Sri Lanka
State of the Economy Report 2015

Chapter 1
Policy Perspectives

by
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1. Policy Perspectives

The direction of Sri Lanka's post-war socio-political and economic development took a decisive turn in January 2015 with the election of Maithripala Sirisena as Sri Lanka's sixth Executive President, ending a tumultuous 10 year rule by former President Mahinda Rajapaksa. In those 10 years, Sri Lanka overcame the most visible challenge to its statehood since Independence by finally claiming victory over a 30-year armed separatist conflict in May 2009. Credited with overseeing the war, it also marked the peak of popularity of the incumbent - winning a second term handsomely in 2010 and presiding over an unassailable two-third majority in Parliament. The unprecedented concentration of political power, however, had a downside; a slide towards steps deemed undemocratic, embodied by the lifting of Presidential term limits through a constitutional amendment. Thus, despite an ambitious economic development drive that delivered high growth, charges of corruption, nepotism and hubris were sufficient for an eclectic mix of political opponents to line-up behind a 'common opposition candidate' and bring about a 'regime change' at the polls.

The coalition of parties behind the common opposition Presidential candidate - sprung from the ruling Sri Lanka Freedom Party (SLFP) led United People's Freedom Alliance (UPFA) - was steered primarily by the SLFP's arch rival, the United National Party (UNP). Together, proclaiming the campaign to be a harbinger of change, a common policy platform - 100-day programme - promised to present the new Parliament with a series of constitutional reforms aimed to abolish or curb the powers provided for a strong executive head of state. For good measure, the 100-day programme also threw in some populist spending promises such as public sector salary increases and administered price reductions on select items such as fuel.

The electoral victory for Maithripala Sirisena - and subsequent appointment of UNP's Ranil Wickramasinghe to lead a minority government - suggests that the 100-day programme appealed to a majority of Sri Lankans disillusioned with the workings of their political system. A broad cross-party consensus held together to pass the 19th Amendment to the Constitution that eroded some powers of the Executive Presidency; most notably, it reintroduced a two-term presidential limit and reinstated a Constitutional Council to oversee appointments to independent Commissions. Whilst it is a far cry from the more ambitious promises to abolish an all-powerful Presidential-style of government and re-establish a Westminster-style parliament- led government, the 19th Amendment is nonetheless a significant step forward in strengthening institutional and governance structures in Sri Lanka.

The 19th Amendment was passed on 28 April 2015, but a proposed 20th Amendment to the Constitution to change Sri Lanka's electoral system got mired in cross-party wrangling. Therein lay the dilemma for the new administration and for Sri Lanka; a troubling pattern of delays and uncertainty began creeping in to take the gloss off the initial exhilaration generated by the 'regime change'.

The main drawback was the interminable delay in dissolving Parliament at the end of the 100 days to allow political parties to seek a fresh mandate. The UNP was clearly in favour of an early election to capitalize on a perceived swing in voter sentiment. The SLFP, on the other hand, was in some disarray, with party loyalties divided between President Sirisena and former President Rajapaksa in the face of moves to secure a nomination for the latter to re-enter politics as a parliamentarian, and possibly be elected as Prime Minister. Having secured 47.6 per cent of the popular vote in January 2015, the beleaguered UPFA considered him as their best bet to retain those votes.

In the event, the much delayed August 2015 general elections produced a hung Parliament, with the UNP securing the highest number of seats (106), but short of the required 113 for a majority in Sri Lanka's 225 seat legislature. Nonetheless, the UNP is able to command a working majority with the support of a section of SLFP parliamentarians drawn from the UPFA's 95 seats. The arrangement offers Sri Lanka a measure of political stability in the near term. The more difficult task will be to ensure it holds for the full five year parliamentary term whilst setting and implementing policies on both political and economic fronts.

The most pressing of these relate to the economy. The state of Sri Lanka's economy received little attention in the run-up to the Presidential elections. This was for two reasons; economic issues matter to voters if there is a deep and widespread sense of crisis to tap into. By headline numbers alone, the Sri Lankan economy appeared in good shape. At end-2014, GDP growth was averaging in excess of 7 per cent in an environment of moderate inflation, unemployment was at a low 4 per cent, and head count poverty was down to less than 7 per cent. There were also visible signs of infrastructure development of roads, expressways, ports and airports. These masked some inherent structural weaknesses in Sri Lanka's public investment-led and external debt-financed growth. As noted in *Sri Lanka: State of the Economy 2014* report "beyond the immediate headline macroeconomic numbers, the Sri Lankan economy continues to show skewed growth, high levels of external indebtedness, modest export earnings growth and limited private investor appetite to expand production capacity." Stacked against headlines statistics, structural weaknesses in the economy, however, are not as readily explainable on election platforms.

