees in Sri Lanka, personnel reductions through attrition alone may not be an adequate solution. In any case, the data show that over the last two years of the current hiring freeze a significant number of vacancies have been filled, and new posts have been created (Table 8).

Table 8. Sri Lanka: Growth in Employment, Population, Labor Force, and Real GDP, 1998-2002

				percentage change		
	1998	2000	2002	1998-00	2000-02	1998-02
Central Govt Employment	354,160	413,300	436,390	16.7	5.6	23.2
Population	17,935,000	18,467,000	18,968,480	3.0	2.7	5.8
Labour Force	7,722,811	8,103,320	8,410,623	4.9	3.8	8.9
GDP (constant 1995 US $)	15,067	16,658	16,909	10.6	1.5	12.2

Sources: Sri Lanka Department of Census & Statistics, " Census of Public and Semi-Government Sector Employment 1998" and " Census of Public and Semi-Government Sector Employment 2002" (preliminary report); Sri Lanka MoF " Budget Estimates 2002" (vol. I-III); and World Bank Development Indicators.

42. **Employment Reductions via a Voluntary Retirement Scheme.** A carefully crafted, targeted voluntary retirement scheme might be combined with a hiring freeze to generate more rapid reductions in surplus staff, particularly at mid and lower grades. The "Report of the Salaries Commission 2000" sets an ambitious goal of a 30 percent reduction in staff, focused on Categories C & D employees.

43. **Creating a New Pay Scale.** The 2000 Salaries Commission, in accordance with its mandate, has proposed a detailed revision of Sri Lanka's public pay scales. One goal of the Commission is to reduce the number of pay scales. That would be a welcome change to strengthen the coherence, consistency, and transparency of pay policy. However, the Commission's proposals in this area are relatively timid. The Commission recommends eliminating 22 scales and creating another seven. If implemented, the reform would still leave government with more than 100 separate pay scales. Greater consolidation is warranted.

44. **Target pay increases to higher-level staff.** The 2000 Salaries Commission proposed a more generous pay increase for manual laborers than for any other employee group. However, the Commission's study of private sector wages reveals that manual laborers in government receive 25 percent to 125 percent more than a similar person in a private company. Clerical workers, too, receive up to one-third more than their private sector equivalents. By offering a more generous percentage increase to the less skilled segment of the public sector labor force, the effect of the Salaries Commission proposal would be a further erosion of the compression ratio, thereby weakening incentives for advancement in the public service.

45. The compression ratio was already a modest 9.1 under the salary scales fixed in 1992 and fell to 8.1 in 1997. It would fall further to 7.1 under the current proposals of the Commission. Targeting increases to higher-level staff is an obvious alternative approach to decompress the wage scale and thereby ease difficulties in recruiting staff with skills highly sought-after by the private sector (a problem identified by the Commission). Targeted increases also would also be fiscally more affordable.

46. **Promoting Merit in Appointments.** Patronage-style appointments have become commonplace in Sri Lanka. The Ceylon constitution of 1948 established an independent Public Service Commission with authority over the appointment, promotion, transfer, and disciplinary control of permanent employees. However, the authority of the Public Service Commission was severely weakened in 1972 when the new constitution

transferred the power of appointment to the Cabinet of Ministers. An important remedy is the recently approved 17th amendment to the constitution. In accordance with that amendment the national Public Service Commission (PSC) is granted the authority to appoint, promote, transfer and dismiss all public officers, with the exception of department heads. However, the PSC must receive greater support from central government in order to reestablish its former authority.

PART 2. SECTOR EXPENDITURE REVIEWS

V. HEALTH

Sri Lanka has achieved exceptional improvements in health outcomes despite relatively low levels of spending in the sector. There is however a need to consolidate impressive gains and respond to emerging challenges, such as non-communicable diseases, associated with the rapidly aging population. While unit costs are low, there is evidence of inefficiency, such as an increasing share of resources going to curative rather than preventive care. Malnutrition is a major problem with over 30 percent of pregnant and lactating mothers suffering from anemia. There are also some inequities in the provision of health services and in health outcomes, with differences in nutritional outcomes particularly notable. Inequalities persist in terms of financial inputs (though much of this is accounted for by differences in private expenditures)—notably in the Western Province.

SECTOR PERFORMANCE

47. **Sri Lanka has achieved exceptional improvements in its health status despite relatively low level of spending in the sector.** Infant and maternal mortality rates of 16.3 per 1,000 live births and 2.3 per 10,000 live births are already close to those enjoyed in OECD countries. As a result significant additional improvements in these indicators, as proposed by the Millennium Development Goals, are not achievable within the Sri Lanka context.

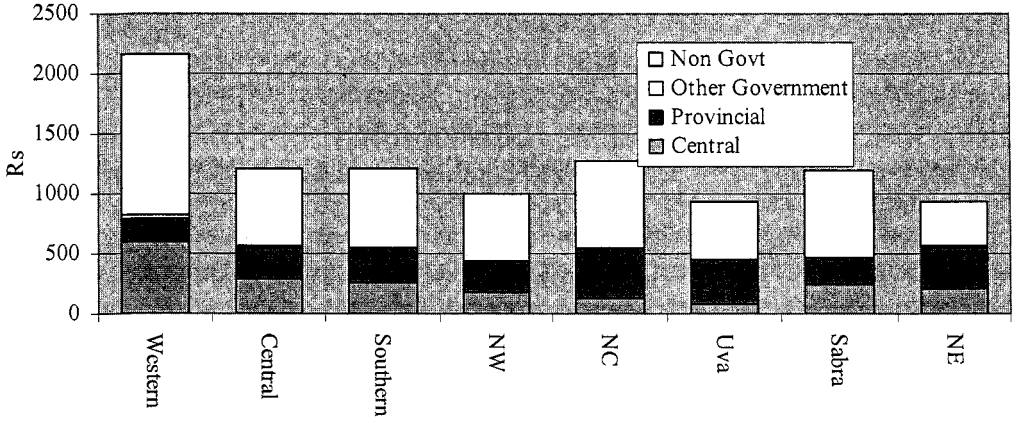
48. **Sri Lanka's success reflects factors within and outside the health sector**—a highly educated population making full and informed use of available health services and adopting reasonably healthy lifestyles. Geography, climate and a range of socio-cultural factors also play a major role. Nonetheless, the health sector can also take significant credit for these trends by ensuring that resources have generally been utilized in an equitable and efficient manner. There is almost universal coverage of essential services. Immunization rates exceed 95 percent even for disadvantaged groups whilst the share of deliveries which are assisted by trained health personnel—estimated at 93.9 percent in 2000—is exceptionally high. Moreover, such coverage has been provided at extremely low cost. Studies show that unit costs are low in comparison to other countries in the region—largely a reflection of the high (in some cases, excessive) levels of utilization—and have been declining over time. Public services have generally been allocated in a pro poor manner. Though a large share of resources is allocated to secondary and tertiary care poorer groups appear to have significant access to services provided by these institutions. As a result, the hospital sector appears to provide an effective, if basic, safety net for those facing the potentially catastrophic effects associated with hospitalization. Benefit incidence studies demonstrate that the poor utilize a far greater share of public subsidies than in India, Nepal and Bangladesh.

49. However, there is an unfinished agenda. **Despite low unit costs there is still evidence of inefficiency.** Utilization of in-patient services is much higher even than OECD countries indicating that much of this care could perhaps be delivered more cost effectively at lower levels in the system. Maternity homes, on the other hand, have very low levels of utilization—partly a reflection of the declining number of births but also due to the fact that such facilities are typically bypassed. In practice, the lack of administrative or financial incentives to encourage more appropriate referral system has encouraged such behavior.

50. **Nutrition is a major problem with over 30 percent of pregnant and lactating mothers suffering from anemia.** The poor underlying health of mothers has also contributed to persistently high level of low birth weighed babies. Vulnerable groups including the economically disadvantaged living in the estates sector and those living in conflict-affected areas are particularly affected. Malnutrition is on the increase in these areas and the incidence of malaria is increasing with over 50 percent of reported cases in conflict-affected areas.

51. **There exist some inequities in the provision of health services and health outcomes.** Sri Lanka's achievements in providing universal and free education and health care to the general population are reflected in good social indicators for the poor and the poor fare considerably better in some key non-income dimensions of poverty than in most other developing countries, a few crucial pockets of inequity persist. In the health sector, this is illustrated by lower access for some health services and weaker health indicators for poor and vulnerable groups, especially those living in estates, or remote or conflict-affected areas.

Figure 6. Per Capita Expenditure on Health in Sri Lanka by Province (1997)



52. **Inequalities persist in terms of financial inputs (though much of this is accounted for by differences in private expenditures)—notably in Western Province.** As indicated in Figure 6, there are significant differences in per capita public spending on health by province although these are partly offset by expenditures through central programs. However, there has been a trend toward greater equity in public expenditure on health by province over the 1990s. Yet, there are some substantial differences in terms of infrastructure and human resources across the regions. The number of hospital beds

varies from 4.8 per thousand population in Colombo to 2.0 or less in Jaffna, Kilinochi and Vavuniya whilst the number of medical officers per 100,000 population varies from around 99 in Colombo to less than 12 in Jaffna, Kilinochi and Mannar. Such differences are mainly due to the presence of teaching, provincial and specialized hospitals in the major urban centers.

53. **Performance against some of the key health service indicators is generally good with little, if any, inequality.** The proportion of children between 12 and 23 months immunized for DPT3/4—a good indicator of health system performance—is around 98 percent (97.2 percent in estates). The proportion of children immunized against measles—an indicator closely linked to child mortality rates—averaged 94 percent according to DHS 2000 (86.1 percent in the estates sector though more recent date suggests this gap has reduced significantly since). Overall utilization of public services does differ widely by district. The number of in patient admissions per head in Colombo, for instance, is double that in Nuwara Eliya. Per capita out patient contacts in Anuradapura are almost double those in Matara.

