

Country Study

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***Southern Perspectives on
Reform of the International
Development Architecture***

Sri Lanka

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List of abbreviations and acronyms

ADB	Asian Development Bank
ARPP	Annual Review of Project Performance
BWIs	Bretton Woods institutions
CEB	Ceylon Electricity Board
CFA	Ceasefire Agreement
ERD	External Resources Department
FDI	foreign direct investment
GDP	gross domestic product
HIPC	Heavily Indebted Poor Countries
ICP	IDA Country Performance
IDA	International Development Association
IFIs	international financial institutions
IMF	International Monetary Fund
INGOs	international non-governmental organizations
JBIC	Japan Bank for International Cooperation
JICA	Japan International Cooperation Agency
JVO	Janatha Vimukthi Peramuna
LTTE	Liberation Tigers of Tamil Eelam
MC	Mahinda Chinthanaya
NGOs	non-governmental organizations
OCR	Ordinary Capital Resource
PBA	performance-based allocation
PRGF/EFF	Poverty Reduction and Growth Facility/ Extended Fund Facility
PRS	poverty reduction strategy
PRSCs	Poverty Reduction Support Credits
PRSPs	Poverty Reduction Strategy Papers
RDA	Road Development Authority
RSL	Regaining Sri Lanka
SAPs	Structural Adjustment Programs
SIDA	Swedish International Development Agency
SLFP	Sri Lanka Freedom Party
SMEs	small and medium size enterprises
TA	Technical Assistance
TETD	Teacher Education-Teacher Deployment
UNHCR	United Nations High Commissioner for Refugees
UNOCHA	United Nations Office for the Coordination of Humanitarian Affairs
UNP	United National Party
WB	World Bank

Summary

This paper is written as part of an overall study on Southern perspectives on reform of the international development architecture. Sri Lanka's case study as expressed in this paper is one of particular interest. The present government is pressing for increased policy space from donor imposed conditions in the backdrop of the country's present circumstances as a conflict country with substantial aid reliance given the urgent requirement for investment in public infrastructure. These conflicting needs of increased funding and greater policy space have pushed the government towards alternative sources of finance, moving beyond the concessional lending of international financial institutions, towards commercial borrowing and emerging bilateral donors. The paper explores the opportunities and challenges offered by this new path. It provides some background information on Sri Lanka's recent relationship with international donors including the roles played by the Bretton Woods institutions, the UN system, bilateral donors, and NGOs.

Two key thematic issues in the relationship between Sri Lanka and the international aid architecture are highlighted – leadership and legitimacy. The paper examines the extent to which donors drive the development agenda in the country. The research finds that whilst in theory aid projects are very much government driven, in practice donors exert significant influence through project proposals, donor research, and consultancy. The extent of donor influence is very much contingent on the capacity of line ministries, and in many cases the lack of capacity at this level has resulted in a donor driven agenda. The paper outlines issues emerging from the political conditionality of aid, questioning the use of “development assistance” as a political tool. Sri Lanka's unsatisfactory experience with general budgetary support during the PRSP implementation is touched upon, as well as the relatively lower levels of macroeconomic conditionality associated with project-based lending that is preferred today. The paper also looks at emerging issues in project-based lending, in particular the impact of loan covenants and safeguards, and debates the role played by donors in such matters.

Sri Lanka's perspectives on donor reform initiatives including the Paris Declaration are reflected upon in the paper. A key finding is the very low level of awareness of the Paris Declaration in Sri Lanka – resulting in a failure to take advantage of opportunities provided to recipient governments through this agreement. However, it was also found that many of the initiatives have been implemented unilaterally in Sri Lanka, particularly donor coordination and harmonisation efforts. Other key aid reform issues such as the scaling up of aid, the use of performance-based allocations, and technical assistance are discussed from a Sri Lankan perspective in the paper. To conclude, the paper provides recommendations for reform – both from a donor perspective and recipient country perspective.

PART A

DEVELOPMENT CONTEXT

Sri Lanka is a small island nation of 20 million people south of India. Having obtained independence from Britain in 1948, Sri Lanka has endured a fluctuating journey of development in the ensuing 60 years. Being a small nation Sri Lanka realized the importance of an open economy and in 1977 became the first South Asian nation to liberalize its trade regime. This was followed by extensive infrastructure investments in the 1980s supported by foreign donors. However, civil conflict since the 1980s has stunted Sri Lanka's development and has contributed to its inability to realize its potential as an economic force in the region.

Sri Lanka has had a longstanding relationship with international donors and the changing aid architecture. The World Bank (WB), the Government of Japan and the Asian Development Bank (ADB) have been long-time development partners of the Government of Sri Lanka and have dominated aid to the country. At present there is a shift in this longstanding relationship. New donors are emerging and there has been an increase in commercial borrowing in the wake of another wave of infrastructure development in the country. In this context, it is an apt moment to reflect on Sri Lanka's relationship with the international development architecture and examine perspectives on economic reform.

KEY DEVELOPMENT CHALLENGES

Security

Sri Lanka has been engulfed in a war in the Northeast of the country since 1983. Tamil rebels, the Liberation Tigers of Tamil Eelam (LTTE), have been fighting government forces for a separate state in the North and East of the island. The conflict has resulted in more than 60,000 deaths and, while the outright warfare has been limited to the North and East, there has been spillover in the rest of the country, including numerous bombings in the capital city, Colombo, and in several other major cities, including Kandy, Galle and Anuradhapura. At present the conflict is governed by a ceasefire agreement (CFA) that has been in place since 2002. However, since late 2005 there has been a sharp escalation in hostilities between the government and the LTTE. The recent attempts at peace talks in June 2006 broke down in Oslo, Norway. The Northeast conflict has been the most significant curb on development attempts in Sri Lanka for several reasons. The continued violence has brought economic activities to an almost complete halt in the region which includes two-thirds of Sri Lanka's coastline; a large proportion of the population (14 per cent of Sri Lanka's population) live as refugees and infrastructure in the region has been decimated by fighting. The combined GDP of the once prosperous North and East provinces make up just eight per cent of national GDP (Central Bank of Sri Lanka, 2003). The population in the region has limited access to effective economic infrastructure, services and markets, presenting a critical development challenge.

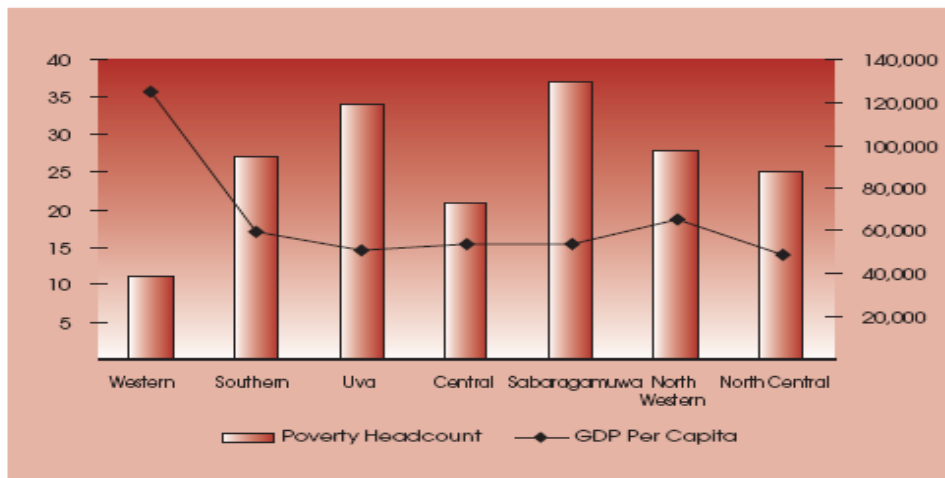
The civil war has had a wide-ranging impact on the economy, beyond the geographic limits of the Northern and Eastern provinces. The private sector has been deterred from investing in long-term projects due to security concerns and political instability. Several national leaders have been assassinated by the LTTE, including a former president, presidential candidates and leading cabinet ministers, and there has been an attempted assassination of another former president, resulting in political instability and weakening political leadership. These same threats have significantly curbed both foreign direct investment (FDI) and tourism (Arunatilake, *et al.*, 2001). Military expenditure by the government diverts resources from the financing of economic production and puts further strain on public funding, which is already a significant problem (see below). Another major outcome of the civil war has been the brain drain. Sri Lanka's human resources have been depleted by an exodus of some of its finest minds over the last 24 years, many of whom fled after the communal violence in 1983 and in the ensuing years due to the security concerns in the country.

Concentrated Economic Growth

GDP growth in Sri Lanka has been steady but has not quite reached potential. Average growth was around four to five per cent through the 1990s and up to 2005, but has picked up since 2006 when the growth rate reached 7.4 per cent. However, the benefits of this growth have been unevenly distributed. When considering national aggregates, Sri Lanka's Gini coefficient has increased from 0.48 in 1996 to 0.50 in 2004, indicating that the benefits of growth have been relatively concentrated among the wealthy sectors of the country.

In terms of geography, GDP has been concentrated in the urban Western province, with 49.4 per cent of national GDP coming from this province. None of the other provinces contribute more than 10 per cent of national GDP, with certain provinces being particularly low contributors, such as the Northern province (2.7 per cent), North Central (3.9 per cent) and Uva (4.4 per cent). This is a significant problem as the differentials between the urban West and the predominantly rural remainder of the country have become increasingly stark. While the Western province has managed to pull down poverty rates to below 10 per cent, provinces such as Uva and Sabaragamuwa have poverty rates around the 40 per cent mark, and this is expected to be even higher in the North and East where conflict rages.

GDP Per Capita and Poverty Headcount, 2002



Source: World Bank

However impressive the national aggregate achievements are, the results are hollow if the benefits have failed to filter down to the rural poor. The sustainability of any economic reforms or political regimes also rests on the ability for benefits of these processes to be felt by the vast majority of the country as opposed to a concentrated minority. Steps have been taken in the past to address this problem, such as the *Gamudawa* movement in the 1980s and the *Samurdhi*¹ scheme in operation since 1994. However, these have not been very well targeted. For instance, the Western province has twice as many *Samurdhi* beneficiaries as its share of the poor (IPS, 2006). The present government has recognized this problem and has taken steps to upgrade infrastructure in rural regions, and a strong focus of the current policies is geared towards spreading the benefits of economic growth to hitherto unprosperous regions.

¹ Income transfer scheme aimed at targeted poverty alleviation.

Public Finances

Sri Lanka's recent history of fiscal management has been weak, as the following table indicates.

Table 1: Selected indicators of public finances: 2002-2006

%GDP	2001	2002	2003	2004	2005	2006
Revenue	16.7	16.5	15.7	15.4	16.1	17.8
Expenditure	27.5	25.4	23.7	23.5	24.7	26.9
Budget Balance	-10.8	-8.9	-8.0	-8.2	-8.7	-9.1
Public Debt	103.2	105.4	105.8	105.5	93.9	93.0

Source - CBSL Annual Report, various issues.

Expenditure has consistently exceeded revenue. However, provisional figures for 2006 suggest that revenue collection has improved following tax reforms, reaching 17.8 per cent of GDP.² Nonetheless, the budget balance has further deteriorated in 2006 due to even higher expenditure amounting to 26.9 per cent of GDP, resulting in a deficit of 8.5 per cent of GDP. Encouragingly much of the 2.2 per cent of GDP increase in expenditure in 2006 has been focused on capital expenditure. However, recurrent expenditure remains high and requires rationalization, particularly in terms of poorly targeted subsidies and a ballooning bureaucracy. Expenditure on salaries increased from 5.2 per cent of GDP in 2004 to 5.9 per cent of GDP in 2005. Current transfers and subsidies also increased from four per cent of GDP in 2004 to 5.4 per cent of GDP in 2005. The resulting high levels of public debt remain a concern. The fall in public debt to 93 per cent of GDP in 2006 appears encouraging but, as can be seen, this is not due to a fundamental improvement in public finance management as the budget deficit has been increasing. This fall in public debt could be better explained by the increase in nominal GDP. The underlying problem of poor management of public finances remains a concern.

Debt service payments are a major opportunity cost of maintaining a high public debt: in 2005 total debt service payments amounted to Rs. 344.9 billion, which makes up 91 per cent of government revenue and 14.6 per cent of GDP. This figure would have been greater if not for the Rs. 26.3 billion debt moratorium as tsunami relief in 2005. A second problem is the inflationary pressure that results from excessive budget deficits, particularly when the deficit is financed by bank borrowing. Inflationary pressure has also been a problem in Sri Lanka with inflation hitting 19.3 per cent on a point-to-point basis in December 2006, while the official 12-month moving average reached 13.7 per cent in the same month. This is a problem as inflation undermines investment in long-term projects by the private sector due to increased perception of risk. The Central Bank has tightened monetary policy by increasing the Treasury Bill rate to 11.5 per cent, which again acts as a deterrent to private investment.

Table 2: Government debt indicators

Indicator	2004	2005	2006
Government Debt / GDP	105.5	93.9	93
Foreign Debt / GDP	49.1	40.4	40.5
Foreign Debt / Exports	134.9	120.7	127.7
Total Debt Service / GDP	14.8	14.3	15.9
Total Debt / Service/ Government Revenue	96.5	91.0	93.1
Foreign Debt Service /Exports	6.4	3.6	7.1

Source Central Bank of Sri Lanka Annual Report 2006

² Budget 2006 estimates.

Infrastructure

Weak physical infrastructure has contributed to distortions in economic development between the regions. There is only limited connectivity between the urban Western province and rural regions due to poor road and rail infrastructure, limited telecommunications infrastructure and limited power and energy infrastructure. Sri Lanka faces problems in the energy sector on two fronts. First, the country has one of the most expensive electricity charges in the region due to inefficiencies within the state-owned Ceylon Electricity Board (CEB) (World Bank, 2005). The second and related problem is that Sri Lanka is a net oil importer and has faced a significant external account constraint due to increases in world oil prices.

According to Central Bank figures, the CEB is expected to post a Rs. 20 billion loss in 2006, mainly due to selling electricity below cost. Despite the CEB selling below cost, due to reliance on liquid thermal energy, Sri Lanka faces among the highest per unit energy costs in the region. Delays in the implementation of other energy sources, such as the coal power plant in Norochchalai, have forced this reliance on liquid thermal energy. The proposed new power generation projects (mentioned below) are in progress but will not be completed till at least 2011. According to the Central Bank, Sri Lanka's electricity supply needs to increase by 1.5 to 2.0 per cent to realize a 1.0 per cent increase in economic growth. The reform of the CEB began in 1996, but little progress has been made in terms of meaningful outcomes.