A second reason why the economy received little attention is because the loose coalition of political parties that lined up behind the common opposition candidate, subscribe to very different policies. Indeed, it differs widely from the market-friendly UNP to the Marxist-leaning Janatha Vimukthi Peramuna (JVP). Thus, any economics in the 100-day programme was confined to addressing 'cost of living' issues, through price reductions and state salary and pension increases which all parties could agree on. The new budget proposals presented in January 2015 upheld these promises, delivering a mix of populist measures and slapping taxes on business profits as a one-off exercise to cover additional expenses incurred as a result.

The economy was a casualty of political intransigence in the months to follow. A Bill to raise government borrowing limits was defeated in April 2015, after which Bills to pass new tax measures announced in budget proposals appeared to have been put on hold indefinitely. With delays also in tapping foreign borrowing via a planned Sovereign bond, the government resorted to heavy domestic borrowing instead. In fact, net domestic financing of the fiscal deficit of Rs. 444 billion up to June 2015 exceeded the total net domestic financing for the entire year in 2014. Not surprisingly, interest rates began to edge up as a result.

The currency too has been under pressure. Inflows of development loans slowed with stalled infrastructure projects and efforts to issue a Sovereign bond took longer than anticipated, even as the Central Bank of Sri Lanka (CBSL) used its official reserves to service debt repayments and prop up the currency. As of mid-2015, the outlook stabilized somewhat with official reserves at US$ 7.5 billion, sufficient for 4.5 months of imports, helped by swap agreements with the Reserve Bank of India (RBI) and capital inflows of US$ 650 million from a Sovereign bond issued in May 2015. At the same time, however, Sri Lanka's foreign earnings growth is stagnant with a likely weakening of the current account. In the first six months of 2015, export earnings contracted by 0.6 per cent, with a 15 per cent expansion in the trade deficit; earnings from worker remittances also slowed to a low 2.2 per cent.

First quarter 2015 GDP estimates indicate that Sri Lanka's above 7 per cent stable growth of recent years - annualized at 7.4 per cent in 2014 - is moderating.[1] Quarterly growth fell to 6.4 per cent for the second consecutive quarter, and marked a drop from 7.6 per cent growth in the first quarter of 2014. Even as growth appears to be slowing, fiscal conditions are weakening. Fiscal adjustments will likely take the form of cuts to public investment, already slashed substantively to 4.4 per cent of GDP in 2015; in an economy that has relied massively on such investment for growth, the impact will be all the more immediate.

Interest rates too are rising as domestic market liquidity is absorbed by the state. It can be expected that the very modest private sector appetite for credit of the last 18 months will begin to reverse soon with electoral related uncertainties largely out of the way. Private sector investment that can support higher growth will begin to get crowded out if government fiscal laxity is not restrained.

Thus, the economic policy challenges for the new government are many. Of first and immediate priority is fiscal consolidation. A stronger fiscal position is necessary to stabilize macroeconomic fundamentals and lay a platform from which broad-based productivity-enhancing reforms can begin.

While public infrastructure investment boosted growth, Sri Lanka's export share of GDP has shrunk to less than 15 per cent. The economy remains overwhelmingly consumption driven, with consumption fuelled by capital inflows in the context of low private investment demand. Capital inflows also feed into an appreciating exchange rate which further aggravates scarcity of investment. As a result, the profitability of tradeable industries declines. In addition, Sri Lanka's modest skills base, institutional weaknesses and inadequate infrastructure hamper the competitiveness and efficiency of its export industries.