Figure 7. Sri Lanka: Percentage of children aged 3 to 59 months who are stunted by place of residence

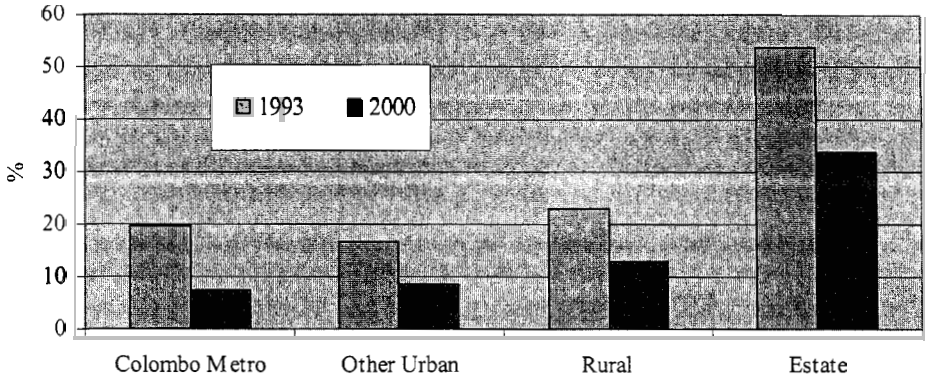
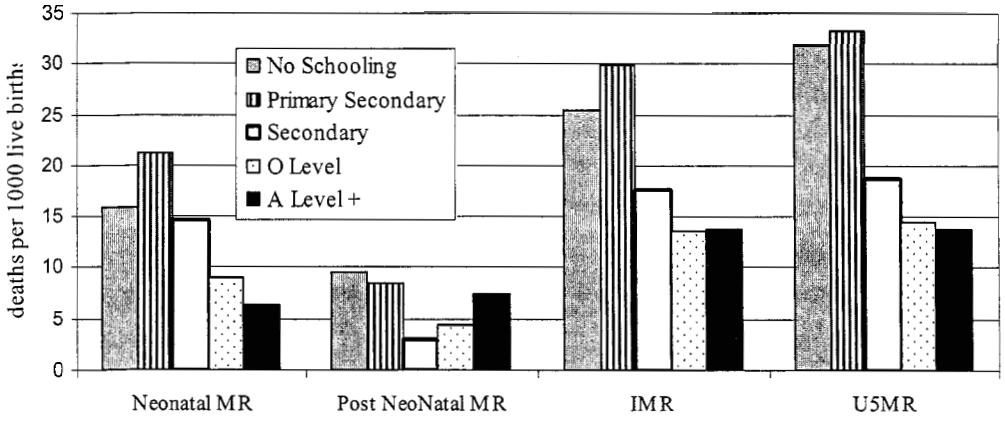


Figure 8. Sri Lanka: Health Outcomes by Level of Mothers Schooling



54. As noted above, significant inequity in outcomes persist. **Differences in nutritional outcomes are particularly notable.** A child living in the estates sector is over four times more likely to be stunted than one living in Colombo and almost three times more likely than one living in rural areas (although the differential is narrowing) (see Figure 7). Outcomes are closely linked to socio-economic status as children with mothers with higher levels of educational attainment having far better outcomes (see Figure 8).

HEALTH EXPENDITURE

55. **Sri Lanka has achieved extraordinarily good health outcomes with relative modest level of spending on health.** Total expenditure on health was SLR 39,177 million in 1999 of which 13 percent was capital investment. This amounts to 3.5 percent of GDP, which is somewhat lower than other regional countries (Bangladesh 3.8 percent, India 5.0 percent, China 4.5 percent, and Thailand 4.0 percent). Government funding for health mainly comes from central funds (47 percent) with provincial taxes contributing 4 percent. Private expenditure is predominantly out-of-pocket expenditure (43 percent), with a further 4 percent coming from employers and 3 percent from private insurance. Health expenditure has been increasing, albeit from a low base. Since 1990, total expenditure has been between 3-3.5 percent of GDP of which the Government share has fluctuated between 1.4 percent and 1.7 percent. The level of external development assistance to this sector is also low (currently between 4-6 percent of the total health expenditure).

56. **By regional and international standards the health system is extremely equitable and displays high levels of technical efficiency (although less so for allocative efficiency with the increasing share of resources going to curative care).** Nonetheless, there is room for improvement in a number of areas. There are still sections of the population who lack access to basic health services. In terms of technical efficiency whilst unit costs are low, in part because hospitals are overcrowded, many services could still be provided more cost effectively at lower levels of the system. Perhaps more importantly, the large and rising share of public spending going to the hospital sector in response to strong public demand for the provision of such services, threatens future progress in other important areas. Overall spending on public health and preventive services, for example, declined by around 15 percent in real terms during the 1990s. Sri Lanka also faces new challenges particularly those associated with its rapidly aging population which will require a reorientation of support.

KEY CHALLENGES

57. **Sri Lanka needs to consolidate impressive gains, address the remaining shortcomings, and respond to emerging threat such as non-communicable diseases associated with the rapidly aging population.** The latter include a rising incidence of cancers, health disease, diabetes, accidents and suicides. Sri Lanka is unusual in having gone into the demographic transition at a low level of per capita income. This makes an emphasis on the prevention of NCDs especially pressing, as the financial means to provide effective treatment for such conditions are unlikely to be available. The system

also has to face new threats such as HIV/AIDS and the re-emergence of dengue and malaria.

58. **Support needs to be targeted towards meeting the needs of the most vulnerable, the elderly, disable, adolescents, estates workers and those affected by conflict**. Steps will need to be taken to make more rational use of the existing health infrastructure—addressing issues of overcrowding at higher level facilities and improving utilization at lower levels.

59. **In order to improve efficiency it will be essential to develop more flexible management approaches** to promote greater delegation of authority, the development of more effective financial and information systems, better planning and management of human resources. Government will need to take a lead in developing and strengthening partnerships and coordination between key stakeholders in the sector including the private sector, civil society and traditional systems of medicine

60. **Financing mechanisms need to be strengthened.** This will require the strengthening of incentives for better performance, ensuring resources continue to be allocated in a pro poor manner and the development of further mechanisms to promote this, ensuring that adequate provision is made for new initiatives, reviewing strategic health financing options and strengthening the information base.

61. **Continued progress will depend heavily on the performance of the provincial councils who are responsible for the delivery of services.** There is no mechanism, at present, for ensuring that councils devote adequate resources to meet the health needs of their populations. Currently, they are not even required to report formally on their spending. Provincial councils face major human resource and financial capacity constraints and remain heavily dependant upon central Government for their funding whilst there are general concerns about the overall methods of allocating resources to the provinces.

Future resource requirements

62. **Future health care costs over the coming decade will depend on patient behavior, specifically the propensity of the population to use health services when ill.** Recent macro costing studies suggest that traditional increases of 1-3 percent per annum for outpatient care imply an increase requirement of 0.2 percent of GDP. The changing demographic structure—and additional costs for meeting the needs of an increasingly elderly population—is anticipated to require a similar amount of additional expenditure. Improvements in productivity of up to 2 percent per annum based on historical trends would be expected to offset some of this increase. A key area of uncertainty is the rate of price inflation in the private sector which has major implications both for overall health expenditure as well influencing whether patients seek to access care in public or private sectors. Just to stand and maintain existing levels of provision the study estimates that the share of public spending on health needs to increase to around 1.6-1.7 percent of GDP. This relates to the base case scenario—the figures could be much higher under less optimistic assumptions.

63. **Achieving significant improvements in health services would require additional expenditure.** Preliminary estimates suggest that significant improvements in the quality of care could require up to 0.5 percent of GDP whilst new programs including the provision of anti retrovirals to HIV/AIDS patients, integration of the estate sector, development of the infrastructure in the North and North East could add the same again. The establishment of a publicly funded family practitioner program could add up to 0.7 percent of GDP.

POLICY RECOMMENDATIONS

64. The key reform areas that need to be tackled by the sector are:

- Improve curative health care services (through hospitals and other providers) at the Provincial and district levels in order to make these services more accessible in poor, rural areas;
- expansion of health care services to meet the needs of specific groups such as the elderly, victims of war and conflict and promoting specific areas of health care such as occupational health problems, mental health care and estate health services; development of health promotional programs, with special emphasis on outreach through the schools;
- improvement of disease prevention amongst the poor can reduce the health financing burden and contribute to more rewarding and productive lifestyles;
- reform of health care funding, with the aim of concentrating public support on the poor, including a better effort to mobilize and manage resources in both the public and private sectors; and coordinating financing mechanisms such as social insurance;
- rationalization of human resources and health infrastructure;
- development of a coherent policy framework for redefining the roles of the public and private sectors in health care provision.

65. In terms of resource allocation priorities the changing nature of the health sector in Sri Lanka suggests a need for the following:

- a modest increase in overall spending on health to maintain the current levels of provision and significant increases if Government is to take serious steps to improve quality and expand access to services;
- a general increase in the share of public expenditure going to preventive care;
- greater focus on specific program areas notably nutrition, NCDs, maternal and child health, mental health and less on program areas where the threat is declining (whilst continuing to provide sufficient support to consolidate previous gains and respond to outbreaks as they occur);
- greater focus on effective approaches within program areas, e.g. behavioral changes programs aimed at alcohol and tobacco;
- the development of mechanisms to ensure that resources are increasingly focused on those district and provinces in greatest need;

- increases in the allocation of resources to support measures to increase hospital efficiency and to make more effective use of lower level facilities.

66. Over the last decade there has been a major reorientation of resources away from promotive and preventive services towards curative care. This shift has a large constituency—it is popular with the public, politicians and medical professionals. A shift in the allocation of resources towards preventive care would signify a significant break with recent trends. Two other areas requiring major attention are:

- the relationship between the centre and provinces and
- public sector reform efforts to improve the efficiency of the public sector.

67. Neither of these can be taken forward at the sector level but both need greater clarity and action if sustained health development is to be achieved.

VI. EDUCATION

Universal access to primary education has been largely attained through the establishment of an island-wide network of schools offering tuition free public education. However, raising the quality of education constitutes the next major policy challenge. Education continues to enjoy a prominent place in the government budget, accounting for about 8 percent of public expenditure. Public expenditure in education is currently chiefly absorbed by salaries and wages and administrative costs in the recurrent budget and building construction in the capital budget. Obtaining higher quality educational outcomes will necessitate a greater share of resources being shifted towards capital expenditures.

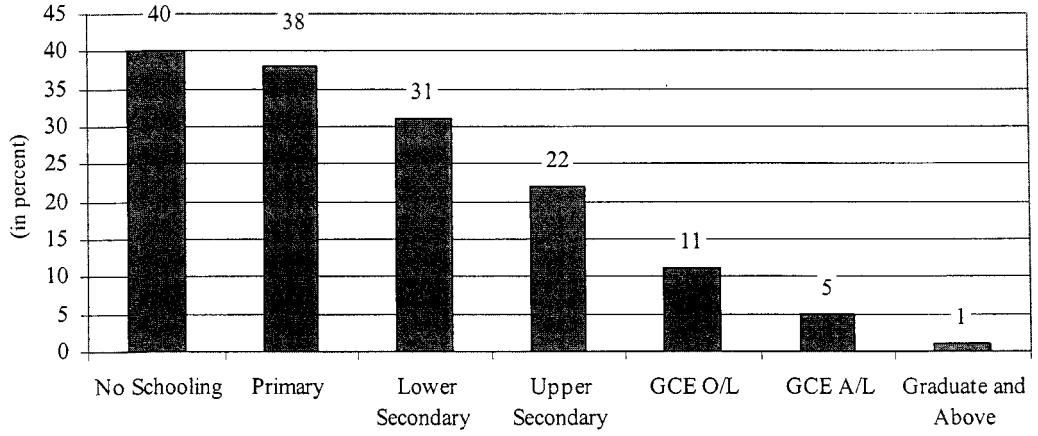
EDUCATION ACHIEVEMENTS AND CHALLENGES

68. **Education continues to enjoy a prominent place in the government budget, accounting for about 8 percent of public expenditure.** Sri Lanka is well-known in the development policy literature as a country that has attained high levels of human development relative to its per capita income. Historically, the Government of Sri Lanka (GOSL) awarded high priority to investment in education, devoting the largest share of the government budget to education. In recent years, as military expenditures increased as a result of the conflict in the North-Eastern region and crowded out resources for development, the share of public spending on human capital declined.