Political Instability

Political instability has been a major impediment to sustained economic reform and policy making, particularly in the new millennium. Sri Lanka is a constitutional democracy with two main political parties, the governing Sri Lanka Freedom Party (SLFP) and the opposition United National Party (UNP), while the Marxist Janatha Vimukthi Peramuna (JVP) is the third significant political party. Sri Lanka's constitution enshrines a proportional representation system to determine which party can form a government out of the 225-member parliament. In recent history, no party has been able to form a strong majority and elected parties have been forced to engage in fragile political coalitions with minority parties. As a result, it has been difficult to push through contentious economic reform programs. Furthermore, Sri Lanka has a political system akin to that of France where the president and governing parliament can be of two different parties. While in theory this ought to be a form of checks and balances, in practice it can result in political instability. This was manifest in Sri Lanka for the first time in 2002-2004, and resulted in conflict which saw parliament dissolved in 2004. Another result of this lack of political stability is a very short election cycle. There were major elections (presidential and parliamentary) on five occasions between 1999 and 2005, and often the policies put in place by the incumbent body were reversed by the newly elected body. In fact, since 2001 Sri Lanka has seen three separate development plans in action — Regaining Sri Lanka (RSL) under the UNP in 2002, Rata Perata under the SLFP of President Kumaratunga in 2004 and the Mahinda Chinthanaya (MC) under President Rajapakse's SLFP in 2005. The limited chance for a cohesive policy package to evolve into some productive outcomes is certainly a great challenge that needs to be overcome for economic development to take place. The lack of policy continuance undermines investment decisions by both private firms and potential foreign direct investment (FDI). Trade union action, often backed by political parties, is another frequent disruption to the progress of the Sri Lankan economy. In 2006 alone there were major strikes in the Colombo port which lasted for a month in July, disrupting not only shipping services but having an impact that was felt throughout the economy. A plantation strike in November and December 2006 resulted in losses of over Rs. 1 billion³ to the sector, and the resultant wage hike incurred a cost to the plantation companies close to Rs. 3 billion per annum.

³ www.lbo.lk , "Closing Talks", December 19, 2006.

FRAMEWORK FOR COUNTRY-LED DEVELOPMENT

The policy approach of the MC is a departure from the market-led economic policies championed in the RSL. The MC takes a far more interventionist stance and attempts to address the areas that have been neglected by three decades of neo-liberal market reforms: “The new approach integrates the positive attributes of market economic policies with the domestic aspirations by providing necessary support to domestic enterprises and encouraging foreign investments.” The key focus areas of the MC are infrastructure development, particularly in rural areas, agriculture, and small and medium industrial development, all under a general theme of poverty reduction and equitable growth.

Infrastructure Development

The planned investment rate is around 32 to 38 per cent of GDP, while the savings rate remains around 25 per cent of GDP, but the government expects this to increase with growing incomes. The government is also expecting a relatively large current account deficit in the short run given the increased use of foreign finances in plugging the investment savings gap, particularly for infrastructure projects. The MC focuses on developing the basic infrastructure and other services in rural areas – electricity services, telecommunications, drinking and irrigation water, access roads, agricultural storage, health and education facilities. The 10-year plan⁴ envisages three coal fire plants to be completed with a total capacity of 2,000MW, along with five hydroelectric plants with a capacity of 410MW. Fifteen per cent of electricity needs are expected to be supplied by non-conventional renewable energy sources. These projects will be funded by public-private partnerships, concessional financing from overseas, bilateral assistance and commercial borrowing by the CEB for certain projects. Improving rural connectivity and access to markets through improved transport networks is another focus area. The highways planned include the Southern expressway and the Colombo-Katunayake (airport) highway, along with two others totalling US\$1 billion. The major road projects include three general national road network development projects and development of some specific highways. The total cost is envisaged to be US\$390 million. Funding will be supported by the ADB, the Japan Bank for International Cooperation (JBIC) and the World Bank in the three general road network development projects. Fifty-two per cent of the financing will be met by foreign funding while the rest will be made up of government financing and public-private partnerships. The government is also aiming to upgrade seaports and airports in Sri Lanka. Assuming increased sea traffic going through Sri Lanka and the ever-increasing need for efficient service delivery, the 10-year plan includes steps to construct the Hambantota seaport (US\$300 million) and Galle seaport (US\$150 million) and to upgrade the Colombo port (US\$220 million) with funding from the ADB. The second airport in Sri Lanka will also be built under the 10-year plan in Weerawila in the Southern province at a cost of US\$125 million.

Irrigation and Agriculture

The government plans to encourage new areas of growth to what has been a stagnant sector. The state aims to encourage improved use of technology through state investment assistance. The state also recognizes the need to step into research in the sector, given private sector reluctance to invest in research and development because of the limited intellectual property rights in Sri Lanka. Agricultural investment has been identified as requiring government and donor funding. Resources are already available to fund the first five years of the development plan. Government funding will account for 50 per cent, donor funding for 34 per cent and the private sector for 10 per cent of this agricultural investment. Investment in irrigation consists of 10 major projects over the next decade, with total funding of US\$210 billion. The funds will be made up of 40 per cent government funding, 30 per cent from international donors and 15 per cent in private funding.

⁴ Mahinda Chinthanaya: Ten Year Development Plan, Department of National Planning, GoSL, 2006.

Challenges

The 10-year plan is an extensive and all encompassing document with ambitious goals and targets. However, there are a number of challenges that will need to be overcome in order to successfully implement this plan.

1) Macroeconomic framework. The 10-year plan entails a significant amount of government expenditure and, though revenue collection has improved due to economic growth and improved tax administration, it is unlikely that this will be sufficient to curb the large public debt that now stands at 94 per cent of GDP. Inflation too is a worry and reached 17.3 per cent (annual average inflation) in April 2007. This has forced a more stringent monetary policy (11.5 per cent inter-bank lending rate) which could crowd out the private sector investment needed to play an important role in the development process. Furthermore, given increases in defence expenditure levels, it would be a great challenge to maintain a stable macroeconomic environment for sustained continued private sector growth – the ultimate aim of government intervention in the short run.

2) Sustainability of commercial borrowing. The government has shifted its development-oriented borrowing from concessional borrowing from international financial institutions (IFIs) to commercial borrowing and bilateral assistance. In 2006, Sri Lanka borrowed US\$680 million from commercial sources,⁵ up from US\$106 million in 2003, with no commercial borrowing in 2004.⁶ Sri Lanka went for its first international credit rating in 2005 and received a stable BB- rating from Fitch Ratings. However, with the escalation of the conflict, this rating was downgraded from stable to negative. Sri Lanka also carries a “Junk Bond” B+ rating from Standard and Poor’s with a negative outlook. Agost Bernard of Standard and Poor’s explained the ratings thus: “The ratings on Sri Lanka reflect the high level of government indebtedness and weak revenue mobilization, together with security concerns posed by the unresolved conflict with Tamil separatists.”⁷ Given this decline in ratings, and no immediate prospect of cessation of hostilities, commercial borrowing will be increasingly difficult to sustain, particularly given the present debt levels in the country. The government may have to resort to more bilateral financing or to return to concession lending from the IFIs.

3) Effective expenditure. The aim of government intervention in the economy is to foster growth and poverty alleviation, particularly among hitherto economically stagnant regions and communities. In order to achieve this, it is important that the government ensure that the large part of its resources is spent on productivity enhancing activities rather than income transfers. The former will lead to sustainable long-term growth while the latter is less sustainable and more of a short-run solution to poverty alleviation. Unfortunately the 10-year plan at times leans towards the latter. The following are cases in point:

Agricultural expenditure – 33.4 per cent of the budget for agriculture will be spent on the fertilizer subsidy, while technology research will receive only 1.9 per cent.⁸

Labour – Expenditure on unemployment insurance, occupational health and safety, and welfare of migrant workers comes to Rs. 3.6 billion out of the Rs. 19.3 billion budget for the labour market over the next decade. At the same time, the program to improve national productivity receives only Rs. 0.8 billion during this period.

⁵ US\$580 million in Sri Lanka Development Bonds and US\$100 million in syndicated loans (Central Bank press release 26/12/06).

⁶ Foreign Aid Review, 2004.

⁷ www.lbo.lk, “Big Government”, January 28, 2007.

⁸ Table 4, page 13, Mahinda Chinthanaya, Ten Year Development Plan.

Industry – Financial assistance for small and medium size enterprises (SMEs) makes up Rs. 21.5 billion out of a budget of 48.4 billion (44.4 per cent), while productivity, quality and skills development programs receive Rs. 135 million – a miniscule proportion.

The second challenge for the government will be to reverse a trend of wastage of public finances, particularly through a large (and expanding) bureaucracy. Large amounts of spending alone will not help alleviate poverty. It is essential that the expenditure is not wasted and is channelled to its best possible use. Effective budgeting, monitoring and evaluation of programs, preferably by third-party audits, would be key to implementing the MC in an effective and useful manner.

MAIN GOVERNMENT BODIES THAT INTERACT WITH THE IDA

External Resources Department (ERD)

The ERD falls under the Ministry of Finance and Planning. It is the government agency responsible for mobilization of official development assistance (ODA), including technical cooperation. The department is involved in identifying and prioritizing development assistance strategies, and also coordinating donor activities with the requirements of line ministries. The ERD is also tasked with negotiating foreign aid and making loans/grants effective. Indirect monitoring of donor-funded projects in conjunction with line ministries is part of the mandate of the ERD. Under technical cooperation, the ERD must manage foreign training programs with the consultants and volunteers from donor agencies.

Department of Foreign Aid and Budgeting

This department has a mandate to monitor all development work of the government but with special emphasis on foreign-funded projects. The Department of Foreign Aid and Budget is mandated to “monitor the implementation of Foreign Funded Projects; the utilization of foreign aid and intervene to accelerate the implementation of development projects and programs.” The department is also expected to work towards improving aid utilization levels, and to improve foreign aid disbursement.

Ministry of Finance and Planning

This is the main ministry for preparation of national development programs and management of financial resources. It is the main overseeing body of coordination with international agencies, donors and international financial institutions, and in mobilizing foreign resources. The Department of Fiscal Policy and Economic Affairs also falls under the Ministry of Finance and Planning and handles all matters related to the International Monetary Fund (IMF).

PART B THE CURRENT INTERNATIONAL DEVELOPMENT ARCHITECTURE

In 2006 Sri Lanka received US\$1.220 million in foreign aid commitments, the highest aid commitment in the recent past. This consisted of US\$1.025 million in loans and US\$95 million in grants. The Government of Japan disbursed US\$262.5 million, World Bank US\$100.2 million, the ADB US\$174.9 million and the Government of Germany US\$55.2 million in the year 2006. At the same time, the government took two major syndicated commercial loans in 2006, amounting to US\$100 million from Citibank and US\$50 million from HSBC. The rest of the figures in this section refer to the 2004 statistics from the Department of External Resources, since data beyond 2004 will be skewed by the impacts of tsunami assistance.

Table 3: Foreign aid commitments 2004

Donor	Amount (US\$ Million)	% of total foreign aid
Asian Development Bank	387.5	34 %
Government of Japan	286.6	25 %
World Bank	236.4	20 %
UN Agencies	25.5	2 %
IFAD	24.9	2 %
Government of China	24.4	2 %
Government of India	25.0	2 %
Government of Sweden	41.7	3 %
Saudi Fund for Arab Economic Development	10.9	1 %
USA	13.8	1.2 %
Government of Germany	10.0	1.0 %
Government of Norway	2.1	0.4%
Government of the Netherlands	2.7	0.4%

Source Foreign Aid Review 2004

This aid in 2004 was in the form of loans, grants and technical cooperation. Loans accounted for 81.5 per cent of the total commitment (US\$961 million) and grants accounted for the remaining 18.5 per cent.

Table 4: Foreign aid commitments 1999-2004 (US\$ million)

Years	1999	2000	2001	2002	2003	2004
Loans	640	351	687	779	914	961
Grants	71	96	67	111	144	219
Total	711	447	745	890	1058	1180

Source Foreign Aid Review 2004

Table 5: Foreign aid commitments by type of financing 1999-2004 (US\$ million)

Source	1999	2000	2001	2002	2003	2004
ODA	587 (92%)	235 (67%)	610 (89%)	728 (93%)	739 (81%)	876 (91%)
Export credit	53 (8%)	18 (5%)	77 (11%)	51 (7%)	69 (8%)	85 (9%)
Commercial borrowing	0	97 (28%)	0	0	106 (11%)	0
Total	640	350	687	779	914	961

Source Foreign Aid Review 2004

Table 3 shows a breakdown of foreign aid received by Sri Lanka in terms of the types of financing. Over the five-year period in question, overseas development assistance dominated the shares of foreign aid commitments. This trend is changing with the government undertaking commercial borrowing in 2006. It can be seen that almost 80 per cent of lending is through the ADB, World Bank and the Government of Japan. The UN system and bilateral lending had a smaller role to play in 2004. However, this trend is

expected to change with the government's increasing interest in bilateral assistance. This section will provide some information on the role of the main institutions of the international development architecture in Sri Lanka. This will take into account the amount of lending and the influence of the institution on macro level policy-making by the government.

ADB - The ADB has operated in Sri Lanka since 1968. Over the past 40 years ADB funding has been focused on the following sectors: agriculture 38 per cent, social infrastructure 20 per cent, finance and industry 15 per cent, energy 12 per cent, and transport and communications about 14 per cent. ADB has also provided \$55.7 million for 162 technical assistance (TA) projects, of which 94 were advisory and 68 for project preparation. The main sectors that have received TA are agriculture and natural resources (42 per cent), social infrastructure (20 per cent), transport and communications (14 per cent) and finance and industry (eight per cent). However, of late the majority of ADB projects have focused on physical infrastructure, such as roads, highways, ports and the energy sector. ADB loans have become less concessionary as Sri Lanka's per capita income has increased. Fewer loans are from the Special Fund Resources (30 year maturity at 0.5 per cent interest per year). About US\$70 million a year worth of loans are drawn from this fund. Ordinary Capital Resource (OCR) lending is now on the increase. These have maturity of anything between 12 and 20 years and have higher rates of interest (LIBOR + 0.6 per cent). ADB lending is governed by a system of performance-based allocation similar to that of the World Bank, where country-specific allocation is determined by the borrower's per capita gross national product, the size of its population, and performance of its economy. Sri Lanka's specific lending factors include macroeconomic management, structural policies, poverty reduction policies, protection of the environment, governance and public sector management and portfolio performance.

