1. Policy Perspectives

The Sri Lankan economy did better than anticipated in 2005. Among the positive signs has been a return to a relatively strong performance with a healthy GDP growth of 6 per cent, driven largely by continued strong expansion in industry and services. Output growth has also led to improvement in the labour market in aggregate; the progressive decline in the rate of unemployment since 2002 has continued into the first quarter of 2006 with estimates suggesting that unemployment has dropped to 7.2 per cent as compared to a corresponding figure of 8.1 per cent in 2004. The post-tsunami surge in aid inflows, remittances and debt relief in 2005 also offered a reprieve to the economy to withstand pressure on the external front emanating from high international oil prices. The strong performance in GDP growth continued into the first quarter of 2006 with a growth rate of 8 per cent. The forecast for output expansion in 2006 thus remains optimistic with an expected real GDP growth rate of close to 7 per cent.

While the short-term economic outlook has brightened, Sri Lanka faces deep-rooted obstacles before it can be confident of sustaining the growth momentum. The imminent threat of a resumption of hostilities remains at the forefront as a key risk in efforts to move to a durable growth rate of 7 per cent and over. The risks to the economy from a return to war stem not so much from a curtailment of the contribution from the conflict affected Northern and Eastern Provinces to the country's GDP - with the contribution of the Northern Province for example estimated at less than 3 per cent - but primarily from the additional fiscal pressures and loss of investor confidence on the long-term outlook for the country.

The sustainability of the growth performance, therefore, needs to be looked at carefully. This entails the performance of the macro economy in ensuring stability, as well as the effectiveness and cohesion of an economic reform agenda that supports the long-term task of raising economic growth. At best, the performance on both fronts during 2005-06 has been mixed.

In Sri Lanka, calls for economic reforms have been heard more often than they have been heeded. Since the late 1990s, reforms have more or less been held at a standstill, and where they have occurred they have been piecemeal and half-hearted. While the momentum from the earlier reforms still continues, the prospects for economic success - building for robust and sustained growth - may look uninspired unless political weight is placed firmly behind the direction of more reforms. Sri Lanka's Presidential election of November 2005 was expected to be decisive economically as well as politically. The 2004 general election victory for the opposition United People's Freedom Alliance (UPFA) against the backdrop of a relatively buoyant economy was widely interpreted as a response to the perceived neglect of the rural economy where 70 per cent of Sri Lanka's population resides, many of them in poverty. Much of the policy programme - enunciated in the 'Mahinda Chintana' - adopted by the winning presidential candidate was a promise to tackle their plight.

Few voters ever read manifestos, and governments are shaped more by events than by policies. But manifestos nevertheless matter in that they are an indication of how political parties want to be seen by voters. Going by the election manifesto, the intention of the government's economic programme appears to be to mark a shift to a more sustainable growth model; the transformation includes ensuring that growth is more evenly shared across the country. These are sound objectives. The mere fact that the Sri Lankan economy continued to post an average growth rate in excess of 5 per cent per annum during a decade of conflict in the 1990s reflects the growing economic marginalization of the conflict affected provinces in the Northern and Eastern parts of the country. A fast growing gap between regions, and between rich and poor, can exacerbate social unrest and defeat long-term socio-economic and political objectives.

However, a renewed concern about the discontent among those left behind by economic progress should not be viewed as a reason to mitigate liberalization. The need for reforms to boost economic performance is all the more important in that growth could suffer as an unintentional consequence of pursuing equality. Successive governments have long recognized where they need to concentrate resources - raising levels of investment, especially in infrastructure - if the country is to raise its long-term growth prospects from about 6 per cent a year to 7-8 per cent or more. The recognition has come about with the understanding that Sri Lanka's economic priorities - unemployment, regional disparities and enduring rural poverty - require more than spurts of growth.

However, acknowledgement of the problem and recognition of what needs to be done has not automatically materialized into policy implementation. And nowhere are the cumulative results more evident than in the state of the country's public finances. Failure to restructure fiscal management has meant that fiscal deficits have hovered in the range of 9 per cent over the past decade, leaving little leeway to build for growth. The experience in 2005 has been no different, the budget deficit, despite improvements in revenue collection, amounting to 8.7 per cent of GDP.