69. **Educational attainment is strongly associated with poverty in Sri Lanka.** Poverty rates decline steeply as education levels increase (see Figure 9). Poverty incidence was 40 percent among households whose head was uneducated and 38 percent among households with a primary educated head in 1995/96. Among households with junior secondary educated heads, poverty incidence was 31 percent. Poverty rates declined continually across school levels to just 1 percent among households with heads who were university graduates or higher.

70. GOSL's education policy framework emphasizes three key elements: (a) providing universal access to public primary and secondary schooling, and controlled access to public university education; (b) enhancing the quality of education, especially cognitive achievement, and other dimensions of quality such as good team work, a disciplined and productive work ethic, a positive, problem solving approach, and attitudes favorable to a multi-ethnic, multi-religious society; and (c) increasing the economic and social relevance of the education system. In support of this overarching policy framework, GOSL under the leadership of the National Education Commission (NEC) has developed wide-ranging policy initiatives and measures to develop the education system [see NEC (1997), (2003)]. GOSL has invited the World Bank (WB) to support the development of a medium term budgetary framework for the education sector to facilitate investment planning and enhance the efficiency and equity of public spending.

Figure 9. Sri Lanka: Poverty Incidence by Education Level of Household Head, 1995/6



Source: Gunewardena, 2000.

Compulsory basic (Grade 1-9) education: enrolment and completion

71. **One of the chief priorities of education policy makers is the provision of universal access to primary and secondary education, especially the compulsory education cycle, grades 1-9.** This policy objective has largely been attained at the primary level through the establishment of an island-wide network of schools offering tuition free public education. Net enrolment at grade 1 is about 97 percent, and net primary completion around 95 percent. However, further progress is required in the junior secondary (grade 6-9) cycle. Only about 82 percent of students complete grade 9. GOSL has adopted several initiatives, such as catch-up education programs, special education programs and non-formal education programs, targeted at these groups of children. These need to be further strengthened to reach the final set of children in the age group 6-14 outside the school system.

Education quality

72. **In contrast to the high levels of education attainment at the primary and junior secondary levels, GOSL policy makers have become increasingly aware that education achievement is unsatisfactory, and raising the quality of education constitutes the next major policy challenge.** Cognitive achievement tests among primary school children, for instance, show substantial shortfalls in mastery of basic language and numeracy skills. In first language (Sinhalese or Tamil), average mastery is only 37 percent. This implies that two out of every three children in the primary cycle have not mastered their first language. English language writing skills are virtually non-existent, with just 10 percent of children exhibiting the required skill level. In mathematics achievement, too, overall mastery is only 38 percent. The low level of cognitive achievement among primary students is especially worrying, from a policy perspective, as primary education forms the foundation upon which higher levels of education and various types of skills training are built. Hence, the quality of the entire

education system is severely constrained by the low achievement levels in primary grades.

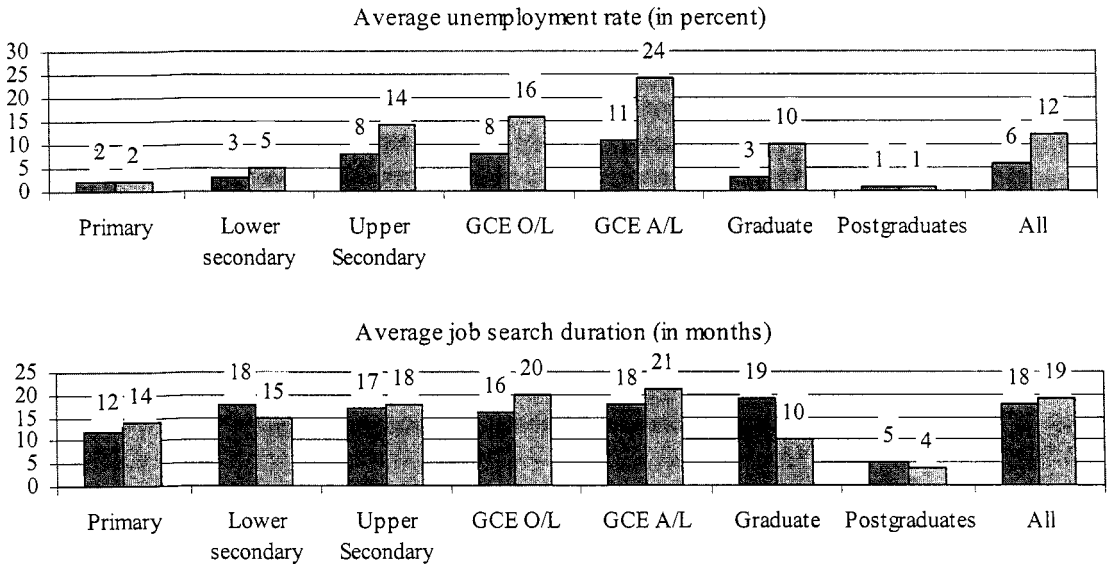
73. **The unsatisfactory state of education quality is also evident at the level of senior secondary education.** The proportion of students passing the GCE O/L is low, only 37 percent, implying that about two out of every three students taking the examination fails. Further, this low pass rate has been fairly constant over the period 1998-2002. A substantial majority of students appear to struggle with subjects such as mathematics, English language, science and social studies. At the GCE A/L examination, too, pass rates have been around the 50-55 percent level since 1998 over the 1998-2002 period. This implies that only about one out of every two students actually passes the GCE A/L examination. These are low pass rates at the GCE O/L and GCE A/L examinations, especially since successful completion of these examinations is necessary for a variety of skills training courses or access to tertiary education programs, or for entrance into a range of labor market occupations.

74. In addition to the problem of poor education quality as measured by low learning achievement scores or high examination failure rates, **policy makers and employers have argued that other, non-cognitive dimensions of education quality are also unsatisfactory and need urgent improvement** [NEC (1997), (2003)]. Education policy makers have stressed the importance of producing characteristics such as a disciplined work ethic, good team work, creativity and initiative, a problem solving approach and sound civic consciousness among school children and university students.

Educated youth unemployment

75. **A major problem facing GOSL policy makers is that of unemployed educated individuals, especially women** (see Figure 10)**.** Unemployment rates tend to be highest among university graduates and GCE O/L and GCE A/L completers. The high unemployment rates of educated labor force participants are mainly caused by lengthy job search durations by new entrants into the labor market. The lengthy periods of job search has led to considerable social unrest in the past, particularly among university graduates. The main cause of high unemployment rates and long job search durations among educated young people has been the slow growth rate of the economy, which has prevented the demand for educated labor rising sufficiently fast to absorb the rising supply of educated young people entering the labor market. Secondary causes of educated youth unemployment have included the production of graduates with low generic skills in demand within the labor market, such as English language fluency and IT skills, and the moderate quality of some university degree programs.

Figure 10. Sri Lanka: Unemployment Rates and Job Search Durations by Education Level, Men and Women, 2000



Source: Department of Census and Statistics, Labor Force Survey 2000.

PUBLIC SPENDING IN EDUCATION

Comparatively low public expenditure on education by international levels

76. Public education expenditure in Sri Lanka currently amounts to about SLR40 billion (US$415 million) annually. In recent years, the education budget has accounted for approximately 3 percent of GDP and 7-8 percent of government spending. This level of spending is somewhat lower than South Asian countries and low income nations which devote about 3.2 percent of national income and 11 percent of government expenditures to education. The group of lower middle income countries, to which Sri Lanka is expected to belong in the near future, spends about 4 percent of GDP on public education. Countries such as South Korea, Malaysia, Thailand and Singapore, which act as policy models for Sri Lankan policy makers, devote considerably higher resources to education (Table 9).

Table 9. Education Expenditure as a Share of National Income and Government Expenditures, Sri Lanka and Selected Other Countries

Country	Education expenditure as a % of GDP	Education expenditure as a % of government expenditure	Recurrent education expenditure per student as a % of GDP per capita	Average teacher salaries as a % of GDP per capita
Sri Lanka	2.9	6.8	9.7	1.5
India	4.1	12.7	16.3	3
Bangladesh	2.5	15.7		3.3
Pakistan	1.8	7.8		
Nepal	3.7	14.1	14.5	
Malaysia	6.2	26.7	20.7	2.9
Maldives	3.9	11.2		
Bhutan	5.2	12.9		
Thailand	5.4	31	25.3	3.1
South Korea	3.8	17.4		4.1
Singapore	3.7	23.6		
Phillipines	4.2	20.6		
Costa Rica	4.4	22.8		
South Asia	3.2	11.2	14.5	2.8
Low Income Countries	3.2		16.3	
Lower Middle Income Countries	4.1		18.5	
Upper Middle Income Countries	5		23	

Sources: Sri Lanka, calculations from Central Bank of Ceylon Annual Reports, various issues; Other Countries, World Development Indicators (World Bank) and UNESCO Statistics, various issues. The information above for Sri Lanka is computed from 2002 data. Other countries and regions are from the closest available year in the late 1990's and early 2000's.

Equity of public education spending

77. **The enrolment pattern across economic groups shows a high degree of equity in education attainment at the lower education levels** (Table 10). Net primary enrolment is almost equal across consumption quintiles and among poor and non-poor households. Net primary enrolment in 1995/96 ranged only from 95 percent to 97 percent between the poorest and richest consumption quintiles. At the junior secondary education level net primary enrolment ranged from 61 percent among the poorest consumption quintile to 76 percent among the richest consumption quintile, while at the senior secondary education level net primary enrolment varied between 31 percent among the lowest consumption quintile to 60 percent among the highest consumption quintile. These are progressive enrolment patterns by developing country standards.

78. **At the tertiary education level, however, the pattern of enrolment is heavily weighted in favor of the richest quintile**, with 13 percent enrolment, as against the poorest two consumption quintiles, where only 2 percent of students enroll in tertiary education. This is an unfavorable distribution of tertiary education enrolment, from an equity perspective, with a large gap between the highest consumption quintile and the two lowest consumption quintiles. Overall, public education spending at primary and secondary education level appears equitable, while public education expenditures at tertiary level appear comparatively inequitable.

Table 10. Sri Lanka: Net Enrolment Rates in Major Grade Cycles by Economic Groups

Consumption quintiles	Net primary enrolment (grade 1-5) %	Net junior secondary enrolment (grade 6-9) %	Net enrolment (grade 10-13) %	Net tertiary enrolment %
Lowest 1-20	95	61	31	2
Quintile 21-40	96	66	35	2
Quintile 41-60	95	67	41	4
Quintile 61-80	96	77	47	5
Highest 81-100	97	76	60	13
Poor	95	63	32	2
Non-Poor	96	71	47	6
Sri Lanka	96	68	42	5

Source: Calculated from the Household Income and Expenditure Survey, Department of Census and Statistics, 1995/96.