Despite the said conditionalities, the ADB is generally perceived as being more flexible in its lending practices. For instance, while program-based funding from the World Bank and IMF have ended since the change of government in 2004, the ADB has recognized the change in the government stance away from "orthodox" neo-liberal practices and altered its funding patterns to better fit this alternative approach by the government. "The government is committed to increasing role of the state while leaving room for private sector development. The ADB as a result has had to alter its programs to take this change into account."⁹ An example of this is how ADB assistance changed when the present government ruled out privatization of state institutions as an option. The ADB's initial assistance in privatizing the People's Bank was altered to support restructuring the institution instead. The ADB also halted a program that aimed to increase private participation in agriculture. Another interesting ADB approach concerns the peace process. At the Tokyo donor conference of June 2003, US\$4.5 billion was pledged by donors but tied to performance of the peace process. With the failure to effectively pursue the peace process, much of this funding has not been disbursed. The ADB, however, has not curtailed lending due to lack of progress in the peace process, but instead has attempted to tailor lending to best suit the need of the hour. The following extract from the Country Strategy for 2006-2008 is testament to this endeavour: "Continued investment to improve living conditions and provide economic opportunities in areas affected by conflict areas, together with heightened sensitivity about how post-tsunami and post-conflict reconstruction are implemented, are the most tangible contributions that ADB can make to consolidating peace."¹⁰

Government of Japan – The Government of Japan has been a key lending partner of Sri Lanka ever since the two countries commenced diplomatic relations in 1952. The present focus of Japanese ODA has been in support of peace building and in economic and social infrastructure, institutional reform, measures for acquisition of foreign currency and poverty alleviation.¹¹ Japanese aid to Sri Lanka is channelled through the Japanese International Cooperation Agency (JICA) and the JBIC, and one cannot

⁹ ADB (2005), 'Country Strategy for Sri Lanka: 2006-2008', ADB Publication.

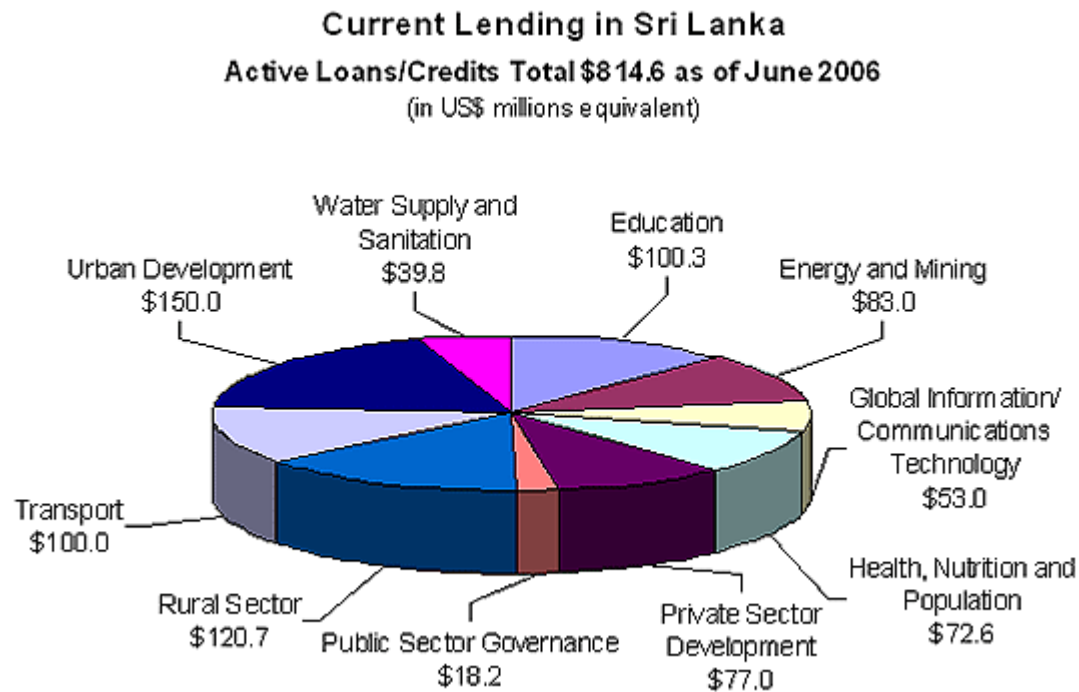
¹⁰ Ibid.

¹¹ Japanese Embassy.

ignore Japan's contribution to the ADB. The vast majority of Japanese aid has been untied and at a concessional rate. Furthermore, the aid has very closely tracked the key development challenges in Sri Lanka, focusing on issues such as physical infrastructure, the conflict, rural inequalities and the energy sector. This is elaborated in Part A. Japanese ODA consists of loans, grants and technical assistance. JBIC's assistance is dominated by untied concessionary loans, while JICA's funding consists of a mix of loans, grants and TA. In 2005, Japan provided ¥1.1 billion worth of grants to Sri Lanka and ¥30 billion in loans to Sri Lanka, and as of 2004, 6,044 Sri Lankan citizens have been received as trainees by the Government of Japan and 1,172 Japanese technical consultants have been dispersed to work in Sri Lanka.

Japanese lending is looked upon very favourably by the Sri Lankan government due to a close working relationship between the two countries on matters of aid. These are conducted in a very diplomatic manner with the Japanese imposing little donor pressure. Whatever reforms are suggested are considered by the Sri Lankan government but Japan tends to consider issues from the recipient's point of view, which therefore allows them to be more flexible in lending. Another positive factor has been the fact that Japanese aid has been stepped up to meet the increased demand for aid following Sri Lanka's present infrastructure drive. The average annual aid delivery from Japan is ¥32 billion, while this year it has increased to ¥39 billion. There has not been a similar response from the other major donors, forcing Sri Lanka to take on expensive commercial borrowing and look to alternative donors.

Bretton Woods Institutions (BWIs) - The World Bank has had a long relationship with Sri Lanka. In fact, the first Bank credit to the country was signed in 1954. The assistance is provided in the form of grants and interest-free loans (known as credits) from the World Bank's International Development Association (IDA). The major areas of support identified by the Bank include sustaining the peace process, boosting economic growth through improving environment for private sector activity and increasing equity through improving access to public services. At present there are 16 active operations under Bank funding. The total value of these is US\$806.6 million and an undisbursed balance remains of US\$519.7 million.



Source – World Bank

At present the Bank's focus is on project-based lending with an emphasis on development of human and physical capital (roads, education). The program lending which occurred in the 2003-2004 period came to an end when the Sri Lankan government abandoned the then Poverty Reduction Strategy Paper (PRSP) on which Bank funding was based. The Country Assistance Strategy of 2006 states that following the abandonment of the PRSP, the Bank's activities in the country will focus on "investment and analytic" activities to support growth, peace and equity. Sri Lanka used to receive Bank loans at zero per cent interest with a 0.75 per cent service charge and 40-year repayment periods. However, from 2007 these terms were no longer available since per capita income levels have increased above the threshold levels for such concessionary finance. Repayment is now over a 20-year period, including a 10-year grace period, before repayment begins. Sri Lanka is not yet borrowing on International Bank for Reconstruction and Development (IBRD) terms even though the income thresholds for this have been reached. This is due to other factors, such as debt sustainability.

It should also be noted that the data from 2004 does not take into account the role of the IMF. The IMF came to Sri Lanka's assistance when negative shocks resulted in imbalance in its financial position, key examples of which are in the early 1980s, 1991-1992, 2001 and following the tsunami in 2005. In this sense the role of the IMF in supporting Sri Lanka's open economy has been crucial. However, between 1994 and 2001 there were very few transactions with the IMF, and in April 2006 Sri Lanka declined an offer to be granted Heavily Indebted Poor Country (HIPC) status by the IMF. At the same time the Fund historically has played an important role in advising government policy through Article IV consultations. However, it is perceived that this role has declined as state capacity and institutions have improved with time. In fact, the IMF office in Colombo closed down in February 2007 because there is no longer a program with the government following the abandonment of the Poverty Reduction and Growth Facility (PRGF) funding for the PRSP after the first disbursement. Nonetheless, the Fund remains an important donor in times of crisis and will continue to advise the government through Article IV consultations.

PART C THE AID ARCHITECTURE'S INSTITUTIONS AND FINANCING TYPES

Relative importance, influence and comparative advantages

The major donors in Sri Lanka were introduced in the previous section. The World Bank, Japan and the ADB have provided the bulk of foreign assistance to Sri Lanka over the last three decades or so. This trend is gradually changing. Over the past five years Sri Lanka has managed to increase per capita income over the US\$1,000 mark (at present US\$1,355 per capita) and, as a result, has more limited access to concessionary finance. However, at the same time, the government has made an active decision to shift away from concessionary lending from the IFIs in order to achieve greater policy space. The present development policy plan of the government entails greater state intervention in terms of extensive public spending on infrastructure and income transfers to the poor, particularly in the context of vast rural underdevelopment. This level of intervention is at odds with conditionalities on fiscal policy imposed by IFIs, particularly given the experience of the failed PRSP process of 2002. The economically right-wing UNP government of 2002 obtained funding from the World Bank and IMF to support its economic policy package (PRSP) entitled *Regaining Sri Lanka (RSL)*. The RSL included extensive reforms in terms of fiscal discipline (reducing budget deficits to 5.1 per cent by 2005) and smaller government (reducing government expenditure from 26 per cent of GDP to 23 per cent of GDP over three years), reform and privatization of money-losing state enterprises and emphasis on private sector led growth.¹² This

¹² GOSL (2003), *Regaining Sri Lanka*, Government of Sri Lanka.

support¹³ was extended on the condition that the government not deviate from the stated PRS. However, after just one initial disbursement, IMF support was halted due to a lack of progress on the required conditions. With a change in government in 2004, the PRS was abandoned and with it the program-based funding from the Fund and the Bank fell away.

*“The three-year arrangements under the PRGF/EFF facilities, amounting to \$567 million for Sri Lanka, were approved in April 2003. Only the first disbursements, upon approval, have taken place thus far. The first reviews of the program were initially delayed because of lack of progress on key structural reforms — namely, in the areas of tax administration and the restructuring of the state-owned People’s Bank. During 2004, however, macroeconomic policies also deteriorated.”*¹⁴ – IMF, Staff report

*“With the prospect of continued uncertainty over both the reform and peace processes, the indicative program would not place Poverty Reduction Support Credits (PRSCs) at the center as proposed in the Country Assistance Strategy. Rather it proposes a core program of investment and analytical activities that would support the outcomes in the three thematic areas, while providing the option of adding policy-based lending in a higher case in the event of an improved framework.”*¹⁵ – World Bank, CAS 2006

In this context, the government under President Mahinda Rajapakse was left with the alternative of altering its policies to be in line with the PRSP of 2002, or seeking other sources of funding for its projects, thus moving away from IFI funding. As mentioned in the previous section, on the main framework for development in Sri Lanka, the Mahinda Chinthanaya takes a stance of significant state intervention to buttress and encourage the market economy. The government has not engaged in any further PRSP discussions with the Bank or the Fund since 2003, and this appears to be due to the fact that IFI lending constrains the policy space desired by the government to implement its own policy framework. The state has instead focused on bilateral funding for major projects, coupled with commercial borrowing.

To what extent are donors driving the development agenda?

Donors in general have a relatively limited influence on the development agenda at the moment. This is in contrast to earlier in this decade when, in 2001, the government requested a standby agreement from the IMF in the wake of a weakening balance of payments position. Inflation had increased from four per cent to 11 per cent and the current account deficit widened from 3.75 per cent of GDP to close to seven per cent of GDP by the end of 2000. The fiscal deficit worsened by 2.5 per cent to reach 10 per cent of GDP. Official foreign reserves declined by more than \$600 million as the central bank defended the rupee. Import cover declined from 2¼ months at the end of 1999 to 1¼ months by the end of 2000. In this context, the Sri Lankan government undertook a program of structural adjustment that included floating the exchange rate in January 2001, limiting external commercial borrowing, reducing fiscal deficit through a civil service hiring freeze and eliminating pay hikes temporarily, and including privatization and restructuring plans in the 2001 budget.¹⁶ Given the adverse economic climate, the IMF was able to influence the economic policies of the Sri Lankan government in providing a standby arrangement of SDR 200 million in April 2001. While the government program of structural adjustment was designed by the government itself, it is clear that the policies adopted are very much tailored to receive funding from the IMF.

¹³ The RSL was supported by the IMF PRGF-EFF amounting to US\$567 million for three years. The World Bank too extended support to the PRSP through its PRSC budgetary support program.

¹⁴ Sri Lanka Use of Fund Resources – Staff Report – IMF country report 05/84 March 2005.

¹⁵ World Bank Country Assistance Strategy – January 2006.

¹⁶ Government of Sri Lanka Memorandum on economic and financial policies requesting Standby Arrangement from the IMF, March 2001.

As mentioned above, following a change in government in late 2001, the UNP introduced the RSL package which was put forward as a PRSP. Like the reforms funded by the standby arrangement, the RSL was a “home-grown” policy set since it was designed by the government in consultation with domestic stakeholders. However, the fact that it was to be proposed as a PRSP to receive budgetary support from the World Bank and IMF could have caused the government to frame it so as to be in line with the policies usually approved by the Bretton Woods institutions. The macroeconomic targets envisaged in the RSL are very reminiscent of the kind of targets prescribed in Structural Adjustment Programs (SAPs) mentioned at the start of this section. In fact it could be argued that there is little real difference between the PRSP process and SAPs of the early 1990s. At the same time, it could be argued that the RSL reforms were simply a reflection of the economic ideology of the UNP leadership that proposed it. The government then attempted to use the conditions of the PRGF, PRSC funding to “tie their hands,” enabling them to push reforms through despite opposition. However, as events transpired, many of the reforms were politically not feasible, and ran into significant public opposition and trade union action (Kelegama, 2006a, Chapters 6 and 8). Failure to reform tax administration and restructure key public enterprises, such as the government-owned People’s Bank, resulted in only one of the PRGF disbursements coming through.

It is clear that donors have a strong hand in the economy during times of economic crisis and when the ruling government has an economic agenda similar to that of the BWIs. However, given Sri Lanka’s experience with the PRSP, even a right-wing government needs to fall in line with domestic political realities and the failure to do so saw the UNP fall out of favour. The policies failed to appropriately take into account the fragility of the UNP’s political position (with the president representing the opposition). The fact that the IMF did not disburse more than one instalment of the PRGF due to slow implementation was a reflection of its lack of flexibility and sensitivity to political realities in the country.

At present there is no major program lending by donors and therefore, theoretically, less scope for donor-driven agendas since projects are usually chosen by the government and then proposed for foreign assistance. A subtle way that donors can drive the agenda is through their advantage in knowledge and expertise. Sri Lanka has in theory an organized system of generating locally driven projects supported by foreign funding. A line ministry will submit a project proposal to the Department of National Planning which will then determine whether the proposal is not a duplication of existing projects. If foreign funds are required, the project will be sent to the Department of External Resources which will choose an appropriate donor. Unfortunately the quality of projects proposed by line ministries is weak. As a result, what usually happens is that donors submit a study to the line ministry, signalling the kinds of support they are willing to provide. The line ministry will then propose a similar project for funding to the ERD and may even state a preferred donor to fund the project. Alternatively, the line ministry often receives studies commissioned by international consultants funded by donors. The consultant would naturally propose a project in such a way as to maximize the likelihood of receiving support, and thereby tailor the project to the requirements of donors. The ADB technical assistance pipeline has a similar effect. In this way even project-based support can be donor led. This matter will be further explored in the section on ownership. Donors also influence economic policy and debate through their statements in the media, country reports and in specific research studies. This is particularly true of the major donors — the World Bank, ADB and IMF. While these do not necessarily drive the development agenda, they do provide an alternative to the government’s stance and influence local economic policy debate significantly.