While it has been encouraging that despite political pressures, the government has not embarked on large populist public spending schemes, the criticism is that budget policy is doing too little to ensure sustained growth in the long term. The deficit in 2005 was contained not by streamlining government spending but primarily by reaping the extra revenue that comes with growth. There were big rises in spending in some areas - adding workers to the government pay-roll where payments on salaries and wages increased from 5.2 per cent of GDP in 2004 to 5.9 per cent of GDP in 2005 - that do little to strengthen long-term growth prospects. Current transfers and subsidies over time have increased from 4 per cent of GDP in 2003 to 5.4 per cent of GDP in 2005.

There is also waste in the budget, notably in the form of ill-directed fuel subsidies. Fuel subsidies in theory are aimed at the poor but benefit the rich disproportionately. After much deliberation, the government took a positive step in reducing subsidies on various fuels in May 2005, the first fuel price rise in 8 months. The move - and a subsequent price increase in July 2006 - partially resolves concerns about the stresses that rising global energy prices have placed on the fiscal balance through fuel subsidies and huge losses incurred by the state-owned Ceylon Petroleum Corporation (CPC). Oil markets have seen an unprecedented combination of tight supply, surging demand and financial speculation. Notwithstanding the recent volatility in prices, there is a growing perception that the price increases may prove more enduring than previously anticipated. Given the steady upward rise in oil prices, overhauling energy policies - cutting subsidies and raising domestic prices - are inevitable to curb demand and allow government budgets to be maintained.

Most expenditure is hard to cut. The spending goes largely on interest payments, defence, and public sector wages and pensions, leaving little room for big capital investments. Given the limited room for manoeuvre, curtailing expenditure in non-productive areas is critical. But most importantly, if the government is going to make a difference, it needs to raise more revenue. It has made a start by reversing the steady decline in the tax/GDP ratio experienced since 1999. It may be argued that now, while the economy is growing healthily at 6 per cent, it would be far easier to make difficult choices than later in the economic cycle. However, one of the most pressing tasks here will be to raise tax revenues without discouraging investment. Tax increases effected on an ad hoc basis - and with limited regard for the overall structure and incentive implications of the tax system - can prove counterproductive if it undermines the predictability and consistency of the policy regime. Many 'temporary' taxes - such as the imposition of excise duties on select 'luxury' goods and cesses - introduced for short-term fiscal consolidation also tend to become entrenched in the system over time.

Simplification of a system riddled with exemptions would also help. Tax exemptions are often used to attract foreign investment but the cost can be quite heavy, going beyond the mere fiscal outlay or foregone revenue. Faced with a narrow tax base, competing claims for social spending and economic infrastructure can put borrowing requirements under strain. Tax breaks that leads to seepage from revenue - and as a result militates against macroeconomic stability - runs the risk of discouraging long-term investment. There is also emerging international evidence to suggest that a sound macroeconomic environment and good infrastructure are far more effective in encouraging inward investment than tax exemptions, which also run the risk of distorting investment decisions in favour of inefficient projects.

The quality of fiscal consolidation needs to be improved by re-orienting expenditures to priority and growth enhancing areas. Given the strong growth performance of the economy and the risk of a further widening of the external current account deficit, the authorities should resist any temptation to loosen the fiscal stance and use the additional revenues from higher growth for debt reduction. Fiscal consolidation would also reinforce monetary policy in controlling inflation. The failure to rein in the fiscal deficit saw the economy grappling with rising inflation in 2005. Under inflation, the government benefits; not only is the debt burden reduced but inflation automatically raises taxes. The reduction of Sri Lanka's overall debt from 105 per cent of GDP to 94 per cent of GDP in 2005 is explained partly by inflation. But high inflation has a far higher cost to the economy in terms of its potential to disrupt steady growth.

Nevertheless, steady progress was made from mid-2005 in reining in inflation which peaked at nearly 16 per cent on a point-to-point basis in February 2005 to finish with an end-year inflation rate of 11.6 per cent. The initial response to rising inflationary pressure was slow. Policy rates remained unchanged for 6 months from November 2004 allowing credit growth to expand at a rate of over 20 per cent. The first policy rate hike of 25 basis points in May 2005 was followed by further tightening in June, September and December 2005 - in total an increase of 125 basis points in the year. As the downward trend in inflation reversed sharply in May 2006, further rate hikes of 25 and 12.5 basis points were effected in June and July 2006, respectively.