Composition of public education expenditure

79. **Public investment in education is chiefly absorbed by salaries and wages in the recurrent budget and building construction in the capital budget.** In consequence, investment in quality inputs, such as equipment, technology, reading material and tools, and quality processes, such as professional development of principals, sections heads and teachers in the school system and university academics and administrators in the university system, has been crowded out. As Sri Lanka moves from the first stage of education development, providing universal access to basic education, to the second stage of education development, producing a good quality and high performing education system at all levels, an increasing share of resources needs to be invested in quality inputs and quality processes.

CHALLENGES IN GOVERNANCE AND SERVICE DELIVERY

80. While the level and pattern of public expenditure on education can be important determinants of education attainment, equally important is **the quality and effectiveness of service delivery**. In this context, the following areas have been highlighted as the main issue that need to be addressed: (i) poor teacher deployment and high teacher absenteeism: (ii) inadequate empowerment of education institutions, such as schools, NCOEs and TCs, especially in staffing, planning and administration; (iii) limited administrative capacity and inadequate use of technology, which leads to delays in policy implementation, operations and procurement; and (iv) the difficulty of attracting and retaining highly qualified university academic staff, given the enormous difference in academic salaries paid by developed countries and Sri Lanka, and the ability of well-educated individuals to compete on overseas labor markets.

POLICY DEVELOPMENT FOR THE MEDIUM-TERM BUDGET FRAMEWORK

81. The government faces several key challenges to increase the quality of education, enhance equity of public spending, strengthen service delivery within the system, and improve the economic and social relevance of schools, universities and technical

education institutions. These challenges exist at a time when public spending in education is relatively low by international standards and the state experiences a high fiscal deficit which compels it to adopt a conservative fiscal policy. In this context, the government can consider four sets of measures to increase education spending and enhance the efficiency and equity of public spending.

Increase private sector investment and participation in education

82. **There is a need to promote private sector participation in education, especially at tertiary level.** Relaxing the legal barriers to private sector participation in education could produce several benefits. First, it would increase the overall volume of resources invested in the education sector. Second, since the students attending private schools and education institutions are likely to be drawn from upper income families, it would release more public resources, on a per student basis, for students from poorer families. Third, it would stimulate economic activity in a sector where investment has been artificially restricted and contribute to higher growth. Fourth, it would provide an alternative mode of service delivery, with considerable power and responsibility at the level of the individual education institutions, such as private schools and education institutes. These private education organizations would be compelled to offer high quality services to remain viable in an economic context where they are in competition with free public education institutions.

Protect and gradually increase public spending in the school system

83. Government policy to improve education quality envisages several important education policy measures (see NEC (2003)). These policy initiatives require considerable investment of resources in the education system. Given the low level and decreasing trend of real public education spending, and the major challenges Sri Lanka faces in improving the quality and economic and social relevance of the education system, **it is important that the government preserve the current level of real expenditure in the short-term and increase public investment in education gradually over the medium-term.** The real value of the education budget needs to be preserved in 2005, and from 2006 onwards gradually increased, with the real value of the increase in resources targeted at the school system.

Enhance the equity of public education spending

84. The pattern of student enrolment over major grade cycles and the unit costs of education by grade level, show that spending in primary and secondary education is relatively progressive and benefit students from low and middle income households, while spending in tertiary education tends to benefit students from upper-income households. In consequence**, there is a strong case for allocating the major share of any increase in public resources for the education sector to primary and secondary schooling**, while carefully controlling the expansion of the public university system and allowing enrolment expansion in tertiary education take place mainly in the private sector. Opportunities for poorer students to access tertiary education could be expanded

through schemes such as student vouchers and student loans, rather than through direct public sector provision.

Increase cost-effectiveness of the education system

85. The tight resource constraint faced by the government makes it extremely important that the education system generates internal savings to reduce costs. In this context, three important policy measures are available.

i. **School rationalization.** The cost-effectiveness of operating the school system can be enhanced by consolidating and amalgamating small, uneconomical schools, where this can be accomplished without reducing access to schooling and damaging enrolment and attendance. The public school network is such that a sizable proportion of small schools are located close to other, larger government schools. MHRECA and the provincial councils designed and implemented a successful school rationalization program, during 1998-2002. This program, which was temporarily suspended due to intense political pressure, needs to be re-opened, but with careful safeguards to protect access for poor and vulnerable groups.

ii. **Raise the student-teacher ratio in schools and tertiary education institutions.** Currently, the student teacher ratio in schools, at 21:1, is low. Countries with outstanding education systems and far higher income levels, such as South Korea, Singapore and Hong Kong, have higher student-teacher ratios and more cost-effective systems. The current teacher employment and deployment policy is based on a target student-teacher ratio of 22:1 for secondary grades and 26:1 for primary grades. The government could consider increasing the target student-teacher ratio to 23:1 for secondary grades and 27:1 for primary grades. In addition, the student-teacher ratio in the public university system tends to be very low, at 14:1. The government could consider increasing this student-teacher ratio to the internal academic norm of 18:1, so that cost savings can be generated within the system.

iii. **Rationalize administrative staffing**. The roles, functions and responsibilities of staff within the complex, multi-tiered education administrative system is unclear. A careful analysis of work loads, and de jure and de facto roles, functions and responsibilities of staff in the various education ministries, provincial councils, zonal education offices, division education offices and tertiary education institutions is likely to identify both duplication of roles and functions, and gaps and shortages of staff. Overall, there may be an excess of staff, which a carefully designed voluntary retirement scheme could decrease, reducing pressure on the budget and releasing more resources for investment.

Re-investing resources saved within the education system back in the sector

86. In order to increase resources for quality enhancing education policy initiatives through the implementation of cost saving measures within the education system, **it is vitally important that the Ministry of Finance permits funds saved to be channeled back into the education system for investment**. If the funds saved through cost-reducing measures are not re-invested in the education system the objective of enhancing education quality would be defeated. Further, the education system would lose the incentive to implement difficult measures such as school rationalization and higher student-teacher ratios.

Intra-budget shifts in resource allocation in favor of quality inputs and quality processes

87. **Over time, the balance of capital and recurrent spending within the education budget needs to shift to allocate a greater share of resources to capital expenditure.** Within the capital budget, a higher proportion of resources needs to be invested in quality inputs such as IT centers, science laboratories, libraries, activity rooms, multi-purpose rooms, equipment, technology and tools. The construction and expansion of buildings, which absorbs the highest share of the capital budget, needs to be rationalized, prioritizing the urban school system which is experiencing rising demand. Construction work within the university system, beyond the current cycle of buildings in progress, should be halted until a careful needs assessment has been completed. Within the recurrent budget, too, resources need to be reallocated from salaries and administrative expenses to quality processes, such as teacher education and training, management and academic training of school principals, and the purchase of teaching material and learning resources.

INCREASING THE QUALITY OF SERVICE DELIVERY

Decentralizing education management and establishing school boards

88. **Measures to improve the quality of service delivery within the education sector are extremely important.** In this context, the government has identified a key policy proposal to improve service delivery within the school system. This is the establishment of school boards and decentralization of education management to schools. The objective of this policy initiative is to empower principals, section heads and teachers, enable schools to forge links with local communities to improve resource mobilization and public accountability, increase the efficiency of decision making by decreasing administrative layers, and improve service delivery. A sound evaluation of this pilot program would be extremely helpful for future policy making on the structure of school governance.

89. **The government should also consider applying the principle of education decentralization to other education institutions, such as National Colleges of Education (NCOE's) and Teacher Centers (TC's).** Currently, the NCOE's have little managerial responsibility and autonomy. Curriculum design, assessment and certification

of teacher education courses offered by NCOE's are undertaken by the National Institute of Education (NIE). Recruitment of academic staff is to a centralized teacher educators service, and NCOE's rarely have a voice in the choice of academic staff allocated to them. TC's operate in an inefficient administrative structure. The NIE designs the curricula of continuing teacher education programs offered by TC's. The NCOE's act as academic advisors to TC's. For administrative purposes, including finances, the TC's come under the zonal education offices. This complex administrative and academic structure has badly hampered the development of TC's. Devolving a greater degree of managerial autonomy and responsibility to NCOE's and TC's could increase the operational efficiency of the institutions and enhance the quality of service delivery.

Monitoring and evaluation

90. The development of a public expenditure tracking system would help identify the quantity of resources flowing to and within service delivery points, such as schools, NCOE's, TC's, universities, vocational training and technical education institutions, and the NIE, and the transactions cost of the system. Such **a public expenditure tracking mechanism would be an extremely useful management tool to increase the efficiency and equity of resource flows and the quality of service delivery.**

VII. SOCIAL WELFARE

A review of expenditures of the Ministry of Samurdhi and Social Welfare reveals a high concentration of spending on direct welfare related benefits for both Ministries. Of the two, the Samurdhi Ministry is responsible for the larger share of direct welfare payments. Yet, the poverty impact of the Samurdhi consumption transfer is weak: the scheme misses 37-47 percent the two lowest income quintiles while over 40 percent of transfers are made to the wealthiest 60 percent. Most of the Ministry of Social Welfare spending goes towards disabled soldiers and families of soldiers killed in action. While this is a needy segment of society, the Ministry of Social Welfare needs to carve out a role for itself as a primary agency for the design and delivery of social welfare to all the vulnerable groups in the country. A number of areas require enhanced social protection schemes. One such area is the provision of social protection for the elderly.

OVERVIEW[3]

91. Social welfare spending in Sri Lanka comprises of a multitude of overlapping programs administered by a number of Ministries. **Total welfare expenditure amounted to an estimated 3.2 percent of GDP and 12.2 percent of total government expenditure in 2003**—higher than the overall education budget. Welfare programs include Samurdhi transfer payments, pensions to retired government personnel, expenditures on school uniforms and textbooks, payments to disabled soldiers and dry rations to refugees. The main agencies directly involved with program delivery at the central level are the Ministries of Samurdhi, Social Welfare, Education and Health, and Triple R (Relief, Rehabilitation & Resettlement). The Provincial Ministries are also involved in the implementation of social welfare programs, notably the disbursement of the "Poor Relief", which is financed by the decentralized budgets.

92. **The Samurdhi transfers program, run by the Ministry of Samurdhi, is the most significant of welfare programs**. Samurdhi constitutes the second highest budget item in welfare spending (after pension payments to retired public servants). At its peak in 2002, expenditures of the Ministry of Samurdhi—of which the transfer payments comprise a significant share—consumed close to 1 percent of GDP and 4 percent of the government budget; the 2003 estimates are 0.75 percent of GDP and about 3 percent of total government spending.

POLICY FRAMEWORK OF THE MINISTRIES AND RELATED ISSUES

93. Broadly defined, social welfare is the provision of government assistance to people in need. The categories of people in need are defined as the vulnerable sections of the elderly, disabled, children and mothers, and the poor. Strategies to support these segments of society typically take the form of safety nets and income support programs.