Nonetheless, it is widely accepted that at present donors have a far more muted role in the economic agenda compared to the first four years of this decade. The current Secretary to the Treasury, P.B. Jayasundara, has a large say in the role of donors and in the projects chosen. It was clear from interviews with the government and donors that he is respected by the donors because of his capabilities and authority and, as a result, he has an influential voice in the development agenda. This highlights the important point that aid is necessarily a negotiation between two parties, and the negotiating strength

depends a great deal on the capacity of the parties. At present Sri Lanka enjoys a position of strength due to the capabilities of the major decision-maker and the power accorded to him. Other factors that influence the present strength of the Sri Lanka government include the accessibility to alternative sources of finance. The emergence of countries like China and India as major donors allows the government to dictate terms of negotiations with the more traditional donors. Furthermore, the government has the support of the public, given the less than savoury experience with the previous government's efforts with the PRSP. As a result, there was a *perception* that the Regaining Sri Lanka package was against the interests of the people because it was imposed by the donors, and that the assistance was conditional on following a "Washington consensus type" economic agenda. The new government came to power on a platform of local ownership of the development agenda.

Preferences between Donors

It is clear that the present government is seeking aid without strings attached. Many of the macroeconomic fundamentals required for program loans of the Bank and the Fund are not in line with the aims of this government. In fact, most stakeholders were of the view that the present Mahinda Chinthanaya would not receive donor support if it were put forward as a PRSP. In this context, the role of the World Bank and the IMF are greatly diminished compared to their role with the previous government. The World Bank is still involved in project-based lending, while the ADB and Japan continue to lend for projects as well. The lack of macroeconomic conditions attached to project-based lending make them more attractive to the government.

Regional development banks - The lack of macroeconomic conditions and the focus on infrastructure make ADB lending a relatively popular choice among governments. ADB lending has not changed a great deal with changes in government and this is in part due to the lack of ideological attachment to ADB practices. Flexibility is another factor that makes the ADB desirable. An example is the People's Bank restructuring loan. The loan was initially in support of privatizing the People's Bank but, with the change in government, the policy of privatization was changed to restructuring. The ADB in turn shifted its lending to support the restructuring process. This degree of flexibility was not experienced with the Bank or the Fund. The ADB's flexibility has been seen by critics as a weakness and as undermining the credibility of project-specific conditions. However, the ADB was also supporting the restructuring of the Ceylon Electricity Board but withdrew funding when the necessary reforms did not take place. There is a perception that the ADB's Asian management explains the greater understanding of the economic and cultural concerns of Sri Lanka. However, this is difficult to substantiate, particularly given that much of the country team of the ADB in Sri Lanka is not of Asian origin. Japan's aid has been considered favourably by Sri Lanka for similar reasons that were discussed in Part B of this paper (diplomatic relations, flexibility and sensitivity to the government's constraints and a focus on infrastructure). While the ADB and Japan have historically focused on infrastructure, the World Bank's focus has shifted over time. In the 1980s, emphasis was placed on infrastructure and structural adjustment. In the 1990s, it shifted to institutions and since then it has focused on social development. In the recent past, the Bank has again considered infrastructure and is now supporting the Sri Lankan government on one major road development project. It can be seen that assistance from the Bank has been driven more by its own determinants of what the priorities are rather than by the country's requirements.

Bilateral Partners - The Sri Lankan government of late has focused more on bilateral donors. Several reasons have been suggested for this. A major one is that there is an increase in finance available for countries like China and India and, for economic and geopolitical reasons, there is incentive to lend this capital, while there has been a decline in available concessional finance from the major donors. At the same time, Sri Lanka is undergoing a vast infrastructure enhancement drive and therefore requires more capital than is available domestically, even stretching beyond traditional donor limits. Furthermore, some of the projects are not usually undertaken by traditional donors. For instance, the major energy projects in the pipeline have limited concessional finance available to them and are therefore being funded by China

and India. Many of the stakeholders within government also felt that bilateral aid is easier to negotiate than multilateral aid, which is often characterized by numerous fact-finding missions, targets, assessments and administrative requirements. On the other hand, aid from a country like China would in general be managed from afar. Flexibility is another issue that makes these new bilateral donors attractive. There are few or no macroeconomic or policy-based conditionalities attached to this aid. Former minister of finance Sarath Amunugama was quoted in a newspapers saying, “Some have misunderstood that the government today relies more on bilateral partnerships for development assistance rather than depending on development agencies. Most importantly such assistance comes without any strings attached.¹⁷” Therefore, while Japanese aid is also characterized by loan covenants and safeguards, their highly diplomatic and sensitive negotiation process allows a clear input from domestic stakeholders, resulting in a smoother project workflow.

However, it remains clear that there are indirect costs of bilateral aid. For instance, while there may be no macroeconomic conditionality, a condition of aid could be that work is conducted using labour, consultancy, machinery or raw materials from the lending country. As a result, there will be no competition or tender processes as with WB or ADB loans, resulting in a more expensive procurement process. Most Chinese aid to Sri Lanka is of this nature. In fact, the Chinese government specifies the exact contractor or consultant to be used. With regard to Korean aid, the Government of Korea will require that the contractor is of Korean origin but there will be competition between Korean producers to supply the service. Indian aid is in the form of Indian lines-of-credit, in which cases Sri Lanka can buy x US\$-worth of Indian imports under the support measure. Sri Lanka recently identified eight offshore oil exploration blocks and, while six of these will soon be up for competitive international bidding, two of the blocks have been reserved for China and India in a government-to-government deal. It could be argued that this is a result of the aid relationship between Sri Lanka and these two countries. In the long run, it could turn out that bilateral aid is more expensive than borrowing on the commercial market.

In monetary terms most of this aid is concessionary. For instance, Chinese aid (two per cent interest) is only slightly more expensive than ADB and World Bank charges (15 per cent and 0.75 per cent).

Hidden conditionality can extend beyond economic and commercial considerations to political ones as well, particularly in terms of support in international forums. Furthermore, the newer donors have less experience in the aid architecture and therefore have less developed programs, their work seems to be more *ad hoc*, and seems to be based on political and commercial interests rather than on those of the recipient country. Critics of bilateral aid have also suggested that the lack of transparency in terms of bidding for contracts leaves more room for corruption. A government can give a project to a bilateral partner who will determine the contractors, often at a price higher than the market rate, which allows scope for “skimming off the top.” With multilateral donors there is less scope for such an outcome since competitive bidding in a transparent manner is mandatory.

While countries like China have emerged as new donors to Sri Lanka, there have been traditional bilateral donors who have worked closely with the government. Japan has been mentioned already as a very successful and important bilateral partner. However, other bilateral partners do not all have the same positive impacts. A key issue with bilateral aid is the fact that it is almost always tied to some agenda. For instance, USAID focuses on issues such as competitiveness, corruption, and so on. However, one needs to ask whether these are priorities. Have consultations taken place prior to these programs or are they based purely on what the donor feels is required? The fact that bilateral donors are accountable to their domestic constituents again can result in biases that can work against recipient country interests. An example of this is the USAID competitiveness program that excluded support for the garment industry in Sri Lanka due to the adverse impacts this would have on the domestic industry in the US. The garment industry in

¹⁷ Ceylon Daily News, February 6, 2007.

Sri Lanka accounts for more than 45 per cent of exports from the country and 40 per cent of industrial production, and excluding this sector from the program greatly dilutes its real impact on the country. Another example is Canada, which has a large Tamil diaspora that exerts a great deal of pressure on the Canadian government to disburse aid to areas beyond the control of the Sri Lankan government and under the control of the LTTE. Unfortunately, such aid has to be distributed through NGOs and other organizations that often lack the credibility or capability to carry out development assistance on behalf of the government. In fact, there have been instances where such aid has fallen into the hands of separatists who used funds quite contrary to what was intended by donors. Furthermore, other bilateral partners do not supply money directly to the government but through NGOs in the rest of the country as well. This creates problems of coordination of aid and may result in duplication since the projects do not go through the Department of National Planning. Often these donors fund via NGOs because of a lack of faith in government credibility and wastage. However, many of the large international non-governmental organizations (INGOs) and national NGOs are themselves not above waste and are often unaccountable for their actions. Canada, the UK and many EU countries function through the NGO sector rather than state-to-state funding. Norway, Sweden and Germany fund mainly through the state but they also have non-state funding. However, there is an effective reporting mechanism of project details and implementation to the government. The US programs are mainly non-governmental, the money not coming to the state, but they too have a useful reporting mechanism. In such cases, the agreement is signed with the government but implemented in general by NGOs.

Commercial borrowing – Sri Lanka’s government has realized that with increasing income per capita, access to concessional finance will be on the decline. As a result, it obtained international credit ratings from Standard and Poor’s (B+) and Fitch ratings (BB-), and went on to borrow US\$680 million commercially in 2006.¹⁸ Sri Lanka has aggressively been selling what are known as Sri Lanka Development Bonds to international commercial banks, firms and individuals in order to raise funds to finance development and bridge budget deficits. In March 2007 the government was able to sell US\$215 million-worth of development bonds, four times the amount that it had initially envisaged. These two-year bonds are sold at the rate of LIBOR + 155 basis points. In September 2006 the government was able to sell bonds at LIBOR + 144 basis points. In 2006 the IMF offered Sri Lanka HIPC status in order to ease its significant debt problems. However, the government refused the offer because it was felt that HIPC status would undermine its ability to borrow on the commercial market, since it would adversely affect its credit rating. This is a signal that commercial borrowing will remain on the agenda as the government will be relying less on development assistance and concessional finance.

As mentioned earlier, access to concessional finance has declined. There is, nonetheless, a great deal of reliance on development partners with no declines in borrowings from the partners. However, given that there is now increased access to commercial borrowing, increased monetary costs of borrowing from development partners, and the non-monetary costs of dealing with development partners (bureaucratic costs, delays due to safeguards and covenants), the government is looking to reduce this reliance on donors. It could be argued that a move toward commercial borrowing is desirable since it would increase discipline in the use of funds and, because of repayment requirements, there will be incentives to invest in commercially viable projects. At the same time, it is important to understand the dangers of this route. Commercial borrowing may create a bias toward projects with quick short-term benefits and may make governments more reluctant to invest in the larger longer-term projects with social rather than commercial benefits. Due to the civil war, there is a lot of downward pressure on Sri Lanka’s credit rating, and further declines in the rating would make it even more expensive to borrow commercially. This would be detrimental to long-term economic prospects because it would increase the debt burden in the future. As it stands, Sri Lanka has public debt of 93 per cent of GDP, but much of the international component of this

¹⁸ Central Bank Press releases detailed US\$580 million borrowed through Sri Lanka Development Bonds and a further US\$100 million borrowed through Citibank in 2006.

is concessionally obtained loans. If this changes, it is likely that debt service payments would increase exponentially. The government continues to need external sources of finance, since other sources of capital – such as remittances and FDI – are not always invested in public infrastructure such as roads, power plants and ports, which are much needed in the country. Remittances are very important but are primarily spent on consumption needs. While FDI continues to play an important role in the country, it is usually focused in the metropolitan Western province and in profit-making sectors, such as telecom and finance. Raising domestic financing is again a problem for the Sri Lankan government. Government revenue was 17 per cent of GDP in 2006. The bulk of the expenditure is on current expenditure (19.5 per cent of GDP) rather than capital expenditure (5.8 per cent of GDP). Furthermore, domestic borrowing puts pressure on interest rates and bank borrowing in particular (2.8 per cent of GDP in 2006) is inflationary. This makes foreign sources of capital all the more important.

The UN system in Sri Lanka

The United Nations has only a limited influence in Sri Lanka. This is true of the economic development process. In Part B it was shown that the UN contributes only a small amount (two per cent) to total aid in Sri Lanka. Furthermore, this is mainly in the form of technical assistance and micro level projects. However, there is a strong perception that the relevant UN agencies play a very important role in humanitarian activities, particularly in dealing with refugees. None of the other major development partners focus on such issues and the UN could continue to place emphasis on these matters. There was a less favourable response to other UN agencies. Of the 13 active UN bodies in Sri Lanka, only about six play an active role in the country, and there were certain criticisms levelled against these. Organizations like UNICEF disburse most of their funding through NGOs, undermining attempts at monitoring and harmonization of aid. Furthermore, the UN was singled out as a major source of losses through bureaucratic waste. Large amounts of money are spent on expensive consultants and, in the immediate aftermath of the tsunami, the UN country office was awash with a new fleet of vehicles. The UN lacks the bureaucratic fluidity to handle as many tasks as it attempts in Sri Lanka. There was little familiarity with the “Delivering as One” reform proposal among interviewees, possibly due to the general lack of interest in the UN in this country, given its limited role in the development architecture. The reforms required in the UN at the country level in Sri Lanka are far simpler than what needs to be spelled out in a major document. The key change required is to rationalize the UN’s role in the country and to concentrate its resources in that particular area — and humanitarian assistance seems to be that niche. It needs to work more closely with the government to determine its role in the country, and to avoid disbursing aid through third parties. Once these steps are achieved, it would be relevant to look at the more detailed secondary steps suggested in the UN reform paper. It is encouraging to note that recent discussions may have resulted in a change in UN aid, with aid being channelled through the government to a greater extent.

The Role of NGOs in the Development Architecture

The role of NGOs in Sri Lanka changed drastically following the tsunami of December 2004. Until then the country had a few well developed local NGOs, such as Sarvodaya, which had expertise and experience in working in Sri Lanka. Following the tsunami there was an influx of INGOs and the creation of new local NGOs in response to the unprecedented humanitarian crisis that took place. However, with this mass of NGO activity, significant aid management problems arose. Coordination of donor aid was an issue in the immediate aftermath of the tsunami and in the two years since. Unlike the major multilateral and bilateral donors, the majority of NGOs do not fund through the government. Therefore, the ERD relies on the donors reporting their activities effectively. Often this reporting process is prolonged and information provided is imperfect. (For instance, a donor may state that 10 hospitals were built in district X without specifying the distribution of hospitals within the district.) In order to tackle this, the Ministry of Finance has established a centre for non-governmental activities that facilitates the registrations of INGOs. Facilitation of registration and feedback on the activities of NGO, along with assessments of capacity, is to take place in this centre. However, it needs an effort on the part of the donors as well to make the process effective. The lack of coordination results in aid duplication and in significant aid waste.

Like the UN, many of the larger NGOs and INGOs in particular run large bureaucratic costs. Expensive foreign consultants (local consultants often expect the high fees paid to foreign consultants), poor financial management (weak cost-benefit analysis), high maintenance costs due to excessive per diems, and multiple layers of bureaucracy contribute to this. In this context it is unfortunate that a lot of aid goes via NGOs instead of via the government due to concerns that governments spend money inefficiently, when a similar charge could be levelled against some of the larger NGOs. This is especially true when there are multiple layers of bureaucracy —for instance, if a donor funds an international organization, which then funds an INGO in the field that will then fund a local NGO. At each layer of bureaucracy, some of the donors' funds will be kept aside for administrative charges. Eventually only small amounts of the actual funding will reach the grassroots they are meant to reach.