Monetary policy has constantly to deal with uncertainty - emerging bubbles, size of output gap, etc. - and may be a reason for responding cautiously, and to avoid inflicting too much damage on the prospects for growth. Nevertheless, if central banks hold interest rates low, this will encourage risk-taking in financial markets and excess liquidity will spill over into inflation. When prices have lost touch with fundamentals, there are other signs of excess, such as rapid credit growth. And fiscal discipline overall becomes a less effective rallying cry when interest rates remain low despite large budget deficits. In the prevailing macroeconomic environment in Sri Lanka, therefore, monetary policy should remain focused primarily on the requirements of continuing disinflation.

Fiscal and exchange rate developments are interrelated. High public debt and rising fiscal deficits raise concerns about fiscal sustainability and in the normal course of events would trigger a depreciation of the currency and an increase in import prices. However, in 2005, the fiscal consequences on the exchange rate were mitigated by the generous post-tsunami aid package that the country received. This not only assisted Sri Lanka in maintaining a healthy surplus on its external account and a steady exchange rate but also saw an increase in investment spending that is providing an immediate boost to GDP growth. Total investment in the economy increased from 25 per cent of GDP to 26.5 per cent of GDP in 2005, driven primarily by the tsunami related reconstruction costs borne by the government. Private investment in fact declined marginally in 2005. The increase in tsunami related investment is essentially a replacement of lost capital stock rather than additional investment - *albeit* with some expected improvement. As the tsunami related capital inflows ease, the government appears to be increasingly looking to raise foreign loans for budgetary support, forecast to increase from 1.8 per cent of GDP in 2004 to 3 per cent of GDP in 2006 to bridge some of the financing gap.

Foreign currency denominated borrowing carries its own risks. Sri Lanka went in for a sovereign rating in December 2005 as the first step to raising an estimated US$ 500 million through the international bond market. Credit ratings offer assessments of the likelihood that an issuer will default on the interest or principal due on its bonds and routinely cover bond issues of all kinds. Whether a country has the highest possible AAA rating or a DDD plays an important part in determining the rate at which it can borrow. For Sri Lanka, rating agencies - transfixed by stubborn budget deficits and a large public debt - assigned a BB- (below investment grade) and a B+. The escalation in hostilities saw a downgrading of Sri Lanka's credit outlook from stable to negative at end April 2006.

There are inherent risks in increasing exposure to borrowing - any rise in risk premia not only increases the government's current borrowing costs, but immediately reflects on the financing costs of the stock of liabilities - but they may be heightened when resorting to foreign currency denominated debt given the additional exchange rate risk. Nevertheless, in June 2006, the government announced the issue of US$ 300 million Sri Lanka Development Bonds (SLDBs) with a mix of two and three year maturity, and a further US$ 175 million with a three year maturity in August 2006.

Strong growth across all sectors characterizes the on-going recovery. Yet it is too early to determine at this point to what extent the rebound reflects a transition to a higher medium-term growth path. As agriculture's share in the Sri Lankan economy has shrunk, its place has been taken not by industry but by services. It can fuel speculation that the country can somehow skip a development phase and proceed to a post-industrial, services-led economy. However, most successful developing economies have managed a rapid climb into the ranks of middle-income and rich countries with a boom in export-oriented manufacturing, and Sri Lanka is unlikely to be different. It is therefore worrying that industry has grown much more slowly than services, particularly in view of the fact that a dynamic industrial sector is likely to generate more employment opportunities for the lower skilled workers.

Sri Lanka has an important export-based garment industry that has grown because of guaranteed US and EU quotas as much as because of any natural comparative advantage. The lifting at the beginning of 2005 of textile and garment import quotas in the US and EU has brought both an opportunity - to exceed quota levels - and a risk of loss of market share to newly unfettered competitors. Sri Lanka was cited by US manufacturers as a likely victim of the Chinese garment boom. Eighteen months into the new trading regime, the impact has been less dramatic with Sri Lanka's exports to the US in dollar terms rising by about 8 per cent in 2005. Nevertheless, the long-term consequences remain murky. The industry will require a supporting regulatory environment to meet the new challenges. Existing restrictive labour laws, for example, may make firms reluctant to take on staff to meet a big one-off order because of the difficulty of laying workers off later, curtailing the flexibility to respond to changing global conditions in the industry.