[3] The analysis here is confined to the two main agents at the central government level delivering welfare programs, the Ministry of Samurdhi and the Ministry of Social Welfare, as they have the most explicit mandate to serve the neediest and the most vulnerable sections of society and are the most significant in terms of budget allocation.

If this understanding is translated into the policy frameworks of the two Ministries that are assessed in this study, the vision and mandate of the Ministry of Social Welfare comes closest to that of a welfare program. It explicitly aims to target the disadvantaged sections of society and make them partners in the national development process. Samurdhi, on the other hand, presents itself as a poverty alleviation program, which pledges to improve the social and economic conditions of disadvantaged sections of society.

94. As the expenditure analysis that follows reveals, **the Ministry of Social Welfare dedicates the bulk of its spending on a disadvantaged section of society—disabled soldiers and families of soldiers killed in action.** It could be argued that care for this section of society should be the priority and responsibility of the defense institutions. They are different from war victims, which is rightfully the target group of the welfare agencies. This dilemma is all the more important to be addressed since this group receive a predominant share of the benefits, with little left for all other disadvantaged groups—vulnerable children, or those affected by natural disasters, disability, or old age—targeting whom is actually the stated objective of the Ministry. Thus there appears to be a mis-match between the profile of expenditures by the ministry and its stated objective.

95. Conversely, the Samurdhi program, which describes itself as a development program, is in terms of its expenditure profile primarily a welfare program, providing income support to poor families (as the expenditure review below will show). The substantial transfer component of the program cannot be reconciled with the stated aim of the Samurdhi program to "empower the rural poor" to mobilize their potentials. Thus there is a need to re-define the objectives of the program to better match the composition of its expenditures. This would also help rationalize the objectives and target group of the Samurdhi, in the context of the broader Welfare system that includes a multitude of smaller programs, including those administered by the Ministry of Social Welfare. Effectiveness of spending is also an issue, due to the fact that expenditures for Samurdhi transfers have not realized their potential in terms of improving welfare.

96. As studies on the Samurdhi program reveal, the poverty impact of the consumption transfer is weak. The high degree of politicization of the program has resulted in considerable mis-targeting, with the result that Samurdhi covers many of the non-poor (total coverage of almost half of the population), while missing some of the neediest, and consequently provides too little to have a marked impact on consumption levels of the poor. The Sri Lanka Integrated Survey (SLIS) supported by the World Bank, found clear evidence of both leakage and exclusion in regard to Samurdhi coverage. SLIS found that while 14-42 percent of households in the three higher income quintiles also receive Samurdhi transfers, 36-47 of households in the two lowest income quintiles did not receive the transfers (see Table 11). More than 40 percent Samurdhi transfers in the sample were made to the wealthiest 60 percent of the population.

Table 11. Samurdhi Coverage and Benefits by Income Quintile

Benefit	Quintile					
	1 (Lowest)	2	3	4	5 (highest)	**Total**
% of recipients	64	53	42	30	14	40
Rs. / HH (gross)	403	390	378	362	303	381
Rs. / capita (gross)	88	96	93	105	107	95
Rs. / HH (net)	322	315	307	301	260	310
Rs. / capita (net)	71	78	77	88	94	78

Source. SLIS quoted in World Bank 2002, p.36.
Note. Gross receipt includes compulsory deductions while net receipt excludes them.

97. The lack of clarity on objectives of the Ministries has also resulted in insufficient coordination across programs, in the context of targeting. This has led to considerable duplication between the beneficiaries of different programs, while at the same time some of the poorest and most vulnerable groups are missed altogether. Effectiveness of welfare expenditure in terms of its impact can thus be enhanced by better rationalization between the programs of different Ministries, in terms of their stated objectives and expenditures.

EXPENDITURE PATTERNS AND TRENDS

98. **The review of expenditures of the Ministry of Samurdhi and Social Welfare reveals a high concentration of spending on direct welfare related benefits for both Ministries**—in practice both Ministries are thus strongly oriented towards welfare, although the stated objective of Samurdhi would suggest otherwise. More than two thirds of the total budgets of the Ministries are spent in the form of direct transfers to households. Together, the two Ministries cover about half the population of the country. In the case of the Ministry of Samurdhi, which administers the Samurdhi program, the transfer goes into the payment of the consumption grant to poor households. In the case of the Ministry of Social Welfare, a large part of the transfer payments goes to a more specialized group—disabled soldiers and families of soldiers killed in action; other beneficiaries include vulnerable children, or those whose vulnerability is caused by natural disasters, disability, or old age. At the same time, there is evidence of considerable overlap between the beneficiaries of the programs administered by the two ministries.

99. Since the transfers are in the form of regular cash payments, the expenditures are classified under recurrent expenditure, which dominate the spending pattern. The other significant category of recurrent spending is administrative costs, including payments on personal emoluments, which consume a substantial portion of their budgets—especially for the Ministry of Samurdhi.

100. **An annual average of SLR 13.2bn was allocated to Samurdhi between 2000 and 2003, which amounts to 1 percent of annual GDP, over 10 percent of social service expenditures and a third of welfare expenditures** (Table 12). Total Samurdhi expenditures (nominal) increased from around SLR 10 billion in 2000 to SLR 15.2 billion in 2002, and then declined to around SLR 12.2 billion in 2003. These movements have

largely occurred due to changes in the size of the transfer component. Recurrent spending typically accounts for about 98 percent of total expenditure, and about 97 percent of that consists of payments for the consumption grant to households and salaries paid by the Samurdhi Authority to the more than 26,000 cadre of staff that administers the program. For instance in 2003, recurrent spending accounted for SLR 12.2 billion out of a total of SLR 12.5 billion, of which SLR 9.2 billion was spent on consumption grants or transfers, and SLR 2.8 billion on the salary bill of the Samurdhi Authority (about 23 percent of the total expenditure of the program). The large salary bill constitutes a drain on the expenditures of the Ministry, and reduces the welfare impact of spending.

Table 12. Total expenditures of the Ministry of Samurdhi and Social Welfare

Ministry	2000 Actual	2001 Actual	2002 Estimate	2003 Estimate
		In SLR million		
Ministry of Samurdhi	10,682	14,103	15,384	12,484
Ministry of Social Welfare	2,555	3,779	4,513	4,047
Combined expenditure	13,237	17,882	19,897	16,531
		As % of GDP		
Samurdhi	0.85	1	0.97	0.75
Social Welfare	0.2	0.27	0.28	0.24
		As % of total govt. spending		
Samurdhi	3.19	3.66	3.82	2.84
Social Welfare	0.76	0.98	1.12	0.92

101. **In contrast to the Ministry of Samurdhi, the Ministry of Social Welfare and its two associated departments, consume only 0.2 percent of GDP, 3 percent of the social services expenditure and 7.5 percent of the spending on welfare.** The breakdown of expenditures of the three institutions shows that recurrent expenditure accounts for about 98 percent of the total. Mirroring the pattern seen for Samurdhi, there was a steady increase in total expenditures from 2000 to 2002, from around SLR 2.5 billion to SLR 4.4 billion, followed by a decline to around SLR 4 billion in 2003. The increase is primarily explained by an increase in the size of the transfer component; the share of this component in the total budget has also significantly increased over time, from 79 percent in 2000 to 94 percent in 2003. As much as 92 percent of transfers in 2003 went for social security for disabled soldiers (including families of soldiers who have lost their lives), leaving only 8 percent for beneficiaries within other vulnerable groups.

REFORMS IN PROGRESS

102. The issue of politicization and mis-targeting of the Samurdhi program started to be addressed through the introduction of the Welfare Benefits Act (WBA) (in 2002) and the establishment of the Welfare Benefit Board (WBB). The WBB has the mandate to select persons eligible to receive welfare benefit payments, on the basis of transparent and prescribed selection criteria. The selection criteria considered involved a proxy-means test formula, based on a poverty predictor model developed using household data, to identify households whose "scores" fall below a pre-determined cut-off as eligible for benefits. A computerized database would be used to monitor the eligibility of households, entry and exit, as well as crosscheck for benefits received from multiple sources by the same household. A pilot survey covering 48,000 households in 114 GN divisions was

conducted in 2003 to test a proxy-means tested application process for selection of beneficiaries of the Samurdhi program under the new Act. After completion of the enrolment phase of the pilot, the island-wide application and targeting process would be initiated, along with a widespread publicity campaign to generate awareness about the reformed system, which is expected to be operational by the early part of 2005. The role of the WBB would be limited to selection of beneficiaries and defining the payment schedules, while the actual disbursement of benefits under the various welfare schemes would be carried out by the relevant agencies.

103. While the Samurdhi program, being the largest transfer program for the poor in the country, represented the first phase of reforms, the medium-term agenda would be to rationalize the selection of beneficiaries of all transfer programs in the country, by bringing them under a set of criteria applied by the WBB. This would help minimize duplication and inefficiencies across programs, and enable each program to be better aligned to its stated goals and rationale.

104. Some key implications of the implementation of WBA are noted here. First, the WBA provides for transparency and accountability not only on the part of the applicant who seeks benefits, but also on the part of officials who sanction those benefits. Second, a number of easily observable characteristics would be used in determining a household's eligibility for the Samurdhi transfers rather than the current practice of relying on subjective reports on income levels. Third, the WBA would explicitly define the criteria for entry and exit of households in and out of the program, and the status of households would be tracked so that overlaps in the coverage of the different welfare programs can be minimized.

105. The cut-off point for the new selection mechanism is proposed as such that the program would cover a proportion of the population that is roughly in accordance with the incidence of poverty in Sri Lanka (as estimated by the Department of Census and Statistics). The proposals for cut-off point and payment schemes that are being considered, informed by simulations using data, will likely lead to: (a) limiting the Samurdhi transfers to the bottom 25-27 percent of the population, which will substantially increase the amounts of transfers to target households; (b) better accuracy in identifying the poor; (c) making the transfers progressive, i.e. giving larger amounts to the poorer households. As a part of the reform plan, the possibility of separating the Samurdhi transfers from the compulsory savings, insurance and lottery schemes, will also be considered.

POLICY RECOMMENDATIONS TO SUPPORT AND COMPLEMENT THE REFORM PROCESS

106. On the basis of the policy issues highlighted previously and the review of expenditures—and in the light of the ongoing reforms in the sector—a number of policy implications emerge. These should also be looked upon as steps that could complement, and strengthen, the reforms in the targeting and payment mechanisms initiated by the Welfare Benefits Board.

Strategic areas of policy

107. In addition to the issue of mis-targeting, which remains the main focus of the ongoing reforms, **the experience with Samurdhi program suggests that some thought be given to its conceptual focus.** According to its declared goals, the Samurdhi program should be regarded more as a poverty alleviation program; this is however belied by the fact that a very large share of its budget goes to the transfer program, which in turn "subsidizes" the savings and credit components that are more aligned towards poverty alleviation. There is a good case for the latter to be de-linked from the welfare component, operationally and financially. This is likely to improve the efficiency and impact of both types of programs, on account that the objectives and the potential clientele are likely to be quite different from each other, and the incentives of beneficiaries and program staff often work at cross-purposes when the two kinds of programs are combined.