NGO Activity in the Post-Tsunami Recovery Period

Sri Lanka's post-tsunami experience is an interesting case study of NGO activity in a country. In the immediate aftermath, there was a major relief attempt with the input of individuals, the private sector, the government, NGOs, major donors and INGOs. The NGO sector played an important role with immediate humanitarian relief and in the reconstruction phase as well. It was to the credit of all involved in the relief process that Sri Lanka did not face any of the predicted crises, such as communicable diseases ravaging refugee camps. However, with time, as the aid flowed in, complications arose in attempts to coordinate and manage the resources for reconstruction. Some sectors were well managed. For instance, in the road sector the ADB played an influential role in donor coordination for reconstruction. The World Bank played a similar role in the initial housing sector reconstruction process, creating the institutional structures required. However, the livelihood sector was far less successful as the same processes of institutional framework creation were not followed. The International Labour Organization (ILO) attempted to lead this process but it was not followed by all the donors, as by this stage there were several small players eager to contribute. Needs assessments were not properly carried out and donors simply wanted to "do something," and unfortunately the correct thing was not always done. For instance, fishing boats were given to people who weren't fishermen prior to the tsunami — and over-fishing and pollution resulted. Inappropriate technologies were distributed, such as technology for creating products that had few marketing and distribution networks in the area. Schools were created without having teachers to teach in them. Information technology units were built with no IT teachers and no connectivity. These facilities often remained unused or underused for prolonged periods. Many projects were conducted simply with a view to being visible to the principal (original donor) which resulted in priority areas not being addressed. For instance, community centres were being built in areas where people didn't have access to health or other more basic priorities. This was the result of the government opening the doors to all donors and naturally it did not have the capacity to regulate such a massive inflow. It would have been more prudent to allow a few key donors to enter the country and ask other donors to fund through them. This would have made coordination and regulation a lot easier. Massive waste took place and continues to take place as a result.

However, the problems that were experienced in Sri Lanka extend beyond waste. There were some practices that left the population worse off as a result of donor intervention. In the micro-finance sector, for instance, numerous donors provided funds at very cheap rates and often treated these funds as grants and left without claiming repayments. Such practices undermine the credit culture built up by established micro-finance institutions over several years. INGOs employed international volunteers (though they do not draw a salary, they receive subsistence allowances, travel allowances, and so on) without making full use of the large cadre of unemployed graduates in the country who had knowledge of local languages, cultures and social fabrics. This undermined local ownership of reconstruction. In villages affected by the tsunami, the logos and flags of numerous INGO and donor countries still remain, claiming ownership of everything ranging from water tanks to vehicles and even houses. Such patronizing behaviour creates a culture of aid dependency, and aid is often considered as a gift which does not need to be used with the utmost efficiency. This perception is furthered when there are numerous donors providing nearly

unlimited funds and there is little incentive for efficiency. This was exacerbated by many of the post-tsunami aid activities.

Local knowledge, expertise, debate and analysis had little or no place in the aid process in the NGO-dominated post-tsunami recovery process. Everything was done from the “outside” with foreign consultants, foreign administrators and volunteers dominating the activities. Local experts were often reduced to the level of research assistants and left to carry out mundane administrative tasks instead of contributing to the leadership of the process. This fuelled aid dependency due to a lack of ownership of the process and responsibility for outcomes. Consultants and foreign workers should have been allowed only in cases of exceptional need and lack of proven local expertise. Another frequent problem was that of donors overstepping their mandate and their areas of expertise. Rajasingham¹⁹ provides details of this in her paper. An example she cites is of the International Red Cross in Sri Lanka. This institution received US\$2 billion for reconstruction, hired 183 expatriate volunteers, each worth over US\$120,000, but with limited technical expertise and knowledge of local society, culture and languages. Following a pledge to build 15,000 homes, only 64 were built in the first year. Bad land was blamed for this, but only one-third of the land had problems. This begs the question as to whether the Red Cross attempted to undertake this task without expertise simply because it had the funding. In April 2007²⁰ the government of Sri Lanka requested the UN Office for the Coordination of Humanitarian Affairs (UNOCHA) to leave the country as it was “overstaying its mandate.” UNOCHA originally was involved in Sri Lanka to coordinate the humanitarian response to the tsunami, but continued to work in the country after amending its mandate to include those displaced in the internal conflict. There are other organizations that handle this, such as the UNHCR in Sri Lanka. Such actions by donors, attempting to continue working in a country even when their role is over, suggests that some donors are more interested in self-sustenance than in playing a genuine role in the development of countries.

The tsunami experience in Sri Lanka is an interesting capsule of the pitfalls of extensive NGO activity in a country. However, it is in the interest of the recipient country to play the lead in regulating and coordinating NGO activities. The government needs to specify the framework and rules of the game. Donors have their own agendas. It is the government’s role to harness the work of the useful NGOs and effectively monitor their activities. NGOs are far less clearly defined than the established donors — they are smaller, fragmented players. Furthermore, they engage in small-scale activities that have micro-level impacts and focus areas, again requiring a concerted effort in coordination. Therefore, it is difficult to expect donor coordination in the NGO field to be led by donors themselves. The government is the legitimate authority to conduct this and it is in the interest of the state to ensure this. The tsunami experience was a good lesson in the positives and negatives of NGO activities in a country. The biggest drawback in Sri Lanka was an overflow of different players, making regulation nearly impossible.

PART D THE ARCHITECTURE – KEY THEMATIC ISSUES

The themes most relevant to Sri Lanka at this stage in its relationship with the development architecture are leadership, ownership and legitimacy. Part D will therefore focus on these areas. While these themes have been touched upon in previous sections, a more in-depth analysis will be provided here.

Leadership and ownership

This issue was touched upon in Part C when the extent to which the donors drive the development agenda was discussed. It was explained there that the PRSP process in 2003 was in stark contrast to the role of

¹⁹ Rajasingham (2006).

²⁰ Sunday Times, April 22, 2007.

donors at present. The present lending patterns are dominated by project-based lending, and are therefore in theory more state-led as the line ministries select projects and then submit them for foreign funding through the ERD and Department of National Planning. However, as explained earlier, the reality is often different. The extent of actual domestic ownership of donor-funded policies depends a great deal on the capacity on the relevant line ministry and the nature of the work handled by the ministry. The initial stage in the lending process is the country assistance program that spells out the planned lending over a three-to-four year cycle. This is produced by donor staff drawing from the country's national development framework, inputs from government, civil society and consultants. In the identification of priority areas of support, donors have the opportunity to influence and drive the development agenda to some extent, though this is tempered by the consultations with other stakeholders. The donor would approach the ministry with a background proposal or concept paper, explaining the gaps in the system that have been identified and proposing how these can be remedied, along with the type of support they are willing to provide. The issue is then studied by the line ministry and their inputs are submitted. The line ministries' inputs and suggestions would be within a framework provided by the donor, such as limitations on the types of assistance that can be given. (Take an arbitrary example: in a certain education project the assistance may not extend beyond the primary level, and may include teacher training but not training of administrative staff.) Line ministry interviewees were of the view that the donors take great pains to emphasize that the projects are government-driven, even though in reality the foundation and direction is provided by the donor. This was not perceived as a problem because the ministry has the capability to provide its input and address any concerns it might have. The capabilities of the ministry in question are the key here. If the ministry has experienced officers well versed in the country's requirements, they will be able to effectively mould the donor suggestions into the type of action plan required by the country. However, if the ministry officials lack the capability to comprehend the full implications of the donor suggestions, there could well be a situation where the ministry accepts — in fact, proposes to the Department of National Planning — a project which is not in the country's interest. Therefore, the issue of ownership cannot be looked at in a singular manner — it is conditional on domestic capabilities. The greater domestic capabilities are, the greater the national input, voice and ownership of the project. In terms of leadership, it seems that even in project-based lending, it is often the case that the donors will provide the initial direction and signals for donor-funded projects. However, there are exceptions to the rule.

In the Road Development Authority (RDA), one of the key Sri Lankan institutions that works with donors, the relationship with donors is somewhat different in that there is greater leadership on the local front in this sector. The RDA has a national plan for the road sector, and it would prioritize what improvements are required most urgently and then approach donors with the proposed improvements. The RDA then proceeds with project formulation, detailed design, loan negotiation, procurement, bid document preparation, and award and contract administration within the parameters of donor guidelines. These guidelines do not vary a great deal between donors and were said to be standard requirements that do not undermine project implementation. The project implementation is carried out by the government, and it is at this stage that the donor influences the project the most. The donors have very strong expertise in the relevant area, with officers armed with extensive academic qualifications and experience who have the knowledge to influence the design of the plan. Therefore, while plans produced are not necessarily opposed to the country's interest, their design is often tailored towards the expectations and requirements of the donor. This again is inevitable given disparities between donor and recipient expertise. However, the concern is the possibility of abuse of this advantage in expertise.

It is interesting to contrast the situation with regard to project-based aid with the program-based lending experienced in the PRSP process. This process is almost by definition wholly recipient-owned. According to the IMF's description of the PRSP process, "PRSPs are prepared by governments with the active participation of civil society and other development partners. PRSPs are then considered by the Executive Boards of the IMF and World Bank as the basis for concessional lending from each institution." However,

in the Sri Lankan case, this was not perceived to be the reality. While the RSL document states that consultations were held with a wide range of stakeholders, including local think tanks, NGOs, academics, and so on, it could be argued that these consultations were at far too superficial a level to have any real impact on the content and spirit of the PRSP. It is widely accepted that the Sri Lankan PRSP in 2003 was the result of the ideas and deliberations of a small group of advisors to the then government, including foreign experts. The fact that the contents of the PRSP were very similar to the types of policies prescribed by the Bretton Woods institutions calls into question their local origins. The RSL did not appear to comply with the aspirations of the average Sri Lankan. Many of the proposed reforms were sensible and important for the country, but there were insufficient measures to compensate for the losses in liberalization, and reforms were on a grand scale both in terms of speed and scope (Kelegama, 2006a, Chapters 6 and 8). It was felt by many that the country was not in a position to face that extent of reform in such a short time.

It was pointed out earlier that it is a matter of debate whether the RSL was tailored to receive funding from the Bretton Woods institutions or whether its content was a reflection of UNP economic ideology. What is clear is that the document lacked ownership on a national scale since it did not reflect the aspirations of the majority of the population. The interesting question here is whether any PRSP process can obtain national ownership through only stakeholder discussions. National ownership is a concept that evolves over time and is a reflection of the social-economic, ethnic and political fabric of a population. These qualities cannot be created in a one-off document aimed at generating donor funding. The very fact that a PRSP is to be put forward to attract donors will naturally create incentives for some degree of tailoring of the document to obtain funding. This will indirectly cause the proposals to have a donor interest bias at the expense of a domestic interest. This seems to be what happened with the PRSP in Sri Lanka.

At present, project-based lending is the major form of aid transfers. In this context the architecture does leave room for a home-grown development strategy. If a well designed project emanates from a line ministry, it could receive donor funding. For instance, the World Bank funding of education in Sri Lanka saw a mix between donor-initiated projects and government-initiated projects. The education reform process that began in 1997 was very much home-grown in that it was the outcome of a presidential task force on education. The World Bank supported these home-grown reforms through the General Education Project II and the Teacher Education-Teacher Deployment (TETD) projects which began in the same year. Over the years, the Bank also initiated project proposals which were then considered and modified by the Ministry of Education prior to implementation using Bank support.

Conditionality and Policy Space

The government of Sri Lanka in the recent past has emphasized the fact that Sri Lanka is keen on reducing dependence on aid attached to conditionalities, in order to achieve more “policy space.” The term “policy space” itself is not clearly defined nor used in a consistent manner in the debate. However, for the purposes of this paper it will be defined as the level of flexibility a government has in determining its own development agenda. The former minister of finance, Dr Sarath Amunugama, was quoted as saying, “Our development partners in the forefront are now Japan, China, India, Eastern Europe, Hungary and the European Union. We do not have to go behind the World Bank and the ADB who are posing conditions.”²¹ The major conditions that concern the Sri Lankan government are political conditions regarding progress in the peace process and human rights issues, and economic conditions regarding macroeconomic fundamentals.

Aid and the military conflict – The Tokyo Conference on Reconstruction and Development of Sri Lanka in June 2003 saw US\$4.5 billion pledged to the country by different donors. However, it was noted in the

²¹ Sunday Times, February 4, 2007.

declaration that the continued disbursement of this money was conditional on progress in the peace process. “In view of the linkage between donor support and progress in the peace process, the international community will monitor and review the progress in the peace process.²²” The US\$4.5 billion included the PRGF pledged by the IMF in support of the PRSP. Part of the reason that the PRGF disbursements came to a halt was the deterioration in the conflict situation in Sri Lanka. At a more recent donor conference in Galle in January 2007, the importance of reaching a peaceful settlement was emphasized by Sri Lanka’s development partners. However, the government was keen on de-linking aid from the peace process and allowing the administration to press ahead with its agenda. Sri Lanka’s Central Bank Governor was quoted by AFP as saying, “We are not ready to accept any conditions linking aid with peace.²³” The donor community feels that it is the responsibility of the international community to ensure that whatever aid is received by the country has a maximum impact. Development will have its greatest effect reaching the entire population in a secure, peaceful environment. However, the donors’ means to achieving this end have been called into question by the Sri Lankan government and civil society.

The argument by the Sri Lankan government is that there are two parties required to ensure progress in the peace process, and one of those parties (the separatist LTTE) has a vested interest in the government not receiving donor financing (Kelegama, 2006b, Chapter 8). Therefore, it is in the LTTE’s interest to stall the peace process, resulting in reduced development finance to the government. One aim of the donors could be to reduce the government’s military expenditure by not disbursing aid. While none of the aid is technically for military expenditure, it could be argued that, if donors fund infrastructure projects, it frees up money for the government to spend on the military front. However, this would be a faulty argument since the result would simply be that the said infrastructure projects would get delayed in the name of military spending requirements. This would not be in the interest of the long-term development of the country. There is very little scope for aid to be used as a lever in influencing the peace process. Nonetheless, some members of civil society are of the view that the failure of the development architecture to address the military situation is a great fault in the effectiveness of the architecture. “The international peace builders colluded with the main actors in deferring the core social, political economic issues that structure the dynamics of the conflict in order to promote a neo-liberal economic reconstruction agenda that is integral to the (phantom) aid industry.²⁴” It was argued that this failure contributes to the notion that economic progress is possible in a military situation, while failing to take into account the massive economic declines in the conflict areas of the North and East of the country. However, there are only limited ways in which the aid architecture can hope to influence steps towards peace without unnecessarily inhibiting the development of the country. One option is for the aid architecture to encourage the development of a Southern consensus of political devolution of power. However, even this would be a grey area of involvement because donors do not have the expertise or mandate to play a role in domestic political processes.