Thus, the renewed attention being paid to improving the country's 'investment climate' - the policies, regulations and institutions that can encourage active private sector participation - is a reminder of the importance of addressing supply side rigidities to raise investment levels in the country. The government's priorities - investment in infrastructure, agriculture, social sectors, etc. - are hard to contest. But these familiar lines need to be backed by a broad economic strategy directed at diverting government spending towards achieving a targeted development programme and removing deterrents to private investment.

Policymaking does not take place in a vacuum, and the idea is growing that each country must fashion a reform strategy that suits its own political and social conditions. In doing so, the decisions will be purely political in some areas while in others - such as in policy towards deregulation - the rifts may be very real. Unfortunately, Sri Lanka has been struggling to move its economic reforms on to the next stage to tackle the remaining supply-side rigidities. In retrospect, introducing measures that slashed tariffs, scrapped exchange controls and abolished administrative red tape has been the easier part. But what is needed now is a raft of supply-side reforms as the economy increasingly comes up against supply side constraints. It is noteworthy that some key infrastructure projects in the areas of energy, roads, etc. have been initiated. Nevertheless, while positive developments in infrastructure have begun, deregulatory reforms have been lagging. The slow pace of such reform - in stop-go cycles and back pedaling - is partly the price increasingly of having to enunciate policy within fragmented coalitions.

In managing coalitions, economic policy is likely to be tailored to the need to find consensus between the more reform-minded and their opponents which in turn can lead to policy inertia. The shortening of Sri Lanka's electoral cycle in recent years too has been a reminder of just how powerfully politics can constrain economics. Policymaking gets complicated by elections, and when faced with a choice between political survival and economic reform, most governments will choose the former. Disruptions to the activities of the Colombo port as a result of labour union strikes over pay or the strikes by the CPC unions opposing attempts at restructuring are reminders of obstacles to reform.

There are grounds for cautious optimism that Sri Lanka can build on its healthy economic recovery of 2005, and a period of consolidation - both in economic and political spheres - may be necessary. However, with the recent escalation in hostilities, it seems increasingly unlikely that the government will face as benign a political environment in which to implement difficult economic programmes. Nevertheless, the list of what needs to be done is a long one including the restructuring of a plethora of state owned enterprises (SOEs), more labour market reforms, more tax reforms, more investment in people and infrastructure, etc.

This year's report examines in some detail the policy priorities which simultaneously increase growth and reduce poverty with emphasis on specific sectors of the economy. Widespread poverty and inequity can itself be a drag on growth as the poor cannot take a full part in the economy. The policy prescriptions support the notion that subsidies and hand-outs are less effective methods of tackling poverty in the long run than policies that generate faster economic growth. Governments may build up large budget deficits thanks to subsidies leaving limited spending on improvements to social and physical infrastructure that would do most to lift the growth rate.

The findings also add an economic argument to the political case for well designed anti-poverty programmes. Sri Lanka has adopted these on a large scale, providing credit and employment opportunities rather than merely relying on cash hand-outs. Nevertheless, an examination of the Samurdhi programme - where benefits are being raised by as much as 50 per cent from 2006 - suggests several shortcomings, particularly in targeting those truly in need. Targeting is also highly skewed across provinces; for example, the Western Province which has relatively less poor nevertheless has twice as many Samurdhi beneficiaries as its share of the poor. Given the fiscal constraints under which the government is operating, it is essential to bring down the costs of such programmes through effective targeting.

There are other factor market rigidities that can also impact on the poor; for example, it has long been argued that rural poverty in Sri Lanka is significantly influenced by land tenure patterns. While data is limited, it is estimated that the Land Development Ordinance (LDO) - which restricts and controls many actions by permit-holders and grantees - covers over 70 per cent of smallholder farmers and over 65 per cent of the land cultivated by smallholders. However, land reform is still an emotive and politically explosive issue. There is still an unresolved debate over whether land reforms will encourage small family farms or lead to a dominance by large commercial holdings. Based on empirical evidence examining the links between LDO land and rural poverty in Sri Lanka, this report challenges the assumed strong relationships between LDO tenure and productivity, access to credit or ability to engage in off-farm employment. It points to informal and illegal transactions adopted by farmer families in mortgaging, leasing and selling LDO land and while it recommends that many LDO restrictions be lifted - especially those regarding inheritance and subdivision - it also argues that restrictions on 'transfers' or sales be retained temporarily as they are not the key to addressing the root cause of land-related rural poverty in Sri Lanka.