108. To the extent that such de-linking may lead to financial difficulties for the savings and credit components, alternate budget transfer mechanisms can be thought of to provide subsidies directly to these programs. Such support would however have to be justified by a close examination of the potential impact of these programs, and can be limited to a period of time deemed necessary for the programs to become financially viable on their own. Moreover, as far as the microfinance component is concerned, it can be argued that in the long run, the government's role should be replaced by non-government and private sector institutions. Major policy and regulatory reforms envisaged to streamline microfinance in the country creates the potential for working towards a long-term goal of minimizing the role of Ministry of Samurdhi in the delivery of microfinance services.

109. On the budgetary front, the planned reforms in the targeting and payment of Samurdhi benefits do not have any implication as far as the budget for transfers is concerned, since all simulations that drive the current proposals hold the current budget of SLR 9 billion for transfers constant in real terms—recognizing that this would be the minimum budget required to provide a meaningful subsidy to the poorest 25-27 percent of the population. At the same time, with the WBB taking over the selection of beneficiaries, the administration of the consumption grant can be handed back to the decentralized bodies to a large extent. This would obviate the need to employ a large cadre of development officers, and result in considerable savings on the salaries bill and other administrative overheads (that amounted to 22 percent of the total budget in 2003). The exact impact of reforms on the staffing needs of the Samurdhi Ministry is however not known yet, and would require careful examination once the full reform takes shape. The implementation of administrative and staffing reforms would also have to be integrated with the broader public sector reforms underway in the country, for instance, the implementation of the VRS plan.

110. **There is scope for the various other associated activities implemented by various departments of the Samurdhi Ministry to be streamlined and rationalized with regards to functions of other ministries.** These include activities in health, nutrition, education, training, and social security, when other ministries are specifically

dedicated to these functions. The budgetary implications of eliminating some of these functions would save expenditures at the Samurdhi Ministry, including administrative expenses. Although this would not amount to a significant saving, since the budgets on these activities are low to begin with, it could result in better efficiency emerging from a focus on the delivery of services in a few key areas.

111. **The Ministry of Social Welfare needs to carve out a role for itself as a primary agency for the design and delivery of social welfare in the country.** To start with the payment to soldiers could be reallocated to the budgets of the Defense Ministry. While they do represent a marginalized segment of society, responsibility for the provision of care for disabled soldiers and their families rightfully rests with the defense institutions and the required finances allocated from its budgets. In the event of a re-allocation it is not recommended at this stage that the budget of the Ministry be reduced, and any such steps should be preceded by careful examination of the needs of the programs administered by this Ministry and their target groups.

112. **It will be useful for the Ministry to undertake stocktaking of its many programs and activities, many of which overlap with other Ministries (e.g., health) and even involve duplication within its own departments.** If the activities of the Ministry are rationalized, the same budget can be used for activities that directly address the creation of safety nets for disadvantaged groups in need, such as the provision of care for the elderly. Sri Lanka's demographics point to a serious crisis in the provision of care to its aging population. The provision of social insurance schemes for the informal sector is another area in need of attention. The International Labour Organisation is providing significant technical input into this area, and the support for such programs could be another focal area for the Ministry.

113. Further, **the administrative costs of the Ministry have room for rationalization.** While administrative costs as a share of total budget are lower than that for the Samurdhi Ministry, the spending on personal emoluments is still high relative to the total spending minus the transfer (13 percent in 2003). The expenses are partly justified due to the need for a high level of skilled counselors and trainers (e.g., probation officers), but if this is the case, the programs themselves should be expanded in size and coverage to justify the personnel cost.

114. The welfare reform's medium/long-term vision involves the WBB coordinating the beneficiary selection of all welfare programs involving transfer payments in the country, with the goal to minimize duplication, and achieve better targeting and budget planning. This would however require that the rationale, objectives and potential target group of all transfer programs be examined carefully before the selection criteria for different programs can be devised and applied in an integrated manner. In order for this to occur, the ministries administering these programs would need to look across the entire landscape of programs, to identify the areas of duplication and gaps in the coverage of existing programs, and rationalize their programs accordingly. For instance, to complement the primary transfer program, Samurdhi, which aims to target chronically poor households, the programs of the Ministry of Social Welfare can be positioned to

focus on more narrowly defined vulnerable groups, including those affected by short-term shocks like natural disasters.

Issues of process: budgeting and audit

115. **There are a number of areas where the budgeting and auditing process can be improved, to better align the strategic direction of different ministries and departments with budget planning.** While many of these are not limited to the Welfare sector, but rather reflect endemic problems, they have explicit implications for this sector, and thus deserve a mention.

116. First, **there is a need for greater coordination between the Treasury and the line Ministries and Departments.** Frequently, the reclassification of expenditures by the Treasury in the Budget Estimates is not clear to the planners at the Ministries, which constrains effective budgeting and planning by the Ministries. Second, monitoring of programs and activities can be enhanced beyond the largely financial and physical monitoring of targets that presently takes place, to outcome monitoring that involves looking at what has happened once the output is delivered and utilized by the beneficiary or recipient. With the significant reforms in the welfare sector that are planned, such monitoring of outcomes assumes special importance, to inform how the programs can be adjusted and fine-tuned over time to achieve better impact.

117. Third, **greater efforts are required to capture public expenditure at the decentralized level, especially those of the Provincial Councils.** Although Constitutional requirements do not oblige Provincial Councils to report their expenditures in detail to the Treasury, some link to decentralized spending should be made in the Budget Estimates. This will lead to improvements in public accountability and facilitate current efforts towards greater devolution; it will also lead to better coordination between the strategic planning on Welfare at the federal and provincial levels and avoid duplication of efforts between the central line ministries and Provincial Councils.

118. Fourth, **both internal and external audit processes suffer from a lack of trained staff and facilities that limit the effective functioning of the audit process.** The internal auditing by the audit units of the Ministries could also be made more independent so that these units play a more stringent role in overlooking the expenditures of Ministries and Departments. Instruments such as the Audit and Management Committees could be enhanced by the compulsory attendance of the Audit Superintendent from the Auditor Generals department, and the profile and legal authority of the Internal Audit and Investigation Division of the Ministry of Finance could be enhanced to allow more autonomy and legislative clout in the internal auditing process

VIII. IRRIGATION

Public investment and donor support for the irrigation sector has diminished. Operation and maintenance (O&M) work is given inadequate priority and funding. A review of irrigation expenditure on major systems (> 80 hectares) over 2000-2003 reveals an inadequate provision for recurrent expenditure. A low allocation for recurrent expenditure could be one reason why forward planning/programming of irrigation activities are not possible. Expenditure on rehabilitation is largely driven by donors with insufficient beneficiary involvement. A considerable problem faced by the sector is the political pressure to maintain supply driven free services.

SECTOR PERFORMANCE

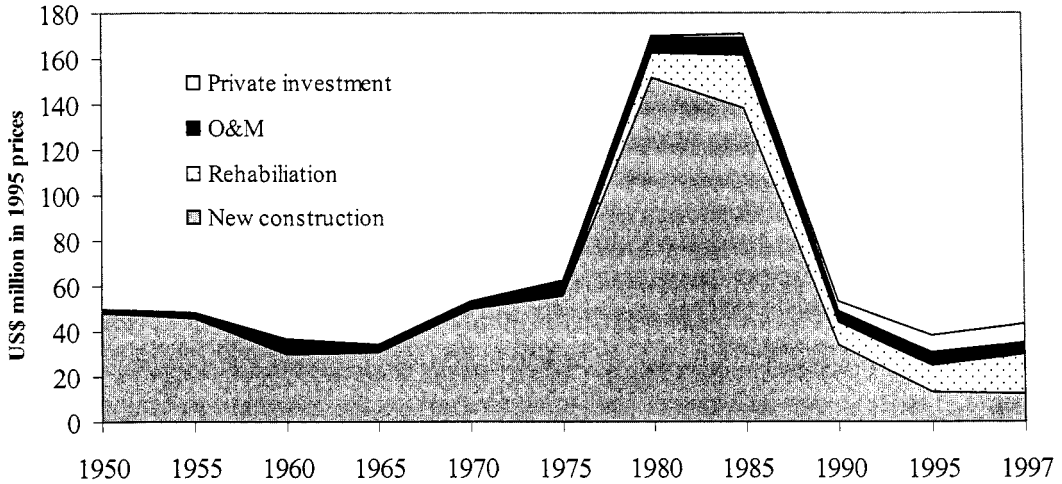
119. **Irrigation, together with new seed and fertilizer technologies, has been the main driver of agricultural productivity in the post-independence period.** Irrigation has been of particular importance for the rice sector, which has moved from producing 36 percent of the total domestic rice requirement in 1948 to supplying nearly all the country's rice needs today. In addition to maintaining rice self-sufficiency, the agricultural sector aims to further raise productivity and diversify into high value alternative crops.

120. **Poverty in Sri Lanka is closely linked with agriculture.** A large proportion of the poor are dependent on the agricultural sector for their incomes, with approximately 43 percent of principal income earners in poor households employed in agriculture. Less than 2 percent growth in this sector has contributed to keeping poverty at relatively at high levels. More rapid agricultural productivity growth is fundamental for reducing poverty in Sri Lanka since nearly 90 percent of the poor live in the rural sector. A JBIC study in 2002 highlighted the strong empirical evidence on the role of irrigation infrastructure on poverty alleviation. The findings suggest that incidence, depth and severity of poverty are highest in areas without irrigation.

121. **The rural population has shifted from farming as returns from agriculture have declined.** About 80 percent of the population was still based in rural areas in 2000, but only 23 percent of the mean earnings of rural households came from agriculture. The share of the workers employed in agriculture fell from 47 percent of total employment in 1990 to 36 percent in 1999. Workers employed in irrigated agriculture account for 18-20 percent of the total employed. At the same time, agriculture productivity per worker stagnated at around SLR 53,000 per annum (in constant 1996 price). Agriculture is becoming increasingly divided between a small dynamic sector concentrating on higher return fruits, vegetables and spices and a large, relatively stagnant sector producing paddy and tree crops. Domestic (especially tourist) and export demand spurs sector growth, while the reduction of import restrictions and relatively high cost restrict demand for the

stagnant sector. Much of the irrigated land is used for paddy production, which has seen its share of GDP fall from 28 percent in 1982-85 to 22 percent in 1996-2000.[4]

Figure 11. Investments in Sri Lanka by type of investment and their shares, 1950-97



Source: IWMI, 2002.

IRRIGATION SECTOR EXPENDITURE TRENDS

122. **Public investment and donor support for the irrigation sector has diminished.** The trends and composition of public irrigation expenditure in constant 1995 prices is given in Figure 11 and Table 13. Total public expenditure on irrigation has fallen to under 10 percent of its peak levels in the 1980s. Sri Lanka is not alone in experiencing a stark reduction in public investment in the irrigation sector. Irrigation investment fell from the 1980s onwards in other Asian countries due to fiscal pressures and foreign donor disenchantment with the low economic returns from investments in the sector. Total investment in agriculture has been declining at a similar rate to irrigation expenditure. Even as spending falls, irrigation continues to dominate total agricultural expenditure. During the late 1990s, irrigation represented a half of total public expenditure in agriculture (Table 14).