It is important to note that none of this has resulted in any reduced project-based borrowing from the World Bank or ADB. At present neither institution ties lending to the peace process. This is despite statements by key Bank personnel, including Praful Patel who commented, “There is no way to politely skirt this issue; as a major development partner to Sri Lanka, the World Bank would be failing if we did not place the conflict front and centre in our deliberations.²⁵” Bilateral donors, however, have been more active in their attempts to influence the peace process. The British government has threatened to stop a US\$82 million grant due to the government “(b)reaching international obligations, especially human

²² www.lbo.lk, “Tokyo Donor Conference Ends”, June 11, 2003.

²³ www.lbo.lk, “Tug o’ War”, January 30, 2007.

²⁴ Rajasingham (2006).

²⁵ www.lbo.lk, “Tug O’ War”.

rights violations, and for unjustified military spending.²⁶ This money was due to be part of post-tsunami multilateral debt relief initiative. The German government too initially claimed to be halting development assistance on account of failure to adhere to the peace process. However, there have been contradicting comments from different German officials regarding this issue. Sri Lanka's Foreign Minister, on a recent trip to Germany, claimed that the German government will "continue to give aid."²⁷ However, the emerging donors are less interested in tying aid to the peace process and this has made them a popular choice for state borrowing.

Economic conditionality - Economic conditions are less of an issue now than they were during the PRSP implementation process. As has been discussed, the PRSP included macroeconomic targets that greatly resembled those pushed by the Bretton Woods institutions during the SAPs of the 1980s and 1990s. The funding in support of the PRSP was conditional on policies not wavering from what was agreed to in the PRSP. The government at the time was unable to stick to the PRSP pledges and the support for the PRSP was halted following the first disbursement. The new government did not renew PRSP discussions with the Bank and the Fund, and there has been no program lending since then. The IMF office in Colombo closed down in February 2007 since they no longer had a program with the government. While it is likely that most of the government rhetoric regarding "policy space" is in reference to conditional aid tied to the peace process, there is an element of economic conditionality as experienced in the PRSP process that also worries the government. The Mahinda Chinthanaya 10-year development plan does not follow the PRSP type of policies. It envisages more state intervention in economic activities. As a result of this, many commentators and interviewees feel that, even if the Mahinda Chinthanaya were to be proposed as a PRSP, it would not receive the same kind of support that the Regaining Sri Lanka policy paper received. Given this backdrop, the government rhetoric has focused on the need for independence from conditionality in forging its own development agenda.

Nonetheless, the level of borrowing from the Bank and the ADB has not declined. The project-based lending practices that are prevalent in Sri Lanka today are more flexible in terms of conditionality. Macroeconomic conditions — such as budgetary targets, inflation targets and privatization policy — are no longer applicable to project-based lending. The loan agreements are managed through safeguard agreements and loan covenants. A loan covenant is an agreement signed between the donor and the recipient government detailing agreed actions and reforms to be carried out along with the project. These are not conditions, in that funding will usually continue even if the covenants are not adhered to. The effect of not carrying out an agreed covenant is a lower project rating that may influence long-term financing. If both sides fail to agree upon a suggested covenant, it will not be part of the signed agreement. In this way covenants allow a great deal of flexibility. There is the possibility of a government signing on to a covenant which is not entirely in its interest if the project is very urgently required (as happened with some of the highway projects in Sri Lanka) or if the donor is able to use superior expertise in persuading the adoption of a covenant. There are other problems with covenants that will be discussed later in the paper. However, their impact on policy space is limited. Given this relative flexibility, coupled with a significant need for funding of public infrastructure projects, Sri Lanka continues to borrow significantly from the multilateral donors at concessional rates. (Concessional borrowing is important for public infrastructure projects due to the longer time lags before returns on investment are forthcoming, making commercial borrowing unsuitable.)

Other Factors

Issues that were touched upon in previous sections have impacts on ownership of development processes as well. For instance, with regard to the role of NGOs, it was explained that in the post-tsunami reconstruction stage there was an influx of a large number of donors working in the country. These donors

²⁶ Sunday Times, February 18, 2007.

²⁷ Ceylon Daily News, February 6, 2007.

emphasized visibility both in their actions and in the outcomes of their actions. Development projects were “labelled” with the donor’s national flag or logo, foreign workers were brought in and local skills were underutilized, and the overflow of aid enhanced a dependence syndrome and encouraged a passive response by the locals. It was initially thought that this influx of donors would be a short-term phenomenon following the tsunami. However, two and a half years on, there are still numerous donors working on all manner of projects in the country. The impacts on ownership mimic those that took place in the immediate aftermath of the tsunami. Seeing villagers riding bicycles with donor logos splashed across them remains a common sight on the Colombo-Galle road. The greater effect, however, is the impact of a large number of bilateral donors on ownership of the development agenda in the long run. Most bilateral donors fund smaller projects and do this via NGOs and other agencies, as opposed to funding via the government. This does not necessarily undermine national ownership, but there is often less stakeholder voice in such projects. This is in contrast to funding by major donors, including large bilateral donors such as Japan that work through the government so that there is necessarily state input into project design and implementation. If, on the other hand, all bilateral donors went through the government, having to deal with a large number of bilateral donors would put pressure on the ERD’s capacity. One option would be for bilateral donors to support larger projects funded by the bigger donors. For instance, in the road sector some bilateral donors helped with funding for secondary activities, such as management consultants for major projects. The Nordic countries and the Swedish International Development Agency (SIDA), for example, funded management consultants for the Southern Highway project. The idea of a general shift of all bilateral donors towards multilateral aid channels would not be favourable to Sri Lanka since this would reduce aid from countries like Japan with which Sri Lanka enjoys excellent aid relations. Furthermore, it was felt that such a shift would undermine the government’s negotiating position with donors since it would reduce choices available for development finance. This negotiating strength is essential to maximizing voice input and ownership of the agenda.

The system of aid management and relationship between donors and the government is another factor that influences ownership. In Sri Lanka, the major forum in which the donor community and the government discuss aid and development in the country is the annual Development Forum. All the major donors and different government representatives discuss possible future aid pledges, the usage of present aid and development plans. On top of this there are annual consultations with Japan, Norway and Germany, Article IV consultations with the IMF, and discussions of country assistance strategies of the World Bank and ADB. Beyond these, there are also more *ad hoc* meetings between the donors and government representatives. There is no system of a donor roundtable and no more PRSP discussions. However, this is not thought to be a major problem in terms of aid management since projects must be cleared through the Department of National Planning, thus ensuring the prevention of duplication. Nonetheless, this fails to capture the aid duplication and waste issues that occur through smaller bilateral donors and NGOs. In the annual donor forum, priority is given to the major projects and therefore the smaller donors are less prominent. As a result, the problems raised by the proliferation of smaller donors are also less prominent. Donors themselves have organized an institutionalized forum of aid coordination with a rotating chair in Sri Lanka. This refers to the major donors — the World Bank, ADB and Japan. However, some donors felt that the government is happier dealing with donors on an individual basis to avoid the possibility of the formation of a “donor cartel,” which would reduce choices and the negotiating leverage of the government. Donors interviewed were somewhat concerned about the lack of technical level discussions on implementation of development programs. The donor forum addresses broader plans and strategies, but there is a lack of institutionalized technical level discussions. It should be a priority for both donors and the government to remedy this situation. Sri Lanka’s relationship with Japan in terms of aid management again stands out as a success story. The government has regular consultations with the Japanese embassy, JBIC and JICA.²⁸ These discussions centre on any concerns that the government has

²⁸ Japan Bank for International Cooperation (loans) and Japan International Cooperation Agency (technical assistance and grants).

and this helps resolve matters that need to be addressed. The Japanese themselves are very keen on getting a clear idea of the strategies and plans, and they are keen on discussing these and clearing doubts and sharing ideas. This helps the two countries share a development partnership that is more effective than those with other development partners. The diplomatic nature of the discussion forum makes negotiations easier.

Legitimacy

This section focuses on the levels of voice and representation enjoyed by domestic stakeholders in their interactions with the development architecture. It was explained in the previous section how donors and the recipient government interact in deciding upon projects and their implementation. It was clear that the level of voice and representation of the local stakeholders depends to a great extent on the capacity of the agency handling the project. If the government officers have little understanding of the issues relevant to the Sri Lankan development situation, it is likely that the project framework as envisaged by donors will go through relatively unscathed. On the other hand, if officers are well informed and have the confidence to make their case, the government will be able to have the kind of input it desires. That said, aid must be seen as a compromise between the preferences of donors, recipients, and their respective domestic political constituencies. These preferences are usually misaligned, and donor voice and conditionality is used to realign them. The disciplines inherent in this compromise would be beneficial to the long-run impact of aid as long as there is a balance in capabilities on either side. Unfortunately, in Sri Lanka many ministries handling aid projects cannot match the experience, technical competence and authority of donor representatives.

One way to overcome this capacity gap is to involve a broader group of stakeholders in meaningful discussions with donors and the government in order to flesh out the different implications of a project. As it stands, the donor-recipient dialogue is confined to donor representatives and government representatives. If experts in the field from outside the government could also be involved in discussions at a meaningful level (at present, there are some stakeholder discussions but these occur at a superficial level), it would improve the weight of experience and authority on the recipient's side of the negotiating table. An example of this was pointed out in the interviews. The E-Sri Lanka project initiated in 2003 had its origins in the private sector in collaboration with USAID. The World Bank supported the project as it was integrated into the RSL program. The key in this project design was the incorporation of a multi-stakeholder approach to ensure broad ownership and sustainability. "The eventual design of the initiative for funding purposes evolved significantly during the preparation of a detailed implementation plan. This was a collaborative process involving the ICTA team, representatives of the different sectors, and stakeholders appointed to Focus Groups set up to guide the preparation of the programmes and major projects, and the World Bank.²⁹" While such an approach may not be possible for all sectors, it is certainly desirable if conducted appropriately. The problem with involving multiple stakeholders is the difficulty in reaching compromise. This could result in further unwanted delays in project implementation. However, a smoothly functioning stakeholder forum, with an appropriate number of experts, will certainly improve the quality of projects implemented using donor funding. At the same time, for complete success, the executing agency needs the capacity to implement the project and sustain it after completion.

With regard to the differences in recipient voice between types of donors, the multilateral development agencies provide the most satisfactory climate. The fact that Sri Lanka is a shareholder in the IFIs, has a seat in board deliberations and pays subscriptions allows it to raise any grievances regarding the relationship with the donor in a legitimate forum. This facility is not available with most bilateral partners. However, the relationship with Japan remains positive in this regard due to the close diplomatic

²⁹ Rainford, S – "E- Sri Lanka: An integrated approach to E-Government" ICTA, (<http://www.apdip.net/projects/e-government/capblg/casestudies/>).

relations, levels of dialogue, and understanding between the two countries. This relationship has been developed over several decades and helps overcome the problem of legitimacy that underpins less established bilateral partnerships. For instance, this could be an issue when dealing with newer donors, such as China and India. With regard to IFIs, while it was felt that legitimacy is enhanced by Sri Lanka's seat in the institutions' governance, there is a relatively little influence at this highest level. Not a lot of emphasis was given to the importance of governance of IFIs since Sri Lanka could not realistically be a major player and is unlikely, therefore, to have a useful influence in governance decisions. Increased decision-making authority at the level of country offices of donors is a greater priority. Aid must be provided based on a country's specific requirements and not be determined at the headquarters of IFIs. The weight of decision-making should shift towards country offices, and the recipient countries should dialogue effectively with these offices.

Sri Lanka's experience with budgetary support in the form of the PRSP was not a satisfactory experiment. The following table outlines the concern that, even though the PRSP was said to be home-grown, the contents were much the same as those seen in a SAP.

Table 6: Poverty reduction target figures regaining Sri Lanka

Accelerate Economic Growth								
			Baseline	2001	2002	2003	2004	2005
GDP growth rate	2000	%	6.0	-1.4	3.7	5.5	6.5	6.8
Per capita GDP	2000	US \$	901	838	866	942	1024	1114
Investment GDP ratio	2000	%	28	22	23	24	27	28
Preserve Macroeconomic Stability								
Rate of Inflation	2000	%	6.2	12.0	9.3	7.5	6.5	6.0
Expenditure GDP ratio	2000	%	27	27	26	25	24.2	23.6
Revenue GDP ratio	2000	%	17	16.5	16.8	17.1	17.9	18.7
Budget deficit GDP ratio	2000	%	-9.9	-10.9	-8.9	-7.5	-6.4	-5.1
Current account balance/ GDP ratio	2000	%	-6.4	-1.7	-2.7	-3.3	-4.1	-4.2
Gross reserves (in months of importation)	2000	-	1.7	2.5	3.3	3.7	3.9	3.9

Source: Regaining Sri Lanka December 2002, Government of Sri Lanka.³⁰

In designing the RSL, the government was open in its aim of attracting foreign funding. "The policies described above and our commitments under the PRGF-EFF supported program would help to galvanize donor financing. The estimated financing gap of about \$426 million in 2003 is expected to be filled by mostly concessional financing from official creditors. The World Bank has committed \$110 million of balance of payments support under the PRSC facility, while the ADB plans to provide about \$60 million through their sectoral loans. Bilateral donors are expected to provide \$95 million, including \$70 million that was already committed during the Oslo donors meeting in November 2002. The remainder of the gap (\$161 million) is expected to be financed by the PRGF/EFF arrangements.³¹" When the incentives of the government are aimed so clearly at attracting funding from donors, there is limited scope for the PRSP process to achieve what it was meant to achieve, namely ownership and voice of domestic stakeholders. There is a consensus that the stakeholder discussions in creating the PRSP had little real impact in terms

³⁰ GOSL (2003), Regaining Sri Lanka, Government of Sri Lanka, pp. 157.

³¹ Ibid.

of incorporating greater domestic voice. The overriding incentives were to tailor the policy to maximize the attraction of funding to support the policy programs.

Budget support may not be ideal in Sri Lanka because of the budget management record of successive governments in the country. Poor fiscal discipline has led to a public debt of 93 per cent of GDP and it is unlikely that any donor will provide budget support without expecting significant conditions on fiscal discipline, which may overstep the country's requirements. Furthermore, if conditionality is lax, budgetary support may not create the required incentives to improve fiscal management and thrift. Budgetary support in general, however, has not been a failure in Sri Lanka. In March 2007 the Government of Japan extended a US\$10.2 million grant to the Sri Lankan government to support the country's balance of payments. A statement by the Japanese embassy read: "This grant will be utilised for economic structure reforms, mitigation of balance of payment difficulties as well as for poverty reduction through rural development projects."³² The only condition attached to this grant was that the money could not be used to fund military purchases. Previous Japanese grants of this nature were used to purchase fertilizers, jet oil and crude oil. This type of budgetary support, which is given for a specific purpose, does not create incentives within the recipient government to tailor policies in order to receive such funding. The government has control over how the funds are spent and it is given the flexibility to approach development in the way it sees fit. For instance, fertilizer subsidies are a significant source of government expenditure, and a grant to import fertilizer will help the government better manage its fiscal position while engaging in poverty reduction activities that go against orthodox norms supported by the traditional donors. It is possible and likely that the government will try to ensure effective and just use of the funds in order to maintain the good donor relations enjoyed with Japan.