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Fiscal constraints, the demographics of a contracting labour force, and skill deficiencies suggest that the new government will have to confront difficult trade-offs that have been avoided during years of steady economic growth. Overhauling Sri Lanka's tax system, tackling loss making state-owned-enterprises (SOEs), improving labour market efficiency, filling skill gaps in the workforce, improving productivity of agriculture, delivering a better safety net to the poor and vulnerable, to name a few, are amongst a raft of reforms that need attention. Such

[1] The Department of Census and Statistics (DCS) is currently engaged in re-basing the country's national accounts. Initial estimates suggest that real growth rates as a result will be reset at much lower rates than under the old series (see Box 2.1 of this report).

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reforms are politically difficult to deliver through the legislative phase, and are often even more difficult to implement. Reforms generate distributional impacts that create 'losers' and 'winners', entailing short-term adjustment costs, but with potential for long term benefits. Losers can easily identify themselves; although many more may benefit from reforms, there is less likelihood of an organized platform emerging in support of reform as opposed to those who may organize on an anti-reform platform.

Reforms are more likely to get off the ground and succeed in the presence of certain catalysts: a widespread sense of economic crisis and an electorate that accepts there is no alternative to change; a break from interest groups with vested interests in the prevailing economic system; strong political leadership and an electoral mandate to push reforms through; and ownership of a reform process rather than a perception that it is being forced on them from outside.

Many of the above can often times converge. For instance, an economic crisis can provide a window of opportunity for reform - allowing governments to overcome rent seeking interest groups who have a stake in maintaining past systems of state patronage. It may also be that domestic economic difficulties precede a change of political leadership, facilitating the shift of powerful vested interests that have developed around certain policies. Economic difficulties can also build broad support amongst the public for a change, whilst international lending agencies may step in to offer 'conditional' soft loans that can ease fiscal constraints, allowing governments to offer 'sweeteners' to make reforms more palatable.

However, an economic crisis is neither a necessary nor a sufficient condition to drive a successful reform process. A newly elected and popular government with a strong mandate can as easily initiate reforms during its early 'honeymoon' period in office. Indeed, strong political leadership can be a key determinant in driving a reform process through even in the absence of significant political control. Here, support from competent technocrats in the public sector will be a key determinant.

Sri Lanka's past experience of relatively successful reform efforts - in 1977/78 and 1990/91, both times under the UNP - contain a mix of these elements. Widespread disenchantment with the country's economic progress saw the UNP obtain an overwhelming political mandate in 1977 to bring about sweeping reforms. In the late 1980s, in spite of a much reduced political space for a broad based reform effort, strong political leadership in the midst of a weakened economy provided the impetus for change.[2]

[2] Dunham, D., and S. Kelegama (1997), "Does Leadership Matter in the Economic Reform Process? Liberalization and Governance in Sri Lanka, 1989-93", *World Development*, 25(2):170-190.

By contrast, Sri Lanka has also witnessed reform initiatives that barely made it beyond the drawing board. In 1994, a change of political leadership saw an initial burst of privatization initiatives, but the enthusiasm for reforms petered out towards the latter part of the 1990s under the pressure of coalition governments and thin parliamentary majorities. A brief hiatus in 2002-04 by a UNP parliamentary-led government foretold an unsuccessful reform effort under the weight of electorally unpopular measures such as a freeze on public sector wages and withdrawal of subsidies. On the other hand, potential catalysts for reforms of political leadership and a strong electoral mandate prevailed during 2010-14, but there was no real belief in the necessity for them.

Overall, Sri Lanka's reform efforts delivered partial benefits; they were also frequently delayed, compromised, or failed altogether. Delays and compromise are to be expected in the context of political economy risks associated with reforms. The reform efforts that did prevail offered compensating mechanisms to potential losers; in the 1977/78 episode, it entailed the promise of new employment, livelihood, and housing opportunities through public investment. The packaging to garner popular support was more direct in the 1990/91 episode - an ambitious national poverty alleviation programme, incentivizing industries to generate rural youth employment, a village reawakening programme, etc. - to ease perceptions of inequity in access to the benefits of market-driven policies following the 1987-89 JVP-led youth uprising.[3]

Some of the important catalysts that triggered Sri Lanka's past economic reform initiatives - a strong political majority and a widespread economic crisis - are less apparent today. That makes the task of building consensus on an economic reform agenda and persuading entrenched interests to accept it more difficult. Reforms need to be ambitious in scope; but ambition may have to be tempered by political economy realities. An agenda setting for reforms thus must begin with attempts to strengthen interactions between institutions, policy processes, and policy outcomes. The environment in which many of these sorts of transitions take place is strongly influenced by broader factors such as the quality of institutions and governance in a country.