[4] World Bank, Sri Lanka: Promoting Agricultural and Rural Non-farm Sector Growth (Report No. 25387), February 26, 2003.

Table 13. Irrigation investments in Sri Lanka by type of investment and their shares, 1950-97 1/

	Investment (US million in 1995 prices)					Investment (US million in 1995 prices) Share (%)				
	Public investment					Public investment				
	New construction	Rehabiliation	O&M	Private investment 2/	Total	New construction	Rehabiliation	O&M	Private investment	Total
1950	48.2	.	1.8	.	49.9	96	.	4	.	100
1955	46.0	.	2.1	.	48.0	96	.	4	.	100
1960	30.0	.	6.2	.	36.3	83	.	17	.	100
1965	31.0	.	3.1	.	34.1	91	.	9	.	100
1970	49.8	.	3.9	.	53.7	93	.	7	.	100
1975	55.8	0.2	6.4	0.4	62.8	89	.	10	1	100
1980	151.4	11.3	6.8	0.6	169.9	89	7	4	.	100
1985	138.7	22.6	7.8	1.6	170.5	81	13	5	1	100
1990	33.8	10.1	5.3	4.5	53.5	63	19	10	8	100
1995	13.5	11.9	5.5	7.2	38.2	35	31	14	19	100
1997	12.1	18.0	5.1	8.6	43.5	28	41	11	19	100

Source: IWMI, 2002.
Notes. 1/ Five-year averages centering on the years shown.
2/ Investments on agro-wells and irrigation pumps by farmers.

Table 14. Sri Lanka: Percentage Share of Major Subsectors in Total Agricultural Expenditure, 1981-2000

	Average Share (%)			
Period	1981-85	1986-90	1991-95	1996-00
Subsector				
Plantation	4.2	11.0	15.3	12.1
Irrigation	79.6	62.6	49.9	50.5
Land Related	1.2	2.0	0.6	0.6
Crops	10.0	14.3	21.3	21.7
Others	5.0	10.1	12.9	15.1

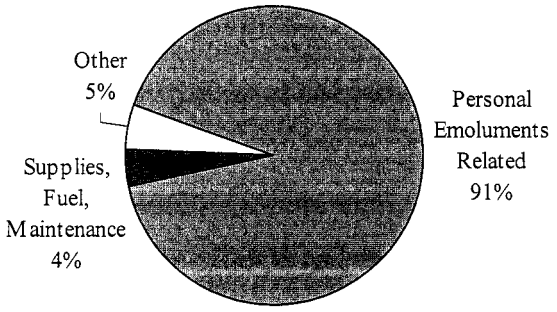
Source: World Bank, 2003 (Abeysekera, forthcoming).

123. **Expenditure on rehabilitation is largely driven by donors with insufficient beneficiary involvement.** New construction has declined substantially both in levels and as a share of total irrigation expenditure since the 1980s; a larger share of the irrigation budget is now devoted to rehabilitation and operation and maintenance (O&M). However, expenditure on rehabilitation has decreased to less than half its maximum level in the mid-1980s. The lack of a national policy, setting criteria and technical guidelines has by and large made system rehabilitation a donor driven exercise. Beneficiary contribution is stipulated (at 10 percent to 20 percent of tertiary improvement costs) in some donor projects, while in other donor and consolidated fund projects it is not, leading to inconsistency and inequity of approach. Beneficiary contribution entails consultation, leading to user-oriented improvements, quality control and a sense of ownership by the beneficiaries. This is vital if turnover of management is a condition of rehabilitation (e.g. MRRP-SIRP, NIRP etc.). With practices not consistent across the sector, the result can be two adjacent projects operating under different criteria, creating problems and confusion among the respective beneficiaries.

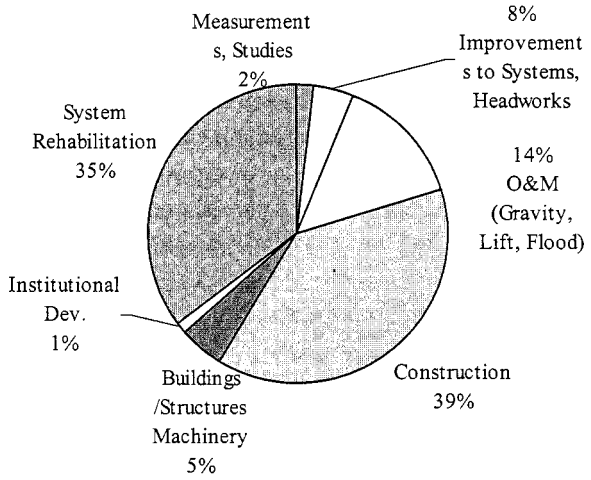
124. **Operation and maintenance (O&M) work is given inadequate priority and funding.** O&M expenditures have been falling since the mid-1980s, despite the slight increase in the irrigated area for this period. Nominal resources provided for O&M have declined by 30 percent since 2000. Inadequate funding has led to a rapid deterioration of canal systems, which results in a poor quality of water service to farmers and thereby contributes to low crop yields. Poor maintenance of the large dams and their major structural components has created potential safety risks and in turn potential threats to public safety.[5] The lack of O&M resources also bring about the need for repeated and expensive rehabilitation programs. The fact that donors support rehabilitation rather than O&M has led to the practice whereby O&M investments are substituted by shorter donor funded soft loan/grant rehabilitation cycles in order to overcome system deterioration. In a monsoonal climate where O&M costs remain high and in an environment of fiscal constraint, this practice has now almost become the norm.

Figure 12. Major Irrigation: Spread of Investments in 2003

Recurrent Expenditure SLR 527 Million



Capital Expenditure SLR 893 Million



* Head 310 – Project 02 & Head 853 – Project 1, 2, 3 & 4

[5] World Bank: Mahaweli Restructuring and Rehabilitation Project, Implementation Completion Report, May 2004

125. **A review of irrigation expenditure on major systems (> 80 hectares) over 2000-2003 reveals an inadequate provision for recurrent expenditure** (Figure 12). Recurrent expenditures for Irrigation System Management and Construction (policy is excluded) show that a major part of the provision goes to support personnel emoluments with meager 10-15 percent provision for operational support. The result is invariably that recurrent costs are charged to capital provision. For meaningful performance in relation to investment on high value human resources in the sector a more performance oriented ratio for operational support needs to be provided. While technical support in construction activities could be subsumed within capital provision, aspects such as institutional development work which could have a major impact on long term savings and specialized services vital for planning design, investigation etc. suffer.

126. **A low allocation for recurrent expenditure could be one reason why forward planning/programming of irrigation activities are not possible** and such services can only survive on provision made available through currently implemented activities from capital budgets. It would appear that a minimum provision of 25 percent needs to be provided in the recurrent budget to enable proper utilization of the human resources made available. Unless such a development occurs development of effective programmatic forward-looking planning for the sector will not be possible. Adequate provision for recurrent expenditure is crucial to ensure functional effectiveness of dedicated staff performing duties that cannot access funding from capital projects, such as monitoring and evaluation (M&E), project preparation, specialized technical services, etc.

127. **Presently around 35 percent of capital votes go to support recurrent expenditure.** Major costs such as vehicle fuel/ maintenance etc. were charged approximately 80 percent to Capital votes. The mixing of recurrent and capital expenditure streams leads to misallocation and distortions in use of resources. While it may be attractive to show large capital budgets the fact that really a third of such budgets go for recurrent costs anyway while gravely affecting programs that do not have support of capital projects leads to a skewed and distorted evaluation of performance. One reason for the low recurrent-to-capital ratio could be attributed to the lack of adequate operational provision under recurrent votes. For example, of the SLR 242 million, SLR 393 million and SLR 434 million in of recurrent expenditure in 1999, 2000 and 2001 respectively, approximately 91 percent, 89 percent and 92 percent respectively went for personnel emoluments. Adequate levels of recurrent operational costs need to be provided for balanced program implementation.

SECTOR POLICY AND PLANNING

128. **Sri Lanka has invested heavily in irrigation, but the results have been disappointing.** About 90 percent of irrigated land is taken up with paddy as a result of combined agricultural policies to promote rice production. This ties most farm households to low productivity activities, constraining the public sector from introducing charges needed to fund the maintenance of the irrigation system. The subsequent lack of fiscal funds continues to impede water delivery blocking farmers from diversification into higher value crops in many areas of the dry zone. The strategy must be to break this

vicious circle. The main challenges faced by the public sector in providing irrigation services are outlined in Box 2.

129. **A considerable problem faced by the sector is the political pressure to maintain supply driven free services.** First, this results an under-funding of the sector. Second, the lack of cost sharing of services and improvements by beneficiaries result in agency driven infrastructure development and rehabilitation. Third, the free public good nature of irrigation infrastructure attracts political leverage to be exerted to undertake local projects of doubtful economic viability, sometimes led by local interests and nexus between local political authorities and agency staff. Lack of proper technical investigation and economic and financial assessments result in cost over-runs and reduction of benefits with opportunities for attention to more viable projects being reduced. Political patronage precludes a rational transformation of irrigation agencies to provide services required under a new environment. Internal resistance to change, unless faced with severe financial crisis, is also a factor. Crucially, the lack of cost sharing encourages an inefficient usage of scarce water resources as farmers do not have any incentive to conserve water in line with its marginal cost.

Box 2. Main challenges for public sector in irrigation services provision

1) Transform the public sector role from provider of supply-driven free goods and services for the peasant based irrigated subsistence farming sector to supporter of commercially oriented viable farming enterprise development of small holder agriculture through management and cost sharing.

2) Development of an institutional and operational framework within which irrigation institutions will regulate through quality control and essential intervention rather than providing resources and services that may be effectively outsourced.

3) Address the political dimension of provision of free public goods and services. The irrigation sector remains the only sector where a unit of economic infrastructure costing up to and over Rs. 1 million is provided free of charge, together with subsequent follow-up services and improvements. These are given to persons without proven investment or other capability resulting in a supply driven expansion. Such a policy does not promote full employment, and invariably holds the recipient in a poverty trap and results in investment with inadequate returns for the economy.

4) Through augmentation, improvements, technology adoption and better management transform irrigation systems established earlier to provide only supplementary irrigation to systems being capable of providing higher incomes through full employment (250 man days/ yr).

130. Water resources need to be managed in an integrated fashion within a river basin context supported by a coherent water sector policy and institutional framework. Competition among different sectors and users for water has increased dramatically resulting in disputes and conflicts. A recent study forecasts that, if the current rates of high usage and low irrigation efficiency continue growing water scarcity would affect a number of predominantly poverty stricken rural districts by the year 2025. Therefore, an integrated water resources management approach is indispensable to strike a sustainable supply and demand balance of resources while complementing economic, social, and environmental development needs of the country and recognizing the inherent political dimensions. This is particularly true given that some major rivers are shared between the South and North-East areas which are presently in political conflict.