One issue that undermines the recipient voice in donor-supported programs is the extent of international staff utilized in projects. This criticism is often levelled against the IFIs, the UN system and INGOs. While some local staff are usually hired, the major decision-making positions are occupied by foreign nationals. Consultants are also often hired from abroad and have greater authority than local staff who are perfectly competent. Even those local staff who are hired have often been trained in foreign education systems and are entrenched in donor systems. Therefore locally generated knowledge and debate is usually excluded from decision-making processes within donor-supported programs even at the country level.

PART E THE ARCHITECTURE – EFFECTIVENESS OF SPECIFIC ASPECTS

This section focuses on some specific areas of aid effectiveness measures relevant to Sri Lanka and some perspectives on their impacts.

The Paris Declaration – There was a mixed response to the Paris Declaration when this issue came up in the interviews. Many of the stakeholders had only the vaguest idea of what was entailed, and awareness was clearly at a very low level. Only about three of the interviewees had any real grasp and understanding of the purpose of the agreement. The reason for this lack of awareness is a large gap between those in the government who interact with donors directly and those who sign international agreements at the highest political echelons. This is a shame because the Paris Declaration provides a useful template to address many of the government's concerns with regard to interaction with the aid architecture. This is particularly so with regard to donors aligning aid with country development plans, increased accountability on the part of donors and partners to citizens, and the need for increased authority for

³² www.lbo.lk, "Nippon Help", March 13, 2007.

donors' field staff — as opposed to authority residing in boardrooms in Washington. Most importantly the Paris Declaration needs to be used as a negotiating tool in order to increase recipient voice and ownership in the aid bargain. In this light, an urgent effort is needed to sensitize the ERD and key line ministries to use the Paris Declaration in aid negotiations. At this stage it is not possible to evaluate the usefulness of the Paris Declaration in Sri Lanka because it has hardly been used. However, it seems that at best it could be used to put pressure on donors who are wavering from declaration commitments. It would not guarantee a swift improvement but would certainly increase the chances thereof.

The Paris Declaration addresses a lot of the issues that arise when dealing with the development architecture, but it fails to address some of the pressing problems that affect Sri Lanka in this regard. A major problem has been the conduct and regulation of NGO and INGO development activities following the tsunami in Sri Lanka. It is unclear whether INGOs are also subject to the conditions of the declaration. The problems were discussed in detail in an earlier section and therefore do not require revisiting. The government has more control over dealing with the major donors who are bound by the Paris Declaration, and many of the suggested improvements in the Paris Declaration have been implemented unilaterally in dealings between the government and the major donors. It is the more fragmented and less regularized INGOs that really need to be brought under some form of control. Another issue missed by the declaration is the importance of state sovereignty in terms of political conduct. This refers to the political conditionalities placed by bilateral donors targeting the peace process, human rights violations, and so on. The Paris agenda contains no targets or indicators relating to the reduction of such measures. Political conditionalities undermine a democratically elected government's accountability to its people and undermine the principle of mutual accountability enshrined in the Paris Declaration, according to which both donors and recipients are responsible for the developmental outcomes of aid. Furthermore, the seventh target of the Paris agenda, related to the predictability of aid by ensuring that aid disbursements are released according to schedule in annual or multi-year frameworks, has been compromised in Sri Lanka as several countries³³ have withheld some aid disbursements due to politically motivated considerations. The utility of the Paris Declaration in the face of geopolitical objectives of donors must be called into doubt, given the Sri Lankan experience. While the declaration refers to the importance of harmonizing environmental and other safeguards, it fails to point out the importance of rationalizing and trimming such safeguards. Massive transaction costs are incurred in attempting to implement these safeguards and bureaucratic capacity is also constrained when dealing with safeguard texts which run into numerous chapters of documentation. Finally, the Paris Declaration will struggle to achieve results as long as it remains an agreement involving a large number of actors, often with conflicting interests, attempting collective action, with no penalties for renegeing.

Specific tools – Donor coordination has been considered a priority in the aid architecture literature. In Sri Lanka, this is considered less of an issue when dealing with the major donors and large projects. All projects go through the Department of National Planning and therefore duplication is prevented at that stage; transaction costs are limited due to different donor processes and the high concentration of donors. This is more of an issue when considering fragmented smaller donors who do not work through the government. Reporting of activities by such players is also weak, undermining coordination efforts. (For instance, Canada, which provides most of its assistance through NGOs, has been reluctant to inform the ERD about such funding even to the extent of not providing data to the ERD to enable it to capture grant flows.) Sri Lanka's position on this matter is to encourage donors to work through the government instead of working through NGOs. In this way, the Department of National Planning can ensure funding goes to the most needy and prioritized sectors. The INGO sector is so fragmented and dispersed it is unlikely that effective coordination will ever be a reality. In this context, it would be more prudent to evaluate the functionality and effectiveness of individual donors; if they are failing to deliver useful outputs, they should be asked to cease activities in the country. The major donors themselves have an institutionalized

³³ Germany, Britain and the USA.

system of coordination. There is a regular meeting of the major donors (ADB, WB and Japan) with a rotating chair, aimed at coordination of lending practices and harmonization of measures, such as procurement guidelines. Coordination of lending policy is challenging due to varying stances adopted by the different donors. The government often prefers to deal with the major donors individually because this provides it with more choice and negotiating power. For instance, with regard to water distribution, the World Bank was in favour of privatization while the ADB was more open to working without privatization. The government would be keener on adopting the ADB approach but, if there is donor coordination in terms of policies, there is a chance that the World Bank approach would take precedence. This would not be in the government's interest. Morocco is another country that prefers to deal with donors in this manner, thereby trading slightly higher transaction costs for improved negotiating leverage. Harmonization in this case could refer to donors individually improving their offers in terms of flexibility and predictability around a recipient-led mandate, rather than a group-based decision. For instance, in Sri Lanka harmonization is still required in procurement processes. While the ADB and World Bank adopt similar methods, the Japanese procurement processes vary. At present, the National Procurement Agency is working with donors in attempts to improve harmonization.

However, there are cases where the decentralization of aid to non-state actors is in fact beneficial. Projects that go through the state system for acquiring foreign assistance are often prioritized based on political visibility. Therefore, an important but less politically desirable project may have to take a back seat. With decentralization of aid delivery to institutions such as embassies, the decision as to whether the project will be funded or not will be with that institution nominated by the donor, thereby avoiding political capture.

Another specific approach taken by donors has been an attempt to align with the national development plan designed by local stakeholders. This process is not at a mature stage in Sri Lanka as the government only presented a 10-year development plan to donors at the Galle Development Forum in January 2007. Unfortunately Sri Lanka's volatile political climate has resulted in three separate development frameworks in the last four years (Regaining Sri Lanka, Rata Perata and Mahinda Chinthanaya). Donor alignment cannot be expected when there is a change in the national development plan with each change in government. In this context, it is important that country development plans attempt to capture a greater degree of political consensus and reach a compromise that will result in general continuation of the program despite changes in government. The present development plan was framed primarily by the Department of National Planning with input from relevant line ministries. It is essential that greater stakeholder input from academia, civil society and political parties be drawn into this framework in order for it to better reflect national ownership. It is encouraging to note that the present draft of the Mahinda Chinthanaya is now undergoing revision along these lines.

Alignment, according to the Paris Declaration, requires donors to align country aid programs to national development strategies designed by partner countries through broad national consultations and translated into results-oriented operational programs expressed in medium-term expenditure frameworks and reflected in annual budgets.³⁴ This demands a lot of capacity on the part of partner countries, and in reality this is often lacking. In terms of Sri Lanka's 10-year development framework, initial donor response has been positive and donors feel that the plan provides a useful template; however, it remains very broad, making it difficult to use as an exact reference point to target support effectively. Sri Lanka's last three national development plans have been based on election manifestos and therefore have lacked broad consensus and ownership at all levels. By focusing on national development frameworks, the Paris Declaration inadvertently takes a state-centric position with regard to ownership of the development process. While the state must be the key player, too much focus on the national development framework could undermine the interests of the marginalized poor who lack voice in the development debate. In most

³⁴ Paris Declaration item 14.

developing countries where democracy remains nascent, the voice of many marginalized groups is often not represented in political processes. Therefore, it is unrealistic to expect well developed and coherent national development frameworks to emerge within a short period of time. Alignment to recipient development frameworks can also be undermined by overarching policy, goals and targets articulated by donors' head offices. This is another argument for increased decentralization of aid delivery, as it would better suit effective alignment of aid as per the Paris Declaration.

Technical assistance – The impact of technical assistance in Sri Lanka has been mixed. While there are benefits such as the access to high quality technical expertise and to technology itself, there is also a great deal of wastage. Recipients working with Japanese aid in particular were happy with the extent of technological flows that have been absorbed into the country. A good project proposal is another key factor in ensuring the best use of technical assistance. There have also been high quality capacity development exercises by bilateral donors, such as Germany and the EU, that have targeted important long-term institution building. For instance, one of the EU-assisted projects³⁵ involves capacity building of trade negotiators in Sri Lanka, an essential tool for improved accessibility and integration into global markets. However, some of the technical assistance has been of a poor quality. For instance, a technical assistance project in the education sector saw teachers being sent to England for a training program at a relatively unknown university. Often with a technical assistance grant, a large proportion of the money is spent on hiring very costly consultants from abroad. However, if technical assistance is part of a loan, the government hires the consultants and would have greater incentive to hire a more cost-effective alternative, often available locally.

Scaling up aid – The Paris agenda has called for a “scaling up of more effective aid”, reflecting the urges of many international civil society organizations. However, scaling up the quantity of aid is not always the priority. Donors should not be seen as an expanding entity with an ever-increasing role, particularly in lower middle-income countries like Sri Lanka. It is more pertinent to ensure better quality aid and more efficient use of present aid flows. The concerns about aid dependency and absorption capacity are well known. As donors, particularly bilateral donors, scale up aid, there will be increased demands from domestic constituencies in donor countries for results. This may create incentives for donors to focus on projects yielding benefits in the short term and to prioritize visibility over developmental impact. Furthermore, with increased expectations of visibility, it will make it politically more difficult for donors to provide general budgetary support, which is seen as a priority in many developing countries. Donor governments may also need to “buy” political support for increased aid by ensuring greater benefits for their constituents. This may entail more tied aid requiring the use of products and services from donor countries.

Performance-based allocations – Most bilateral donors base aid allocations on mixed objectives, depending on political considerations, recipient need, the aid utilization record and so on. Multilateral donors and some bilateral donors base allocation on a need-performance selectivity model. The result of this overall lending pattern is a patchwork of allocations, creating donor darlings who include both good performers and bad performers with powerful allies, while many countries in between often miss out despite being among the most deserving. Between 1999 and 2005, 75 per cent of World Bank lending was to 12 countries – Turkey, Brazil, China, Argentina, India, Mexico, Indonesia, Cambodia, Russia, Romania, Korea and Thailand. Despite having strong institutions to make good use of aid, these countries are not necessarily the most worthy recipients of bank funding since they have access to commercial finance as well. In fact, IBRD funds account for less than one per cent of private financial flows into these economies. This suggests the need for a shift of resources to countries with less access to capital markets. As Afghanistan's Minister of Finance stated at the ADB's Kyoto meeting in 2007, support must now focus on the poorest and most compromised members. “It is these countries — the fragile states — where

³⁵ EU, International Trade Centre (ITC) Sri Lanka Trade Development Project 2004.

ADB has the greatest impact,” he said. Lending criteria, such as the World Bank’s Country Policy and Institutional Assessment (CPIA) and other performance-based lending schemes, will need to be reformed to reflect this need.

Sri Lanka is affected by the allocation measures used by the World Bank and ADB which are broadly similar. The World Bank rates the economic and social policies of borrowing governments based on 16 criteria under the themes of economic management (macroeconomic policies, fiscal policy, debt policy), structural policies (trade policy, financial markets, regulatory environments), social inclusion (gender, labour standards, environment), and institutions and the public sector (transparency, accountability, property rights, public administration quality and budget management). The CPIA is used in determining the allocation of resources to borrowing countries as a performance indicator along with a country’s “need” when calculating lending levels. The IDA Country Performance (ICP) rating, the dominant determinant of IDA’s country allocations, is based on a two-step calculation: (i) the weighted average of the country’s CPIA (80 per cent) rating and its Annual Review of Project Performance (ARPP) rating (20 per cent); and (ii) the multiplication of this weighted average by the governance factor. Governance is the dominant element in the IDA’s performance-based allocation system, the effective weight of which is 66 per cent.³⁶ The ARPP rating is a measure of a government’s management of its loan resources.

The idea of performance-based allocation (PBAs) turns the issue of conditionality on its head. Conditions are required when a recipient has interests misaligned with those of the donor. Using PBAs, the donor will support countries showing evidence that their preferences are already aligned with donors. It is a form of *ex-post* conditionality, where past performance is assumed to be a good predictor of future performance. However, this form of aid allocation runs into several criticisms. Most importantly the CPIA is at loggerheads with the spirit of the Paris Declaration since it has no recipient ownership. The criteria included in it may well be completely at odds with a country’s development strategy. Unfortunately for countries lacking access to alternative sources of finance, it may become necessary to tailor economic and political policies in order to increase funding allocations from the major donors. This has far reaching impacts on the sovereignty of recipient governments. The Bank’s CPIA appears to retain a one-size-fits-all measure, reminiscent of failed structural adjustment policies. What constitutes “good trade policy” or “good fiscal policy” varies with the circumstances of one country to another. There is also reason to doubt the credibility of the scoring system adopted by the Bank in the CPIA. Sri Lanka in 2005 was given a rating of 3.5 for trade policy despite being one of the most liberal trading economies in the developing world, and social protection and labour was given a rating of 3.5 despite universal health care and education and one of the most protected labour markets in Asia. There are other indicators such as “quality of public administration” which are numerically rated without much indication as to how the figures are derived. It begs the question as to what qualifications the Bank has to rate aspects such as gender equality, labour standards, and environmental sustainability.

Sri Lanka at present has substantial need for resources, particularly for the development of much needed public infrastructure, such as road networks and in the energy sector. However, concessional lending to Sri Lanka, determined through measures such as the CPIA, has declined, forcing the country to seek expensive commercial capital. Therefore, there is a case for revisiting the criteria upon which aid disbursement levels are determined. The positive feature of the CPIA is that it could create incentives to generate the institutions required for better aid management. However, in reality tools such as the CPIA are not necessarily going to bring about the required improvements in governance that are essential in a democracy. These need to be developed from within, with democratic participation and ownership to ensure sustainability.

³⁶ IDA’s Performance Based Allocation System: IDA rating disclosure and fine-tuning the governance measure, IDA September 2004.