This year's *Sri Lanka: State of the Economy* report centres around the theme of "Economic Reforms in Sri Lanka: Political Economy and Institutional Challenges". The conditions for introducing, implementing and sustaining an economic reform effort are weaker today than during past successful efforts; a failure to strengthen institutions and governance structures lies at the heart of it. Incentives built into institutional structures determine whether they act more as rent seeking entities, influencing the allocation of resources. Weak institutional structures lead to administrative confusion and entrench privileges of the political elite over time.

The typical rent-seeking activities under a licence-regime have been replaced by stronger patron-client relationships between politicians and other key actors in the policy making process. Posts and privileges are dispensed freely, encouraging the practice of 'competitive populism' to the detriment of sound policy making. The concentration of state power has intensified, with political parties dominated by a handful of individuals, stifling democratic practice within parties, and centralizing decision-making. The bureaucracy has also become more politicized and powerful, performing both administrative and political functions as politicians rely on a few hand-picked technocrats to formulate and implement policy. The dual role and discretionary powers they enjoy mean a greater blurring of transparency and accountability in policy decisions, and a distancing of policy makers and elected politicians from their constituencies.

[3] Weerakoon, D., (2012), "Sri Lanka's Economic Reform Process: Progress and Constraints" in Dee, P., (ed.), *Economic Reform Processes in South Asia: Towards Policy Efficiency,* Routledge, Oxford, U.K.

The quality of a country's institutions therefore matters in shaping opportunities for reform and their outcomes. In this context, Sri Lanka's current focus on re-invigourating its politico-institutional structures to institute norms and rules that will restrain the drift towards arbitrary action and corruption is promising. Institutions based on transparent rules and governance structures will help instil confidence in investors and businesses to undertake productive investments rather than rent-seek.

Productive investments are needed to build a competitive export sector. For a small developing economy such as Sri Lanka, external demand is critical as an enabler of sustained high growth, generating demand, absorbing surplus labour and raising productivity. Sri Lanka's shrinking export share of GDP and global market share for exports must be reversed. Reform efforts to improve export competitiveness will require addressing constraints on multiple fronts. These include tackling supply-side capacities, addressing weaknesses in the business environment, and strengthening demand-side conditions. Improvements on these fronts will help attract the right kind of foreign direct investment (FDI) that brings technology and knowledge transfer to instil competitiveness across the economy. Governments must facilitate this by providing a consistent and predictable policy environment. Opaque and discretionary tariff setting must be rationalized and streamlined to promote exports, and efforts made to penetrate new export markets through strategic trade partnerships.

A competitive export-led economy will depend, among other factors, on the availability of a highly skilled and trained workforce that can enjoy better quality employment. Sri Lanka's demographic transition means that its population is ageing and the working age population is on the decline. Already, many industries are impeded by human resource constraints, forcing them to contemplate importing workers and/or resort to automation. How to source the required workers and utilize existing labour resources more effectively are high on the priority

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of labour market challenges. Reforms need to address gaps in coordination and information gathering amongst different labour market institutions, bridge weaknesses in the traditional modes of vocational and technical training, address impediments that deter women from entering the labour force, as well as regulatory barriers that constrain job creation in the formal sector of the economy.

Low levels of female labour force participation and high levels of migration of workers are exacerbating the labour shortage problem. The lack of access to good jobs in Sri Lanka - i.e., those with adequate remuneration and social protection - makes migration for domestic work a popular employment choice among women. While it is recognized that migration is a double-edged sword that on the one hand helps women, it also holds significant social costs. One mitigating legislative reform is the recently introduced Family Background Report (FBR) aimed at discouraging females with children under the age of five years from seeking foreign employment. However, the FBR in its current form discriminates against women, curtailing their livelihood options further. Regulatory strictures on migration must remain open to policy revision.