POLICY RECOMMENDATIONS

131. **Clear policy directions and criteria are required with respect to new development and expansion, especially where it may affect current availability of water to stakeholders in a basin and create greater irrigation and environmental problems.** While rehabilitation has been shown to have better economic returns, reduction in O&M provision coupled with take up for rehabilitation of those systems at high investment, where potential returns are low need re-examination. This calls for longer rehabilitation cycles which are now ever getting shorter with poor O&M.

132. **Budgetary allocation criteria and guidelines need to be established.** A focus on construction and sector ceilings on funding should not occur at the expense of adequate levels of O&M. High investment in "development" at the expense of O&M is self defeating. A fixed proportion of the budget should be allocated for O&M, while some rationalization of O&M provision between types of systems needs to be established. Provision for Head Works O&M is inadequate in relation to functions and responsibilities both in Irrigation Department (ID) and Mahaweli Authority of Sri Lanka (MASL). Similarly for O&M related institutional activities. Greater mileage from funds for rehabilitation & O&M with beneficiary contribution with linkages to farmers' organizations appears possible. In the context of operations of field canals through private sector, ID needs to develop and investment strategy that includes private sector as a player.

133. **Policy review and M&E of policy implementation is ancillary to expenditure and physical progress review and should be undertaken by the central planning units in the ministry and agencies.** As irrigation is an input to agriculture and a vehicle for poverty reduction, these efforts need harmonizing and integration. The Central Coordination Committee on Irrigation Management (CCCIM) could be the forum for integrating irrigation and agricultural policies and needs to be reconvened regularly. Policy studies offer opportunities for examination of policy gaps while reinforcing capacity building. Surveys and case studies help provide the necessary feedback for impact assessment of policy and implementation.

134. There is a need to transform the agencies involved in irrigation and reassess their mission/functions in line with overall economic and structural changes and the future investment strategy for the sector. Both ID and Irrigation Management Division (IMD) can transfer some ground level activities and take up more upstream activities focusing on water resource management through multi-disciplinary approaches. There is additionally a need for integration of O&M items, improvements, and rehabilitation with segregation from new development activities to ensure greater clarity with respect to investment. Need to adhere strictly to construction timelines, as take up of many new items in the context of sector ceilings, result in most initiated itemized works programmed for 1 to 2 years sometimes taking 5 to 7 years to compete with reduced annual budgets resulting in cost overruns and reduction in benefits. Even anniversary programs, such as Centenary Irrigation Agriculture Development Project, seem to continue far beyond anticipated conclusion of event.

135. While strategic plans, including six-year investment plans and pipe line projects were initiated by the Ministry of Irrigation and Water Management, **there is a mismatch and a lack of coherence in the implementation process,** due to: (1) Investment ceilings and funding constraints delay implementation of on-going projects and reduce opportunities for take-up new initiatives. (2) Increased ground level political pressures promote take up of "ad-hoc projects" and resources are directed to discrete activities rather than planned programmatic approaches, leading to distortions of intentions vis-à-vis goals. (3) New items funded through the consolidated fund invariably reflect very localized interests and though they should be channeled through the local authorities (Provincial Councils) by virtue of falling within their mandate are taken up at national level on the basis that they are within the major system classification (>80 ha). While Provincial Councils are generally unwilling to support these projects financially. Consequently, the investigation, planning, and design processes for such "itemized work" are mostly short circuited to meet political priorities leading to, (a) Take up of items even without proper preliminary investigation reports resulting in: complications to construction during implementation; escalation of costs through changes to the Technical Evaluation Committee during construction; reduction of benefits due to poor planning assumptions; delays due to unanticipated social/ land issues; doubtful financial/ economic viability. (b) Investment budgets are diffused and lack focus leading to: most local funding channeled to construction activities normally within purview of local authorities; lack of priority by other agencies affect realization of benefits due to problems in settlement, land development, agricultural extension or credit and social infrastructure; long gestation periods due to many competing items within investment and institutional capacity affects costs and benefits; reduced interest and investment to support program areas such as O&M, joint management and turnover, policy studies, specialized services and monitoring, project planning and design.

136. **The more feasible approach to reforming the water sector in Sri Lanka may be a "bottom up" approach for policy and institutional reforms as indicated by the Mahaweli Restructuring and Rehabilitation Project (MRRP).** A key lesson drawn from MRRP is that a practical approach to water sector reform is to involve water sector agencies and water users in pilot demonstrations and activities that incorporate the major policy recommendations and instruments (e.g. entitlements, farmer managed systems, bulk water based water management). Such a method is likely to be more fruitful rather than pushing a reform agenda on a purely academic/conceptual basis. Pilot interventions are likely to get more support from water users and agencies, particularly if the programs are action oriented and aimed at resolving real time and emerging water management problems and issues in river basins. The idea would be to get farmers closely involved in designing pilot interventions, and create strong links between bottom up reforms and investment to create the right incentives.

ANNEX

March 23, 2004 Draft

National Budget Circular No:

Department of National Budget,
Secretariat
Colombo

To: All Secretaries of Ministries
Chief Secretaries of the Provincial Councils
Secretary to the Finance Commission

Preparation of the 2005 Budget and Medium Term Budget Estimates in Consultation with Ministries

1. Introduction and Purpose of This Circular

To build on budget reform efforts and to assure that the 2005 Budget and the estimates for the subsequent two years reflect:

- the requirement of the Fiscal Management (Responsibility) Act No. 3 of 2003 to achieve a deficit not in excess of 5 % of GDP by 2006;
- the integration of policy priorities and expenditure;
- information on program performance, including the initial results of performance budgeting and the identification of performance indicators to measure progress in terms of results; and
- a sectoral perspective to priority setting and elimination of low priority and duplicative sectoral projects and activities;

the following procedures will be adopted for developing the 2005 Budget and the estimates for the two subsequent years.

2. Sectoral Consultative Committee on Budgets (SCCBs)

To strengthen the focus on priorities and performance over the medium term, the Ministry of Finance and the Planning Department will engage spending agencies in a dialogue from the outset of the Budget process. As a means of advancing this objective, Sectoral Consultative Committees on Budgets (SCCBs) for each sector (as shown in Annexure I) are being established. Depending upon their responsibilities, individual Ministries may be represented on more than one SCCB.

Please also be informed that Sectoral working groups already set up under the Public Expenditure Review Program supported by the World Bank, on Health, Irrigation, Education, and Social Protection will be absorbed into the appropriate SCCB.

3. Composition of the Committees

SCCBs will be comprised of Secretaries to the Ministries and Heads of Spending Agencies in each sector, officers from the Departments of National Budget, National Planning, Public Enterprises, External Resources, and Management Services as appropriate. In order to assist with the integration of policy priorities and the Budget, officers of the National Planning Department will be appointed to the appropriate SCCBs. Provincial Councils and representatives of the Finance Commission will also be co-opted to the SCCBs that are reviewing devolved subjects.

4. Objectives of the Sectoral Consultative Committees on Budgets

a) To review Sectoral priorities and re-define the role of each Ministry within the Sector, if necessary;

b) To identify issues pertaining to resource allocation within the Sectors, including duplication and overlapping of activities among Ministries within each sector;

c) To work with preliminary Sectoral budgetary limits and to ensure their most appropriate allocation.

d) Prepare Policy Notes for each sector on the basis of findings under (a), (b), and (c) above, including:

   i) an analysis of expenditure trends in the sector in general and sub-sectors in particular;

   ii) a review of cadre levels and distribution among projects to assure that staffing is aligned with administrative responsibilities and priorities;

   iii) comments/views on existing allocations of resources, policy priorities, and the current performance of the sector, drawing on a review of results, as measured by performance indicators, including those required by Budget Circular 111, dated July 31, 2003;

   iv) the identification of specific policy options and the recommended re-allocation of resources to priority areas in 2005 and over the medium term; and

   v) the identification of low priorities, including duplicated activities, that can be terminated to permit funding of high priority sector policies, programs, and projects.

Where sectors believe there is a case for any increase in the preliminary expenditure limit they must present a rigorous case for any such increase. For those sectors that have not engaged in developing a sector based strategy (strategic plan, master plan, a sector policy note as part of the public expenditure review process) the SCCB should focus particularly on expenditure trends and identifying options for eliminating duplicated functions.

5. Preliminary 2005 Expenditure and Cadre Limits

Preliminary expenditure and cadre limits for each sector are given at Annexure II. The starting point for these limits was the spending agency estimates for the year 2005 as shown in the printed 2004 estimates. The 2005 expenditure estimates have been increased, and there has been some reallocation between objects, to accommodate the estimated costs of the 2004 salary adjustments.

The challenging macroeconomic environment is illustrated in Annexure III. This provides the background against which SCCBs will have to ensure that they work within their limits and recognize that any increase in those limits will be at the expense of other sectors.

6. Activities to be Performed by SCCBs by mid-June, 2004:

SCCB meetings should initially focus on:

a) The identification of key issues confronting the sector;

b) A review and re-affirmation or adjustment of sectoral priorities; and

c) The identification of instances of duplication and overlapping activities.

Regular SCCB meetings to discuss progress and issues emerging from the work to date will be necessary.

On the basis of SCCB deliberations, the following should be forwarded to the Treasury by mid-June:

d) The Policy Note, containing a realistic assessment of the priority needs of the individual sectors in relation to the preliminary expenditure limits and the analysis referred to in 4 (d);

e) Distribution of the 2005 preliminary expenditure and cadre limits.

It is expected that SCCBs will fully engage their Ministers in the issues arising from SCCB deliberations.

7. Final Expenditure Ceilings

The Treasury will submit a Budget Framework Paper on the macroeconomic and fiscal outlook, cross-cutting issues, such as pay and employment, and proposed expenditure ceilings (after review of the recommended allocations of the SCCBs) for the approval of the Economic Policy Committee of the Cabinet by the end of July 2004. Upon approval of same by the Economic Policy Committee, such approved ceilings will be conveyed to the SCCBs for final agreement on ministry/sub-sector allocations.

8. Submission of Estimates for 2005 and Projections for 2006 and 2007

On the basis of the final 2005 expenditure and cadre ceilings approved by the Economic Policy Committee, and the sub-sector/ministry allocations within the final sectoral ceilings agreed

by the SCCBs, Secretaries to Ministries should submit final 2005 estimates and expenditure projections for the years 2006 and 2007 to the Treasury by end of July 2004.

9. Preliminary SCCB Meetings

In order to discuss the logistics of SCCB operations, including arrangements for chairmanship of each SCCB, an initial meeting for each sector will be scheduled by the Director General of National Budget for the last week of April, 2004. Additional guidance on the role and functions of SCCBs and on what might constitute a case for any variation to the preliminary limit to be entertained will also be provided at this meeting.

Your active participation in the Budget preparation process is solicited in order to ensure the optimal allocation of scarce resources.

Secretary to the Treasury