PART F OVERALL EFFECTIVENESS AND REFORM OPTIONS

The present relationship between Sri Lanka and the international development architecture is in a transitional period. Following the unsuccessful PRSP process, project-based lending from the major donors took over as the major form of donor assistance. However, with a resource-consuming infrastructure drive and declining availability of concessional finance from the major donors, Sri Lanka has been moving towards other sources of finance, including new donors and commercial borrowing. Both approaches are fraught with risk. Bilateral partners usually have commercial or political interests when giving aid, especially emerging political powers in Asia, such as China and India. Furthermore, given their lack of credentials as established donors, the quality of aid comes into question. The lower levels of transparency inherent in bilateral aid deals also leave room for increased corruption. Commercial borrowing too could be a burden in the long run since the higher rates of interest put pressure on future repayments. All this has taken place with little or no downward change in borrowing from the established donors who contribute 80 per cent of Sri Lanka's foreign borrowings — ADB, WB and Japan. Even though Sri Lanka's per capita income has increased to US\$1,355 in 2006, there are regional inequalities in income and development. Therefore, the aid architecture still has a role to play, particularly in helping bridge the gap between rural populations and the urbanized Western province. The infrastructure projects in which the ADB, WB and Japan are involved are certainly a good step in this direction. Furthermore, it could be argued that it is not a bad thing to move away from concessional finance, given the record of poor utilization of low cost finance. It is often perceived that concessional loans are equivalent to grants, particularly when repayment periods are significantly beyond political horizons. This results in inefficient use of funds and investment in unviable projects that are not priority requirements. The incentive sets of lenders tell them to keep lending, and the recipient does not always realize the wastage because it is perceived as a grant. Since none of the actors feel the pinch of a real cost that needs to be paid back, there is greater scope for waste.

The government has been concerned about the issue of conditionality and policy space. However, with regard to the recent relationship with the aid architecture, this seems to refer primarily to concerns about aid being tied to the peace process in the country. Macroeconomic conditionality is no longer a factor when project-based lending is at the forefront. This kind of arrangement can be considered in a favourable light compared to the era of budgetary support under the PRSP. The latter necessarily entailed increased donor involvement across most areas of the economy. It would be naïve to expect donors simply to fund a budget and then step aside. In order to ensure effective use of the budget, donors will be concerned about issues such as inflation, and this would result in either direct or indirect infringement of macroeconomic policy sovereignty. For instance, the current government is more interested in investing heavily in infrastructure and therefore it is likely that there will be a greater component of state expenditure. This would not always be consistent with the low budget deficits and low inflation which are characteristics of more orthodox economic management advocated by established donors. In the present system of project-based lending, the state can choose which specific areas it wants support in and can utilize donor expertise in those limited areas. Macroeconomic conditionality becomes less of an issue, and conditions are limited to sector-specific matters which are easier to handle.

Despite the government's concerns about it, conditionality in some form is an inevitable feature of any aid relationship, since it is the conduit by which recipient's preferences and donor's preferences are aligned. Therefore, it is unrealistic to expect the incentives that brought forth conditionality to simply vanish overnight. What is required is to ensure that conditions do not overstep this function and do not completely undermine legitimate recipient interests. In fact, conditionality cannot be written off as categorically bad. An example of this occurred in the energy sector: a project funded by the ADB included the condition that Ceylon Electricity Board reforms were pushed through. These reforms were much needed, given the inefficiencies inherent in the system. However, due to trade union problems, the

required reforms did not take place and the ADB froze funding for the project. This type of conditionality can be useful for the government in attempting to push through necessary but politically contentious reforms. However, it is a thin line that needs to be trodden with care. A key concern regarding the donor relationship in Sri Lanka is the donors' relative lack of sensitivity to political contexts in the country. As explained in Part A, Sri Lankan politics is characterized by coalition governments, slim majorities and sharp ideological cleavages.

While the relationship with the major donors is at this stage a satisfactory one, there remain concerns about the role of INGOs in the country. This issue has been dealt with extensively in this paper and it is important that the government be more prudent in its management of INGOs, especially in terms of numbers operating in the country with little accountability for their actions. The UN system also requires reform. Comparative advantages and areas of expertise have been identified. It is important that the UN focus on these areas without attempting to involve itself in a number of other areas that are not a priority in the country.

Reform Priorities

Sensitivity to political context – As mentioned earlier, this is an issue that is frequently highlighted in Sri Lanka because of donor attempts to influence political processes in the country, particularly in light of the conflict that is taking place. The argument of the state and civil society is that this conflict and the solutions to it are complex and embedded within socio-political structures that have evolved over several decades. It is impossible for outsiders to comprehend the problem, let alone suggest solutions, and therefore they should not attempt to influence political processes. The other aspect of political sensitivity is the lack of donor understanding of the political constraints faced by the government. Many required and essential reforms are not easy to push through. Parliamentary majorities are often slim due to the proportional representation electoral system. As a result, the government needs to rely on coalition partners who often have ideologies divergent from traditional political economy. Many reforms are difficult to attain because of this, but sometimes donors fail to recognize these issues and are dogmatic about policy options. For instance, the World Bank in one of its education support programs insisted on a halt on new teacher hiring. The government soon afterwards recruited 40,000 unemployed graduates into the public sector,³⁷ some of whom had to be drafted as teachers. The World Bank was greatly opposed to this and the discussions and arguments over this issue resulted in major delays in implementation of some of the programs that were being funded. While most would agree that the mass recruitment into the state sector is not an economically prudent policy, the delays could have been avoided if the World Bank were more sensitive to the political contexts in the country. Beyond understanding of political contexts, it is important for donors, and the less established INGOs in particular, to have a greater understanding of the local socio-political and cultural fabric. At present, these organizations are dominated by internationals and internationalized local staff, particularly at the higher echelons of leadership. As a result, there is a lack of understanding of the local situation. For example, the multilateral needs-assessment study by the WB, ADB and Japan for post-tsunami reconstruction pegged the loss borne by the tourism industry at US\$300 million, versus US\$90 million by the fisheries industry, though the latter was more severely affected. This style of accounting is a reflection of the failure to understand the foundations of conflict and local conditions that have marginalized poor fisheries communities in the Northeast and South and driven them towards conflict.³⁸

Reduction in operational costs – A concern with major donors, INGOs, and the UN system is the bureaucracy that characterizes their activities. Phantom aid is defined by Action Aid as “aid that never

³⁷ Youth unrest due to unemployment and economic hardship led to violent civil conflict in 1971 and 1987, the legacy of which continues to influence governments.

³⁸ Rajasingham (2006).

materializes to poor countries but is instead diverted for other purposes within the aid system.” It is tied to goods purchased from donor countries, overpriced technical assistance, administration costs and transaction costs.³⁹ In Sri Lanka, administration costs make up the greatest segment of phantom aid. Large salaries are paid to international consultants who do not necessarily add an equivalent value to the development process. Costly per diems, vehicles, excess staff and projects with weak cost-benefit ratios remain prevalent in the aid bureaucracy in the country. The aid bureaucracy is often perceived as a self-sustaining entity that acts as a system for the export of labour from developed nations. While different organizations have different levels of wrongdoing in this regard, it is widely accepted that the UN system and some of the larger INGOs are particularly at fault here. The Action Aid report stated: “In 2003 developing countries transferred a net US\$210 Bn to the rich world, interest payments alone continued to take US\$95 Bn of developing country resources, almost three times the value of what they receive in grant payments.” Since there is limited economic motive for efficient use of finances, it is essential that extra effort be taken to minimize operational costs of the aid architecture institutions. The money that is spent on these institutions is meant to feed directly to the poor people in developing nations. However, much of this money is simply wasted on bureaucratic processes. Furthermore, this money needs to be repaid by the recipient country. Transparency is the key here. Institutions need to be audited. Projects should clearly specify the details of operational costs incurred. Salaries paid to consultants need to be publicized and justification should be provided for the need to hire foreign consultants.

Loan covenants and micromanagement of projects – Loan covenants are considered an improvement from the stricter conditionality system that was attached to loans in the past. Covenants and safeguards too have their drawbacks. As explained earlier, these are agreements between the state and the donor on what processes need to be carried out alongside the project in question. Safeguards usually refer to environmental aspects and resettlement and compensation of individuals disrupted by projects. While both of these objectives are noble and required, it could be argued that the state is in the best position to decide what is required for its own people in the long run. The Sri Lankan government has the democratically elected mandate to look after the concerns of the population, and therefore the development architecture does not really need to ensure safeguards for a population over whom they have no mandate. The government is accountable to the people if its conduct in development projects incurs any damage, while the development agencies are not accountable to anyone for the delays and costs inherent in the implementation of safeguards. According to an interviewee, US\$40 million of a recently approved US\$150 million ADB loan was spent on resettlement by the government. This accorded with the ADB’s safeguard requirements. As mentioned earlier, the ADB and other development agencies are not in a position to fully understand the cost structures that occur locally and therefore may not have the best idea as to how best determine safeguard requirements. Since the government is taking out the loan and spending the money, it should have the freedom to decide how best to spend it, taking into account the short-term and long-term costs and benefits to the people concerned. This is what they have been elected to do. One school of thought suggests that the incorporation of environmental, resettlement and other safeguards are the result of donors trying to clean up their own acts, along with pressure from activist groups in the global North. These safeguards may not be in the long-term interest of developing countries that have different preference sets than developed nations.

The other problem with safeguards and covenants is the extent of paperwork and bureaucratic processes required. As a result, much time and energy is spent understanding the agreements in question. This contributes to delays in project implementation, and often repayment of the loan has started before the project is completed. Covenant agreements can run up to 80 pages in length. Micromanagement by donors is another issue. Implementing units have to report to the donors with details of the implementation. Government stakeholders are of the view that the present level of micromanagement is too extensive and contributes to delays and strain on institutional capacity. It was argued that, since the

³⁹ Ibid.

government is repaying the loans with interest, the donors should not burden them with requirements of monitoring and management, and the government should be given a more liberal hand in running projects. That said, the donor does have a responsibility to see that funds are not wasted, and a compromise would require some form of streamlining of present monitoring processes. An alternative mechanism would be to make use of the inter-agency committees that most loan-financed projects set up to monitor performance. The reporting burden could be shifted to these units from the implementing units. However, this would require more efficient and effective inter-agency committees.

Transparency - The need for improved transparency at all levels of donor activity is a theme that recurs frequently in the aid literature, and it is no different in Sri Lanka. The issues with operational costs, excessive expenditure on consultants and so on were highlighted earlier. Transparency is important to streamline these costs. Transparency is also important to tackle the issue of corruption in donor-funded projects, which has been a longstanding problem in Sri Lanka. A detailed examination of corruption in this sector is beyond the scope of this paper, but it is a problem at many levels in the entire process. Again transparency is the key to tackling this. The implementing ministry should publicize the amount of aid received and how these funds were used. Often transparency within the donor administrative system is insufficient (i.e., the implementing agency reporting to the donor who in turn reports to Manila or Washington) since the country-based donor has an incentive to show that projects under his/her watch are running well to maintain confidence in aid systems.

Another option for reform is to look at present feedback mechanisms within projects. As it stands, aid and information flows resemble the following system:

1) Aid

Donor official → Government official → Beneficiary

2) Feedback

Beneficiary → Government official → Donor official

3) No link of Beneficiary → Donor official

If the link (3) is created, it would increase accountability, improve the flow of information, and allow service provision to be more effective since it sidesteps the extra layer of service delivery.

In the past there have been attempts by donors to increase this kind of transparency. Public Expenditure Tracking Systems (PETS) were introduced in some of the donor-funded projects in Sri Lanka. However, these did not sustain momentum and it is unclear whether they are being used extensively at the moment. It would certainly be advisable to have this kind of information for public knowledge rather than just information between donors and the implementing agency.

Domestic capacity development – Domestic capacity development has often been seen by donors as essential to improve capability. While it was pointed out that such attempts in the form of technical assistance have had mixed results, there are more pertinent ways to contribute to this process. The key here is to allow domestic institutions to build their own capacity through experience and involvement. The Paris Declaration recognizes this fact. According to Article 21, donors commit to “Use country systems and procedures to the maximum extent possible. Where use of country systems is not feasible, establish additional safeguards and measures in ways that strengthen rather than undermine country systems and procedures.” While this has been happening already, there remains room for improvement. For instance, the donors can reduce the burden placed on domestic institutions through extensive bureaucratic requirements of handling aid, and the extensive missions that characterize lending practices (ADB in particular) which take up a lot of time of government officers. Mission-free periods, particularly

during budget periods, have been suggested to overcome this problem. However, the extent of missions is a symptom of the insufficient decentralization of decision-making power to country offices. With decentralization, there will be less need for donor missions. Furthermore, aid architecture institutions tend to capture some of the best human resources from the government and civil society by employing them at far better salaries than available locally. This creates an internal brain drain of sorts, undermining country capacity. Here again donors need to minimize their role in the aid partnership. The greater the number of people involved, the greater the bureaucracy, and the greater will be the transaction costs of the transfer of resources from lender to borrower. The bulk of the planning, implementation, and design of work needs to be from the recipient's end. While present capacity leaves much to be desired, part of the reason for this has been the lack of opportunity to build their own capacity.

The most important reform, however, needs to be in the attitude of donors. The aim of the development architecture should be to transfer resources to a developing nation, support the process of development, and then leave. However, aid has become an industry in itself, and the incentives to fulfill a temporary role are blurred by requirements of careers. This is epitomized in the Sri Lankan post-tsunami experience where donors who entered the country to help with disaster relief ended up staying on and branching out into a range of different activities where their services were hardly needed, simply to fulfill the requirements of a self-sustaining industry. This attitude needs to change. Then it will be easier to move on in terms of recipient country development to a more sustainable and productive development relationship.

Domestic Reform

As has been emphasized throughout this paper, aid is a partnership and reform therefore also requires work from both sides. The first priority of the government is to improve the quality of the Ten Year Development Plan that has been put forward as a framework for development activities over the next decade. At present, the plan remains imprecise and lacks focus. As the plan was created primarily through the Department of National Planning and relevant line ministries, this would require broader stakeholder discussions to incorporate the views of a wider range of the public. This would help donors make more precise contributions to the development process and help categorize and delegate different donor activities. It is encouraging to note that at present the 10-year plan is undergoing changes to reflect a broader range of views. The responsibility for development of domestic capacity lies to a great extent with the state which needs to decentralize decision-making in terms of donor management. For instance, in an ideal world, donor coordination at the provincial level would be handled by provincial governments, particularly with regard to dealing with fragmented INGOs. Provincial governments would be better placed to understand the needs of the community and be better able to handle donor coordination within a smaller geographic area. A major criticism has been the lack of regulation of NGO activity. It is important for the government to prioritize the creation of a framework of regulation of this area. It should also be more prudent in deciding who it allows into the country to conduct development activities and what they will be doing. Finally, transparency is important on the part of the government as well as donors. This is particularly true of bilateral aid projects where there are inherently fewer transparent bidding practices and strings attached. These need to be publicized to minimize loss of public funds through waste or corruption.

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