As in the case of land reform, while the need for reform of agricultural irrigated water policy in Sri Lanka is duly recognized - arising from inefficiency of irrigation water utilization and the rising budgetary burden of providing irrigation water - it remains a politically difficult area for intervention. The free provision of irrigated water by the state is viewed as the main cause of inefficient and wasteful water use in Sri Lanka. Nevertheless, as highlighted in this report, charging for irrigation water is complex and has many inherent problems - including problems of inequity in water distribution - and Sri Lanka has opted to follow the alternative of participatory irrigation management. This, however, does not address the issue of cost recovery and the burden on the Treasury still remains large. What is proposed as a practically feasible option for Sri Lanka is a land based irrigation tax with a suitable combination of participatory management.

The burden on government finances is compounded by the continuing financial support extended to SOEs. Structural reforms in the SOE sector - at least in the short term - have the potential to hurt powerful interests; restructuring of SOEs do, therefore, run into serious opposition by labour unions and affiliated parties. As discussed in this report, privatization has been ruled out as an option to improve the performance of these entities in Sri Lanka. While it is recognized that there are various modalities of public ownership - with varying degrees of success across countries - key elements for a successful reform process include strong institutional capacity with a clear legal framework, sound regulatory governance and elements of accountability, transparency and credibility. Restructuring of SOEs in Sri Lanka as envisaged under the broad umbrella of the Strategic Enterprise Management Agency (SEMA), however, may fail to address the root cause for poor performance; SOEs remain, ultimately, under the control of the government and not the rules of performance driven private business. As long as this is so, the pressure to meet needs on the basis of political patronage - rather than market efficiency - will persist, undermining the best intentions of policymakers.

Sri Lanka's business environment exhibits many strengths but the private sector has also to cope with a plethora of investment-deterring labour laws. The key battleground is the labour laws that prevent any company with more than 15 employees from making redundancies without obtaining approval from the Labour Commissioner. Efforts to preserve jobs by trying to protect workers by making it more costly to fire them can be counterproductive. According to unions, this protects workers from unscrupulous employers. In fact, it can make employers wary of taking on new staff, opening new factories or, in the case of smaller companies, growing beyond the threshold of 15 employees.

Restrictive labour laws can also make recruitment beyond the control of unions - and sometimes outside the law altogether - more attractive by comparison. And it is typically the case that those who lose out from unreformed labour laws are the marginally employed in the countryside. As discussed in this report, the Sri Lankan economy is subject to a significant extent of informal activities accounting for more than 40-60 per cent of total employment. Most of these workers in the informal sector are not safeguarded by protection available to workers in the formal sector. But their socio-demographic backgrounds and economic activities subject them to various types of risks; government policy should not only facilitate the provision of social safety nets but also amend existing labour legislation which reduces incentives for job creation and limits informal sector workers from entering the formal sector.

In the final analysis, policies matter, but so do the political institutions through which they are approved and implemented. This report also reviews inadequacies in governance that has led to sub-optimal outcomes from development initiatives in Sri Lanka. There has been a proliferation of ministries that has resulted in the truncation of responsibilities for sectors - and duplication of ad hoc project initiatives - leading to a lack of clarity as to the actual responsibility for specific areas of development policy. Lack of effective governance can also lead to corruption that saps the will of donor governments as well as domestic tax payers. While the precise dimensions of corruption are hard to measure, some trends are discernible. In the latest international 'corruptions perceptions index' produced by Transparency International, Sri Lanka has fallen in the country ranking in 2005 to 78 (from a rank of 67 in 2004) indicating an increase in perceived corruption that does not bode well for economic success. The latter owes much to political and related governance factors - a relatively effective and uncorrupted public service and judiciary, and a broad political consensus which gives investors confidence that they will not face unexpected policy changes.

These and other issues of emerging policy interest will be dealt with in more detail in the rest of the report.