The fact of Sri Lanka's female migrants seeking employment abroad owing to lack of access to good jobs at home is reflective of mismatches in the labour market at large. High numbers of unemployed educated youth suggests that people enter work not equipped with the skills demanded by firms. Indeed, a shortage of manpower with required skills has become the most severe constraint encountered by the business community in the country. Sri Lanka's education sector suffers from poor responsiveness to drive innovation and technological transformation, an inability to provide equitable access to quality education, and lacks capacity in the tertiary education system. Reforms must focus on allocating sufficient funds for education, enhance the quality and relevance of the curriculum, address deficiencies in human resources in recruiting and training, and ensure consistent implementation of proposed education sector reforms.

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Closely aligned to better education outcomes is the provision of adequate health care. While Sri Lanka has achieved noteworthy health outcomes, the country needs to strengthen its existing health system, both public and private, in view of changes brought on by demographic and epidemiological transitions. The demand for health care increases and changes shape with an ageing population; the rise of non-communicable diseases (NCDs) that require long-term intervention pushes up the cost of health care provision; moreover, countries are increasingly more vulnerable to global health epidemics. Reforms to strengthen health care financing, and regulatory changes to improve public and private health care delivery systems are essential to continually improve on Sri Lanka's socio-economic outcomes in a cost-effective and efficient way.

Sri Lanka's labour market conditions and changing demographics - with 60 per cent currently finding employment in the informal sector and a quarter of the population set to be over 60 years by 2031 - call for a revamping of the existing social protection system in the country. Despite a multitude of programmes, low coverage, poor targeting, inadequacy of benefits, lack of coordination among programmes, budgetary constraints, and inequitable resource allocation mean that a large proportion of the vulnerable population are inadequately covered. Reforms are needed to Sri Lanka's retirement benefit schemes, cash transfer/subsidy programmes, and the social protection system as a whole, to mitigate inequities and provide adequate safety nets in pursuit of broader poverty alleviation goals.

The most vulnerable to high incidences of poverty is the rural agriculture-reliant population in Sri Lanka. Despite the shrinking share of agriculture in GDP, it continues to be an important source of income, employment, food security, alleviating agrarian poverty and improving export earnings. The agriculture sector however, suffers from stagnant productivity, limited diversification and inefficient resource management. A broad based shift from

traditional low value to modern high value agriculture, accompanied by sustained improvements in productivity and competitiveness through policy reforms, is critical to support a broader structural transformation of the Sri Lankan economy. The priority areas for reform include land, irrigation and technology development policies, as well as in processing, marketing and down-streaming activities to increase value addition to agricultural products.

The agriculture sector is also particularly vulnerable to climate change impacts such as rainfall patterns. At the same time, exploitative land and forest usage is leading to natural resource degradation in Sri Lanka. Deforestation and land degradation is worsening; environment pollution is rising from excessive application of chemicals, poor waste management and air pollution. The country's response to global environment threats such as climate change has many gaps in policy coordination, information, and resource mobilization. To mitigate adverse environmental impacts, an effective environment management system must be in place. It requires reforms to governance structures to better coordinate policy, strengthen planning and monitoring to include strategic environmental assessments, and in approaches to environmental management such as the adoption of market based instruments.

The above policy areas, while not exhaustive, are some of the many issues that the *Sri Lanka: State of the Economy 2015* report examines in some detail in the chapters to follow. In recent years, rapid infrastructure development was viewed as Sri Lanka's opportunity to unlock growth; it paid dividends in the medium term in reviving a war ravaged economy. However, external debt financed, consumption driven growth without complementary reform initiatives to raise export competitiveness is

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not a sustainable long-term option for a small open economy such as Sri Lanka.

As the infrastructure boost to growth of recent years begins to deplete, a new direction for sustained long-term growth needs to be set. The economic policy choices for Sri Lanka are dwindling swiftly; growth is moderating amidst weakening fiscal conditions and external current account, interest rates are on the rise while the currency is under depreciating pressure. While Sri Lankan voters have not delivered a sweeping election win to any one party, the UNP's electoral mandate to form a government is sufficiently decisive to set and pursue a transformational economic reform agenda. The formation of a national unity government with the support of a section of the SLFP can provide the necessary political stability. It leaves sufficient room for the government to adopt a pragmatic approach on the economic front - to weigh its options and decide what is feasible, picking on what is more easily doable and building on the reform process in the medium term. What Sri Lanka must avoid is fractious horse-trading that at times typifies loose coalition arrangements; such outcomes can lead to policy gridlock, and undermine the very same checks and balances of good governance that is sought to be strengthened.